Dorset Council

Quarterly Report

Steve Tyson, Independent Investment Adviser

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- Q1 was a strong quarter for equities and bonds, however the headline numbers obscure some dramatic market events that took place. Macroeconomic data was generally resilient in the quarter, as inflation continued to decline (with the exception of the UK), employment data generally showed tight labour markets and Central Banks continued their rate hikes, albeit at a slower pace. The focus on inflation took a brief backseat in early March, as a confidence crisis, which started with US-tech focused Silicon Valley Bank (SVB), spread to other similar US lenders (Signature Bank, First Republic), and then to struggling Swiss bank, Credit Suisse (CS). In the short-term, the underlying causes of the stress (mark-to-market losses on balance sheets combined with competition for deposits, both driven by the sharp rise in rates) remain, and are likely to have medium term repercussions.
- Despite the banking crisis mentioned, equity markets rose over the quarter and were led by growth-oriented stocks (+14.9% for growth, +0.2% for value). However, the quarterly gain of +7.7% for the MSCI World (c. +6% in GBP terms) was not a smooth ride with the index up sharply in January, before declining in February and early March as the banking crisis unfolded, and then rallying strongly to end the quarter up +7.7%. European and Japanese equities performed particularly strongly (around +12% and +7% in GBP terms respectively).

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

- **Tighter credit conditions following the banking crisis makes recession more likely.** Keen competition between banks for deposits, together with the reaction to the SNB imposing losses on contingent "AT1" bondholders in the CS rescue, have put significant pressure on bank funding. This has fed quickly through to tighter credit conditions, which, by some measures, are as tight as they were following the 2008 financial crisis. So, while it is important to note that consumption and employment are still relatively strong in most developed economies, they are trending weaker.
- **Inflation – continuing to grind lower, but rates likely to remain elevated for some time.** The UK was the outlier in the quarter with annual CPI rising in February to +10.4%, having fallen for the prior 3 months. However, headline UK inflation is expected to decline in the months ahead (current consensus c. +5% in 2023 and +3% in 2024) as energy prices have fallen from their dramatic highs last year. But while labour markets remain relatively tight, Central banks are likely to maintain high short term rates, and there is potential for the energy genie to return later in 2023. So rate cuts still look to be some way off.
- **Volatility has increased in "stabilising" asset classes (fixed income).** Concerns over the path of US rates, and the fallout from the banking crisis has led to increased volatility in bond markets. While this volatility has affected the rate-sensitive (long) government bond market in particular, the next phase of tighter credit is likely to see increased volatility in asset-classes exposed to credit risk (corporate bonds, private debt etc)
- **Equity valuations rise despite earnings risk.** While US equities rallied strongly in Q1, analysts have at the same time lowered their forecast earnings for Q1 2023 and for full year earnings

2023. Companies have generally been guiding that they expect minimal revenue growth for 2023, and slightly contracting profit margins (albeit still at historically elevated levels of c. 11.2%). This appears to leave scope for disappointment.

- Global equities rose sharply in Q1, as investors initially embraced cooling inflation data in the US before strong US economic data (jobs report, ISM survey) reminded investors that the Fed is still in a rate hiking cycle.
  - In the US, the S&P 500 rose by +7.9% and the NASDAQ soared by +21.6% driven by a handful of technology stocks, specifically Apple, Amazon, Microsoft, Nvidia, Alphabet and Facebook
  - UK equities rose +2.1% in Q1 but underperformed global equities and ending below the February high. Earnings updates from large index constituents in energy and financials drove strong performance. Economic data has also proven more resilient than dire forecasts in late 2022, with a sharp decline in energy prices contributing, and the Bank of England noting that while it still expects a recession in 2023 it now expects a shallower one than previously. The BoE raised the base rate in both February and March, by 50bps and then 25bps, to 4.25% and after quarter-end to 4.5%.
  - The Euro Stoxx 50 rose by 12.4% in Q1, to follow its strong gain last quarter. Economic data was better than expected with falling inflation and a strong PMI index result in February indicating strong business activity. The ECB raised the deposit rate twice by 50bps in the quarter, to 3.5%.
  - Japanese equities outperformed global equity markets, rising by +10.0% in Q1. Japanese equities appeared to be catching up to global equities after a weak Q4, and were buoyed by comments from the incoming new Bank of Japan Governor that he supported the current easy monetary conditions.
  - Emerging market equities rose +4.0%, lower than global equities due to an -8.9% decline in the relatively expensive Indian equities market.
- Medium- and longer-term bond yields fell over the quarter resulting in solid performance for bonds, while very short-term yields rose following various Central Banks rate hikes. The US yield curve inversion as measured by the 10 year yield –2 year yield ended the quarter at -58bps, close to the 2022 year end -61bps, but much steeper than a peak in March of -107bps. In corporate bonds, high-yield credit and investment grade performed roughly in line as credit spreads for the high yield index tightened slightly over the quarter. Emerging market bonds rose 4.8% in local currency, and 1.9% in hard currency.
- Energy prices fell over Q1 which has supported recent headline inflation figures. Warmer weather over winter in Europe has resulted in a sharp downward repricing in natural gas, while for oil, markets continue to grapple with the trade-off between potential economic slowdown from tighter monetary policies vs a boost in demand from China re-opening and OPEC+ production cuts.
- Global listed property continued to decline, with the FTSE EPRA Nareit Global Index falling -2.0% in Q1.

- The Nationwide House Price Index in the UK has continued its decline, with the price index down -1.8% for the quarter, and down -1.0% for the year. While only a modest decline, this is a considerable deterioration from the 9.5% YoY growth in Q3, and 10.7% in Q2.
- European commercial property has also continued to decline in the face of higher interest rates, with the Green Street Commercial Property Price Index down by -2% this quarter and -15% for the past 12 months.

- In currencies, sterling strengthened against the US dollar (+2.1%) and the euro (+0.7%) over the quarter, as the ongoing high and uncertain inflation in the UK is viewed as requiring a more lengthy period of tighter monetary policy. The US dollar fell in Q1 (Dollar index -1.0%), continuing to reverse some of the prior 2022 dollar strength.

Fund Performance and Investment Strategy

Overall performance of the Dorset Pension Fund was greatly improved in Q1 +3.2% versus benchmark performance of +1.4%. The 1-year performance still lags (-4.8% versus -2.8% for the benchmark).

The better Q1 was partly due to a correction in the technical issues of the previous quarter relating to the timing of private markets comparisons, but more importantly the performance of Brunel funds improved greatly. With growth outperforming value, this is a tailwind for many of the Brunel funds, for example with technology outperforming, and energy and banks underperforming. It is gratifying that Brunel performed better even though the technology leadership was quite narrow (with only a few "leaders") and Brunel are mainly underweight those few stocks. Brunel's performance needs to continue to be monitored very closely, we should request an update on the current quarter-to-date at the Committee meeting. At the pre-meeting, Brunel indicated performance was mainly slightly behind benchmark quarter-to-date, but this can change quickly.

Another factor in Q1 performance, is that the 2022 troubles are finally taking a toll on our external private market managers such as Harbourvest (private equity) and IFM (infrastructure) as the market environment worsens. However, there is a great deal of past success already banked, so this is not something to be unduly concerned about at this stage. Private market managers can only be judged over very long time periods, and both those managers have stellar track records.

Mercer are presenting the Investment Strategy findings at Committee and preceding Training Day. At the time of writing in late May, the first draft has been presented to the Chairman, officers, and myself. It is somewhat reassuring that no major revisions are proposed. Following the changes to the LDI mandate in 2022, the current strategy has a higher probability of successfully achieving the discount rate of 4.9% than was seen as the previous investment strategy review.

However, we should note there are still many risks relating both to asset strategy and to implementation: a serious global economic and profits recession would hurt equities, corporate bonds and real estate; and we continue to rely heavily on Brunel to match or beat their benchmarks.

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