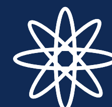

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ASSET MANAGEMENT (C.I.) LIMITED

INVESTMENT MEMORANDUM

International equities drifted very slightly lower over the quarter in contrast to fixed interest securities which fell quite sharply as interest rates continued to rise. Movements in the foreign exchange markets were limited. Gold rose only slightly over the quarter, reflecting the conflicting influences of higher interest rates and geopolitical and economic uncertainty.

The tables below detail relevant movements in markets :

International Equities 30.11.22 - 28.02.23

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	+0.1	-0.8	+0.8	-2.1
Finland	+2.1	+3.5	+5.2	+2.1
France	+7.9	+9.3	+11.1	+7.9
Germany	+7.4	+8.8	+10.6	+7.4
Hong Kong	+5.6	+3.3	+5.0	+2.0
Italy	+10.9	+12.4	+14.2	+10.9
Japan	+0.1	+0.9	+2.6	-0.4
Netherlands	+5.4	+6.8	+8.6	+5.4
Spain	+13.4	+14.9	+16.8	+13.4
Switzerland	+0.3	+0.3	+1.9	-1.1
UK	+5.0	+5.0	+6.7	+3.6
USA	-2.1	-3.7	-2.1	-4.9
All World Europe ex UK	+6.0	+7.0	+8.7	+5.6
All World Asia Pacific ex Japan	+0.9	-0.8	+0.8	-2.1
All World Asia Pacific	+0.6	-0.2	+1.4	-1.5
All World Latin America	-3.1	-2.1	-0.5	-3.4
All World All Emerging Markets	-0.2	-2.0	-0.4	-3.3
All World	-0.3	-1.5	+0.2	-2.7

Source : FTSE All World Indices

FTSE UK Government Securities Index All Stocks (total return) : -4.8%

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

Currency	30.11.22	28.02.23
Sterling	3.16	3.82
US Dollar	3.61	3.92
Yen	0.25	0.50
Germany (Euro)	1.93	2.65

Sterling's performance during the quarter ending 28.02.23 (%)

Currency	Quarter Ending 28.02.23
US Dollar	-0.3
Canadian Dollar	+1.4
Yen	-1.4
Euro	-1.9
Swiss Franc	-0.6
Australian Dollar	+0.6

Other currency movements during the quarter ending 28.02.23 (%)

Currency	Quarter Ending 28.02.23
US Dollar / Canadian Dollar	+1.6
US Dollar / Yen	-0.2
US Dollar / Euro	-1.4
Swiss Franc / Euro	-0.9
Euro / Yen	+1.2

Significant Commodities (US dollar terms) 30.11.22 - 28.02.23 (%)

Currency	Quarter Ending 28.02.23
Oil	-3.6
Gold	+3.8

MARKETS

International equity markets have drifted slightly lower over the quarter. In local currency terms, the FTSE All World index showed a total return of -0.3%, in sterling terms -1.5%, in US dollar terms +0.2% and, in euro terms, -2.7%. Looking at local currency returns firstly, the stand out performer has been the FTSE All World Europe ex UK Index which returned +6.0%. The FTSE UK Index also significantly outperformed, returning +5.0%. On the negative side was the FTSE USA Index which returned -2.1% and the FTSE All World Latin America Index which returned -3.1%. In sterling adjusted terms, the outperformance of the FTSE All World Europe ex UK Index was more pronounced with a return of +7.0%, whilst the converse was true of the FTSE USA Index which returned -3.7%.

The international bond markets underperformed equities. Taking benchmark ten year government bonds, the gross redemption yield on the UK gilt rose by 66 basis points to 3.82%, on the US Treasury bond by 31 basis points to 3.92%, on the Japanese Government Bond by 25 basis points to 0.50% and on the German Bund by 72 basis points to 2.65%,

In the foreign exchange markets, movements were relatively limited. Against the euro, sterling fell by 1.9%, against the yen by 1.4%, against the Swiss Franc by 0.6% and against the US dollar by 0.3%. On the other hand, sterling rose by 1.4% against the Canadian dollar and by 0.6% against the Australian dollar.

In the commodity markets, oil, as measured by Brent crude, fell by 3.5%, whilst gold rose by 3.8%.

ECONOMICS

Congratulations to those who are still maintaining their new year's resolutions and there may well be some who have resolved to make this investment memorandum a regular monthly read which, in many ways, is a reminder that we often find ourselves in positions where hope triumphs expectation. The new year offers the opportunity for resolutions and a reinvention of some sort. For some it is a chance to look forward to better times - which may be particularly appropriate this year, and the twenty first century zeitgeist offers us in the first month of the year Blue Monday* and, also, Dry January, a self-reflective time for some to try to reverse, possibly, the excesses of the recent past. What is clear in all this is that different views abound, the hopeful and the expectant, the optimists and the pessimists and the glass half full people against the glass half empty.

The first two months of the year have ended and the glass half full view has helped lift markets after what was, in so many ways, a very bad year. World markets have risen a healthy 4.5% in local currency terms and a slightly stronger pound means that figure translates to 3.4% in sterling terms. The December investment memorandum reflected at length on the performance of markets in 2022 and, in summary, unusually, equity markets, bond markets and property markets all had a torrid time. Factoring in inflation made poor nominal returns even worse. These negative outturns could easily be extended to cash where the return of positive interest rates has had barely any impact on the returns for savers as three percentage points of interest for sterling savers was subsumed by a double digit rate of inflation; the return would, of course, been even worse had those rate rises not happened.

** Blue Monday is said to be a date in mid January, which is the most depressing day of the year, but, in fact, was created by a travel company and widely regarded as pseudoscience.*

This has felt like a reversal of 2022 as investors have bought into an improving economic direction though the picture is far from consistent as to the speed and extent of recovery after the turbulent global events of the past three years, or, if your glass is half empty, how persistent and harmful the recession of 2023 will be. What is noteworthy at present is the margin by which economic forecasts for 2023 and beyond have been amended. A direct consequence of this is that rubbing one's crystal ball to predict how markets will perform is as difficult as it has been for some time. It seems that it is an uncertain time for both groups - the optimists and the pessimists, such is the volume of data hitting markets, often conflicting and this only adds to the uncertainty created by the global events that we have been, or are, experiencing.

The fascination of economics is that change is inevitable and no two periods in history are the same; many are similar and elements and factors repeat but the position we find ourselves in at present is the consequence of a truly unique set of factors. The extraordinary sequence of events that leads us to the current position can be highlighted by three pieces of data where the magnitude of change in their values within a three year period amply shows the extraordinary forces at work in the world economy at this time. The price of oil as measured by Brent crude has fluctuated between $19 and $127, the cost of sending a 40 foot shipping container from Shanghai to Los Angeles has moved between $1,327 and $12,424 and the gross redemption yield on a 10 year US Treasury bond had a low of 0.51% and a high of 4.24%. The turbulent forces that have created these violent swings are moderating and we now feel that we have some sense of measure of the virus and war that have dominated this time.

Neither viruses nor war are new. The fabric of history is pock-marked by both and, whenever we look back, it is by magnitude that they are considered. Two wars involving Germany and Great Britain serve as examples, being the Anglo-Zanzibar War of 1896 and the First World War, which were separated by fewer than 20 years. Both were over sovereignty of territory but the earlier of the two wars was over in around 38 minutes with an estimate of 500 deaths. The contrast with the scale and consequences of the First World War needs no explanation. This plays across to current times where it is the magnitude of the pandemic and the war in Ukraine that puts us where we are. The coldest of numbers, deaths, does not inform understanding of the consequences. The World Health Organisation gives cumulative COVID-related deaths at 6.8 million, or 0.09% of the world population and deaths in the war in Ukraine would be a very small fraction of the COVID figure. The magnitude of these two events is captured in the sequence of events that have been experienced. With COVID it has been the over-flowing hospitals, lockdowns, furloughs, support schemes, ballooning debt, inflation, rising taxes, strikes and faltering governments. With Ukraine it has been disruption to the energy and basic foodstuffs markets with sanctions and blocked trade with Russia not creating much of an impact on the world economy; despite its mighty landmass, Russia's economy is around the same size as Italy's.

Economists have a wealth of tools at their disposal and the benefit of experience of previous scenarios to look back on, which begs the question why is it so difficult to predict what will happen next? Presumably if you understand what is likely to happen next then it is possible to pre-empt those outcomes and take positive actions beforehand. History tells us that such detection and the applying of preventative or supportive measures is far from a consistent success. The most recent failure, one which has had a lasting impact, must be when most leading central banks' post-COVID assessment that high inflation was transitory was proven wrong and the subsequent late response of monetary tightening appears to have worsened the situation we currently find ourselves in. As we have re-acquainted ourselves with inflation after so many decades, possibly believing it had been defeated, we have had to learn the vocabulary around it too. As COVID subsided and the economy was re-awakening it was described as transitory. Central banks were comfortable with this premise whilst many others weren't and then transitory was replaced with 'embedded' as the fear that double digit pay rises could create a level of demand that fuelled the vicious inflationary circle. The latest adjective to be applied is 'sticky' and the bank of all banks, the Bank for International Settlements'

Head of Research, Hyun Song Shin warned in February "The reason central banks have been emphasising [the importance of] going the last mile on bringing inflation down is that, if you are not fully back to target and relax too early, you will undo all the work you have done before".

The current quandary centres on the speed at which inflation is likely to peak and then fall and, at the same time, the depth of recession that economies are either suffering, going to suffer or narrowly avoid.

One of the most highly regarded books on economics of the last century, which despite its academic approach managed to sell beyond its specialist area, was This Time is Different, by two American economics professors, Carmen Reinhart and Kenneth Rogoff. The aspect of economics that is explored is the inability of people to learn from previous cycles and historic precedents and have an unduly optimistic view of the economy. Examples being after the First World War there was a belief that large scale wars were a thing of the past and, more recently, leading up to 2008 there was similar optimism that globalisation, improved and wider technical knowledge and more sophisticated monetary controls had spelt the end for economic collapses. As much as this may be true the book also observes that the circumstances leading up to each financial downturn are uniquely different. We currently find ourselves in a world recovering from a global pandemic that has killed over 6 million people. The figure is only that 'low' because of the efforts of governments to provide over 13 billion vaccines, which has come at a financial cost as well as support schemes to protect businesses and jobs. The legacy of the pandemic is the subsequent supply side disruption and the effect on price inflation. With timing that could not be much more damaging, the invasion of Ukraine has compounded inflationary pressures by excluding, in large part, one of the world's leading primary producers of petroleum products and basic foodstuffs, Russia, from the market. The third element to consider is the position the world was in going into 2020, as COVID bit. The levels of sovereign indebtedness and the suppressed rates of interest were, respectively, very high and very low and set for maximum stimulatory effect. No harm was done during the lowest points of the COVID crisis but as catch up spending kicked in and other event-driven inflationary pressures were introduced to the world economy, policy very suddenly looked very inappropriate.

Starting off with the issue of debt we can consider the position of the United Kingdom, though it is not an outlier amongst its usual comparators. According to the Office for Budget Responsibility's most recent estimates, debt interest spending doubled in 2022/23 to £120.4 billion, or, 4.8% of GDP, from £56.4 billion in 2021/22 (2.4% of GDP). The build up of UK debt is mirrored by most other similar countries and the overall debt stock has quadrupled in just over 20 years from 28% of GDP in 2000/01 to 102% of GDP in 2022/23. These increased servicing costs feed into the Public Sector Net Borrowing requirement which rose from £133.3 billion in 2021/22 to an estimated £177.0 billion in 2022/23. The issue of taxation is very topical and the current British government is being characterised as a high tax one. It is worth pointing out that in 7 of the past 15 years the budget deficit has been above 7% of GDP as extraordinary steps have been taken to deal with the Great Financial Crisis and the events of the last three years. To illustrate further, debt as a percentage of GDP has risen from 36% of GDP in 2007/08 to the current level of around 102%. Neither the Labour nor Conservative governments can be blamed for the *forces majeures* which created the back story that led to the current fiscal position but, clearly, there is little room for manoeuvre now. The legendary American investor, Warren Buffett, had a great response when asked how he would manage down the US Federal Budget deficit when he said "I could end the deficit in five minutes. You just pass a law that says anytime there is a deficit of more than 3% of GDP, all sitting members of Congress are ineligible for re-election". How that approach may stand up in times of crisis is debatable. Looking back to last September, Liz Truss's attempt at expansionary policy was given short shrift by bond investors who found it easy to find reasons to fear a new unknown in the market - unfunded government spending in the hope of growing GDP. The economics of the policy may have been justified but the execution was poor and it has probably closed the door on that policy direction for quite some time. If that is proven to be true it represents a considerable constraint of future government policy. The rate of increase in indebtedness is, again, to be highlighted as the risks and

accompanying constraints around high levels of indebtedness are accepted as norms but represent a foray into uncharted territory. For reasons of familiarity the situation summarised above relates to the United Kingdom but other countries face equal or, in some cases, larger challenges. The United Kingdom has its currency and its own central bank which gives it some leeway in managing financial pressures through monetary policy as well as fiscal policy.

What the national debt of the UK tells us is echoed around the globe with most countries having more debt than at any time in the past with new debt being created at an unprecedented rate, at a time when interest rates have risen at a rate rarely if ever seen before and where some countries have more debt denominated in a foreign currency than at any time in the past. It is hard to accept this without accepting the traditional assessment of risk in holding bonds has changed considerably.

At this stage there is a working assumption that the governments of all significant nations can continue to finance their debt but can they do it in such a way as to not to damage their domestic economies and, ideally for them, remain in power? Affordability, in absolute terms, is not the question for many countries but the slice of tax revenue which will be consumed by debt refinancing at higher interest rates and interest on money borrowed for continuing budget deficits could lead to reduced creditworthiness. One important role of government is to smooth out demand in the economy over time as the cycle moves from growth to recession and back again. As economies falter it makes sense for governments to invest in ways that will increase productivity in the medium to long term and will create employment in the short term; infrastructure projects are often held up as a good example of this.

Earlier in this piece reference was made to three economic indicators that have experienced huge fluctuations in values and the distended sovereign debt market is another example where an element of uncertainty has been introduced to markets, but it is in the real economy that the pressures are most abundantly apparent. Prices of goods and services have been rising fast and fears of stagflation have re-emerged. In the United Kingdom inflation is high and growth is low. This raises issues around consumer spending, around the strength of the pound and also inward investment into the country. The focus needs to be on the potential growth rate and improving productivity, both of which are low, but, with the public purse under such pressure, the availability of public investment in the economy is compromised.

Just as shares reflect the prospects of companies, companies viewed en masse reflect the prospects of the economies in which they operate. Growth in world GDP measured by consumption or production means growth in volumes of goods and services provided by those companies. 2022 was a year when markets (bond and equity) revised down their expectations of prosperity in the world as inflated prices of basic staples and energy threatened levels of consumption. The absence of significant inflation for such a long period and the previous perceived wisdom that the spike in inflation was transitory only contributed to the concerns around 10%+ inflation around the globe. Markets continue to be forward looking and as the antidote to high inflation is higher interest rates, markets have obsessed and continue to obsess about peak inflation. Commentators and economists have been in agreement that a peak point would be reached in 2023 but there have been warnings from, amongst others, the Governor of the Bank of England that pressures in the labour market, especially in the US and UK would mean that relatively high wage inflation could lead to a spiral of rising costs of production embedding inflation into the system. It should be remembered that unemployment levels are very low, in historic terms with the figure for January in United States falling to 3.4% in the fabled non-farm payrolls. This is the lowest level since May 1969. Also announced in February was the January inflation figure which came in at 6.4%, slightly higher than forecast but still on a gentle downward trend. Whilst wage inflation is, naturally, an issue for companies, passing the high water mark for inflation is far more significant. Inflation and higher interest rates are likely to mean higher borrowing costs, foreign exchange volatility and potentially hedging costs and supplier credit issues. Aside from the direct financial impact, it is evident that there are uncertainties that come with any rapid change in the monetary landscape and it would take a good look through the history books to find a period of

monetary change as rapid and significant as what has been experienced over the last three years. Higher interest rates also hit the consumer's pocket as mortgages, credit cards and other forms of debt become more costly reducing the capacity to spend with those companies. Central banks engineer this hit to demand with the intention of damping down the inflationary effect of excessive demand but there is no pure science in removing inflation from the economy without risking pushing the economy towards recession.

The economic data that reaches the market informs on the success, or not, of governments and their agencies in delivering the stable monetary landscape that is sought by companies. At this time there is a sense of displacement and a need to get back to the more familiar low inflation/low interest rate environment which foments healthy economic growth. It follows that there is a great deal of sensitivity or volatility around new data which will point to a normalising position or a deteriorating position. The best combination of news at present would be a resolution to the war in Ukraine, the continuing opening up of the (post-COVID?) Chinese economy and the ongoing recovery of supply chains. This would be against a backdrop of improved productivity, restraint in fiscal policy and healthy confidence among consumers and producers. More important than any other marker, a sustained downward trend in inflation would buoy bond and equity markets.

2022 was very difficult for almost all investors yet many could reflect on the year in the context of strong returns over a long period up until then. The economic disruption of the war and COVID has, as illustrated earlier, led to extraordinary volatility in so many markets, not just financial markets, which is still making economic forecasting very difficult. Equity investing is much more for the optimist than the pessimist but looking forward is far easier, in general, for the former. We continue to see risks associated with bond markets and do not see the returns available for taking such risks as being appropriate, but they have, of course, improved significantly. Where mandates allow, we continue to hold financially strong companies within diversified portfolios which have pricing power in the markets they operate. The best companies are managing to weather the storm of slower economic growth and the pressures created by inflation. Inflation will peak and valuations will, at some point soon, rise. It's worth raising a half full glass to that.

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