Independent Adviser's Report for Teesside Pension Fund Committee

William Bourne **3rd June 2020**

Market commentary

1. When I last wrote in February, I said that coronavirus would reduce global growth but my default case was that the environment for markets would remain gently upwards, with valuations supported by i) low bond yields, ii) supportive central bank monetary policy and iii) attractiveness relative to other asset classes. I added that political actions had the potential to knock them off course.

2. I did not, of course, expect politicians to switch off the great majority of the productive parts of western economies by imposing 'lock-down'. **The IMF expects western economies to contract by 6% in 2020, compared to the previous estimate of +2%.** The big questions for investors are:
    - How quickly can economies be put back on track?
    - How much will the way we live and work change as a result of COVID-19?
    - What are the implication of those two for markets?

3. The answer to all three is far from clear. In this report I will therefore deviate from my usual format. I will start by looking at what we know, and then turn to what is less certain but we can make some assumptions. I will look at each asset class the Fund invests in, and finish with my recommendations.

4. We can expect with some certainty:
    - A deep global recession in 2020, caused by the shutdown of most 'non-essential' businesses.
    - Lower corporate earnings, with companies focusing on cashflow preservation.
    - Significant levels of corporate failures and much higher unemployment.
    - Aggregate dividend cuts of around 30% or more in the UK, maybe 10-15% globally.
    - Low interest rates and plentiful liquidity for the foreseeable future. Money is essentially free.
    - A much larger role for the government within the economy.
    - A big increase in government bond issuance to pay for everything.

5. From the Fund's perspective, in the short term this means:
    - A substantial reduction in investment income in 2020 and probably thereafter.
    - Valuation downgrades from real estate and private markets still to come.

6. We do not yet know how quickly the economy will recover or what the long-term consequences are. Most central banks and governments were quick to use monetary and fiscal policy to try and shore up the economy: the major elements were to reduce interest rates, purchase bonds and investment-grade corporate debt, and temporarily to finance 'furloughed' employees.

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7. This has had the important positive impact of ensuring that, **unlike in 2008, the financial system has continued to function.** Credit markets, as I have highlighted over the past 12 months or so, are a major stress point and at one point in March became illiquid, but generally this crisis is not centred on malfunctions of markets or banks.

8. There are a number of paths the global economy might follow, which economists are labelling by the letters of the alphabet: one is a V-shaped economy, with recovery by the end of the year; a second is U-shaped, with no recovery till end 2021 or even 2022; a third is W-shaped, with an initial recovery followed by a second recession but eventual recovery in (say) 2023; and finally L-shaped, where the economy fails to recover meaningfully at all and the world falls into a longer depression.

9. At the time of writing, I would suggest that there is **a high probability, perhaps 90%+, of a relatively optimistic eventual outcome for the global economy** ie. V-, U- or W-shaped. It may be a bumpy road but there will eventually be a substantial recovery. The scale of support given by most governments and central banks is so huge that it will in my view have the desired impact. The rating agency Fitch estimates a total global stimulus of US$6 trillion or three times as much as in the GFC. I also note that some forward-looking economic indicators in the US are already showing a sharp improvement.

10. That does not mean that nothing will change as a result of COVID-19. I would suggest:
    - Global trade will be permanently lower as companies choose to diversify their supply chains.
    - The shift to the digital economy will accelerate - more working from home and on-line shopping.
    - Travel patterns will change – less business and leisure travel.
    - Inflation is inevitable, the question is whether sooner or later.
    - Greater acceptance of state intervention in lives (and less enterprise).
    - Changes in political norms, perhaps away from democracy to a less orderly world.

11. **BREXIT remains a potential pitfall for Europe and of course the UK in particular**. The last thing a fragile recovery needs is another political thunderbolt, so I expect both sides to come to an accommodation. However, the potential for uncertainty and a political mis-step has the capacity to adversely affect sterling in particular.

12. The other major event of the past few months has been the halving of oil prices as a result of the collapse of the OPEC/Russia 'cartel'. This is designed to put pressure on the US shale gas industry, where the cost of extraction is too high to be able to survive at low prices. In theory, a low oil price should be good for the global economy, but it causes further disruption at a time of uncertainty, particularly to the US, Saudi Arabia and Russia.

Asset classes

13. Redemption yields on conventional Government bonds have fallen to close to near zero. Even in the US, the return on the 10-year bond is only 0.66% at the time of writing (cf 1.92% at 31/12/19) and in many countries it is negative. There are good fundamental and technical reasons for expecting yields over the medium or longer term to rise, and the returns on bonds to be negative. Investment grade corporate bond yields dipped sharply in March but recovered as it became clear that the Federal Reserve will make purchases as part of Quantitative Easing. I expect a return of around 2% from corporate and Government bonds in aggregate.

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14. Equities are susceptible to the future path of the economy. They are currently pricing in a quick recovery and a moderately inflationary background is normally quite positive for corporate earnings. However, prolonged dividend cuts will lower valuations. Particular sectors (retail, airlines, hotels, some leisure) may find that their business models are no longer valid in the post COVID-19 world. Governments needing cash may also choose to increase taxation on corporates. Generally, however, unless the future is L-shaped (ie. a long-term depression), I would expect equities to deliver a long-term return of around 5% annualized. UK equities may do worse because there is a higher weighting to areas such as oil and service industries, and significantly greater dividend cuts.

15. **Real estate has been the most affected asset class by lockdown.** Tenants have been unable to use their property to trade or work from. The immediate effect has been an approximate 30-40% fall in quarterly rental income, concentrated on sectors such as hotels, retail, and leisure. It has made it difficult to value properties accurately and transactions have fallen to low levels. Whether or not rental income recovers depends partly on the pace of economic recovery and partly on whether working patterns change. Income levels are likely to fall by about 10% and aggregate returns to be around 4%, albeit different sectors may do better or worse.

16. The role of Alternative assets (ie. private equity, infrastructure) is to diversify and in some cases provide more secure income. Like real estate, the net asset values are far from robust and may turn out to be over or understated. There will undoubtedly be good opportunities to purchase assets at attractive discounts over the next 12 to 24 months, but as yet there is little visibility. I would counsel caution in the short-term.

Portfolio recommendations

17. Returns from all risk asset classes are likely to be lower as free market capitalism is reined in, taxation eventually rises and a degree of disruption ensues from the shifts in behaviour which COVID-19 has triggered. However, unless the world falls into depression (i.e. an L-shaped 'recovery') this is an outcome within the bounds of actuarial prudence.

18. The fund was 72% invested in public equities at 31/3/20 even after the falls in equity markets. Since then, markets have risen substantially and the weighting will have finished. As I have said previously, I am not comfortable with this weighting, given i) the Fund's increasing maturity and ii) the currently agreed SAA target for equities of 50% (though I appreciate this may well be raised). If equities do tumble again, which is certainly possible, the funding level will drop back to 100% or lower.

19. The long-term stated strategy is to allocate more to alternatives but, as mentioned above, I am cautious about making major allocations here when there is so much uncertainty about valuations of existing assets. I am more comfortable investing in new vintages which can take advantage of the opportunities arising from dislocations in markets.

20. I believe there is a good argument for using the current equity rally to put in place a hedging overlay which would give us a limited amount of upside but protect the downside, ie. the funding level.

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