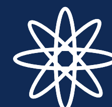

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ASSET MANAGEMENT (C.I.) LIMITED

INVESTMENT MEMORANDUM

What looked to be a satisfactory quarter turned into a negative one for international equity indices as markets suffered a significant setback in the last week of February as investors reassessed their view of the economic consequences of the coronavirus outbreak. Conversely, high quality bonds benefited from a perceived flight to safety, in some cases driving yields down further into negative territory. Sterling was generally weaker over the quarter whilst, in the commodity markets, oil fell on the prospect of lower economic activity and gold benefited from its status as a safe haven in uncertain times.

The tables below detail relevant movements in markets :

International Equities 29.11.19 - 28.02.20

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	-4.9	-8.2	-9.4	-9.0
Finland	+0.1	+1.0	-0.3	+0.1
France	-8.8	-8.0	-9.1	-8.8
Germany	-9.6	-8.8	-10.0	-9.6
Hong Kong, China	-2.3	-0.6	-1.8	-1.5
Italy	-5.7	-4.9	-6.1	-5.7
Japan	-10.3	-7.8	-8.9	-8.6
Netherlands	-7.6	-6.8	-8.0	-7.6
Spain	-5.4	-4.5	-5.7	-5.4
Switzerland	-6.1	-1.8	-3.0	-2.7
UK	-9.5	-9.5	-10.6	-10.3
USA	-5.2	-4.0	-5.2	-4.8
All World Europe ex UK	-7.4	-6.0	-7.2	-6.8
All World Asia Pacific ex Japan	-1.6	-1.5	-2.7	-2.4
All World Asia Pacific	-5.0	-3.9	-5.1	-4.8
All World Latin America	-3.6	-7.0	-8.2	-7.8
All World All Emerging Markets	-2.1	-1.8	-3.0	-2.7
All World	-5.6	-4.6	-5.8	-5.5

Source : FTSE All World Indices

FTSE UK Government Securities Index All Stocks (total return) : +3.5%

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

Currency	29.11.19	28.02.20
Sterling	0.70	0.44
US Dollar	1.78	1.15
Yen	-0.09	-0.16
Germany (Euro)	-0.36	-0.61

Sterling's performance during the quarter ending 28.02.20 (%)

Currency	Quarter Ending 28.02.20
US Dollar	-1.3
Canadian Dollar	-0.2
Yen	-2.4
Euro	-1.2
Swiss Franc	-4.4
Australian Dollar	+2.8

Other currency movements during the quarter ending 28.02.20 (%)

Currency	Quarter Ending 28.02.20
US Dollar / Canadian Dollar	+1.1
US Dollar / Yen	-1.1
US Dollar / Euro	+0.1
Swiss Franc / Euro	+3.4
Euro / Yen	-1.3

Significant Commodities (US dollar terms) 29.11.19 - 28.02.20 (%)

Currency	Quarter Ending 28.02.20
Oil	-17.4
Gold	+13.6

MARKETS

What was shaping up to be a satisfactory quarter until the last week of February turned sharply negative in the final week of the month So, for the quarter, the FTSE All World Index in total return local currency terms returned -5.6%, in sterling terms -4.6%, in US dollar terms -5.8% and in euro terms -5.5%. Looking at individual markets in local currency terms, the worst performer on our table was Japan where the FTSE Japan Index returned -10.3%. Not far behind was the UK and, within Europe, the FTSE Germany Index, -9.6%, and the FTSE France Index, -8.8%, were underperformers. There were no positive performances in local currency terms, but the USA outperformed with the FTSE USA Index returning -5.2%. The FTSE Asia Pacific ex Japan Index, -1.6%, the FTSE All World All Emerging Markets Index, -2.1% and the FTSE All World Latin American Index, -3.6%, all outperformed the FTSE All World Index. Because sterling, except against the Australian dollar, was weaker over the quarter, returns were less negative in sterling terms. With the UK market particularly weak, sterling based investors with an unhedged exposure to overseas equity markets were able to mitigate some of the effects of the market's fall at the end of February. In particular, those with exposure to the USA, Switzerland, Asia Pacific ex Japan and Emerging Markets escaped the worst of the fall, although still in negative territory.

The coronavirus scare drove money into good quality bonds, notwithstanding their lack of fundamental value. Taking ten year government bonds as a benchmark, the gross redemption yield on the UK government bond fell by 26 basis points to 0.44%, that on the US Treasury bond by 63 basis points to 1.15%, on the Japanese Government bond by 7 basis points to -0.16% and on the German Bund by 25 basis points to -0.61%.

In the currency markets, sterling was generally weaker except against the Australian dollar where it rose by 2.8%. Against the Swiss Franc, sterling weakened by 4.4%, against the yen by 2.4%, against the US dollar by 1.3%, against the euro by 1.2% and against the Canadian dollar by 0.2%.

In the commodity markets, oil fell sharply by 17.4%, reflecting the view that temporary weaker economic growth will reduce the demand for oil, whilst gold, on this occasion justifying its reputation as a safe haven in uncertain times, rose 13.6%.

ECONOMICS

For the moment, the issues which we would probably have been discussing in our February economic review such as the US/China trade dispute, the course of monetary policy, Iran and the forthcoming US Presidential election, have given way to the spread of the coronavirus from China and, after a steady quarter up to the third week of February, markets suffered a very significant correction in the last week of February in response to the spread of the virus.

Whilst markets can absorb known events and facts and take a view on other issues, sudden and unexpected events, which investors had not anticipated, can cause significant moves in markets such as the ones we are now witnessing. There is a precedent in the SARS outbreak of 2002/3 which was contained, though the time which has elapsed since then may reduce its predictive value. It is, nevertheless, something to consider and of some value.

There are two dimensions of the outbreak to consider, the human one and the economic one. The human one is the loss of life (the mortality rate is now estimated by the WHO at 3.4% but this may change) and the suffering which it causes, and the economic one is the cost to the world economy. At the moment, it is impossible to say how well the virus can be contained. What we can do is to consider the economic effects, imprecise as the guesses have to be. The outbreak, of course, started in Wuhan in Hubei province in China. Wuhan is an important manufacturing centre and the lockdown in a highly interconnected supply chain has a knock on effect on manufacturing elsewhere in the world. This is replicated elsewhere in China and supply shortages affect manufacturing throughout the world. Whilst a globally connected supply chain implies economic efficiency, with each part of the final manufactured product being sourced from the most efficient producer (that is the theory anyway), in exceptional circumstances, like the present one, it can be a disadvantage. So, with many businesses not reopening in China after the Chinese New Year, China's GDP will take a significant hit in the first and second quarters of the year at least. Not only will manufacturers in China, directly, and overseas, indirectly, where Chinese components are bought, be adversely affected, but so will service industries. Chinese tourists are big spenders so the effect on airlines, shops and hotels will be significant. Tourism elsewhere will be affected as individuals are less inclined to travel to certain areas. If individuals anywhere in the world cannot get to work because of restraints then economic activity will suffer. So, it is quite obvious that economic activity will be hit, at least in the first part of the year, with some countries much more affected than others.

Starting in China, what are the consequences for businesses, individuals and governments? The shutdowns, or loss of business, will badly affect cash flows. Many companies are highly leveraged so the effect, particularly on small and medium sized businesses, will be serious and perhaps terminal. For banks and the shadow banking sector, bad debts will increase in a system where bad debts are a problem anyway. Individuals are likely to draw on their savings to finance day to day spending, but discretionary expenditure is likely to fall sharply. Holders of lower quality corporate debt are vulnerable. Prior to the outbreak of trade hostilities between the USA and China, the Chinese authorities had been attempting to clamp down on the shadow banking sector in order to reduce leverage in the Chinese economy. The policy had to be paused when the trade hostilities broke out and monetary policy was eased but the high level of debt in the Chinese economy means that there is vulnerability in the corporate and banking sectors. One would expect the Chinese authorities to do what they can for the affected businesses and they have already started to help companies with their financing. In an article in the Financial Times, the Deputy Governor of the People's Bank of China outlined some of the measures taken to deal with the situation. Open market operations have been used to provide reasonable and adequate levels of liquidity. The Deputy Governor said that the PBoC, with other financial regulators, had taken 30 policy measures to support enterprises heavily affected by the epidemic, in particular small and micro ones, private enterprises and the manufacturing sector. The PBoC also provided Rmb300 billion (c. US$43 billion) in special central bank lending to large banks and selected local banks in Hubei and other severely hit provinces. Credit support at preferential interest rates has also been provided to manufacturers in certain important industries. The Deputy Governor said that the Chinese economy is expected to show a "V" shaped recovery, reflecting weakness now, and then a compensatory recovery. The trajectory of both parts of the "V" will depend on how far the dip in growth will extend and how much of that will be recovered in the upturn. The point to make in this period of deep uncertainty about the path the coronavirus epidemic will follow is that governments and central banks will act to counter its negative economic effects. How effective this will be we cannot yet tell. The point for investors to take on board is that, in this negative environment, it is important to consider what the authorities will do to try to counteract the negative effects of the outbreak. Going back to the SARS outbreak in 2002/3, it is estimated that global growth was cut by 1% in the second quarter of 2003, but soon recovered. For China, the fall was 2%, this at a time when the Chinese economy was growing more quickly than now. Of course, the Chinese economy forms a much larger percentage of world GDP now than it did then. It is now just under 19%, so the value of the precedent might be diluted, but it is as good an indicator as there is about what might happen.

Whilst there is little doubt that the actions of China, in terms of trying to offset the economic danger of the outbreak, will be replicated as necessary elsewhere, a word of caution is necessary about how effective counter cyclical measures might be on this occasion. Whereas China does have some room for manoeuvre on interest rates, other areas, the eurozone most notably, have very little room. China also has room to ease bank reserve requirements, which it has been doing to free up more money for the banks to lend. But, with interest rates at such low levels in most countries, one doubts how much more effective they can be. If monetary easing can only have limited effects, then it has to be fiscal policy and here a number of countries have large budget deficits which would normally restrict their room for manoeuvre. China and the USA already have very large budget deficits as a percentage of GDP, estimated at well over 4% for 2019, and Japan's budget deficit is around 3% of GDP. Parts of the eurozone would seem to be best placed with Germany and the Netherlands, both running quite large budget surpluses in 2019. Germany has always been fiscally very prudent, with an aversion to running deficits, but the tide may be turning. Given weakness in the eurozone and particular difficulties for Germany in the motor industry, the mood may change. Given negative interest rates in the eurozone, some fiscal expansion by those countries which can safely do it, like Germany, would look to be the most effective counter cyclical policy, although it does not work overnight. A number of Asian countries are quite constrained by their fiscal position, as are Latin American economies. However, if there is a significant spread of the virus there may be no option but to take risks with fiscal policy which would not normally be done.

This leads on neatly to one of our constant themes in these reviews, namely the distortions in financial markets and the economy caused by the extreme monetary policy which has been in place since the financial crisis, around twelve years ago. What was seen as a temporary expedient then to deal with a major emergency, now has the feel of a policy which has acquired an air of permanence. Whilst it has certainly boosted asset prices, it has also, as we have often mentioned, introduced major distortions in the financial markets, which have undesirable consequences. At a business level, it has allowed "zombie" companies to continue in business at the expense of more promising companies, the effect of which is to reduce an economy's potential growth rate. Zombie companies, at current levels of interest rates, can afford to service their debt, even if they cannot afford to repay the principal. This crowds out companies with better growth prospects as they are denied business opportunities. But, from an investment perspective, there are significant dangers caused by the distortion which monetary policy has caused. If we look at 10 year government bonds, negative gross redemption yields are seen in those issued by Germany, Japan, France, Sweden, the Netherlands and Switzerland. Even more extraordinary, the Greek and Italian bonds show yields of around 1%. Both, of course, are heavily indebted countries. In the 30 year government bond market, there are negative gross redemption yields for government bonds issued by Germany, the Netherlands and Switzerland. Whilst these countries are good credits, it seems scarcely believable that a new investor would have to pay for the privilege of lending to these governments for ten and, especially, thirty years, and, if the bonds were held to maturity, be certain to lose money. Therein lies the problem. Some investors have been forced to take risks in order to obtain income. Some of those risks lie in the bond markets. They have moved to more risky assets, including junk bonds, to try to obtain yield. There is also a very crowded market at the lowest end of the investment grade range. This is where the relevance lies in the possible economic effects of the coronavirus outbreak. The hit to their businesses could well lead to a rise in defaults with losses for investors. Notwithstanding the performance of bonds and understanding why yields are where they are at present, the level of yields cannot be sensible entry points for long term investors as the capital risks when interest rates do eventually approach more normal levels are very significant. Although there will be a hit to profits for many companies caused by the coronavirus induced economic slowdown, high quality companies which can generally maintain or even increase their dividends in the current environment look the safer way to deal with the situation. Whilst shares may see further temporary sharp corrections, the long term performance of shares indicates recovery and then a further advance. It is not our policy to make a knee jerk reaction to events such as the present one by selling

good quality securities. One has to anticipate what governments and central banks will do to offset the negative economic effect of the economic slowdown. Even though their effect may be more limited than before for the reasons given, they should ameliorate some of the problems and investors need to look at the upward line of the "V" referred to earlier by the Deputy Governor of the PBoC.

Other issues, which would normally achieve more prominence in our reviews, would include the developments in the US/China trade dispute. The news is slightly better. In January, the two sides signed a "phase one" deal in which China pledged to raise US imports by US$200 billion above 2017 levels and boost intellectual property rules. In turn, the USA agreed to halve some of the new tariffs which it had imposed on China, with additional issues to be tackled in a "phase two" deal. Since January, China said that it would halve tariffs on US$75 billion worth of goods in line with the phase one deal. Some items will see the tariffs moving from 10% to 5% and others from 5% to 2.5%. China has also said it will grant tariff exemptions on 696 goods to support purchases and, later on in February, it unveiled a further two new lists to exempt some of the US imports from additional Chinese tariffs. We have discussed at length in many previous reviews the economic dangers of protectionism, mainly the danger to economic growth prospects with all of the negative consequences which that entails.

Another concern which has been overtaken by the coronavirus outbreak was Iran and what action the Iranians might take in response to the US killing of Major General Qassim Suleiman. Political tensions in the Middle East are always apparent but it is fair, even though it may seem to be complacent, to say that the issue has gone down the list of concerns. Iran is, of course, one of the countries now in the front line of the coronavirus outbreak.

In 2019, one of our concerns for the UK stock market was the political uncertainty, not so much around Brexit, although it was inextricably linked, but about the future of the then minority government and the possibility of a change to, by UK standards, a government advocating extreme economic policies which would undoubtedly have had a severe effect on the stock market and sterling. Our investment policy reflected this risk. Following the 12th December General Election, the situation is much clearer in the UK, both regarding Brexit, which has obviously happened, and the future of the government, now with a significant majority. So, we regard the UK relatively favourably now. Early skirmishes suggest that trade negotiations between the UK and EU will be tough but there is nothing unexpected there, but now that so much uncertainty has disappeared as a result of the election, there is more clarity in the situation.

Interestingly, however, this leads on to the US political situation where there were some interesting parallels with the UK situation last year. As in the UK, the USA does not have a history of electing Presidents with extreme economic policies. Recent Democratic Presidents, Bill Clinton and Barack Obama, have been fairly centrist in their economic policies, but the field of candidates vying for the Democratic Presidential nomination spans quite a range, including two, Bernie Sanders and Elizabeth Warren, with, by US standards, extreme economic policies. Even the eponymous Michael Bloomberg, a late entrant to the race and a former Republican, is putting forward a left wing programme although, unlike Elizabeth Warren, is not proposing a wealth tax. There is little doubt that, were Bernie Sanders, more likely, or Elizabeth Warren, less likely, to win the Democratic nomination, there would be concerns on Wall Street. It is quite possible that Bernie Sanders will win the nomination because the moderates are divided and could split the votes, though the withdrawal of three moderates has reduced his chances. Although he is now a Democrat, he has only recently moved from being an independent Senator for Vermont and he described himself as a Democratic Socialist. By American standards, this is extreme stuff and he has been likened to Jeremy Corbyn. Many people think that his policies would condemn the Democrats to the same fate as the Labour Party under Jeremy Corbyn. This is pure speculation, but there is a further difference relating to the checks and balances in the US political system. Depending upon the outcome of the elections for the two Houses of Congress would be his ability to get his proposals into law. In this respect, there is a valid difference with the UK position where the government can generally get its proposals through Parliament.

There is a long way to go before next November's elections and there are far too many variables to form a view of what may happen, but it is important to flag the issue because politics can be as important as economics for markets.

Conclusion

Markets are performing very badly because of fears of the unknown. Good companies do not become bad companies because of the inevitable effect on world economic growth and therefore corporate profits. It is a serious outbreak but, like SARS in 2002/3, it will come under control at some stage. Government and central banks will take what they consider to be appropriate action to offset as many of the adverse economic effects as they can, as outlined in this note. At some stage, the upward line in the "V" shaped trajectory of the world economy will become apparent and markets should reflect this. There will be corporate casualties if the economic slowdown is protracted, but our focus has always been on large capitalisation marketable blue chips and our policy is to retain these for recovery during this very uncertain period.

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