AGENDA ITEM 8

Border to Coast Pensions Partnership Joint Committee

Date of Meeting: 13 June 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

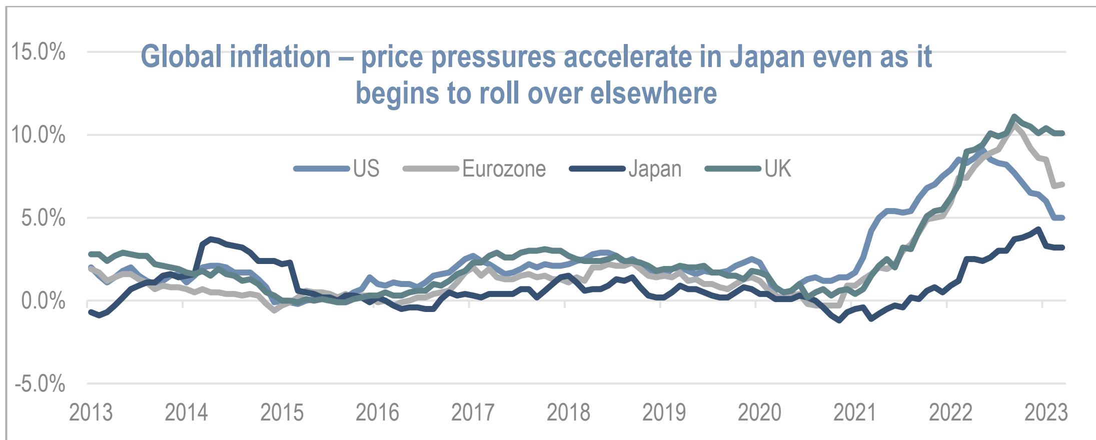
3.1 In the first quarter of 2023 risk assets did well, Global Aggregate bonds returned +3% over the quarter and the fall in yields also led to a rally in growth stocks by more than +14% while value delivered just 1% over the quarter. Much of this good performance was owed to supportive economic activity levels.

3.2 The fall in market volatility and relative strength in Q1 was also driven by the belief that we are closer to the end of the tightening cycle and the Fed will eventually take the lead when we get into an easing phase.

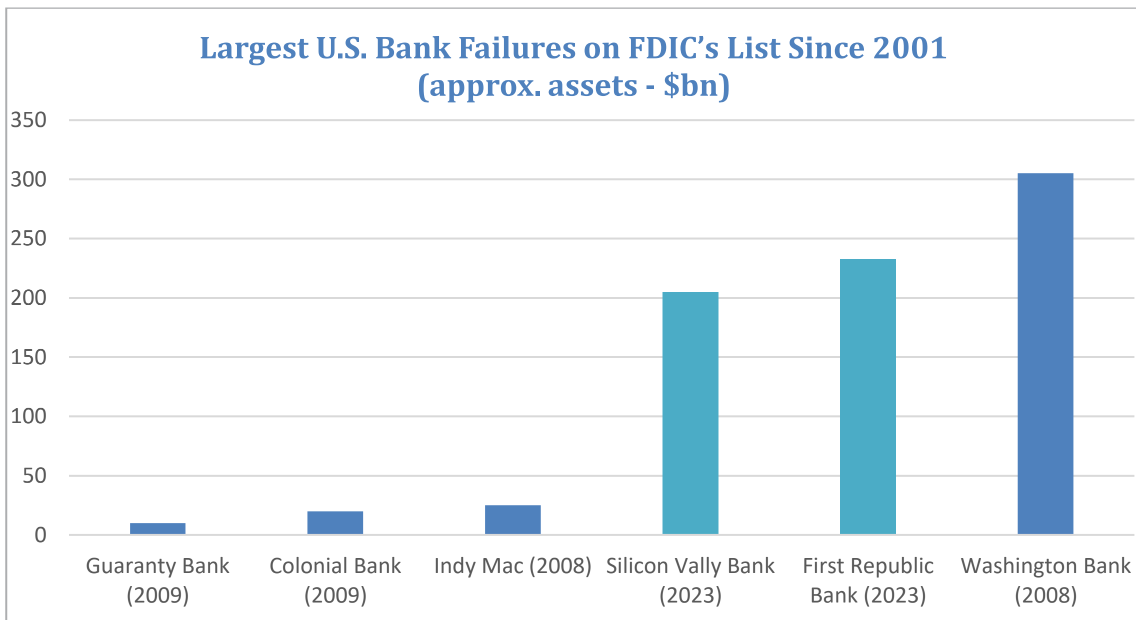
3.3 Earnings are expected to decelerate in the second half of the year which will further support the argument to bring an end to rate hiking.

3.4 Geopolitical risk remains a drag with ongoing US debt ceiling posturing and the Ukraine conflict escalating as the leading factors.

3.5 The general view is that while inflation is sticker than expected it will gradually ease throughout the rest of the year. As you can see in the below diagram all Developed Market economies other than Japan should see a significant fall in inflation in the second half of 2023.



3.6 There was a dramatic turn of events in March with Bank failures in the US with Silicon Valley Bank, which catered to the tech industry, collapsing. This was not a one-off event with subsequent pressure put on weaker US regional banks (First Republic) and this subsequently spilled over to weaker European financials (Credit Suisse). The below diagram illustrates that the recent bank failures are very material.



3.7 In the short term, an immediate response from regulators and stronger banks helped reduce market volatility but these events did highlight – banks with poor business models can fail. Credit conditions are tightening, and this often leads to further financial stresses. Undoubtedly, banks/other lenders are looking to reduce risk and pursue a higher quality borrower. As rates are at attractive levels, we are seeing bank deposits fall as money market funds grow. Hard economic landings/recessions are historically preceded by tight lending standards.

3.8 Global growth is decelerating – in particularly, in the US and Europe. While post COVID China is accelerating it is unclear if this recovery will be sustained. China recovery is pretty crucial for the prospects of Global growth. At the moment it is somewhat uneven. Domestic flights have recovered to 84% of pre-COVID level and auto sales are improving but steel production has fallen. The real estate market remains the largest concern and home sales have weakened visibly.

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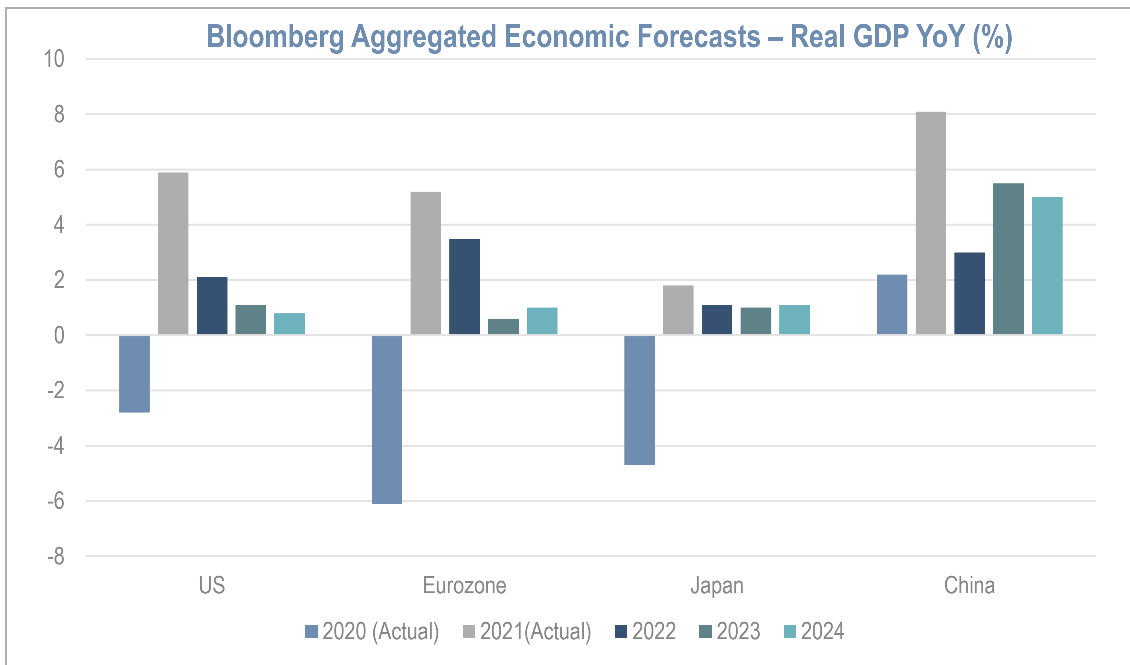
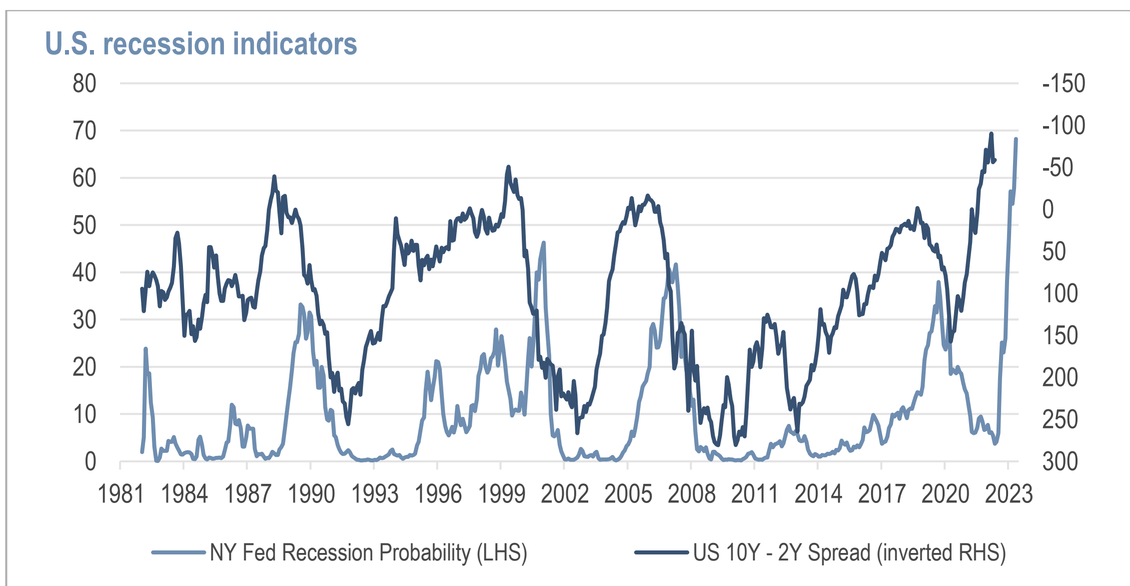


3.9 The slowdown in economic growth and the challenges of trying to manage a soft landing while raising rates quickly over the past 12 months is increasing the probability of recession. The diagram below – shows that the New York Fed is estimating a 70% probability off recession over the next 12 months which is further indicated by an inverted yield curve.



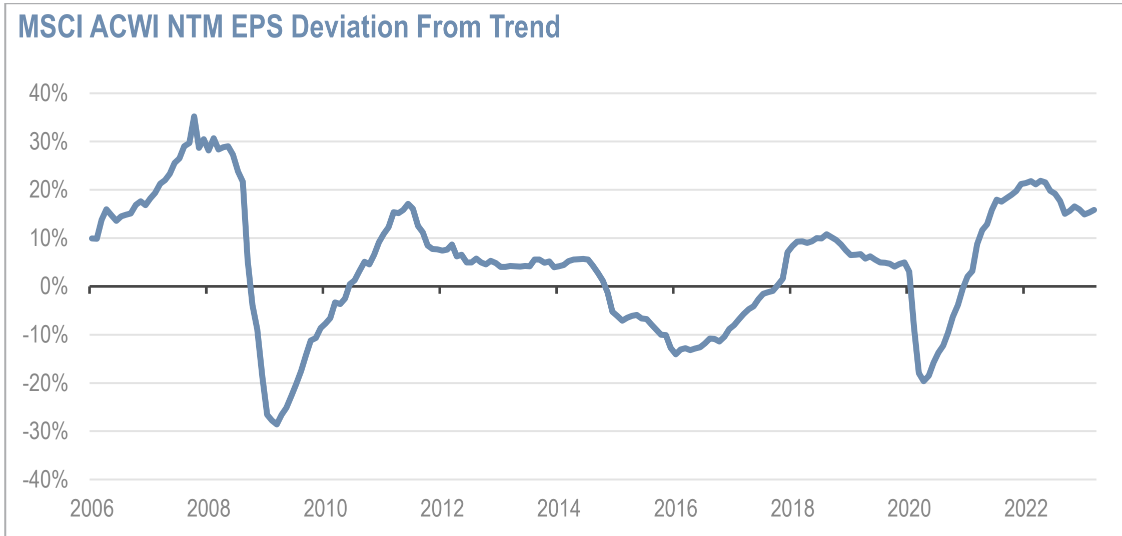
3.10 The labour market is still solid but there are signs of a cool down. There are headline job losses coming from individual companies but US, EU and UK wage growth remains robust.

3.11 Lower energy prices are certainly helping cushion growth in Europe, and this should ease pressure on real wages, although the outlook here is at the mercy of the evolution of the Ukraine-Russia conflict.

4 Valuations

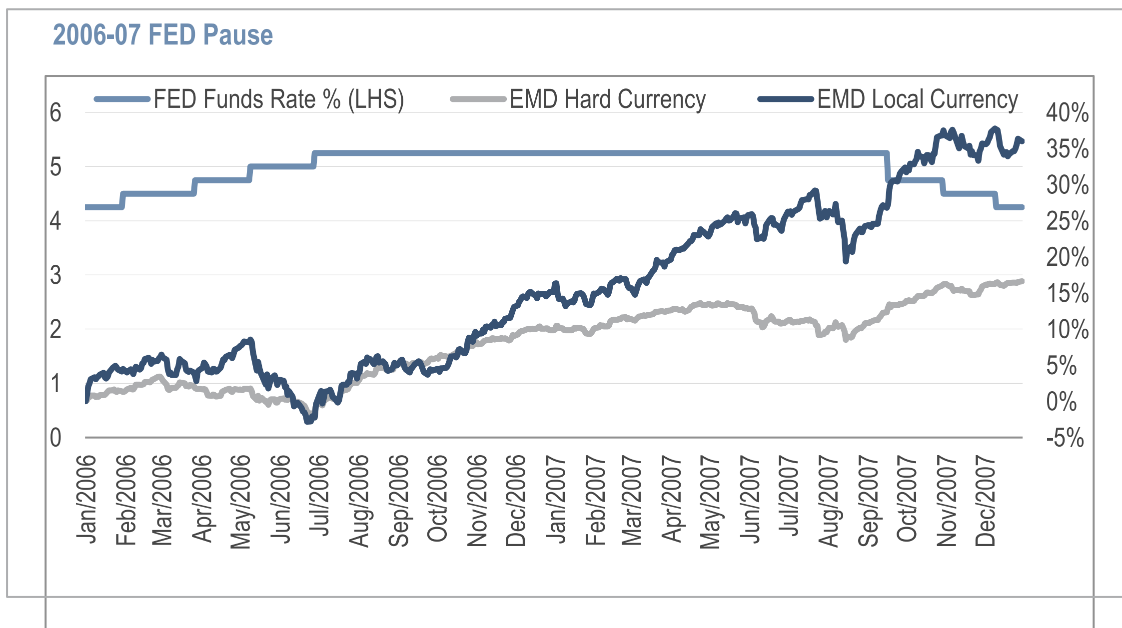
4.1 The equity risk premium has come down a lot, particularly in the US and the dividend yield gap to government bonds has evaporated except for Japan. Cash and bonds now offer competitive yields versus equities.

4.2 In terms of market valuations equity earnings estimates are significantly above trend and vulnerable to downturn.



4.3 While corporate spreads have widened, they are still close to historical averages. Investment Grade (end of April +141bps versus +137bps 30-year median) and High Yield +453bps versus +462bps 30-year median).

4.4 From a valuation perspective emerging market have a brighter prospect after two years of weak growth versus developed countries. Manufacturing PMIs (activity) are better than developed markets. Previous episodes of FED pause tended to be positive for EM bonds, as long as a deep global recession is averted. The diagram below looks at one of these periods when there was a pause in interest rates hikes (2006-7). When this occurred local emerging market debt did particularly well.



5 Fund Performance

5.1 The table below shows performance data for the ACS funds (listed assets) to 31 March 2023 for funds with more than 12 months since inception. Note these returns are annualised.

% p.a. Since inception	Type	Launch date	Return	Benchmark	Relative
Equities					
UK Listed Equities	Internal	Jul-18	4.3%	3.4%	+1.0%
UK Equity Alpha	External	Dec-18	5.7%	6.2%	-0.5%
Overseas Developed	Internal	Jul-18	8.8%	7.6%	+1.3%
Global Equity Alpha	External	Oct-19	9.5%	9.1%	+0.4%
Emerging Market Equities	Hybrid	Oct-18	2.8%	4.6%	-1.8%
Alternatives					
Listed Alternatives	Internal	Feb-22	-4.5%	2.3%	-6.8%
Fixed Income					
Sterling Investment Grade Credit	External	Mar-20	-1.7%	-2.8%	+1.1%
Sterling Index Linked Bonds	Internal	Oct-20	-19.0%	-19.3%	+0.3%
Multi Asset Credit Fund	Hybrid	Nov-21	-6.0%	5.3%	-11.2%

5.2 The relative performance of our internal equity funds (UK Equity & Overseas Developed) remains above target. Managing to a relatively tight tracking error in avoiding major factor/sector positions and more focus on stock selection to generate excess returns has worked well.

5.3 The performance of our externally managed equity funds (UK and Global Alpha) has improved significantly in Q1 2023. Global Alpha is now above benchmark and UK Equity Alpha, while still lagging, has made up ground.

5.4 Emerging Markets Equity underperformed from inception to the restructure in early 2021 when the mandate of the internal sleeve was changed to ex China and two specialist China managers were added. Although the recent performance of the internal sleeve in particular has been strong, the fund has underperformed its post restructure benchmark. Performance has been impacted by an overweight to Russia at the time of the Ukraine invasion and difficult market conditions in China.

5.5 Our Listed Alternative fund that was launched in Q1 2022 has struggled and this reflects investor concern over listed private market strategies. Since inception the portfolio has suffered from a significant currency mismatch with sub-funds having a structural underweight during a period of $US strength. The fact that a large proposition of the listed alternatives universe is highly sensitive to interest rates has also been a drag on performance. On a forward-looking basis these headwinds could become tailwinds and the high embedded yield (versus equities) should be supportive.

5.6 Credit did stabilise in Q1. Sterling Investment Grade saw solid relative performance of our managers and the fund is above its performance target. After a very disappointing 2022 Inflation linked bonds return +5% in Q1 and the relative performance of our internal funds remains above target. Multi-Asset Credit (MAC) did do better in Q1 but the relative

performance versus a cash plus benchmark remains negative. MAC has performed poorly since inception falling short of its absolute (cash plus) performance target.

6. Looking forward

6.1 We have transitioned from a world of low/negative yields, abundant liquidity, globalisation, no inflation, profit margin tailwinds and investor willingness to back long-term growth to a world of normalised/attractive yields, contracting liquidity, fragmentation, structurally higher inflation, profit margin headwinds and a ‘cash now’ environment.

6.2 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. Investors will be focused on how material will be China recovery.

6.3 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. Central Banks are closer to the end of the tightening tunnel. 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. We remain optimistic on income generating assets from government bonds to credit and liquid alternatives.

6.4 Equity valuations are also closer to historic averages, but a lot depends on the 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.

6.5 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.

6.6 We saw notable dispersion in 2022 between large cap/small cap, growth and value and regions (UK/US) and this flipped around in Q1 2023 with growth out-performing value by a considerable margin. This is tricky from an asset allocation perspective, and it is important that investors have a good balance of factors exposure in their equity portfolios. 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.

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25 May 2023

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