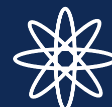

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ASSET MANAGEMENT (C.I.) LIMITED

# INVESTMENT MEMORANDUM

After some weakness at the end of September and the beginning of October, international equities markets soon recovered their poise and the quarter has shown strong returns. On the other hand, bonds have experienced a weak quarter as inflation and interest rate fears have increased. Sterling has seen a mixed performance over the quarter but, overall, has weakened. Energy prices have risen sharply, leaving their mark on inflation.

The tables below detail relevant movements in markets :

## International Equities 30.07.21 - 29.10.21

| Total Return Performances (%) | | | | |
|---|---|---|---|---|
| **Country** | **Local Currency** | **£** | **US$** | **€** |
| Australia | +0.2 | +3.9 | +2.4 | +4.9 |
| Finland | -2.5 | -3.5 | -4.8 | -2.5 |
| France | +3.5 | +2.5 | +1.0 | +3.5 |
| Germany | +0.3 | -0.7 | -2.1 | +0.3 |
| Hong Kong, China | -5.8 | -4.5 | -5.9 | -3.5 |
| Italy | +5.6 | +4.5 | +3.1 | +5.6 |
| Japan | +6.1 | +3.6 | +2.1 | +4.6 |
| Netherlands | +8.5 | +7.4 | +5.9 | +8.5 |
| Spain | +4.7 | +3.6 | +2.2 | +4.7 |
| Switzerland | +0.4 | +1.0 | -0.4 | +2.0 |
| UK | +3.7 | +3.7 | +2.2 | +4.8 |
| USA | +5.0 | +6.5 | +5.0 | +7.5 |
| All World Europe ex UK | +3.0 | +2.5 | +1.1 | +3.6 |
| All World Asia Pacific ex Japan | N/C | +1.6 | +0.1 | +2.6 |
| All World Asia Pacific | +2.1 | +2.3 | +0.8 | +3.3 |
| All World Latin America | -9.8 | -14.8 | -16.0 | -13.9 |
| All World All Emerging Markets | +2.0 | +2.5 | +1.1 | +3.6 |
| All World | +4.0 | +4.8 | +3.3 | +5.9 |

*Source : FTSE All World Indices*

FTSE UK Government Securities Index All Stocks (total return) : -2.3%

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

| Currency | 30.07.21 | 29.10.21 |
|---|---|---|
| Sterling | 0.56 | 1.03 |
| US Dollar | 1.22 | 1.55 |
| Yen | 0.01 | 0.09 |
| Germany (Euro) | -0.46 | -0.11 |

## Sterling's performance during the quarter ending 29.10.21 (%)

| Currency | Quarter Ending 29.10.21 |
|---|---|
| US Dollar | -1.5 |
| Canadian Dollar | -2.2 |
| Yen | +2.4 |
| Euro | +1.1 |
| Swiss Franc | -0.4 |
| Australian Dollar | -3.9 |

## Other currency movements during the quarter ending 29.10.21 (%)

| Currency | Quarter Ending 29.10.21 |
|---|---|
| US Dollar / Canadian Dollar | -0.6 |
| US Dollar / Yen | +3.9 |
| US Dollar / Euro | +2.8 |
| Swiss Franc / Euro | +1.6 |
| Euro / Yen | +1.1 |

## Significant Commodities (US dollar terms) 30.07.21 - 29.10.21 (%)

| Currency | Quarter Ending 29.10.21 |
|---|---|
| Oil | +11.1 |
| Gold | -2.7 |

## MARKETS

International equities have experienced a good quarter with a brief period of uncertainty around the end of September and early October being followed by record strength in share prices up to the end of the quarter.

The total return on the FTSE All World Index in local currency terms for the quarter was +4.0%, in sterling terms +4.8%, in US dollar terms +3.3% and in euro terms +5.9%. Looking at local currency returns first, there was relative strength in the FTSE Japan Index, +6.1%, and in the FTSE USA Index, +5.0%. There was significant weakness in the FTSE All World Latin America Index, -9.8%, and relative weakness in the FTSE All World Asia ex Japan Index, where there was no change. The FTSE Australia Index also showed relative weakness, +0.2%. Looking at sterling adjusted terms, the FTSE USA Index's relative strength increased further, with the FTSE USA Index returning +6.5%. Weakness in the yen lowered the return on the FTSE Japan Index to +3.6%, whilst strength in the Australian dollar raised the return on the FTSE Australia Index to +3.9%. Currency weakness exacerbated the negative return on the FTSE All World Latin America Index to -14.8%. The return on the FTSE UK Index was good, but slightly below average at +3.7%.

However, it was not such a good quarter for the bond market where inflation and interest rate fears took their toll. Using ten year government bond yields as a benchmark, the gross redemption yield on the UK gilt rose by 47 basis points to 1.03%, on the US Treasury bond by 33 basis points to 1.55%, on the Japanese Government Bond by 8 basis points to 0.09% and on the German Bund by 35 basis points to -0.11%.

In the foreign exchange markets, sterling was weaker against the Australian dollar, -3.9%, against the Canadian dollar, -2.2%, against the US dollar -1.5%, and against the Swiss Franc, -0.4%. However, it strengthened against the yen, +2.4%, and the euro, +1.1%.

In the commodity markets, oil, as measured by Brent crude, rose by 11.1%, whilst gold fell by 2.7%.

## ECONOMICS

The last 10 or so years have been extraordinary and it is not an exaggeration to say that this period has started and ended with once in a hundred year events. This economic memorandum could not possibly provide a comprehensive summary of the effects felt but it is safe to say that the coordinated policy response from governments and central banks has been of such a scale that, whilst we find ourselves deep into uncharted waters, those waters have appeared navigable.

It is scarcely imaginable that central banks could have done more, considering how much their balance sheets have grown and how low they have forced interest rates. With the Great Financial Crisis becoming a memory and, written with some hesitancy, the COVID pandemic coming to an end, we now find the patient out of intensive care, recovering better than expected, but with full doses of monetary steroids and oxygen still being administered. There is an immediacy to the situation as economic growth, particularly across the developed world, is currently strong, boosted by counter-cyclical government spending in some economies and two years of supply-side disruption and generous furlough schemes have meant that tooling up for full production has not kept up with growth in demand driven by optimism and catch-up spending.

Ten years is a long time to get used to things and swollen-to-bursting central banks' balance sheets, zero per cent interest rates and (largely) below-target inflation are what we have, more or less, adapted to accept as an enduring norm with subdued inflation making the two others easy to justify, supported by the circumstantial evidence of all countries taking similar steps and almost all economists agreeing that outcomes would have been much worse had less been done; it takes something quite compelling for economists to agree. The next phase of the project is now upon us which is the removal of the stimulus measures, the timing of which is not as much in the hands of the central bankers as they might wish. Headline inflation in United States is 5.4% and consumer prices in United Kingdom rose by 3.1% in the year to September 2021 so inflation has made an unwelcome return to the 6 o'clock news. The party line amongst central bankers, almost without exception, the IMF and the OECD is that the current burst of inflation is just that, a transitory episode with a reversion to less eye-catching levels in 12 to 24 months. They explain that price rises come with the adjustment to a higher velocity of circulation of money and supply chains will re-form and assume previous efficiencies and that current price comparisons with periods a year ago have a depressed reference level.

Will inflation prove to be transitory? Next year's inflation figures will be using current levels as their starting point, so just as last year's were depressed leading to higher reads now, the current inflated levels will squeeze any rise over the next twelve months. As an example, on 30th October 2020 the reference price of a barrel of Brent Crude oil was $37.46. One year on, at 29th October 2021, it was $83.78. This represents a rise of 123.6%. In twelve months' time the starting point of the calculation will be $83.78 and it seems likely that the oil price cannot rise nearly as much in percentage terms from this higher starting reference, though far smaller rises are, of course, still inflationary to the end user.

Another contributor to inflation at this time is supply chain disruption and it's worth considering what is meant by this and how temporary it may be. A good example of inflationary supply chain disruption is shipping. Crew and ships are not in the right place, there are new rules around distancing and crew rotation which are butting up against a shortage of containers at the same time that depleted inventories in the world's warehouses are needing to be filled as aggregate demand bounces back. Reference indices for shipping rates have always been volatile due to the costs of running ships and there is always a delicately balanced supply and demand equation. Following a long period of disruption, not helped by the Suez event, the price of immediate delivery is high. The OECD calculates that the sharp rise in the cost of moving containers from one global port to another, with spot prices being 2 to 3 times higher than a year ago, along with the rise in commodity prices, is adding around 11 percentage points to annual merchandise import price inflation in the G20 economies. The journey from factory to consumer has been encumbered further by restrictions being lifted unevenly around the world with the Delta variant leading to greater restrictions in exporting Asia whilst many wealthy importing G20 countries are opening up at a rapid rate. The OECD adds that these factors were making a negative contribution to inflation a year ago, pushing down consumer price inflation in the G20 by around ¼ percentage point. Surging demand and limited supply growth capacity mean that shipping rates are unlikely to fall significantly for another year and, overall, this suggests that higher commodity prices and shipping costs account for around three quarters of the 2¼ percentage point change in G20 consumer price inflation since the latter half of 2020. Whilst we consider inflation as goods pass from factory to consumer it is also the broad rise in the price of commodities that is the fuel that powers the factory and the constituent parts of the goods on the production line. Again, referring to OECD figures, global commodity prices in July and August this year were around 55% higher than a year earlier. Oil prices have rebounded to their pre-pandemic level, metals prices have surged due to strong demand in China and developed economies and global food prices have risen to their highest level in a decade, amidst strong demand and weather-related disruptions to production in key food exporting economies.

Another high profile case in point is car manufacturing. COVID shutdowns suppressed demand for new cars, leading to car plants shutting for short periods or cutting shifts. Demand has now bounced back and supply is struggling to keep up. Modern manufacturing relies on a 'just in time' system pioneered by the Japanese whereby components arrive at the factory the shortest time possible before assembly which creates a frailty in the manufacturing process. The pinch point has been semiconductors, the chips that power the engine management system but also almost every electric component on a modern car. Chip producers have had their own issues and have been prioritising more lucrative clients such as mobile phone and game console manufacturers. The result has been profit warnings from most car manufacturers and limited supply to the market, leading to higher prices in not only the new car market but also the second hand market. Peugeot has been installing older style analogue speedometers in cheaper models in place of digital units and Porsche has warned US dealers that customers may have to wait an extra 12 weeks to get their cars, because they lack a chip to monitor tyre pressures. Renault's deputy chief executive told analysts that they are steering production to more profitable luxury models, saying "We're trying to find an intelligent way to prioritise cars with the higher margins".

The points above suggest that deflationary pressures in the supply chain existed a year ago and that over the past twelve months the pendulum has swung, leading to target-busting inflation levels at present, particularly in the United States and United Kingdom and now the eurozone. There is also sufficient evidence to suggest that contributing factors in the swing to higher levels of inflation may moderate somewhat in the short to medium term. On top of these, other contributors to inflation exist which may be more enduring.

There is a greater consensus on global warming now than at any time before and even with politics moving slightly more slowly than shifting public opinion we are likely to see wholesale changes in the mix of energy generation. There is pressure to decarbonise with coal the first to go, followed by oil and natural gas-powered generation. The target will be a balanced mix of renewables such as solar, wind and hydro but the faster the move from old to new, the more cost risk is introduced. This year energy costs have risen as high polluting plant has been mothballed in favour of clean energy but has been, and is likely to be, needed as we go into winter. One advantage of coal and to a lesser extent oil and natural gas is the ability to stockpile in anticipation of future energy demand. The second contributor, which is increasingly of our time, is in the realm of barriers to trade. Looking at the two largest trade partners, Donald Trump introduced higher levels of tariffs on Chinese goods than had been seen before and, in the main, these have been maintained by President Biden. Tariffs on Chinese imports to the U.S. average 19%. Tariffs on goods invariably lead to higher prices as the costs are, either immediately or eventually, passed on to the end user. Supplier choice may also change with the consumer choosing to buy from a less efficient producer of goods, which was the second choice before the introduction of the tariff, which, economically, is not ideal. Whilst the benefit of imposing tariffs may be political, there is an inevitability that retaliatory tariffs will be introduced. It is also, surely, the case that the benefits of protectionism appear strongest when shortages exist in a market, which may well feed into the current situation. A final epochal contributor in world trade, which will make a smaller contribution to inflation, would be the export of internal standards. Increasingly companies' supply chains are coming under scrutiny so that goods are produced under working conditions that are more similar to those in the end market. It is hard to argue that this is a bad thing in human terms but, looking at it purely economically, it can add to price pressure and reduce the attractiveness of the country of production.

This piece started with the observation that over the last decade central banks had unstintingly acted to remain in control; a pre-requisite of any central banker would be the need to remain in control and this has been tested like never before in the recent past. The avuncular message from central banks is summed up by Mario Draghi, then President of the European Central Bank, when in July 2012 he promised that his bank was "ready to do whatever it takes" in face of falling sovereign bond prices

for certain weaker eurozone countries, driving up their cost of borrowing. This was enough and led to an instant rally in markets, both bond and equity. Italy's 2 year borrowing costs fell by 89 basis points to 4.06% and its stock market rallied over 5% on the day.

Now we are in 2021, the challenge for Mr Draghi's successor, Christine Lagarde, and her cohort is to take away the stimulatory support to which markets have grown accustomed in the face of target-busting inflation. If their belief is that we are going through a short term spike then they have much more time to deal with the simmering pressures but markets are of the view that central banks are downplaying the risk and feel a faster rate of rises in interest rates will be necessary. It may be that there is a limit to the rate of change in the message that central bankers give out.

What is sure is that we will have to adapt to a time of higher interest rates, though that is meant relatively, not absolutely. Referring back to 2012, Italy's 2 year borrowing costs was 4.06%. At the time of writing it is -0.035%, having risen over the quarter from -0.301%. Two things will happen to affect the price of sovereign bonds such as Italy's. Cash interest rates will rise, leading to rises in bond yields as investors demand a better relative return and, perhaps more importantly, the exceptional level of demand for sovereign debt due to central bank buying will be withdrawn at a time when state borrowing requirements are still very high. This is bound to have an effect on the credit outlook for certain countries which may translate into affordability issues. This is going to present budgetary issues for the treasuries of countries and there are risks of central bankers being drawn into politics as they reflect on the rate of change of monetary policy.

A cornerstone of central bank policy has been the wholesale buying of bonds in the secondary market with this false buyer, with almost unlimited buying power, pursuing a policy outcome rather than seeking a meaningful return on its asset purchases. The cost of borrowing at all points through the market, from risk-free sovereign debt down to non-investment grade, or junk, bonds has been driven down. Looking now at the corporate debt market companies have been able to borrow money at a lower cost and appetite for longer dated debt has allowed borrowers to extend the duration of their debt by pushing out maturities to points further in the future. This does not imply that the risk of lending to these issuers is lower because yields are lower, but rather, the normal risk/reward model that drives price discovery has been suspended artificially. Low market yields on debt do not reflect a lowering of risk but rather a masking of risk.

The sustainability of high bond prices/low yields is likely to be challenged strongly in the coming months and years and is a risk that has been highlighted consistently in our economic reviews. It is difficult to argue that bonds can continue their recent past performance when the economic tailwind of falling interest rates and low inflation turn into a clear headwind. Bill Gross is a man who has a view on bonds having built the American asset manager Pimco into a $2 trillion business before leaving it in 2014 and he expressed the view in September that bonds are 'trash' and buying US government debt is all but certain to be a losing bet. He is known for his ability to add colour to the market but future bond returns are very unlikely to match the returns of the past.

There are a great number of professionals in financial markets who have no experience of a bond market that performs badly for a period of years because the current rally has lasted over 40 years. The tailwind of falling interest rates and relatively low inflation has carried the bond market forward and instilled in portfolio management a belief that a balanced portfolio might typically be 40% bonds and 60% equities. Indeed, this balance has produced strong results and reduced the impact of the various falls which have beset the equity market, though on every occasion equities have recovered and gone on to higher levels and better returns. Looking at bonds issued by the US government as a proxy for the whole bond market, over the last 120 years there have been six decades of negative returns out of the twelve, though none in the last 40 years. This is a sobering statistic and runs against what many investors may perceive when thinking about bond returns.

Above target inflation is likely to persist for a number of years though the question at the moment is how soon will peak inflation arrive before it falls back to more acceptable levels. As investment managers, our first concern is the impact rising rates and the reversing of QE will have on bond markets in light of above target inflation. It appears the central bankers are very sensitive to any disruption they can cause in financial markets and, accordingly, are offering a more hawkish outlook as markets move in anticipation of any change. Much is said about effective signalling and it looks like there will be more tolerance of above target inflation than there is in more normal times. Losses in bond markets are very likely to continue to occur and longer duration, lower coupon bonds will be particularly badly hit. Credit quality is likely to slip, particularly at the lower end of the market reducing further the attractions of fixed income as a portfolio constituent which means that the traditional view of bonds being a low to middle risk investment needs to be re-considered. Sudden rises in inflation represent a level of risk to equity markets, too, as we are currently seeing, with companies' reported margins being squeezed as input costs rise but can't be passed on to the consumer. There is, however, substantial historic data to show that equity markets can absorb the effects of inflation as, in the main, price rises are eventually at the cost to the consumer. Companies also own real assets which offer some inflation protection though many indebted zombie companies will inevitably fail as the cost of refinancing rises. The outlook for bonds is weak given the inflation-adjusted returns they currently offer and the likely trajectory of monetary policy both in terms of raised interest rates and reduced central banks' bond buying. Cash remains for the ultra-cautious but it has provided a very poor real return for the past 10 years and, in real terms, interest rates are exceedingly low and often negative. Whilst equities may look expensive relative to past multiples, they continue to be more attractive than bonds and cash and the highest quality companies can protect themselves from the worst effects of inflation in the medium term. In the short term there are likely to be some market setbacks which may present an opportunity for those with cash on the sidelines.

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