REPORT PREPARED FOR

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Global overview

Q3 was challenging for most investors, with only temporary optimism that Central Banks would soon end their rate hikes. Markets continued to grapple with the challenges of high inflation, slowing economic growth, a strong US dollar, and accelerated interest rate hikes. Equity markets rose for the first half of the quarter, until monetary policy became more hawkish, and led to repricing in light of persistent high inflation. Long-term bond yields fell until late July as markets viewed recession risk as taking precedence over inflation, however policymakers tightened monetary policy further with additional rate hikes. Global equities fell again, declining by -6.1% over the course of the quarter. Emerging markets detracted the most within equity markets (-11.5%), facing the headwinds of slowing growth from China and a strong US dollar. US equities fell -4.9%; followed by European and UK equities (-3.7% and -3.5% respectively). Growth stocks fell less (-5.2%) than value stocks (-7.8%). Corporate and government bond indices also fell sharply (with UK Gilts and UK investment grade credit falling by -12.8% and -11.4% respectively), while emerging market bonds in hard currency terms fell by -4.6%. Real assets such as commodities and real estate generally also fell, and the US dollar strengthened against most currencies, benefiting from broad risk aversion and increasing interest rate differentials in its favour.

GDP growth: Despite the ongoing recovery from the pandemic, the impact of the war in Ukraine and high inflation are both expected to slow growth in the UK and Europe in particular. As the war continues, commodity prices remain high and volatile, and supply chains disrupted. The US has reported a GDP growth rate of 0.6% for Q3, following declines in both Q1 and Q2. China's growth has been disrupted by ongoing COVID-19 lockdowns and a real estate slump - its GDP growth is expected to slow sharply to 2.8% in 2022.

The new UK Government's September "mini-budget", in part aimed at boosting growth, appears to have been misjudged: markets were spooked by the risk which the unfunded tax cuts pose to the UK's fiscal position, resulting in a rapid rise in long term interest rates, and a sharp fall in GBP. Gilt markets have stabilized following the BoE's intervention, but the increased volatility does represent a risk factor to UK pension funds, whilst those with "Liability Driven Investment" (LDI) portfolios have had to source liquidity in order to meet significant margin calls.

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

Inflation – the end is not yet in sight. While YoY CPI inflation appears more or less to have plateaued near double digit levels (in the US, August CPI increased to 8.3% YoY, Eurozone inflation rose to 10.0% and the BoE expects UK inflation to be in double digits for the next few months) there are clear indications of inflation becoming more entrenched. Euro core inflation rose to a new high at 4.8%, highlighting the stickiness as it shifts from goods to service prices, while average earnings are starting to rise faster (average hourly earnings rose to 5.2% in the US in August, 5.5% in the UK in July). 10-year inflation break-evens are well above Central Bank targets (e.g. c. 4% in UK), suggesting inflation is likely to remain "higher for longer".

Inflation vs Recession – the monetary policy conflict. To combat this, monetary policy continued to tighten in most major developed countries, with the Fed, the BoE and the ECB all raising rates several times in Q3. In addition, the Fed is expected to increase the pace of reducing its balance sheet ("Quantitative Tightening", QT), while the BoE was planning to start QT at the end October before the mini-budget caused a rethink. Markets now expect rates to peak in the 4.5-4.75% range in the US, and around 5.5% in the UK. But 10-year real rates are still only barely positive, suggesting further rises may be needed to quell inflation, and Central Banks remain very focussed on the latter. As a result the likelihood of a "hard recession" is increasing, particularly in the UK and Europe.

Liquidity risk rising: While higher rates increase the attractiveness of cash, the tighter monetary policy (particularly QT) increases the risk of liquidity stresses appearing in financial markets. The spiral in UK Gilt yields, which caused UK pension funds with LDI exposure to sell other assets in order to meet margin calls is symptomatic of this. Investors may want to take this opportunity to examine the liquidity profiles of their portfolios, and ensure they are comfortable.

Valuations – looking more attractive if earnings are sustained: With global equities over 25% off their peak and credit markets 15-20% down, valuations are looking more in line with long-term averages. US equities are trading on 15x forward P/E, while most other regions are nearer 10x, and global investment grade indices yield c.4-5%. Corporate profits have so far remained broadly resilient, and expectations for 2023 earnings are still strong despite the strong US dollar which historically has a negative impact on S&P 500 earnings. US profit margins have declined to 10.9% for Q2, down from 11.9% for Q1, but still above the long-term trend and recessionary levels. Similarly, credit spreads have widened only slightly beyond their long-term average, signalling investors' views that economic recession may well occur, but widespread defaults are less likely. This potentially indicates that earnings forecasts and default expectations may still be too sanguine.

Summary and Market Background

The value of the Fund in the quarter fell very slightly to £3.259bn, a decrease of £6m compared to the end March value of £3.265bn. The Fund produced a return of -0.4% over the quarter, which was 0.6% ahead of the benchmark. The main reason for the outperformance was attributed to the Property, Infrastructure and Corporate Bond mandates. The equity protection strategy was unwound during September. Over a 12-month period the Fund recorded a negative relative return against the benchmark of -1.5% (-3.8% v. -2.3%). The Fund has performed at or near the benchmark over the three, five and ten year periods, details of which can be found in Portfolio Evaluation Limited's report.

Following on from the changes reported in my last review concerning the equity protection strategy mandate, the active positions have now been closed. As a reminder, the division of River & Mercantile that included the derivates team has been taken over by Schroders. Despite assurances at the time that it would be "business as usual", the three key members of the team either did not transfer or have now left the business. It is therefore appropriate that our arrangements should be reviewed. The strategy has been successful, particularly once the management of it was moved to be on a more dynamic basis, ensuring the protection offered remained appropriate as markets moved. A key element has been that one of the options available in managing the strategy would include removing protection if it was felt that markets were at a level that it was no longer required. It is important that the capability to implement protection again is maintained, given that the asset allocation continues to have a relatively high percentage of the Fund's assets (70%) invested in equities. The equity protection strategy forms part of the overall risk management arrangements, with the objective of continuing to provide some protection to the funding level in the event of future significant falls in equity markets.

The Triennial Actuarial Valuation currently being undertaken by Mercers does not appear to be throwing up anything that is unexpected or that would require major changes in the Fund's asset allocation. Currently the main items that need to be considered are ensuring that the mix of assets are appropriate to deal with a) inflation likely to be running at a higher level than we have been accustomed to in recent years and b) a higher cash flow requirement to accommodate the increase in pension payments resulting from higher inflation. The Fund has experienced a lot of changes in the way that the investment assets are managed over the last three years, partly as a result of the pooling of those assets with LGPS Central. This has carried a high price in the short term, so a period of consolidation would now be prudent. Therefore, any changes should be kept to the minimum, such as to accommodate the above.

The Strategic Asset Allocation review does however provide the opportunity to consider some aspects of investment strategy within the main asset groups, to ensure that we continue to have the right mix of investments to diversify risk and to meet the longer term objectives. This is supported by the review of the Fund's investments undertaken by Hymans Robertson, which was presented to the PISC meeting in September.

We also need to be cognisant of the constantly rising expectations and requirements relating to ESG and climate change considerations. Considerable progress has already been made in this respect by the Fund and by LGPS Central, but this is an evolving process and consideration needs to be given to the pace of next steps and what they should be.

Performance during Q3 2022 has once again been a bit of a mixed bag, but also has highlighted the value of having a diversified portfolio of asset types, particularly in the current volatile environment for public markets. I'm going to leave it to the politicians amongst you to make sense of the events of the last few months, if you can! Certainly the brief foray into Trussonomics gave the markets quite a fright, particularly the Gilt market. The need for corporate pension funds to provide additional collateral for their LDI positions was unpleasant to watch, but at least it had minimal impact on the LGPS in general and our own Fund in particular. The upheaval in September was particularly irritating because over July and August markets had been trending steadily upwards, a welcome respite from the difficult times seen in H1. The tide of fortunes for Ukraine seemed to be turning for the better and although the impact of inflation on the cost of living was really starting to manifest itself, markets generally seemed to be trying to look through the economic gloom to potentially better times ahead. In performance terms from our active managers Nomura (Pacific) showed an outperformance of 1.3% and LGPS Central (Emerging Markets) underperformed by -1.5%, with two out of three managers contributing to that. It is good to see a positive contribution in Q3 from the LGPS Central Global Sustainable Active Funds, with the Targeted strategy at 2.8% and the Thematic strategy at 1.4% relative. LGPS Central (Corporate Bonds) performed inline their benchmark. The total property fund showed an outperformance against our own benchmark of 3.5%, which is showing a continuing improving trend post the Covid hiatus. Hopefully recession won't damage that recovery and in the context of the long term nature of the Fund's investment strategy these irritations are not significant detractors from overall performance. Infrastructure continued to perform well.

The passive equities slightly outperformed the alternative passive strategies by 0.1% (-0.1% v. -0.2%). Active market equities also slightly outperformed passive equities, by 0.2% (0.1% v. -0.1%). Out of the passive geographies, North America was the winner (3.5%), with UK (-3.4%) and Europe (-2.4%) being the laggards this time.

Equities

Global equities fell sharply in Q3, continuing the year-to-date trend. In addition to the ongoing war in Ukraine, the impact from slowing economic growth, rising interest rates, and high inflation have all significantly hit markets. Given the selloff in equity markets, the VIX increased by 10.1%, from 28.7 to 31.6.

In the US, the S&P 500 fell by -4.9% and the NASDAQ fell by -3.9% in response to interest rate hikes. Communication services and REITs were the hardest hit in the quarter, down -12.7% and -11.0% respectively. Energy and consumer discretionary were the only positive sectors in the quarter, although consumer discretionary had fallen significantly in Q2.

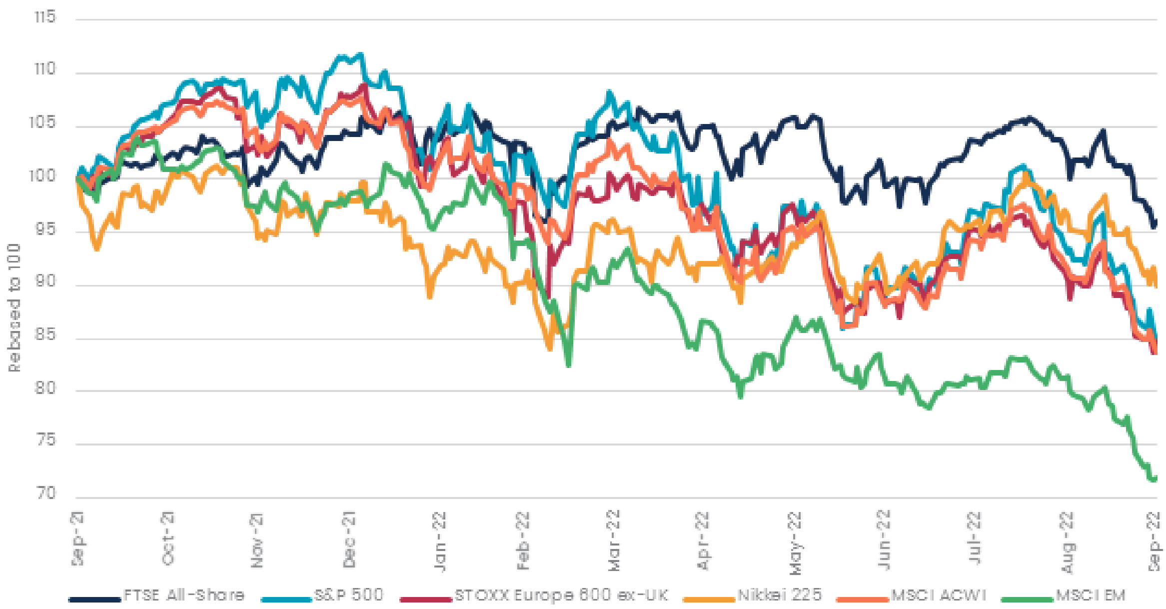
UK equities continued to be impacted by the war in Ukraine and subsequent volatility in energy prices. The BoE raised the base rate to 2.25% in September. New fiscal policies from the new Government resulted in markets falling sharply and Gilt yields rising dramatically at the end of the quarter. However. On a relative basis the UK somewhat outperformed global equities, declining by -2.8% (FTSE 100) and -3.5% (FTSE All-Share).

The Euro Stoxx 50 fell by -3.7% in Q3 as the ECB ended its long period of negative rates. Concerns over the higher cost of living and the possibility of recession saw the European Commission’s consumer confidence reading fall to -28.8 in September, a level lower than during the peak fear of the pandemic.

Japanese equities fell by -0.9% in Q3. While inflation has been trending higher and above the target range, it remains well anchored relative to peers, at only 3.0% for August. The BoJ has steadfastly kept monetary policy stable, but was forced to intervene in currency markets as the yen has fallen particularly sharply against the US dollar, reaching 144.

Emerging market equities fell more (-11.5%) than global equities, with US dollar strength the main headwind as well as marked weakness in Chinese economic data.

Global Equity Markets Performance



Source: Bloomberg. All in local currency.
FTSE All-Share Index (Ticker: ASX Index) S&P 500 Index (Ticker: SPX Index) STOXX Europe 600 (Ticker: SXXP Index)
Nikkei 225 Index (Ticker: NKY Index) MSCI World Index (Ticker: MXWO Index) MSCI Emerging Markets (Ticker: MXEF Index)

Fixed Income

Bond yields rose in Q3 amid elevated inflation and rising interest rates. Yield's initially fell in July/August due to rising recession concerns; but ended the quarter higher on Central Banks' comments and rate hikes. In corporate bonds, high-yield credit outperformed as spreads were largely unchanged and have less duration sensitivity. Emerging market bonds fell -4.3% in local currency, and -4.6% in hard currency.

The US 10-year Treasury yield rose from 2.98% to 3.83% and the 2-year from 2.93% to 4.22%. Treasuries provided a total Q3 return of -4.3%. The unemployment rate rose slightly to 3.7% in August, indicating a still strong labour market, and supporting the Fed's case for further policy tightening. The Michigan Consumer Sentiment index rose to 58.6 in September but remains well below pre-pandemic levels.

The UK 10-year Gilt yield increased from 2.23% to 4.09% and 2-year rose from 1.88% to 4.30%. Much of the increase occurred in August/September due to the proposed tax cuts and borrowing by the new government, which caused sterling to slump and yields to spike, and for the BoE to announce emergency gilt buying. The yield spike is understood to have also resulted in forced selling to meet margin calls from some pension funds with LDI strategies.

European government bonds had a total return of -5.1% in Q3. The selloff in European government bonds took place as the ECB raised rates by 125bps in Q3 with further rises expected to try and reduce inflation, following the same path as the BoE and Fed. The German 10-year bund yield increased from 1.37% to 1.87% with Italy's up from 3.19% to 4.17%, although hitting as high as 4.75% in September.

US high-yield bonds outperformed the global bonds market, returning -0.6%, and European high-yield bonds returned -0.9%. Investment-grade bonds returned -11.4% in the UK, -4.7% in Europe and -5.1% in the US.

Currencies

In Q3, sterling weakened sharply against the US dollar (-8.3%) and the euro (-2.0%). The principal driver came late in September as the new Chancellor proposed cutting taxes and increasing government borrowing. Existing fears of a UK recession and inflation uncertainty had already placed relatively low confidence in the UK economy and currency. Overall, the US dollar (Dollar index +7.1%) had a strong Q3 and strong YTD (+17.2%). Notably the US dollar also strengthened against the Japanese yen by 6.7% despite the intervention by the BoJ, reflecting the attractive mix of a high interest rate and "safe haven" status that the dollar currently offers.

Commodities

Energy prices fluctuated in Q3 2022, with the continuation of the war in Ukraine, and tension regarding the Nord Stream pipeline. Natural gas prices rose, while crude oil prices fell as recession fears (and expectations of falling oil demand) weighed on sentiment. Precious metals fell, negatively impacted by the rise in rates.

US gas prices rose 24.7% over Q3, influenced by concerns over global supply. The increase in exports from the US to Europe, due to Europe seeking to replace Russian gas, has led US prices to rise. Prices in Europe climbed over Q3 (Dutch TTF Gas Futures +33%) due to the aforementioned Nord Stream issues. Prices spiked round 330 €/MWh in August when Russia announced a 3-day shutdown of Nord Stream 1, but subsequently retreated to end the quarter at 188.

Brent crude oil fell -23.4% in Q3. 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 disruptions. Oil prices fell through the quarter except a small jump prior to the OPEC+ meeting in early September where the group agreed a marginal but symbolic cut in production. Brent closed the quarter at $88 per barrel.

Gold and Copper fell -8.0% and -8.1% respectively in Q3, with gold falling on rising interest rates, and copper falling on concerns of slowing economic growth, Chinese economic growth in particular. Gold and Copper closed Q3 at 1,662 USD/toz and 341 USD/lb, respectively.