Independent Adviser's Report for Teesside Pension Fund Committee

William Bourne **28th November 2018**

Market commentary

1. In previous commentary to clients I have highlighted that signals presaging a more difficult environment were still coming through strongly, despite good earnings from corporates. In October markets finally took notice: the US 10-year bond yield rose above 3% and major equity markets sold off by about 10%. Emerging markets have shown more stress, in particular via their currencies.

2. **The economic backdrop has not changed greatly**. Global growth remains at the 2% to 3% level, inflation remains on a 2% trend and 3Q earnings results have broadly been in line with expectations. The US added further trade sanctions to China, but markets currently believe that these are primarily negotiating tactics.

3. Political stresses at the global level remain elevated but not greatly changed. The US mid-term elections ended in a score-draw, with the Democrats winning the House of Representatives, while the Republicans gained a decisive majority in the Senate. It suggests that President Trump will find it more difficult to pursue his more extreme agendas over the next two years, but he is unlikely to change his direction of travel.

4. **The financial background** - ie. the money and credit available for businesses and consumers to settle bills and pay for things – **remains very weak indeed** and is pointing to a significant economic downturn. This is a major reason why I expect a further leg down in markets.

5. The UK political situation has clearly deteriorated. At the time of writing, the withdrawal agreement overseen by the Prime Minister looks unlikely to pass Parliament. Whether it does or not, in the absence of a major change of heart by somebody, an extended period of transition looks inevitable.

6. A 'no-deal' will add uncertainty to that, though the doomsday predictions are probably overblown. For example, financial services - where regulators rather than civil servants have been in charge - largely have plans in place for a hard BREXIT and are invoking them. Two other points suggesting that UK markets may perhaps rise on 'no deal' are that i) the Bank of England is unlikely to raise rates against this background ii) if sterling falls, UK exporters (ie 50% of FTSE All-share) will benefit from improved terms of trade.

7. The one area of better news has been equity valuations. The combination of the 10% price drop and around 25% earnings growth in 2018 so far has meant that US equities are now trading at around 15x their earnings, ie. not far above their long-term average.

8. **10 year US bond yields rose above 3%, an important mark**, for the first time in over seven years, though other major bond markets have emphatically not followed suit as table 1 shows. The optimists will ascribe this to the superior performance of the US economy and concern about inflationary pressures, the pessimists to the inability of the rest of the world to extract themselves from the zero-rate environment of Quantitative Easing.

Table 1 Major market bond yield movement since June 2011 (when US 10yr bond last yielded 3%)

Country	10 yr bond yield 6/2011	10 yr bond yield 11/2018	Change
US	3.1%	3.1%	0.0%
UK	3.4%	1.4%	-2.0%
Germany	3.0%	0.4%	-2.6%
Italy	4.9%	3.5%	-1.4%
Japan	1.1%	0.1%	-1.0%

9. **My number one concern in the past twelve months has been that central banks, and particularly the Federal Reserve, raise rates too far and tip the global economy into recession**. Most commentators and the markets are expecting substantial tightening, and if they are right about this, I view a further down leg in markets as inevitable. Only if central banks change tack by not raising rates might it be averted.

Portfolio commentary

10. The falls in equity markets have made valuations substantially more attractive in relative terms. However, the deteriorating fundamental and financial background means that there is still very significant downside risk in equities, the core of the portfolio. If a decision is made to put on some equity protection ahead of the 2019 valuation, it should be done sooner rather than later. The cost of such protection should be carefully assessed against the potential value, as the rise in market volatility means it will be more expensive than it was earlier in the year.

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