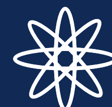

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ASSET MANAGEMENT (C.I.) LIMITED

INVESTMENT MEMORANDUM

This has been a quarter of contrasting fortunes with equities performing well and bonds moving in the opposite direction as investors' expectations on interest rate reductions in the near future were dashed by sticky inflation numbers. In the foreign exchange markets, there were some significant movements, notably weakness in the Yen and the Swiss Franc against the US dollar. Gold performed very strongly, perhaps helped by Chinese buying.

The tables below detail relevant movements in markets :

International Equities 31.01.24 - 30.04.24

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	+0.8	+0.7	-1.0	+0.5
Finland	+0.9	+1.0	-0.7	+0.9
France	+4.7	+4.8	+3.1	+4.7
Germany	+5.9	+6.0	+4.2	+5.9
Hong Kong	+4.7	+6.5	+4.7	+6.3
Italy	+11.7	+11.9	+10.0	+11.7
Japan	+8.9	+2.9	+1.2	+2.8
Netherlands	+6.1	+6.2	+4.4	+6.1
Spain	+9.6	+9.7	+7.9	+9.6
Switzerland	+1.8	-3.1	-4.8	-3.3
UK	+8.3	+8.3	+6.5	+8.2
USA	+4.1	+5.9	+4.1	+5.8
All World Europe ex UK	+6.0	+4.7	+2.9	+4.6
All World Asia Pacific ex Japan	+9.3	+9.4	+7.5	+9.2
All World Asia Pacific	+9.2	+7.0	+5.2	+6.9
All World Latin America	-0.3	-1.4	-3.0	-1.5
All World All Emerging Markets	+9.5	+9.7	+7.9	+9.6
All World	+5.3	+5.8	+4.1	+5.7

Source : FTSE All World Indices

FTSE UK Government Securities Index All Stocks (total return) : -2.3%

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

Currency	31.01.24	30.04.24
Sterling	3.79	4.35
US Dollar	3.91	4.68
Yen	0.73	0.87
Germany (Euro)	2.17	2.58

Sterling's performance during the quarter ending 30.04.24 (%)

Currency	Quarter Ending 30.04.24
US Dollar	-1.5
Canadian Dollar	+1.0
Yen	+5.8
Euro	-0.2
Swiss Franc	+5.1
Australian Dollar	-0.1

Other currency movements during the quarter ending 30.04.24 (%)

Currency	Quarter Ending 30.04.24
US Dollar / Canadian Dollar	+2.7
US Dollar / Yen	+7.6
US Dollar / Euro	+1.6
Swiss Franc / Euro	-4.8
Euro / Yen	+5.9

Significant Commodities (US dollar terms) 31.01.24 - 30.04.24 (%)

Currency	Quarter Ending 30.04.24
Oil	+6.7
Gold	+14.2

MARKETS

Despite a setback in international equity markets at the end of the quarter, it has still been a good period of performance for international equities, although the same cannot be said for bonds which endured a negative return.

Looking firstly at equities, the total return on the FTSE All World Index in local currency terms was +5.3%, in sterling terms, +5.8%, in US dollar terms, +4.1%, and, in euro terms, +5.7%. Looking at local currency returns firstly, there were above average performances from the FTSE All World Emerging Markets Index, +9.5%, the FTSE All World Asia Pacific ex Japan Index, +9.3%, the FTSE Asia Pacific Index, +9.2%, the FTSE UK Index, +8.3%, and the FTSE All World Europe ex UK Index, +6.0%. The only negative performance in our table came from the FTSE All World Latin America Index, -0.3%, but there was also an underperformance from the FTSE Australia Index, +0.8%. Turning to sterling adjusted performances, the FTSE All World Emerging Markets Index still returned the best performance, +9.7%. The FTSE UK Index, +8.3%, the FTSE Asia Pacific ex Japan Index, +9.4%, and the FTSE All World Asia Pacific Index, +7.0%, also maintained their relative strength. The FTSE USA Index, +5.9%, also showed a slightly above average performance. At the other end of the performance list, the FTSE All World Latin America Index, -1.4%, and the FTSE Australia Index, +0.7%, remained laggards.

With hopes of lower interest rates being pushed back because of sticky inflation, earlier optimism about the outlook for bonds disappeared, resulting in a big rise in yields. Looking at benchmark ten year government bond yields, the gross redemption yield on the UK gilt rose by 56 basis points to 4.35%, on the US Treasury Bond by 77 basis points to 4.68%, on the Japanese Government Bond by 14 basis pints to 0.87% and on the German Bund by 41 basis points to 2.58%.

In the foreign exchange markets, sterling rose strongly by 5.8% against the yen and by 5.1% against the Swiss franc. Against the Canadian dollar, sterling rose by 1.0%. On the other hand, it fell by 1.5% against a strong US dollar and by 0.2% against the euro and 0.1% against the Australian dollar.

In the commodity markets, the unsettled geopolitical situation pushed up the price of oil, as measured by Brent crude, by 6.7% and gold performed exceptionally well, +14.2%, perhaps pushed higher by buying from China.

ECONOMICS

Markets are having to contend with an unusually large number of uncertainties but have, so far this year, taken them in their stride. However, there is no room for complacency as any one of the issues could have serious economic consequences. This remark should be seen in the context of our investment review and isn't meant to downplay the horrific human tragedies which are occurring in Ukraine and the Middle East. But, as we have said in previous reviews, there is always a reason not to invest and those who have followed this path have not achieved good investment results over the years. This has been the case so far this year as well, certainly for international equity investors. For bond investors, the story has been different. Whilst we have held a negative view on bonds for a long

time believing at one stage that they were dangerously overvalued, it is still the case, in our view, that they remain overvalued but less so than in the past as inflation has subsided. Nevertheless, what has helped to drive markets higher this year was the early belief that interest rates would show a steady fall on the back of better inflation prospects. However, such expectations have suffered a setback in recent weeks as inflation has proved to be sticky downwards causing analysts and economists to pare back their forecasts of the timing and the size of central bank interest rate cuts this year. Whilst one might therefore have expected equities to pull back from their earlier rises, this has not happened to any meaningful extent although we have to note weakness at the end of April. Bonds have, however, fallen back quite significantly in the latest quarter. Part of the reason for the strong equity performance last year, especially in the USA, was AI excitement around some of the "Magnificent 7" tech stocks which carried over from last year in the early weeks of 2024. At the time of writing, there has been a meaningful pull back in some of the "Magnificent 7" so some sector rotation may be occurring; one of the beneficiaries of the unsettled Middle East situation being the energy sector which has performed well so far this year. What we can see in the year to date is that the relative strength of equities against bonds continues to be a noticeable feature of markets. The "goldilocks" state for markets would be that the steep rise in interest rates instituted by central banks in 2022 and 2023 would be successful in bearing down on inflation yet would not cause a recession and a sharp rise in unemployment. How does this scenario look?

The IMF has just published its April 2024 World Economic Outlook. Its overall estimate for world economic growth in 2024 is 3.2%, the same level as achieved in 2023. It is also its forecast for 2025. The stand out area, in relative terms, for economic growth is the USA which it forecasts to grow by 2.7% this year, slightly faster than the 2.5% it achieved in 2023. It forecasts a slowdown in the USA's rate of growth in 2025 to 1.9%. The IMF's expectation for growth in Advanced Economies in 2024 is 1.7% so it can be seen from this figure that the overall rate of growth in Advanced Economics is being dragged down by other areas. Those areas are the eurozone, Japan, the UK and Canada. Looking at the euro area firstly, the IMF expects only a modest pick up after 2023's growth rate of 0.4% to 0.8% this year, rising to 1.5% in 2025. Within the euro area, the largest economy, Germany, is expected to show a particularly poor performance, growing by only 0.2%. Elsewhere, the second largest economy, France, is forecast to grow by 0.7%, the third largest, Italy, by 0.7% also. The fourth largest eurozone economy, Spain, is forecast to show a much stronger performance, growing by 1.9%. The UK's growth rate is put at 0.5%, that of Japan by 0.9% and Canada by 1.2%. So, amongst the Advanced Economies, the USA is doing a lot of the heavy lifting.

As would be expected, Emerging Markets and Developing Economies are forecast to grow more strongly. Overall, growth is put as 4.2% for 2024, slightly below 2023's level of 4.3%. 2025's forecast is 4.9%. Within that total, India is by far the leader, predicted to grow by 6.8% this year, well ahead of China at 4.6%. Interestingly, Indonesia, a giant economy in its own right, is expected to grow by 5.0% this year. The dynamics for India look far better than they do for China at this stage and it will pick up its share of the heavy lifting for the world economy. Overall, the IMF's forecasts for the world economy differ very little overall, at this stage, between 2024 and 2025. As mentioned earlier, the IMF's current forecast for world growth overall in 2024 and 2025 is the same at 3.2%. Within that, the IMF forecast for 2025 for Advanced Economies shows a relative improvement in the position of the laggards mentioned above against the USA with euro area growth at 1.5% and, within that, Germany pushing up to 1.3% and France to 1.4%. The UK and Canada are also forecast to show much better growth than in 2024 at 1.5% and 2.3% respectively. However, historically, these figures are below trend, reflecting different issues but they do suggest the avoidance of a recession.

So, those are growth forecasts, one element of the "goldilocks" scenario, but what about inflation, the other element and a clue to what might happen to interest rates which investors obviously want to fall? The IMF forecasts that World Consumer Prices will rise by 5.9% this year, compared to 6.8% in 2023 and in 2025 will rise by 4.5%. Within those overall levels, the trajectory for Advanced Economies is forecast to be from 4.6% in 2023 to 2.6% this year and to 2.0% next year. For the Emerging Market and Developing Economies, the forecast for 2023 and 2024 is 8.3%, falling to 6.2%

next year. An impediment to the inflation element of the “goldilocks” scenario in Advanced Economies is the stickiness of inflation in what is called “the last mile”, namely the move to the usual central banks’ target of an inflation rate of around 2%. If we look at current inflation rates in some of the Advanced Economies, we can see that they are having difficulty managing the “last mile” to 2% and often this is because wages are proving to be “sticky” on the downside, meaning that they are not reacting to the fall in inflation. Latest figures for wage growth in the USA are 5.8%, for the UK 5.6% and for the euro area 3.1%. Latest consumer price inflation is 3.5% in the USA, 3.2% in the UK and 2.4% in the euro area. It is the stickiness of inflation, partly caused by the stickiness of wage levels, which is proving to be a stumbling block on the earlier predicted path of interest rate reductions. What is unhelpful at the moment is the rise in the price of oil caused by the Middle Eastern situation and it is difficult to see how this will work out. On a positive note, however, we can see that the turmoil in the Middle East is not having the effect on oil prices which it has done in the past. As an input to each unit of production, oil is far less important than it was during the 1970’s oil price increases. Nevertheless, the impact which consumers feel at the pumps is still very real. However, with inflation where it is at present, much closer to central banks’ targets than it was, the likelihood, but not the absolute certainty, is that short term interest rates administered by central banks have peaked and that there will be a gradual move downwards. Further increases are not impossible if inflation doesn’t behave as expected because of more increases in the oil price or because of indirect effects such as increased shipping costs and supply disruptions due to Houthi rebels’ attacks on Red Sea shipping, causing ships to go round the Cape. On balance, this looks an unlikely scenario so it is likely to be interest rate reductions deferred rather than cancelled. Equity markets should be able to live with that.

Whilst we are not complacent about the recent decoupling of the expected movements between equity and bond prices, we do think that bonds face more challenges than equities. One of these is the huge borrowing requirements of many governments.

In this context, and staying with the IMF, a new blog by three of its senior officials emphasised what investors in the bond market will already know, namely that the volume of public debt is expanding dangerously. The IMF officials said that the average debt ratio of rich countries was on course to reach 120% of GDP by 2028 compared with about 75% in 2000. The officials said that governments would be stuck with permanently higher borrowing costs in the coming decades as they increased public expenditure and maintained interest rates far higher than they had been for twenty years. From an economic perspective, it will depress future economic growth rates as the increased cost of debt servicing will weigh on budgets and lead to fiscal tightness and contractionary influences on the economies in question. From a bond investor’s perspective, if bond issuance grows substantially, intuitively one would be looking for higher real interest rate. Particularly concerning is the USA’s situation. The country and the currency obviously enjoy the benefits of having the world’s major reserve currency but that does not mean that it is immune from market forces. The USA’s Congressional Budget office (“CBO”) projects budget deficits on current policies of over 5% of GDP and moving to well over 6% as far ahead as the eye can see. The primary deficits, which exclude interest payments, will average well over 2%, signifying a major structural problem. Intuitively, one feels that something has to give and it may well be the real rate of interest which will need to rise. It is not only the USA where there is a problem. Some of the eurozone members have very high debt levels and so does the UK. Assuming central banks do not revert to money printing, and they are moving the other way at present, we feel that bond markets in future will have to offer significantly higher real rates of interest to attract buyers.

But, of course, one buys equities for their growth potential and the corporate sector as a whole cannot grow independently of the world economy. It needs economic growth to stimulate demand for its products and services and if the servicing costs of the debt overhang meant budget austerity, an equity investor has to be very choosy in his or her selection of equities. There might be a wide dispersion of company growth rates within limited overall economic growth so selectivity will become increasingly important.

In recent reviews, we have emphasized not only economic influences on markets but also political and, increasingly, regulatory ones. We don't opine on policies themselves but, rather, point out what effect they may have on investments or investors' attitudes to the attraction or otherwise of particular countries. At the moment with important elections coming up, most notably in the USA, it will be our job to comment on the implications for markets of any changes in policies or regulations as they affect investors. As a broad generalisation, we would want to be invested in countries and areas which can show decent economic growth perhaps because policies and regulations do not stifle investment and adversely affect a country's prospects. More of this in future commentaries, especially as the important elections get nearer.

For the moment, for our sterling based investors, we feel that is important to bear in mind that the UK equity market now accounts for less than 4% of the world stock market value and the USA over 60%. Except in particular circumstances for our clients, the argument for a degree of matching assets and liabilities by currency carries very little weight and, certainly, looking back at the performance of the UK stock market against the world markets, dominated by the USA, home bias has proved very costly. We will go into this in more depth in future reviews but, for now, the importance of geographical diversification, with substantial exposure to the USA, remains essential particularly in view of the medium term prospect of subdued economic growth as countries are weighed down by debt. There are more companies in the USA where growth prospects will still be good even if US economic growth is subdued.

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