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ASSET MANAGEMENT (C.I.) LIMITED

INVESTMENT MEMORANDUM

International equity markets have recovered well after the late summer setback on the Chinese devaluation and most areas showed an improvement over the quarter. Bond markets were slightly firmer. In the currency markets, weakness in the euro and Swiss Franc was a feature. Commodity markets remained depressed with oil very weak over the quarter.

The tables below detail relevant movements in markets :

International Equities 31.08.15 - 30.11.15

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	+0.4	+4.8	+2.6	+8.8
Finland	+14.7	+10.5	+8.1	+14.7
France	+7.2	+3.3	+1.1	+7.2
Germany	+10.2	+6.1	+3.8	+10.2
Hong Kong, China	+2.4	+4.6	+2.3	+8.6
Italy	+4.4	+0.5	-1.6	+4.4
Japan	+3.7	+4.2	+1.9	+8.2
Netherlands	+6.2	+2.3	+0.1	+6.2
Spain	+1.4	-2.4	-4.4	+1.4
Switzerland	+2.9	-1.1	-3.2	+2.7
UK	+2.5	+2.5	+0.4	+6.5
USA	+5.6	+7.9	+5.6	+12.1
Europe ex UK	+6.1	+2.5	+0.3	+6.4
Asia Pacific ex Japan	+1.9	+5.1	+2.9	+9.2
Asia Pacific	+2.8	+4.5	+2.3	+8.6
Latin America	-2.8	-4.2	-6.3	-0.6
All World All Emerging	+0.3	+0.8	-1.3	+4.7
The World	+4.6	+5.5	+3.3	+9.6

Source FTSE World Indices

FT Government Securities Index All Stocks (total return) : +1.0%

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

Currency	31.08.15	30.11.15
Sterling	1.96	1.84
US Dollar	2.18	2.24
Yen	0.38	0.31
Germany (Euro)	0.74	0.48

Sterling's performance during the quarter ending 30.11.15 (%)

Currency	Quarter Ending 30.11.15
US Dollar	-2.0
Canadian Dollar	-1.0
Yen	-0.5
Euro	+3.9
Swiss Franc	+4.1
Australian dollar	-3.6

Other currency movements during the quarter ending 30.11.15 (%)

Currency	Quarter Ending 30.11.15
US Dollar/Canadian Dollar	+1.1
US Dollar/Yen	+1.6
US Dollar/Euro	+6.1
Swiss Franc/Euro	-0.1
Euro/Yen	-4.3

Significant Commodities (US dollar terms) 31.08.15 - 30.11.15 (%)

Currency	Quarter Ending 30.11.15
Oil	-13.9
Gold	-6.4

MARKETS

International equity markets have staged a significant recovery following the late summer setback sparked off by the Chinese devaluation of its currency which has turned out to be very modest. As a result, for the latest quarter, the FTSE World Index has returned 4.6% in local currency terms, 5.5% in sterling terms, 3.3% in US dollar terms and 9.6% in euro terms. Looking at local currency returns first, we note above average performances from the FTSE Europe ex UK Index and the FTSE USA Index with returns of 6.1% and 5.6% respectively whilst there were below average performances from the FTSE UK Index (2.5%), the FTSE Asia Pacific ex Japan Index (1.9%), the FTSE Latin American Index (-2.8%) and the FTSE All World All Emerging Markets Index (0.3%). Looking at sterling adjusted returns, the strength of the US dollar pushed up the return on the FTSE USA Index to 7.9% whilst weakness in the European currencies reduced the return on the FTSE Europe ex UK Index to a below average 2.5%.

High quality government bonds, as measured by ten year benchmark bonds, generally showed a firmer trend except for the US Treasury bond where the gross redemption yield rose by 6 basis points to 2.24%. In the UK government bond market, the yield dropped by 12 basis points to 1.84%, in the Japanese Government bond the yield dropped by 7 basis points to 0.31% and, in the German government bond, there was a significant 26 basis point fall to 0.48%.

In the currency markets, there was notable weakness in the euro and Swiss Franc against which sterling rose by 3.9% and 4.1% respectively. On the other hand, sterling fell by 3.6% against a recovering Australian dollar and by 2.0% against the US dollar.

Weak commodity prices continued to be a feature with oil, as measured by Brent crude, falling by 13.9% and gold by 6.4%.

ECONOMICS

Last month this memorandum reflected on the International Monetary Fund's decision to downgrade its forecast for world growth in its World Economic Outlook. Then, the IMF, citing a slowing in emerging markets and a modest pick-up in advanced economies, estimated growth in the world economy will be 3.1% in 2015, which is 0.3% lower than in 2014 (and 0.2% lower than it was forecasting in July 2015). It said it expects 2016 will be stronger, rebounding to 3.6%. In November it was the turn of the OECD to trim its global economic forecasts for the second time in three months. It, too, warned on the risks of slower growth in emerging markets and commented on how that could spill over into countries such as Germany. The OECD says world output will expand at 2.9% in 2015 and 3.3% in 2016, down from 3% and 3.6% which it predicted in September. "Global growth prospects have clouded this year" its report reads, continuing "The outlook for emerging market economies is a key source of global uncertainty at present."

The OECD barely changed its forecasts for Chinese output (+6.8% in 2015 and +6.5% in 2016) but more alarming is that Brazil and Russia are now deep in recession with Brazil's economy now forecast to shrink by -3.1% in 2015 and -1.2% in 2016, which compares with its September forecasts of -2.8% and -0.7%. Russia's figures are equally bleak with figures of -4.0% for 2015 and -0.4% for 2016 (cf. OECD's June estimates of -3.1% and -0.8%. No forecasts were made for Russia in September). For emerging markets, "challenges have increased," the report reads, warning that, should the situation deteriorate "growth would also be hit in the euro area, as well as Japan." The United States is likely to be less affected as its economy is more closed as it has a lower level of import/export business relative to its size.

Much has been written about China and its need to re-focus away from manufacturing and infrastructure spend towards a consumer based economy - even at the expense of a lower overall growth rate. The next largest emerging market economy is Brazil, which has a completely different set of issues and, along with Russia, means that three countries that previously had driven the rate of world economic growth forward are now significant contributors to the cuts in these economic forecasts. We will return to Brazil a little later but it is worth spending a little time considering why global growth rates are where they are and why there is a recurring pattern of forecasts being revised downwards year after year.

If we look at world growth rates over the 25 years until 2007 there is a level of consistency with world growth averaging 3.8% per annum. Equity markets have risen inconsistently over the same period with various notable periods of negative performance triggered by differing factors each time. It is also worth commenting that equity markets recovered more quickly after the 2007/2008 financial crisis than they did at the start of the decade after the collapse of the dot.com boom. It took four full years before world equity markets regained their previous highs as the collapse was characterised as a shallower fall, followed by a more gradual recovery than the more recent crisis.

There are many drivers of growth and in economic terms they are often considered in terms of demand side causes and supply side causes. The demand side is influenced by levels of confidence, levels of investment, government spending and the simple fact that population increase will lead to more economic activity. The supply side is more concerned with productive capacity and is boosted by improvements to productivity, innovation and improvements to the capital stock. Examples would be new technologies and better working practices with more highly skilled staff leading to the construction of a new factory to replace an outdated unit whose end products can be delivered to the customer at a far lower unit cost. The consumer can then spend his or her money more efficiently which, as the same effect is replicated across the whole economy, creates an economic uplift.

A reasonable question to ask, and there are a wide range of economic responses to the question, is why the economic growth rate in the world economy has not recovered the lost ground of the immediate post-crisis period and caught up with its long term trend. The repeated over-estimating of future growth rates and their subsequent revising down suggests that there has been an expectation that the rate would at some time rise, only for those expectations to be moderated as economic reality has confounded the forecasters. There are two areas worthy of consideration, firstly, the effect of austerity, in its various guises, and, secondly, the constraints created by the levels of indebtedness, particularly at a government level.

Economics is a human science and the effect of austerity when considering consumer behaviour is complicated. The policy response we have seen from central authorities around the world has been most noticeable through the actions of the central banks. It is likely that, before the financial crisis, awareness of the names of the central bankers of the various large economies would have been lower than it is now. Central bankers have been prominent because of their unequalled ability to have an immediate effect on the financial position of consumers and companies. Interest rates have been cut to historically low levels in most leading economies, so that indebtedness is more manageable and the money supply has been increased which has inflated asset prices, bringing a direct boost to confidence as asset owners have felt more wealthy. Independent (and less independent) central banks have been able to open the taps freely and most commentators would support the view that the monetary policy response has had a considerable effect on reflating the economy, relative to where it may have been, with no, or less, loosening. As is to be expected this strategy has not been without risk; an example would be the theoretical risk to inflation. If there is more money chasing a fixed output of goods and services (and assets) then it would be expected that prices would rise to the point that supply and demand balance. Until now, this risk has been contained as economies have stuttered forward with the consistent push in the back of artificial stimulus rather than a more natural and self-sustaining growth momentum. More recently, the sharp fall in the price of oil and other commodities as well as depressed food prices has had a disinflationary effect which has supported the bias towards keeping interest rates at unnaturally low levels. It has been said before, but it now looks as if a rise in US dollar rates is imminent.

Another area where monetary policy could be considered contentious is in relation to foreign exchange levels. Deliberate devaluation of a country’s currency is often frowned upon by that country’s trading partners as it is a way of exporting that country’s problems. A weaker currency has the effect of making exports cheaper and increasing the cost of imports. In a country that produces a wide range of goods and services this can have the effect of diminishing international trade to the benefit of the domestic economy. In the context of monetary policy we have seen violent swings in exchange rates and significant movements of capital as money flows are channeled to be used the most effectively. As different economic areas have applied monetary stimulus at different times this has also produced uneven pressures on currencies, with the inherent difficulties that creates for economic activity between two trading partners. This can be shown in the relationship between the euro and the U.S. dollar. The United States was first into the crisis and first to respond through its programme of quantitative easing. QE1, as it became known, was announced in November 2008 and QE3, which followed QE2 and Operation Twist, ended in October 2014. The US Dollar base interest rate was 5.25% in August 2007 and sixteen months later it was nearly zero. We now see a reversal in relative policy as Mario Draghi, President of the European Central Bank, employs increasingly loose monetary policy just as the United States is poised to start tightening. One euro was worth $1.59 on 22nd April 2008 and as of 1st December 2015 it was worth $1.06.

Dollar strength has been cited frequently in the quarterly reporting of American companies recently as foreign earnings are translated back into fewer dollars. To an extent, any fall in the dollar share price is balanced by an increased value of the lower dollar price, when re-based into sterling, for example. For investors it should be stressed that this period has provided extraordinarily benign conditions for companies as they have been able to re-finance debt at incredibly low levels, have been able to manage costs with less controversy and even raise debt to buy back shares. Despite this being a period of relatively poor economic growth, policy has had the desired feel-good effect in increasing valuations of equities, bonds and property and contributed to the background level of consumer confidence.

Looking at government response to the crisis, the adage ‘first you put the fire out and then you think about repairing the damage’ applies where governments felt obliged to rescue the financial system, at high financial and political cost, and then turn their attention to creating the right conditions to encourage economic growth. It is at this point that it is necessary to consider the levels of debt which countries had accumulated up to that point, plus the costs of the financial rescue - which to countries such as Ireland were to transform their financial position, and then consider what policy decisions could be made, whilst keeping sovereign debt markets on side.

After the longest and deepest global recession since the Second World War it would be reasonable to think that a long period of deleveraging would take place; the rational response to being too much in debt is to work to reduce it. This is not, however, what has happened and debt continues to grow in nearly all countries, whether measured in absolute terms or relative to GDP. According to a 2015 study by the management consultants, McKinsey, global debt has grown by $57 trillion since 2007, raising the average ratio of debt to GDP by 17 percentage points. The report observes that half of the new debt is in developing countries and in advanced economies, government debt has soared and private sector deleveraging has been limited.

It is an excess of borrowing that is an economic ill rather than borrowing itself. Equally the absence of lending activity can be troubling as a lack of appetite for lending by banks, an unwillingness for companies to invest or a combination of the two can contribute to sclerotic growth rates, which is especially damaging in times of economic hardship and it is in those times when it is most likely to be absent. As debt is traded openly it is subject to fluctuations in perceived value and it is often confidence that can edge perceptions towards situations of excess borrowing. Borrowing is the sponsor of capital investment and innovation which, in a properly functioning and well regulated economy, contributes to economic growth by allocating resources where they can be best applied. Thinking back to the demand side/supply side approach, government spending, if spent efficiently, creates economic growth by creating jobs, creating infrastructure and improving the efficiency of an economy. There is also the multiplier effect that money spent by a government through its initial investment will continue to circulate through the economy, create wealth beyond the original figure spent. Over the last seven or eight years all government spending considerations have had to be made with one eye on the country's debt position and ability to raise money in international markets. As a consequence, across the political spectrum 'austerity' has been interpreted as either a driver of prudent and necessary policy restraint or as a limiting factor in sponsoring economic recovery. The difficulty is that whatever policy choices are made, the outcome will be compared with a hypothetical policy programme that was never applied.

It is often said that the absence of risk cannot be a pre-condition to making financial investments and the investor has certainly had his or her resolve tested in recent times. As more years pass and the economy of the world continues to labour under conditions that do not normally apply, the clearer the longer term impact of the financial crisis appears. The issue of indebtedness has been present since before the financial crisis and continues to be a characterising element of our times.

The earliest signs of trouble brewing back in 2007 were in the United States when it became clear that money was being lent to borrowers that had little chance of being re-paid. NINJA loans – No Income, No Job or Assets became a nickname for very low quality sub-prime loans, and where the appetite for banks to lend in such circumstances was fed by the ability to package these loans up into securities and, with the blessing of credit rating agencies, be sold to international investors as Mortgage Backed Securities (MBS) and Collateralised Debt Obligations (CDO). This false market coincided with a domestic recession where home prices fell, unemployment rose and mortgage delinquencies spiraled. It became rapidly clear that the market for MBS and CDO was narrow and liquidity dried up causing a collapse in the whole market, greatly damaging the banking and shadow banking sectors. As delinquencies rose, and most lending was non-recourse, it made sense for house owners to default on their mortgages, flooding the already falling market with yet more property and creating a vicious circle. America's leading investment banks were carrying unprecedented levels of debt and were over exposed to the market. Two of the five, Morgan Stanley and Goldman Sachs, changed their models and became commercial banks, two others, Bear Stearns and Merrill Lynch, were sold at bargain basement prices and the last, Lehman Brothers, went bankrupt. It was the largest bankruptcy filing in US history and is now seen as a significant tipping point in the crisis.

This is the briefest of précis whose inclusion is intended as a reminder that it was debt and indebtedness which ignited the financial crisis and, not surprisingly it was the effect on banking around the world which is best remembered in this early phase of the crisis. To consider the health of any economy a study of the health of its banking sector is usually very revealing and, fast forwarding to 2015, it is apparent to all that the seven intervening years have been a supremely difficult time for banks. Added to the task of repairing their balance sheets and adapting to new, more stringent capital adequacy rules, news wires have been full of stories of market manipulation, fraud, money-laundering and mis-selling to name just a few misdemeanours. The banking sector has, not surprisingly, had few friends recently.

Returning to the OECD forecasts it is interesting to note that the gap between growth levels in the developed world and the developing markets is narrower now than it has been for some time. Much has been written about the slowdown in China; the OECD's Economic Outlook now gives a growth rate of 6.8% in 2015, gradually declining to 6.2% by 2017. Whilst a resurgent India shines under Prime Minister Narendra Modi, Brazil and Russia find themselves in recession, reflecting weaker commodity prices, tighter credit conditions and lower potential output growth. As with most emerging economies in these conditions the ongoing risk of capital outflows and depreciating currencies has an effect on their financial stability. These four countries have been grouped together in economic terms as the 'BRIC' nations but this moniker is decreasingly useful as their economies diverge. All emerging market economies together now account for 57% of world GDP (on a purchasing power parity basis) and 37% of global trade.

As much as China, the second largest economy in the world and which has been reported upon extensively, Brazil's current plight informs us of some of the pressures faced by developing nations at this time. The country escaped the worst of the financial crisis as enduring demand for its commodities provided strong levels of foreign income. At that time it was lauded for its resilience and singled out as a driver of world economic growth. Consumer spending continued to grow as did the ability to borrow, helped by attractive interest rates. Total loans over the past decade climbed five-fold and family household indebtedness jumped to 46% from 20%. Borrowing costs are now much higher with the country's benchmark interest rates at 14.25% as policymakers fight inflation and defend a weakening currency. The consequence is, of course, increased loan delinquency with the Bank of Brazil saying that in August 3.1% of all loans were in deficit. Until recently the job market provided some cause for optimism but in the last nine months the national rate of unemployment has risen from 4.3% to 7.6%.

Putting aside political scandal and infighting the Central Bank is sandwiched between an inability to lower interest rates as it needs to defend the weak real to prevent inflation rising even higher and the country is unable to borrow more money as its credit rating was reduced in August to non-investment grade – only seven years after reaching that level. The inability of the government to balance the budget, exacerbated by the political impasse has led one rating agency to keep the sovereign 'on watch', a warning that the risk of a further downgrade is a possibility. These are not the circumstances that any government would want to be in and strengthening hard currencies, especially the US dollar, only serve to provide more of a headwind.

Brazil has a relatively modest level of gross government debt at around 62% of GDP. This compares with UK's level of 90%, Greece 175% and Japan 227%. With interest rates so high, the cost of servicing the debt is also relatively high. In 2014 debt payments accounted for more than 6% of output. High interest rate costs within the country have been mitigated somewhat for consumers and companies by public banks offering subsidised loans. These went from 40% of all lending in 2010 to 55% in 2014. Its government cannot loosen fiscal policy without precipitating a downgrade of Brazil's credit rating. In fact, her hawkish finance minister, Joaquim Levy, has slashed 70 billion reais off the discretionary spending planned for this year (on top of the modest welfare reforms). Nor can the Central Bank ease monetary policy. That would once again undermine its credibility—and weaken the currency. A depreciating real, which is oscillating around a 10-year low, pushes up inflation; it also makes Brazil's $230 billion dollar-denominated debt dearer by the day.

Looking at the developed market picture again low interest rates have undoubtedly managed down the risks associated with high levels of debt. Many countries have lowered the short end of the yield curve by lowering official interest rates and lowered the long end of the curve by using their central banks to buy back their own debt. Countries have been able to borrow at rates never previously imagined and the most prudent have managed to extend the average maturity of their debt. Low interest rates have also raised asset prices but have been less successful at encouraging capital investment. Companies are sitting on record levels of cash and have often chosen to return it to shareholders, buy back shares or remain with it on their balance sheets rather than invest in their businesses. Low productivity gains point towards an ongoing lack of investment and examples of companies in this position can be found all around the world. This would seemingly support the view that behaviour since the financial crisis has changed with the suppression of 'animal spirits' in the free market. Again, the behavioural change around confidence and austerity mentality is very difficult to quantify but it is more clear that debt around the world remains extremely high and the risks therein are somewhat masked by conditions of low interest rates and low inflation.

The companies in which we invest are all affected by the economic weather and changes to the economic climate. The time to recover is often in direct proportion to the size of a setback and it is clear that there is still a significant amount of work to be done to normalise interest rates and levels of indebtedness without creating high levels of volatility in markets. Bond markets which, in our opinion, remain significantly over-priced are vulnerable to such changes and equity markets are certainly not immune to changing sentiment. For the investor who maintains the long term view – as all equity investors must, we maintain that high grade companies, with a progressive dividend policy, are well placed to remain attractive in a diversified portfolio. It would also appear that the damage done by the financial crisis and the burden of indebtedness have been underestimated in the past.

Our view has been that international equity markets would grind modestly higher over the year with periods of weakness reflecting difficult political and economic times. Although there is one month of the year left, it looks as if this may be the outcome. With bond markets remaining very expensive and with a wide range of government bonds showing negative yields, equities, in our view, offer better value. Instability is there for all to see but, even though we have seen some significant volatility this year, markets have recovered from bouts of weakness. In this environment of very low inflation or deflation, at least as measured by the headline numbers, low nominal returns can still mean positive real returns. With only modest economic growth in prospect, returns are likely to reflect this outlook albeit that this would still mean a positive real return.