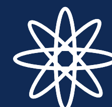

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ASSET MANAGEMENT (C.I.) LIMITED

INVESTMENT MEMORANDUM

Although there have been significant economic and political events during the quarter, international equity markets ended the quarter little changed. Bond markets have been volatile, latterly reflecting the uncertain political situation in Italy with a flight to perceived quality in evidence. The foreign exchange market was noticeable for the strength of the U.S. dollar which reversed a period of weakness. In the commodity markets, oil has risen strongly as a result of supply constraints either imposed or as a result of other factors.

The tables below detail relevant movements in markets :

International Equities 28.02.18 - 31.05.18

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	+1.2	+1.7	-1.8	+2.7
Finland	+6.2	+5.2	+1.6	+6.2
France	+4.2	+3.3	-0.3	+4.2
Germany	+1.6	+0.7	-2.8	+1.6
Hong Kong, China	+0.8	+4.1	+0.5	+5.0
Italy	-1.9	-2.8	-6.1	-1.9
Japan	-0.3	+1.4	-2.1	+2.3
Netherlands	+2.7	+1.8	-1.7	+2.7
Spain	-4.3	-5.2	-8.4	-4.3
Switzerland	-0.8	-1.3	-4.7	-0.4
UK	+7.5	+7.5	+3.9	+8.5
USA	+0.3	+3.8	+0.3	+4.8
All World Europe ex UK	+0.5	-0.5	-3.9	+0.4
All World Asia Pacific ex Japan	-1.1	+1.2	-2.3	+2.1
All World Asia Pacific	-0.8	+1.2	-2.2	+2.1
All World Latin America	-7.1	-13.2	-16.2	-12.4
All World All Emerging Markets	-3.9	-3.7	-7.0	-2.9
All World	+0.5	+2.5	-1.0	+3.4

Source FTSE World Indices

FTSE UK Government Securities Index All Stocks (total return) : +2.8%

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

Currency	28.02.18	31.05.18
Sterling	1.59	1.28
US Dollar	2.93	2.86
Yen	0.04	0.01
Germany (Euro)	0.62	0.28

Sterling's performance during the quarter ending 31.05.18 (%)

Currency	Quarter Ending 31.05.18
US Dollar	-3.6
Canadian Dollar	-2.5
Yen	-1.8
Euro	+0.9
Swiss Franc	+0.5
Australian Dollar	-0.7

Other currency movements during the quarter ending 31.05.18 (%)

Currency	Quarter Ending 31.05.18
US Dollar / Canadian Dollar	+1.1
US Dollar / Yen	+1.9
US Dollar / Euro	+4.6
Swiss Franc / Euro	+0.3
Euro / Yen	-2.6

Significant Commodities (US dollar terms) 28.02.18 - 31.05.18 (%)

Currency	Quarter Ending 31.05.18
Oil	+19.0
Gold	-1.3

MARKETS

Although there were many political and economic distractions during the quarter, international equity markets ended the quarter little changed. In total return terms, the FTSE All World Index returned +0.5% in local currency terms, +2.5% in sterling terms, -1.0% in US dollar terms and +3.4% in euro terms. Looking at local currency returns first, we see that the outstanding performer was the UK with the FTSE UK Index returning +7.5%. On the negative side, there were significant underperformances from the FTSE All World Latin America Index which returned -7.1% and the FTSE All World All Emerging Markets Index which returned -3.9%. Moving on to returns in sterling adjusted terms, the FTSE UK Index remained the outstanding performer but the strength of the US dollar meant that, with the FTSE USA Index returning +3.8% in sterling terms, the gap in performance narrowed. On the negative side, weakness in Latin American currencies meant that the sterling adjusted return on the FTSE All World Latin America index widened to -13.2%.

In the international bond markets, the turbulence in the Italian bond market in particular following the political impasse meant that there was a flight to quality in the face of rocketing Italian bond yields. Taking ten year government bonds as a benchmark, the gross redemption yield on the UK government bond narrowed by 31 basis points to 1.28%. Although the ten year US Treasury bond's yield broke above 3% at one stage towards the end of the quarter, it fell back right at the end and there was a 5 basis point fall in the yield to 2.86%. Germany is, of course, regarded as the safest haven in the eurozone and the gross redemption yield on the ten year Bund fell dramatically by 34 basis points to 0.28%. The Japanese Government Bond, where the yield is managed by the Bank of Japan as part of its monetary policy, showed a 3 basis point reduction in yield to 0.01%.

The feature of the foreign exchange market in the quarter was the strength of the US dollar as it recovered from a period of weakness and the euro became less attractive because of the political problems in the eurozone. Against the US dollar, sterling fell by 3.6%, against the Canadian dollar by 2.5%, against the yen by 1.8% and against the Australian dollar by 0.7%. Sterling rose by 0.9% against the euro and by 0.5% against the Swiss Franc.

In the commodity markets, OPEC output discipline and supply problems pushed Brent crude up by 19.0%. Gold showed little reaction to political events and fell by 1.3%.

ECONOMICS

Where often months can pass with little new to write on the economy, May has been a time of plenty. This month's investment memorandum will cover three themes, all of which have figured over the period, starting in the United States and, more specifically, talking about its currency. At the beginning of the month bond markets, particularly, were feeling the weight of changing expectations on interest rate rises and a strengthening dollar, and its consequential effects, were very comment worthy. If there is one leading country where political instability is an ongoing issue it is Italy but the voice of the people calling for change has been growing in number and in volume and, given its nearness to the centre of the eurozone and the rise in strength of pro-Italy/anti-other feeling, there is always a small chance that the country could seek a wholly new economic path. Developments there mid-month mean that this is worth exploring. Finally, on the last day of the month, President Trump,

using special powers reserved more for matters of national security, decided to impose import tariffs of 25% on European steel and 10% on European aluminium as well as on Canada and Mexico. His claim is that it is, more than anything, a ruse to drag trading partners to the negotiating table but his starting position seems that the United States is the victim of world trade rather than a beneficiary. Any of these three on their own could escalate unpredictably and wreak untold economic damage in differing ways, but as well as the impact component of risk, another element is probability. Here, impact is very difficult to predict but consideration of probability may mean that U.S. monetary policy remains the most significant of these three in the context of threat to financial markets. Having said that, monetary policy is in the hands of central bankers whilst politicians dominate the two others.

It is, of course, most uncharacteristic for we British to talk, or even complain, about the weather but its sometime nefarious effect on economic growth allows us to reflect on it here. This usually comes into play when governments publish their first quarter GDP growth figures and the 'beast from the east' or America's 'bomb cyclone' have to be considered. This winter's harsh weather on both sides of the Atlantic may have depressed growth figures meaning that second quarter results, out in July, will be heavily scrutinised. A bounce back due to deferred spending or, alternatively, signs of ongoing malaise may be telling on markets. First quarter growth in United States cooled to a 2.2% annualised rate after logging 2.9% in the last quarter of 2017, with the two middle quarters of 2017 also being around that level. It was, it must be said, also the strongest first quarter since 2015. The figure of 2.2% beat a survey of economists by Bloomberg, which suggested a figure of 2.0%. Expectations are high for the second quarter as corporate and individual tax cuts announced in January percolate through to the real economy. The job market is strong and low inflation and borrowing costs help provide tailwinds. Companies continue to make their contribution with improving profitability and rising dividends. The Federal Reserve said that it believed the first quarter figure to be transitory, with the economy reaching a significant milestone in May, which marked the second longest period of expansion for the country. Interest rate futures are pricing in a second interest rate rise of the year in June.

There is enough in this brief synopsis of the American economy to understand that it is doing moderately well, notwithstanding a lower first quarter figure. The Commerce Department's Bureau of Economic Analysis is currently revamping its methodology to address the issue of 'residual seasonality' which has caused the first quarter figure to be the lowest of the year in five out of the eight last periods. Whether growth is strong enough to meet Mr Trump's target of 3% per annum remains to be seen as wage pressures are building given unemployment is low, though this must be qualified by a low participation rate and a relatively high underemployment rate, and changes to U.S. trade and tariffs policies pose a risk to the outlook, though small at this stage.

There are many reasons why we devote many column inches to the United States. It has the largest economy, it has the largest stock market, it has the largest presence on the international stage and it has a leadership whose incontrovertible style demands comment. Furthermore it is a favoured place to invest, being a country that has shown great long term performance and is a country of entrepreneurs, comfortable with the concept of equities. Two other things are accompanying this phase of positive growth: quantitative easing is reversing and the dollar, partly as a consequence of that, is strengthening.

The dollar's uses extend beyond being just the currency to trade American goods and services. To many other countries it is the currency of choice for holding foreign reserves and for some of those countries and, disproportionately, less developed ones, it is the currency in which much borrowing is done. Needless to say when the price of money, its interest rate, is changing, the consequential effects extend far beyond the fifty states.

Yields on U.S. Treasury bonds have risen quite sharply as it is more widely seen that we have reached a period of change in central bank policy. Perhaps the surprise is not that change has come but, rather, that it has taken so long to come. More than in any other period monetary policy has been used over the last 10 years to revitalise the economy. Short term interest rates have been reduced by cutting base rates and long term interest rates have been reduced by increasing demand for long dated bonds. This has increased the price of those bonds, which has reduced the effective yield. The intervention by central banks has had a major effect on the shape of the yield curve in many currency areas. Central banks have bought bonds in the secondary markets which has injected cash into the economy. Corporates have found it incredibly cheap to borrow money – and have even been paid to borrow money by investors in certain cases, with the argument being that increasing the money supply through lending activity, in tandem with central bank intervention, has provided oxygen and water to a withered economy.

The commonly used benchmark of lending conditions is the 10 year U.S. Treasury bond – how much it costs the United States government to borrow for 10 years, repaying the original amount at term. To summarise 60 years of interest rate history very succinctly, yields rose from around 4% in the early 1960s to peak very briefly at over 15% in 1981. Yields have fallen fairly consistently since then until reaching a low of 1.47% in 2016, reflecting more than anything a period of falling inflation. These conditions of falling interest rates and lowering inflation provided a strong tailwind for bond markets where the fixed coupon on each becomes progressively more attractive relative to lowering market rates. The attraction of owning bonds, as a consequence, has been heightened, indeed there are many inside and outside financial services whose only experience of bond markets has been against this favourable thirty seven year backdrop. As assets held for private investors this has created the perception of lower risk and given attractive returns. This will not always be the case in the future and the recent rise in U.S. yields points to our passing a point of inflection.

Yields on 10 year Treasuries have risen quite sharply since that low point of 2016 and the 10 year yield is, at the time of writing, around 3.0%. This is still low compared with the historic average level and the key questions are how far and how fast rates will rise over the next few years. The artificiality of the current bond market must be stressed as the actions of central banks through quantitative easing has mis-priced risk by creating demand at any price. When trying to anticipate where bond yields will go and how quickly they might get there, it is worth considering the strong correlation over time between 10 year yields and nominal GDP growth. This makes sense as the two elements contained in that measure are GDP growth, where periods of strong growth would imply higher interest rate expectations, and inflation; as most bonds repay a fixed amount at term, bondholders will always demand a higher yield to reflect the time value of that final repayment – less in times of high inflation and more when the opposite is true. Staying with the United States GDP growth is around 3.0% and inflation adds roughly 2.5%. On that measure yields still have some way to go. The Federal Reserve's most important job at the moment is reassuring investors that the move towards such a level will be gentle and well sign-posted. The period since 2009 has been referred to as one of secular (as opposed to cyclical) stagnation where growth has been low for a long time and this theory suggests that advanced economies will be prone to poor growth due to insufficient aggregate demand in the private sector, unless supported by extraordinary monetary or fiscal policy. Whilst U.S. growth has picked up recently and is starting to look as if it is more self-sustaining it has hard to imagine having seen any significant growth in the last decade without the government running a budget deficit, with 'normal' interest rates and without quantitative easing. These were, at first, crisis response measures but the fact they largely remain in place in 2018, to which significant economic stimulus through tax cuts can be added, supports this advanced economy theory. To this public sector support can also be added market factors such as a depressed oil price (now being reversed) and wealth creation through asset price rises in areas such as stock markets and property which have created around $10 trillion of extra wealth.

The IMF and OECD, as well as America's Congressional Budget Office, agree that, barring odd quarters, growth appears to be accelerating which brings us to the stage where the artificial aids can gradually be taken away. Unemployment has fallen to the point that the headline figure is suggesting full employment, even if the headline rate neglects a lot of the detail about the employment market and those who are absent from it. The conditions that necessitate a change in monetary policy in United States are positive. Historically, phases of dollar strengthening have created strains in foreign lands. Emerging market countries are often forced to defend their currencies to prevent imported inflation and raised dollar interest servicing costs. Argentina raised its interest rate three times in May and Turkey's lira has fallen sharply, not that these two examples can be explained wholly by a stronger dollar. More conclusively, emerging market bond indices have fallen back sharply though, at the moment, they appear to reflect yield readjustments more than a desperate rush for the exits.

The most eye catching movements in markets in May have been in European debt markets with Italian government bonds marking the epicentre of the constitutional crisis in the country. The yields on Italian bonds rose sharply as demand for them has fallen, lowering their prices as buyers re-assess the risk premium needed over buying, for example, German government debt. Herein lies the problem for Italy in that for many years the political ambition of Brussels (and Rome presumably) has been that, through ever closer union, the countries at the core of Europe would converge to become one homogenous economic unit. Government bonds markets have shown elements of that and shown it best in the good times - at one point before the financial crisis Ireland could borrow money more cheaply than Germany but, in moments of volatility, frailties build at the weakest points and the flight to quality amplifies the creditworthiness gap. Much could be written about convergence in eurozone creditworthiness but, needless to say, it is not a completed piece of work. When over 50% of the electorate choose anti-establishment parties the only conclusion can be that a majority of Italians reject many decision-making policies that have brought the country to the present position. This is not the time to test the loyalty of bond markets.

In terms of mainland Europe, Italy remains the elephant in the European room with the largest debt problem in Europe, excepting Greece, with an economy still smaller than it was before the financial crisis, with high levels of unemployment and a banking system heavily burdened by bad loans. At some point rational people ask themselves if something needs to change. Change in Italy has come through having many different governments which have struggled to work to a mandate, hindered by the over-democratic political system. There is now a groundswell of Italians who are questioning the wisdom of remaining in the eurozone and who recall the years with the lira when devaluation of the currency enabled its goods and services producers to remain as competitive exporters and to defend their home market. As much as Germany benefits from the euro, countries like Italy are trapped in a low growth deflationary trap. Domestic demand is low and productivity does not improve. This was always a hard-to-love credit story in the last century when the lira was seen as a poor store of value and it alternated between periods of frequent devaluation and constant devaluation. Come the euro and the implied security of the larger economic bloc and the inflation risk has been curtailed but at some cost. With Italy's economy being shackled to those of countries like Germany's the most positive facet of inflation has been lost. The eurozone has always straddled dissimilar economies with the political vision of convergence being stronger than the practical reality of the economics. Italy has always struggled to match the productivity levels of Germany and France and this has consistently been the case for life post-lira. In fact, in real terms, productivity is lower now than it was in 2002. It is an outlier when compared with the other six G7 countries. The ability to remain competitive in such circumstances comes from the devaluation of the currency where an importer in another country remains attracted to Italian goods and services because of the weakening exchange rate improving their affordability in the non-Italian currency. This has worked in two ways. In all probability the euro

has been stronger for the last 16 years than the lira would have been had Italy remained outside the eurozone and the competitive advantage of a depreciating currency has been lost in trade with other eurozone currencies because of both countries sharing the same euro. To make that point the pound moved from being worth around 2,100 lira in 1991 to peak at around 3,100 in 2000. Using the fixed lira to euro rate a pound is now worth 2,200 lira.

Foreign direct investment would help both productivity and unemployment levels but here again Italy scores poorly. In 2007 it was ranked 156th in the World Bank's ease of doing business global survey. The good news here is that the country has moved up to 46th by 2017 but such investment seeks a home where doing business is simple and transparent and the political environment is stable. There is, rightly, much competition between countries in this area. It should also be said that over the past four years there has been economic growth every quarter and unemployment has fallen.

There is a sensitivity to a wider, reasoned questioning by Italians of the pros and cons of being in the eurozone. Those in favour of leaving point out the benefits for exporters of using a weaker currency and being freed from fiscal rules could allow more government spending to stimulate the economy. The risks to leaving are significant, too, as interest rates and inflation could rise, savings could be devalued, banks may be subsumed with bad debts and that the country could end up having large parts of its significant debt burden denominated in a foreign currency, leading to potential default.

It is difficult to say what the true cost of borrowing is for any country in the eurozone given the yield suppression deliberately created by central bank policy though nobody should be surprised at falling demand for sovereign debt in Europe. For some years the planets have aligned to pull yields down (due to demand-led price rises for bonds) with the European Central Bank buying regardless of return, with Europe's banks being strongly encouraged to hold such bonds for regulatory reasons and many other mandated buyers of sovereign debt forced to participate in a market with more buyers than sellers. Now inflation expectations are rising, the potential for a political shock is a relevant risk, there is a wider feeling that interest rates have passed their lowest point and the finances of the weakest countries of the eurozone are contrasting as strongly as ever with the finances of the strongest. Here we enter another different phase of difficult interest rate management for the central bank.

According to Eurobarometer, the European Commission's own analysis tool, in April 2002, a few months after the introduction of euro notes and coins Italy, was the most pro-euro nation in the bloc after Luxembourg with 79% of respondents expressing a positive opinion. With the possibility of economic decline continuing towards a third decade and youth unemployment at 40% the same pollsters observed that in December 2016 only 41% said the euro was "a good thing" while 47% said it was "a bad thing".

Now, writing at the beginning of June, yields on Italian bonds have settled back as the intensity of the crisis has subsided. The reaction of markets remains secondary to the sentiment expressed by the people of Italy. With the compromise selection of Guiseppe Conte as Prime Minister and with Giovanni Tria as the new Minister of Economy and Finances, everything is yet to be done to satisfy the electorate that a new model will be established that is capable of ending their frustration.

Almost eighteen months into Donald Trump's presidency and he continues to assert his pledge to follow through on the commitments he gave those who elected him at the end of 2016. In his inauguration speech he spoke of "Transferring power from Washington, D.C. and giving it back to you, the American People" explaining how "we've enriched foreign industry at the expense of American industry;" This now manifests itself as a burgeoning trade war with real tariffs in place, which will shift trade and have an impact on jobs. The word 'war', in this context economic, seems to capture a lot of Trump's thinking and two things about any war are apparent to everyone. Firstly they are unpredictable and, secondly, there are inevitably more casualties on all sides than anyone would have liked. Trump, it would appear, sees strong leadership as making decisions that reflect the

interests of "the American People" but, presumably, well advised as he is, is aware of the secondary effects of deliberately making trade harder by making goods more expensive. The tit-for-tat retaliations are starting with the E.U. hitting back with high profile proposed tariffs on, for example, Harley-Davidson motorcycles, emblematic of their country of manufacture, endorsed by Donald Trump for that and built (less and less) in Wisconsin where Trump achieved a significant Presidential victory.

The economic weather never remains wholly favourable for long and May has been a reminder of that. Equity markets have not been troubled too much by these events and the FTSE All-World total return index, in local currencies, was up 0.9% in May, which is the same figure as for the first five months of 2018. The possibility of tariffs biting into economic growth is some way off and diversified portfolios, such as those of our clients, will be insulated from targeted tariffs that affect specific companies, or parts of specific companies, to the extent that no change in investment policy is planned at present. The same also applies regarding the situation in Italy. It remains our view that a stronger dollar, driven by the USA's economic performance and the reversing of monetary policy, has the potential to create a more immediate amount of disruption and this is likely to be felt in bond markets more than equity markets. Unless held to meet specific mandates we do not see yields on high grade bonds, on a hold to maturity basis, being high enough to justify their contribution to a long term portfolio and remain concerned that their performance could be badly affected by a broader change in the direction of interest rates or speed of increase.

So, notwithstanding the increased volatility of international equity markets and the realistic expectation of some negative quarters, the economic background, if not the political background, still means that equities are our preferred asset class. As we have said in a number of recent reviews, we regard the U.K. as a market of elevated risk because of the uncertain political situation which could, at some stage, lead to a government with economic policies extreme by any previous experience. For this reason, apart from the general benefit of diversification, our client portfolios have significant overseas content as an insurance policy.

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