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ASSET MANAGEMENT (C.I.) LIMITED

INVESTMENT MEMORANDUM

With international equity markets pulled both ways by economic and geopolitical developments, markets have reflected these conflicting tensions by ending little changed over the quarter. There has been a mixed performance from international bond markets, but an outlier has been the UK which has been noticeably weak in the face of stubbornly high inflation. However, the implications for UK interest rates mean that sterling has become one of the strongest currencies this quarter. Gold, whilst up over the quarter, ended off its high point.

The tables below detail relevant movements in markets :

International Equities 28.02.23 - 31.05.23

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	-1.2	-7.4	-5.2	-5.7
Finland	-10.3	-11.9	-9.8	-10.3
France	+0.1	-1.8	+0.6	+0.1
Germany	+1.7	-0.1	+2.2	+1.7
Hong Kong, China	-7.2	-9.1	-6.9	-7.4
Italy	-1.7	-3.5	-1.2	-1.7
Japan	+8.8	+3.6	+6.1	+5.5
Netherlands	+3.6	+1.7	+4.2	+3.6
Spain	-2.3	-4.1	-1.8	-2.3
Switzerland	+3.8	+3.9	+6.4	+5.8
UK	-4.0	-4.0	-1.7	-2.2
USA	+5.7	+3.2	+5.7	+5.1
All World Europe ex UK	+4.1	-0.9	+1.5	+0.9
All World Asia Pacific ex Japan	-0.4	-3.5	-1.2	-1.7
All World Asia Pacific	+2.7	-1.1	+1.3	+0.7
All World Latin America	+0.9	+1.0	+3.4	+2.8
All World All Emerging Markets	-0.6	-3.1	-0.8	-1.3
All World	+3.7	+1.2	+3.6	+3.1

Source : FTSE All World Indices

FTSE UK Government Securities Index All Stocks (total return) : -2.3%

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

Currency	28.02.23	31.05.23
Sterling	3.82	4.18
US Dollar	3.92	3.65
Yen	0.50	0.43
Germany (Euro)	2.65	2.28

Sterling's performance during the quarter ending 31.05.23 (%)

Currency	Quarter Ending 31.05.23
US Dollar	+3.4
Canadian Dollar	+2.8
Yen	+5.6
Euro	+2.3
Swiss Franc	-0.1
Australian Dollar	+7.0

Other currency movements during the quarter ending 31.05.23 (%)

Currency	Quarter Ending 31.05.23
US Dollar / Canadian Dollar	-0.1
US Dollar / Yen	+2.9
US Dollar / Euro	-0.3
Swiss Franc / Euro	+2.2
Euro / Yen	+3.2

Significant Commodities (US dollar terms) 28.02.23 - 31.05.23 (%)

Currency	Quarter Ending 31.05.23
Oil	-12.2
Gold	+7.4

MARKETS

International equity markets have trended slightly higher in the latest quarter. In local currency terms, the FTSE All World Index showed a total return of +3.7%, in sterling terms, +1.2%, in US dollar terms, +3.6%, and, in euro terms, +3.1%. Looking at local currency returns firstly, the FTSE Japan Index, +8.8%, the FTSE USA Index, +5.7%, and the FTSE Switzerland Index, +3.8%, all showed above average returns. Standing out on the negative side were the FTSE UK Index, -4.0%, the FTSE Australia Index, -1.2%, and the FTSE Hong Kong Index, -7.2%. There were also negative performances from the FTSE All World All Emerging Markets Index, -0.6%, and the FTSE Asia Pacific ex Japan Index, -0.6%. Moving on to sterling adjusted returns, Japan, the USA and Switzerland still stand out on the positive side, but the returns worsened for the FTSE Australia Index, -7.4%, the FTSE Hong Kong Index, -9.1%, the FTSE Asia Pacific ex Japan Index, -3.5%, and the FTSE All World All Emerging Markets Index, -3.1%.

In the international government bond markets, performances were mixed, but the relatively high level of inflation in the UK and the implications for interest rates pushed gross redemption yields higher and, on the benchmark ten year UK government bond, the yield rose by 36 basis points to 4.18%. Elsewhere in our table, gross redemption yields fell in the ten year government bond market. On the US Treasury bond, the yield fell by 27 basis points to 3.65%, on the Japanese Government Bond by 7 basis points to 0.43% and on the German Bund by 37 basis points to 2.28%.

The feature of foreign exchange markets over the quarter was strength in the Swiss Franc and sterling. Only against the Swiss Franc did sterling weaken and then by only 0.1%. Elsewhere, sterling gained 7.0% against the Australian dollar, 5.6% against the yen, 3.4% against the US dollar, 2.8% against the Canadian dollar and 2.3% against the euro.

In the commodity markets, prices have overall been trending lower in 2023. In our table, perhaps surprisingly in view of OPEC+ supply reductions, the price, as measured by Brent crude, fell significantly last quarter by 12.2%, prompting Saudi Arabia at the beginning of June to announce a further voluntary cut of 1 million barrels a day in its production. Gold, although well off its peak, still managed a rise of 7.4% over the quarter.

ECONOMICS

There was a time when the short and, possibly, medium term economic and geopolitical outlook was reasonably predictable and unpleasant surprises or events were rare. Not any more, with the “new normal” being unpleasant economic and geopolitical surprises occurring with unwelcome regularity. Investors have resigned themselves to facing bad news and not to be surprised by unwelcome events as they unfold. Surprisingly, given the avalanche of bad news, equity markets, although off their highs, have held up relatively well. Bond markets have been more adversely affected in some markets. In the past, any of the major geopolitical and economic issues which we are now facing would have been of sufficient importance to have a significant adverse effect on markets, but that no longer seems to be the case.

So, as this is written, what are the major geopolitical and economic issues which may have affected markets badly in the past but which are being absorbed by markets now without too much effect? On the geopolitical front, Russia's continuing war on Ukraine, the China / US economic and political stand off and concerns that China might invade Taiwan at some stage. On the economic front, there is very high inflation, large budget deficits, very high bond yields by recent standards and increasing concern about banks with commercial property loans, especially following the collapse of 4 US banks including SVB, the large regional Californian bank. Yet, as this is written, although markets have shown some moderate signs of nervousness, it is no more than that at present. This statement must not be taken as a sign of complacency, it is just a current observation.

Are investors right to show what, on the face of it, is a risky level of complacency? The obvious point to make is that institutions and individuals have to invest somewhere and current high levels of inflation make cash, a once obvious choice for the highly risk averse investor, much less appealing given negative real interest rates in many countries. So, for example, taking into account bank deposit rates and the current inflation level, the real rate of interest in the UK is around -4.5%. Of course, some investors may be prepared to accept this, but it is a much less comfortable choice than in the past when interest rates on deposits were usually higher than the inflation rate. Holding cash for precautionary or opportunistic reasons is one thing, but holding it as a main asset class, instead of, say, shares, is another, carrying with it a high opportunity cost risk. Money illusion is an economic concept reflecting the situation where money is thought of in nominal rather than real terms, so it is quite probable that many investors holding cash as a main asset are experiencing money illusion. In the current world of high inflation, unless an investor has a short time horizon or a level of nervousness which trumps investment considerations, cash cannot be considered a suitable investment as a main asset class.

Another option is the fixed interest market. As clients who have read our previous economic reviews will know, we have held a negative view of this asset class and that continues to be our view. It is worth reiterating our reasons for this policy, which relate to those portfolios where the mandate is not constrained. Many institutional investors have to hold fixed interest securities, for instance for matching purposes. For those who don't, the negative real interest problem applies again. Bond yields are generally well below inflation levels. The pain suffered by holders of fixed interest securities in 2022 and, again, so far in 2023 for sterling bond investors, should dispel the idea, held by many, that fixed interest securities are low risk investments which moderate the volatility of equities when held in a balanced portfolio. In fact, for sterling based investors in 2022, a representative selection of unhedged international equities would have shown about a 16% less negative return that the representative UK government bond index, with equities and bonds, unusually, moving in the same direction. At least cash had much greater resilience, with a stable nominal value unlike a fixed interest security which, in 2022, would probably have fallen sharply in price. Fixed interest markets continue to face serious headwinds and it is important that investors do not allow themselves to be seduced by the much higher nominal yields reached in 2022 and the early part of 2023. They must avoid money illusion because inflation remains very high. By raising interest rates so significantly central banks were reacting to serious overcomplacency in 2021 about inflation and they were party, along with the Russian attack on Ukraine, to the explosion in inflation which occurred in 2022. Whilst headline inflation rates have been trending downwards, core inflation levels remain stubbornly high, suggesting that inflation has become embedded in many economies and, with it, inflationary expectations. There has been a view in the market that interest rates may start to fall towards the end of the year, but this view has not been endorsed by central bankers and yields may rise further along the curve. Inflation and potential further interest rate increases remain one headwind for the market. A second powerful one is supply. As a result of low economic or no growth, many countries' budget deficits remain significant and, therefore, have to be funded through additional bond issuance. On top of this, central banks are starting to engage in Quantitative Tightening (QT), whereby they are selling back to the private sector assets purchased during the period of Quantitative Easing (QE) or not replacing maturing debt. As with interest rate increases, this represents another aspect of monetary policy tightening after a long period of extremely loose monetary policy. As with anything which is in oversupply, the price is likely to go down, with the flip side in this case being a rise in yields. For these different reasons, we still find it hard to make a case for bonds, notwithstanding their poor performance in 2022 and so far this year in markets like the sterling bond market.

Directly or indirectly, property has been an important asset for investors in the past, although any exposure we have had for clients has been through shares and REITS. The attraction has been diminished in a number of ways in recent times. We are talking generally, not specifically, as some assets are clearly attractive. Buy to let has been a popular investment strategy, but tax changes and government action have made life harder for landlords, not to mention rising interest rates. Landlords can be an easy target for politicians. Covid has changed working habits considerably and Work From Home (WFH) seems to have become established in many businesses. The demand for office space has been affected, making this sector of the market less attractive. Retail space has suffered, too, with the combination of the recession and the growth of online shopping causing many retail closures. This has been to the benefit of industrial property as warehouses have grown in the wake of the increase in online shopping. There is some concern about oversupply in the property sector generally and some REITS in the sector have fallen back sharply. These comments, of course, represent generalisations, but the sector, as a whole, for different reasons, looks less attractive than before and, certainly, for private landlords, the political weather has become more challenging.

Then there is gold, where the traditional case has been that it represents a store of value in troubled times, which these certainly are, and a hedge against inflation. The performance, after a long period of lacklustre returns, has been good recently, although the price is off its high point this year, and this despite the rise in interest rates which would normally be a negative influence on the price of this non interest bearing asset. So, there is a two way pull at present. However, there is now a further influence, which is central bank buying. With the political stand offs around the world, particularly between the USA and China, not to mention the war on Ukraine, paper currencies can be seen to be less attractive than they were as they carry a higher risk. Central banks clearly recognise this fact, hence their increased buying, with emerging markets prominent.

The period of ultra low interest rates encouraged some investors into more risky assets to try to improve their returns, with cryptocurrencies being the main beneficiary. Some high profile scandals have taken some of the shine off the asset, but it is a speculative asset with nothing behind it and no inherent value and it remains a mystery how it has attracted the following which it has, despite warnings from regulators. It is not an investment which we would consider for our clients. The regulators are also on the case with the USA's SEC accusing Coinban Global Inc. of operating on unlawful exchanges.

So, this leads back to shares, the main asset class in our unconstrained client portfolios. In stating the obvious earlier in this review that one has to invest in something, we are left with shares. With a negative bias, and against the current geopolitical and economic background, some might say that shares were the least unattractive asset to be holding but those with a more positive view like ourselves can see attractions in this asset class. In this difficult economic environment, what are they? As we see the dividends coming in on our portfolio holdings, it is noticeable that many of them are coming in higher than last year. Companies appear to be weathering the difficult economic conditions quite well. Whilst supply difficulties arising from Covid seem to have lessened, input costs are still rising quite sharply for many companies, although there seems to be some gradual relief occurring. Many companies seem able to pass on their cost increases. Dividends are important, especially now that the dividend yield advantages which shares had enjoyed over bonds has been eliminated or reduced. Rising dividends are helpful in this respect. We believe that holding shares in good quality companies which will continue to grow their earnings and dividends over time, whatever the economic conditions, represents the best way to support one's investment aspirations.

Whilst this represents our investment view and our current asset allocation, it is right to discuss some of the challenges and dangers facing investors. On the geopolitical front, the war in Ukraine goes on. The human cost is catastrophic, but over a year into the war no one has any idea what the end game will be and, whatever it is, the market seems to have discounted it at present. This is not to appear callous, it is just a reflection of where we are at present. Gradually, the economic issues arising from it appear to being worked through and the energy position is more secure than it has been thanks, in part, to a mild winter in Europe and, importantly, costs are easing. US/China tensions, both economically and politically, are ever present, with China becoming ever more belligerent towards Taiwan. The danger is that China will go beyond the point of no return with its military exercises and some sort of accident will provoke an invasion. If the USA becomes involved, the economic consequences would be catastrophic. On the economic front, Taiwan is such an important source of semiconductors that the world economy would be seriously hit. The belief is that, although it is a non trivial risk, it is unlikely to happen in the foreseeable future. Let us hope that this thinking is correct because, if it is not, it would be very serious for markets through its effect on the world economy, of that there is no doubt. However, investment decisions cannot be based on a presumption that an invasion will take place. They have to be made on the balance of probabilities/possibilities.

We were going to add the serious concerns about the repercussions of a failure of the US President and the House of Representatives, controlled by the Republicans, to reach an agreement on extending the debt ceiling but, fortunately, there has been an agreement and markets have, in the short term, taken this well, so this is one market negative which has been pushed into the future but may well come again.

During the pandemic, political influences on markets took second place to economic actions and developments to stabilise economies, but, in more normal times, politics can be equally or more important as it also defines the potential risks and rewards of each market and asset class. Perhaps, inevitably, even if mistakenly, companies have borne the brunt of criticism about rising prices. Current high inflation rates, a function of faulty central banks' monetary policy in 2021 and the economic consequences of the Russian invasion of Ukraine in 2022, have left companies an easy target, but there are investment consequences.

If we look at our normally largest country or region of exposure, the USA, the current position looks relatively good, but it could change next year after the Presidential and Congressional elections with a third of the Senate and all the House of Representatives seats to be contested. The President's 2023 budget proposals would not be welcome to US equity market investors, involving substantial tax increases for the corporate and parts of the personal sector. For example, President Biden's proposal for a sharp increase in company taxation would reduce earnings per share and, other things being equal, raise the price/earnings ratio on the market, as well as having some effect on dividend levels. One would expect measures like this to cause the equity market to trade at lower levels than would otherwise have been the case. A proposed 4% tax on share buybacks, a source of support for the US equity market, would be damaging to US equities but could support dividends. However, at the moment, with a split Congress with Democrats holding the Senate and the Republicans the House of Representatives, the stalemate works well for the markets as nothing meaningful can get done. It is in this context that next year's Presidential and Congressional elections will be important. For the moment, the outlook is relatively good on the political risk front, but this is a short term view.

However, the President is not without power in that he can make appointees to various organisations that will reflect his views. One area where this influence is being felt is in the area of competition investigations, or proposed investigations, where the Federal Trade Commission and the Department of Justice have been active in trying to block certain takeovers, with technology and pharmaceutical industries being targeted, even though the logic behind such action is not always clear and does not accord with precedent. Some of these investigations will be contested by the companies involved and may be overturned but, because M & A activity is often a catalyst for positive market movements, this is a negative development, albeit not a major one at the moment.

The risks, however, in the UK are rising, there not being the checks and balances which there are in the US Constitution between the executive and the legislature. But, just picking up on the anti trust point made in relation to the USA, the position in the UK is more extreme. The Competition and Markets Authority has become extraordinarily aggressive in some areas, focusing its attention most noticeably on the technology sector where it has recently blocked Microsoft's bid for Activision Blizzard at a time when the EU regulator, itself quite aggressive, has cleared the bid, taking exactly the opposite view to the CMA. It has even forced Meta (formerly Facebook) to undo an acquisition which it had already made, Giphy, at a substantial loss. This deal was blocked on hypothetical grounds rather than on an actual present competitive position in the market. There are signs that the UK government and others are becoming concerned about the aggressive attitude of the CMA because of the message it sends out about the UK being a place to do business for the technology companies. Microsoft has been very vocal about this. The point is that, whether or not one agrees with the CMA's decisions, it is not sending out a positive message to investors in the UK and can indirectly inform investment decisions. An activist regulator, which it can be argued that the CMA has become, can do damage to the image of a country from a business point of view and, indirectly, affect the level of the stock market and cause a rise the cost of capital.

As far as political influences in the UK are concerned, they are becoming more of an issue because a General Election has to be held by January 2025. Inevitably, politicians usually take a much shorter view in terms of policy making than the longer term policies that economies will ideally require. With inflation very high in the UK, politicians are under pressure to do something and companies are an easy target, particularly in the fairly strong anti business climate which prevails in the UK (and other countries) at present. There is no clearer example than the imposition of windfall taxes on energy companies following a sharp rise in their profits which had followed a period in the aftermath of the start of Covid when oil companies' profits collapsed, such is the nature of being involved in a commodity with sharp price fluctuations. As far as some governments are concerned, it's a "heads I win, tails you lose" position. However, the contradiction in the case of the UK is that the government is keen to license new North Sea oil and gas developments but it has taken short term measures on tax which have had a deterrent effect for companies which might apply for North Sea licences and activity is being scaled back in the industry. The UK market sells at a discount to many others, partly because of the "old economy" profile of a number of its large companies but also one feels that it is vulnerable to a further political and regulatory discount. It is important to emphasise that we do not air political views in these reviews, but we do point out the economic consequences of political and, in the cases of the UK and USA, tax decisions which should be relatively easy to discern and less controversial, with the example of North Sea exploration licences, detailed above, being a prime example. Whether or not one agrees with the policies, as investors or investment managers one must take into account the economic consequences which are easier to understand and from there to draw investment conclusions about a particular market. As it appears to us at the moment, even with its higher market rating, the USA looks a more reliable short term prospect than the UK and this continues to inform our investment thinking.

As we said at the start of this review, the "new normal" seems to be absorbing events which would normally be considered abnormal but, if we put this to one side, bond and equity markets are likely to be driven by developments on inflation and interest rates. Having been behind the curve in 2021 in failing to anticipate and act in a timely fashion on inflation, as far as one can see central banks are now moving the other way and taking a much more hawkish stance towards interest rates by not giving encouragement to those who see lower interest rates, at least in the USA, by the end of the year. Core inflation rates, i.e. those which exclude volatile items, remain stubbornly high. In the USA, the current core inflation rate is 5.5%, in the UK 6.8%, in the euro area 5.3% and in Japan 3.4%. Only in China is it below 1% at 0.7%. These are generally well above target levels of around 2%. So central banks will need to see a significant improvement in these levels if they are to relax monetary policy.

We explained earlier why we consider bonds still to be unattractive and cash also as an asset class, as opposed to being held for opportunistic reasons or short term requirements. Companies appear better able to keep up with inflation and it means that many with some pricing power are able to provide some compensation for investors by way of higher dividends. But, if we are right in being cautious about the outlook for interest rates this year because of the stickiness of core inflation, then, after a solid start to the year for international equities, it would be prudent to expect rises to be modest from here. But, because of the lack of attractions for other assets, equities remain our favoured asset because of the ability of many companies to pass on their increased costs and thus provide some protection from inflation. Above all, for sterling based investors, significant overseas exposure remains important in view of increasing risks in the UK outlined in this review.