Border to Coast Pensions Partnership Joint Committee

Date of Meeting: 23 November 2021

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

Report Sponsor: Border to Coast CIO – Daniel Booth

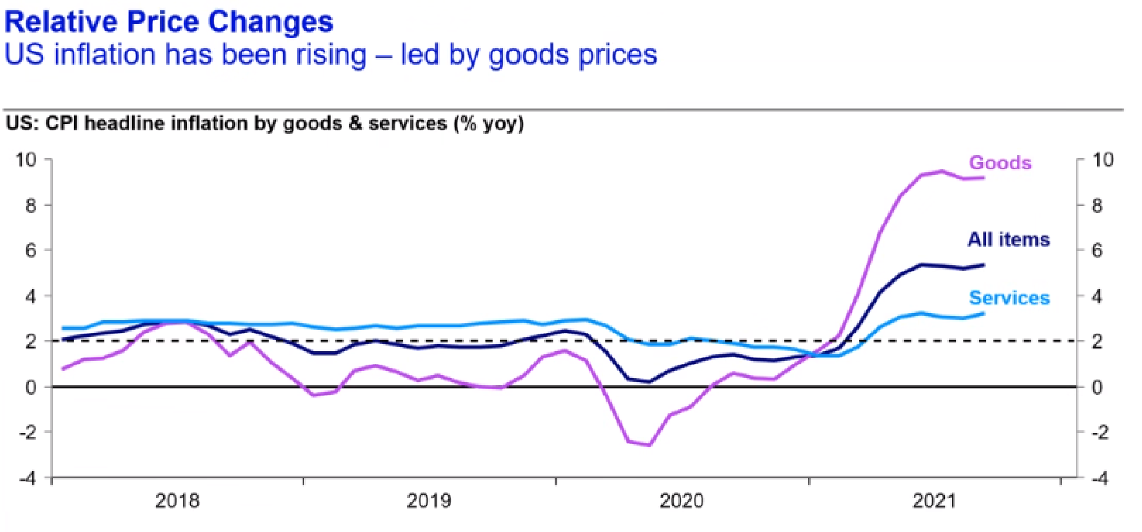
1 Executive Summary

1.1 This report provides an overview of the macroeconomic environment as well as high level details on market and fund performance.

2 Macroeconomic Environment

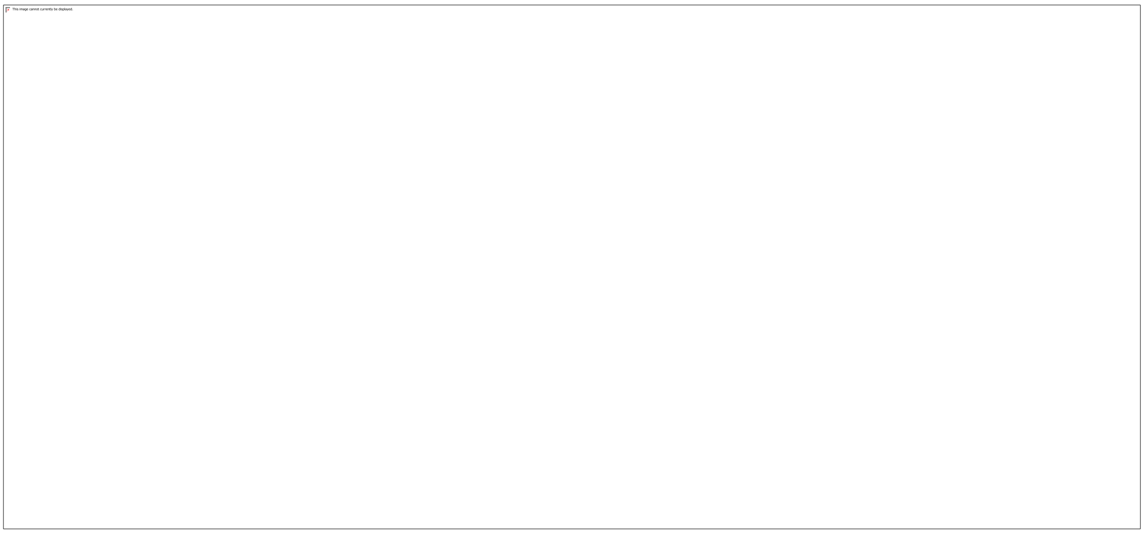
2.1 Strong cyclical conditions following record amounts of monetary and fiscal stimulus combined with elevated levels of cash on household and corporate balance sheets. This has led to demand outstripping supply with resultant rising prices (inflation) and inflation expectations. With elevated inflation levels above central bank targets this is starting to put pressure on banks to react and as a result we have seen some banks raise interest rates (e.g. New Zealand) or discontinue quantitative easing programs roll off (e.g. United Kingdom). The speed and intensity of monetary tightening versus market expectations will be a key determinate for asset price performance in 2022.

2.2 *US Inflation:* Goods prices are now rising 9% YoY with Service process rising around 3% YoY (in line with pre-COVID trend). In the past decades we had seen falling goods prices (due to globalisation) but COVID has reversed this trend with goods prices leading and service prices lagging although likely a temporary factor. Nevertheless, the all-items CPI number has risen substantially, and it is not only goods prices.



Source: Invesco

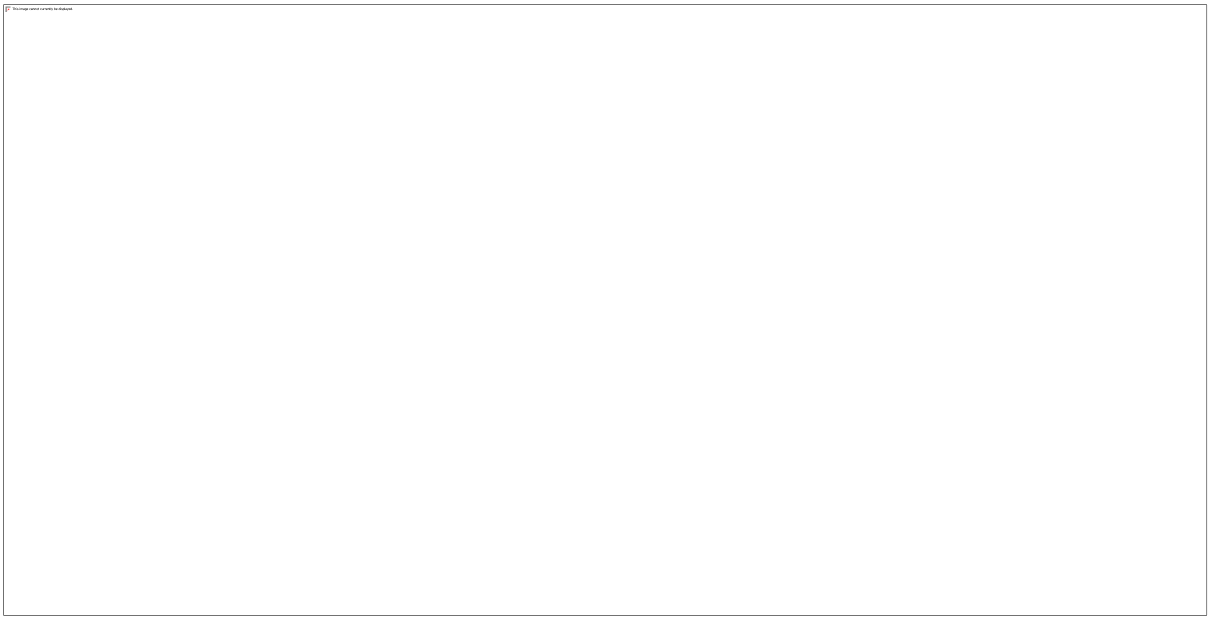
2.3 *Eurozone:* seeing the same trend as the US with goods prices (4-5%) now leading price increases having previously lagged price index. Similar picture in UK but less differentiation.



Source: Invesco

2.4 *Asia:* same relative inflation trend in Japan, albeit with much lower aggregate inflation level as seeing deflation in service prices. In China absolute levels of inflation are low and relative price changes are distorted by falling pork prices following 2019/20 swine flu cull.

2.5 *Money Supply:* table below shows cumulative broad money growth across different countries as well as an estimate of the excess amount of money once you've subtracted real GDP and average annual growth in the money supply. One can see the US had cumulative 35.6% M2 growth since Feb 2020, so the total stock of money increased by over one third in 18-mth period! The US and Israel are likely to see lingering high levels of inflation for several years as a result and whilst the UK isn't as high we've still experienced a 19% increase in our broad money measure (M4x). Monetary growth was more constrained in Asia and Switzerland and China in particular running tight monetary policy once subtract real GDP and average monetary growth.



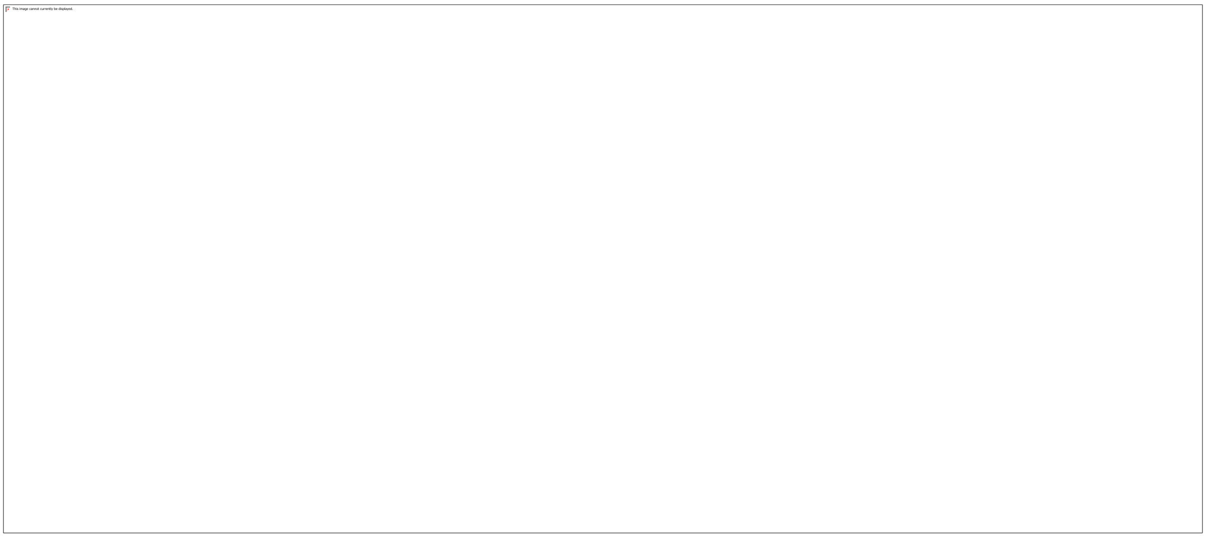
Source: Invesco

2.6 Excess Money Supply growth is correlated with strong performance across Real Assets (including Public Equity, Real Estate and Commodities). Economist John Greenwood from Invesco estimates asset prices are still circa 10% behind levels of monetary growth.

2.7 Demand is outstripping Supply resulting in rising prices across several sectors. US housing demand is exceeding new supply (depressed post-08 GFC) leading to increasing prices and increasing rents with the effect of the latter lagging in the US CPI data:

Source: Bridgewater

2.8 *Transportation*: more ships than ever before, ports operating around the clock, shortage of port workers, truck drivers (for onward movement) and warehouse / distribution staff (for unloading) and the factors limiting transportation capacity seem likely to remain in place at least until mid-2022 and, in some cases, well into 2023 or beyond. Ship orders are increasing following a decade of declining investment but new capacity will take years to deliver:



Source: Bridgewater

- Delays unloading at Ports have increased despite the largest US Port (L.A.) operating around the clock following a 30% increase in imports:

Source: Bridgewater

- Shortage of trucks once offloaded into ports with the demand for trucks up whilst in the US truck tonnage index is actually flat due to a shortage of drivers and trucks (and for the latter new orders have a 1-year wait time due to semiconductor shortage). The existing shortage of truck drivers in both US and UK has been exacerbated by COVID so relative wages will need to rise to attract workers from other sectors:

Source: Bridgewater

- In the US understaffed warehouses / distribution centres are increasing unloading / wait times for trucks:

Source: Bridgewater

2.9 The monetarization of fiscal deficits (i.e. the creation of new money to fund fiscal programs) has transformed Private Sector balance sheets, which now have both the means (income) and incentive (record low real rates) to increase spending. This will likely more than offset any reduction in government spending so the prior policy response will continue to reverberate in the economy well after the peak in fiscal spending. This is likely bullish for the economy, although less supportive for markets, as investors spend down some of the excess cash that has been supporting asset prices.

3 Market Performance

3.1 *Equity Markets*: equity markets have performed strongly given stronger than expected growth with subsequent upward revisions to corporate earnings. As of end October 2021, the developed equity market MSCI World (GBP) and all country equity market MSCI ACWI (GBP) returned 19.6% and 16.9% respectively, with the latter impacted by emerging markets underperformance (in turn caused by negative Chinese equity returns). 5 and 10 year equity returns are above long-term expectations whereas longer term return history since 1987 is more in-line with asset class expectations:

INDEX PERFORMANCE — GROSS RETURNS (%) (OCT 29, 2021)					ANNUALIZED				FUNDAMENTALS (OCT 29, 2021)			
	1 Mo	3 Mo	1 Yr	YTD	3 Yr	5 Yr	10 Yr	Since Dec 31, 1987	Div Yld (%)	P/E	P/E Fwd	P/BV
MSCI World	3.96	5.39	33.05	19.55	16.06	13.41	14.67	9.69	1.65	23.82	19.54	3.37
MSCI Emerging Markets	-0.65	1.02	10.68	-0.28	10.08	7.27	6.98	11.65	2.24	15.08	12.67	1.93
MSCI ACWI	3.41	4.87	30.04	16.88	15.33	12.67	13.76	9.57	1.72	22.33	18.40	3.10

Source: MSCI

4 Fund Performance

4.1 The tables below show fund absolute and relative performance (versus benchmark), since inception, up until the end of September 2021 (current reporting period):

Period (end Sept 2021)		**ITD (% p.a.)**	
Fund Name	Fund	Benchmark	Relative
Internal Equity Composite	**6.8%**	**6.1%**	**0.7%**
UK Listed Equity	3.4%	2.6%	0.9%
Overseas Developed Equity	11.3%	10.3%	1.1%
*Emerging Market Equity ***	8.2%	10.1%	-1.9%
External Equity Composite	**13.8%**	**12.9%**	**0.9%**
UK Listed Equity Alpha	10.2%	6.8%	3.4%
Global Listed Equity Alpha	15.3%	15.6%	-0.2%
Fixed Income Composite	**6.8%**	**5.5%**	**1.3%**
Sterling Investment Grade Credit	7.1%	5.5%	1.5%
*Sterling Index Linked Bonds **	1.0%	0.4%	0.6%

* Less than 1-year (Oct 21 launch) ** Hybird Fund with both internal and external funds

4.2 *Internal Equity composite*: (asset-weighted) delivered 0.7% outperformance above benchmark since launch, with positive relative performance from 5 of our 6 internal portfolios. The outperformance was focused on stock selection (higher performance persistence) and achieved with a low tracking error and a high risk-adjusted return ratio (an Information Ratio of 1). Our Emerging Market fund has been restructured with the non-China allocation managed internally and the China allocation managed externally, which we believe will be accretive for investors, as they benefit from a large, local research team covering a deep and innovation growth market.

4.3 *External Equity composite*: (asset weighted) delivered 0.9% outperformance over benchmark with strong outperformance from our UK Alpha fund whilst our Global Alpha fund was broadly in-line with benchmark. Year-to-date outperformance has been driven by the funds' Value managers and our rebalancing activity (from Growth and into Value) has been accretive for our UK Alpha fund.

4.4 *Fixed Income composite*: produced strong outperformance and was 1.3% above benchmark with both our underlying funds benefiting from credit spread compression.

5 Conclusion

5.1 The excessive rates of monetary growth will likely lead to prolonged periods of elevated inflation in those countries enacting larger scale monetary easing. 2022 inflation will remain elevated with multiple areas of the economy experiencing significant supply side constraints (i.e. semi-conductors, transportation, energy etc). The combination of strong cyclical conditions (supported by the remnants of record monetary and fiscal stimulus and record levels of household and corporate cash balances) and longer-term structural trends (higher corporate taxes, RI / ESG costs and unit labour costs) mean upside risks to inflation. The 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.

5.2 The remanent of record Fiscal and Monetary stimulus has led to higher than forecasted growth and inflation rates and resulted in a strong liquidity induced rally in risky assets. As we move into the mid-cycle period a diversified pool of risky assets still appears attractive relative to cash (guaranteed negative real returns) but you're likely to see higher future levels of risk and performance dispersion. Sustained elevated levels of inflation in 2022 will provide central banks with a policy dilemma and how their tightening cycle evolves versus market expectations will determine the future market outcome.

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10th November 2021

Important Information