



Border to Coast Pensions Partnership Limited Joint Committee

Date of Meeting: 30 November 2022

Report Title: Summary of Investment Performance and Market Review

Report Sponsor: John Harrison – Interim CIO

1 Executive Summary

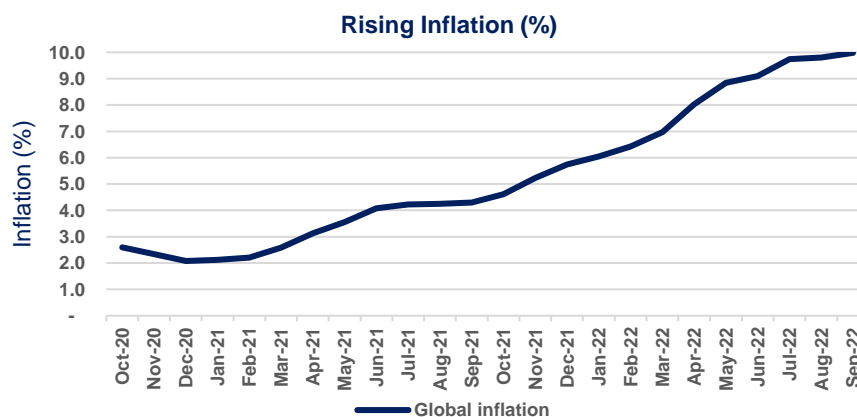
1.1 This report provides an overview of the macroeconomic and market environment, the performance of Border to Coast funds and the medium-term investment outlook.

2 Recommendation

2.1 That the report is noted.

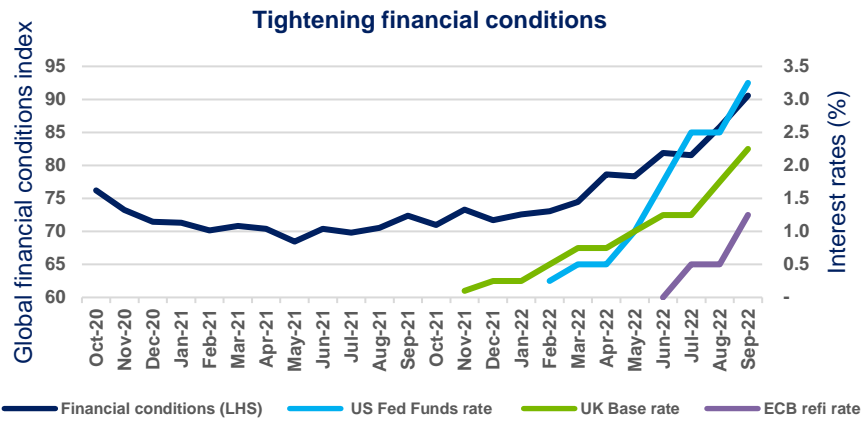
3 Macroeconomic environment

3.1 Inflation has increased dramatically in the last year driven by loose monetary policy, tight labour markets, post-Covid reopening of economies, supply chain disruption and rising commodity prices as a result of the Russia/Ukraine conflict. The rate of change is reducing and the balance of market commentary is that inflation has peaked although it may take some time for it to fall. There remains a risk that inflation becomes entrenched requiring greater central bank intervention.



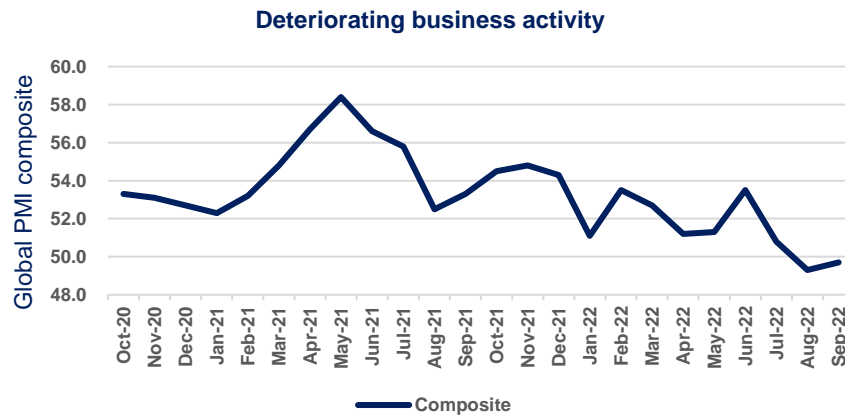
Source: Bloomberg, Border to Coast

3.2 Financial conditions were already tightening as central banks started to reverse quantitative easing. This has been exacerbated by the recent sharp rise in interest rates which now stand at 2% in Europe, 3% in the UK and 4% in the US following further increases towards the end of October.



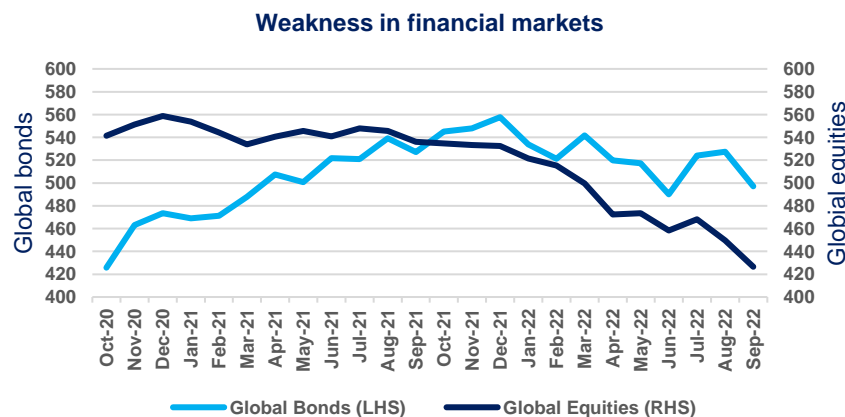
Source: Bloomberg, Border to Coast

3.3 High inflation and rising interest rates have had a significant adverse impact on business activity. Market expectations are for the majority of major economies to fall into recession in the next 6 – 12 months with the downturn in Europe expected to be particularly sharp given its proximity to the Russia/Ukraine conflict.



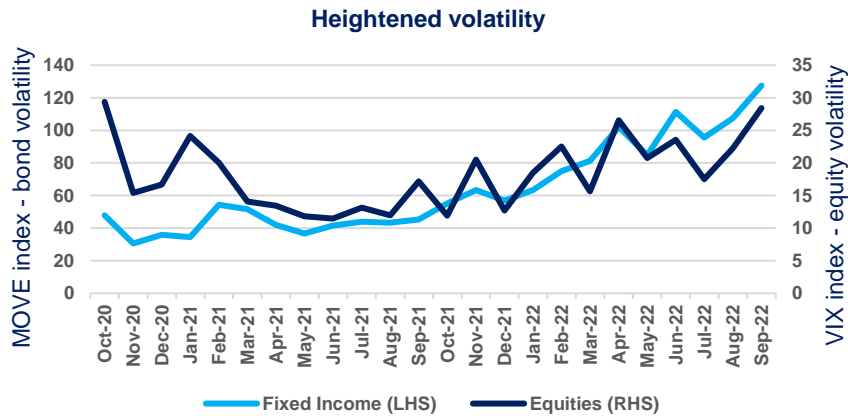
Source: Bloomberg, Border to Coast

3.4 This has resulted in significant weakness in financial markets with global equities and bonds falling by ~20% and ~15% respectively since peaking towards the end of 2021. This is perhaps not surprising as financial markets typically anticipate, and perhaps overreact to, bad news.



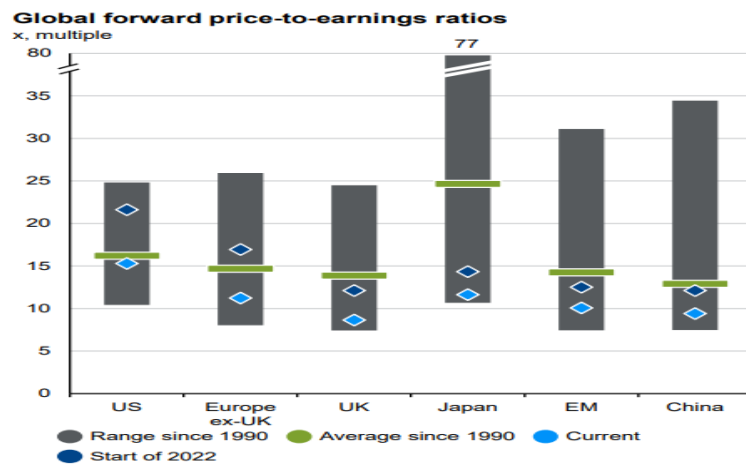
Source: Bloomberg, Border to Coast

3.5 Unsurprisingly given the political and economic turmoil of the last few months, volatility in financial markets has increased. It has been particularly notable in the fixed income markets. For example, during Q3 the UK index-linked gilt market was more volatile than Bitcoin!



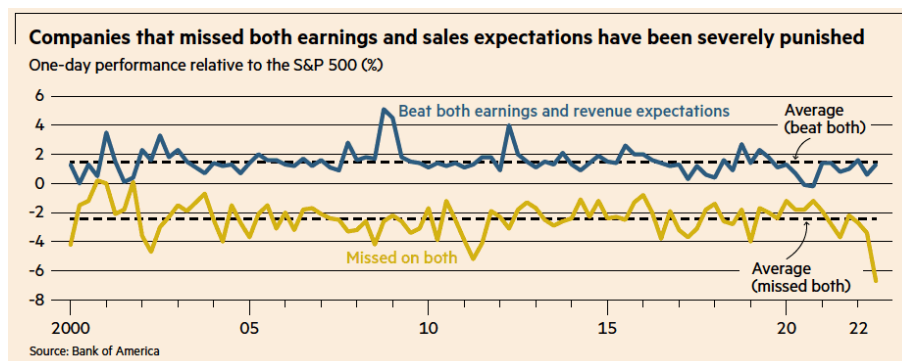
Source: Bloomberg, Border to Coast

3.6 The sharp correction in equity markets has resulted in a fall in valuation multiples which are now significantly lower than at the start of 2022, below the long term average for the majority of markets, and close to the lowest in the last three decades in the UK and Japan.



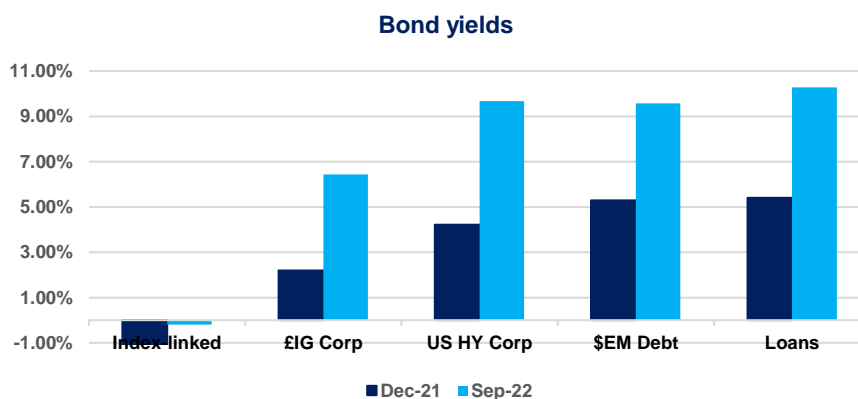
Source: JP Morgan

3.7 However, earnings expectations have been slow to react to the deterioration in macroeconomic data raising the risk of a “value trap”. Results announcements for Q3 so far are starting to reflect this weakness and investors are punishing companies that miss these short term forecasts.



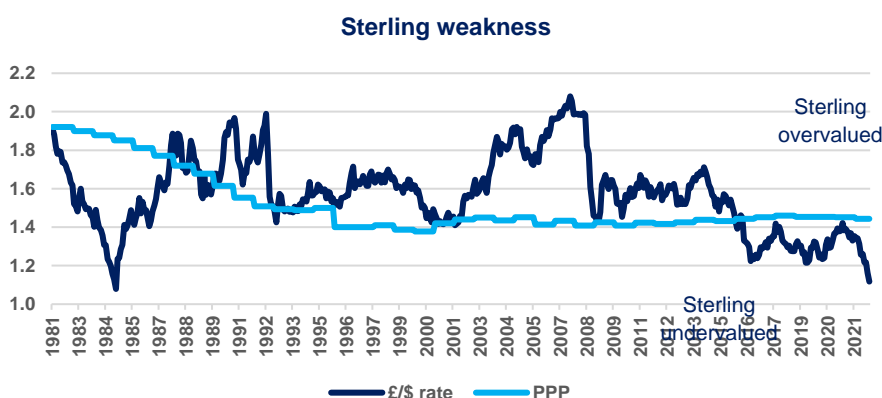
Source: FT

3.8 As with equity markets, the correction in bond markets has increased the yields available with high single digit yields for most bond types. Even real index-linked bond yields are close to positive and reached the heady heights of 1.5% towards the end of September.



Source: Bloomberg, Border to Coast

3.9 The other key trend has been the sharp devaluation of Sterling, particularly relative to the US Dollar. This has been due to less aggressive monetary tightening in the UK as well as the market reaction to the “mini-Budget” towards the end of September. This weakness has somewhat protected the returns from overseas investments for sterling investors. Sterling has since stabilised as a result of the recent political changes but remains relatively weak and below the long term fair value implied by the albeit simplistic “purchasing power parity” model.



Source: Bloomberg, Border to Coast

3.10 Economic forecasts have deteriorated further since the last update with a fall in economic growth, higher inflation, higher unemployment and higher bond yields – perhaps the darkest hour is just before the dawn!

2023 forecasts	Real GDP	CPI Inflation	Unemployment	10 year yield
UK	-0.5% (-0.1%)	6.3% (6.6%)	4.4% (4.4%)	3.7% (3.1%)
US	0.4% (0.9%)	4.2% (3.7%)	4.3% (4.1%)	3.4% (3.3%)
Germany	-0.6% (0.3%)	6.3% (4.7%)	5.6% (5.4%)	2.0% (1.7%)
Japan	1.4% (1.6%)	1.6% (1.3%)	2.5% (2.5%)	0.2% (0.2%)
China	4.8% (5.2%)	2.4% (2.3%)	4.0% (3.9%)	2.9% (2.7%)

Source: Bloomberg consensus forecasts (data as at 7 November 2022, comparatives in parentheses as at 13 September 2022)

4 Fund Performance

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

% pa since inception	Type	Launch date	Return	Benchmark	Relative
Equities					
UK Listed Equities	Internal	July 2018	2.0	1.0	+1.0
UK Equity Alpha	External	Dec 2018	2.6	3.9	-1.3
Overseas Developed	Internal	July 2018	7.2	5.9	+1.3
Global Equity Alpha	External	Oct 2019	6.9	8.4	-1.5
Emerging Market Equities	Hybrid	Oct 2018	3.1	4.9	-1.8
Fixed Income					
Sterling Investment Grade Credit	External	Mar 2020	-5.3	-6.3	+1.0
Sterling Index Linked Bonds	Internal	Oct 2020	-19.6	-20.0	+0.4

4.2 4 of the 5 equity funds outperformed during Q3 with only Global Equity Alpha behind benchmark. The equity market backdrop was relatively volatile with a strong recovery earlier in the quarter petering out towards the end. Portfolios with a more defensive and quality stance performed better in these market conditions.

4.3 With regards to Fixed Income, the Index-linked fund modestly outperformed and the investment grade fund underperformed by a similar margin with both benchmarks falling by ~11%. The majority of the market fall occurred in September as bond yields rose sharply following the fallout from the “mini-Budget”.

4.4 Since inception, 4 of the 7 funds are in line or ahead of their targets.

Looking forward

4.5 Whilst the macroeconomic backdrop is challenging there are some signs for optimism (or perhaps less pessimism).

4.6 Whilst high inflation and tightening financial conditions are not particularly conducive for financial markets, heightened volatility and weak business activity tend to be leading indicators of improved market returns in the short term. This is because investor sentiment tends to overreact and any reduction in volatility or improvement in business activity is taken positively.

4.7 Lower equity multiples also tend to result in higher market returns for a similar reason, although this is likely to require a stabilisation in earnings expectations which may be a challenge if we are on the cusp of a global recession.

4.8 Bond yields are discounting higher interest rates and increased default rates. In the event that the peaks in the interest rate and default cycles are lower, bonds could appear relatively attractive, certainly more attractive than they have done for a number of years.

4.9 Investors’ asset allocations are likely to have shifted significantly due to recent market movements which may result in an increase in rebalancing activity. As the values of private market assets do not respond in as timely a manner it is likely that allocations to these asset classes will be optically higher. There is some market chatter around

overextended investors reducing their exposure through the secondary market often at sizeable discounts.

- 4.10 In addition, the sharp rise in UK index-linked yields should have had a beneficial impact on the liability side of the equation, particularly for those funds that have not historically hedged.

5 Author

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11 November 2022

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