Appendix A

Independent Adviser's Report for Teesside Pension Fund

William Bourne **20th August 2019**

Market commentary

1. In June I described a sea-change in markets. For the foreseeable future the Federal Reserve will need to delay normalization and keep monetary policy - at least in terms of interest rate levels and the size of their balance sheet – substantially looser than they had wanted. I doubted whether equity markets would embark on another major bull market but suggested a prolonged bear market was unlikely, because the Fed and other central banks would respond by easing monetary policy.

2. Three months later this seems to be broadly the case. Markets have touched new highs but not surged, while Government bond yields have fallen significantly (eg. the US 10 year bond yield is now 1.58% (2.12% on 1/6/19), the UK equivalent yield 0.43% cf. (0.85%). The Fed cut rates by 25bps in August as recession fears grew. **The price of gold has risen by 20% over the past year**, which I view as an appropriate response to the prospect of an increase in the supply of paper money.

3. On the other hand**, political risk has ratcheted up again**. At a global level Trump is pushing for further concessions from China, India and Pakistan are skirmishing, Japan and South Korea are locked in a separate dispute, while tighter sanctions on Iran have pushed it to more confrontational actions in the Gulf. In Europe we wait to see whether BREXIT will take place and who will fill Angela Merkel's role. **The question for markets is how much of this has already been factored into valuations**.

4. **Global economic growth is undoubtedly slowing as we reach the top of a business cycle**. Forward looking indicators such as business confidence and purchasing managers' indices are all pointing downwards in the US and 2nd quarter growth fell from 3.1% to around 2.1%. The OECD's latest report suggests global growth will stabilize at a little over 3%, with the EU growing at around half that and Emerging Markets about 1% higher. The most recent reports out of Germany, Japan, the UK and Italy suggest very little positive growth at the moment. Global trade volume growth, not surprisingly, is expected to slip from around 5% to just 4%.

5. Companies as varied as Ford, Boeing and Amazon all delivered disappointing quarterly earnings growth. The retail and airline sectors in particular have suffered a slew of bankruptcies, administration events and defaults globally as buying habits change. The Fed is likely to respond to further economic slowdown by easing policy, which will probably limit the downside.

6. **The UK does seem to be facing particular problems, reflected in sterling's weakness**. Apart from the political uncertainty and the seemingly unbreakable impasse over BREXIT, there seems to be little sense of strategy and the need to have allies in the world. Domestically, stronger than expected tax receipts will give the new Chancellor some room for manoeuvre. An autumn General Election is now a distinct possibility: the threat of a Corbyn/MacDonnell Government is probably one thing which could spook the broader UK stockmarket and particularly infrastructure.

7. Bond yields have fallen as investors seek safe havens ahead of an economic downturn. If there are further rate cuts in response to economic or systemic weakness, I would expect that trend to continue at least for short and medium term bonds. I continue to be wary of some parts of the corporate bond markets for technical reasons.

8. **In a slow-growth world governments left and right are turning to fiscal policy to stimulate growth.** Economic theory suggests this will lead to higher demand, and consequently inflation. My view is that deflationary forces (technology, globalisation) are still sufficiently strong today that this will take time to develop. However, the advent of higher trade tariffs globally (or for the UK further currency weakness) would likely change this, and in the longer term inflation remains the only route other than default whereby governments can reduce their debt burden.

9. In summary, equity and bond prices remain high despite plenty of dark clouds around. However, most are 'known unknowns', i.e. largely discounted by investors. Recession fears may drag markets down sharply, as happened in 2018 Q4, but I expect that to result in further monetary and fiscal easing, which will limit the downside.

Portfolio commentary

10. We are coming out of a ten year period of unprecedented asset growth, which is most unlikely to continue. Even loose monetary and fiscal policy will only provide some downside protection. We should therefore expect asset growth to be moderate, with the potential for shocks from geo-politics, trade wars and disappointing economic growth.

11. **The Fund's current positioning remains a long way from the agreed strategic allocation.** In particular, the equity weighting is substantially higher than the 50% target, and alternatives are well below its 20% allocation. The assets allocated to Protection (ie. there to provide some ballast when equity markets are volatile) consist only of cash and bonds, both very low-yielding assets at present. **The Fund continues to rely heavily on equities to deliver the required actuarial return.**

12. I am reasonably sanguine about the prospects for equities, for the reasons given above, but the divergence from the strategic allocation remains a substantial risk. **If I am wrong and equity markets fall sharply, so will the Fund's funding ratio**. Efforts to find suitable diversifying investments which meet the Fund's requirements should be prioritised.

13. I have separately written a paper for Officers proposing that, in addition to bonds and cash, property and property debt be included within the Protection 'bucket'. My main argument is that property's characteristics as an asset class are substantially more similar to bonds than anything else and deliver reasonable diversification from equities. They are therefore the most suitable substitute to provide ballast when bonds go AWOL. The benefit would be a reduction in the weighting the Fund currently has to cash in particular, which is currently acting as a drag on returns.