



REPORT PREPARED FOR
Oxfordshire Pension Fund Committee

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Summary

The value of the Fund in the quarter rose to £3.38bn, an increase of £160m compared to the end September value of £3.22bn. The Fund produced a return of 5.1% over the quarter, which was 0.4% ahead of the benchmark. On a performance against benchmark basis there aren't really any standout highlights to report in public markets, generally steady performance from most of the active portfolios, with an unfortunate negative mark against the Global High Alpha Equity portfolio. That was due to another poor quarter from Baillie Gifford, nevertheless their longer-term performance remains good. Over a 12-month period the Fund recorded a healthy positive relative return against the benchmark of 1.3% (16.0% v.14.7%). The Fund has performed ahead of benchmark over the three, five and ten year periods, details of which can be found in Brunel's report.

The highlights

1. Once again within the equity mandates it was good to see a healthy outperformance over the quarter of the global sustainable equities over the high alpha equivalent (by 0.5%), but with performance over the one-year period still reversed (by 1.4%). This is still reflecting the previous exceptionally strong performance of Baillie Gifford, which has declined over the last six months.
2. The quarter saw the funding of the transition into the Passive Developed Equities Paris Aligned portfolio, out of the Passive Low Carbon Equities, Passive UK Equities and the Passive Developed Equities mandates.
3. Global property valuations once again enjoyed a strong quarter as Covid concerns receded. In some areas valuations are now well in excess of pre Covid levels.
4. Brunel highlight some of the developing themes that I touched on last time, namely the divergence in valuations between energy efficient buildings that have some element of future proofing on the road to net zero carbon and those that don't. Some of the older stock may well be suitable for upgrading and/or change of use, but will require a relatively high level of capital investment.
5. Private Equity in general continues to enjoy a high level of activity, with growing valuations. One note of caution though, historically private equity funding is reliant on positive sentiment in markets generally. This does tend to be dampened in periods of high volatility, which is discussed below, and certainly if equity markets are falling.

The lower points

1. I referred to the poor performance of the Global High Alpha Equity Fund in the summary above. Over 12 months this sub fund has underperformed by 1.6%. With five managers involved with elements of this fund there will inevitably be winners

and losers in the mix, and that is exactly what we have seen. There is a wide range between the best (+3.2% relative to benchmark) and the worst (-10.5%). As the fund name implies, this is indeed a group of high conviction managers with differing styles.

2. A rather similar picture for Emerging Markets, with an underperformance of -0.9% over the quarter, three managers; one underperformed, dragging down the other two who outperformed. The relative performance shown was -2.9%, +0.8%, +0.2%.
3. Still early days for the Multi Asset Credit Fund, having initiated on 1 June last year, but so far against the primary benchmark performance isn't looking good. Performance for Q4 was -0.6% and since inception -1.2%. However against the secondary composite benchmark, which probably better reflects the actual investment shape, the picture is much better with positive returns. This is a good example of a situation where clear input from the portfolio manager at Brunel would be helpful.
4. Brunel declare themselves to be "very pleased" with how the initial spread of investments in Infrastructure has developed. This Cycle 1 tranche is now fully committed to managers, but the managers themselves have still only called just over 50% of commitments on average.
5. Again with Infra Cycle 2 Brunel are very pleased; being fully committed by the end of 2021, but less than 4% called in the General sub fund and 15% in the renewable sub fund.
6. Turning to Private Equity, we see a similar situation, Cycle 1 is fully committed, but only 41% drawn. Cycle 2 is 70% committed, 20% drawn.
7. The Brunel International Property portfolio performance continues to be lagging the objective, including over 5 years. It isn't clear from the commentary why this is so, but separately I understand this is a legacy portfolio that is effectively part of Brunel's "work in progress".

Points for consideration

1. At the time of writing this we are in the midst of the Winter Olympics in China, so probably not surprisingly political and economic news flow is "on mute". However the headlines are taken up by "what happens next" concerning the massive military presence that Russia has installed around Ukraine. Clearly this has unsettled world markets, adding to the volatility that we have seen so far in Q1 2022.
2. I have now had the opportunity to look at the background papers relating to the creation of the Brunel sub funds, which has provided me with considerable reassurance about the thorough process that was followed in the appointment of the investment managers. However, I remain of the view that more detailed performance information from Brunel will help with the understanding of the structure of each sub fund, including performance attribution for each manager over different time periods. A multi manager approach may bring diversification of style,

but it also comes with the risk of overall performance reverting to average, at best, as seen recently with the outperformers being dragged back by underperformance elsewhere.

3. I have had the opportunity to raise the subject of Brunel reporting performance for their active managers against the set targets with their CIO. Following on from that I suggest that Brunel should be formally asked to report against these (and the underlying managers), as well as against their benchmarks. Active management fees are being paid, so that must be justified.
4. The slow rate of draw down for private market investments is clearly a concern, although it is always a balancing act between wishing to see committed funds drawn down as quickly as possible against managers identifying suitable investments. This needs to be borne in mind during the consideration of commitments to the forthcoming Cycle 3.

Cycle 3; keeping your balance

Talking of Cycle 3, we do need to consider what additional, if any, further investments should be made within Brunel's alternatives portfolio over the next two year period over and above what the Fund has already committed to. Bear in mind that there is still a substantial sum to be drawn down and invested from those prior commitments.

We need to consider at this stage that we have the triennial valuation of the Fund's assets and liabilities this year, then following on from that will be the strategic asset allocation review which will consider the recommendations and outcomes from the valuation. Since the 2019 valuation and 2020 asset allocation review we have seen the Fund move to a fully funded position, but we are also seeing a likely move upwards in medium term inflation, with cash flow and liability implications around that. It is highly likely that some changes to the strategic asset allocation will be desirable and therefore it would be prudent at this stage to keep any changes to asset allocations to a minimum. I am also conscious that the Fund has seen many changes to the investment management arrangements in recent times, so it would be prudent to allow those to bed down.

Against that background however it does make sense to review progress in terms of the shape and scale of the Fund's alternatives investments at this stage and make appropriate adjustments accordingly to keep the portfolio in balance. There are six elements within alternatives (private markets); Property, private equity, secured income, private debt, multi asset (DGF) and infrastructure.

Private Equity includes both listed and unlisted investments. Although we have enjoyed a good period of performance, with the weighting now at 10.2%, distributions and falls in value should be considered. As such a "core" weighting of 10% would acknowledge that.

Secured Income is likely to become a focus of attention as we go through the valuation and assessment process to ensure the cash flow is appropriately balanced. The plan has been to move towards a 5% allocation, so my recommendation would be to confirm that position.

Private Debt has increased in significance in recent years, as the banks have reigned back their ability and willingness to be prime lenders. An ongoing concern from the Global Financial Crisis has been default risk, and it was this concern that was raised two years ago as the emergence of Covid played heavily on investors minds. In reality the security of loans is much tighter now than historically, with attractive risk adjusted returns available. Like secured income, private debt is likely to have a greater presence in portfolios working through this LGPS valuation cycle. Once again for an allocation to be meaningful in Fund terms, my recommendation would be for this to be set at 5%.

Infrastructure has become a rather hot topic in the LGPS, partly around political intervention. In my experience this can actually be a very attractive area of investment, with some highly impactful opportunities that would well match the Fund’s developing investment strategy in embracing climate change issues. Examples include renewable energy generation and storage, waste management and vertical farming. Again, I would recommend moving to a meaningful allocation of at least 5%. However, a full dialogue with Brunel would need to be undertaken to ensure investments are in accordance with the Fund’s investment and ESG objectives.

Multi Asset (DGF) I do not consider that the Fund needs an allocation in this area, as many of the component parts are included elsewhere in the asset allocation. With the resources now available through Brunel the added diversity that a multi asset manager offers is no longer required. My recommendation is that the existing allocation is used as a source of funds to increase the targeted allocations recommended above.

The current actual, target and suggested weightings are:

	<u>Actual</u>	<u>Target</u>	<u>Suggested</u>
Property	6.4%	8.0%	8.0%
Private Equity	10.2%	9.0%	10.0%
Multi Asset (DGF)	4.9%	5.0%	0%
Infrastructure	1.4%	3.0%	5.0%
Secured Income	2.8%	5.0%	5.0%
Private Debt	0.4%	3.0%	5.0%
Total Alternative Investments	26.1%	33.0%	33.0%

In conclusion my recommendation is that the allocation to Private Equity is increased from 9% to 10%, Infrastructure is increased from 3.0% to 5.0%, Private Debt is increased from 3.0% to 5.0% and the allocation to Multi Asset (DGF) is removed (5.0% to 0%). The total allocation to Alternatives would remain at 33% of Fund investments.

Overview and Outlook thoughts

Global overview

Markets continued their positive trend in Q4, despite surging inflation, central banks moving to a more hawkish policy stance and the resurgence of Covid as the Omicron variant pushed daily infections to new heights in December. Corporate earnings continued to beat expectations in Q4 and the growing evidence that the likely impact from Omicron would be less than initially feared, helped provide tailwinds in most equity markers in December. Developed market equities were generally strong with the S&P reaching fresh all-time highs, with only Japan retreating, as concerns for Chinese growth continued. Emerging Markets suffered over the quarter; the USD strengthened, with tightening policy, while Chinese equities were weak, following the summers' technology crackdown, amid continued concerns over property debt and the potential for lockdowns. Growth orientated stocks modestly outperformed Value stocks (+8.1% against +6.7%). Bond performance was mixed: index-linked gilts returned 5.4% on rising inflation expectations, while returns on shorter dated credit were more muted (US high yield bonds slightly up, European high yield bonds slightly down) as investors priced in a faster pace of rate hikes with the BOE. Energy commodities lagged, in contrast to metals.

GDP growth remained positive in Q4 for developed markets; the US posted +1.7% quarterly growth¹, the UK +1%, the Eurozone +0.3% and Japan +1.3%. With the reopening upswing now behind us and inflation continuing to run far above target economists will be considering whether central bank policies can bring inflation back in line with their target without stymieing growth. This has led the World Bank to predict global GDP growth to slow from 5.5% in 2021 to 4.1% in 2022. Though year-on-year S&P500 corporate earnings for Q4 are expected to grow by 21.7%, this is the first quarter that more companies are issuing negative guidance than positive since Q2 2020. Energy is the sector with the greatest increase in estimated earnings, whilst consumer discretionary and industrials have the largest decreases in estimated earnings.

GDP Growth Rate and Monthly CPI

%	GDP		CPI		
	Q4 2021	Q3 2021	Oct	Nov	Dec
UK	1.0*	1.1	4.2	4.6	5.4*
US	1.5*	2.3	6.2	6.8	7.0
Eurozone	0.7*	2.2	4.1	4.9	5.0
Japan	1.5*	-0.9	0.1	0.6	0.7*

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

GDP Notes: UK Real GDP (Ticker: UKGRABIQ Index); US Real GDP (Ticker: EHGDU5 Index); Eurozone Real GDP (Ticker: EUGNEMUQ Index); Japan Real GDP (Ticker: EHGJJP Index)

¹ Note: US GDP has been de-annualised to be consistent with the other regions.

Omicron: The discovery of this variant initially caused widespread market selloffs, particularly in the travel & leisure and hospitality sectors, and a risk-off attitude. Following the implementation of new travel restrictions and partial lockdowns across the globe, renewed vaccine booster campaigns, and further information on the variant, markets reassessed the likely impact of the variant. A broad-market recovery followed in December, with risk appetite increasing. China's continuing zero Covid policy has meant renewed lockdowns, potentially further impacting the domestic economy and global supply chains.

Outlook thoughts

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

Time to retire the word “transitory”; inflation is likely to be sustained, even if only in the short term: As inflation has continued to surge globally, central banks have moved away from their previous position that the price rises are transitory. In the US, December CPI hit a multi-decade high of 7.0% while Eurozone reported 5.0% and in November the UK reported 5.1%. Critically, core inflation (excluding food/energy) in December hit 5.5% in the US and is expected to hit 4.0% in UK, indicating more widespread/persistent effects. While most economists expect inflation to return to modest levels (2-3%) over the next couple of years, there is increased risk that central banks may have difficulty bringing inflation in line with their target without causing economic harm.

Monetary policy is tightening, and interest rates increasing, but rates are still negative in real terms: The Federal Reserve indicated at the end of the year, that it would start to unwind the \$120 billion monthly asset purchase programme, which is likely to have ceased entirely by mid-2022, while the market is now discounting 3 x 0.25% interest rate increases in 2022. Equally, the BOE voted to increase the Bank of England base rate to 0.25% from 0.1%, becoming the first major central bank to raise its benchmark interest rate. UK 10-year rates declined from 1.04% to 0.97% over the quarter. In contrast, the ECB is likely to continue with expansionary monetary policy, despite surging inflation.

Increased volatility expected: With increased risk of policy errors/overshoots as central banks tackle inflation, the potential for investment style (e.g. growth/value) volatility due to an inflection point in the interest rate cycle and uncertainty as to the impact of Omicron, particularly on China with its zero Covid policy, there is the potential for significant under/over performance between asset classes, emphasising the importance of diversification for those concerned about volatility.

Equities

Global equities had a mixed Q4, there was strong performance across most of the developed markets, while Japan and Emerging markets suffered declines. Over the quarter, renewed COVID fears due to the Omicron variant and increased restrictions, along with a shift to hawkish central bank policy to combat surging inflation dominated the headlines. However, markets rebounded in December, as markets reassessed the level of severity of

the variant, with the MSCI World finishing the quarter at its highest end of year close. The VIX decreased by -25.6% in Q4, from 23.1 to 17.2. Growth continued to outperform Value (+8.1% against +6.7%).

US equities, measured by the S&P 500, posted strong gains over Q4 with the S&P 500 rising +11.0% and the tech heavy NASDAQ rising +11.3%. Despite the many headwinds, including lingering supply chain disruption, surging inflation and a move to more hawkish monetary policy, the US was the best performing region over the quarter. US companies continued to beat analysts' expectations, and Biden signed the long-awaited infrastructure bill, whilst the Federal Reserve acted in line with market expectations in announcing QE tapering. This propelled markets in October and early November. However, markets were hit by a more hawkish stance from the Federal Reserve along with fears of the Omicron variant. Markets ended Q4 strong, despite surging infection rates, with the US implementing limited new restrictions, and markets reassessed the likely economic impact of the new variant. The S&P 500 ended year at all-time highs. The technology and real estate sectors were the best performing, while energy and financials lagged.

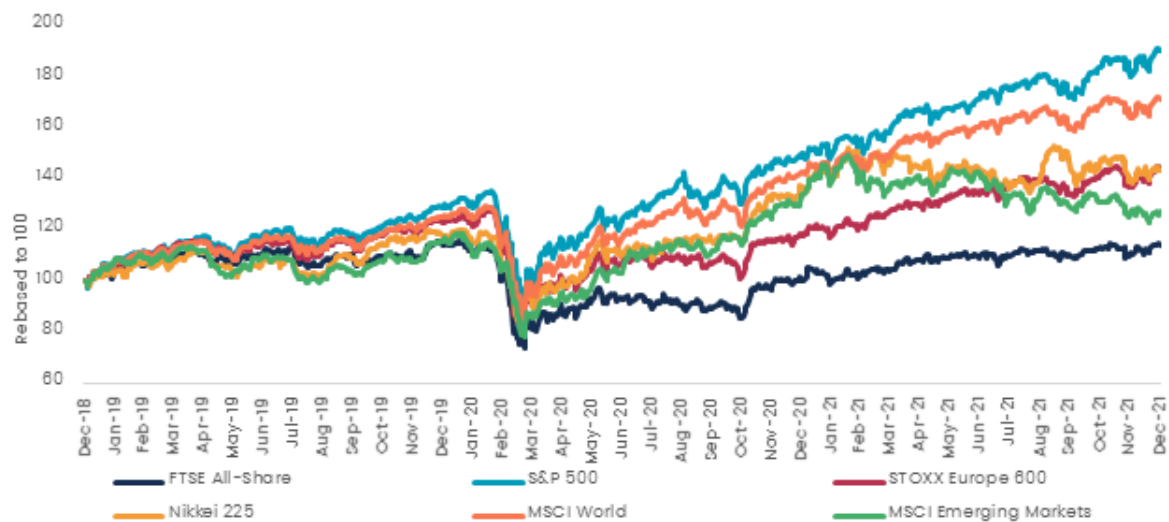
UK equities performed well over Q4, with both the FTSE 100 (+4.7%) and FTSE All-share (+4.2%) indices delivering positive returns. While there was strong performance through October concerns around Omicron caused a broad market selloff, particularly in the energy, travel, and leisure sectors. However, these fears had largely abated over December with bright spots amongst Banks and internationally diversified consumer staples groups. Ongoing supply chain disruptions have continued to cause pain for the retail sector, despite robust consumer demand, backed by falling unemployment.

The Euro Stoxx 50 increased by +6.5% over Q4. Much like the US, performance was supported by strong corporate earnings, outweighing the impact on travel and hospitality of restrictions imposed by some nations. The communication and real estate sectors lagged the index while utilities and IT were some of the strongest performers.

Japanese equities underperformed other developed markets in Q4, declining -2.1%. Despite the Liberal Democratic Party's election success in retaining a majority and the subsequent passing of a \$490 billion stimulus package, including direct handouts, December's gains were not enough to offset losses in October and November.

Emerging market equities were negative over the quarter (-1.4%), and the only market we track to suffer a decline over 2021, equal to -2.5%. Turkish equities, as measured by the Borsa Istanbul 100, suffered heavily, due to inflation hitting a 19 year high of 36%, and increasingly dovish monetary policy; an approach President Erdogan is belligerently sticking to. Chinese equities continued to perform poorly, both those listed within mainland China and those listed on foreign exchanges; technology related stocks were particularly disappointing, especially when compared to their western counterparts. Furthermore, ongoing concern around the Chinese property market and the effects of a potential slowdown on the broader economy were another worry. Despite the overall EM losses, Egypt, UAE and Peru all had a positive quarter. Taiwan benefited from its IT and semiconductor sector despite escalating tensions with China.

Global Equity Markets Performance



Fixed Income

Bonds had a mixed quarter as markets reacted to the impacts of the Omicron variant, rising inflation and tightening monetary policy. Government bond yields declined in Europe and the UK, but rose in the US. The short end of the yield curve moved higher in the US and the UK as investors priced in a faster pace of rate hikes, despite the Omicron variant. Corporate investment-grade bonds performed broadly in line with government bonds over the quarter, while US high-yield corporate bonds were positive.

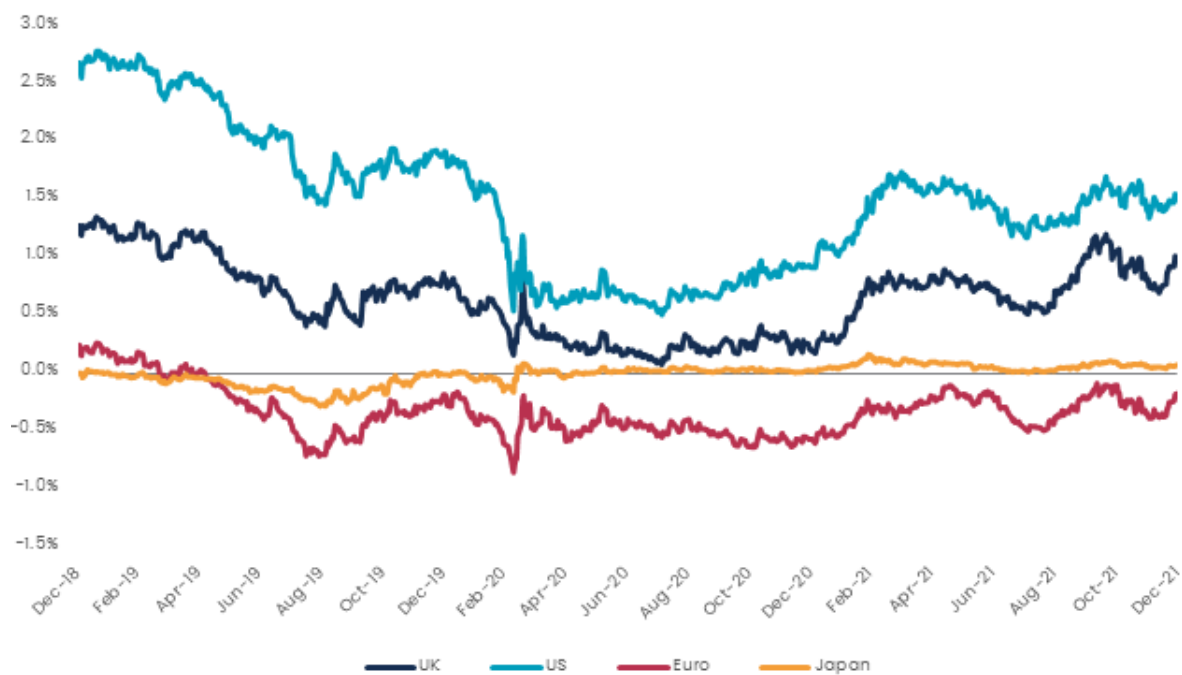
The 10-year US Treasury yield ended the quarter two basis points higher at 1.51%, with Treasuries as a whole providing a total return of +0.2%. Earlier in the quarter, the yield reached 1.7% as the Fed turned increasingly hawkish amidst persisting inflation and a tightening labour market. US CPI jumped to 6.8% in November, the highest reading in 39 years. In response, the Fed announced plans to accelerate the tapering of asset purchases from \$15 billion to \$30 billion per month, starting in January. However, the Committee voted to maintain the federal funds target rate at the current level. Yields fell to a low of 1.34% in early December over Omicron fears, before recovering as emerging data from the UK and South Africa indicated a lower risk of severe infection. The impact of tightening policy and a weaker future growth backdrop led to a flattening of the US yield curve, with shorter-dated bond yields increasing significantly.

The 10-year Gilt yield declined from 1.04% to 0.97%, with Gilts delivering a total return of 2.6%. Yields dropped sharply in November when the Bank of England opted not to raise rates, against market expectations. Yields recovered in December however, as fears over Omicron faded and the BOE raised rates by 0.15% to 0.25%. Index-linked Gilts had another strong quarter following a further rise in inflation to 5.1%, with the over-5 year and over-15-year index-linked bonds returning +5.4% and +6.2% respectively. A record 1.2 million job vacancies reported in Q4 suggest price and wage increases have the potential to be sustained.

European government bonds provided a total return of -0.5%. The European Central Bank reaffirmed their dovish stance, despite Eurozone inflation reaching the highest level in 30 years. In stark contrast to the US and UK, the ECB have provisionally boosted their monthly bond purchases, aiming to create a more cushioned exit from its pandemic stimulus.

US high yields continued their strong performance, returning +0.7%, despite flat performance for European high yield. UK investment-grade bonds returned +0.6% over Q4, performance was flat in Europe and positive in the US (+0.2%).

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 the fourth quarter, Sterling strengthened against the Dollar (+0.5%) and the Euro (+2.2%), as the Bank of England adopted an increasingly hawkish stance, especially when compared to the European Central Bank. The Dollar had another solid quarter (Dollar Index Spot rose +1.5%), boosted by the Fed’s acceleration of tapering which will pave the way for more imminent rate hikes. The Euro weakened notably against the Dollar in Q4 (-1.7%), with the ECB’s monetary stance continuing to lag the Fed’s.

Commodities

Energy commodities generally performed negatively in Q4, despite soaring prices over the course of 2021. In contrast, precious and industrial metals performed stronger.

US Natural gas prices declined substantially in Q4 (-36.4%) to \$3.7/MMBTU, reducing the YTD appreciation to +46.9%, from +131% in Q3. Weather forecasts predicted a relatively mild winter, reducing expectations of gas demand in the US. Conversely, European gas prices reached an all-time high on the 21st December due to artificial supply-constraints from Russia; this was alleviated by the arrival of Liquid Natural Gas (LNG) tankers from the US at the end of the Q4.

Brent crude oil also fell this quarter (-0.9%) but YTD appreciation remained significant at 50.2%. There was a sharp decline in response to the Omicron variant in late-November. This coincided with the U.S. government's decision to release 50 million barrels of crude oil from the Strategic Petroleum Reserve (8% of the total reserve), in co-ordination with a number of other governments, putting downward-pressure on prices. However, as the Omicron variant has been linked with fewer hospitalisations than the Delta variant, concerns about declining aggregate demand subsided. However, the increase in oil output from OPEC+ in December undershot the targets initially agreed with allies, owing to capacity constraints. As such, a full recovery in oil prices was observed throughout December.

Gold prices rose 4.2% in Q4, ameliorating a moderately poor performance for 2021 overall (prices rose +3.5% in 2021).

Copper also rose in Q4, by 9.2%, with appreciation of 26.8% overall for 2021. Industrial metals generally performed well.

Property

Global listed property performed strongly: the FTSE EPRA Nareit index rose +8.7% in Q4. Green Street Advisor's US Commercial Property Price Index rose by +5.7% over the quarter. This represents a 24% increase for 2021 with strong performance across the board and a 14.4% increase from pre Covid levels.

The Nationwide UK house price index rose once again across Q4 (+2.6%). Annual house price growth was +10.4% in December, up from +10.0% in September, which made 2021 the best performing year since 2006.

Key Indicators at a Glance

Market Indicators

Index (Local Currency)		Q4 2021	Quarter-on-Quarter	YTD
Equities				
UK Equities	FTSE 100 Index	7,384.5	4.7%	18.4%
UK Equities	FTSE All-Share Index	4,208.0	4.2%	18.3%
US Equities	S&P 500 Index	4,766.2	11.0%	28.7%
European Equities	EURO STOXX 50 Price EUR	4,298.4	6.5%	24.1%
Japanese Equities	Nikkei 225	28,791.7	-2.1%	7.4%
Emerging Markets Equities	MSCI Emerging Markets	1,232.0	-1.4%	-2.5%
Global Equities	MSCI World	3,231.7	7.9%	22.4%
Government Bonds				
UK Govt Bonds	Bloomberg Barclays UK Govt All Bonds TR	410.7	2.6%	-5.2%
UK Govt Bonds Over 15 Years	FTSE Actuaries Govt Securities UK Gilt TR Over 15 Yr	6,161.8	5.6%	-7.3%
UK Govt Bonds Over 15 Years	FTSE Actuaries Govt Securities UK Index Linked TR Over 15 Yr	8,597.8	6.2%	4.0%
UK Index Linked Bonds	FTSE Actuaries Govt Securities UK Index Linked TR over 5 Year	6,670.1	5.4%	4.2%
Euro Govt Bonds	Bloomberg Barclays EU Govt All Bonds TR	255.4	-0.5%	-3.5%
US Govt Bonds	Bloomberg Barclays US Treasury TR Unhedged USD Index	2,500.0	0.2%	-2.3%
Emerging Market Govt Bonds (Soft Currency)	J.P. Morgan Government Bond Index Emerging Markets Core Index	137.7	-3.2%	-9.2%
Emerging Market Govt Bonds (Hard Currency)	J.P. Morgan Emerging Markets Global Diversified Index	977.3	-0.4%	-1.8%
Corporate Bonds				
Pan-European Investment Grade	Bloomberg Barclays Pan-European Aggregate Corporate TR Index Value Unhedged	250.8	0.0%	-0.2%
Pan-European High Yield	Bloomberg Barclays Pan-European HY TR Index Value Unhedged	437.9	0.0%	4.2%
US Corporate Investment Grade	Bloomberg Barclays US Corporate Investment Grade TR Index Unhedged	218.0	0.2%	-1.0%
US High Yield	Bloomberg Barclays US Corporate High Yield TR Index Value Unhedged	2,461.4	0.7%	5.3%
UK Corporate Investment Grade	S&P UK Investment Grade Corporate Bond Index TR	404.1	0.6%	-2.9%
Commodities				
Brent Crude Oil	Generic 1st Crude Oil, Brent, Bbl	77.8	-0.9%	50.2%
Natural Gas	Generic 1st Natural Gas, MMBtu	3.7	-36.4%	46.9%
Gold	Generic 1st Gold, 100oz	1,828.6	4.2%	-3.5%
Copper	Generic 1st Copper, lb	446.4	9.2%	26.8%
Currencies				
GBP/EUR	GBP/EUR Spot Exchange Rate	1.2	2.2%	6.5%
GBP/USD	GBP/USD Spot Exchange Rate	1.4	0.5%	-0.9%
EUR/USD	EUR/USD Spot Exchange Rate	1.1	-1.7%	-7.0%
USD/JPY	U.S. Dollar - Japanese Yen Spot Exchange Rate	115.1	3.3%	11.4%
Dollar Index	Dollar Index Spot	95.7	1.5%	6.4%
AUD/USD	AUD/USD Spot Exchange Rate	0.7	0.7%	-5.6%
USD/CNY	USD/CNY Spot Exchange Rate	6.4	-1.4%	-2.6%
Alternatives				
Infrastructure	S&P Global Infrastructure Index	2,759.3	4.6%	11.8%
Private Equity	S&P Listed Private Equity Index	232.2	9.0%	43.2%
Hedge Funds	Hedge Fund Research HFR1 Fund-Weighted Composite Index	18,017.4	-0.7%	8.9%
Property				
Global Real Estate	FTSE EPRA Nareit Global Index TR GBP	4,171.9	8.7%	24.2%
Volatility				
VIX	Chicago Board Options Exchange SPX Volatility Index	17.2	-25.6%	-24.3%

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

Source: Bloomberg

Market thoughts



At this time of year my inbox, and probably yours as well, is stuffed full of predictions about what will happen over the next 12 months. Most are written by very intelligent people, if the initials after their names are anything to go by. There is something for everyone, some bullish, some bearish. Take your pick, because frankly your guess is as good as theirs.

Having virtually reached the same state as our thinker above, two themes have stuck me as vaguely interesting and worth sharing. One is the disconnect between China and the US, one could say in many ways, but actually it is the divergence of economic policy that is worth considering. A benefit of being appointed as your advisor is that I now have access to research from Jefferies, including excellent work from Christopher Wood, under the catching title of *GREED & fear*. So here are his recent thoughts on this subject.

The contrast between the US and China monetary cycles could not have become more crystal clear this week, with China announcing its most significant rate cut since April 2020 while Federal Reserve governors and US economists compete to sound more hawkish as the realisation has dawned how far “behind the curve” the Fed appears to be.

The PBOC cut on Monday the one-year medium-term lending facility rate and the seven-day reverse repurchase rate by 10bp each to 2.85% and 2.1%, respectively, the biggest rate cuts since April 2020. It also cut the one-year and five-year loan prime rates by 10bp and 5bp, respectively, today to 3.7% and 4.6%. This followed the 5bp cut in the one-year loan prime rate in December.

The Chinese rate cuts followed the release of another series of weak data. Retail sales data again highlight the damage done to the economy by the Covid suppression policy, rising by only 1.7% YoY in December, the slowest growth since August 2020.

A key issue for China remains whether Covid policy will be adjusted for the practical realities of Omicron. China M2 growth picked up in December while credit growth should turn up in the present quarter as credit quotas are allocated. The other issue is whether the PBOC will relax the requirement to keep credit growth

in line with nominal GDP growth, which has been the focus of the deleveraging policy in recent years.

But it is in America where the prime market focus now is with the ten-year Treasury bond yield this week breaking above the perceived 1.8% resistance level. While a far more hawkish Fed is fast being discounted in terms of rate hikes, there is, in *GREED & fear's* view, room for a lot more damage to be done to the profitless tech thematic if the Fed moves sooner and more forcefully than previously expected on the quantitative tightening issue.

The Fed balance sheet, which should total US\$8.9tn by the end of March, has now become a prime focus for *GREED & fear* and also for the markets. This is because quanto tightening is, to *GREED & fear*, a much blunter tool than rate hikes. There is also a lack of precedents.

The only significant attempt to shrink the balance sheet in the modern era occurred between October 2017 and September 2019 when, first, Janet Yellen and Jerome Powell from February 2018 sought to normalise monetary policy by reducing the balance sheet by US\$710bn or 16% from US\$4.47tn to US\$3.76tn. The experiment under Powell ended with a surge in rates in the repo market in September 2019.

This previous experience will make investors naturally nervous about the impact of quanto tightening, with the analogy of a mainlining addict being deprived of his daily fix. This is despite cogent explanations of why it will be different this time.

Before the Jekyll and Hyde act staged by the Fed in the past two months, *GREED & fear* would have assumed that the Powell Fed would be in no hurry to start contracting the balance sheet after ending quanto easing and would let rate hikes do the tightening work to begin with. But it has become clear of late that there are those on the Fed who want to move sooner, though Powell left the timing of the commencement of balance sheet contraction open in his testimony last week.

There is no doubt that investor focus on the balance sheet issue is rising. This increased focus is the result of recent Fed governor chatter. One example is a remark by Atlanta Fed president Raphael Bostic in an interview with Reuters last week that the Fed should reduce the size of the balance sheet by at least US\$100bn a month, with the aim to reduce it by at least US\$1.5tn.

From an equity standpoint, the stocks that have already been hit hard, be it ARK Innovation ETF's "exponential" holdings or biotech, would continue to lead the market down, driven by ETF redemption pressures, if the Fed really embarks on a dramatic quanto tightening. While the FAANG and value stocks will find themselves increasingly outperforming in relative, not absolute, terms. *GREED &*

fear would also expect further weakness in the crypto asset class in spite of the undoubtedly interesting long-term story.

The implementation of such a dramatic quanto tightening policy would also put more upward pressure on long-term Treasury bond yields. This is because the market will in the first instance sell Treasuries because the process of balance sheet contraction implies the Fed selling some of its Treasury bond holdings or at least not reinvesting them as they mature. Still, this is only the initial reaction.

The history of the quanto easing era shows that, contrary to the views maintained by central banks and most conventional economists, quantitative easing ends up in practice being bearish for long-term Treasury bonds, while, conversely, quantitative tightening is bullish. This is because the former is an effective form of monetary easing and the latter is perhaps an even more effective form of monetary tightening.

If the Fed really does embark on the sort of quanto tightening programme now beginning to be talked about, *GREED & fear* may have to review the current recommendation maintained here since the end of March 2020, namely that investors should sell all Treasury bonds as well as all G7 government bonds. That remains a big if, of course. But in the meantime, there will be continuing political pressure on the Fed to be seen to be doing something about inflation in the run-up to the November mid-term elections.

With the base effect on US inflation not due to kick in until the March CPI report, there is plenty of scope for markets to worry more about tightening in the next few months even if the eventual outcome ends up being nothing as dramatic as markets start discounting, in terms of both the number of rate hikes and the scale of balance sheet contraction. Another point is that this is the first monetary tightening cycle since at least the early 1990s when the Fed is tightening because it is perceived to be way behind the curve in terms of managing inflation.

You may recall that at the last meeting I made reference to Central Banks dithering on the whole issue of Quantitative Tightening, inflation threats and interest rates. Put simply, repeating history, too little, too late. We'll stick with Christopher, because after the end of January Fed meeting, he came out with this erudite piece.

GREED & fear: A lack of relief

In *GREED & fear's* view it remains all about the Fed balance sheet. And, unfortunately for stock markets, the Federal Reserve has provided little relief on that score at this week's FOMC meeting. Indeed markets are still faced with

uncertainty in terms of both the timing and the scale of any potential quantitative tightening.

Investors are not just having to contest with a behind the curve Fed which is not just perceived as needing to tighten to restore its own credibility, but one which is under political pressure to tighten. This has literally not been the case in America for decades, probably not since Paul Volcker succeeded William Miller back in 1979. The reason for that political pressure is evident from the collapse in Joe Biden's polling data along with the rise in inflation.

When Volcker embarked on his monetary tightening cycle in 1979, debt levels in America were dramatically lower than is the case today. The much higher debt levels today mean the deflationary impact of monetary tightening impacts much more quickly, most particularly if that form of tightening involves the much blunter mechanism of central bank balance sheet contraction. This is because the marginal utility of debt has been declining for years in the Western world as higher debt levels have led to slowing economic growth.

The downside of debt-driven growth is a charge which has usually been levelled against China in recent years, if not recent decades, with China bears long predicting the collapse of the command economy model. Still the reality is that a lot of the build-up in debt in China in the past two decades has gone into productive infrastructure which has added economic value. That is much less the case in the G7 world.

If the Fed is really intent, for now at least, on implementing meaningful monetary tightening, the only sensible course for equity investors is to look to sell rallies in stocks, most particularly rallies in growth stocks. In this respect, the crypto asset class has also succumbed to the tightening scare. It will, in *GREED & fear's* view, remain under pressure so long as quantitative tightening is on the Fed's agenda.

In terms of the ETF asset class as a whole the interesting point to *GREED & fear* is that outflows out of US equity ETFs have barely commenced. This reflects the strength of the belief in "buy the dip". Yet as Fed tightening proceeds, it should be expected that the damage will move from the high beta area of equities, such as ARK and its equivalents, to the more mainstream parts of the market, be it FAANGs or, yes, cyclicals.

The more the Fed tightens, the more it should be expected that cyclical optimism on the economy will be questioned, not to mention the wealth effect of all the money which will have been lost in the markets. There has been a meaningful retail component in the transfer payment-driven Covid bull market in America the past nearly two years. This wealth effect dynamic increases the likelihood that Americans revert to deleveraging the longer Fed tightening proceeds.

Still the silver lining of such an outcome is that it will give an excuse for the Jekyll and Hyde Fed to execute yet another U-turn. For if the money markets are now discounting 4-5 rate hikes this year, that does not necessarily mean those rate hikes will happen. There may also be then be political pressure for such a change. But at present any such a U-turn looks premature which is why equities remain at risk, most particularly US equities.

The pressure on the Fed to be seen to be doing something on inflation is now coming from the moderate side of the Democratic Party which fears a Republican landslide in November while the so-called progressives are on the defensive, having overplayed their hand in terms of what they tried to implement in the now lapsed "Build Back Better".

If the Fed has remained at the centre of market attention, there are also other goings on in Washington worth monitoring. One is the Biden administration's efforts to come up with something to replace the Build Back Better bill before the November mid-term elections. The consensus seems to be for renewed negotiations to commence in the coming month on some slimmed down version of Build Back Better which has a better chance of getting Democrat Senator Joe Manchin's support. The question is how slimmed down.

An interesting development also occurred last Thursday when the Senate Judiciary Committee passed by a 16 to 6 vote a motion to advance a bill targeting Big Tech on the antitrust angle. The bill would in essence stop the biggest tech platforms from favouring their own products and services over that of competitors. As such it addresses the longstanding conflict of interest at the heart of the business model.

This is a potentially big deal, most particularly given the powerful lobbying effort levelled against it. While nothing is certain in terms of concrete legislative outcomes, there is clearly the potential for progressive Democrats and more free market Republicans to find common ground on this issue even if the Democratic establishment seemingly remains firmly in bed with Big Tech.

If the suddenly hawkish Fed was not enough to be dealing with, markets have also had to contend with the standoff in Ukraine. The interesting point is why Russian President Vladimir Putin has chosen this moment to escalate the issue.

GREED & fear's best guess is that he is seeking to use his assumed leverage, in terms of Europe's need for Russian gas, to try and secure a deal whereby Eastern Ukraine becomes an accepted Russian enclave, or at least an agreement with the Western powers whereby the so-called Minsk Agreements of 2014 and 2015 are enforced. This would turn Ukraine into a federal state allowing a certain amount of autonomy for the ethnically Russian dominated East. The latter might even be preferable to Putin since he would not have to fund an enclave.

If this is indeed the intent it should be feasible to negotiate a deal, most particular as Germany is clearly sympathetic to the Russian stance. There is also the issue of Nord Stream 2 from a Berlin perspective. Still the more weapons the West sends to the Western part of Ukraine, the more incentive there is for the Ukrainian Government not to want to implement the Minsk agreements.

Russia surely has no interest in invading Western Ukraine. Knowing this, the Western allies may be calling the Russian leader's bluff knowing he will not want to commit to such a costly encounter. Still Russia is also in a better position to defend itself against sanctions than was the case in 2014-2015 given the price of oil, its lack of debt and high level of foreign exchange reserves. *GREED & fear's* base case is that a deal will be agreed on Ukraine and that Russian stocks, particularly energy stocks, are a buy.

The trillion dollar question is how much market damage is done in the interim before the Fed does its seemingly inevitable U-turn, thereby signalling that it continues to favour financial repression over meaningful monetary tightening. *GREED & fear* would define really meaningful monetary tightening as raising the federal funds rate to 3% and shrinking the balance sheet from nearly US\$9tn to US\$6tn. The implementation of such a policy would cause carnage in stock markets and trigger a massive rally in the long end of the bond market.

Markets hate uncertainty, so the lack of guidance from the Fed and others will continue to fuel volatility, as investors try to second guess the next move. I left the piece in about the Ukraine/ Russia situation, even though events may well have moved on by the time that you get to read this. It fits quite well with what a student of history and Russian politics told me recently, as I tried to fathom out what Putin's end game is.