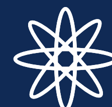

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ASSET MANAGEMENT (C.I.) LIMITED

INVESTMENT MEMORANDUM

Because of the current circumstances, we are producing an abbreviated version of our regular economic review. We hope you will understand why it is necessary to do this with all members of staff working from home and the office unavailable for use until the emergency is over.

Selected International Equities Indices 31.12.19 - 31.03.20

Total Return Performances (£ terms)	**%**
UK	-24.2
USA	-14.1
All World Europe ex UK	-18.0
Japan	-11.0
Australia	-28.7
All World Asia Pacific ex Japan	-15.8
All World All Emerging Markets	-19.0
All World	-16.0

Source : FTSE All World Indices

FTSE UK Government Securities Index All Stocks (total return) : +6.3%

International Bonds - Benchmark Ten Year Government Bond Yields (%)

Currency	31.12.19	31.03.20
Sterling	0.82	0.35
US Dollar	1.92	0.67
Yen	-0.03	0.00
Germany (Euro)	-0.19	-0.47

Sterling's performance during the quarter ending 31.03.20 (%)

Currency	Quarter Ending 31.03.20
US Dollar	-6.4
Canadian Dollar	+1.5
Yen	-7.3
Euro	-4.7
Swiss Franc	-6.9
Australian Dollar	+7.4

Significant Commodities (US dollar terms) 31.12.19 - 31.03.20 (%)

Currency	Quarter Ending 31.03.20
Oil	-60.1
Gold	+6.8

ECONOMICS

At a desperate time for individuals everywhere facing the threats caused by the coronavirus epidemic, for those concerned about their jobs, for businesses concerned about their survival and investors fearful about the value of their savings and investments, it is perhaps wise to take a step back whilst making the obvious point that public health is paramount.

Having made the latter point clear, we will try to look at the economic concerns, the steps taken to try to address these and, finally, the implications for investors.

In our note to clients in early March, we made the point that governments and central banks would take measures to offset some of the economic damage caused by the pandemic. This would be reflected in the loss of economic output either by damage to the supply chain or by the lockdown which shuts businesses temporarily and reduces demand. This is not just an economic contraction caused by a fall in demand but also one caused by a lack of supply. However, unlike the financial crisis of 2008, many countries' banks are in a healthier condition, having built up their capital bases in the intervening years. As result of what has happened, the world economy will experience a recession and the task of policymakers is to stop this becoming a depression. In this respect, the good news is that policymakers have, hopefully, learnt from their past mistakes, notably in the Great Depression, and will use the policies at their disposal wisely.

So, what will the policymakers aim to do? Prior to the coronavirus outbreak, the world economy was in a moderately satisfactory state, with world economic growth expected to be in excess of 3% this year. That, of course, is now history, but the important aim will be to maintain as much of the infrastructure of business as possible so that, when it is safe for businesses to start up again, as much as can be of the manufacturing and services output and capacity is restored, although much will be lost for ever. There are obviously going to be more business casualties and unemployment will rise sharply, so the aim of monetary and fiscal policy will be to minimise the medium and long term damage to the world economy as well as doing as much as possible to shore up the short term position.

In normal times, these reviews have often considered the negative economic consequences of ultra low interest rates in that they have enabled what are termed "zombie" companies to continue in existence at the expense of the growth prospects of viable companies, with the longer term consequence that the potential growth rate of an economy is less than it would otherwise have been. Sadly, many companies will now fail, but policymakers will aim to take measures to give viable companies the support they need to survive until they can restart their businesses at more normal levels of capacity. At times like this, when a company's revenue dries up, but it is a viable business, it will need access to cash through its bank so that it can meet its costs and, if it does not have the resources itself, financial help. But the banks, too, will need access to liquidity and also some guarantee that, in providing credit to their customers, they will not incur larger loan losses. So, central banks have to make sure that liquidity does not dry up and governments have to consider what guarantees they can give to banks or businesses so that businesses can finance themselves through this crisis. At an individual level, the same broad issues apply. Interest rates were already extraordinarily low or negative and central banks have reduced them further. At the margin, one doubts whether these further reductions will have much effect, but access to liquidity and cash are much more important.

Monetary policy and measures must work hand in hand with fiscal measures and, like central banks everywhere, governments all over the world have been taking extraordinary action. In a normal recession, counter cyclical fiscal policy would involve higher public spending on infrastructure, for example, which has a longer lead time. But this is a supply shock causing a demand shock and so fiscal policy is concentrated on paying wages of those who would be laid off, paying unemployment benefit and financing companies through measures like loan guarantees, all these measures and more with the aim of preserving the infrastructure of businesses so that they can restart when this is all over.

These fiscal stimuli and commitments are on an astonishing scale, exploding budget deficits and outstanding public debt as a percentage of GDP. We will give a brief summary shortly of the measures taken to offset the economic recession but these figures give some idea of the scale of the stimulus in different countries, albeit that they are bound to change. So, for example, in the UK it is estimated that potential fiscal commitments amount to 15% of GDP. In the USA, the estimate is 11%. These figures can change but the point is that these are extraordinary fiscal measures being replicated throughout the world.

With events moving so fast, it is not meaningful to itemise each country's fiscal and monetary measures in detail because the figures are so large and it is difficult to put them into context. Rather, the value is in making an impression of the extremity of the measures taken to stabilise different economies whilst the crisis continues.

In the UK, on the monetary front, the Bank of England has cut interest rates in stages by 0.65% to 0.1%. It has lowered capital requirements for UK banks which would allow another £390 billion in loans and it has restarted quantitative easing (QE) by buying £228 billion of UK government and corporate bonds. On the fiscal side, since the UK budget on the 11th March, possible commitments, including guarantees, add up to something like £480 billion. This money covers help for businesses, including loan guarantees and individuals.

In the USA on the monetary side, the Federal Reserve has introduced a raft of measures to support the economy and maintain liquidity in markets. On interest rates, it cut, in two stages, the target federal funds rate by 1.5% to a range of 0.00% to 0.25%. It lowered its interest rate in the discount window to 0.25% and encouraged banks to borrow from it. It introduced a Commercial Paper Funding Facility and a Primary Dealer Credit Facility as well as a Mutual Fund Liquidity Facility. It restarted QE with a purchase of US$500 billion of Treasuries and US$200 billion of mortgage backed securities. It followed up its first announcement about restarting QE with another US$625 billion and committed to continue purchasing however many assets are needed to support the smooth functioning of markets. It established a Primary Market Corporate Credit Facility to buy bonds and loans banks give to large companies. It established the Secondary Market Corporate Credit Facility to purchase bonds and exchange traded funds to provide liquidity for the corporate bond market. It re-established the Term Asset Backed Securities Loan Facility to purchase asset backed securities, backed by things like auto loans, student loans or small business loans. It extended reverse repo operations dramatically to keep liquidity available in the markets. On 8th April, the Federal Reserve went even further, taking measures which would previously have been thought out of the question on credit quality or political grounds. It announced measures to provide additional aid of as much as US$2.3 trillion. These were aimed at helping organisations such as small and medium sized businesses and state and local governments. Extraordinarily, as evidence of the seriousness of the current situation, the Federal Reserve is prepared to purchase certain high yield (junk) bonds, collateralised loan obligations and commercial mortgage backed securities. In the current economic conditions, many lower grade investment rated bonds are tipping into the sub investment grade category even though the companies in question would normally be considered investment grade. Buying municipal bonds would

normally be considered fraught with political risk. Some of these purchases would be effected through exchange traded funds. These programmes will support as much as US$850 billion in credit. Some other figures from this latest announcement are US$500 billion for the Municipal Liquidity Facility, US$600 billion for the Main Street Lending Program (small and mid sized businesses). There is US$850 billion for the expanded Primary and Secondary Market Corporate Credit Facilities and the Term Asset Backed Securities Loan Facility. The Federal Reserve will also be starting the Paycheck Protection Program Liquidity Facility. On the fiscal front, there have been three phases of help to individuals and businesses culminating in the Phase 3 US$2 trillion, an enormous sum on top of earlier smaller, but still large, stimuli. These fiscal and monetary measures are mind blowing in their size but the point in mentioning them and the figures involved is to give an idea of the magnitude of the measures aimed at stabilising the US economy.

In the eurozone, the ECB announced an additional US$128 billion in bond purchases over the course of 2020 and it loosened capital requirements on banks to enable them to lend more. It eased lending requirements for its targeted long term refinancing operations (TLTRO) and reduced interest rates. It also announced a Pandemic Emergency Purchase Programme which added another US$800 billion of bonds to be purchased in 2020. On the fiscal side, all the eurozone countries have announced measures to help individuals and businesses along the lines mentioned earlier in the context of the UK. The very nature of the EU makes actions and agreements more difficult than in a single country and, after much discussion, a €500 billion rescue package for European countries especially hard hit by the pandemic have been agreed. The European Stability Mechanism, which is the EU's bailout fund, will make €240 billion available, and there will be €200 billion available in guarantees from the European Investment Bank and a European Commission payment for national short time working schemes.

In Japan, a fiscal package has been announced including a plan to give up to US$2,800 per household which suffered an income decline because of the pandemic. On the monetary side, the Bank of Japan announced a significant uplift in QE. It will be doubling the rate at which it is purchasing ETFs to US$112 billion and announced increases in the purchase of corporate bonds and commercial paper. It will make available 0% loans to businesses hit by the coronavirus.

China's measures have been mainly on the monetary front to keep money markets functioning and there have been multilateral initiatives from the IMF and World Bank.

We have listed the above measures just to give the flavour of the extraordinary monetary and fiscal measures which have been put in place to try to ensure that the world economy can recover to some semblance of normality when the pandemic has passed. Many other countries have taken measures and more will be taken. At the end of the day, central banks can monetise debt by printing money and financing government debts directly and, if events deteriorate further, in some countries this may happen. This is fraught with danger and mainstream economists would be wary of such an action because it could portend a loss of trust in a currency and higher rates of inflation or hyperinflation.

So, what implications can investors draw from this with conditions in markets still volatile, although slightly less so than they were, and, at the time of writing, having experienced a big recovery from their low points? When investors are blindsided by an event, such as the coronavirus outbreak which they cannot predict, some investors have to sell in a hurry and at distressed prices, perhaps to provide collateral or because they are leveraged. Some panic. History shows that those who sell out because of a market sell off, such as happened in 1987, the dot com bust in the early 2000s or the financial crises of 2008/9, do less well long term than those who stay the course. Over time, what seems a very worrying fall in share prices shrinks to a blip in the long term graph. Some flee to the perceived safety of bonds. In this case, the yields on high quality bonds are minuscule or negative and lower grade bonds have been hit very badly by concerns about credit quality. Eventually, these types of weak holders are shaken out and, at some stage, confidence returns and shares anticipate better times. The sheer volume of monetary and fiscal ammunition thrown at the world economy should help to

get through the current economic storm. Once there is evidence of a more comforting trend in the pandemic, markets are likely to look ahead to better, although not great times. A lot of damage will have been done. But the sheer size of the stimulus can be expected to work its way through the world economy and begin to be reflected in the economic data.

The cost, as we have attempted to show in the figures we have mentioned earlier, will be astronomic and outstanding public debt will balloon. At the moment, governments are able to finance these huge borrowings because high quality government debt is regarded as safe even if there is no effective yield. However, once there is some semblance of normality, one would expect investors to demand a better yield as other assets like shares appear to increase their relative attractions.

The fall in company profits which will occur as a result of the economic recession in 2020 is already affecting dividends, either through omissions or cancellations of dividends already announced, and political and regulatory pressure has already meant that UK and eurozone banks and some insurance companies have had to cancel their dividends. So dividends will be reduced this year, but by how much we don't know as this will depend on how long the lockdowns last. What we can almost be certain of, however, is that the yield on equities, even after the reduction in dividends, will be much superior to that on cash or high quality bonds and income is very important to many investors. As we said in our note in March, good companies do not become bad companies in a short space of time. Some sectors have and will continue to suffer badly because many things will change. Other companies will emerge stronger. Longer term, although not many feel like looking that far ahead, the vast monetary and fiscal expansion we are witnessing could well stoke inflation, in which case a stake in real assets like shares will have appeal.

In summary, although current circumstances are deeply unpleasant for investors as a result of this "black swan" event, we believe it would be wrong to sell shares. This was our message in 2008 and early 2009 when the world was experiencing a different sort of crisis and it is our message again. We also need to recognise that, whilst high quality bonds have been a short term refuge for some investors, the vast expansion of debt will mean that investors will, at some stage, demand a higher yield. For the moment, quite naturally, everyone is concentrating on the awful health effects of the pandemic and the personal and economic misery which it is causing, but it is also right to be considering the longer term economic consequences of the enormous monetary and fiscal stimuli which have been applied worldwide.

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