MJ HUDSON

London Borough of Bromley

Quarterly Report

Q4 2021

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All comments below are based on my understanding of economics and investment markets and are written dispassionately. Please do not see this as a lack of understanding or care about how this affects individual people on the ground.

Performance Summary

The Fund fell 6.88% in the quarter, underperforming its benchmark by 4.93% and is now valued at £1.327bn. Over 4% of the underperformance can be attributed to the underperformance of the Baillie Gifford Global Alpha Equity portfolio which fell 12.37% in the quarter against a fall in the Global Equity index of 2.54%. The Multi-Asset Income portfolios managed by Schroders and Fidelity also underperformed their benchmarks because these benchmarks are stable 'cash +' style benchmarks and in an environment where almost all asset classes fell these two portfolios will underperform their benchmark. The Fund is now fractionally behind it's benchmark over 3years returning 9.5% per annum against 9.8% for the benchmark. The Fund remains above the benchmark over 5 years and longer. Longer term returns remain usefully above the actuarial assumptions which is positive for the Fund's funding ratio.

Comment

By the end of 2021, markets were becoming increasingly concerned about inflation being a more intractable problem than central banks were stating (as discussed in previous reports). The enormous economic stimuluses enacted by various governments to get through the Covid pandemic, on top of loose monetary policy still fighting the 2008/9 global financial crisis (low interest rates and quantitative easing), had left markets awash with cash and the majority of consumers and corporations well financed and ready to spend. Unemployment rates had dropped in the US and EU to pre covid levels and in the US particularly were very low by historic standards.

From an economic point of view, the lockdowns imposed as a result of high Covid infection rates had disrupted global supply chains leading to an inability to respond to any increase in demand. This mismatch between recovering consumer demand hitting still disrupted supply chains was further exaggerated by the Omicron variant of Covid. As much of the northern hemisphere came out of the Omicron wave of Covid in early 2022, China entered it. The strict zero Covid policy adopted by Chairman Xi has led to whole regions being placed into strict lockdown including the economically important region of Shanghai, further disrupting global supply chains. This reinforced the inflation building in the system and raised the prospect of high inflation lasting longer than expected.

Russia's invasion of neighbouring Ukraine has the potential to make the inflationary problem far more intractable. Russia, as a major exporter of oil and gas and both Russia and the Ukraine as major exporters of wheat, maize and sunflower oil as well as other important commodities, has led to price squeezes. In the case of oil and gas it is because much of Europe no longer wants to deal with Russia and is therefore looking for alternative suppliers pushing up prices. In the case of wheat,

Russia's blockading of the Black Sea port of Odessa means that Ukrainian wheat is unable to be shipped to European and global markets.

I do not believe we have fully understood all the implications of these events as yet but, undoubtedly, central banks were too lax in allowing inflation to rise above their 2% target through 2021 in the belief that the rise was due to supply shocks and would, therefore, be transitory. Lockdowns in early 2022 in China, which from April to June this year included a strict lockdown on 26 million people living in the Shanghai region, accentuated this issue but this was still seen as a supply shock and so it could still be argued that the surge in inflation was still transitory.

The Russian invasion of Ukraine changes this. The shock is obviously no longer transitory, the rise in oil, gas, wheat and fertilizer prices will last longer unless the war ends quickly, but the desire for western companies and consumers to no longer trade with Putin's Russia will require an extensive redesign of the global supply for many commodities. Higher prices for food and energy costs are rapidly felt by consumers and leads to demands for higher pay which reinforces the inflationary spiral particularly in countries where unemployment is already low.

Regime shift – Are we there yet?

Regime shifts are large, abrupt, persistent changes in the structure and function of ecosystems, the climate, financial systems or other complex systems. A regime is the characteristic behaviour of a system which is maintained by mutually reinforced processes or feedbacks. Regimes are considered persistent over time. The change of regimes, or the shift, usually occurs when a smooth change in an internal process (feedback) or a single disturbance (external shocks) triggers a completely different system behaviour. – Wikipedia.

In financial markets, regime shifts are denoted by periods of heightened market volatility and uncertainty because we can no longer describe how the economic system works with much certainty.

In my previous reports I have set out the structural factors which have acted as a consistent brake on inflation since Paul Volker's appointment to the US Federal Reserve (US Fed) in 1980 and his drive to bring inflation under control. With the exception of technological change, the other factors are changing and the affect they have on inflation reducing. These are long-term, structural forces which have helped define the disinflationary regime of the last 40 years.

Factor	Past	Future?
Central banks' use of interest rates	Focused on curbing inflation	Focused on not causing a recession and constrained by high national debt levels
Technological innovation	Disrupting businesses and lowering costs	Continuing unabated
Globalisation	Corporate supply chains moving to areas of lowest cost of production	Corporate supply chains focused on areas of secure, stable and friendly government
Demographics	An increasing percentage of the population of working age and economically active	Declining demographic and aging populations reducing the available labour force
Decarbonising the economy	Hardly seen as an issue	A focus of corporate planning and investment, likely to add costs in the medium-term

In addition to these underlying changes are the impacts of two major exogenous shocks, Covid and the Russian invasion of Ukraine.

Covid has forced the closure of whole economies and disrupted supply chains but also encouraged many temporary workers to return to their wider families and places of origin, removing a source of cheap labour from the developed world. This has been particularly true in the UK following Brexit.

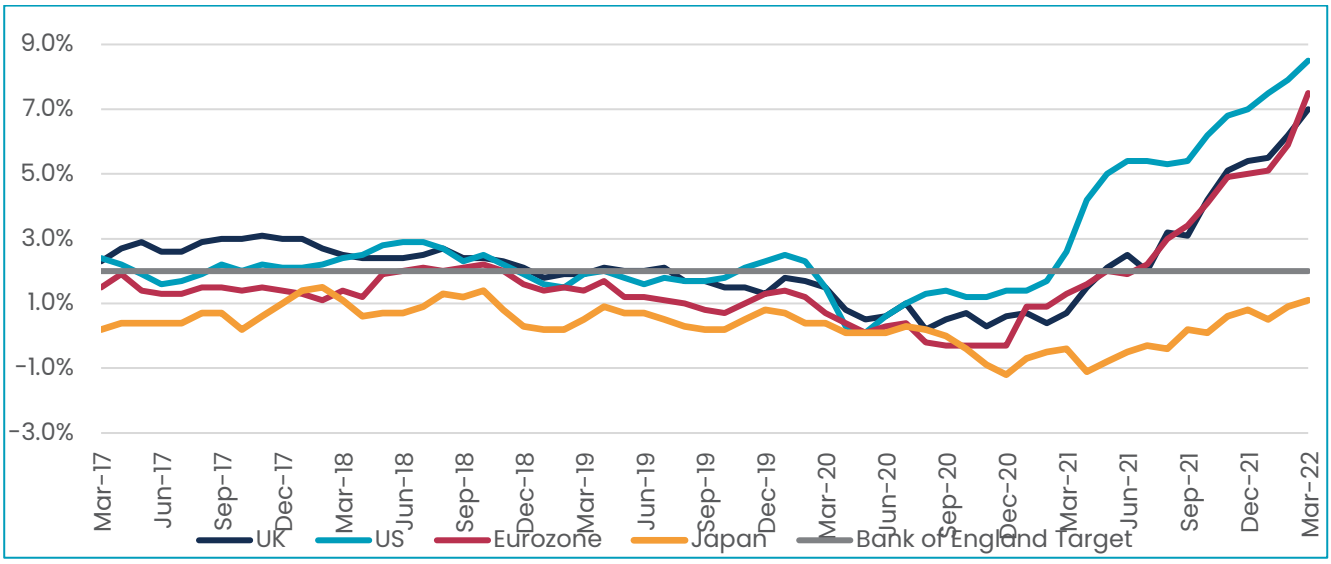
In China, with the 20th National Congress happening in October 2022 where Xi will be elected for a third term and Chairman for life of the Communist party (putting him on a par with Chairman Mao) it is very unlikely that we will see a change to the strict Covid lockdown policy, however, the Chinese vaccines are less efficacious than the US/Europe versions and less of the

population has been vaccinated so the spread of the highly infectious Omicron version is unlikely to be curtailed and lockdowns are likely to continue to disrupt global supply chains.

The Russian war in the Ukraine has reset the clock back to the Cold War, forcing governments and corporates to rethink where and with whom they are prepared to do business. As things stand, there is no obvious exit strategy for President Putin that is acceptable to the West. History tells us that for a conflict to end, there needs to either be a complete victory by one side or, that both sides can claim their objectives have been achieved and therefore sell the end of hostilities to their domestic audience as a success. The further the West pushes Putin into a corner, the more brutal his response will be. If he sees the threat as existential then no action is out of bounds.

In the immediate future, it is no longer about what level of inflation we reach (currently annual Consumer Price Inflation (CPI) is 8.3% in the US; 7.4% in the Eurozone and 7.0% in the UK) as central banks now recognise that inflation is out of control. The question now is whether the response from central banks in raising interest rates and tightening monetary policy will force the global economy into a recession. Their problem is that many of the causes of the current rise in inflation are structural and will not diminish by much in a slowing or falling economy. Central banks have to raise interest rates to show that they are attempting to control inflation and thereby retain investor confidence whilst recognising that doing so will not do much to solve the problem but could make it much worse by pushing the world into a recession.

The chart below shows Consumer Price Inflation for the major economies.



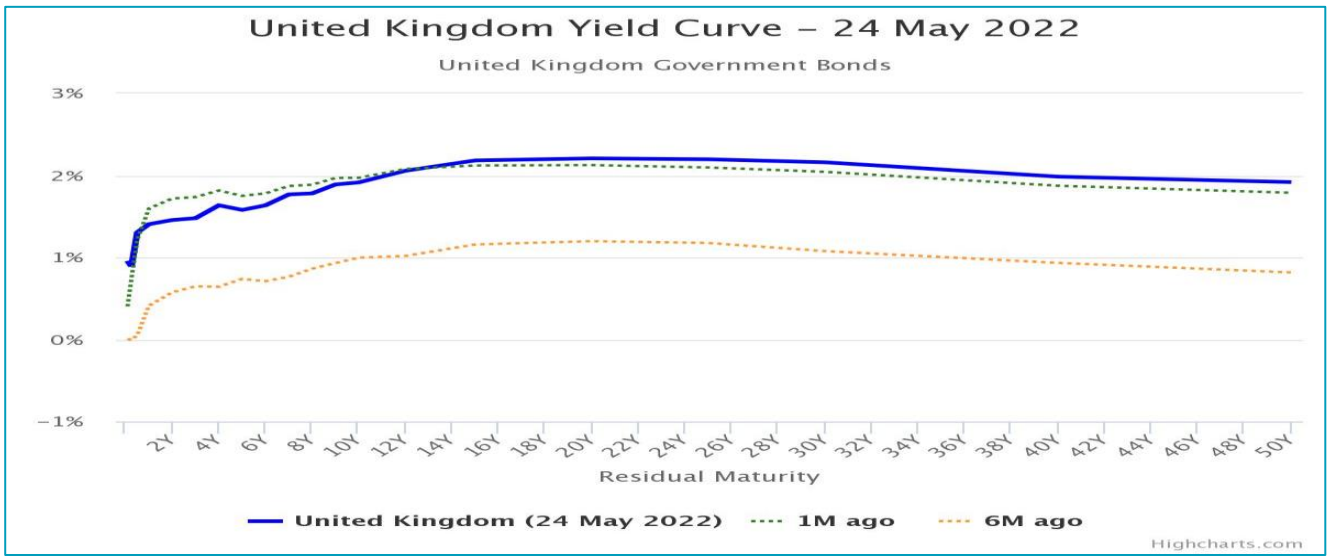
Where my expectations differ from the mainstream is in my belief that inflation will not be transitory but become entrenched for a number of years. The UK and US are particularly susceptible to structural inflation as they have a tight labour market and desire to reduce immigration. Europe will be more impacted by any further curtailment of Russian gas exports and the potential for either Russia or Europe to terminate these export contracts as this is one way the war in Ukraine could be bought to a head, but at a major economic cost with a certain recession in Germany and much of Europe. It is also highly likely that Putin will use the supply of wheat as a bargaining chip with the west despite the effect of this potentially causing starvation across parts of the emerging world.

What to expect in the future.

- Higher and more volatile inflation which may appear in pockets as particular goods or commodities become restricted. The outlook for the lockdown in Shanghai is particularly important here.
- Central banks raising interest rates and inflation potentially coming off its peak but not declining as much as expected.
- Heightened unrest as the price of basic foods rise. A persistent rise in the price of basic foods hits the poor particularly hard. This will lead to strikes in developed countries and is not good for the incumbent political party. In emerging countries without a functioning democracy this is likely to lead to social unrest as currently seen in Sri Lanka.

Markets

Investors have reacted to the spectre of higher inflation lasting more than a few quarters by selling government bonds in the belief that interest rates would have to rise more sharply than consensus. In the UK, Gilt yields moved higher (prices fell) right along the maturity curve suggesting that both short and long-term inflation expectations were rising. This rise in government bond yields has affected the discount rate that investors use to value equities and thereby undermined valuations, particularly of high growth companies where the expected earnings and dividends are further into the future. This resulted in a correlated fall in both equities and bonds which spread across most asset classes in Q1, this has continued into Q2.



At the time of writing (24/5/22) the S&P index (US Equities) is down 18% since the end of the year and UK 10 year Gilts have fallen by 9% with yields rising from 0.9% at year end to 1.8%. Almost all other asset classes have continued to fall so far in Q2.

Investors now expect US interest rates to rise to 3.25% in 2023 and 3.5% in 2024 from 0% as recently as February 2022 and 0.75% currently. If you assume that inflation will subside to 4% by 2024 then current expectations for US interest rates appear about right suggesting that asset prices have adjusted to reflect current expectations. The next few quarters could then see a minor market recovery as central banks raise interest rates and are, therefore, seen as tough on inflation, whilst, inflation, as it is a measure of the year on year change in prices, will peak as previous years price rises fall out of the calculation. The likelihood of an economic slowdown globally in this scenario will cap investors' expectations of how far interest rate rises will have to go allowing bonds to stabilise and equity markets to regain some composure, especially as corporate profits are still growing across many sectors of the economy. Market sentiment is also at very depressed levels suggesting a short-term rebound.

However, this is dependent on China coming out of the present Covid wave and reopening (China may have negative GDP growth in Q2) and on Russia and Ukraine reaching a truce or stalemate. I suspect it is more likely that Putin will use his control of wheat and oil and gas to restrict supply increasing the economic cost to all sides. Personally, I cannot see the situation in Ukraine changing without Europe sanctioning Russian Gas supplies and accepting the severe economic recession that would ensue or Russia acting pre-emptively to shut the gas pipelines down. This situation would undoubtedly push equity markets lower with government bonds reverting to their safe haven status.

The probability that central banks can do just enough to take the steam out of the economy and yet avoid a recession seems unlikely to me and I would expect further downside in markets in the medium term as we adjust to a more inflationary, higher interest rate environment. Once inflation is more stable, equities do have some natural inflation protection making them a more attractive asset class in a higher inflation environment.

The table below gives the 3 month and 2021 return for the major asset classes.

	Index (Local Currency)	Q1 2022	Quarter-on-Quarter	2021
Equities		**Index Value**	**Total Return**	
UK Large-Cap Equities	FTSE 100	7,516	2.9%	18.4%
UK All-Cap Equities	FTSE All-Share	4,188	0.5%	18.3%
US Equities	S&P 500	4,530	-4.6%	28.7%
European Equities	EURO STOXX 50 Price EUR	3,903	-8.9%	24.1%
Japanese Equities	Nikkei 225	27,821	-4.3%	7.4%
EM Equities	MSCI Emerging Markets	1,142	-7.0%	-2.3%
Global Equities	MSCI World	3,053	-5.0%	22.4%
Government Bonds				
UK Gilts	FTSE Actuaries UK Gilts TR All Socks	3,678	-7.2%	-5.2%
UK Govt Bonds Over 15 Years	FTSE Actuaries UK Gilts Over 15 Yr	5,402	-12.3%	-7.3%
UK Index-Linked Gilts	FTSE Actuaries UK Index-Linked Gilts TR All Stocks	5,693	-5.5%	4.2%
UK Index-Linked Gilts Over 15 Years	FTSE Actuaries UK Index-Linked Gilts TR Over 15 Yr	7,859	-8.6%	4.0%
Euro Gov Bonds	Bloomberg EU Govt All Bonds TR	242	-5.3%	-3.5%
US Gov Bonds	Bloomberg US Treasuries TR Unhedged	2,361	-5.6%	-2.3%
EM Gov Bonds (Local)	JP.Morgan Government Bond Index EM Core Index	131	-5.1%	-9.2%
EM Gov Bonds (Hard/USD)	JP.Morgan EM Global Diversified Index	879	-10.0%	-1.8%
Bond Indices				
UK Corporate Investment Grade	S&P UK Investment Grade Corporate Bond Index TR	378	-6.5%	-2.9%
European Corporate Investment Grade	Bloomberg Pan-European Aggregate Corporate TR Unhedge	238	-5.3%	-0.2%
European Corporate High Yield	Bloomberg Pan-European HY TR Unhedged	420	-4.1%	4.2%
US Corporate Investment Grade	Bloomberg US Corporate Investment Grade TR Unhedged	201	-7.7%	-1.0%
US Corporate High Yield	Bloomberg US Corporate HY TR Unhedged	2,342	-4.8%	5.3%
Commodities				
Brent Crude Oil	Generic 1st Crude Oil, Brent, USD/bbl	108	38.7%	50.2%
Natural Gas (US)	Generic 1st Natural Gas, USD/MMBtu	5.64	51.3%	46.9%
Gold	Generic 1st Gold, USD/toz	1,949	6.6%	-3.5%
Copper	Generic 1st Copper, USD/lb	475	6.4%	26.8%
Currencies				
GBP/EUR	GBPEUR Exchange Rate	1.19	-0.3%	6.5%
GBP/USD	GBPUSD Exchange Rate	1.31	-2.9%	-0.9%
EUR/USD	EURUSD Exchange Rate	1.11	-2.5%	-7.0%
USD/JPY	USDJPY Exchange Rate	121.56	5.6%	11.4%
Dollar Index	Dollar Index Spot	98.31	2.8%	6.4%
USD/CNY	USDCNY Exchange Rate	6.34	-0.3%	-2.6%
Alternatives				
Infrastructure	S&P Global Infrastructure Index	2,944	7.5%	11.8%
Private Equity	S&P Listed Private Equity Index	208	-9.5%	43.2%
Hedge Funds	Hedge Fund Research HFRI Fund-Weighted Composite Index	18,083	-0.8%	10.2%
Global Real Estate	FTSE EPRA Nareit Global Index TR GBP	4,148	-0.6%	24.2%
Volatility				
VIX	Chicago Board Options Exchange SPX Volatility Index	21	19.4%	-24.3%

* All return figures quoted are total return, calculated with gross dividends/income reinvested.

Source: Bloomberg

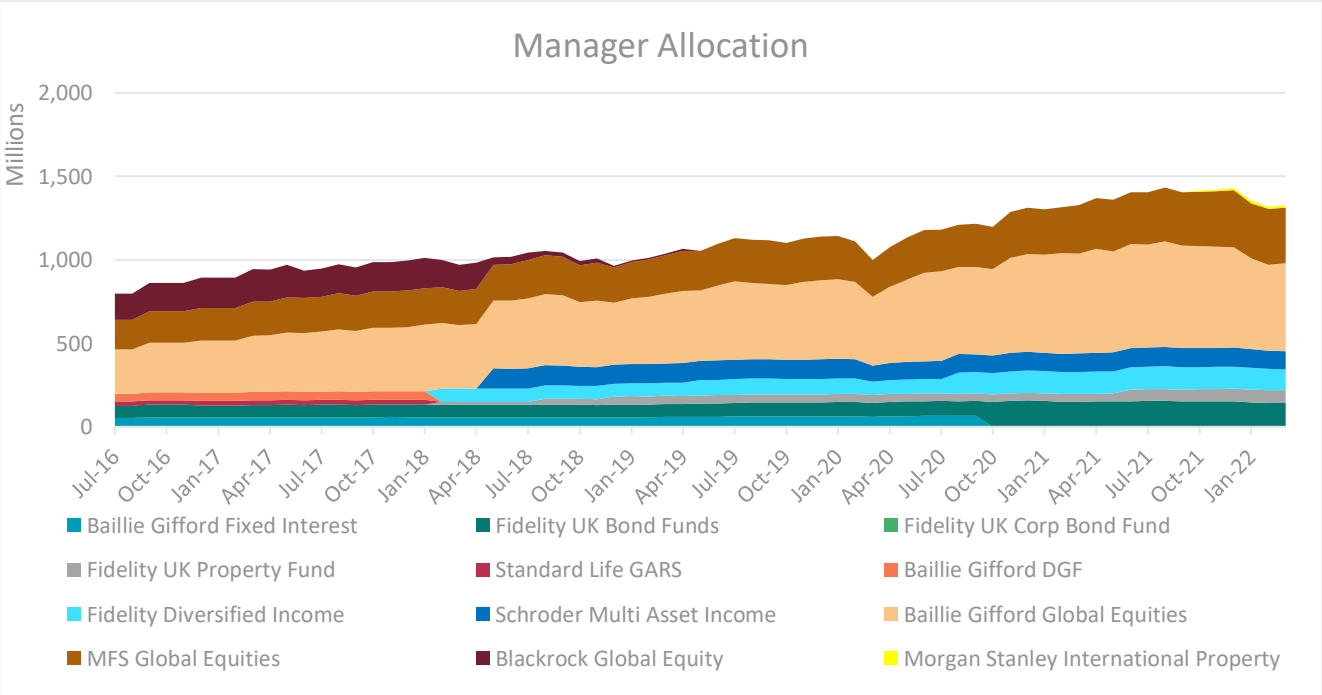
Asset Allocation

The Fund's tactical asset allocation continues to deviate from the Strategic Asset Allocation (SAA) Benchmark, being overweight equities, as shown in the table below. The Fund has commenced drawdown into the International Property Fund and has allocated money to US$ cash to cover the next 9 months of drawdowns. During the fourth quarter the Fidelity Fixed Interest mandate commenced distributing interest payments back to the Fund rather than reinvesting. This will increase the cash flow into the Fund by about £2m p.a.

Asset class	Asset Allocation as at 31/12/2019	Benchmark as at 31/12/2019	Position against the existing benchmark	Asset Allocation as at 31/3/2022	New benchmark going forward	Position against the new benchmark
Equities	64.6%	60%	+4.6%	64.6%	57.5%	+7.1%
Fixed Interest	12.7%	15%	-2.3%	10.7%	12.5%	-1.8%
Property	4.2%	5%	-0.8%	5.9%	5%	+0.9%
Multi-Asset Income	18.5%	20%	-1.5%	17.7%	20%	-2.3%
Int'l Property +US$	n/a	n/a	n/a	1.1%	5%	-3.9%

Because the Fund's investment return has surpassed the level assumed by the actuarial discount rate at the 2019 actuarial revaluation (3.65%) over the last three years, the funding level should have improved, all else being equal. Of course, everything else has not stayed constant and the Fund's liabilities will have increased slightly due to the McCloud judgement and a number of other legisaltive issues. In addition, rising inflation will also have affected the actuary's calculation of the Fund's pension liabilities. These calculations are for the Fund as an open, on-going Defined Benefit Scheme. If the Scheme was to close, less risk should be taken within the investment portfolios and the discount rate would be lower, increasing the current valuation of the Fund's liabilities.

The chart below shows the Fund's assets by manager/mandate



Cash Flow

Your officers have updated their cashflow forecasts for the Fund. These show that the Fund is forecast to have received £34m in contributions but to have paid out £41m in benefits in 2020/1. This shortfall in cashflow, as well as the administrative and investment manager costs, is covered by income received from the Fund's investments. Income is currently taken from the two Multi-Asset Income portfolios, the UK Property portfolio and now the Fixed Interest portfolio. Income from the two Global Equity portfolios continues to be reinvested by their investment managers.

Medium term, the cashflow shortfall (benefits paid less contributions received) is forecast to increase but not exceed the amount of income generated by the portfolio until later this decade.

Given the current high rate of inflation, your officers have stress tested the cashflow figures using current inflation rates for benefit increases, under this scenario the Fund remains able to cover benefit payments from contributions and the income currently taken from investments.

The Fund holds a small element of £ cash as well as the allocation to US$ cash awaiting drawdown into the International Property portfolio.

Funding level

Date	Assets	Current Liabilities	Funding Level	Discount rate
31/3/10	£429m	£511m	84%	6.9%
31/3/13	£584m	£712m	92%	4.95%
31/3/16	£748m	£818m	91%	4.2%
31/3/19	£1,039m	£945m	110%	3.65%
Current	£1,327m	£1,054m	126%*	?

*This is an informed estimate!

The Funding level may deviate from this current forecast due to the impact of legislative changes e.g. the McCloud judgement, changes to the actuarial discount rate or changes to inflation expectations. All these issues should be expected to increase the current valuation of future pension liabilities: even so, I would guess that the Fund currently has in excess of 125% of the value of existing pension liabilities. The actuary assumes that future investment returns will cover the accrual of future pension liabilities. The next actuarial revaluation will commence using the figures from 31/3/2022. I would expect the main change to be the assumptions used for inflation which will have to rise from the 2.4% used in the 2019 revaluation. This will affect the assumptions used for pension increases and salary increases and is likely to increase the cash outflow from the Fund.

Environmental, Social and Governance (ESG)

We continue to await the delayed announcement from the Government regarding the timescale for LGPS funds to prepare TCFD reporting (Taskforce for Climate Related Financial Disclosure). This will be a major task for the Fund as it requires the Committee to set out the following:

- Governance: The organization's governance around climate-related risks and opportunities.
- Strategy: The actual and potential impacts of climate-related risks and opportunities on the organization's businesses, strategy and financial planning.
- Risk Management: The processes used by the organization to identify, assess and manage climate-related risks.
- Metrics and Targets: The metrics and targets used to assess and manage relevant climate-related risks and opportunities.

Each of these sections will require the Committee to think through its current approach to climate change, how this will evolve into the future and what metrics and targets it will monitor to hold itself to account.

It is my intention to update the Carbon emissions reporting from the underlying managers annually in Q4 each year.

Executive Summary

- Investors faced a challenging Q1: rising inflation pressures were exacerbated by Russia's invasion of Ukraine, while central banks' increasingly tough rhetoric led to increased fears that the tighter monetary policy may lead to recession. In addition, China faced a new wave of COVID infections and implemented severe lockdowns in major cities, impacting growth in March. As a result, global equities fell -5.0% over the quarter, with only UK equities bucking the trend (up +2.9%); European and Emerging markets equities suffered most (down -8.9% and -7.0% respectively). Value-oriented stocks experienced more muted declines than growth stocks (-1.2% for the MSCI World Value Index vs -9.8% for the MSCI World Growth Index). Corporate and government bond indices also declined (for the UK indices, by -6.5% and -7.2% respectively), while the hard currency emerging market bond index fell -10.0%, posing a significant challenge to "traditionally diversified" portfolios. Real assets (commodities, real estate) fared better and the USD strengthened against most currencies.
- **GDP growth:** While the growth outlook remained positive in Q1 for developed markets, the expected growth rates are already well below Q4 comparatives and face further headwinds from Russia's invasion of Ukraine. The US is expected to post +0.3% quarterly growth[1], the Eurozone +0.3% and the UK flat. In China, the Chinese Communist Party is continuing to stick to a zero-Covid policy, which has led to widescale lockdowns, including in the financial hub of Shanghai; this has cast doubt on the viability of the +5.5% official target growth over 2022. The World Bank has revised its expected global GDP growth for 2022 from +4.1 to +3.2%. Over the last year, strong corporate earnings have provided significant momentum to global equity markets, however, there are now increased fears that Q1 earnings could disappoint investors as firms face challenges on two fronts with pricing pressures affecting both margins and curtailing consumer demand.

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

  - **Inflation:** Inflationary expectations are now reasonably well discounted by markets (US inflation is expected to average some 4% in 2022, falling to between 2.5 and 3% in 2023) and it is possible that year-on-year inflation is close to reaching its peak, but there are clearly risks to this. The inflationary aspect of Russia's invasion of Ukraine has so far been most acutely felt through the pricing in energy markets, with consumers facing rising fuel and heating costs. This could be further exacerbated by calls for European nations to boycott Russian energy imports, which provide the Kremlin with approximately $400 million per day. Furthermore, the increasing focus on energy security is likely to cause sustained upward pressure on consumers' energy bills. Food costs, particularly wheat, have also increased due to the war given that Russia and Ukraine are among the world's largest exporters. Nonetheless, wage growth has so far lagged behind inflation, despite a tight labour market. If this were to change it is likely to entrench higher inflation expectations, keeping inflation above the policy target rate for longer.
  - **Monetary policy is tightening and interest rates are increasing, but rates remain negative in real terms:** The US Fed increased interest rates by 25bps on 16th March, their first increase since 2018, with the expectation that US rates may peak around 3% in 2023. In addition, the US Fed is expected to start briskly reducing its holdings of high-quality bonds ("quantitative tightening"), which could put more upward pressure on long-term rates and tighten credit conditions. The Bank of England (BofE) also increased the base rate by 25bps in both February and March (to 0.75%) while more hawkish members of the European Central Bank (ECB) have called for the next rate hike as early as the summer.
  - **Increasing risk of recession:** With many of the inflationary pressures being "supply-side", the ability of the central banks to rein in price rises without causing a recession is coming under increased scrutiny. The recent inversion of the US yield curve (with 10-year yields falling below 2-year yields, implying expectations of weakening growth) added to concerns. Market expectations still do not have a recession as the "base case" - employment remains high, consumers well financed and post-COVID recovery momentum continues – but it is no longer a "tail risk". Europe looks more exposed that the US, due to its greater exposure to Russian energy and emerging market exports.
- Global equities had a challenging Q1. All tracked indexes, except for UK equities, suffered significant declines but followed differing paths. In March, most of the developed markets had regained some lost ground as the stalling Russian

[1] Note: US GDP has been de-annualised to be consistent with the other regions.

invasion eased fears of the conflict extending beyond Ukraine's borders. Unsurprisingly, the VIX increased by 19.4% in Q1, from 17.2 to 20.6.

- US equities, measured by the S&P 500, posted large losses over Q1 with the S&P 500 falling -5.2% and the tech-heavy NASDAQ falling by -8.9%. The communication services, technology, and consumer discretionary sectors all declined while energy and utility companies were positive and defence stocks enjoyed double-digit growth over the quarter.
- UK equities performed well over Q1, with both the FTSE 100 (+2.9%) and FTSE All-Share (+0.5%) indices delivering positive returns. Defence stocks along with the oil, mining, healthcare and banking sectors all provided tailwinds for UK large caps. The consumer-focused constituents of the small and mid-cap sectors contributed to their underperformance.
- The Euro Stoxx 50 declined by -8.9% over Q1. Having started the quarter suffering more muted losses than other markets, the geopolitical impact of Russia's invasion caused significant pain across European markets. While sanctions have an obvious adverse effect on trade and capital flows, Russia's position as one of Europe's foremost energy suppliers reflects both further inflationary pressure and concerns around energy security. As such the energy sector was the only source of positive returns while consumer discretionary and information technology were hit hardest.
- Japanese equities continued to decline over Q1 registering a decline of -4.3%. Losses were most severe in January while the market enjoyed a modest recovery in March. Banking and insurance stocks were some of the top performers.
- Emerging market equities were negative over the quarter (-7.0%). The Moscow based MOEX Index declined around -30%, suffering widespread disruption and suspension of normal trading. This was followed by the removal of Russia from the MSCI Emerging Markets Index on 9th March. Chinese stocks also declined as China's zero-Covid policy faltered with surging cases and tens of millions of citizens placed under lockdown. The continued disruption was caused by the de-listing of some Chinese stocks from foreign exchanges. Brazilian markets continued to perform strongly with other net commodity exporters in the Gulf states and South Africa enjoying quarterly gains.

- Global bonds were unusually volatile given the geopolitical situation and the macro-economic backdrop of accelerating inflation and interest rate hikes which underpinned the rise in bond yields. Investors rotated toward safe-haven assets as the war began in February but soon appeared to change stance. Government bond yields rose sharply (prices moved in the opposite direction) in Europe, the UK and the US due to monetary normalisation. Corporate bonds also saw significant negative returns and performed broadly in line with government bonds over the quarter.
  - The 10-year US Treasury Bond yield ended the quarter 83 basis points higher at 2.34%, with Treasuries as a whole providing a total return of -5.6%, with the 2-year yield rising from 0.73% to 2.34%. The 2-year and 10-year portion of the US Treasury yield curve flattened, briefly inverting in March for the first time since 2019 which sent a potential warning sign of a coming recession within a one-to-two-year window. To combat the 40-year high US inflation, which reached 8.5% in March, the US Fed raised interest rates to a target range of 0.25% to 0.5%, which was the first increase since 2018. The unemployment rate edged down to 3.6% and stood at its lowest level since before the pandemic, bolstering the case for the US Fed to speed up the tightening of monetary policy in the fight against inflation.
  - The 10-year Gilt yield increased from 0.97% to 1.61%, with Gilts delivering a total return of -7.2%. Given the UK CPI jumped to a 30-year high of 7.0% in March 2022, the Bank of England raised rates twice in Q1, reaching 0.75% from 0.25% in December 2021. This was done despite concerns around the UK economic outlook and particularly the cost-of-living pressures on households, causing a significant purchasing power squeeze due to higher energy bills. Index-linked Gilts had returned -5.5% by combining the effect of future inflation expectations and the future expected UK Central Bank rate.
  - European government bonds provided a total return of -5.3%. The ECB pivoted towards a more hawkish stance in February and outlined the plan to end bond purchases. The ECB further indicated that a first interest rate rise could potentially come in 2022. The annual Eurozone inflation surged to a record high of 7.5% in March, the highest since the introduction of the Euro in 1992. The Euro area unemployment rate dropped to 6.8% in February, the lowest level on record.
  - US high-yield bonds aligned with the global bonds market, returning -4.8%, with -4.1% performance for European high-yield bonds. Investment-grade bonds returned -6.5% in the UK, -5.3% in Europe and -7.7% in the US.

- Energy prices soared in the first quarter of 2022 with the Russian-Ukraine conflict putting further pressure on already rising prices. The situation exacerbated the effect of rising energy demand and on-going supply constraints, which had already put upward pressure on energy prices in January. Precious metals also surged, with investors moving into traditional safe-haven assets following the Russian invasion.
    - Natural gas prices spiked to $5.64/MMBtu (+51.3%) in the US and to $39.22/MMBtu (+70.0%) in Europe. Russian gas is still flowing through to Europe in large quantities, but investors fear that these supplies could be disrupted by Western sanctions, or even cut off completely as fighting in Ukraine intensifies. Europe currently receives around 40% of its gas supplies from Russia, so is more reluctant to impose sanctions than the US, which has already banned Russian gas imports and, the UK which will phase out imports by the end of the year. Nonetheless, Germany suspended certification of the Russian Nord Stream 2 pipeline.
    - Brent crude oil also experienced soaring prices in Q1 (+38.7%) and reached an intra quarter high of $128 a barrel, reflecting uncertainties about disruptions to supply and further sanctions related to Russia's invasion. The US was able to ban imports of oil from Russia due to its relatively low dependence on Russian supply.
    - Wheat recorded sharp price gains (Chicago Board of Trade Exchange Wheat +30.5%) on supply fears, with Russia and Ukraine together accounting for around 30% of global wheat exports. Wheat is a staple food upon which the most vulnerable depend, so this disruption could have far-reaching consequences for global food security, with Egypt imposing price caps on bread.
    - Gold and Silver prices rose +6.6% and +7.6% respectively in Q1 as investors sought haven assets.
    - Nickel prices rose 54.7% over the month to $32,107/t. Trading of the metal on the London Metal Exchange (LME) was suspended in mid-March following a short squeeze, with prices doubling to a new record high during a single morning. The LME scrapped $3.9bn of trades prior to closing the market, stating that prices no longer reflected the underlying physical market.
- Global listed property had a weak quarter, with the FTSE EPRA Nareit Global Property Index declining -0.6% in Q1.
    - Green Street Advisor's US Commercial Property Price Index remained broadly flat (+0.2%) over the quarter. Nevertheless, this follows a year of strong performance, with an increase of 21.5% over the past 12 months and a 14.6% increase from pre-Covid levels.
    - The Nationwide UK house price index rose once again across Q1 (+4.1%). Annual house price growth increased to +14.3% in March, up from +10.4% in December.
- In the first quarter of 2022, Sterling weakened against the Dollar (-0.3%) and the Euro (-2.9%), with rising living costs, weakening consumer sentiment and greater uncertainty over inflation all undermining confidence in the UK's economic outlook. The Dollar had a strong quarter (Dollar Index +2.8%). The Euro weakened notably against the Dollar (-2.5%) as investors favoured the US over Europe amid heightened uncertainty. The Russian rouble experienced a sharp devaluation, with the decision to invade Ukraine being met by powerful economic retaliation from the West, severely threatening financial stability in Russia.

Performance report

Asset Class/ Manager	Global Equities/ Baillie Gifford
Fund AuM	£526m Segregated Fund; 39.6% of the Fund
Benchmark/ Target	MSCI All Countries World Index +2-3% p.a over a rolling 5 years
Adviser opinion	Manager has exceeded their performance target over the long-term
Last meeting with manager	John Arthur/John Carnegie by phone
Fees	

The Baillie Gifford Global High Alpha portfolio fell -12.37% over the quarter against a benchmark fall of -2.54%. The portfolio is now behind the index over the last year by -19.65%. Long-term performance remains strong with 5-year returns over 1.4% per annum above the benchmark and outperformance of the benchmark since inception of this mandate in 2013.

The table below gives the recent calendar year returns for both the portfolio and the benchmark. As can be seen in the table, performance has varied markedly from the benchmark over the last 5 years and this is because Baillie Gifford have a very strong investment philosophy and process which leads them to build a portfolio which differs markedly from the benchmark index.

	2017	2018	2019	2020	2021	1Q2022
BG Global Alpha	23.3%	-3.7%	28.4%	33.1%	8.9%	-12.4%
MSCI All Country World	13.8%	-3.3%	22.4%	13.2%	20.1%	-2.5%
Relative performance	+9.5%	-0.4%	+6.0%	+19.9%	-11.2%	-9.8%

Baillie Gifford refer to the start of 2022 as an almost perfect storm for their approach to investing with an increasing fear of rising inflation suddenly shrouded in the fog of a war in Europe resulting in an extreme shift in market sentiment away from long-term growth and in favour of companies where it is easier to justify the share price based on today's profitability. The scale of the underperformance is sever and unpleasant for both the manager and the Fund, however, I would not expect Baillie Gifford to alter the way they invest in any way, but to re-examine each of their existing holdings to check whether the original business thesis they built up will withstand a period of higher inflation and perhaps weed out some of the lower conviction investments or those where the business was, in hindsight, at too earlier stage and the growth forecasts unlikely to stand up to a recession. I note there is no increase in turnover within the portfolio and each investment decision made during the last quarter continues to fit with their investment philosophy.

There are however, a number of lessons I think could be learnt from the sudden and severe underperformance of this portfolio following a period of major outperformance.

- I would like to see the Fund adopt a formal rebalancing process such that the weightings of the major asset classes and managers stay within a tighter range around the weightings set out in the Strategic Benchmark. Moving away from the current process of an assumption of 'no action' to one where there are a set of rules which dictates that asset class and manager weightings are rebalance back towards the strategic benchmark once they have drifted away by an agreed. I am happy to put forward a methodology to achieve this and to monitor this going forward.
- To be even more stringent in questioning a manager whose performance is outside of expectations, whether better or worse, and to retain humility.
- Personally for me to try harder to influence the Committee and act with more conviction when I expect a regime shift and the market to alter its behaviour over the medium term.

Since 2020 the Fund has divested £70 from the Baillie Gifford portfolio and allocated over £80m to UK and International property, in part due to this asset classes greater ability to act as an inflation hedge.

Asset Class/ Manager	**Global Equities/MFS**
Fund AuM	£331m Segregated Fund; 25.0% of the Fund
Benchmark/ Target	MSCI World Index (Developed Markets)
Adviser opinion	This portfolio should outperform in a more inflationary environment
Last meeting with manager	18/5/22 Elaine Alston/John Arthur
Fees	

The MFS Global Equity portfolio marginally outperformed the benchmark in the first quarter, returning -2.2% against -2.4% for the benchmark. The portfolio has underperformed over the last 5 years but has marginally outperformed since inception 9 years ago.

The MFS portfolio acts as a useful counterweight to the Baillie Gifford Global Equity portfolio which helps reduce the level of risk taken by the Fund and hence overall volatility. It focuses on companies with a below market valuation but where returns are consistent and competitive positioning within their industry defensible. This makes them more stable in an environment where inflation is rising as the retain more pricing power.

The first quarter of 2022 saw energy companies continue their short-term outperformance. Over the last 12 months, the energy sector within global equity markets is up 60% against the benchmark index returning 15%. MFS do hold a number of energy companies but are marginally below index weighting in this sector. Very few asset managers would have been overweight this sector given the client pressure to show ESG credentials and low carbon emissions.

Turnover within the portfolio has increased over the last few years, no doubt in part driven by the challenges of mediocre performance.

Asset Class/Manager	**UK Aggregate Bond Fund and UK Corporate Bond Fund/ Fidelity**
Fund AuM	£142m pooled fund; 10.7% of the Fund
Performance target	25% Sterling Gilts; 25% Sterling Non-Gilts; 50% UK Corporate Bonds +0.75 p.a rolling 3 year
Adviser opinion	Manager continues to meet long-term performance targets
Last meeting with manager	Phone call during the quarter: Paul Harris/John Arthur
Fees	

The Fund now has two similar Fidelity Fixed Interest portfolios. The UK Aggregate Bond Fund has a benchmark which is 50% UK Gilts and 50% UK non-Gilts; the UK Corporate Bond Fund has a benchmark consisting entirely of UK Investment Grade Corporates and, as such, contains slightly higher credit risk and receives a slightly higher yield. These two portfolios are combined for reporting.

Portfolio	4Q21 performance	Duration	Yield
UK Agg Bond	-6.4%	10.0 years	2.6%
UK Corp Bond	-5.6%	7.9 years	2.8%

The combined portfolio has matched the benchmark over the last quarter and over the last 12 months. Fidelity have added approximately 0.75% of outperformance over the longer term and since inception.

The 1st quarter of 2022 was one of the worst in history for fixed income assets. With the speed of price falls (yield rising) led by changing expectations on interest rates across many countries. This was particularly apparent at shorter maturities of up to 2 years as it was here that the changing expectations were at their greatest. Rising yields for government bonds fed through into the corporate sector and the spread of corporate over government bonds widened although the higher yield available in corporate bonds off set this and cushioned the fall slightly.

The rise in shorter dated maturities has lead to a very flat yield curve with little difference between the yield on 2-year US Treasuries and 10-year US Treasuries. Historically, 2 year US Treasury yields above 10 year US Treasury yields has historically been a sign of an impending recession. This happened briefly during March this year but has now backed off as investors concerns shift from rising interest rates driven higher to combat rising inflation to concerns over a recession and the need for central banks to lower interest rates to aid an economic recovery.

Asset Class/Manager	Mult-Asset Income / Fidelity
Fund AuM	£126m Pooled Fund; 9.5% of the Fund
Performance target	LIBOR +4% including a yield of 4% per annum
Adviser opinion	
Last meeting with manager	By phone during the quarter John Arthur/Paul Harris
Fees	

Asset Class/Manager	Multi-Asset Income / Schroders
Fund AuM	£109m Pooled Fund; 8.2% of the Fund
Performance target	LIBOR +5% including a yield of 4% per annum
Adviser opinion	
Last meeting with manager	By phone during the quarter: John Arthur/ Russel Smith/Remi Olu-Pitan
Fees	

The Fidelity Multi-Asset Income portfolio fell 4% over the quarter whilst the Schroders portfolio fell 4.2%. Over 12 months the Fidelity portfolio has returned -0.4% and the Schroders portfolio +1.1%. Over three years the Fidelity portfolio has returned 2.1% per annum and the Schroders portfolio 1.8% per annum. Both these returns are below their benchmark for each period. As previously noted, the benchmarks for these portfolios are of a cash +x style (see boxes above) and as such will increase by a margin over cash each quarter irrespective of market moves. Whilst both portfolios have underperformed their respective cash benchmarks they do serve an important purpose in that they distribute dividends back to the main Fund which helps cover the cash outflow as pension payments are greater than employer and employee contributions. By removing the need to constantly divest assets form the Fund to cover this cash outflow the Fund is more secure and does not have to sell assets during a period of stressed market conditions. Over the past 10 years diversifying away from Equities and Bonds has lowered Fund returns but this may now change as we move into a more complex and volatile economic and market environment.

Asset Class/Manager	UK Commercial Property / Fidelity
Fund AuM	£78m Pooled Fund; 5.9% of the Fund
Performance target	IPD UK All Balanced Property Index
Adviser opinion	
Last meeting with manager	Phone calls during the quarter John Arthur/Paul Harris
Fees	

I am currently in discussions with your custodian over the calculation of this benchmark as I believe it may be incorrectly calculated.

The Fund increase its weighting in the Fidelity UK property portfolio 12 months ago partly as an inflation hedge. Over the quarter property was again the strongest performing asset class with the portfolio returning 4.3%.

Over the last 12 months the UK property portfolio has returned 22.9% against global Equities returning 12.9% and the combined Fixed Interest portfolio returning -5.4%.

The portfolio performance has been driven by an underweight in retail and a high exposure to industrial properties. On top of this a number of major properties has been redeveloped to a higher environmental standard and to be industry leading in their sector and geography, this has lead to higher rents and thereby higher valuations. The vacancy rate within the portfolio has fallen from a very high 15% at the start of the redevelopment cycle and is expected to fall below the industry average of below 10% by the end of this year.

I would expect the very strong performance of the last 12 month to begin to slow over the rest of the year but still see this portfolio as a useful inflation hedge. If we do enter a recession, the exposure to offices may need some thought as I would expect tenants to reduce their office space requirements when under financial stress as the new mode of increased working from home crystalises in a lower requirement for office space.

The manager continues to make progress on the four major redevelopments

Asset Class/Manager	International Property / Morgan Stanley
Fund AuM	US$80m(£57.5M) committed / £3.6m drawn. Limited Partnership; 0.2% of the Fund
Performance target	Absolute return
Adviser opinion	
Last meeting with manager	Phone calls during the quarter John Arthur/Gareth Dittmer
Fees	

The International Property portfolio is now valued at £3.6m and we should expect drawdowns of around £15-20m over the remainder of this year. The Fund currently holds £11.1m in US cash to cover this drawdown, has some UK cash and is cash positive when distributions from other portfolios is taken into account. I understand from your officers that the Fund could expect some pension contributions from admitted bodies to be bought forward following the current actuarial review. Given this, the Fund is currently expecting to have enough cash to finance the next 9-15 months of drawdowns and possibly longer. This means that there is currently no requirement to sell assets to finance the expected drawdowns.

The portfolio remains diversified globally with investments in the US, UK, Europe, Japan and India and is invested in industrial warehouses and residential at the current time. It will become more diversified by geography and sector as further investment are made.