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ASSET MANAGEMENT (C.I.) LIMITED

INVESTMENT MEMORANDUM

This has been a strong quarter for international equity markets with gains almost everywhere as fears about interest rates and trade wars receded, at least temporarily. Bonds, too, performed well so there was the strange position of many government bonds moving to negative yields out at the ten year maturity level, indicating serious economic concerns amongst investors, yet equities rising at the same time and Wall Street hitting new highs. In the foreign exchange markets, the US dollar was the best performer whilst, in commodities, the oil price was strong.

The tables below detail relevant movements in markets :

International Equities 31.01.19 - 30.04.19

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	+9.0	+6.2	+5.2	+7.8
Finland	+2.6	+1.1	+0.2	+2.6
France	+12.4	+10.8	+9.8	+12.4
Germany	+9.8	+8.2	+7.3	+9.8
Hong Kong, China	+8.4	+9.4	+8.4	+11.0
Italy	+11.0	+9.4	+8.4	+11.0
Japan	+4.4	+3.0	+2.0	+4.5
Netherlands	+13.1	+11.4	+10.4	+13.1
Spain	+7.5	+6.0	+5.0	+7.5
Switzerland	+11.9	+9.9	+8.9	+11.5
UK	+8.3	+8.3	+7.2	+9.7
USA	+9.5	+10.5	+9.5	+12.2
All World Europe ex UK	+10.6	+8.7	+7.8	+10.3
All World Asia Pacific ex Japan	+6.9	+6.5	+5.6	+8.1
All World Asia Pacific	+5.9	+5.1	+4.2	+6.7
All World Latin America	-0.1	-4.6	-5.5	-3.2
All World All Emerging Markets	+6.0	+5.4	+4.4	+6.9
All World	+8.6	+8.6	+8.1	+10.2

Source : FTSE All World Indices

FTSE UK Government Securities Index All Stocks (total return) : +0.7%

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

Currency	31.01.19	30.04.19
Sterling	1.24	1.12
US Dollar	2.71	2.53
Yen	0.01	-0.07
Germany (Euro)	0.08	-0.10

Sterling's performance during the quarter ending 30.04.19 (%)

Currency	Quarter Ending 30.04.19
US Dollar	-0.6
Canadian Dollar	+1.4
Yen	+1.7
Euro	+1.5
Swiss Franc	+1.9
Australian Dollar	+2.5

Other currency movements during the quarter ending 30.04.19 (%)

Currency	Quarter Ending 30.04.19
US Dollar / Canadian Dollar	+2.0
US Dollar / Yen	+2.3
US Dollar / Euro	+1.4
Swiss Franc / Euro	-0.4
Euro / Yen	+0.2

Significant Commodities (US dollar terms) 31.01.19 - 30.04.19 (%)

Currency	Quarter Ending 30.04.19
Oil	+16.9
Gold	-2.4

MARKETS

International equity markets performed strongly during the last quarter with the FTSE All World Index showing a total return of 8.6% in local currency terms, the same as the sterling adjusted return. In US dollar terms, the index returned 8.1% and, in euro terms, 10.2%. In local currency terms, the only area to show a negative return was Latin America where the FTSE All World Latin America Index returned -0.1%. Elsewhere, returns were fairly close to that of the FTSE All World Index with the laggard being Japan where the return on the FTSE Japan Index was 4.4% but that was still an excellent return. When we look at the indices in sterling adjusted terms, the USA stands out with the FTSE USA Index returning 10.5%. Because of currency weakness, the relative performance of the FTSE All World Latin America Index worsened with a -4.6% total return. Everywhere else, the picture is one of strong returns and we will discuss the reason for this in our review.

Perhaps surprisingly, with equities so strong one might have expected a reaction in bonds but that market, too, performed well. Taking ten year government bonds as a benchmark, we note that the gross redemption yield on the UK bond fell by 12 basis points to 1.12%, on the US dollar bond by 18 basis points to 2.53%, on the Japanese Government bond by 8 basis points to -0.07% and on the German Bund by 18 basis points to -0.10%. Negative yields would suggest that investors are expecting serious economic developments and require the safety of government bonds, yet equities tell a different story.

In the foreign exchange markets, the best performer was the US dollar against which a generally strong sterling fell by 0.6%, but against the Australian dollar sterling rose by 2.5%, against the Swiss Franc by 1.9%, against the yen by 1.7%, against the euro by 1.5% and against the Canadian dollar by 1.4%.

In the commodity markets, oil, as measured by Brent crude, rose by 16.9% on supply concerns, but gold fell by 2.4%.

ECONOMICS

Despite a moderate deterioration in the economic outlook, international equity markets have shown a resilient performance in the first four months of 2019, thereby reversing the weakness seen in the fourth quarter of 2018. In basic terms, we attribute this to the marked change in monetary policy projections, particularly in the USA where the Federal Reserve made an abrupt about turn in policy at the end of January in the face of less promising international economic prospects. At the same time, there appeared to be some easing of the trade tensions between the USA and China, although we await the final outcome of negotiations. Put simply, the issues which caused marked weakness in Q4 2018 appeared to reverse and equities recovered the ground lost there.

This bull market is now entering its eleventh year and its sheer longevity naturally makes some investors nervous but, in considering this remarkable run, we must return to the extraordinarily accommodative monetary policy which was adopted to fight the effects of the global financial crisis at that time and the ensuing economic recession. So far, it has proved almost impossible to wean the world economy off ultra loose monetary policy, although there have been central banks, notably the Federal Reserve in the USA, which have taken some steps in that direction, but always from an extreme position. With the USA leading the economic recovery in the developed world, the Federal Reserve instituted nine rate increases since interest rates reached their trough and was expected to make two further increases this year. This is not now expected to be the case.

With the world economy slowing down, at least temporarily, one might expect shares to reflect the more cautious outlook for company earnings but, as the progress of international stock markets shows so far this year, this has not happened. This, we believe, is due to the changed perception of the relationship between interest rates, whether short or longer term, and dividend yields. Until the Federal Reserve's U turn on interest rates in January, the prospect of further rises in US interest rates made the relationship between interest rates and dividend yields less appealing to equity investors, this being particularly true of the USA. If we look at the relationship between the relevant ten year government bond and the dividend yield on the same equity market, it is generally the case that equity yields are well in excess of the relevant bond yield. It is unlikely that there will be an economic recession in the near future which would lead to significant dividend cuts, so the cushion which dividends have over fixed interest securities remains appealing in these markets. So, for example, if we look at the Euro Stoxx 50, the yield difference against the negative yielding ten year German Bund is currently 3.5%, in the case of the UK, using the FTSE100, it is 3.7%, in the case of Switzerland, it is 3.645% (again the ten year government bond yield is negative) and, in the case of Japan, it is 2.13% (also a negative ten year government bond yield). The exception, and it is a big one, is the USA where the ten year US Treasury bond has a yield advantage against the S&P500 of 0.62%. But this is not an enormous difference as we can still expect the dividends of US companies to grow and, of course, for many years this reverse yield gap would have been the norm. With US ten year government bond yields having fallen back from their peak in the recent past of around 3.24%, they are now about 2.5%, the relationship does not seem to be uncomfortable for equities given that the S & P 500 index is yielding around 1.9%.

This relationship is important when we consider the shape of the yield curve which market bears have cited as a reason to be sceptical about the stock market's recovery this year. Depending upon which measure of short term interest rates one takes and which maturity of bond is used, the US yield curve did temporarily invert. For many people, this indicates a recession is on the horizon with the lower yield on the longer maturity, say the relevant ten year government bond, indicating that short term rates will need to be cut to deal with the expected recession. One of the dangers is that investors may believe that "this time it is different" and we will not know for some time how the economy will perform in the foreseeable future. However, we do give credibility to the view that monetary policy has so distorted markets and suppressed yields that it may not be a reliable indicator this time. At the moment, if we look at the USA, and even if we take the three month US Treasury Bill rate and compare it with the ten year US Treasury bond yield, there is a very gentle upward slope and a more pronounced one if we compare the two year US Treasury Bond yield with the ten year US Treasury Bond yield. Elsewhere, the yields are upward sloping with the recovery in equity prices engendering more confidence and this has had the effect of pushing up bond yields from recent low points. For the moment, we do not see enough evidence to suggest that a recession is likely. Obviously, things can change, for instance a full scale trade war may ensue, but this is not our central case at present. For us, the interest rate background is more persuasive as a guide to where equity prices might go. Whilst this might be positive in the short term, it does not change the view that monetary policy, as currently implemented, is creating enormous economic distortions and it remains essential that there is a move towards normality as soon as possible although, with inflation low, it is likely that "normal" will mean a lower interest rate level than in the past.

So what is the near term economic outlook? The IMF has just published its latest economic projections and, not unexpectedly, they are weaker than the ones they made in January. Looking at the prospects for 2019, it now sees world economic growth at 3.3%, a reduction of 0.2% on January's projection, and 3.6% for 2020 which is unchanged. This compares with growth of 3.6% in 2018. This is a modest level of growth but not a disaster. Within this overall total, the expectation for Advanced Economies is of growth of 1.8% in 2019, a reduction of 0.2% on its forecast in January, and 1.7% for 2020 which is no change from January. The growth rate for Advanced Economies in 2018 was 2.2%. When this figure is broken down by the IMF, it shows that it has reduced its forecasts all round. It projects growth of 2.3% for the USA in 2019 (2018, 2.9%), a reduction of 0.2% from January, but it has raised its projection for 2020 by 0.1% to 1.9%. The eurozone has seen a larger reduction of 0.3% for 2019 to 1.3% (1.8% in 2018), and 0.2% for 2020 to 1.5%. The two biggest reductions in forecasts for 2019, 0.5% in each case, are for Germany and Italy to 0.8% and 0.1% respectively. The 2020 forecast for Germany has been cut by 0.2% to 1.4% and for Italy the figure remains unchanged at 0.9%. Although the projections for France have been reduced for both 2019 and 2020 by 0.2% to 1.3% and 1.4% respectively, they compare favourably against Germany for 2019 and against Italy for both years. The change for Japan is minor, down just 0.1% in 2019 to 1.0% and unchanged for 2020 at 0.5%. The UK has seen a 0.3% downgrade in the forecast for 2019 at 1.2% and of 0.2% in 2020 at 1.4%. Looking at Emerging Markets and Developing Economies, the downward adjustment is very minor at 0.1% for both 2019 and 2020 to 4.4% for 2019 and 4.8% for 2020. There is actually very little change for China, up 0.1% in 2019 to 6.3% and down 0.1% for 2020 to 6.1%. The forecasts for India have been reduced for both years by 0.2%, to 7.3% for 2019 and to 7.5% for 2020. The IMF describes the background as one of "A Weakening Expansion" with the risks tilted to the downside. Nevertheless, the projections still show the world economies to be expanding, something for equity bulls to focus upon against the supportive interest rate background described earlier.

There are always issues to worry investors and most of the time they do not have a major effect on markets but sometimes, of course, they do and investors have to weigh them up to see where the balance lies. What are the current negatives and possible negatives that we can see at present? One of the two negatives which weighed on markets in the final quarter of 2018, the US/China trade dispute, has not yet been settled but the atmosphere seems to have improved, leading to an increasing expectation of a successful outcome to the negotiations. We will have to see but, on this score, the balance of probabilities does not validate a negative view of the stock market. Whilst this negative may be waning in importance, another one is assuming more importance and this is the trade dispute between the USA and the EU. President Trump has threatened to impose tariffs on US$11 billion of EU products as a result of what he determines are unfair subsidies given to Airbus. The EU has threatened to retaliate by listing US$22.6 billion of US imports which could be hit with tariffs. We do not know how this dispute will end but we can say that the magnitude of goods threatened with tariffs is far less than those involved in the US/China trade dispute. Protectionism is unreservedly bad and it is to be hoped that some agreement will be reached. At the moment, there is not sufficient evidence of a significant threat to influence a decision to downgrade investors' equity exposure.

A further potential threat is from a rising oil price. The US sanctions on Iran have now been stiffened as the waivers provided to some countries, namely Italy, Greece, Turkey, China, India, Japan, South Korea and Taiwan will be withdrawn in May. It may be asked how the USA can enforce its sanctions extra territorially. The answer is that oil is paid for in US dollars, and these have to be cleared through the USA, so the USA can shut foreign banks out of its payments system. This is a very severe sanction and the reason why it is likely to be effective. The problem for President Trump, seeking re-election next year, is that if the price of oil increases to, say, US$100 a barrel, the rise in motoring costs in the USA will not be popular with the electorate. The International Energy Authority says that the market is well supplied with oil but there are a number of problems which could affect this judgement. Libya is one, Venezuela is always an issue, and the ability of Saudi Arabia and the UAE to produce more as well as the ramp up of US shale oil production are others. So there are quite a number of variables which have to go the right way if Iran's oil exports are curtailed. Whilst the world economy can probably weather the current price (Brent crude at c. US$72 a barrel), a move to, say, US$100 a barrel would cause a headwind for the world economy. The move by President Trump to end the oil waiver has caused some surprise given the unpopularity of rising petrol prices in the USA, so he has taken a risk given that he has to face re-election next year.

The eurozone also presents a risk. Whilst Brexit has taken centre stage, it is less of an issue, at least in the medium and longer term, than the problems of the eurozone. If we look at the latest IMF projections, we see some very weak numbers within the eurozone and the one which stands out most is Italy where the IMF sees hardly any growth this year and very little even next year. In the context of very high debt levels, with government debt probably around 133% of GDP, a very weak growth figure will exacerbate the country's budget deficit situation and put it outside the EU's Stability and Growth Pact rules. There was a major struggle last year between the new coalition government in Italy and the EU over the country's budget, which ended up with a compromise of a deficit at 2.04% of GDP, but it was predicated on a growth rate which was thought to be unrealistic. The government now expects a budget deficit for this year of 2.4%, above what was agreed with the IMF, and that the deficit would fall to 2.1% in 2020. If the economy does grow at only 0.1% this year, a level of 2.4% would seem to be unrealistically low. The danger in the long term is that, if interest rates revert to their mean, the servicing costs will become very burdensome and cause a loss of confidence. For some economists, the level of Italian debt has gone beyond the point of no return where it will be very difficult to stop it growing. This introduces the concept of the doom loop with the sovereign's problems feeding through to the banks, which are large holders of Italian government debt to the tune of up to 15% of their assets. The ECB holds 15% of outstanding Italian government debt. With Italian banks having a substantial proportion of non performing loans, the ratio is nearly 10%, any weakening of the capital ratios because of a fall in the value of their holdings exacerbates their problems. Other countries, notably France's banks, are large holders of Italian government debt. So, whilst, at the moment, it is not an issue which is affecting markets, it is one which could rear its head at any time, which is one reason we often draw attention to the potential problem of Italy in our reviews.

Nearer home, there is Brexit. Given that the subject dominates the British news, it might be thought that it was one of the major issues dominating international stock markets. The truth is that, on an international scale, it is not an important issue. At a local level, a concern is that, leaving without a deal, will, at least in the short term, affect the UK and EU economies which, in a rational world, is a good reason for reaching a mutually beneficial deal. However, even then, in the absence of a deal there is no reason why there should be a much longer term effect on either the UK or EU economies since businesses are good at reacting to different scenarios. The real danger remains the collateral political damage being done in the UK which must have increased the possibility of a change in government in 2022, or earlier, if the Fixed Term Parliament Act is overcome. The coming into office of a Labour government with policies extreme by UK standards would almost certainly hit the stock market and sterling hard. As we repeat in every review, this possibility places the UK stock market in the high risk category, which is unfortunate because, in many respects, it is one of the most attractive, absent the political risk. However, the risk is very clear which is why it is the most significant of the possible risks detailed so far in this review for sterling based investors. Our investment policy, which centres on geographical diversification, reflects this and we do not see it changing soon.

As is often the case in our reviews, we look at the latest purchasing managers indices to gain an understanding of the pace of activity in different parts of the world. These are well regarded indicators and investors take a great deal of notice of them. In the case of the USA, these remain satisfactory, although off peak levels seen last year. The latest index for manufacturing stands at 52.8 and that for non manufacturing at 55.1, suggesting moderate growth, although the first estimate of first quarter US GDP exceeded estimates as it showed annualised growth of 3.2%. Behind the figures, there is some room for caution, but they do not suggest that a recession is as imminent as yield curve followers might suggest. Unusual factors might include businesses changing their behaviour because of the US/China trade dispute. A narrowing of the trade gap was a positive driver of growth but it may not be a valuable indicator for the future. The latest employment figures remain strong. Nevertheless, as we see matters now, the rebound in the US stock market does not seem an aberration. At a record level, Wall Street stands slightly above its forward looking long term price/earnings ratio but, given the outlook for interest rates, this can be accommodated. It does mean, however, that expectations of market movements in the near future must be more modest. In the eurozone, however, the picture is concerning. The IMF's forecasts, detailed earlier, show the growth outlook in the immediate future to be quite modest and the indices reflect this. The latest composite PMI index for the eurozone stands at 51.3 which signals low growth. Within that, the services sector index stood at 52.5 and that for manufacturing at 47.8. In the three largest eurozone economies, Germany, France and Italy, the manufacturing PMIs were all in negative territory with index readings of 44.5, 49.6 and 49.1

respectively. In all three cases, the composite index stood at 50 or above because the more important services sector indices were in positive territory. However, there is some evidence that the eurozone may be in a better position than the PMIs indicate. The flash estimate from Eurostat suggests first quarter GDP growth of 0.4%, up from 0.2% in the fourth quarter of 2018. It remains to be seen if this carries through. The PMIs were weak for the UK with the composite index at 50.0, the dividing line between growth and recession. Whilst the services PMI was weak at 48.9, the much smaller manufacturing sector stood at 55.1. The paradox is, of course, that a number of UK economic indicators are strong such as employment levels and government finances. It is unfortunate that Brexit crowds out the economic news as the UK's relative economic position is quite good notwithstanding the weak PMIs. In Japan, the figures are lacklustre with the composite PMI standing at 50.4, manufacturing at 49.2 and services at 52.0. In China, the latest data continues the trend evident this year of little change in monthly movements. The manufacturing PMI stands at 50.1 (in January it was 49.5) and the non-manufacturing index stands at 54.3 (54.7 in January).

Whilst the overall picture derived from the PMIs, apart from the USA, is dull in the developed markets, they should be seen in the context of their influence on central banks' interest rate setting committees, and that includes the USA. In our reviews at the beginning of 2018, the major issue we highlighted was how the interaction of rising interest rates, which we knew were coming from the USA, and equities would play out. Our feeling was that the outlook for company earnings was sufficiently good for shares to be able to taking rising interest rates in their stride although this would be the main issue for investors. As we know, other issues intervened but that was likely to be the overarching influence on markets. In the end, markets showed a modest negative return for the year because of a poor fourth quarter where fears of an aggressive interest rate policy by the Federal Reserve and the trade friction between the USA and China tipped the balance against what would probably have been a modestly positive year for equities.

However, with the Federal Reserve's abrupt about turn on interest rates, investors seemingly do not have to concern themselves with interest rates this year and should be able to live with the more modest outlook for corporate earnings growth this year in the USA, perhaps about 3% year on year. Any of the issues which we mentioned earlier in this review could hit the market and, apart from in the USA, monetary policy's ability to do the heavy lifting is much diminished so, if there is a slowdown, fiscal policy might have to be used. The distortions which the extreme use of monetary policy has caused are highly undesirable but, in the short term, should support equity markets. It is likely to be a long time before we see any value in bonds. The vast majority of our clients are sterling based and it is difficult to overstate the risks in the UK because of the political situation, so we retain, unless the mandate dictates otherwise, our substantial overseas exposure as an insurance policy apart from the enduring desirability of holding a well diversified portfolio of assets.