AGENDA ITEM 07

Border to Coast Joint Committee

Date of Meeting: **28 September 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.

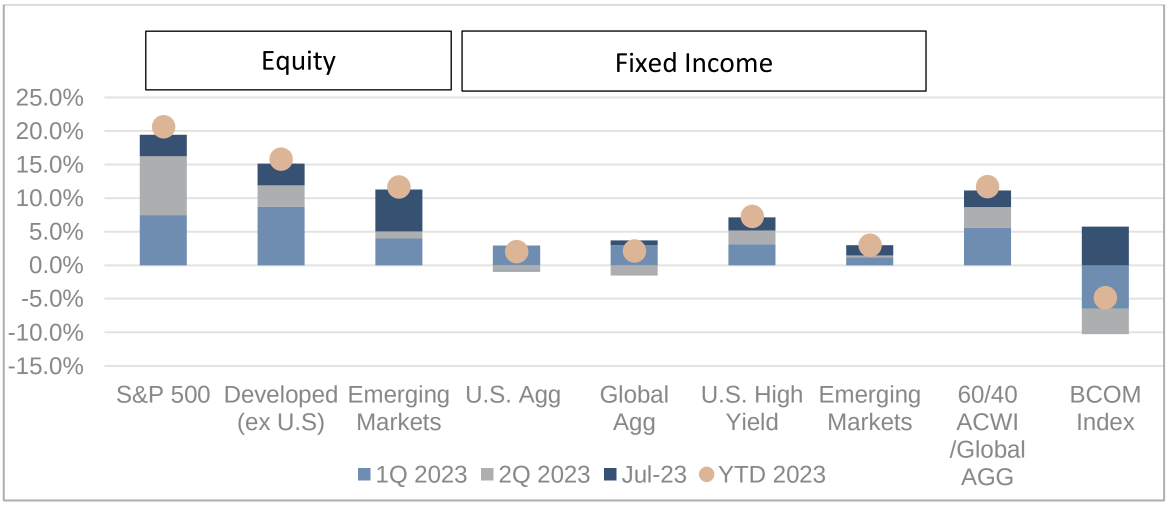
2 Recommendations

2.1 That the report is noted.

3 Macroeconomic environment

3.1 Risk assets have continued to perform well year-to-date. In 2023 stocks rebounded despite slowing growth, inflation and a mini-banking crisis.

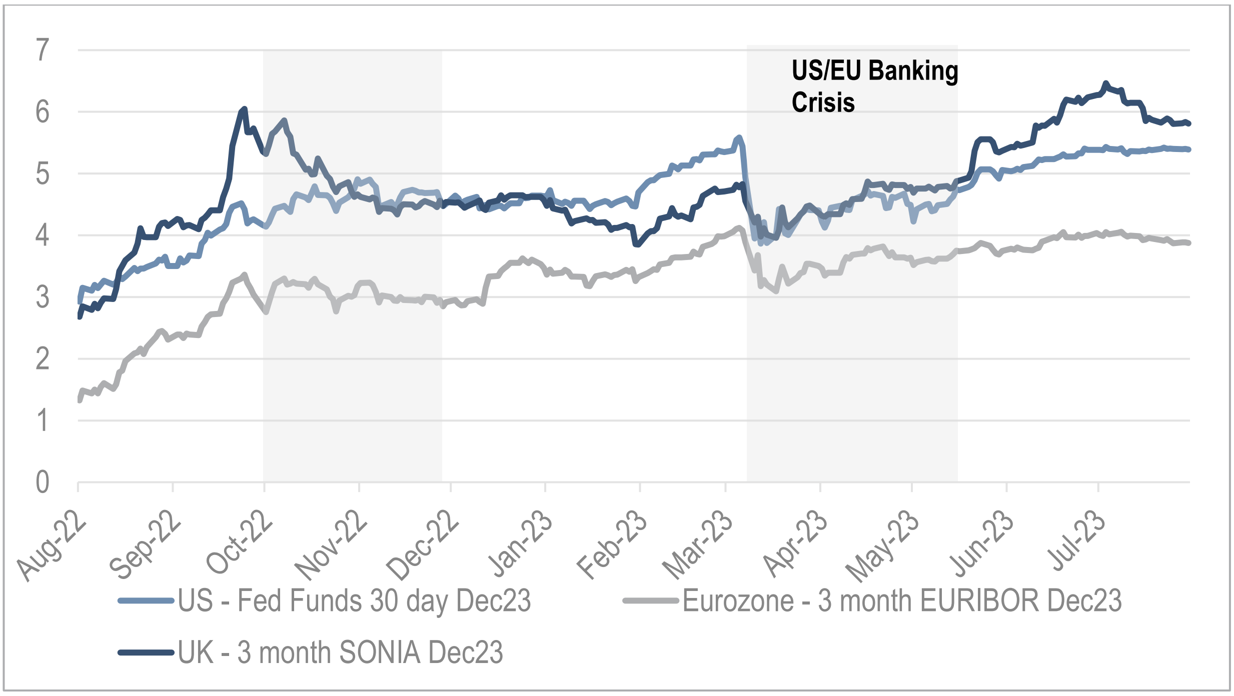
3.2 There has been considerable performance dispersion with global growth stocks generating the lion share of all returns (MSCI ACWI Growth +18.34%) while value has had a disappointing year to date (MSCI ACWI Value -0.26%) to the end of August.



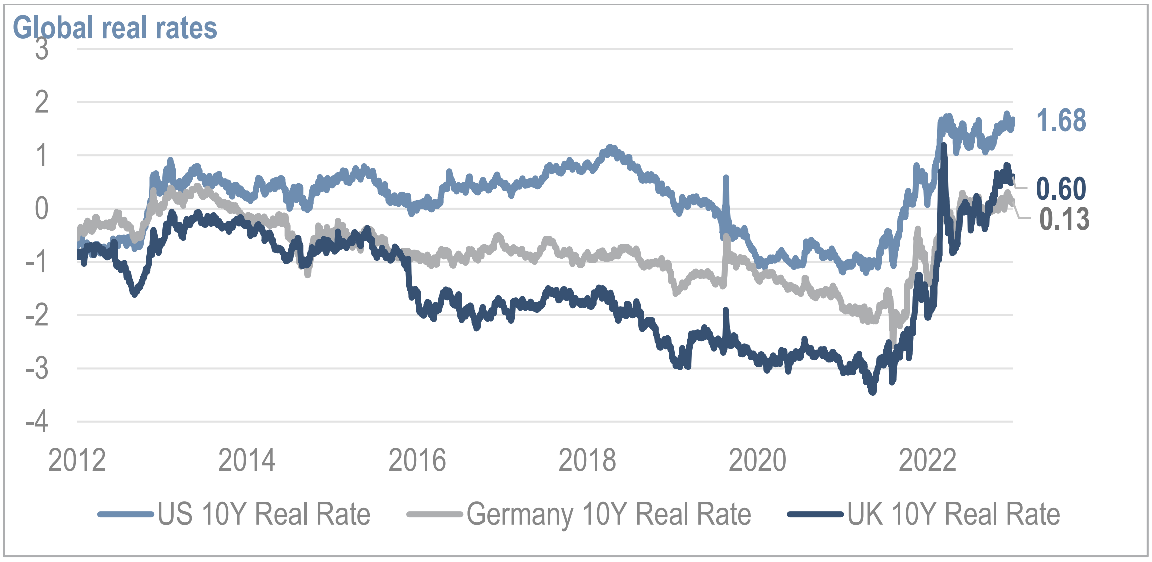
3.3 The short-term outlook has improved but rising rates threaten as we move towards 2024. The US economy has remained resilient while Europe and China disappoint.

3.4 Inflation has now peaked but a return to central bank targets for core inflation may prove difficult. Headline inflation continues to ease but core inflation remains sticky. As at end of July, core Inflation in the US is 5.5% and 6.9% in the UK.

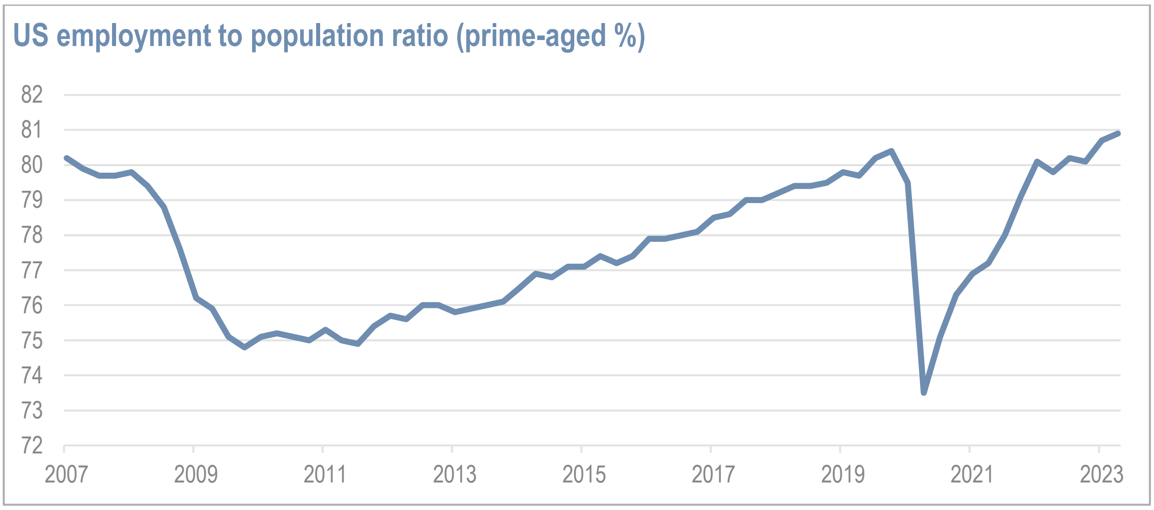
3.5 Resilient growth and sticky inflation force a “higher for longer” reassessment for interest rates. Short term rate expectations for the end of 2023 are 5.75% for the UK, 5.5% for the US and 4% for the eurozone.

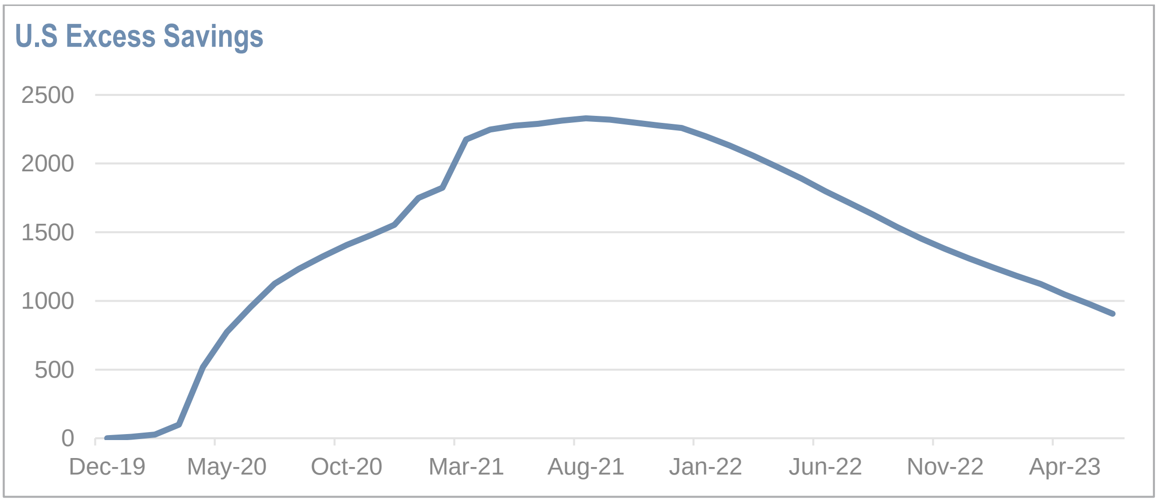


3.6 Real rates are now back to previous highs with the UK moving sharply higher.



3.7 The Consumer and US employment has remained very solid year to date. However, there is a notable fall in excess savings and a rise in credit card delinquencies.

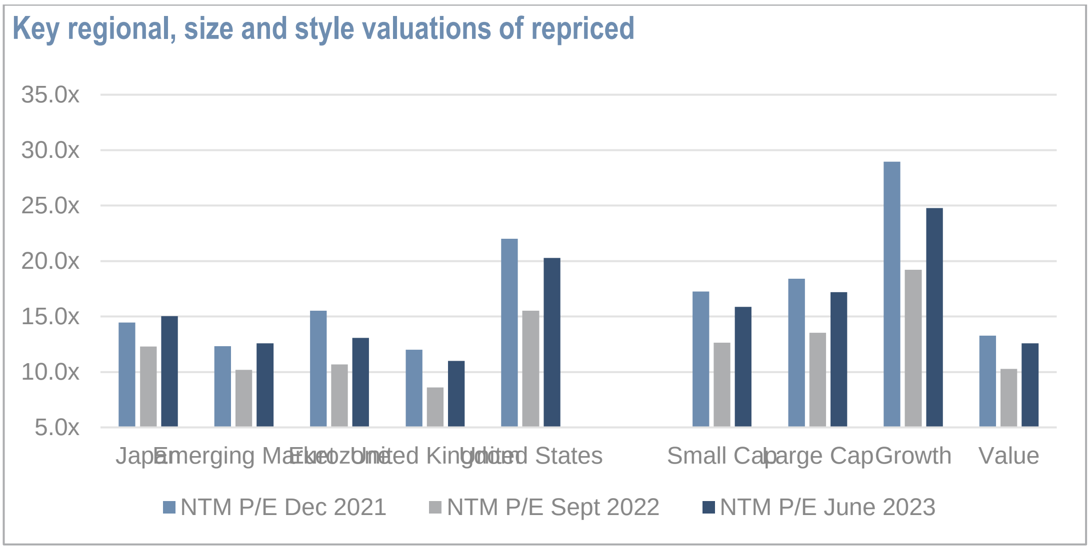




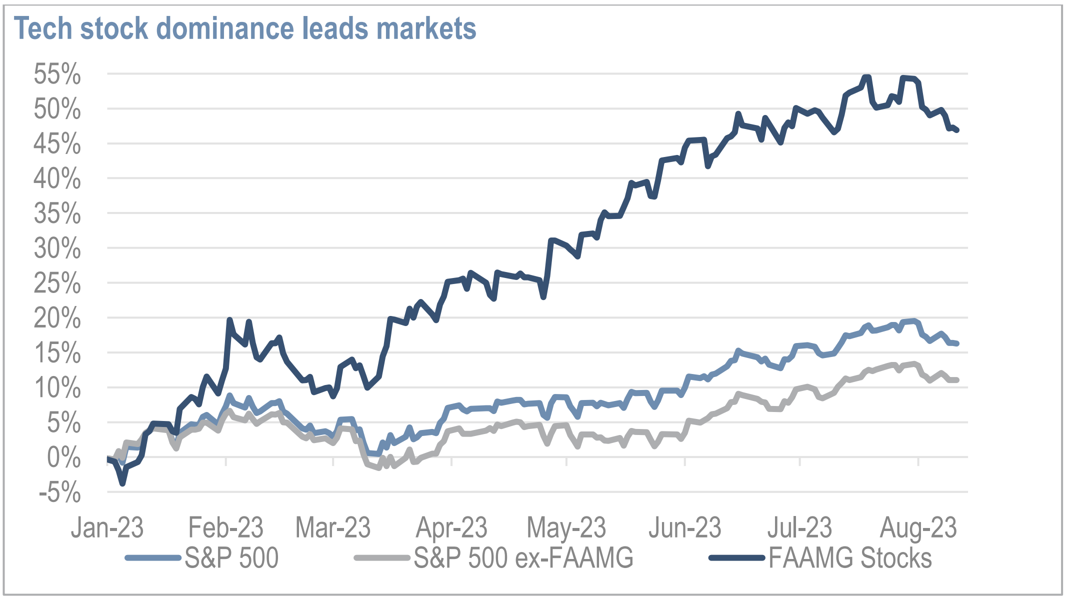
3.8 China economic weakness feeds through into commodities and deflation in industrial goods. The key question here is the level at which authorities start to stimulate the economy aggressively. Key to this is whether a weak China benefits the west in its current state. The focus on China has shifted – it is now no longer a re-opening story, it's all about how lack lustre it is and the pace of its deceleration. The default of Country Garden, one of the larger "more stable" developers, is a shock and a sign of the stress within the system. It is near inevitable that they will need to stimulate the economy. With the state of the balance sheets at the local government level this needs to be done centrally so expect them to roll out the old playbook of lowering reserve requirements for the banks and throwing money at the problem.

4. Valuations

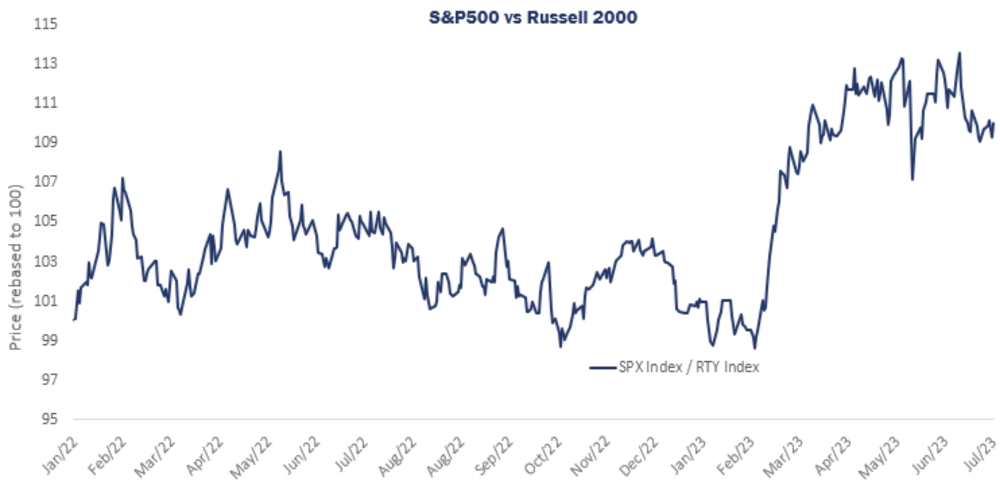
4.1 Equity valuation multiples have bounced after the correction in 2022.



4.2 The US equity market is now more concentrated than at any other time over the last 90 years.



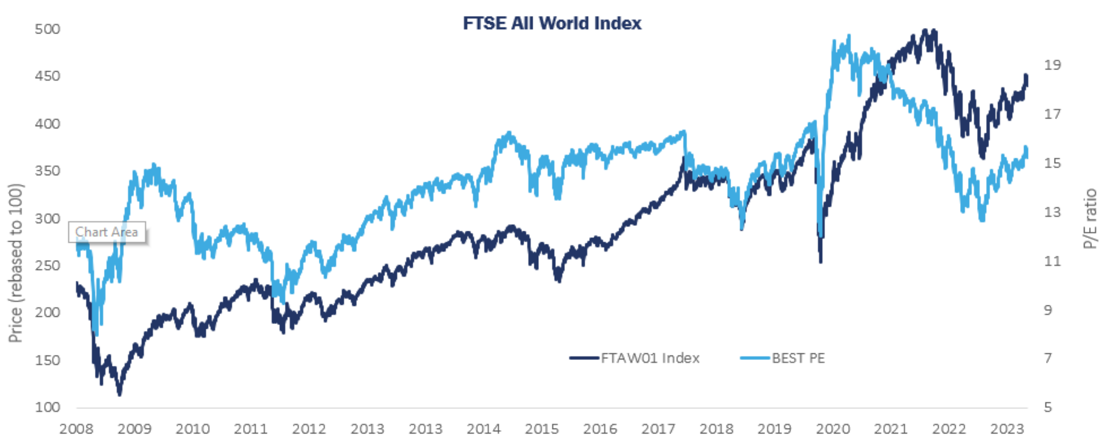
4.3 Mid/small cap stocks are feeling the brunt of the rate increases, the tightening of lending standards and rising wage inflation. The large caps are generally well positioned for high interest rates having strong balance sheets and refinance/locked in lower rates, whilst small/mid-caps are feeling the pressure of higher rates due to their more levered balance sheets. The chart below shows the S&P 500 vs the Russell 2000 with the S&P 500 outperforming by ~10% year to date.



4.4 The chart below does not do it justice, but year to date MSCI China has underperformed the S&P 500 by 18%. It now trades on 10x earnings vs 20x for the S&P, half the multiple.

4.5 On a global basis, world equity markets do not look excessively expensive; 15.5x earnings; but you need to factor in that growth expectations for next year have been high and are moving lower (see below).

VALUATIONS HAVE STARTED TO MOVE HIGHER



4.6 From an earnings perspective, everyone has been anticipating the recession, but it hasn't happened, in fact we are seeing earnings move higher. That being said, the expectations for 2024 have been drifting lower as people push out what is seen as the inevitable slow down.

5. Fund Performance

5.1 The table below shows performance data for the ACS funds (listed assets) to 30 June 2023 for funds with more than 12 months since inception. Note these returns are annualised. Performance for the private markets assets are given in a later report.

% p.a. Since inception	Target vs. B'Mark	Type	Launch date	Return	B'Mark	Relative to B'Mark	Relative to Target
Equities							
UK Listed Equities	+1%	Internal	Jul-18	4.0%	3.1%	+0.9%	-0.1%
UK Equity Alpha	+2%	External	Dec-18	5.2%	5.8%	-0.6%	-2.6%
Overseas Developed	+1%	Internal	Jul-18	9.1%	7.6%	+1.5%	+0.5%
Global Equity Alpha	+2%	External	Oct-19	9.5%	9.4%	+0.1%	-1.9%
Emerging Market Equities	+1.5%	Hybrid	Oct-18	2.2%	3.9%	-1.6%	-2.9%
Alternatives							
Listed Alternatives	N/A	Internal	Feb-22	-3.6%	4.3%	-7.9%	N/A
Fixed Income							
Sterling Inv Grade Credit	+0.6%	External	Mar-20	-2.4%	-3.6%	+1.2%	+0.6%
Sterling Index Linked Bonds	+0.2%	Internal	Oct-20	-20.6%	-20.9%	+0.3%	+0.1%
Multi Asset Credit Fund	N/A	Hybrid	Nov-21	-4.3%	5.7%	-10.0%	N/A

5.2 **Benchmark Relative Returns:** As can be seen in the table above 5/9 ACS funds are ahead of benchmark since inception. UK Listed Equities, Overseas Developed, Global Equity Alpha, Sterling Investment Grade Credit and Sterling Index Linked Bonds are all ahead of benchmark since inception. UK Equity Alpha, Emerging Markets Equity, Listed Alternatives and Multi-Asset Credit Funds are below benchmark since inception.

5.3 **Target Relative Returns**: Target returns in excess of benchmark are set for each ACS fund. These excess return targets reflect the return we feel is commensurate with the active risk we take. Since inception Overseas Developed Equity, Sterling Index Linked Bonds and Investment Grade Credit are above target. UK Listed Equities is close to its target excess return. UK Equity Alpha, Global Equity Alpha, Emerging Marekts Equity and Listed Alternatives are below their target return.

5.4 Shorter term performance (from the start of 2023 to end June) has been good with 8 out of 9 of the funds beating their benchmarks. The performance of our externally managed equity funds has improved significantly in 2023 (UK listed Alpha +2.2% and Global Equity Alpha +1.3% relative to the benchmark year to date). Over this shorter time period, performance relative to a long-term outperformance target becomes less meaningful.

5.5 Emerging Markets Equity relative performance has been positive in 2023, +0.9% versus the benchmark year to date. The fund is split China (external managers) and ex-China Internal. The Internal manager has beaten the benchmark by +3.3% year to date. The domestic China equity markets have been challenging in 2023 and our two managers – UBS and Fountain Cap have lagged their benchmarks.

5.6 A new ACS fund – Emerging Markets Equity Alpha (EMEA) was launched in August 2023 with four external managers: two China – Fountain Cap and UBS; and two Ex-China – Ballie Gifford and GSAM. Performance of this fund will be reported to the Joint Committee after its 1 year anniversary.

5.7 Credit spreads have been stable year-to-date. Sterling Investment Grade saw solid relative performance from our managers and the fund is above its performance target +1.0% year-to-date. Index linked bonds continue to have headwinds in 2023 but has seen good relative year-to-date performance of +0.1%. The Multi-Asset Credit (MAC) fund has had a better 2023 year to date both absolute (+4.1%) and relative (+0.3%) returns.

5.8 The rising/high interest rate environment has been challenging for the Listed Alternatives fund. Based on the output of the annual review we are proposing to shift the portfolio to capture a broader opportunity set including an allocation to liquid investment grade bonds of issuers withing the Listed Alternatives universes. We are also looking to improve overall risk balance of the portfolio.

6. Looking forward

6.1 To this point, high rates have not had a significant impact on economic activity, but now rates have normalised we are likely to see more pressure on risk assets as the opportunity cost of holding cash is low.

6.2 The resilience of US profitability and margins may be challenged in Q4 as we see early signs of stress on consumer (upward trend in credit card delinquencies) and some softening in employment data. Moderating inflation will be a positive development for the remainder of 2023 but at the same time earnings are likely to fall.

6.3 Equity valuations in the US, whilst Europe and Japan look more attractive on a relative basis.

6.4 The main risks from Q4 2023 and beyond are the disappointing slowdown/deflation in China and the possibility that, with tightening credit conditions, the banking crisis from Q1 2023 re-emerges. The geopolitical environment remains a concern and 2024, given the electoral cycle, is likely to be even more challenging.

6.5 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 there is any meaningful uplift in defaults as growth slows. We remain constructive on income generating assets from government bonds to credit and liquid alternatives.

6.6 Given the very strong performance of tech/growth year to date, the resultant narrowness of the US equity market (see 4.2) and moderating global growth, we believe a bias towards Quality at this point in the cycle is prudent.

6.7 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. A higher average inflation environment (above 3%) and low/modest growth is an investment regime that is supportive of portfolios that combine public and private (real assets). 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.

7. Author

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8 September 2023

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