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Quarterly Report

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QUARTERLY REPORT

- Q3 was challenging for most investors, with only temporary optimism that Central Banks would soon end their rate hikes. Markets continued to grapple with the challenges of high inflation, slowing economic growth, a strong US dollar, and accelerated interest rate hikes. Equity markets rose for the first half of Q3, until monetary policy became more hawkish, and led to repricing in light of persistent high inflation. Long-term bond yields fell until late July as markets viewed recession risk as taking precedence over inflation, however policymakers tightened monetary policy further with additional rate hikes. Global equities fell again, declining by -6.1% over the course of the quarter. Emerging markets detracted the most within equity markets (-11.5%), facing the headwinds of slowing growth from China and a strong US dollar. US equities fell -4.9%; followed by European and UK equities (-3.7% and -3.5% respectively). Growth stocks fell less (-5.2%) than value stocks (-7.8%). Corporate and government bond indices also fell sharply (with UK Gilts and UK investment grade credit falling by -12.8% and -11.4% respectively), while hard currency emerging market bonds fell by -4.6%. Real assets such as commodities and real estate generally also fell, and the US dollar strengthened against most currencies, benefiting from broad risk aversion and increasing rate differentials in its favour.
- The Truss/Kwarteng September "mini-budget", in part aimed at boosting growth, was misjudged: markets were spooked by the risk which the unfunded tax cuts pose to the UK's fiscal position, resulting in a rapid rise in long term interest rates, and a sharp fall in GBP. Gilt markets have stabilized following the BoE's intervention, and as at the time of writing the new Chancellor is introducing fiscal policies designed to reassure the markets and deal with the fiscal 'black hole".

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

- **Inflation – the end is not yet in sight.** US CPI appears to have peaked near double digit levels with October CPI at 7.7% which was in fact down from the previous month. This could be the first sign that inflation might be peaking in the US. On bank is forecasting US CPI to be at 2% by the end of 2023. UK inflation however shows no sign of peaking yet. UK CPI is 11.1% and still rising. The key consideration is that when it falls, what level will it fall to and stabilise at?
- **Inflation vs Recession – the monetary policy conflict**. To combat this, monetary policy continued to tighten in most major developed countries, with the Fed, the BoE and the ECB all raising rates several times. In addition, the Fed is expected to reduce its balance sheet ("Quantitative Tightening", QT), while the BoE plans is also starting QT. Markets now expect rates to peak in the 4.5-4.75% range in the US, possibly as early as Q1 2023 and around 5.5% in the UK. The Central Banks need to demonstrate they have won the battle against inflation. The likelihood of a "hard recession" is increasing, particularly in the UK and Europe.
- **Valuations – looking more attractive if earnings are sustained**: With global equities over 25% off their peak and credit markets 15-20% down, valuations are looking more in line with long-term averages. US equities are trading on 15x forward P/E, while most other regions are nearer 10x, and global investment grade indices yield c.4-5%. Corporate profits have so far remained broadly resilient, and expectations for 2023 earnings are still strong despite the strong US dollar which historically has a negative impact on S&P 500 earnings. US profit margins have declined

to 10.9% for Q2, down from 11.9% for Q1, but still above the long-term trend and recessionary levels.

- **Global equities** fell sharply in Q3, continuing the year-to-date trend. In addition to the ongoing war in Ukraine, the impact from slowing economic growth, rising interest rates, and high inflation have all significantly hit markets.
  - In the US, the S&P 500 fell by -4.9% and the NASDAQ fell by -3.9%. Communication services and REITs were the hardest hit in the quarter, down 12.7% and 11.0% respectively. Energy and consumer discretionary were the only positive sectors in the quarter, although consumer discretionary had fallen significantly in Q2.
  - UK equities continued to be impacted by the war in Ukraine and subsequent volatility in energy prices. The BoE raised the base rate to 2.25% in September and 3% in November. On a relative basis the UK somewhat outperformed global equities, declining by -2.8% (FTSE 100) and -3.5% (FTSE All-Share).
  - The Euro Stoxx 50 fell by -3.7% in Q3 as the ECB ended its long period of negative rates. Concerns over the higher cost of living and the possibility of recession saw the European Commission's consumer confidence reading fall to -28.8 in September, a level lower than during the peak fear of the pandemic.
  - Elsewhere, Japanese equities fell by -0.9% in Q3 and Emerging Market equities fell by 11.5%.
- **Bond yields** rose in Q3 amid elevated inflation and rising interest rates. Yield's initially fell in July/August due to rising recession concerns; but ended the quarter high on Central Banks' comments and rate hikes. In corporate bonds, high-yield credit outperformed as spreads were largely unchanged and have less duration sensitivity. Emerging market bonds fell -4.3% in local currency, and -4.6% in hard currency.
- **Global listed property** had a weak quarter, with the FTSE EPRA Nareit Global Index falling -3.8% in Q3.
  - Property prices in the UK have begun to decline recently, with the Green Street Commercial Property Price Index down by -4.9% this quarter. The all-property index is now down -5.9% since the start of the year.
  - The Nationwide House Price Index in the UK fell slightly to 9.5% YoY in Q3, down from 10.7% in Q2. Expectations indicate a slowdown, with mortgage approvals falling back towards pre-pandemic levels and rising mortgage rates.

- **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 changed to rising rates. Whilst this is true, I have a residual concern that insufficient attention was being paid to value as a factor when investing by Brunel and their underlying managers.

I expect Brunel's underlying fund performance to start to recover. 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 latest government.

The good news is that there is now much better value in markets. Yes there is a recession underway, and this will impact corporate profits and increase defaults, but the markets will bottom out with the faintest hint of light at the end of the tunnel. It is too soon to call it, but hopefully the worst of the declines are over.

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