Border to Coast Pensions Partnership Ltd Joint Committee

Date of Meeting: 08 March 2022

Report Title: Market Review

Report Sponsor: Interim Chief Investment Officer – John Harrison

1 Executive Summary

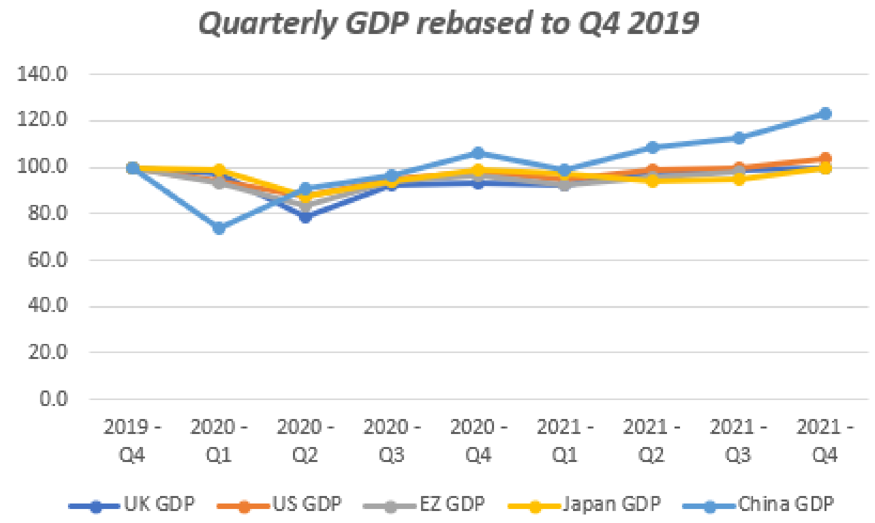
1.1 This report provides an overview of the macroeconomic environment, the performance of Border to Coast funds and the medium-term investment outlook.

2 Recommendation

2.1 That the report content be noted.

3 Macro-Economic Environment

3.1 Economic growth has recovered strongly since the initial shock of the pandemic. In the UK and Europe real GDP is now back to pre-pandemic levels, with the US and China materially higher.



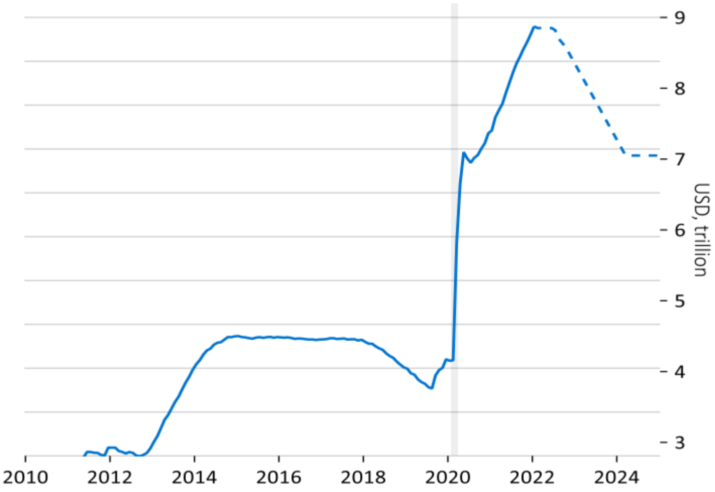
Quarterly GDP rebased to Q4 2019

Source: Bloomberg

Note: Real GDP in local currency and not seasonally adjusted. Eurozone Q4 2021 datum is not yet available.

3.2 The economic rebound owes a lot to the massive monetary stimulus delivered by central banks, following the playbook established in the wake of the Global Financial Crisis in 2007/9. Central bank balance sheets in developed markets rose sharply through Quantitative Easing to support fragile economies. The original intention was to withdraw the stimulus when economies had recovered but in practice this was slow and muted. The response to the pandemic was even more dramatic in both scale and speed.

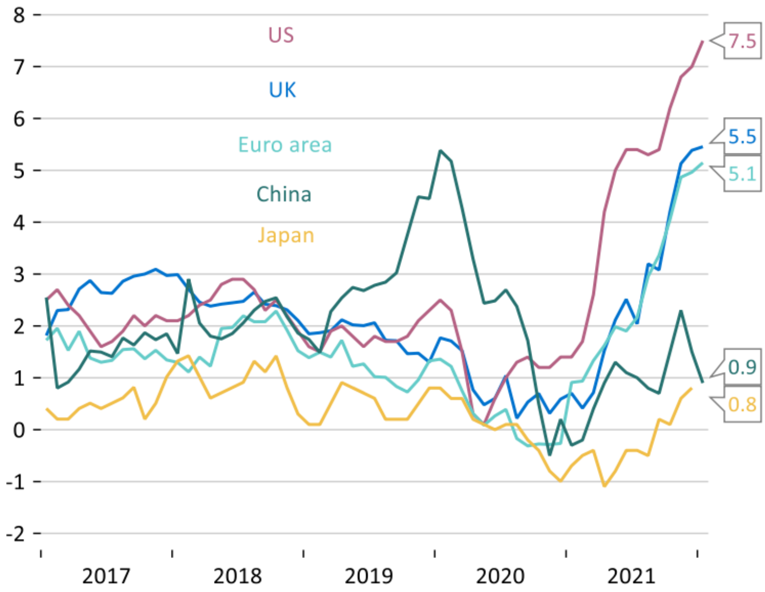
Quantitive Tightening of US Fed Reserve Balance Sheet



Source: Macrobond, 17.02.22

3.3 The difference now is inflation, which is not only spiking upwards but threatening to become engrained through wage increases. Rising energy prices in the wake of Russia's invasion of Ukraine will do nothing to ease the pressure. Central banks will need to respond, so we may now be at an inflexion point for the US from a prolonged period of Quantitative Easing to one of Quantitative Tightening.

Global Inflation Rates



Source: Macrobond, 17.02.22

3.4 The market consensus is that central banks will raise interest rates far enough and fast enough to bring inflation back under control, but not until 2023. Bond markets are discounting five rate rises in the US and three in the UK over 2022. Inflation rates are expected to stabilise in 2023 but are likely to do so at a higher level than we have seen over the last 10 years.

3.5 Consensus economic forecasts:

As at 22nd Feb 2022	*Real GDP*	*CPI Inflation*	*Unemployment*	*10yr Sov Bond*
UK	4.3%	5.3%	4.1%	1.5%
US	3.7%	5.1%	3.6%	2.2%
Germany	3.7%	3.7%	5.0%	0.3%
Japan	2.8%	0.9%	2.6%	0.2%
China	5.2%	2.2%	3.7%	2.8%

Source: Bloomberg

4 Fund Performance

4.1 The table below shows the absolute and relative performance of the various ACS sub-funds from inception to 31 December 2021 – the period under review.

% p.a. Since Inception	*Return*	*Benchmark*	*Relative*
Internal Equities			
UK Listed Equity	4.3	3.6	**+0.7**
Overseas Developed	12.2	11.1	**+1.1**
*Emerging Markets Equity**	7.2	8.8	**- 1.6**
External Equities			
UK Listed Equity Alpha	10.1	7.7	**+2.4**
Global Equity Alpha	15.5	16.8	**- 1.3**
Fixed Income			
Sterling Investment Grade Credit	6.4	4.9	**+1.5**
Sterling Index Linked Bonds	6.0	5.5	**+0.5**

Source: Border to Coast

** Hybrid structure since April 2021; performance data from launch of fund in 2018*

4.2 *UK Listed Equity:* The Fund is still above benchmark since inception, but relative outperformance has fallen below target after a disappointing 2021 in which the fund lagged the benchmark by 1.5%. The Fund takes low active sector and style positions but has a slight bias to quality, which was left behind in a rapid market recovery. Most of the shortfall arose from cautious stock selection in cyclical sectors, such as basic materials and industrials.

4.3 *Overseas Developed:* The Fund continued its consistent track record with all four regional sleeves outperforming their respective benchmarks over the year. The Fund outperformed by 1.2% in 2021 and has achieved its target since launch.

4.4 *Emerging Markets Equity:* The Fund outperformed its benchmark by 1.8% in 2021 but remains well behind benchmark since inception. The Fund was restructured to a hybrid structure in April 2021.

4.5 *UK Listed Equity Alpha:* The Fund is still above target since inception despite lagging the benchmark by 1.1% in 2021. Janus Henderson and UBS both performed well relative to their style benchmarks, but Baillie Gifford's more concentrated approach performed very poorly.

4.6 *Global Equity Alpha:* A poor final quarter resulted in the Fund lagging its benchmark by 0.3% in 2021. It is now 1.3% pa below benchmark since launch. Strong performance by the value (Harris and 91 Value) and growth (Loomis Sayles) managers was more than offset by poor returns from Lindsell Train.

4.7 *Sterling Investment Grade:* The Fund outperformed its benchmark by 1.0% albeit in a falling bond market in 2021. It remains well ahead of target since inception. The benchmark return for the year was -3.1% as investors worried about growing inflation pressures. By contrast the benchmark return from index linked bonds was +4.0%.

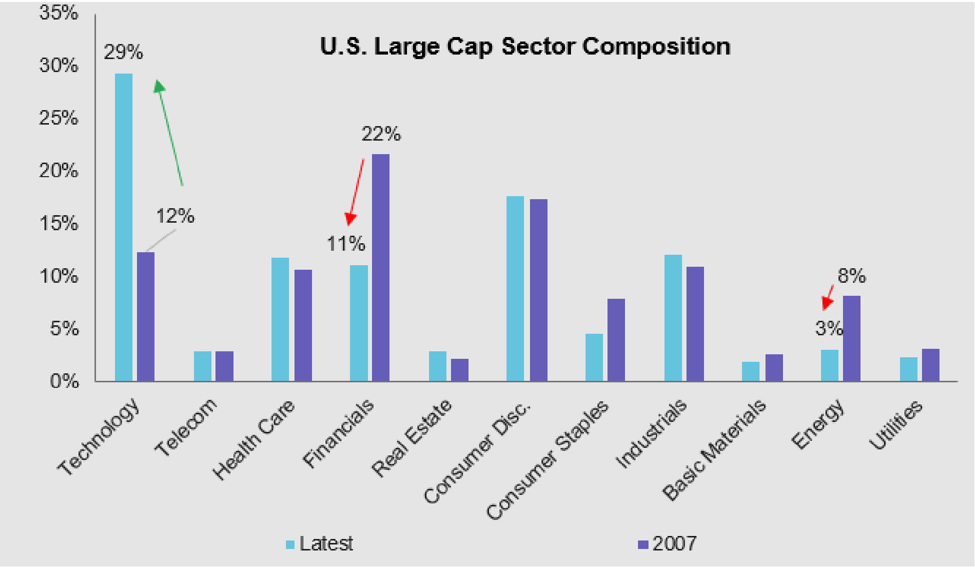
4.8 *Sterling Index Linked Bonds:* The Fund outperformed its benchmark by 0.3% in 2021 and remains well ahead of target since inception.

4.9 *MAC:* The Mac fund was launched in October 2021 and therefore does not have a sufficient track record to report performance.

5 Looking Forward

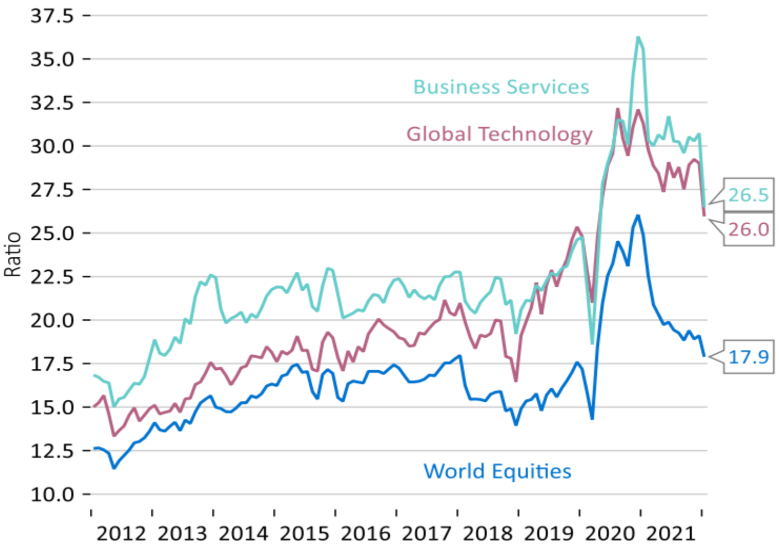
5.1 The challenge for equity investors is that the composition of indices is potentially more sensitive to changes in long term interest rates. The technology sector has been a key driver of stock market performance and now represents a significant proportion of market indices.

U.S. Large Cap Sector Composition



5.2 The valuation ratings on technology stocks have started to roll over but remain high on an historic basis.

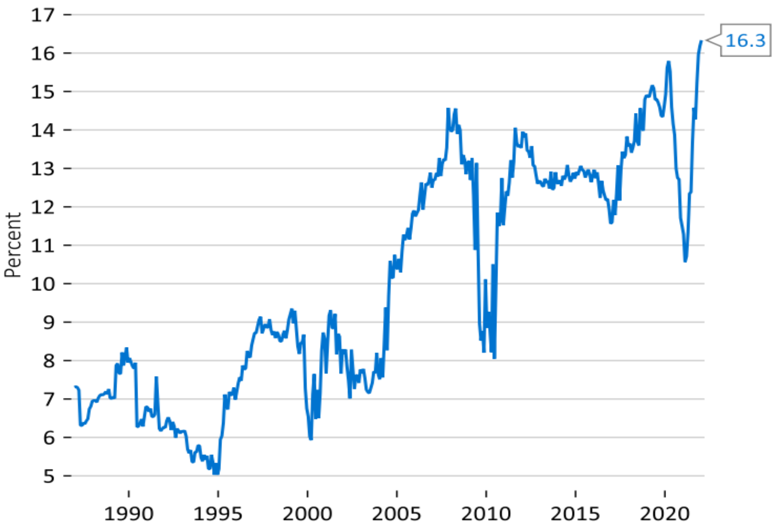
Equity Indices 1 year forward PE (Factset)



Source: Macrobond, 17.02.22

5.3 At the same time, profit margins are at all-time highs. High multiples of high earnings in an environment of rising inflation and tightening interest rates is a potentially uncomfortable cocktail for investors.

Net Margins for World Equities (FactSet)



Source: Macrobond, 17.02.22

6 Conclusion

6.1 The benign environment for investors of persistently low inflation and economic growth underpinned by accommodative central banks has probably come to an end. Inflation pressures also constrain the ability of central banks to step in to support financial markets and smooth out volatility (the so-called Fed put). Investors may face a bumpier ride in future.

6.2 LGPS funding levels have improved significantly since the last triennial valuation in March 2019. Asset prices have been strong at the same time as liabilities have been constrained by rising bond yields and changes to life expectancy assumptions.

6.3 The next few years may prove more challenging. Corporate margins may be close to a peak and valuation multiples are already stretched so prospective returns from equities are likely to be lower than we have enjoyed in recent years. Bonds offer little protection if inflation persists especially given low current yields. With cash effectively guaranteeing a negative real return, it seems likely that institutional investors will favour increased diversification across a broad range of 'risk' assets.

7 Author

John Harrison (Interim Chief Investment Officer): 25th February 2022

Important Information

Border to Coast Pensions Partnership Ltd is authorised and regulated by the Financial Conduct Authority (FRN 800511). The information provided in this paper does not constitute a financial promotion and is only intended for the use of Professional Investors. The value of your investment and any income you take from it may fall as well as rise and is not guaranteed. You might get back less than you invested. Issued by Border to Coast Pensions Partnership Ltd, Toronto Square, Leeds, LS1 2HP.