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ASSET MANAGEMENT (C.I.) LIMITED

INVESTMENT MEMORANDUM

This has been a strong quarter for international equity markets as news of successful vaccine trials strengthened investor confidence about the outlook for an economic recovery. That same feeling and increasing talk of a rise in inflation had the opposite effect on fixed interest securities. In the foreign exchange markets, the US dollar was noticeably weak. In the commodity markets, the oil price reflected a better economic outlook and supply discipline

The tables below detail relevant movements in markets :

International Equities 30.10.20 - 29.01.21

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	+12.3	+15.5	+22.7	+17.6
Finland	+13.2	+11.2	+18.1	+13.2
France	+17.2	+15.1	+22.2	+17.2
Germany	+17.3	+15.2	+22.4	+17.3
Hong Kong, China	+21.0	+14.0	+21.1	+16.1
Italy	+20.4	+18.2	+25.6	+20.4
Japan	+15.9	+8.9	+15.7	+10.9
Netherlands	+20.7	+18.5	+25.9	+20.7
Spain	+22.0	+19.8	+27.2	+22.0
Switzerland	+9.3	+6.1	+12.6	+8.0
UK	+15.6	+15.6	+22.8	+17.7
USA	+15.0	+8.3	+15.0	+10.3
All World Europe ex UK	+16.1	+14.0	+21.1	+16.1
All World Asia Pacific ex Japan	+18.2	+13.7	+20.8	+15.8
All World Asia Pacific	+17.4	+12.1	+19.0	+14.1
All World Latin America	+21.0	+20.2	+27.7	+22.4
All World All Emerging Markets	+16.8	+11.7	+18.6	+13.7
All World	+15.7	+10.3	+17.2	+12.3

Source : FTSE All World Indices

FTSE UK Government Securities Index All Stocks (total return) : -0.6%

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

Currency	30.10.20	29.01.21
Sterling	0.26	0.33
US Dollar	0.87	1.07
Yen	0.03	0.05
Germany (Euro)	-0.63	-0.52

Sterling's performance during the quarter ending 29.01.21 (%)

Currency	Quarter Ending 29.01.21
US Dollar	+5.8
Canadian Dollar	+1.4
Yen	+5.8
Euro	+1.5
Swiss Franc	+2.7
Australian Dollar	-2.7

Other currency movements during the quarter ending 29.01.21 (%)

Currency	Quarter Ending 29.01.21
US Dollar / Canadian Dollar	-4.0
US Dollar / Yen	N/C
US Dollar / Euro	-4.0
Swiss Franc / Euro	-1.1
Euro / Yen	-3.5

Significant Commodities (US dollar terms) 30.10.20 - 29.01.21 (%)

Currency	Quarter Ending 29.01.21
Oil	+46.3
Gold	-0.9

MARKETS

Although there has been some modest weakness right at the end of the quarter, overall it has been a very strong quarter driven, initially, by positive news on the Covid-19 vaccine front. The thinking was that a successful vaccination programme would stimulate an economic recovery from the recession of 2020 with the economic benefits which that would bring.

Looking at international equity markets, the FTSE All World Index returned +15.7% in local currency terms, +10.3% in sterling terms, +17.2% in US dollar terms and +12.3% in euro terms. In local currency terms, there were strong performances all round with the best performance coming from the FTSE All World Latin America index which returned +21.0%. The FTSE All World Asia Pacific ex Japan index was also a notably good performer with a return of +18.2%. With sterling performing well during the quarter, returns in the currency were generally lower, but still very strong. Again, Latin America performed best, with the FTSE All World Latin America index returning +20.2% in sterling terms. With the Australian dollar strong, the FTSE Australia index showed relative strength, returning +15.5%. The UK's relative performance strengthened with the FTSE UK index returning +15.6%. The FTSE All World Europe ex UK index performed well, with a return of +14.0% and, despite currency weakness against sterling, the FTSE All World Asia Pacific ex Japan index still outperformed, returning +13.7%. With the US Dollar and yen weak over the quarter, the FTSE USA index and the FTSE Japan index both underperformed, with sterling adjusted returns of +8.3% and +8.9% respectively, but these are, of course, excellent returns in absolute terms.

In the international bond markets, yields rose towards the end of the quarter as investors began to think more about the possibility of a rise in inflation. Yield rises were more pronounced at the very long end of the market, less so in the ten year bonds but still, nevertheless, a noticeable difference. The gross redemption yield on the ten year UK government bond was 7 basis points higher over the quarter at 0.33% and on the US Treasury bond it was 20 basis points higher at 1.07%. There was little difference in the JGB market where the Bank of Japan operates yield control. The yield on the ten year JGB rose by 2 basis points to 0.05%. The yield on the German Bund moved by 11 basis points from -0.63% to -0.52%.

In the foreign exchange market, as touched upon earlier, sterling was generally stronger. In our table, the only currency against which it weakened was the Australian dollar, against which it fell by 2.7%. Against the US dollar and yen, sterling rose by 5.8%, against the Swiss Franc by 2.7%, against the euro by 1.5% and against the Canadian dollar by 1.4%.

In the commodity markets, the implications for a recovery in the world economy as a result of the successful vaccine trials and supply disciplines pushed the oil price sharply higher, with Brent crude rising by 46.3% over the quarter. Gold, after its sharp rise in 2020, was little changed.

ECONOMICS

In one sense, the public health and economic outlook has deteriorated and in another it has improved. The deterioration is evident in the number of Covid-19 cases around the world which are being reported each day and the serious economic damage which the virus is still causing. But, on the positive side, the development of effective vaccines gives realistic hope that the virus will be tamed and that economic recovery will ensue. Maybe this is the darkest hour before the dawn. The development of effective vaccines in such a short space of time is a remarkable achievement which does not receive sufficient recognition.

So, it is against this background that the latest IMF World Economic Outlook update has been published in January. It now expects the world economy to have contracted by 3.5% in 2020, which is less severe than its October expectation of a contraction of 4.4% as a result of a stronger finish to the year. For 2021, the IMF is now forecasting growth of 5.5%, which is an improvement of 0.3% on its October forecast. For 2022, its forecast remains unchanged at 4.2%. Its forecast for Advanced Economies has been increased by 0.4% to 4.3% growth for this year. This is due to a significant increase in its expectation of growth in the USA. It has raised its forecast for this year by 2.0% to 5.1%. On the other hand, it has reduced by 1.0% its forecast for the eurozone's economic growth this year to 4.2%. Looking at the four largest eurozone countries, Italy has seen the biggest reduction in its growth forecast by 2.2% to 3.0%. Of the four biggest eurozone economies, the second largest reduction in forecast comes from Spain, where the IMF has reduced its growth forecast by 1.3% to 5.9%. Elsewhere, the forecast for Germany has been cut by 0.7% to 3.5% and for France by 0.5% to 5.5%. It has raised its forecast for Japan by 0.8% to 3.1% and reduced its forecast for the UK by 1.4% to 4.5%. Moving on to Emerging Market and Developing Economies, the IMF has raised its growth forecast for 2021 to 6.3%, an increase of 0.3%. Within that, the forecast for Emerging and Developing Asia has been raised by 0.3% to 8.3%, largely because the forecast for India has been raised by 2.7% to 11.5% (India's forecasts are presented on a fiscal year basis) following a very severe setback in 2020 where the economy is estimated to have contracted by 8.0%. China, which has been the best performing major economy and is estimated to have recorded economic growth of 2.3% in 2020, has seen the IMF slightly reduce its forecast for 2021 to growth of 8.1%, 0.1% lower than its October 2020 estimate. The ASEAN 5, Indonesia, Malaysia, Philippines, Thailand and Vietnam, have seen their growth estimate for 2021 reduced by 1.0% to 5.2%. Latin America and the Caribbean, which are estimated to have contracted by 7.4% in 2020, are forecast to recover by 4.1% in 2021, 0.5% better than the IMF's October 2020 estimate.

These forecasts, of necessity, have to be subject to a higher than usual margin of error and will largely depend upon the progress of the mass vaccination effort. The faster the progress, the bigger should be the economic rebound. As this is written, there is unseemly political wrangling over vaccine supplies. The fastest progress amongst the major industrialised economies has been seen in the UK and the USA. It would therefore seem logical to expect the economies of those countries to open up more quickly, with consequent benefits for the timing and magnitude of the recovery. So many unexpected events have occurred over the past year that one hesitates to make any kind of prediction on the course of events, but the expected positive economic effects of an early release from many restrictions seems soundly based.

The themes of our reviews for many months now have been constant and they are still relevant. The extraordinarily loose monetary policy, evidenced by the enormous amount of quantitative easing (QE) and ultra low or negative interest rates, has elevated the attractions of assets like equities and fixed interest securities. Money has leaked into these markets as a result of the substantial rise in the size of central banks' balance sheets and, on a more fundamental note, has increased the attractions of equities as future corporate earnings are discounted by very low interest rates, giving them a higher net present value. With the level of bond yields, which we see in the table at the beginning of this review, the relative attraction of dividend yields, in most cases significantly higher than those on high quality fixed interest securities, is apparent and, even though price/earnings ratios may look high, their reciprocal, the earnings yield, is well above the yield on bonds at any maturity. This very simple model therefore has two variables, interest rates and future earnings. A significant change in either could alter the position. At some stage, interest rates have to rise, although it is understandable that many will feel that current interest rates are developing an air of permanence about them, given that they have been low (despite occasional attempts to raise them) since the Global Financial Crisis thirteen years ago. Central banks have indicated that short term interest rates will remain at this kind of level for the foreseeable future. Longer term rates are more difficult to control unless, like the JGB, central banks go in for yield control, which involves buying or selling government bonds to ensure their yield stays at the targeted level. This comes with its own difficulties, however, given the open ended nature of the commitment. The danger for the bond markets as one goes out along the yield curve is that, in the absence of heavy buying by central banks, yields can rise. QE has suppressed yields and price signalling has become very weak, leading to economic distortions. However, where price signalling may begin to have a modest influence is in the medium and longer dated maturities and there could be two likely causes of this. Firstly, and we have seen a little evidence of this recently, investors could start to become worried about inflation. We sense some complacency here. Given past worries about inflation, which involved tough economic measures to try to control it, it seems ironic that now the concern of some central banks is lack of inflation. It is true that deflation or lack of any meaningful inflation is undesirable economically. If individuals or businesses feel that prices are going to fall, or at least not rise or rise only very slowly, they have an incentive, especially in bad economic times, which this state of affairs would suggest, to defer purchases or investment which are not strictly necessary. This weakens an economy and has been the concern recently. The reason modest inflation can be considered beneficial is that it encourages economic activity with the incentive to spend, a function of the expectation that goods and services will become more expensive. Until recently, the more common danger would be considered to be inflation, which would normally be attempted to be controlled by higher interest rates which would dampen economic activity, raise unemployment and perhaps lead to a recession, all undesirable consequences. So, the policy in the past has been to try to ward off the dangers of inflation by being monetarily and fiscally proactive. With the depth of the current recession and the unprecedented public health background, the authorities have had to follow extreme monetary and fiscal policy. With the huge amount of money creation, the danger is that with any upturn of confidence this money will start to circulate around the economy much more quickly. The recession has been primarily caused by a collapse of demand, but it must also be remembered that supply has been affected with some businesses having been lost altogether. One can envisage a situation where a sudden increase in demand leads to supply shortages and, hence, increased prices. So far, with economic confidence low, this has not been an issue but this situation can change. For example, whilst many people have faced very hard times and difficulties during the pandemic, others, who have retained their jobs and pay, have built up large cash balances and the savings ratio has risen sharply. Once the prospects look better, some of these excess cash balances will be spent. But there are other signs. Prices of commodities such as oil, copper and iron ore have all increased sharply. If real yields stay negative or become more negative because of inflation, that could be a dangerous mix if the conventional policy tools, i.e. interest rate increases, are not used. Inflation could become a real problem. It would be quite wrong to write off inflation which remains a threat to securities, especially fixed interest securities.

The other threat to bond markets and yields going out along the yield curve is a loss of confidence in the creditworthiness of countries or, in the corporate bond market, companies. Governments have had to borrow amounts of money which would previously have been considered off the radar. Servicing this debt has been possible so far because of its very low cost and the absorption of government (and other) bonds in the secondary market through central bank purchases. At some stage, interest rates will have to rise, perhaps for the reason mentioned earlier, namely inflation, and then servicing costs will rise sharply. This is a particularly difficult problem for the eurozone where there are some highly indebted countries with outstanding public borrowing at over 100% of GDP. Countries in this bracket are Greece, Italy, Portugal, Belgium, France, Cyprus and Spain. At present, the ECB is hoovering up their debt in the secondary market but there are limits to the amount they can buy. We mentioned earlier that the suppression of yields by central banks has meant that price signalling is very weak in the eurozone. At the time of writing, Greece can borrow for ten years at 0.65% and Germany at -0.481%, a difference of 1.14%. That is very weak price signalling of their respective credits because the gap in yields should be much wider and the absolute levels of yield are not realistic in normal circumstances. This is a particular issue for overindebted countries in the eurozone. They cannot issue their own currency like the UK and USA, for example, and because they are in a currency union their currencies are effectively fixed against other members. If they are uncompetitive to start with and, say, their inflation rate rises relative to their competitors' rates, the position becomes worse. It is likely that the deterioration in their economy will find its manifestation in a weaker budgetary position and the need for the government to borrow more. Markets may then work out that the yield on their bonds does not compensate for the risk involved and a buyer's strike could ensue, thus forcing up yields on the country's debt. The natural adjuster would normally be the exchange rate, but that is impossible for an individual country in a monetary union. There could be a big test to come for the eurozone in these very difficult conditions. Countries like the UK and USA can theoretically print their way out of trouble, albeit with a serious loss of credibility for their respective currencies. It is not a pain free way out of trouble but has its advantages over a similar country in a monetary union. It is easy to say that nearly all major countries are in the same predicament and that those which keep borrowing, even at unsustainable levels, don't have to fear the market. But, of course, they do. If the foreign exchange markets sense a weakness, they will exploit it, which is why a run on a major currency is always a possibility and, if that happens, one of the weapons is raising interest rates, expensive though that will be for many investors.

So, interest rates are one variable of the two which we mentioned earlier in support of current equity valuations and we have discussed two of the factors which could change the outlook for interest rates, namely inflation and credit risk. The second factor is the future course of company earnings and cash flows. Will they be permanently damaged or will they recover to previously expected levels once this crisis is over? The first answer is straightforward and fairly obvious. Some companies will do better in the future than might have been expected before the pandemic. We can see this from what has happened during the pandemic. Some technology companies have clearly benefited and are likely to continue to do so as habits change, for instance more people working from home. Healthcare and personal hygiene is another obvious area as habits developed during the pandemic are not completely unwound. On the other hand, companies in the leisure and commercial property sectors may find that trading conditions have permanently changed. These are very broad statements and the effects will vary within each sector but, within the corporate world, there will be winners and losers which the stock market will distinguish between. In the short term, because of the build up amongst some people of large savings, there may be quite an economic upturn as pent up spending is released. Beyond that, macroeconomic conditions will come into play and hence we come back to our earlier discussion of debt and associated servicing costs. Some economists had thought that, once public debt as a percentage of GDP grows beyond 90% of GDP, the future level of economic growth would be adversely affected, the thinking being that debt servicing costs would weigh on national budgets which might need tax increases or public spending cuts to address the problems. Both of these individually or a combination of them would reduce growth. Now, of course, many countries have moved well over 100%, albeit that ultra low interest rates have weakened the effect of increasing debt for the time being. But debt servicing costs will grow and the extent to which they bear down on public finances will affect economic growth. This is the elephant in the room and, if the level of debt assumed by governments in the pandemic does weigh heavily on public finances in future and reduces growth, then corporate earnings overall are likely to be negatively affected, with their rate of growth less than might previously have been expected. Of course, the level of a government's indebtedness would, in normal times, find its reflection in the relative interest rates which they are charged. Current monetary policy, as administered through QE, has largely suppressed interest rate differentials, but the policy cannot last forever. So, at some stage, but not at the moment, investors will have to take into account how the level of debt, reflecting itself in interest rates, reduces an economy's potential growth rate and, therefore, corporate earnings.

The pandemic is clearly dominating anything else which would normally be a significant market consideration. We have discussed, in particular, the effect of the monetary policy currently being applied to support the world economy, but we have discussed the fiscal side less. Of course, in the sense that the vast sums of money which governments around the world are pouring into their economies are effectively, although not formally, being financed by central banks, it might not seem to matter, but the expansion of central banks' balance sheets as they purchase government and other debt in the secondary market with newly created electronic money cannot go on indefinitely. Not many governments have started to lay the ground for tax increases/public expenditure cuts, or both, although the UK Chancellor of the Exchequer has. It is a very difficult juggling act. On the one hand, economists will want to see some move towards repairing countries' public finances but, on the other, tax increases seem particularly inappropriate when an economy is starting to emerge from a severe recession. However, we come back to an earlier point which we made about the necessity of retaining confidence in a currency. If investors feel that a country is playing fast and loose with its public finances, the foreign exchange market will take note and perhaps will take the situation out of a government's hands. Currency movements should be monitored for a possible loss of confidence, a warning sign for investors.

In normal times, we would be discussing in this review the political events in the USA. The effective control of the Senate through the Vice President's casting vote gives the Democrats more leverage to enact their policies in the areas of higher taxes and more regulation. These may well be issues later on but, for now, the emphasis will be on dealing with the pandemic and the additional fiscal stimulus which the Democrats want to enact. The markets seemed to like the prospect of a larger stimulus than the Republicans were prepared to accept and we will see how this turns out. However, the point remains that the USA's public finances will be severely compromised, as is the case in other countries. It is noticeable, over the last quarter, how weak the US dollar has been, although the weakness will benefit many US companies' profits.

At the end of January, there was a well publicised frenzy of activity on Wall Street as investors ganged up to embarrass hedge funds with short positions by buying some of the affected shares and driving up their prices to levels which bore no relation to reality, but which caused severe financial pain to at least one well known hedge fund. We have also seen enormous volatility in cryptocurrencies and some observers have indicated that they believe such frothiness signals the tip of the market. The more prosaic explanation is that people with more time on their hands and perhaps more money, because they are at home and have been paid, have been playing the market in stocks that they believe will embarrass hedge funds which are short of them and the tone of some of the players in this activity has been highly political. We think that this is a specific rather than a general issue.

In summary, our view of markets remains unchanged from that we have outlined in previous months. It follows from our discussion on the possible course of interest rates that bond yields at these levels bear no relation to reality and cannot be suppressed for ever. A rise in fixed interest yields, which we have started to see, particularly at the longer end of the market, will cause capital losses. On the one hand, the case for equities is that they are not fixed interest securities which are clearly overvalued. On the other hand, current equity levels can be justified and a recovery in the world economy, obviously partly discounted in prices, could raise them further, perhaps enabling some value stocks, so badly affected in 2021, to continue their recovery which started on the vaccine news in November. As always, an international spread of exposure is essential and quality names should predominate, especially after such a good performance. Some negative quarters must be expected, given the economic background and the sharp recovery in share prices, but the medium and longer term outlook, driven by a post pandemic economic recovery, makes the case for equities over those time periods.