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ASSET MANAGEMENT (C.I.) LIMITED

INVESTMENT MEMORANDUM

Notwithstanding continued geopolitical and economic uncertainties, international equity markets have continued their upward progress, seemingly taking their cue from any piece of news which might be construed favourably and largely, ignoring anything negative. We try to rationalise this strength in equites in our review as we note their continued outperformance against bonds.

The tables below detail relevant movements in markets :

International Equities 30.04.26 - 31.07.26

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	+5.2	+3.7	+2.7	+4.7
Finland	-3.9	-4.8	-5.8	-3.9
France	+7.1	+6.1	+5.1	+7.1
Germany	+5.2	+4.2	+3.2	+5.2
Hong Kong	+2.8	+3.7	+2.7	+4.7
Italy	+10.7	+9.7	+8.6	+10.7
Japan	+6.8	+6.2	+5.1	+7.2
Netherlands	+12.3	+11.2	+10.1	+12.3
Spain	+13.2	+12.1	+11.0	+13.2
Switzerland	+9.0	+6.4	+5.4	+7.4
UK	+5.4	+5.4	+4.3	+6.4
USA	+4.4	+5.4	+4.4	+6.5
All World Europe ex UK	+8.2	+6.8	+5.7	+7.8
All World Asia Pacific ex Japan	+5.5	+6.1	+5.1	+7.1
All World Asia Pacific	+5.9	+6.1	+5.1	+7.2
All World Latin America	-2.0	-1.7	-2.7	-0.7
All World Emerging Markets	+3.4	+3.4	+2.5	+4.5
All World	+5.0	+5.4	+4.4	+6.5

Source : FTSE All World Indices

FTSE Actuaries UK Conventional Gilts All Stocks Index (total return) : +0.9%

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

	30.04.26	31.07.26
Sterling	5.01	5.05
US Dollar	4.39	4.69
Yen	2.49	2.80
Germany (Euro)	3.03	3.15

Sterling's performance during the quarter ending 31.07.26 (%)

	Quarter Ending 31.07.26
US Dollar	-0.7
Canadian Dollar	+2.3
Yen	-0.2
Euro	+1.0
Swiss Franc	+2.5
Australian Dollar	+1.6

Other currency movements during the quarter ending 31.07.26 (%)

	Quarter Ending 31.07.26
US Dollar / Canadian Dollar	+3.0
US Dollar / Yen	+0.5
US Dollar / Euro	+1.7
Swiss Franc / Euro	-1.4
Euro / Yen	-1.2

Significant Commodities (US dollar terms) 30.04.26 - 31.07.26 (%)

	Quarter Ending 31.07.26
Oil	-21.2
Gold	-12.3

MARKETS

- A very solid quarter for international equities with meaningful gains in most areas. There was a notable outperformance from Europe ex UK in both local currency and sterling terms. Latin America was an underperformer with negative local currency and sterling returns.

- Bond yields, as measured by ten year government bonds, moved higher as interest rate expectations changed and inflation worries surfaced again.

- In the foreign exchange markets, the US dollar strengthened but sterling was higher against most other currencies.

- In commodities, the oil price retreated sharply but was prone to upward spikes in response to the latest news on the state of passage through the Strait of Hormuz. Gold continued its retreat.

ECONOMICS

As we write these monthly economic reviews, we are increasingly aware of the paradox arising from our support for equities as our preferred asset class and our discussions on the potential threats to them from bond markets because of growing public debt in many countries. If we are concerned about debt sustainability, should we also not be concerned about the effect of a crisis in the bond market on equity prices?

Four of the markets where debt levels are a concern are the USA, UK, France and Italy and, additionally, a fifth one in a different context, Japan. Each has different characteristics but, before looking in more detail at the particular countries' issues, let us consider in basic terms the dangers an over indebted country can face. If the debt metrics, particularly outstanding levels of government debt in relation to GDP, but also the size of budget deficits, become dangerously high, those who fund the debt, whether they be domestic or overseas investors, may demand a higher interest rate in absolute or relative terms against other countries. This, in turn, increases debt servicing costs which weigh on the budget deficit. The combination of these higher interest costs and, perhaps, higher taxes to pay for them bear down on economic growth which then adversely affects tax revenue and so a vicious circle ensues. The currency may well come under pressure, thereby increasing inflation and, in extremis, a bail out from the IMF to provide financial support could be necessary such as happened in the UK in 1976. A government then partially loses control of its economic policy. In the case of the IMF's stand by loan for the UK in 1976, it demanded significant public expenditure cuts. This is a simplified description of a possible chain of events arising from a government not prepared to tackle its fiscal weakness before it becomes a major problem and is a situation in which no government would like to find itself. If we take the UK, the Office for Budget Responsibility (OBR) produced a very sobering warning in early July about the UK's position. It said that the UK government needs to tackle its "unsustainable" public finances to minimise the risks to the economy. It said that even if the government takes urgent action, spending cuts or tax rises equivalent to more than £100 billion would be required to stabilise debt at 95% of GDP from 2030/2031 onwards. On the OBR's central scenario, government spending, excluding interest, is set to rise from 40% of GDP in 2030/31 to 49% by 2075/76. It said that, if the incoming Prime Minister took immediate action, it would be possible to stabilise debt at 95% of GDP from 2030/31 through spending reductions or tax rises that cut the deficit by 3.8% of GDP in that year. The OBR report is alarming but entirely realistic and supports our view that UK government bonds are not attractive even with the 10 year UK gilt's gross redemption yield now around 5%. However, for any country there is an option which could offer the hope, but not the certainty, of a way out of this serious problem. Most economists would agree that the best way for a country to tackle its over indebtedness is to encourage economic growth which should lead to an improved tax take and certain expenditure reductions which would help to reduce or eliminate a budget deficit. But growth does not happen in isolation. It needs supportive government supply side measures on the tax and regulatory front to increase productivity and efficiency in an economy.

Leaving the UK for a moment, we move to Germany. Germany, of course, is an AAA rated borrower with a manageable public debt burden which has given it the space to increase military spending substantially in response to Russia's military threat and, separately, infrastructure and energy transaction projects. But the economy is in a bad way with very little growth forecast and the manufacturing profile of the economy, so long a strength, is now a weakness as it competes with China. Its auto industry is suffering very badly from Chinese EV imports and manufacturing from sky high energy prices. Germany doesn't face the fiscal challenges which affect the UK, France and Italy because it remains a strong credit but it does face an economic threat which could eventually lead to a fiscal problem, albeit many years ahead. Rather than wait for that, the coalition government has put forward a 34 point economic reform package covering Tax and Financial Adjustments, Labour Market and Workplace Rules and Bureaucracy and Structural Reforms. It's worth giving a flavour of these proposed reforms before we revert to the UK and France. Under Tax and Financial Adjustments, it is proposed that there will be €10 billion in yearly tax cuts targeted at lower and middle income factors paid for by increasing the top rate of income tax from 45% to 47% for those whose annual income exceeds €280,000. Under Labour Market and Workplace Rules, there are to be stricter sick leave rules, an extension of flexible contracts' time periods and retail flexibility on Sundays for bakeries and pastry shops. Under Bureaucracy and Structural Reforms, there is to be red tape reduction in terms or reporting obligations and an expansion of deemed approvals. There is to be a pension overhaul which will link the retirement age gradually upward in line with increasing life expectancy and introduces capital market investment funds into public pension contributions. We have talked in previous reviews about the importance of a country's messaging to the outside world and the direction of travel implied by these proposals is positive even if they are only a start. Germany is still a highly regulated economy but these planned reforms show intent and this is the important message for investors.

Now let's go back to the UK and, then, France. We do not give political views in these reviews, but we do acknowledge the economic and, therefore, investment consequences of policy decisions which should be less subjective. It would not be controversial to say that the level of fiscal adjustment required in the UK, as outlined by the OBR, is going to be almost impossible for the present UK government to make in the area of spending cuts with the Prime Minister having ruled out changing the pensions triple lock, a particularly costly burden which would require a lot of political courage to undo. That leaves tax increases, in the current environment a much more likely way to try to reduce the budget deficit. However, if it is agreed that the UK needs to raise its growth rate, tax increases would almost certainly have the opposite effect. Then, if we compare moves on labour market flexibility, the UK is moving in the opposite direction to Germany whether it be in the way of employment legislation, minimum wages or flexible contracts. Whatever one's view of such developments in the UK, these measures are likely to adversely affect growth as they increase costs for businesses. So, as things stand, it appears unlikely that the UK can grow its way out of its current fiscal problems because there have been so few positive tax and regulatory drivers put in place to encourage growth.

Arguably, the position is worse in France where there is no effective government and the 2026 budget was passed with great difficulty with the burden of fiscal measures falling on large companies and wealthy individuals. One of the compromises which had to be made was to change the plan to raise the pension age to 64 from 62, so it has now been put back until after the 2027 presidential election, a course quite different from that taken by other countries. This is a major setback for a country in such a poor fiscal position because most objective observers would say that this climbdown poses a serious threat to France's already challenged finances.

And, of course, investors notice these things. If we take ten year government benchmark bonds, it is noticeable that the UK has to pay more for its borrowings than any other G7 country, an important reason being its above average rate of inflation as well as, almost certainly, concerns about its fiscal position. As far as France is concerned, only Italy of the main eurozone countries has to pay more for its ten year borrowing than France and that is a recent reversal of the position. Compared with Germany, the eurozone's best credit, France has to pay just under 80 basis points more on its ten year bonds. It is reasonable to believe that unless the UK and France reverse course and introduce pro growth measures which give investors some hope that the fiscal position can ultimately improve, their bond markets remain highly vulnerable to external and internal shocks and, in our view, current interest rates do not reflect these risks. What is really interesting is that Germany, in difficult but different economic circumstances, is going to try classic supply side reforms to generate growth even though they may be modest at this stage. We have said in previous reviews that the bond markets can be an investor's best friend if they impose discipline on governments who cannot or will not take the necessary measures to tackle their fiscal problems. Bond investors are the ultimate arbiter of a country's creditworthiness and it might not be long before this statement is tested.

Turning to the USA, it has to pay more for its ten year money than any of the G7 countries other than the UK. In part this reflects its above average inflation rate and its very weak fiscal position, both in relation to its budget deficit and its outstanding level of public debt in relation to GDP. However, as we have often said before in these reviews, the USA is able to withstand pressures, although not indefinitely, which other smaller countries cannot. These centre around the US dollar's importance in trade, banking and as the largest reserve currency held by foreign central banks which means that there is always a need for US dollars. This gives the US dollar some insulation from the problems which its debt metrics might suggest. For example, the Economist magazine's Economic Intelligence Unit's forecast for the USA's budget deficit in 2026 is 6.5% of GDP and there is no way that, even as the G7's fastest growing economy this year, it can grow fast enough to make a dent in this, especially with all the uncertainty about President Trump's tariffs. The outstanding public debt ratio is approximately 123% of GDP. All the projections suggest a long future stream of large budget deficits and increasing outstanding debt in relation to GDP. Neither of the two US political parties seem minded to address the fiscal position. What can be said in mitigation is that, notwithstanding the tariff decisions, there have been some significant supply side policies implemented in the USA in terms of tax and regulation meaning that the messaging for overseas investors in the stock market is more positive than the tariff measures, which have malign economic effects domestically and internationally, would suggest.

We put Japan on our list at the beginning of this review as it is the most indebted of all the countries mentioned although it has an important advantage which is that the vast majority of its outstanding debt is held within Japan. Its gross debt ratio is around 248% of GDP and on IMF/Standardised measures it is still over 200% so whichever way one looks at it, Japan is a very highly indebted country. It is less vulnerable to a flight of capital in some respects because a very high percentage of this debt is held internally, around 88%, and almost half the debt is held by the Bank of Japan. Whilst that is true, the background has changed quite dramatically. The country had been known for its price stability or deflation. A small amount of inflation is generally considered to be desirable in an economy as it provides an incentive for consumers to spend money, knowing that an item can be bought more cheaply now rather than later on, and companies might invest based on the same rationale. In a deflationary environment, consumers and businesses have incentives to hold off unnecessary purchases or investments which may be made more cheaply later on, potentially leading to a recession. Now, for various reasons including the oil price increase, inflation is in the system with the latest year on year figure showing consumer price inflation at 1.7%. It is true that this is a lower level than in most other countries but this level of inflation represents a departure for Japan. Amongst other consequences, it has caused a sharp upturn in Japanese Government Bond yields with the ten year government bond yield being about 2.8% at the time of writing. Investors are also concerned about the policies of the new Japanese Prime Minister which they worry may be too fiscally loose with spending and tax cuts unfunded. As an aside, by Japanese investors' standards, the very high yields available on Japanerse government bonds, may mean money could be withdrawn from US Treasuries, where the Japanese are very large investors with knock on effects on the yields on US Treasuries. Japanese investors own US$1.14 trillion of US government debt and is the largest single foreign holder. Besides these fiscal concerns, some investors are worried that the new Prime Minister is pushing back on corporate governance reforms which were seen to benefit shareholders and have helped the Japanese stock market to perform well so far this year. We might separately note Federal Reserve intervention in supporting the weak Yen first time in 10 years.

If we can sum up this part of the review encompassing the bond market, there is little doubt that the countries we have particularly mentioned, with the exception of Germany, have elevated debt levels both in relation to their budget deficits and their outstanding level of public debt. We have also stated that the best way to start to correct the position is for the country in question to register a satisfactory rate of economic growth which can help to raise tax revenues and reduce or at least stabilise public spending. That should be a fairly uncontentious statement. We have suggested that supply side reforms are an important step in achieving this desired aim. These are a more contentious issue because they have political overtones but we are looking at it in purely economic terms. A good template might be the type of reforms which Germany is proposing and which we outlined earlier. Although Germany's debt position is worsening, it still has one of the strongest credit ratings so the measures which the coalition proposes are taken because of economic weakness, particularly in the manufacturing sector. It faces significant challenges, including from China, and because of high energy costs. Of the economies with elevated debt levels, we can say that supply side measures are apparent in the USA and Japan, to some degree, although in the USA tariffs operate with the opposite effect because they introduce inefficiencies into the US economy which act as a drag on growth. But on the supply side measures which include tax and regulation changes, both countries have acted or sent out a good signal. The general conclusion is that both countries are moving in the right direction as far as stimulating growth is concerned which might help to fend off a crisis in the bond market if economic growth is seen as the best way of escaping from fiscal problems. However, their debt problems are very severe and the markets might force both countries to take action. It is not possible to be as sanguine about the UK and France. Hardly any supply side measures are being taken, in fact the movement is in the opposite direction. So it would be hard to find measures which stimulate Lord Keynes' "animal spirits" in business, as the combination of tax and regulation becomes more difficult for companies to deal with. Coming back to the bond market, what this means is that the economic growth which is necessary to make a dent in the UK's and France's budget deficits is likely to be more elusive. Realistically, it is not possible to see supply side reforms being introduced in either of these two countries, rather the opposite. These are the reasons why we find the bond markets unattractive at present. We mentioned Italy earlier and it is instructive that the country's ten year government bond yields have crept up above those of France. Its outstanding public debt as a percentage of GDP is around 139% although its budget deficit is not as high as those of France and the UK. Italy has benefited from perceived political stability under Prime Minister Meloni but it looks as if that benefit is wearing off. As ever, like France, Italy's debt issues are concerns for the eurozone.

From here, we can move to the current geopolitical and economic situation. As this is written, the position in the Strait of Hormuz, in particular, and Iran, in general, remains as uncertain as ever. In the stock market, for instance, this is manifested in the fluctuation in the price of oil shares, itself a function of daily movements in oil prices. Amongst the many worries for investors is that the oil price will spike sharply higher and remain elevated. The downward trend of official interest rates has also been halted and started to be reversed, notably in the eurozone and Norway as well as Australia. If the oil price and other oil based goods cause consumer prices to rise, then we can also expect bond yields to rise on the back of official increases in interest rates. These variables make economic forecasting very difficult and subject to regular revisions but it is nevertheless instructive to consider the IMF's latest forecasts published in June. Compared with its April forecast, the IMF sees no change in its 2.3% growth forecast for the USA in 2026 but it raised its 2027 forecast by a very small 0.1% to 2.2%. Its world growth forecast for 2026 is 3.0%, down 0.1% from its April, forecast whilst its 2027 forecast is 3.4% which represents a rise of 0.2% since its April forecast. But elsewhere amongst the G7, the forecasts are not as strong as they are for the USA. For the euro area, it now forecasts growth of 0.9% this year which is a reduction of 0.2% from April. Its 2027 forecast of 1.2% remains unchanged. Within the eurozone, Spain is the stand out performer with growth forecast for 2026 and 2027 respectively at 2.1% and 1.8% but, elsewhere, the three largest eurozone economies Germany, France and Italy are all forecast to grow by less than 1% this year, the figures being 0.7%, 0.6% and 0.5% respectively. The forecasts for Germany and France were downgrades on the IMF's April forecasts. Next year, the respective forecasts are 1.0%, 0.9% and 0.5%, the only downgrade being for Germany. For the UK, the IMF forecasts growth this year of 1.0% and 1.3% in 2027, the forecast for 2026 being 0.3% higher than its April forecast. Going back to our analysis of the position regarding bonds and excluding Germany because of its much stronger financial position these very low growth expectations show why it is going to be difficult for the UK, France and Italy to escape from their fiscal problems because, if the forecasts are anywhere near correct, their economic growth rates will not be good enough to arrest the increase in their overall level of indebtedness. Japan, too, although in a different position because of its large domestic holdings of Japanese government debt, is not expected to grow sufficiently to make a dent into its debt levels with the IMF forecasting respective growth rates for 2026 and 2027 of 0.6% and 0.7%. Emerging Markets and Developing Economies are forecast to grow 3.8% in 2026 and 4.5% in 2027 and, within that, India is expected to lead the way with expectations of 6.4% and 6.7% and China with 4.6% and 4.1%. All these forecasts can be upended by a further deterioration in the geopolitical situation with a prolonged rise in the oil price and/or a supply shortage threatening these growth forecasts which themselves are modest.

It is these forecasts and potential threats to bond markets which make it important to validate one's investment stance by looking ahead to the day (for believers) that AI will be a transformative influence on the world economy. We have tried to show in this review how potentially serious the over indebtedness of some important countries is in terms of the economic consequences of a loss of investors confidence. It is also apparent that there is little appetite for decisive action to address the problem in the countries which we have particularly highlighted. With the bond markets unsettled by current events in the Middle East resulting in bond yields rising, the current situation is unsettling. But while we are allowing some cash in client portfolios to build up through income receipts, this is not a main asset allocation choice. As we have tried to show, we feel that fixed interest securities have very little attraction and that whilst there are some negative points about equities, there are also some positive ones. We have emphasised the attraction of supply side measures and have not talked about other positive aspects including large share buy backs and strong earnings growth in some countries, including the USA, all of which have been important factors in the markets' strength, particularly in the USA.

So, if equities remain our favoured asset class, where would be our favoured areas? That really follows on from the theme of our review. The USA, obviously, has a lot going for it as well as negative issues, mainly surrounding tariffs and the consequences of its very poor fiscal position but, at the moment, that looks like an issue for another day. We also need to be aware that political changes may not be as favourable for investors as they have been in recent times. Whilst we haven't concentrated on Asia in this review, apart from Japan, a number of the countries are benefiting from the AI boom and there is a strong pro business culture in some of the countries in the region. Caution is in order in the UK and Continental Europe. They have difficult economic and fiscal problems and not every country will follow Germany's lead in trying to introduce some supply side reforms to try to kick start the economy. The UK, France and Italy are the countries to watch here. But what type of stock is suitable to be held in current circumstances? Given that none of us has a crystal ball, it is sensible to diversify by type of style i.e. some growth stocks and some value stocks. Whilst the money spent on AI has helped to drive economic growth in the USA, the performance of the US market this year has been very interesting and makes the above point. At the end of July, the year to date performance in total return terms of the "Magnificent 7" stocks were as follows: Apple +13.8%, Microsoft -3.5%, Amazon +17.7%, Alphabet A +13.9%, Nvidia +7.8% Tesla -30.8% and Meta Platforms -15.5%. The S&P 500 showed a total return of +10.1% and the S&P 500 Equal Weighted Index returned +13.3%. The S&P 500 is, of course, heavily influenced by the performance of the "Magnificent 7" and their mixed performance so far this year, as shown by the above movements, is the reason why the S&P 500 has underperformed the S&P 500 Equal Weighted Index which comprises many value stocks. So fashions in the investment world change which is why it is sensible to mix the styles. We have witnessed some very violent movements in share prices this year and this is a reason for short term caution. We must realistically expect some negative quarters after a strong performance so far this year but these would be against the background of expected further long term appreciation in share prices in our view plausibly driven by productivity and economic growth improvements which could result from the benefits of AI.