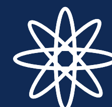

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ASSET MANAGEMENT (C.I.) LIMITED

INVESTMENT MEMORANDUM

It is not easy to say anything positive against the background of the dreadful humanitarian crisis being experienced in Ukraine. The economic implications seem almost secondary, but they are immensely important and we consider these in our review. Given the gravity of the situation, securities' markets have held up reasonably well, especially equities, but some areas of the fixed interest market have experienced heavy losses as yields have risen.

The tables below detail relevant movements in markets :

International Equities 31.01.22 - 29.04.22

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	+9.5	+18.1	+10.5	+17.4
Finland	-5.0	-4.4	-10.6	-5.0
France	-5.6	-5.1	-11.2	-5.6
Germany	-11.2	-10.7	-16.5	-11.2
Hong Kong, China	-8.0	-2.3	-8.6	-2.8
Italy	-8.7	-8.2	-14.1	-8.7
Japan	+1.3	-3.8	-10.0	-4.3
Netherlands	-10.1	-9.6	-15.4	-10.1
Spain	+1.3	+1.9	-4.7	+1.3
Switzerland	+1.2	+3.8	-2.9	+3.2
UK	+2.5	+2.5	-4.1	+1.9
USA	-8.7	-2.4	-8.7	-3.0
All World Europe ex UK	-7.2	-6.2	-12.2	-6.7
All World Asia Pacific ex Japan	-4.2	+0.3	-6.2	-0.3
All World Asia Pacific	-2.4	-1.1	-7.4	-1.6
All World Latin America	-1.2	+10.4	+3.3	+9.8
All World All Emerging Markets	-8.3	-3.6	-9.8	-4.2
All World	-6.5	-1.9	-8.2	-2.5

Source : FTSE All World Indices

FTSE UK Government Securities Index All Stocks (total return) : -6.2%

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

Currency	31.01.22	29.04.22
Sterling	1.30	1.90
US Dollar	1.78	2.93
Yen	0.17	0.21
Germany (Euro)	0.01	0.94

Sterling's performance during the quarter ending 29.04.22 (%)

Currency	Quarter Ending 29.04.22
US Dollar	-6.5
Canadian Dollar	-5.2
Yen	+5.5
Euro	-0.4
Swiss Franc	-1.7
Australian Dollar	-6.4

Other currency movements during the quarter ending 29.04.22 (%)

Currency	Quarter Ending 29.04.22
US Dollar / Canadian Dollar	+0.9
US Dollar / Yen	+12.6
US Dollar / Euro	+6.4
Swiss Franc / Euro	+1.7
Euro / Yen	+5.9

Significant Commodities (US dollar terms) 31.01.22 - 29.04.22 (%)

Currency	Quarter Ending 29.04.22
Oil	+22.1
Gold	+5.6

MARKETS

The Russian invasion of Ukraine has, as one would expect, left its impact on markets during the quarter. The total return on the FTSE All World Index in local currency terms was -6.5%, in sterling terms -1.9%, in US dollar terms -8.2% and, in euro terms, -2.5%. Looking at individual countries and areas in local currency terms, the FTSE USA Index underperformed the FTSE All World Index, returning -8.7%. Not surprisingly, the FTSE All World Europe ex UK Index also underperformed, returning -7.2%, although, within that area, Switzerland and Spain returned positive results. Emerging markets, too, underperformed, with the FTSE All World All Emerging Markets Index returning -8.3%. By far the best market, reflecting its commodity status, was Australia, where the FTSE Australia Index returned +9.5%. The UK also performed well, reflecting the weighting of the index in energy, mining and value stocks generally. It returned +2.5%. Moving on to sterling adjusted returns, the picture changes. With the strength of the Australian dollar, the FTSE Australia Index returned +18.1% and the FTSE All World Latin America Index moved from a slightly negative local currency return to a positive sterling return of +10.4%. Within the FTSE All World Europe ex UK section, the performance of the FTSE Switzerland Index advanced to +3.8%. Although the FTSE USA Index returned -2.4% in sterling terms, this was much less negative than the local currency return of -8.7%. The FTSE All World Asia Pacific ex Japan Index also managed a very small positive return in sterling terms, +0.3%.

International bond markets experienced a poor quarter, not unexpectedly. The serious overvaluation which was evident pre Ukraine was made worse by the inflationary effects of the invasion, especially from commodity prices. Taking ten year government bond yields as a benchmark, the gross redemption yield on the ten year UK Government Bond rose by 60 basis points to 1.90%, on the US Treasury Bond by 115 basis points to 2.93%, on the Japanese Government Bond by 4 basis points to 0.21% (the Bank of Japan operates a policy of yield control so the rise is much less than elsewhere) and on the German Bund by 93 basis points to 0.94%.

The feature of the currency markets was the significant weakness in the Yen, against which sterling, itself weak, rose by 5.5%. Against the US dollar, sterling fell by 6.5%, against the Australian dollar by 6.4%, against the Canadian dollar by 5.2%, against the Swiss Franc by 1.7% and against the euro by 0.4%.

Commodity prices, as one would expect, were seriously affected by the invasion. Oil, for example, as measured by Brent crude, rose by 22.1% and gas prices rose dramatically. Gold rose by 5.6% over the quarter.

ECONOMICS

It is difficult to find anything positive to say about the current economic situation. It is unremittingly bad although, as we will argue later in this review, that does not necessarily read across to the stock market or, at least, the equity part of it. Against such a dreadful humanitarian crisis it seems almost indecent to be discussing the economic implications of what has happened since the end of February. Even in the unlikely event that some sort of solution is reached in Ukraine in the near term, the economic consequences are likely to be long lasting and very painful for many.

As we said in our review last month, investors' concerns at the beginning of 2022 centred on rising inflation and the prospect of higher interest rates and the brakes being put on quantitative easing (QE) or even its reversal, quantitative tightening (QT). For reasons which were not foreseen, i.e. the Russian invasion of Ukraine, these fears have intensified and become reality as far as worsening inflation is concerned and higher interest rates in some countries as well as more hawkish indications from central banks about pausing QE or moving to QT.

Years of low inflation have lulled many investors into a false sense of security and maybe central banks too. Yet ballooning central bank balance sheets as a result of QE left an uneasy feeling that, if economic confidence returned, the money which had been created would lead to strong growth in money supply as the money multiplier rose as banks made more loans. For whatever reason, central banks appeared to believe that supply shortages caused by the pandemic, which resulted in rising inflation, would fall back as soon as normality returned. For this reason, central banks often referred to the spike in inflation as transitory.

However, inflation can easily become embedded in an economy. With many people having left employment during the pandemic, a new issue arose, namely the shortage of staff within the hospitality industry, a well known example of the "great resignation". With strong competition for staff, wages in the affected industries have been rising sharply, and prices, too. At the moment, it is difficult to forecast what will happen to money supply growth because the Russian invasion of Ukraine will have dented confidence, but there is no doubt that central banks, led by the USA and UK, are sufficiently concerned about the potentially inflationary effects of their bloated balance sheets to be instigating actions to reduce their size. Whether this is done by not reinvesting maturing securities or by actually selling existing ones, this can be expected to place upward pressure on interest rates as new sellers of existing securities (i.e. central banks) enter the market. These are markets setting interest rates with fixed interest yields being determined by buyers and sellers. With governments still having to borrow heavily to fund their budget deficits and some central banks curtailing or stopping their buying or planning to sell some of their fixed interest inventory as just mentioned, there is a big headwind for fixed interest securities and we expect yields to continue to rise for market related reasons. At the same time, administered interest rates, those determined by central banks, will certainly be rising and, in the case of the USA, almost certainly in steps of 50 basis points, quite an aggressive position to take but reflecting the fact that inflation has got away from the Federal Reserve. When this happens, central banks have to overcompensate for earlier failures to tackle incipient inflation, with the probable result that economic growth suffers as interest rates rise to higher levels than need have been the case had action been taken earlier. In fact, on 4th May, the Federal Reserve did raise interest rates by 0.5%.

The dilemma for central banks has become even more difficult following the Russian invasion of Ukraine. Inflationary pressures have become more acute as energy prices have increased sharply as buyers have sought alternatives to Russia. According to the OECD, Russa supplied around 19% of the world's natural gas and 11% of oil. As the OECD points out, Russia and Ukraine are important producers of wheat, fertilisers and metals used in industry such as nickel and palladium. On top of this, a further threat to the world economy has arisen from the drastic lockdowns in China as a result of the country's zero Covid policy. As China is still an important supplier of manufacturing components, such a drastic lockdown will affect the world economy further. On top of this, there are severe shipping delays caused by Chinese ports being clogged up.

The world economy therefore faces a perfect storm, namely central banks being "behind the curve" on monetary policy tightening prior to the Russian invasion of Ukraine, the existing pre-invasion inflation problem being exacerbated by the invasion, the downgrading of international economic growth projections as a result of the invasion and further threats to growth caused by China's zero Covid policy, which has cut Chinese manufacturing output on the back of lockdowns and serious congestion at Chinese ports, all of which affect the international supply chain and damage growth prospects in the foreseeable future.

The combination of these events has increased significantly the prospect of "stagflation", a state of affairs which economists find very concerning as it combines high inflation with little or no economic growth and takes many economists back to the 1970s, a very difficult time economically. The situation is evolving on a daily basis in Ukraine and China and forecasts made recently may easily be proved wrong in a short time. In its April 2022 World Economic Review, the IMF forecast that global economic growth would be 3.6% in 2022 and the same again in 2023 compared with 6.1% in 2021. The forecast growth rates for 2022 and 2023 are 0.8% and 0.2% lower than the IMF's January forecasts. On the inflation front, it expects war induced commodity price increases and broadening price pressures to mean inflation of 5.7% in advanced economies and 8.7% in emerging market and developing economies, these figures being 1.8% and 2.8% higher than projected in January. Given the lockdown in China and little sign of the zero Covid policy being reversed, it may be that these figures will have to be raised further. As the second largest economy, what happens in China will be important. Whilst the official target for growth in China this year is 5.5%, most commentators believe this to be optimistic in view of the drastic lockdowns and the IMF's latest forecast is a more realistic 4.4% which compares with a growth rate of 8.1% in 2021.

If we look back to 2021 and the policies which central banks were following, it was clear that they were focused on not doing anything to damage economic growth prospects as countries started to recover from the Covid-19 induced recession of 2020. Had not inflation taken off so significantly in 2021 and 2022, it was likely that they would want to have sustained their loose monetary policy for longer than now looks likely. Now, however, they have been backed into a corner and it seems that central banks are now prioritising the fight against inflation, so we can expect to see, in most countries, a series of interest rate increases, some of them quite sharp, i.e. 50 basis points at a time as the Federal Reserve has just announced, even if it further reduces economic growth prospects.

Given the global implications of this prospective significant tightening of monetary policy, there seems little point in delving too deeply into each country's or area's particular prospects because of the fast moving background. The broad implications of "stagflation", if it occurs, are to some degree relevant everywhere. However, before we discuss the general implications for the different asset classes, it is worth looking at how various markets have performed so far this year and why there may have been differing performances and see what they might tell us about investors' perceptions of the current situation.

If we take the year to date picture rather than the last three months, as shown in the tables at the beginning of this review, and look at equities first in local currency terms, we can see that the USA, Europe and China have suffered badly. At the time of writing, and looking at the USA first, we can see that the NASDAQ index fared particularly badly, falling by nearly 20%. This accords with investment theory, namely that at a time of rising interest rates, those companies with earnings well into the future and possibly having no or little yield will underperform as those earnings, if they exist at all, will be discounted at a higher rate as interest rates rise. This is the opposite of what has happened previously when the type of stocks represented in the NASDAQ outperformed as growth companies benefited from a period of ultra low interest rate as the discount rate was lower. Elsewhere, Europe has performed poorly, not surprisingly considering that some of the worst effects of the invasion have been seen there,

with Germany, for example, being in a compromised energy situation given its reliance on Russia. China has been one of the worst performers for a myriad of reasons, amongst the most recent ones being the regulatory crackdown on certain sectors, sometimes linked with the "common prosperity" theme of President Xi and, now, the zero Covid-19 strategy which has locked down important parts of the Chinese economy and damaged the country's economic growth outlook, such that the 5.5% growth target set for 2022 looks very unlikely to be achieved. As for the relatively strong performers, the UK, Australia, Canada and Brazil, stand out. There is no mystery about the last three. They have benefited from the boom in commodity prices. As far as the UK is concerned, the importance of oil and mining stocks has helped, together with its bias towards value stocks where dependable future earnings and reasonable dividend yields make them relatively more attractive at a time of rising interest rates. This is in local currency terms. Whilst the USA has had a difficult time in local currency terms, in times of uncertainty, the US dollar is seen as a safe haven currency and the decline in the S & P 500 index in sterling terms has been reduced to a more modest -5.3%. The European and Chinese markets have given no significant relief to foreign investors from currency movements. On the other hand, the Canadian, Australian and Brazilian currencies have all been strong and, in sterling terms, all three markets are showing gains so far this year. So, we can reasonably cite the reasons for the divergence in international equity markets' performance so far this year.

Turning to the international bond markets for the calendar year to date and taking by way of example ten year government bond yields, we can see the extent of the rise in gross redemption yields and, therefore, the extent of the negative returns. Taking three markets, the USA, UK and Germany, the gross redemption yield on the US Treasury bond has risen by 1.442% to 2.952% (total return c. -8.1%), on the UK government bond by 0.999% to 1.963% (total return c. -7.4%) and on the German Bund by 1.154% to 0.968% (total return c. -9.74%). If we look at 30 year maturities, where the greater risk lies, the total return on the US Treasury bond is c -21.1%, on the UK government bond c. -19.7% and on the German Bund c. -34.4%. These are substantial losses and show the risks involved in investing in the fixed interest market when yields are completely unrealistic, as they have been for a long time. And what happens when you issue a 100 year maturity bond like highly rated Austria has done? So far this year, the total return has been -37.7%. Unless there was a requirement to invest in these fixed interest securities, why would one buy one if operating an unconstrainted mandate? If we look at the extreme example of the Austria bond, the gross redemption yield at the time of writing is 1.87% and the Austrian rate of inflation is 6.7%. That still looks a terrible investment, but full credit to Austria for locking in such an attractive interest rate. But back to 10 year government bond yields and inflation. In the USA, we can compare the ten year government bond yield of 2.952% with the current annual inflation rate of 8.54%. In the UK, the relevant rates are 1.963% and 6.2% and, in Germany, 0.968% and 7.31%. It is also worth looking at the 30 year government bond yields in the context of the inflation figures detailed above. In the USA, the US Treasury bond yields 3.045%, in the UK 2.119% and in Germany 1.102%. These are not much higher than the yields on the ten year bonds and they look totally unrealistic, so the large negative returns seen so far this calendar year look set to get worse in our view. One might query why the USA has to pay a premium for its borrowing over, say, the UK, particularly when the US dollar is strong against sterling. The answer probably lies in its more expansionary fiscal policy and its projected larger budget deficit this year, estimated by the Economist Intelligence Unit this year at 7.5% of GDP. An area where rising interest rates might be expected to cause particular problems is the eurozone where fault lines might be caused by the high level of outstanding public debt as a percentage of GDP in different countries. We can see this in the widening yield spreads against the best eurozone credit, Germany. At the time of writing, the 10 year German government bond yield of 0.968% compares with that of heavily indebted Italy of 2.90% and Greece of 3.367%. As interest rates rise, one can expect bond markets to probe for signs of weakness and the eurozone with its common currency but, with countries in very different financial positions, looks vulnerable. If eurozone countries' performance was supposed to converge under the euro, it has actually gone the other way. We think that the notable caution of the ECB in starting to tighten monetary policy may be connected with potential vulnerabilities arising from various eurozone countries' financial and economic weakness.

So where does this leave investors? As we said earlier on, the fact that the economic outlook is dreadful does not necessarily read across to all securities markets. Investors have to invest in something whether it be fixed interest securities, cash or shares. We are excluding here consideration of investment in other asset classes like alternative investments, cryptocurrencies, physical real estate (although not REITs) or gold. From what we have written above, it can be seen that we are extremely negative still on the fixed interest market and we have a high degree of certainty that anything other than the shortest maturities will prove poor investments and the further along the yield curve that one goes the negative returns will be ever more significant. Cash as an investment, as opposed to being held for near term potential liabilities, has the advantage over fixed interest investments in that its nominal value will not fall but, in terms of keeping up with inflation, even as interest rates rise, its purchasing power will fall each year. For long term investors, this leaves shares. Normally, in the early stages of central bank monetary tightening through interest rate increases, shares may do well because it implies that an economy is growing more strongly, which should be good for corporate profits. This clearly is not the case now but, with other assets unattractive in our view, we feel that shares win by default. The positive case is that some companies are able to withstand inflationary pressures by raising prices, whilst others benefit from what are probably secular price trends in energy and mining companies as a result of various recent political and economic developments. Banks may be expected to benefit from wider net interest margins as interest rates rise. So, it is not all bad, but the background is so uncertain that investors must expect a volatile ride and certainly some negative quarters but should always bear in mind the longer term perspective that the world economy is likely to continue to grow with the likely benefit to investors of increased dividends arising from increased profits which should provide at least a good support for share prices and, hopefully, more capital growth.

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