



LGPS CENTRAL LIMITED TACTICAL ASSET ALLOCATION

ISSUE 12 ● December 2020



**FOR PROFESSIONAL
CLIENTS ONLY**

CIO SUMMARY

Introduction

Welcome to the twelfth edition of our LGPS Central Limited (“LGPSC”) Tactical Asset Allocation (“TAA”) Report. We hope that you, your family and friends have had a relaxing Christmas and New Year and are safe and in good spirits.

Summary of Strategy Thoughts

Since the publication of the previous edition of this report, both US elections and Brexit are behind us. Further, vaccination programs have started in the developed economies as we are witnessing another wave of the coronavirus and all the consequences that this imposes. The speed of economic recovery will likely depend on the effectiveness of vaccination programs, although economic data may reflect a recovery starting from the end of March only due to basis effects, but we may explain this recovery as distortion-led. In case the economies re-open and their positive effect coincides with the depressed levels from last year, then this may lead to a spike in reported growth numbers, but this is not our base case scenario.

We continue to see the recovery as a radical (the shape of a square root symbol), with a slight slope of recovery moving forward that will most likely depend on various factors: (a) continued fiscal and monetary support, (b) the level of unemployment, (c) consumer behaviour, which will determine to a large extent the survival of many SMEs, and (d) how long it will take for the vaccination to be completed and if new variants of the virus will be resistant with respect to the vaccine.

We are upgrading growth assets to **neutral** from **underweight**. The main drivers behind the upgrade is the market risk factor being on the upside following the deployment of the vaccination programs and expected re-opening of the economies in a few months from now. We remain **underweight** on stabilising assets and **overweight** on income assets.

In terms of factors, the model continues to be **overweight** on **quality** and **low volatility**. We upgrade **size** to **overweight** considering that small cap companies may become the main beneficiaries behind the re-opening of the economies. On currencies, we continue to remain positive on Sterling. With the current low level of domestic rates, the increasing size of the domestic deficit, the current sentiment score and oversold nature of Sterling, we believe much of the bad news is already discounted. We continue to support the US Dollar’s prolonged period of weakness. JPY and EUR continue to trade in response to the market’s perception of relative risk, and of the two we favour the JPY over the EUR, on which we are neutral.

Gordon Ross (CIO)

LGPS CENTRAL LIMITED'S VIEW ON WEIGHTINGS

The following table gives a summary of our view on the 6-18 months tactical positioning horizon.

Table1: Weightings ▲ Upgraded, ▼ Downgraded compared to previous quarter

	Significant Underweight	Underweight	Neutral	Overweight	Significant Overweight
Estimated Probability	80-70%	70-65%	55-45%	70-65%	70-80%
BROAD ASSET CLASS		Stabilising	Growth ▲	Income	
GROWTH ASSET CLASS	US Equities		UK Equities ▲ EU Equities ▲ Private Equity ▲	Commodities ▲ GEM Equities ▲ Japan Equities ▲ Asia Pac Equities ▲	
INCOME ASSETS	Property		Credit		EM Debt Infrastructure
STABILISING ASSETS	EU Bonds ▼	UK Bonds ▲ JP Bonds ▲	Index-Linked ▲ US Bonds ▲	Gold IG Bonds	
INVESTMENT STYLES		Growth Momentum ▼		Value Size ▲	Quality/ESG Low Volatility
CURRENCIES		US Dollar	Euro ▼	GBP, Yen	

LGPSC's view on "Weightings":

- We maintain an overweight allocation to Income Assets, mainly due to Infrastructure and EM Debt.
- Growth Assets we have increased to neutral, reflecting that the risk is more on the upside than the downside, given the start of the vaccination programmes and the subsequent opening of the economies.
- Stabilising Assets we keep at underweight as last time, mainly due to their high valuations.

LGPS CENTRAL LIMITED TACTICAL ASSET ALLOCATION: ISSUE 12

BROAD ASSET CLASSES

Table 2: Growth/Income/Stabilising Assets

	Model Score ¹	View	Investment Notes
GROWTH	0	Neutral	Upgraded to neutral to reflect the positive development of the pandemic, with vaccination programmes running since December and the expected opening of the economies as soon as possible thereafter. This changed our market risk expectations by shifting the risk expectations from being to the downside to being to the upside.
INCOME	1	Overweight	No change from last time.
STABILISING	-1	Underweight	No change from last time.

Table 3: Historical Annualised Returns in local currency (* except for the 3 months, where total return is used)

	3 months*	One year	Three years	Five years	Ten years	Twenty years	Bloomberg Ticker
GLOBAL EQUITIES	14.8%	16.6%	10.5%	12.8%	9.7%	6.2%	FTAW01 Index
PRIVATE EQUITY	14.8%	1.2%	8.7%	14.9%	10.8%	N/A	IPRV LN Index
PROPERTY	8.3%	-4.8%	5.5%	6.8%	9.2%	10.0%	REIT INDEX
INFRASTRUCTURE	15.0%	-5.8%	2.7%	7.9%	6.5%	N/A	SPGTIND Index
HIGH YIELD	6.4%	4.6%	5.3%	6.8%	8.7%	10.4%	HL00 Index
UK GILTS	0.6%	8.8%	5.5%	5.8%	5.8%	5.6%	G0L0 Index
UK INDEX-LINKED	1.2%	11.2%	5.7%	8.6%	8.1%	7.0%	G0L1 Index
GOLD	-4.8%	21.3%	12.8%	14.0%	4.3%	10.7%	XAUGBP Currency

Source: Bloomberg (NB: assumes dividends were reinvested), Note: Listed proxies have been used for Infrastructure, Property and Private Equity.

Table 4: Correlation Matrix (5 year historical correlation)

	FTSE All World AW TR GBP	iShares Listed Private	DJ REIT	S&P Global Infra	Sterling High-Yield	UK Gilt	UK Inf-Link Gilt	XAUGBP Index
GLOBAL EQUITIES	1	0.802	0.759	0.871	0.710	-0.107	0.094	-0.150
PRIVATE EQUITY		1	0.723	0.792	0.643	-0.011	0.182	0.058
PROPERTY			1	0.837	0.630	0.151	0.292	-0.007
INFRASTRUCTURE				1	0.738	0.077	0.235	-0.020
HIGH YIELD					1	0.026	0.189	-0.142
UK GILTS						1	0.791	0.491
UK INDEX-LINKED							1	0.415
GOLD								1

Source: Bloomberg Note: listed proxies have been used for Infrastructure, Property and Private Equity

LGPSC's view on Broad Asset Classes:

- We can see from Table 3 above, that during the last Quarter, the Growth Asset class enjoyed strong performance, beating its ten and twenty year averages. On the other side was the Stabilising Asset class with Q4 returns well below its long-term averages. The Income Asset class performed close or slightly below its long-term averages with Infrastructure being an outlier, managing to beat all its past averages.
- From Table 4, we can see that the best asset class to protect both equity and high yield exposure is not UK sovereign bonds (gilts) but rather gold, which has a higher negative correlation.
- While our recommendation is to be underweight Stabilising Asset classes, this recommendation still allows room for a selective approach in which one can still find niche opportunities.

¹ Refers to LGPSC model as described on page 7

LGPS CENTRAL LIMITED TACTICAL ASSET ALLOCATION: ISSUE 12

GROWTH ASSET VIEW

Table 5: Growth Assets

	Model Score ¹	View	Investment Notes
UK Equities	0	Neutral	No change from last quarter, given that Soft Brexit is now a reality
NORTH AMERICA Equities	-9	Underweight	Underweight due to high valuations, economic outlook, poor currency outlook, as well as increased market risk linked to the political agenda of the Democrats who also won the Senate
EUROPE Equities	0 ▲	Neutral	Increased to neutral given better Market Risk score to reflect the start of vaccination programs and future reopening of the economies
JAPAN Equities	3	Overweight	Kept at overweight with an improved market risk score
ASIA PAC Equities	2 ▲	Overweight	Upgraded due to market risk and sentiment
GEMs Equities	1 ▲	Overweight	Upgraded due to market risk, currency expectations and sentiment
PRIVATE EQUITY	0 ▲	Neutral	Upgraded mainly due to valuations and sentiment
COMMODITIES	1	Overweight	No change from last time on the recommendation, while decreased sentiment was balanced by a higher score on market risk

LGPSC's view on Growth Assets:

- Growth Assets continue to have expensive valuations.
- We are either overweight or neutral on most of the regional Growth Assets, reflecting improved market risk scores, except for North America. The USA is facing a new President, backed by both the House and the Senate to execute its agenda focused on breaking monopolies in the tech sector and increasing corporate taxes. We see these measures as headwinds to North American equities.
- After Q1 2020, markets have recovered their falls helped by increased monetary stimulus, and given that the monetary and fiscal stimulus will continue in the Q1 21, and the pandemic risk taking its time to diminish, we can expect the valuations of the asset class to remain high.

INCOME ASSET VIEW

Table 6: Income Assets

	Model Score ¹	View	▼ Investment Notes
CREDIT	0	Neutral	No change from last time.
EMERGING MARKET DEBT	2	Overweight	No change from last time.
PROPERTY	-3	Underweight	No change from last time. Valuations, sentiment, economics and market risk – all continue to have a negative impact on Property.
INFRASTRUCTURE	3	Overweight	No change from last time.

LGPSC's view on Income Assets:

- We continue to prefer Infrastructure and Emerging Market Debt.

LGPS CENTRAL LIMITED TACTICAL ASSET ALLOCATION: ISSUE 12

STABILISING ASSET VIEW

Table 7: Stabilising Assets

	Model Score ¹	View	Investment Notes
UK BONDS	-1 ▲	Underweight	Kept at underweight due to sentiment and valuations.
INDEX-LINKED	0 ▲	Neutral	Increased to neutral due to positive sentiment and currency scores.
US BONDS	0 ▲	Neutral	Increased to neutral mainly due to better sentiment scores.
JP BONDS	-2 ▲	Underweight	Still kept at underweight while currency and sentiment scores improved.
EU BONDS	-4 ▼	Underweight	Kept at underweight while the currency score deteriorated.
IG CORPORATE BONDS	2	Overweight	No change from last time.
GOLD	1	Overweight	No change from last time.

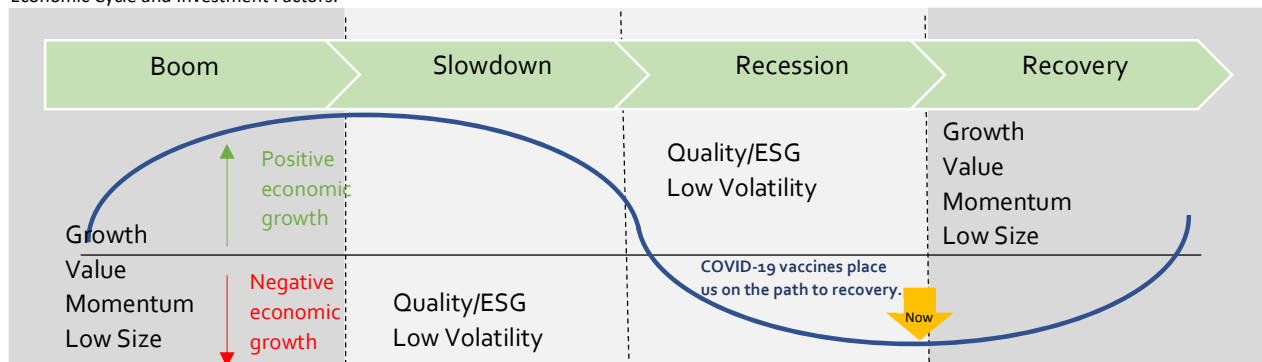
LGPSC’s view on Stabilising Assets:

- Regionally, on government bonds, we are underweight or neutral across all regions.
- We remain overweight IG corporate bonds and Gold due to positive sentiment and market risk scores
- Gold offers good diversification and a hedge against currency debasement

INVESTMENT FACTORS (EQUITIES)

Factor Based investing provides a way of potentially adding outperformance relative to a market-cap-based approach at a much lower cost than active investing. It recognises that the market-cap-based index does not provide the best risk-adjusted return for a portfolio given its natural overweight to momentum, large cap and expensive stocks. In the following factor model, we have taken the seven factors of value, growth, income growth, size (small cap), ESG, low volatility and momentum and then applied the same criteria we use to consider other asset classes in our model assessing each factor for valuation, sentiment, economic suitability, risk suitability, investment cost and currency. Investment cost in factor-based investing is low relative to the other asset classes, though the momentum factor (given their higher turnover) and ESG factors (given their higher index costs) are both scored neutral. Given all strategies are global, the currency scores are all neutral. Note that ESG and quality share similar characteristics. Climate change as a factor is little correlated to specific economic cycles given its long-term investment impact horizon of 10-20 years. The graph below summarises the preferred overweight factor(s) depending on the various stages of the economic cycle.

Economic Cycle and Investment Factors:



LGPS CENTRAL LIMITED TACTICAL ASSET ALLOCATION: ISSUE 12

FACTOR ASSET VIEW

Table 8: Investment Factors

	Model Score ¹	View	Investment Notes
Value	1	Overweight	No change from last time
Growth	-2 ▼	Underweight	We keep it at underweight.
Size	1 ▲	Overweight	Increased the overweight due to improved market risk and sentiment scores.
Momentum	-1 ▼	Underweight	Kept at underweight while the valuation score deteriorated.
Low Volatility	2 ▼	Overweight	Kept at overweight while the valuation and market risk scores deteriorated
Quality/ESG	2 ▼	Overweight	Still kept at overweight while the valuation score significantly deteriorated and the market risk, and economic scores slightly improved

LGPSC's view on Investment Factors:

- Our favourite factors remain Quality/ESG, Low Volatility, Value and Size.
- Least favoured factor is Growth due to high valuations.

ABOUT LGPS CENTRAL LIMITED'S SCORING MODEL

LGPSC's model scores each asset class against its valuation, sentiment, economic outlook, market risk, currency and investment cost (scored between -2 and +2). Positive scores suggest strong overweight positions and negative scores, strong underweight positions. Where a zero is assigned, our view is neutral. The scores for the different assessment areas, e.g. valuation, sentiment etc. are then added to derive the final score for that asset class. Please note that sentiment is measured as to whether an asset class is over owned or over loved. We prefer to own asset classes that are under owned and under loved. We are constantly developing this scoring to include other variables such as ESG measures and technical factors.

This quarter we have changed the model to exclude the investment cost as a factor. We believe with the abundant liquidity at present, and the fact that the investment cost is reflected in the price, asset class scores do not need to reflect the investment cost.

LGPS CENTRAL LIMITED TACTICAL ASSET ALLOCATION: ISSUE 12

Q4 LGPS CENTRAL LIMITED MARKET UPDATE²

The final quarter of 2020 saw global markets surge as Covid-19 vaccines were approved and the roll-out began. The US Presidential election concluded with Joe Biden as the victor, and markets responded positively to the news. While the Democrats held on to the House, control of the Senate would not be decided until the New Year. In late December, it became apparent that Brexit was no longer a big concern for investors as the UK and EU agreed on a Brexit trade deal which was then overwhelmingly approved by the UK Parliament.

As Covid-19 vaccine milestones were reached, markets around the world made significant gains in the quarter, with the MSCI World Index returning 13.63%. The approval of the \$900bn stimulus package from the US Congress in December helped the S&P 500 to return 11.69% in the quarter, even after the 2.8% decline in October. The UK FTSE 100 returned 10.13% in the period as investor sentiment improved upon news of the avoidance of a "no-deal" Brexit. The Euro Stoxx 50, like other developed markets, declined in October amid fears of an acceleration of Covid-19 cases and finished the quarter significantly higher, returning 11.24% over the period. The biggest returns came from the emerging markets as the US dollar weakness amplified returns. Hang Seng and Nikkei 225 returned 16.08% and 18.37% respectively.

The Flash Composite PMI's (company surveys) in the UK showed consistent growth in the manufacturing sector throughout the quarter. The services sector however, showed slight contraction, being under 50 in November and December. While some service providers noted a rise in activity following the easing of lockdown measures, there were still widespread reports that Covid-19 restrictions had either reduced customer demand or led to business closures, especially given the November lockdown. The Eurozone told a similar story, having consistent growth in manufacturing, but contraction in services.

The Michigan Consumer Sentiment Index was broadly unchanged during the quarter while US Initial Jobless claims remained at a steady level throughout the period. The VIX index spiked up at the end of October, reflecting the uncertainty of the US Presidential election. The index has since come down following a convincing win by Joe Biden and the breakthroughs made by the Covid-19 vaccines.

On Christmas Eve, the UK and EU reached a Brexit trade deal which was overwhelmingly approved by the UK Parliament. This led to the GBP/USD price finishing 5.80% higher than it was at the start of the quarter. The closing value of 1.367 was also its highest value in 2020. The US Congress approved a \$900bn stimulus package which will be the second-largest economic relief bill in American history. The incoming US President, Joe Biden, is expected to take a more diplomatic and less confrontational approach in foreign policy matters than Donald Trump. Biden is also intending to re-join the Paris Climate Agreement to help drive his 'green' agenda.

Oil prices fell sharply going into the US Presidential election. Since the election, the oil price has risen and continued to rise following the latest OPEC meeting which agreed production cuts to take place in Q1 2021. Oil prices finished the quarter 26.50% up.

Q4 2020 was a busy and positive quarter for equities and science, with the S&P 500 hitting record highs, a Brexit trade deal being agreed, and a Covid-19 vaccine being approved and rolled-out. 2021 is expected to bring stabilisation and a reset for a number of disruptions experienced in 2020, with an economic recovery to follow, although the timing is as yet to be decided.

² Performance for the quarter measured over period of 30/09/2020 to 31/12/2020

LGPS CENTRAL LIMITED TACTICAL ASSET ALLOCATION: ISSUE 12

Q4 2020 LGPS CENTRAL LIMITED RESPONSIBLE INVESTING UPDATE

In late 2020, the UK government announced that a domestic Emissions Trading Scheme (ETS) will be established following the UK's withdrawal from the European Union, and consequently, the EU ETS. The new UK scheme officially commenced on 1st January 2021, and covers energy intensive industries, the power generation sector and the aviation sector. Similarly to the EU ETS, the new UK ETS will work on the 'cap and trade' principle, whereby a limit is set on the total emissions that can be emitted by sectors. Organisations covered by the scheme will receive free allocations of emission allowances and auctioned emission allowances will have a floor price of £15/tonne. Several research reports maintain however that a carbon price between £30 and £60 is necessary to meet the goals of the Paris Agreement. The UK government has indicated that its domestic ETS will be more ambitious than its EU counterpart, with the emission's cap to be set 5% below the UK's notional share of the EU ETS cap. Additionally, the government has signalled that the UK ETS will play a significant role in the country achieving its net-zero emissions target by 2050. Following persistent overallocation and low prices in the EU ETS, the Market Stability Reserve (MSR) was introduced in 2019, which in large can be credited with providing price stability and higher allowance prices. While a similar mechanism, the Supply Adjustment Mechanism (SAM), was proposed in the consultation, the UK government has yet to include this feature in legislation, which may ultimately negatively impact volatility and liquidity in the UK ETS market.

Joe Biden's election has been hailed as a significant turning point in US climate policy, which was a key election issue. Since the election, Biden's transition team have made several consequential appointments to lead on implementing Biden's \$2tn climate action plan. Former Secretary of State, John F. Kerry, who played a key role in the 2015 Paris Climate Accord negotiations, has been named as Biden's Special Presidential Envoy for Climate. In national affairs, his counterpart is Gina McCarthy, who under the Obama administration served as the administrator for the Environmental Protection Agency. She is now set to lead on domestic climate policy. Biden has nominated Michael Regan to head the Environmental Protection Agency, who will take over from Trump's controversial pick Andrew Wheeler, a former coal lobbyist. Further key appointments include; Deb Haaland, the first Native American Cabinet secretary, as head of Department of Interior; and Attorney Brenda Mallory, who is to lead the Council on Environmental Quality. These appointments, along with others, indicate that Biden's cabinet is set to be both climate ambitious and diverse. In recent weeks the democrats gained control of the senate, following the two Senate runoff elections in Georgia, which is likely to provide the Biden administration more leeway in passing ambitious climate change legislation. However, the events at the Capitol Building on the 6th January suggest that climate change will remain a politically charged issue in the US with individual states maintaining significant control over policy.

The United Nations Principles for Responsible Investment (PRI) has, for the first time, delisted investors for failing to meet minimum requirements. The PRI is a multi-national investor initiative whose aim is to promote the inclusion of environmental, social and governance factors into investment and ownership decisions. To date, the PRI has gained more than 3,000 signatories with over \$100 trillion assets under management since it was launched in 2006. In 2016 the PRI announced that it would delist signatories who did not align themselves to the PRI principles. By 2018, the PRI compiled a watch-list of 165 signatories who had not lived up to the PRI principles and engaged with them over two years to address their shortcomings. Following the engagement period in 2020, the PRI delisted five signatories – BPE, Corfina Capital, Delta Alternative Management, Primary Wave IP Investment Management and Stichting Gemeenschappelijk Beleggingsfonds FNV – for not meeting the minimum requirements. During this period a further 23 signatories either voluntarily delisted or were delisted for failure to submit their annual PRI report. These recent actions by the PRI demonstrate that in order to continue as a signatory, investors must implement material changes to their operations, rather than completing the PRI report simply as a token exercise, and that minimum standards in the PRI are rising.

LGPS CENTRAL LIMITED TACTICAL ASSET ALLOCATION: **ISSUE 12****Sources:**

<https://www.gov.uk/government/publications/participating-in-the-uk-ets/participating-in-the-uk-ets>

https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/889037/Government_Response_to_Consultation_on_Future_of_UK_Carbon_Pricing.pdf

<https://www.carbonbrief.org/us-election-climate-experts-react-to-joe-bidens-victory>

<https://www.nytimes.com/2020/12/16/climate/brenda-mallory-council-environmental-quality.html>

<https://www.theguardian.com/us-news/2020/dec/17/deb-haaland-joe-biden-interior-secretary>

<https://www.washingtonpost.com/climate-environment/2020/11/23/kerry-climate-change/>







<https://www.unpri.org/reporting-and-assessment/signatories-delisted-for-not-meeting-the-minimum-requirements/6480.article>

<https://www.ipe.com/news/pri-delists-five-plans-to-raise-minimum-requirements/10048091.article>

<https://www.spglobal.com/en/research-insights/articles/daily-update-january-6-2021>

RISK ANALYSIS

Table 9: Risk in order of probability

RISK	LGPSC Possibility	LGPSC Impact	Change on quarter	Comment	LGPSC favoured assets to protect against the risk
CORONAVIRUS	High	High		The second wave of the coronavirus is among us thus increasing the risk of a lengthy recession. While a vaccine is deployed, it is hard to know for sure how effective it will be with respect to the new variant.	Clients without equity protection should consider re-establishing protection. Selectively investing in Quality Assets and a diversified portfolio.
EQUITY DOWNTURN	Medium	Medium		The probability of equity downturn has decreased as we face a solution to the coronavirus, with fiscal and monetary stimulus on the table.	Safe haven assets such as gold. Renewing equity protection should be considered.
NATURE OF RECOVERY	High	High		Not likely to be a straightforward V-shaped recovery, most likely either a W-shaped or looking like a radical sign (V with a "tail"). Possibility of zombie companies slowing down the economy with bankruptcies having slowed down, with zombie companies relying on support to stay alive.	Hold a well-diversified portfolio with emphasis on Quality. Once the recession is gone, factors such as Size and Value are expected to perform best.
POLITICAL RISKS	Low	Medium		The main risk is how Joe Biden will implement his mandate. Some European countries will go through elections later in the year.	Overweight protective assets such as Gold.
ISOLATION & PROTECTION/CHINA	Medium	Medium		Less extreme than if Donald Trump had won the election. One point will be what relationships China will build with the rest of the world post-Covid-19.	Current tactical asset allocation will be dominated by the Coronavirus.
CREDIT RISK/DEBT ISSUES	High	High		Emerging sovereign debt crisis has become the biggest risk. Argentina, for example, experiences more problems after the restructuring. Credit markets to a big extent are underwritten by the central banks, thus keeping the default rates at artificially low levels. Mounting government debt, through	Selective Credit and IG Corporate Bonds.

LGPS CENTRAL LIMITED TACTICAL ASSET ALLOCATION: ISSUE 12

RISK	LGPSCL Possibility	LGPSCL Impact	Change on quarter	Comment	LGPSCL favoured assets to protect against the risk
				new issuance, is met with an increase in the QE programmes.	
CURRENCY RISK/ STERLING STRENGTH/US\$ WEAKNESS	Low	Moderate	→	Expectation for a long downtrend in the USD. The currency preference will be (in declining order) GBP, YEN, EUR, USD; in particular, GBP strength and USD weakness is expected. Gold we view as positive.	Buy GEM equities, commodities which historically benefit from a weaker dollar.
CLIMATE-RELATED TRANSITION RISK	Medium	Moderate	→	<p>The EU Carbon Price has reached new highs of €34.5/tonne.</p> <p>Joe Biden, whose campaign included climate friendly policies, has been elected as the next President of the US</p> <p>At the UN General Assembly, China announced it aimed to become carbon neutral before 2060.</p> <p>European leaders have agreed a deal on the new 7 year EU budget and the Next Generation EU recovery instrument, with 30% of funds allocated to climate projects.</p> <p>Green bond issuance for Q3 2020 \$64.9bn, up 21% from the previous quarter and the highest volume in any third quarter period</p>	Underweight Energy & GEMs, overweight Renewables and Sustainable Investment themes such as Infrastructure.
CLIMATE-RELATED PHYSICAL RISK	Medium	Moderate	→	<p>Carbon emissions are beginning to rebound following national lockdowns</p> <p>Amazon deforestation surges to 12-year high</p> <p>Extreme weather events across the world have led to significant losses in 2020. The hurricanes and wildfires in the US are estimated to have caused \$60bn in losses, while six extreme weather events in Asia caused damages of more than \$40bn.</p>	Hold a well-diversified portfolio.
LIQUIDITY RISK	Low	Low	→	Liquidity risk is not considered to be a main problem given the ample liquidity support from the central banks.	
UNEXPECTED INFLATION RISK	Low	Low	→	Unexpected Inflation is not seen on the horizon, though the conditions that could lead to it are present, even though it may take some time till these materialize. Currently the view is that it will be supply driven rather than demand driven when it happens.	

LGPSCL’s view on “Scenario Risks”:

- The deployment of the vaccines is a game changer, though it is still a bit too early to declare victory. The short history of the vaccines, possible side effects, new variants and the effectiveness of the vaccines with respect to these remain open questions. Still, having a vaccine is the key to the path to normality.
- We also have reviewed the likelihood and impact of risks, and we now see that the biggest risk is a prolonged recession caused by the economic impact from the second wave of Covid-19.
- We highlight that holding a diversified portfolio still offers the best protection against those risks. Equity protection may be necessary. Specific risks such as a weakening US\$ can be mitigated by hedging the currency risk. Reducing home-bias investments could prove to be beneficial post-Brexit.

SPECIAL FEATURE: INFLATION



Inflation

Stan Grozev – Portfolio Manager

Inflation is one of the most important concepts in the world of investments. These days, in the world of seemingly endless money printing, there is the question of how, when and under which conditions could inflation enter the real economy. While we have all witnessed inflation in the value of financial assets in recent years, we have hardly seen any inflation in the 'real' economy.

With respect to the UK, there are currently different schools of thought; some believing that inflation is unavoidable, while others don't see inflation at any meaningful level anytime in the foreseeable future. While inflation has been given a negative image, it can have either a very positive or a very negative effect on an economy, depending on which side of the 'liquidity fence' one is situated. As a borrower, in an inflationary world, one can easily find one's debt burden diminishing in real terms. On the other side (i.e. for those holding cash/non real assets or on fixed incomes), inflation can quickly destroy one's wealth, and this scenario is the nightmare of every single wealth manager. Since the benefits payable within pension schemes such as the LGPS are linked directly to inflation, it is important to safeguard asset values from the potentially negative impact of inflation.

What is Inflation?

While there are different measures of inflation (RPI, CPIH and CPI), we will use the CPI as the prime measure for inflation as this is the measure used within the LGPS. CPI stands for the Consumer Price Index and it measures the prices of a basket of goods and services where each good/service has a given weight. CPI covers all the expenditure within the UK by: (1) private households, (2) residents of institutions such as university halls or nursing homes, and (3) visitors to the UK from abroad. When we refer to inflation, we refer to the change in the CPI. When the CPI change is small, positive and increasing, then we have inflation, while when the change is small, positive and decreasing, then we have dis-inflation. Further, when the change is rapid, out of control and positive, then we have hyperinflation. On the other side, when the CPI is negative, then we have deflation. The components and their weights in the CPI for the Feb-Dec 2020 period are as follows:

Components of the UK CPI for the Feb-Dec 2020 period with their weights			
1. Recreation and culture	16.8%	7. Clothing and footwear	6.1%
2. Transport	14.7%	8. Furniture, household equipment & maintenance	6.0%
3. Housing, water, electricity, gas & other fuels	13.1%	9. Alcoholic beverages and tobacco	4.0%
4. Restaurants and hotels	11.9%	10. Education	2.9%
5. Food and non-alcoholic beverages	9.9%	11. Health	2.7%
6. Miscellaneous goods and services	9.8%	12. Communication	2.1%

(Source: Office for National Statistics)

While CPI is a backward-looking measure of inflation, the market is also concerned about future inflation and the measure often used to account for expected inflation on a forward-looking basis is the 'breakeven inflation rate'. The breakeven rate is simply the difference between the yields of the nominal bond and the inflation-linked bond of the same maturity. Currently this forward-looking indicator doesn't show significant inflationary pressures.

What causes inflation?

The same question can be asked in a slightly different way – what causes the prices of the goods and services to move up? Since inflation is related to both goods and services, as well as money that these services are exchanged against, we can look separately at these two aspects from a supply and demand perspective.

When there are fewer goods available, and there are no substitutes for these goods, then we can expect the average consumer to be willing to pay the same amount of money for a smaller quantity of the same good, meaning that the price for a single unit of that good has increased. This leads us to supply-driven inflation. The supply-driven inflation is linked to the production of goods and the supply chains of these goods. In addition to that, in an importing economy, the cost of imported goods is linked to the strength of the local currency, i.e. when the local currency is strong, one can buy more units of foreign goods and services compared to when the local currency is weak. In the past decades there have been a couple of factors that actually increased the amount of goods on the market, and the supply of these goods became far easier than could have been forecast. These factors include: (1) the globalization effect with the main beneficiary of increased production being China, (2) price discovery facilitated by e-commerce, and (3) automation. All these factors have brought deflationary pressures until now.

LGPS CENTRAL LIMITED TACTICAL ASSET ALLOCATION: ISSUE 12

On the other hand, when the quantity of goods has remained the same, but there is more money in the pockets of the consumer, then the consumer may be willing to spend some of this extra money on more goods and services and/or be willing to go for higher quality, and higher cost goods and services and thus create demand driven inflation. How can consumers have more money to spend in their pockets? Well, there are a number ways: (1) through higher wages, (2) through borrowing, (3) through shifting money from savings into spending, and most recently (4) through the latest form of monetary policy – by Central Banks using quantitative easing ('QE')/debt monetization and thus supporting the fiscal programs of governments, which are designed to encourage economic growth. In the following part, we will try to identify which of these will play the most important role into our outlook.

Outlook

While there are four possible scenarios moving forward: (1) higher inflation, (2) no inflation, (3) disinflation and (4) deflation, we will focus on the first three. While deflation cannot be ruled out, there are very few analysts that currently consider it to be a likely scenario and we agree because the supply and demand indicators as well as the policy actions point to anything but deflation. We will examine what pricing forces are currently present and if these forces create inflationary or deflationary pressures.

The case of higher inflation can be supported with different arguments. If we start with the supply side of the inflation, we can argue that the dominance of China will be different in the future and will create cost pressures. While China currently dominates production of certain supplies, the future may well look different, with diversification away from China due to deglobalisation dynamics and a more geographically spread portfolio of suppliers, including countries with higher unit costs of production. One can easily see how this move away from China could be inflationary. The inflationary effect could be both on the supply side and the demand side given that the costs of the goods produced will be higher to reflect on higher production costs, and the cost of labour will have the potential to push up wage inflation in those countries where the manufacturing will be moved to. It should also be noted that China is rebalancing its economy away from being a producer of cheap exports and more towards a consumer-based economy, so the historical deflationary impact of Chinese production may well have been reducing anyway.

We could also argue that from the demand side (through the big increase in government borrowing and fiscal spending), and the policy actions (through a big increase in money and credit, and the monetary debasement) one can see inflationary pressures. The main question that remains to be answered, is how the newly printed money can enter into the pocket of the consumer, i.e. how the transmission mechanism would work. Obviously, the consumers whose wealth is concentrated into financial assets, and to a certain extent into property, are indeed getting more money into their pockets (in the case of property through re-mortgaging), and their spending can create certain inflationary pressures. But many people have their human capital (i.e. their knowledge and skills) as the main and only source of wealth; and for these people to have more money in their pocket, there needs to be a higher price paid for their human capital through higher wages. It is also true that fiscal programs, through initiatives like furlough schemes, indeed put money into the pockets of the consumer, however these furlough funds total less than the consumer used to earn prior to the introduction of such schemes.

The case of no, or continuing low, inflation moving forward, also has its arguments. If we start again from the supply side, we are witnessing more than ever the ability of the consumer to perform price discovery on a global scale through the use of mobile phones and using one of the e-commerce applications. This factor has increased substantially over the last decade and with the Covid-19 pandemic situation in 2020 has gained even further momentum – there is anecdotal evidence that many people who would not naturally have switched to on-line purchasing were forced to do so during lockdowns. This price discovery is deflationary as the goods to be sold first will generally be the ones with the lowest price tags.

The other main driver behind lack of inflationary pressures is the process of automation. Many jobs that require the execution of tasks that follow an algorithm are easily replaced by machines following that algorithm. This has a double effect – it increases the quantity of goods produced, and it also increases unemployment, thus resulting in a deflationary impact.

It is harder to see the inflationary pressures through higher wages in the UK. First, unemployment has risen following the impact of COVID-19 and it is hard to see higher wages coupled with high unemployment. Government policy in respect of the minimum wage may help the very low-paid to have more spending power, but the nature of the additional goods and services that they will 'consume' is unlikely to have a meaningful impact on inflation. Secondly, given that UK wages are already relatively high, making these higher will result in making local production less competitively priced. While the impact of COVID-19 onto supply chains has brought many comments about the need to diversify supply chains – notably away from China, given it was the first major supply line to be affected – it remains to be seen whether there will be any meaningful 'localisation' of production or whether supply simply moves to low cost Eastern European countries or other low-cost Asian alternatives to China.

Borrowing is another medium that inflation can filter through. Given that there is evidence that some banks are tightening credit

LGPS CENTRAL LIMITED TACTICAL ASSET ALLOCATION: ISSUE 12

conditions, the UK household debt to GDP ratio is close to 90%, the unemployment rate is high, and also that banks refuse to provide credit to people who have been on furlough schemes, it is difficult to see inflation coming through household borrowing, at least in the near future.

Another potential source of funding is via savings. The unleashing of a wave of existing savings does not seem particularly likely in the UK, given the historically low savings rate which is tied into the mentality of a large part of the population which has favoured spending over savings. However, the lockdown periods have helped some people to increase their savings more than they managed previously, given the fact that many are able (or forced) to work from home and thus save on transportation. Further, "Restaurants and hotels" as well as "Recreation and culture" items have become a source of savings as people were in 'lockdown' and unable to spend on these. Thus, while we see little evidence that using savings in the UK can lead to inflation, we acknowledge that savings levels have increased and have the potential to create inflation. However, whether these people decide to spend their savings, or actually increase them, given the inherent economic uncertainty that remains, is questionable.

Where to invest depending on inflation expectations

Successful COVID-19 vaccine programs may see a fairly speedy return to 'normality'. The unknown path of recovery from a major global pandemic makes the judgement of what will happen to inflation very difficult to assess, but most economists suggest that modest and controlled inflation is the most likely outcome in the years ahead. We see no obvious reason to suggest that this is wrong. Early signs of inflation may be seen already as shown in the below table:

Inflationary Indicators			
	last 12 month change	'20	'21
Market Indicators			
Implied inflation LT breakeven	Nominal yields fell further	Blue	Blue
Implied inflation 10y breakeven	US at 2%, UK at 3%	Yellow	Yellow
Short Term Rates	Near zero	Blue	Blue
Gold Price	Went to \$2,000 and fell after that	Red	Red
Supply Indicators			
Commodity Prices	Oil down, industrials & agricultural commodities up	Yellow	Red
Cost Pressures	Covid-19 and trade frictions rising	Red	Red
Overcapacity	Old Industries – redundancies, new Industries – supply shortages	Blue	Yellow
Demand Indicators			
Higher Growth	Recovery after '20 but at low trend	Blue	Blue
Leverage	Big increase in government borrowing	Red	Red
New Sources of Demand	Big increase in fiscal spending	Red	Red
Policy Action			
Liquidity Creation	Big increase in money & credit	Yellow	Red
Monetary Debasement	Inevitable in the West	Red	Red
where	Blue Deflationary pressure	Yellow neutral	Red Inflationary pressure

(Source: Linchpin)

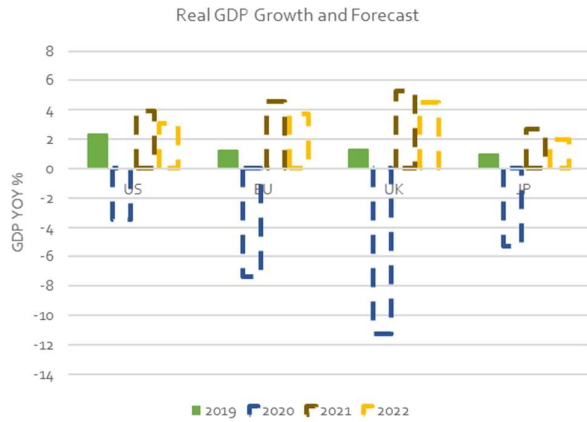
If we consider the two main outcomes from the current level of inflation, i.e. rising inflation or falling inflation, then we can categorize the asset classes accordingly and position the portfolio to benefit from either of the two outcomes, as shown below:

Asset Class	Rising Inflation	Falling or Lack of Inflation
Fixed Income	Inflation-Linked Bonds	Government Bonds and Inv. Grade Bonds
Currencies	Reduce Cash, Increase Gold	
Commodities	Energy	Soft Commodities
Equities (Sectors)	Energy, Materials, Property	Utilities, Telecom Services and IT
Alternatives	Property, Infrastructure, Land, Real Assets	

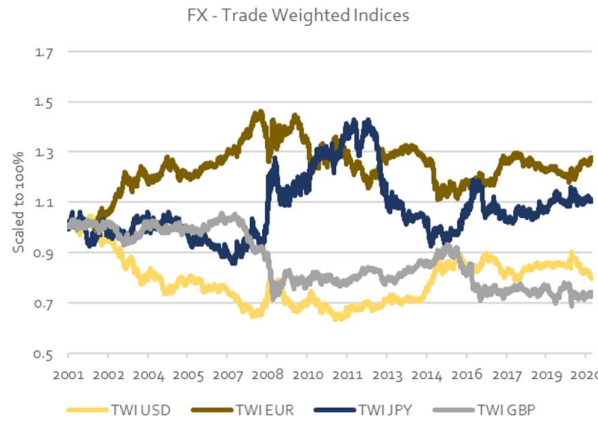
While 2021 will bring more than USD 3 trillion of newly printed money into the global financial system, it will remain to be seen whether this will create inflation or if the world will look more like Japan. There have been comments from several central bank leaders suggesting that they will tolerate higher-than-target inflation for a time and will not use their policy levers to counter such pressures if there is perceived to be any risk to economic growth. Central bank encouragement of inflation to reduce the real value of the high debt burden cannot be ruled out, but not to the extent that inflation gets out of control. Some believe that if the inflation 'genie' gets out of the bottle, it will be very difficult to get it back in and this is also plausible.

While we currently tend to agree with the market consensus that inflationary pressures are not significant at present, we acknowledge that due to "basis effects" from 2020, caused by depressed prices a year ago, the year-on-year change in CPI numbers from March 2021 onwards will move up significantly. This distortion-led inflation is not what we consider to be true inflation. For true inflation we will monitor all the indicators closely as 2021 progresses.

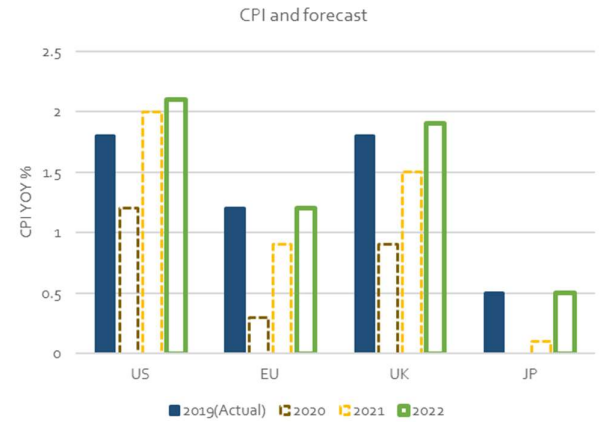
APPENDIX 1: ECONOMIC OUTLOOK



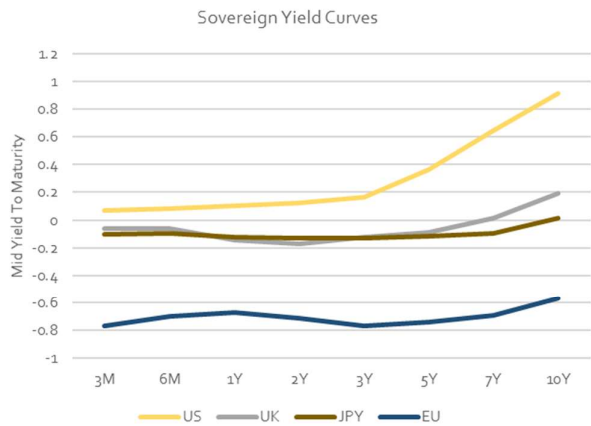
The current crisis impacted 2020 GDP growth negatively.



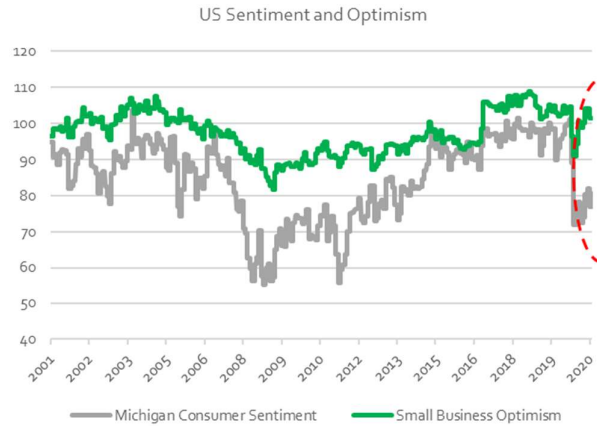
Trade weighted indices stayed at depressed levels.



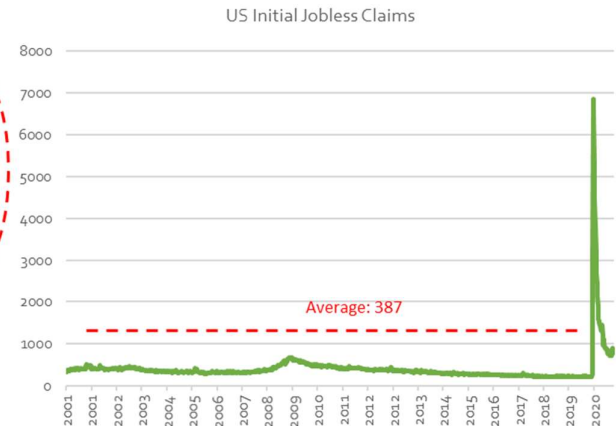
Deflationary pressures seem to have found a bottom in 2020.



Yield curves positively sloping reflecting the money printed impact on the long term.



Consumer confidence and small business optimism trying to recover.



Initial jobless claims continued to normalize.

Source: Bloomberg, OECD, data as of 31/12/2020

Please read important information at the end of the report

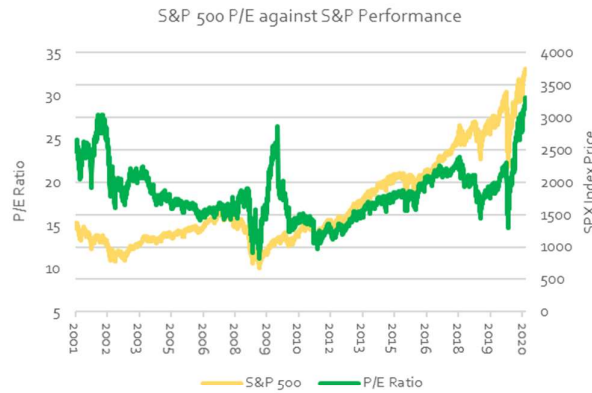
For professional clients only

LGPS CENTRAL LIMITED TACTICAL ASSET ALLOCATION: ISSUE 12

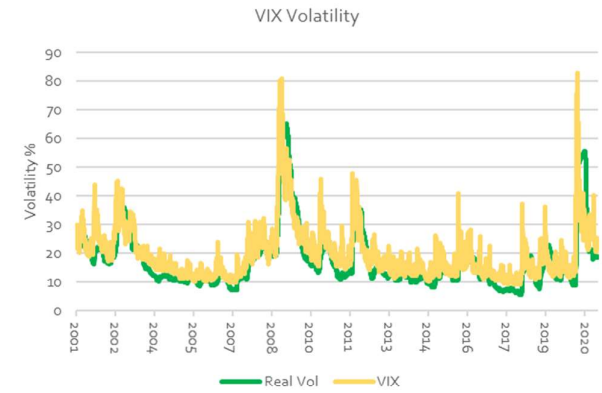
APPENDIX 2: MARKET OUTLOOK



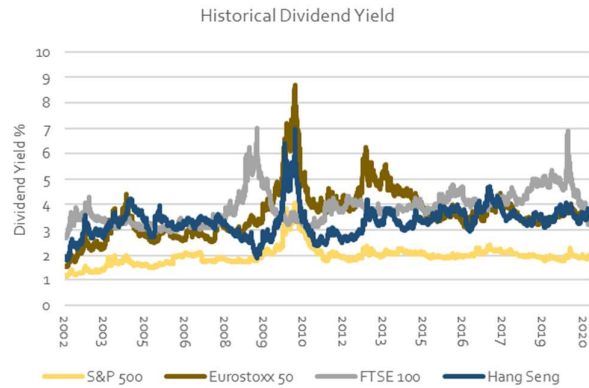
Markets have recovered as if there were no virus, given the support of governments and central banks.



P/E ratios reached new heights.



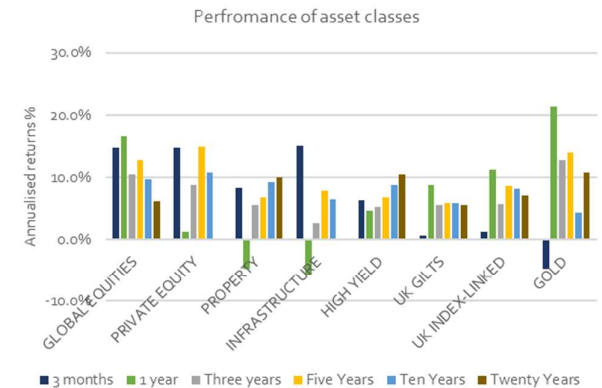
...VIX(fear) dropped...



Dividend yields dropped as share prices rose.



Corporate bond spreads declined, following the FED purchase programme.



During Q4, infrastructure together with public and private equity performed best.

Source: Bloomberg, OECD, data as of 31/12/2020

Please read important information at the end of the report

For professional clients only

LGPS CENTRAL LIMITED TACTICAL ASSET ALLOCATION: ISSUE 12

APPENDIX 3: INVESTMENT IDEAS – MEET THE TEAM



Gordon Ross
CIO
Gordon.Ross@lgpscentral.co.uk
Phone: 01902 916 167



Callum Campbell
Head of Client Services &
Stakeholder Relations
Callum.Campbell@lgpscentral.co.uk
Phone: 01902 916 204



Mark Davies
ID Active Equities
mark.davies@lgpscentral.co.uk
Phone: 01902 916 195



Mike Hardwick
ID Property &
Infrastructure
Mike.Hardwick@lgpscentral.co.uk
Phone: 01902 552 089



Valborg Lie
Stewardship Manager
Valborg.Lie@lgpscentral.co.uk
Phone: 01902 916345



Colin Pratt
ID Manager of
Managers
Colin.Pratt@lgpscentral.co.uk
Phone: 01902 916 209



David Evans
ID Passive Equities
David.Evans@lgpscentral.co.uk
Phone: 01902 916 199



Jaswant Sidhu
SPM Private Equities
Jaswant.Sidhu@lgpscentral.co.uk
Phone: 01902 916 185



Vania Clayton
SPM
(Equity, FI, Derivatives)
Vania.clayton@lgpscentral.co.uk
Phone: 01902 916 206



Stan Grozev
PM
Stan.Grozev@lgpscentral.co.uk
Phone: 01902 916 169

Please contact Callum Campbell, Head of Client Services and Stakeholder Relations, if you would like to discuss the views outlined in this report with LGPS Central's Investment Directors

1 Selective Overweight Private Equity (J. Sidhu)

- Q4 activity is expected to be robust despite the on-going, and worsening, global pandemic
- Strong demand and pricing prevails for quality assets
- The UK's trade agreement with the European Union is expected to see greater UK deal activity
- Valuations are likely to remain volatile in line with public markets and remain attractive to public equities
- Debt financing for portfolio companies has been abundant, this may now subside
- Some LP inertia towards new fund commitments given uncertainty and slower pace of distributions
- GP's are targeting new fund raising towards 'knowledgeable' LPs

2 Underweight property (M. Hardwick)

- Despite material Uncertainty Clauses having been lifted across various property sub-sectors, there is a chance they will be re-imposed following lockdowns
- Valuations down but on the whole resilient, although this may be challenged going forward
- Expect transactional volumes to remain depressed
- Demise in traditional Retail continues, with Logistics prime benefactor
- General economic fallout from the new strain of COVID yet to play out in occupational demand creating further uncertainty

3 Overweight Infrastructure (M. Hardwick)

- Institutional investor interest high, underpinning valuations and providing limited scope for bargain hunting
- Transactional volumes down
- Some evidence of more resilient sectors increasing in valuation
- Political desire for more infrastructure still high
- New lockdown measures weigh heavily on the transportation sector, deferring longer term recovery

Please read important information at the end of the report

For professional clients only

LGPS CENTRAL LIMITED TACTICAL ASSET ALLOCATION: ISSUE 12

4 Underweight Fixed Income (G. Ross)

- Historically low Gilt yields remain unattractive with the prospect of increased issuance to fund fiscal stimulation may push yields higher
- Intermediate peripheral EU bonds (Italy, Spain, Portugal) offer attractive hedged yield pickup in GBP terms
- Global interest rates likely to remain low over the next several years with little immediate sign of inflationary pressures.
- Credit markets offer excellent value given the recent increase in yields and spreads and with the underlying support of the Central Bank purchases
- Post Brexit Sterling has remained under pressure, although continues to be undervalued on a global basis. Covid-19 and the possibilities of negative interest rates is likely to continue to weigh on the GBP.

5 Neutral Equities (M. Davies)

- We harbour a cautiously optimistic view on equities
- We anticipate a sharp economic recovery in 2021 after the Covid-19 related lockdowns begin to end with the commencement of vaccine programmes.
- However, we expect unemployment to recover unevenly and the economy to remain reliant on fiscal and monetary support
- A selective stance on investment both by region and stock is therefore warranted
- We prefer Emerging Markets to Developed Markets and remain negative on North America
- We favour Value and Quality as opposed to Growth largely on valuation grounds

GLOSSARY:

GEMs	Global Emerging Markets
ESG	Environmental, social and governance
LTM	Last twelve months
IG	Investment Grade
VIX	S&P Implied Volatility Index
IPO	Initial Public Offering
OPEC	Organisation of Petroleum Exporting Countries
FAANG	Facebook, Apple, Amazon, Netflix & Google
UNPRI	Principles for Responsible Investment
YTD	Year to date
PE	Private Equity

This document has been produced by LGPS Central Limited and is intended solely for information purposes. Any opinions, forecasts or estimates herein constitute a judgement, as at the date of this report, that is subject to change without notice. It does not constitute an offer or an invitation by or on behalf of LGPS Central Limited to any person to buy or sell any security. Any reference to past performance is not a guide to the future. The information and analysis contained in this publication have been compiled or arrived at from sources believed to be reliable, but LGPS Central Limited does not make any representation as to their accuracy or completeness and does not accept any liability from loss arising from the use thereof. The opinions and conclusions expressed in this document are solely those of the author. This document may not be produced, either in whole or part, without the written permission of LGPS Central Limited.

All information is prepared as of 31.12.2020, if not stated otherwise.

This document is intended for PROFESSIONAL CLIENTS only.

*LGPS Central Limited is authorised and regulated by the Financial Conduct Authority.
Registered in England Registered No: 10425159.
Registered Office: Mander House, Mander Centre, Wolverhampton, WV1 3NB*

This page is intentionally left blank