MJ HUDSON

Gloucestershire Pension Fund

Quarterly Report

Q1 2023

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Performance Summary

Market Indicators

Index (Local Currency)		Q1 2023	Quarter-on-Quarter	YTD
Equities			**Total Return**	
UK Large-Cap Equities	FTSE 100	7,632	2.1%	2.1%
UK All-Cap Equities	FTSE All-Share	4,158	1.7%	1.7%
US Equities	S&P 500	4,109	7.9%	7.9%
European Equities	EURO STOXX 50 Price EUR	4,315	12.4%	12.4%
Japanese Equities	Nikkei 225	28,041	10.0%	10.0%
EM Equities	MSCI Emerging Markets	990	4.0%	4.0%
Global Equities	MSCI World	2,791	7.7%	7.7%
Government Bonds				
UK Gilts	FTSE Actuaries UK Gilts TR All Stocks	3,080	2.0%	2.0%
UK Gilts Over 15 Years	FTSE Actuaries Uk Gilts Over 15 Yr	3,797	2.8%	2.8%
UK Index-Linked Gilts	FTSE Actuaries UK Index-Linked Gilts TR All Stocks	4,172	4.3%	4.3%
UK Index-Linked Gilts Over 15 Years	FTSE Actuaries UK Index-Linked Gilts TR Over 15 Yr	4,786	4.9%	4.9%
Euro Gov Bonds	Bloomberg EU Govt All Bonds TR	213	2.5%	2.5%
US Gov Bonds	Bloomberg US Treasuries TR Unhedged	2,254	3.0%	3.0%
EM Gov Bonds (Local)	J.P. Morgan Government Bond Index Emerging Markets Core Index	130	4.8%	4.8%
EM Gov Bonds (Hard/USD)	J.P. Morgan Emerging Markets Global Diversified Index	818	1.9%	1.9%
Bond Indices				
UK Corporate Investment Grade	S&P UK Investment Grade Corporate Bond Index TR	338	2.4%	2.4%
European Corporate Investment Grade	Bloomberg Pan-European Aggregate Corporate TR Unhedged	217	2.0%	2.0%
European Corporate High Yield	Bloomberg Pan-European HY TR Unhedged	400	2.9%	2.9%
US Corporate Investment Grade	Bloomberg US Corporate Investment Grade TR Unhedged	3,072	3.5%	3.5%
US Corporate High Yield	Bloomberg US Corporate HY TR Unhedged	2,264	3.6%	3.6%
Commodities				
Brent Crude Oil	Generic 1st Crude Oil, Brent, USD/bbl	80	-7.1%	-7.1%
Natural Gas (US)	Generic 1st Natural Gas, USD/MMBtu	2.2	-50.5%	-50.5%
Gold	Generic 1st Gold, USD/toz	1,969	7.8%	7.8%
Copper	Generic 1st Copper, USD/lb	409	7.5%	7.5%
Currencies				
GBP/EUR	GBPEUR Exchange Rate	1.14	0.7%	0.7%
GBP/USD	GBPUSD Exchange Rate	1.23	2.1%	2.1%
EUR/USD	EURUSD Exchange Rate	1.08	1.3%	1.3%
USD/JPY	USDJPY Exchange Rate	132.86	1.3%	1.3%
Dollar Index	Dollar Index Spot	102.51	-1.0%	-1.0%
USD/CNY	USDCNY Exchange Rate	6.87	-0.4%	-0.4%
Alternatives				
Infrastructure	S&P Global Infrastructure Index	2,741	3.6%	3.6%
Private Equity	S&P Listed Private Equity Index	165	5.3%	5.3%
Hedge Funds	Hedge Fund Research HFRI Fund-Weighted Composite Index	17,820	1.7%	1.7%
Global Real Estate	FTSE EPRA Nareit Global Index TR GBP	3,519	-2.0%	-2.0%
Volatility			**Change in Volatility**	
VIX	Chicago Board Options Exchange SPX Volatility Index	19	-13.7%	-13.7%

Source: Bloomberg

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

The rebound across all asset classes since the October 2022 lows can be seen in the table above. I would note the heavy fall in oil and gas prices, which has been instrumental in inflation passing its peak, and the relatively strong performance of Gold in the face of continued economic uncertainty, both of these factors have continued since the quarter end.

Performance

The Fund rose by 3.4% over the quarter as most assets continued to recover from the October lows. The benchmark returned 2.8% over the quarter with the outperformance by the Fund coming mainly from asset allocation as Equities outperformed Fixed Interest and Alternatives. The strength of Sterling against the US Dollar will have impacted returns negatively with over 60% of Global Equities being US Dollar dominated and some US Dollar based Alternative Assets, although this impact will lessen going forward as the Fund's increased hedging is now in place.

Over the last year the Fund fell by -2.0% against a fall in the benchmark of -2.8%. Over the last ten years the Fund has risen by 7.3% per annum which is in line with the benchmark. This long-term return is usefully above the return assumed in the actuarial calculations and has driven the improvement in the Funding ratio. The Fund was valued at £3.051m at the year end.

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.
- Further work on the Committee's agenda on climate change and production of a Taskforce for Climate-related Financial Disclosure (TCFD) report although it now seems possible that this Government may further delay publication of the final regulation on when LGPS funds must produce this report. Current expectations is on using 2023/4 data.

Comment

Are we likely to enter a recession? My answer remains yes, we will find out over the next two quarters. (Probability 80%). Central banks are raising interest rates to slow demand and hence contain inflation. Historically, we have never seen central banks raise interest rates to just the right level to bring demand down to a non-inflationary level, that is why we have economic cycles and, across the globe, it usually takes longer than 5 years to bring inflation down to target levels after an inflationary spike, not 9 months.

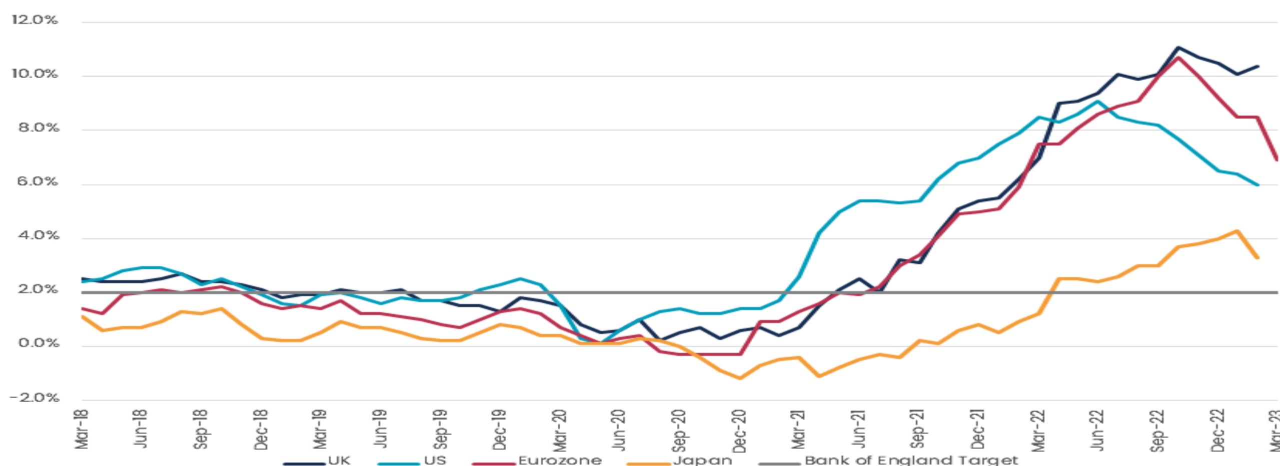
Will this be a shallow recession of a couple of quarters or a deeper longer lasting recession? The answer here is more balanced. Many developed economies continue to be driven by the consumer who still appears to have excess savings built up during the Covid pandemic but, because central banks are working off backward looking data and because inflation is a lagging indicator for the state of an economy, I would expect interest rates to continue to rise until something breaks! (Probability of a deep recession 50%; mild recession 30%).

Will the recent banking issues develop into a much more fundamental undermining of the banking industry? No, but the run on a number of US regional banks will have the effect of tightening credit conditions further and could be approximately equivalent to a 0.25-0.5% increase in interest rates. Banks borrow short-term money and lend it for a longer duration. When interest rates rise rapidly, as they have done, the cost of short-term deposits rises whilst it takes time for medium-term loans (e.g. mortgages) to roll off the books and reprice to reflect higher interest rates. If a bank has a concentrated and mobile deposit base and cannot realise their loan book or investments quickly and profitably, they are in danger of seeing a run on their deposits. Banks become more cautious and reticent about growing their lending book if they fear a loss of deposits, this leads to tighter credit conditions.

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 past 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 the headline inflation rate below 5% quite quickly in some regions.

As can be seen from this chart, US and then EU inflation have now peaked with the UK to follow.

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)

Already noted in the previous quarterly, other commodities and food prices are starting to fall and supply lines look to be functioning better as shown by falling shipping rates. However, it is headline inflation which is falling rapidly due to these factors whereas core inflation, which excludes the effect of energy and food prices and is, therefore, a better guide to underlying wage inflation, is proving to be much stickier and I expect this to continue to be the case for the remainder of this year and into 2024. Whilst the fall in headline inflation may allow central banks to pause from raising interest rates higher at the current time, stubborn core inflation figures will likely mean there is no interest rate cut this year in the US, EU or UK.

It is the consumer globally who is keeping the economy afloat at present as they work through the excess savings built up during the Covid pandemic but it is very difficult to understand how long this will last as the savings rate in any economy is not a fixed figure but varies considerably over time and, therefore, it is impossible to accurately calculate the level of excess savings and how long this will last at current consumer spending rates. It is noticeable that spending on credit cards in the US has picked up recently suggesting current spending is starting to increase household debt rather than reduce savings.

Inflation, like the pandemic, does not affect everyone equally. Both tend to have a more detrimental effect on the least well off. Businesses tend to be able to rise prices faster than workers can force wages higher, this can be particularly true in the public sector and for those on benefits. In the UK, whilst average wages rose by 6.9% in the year to February 2023, that was a fall of 3.2% p.a in real terms given 10% annual inflation. The Rowntree Foundation estimates that UK unemployment benefit has fallen by 12% in real terms between March 2021 and March 2023. But even this underestimates reality for claimants as it is the basic food stuffs and necessities which have seen the steepest price rises in many cases. This unequal effect on individuals and countries of the Covid pandemic and then inflation is what is making it particularly difficult to understand when and how quickly the global economy will slow given the rise in interest rates. Inflation is often said to be a tax on the poor and whilst the effect of Covid and inflation on differing segments of society may be hidden within most

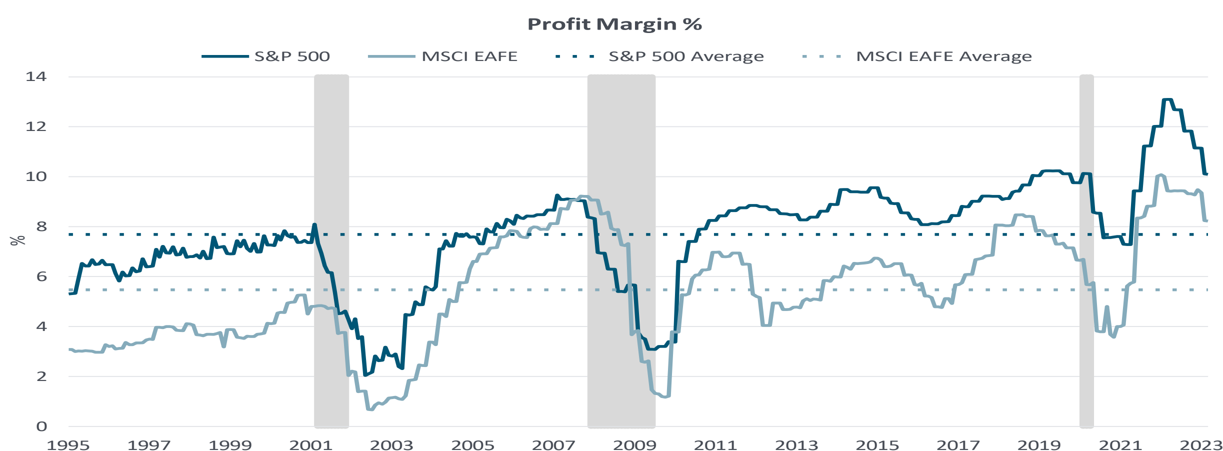
economic figures it will have an effect on socio-economic factors and, in all likelihood, the political environment. I would expect this to be an increasing theme in the years ahead and may possibly go some way to explain the poor productivity growth seen by many developed countries since the Global Financial Crisis in 2008/9.

It is also noticeable that corporate profit margins remain high and many companies seem to be able to put through price rises and maintain margins at the current time, this will only last whilst the consumer continues to spend. There is now a noticeable difference between the luxury good sector (LVMH sales up 17% year on year in Q1 2023) and discount stores (US discount retailer Target sales growth of 0.5% year on year in Q1 2023).

Corporate profit margins are at extreme levels and suggests many companies have used inflation to push prices up in excess of costs. Some of this will be from the energy sector which had a bumper 2022 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 equity valuations. Note the collapse in margins during previous recessions as shown by the shaded areas in the chart below.

Cash Flows

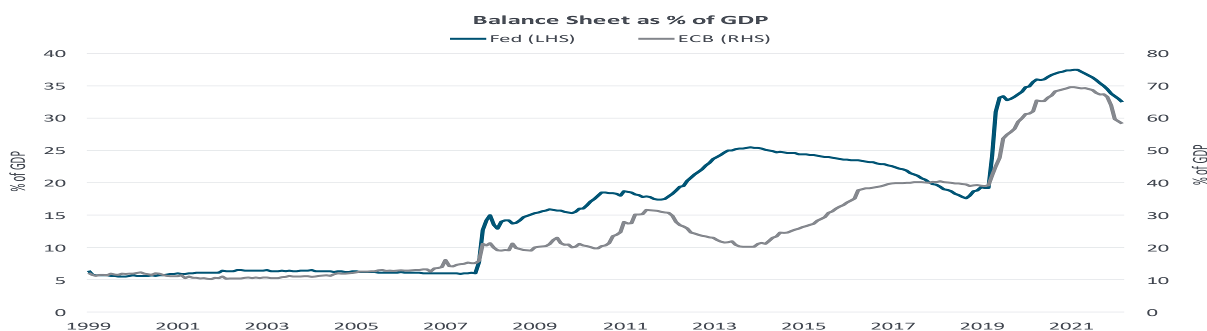
Margins drive financial asset prices



Source: Bloomberg. Monthly data from 31 January 1995 to 31 March 2023. Shaded areas = US Recessions.

In the US there are signs of companies resorting to exceptional items to maintain profits with an increasing divergence of Generally Accepted Accounting Principles (GAAP) earnings and reported earnings. This again is a sign of coming stress in corporate earnings.

The last unknown is the effect of quantitative easing. We have seen an unprecedented expansion of central bank balance sheets across the developed world as economies flirted with deflation during the 2010's and again during the response to the economic impact of the Covid pandemic. Central banks would like to reduce their balance sheets and have started to sell off some of the accumulated bonds they have bought (Quantitative Tightening) but this has only just begun and the effect of this is unlikely to be fully understood at the current time. We now recognise that quantitative easing inflated asset prices, it would therefore seem logical that quantitative tightening and the removal of cash from the monetary system will do the opposite?



Source: Bloomberg. Monthly data from 31 December 1999 to 28 February 2023. Fed = US Federal Reserve. ECB = European Central Bank.

Economic slowdowns do not unfold smoothly; they are the sum of an irregular series of unpleasant surprises.

Since the end of the first quarter, equity markets have continued to push higher led by the US. However, this rise is being entirely driven by a very small group of large tech stocks including Amazon, Alphabet (Google) and Apple. I see this as investors needing to remain invested but backing a smaller and smaller group of stocks which they believe will provide a defence against a potential recession. The scale of excess liquidity in markets will reduce as Quantitative Tightening by central banks starts to drain cash from the economy. This supports my current expectation is for equity markets to fall over the next 12 to 18 months.

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 APEX (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%

Given that I expect the major economies to enter a recession by year end, I expect equities and some other asset classes to fall over the near term. High quality Fixed Interest should do well but an economic downturn will result in higher defaults and credit losses and, as such, I am more cautious on higher yielding, lower quality credit. I also suspect that Private Equity has not fully reflected the changing economic environment yet and that returns may disappoint form here. I am more optimistic about areas of Private Debt and see this as one of the most attractive asset classes at present. The banking crisis amongst US regional banks and concern over their deposit bases will reduce banks' appetite for lending to mid-size corporate companies, allowing private debt funds to increase prices and cherry pick good credit risk in areas such as healthcare, subscription based technology and monitoring and measuring systems. Private debt funds turn over their loans on average every 18 months and so the recent interest rates rises are now feeding into returns.

In addition, the diversification provided by Social Housing, which should be relatively immune to the prevailing economic backdrop and provides diversification from market risk looks attractive as it should provide a stable yield going forward.

Strategic Asset Allocation (SAA)

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. I have updated the Strategic Benchmark in the table below to reflect these changes.

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 31/3/23	New SAA going forward	Position against the new SAA	Transition required in cash terms
Equities	54.6%	**53%**	+1.6%	-£49m
Fixed Interest	17.9%	**17%**	+0.9%	-£27m
Property	8.7%	**10%**	-1.3%	+£40m
Diversified Risk	7.9%	**0%**	-7.9%	-£241m
Alternatives	10.0%	**20%**	+10.0%	+£301m
Cash	1.0%	**0%**	+1.0%	-£30m

Figures may not add up due to rounding

The Fund has committed to invest into Alternative Asset classes via Brunel who are 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	£32m/£40m	£35m/£40m	£56m*/£80m
Cycle 2 Apr 2020	£23m/£70m	£78m/£130m	£56m/£120m
Cycle 3 Apr 2022	£0m/£16m	£3m/£38m	£3m/£20m
Total	**£55m/£126m**	**£116m/£208m**	**£115m/£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. In addition, a further 5% of the Fund (£152m) is earmarked for investing into Social Housing. Assuming an 80% maximum investment of committed capital in Alternative funds these figures remain approximately in line. Money awaiting drawdown into Alternative asset classes is currently invested in the Diversified Returns Fund which has a low risk profile. This means that the portfolio should provide some return without taking too much risk with the capital which has been committed to invest into these asset classes.

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 9.8% p.a. and 6.3% p.a. respectively against a benchmark return of 5.9% 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)

In view of the change in membership of the Pensions Committee I have replicated the comment made last quarter following Brunel's Climate Change 2023-2030 announcement as this will set the tone for the Committee's approach to ESG issues going forward. I am aware that the Committee has continued to move forward in developing its own ESG and Climate Change commitment and support this move.

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, doing so ahead of industry peers carries an short term performance risk both in real terms and terms of relative performance against one's 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 noticeably poor performance in 2022 when energy stocks were amongst 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 they recruit and monitor the managers they appoint to run mandates on those portfolios. Finally, it will impact how they engage more broadly beyond our partnership, whether coordinating with other asset owners on Responsible Investment issues, or pressuring companies to improve their practices.

Executive Summary

- Q1 was a strong quarter for equities and bonds, however, the headline numbers obscure some dramatic market events that took place. Macroeconomic data was generally resilient in the quarter, as inflation continued to decline (with the exception of the UK), employment data generally showed tight labour markets and central banks continued their rate hikes, albeit at a slower pace. The focus on inflation and central bank outlooks took a backseat in early March, as a confidence crisis, which started with US-tech focused Silicon Valley Bank (SVB), spread to other similar US lenders (Signature Bank, First Republic) and then to struggling Swiss bank, Credit Suisse (CS). Central bank regulators acted swiftly to restore confidence: US Federal Reserve (US Fed) opened swap lines (providing liquidity to banks) and guaranteed depositors in the afflicted banks, while the Swiss National Bank (SNB) organised a rescue bid for CS from rival Swiss bank UBS. While these actions have restored confidence in the short-term, the underlying causes of the stress (mark-to-market losses on balance sheets combined with competition for deposits, both driven by the sharp rise in interest rates) remain and are likely to have medium-term repercussions.

- Despite the banking crisis mentioned, equity markets rose over the quarter and, in particular, were led by growth-oriented stocks (+14.9% for growth, +0.2% for value). However, the quarterly gain of +7.7% for the MSCI World (c. +6% in GBP terms) was not a smooth ride with the index up sharply in January, before declining in February and early March as the banking crisis unfolded and then rallying strongly to end the quarter up +7.7%. European and Japanese equities performed particularly strongly (around +12% and +7% in GBP terms respectively). The US Fed providing large amounts of liquidity led to long bond yields falling sharply in March despite a small upward move in short-term rates, resulting in performances between +2% and +5% for most fixed income and interest rate-sensitive alternative asset classes (except real estate, which continued to decline -2%). Index-linked gilts and EM debt performed particularly well. Energy prices softened (oil down -7%) and the US Dollar continued its weakening trend (-1%).

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

  - **Tighter credit conditions following the banking crisis makes recession more likely.** Keen competition between banks for deposits, together with the reaction to the SNB imposing losses on contingent "AT1" bondholders in the CS rescue, have put significant pressure on bank funding. This has fed quickly through to tighter credit conditions, which, by some measures, are as tight as they were following the 2008 financial crisis. So, while it is important to note that consumption and employment are still relatively strong in most developed economies, they are trending weaker and the tight credit conditions will make survival tougher for any struggling businesses. This is likely to put pressure on corporate earnings in the second half of 2023, and increase defaults in credit portfolios.

  - **Inflation – continuing to grind lower, but rates likely to remain elevated for some time.** The UK was the outlier in the quarter with annual CPI rising in February to +10.4%, having fallen for the prior 3 months. However, headline UK inflation is expected to decline in the months ahead (current consensus c. +5% in 2023 and +3% in 2024) as energy prices have fallen from their dramatic highs last year. But, while labour markets remain relatively tight, central banks are likely to maintain high short-term rates and there is potential for the energy genie to return later in 2023. So rate cuts still look to be some way off.

  - **Volatility has increased in "stabilising" asset classes (fixed income).** Concerns over the path of US rates and the fallout from the banking crisis has led to increased volatility in bond markets. The MOVE index, which measures the volatility of the US Treasury bond market, ended 2022 at an already elevated level of 122 but spiked in March to 199, well above the Covid-19 March 2020 levels, as bond yields fell dramatically in mid-March 2023. While this volatility has affected the rate-sensitive (long) government bond market in particular, the next phase of tighter credit is likely to see increased volatility in asset-classes exposed to credit risk (corporate bonds, private debt etc).

  - **Equity valuations rise despite earnings risk.** While US equities rallied strongly in Q1, analysts have at the same time lowered their forecast earnings for Q1 2023 and for full year earnings 2023. If correct, this will mark consecutive quarters of declining earnings and, for Q1 2023, the expected decline is the largest quarterly decline since the Covid impacted Q2 2020. This combination has led the forward earnings ratio for the S&P 500 to rise to 17.8x, from 16.7x at year end 2022. Companies have generally been guiding that they expect minimal revenue growth for 2023 and slightly contracting profit margins (albeit still at historically elevated levels of c. 11.2%). This appears to leave scope for disappointment.

- Global equities rose sharply in Q1, as investors initially embraced cooling inflation data in the US before strong US economic data (jobs report, ISM survey) reminded investors that the US Fed is still in a rate hiking cycle. The VIX declined over the quarter from 22 to 19, although reaching 27 in the midst of the March banking crisis.

  - In the US, the S&P 500 rose by +7.9% and the NASDAQ soared by +21.6%. Markets rallied despite the turmoil in banks in the US and Europe in March, seemingly driven by support from the US Fed and this potentially signalling a near term end to rate hikes.

- UK equities rose +2.1% in Q1 but underperformed global equities and ending below the February high. Earnings updates from large index constituents in energy and financials drove strong performance. Economic data has also proven more resilient than dire forecasts in late 2022, with a sharp decline in energy prices contributing and the Bank of England noting that while it still expects a recession in 2023, it now expects a shallower one than previously. The BoE raised the base rate in both February and March by 50bps and then 25bps, to 4.25%.
- The Euro Stoxx 50 rose by 12.4% in Q1, to follow its strong gain last quarter. Economic data was better than expected with falling inflation and a strong purchasing managers index result in February indicating strong business activity. The ECB raised the deposit rate twice by 50bps in the quarter, to 3.5%.
- Japanese equities outperformed global equity markets, rising by +10.0% in Q1. Japanese equities appeared to be catching up to global equities after a weak Q4 and were buoyed by comments from the incoming new Bank of Japan Governor that he supported the current easy monetary conditions. Inflation has been rising in recent months but in February declined to +3.3% from +4.3% the month prior. The yen was largely flat vs the US Dollar over the quarter.
- Emerging market equities rose +4.0%, lower than global equities due to an -8.9% decline in the relatively expensive Indian equities market.

- Medium- and longer-term bond yields fell over the quarter resulting in solid performance for bonds, while very short-term yields rose following various central banks rate hikes. The US yield curve inversion as measured by the 10 year yield –2 year yield ended the quarter at -58bps, close to the 2022 year end -61bps, but much steeper than a peak in March of -107bps. In corporate bonds, high-yield credit and investment grade performed roughly in line as credit spreads for the high yield index tightened slightly over the quarter. Emerging market bonds rose 4.8% in local currency and 1.9% in hard currency.
  - The US 10-year Treasury yield fell in Q1, ending at 3.48% from 3.88%. US rates rose initially until early March, at which point the banking crisis led the US Fed to introduce new liquidity provisions. US CPI data prints also declined during Q1 but remain uncomfortably high (6.0% as of February 2023). The US Fed raised their policy rate 0.25% twice in the quarter (to 4.75%-5.0%) despite the banking crisis.
  - The UK 10-year Gilt yield fell from 3.65% to 3.49% and 2-year from 3.60% to 3.44%. Since Q4, UK Gilts have returned to their approximate positioning relative to German Bunds (UK approx. +120bps) following the sharp yield spikes due to the September/ October 'mini budget'. The BoE hiked rates by 75bps in the quarter which led only short term rates to rise, with maturities from 2 years onwards all falling in yield.
  - European government bonds had a total return of 2.5% in Q1. Yield curves flattened further over Q1, as short end rates rose in response to the ECB raising its policy rate to 3.5% while yields for medium and longer-term yields fell. The German 10-year bund yield fell from 2.44% to 2.29%, while Italy's fell from 4.55% to 4.09%.
  - US high-yield bonds narrowly outperformed investment grade, returning 3.6% and 3.5% respectively. European high-yield bonds returned 2.9%, outperforming the 2.0% for European investment grade and 2.4% for UK investment grade.
- Energy prices fell over Q1 which has supported recent headline inflation figures. Warmer weather over winter in Europe has resulted in a sharp downward repricing in natural gas, while for oil, markets continue to grapple with the trade-off between potential economic slowdown from tighter monetary policies vs a boost in demand from China re-opening and OPEC+ production cuts.
  - US gas prices fell -50.5% over Q1, reversing the sharp rise that occurred through 2021 and 2022 and are now back to 2020 levels.
  - Brent crude oil fell -7.1% over Q1, to USD80 per barrel at quarter end, although this was up from the mid-March price of US$73. Prices have continued to be volatile as fears of a recessionary fall in demand have clashed with supply side dynamics relating to Russia's invasion of Ukraine, OPEC+ production cuts and China's reopening from Covid restrictions.
  - Gold and Copper rose +7.8% and +7.5% respectively over Q1, with gold rising as investors sought a safe haven asset amidst the banking turmoil. Copper rose with a boost from China, a significant copper importer, loosening regulations on its stricken real estate sector which has been hampered since the 2021 property deleveraging policies. Gold and Copper closed Q1 at 1,969 USD/toz and 409 USD/lb, respectively.
- Global listed property continued to decline, with the FTSE EPRA Nareit Global Index falling -2.0% in Q1 2023.
  - The Nationwide House Price Index in the UK has continued its decline, with the price index down -1.8% for the quarter, and down -1.0% for the year. While only a modest decline, this is a considerable deterioration from the 9.5% YoY growth in Q3 2022, and 10.7% in Q2 2022.
  - European commercial property has also continued to decline in the face of higher interest rates, with the Green Street Commercial Property Price Index down by -2% this quarter and -15% for the past 12 months.

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

Special Note: Anatomy of the Banking Crisis

While much has already been written about the banking crisis witnessed to date in 2023, a brief summary is: deposits at US banks rose sharply in 2020 and 2021 following the Covid social security payments, and perhaps due to a decline in spending following Covid restrictions, as well as large amounts of capital raised by venture capital firms which flocked to SVB. Interest rates fell to near zero given the extremely loose monetary policy. Banks then needed to use this capital to provide loans, or to invest in securities (commonly US Treasuries). Due to strict risk based capital requirements, many banks invested in Treasuries and engaged in interest rate hedging. SVB was particularly exposed due to: reducing its interest rate hedging ratio on securities leading to large unrealised losses, having an undiversified depositor base largely of Venture Capital firms and having a large proportion of deposits above the US$250kFederal Deposit Insurance Corporation (FDIC) insured limit. Depositors and investors became alarmed that SVB would not be able to sell its securities to provide cash to depositors if required (essentially a 'bank run'). SVB's depositors then, en masse, began withdrawing cash, leading SVB to attempt to raise equity capital which proved unsuccessful. Signature Bank also had a very high proportion of uninsured deposits (90%) and was rapidly closed by the FDIC 2 days after SVB. Investors then turned their attention to CS, despite very different underlying issues, with CS more troubled by legacy profitability and compliance issues, leading to outflows of assets under management and deposits. With unfortunate timing, in early March CS announced a Stock Exchange Commission (SEC) assessment of issues in its financial reporting in 2021 and 2022 which triggered a share price drop. The following day, large investor Saudi National Bank declared it would 'absolutely not' invest further prompting a collapse in the share price and subsequent forced sale to UBS.

Underlying Mandates

Rather than comment on each portfolio separately duplicating the reporting from Brunel, the table below sets out each portfolio within the Fund with a note on my opinion of the management and performance using the a traffic light system. 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 slow and Brunel's speed of commitment was poor, returns do suggest that Brunel are achieving a reasonable level of return from these asset classes.

From an asset allocation point of view I am very ambivalent towards having a standalone UK equity portfolio rather than Global Equities and am happy to see any further reduction in the Fund's equity weight continuing to come from UK Equities.

Portfolio	Benchmark	Inception	Performance	Comment
UK Equity	FT All-Share EX IT	09/18		Reduced to two managers
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
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