Border to Coast Joint Committee

Date of Meeting: 26 March 2024

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.

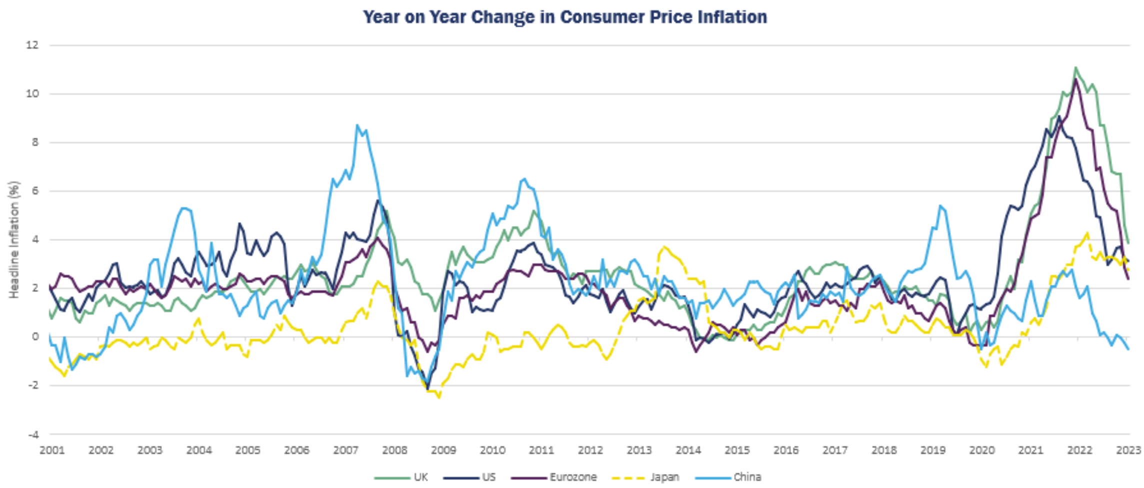
2 Recommendations

2.1 That the report is noted.

3 Macroeconomic environment

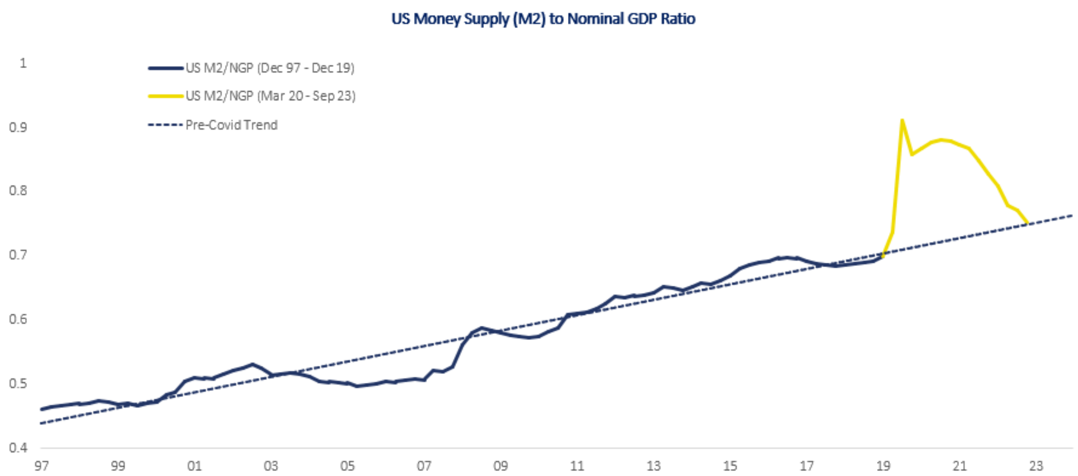
3.1 We started 2023 with most economists predicting the onset of a recession as higher interest rates were expected to feed into the real economy and therefore diminish the propensity for consumers to spend. At least in theory, this is the way that the monetary tightening system is supposed to work - damping consumer demand by making the cost of borrowing more expensive. The reality, however, is that consumers entered the year with significant post pandemic savings that allowed them to spend even in this high inflation high-rate environment. Also, in the US economy, consumption was helped by the fact that more than 85% of mortgages are fixed for 30-years, many of which originated during the pandemic when interest rates were at record lows. Most of these homeowners have essentially locked in extra purchasing power for decades ahead as their interest payments are significantly less than the current level of rates. The labour market also defied expectations that tighter monetary policy would trigger a steady deceleration - for example, the US has added nearly 7 million new jobs since January 2022. Despite this economic resilience, inflation has been resetting faster than anticipated across the major developed economies. This prompted markets to reprice the number of cuts for most developed economies next year driving the easing in financial conditions and a strong rally in risk assets.

3.2 Inflation has continued to fall in all major markets. After soaring during pandemic-induced supply shortages, good prices have been moving sideways-to lower since mid-2022. This drop-off in inflationary pressures was due in part the healing supply chains, but soft demand in the rest of the world, and excess capacity in China, also contributed. Rising shipping costs and geopolitical maritime risk couples with a recovery in goods sectors demand suggest less disinflationary help going forward.



Source: Bloomberg, Border to Coast.

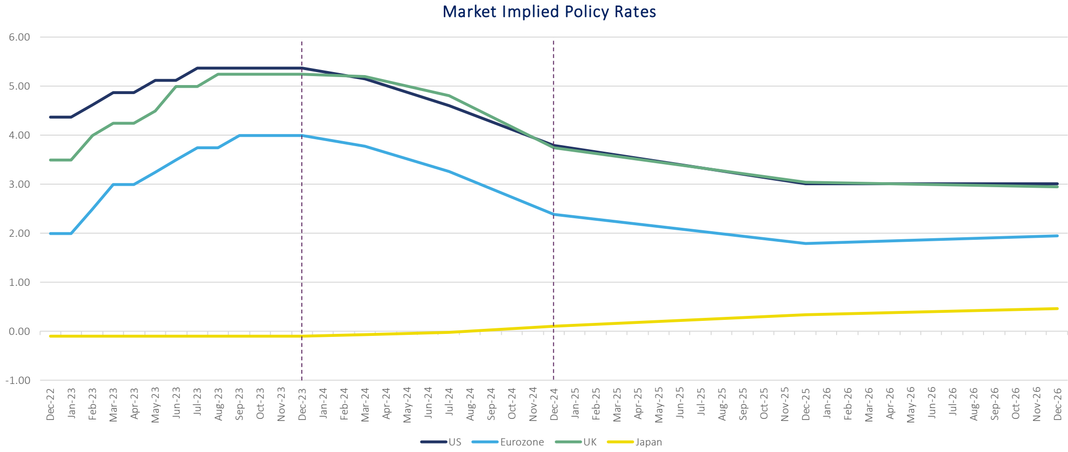
3.3 Markets are clearly focused on the level of interest rates; however, we would also argue that investors should be paying a closer look at the aggregate money supply (i.e. liquidity) adjusted for the level of the economy. Over the past eighteen months, the Fed has drained more than $1 trillion in liquidity as it reduced the size of its balance sheet. However, some argue that the actual dollar amount of money in the system is still $4 trillion higher than it was pre-pandemic. So why does it matter? As the chart below shows, you can't really have a growing economy when the money supply is decreasing. More importantly, simply looking at the absolute dollar amount of money in circulation ignores the fact that most developed economies require more liquidity to support current levels of GDP growth compared to what was required 20 years ago. This is the result of the stagnating productivity growth.



Source: Federal Reserve, Bureau of Economic Analysis, Jefferies

3.4 This is perhaps more evident in Europe, a manufacturing led economy that is reliant on money supply and private sector borrowing to drive economic growth. The ECB's Bank Lending Survey indicates that banks have tightened access to credit by the most since the bloc's debt crisis a decade ago. The issues in Europe are further exacerbated given its reliance on China and the concerns around its struggling real estate sector and the likely knock-on effects to the Chinese economy.

3.5 The markets are assuming significant rate cuts late in 2024 and going into 2025. This optimism has certainly fed into a broad appreciation of risk assets.

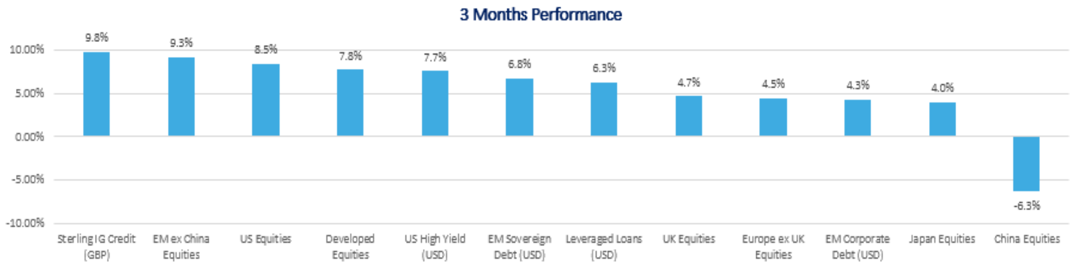


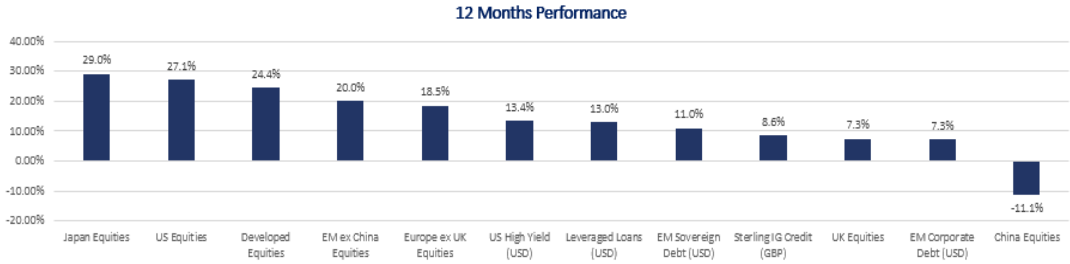
Source: Bloomberg, Border to Coast.

4 Markets

4.1 Despite widespread pessimism about the economic outlook, stocks had a strong end to the year and a very strong 2023 overall. The US and Japan lead the way and China was the only major disappointment. Resilient corporate profits have been the key, together with enthusiasm over the potential for artificial intelligence (AI) to boost profits even further. With anticipation of future rate cuts in 2024 the fourth quarter of 2023 was very strong with Global Equities +7.8%, Sterling IG Credit +9.8%, US High Yield +7.7% and UK Equities +4.7%.

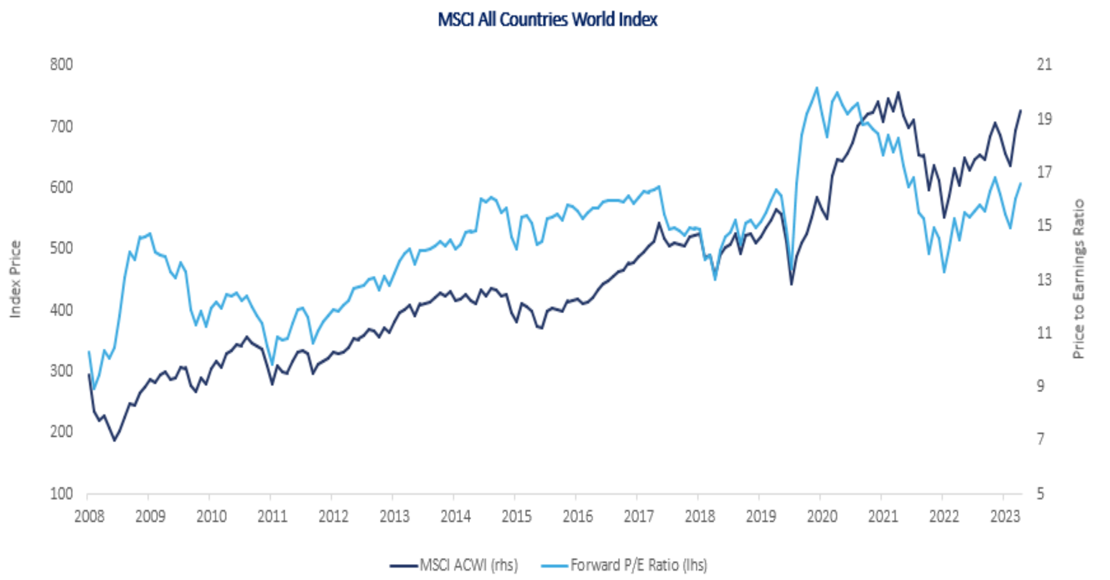
4.2 For the year Japanese equities led the way +29%, with US Equities close behind +27% and credit did very well - US High Yield +13.4% and Sterling IG +8.6%. China with its disappointing post COVID growth, real estate and more structural problems is poorly in the year – China Equities fell -11%. Most commentators are anticipating a rebound in the global goods cycle to further support equities. However, the view of the Border to Coast Asset Allocation Committee which met in December is more reserved with the view that growth will likely disappoint in 2024. Equity valuations are ‘defying gravity’ especially in the US. We are generally more constructive on credit with a preference for higher quality.



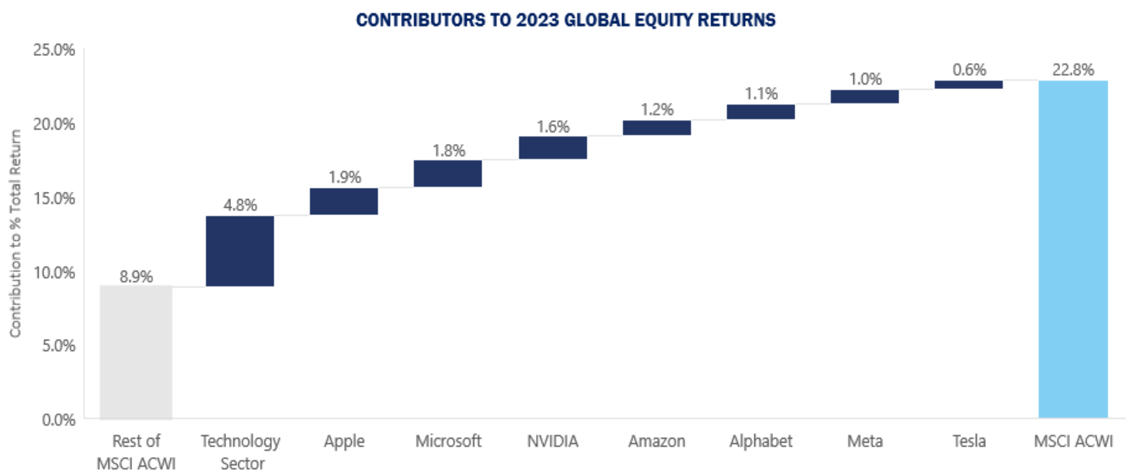


Source: Bloomberg, Border to Coast. As at 31 December 2023

4.3 In terms of market valuations – things have moved higher with the Forward P/E of the MSCI ACWI at x17. Although equity markets performed well last year, much of their momentum stemmed from the so-called ‘Magnificent 7’ stocks, which were buoyed by the artificial intelligence boom that captured investors’ attention. Understandably, these companies now trade at eye-watering valuations and while they undoubtedly have room left to run in time, we are mindful of the expectations embedded in the current prices. Selectivity is key in this sector as we still need to evaluate the impact artificial intelligence may have on economic productivity and more importantly the ability for companies to monetise this opportunity.

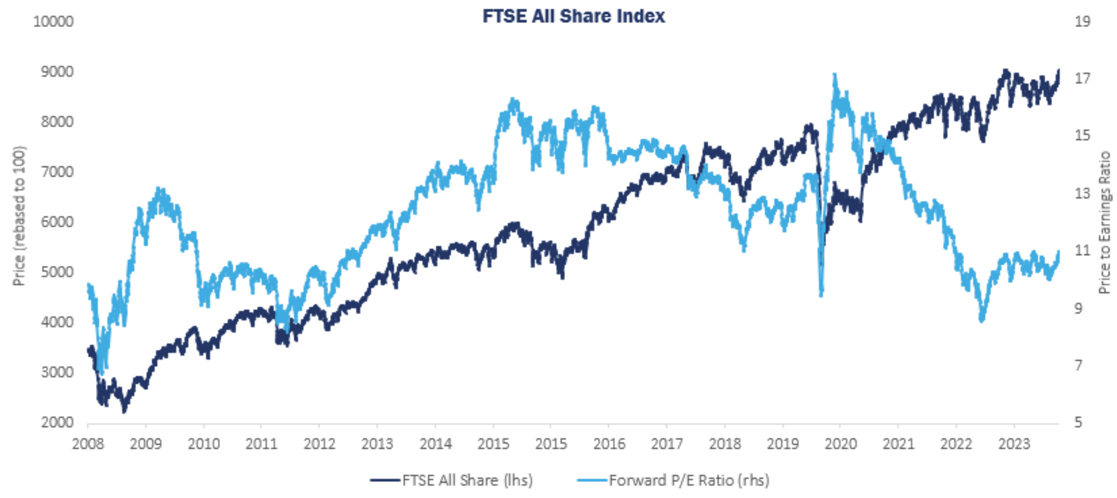


Source: MSCI, Bloomberg, Border to Coast.



Source: Bloomberg, Border to Coast 31st Dec 2023. Total returns for MSCI ACWI Index (GBP) using ICB Level 1 Sector Classifications.

4.4 UK equities stand out as having de-rated over the past there years. With a forward P/E of x11 and the market offers notable sector/factor level diversification versus the US equity market



e: MSCI, Bloomberg, Border to Coast. 31sts Dec 2023

5 Fund Performance

5.1 As at year end asset under management in the ACS funds stood at £30.4bn (31st December 2023).

5.2 The table below shows performance data for the ACS funds (listed assets) to 31 December 2023 for funds with more than 12 months since inception. Note these returns are annualised. Performance for the private market's assets is 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	4.5%	3.8%	+0.7%	-0.3%
UK Equity Alpha	+2%	External	Dec-18	5.3%	6.2%	-0.9%	-2.9%
Overseas Developed	+1%	Internal	Jul-18	9.7%	8.2%	+1.5%	+0.5%
Global Equity Alpha	+2%	External	Oct-19	10.1%	10.0%	+0.1%	-1.9%
Emerging Market Equities	+1.5%	Hybrid	Oct-18	2.7%	4.4%	-1.6%	-2.9%
Alternatives							
Listed Alternatives	N/A	Internal	Feb-22	2.7%	6.9%	-4.2%	N/A
Fixed Income							
Sterling Inv Grade Credit	+0.6%	External	Mar-20	0.4%	-0.7%	+1.1%	+0.5%
Sterling Index Linked Bonds	+0.2%	Internal	Oct-20	-17.2%	-17.5%	+0.3%	+0.1%
Multi Asset Credit Fund	N/A	Hybrid	Nov-21	-0.6%	6.4%	-7.1%	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. Overseas Developed, Global Equity Alpha, UK Listed Equities, 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 Markets Equity and Listed Alternatives are below their target return.

5.4 **2023 Year End Performance:** The ACS funds generally had a strong end to the year. Overall, 6/9 funds with full year performance finished Q4 ahead of benchmark and 7/9 ahead of their benchmarks for the year. In equities the Overseas Developed Fund (Internal) was up +0.35% in Q4 and finished the year +2.1% versus its benchmark. The Global Equity Alpha Fund (external) trailed its benchmark by -0.27% in Q4 but was up +1.55% for the year. The two UK Equity funds – Alpha (external) was up +0.15% in Q4 and was slightly ahead of the benchmark for the year, while UK Listed (Internal) had a challenging Q4 under-performing the benchmark by -0.45% and -0.68% year to date. The Emerging Market Equity Fund returned -0.11% relative in Q4 but was +0.22% ahead of benchmark for the year. The positive relative return was driven by the Border to Coast EM ex China sleeve that was up +3.2% in 2023. The Listed Alternatives Fund did very well in Q4 returning +11% (+4.72 ahead of the MSCI ACWI) and returned +9.8% for the year (-5.5% below the MSCI ACWI).

5.5 The Fixed Income ACS funds had generally a positive Q4 and a strong overall 2023. Multi-Asset Credit was up +5.9% in Q4 and beat the SONIA +3.5% benchmark by +2% for the year. SIG was up +0.31% in Q4 and +1.4% for the year. Finally, SIL was modestly up in Q4 +0.1% with a similar relative positive return for the year.

6 Looking forward

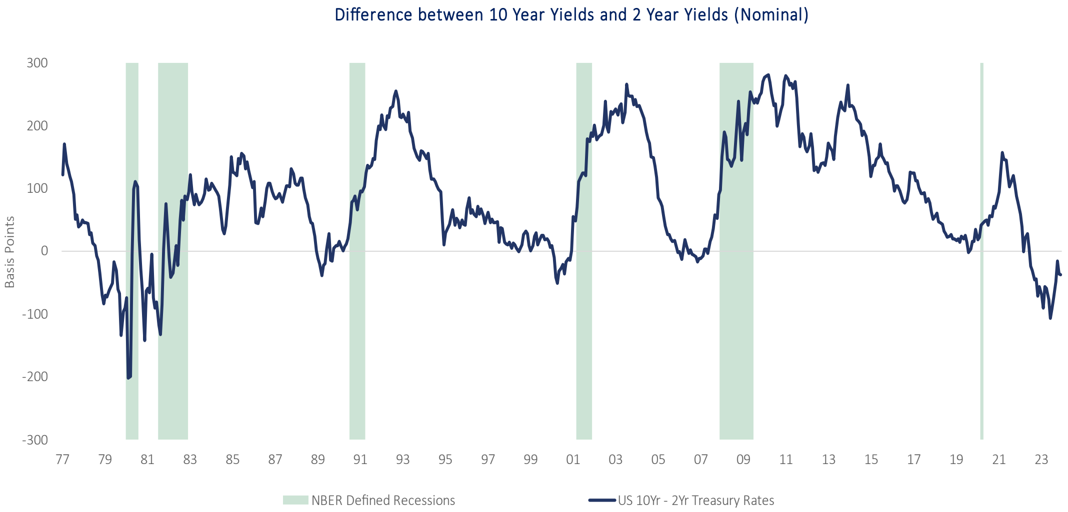
6.1 As a long-term global investor on behalf of the LGPS, we appraise the markets for structural shifts to guide strategic asset allocation decision making. We are approaching the coming months with caution. A look over our shoulders at last year, when the markets surprised to the upside, is a relevant starting point.

6.2 From an economic perspective, 2023 delivered better-than-expected results, with several major economies avoiding the recessions that had been forecasted. This was, in large part, due to consumers saving during the Covid-19 lockdowns, which allowed for continued post-pandemic spending despite the higher interest rate environment.

6.3 However, as 2024 progresses, we expect to see a curtailment of consumer demand, as the economic pressures of the past two years begin to weigh more heavily. The aggressive monetary tightening by central banks has increased debt repayments and will likely stifle consumer spending during the coming months. Similarly, businesses are left to grapple with tighter balance sheets, increased borrowing costs and subdued growth.

6.4 While the market remains primarily focused on interest rates, as illustrated in 3.3 there is another risk on the horizon – the US money supply. During the tightening cycle, the US Federal Reserve's balance sheet liquidity contracted by around $1 trillion. While there is still an abundance of dollar liquidity in absolute terms, this contraction is likely to have a negative effect on GDP improvements as developed economies have become increasingly dependent on upping their money supply to fuel growth.

6.5 With this in mind, we feel it is prudent to adopt a cautious approach for the coming months for higher quality and more defensive assets that offer better risk reward characteristics, particularly in the event of a market downturn. The Treasury curve remains inverted, and this has been a reliable indicator of economic slowdown.



Source: Bloomberg, Border to Coast.

6.6 The forthcoming year will be challenging on the geopolitical front with over 40 elections taking place – including the US and UK. Two key conflicts – Ukraine/Russia and Israel--Palestine are not likely to improve any time soon. Escalation on either front will impact risk assets and indeed may have more significant sustainable impact on energy prices.

Source: American Progressong; Jefferies Dec 2023

6.7 With some moderation likely in terms of US equity valuations we are currently more positive in Asia, specifically in Japan and China. Japan was one of the top performing markets of 2023, as inflation prompted a welcome and needed uptick in wage growth. One can seldom describe the Bank of Japan's monetary policy as 'aggressive' but certainly it has been more assertive in addressing yen weakness, and we expect this to continue this year. With this in mind, we prefer domestic companies with the potential to enhance shareholder value by improving governance and capital allocation.

6.8 Much was made of China's re-opening at the back end of 2022 but it's fair to say that 2023 was something of a damp squib, to put it mildly. However, we believe there remains room for optimism for domestic companies, particularly in high growth areas such as clean energy technology and digitisation, which Chinese policymakers appear committed to supporting.

6.9 While acknowledging that the muscle of the US economy may continue to lead markets higher over the coming months, we feel there is relative value in Asia and a more neutral stance towards the US is appropriate at this point in the cycle.

6.10 For fixed income, we continue to believe that long duration is the most prudent allocation, given the current economic climate. Having seen the worst of inflation, market expectations have refocused toward interest rate cuts; in fact, these were being priced in from December of last year. Although we do not anticipate rates falling at a similar velocity to when they were raised, we do expect a marked reduction by the close of 2024, as global economic weakness becomes more apparent. This type of environment is likely to benefit long duration fixed income assets.

6.11 We believe government bonds are among the most attractive instruments on offer, as they are an obvious beneficiary of inflation peaking. Should the economy soften as expected, government bonds are well placed to outperform. Additionally, with yields currently comparable to those seen during the global financial crisis, government bonds also provide a degree of diversification, which will be useful should equity markets begin to suffer. This also extends to emerging market debt, where proactive monetary policy over the past two years has been of net benefit to local economies. This has raised the value of emerging market debt in the eyes of many and has set the requisite conditions for continued regional growth.

6.12 In summary the main themes that have come out of the Border to Coast Asset Allocation Q4 Committee are – 1) Growth may disappoint in 2024 against a backdrop of declining consumer strength and increased credit stress. 2) Equity valuations are stretched in certain markets (US) and may come under pressure given the continued liquidity tightening and the consumer.

7. Author

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13 March 2024

Important Information