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Dorset Council

Quarterly Report

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QUARTERLY REPORT

Investors faced a challenging Q1: rising inflation pressures were exacerbated by Russia's invasion of Ukraine, while central banks' increasingly tough rhetoric led to increased fears that the tighter monetary policy may lead to recession. In addition, China faced a new wave of COVID infections, and implemented severe lockdowns in major cities, impacting growth in March. As a result, global equities fell -5.0% over the quarter, with only UK equities bucking the trend (up +2.9%); European and Emerging markets equities suffered most (down -8.9% and -7.0% respectively). Value-oriented stocks experienced more muted declines than growth stocks (-1.2% for the MSCI World Value Index vs -9.8% for the MSCI World Growth Index). Corporate and government bond indices also declined (for the UK indices, by -6.5% and -7.2% respectively), while the hard currency emerging market bond index fell -10.0%. Real assets (commodities, real estate) fared better, and the USD strengthened against most currencies.

GDP growth: Growth expectations are falling rapidly. US GDP declined at a 1.4% pace in the first quarter, below analysts expectations of a 1% gain. In the UK, GDP increased by 0.8%. In China, the Chinese Communist Party is continuing to stick to a zero-Covid policy, which has led to widescale lockdowns, including in the financial hub of Shanghai; this has cast doubt on the viability of the +5.5% official target growth over 2022. The World Bank has revised its expected global GDP growth for 2022 from +4.1 to +3.2%. There is increasing risk of recession.

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

Inflation: The inflationary aspect of Russia's invasion of Ukraine has so far been most acutely felt through the pricing in energy markets, with consumers facing rising fuel and heating costs. This could be further exacerbated by further calls for European nations to boycott Russian energy imports, which provide the Kremlin with approximately $400 million per day. Furthermore, the increasing focus on energy security is likely to cause sustained upward pressure on consumers' energy bills. Food costs, particularly wheat, have also increased due to the war given that Russia and Ukraine are among the world's largest exporters.

The UK CPI stands at 9.0% which is the highest level in 40 years and the highest in the G7. The Governor of the Bank of England, Andrew Bailey has warned it will be impossible to stop inflation reaching 10% this year due to a combination of energy prices, the Russia-Ukraine war and supply chain constraints.

Wage growth has so far lagged inflation, despite a tight labour market with UK unemployment rate at 3.7%, the lowest in 50 years. Wage inflation is inevitable in my opinion. However, inflation expectations, as priced by the derivatives market, are stuck around 3.8% over the next 20 years and this has not worsened in the last 3 months.

Monetary policy is tightening, and interest rates are increasing, but rates remain negative in real terms: The Federal Reserve increased interest rates by 25bps on 16th March and 50bps on 4th May. The Fed Chairman Jerome Powell has indicated 50bps increases are likely, with the expectation that US rates may peak around 3% in 2023. In addition, the Fed is expected to start briskly reducing its holdings of high-quality bonds ("quantitative tightening"), which could put more upward pressure on long term rates and tighten credit conditions. The Bank of England also

increased the base rate by 25bps in both February and March (to 0.75%) while more hawkish members of the ECB have called for the next rate hike as early as the summer. It is likely we are in for a period of sustained monetary tightening.

Increasing risk of recession: With many of the inflationary pressures being "supply-side", the ability of the central banks to rein in price rises without causing a recession is coming under increased scrutiny. The recent inversion of the US yield curve (with 10-year yields falling below 2-year yields, implying expectations of weakening growth) added to concerns. Market expectations still do not have a recession as the "base case" - employment remains high, consumers well financed and post-COVID recovery momentum continues – but I believe recession to be increasingly likely.

MARKETS

Global equities had a challenging Q1. All tracked indexes, except for UK equities, suffered significant declines but followed differing paths.

US equities posted large losses over Q1 with the S&P 500 falling -5.2% and the tech-heavy NASDAQ falling by -8.9%. The communication services, technology, and consumer discretionary sectors all declined while energy and utility companies were positive, and defence stocks enjoyed double-digit growth over the quarter.

UK equities performed well over Q1, with both the FTSE 100 (+2.9%) and FTSE All-Share (+0.5%) indices delivering positive returns. Defence stocks along with the oil, mining, healthcare, and banking sectors all provided tailwinds for UK large caps. The consumer-focused constituents of the small and mid-cap sectors contributed to their underperformance

- The Euro Stoxx 50 declined by -8.9% over Q1.
- Japanese equities continued to decline over Q1 registering a decline of -4.3%.
- Emerging market equities were negative over the quarter (-7.0%).

Global bonds were unusually volatile due to the geopolitical situation and the macro-economic backdrop of accelerating inflation and interest rate hikes which underpinned the rise in bond yields. Government bond yields rose sharply (prices moved in the opposite direction) in Europe, the UK, and the US due to monetary normalisation. Corporate bonds also saw significant negative returns and performed broadly in line with government bonds over the quarter.

Energy prices soared in the first quarter of 2022 with the Russian-Ukraine conflict putting further pressure on already rising prices. The situation exacerbated the effect of rising energy demand and ongoing supply constraints, which had already put upward pressure on energy prices in January. Precious metals also surged, with investors moving into traditional safe-haven assets following the Russian invasion.

Global listed property had a weak quarter, with the FTSE EPRA Nareit Global Index declining -0.6% in Q1.

In the first quarter of 2022, Sterling weakened against the Dollar (-0.3%) and the Euro (-2.9%), with rising living costs, weakening consumer sentiment, and greater uncertainty over inflation all undermining confidence in the UK's economic outlook.

Since the end of March, the FTSE has fallen a further 2% and the S&P500 has fallen 15%. This means that at the time of writing in late May, the US is on the verge of entering what is technically defined as a "bear market", meaning it has fallen 20% from peak to trough. Whatever the technical definitions may be, this is an extremely uncomfortable period for risk assets.

It is increasingly likely in my opinion that a recession cannot be avoided.

INVESTMENT OUTLOOK AND STRATEGY

This is a challenging environment for investors. Equities may be under pressure from declining economic activity and subsequent corporate profit falls for a period of time. Valuations are getting cheaper but are not yet cheap by historical standards. Bonds will suffer the headwinds of monetary tightening and credit markets spreads are rising with the risk of recession. It is noteworthy that active managers are underperforming, and the sustainable funds of responsible investors are suffering poor relative performance due to their underweight in resources.

The strategy of the fund balances the need for growth with diversification across a wide range of asset classes. The fund has been reducing its carbon footprint and investing responsibly via its pool partner Brunel.

In the coming months, we will know the results of the 2022 trienniel valuation. It is quite possible we will see a funding ratio under downward pressure.

We must remember that this fund has a very long-term perspective and short periods of underperformance should be expected.

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