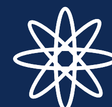

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ASSET MANAGEMENT (C.I.) LIMITED

INVESTMENT MEMORANDUM

Against the background of a scarcely imaginable humanitarian catastrophe, it almost seems indecent to discuss the economic background and its effect on the stock market. That there will be serious economic consequences of the war in Ukraine, there can be no doubt and, in this review, apart from other consequences, we discuss what it might mean for the main asset classes.

The tables below detail relevant movements in markets :

International Equities 31.12.21 - 31.03.22

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	+3.6	+10.1	+7.0	+9.4
Finland	-10.4	-9.8	-12.3	-10.4
France	-6.8	-6.2	-8.8	-6.8
Germany	-10.8	-10.2	-12.7	-10.8
Hong Kong, China	-3.4	-1.0	-3.8	-1.7
Italy	-8.3	-7.7	-10.3	-8.3
Japan	-1.2	-3.5	-6.2	-4.2
Netherlands	-14.6	-14.0	-16.4	-14.6
Spain	-2.1	-1.5	-4.2	-2.1
Switzerland	-5.2	-3.5	-6.2	-4.1
UK	+2.7	+2.7	-0.2	+2.0
USA	-5.2	-2.5	-5.2	-3.1
All World Europe ex UK	-10.3	-9.5	-12.0	-10.0
All World Asia Pacific ex Japan	-4.4	-2.2	-4.9	-2.8
All World Asia Pacific	-3.3	-2.7	-5.4	-3.3
All World Latin America	+12.4	+30.1	+26.5	+29.3
All World All Emerging Markets	-5.5	-2.5	-5.2	-3.1
All World	-4.6	-2.4	-5.1	-3.1

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	31.12.21	31.03.22
Sterling	0.96	1.61
US Dollar	1.51	2.34
Yen	0.06	0.21
Germany (Euro)	-0.19	0.55

Sterling's performance during the quarter ending 31.03.22 (%)

Currency	Quarter Ending 31.03.22
US Dollar	-2.8
Canadian Dollar	-3.9
Yen	+2.8
Euro	-0.1
Swiss Franc	-1.7
Australian Dollar	-5.7

Other currency movements during the quarter ending 31.03.22 (%)

Currency	Quarter Ending 31.03.22
US Dollar / Canadian Dollar	-1.3
US Dollar / Yen	+5.7
US Dollar / Euro	+2.7
Swiss Franc / Euro	+1.5
Euro / Yen	+2.9

Significant Commodities (US dollar terms) 31.12.21 - 31.03.22 (%)

Currency	Quarter Ending 31.03.22
Oil	+38.6
Gold	+5.7

MARKETS

Given the gravity of the international situation, international equity markets held up well during the quarter. In local currency terms, the FTSE All World Index returned -4.6%, in sterling terms -2.4%, in US dollar terms -5.1% and, in euro terms, -3.1%. Looking at local currency returns first, the most remarkable performance was seen in Latin America. The FTSE All World Latin America Index returned +12.4%. Australia and the UK were the other two markets to show positive returns, with the FTSE Australia Index returning +3.6% and the FTSE UK Index +2.7%. Perhaps not surprisingly, the worst performance was seen in the FTSE All World Europe ex UK Index, which returned -10.3%. Looking at sterling adjusted returns, the performance of Latin America was even more startling. Not only did the strength of commodities push the index higher in local currency terms, the currencies did also, which led to the FTSE All World Latin America Index returning +30.1% in sterling terms. The strength of commodity prices also pushed up the value of the Australian dollar to leave the FTSE Australia Index showing a return of +10.1%. In sterling terms, the FTSE USA Index showed a return almost exactly in line with the FTSE All World Index, -2.5% against -2.4%.

International bond markets fared poorly over the first quarter as fears of rising interest rates on the back of rising inflation brought some sense of reality to a market which was very expensive and still is. Taking ten year government bond yields as a benchmark, the gross redemption yield on the UK Government Bond rose by 65 basis points to 1.61%, on the US Treasury by 83 basis points to 2.34%, on the Japanese Government Bond by 15 basis points to 0.21% and on the German Bund by 74 basis points to 0.55%, thereby moving yields out of negative territory.

In the foreign exchange market, the two commodity currencies were the outstanding performers. Against the Australian dollar, sterling fell by 5.7% and against the Canadian dollar by 3.9%. It fell against the US dollar by 2.8%, against the Swiss Franc by 1.7% and against the euro by 0.1%. Against a very weak yen, it rose by 2.8%.

The invasion of Ukraine by Russia caused a sharp rise in many commodity prices. Oil, for example, as measured by Brent crude, rose by 38.6% over the quarter. Gold moved modestly higher, by 5.7%, although supporters of gold might have been slightly disappointed that it was not stronger, given its reputation as a store of value in troubled times.

ECONOMICS

It is hard to write about economics and the stock market in the context of an unimaginable humanitarian catastrophe unfolding in Ukraine following the Russian attack on the country. Everything else seems secondary. Nevertheless, whilst the suffering of the Ukrainian people is the most shocking and immediate issue, the economic effects will be felt worldwide and they will not be good. Furthermore, they may well last a long time. It is hard to find anything good to say in the current situation, except perhaps that it will bring the West closer together.

Whilst the equity markets have recovered some of their poise towards the end of the quarter and perhaps surprised many people with their resilience, the bond markets have experienced a significant

fall. Coming into 2022, before the Russian attack on Ukraine, investors' main concerns surrounded inflation and interest rates. It was becoming clear that central banks had misjudged the inflation risks in the world economy and that they were going to have to start reversing their extraordinarily loose monetary policy in terms of interest rate rises and throttling back on quantitative easing (QE) or moving on to quantitative tightening (QT). This was not a good background for fixed interest securities, which, in our view, as we have repeatedly said, were seriously and dangerously overvalued, and the question was how equities, after another positive year in 2021, would hold up.

This all changed at the end of February when Russia invaded Ukraine. Suddenly, what seemed to be important economic issues paled into insignificance against the background of the shock of the invasion but, as the weeks have passed, and not downplaying the desperate humanitarian position, the economic consequences have started to loom larger and they will be felt worldwide.

There are two very obvious and immediate economic consequences. Firstly, inflation will increase. Whilst Russia's economic dependence on energy exports is both a strength and a weakness, a strength in that many countries, Germany, for example, import a lot of gas from Russia and therefore would prefer to remain close to it, the banning or scaling down of Russian energy imports will have a serious effect on Russia as it seeks hard currency, but it will also tighten energy supplies and hence the cost of it. Energy costs are the biggest single political issue in most countries just now. The energy taps cannot just be turned on. Food prices, already rising significantly, are likely to rise further. Russia and Ukraine are huge suppliers of wheat and, even if sanctions stopped now, the damage will be done. All consumers are aware of rising petrol and food prices as well as many other items and this position will get worse. At the time of writing, year on year consumer price inflation is 7.9% in the USA, 6.2% in the UK, 5.1% in Germany, 3.6% in France, 5.7% in Italy, 0.8% in Japan and 5.7% in Canada, to give the levels for the G7 countries. The position is going to worsen leading to a very large fall in living standards. Supply chains have already been badly disrupted by Covid-19 which has been one reason behind the pre-invasion spike in prices. Globalisation, in theory a very good benefit, as it enables consumers to benefit from lower prices as goods and services are sourced from the countries which have a competitive advantage in the relevant areas, has suffered a setback in recent years. The argument between the USA and China has become more bitter as the USA imposed tariffs on certain US imports from China. Covid shut down and continues to shut down a lot of manufacturing capacity in China which follows a zero Covid policy. Since China is a vital source of many components for goods manufactured elsewhere, disruption has led to cost increases as companies search out other suppliers. Shipping costs have also increased substantially as Covid led to ships being out of position. Now, as a result of the Russian invasion, vast supplies of vital crops, such as wheat, have been curtailed, leading to the prospect of scarcity of supplies and shop price increases. So, basic foodstuffs like bread are bound to rise in price sharply. The energy taps cannot just be turned on so it will take time for supply to adapt to the attraction of higher prices. Energy prices are likely to remain a long term problem, not helped by some very erratic policy making on energy around the world. Wages are very unlikely to be able to catch up with price rises therefore leading to a big fall in the standard of living of many people. In turn, growth projections made at the beginning of 2022 are likely now to be optimistic. In March, the OECD estimated that global growth could be more than 1% lower because of the war and inflation 2.5% higher. Rising inflation and reduced economic growth point to the possibility of a period of "stagflation", a state of affairs which economists regard as a very bad place in which to be. In the usual meaning, it would involve a mixture of high inflation, little or no growth and high unemployment, although the latter has not yet manifested itself.

These are the obvious short term effects, namely rising inflation and lower economic growth, but there will be many longer term ones, some of which are clear and others which will reveal themselves later on. Obvious ones are the search for alternative energy supplies. Countries like Germany, which had an above average dependence on Russia stand out. Increased defence spending is a certainty. Europe has had a big wake up call and the abrupt about turn by Germany on defence spending is a case in point. This is reflected in the performance of defence stocks. We talked about the benefits of globalisation earlier on and, in a perfect world, where countries live together harmoniously, everyone

would benefit from competitive prices and an enhanced standard of living. But, of course, this is now fantasy land economics and there will be a move to what is now being termed "deglobalisation". By this, we mean that countries and companies will place a premium on security of supply and, whilst this is not likely to be the lowest cost and most efficient option, it may prove to be the safest in terms of business certainty. Companies had already had a major supply chain shock with Covid and the invasion of Ukraine has amplified the shock. As second order effects become apparent, we will no doubt be writing about them. There will be many, some of which will only become apparent later on.

But, for now, we will concentrate on the short term economic effects and what the implications are for markets. It goes without saying that the economic outlook is very poor and the level of uncertainty very high. That, however, is not the same thing as saying that the outlook for the stock market is bad. Given the magnitude of what has happened, it is remarkable how little equity markets have moved over the quarter. There will be a number of reasons for this, but one may relate back to the situation two years ago when the Covid-19 pandemic broke out causing an immediate very sharp drop in markets only for them to recover and move ahead to record levels. Investors might regard this as a precedent and consider the risks of selling good quality equities too great in view of what subsequently happened.

Let us just look at the implications for bond investors arising from the war. Our reason for being negative on fixed interest securities for a long time before the Ukraine invasion happened was a simple one. Negative real yields, which had prevailed for a considerable time in most countries, could not offer any fundamental value. When gross redemption yields were negative in nominal and real terms, it would be very hard to construct a case for holding these bonds. After all, one does not invest to make a certain loss, which was the case here if the bonds had been held to redemption. Now the negative nominal yields on, say, ten year bonds have disappeared (even in Switzerland and Germany), we can still extend that argument because although the bonds, if held to redemption, can provide an absolute return, they will not be positive returns in real inflation adjusted terms. So, at the time of writing, if we take the ten year US Treasury bond, its gross redemption yield is 2.4%, whilst inflation stands at 7.9%. In the UK, the relevant figures are 1.6% and 6.2% and the relationships will probably deteriorate further. The long term investment objectives for a portfolio should be an appreciation in real terms. The situation is the same almost everywhere else. These minuscule gross redemption yields on fixed interest securities were, of course, a function of monetary policy, as practised by central banks all over the world, both through administered interest rates and Quantitative Easing (QE), whereby central banks bought vast quantities of fixed interest securities in a price insensitive way and created large amounts of bank reserves. By keeping interest rates so low and liquidity plentiful, the objective was to keep economies in working order following the ravages of Covid-19. Central banks are supposed to be completely independent of governments but there has been a belief, especially during Covid, that they are far too close. For example, the constant talk about the spike in inflation being temporary, which was a feature of central banks' narrative, was very welcome to governments as they struggled to support their economies with vast levels of expenditure. This strengthened the view that some central banks, although it was strictly off limits, were effectively financing government expenditure, although they are not allowed to. But, by being active in the secondary markets, buyers of government bonds in the primary market knew that there would be a buyer behind them. As long as inflation remained subdued, central banks could continue with their very loose monetary policy without seemingly being too concerned, even though, for many of us, red flags were flying. We have often written in the past about the explosion in the size of central banks' balance sheets as a result of QE. Since the beginning of 2020, when Covid-19 came to the world's attention, the balance sheet of the Federal Reserve has more than doubled to nearly US$9 trillion and that of the European Central Bank (ECB) has risen by around 80% to just short of US$10 trillion equivalent. The balance sheets of the Bank of Japan and the People's Bank of China have shown much smaller increases. The Bank of England's balance sheet increased by around 80% during the same period. Whilst economic activity was subdued as a result of the pandemic, an increase in the velocity of circulation, which could have arisen as a result of higher business and consumer confidence, did not occur, perhaps leading to some complacency by policy makers. But, once confidence increases and banks lend more, economic activity will pick up and, with it, inflationary pressures. So, by the end

of 2021, but before the Russian invasion of Ukraine, the year on year inflation rate in the USA was 7.0%, in the UK 5.4% and, in the eurozone, 5.0%, all well above target levels. For much of 2021, central banks continued to term these high inflation levels as "transitory" on the basis that they were caused by temporary price rises, occasioned by Covid-19 supply chain difficulties. This looked like wishful thinking at the time and just did not feel right, given the evidence around us. Now, of course, with the invasion of Ukraine and the inflationary side effects, which have hardly started except in the energy market, inflation is certainly in the system. We might well see double figure inflation levels in the near future, which makes the yields on bonds more unappealing than ever. In an ideal world, central banks would have looked to have increased interest rates gradually and to do the same with reversing QE, whilst, at the same time, keeping economic growth going. For this to happen, everything would have had to have gone right but, in practice, everything has gone wrong. Obviously, central banks could not have anticipated the Russian invasion of Ukraine, but they were clearly well behind the events last year in failing to address the (to many people) clear inflation risk and find themselves, as economists say, "behind the curve". It meant that, by failing to act earlier to tighten monetary policy, central banks have let inflation get out of their control. With the war in Ukraine, the situation has got even worse. This now means that, irrespective of the damage done to world economic growth by the war, central banks in the USA, UK and eurozone have no option but to tighten monetary policy sooner and more strongly than they would have liked.

The current position is a really difficult one for central banks. Because they failed to change course last year when above target inflation was clearly a threat, they now find themselves caught with a very unwelcome dilemma. If they don't act quickly to raise interest rates and try to quell inflation, it could become embedded in the system by raising inflationary expectations to a new level. Those in work, where they can, will be pressing for higher pay which will be reflected, together with other factors, in higher prices and move them to a level from which they will not retreat. This would be cost push inflation. The other part of the dilemma is that, if central banks do tighten more quickly than they had previously intended, their actions will damage many countries' economic recovery prospects. Our guess is that the inflation danger is the one which will exercise them more because excessive inflation is malign for so many people. Goods and services become much more expensive so purchasing power is reduced, resulting in a serious decline in many people's real incomes leading to spending cutbacks and a negative effect on economic activity. Savings are eroded. Because of this "stagflation" is a real prospect.

As we have noted, a number of central banks have effectively been financing government budget deficits during the Covid-19 pandemic, but now the situation is changing. The war in Ukraine is going to have negative budgetary implications for many governments because of the inflationary consequences and reduced economic activity, compared with pre invasion scenarios. But if, as indicated by central banks, they are going to raise interest rates and pull back on QE, or even go to quantitative tightening (QT) whereby central banks' balance sheets are scaled back as they sell securities purchased during the QE period, the monetary tightening will put further upward pressure on interest rates through the effect on bond markets. It will be administered and market pressure which will force up interest rates.

During the Covid-19 pandemic, the impression, rightly or wrongly, has been gained that normally independent central banks were too close to their finance ministers. This felt especially the case last year when central banks' views seemed to be close to finance ministers' hopes for monetary policy, namely that it would remain very loose so that loose fiscal policy could be accommodated. That has now changed, but one cannot help feeling that it is too late. Central banks have helped the inflationary genie to get out of the bottle.

We think that Europe will face particular problems in this very difficult environment. Apart from the overdependence of countries like Germany on Russian energy resources, the euro faces a particular problem which will grow as interest rates rise. During the pandemic governments everywhere have seen their outstanding public debt as a percentage of GDP rise sharply and in the eurozone some of

the increases have been substantial. From the final quarter of 2019 to the end of the third quarter in 2021, Eurostat indicates that Spain's debt increased by over 25%, Italy's by over 20%, Greece's by 20% and France's by around 19%. During the pandemic, ultra low interest rates and substantial buying of eurozone government bonds by the central bank masked the problems. However, rising interest rates, as we can expect to see over the next few years, will uncover the problems which remained out of view in the environment which we have experienced. For a start, credit quality will rise to the top in investors' considerations. This should always be the case, but the suppression of eurozone government bond yields as a result of the ECB's extremely loose monetary policy has meant that the wide divergence of eurozone countries' credit qualities has not been reflected in relative bond yields. As interest rates rise, raising eurozone members' financing costs and putting pressure on their budgets, investors are bound to want to be rewarded for increased risk much more than they are now, not only in the absolute levels of interest rates but also in the relative levels. The withdrawal, in due course, of central bank QE, allied with rising interest rates, will present particular problems for the eurozone because of the "one size fits all" interest rate policy. The tightening of monetary policy will present the eurozone with a very difficult problem and perhaps explains why the ECB was the most reluctant central bank to change tack on monetary policy.

So, here we are in the first part of 2022 facing high (by recent standards) inflation and large negative real interest rates and major supply problems on the horizon arising from the war in Ukraine, which will most likely make things worse. What does a central bank do? What should governments do? Is there any benefit arising from high inflation? Well, one group benefits and that is borrowers, whether they be governments, companies or individuals. Inflation reduces the real value of their debts which are fixed in nominal terms (except for index linked issues), but high inflation is not going to be popular with electorates. Savers are going to be very unhappy with a fall in the real value of their savings and many households whose earnings are not able to keep up with inflation will suffer a drop in their purchasing power and standard of living. With demand affected, economic growth will suffer and run the risk of a downward spiral in the economy. There will be a lot of losers in this situation and complaints seen in the press about price increases are bound to grow. In our view, the central banks will concentrate on inflation and try to reduce it through much stronger measures which they will take themselves. Stopping inflation from getting out of control will be their main target, even though it is bound to have harmful side effects.

At the moment, equity, if not bond, markets seem to be remarkably sanguine about prospects. After all, if strong monetary measures are taken they will affect economic growth and profits. Some companies will be able to weather the storm, but many will not, and the outlook for profits will be compromised. The early stages of a shift in monetary policy towards monetary tightening through interest rate increases can be good for shares as, in normal circumstances, they would imply a recovery in economic activity and, therefore, profits which should be good for shareholders. But, if central banks raise interest rates to crisis levels, this state of affairs does not apply and, beyond a certain level, equities would normally expect to suffer as well as, of course, bonds.

But these are not normal times and equities have been more resilient than bonds this quarter. One reason might be that investors have become inured to completely unexpected events and have learned that it might not be sensible to react without considering the consequences. Two events in the last fifteen years show this, the global financial crisis fifteen years ago and the Covid-19 pandemic. Both witnessed sharp falls in the stock market and then more substantial recoveries. Whilst it is always comforting to say that, if one sells on bad news one will re-enter the market at a lower price, it is a lucky investor who does this. More likely, confidence will only return once markets have moved higher and well past the level at which the stocks were sold. The flow of dividends will also be interrupted and, especially with very low or non existent interest rates, income will be reduced. The evidence of what has happened since the Russian invasion of Ukraine is, a fall of much lesser magnitude than two years ago when the Covid-19 pandemic started.

As we move past the first week in April, central bankers are becoming more shrill in their statements abut how they plan to start tightening monetary policy. It is clear that they have been well and truly shaken out of their recent complacency and now put the task of curbing inflation above supporting economic growth. In fact, labour markets in a number of countries are becoming tight, with large numbers of unfilled vacancies, no more so than in the USA. Of course, no one, except perhaps President Putin last year, could have expected Russia to invade Ukraine, but the fact remains that central bankers were far too complacent about the dangers of inflation getting out of hand and being "behind the curve" means that they will have to act more forcefully to tighten monetary policy. So, we have a perfect economic storm, high and rising inflation, a severe threat to economic growth occasioned by the attack on Ukraine and the necessity for central banks to act on monetary policy, which could lead to the dreaded economic state of "stagflation".

So, how do investment managers and investors make sense of a situation like this? Should they adjust policy or see it through, aware of significant dangers in terms of opportunity cost of being excessively liquid if markets surprise on the upside. A good starting point is to decide which investments look distinctly unattractive. As we have said earlier in this piece and in many previous reviews, we feel a very high degree of confidence in saying that fixed interest investments are extremely unattractive. The size of negative real yields means, almost certainly, that in most areas they are going to be very bad investments. Why should one want to invest, with the high probability at the outset that the real return, if held to redemption, is going to be significantly negative. Of course, one does not have to hold fixed interest securities until maturity and an investor might feel that they can pass the parcel to another investor prepared to pay a higher price before the music stops, but that is a gamble. One long standing belief in the investment community has been that having bonds in a portfolio reduces volatility and that they are a "safer" investment. This now seems a very dangerous assumption, given the extent of their mispricing as a result of the extreme monetary policy which central banks have been following. The distortions caused have, in our view, upset this view of bonds, perhaps most clearly evidenced in the 60:40 policy between equities and bonds that has, for a long time, been advocated as a sensible balanced portfolio combination.

So, in coming to a decision about how to structure a portfolio in these unprecedented times, it does help to be able to eliminate one of the major asset classes in the absence of a specific mandate to hold bonds.

Cash obviously gives flexibility and, given the uncertainties, practically and economically, should be kept if likely to be required in the foreseeable future, but as an investment has little attraction. It is true that interest rates are on the rise, but they are highly likely to lag behind inflation and so will, like bonds, provide negative real returns, although, if we are correct in our assessment about the overvaluation of bonds, the negative real returns are not likely to be as large. For the very nervous investor, however, cash, even if falling in value in real terms, does provide some comfort and for investors with a very low level of risk tolerance can be suitable, even in current inflation circumstances.

This leaves equities, given that we are not discussing here gold, property, alternative assets or cryptocurrencies. It is easy to outline the negatives, such as high and rising inflation (for some companies), rising interest rates and tightening monetary policy and the possibility of a recession (those who follow bond yield curves will cite an almost flat yield curve in the USA with very little difference in gross redemption yields on US Treasuries between two year and thirty years maturities). Given our view of the lack of attraction of bonds, in particular, and cash as an asset class in its own right, one could describe equities as the least unattractive investment asset class given that one has to invest somewhere. But we would be more positive than that, even in this most depressing of times. Even if, in the worst case, a recession beckons, economic growth should resume. Some companies have pricing power, which is important at a time when input costs are rising sharply, and some companies whose prices are rising sharply will benefit even if they are in industries where prices can also go into

reverse and cause big losses, oil being a case in point. In many markets, but no longer in the USA, dividend yields exceed the yields on bonds and, at the moment, although this could change if economic circumstances deteriorate badly, dividends are rising. There are, therefore, positive reasons to continue to invest in equities, notwithstanding their strong performances in recent years. Above all, we must emphasise that it is extremely difficult to predict short term market movements, particularly at present, and we must expect to see more volatility and swings in quarterly performances.

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