# Gloucestershire Pension Fund

## Quarterly Report

**Q4 2022**

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# Performance Summary

The fourth quarter showed some rebound from the poor performance of the first 9 months as, although central banks continued to raise interest rates, markets began to look forward to a period of falling inflation. The table below shows that whilst many asset classes recovered in the fourth quarter, they were still down over 2022 as a whole.

| | Index (Local Currency) | Q4 2022 | Quarter-on-Quarter | YTD |
|---|---|---|---|---|
| **Equities** | | | **Total Return** | |
| UK Large-Cap Equities | FTSE 100 | 7,452 | 8.7% | 4.6% |
| UK All-Cap Equities | FTSE All-Share | 4,075 | 8.9% | 0.2% |
| US Equities | S&P 500 | 3,840 | 7.5% | -18.1% |
| European Equities | EURO STOXX 50 Price EUR | 3,794 | 14.9% | -8.5% |
| Japanese Equities | Nikkei 225 | 26,095 | 0.7% | -9.0% |
| EM Equities | MSCI Emerging Markets | 956 | 9.6% | -19.9% |
| Global Equities | MSCI World | 2,603 | 9.9% | -17.7% |
| **Government Bonds** | | | | |
| UK Gilts | FTSE Actuaries UK Gilts TR All Socks | 3,018 | 1.7% | -23.8% |
| UK Gilts Over 15 Years | FTSE Actuaries Uk Gilts Over 15 Yr | 3,694 | -1.8% | -40.1% |
| UK Index-Linked Gilts | FTSE Actuaries UK Index-Linked Gilts TR All Stocks | 4,000 | -6.0% | -33.6% |
| UK Index-Linked Gilts Over 15 Years | FTSE Actuaries UK Index-Linked Gilts TR Over 15 Yr | 4,564 | -12.8% | -46.9% |
| Euro Gov Bonds | Bloomberg EU Govt All Bonds TR | 208 | -2.1% | -18.5% |
| US Gov Bonds | Bloomberg US Treasuries TR Unhedged | 2,188 | 0.7% | -12.5% |
| EM Gov Bonds (Local) | J.P. Morgan Government Bond Index Emerging Markets Core Index | 124 | 7.8% | -10.2% |
| EM Gov Bonds (Hard/USD) | J.P. Morgan Emerging Markets Global Diversified Index | 804 | 8.1% | -17.8% |
| **Bond Indices** | | | | |
| UK Corporate Investment Grade | S&P UK Investment Grade Corporate Bond Index TR | 330 | 6.4% | -18.4% |
| European Corporate Investment Grade | Bloomberg Pan-European Aggregate Corporate TR Unhedged | 213 | 1.7% | -15.1% |
| European Corporate High Yield | Bloomberg Pan-European HY TR Unhedged | 389 | 4.7% | -11.1% |
| US Corporate Investment Grade | Bloomberg US Corporate Investment Grade TR Unhedged | 2,968 | 3.6% | -15.8% |
| US Corporate High Yield | Bloomberg US Corporate HY TR Unhedged | 2,186 | 4.2% | -11.2% |
| **Commodities** | | | | |
| Brent Crude Oil | Generic 1st Crude Oil, Brent, USD/bbl | 86 | -2.3% | 10.5% |
| Natural Gas (US) | Generic 1st Natural Gas, USD/MMBtu | 4.48 | -33.9% | 20.0% |
| Gold | Generic 1st Gold, USD/toz | 1,826 | 9.9% | -0.1% |
| Copper | Generic 1st Copper, USD/lb | 381 | 11.7% | -14.6% |
| **Currencies** | | | | |
| GBP/EUR | GBPEUR Exchange Rate | 1.13 | -0.8% | -5.0% |
| GBP/USD | GBPUSD Exchange Rate | 1.21 | 8.2% | -10.7% |
| EUR/USD | EURUSD Exchange Rate | 1.07 | 9.2% | -5.8% |
| USD/JPY | USDJPY Exchange Rate | 131.12 | -9.4% | 13.9% |
| Dollar Index | Dollar Index Spot | 103.52 | -7.7% | 8.2% |
| **Alternatives** | | | | |
| Infrastructure | S&P Global Infrastructure Index | 2,658 | 11.0% | -0.2% |
| Private Equity | S&P Listed Private Equity Index | 159 | 11.8% | -28.2% |
| Hedge Funds | Hedge Fund Research HFRI Fund-Weighted Composite Index | 17,520 | 1.7% | -3.9% |
| Global Real Estate | FTSE EPRA Nareit Global Index TR GBP | 3,590 | -0.3% | -14.0% |
| **Volatility** | | | **Change in Volatility** | |
| VIX | Chicago Board Options Exchange SPX Volatility Index | 22 | -31.5% | 25.8% |

Source: Bloomberg

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

The Fund rose by 2.1% over the quarter which looks poor given the equity market recovery shown in the table above but the asset class returns quoted above are in local currency. The recovery in Sterling from the Truss/Kwarteng debacle has been reasonably rapid but has actually been driven more by the weakness of the US Dollar than by Sterling strength. US domiciled stocks account for over 60% of the MSCI Global Equity index. A global equity portfolio hedged back to Sterling would have returned nearer 7% over the quarter. This Fund return outperformed that of the benchmark by 0.1%. The Fund was valued at £2.947bn at the year end. Over the last year the Fund fell by -8.7%, against a fall in the benchmark of -6.9%. As discussed in the previous report, this underperformance was mainly at the manager level and given the market movements of last year would seem to be linked to the low carbon approach driven by Brunel in their manager selection process as energy stocks were one of the very few positive areas of return last year. Over the longer term the Fund has risen by 7.9% per annum which is in line with the benchmark.

# Issues for the Future

- To decide whether to follow the Government's Levelling-Up agenda in setting aside 5% of the Fund to invest in UK based Infrastructure and Social/Affordable housing.

# Comment

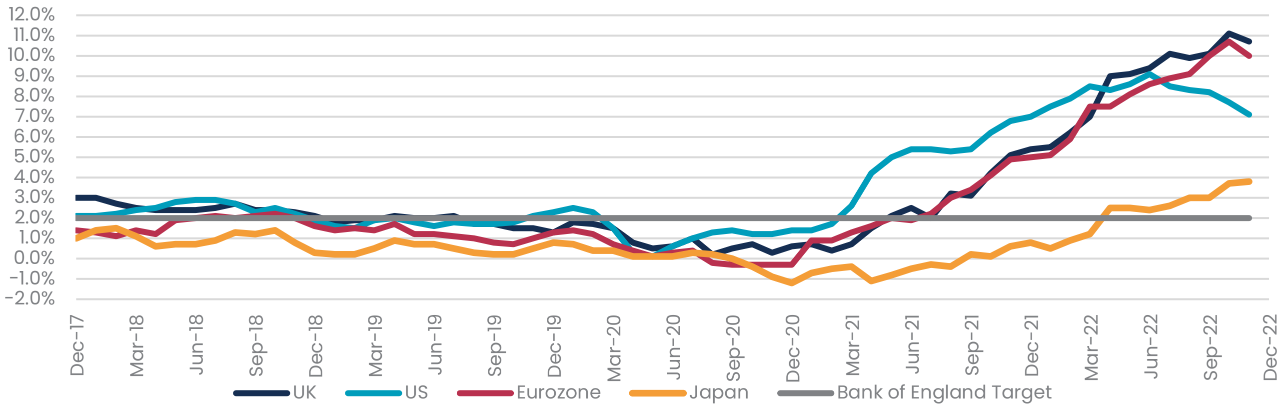
Interest rates continue to rise and will do so for at least another quarter across the US, UK and EU. The questions are:

- Has inflation peaked?
- How quickly it will come down?
- Will the rise in interest rates cause a recession?

The answer to these questions will set the tone for markets globally because all asset classes are, to some extent, priced off the expected government bond yield (theoretical risk free rate).

The chart below shows the Consumer Price Inflation (CPI) rate for the major economies. This is a year on year comparison and measures how much prices have changed against this time last year. We are now at the stage where the rapid rise in energy prices following the Russian invasion of Ukraine will fall out of the year on year comparison and be replaced by falling prices for energy as gas and oil prices have fallen back from their peak. This will push inflation lower at quite a pace and has the potential to push inflation below 5% quite quickly in some areas.

Chart 1: CPI – Annual rate of Inflation - Five Years to December 2022



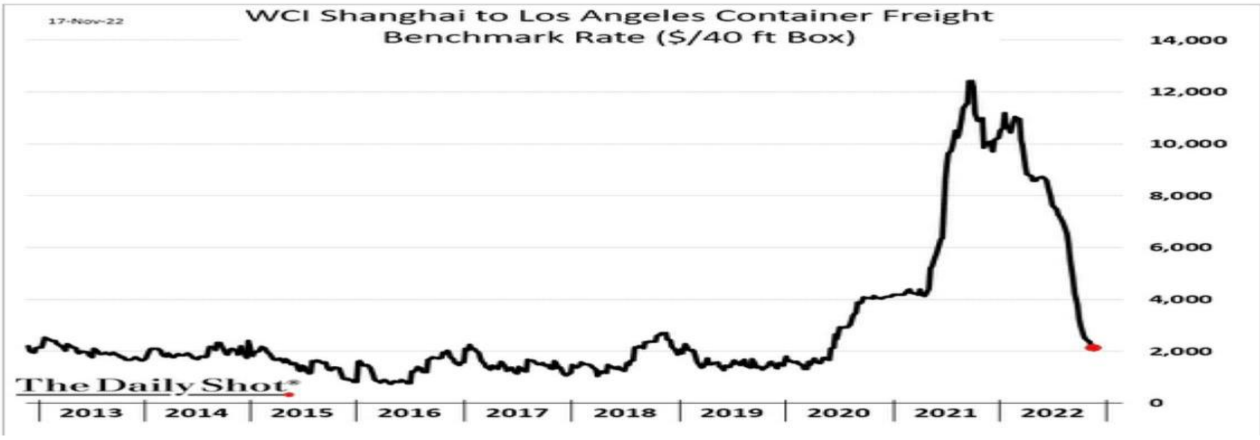

Source: Bloomberg

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)

As can be seen from this chart, US inflation looks to have peaked and this should be followed by the Eurozone and hopefully UK inflation.

In addition to falling energy prices due to a warm winter in the northern hemisphere lowering demand and enabling Europe to replace Russian gas with gas from other sources, the common thread on inflation is that the global supply chain disruptions post Covid are being solved as shown by falling shipping rates. The chart below shows the cost of shipping a standard container from China to the US west coast.

Chart 2: Container shipping rates




This chart is echoed in second hand car prices which are now falling and further evidenced by the recent cut in the list price of Tesla's model Y by 20% amongst other data points all indicating that supply chains are becoming more efficient again.

However, in the US, part of the inflationary problem is a very tight labour market which has been pushing up wages. This will only change when the economy slows, reducing the demand for labour and raising unemployment. Arguably, this can only be achieved by causing a recession. Historically, we have not seen an increase in US interest rates of the current magnitude, over a such a short period of time, without it causing a recession.

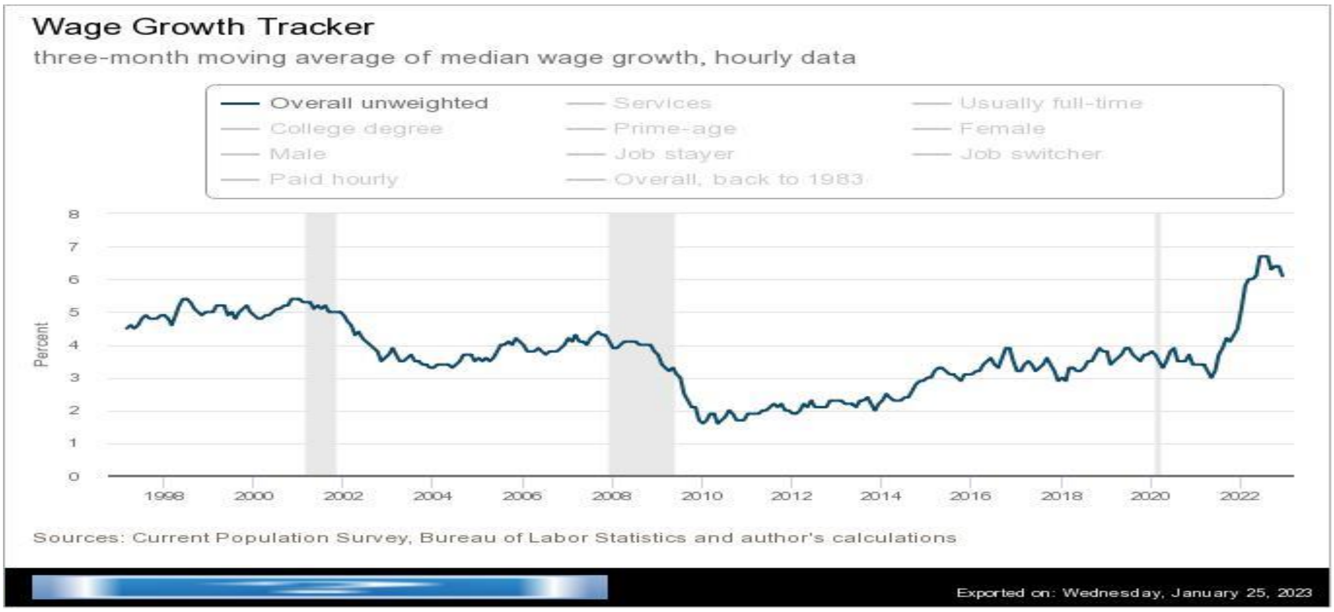
Even as inflation slows in the US, it is energy and food inflation which is coming down. Wage inflation and service sector inflation will be much harder to squeeze out of the system and I am concerned that the US Federal Reserve (US Fed), which sets US interest rates, may hold interest rates higher for longer than the market now expects.

The chart below shows the US unemployment rate which is still at multi decade lows suggesting little slack in the economy and will force a continuation of wage inflation.

Chart 3: US Unemployment rate


The level of job vacancies continues to run at a multiple of those looking for work and wage pressures are only slowly rolling over.

Chart 4: US Wage Growth




Within Europe, energy prices have had a much more direct effect on inflation due to the reliance of the region on Russian gas prior to the invasion of Ukraine. The fact the energy prices are now well below the level hit last year will mean that their effect on inflation will fall out of the calculation very rapidly and we will see falling inflation for the region going forward. Nonetheless, I would expect the European Central Bank to continue to raise interest rates for a while yet. Europe does not have such a tight labour market as the US and hence wage growth is likely to come under control much faster in this region providing the Russian war in Ukraine does not cause further disruptions.

Unfortunately, the problem child is the UK where our energy prices are linked to the European gas price and we have a labour shortage in a number of sectors, in part caused by Brexit. When I wrote about Brexit 5 years ago, my expectation was that there would be a short-term cost as regulations changed but that over the long-term, the UK's innovative and entrepreneurial spirit would eventually shine through, the problem was I was unsure of how long that would take, potentially a couple of years or potentially a generation! Unfortunately, not one of the string of governments we have had post Brexit has really thought through how to reorganise the UK economy and to enact detailed regulation to take advantage of leaving the EU. There appears to be no long-term planning and little intellectual foresight at present. The UK is predicted by the International Monetary Fund (IMF) to have the slowest economic growth of all G7 developed countries for both 2023 and 2024 and be the only G7 country where the economy has failed to recover to pre Covid levels over this period.

For Investors, there has been a substantial rally in global equity markets from the October lows, with the MSCI global equity index up 17% by end January 2023, investors now seem to be predicting that the US and EU will not enter a recession this year, inflation will fall back below 5% and that central banks will stop rising interest rates soon and start cutting by year end. Whilst this is possible it does not seem the most likely scenario for the future to me. If either the economy weakens into a recession or stays strong forcing central banks to raise interest rates further, then markets may struggle to make further progress for much of this year. The US will remain the lead economy and therefore the actions of the US Fed are likely to set the market tone.

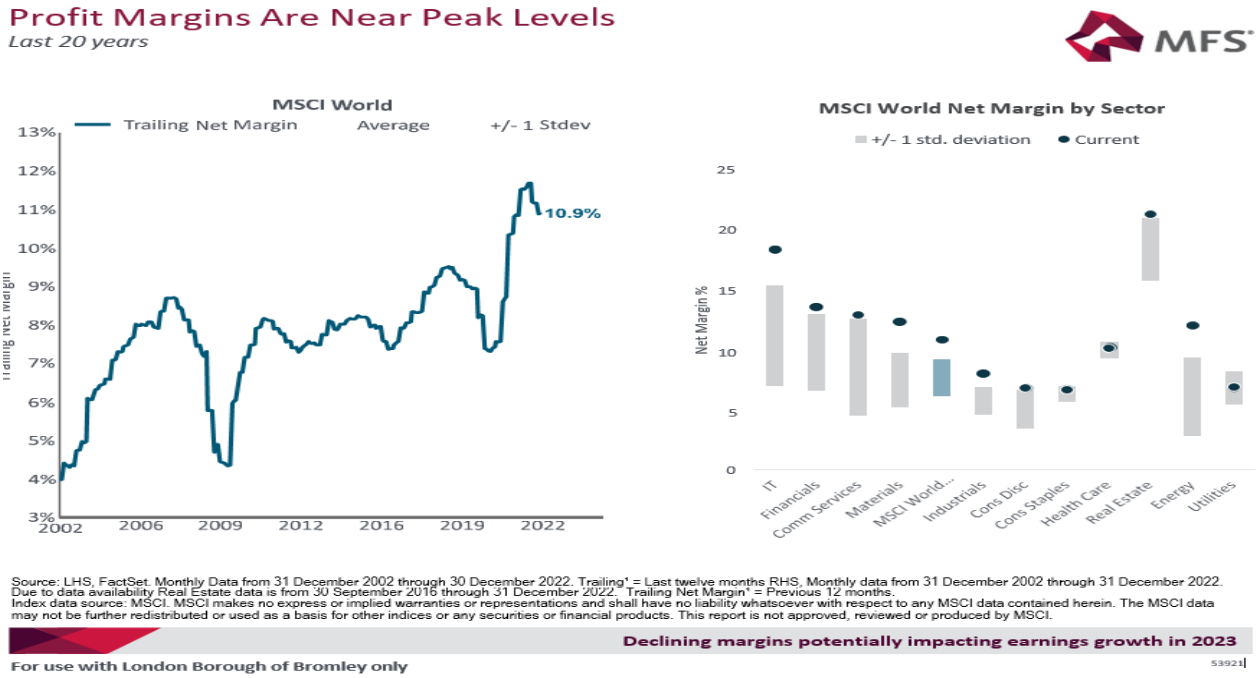
There are three potential economic outcomes for the future to my mind, listed below. I have added my own thoughts on the probability of each outcome:-

1) A 'Soft Landing' with the US Fed hiking rates from the current 4.5% up to 5% over the spring and then pausing during which time US inflation slows allowing the US Fed to cut interest rates into a slowing economy during the second half of this year. In this scenario, Equities would rise further as we would revert to a low interest rate environment. (Likelihood 10%.)

2) A quick ‘Hard Landing’ as the effect of the recent rises in interest rates finally impacts the consumer, the economy slows rapidly allowing the US Fed to step in and cut rates. In this scenario Equities would fall as corporate earnings expectations take a hit but short-dated bonds would do well as interest rates are cut in the second half of the year. (Likelihood 20%.)
3) Persistent underlying inflation and a longer recession. In this scenario, the US Fed raises rates to 5% over the next few months and then pauses as inflation is falling. However, because the fall in inflation is driven by falling energy prices and other more transitory factors rather than falling wage growth, inflation bottoms in the summer but then rises back towards 5% forcing the US Fed to recommence raising interest rates in the autumn, this is likely to drive both equities and bonds lower. (Likelihood 70%.)

I would note that corporate profit margins are at extreme levels at present, as shown in the charts below. It may be that corporates will allow profit margins to reduce in the interest of retaining labour, but the chart suggests there should be little further upside in profit margins from current levels and the potential for earnings downgrades during a recession is high. This would undermine current earnings valuations.

Chart 5: Global profit margins




## Long-Term Capital Market (LTCM) Assumptions

Below is printed a table of forecast asset class returns produced by J.P. Morgan, I find these the most comprehensive. The exception is the return forecast for Social/Affordable housing which is an MJ Hudson figure using a combination of forecasts from various asset managers active in this sector and cross checked by our analysts. Whilst there is some difference between the forecast returns set out here and those forecast by the Fund’s individual asset managers, the actual numbers are not dissimilar and, in particular, the relative returns forecast between the various asset classes are fairly consistent.

These are 10-year forecasts and given that interest rates are still rising and a number of major economies may be about to enter a recession, forecast returns may be back-end loaded from here with the next two years remaining difficult.

The table below sets out the LTCM forecast produced by JP Morgan in 2021 and 2022.

| Asset Class | Index | 2021 10 year return forecast | 2022 10 year return forecast | 2022 volatility forecast |
|---|---|---|---|---|
| Global Equities | MSCI AC World | 5.2% | 6.7% | 13.9% |
| Fixed interest | UK Gilts | 0.0% | 4.2% | 7.6% |
| | Global Investment Grade Bonds | 2.5% | 5.1% | 5.4% |
| | UK Investment Grade Bonds | 2.2% | 4.2% | 7.6% |
| Property | UK Core Real Estate | 6.6% | 5.5% | 13.0% |
| | US Core Real Estate | 5.6% | 3.9% | 10.2% |
| Alternatives | Global Core infrastructure | 5.8% | 4.5% | 10.8% |
| | Private Equity | 8.2% | 8.1% | 17.5% |
| | Private Debt | 7.4% | 6.0% | 15.8% |
| | Social/Affordable housing | 4.0% | 4.0% | 10.8% |

Since these forecasts were made, the main change has been a fall in the valuation of Real Estate assets and, to a lesser extent, Infrastructure. The valuation of both these assets is influenced by Bond yields but, due to the illiquid nature of real estate and infrastructure, they re-price with a lag following the rise in bond yields (fall in prices). Real Estate was the poorest performing asset this quarter having held up well through 2022.

## Government Levelling-Up agenda

As the Committee is aware, there is possible future legislation mandating that UK Local Government Pension Schemes (LGPS) to invest 5% of their assets in UK based projects, for example assets like Infrastructure and Social/Affordable housing. Whilst nothing concrete has been outlined yet, the Pensions Committee is considering the allocation of 5% of the Fund to infrastructure and Social/Affordable Housing in the UK. This would fit with the outcome of the Funds strategic Asset Allocation Review conducted during the summer of 2022. 5% of the Fund equates to around £150m, I would suggest not being too prescriptive about the breakdown of this £150m between Infrastructure and Social/Affordable Housing as the exact balance will depend on the availability of the underlying assets. I would also look to avoid investing entirely in the Gloucestershire area as this will limit the number of assets available and may lead to a concentration of investment into a small number of assets which increases the operational risk of one such asset having issues. It would be better to look nationally or, potentially, to work with other Brunel member funds in this area.

### Infrastructure

Our strategic assumptions in the table above are for “core” infrastructure, which is the most conservative in terms of risk/return profile. The regular income stream can provide good portfolio diversification with an often inflation-linked income profile. However, a key concern is the entry price of these assets in light of the wider market sell-off in 2022. Many assets, as they are illiquid, have not yet been repriced to reflect more recent conditions and higher gilt yields. Consequently, the long-term assumptions are currently low. This repricing has started to happen over the fourth quarter 2022.

There are potentially higher returns in non-core infrastructure, the so-called “core-plus”, “value-added” and “opportunistic” sub-strategies. These typically involve greater risk from higher leveraged assets and potentially some degree of construction risk. We have not modelled allocations to these.

Investing in renewable energy infrastructure is compelling from an ESG standpoint and attractive in the long-term, as the world attempts to address climate change. The war in Ukraine has also highlighted the importance of energy security which is further supportive of the energy transition tailwind. However, the sector has faced challenges in recent years as many of the “early mover” subsidy incentives from the Government have been withdrawn. In addition, there are short-term concerns over Government windfall taxes targeting all energy companies, including renewables, to help subsidise skyrocketing energy bills for both consumers and businesses.

### Social/Affordable Housing

Investment into Social/Affordable housing is also attractive from a "levelling-up"/ESG perspective and has started to gain popularity with other LGPS and Pools looking for ESG-friendly impact investment exposure. However, one must consider the Fund's current allocation to property (10.3%), the lower risk/return profile compared to "standard" UK commercial property and the now comparative attractiveness of fixed income. Now that forecasted returns for UK Gilts are much higher (making them comparable to forecast returns for social housing), with lower forecasted risk, there is a weaker argument to make for this asset class at the current moment in time.

Given the potential for both UK Infrastructure and Social/Affordable housing to reprice downward over the next couple of years to reflect higher UK gilt yields, it makes sense to create an allocation and be operationally ready to invest into both these asset classes but delay the actual point of committing capital at the current time awaiting a more attractive entry point.

## Strategic Asset Allocation

At the last Pensions Committee meeting it was agreed to allocate 5% of the Fund to Social/Affordable housing and increase the allocation to Infrastructure by 2% giving greater diversification and the ability to create a social impact potentially within the South West region. The money for this is to come from UK Equities (-2%) and Fixed Interest (-5%). The work for this recommendation was conducted over the summer and asset prices have moved substantially from then, particularly for UK Gilts. Whilst the allocation changes still make sense, the timing of such a move will need to be given appropriate consideration.

The current asset allocation against the Strategic Benchmark is given in the table below. The last column gives the amount which would need to be invested/divested to bring each asset class weighting into line with the Strategic Benchmark.

| Asset class | Asset Allocation as at 31/12/22 | New SAA going forward | Position against the new SAA | Transition required in cash terms |
|---|---|---|---|---|
| **Equities** | 57.1% | **55%** | +2.1% | -£62m |
| **Fixed Interest** | 17.2% | **22%** | -4.8% | +£141m |
| **Property** | 8.9% | **10%** | -1.1% | +£32m |
| **Diversified Risk** | 6.8% | **0%** | +6.8% | -£201m |
| **Alternatives** | 9.6% | **13.0%** | -3.4% | +£100m |
| **Cash** | 0.3% | **0%** | +0.3% | -£8m |

Figures may not add up due to rounding

The Fund has committed to invest into Alternative Asset classes via Brunel who will be responsible for selecting the individual managers and funds for each of these asset classes going forward. Much of the cash awaiting drawdown is currently held in the Diversified Risk portfolio as this provides an acceptable return at relatively low risk. Commitments made so far are as follows:

| Invested/Committed | Private Equity | Infrastructure | Private Debt |
|---|---|---|---|
| **Cycle 1 March 2018** | £33m/£40m | £32m/£40m | £58m*/£80m |
| **Cycle 2 Apr 2020** | £20m/£70m | £53m/£130m | £46m/£120m |
| **Cycle 3 Apr 2022** | £0m/£16m | £1m/£38m | £0m/£20m |
| **Total** | **£53m/£126m** | **£86m/£208m** | **£104m/£220m** |

*Allocated by GCCPF in June 2017, the managers are now returning capital to investors.

The Fund has currently committed a total of £554m to Alternatives of which £474m is via Brunel. This compares to a requirement to invest £383m to achieve the weighting within the new Strategic Benchmark in Alternatives. Assuming an 80% maximum investment of committed capital these figures remain approximately in line.

The Fund committed to the existing Private Debt portfolios invested with Golub and Arcmont in mid 2017 and these two portfolios have performed above expectations returning 10.5% p.a. and 6.1% p.a. respectively against a benchmark return of 5.7% in the 4+ years since inception. These are now in wind-down and have begun returning cash to shareholders and so a further commitment will be required to retain the target weighting in this asset class. The Fund has indicated that it will make further commitments but has not finalised the amounts. Brunel are moving forward with selecting managers in each of the Infrastructure, Private Equity and Private Debt portfolios.

### Environmental, Social and Governance (ESG)

The text below is taken directly from Brunel's recently released Climate Change 2023-2030 announcement and follows an in depth review of their existing climate change policy and its effectiveness. Brunel's commitment to the climate change agenda is commendable and I recognise it has a lot of support within the Gloucestershire Pensions Committee. I would note that in agreeing to Brunel's agenda the Committee is agreeing to their desire to take an industry leading role in this area. Brunel's attitude towards climate change already influences their selection of investment managers and how those managers select underlying investments and will do so increasingly into the future. This will influence where risk is being taken within each portfolio and, whilst not adapting to climate change is quite possibly the greatest risk, in doing so ahead of industry peers carries an expense both in real terms and terms of relative performance against ones peers. It is likely that the Fund will have to accept greater short-term volatility in performance whilst looking to achieve its climate change aims and we have already seen this in the good performance across most underlying investment managers employed by Brunel in 2020 and 2021 and in the poor performance in 2022 when energy stocks were amougst the very few areas of the market which rose in value.

Brunel's new Policy will not only affect how we design and evolve our portfolios. It will also impact how we recruit and monitor the managers we appoint to run mandates on those portfolios. Finally, it will impact how we engage more broadly beyond our partnership, whether coordinating with other asset owners on RI issues, or pressuring companies to improve their practices.

# Executive Summary

- 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. 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 US Dollar. Value stocks (+14.2%) outperformed growth (+4.6%) by a wide margin this quarter.
- **GDP growth and labour markets:** Despite the on-going 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 'new' 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 although this has not entirely fed through to mortgage rates yet.
- **It is worth highlighting the following themes, impacting investment markets:**

- **Inflation – the story after the peak.** While CPI inflation appears to have now peaked for the US, UK and Europe, concern remains over how rapidly and to what level inflation will fall. 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. Euro inflation reached 10.6% in October, a fresh high, however this fell in November to 10.1%. Similarly for the UK, a high of 11.1% was reached in October before falling in November. For the US, the high in CPI appears to have been reached in June at 9.1% and has since declined to 7.1%.
- **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 end. 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 in 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 starts his term in April.
- **A return to fixed income?** The repricing of debt of all forms, following the rapid rises in interest rates last year, has increased yields on many fixed interest asset classes, potentially increasing long-term returns. Interest rates are now in a more volatile phase, in marked contrast to the repressed volatility of the past decade of QE, so this potential for improved returns is likely to come with increased volatility.
- **Equity valuations reflect "mild" recession – earnings on watch in 2023.** Following the 18% decline in US equities in 2022, 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 recession. 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 probably been avoided and gas storage levels are high, the problem is not over. Furthermore. China's reopening is likely to increase demand pressure on global supplies.

- Global equities rose sharply in Q4, as inflation appears to have now peaked and investors expect that central banks will not need to maintain restrictive monetary policies for as long as they have been guiding. Given the rise in equity markets, the VIX which measures equity volatility and can be read as a "fear" gauge decreased by -31.5%, from 32 to 22, although this level is above the pre-COVID-19 average.
  - In the US, the S&P 500 rose by 7.5% and the NASDAQ fell by -1.0% as markets rallied due to falling inflation data, but investors remain wary of growth and tech stocks. A number of tech companies have announced staff layoffs and cost cutting measures in a response to investor concerns.
  - UK equities rallied in Q4, rising 8.7% as investors welcomed the government leadership change and return to a normal market functioning of gilts following the Truss/Kwarteng debacle and subsequent BoE intervention in the Gilt market. Energy price declines amid warmer temperature and rising inventories of natural gas also helped temper inflation expectations. The BoE raised the base rate to 3.5% in December, however two committee members voted to keep rates unchanged which could signal the start of a shift toward more dovish policy. The BoE also expects Q4 GDP at -0.1%, a 0.2% improvement from its November report.
  - The Euro Stoxx 50 rose by 14.9% in Q4 as investors were cheered by inflation data declining in the quarter, albeit it is still at high levels. Inflation in Europe has been particularly high due to the impact of energy prices following Russia's invasion of Ukraine and their consequent impact on European energy supply.
  - Japanese equities underperformed other equity markets, rising by only 0.7% in Q4. Japanese equities performed well in the quarter until core CPI in December was announced at a 40-year high and the BoJ increased the ceiling of the trading range for the 10-year bond to 0.5% (from 0.25%) which proved a headwind for equities. While inflation remains well below other major economies, investors are wary of a hawkish pivot at upcoming BoJ meetings due to the impending retirement of Governor Kuroda. The Yen reached a high (i.e. a weak Yen) of 150 vs the US Dollar during Q4 but ended the year at 131 following the inflation peak and yield curve adjustment.

    - Emerging market equities performed strongly (+9.6%) with sentiment improving in China following the announcement of COVID-19 restrictions easing. US Dollar weakness also provided a boost.

- Medium and longer term bond yields were largely rangebound in Q4 as investors weighed expected declines in inflation against central banks' desires to ensure inflation is stamped out. Additionally, employment data generally has remained strong which provides the impetus for central banks to hike rates now while labour markets are viewed as strong enough to withstand it. In corporate bonds, high-yield credit outperformed as spreads tightened over the quarter but remain around their long-term average level. Emerging market bonds rose 7.8% in local currency and 8.1% in hard currency.

    - The US 10-year Treasury yield rose marginally in Q4 ending at 3.88% from 3.83%. The 2-year yield rose in Q4, from 4.22% to 4.41%, as the yield curve inverted further. US rates rose initially in the quarter as core inflation data continued to be strong and the US Fed speakers maintained the narrative that hawkish policy needed to be maintained. Later in the quarter rates fell though, as markets took the view that the US Fed will pivot and cut rates in 2023 as inflation falls, spurred by recent falls in monthly CPI data. The US Fed raised short term rates to 4.25-4.5% as at end of Q4..

    - The UK 10-year Gilt yield fell from 4.09% to 3.67% and the 2-year from 4.30% to 3.56%. The declines largely reflected markets returning to normal following the spike in yields in Q3 following the disastrous Truss government 'mini budget' and occurred despite the BoE hiking rates by 125bps. While Gilt rates fell sharply over the quarter, UK Gilts now trade in a similar relative position to peer Government bonds as they did before Q3.

    - European Government Bonds had a total return of -2.1% in Q4. Yield curves flattened or inverted during the quarter, as short end rates rose in response to the ECB raising its policy rate to 2.5% during the quarter and noted it expects to hike rates further based on its inflation outlook. Long-end rates rose less, as investors view inflation as likely to fall steadily. The German 10-year Bund yield increased from 2.11% to 2.57%, and Italy's went up from 4.51% to 4.70%.

    - US high-yield bonds outperformed investment grade, returning 4.2%, and European high-yield bonds returned 4.7%. Investment-grade bonds returned 6.4% in the UK, 1.7% in Europe and 3.6% in the US.

- Energy prices fluctuated during Q4 as investors mulled over China re-opening, risk of looming recessions in Europe, UK and USA and warmer weather than expected reducing near-term demand for natural gas. Precious metals rose as the US Dollar declined and also received a boost from falling interest rates.

    - US gas prices fell -33.9% over Q4, reversing some of the sharp gains earlier in 2022 as winter weather has been warmer than expected (reducing demand) and inventories have been higher than previously expected.

    - Brent crude oil fell -2.3% in Q4. Prices have been volatile as fears of a fall in demand from a global recession and structural trends toward renewable energy have clashed with supply side dynamics relating to Russia's invasion of Ukraine, OPEC production and the US releasing oil from its Strategic Petroleum Reserve. Brent closed the quarter at US$86 per barrel.

    - Gold and Copper rose 9.9% and 11.7% respectively in Q4, with gold rising as interest rates and the US dollar declined, as well as reports of central banks including China and Turkey increasing their purchases. Copper rose as China, a significant copper importer, announced the start of COVID-19 re-opening. Gold and copper closed Q4 at 1,826 USD/oz and 381 USD/lb, respectively.

- Global listed property had another weak quarter, with the FTSE EPRA Nareit Global Index falling -0.3% in Q4.

    - The Nationwide House Price Index in the UK fell sharply over the quarter, with YoY growth at 2.8% for December. This is markedly down from 9.5% YoY growth in Q3, and 10.7% in Q2. The performance by region showed a smaller variance than prior years as the macro environment of high inflation and high mortgage rates are impacting affordability as real wages struggle to keep up.

    - European commercial property remained under pressure in Q4, with the Green Street Commercial Property Price Index down by -7% this quarter and -12% for the 2022 full year.

In currencies, Sterling strengthened sharply against the US Dollar (+8.2%) but fell against the Euro (-0.8%) over the fourth quarter. The principal driver was the appointment of Rishi Sunak as Prime Minister who is viewed as likely to pursue a more fiscally conservative agenda and the BoE's intervention in gilt markets to stabilise yields. Overall, the US Dollar fell in Q4 (Dollar index -7.7%) reversing much of the Q3 gains. Over the year 2022, the Dollar Index rose +8.2%. Notably, the US Dollar also fell against the Japanese Yen by -9.4% in Q4 as the BoJ shocked markets in December by increasing the top range at which the 10-year bond could yield.

# Underlying Mandates

Rather than comment on each portfolio separately which duplicates the reporting from Brunel, the table below sets out each portfolio within the Fund with a brief note on my opinion of the management and performance using the same traffic light system as in the past. Because of the transfer of assets to Brunel all the portfolios will have changed manager over the last four years. For this reason I have rated some of the portfolios amber purely because the performance history is too short to support an opinion. I remain impressed by the intellectual rigour with which Brunel designs portfolios and selects managers.

We now have 3-year performance figures for both Private equity and Infrastructure and whilst the initial allocations to these portfolios will have been very low and Brunel's speed of commitment was poor, returns do suggest that Brunel are achieving a reasonable level of return from these asset classes.

| Portfolio | Benchmark | Inception | Performance | Comment |
|---|---|---|---|---|
| UK Equity | FT All-Share EX IT | 09/18 | | Reduced to two managers post sacking of ASI |
| Global High Alpha | MSCI World Equity | 09/19 | | Acceptable performance to date |
| Global Sustainable | MSCI All World Equity | 09/20 | | Too early to comment |
| Global Paris Aligned | MSCI Paris Aligned | 07/18 | | Passive portfolio |
| Emerging Markets | MSCI Emerging Markets | 10/19 | | Poor performance to date |
| UK Fixed Interest | £ Non-Gilt Credit | 11/21 | | Transitioned to Brunel in the second quarter 2021 |
| Multi Asset Credit | Cash + 2% | 11/21 | | Transitioned to Brunel in the second quarter 2021 |
| Property | Property benchmark | 04/20 | | Too early to comment; some concerns |
| Diversified Return | Cash + 4% | 07/20 | | Portfolio construction is sound; performance strong |
| Infrastructure | CPI | 01/19 | | Drawdown has been slow; performance looks strong |
| Private Equity | MSCI All World Equity | 01/19 | | Drawdown has been slow; performance looks strong |
| Private Debt | Cash + 5% | 08/17 | | Existing managers have performed well |