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ASSET MANAGEMENT (C.I.) LIMITED

INVESTMENT MEMORANDUM

It has been another positive quarter for most equity markets although there have been areas of weakness in Asia and Emerging Markets. Bond prices have also been firm. Currency movements have been mixed with the US dollar the outstanding major currency. There was no significant movement in either gold or oil over the quarter although commodity prices overall have risen strongly so far this year.

The tables below detail relevant movements in markets :

International Equities 31.05.21 - 31.08.21

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	+4.4	+2.5	-0.7	+2.8
Finland	+10.1	+9.8	+6.3	+10.1
France	+4.0	+3.8	+0.5	+4.0
Germany	+3.3	+3.0	-0.3	+3.3
Hong Kong, China	-5.0	-2.1	-5.2	-1.8
Italy	+2.6	+2.3	-0.9	+2.6
Japan	+1.8	+4.7	+1.4	+5.0
Netherlands	+16.0	+15.7	+12.0	+16.0
Spain	-1.8	-2.0	-5.2	-1.8
Switzerland	+9.0	+10.5	+7.0	+10.9
UK	+2.8	+2.8	-0.5	+3.1
USA	+8.1	+11.6	+8.1	+11.9
All World Europe ex UK	+6.4	+6.5	+3.1	+6.8
All World Asia Pacific ex Japan	-2.6	-1.2	-4.3	-0.9
All World Asia Pacific	-1.2	+0.8	-2.4	+1.1
All World Latin America	-2.6	+1.6	-1.6	+1.9
All World All Emerging Markets	-3.0	-0.2	-3.4	+0.1
All World	+5.5	+7.9	+4.5	+8.2

Source : FTSE All World Indices

FTSE UK Government Securities Index All Stocks (total return) : +2.7%

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

Currency	31.05.21	31.08.21
Sterling	0.79	0.71
US Dollar	1.60	1.31
Yen	0.08	0.02
Germany (Euro)	-0.19	-0.39

Sterling's performance during the quarter ending 31.08.21 (%)

Currency	Quarter Ending 31.08.21
US Dollar	-3.2
Canadian Dollar	+1.2
Yen	-2.9
Euro	+0.2
Swiss Franc	-1.4
Australian Dollar	+2.4

Other currency movements during the quarter ending 31.08.21 (%)

Currency	Quarter Ending 31.08.21
US Dollar / Canadian Dollar	+4.6
US Dollar / Yen	+0.4
US Dollar / Euro	+3.6
Swiss Franc / Euro	+1.6
Euro / Yen	-3.0

Significant Commodities (US dollar terms) 31.05.21 - 31.08.21 (%)

Currency	Quarter Ending 31.08.21
Oil	+4.0
Gold	-5.3

MARKETS

It has been another strong quarter for international equity markets. In local currency terms the FTSE All World Index has shown a total return of +5.5%, in sterling terms +7.9%, in US dollar terms +4.5% and in euro terms +8.2%. Looking at local currency returns first, we see that the standout performer was the USA, with the FTSE USA index returning +8.1%. There was also an above average performance from the FTSE All World Europe ex UK index which returned +6.4%. On the other hand, there were negative performances from the FTSE All World All Emerging Market index, -3.0%, the FTSE All World Latin American index, -2.6%, and the FTSE All World Asia Pacific ex Japan index, -2.6%. Although in positive territory, the FTSE UK index underperformed world markets, with the FTSE UK index returning +2.8%. Looking at returns in sterling adjusted terms, the performance of the US market was magnified by the strength of the US dollar and the FTSE USA Index returned +11.6%. Currency strength improved the performances of the FTSE All World All Emerging Market Index to -0.2%, the FTSE All World Latin America index to +1.6% and the FTSE All World Asia Pacific ex Japan index to -1.2%. Japan, where previous currency weakness had adversely affected many non local currency returns, saw the yen return to favour and a local currency return of +1.8% in the FTSE Japan index became one of +4.7% in sterling terms. Currency weakness in Europe, except for the Swiss Franc, meant that the FTSE All World Europe ex UK index slightly underperformed the FTSE All World Index, although there was a still very good return of +6.5%.

Unusually, fixed interest securities provided positive returns along with those of equities. Taking the ten year government bonds as a benchmark, the gross redemption yield of the UK gilt fell by 8 basis points to 0.71%, on the US Treasury bond by 29 basis points to 1.31%, on the Japanese Government bond by 6 basis points to 0.02% and on the German Bund by 20 basis points to -0.39%.

Currency markets were mixed. Against the US dollar, sterling fell by 3.2%, against the yen by 2.9% and against the Swiss Franc by 1.4%. On the other hand, it rose against the Australian dollar by 2.4%, against the Canadian dollar by 1.2% and against the euro by 0.2%.

In the commodity markets, oil, as measured by Brent crude rose by 4.0%, whilst gold fell back by 5.3%.

ECONOMICS

Whilst it is always pleasing to see stock markets posting a positive quarterly performance, investors should not in any way be complacent. The narrative has not changed for many months. Asset prices are being inflated by newly created money and ultra low interest rates. Whilst it has been an unusual quarter, in that bonds and equities have both risen in price, it is still the case that the current level of interest rates still supports the relative attraction of equities. In this sense, the story is much the same as it has been for many months and our reviews have therefore reflected this unchanged driver of asset prices, in this case equities, our favoured asset class. Because one can see the negative attributes of bonds and cash at a time of rising inflation whilst interest rates remain so low, the attractions of equities seem relatively strong. The reason for saying this is that, if and when there is some reversion to mean in bond yields, the negative returns will be very significant, with little chance of recovery, whilst equities, which can also be expected to fall during a period of significantly rising interest rates, should recover and advance again over time on the back of economic recovery and rising profits. Cash would have the advantage of holding its nominal value but may well decline in purchasing power terms as interest rates are insufficient to offset inflation. At a general level, this is the reason for the steady drift upwards in share prices. Unless one is a forced buyer of fixed interest securities, and there are large numbers who are price insensitive buyers, it is almost impossible to make a case for buying them at these yield levels. Our table at the beginning of this review shows the yield on four government ten year bonds. The levels of gross redemption yield on those with a positive figure cannot be considered attractive and are almost certain to be negative when inflation is taken into account, whilst, in Germany, a buyer is certain to lose money in nominal terms if the bonds are held to redemption and an even greater loss in inflation adjusted terms.

With shares drifting upwards, volatility low and the monetary and fiscal background, at least for now, unchanged, it is easy to feel complacent. Sentiment is undoubtedly bullish and many market bears seem to have capitulated. Those who remain in the bearish camp point to the high stock market ratings of shares and, of course, they are right in many cases, even though company profits are recovering strongly as are dividend payments. But there are strong arguments in favour of equities, even at the all time high levels, which we are now witnessing, and it all surrounds current monetary policy with ultra low interest rates almost everywhere. Theoretically, share prices should reflect the net present value of future company dividends or cash flows. If those are discounted at, say, the level of short term official interest rates or ten year government bond yields, the net present value is higher than it would be if discounted at more traditional higher interest rates. Then, if we look at the largest and most highly rated equity market, the US one, the prospective price/earnings ratio of around 22 implies an earnings yield of around 4.5%, well ahead of the ten year US Treasury bond of about 1.3%. Then, if we look at the dividend yield on the S & P 500 index, which stands at around that same 1.3% yield on the ten year US Treasury bond and the fact that, over time, dividends are likely to continue to grow, that equity dividend yield, although low in absolute terms, looks attractive in relative terms. These are gross yields before tax. This attractive relative relationship for equity yields against bond yields is even more pronounced almost everywhere else. The dividend yield on the FTSE 100 index in the UK is estimated to be around 4.0%, well ahead of the ten year UK gilt yield of 0.7%, in Germany the relative figures are 2.3% and -0.39% and in Japan it is 1.5% against zero. These types of relationships are to be seen almost everywhere. So, for those investors who favour equities out of the main asset classes, there are solid reasons behind their thinking.

But, and this is the big "but", as the above narrative indicates, monetary policy is crucial in supporting equities and bonds, and this is where the major debate is taking place. We have written extensively about this in all of our recent reviews and will do so again now as it is critical to getting asset allocation correct. The background is that central banks are usually, and certainly in most major developed economies, independent of central government and are not expected to finance governments. During the pandemic, which, of course, played havoc with governments' finances, the suspicion developed that the strict demarcation lines were being frayed and that central banks were effectively financing governments to enable them to meet the economic costs of the pandemic. The central banks, in effecting their quantitative easing (QE) programmes, have been actively buying government and corporate bonds in the secondary market, and those buying in the primary market knew that there would be purchasers behind them. Whilst these policies were necessary and have been effective, this process cannot continue indefinitely. In previous reviews, we have illustrated how these QE programmes have caused central banks' balance sheets to explode in size, a situation which is potentially dangerous. The magnitude of central banks' monetary stimulus, whether it be through QE or interest rate policy, even negative interest rates in Europe, would not have been believed possible in the past, so we are really treading new ground. Many economists would have considered it inevitable that printing money, albeit electronically now, combined with current interest rate levels and elevated money supply growth, would inevitably lead to an inflation problem. Put very simplistically, more money chasing a limited supply of goods and services equals higher prices. In the early part of the pandemic, when demand collapsed, pricing power was weak and inflation was not an issue, but, now, as we enter the nineteenth month of the pandemic, with some move towards normality in many countries, inflation is becoming an issue. Looking at the latest consumer price index figures for various countries, year on year inflation in the USA is 5.4%, in Germany 3.8% and in the UK 2.0%, to name just three countries. This means that real inflation adjusted interest rates are significantly negative. That, in itself, carries risks because it encourages borrowing and can lead to unsustainable bubbles, with the possibility of collapse. So, we can see various asset bubbles. We would not include equities in this, but some undoubtedly would. House prices are, however, a good example. In the USA and UK, for example, house prices have risen significantly over the last year, partly aided by very low borrowing rates. When interest rates rise and servicing debt becomes more problematical, the danger of the bubble bursting and increasing financial stress occurring is real. We see dangers of investors looking for increasing returns in an era of cheap money in cryptocurrencies, for example. There is no intrinsic value in them, as regulators have warned, yet they have attracted vast amounts of speculative money. This is not healthy.

Back to inflation. The question is what has caused the present rise and is it permanent and calling for action, or is it transitory? Three reasons are clearly behind the rise. One is supply difficulties as the normal supply chain has been disrupted by the pandemic causing prices to rise. One well documented area of shortages is semiconductors. Another area, perhaps surprisingly, is the labour market, where companies, a high proportion of which are in the leisure and hospitality sectors, are finding it difficult to attract staff and they are having to pay up accordingly. A resumption of spending by those building up "accidental savings" during the pandemic will have exacerbated the supply shortage as there is a sudden increase in demand for some goods and services and will have inflationary consequences. Commodity prices have been strong for different reasons. One example is iron ore, which China needed as it ramped up steel production. Commodities generally, as measured by the S & P GSCI index are up about 28% in sterling terms this year. Once there has been a steep change in the price level, which is happening, as illustrated by the inflation rates quoted above, it is difficult to remove inflation from the system. It also raises inflationary expectations and, therefore, pay demands. There is regular evidence from many companies that their input costs are rising sharply as a result of the supply shortages and that employment costs are rising significantly in a number of sectors. The contrary view, expressed by a number of central banks, is that this is just an inflation spike which will work itself out of the system and is therefore transitory, and that there is, therefore, no need to tighten monetary policy for the moment. With official interest rates and bond yields significantly negative in real terms, one hopes that they are correct in their thinking because, if inflation persists at well above target levels, it will ultimately be more difficult to control and will require more extensive monetary tightening. Central banks, in our view, are running a high risk strategy.

The problem is that most countries' finances are shot to pieces as a result of the costs of the pandemic. With debt servicing costs artificially low as a result of central banks' monetary policies, the pain and the potential problems have not been really felt, and it is tempting to think that this benign condition will exist indefinitely or, at least, to beyond a normal investment horizon. But, of course, it cannot do, whatever some may think. If money continues to be created at the rate it has been, it will lose all credibility and people and businesses will turn to other assets as a store of value. At an extreme level, if one looks at countries such as Venezuela and Zimbabwe, which have printed money on an enormous scale, it has led to astronomic inflation levels and a complete loss of confidence in their particular currencies. These are the most egregious examples, but the principles behind the loss of trust in their respective currencies are some of those which could affect the major currencies.

Central banks are in an unenviable position. As we mentioned earlier, they have, many think, become more politicised, so that they are likely to take more risks with monetary policy to try to sustain the economic recovery through ultra low interest rates and QE. For example, the US Federal Reserve's mandate, besides targeting growth and employment levels, includes the requirement that the employment recovery is inclusive. That, of course, is a worthy objective but it is also a political objective, so one can foresee a situation where the employment objectives overall are being met but the composition of them is not, meaning that the Federal Reserve delays its move towards tightening monetary policy. In the eurozone, the problem is different. Because the economies comprising the eurozone are not of an homogenous nature, the “one size fits all” policy is particularly inappropriate. There are some very highly indebted members of the eurozone, and, of the largest members, Italy, Spain and, now, even France, come to mind. Looking at budget deficits, and taking the Economist Intelligence Unit’s (EIU) estimates, Italy will run a budget deficit of 11.5% of GDP this year, Spain 8.6% and France 8.7%. If debt servicing costs start to rise, not only because of additional borrowing necessitated by budget deficits but because interest rates start to rise, investors, particularly bond ones, may well start to become alarmed. In a currency zone, the effects of a loss of confidence in one country cannot be isolated. This is a particular problem for the eurozone.

Looking at the stance of various central banks in relation to starting to unwind their ultra loose monetary policy, we note that the Bank of England’s Monetary Policy Committee intends to begin reducing its stock of purchased assets when the bank rate has risen to 0.5% (currently 0.1%), given the appropriate economic circumstances, by ceasing to reinvest in maturing UK government bonds. The MPC forecasts that its main interest rate would reach 0.5% in the third quarter of 2024, with intermediate steps of 0.2% in the third quarter of 2022 and 0.4% a year later. This trajectory is very gradual, but the risk is that a significant upturn in inflation could force its hand to act earlier. In the USA, the Federal Reserve expects that it will be appropriate to maintain its current target range for the federal funds rate, near zero, until labour market conditions have reached levels consistent with its assessment of maximising employment and inflation has risen to 2% and it is on track to moderately exceed that rate for some time. In terms of its balance sheet policy, the Federal Reserve plans to continue to undertake asset purchases, increasing its holdings of Treasury securities by US$80 billion per month and its holdings of agency mortgage backed securities by US$40 billion per month. The Federal Reserve says that these purchases are expected to continue, at least at this pace, until further substantial progress has been made towards its maximum employment and price stability goals. So, in the USA, at the present time, there is less hard guidance than in the UK. In the case of the eurozone, the ECB agreed a symmetric inflation target of 2% over the medium term. It said, in July, that the key ECB interest rates have been close to their lower band for some time and the medium term outlook for inflation is still well below the Governing Council’s target. As a result, the Governing Council revised its forward guidance on interest rates to underline its commitment to maintain a persistently accommodative monetary policy stance to meet its inflation target. In support of its symmetric 2% inflation target and in line with its monetary policy strategy, the key ECB interest rates are expected to remain at their present levels, or lower, until it sees inflation reaching 2% well ahead of the end of its projection horizon. There are further qualifications, but, importantly, it may be prepared to accept a transitory period in which inflation is modestly above target. The Asset Purchasing Programme will continue at a monthly pace of €20 billion for as long as necessary and the Pandemic Emergency Purchase Programme will continue to conduct net asset purchases with a total envelope of €1,850 billion until at least March 2022. However, it is important to note that there are different views within the main central banks. Not all members of the rate setting bodies are sanguine about inflation prospects, so, if they prevail, one may see monetary tightening earlier than anticipated.

The above gives a flavour of current monetary policy in the UK, USA and eurozone and, as can be seen, it remains highly accommodative and goes a long way to explaining the current strength of markets. However, it is important that the central banks’ sanguine view of inflation is correct because there appears to be no Plan B. In an ideal world, these relaxed views on inflation will be proved to be correct and central banks can very gently tighten monetary policy through gradual interest rate increases and the reining back and unwinding of QE without frightening markets. If they are wrong about inflation and the anecdotal evidence which one reads about almost every day in the financial press is correct, and follows through, the central banks will have a big policy problem. In normal times, monetary policy can be calibrated to reflect the need to tighten or ease, relatively gently, with an interest rate increase here or an interest rate reduction there. But, with the extreme implementation of monetary policy during the pandemic, tightening measures necessary to deal with above target inflation risk serious economic consequences. Debt servicing costs for governments, which we referred to earlier, is one problem and, of course, this affects the private sector. Economic confidence, although it has recovered significantly, would almost certainly suffer a severe setback, leading to another recession. If one was cynical, given the evidence of inflation which we see around us, one could say that the fear of having to act to deal with it, is informing central banks' inflation forecasts and therefore their immediate policy decisions.

We have looked at the big picture so far in this review, rather than at individual countries or areas, but, in the light of concerns expressed about the inflation outlook, it is worth looking at the USA. Again, taking the EIU's forecasts, it forecasts economic growth of 6.0% this year and a budget deficit of 12.7% of GDP, the highest level of any major economy. President Biden has big spending plans. The first measure was the US$1.9 trillion American Rescue Plan which was a Covid-19 stimulus plan. Now he plans more spending, if he can get it through Congress. At present, he is trying to pass a US$ 3.5 trillion budget plan to expand social programmes but faces some Democrat opposition from the moderate wing of the party. Given the fact that the US economy appears to be recovering well and given the size of the monetary and fiscal stimulus given so far, further spending on the scale planned is likely to risk a further rise in inflation.

As we have seen, one of the effects of very low, or negative, interest rates and QE has been to raise asset prices, so that we have the situation where many people who hold real assets, whether they be securities, houses or other assets, have seen an increase in their wealth, whilst many people and businesses have had severe financial struggles. This is an inevitable result of the monetary policy which has been followed, with a lot of money chasing a limited amount of assets. But, it is likely to have a political cost. Ideologically, President Biden is in favour of higher taxes on individuals and companies, and present circumstances almost certainly reinforce his instincts. Thus, his plan, if he can get it past Congress, is to raise an additional US$4 trillion in tax revenue by increasing the top rate of tax for individuals to 39.6%, taxing capital gains at ordinary rates and raising the corporate tax rate to 28%. If these measures are passed, particularly a rise in corporate taxes, they could produce some headwinds for markets since, of itself, an increase in corporate tax rates would raise the rating of the market on unchanged share prices as net earnings will be lower. With national budgets in a very poor state elsewhere, market unfriendly tax increases may be introduced. This is something to bear in mind at a time when markets are performing so well.

It would be wrong to close this review without a word on developments in China. The situation has changed radically there as a result of the state increasing its influence in many walks of life, including the private sector, with edicts changing the investment case for many companies, meaning that the risk premium for the equity market has been substantially raised as a result of uncertainty. It has been one of the most poorly performing markets this year and this is no surprise, given what has been happening. In macroeconomic terms, given that China is the world's second largest economy, there must be a chance that the move towards common prosperity, the latest doctrine of the Chinese government, which implies a redistribution from companies (and some very rich people), will adversely affect economic growth, with some knock on effects on the world economy. It is early days, but so quickly is the background changing in China, that it is sensible to flag up the issue now.

In summary, as we have said in so many recent reviews, investors must not be complacent. International equities remain our favoured asset class as neither of the main alternatives, fixed interest securities and cash, especially the former, have attractions. We have highlighted what we think is the main threat to markets, which is inflation which does not fall back from current elevated levels, particularly in the USA. We are assuming that there is no setback to the vaccination programmes. The rise in equity markets has continued almost unabated since its low point in March 2020 and setbacks are inevitable, but, as long term investors, we ride these setbacks so as not to prejudice long term returns by being excessively liquid when the recovery in share prices occurs.