MJ HUDSON

Dorset Council

Quarterly Report

Steve Tyson, Independent Investment Adviser

MARCH 2023

QUARTERLY REPORT

Q4 was a very positive quarter for risk assets generally, with equities and credit rebounding from losses in Q3 as investors have grown more optimistic that inflation may have peaked and Central Banks will soon have reason to end their rate hikes. Inflation still remains uncomfortably high however, and Central Bank rhetoric has so far remained hawkish generally. Long-term bond yields showed little overall movement (with the exception of UK gilts returning to normality), while short-term yields generally rose as monetary policy was tightened further. Additional positive impetus was provided by China's relaxing of its zero-COVID policy, improving the outlook for growth in its economy, and by the surprising resilience of European gas supplies, reducing oil/gas prices and easing fears of recession: oil and gas finished the year only 10% and 20% above their end-2021 levels. Equity markets rallied this quarter, especially beleaguered European and Emerging Markets, although global equities are overall unchanged from June 2022 levels, despite volatile price moves in this period. The UK was one of the best-performing equity markets, and sterling recovered some of its earlier losses vs the dollar. Value stocks (+14.2%) outperformed growth (+4.6%) by a wide margin this quarter.

GDP growth and labour markets: Despite the ongoing recovery from the pandemic, the impact of tight monetary policy and the war in Ukraine are expected to slow growth, particularly in the UK and Europe. Labour markets have to date remained strong with unemployment at very low levels historically for the US, UK and Europe (3.5%, 3.7%, and 6.0% respectively from the most recent data).

The UK Government under Rishi Sunak has restored order to gilt markets and sterling by promising fiscally conservative plans. Markets have so far looked favourably on this and returned bond yields to their former positions relative to peer yields.

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

- **Inflation – peaking but what happens next?** While YoY CPI inflation appears to have now peaked for the US, UK and Europe, concern remains over how rapidly and to what level inflation will return. There are indications of inflation becoming more entrenched, but investors appear to be pricing in a more rapid cut in rates than that which Central banks are currently forecasting. Perhaps the misstep by the Fed in 2021 of calling inflation 'transitory' has reduced markets' trust. Euro inflation reached 10.6% in October, a fresh high, however this has fallen to 8.6%. Similarly for the UK, a high of 11.1% was reached in October before falling to 10.1% in January. For the US, the high in CPI appears to have been reached in June at 9.1% and has since declined to 6.4%.

- **Inflation vs Recession – the next stage for monetary policy**. Monetary policy continued to tighten in most major developed countries, with the Fed, the BoE and the ECB all raising rates several times in Q4. Markets now expect rates to peak at ~4.5% for the UK, ~5% for the US, and a little over 3% for the ECB which indicates hiking cycles are coming towards their peak. In addition, the Bank of Japan (BoJ) surprised markets by lifting the yield ceiling for their 10-year bond to 0.5% from 0.25%. The BoJ noted this was to restore proper market function, but as the BoJ owns over half of the bonds on issue investors have questioned if there is another rationale for the change. Prime Minister Kishida has also announced they will discuss the BoJ's inflation target approach when a new BoJ Governor begins in April.

- **A return to fixed income?** The repricing of debt of all forms, following the rapid rises in interest rates last year, has made many debt asset classes potentially attractive once again. Clearly interest rates are in a more volatile phase, in marked contrast to the repressed volatility of the past decade of QE, so these improved returns are likely to come with increased volatility.

- **Equity valuations reflect "mild" recession – earnings on watch in 2023**. Following the 18% decline in US equities this year they are now trading at 16.5x forward earnings, below the 10-year average of 17.2x, but up from 15x in Q3. Over the course of Q4, expectations for 2023 earnings fell by -4.4% with much of the negative impact expected in the first half of 2023, and some of the leading economic indicators (e.g. ISM survey data) are starting to signal a decline. Investors appear willing to look through any potential decline in earnings but clearly there remains a risk to earnings, as corporate profit margins remain elevated by historical standards, and inflating costs may yet impact these.
- **Energy crisis: off the boil, but not gone**. While the immediate threat of blackouts in Europe this winter has been avoided, and gas storage levels are high, the problem is not over. And China's reopening is likely to increase demand pressure on global supplies.

Fund Performance and Investment Strategy

Overall performance of the Dorset Pension Fund lagged the benchmark in the fourth quarter (+0.9% versus +1.9%) and this has further dragged down the 1 year performance to -10.2% versus -4.4% for the benchmark. However, there was a technical issue depressing the fourth quarter: the comparisons are distorted by the unavailability of the private market benchmarks at the time the report is produced. In fact, what is being reported is December-December private market asset performance versus September-September private market benchmarks. This is most noticeable in the property asset class. Q4 was a moment of reckoning for private markets including property as private market valuations finally caught up with the earlier decline in public markets. Thus, there is a timing issue in this and other comparisons which means that the reported numbers are not strictly apples-to-apples comparisons. This has affected the overall performance numbers. Since the data is unavailable in time to meet the State Street and Brunel report deadlines, a true comparison can never be achieved, and the performance numbers have to "wash out" over time. But at a minimum I suggest this be investigated further, for example, even if December benchmark data is not available, it would have helped the comparison in this instance if end-November data had been used.

None of this affects the public market performance data.

Overall the story of 2022 from a performance perspective was the poor performance of Brunel in the first half, and the distortions arising from private markets in Q4. Brunel is recovering modestly in Q4.

Turning to Brunel, the first point to note is that they have gone through a significant improvement in the quality of client reporting. The Report is better written and more relevant, and Brunel should be congratulated. Brunel now manage 72% of Dorset assets, up from 62% in the previous quarter. Brunel's pubic (listed) equity fund performance overall showed a welcome improvement in Q4 and I understand this has continued in Q1 to date. Details are noted in the Brunel report. In my previous report I questioned how rapidly Brunel might recover from the performance difficulties of the first half, which resulted from a bias towards quality and growth as a result of the responsible investing approach. The process of recovery has begun, but there may be some drag in the 3 year performance numbers for some time. On a positive note, Brunel completed a "Climate Stocktake" of its Climate Change Policy and published a new policy for the 2023-2030. The outcome of this review was very positive. Brunel is at the forefront of responsible investing.

Dorset will soon be undertaking an Investment Strategy Review. In the meantime, the fund has already been through important changes. The LDI mandate has been in the process of disinvestment since

November 2022 following a detailed review, and those proceeds have been reinvested in listed equities and bonds. As I mentioned in my last quarterly report, there was much better value in public markets following the 2022 bear market in equities and bonds, and fortuitously the above asset changes should have captured some of the subsequent recovery in public markets.

I look forward to participating in the upcoming strategy review, this involves and important deep consideration of our asset strategy.

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