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ASSET MANAGEMENT (C.I.) LIMITED

INVESTMENT MEMORANDUM

Whilst markets remain highly sensitive to news on inflation and interest rates, they have performed quite well during the last quarter. Whilst the dreadful situation in Ukraine continues to shock, investors appear to have absorbed the geopolitical position and are concentrating more on economic aspects of the world economy.

The tables below detail relevant movements in markets :

International Equities 31.10.22 - 31.01.23

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	+9.6	+13.0	+20.8	+9.9
Finland	+6.1	+9.0	+16.6	+6.1
France	+13.0	+16.1	+24.2	+13.0
Germany	+16.8	+20.1	+28.4	+16.8
Hong Kong	+39.5	+30.7	+39.7	+27.1
Italy	+17.2	+20.4	+28.8	+17.2
Japan	+2.1	+9.1	+16.7	+6.2
Netherlands	+19.4	+22.7	+31.2	+19.4
Spain	+13.6	+16.7	+24.8	+13.6
Switzerland	+4.4	+6.3	+13.7	+3.5
UK	+10.4	+10.4	+18.0	+7.4
USA	+5.8	-1.0	+5.8	-3.7
All World Europe ex UK	+12.1	+14.5	+22.4	+11.4
All World Asia Pacific ex Japan	+19.7	+18.1	+26.2	+14.9
All World Asia Pacific	+13.5	+15.0	+22.9	+11.9
All World Latin America	+1.4	-0.6	+6.3	-3.3
All World All Emerging Markets	+17.7	+13.2	+21.0	+10.2
All World	+8.0	+4.0	+11.2	+1.2

Source : FTSE All World Indices

FTSE UK Government Securities Index All Stocks (total return) : +1.1%

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

Currency	31.10.22	31.01.23
Sterling	3.51	3.33
US Dollar	4.05	3.51
Yen	0.24	0.49
Germany (Euro)	2.14	2.28

Sterling’s performance during the quarter ending 31.01.23 (%)

Currency	Quarter Ending 31.01.23
US Dollar	+7.3
Canadian Dollar	+4.9
Yen	-6.1
Euro	-2.3
Swiss Franc	-1.8
Australian Dollar	-2.4

Other currency movements during the quarter ending 31.01.23 (%)

Currency	Quarter Ending 31.01.23
US Dollar / Canadian Dollar	-2.3
US Dollar / Yen	-12.4
US Dollar / Euro	-9.0
Swiss Franc / Euro	-0.7
Euro / Yen	-3.7

Significant Commodities (US dollar terms) 31.10.22 - 31.01.23 (%)

Currency	Quarter Ending 31.01.23
Oil	-7.9
Gold	+16.8

MARKETS

It has been a solid quarter for international equity markets with the FTSE All World Index returning +8.0% in local currency terms, +4.0% in sterling terms, +11.2% in US dollar terms and +1.2% in euro terms. Looking at local currency returns first, we note the substantial recovery in the FTSE All World Hong Kong Index (+39.5%) as China reversed its strict Covid-19 lockdown policy. Apart from this exceptional case, the region as a whole performed very well, with the FTSE All World Asia Pacific ex Japan index returning +19.7%. Partly because the US dollar reversed its previous strength, the FTSE All World All Emerging Markets Index put in a very strong performance with a return of +17.7%. Elsewhere, the FTSE All World Europe ex UK Index was a notable performer with a return of +12.1%. A below average performance, unusually, came from the FTSE USA Index which returned +5.8%. The FTSE All World Latin America Index was also below average, returning +1.4%. Looking at sterling adjusted performances, currency movements made a significant difference. Most notably, the USA moved into negative territory with the FTSE USA Index returning -1.0%, whilst the other local currency underperformer, the FTSE All World Latin America Index, returned -0.6%. Weakness in the currency pulled down the FTSE All World Hong Kong Index, but the sterling adjusted return was a still spectacular +30.7%. Although the currencies weakened, there were still excellent performances from the FTSE All World Asia Pacific ex Japan Index (+18.1%) and the FTSE All World All Emerging Markets Index (+13.2%). On the other hand, currency strength against sterling raised the return on the FTSE All World Europe ex UK Index to +14.5% and, on the FTSE Australia Index, to +13.0%. The FTSE Japan Index outperformed in sterling terms with the index returning +9.1%. The relative performance of the UK market improved, with the FTSE UK Index's return of +10.4% being well above the +4.0% return on the sterling adjusted FTSE All World Index.

In the international bond markets, there were mixed performances in the face of inflation and interest rate uncertainty. Taking ten year government bonds as a benchmark, the gross redemption yield on the UK government bond fell by 18 basis points to 3.33% and on the US Treasury bond by 54 basis points to 3.51%. On the other hand, the gross redemption yield on the Japanese government bond rose by 25 basis points to 0.49%, an issue we discuss in this review, whilst that on the German Bund rose by 14 basis points to 2.28%.

In the foreign exchange markets, as touched upon above, the US dollar started to reverse previous strength and fall back quite substantially, with sterling somewhere in the middle of these movements. Against the US dollar, sterling rose by 7.3% and, against the Canadian dollar, by 4.9%. On the other hand, on the back of a strong recovery against the yen, sterling fell by 6.1%. It fell against the Australian dollar by 2.4%, against the euro by 2.3% and against the Swiss Franc by 1.8%.

Although the commodity markets have started the year quite strongly, partly influenced by China's reopening, overall they have come off quite sharply since the summer. Oil, as measured by Brent crude, fell back by 7.9%. Gold had a good quarter, rising by 16.8% after a disappointing 2022.

ECONOMICS

It goes without saying that the geopolitical and economic background remains very unsettled but, over the last quarter, markets have moved ahead and, within this period, January has been a good month for investors, so therefore the year has got off to a good start. Feet must be kept firmly on the ground but there are glimmers of hope. Above all, investors have accepted the current unsettled background as a known input to their thinking in constructing their investment strategy. It is unknown events occurring which can suddenly upset markets and these may yet occur as it is not easy to know how the Russia/Ukraine war will develop.

Markets look ahead and, as we have mentioned on a number of occasions in recent reviews, it is important that investors do not automatically do a read across from current geopolitical and economic conditions to the markets and think that, because the background is bad, markets will be weak. It is like a game of chess as investors, like chess players, need to look several moves ahead and that is what they are doing at present. Those who are looking at the glass as half full, rather than half empty, are taking a more optimistic view on inflation and translating that into a view that interest rates, although they still have further to rise, may not be far off their peak or what is now known as the terminal rate.

The sharp about turn by central banks last year in their monetary policy explains part of market movements in 2022. It is generally accepted that central banks were far too late in starting to tighten monetary policy in 2021 because they continued to believe that the rise in inflation was "transitory" and was due to Covid-19 related supply shortages which would disappear when supply chains reverted to their normal state. This stance did not seem reasonable at the time and this is not said with the benefit of hindsight. Of course, what central banks did not know at the time was that Russia would attack Ukraine with the resulting economic consequences in terms of inflation, especially in energy and food prices. So, central banks cannot be blamed for the war induced part of the rise in inflation but it built on a position where inflation had started to rise as a result of policy errors, resulting in double digit inflation levels in a number of countries and high single digit levels in many others. The Russian attack on Ukraine induced an inflation and growth shock, creating a difficult problem for central banks. On the one hand, the advent of an economic shock arising from the Global Financial Crisis in 2008 and from Covid-19 in 2020 demanded swift and aggressive monetary policy actions in terms of cutting interest rates and engaging in Quantitative Easing (QE) but, in this emergency, they faced only unenviable choices. If they did a sharp about turn on monetary policy, either by raising interest rates sharply, or by starting Quantitative Tightening (QT), or both, they risked making worse the continuing effects on the world economy of the Russian invasion's economic shock, with a strong chance of an economic recession ensuing. That, amongst other economic effects, would have increased unemployment and made life particularly difficult for developing economies. The alternative option was to keep monetary policy very loose in order to alleviate some of the malign effects of the Russian invasion, but at the expense of making a bad inflation situation worse. In the event, central banks opted for the former option, thereby setting the path for sharp (sometimes 0.75%) rises in interest rates on a regular basis and starting QT at different times. Whilst, pre the Russian invasion, investors would have expected a gradual tightening of monetary policy, they were not prepared for the faster pace of interest rate increases and therefore did not have the chance to discount the abrupt change in monetary policy in their investment thinking. For many, but not all, investors, 2022 turned out to be a poor year for investment returns, with both fixed interest and equities performing badly, an unusual situation since normally one would expect an inverse correlation. Bonds, coming into 2022, were seriously overvalued as a result of yields being suppressed by central banks' monetary policy and many bonds were selling on negative yields, a bizarre and unsustainable position. Therefore, when there was an abrupt change in monetary policy, they were bound to suffer and price falls were dramatic and often they performed worse than equities. The position for equities was more nuanced up to the end of 2021. Growth stocks had outperformed value stocks on the back of very low or negative interest rates, supporting share prices as future earnings were discounted at very low interest rates. Often these earnings were well into the future and unpredictable. However, with a sharp rise in interest rates, future cash flows were discounted at higher interest rates, having a significant effect on reducing the present value of these type of companies' shares leading to, in some cases, dramatic price falls. On the other hand, value stocks, those with reasonable dividend yields and more predictable near term earnings, became relatively more attractive. So, for example, the FTSE 100 index is full of old economy value stocks and actually rose in 2022 (+0.91% capital and +4.57% total return), whereas the NASDAQ index in the USA fell (-33.10% capital and -32.51% in total). What these quite different performances show is that, depending upon the portfolio construction, the variance in performances was quite substantial last year.

Now, as we enter 2023, the inflation/interest rate trade off remains highly relevant. We are still in a period of negative real interest rates as the table below shows, relating as it does inflation rates, policy rates and ten year government bond yields.

Country/Area	**Inflation Rate**	**10 Year Government Bond Yields (at 02.02.23)**	**Policy Rate**
	%	**%**	**%**
United States	6.5	3.40	4.75
United Kingdom	10.5	3.00	4.00
Euro Area	8.5		3.00
Germany	8.6	2.07	3.00
Japan	4.0	0.49	-0.1

However, whether measured by policy rates or ten year government bond yields, interest rates remain significantly negative in real terms but what the optimists are looking for is a reduction in the rate of inflation and the peak of short term interest rates, the terminal rate, which comes to meet the rate of inflation as the latter falls, thus providing a possible rationale for central banks then to start easing monetary policy. Not necessarily the absolute level of interest rates but more the direction of interest rates will drive share prices, the glass half full camp would say.

As the first anniversary of the Russian invasion is approaching, some of the inflationary consequences of the invasion should start to drop out of the figures. We are already seeing some energy costs falling, as well as many commodity prices, so there is a reasonable expectation that we are over the worst of the inflation problem. However, this comes with a major qualification, namely the uncertainty of the course of the war in Ukraine and its future economic consequences. In discussing inflation, China is important here. The sudden U-turn on the Covid-19 restrictions means supplies of components from Chinese factories used for manufacturing elsewhere should become more reliable, thus easing the price pressures on those items when they were in short supply. Working the other way could be the reopening of China leading to an increase in the prices of raw materials which it will be using such as iron ore which would then work its way into prices. After falling quite sharply from their peak last year, iron ore and copper, to give two examples, have started to move noticeably higher since China reopened.

Another issue which is important for central banks' thinking is the public's inflationary expectations which inform many pay negotiations. If people believe that current inflation levels are here to stay for the foreseeable future, then pay negotiators will try to build this into their pay demands. If successful, this will reinforce current high inflation levels and help to build inflation into the system. This is what central bankers fear and their policy response in these circumstances is likely to be more forceful. The current wave of strikes in the UK is symptomatic of this issue and, depending upon the outcome, will either reinforce the case for further interest rate increases and for the higher rates to stay for longer or will give the Bank of England's Monetary Policy Committee, in the case of the UK, more confidence to ease monetary policy sooner rather than later, but not before interest rates have risen further in the meantime.

We have rather lumped central banks together in our comments so far but, whilst the USA, UK and the eurozone are broadly following the same tightening path, though not at the same rate, there are two outliers. The Bank of Japan has been following an idiosyncratic policy for some time, one of yield curve control whereby it had been intervening in the market to keep ten year government bond yields 0.25% either side of zero. Suddenly, in December, it announced that the band would be raised to 0.5%.

Some took this to mean that it indicated that the Bank of Japan was tightening monetary policy, although it denied that it was doing so, and it has been buying bonds heavily since the announcement. The Bank of Japan is estimated to own over 50% of the Japanese Government Bond market. Clearly, this trend cannot go on forever. One consequence will be that liquidity in the JGB market will reduce even further. Furthermore, by Japanese standards, inflation is very high, at 3.8%, so bond yields, as elsewhere, seem out of line with reality. The irony is that successive Japanese governments and the Bank of Japan, when inflation was very low or negative, were keen to raise the level in order to stimulate the economy through consumption. If citizens felt that they were losing out to price rises they might well loosen their purse strings and stimulate economic activity. The government is trying to persuade Japanese companies to raise wages to stimulate consumption. If wages are rising less fast than inflation, consumers may feel less inclined to spend. So, the Japanese position on monetary policy raises different questions and we will want to see what recent moves by the Bank of Japan mean.

China's monetary policy is different again. Inflation is hardly a problem. The latest Consumer Price Index is just 1.8% higher than a year ago and growth at 3.0% in 2022, whilst a better level than for most developed countries, is low by Chinese standards. Growth is necessary to keep down unemployment, currently 5.5%, but worse amongst the young, not only for economic reasons but also for political reasons. The economy was seriously affected by China's Covid-19 lockdowns, with a considerable amount of production lost. With the policy being dramatically reversed in December after widespread unrest, growth should improve, but the economy was badly damaged. Besides the Covid-19 issue, problems in the real estate market through overleveraged property companies and large bank exposure to this problem will be exercising the minds of the authorities, so the People's Bank of China is in a loosening mode to stimulate the economy and assist the real estate sector. Whilst the reopening of the Chinese economy may increase the inflationary problems elsewhere as China's demand for commodities increases, it should also help to raise economic growth levels. Also, of course, it has to battle with US sanctions on its technology sector, which imposes an extra burden on economic growth beyond this year as technological progress is hampered by the lack of vital components.

In the past, we have often referred to political considerations which may affect different markets. This was not particularly relevant when governments and central banks were struggling with the economic effects of Covid-19 as their measures were aimed at supporting their economies through sudden and unexpected economic shocks. Now that the situation is more settled, not in the sense that there the still serious geopolitical and economic problems have gone away, but in the sense that they are much more fully absorbed, it is time to look at the policies being followed by governments to deal with their main current concern, inflation.

For investors, we think that the situation is most favourable in the USA, at least until the Presidential and Congressional elections in 2024. Because of the checks and balances in the US Constitution, the loss of the House of Representatives in the recent mid term elections means that the tax increases which the President had planned will not be enacted. Paradoxically, this means that there is more clarity about the outlook, namely that not much will change in the next two years. Given the fact that investors do not like uncertainty, this is a positive factor for investors in the US equity market. At the other end of the spectrum is China. We do not invest directly in China, but this is the most politically driven market, as we have seen in recent times when the Chinese authorities, for various reasons including President Xi's "common prosperity" theme, have cracked down on companies in different sectors, causing a major loss of value for shareholders. Perhaps because of the need to restore confidence in the Chinese economy, the clampdown on businesses seems to be being reversed, at least for the time being and in a limited way, but it does not alter the fact that many share prices are politically driven. Foreign outflows from the Chinese market suggest that some investors feel that there is too much uncertainty to invest there and there is always the fear of a Chinese invasion of Taiwan, which would, it goes without saying, have serious consequences for investors. China aside, Europe, including the UK, are two areas where the investment climate may be becoming less welcoming. With state finances in a serious condition as a result of the pandemic induced recession and the need to support businesses and individuals, budget deficits and government borrowing ballooned, leaving, for many countries, an unstable position. In the UK, a Prime Minister and Chancellor of the Exchequer, trying to borrow to stimulate growth and, ultimately, tax receipts, were effectively toppled by the bond and foreign exchange markets. This shows the strength of the disciplines now being imposed on many countries by their straitened financial circumstances. The UK mini budget in November reversed the September mini budget and the tax bill for individuals and companies through a Corporation Tax increase is set to rise sharply. But, symptomatic of the problem, are the windfall taxes imposed by UK and European governments on the energy sector, but not only the energy sector. At a time of energy shortage, nothing could be more damaging to investment in the industry than windfall taxes. Investment in the North Sea has already been curtailed because of these. Companies are always easy targets for governments looking for money but the malign side effects inevitably reduce the attraction of investment opportunities in the particular country. So, we would say that political developments in the UK and parts of Europe reduce the relative attractions of those markets. There are exceptions, Switzerland for example.

Some commentators are saying that fixed interest securities are now more attractive because of the sharp rise in yields. Although there are hopes for a better inflation outcome, we do not believe they are yet at levels which make them interesting, particularly as there will be plentiful supplies coming on to the market as a result of the continuing need to fund large budget deficits and the bonds coming on to the market as central banks reduce their inventories through QT. Equities remain our preferred asset. Whilst it will not be an easy year for companies, it is unlikely to be very bad and companies should be producing reasonable profits and dividends, although the pattern will be patchy. The latest IMF World Economic Outlook, just released, forecasts world economic growth of 2.9%, an upgrade, in 2023 and 3.1% in 2024. Whilst these are not exciting figures, they do suggest, if they are anywhere near correct, that companies overall should earn satisfactory profits given the very difficult economic background. Given the lack of attraction of bonds and cash in this inflationary environment, investment in good quality international equities with a value bias, to us, represents the best way of retaining the real inflation adjusted value of assets. The USA remains our favoured area, for the reasons detailed earlier, but as part of an internationally diversified portfolio.

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