Quarterly Market Report

Q2 2023

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Key Indicators at a Glance

	Index (Local Currency)	Q2 2023	Q2	YTD
Equities			**Total Return**	
UK Large-Cap Equities	FTSE 100	7,532	-0.4%	1.7%
UK All-Cap Equities	FTSE All-Share	4,096	-0.6%	1.1%
US Equities	S&P 500	4,450	8.7%	17.3%
European Equities	EURO STOXX 50 Price EUR	4,399	4.2%	17.2%
Japanese Equities	Nikkei 225	33,189	18.5%	30.5%
EM Equities	MSCI Emerging Markets	989	1.0%	5.0%
Global Equities	MSCI World	2,967	7.0%	15.2%
Government Bonds				
UK Gilts	FTSE Actuaries UK Gilts TR All Stocks	2,913	-5.4%	-3.5%
UK Gilts Over 15 Years	FTSE Actuaries Uk Gilts Over 15 Yr	3,481	-8.3%	-5.8%
UK Index-Linked Gilts	FTSE Actuaries UK Index-Linked Gilts TR All Stocks	3,897	-6.6%	-2.6%
UK Index-Linked Gilts Over 15 Years	FTSE Actuaries UK Index-Linked Gilts TR Over 15 Yr	4,298	-10.2%	-5.8%
Euro Gov Bonds	Bloomberg EU Govt All Bonds TR	214	0.0%	2.5%
US Gov Bonds	Bloomberg US Treasuries TR Unhedged	2,223	-1.4%	1.6%
EM Gov Bonds (Local)	JP. Morgan Government Bond Index Emerging Markets Core Index	133	2.7%	7.6%
EM Gov Bonds (Hard/USD)	JP. Morgan Emerging Markets Global Diversified Index	836	2.2%	4.1%
Bond Indices				
UK Corporate Investment Grade	S&P UK Investment Grade Corporate Bond Index TR	327	-3.1%	-0.8%
European Corporate Investment Grade	Bloomberg Pan-European Aggregate Corporate TR Unhedged	218	0.2%	2.2%
European Corporate High Yield	Bloomberg Pan-European HY TR Unhedged	408	1.8%	4.8%
US Corporate Investment Grade	Bloomberg US Corporate Investment Grade TR Unhedged	3,063	-0.3%	3.2%
US Corporate High Yield	Bloomberg US Corporate HY TR Unhedged	2,304	1.7%	5.4%
Commodities				
Brent Crude Oil	Generic 1st Crude Oil, Brent, USD/bbl	75	-6.1%	-12.8%
Natural Gas (US)	Generic 1st Natural Gas, USD/MMBtu	2.8	26.3%	-37.5%
Gold	Generic 1st Gold, USD/toz	1,929	-2.0%	5.7%
Copper	Generic 1st Copper, USD/lb	374	-8.6%	-1.8%
Currencies				
GBP/EUR	GBPEUR Exchange Rate	1.1637	2.3%	3.0%
GBP/USD	GBPUSD Exchange Rate	1.2703	3.0%	5.1%
EUR/USD	EURUSD Exchange Rate	1.0909	0.6%	1.9%
USD/JPY	USDJPY Exchange Rate	144.3100	8.6%	10.1%
Dollar Index	Dollar Index Spot	102.9120	0.4%	-0.6%
USD/CNY	USDCNY Exchange Rate	7.25	5.5%	5.1%
Alternatives				
Infrastructure	S&P Global Infrastructure Index	2,697	-0.1%	3.5%
Private Equity	S&P Listed Private Equity Index	175	7.7%	13.5%
Hedge Funds	Hedge Fund Research HFRI Fund-Weighted Composite Index	17,684	-0.8%	0.9%
Global Real Estate	FTSE EPRA Nareit Global Index TR GBP	3,433	-2.4%	-4.4%
Volatility			**Change in Volatility**	
VIX	Chicago Board Options Exchange SPX Volatility Index	14	-27.3%	-37.3%

Source: Bloomberg. All return figures quoted are total return, calculated with gross dividends/income reinvested.

Executive Summary

- Macroeconomic data was generally resilient globally in the quarter, with headline inflation falling in the US and Europe, and remaining steady in Japan. Labour markets remained surprisingly robust and GDP growth remains below trend, but generally positive. Chinese and European manufacturing data has softened in recent months leading to some concern over the anticipated post-COVID rebound for China. The UK was an exception to the disinflation trend, with inflation at an uncomfortably high 8.7% in May but falling more recently to 6.8% in July. Despite falling inflation, the US Fed and ECB continued to hike rates and maintain a hawkish posture because of tight labour markets and stubborn core inflation data. The Q1 banking crisis appears to have been contained, but there are signs of consumer credit card defaults starting to tick up, and it is likely that the effects of the interest rate increases will take time to filter into real economies.
- Q2 was another strong quarter for equities, with global equities (MSCI World) rising around +7% in local currency (+4% in GBP terms). Equity markets were led by growth-oriented stocks (+10.1% for growth, +2.2% for value) as investors jumped on board the new innovation of Artificial Intelligence (AI). Japanese equities performed particularly strongly (+18.5% in local currency, and up +5.9% in GBP terms), as the Bank of Japan has maintained a more accommodative policy than its peers. The Tokyo Stock Exchange has also urged listed companies to become more focused on value creation, such as using cash stockpiles to remedy the low book values to market capitalisations. The combination of the very weak JPY and potential corporate governance improvement has attracted investors to the region. US equities returned just under +5%, though gains have been very concentrated in a few large tech stocks, leaving the rest of the index flat. UK equities, on the other hand, have lagged peers (slightly down in Q2) after a relatively strong 2022, and markets view more risk of recession and negative impacts to employment in the UK than for some other developed markets.
- Bonds, too, faced headwinds as interest rates continued to rise with central banks not yet ready to signal a shift in direction in the fight to reduce inflation. Global investment grade credit was flat over the quarter, but UK long index-linked gilts fell around -10% as yields jumped higher in light of stubborn inflation, and investors now expect UK rates to peak above 6%. Energy prices softened further (oil down -6%), while GBP has continued to strengthen against both JPY and USD, retracing a fair amount of its weakness during 2022.

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

- **Credit spreads indicate a sanguine sentiment to risk.** Credit spreads have tightened since the March banking crisis with US investment grade credit spreads ending Q2 at 120bps, having reached a year to date high of 165bps in March. US high yield bonds spreads have similarly tightened, from a high of 516bps, to 392bps at quarter end, despite incipient signs of rising delinquencies. In the first half of 2023, for example, US Chapter 11 bankruptcies have risen sharply on the same period last year.
- **Inflation – heading towards target, but core inflation proving sticky.** The UK was again the outlier in the quarter with annual CPI only falling to 8.7% in the quarter, compared to 4.0% for the US and 5.5% for Eurozone. However, core inflation (excluding energy and food prices) has been telling a different story. UK core inflation has worryingly risen to a new high at 7.1% in Q2, while US core inflation is now above headline inflation at 5.3% and has only slowly decreased from 6.0% 12 months prior.
- **A narrow range of stocks is driving global equities performance.** In May, Nvidia announced a vastly improved earnings forecast (50% above Wall Street consensus for Q2) driven by the demand for high specification chips used by entities pursuing AI efforts. This prompted a 52% rise in the share price over Q2, and has been emblematic of the recent attention investors are paying to companies with any form of potential for AI products. Indeed, Nvidia, Tesla and Meta have risen by 196%, 142%, and 130% respectively over the year to date. This characteristic, of performance being concentrated in a narrow number of stocks can be symptomatic of the late phases of equity bull markets.
- **Equity valuations rise despite earnings risk.** Equities rose for another quarter, despite analysts' forecasting S&P 500 Q2 earnings declining 7.2% on the year prior. This has led the forward earnings ratio for the S&P 500 to rise to 18.9x, from 17.8x in Q1, and comfortably above its 10-year average of 17.4x. Profit margins for US equities have declined to c.12%, from 14% in 2021 but remain above longer term averages and equity markets appear to be looking past the potential effects of high interest rates and discounting a "soft landing" scenario.

- Global equities rose sharply in Q2, led by US and Japanese equities for varying reasons. The VIX declined over the quarter from 19 to 14, well down on its average level of 21 for the 5 calendar years 2017 to 2022.
  - In the US, the S&P 500 rose by +8.7% and the NASDAQ soared by +15.2%. Markets rallied as enthusiasm for AI boosted a number of some stocks and an upward adjustment to the Q1 annualised GDP figure (from 1.3% to 2.0%) provided support to the view that the US economy may avoid a recession or 'hard landing' despite the sharp rise in interest rates.
  - UK equities fell -0.4% and underperformed global equities. Inflation has remained too high in the UK for the Bank of England, resulting in the base rate being raised to 5.0%, from 4.25% at the end of Q1. The BoE had slowed the pace of rate rises from 50bps to 25bps, but moved back to a 50bps rise in Q2. UK CPI was 8.7% in May, well above the 6.1% figure for the Eurozone.
  - The Euro Stoxx 50 rose by 4.2% in Q2. Economic data was better than expected with inflation continuing to move downwards, although the ECB has maintained a hawkish rhetoric. The composite PMI has however been declining in Q2 and in June fell just into contractionary territory at 49.9.
  - Japanese equities continued their strong run, rising by +18.5% in Q2. A weakening JPY has boosted exporters, as the BoJ maintains very accommodative monetary policy with core inflation currently at 3.2%, as well as the mentioned prospective corporate governance reform. The yen fell 8.6% vs the USD over the quarter.

- Emerging market equities rose +1.0%, underperforming global equities as Chinese stocks fell. Investors had previously pinned hope on a rebound in Chinese stimulus and growth which had propelled Chinese equities in late 2022 and early 2023; however the country has not yet provided meaningful policy stimulus.

- Medium- and longer-term bond yields rose over the quarter, generally rising with rate hikes from central banks resulting in negative performance for government bonds. The US yield curve inversion as measured by the 10 year–2 year ended the quarter at -106bps, as short and mid term rates rose more so than longer bond yields. In corporate bonds, high-yield credit outperformed as credit spreads tightened over the quarter. Emerging market bonds rose 2.7% in local currency, and 2.2% in hard currency.
  - The US 10-year Treasury yield rose in Q2, ending at 3.81% from 3.48%. US rates rose steadily through the quarter, with US GDP being revised upwards for Q1 and job openings (JOLTS) at a strong 9.8 million, compared to 7.2 million in January 2020. The Fed raised their policy rate by 0.25% just once in the quarter (to 5.0%-5.25%).
  - The UK 10-year Gilt yield rose sharply from 3.49% to 4.39% and 2-year from 3.44% to 5.27%. Over the quarter, the spread between UK and German 10 year bond yields widened, reflecting the increased stress viewed on the UK economy (UK approx. +200bps now vs +120bps in Q1, and close to the +228bps in September 2022 during the 'mini budget'). The BoE hiked rates by 25bps two times in the quarter.
  - US high-yield bonds outperformed investment grade, returning +1.7% and -0.3% respectively. European high-yield bonds returned 1.8%, outperforming the 0.2% for European investment grade and -3.1% for UK investment grade.
- Energy prices were mixed over Q2, as gas prices rebounded somewhat although still sharply down from the pre-winter figures. Oil prices have traded down driven by concerns over global growth and oil demand.
- Global listed property continued to decline, with the FTSE EPRA Nareit Global Index falling -2.4% in Q2.
  - The Nationwide House Price Index in the UK has continued its decline, with the price index down -0.3% for the quarter, and down -3.5% on annual basis.
- 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 -2.3% this quarter and -15.9% over the past 12 months.
- In currencies, sterling strengthened against the US dollar (+3.0%) and the euro (+2.3%) 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 rose modestly in Q2 (Dollar index +0.4%).

FUND PERFORMANCE AND INVESTMENT STRATEGY

Overall performance of the Dorset Pension Fund was +1.4% in Q2, matching the benchmark return. The fund lags the benchmark over 1 year and longer time periods and this is a function of the poor performance in 2022 primarily. This is mainly due to disappointing underlying performance from Brunel over the last few years. It is noteworthy on page 12 of the client report, that "excess (performance) since inception (of investment into specific Brunel funds)" shows that positive numbers are scarce. Only Brunel Global High Alpha positively stands out. I also note that the decision to allocate to Global Sustainable Equities has detracted from performance so far, although this fund is not quite 3 years old yet.

Equities represent 57% of the total fund so it is worth studying the individual Brunel equity portfolios. Over a very short period of 3 months the returns range from -0.4% to +8.8% in absolute terms, quite a wide range. Partly this is due to some funds being hedged whilst other are not (GBP was strong during the quarter), partly it is due to regional variations (UK equities are global laggards versus, say, the USA), and partly it is due to the narrow leadership of the world's largest equities, viz. the UK mega-cap technology stocks. This latter factor - whether individual portfolio were overweight or underweight the biggest 7 tech names - determined which portfolios out or under-performed, and was the subject of some of our dialogue with Brunel at the pre-meeting on August 23rd. For example, the Paris Aligned and Climate Transition portfolios are overweight technology, whereas the active managers of the Global Sustainable portfolio wish to underweight them. The outshot is that the former returned +5.3/5.5% over this very short period, whereas the latter returned only +0.1%. Quite a difference.

In coming months we are due a review of the composition of funds within our 57% allocation to equities. This will involve decisions about active versus passive, sustainable versus traditional, emerging versus developed and more. The training events and committee discussion, alongside professional advice, leading up to that should inform the eventual recommendations and decisions.

Brunel has a relatively short track record of only a few years, in line with the development of pooling. During it's time it has been investing against a background that has had three major disruptive events. Firstly Covid, secondly the invasion of Ukraine, and thirdly we now have the emergence of the Artificial Intelligence theme. The first two were sudden and hard to navigate, so we may reasonably make allowances for some performance challenges. That said, whether we achieve our expected investment rate of return in the future will critically depend on Brunel manager selection and over time we should expect them to at least perform in line with benchmarks

Legacy private markets portfolios show good 3 year performance, with quite a lot of noise still in the 1 year data.

Steve Tyson, Independent Investment Adviser

September 2023

APEX

Charts and Data

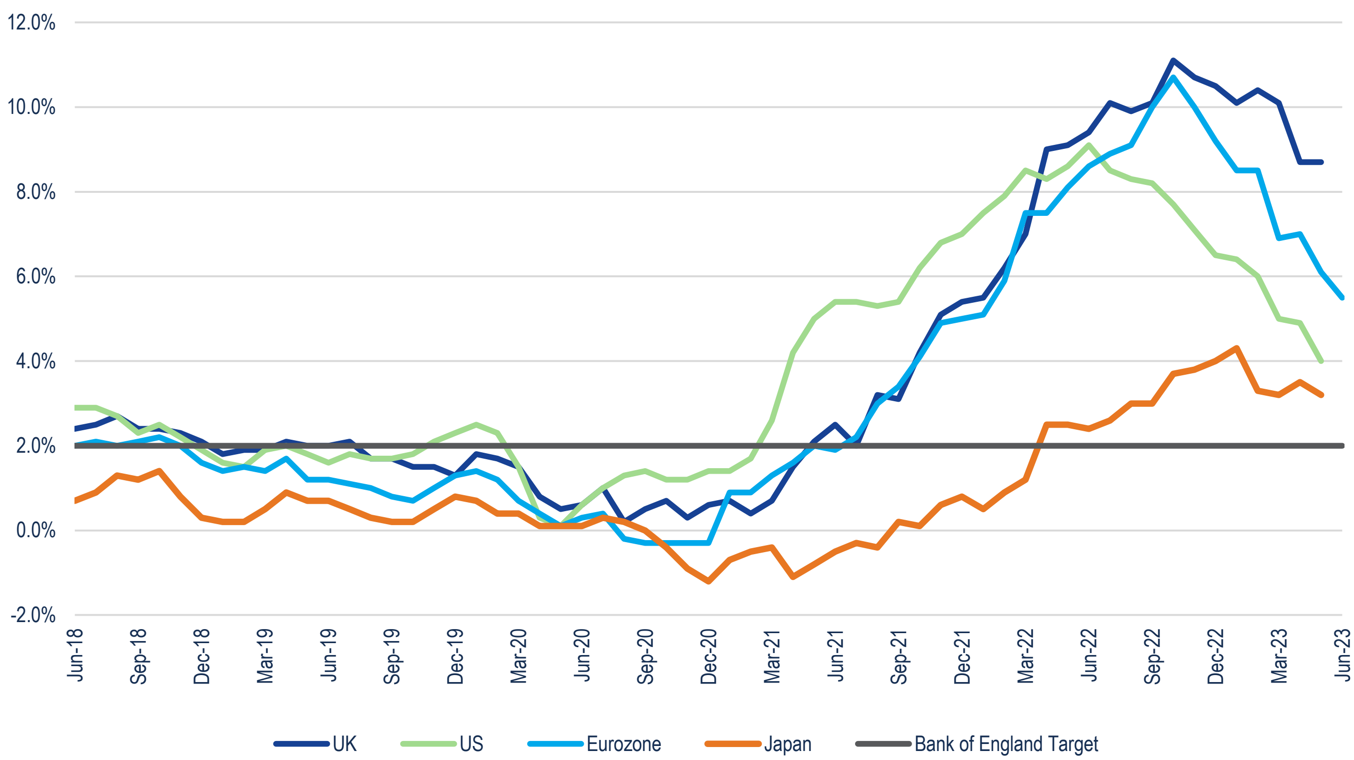
Economic Indicators

Table 1: Quarterly GDP Growth Rate and Monthly CPI

%	GDP		CPI		
	Q1 2023	Q2 2023	Apr	May	Jun
UK	0.1	0.1**	8.7	8.7	n/a*
US	0.5	n/a*	4.9	4.0	n/a*
Eurozone	-0.1	0.3**	7.0	6.1	5.5**
Japan	0.7	1.1**	3.5	3.2	n/a*

Source: Bloomberg; Trading Economics.
Notes: * Not available at time of publication; ** Forecasts based on leading indicators
UK: UK CPI EU Harmonised YoY NSA (Ticker: UKRPCJYR Index); US: US CPI Urban Consumer YoY NSA (Ticker: CPI YOY Index); Eurozone: Eurostat Eurozone MUICP All Items YoY Flash Estimate (Ticker: ECCPEST Index); Japan: Japan CPI Nationwide YOY (Ticker: JNCPIYOY Index).

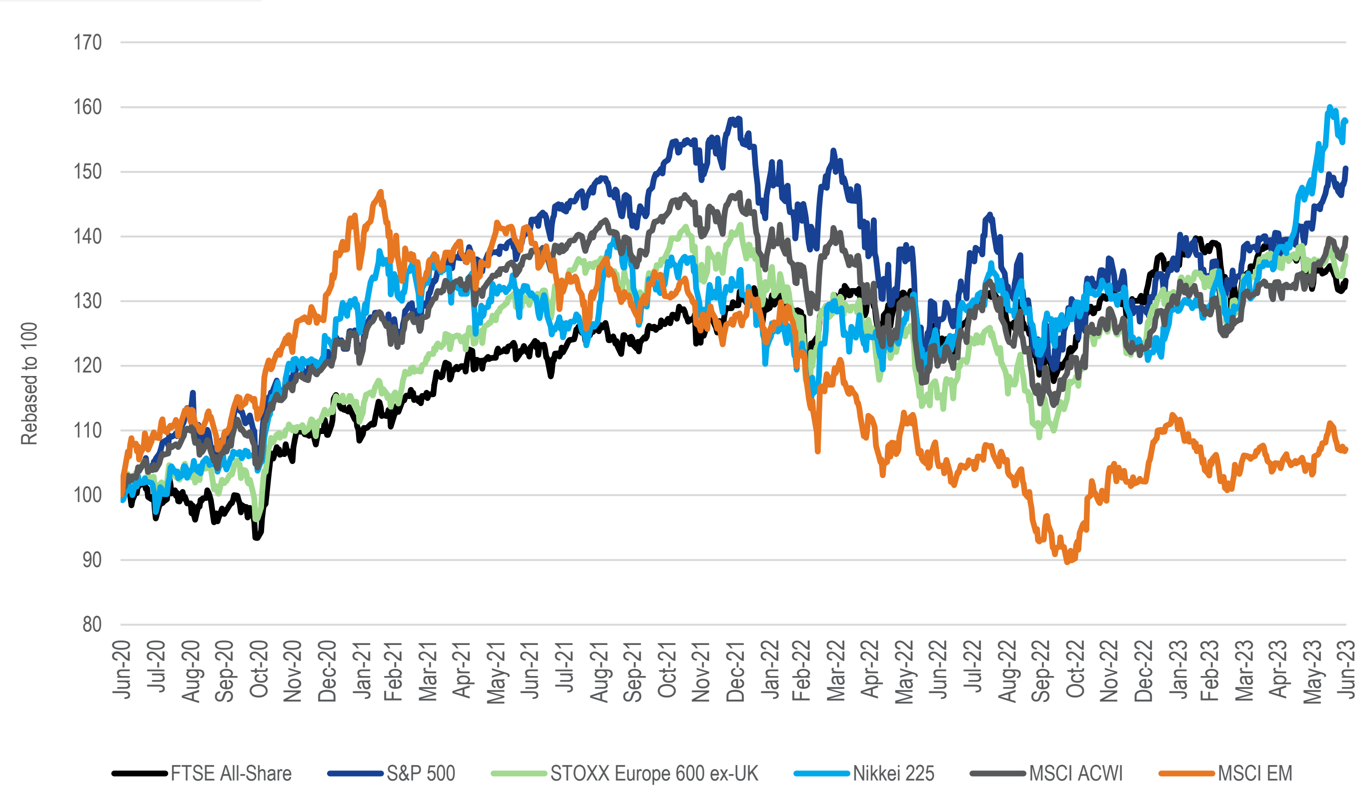
Chart 1: CPI – Annual Rate of Inflation - Five Years to March 2023



Source: Bloomberg
Notes: UK: UK CPI EU Harmonised YoY NSA (Ticker: UKRPCJYR Index); US: US CPI Urban Consumer YoY NSA (Ticker: CPI YOY Index); Eurozone: Eurostat Eurozone MUICP All Items YoY Flash Estimate (Ticker: ECCPEST Index); Japan: Japan CPI Nationwide YOY (Ticker: JNCPIYOY Index).

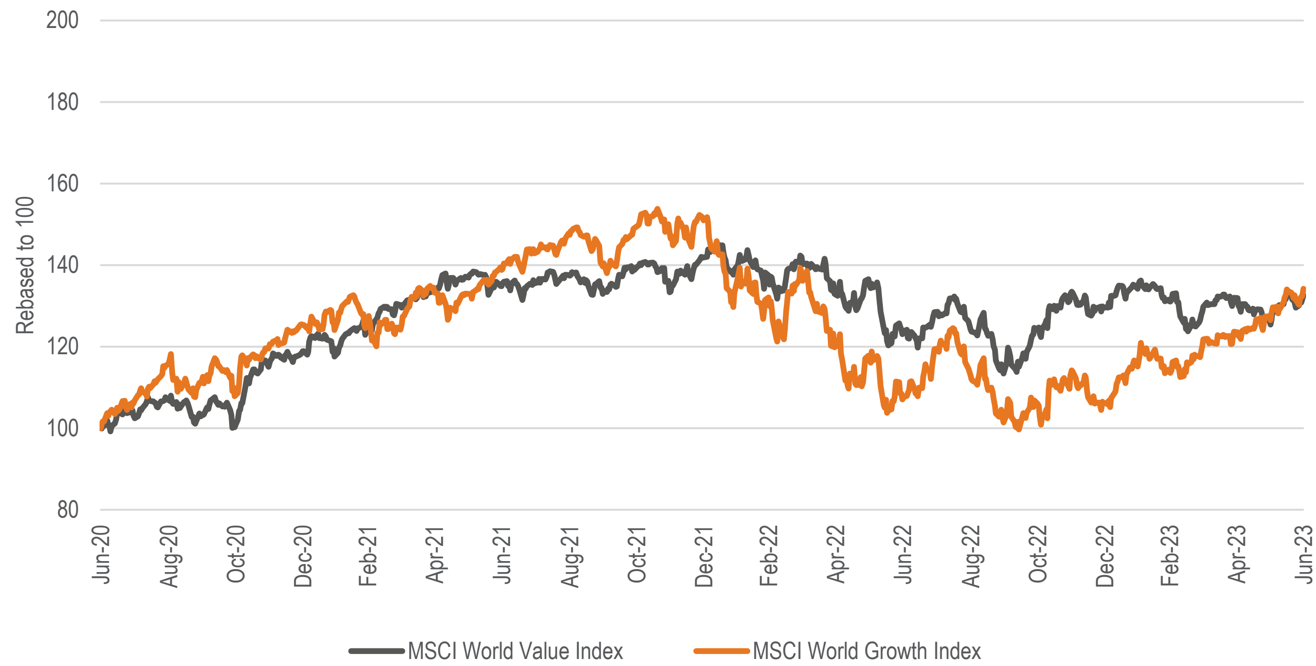
Equities

Chart 2: Global Equity Markets Performance



Source: Bloomberg. All in local currencies
Notes: FTSE All-Share Index (Ticker: ASXTR Index); S&P 500 Index (Ticker: SPXT Index); STOXX Europe 600 (Ticker: SXXG Index); Nikkei 225 Index (Ticker: NKYTR Index); MSCI World Index (Ticker: DLEACWF Index); MSCI Emerging Markets (Ticker: M1EF Index).

Chart 3: Global Equity Markets, Growth vs Value



Source: Bloomberg
Notes: MSCI World Value Index (Ticker: MXWO000V Index); MSCI World Growth Index (Ticker: MXWO000G Index).

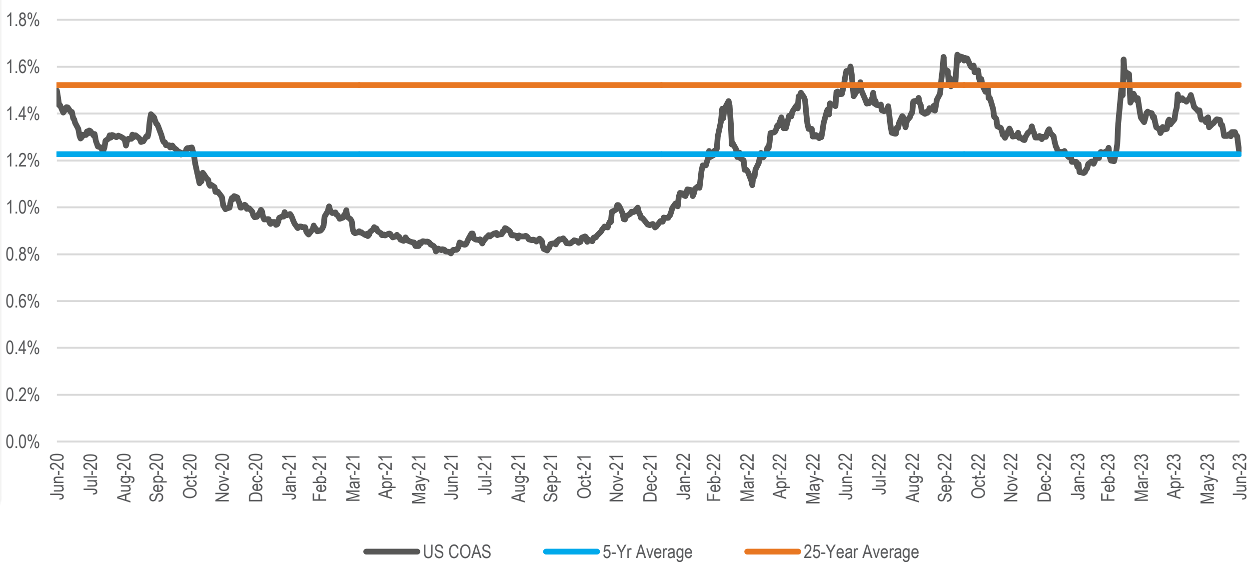
Table 2: MSCI ACWI Composition

Region	Q1 2023 (%)	Q2 2023 (%)
US	60.3	61.9
UK	3.9	3.6
Europe (ex-UK)	13.0	12.4
Japan	5.6	5.5
Emerging Markets	10.6	10.2
Developed Asia-Pacific	3.2	2.8
Other	3.4	3.6

Source: iShares MSCI ACWI ETF

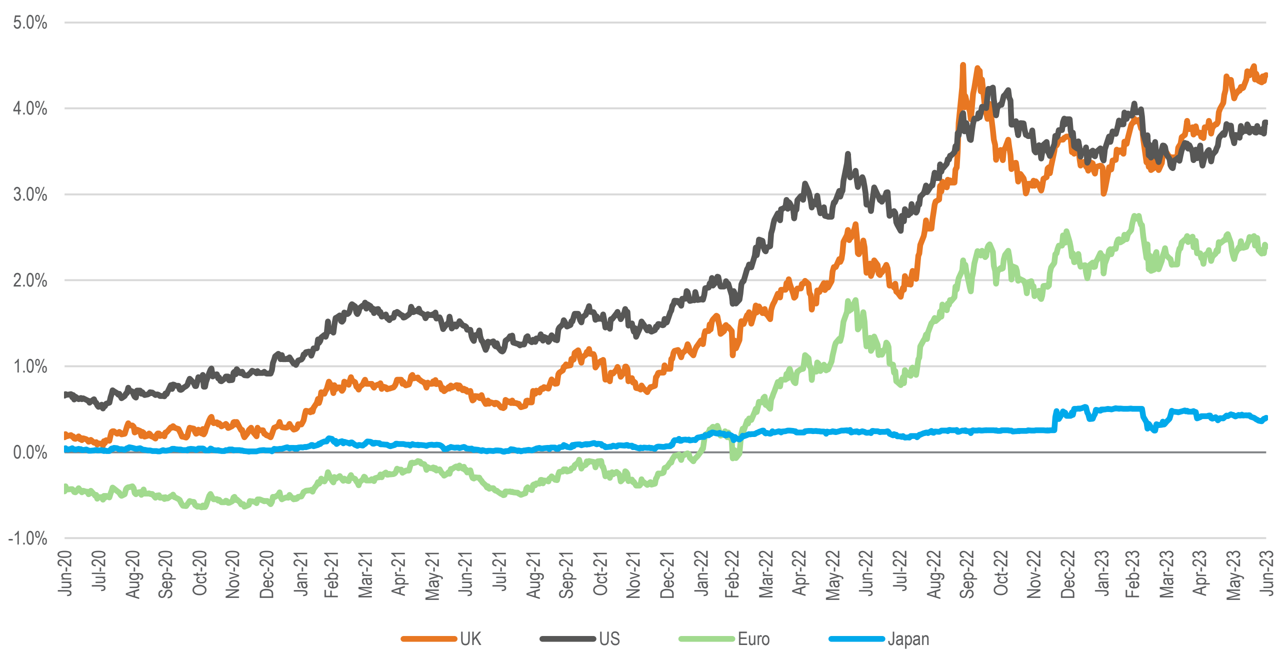
Fixed Income

Chart 4: US Corporate Bond Spreads



Source: Bloomberg
Notes: Bloomberg Barclays US Corporate Option Adjusted Spread (Ticker: LUACSTAT Index); Option-Adjusted Spreads (OAS) represent the difference between the index yield and the yield of a comparable maturity treasury.

Chart 5: Government Bond Yields



Source: Bloomberg
Notes: US Generic Govt 10 Year Yield (Ticker: USGG10YR Index); UK Govt Bonds 10 Year Note Generic Bid Yield (Ticker: GUKG10 Index); Euro Generic Govt Bond 10 Year (Ticker: GECU10YR Index); Japan Generic Govt Bond 10 Year Yield (Ticker: GJGB10 Index).

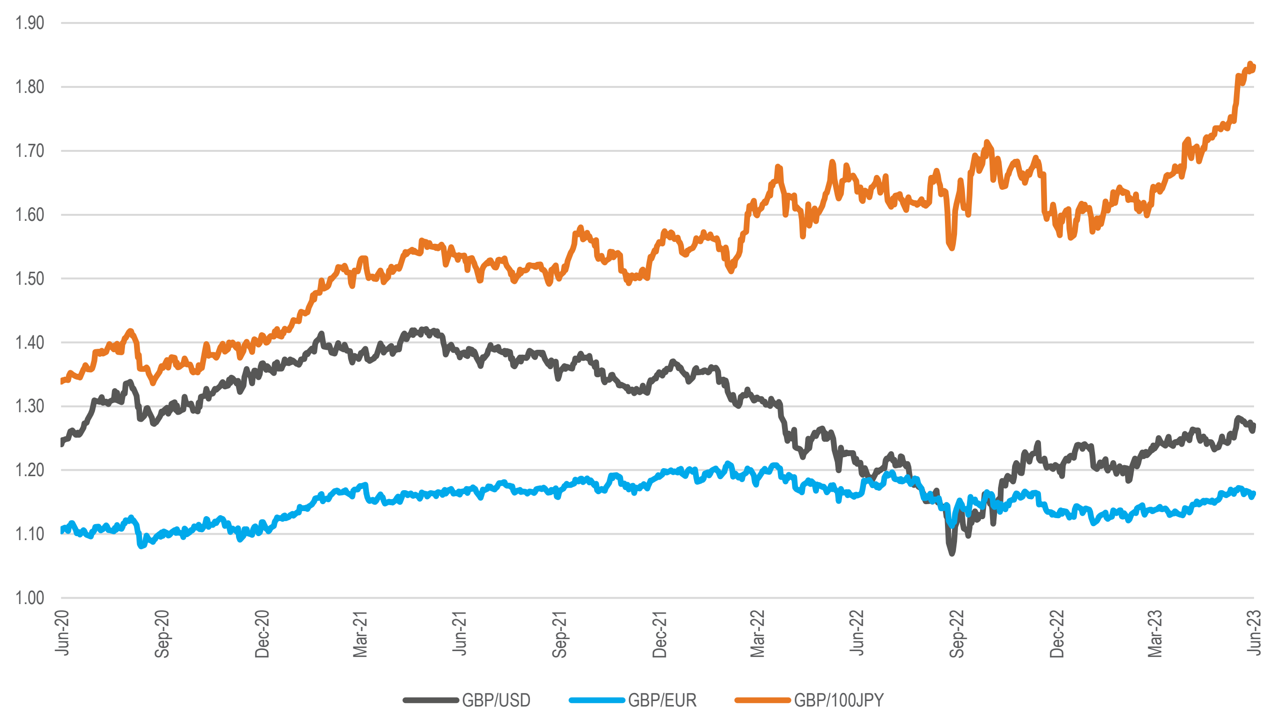
Commodities

Chart 6: Gold and Brent Crude Oil Prices

Source: Bloomberg
Notes: Gold USD Spot (Ticker: XAU Currency); Generic 1st Brent Crude Oil (Ticker: CO1 Commodity).

Currencies

Chart 7: Three-Year Currency Rates of Major Currencies vs Pound Sterling



Source: Bloomberg
Notes: GBPEUR Spot Exchange Rate (Ticker: GBPEUR Currency); GBPUSD Spot Exchange Rate (Ticker: GBPUSD Currency); GBPJPY Spot Exchange Rate (Ticker: GBPJPY Currency).

Table 3: Currency Rates as of 30 June 2023

Pair	Q2 Value	% Change Over Quarter
GBP/EUR	1.1637	2.3%
GBP/USD	1.2703	3.0%
EUR/USD	1.0909	0.6%
USD/JPY	144.31	8.6%

Source: Bloomberg
Notes: GBPEUR Spot Exchange Rate (Ticker: GBPEUR Currency); GBPUSD Spot Exchange Rate (Ticker: GBPUSD Currency); EURUSD Spot Exchange Rate (Ticker: EURUSD Currency); USDJPY Spot Exchange Rate (Ticker: USDJPY Currency)