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ASSET MANAGEMENT (C.I.) LIMITED

INVESTMENT MEMORANDUM

The strength of sterling over the quarter has meant that the local currency gains in international equity markets have almost been eliminated in sterling terms, but that must be considered a good result after previous quarters' strength. More noteworthy has been the sharp setback in the bond markets as investors started to take on board the possibility of rising inflation. In this respect, the sharp rise in the oil price as well as metals could be a harbinger of some upward movement in inflation.

The tables below detail relevant movements in markets :

International Equities 30.11.20 - 26.02.21

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	+3.4	+3.8	+8.7	+7.1
Finland	+2.2	-0.9	+3.8	+2.2
France	+3.2	-0.1	+4.7	+3.2
Germany	+5.0	+1.7	+6.5	+5.0
Hong Kong, China	+12.9	+7.7	+12.8	+11.2
Italy	+3.8	+0.6	+5.3	+3.8
Japan	+6.9	-0.1	+4.7	+3.1
Netherlands	+12.0	+8.5	+13.6	+12.0
Spain	+2.1	-1.0	+3.7	+2.1
Switzerland	+0.6	-4.0	+0.6	-0.9
UK	+4.2	+4.2	+9.2	+7.6
USA	+5.8	+1.0	+5.8	+4.2
All World Europe ex UK	+4.0	+0.5	+5.3	+3.8
All World Asia Pacific ex Japan	+11.1	+7.0	+12.1	+10.5
All World Asia Pacific	+9.6	+4.6	+9.5	+7.9
All World Latin America	+3.9	-3.5	+1.1	-0.4
All World All Emerging Markets	+10.5	+5.9	+10.9	+9.3
All World	+6.3	+1.9	+6.7	+5.1

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	30.11.20	26.02.21
Sterling	0.30	0.82
US Dollar	0.84	1.41
Yen	0.01	0.15
Germany (Euro)	-0.57	-0.26

Sterling's performance during the quarter ending 26.02.21 (%)

Currency	Quarter Ending 26.02.21
US Dollar	+4.5
Canadian Dollar	+2.4
Yen	+6.7
Euro	+3.3
Swiss Franc	+4.4
Australian Dollar	-0.4

Other currency movements during the quarter ending 26.02.21 (%)

Currency	Quarter Ending 26.02.21
US Dollar / Canadian Dollar	-2.0
US Dollar / Yen	+2.3
US Dollar / Euro	-1.0
Swiss Franc / Euro	-1.5
Euro / Yen	+3.3

Significant Commodities (US dollar terms) 30.11.20 - 26.02.21 (%)

Currency	Quarter Ending 26.02.21
Oil	+37.4
Gold	N/C

MARKETS

International equity markets have generally strengthened over the quarter, although there was some weakness at the end of the quarter as the bond markets faltered and yields rose. For sterling based investors, the strength of the currency pulled back returns.

In local currency terms, the FTSE All World Index returned +6.3% over the quarter, in sterling terms +1.9%, in U.S. dollar terms +6.7%, and in euro terms +5.1%. Looking at individual countries' and regions' total returns first, in local currency terms, we note particular relative strength from the FTSE All World Asia Pacific ex Japan Index (+11.1%) and the FTSE All World All Emerging Markets Index (+10.5%). There were no negative returns, but there was relative underperformance from the FTSE Australia Index (+3.4%), the FTSE All World Latin America Index (+3.9%) and the FTSE All World Europe ex UK Index (+4.0%). Within the latter, the FTSE Switzerland Index (+0.6%) underperformed the area as its defensive qualities became, at least temporarily, less important in investors' eyes. When we look at the sterling adjusted returns, the picture changes. There was still an outperformance from the FTSE All World Asia Pacific ex Japan Index (+7.0%) and the FTSE All World All Emerging Markets Index (+5.9%) and they were joined by the FTSE Australia Index (+3.8%) where the strength of the Australian dollar turned a below average local currency return into an above average sterling return. Weakness in the yen turned the FTSE Japan Index slightly negative (-0.1%), whilst the currency weakness in Latin America meant that the FTSE All World Latin America Index returned a negative figure (-3.5%).

The bond market endured a poor quarter as, towards its end, investors began to fret about inflation, leading to a sell off. We have repeatedly made it clear in our reviews that we believe bond markets are extremely expensive and risky, in the sense that any return towards more normal yields will involve significant capital losses. Taking 10 year government bond yields as a benchmark, the gross redemption yield on the U.K. gilt rose by 52 basis points to 0.82%, on the U.S. Treasury bond by 57 basis points to 1.41%, on the Japanese Government Bond by 14 basis points to 0.15% and on the German Bund by 31 basis points to -0.26%.

In the foreign exchange markets, sterling was the feature, rising against all the currencies in our list except the Australian dollar, against which it fell by 0.4%. Against the yen, sterling rose by 6.7%, against the U.S. dollar by 4.5%, against the Swiss Franc by 4.4%, against the euro by 3.3% and against the Canadian dollar by 2.4%.

One reason why bond investors became more fearful about the return of inflation was the rise in commodity prices, including oil, where Brent crude rose by 37.4% over the quarter. Gold, however, was unchanged, but this masked price weakness from an early January high during the quarter under review.

ECONOMICS

The course of the world economy in 2021 will largely be set by how successful countries are in controlling the coronavirus pandemic and that will be largely a function of how effective each country's vaccine roll out is. It will be a race against time to limit a further wave of the pandemic hitting next autumn and winter, which could prolong existing lockdowns, or institute a renewed lockdown where it has been lifted with the catastrophic economic consequences which would ensue. Markets had a lift from the news of the successful vaccine programmes last November and, at this early stage, we can say that the UK, USA and parts of Asia, including, importantly, China, are ahead of the game, but Europe and Latin America are behind. So, in a country like the UK which is well advanced with its vaccination programme, it has been able to map a path back to normality which would enable the economy to recover, probably quite sharply. This path out of lockdown, of necessity, has to be covered with many qualifications, for example the effectiveness of the vaccines against the new variants of the virus which have appeared and presumably others will appear. But, as a general statement, we can say that the economic prospects look brighter, albeit uneven for the reasons described above.

Back in January, the IMF, in its World Economic Outlook update, projected world economic growth of 5.5% against its estimate of -3.5% in 2020 and it forecast a further 4.2% growth in 2022; these figures, of course, are highly tentative in view of all the uncertainties. Within that figure, Advanced Economies were forecast to grow at 4.3% this year and Emerging Market and Developing Economies by 6.3%. Within the Advanced Economies group, the USA was forecast to grow by 5.1% this year, the eurozone by 4.2%, Japan by 3.1% and the UK by 4.5%. Within the Emerging Markets and Developing Economies group, China's growth for this year is forecast at 8.1% and India at 11.5% (on a fiscal year basis) but the latter reflects a recovery from -8.0% in 2020, whilst China's economy grew in 2020 at a rate of 2.3% based on the IMF's expectations. With so much uncertainty, the forecasts are bound to be amended in the light of new information but reflect the expectation of economic recovery. Most countries' economies, with China and the USA being exceptions, are not expected to have returned to the level of GDP at the end of 2019. Such is the massive damage which the world economy has suffered as a result of the pandemic that figures are almost meaningless, and the sheer size is hard to grasp, that we think it better, generally, to stick to themes in this review.

Perhaps the most interesting development this quarter, which we touched upon earlier, was the notable weakness in international bond markets towards the end of the quarter. This is reflected in the rise in yields which can be seen in the table at the beginning of this review, this table reflecting ten year maturities. One of our constant themes in these reviews for a long time has been the severe overvaluation of bonds. Of course, we all know why this is the case. Central banks have embarked on unheard of levels of bond buying, which has suppressed yields, and price signalling has become more or less non existent. There are buyers of fixed interest securities who are price insensitive because they have to buy them, perhaps for matching reasons, but, for those investors who have the ability to choose their asset allocation without restrictions, the fixed interest market shows too many red flags.

One of the red flags is the potential for inflation to increase. It has been quiescent for a long time, but it does not mean that it will not return. Commodity prices, as measured by the S & P GSCI Commodity Index have risen about 108% in US dollar terms since their low point on 21st April 2020, admittedly a depressed level, and have risen almost 16% in US dollar terms this year. This is the canary in the mine. In some ways, it is surprising that the bond markets have not been indicating these concerns before. The massive build up in central banks' balance sheets, which we have highlighted in a number of previous reviews and which has occurred as a result of the quantitative easing programme, has left a lot of money in the system, ready to be mobilised when business and individual confidence increases. As the money moves round the economies and raises demand, prices are likely to rise for many goods and services. But it's also a supply issue. Supply chains have been damaged by Covid-19 and some companies have gone out of business. Supply restraints, coupled with increased demand, are a recipe for increased prices and, when confidence returns, we are likely to see an acceleration in prices. Money supply growth, because of the monetary policy which has been followed, has risen very rapidly in many countries and this, for many economists, is a warning sign. When one looks at the minuscule yields on offer from selected government bonds in the table at the beginning of this review, they look very inadequate against rising inflation. Whilst central banks can usually control interest rates at the short end of the market, it is much more difficult further out along the yield curve unless they operate a yield control policy, as the Bank of Japan has done. However, that has its own perils because, if a central bank is pushing hard against upward pressure on interest rates, it risks an open ended commitment to quantitative easing, a dangerous policy for its balance sheet. Negative real yields, where inflation exceeds the yield on a fixed interest security, is highly undesirable in normal times. It distorts price signalling and, therefore, the risks involved, and they skew investment decisions and are likely to lead to increased inflation, if they last for long, as people and businesses are encouraged to spend with the money they have borrowed. For lenders, as opposed to borrowers, they represent a transfer of value to the borrower and a loss to themselves in real terms.

We seem to have entered a situation where very low or negative short term interest rates are considered a permanent feature of monetary policy and it is not much of a stretch to the imagination for some to believe that governments can continue to borrow vast sums indefinitely, financed effectively by central banks. Central banks are not meant to finance governments directly. In the case of the UK, for example, the Bank of England cannot finance the government by purchasing a new government bond directly from the UK Treasury. Many people will not see much difference to what happens at present where the Bank of England, under its QE programme, buys bonds in the secondary market. Buyers in the primary market will know that there is a buyer behind them. This is replicated elsewhere. So, some may ask, why cannot this state of affairs continue for as long as necessary to enable economies to recover without having to take measures to restore public finances which would involve tax rises and/or public spending cuts? One is that the build up of debt risks very severe problems in the future when it has to be refinanced at probably much higher interest rates. At the moment, ultra low interest rates make the servicing of increased borrowing manageable, but that would not be the case if interest rates were at more normal levels. It is not realistic to expect that this state of affairs can continue indefinitely. As cheap debt matures, it would need to be replaced by more expensive new debt, the servicing cost of which will affect the budgets at the time. The danger, however, is that investors will lose confidence if they believe that no effort is being made to restore public finances on a sounder footing, so signals like a rise in bond market yields or significant currency weakness are warnings of problems to come.

It is against this background that the UK Budget on the 3rd March was particularly relevant. The UK was hit very hard by the pandemic, both in terms of deaths from Covid-19 but also economically, partly because of the profile of the UK economy, with the services sector very badly hit. Now, however, because of the success of the vaccination programme, the UK stands a good chance of emerging early from the recession and resuming growth ahead of many other countries. The UK Budget was interesting because not only did the Chancellor of the Exchequer continue measures to help the economy get through this year but he also started on the road to restoring public finances with future tax increases. So, in the short term, the furlough scheme is being extended until the end of September, together with the VAT reduction for hard hit sectors but, in order to start to deal with the damage to public finances, tax increases in the form of frozen thresholds and a Corporation Tax rise are going to take effect after that. In the short term, it is essential in the UK, as elsewhere, that nothing is done to damage the economic recovery, as faster economic growth is the best way to improve the taxation take but, when growth is established again, it will be easier to raise taxes. It is a very difficult balancing judgement for any finance minister to make but, in giving a signal to markets that the importance of starting on the long road to restoring public finances is understood, this should reduce the risk to financial markets. The UK seems to be leading the way in this strategy. The Office for Budget Responsibility's latest economic forecast, released with the Budget, forecasts 2021 growth of 4.0% and, for 2022, 7.3%. Against this latter forecast, fiscal tightening, as announced in the Budget, would strike a reasonable balance between not jeopardising economic growth, yet starting to address the huge hole in public finances. The measures which the Chancellor of the Exchequer has taken to raise taxes are surely not ones which he would want to have taken. For instance, the sharp rise in Corporation Tax risks sending out the wrong signal internationally, but it is probably the lesser of two evils set against the risk of a loss of confidence in the bond and currency markets.

Other countries will need to go down this path as well but a lot will depend on where they are in the vaccination campaign and whether they are likely to face another major outbreak of the virus later this year. Allowing a tightening of fiscal policy before the vaccination programme has been completed, and therefore the economic outlook is more uncertain, would be a risk to the necessary restoration of confidence and would be counterproductive. The eurozone is likely to be one of the most problematic areas for different reasons. The vaccination roll out has been slow and the risk is that not enough people will have been vaccinated to prevent a possible third wave later this year. The current position in the eurozone is serious enough, but any third wave would be very damaging to the economy.

The problem for the eurozone is that, whilst it is a currency union, it does not represent a homogenous group of countries. The ECB is pursuing an aggressive quantitative easing policy, but the debt profile of the eurozone's members is very different. Important eurozone countries like Italy, the third largest, have enormous debt levels, whilst that of Germany, although it has risen as a result of the pandemic, is much lower at below half the level measured by the level of outstanding public debt as a percentage of GDP. Financial disciplines in the eurozone were governed by the Stability and Growth Pact, which limited the levels of outstanding government debt as a percentage of GDP and also the size of the budget deficit as a percentage of GDP at 3% maximum. As a result of the crisis, the IMF estimates that the budget deficit for the eurozone in 2020 was 8.4%. There is a limit to how much debt the ECB can keep hoovering up, not only in absolute terms but also in country terms. The crisis for the eurozone will come if markets start to lose confidence in particular credits. This might find its reflection in the currency. Meanwhile, the Stability and Growth Pact has been rendered obsolete by the serious deterioration in the eurozone's finances.

Whilst our investment view is that bonds, in general, are highly unattractive because the return gives no proper reward for the risk taken because of the inflation risk, or even credit risk, equities do remain our preferred asset. We do, however, need to recognise the risks to equities which rising bond yields pose.

At its simplest, we have the current situation where, in nearly every country, dividend yields exceed bond yields. Historically, that is an unusual position, but it has been the case for some time. For many investors who require income from their investments, equities have provided an answer, on the basis that they understand the risks which come with them. Those who are concerned about some high equity valuations can gain some comfort from the fact that low interest rates mean applying a low discount rate to the stream of future company earnings, thereby justifying a higher net present value. But, if interest rates go up, equities' yield advantage may narrow or even reverse against bonds and the net present value of the future earnings decrease, theoretically justifying a lower price for shares.

Investors who favour equities as their preferred asset class are aware of this, hence the jitters towards the end of the quarter when bond yields rose quite sharply. We noted in previous reviews that, when news of the success of the Covid-19 vaccine trials emerged last November, there was a swing in sentiment towards value stocks which had been badly hit by the pandemic. The rationale for some return to favour in this sector after a long period of underperformance was that these businesses would benefit from an economic upturn. Even though many of the value stocks cut their dividends, they still overall had some reasonable yields to show, especially against growth stocks, some of them with no yield and others with a low yield. Rising interest rates made their share price levels more challenging, whilst value stocks offer a reasonable yield which helps to offset a rise in interest rates and offer the prospect of a sharp profits recovery from very low levels. This is a broad generalisation. We would not sell high quality growth companies but we could expect a recovery in some of the value stocks like financials, miners and energy companies. A sharp, as opposed to a gradual rise in yields, is probably the biggest threat to equity prices. Whilst the central banks may have limited tools to deal with rising bond yields out along the maturity spectrum, when the time comes for them to start raising interest rates, it is essential that the signalling is correct so that investors are prepared for a gradual tightening of policy. What investors do not like is surprises. One remembers the "taper tantrum" in markets in 2013 which unsettled investors. It is unlikely that central banks will make any mistakes on the signalling front this time because maintaining market confidence is vital as monetary policy gradually tightens. We must emphasise that monetary tightening is not going to happen yet at the short end of the market.

For this review, we have discussed events at a high level rather than drilled down into each country's or region's outlook apart, in general terms, for the UK and eurozone. In more normal times, we would be discussing each area in more detail, in particular the USA after the election. However, the big picture and theoretical as well as practical risks to markets are more relevant at the moment, hence the contents of this review.

We remain of the view that equities are the preferred asset class and that, although bond yields have risen over the last quarter, they are far from offering any value for investors who do not have to hold them. Equities can look forward to a vaccine driven recovery, although uneven because countries are at different stages of the vaccine programme. This should help earnings and dividends. Particularly because of some nervousness in the bond markets, we must expect equities to have some periods of weakness after a good recovery from March 2020 lows, but our time horizons are longer term. Where cash levels have built up, we will be looking to invest on any significant market setback.