Dorset Council

Quarterly Report

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QUARTERLY REPORT

This is my first report to the Dorset Pension Fund Committee as your new independent adviser from MJ Hudson replacing Alan Saunders who has retired. I look forward to working with the officers and committee to further the aims and objectives of the pension fund.

INVESTMENT OUTLOOK

Since the start of 2022, markets have entered a turbulent period, characterised by some dramatic moves in stocks, bonds and investment themes as a result of heightened anxiety about inflation and interest rates.

Although Q4 saw a continuing positive trend with global equities returning 7.9% which capped a year of 22% return, so far in 2022 they have fallen back by 5.5%. The US equity markets have led the downturn falling 6.2% and the Nasdaq by a sharp 10.1% decline, whilst emerging markets equities have barely fallen by 0.2%. (All dates to February 15th in local currency). At the same time the return on Bonds has been negative as yields have risen, UK Gilts All Bonds index generating a total return of -6.4%.

The turmoil has been especially noteworthy within the equity markets. Growth stocks have fallen sharply, but Value stocks have remained stable, which is the reverse of the trend over previous years. For example, this year in the US, lowly valued companies are returning +0.8% whilst highly valued have fallen -10.4%; in the Rest of the World the comparable figures are +2.2% (for lowly valued stocks) and -10.4% (for highly valued). This is a major market rotation from Growth into Value and it will be very interesting to see how Brunel and our managers navigate these choppy waters.

The notable exceptions to the turmoil have been the UK market, where the FTSE All Share Index is up 4.2%, and the European EuroStoxx 50 is up 6.5%. The UK has significantly lagged the US in recent years due to its dearth of technology stocks and heavy weighting towards large-cap banks, energy and miners. It is good to note the Fund has a weighting in the Brunel UK Fund in this context.

The cause of this turmoil is the markets' realisation that the Central Banks have been slow to raise interest rates to counter surging inflation. After a prolonged period of loose monetary policy and quantitative easing, led by the Federal Reserve, The Bank of England and the European Central Bank, these banks have signalled their intention to stop expanding their balance sheets and to raise rates. The markets were highly sensitive to these signals, particularly at a time when both equity and bond markets were at record high levels.

The volatility associated with the pandemic is easing, and the developed economies at least, see light at the end of the tunnel and the beginning of a return to normal. At the time of writing, the invasion of Ukraine is causing additional anxiety in markets. Gas prices have shot up and this will have a knock-on effect on oil and, for example, fertiliser prices which will in turn affect food prices later.

Clearly if war is breaking out one would expect an initial market decline, but markets have a tendency to recover and our hope is that the tensions can be de-escalated by governments.

We are likely to see a volatile and nervous year in 2022 as interest rates rise. The key determinant of how long this will last will be whether or not the rise inflation proves transitory or not. Central Banks had been positioning themselves that this would be transitory, but any thought that CPI might return quickly to the Bank of England's 2% target is looking increasingly unlikely. No-one knows to what extent wage inflation will rise, but there are warning signs it will not be easy to contain and the Bank of England governor Andrew Bailey's plea for wage restraint is likely to fall on deaf ears. Once wages rise there is a risk that the UK enters a wage-price spiral that becomes hard to control.

ECONOMY

UK GDP rebounded 7.5% year on year as we recovered from the pandemic, and the Bank expects the UK economy to grow over the next few years. The Bank optimistically expects inflation to peak around 7% in the summer and fall down to the 2% target in 2 years time. With real disposable income falling, there is a cost of living crisis that I expect to persist for some time.

In the USA, the January reported CPI was 7.5% the highest in 40 years. All components are showing exceedingly high price increases led by energy. Inflation in commodities and food are notably high. Investors now expect the Fed to move interest rates up to 2% by June 2023. At the same time the Fed will be reducing its bond holdings, possibly to the tune of $100bn per month. Breakeven inflation rates on 10 year inflation protected Treasury Bonds have actually declined from the start of the year by 0.15% to 2.45%, this suggests a market not overly worried about inflation. But, in my view, the risks are skewed to an upside surprise in inflation.

MARKETS

There is a correction in the US equity market, and the S&P500 fell 6.2% year-to-date. The large-capitalisation technology stocks led the market down, which is hardly surprising given their elevated valuations. The sell-off in growth stocks is partly attributable to their interest rate sensitivity – high growth companies have valuations based on profits far out in the future, and when those far-distant profits are discounted back at a higher, rising, interest rate, the present value becomes relatively less. Those profits are worth less in "today's money". Thus, the market believes growth stocks are worth less when interest rates are higher, and conversely value stocks are worth more. A key question is whether value will outperform growth. This is a complex issue as the value factor contains industries that are, arguably, environmentally less-well positioned such as mining and energy. My view is that there has been a bubble in growth stocks in recent years and their performance will suffer on a relative basis for a while.

Overall, corporate earnings have been strong recently and this has continued into 2022.

INVESTMENT STRATEGY

As your new independent adviser I am undergoing a series of meetings with both external managers, Brunel and the scheme actuary to consider the mandates and the strategy. I will refrain from writing my initial conclusions in this report as these meetings are not concluded as of the date of writing but will update the committee in person.

The portfolio is broadly in line with the agreed investment strategy.

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