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ASSET MANAGEMENT (C.I.) LIMITED

INVESTMENT MEMORANDUM

It has been a satisfactory quarter for international equity and bond investors, although for sterling based portfolios the currency, for once, has exerted a negative influence on returns, unlike portfolios based in the major currencies. Sterling has recovered strongly as hopes of a Brexit deal were raised and then confirmed. In the six weeks up to the General Election on the 12th December, UK stock markets and sterling are likely to be influenced by the opinion polls. During the quarter, the oil price weakened, whilst gold improved.

The tables below detail relevant movements in markets :

International Equities 31.07.19 - 31.10.19

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	-0.5	-5.9	+2.3	-0.7
Finland	+1.5	-3.8	+1.7	+1.5
France	+3.8	-1.6	+4.0	+3.8
Germany	+5.1	-0.3	+5.4	+5.1
Hong Kong, China	-3.9	-9.2	-4.1	-4.3
Italy	+6.0	+0.5	+6.2	+6.0
Japan	+7.7	+2.3	+8.1	+7.9
Netherlands	+2.4	-2.9	+2.6	+2.4
Spain	+2.7	-2.6	+2.9	+2.7
Switzerland	+2.6	-2.6	+2.9	+2.7
UK	-2.8	-2.8	+2.7	+2.5
USA	+2.3	-3.2	+2.3	+2.1
All World Europe ex UK	+3.6	-1.8	+3.8	+3.6
All World Asia Pacific ex Japan	+1.3	-4.1	+1.4	+1.2
All World Asia Pacific	+3.7	-1.6	+4.0	+3.7
All World Latin America	+5.0	-5.5	-0.2	-0.4
All World All Emerging Markets	+2.1	-4.6	+0.9	+0.6
All World	+2.5	-2.8	+2.7	+2.5

Source : FTSE All World Indices

FTSE UK Government Securities Index All Stocks (total return) : +2.2%

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

Currency	31.07.19	31.10.19
Sterling	0.60	0.57
US Dollar	2.03	1.77
Yen	-0.18	-0.17
Germany (Euro)	-0.52	-0.41

Sterling's performance during the quarter ending 31.10.19 (%)

Currency	Quarter Ending 31.10.19
US Dollar	+5.9
Canadian Dollar	+6.0
Yen	+5.3
Euro	+5.7
Swiss Franc	+5.6
Australian Dollar	+5.8

Other currency movements during the quarter ending 31.10.19 (%)

Currency	Quarter Ending 31.10.19
US Dollar / Canadian Dollar	+0.1
US Dollar / Yen	-0.6
US Dollar / Euro	-0.2
Swiss Franc / Euro	+0.2
Euro / Yen	-0.4

Significant Commodities (US dollar terms) 31.07.19 - 31.10.19 (%)

Currency	Quarter Ending 31.10.19
Oil	-8.6
Gold	+4.6

MARKETS

Against recent trends, sterling recovered strongly during the quarter which meant that satisfactory local currency returns in most markets turned into negative ones in sterling terms. In local currency returns, the FTSE All World Index returned +2.5%, in sterling terms -2.8%, in US dollar terms +2.7% and in euro terms +2.5%. In local currency terms, the stand out performer was the FTSE Japan Index which returned +7.7% whilst, on the negative side, the FTSE UK Index returned -2.8% and the FTSE Australia Index -0.5%. Looking at sterling adjusted returns, the local currency underperformance of the FTSE UK Index turned into exactly the same performance as the FTSE All World Index, which was -2.8%. Despite the fall in the yen against sterling, the sterling adjusted FTSE Japan performance still returned a creditable result, +2.3%. Because of the weakness of the Australian dollar, the underperformance in sterling terms was quite noticeable with the FTSE Australia Index returning -5.9%.

In the international bond markets, as represented by ten year government benchmark bonds, the gross redemption yield on the UK gilt fell by 3 basis points to 0.57%, on the US Treasury bond by 26 basis points to 1.77%, on the Japanese Government Bond by 1 basis point to -0.17% and on the German Bund by 11 basis points to -0.41%.

In the foreign exchange market, as indicated above, sterling strengthened quite noticeably, rising by 6.0% against the Canadian dollar, by 5.9% against the US dollar, by 5.8% against the Australian dollar, by 5.7% against the euro, by 5.6% against the Swiss Franc and by 5.3% against the yen.

In the commodity markets, oil, as measured by Brent crude fell by 8.6%, whilst gold rose by 4.6%.

ECONOMICS

Most economic forecasters have been steadily reducing their estimates of economic growth in the face of economic headwinds, notably rising trade tensions, especially between the USA and China. Despite this, and perhaps counterintuitively, securities markets have, so far at least, held up well, posting satisfactory returns.

The themes of our monthly economic reviews have been consistent throughout the year to the point of repetition, yet they remain valid, and it is difficult to put forward new issues which are driving markets and investor sentiment. The general issues driving market movements seem to be pulling in opposite directions but, at least to the end of October, what investors see as the positive catalyst has had the upper hand. The negative influence is clearly the rise of protectionism, mainly surrounding the USA/ China trade dispute, but also developing elsewhere, and the positive one is the move to an even easier monetary policy which makes shares and fixed interest securities theoretically, at least, more interesting.

Protectionism, in the form of tariffs, quotas or more subtle policies, is one of the reasons why organisations like the IMF have been reducing their forecasts for economic growth. In its October World Economic Outlook, it now estimates world economic growth this year at 3.0%, down from its April figure of 3.3%. For 2020, it now sees growth at 3.4%, 0.2% lower than in April. These forecasts are not disastrous for they are not at levels which presage a recession, but the downward trend of forecasts is nevertheless a concern. For reference, growth in 2017 was 3.8% and, in 2018, 3.6%. The IMF’s projections for Advanced Economies show growth of 1.7% in both 2019 and 2020. The only difference here from its April forecast is a reduction of 0.1% for this year, with no change next year. For the USA, the IMF’s forecasts have actually risen since April. It now sees growth of 2.4% this year and 2.1% next year compared with its earlier forecasts of 2.3% and 1.9% respectively. For the eurozone, the movement is the other way, with the 2019 forecast for 1.2% growth and the 2020 forecast for 1.3% growth, in both cases a reduction of 0.1%. Within the eurozone, there is a noticeable downgrade in the projections for Germany. For 2019, the IMF now sees growth of only 0.5% against 0.8% in April and for 2020 the downgrade is 0.2% to 1.2%. The downgrade for France is much smaller by just 0.1% in both years to 1.2% and 1.3% respectively. Whereas Italy was forecast to show growth of 0.1% for the year last April, the IMF now sees no growth and the 2020 forecast has now been pared back to 0.5% from 0.9%. Spain, which has been a relatively good performer within the eurozone, has seen its growth forecast raised to 2.2% this year from 2.1%, but for next year the forecast is trimmed back by 0.8% to 1.8%. There is a very slight reduction in the forecast for Japan this year, down by 0.1% to 0.9% but no change for next year at 0.5%. There is no change in the forecasts for the UK at 1.2% and 1.4% respectively. Emerging Markets and Developing Economies have seen a reasonably significant reduction in their growth forecasts. The IMF now sees 3.9% growth for this year against 4.4% in April and 4.6% for next year against 4.8%. Within that, perhaps not surprisingly, growth forecasts for China have been downgraded from 6.3% for 2019 to 6.1% and for 2020 from 6.1% to 5.8%. India, where the forecasts are prepared on a fiscal year basis, has seen quite a dramatic downgrade, from 7.3% to 6.1% for the current year and from 7.5% to 7.0% for the following year. Russia has seen a significant downgrade this year from 1.6% to 1.1% but an increase next year from 1.7% to 1.9%. Brazil has seen a large downgrade, particularly for this year, from 2.1% to 0.9% and, for next year, from 2.5% to 2.0%.

So, the trend is pretty clear and it tells us that economic conditions are worsening, although not yet, at least, pointing to a recession. Most economic indicators back this up and tell us that one of the main factors keeping economic growth going, albeit at a reduced rate, is consumption, although, with debt rising, there must be question marks as to how long this can continue. It is not difficult to say why this is happening. The growth in world trade is being hampered by the trade dispute between the USA and China and friction elsewhere, for instance between Japan and South Korea. If sand is put in the wheels of economic growth, it will slow down. These are particular problems and large ones at that, but there is also a major overarching problem which we always have to refer to in these reviews, because it is so important, and that is the increasing impotence of monetary policy's ability to affect economic outcomes, this particularly being a problem in the eurozone. As we see above, there are some weak numbers from the eurozone and the powerhouse of the eurozone, Germany, is suffering because, as an economy which benefits from the growth of international trade, the present restrictions are affecting it. It also has particular problems because of the difficulties facing the auto industry which is so important for Germany.

It is fair to say that very few observers expected the emergency monetary policy, instituted after the financial and economic crisis over ten years ago, to still be in position and being accelerated in some cases now. The longer quantitative easing and ultra low or negative interest rates continue in existence, the more they seem like a permanent fixture and, so, difficult to reverse without significant negative consequences in the short term. It is important to say, at this stage, that current interest rate levels are highly undesirable on anything other than a short term view because of the distortions which they cause, so we need to separate the short and long term effects of moving monetary policy back to normality. But, even in the short term, it is clear that central banks, especially in the eurozone, are getting less value from quantitative easing and lower interest rates. It is the law of diminishing returns. This is a particular problem in the eurozone where, because of the Stability and Growth Pact, fiscal action is limited by its constraints. It would not be possible to do the type of tax cutting which President Trump originated in the USA last year. Within the eurozone, both Germany and the Netherlands run very large current account surpluses at around 6.6% and 9.7% of GDP respectively. They both run a budget surplus of around 0.5% and 0.6% of GDP respectively. Germany, of course, is a much larger economy than that of the Netherlands, which is why it is facing pressure to reflate its economy. One of the major problems of the euro is that it encompasses countries with completely different economic profiles. It is not an optimal currency zone. If Germany and the Netherlands still had their own currencies, they would have floated upwards against, say, the Italian one which would be a self-correcting mechanism for differential inflation rates. As it is, with the eurozone having a common currency, there is no self-correcting mechanism. Absent that, many economists consider that a fiscal stimulus for the area would be helpful in complementing monetary policy. The country best placed to do this is Germany and there are plenty of projects for it to spend money on, infrastructure for example. A major fiscal stimulus by Germany would be helpful. That is going to be difficult, however. There has, at least up to now, been a cross party consensus in Germany about the desirability of a balanced budget and a constitutional requirement to limit the structural budget deficit to 0.35% of GDP. Germany also has a relatively low rate of outstanding public debt to GDP at 60.9%, which is on the limit of the allowable percentage ordained in the Stability and Growth Pact. If there was the political will to change tack and introduce a powerful fiscal stimulus, it would be a sensible action to take in the context of the eurozone's problems and Germany's specific issues. With Mario Draghi just having stepped down as President of the ECB, to be replaced by Christine Lagarde, the ECB is at a crossroads. Its latest easing of monetary policy in September, a month before Mr Draghi stepped down, introduced a multi tier deposit rate as it reduced interest rates to ensure some mitigation of the effects of lower interest rates on banks' profitability. It also restarted bond purchases at the rate of €20 billion a month from the 1st November. There were differences of opinion within the ECB with some members opposing further monetary easing. It does seem intuitive that if the eurozone economy had not been stimulated by interest rates cuts and previous bond purchases prior to September, the latest moves to ease further are hardly going to represent a tipping point which ignites economic growth.

Over in the USA, as this is written, the Federal Reserve has cut interest rates for the third time this year, although it did indicate that the cuts might now be paused. The target federal funds rate was reduced by 0.25% to a range of 1.5% to 1.75%. In announcing this further reduction in interest rates, the Chairman of the Federal Reserve, Jay Powell, said that "weakness in global growth and trade developments have weighed on the economy and posed ongoing risks". At least in the USA, with interest rates being positive, there is a chance that interest rate cuts may be more effective than in the eurozone. Generally, the impression one has is that in order to reach even the very modest levels of economic growth, apparent for example in the IMF forecasts, current interest rate levels must become the norm. Apart from Germany and the Netherlands in the eurozone, there does not seem to be much fiscal firepower available to complement monetary policy without running unacceptable credit risks. One danger is that, in an effort to obtain yield, investors are taking significant credit risks. The normal theory is that an investor has to be paid to take risks and any investment is, theoretically, a risk, although within a wide spectrum. As this is written, there is US$12.8 trillion of negative yielding debt out there and it has been over US$17 trillion. It cannot be a healthy state of affairs when one has to pay for the privilege of lending to a government or company. Although bond yields have risen recently, an investor would pay a yield of -0.41% to lend to the German government for ten years, so, if the bond was held to maturity, there would be a certain loss. Admittedly, Germany is a top credit, but one cannot believe it is a sensible investment decision to invest for a negative return. In saying that, we realise that short term investors may want to buy these speculatively in the hope or expectation that they will sell to an investor prepared to buy on an even lower negative yield. That is something we would never do as it is pure speculation and would be impossible to defend if there was a reversion to mean in the yield. If we look at the five year government bond market, we note that the Greek government bond is standing on a gross redemption yield of 0.36%. One feels that cannot reflect a realistic assessment of the risk, yet one appreciates that it reflects a desperate search for yield.

What would move us out of this highly dysfunctional market position and back to more normal conditions where interest rates and bond yields were at more usual levels by historical standards? The answer would be a sustained period of economic growth which could support higher interest rates. What would cause the growth rate to accelerate? Certainly, a resolution of the trade tensions would be necessary. Growth is best served by free trade and therefore the move towards heightened protectionism which we are witnessing is counterproductive. Productivity growth has been disappointing but for real incomes to increase it is necessary for this to resume and, if real incomes do increase, economic growth will do so. Once interest rates rise to more normal levels and the distortions start to disappear, capital will be allocated more effectively. But, we have to be realistic. This is a hope at present and unlikely to be realised in the short term.

So, we come back to the point we have mentioned in numerous recent investment reviews and the reason equities remain our preferred asset class. Whereas investors used to buy fixed interest securities for their yield and equities for capital growth, the tables have at least been partly turned and in most markets it is equities which provide the yield. Obviously, that yield comes under threat if there is a recession and widespread cutting of dividends. At the moment, we do not see this happening, although we concede that it is a possibility. It underlines the case for solid blue chips which, as a class, are unlikely to cut their dividends, although there will be individual exceptions. It is a simplistic argument but, given the current stance of monetary policy, we can be confident that there is not going to be a sudden upward movement in interest rates to make the yield difference between equities and bonds less appealing. This argument has, we think, been one of the drivers behind the strong performance of equities, at least until the end of October, and this is the argument that we maintain for equities.

But politics is as important as economics for investors' assessments of markets and, in this area, we want to discuss briefly the position in the USA and UK. The US has been our favoured market, and still is, but we are now almost a year away from the Presidential election and, at present, it is difficult to call. With Donald Trump, one knows what one gets, and markets have moved ahead since he was elected in November 2017. Without getting into personalities, one can say that, for investors, the good things have been the tax cuts and some deregulation, and the bad ones have been surrounding the trade war with its increasing economic effects. But perhaps investors should start to be looking at potential Democrat candidates for the Presidency. Who will win next November is very difficult to call at the moment, with a lot depending on the economy, which is why there must be some pressure on the President to come to a trade arrangement with China. We are assuming here that impeachment proceedings will not be successful. The Democrats are obviously in with a serious chance of landing the Presidency and two of the front runners, Elizabeth Warren for the Democrats and Bernie Sanders, the leftwing independent, are putting forward radical economic and tax agendas which would spook investors, if enacted. Of course, the checks and balances in the US system may make the enactment of their proposals difficult, but it is something of which investors should be aware. Investors must increasingly look at developments on the US political scene.

As our clients will know, one important reason why we have reinforced our arguments for substantial diversification for sterling based portfolios is the political risk in the UK, not so much from Brexit, but from the election of a very radical and extreme government by UK standards. In many respects, the UK is one of the most attractive equity markets, but it has been held back by the political risks. It is a high risk/potentially high reward market and, now that a General Election has been called for the 12th December, it is to be hoped that there will be more clarity. It is essential to retain our insurance policy of extensive overseas exposure to mitigate against political risks which might result from the General Election outcome. This General Election, more than any other in recent times, is crucial because of the two main parties' widely differing economic policies so it is the most important driver of investment policy for sterling based investors. The stakes could not be higher.