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REPORT PREPARED FOR

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INVESTMENT OUTLOOK

For my last report, it is pleasing to note that equities have held on to the gains established in the first half of the year, though Q3 saw a sideways movement with a fall in China offsetting stability in markets like the US and UK. The current quarter though has seen a modest upward trend led by the US, supported by a mild recovery in bond markets with falling gilt yields, for example. At end October, UK equities were up 13% and US equities some 23% for the year to date.

This equanimity might seem surprising given the background news of continuing high infection rates, some loss of momentum in the economic recovery and above all alarming rises in inflation. led by soaring energy and petrol prices. Markets seem to be reassured by the slowness of the central banks in tightening monetary policy, evidenced by the Bank of England's surprising decision not to raise interest rates, despite their more hawkish noises. In addition, there is the continuing fiscal expansion despite the looming budget deficits, as demonstrated by the Chancellor's recent huge public spending increases.

With the continuation of a supportive policy framework, good corporate earnings recovery, the restoration of dividends and rising takeover activity, markets should hold onto these gains through to year end. The inflation prospect is concerning though and if central banks start tightening seriously in the new year, then a correction in markets is likely.

The Glasgow COP 26 conference looks as though there have been insufficient commitments to hit the 2 degree target for 2050, let alone 1.5. Markets have not been greatly affected by the debate though individual sectors clearly are. Most carbon reduction targets are on production rather than consumption so net importers like the US and UK are understating their footprint. Expect to see more discussion on carbon taxes, adding to the longer term costs to be absorbed by consumers to achieve carbon neutrality.

ECONOMY

The Bank of England is now forecasting UK GNP growth this year of 7% and 5% next year, a slight downgrade, with unemployment around 4.5% as the evidence suggests most people on furlough are being retained in employment. There is though a big jump in the inflation forecast with a peak of 5% early next year- equivalent to 6% in old RPI terms- and falling back to 2% only in 2024. With natural gas prices up 60% in Q3, crude oil around $80/bbl, supply shortages forcing up product prices and wages rising in certain sectors, this should be no surprise but the jury is still out on whether this spike is temporary as the central banks persist in saying. Real incomes will clearly face a big squeeze and consumer spending may falter but the slack will be taken up by the public sector. The recent budget projects a deficit of over 5% this fiscal year, admittedly down from 12% last year, before tapering off as the recent tax rises start to come through. Without doubt, the government's Keynesian response to the covid crisis has preserved the economic health of the country but there is little evidence yet that longer term productivity and supply side issues are set to improve.

In the US, the Fed has also just decided not to raise interest rates yet though the time cannot be far off. It has though agreed to start tapering the bond purchase QE programme. President Biden hit difficulties in Congress with his two major programmes to raise infrastructure and welfare spending but the infrastructure bill has now passed. The latter is more contentious and has been scaled back. Both programmes are longer term in their impact. This year the US looks set for GNP growth approaching 6% falling to 4% next year. Inflation is expected to be 4-5% this year falling to 3.5%. Unemployment rose much higher in the US without any furlough but looks like falling back to 4% next year from 8%.

In Europe, covid rates have of course been much lower in the main countries as they have caught up on vaccination rates and been stricter on social control measures. The ECB has been clear it will not tighten policy for some time and has condoned the rise in inflation above 2%, a high rate for countries like Germany. Economic recovery is proceeding well with GNP growth of 5% expected this year. Japan's recovery is of course more modest with some 2.5% expected. China in contrast has probably bounced back some 8% this year with supportive central bank policy.

In summary, while there has been some slowing of recovery in Q3, the global rebound seems still intact. Rising inflation though will eat into consumer real incomes so fiscal support is helpful in the transition. The main uncertainty is whether inflation will feed into the labour market in a big way creating a wage price spiral not analogous to the 1970's but making it difficult to get inflation back to policy rates like 2%. That is why markets are discounting a rise in UK base rates of some 1% over the next year. Sterling has weakened recently losing ground against the dollar but is still some 4% up against the euro this year.

MARKETS

Markets trended sideways in Q3 with the US. UK and Japan up around 2% but emerging markets down by 8% led by the continuing selloff in China. Nevertheless, it has been a good year for equities with UK and global equities up some 13% to end September. The buoyant performance has continued into Q4 with

the US making new highs with a rise approaching 10% in the quarter and the UK holding onto more modest gains.

Bonds have of course produced negative returns on the back of rising yields though the more recent fall in yields has tempered the bad news. Gilts produced negative return of 2% and 7% for the quarter and year to date but index linked have done better as rising inflation has more than compensated to produce slight falls in real yields. Corporate bonds have produced slightly negative returns with credit spreads narrowing a touch. There has been a lot of volatility in the gilt market as it struggles to respond to the news on inflation, government borrowing and the monetary policy response. Thus 20 year gilt yields rose from 0.7% at the start of the year to 1.4% end September but have since fallen back to 1.1%. Inflation of similar duration has risen from 3.3% to 3.9% in November. Clearly, the market has been encouraged by the Bank's lack of movement on rates and perhaps by the fact that the budget deficit numbers are coming in better than expected despite the spending commitments. Rising inflation and falling nominal yields benefit our LDI hedges .

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INVESTMENT STRATEGY

The same comment as the last report. The portfolio is now broadly aligned with the agreed investment strategy following the major restructuring of the global equity portfolio in the first quarter. Any further changes would be relatively marginal, such as trimming the corporate bond portfolio or property. An area for discussion is whether to commit to a private debt allocation in addition to the existing multi- asset credit exposure. Similarly, the LDI portfolio has more than recovered the losses incurred over the RPI-CPI wedge issue. Hedging remains at around 30% of inflation risk and leverage has dropped markedly to just over 2.0 times, allowing for some increase in the hedge to be possible without more collateral or for collateral to be used elsewhere.

FOR FURTHER INFORMATION

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