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ASSET MANAGEMENT (C.I.) LIMITED

# INVESTMENT MEMORANDUM

Recent reviews have largely concentrated on the risks of rising inflation and interest rates but all this now seems minor compared with the humanitarian and economic consequences of the Russian attack on Ukraine. Writing a review has been particularly difficult this month because, day by day, the news changes and, in the last few days, the markets have reacted more severely than initially in the light of the tragic events in Ukraine and ever escalating commodity prices with the threat they pose to inflation and living standards.

The tables below detail relevant movements in markets :

## International Equities 30.11.21 - 28.02.22

| Total Return Performances (%) | | | | |
|---|---|---|---|---|
| **Country** | **Local Currency** | **£** | **US$** | **€** |
| Australia | -0.7 | +0.2 | +1.7 | +1.9 |
| Finland | -7.3 | -8.8 | -7.5 | -7.3 |
| France | -1.7 | -3.2 | -1.9 | -1.7 |
| Germany | -5.2 | -6.7 | -5.4 | -5.2 |
| Hong Kong, China | -2.6 | -4.2 | -2.8 | -2.6 |
| Italy | -0.7 | -2.3 | -0.9 | -0.7 |
| Japan | -2.3 | -5.0 | -3.7 | -3.5 |
| Netherlands | -12.5 | -14.0 | -12.7 | -12.5 |
| Spain | +2.6 | +0.9 | +2.3 | +2.6 |
| Switzerland | -2.1 | -2.6 | -1.3 | -1.1 |
| UK | +6.3 | +6.3 | +7.8 | +8.0 |
| USA | -4.7 | -6.0 | -4.7 | -4.5 |
| All World Europe ex UK | -5.3 | -6.8 | -5.5 | -5.3 |
| All World Asia Pacific ex Japan | -2.7 | -4.0 | -2.6 | -2.4 |
| All World Asia Pacific | -2.5 | -4.3 | -3.0 | -2.8 |
| All World Latin America | +10.2 | +17.4 | +19.1 | +19.3 |
| All World All Emerging Markets | -2.2 | -3.0 | -1.7 | -1.5 |
| All World | -3.4 | -4.7 | -3.3 | -3.1 |

*Source : FTSE All World Indices*

FTSE UK Government Securities Index All Stocks (total return) : -7.7%

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

| Currency | 30.11.21 | 28.02.22 |
|---|---|---|
| Sterling | 0.81 | 1.41 |
| US Dollar | 1.45 | 1.83 |
| Yen | 0.05 | 0.19 |
| Germany (Euro) | -0.35 | 0.13 |

## Sterling's performance during the quarter ending 28.02.22 (%)

| Currency | Quarter Ending 28.02.02 |
|---|---|
| US Dollar | +0.8 |
| Canadian Dollar | N/C |
| Yen | +2.4 |
| Euro | +1.9 |
| Swiss Franc | +0.6 |
| Australian Dollar | -1.1 |

## Other currency movements during the quarter ending 28.02.02 (%)

| Currency | Quarter Ending 28.02.22 |
|---|---|
| US Dollar / Canadian Dollar | -1.0 |
| US Dollar / Yen | +1.8 |
| US Dollar / Euro | +0.9 |
| Swiss Franc / Euro | +1.2 |
| Euro / Yen | +0.8 |

## Significant Commodities (US dollar terms) 30.11.21 - 28.02.22 (%)

| Currency | Quarter Ending 28.02.22 |
|---|---|
| Oil | +42.5 |
| Gold | +4.5 |

## MARKETS

The Russian invasion of Ukraine and the resulting uncertainty meant that markets ended the quarter in negative territory. In local currency terms, the FTSE All World Index returned -3.4%, in sterling terms -4.7%, in US dollar terms -3.3% and in euro terms -3.1%. Looking at local currency returns first, the two stand out performers were Latin America, where the FTSE All World Latin America Index returned +10.2%, and the FTSE UK Index, which returned +6.3%. The heavy emphasis on previously unfashionable sectors in the UK market, such as energy, mining and financials, and low emphasis on technology stocks, helped the unloved UK market to recover some relative performance. On the negative side, the FTSE USA Index and the FTSE All World Europe ex UK Index both underperformed the FTSE All World Index, returning -4.7% and -5.3% respectively, although the underperformance was not significant. Looking at sterling adjusted returns, the performance of the FTSE All World Latin America Index was raised to +17.4%, an astonishing performance reflecting strong Brazilian and Mexican markets and also currency strength. Of course, previously, the Latin American markets significantly underperformed. With sterling drifting higher, most of the indices showed a more negative performance in sterling terms. An exception was Australia, where a very small negative performance from the FTSE Australia Index in local currency terms, -0.7%, became a small positive return, +0.2%, in sterling terms.

Although bonds rallied on the basis of being a safe haven in troubled ties, they still experienced a very poor quarter as the spectre of rising inflation, rising interest rates and quantitative tightening (QT) lurked. Rising inflation increased negative real yields, alerting investors, if they did not already know it, to the significant mispricing of bonds. Taking 10 year government bond yields as a benchmark, the gross redemption yield on the UK gilt rose by 60 basis pints to 1.41%, on the US Treasury bond by 38 basis points to 1.83%, on the Japanese Government Bond by 14 basis points to 0.19%, on the German Bund by 48 basis points to 0.13% and returning yields to positive levels after having been in negative territory for so long.

In the foreign exchange market, as implied above, sterling was generally stronger. Against the yen, it rose by 2.4%, against the euro by 1.9%, against the US dollar by 0.8% and against the Swiss Franc by 0.6%. Against the Australian dollar, however, it fell by 1.1%.

In the commodity markets, oil was obviously a feature because of the worsening geopolitical scene and concern about energy supplies. As measured by Brent crude, it rose 42.5% during the quarter. Although gold is supposed to represent a store of value in uncertain times, its rise was modest at 4.5%. Rising interest rates will pose a threat to it.

## ECONOMICS

In writing this economic memorandum there is a primary goal, which is to aim to make some sense of the economics of the world and what effect it will have, both short term and longer term, on the markets in which the reader may be invested. It has always been a belief of the writers of the memorandum that there is more to be gained from avoiding politics or expressing a view or comment than there is from celebrating or condemning any aspect of it. The memorandum for the month of February has been largely re-written over the month and it is impossible not to write without inclusion of the events in the final week in Ukraine.

The geography of Russia is quite extraordinary in that it spans 11 time zones and its land mass is around 70 times larger than the United Kingdom's. The physical distance from its borders to Moscow, allied to both extremes of weather, has meant that both European attempts to conquer the country have failed. The sheer distances across its flanks to the south and east mean that maintaining supply lines to an invading army is nigh on impossible. A name from the recent past, the Union of Soviet Socialist Republics, came into being exactly 100 years ago and its former status in the world appears to cast a shadow over those who live in and oversee its successor, the Russian Federation. There is a burden that can be associated with diminished standing, where many Russians might reflect on its sense of invulnerability, its (waning) superpower status and the technological triumphs of the last century. How many Russians look to the past and how many look to the future is probably quite generational and it is difficult to gauge how popular Putin's actions are amongst the populus. The leadership of the country is extremely narrow, and given the country's recent history and the ignominy of the collapse of the USSR in 1991, which, to some, still feels like capitulation to the West, Vladimir Putin's crusades to former territories are ever more determined.

As much as Russia's presence on the world map is eye-catching, its economic presence is less so. The 145 million inhabitants of the country contribute to it being the eleventh largest economy in the world which, in itself, is quite impressive but places it behind the economies of Italy, Canada and South Korea in size. This adds a great deal of perspective to the perceived might of the country and when calculated on a per capita basis serves as a reminder that the average Russian does not enjoy a high level of wealth relative to citizens of other countries. The distribution of wealth is also extremely uneven. According to research by the European Parliament, statistics show that wealth and income are shared less equally in Russia than almost all other developed countries, one exception being the United States, and nearly half of pre-tax national income goes to Russia's wealthiest 10%, compared to roughly a third in France. Russia has more billionaires, relative to the size of its economy, than any other large country and personal income tax is a flat 13%. Transparency International ranks Russia 136th out of 180 countries in its Corruption Perceptions Index (Denmark, Finland and New Zealand share first place with United Kingdom in 11th). Its education system, however, is relatively strong and rated highly for inclusiveness though where someone is born and into what background of wealth are likely to be very large determinants of wealth outcome.

Vladimir Putin has now been President for over twenty years and his style of leadership is quite easy to characterise. With a seemingly divine right to govern and a lust for the glories of empire his demeanour is a reminder of Russia's imperial past, long before the century of socialism. His contempt towards the very existence of Ukraine was shown in his essay published in 2021 'On the Historical Unity of the Russians and Ukrainians' and the early premise that its argument with Ukraine was as an issue of potential NATO membership now looks to be so flimsy as to be laughable. In a 2019 interview with the Financial Times, he cited Peter the Great as his favourite leader and it was Peter who founded the Russian navy and formed a regular army through conscription. The defeat of Sweden, then a regional power, yielded new territory that permitted access to the Baltic Sea and territory was gained in the south, too, allowing the establishment of a port on the Black Sea at Avoz. Perhaps, after twenty or so years in power, Putin feels that a crowning achievement is long overdue and, perhaps, his need to cement a legacy for his decades in power obscures the risks involved in this invasion. Such a move is an immense gamble for his leadership and the hope is that he has underestimated the reaction that has come from the international community, from his own people or, of course, from the people of Ukraine.

As much as there is a question to ask about what is the best outcome Putin could hope for, there is the question of what could be the worst outcome for him. A relatively bloodless taking of the cities of Ukraine followed by the capitulation of the leadership and a gradual dissipation of sanctions would be a great pre-cursor to the raising of Russian flags on Kyiv's government buildings and, perhaps, a victory parade. Being more optimistic, from a western perspective, and it may seem unlikely right now, but there is the possibility that the biggest threat to Putin is his Russian people as they reject the initiative. Interest rates have been hiked to 20% from 9.5% (at the time of writing) and a run on the banks has started as account holders lose faith in the banking system and attempt to withdraw their roubles to hide them under the proverbial mattress. This memorandum has written at length over the past months quantifying the effects rising inflation may have on the world economy but it is likely to be nothing in comparison with what may happen in the Russian internal market. As Russian banks get frozen out internationally, the settlement of non-rouble payments will become very difficult with the consequent effect on availability and access to imported goods. There will be no shortage of natural gas or petrol but it may be harder at the supermarket or the pharmacy.

If western powers decide, the Russian Central Bank (RCB) will have limited options on how to defend its currency which has reached an all time low against the US dollar. Through the sale of oil and gas the country has built up foreign reserves which, at the end of January, were worth $630 billion, some of which is in liquid non-rouble currencies and some of which is in highly liquid securities, typically highly rated bonds and gold. Central banks foreign reserves are usually not held within the country but, rather, in international financial centres such as London, New York or Tokyo where they can be traded, settled or exchanged for roubles. The action of the RCB selling a bond is no different from Meridian selling a security for a client where a broker in the market concerned finds a buyer, settlement instructions are exchanged, the trade is settled with the buyer's name being recorded as the new owner in, for example, Euroclear and the proceeds paid to the seller's bank. Normally, all central bank assets are immune from interference by other central banks but, increasingly, this is being challenged. By the imposition of sanctions, brokers or banks can be prevented from acting in the transfer of ownership of assets or the conversion of currency for an entity that has had sanctions imposed on it. Assets held at the Bank of International Settlements - the central bank of central banks, can also be subject to sanctions cutting down Russia's option further. Russia may have to strengthen allegiances with China and find marriages of convenience as it seeks to trade assets as it sees fit. Included in its portfolio of non-rouble assets is around $130 billion of gold which, unusually but not surprisingly, is all held physically within the country. The simple option here is to transport it to a partner country where it can be sold for cash and that cash converted into roubles. The goal is invariably the same, there is a need to create a demand for roubles in the market and we may now see the inability of an isolated central bank to do what it is there to do, in failing to ensure financial stability and showing an inability to slow the pace of economic decline within the Russian economy. Interest rate rises and capital controls are the two other tools which the RCB has now used, both of which make day to day life in Russia more difficult. Over the last decade, or so, confidence in the world economy has been maintained through the proven ability of the world's central banks to work in concert to steer past two major crises, one financial and one health but the financial isolation of a country is a daunting prospect for its currency area and domestic banking system and, ergo, the people of the country.

It is worth reflecting upon the development of the relationship between Russia and China and wonder to what extent they can or do form a partnership. Some countries have allies and some countries have interests. It would seem to suit Russia and China to cooperate in areas which benefit them both. The two share a land border which is almost 2,700 miles long, one has too much oil and natural gas and one does not have enough. Furthermore, China always feels a vulnerability to its tanker supply lines that route through the narrow straits around Malaysia. Russia could be forgiven for feeling isolated due to its relations with most of Europe and the United States and can benefit from standing with China alongside and if sanctions start to bite then China could provide a great deal of relief; China has already become Russia's largest source of imports and its largest export market. It could even be said that Ukraine offers a diversionary opportunity for China to act elsewhere. A cynic would say that at the very least it would make sense to coordinate their hostilities, especially as they may have very different areas of focus. Supporting Russia at this time, however, will not come without risks as international opprobrium grows. China will need to consider the risks to its own institutions if it chooses to support Russia by buying assets it is trying to sell as G7 countries will always have the option of imposing secondary sanctions on China, or indeed, any other country that chooses to curry favour with Russia at this time.

In the build up to the invasion, markets seemed reluctant to price in the threat of war and the consequences of war which, given the whole range of potential outcomes, are very difficult to price. Events have moved on and writing at the beginning of March, two weeks into the conflict, markets have not seen a significant correction, especially in the face of the devastation on the ground in Ukraine. There has been some flight to haven assets with gold rising to over $1,950 per ounce and the yield on 10 year U.S. Treasuries has fallen to 1.77%, from over 2% in January. Other high quality sovereign bonds have also risen in price, going against the recent sell off which was being driven by inflation concerns. Equities, also on concerns around inflation, had a bad start to the year before a short rally at the end of January. The market has fallen again as images of fighter aircraft over Ukrainian soil were beamed around the world.

At the time of writing it is not clear how Russia will exercise its legitimate and illegitimate options beyond Ukraine. Commodity prices have risen sharply as shown by the Bloomberg Commodities Index, a long running benchmark index of a broad range of soft and hard commodities. It is currently around 65% above its pre-COVID levels with a correlation between the size of Russia's stake in any particular market and the size of the price rise. One example would be nickel where Russia represents around 7% of the world market and prices have hit the highest level since 2007. Aluminium is at a record high of over $3,850 per tonne, having been below $2,000 per tonne for most of the past five years. Brent crude is above $120 per barrel and Russia and Ukraine export around a quarter of the world's wheat. Some countries in the Middle East and North Africa have a near total reliance on this source for an essential foodstuff. More nefarious options available to Putin could involve cyber-crime, interference in the internal affairs of hostile countries such as elections or orchestrating a humanitarian crisis of refugees. These are just three that have been talked about but others may well be possible. The most serious escalation would, naturally, be arms against what he might term western aggressors but with no sign of intent to put allied soldiers on the ground, this is far less likely to develop as a possibility.

It is extreme events that challenge the way the world thinks and at this time this is about a reflection on vulnerabilities in national security. Germany has moved the most so far and has reacted to the crisis by announced a transformational increase in defence spending, channelling €100 billion of money into modernising its military this year and pledging that by 2024 it will spend at least 2% of GDP (€80 billion) on defence; 2% is the NATO target defence spend for its members. Its energy policy has become very virtuous, driven by the need and wish to go green, for reasons that are clear to all. The Greens enjoy more mainstream support in Germany than its equivalent does in the United Kingdom and forms a part of the three way coalition government under Chancellor Olaf Scholz. The country is keen to move away from brown coal and decided in 2011, in the fall out from the Fukushima disaster, to close all of the country's nuclear plants by 2022. Solar and wind are a large part of the solution but are not large enough and this crisis and the consequent decision to delay the sign off of Nordstream 2, when linked to previous energy policy decisions, places Germany in a difficult position. Also, at the end of February, the country said it would accelerate the construction of two liquid natural gas storage facilities, one with capacity to store 8 billion cubic metres of natural gas and the second with capacity of 12 billion cubic metres. The first of these has been planned, but subjected to unanticipated delays a few times, but with a current annual consumption of over 80 billion cubic metres per year this would seem like a sensible, but expensive, policy decision. All of this is, unfortunately in some ways, a reminder that there are a number of risks associated with rapid changes in energy policies and as BP and Shell dispose of their Russian assets it is also a reminder of the long tail risks Russia faces in international diplomacy.

The magnitude of the equity market falls has, so far, been in mid-single digits and without wishing to play down something that is having such a devastating human cost, markets, to an extent, are not seeing this as an event which will escalate to threatening proportions. This may be a correct reading of the situation or it may yet prove to be a terrible underestimation but we are not seeing, however, a rush for the exits. Equity markets have grown to show more resilience in the face of negative news stories in recent years and, so far, this appears to be the case here. It is tempting to view any global event that invites such a high level of uncertainty in apocalyptic terms whereby too much weighting is given to the most negative outcomes. The previous global event which invited such a high level of uncertainty was the coronavirus pandemic in early 2020 where world equity markets fell 25% in 25 days before recovering to end the calendar year in positive territory. It is tempting to sell out when something occurs to blight the outlook and the worse it gets, the greater the temptation to sell out. Market history repeats itself and we have not seen the last significant correction in the equity market but hindsight shows that the worst course of action is to sell out in or at the bottom of the dip. There is an argument that selling out with the intention of buying back in at a lower point is attractive but for long term equity investors the risks of doing so, in our opinion, are outweighed by the benefits of remaining invested throughout. For the month of February up to 4$^{th}$ March the FTSE All-World index, total return in local currency terms is down 5.0%.

Vladimir Putin has embarked on the biggest gamble of his presidency and his motivations are straightforward. The question is whether he has under-estimated the resolve of the other combatants in the fight. Early indications show that the Ukrainian army is putting up more resistance than expected, the openness, relative to the past, of the Russian economy leaves it vulnerable to sanctions and international isolation and, looking beyond combatants, it is possible that the Russian people may turn against the initiative in the face of declining living standards and a failing financial system. The risk to Putin is that defeat, and how that is defined, is subject to much conjecture and may represent an era-defining event for Russia. Its significance as a global power would be diminished, the relationship with European ex-Soviet states irreparably damaged and Russia may decide it is time for a change of management. The stakes remain high.