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ASSET MANAGEMENT (C.I.) LIMITED

INVESTMENT MEMORANDUM

International equity markets suffered a setback during the quarter as various issues which had been simmering in the background captured investors' attention in a more negative way that they had done previously. Bonds were generally easier. In the foreign exchange markets, the US and Australian dollars strengthened against sterling. In the currency markets, oil fell sharply.

The tables below detail relevant movements in markets :

International Equities 31.08.18 - 30.11.18

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	-9.4	-6.8	-8.5	-5.9
Finland	-11.7	-12.5	-14.1	-11.7
France	-7.2	-8.0	-9.7	-7.2
Germany	-9.5	-10.3	-12.0	-9.5
Hong Kong, China	-6.0	-4.0	-5.8	-3.2
Italy	-3.9	-4.8	-6.5	-3.9
Japan	-3.0	-3.5	-5.3	-2.6
Netherlands	-7.6	-8.4	-10.0	-7.6
Spain	-2.3	-3.2	-5.0	-2.3
Switzerland	-1.0	-2.4	-4.2	-1.6
UK	-5.5	-5.5	-7.2	-4.7
USA	-4.6	-2.8	-4.6	-1.9
All World Europe ex UK	-6.1	-6.7	-8.4	-5.9
All World Asia Pacific ex Japan	-7.9	-5.8	-7.5	-5.0
All World Asia Pacific	-5.9	-4.9	-6.6	-4.0
All World Latin America	+4.5	+8.3	+6.3	+9.2
All World All Emerging Markets	-5.2	-2.4	-4.2	-1.6
All World	-5.0	-3.8	-5.3	-3.0

Source : FTSE All World Indices

FTSE UK Government Securities Index All Stocks (total return) : -1.8%

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

Currency	31.08.18	30.11.18
Sterling	1.31	1.23
US Dollar	2.86	3.11
Yen	0.08	0.10
Germany (Euro)	0.23	0.28

Sterling's performance during the quarter ending 30.11.18 (%)

Currency	Quarter Ending 30.11.18
US Dollar	-1.6
Canadian Dollar	+0.2
Yen	+0.7
Euro	+0.9
Swiss Franc	+1.3
Australian Dollar	-3.1

Other currency movements during the quarter ending 30.11.18 (%)

Currency	Quarter Ending 30.11.18
US Dollar / Canadian Dollar	+1.9
US Dollar / Yen	+2.3
US Dollar / Euro	+2.5
Swiss Franc / Euro	-0.5
Euro / Yen	-0.2

Significant Commodities (US dollar terms) 31.08.18 - 30.11.18 (%)

Currency	Quarter Ending 30.11.18
Oil	-23.3
Gold	+2.4

MARKETS

After a long run of generally strong performances international equity markets experienced a setback in the latest quarter, with October being a particularly poor month. Nevertheless, in the context of the magnitude of returns seen in recent years, the setback was not significant. In local currency terms, the total return on the FTSE All World Index for the latest quarter was -5.0%, in sterling terms -3.8%, in US dollar terms -5.3% and, in euro terms, -3.0%. On the positive side, there was one standout performance which was the FTSE All World Latin America Index which, aided by the Brazilian election result, returned +4.5% in local currency terms. Relative to the FTSE All World Index, there were noticeable underperformances from the FTSE Australia Index, -9.4%, the FTSE All World Asia Pacific ex Japan Index, -7.9%, and the FTSE All World Europe ex UK Index, -6.1%. In sterling adjusted terms, the relative outperformance of the FTSE All World Latin America Index increased as it returned +8.3%. Elsewhere, the strength of the US dollar meant that the relative performance of the FTSE USA Index improved, the return being -2.8%.

In the government bond markets, there were not major changes in yields, but the 10 year US government bond yield broke through and stayed above the 3% level, with the yield rising by 25 basis points over the quarter to end at 3.11%. Elsewhere, the stand off between the new Italian coalition government and the EU meant that the yield on the ten year Italian government bond leapt to over 3% ending the quarter at 3.207%, although this was below the peak level of 3.68%.

In the currency markets, the Australian dollar and US dollar performed best. Against the Australian dollar, sterling fell by 3.1% and against the US dollar it fell by 1.6%. On the other hand, sterling rose by 1.3% against the Swiss Franc, by 0.9% against the euro, by 0.7% against the yen and by 0.2% against the Canadian dollar.

In the commodity markets, the stand out feature was the collapse in the oil price which caught many people by surprise. Against the Brent benchmark, it fell by 23.3% over the quarter. Gold ticked higher, rising by 2.4%.

ECONOMICS

There has been considerable turbulence in markets this quarter as a result of negative background factors, which we have previously mentioned in these reviews, becoming more prominent and capturing investors' attention whereas, before, they had been noted but had not influenced markets greatly. Having said that, and looking at the overall movements in international markets over the quarter, the effect of investors' more negative sentiment has not been that marked as evidenced by the movement in the indices. It is important to say that there have been no major new issues, just that they have come more to the fore. So how concerned should we be? The stand off between the USA and China over trade is certainly not good news. Whilst the effects so far have not been too serious, they have the potential to do damage and slow down economic activity. From President Trump's viewpoint, one of the factors he will want to consider is whether the loss of control of the House of Representatives in November's mid term elections should make him ease back on the rhetoric, given that his "America First" approach did not seem to resonate with the electorate or whether he should double up and impose tariffs on all Chinese imports in the hope of attracting more support. The ultimate threat was that the USA would raise the 10% tariffs already in place on US$200 billion of imports to 25% in January and then look to place tariffs on the US$267 billion of imports not yet covered by the recent tariff measures. Of course, the President may go further with auto imports from the EU and Japan in his sights. China will not want to be seen to back down and will have a range of further measures which it will action if necessary. Both countries have a case to answer and a full scale trade war will damage economic growth which is what the equity market depends upon for long term performance. Protectionism is unreservedly a bad economic policy. It reduces growth and it reduces consumers' welfare. The stock market will be sensitive to developments between President Trump and Xi and are likely to react either way depending upon the news. In the short term, a truce has been agreed in that China has agreed to increase its purchases of US farm products, energy and some industrial goods. As a quid pro quo, the USA will delay the increase in proposed tariffs on the 1st January. This truce lasts until 1st March so that negotiations can continue.

There are longer term issues as well which arise from this ramp up in protectionism. Trade patterns can change in response to protectionism. We are already seeing some companies moving business from China to other countries to avoid or mitigate the effect of US tariffs. Domestically, China has had to take measures to ease economic policy to offset the slowdown in its economy and this at a time when it has been trying to reduce risk in its financial system due to the high level of leverage in the economy often associated with the property market and the shadow banking sector. Growth rates in China influence market movements and will be important for President Xi as he consolidates his power.

The Italian political situation and the potential stand off with the EU has come to the fore in the current quarter as the populist coalition produced a budget with a higher deficit than the previous government had indicated, with tax cuts and spending increases which the EU has rejected. With public debt outstanding at over 130% of GDP, Italy is vulnerable to financial and economic crises. It will be very difficult for either side to back down, yet the stakes are very high. In the background is the coalition's background planning before the election on using a mini BOT, a sort of parallel currency, to enable settlement of public sector claims, for instance tax payments. This would severely undermine the credibility of the euro and even cause its break up. There is a big doom loop which could threaten the Italian banks with their large holdings of Italian government debt. Italian banks hold around €375 billion of Italian government debt making up about 10% of their total assets. A sharp rise in yields which would reduce the value of their bond holdings would be very serious. Furthermore, the amount owed to other eurozone countries, as measured by what are called Target 2 balances, is vast. Whilst the euro continues in existence this is not a problem but, if the euro were to break up because of an implosion in Italy, this would be extremely serious, to say the least. The working assumption within the EU is that the issue will be fudged but that the credibility of the Stability and Growth Pact will be questioned.

Important members of the eurozone have outstanding public debt at well over 60% of GDP, the required level, and nothing has really happened to bring them into line. The Italian situation is particularly relevant in terms of the ECB's monetary policy. As matters stand, the ECB is due to end its quantitative easing (QE) programme at the end of the year. The level of asset purchases has been reduced to €15 billion a month and, although the ECB cannot finance the Italian government directly, its purchases in the secondary market have indirectly helped Italy. When this stops, assuming no change in plan, Italy will have to stand on its own feet and the discipline of the bond market will be brought to bear on the Italian government. This is potentially a major problem and it will be interesting to see who blinks first, the EU or the Italian coalition government.

In our October economic review, we discussed the possibility of a rising oil price impacting on economic growth as the US sanctions on Iran were extended on 4th November. However, the passage of one month has made a great difference as the oil price has unexpectedly collapsed. The extent of the fall was surprising but an oversupply, the granting of a significant number of exceptions to the sanctions by the USA and some evidence of weaker demand were contributory factors, it seems. The fall in the oil price is a two edged sword. On the one hand, it helps to subdue inflation, increases consumer purchasing power and may encourage central banks to moderate their monetary tightening policies. Against that, if the oil price does reflect weakening demand and, therefore, lower growth, that is a negative factor. Given that some energy companies have high yield bonds outstanding and, by implication, carry a lower credit rating, the risks to that sector increase. But, overall, we would consider the fall in the oil price, if sustained at around this level, a positive for markets.

At a localised level, rather than a global level where the issue does not resonate nearly as much, is Brexit. As this is written, there is no clarity as to how matters will unfold but our view is that Brexit is less of an issue for markets than the possibility of a change in government, perhaps because of the fall out from Brexit. Whilst the Fixed Term Parliament Act makes it more difficult to hold an election before the five years of the parliament is up, it could happen with a minority government in power as at present if, for example, the DUP were to change sides. The extreme changes in economic policy which would be likely to follow a change in government, some of which have been floated, would pose a significant threat to share prices, bonds and sterling. Foreign investors have picked up on this, hence the unpopularity of UK assets. This is mainly an issue for sterling based UK investors and we will come on to this later.

The fundamental issue, absent these specific events or possibilities, which we outlined in our reviews at the beginning of this year, was the interaction of monetary policy with shares and bonds. Whilst there has been a lot of political and economic "noise" this year, much of which we have noted above, the world economy has been growing, even though it would be right to note some slowdown of activity in some countries and regions. The question for investors is how moves to restore some normality to monetary policy will affect securities' prices. Very low interest rates and Quantitative Easing were meant to boost asset prices after the financial crisis ten years ago and, in that, they were successful. Shares and bonds both performed well after that policy was introduced. However, it is not desirable that this extreme monetary policy, which has been followed by central banks, continues indefinitely because it threatens asset bubbles and distorts economic and investment behaviour. For economies to depend upon ultra low interest rates and newly created money to provide the drivers for economic growth is very unhealthy and provides no room to act in future should there be another recession, which there will be at some stage. Amongst the major economies, the USA has been showing the best economic growth and the Federal Reserve is in the forefront of restoring some normality to monetary policy as it has introduced a series of interest rate increases, eight since 2015, and has also introduced Quantitative Tightening (QT) to reduce the size of its balance sheet. The UK probably comes next, but a long way behind the USA. Interest rate increases are well behind those from the US central bank and the Bank of England has long since ended QE but it has not started QT and, given the febrile political atmosphere in the UK, is not likely to do so in the near future. The ECB has not moved on interest rates, its official interest rate is zero, and many depositors are experiencing negative interest rates on their deposits. The ECB is due to end QE at the end of this year after a series of reductions in the amount of QE it has been carrying out. That is as far as it is likely to go at present. The Bank of Japan continues to follow a very easy monetary policy, although perhaps very slightly tightened as evidenced by the drift up in the ten year JGB yield and a reduction in the size of the Bank of Japan's balance sheet. However, the volatility in markets has caused yields on government bond markets to fall back, at least temporarily. The point which we have been making throughout this year is that central banks have to try to ensure that their signalling to markets is clear so that monetary tightening, in whatever form, does not come as a nasty shock to investors. Reasonable economic growth and a gradual move to some sort of normality in interest rates would be the desired outcome as the combination would gradually reduce distortions in the economy and markets and provide some monetary ammunition to use in the next economic downturn. So how does the desired move towards some semblance of normality in monetary policy dovetail with a reasonable assessment of the economic outlook?

For this, we might look for some support from the latest projections in the IMF's October 2018 World Economic Outlook. Some of the recent developments outlined above have caused the IMF to reduce its projections, but not dramatically, and, of course, it outlines the uncertainties of the current political and economic situation. Its world growth projections for 2018 and 2019 now stand at 3.7% which, in both cases, is a reduction of 0.2% on its July 2018 update. Those outcomes are the same as for 2017. Within those projections, the IMF has only made a slight change to those for the Advanced Economies with no change for 2018 at 2.4% and a 0.1% reduction for 2019 to 2.1%. Within the Advanced Economies area, the IMF has left unchanged its projection for 2018 at 2.9% but reduced the figure for 2019 by 0.2% to 2.5%. The eurozone has suffered a reduction of 0.2% this year to 2.0% with the 2019 level left unchanged at 1.9%. Amongst the largest eurozone countries, Germany has seen its forecast reduced sharply this year by 0.3% to 1.9% and by 0.2% next year to 1.9%. France has seen a 0.2% downgrade this year to 1.6% and a 0.1% downgrade to 1.6% for next year. Despite all the discussion on Italy the IMF has left its forecasts unchanged for 2018 and 2019 at 1.2% and 1.0% but the background is obviously very fluid there. For the fourth largest eurozone country, Spain, the IMF has slightly reduced its forecast this year by 0.1% to 2.7% but left next year's forecast unchanged at 2.2%. The forecast for Japan has actually been raised by 0.1% to 1.1% this year and left unchanged at 0.9% next year. Projections for the UK have also been left unchanged at 1.4% and 1.5% respectively, as have those for Canada at 2.1% and 2.0%. Perhaps, not surprisingly, in view of developments in some emerging markets, the IMF has made reductions for both years in its Emerging Market and Developing Economies forecast, by 0.2% this year to 4.7% and by 0.4% in 2019 to 4.7% also. Within that area, the IMF has left China's forecast unchanged at 6.6% this year but reduced it by 0.2% next year. The changes for India have been very minor, unchanged this year at 7.3% and reduced by 0.1% next year to 7.4% (fiscal year in the case of India). Brazil, where there has been much turmoil and an election which is likely to bring significant change, has seen its forecasts reduced by 0.4% this year to 1.4% and by 0.1% next year to 2.4%. These reductions might seem to be a negative pointer for markets but, at this stage, the downgrades are not significant and the absolute levels of growth forecast should be supportive of equity markets. Nevertheless, there has to be a significant level of doubt about the outcome for this year and next, in particular, given the political and economic background described in this review.

Just looking at the latest indicators from around the world and using the highly regarded purchasing managers indices (PMI) as an economic bellweather, we see a mixed picture. We know that the US economy grew at an annualised rate of 3.5% in the latest quarter and by 3.0% a year earlier and that this strong growth rate is backed up by the PMIs. The latest one for manufacturing stands at 59.3 and for non-manufacturing at 60.3, both indicative of a stronger US growth rate. The unemployment rate remains very low at 3.7% and the non farm payroll figures have been strong. Realistically, we have to be aware that the strong fiscal boost arising from the tax cuts on top of an economy which was performing reasonably well is a pro cyclical boost. This is, in effect, dismantling the automatic stabilisers in the US economy which should suggest that the government should be banking the effects of growth for its budget so that it would be in a better position to give a fiscal boost in the next downturn. Whilst tax cuts are generally welcome, the danger for the US economy is a much larger budget deficit before any benefits come through, higher interest rates to fund the increased deficit and a rise in inflation as the economy overheats and comes up against capacity constraints. That is for the future but, in the short term, it is important that the costs to companies and consumers from the US trade tariffs against China do not have more than a marginal effect. What is true is that the US economy is in a better position than most and shareholders in US companies have benefited from higher dividends and share buybacks. What is needed now, and one of the aims of the tax cuts, is to stimulate business investment and, therefore, long term economic growth. Recent news on this score has been less promising with the rate of growth slowing down in the third quarter. The threat of trade wars may be affecting investment, even if the tariffs against China and anywhere else to which they may be applied, like the EU, are meant to bring business back to the USA. But, overall, the USA is in a better position than most and the relative performance of the US equity market so far this year reflects this.

Turning to the eurozone, a political feature, with economic consequences, has been the rise of populist parties which is apparent in a number of countries in the area. Italy, of course, is to the fore with populists in government who are challenging the EU with their budget proposals. In Germany, we have seen the collapse in support for the two traditional main parties, the CDU and SPD. In the recent

Spanish regional election in Andalusia, a far right party gained significant representation. In France, the emergence of the gilets jaunes, originally protesting against the rise in diesel and petrol taxes but morphing into a general protest group, has led to violence in major parts of France which are bound to affect economic activity in the fourth quarter. The protests have forced the government to defer the imposition of the higher diesel and petrol taxes and one feels that this must mark some sort of watershed for President Macron. Having been initially successful in introducing some important reforms, he has now run into trouble and the protestors, stirred on by their success, may feel that they can block important pension and social security reforms which are due to be considered. With the political background darkening in some eurozone countries, there are signs of an economic slowdown in some areas. The latest composite PMI for the eurozone stands at 52.7 which is consistent with weak growth. That for the largest economy, Germany, stands at 52.2. It should be said that the Bundesbank foresees a fairly strong bounce in the fourth quarter as car manufacturers adapt to new emission testing and increased production This situation contributed to a very poor third quarter for Germany where the annualised rate of growth was negative at -0.6%. The latest string of German factory orders data suggests that growth will pick up after such a poor second quarter. The French composite PMI index was better, standing at 54.2, but one would expect that the protests and violence in France in recent weeks will show up in the economic data. What is really concerning is the very poor data from Italy where the latest composite PMI stands at 49.3 which suggests economic contraction. Bearing in mind that the 2019 budget, which was rejected by the EU, was predicated on an economic forecast of 1.5% growth in 2019, 1.6% in 2020 and 1.4% in 2021, one can see that there were some heroic assumptions there. All this is relevant in terms of the ECB's plans to end QE at the end of this year. If the eurozone is entering a period of lower growth, even if temporarily, tighter monetary policy (all things are relative here because in absolute terms monetary policy is extremely lax) could exacerbate the position. Yet continuing to print money just to maintain even a modest rate of growth in the eurozone is only storing up trouble for the future. In looking at the performance of European shares this year, which has been disappointing, it is worth reflecting on the relative outperformance of the Swiss market, a country outside the eurozone and therefore avoiding some of its problems. Year on year, the Swiss economy has grown by 3.4% and second quarter annualised growth was 2.9%. This is a market we emphasise with its collection of world class companies. For the eurozone as a whole, third quarter annualised growth was a mere 0.7%.

With all that is going on elsewhere in the major markets, Japan tends to keep out of the limelight and the performance of its stock market has been relatively good so far this year. The economy had a poor third quarter with the quarterly annualised growth rate in negative territory at -1.2% and the year on year growth rate at 0.3%. The country's PMIs indicate only modest growth in the future with the composite index standing at 52.4. QE has taken place on an epic scale in Japan, in relative terms far greater than elsewhere. However, the central bank's balance sheet is beginning to contract, possibly evidencing some movement towards tightening monetary policy. Next year, it is planned to raise the level of consumption tax to 10% in October 2019. Previous experiences of raising consumption tax levels have not been good for Japan but, such is its level of indebtedness, that Japan cannot indefinitely keep raising its debt levels. Outstanding public debt as a percentage of GDP is over 250% of GDP. Even though most of its debt is financed internally, this problem has to be addressed, particularly in view of the country's very poor demographics. But, for the moment, Japan seems to be quietly reining back on its central bank balance sheet size. Japan is unusual in that part of the country's QE asset purchases have been of shares through exchange traded funds which will have been of some support to the market but is not a healthy position to be in, raising amongst other matters, corporate governance issues.

For China, which has been an especially poor performer this year, the problems have been mounting as a result of the US tariffs on some of its exports, amounting to US$250 billion so far. Of course, China continues to have attractive long term prospects and its growth rates are ones that developed countries can only envy. Year on year growth at the end of the third quarter was 6.5% and the third quarter's annualised growth rate was 6.6%. But overall debt levels in China are high and the authorities have been trying to deleverage the economy by cutting back on the activities of the shadow banking sector. However, the authorities have felt the need to counteract the negative effect of sanctions and monetary policy has been loosened by reducing the Chinese banks' reserve requirements. The reserve requirement for large and small banks was cut from 15.5% to 13.5% in October, which freed up the equivalent of US$109 billion in the hope of stimulating economic growth. There are other issues with China such as the increasing use of companies to promote various economic and social policies, which lessen their attractions as commercial considerations take second place to political considerations. But, for now, what would put new life back into the Chinese equity market, as for others, would be a resolution of the trade dispute with the USA.

In the UK, there are really only two issues to consider which are Brexit and the political consequences of what is happening now. We have discussed this earlier and we strongly believe that the value of an internationally diversified portfolio cannot be overestimated given the high risk which the UK market displays now. A change of government is the main risk and the value of holding significant overseas assets cannot be overstated. It is always sensible, and always our policy, to invest internationally which, over the years, has led to enhanced returns against a purely UK portfolio. At this time, this policy provides vital insurance cover. Absent these political issues, the UK market looks good value but cutting the risk, implied in UK investments, is paramount at this time.

Since the end of the quarter, share prices have been volatile and weak. Trade issues have been to the fore but, just when there was some better news surrounding the temporary truce between the USA and China, as we described earlier in this review, the markets were spooked by news that Huawei's Chief Financial Officer had been arrested in Canada on sanctions busting charges which led to an angry response from China. In such a febrile atmosphere, events such as this can lead to sharp market movements. From an investment perspective, we cannot assume that a full scale trade war will result from the USA/China stand off. It would be a rash decision to make changes to an investment policy on the basis that the talks will ultimately fail because, at the end of the day, it is in neither side's interests for protectionism to take hold, even though the US President seems protectionist by nature. So, we do expect periods of market weakness against the background of a medium term uptrend on the back of a moderately favourable economic background. What we do strongly believe is that sterling based investors should ensure that significant overseas diversification is in place.