Border to Coast Pensions Partnership Joint Committee

Date of Meeting: **24 November 2020**

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

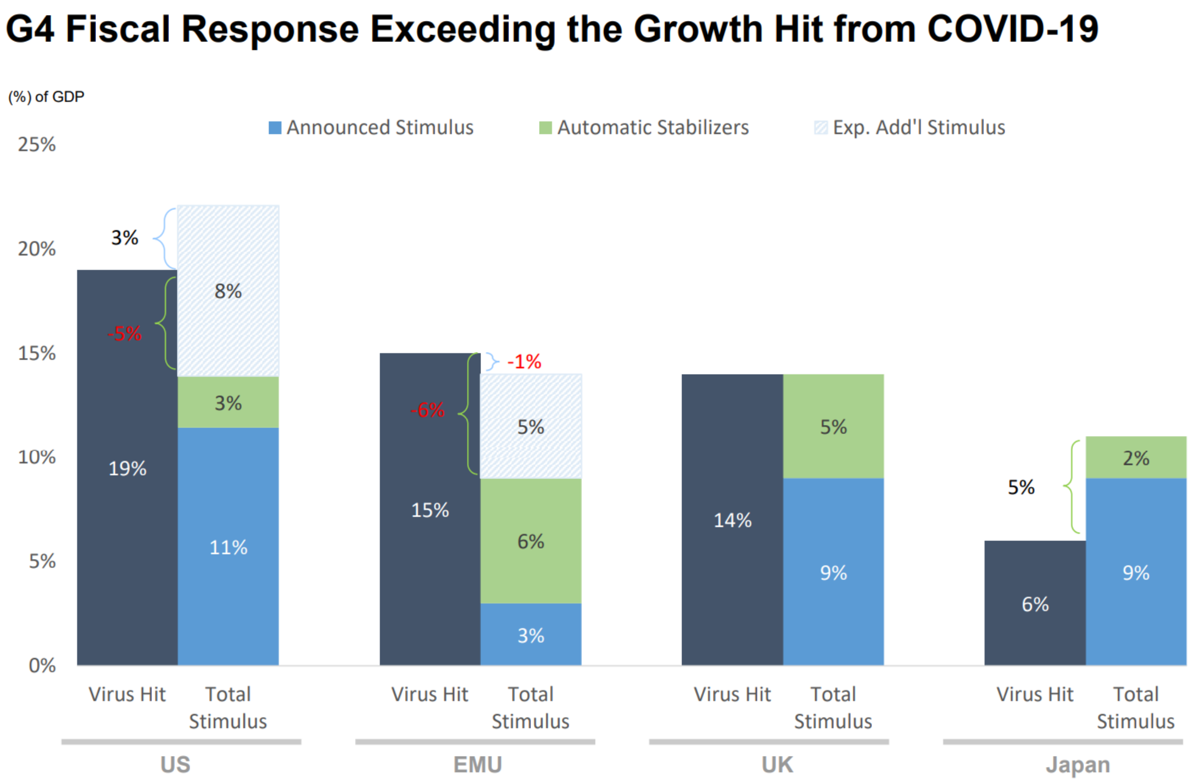
Report Sponsor: **Border to Coast CIO – Daniel Booth**

1 Executive Summary

1.1 This report provides an overview of 2020 market performance, high level details on fund performance and the broader macroeconomic environment.

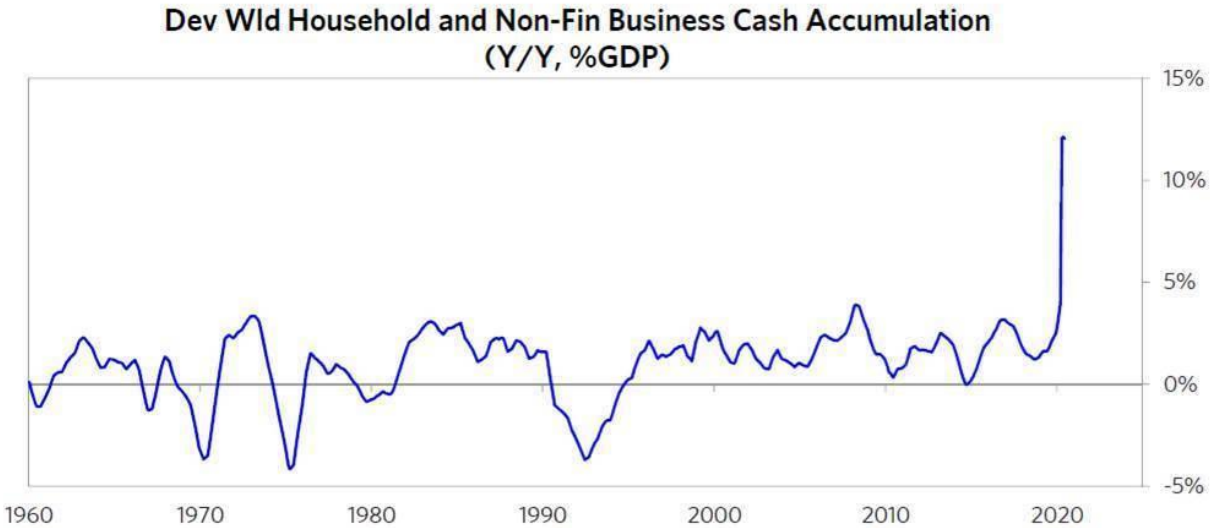
2 Macroeconomic Environment

2.1 COVID crisis caused a collapse in the expected Growth and Inflation outlook with a reduction in market liquidity and expanding risk premiums. Authorities responded with large scale monetary and fiscal easing injecting liquidity into the system leading to a fall in interest rates and contracting risk premiums (rising asset prices). The combination of automatic stabilizers (existing unemployment benefits), announced stimulus (UK furlough programs or US national unemployment additions) and future expected stimulus will broadly offset weakness caused by the virus:



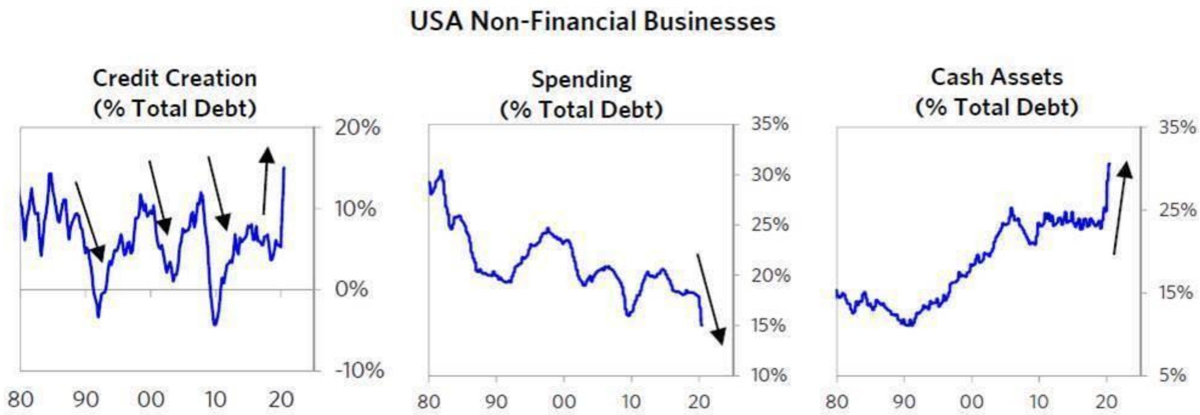
Source: Morgan Stanley

2.2 Money distributed by governments has replaced lost incomes (and in some cases such as US exceeded amount of lost income). Seen an enforced reduction in spending that has led to a rising household Saving Rate (with building cash balances) with current developed world household cash balances equal to 12.5% of GDP (5x normal level). It is typical for cash balances to increase during a recession, but the magnitude of this cash build-up is atypical as can be seen below. The future liquidation of this excess cash could act as a future stimulus.



Source: Bridgewater

2.3 Global Government programs have enabled easy credit availability, so companies have increased borrowing at the same time as they've been cutting spending, so the additional borrowing has just seen an offsetting increase in corporate cash balances. So effectively we've seen an increase in corporate credit creation, a reduction corporate spending and an increase in corporate cash holdings.



Source: Bridgewater

2.4 Virus caused an acute liquidity crisis that led to policy response (much faster, larger and broader than prior responses) opening up the credit markets (with spreads contracting rapidly within weeks) and the stimulative monetary and fiscal policy leading to rising household incomes and corporate credit creation, which both typically contract during a recession. In addition to the large stores of cash (on both household and corporate balance sheets), we are likely to see ongoing Monetary and Fiscal stimulus, which when combined with low inventory levels and an expectation of economic normalization in 2021 could create a powerful dynamic.

3 Market Performance

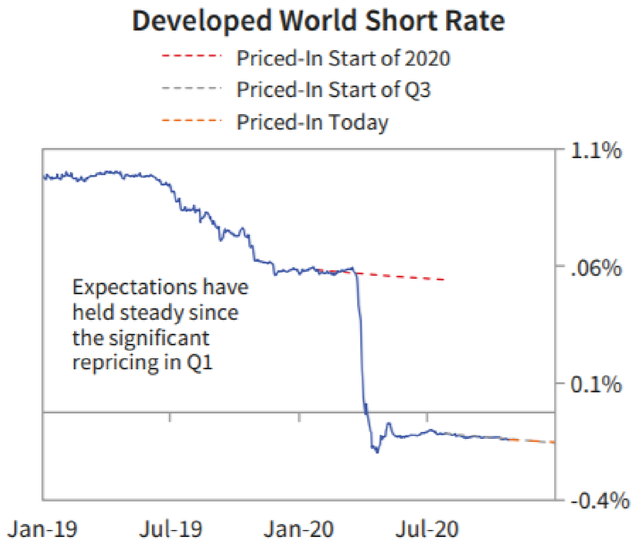
3.1 As of 3Q 2020 global equities (+2.3%) delivered a marginal positive return with the US S&P 500 outperforming the UK and EU markets. Global Government bond indices registered strong positive gains, with the positive interest rate impact supporting Investment Grade credit returns. Higher yielding credit spreads remain wider than pre-COVID levels whilst mixed commodity performance with drawdown in oil (weaker near-term demand) but rally in Gold (store of wealth).

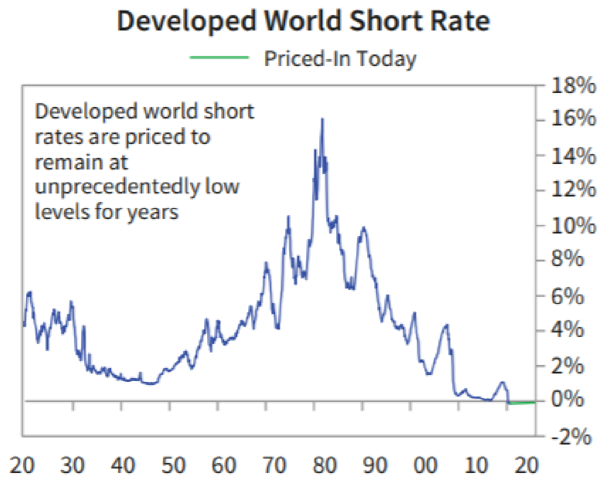
	Passive Total Return* Scaled to 16% Volatility		
Asset Class	**Q1 & Q2 2020**	**Q3 2020**	**YTD**
Equities			
Global (Unhedged)	-5.4%	8.1%	2.3%
US Large Cap (S&P 500)	-3.1%	8.9%	5.6%
US Large Cap Growth (Russell 1000 Growth)	9.8%	13.2%	24.3%
US Large Cap Value (Russell 1000 Value)	-16.3%	5.6%	-11.6%
US Small Cap (Russell 2000)	-13.0%	4.9%	-8.7%
Germany	-5.3%	4.6%	-1.0%
France	-13.8%	-0.7%	-14.4%
Italy	-15.3%	-0.9%	-16.1%
Spain	-20.9%	-6.3%	-25.9%
Japan	-5.9%	5.2%	-1.1%
UK	-16.9%	-3.3%	-19.6%
China	3.2%	11.5%	15.1%
Canada	-4.9%	4.7%	-0.4%
Australia	-10.3%	0.3%	-10.1%
Emerging Markets Ex-China (Unhedged)	-16.3%	7.8%	-9.1%
Government Bonds			
US	26.1%	1.0%	27.4%
Germany	6.9%	1.0%	8.0%
Japan	-0.1%	0.4%	0.3%
UK	12.9%	-0.8%	12.0%
Canada	24.0%	-0.2%	23.7%

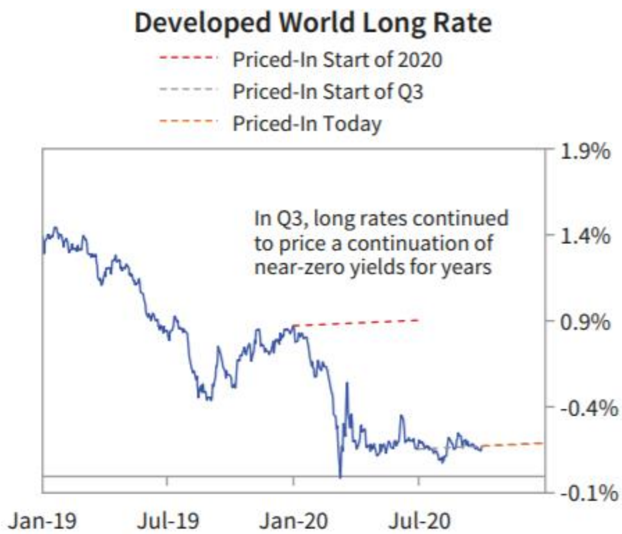
	Passive Total Return* Scaled to 16% Volatility		
Asset Class	**Q1 & Q2 2020**	**Q3 2020**	**YTD**
IG Corporate Spreads			
US	-0.2%	-0.3%	-0.5%
Europe	-0.2%	0.7%	0.5%
High-Yield Corporate Spreads			
US	-14.8%	4.9%	-10.6%
Europe	-4.3%	1.1%	-3.2%
Sovereign Spreads			
Europe	-0.1%	2.4%	2.3%
Basket of Emerging Markets	-9.4%	1.8%	-7.8%
Bond Aggregates (Bloomberg)			
US	22.7%	2.1%	25.2%
Global	13.4%	2.5%	16.2%
Commodities			
S&P-GSCI Commodity Index	-20.2%	2.4%	-18.2%
Bloomberg Commodity Index	-18.2%	8.2%	-11.5%
Crude Oil	-14.8%	0.7%	-14.3%
Gold	16.6%	3.7%	20.9%
Industrial Metals	-7.6%	9.0%	0.7%

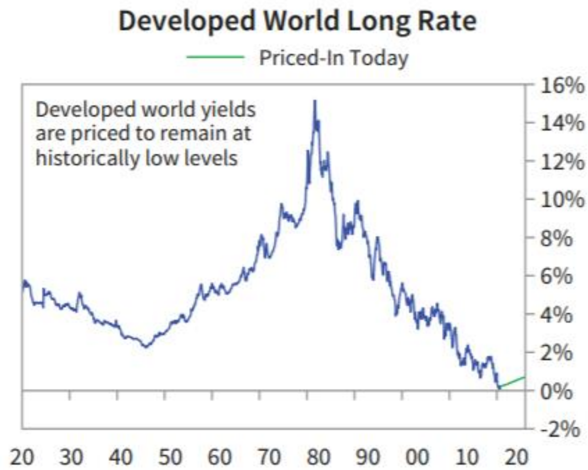
Source: Bridgewater

3.2 Developed World short-term interest rates were low and expected to remain unchanged at the beginning of 2020. The COVID crises caused a decline in short term interest rates which are now globally at flat to negative levels. Developed World long-term interest rates (bonds) were also priced to remain unchanged at low levels but with lower interest rates and central bank purchases (quantitative easing) yields have declined toward lower 0% bound. These are both shown in the graphs overleaf:



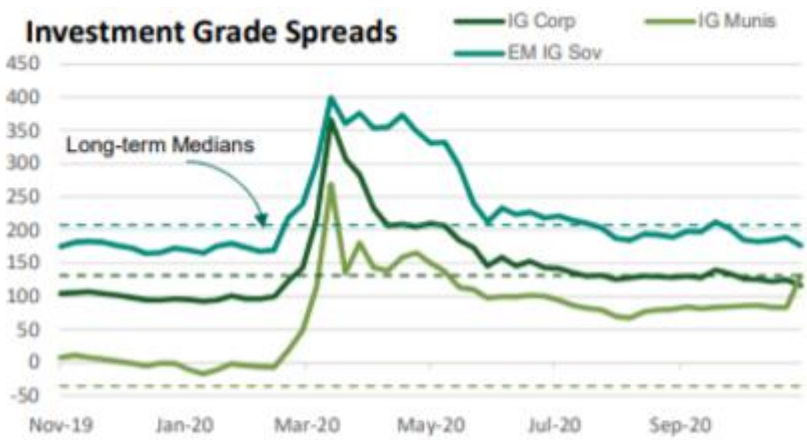






Source: Bridgewater

3.3 Higher yielding credit markets have recovered most but not all YTD spread widening:



Source: Goldman Sachs

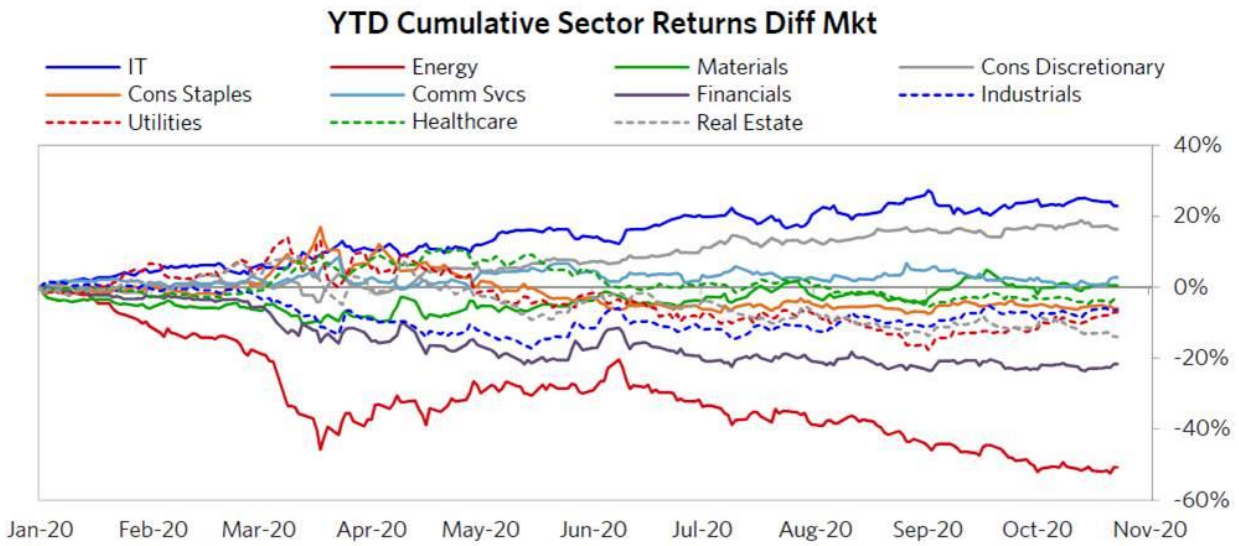
3.4 Equities S&P earnings held up better than expected. After 2/3rd of S&P 500 companies reported 3Q earnings, 19% of companies beat consensus with reported earning declining -7% yoy (vs -22% expected). Furthermore 13% of corporates raised future guidance (a new record).

Source: Goldman Sachs

3.5 Year to date there has been a 30-point performance differential between Russell Growth index (high priced faster growing companies) and the Russell Value index (low priced slower growing companies):

Source: Bloomberg

3.6 Equity markets seen large sector differentials between the top performing sector (Information Technology +20%) and the worst performing sectors (Financials -20% & Energy -50%):



Source: Bridgewater

4 Fund Performance

4.1 The table below shows our fund relative performance (versus benchmark) up until the end of Sept 2020 for the 4 underlying funds with a track record of at least 12 months:

Fund Name	QTD (%)			1 Year (%)			ITD (% p.a.)		
	Fund	Benchmark	Relative	Fund	Benchmark	Relative	Fund	Benchmark	Relative
Internal Equity	-0.11	-0.18	0.07	-6.41	-7.66	1.25	-0.6	-1.73	1.13
UK Listed Equity Fund	-2.78	-2.92	+0.14	-15.12	-16.59	+1.47	-5.74	-7.28	+1.54
Overseas Developed Equity Fund	2.94	2.42	+0.52	5.21	3.22	+1.99	6.43	5.13	+1.30
Emerging Markets Equity Fund	1.91	4.00	-2.09	0.37	3.52	-3.15	5.43	8.33	-2.89
External Equity									
UK Listed Equity Alpha Fund	0.47	-2.92	+3.40	-12.85	-16.59	+3.74	-1.13	-3.37	+2.23

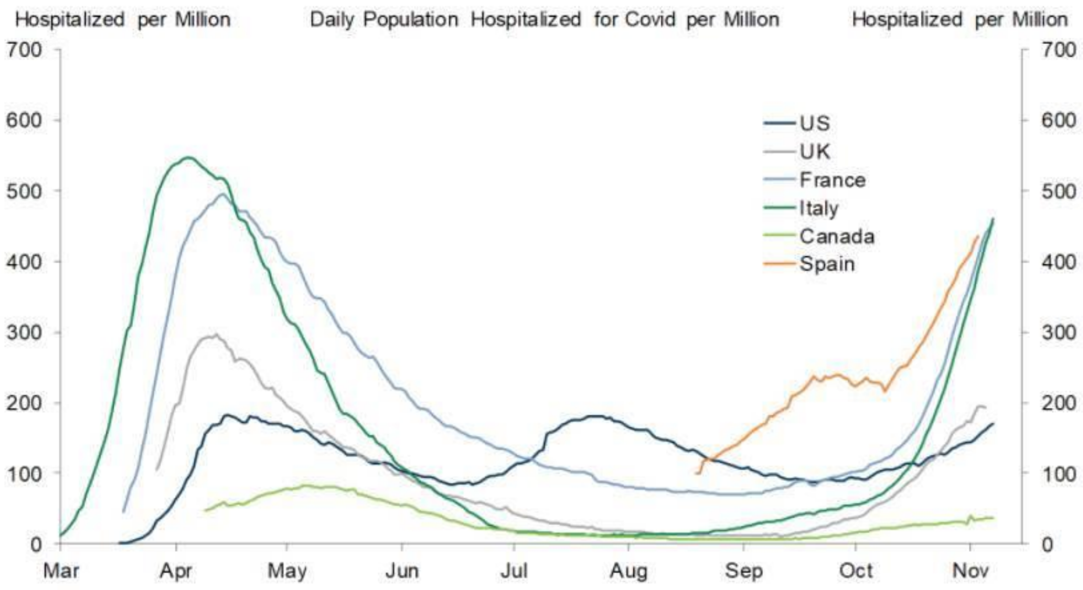
4.2 Internal Equity composite (asset-weighted) has delivered 1.13% outperformance over benchmark (target +1%) since launch. 5 of 6 internal PMs have outperformed with the majority of excess returns driven by stock selection (high quality return) and achieved with a low tracking error (and a high risk-adjusted return). Our Emerging Market fund has underperformed year-to-date with a material contribution due to not owning smaller Chinese technology stocks which have performed strongly. The planned transition to a hybrid structure with China managed externally is due late 1Q 2021 and will enable superior coverage of the Chinese market which is becoming a hub for technology innovation.

4.3 External Equity our UK Listed Equity Alpha fund has delivered +2.23% outperformance and is back above target level (benchmark +2%) following 1Q 2020 drawdown. The earlier underperformance was due to combined weakness across Value, Small Cap and Consumer Services stocks with the latter 2 having recovered by the end of September.

4.4 It should be noted that we are also managing Global Equity Alpha (Nov-19) in external equities, UK Investment Grade Credit fund (Mar-20) and Sterling Inflation Linked Bond fund (Oct-20).

5 CoVid Update

5.1 As of early November COVID, hospitalized cases per million have been increased especially in Eurozone countries:



5.2 On Monday 9th November Pfizer announced initial trail results were pleasing and that they expected emergency usage authorization (EUA) to be granted.

6 Conclusion

6.1 The liquidity induced recovery has seen equities rally, credit spreads normalize and interest rates decline. Investors are likely underestimating the probability of a 2021 strong recovery financed by a liquidation of excess cash holdings, in an environment of easy monetary and fiscal policy, and the continued compression of risk premiums as investors search for yield.

6.2 The authorities are likely to want to stimulate economies further by lowering real interest rates and with nominal interest rates at lower 0% bound they can do this by increasing inflation and inflation expectations. The US Fed Reserve move to an inflation averaging regime is a clear indication of this direction. 2021 inflation outlook will be distorted upwards by the low 2020 base impact and thereafter the competing demands of inflationary policies and the output gap will determine the longer-term outcome. LGPS with long-dated inflation linked liabilities should be mindful of the longer-term inflation risk and potential impact on both their assets and liabilities.

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15th November 2020

Important Information