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ASSET MANAGEMENT (C.I.) LIMITED

INVESTMENT MEMORANDUM

Although international equity markets show little change overall this quarter, the limited movements do not reflect the volatility during the quarter. The strong performance in July brought equity markets back close to breakeven over the period. International fixed interest markets were also highly volatile and ended the quarter strongly, so we had the unusual position of bonds and equities moving in the same direction. In the foreign exchange markets, sterling weakened against all the major currencies. It was notable, against such an unsettled background, that gold performed poorly.

The tables below detail relevant movements in markets :

International Equities 29.04.22 - 29.07.22

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	-5.6	-4.3	-7.3	-4.1
Finland	+0.1	-0.2	-3.2	+0.1
France	+0.6	+0.4	-2.7	+0.6
Germany	-5.2	-5.5	-8.4	-5.2
Hong Kong, China	N/C	+3.1	-0.1	+3.4
Italy	-5.9	-6.2	-9.0	-5.9
Japan	+2.4	+2.4	-0.8	+2.7
Netherlands	+2.1	+1.8	+1.8	+2.1
Spain	-4.4	-4.7	-7.6	-4.4
Switzerland	-7.4	-2.7	-5.7	-2.4
UK	-0.8	-0.8	-3.9	-0.5
USA	+0.1	+3.3	+0.1	+3.6
All World Europe ex UK	-2.9	-2.2	-5.2	-1.9
All World Asia Pacific ex Japan	-4.1	-2.6	-5.6	-2.4
All World Asia Pacific	-2.0	-1.0	-4.1	-0.8
All World Latin America	-2.9	-3.4	-6.3	-3.1
All World All Emerging Markets	-4.2	-2.9	-5.9	-2.6
All World	-1.0	+1.2	-1.9	+1.5

Source : FTSE All World Indices

FTSE UK Government Securities Index All Stocks (total return) : -2.2%

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

Currency	29.04.22	29.07.22
Sterling	1.90	1.86
US Dollar	2.93	2.65
Yen	0.21	0.17
Germany (Euro)	0.94	0.81

Sterling's performance during the quarter ending 29.07.22 (%)

Currency	Quarter Ending 29.07.22
US Dollar	-3.1
Canadian Dollar	-3.6
Yen	-0.6
Euro	-0.1
Swiss Franc	-5.4
Australian Dollar	-2.2

Other currency movements during the quarter ending 29.07.22 (%)

Currency	Quarter Ending 29.07.22
US Dollar / Canadian Dollar	N/C
US Dollar / Yen	+2.8
US Dollar / Euro	+1.5
Swiss Franc / Euro	+5.6
Euro / Yen	-0.6

Significant Commodities (US dollar terms) 29.04.22 - 29.07.22 (%)

Currency	Quarter Ending 29.07.22
Oil	-3.3
Gold	-7.1

MARKETS

A very strong rally in July has meant that there has been little overall change in equity markets over the quarter. The total return on the FTSE All World Index in local currency terms was -1.0%, in sterling terms +1.2%, in US dollar terms -1.9% and in euro terms +1.5%. Looking at individual markets in local currency terms, the strongest performance came from Japan where the FTSE Japan Index returned +2.4%. The performance of the FTSE USA Index was marginally positive at +0.1%. On the negative side, the worst performer was the FTSE Australia Index which returned -5.6%. The FTSE All World All Emerging Markets Index, -4.2%, and the FTSE All World Asia Pacific ex Japan, -4.1%, were also relative underperformers. In sterling terms, the FTSE USA Index was the best performer with a return of +3.3% and the FTSE Japan also remained in positive territory, +2.4%. The worst performers were the FTSE All World Latin America Index, -3.4%, and the FTSE Australia Index, -4.3%.

The international bond market, as measured by ten year government benchmark bonds, staged a very strong rally late in the quarter and gross redemption yields fell to below the level at the end of April. The yield on the ten year UK government bond fell by 4 basis points to 1.86%, on the US government bond by 28 basis points to 2.65%, on the Japanese government bond by 4 basis points to 0.17% and on the German Bund by 13 basis points to 0.81%.

In the foreign exchange market, sterling moved lower against all the main currencies. Against the Swiss Franc it fell by 5.4%, against the Canadian dollar by 3.6%, against the US dollar by 3.1%, against the Australian dollar by 2.2%, against the yen by 0.6% and against the euro by 0.1%.

There was significant weakness in some hard commodities and in the all important oil market, oil, as measured by Brent crude, fell 3.3% and gold, with a reputation for being a safe haven in troubled times, belied that this quarter with a fall of 7.1%.

ECONOMICS

Whilst markets have displayed significant resilience in July, the geopolitical and economic background clearly remains very troubled with no discernible light at the end of the tunnel. As we said in our June review, that does not necessarily read across to equities, although they did show a meaningful retreat from their pre invasion point, mitigated to some extent by July's powerful rally.

As the Russian invasion of Ukraine enters its sixth month, inevitably the news moves on to other matters even though the atrocities committed in Ukraine are no less shocking. That is unfortunate given the magnitude of the suffering inflicted on the people of Ukraine, but attention spans sadly wane and now the economic consequences of the invasion are rising to the top of people's lists of concerns and these are very serious.

The state of affairs which economists dread, stagflation, a ghost from the past, threatens to return. As the rather inelegant name implies, it describes an economic state of little or no growth, or even recession, and inflation. There is no doubt that the latter part of the name is here, with inflation levels of 9.1% in the USA, 9.4% in the UK, 7.6% in Germany, 5.8% in France, 8.0% in Italy, 8.1% in Canada, 2.3% in Japan, 2.5% in China and 8.6% in the euro area, to give some examples. Whilst Japan and China are outliers, the rest show an alarmingly high level of inflation. So, there is no doubt that the world economy is experiencing the inflation part of stagflation. If we look at the latest quarterly annualised GDP growth figures, we see the USA at -1.6%, the UK at 3.1%, Germany at 0.9%, France at -0.8%, Italy at 0.5%, Canada at 3.1%, Japan at -0.5%, China at -10.0% and the euro area at 2.0%. There is, therefore, an argument for saying that stagflation already exists in a number of large economies. Because of the energy crisis, particularly in Europe and its largest economy, Germany, there is the possibility of a significant recession if gas supplies are permanently reduced or even stopped by Russia. The unfortunate irony is that, because of the Russian action in Ukraine and the sharp rise in oil and gas prices, Russia is earning vast amounts of foreign currency to help pursue its invasion. The long term effect of sanctions on Russia and the move away by some important countries from purchasing its gas and oil will adversely affect Russia but, for the moment, it is managing to inflict serious inflationary economic pain elsewhere.

With the news varying each day between bad and less bad, but never good, it is not surprising that markets have become listless, although the recovery in some markets from their recent lows is good news, suggesting, as it does, some degree of resilience.

Let us look at the challenges which investors are currently facing, starting with inflation. The key question here is whether these elevated levels will be sustained, rise or fall. One of the big surprises, which we have discussed in a number of these reviews, is how central banks can have made such large errors in their inflation forecasting last year. Their insistence that inflation was "transitory" seemed open to serious challenge at the time and, not with the benefit of hindsight now, it was clearly wrong. Their argument that supply chain disruptions caused by Covid, which were pushing up prices, were temporary and therefore that prices would fall back when Covid eased, seemed optimistic at the time and now definitely is. For example, as a result of various government support actions resulting in involuntary savings building up during lockdown, strong demand against a supply chain which could not respond in the normal way could be expected to result in higher prices and this is what has happened. So, it seemed highly optimistic of central banks to expect inflation to fall back and base their monetary policy on that view. As a result, interest rates were kept too low and quantitative easing (QE) was not throttled back or reversed quickly enough, meaning that monetary policy was too loose for the higher inflation environment which was unfolding. Only towards the end of the year did central banks realise their error and "transitory" began to disappear from central banks' language. By then, it was too late to stem the tide of inflation. No one, of course, knew that Russia was going to invade Ukraine and the inflation position now is much worse than it would have been if no invasion had taken place. Nevertheless, a problem in the form of inflation rates above target levels was already in the pipeline but what has happened since the Russian invasion has made a bad situation much worse. Real inflation adjusted yields on good quality bonds and cash are deeply negative and have no fundamental investment attraction since no one, other than those who have to, will normally want to invest for negative real returns.

The table of ten year government bond yields at the beginning of this review, measured against the current inflation rate, which we detail above for the main economies, shows the extent of the negative real returns. Yet, as this review is being written, the bond markets have recovered strongly. Why might this be so? The thinking is probably that central banks, realising that they failed to tighten monetary policy in time to control inflation last year, will now overcompensate in the face of current very high inflation rates by raising interest rates sharply and in larger than usual steps, i.e. 75 basis points. They will also tighten monetary policy another way to put upward pressure on interest rates by ending quantitative easing (QE) and starting quantitative tightening (QT), although different countries and the eurozone will move at different speeds. This will have the effect of reducing central banks' balance sheets and of sucking money out of the economy as they sell securities back to the private sector. Price signalling, which effectively disappeared during the period of QE, will start to reappear in a modest way as there will be no interest rate insensitive central banks to buy securities and, in this way, it will start to regain some, but by no means all, of its former importance. By this, we mean not only what might be a more appropriate absolute level of interest rates, given the economic background, but also the relative rate, meaning that different credit risks will be more accurately reflected in spreads between various issuers. Central banks have to tread a fine balance between trying to bear down on inflation through a significant tightening of monetary policy, yet not precipitating a recession by overdoing it. Their task is made so much more difficult as a result of inflation almost getting out of control.

So, to get back to the question of why bond markets, at least temporarily, have moved significantly higher recently despite high inflation levels, the answer would seem to lie in the belief that central banks will go into overkill on interest rates and provoke a recession, which would be accompanied by a significant fall in inflation, helping to validate low bond yields. But there is a snag here. There are two types of inflation, cost push and demand pull. Demand has been quite strong in various areas as the involuntary savings built up during the Covid-19 lockdown have been run down and, with many supply constraints still existing, prices have risen sharply. When these involuntary savings are exhausted and, given the fall in real incomes which we are now seeing, demand will be weaker. However, this does not necessarily indicate that inflation will subside or not, at least, to central banks' target levels, because cost push has been a significant factor in causing current elevated inflation levels. One obvious cause is rocketing energy prices, partly caused by Russia's invasion of Ukraine, subsequent sanctions and Russia's action on gas supplies to Europe. But, of course, it is not only energy prices which have been rising. The supply dislocation and the importance of Russia and Ukraine as agricultural commodity producers has had a dramatic effect on prices, which are being reflected in the shops. So, for items like food and energy, where demand is fairly price inelastic, the cost push driver of inflation looks set to continue. One of the features of the aftermath of Covid-19 has been what is called the "Great Resignation". As business has ramped up post the worst of Covid, many businesses, especially it seems in the services industries, have found it very difficult to find new staff to fill vacancies. Normal economics in the form of market forces has come into play as companies have had to bid up pay to attract staff. Prices in services industries have risen sharply, again another example of short term cost push inflation. However, demand in many service industries, like hotels and restaurants, is much more price elastic in normal times and this may change the situation in the future. Central banks, in their policy decisions, take significant note of inflation expectations and there is evidence that these are beginning to become embedded in some economies like the UK, for example. Pay negotiations now often reflect current inflation rates as if they are here to stay and not fall back. As mentioned earlier "transitory" has long since disappeared from central banks' language. Whilst it may be expected that there is some return to normality in supply chains as the world comes to terms with Covid-19 and the Ukraine war, there is one shorter term and one longer term issue which may keep inflation elevated. The shorter term one is the idiosyncratic policy followed by China in trying to get to a zero Covid position through major lockdowns, which has affected economic growth in China, but also in the world as a consequence of the country being a key player in international supply chains. Supply constraints are raising prices of components and other inputs and numerous companies are reporting the problems which they are experiencing in this area. This remains a short term problem for inflation together with the fall out from the Russian invasion of Ukraine. In the medium and long term, Covid-19 and the war in Ukraine will cause a rethink on how supply chains are managed. Globalisation has many advantages, assuming that everything works perfectly. In an ideal world, a manufacturing company based in a particular country would source its components and raw materials from wherever it was most efficient to do so in terms of cost and quality and to receive its components on a "just in time" basis so that stock levels, and therefore working capital requirements, were minimised. Pre Covid-19 and the Russian invasion of Ukraine, this was the way manufacturing companies had been moving, but these two events will cause a major rethink, with security of supply being the prime concern. This may mean, for example, a company sourcing more components domestically or from a reliable country but there would be a cost in terms of higher prices, but that is the trade off. This also will have an effect on inflation.

For all of the reasons given, it seems to us that cost push inflation will remain the problem and, therefore, more difficult to deal with. If it is just demand pull inflation that central banks have to deal with, they would be more confident about the effects which raising interest rates and the reversal of QE would have on demand and therefore, in due course, inflation. But when inflation is driven by rising costs which are independent of the demand side of the equation, monetary policy is likely to be less effective. Of course, there are two sides to economic management and we have not talked about fiscal policy. With electorates facing falls in real incomes, it is a tough time to be in government and, therefore, there is pressure on governments to relax fiscal policy. However, as a result of the aftermath of the Covid-19 induced recession and the support which fiscal policy had to provide to support individuals and businesses, most countries' finances are in a poor state. Whilst central banks can control short term interest rates, they have less control over longer term rates, although with the qualification that QE can suppress interest rates, although not indefinitely. With that caveat, bond markets can be a great enforcer. An example, at present, is Italy, which is facing elections in September following Mr. Draghi's resignation after the loss of support for him amongst the coalition parties. Italy's financial position is very poor, with outstanding public debt as a percentage of GDP at around 150% and an estimated budget deficit as a percentage of GDP over 6% for 2022. The government bond market is now beginning to exert pressure on Italy, as evidenced by the widening spreads on, say, ten year government bond yields between the eurozone's strongest credit, Germany, and Italy. This now stands at about 223 basis points and this is a monetary union where economies, and therefore interest rates, are meant to converge.

In economics, relationships are relative. So, for example, if, say, fiscal policy in the eurozone is considered by markets to be too loose with excessive budget deficits being run, monetary policy may have to be relatively tight to compensate to attract buyers for a country's debt and to support the exchange rate. An example of the effect of the tightening of monetary policy is the significant recent strength of the US dollar against the euro. We know that the Federal Reserve is the most hawkish of the major central banks and that the ECB is probably the most reluctant to tighten monetary policy, although it is doing so now. Tighter monetary policy in the USA, evidenced by the size of interest rate increases and the move from QE to QT, which will also push up interest rates, makes the US dollar more attractive whilst this process continues and if, as has been the case, the euro weakens, it raises inflationary pressures in the eurozone. This, therefore, has implications for the ECB's monetary policy since it cannot be indifferent to the euro's weakness. Substantial amounts of eurozone debt have to be rolled over as well as new money raised. Currencies cannot all be weak at the same time and the ones which will be relatively weak because of the loose monetary and fiscal policy being followed are the ones where the most problems will occur. Another consequence of the US dollar's strength is to put pressure on emerging markets many of which have large US dollar debt obligations. A number have been amongst the first to raise interest rates in an attempt to support their currencies.

What this boils down to is that, if cost push inflation is going to be the main driving force behind the overall inflation level, central banks are going to have to raise interest rates by more than they would do if it was demand pull inflation because it will be less quick acting. However, there is one important caveat to this statement arising from the consequences of Russian action on gas supplies to Germany and Europe. Were Russia to cut off supplies or maintain current tight restrictions on supply through the pipeline, Europe, led by Germany, would see a serious recession and a decline in GDP. Although the cost push inflation arising from elevated energy prices would be unlikely to go away because Europe would be seeking alternative scarce supplies, the ECB might be reluctant to raise interest rates to what would usually be considered a more appropriate level for fear of making the recession worse. One of the risks would be that, if the recession issues were more relevant to Europe than elsewhere, which seems plausible in view of Europe's particular dependency on Russian energy supplies, the euro would be relatively weak and, as we said earlier, this would raise the inflation level. Unless the ECB, in those circumstances, returned to QE and suppressed yields, interest rates would be likely to rise, reflecting greater inflation and currency risks. Investors have to factor in geopolitical risks and, as things stand, Russia does not look like retreating from Ukraine, or reaching a settlement which would be acceptable to Ukraine. We, therefore, have to accept that the economic dislocation will continue and that the area most affected will be Europe. The ECB's monetary dilemma is worse than most.

Whilst talking about Europe, and the eurozone in particular, the problem of a monetary union such as the euro area, which is not an optimal currency area, is once again coming to the fore. To have a chance of it working better than it has done there needs to be a fiscal union but this has little chance of coming to fruition in the foreseeable future. Instead of converging, as the eurozone economies were meant to do, they have been diverging, which brings problems for the "one size fits all" policy. The political impasse in Italy, to which we referred earlier, has caused the spread in yield between the ten year German government bond and that of Italy to widen to over 220 basis points. The problem for the ECB is that Italy is the third largest eurozone economy with enormous indebtedness, as we mentioned earlier, and a loss of faith in Italy's credit would cause serious problems for the eurozone. Against this background, the ECB is now looking at a tool, the Transmission Protection Instrument (TPI) which will try to control the spreads in the eurozone bond market if it thinks that they are unreasonable in relation to a country's financial position. This is going to be fraught with difficulty. Who decides which countries are being unreasonably treated by the markets and what are the criteria? Conflicts of interest are bound to emerge. Will the ECB, or whoever else is involved, ever have the nerve to say that the markets are wrong if the yield spreads widen out between different eurozone credits to the extent that they threaten an existential crisis for the euro? If the ECB does feel the need to intervene to manage spreads, what will the conditions be? Outright Monetary Transactions (OMT), a tool which has not been used so far, would impose significant conditions upon a recipient country. Could these countries accept them? Probably not without severe political turmoil. The TPI is not a step this far but there is bound to be serious scepticism amongst the more conservative northern eurozone countries. One feels that there are going to be some difficult issues here because it is impossible for it not to be politicised. It is certainly not the job of the ECB to determine whether the market has correctly priced the yield spreads between the various eurozone credits.

At this stage, for the reasons given in this review, it is difficult to see inflation coming back to levels seen before Covid, in which case substantial negative real yields, which we continue to see, remain inappropriate and, at some stage, could lead to their own inflationary pressures. After all, even though the latest IMF World Economic Outlook is entitled "Gloomy and More Uncertain", it is still forecasting World Economic Output to grow by 3.2% this year and 2.9% next year. With this, it forecasts Advanced Economies to grow by 2.5% this year and 1.4% next year, with the respective figures for Emerging Markets and Developing Economies being 3.6% and 3.9%. Now, these figures are not great and they will almost certainly be changed as more developments can be factored in during the year, but they do point to some growth and it should also be borne in mind that many countries' labour markets are very tight, those of the USA and UK for example, where, as referred to earlier, shortage of staff is leading to significant increases in pay in certain sectors.

This background does not give us any confidence that fixed interest securities offer anything near good value and we continue to view their very significant negative real yields as unappealing and offering nothing for long term investors with an unconstrained mandate. Dreadful as the current geopolitical and economic situation is, and the foreseeable outlook likewise, it is encouraging that equities have recovered from some of their falls this year, with the year to date performance much better than many could have imagined, given the gravity of the position. It suggests to us that investors have taken note of what happened in previous market shocks, the Global Financial Crisis in 2008 and the Covid-19 pandemic starting in 2020 when steep falls in share prices were followed by sharp equity market recoveries. The case for equities is that many companies have the flexibility to adjust their business model in these unprecedented times and quite a number of companies currently reporting have indicated that they have been able to reflect cost increases in their prices. Dividends still look fairly solid and many companies continue to increase them. The ability to invest worldwide is very important. For example, although many US companies are facing foreign exchange headwinds with the US dollar being very strong, the US economy is much better placed as far as energy resources are concerned. This is despite a large IMF downgrade of 1.4% for this year's growth rate compared with its April forecast. Competing assets, like bonds, cash and even gold, appear to us to have more drawbacks than equities and, given that the world economy is likely to recover once the current crisis is over, equities seem to us to be best placed to benefit from this trend as they have always done in the past.

It will continue to be a bumpy ride and more volatility and periods of negative performance must be expected, but that is no reason for taking the risk of not being invested in assets which promise long term growth, just as they have done in the past.