

REPORT PREPARED FOR  
**Oxfordshire Pension Fund Committee**

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Summary

The value of the Fund in the quarter fell slightly to £3.01bn, a decrease of £35m compared to the end March value of £3.05bn. The Fund produced a return of -1.2% over the quarter, which was -0.5% behind the benchmark. While disappointing, it would be fair to say that the Fund is not suffering unduly from the challenges that we have seen in markets over 2022, which has certainly been helped by the diversified spread of assets. Put simply the alternatives portfolio have provided support while public markets have suffered a fair amount of stress, including volatility. Over a 12-month period the Fund recorded a negative relative return against the benchmark of -4.0% (-6.4% v.-2.4%). The scale of the recent underperformance has also had an impact on the longer term performance periods, now behind the benchmark over the three and five year periods and in line over the ten year period, details of which can be found in Brunel's report.

The highlights

1. 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 rush by 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.
2. 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. Ultimately these minor irritants should not be a significant concern for long term investors like the Fund.
3. As I wrote last time this included seeing an environment better suited to the growth style slants seen within the Brunel active mandates. Although that hope was to some degree postponed, two of the active equity mandates (Global Sustainable and UK Active) did experience small positive performance in the quarter. I remain cautiously optimistic that as the political situation settles down then we will see brave investors emerging from their bunkers. Strangely enough that may well include renewed interest in Emerging Markets, a thoroughly bombed out area!
4. Our Private Markets valuations have in general terms held up well during 2022, certainly when compared to Public Markets. As flagged previously, valuations are starting to trend downwards though, reflecting growing economic concerns and comparisons to public markets. The listed private equity portfolio had another difficult quarter, but longer-term performance is still well in excess of public

markets. Some of the discounts to NAV being seen are reminiscent of the period during the Global Financial Crisis, but the underlying health of the portfolios is substantially better than it was then. As confidence returns I would expect to see those discounts start to narrow again.

5. I am pleased to report to members that I now have access to the information about our underlying managers' performance, however I have not had time to analyse this information in sufficient detail to make comments on this occasion. Watch this space!

### The lower points

1. You'll no doubt be pleased to read that I don't need to highlight so much with a negative slant this time around. Out of active equities, Emerging Markets continues to be the main drag (-1.2% against benchmark), which is very much to do with China falling by 15.7% in local currency terms. September alone saw a fall of 10.9%.
2. Bonds clearly had a pretty horrific quarter in valuation terms, but fared relatively well against benchmarks. In a high inflation environment, it is difficult to see a speedy recovery in those valuations, beyond some stabilisation seen following the unwinding of the measures contained in the Kwarteng "mini budget".
3. You have probably realised by now that I am not a fan of the multi manager approach to asset management, with reversion to mean performance (at best) being the likely outcome. I am also not keen on multi component funds either, such as Multi Asset Credit and Diversified Growth Funds. In my experience they tend to be disappointing over time and with the creation of Pools they should have sufficient scale to provide the different elements as stand alone products. Rant over, but note the poor performance.
4. I have raised the issue of the slow rate of drawdowns in some of the Private Market commitments with Richard Fanshawe. While he acknowledges that more suitable investment opportunities may become available given the deteriorating economic background, particularly in the secondaries market, they are determined to remain highly selective in their process. He does anticipate a higher rate of call down from the managers in Private Equity Cycle 2 going forwards, despite limited progress in the last quarter.

### Points for consideration

1. The revised format of the Brunel report is to be welcomed, particularly the section dealing with Private Markets. It would be good to see the Fund value included over the short, medium and long term periods. The emphasis on assets transitioned to Brunel is not particularly useful, in my opinion.
2. The Triennial Actuarial Valuation currently being undertaken by Hymans 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.

3. The Fund has experienced a lot of changes in the way that the investment assets are managed over the last three years, mainly as a result of the pooling of those assets with Brunel. This has carried a heavy 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.
4. 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.
5. 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 Brunel, but this is an evolving process and consideration needs to be given to the pace of next steps and what they should be.
6. In this context, is a specific allocation to UK equities in addition to global equities still relevant or desirable? The FTSE All Share index is not really a good representation of UK plc, but it is a sterling based market, so is directly matched to the home currency of the Fund. It also carries a heavy comparative weighting to fossil fuels and commodities.
7. The recent conflict in Ukraine has thrown the Putin administration in Russia into sharp focus and as a result has heightened concerns about China's ambitions. The recent 20<sup>th</sup> National Congress has if anything exacerbated those concerns. My thought piece in this report focuses on China and the pros and cons of investing there. Your thoughts on this and possibly investment in other countries would be welcomed.

## Overview and Outlook thoughts

### 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 is forecasting a GDP growth rate of 0.3% 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.

GDP Growth Rate and Monthly CPI

%	GDP		CPI		
	Q2 2022	Q3 2022	Jul	Aug	Sep
UK	0.2	-0.2	10.1	9.9	10.1
US	-0.6	0.6	8.5	8.3	8.2
Eurozone	0.8	-0.2	8.9	9.1	9.9
Japan	0.9	-0.3	2.6	3.0	3.0

Source: Bloomberg; Trading Economics. \*Forecasts based on leading indicators.

GDP Notes: UK Real GDP (Ticker: UKGRABIQ Index); US Real GDP (Ticker: EHGUS Index); Eurozone Real GDP (Ticker: EUGNEMUQ Index); Japan Real GDP (Ticker: EHGJJP Index)

### Outlook thoughts

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.

## 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)  
Nikkei 225 Index (Ticker: NKY Index)

S&P 500 Index (Ticker: SPX Index)  
MSCI World Index (Ticker: MXWO Index)

STOXX Europe 600 (Ticker: SXXP 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.

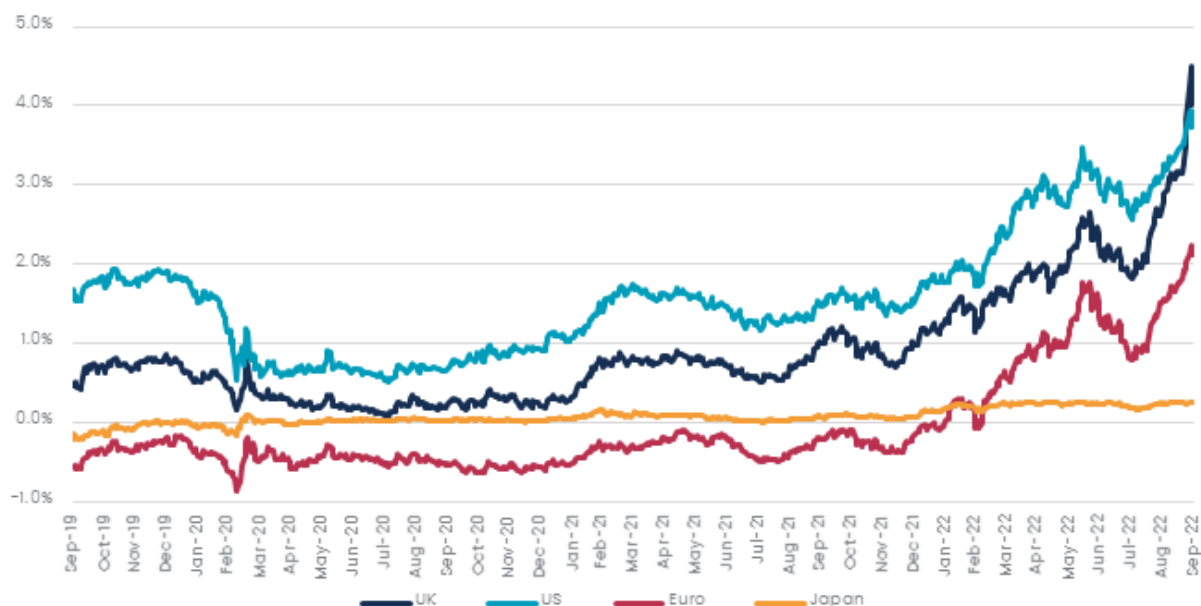
The US 10-year Treasury yield rose from 2.98% to 3.83% and the 2-year from 2.93% to 4.22%. Treasuries provided a total Q3 return of -4.3%. The unemployment rate rose slightly to 3.7% in August, indicating a still strong labour market, and supporting the Fed's case for further policy tightening. The Michigan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

### Government Bond Yields



Source Bloomberg. US Generic Govt 10 Year Yield (Ticker: USGG10YR Index); UK Govt Bonds 10 Year Note Generic Bid Yield (Ticker: GUKG10 Index); Euro Generic Govt Bond 10 Year (Ticker: GECU10YR Index).

### 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

## Property

Global listed property had a weak quarter, with the FTSE EPRA Nareit Global Index falling -3.8% in Q3.

Property prices in the UK have begun to decline recently, with the Green Street Commercial Property Price Index down by -4.9% this quarter. The all-property index is now down -5.9% since the start of the year.

The Nationwide House Price Index in the UK fell slightly to 9.5% YoY in Q3, down from 10.7% in Q2. Expectations indicate a slowdown, with mortgage approvals falling back towards pre-pandemic levels and rising mortgage rates. However, the housing market has retained some momentum given rising inflation and further stamp duty cuts.

# Key Indicators at a Glance

## Market Indicators

	Index (Local Currency)	Q3 2022	Quarter-on-Quarter	YTD
<b>Equities</b>		<b>Index Value</b>	<b>Total Return</b>	
UK Large-Cap Equities	FTSE 100	6,894	-2.8%	-3.8%
UK All-Cap Equities	FTSE All-Share	3,763	-3.5%	-8.0%
US Equities	S&P 500	3,586	-4.9%	-23.9%
European Equities	EURO STOXX 50 Price EUR	3,318	-3.7%	-20.4%
Japanese Equities	Nikkei 225	25,937	-0.9%	-9.8%
EM Equities	MSCI Emerging Markets (USD)	876	-11.5%	-27.0%
Global Equities	MSCI World (USD)	2,379	-6.07%	-25.12%
<b>Government Bonds</b>				
UK Gilts	FTSE Actuaries UK Gilts TR All Socks	2,968	-12.8%	-25.1%
UK Gilts Over 15 Years	FTSE Actuaries Uk Gilts Over 15 Yr	3,764	-18.8%	-38.9%
UK Index-Linked Gilts	FTSE Actuaries UK Index-Linked Gilts TR All Stocks	4,256	-9.3%	-29.3%
UK Index-Linked Gilts Over 15 Years	FTSE Actuaries UK Index-Linked Gilts TR Over 15 Yr	5,231	-11.1%	-39.2%
Euro Gov Bonds	Bloomberg EU Govt All Bonds TR	213	-5.1%	-16.7%
US Gov Bonds	Bloomberg US Treasuries TR Unhedged	2,173	-4.3%	-13.1%
EM Gov Bonds (Local)	J.P. Morgan Government Bond Index Emerging Markets Core Index	115	-4.3%	-16.7%
EM Gov Bonds (Hard/USD)	J.P. Morgan Emerging Markets Global Diversified Index	743	-4.6%	-23.9%
<b>Bond Indices</b>				
UK Corporate Investment Grade	S&P UK Investment Grade Corporate Bond Index TR	310	-11.4%	-23.3%
European Corporate Investment Grade	Bloomberg Pan-European Aggregate Corporate TR Unhedged	209	-4.7%	-16.6%
European Corporate High Yield	Bloomberg Pan-European HY TR Unhedged	372	-0.9%	-15.1%
US Corporate Investment Grade	Bloomberg US Corporate Investment Grade TR Unhedged	2,864	-5.1%	-18.7%
US Corporate High Yield	Bloomberg US Corporate HY TR Unhedged	2,099	-0.6%	-14.7%
<b>Commodities</b>				
Brent Crude Oil	Generic 1st Crude Oil, Brent, USD/bbl	88	-23.4%	13.1%
Natural Gas (US)	Generic 1st Natural Gas, USD/MMBtu	6.77	24.7%	81.4%
Gold	Generic 1st Gold, USD/toz	1,662	-8.0%	-9.1%
Copper	Generic 1st Copper, USD/lb	341	-8.1%	-23.5%
<b>Currencies</b>				
GBP/EUR	GBPEUR Exchange Rate	1.14	-2.0%	-4.2%
GBP/USD	GBPUSD Exchange Rate	1.12	-8.3%	-17.5%
EUR/USD	EURUSD Exchange Rate	0.98	-6.5%	-13.8%
USD/JPY	USDJPY Exchange Rate	144.74	6.7%	25.8%
Dollar Index	Dollar Index Spot	112.12	7.1%	17.2%
<b>Alternatives</b>				
Infrastructure	S&P Global Infrastructure Index	2,411	-9.6%	-10.1%
Private Equity	S&P Listed Private Equity Index	144	-10.2%	-35.8%
Hedge Funds	Hedge Fund Research HFRI Fund-Weighted Composite Index	17,496	1.7%	-4.0%
Global Real Estate	FTSE EPRA Nareit Global Index TR GBP	3,599	-3.8%	-13.7%
<b>Volatility</b>			<b>Change in Volatility</b>	
VIX	Chicago Board Options Exchange SPX Volatility Index	32	10.1%	83.6%

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

Source: Bloomberg

## Market thoughts



### **China; broken?**

Through my connections with Nomura Asset Management I asked their Head of Investments for Asia Pacific ex Japan, Vipul Mehta, to put his thoughts about the investment proposition for China into writing. He has provided a very well balanced essay on the China conundrum which I share with you below. It doesn't provide an answer, but does provide a lot of food for thought.

## **The China Saga**

China has been in the middle of a long-lasting saga, which unfortunately does not seem to end as new events give rise to new controversies and the muddle gets messier. There is little doubt that there must be a long-lasting impact from everything that the country has gone through, on the population at large, socially and economically. It has also been nothing short of an enormous struggle for investors who would inevitably have had large stakes in China, just given its enormous presence in the world and the huge influence on all aspects of global economics. This discussion will be largely limited to the impact on equity markets and equity investors, though there is an obvious reference to everything that has an influence on the same. The all-important National Party Congress, which just concluded in the last few days of October 2022, an update of which is added at the end of this paper, further seems to set the direction in which the economy and the markets could be heading.

### **Dismal equity market performance over the long term**

Graphs and numbers can be very deceptive, especially in the world of equity markets and very likely they hide more than they reveal. The MSCI China Index is one such example wherein the index could be cut, diced and interpreted in several ways. One also needs to be mindful that the composition of the index itself would have undergone significant changes over the last few decades.

Looking at a point to point three decade performance would leave most investors aghast given the fact that in USD terms, the index has lost a third of its value. The data turns on its head though as a two-decade period from the lows of 2002 would have generated almost a four hundred percent return, whilst the last ten years have been exasperating with no returns generated at all. This also hides many periods when the markets generated super normal returns, the most notable being the period between 2004-2007, but in more recent times the big moves in 2017 and then the Covid move, both of which enabled investors to generate more than 50% returns in a short period of time at the index level and much more if one were to correctly pick individual stocks.

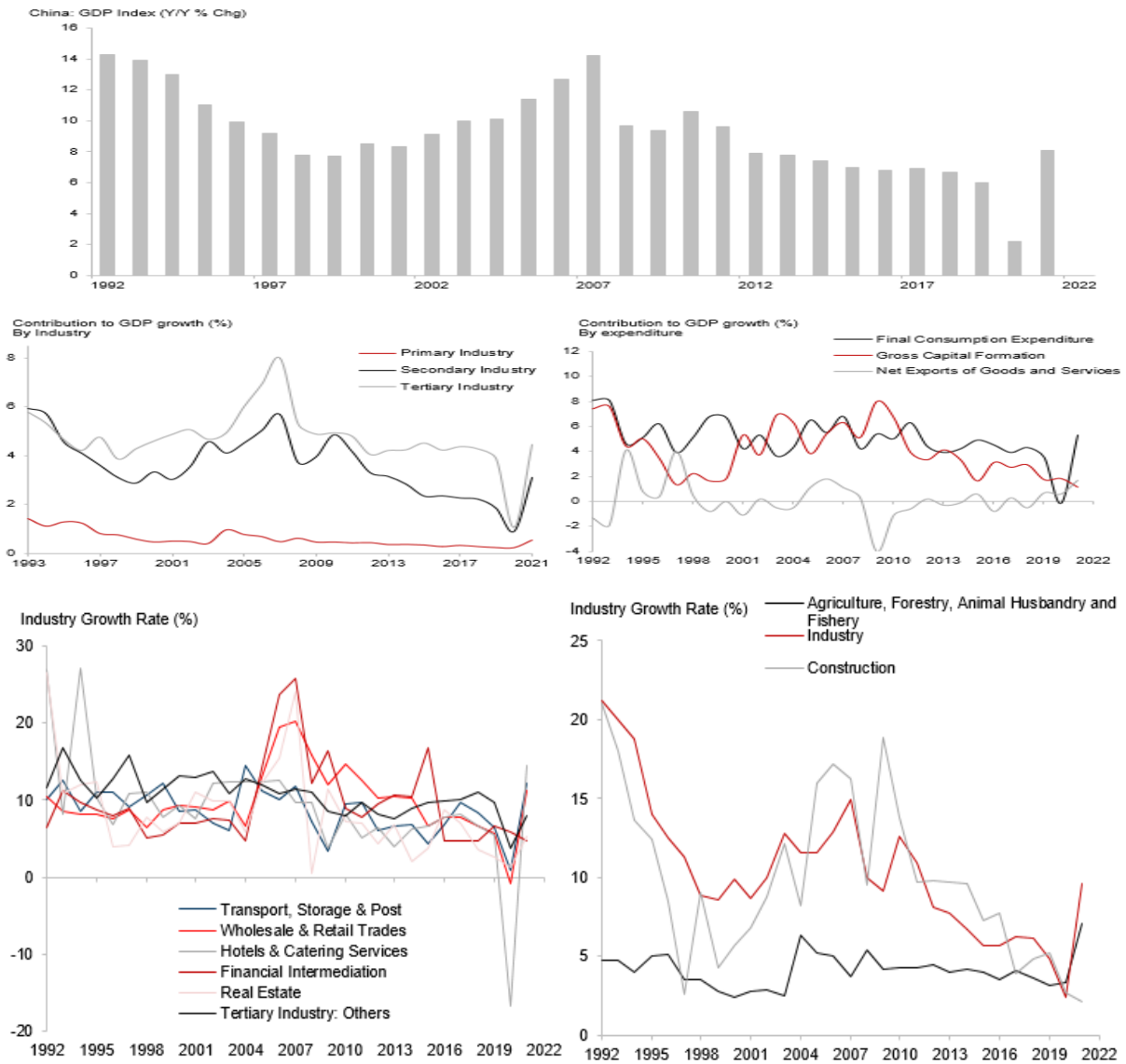
## Performance of MSCI China in USD terms over three decades and broken down by each decade



Sources: Bloomberg, Factset, NAMS, Oct 2022

### The growth years

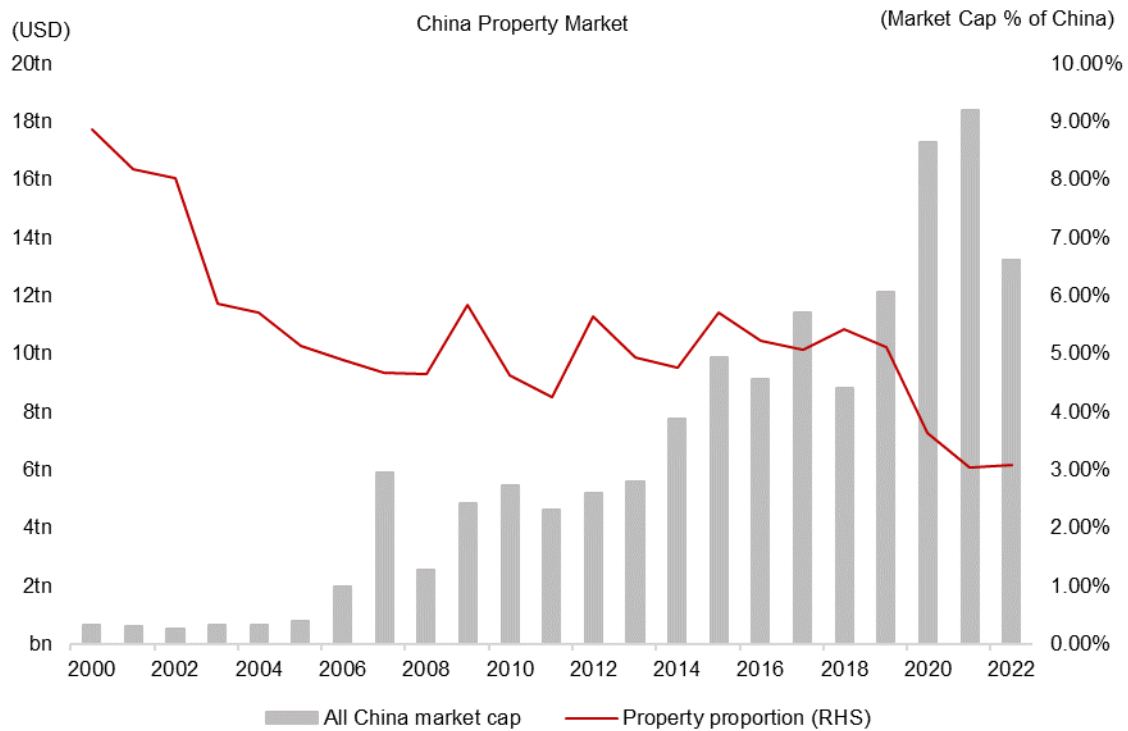
The economic boom in China started with entry to the WTO in 2001, post-which the country embarked on a massive infrastructure and asset building boom, also becoming the factory to the world and in the process stamping its status as the growth engine to the globe and exporting significant deflation too. Incidentally, a massive after-effect of this can be felt in the current supply led inflation turmoil. This economic boom and prosperity planted the roots of what has created two deep and connected malaises; the uninhibited growth in the property sector and the uncontrolled leverage, direct and indirect at every level of the economy, the most impactful being the corporate leverage reflected in the poor banking system metrics. It was all too good while it lasted. Yet another trend, which emerged from the restrictive policies of China, was the emergence of the new economy, the internet/e-commerce sector. On the one hand, the American architects of Google, Facebook and Amazon were restricted from having a free market participation in China and on the other hand, the Chinese built its own ecosystem in these areas and further improved on them. This resulted in one of the biggest stock market wealth creation phenomenon as these Chinese new economy giants matched the American behemoths dollar for dollar in terms of market capitalisation and at its peak the new economy in China went from nothing in 2010 to an aggregate market capitalization of USD 3 trillion in a short period of time. And this now represents more than a third of the Chinese markets with reference to the MSCI Indices.



Sources: Haver, Goldman Sachs, Oct 2022

### The start of the problems

The events above had laid the foundation for various problems that China was to face over the next few years. On the macro front, the economic boom and prosperity had created a massive leverage, while on the micro front it was also responsible for creating corporate billionaires, which was against the basic thread of the Chinese ruling system. The economic boom had also created a huge bubble in the real estate market where large amounts of wealth generated was parked and resulted in the creation of ghost towns – something that needed to be seen to be believed. Obviously, it also resulted in massive leverage being taken by the developers under the assumption that the wheel would keep rolling on forever.



Sources: Factset, Goldman Sachs, Oct 2022

In the middle of the last decade, there was one large clamp down on corruption, but it was limited in its scope. Meanwhile, the repercussions of being the factory to the world, the advent of Donald Trump as the POTUS and the threat of intellectual property being at risk to China laid the seeds of the Sino-US trade war. It was turbulent waters as far as the equity markets was concerned thereafter. The trade war had widespread implications in areas of technology, investments and ADR listings, amongst many others.

Socialistic dynamics in China was another aspect of the economy, which was to have far-reaching consequences. The government had announced a ban on approval of new games way back in 2018, which at the time was thought to have limited consequences. Little did we know that the implications, especially when combined with the creation of super rich corporate tycoons was a part of the larger social plan, which later morphed into what was called the “Common Prosperity Program”. Bigger trouble came through in the huge wealth creating new economy sector when the ANT group’s IPO was halted, which in turn brought parent Alibaba and its founder Jack Ma to its knees and even this was ignored by the markets to an extent as a specific case. What preceded the Alibaba events was one of the huge bull runs in the new economy sector because of Covid, the loose monetary policy in the US and the rise of Nasdaq-listed technology stocks, but more on that later.

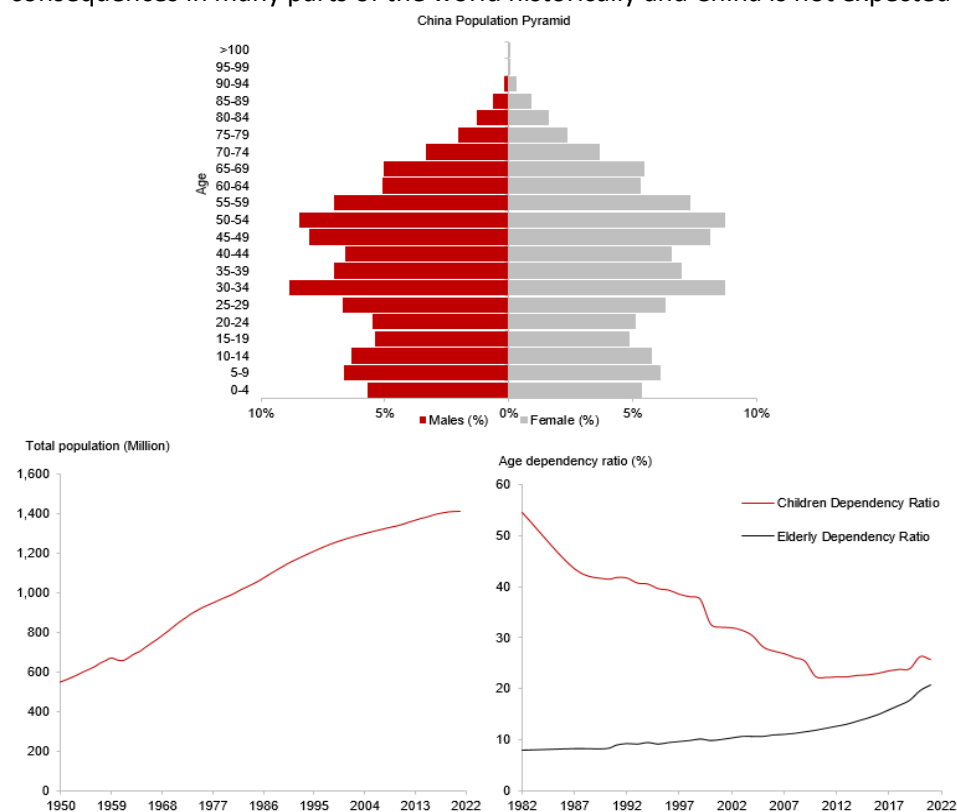
The next event was an absolute hammer blow for the new economy in China and most so the equity markets when private school tutoring were declared non-profit organisations. Imagine a listed industry which had delivered phenomenal returns over the years, which was a market darling in popular parlance being told on an overnight basis that they could not make profits. It was mayhem as these specific stocks lost 90% of their value in a very short period and it was just the beginning of a trend. Meanwhile, cybersecurity issues and overseas listing guidelines for US listed ADRs, themselves a large size, was creating further controversy and imposing pressure on the Chinese. And to cap everything off, the overarching but less understood Common Prosperity Program was to have far-reaching consequences. From the new economy perspective, it meant transfer of wealth from enriched equity holders to the workers, a floor on wages and insurance benefits – in sum total – a cap on the profitability of companies. Even in the beleaguered property sector which was already drowned in debt, it meant that property was meant for residing and not for investments and gains, which in turn implied that clearing of inventory was a mirage.

It is said that the pandemic, eventually named as Covid-19 started off in China and as we all know spread around the world with disastrous consequences, until then, probably an event not experienced by anyone in their living memory. China set the tone with citywide and province-wide lock downs and in the first phase was the least impacted from Covid in terms of fatalities. While most of the rest of the world moved on, especially with vaccines coming on stream, it seemed like China refused to accept the international vaccines, whilst it is believed that their own vaccine was not as effective. As a result, while most of the world has almost normalised out of Covid, China is unable to get out of its zero Covid policy and the start-stop phenomenon of the economy continues almost two years after the onset of the pandemic and still with little visibility. This has had widespread implications, not least of which is a sharp slowdown in growth rates in spite of a monetary policy which is going in the opposite direction to the rest of the world. It is after all a fine balancing act between stimulus and leverage. The longer term and humane consequences of the lock downs notwithstanding, the slowdown would continue to be accentuated with every day of delay in a complete reopening of the economy.

The only bright spot came in the initial phase post the pandemic and the lock downs when it seemed like the country was the first to have controlled the virus and the equity market performance was amongst the best in the world in 2020. After that, it was all downhill. In conclusion, as we see it at the end of three quarters of calendar 2022, everything that could have gone wrong with the country has gone wrong and most so with the equity markets. Not in recent history has one seen one of the largest equity markets in the world lose more than 25% for two consecutive years, with a number of sectors and stocks decimated. Corporate earnings growth is sparse given the anemic economic growth and it almost feels like there is no place to hide with respect to equity markets.

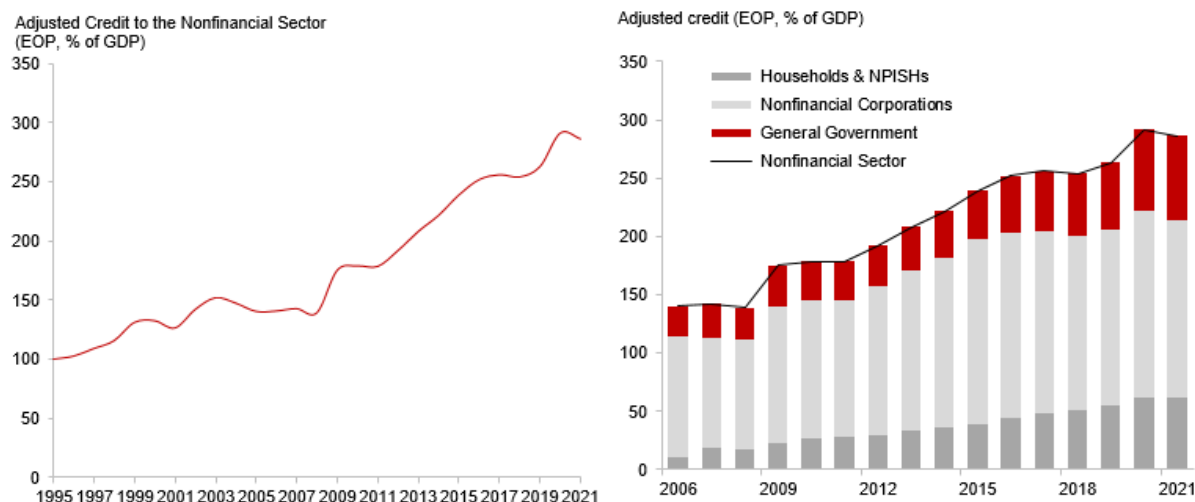
### Debt and demographics

To get the negatives out of the way, some of the issues are of a longer term if not of a permanent nature. Demographics will possibly be the biggest negative factor as the absolute population of China starts declining from the current year and more importantly, the working population is on the fall while age dependency increases. The consequences of this demographic profile has been witnessed with negative consequences in many parts of the world historically and China is not expected to be any different.



Sources: CEIC, NBS, Goldman Sach, Oct 2022

The Common Prosperity program as it is shaping up could have serious and far-reaching consequences, least of which, they are very socialistic in nature and therefore not in favor of minority shareholders whatsoever. What seems to be obvious is that the woes of the property sector are not going away soon which means a drag on the fiscal revenues, hurting international bond markets for Chinese debt and a vicious cycle of domestic leverage. Further, the new economy might never come back in the form and prosperity which we witnessed at its formation and growth stage and this could impact employment within the country. Finally, the geo-political issues, the trade war and intellectual property matters are all factors which could increase the risk premium for the markets.



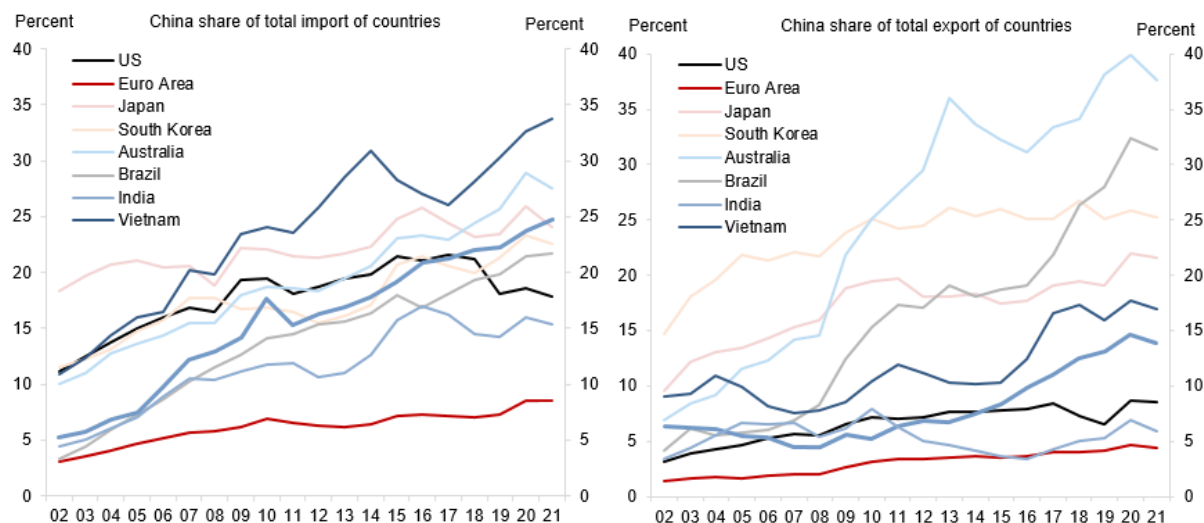
Sources: CEIC, NBS, Goldman Sachs, Oct 2022

For investors and even otherwise, it cannot be all doom and gloom though, as everything above has suggested, for two reasons; first, China has the resources and the firepower to fight off various issues on different fronts and second there has been many a surprise historically, and that too a sizeable one. Therefore, it is worth getting into what can be a positive investment case on China. The easiest argument to present would be to say that it is darkest before dawn or that we are absolutely at the rock bottom as far as the country is concerned, from which there is only one way to go.

Getting more granular on the positive arguments: China is one of the largest economic superpowers in the world still yielding a large influence on most other economies, especially with respect to trading relations. It might not be a big surprise to conclude that China is the largest trading partner to most other countries in the world and prices of goods and services and therefore economic policies are greatly influenced. No matter, how slow the growth rates, it is one of the few large countries with a sustained positive growth rate and therefore its ranking in the world pecking order is only going to increase. China's fiscal prowess cannot be doubted and there is a lot of room for monetary adjustments to get the economy back on its feet.



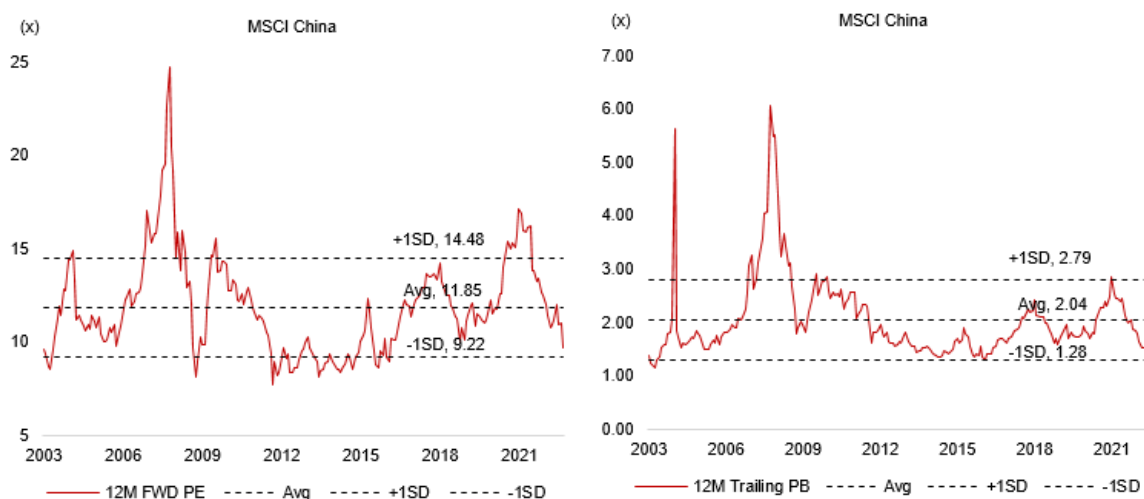
## China as a trading partner



Sources: CEIC, NBS, Goldman Sach, Oct 2022

Looking at the short to medium term, there is a positive set-up for the equity markets. The huge underperformance of the markets for such a long period and to such an extent is in itself a positive from a mean reversion perspective. From the pandemic perspective, we have seen the rest of the world open up and move on to a more normalised state of affairs. Economies recovered sharply on normalization and it should be a matter of time before China gets going, out of the zero Covid policy to a more dynamic and flexible environment and therefore the start of the economic recovery. Maybe the Party Congress and the re-election of President Xi with the seven members of the cabinet is a catalyst for some distinct visibility in the Covid policy and following that the economic policy. Notwithstanding some of the longer-term problems mentioned above, the economy and the corporate sector would be looking behind at a very favorable base effect and therefore more positive growth rates even as the rest of the world is slowing down for all the obvious reasons. The internet and the new economy related sectors have witnessed severe regulatory and restrictive action and we have seen some signs of these restrictions abating as well. Meanwhile, companies have lost more than half of their market caps in most cases, even as they are looked upon as huge employment generating entities. On the other hand, most traditional components of economic activity, consumption, investments and trade have seen a significant slowdown in the last few quarters and as a result corporate earnings growth rates have been decimated. This has been accompanied by obvious apathy from foreign investors who have been significantly disillusioned by various aspects of the Chinese financial markets, not least the opacity, unpredictability and volatility. Moreover, all of the above has resulted in valuations of the Chinese equity markets being at their lowest levels for a long time in history. The spring effect in the form of a rebound is therefore a very high probability event. Then there is a large and undiscovered domestic market to be discovered which is reasonably well supported by a large pool of domestic investors with deep pockets as well.

## Valuations



Sources: Factset, Oct 2022

At the end of the day, China is still one of the largest markets in the world, a large component of most global indices yielding a significant influence on all aspects of global financial markets. There is a huge array of large investible companies, which offer tremendous moneymaking opportunities as we have witnessed several times in history. In conclusion, therefore, it would be foolhardy to write China off as an investment case.

### Environmental, social and governance considerations

There is also a very important element of Environment, Social and Governance (ESG) which needs to be addressed and we have chosen to write about some of the aspects of ESG in a separate section below.

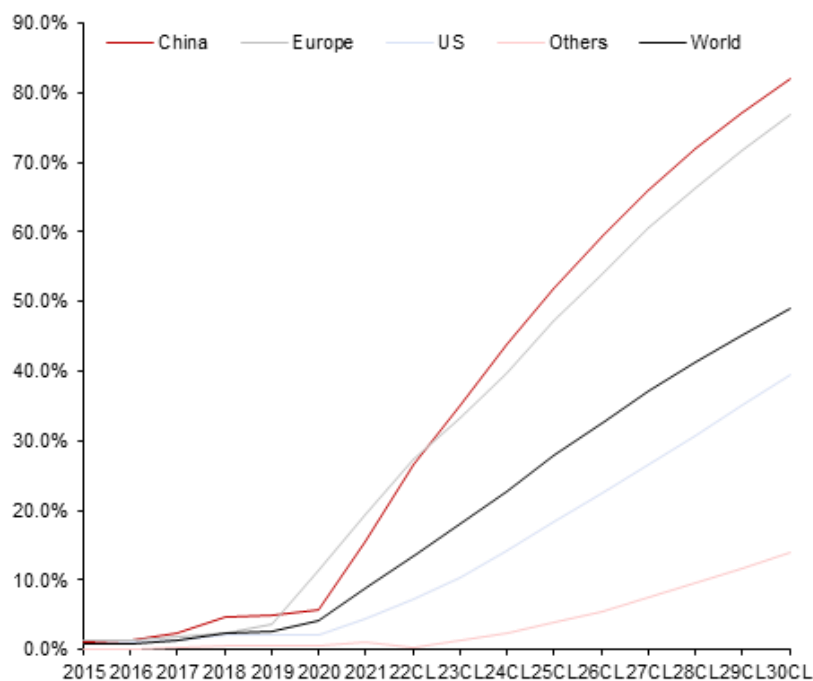
China's communist party agenda of driving an economic transformation, from prioritising growth at any cost to pursuing its Common Prosperity agenda, as well as tackling climate change, at a high level suggest an alignment on sustainability issues. China's "Carbon Neutral 2060" pledge (peaking of carbon emissions before 2030 and becoming carbon neutral by 2060) is a reflection of its commitment to tackle climate change issues. However, the target still falls below what is expected for well-below 2 degrees or 1.5 degrees and while the EU, US, Japan and Korea aim for net zero by 2050, China's carbon neutrality goals come after, in 2060.

### Carbon Peaking by 2030

Peaking by 2030 implies higher absolute emissions for the next few years, which is in contrast to an approximate 50% reduction required by 2030 under the "net-zero by 2050" ambition.

We believe the Central Party's agenda of ensuring energy security (besides economic and social security) as a long-term priority is also dictating China's stance towards a gradual (instead of aggressive) phasing down of coal (fossil fuel) share in the overall energy mix. In the same vein, it is important to highlight the superior progress, supported by central policy directions, guidelines and incentives, across the value chain of electric vehicles and renewable infrastructure achieved by China. We think decarbonisation is a secular theme in China and the Party remains committed to achieving the carbon emission related goals.

## Electric vehicle volume penetration by region



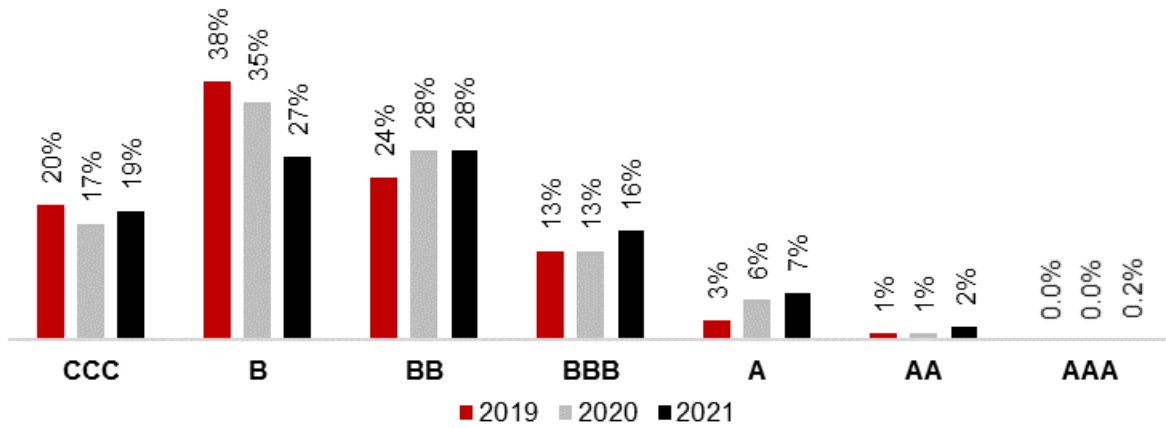
Source: IEA, CLSA

Pursuing Common Prosperity has been a strategic initiative that has gathered momentum in the recent past. The focus of these initiatives has been to achieve an equal distribution of income, wealth and opportunities to alleviate poverty, which is in line with the UN SDG 2030 agenda. We have seen tighter regulations in the financial and technology sectors resulting in significant erosion in market cap for some of the big tech companies. While it is difficult to predict additional policy measures across sectors, we are of the opinion that regulations for the technology sector have peaked based on the government's declaration of a sustained development of the platform economy as well as taking into account the current high levels of unemployment (approximately 20% unemployment in the 19-24 age group).

The challenge, however, crops up when the discussion shifts towards human rights issues, including forced labour. We have seen countries imposing measures against China over human rights controversies, for example - US Uyghur Forced Labor Prevention Act (effective June 22) prohibits imports of goods made in part or wholly in Xinjiang unless the US Custom and Border Protection Agency can certify that products are not made with forced labour. Increasing human rights scrutiny globally could result in stringent policies compelling the decoupling of supply chains and relocation of production away from China. In addition, recent geopolitical tensions (Russia-Ukraine invasion) also bring forth concerns about China's authoritarian style of governance.

On governance, companies in general are ranked lower due to their stated owned enterprise (SOE) nature and higher shares of controlling shareholders, implying likely lower board independence and diversity. However, we have noticed an upward shift in the MSCI ESG ratings for MSCI China Index constituents (share of ESG laggards – CCC and B- rated companies have declined from 59% in 2019 to 46% as of the end of 2021). We expect more companies to be upgraded over time as we see more detailed corporate social responsibility reports published annually and improved responsiveness of companies to addressing ESG issues.

### ESG Ratings Distribution of MSCI China Index



Source: MSCI ESG Research, as of Dec 31 of each year. Companies without ESG Ratings

We view that China is actively pursuing measures to address core sustainability issues such as climate change, while taking other ESG objectives such as Social and Governance at a more measured pace. The central government is driving these ESG objectives changes through the SOE companies and we absolutely take into consideration whether these objectives are fair to non-controlling shareholders before making an investment decision. We are hopeful that China will improve its ESG standards and we will continue to select companies that have ESG initiatives that will benefit minority shareholders.

### Latest developments - 20<sup>th</sup> Party Congress, October 2022

Over the last weekend, the all-important 20<sup>th</sup> Party Congress was concluded and the 20<sup>th</sup> Politburo Standing Committee (PSC) was announced. President Xi was elected as the General Secretary of the CCP and the Chairman of the Central Military Commission. The number of members were unchanged at seven with four newly appointed members:

The new 'board' is dominated by President Xi's close associates

<ul style="list-style-type: none"> <li>• Party General Secretary, CMC Chairman, President</li> <li>• To stay with same posts</li> <li>• Born in 1953</li> </ul> <p><b>Xi Jinping</b></p> 	<ul style="list-style-type: none"> <li>• Shanghai Party Secretary</li> <li>• Likely to become the Premier</li> <li>• Used to work with President Xi in Zhejiang in 2000s</li> <li>• Born in 1959</li> </ul> <p><b>Li Qiang</b></p> 	<ul style="list-style-type: none"> <li>• Head of CCDI</li> <li>• Likely to become the NPC Chairman</li> <li>• Born in 1957</li> </ul> <p><b>Zhao Leji</b></p> 	
<ul style="list-style-type: none"> <li>• Executive Secretary of the Secretariat</li> <li>• Likely to become the CPPCC Chairman</li> <li>• Born in 1955</li> </ul> <p><b>Wang Huning</b></p> 	<ul style="list-style-type: none"> <li>• Party Secretary of Beijing</li> <li>• To become the Executive Secretary of the Secretariat</li> <li>• Used to work with President Xi in Fujian and Zhejiang</li> <li>• Born in 1955</li> </ul> <p><b>Cai Qi</b></p> 	<ul style="list-style-type: none"> <li>• Director of the General Office</li> <li>• Likely to become the executive Vice Premier</li> <li>• Started to work with President Xi in Shanghai in 2007</li> <li>• Born in 1962</li> </ul> <p><b>Ding Xuexiang</b></p> 	<ul style="list-style-type: none"> <li>• Party Secretary of Guangdong province</li> <li>• To become the head of the CCDI</li> <li>• Used to work in Shaanxi, where Xi's family was from</li> <li>• Born in 1956</li> </ul> <p><b>Li Xi</b></p> 

Source: Government websites, Xinhua News Agency

Li Qiang – now the Premier or the No 2 in the PSC, recently the Shanghai Party Secretary and well known in international market circles for the Shanghai lockdowns. Cai Qi, Ding Xuexiang and Li Xi are the other three members who are promoted and take the place of Premier Li Keqiang, NPC Chairman Li Zhanshu, CPPCC Chairman Wang Yang and Hu Chunhua.

### **The key messages from the line-up include:**

The newly formed PSC worked with President Xi Jinping closely in the past. Markets are interpreting that these are President Xi's protégés and the President has consolidated his power further and will heavily influence how China will be run going forward. The new leadership also indicates more concentration in top decision-making procedures and paves the way for policies to be executed with minimum challenge. In addition, there were no signs of a viable successor to President Xi, though younger loyalists were promoted.

In line with expectations, specific policies will only be discussed next year and nothing will be announced this year. Government related positions will be announced at the National People's Congress scheduled in March 2023. However, "common prosperity" was reiterated during the Congress, which in turn can be construed as redistribution of wealth from the wealthy to the low/middle income groups and to the rural economy which in turn could hurt certain private sectors, more specifically the new economy related areas. Taking a look back in history, in September last year, Vice Premier Liu vowed that the government would keep supporting the private sector and in October President Xi emphasized the healthy development of China's digital economy. Even recently in the first half of 2022, China's PSC calls for a normalisation of regulation. With the recent changes in the PSC, one will need to reassess how much support will be given to the platform economy given that "common prosperity" appears to be the key focus and this was exacerbated by removing pro-market proponents such as Li Ke Qiang and Liu He. Another statement, which caught attention was "regulation of wealth accumulation".

The Chinese markets took a massive beating on the first trading day after the NPC with the brunt of it being borne by the new economy sector. KWEB, the new economy ETF listed in the USA was down as much as 14% and prominent leaders such as Tencents, Alibaba, Meituan and JD.COM in the local trading preceding that, all registered double digit losses.

China's "Dynamic Zero Covid" policy was also addressed during the meeting and it will remain the case until further notice. Li Qiang who currently serves as the Party Secretary of Shanghai was appointed as the No.2 member in the PSC. He was in charge of overseeing the lockdowns in Shanghai and the market is worried that his appointment will lead to China not reopening in 2<sup>nd</sup> quarter next year, which was the prominent expectation. China's zero Covid policy might continue to have a significant impact on various aspects of the country – economic as well as social - and every delay is only worsening the impact on the potential recovery.

Another point of concern is China's property sector. The property sector continues to drag on the overall economy and the latest property investment print which was released this week showed a 12% decline in September over the same period last year, bringing the year to date number to -8% cumulative in the first three quarters of the year. New starts were also down almost 50% in September. Sales continue to remain very weak given the poor sentiment and it is hard to see this changing anytime soon. New marriages also point towards weak demand and without a meaningful stimulus from the government, this sector will continue to remain sluggish. Stimulus of a mega proportion would be needed to revive this sector and that in turn would impact the debt situation of China.

Post the party congress, it is not unthinkable to compare the Chinese market to Russia as an extreme case and assign a similar risk premium and valuation. If this is the case, China will continue to de-rate until President Xi can deliver concrete policies which are shareholder friendly.

Security is another thematic, which is a priority and it encompasses various forms – technology, energy, trade, and dependence on capital, defense and any other aspect, which China might be short on.

Finally, the chances of conflict over Taiwan are probably higher than the very low probability assigned to it before the event. Engagement with the West might suffer, technology and trade wars might remain escalated and the ADR saga could take a turn for the worse.

From a market perspective, we do not however think it is all negative. Chinese markets have been decimated over the last couple of calendar years and a lot of negativity might have been captured. Admittedly, there will continue to be a lot of opacity in policies, unpredictability in the direction of the economy and uncertainty and volatility in the markets. It will be easier said than done to be in the right sectors and then in the right stocks will also be challenging. From an allocation perspective therefore, risk premium on China has definitely increased and therefore, on a relative basis, we currently prefer to take a negative stance on the markets, reflecting an underweight position.

That said, we continue to look for companies, which can grow, regardless of policy direction and monitor any clues for a shift in policy towards certain sectors. For now, the internet sector will probably remain under pressure and it will be a funding source for other stocks. We have gradually shifted weight further to reopening plays which are SOEs which we deem to have lesser risks vis-à-vis other sectors. China currently faces many challenges and without clarity on policy direction, a weak property market and “common prosperity”, confidence will continue to remain weak.

## Recommendations

1. That members and relevant officers hold an informal session to consider future strategic asset allocation, including ESG and climate change considerations.
2. A meeting is then arranged with Brunel to discuss the forthcoming Strategic Asset Allocation review and this Fund's aspirations, along with any actions required to address a higher inflation environment.
3. To progress a Brunel led training programme for Fund elected members and others that will provide information about the asset classes that they manage and their processes.