Independent Adviser's Report for Teesside Pension Fund Committee

William Bourne **1st September 2020**

Market commentary

1. When I last wrote on 3rd June, most countries were still in lock-down as a consequence of the COVID-19 epidemic. I commented that there would inevitably be a sharp economic slow-down globally, but the scale of central bank and government responses made me hopeful that a meaningful recovery would follow if not immediately at least within the time scale of a normal recession. Against this background I expected markets to trend upwards unless a political shock derailed them. I suggested the focus should be on the longer-term implications and in particular on the course of inflation.

2. Public markets have indeed risen. UK 10-year gilt yields fell to a low of 0.1% (ie. the annual return on a £1,000 investment for the privilege of lending your money to the Government is £1), their lowest ever, and two year gilt yields at the time of writing stand at near zero. The US equity market (S&P 500), after falling 34% between January and March, reached a new all-time high in August. UK equities have not done as well because they are more weighted to oil and financials.

3. Private markets have been more difficult to evaluate because they only provide net asset value (NAV) estimates once every three, six or 12 months. In particular it is likely that some real estate NAVs will be marked down as the change in living styles (more on-line shopping and perhaps working from home) begins to affect the price of commercial property.

4. The global economy is on course to fall around 5% in 2020 (IMF data). The IMF expects it to grow by 5.6% in 2021 on the back of the various stimuli. While unemployment has risen and will rise as government support for business is withdrawn, the political imperative in democracies is to get money into the hands of the 'have nots' - a theme I have mentioned in previous reports. They are much more likely to spend it and to spend it domestically because of the restrictions on travelling. The actions of governments can either help or hinder the economy, but I concur with the IMF view that we will see a global recovery over the next 12 months.

5. The UK economy fell by a headline 20% in the 2nd quarter, and has been slower to recover than other economies, partly because lockdown has been lifted more slowly than elsewhere. A recent Bank of England report suggests that economic activity will only recover its 2019 level at the end of 2021. Despite this, the BoE's monetary easing has already slowed down and the furlough model ends in October. Although the trade balance has improved (fewer holidays abroad, lower car imports), sterling has been in a long-term downtrend for 35 years, reflecting the lack of consistent policy leadership much of the time. In my view, if the economy stagnates at this lower level or there are any political shenanigans, the risk of another lurch down in the exchange rate is growing.

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6. The traditional response to a sterling crisis has been to raise interest rates and there is plenty of scope to do that. However, I doubt the current Government, already on the defensive over its handling of the crisis, has the appetite. The alternatives are to cut back the fiscal largesse already promised, to raise taxes significantly, or - less likely but not impossible - to reimpose some form of currency control. Any of these reactions would deepen or prolong the recession in the UK. The one ray of sunshine here is that it may concentrate minds when negotiating the post BREXIT regime because neither the EU nor the UK will want a further burden on their economies.

7. Last quarter I mentioned the following longer-term changes:
   - 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.

8. In my view all these remain in place. The first three will have most impact on individual companies and sectors. There will be winners and losers, but it is for Borders to Coast who manage the Fund's equities to navigate those waters. I will therefore focus my remaining comments in this report on the last three.

9. There is still a powerful long-term deflationary trend in place coming from technical innovations. Producer prices fell sharply (OECD data) in 2020 Q2 and CPI is still hovering around 0 to 1% in all major economies as a consequence of the downturn, albeit food inflation is higher. A retreat from globalisation and a move away from market capitalism (ie. greater state involvement) would both be inflationary in nature, but a sustained rise in inflation is in my view still a number of years away.

10. China and the US continue to move apart from each other. Both have reasons to do business with each other but China now considers itself as an equal to the US with its own sphere of influence. It has been successful in building capacity and know-how in many areas from rare earths to artificial intelligence, but the US remains well ahead in military sophistication. In the long-term I expect this to lead to a world of two super-powers and other countries will have to choose whose 'gang' they want to be in. In the short-term further friction is likely, especially if Trump wins the US election.

11. Returns from all risk asset classes are likely to be lower as free market capitalism is reined in. Bonds look more vulnerable than equities given their current valuations. However, unless the world falls into depression (ie. an L-shaped 'recovery'), which in my view is unlikely, this outcome is well within the bounds of actuarial prudence and should not precipitate any change of course for the Fund.

Portfolio recommendations

12. Government and investment grade corporate bond yields are unattractive at this level, as we have discussed before. Equity valuations are also high in absolute terms, though still moderate relative to bonds. COVID-19 has left question marks over alternatives, because of the difficulty of being sure that the NAVs represent reality.

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13. Like other investors the Fund has been forced to stay with a high weighting in equities because of the unattractiveness of the other two main asset class buckets and the near zero return on cash. The risk, as stated before, is that if there is a fall in equity markets, which is not always predictable, the funding ratio may drop back to or below 100%.

14. Officers and the independent advisors have since the last meeting discussed using an overlay to provide some protection against this risk. While the investment and risk management case is in my view a good one, there are concerns about transparency, complexity and governance. If the decision is taken that these outweigh the investment benefits, the Committee should note the possibility of a sharp reduction in the funding ratio under certain scenarios. As the Fund is investing for the long-term, this is not an immediate concern but may lead to criticism from stakeholders.

15. In the longer-term, a rise in inflation is the largest risk to the fund and I would continue to advise identifying and investing in assets which provide some form of mitigation to this risk.

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