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ASSET MANAGEMENT (C.I.) LIMITED

INVESTMENT MEMORANDUM

It has been a strong quarter for equities and bonds, an unusual phenomenon as they could be expected to be negatively correlated, but the interest rate background has upended this relationship by providing an impetus to both asset classes. A further feature of the quarter has been the weakness of sterling as a consequence of the political background in the UK. A notable feature has been the strength of gold, providing a haven in these unsettled times.

The tables below detail relevant movements in markets :

International Equities 31.05.19 - 30.08.19

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	+4.2	+4.8	+1.3	+2.5
Finland	+1.1	+3.4	-0.1	+1.1
France	+5.9	+8.3	+4.6	+5.9
Germany	+2.0	+4.3	+0.8	+2.0
Hong Kong, China	-4.9	-1.5	-4.9	-3.7
Italy	+8.0	+10.5	+6.8	+8.0
Japan	+0.3	+6.2	+2.6	+3.8
Netherlands	+6.5	+8.9	+5.3	+6.5
Spain	-1.3	+1.0	-2.5	-1.3
Switzerland	+4.8	+10.3	+6.6	+7.8
UK	+2.1	+2.1	-1.4	-0.2
USA	+6.7	+10.5	+6.7	+8.0
All World Europe ex UK	+4.2	+7.0	+3.4	+4.6
All World Asia Pacific ex Japan	+1.0	+3.7	+0.2	+1.4
All World Asia Pacific	+0.7	+4.7	+1.1	+2.3
All World Latin America	+3.0	+2.1	-1.4	-0.2
All World All Emerging Markets	+1.3	+4.0	+0.4	+1.6
All World	+4.6	+8.0	+4.4	+5.6

Source : FTSE All World Indices

FTSE UK Government Securities Index All Stocks (total return) : +5.8%

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

Currency	31.05.19	30.08.19
Sterling	0.87	0.32
US Dollar	2.22	1.50
Yen	-0.10	-0.32
Germany (Euro)	-0.27	-0.70

Sterling's performance during the quarter ending 30.08.19 (%)

Currency	Quarter Ending 30.08.19
US Dollar	-3.7
Canadian Dollar	-5.2
Yen	-5.6
Euro	-2.1
Swiss Franc	-4.8
Australian Dollar	-0.7

Other currency movements during the quarter ending 30.08.19 (%)

Currency	Quarter Ending 30.08.19
US Dollar / Canadian Dollar	-1.6
US Dollar / Yen	-2.0
US Dollar / Euro	+1.6
Swiss Franc / Euro	+2.8
Euro / Yen	-3.5

Significant Commodities (US dollar terms) 31.05.19 - 30.08.19 (%)

Currency	Quarter Ending 30.08.19
Oil	-6.8
Gold	+20.2

MARKETS

It has been a strong quarter for international equity and bond markets. In the equity markets, the total return on the FTSE All World Index in local currency terms was +4.6%, in sterling terms +8.0%, in US dollar terms +4.4% and in euro terms +5.6%. Looking at local currency returns first, the stand out market was the USA where the FTSE USA Index returned +6.7%. There was not a wide dispersion of performance but there was some underperformance in Asian markets with the FTSE Hong Kong, China Index returning -4.9%, the FTSE All World Asia Pacific ex Japan Index returning +1.0% and the FTSE Japan Index returning +0.3%. Although in positive territory, the FTSE UK Index underperformed, returning a still respectable +2.1%. In sterling terms, the picture changed significantly given the weakness of sterling and here the UK underperformance was quite large, +2.1% against +8.0% for the FTSE All World Index. The FTSE USA Index returned +10.5% and it is worth noting the strong performance by Swiss shares with the FTSE Switzerland Index returning +10.3%. There were positive sterling performances everywhere in our table with the exception of the FTSE Hong Kong, China Index which returned -1.5%.

The situation in the international bond market becomes ever more surreal. Taking ten year government bond yields as a benchmark, the gross redemption yield on the UK gilt fell by 55 basis points to 0.32%, on the US Treasury bond by 72 basis points to 1.50%, on the Japanese Government Bond by 22 basis points to -0.32% and on the German Bund by 43 basis points to -0.70%.

In the foreign exchange markets, the weakness of sterling was the feature. Against the yen it fell by 5.6%, against the Canadian dollar by 5.2%, against the Swiss Franc by 4.8%, against the US dollar by 3.7%, against the euro by 2.1% and against the Australian dollar by 0.7%.

In the commodity markets, oil, as measured by Brent crude, fell by 6.8% but gold, living up to its reputation as a safe haven in troubled times and helped by very low or negative interest rates, rose by 20.2%.

ECONOMICS

The political and economic background has become more disturbed as the year has progressed leading to more volatility in share prices and polarisation of opinions amongst investors. Whilst, for sterling based investors, the UK political situation and Brexit uncertainty are the most complex issues, on the international stage, and more important, is the trade war between the USA and China and the collateral damage which this is inflicting with the threat of this situation worsening. If sand is put in the wheels of world trade, growth will slow down and a recession could ensue.

These same concerns have been echoed in our economic reviews for many months so that our clients may think that they are listening to a broken record. How these events are interpreted by investors will determine the course of markets and it is clear from the way markets are moving quite sharply on a day to day basis in both directions that there is a fine balance between bulls and bears. Day to day, or even intra day, movements are influenced by the latest news, very often a tweet from President Trump. It is at times like this that investors must reassure themselves that they are taking a long term view and not be unduly influenced by the latest news or swing in sentiment.

The USA/China trade war is a battle between the world's two major superpowers for supremacy, with President Trump determined to see off what he sees as a threat to the USA's pre-eminence from China. Seen in these terms, rational economic thoughts might take a back seat except for the fact that the President is up for re-election in November 2020 and a weak economy will not be helpful to his prospects. At the moment, the US economy remains in relatively good shape, although the latest opinion polls in the USA show all of the leading Democrat contenders for the Presidency ahead of President Trump. This suggests that, even against this background of a battle of wills, the President must have one eye on the economic consequences of a trade war with China. If one assumes that his main objective is to be re-elected in November 2020, then it would be a reasonable assumption to make that a deal will be done with China. In normal times, the current economic background would favour the re-election of a US President but, at this stage, things look quite tough for him. Those who are tending to take a more optimistic view of the stock market will assume a resolution of the trade dispute as more likely than not.

Investors and commentators tend to look at the trade war through the prism of President Trump but it is also important to look at it through the eyes of President Xi. One of the developments which agitated the U.S. President was China's "Made in China 2025", which aims to make China a manufacturing superpower. Priority sectors highlighted in this plan included new generation information technology, advanced numerical control machine tools and robotics, aerospace technology including aircraft engines and airborne equipment, biopharmaceuticals and high performance medical equipment. This plan, which has been de-emphasised publicly by China, at least in terms of rhetoric, probably to lower the USA's sensitivities on the subject, is seen by the USA as a major threat to its world economic leadership. One of the major complaints by the USA and many other countries against China has been on the intellectual property front as firms wanting to do business in China have had to pass this over in some cases. But for China to achieve the objectives of "Made in China 2025", it needs to have a robust economy and slowing growth and bad trade relations will make China's task more difficult. President Xi has very obviously cemented his grip on power, but the other side of the coin is that he needs success to go with this move. In this context, the civil unrest in Hong Kong has come at a bad time for China. What has happened, and the way it has been dealt with, does not look good for China and any hardening of its reaction is a risk. So, China will be keen for this trade dispute to be resolved because it is getting in the way of its domestic agenda. Whilst China can make life difficult for US companies doing business in China, the massive trade imbalance with the USA makes retaliation on tariffs less effective. Additionally, US companies may move sourcing to other Asian countries like Vietnam, meaning a permanent loss of business. China cannot be seen to be backing down and neither can the USA so some face saving agreement needs to be reached.

This is what would happen in a rational world. Despite what President Trump has said in the past, a trade war is not an easy win and it is very poor economics. In an ideal world, the theory of comparative advantage in simple terms would have countries producing more of the goods in which they had a comparative advantage and consume less of them, whilst importing goods where it does not have a comparative advantage. In this way, consumers' welfare benefits. But this depends on a level playing field, so one country should not be subsidising its exports in an overt or covert way and tariffs or quotas should not be imposed by the importing country to shift the apparent balance of comparative advantage. In very simple practical terms, one might take the case of steel exports to the USA which attracted an early tariff from the USA. The idea was to save US steel jobs which President Trump said were being lost to cheap imports. The benefit might be that US steel jobs were preserved. The cost to the USA would be that US companies buying US produced steel instead of previously imported cheaper steel would either have to absorb the higher input costs or pass them on to their customers. If the first option occurred, the company may have less money for investment and possibly job creation and, in the second case, consumers of the ultimate product for which the steel was an input would have less to spend on other products so would be worse off themselves and indirectly affect employment prospects elsewhere. If the exporting country subsidised its steel and therefore distorted the competitive positon so that there was not a level playing field, it, too would suffer a cost, though perhaps a less obvious one. The subsidies would have to be financed one way or another by taxpayers, perhaps by higher taxes to cover the subsidies or, if the money was borrowed, by the interest payments on the country's extra debt.

One obvious conclusion from this enormously oversimplified example is that it slows down business and trade and, therefore, economic growth and could lead to a recession from which there would be many losers. The "easy win" turns out to be very limited and the losers much more numerous.

This is what investors have to consider now. Intuitively, trade wars are bad for economic growth, employment, company profits, dividends and tax collection, to name but some issues. So, prima facie, investors are right to be nervous about what is happening at present. They would be right to say that rational action by the USA and China would point towards an agreement. Assuming President Trump wants to be re-elected, not a bold assumption, he will want a strong US economy so a trade war stretching into next year militates against this. President Xi, faced with challenges like the trade war and Hong Kong, will not want his authority questioned by a weakening economy. It is more difficult than ever to make predictions in the current environment, but we see self interest as the most likely result, which means a deal. That is our central investment case at present and, if that is a correct assumption, we think that the stock market would react positively judging by how it moves when the trade news seems more hopeful.

We said earlier that these reviews might seem like a broken record in that the same issues are discussed each time but that is the reality of the current situation. One of these topics has been monetary policy and the level of interest rates which are more surreal than ever. As this is written, the Bloomberg Barclays Global Aggregate Negative Yielding Debt Market Value is US$16.4 trillion. The whole of the German, Swiss and Netherlands government bond market is on a negative yield. Taking three month interest rates against the ten year government bond yield as a measure of the slope of the yield curve, it is downward sloping (i.e. the ten year bond yield is lower than the three month interest rate) in the USA, Germany, Japan and the UK and almost everywhere else. For many, based on past experiences, that portends a recession. But, before we discuss the shape of the yield curve, let us think about the phenomenon of negative interest rates which, incidentally, does not just cover government bonds. It is estimated that something like US$1.2 trillion of corporate bonds is standing on a negative yield. Why would one want to pay a government or a company (albeit a high quality one) to lend money to them? For an institution, it is obviously not practical to stuff billions of US dollars, pounds, Swiss Francs or euros under the proverbial mattress but, for individuals, leaving out the risk practicalities, it would be better than if their bank was paying negative interest rates, as has started to happen. One reason could be that it is the least bad alternative. Losing money with negative interest rates might be more acceptable than losing a lot more elsewhere. Where might that "elsewhere" be? One place might be the banks if they were considered to be unsafe. Although there are issues with banks in some countries, capital ratios have been strengthened since the financial crisis over ten years ago and the chances of a banking collapse at present are considered low. A lot of institutional investors have to hold bonds in their portfolios but, for those who don't, are the alternatives so unappealing that they would be prepared to lose money if the bonds were held to maturity? Let us look at thirty year government bonds. At the time of writing, the gross redemption yield on the US Treasury bond is 2.012%, on the German Bund -0.072%, on the Japanese Government bond 0.125% and, on the UK gilt, 1.072%. All except the German government bond are on positive yields but, on any relative scenario, can even the 2.012% gross redemption yield on a US Treasury bond be attractive against, say, potential equity or real estate returns? Many investors would not be holding the bonds for thirty years and they could argue that they may be selling their bonds within this time frame and make money on them. That may be true and some holders have made a lot of money on their bond holdings this year but we would have found the risk/reward ratio unacceptable. If there is any reversion towards mean, the capital value of the securities is at significant risk as one moves along the yield curve. It would be difficult to justify, on a fundamental basis, the purchase of a bond on a negative yield if and when it goes wrong because of some move towards the normalisation of interest rates. With a share, if it goes down, assuming it is of good quality it is likely to recover and move ahead of the purchase price in time. We think that we are in a very dangerous place in the bond market this year. We know why we find ourselves in this surreal position in the bond market at present. Very loose monetary policy and quantitative easing, whereby vast amounts of bonds have been purchased by central banks, have soaked up a lot of supply and driven down yields. Negative interest rates set by central banks in the eurozone and elsewhere have set down a marker but, especially in the eurozone, they have failed to drive growth to acceptable levels and it is possible that the ECB will drive interest rates into even deeper negative territory which would help to explain the theory on the reasoning and consequences of a negative yield curve. It would generally imply that investors are prepared to lock in lower long term yields now in the belief that central banks would soon be reducing short term interest rates to address economic weakness.

How likely is it that the world is facing an economic recession? The latest IMF forecast in its July World Economic Outlook suggests 3.2% growth this year for the world economy and 3.5% next year. Like other forecasters, it has been reducing its estimates for growth this year and next but the figures are not disastrous and do not presage a recession although, if events turn even nastier on the trade war front, that could develop. One area which is causing concern is the eurozone. Although, in the USA, President Trump is berating the Federal Reserve for not cutting interest rates further, the case for doing so is not clear cut and it sets a dangerous precedent for the President to be trying to bulldoze the independent central bank into taking the action he wants. In the eurozone, however, the economy is definitely weakening and we have seen some very poor purchasing managers indices. The latest composite PMI for the eurozone is 51.9, signalling very mild expansion. Within that, the dominant services sector stands at 53.5, but that for manufacturing stands at 47.0, signalling a downturn in that area of the economy. For Germany, the latest composite index stands at 51.7 and, within that, the services sector stands at 54.8, but the manufacturing index is an alarming 43.5, showing a significant contraction. Germany is being hit by a perfect storm. As a major exporter, it is being caught up in the slowdown in world trade and its dominant car sector is being damaged, in addition, by the moves from petrol and diesel to electric. Additionally, if there isn't a satisfactory outcome to the Brexit negotiations, Germany, as a major car exporter to the UK, could face a further hit. The latest PMIs for France and Italy are better than those for Germany, although still quite weak, with Italy's manufacturing PMI standing at 48.7.

The problem for eurozone policy makers is that monetary policy has been doing the heavy lifting for a long time without any significant results in the sense that the eurozone's economy has never really taken off for any meaningful period of time. The weapons left in the ECB's armoury remain the same but one feels that they must be losing their power to influence the economy. Cutting interest rates further into negative territory risks affecting banks' profitability as the cost of leaving their reserves at the ECB rises and it is difficult to get customers to accept negative interest rates. In any case, given where interest rates are in the eurozone at present, is making money even cheaper going to change the spending mindset of consumers and businesses? Almost certainly not is the answer. Bond buying would become more problematic given the amount of bonds the ECB owns and the shortage of supply with Germany running a budget surplus. As with cutting interest rate further, it is difficult to see a further bond buying programme stimulating the economy to any noticeable effect.

When considering what might stimulate economic activity in the eurozone, the role of fiscal policy is not often discussed and there is a reason for this. After all, the interaction of monetary and fiscal policy drives economic policy but the eurozone's rules, governed by the Stability and Growth Pact, strictly limit the room for fiscal activism because of budget deficit and borrowing constraints embedded in the rules. In the country with leeway to use fiscal policy, Germany, there are constitutional limits on the size of the structural deficit of 0.35% of GDP and there is a cross party consensus on the wisdom of balanced budgets, although this seems to be fragmenting. Another country, although much smaller than Germany, which could do something is the Netherlands. The three largest eurozone countries after Germany, France, Italy and Spain, are constrained by the rules, although France has relented in the face of social unrest and will exceed the 3% budget deficit limit this year, but is too big a country to be punished by the EU. Monetary policy has, therefore, done the heavy lifting in the eurozone but the scope for more action is limited and the effectiveness of further monetary action is likely to diminish. One cause for a little more optimism is that the sharp deterioration in the German economy is causing a rethink about fiscal policy. Certainly, Germany has plenty of scope for fiscal easing, just looking at its figures, and plenty of areas which can benefit from further spending, such as infrastructure. With fiscal and monetary policy becoming unbalanced, there is a strong argument for fiscal action by Germany.

The view which we have taken on the implications of the downward sloping yield curve is that, because its shape has been partly determined by quantitative easing and the extreme use of monetary policy, its predictive value is reduced. Whilst there are plenty of signs of economic weakness developing, it does not yet feel like the onset of a recession. Bad policy decisions can, of course, change this, but this is how we see the situation at present. Furthermore, in terms of asset allocation, we return to our theme that the yield difference between equities and bonds is such that, even if there were to be a mild recession, the danger to dividends would be fairly limited. Compared to the risks from another potential source of yield, low quality bonds, quality shares with reasonable dividend yields would be the more attractive option. It is interesting to note that, in the unsettled month of August, high quality companies in the consumer staples sector have performed relatively very well, with a number of stocks standing at all time highs. These stocks are characterised by solid dividends and, in most cases, predictable earnings performance. To give one example, Nestlé, one of the most reliable companies in its sector, has a gross dividend yield of about 2.2%, whilst the ten year Swiss government bond has a gross redemption yield of -0.968%. There has to be a strong argument for favouring the former as an investment rather than the latter where one is bound to lose money if the bond is held to maturity. One can argue about the valuations of shares but, if one investment is bound to lose money if held for a certain period, there has to be a presumption in favour of shares which are not bound to lose money. One can argue that, if there was a sudden change in the direction of interest rates, both asset classes would suffer but, at the moment, it seems very likely that interest rates will stay around current levels or move even lower. That being the case, shares are likely to be well supported in the absence of a deterioration in the trade war but, unfortunately, one cannot count on the latter.

Politics is as important as economics in formulating an investment policy and we want firstly to revert to the USA and then discuss the UK.

With the US Presidential election not much more than a year away, it is time to start bringing this into view in relation to possible outcomes and consequences. So unorthodox is the President's way of doing things that it cannot be assumed that the current favourable economic background will carry him to re-election. As mentioned earlier, the latest opinion polls show all of the leading Democrat contenders ahead of President Trump. This is relevant because the Democrats, or at least their activists and candidates, have moved sharply to the left and the policies they are putting forward, if enacted, would make for a more difficult investment background. Congressional elections will be important in this respect given the legislation which needs to be enacted to carry policies into law. At the moment, this is not an issue, but it might be as the months pass. To give a flavour of the issues which might concern investors, one of some of the Democrats' targets is share buybacks, which have been massive in the USA and must have contributed to shares' strong showing at a time when surveys showed that many investors were negative about the stock market. Survey findings often belie stock market movements.

Finally, we must end up by discussing the UK. For many months now we have regarded the UK as a very high risk market because of the political uncertainty and the possibility of an extreme government, by UK standards, coming into power as a fallout from Brexit. We regard this as a greater risk to the market than Brexit itself. The stakes are very high and investors have to take this into account in the construction of their portfolios. This is why, where the mandate allows, we have the majority of our clients' assets in foreign securities. Although the UK equity markets is usefully higher this year, it has lagged most other markets and the risks arising from the UK's political situation are no doubt behind this. As things stand, the outcome seems binary. The positive case is that the UK leaves the EU on 31st October, the government survives and/or wins an election and puts into effect its more pro market policies. Such an outcome would probably see the UK stock market recover some relative performance. The negative case is that the government does not manage to get the UK out of the EU by 31st October, and events in the last few days suggest this is quite likely, the Conservative party collapses and a new radical government emerges with extreme policies which causes a sharp fall in the UK stock market and sterling. The outlook is so uncertain that we are not prepared to take the risk of raising exposure to the UK. Absent the political risk, the UK would look an attractive stock market, but the political risk is the paramount consideration.

In conclusion, we think that the asset class which has the most going for it is equities but realise that one of the reasons for this is the boost given to them by current interest rate levels. It is certainly not the best of fundamental reasons for supporting an asset class but there seems to be considerably more value in equities than to bonds, where the risk of long term losses must be high given current interest rate levels. We have highlighted the risks to equities in this review, notably the fallout from the trade war, and articulated our view on the likely outcome. Above all, for our base of sterling investors, portfolios need to be protected from a very uncertain political situation in the UK which could, in certain circumstances, lead to a very hostile investment climate. With the news background, politically and economically, so uncertain, investors must be braced for volatility.