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ASSET MANAGEMENT (C.I.) LIMITED

INVESTMENT MEMORANDUM

Against a background which remains unsettled, markets have shown quite impressive resilience. Even renewed problems in certain areas of the U.S. banking sector failed to have more than a temporary effect on markets, at least until the end of April. Movements in bond markets were mixed. In the foreign exchange markets, there were some significant movements over the quarter. In the commodities market, oil performed surprisingly weakly in the light of OPEC output cuts.

The tables below detail relevant movements in markets :

International Equities 31.01.23 - 28.04.23

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	-1.2	-9.2	-7.3	-8.8
Finland	-2.2	-2.6	-0.5	-2.2
France	+6.4	+6.0	+8.2	+6.4
Germany	+4.0	+3.5	+5.7	+4.0
Hong Kong, China	-4.8	-6.9	-6.9	-6.5
Italy	+4.6	+4.2	+6.3	+4.6
Japan	+5.6	-1.3	+0.8	-0.8
Netherlands	-1.5	-1.9	+0.2	-1.5
Spain	+4.8	+4.4	+6.6	+4.8
Switzerland	+4.3	+5.5	+7.7	+5.9
UK	+2.8	+2.8	+5.0	+3.3
USA	+2.5	+0.4	+2.5	+0.8
All World Europe ex UK	+4.4	+4.2	+6.3	+4.6
All World Asia Pacific ex Japan	-3.3	-7.6	-5.7	-7.2
All World Asia Pacific	-0.4	-5.6	-3.6	-5.2
All World Latin America	-4.8	-4.6	-2.6	-4.2
All World All Emerging Markets	-4.2	-6.6	-4.7	-6.2
All World	+2.0	-0.4	+1.7	+0.1

Source : FTSE All World Indices

FTSE UK Government Securities Index All Stocks (total return) : -2.2%

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

Currency	31.01.23	28.04.23
Sterling	3.33	3.71
US Dollar	3.51	3.42
Yen	0.49	0.38
Germany (Euro)	2.28	2.31

Sterling's performance during the quarter ending 28.04.23 (%)

Currency	Quarter Ending 28.04.23
US Dollar	+2.1
Canadian Dollar	+3.9
Yen	+7.0
Euro	+0.6
Swiss Franc	-0.4
Australian Dollar	+8.8

Other currency movements during the quarter ending 28.04.23 (%)

Currency	Quarter Ending 28.04.23
US Dollar / Canadian Dollar	+1.7
US Dollar / Yen	+4.7
US Dollar / Euro	-1.4
Swiss Franc / Euro	+1.1
Euro / Yen	+6.2

Significant Commodities (US dollar terms) 31.01.23 - 28.04.23 (%)

Currency	Quarter Ending 28.04.23
Oil	-5.8
Gold	+3.2

MARKETS

It has been a quarter of little change in international equity markets. After the shock of three US bank collapses, markets recovered their poise towards the end of the quarter. In local currency terms, the FTSE All World Index returned +2.0%, in sterling terms -0.4%, in US dollar terms +1.7% and, in euro terms, +0.1%. Looking at local currency returns firstly, the best returns came from the FTSE Japan Index, +5.6%, and the FTSE All World Europe ex UK Index, +4.4%. The FTSE UK Index returned +2.8% and the FTSE SA Index +2.5%, both higher than the return on the FTSE All World Index. At the other end of the scale were the FTSE All World Latin American Index, -4.8%, and the FTSE All World Emerging Markets Index, -4.2%. In sterling terms, the picture changes. The strongest areas were the FTSE All World Europe ex UK Index, +4.2%, and the FTSE UK Index, +2.8%, whilst the FTSE All World Asia Pacific ex Japan Index, -7.6%, the FTSE All World Asia Pacific Index, -5.6%, all underperformed. So did the FTSE Australia Index, -9.2%, and the FTSE Japan Index, -1.3%, both affected by currency weakness.

In government bond markets, as measured by ten year government benchmark bond yields, the experience was mixed. In the UK and Germany, gross redemption yields rose, although only modestly in the case of Germany. In the UK, the gross redemption yield rose by 38 basis points to 3.71% and, in Germany, by 3 basis points to 2.31%. In the USA, the gross redemption yield on the US Treasury bond fell by 9 basis points to 3.42% and on the Japanese Government Bond by 11 basis points to 0.38%.

The feature of the foreign exchange markets was the strength of sterling and the Swiss Franc. Against the Australian dollar, it rose by 8.8%, against the yen by 7.0%, against the Canadian dollar by 3.9%, against the US dollar by 2.1% and against the euro by 0.6%. Only against the Swiss Franc did it weaken, falling by 0.4%.

In the commodities market, oil, as measured by Brent crude, fell by 5.8%, whilst gold remained strong, rising by 3.2%.

ECONOMICS

Writing this economic memorandum means starting with a blank piece of paper and with an unencumbered mandate to consider developments in the world, economic and other, and what impact those events might have on the world of investment. The subject area is, not surprisingly, broad and this piece could head off in any number of different directions. As such, an infinite number of economists sitting at an infinite number of typewriters would come up with an infinite set of points with differing conclusions with the accent there being very much on the word ‘differing’. That implies that there is an absence of science in the subject, or perhaps it is just a reminder that it is the complexity of the subject matter that leads to so much uncertainty around, for example, economic forecasting. Much like predicting the weather in three weeks’ time or other examples where chaos theory can be applied, the realm of economics can be referred to as a non-deterministic system where the same, or similar, inputs, do not produce the same outcome. Equally, it can be the absence of inputs which influences outcomes, something that complicates the picture further and, also, imperfect decisions are often made because of self-interest, political compromise or simple human error. The caveat at the start of this economic memorandum is that in all probability, errors and omissions are included!

Continuing in the vein of science, knowledge and outcome are qualified by evidential reasoning. If a ball is dropped, will it fall down or rise up? Science tells us it will fall and philosophy questions why it shouldn't rise. The relatively young study, or science, of economics does not have the luxury of evidential reasoning as history offers situations which are similar but unalike. Looking at the two most recent one-in-a-hundred year events, the Great Financial Crisis [GFC] and COVID-19, banking crises had occurred before on numerous occasions and global pandemics are not without precedent. One enduring consequence of the GFC was the decision to, and need for, quantitative easing where demand in the world economy was stimulated by the creation of what until that point were unimaginable amounts of money, leading central banks around the world collectively to grow their balance sheets from under $4 trillion in 2007 to a peak of over $15 trillion by 2018. Those new dollars, yen, euros, pounds and other currencies were pushed out into the real economy creating a wealth effect. Jersey, it will be remembered by local readers, went one stage further and offered 'helicopter money' where everyone on the island was gifted £100 on the proviso that it should be spent locally. Jersey was not alone in employing this reverse taxation measure and the United States twice enacted such 'helicopter drops' in 2020. The balance sheets of central banks took another incremental leap in 2020 to deal with the sudden impact of COVID-19 and whereas the measure of their assets was $15 trillion in 2018, it was over $26 trillion by the end of 2022. There has been some normalisation since then but the total still remains comfortably over $20 trillion. We remain in completely new territory and the last 15 years has, in economic terms, taken the world to a new place where it is known that certain policy decisions will have effects that could be restrictive or expansive but less easy to discern is how effective they will be and in what time scale.

What effects this unmatched experiment in quantitative easing would have was never completely understood and it is appropriate that one of the architects and sponsors of the policy, Ben Bernanke, Chairman of the US Federal Reserve at the key period of 2006 to 2014 offered a now famous quip on the subject when he was asked specifically whether this policy of central banks buying bonds, with the goal of driving down long term interest rates, to facilitate stimulatory lending when short term interest rates were already around zero would work. His answer was "The problem with QE is that it works in practice, but it doesn't work in theory". A gloriously unscientific response. He had the luxury of cracking that joke in 2014 comfortable in the knowledge that it was what hadn't happened as a consequence of the policy decision that was important. Few doubted that the measures taken through quantitative easing, interest rate cutting and bank rescues had contributed greatly to avoiding a catastrophic recession.

The uncertainty of today's economic landscape centres on one indicator that, with no pun intended, has grown in everyone's awareness, namely inflation. Post-2009 as the banking sector stabilised but remained damaged, the fear of the return of inflation remained just that. Inflation remained at very low levels and, indeed, at certain points in the following decade the even more dangerous risk of deflation emerged, though never threatened. If we call the times we are now in as post-COVID, the sum of policy decisions as a consequence of the GFC, with the supply side issues created by economic shut down and the deferred spending that went with it, meant the inflation genie was forced out of the bottle, against a background of artillery fire in Ukraine and the economic effects that the war has had on commodity markets. Displaced markets, uneven demand, recovering supply of goods and inflationary re-pricing means that the job of understanding what will happen next is exceedingly difficult.

Looking at the United Kingdom, April has been a month where strikes have been a reminder that inflation has raised issues about, in economic terms, the cost of labour. Inflation to those most affected by price rises is not about the cost of labour but the cost of living. To policy setters the risk of pay rises is that it fuels higher demand which becomes self-feeding in inflationary terms but this highlights an economic paradox that what is best for the economy may not be best for those living in it, in the short term at least, which, inevitably, leads to the door of 10 and 11 Downing Street. The government's response to those public sector workers that are striking is that the pay demands are unaffordable and this is backed up by a glance at the pressures on the government's accounts with the country more indebted than ever before and with a budget deficit of 5.5% of GDP. There are only two ways, which are not mutually exclusive, to improve the current position and that is for the government to stimulate growth in the economy and/or to spend less. The Chancellor must, of course, consider these goals in terms of tax policy. Therein lie decisions around the distribution of the tax burden and the overall amount raised, allowing for the effect it will have on economic output.

In April, Nigel Lawson died. His legacy is entwined with Margaret Thatcher's and he will be remembered as the Chancellor who championed privatisation of the government's estate and reductions in the burden of taxation. The long tail of the GFC and COVID have put the country in a position where the policy options available to the government are more limited than they were in 1983 when Lawson moved into Downing Street and the level of indebtedness has also changed since 2010 – and not for the better – when the outgoing Chief Secretary to the Treasury left a note for his successor saying simply "I'm afraid there is no money." These are difficult times to be in power and any focus here on the position in the United Kingdom should not lead to the impression that the economic landscape is far rosier in other similar economies.

Inflation continues to be public enemy number one for consumers who fear eroded spending power, for central bankers whose obligation is to raise interest rates beyond where they might wish to and for economists who fear that unbottled genie. Politicians share a fear of all of the above. Markets continue to search for signs that peak inflation, and closely correlated peak interest rates are near and the reaction to good, or bad news is noteworthy. On 14th April the President of the Atlanta Federal Reserve observed that one more quarter percentage point interest rate rise could allow the Federal Reserve to end its tightening cycle with some confidence inflation will steadily return to its 2% inflation target. These comments came a day after slowing consumer price inflation made the central bank's job easier. The dollar fell and equity markets and bond markets rose. Similarly, hawkish comments caused the reverse on other occasion.

The OECD's Economic Outlook report, released in March, was titled 'A Fragile Recovery', citing recent signs of improvements but still with only moderate recovery over the next two years. It also mentions concerns about financial vulnerabilities rising and stress in housing markets and low income countries. Higher interest rates and their persistence feed all three but better expectations of GDP growth in China (+5.3%), India (+5.0%) and Indonesia (+4.7%) help raise the world forecast to 2.6%. The United States is forecast to grow at 1.5% and the euro area at 0.8%. The UK is forecast to shrink by 0.2%. The price of a barrel of Brent crude oil has fallen from around $130 in June 2022 to around $72 at the time of writing and the report explains that this is a key factor in the improvement in activity and sentiment, along with reducing food prices. Lower commodity prices and the reopening of China are two more tailwinds.

A news story that has been bubbling for a number of years, but which has been brought to the boil by a combination of factors, not least the upward shift in interest rates, is the finances of the Republic of Italy. The credit rating agency, Moody's, released a statement in April saying that Italy's credit rating is under review and will be re-assessed on 19th May and that the country may be downgraded to non-investment grade, sometimes called junk. Moody's didn't state the likelihood of it happening but it is sure to make the news if it happens. Along with other G8 countries the deterioration in the country's finances has been consistent and higher interest rates mean that the burden of supporting a very high level of debt has increased markedly. This will not make a difference to the European Central Bank's bond buying programme as its debt will remain eligible as long as one rating agency sees the country as investment grade but it does create an unfavourable reference point for investors. Moody's comments that 28 countries have fallen below investment grade in the last 28 years and of those, only 12 have regained that status, taking between 3 and 14 years to do so. Moody's commented that countries that did, underwent "major transformations", including institutional improvements and strengthened government finances. Until now, the market in government bonds, not just in Europe, has been very kind to issuers. Central banks have bought up government bonds in the secondary market which has raised prices, and consequently lowered borrowing costs. If you wish to borrow money, having a buyer of your debt who is insensitive to both the amount they purchase and the rate they receive is very helpful. In this example it is the European Central Bank that has bought

€341 billion of Italian national debt under the Public Sector Purchase Programme For perspective, the ECB has purchased almost €5 trillion of euro-denominated sovereign debt under its longstanding quantitative easing policy but is now reducing this amount by €15 billion per month on a Europe-wide basis, reviewed in June. Italian banks held 6.6% of Italian government bonds in 2022 which represents over 10% of their assets. This presents two types of risk. Relating to the ECB (or more accurately the Banca di Italia), the risk is that the erstwhile buyer of Italian debt is becoming a seller and the second is the falling value of those Italian bonds on the balance sheets of Italy's financial institutions. To draw these together, Italy's ability to service its debt has weakened, a reliable buyer of its bonds is becoming a seller and background interest rates in the eurozone have risen by 3.5 percentage points.

Two countries that can contribute to this narrative are Portugal and Greece. Portugal lost and then in 2017 regained its investment grade status and the news of the upgrade caused its bond yield, relative to Spanish bonds, to fall by 36 basis points on the day. Greece was downgraded to junk in 2010 following the largest sovereign restructuring in history. Debt as a percentage of GDP peaked at just over 200% in 2020 but the country is making strong progress and rating agencies hold the country just below investment grade but with a positive outlook There is a general election on 21st May which will see the introduction of a new proportional representation system and with a favourable outcome, the country may re-join the ranks of investment grade countries. The government has managed to maintain positive primary surplus in most recent years and has restructured its financial sector and is optimistic that its debt level with fall below 160% by the end of 2023. This points to a different direction of travel compared with Italy and this is reflected in current market bond yields. Despite having a slightly lower credit rating Greek 10 year bonds are trading at 4.05% compared with similarly dated Italian bonds which yield 4.15%.

There is always a worry that is top of the list and sometime towards the end of last year inflation overtook COVID as number one. At some point soon, inflation will be seen to have peaked and a new global concern will occupy more of our thoughts than any other. A possible contender is the banking sector.

Currently, the frailties of the banking system remain contained within a few known weak links and regulators and central banks have the benefit of recent experience and the fear of getting it wrong as drivers of decision making. The banks which have failed so far all bear unusual characteristics, which, it would be hoped, is a trait that insulates the majority of regular deposit-taking institutions. Credit Suisse's failure followed a seemingly never-ending series of calamities and poor management of the ensuing mess, Silicon Valley Bank managed its balance sheet very poorly, Signature Bank which had 20% of its deposits in crypto and now First Republic Bank. The latter represented a more significant risk as it is the 14th largest commercial bank. Its target market was affluent entrepreneurs and the well-heeled but suffered eye-watering levels of deposit withdrawals as a large tranche of those depositors had balances over the $250,000 Federal Deposit Insurance Corp. protection limit and, it seems, decided to get their money out. Two thirds of its deposits were uninsured and bank deposits continued to leave despite larger stronger banks such as JPMorgan and Bank of America, amongst others, agreeing to lay off $25 billion of deposits with the bank. The picture was not helped by the fact that top executives of the bank sold millions of dollars of shares in the bank two months before the sharp fall in the share price and the firm also paid family members of its founder millions of dollars in recent years, including for consulting services relating to interest rates and risk. It is often commented that no bank can survive if all of its depositors turn up on the same day and ask for all of their money back. The overseers of the community of banks needs to ensure that this scenario doesn't arise.

If the question of economics as a science needs a good current example then it is worth considering the current health of banks in the United States. What everyone wants to know is what happens next. On one hand banks are better capitalised than ever, the FDIC stands strong behind them and the Federal Reserve is primed to act, should it be necessary. The pessimists will point to the second biggest banking collapse in the country's history, rapidly following two smaller ones in March, rising bad debts and some smaller regional banks reporting deposit outflows with depressed share prices.

There is the primary issue of the safety of leaving deposits with banks and the consequence of how banks' appetite and capacity to lend will be, after the dust settles. A third aspect will be how regulation, particularly of those smaller regional banks, will be introduced, something that is sure to happen and which is likely to act as a brake on the economy. It is easy for the more extreme ends of the range of potential outcomes to add to the pessimist/optimist view but runs on banks are not terribly scientific matters.

Most central banks face a conundrum at this time and this is illustrated by the Federal Reserve's decision on 3rd May. They have one key lever to pull, push or not touch, being their control on interest rates. Nobody imagined they would cut rates, given stubbornly high inflation, leaving a choice of leaving rates where they are or raising them. In the event it raised interest rates by 0.25%. Raising them discourages new borrowing and adds to the cost of existing borrowing (once fixed rates convert to floating rates and hedges run their course), banks tend to make more profit because of this, banks' levels of bad debt are likely to rise and the monumental number of bonds that banks own fall in value as market yields rise. The focus here is on banks because sharp falls in their profitability make depositors jittery. Regulation of banks has stepped up over the years and, in particular, following crises. In America the Glass-Steagall Act was emergency legislation introduced in 1933 which separated commercial banking from investment banking so that regular depositors could be insulated from more speculative activities of banks, linked to markets. It also created the deposit insurance scheme which is still run by the FDIC. In 2010, following the Great Financial Crisis the Dodd-Frank legislation was added to the statute book with a raft of rules requiring banks to hold higher levels of capital, more rigorous stress testing, clearer rules around derivatives and more risk-sharing on securitised assets. Much focus was placed on 'too big to fail' institutions that benefited from their size as counterparts saw them as underwritten by the federal government, and hence a better risk. Events have conspired to force a surge in interest rates and it is smaller regional banks that are feeling the pressure. Perhaps the regulation around the systemically important larger banks has worked and the problem here has been the effect of interest rises on bank assets (holdings of bonds), property development or even the ease with which depositors can withdraw their money via their devices without the inconvenience of queuing at the bank – something Americans might call a home run.

JPMorgan Chase was an adviser to First Republic Bank, then, as mentioned above, was one of the banks that become a depositor and now has become the owner, through a federal auction. JPMorgan has taken on all of the deposits and has agreed a loss-sharing agreement with federal regulators to protect against the worst of potential outcomes. As they start replacing all of the signs above First Republic's entrances, the risks have probably gone away, given JPMorgan's financial heft but the febrile atmosphere remains and, as they say, if you want to look at the health of a country's economy, look at the health of its banks. Some question marks remain on both fronts as interest rates rise, consumer spending power is squeezed and banks mark to market the bonds on their balance sheets.
Rapidly rising interest rates have, inevitably, created higher levels of interest rate risk. Over the past ten years the lending market had become incredibly skewed towards the borrower, conditions created by design. Banks had been encouraged to lend and borrowers had not been able to believe how attractive the terms were. A similar phenomenon was visited upon the bond market with many governments, and even some corporates, being paid to borrow money, rather than being charged for the privilege. The dynamics of the market have changed and those well hedged through fixed rates are better placed than those on variable rates. Bondholders who have to mark to market the value of their bond portfolios are sitting on significant losses having bought them at points of high price/low yield and now valuing them at a time of low price/high yield, speaking relatively. Bank of America was one of the biggest buyers of government-backed bonds and COVID spurred such banks to park deposits that were not being lent, due to the pandemic, in bonds. At the end of September, the bank was sitting on paper losses of $116 billion which, had it forced to sell all of them in the market, would have wiped out 43% of its total equity but by April 2023 this had fallen to around $99 billion. It won't need to sell those bonds and most will mature at par but it's another example where nothing will go wrong unless it does. Banks evolve to operate in the conditions that prevail and changing circumstances create pressures. Such fast changing circumstances create stronger pressures and banks

are having to adapt to far tighter monetary conditions where lending decisions of the past are being re-evaluated and fixed interest securities are not worth nearly the money they were bought for.

Quantitative easing has been described as a huge financial experiment and like all experiments you can only assess the results once it has been completed. The success of the immediate post-GFC has been very widely acknowledged and using the ‘first, put the fire out’ analogy, little thought was given to the reversal process, though clearly if it does more damage than the initial fix then there is a problem. Higher interest rates were being hailed as a good thing for banks as mortgage rates were allowed to rise at a much faster pace than deposit rates, widening their net interest rate margin. Banks now form part of the problem as bad debts rise in direct proportion to the rises in interest rates but, more importantly, those bonds bought when prices were high may now be causing sleepless nights for the finance directors of banks, fretting that they may be forced to sell them in the market rather than holding them to maturity. As long as they don’t start causing sleepless nights for the depositors it won’t be a problem.

2022 was the worst year in living memory for major parts of the bond markets as yields rose and prices fell. Inflation is an enemy of bonds, as it points towards higher interest rates and diminished repayments at maturity, in real terms. We continue to believe that bonds, despite last year’s significant re-pricing, continue to represent unconvincing value and the opportunity that they represent would only come from a significant fall in interest rates. The inflation-adjusted return on cash continues to be unattractive and other asset allocations such as commercial property are facing far higher risks than they have in the past. For some, it would seem strange that we continue to remain loyal to equities, though market support for them is shown over the first four months of the year. The FTSE All-World Index (total return in local currencies) is +8.6%. Equities represent an investment in the future cash flows of businesses and markets are, in more cases than not, looking past the shorter term issues of supply chains, staff shortages and the pernicious effect of inflation. The Consumer Price Index is, more than anything, a measure of rises in the prices of goods and services provided by companies typically held in client portfolios and recently reported results do not point to a collapse in real income for these businesses though the element of change is creating volatility.

This month’s memorandum has not strayed far from the topic of interest rates and inflation. Science is best understood when it considers steady state situations and circumstances where a new stimulus or catalyst is introduced lead to change and a second order rate of change. Economics shares that parallel that long periods of consistent economic data tend to support stable and favourable economic conditions. COVID has been a function of biology and the war in Ukraine has been a function of politics. The rapid rates of change we have seen in inflation and interest rates have created a fast-changing, dynamic situation where the background causal factors are having a changing influence too. Uncertainty always presents challenges and to seek circumstances where uncertainty does not exist is unrealistic. We continue to be confident that clients who have the luxury of being long term investors should continue to look beyond disappointing quarters and keep focus on the long term inflation-adjusted track record of equities.