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ASSET MANAGEMENT (C.I.) LIMITED

INVESTMENT MEMORANDUM

Difficult geopolitical developments in October have contributed to a setback in equity and fixed interest markets over the last quarter, not helped by a re-evaluation of the thinking of when interest rates will start to fall back again. As a result it has been a quarter of negative returns for equity and fixed interest investors. The quarter has also been notable for the strength of the US dollar, reflecting the relatively good position of its economy and interest rate attractions.

The tables below detail relevant movements in markets :

International Equities 31.07.23 - 31.10.23

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	-6.6	-6.9	-12.2	-8.5
Finland	-4.5	-2.9	-8.5	-4.5
France	-8.5	-7.0	-12.3	-8.5
Germany	-10.3	-8.8	-14.0	-10.3
Hong Kong	-14.1	-9.2	-14.4	-10.7
Italy	-4.8	-3.2	-8.8	-4.8
Japan	-2.4	-2.9	-8.4	-4.5
Netherlands	-14.7	-13.2	-18.2	-14.7
Spain	-5.4	-3.9	-9.3	-5.4
Switzerland	-8.6	-7.7	-12.9	-9.2
UK	-3.7	-3.7	-9.2	-5.3
USA	-8.3	-2.8	-8.3	-4.4
All World Europe ex UK	-7.6	-6.4	-11.7	-7.9
All World Asia Pacific ex Japan	-9.3	-6.5	-11.8	-8.0
All World Asia Pacific	-6.9	-5.3	-10.6	-6.8
All World Latin America	-7.7	-8.3	-13.5	-9.8
All World All Emerging Markets	-8.8	-5.4	-10.8	-6.9
All World	-7.8	-3.9	-9.4	-5.5

Source : FTSE All World Indices

FTSE UK Government Securities Index All Stocks (total return) : -1.7%

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

Currency	31.07.23	31.10.23
Sterling	4.31	4.51
US Dollar	3.96	4.93
Yen	0.60	0.94
Germany (Euro)	2.49	2.80

Sterling's performance during the quarter ending 31.10.23 (%)

Currency	Quarter Ending 31.10.23
US Dollar	-5.4
Canadian Dollar	-0.5
Yen	+0.6
Euro	-1.6
Swiss Franc	-1.2
Australian Dollar	+0.3

Other currency movements during the quarter ending 31.10.23 (%)

Currency	Quarter Ending 31.10.23
US Dollar / Canadian Dollar	+5.0
US Dollar / Yen	+6.0
US Dollar / Euro	+4.1
Swiss Franc / Euro	-0.1
Euro / Yen	+1.8

Significant Commodities (US dollar terms) 31.07.23 - 31.10.23 (%)

Currency	Quarter Ending 31.10.23
Oil	-2.7
Gold	+2.2

MARKETS

It has been a poor quarter for bonds and equities as the geopolitical background worsened considerably in October and investors became more cautious on the interest rate outlook.

In local currency terms, the FTSE All World Index showed a total return of -7.8%, in sterling terms -3.9%, in US dollar terms -9.4% and in euro terms -5.5%. Looking at local currency returns firstly, there was relative strength shown by the FTSE Japan Index, -2.4%, and the FTSE UK Index, -3.7%. The most notable underperformer was the FTSE All World Asia Pacific ex Japan Index, -9.3%. Looking at sterling adjusted returns, the strongest relative return was shown by the FTSE USA Index, -2.8%, followed by the FTSE Japan Index, -2.9%. There was relative weakness in the FTSE Australia Index, -6.9%, the FTSE All World Asia Pacific ex Japan Index, -6.5%, the FTSE All World Latin America Index, -8.3%, and the FTSE All World Europe ex UK Index, -6.4%.

Fixed interest securities had a difficult quarter. Taking benchmark ten year government bond yields, the gross redemption yield on the UK gilt rose by 20 basis points to 4.51%, on the US Treasury bond by 97 basis points to 4.93%, on the Japanese Government Bond by 34 basis points to 0.94% and on the German Bund by 31 basis points to 2.80%.

In the currency markets, the stand out currency was the US dollar against which sterling fell by 5.4%. Against the euro sterling fell by 1.6%, against the Swiss Franc by 1.2% and against the Canadian dollar by 0.5%. Sterling rose by 0.6% against the yen and by 0.3% against the Australian dollar.

In the commodity markets, oil, as measured by Brent crude, actually fell slightly, having risen after the 7th October attack on Israel. Gold has recovered much of its earlier weakness and rose by 2.2%.

ECONOMICS

The appalling carnage in, firstly, Ukraine, and now the Middle East as well, is the most important event, human rather than economic, to concern everyone. Markets have to make different judgements and do not always react as one might expect. Take the Russian attack on Ukraine. Equities did not have a disastrous year in 2022 at least as far as sterling based investors with important US exposure were concerned and had started to recover this year. For bonds, it was a different story but part of that was a function of their earlier gross mispricing. Now there is a war involving brutality on a hardly believable scale. There has been some market reaction but it has not been proportionate to the scale of the atrocities committed. Yet when we look back to 1973, the Middle Eastern war had a dramatic effect on the world economy as the oil price rose about two and a half times in a short time and petrol rationing came into play, formally or informally. The stock markets crashed. We had the sight of a UK cabinet minister travelling to Switzerland to meet the Shah of Iran to plead for some oil. It is early days in the current conflict between Hamas and Israel but the oil price has not jumped significantly and nor have stock markets moved a great deal. However, these are early days and a widening of the conflict in the Middle East involving oil producing countries would be a major threat to the stock market as the oil price would certainly react. Rightly or wrongly, the stock market suggests that the conflict can remain contained and that it is the oil price which is the main issue, so, if a view was taken that the conflict would not spread, investors could feel more relaxed about the prospects for inflation.

On the other hand, the Russian invasion of Ukraine has had widespread economic consequences, one of the main impacts being on food prices and helping to drive inflation higher with consequences for interest rates. It is changing views on the outlook for interest rates which has caused equity markets to pause and are likely to influence short term market movements.

In looking at the prospect for interest rates, it is worth revisiting the state of monetary policy in 2021 when, it is generally agreed, central banks were too tardy in raising interest rates in the face of stronger inflation numbers, which they incorrectly thought were "transitory" as a result of supply disruptions caused by Covid. Many commentators thought that their stance was too complacent at the time and history has proved them to be right. This meant that, when inflation did start to rise in 2021, they were not well placed to deal with the subsequent inflationary fallout from the invasion of Ukraine, hence the short period of sharp interest rate increases which inflicted such pain on bond markets in 2022. So, having been wrong footed by inflation two years ago, central banks seem determined not to be caught out again. At the beginning of 2023, many investors were prepared to back bonds because the extremely unfavourable relationship between interest rates and inflation looked like improving after a period of large negative real yields and that has happened in certain countries, notably the USA where the current core inflation rate and headline inflation rate are below nominal yields right along the spectrum. But, in the UK, Germany and Japan, core inflation adjusted yields are negative along all of the maturities and this, naturally, makes central banks cautious about cutting interest rates. Although energy prices are excluded from core inflation rate calculations, nervousness about the effect of rising oil prices as a result of the Middle Eastern conflict on the headline inflation rate calculation naturally remains. So, at the current time, what is being termed as the "Table Mountain" scenario is gaining ground amongst some commentators and investors. This is the "higher for longer" stage where interest rates stay at around current levels for a considerable time. Earlier on in the year, there had been optimism that they would be starting to fall by now but that looks misplaced. We cannot be sure that interest rates will not be raised further by central banks but, even if they are not, it now seems optimistic to expect an early reduction. As detailed above, the most favourable relationship between interest rates and inflation (China excluded here) lies in the USA. However, the US economy remains resilient in the face of the steep interest rate increases instituted by the Federal Reserve, a factor which will surely stay the Federal Reserve's hand for an early reduction in interest rates. Third quarter GDP figures show an annualised growth rate of 4.9% compared with 2.1% in the second quarter and, if this figure is confirmed, it will be the fastest rate of growth for nearly two years. One of the drivers of third quarter growth was consumer spending which rose at an annualised rate of 4%. The 3.8% unemployment rate also reflects strength in the US economy. So, whilst this is a reason for US interest rates to remain at least at their current level for a while, in the UK and eurozone it is inflation rather than economic strength which is likely to keep interest rates at least at this current level.

However, whether it is in the USA or here, it is important to reflect on the lags in monetary policy bearing in mind that it was only last year that central banks started to get serious about raising interest rates. If we take the UK, for example, many fixed rate mortgages at low interest rates are still in place but the hit to disposable incomes and therefore spending will not be felt until they are refixed so that the drag on economic growth will be drawn out. In the USA, for example, whilst the currency is buoyant at present, there is increasing concern about the property sector and problems for part of the banking system which this may cause. In this case, in the commercial property sector, it is not only higher interest rates which will affect borrowers but also the drop in demand for office space, in particular, following the "work from home" consequences of Covid. There is concern about the effect on some US banks' loan books relating to the property sector. Whilst the negative effect on banks' balance sheets in the main developed countries has not really shown through yet and they have had the benefit of rising net interest margins as interest rates have risen (though this effect shows signs of coming to an end), it will be realistic to expect some pain for them.

The lagged effect will also be felt in the sovereign and corporate debt sector and this is one of the main reasons why we remain negative on the fixed interest market notwithstanding the big fall in bond prices as interest rates have risen sharply. Dealing with sovereigns firstly, the negative factors are threefold, the large budget deficits which have to be financed, the refinancing of maturing debt which was issued at lower interest rates and, thirdly, the selling back to the private sector of central banks' stocks of fixed interest securities acquired during the period of Quantitative Easing as central banks, notably the Federal Reserve, Bank of England and ECB, embark upon Quantitative Tightening. If we look at forecasts from the Economist Intelligence Unit, it estimates the US budget deficit at 5.7% of GDP this year, the UK at 3.9%, the euro area overall at 3.4%, Japan at 5.2% and China at 3.2%. Within the euro area, there are, however, some big numbers, notably Italy at 5.3%, France at 5.0% and Spain at 4.1%. Looking at the USA, the US dollar is the world's largest reserve currency and there is always a demand for US dollars but this does not mean that the US budget deficit is not an issue. The size of new funding required to cover the US Treasury's requirements has implications for the interest rate that investors require. Of course, that is the case everywhere but the point is that the USA does not have immunity from normal supply/demand factors which determine pricing, i.e. interest rates. Where the USA and the UK have the advantage of issuing their own currencies, the eurozone does not and we see particular problems here, ones which we have articulated over many years in these reviews. The main problem, as we see it, is that it is not an optimal currency area with the members being too dissimilar to claim that. Since the euro came into being in 1999, eurozone economies have tended to diverge rather than converge as they were supposed to given the "one size fits all" interest rates. At present, Italy is the main concern with a government debt to GDP ratio of around 145% of GDP at the end of December and higher now. The Stability and Growth Pact rules suspended during Covid but now reinstated define budget deficit levels and ratios of outstanding government debt to GDP and were drawn up to meet the convergence requirements of monetary union. The recent Italian budget showed slippage from the goals of the Stability and Growth Pact as the government seeks to kick start a sluggish economy. The latest IMF World Economic outlook growth projections for Italy are just 0.7% for 2023 and 2024 which makes stabilising public debt difficult. Because it does not have a high credit rating, unlike Germany, its borrowing costs are higher with the yield on its ten year government bond being just under two percentage points higher than the equivalent German bund and it has briefly been more. Why does this matter in a monetary union? One obvious reason is confidence. The fact that Italy is running a large budget deficit, growing only slowly and paying a higher rate on it borrowing is likely to spark concern about its creditworthiness. Furthermore, because, unlike the USA and UK, it cannot issue its own currency, the traditional method of improving competitiveness by devaluing its currency is not available to it. In a currency union, it is difficult to contain a crisis. When Greece, a much smaller economy than that of Italy, got into severe trouble, it caused a major crisis for the single currency. Problems with Italy would be of a different order. The Italian government bond market is vast, about €2.840 trillion. Any credibility problems here would undermine the euro, the central bank and the Italian commercial banks which hold, it is estimated, €400 billion of Italian tradable debt. The relationship between a country's commercial banks with large holdings of its domestic sovereign debt gives rise to fears of a "doom loop". France's debt to GDP ratio is around 112% and it, too, is not making sufficient progress in reducing its budget deficit as the recent budget shows with a forecast deficit of 4.4% of GDP in 2024. Whereas Italy has to pay 190 basis points more for its 10 year government debt, France has to pay a 60 basis points premium and Spain where the debt to GDP ratio is about 113% has to pay about 103 basis point more. Both countries have better short term growth prospects than Italy, though still very modest. According to the IMF's latest projections, France will grow 1.0% this year and 1.3% next year whilst Spain will grow 2.5% this year and 1.7% next year. Debt at over 100% of GDP is considered too high, one reason being that additional debt service charges weigh down on countries' budgets and adversely affect growth through their effect on fiscal policy which has to accommodate the extra interest costs.

As one of the tools in its armoury, the ECB proposed a Transmission Protection Instrument (TPI) which is designed to allow bond purchases of individual euro states issues under certain circumstances in order to contain unwarranted interest rate hikes. By "unwarranted" it means relative interest rates which it considers too high on fundamentals. It will be interesting to see if it is used and, if it is, whether it will only be for the countries which are observing the rules of the Stability and Growth Pact. If they are not observing the disciplines required, for example by running budget deficits considered too large, the ECB could not use the TPI or, at least, it should not. The difficulty for the ECB, if bond spreads widen out as a result of a country's fiscal indiscipline, is that it would make its desired transmission of monetary policy more difficult overall. Whatever happens, we believe that the present economic position puts the eurozone in a very difficult place as far as monetary policy is concerned since three of the largest four eurozone countries are running excessive deficits and two of them appear to be rowing back on budget disciplines.

So, whilst the USA's problem is probably the price of money given its vast level of borrowing with the debt to GDP ratio being about 122% and the eurozone's is, in addition, strains caused by a monetary union which is non optimal, the UK faces a modified US issue. It certainly has to borrow plenty of money to finance its budget deficit but, like the USA, has the advantage of having its own currency. However, it has one major structural problem with its debt and this is the amount of index linked debt which has been issued. Around 25% of UK gilts are index linked and the high level of inflation over the last nearly two years has increased servicing and principal repayment costs when they fall due. In July, the ratings agency, Fitch, reckoned that the UK faced the highest debt interest servicing cost as a percentage of government revenue in the developed world in 2023 with the UK spending 10.4% of total government revenue on debt servicing costs, £110 billion. The UK is around the 100% debt to GDP ratio underlining the reasons why fiscal policy has to remain tight. The UK will be able to finance this, the price at which it does so being the question.

So, as far as fixed interest securities are concerned, in the short term inflation is not likely to fall enough for central banks to want to take any risk by relaxing monetary policy too early having been blindsided by the speed of the rise in inflation in 2022 even though it was partly caused by an unforeseeable event, the Russian invasion of Ukraine. In the very short term, there is the concern about the oil price in the wake of the Hamas attack on Israel. Notwithstanding that, OPEC+'s decision to restrict the supply of oil in order to keep the price of oil up was already effective and adversely affecting the headline rate of inflation. Traditionally, it was thought that the market was not affected by the size of bond issuance but views are changing in view of the vast supply of new issues to fund governments' budget deficits (corporates also want to borrow money) and the run down of central banks' balance sheets as they engage in Quantitative Tightening. Intuitively, it feels as if this will put upward pressure on interest rates or limit the size of any decline should inflation fall back. We have avoided fixed interest markets for a long time and, notwithstanding the sharp fall in bond prices, do not feel tempted to enter the market at this stage. It is interesting to note that, so far this year, equities have outperformed bonds measuring the FTSE All World Index against the Bloomberg US Agg Index in US dollar terms.

Of course, it has not been a banner year so far for equities, measured to the end of October, but it has been an impressive performance to notch up a small rise in the FTSE All World Index against such an inauspicious geopolitical and economic background. It is not a glib comment to say that one has to invest somewhere even if it is the least bad option. If we look at the areas in which we invest for clients, bonds, cash and equities (if we invest in property it would be through an equity or a REIT), we have indicated above why we still find bonds unappealing and would not include them in a portfolio unless the mandates required them to be included. We would hold cash in two circumstances. The first, which is appropriate to our client portfolios, is where, in a largely fully invested portfolio, we hold cash opportunistically, perhaps built up through dividend receipts, to take advantage of any really significant fall in markets to add to equity positions or for a known short term liability. As cash held this way will not detract significantly from performance in a rising market because the percentage held this way will be modest, we feel comfortable to have some cash to take advantage of a significant setback. The second circumstance for holding cash is one which does not feature in our thinking at present, namely as an asset class in its own right. We are long term investors and cash has never been a good long term investment when measured against equities. Even though interest rates have risen sharply in the UK, the interest rate is insufficient to offset the real value erosion of purchasing power caused by inflation. We would have to feel exceptionally negative about the prospect for equities to include cash as a main asset class in its own right.

In many markets equities do not look fundamentally expensive. Particularly in Europe, the low price/earnings ratios and therefore high earnings yields means that there is a large positive gap between them and their countries' ten year bond yields. The dividend yield advantages over, say, the relevant ten year government bond have largely disappeared so that part of the positive argument for equities can no longer be used. The US market is different. It is, as usual, more highly rated with a prospective price/earnings ratio of around 18 meaning an earnings yield of about 5.55% still ahead of that on the ten year US Treasury and marginally ahead of that on the two year US Treasury bond. Although the corporate earnings outlook is subdued, we note that most of the individual US equities which we hold have been raising their dividends when they are due for review, usually once a year. Whilst the US stock market has risen so far overall this year, the movement hides a wide range of sectoral outcomes. The S&P 500 Communications Services index, the S&P Information Technology Index and the S&P Consumer Discretionary Index have all performed very strongly whilst, at the other end of the scale, a number of sectors like the S&P 500 Utilities Index, the S&P Real Estate Index, the S&P Healthcare Index and the S&P Financials Index have performed poorly. Investment theory hasn't helped either this year. In a period of rising interest rates, one would have expected stocks, such as some of those in the technology sector with earnings well into the future and more difficult to calculate, to perform poorly. But, of course, some of them like the biggest two US companies, Apple Inc. and Microsoft Corporation are immensely profitable and also pay dividends. The theory behind the view that the sector can be expected to underperform at a time of rising interest rates is that future earnings may be a long way off but have to be discounted at a higher interest rate meaning that the net present value of those earnings streams is reduced. On the other hand, companies in steady sectors such as consumer staples with predictable near term earnings and reasonable dividend yields would hold up better but that has not happened either. In practice, a conservative investment management approach would be likely to favour the more defensive sectors in this economic environment where visibility is easier. What has happened is that for the technology sector one of the major events this year has been how AI has been pushed to the fore of investors' and politicians' attention and companies like Nvidia Corporation, whose chips are used, have put in a stellar performance. However, whilst US shares may seem expensive, we still have the area as our major geographical asset allocation because of the breadth of sectors reflected in the market and exposure to particularly interesting areas. It has plenty of economic issues to face, perhaps notably the budget deficit with the resulting enormous borrowing requirement and what it means for US interest rates.

In recent reviews, we have also started to focus increasingly of political and regulatory developments and we will have more to say in future reviews about this, particularly with the US Presidential and mid term Congressional elections taking place next November. The outcomes will be important for investors because one of the unfortunate outcomes of the Covid induced recession is that anti business rhetoric has ramped up and politicians seeking re election are not immune to populist pressures. There is the irony of the US President and probable opponent standing on UAW picket lines at a time when the Federal Reserve is fretting about inflation. We have also seen activist regulators in the USA, UK and EU coming to the forefront with their sights set on industries, notably technology and healthcare. We will say more about these issues in future reviews but they may well be relevant for investors.

Against such an uncertain background, we must expect a period of uneven returns. Investors will be relieved when they can feel more confident that interest rates have peaked and can look forward to the time when they can start to fall. Meanwhile, on the geopolitical front, the two major issues seemingly have no end in sight. However, it does seem that investors are now beginning to take events which, in previous eras, would have hit markets hard as part of a new normal and realising that to take a knee jerk reaction to their portfolios by selling good stocks could prove expensive. The most recent example of that is the brief but sharp fall in markets in late February 2020 when Covid came on the scene only to be followed by a strong recovery when central banks and government reacted. Those who sold out in late February 2020 suffered a huge opportunity cost losses.