Gloucestershire County Council Pension Fund

Quarterly Investment Report

Q2 2023

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Key Indicators at a Glance

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

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

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Following the takeover of MJHudson by Apex Group we are now starting to renew the corporate structure of the business and will be updating the disclaimers as various MJHudson corporate entities are replace with Apex ones. Obviously I have now updated the branding for my quarterly report.

Performance

The Fund rose by 1.5% over the second quarter, in line with the benchmark. Global equities rose just over 3% in Sterling terms whilst UK Corporate Investment Grade Bonds fell just over 3% over the quarter. At the manager level most portfolios were close, if slightly behind, their benchmark with the excepting of the Sustainable Equity portfolio which underperformed its benchmark by 3.3% over the quarter dragging down Total Fund performance by approximately 0.4%. This was made up for by the Funds asset allocation against its Strategic Benchmark which remains overweight Equities and underweight Bonds and Alternatives. The Fund has returned 5.1% per annum over the last 5 years which is 0.1% per annum behind the benchmark, mainly driven by poor performance at the manager level over this period. Over 10 years the Fund has returned 7.5% per annum, usefully above the actuarially assumed investment return and it is this that has driven the improved funding level over time.

Comment

Inflation is now falling across much of the developed world and with that we should see interest rates nearing a peak, in the US, EU and UK, although I believe any interest rate cuts are unlikely till late 2024 unless economies are much weaker than expected. Because of this, short duration bonds now look attractive with UK Corporate Investment Grade Bond funds with a duration of 2 years or less yielding close to 7%. Because the duration is short these bonds can be held to maturity giving little risk in exchange for a 7% yield. Obviously, such high yield is above the future investment return required by the actuary and is above the return I would expect from other asset classes over the next couple of years. Unfortunately Brunel does not have an investment offering in this space and I am not yet convinced that inflation is truly under control for me to recommend investing into longer duration bonds which is where the Brunel bond offering is.

My comments in the last quarterly report were pretty gloomy about the global economic outlook and yet the data reported during the second quarter continued to convince many investors that we are heading for a soft landing in the US, with the Federal Reserve (US Fed) raising interest rates to just the right level to slow inflation which would benignly fall back to the 2% range that existed before the Covid pandemic struck, whilst economic growth will move along at 2% per annum with high rates of employment and moderate wage inflation. So why do I remain concerned?

1) We have never seen central banks bring inflation down, over a short period of time, to exactly their target level, through the raising of interest rates to slow demand and cool the economy. Interest rates are a very blunt tool which acts on the economy with a variable and indeterminable time lag. There are reasons to believe that, on this occasion, interest rates will affect the economy with a longer time delay than usual due to the savings built up during Covid for the majority of the population and a higher percentage of corporate debt and mortgages being fixed at low rates for a longer duration than in the past. However, as the market begins to understand that interest rates will stay higher for longer to combat stubborn inflation, even 3–5-year mortgages will eventually have to be renewed at much higher interest rates. Consumers, in particular, had a real propensity to spend post covid and became noticeably price insensitive in the immediate aftermath of the Covid induced economic lockdowns. It appears from credit card data that much of the Covid induced savings have now been spent.
2) Interest rates will stay higher for longer as wage expectations have risen. For employees who have accepted a 6% wage increase whilst inflation was 10%, they will expect to reclaim that loss of real purchasing power at a later stage. This expectation will only be lowered through the destruction of demand and therefore jobs with the increased unemployment undermining wage demands. We have yet to see this happening. US jobs' data shows the economy

creating 185,000 new jobs in June and July, down from earlier this year but still above the 100,00 level which would be consistent with 2% inflation. US wage growth is rising and now at 6% per annum, this again is not consistent with 2% inflation. The situation in the UK is similar with a shrunken workforce unable to fill current vacancies. Europe looks better on this metric with sufficient levels of unemployment to stop higher wage demands becoming entrenched but will still need to raise interest rates above current levels.

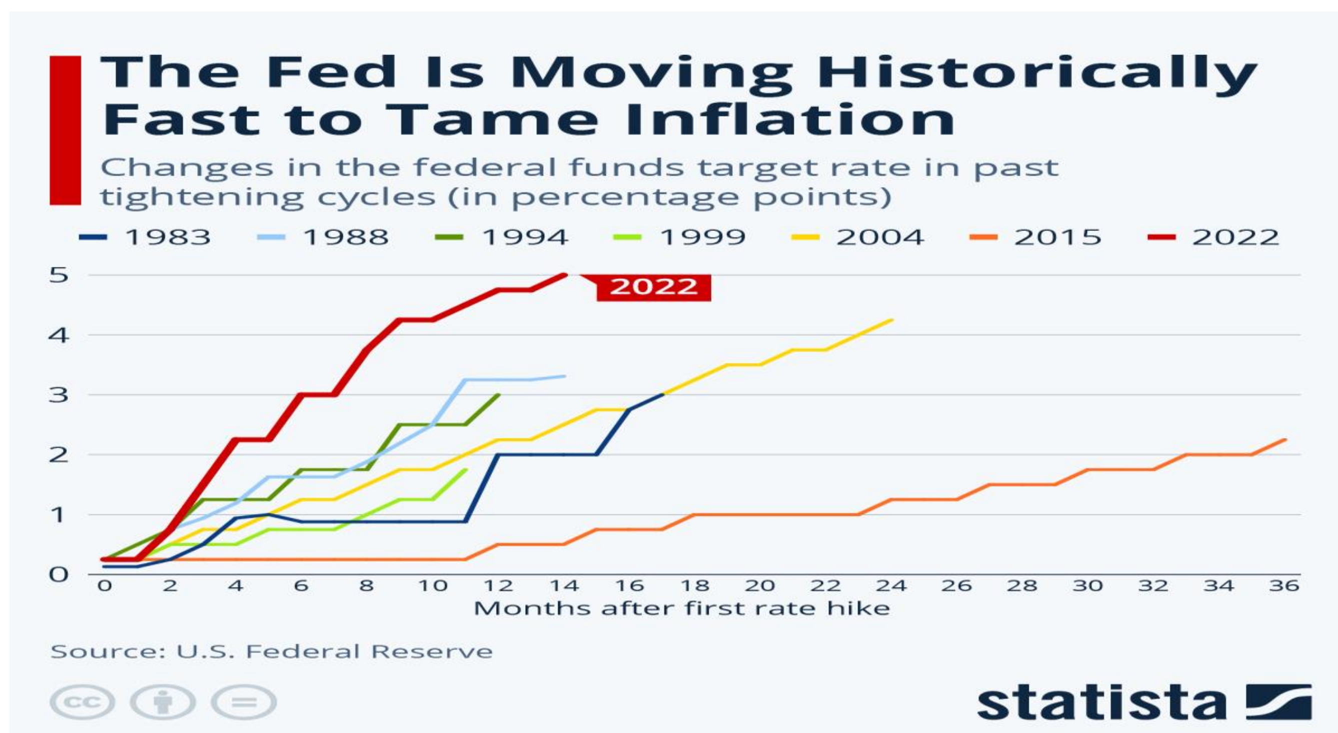
3) Inflation is a year-on-year measure, the massive rise in energy prices post the Russian invasion of Ukraine in spring 2022 has now fallen out of the inflation calculation and the effect of energy on the yearly inflation number has switched from being a major upward pressure to a negative, that reverts to a more neutral to positive push to inflation as we move through the second half of the year particularly as oil prices have been rising through the summer as we hit the peak US demand over the summer driving season. Headline inflation is falling as high inflation numbers of a year ago fall out of the equation. US inflation could get to 3% during the Autumn before picking up but may well end the year nearer 4%. This is not the same as stable 2% inflation.

4) Whilst the price of oil and gas has fallen back to pre-Covid levels, the situation in Ukraine and stressed relations with Russia still mean we could see further price volatility in the future. Whilst great efforts have been made to wean Europe off Russian gas there is still scope for further disruption.

Whilst I do expect headline inflation to dip through the summer, wage inflation shows that central bank targets of 2% inflation are out of reach at the current time. Because of this either interest rates will rise further to slow the economy or the rate rises to date will begin to have a greater impact on economic activity, either way I would still expect to see a recession across much of the developed world in 2024/5 and remain sceptical of a soft landing.

The current rise in interest rates is the fastest in recent history and has come after a period of prolonged ultra-low rates. We have never seen rates rise this quickly and not cause a recession. But what if the changes in corporate and consumer behaviour mean the effect of the interest rate rises are hitting spending with a much-delayed response? Is this giving corporates and consumers more time to react and get ready for higher interest rates or is it just delaying the inevitable?

Chart 1: US Fed interest rate tightening cycles



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The chart above shows the extent and unprecedented speed with which the US Fed has raised interest rates compared to past cycles.

Inflation

It is worth revisiting why inflation will be stickier in the future and why we are unlikely to return to the ultra-low interest rates of the past. There are a number of long-term trends which have held inflation down in the past but which are now changing as well as new inflationary factors to be considered.

1) Demographics – Global demographics are predictable as we know approximately how many people are alive and an estimation of their age and mortality. That the population is aging in most parts of the developed world is recognised, but, whereas over the past 40 years, an increasing percentage of the population in the developed world was of working age with more women entering the workforce due to a lower childcare burden, now the baby boomers are retiring and will need increased care in their old age, removing more people from the workforce. This will not just lower the available workforce but also reduce the level of savings in the economy as baby boomers draw on their savings to fund their retirement and later life care. This will lead to less money being available for investment, lowering potential economic growth (as seen in Japan). One economic solution to this could be to accept greater immigration but that seems to be politically unacceptable at present in many countries but, without this, the bargaining power of the remaining workforce increases forcing up wages and thus inflation and interest rates. China’s own demographics are now also negative with a shrinking working age population.
2) Energy supply – The weaponization of energy supply is not new, the OPEC cartel was formed in the 1970’s to force oil prices higher and redistribute economic wealth towards oil producers, mainly the middle east. President Putin has now followed the same playbook with Russian gas but, as the western world looks to switch away from carbon-based energy sources, it should be remembered that China produces over 50% of the world supply of car batteries and over 80% of solar panels as well as having a near monopoly on a number of metals vital to decarbonising the global economy. China’s avowed intention to reunite Taiwan into the Chinese fold could again lead to the weaponization of critical energy supply chains even as the world moves to renewable energy.
3) Decarbonising the economy – The cost of moving towards a decarbonised economy will have to initially be borne by the consumer. Rethinking business methods may eventually lead to efficiency gains but the initial cost will need to be passed through the system.
4) Geopolitics – Politics are rarely important to investment markets with very few political leaders capable of having the vision and political longevity to really make a marked difference in how the world works. One notable exception would be Deng Xiaoping and his decision to shift China towards being an export-oriented, market-tolerating economy in the 1980s. This released a very sizable fresh workforce onto the world economy which drove down unskilled and semi-skilled wages and hence inflation for a 40-year period. It seems any geopolitical consensus is now fraying at the time when climate change demands just such a consensus.
5) Globalisation of trade – undoubtedly in the 40 years to 2010 global trade expanded as companies took advantage of the opening of China and other markets with their cheap labour force to bear down on the cost of manufacture, but rising geopolitical tensions mean that globalisation, whilst not in retreat, has stalled; in 2022, exports were slightly lower, as a proportion of global GDP, than they were in 2008. The move from ‘just in time’, low-cost production, to ‘just in case’ production with multiple supply chains located in, hopefully, more stable areas of the world must mean a higher overall cost of production.

The five points above have all worked to reduce inflation for a prolonged period of time but their long-term dynamic looks to have changed. However, going forward, there is one factor which continues to bear down on inflation and that is the speed of technological change. Artificial Intelligence (AI) is being touted as having similar potential to the introduction of the Internet to alter the way we live and how the corporate world works. I see this as having a simpler economic impact. For all

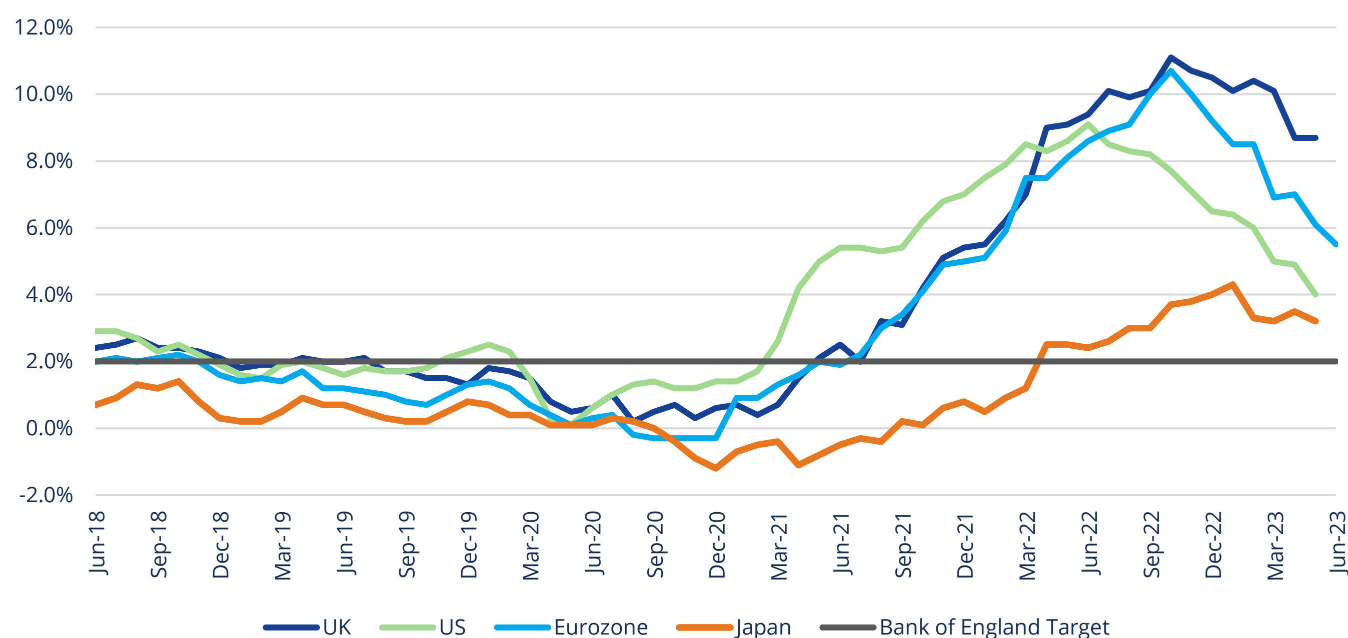
my working career, technology has advanced, altering the way I work, removing one competitive edge and opening up opportunities to create others. I see AI as a continuation of this trend. It pushes the substitution of labour by computing power up the value chain from skilled and semi-skilled work to highly skilled and professional work and will have the ability to drive the price for certain jobs lower whilst creating new roles in the monitoring and managing of AI itself as well as challenging its assumptions and results.

The above economic outline leaves scope for short-term interest rates to be nearing a peak in the US and UK and soon Europe whilst long-term bond yields may still exhibit some volatility as markets come to realise that inflation is not beaten yet; that interest rates will stay higher for longer; that high government debt levels will lead to higher interest charges with greater government bond issuance and that Quantitative Tightening removes a major buyer from the bond markets as central banks let their existing holdings of bonds bought during Quantitative Easing mature and fall off their balance sheet.

US inflation should bottom above 3%, quite possibly rising into the year end back towards 4% due to tougher year-on-year comparisons and continued high wage growth. This will not be an environment where US interest rates can be cut. The only alternative to this is a more obvious slowdown in the US economy and increased unemployment but any negative data will initially be used by the US Fed to pause interest rate increase rather than cut them. A reacceleration of the US economy seems unlikely from here. Whilst the time scale for the effect of higher interest rates may have lengthened, rates have still risen and, as such, eventually corporates and consumers will be paying higher debt servicing costs, the effect of which is to redirect cash-flow generated by the business from growth towards interest payments.

Outside of the US, Europe does not have the same tight labour market and is, therefore, more able to bring inflation under control especially as economic growth is slow across much of the EU. The outlook here is for a mild recession but falling inflation. The UK remains the problem child, it has many of the same problems as the US with a tight labour market and inflation now built into many employees' wage expectations. The Bank of England (BoE) may still need to raise interest rates further into a sluggish economy and any indecision or tailing off in the inflation fight will undermine investor confidence in the UK and be felt through weaker Sterling and rising long-term bond yields which again emphasises my preference for the shorter duration bonds particularly in the UK.

Chart 2: CPI – Annual Rate of Inflation - Five Years to June 2023



All central banks in the western world would like to drop their 2% inflation targets but feel unable to do this until there are, at least short-term, signs that inflation will hit the 2% level. They will have to row back on their 2% target from a position of strength and credibility or lose the confidence of investors in their anti-inflationary stance.

China

China has not seen the same economic rebound from ending the Covid era economic lockdowns as the developed world. There seem to be two main reasons for this. Firstly, the Chinese property market has over expanded and become over indebted. This needs to be worked through but, more importantly, if the government lowers interest rates it will just reignite the property sector and exacerbate the existing issues. Secondly, the consumer seems to have been scarred by their experience through Covid and is responding to what they see as the unpredictability of central government in the imposition of severe economic lockdowns over a multi-year period by increasing their propensity to save and storing more money away, this has negated the post lockdown consumption boom which we have seen in most other countries and is an interesting side effect of a totalitarian regime which can have an immediate and high impact on a population's daily lives. This should be a transitory impact and consumption should pick up in time.

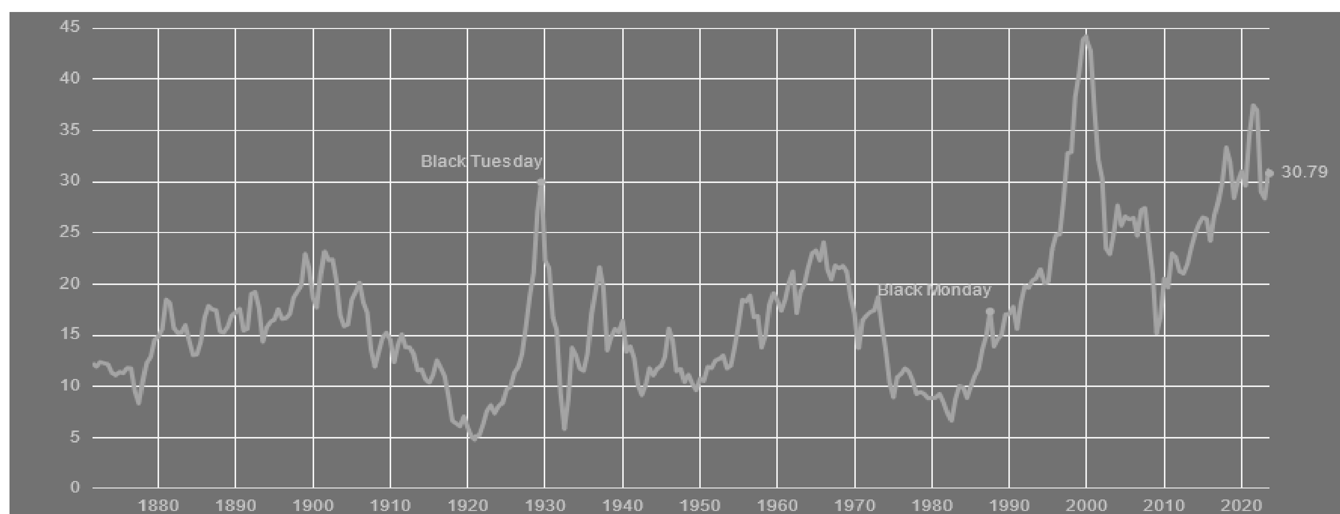
Markets

Given the above my expectation is for interest rates to stay high for the remainder of 2024 with any attempts to cut rates needing to be reversed quite quickly as inflationary pressures remain nearer the surface than in the recent past. This makes current yields quite attractive, particularly the shorter duration end of the yield curve as short rates are higher than long rates at present. A negative yield curve, where short duration yields are higher than longer duration yields, is traditionally seen as a sign of an impending recession. If interest rates stay higher for longer, short-term bond yields will remain high whilst longer duration bond yields may have to rise further leading to some price weakness in 5–20-year bonds.

In this higher rate environment, I would not expect equities to perform that well, on the one hand they are a partial inflation hedge but when the risks are of a slowing economy and stubborn inflation, the ability to pass costs on to consumers may become constrained. Earnings expectations have fallen back for this year but remain unaltered for 2024 and have, therefore, yet to recognise any impending economic slowdown.

The chart below shows the Shiller or CAPE price/earnings (P/E) ratio for the S&P 500 using average 10-year earnings and can be used as an indicator of long-term value for equity markets. It makes sense for equity markets to trade more expensively when interest rates, and thereby the cost of capital, is low but the recent rise in bond yields should lower valuations in the medium-term. This suggests that equities are not particularly cheap at the present time.

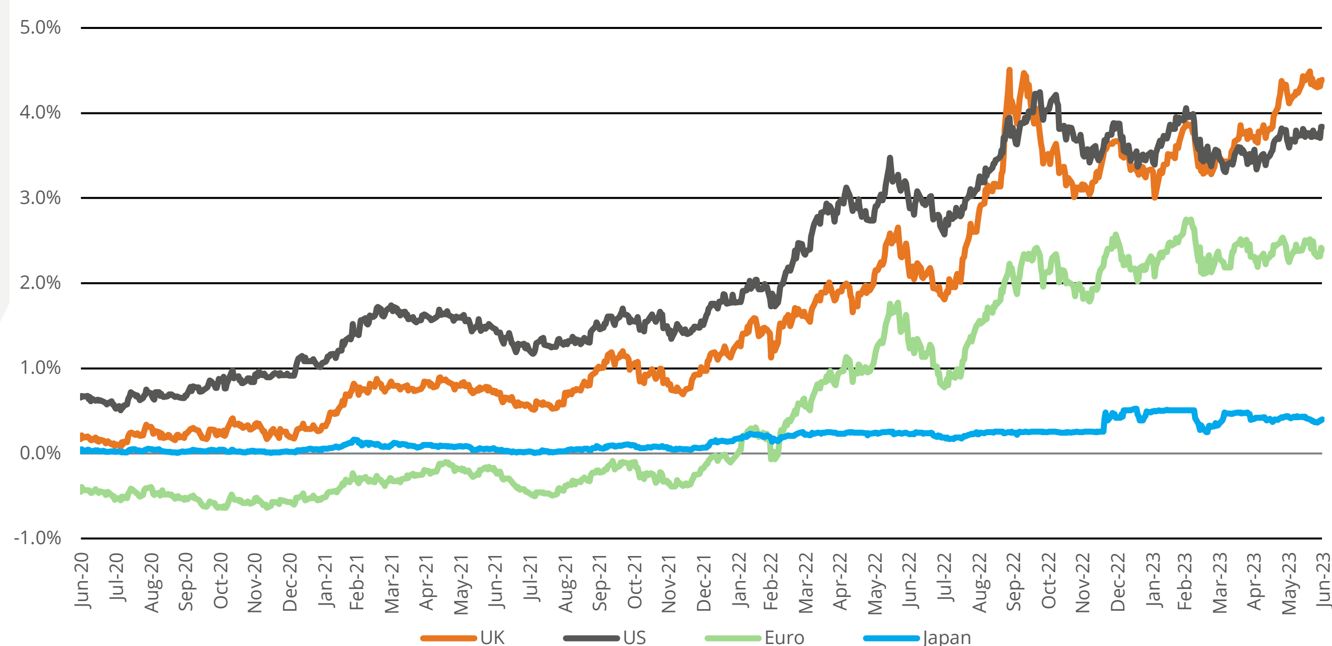
Chart 3: Shiller P/E



Asset Allocation

At the Strategic Asset Allocation review, conducted by MJHudson in 2022, The Fund agreed to increase investment into Infrastructure and Social/Affordable housing and reduce investments into UK Equities and Bonds. At the time bond yields were rising (prices falling) and looked unattractive as inflation was still rising requiring higher interest rates whilst UK equities had outperformed other equity markets during the Covid induced market fall and looked somewhat overvalued. What has now changed is that there is more confidence that inflation has at least peaked and that higher interest rates will reduce inflation over time, interest rates in the US and UK are nearing their peak making short duration bonds more attractive to investors, whilst equities have risen over the last year making them more expensive.

Chart 4: Government 10-year Bond Yields



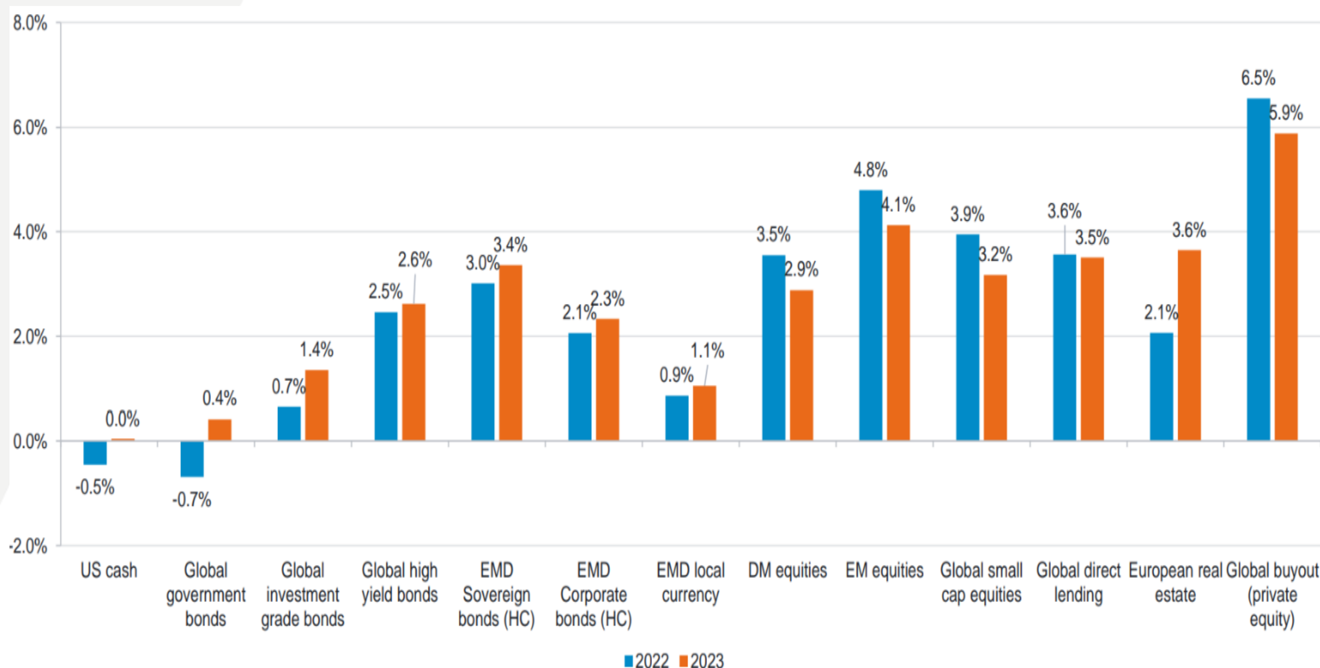
In that Strategy review MJHudson used forward looking risk and return assumptions for all the major asset classes, these assumptions showed Equities as one of the most attractive asset classes on a 10-year view with a return assumption of 6.7% per annum. Since then, equities are up 15% year-to-date whilst bond yields have continued to rise (prices fall) and the yield of UK Government Gilts now surpasses the yield levels reached in autumn last year when the Truss/Kwarteng budget brought the UK Gilt market into a panic.

Given the move in markets so far this year, I would set the assumed return on UK cash equal to current interest rates of 5.25% (previously 2.2% reflecting interest rates at the time). Consensus is for UK interest rates to reach 5.5-5.75% during the Autumn although I suspect the peak may need to be over 6%. UK Gilt return expectations should reflect the current 10-year Gilt yield so 4.5% with UK Investment Grade and Global Bond returns also looking slightly higher at 6.0% (UK Gilt return plus credit risk premium).

Against this I would argue the All Country World Equity Index returns should be lower to around 6.0% per annum for the next 10 years. I would also argue for a lower assumed return on Private Equity as I do not believe higher interest rates have been realistically fed through into valuations at present, yet deal flow and sales or flotations have fallen markedly, giving limited pricing points to check valuations against. (It will not just be a few UK water companies which bear the scars of the private equity industries desire to boost short-term returns by increasing the level of indebtedness within businesses.).

Direct lending is an area where returns are currently very attractive with yields currently over 10% with fee income on top. Given this high current return, 10-year returns could easily reach 7.5% or more. This remains an attractive area but is illiquid and takes time to invest into meaning that it would need to be seen as a long-term allocation rather than a move to take advantage of higher current bond yields

Chart 5: Forecast Real returns by asset class, comparing 2023 with 2022 forecasts



Source Fidelity

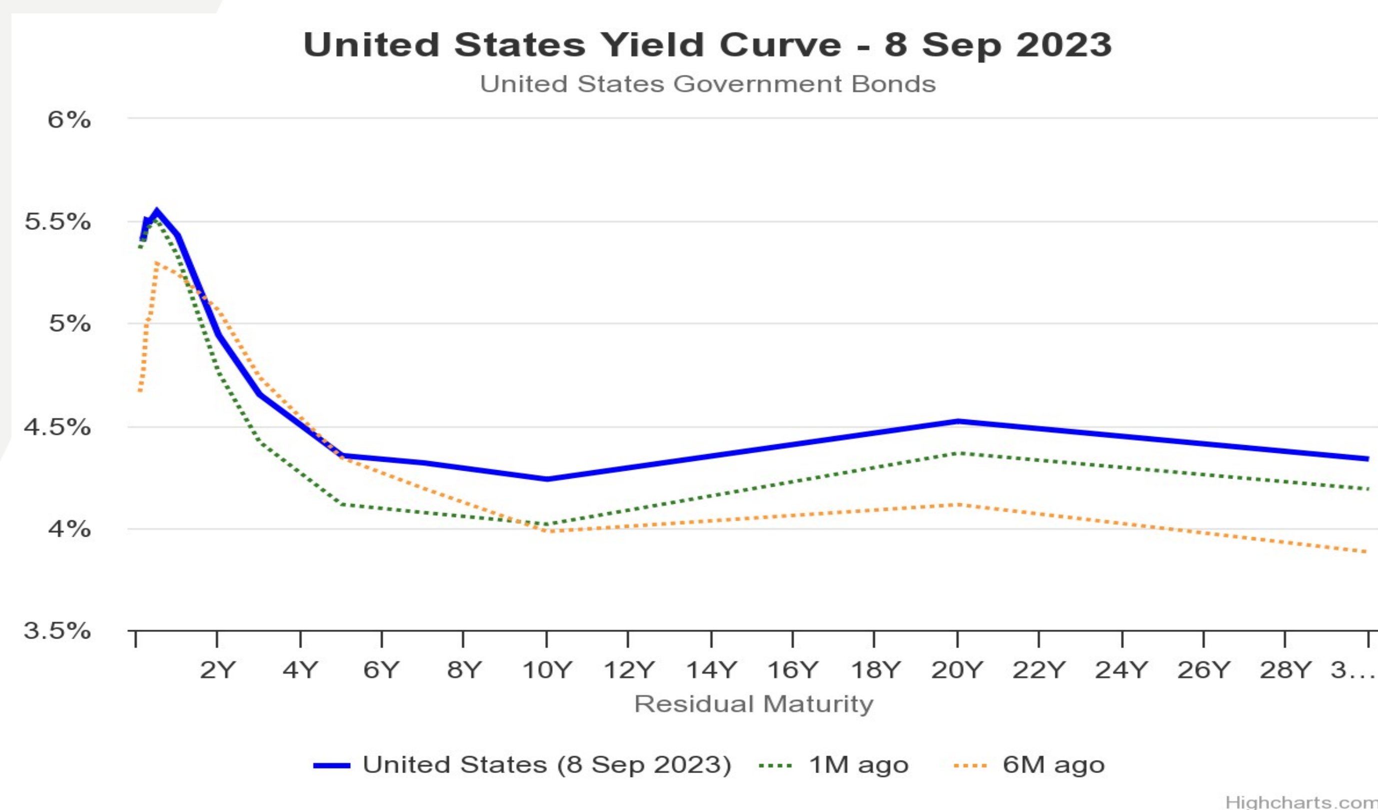
The chart above shows the forecast asset class real (post assumed 10-year inflation) returns for 2023 compared with those forecast a year ago. These are from Fidelity International. The exact numbers are less important than the change between 2022 and 2023. In particular, note the rise in forecast return for bonds as interest rates and yields have risen and the fall in expected returns from equity markets. I would argue that the return forecasts for Global Equities looks slightly high given historically high profit margins currently enjoyed by many corporates.

Within Global Bonds, we currently have an inverted yield curve which means that short duration bonds are yielding more than longer duration bonds. This means that, with interest rates peaking, investing in short duration bonds looks attractive. In the UK, short duration investment grade bonds are currently yielding around 6.8% which, I would regard as being at or above the expected return for global equities for the next ten years and comfortably above the Fund's actuarial assumed investment return. Investing in this area would allow the Fund to lock in a return noticeably above the actuarial required return for minimal risk as short duration bonds will only fall if interest rates have to rise significantly from here. I would note, however, that Brunel do not currently offer a short duration bond fund.

At some stage in the future, when the inflation outlook is clearer, longer maturity bonds could look attractive as they would gain from any decline in yields as long-term inflation expectations fa

ll but I expect that to be 2-5 years away. Fixed interest investments are held for diversification purposes as they tend to rise in value when investors seek security during times of market stress when equities may be falling, but that diversification benefit is usually best at the longer duration end of the bond market. They are also held for yield which, at present, is most attractive at the short end of the duration curve.

Chart 6: US yield curve (bond yield across varying maturities).



As can be seen in the chart above, bond yields are highest at the short duration end up to about 2 years.

Table 1: The Funds current asset allocation against 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	54.3%	**53%**	+1.3%	-£40m
Fixed Interest	17.4%	**17%**	+0.4%	-£12m
Property	8.6%	**10%**	-1.4%	+£44m
Diversified Risk	7.8%	**0%**	+7.9%	-£246m
Alternatives	10.1%	**20%**	-9.9%	+£308m
Cash	1.8%	**0%**	+1.8%	-£56m

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 to Alternative investments made so far are as follows:

Table 2: Allocations to Alternative Investments Invested/Committed

Invested/Committed	Private Equity	Infrastructure	Private Debt
Cycle 1 March 2018	£35m/£40m	£37m/£40m	£55m*/£80m
Cycle 2 Apr 2020	£27m/£70m	£80m/£130m	£68m/£120m
Cycle 3 Apr 2022	£0m/£16m	£3m/£38m	£5m/£20m
Total	**£62m/£126m**	**£120m/£208m**	**£118m/£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 is earmarked for investing into Social Housing and 2% of the Fund into a Brunel area renewable infrastructure fund. Assuming an 80% maximum investment of committed capital in Alternative funds these figures remain approximately in line with the target allocation of the Fund. 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 before joining Brunel and these two portfolios have performed above expectations returning 9.4% p.a. and 6.4% p.a. respectively against a benchmark return of 6.0% in the 6 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 with further drawdowns occurring into each asset class in the second quarter.

Executive Summary

- Macroeconomic data was generally resilient globally in the quarter, with headline inflation falling in the US and Europe, and remaining steady in Japan. Labour markets remained surprisingly robust and GDP growth remains below trend, but generally positive. Chinese and European manufacturing data has softened in recent months leading to some concern over the anticipated post-COVID rebound for China. The UK was an exception to the disinflation trend, with inflation at an uncomfortably high 8.7% in May. Despite falling inflation, the US Fed and ECB continued to hike rates and maintain a hawkish posture because of tight labour markets and stubborn core inflation data. The Q1 banking crisis appears to have been contained, but there are signs of consumer credit card defaults starting to tick up, and it is likely that the effects of the interest rate increases will take time to filter into real economies.

- Q2 was another strong quarter for equities, with global equities (MSCI World) rising around +7% in local currency (+4% in GBP terms). Equity markets were led by growth-oriented stocks (+10.1% for growth, +2.2% for value) as investors jumped on board the new innovation of Artificial Intelligence (AI). Japanese equities performed particularly strongly (+18.5% in local currency, and up +5.9% in GBP terms), as the Bank of Japan has maintained a more accommodative policy than its peers. The Tokyo Stock Exchange has also urged listed companies to become more focused on value creation, such as using cash stockpiles to remedy the low book values to market capitalisations. The combination of the very weak JPY and potential corporate governance improvement has attracted investors to the region. US equities returned just under +5%, though gains have been very concentrated in a few large tech stocks, leaving the rest of the index flat. UK equities, on the other hand, have lagged peers (slightly down in Q2) after a relatively strong 2022 and markets view more risk of recession and negative impacts to employment than for some other developed markets. Bonds, too, faced headwinds as interest rates continued to rise with central banks not yet ready to signal a shift in direction in the fight to reduce inflation. Global investment grade credit was flat over the quarter, but UK long index-linked gilts fell around -10% as yields jumped higher in light of stubborn inflation and investors now expect UK rates to peak above 6%. Energy prices softened further (oil down -6%), while GBP has continued to strengthen against both JPY and USD, retracing a fair amount of its weakness during 2022.

It is worth highlighting the following themes impacting investment markets:

- **Credit spreads indicate a sanguine sentiment to risk.** Credit spreads have tightened since the March banking crisis with US investment grade credit spreads ending Q2 at 120bps, having reached a year-to-date high of 165bps in March. US high yield bonds spreads have similarly tightened, from a high of 516bps, to 392bps at quarter end, despite incipient signs of rising delinquencies. In the first half of 2023, for example, US Chapter 11 bankruptcies have risen sharply on the same period last year.
- **Inflation – heading towards target, but core inflation proving sticky.** The UK was again the outlier in the quarter with annual CPI only falling to 8.7% in the quarter, compared to 4.0% for the US and 5.5% for Eurozone. However, core inflation (excluding energy and food prices) has been telling a different story. UK core inflation has worryingly risen to a new high at 7.1% in Q2, while US core inflation is now above headline inflation at 5.3% and has only slowly decreased from 6.0% 12 months prior. Similarly, Eurozone core inflation rose in June to 5.4% and is well above the 3.8% figure of 12 months ago. This all suggests the high inflation / high rates environment may last for rather longer than currently discounted.
- **A narrow range of stocks is driving global equities performance.** In May, Nvidia announced a vastly improved earnings forecast (50% above Wall Street consensus for Q2) driven by the demand for high specification chips used by entities pursuing AI efforts. This prompted a 52% rise in the share price over Q2, and has been emblematic of the recent attention investors are paying to companies with any form of potential for AI products. Indeed, Nvidia, Tesla and Meta have risen by 196%, 142%, and 130% respectively over the year to date. This characteristic, of performance being concentrated in a narrow number of stocks, can be symptomatic of the late phases of equity bull markets.
- **Equity valuations rise despite earnings risk.** Equities rose for another quarter, despite analysts' forecasting S&P 500 Q2 earnings declining 7.2% on the year prior. This has led the forward earnings ratio for the S&P 500 to rise to 18.9x, from 17.8x in Q1, and comfortably above its 10-year average of 17.4x. Profit margins for US equities have declined to c.12%, from 14% in 2021 but remain above longer term averages and equity markets appear to be looking past the potential effects of high interest rates and discounting a "soft landing" scenario. This would seem to leave the asset class exposed to disappointment.

- Global equities rose sharply in Q2, led by US and Japanese equities for varying reasons. The VIX declined over the quarter from 19 to 14, well down on its average level of 21 for the 5 calendar years 2017 to 2022.
  - In the US, the S&P 500 rose by +8.7% and the NASDAQ soared by +15.2%. Markets rallied as enthusiasm for AI boosted a number of some stocks and an upward adjustment to the Q1 annualised GDP figure (from 1.3% to 2.0%) provided support to the view that the US economy may avoid a recession or 'hard landing' despite the sharp rise in interest rates.

APEX

- UK equities fell -0.4% and underperformed global equities. Inflation has remained too high in the UK for the BoE, resulting in the base rate being raised to 5.0%, from 4.25% at the end of Q1. The BoE had slowed the pace of rate rises from 50bps to 25bps, but moved back to a 50bps rise in Q2. UK CPI was 8.7% in May, well above the 6.1% figure for the Eurozone.
- The Euro Stoxx 50 rose by 4.2% in Q2. Economic data was better than expected with inflation continuing to move downwards, although the ECB has maintained a hawkish rhetoric. The composite PMI has, however, been declining in Q2 and in June fell just into contractionary territory at 49.9.
- Japanese equities continued their strong run, rising by +18.5% in Q2. A weakening JPY has boosted exporters, as the BoJ maintains very accommodative monetary policy with core inflation currently at 3.2%, as well as the mentioned prospective corporate governance reform. The JPY yen fell 8.6% vs the USD over the quarter.
- Emerging market equities rose +1.0%, underperforming global equities as Chinese stocks fell. Investors had previously pinned hope on a rebound in Chinese stimulus and growth which had propelled Chinese equities in late 2022 and early 2023; however, the country has not yet provided meaningful policy stimulus.

- Medium- and longer-term bond yields rose over the quarter, generally rising with rate hikes from central banks resulting in negative performance for government bonds. The US yield curve inversion as measured by the 10-year–2-year ended the quarter at -106bps, as short and mid-term rates rose more so than longer bond yields. In corporate bonds, high-yield credit outperformed as credit spreads tightened over the quarter. Emerging market bonds rose 2.7% in local currency and 2.2% in hard currency.
  - The US 10-year Treasury yield rose in Q2, ending at 3.81% from 3.48%. US rates rose steadily through the quarter, with US GDP being revised upwards for Q1 and job openings (JOLTS) at a strong 9.8 million, compared to 7.2 million in January 2020. The US Fed raised their policy rate by 0.25% just once in the quarter to 5.0%-5.25%.
  - The UK 10-year Gilt yield rose sharply from 3.49% to 4.39% and 2-year from 3.44% to 5.27%. Over the quarter, the spread between UK and German 10-year bond yields widened, reflecting the increased stress viewed on the UK economy (UK approx. +200bps now vs +120bps in Q1, and close to the +228bps in September 2022 during the 'mini budget'). The BoE hiked rates by 25bps two times in the quarter.
  - European government bonds returned flat in Q2. Yield curves steepened further over Q2, as short-end rates rose with rate hikes, with the main refinancing rate now at 4.0% (up from 3.5%), while longer term bond yields were little changed. The German 10-year Bund yield rose to 2.39% from 2.29%, while Italy's fell from 4.09% to 4.07%.
  - US high-yield bonds outperformed investment grade, returning +1.7% and -0.3% respectively. European high-yield bonds returned 1.8%, outperforming the 0.2% for European investment grade and -3.1% for UK investment grade.
- Energy prices were mixed over Q2, as gas prices rebounded somewhat, although still sharply down from the pre-winter figures. Oil prices have traded down driven by concerns over global growth and oil demand.
  - US gas prices rose 26% in Q2. Prices have fallen dramatically from their 2021/ 2022 peaks.
  - Brent crude oil fell -6.1% over Q2, to US$75 per barrel. Falling prices since 2022 triggered various OPEC+ announcements of production cuts which have thus far only resulted in small reactions from the market. The US released oil from its Strategic Petroleum Reserve in 2021/ 2022 to meet demand and address high prices, but has yet to restock the inventory.
  - Gold and Copper fell -2.0% and -8.6% respectively over Q2. Gold fell as investors returned to risk assets and with high yields available on cash alternatives. Copper fell over the quarter from a high in April, with the growth outlook for China a headwind. Gold and Copper closed Q2 at 1,929 USD/toz and 374 USD/lb, respectively.
- Global listed property continued to decline, with the FTSE EPRA Nareit Global Index falling -2.4% in Q2.

APEX

  - The Nationwide House Price Index in the UK has continued its decline, with the price index down -0.3% for the quarter, and down -3.5% on an annual basis.

- European commercial property has also continued to decline in the face of higher interest rates, with the Green Street Commercial Property Price Index down by -2.3% this quarter and -15.9% over the past 12 months.

- In currencies, Sterling strengthened against the US$ (+3.0%) and the Euro (+2.3%) over the quarter, as the ongoing high and uncertain inflation in the UK is viewed as requiring a lengthier period of tighter monetary policy. The US$ rose modestly in Q2 (Dollar index +0.4%).

APEX

• 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 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

The poor performance of the Sustainable Equity portfolio against its benchmark this quarter is driven by the small number of large stocks which have driven equity markets higher this quarter. 7 stocks account for the vast majority of the gains within global equities in Q2 (Apple, Microsoft, Alphabet (Google), Amazon, NVIDIA, Tesla and Meta (Facebook)) and a portfolio's relative performance against their benchmark has depended on how much of these 7 stocks they held rather than any of the other investments in their portfolio. Within the Global High Alpha portfolio, one of the three managers, Baillie Gifford, has a high weighting to technology stocks including Tesla and NVIDIA which meant that this portfolio as a whole managed to perform in line with its benchmark during the quarter. The Sustainable Equity portfolio is managed by one manager and they did not have a great exposure to these 7 stocks and hence underperformed. Unfortunately, the Sustainable Equity portfolio has not performed well since inception but that was September 2020 with the Russian invasion of Ukraine occurring in February 2022 which pushed energy stocks higher leading to the underperformance of most environmental stocks. I remain supportive of the investment philosophy and process behind the Sustainable Equity mandate and believe it will add value over time.