



Market Review

Quarterly Report
Dorset Council Pension Fund Committee

Q3 2023

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Key Indicators at a Glance

Index (Local Currency)		Q3 2023	Q3	YTD
Equities		Total Return		
UK Large-Cap Equities	FTSE 100	7,608	2.07%	3.82%
UK All-Cap Equities	FTSE All-Share	4,127	1.78%	2.91%
US Equities	S&P 500	4,288	-3.27%	13.51%
European Equities	EURO STOXX 50 Price EUR	4,175	-4.83%	11.51%
Japanese Equities	Nikkei 225	31,858	-3.36%	26.16%
EM Equities	MSCI Emerging Markets	953	-2.85%	2.09%
Global Equities	MSCI World	2,853	-3.36%	11.36%
Government Bonds				
UK Gilts	FTSE Actuaries UK Gilts TR All Stocks	2,895	-0.63%	-4.09%
UK Gilts Over 15 Years	FTSE Actuaries UK Gilts Over 15 Yr	3,283	-5.69%	-11.13%
UK Index-Linked Gilts	FTSE Actuaries UK Index-Linked Gilts TR All Stocks	3,714	-4.69%	-7.16%
UK Index-Linked Gilts Over 15 Years	FTSE Actuaries UK Index-Linked Gilts TR Over 15 Yr	3,839	-10.67%	-15.87%
Euro Gov Bonds	Bloomberg EU Govt All Bonds TR	208	-2.54%	-0.08%
US Gov Bonds	Bloomberg US Treasuries TR Unhedged	2,155	-3.06%	-1.52%
EM Gov Bonds (Local)	JP. Morgan Government Bond Index Emerging Markets Core In	128	-3.65%	3.72%
EM Gov Bonds (Hard/USD)	JP. Morgan Emerging Markets Global Diversified Index	818	-2.23%	1.76%
Bond Indices				
UK Corporate Investment Grade	S&P UK Investment Grade Corporate Bond Index TR	334	-1.01%	1.39%
European Corporate Investment Grade	Bloomberg Pan-European Aggregate Corporate TR Unhedged	219	0.70%	2.69%
European Corporate High Yield	Bloomberg Pan-European HY TR Unhedged	415	3.76%	6.76%
US Corporate Investment Grade	Bloomberg US Corporate Investment Grade TR Unhedged	2,969	-3.37%	0.02%
US Corporate High Yield	Bloomberg US Corporate HY TR Unhedged	2,314	2.21%	5.86%
Commodities				
Brent Crude Oil	Generic 1st Crude Oil, Brent, USD/bbl	95	19.48%	10.94%
Natural Gas (US)	Generic 1st Natural Gas, USD/MMBtu	2.93	32.18%	-34.55%
Gold	Generic 1st Gold, USD/toz	1,848	-6.14%	1.20%
Copper	Generic 1st Copper, USD/lb	374	-8.72%	-1.92%
Currencies				
GBP/EUR	GBPEUR Exchange Rate	1.15	1.44%	2.15%
GBP/USD	GBPUSD Exchange Rate	1.22	-1.12%	0.96%
EUR/USD	EURUSD Exchange Rate	1.06	-2.45%	-1.23%
USD/JPY	USDJPY Exchange Rate	149	12.43%	13.92%
Dollar Index	Dollar Index Spot	106	3.58%	2.56%
USD/CNY	USDCNY Exchange Rate	7.30	6.17%	5.79%
Alternatives				
Infrastructure	S&P Global Infrastructure Index	2,476	-7.27%	-4.04%
Private Equity	S&P Listed Private Equity Index	181	4.75%	18.84%
Hedge Funds	Hedge Fund Research HFR1 Fund-Weighted Composite Index	18,215	1.43%	4.27%
Global Real Estate	FTSE EPRA Nareit Global Index TR GBP	3,383	-3.86%	-5.76%
Volatility				Change in Volatility
VIX	Chicago Board Options Exchange SPX Volatility Index	18	-6.31%	-19.15%

Source: Bloomberg. All return figures quoted are total return, calculated with gross dividends/income reinvested.

Executive Summary

- Inflation has broadly continued to fall throughout Q3 and whilst the Fed, ECB and BoE all raised interest rates during the quarter, the rate of increase has slowed. With inflation decreasing across the board (with the exception of a slight rebound in the US), it is likely that rates will not increase much further. However, the slow pace of the decline in core inflation, as well as an uptick in the US over the quarter and the risk of renewed energy supply shortages as winter approaches, suggest that rates are likely to remain high for a longer period than previously thought: 10Y UK rates rose very slightly over Q3 to 4.5%, but US 10Y rates have risen nearly 1% to 4.6%. Labour markets remain robust, especially in the US (unemployment at 3.8% and job openings up 5.8% YoY in August), and GDP growth remains slow but largely positive.
- Q3 showed a reversal in the H1 trend for Equities. Global equities (MSCI World) fell -3.4% in local currency terms over the quarter, with Value (-2.5%) proving more resilient than Growth (-5.1%). Japanese and UK equities were notable exceptions to the downward trend, with Japanese equities returning 2.5% (TOPIX Index) in local currency and UK equities returning 1.8%. Performance in Japanese equities as a whole was largely down to the weakening yen which fell further against the dollar, however, large growth stocks were negatively affected by the rising interest rates and yields resulting in a -3.4% performance in the Nikkei 225 Total return. UK equities, due to their energy tilt, benefitted from the rising oil prices caused by Russia and Saudi Arabia's extension of voluntary output cuts. US equities (-3.3%) fell as expectations of near term cuts in rates were disappointed. Bonds continued to face headwinds caused by rising interest rates, with all government bonds performing negatively over the quarter, and long dated index-linked down over 10%. Investment grade performed better, and spreads over government bond yields remained stable over Q3: European Investment grade indices rose marginally, while the US index fell 3.4%. Tightening spreads and higher carry (coupon) allowed high yield to outperform credit. Interest rate-sensitive alternatives (e.g. Real Estate, Infrastructure) also showed a modest decline.

It is worth highlighting the following themes, impacting investment markets:

- **Core inflation proving sticky, so interest rates may stay higher for longer.** Inflation fell across the board this quarter (barring the US), with UK annual CPI falling to 6.7% in August, compared to 3.7% for the US and 4.3% for Eurozone in September (UK data for September not yet available). Core inflation (excluding energy and food prices) has also been falling, but much more slowly. US and Eurozone core inflation are both above headline inflation at 4.1% and 4.5% respectively. This all suggests the high inflation / high rates environment may last for rather longer than previously thought. This was reinforced by the Fed 'dot plot', which revised median expected rates for 2024 and 2025 up by 0.5%.
- **The US Dollar – tension between reserve currency status and ratings downgrade might cause increased FX volatility.** The Dollar Index (DXY) steadily increased throughout the first 10 months of 2022 (by around 17.5%) on strong economic data and ongoing geopolitical uncertainty. The net result of this is that the dollar is the strongest it has been (barring the 2022 peak) since the early 2000s. At the same time, Fitch became the second major ratings agency to downgrade US Treasuries from a AAA to a AA+ over concerns around the extent of the US government debt and deficit as well as political brinkmanship in the debt limiting process. Whilst the move from AAA to AA+ is unlikely to have major impacts in the short-term, it increases the risk of changes in sentiment toward the USD, potentially causing significant volatility.

- **China’s weak Covid recovery and ongoing property crisis remove a key engine of global growth.** Low consumption spending and industrial activity as well as the struggling real estate sector are likely to lead to weak Chinese growth. The composite PMI remains above 50 but is decreasing, with the largest fall seen in services. The property market accounts for a quarter of all Chinese economic activity with real estate employing millions and providing the bulk of most people’s savings. As the property prices drop, many people’s savings have reduced significantly and so spending has decreased. Local governments rely on land sales to developers, which have dropped, and local governments are having to cut back on services as a result. Trust companies that invest heavily in development loans are now seeing significant losses too. In short, the size and heavily debt-funded nature of the Chinese housing economy has caused it to spill over significantly into the rest of the economy. This has led Chinese growth to dip below US growth, after having been a leader of global growth since the GFC.
- Global equities fell in Q3, following the rally in the first half of the year. The VIX increased over the quarter from 14 to 18, back towards its 2022 level. The sell-off of global bonds has increased yields and put pressure on risk assets.
 - In the US, the S&P 500 fell by -3.3% and the NASDAQ composite also fell by -4%. Optimism over the end of policy tightening proved premature as inflation actually rebounded slightly this quarter and the Fed indicated median rates would remain higher than expected through 2024.
 - UK equities increased by 1.8%, outperforming global equities. Inflation fell noticeably from 8.7% in May to 6.7% in August. This is the second quarter of significant falls from the highs of around 11% experienced in 2022. Therefore, after the August hike to 5.25%, the BoE kept the rate unchanged during September. The rising oil price contributed strongly to outperformance given the UK’s energy tilt.
 - The Euro Stoxx 50 fell by -4.8% in Q3. Inflation continued to move downwards, aided by the ECB’s double hike during the quarter. The ECB began to loosen its hawkish rhetoric as a result. The composite PMI has remained in marginal territory at 48.7.
 - Japanese equities continued their strong run in Q3 (TOPIX returned 2.5%), but large growth companies underperformed, hence the Nikkei returned -3.4%. A weakening JPY has boosted exporters, as the BoJ maintains very accommodative monetary policy with core inflation remaining at 2.7%. The yen fell a further -3.4% vs the USD over the quarter. The extent of its weakening is beginning to cause some concern.
 - Emerging market equities fell by -2.9% as concerns over a more extended period of high US interest rates reduced risk appetites. Political uncertainty in Poland and falling Lithium prices in Chile contributed to the negative performance, but the underwhelming Chinese recovery and resurfacing issues with its housing sector were more significant contributors. Turkey notably outperformed following two rate rises, indicative of a more orthodox policy by the central bank.
- Medium- and longer-term bond yields rose over the quarter, as a result of predictions of more persistent high rates. This resulted in negative performance across the main government bond markets. The inversion of US yield curve, as measured by the 10 year–2 year yields, reduced, ending the quarter at around -50bps, as mid and long term yields rose more than shorter bond yields. August saw Fitch downgrade the US’s rating from AAA to AA+ leaving Moody’s as the only major rating agency keeping US treasury debt at AAA. Fitch cited the increasing debt and deficit as well as ‘erosion of governance’ and

political partisanship in the debt limiting process. In corporate bonds, high-yield credit outperformed as credit spreads tightened over the quarter.

- The US 10-year Treasury yield rose in Q3, ending at 4.57% from 3.81%, while the 2-year yield rose from 4.90% to 5.05%. Fed policy rates rose by 25 basis points to 5.25-5.50% in July.
- The UK 10-year Gilt yield rose from 4.39% to 4.44% while 2-year yields fell from 5.25% to 4.90% due to an increase in demand in shorter-dated Gilts. BoE policy rates rose from 5% to 5.25% in August.
- European government bonds fell in Q3 as yields rose. Yields rose more in the medium to long term.
- US high-yield bonds outperformed investment grade, returning +2.2% and -3.4% respectively. European high-yield bonds returned +3.8%, outperforming the +0.7% for European investment grade and -1.0% for UK investment grade.
- Energy prices rose during Q3, as gas prices continued to rebound this quarter, although still sharply down from the pre-winter figures. Oil prices were also a major driver as Russia and Saudi Arabia’s extended their voluntary output cuts.
 - US gas prices rose 32% in Q3. Prices remain low compared to their 2021/ 2022 peaks.
 - Brent crude oil rose 19.5% over Q3, to \$95 per barrel.
 - Gold and Copper fell -6.1% and -8.7% respectively over Q3.
- Global listed property continued to decline, with the FTSE EPRA Nareit Global Index falling -3.9% in Q3.
 - The Nationwide House Price Index in the UK has declined after its increase last quarter, with the price index down -4.7% for the quarter, but up +4.5% for the last 12 months.
- In currencies, US dollar strengthened generally throughout the quarter (DXY +3.6%), strengthening against sterling, the euro and the Japanese yen. UK inflation is now in its second quarter of significant decrease. Bitcoin and Ethereum saw strong losses as the US increased regulation, although Ethereum’s proof of stake concept has worked well so far since its introduction.

FUND PERFORMANCE AND INVESTMENT STRATEGY

- Overall fund performance was -0.3% in the third quarter versus benchmark return of +1.2%. This dragged the 12 month return down to +5.4% versus +6.0%. These are short periods of time to come to any conclusion and if they were “one-offs” they shouldn’t be too concerning, but due to cumulative under-benchmark quarters, the 3 year and 5 year track records now lag by 1.4% p.a. and 1.1% p.a. relative. So it is worth reflecting on what the causes are.
- Looking at just the third quarter, the main culprit was the Brunel Global Sustainable Equities fund which attributed 0.5% of the total fund shortfall (in other words one-third of it). As Brunel explain in their quarterly report, sustainable equity funds have been performing poorly generally in recent quarters, notably since the beginning of the Ukraine war because of rises in the price of oil and gas. They make the case that their performance is not too dissimilar to other sustainable funds, maybe even a bit better. Whilst this is a fair point, I did look back to the Brunel q2 2022 report to see what the top 20 holdings in the fund were at that time and how they had subsequently performed. My conclusion was that our

sustainable fund managers had not been applying sufficiently rigorous valuation discipline and had got “sucked in” to some highly priced stocks that were part of the ESG boom of 2/3 years ago. It was more about this aspect than anything connected with a strong oil sector, and in aggregate this had led to subsequent underperformance. It is to be hoped that Brunel can remedy this going forward and impress on their managers the importance of performance.

- Elsewhere the 3 year track records of Brunel’s Global High Alpha, Emerging Markets and Global Small Cap Equity funds has lagged, probably for similar reasons...a lack of valuation discipline.
- On a more positive note, the Multi-Asset Credit fund, which does not yet have a 3 year record has performed well, rising 10.6% over the last year. If we were overweight this fund I would suggest some pruning of the position might be wise, but we are not.
- In the Private Markets arena, the external legacy funds are coming off the boil as we enter much more challenging water for the private sector. Higher interest rates are likely to suppress the returns on illiquid assets for perhaps a prolonged period of time, as it is hard to imagine interest rates returning back down to the benign environment of the 2010s. Many observers are sceptical about the current valuations of private assets, saying they are still overvalued. It is probably going to be a difficult few years.
- The fund is currently undergoing a review by Mercer of the whole equity portfolio, which is 57% of the total fund. The preliminary results are due before this committee meeting.

Steve Tyson, Independent Investment Adviser

November 2023

Charts and Data

Economic Indicators

Table 1: Quarterly GDP Growth Rate and Monthly CPI

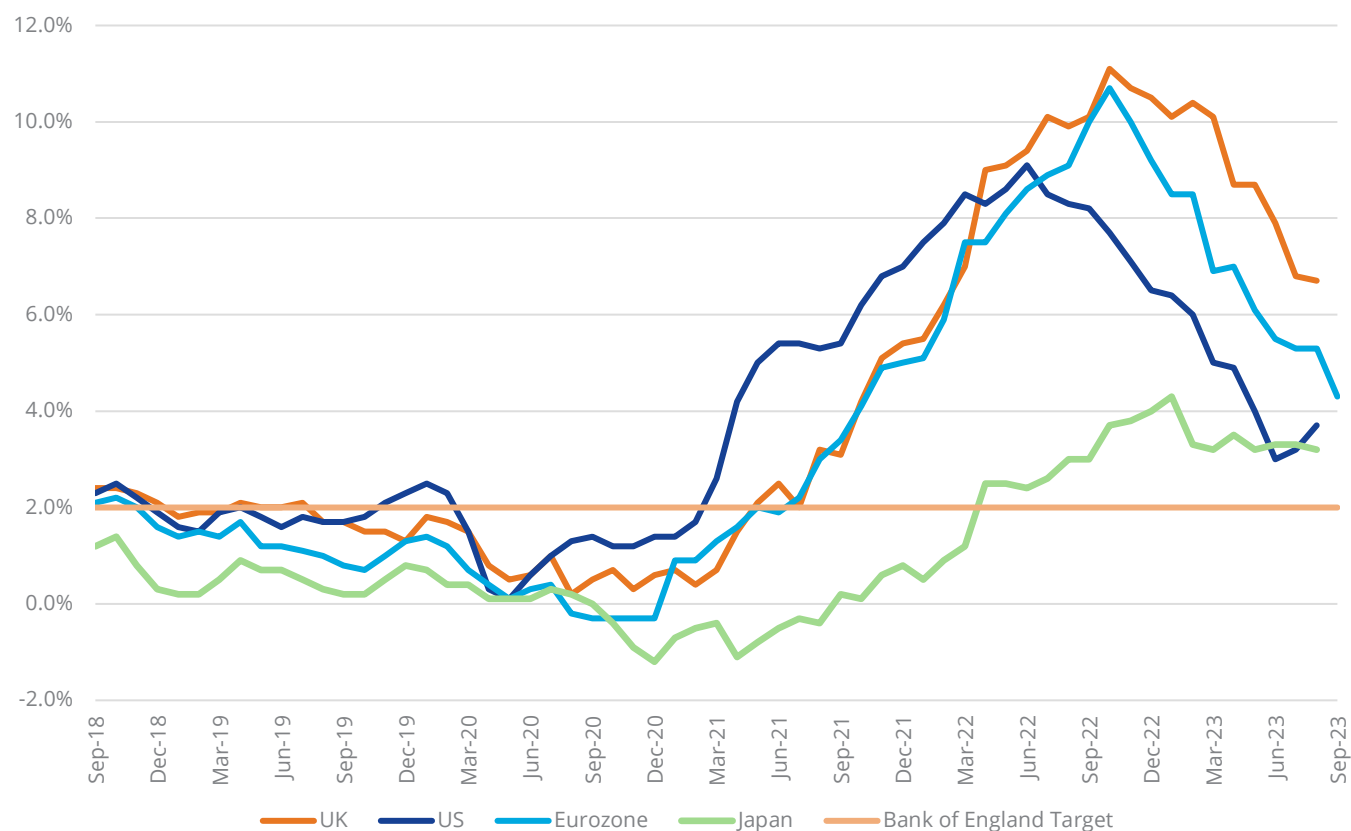
%	GDP		CPI		
	Q2 2023	Q3 2023	Jul	Aug	Sep
UK	0.1	N/A*	6.8	6.7	N/A*
US	0.6	N/A*	3.2	3.7	3.7
Eurozone	0.1	N/A*	5.3	5.2	4.3
Japan	0.4	N/A*	3.3	3.2	N/A*

Source: Bloomberg; Trading Economics.

Notes: * Not available at time of publication; ** Forecasts based on leading indicators

UK: UK CPI EU Harmonised YoY NSA (Ticker: UKRPCJYR Index); US: US CPI Urban Consumer YoY NSA (Ticker: CPI YOY Index); Eurozone: Eurostat Eurozone MUICP All Items YoY Flash Estimate (Ticker: ECCPEST Index); Japan: Japan CPI Nationwide YOY (Ticker: JNCPIYOY Index)

Chart 1: CPI – Annual rate of Inflation - Five Years to September 2023



Source: Bloomberg

Notes: UK: UK CPI EU Harmonised YoY NSA (Ticker: UKRPCJYR Index); US: US CPI Urban Consumer YoY NSA (Ticker: CPI YOY Index); Eurozone: Eurostat Eurozone MUICP All Items YoY Flash Estimate (Ticker: ECCPEST Index); Japan: Japan CPI Nationwide YOY (Ticker: JNCPIYOY Index)

Equities

Chart 2: Global Equity Markets Performance



Source: Bloomberg. All in local currencies

Notes: FTSE All-Share Index (Ticker: ASXTR Index); S&P 500 Index (Ticker: SPXT Index); STOXX Europe 600 (Ticker: SXXG Index); Nikkei 225 Index (Ticker: NKYTR Index); MSCI World Index (Ticker: DLEACWF Index); MSCI Emerging Markets (Ticker: M1EF Index)

Chart 3: Global Equity Markets, Growth vs Value



Source: Bloomberg

Notes: MSCI World Value Index (Ticker: MXWO00V Index); MSCI World Growth Index (Ticker: MXWO00G Index)

Table 2: MSCI ACWI Composition

Region	Q2 2023 (%)	Q3 2023 (%)
US	61.9	65.2
UK	3.6	3.7
Europe (ex-UK)	12.4	12.2
Japan	5.5	5.7
Emerging Markets	10.2	10.2
Developed Asia-Pacific	2.8	2.8
Other	3.6	0.2

Source: iShares MSCI ACWI ETF

Fixed Income

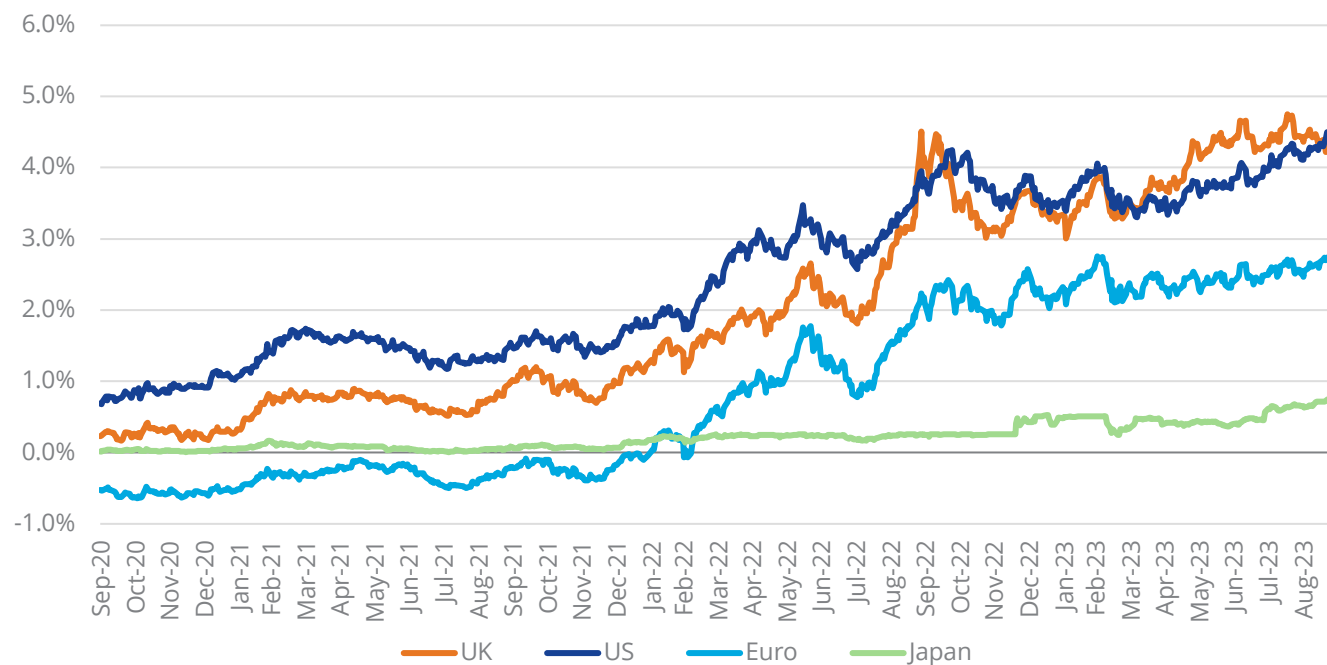
Chart 4: US Corporate Bond Spreads



Source: Bloomberg

Notes: Bloomberg Barclays US Corporate Option Adjusted Spread (Ticker: LUACSTAT Index); Option-Adjusted Spreads (OAS) represent the difference between the index yield and the yield of a comparable maturity treasury

Chart 5: Government Bond Yields

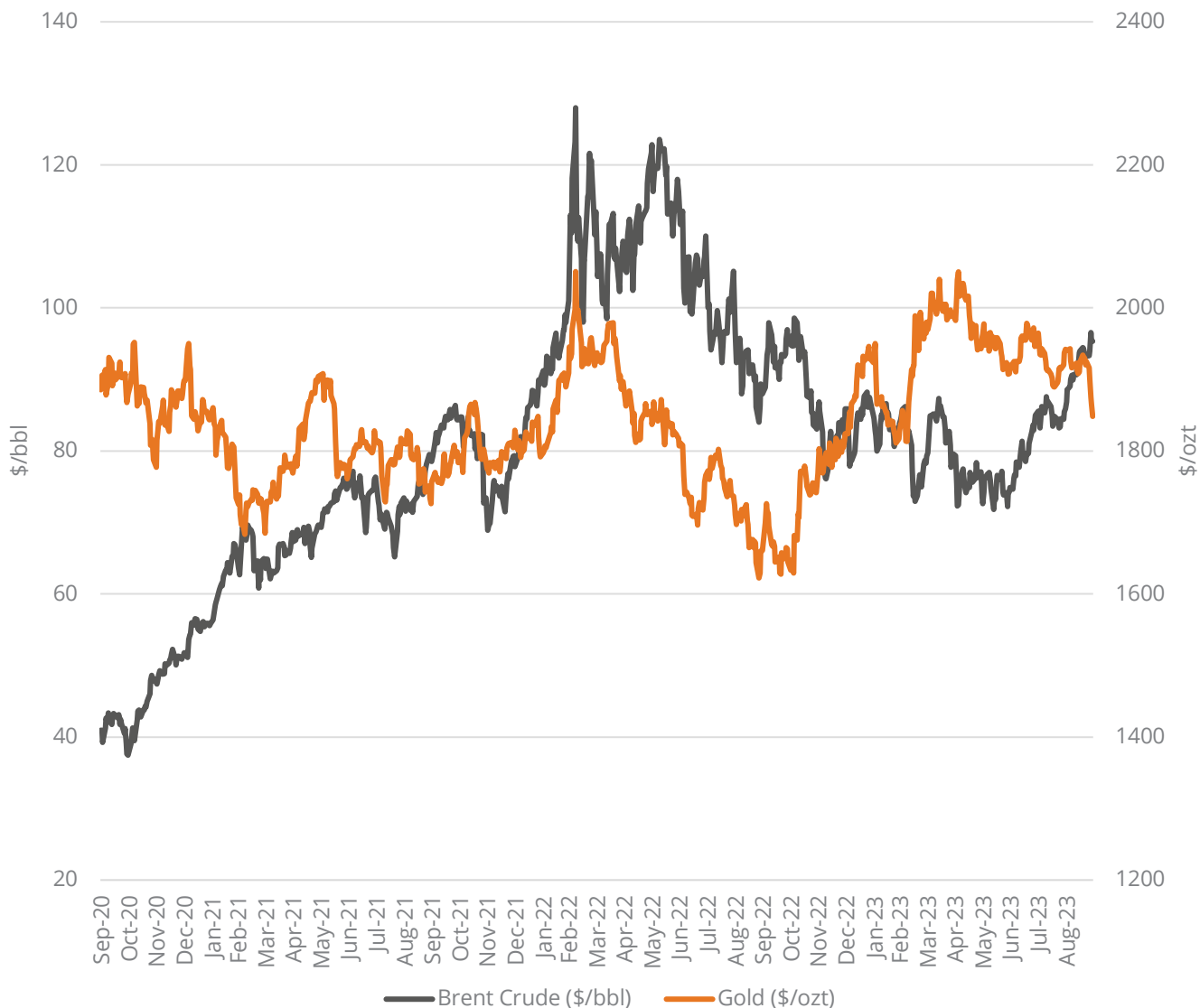


Source: Bloomberg

Notes: US Generic Govt 10 Year Yield (Ticker: USGG10YR Index); UK Govt Bonds 10 Year Note Generic Bid Yield (Ticker: GUKG10 Index); Euro Generic Govt Bond 10 Year (Ticker: GECU10YR Index); Japan Generic Govt Bond 10 Year Yield (Ticker: GJGB10 Index)

Commodities

Chart 6: Gold and Brent Crude Oil Prices



Source: Bloomberg

Notes: Gold USD Spot (Ticker: XAU Currency); Generic 1st Brent Crude Oil (Ticker: CO1 Commodity)

Currencies

Chart 7: Three-Year Currency Rates of Major Currencies vs Pound Sterling



Source: Bloomberg

Notes: GBPEUR Spot Exchange Rate (Ticker: GBPEUR Currency); GBPUSD Spot Exchange Rate (Ticker: GBPUSD Currency); GBPJPY Spot Exchange Rate (Ticker: GBPJPY Currency)

Table 3: Currency Rates as of 30 September 2023

Pair	Q3 Value	% Change Over Quarter
GBP/EUR	1.1538	-0.85%
GBP/USD	1.2199	-3.97%
EUR/USD	1.0573	-3.08%
USD/JPY	149.37	3.51%

Source: Bloomberg

Notes: GBPEUR Spot Exchange Rate (Ticker: GBPEUR Currency); GBPUSD Spot Exchange Rate (Ticker: GBPUSD Currency); EURUSD Spot Exchange Rate (Ticker: EURUSD Currency); USDJPY Spot Exchange Rate (Ticker: USDJPY Currency)

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