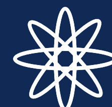

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ASSET MANAGEMENT (C.I.) LIMITED

INVESTMENT MEMORANDUM

International equities have broadly held and even advanced a little on the gains made in 2020, which has to be a satisfactory result against a very difficult economic background, even though the reason for the performance is not of the best quality, driven as it has been by very loose monetary and, now, fiscal policy. On the other hand, the bond markets endured a poor quarter, not surprising given the extreme overvaluation of that market. Sterling performed well as investors re-evaluated the UK's economic position post Brexit and with an apparently good start to the vaccination programme which should herald better economic prospects. Gold had a poor quarter.

The tables below detail relevant movements in markets :

International Equities 31.12.20 - 31.03.21

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	+4.7	+2.3	+3.3	+7.5
Finland	+6.4	+1.3	+2.2	+6.4
France	+8.6	+3.4	+4.4	+8.6
Germany	+8.4	+3.1	+4.1	+8.4
Hong Kong, China	+7.9	+6.6	+7.6	+12.0
Italy	+11.1	+5.7	+6.7	+11.1
Japan	+9.3	+1.2	+2.1	+6.3
Netherlands	+16.1	+10.5	+11.5	+16.1
Spain	+5.6	+0.5	+1.5	+5.6
Switzerland	+4.9	-2.4	-1.5	+2.6
UK	+5.1	+5.1	+6.1	+10.4
USA	+5.6	+4.7	+5.6	+10.0
All World Europe ex UK	+8.2	+2.5	+3.5	+7.7
All World Asia Pacific ex Japan	+4.4	+2.1	+3.0	+7.3
All World Asia Pacific	+6.0	+1.8	+2.8	+7.0
All World Latin America	+1.2	-5.9	-5.0	-1.1
All World All Emerging Markets	+4.1	+1.9	+2.8	+7.0
All World	+6.2	+3.9	+4.8	+9.1

Source : FTSE All World Indices

FTSE UK Government Securities Index All Stocks (total return) : -7.2%

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

Currency	31.12.20	31.03.21
Sterling	0.19	0.84
US Dollar	0.91	1.74
Yen	0.01	0.09
Germany (Euro)	-0.52	-0.29

Sterling's performance during the quarter ending 31.03.21 (%)

Currency	Quarter Ending 31.03.21
US Dollar	+0.8
Canadian Dollar	-0.4
Yen	+8.2
Euro	+5.1
Swiss Franc	+7.6
Australian Dollar	+2.1

Other currency movements during the quarter ending 31.03.21 (%)

Currency	Quarter Ending 31.03.21
US Dollar / Canadian Dollar	-1.2
US Dollar / Yen	+7.2
US Dollar / Euro	+4.0
Swiss Franc / Euro	-2.2
Euro / Yen	+3.1

Significant Commodities (US dollar terms) 31.12.20 - 31.03.21 (%)

Currency	Quarter Ending 31.03.21
Oil	+24.4
Gold	-10.8

MARKETS

International equity markets have trended slightly higher in the first quarter of 2021, with the gains which occurred after the Q2 2020 nadir having been consolidated.

Looking at international equity markets first, the total return in the first quarter on the FTSE All World Index in local currency terms was +6.2%, in sterling terms +3.9%, in US dollar terms +4.8% and, in euro terms, +9.1%. In local currency terms, none of the indices on the table at the front of this review showed a negative return. The strongest regional returns were from the FTSE All World Europe ex UK Index (+8.2%) and the lowest return was from the FTSE All World Latin America Index which returned +1.2%. However, in sterling adjusted terms, the picture changes. The best performances in the most significant markets came from the FTSE UK Index (+5.1%) and the FTSE USA Index (+4.7%), whilst, at the other end of the scale, the FTSE All World Latin America moved into negative territory (-5.9%) and the FTSE All World Europe ex UK Index moved to an underperforming position (+2.5%).

The feature of the quarter was the weakness in international bond markets, not unexpected given the market's serious overvaluation. Taking ten year government bonds as the benchmark, the gross redemption yield on the ten year UK gilt rose by 65 basis points to 0.84%, on the US Treasury bond by 83 basis points to 1.74%, on the Japanese Government bond by 8 basis points to 0.09% and on the German Bund by 23 basis points to -0.29%. Although these yields are still very low, or negative, in absolute terms, the moves were large and meant significant negative returns, especially as one moves along the yield curve.

As implied above by the changes in local currency and sterling based performances of different equity markets, there were some significant currency movements over the quarter with the Canadian dollar and sterling being the strongest currencies, the Canadian dollar because of commodity prices and sterling post Brexit and its successful start to the vaccination campaign and the promise which this brings for early economic recovery. Whilst sterling fell against the Canadian dollar by 0.4%, it rose against a very weak yen by 8.2%, against the Swiss Franc by 7.6%, against the euro by 5.1%, against the Australian dollar by 2.1% and against the US dollar by 0.8%.

In generally firm commodity markets, oil rose by 24.4%, but gold fell back by 10.8%.

ECONOMICS

In the end, 2020, turned out to be a satisfactory year for investors and that could be said to be an understatement when considered against the background of the severe coronavirus induced recession which played havoc with so many economies. Investors, after a ghastly first quarter in 2020, enjoyed the benefits of extremely loose monetary policy, manifested in very low or negative interest rates and huge amounts of quantitative easing (QE) which leaked into asset prices. Now, although the returns made in 2020 have been consolidated in the first quarter of 2021, more questions are being asked about the course of economic policy in 2021 and beyond as investors look past the immediate economic problems.

The first quarter of 2021 was positively influenced by the successful trials, announced in November, of three vaccines which held out the prospect of economic recovery in 2021 and there has been further good news on the vaccination front since. Markets look ahead rather than at the present, so, whilst the economic background last November was grim, it was possible to see light at the end of the tunnel. Now, however, the outlook is more nuanced, with a mixed picture on the vaccination programme. With countries like Israel, the USA and UK well advanced with the roll out, the EU is not performing well, threatening further lockdowns and economic damage to the area, and the effects will be seen outside the eurozone.

Before we go further, we have the benefit of the latest OECD Economic Outlook, published in March. With so much uncertainty about the course of the pandemic, economic forecasts can soon become out of date, but they do have the value of reflecting the different stages of economic recovery, or otherwise, resulting from the progress of the vaccination roll outs and, by extension, the underlying economic prospects for different countries and regions.

The OECD has become more optimistic about economic prospects since last December, the time of its previous Economic Outlook. It now expects world economic growth to be 5.6% this year, an increase of 1.4% over its forecast then. This compares with an estimated world economic contraction of 3.4% in 2020. The OECD has also raised its projection for 2022 to 4.0%, a 0.3% increase compared to last December. So where has this quite considerable increase in forecast come from? The answer lies mostly from the USA where, on the back of the latest extra US$1.9 trillion stimulus, the OECD has raised its forecast for this year's economic growth by 3.3% to 6.5% and, for 2022, it now projects growth of 4.0%, 0.5% higher than last December. The growth rate for the eurozone has only been raised modestly by 0.3% for this year to 3.9% and by 0.5% to 3.8% for next year. The slow pace of the vaccination programme and quite high possibility of a third wave of the pandemic later this year has put a dampener on prospects. Within the eurozone, Germany's growth forecast is quite modest this year, an increase of just 0.2% to 3.0%. This partly reflects the better than average economic performance in 2020, when the economy shrank by just 5.3% against 6.8% for the eurozone as a whole. In 2022, it is expected to be more in line with the average for the eurozone area at 3.7%, an uplift of 0.4% on December's projection. For this year, France (5.9%), Italy (4.1%) and Spain (5.7%) are expected to grow more quickly but this is against much worse performances than Germany in 2020. Elsewhere, the UK, reflecting its success up to now in rolling out its vaccination programme, has seen the OECD raise its forecast by 0.9% to 5.1% for 2021 and by 0.6% to 4.7% for 2022. It is also worth noting that Australia, with commodity prices currently strong, has seen a significant upgrade in the OECD's forecast for this year by 1.3% to 4.5%. Japan's growth is forecast to be 2.7% this year, up 0.4% from the OECD's December forecast. The only major economy to grow in 2020 was China, at 2.3%. The OECD has actually slightly reduced its forecast for China this year, by 0.2% to 7.8% and has left it unchanged at 4.9% for 2022. India, where the forecasts are for the fiscal year which begins in April, is expected to recover from negative growth of 7.4% in 2020 to 12.6% in the coming year, an upgrade of 4.7% with 5.4% projected for the following year, an upgrade of 0.6%.

Any forecasts made now must have more qualifications than usual, simply because of the enormous uncertainty surrounding the development of the pandemic. On the positive side, the evidence suggests that companies and economies are beginning to work round the pandemic, now that they have more experience of it, so that the damage is not as great as when most lockdowns started last March. Also, for those fortunate enough to have retained their income, a burst of spending is likely. Savings ratios have risen very sharply, so economic rebounds could be quite sharp as this pent up spending is released. It is self evident that countries which have had early successes with their vaccination programmes will recover more quickly than those which have fallen behind and have had to delay the gradual reopening of their economies. Many companies' profits, especially in the USA, seem to have held up well and dividends there have been robust, given the economic background, with a number of large companies raising their dividends and continuing with share buybacks. The situation has not been as good in the UK and Europe. Overall, though, there is a much calmer atmosphere in markets now than a year ago when the world economy was plunged into a crisis of which it had no previous experience. Apart from

a recovery in share prices, volatility, which reached alarming levels a year ago, has become much less severe.

However, investors who have fared generally well during the pandemic, as evidenced by movements in stock markets, have to be fully aware of the immense economic damage unleashed by the pandemic and try to consider the consequences when structuring their investment policy. As the first quarter of 2021 progressed, there was much more evidence of this damage, particularly in the area of government finances and how central banks and governments plan to deal with the current problems that the pandemic has caused and the implications for future economic prospects.

As our table at the beginning of this review shows, there has been a sharp rise in bond yields, albeit that they remain at extraordinarily low levels. With quantitative easing through central bank bond purchases still continuing apace in the secondary market, there is an important backstop to the market. Price signalling has been suppressed by QE and the yields on fixed interest securities do not reflect a normal situation. For example, no one would ever have contemplated negative yields on government bonds in a situation where the supply/demand position was not as distorted by QE as it is now. But, although fixed interest yields are a long way from reality, glimpses of price signalling have been appearing during the quarter, as the sharp rise in yields has shown. The primary cause of this is fears about inflation. We have discussed in previous reviews how central banks' balance sheets have exploded in size as a result of QE. Since the beginning of 2020, the US Federal Reserve's balance sheet has grown by approximately 85%, that of the ECB by approximately 70% and that of the Bank of Japan by approximately 30%, whilst that of the People's Bank of China has grown much more modestly, by around 9%. Whilst the Bank of Japan's balance sheet has grown by less than those of the Federal Reserve or ECB, as a percentage of GDP it is much larger, at around 127% of GDP, a truly staggering level. One of the reasons for the jitters in the bond markets during the quarter, which led to the big increase in yields, was this fear of inflation. With the more encouraging vaccine news, notwithstanding the current problems in some countries, the fear amongst some investors is that the newly created reserves could move around the world economies much more quickly and, given that the supply chain has been adversely affected by the pandemic, cause shortages which would raise prices. There have been early signals of inflationary stirrings in the commodities markets. For example, the S & P GSCI Commodity Index is up around 13% in sterling terms over the first quarter and, year on year, around 64% in sterling terms and 83% in US dollar terms. At the end of the quarter, prices came off quite sharply, perhaps as a result of second thoughts about how quickly the world economy will recover this year in the light of the vaccination programme problems in some countries. Nevertheless, in those countries which are leading the way in the vaccination programme and, therefore, may re-open their economies earlier, there must be substantial pent up demand for goods and services and it would not be a surprise if inflation picked up.

The danger, which some investors and economists fear, is that, perhaps, especially in the USA, too much stimulus is being given at a time when the economy may be turning. The huge additional stimulus being given to the US economy, which is recovering quite well, could mean that it is a strongly pro-cyclical move and more than is needed, leading in time to excessive demand and to a pick up in inflation. The Federal Reserve has already moved the target on inflation, so that its absolute level of 2% inflation now becomes an average of 2% inflation, meaning that, because inflation has been below target, it can tolerate inflation going above 2% because its recent average would be below that level. In the real world, it is very unlikely that the market would buy this argument if the absolute level of inflation went much above 2%, since the past is irrelevant. By this time, it would be quite possible that the inflationary genie has escaped from the bottle and would be difficult to put back in without severe monetary measures, like a big hike in interest rates or a reversal of QE leading to a worse growth outcome. Fiscal measures could also be needed. This seems a realistic fear for bond markets. In economic policy terms, it is possible to miss turning points which, with the benefit of hindsight, have already occurred, so the economic data coming out of the USA will be particularly important in this context.

Whilst central banks can control short term interest rates, they have much less ability to control rates beyond that time horizon. One possibility is yield control, where the central bank buys or sells fixed interest securities to keep the yield at a certain level. This is an open ended commitment so, for example, if a central bank, and the Japanese one has operated yield control, wants to stop yields from rising, it has to keep buying government bonds to try to suppress the yield level. This risks a ballooning balance sheet. It is a reasonable assumption to expect interest rates to rise at some stage, although perhaps not back to where they used to be, but, if this happens, there are implications for the rising cost of servicing a government's debt, with its negative effect on a country's budget deficit. Because of ultra low, or negative, interest rates, the full cost of taking on so much government debt internationally has not been fully apparent, given the initially low servicing costs, but this is just a problem deferred. According to the Economist Intelligence Unit's forecasts for budget deficits in 2021, that for the USA will be 10.0% of GDP, for the euro area 5.9%, for Japan 9.0% and for the UK 11.5%. Within the euro area, the forecasts for some of the heavily borrowed countries are particularly high, with France at 7.5%, Italy at 8.0% and Spain at 8.5%. There are several issues within the eurozone which could be problematical for the future. Over many years in these reviews, we have indicated our view that the eurozone is not an optimal currency area. The countries within it do not comprise an homogenous group, with widely divergent profiles and national finances. This will provide probably an even bigger challenge than in the Global Financial Crisis (GFC) in 2008. The very aggressive QE tactics of the ECB have, as we mentioned earlier, suppressed price signalling to a major extent. Thus, if we take ten year government bond yields within the eurozone, we see the best eurozone credit, Germany, showing a ten year government bond yield of -0.29% at the end of the quarter, whilst heavily indebted countries, such as Spain (yield 0.34%), Italy (0.67%) and Greece (0.86%), do not suggest the heavy levels of debt which they carry, with the yield premium over Germany also not as large as one would think would normally be required. These are countries with outstanding public debt to GDP ratios well in excess of 100%. The European Commission forecasts debt to peak at 122% of GDP in Spain, 127% in Portugal, 159% in Italy and 194% in Greece, and even these figures could be low if a third wave of the pandemic hits. Especially, if there is a catastrophic third wave of the pandemic, investors will not indefinitely remain unconcerned about these rising debt levels and countries' future ability to service these debts. The Stability and Growth Pact's constraints on the levels of public debt as a percentage of GDP and budget deficit limits as a percentage of GDP cannot possibly be met in the foreseeable future in some of the countries in the euro area. These constraints were originally introduced to support the credibility of the currency. Whilst there is a feeling in some quarters that QE can continue with impunity as long as the economic situation demands it and that it does not matter how big the central banks' balance sheets can grow to, it does matter. For one, if, as we outlined earlier, inflation were to become a problem, later rather than earlier action to suppress it could mean that the reversal of QE would have to be started on a larger scale as central banks sought to drive up interest rates, one of the standard measures taken to try to control inflation. It is only a short time to consider, but the euro has been noticeably weak recently. This could be because the area's economic prospects relative to elsewhere have weakened because of the vaccination rollout problems, but it could also be because investors are wondering how far QE can continue to go when some countries' finances are becoming even more dire. In Germany, where there has long been scepticism about the ECB's bond buying, and the thin line between directly financing governments and buying bonds in the secondary market, some objectors have gone back to the Constitutional Court, as they fear that Germany is on the hook for some very large losses. Any feeling that, because most major governments and areas are persisting with QE, all countries are in this together and, therefore, will not be individually punished, is very dangerous. The eurozone is particularly vulnerable because it is a currency union whose members have vastly different characteristics and financial positions. If one or more countries gets into financial trouble, particularly one of the larger eurozone members, confidence in the whole eurozone may collapse, threatening the euro itself. What would support the eurozone would be complementing a monetary union with a fiscal union where money could be transferred to weaker countries within the union, but it is very difficult to see that being agreed when Germany and others oppose it, and this is a fundamental flaw in the euro. It is true that, last July, the EU agreed a stimulus package worth €750 billion. €390 billion of that will be grants and €360 billion low interest rate loans. Money raised through bonds will be done collectively and not by individual countries and it will be directed to European countries

hardest hit by the pandemic in the form of grants which do not have to be repaid. However, this was not agreed without a good deal of hard bargaining and it represents only a very small step towards a fiscal union. It could also run into problems with the German Constitutional Court. Given the course of the pandemic since this programme was agreed, this sum spread over time looks small and looks increasingly to becoming a symbolic rather than game changing action.

We have spent some time discussing what might happen if there was to be a loss of confidence in a particular country or currency as a result of the economic problems caused by the pandemic. One way of maintaining confidence is to plot a path out of the present economic crisis which, crucially, addresses the issue of future action to restore public finances. It is in this context that the recent UK Budget was interesting. Having been badly affected in 2020 when the economy contracted by 9.9%, one of the worst performances amongst the G20 nations, the UK is poised to recover this year, not at the rate of the USA, but better than that of the eurozone and Japan as a result of the success so far of the vaccination programme. The immediate focus of the Budget was to support the economy through its present difficulties but, after that, to concentrate on starting to repair the UK's public finances. Clearly, no government is wanting to take measures now which will damage economic recovery, for it is that which will help to repair public finances as the tax take improves and certain items of emergency government spending fall away. But, after the shocking hit to public finances arising from the pandemic, economic recovery alone will not provide the revenue to plug the hole. So, in the UK, from the 2022/23 UK tax year, personal allowances and higher rate thresholds will be frozen for four years, and, from the following tax year, 2023/24, Corporation Tax will rise to 25% from 19%. It is a very difficult balancing act for the Chancellor to make. On the one hand, it is essential not to do anything which will destabilise the economic recovery but, on the other, not to play fast and loose with public finances which could cause a loss of confidence in sterling, with far greater negative knock on effects than the proposed tax rises. At this stage, the balance between the two imperatives sounds reasonable. It is, however, interesting that the UK seems the furthest advanced at looking ahead at the need to address the damage caused to public finances. It is also interesting to note the strength of sterling over the quarter as, post Brexit and an improvement in the economic outlook, a more positive view of the UK seems to be being taken.

We think it correct to concentrate on the immediate general issues arising from the pandemic, given their almost universal relevance and, as mentioned above, more specific issues in the UK because of its move to the next stage of the economic consequences of the pandemic, namely the start of measures to restore public finances. In normal times, we would be discussing the main markets and regions, with the USA, of course, looming large. It is early in President Biden's term and the main event has been the US$1.9 trillion stimulus package, representing about 9% of GDP, which the stock market has liked as Wall Street has powered to new highs. More spending is to come on infrastructure with higher company and personal taxation rates being planned to pay for this, something that Wall Street may not like as much. However, the point we want to make here, and which we touched upon earlier, was whether this is overkill in the context of an improving US economy which may ignite inflation. The bond market is certainly uneasy. In future reviews, we will probably be talking about events which the US stock market will like less, such as the President's proposals to raise company taxation and taxes on the better off, as just mentioned. Whereas in the UK, the Chancellor would have been reluctant to raise taxes on ideological grounds, but felt he had no choice if there was to be a serious attempt to start repair work on the UK's public finances, in the USA the new Administration is ideologically in favour of raising taxes on companies and wealthy individuals and this fits in with the need to finance its big infrastructure programme.

One noticeable trend arising from the positive vaccine news last November, with its promise of accelerating an economic recovery, was the resurrection of interest in value stocks after a long period of underperformance against growth stocks, the argument being that value stocks' earnings had been badly hit by the lockdowns, whilst those of growth stocks had been much less, or not at all, affected and now there was the prospect of a sharp recovery in earnings from value stocks. If interest rates rise and, as we see, they have done in the bond market, then stocks, like technology stocks, for example, with

little or no yield, would become less attractive than value stocks which, even after last year's dividend cuts, offer a better yield. In practice, we would have both types of stocks in our portfolios, since we would not take an extreme position in either style, but, as we look at the list of best performing stocks for this quarter, the top performers contain many value stocks. Notwithstanding the rise in bond yields along the maturity curve, shares tend to yield more than bonds, except in the US market. Of course, the US market, being by far the largest, is very important and the strength of Wall Street and weakness in the bond markets has meant that the ten year US Treasury bond yield has now risen above the yield on the S & P 500 Index, but not by much, and one has the expectation that US dividends will continue to grow over time. At the moment, this yield relationship should not be a problem. Whether or not the recent relative recovery in value stocks is anything but a short term trend is difficult to tell, but our investment view is not to take an extreme position in either style but to have a mixture, but with the growth stocks being well established companies in their field.

One of the now famous sayings by James Carville, who was President Clinton's advisor in the 1990's, was, to paraphrase, that, if there was a reincarnation, he would like to come back as the bond market because it can intimidate everybody. In the current environment, one can see what he means. Although the stock market has had a steady quarter, there were one or two bouts of equity nervousness when there was a spike in bond yields. On fundamentals, the bond market is significantly overvalued, with yields suppressed by vast amounts of QE. The latter policy is expected to continue, but increases in the size of central banks' balance sheets cannot continue indefinitely. There is always the chance of an accident in the markets, for instance, the loss of confidence in a major currency. It is important that central banks signal their intentions on interest rates very carefully so that there is no repeat of 2013's "taper tantrum". The greatest danger to equities, which are still our long term preferred asset, is the bond market, given how far from reality are yields on bonds. Bonds remain very unattractive, except at the shortest end, and the further out along the yield curve one travels, the greater the risk. For example, the 30 year UK gilt has returned -15.7% in the first quarter, so sensitive is it to the movement in interest rates. Unlike equities, the losses may never be recovered unless the bond is held to maturity and then only on a total return basis, given how many bonds are standing over par.

Economic recovery, when it comes, should continue to support equities and, as always, a well diversified position is essential, not only geographically but between growth and value stocks, as described above. The biggest danger to this view is the bond market and, for this reason, investors must expect some negative quarters against a positive longer term trend for equities. The paradox of a strong equity market and much weakened economies is not an entirely comfortable one, even though it can be explained by very loose monetary policy. The challenge for equity investors is how the transition to more normal interest rates plays out and the recognition that central banks are much less able to influence medium and long dated bond yields.

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