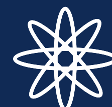

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ASSET MANAGEMENT (C.I.) LIMITED

INVESTMENT MEMORANDUM

International equity markets have continued their upwards move in this latest quarter with all markets shown in our table below rising in local currency terms and only the Japanese market negative in sterling adjusted terms. International bond markets, as shown in our table overleaf, generally also showed positive performances. Currency movements were mixed. Commodity prices have risen significantly so far this year and oil, as shown overleaf, has continued its strong recovery.

The tables below detail relevant movements in markets :

International Equities 31.03.21 - 30.06.21

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	+8.4	+6.7	+6.9	+5.9
Finland	+10.2	+11.0	+11.2	+10.2
France	+8.5	+9.3	+9.5	+8.5
Germany	+4.3	+5.1	+5.3	+4.3
Hong Kong, China	+3.0	+3.0	+3.1	+2.2
Italy	+3.1	+3.9	+4.1	+3.1
Japan	+0.1	-0.5	-0.4	-1.3
Netherlands	+6.6	+7.4	+7.5	+6.6
Spain	+4.4	+5.2	+5.3	+4.4
Switzerland	+10.0	+11.9	+12.0	+11.0
UK	+5.6	+5.6	+5.7	+4.8
USA	+8.8	+8.6	+8.8	+7.8
All World Europe ex UK	+7.4	+8.4	+8.5	+7.6
All World Asia Pacific ex Japan	+4.3	+4.1	+4.3	+3.3
All World Asia Pacific	+2.8	+2.6	+2.7	+1.8
All World Latin America	+6.8	+15.9	+16.0	+15.0
All World All Emerging Markets	+4.1	+5.1	+5.3	+4.3
All World	+7.1	+7.3	+7.4	+6.4

Source : FTSE All World Indices

FTSE UK Government Securities Index All Stocks (total return) : +1.7%

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

Currency	31.03.21	30.06.21
Sterling	0.84	0.72
US Dollar	1.74	1.47
Yen	0.09	0.05
Germany (Euro)	-0.29	-0.21

Sterling's performance during the quarter ending 30.06.21 (%)

Currency	Quarter Ending 30.06.21
US Dollar	+0.3
Canadian Dollar	-1.0
Yen	+0.7
Euro	-0.8
Swiss Franc	-1.6
Australian Dollar	+1.6

Other currency movements during the quarter ending 30.06.21 (%)

Currency	Quarter Ending 30.06.21
US Dollar / Canadian Dollar	-1.3
US Dollar / Yen	+0.4
US Dollar / Euro	-0.8
Swiss Franc / Euro	+0.4
Euro / Yen	+1.3

Significant Commodities (US dollar terms) 31.03.21 - 30.06.21 (%)

Currency	Quarter Ending 30.06.21
Oil	+16.4
Gold	+4.2

MARKETS

International equity markets have experienced a solid quarter with a number of markets at around their all time highs. In local currency terms, the FTSE All World Index has returned +7.1% in sterling terms, +7.3% in US dollar terms +7.4% and in euro terms +6.4%. Looking at individual markets in local currency terms, the USA, of the major markets, stood out with a return of +8.8%. There was also an above average performance from the FTSE Australia Index, +8.4%, and, in Europe, Switzerland and Finland were notable performers, with the FTSE Switzerland and the FTSE Finland indices returning +10.0% and 10.2% respectively. The weakest performer on our list was the FTSE Japan Index which returned +0.1%. Although well in positive territory, the FTSE All World All Emerging Markets Index, +4.1%, and the FTSE All World Asia Pacific ex Japan Index, +4.3%, underperformed the FTSE All World Index. If we look at the sterling adjusted figures, the most startling result comes from the FTSE All World Latin American Index where a highly respectable local currency return of +6.8% became +15.9% in sterling terms as a result of considerable strength in the Brazilian real. Elsewhere, strength in the euro and Swiss Franc against the US dollar meant that the FTSE All World Europe ex UK Index improved its relative performance against the FTSE All World Index, returning +8.4% against +7.3% for the FTSE All World Index. The only negative returns in our table came from the FTSE Japan Index in sterling, US dollar and currency adjusted terms. In sterling terms, the FTSE Japan Index showed a return of -0.5%.

In the government bond market, as measured by ten year benchmark yields, there were declines in yields from the UK, US and Japanese bonds of 12, 27 and 4 basis points respectively. The exception was Germany where the negative yield moved by 8 basis points to a still negative -0.21%.

In the foreign exchange market, sterling experienced a mixed quarter. It strengthened against the Australian dollar, yen and US dollar by 1.6%, 0.7% and 0.3% respectively but weakened against the Swiss Franc, Canadian dollar and euro by 1.6%, 1.0% and 0.8% respectively.

In the commodity markets, oil continued to strengthen, rising by 16.4% as measured by Brent crude. Gold recovered some ground, rising by 4.2%.

ECONOMICS

Whilst the Covid-19 pandemic informs investors' thinking and will do for a long time, the fact that the world economy is around sixteen months into the pandemic means that other issues are beginning to surface. In the initial stages of the pandemic, the emphasis was on trying to contain the economic fallout, apart from the overriding need of trying to protect public health. In terms of the world economy, for most countries, money was no object. It had to be borrowed, of course, but not too many people were worried about the consequences at the time. As the vaccination programme progresses and economic recovery becomes more apparent, the concerns grow about how this huge borrowing programme will affect different countries.

The main concern is inflation and, as usual, economists are divided in their views. This is a subject which has been increasingly discussed in our recent economic reviews because we feel that it is key to considering how securities markets will perform in the foreseeable future. At the risk of repeating ourselves, we will set out why those who have concerns about inflation feel the evidence supports their view. Not so long ago, it would have been unthinkable for central banks to print money on the scale which we have witnessed since early 2020. Of course, we understand why that has happened. Governments had to support their countries' economic infrastructure and their citizens' income and, with demand collapsing, inflation was not a concern at the time. With funding costs so low as a result of central banks' policies, debt servicing costs were manageable. Those who were fortunate enough to retain their income did not have big spending opportunities, so involuntary savings picked up. But, as well as demand collapsing, supply chains were badly affected. In normal times, and at the risk of gross oversimplification, a greater amount of money chasing a limited supply of goods would have been inflationary but, at the time, supply weakness was met by demand weakness. With central banks' balance sheets having exploded in size as a result of money creation for their respective quantitative easing (QI) programmes, bank reserves have been picking up. If the velocity of circulation increases as those with surplus cash balances now have the confidence to spend what they could not do during the pandemic, the big upturn in demand could push up the prices of supply constrained goods and services. There is some evidence that this is happening as we see a spike in consumer price indices. In the USA, the consumer price index for May was up 5.0% on a year ago. The latest personal consumption expenditures price index for April was up 3.6%. This is an important index as it is one which is followed by the Federal Reserve. In the eurozone, the annual inflation figure to May was 2.0%, slightly above the ECB's target level. In the UK, the figure to April was 2.1%, also slightly above the target level. In Germany, the figure is 2.5%. The optimists and some central bankers point to the comparison being with a very depressed period last year, suggesting that the figures will improve once the difficult comparison is out of the system. The pessimists will point to the sharp increase in commodity prices. So far this year, the S & P GSCI commodity index has risen about 25% in sterling terms, which is not an encouraging sign. Hard and soft commodity prices have risen. Money supply in the USA, as measured by M2 (cash, checking deposits and easily convertible near money) on the latest figures is showing a year on year increase of 17%. The figure in the UK is not as large, but it is still significant at 8.9%. In the eurozone, the figure is 9.2%. For those economists who favour money supply figures as a basis for their inflation forecasts, these are not comfortable figures.

For the short to medium term, much will depend on how the supply side develops. Despite the loss of jobs resulting from the pandemic, there are anecdotal reports, especially in the USA, of jobs being hard to fill and wages being bid up in order to fill vacancies. This may change when various support schemes end but, for the moment, it is an issue, it seems, particularly in the leisure sector. In the manufacturing sectors, one would expect supply to be restored quite quickly, but there are obviously localised difficulties, semiconductors being a particularly high profile example. This is, for example, hitting the auto market. In longer term, industries, such as mining and oil, where there are long lead times between developing mines and oilfields, lack of investment could lead to supply constraints and higher prices. In other words, supply cannot just be turned on, so increasing demand could easily cause further price rises.

That real interest rates are negative, quite significantly so in some countries or regions, should be a concern. In some areas, they encourage a voluntary accumulation of debt on the basis that, because money is so cheap, it would be silly not to take advantage of this. This could lead to speculative or unwise use of this money, increasing low quality activity in the economy and asset bubbles, all the time driving inflationary pressures. In normal times, interest rates give out meaningful signals either through official short term interest rates or through the market in respect of bond yields. So, for example, if inflation is threatening to breach targets, central banks can be expected to raise interest rates to dampen down economic activity and, hopefully, inflationary pressures. In the opposite position, when central banks want to stimulate activity and inflation, if the latter was below target levels, interest rates would be reduced. Allied with fiscal policy, these would be the tools to manage an economy. In the current economic conditions, price signalling is non existent as interest rates have been suppressed

by central bank action, whether through low or negative short term interest rates and QI which has suppressed fixed interest yields further out along the yield curve. Now, let us look at the example of the USA. The 5% inflation rate will probably ease back in the coming months, but, as an extreme example, let us suppose that it is representative of the year on year inflation rate in the forthcoming months. The current yield on the ten year US Treasury bond is just 1.25% (at the time of writing post quarter end), implying a negative real yield of 3.75%. If we ignore, for a moment, the current pandemic background, a rational individual or business would borrow to invest in or buy something which is going to rise in price. That would be likely to cause more inflation. If 5% was a representative inflation rate in the USA and absent a background such as we have at present and a 2% real positive inflation adjusted yield was considered normal, then one would be looking at a 7% nominal yield. This is an extreme example, because 5% is probably not a representative inflation rate for the coming months, but, even if it was 3% and a 2% real inflation adjusted yield was realistic in normal circumstances, we would be looking at a 5% nominal yield.

For the ten year US Treasury bond to move from the current approximate 1.25% level to 5% would represent a very significant price adjustment which would have serious stock market ramifications, which is why inflation bears are concerned that the Federal Reserve is behind the curve. The bears fear that the longer a central bank, in this case the Federal Reserve, delays a move towards normality, the greater the inflation risks and the stronger the measures which will be needed to be taken in future to recover the position.

The Federal Reserve and other central bankers, which are more relaxed about their current monetary policy, cite other reasons for maintaining their current policy, such as unemployment, spare economic capacity and the unrepresentative nature of year on year inflation comparisons which should work their way out of the system, even though economic growth forecasts for this year are generally being upgraded. For example, the World Bank has just published its latest economic forecasts. It sees world economic growth at 5.6% this year, an upgrade of 1.5% on its January forecast. It sees growth of 4.3% in 2022, an upgrade of 0.5%. For the USA, it now predicts growth of 6.8% for 2021, a major upgrade of 3.3% on its January forecast. For 2022, it sees growth of 4.2%, an upgrade of 0.9%. The projections are more modest for the eurozone. It has upgraded its forecast for this year by 0.6% to 4.2% and for 2022 by 0.4% to 4.4%. Emerging markets and developing economies have seen their growth forecast for this year raised to 6.0%, an upgrade of 0.8%, and for next year by 0.4% to 4.7%. Within the latter area, the World Bank has raised its forecast for China's growth this year to 8.5%, an increase of 0.6%, and just a modest increase next year of 0.2% to 5.4%. For India, where forecasts are on a fiscal basis, the World Bank has raised its forecast for 2021/22 by 2.9% to 8.3% and for 2022/23 by 2.3% to 7.5%. Of course, these and other organisations' forecasts will change as the year progresses, but the point of detailing the broad outline of the World Bank's latest economic forecasts is to emphasise that economic growth looks to be turning out better than expected this year and that this may inform central banks' and investors' thinking about how monetary policy may change, even though, at the moment, there is no sign of that happening to central banks' thinking that one can surmise.

Given how well stock markets have performed since Q1 2020, investors seem to go along with the central banks' more optimistic approach on inflation and their continued support of very low interest rates and QE. The optimistic view is that inflation will fall back as central banks hope and base their current policy on the view that it will be some time, perhaps 2023, before they have to start the process of raising interest rates. In this ideal scenario, central banks will get their signalling to the markets correct as they guide towards a gradual rise in interest rates in a way which does not frighten investors. Market observers often refer to the "taper tantrum" in 2013 when the Chairman of the Federal Reserve, Ben Bernanke, gave an insight into the Federal Reserve's intention to wind down its QE programme, in an appearance before Congress. This had a significant effect on markets for a time and is regularly referred to in the context of central banks exiting their emergency monetary policy programmes. In the quarter which has just ended, we have seen occasional evidence of markets being spooked by fears of rising interest rates on the back of poor inflation numbers. This makes clear central bank signalling of prime importance.

What would be the ideal scenario for equity markets? The start of a move towards normalising interest rates because of economic recovery and at moderate levels of inflation should be quite benign for equity markets since the rise in interest rates would be for the right reason. Profits would be recovering, along with dividends, and these positive influences would counteract the cost of rising interest rates. This should be quite good for value stocks whose profits should benefit from a cyclical recovery in the economy. If, however, inflation does not remain contained and rises sharply because of over lax monetary policy, as described earlier, markets are likely to be seriously affected as the interest rate increases could be quite sharp and result in the risk of the net present value of future income streams being sharply reduced. A sharp adjustment in prices would be likely. Everyone knows that interest rate rises will have to occur. How they are handled will be of paramount importance.

In dealing with the crisis, monetary policy went hand in hand with fiscal policy. Put crudely, the unimaginable sums spent by governments to safeguard their economies were financed by central banks. Of course, that is not how it was officially handled because central banks, in most countries, cannot directly finance governments as the currency would lose its credibility. However, buyers of government bonds in the primary market knew and still know that they have a buyer of their bonds in the secondary market, so the result is effectively the same. At some stage, for reasons we detailed earlier, monetary policy will be tightened and one of the methods of doing this will be by the gradual withdrawal of QE. By removing a price insensitive buyer from the market, price discovery, which has long been absent in most bond markets, will start to make a comeback. With interest rates well below where they would normally be because of QE, they will gradually come to be more reflective of market conditions, which will entail higher interest rates. The profile of government debt will mean that the immediate cost of servicing debt will vary between countries, so the effect of higher interest costs will not be uniform. However, to a greater or lesser degree, they will concentrate governments' minds on moving to restore their fiscal position to a semblance of normality. It will be a long job, but investors will want to see a realistic plan to get governments' finances on a secure footing if they are to retain their confidence. Whilst a tightening of fiscal policy might not seem good news to investors because of the effects on corporate profits, in these circumstances the more important consideration is retention of confidence in a particular country. The perfect path for investors would therefore seem to be the economic recovery leading to a gradual tightening of monetary policy, either through the tapering and, then, elimination of QE and/or gradual interest rate increases accompanied by governments' actions to restore their fiscal position. Confidence that this is underway rather than deadlines would probably satisfy markets.

Judging by markets' movements, they seem to buy this utopian vision. Apart from a blip in early to mid May when an inflation scare occurred, markets have moved up steadily over the quarter and volatility has been low. Perhaps, surprisingly, given the upturn in inflation, bonds have been unperturbed. If we take ten year government bonds as a benchmark in the major markets, they are nearly all well off their quarter's high. Given the rise in inflation statistics over the quarter, the lack of reaction in the government bond market is surprising. This seems to suggest, at the moment, that they buy the central banks' line that inflation will pull back. Central banks' confidence about inflation falling back is due to their belief that there is economic spare capacity to be used up, that there are still a lot of people job hunting and that supply difficulties, which have caused price rises, will rectify themselves and supply will return. It is a big call, given the number of localised price rises. If it turns out that inflation is permanently higher than the central banks' target range, then they might find that they have to take tougher action to keep inflation under control than they would have done had they been more active earlier.

The area which we feel is vulnerable is the eurozone. Because it is not a homogenous group of countries, fault lines can run through a currency zone. The artificial suppression and compression of yields caused by QE means that price signalling is virtually non existent and, therefore, risk is not correctly priced.

So, if we look at ten year eurozone government bond yields, we see that of the strongest credit, Germany, with a yield of -0.341%, and two much weaker credits, Greece and Italy, showing yields of 0.700% and 0.739% respectively. These yields are at the time of writing post quarter end. That difference does not begin to reflect the difference between the three countries in terms of outstanding public indebtedness as a percentage of GDP. As interest rates eventually rise and debt servicing costs with them, the debt problems will become more apparent but, if interest rates have to rise more quickly and more sharply as a result of inflation persistently exceeding the ECB's target, then the problem will become worse for these heavily indebted countries. The problems of such countries cannot really be isolated within a currency area like the eurozone and would be likely to rub off on the currency, exacerbated by the central bank holding a large amount of the affected countries' bonds as a result of its asset purchase programme. For investors, the importance of central banks' judgement on when to start raising interest rates and not being behind the curve if inflation does start to exceed targets, is vital.

What we can say is that, almost certainly, fixed interest securities are overvalued. Minuscule or negative normal yields and negative real yields offer no attraction and plenty of capital risk (and credit risk for lower grade bonds) when interest rates rise. One of the surprising facts has been that bond yields have ended the quarter well off the quarter's highs, despite rising, inflation. This suggests that investors are buying the central banks' narratives on inflation and interest rates, but we feel that this can only be a temporary situation.

But, of course, interest rates are important for share prices. Shares have performed well because competing assets, like cash and fixed interest securities, have not offered a significant yield and, in most markets, equity yields have been higher, historically an unusual situation although this is not the situation in the USA at present. This has meant that very low or nil yielding shares like technology stocks have been able to perform well, whilst, at least until last November's vaccine news, value stocks, typically with a better yield but many hit hard by the Covid-19 induced recession and having to cut or omit their dividends, often performed poorly. To some extent, the position has been reversed, but, at the time of writing, technology stocks have regained their poise, with the NASDAQ index having regained its all time high, along with the S & P 500 Index. With a gentle upward trajectory in interest rates on the back of an improving economy, value stocks, with their superior yield, could be expected to do well. The danger for shares and, of course, bonds, would be a sharp increase in interest rates forced on central banks by unacceptable rises in inflation. It is a fine balance. Although the quarter has been a positive one for investors, on certain days when inflationary worries have been highlighted in the news, markets have demonstrated some nervousness. Inflation is probably the most prominent issue for investors at the moment, so the data for the remainder of the year will be an important indicator of whether the monetary hawks or doves gain the ascendancy.

If monetary tightening through a tapering, elimination or reversal of QE and/or interest rate increases occurs, and has to be at an accelerated rate because inflation is rising at an unacceptable rate, it can be expected to slow, or even reverse, economic growth. Modest and well flagged tightening, at a time when the economy is performing well, should be able to be accommodated by markets, firstly, because company profits are likely to be rising and, secondly, because investors realise that artificially suppressed interest rates are not healthy for an economy, whilst accepting that they were needed for the Global Financial Crisis thirteen years ago and for the current pandemic crisis. Monetary policy and fiscal policy have gone hand in hand in this crisis and, at the risk of over generalising, monetary policy in the form of QE has financed the hugely expansive fiscal policy necessary to finance the emergency economic measures which had to be taken to secure economies for the eventual recovery. Easily lost in the host of measures taken by governments around the world is their cost, evidenced by hugely expanded budget deficits. Budget deficits used to matter and they still do. Depending upon the level of economic growth in an economy, budget deficits in weak growth countries will expand the outstanding level of public debt in relation to GDP and eventually raise concerns about a government's solvency. Interest rates may have to be raised significantly to attract buyers for a government's debt and this will affect a country's economic growth. In the pandemic crisis, governments have seen an

enormous expansion in their budget deficits, yet, perhaps understandably with so much going on, the usual concerns have not been expressed as strongly as usual. The figures are alarming. If we look at, say, the well respected Economist Intelligence Unit's budget deficit forecasts for 2021, we see figures like 13.5% for the USA, 11.5% for the UK, 6.8% for the euro area and 8.8% for Japan. The smaller, but still high in terms of the temporarily suspended Stability and Growth Pact, budget deficit for the eurozone is kept relatively low by Germany, at 3.6%, but, look elsewhere, and it forecasts 9.0% for France, 11.9% for Italy and 8.7% for Spain. If we look at the last three economies, public debt as a percentage of GDP is way above 100% and, in the case of Italy, well above 150%. These are dangerously high levels of debt which will leave a legacy of high servicing costs which will worsen as interest rates increase. As we said earlier in this review, current interest rate spreads within the eurozone do not show correct price signalling in respect of the various members' sovereign risk and the risk for the eurozone is that, if confidence is weakened in one or more members' creditworthiness, it will threaten the euro, both through the ECB's very large sovereign debt holdings and the so called "doom loop" whereby domestic eurozone banks hold large amounts of their own countries' sovereign debt. What all this comes down to is that budget deficits are still very important and that action will be needed to address them. So far, there has been little done in most countries to address the problem, which will emerge when some semblance of economic normality is restored. The UK is an exception, with the Chancellor of the Exchequer having set out plans to raise personal and corporate taxes, starting from 2022/23 in the case of personal taxes. Whilst, it is essential for long term confidence in an economy that public finances are put on a much sounder footing as, with monetary policy being tightened too quickly, this could choke off an economic recovery. Some painful political decisions have to be made, not only in the UK but elsewhere. Pensions is a case in point.

The conclusion from this discussion of the start of the exit from current very loose monetary and fiscal policy is that central banks have to walk a tightrope between doing too much and too little, which could result in allowing inflation to get out of hand (too little) and tightening too quickly (too much) and choking off the economic recovery. Similar issues arise for fiscal policy. Equity markets are likely to be sensitive to problems which arise on the implementation of these tightening policies, but, equally, to respond well to the authorities getting the right balance.

Politics is usually as important as economics in determining the course of markets, but, since the start of the pandemic in February 2020, economics has pushed politics to the side. We have mentioned that, on the economic front, inflation is becoming an issue and, on the political front, US politics are coming more into focus. Wall Street ignored the results of last November's Presidential and Congressional Elections because it was still focused on the pandemic. As a result of a tie in the Senate, control passed to the Democrats through the Vice President's casting vote. Plans put forward by President Biden on the economy were, by US standards, very radical and were tilted towards the progressive wing of the Democratic party. Proposed sharp tax rises for companies and wealthier individuals, plus more regulation, do not normally play well with investors. Outsized spending plans, which, if enacted, would move the USA more towards the European social model, have also been announced, pushing the USA into experiencing a much higher level of outstanding debt as a percentage of GDP. Additionally, there are plans to tackle the big technology companies which were thought to be too big and powerful. One would have thought that these moves towards higher taxation and regulation would have left their mark on share prices, but, so far, this has not happened. This may be because there are splits within the Democratic party, with some of the moderate Senators balking at the size of the spending plans and proposed tax increases as well as being cautious about plans to break up some of the technology companies. The feeling, at the moment, although this could change, is that the proposals will have to be watered down. Corporate tax increases would affect companies' earnings and, other things being equal, cause valuations to rise unless share prices fell. Dividend growth could also be affected. Depending on how these plans develop, and mid term elections in November 2022 may change the balance of power in Congress, will decide the relative attraction of the US market against those on lower ratings.

As we look back at a positive quarter and note the good progress that international equity markets have made in the first six months of the year, it is necessary to retain a sense of realism and recognise that the recovery since the 23rd March 2020 low point has been largely driven by cheap and newly created money, not the best reason for a strong bull market. That makes it all the more important that attention is paid to the issues we have been discussing, in particular, what happens to inflation and the monetary and fiscal policies which are followed to lead the world economy out of the pandemic and back to some semblance of monetary and fiscal policy normality. Of one thing we feel highly confident, and that is that fixed interest yields remain far from reality and the capital risk to holders in anything other than short maturities is considerable. Even if investors are concerned about buying and/or holding equities after the rise which they have experienced, they may wish to reflect that if, as is inevitable, there are some quarterly setbacks in equity performances, they will recover and move ahead at some stage. This is unlikely to be the case with fixed interest securities, such as is the level of overvaluation unless they are held to their eventual maturity when the return will be minuscule. We are, therefore, maintaining our policy of investing in high quality stocks in international equity markets. We are allowing some liquidity to build up through dividends, where income is not paid out, in order to take advantage of any meaningful setback in markets.

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