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ASSET MANAGEMENT (C.I.) LIMITED

INVESTMENT MEMORANDUM

Whilst the performances of the equity indices shown in the table below may seem unremarkable, the geopolitical and economic background remains anything but that. Investors have shown signs of coming to terms with the tragedy which is Ukraine and the economic consequences of higher inflation and interest rates, part of the monetary tightening which is being exercised by central banks. Whilst bonds have shown negative returns, some of the losses were recovered towards the quarter end. The US dollar reversed some of its earlier strength which was also helpful to markets.

The tables below detail relevant movements in markets :

International Equities 31.08.22 - 30.11.22

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	+6.6	+1.7	+4.1	+1.7
Finland	+4.4	+4.5	+6.9	+4.4
France	+9.3	+9.3	+11.9	+9.3
Germany	+10.8	+10.8	+13.4	+10.8
Hong Kong	-3.2	-4.9	-2.7	-5.0
Italy	+15.2	+15.3	+18.0	+15.2
Japan	+2.0	-1.0	+1.3	-1.1
Netherlands	+8.4	+8.5	+11.0	+8.4
Spain	+6.5	+6.5	+9.0	+6.5
Switzerland	+1.4	+1.5	+3.8	+1.4
UK	+4.7	+4.7	+7.2	+4.7
USA	+3.3	+0.9	+3.3	+0.9
All World Europe ex UK	+7.4	+7.2	+9.7	+7.1
All World Asia Pacific ex Japan	-1.0	-3.8	-1.5	-3.8
All World Asia Pacific	-0.1	-2.9	-0.6	-2.9
All World Latin America	+5.4	+2.9	+5.4	+2.9
All World All Emerging Markets	-1.7	-4.4	-2.1	-4.4
All World	+3.3	+1.0	+3.4	+1.0

Source : FTSE All World Indices

FTSE UK Government Securities Index All Stocks (total return) : -2.5%

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

Currency	31.08.22	30.11.22
Sterling	2.80	3.16
US Dollar	3.20	3.61
Yen	0.22	0.25
Germany (Euro)	1.54	1.93

Sterling's performance during the quarter ending 30.11.22 (%)

Currency	Quarter Ending 30.11.22
US Dollar	+3.9
Canadian Dollar	+6.2
Yen	+3.0
Euro	+0.3
Swiss Franc	+0.4
Australian Dollar	+4.6

Other currency movements during the quarter ending 30.11.22 (%)

Currency	Quarter Ending 30.11.22
US Dollar / Canadian Dollar	+2.3
US Dollar / Yen	-1.9
US Dollar / Euro	-3.9
Swiss Franc / Euro	-0.4
Euro / Yen	+2.1

Significant Commodities (US dollar terms) 31.08.22 - 30.11.22 (%)

Currency	Quarter Ending 30.11.22
Oil	-10.9
Gold	+1.3

MARKETS

Despite the unsettling geopolitical and economic background and periods of volatility, international equity markets overall have ended the quarter slightly higher. In local currency terms, the FTSE All World Index has returned +3.3%, in sterling terms +1.0%, in US dollar terms +3.4% and, in euro terms, +1.0%. Looking at local currency returns first, there were above average returns from the FTSE All World Europe ex UK Index (+7.4%), the FTSE Australia Index (+6.6%), the FTSE All World Latin America Index (+5.4%) and the FTSE UK Index (+4.7%). Asian markets were weaker, although they picked up strongly in November. Over the quarter, the FTSE Asia Pacific ex Japan Index showed a return of -1.0%. The FTSE All World All Emerging Markets Index was also in negative territory, returning -1.7%. With sterling strengthening over the quarter, foreign currency returns were pared back in many cases. The sterling return on the FTSE Australia Index was just +1.7%, although that still slightly exceeded the return on the FTSE All World Index. The return on the FTSE USA Index was marginally below that on the FTSE All World Index at +0.9%, whilst the returns on the FTSE Asia Pacific ex Japan (-3.8%) and the FTSE All World All Emerging Markets Index (-4.4%) moved further into negative territory. After the FTSE All World Europe ex UK Index (+7.2%), the FTSE UK Index (+4.7%) and the FTSE All World Latin America Index (+2.9%) were outperformers.

Bond markets experienced enormous volatility and, although returns were negative over the quarter, they were much less so than at their worst times during the quarter. Taking ten year government bond yields as the benchmark, the gross redemption yield on the UK government bond rose by 36 basis points to 3.16% and the US Treasury bond by 41 basis points to 3.61% and, on the German Bund, by 39 basis points to 1.93%. The Bank of Japan follows a yield control policy, hence the small rise of 3 basis points on the gross redemption yield of the JGB to 0.25%.

Sterling, despite a significant wobble after the UK's mini budget in September, showed a meaningful recovery over the quarter as a whole. Against the Canadian dollar it rose by 6.2%, against the Australian dollar by 4.6%, against the US dollar by 3.9%, against the yen by 3.0%, against the Swiss Franc by 0.4% and against the euro by 0.3%.

In the commodity markets, oil fell back by 10.9% and the commodities were weaker. Gold rose slightly by 1.3%.

ECONOMICS

There is not much that can happen in December that can stop 2022 being recorded as an exceptional year, yet it doesn't seem that there is any dilution of the sense of the word 'exceptional' when saying we have been having quite a few exceptional years though it's possible that, logically, there's a limit to how many exceptional events you can have. Collins Dictionary's Word of the Year contenders tend to frame the year quite succinctly and in November we learned that Carolean (*from the medieval Latin for Charles, Carolus*), Kyiv and 'warm banks' were some of the runners up for 2022. A central part of this and previous reviews is the performance of capital markets which must always be considered against the economic and political backdrop, whether good, bad or indifferent and of those three, bad has prevailed for a number of years for a number of reasons, hence, perhaps, the justification for the choice of this year's Collins winner, 'permacrisis'.

Within the realm of leadership, crisis provides the greatest opportunity and within that realm we seem to find it easier to applaud and lionise military leaders than political and economic leaders. Furthermore, the dichotomy appears to be growing. Either the quality of our non-military leaders is falling rapidly or the job is getting more difficult. It's tempting to rush to say the former is the explanation but there can be little doubt that the latter appears to bear some truth. One such leader whose performance has been subject to a high level of scrutiny is the current Governor of the Bank of England, Andrew Bailey, who has found himself in a rather invidious position. His mandate is to protect the economy from shocks and ensure a stable financial system with inflation targeting being the central strategy. This has worked well for the last two decades which means that as soon as it stops working, questions are asked. The Governor can hardly be blamed for the causes of the economic conditions in which we find ourselves and yet in mid-October he warned of a "material risk to UK financial stability". The pandemic has cost the country, using figures from the Houses of Commons Library, between £310 billion and £410 billion with most of this money being spent on public services (such as the NHS), support for businesses and support for individuals. The largest costs were attributable to the Coronavirus Job Retention Scheme and NHS Test and Trace. The other side of the fiscal coin is that tax raised during the period was lower than usual, given more limited economic activity; the country was put into furlough and keeping the lights on was very costly. World trade, disrupted by COVID, continues to contribute to supply side inflation but perhaps not to the extreme levels experienced in 2020/21 and, finally, inflated prices of foodstuffs and oil due to the war in Ukraine must be considered but in the shadow of the horrors that its poor people are suffering. So, against this backdrop, the Governor has endeavoured to steer a steady course whilst reversing the monetary policy initiated after the previous world crisis of 2009.

Scrutiny of his Bank's performance may warrant more consideration because of earlier decisions and this review has been in agreement with the wider consensus that the Bank of England, along with most other leading central banks, failed to act quickly enough last year when inflation was taking root. The bankers' view then was that inflation would blow through as soon as the disruption caused by COVID passed. This did not prove to be the case and the situation has been exacerbated by the conflict in Ukraine. It is often true in markets that the speed of change can be as dangerous as the extent of change and we are now starting to feel the discomfort of much more expensive money as the sterling base rate has been forced up from 0.1% to 3% in 10 months with warnings of more to come and US dollar rates have risen by 3.75 percentage points since March. Whilst there are good grounds to argue that the prospects for the British economy are no worse than some other G7 countries, recession looms as consumer spending falls and confidence ebbs. The language around inflation forecasting has shifted. Where once it was deemed 'transitory' it is now referred to as 'broad-based' with markets still pricing in peak inflation around the end of 2022 or first half of 2023 but then falling back to levels that are more familiar. The Bank of England's website offers three reasons why inflation will fall sharply from the middle of next year. Firstly, the energy price cap will provide a ceiling to price growth for consumers. Secondly, the supply of imported goods will continue to improve and thirdly, demand for goods and services will be lower, creating downward pressure on the price of those goods and services. Nobody is blind to the downside of raising interest rates aggressively but, in some ways, the pain caused is the medicine.

Whilst the economic situation domestically and internationally is very difficult, the last few months have not put the political leadership of the United Kingdom in a good light. This memorandum seeks to avoid, as much as possible, the arena of politics but we have all witnessed at close hand the collision of political leadership and the bond markets and the damage caused. One way that bond markets differ from equity markets in that the market is constantly weighing up the supply of new bonds to the market. Issuers need to stay close to buyers so that changes to the level of supply are well signalled and digested by bond investors. Prices in most bond markets have fallen as higher inflation has eaten away at the real capital return at maturity and higher interest rates have also pushed prices down as the (usually) fixed coupon become less attractive compared with cash rates. When the Liz Truss government announced new growth-driven policy which would require an unquantified amount of fresh borrowing, there followed a rush for the exits which appeared to catch out the government. Bond investors have choices but the government does not; the UK government relies on there being a predictable and liquid market in the securities created to finance its spending and has learnt an expensive and politically embarrassing lesson.

Why is the Gilt market so important? It is a cornerstone of the investment market and longer dated Gilts are held by pension funds to hedge the long term interest rate and inflation risk against their liabilities - what they have to pay out to their members. The pension funds do not just sit on these Gilts but use them as collateral against borrowings which are then invested more profitably. The new Government's policy announcements led to a rise in yield on 30 year Gilts which rose 1.3 percentage points, causing a significant fall in price. This amplified the level of borrowing against the reduced amount of collateral, triggering margin calls, where the lender asked for more cash to act as a security buffer against the sums lent. The pension funds only held small amounts of cash so, once these were offered to the lenders, there was no choice but to consider selling some of the Gilt positions to repay the loans. At this point falling bond prices in the market were being met with forced sales, adding fuel to the fire and creating a position of illiquidity in the market. The Bank of England estimates that the effect of this squeeze on around £200 billion of pooled [LDI] pension funds threatened the £1.4 trillion traded Gilt market, which underlies around £2 trillion of lending to the real economy through wider credit markets. This is what caused the Bank to intervene over a period of 13 days with £19.3 billion of purchases. This episode has thrown up issues of supervision around leverage within the pension market but more importantly for this piece is the effect it has had on the standing of UK bond markets.

There are two factors relating to bond markets which, in some ways, are unrelated. As outlined, at this point in time governments are having to borrow to fund budgetary shortfalls as well as refinancing existing debt and the affordability of the debt burden is being scrutinised more than in the past given the high levels of debt compared with historic norms. This is ultimately a credit issue and feeds into market pricing. Secondly, and notwithstanding any credit deterioration, interest rates are increasing almost universally meaning new borrowings and refinanced maturing debt are subject to higher interest rates than in the recent past.

Buyers of bonds are unsentimental and unpatriotic and risk-based returns drive buyers' intentions. This is worth considering in the context of continental Europe where individual countries issue bonds depending on their economic and budgetary needs, but as far as eurozone members are concerned, those member countries' debt is all issued in the same currency, which is overseen by one central bank, the European Central Bank in Frankfurt. Its postal address is German but its mandate covers all member countries and all is well so long as all of those countries' economies are experiencing similar pressures. This hasn't been the case for a long time and times of crisis expose the weaker members of the group, as was shown during the Great Financial Crisis of 2009 and the debt crisis of 2012. A simple measure of divergence within the euro area is the level of member country debt. Whilst the levels of debt as a proportion of every country's GDP has risen to fund COVID, the relative cost of servicing debt in each country has changed even more, raising questions about how sustainable those debt piles are. It would be hard to find an investor who is too concerned about Germany repaying its debts and Greece is small enough to be held back from default but a country like Italy faces some very difficult decisions. Italy now has a level of debt around 150% of GDP, which in context stands against an agreed EU target of 60%. Germany is, not surprisingly, one of the country's best placed to manage its finances with a level of debt of around 70%, however, rising euro interest rates and widening credit risk spreads put particular pressure on government spending in weaker countries. Italy can currently borrow from the market at 3.7% for 10 years but for most of 2021 it could have borrowed for under 1%. The last time borrowing costs were this high were in 2013 at the tail end of the European debt crisis. Again, some context is needed because borrowing at 1% was the almost freakish final phase of the decade of quantitative easing and rates were always going to rise. Unfortunately, the reversal of quantitative easing, involving money supply contraction and rising interest rates, is not conducive to economic expansion. In summary, some, if not all, leading countries face increased debt servicing costs at the same point as having to raise taxes or cut public spending and face rising unemployment in a period of negative growth. The impact of the raised cost of debt will be felt disproportionately as the credit quality of the issuer decreases. Going back to the example of Italy debt servicing at 4% means that the country needs to maintain an average primary budget surplus (excluding debt servicing costs) of almost 1.5% of GDP. This represents a significant constraint on the public purse that normal economics would dictate would be used more freely through recessionary times to stimulate a faltering economy and this is just to maintain debt at its current level. Trimming the debt level back down to 60% of GDP appears to be a very long term target.

The United Kingdom, after its brief flirtation with expansionary fiscal policy met with disapproval from the bond markets, has been forced to turn to prudent Swabian housewife economics, though it is not conducive to economic growth. Now is the point that the huge overdraft created by COVID needs to be addressed in all countries and the changing spreads between sovereign issues underlines the point that this is going to be a testing time. Again, it should be highlighted that much lower levels of government debt would allow for more accommodative fiscal policy which would suit the background of economic contraction but that does not present as an option at this time. Throughout the 1970s the UK's debt to GDP ratio did not rise above 50% and so is approaching double that level now. From the debt buyer's perspective it is aways a question of knowing that the issuer's level of debt is sustainable and the boundaries of what can be sustained are being explored at present. Returning to the 45 days of Liz Truss's leadership, bond markets considered this boundary to be tested and the ECB has, since July, a bond-buying mechanism known as TPI (Transmission Protection Instrument) which is intended to make sure that the monetary transmission mechanism is equally effective in all countries. Highly indebted countries will be more sensitive to interest rate rises and a country which trades openly with non-euro countries will be more affected by movements in the value of the currency as it fluctuates, as a consequence of relative interest rate changes. How the TPI will be used will be closely observed as it seems that the decision to buy a particular country's bonds will inevitably subsidise the cost of borrowing for that country against the natural market level. It also appears to have a similar purpose as the existing bond buying instrument - OMT (Outright Monetary Transactions) though fewer conditions are attached to TPI than OMT. Greater flexibility would imply simpler application, with everything that goes with that.

This is targeted artificial demand in times of unhealthily weak demand for that sovereign and is not dissimilar to the Bank of England intervening in the Gilt market earlier in the autumn, spending two weeks buying £19 billion of government debt in response to the market meltdown. It is now selling down its holdings of bonds as part of its quantitative tightening programme as prices have largely recovered and the market for UK debt now appears self-sustaining.

Great political satires such as *Yes, Prime Minister* and *The Thick of It*, have always invoked a sense of permacrisis and it's easy to imagine the febrile atmosphere around those in high office at any time, day or night, with crisis always much closer than salvation. In financial markets there are always a number of things to worry about and, over time, some overtake others and then fall back. For a while government policy in China, inflation and Ukraine have been the top three with COVID feeding in most directly to the first of those. At the beginning of November, China appeared to have turned a corner with President Xi signalling a change of policy on COVID lockdowns and a reversal of many of the restrictions around the over-borrowed internal property market. Both signalled a normalisation of policy that invited confidence that the second largest economy in the world could start firing on all cylinders. This would stimulate growth and reduce supply side disruption and, after a time, apply downward pressure on inflation which, in November, has shown signs of peaking; in November, the EU inflation figure fell for the first time since mid-2021 and Federal Reserve comments became more dovish. By the end of the month protests on the streets of numerous Chinese cities remind us that its people have a voice and the Chinese Communist Party must decide whether to face down the protesters or to change significantly the party policy on virus containment. Both have downsides. We are reminded of the grinding horror of the war in Ukraine every day and with winter approaching armies are digging in. Defence trumps attack in such circumstances and whilst Ukraine has been the winner on the ground, Russia has had control in the air. It doesn't look like it will end any time soon, but it doesn't look likely to spread beyond its current theatre.

Feedback from clients on performance so far this year has generally reflected some surprise that results seem not to have reflected the gravity of the geopolitical and economic background. Our interpretation of this is that expectations in these difficult times are very low and 2022 follows a long period of strong returns when averaged. It certainly feels like permacrisis with the six o'clock news best viewed from behind the sofa, but equities continue to be our favoured investment class. Equity valuations are always forward looking and have responded strongly to better, recent news on inflation and China when it has come, though there has been some symmetry with unfavourable news. Markets have had to absorb recent downgrades to economic growth forecasts driven by diminished consumer spending power and the recent economic performance of and the outlook for the UK is a reminder of the importance of meaningful diversification in portfolios and in all cases, where it is possible, portfolios should invest internationally. Furthermore, the UK-listed companies which our portfolios tend to hold are international in their outlook which has helped support their share prices as overseas income has been flattered by the depreciation of the pound. Comparative performance of the FTSE 100 versus the FTSE250, which is more UK-focused and represents the next biggest companies, illustrates this with the total return over the first 11 months of this year being +6.2% for the former and -16.2% for the latter. Companies generating resilient income streams and which have strong positions in their markets continue to be the bread and butter of our portfolios.

The review this month has touched upon three main subjects, being the UK recovering its standing in the bond markets, a better inflation outlook suggesting that the darkest hour may be passing and China reverting to policies conducive to better economic growth (iShares China Large-Cap ETF, covering fifty of the largest and most liquid Chinese stocks - Red Chips, P Chips and H shares - listed on the Hong Kong Stock Exchange), is up 27.3% in sterling terms in November). A fourth subject would be the mid-term elections in the United States which have allowed both parties to claim some sort of positive outcome and markets appear happier that the Republicans' foothold in the House stymies the Democrats' legislative programme. It's a lame duck administration until the beginning of January which allows the Democrats a short window to get legislation through whilst they still have the numbers after that it is likely to be the partisan politics of a split Congress preventing much being done, something that markets do not mind.

We face a winter where the reduced spending power of income will force many to face difficult choices, whilst a season of strikes will add to the gloom. Unemployment is likely to start rising and some businesses will fail, especially those reliant on discretionary spend. Markets continue to look forward and look past this difficult period and there is enough to believe that a permacrisis can only go on for so long.