MJ HUDSON

Dorset Council

Quarterly Report
Steve Tyson, Independent Investment Adviser

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QUARTERLY REPORT

- Q2 was tough for most investors. Global markets continued to face the challenges of the ongoing war in Ukraine, lockdowns in China, continued supply chain disruptions, rising inflation, slowing economic growth and accelerated interest rate hikes. Inflation moved higher, with both equities and fixed income markets under pressure with the increased risk of recession. Global equity markets significantly declined, falling -16.1% over the quarter. US equities suffered the most (-16.1%); followed by Emerging Markets and European equities (-11.4% and -9.4% respectively); and UK equities registered slightly negative return (-3.8%). Value-oriented stocks experienced a smaller decline than growth stocks (-12.2% for the MSCI World Value Index vs -21.4% for the MSCI World Growth Index). Corporate and government bond indices also sharply declined (for the UK indices, both by -7.4%). Real assets such as commodities and real estate continued the volatility experienced last quarter, and the US dollar strengthened against most currencies, benefiting from broad risk aversion.
- **GDP growth:** Despite the ongoing recovery of the UK economy from the pandemic, the impact of the Russia/Ukraine war is expected to slow growth in the UK alongside other advanced economies. The UK is expected to hit an inflation peak in double digits %. The war is expected to hinder growth through higher commodity prices and supply chain disruption. The US is forecast to post a GDP growth rate of 2.4% for 2022, following a 1.6% slump in Q1. China's growth has been disrupted by another COVID-19 wave.

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

- **Inflation – becoming entrenched? :** For the first half of this year, surging energy prices from the Russia-Ukraine war and global supply-chain disruptions from China's zero-tolerance COVID-19 lockdowns have pushed inflation even higher. In the US, inflation is marking a new 40-year high, while the BoE has forecast UK inflation may peak at c.11% October. It may peak higher than that. With labour markets remaining remarkably tight, average earnings are starting to rise faster, and industrial action is increasingly common. Together with the likelihood of further energy price rises this winter, it seems likely that inflation will not fall back to Central Banks' targets.
- **Tighter monetary policy:** Monetary policies continued to tighten to tame inflation: the Fed is expected to continue reducing its balance sheet and hiking rates through 2023. The BoE also increased interest rates for a sixth successive time to 1.75%, and the ECB raised interest rates in July. Increasing rates will put a severe strain on many Government finances, and may constrain central banks' policy choices. In the UK the BoE may be challenged regarding its independence, with consequences for Sterling. Some of this is undoubtedly political rhetoric.
- **Rising fears of recession :** The bond market flashed recession warning lights as the yield curve between the 10-year Treasury yield and the 2-year yield has become inverted again during the quarter.

- Global equities fell sharply in Q2. All tracked indexes suffered significant declines. In addition to the continued Ukraine war, the impacts from slowing economic growth, tightening monetary policy, rising interest rates, and high inflation have all significantly hit the market.
  - US equities, measured by the S&P 500, fell sharply over the quarter by -16.1% and the NASDAQ fell by 22.4% QoQ in response to the more aggressive path of interest rate hikes, with the Fed raising rates by 0.5% in May and 0.75% in June, in an effort to slow inflation,

and reached the target range between 1.50% and 1.75%. This is the greatest rate increase since 1994. Consumer discretionary slumped -26.3% QoQ due to rising consumer concerns over the effect of inflation on households. All sectors experienced declines, although consumer staples and utilities were comparatively resilient. July in contrast saw the strongest single monthly rise in the S&P 500 for a long time, however, since then it has fallen back. Simply, volatility is the order of the day.

  - UK equities continued to be impacted by the war in Ukraine, and the BoE raising rates. The FTSE 100 (-3.8%) and FTSE All-Share (-5.1%) fell over the quarter. Large-cap companies held up relatively well as traditionally defensive areas of the market outperformed, including the telecoms, healthcare and consumer staples sectors. Small and mid-caps (SMIDs) suffered significant valuation declines as the growth companies in general have suffered against the backdrop of rising rates.
  - Elsewhere, the Euro Stoxx 50 declined by 9.4% over the quarter, Japanese equities registered a decline of 5.0% from the end of March. Emerging market (EM) equities aligned with the global equities markets and delivered a negative 11.4% over the quarter, with US dollar strength a key headwind.

- Global bonds continued to sell off sharply in Q2 sending yields higher amid elevated inflation and rising interest rates. Global bonds rallied into quarter-end amid rising growth concerns, slightly curtailing the negative returns. Within corporate bonds, high-yield credit was hardest hit, with mounting concerns over the economic outlook. Emerging market bonds also suffered similar declines.
  - The US 10-year bond yield rose from 2.35% to 2.98% and the 2-year yield from 2.33% to 2.93%. Treasuries provided a total Q2 return of -3.8%. The unemployment rate also edged down, bolstering the case for the Fed to speed up the tightening of monetary policy in the fight against inflation. The Michigan Consumer Sentiment index declined to 50.0 in June, a record low in its 70-year history, going back to 1952.
  - The UK 10-year Gilt yield increased from 1.61% to 2.23% and 2-year yield rose from 1.36% to 1.88%. Real rates have been rising significantly and perhaps surprisingly, inflation expectations as measured by breakeven inflation – the difference between yields on nominal and index-linked gilts has actually been moving only sideways since February. In other words, the market price on inflation is not rising whilst the headline inflation rate soars. How can one explain this? I believe it is partly because the markets expect recession and partly because the index-linked market is dominated by pension funds who have been selling.

- Energy prices fluctuated in Q2 2022, with the continuation of the Russia-Ukraine conflict putting further pressure on the rising prices from Q1. Increases in price occurred via tight supply reflecting uncertainties about further sanctions related to Russia's invasion. Precious metals also surged, with investors seeking safe-haven assets – which saw gold prices rise.

- Global listed property had a weak quarter, with the FTSE EPRA Nareit Global Index declining -9.8% in Q2. There is a lag in terms of the effect on direct property, which has to go through a quarterly valuation process before it catches up.

- In Q2, sterling weakened sharply against the euro (-2.0%) and against the US dollar (-7.3%) as recession fears, rising living costs, public sector strikes, and inflation uncertainty all undermined confidence in the UK's economic outlook and the strength of its currency. Overall, the US dollar (Dollar index +6.5%) had a strong Q2, as investors preferred the US over Europe amid uncertainty among ECB policy makers growth outlook. Notably it also strengthened against the Japanese yen by 11.6%, again reflecting the divergence in policy between the Fed and the BoJ. Sterling's

weakness is continuing during the period of the PM election campaign due to various pronouncements by Ms Truss which have unsettled markets.

Performance and Strategy

Performance of the pension fund is lagging benchmark and it has affected the long-term performance. Some of the negative performance is due to external legacy mandates, but mostly this relative comparison is attributable to the performance of the underlying Brunel equity funds which have a strong tilt to Responsible Investing. It is to be expected that during a period when energy prices shoot up that both the Brunel funds and consequently our pension fund have a period of underperformance. But what we have to scrutinise is whether the magnitude of the underperformance is reasonable in the context of the long term. This is a complex subject. Brunel have explained that it is not just about the energy sector, but more importantly their tilts towards growth and quality have suffered as the environment suddenly changed from February 2022. Whilst this is true, I have a residual concern that insufficient attention was being paid to value as a consideration when investing by Brunel and their underlying managers.

I expect Brunel's underlying fund performance to start to recover, in fact it has already begun. Whether the performance of the last year is ever fully recovered is an open question that we should monitor. ESG investing has come into question after a year of underperformance relative to traditional benchmarks and now there is starting to be a more intelligent debate about whether and how we can invest responsibly and achieve our climate aims without a consequent performance drag. This is not easily answered and we should continue to understand whether there is a trade-off between investing responsibly and performance.

In the immediate future, the fund faces the challenge of economic recession and consequent market uncertainty. Societal strains will be great this winter as a consequence of the cost of living crisis, and it remains to be seen at what level CPI will peak. It will be in the teens, but whether it is in the low-teens or the high-teens is very hard to predict. The risk of policy mistakes is great – either monetary policy mistakes by tightening too little or too much, or fiscal mistakes made by the incoming government. We are coming up to our triennial valuation results and investment strategy review. Whilst it is bad news that markets are declining, at least this has the effect of increasing the prospective rate of return from these lower levels! And we are in the fortunate position of taking a long-term perspective.

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