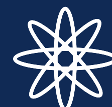

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ASSET MANAGEMENT (C.I.) LIMITED

INVESTMENT MEMORANDUM

It has been a strong quarter for international equity markets which have been buoyed by the development of the vaccination programme and with it improved prospects for the world economy. Bond performances have been mixed. In the foreign exchange markets, sterling has generally been a strong performer. Commodity prices have been rising strongly, a topic we discuss in this review.

The tables below detail relevant movements in markets :

International Equities 26.02.21 - 31.05.21

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	+9.1	+7.3	+9.1	+8.3
Finland	+9.8	+8.7	+10.6	+9.8
France	+13.3	+12.2	+14.1	+13.3
Germany	+10.5	+9.5	+11.3	+10.5
Hong Kong, China	+5.2	+3.4	+5.1	+4.4
Italy	+11.7	+10.6	+12.5	+11.7
Japan	+4.3	-0.1	+1.6	+0.8
Netherlands	+12.7	+11.6	+13.5	+12.7
Spain	+11.4	+10.4	+12.2	+11.4
Switzerland	+12.2	+11.1	+12.9	+12.1
UK	+9.6	+9.6	+11.4	+10.6
USA	+10.1	+8.2	+10.1	+9.3
All World Europe ex UK	+12.2	+11.1	+13.0	+10.6
All World Asia Pacific ex Japan	+2.3	+0.9	+2.6	+1.9
All World Asia Pacific	+3.0	+0.6	+2.3	+1.6
All World Latin America	+12.5	+16.5	+18.5	+17.6
All World All Emerging Markets	+2.6	+1.9	+3.6	+2.9
All World	+8.8	+7.3	+9.1	+8.3

Source : FTSE All World Indices

FTSE UK Government Securities Index All Stocks (total return) : +1.0%

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

Currency	26.02.21	31.05.21
Sterling	0.82	0.79
US Dollar	1.41	1.60
Yen	0.15	0.08
Germany (Euro)	-0.26	-0.19

Sterling's performance during the quarter ending 31.05.21 (%)

Currency	Quarter Ending 31.05.21
US Dollar	+2.1
Canadian Dollar	-3.4
Yen	+5.0
Euro	+1.0
Swiss Franc	+1.0
Australian Dollar	+1.7

Other currency movements during the quarter ending 31.05.21 (%)

Currency	Quarter Ending 31.05.21
US Dollar / Canadian Dollar	-5.1
US Dollar / Yen	+2.7
US Dollar / Euro	-1.2
Swiss Franc / Euro	N/C
Euro / Yen	+3.9

Significant Commodities (US dollar terms) 26.02.21 - 31.05.21 (%)

Currency	Quarter Ending 31.05.21
Oil	+6.4
Gold	+6.8

MARKETS

It has been a strong quarter for international equity markets. The total return on the FTSE All World Index in local currency terms was +8.8%, in sterling terms +7.3%, in US dollar terms +9.1% and, in euro terms, +8.3%. Looking at local currency returns first, of the larger areas the FTSE All World Europe ex UK Index was particularly strong, returning +12.2%. The FTSE USA Index (+10.1%), the FTSE UK Index (+9.6%), the FTSE Australia index (+9.1%) and, best of all, the FTSE All World Latin America Index (+12.5%), all performed better than the FTSE All World Index. Underperformers, although still in positive territory, were the FTSE Japan Index (+4.3%), the FTSE All World Asia Pacific ex Japan Index (+2.3%) and the FTSE All World All Emerging Markets Index (+2.6%). Looking at sterling adjusted returns, the star performer was the FTSE All World Latin America Index (+16.5%) followed by the FTSE All World Europe ex UK Index (+11.1%), the FTSE UK Index (+9.6%) and the FTSE USA Index (+8.2%). There was one very slightly negative return from the FTSE Japan Index (-0.1%) and only slightly positive returns from the FTSE All World All Emerging Markets Index (+1.9%) and the FTSE All World Asia Pacific ex Japan Index (+0.9%).

Fixed interest markets, as measured by ten year government benchmark bonds, were mixed. The gross redemption yield on the UK Government Bond fell by 3 basis points to 0.79% and on the Japanese Government Bond by 7 basis points to 0.08%. On the other hand, the yield on the US Treasury Bond rose by 19 basis points to 1.60% and on the German Bund by 7 basis points to -0.19%.

In the foreign exchange market, sterling was generally stronger as post Brexit uncertainties diminished and the vaccination programme continued apace, promising a stronger economic recovery. It only weakened against the Canadian dollar (-3.4%) but, elsewhere, was stronger against the yen (+5.0%), the US dollar (+2.1%), the Australian dollar (+1.7%) and the euro and the Swiss Franc (both +1.0%).

Commodity markets have performed strongly this year. Over the quarter, oil, as measured by Brent crude, rose by 6.4% and other commodities were stronger still. Gold rose by 6.8%.

ECONOMICS

A positive quarter for international equity markets continues the impressive recovery in share prices from their nadir in Q1 2020 at the height of the pandemic crisis. The story then was that investors should be looking ahead to what central banks and governments would do to limit the economic damage and the story now is the effect on markets of those measures. Of course, hindsight is a wonderful thing, but the point we were making at the end of Q1 2020, and repeat now, is that investors should look ahead rather than be overinfluenced by the present. It was natural for some investors to be overwhelmed by the avalanche of sudden and unexpected bad news at that time and make what have turned out to be bad investment decisions. However, the direction to look at was the future, with the certainty that central banks and governments would take their cue from the playbook of the Global Financial Crisis (GFC) twelve years earlier by pump priming the economy with expensive monetary and fiscal policy. The efforts were aimed at stabilising economies so that they would be in a position to recover when the pandemic died down. Importantly, there was also an important difference between the pandemic crisis in 2020 and the GFC in 2008. The pandemic crisis is essentially a supply and demand shock which should be self-correcting in the wider economic sense, although not always in the detail as some industries will emerge in a different shape. The GFC was a more dangerous economic threat in that there were concerns about the health of the banking system with all the attendant threats to the world economy. This crisis is, of course, a devastating health one, so feels worse overall, but the economic profile is different.

Broadly speaking, the efforts of central banks and governments to stabilise their economies have been successful, but it comes with a huge cost, as we will discuss. The latest IMF World Economic Outlook, published in April, sees world output increasing by 6.0% this year, following the 3.3% contraction in 2020, and it sees 2022 showing growth of 4.4%. The figures may get even better as much of the recent economic news has been better than expected. The latest OECD Economic Outlook, just published, forecasts world economic growth this year of 5.8%, followed by 4.4% in 2022. After the initial and sudden unexpected lockdown last year, for which businesses had little time to prepare, there is evidence that they have become more adept at working round problems so that subsequent lockdowns have been less damaging. The effect is not only being seen in levels of economic activity but also in corporate earnings, which are often coming in better than expected with dividends to match in some cases. This is one factor behind the continued buoyancy of equity markets. The second, and more important one, remains the very loose monetary and fiscal policies which are being followed which have leaked into asset prices. This latter factor has been a constant theme of our reviews, even during the worst moments of the pandemic crisis, and remains as valid today as it was then.

So, a year ago, when we looked ahead, we could foresee what central banks and governments were going to do to try to stabilise their economies and be reasonably confident that the stock market would recover, notwithstanding the devastating effect of the pandemic and its immediate consequences for it. Now that the worst seems to be over and markets have moved to around all time highs, it is equally important, as it was then, to look ahead. The fact that the situation looks better now is no reason for complacency. The amount of debt which governments have taken on as a function of funding budget deficits is astronomic and there will be consequences which investors have to start considering. Assuming that economic recovery continues as vaccinations are rolled out, investors will have to factor in likely policy moves by central banks and governments. The sums are mind blowing. In April, the IMF's fiscal monitor produced figures which estimated additional government spending and foregone revenue as a percentage of GDP. They ranged from 3.8% in the EU to 25.5% in the USA, with the UK towards the higher end of the range at 16.2%. As a result of this, outstanding public debt, as a percentage of GDP, has risen considerably to levels which would traditionally have caused serious alarm. In many ways, the eurozone is the most worrying area because stress in individual eurozone members might not be contained within the currency union. Of the largest eurozone members, particular concerns could be Italy, France and Spain. Italian public debt is somewhere around 160% of GDP, in France around 120% and a similar level in Spain. For a country which has its own currency, a loss of confidence in its currency because of a poor economic position can partly be contained but, in a currency union, the position is different because the travails of one country can be visited on other members of the currency union. This is being suppressed by unprecedented amounts of intervention by the ECB in the eurozone bond markets. It is estimated that the traditional asset purchase programme so far amounts to €3,109 billion, with €1,850 billion on top from the Pandemic Emergency Purchase Programme. Just to look at these figures, without putting them into any form of context, indicates that they are almost beyond comprehension. What has prevented a major problem within the monetary union so far has been the ECB's action in hoovering up the eurozone members' debt without regard for price and relative risk considerations. We indicated above the approximate level of Italy's outstanding debt as a percentage of GDP, a very significant number. If we compare the gross redemption yields on Italy's ten year government bond, currently around 0.92%, with that on Germany's equivalent bonds, -0.18%, the difference of 1.1% seems insignificant against the two countries' debt profiles. Germany's debt level is below 70%. But, suppose we arrive at a situation where central banks wind down quantitative easing (QE) and countries have to accept the normal disciplines of the market, that yield differential would have to widen markedly. The resulting effect on a weaker country's budget would be very serious and could call into effect its creditworthiness. In a currency union, it is very unlikely that the effect could be contained and the currency would almost certainly be in the firing line. In terms of expected budget deficits as a percentage of GDP, the Economist Intelligence Unit's estimate for 2021 amongst various eurozone members is 10.5% for Italy, 9.0% for France, 8.9% for Spain and 3.6% for

Germany (although other estimates are higher). These figures, again, tell a story about the disparities in economic strength amongst members of the eurozone. When interest rates start to rise, as they must at some stage, the help to public finances given by very low interest rates and, hence, servicing costs, will taper and future servicing costs will have to reflect the cost of new debt, either to cover current budget deficits or to refinance maturing debt. In the USA, it is estimated that US public debt, as a percentage of GDP, will be over 100% this year and that the Economist Intelligence Unit estimates a budget deficit of 13.5% of GDP. In the UK, outstanding public debt as a percentage of GDP is almost 100% and the Economist Intelligence Unit estimates that the budget deficit will be 12.1% of GDP.

In normal circumstances, countries would not get away with budget deficits of this size. They would expect to have to pay higher interest rates to attract buyers for their debt and the weakness of their public finances might be expected to be reflected in weakness in their currencies. A downward economic spiral might be expected to ensue. But, in this strange economic environment where central banks are printing vast sums of money, effectively to finance governments, there is a danger that this will come to be seen as the norm and complacency will set in. If most major countries' central banks are doing this, there might be a feeling of strength in numbers and some protection from the markets because of this. To many economists, the suppression of interest rates by central banks and their exploding balance sheets, reflecting the vast amount of quantitative easing (QE) that they have undertaken, spells danger and, although it has been a strong quarter for equity markets overall, there have been glimpses of concern at times which have temporarily affected markets.

It is worth spelling out the background to some investors' and economists' concerns. Of course, there is a lot of disagreement amongst economists but one school of thought goes as follows. It is that the vast amount of money which has been created by central banks and finds its reflection in bank deposits will be mobilised at some time when businesses and individuals feel more confident to spend and invest. As this money circulates round the economies of the world more quickly and stimulates economic activity, it puts upward pressure on prices as the amount of goods and services which is available is finite. Very simply expressed, it means that more money is chasing a limited amount of goods and services, with the inevitable upward pressure on prices. But, there is a further problem in current circumstances, which, as well as there being a potential demand issue as economic activity increases, there is a supply issue because the supply chains have been disrupted as a result of the pandemic. Supply chains may not be able to react quickly to an increase in demand. Manufacturers may have gone out of business during the pandemic. In the USA, some businesses are finding it difficult to recruit staff for a variety of reasons so are not able to ratchet up supply as a result. Unsurprisingly, as a result of central banks' actions, money supply growth is accelerating sharply, which many economists will see as a harbinger of inflation. It has to be said that it feels as if inflation is in the air. There are anecdotal stories in the building industry of supply shortages and sharp price increases. Commodity prices have been very strong this year. The S & P GSCI index, for example, which includes soft and hard commodities, is up almost a quarter so far this year in sterling terms. One example, which will be clear to most people, is the price of petrol, but, behind the scenes, hard commodities like iron ore and copper have risen in price substantially and soft commodity prices, too, have been strong. Wage pressures in some places are becoming apparent. For example, in the hospitality industry, employers are having to bear higher costs as they replace those who have left the industry in the lockdown. It should also be remembered that many people who were fortunate enough to retain their income during the various lockdowns have built up an enormous pool of involuntary savings and some of these will be spent early on in the recovery, leading to an explosion in demand with the consequences which we have outlined above. So, for some economists, bloated central bank balance sheets arising from QE, a build up of people's and some businesses' cash positions, significant increases in money supply and a probability of an increase in the velocity of circulation as confidence increases, coming up against supply constraints, spells trouble on the inflation front.

Set against these potential causes of inflation, come more relaxed views from many central bankers and other economists. For example, the OECD sees inflation amongst its members this year at 2.7% and 2.4% next year. For those who are more sanguine about inflation, the view seems to be that there will be a spike as the world economy works through these current one off dislocations caused by the pandemic and then inflation will move back to a more normal level. Those taking the more sanguine view about inflation also point to the large number of people out of work as a result of the pandemic and expect subdued wage cost growth. This is a regional issue because, as mentioned above, the USA, probably because its vaccine programme is more advanced than in, say, Europe, sees its economic recovery at a more advanced stage. Putting the two sides of this argument in perspective, the OECD, in its latest Economic Outlook, forecasts US economic growth at 6.9% this year against a decline of 3.5% in 2020, whilst, for the EU, it forecasts economic growth of 4.3% this year against a decline of 6.7% in 2020. Obviously, the actual outcomes cannot be precisely estimated at this stage, but the different stages of the economic recovery cycle in the USA and EU are beyond doubt. Year on year inflation figures are distorted by comparison with the early stages of the Covid-19 pandemic and should be considered in that context, but the year on year increase in US consumer prices is 4.2%, whilst, in the eurozone, it has risen to 2.0%, which puts it slightly above the ECB's target.

The amount of unused capacity in an economy will give some clue to the potential inflation risks, although this will be difficult to measure, given supply disruptions which will inevitably have been caused by the pandemic. But some light might be shed on this by where economies may be in GDP terms by the end of the year. If we look at the latest OECD forecasts, we see that it expects the US economy to have more than recovered its pre-pandemic position by the end of the year and others, like Australia, have already done so. So, the decline in GDP of 3.5% in 2020 will have been more than recovered if the OECD's growth forecast for 2021 is met. On the other hand, with the EU having declined by 6.7% in 2020, it will not have recovered to the end of 2019 position if the growth forecast of 4.3% for this year proves accurate. The most successful country in terms of having recovered from the economic shock of the pandemic will have been China, which actually grew by 2.3% in 2020 and is forecast by the OECD to grow by 8.5% this year. Intuitively, one would feel that inflation is likely to be more of an issue in the fastest growing countries but not necessarily only them.

If inflation is going to return, then it is an issue which investors must address, and this is where our original point about the importance of looking forward rather than at the present is relevant. Investors have prospered since the initial stock market fall in late February and March 2020, provided they did not lose their nerve then. Now, however, investors need to consider the next stages of monetary and fiscal policy, just as they had to in March 2020.

One of the themes of our reviews over many months has been the mispricing of fixed interest securities. We all know why this is. Price insensitive central banks have been buying bonds as part of their quantitative (QE) policy and there are other price insensitive buyers as well. Amongst other issues with price insensitive buying is that yields may bear no relation to inflation or credit risk. If we look at the Economist Intelligence Unit's forecast of inflation for 2021 in the various countries and regions, we see that negative real yields are the norm. The yield on the 10 year US Treasury bond is currently around 1.6% and the EIU forecast for US inflation this year is 2.7%. In the UK, the 10 year gilt is yielding about 0.8% and inflation is forecast to be 1.5%. In the eurozone, we see the 10 year German government bond yielding approximately -0.2%, the French one almost 0.2%, the Italian one almost 0.9% and the Spanish one nearly 0.5%. Against these yields, inflation in the eurozone is forecast to be 1.4% and in individual countries 1.9% in Germany, 1.3% in France, 0.7% in Italy and 1.3% in Spain. In China, however, there is a more normal relationship with the 10 year government bond yielding around 3.1%, with inflation forecast to be 1.6% giving a positive real yield.

There is no doubt that the enormous monetary and fiscal stimulus which was given to the world economy when the pandemic started was necessary to prevent a major economic collapse and maintain vital infrastructure so that economies could start to return to normality once the worst of the pandemic was over. However, continuing with expansive monetary and fiscal policies for too long brings real risks to the world economy. As we have discussed above, these policies could potentially lead to inflationary pressures being unleashed. Negative real interest rates could overstimulate demand which, with a constrained supply situation, would be inflationary. They lead to a misallocation of resources. In the investment world, the absence of a meaningful interest rate encourages some investors to take risks as they seek higher returns than they would obtain on deposits or fixed interest securities. Zombie companies can keep going because, although they may not be able to repay the principal amount of their debt, they can keep the servicing costs going. This crowds out of the market the more successful companies and is damaging to economic growth. They cause damage to pension schemes as, assuming the nominal rate of interest is low, or non existent as is the case at present, future pension liabilities are discounted at very low interest rates, thereby raising their present value and maybe causing companies to have to put more money into their schemes which could otherwise be used for investment in their businesses. It is also, of course, very damaging for savers, with the attendant risk, mentioned above, that they will seek more risky investments. So, there are many undesirable consequences of negative real interest rates and the threat that they may lead to a resurgence of inflationary pressures is perhaps the main one.

The complement to this monetary policy is the fiscal policy which is currently being pursued by many governments, this effectively being funded by central banks' QE policies. Again, that was necessary to support economies during the worst of the crisis but, now that economies are recovering again, there is a real danger that expansionary fiscal policy, on top of very loose monetary policy, could stoke inflationary pressures. This is a particular concern in the USA where the huge expenditure package proposed by the Biden administration is a cause for concern. GDP in the USA grew at a 6.4% annualised rate in the first quarter following a 4.3% growth rate in the fourth quarter of 2020. In recent times, Congress passed a US$900 billion stimulus and relief bill which was attached to the main omnibus budget bill. In March 2021, a package of US$1.9 trillion in stimulus and relief proposals was signed by the President and there are more heavy spending proposals to come, including on infrastructure, which will mean that the USA will continue to run very large budget deficits and experience a rising percentage of outstanding public debt as a percentage of GDP. One concern about these plans, from an economic perspective, is that these policies are pro cyclical and disable automatic stabilisers in the economy. That means that, when an economy is growing strongly with the danger of overheating, by taking measures such as tax increases or making public expenditure cuts, the danger might be reduced. If an economy is weak or in recession, then budget deficits can be allowed to rise to inject spending into the economy. The risk in the USA is that stimulus is being poured into an economy experiencing a sharp economic recovery which threatens overheating and rising inflation.

Where does this leave policymakers? Despite some concerning inflation numbers, central banks seem quite sanguine about inflation, preferring to keep measures aimed at stimulating their economies, restoring GDP to pre Covid-19 levels and beyond and ensuring unemployment comes down. They see failing to achieve these results as a greater danger than allowing inflation to rise above their targets. They will continue to use the combination of very low or negative interest rates and QE. Whilst they can control the very short end of the market, the market will take control further along the yield curve to longer maturities. QE is used to flatten the yield curve but, unless central banks are prepared to use unlimited amounts of QE to buy longer maturities, and this would be a very dangerous policy for their balance sheets, the market would probably eventually win. As we saw during the quarter, yields spiked upwards on inflation fears. Whilst modest inflation, say 2%, is generally felt to be a suitable target range, anything significantly above that will almost certainly lead to a tighter monetary policy in the form of a rise in administered rates or a tapering or ending of QE. The policy has to be very carefully calibrated so as not to frighten investors and central banks' signalling must be clear,

otherwise we might see the equivalent of the 2013 "taper tantrum" when the mere possibility of central bank action caused a temporary but significant downturn in markets. So, we believe that investors must be alert to rising inflation signals and how this may affect portfolios. Fixed interest securities remain dangerously overpriced. If yields move significantly upwards towards more normal (historical) levels, there will be significant capital losses which may not be recovered, at least not until redemption. Other than at the short dated end of the market, where the yields are minuscule, prices look dangerously exposed to rising interest rates.

Since the positive vaccine news last November, unloved "value" stocks have staged a recovery. These companies, whose shares performed badly during the early stages of the pandemic because theirs were often the types of businesses which suffered from a collapse in demand, have been much more in favour since November because the vaccines have significantly increased the prospects of economic recovery and, therefore, these types of companies' profits. Unlike most technology companies which have low yields, and often none at all, these would normally have a reasonable dividend yield. Therefore, if interest rates do rise, and it is for the good reason that the economy is improving, these companies can be expected to outperform relatively to lower yielding ones. They are more likely to be able to raise their prices, whereas some growth companies' profits are only in the future. If interest rates have to be raised sharply because of an inflation fear or because an economy's currency is under pressure, then the argument falls away. That is not the central judgement at present, but many economists and investment managers will have concerns about central banks being behind the curve on raising interest rates. We have many value and growth stocks in client portfolios and many operate in the middle ground between the two, which are companies that show steady but not spectacular growth in profits and dividends but are felt to be safe.

In this review, we have concentrated on the macro picture, rather than discussing in detail, the prospects for each major area of the world stock markets because the latter seem less important in investment policy terms than the big picture. Suffice it to say that our long standing policy of investing internationally to minimise specific risks still stands. We do, however, want to emphasise that, after a run of largely positive quarterly performances since the pandemic struck, it is realistic to expect some quarterly setbacks. This is not a reason to change policy since we would have to have a strong conviction to do so and we would not want to run the risk of holding excessive liquidity arising from portfolio realisations only to see the market more upwards and away from us. In such circumstances, the opportunity cost, measured by the loss of profit, may not be able to be recovered.

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