Border to Coast Pensions Partnership Limited

Joint Committee

Date of Meeting: 21 March 2023

Report Title: Summary of Investment Performance and Market Review

Report Sponsor: Joe McDonnell (CIO)

1 Executive Summary

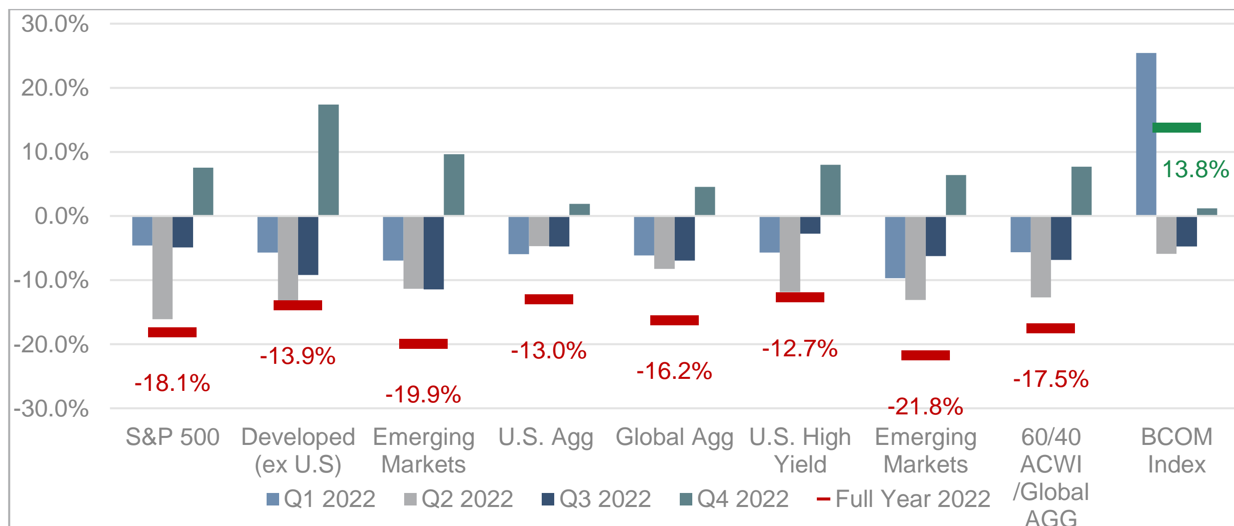
1.1 This report provides an overview of the macroeconomic and market environment, the performance of Border to Coast funds and the medium-term investment outlook.

2 Recommendations

2.1 That the report is noted.

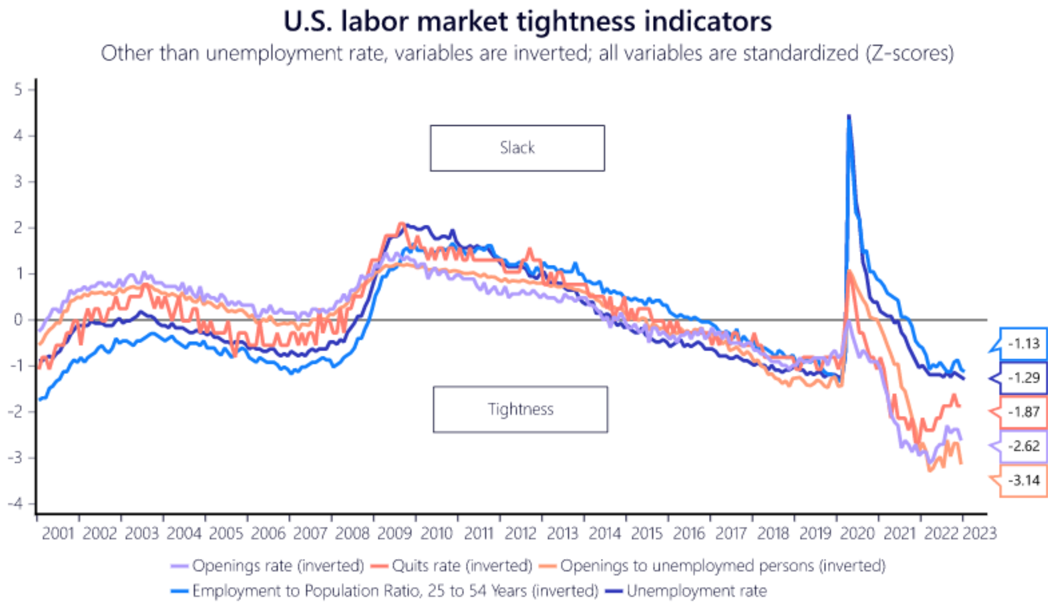
3 Macroeconomic environment

3.1 2022 was an extremely challenging year. The S&P returned -18% and volatility was high throughout the year. The Energy sector had it best year in 30 years +60%, while consumer discretionary -38% and communication services -40% had their worst years ever. Real Estate -28% and Technology-29% had their worst years since the Financial Crisis. At the same time the rising rate environment played havoc in bond markets – Global Aggregate bonds returned -16%. Higher inflation tends to compromise the diversification benefit of bonds and equities. A balanced portfolio of 60/40 returned -17.5% last year.

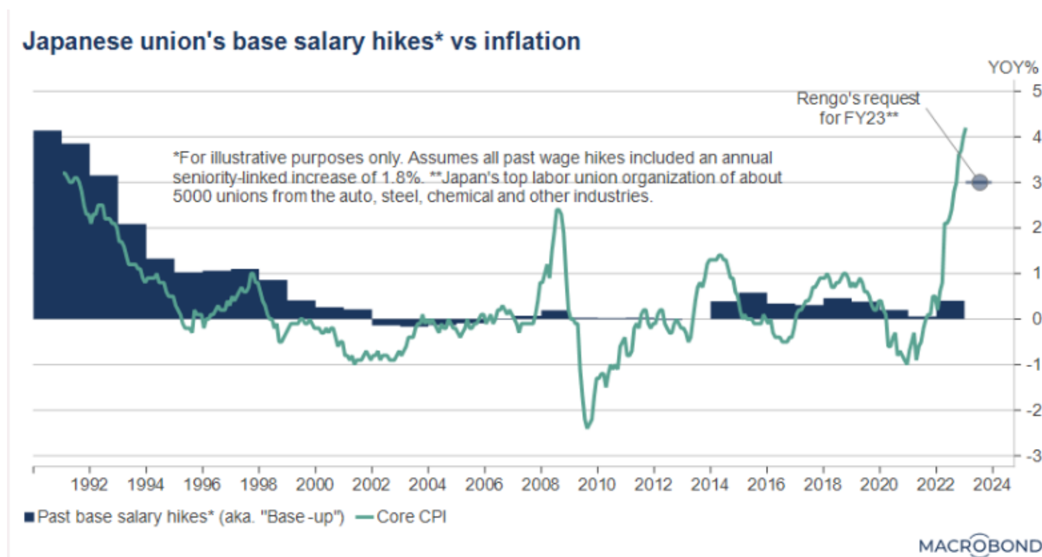


3.2 Inflation remains a key concern but recent data suggests that we should witness notable falls in 2023. The positive supply news, warm weather and the related falls in natural gas prices have provided relief to both consumers and governments. Global CPI peaked at 9.8% in 3Q22 and the forecast for 2023 is 5.3%. However, the road to lower inflation may be choppy as services and wages are likely to be slower to adjust.

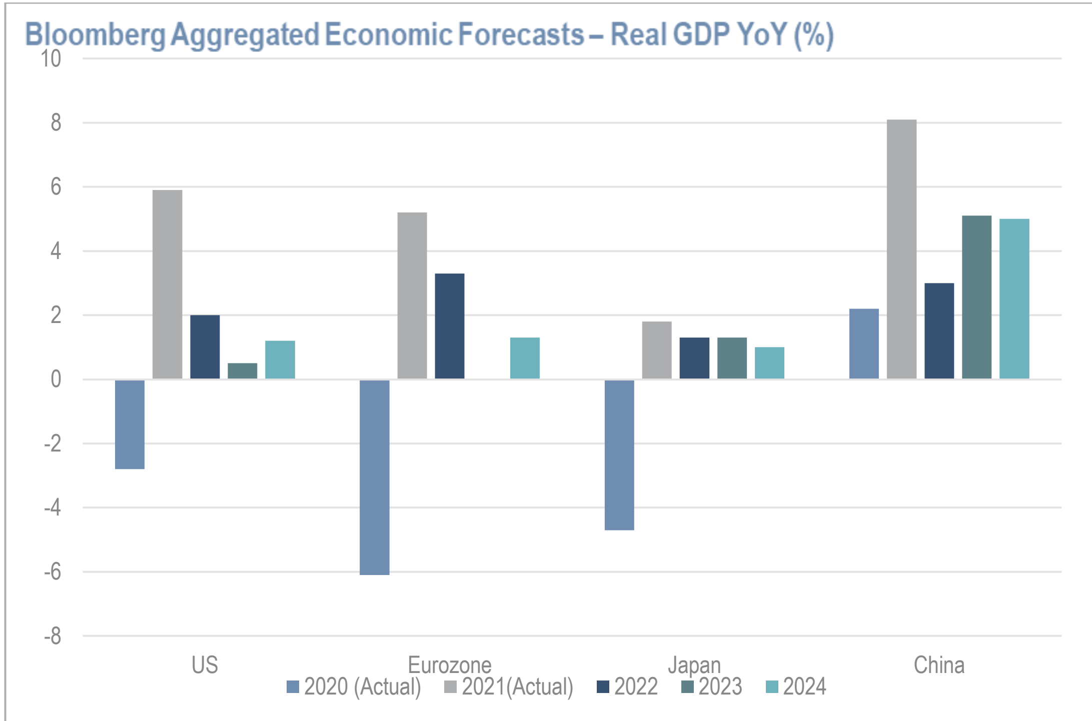
3.3 In the US wage gains are likely to keep inflation above target. While we are seeing some softening in jobs data – notably with technology firms – as can be seen in the diagram below the overall picture is that the job market remains tight,



3.4 The same wage pressure is working through in other major economies. Notably, after decades of wage stagnation, this year Japan is finally seeing wage growth. For decades, base salary hikes have been negligible (see chart below), but the BOJ hopes this will spur a virtuous wage-price inflation spiral.

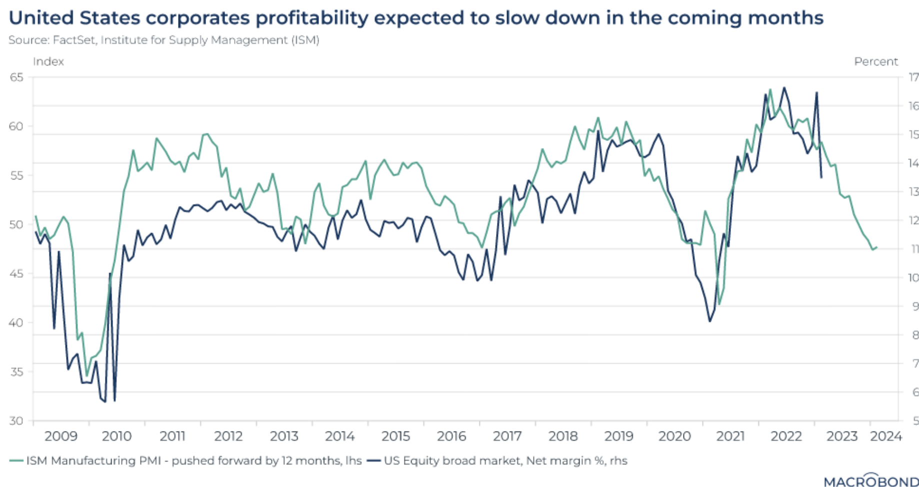


3.5 A warmer winter, improved supply chains, a reopening of China are all leading to the central belief of a non-recessionary growth path and slow, bumpy gradual disinflation. The base case for 2023 is global growth at a meagre 2.4%, down from 3.2% in 2022 and the lowest – leaving aside the crisis years of 2009 and 2020 – since 1983.



Source: Bloomberg

3.6 We are likely to see a sharp decline in corporate profitability in the coming months and this, coupled with higher borrowing costs, will be a headwind for equity markets. Anticipating a slump in corporate profitability the chart below explores the relationship between US companies' profitability and the Institute for Supply Management's purchasing managers index (PMI) for manufacturers. The closely watched PMI surveys are a measure of whether economic contraction is likely, based on whether supply-chain managers are expecting growth to pick up (readings above 50) or recede (below 50). It appears that the ISM PMI is a leading indicator of corporate net margin – closely correlated with a 12-month lag, as our chart shows. Watch for corporate profitability to deteriorate.

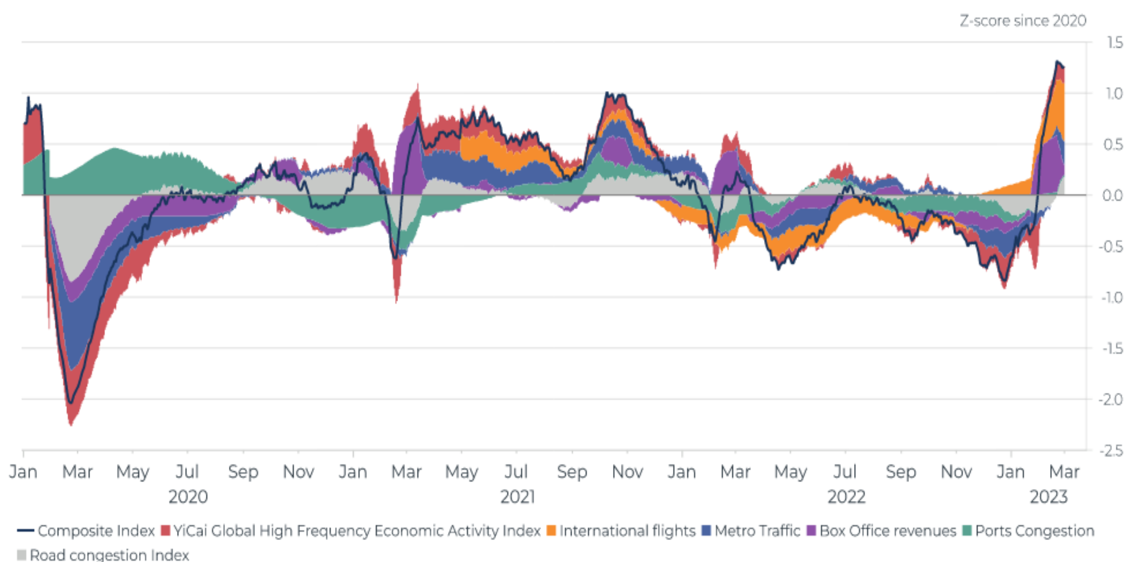


3.7 Unfortunately while global growth is modest and recession risk remains, global interest rates are likely to increase further (although the pace and magnitude of hikes will moderate). The scale of the move in borrowing costs is likely to be a bigger drag on growth. Financial conditions have tightened fast, and households face significantly higher mortgage and credit costs.

3.8 While the drop in inflation is a welcome relief in the UK (likely to average 6% in 2023) – rates will continue to rise (4.5% is expected peek) with no cuts until well into 2024. Nevertheless, UK sentiment has improved over the last few months – helped by the Windsor framework on Northern Ireland, bumper profits from large FTSE constituents and a less volatile bond market.

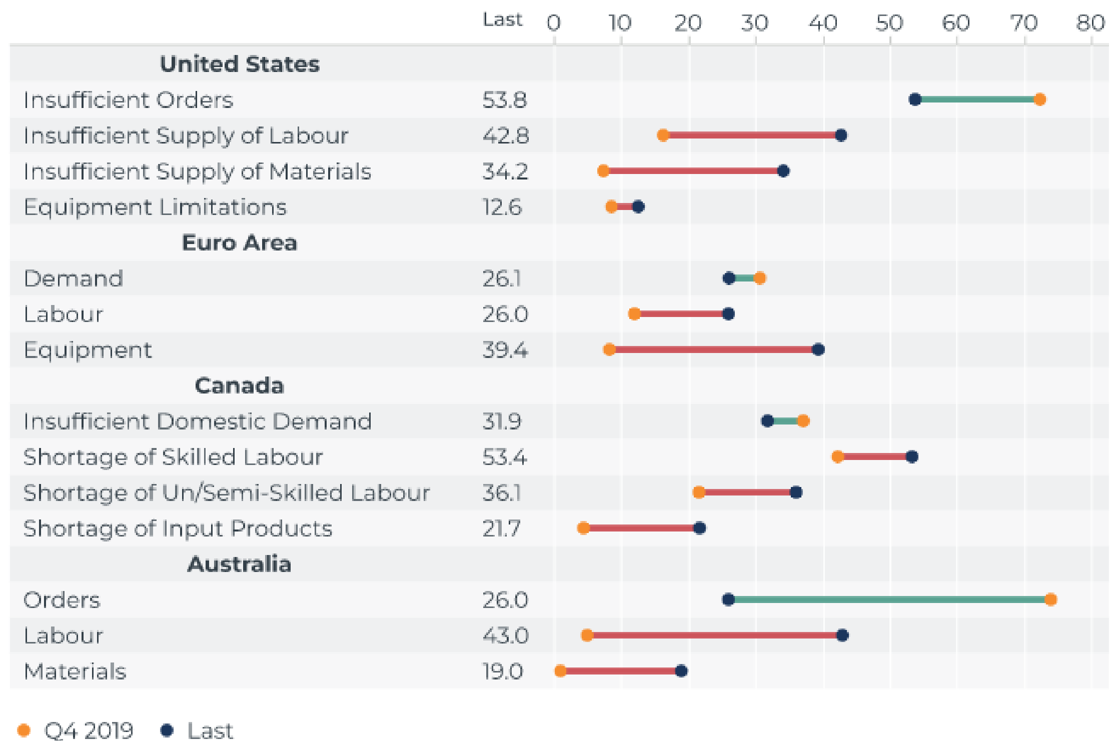
3.9 China exiting from its zero-COVID strategy is a very positive development. Production growth has returned and consumer demand is set for a strong start and will lead the overall recovery this year. Property could be the next source of upside growth. Given the importance of China to global growth a strong 2023 will in turn support economic activity elsewhere. Against this is the continued political tensions between China and the US.

3.10 The chart below shows a composite index to capture the waxing and waning of pandemic restrictions over the past three years. The index uses a broad range of daily alternative datasets, including port activity, road congestion, subway usage, international flights and box-office sales. The chart measures the z-score, or deviation from the historical mean (zero). Throughout 2022, the composite index and most of its components were almost always below average. The strong shift since the start of 2023 is obvious; the most lively indicators are the rebound in box-office revenue and flights abroad.



3.11 The worst of the supply-chain disruptions may be behind us, but this is not a return to normal. The chart below is based on surveys that ask companies in the US, Canada, Australia and the Eurozone about issues that are holding back production. Broadly, the factors measured are demand, the availability of labour and the ease of obtaining raw

materials and equipment. The red lines are trends that are getting worse; green lines show improvement from 2019.These four economies are sharing the same struggles.



3.12 The economic crystal ball is as cloudy as ever. We are now past Inflation peak soon as energy prices moderate significantly and supply chain issues abate, 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.

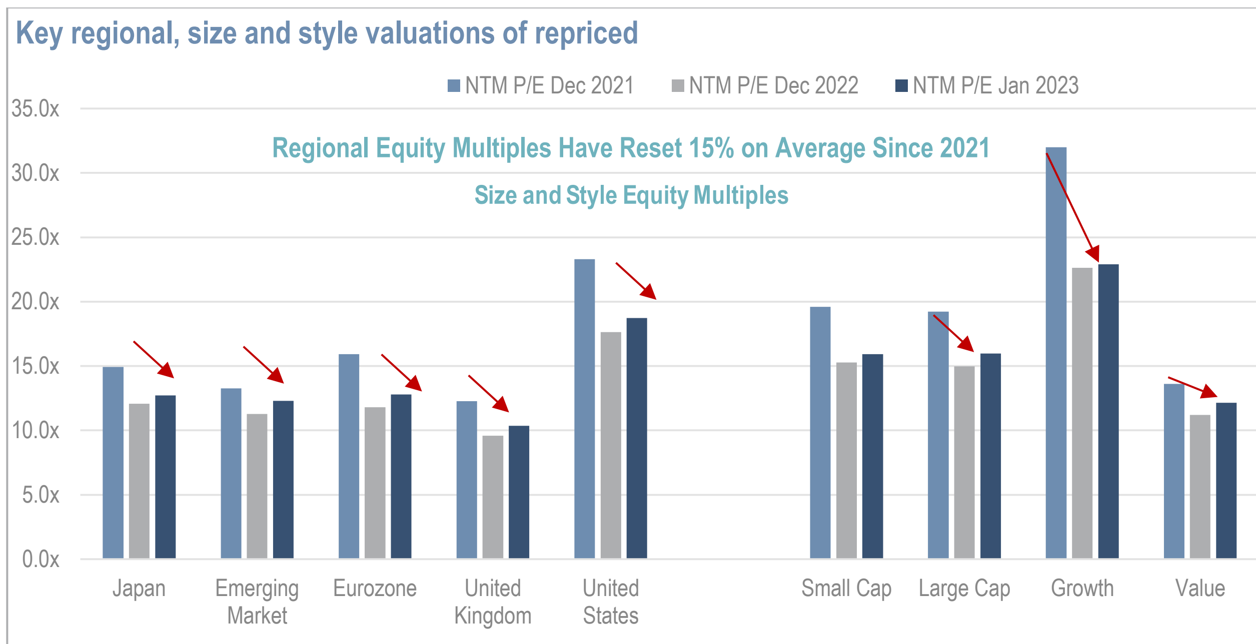
Consensus economic forecasts for 2023 as at March 2023

	Real GDP	CPI Inflation	Unemployment	10-year Sov Bond Yield
UK	-0.6%	6.6%	4.3%	3.1%
US	0.8%	4.0%	3.9%	3.5%
Germany	0.0%	6.1%	5.6%	2.1%
Japan	1.2%	2.1%	2.5%	0.6%
China	5.3%	2.4%	4.1%	3.0%

Source: Bloomberg

4 Market Valuations

4,1 As at year end 2022, US Equities S&P 500 had a forward P/E of 17x close to the 10 year average while the FTSE 100 had a forward P/E of 9.5x versus a 10 year average of 13x. The graph below illustrates that P/E ratios have dropped across the board. Obviously, the composition of the FTSE explains its outperformance in 2022 (after lagging for a number of years) but there continues to be value and its earnings/income is considered less vulnerable than other markets. As at year end the FTSE had a dividend yield of 3.75% versus 1.76% for the S&P.



4.2 The rally in January was owed primarily to the belief that the Fed would pivot later in 2023 and switch from hiking to cutting rates. While this is unlikely it does indicate a return premium from policy that avoids, delays or softens recession. Historically, after a significant sell off like we saw in 2022 the tendency (albeit small sample size) has been for the full-year return to be positive and meaningfully so. The below chart supports this view:

A Big January After A Down Year Has Bulls Smiling

S&P 500 >5% Or More In January After A Negative Year

Year	January Return	Previous Year Returns	Full Year Return
1954	5.1%	-6.6%	45.0%
1961	6.3%	-3.0%	23.1%
1967	7.8%	-13.1%	20.1%
1975	12.3%	-29.7%	31.5%
2019	7.9%	-6.2%	28.9%
2023	6.2%	-19.4%	?
		Average	29.7%
		Median	28.9%
		% Positive	100.0%

Source: Carson Investment Research, FactSet 01/31/2022
@ryandetrick

4.3 Government bonds yields have continued to move higher. The yield on the US Government 2 years is now 4.6% which is very close of the earnings yield on the $&P 500, a relative level not seen since the Global Financial Crisis. Yields in most major credit markets more than doubled during 2022. This correction on bond yields does challenge investors to ask the question why buy equities rather than bonds unless one believes there is an excessive equity risk premium to be harvested. In 2023 this trade-off between a repriced bonds and volatile equities will be a key dynamic.

4.4 In the highly uncertain macro-economic environment the dollar dominated 2022 and rallied strongly against G10 currencies. Forecasting what currencies will do is a very tricky exercise but a softer dollar would be consistent with moving past peak inflation, moderating growth but avoiding recession, improved geopolitics and smooth China

reopening. Obviously, all of these factors could turn the opposite direction hence, it is very difficult to have conviction on currency performance.

5 Fund Performance

5.1 The table below shows performance data for the ACS funds (listed assets) to 31 December 2022 for funds with more than 12 months since inception.
Do note these returns are annualised.

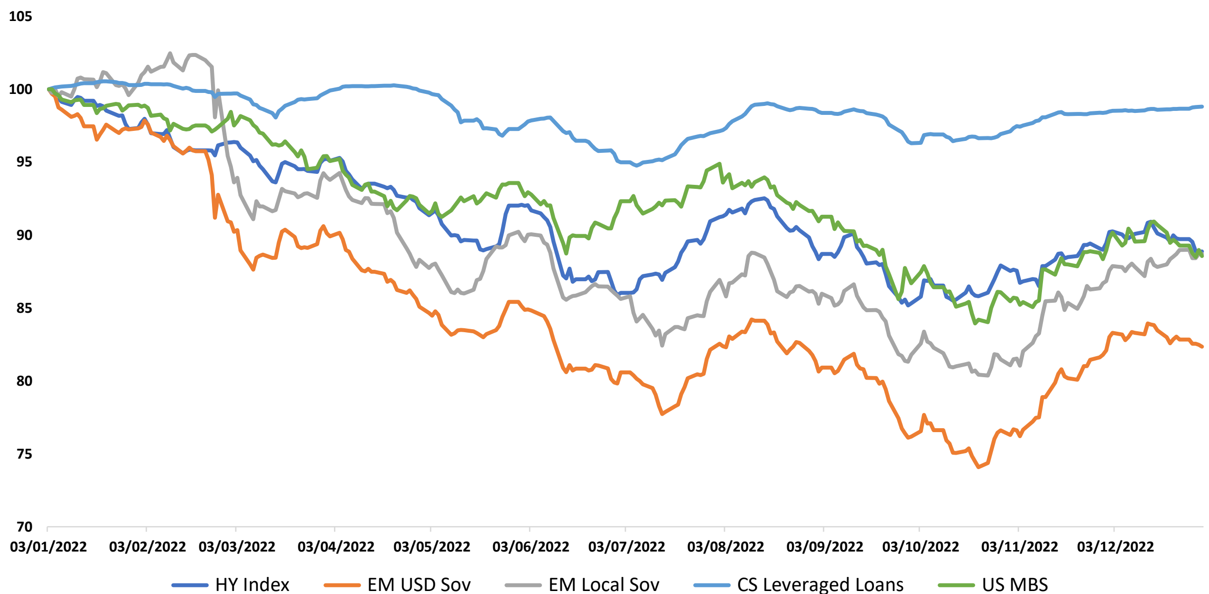
% Since inception	Type	Launch date	Return	Benchmark	Relative
Equities					
UK Listed Equities	Internal	Jul-18	3.9	2.9	+1.0
UK Equity Alpha	External	Dec-18	4.6	5.8	-1.2
Overseas Developed	Internal	Jul-18	8.2	6.9	+1.4
Global Equity Alpha	External	Oct-19	8.1	8.4	-0.3
Emerging Market Equities	Hybrid	Oct-18	2.7	4.8	-2.1
Fixed Income					
Sterling Investment Grade Credit	External	Mar-20	-2.8	-3.8	+1.0
Sterling Index Linked Bonds	Internal	Oct-20	-22.5	-22.9	+0.3
Multi Asset Credit Fund	Hybrid	Nov-21	-9.4	4.8	-14.1

5.2 As discussed, nominal market returns have been poor in 2022 – In a high inflation environment the 'usual' diversification benefit of equity and bonds failed. Nevertheless, the relative returns achieved by our internal equity (UK Listed and Overseas Developed) were ahead of target in 2022. Also good relative performance came from our Sterling Inflation Linked, Sterling Investment Grade credit and our external Global Alpa strategy.

5.3 The strong relative performance of our internal equity strategies is a function of taking modest active risk and avoiding large sector or style risk. So while there was significant sector rotation this did not weigh on our internal team. In 2022 a modest risk budget has gone well versus high tracking error, style bias equity management.

5.4 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.

5.5 All credit suffered in 2022 as high rates and broader macro concerns took hold. This meant a very difficult year for our Multi-Asset Credit fund. Performance was driven by a re-rating of general credit risk (alongside other risk assets) rather than any notable escalation in the defaults. In such a backdrop a cash plus benchmark (always positive) is a very challenging hurdle and under performance was pronounced.



5.6 The most surprising outcome given the upturn in inflation is the Sterling Index Linked Bond fund with an annualised return since inception of -22.5%. This reflects the remarkable fall in the index linked gilt benchmark 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.

6.0 Looking forward

6.1 Moderating inflation will be a positive development in 2023 but at the same time earnings are likely to fall. Policy error (too hawkish) could be the mistake that drags us into a recession. However, our base case is that this is avoided.

6.2 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, and real yields have moved higher. There is now a meaningful yield to support credit but a key focus for investors will be tracking new issuance and if seeing if there is any meaningful uplift in defaults as growth slows.

6.3 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.

6.4 Even as inflation moderates it is not likely to return to explicit targets for some time. Governments will likely allow above trend inflation to persist. With that in mind 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.

6.5 We saw notable dispersion in 2022 between large cap/small cap, growth and value and regions (UK/US). Investors need to be careful extrapolating what worked in 2022. The high-risk free rate available today is a very new experience for investors and will make risk aversion less expensive. Hence, flight to quality will likely feature more in 2023.

7.0 Author

Joe McDonnell (CIO)
Joe.mcdonnell@bordertocoast.org.uk
9 March 2023

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.