Border to Coast Pensions Partnership Limited

Joint Committee

Date of Meeting: 29 September 2022

Report Title: Summary of Investment Performance and Market Review

Report Sponsor: John Harrison (Interim CIO)

1 Executive Summary

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

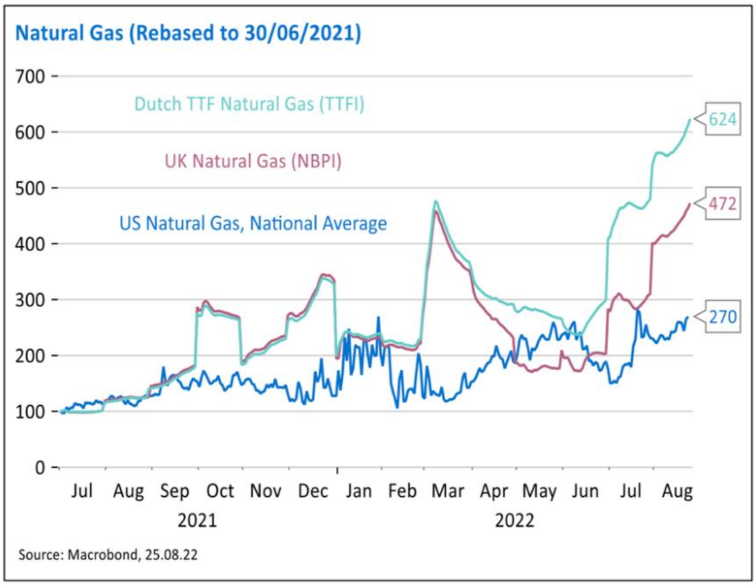
2 Recommendations

2.1 That the report is noted.

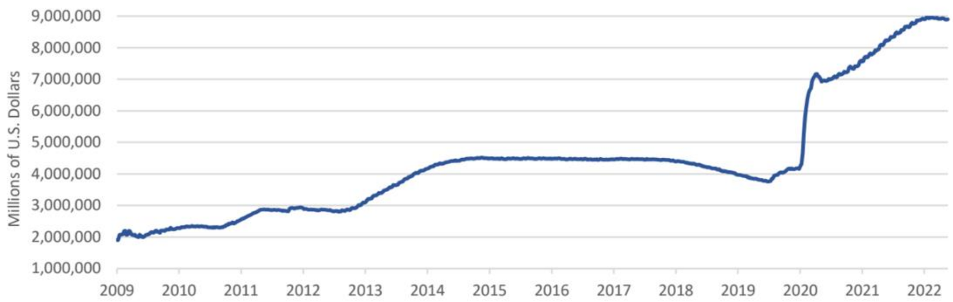
3 Macroeconomic environment

3.1 Inflation remains the dominant economic issue of the moment. The combination of tight labour markets, supply chain issues, food shortages and rising energy prices in the wake of the Russian invasion of Ukraine has triggered a sharp increase in costs across a broad swathe of the economy.

3.2 The scale of the rise in energy prices is extraordinary as highlighted in the chart below showing natural gas price movements since mid-2021. Even the US, with large domestic energy production, has seen prices almost treble, with much larger moves in Europe.

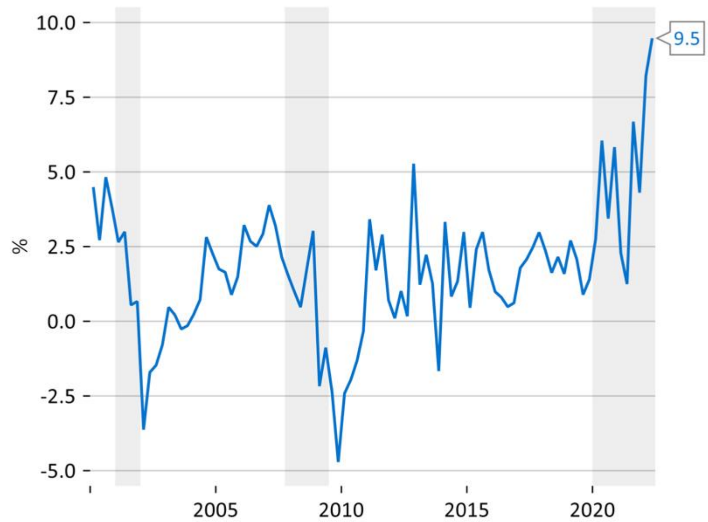


3.3 The challenge facing central banks is how to avoid inflation becoming embedded through wage demands and other behavioural adjustments. For over 20 years expectations of modest and stable inflation in developed markets have underpinned economic activity and allowed a massive increase in money supply without prompting inflation. Given the scale of the financial stimulus, as seen in the US Federal Reserve balance sheet below, the risk of money supply exacerbating inflation pressures is high, but central banks may find it difficult to dampen demand through higher interest rates and drain excess liquidity through Quantitative Tightening without tipping economies into recession.



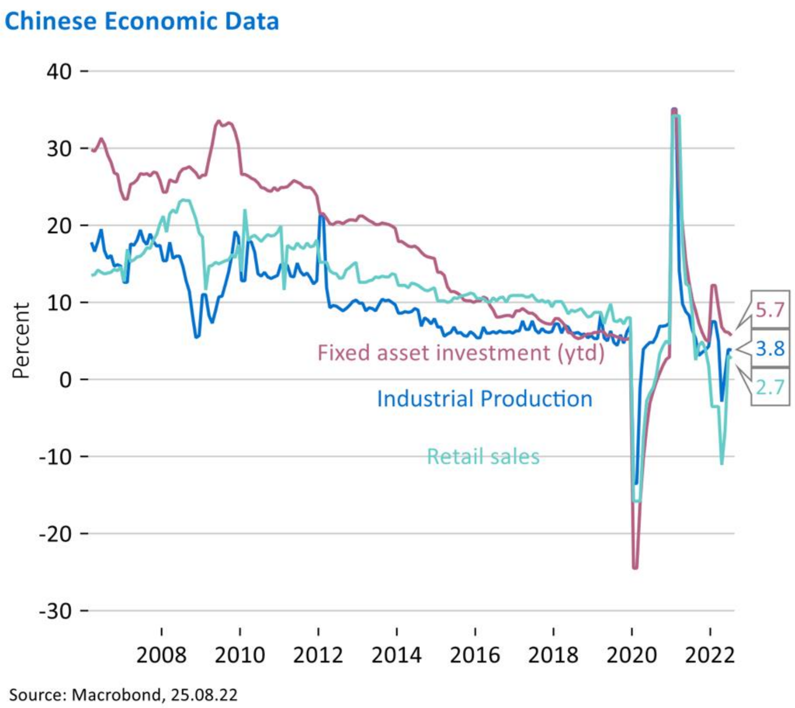
Data: U.S. Bureau of Economic Analysis, Personal Income [PI], U.S. Bureau of Labor Statistics, Producer Price Index by Commodity: All Commodities, retrieved from Federal Reserve Bank of St. Louis, July 28 2022.

3.4 The potential for inflation to become embedded is evident from the increase in wage costs in the US. Historically US wages have tended to fall when the economy is weak, but that is not the case at present.



Source: Macrobond, 25.08.22

3.5 Historically developed economies have been supported during economic downturns by the strength of demand from Asia and especially China. That is no longer the case. The rate of growth in China has been moderating for many years, which is an inevitable consequence of the economy's increased size. In recent years, China's zero-COVID policy has been hugely disruptive, as shown below, with regional lockdowns undermining economic activity and confidence.



3.6 The economic crystal ball is as cloudy as ever. Inflation will probably peak soon as energy prices moderate and supply chain issues abate, but quite how quickly or how far is uncertain. Nonetheless it does seem likely that inflation and interest rates will remain higher than most developed markets have experienced over most of the last 10 years.

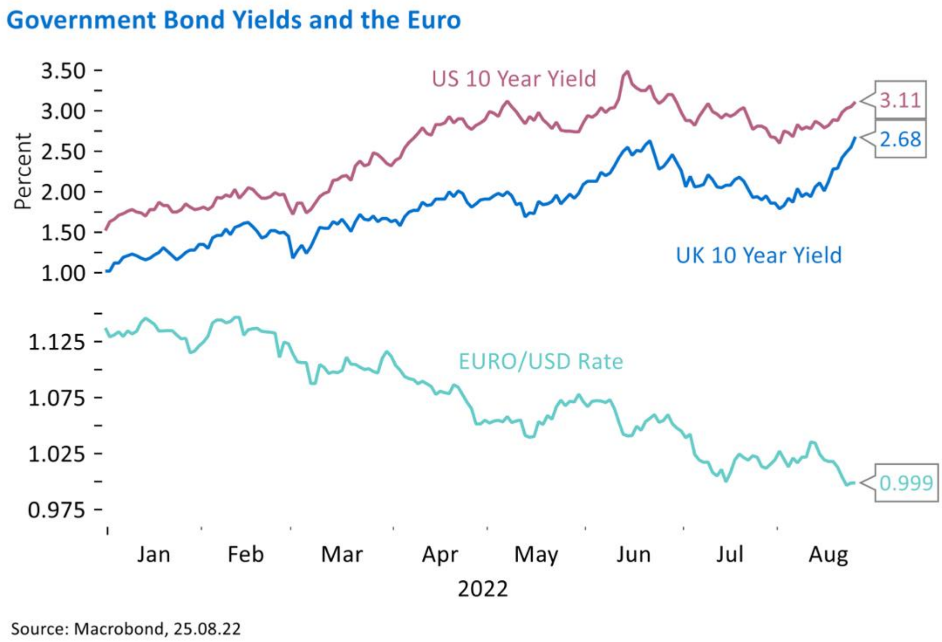
Consensus economic forecasts for 2023

As at 13 Sept 2022	**Real GDP**	**CPI Inflation**	**Unemployment**	**10 year Sov Bond Yield**
UK	-0.1%	6.6%	4.4%	3.1%
US	0.9%	3.7%	4.1%	3.3%
Germany	0.3%	4.7%	5.4%	1.7%
Japan	1.6%	1.3%	2.5%	0.2%
China	5.2%	2.3%	3.9%	2.7%

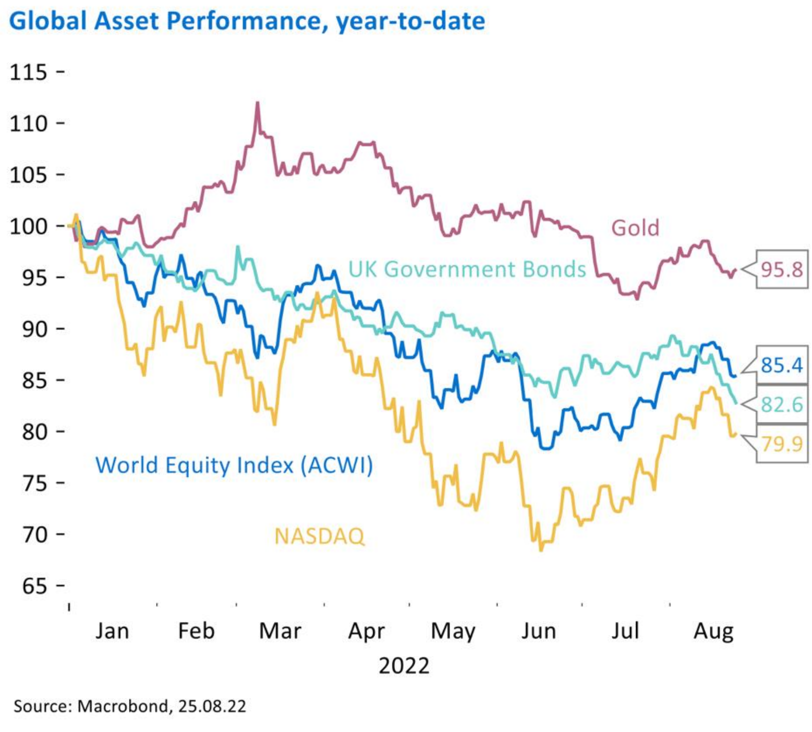
Source: Bloomberg

Market valuation

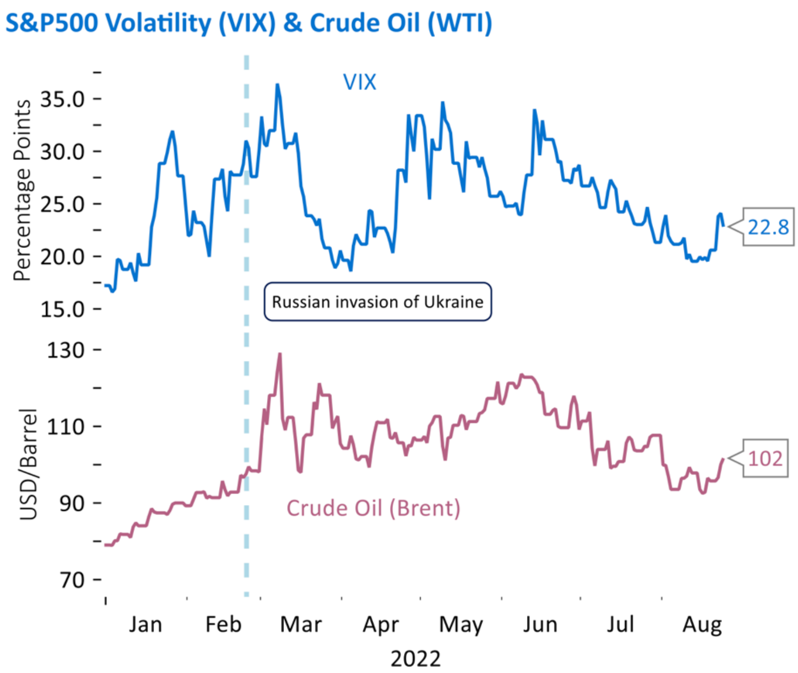
3.7 The deteriorating inflation outlook has been reflected in higher bond yields across developed markets and also in currency movements. It is not just sterling that has been weak. The impact of the Russian invasion on energy prices in Europe has been far higher than elsewhere and has undermined the euro relative to the US dollar. Currency weakness relative to the US dollar is another contributor to inflation pressures across Europe.



3.8 Markets have already discounted much tougher economic times ahead. The resurgence of inflation has resulted in significant falls in both bond and equity indices. Even gold, the traditional safe haven asset, has fallen in value.

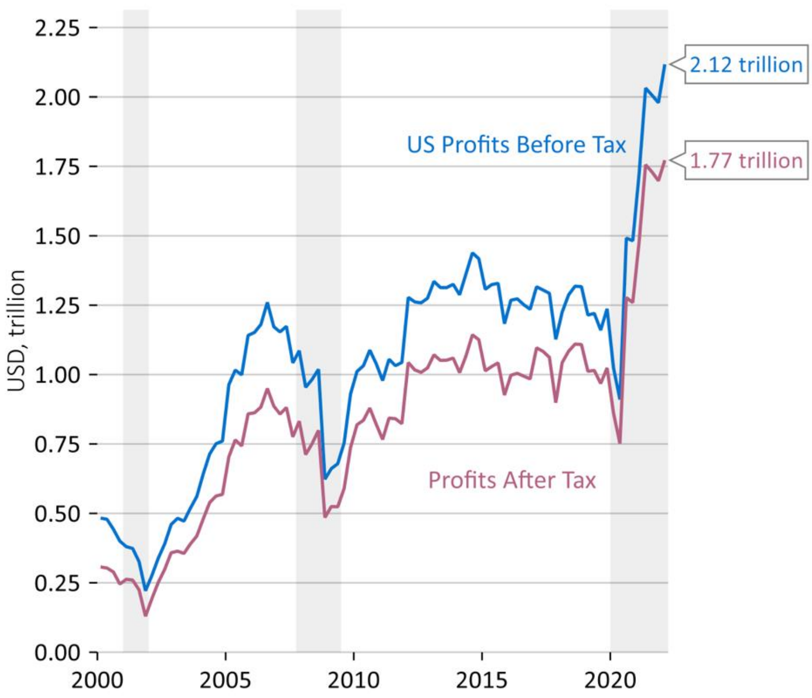


3.9 Given the economic environment, it is perhaps surprising that markets have not fallen further. Indeed, while market volatility picked up sharply in the run up to and immediate aftermath of the Russian invasion, it has stabilised over the summer months, in part reflecting the downward trend in oil prices.



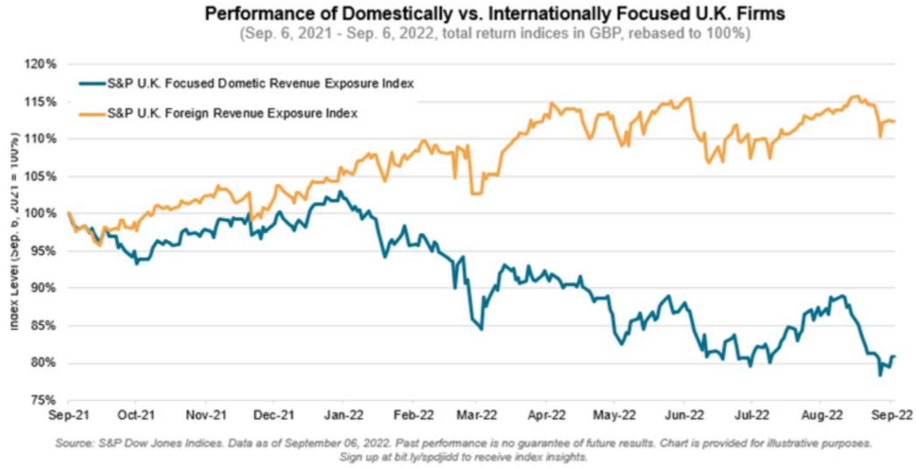
Source: Macrobond, 25.08.22

3.10 The main explanation for the resilience of equity markets over the summer has been the continued strength of corporate profitability, especially in the US. Profits are largely backward-looking measures and may yet be choked off by rising unit labour costs and interest rates. Nonetheless, the scale of the profit uplift has been a positive surprise for investors and leaves businesses with stronger balance sheets.



Source: Macrobond, 25.08.22

3.11 Currency movements have had a significant impact on relative performance within equity markets. For example, in the UK, companies reliant on domestic earnings have performed significantly worse than those generating earnings overseas.



4 Fund Performance

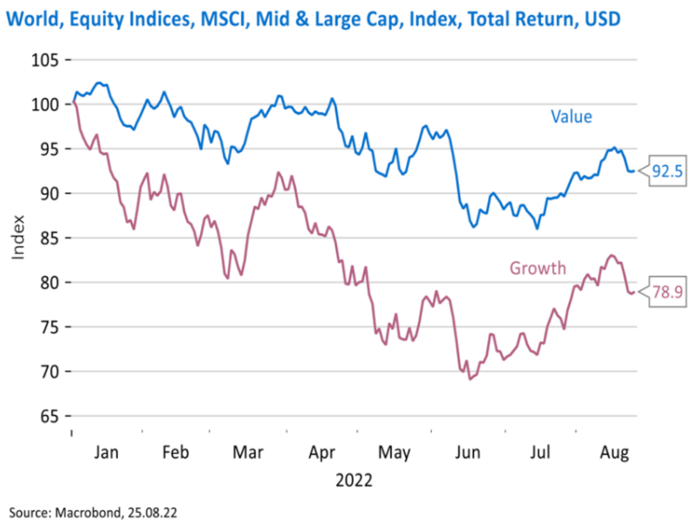
4.1 The table below shows performance data for the ACS funds (listed assets) to 30th June 2022 for funds with more than 12 months since inception.

% since inception	Type	Launch date	Return	Benchmark	Relative
Equities					
UK Listed Equities	*Internal*	*July 2018*	*2.9*	*1.9*	*+1.0*
UK Equity Alpha	*External*	*Dec 2018*	*3.5*	*5.2*	*-1.6*
Overseas Developed	*Internal*	*July 2018*	*7.6*	*6.3*	*+1.3*
Global Equity Alpha	*External*	*Oct 2019*	*7.2*	*8.7*	*-1.5*
Emerging Market Equities	*Hybrid*	*Oct 2018*	*3.6*	*6.0*	*-2.3*
Fixed Income					
Sterling Investment Grade Credit	*External*	*Mar 2020*	*-0.9*	*-2.1*	*+1.1*
Sterling Index Linked Bonds	*Internal*	*Oct 2020*	*-16.7*	*-17.0*	*+0.4*

** Not annualised*

4.2 The most surprising outcome given the upturn in inflation is the Sterling Index Linked Bond fund with an annualised return since inception of -16.7%. This reflects the remarkable fall in the index linked gilt benchmark in the last three months as real yields have risen. The fund has exceeded its relative return target, but this outperformance has been dwarfed by the scale of the benchmark move.

4.3 Internally managed equity funds in developed markets have consistently performed well. The funds do not take large views in relation to region, size or 'style', so have been less impacted by the volatility of style rotation that has been a feature of recent years.



4.4 By contrast, externally managed equity capabilities have been buffeted by style volatility. During the pandemic large growth stocks, particularly in the technology and health sectors, performed strongly. More recently growth stocks have led the market falls, as shown in the chart above. This has been a challenging environment for our external managers.

Looking forward

4.5 The combination of high inflation and the risk of recession is an uncomfortable environment for investors, especially when assessing strategic asset allocation for the next three years.

4.6 Income generating assets will no doubt be an important consideration in the strategic assessments of the Partner Funds. Bond yields are much higher than a year ago, but sovereign bonds in Europe still offer negative real returns and remain vulnerable should inflation persist. Yield spreads for corporate bonds have also widened and are now closer to historic norms.

4.7 Equity valuations are also closer to historic averages, but a lot depends on the future outlook for profits. While financial markets are discounting a recession in developed economies, valuations could be undermined if the downturn is longer or deeper than currently expected.

4.8 Investors will continue to look for diversified sources of investment return, particularly from assets offering explicit or implicit inflation protection. This may encompass a broad range of alternative assets and strategies, including real assets, such as infrastructure and property.

4.9 With valuations relative to earnings broadly in line with historic averages, equities seem likely to remain the cornerstone of growth strategies for long-term investors.

5 Author

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14 September 2022

Important Information

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