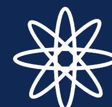

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ASSET MANAGEMENT (C.I.) LIMITED

INVESTMENT MEMORANDUM

Although sterling based investors did not enjoy the benefits of the strong performance of international equities in the last quarter because of the strength of sterling, it has, nevertheless been a stronger than expected year for international investors, even if sterling based. Whilst bond investors enjoyed a good year overall, there was a reverse in trend during the final quarter of 2019. In the currency markets, sterling was the outstanding performer in the final quarter, bolstered by the result of the U.K. General Election on 12th December. For the year as a whole, sterling was stronger. In the commodity markets, oil and gold both strengthened, with the latter reflecting its status as a store of value in uncertain times.

The tables below detail relevant movements in markets :

International Equities 30.09.19 - 31.12.19

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	+0.5	-2.6	+4.7	+1.7
Finland	+2.4	-1.9	+5.5	+2.4
France	+5.1	+0.7	+8.3	+5.1
Germany	+6.7	+2.2	+9.9	+6.7
Hong Kong, China	+7.5	+0.6	+8.2	+5.0
Italy	+5.3	+0.9	+8.4	+5.3
Japan	+8.4	+0.2	+7.8	+4.7
Netherlands	+4.8	+0.3	+7.9	+4.8
Spain	+3.2	-1.2	+6.2	+3.2
Switzerland	+4.6	+0.2	+7.8	+4.7
UK	+3.0	+3.0	+10.7	+7.6
USA	+9.2	+1.6	+9.2	+6.0
All World Europe ex UK	+5.6	+1.2	+8.8	+5.6
All World Asia Pacific ex Japan	+8.3	+2.8	+10.5	+7.3
All World Asia Pacific	+8.3	+1.8	+9.4	+6.3
All World Latin America	+7.3	+3.2	+10.9	+7.7
All World All Emerging Markets	+9.9	+4.0	+11.8	+8.6
All World	+7.9	+1.5	+9.1	+6.0

Source : FTSE All World Indices

FTSE UK Government Securities Index All Stocks (total return) : -3.9%

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

Currency	30.09.19	31.12.19
Sterling	0.39	0.81
US Dollar	1.66	1.92
Yen	-0.28	-0.03
Germany (Euro)	-0.57	-0.19

Sterling's performance during the quarter ending 31.12.19 (%)

Currency	Quarter Ending 31.12.19
US Dollar	+8.4
Canadian Dollar	+5.8
Yen	+8.3
Euro	+4.8
Swiss Franc	+4.5
Australian Dollar	+3.7

Other currency movements during the quarter ending 31.12.19 (%)

Currency	Quarter Ending 31.12.19
US Dollar / Canadian Dollar	-2.0
US Dollar / Yen	+0.4
US Dollar / Euro	-3.1
Swiss Franc / Euro	+0.3
Euro / Yen	+3.4

Significant Commodities (US dollar terms) 30.09.19 - 31.12.19 (%)

Currency	Quarter Ending 31.12.19
Oil	+9.6
Gold	+1.7

PERFORMANCE DURING 2019

International Equities 31.12.18 - 31.12.19

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	+23.7	+18.8	+23.5	+25.8
Finland	+14.3	+7.9	+12.2	+14.3
France	+29.4	+22.2	+27.1	+29.4
Germany	+24.6	+17.6	+22.4	+24.6
Hong Kong, China	+11.2	+7.4	+11.8	+13.8
Italy	+31.0	+23.6	+28.6	+31.0
Japan	+18.3	+14.8	+19.5	+21.7
Netherlands	+31.2	+23.8	+28.8	+31.2
Spain	+15.7	+9.2	+13.6	+15.7
Switzerland	+36.1	+28.4	+33.6	+36.1
UK	+18.1	+18.1	+22.8	+25.1
USA	+31.6	+26.6	+31.6	+34.1
All World Europe ex UK	+27.8	+21.3	+26.1	+28.4
All World Asia Pacific ex Japan	+18.8	+14.5	+19.1	+21.3
All World Asia Pacific	+18.6	+14.6	+19.2	+21.4
All World Latin America	+22.5	+17.7	+20.1	+22.3
All World All Emerging	+19.8	+15.1	+20.6	+22.8
All World	+26.9	+22.3	+27.2	+29.6

Source : FTSE All World Indices

FTSE UK Government Securities Index All Stocks (total return) : +6.9%

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

Currency	31.12.18	31.12.19
Sterling	1.26	0.81
US Dollar	2.72	1.92
Yen	0.02	-0.03
Germany (Euro)	0.17	-0.19

Sterling's performance during the year ending 31.12.19 (%)

Currency	Year Ending 31.12.19
US Dollar	+4.1
Canadian Dollar	-0.9
Yen	+3.0
Euro	+6.1
Swiss Franc	+2.3
Australian Dollar	+4.3

Other currency movements during the year ending 31.12.19 (%)

Currency	Year Ending 31.12.19
US Dollar / Canadian Dollar	-4.8
US Dollar / Yen	-1.0
US Dollar / Euro	+2.0
Swiss Franc / Euro	+5.5
Euro / Yen	+3.7

Significant Commodities (US dollar terms) 31.12.18 - 31.12.19 (%)

Currency	Year Ending 31.12.19
Oil	+21.9
Gold	+18.4

MARKETS

Looking first at the final quarter of 2019, the outcome was a strong international equity performance all round, with gains pared right back for sterling based investors by the recovery in sterling. In local currency returns, the FTSE All World Index returned +7.9%, in sterling terms +1.5%, in US dollar terms +9.1% and in euro terms +6.0%. Looking at individual markets and areas, the USA has been the outstanding performer amongst the major ones with the FTSE USA Index returning +9.2%. The FTSE All World Emerging Markets Index, +9.9%, the FTSE Japan Index, +8.4%, and the FTSE Asia Pacific ex Japan Index, +8.3%, also performed very well. At the lower end of the returns were the FTSE Australia Index, +0.5%, the FTSE UK Index, +3.0% and the FTSE All World Europe ex UK Index, +5.6%. There were no negative returns in our table. The picture is different in sterling terms, with most of the positive return in local currency terms in the FTSE All World Index being eliminated by the strength of sterling. Nevertheless, given the strength of the international stock markets in the first three quarters of 2019, a return of +1.5% can be considered satisfactory. In the table at the front of this review, it can be seen that, apart from two European markets, only the FTSE Australia Index was in negative territory at -2.6%.

Although the bond market has weakened during the quarter, yields remain at extraordinarily low levels. The rise in yields can be viewed positively in that it may reflect a view that the world economy is past its worst. Taking ten year government bond yields as the benchmark, the ten year UK gilt has seen a rise of about 42 basis points to 0.81%, in the US the equivalent yield has risen by about 26 basis points to 1.92%, in Japan the yield has risen by 25 basis points to -0.03% and in Germany the yield has risen by 38 basis points to -0.19%.

Confirmation that the Conservatives won the UK 12th December General Election saw sterling building on its pre-election recovery. Against the US dollar, sterling rose by 8.4%, against the yen by 8.3%, against the Canadian dollar by 5.8%, against the euro by 4.8%, against the Swiss Franc by 4.5% and against the Australian dollar by 3.7%.

In the commodity markets, oil, as measured by Brent crude rose by 9.6% and gold by 1.7%.

Looking at the whole of 2019, we can see a spectacular year in international equity markets. In local currency terms, the FTSE All World Index returned +26.9%, in sterling terms, +22.3%, in US dollar terms, +27.2%, and in euro terms, +29.6%. Looking at local currency returns first, we can see very strong returns all round, with the FTSE USA Index showing one of the best performances with a return of +31.6%. In the table, the FTSE Switzerland Index showed the best return, a remarkable +36.1%. The lowest return in the table is the FTSE Hong Kong, China Index, +11.2%, but in most years that would be considered a very creditable result. Although showing an excellent return in absolute terms at +18.1%, the FTSE UK Index lagged by the FTSE All World Index by 8.8%. The rise in sterling over the year pared back some of the positive local currency returns, but not by nearly enough to make it other than an excellent year. The FTSE UK Index itself underperformed the FTSE All World Index by 4.2% in sterling terms, with the gap being narrowed in the last quarter, as our three month table showed. The FTSE USA Index still showed an outstanding performance in sterling terms, with the return of +26.6% being 4.3% above that of the FTSE All World Index. The Swiss market, as in local currency terms, also showed a relatively very strong performance, with the FTSE Switzerland Index returning +28.4% in sterling terms. At the other end of the spectrum, in most years the +7.4% return on the FTSE Hong Kong, China Index would be regarded as satisfactory.

Despite a reversal in the final quarter of 2019, international government bond markets, as measured by ten year government benchmark bond yields, fell significantly over the year as a whole. The yield on the ten year UK government bond fell by about 45 basis points to 0.81%, on the US Treasury bond by about 80 basis points to 1.92%, on the Japanese Government Bond by 5 basis points to -0.03% and on the German Bund by 36 basis points to -0.19%.

In the foreign exchange markets, the strong rally in sterling in the final quarter meant that, except against the Canadian dollar, it rose against the major currencies. Against the Canadian dollar, it fell by 0.9%, but against the euro it rose by 6.1%, against the Australian dollar by 4.3%, against the US dollar by 4.1%, against the yen by 3.0% and against the Swiss Franc by 2.3%.

In the commodity markets, oil, as measured by Brent crude, recovered strongly, rising by 21.9%, and gold, helped by political and economic uncertainty, rose by 18.4%.

ECONOMICS

Looking at the tables of international equity market performances at the beginning of this review, one might be forgiven for thinking that it was an exceptional year for the world economy, providing strong economic growth, reflected in corporate earnings and dividends. In fact, it was no such thing, and investors have generally been blindsided by the extent of gains shown in the international equity markets and, to a lesser extent, in the international bond markets. Although we have favoured equities as an asset class, not for one moment did we expect the magnitude of returns that we show in our table for the calendar year.

The OECD, in its November economic forecast, estimated that the world economy would have grown by 2.9% in 2019 and it forecast the same again in 2020. This is a very modest growth rate, not one showing a recession, but not one that would normally be expected to fuel a very strong stock market performance. However, the story is the same as it has been for the whole of 2020, and before that, namely that asset prices are being boosted by ultra loose monetary policy, which is leaving investors who are looking for income in a difficult situation. Normally, they would look to bank deposits or fixed interest securities, liking not only the income which they would provide but also the relatively low volatility. Very loose monetary policy, which has been followed since the financial crisis over ten years ago, has upended these beliefs and, in a search for yield, other classes of assets have risen in price, shares being one of them. So, we have the very unusual situation, by historical standards, that shares in many countries yield more than high quality bonds and, for some investors, this has meant a change in their traditional investing patterns and caused them to move into the equity market. It must be said that it does not look likely that interest rates will rise in the foreseeable future and, in some countries such as the USA and the eurozone, monetary policy has been eased recently. Whilst it is always dangerous to oversimplify matters, it seems that this is the one major reason why equities and bonds have performed well against a background of very modest international growth.

It is difficult to write an economic review these days without repeating oneself, but the issues which have determined market movements this year have been around for some time now and do not seem to change, hence our repeated reference to them in our economic reviews.

The background has been unsettled, both politically and economically, yet apart from short periods of weakness, markets have moved ahead, led by the USA. Of the major countries in the developed world, the USA has shown the fastest growth with expectations of growth of 2.3% in 2019 and 2.0% this year, according to the latest OECD forecast. That is not an exciting growth rate but it is a decent one compared with other countries like Japan and also areas like the eurozone, not to mention the UK. But what it does mean is that, if there is only modest economic growth and earnings and dividends growth reflect that picture, the magnitude of share price rises that we have seen this year imply much higher ratings for equities and, with that, comes some risk in normal circumstances. However, it is very difficult to see any real tightening of monetary policy occurring. The Federal Reserve, having been the first to try to move towards normality again through a long series of interest rate increases, has backed down and cut interest rates three times. The ECB has started to buy bonds again as well as lowering interest rates so, if the OECD forecasts are correct, then it does not seem that interest rates are likely to be raised any time in the near future and, therefore, investors have some confidence about buying equities as an attractive alternative to fixed interest securities or cash if they are seeking income.

The problem is that economies seem to find it very difficult to wean themselves off ultra low interest rates or even, in some cases, negative interest rates. Monetary policy has been extremely loose for the last eleven years, following measures taken to try to overcome the financial and economic crisis at the time. But economies have never really recovered quickly enough for central banks to be confident about reversing, to any significant degree, their loose monetary policy, with the USA, as mentioned above, coming nearest. If we take the eurozone, as an example, it seems incapable of showing any reasonable level of growth without the help of negative, nil or very low interest rates and, even then, its growth rate is anaemic. Although these levels of interest rates are highly undesirable because of all the economic distortions which they inflict on the world economy, it is difficult to see central bankers backtracking.

We have discussed many times in our reviews how undesirable this current situation is in respect of monetary policy. Whilst it might seem all good news for those who borrow money to be paying very low interest rates, this can encourage speculation and unhelpful rises in asset prices, such as property. In the case of a property boom, a bubble which develops as a result of this can have severe economic consequences when it collapses, not only for the individuals but also for the banks. Investors may also be looking at more speculative investments to try to boost their returns, but we have all seen in the newspapers how dangerous this can be as investors, chasing yield, have lost money because the assets are not what they seem, or worth what they thought they were. It is not quite so bad for the equity markets, because, if investors stay with high quality companies, their flow of dividend income is unlikely to be interrupted and may be expected to rise over time and to be much more assured than some of the speculative vehicles that are around now. Very low interest rates can also hold back the long term potential growth of an economy. We have often mentioned zombie companies in this respect. These are ones which do not have a strong business case but are able to service their loans, even if they can’t repay the principal, and, by staying in business, they crowd out more productive companies with better long term growth prospects which can assist an economy. Crowding out these potentially faster growing companies has an effect on the economic growth potential of a company. But, when the world economy grows only very modestly, as happened in 2019 with the same prospect for 2020, corporate earnings and dividends cannot be expected to rise significantly and this means that, with the magnitude of share price rises which were seen in 2019, ratings become ever more lofty and, therefore, the potential for a decline is greater. We should say, at this stage, that this is not our central case because we are fairly convinced that monetary policy will be in very loose mode for the foreseeable future, but that does not make it any less desirable that there should be a return to normality. People tend to think about the benefit to borrowers when interest rates are reduced or are around current levels but one should also think of savers. Many are badly impacted by the reductions in income which they receive. They may move to the more speculative vehicles, which we mentioned above, or they may just have to live off their savings or suffer reduced standards of living because their investment income falls.

One of the surprises about the consequences of monetary policy, or rather the lack of it, at the moment, is the fact that inflation remains very subdued. One might have expected that, with so much money being printed, inflationary pressures would emerge but, surprisingly, this has not yet happened. The money created has not been moving around the economy, as the central banks might have expected, with the banks being cautious about their lending and, therefore, we have not seen any inflationary consequences so far. But, in a different environment, when confidence picks up, inflationary pressures could easily emerge as pressure points occur in an economy, either in the labour market or with capacity constraints forcing up prices. Central banks are trying very hard to meet their inflation targets, hence their appetite for keeping monetary policy very loose or even loosening it further, but we should not assume that inflation is dead.

There are two aspects of economic policy, monetary, which we have discussed, and fiscal policy, which tends to be discussed less at the moment because of the extraordinary state of monetary policy. With such low interest rates, some economists say it would be sensible for governments to take advantage of cheap money to borrow and invest, say, in infrastructure, as that will improve the long term productive potential of an economy whilst providing short and medium term economic boosts. That is, of course, true, but the debt has to be repaid at some stage and borrowing has to be carefully targeted. There are signs of fiscal policy being loosened. In the USA, a big fiscal boost occurred in 2018 and, in the UK, one is coming, now that the election is out of the way, whilst, in the eurozone, there is significant pressure on Germany, in particular, to use its strong fiscal and overall financial position to boost investment. In a single currency area, this would help those countries which are struggling with high debts and are not in a position to take on a lot more borrowing. But Germany is very wedded to its conservative fiscal policy and has an aversion to borrowing. Whether this will change remains to be seen. Many Germans are wary of taking on a lot more borrowings, even though the German government can borrow at negative interest rates at present for much of their funding. Whether the political realignment in Germany, which seems to be taking place, changes the position, remains to be seen.

If the state of monetary policy remains the single best explanation of the significant increases in share prices last year and fall in bond yields, then we should not forget that the potential to reverse this lies in the field of the trade dispute between the USA and China, also bringing in other countries. This has been a consistent theme in our economic reviews and, just because the dispute has not had a major effect on stock markets, it does not mean that it will not if things turn nasty. If one looks at the position rationally, then neither President Trump nor President Xi has any vested interest in prolonging the dispute since it will cost both countries dearly. But we should not assume that there will be a rational outcome, because we are talking about politics and the fight between the USA and China is for economic domination, with China expected to become the largest economy in the world in the not too distant future. A big economic arm wrestle is taking place. The strength of the stock market in 2019, and especially towards the end of the year, suggests that investors are taking a sanguine outlook, believing that there will be an accommodation, and there are signs that this is happening, at least in the short term, but we have had so many mixed signals in the past that no one should count on it. For President Trump, his eyes will be firmly focused on the coming election in November and it is usually helpful for an incumbent President to have a strong economy. A trade war with extended periods of tariffs and quotas slows down economic growth and is a thoroughly bad thing. If that effect was manifested before the election, then his re-election prospects could well suffer and, unpredictable though some of his actions are, the one thing one can be certain of is that he wants to be re-elected. In China, President Xi has no such problem as he can now be there for life, but it does not mean that if a politician assumes ever increasing powers, as President Xi has done, one is immune from political trouble. Because he is so dominant he needs to have successes, particularly economic ones, and the problems in Hong Kong are symptomatic of the dangers than can be posed if these civil disturbances were to spread to the mainland. The best way of dealing with a situation in a country with a political system like China is to have economic success and President Xi will not want the economy slowing down too much because of the problems which this could cause him politically. China has problems with high levels of debt and banking issues, and the imposition of US tariffs forced the Chinese authorities to change their economic policy and loosen money policy at a time when they were trying

to rein back the shadow banks and to cut down on overindebtedness. Furthermore, if these tariffs continue, then trade patterns could be changed forever, with China losing business to other Asian countries and not coming back into the supply chain. This is very much a fight to the finish between the two superpowers but, at the moment, markets are suggesting that the outcome will be satisfactory. Investors must certainly hope so.

For sterling investors, the most important event occurred in December, with the Conservatives gaining a significant majority in the General Election and putting an end, for the foreseeable future, to concerns about a change of government resulting from the political paralysis over the last three years. Politics does sometimes matter in investment and, with the UK Labour Party having a very radical manifesto, more than any other in recent times, the result of the election was very important. We have long regarded the political uncertainty in the UK as more debilitating for the market, and certainly more risky, than Brexit, and, since the General Election result was known, the UK stock market has performed well. It is our feeling that a lot of investment was held up and a lot of economic activity delayed because of the uncertainty. There is still Brexit, but, in our view, it was a much lesser issue than the possibility of a change in government and a very extreme economic policy being introduced which would almost certainly have caused a big fall in the stock market and also the currency. So sterling based investors can look with more confidence at the UK now that the election is over. It does not mean that there is any good reason to change the policy of a diversified portfolio geographically to spread the risk, but there can be more confidence in investing in the UK and no aversion to doing so.

So, how do we review the prospects for 2020? The main issues are, again, as they have for a long time been, the persistence of very easy monetary policy, and we have a high degree of confidence that this will not change. That should be supportive to equities. On the trade front, one has a hope, but it cannot be an overwhelming one, that the trade dispute between the USA and China will find a resolution and the protectionism which seems to be growing in the world will be halted. This is a much more uncertain assumption than the one over monetary policy. If there is a rapprochement, however, it is likely to give a boost to the stock market, if only because some of the worst dangers of protectionism will be avoided. But political concerns will be around and new ones might arise. As this is written, the US airstrike which has killed the senior Iranian General in Iraq could lead to unpredictable consequences. In China, we do not know how long the Chinese government will tolerate the situation in Hong Kong and that could be a potentially very significant event. In Latin America, although it may not have so much an effect on markets, we see unrest in many countries, including what was considered to be the most stable one, Chile. Finally, of course, we have the US Presidential Election. This will be a very important event because, as in the UK, there is a polarisation of opinion and political manifestos that are likely to be seen from those vying for the Democratic nomination. Whilst President Trump is unpredictable, one has a fair idea of what his economic policies are likely to be. These may include loose fiscal policy, deregulation and protectionism, the latter generally being very undesirable. As for the Democrats, there is a large field of potential candidates, including some who, by US standards, are quite extreme and many of their actions would be unpalatable to investors if they were to assume the Presidency, rather than, say, the more centrist, Joe Biden. There are, of course, the checks and balances in the USA, with Congress exerting restraining power in certain instances. We assume that President Trump will not be impeached given the majority in the Senate for the Republicans and the fact that a two thirds majority is necessary for that to occur. So, as the year progresses, the US Presidential Election may become more of an investment issue.

When we write our end of year review, we look back to what we said at the end of the previous year and see where we were right, where we were wrong, or where events occurred which could not have been foreseen. We started by saying that we did not consider that all the uncertainties around justified the change in policy, which, as clients know, is very much to favour equities in this environment. We noted that shares did not then look expensive and their relative income attraction compared to fixed interest securities and cash remained appealing. Whilst we favoured equities, we did not foresee the extent of the rise this year, so, given the rise in share prices and the fairly pedestrian performance of corporate earnings, shares, by definition, are more expensive than they were. However, the relative

income attraction remains and we would stay with that view. We were very negative on bonds, pointing out that absolute levels of yield were highly unattractive, and this remains the case. At the time of writing, there is approximately US$11 trillion of debt selling at negative yields, which means that if one were to buy those bonds and hold them to maturity, there would be a guaranteed loss. It is difficult to fathom out how this can possibly be a good investment opportunity on any known investment parameters. Some investors have to buy bonds but the danger is significant when there is any reversion to mean, for capital losses will be significant, whereas shares, if they do fall back, are likely to recover over time and move ahead again, as has been the history in the past. So that part of our conclusion remains the same, as we enter 2020. We did emphasise the political risk in the UK and this has now been significantly reduced as a result of December's General Election. At the time that review was written, investors had experienced a poor quarter in the final three months of 2018 and we did emphasise that we must expect continued volatility, but we did see scope for equity prices to recover on the back of continued modest economic growth and any offsetting action which central banks may take in the face of deteriorating economic data. We have noted that monetary policy has been eased in certain countries and areas like the USA and eurozone as a result of that happening. Finally, and we would concur with the conclusion again this year, we must expect volatility. We have seen an exceptional rise in share prices and it is not healthy that they keep rising at the rate they have been without a pause, so we will expect some negative quarters but, as always, we emphasised then, and we do now, that the far greater danger for long term investors is to be out of market when share prices resume their rise and do not fall back. That is when the opportunity costs can be painful. So, in conclusion, it is extremely unlikely that we will see gains of the magnitude seen in 2019 in 2020 and we may well have some negative quarters, even a negative year. But we are long term investors and the point about opportunity costs cannot be made too strongly.

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