LGPS CENTRAL LIMITED TACTICAL ASSET ALLOCATION

ISSUE 13 • March 2021

LGPS Central Limited

FOR PROFESSIONAL CLIENTS ONLY

CIO SUMMARY

Introduction

Welcome to the thirteenth edition of our LGPS Central Limited ("LGPSC") Tactical Asset Allocation ("TAA") Report. We hope that you, your family and friends have had a nice Easter and are looking forward to the sunny Spring and Summer to come.

Summary of Strategy Thoughts

Since the publication of the previous edition of this report, the vaccination rollout has advanced which has helped with the reopening of the economy. The speed of economic recovery will likely depend on the speed of the vaccination rollouts and also on the effectiveness of vaccination programs against the new variants. The economic data may reflect a recovery starting from the end of March due to the base effect, and we may explain this recovery as a distortion-led one. In case the economies re-open and their positive effects coincide with the depressed levels from last year, then this may lead to a spike in reported growth numbers.

We continue to see the recovery as following the path of a radical sign (that is, 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 whether new variants of the virus will be resistant to the vaccine. Given that the recovery is so much dependent on the vaccination rollout, we see the global recovery happening at different speeds across the globe with the UK, US and China leading it and the rest of the developed world closely behind, followed by emerging markets (ex China).

Our view on tactical positioning maintains growth assets at **neutral** given their stretched valuations. We remain **underweight** on stabilising assets and **overweight** on income assets.

In terms of factors, the model continues to be **overweight** on **value**. On currencies, we continue to remain positive on Sterling (and Yen). Sterling continues to be oversold and we believe that most of the bad news (domestic deficits, low level of rates and continued uncertainty as to the long-term effect of Brexit) are now discounted in the current level. The success of the UK vaccine programme and gradual 'unlocking' of the domestic economy should bode well for future growth and support Sterling's valuation. We continue to believe in the US Dollar's prolonged period of weakness, exacerbated by the twin domestic deficits made worse by further fiscal measures. The Euro continues to suffer from the pandemic effects as much of Europe has had further restrictions imposed as their vaccine roll-out has been slower than expected. The Yen will continue to benefit from any periods of 'risk off' sentiment and we continue to expect its relative appreciation.

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 ▲	Private Equity Asia Pac Equities ▼	Commodities GEM Equities Japan Equities UK Equities ▲ EU Equities ▲	
INCOME ASSETS			Property ▲	HY Credit ▲	EM Debt Infrastructure
STABILISING ASSETS	EU Bonds	UK Bonds JP Bonds Index-Linked ▼ US Bonds ▼ IG Bonds ▼ Gold ▼			
INVESTMENT STYLES		Growth Quality/ESG ▼	Momentum ▲ Low Volatility ▼ Size ▼	Value	
CURRENCIES		US Dollar	Euro	GBP, Yen	

LGPSC's view on "Weightings":

- Income Assets are maintained at overweight, due to Infrastructure, EM Debt; we are upgrading HY Credit and Property to overweight and neutral respectively.
- Growth Assets kept at neutral. We would rather be overweight on growth assets, but the high valuations prevent us from adopting that view.
- Stabilising Assets maintained at underweight, mainly due to their high valuations.

BROAD ASSET CLASSES

Table 2: Growth/Income/Stabilising Assets

	Model Score[1]	View	Investment Notes
GROWTH	0	Neutral	No change from last time.
INCOME	2 ▲	Overweight	Further increase of the exposure from last time.
STABILISING	-2 ▼	Underweight	Further decrease of the exposure 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	4.82	55.38	12.58	13.80	9.74	7.19	FTAW01 Index
PRIVATE EQUITY	10.58	57.95	15.43	16.26	11.64	#N/A N/A	IPRV LN Index
PROPERTY	8.27	34.37	10.88	7.25	9.38	10.45	REIT INDEX
INFRASTRUCTURE	3.00	37.00	5.65	6.72	6.28	#N/A N/A	SPGTIND Index
HIGH YIELD	1.57	22.89	5.82	6.87	8.21	10.15	HL00 Index
UK GILTS	-7.47	-5.72	2.73	3.09	5.05	5.12	G0L0 Index
UK INDEX-LINKED	-6.36	2.46	3.41	5.99	7.37	6.83	G0LI Index
GOLD	-10.83	-5.19	9.43	7.78	3.32	10.08	XAUGBP Curncy

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	1.000	0.803	0.746	0.865	0.703	-0.104	0.081	-0.108
PRIVATE EQUITY		1.000	0.716	0.793	0.641	-0.011	0.183	0.089
PROPERTY			1.000	0.830	0.622	0.155	0.293	0.023
INFRASTRUCTURE				1.000	0.738	0.079	0.230	0.007
HIGH YIELD					1.000	0.036	0.180	-0.112
UK GILTS						1.000	0.794	0.499
UK INDEX-LINKED							1.000	0.426
GOLD								1.000

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. Conversely, the Stabilising Asset class returns well below the long-term averages. The Income Asset class generally performed above its long-term 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

Table 5: Growth Assets

	Model Score[1]	View	Investment Notes
UK Equities	1 ▲	Overweight	Moved to overweight based on improved market risk
NORTH AMERICA Equities	-6 ▲	Underweight	Kept at underweight
EUROPE Equities	1 ▲	Overweight	Increased to overweight from neutral
JAPAN Equities	3	Overweight	No change from last time
ASIA PAC Equities	0 ▼	Neutral	Downgraded to neutral due to lower sentiment and currency
GEMs Equities	1	Overweight	No change from last time
PRIVATE EQUITY	0	Neutral	No change from last time
COMMODITIES	2 ▲	Overweight	Kept at overweight with an improved market risk score

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.
- Markets have recovered from their Q1 2020 lows helped by the increased monetary stimulus, and given that the monetary and fiscal stimulus will continue in the Q2 21, and the pandemic risk is expected to diminish over time, 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
HY CREDIT	2 ▲	Overweight	Increased to overweight from neutral due to improved market risk score
EMERGING MARKET DEBT	2	Overweight	No change from last time
PROPERTY	0 ▲	Neutral	Increased to neutral from underweight due to improved valuation, sentiment & economics scores
INFRASTRUCTURE	3	Overweight	No change from last time

LGPSC's view on Income Assets:

- We prefer Infrastructure, HY Credit and Emerging Market Debt.

STABILISING ASSET VIEW

Table 7: Stabilising Assets

	Model Score[1]	View	Investment Notes
UK BONDS	-2 ▼	Underweight	Kept at underweight with deteriorating market risk score.
INDEX-LINKED	-2 ▼	Underweight	Downgraded to underweight due to negative sentiment score.
US BONDS	-3 ▼	Underweight	Downgraded to underweight due to deteriorating sentiment and market risk scores.
JP BONDS	-3	Underweight	No change from last time.
EU BONDS	-2 ▲	Underweight	Kept at underweight until the market risk score improves.
IG CORPORATE BONDS	0 ▼	Neutral	Downgraded to neutral due to deteriorating market risk score.
GOLD	-2 ▼	Underweight	Downgraded to underweight due to deteriorating market risk score.

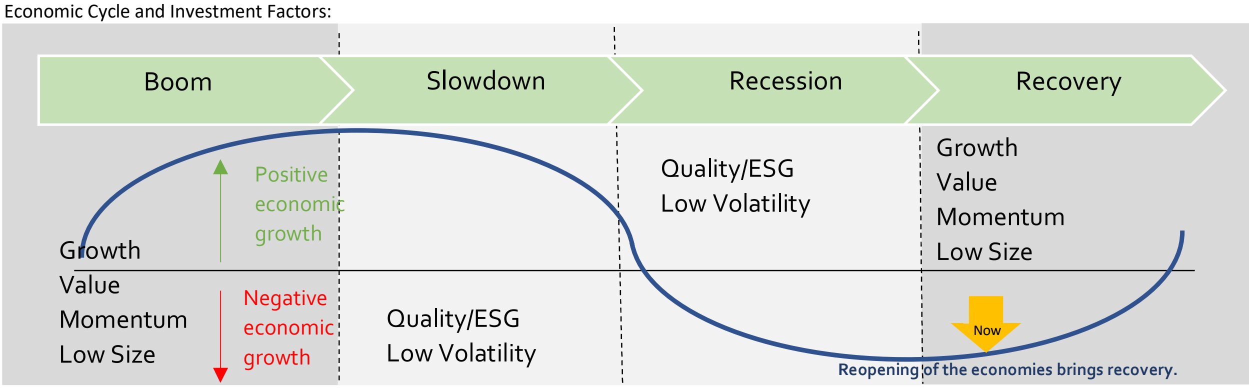
LGPSC's view on Stabilising Assets:

- Regionally, on government bonds, we are underweight across all regions.
- We are neutral on IG corporate bonds.
- 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:



FACTOR ASSET VIEW

Table 8: Investment Factors

	Model Score[1]	View	Investment Notes
Value	2 ▲	Overweight	Kept at overweight while economics score improve.
Growth	-1 ▲	Underweight	Kept at underweight while sentiment and market risk scores improve.
Size	0 ▲	Neutral	Neutral with an improved economics score.
Momentum	0 ▲	Neutral	Increased to neutral with improved sentiment and economics scores.
Low Volatility	0 ▼	Neutral	Downgraded to neutral due to lower sentiment and market risk scores.
Quality/ESG	-2 ▼	Underweight	Downgraded to underweight due to lower economics and market risk scores.

LGPSC's view on Investment Factors:

- Our favourite factor for this quarter is Value.

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 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 on the investment cost.

Q1 LGPS CENTRAL LIMITED MARKET UPDATE[2]

The first quarter of 2021 has been eventful, with volatility returning to global markets. That said, the macroeconomic picture has continued to improve, as a number of major economies have seen improving economic indicators after successful Covid-19 vaccine roll outs.

Throughout the quarter, equity markets experienced significant volatility; however, the majority of major indices finished the quarter in positive territory as many major economies have shaken off fears of further prolonged Covid-19 restrictions as the vaccine roll out continues. The MSCI World Index returned 4.52% and the S&P500 continued its strong performance, returning 5.77% on the quarter. The continued performance of US equity markets has been helped by the continued unprecedented government and central bank support. The quarter saw the Biden administration approve a $1.9tn stimulus package, as well as outlining an historic $2tn Infrastructure plan. Similar performance has been seen across other major markets with the Hang Seng and the Nikkei 225 returning 4.21% and 6.32% respectively. European markets have performed well, as investor sentiment improved following the Brexit trade deal and the vaccine roll out; the Euro Stoxx 50 and the FTSE 100 returned 10.32% and 3.92% respectively.

Bond yields across major markets rose substantially during the first quarter of 2021, particularly in the US where the yield curve has steepened dramatically. The US Treasury 10-year yield reached its highest level since January 2020 on the news that the Chairman of the Federal Reserve, Jerome Powell, expected inflation to rise in 2021 and that the Fed would be happy for the economy to run hotter if it helped achieve full employment.

The Conference Board *Consumer Confidence Index* in the US surged in March to its highest level since the onset of the pandemic. Consumers' assessment of current economic conditions and their short-term outlook improved significantly. Improved optimism boosted consumer purchasing intentions for big-ticket items such as homes and automobiles. However, concerns of inflation in the short-term rose, most likely due to rising prices in commodity markets, which may temper spending intentions in the months ahead.

Sterling has continued to perform strongly against other major currencies, with GBP/USD finishing the quarter at 1.38. As expected, the immediate effect of the UK leaving the EU saw the overall value of UK trade with the EU fall dramatically. Exports fell 40% between December 2020 and January 2021 and imports from the EU fell 29%. Although there has been a slight increase in exports to non-EU countries, the overall value of exports fell between December and January. The UK Government has reaffirmed its ambitious plans to realign policy to focus on developing relations with the US and Asian economies, although major trade agreements are yet to be signed.

Oil prices continued to rise throughout the quarter, finishing 22.66% up at over $63 a barrel. Other industrial commodities have seen similar strong performance as market sentiment has continued to improve, with the success of vaccine programs and stimulus packages in key economies. Although industrial commodities have continued the strong performance, seen in the latter half of 2020, traditional 'safe haven' assets such as gold have not, falling 10% since January, again reaffirming the view that investor expectations are for a swift economic recovery.

[2] Performance for the quarter measured over period of 31/12/2020 to 31/03/2021

Q1 2021 LGPS CENTRAL LIMITED RESPONSIBLE INVESTING UDPATE

The UN Framework Convention on Climate Change (UNFCCC) issued a report in February 2021 analysing the updated climate action plans submitted by 75 nations ahead of COP26. This analysis found that current policies won't come close to meeting the goals of the Paris agreement. According to the UN Intergovernmental Panel on Climate Change, the population must reduce its 2030 CO_2 emissions by approximately 45% from 2010 levels and reach net zero by 2050. The report showed that the revised climate action plans, which cover 40% of countries party to the 2015 Paris Agreement and account for 30% of global emissions, would only deliver a combined emissions reduction of 0.5% from 2010 levels by 2030. This highlights the need for heavy emitting countries to ramp up their efforts to decarbonise.

Toyota plans to roll out its advanced solid-state battery prototype in 2021. The cells use a solid electrolyte rather than a liquid one, as found in most conventional lithium-ion batteries. They further contain a lithium metal anode rather than a graphite one, which allows the battery to store more energy. Toyota has been working on this technology for more than a decade and claims that one charge can power a trip of 500km, about twice the distance of a typical electric car today. Solid state batteries would be able to fully charge in 10 minutes and are smaller than lithium batteries. However, it is not until the middle of this decade that cars are expected to go into mass production.

GM announced its plan to stop selling Diesel and Petrol cars by 2035 and will only sell electric vehicles beyond this date. This ties in with the net zero target the company has set itself for 2040.

A Solactive Index tracking shares in Uranium miners rallied 35% in 2021 on a total return basis, reaching its highest level in more than six years. Nuclear Energy provides a low-carbon source of power that is not intermittent, unlike wind and solar. China has pledged to increase nuclear power generation from 51 to 70 gigawatts by 2025. Joe Biden's US administration has said that nuclear will be included in its "clean energy standard" that would mandate utilities to produce power that is carbon-free by 2035. The EU is expected to decide in the second half of 2021 whether nuclear energy is categorised as green energy in their Green Taxonomy.

The UK Government launched its build back better plan which sets out pathways for sustainable growth post COVID-19 and includes investment in climate friendly infrastructure, skills and innovation and enables the transition to a lower carbon economy. The plan includes the government's 10-point agenda for a Green Industrial Revolution. The government intends to support investment through the new UK Infrastructure Bank to encourage investment in the net zero transition and to boost innovation through a new £375 million Future Fund. Key elements of the 10-point plan include advancing off-shore wind, driving growth of low carbon hydrogen, investing in carbon capture and storage, delivering new & advanced nuclear power and accelerating the shift to net zero transport solutions in road, sea and air transport.

Climate Action 100+ (CA100+) released its Net Zero Company Benchmark which assesses the world's largest corporate greenhouse gas emitters on their progress in the transition to a net zero future. This will prove to be a valuable resource for investors attempting to assess and engage with corporations on their progress. However, results show that only a quarter of these companies have included scope 3 emissions in their net commitments. There is also a need for companies to set shorter term targets consistent with their longer-term ambitions. Companies need to embrace 1.5-degree scenarios in their scenario analysis and commit to aligning their future capital expenditure with their long-term emissions reduction targets. Whilst much has been achieved, there remains a lot to do.

"Say on Climate" gathered momentum in Q1 2021 with 15 companies including Rio Tinto, Glencore, Unilever, Shell, LafargeHolcim, Total and Nestlé voluntarily adopting some form of shareholder vote on their climate plans.

RISK ANALYSIS

Table 9: Risk in order of probability

RISK	LGPSCL Possibility	LGPSCL Impact	Change on quarter	Comment	LGPSC favoured assets to protect against the risk
CORONAVIRUS	Medium	Medium		While some countries are more advanced in the vaccination process, others are lagging behind and experiencing a third wave. Still, we feel comfortable in reducing the risk given the discovery and availability of new vaccines	Clients without equity protection should consider establishing protection. Selectively investments and a diversified portfolio.
EQUITY DOWNTURN	Medium	Medium		The probability of equity downturn has decreased as we see a solution to the coronavirus, with fiscal and monetary stimulus on the table.	Renewing equity protection should be considered.
NATURE OF RECOVERY	Medium	Medium		The recovery in different parts of the world depends on the progress of the vaccination. In some countries with more advanced vaccination programs it may look more like a V-shaped recovery, while globally it may resemble 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.	In the recovery phase, factors such as Size and Value are expected to perform best.
POLITICAL RISKS	Medium	Medium		Vaccination shortages have increased political risks within continental Europe. Some European countries will go through elections later in the year.	Overweight real assets.
ISOLATION & PROTECTION	Medium	Medium		Biden's relationship with China represents more of a continuity rather than a big change. One point will be what relationships China builds with the rest of the world post-Covid-19. The global leadership in technology may well be the focus.	Current tactical asset allocation will be dominated by the Coronavirus.
CREDIT RISK/DEBT ISSUES	High	High		EMD continues to offer opportunities, but concern remains over hard currency borrowings requiring repayment with some regime changes challenging previously agreed restructurings. Credit markets remain well supported by CB liquidity and QE purchases. Search for higher yields has led spreads lower across the credit spectrum despite record levels of issuance.	Selective Credit and IG Corporate Bonds.
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	Medium		The EU Carbon Price remained above €40/tonne during Q1 hitting a new high at €43.56/tonne. Copper, Nickel, Cobalt and Silver - commodities used in electrification and electric batteries rally but Oil & Gas also rallies. In March the European Parliament adopted a resolution backing the introduction of an EU carbon border adjustment mechanism. UK Government releases details of 10-point plan for	Underweight Energy & GEMs, overweight Renewables and Sustainable Investment themes such as Infrastructure.

RISK	LGPSCL Possibility	LGPSCL Impact	Change on quarter	Comment	LGPSC favoured assets to protect against the risk
				Green Industrial Revolution. As well as plans for Mandatory TCFD reporting. EU launches SFDR which mandates detailed sustainability reporting at fund level for asset managers. It has not been adopted by the UK government yet.	
CLIMATE-RELATED PHYSICAL RISK	Medium	Medium	→	Carbon emissions are beginning to rebound following national lockdowns Methane emissions surged in 2020, marking the biggest increase since records began. Amazon deforestation rose 17% in 2020. Forecasts for 2021 Atlantic Hurricane season show hurricanes expected to above 30 year average. One third of the total number wildfires that occurred in Florida in 2020 have occurred already in Q1 2021.	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.	
INFLATION RISK	High	Medium	↑	Short term inflation is expected to increase due to base effect, but we do not believe it has long-term sustainable support to continue rising.	

LGPSC's view on "Scenario Risks":

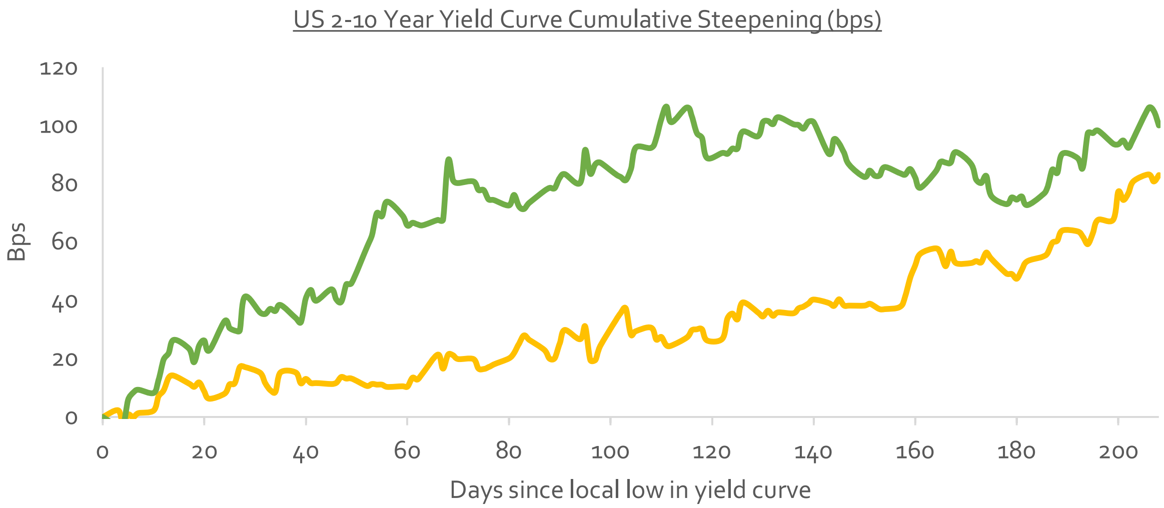
- The deployment of the vaccines is a game changer, though it is still a bit too early to declare victory. The short history and effectiveness of the vaccines, possible side effects and new variants of the virus remain open questions. Still, having a vaccine is the key to reopening the economies.
- We 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: TANTRUM IN A TEACUP

Tantrum in a Teacup

Simon Griffiths, CFA – Investment Risk Manager

The sharp increase in US bond market yields since the start of 2021 has sparked widespread comparisons to the "Taper Tantrum" of 2013, when rates rose sharply following indication from the Federal Reserve Board ("the Fed") that it would begin gradually reducing ("tapering") its quantitative easing program. Whilst there are similarities between these incidents, there are also notable differences in the causes, economic/market consequences and expected policy rate moves from central banks.



To understand the parallels and differences between 2013 and today's taper fears, it helps to understand Quantitative Easing ("QE"). Under QE, central banks create reserves and typically buy large amounts of long-term bonds and assets from banks. This has the effect of reducing long term borrowing costs (due to the inverse relationship between bond pricing and yields) whilst also boosting banks' capital levels.

With the Fed pinning policy rates near zero, QE has the effect of forcing down long rates, flattening the yield curve – in other words, reducing the gap between short and long term borrowing costs. The yield curve is a proxy for banks' lending profitability as they borrow at short rates and lend at long rates, profiting from the difference. A steeper curve therefore can be viewed as a simple measure of increased bank profitability, spurring incentives to extend credit, although without credit demand, banks cannot force loan applications. Conversely, a flatter yield curve constrains banks' willingness to lend as lending margins narrow and risk premiums decrease.

There are strong similarities between the backdrop in 2013 and today. Both incidents occurred over a period where the economy was recovering, inflation was low, short term rates were near zero, unemployment was falling and the Fed was still in QE - longer term yields increased, and curves steepened, though the drivers of these yield increases differ.

Over 2013, the markets misread the Fed's intentions and mistakenly believed that the tapering of bond purchases meant it was making much larger changes to its accommodative stance, leading to a dramatic repricing of short-term interest rates.

The current Fed's policy framework, under Chair Jerome Powell, fundamentally differs from 2013. The Fed is explicitly committed to achieving maximum employment, and has adopted a flexible inflation-tolerant framework, focussed on actual (rather than expected) inflation relative to its long-run target of 2%.

Another key difference between 2013 and today lies in the openness and manner of communication of monetary policy. Bernanke's Fed of 2013 had multiple members opining and making ad hoc comments which often left investors more confused and with more latitude to make assumptions. By contrast, Powell has been clear in his messaging, for example on the March 17th he expressly stated that there would be: no change in the main policy; no change in guidance about future shifts in policy and no real concerns about jumpy government bond markets. He has further stated that QE's end is likely to be years away and that rates would not climb higher until sometime after that.

In the aftermath of the 2013 tantrum, yields fell soon after the Fed reaffirmed its commitment to maintaining QE for longer and did not start rising again until after the actual tapering began in late 2014. Today, in stark contrast, Powell has shown no intention of adjusting the $120 billion monthly bond-buying program or retreating from the Fed's new policy regime.

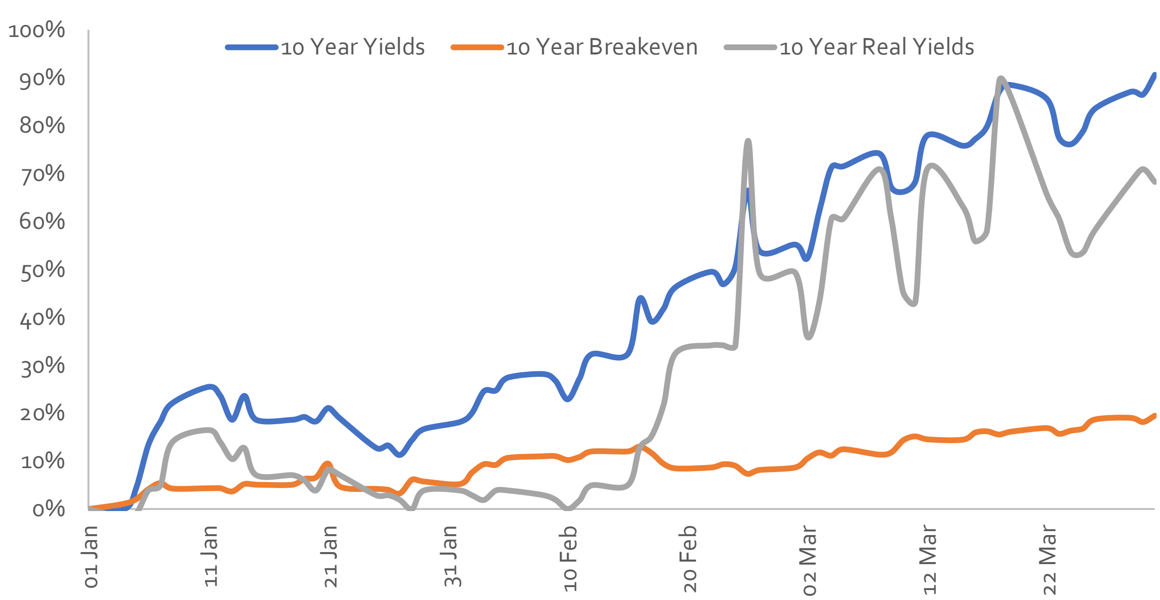
Macroeconomic Backdrop

Core CPI has decreased over the past six months and is currently well below the Fed's target, therefore it is unlikely that either any rate hikes will be forthcoming or that the current QE program will be "tapered". The change in the Fed's inflation target to an average rate of 2% gives more flexibility for it to allow inflation to remain above this target especially if linked to technical factors (base effects), or if future inflation were expected to fall below target.

Another significant contributor to yield curve steepening in early 2021 originates from President Joe Biden's fiscal stimulus response to Covid-19 which, should his infrastructure spending bill pass, would collectively represent over 30% of US GDP, further adding impulse for a substantial economic growth recovery and in turn driving higher inflation expectations.

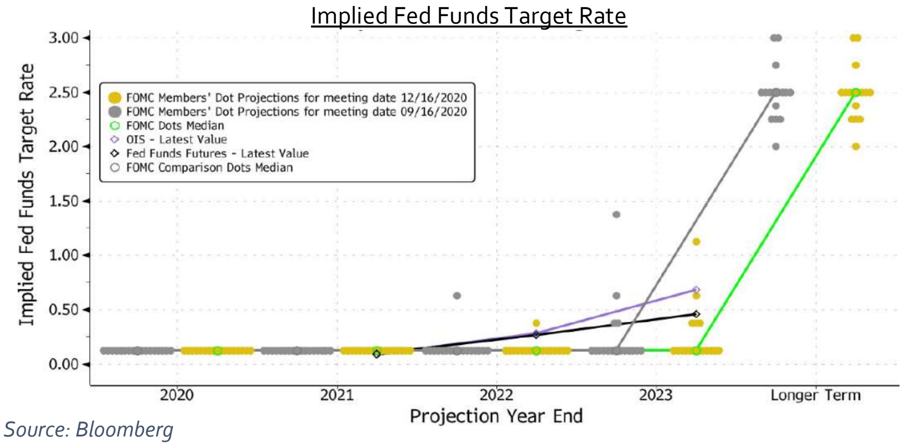
Yield increases year to date, appear to have been driven by "real" (inflation adjusted) interest rates, rather than inflation expectations. This further indicates the market is dubious about the Fed's resolve and is challenging the Fed's communication that they will remain supportive.

Change in US 10 Year Yield Curves (Ytd 2021)



Fed-funds futures rates vs Fed dot-plot projections

While market-implied interest rate expectations are closely aligned with the Fed's median dot-plot projections (representing the independent interest rate forecast for each of the 12 members of the FOMC), markets are now expecting the Fed to start raising rates in the first half of 2023 compared to the first quarter of 2024 as was expected at the start of the year. Markets also expect these rate hikes to be more aggressive and frequent once they start, with three more predicted hikes by the end of 2024. This contrasts with the FOMC timeline, which does not foresee raising rates until at least early 2024.



Source: Bloomberg

Equities

The rapid rise in yields observed year to date are a headwind to riskier assets, particularly when the rise is originating from real yields, as this suggests that risk free assets are becoming more competitive in respect of their future return. This is particularly relevant in the valuation of secular growth stocks, which are more sensitive to moves in interest rates due to their cash flows being expected further out. By way of example, both the Nasdaq 100 and SPACs (Special Purpose Acquisition Companies, which are a quick and convenient way for privately owned companies to obtain a stock market listing) have fallen from all-time highs, at -8% and -14% respectively.

Despite the increase in real yields impacting growth stocks, equity markets overall have remained relatively robust. As a result, after a decade of positive correlation following central bank intervention after the global financial crisis, equity markets have once again turned negatively correlated with bonds. This change in correlation serves to add benefit through diversification.

Summary

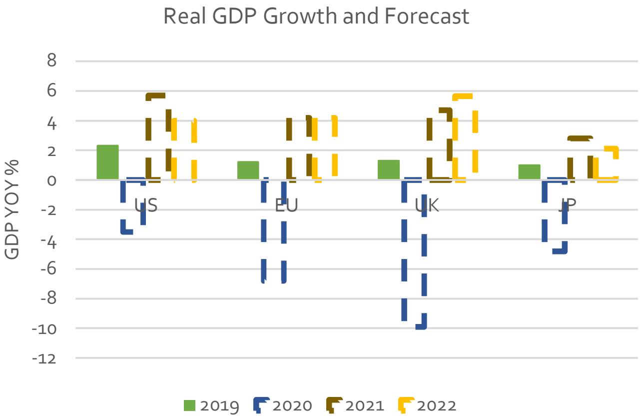
Sharply rising rates driven through real rate increases, flat inflation expectations and rising volatility should be considered as potential headwinds to the economic recovery, but it is unlikely the Fed will act anytime soon to raise official policy rates. In fact, Powell and others have recently communicated they are not concerned with the recent bond yield rise and reinforced that they have no plans to increase policy rates until the economic recovery from Covid-19 is well under way and there is physical evidence of this within the economy.

The recovery in markets since February further suggests the Fed has some leeway before their inflation-tolerant policy is tested, though a pick-up in volatility could spur further action.

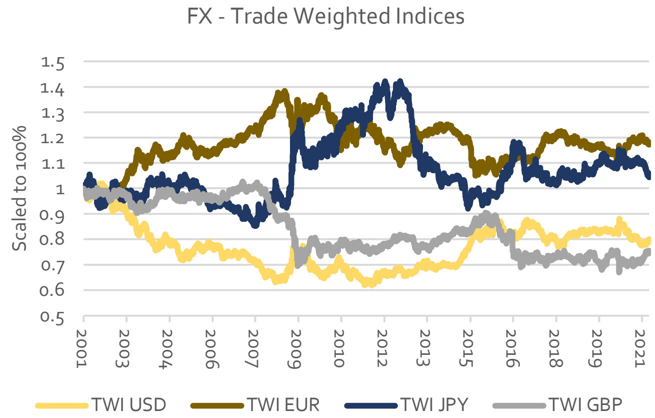
Given that the Fed is targeting a full recovery in employment and seems also to be committed to improving labour force participation, rate hikes in early 2023 would appear to be too aggressive. There are also a series of steps that are taken ahead of any rate action. This typically involves firstly signalling of intention, then actually undertaking tapering. Following the 2013 taper tantrum, this sequence of events took over two years, which on a comparable basis would be H1 2023 at the earliest.

Global markets are likely to remain volatile as investors recalibrate positions to the very different macro environment and Fed policy regime unfolding in 2021 and beyond. It is possible that we will look back in years to come on the recent bond yield rises as a correction from them simply falling to levels which were too low for investors to find them attractive assets to hold.

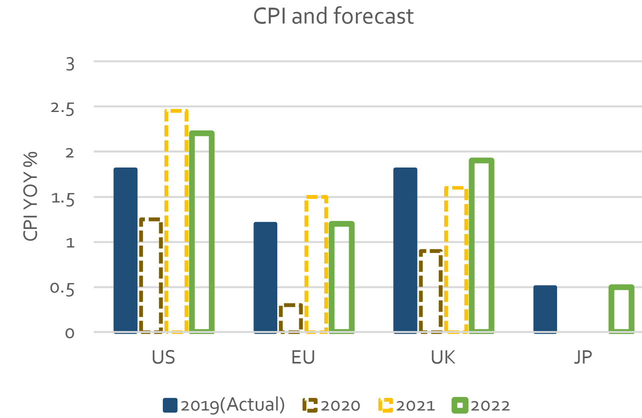
APPENDIX 1: ECONOMIC OUTLOOK



GDP is expected to be positive compared to last year.



Trade weighted indices are still to recover.



Inflationary pressures are forecast to appear in 2021.

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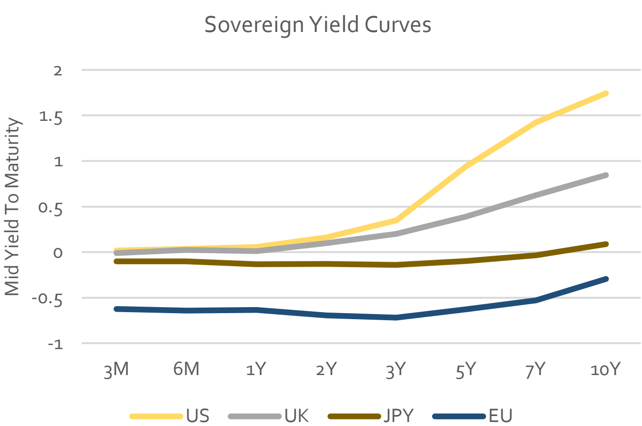
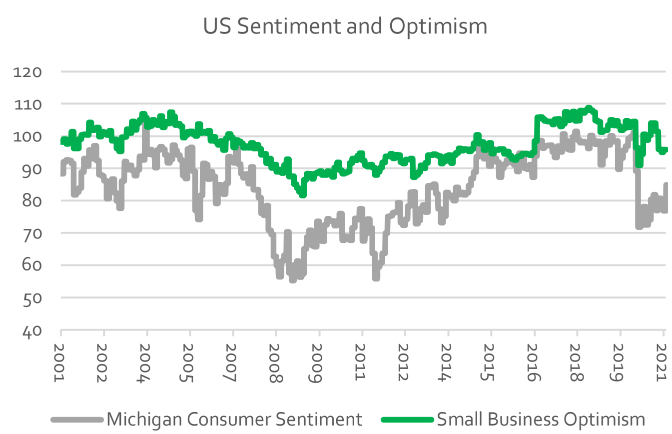
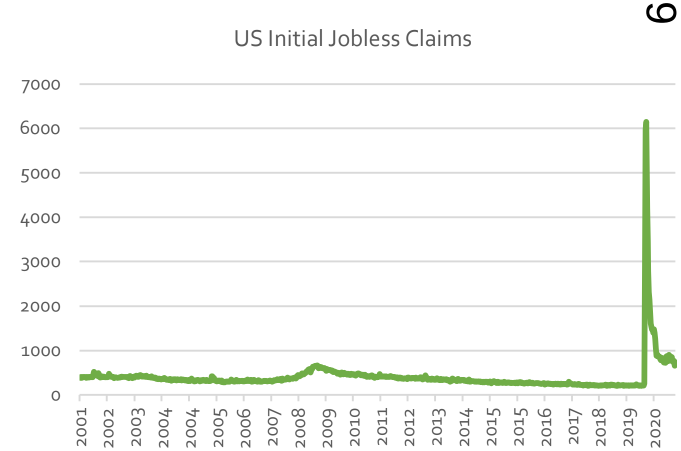


Yield curves positively sloping reflecting inflation expectations.



Consumer confidence and small business optimism trying to recover.



Initial jobless claims normalize with reopening of the economy.

Source: Bloomberg, OECD, data as of 31/03/2021

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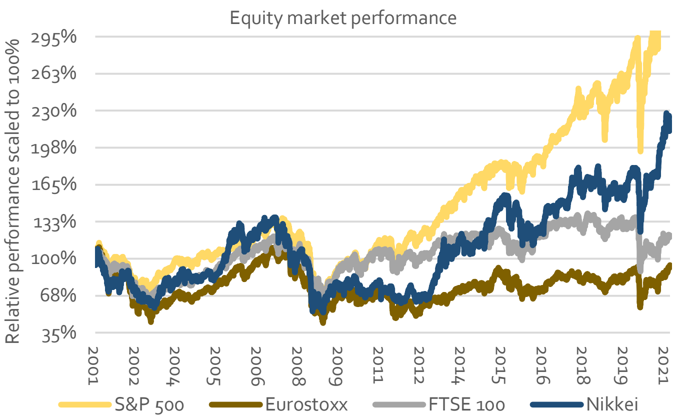
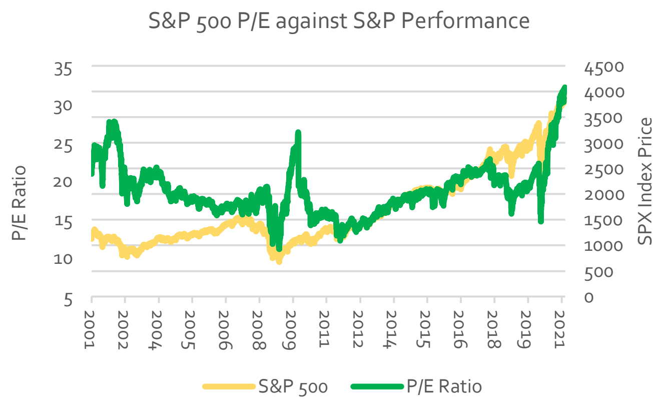
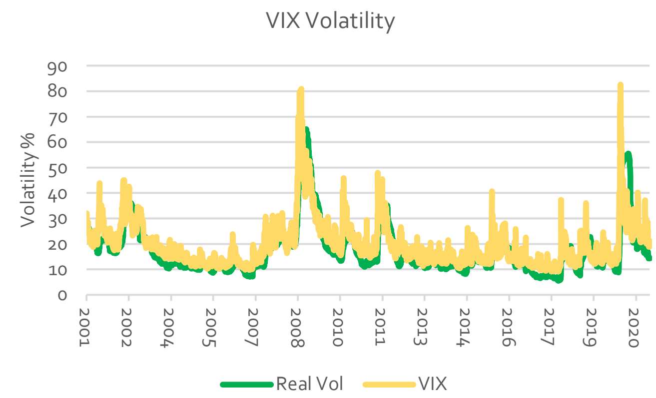
APPENDIX 2: MARKET OUTLOOK



Most of the markets trade at record high levels.



P/E ratios reached new heights.



...VIX(fear) keeps on droping...

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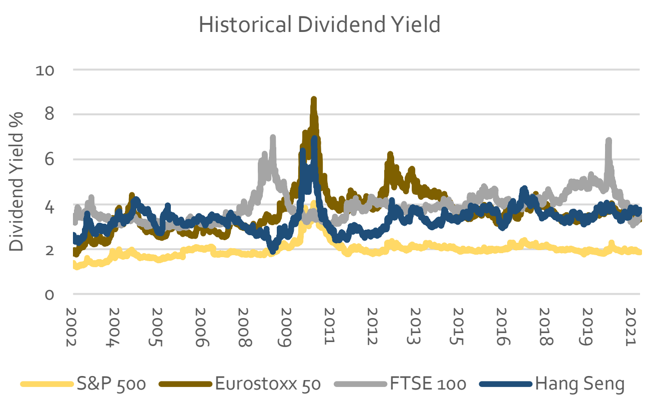
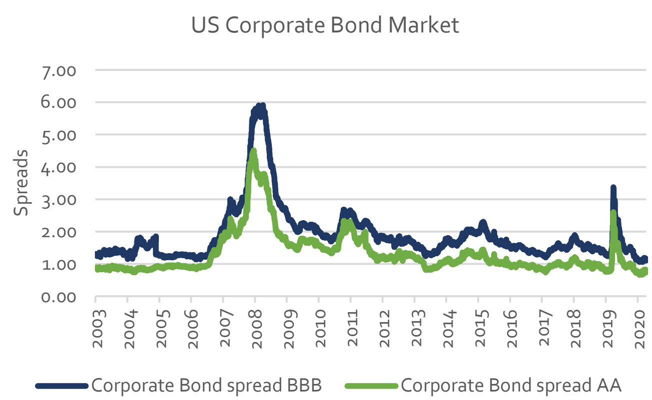
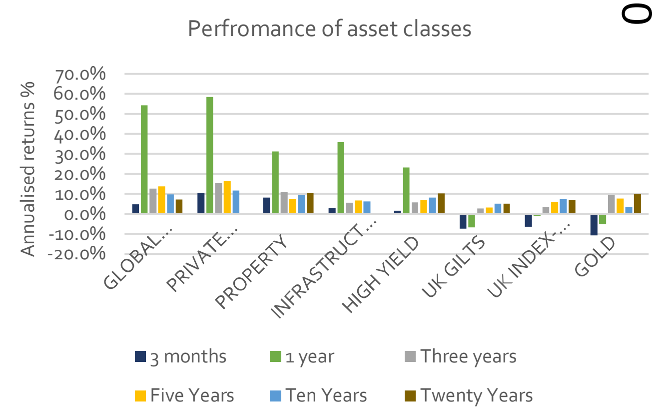


Dividend yields dropped as share prices rose.



Corporate bond spreads declined, following the FED purchase



During Q1, Equities(Public and Private), Infrastructure and Property performed best.

Source: Bloomberg, OECD, data as of 31/03/2021

APPENDIX 3: INVESTMENT IDEAS – MEET THE TEAM

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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

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1 Selective Overweight Private Equity (J. Sidhu)

- Valuation concerns remain
- Strong competition for quality assets
- Pace of distributions remains robust
- Fundraising continues apace

2 Neutral property (M. Hardwick)

- Property remains a story of two halves: industrial and the rest
- Valuations stable, although this may be challenged going forward
- Expect transactional volumes to pick up, but still below long-term average
- Demise in traditional Retail continues, with Logistics prime benefactor
- Office shrouded in uncertainty as new working practices emerge post Covid-19 allowing for flexible working; an excess of second-hand space seems to be emerging

3 Overweight Infrastructure (M. Hardwick)

- Institutional investor interest high, underpinning valuations and providing limited scope for bargain hunting
- Transactional volumes down but expected to pick up, but still below long-term average
- Some evidence of more resilient sectors increasing in valuation; don't expect risk appetite reversing immediately
- Political desire for more infrastructure still high
- Environmental agendas likely to create the biggest source of future opportunities

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4 Underweight Fixed Income (G. Ross)

- Gilt yields have risen from 2020 lows but remain unattractive with 10 year benchmark less than 80 basis points and issuance levels likely to remain high
- Major European government yields remain even lower than those available in the domestic UK market, but do offer increased yields on a hedged basis
- FI markets focused on any signs of inflationary pressures but CB rhetoric implies these will be largely ignored until economies are in full recovery
- Credit markets offer relative value although spreads are narrowing but are not at the tight levels seen in early 2020 before the pandemic
- Selective EMD market offer attractive opportunities as countries and markets are at different levels of economic recovery.

5 Neutral Equities (M. Davies)

- We remain constructive on equities despite the strong start to the year seen across most markets
- The vaccine rollout provides scope for a broad recovery to materialise this year
- We expect monetary policy to be largely supportive of equity markets as central banks are unlikely to risk any recovery at this stage through withdrawing quantitative easing and/or raising interest rates
- Fiscal policy is also likely to remain favourable to markets as governments look to support jobs growth and the consumer through stimulus spending, led by the US
- We still prefer Value to Growth; despite some reversion in valuations over last two quarters, Value still looks more attractive on a relative basis and is likely to benefit more from underlying economic growth
- We prefer EM over DM, despite an increase in regulatory risk in China following the crackdown in the tech sector which we do not consider to represent a wider risk to investors

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**

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All information is prepared as of 31.03.2021, if not stated otherwise.

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