# Border to Coast Pensions Partnership Joint Committee

**Date of Meeting:** 16 June 2020

**Report Title:** Border to Coast Market Review (for information and read only)

**Report Sponsor:** Border to Coast CIO – Daniel Booth

## 1 Executive Summary:

1.1 This report provides an overview of 2020 market performance and environment.

1.2 March 2020 witnessed extreme equity market volatility, with the worst quarterly UK equity market performance since the South Sea bubble burst in 1720 and the 3rd and 5th worst performance days for the US S&P 500 since 1928. The authorities responded with massive fiscal stimulation (3.7% global GDP v 1.6% in the Global Financial Crisis), financed in some cases with unlimited monetary stimulus, which combined with a flattening Covid-19 infection curve, lead to a sharp rebound in equity markets. The S&P 500 dropped 34% in 23 trading days, bottoming on 23$^{rd}$ March 2020, before rallying 25% in the following 13 trading days.

1.3 The graph below shows the price return of the MSCI World (blue shaded area), the outperforming US S&P 500 (green line) and the underperforming UK FTSE (pink line) markets:


*Source: Bloomberg*

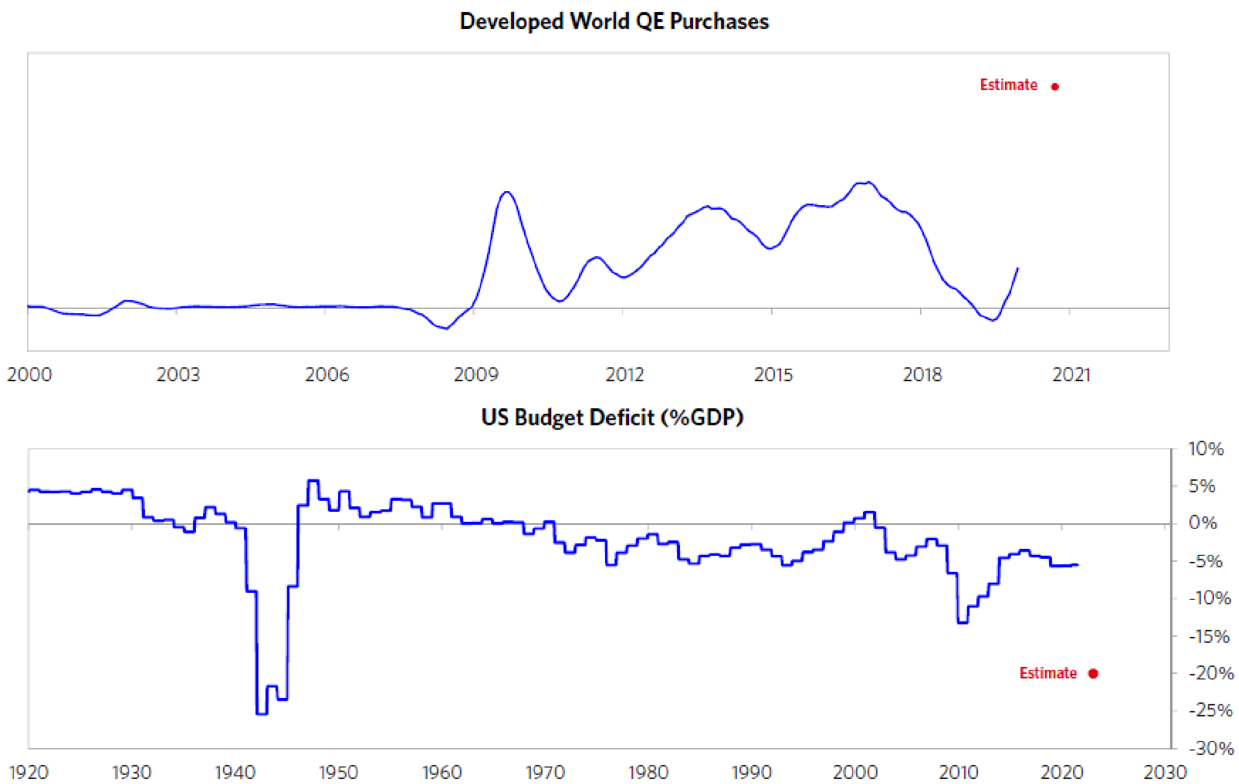
1.4 The performance of our funds throughout this period is dealt with in separate reports. As long-term investors we believe we are well positioned to benefit from the changing market environment and the likely paradigm shift which will follow this crisis period.

## 2 Recommendation

2.1 That the report be noted.

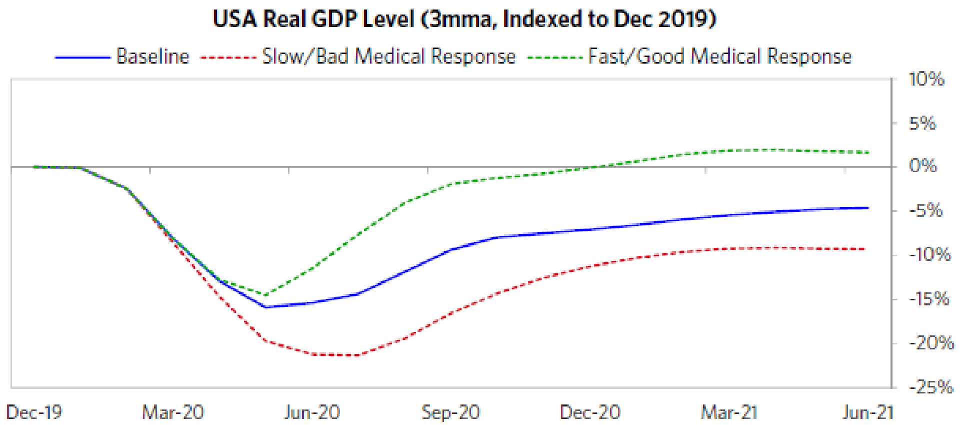
## 3 Macroeconomic Overview:

3.1 Coordinated fiscal and monetary response across countries which have the ability to do so, with substantial budget deficit financed with unprecedented levels of Central Bank purchases. Bridgewater research estimates Developed World QE asset purchases will be a multiple of the stimulation during Great Financial Crisis (GFC) and that the level of US Budget Deficit will be largest in peacetime history.



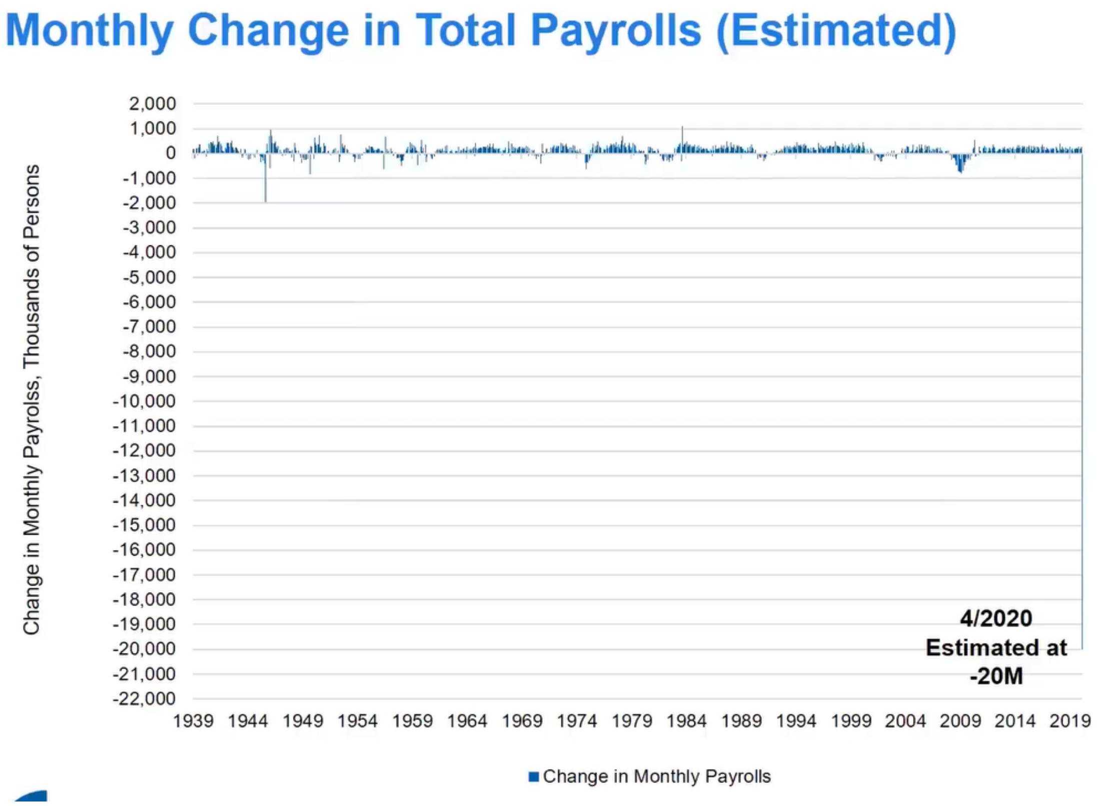

*Source: Bridgewater Associates*

3.2 The above combined fiscal and monetary response has been necessary to ward off a depression following a historical economic shutdown with an unprecedented quarterly decline in economic growth (GDP). The graph below shows Bridgewater expected US GDP decline which in baseline scenario is not forecast to recover to prior crises level in the next 12mths.




*Source: Bridgewater Associates*

3.3 We have seen a substantial rise in unemployment, for example over 20 million Americans registering for benefits over 5-week period (making prior recessions look minor) and increasing US unemployment rate from <4% to 15% (and expected to peak at 20%):




*Source: Research Affilates*

3.4 Near-term strong *deflationary* pressures from lower aggregate demand (related to shut down and gradual re-opening), delay in fixed asset investment (i.e. building), the rise in unemployment and corporate defaults (HY mkt 2020 6$^{th}$ worst year after only first 5mths) and associated individual and corporate scarring likely led to cautious behaviour.

3.5 Longer-term increase *inflationary risk* with majority countries running large fiscal deficits and a substantial increase in monetary supply (quantitative easing). Questionable if future government will practise fiscal discipline (i.e. tax rises) against a background of a weak economic recovery. This is likely to lead to excessive stimulation and a change in the underlying investment environment with higher levels of future inflation.

3.6 This is an important point for managing long-term inflation linked liabilities.

## 4 Market Performance Overview:

4.1 As of 26th May, public equity markets had recovered a large part of their decline with the MSCI World (USD) returning -8.4%, although the FTSE 100 underperformed -17.2% return. Fixed Income markets rallied with US and UK nominal yields declining **124 bps** (to 0.68%) and **63 bps** (to 0.19%) respectively.

| Name | Ccy | Level | 1 Day | WTD | MTD | QTD | YTD |
|---|---|---|---|---|---|---|---|
| **Equity (Δ %)** | | | | | | | |
| MSCI World | USD | 2,137 | 1.1 | 3.1 | 4.3 | 15.8 | -8.4 |
| MSCI EM | USD | 927 | 0.1 | 2.5 | 0.4 | 9.6 | -16.2 |
| S&P 500 | USD | 3,036 | 1.5 | 2.7 | 4.5 | 17.8 | -5.3 |
| Nasdaq 100 | USD | 9,442 | 0.6 | 0.3 | 5.0 | 21.0 | 8.6 |
| Dow Jones | USD | 25,548 | 2.2 | 4.4 | 5.2 | 17.0 | -9.6 |
| Russell 2000 | USD | 1,436 | 3.1 | 6.0 | 9.7 | 24.8 | -13.4 |
| FTSE 100 | GBP | 6,144 | 1.3 | 2.5 | 4.5 | 9.0 | -17.2 |
| Eurostoxx 50 | EUR | 3,051 | 1.7 | 5.0 | 5.0 | 10.6 | -17.3 |
| Nikkei 225 | JPY | 21,419 | 0.7 | 5.1 | 6.1 | 13.2 | -8.6 |
| Hang Seng | HKD | 23,301 | -0.3 | 1.8 | -4.9 | -0.7 | -16.7 |
| **Fixed Income (Δ yld/sprd bps)** | | | | | | | |
| ***Rates - Developed Markets (Δ yld bps)*** | | | | | | | |
| U.S. 10 Yr | USD | 0.68 | -1 | 2 | 4 | 1 | -124 |
| Bund 10 Yr | EUR | -0.41 | 2 | 7 | 17 | 6 | -23 |
| Canada 10 Yr | CAD | 0.55 | 0 | 4 | 0 | -15 | -115 |
| UK Gilts 10 Yr | GBP | 0.19 | -2 | 2 | -4 | -16 | -63 |
| Japan 10 Yr | JPY | 0.00 | 0 | 0 | 3 | -2 | 2 |
| Australia 10 Yr | AUD | 0.88 | -1 | 1 | -1 | 12 | -49 |
| Spain 10 Yr | EUR | 0.65 | 2 | 2 | -8 | -3 | 18 |
| Italy 10 Yr | EUR | 1.50 | -5 | -10 | -26 | -2 | 9 |

*Source: PIMCO*

4.2 Other performance trends we have seen during the crisis period include:

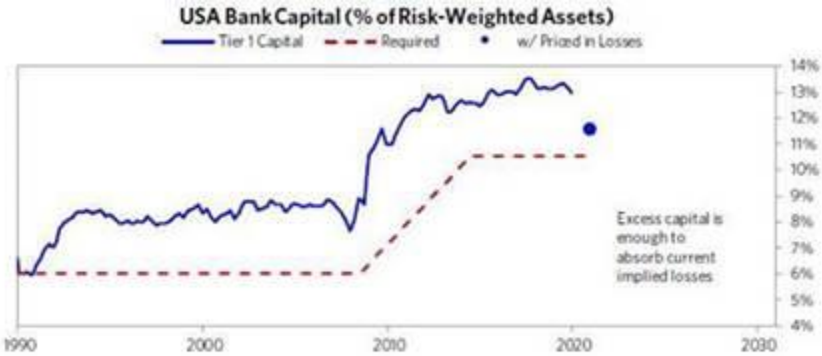
4.2.1 *Market Capitalisation* – small cap has underperformed larger cap by circa 10% YTD.

4.2.2 *Country Positioning* – as noted earlier in the paper, US S&P (*green line*) outperformed UK FTSE 100 (*pink line*) with a greater than 10% performance differential:


*Source: Bloomberg*

4.2.3 *Sector Positioning* – we have seen significant differentiation in performance across sectors in the period. Examples of underperforming sectors include industrials, which have more exposure to cyclical conditions and supply chain interruptions, and financials which are tainted as levered cyclicals with a negative impact from rising defaults and lower net interest margins (lower rates / flatter yield curve).

4.2.4 However, we note risks within financial stocks are lower than at the time of the GFC – for example US Bank Tier 1 capital ratios have improved from 4-5% to 12-14% (with capital build depressing past earnings). Banks could now absorb current market implied losses from their excess regulatory capital without needing to raise additional debt / equity to satisfy higher capital requirements (different position from GFC).




*Source: Bridgewater Associates*

4.2.5 *Style Positioning* –Value stocks (stocks with cheaper valuation to reflect lower future growth prospectus) have underperformed quality as we saw a flight from risk during the period. We note that Value has outperformed long-term (+3.0% p.a. 1963-20) but underperformed during the last 13 years (-3.1% 2007-20). The recent drawdown has resulted in Value factor valuations trading at their cheapest in history (1/10th growth stocks) – below 2000 tech bubble - and now all bar 1 value measures are trading in top (cheapest) decile with many trading in top 1% percentile (Mar 20 percentile rank, far right column):

## Changes in Relative Valuation Hold True for Alternative Definitions of Value

**Performance of Alternative Value Definitions, United States, July 1963 – Mar 2020**

| | Jun 1963–Dec 2006 | | Jan 2007 – Mar 2020 | | Jun 1963 – Mar 2020 | | Historical Percentile Rank | |
|---|---|---|---|---|---|---|---|---|
| | Average | t-stat | Average | t-stat | Average | t-stat | June 2007 | Mar 2020 |
| HML, Book-to-Price | 5.7% | 3.88 | -4.7% | -1.75 | 3.2% | 2.50 | 22% | 100% |
| HML, Small-Cap | 7.5% | 4.35 | -3.9% | -1.44 | 4.9% | 3.29 | 52% | 99% |
| HML, Large-Cap | 3.8% | 2.47 | -5.6% | -1.71 | 1.6% | 1.14 | 13% | 98% |
| Value-to-Neutral | 2.4% | 3.43 | -2.1% | -1.17 | 1.3% | 1.95 | 48% | 96% |
| Neutral-to-Growth | 3.3% | 2.73 | -2.6% | -1.88 | 1.9% | 1.94 | 13% | 99% |
| iHML, iBook-to-Price | 6.2% | 4.78 | -2.3% | -0.88 | 4.2% | 3.61 | 41% | 97% |
| Earnings-to-Price | 5.3% | 3.09 | -1.7% | -0.73 | 3.6% | 2.55 | 40% | 90% |
| Sales-to-Price | 5.8% | 4.01 | -1.0% | -0.48 | 4.2% | 3.47 | 22% | 98% |
| Dividends-to-Price | 1.5% | 1.02 | -2.7% | -1.08 | 0.5% | 0.43 | 80% | 55% |
| Composite | 4.9% | 3.87 | -3.1% | -1.16 | 3.0% | 2.07 | 40% | 95% |

*Source: Research Affilates*

## 5 Conclusion

5.1 Substantial Q1 2020 equity market drawdown from lower earnings and expanding risk premiums was followed by a rapid recovery due to the combination of massive fiscal and monetary stimulus with a flattening infection curve. Fixed Income assets rallied as interest rates and inflation expectations declined. Pension plans with long-dated inflation linked liabilities should look though near-term weakness (over next 18 months) and be cognisant of longer-term inflation risk exposed to.

5.2 As a long-term investor we believe that our underlying portfolios are well positioned to benefit from the changing market environment and the future paradigm shift.

### Report Author:

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28th May 2020

**Important Information**