Border to Coast Pensions Partnership Limited
Joint Committee

Date of Meeting: 20 June 2022

Report Title: Market review (for information)

Report Sponsor: John Harrison, Interim CIO

1 Executive Summary

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

2 Recommendation

2.1 That the Joint Committee notes this paper.

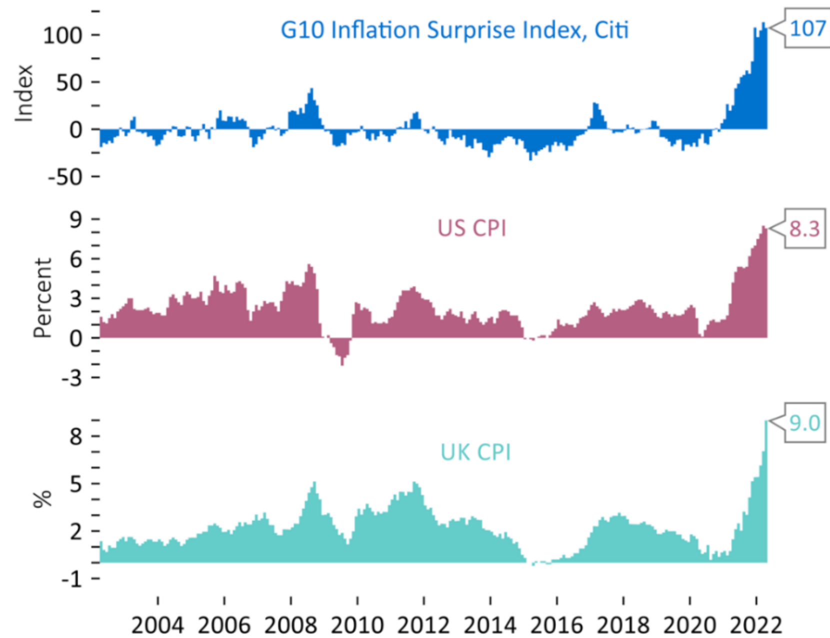
3 Macro-economic background

3.1 The dominant economic issue of the moment is the return of inflation. Throughout this century developed economies have enjoyed a benign environment of steady growth, subdued inflation and low interest rates. This is rapidly starting to change.

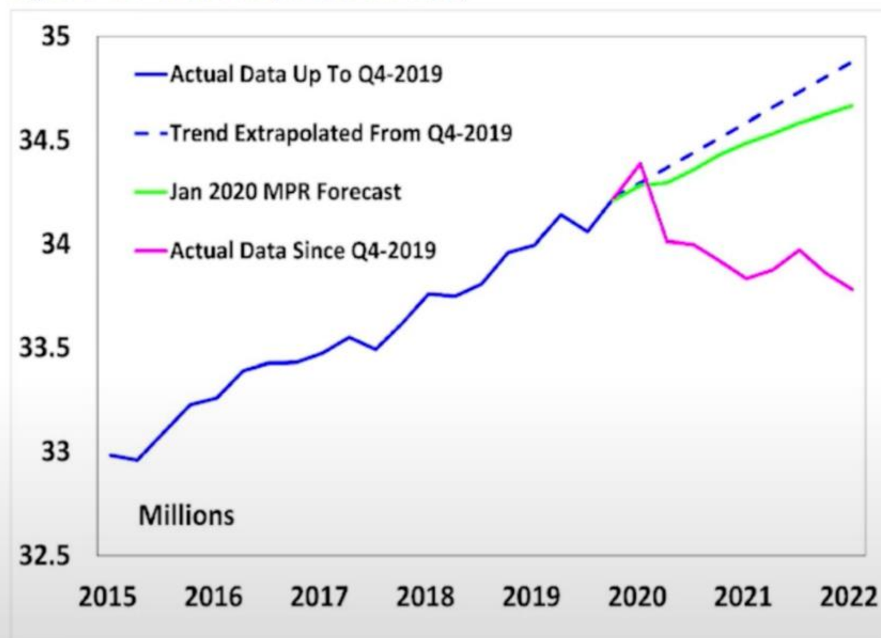
3.2 Inflation has risen not only suddenly but unexpectedly. The inflation surprise index (top chart below) records the degree to which analyst forecasts have underestimated the actual inflation outcome in the major developed economies.

3.3 The two subsequent charts show the scale of the pick-up in inflation in the US and the UK in comparison with the previous 20 years. Supply chain issues, food shortages and rising energy prices in the wake of Russia's invasion of Ukraine have undoubtedly contributed to the inflation shock, but prolonged loose monetary policy over the last 10 years may also have played a part.

3.4 Hopes that inflation would prove transitory have faded. The war in Ukraine is continuing for longer than initially expected and global logistics challenges have been exacerbated by further lockdowns in China. More worryingly, there is growing evidence that current inflation may be feeding into wage demands.

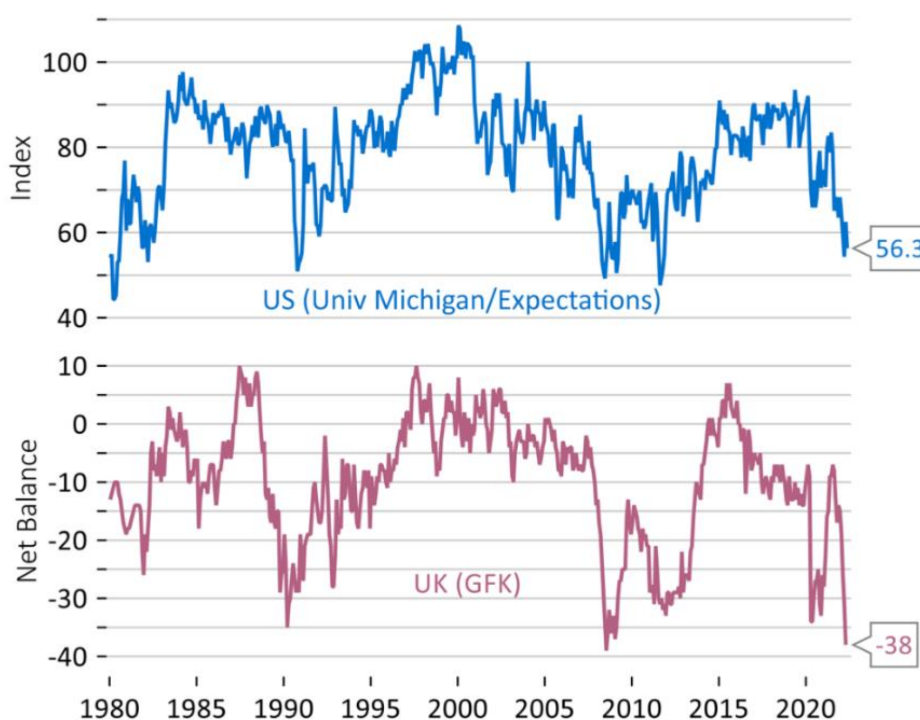


3.5 The rapid pace of recovery post-pandemic has resulted in an unusual situation in the UK and US where job vacancies exceed the number unemployed. Pressure in the labour market also reflects shrinkage in the workforce in the last three years – as shown for the UK below.



3.6 Central banks face a difficult challenge. Moetary policy needs to be tightened quickly to address inflation pressures, but not so much as to push economies into recession. After such a long period with interest rates close to zero and high indebtedness in many areas, central banks will find it hard to predict how quickly the economy will react as interest rates are increased. With several interest rate rises now likely in the next few months both in the US and the UK, there is a much greater than normal risk of a central bank policy error.

3.7 In the meantime, consumer confidence is falling sharply, especially in the UK, increasing the likelihood that the UK will suffer a recession in the coming months.



3.8 Consensus economic forecasts have deteriorated significantly in the last few weeks, with slower growth and higher inflation in most developed countries. Sovereign bond yields have also risen sharply in the UK, US and Europe. Even so, analysts are still forecasting reasonable growth as economies continue to recover from the pandemic.

Consensus economic forecasts for 2022

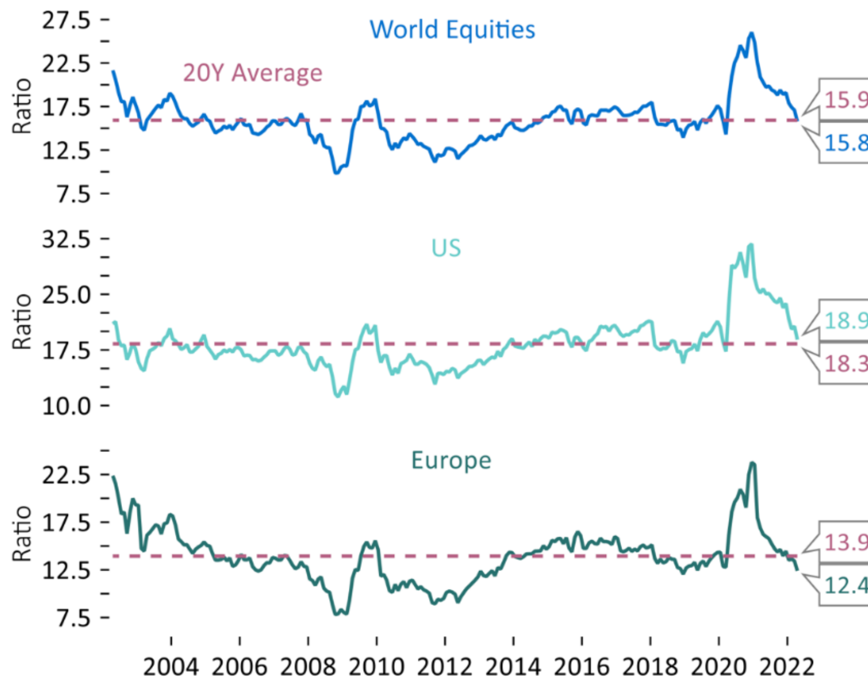
As at 6 June 2022	Real GDP	CPI Inflation	Unemployment	10yr Sov Bond
UK	3.7%	7.8%	3.9%	2.3%
US	2.6%	7.1%	3.6%	3.0%
Germany	2.0%	6.9%	5.0%	1.3%
Japan	1.8%	1.8%	2.6%	0.2%
China	4.5%	2.2%	4.0%	2.8%

Source: Bloomberg

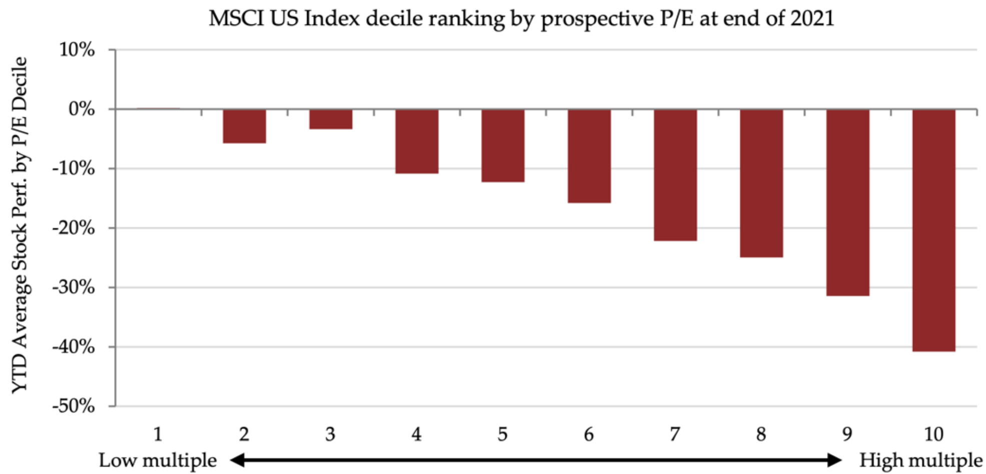
4 Market valuations

4.1 Markets have already discounted less benign economic times ahead. The resurgence of inflation has resulted in significant falls in both bond and equity indices. Growth stocks (e.g. NASDAQ) and speculative investments (e.g. Bitcoin) have fared even worse. Only gold, the traditional safe haven asset, has retained its value since the start of the year.

4.2 Falling asset prices have brought equity valuation measures closer to long term averages. The chart below shows forward P/E multiples in developed economies are now close to the average of the last 20 years. The forward P/E is dependent on corporate earnings remaining robust, so it is still possible that a weaker economic outlook will further erode equity valuations. However, corporate balance sheets are reasonably healthy as evidenced by high levels of share buybacks.



4.3 Perhaps unsurprisingly, one feature of the recent market falls has been that more highly rated stocks have been hardest hit. The chart below shows the average price fall has been much larger for stocks in the higher valuation deciles. This helps to explain why 'growth' stocks have performed so poorly relative to 'value' stocks.



Source: Marathon, Bloomberg

5 Fund performance

5.1 The table below shows performance data for the ACS funds (listed assets) to 31st March 2022.

% pa since inception	Return	Benchmark	Relative
Internal Equities			
UK Listed Equity	4.2	3.5	**+0.7**
Overseas Developed	10.6	9.5	**+1.2**
*Emerging Markets Equity**	4.7	7.3	**- 2.6**
*Listed Alternatives***	7.3	4.1	**+3.2**
External Equities			
UK Listed Equity Alpha	7.5	7.3	**+0.3**
Global Equity Alpha	11.9	13.7	**- 1.9**
Fixed Income			
Sterling Investment Grade Credit	2.5	1.1	**+1.4**
Sterling Index Linked Bonds	- 1.4	- 1.8	**+0.4**
Multi Asset Credit ***	- 5.0	1.4	**- 6.5**

** Hybrid (combines internal and external capabilities)*
*** Not annualised*

5.2 Internally managed equity capabilities have small relative exposures to 'style' factors (e.g. value vs growth), regions or size. This has been an advantage during a period where there have been pronounced swings in relative performance between styles, regions and size. Externally managed equity capabilities have found this market environment more challenging.

5.3 The emerging market equity portfolio faced especially strong headwinds. The Russian invasion of Ukraine, further lockdowns in China and a strengthening US dollar have all contributed to significant market falls in 2022 to date.

5.4 Fixed income capabilities have performed well relative to weak market indices, but the MAC fund has suffered from being measured against a cash benchmark.

6 Looking forward

6.1 Does the fall in financial markets represent a buying opportunity? It is hard to make the case for conventional bonds given that inflation risks have increased significantly, and real yields remain negative. However, the very sharp falls in long-dated index linked gilts – the worst performing gilt index this year to date – may tempt liability driven investors to add to holdings. Real yields may still be well below zero but that is better than the real yield at the start of the year.

6.2 For equities, the worst may be over at least for now. Valuations are no longer stretched compared to history and healthy corporate balance sheets could support strong dividend growth and buy backs.

6.3 The bearishness of institutional investors could also be a trigger for a rally. The chart below from the most recent Bank of America Fund Manager Survey shows investor sentiment is almost as bad as the trough during the financial crisis. Institutions are also holding much larger than normal cash balances.

6.4 Even with sharp rises in interest rates, cash is still guaranteed to deliver returns well below inflation. While it is always dangerous to predict short term market movements, particularly at inflexion points in the economic cycle, low expectations and high cash often mark the nadir of a market cycle.

6.5 One challenge facing businesses and investors is how to adjust to a more volatile economic environment. The deflationary forces of globalisation have kept costs under control for much of the last 20 years and enabled businesses to push up profits without increasing prices. In the new volatile inflationary environment, some companies may find it harder to pass on cost increases to preserve margins. Security selection will be even more important than usual.

7 Conclusion

7.1 The benign economic environment that investors have enjoyed for over 20 years may be coming to an end. Inflation has returned as a major economic and business risk. Financial markets may prove more volatile as a result.

7.2 An outlook of higher and unpredictable inflation seems likely to be difficult for bond markets given yields remain very low from an historical perspective. Equity market valuations are less stretched and appear to have discounted much of the short-term economic downturn.

7.3 Falling equity and bond markets have reinforced the diversification benefits of alternatives, especially those with inflation linked income streams.

8 Report Author:

John Harrison, CIO, 9th June 2022

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