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ASSET MANAGEMENT (C.I.) LIMITED

INVESTMENT MEMORANDUM

A standstill quarter for equities means that the gains so far this year in international markets have been consolidated. Market leadership rotation is a notable current feature with defensive out of favour stocks having their moment as some AI related companies' shares have suffered significant setbacks. Bonds remain out of favour due to inflation and concerns about a number of countries' serious fiscal issues.

The tables below detail relevant movements in markets :

International Equities 31.07.26 - 30.10.26

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	+0.5	+1.2	+0.7	+3.8
Finland	-0.9	-3.4	-3.8	-0.9
France	-5.9	-8.3	-8.7	-5.9
Germany	+1.1	-1.5	-1.9	+1.1
Hong Kong	-4.6	-4.2	-4.6	-1.7
Italy	-5.3	-7.7	-8.1	-5.3
Japan	-0.6	+0.9	+0.5	+3.6
Netherlands	-1.7	-4.2	-4.6	-1.7
Spain	-5.4	-7.8	-8.2	-5.4
Switzerland	+3.2	+2.0	+1.5	+4.6
UK	-0.4	-0.4	-0.8	+2.2
USA	+1.5	+1.9	+1.5	+4.6
All World Europe ex UK	-1.1	-3.3	-3.7	-0.8
All World Asia Pacific ex Japan	-5.7	-4.2	-4.7	-1.7
All World Asia Pacific	-4.1	-2.6	-3.1	-0.1
All World Latin America	-1.5	-7.3	-7.7	-4.9
All World Emerging Markets	-4.2	-4.6	-5.0	-2.1
All World	N/C	+0.3	-0.1	+2.9

Source : FTSE All World Indices

FTSE Actuaries UK Conventional Gilts All Stocks Index (total return) : +0.5%

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

	31.07.26	30.10.26
Sterling	5.05	5.28
US Dollar	4.69	4.91
Yen	2.80	2.76
Germany (Euro)	3.15	3.32

Sterling's performance during the quarter ending 30.10.26 (%)

	Quarter Ending 30.10.26
US Dollar	-0.7
Canadian Dollar	-1.0
Yen	-0.6
Euro	+2.6
Swiss Franc	+1.5
Australian Dollar	-0.9

Other currency movements during the quarter ending 30.10.26 (%)

	Quarter Ending 30.10.26
US Dollar / Canadian Dollar	-0.3
US Dollar / Yen	+0.1
US Dollar / Euro	+3.2
Swiss Franc / Euro	+1.1
Euro / Yen	-3.1

Significant Commodities (US dollar terms) 31.07.26 - 30.10.26 (%)

	Quarter Ending 30.10.26
Oil	+30.9
Gold	-3.8

MARKETS

- Little change over the quarter in international equity markets. In local currency terms, the USA showed an above average performance but there was weakness in the Asian markets.

- In sterling terms, the USA and Australia were relatively strong markets although in absolute terms the rise was not substantial. Following the Brazilian election result, Latin America was a poor performer in sterling terms and the Brazilian currency weakened sharply. Europe ex UK also underperformed as the euro moved lower.

- Fixed interest markets were generally weaker. We comment about the eurozone's issues in this review.

- Ongoing problems in the Middle East meant a sharp rise in the oil price.

ECONOMICS

Often in investments, it is as important to discuss asset classes which one does not own as it is to discuss those which one does. As our clients know, we have not favoured fixed interest securities for a very long time with our strong preference being for equities. Many investment mandates require bonds to be held so in those cases there is not the flexibility which managers of unconstrained portfolios have and we are mostly in this fortunate position. The results are startling. If we go back 20 years and compare the performance of the Bloomberg Global Aggregate Total Return Index unhedged in US dollar terms with the FTSE All World Index, also in US dollar terms, the respective returns were about 53% and 420%. For 15 years, the respective returns are 10% and 409%, for 10 years 5% and 235% and, for 5 years, -7% and 65%. So, it has really been no contest between the two asset classes in terms of investment returns.

In many of our reviews, we have discussed the prospects for bonds in some depth but clients might wonder why we have spent so much time doing this when we have little or no exposure in unconstrained portfolios. The obvious one is that it is the major alternative asset class which we could hold so it's relevant to discuss it. Less obviously is that a negative case for one asset class can make the case for another even if it is on a relative basis, given that staying in cash as a main asset class, as opposed to being held opportunistically, is not a serious long term investment strategy. At times, the case for equities has been clear, at others less so, but we have given them the benefit of the doubt because other main asset classes were, in our view, clearly unattractive. This may be such a time. As we said in last month's review, economics guides our thinking and this is as important as ever in the current situation. One other issue which we discussed at length in the past, but not so much recently, is the euro but this has now become a live issue because of what is going on in the eurozone bond markets and this is where we want to start this month's review.

Our negative view on the fixed interest market has been predicated on the alarming increase in indebtedness seen in many countries and we have particularly discussed the main ones, the USA, France, Italy, the UK and Japan, but we could mention others and just now the eye of the storm is represented by the French Government bond market. France is in the news for the wrong reasons at the moment, namely the violent riots and protests which have been taking place in a number of cities. France's fiscal position is extremely serious both in relation to the size of its budget deficit and its overall level of indebtedness. The budget deficit this year is expected to be around 5.4% of GDP with

slow economic growth and higher interest costs contributing to the larger than planned budget deficit. To put the overall indebtedness into context, the absolute level of French public debt is around €3.5 trillion representing close to 120% of GDP, a dangerously high level. Quoting comparatives shows the seriousness of the problem. France pays more for its debt, and let's just take the ten year government bond market, than Italy and Greece and the gap between French and German ten year government bond yields at the time of writing now stands at over 1.6%. The gap with Italian government bond yields is about 0.48% (and Italy has a higher level of indebtedness at around 140% of GDP) and with Greece about 0.70% (149% of GDP). Furthermore, the depths to which French sovereign debt has fallen is shown by the fact that, according to a Bloomberg report on the 8th October, nearly €215 billion of France's corporate bonds now trade at yields below those on French government bonds, representing 38% of France's total pool of high grade company debt. It is not only the serious state of France's finances which has pushed up yields, it is also the inflationary consequences of the Iran war leading to expectations of more central bank interest rate increases. But the sharp rise in French borrowing costs has increased the relative burdens on countries like Italy and Greece. It is noticeable that, whilst the blow out in French government bond yields has been the greatest (99 basis points in the last three months), the second and third largest increases have occurred in Italy (51 basis points) and Greece (41 basis points). So, there is clearly a contagion risk to which we will return.

In the case of France, the political aspect is central to France's debt market problems. The result of the French legislative elections in 2024 was a disaster for the bond markets in that the ability to tackle the country's fiscal weakness was severely damaged because of the loss of seats for the more economically orthodox parties. Just one example is having to give in to pressure to row back on the planned increase in the pension age to 64. With France's history of social protest, governments have often had to back down in the face of these so it is very difficult to see any progress being made on addressing the fiscal crisis. Part of the stop gap measures to try to stabilise the position involves maintaining a special additional tax on large French companies and added burdens on the wealthy, not a good message to send out about the investment attraction of a country. So far this year, the French equity market has displayed significant relative weakness and the poor messaging coming out of the country will have contributed to this. We emphasised in last month's review that the best way to improve the fiscal position of a country is to try to stimulate economic growth, thereby improving the tax take and saving some costs in social security expenditure, such as unemployment benefit as numbers of those unemployed fall. The messaging in words and actions needs to be positive and essentially pro business and pro investor but in France, and elsewhere, nearly all the measures taken militate against this. It is easier to tax large companies rather than enact the necessary measures on public spending but this has an economic cost. A side note and contributing to the unease about French government bonds is the proposal of one of the leading candidates for the French Presidency, Jean-Luc Mélenchon, to cancel or freeze up to €600 billion of French government debt held by the Bank of France and the ECB. While it is hard to see this happening, proposals like this spark more unease as they put into doubt the country's creditworthiness.

As it stands, the position for France looks extremely serious. We have often written in the past that the bond market is the investor's best friend in that only it can force governments to take action necessary to start to repair a country's finances. A rise in interest rates, as we are seeing in France at the moment, because of concerns about its debt levels, could lead to difficulties obtaining new loans whilst other investors sell its bonds because of the perceived risk in holding them. So, if France is unable to enact credible measures to start on the task of repairing its finances, what happens next?

It is here that we want to come back to the question of the euro. In reviews written in the past, we discussed the underpinning for the euro which we argued was a political construct and not an optimal currency area by which we meant that the countries comprising the eurozone had different economic features. This fact made the convergence of economies, which adoption of the euro was supposed to lead to, very difficult. In fact, as time has gone on, it is clear that they have diverged and this is the problem leaders of eurozone countries now have to face up to as a result of the French bond market

crisis. Not having a central bank which can issue its own currency means that this financial tool has been lost and, importantly, problems for one eurozone member, especially the second largest member, France, cannot be isolated and this is an issue which must be exercising officials at the European Central Bank. Rising interest rates in the eurozone bond market, caused by problems in France, will have a negative effect on the area's growth. In normal circumstances, a country in trouble would be expected to address the problem itself but if it is unable to, as appears to be the case in France, then the ECB has a problem.

Because so much political capital has been sunk into the euro over the years, the ECB will surely do whatever it can to keep the eurozone together but its options all carry difficulties. Many of our clients will remember Mario Draghi, then ECB President, say in 2012 "Within our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough". So, the first question to ask, is does the ECB have to do anything? The answer is most probably "yes". To ignore the red flags flying in the French government bond market is not feasible unless there is some totally unexpected news which suggests a credible plan to tackle the country's finances. The French Presidential election, with the two rounds next April and May, is a long time to wait and, meanwhile, the hiatus goes on. It is fair to say, without being political, that independent commentators do not have a great deal of confidence in the economic policies of at least two of the leading candidates.

How long can the ECB let the present position regarding French governments bonds continue? The spillover effects on other eurozone members' bond yields will be a concern because higher interest rates will affect the area's economic growth rates, as we have suggested above. France's borrowing problems cannot be isolated within the eurozone. So, assuming the problem does not go away or, worse still, becomes bigger, what can the ECB do? Perhaps the lowest profile action could be to reinvest the proceeds of maturing bonds from the Pandemic Emergency Purchase Programmes into French government bonds rather than just let them run off. The point about Mario Draghi's statement in 2012 was that it was a big one which investors could not miss and would therefore be likely to have more impact. In fact, this was what happened at the ECB. The ECB also has the Transmission Protection Instrument (TPI) in reserve. However, this could be problematical. It allows the ECB to buy unlimited quantities of 1 to 10 year public bonds to counter "unwarranted, disorderly market dynamics". However, it is hard to argue that France is following sound macroeconomic and fiscal policies given the size of its budget deficit and inability to obtain parliamentary approval for meaningful measures to deal with the problem. With France facing an Excessive Deficit Procedure, it is hard to see how it could pass the test. However, because of the political capital invested in the euro, one would not bet against a way round this seemingly inescapable hurdle being found.

At this stage, it is relevant to remember that direct ECB financing of a eurozone member's debt is illegal under EU Law. Such an action would involve a eurozone member country issuing debt directly to the ECB. This should be borne in mind when a third mechanism is considered, Outright Monetary Transactions (OMT). This allows the ECB to make unlimited purchases of 1-3 year bonds. However, as one can imagine, this comes with stringent requirements. A formal bailout would have to be requested by France and it would have to agree on very strict conditions, externally managed. Given the propensity in France to use social unrest to try to make governments retract their proposals (for example an increase in the pension age), it is hard to see such an agreement with the ECB being implemented. Also, there would bound to be a strong push back from countries such as Germany which, until recently, has been fiscally conservative and has much stronger finances. So back to the point made earlier about the prohibition on the direct financing of a member country's budget deficits. Whilst TPI and OMT do not represent direct financing, they look very much like it, with the ECB hoovering up bonds in the secondary market and making it easier for a country to issue new debt to investors which would then find its way back to the ECB through the secondary market. These possible short term solutions would face strong pushback within France and, externally, from countries like Germany which would be concerned about the moral hazard. The obvious solution is for France to take the necessary action itself but, in the present political climate, that looks impossible and, depending upon the result of next year's Presidential election, it could get worse. So, this feels like

a pivotal moment for the eurozone. At this stage it is difficult to see the French situation ending well with the problem exacerbated by being in a monetary union and therefore difficult to contain to one country.

Some of the other problem countries like the USA, UK and Japan, do not have that monetary union constraint. They do not appear to be in the same league as those of France. However, their fiscal positions are nevertheless very troublesome.

Looking at the USA firstly, its fiscal position is shockingly bad with the budget deficit level to exceed 6% of GDP 8% including state and local government debt (source IMF) this year and likely to continue at that rate or more into the foreseeable future. Outstanding public debt has reached US$40 trillion, approximately 123% of GDP with federal debt held by the public at around 99% of GDP. What does the USA have in its favour compared with other highly indebted countries? As stated before, being the world's largest reserve currency gives it what is termed an "exorbitant privilege" a phrase coined by the then French Finance Minister, Valéry Giscard d'Estaing, later to become President of France. A lot of institutions, businesses and governments need US dollars for various reasons, more so than for the euro, yen and sterling. The demand for US dollars is always there but the USA faces competition with China pressing hard for its currency to be used more in trade. The USA probably has much better economic growth prospects than other overindebted countries. This is important because, as we have mentioned before, the best way to handle fiscal problems is through economic growth. Compared with other deficit ridden countries, the USA's current generally, but not wholly, pro business and pro investor policies give it an advantage. What this means in terms of halting the growth in outstanding public debt as a percentage of GDP is the relationship between interest rate costs and nominal economic growth, the rate at which an economy generates new income. However, the current budget deficit is so large that this will not save the USA's public debt to GDP ratio continuing to expand and the more US interest rates rise with negative effects on new debt issuance costs, not to mention the effects of refinancing maturing debt, the worse the situation will become. The Congressional Budget Office has some very stark forecasts for the growth in the level of US debt. It measures federal debt held by the public and even this figure is forecast to reach 175% of GDP by 2056. With eye watering debt levels, the risk of a loss of confidence does not need spelling out. Other countries might reduce US dollar holdings in their foreign exchange reserves. We are here particularly thinking of Japan which is the largest holder of US government debt. Japanese investors own US$1.07 trillion of US government debt and, it is estimated, account for roughly 11% to 12% of all foreign owned US Treasuries. Earlier this year, the US intervened in the foreign exchange market to try to support the weak yen by selling euros from its foreign exchange reserves, perhaps out of self preservation. Japanese official and private investors have been attracted to the US Treasury market by the high yields available on US assets relative to Japanese assets but, with Japanese interest rates having risen so sharply, the relative attraction of US Treasuries has lessened. Linked to this is the big danger of an unravelling of the carry trade whereby investors borrowed cheap yen to invest in much higher yielding US assets. As investors unravel these trades, a big threat emerges in the US bond market. So the USA would be faced with not only having to borrow heavily to fund its vast budget deficit, which itself puts pressure on bond yields, but could face further upward pressure from foreign disinvestment, perhaps particularly Japan, as just referenced. Faced with these issues, it is easy to see why US interest rates may rise further. It is hard to find a US politician in either party who is willing to confront the country's fiscal position and, with around 60% of federal expenditure in non discretionary areas, it's a chronic problem. If there were a change of administration at some future date, tax increases would surely be on the agenda but that could impact on economic growth. So, a very difficult position for the USA to be in, although not as bad as the position in France because the latter lacks the USA's pro growth pro investor policies (to set against negative policies like tariffs) which give it a chance of eating into the deficit and holding its leading reserve currency advantage. As stated above, though, the US budget deficit is so large at the moment that even its superior growth prospects will not be enough to halt the rise in the level of outstanding public debt in relation to GDP. As this review is completed the results of the USA's mid term elections are in and we will consider in future reviews the consequences of the change in control in Congress.

Whilst Japan has the highest level of indebtedness of the countries we have discussed so far in this review (different ways of measurement are used but the IMF identifies the figure as 201.4% of GDP), the problem, though significant as one looks at the figures, is probably not as pressing as for France, the USA and UK, as we will mention shortly. A very large part of Japan's public debt is owned within Japan (over 88%) so the danger of a foreign run on Japanese government debt is much less than France, Italy, the USA and UK, and there are others. It is not in any way a cause for complacency, especially with Japan's poor demographics, but a bond market crisis is unlikely to start in Japan.

However, the UK's position is poor, not as bad as France's but a cause for concern, with red flags certainly flying. With a large budget deficit, forecast at 4.2% of GDP expected for this fiscal year and outstanding public debt as a percentage of GDP approaching 100% and outstanding debt now touching £3 trillion, the UK remains vulnerable to a loss of confidence. Whilst the latest IMF growth forecasts offer a glimmer of hope for the UK, the messaging from the UK to businesses and investors has been largely negative. As we have emphasised in this review, the best way to tackle overindebtedness is to try to stimulate economic growth with consequential benefits for tax revenue and control of public spending. When there is a major fiscal problem, as there is in the UK, the choice between cutting public expenditure and raising taxes has to go with the former since increased taxation, particularly at the high levels currently seen in the UK, is an impediment to economic growth. If we look at recent choices in the UK, it has taken the taxation route. Additionally, increased levels of regulation, particularly in the employment market, and the exodus of very high earners and non doms, whether it is justified or not on political grounds, sends a negative message to investors about the UK, in this respect paralleling the messaging from France. There is always a temptation when times are difficult to look to the corporate sector and high earners and the wealthy for more taxation but, economically, this is not a good route to take. Although AI should give some boost to the UK economy, it is difficult to see economic growth being significant enough for the UK economy to escape its current fiscal problems so we find it difficult to be enthusiastic about UK bonds with the risk of higher yields. It is true that the UK with its own currency could theoretically monetise its way out of its current debt problems but, practically, that would be a non starter because all confidence would be lost. After UK budgets which, through heavy tax increases, have hindered the UK economy, the autumn 2026 one was very important for the signal it gave out to investors. Although it was considered as a budget of small measures so as not to upset the bond market, the economic messaging for investors remained negative, with savers, landlords and banks lined up to pay for measures elsewhere. So called windfall taxes, such as contained in the budget on banks, send out a particularly bad signal. In a competitive market, for any government to direct the level of after tax profits reduces the attraction of the sector to investors, raises the cost of capital and is a deterrent to investment. Companies affected by arbitrary windfall taxes will take measures to recover their positions. These measures are not going to assist the UK in escaping from its serious fiscal position through higher economic growth levels. It is fair to say that investors in the UK would have preferred not to see supply side reforms unravelled because of the potential effect on economic growth.

This review has so far concentrated on bonds, an area that features very little in our unconstrained portfolios, and by commenting so far in this review on this sector we have aimed to demonstrate only why that is so. The fiscal position of a number of large economies is serious and there is little evidence of credible attempts to address the weaknesses other than to raise taxes which ultimately makes the necessary economic growth difficult to achieve. Recent events in the bond markets suggest that markets are near a tipping point. Fears of upsetting electorates through unpopular spending cuts does not augur well for the current problems to end well.

Because higher interest rates should be bad for equities why should we not at least reduce our exposure? It would not be flippant to say that the headwinds they are facing are less severe than for bonds, so they win in that respect, and it is not practical, given the long term performance of equities including the more recent performance figures shown at the beginning of this review, to have a very

significant portion of a portfolio in cash as a main asset class as opposed to being held opportunistically. It is also possibly telling that, as we were discussing, a number of French corporate bonds are selling on lower yields than French government bonds. Securities related to highly rated French corporates may be considered better investments and that spills over to their shares and the general attraction of equities. Perhaps there is more confidence in the way that companies run their businesses rather than governments run their countries.

This leads on neatly to the outlook for the world economy, which is the subject of the IMF's Economic Update and highlights its resilience, although distributed unevenly, against the background of the disturbed geopolitical situation. On a global basis, it is forecasting growth of 3.1% for 2026 and 3.4% for 2027, certainly not exciting but acceptable in the circumstances given the wars going on, the elevated oil price and its knock on effects on prices generally and the disruption which it causes to supply chains and the consequences which that has. As is usually the case, Emerging Markets and Developing Economies are outstripping Advanced Economies, with relative growth rates forecast of 3.7% and 2.1% for this year and 4.4% and 1.8% next year. Reflecting on our earlier comment about the US bond market and the advantages which it may enjoy over, say, the UK, eurozone and Japan in terms of the economy's growth prospects, the link being that economic growth can help to improve a country's fiscal position, the IMF's forecasts are relevant. For this year, it sees the USA growing by 2.3% whilst the euro area is expected to grow by 1.1%. Within the latter, it is instructive to notice that France and Italy, two of the countries with the most problematical debt issues, are expected to grow by 0.4% and 0.8% this year, nowhere near enough to move the dial on fiscal deficits. The UK is expected to be one of the better performers this year, growing at 1.3% although the OBR now says 1.0% for 2027, but the other problem country, Japan, is expected to grow by 0.7% this year. Neither of these countries is growing fast enough to improve their fiscal metrics. Next year, the relative position is almost the same for these countries. However, and one reason that equities have performed so well this year so far is that corporate profits are doing well. Earnings per share for members of the S&P 500 index were up 26% over the twelve months to July 2026 driven by AI infrastructure and tech investments. Companies in the STOXX 600 index in Europe are forecasting for earnings to rise 21.9% year on year for Q3 2026. This is helped by strong profits growth in the energy sector. In Japan, the year on year increase to Q2 2026 in recurring profits was 24.6%. These figures are pushing up the "e" in p/e ratios and explain partly why shares have performed so well. It is remarkable how well companies have managed to circumvent the problems caused by supply chain disruptions such as the limited traffic flows through the Strait of Hormuz and the results from the imposition of US tariffs. Of course, as just mentioned, AI has had a very significant effect on economic growth through the heavy investment in data centers. Estimates are that it contributes nearly 0.5% to the US growth rate this year and investment will continue to give the US economy a boost. However, we think that investors are looking beyond the present rather difficult world economic circumstances to the benefits which many expect for the world economy in terms of rising productivity and faster economic growth with the resulting benefits for company profits and dividends. Of course, we can only guess at the benefits and costs of AI but it is not unreasonable to expect positive economic benefits. Companies are already reporting some of these but it is, of course, early days.

So, as we move towards the end of 2026, it is important that no sense of complacency is experienced due to a positive equity market performance over the first ten months of the year because, apart from the wars and the economic fall out from them, the debt position remains serious for many countries. Certainly, in the countries that we have mentioned, there seems no credible way out of the problem given the unwillingness to tackle public spending. The bond markets may have to do governments' dirty work for them.

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