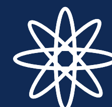

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ASSET MANAGEMENT (C.I.) LIMITED

INVESTMENT MEMORANDUM

There has been very little movement up or down this quarter as equity markets retreated towards the end of the quarter on fears that inflation was becoming embedded in the world economy and that a tightening of monetary policy might come sooner rather than later. Both bond and equity markets became nervous about this prospect as the quarter drew to a close. In the foreign exchange market, sterling was the loser, although movements were not sharp. As the quarter ended, the centre of attention was the sharp rise in energy prices, with the ensuing possible negative economic consequences.

The tables below detail relevant movements in markets :

International Equities 30.06.21 - 30.09.21

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	+1.1	-0.3	-2.7	-0.4
Finland	+1.4	+1.6	-0.9	+1.4
France	+0.5	+0.7	-1.8	+0.5
Germany	-1.9	-1.8	-4.1	-1.9
Hong Kong, China	-10.1	-8.1	-10.3	-8.2
Italy	+1.3	+1.4	-1.1	+1.3
Japan	+5.0	+7.0	+4.4	+6.8
Netherlands	+6.4	+6.6	+4.0	+6.4
Spain	-0.7	-0.6	-3.0	-0.7
Switzerland	-2.1	-0.6	-3.0	-0.7
UK	+1.9	+1.9	-0.5	+1.8
USA	+0.3	+2.7	+0.3	+2.6
All World Europe ex UK	+0.7	+1.1	-1.3	+1.0
All World Asia Pacific ex Japan	-6.3	-5.3	-7.6	-5.4
All World Asia Pacific	-2.6	-1.3	-3.7	-1.4
All World Latin America	-8.0	-12.1	-14.2	-12.2
All World All Emerging Markets	-5.6	-4.3	-6.6	-4.5
All World	-0.2	+1.5	-1.0	+1.3

Source : FTSE All World Indices

FTSE UK Government Securities Index All Stocks (total return) : -1.2%

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

Currency	30.06.21	30.09.21
Sterling	0.72	1.02
US Dollar	1.47	1.49
Yen	0.05	0.07
Germany (Euro)	-0.21	-0.20

Sterling's performance during the quarter ending 30.09.21 (%)

Currency	Quarter Ending 30.09.21
US Dollar	-2.6
Canadian Dollar	-0.3
Yen	-2.3
Euro	-0.2
Swiss Franc	-1.9
Australian Dollar	+1.1

Other currency movements during the quarter ending 30.09.21 (%)

Currency	Quarter Ending 30.09.21
US Dollar / Canadian Dollar	+2.2
US Dollar / Yen	+0.8
US Dollar / Euro	+1.5
Swiss Franc / Euro	+2.4
Euro / Yen	-0.8

Significant Commodities (US dollar terms) 30.06.21 - 30.09.21 (%)

Currency	Quarter Ending 30.09.21
Oil	+5.2
Gold	-1.0

MARKETS

Some turbulence towards the end of the quarter left international equity markets little changed over the quarter either way, with just modest gains and losses. In local currency terms, the FTSE All World Index showed a total return of -0.2%, in sterling terms +1.5%, in U.S. dollar terms -1.0% and in euro terms +1.3%. Looking at local currency returns first, Japan was the stand out performer, with the FTSE Japan Index returning +5.0%. The U.K. also outperformed, with the FTSE U.K. Index returning +1.9%. On the negative side, the FTSE All World Latin America Index returned -8.0%, the FTSE All World Asia Pacific ex Japan Index -6.3% and the FTSE All World All Emerging Markets Index returned -5.6%. However, sterling adjusted returns were mostly boosted by the weakness of sterling over the quarter. Japan remained the strongest performer, with the FTSE Japan Index returning +7.0%. The FTSE U.S.A. Index also showed an above average return, with the FTSE U.S.A. Index returning +2.7%. On the negative side, currency weakness meant that the FTSE All World Latin America Index's negative return increased to -12.1%.

Fixed interest securities also reacted negatively towards the end of the quarter in response to fears about inflation. In our table, this is most noticeably evident in the ten year U.K. government bond where the gross redemption yield rose by 30 basis points to 1.02%. In the other three markets in our table, there was little change, although that masks weakness towards the end of the quarter.

As implied in the comments above about the performance of international equity markets, sterling returns have generally been boosted by the weakness of sterling. In our table, the only currency against which sterling appreciated was the Australian dollar where it rose by 1.1%. Against the U.S. dollar, sterling depreciated by 2.6%, against the yen by 2.3%, against the Swiss Franc by 1.9%, against the Canadian dollar by 0.3% and against the euro by 0.2%.

In the commodity markets, oil, as measured by Brent crude rose by 5.2%, whilst gold was little changed, down by just 1.0%.

ECONOMICS

The mood music is changing on inflation. Central banks, for so long sanguine about the outlook, are beginning to make a subtle shift in their signalling and they are clearly taking the inflationary threat more seriously. Whilst many economists have become increasingly concerned about the rise in inflation, central banks, for the most part, have passed it off as being a transitory effect from the many consequences of the pandemic. The change in sentiment amongst the central bankers has been very noticeable in the last few weeks. In our recent reviews, we have indicated our belief that inflation is an issue which investors will have to consider. As a consumer, one can sense price rises almost everywhere. Once inflation is built into price levels, as at present, it is difficult to contain, and future expectations amongst consumers and businesses for the course of prices can be expected to rise.

As this is written, energy prices are taking centre stage, with a perfect storm in the gas market raising prices sharply. Oil prices are also very firm and these important components of individuals' and companies' costs soon feed through to retail prices, with the knock on effects on other costs related to price indices. There are exceptions, which optimists might draw comfort from, like a fall back in lumber prices and commodities like iron ore, but, to us, these are exceptions. Very high profile expenditure items, such as food, are, like energy, seeing strong price rises and are contributing to the inflationary pressures widely evident throughout the world.

Central banks' until recently relaxed views on inflation were anchored in the belief that the spike in inflation was transitory, caused by supply side difficulties in manufacturing and labour markets which would work themselves out of the system once normality returned. In the manufacturing sector, the shortage of semiconductors is a high profile problem impacting on the manufacture of many finished goods, such as cars, and, where there is a shortage of finished goods, prices will rise. During the early days of the pandemic, demand dipped sharply as businesses and individuals could not spend the money that they normally would have done, so, for prices, it was not generally a major issue that supply was also badly affected. This is a generalisation, of course, as some supply shortages would have pushed up prices, but, overall, it was not an issue. Now, with demand pushing up rapidly, the price effects are becoming evident. Particularly with the "just in time" ordering of supplies of components by manufacturers, industry is very vulnerable to supply shortages and, if companies are not going to be able to produce as many goods as they normally would, they are going to try to exert some pricing power to protect their profits. Anecdotal reports say that, because of a shortage of new cars as a result of the damage to output arising from the semiconductor shortage, some second hand cars are selling for a higher price than new cars. Covid-19 has demonstrated how fragile the supply chain is and the high level of interdependency between companies and countries. Putting sand in the wheel, as Covid-19 has done, upsets the delicate balance. Another example of the effect is freight costs, which have rocketed as ships are out of position. When a major cargo ship becomes stuck in the Suez Canal, as the Ever Given was in March for six days, the knock on effect is significant. According to some estimates, goods worth at least US$1 billion were sitting on the ship pending a resolution of the issue in July with Egypt. It is in the employment market, too, that problems have been felt keenly. For whatever reason, many firms, and the hospitality industry comes to mind, have found it difficult to recruit staff and are raising wages, often significantly, to try to recruit. It may seem counterintuitive at a time when so many people lost their jobs or were furloughed that there should be a labour shortage, but that is the case. Nearer home, the shortage of HGV drivers is a case in point. One way or another, issues like those which we have just discussed are contributing to the spike in inflation which we are now seeing.

However, as mentioned above, not everyone is pessimistic about the inflation outlook, the OECD, for example, which has just published its Interim Report. Before looking at its individual country forecasts, it is worth noting its views on the inflation outlook. It refers to the obvious drivers of inflation at present, which we have mentioned above, namely oil, metals (although some, like iron ore and copper, have fallen back in price), food and shipping costs. The OECD highlights the point that the inflation outlook varies with sharp rises in the USA and some emerging markets but relatively low elsewhere, particularly in Europe. The OECD's view is that inflationary pressures should eventually fade. Its reasoning is that, once bottlenecks are resolved, price increases in durable goods should ease quickly. It recognises sizeable pay increases in sectors like transportation, leisure and hospitality, but it points to overall moderate wage pressure.

One of the worst economic states to be in is "stagflation" where inflation is accompanied by a stagnating economic background. No growth and inflation is a toxic mixture. At the moment, this does not look likely, but this cannot be ruled out if inflation gets out of hand and stifles growth. The OECD growth projections for this year and next do not suggest this and certainly current inflation figures are not bad enough to suggest serious damage to growth, but it must be emphasised that this is how it looks now and things can change. For 2021, the OECD sees world growth at 5.7% and for next year at 4.5%. Looking at the G7 countries, the OECD is projecting growth at 6.0% for this year and 3.9% for next year. For the eurozone, the figures are 5.3% and 4.6%. Within the eurozone, Germany is projected to grow by 2.9% this year and 4.6% next year, whilst the figures for France are 6.3% and 4.0%, for Italy 5.9% and 4.1% and for Spain 6.8% and 6.6%. Elsewhere in the G7, Japan is expected to grow by 2.5% this year and 2.1% next year, Canada by 5.4% and 4.1% and the U.K. by 6.7% and 5.2%. Elsewhere, China is projected to grow by 8.5% and 5.8% and India by 9.7% and 7.9%. By its next

review, and those of every other forecaster, there will be changes to the economic background and forecasts will have to be adjusted accordingly, but the OECD's current forecasts reflect a good economic recovery which has been taking place. It is possible that the current rise in inflation will cause forecasters to trim their next set of projections. China and India, being such large economies, exert an important influence on the world economy and in recent days it has become apparent that both are facing an energy crunch because of the shortage of coal for their power stations. Their economic forecasts may well have to be cut for the fourth quarter of this year.

Even though the current quarter has been more difficult for investors, particularly at the end, the story is the same, as it has been for many months, namely that monetary policy, in the form of ultra low interest rates and quantitative easing (QE), has been supporting asset prices. Given the onset of the pandemic, which could not have been foreseen, and the consequent dramatic drop in economic activity, the massive monetary and fiscal stimulus had to be administered in order to safeguard the economic structures of countries so that they had the chance to recover as they are now doing. The need to stabilise economies was paramount and it was understandable that consequences down the line could not then be considered, so serious was the position. Now, however, central banks have to consider their next steps.

The problem surrounds the relationship between interest rates and inflation. Normally, one would expect interest rates, whether long or short term, to be higher than the inflation level so that there is a real interest rate, i.e. a positive one after inflation is taken into account. But, with interest rates being at negative or minuscule levels, the risk is of money being borrowed to buy high yielding or potentially higher yielding assets, including property, or, indeed, nil yielding assets like cryptocurrencies, thereby causing an asset bubble and, with that, the danger of a burst and serious financial damage to the economy. All the time that real interest rates are negative, this artificial demand for assets also risks stoking further inflation. With the vast amount of QE and money printing which has been taking place, central bank balance sheets have expanded massively. Since the beginning of 2020, the total assets of the Bank of Japan have risen by approximately 24%, that of the Federal Reserve by approximately 100% and that of the ECB by approximately 80%. By contrast, the total assets of the Chinese central bank have risen by a more modest 12%. Overall, since the beginning of 2020, the total assets of the major central banks have grown by over US$10 trillion. The danger for inflation is that, if these bank reserves get mobilised because businesses and individuals become more optimistic and the velocity of circulation increases, the increased demand for goods and services, when supply cannot keep pace, will be inflationary. This danger continues as central banks continue to engage in QE.

The potential dangers now facing central banks have been apparent for a long time. Central banks cannot directly finance governments, but many people feel that this is what has effectively been happening. Those who buy government bonds in the primary market know that there will be a buyer in the secondary market, i.e. the central banks. There was not really an option in the depth of the crisis, or even in the recovery, but the can cannot be kicked down the road for ever. Whilst inflation was very low, central banks could continue QE with a degree of equanimity, even though a day was bound to come when tough decisions had to be made. We feel that we are near this point and the jitters in the bond and equity markets at the end of the quarter reflect this.

So, against this background of rising inflation, what are the latest signals from the central banks? In the latest statement from the Federal Reserve through the Federal Open Market Committee (FOMC), the Chairman noted that tapering "may soon be warranted". As expected, there was no change in its main interest rate, which remained unchanged at 0% to 0.25%, although there is more support for the view that interest rate increases may start next year rather than in 2023. The Federal Reserve has been buying U.S. government bonds and mortgage backed securities at the rate of US$120 billion a month and, when the right signals come on inflation and employment, it will start to pull back on QE. With inflation where it is, one would think that that target had been met and the Federal Reserve acknowledged movement towards the achievement for its goals. Of the two tools which the Federal Reserve has in its locker to tighten monetary policy, the pull back on QE or interest rate increases, the former is the more low profile method. So, the first monetary policy tightening measure will almost

certainly be a tapering of the amount of assets bought each month. With the foreign appetite for U.S. Treasury bonds seemingly quite strong, the hope would be that this will take up the slack caused by reduced Federal Reserve purchases.

In the eurozone, the ECB, too, is indicating the start of a very gentle change in its monetary policy. At its September meeting, it indicated that, whilst its Asset Purchase Programme (APP) would continue at its monthly rate of €20 billion for as long a necessary, it would take a more flexible attitude towards its Pandemic Emergency Purchase Programme (PEPP). This programme has a potential of €1,850 billion and the ECB said that it would continue to conduct net asset purchases at least until the end of March 2022, but it said that, based on a joint assessment of financing conditions and the inflation outlook, favourable financing conditions can be maintained at a moderately lower pace of net asset purchases than in the previous two quarters. It might use less than the €1,850 billion envelope, as it calls it, or go higher if conditions deteriorate. It describes this scenario as "recalibration". We can see the first indications of the move towards monetary tightening in the eurozone even though it is likely to be behind the USA and UK in making the first policy tightening.

The U.K., too, is signalling a tightening of monetary policy in due course depending upon what happens when the furlough scheme ends at the end of September. For the moment, the main policy rate remains at 0.1% but, in the context of its forecast that inflation will rise above 4% next year, it looks right out of step and the Bank of England admitted that the recent strength of prices strengthens the case for a modest tightening of monetary policy over the next few years. It also dropped its guidance that it would not consider tightening policy until the economy had recovered moderately from the pandemic.

One country where inflation is not a problem is Japan. In fact, the latest year on year figure for inflation is -0.3%. The Bank of Japan aims its QE policy at yield control and flattening the yield curve and, as well as fixed interest securities, it is a large investor in the equity market through significant purchases of exchange traded funds. So, Japan's issues are rather different from those of the U.S.A., U.K. and the eurozone. China is different again, and we will comment about events there later in this review, given the momentous events there.

The course of inflation is critical to markets and the world economy is at a very delicate point now. We detailed earlier how central banks' balance sheets have exploded in size. This dates back to the Global Financial Crisis in 2008, but the rate of increase then was nothing like the expansion since the Covid-19 pandemic began. Since this time, the major central banks' balance sheets have increased by something like US$10.5 trillion, as mentioned earlier. If bank reserves get mobilised and the velocity of circulation increases, the inflationary danger is very significant. It is well nigh impossible that central banks' balance sheets can be shrunk meaningfully in the foreseeable future without causing a recession. If central banks tried to do this and sold back assets to the private sector, interest rates would rise, probably sharply, and risk turning the world economy into recession. So, as it appears at present, the most they appear likely to do is to slow the rate of central bank asset purchases and, later, increase interest rates very gently and hope that inflation eases back from the present spike seen in a number of countries. But, what if the pessimists are correct and inflation does not fall back but, rather, it continues to rise? Then, rather than the lower profile QE tapering, the higher profile monetary policy tightening weapon, interest rate increases, would probably have to be employed, perhaps in tandem with fiscal tightening. The world has become so dependent on printed and cheap money that it is going to be very difficult to wean it off it. Rising interest rates will have serious effects on businesses and individuals as they struggle to service their debt. They will also affect governments, particularly highly borrowed ones, as higher debt servicing costs will widen their budget deficits and send borrowings even higher. This may be a particular issue for the eurozone, where debt servicing problems of some of its very highly indebted members could cause problems for the euro. So, central banks are walking on eggshells, frightened, on one hand, of stopping the economic recovery if they tighten too much but equally or probably more, frightened of allowing inflation to take a grip and having to resort to tough measures to bring it back in line with targets.

So far, we have only mentioned fiscal policy in passing because most attention is being placed on monetary policy, but it is important to mention what is happening in the U.K. and U.S.A., with the latter particularly relevant. In the U.K., the government is perhaps ahead of the pack in announcing tax increases for individuals and businesses as it seeks to restore some sort of order to public finances and it has recently announced that it is to raise National Insurance contributions to help to fund long term care. Fiscal tightening is a necessary action to create international confidence in an economy, given the damage that the pandemic has inflicted on countries' finances. It has to be dome carefully, however.

The situation in the U.S.A. is somewhat different. Whereas, for a centre-right government in the U.K., tax rises are not what they would normally want to impose in the U.S.A., President Biden's proposed tax increases for businesses and wealthy individuals do not represent an ideological problem as they are to fund social programmes. That, of course, is a political issue, but the economic effects of much increased government expenditure on an already heavily indebted and fast recovering economy are worth considering.

President Biden's US$3.5 trillion programme for bolstering social spending over ten years comes on top of an economy which, as the OECD forecasts at the beginning of this review suggest, is recovering sharply this year and is expected to continue to grow at an above average rate next year. The U.S.A., according to forecasts by the Economist Intelligence Unit, is expected to show a budget deficit of 12.6% of GDP this year. It would normally be considered economically risky to put more stimulus into an economy which is growing strongly and where inflation is at current levels, 5.3%. This is planned to be funded by raising taxes on wealthy individuals and corporations, which might be expected to have a negative effect on growth. Whether this will go through is another matter, given the opposition of a small number of Democrat Senators in the evenly divided Senate. This is not to make a comment on the plans themselves, but rather on the macroeconomic effects which would be expected to cause overheating and to stoke inflation. As this is written, there is a split with the Democrats and it is not clear what will be the eventual outcome.

Finally, we should turn to events in China. In economic terms, the energy crisis in China, which is affecting output, threatens to have a knock on effect on the world economy. In some areas, output is having to be curtailed because of the energy shortages and a shortage of coal for power stations. Growth forecasts for China and elsewhere may have to be trimmed. The crisis at the real estate company, Evergrande, is spooking markets as it threatens losses for banks and investors. The authorities have been trying to clamp down on property prices and the real estate market, concerned about the knock on effects on the financial sector. As well as the two short term issues for the Chinese economy, the ever growing control of the state as it targets its goal of "common prosperity" has had a deeply unsettling effect on investors as large sums have been lost as the government announces more restrictions and gives more orders. Whereas shareholders own companies and have control on how they are run, in China investors are coming a long way down the chain as companies are expected to execute the government's policies. As a result of these measures, many shareholders are risking heavy stock market losses. With China's expansionary moves, geopolitical tensions and risks are increasing, with its ambitions for Taiwan a cause for concern. So, there are political and economic reasons why the area is unsettled.

Whilst equities remain our favoured asset class, with the negative interpretation in support of them being that other assets are worse, there remains a more positive case, namely that the world economy continues to recover, as do corporate profits. Shareholders' returns are rising through increased dividends and through share buybacks. Those companies which have pricing power should represent a good hedge against the risk of inflation accelerating, although some companies will find it difficult to pass on costs. There is no doubt, however, that, as we move into the final quarter, uncertainty arising from inflation, interest rates and China, not to mention U.S. spending plans, is making markets

more nervous. So, we would expect more volatility this coming quarter, but, with shares likely to remain the best long term investment. Trying to finesse dips in the market risks an expensive opportunity cost when they move ahead again if excessive cash is held. So, our view that an international spread of high quality equities remains the most appropriate investment policy remains, but we do expect periods of heightened nervousness and volatility as the inflation outlook unfolds and, with that, implications for interest rates, the low level of which has driven up asset prices, including, of course, equities. Even since this review began to be written, earlier rather than later tightening of monetary policy now seems more likely. Whilst this latest quarter has meant that the gains of the first half of the year have been mainly held, give or take a little, some negative quarters must be expected. In our view, this does not justify a change in policy, given longer term prospects for equities and the deeply unattractive level of fixed interest yields.

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