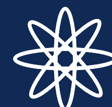

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ASSET MANAGEMENT (C.I.) LIMITED

INVESTMENT MEMORANDUM

The first quarter of 2019 has witnessed a strong rebound in international equity markets after the poor final quarter of 2018. Worries about the international economy have caused bond prices to rise as well with an estimated US$10 trillion of bonds standing on negative yields. In the foreign exchange market, sterling recovered ground over the quarter and, in the commodity markets, oil posted a strong gain.

The tables below detail relevant movements in markets :

International Equities 31.12.18 - 29.03.19

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	+9.1	+9.0	+11.6	+13.6
Finland	+9.7	+5.3	+7.7	+9.7
France	+12.8	+8.3	+10.8	+12.8
Germany	+9.2	+4.8	+7.2	+9.2
Hong Kong, China	+15.9	+13.0	+15.6	+17.7
Italy	+16.6	+11.9	+12.4	+16.6
Japan	+7.8	+4.5	+6.9	+8.8
Netherlands	+14.7	+10.1	+12.7	+14.7
Spain	+9.4	+5.0	+7.4	+9.4
Switzerland	+14.8	+11.0	+13.6	+15.7
UK	+9.7	+9.7	+12.2	+14.2
USA	+13.8	+11.2	+13.8	+15.9
All World Europe ex UK	+12.5	+8.1	+10.6	+12.5
All World Asia Pacific ex Japan	+11.1	+8.6	+11.1	+13.1
All World Asia Pacific	+9.8	+7.0	+9.4	+11.4
All World Latin America	+7.6	+5.3	+8.0	+9.9
All World All Emerging Markets	+10.2	+7.9	+10.4	+12.4
All World	+12.3	+9.6	+12.6	+14.2

Source : FTSE All World Indices

FTSE UK Government Securities Index All Stocks (total return) : +3.4%

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

Currency	31.12.18	29.03.19
Sterling	1.26	0.97
US Dollar	2.72	2.39
Yen	0.02	-0.09
Germany (Euro)	0.17	-0.17

Sterling's performance during the quarter ending 29.03.19 (%)

Currency	Quarter Ending 29.03.19
US Dollar	+1.9
Canadian Dollar	N/C
Yen	+3.0
Euro	+4.0
Swiss Franc	+3.3
Australian Dollar	+1.2

Other currency movements during the quarter ending 29.03.19 (%)

Currency	Quarter Ending 29.03.19
US Dollar / Canadian Dollar	-1.9
US Dollar / Yen	+1.0
US Dollar / Euro	+2.1
Swiss Franc / Euro	+0.7
Euro / Yen	-1.0

Significant Commodities (US dollar terms) 31.12.18 - 29.03.19 (%)

Currency	Quarter Ending 29.03.19
Oil	+29.8
Gold	+1.3

MARKETS

International equity markets broadly recovered the ground lost in the final quarter of 2018. In local currency terms, the FTSE All World Index returned +12.3%, in sterling terms +9.6%, in US dollar terms +12.6% and, in euro terms, +14.2%. If one looks at the returns in local currency terms, the gains were fairly evenly spread with no major outliers and all in positive territory. Although sterling strengthened during the quarter, every area showed a positive return in sterling terms. Relative, but not absolute, weakness in sterling adjusted terms was shown by the FTSE Japan Index, +4.5%, and the FTSE All World Latin American Index, +5.5%, but, by any standards, these were still very good quarterly returns. The FTSE USA Index showed useful outperformance, +11.2%, whilst the return on the FTSE UK Index at +9.7% was almost exactly in line with the FTSE All World Index.

Strangely, whilst equities performed strongly during the quarter, bonds, too, rose in value. Taking ten year government bonds as a benchmark, the gross redemption yield on the UK gilt fell by 29 basis points to a scarcely believable 0.97%, whilst that on the US Treasury bond fell by 33 basis points to 2.39%. German and Japanese bonds went back into negative territory with the gross redemption yield on the Japanese Government Bond falling by 11 basis points to -0.09% and on the German Bund by 34 basis points to -0.17%.

In the foreign exchange market, sterling showed a stronger tendency. Whilst it was unchanged against the Canadian dollar, it rose by 4.0% against the euro, by 3.3% against the Swiss Franc, by 3.0% against the yen, by 1.9% against the US dollar and by 1.2% against the Australian dollar.

In the commodity markets, oil rose strongly by 29.8% whilst gold was marginally stronger by 1.3%.

ECONOMICS

In the first quarter of 2019, stock markets have recovered a significant part of the losses registered in the fourth quarter of 2018, this despite evidence of weakening economies almost everywhere. Whilst this might seem paradoxical, the explanation seems fairly clear and is the flip side of the drivers of the poor performance at the end of 2018. At that time, investors were concerned about the trade stand off between the USA and China which, through the dangers of protectionism, could lead to economic weakness or, even, recession which would have a negative effect on company profits and dividends. A second important reason was the threat posed by tightening monetary policy, most notably interest rate increases in the USA and the end of quantitative easing in the eurozone, which was due to be effective from the end of the year. However, in January, there was an abrupt change of tune by the Federal Reserve as it became noticeably more dovish. After detailing the strong points about the US economy, the Federal Reserve said that it would be patient as it determines what future adjustments to the target range for the federal funds rate may be appropriate to support these outcomes. That change of tune was enough to send Wall Street and other markets higher and the trend has continued over the quarter despite weaker international economic data. There is a more optimistic view on the trade talks taking place between the USA and China, although the outcome of the talks remains far from certain.

One indicator which many investors and economists consider is the shape of the yield curve, and we will come back to this shortly, in the context of the latest economic outlook published by the OECD in March which shows a deterioration in its view of the world economy and this is just one amongst a number of forecasts from other organisations for either specific countries or areas or globally.

The latest OECD Interim Economic Assessment, published in early March, sets the scene for a change in tack for monetary policy in a number of important countries and areas. There are some significant downgrades in its forecasts for economic growth in 2019. Compared with its November 2018 forecasts, the OECD now sees world growth in 2019 at 3.3% compared with its forecast of 3.5% in November and a 3.6% outcome for 2018. Amongst the G20 countries, the only two for which it has raised its forecasts for 2019 are Argentina (it still sees a contraction of 1.5% and South Africa where it now sees growth of 1.7%). Looking within its projections, the best performers amongst the developed countries are expected to be the USA (2.6% growth) and Australia (2.7% growth). But the biggest downgrades in the developed countries are seen in the euro area (1.0% growth) where Germany is now seen growing by only 0.7% and Italy is seen contracting by 0.2%. The forecast for the UK has been reduced to 0.8%. Elsewhere, the forecast for China has been reduced to growth of 6.2% this year (lower than in recent years) and for India to 7.2%. Turkey, an important economy, has seen a sharp fall in the OECD's projection for this year. The OECD sees economic contraction of 1.8%.

These and other similar forecasters' downgrades have been reflected in falls in bond yields causing some to say that the yield curve is predicting a recession. In normal times, the yield curve would have a noticeable upward slope with a significant difference in yield between short and long term yields reflecting the risks, including inflation, of lending for longer periods. However, times are unusual and the shape of the yield curve can be shown in this table of gross redemption yields in different markets and over different maturity periods at the end of March.

	U.K. (£)	**U.S.A. (US$)**	**Germany (€)**	**Japan (JPY)**
2 years	0.611	2.260	-0.621	-0.189
5 years	0.737	2.233	-0.455	-0.210
10 years	0.970	2.390	-0.170	-0.090
30 years	1.555	2.814	0.537	0.492

Gross redemption yields % at 29.03.2019

Whilst not inverted, their table tells an extraordinary tale as it shows the effects of the extreme monetary policy which has been in operation since the financial crisis and has now been exacerbated by a more pessimistic view of the world economy, at least in the short term. If we look at the UK, where year on year inflation is currently 1.9%, real returns are negative throughout the maturity spectrum. As one moves along the yield curve, it is hard to believe that the investment outcome can be anything but bad. One would have to believe that inflation would have to be almost non existent to justify investing on the present yield basis. Of course, in the short term, the bonds can become even more expensive but one would be taking a fundamental risk where anything but the short term odds are stacked against an investor. In the USA, where the current year on year inflation rate is 1.5%, real returns are positive along the yield curve, so this is a much less extreme position than in the UK. As the table above shows, the position in Germany, even though a traditionally low inflation economy, shows negative real yields across the maturity spectrum with the year on year inflation rate currently 1.5%. As for Japan, where the year on year inflation rate is currently running at 0.2%, only the 30 year maturity is showing a positive real return. Notwithstanding all the reasons why we are seeing negative real yields over a wide range of issues and maturities, it is a strange situation where an investor can make a decision to buy a security which, if held to maturity, will almost certainly lead to a significant fall in the real value of the

investment. A modest deterioration in the economic outlook as, for example, shown in the latest OECD downgrades, leads some commentators to say that the yield curve is presaging a recession. On the table we show, only the difference between 2 year and 5 year US and Japanese Government Bonds represents a downward slope in the yield curve, but generally the yield curves are only on a very gently rising trend. The reason a downward sloping yield curve might unsettle investors is because it indicates expectations of lower future interest rates and those are only likely to occur if economic weakness forces central banks to reduce interest rates. On the positive side, and this appears to be winning the argument at the moment, the fall in bond yields makes the dividend yields on equities more attractive in certain circumstances. The caveat to this argument is that the state of the economy is not so bad as to cause companies to reduce their dividends on a wide scale. This scenario does not appear to be likely at the moment and therefore the recovery in share prices in the first quarter of 2019 can be supported by their relative dividend yield attraction against fixed interest securities. The fact that both equity and bond prices have been rising in the first quarter suggests that investors are getting one of the asset classes wrong. If no recession comes, then it is bond holders which are likely to be burnt and, if one comes, then equities can be expected to fall. An argument against being overinfluenced by the shape of the yield curve is that the vast scale of quantitative easing has suppressed yields making the predictive value of the yield curve less convincing.

The OECD forecasts, if they are near correct, are not alarming. Growth will be lower in 2019, but not alarmingly so, and, in the G20, it is forecasting recession in only Italy, Argentina and Turkey. The area of most concern is the eurozone where last November's forecasts of 1.8% growth in 2019 and 1.6% growth in 2020 have been reduced to 1.0% and 1.2% respectively. The downgrade in 2019's projection is particularly startling and within the eurozone the downgrades for Germany and Italy are substantial. For Germany, the downgrade for 2018 is from 1.6% to 0.7% and in 2020 from 1.4% to 1.1%. For Italy, the downgrades are from 0.9% to -0.2% and for 2019 and for 2020 from 0.9% to 0.5%. Given the amount of monetary stimulus in the eurozone, notwithstanding the fact that the ECB's quantitative easing wound down in 2018, these figures suggest deep rooted problems in the area. The weakness in Germany can be partly explained by the particular problems of the auto industry but structural problems are quite evident in the eurozone. That current levels of growth can only be achieved with a very extreme monetary policy in operation, is a concern. Economic rigidities and lack of reform are a given in the eurozone and these factors influence the potential economic growth rates of these economies. The euro was meant to lead to economic convergence in the eurozone, instead it has led to divergence. The euro itself has created a major problem as the eurozone is not an optimal currency area and the one size fits all monetary policy is highly inappropriate in these circumstances. It has led to large imbalances within the eurozone which hamper demand. The eurozone runs a current account surplus of 3.5% of GDP and, within that, Germany runs a surplus of 7.5% and the Netherlands 10.3%. Were those surpluses lower, demand would be boosted elsewhere in the eurozone helping to balance out the situation. As it is, the euro is at a very competitive level for Germany and the Netherlands and at an uncompetitive level for the weaker members of the area. A further problem is the weakness of parts of the banking sector in countries like Italy and Germany with its well publicised issues. If the banking sector is weak, the ability to make loans is more limited.

Whilst the euro is a political rather than a sound economic project, one wonders if it can survive another recession given that it is only managing an anaemic growth rate with zero interest rates. The end of quantitative easing by the ECB coincided with a downturn in the economic fortunes of the eurozone. Interest rates can hardly be cut given where they are and the resumption of ECB asset buying as opposed to reinvesting the proceeds of maturing securities would surely meet opposition from the Bundesbank. What the ECB has done is to launch a new series of quarterly targeted, longer term, refinancing arrangements (TLTRO-III) starting in September 2019 and ending in March 2021, each with a maturity of two years, to encourage lending.

Whilst the downturn in Germany is unhelpful, it is such a strong economy that it is not a major concern for investors, other than the ripple effects from this weakness, but Italy and, to a lesser extent, France are. The stand off between the EU and the coalition government in Italy has ended in a fragile truce,

but Italy's projected and agreed budget deficit of 2.04% in 2019 was predicated on a government growth forecast of 1% for 2019 down from the earlier forecast of 1.5%. If the OECD's projections are anyway near correct, this target is not going to be reached. With Italy's outstanding public debt as a percentage of GDP at over 130% any further deterioration in its budgetary position, will challenge the ECB's rules outlined in the Stability and Growth Pact. Investors worry about the doom loop between Italy's sovereign debt and its banks, which are large holders of government debt. A deterioration in the value of this debt affects the Italian bank's capital ratios and their ability to lend, whilst other eurozone countries' banks are large holders of Italian government debt.

When the Federal Reserve abruptly changed course in January, it will certainly have taken into account what was happening in the eurozone, where this weakness was becoming apparent, even though the US economy was continuing to perform well. With the Federal Reserve being the central bank which was most aggressive in tightening monetary policy, with nine increases in the current tightening cycle, a change of heart there (the two increases this year which were generally expected are not now considered likely to happen) means that one of the negative issues which affected markets in the final quarter of 2019 can probably be parked from this year by investors. To be clear, whilst the extreme monetary policy which has been supporting markets since the financial crisis is likely to continue to be supportive for asset prices, it is a highly undesirable long term policy because of all the distortions it introduces into the world economy. The second specific concern at the end of 2018 was the USA/China trade stand off, and this has still not been resolved although the movement in markets in the first quarter suggests that investors are feeling more optimistic about the outcome. Whether or not that optimism is justified, we shall see, but nothing in the present situation justifies selling shares on the basis that the talks are going to fail. Whilst the politicians are unpredictable, a rational person would conclude that it is in neither party's interest to indulge in a trade war. President Trump is facing re-election next year and will want a strong economy since that will give him the best chance of being re-elected. President Xi, having accumulated such power for himself, will need to show that the Chinese economy is performing well since, if it is not, it is he who will face the criticism.

A more local issue is Brexit, although it is important to note that, in an international context, it is not a major issue. Here, of course, it is and has led to a major constitutional crisis, the resolution of which is uncertain. It is so hard to know what the outcome will be and what collateral issues will arise. Our view is that, whilst Brexit may or may not be a good move, if it were to lead to the collapse of the government and a General Election which could lead to a government with, by UK standards, extreme policies, the UK stock market and sterling would suffer significantly. Our policy on this risk remains unchanged, which is to have significant overseas exposure in client portfolios. This we always do, but it is more important than ever to diversify the risk at a time of extraordinary uncertainty in the UK. The possible political repercussions appear to be the reason why foreign investors have been de-emphasising the UK. This is unfortunate because, absent this significant risk, the UK looks one of the more attractive stock markets.

Whilst the UK is the fifth largest economy in the world, it is dwarfed by the second largest economy, China, so what happens there is far more important in an international investment context. China has had to adjust its economic policy in the face of the tariffs which the USA has so far introduced. As we note, the OECD has slightly reduced its forecast for Chinese economic growth to 6.2% this year which compares with its November forecast of 6.3% and an outcome of 6.6% for 2018. Prior to the trade dispute with the USA, Chinese economic policy had been centred around trying to deleverage the economy and reducing the size of the shadow banking sector. Whilst Chinese government debt as a percentage of GDP is fairly modest by international standards at around 48% of GDP, overall debt in China, is around 300% of GDP, a level which the Chinese authorities wanted to reduce to mitigate risks to the banking sector and, by extension, the Chinese economy. However, the authorities' attempts to deleverage the economy have been set back by the necessity of taking measures to offset the risks caused by the trade stand off with the USA. In the area of monetary policy, China's central bank has reduced the banks' reserve requirements freeing up the equivalent of about US$116 billion. On the fiscal front, China's number two leader, Li Keqiang, announced in March that China would aim to

deliver the equivalent of about US$298 billion of cuts in taxes and other fees. VAT for transportation and construction sectors will be cut from 10% to 9% and VAT for manufacturers will fall from 16% to 13%. The military budget will be increased by 7.5%. Whilst the easing of monetary policy is a short term measure to offset the economic slowdown, it goes against its medium term (and would have been shorter term) objective of deleveraging the economy and reining in the shadow banking sector. The fact that these measures have been necessary because of the danger caused by the US tariffs means that there is pressure on China to come to some sort of agreement with the USA. Its hand is weakened by the huge trade imbalance with the USA.

There are many indicators of a country's economic position at any particular point and one which is highly regarded as taking the pulse of an economy is the purchasing managers index, one we often refer to in these reviews. If we look at the various indices for the USA, we see that they are relatively strong, albeit off the best levels. The latest manufacturing index stands at 55.3, whilst the non manufacturing index stands at 56.1. Both these figures suggest decent economic growth, albeit at not quite the rate of last year when the US economy grew overall by 2.9%. The eurozone, however, tells a different story. The latest composite index stands at 51.6, suggesting weak growth. Within that, the services sector index stands at 53.2, whilst the manufacturing sector indices show economic contraction with a reading of 47.6. The services sector is the more important one representing about two thirds of eurozone GDP. The index levels for Germany are startling. Whilst the services sector is satisfactorily in positive territory with a reading of 55.4, the famed German manufacturing sector is heavily into recession territory at 44.1. Manufacturing represents just over a quarter of German GDP. The composite index stands at 51.4. The PMIs for France are unreservedly poor. The composite index stands at 48.9, the manufacturing index at 49.7 and the services index at 48.1. In the UK, the latest figures are neutral suggesting no growth. The composite index stands at 50.0, the manufacturing index at 55.1 and the services index at 48.9. In Japan, too, where the OECD has downgraded its forecasts to 0.8% growth this year, the index levels suggest hardly any growth. The latest composite index stands at 50.4, that for manufacturing at 49.2 and that for services at 52.0. For China, the manufacturing index stands at a very weak 49.2. Manufacturing represents about 40% of Chinese GDP. The non-manufacturing sector index stood at 54.8. In other data, employment remains buoyant in the USA and UK but, although better than it was, weak in the eurozone.

This snapshot gives a picture of where various countries and regions stand in terms of economic activity and it chimes in with the absolute level and direction of the OECD's latest projections. As always, there are negative and positive influences which could affect the markets and investors have to make a balance of judgement of the potential risks and rewards. Potential negative influences on markets include the risk of a trade war between the USA and China and increased protectionism which would slow down world trade and economic growth with adverse implications for company profits and dividends. With some countries and companies overleveraged, an economic slowdown, or recession in the worst case, could raise credit risks and cause concerns for the banks in a number of countries, perhaps particularly in Europe. We have discussed the eurozone above and this is where the most obvious potential problems lie. An economic slowdown or recession would adversely affect countries' budgets and borrowing levels and could lead to a loss of confidence and a potential doom loop. When looking at the minuscule yields, or lack of them, on eurozone government bonds and the risks involved with some of them, there is no margin for error. Then there is China. If, for any reason, and a trade war is obviously one, the Chinese economy slows down more than expected, it will have collateral effects on growth on its Asian neighbours and further afield. The effect on corporate earnings of a slowdown in the world economy could also cause investors disappointment. For example, even in an economy like that of the USA, which is performing well, the latest estimate for Q1 earnings is a decline of 3.7% year on year and, if that happens, it would, according to Factset, be the first year on year quarterly decline in earnings since Q2 2016. The UK has its own obvious political dangers which we have discussed but, given the international spread of our clients' portfolios, it is not likely to be a major concern looking at the world investment picture as a whole. Any of the political problems which are apparent in the world, like North Korea for example, could become major issues at any time. But there are always concerns and, if one was unduly influenced by those, one might never invest and therefore experience

significant opportunity costs. Looking at positive factors, what investors should take into account is that, notwithstanding weaker growth prospects, it is unlikely that the world economy will experience a recession, so profits should not collapse. Importantly, as we emphasised earlier, the quite dramatic change in the interest rate outlook, as evidenced by the Federal Reserve's change of policy in January, should be supportive of equities even against a dull economic background. Relative yield attractions have been enhanced. We do not believe, therefore, that we should alter our view that equities remain the most attractive asset class, even though it would be wrong to expect more than a modest period of growth until a resolution of some of the present concerns becomes clearer. Whilst the first quarter of 2019 has witnessed strong returns, they are, in effect, reversing a weak final quarter of 2018. Modest but uneven growth in equity values is our best estimate for the rest of 2019 on the information currently available to us. Although bonds have performed well this quarter, we find it very difficult to make any investment case given the minuscule level of yields. For sterling based investors, the message in the very uncertain and high risk political climate in the UK is to emphasise geographical diversification to minimise the risks from the political fall out from Brexit.

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