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ASSET MANAGEMENT (C.I.) LIMITED

INVESTMENT MEMORANDUM

This has been a surprisingly strong quarter for international equity investors. Amongst the catalysts have been hopes of a satisfactory outcome to the Iranian situation, although the news changes from day to day, and continued excitement about AI as well as strong corporate earnings announcements. There has been little overall change in the bond market, so equities have once again outperformed that asset class. Gold has continued its retreat.

The tables below detail relevant movements in markets :

International Equities 31.03.26 - 30.06.26

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	+4.4	+5.0	+5.6	+6.5
Finland	+14.0	+12.4	+13.1	+14.0
France	+9.0	+7.5	+8.2	+9.0
Germany	+9.5	+7.9	+8.6	+9.5
Hong Kong	-2.2	-2.9	-2.2	-1.5
Italy	+20.2	+18.5	+19.3	+20.2
Japan	+15.9	+12.8	+13.5	+14.4
Netherlands	+34.8	+32.9	+33.7	+34.8
Spain	+16.1	+14.4	+15.2	+16.1
Switzerland	+12.7	+11.5	+12.2	+13.1
UK	+3.7	+3.7	+4.4	+5.2
USA	+15.4	+14.7	+15.4	+16.3
All World Europe ex UK	+14.1	+12.5	+13.2	+14.1
All World Asia Pacific ex Japan	+25.3	+22.3	+23.1	+24.0
All World Asia Pacific	+21.0	+19.2	+20.0	+20.9
All World Latin America	-5.2	-4.1	-3.5	-2.7
All World Emerging Markets	+11.7	+11.4	+12.1	+13.0
All World	+15.2	+14.2	+15.0	+15.8

Source : FTSE All World Indices

FTSE Actuaries UK Conventional Gilts All Stocks Index (total return) : +2.0%

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

	31.03.26	30.06.26
Sterling	4.91	4.76
US Dollar	4.32	4.46
Yen	2.35	2.69
Germany (Euro)	3.00	2.86

Sterling's performance during the quarter ending 30.06.26 (%)

	Quarter Ending 30.06.26
US Dollar	+0.3
Canadian Dollar	+2.2
Yen	+2.6
Euro	+1.4
Swiss Franc	+1.2
Australian Dollar	-0.1

Other currency movements during the quarter ending 30.06.26 (%)

	Quarter Ending 30.06.26
US Dollar / Canadian Dollar	+2.0
US Dollar / Yen	+2.3
US Dollar / Euro	+1.1
Swiss Franc / Euro	+0.2
Euro / Yen	+1.2

Significant Commodities (US dollar terms) 31.03.26 - 30.06.26 (%)

	Quarter Ending 30.06.26
Oil	-38.5
Gold	-12.6

MARKETS

- Strong all round international equity performances but with a wide dispersion of performance amongst the different industry sectors.
- In relative terms, there was a significant outperformance in the Asia Pacific ex Japan market whilst the UK and Latin America were significant underperformers, the latter area showing a negative return
- Overall, fixed interest markets showed a marginally positive return but significantly underperformed equities.
- In the foreign exchange markets, sterling was modestly mostly stronger, particularly against the yen.
- In the commodity market, oil fell heavily, back to roughly the pre Iranian war level as hopes for a resumption of traffic through the Strait of Hormuz were raised. Gold continues its weak performance.

ECONOMICS

Reflecting on a positive quarter for international equity markets, we might ask what does it take to put markets into reverse? We should say immediately that equities remain our preferred asset class even though we are allowing cash to build up in portfolios from income received where it is not automatically paid out. Almost any pretext for a market rise is seized upon and it seems to be that although the outlook may remain highly uncertain, it is not as bad as it might have been and this is seen as bullish news. The most recent example relates to hopes that the Strait of Hormuz will be open, leading to a fall back in the oil price to around pre war levels and therefore some of the more negative economic forecasts, which had factored in higher oil prices for longer with knock on effects for inflation and interest rates, might prove to be too pessimistic.

However, it is also right to point out that, notwithstanding the rise in equity markets over the second quarter, there has been a wide dispersion of sector performance which might give a clue as to why equities overall have performed well. If we take the S&P 500 Index as a prime example, the top performing sector was the Information Technology Index, rising by 31.6%. On the other hand, the Energy Index was down about 14% reflecting what was perceived to be better news from the Iranian situation and therefore a lower oil price. For the year to date, as a side note, the S&P Industrials Index has been the strongest sector, rising about 19.5% with the Information Technology sector almost the same at about 19.4%. But back to the Information Technology sector, which may or may not be in a bubble depending on one's viewpoint, and one senses that investors are prepared to look beyond the present troubled geopolitical and economic period to the benefits which AI might bring to the world economy. The pace at which events are moving forward in the AI world concentrates many investors' minds and those potential economic benefits.

Now, of course, there are many views on the development of AI both positive and negative but, in the context of trying to explain why markets may be ignoring the difficult current geopolitical and economic situation, it is worth outlining the optimistic scenario in very broad terms. It should enable productivity growth to be enhanced. Whilst the US has a better productivity record, the UK and Europe lag behind. AI can be expected to enable some tasks to be completed more quickly, accurately and cheaply thus enabling companies to achieve some cost savings. This might help to keep inflation under control which, in turn, should mean interest rates will be lower than they would otherwise have been. Lower prices in absolute or relative terms could then by expected to stimulate demand, helping companies to achieve higher profits than otherwise might have been the case which would feed through to dividends. Faster economic growth should improve countries' fiscal positions, reducing the need for higher taxes and, perhaps, even allowing them to be reduced. Less fiscal pressure and a reduced need to issue new debt could lead to lower interest rates and start a virtuous economic cycle. Of course, there will be disadvantages, notably in accommodating those whose jobs have been displaced by AI so it will not all be one way but even listing the most general benefits can inform a long term expectation that the very good performances which we have witnessed from equities over a long period are likely to continue. AI is developing at a very fast pace and we can see from company reports that regular references, particularly from US companies, to its use and early cost savings mean that we have some firm early evidence of its benefits. It is also right to say that some governments are nervous about AI for a variety of reasons including the effect which it may have on employment and the resulting political consequences. This brings with it the threat of over regulation and even talk of additional taxes on companies who reduce the number of employees because of AI. This is more likely to be an issue in the UK and Europe as opposed to the USA where there is a much more benign business environment and less regulatory zeal in this area. But, overall, we don't think that it is fanciful to suggest that investors in equities at current levels are looking ahead to the effects which AI may have on the world economy and stock markets.

The AI excitement in stock markets, and here we are largely talking about the USA and Asia, is also spreading to companies which may be in the less glamorous but nevertheless very important role of providing ancillary products and services, so it has a wide reach. According, to Gartner Inc. a forecast it made in January suggested worldwide spending on AI will total US$2.52 trillion in 2026, a 44% increase over 2025. It broke it down by sector. The largest sector was AI Infrastructure at US$1.366 trillion, followed by AI services at US$0.589 trillion and AI Software at US$0.452 trillion. The AI Infrastructure spend is on optimised servers, semi conductors and data centres, the Services spend is allocated for system integration and deployment and the Software spending is for enterprise applications and custom tools. Smaller but significant absolute amounts relate to cybersecurity and large language models and training data. The breakdown of this vast sum detailed in Gartner's forecasts shows just how widespread is the reach of AI in benefiting a wide range of companies.

However, it's one thing to be spending vast sums of money on AI and another to know what the return might be on these investments and this is an issue which concerns analysts. In this review we are considering the macroeconomic benefits for the world economy and, assuming there is no sudden pull back in planned investment, we can separate the macro benefits for the world economy from the micro effects on individual companies. And, of course, current spending on AI is powering economic growth. It is estimated that the USA is on track to spend about 2% of its total GDP this year on AI and data centre infrastructure, according to Forbes. Barron's a leading financial commentator, owned by Dow Jones & Co., estimated that in Q1 2026, business spending, particularly on AI equipment and software contributed 1.5% to the 2% growth and from this vast expenditure will occur economic multiplier effects.

So, it is reasonable to assume from market movements so far this year that the effect of AI is such that it has had more influence on prices than current negative geopolitical events, not only because of the contribution to economic growth so far this year in the USA, in particular, but more speculatively and, in our view, quite plausibly, on investors' views that long term benefits will accrue from AI which warrant a positive investment view of equities at the current time.

Moving back to more conventional drivers of security prices, the current economic situation and outlook, we can look at the latest economic growth forecasts from the OECD in its latest Economic Outlook, published in June. It forecasts that the world economy will grow by 2.8% this year and by 3.1% next year although, of course, one must say that in such an unsettled situation as we now see, all forecasts must be subject to a bigger than usual margin of error. In developed economies, the USA is expected to be the best performer this year at 2.0% followed by Australia at 1.9%. Next year, the OECD forecasts the USA to grow at 1.8%, the same as Australia. It is noticeable, however, that the UK and the three largest eurozone countries lag well behind the USA and all, of course, lag behind China, forecast to grow 6.3% this year and 6.4% next year and India, 6.3% this year and 6.4% next year. Sandwiched between those two is Indonesia although it faces significant economic and political problems at present.

It is no coincidence that the UK, Europe and, we can say, Japan (growth forecast of 0.6% and 0.8% respectively for 2026 and 2027) lag behind the USA. We can feel confident in stating a number of reasons. The USA has a much larger number of technology companies where the environment is considerably more business friendly than in the UK and Europe and regulation less burdensome. As a result, the technology sector is growing by leaps and bounds and at a rate it is difficult to contemplate in the UK and Europe. Allied to this, as far as companies are concerned, there is a much more flexible labour market which helps companies to remain competitive in many industries. The USA has much lower energy costs which give companies a competitive advantage. One can also see US companies embracing AI much more quickly as they are less likely to be hindered by regulatory or government policy. For these reasons, it seems highly likely that the USA and, probably, China will be early leaders in the race to use AI to gain the type of benefits which we mentioned earlier so the relative economic growth advantage enjoyed by the USA in the OECD projections is likely to be maintained or even widened.

However, whilst the excitement about AI has helped to drive a positive equity performance in the first half of 2026, it is important to look at other economic data which are relevant to bond and equity markets. The most important one to our mind is the very poor fiscal position of many countries which, as we have often mentioned in these reviews, is the reason we are negative on bond markets. This is a theme which we have developed in many of our recent reviews, especially as there is little sign that the most indebted countries are grasping the nettle. If we look at the very informative page at the back of each week's Economist which gives an excellent economic snapshot of international economic data, the column for The Economist Intelligence Unit's estimate of budget balances for 2026 shows very few in surplus, namely Greece, Denmark, Norway, Switzerland, Singapore, Taiwan and Argentina. The rest are forecast to show budget deficits, some very large. Assuming countries are not going to monetise their debt (print money), and this is not unheard of, they have to persuade domestic and international investors to buy their debt at a reasonable rate of interest and that will be a function of their creditworthiness and competition amongst issuers. If investors lose confidence, they will demand a higher interest rate or may decline to lend at all, thus sparking an economic crisis, a potential bail out by the IMF or, in extremis, monetising their debts. This is why it is reasonable to say that the bond markets can be an investor's best friend because fear of a bond market implosion can make governments take measures they would otherwise avoid. The current situation in the UK is a really interesting example of this. Going back to The Economist's table, the forecast is for a budget deficit of 5.1% of GDP in 2026, the country's outstanding debt as a percentage of GDP is round about 100% (depending on which measure is used) and the UK spends at least £111 billion each year on interest servicing this debt which represents about 3.5% of GDP and 8% of government spending, the fourth largest item of expenditure. The UK has particular issues because around a quarter of outstanding public debt is in the form of index linked gilts and the UK's worse than average inflation performance has exacerbated the position. The more the debt servicing costs rise, the more the pressure on the budget which, in turn, could lead to higher taxes or reduced public spending which would reduce economic growth, thus turning the situation into a vicious circle.

It could be anywhere but the current political situation in the UK gives an excellent example of why the bond market is so important. We are not making political points but merely observations. If Mr Burnham becomes Prime Minister shortly, it is widely expected that he will replace the Chancellor, Rachel Reeves. She has been making the point consistently that it is important that the country's finances remain within her fiscal rules. After having make some remarks last year about the bond markets, which temporarily rattled the gilt market, Mr Burnham now says he will respect the fiscal rules. The Chancellor, in particular, recognises that the bond market relies on confidence and, if the rules are broken, the gilt market would take it badly meaning rising bond yields, more debt interest and possibly a loss of confidence in the country's credit. This is a really good example of the power of bond markets to dictate a fiscal policy and why it can be an investor's best ally if governments take risks with the level of borrowing in order to meet their spending plans.

In Europe, the cases of the UK and France are instructive. Both have broadly the same size of expected budget deficit this year according to The Economist Intelligence Unit, 5.3% for France and 5.1% for the UK, both of which are too high in that the level of outstanding debt will continue rising. The best way to stabilise public finances is through economic growth which should raise the tax take and hold back the level of public spending on areas such as social security. A government has two choices, or a mixture of the two, to deal with an oversized budget deficit which is to reduce public spending, raise taxes or a combination of the two. Government spending as a percentage of GDP in the UK was 44.6% in 2025 and, for France, the figure was 57.2%. In relation to the revenue needed to be raised from taxation, both are considered to be at the limits of what is sustainable. If that is a correct assertion, then moves to raise taxes further, and there are more in the pipeline in the UK and uncertainty in France about what the political future holds, would damage growth prospects and probably adversely affect the tax take. That is not to say that taxes will not be raised further because the other course of action, namely to cut public expenditure is very difficult for the respective governments to take. The other country we want to talk about in this context is the USA. The budget deficit is even worse than in the UK and France with The Economist Intelligence Unit estimating a deficit of 6.5% of GDP this year but there are differences. As often mentioned, the USA has the advantage of having the US dollar as the world's largest reserve currency. Its use in trade and as the foreign reserves for many countries means there is always a demand for US dollars and Treasuries. Whilst tariffs, whose future is uncertain, were meant to provide some revenue to offset the President's tax cuts, the USA's fiscal laxness has provided a growth stimulus which it can get away with at least for the moment but the US dollar's advantages will not shield it for ever, especially as there is no end in sight to these outsized budget deficits. Outstanding public debt as a percentage of GDP is 124% and stands at not far short of US$40 trillion. The USA pays over US$1 trillion per annum in interest costs on this debt. It is true that the USA appears likely to continue to produce better economic growth than most of its competitors which will support tax revenues but not by enough to make a dent in its fiscal weakness.

This is the background which informs our position on the bond markets which themselves have formed a view on various countries' finances. So, for example, the USA has to pay more for its borrowings as measured by 10 and 30 year government bond yields than most developed economies. The exception is the UK which pays more for its money than the USA, reflecting its relatively high inflation as well as its poor fiscal position and maybe even some political instability. Within the major countries in the eurozone, France has to pay most for its money, reflecting its poor fiscal position and political instability. There appears to be very little political will to address the deficits through cutting public expenditure and in the UK and France, taxes could be at a tipping point where they reap negative economic returns. So, it would not surprise us if at any time bonds react badly to developments relating to large budget deficits and high borrowing requirements. There will not be an unlimited buying appetite for new bond supplies that does not allow for the increased risk of holding them.

So, if one has a negative view on bonds, what does it say about the prospects for equities? Yet again in this latest quarter, equities outperformed bonds by a significant amount. If one looks at the Bloomberg Global Aggregate Index for bonds, in dollar total return terms last quarter, its return was 0.87%. Admittedly, equity returns were enhanced by the performance of AI related stocks and a diversified portfolio is not going to hold only the big AI stocks but the outperformance of equities is stark. One buys equities for long term capital growth and that will be a function of the growth in an economy overall whether it be the local one or the international one and then, specifically, companies which shareholders hope will provide an increasing flow of dividends over time. We talked earlier on in this review about the current market strength being a function of investors looking over the hill to the potential economic benefits of AI, but it would also be relevant to mention the strong rise in company profits. FactSet estimates that for Q2 in the USA, the estimated year over year earnings growth rate is 23.1%. FactSet says that for calendar year 2026 analysts are projecting earnings growth of 24.0%. If these figures are anywhere near correct, they can also explain the momentum in markets as well as the larger AI induced picture. It is also possible to postulate in the context of the benefits which AI may confer on the economy that profits will continue to rise as a percentage of GDP.

Whilst the US market stands at a premium to most other markets, we believe that there is a good reason why this is so, namely the favourable messaging for businesses and investment that emanates from the USA. International investors with a choice of markets into which to invest directly and indirectly will want a country which is stable and predictable from a tax and regulatory angle. Generally speaking, the USA meets those conditions. Of course, one can point to negative factors like tariffs and arbitrary policies made but, overall, if one wanted to invest anywhere in the world the USA would be at or around the top of the list. There is generally a much more positive view towards business and success. Non financial factors can also influence where money flows.

We usually have a relatively low weighting in the UK. We make no political points but look at the facts and try to draw a conclusion which investors might reach from an objective viewpoint. There has been a substantial increase in public spending partly financed by significantly higher taxation on businesses and individuals. If companies are facing major cost increases, they will have to react by raising prices, cutting staff numbers or even closing down (as we have seen in the high street). There has also been a heavy increase in regulation, including in the labour market. The ending of non dom status has also sent out a message that is not positive. Many voters will agree with increasing public spending and funding it by taxation increases on business and wealthier individuals but these have economic consequences including almost certainly lower economic growth which we talked about earlier. These are the reasons why we hold a cautious view towards the UK and this is reflected in our current allocation. Large multinational companies which dominate the FTSE 100 Index should be relatively unaffected but lower down the ladder of market capitalisation, more domestically orientated companies are likely to find the going tougher in the face of increasing costs and regulations. The UK bond market is the canary in the mine in relation to the state of government finances. We regard the UK as a relatively high risk market.

Taking the third country in our list of fiscally challenged countries, France, we have noted that the bond market has taken the view that its government bond yields should be higher than previously fiscally challenged countries like Italy, Spain, Portugal and Greece. This is a warning sign in relation to the second largest eurozone county and a G7 member. Since the parliamentary elections in 2024, the parliament is so fragmented between far left and far right and not much in the middle that effective decision making is almost impossible. One thing is certain, though, and that there is no appetite to take what most would regard as necessary measures to address the severe state of government finances, i.e. tackling public spending. To get a budget through, the burden has fallen on large companies and the wealthy. In terms of messaging, this is negative for investors.

Whilst France is a particular case in point, Europe as a whole has a poor productivity record. It is recognised by some including the former Italian Prime Minister, Mario Draghi, who produced a report on European competitiveness recognising the problems within the EU. It has some significant issues which investors will consider when deciding where to invest. It lacks flexibility, over regulates (the tardy approach to AI is a case in point), is fiscally challenged, has a weak energy position and is facing increasing competition from China with, for example, in the auto industry, EVs eating up a lot of its market. It is difficult to see the EU meeting US levels of productivity with implications for future economic growth. Apart from fiscal issues in the area, the difficulties are of a structural nature. Of course, there are many good companies within the area, as there are in the UK, but investors will see more opportunities in the USA.

As our table shows, Asia has been an outstanding performer this quarter led by Taiwan and Korea where the big chip makers reside and where AI fever has caught on. The region should always have a representation in international portfolios because as well as having cutting edge technology it has, in many countries, a pro business pro investor bias which gives positive messaging to investors. Japan obviously has a different profile but has been becoming more pro investor and the new Prime Minister is following up on earlier incentives so, despite its problems, including awful demographics, Japan forms a part of an international portfolio with less risk than say the UK and Europe. This is not ignoring its very high level of indebtedness which, although largely held domestically, could become a problem at some stage.

The international equity market has performed in excess of expectations so far this year and, as we have often warned in these reviews, there will be negative quarters of performance. It is impossible, with all the geopolitical and economic uncertainties in the world, to estimate how markets will perform in the short term, but we always take a longer term perspective which still favours equities over bonds. We have outlined why we maintain our negative view on bonds, notwithstanding their underperformance against equities. This relates to the very poor fiscal positions in many countries, including amongst the largest, as we have outlined in this review, and the reluctance amongst politicians to take the necessary steps, mainly in public spending, to address the position. This means that bonds are vulnerable to sharp losses in confidence in affected countries. For equities, although some markets and, in the view of many, the USA looks historically overvalued, we are prepared to look further ahead as we take an optimistic view of the economic benefits of AI to the world economy, such as we have outlined earlier in this review. Within the equity sector, we continue to view the USA as the market where investors should have the largest exposure, with its wide range of companies in which to invest, including a leading position in AI and related investment. Its pro business and pro investor message as opposed to the position in Europe, is also an important guide to where investors should place their money and the same goes for parts of Asia. We are aware that, with elections coming up in the USA, the message from the USA could begin to change and we will be alert to this. Within our exposure to equities, it is important to have a mix of styles to diversify the risks. This is particularly important when markets have been driven by AI. It is not prudent to place all of one's investment bets in one sector because sentiment can always change dramatically in relation to market leadership. We may well have seen the best of the equity markets' performance in 2026 in the first half of this year, but our focus is on the continued longer term attractions of equities, even against such an uncertain short term background.