Appendix A

Independent Adviser's Report for Teesside Pension Fund Committee

William Bourne **3rd March 2022**

Market commentary

1. I 'called' the top of equity markets last June, suggesting that they were unlikely to rise further and there was scope for considerable downside. Over the ensuing six months bond yields rose while equity markets staggered on as economic growth slowed after the post-COVID bounce. Since the New Year we have seen an acceleration in the downtrend. Bond yields have risen (i.e. prices fallen) and equity markets have swung away from tech and towards value stocks. Indices have therefore fallen by around 10%.

2. U.S. economic growth rebounded in the 4th quarter, but much of this came from companies rebuilding inventories. Growth elsewhere also exceeded expectations, but because of the Omicron variant, December and January data weakened. **In general, economies have now reached or exceeded their 2019 levels of activity,** though the U.K. is a laggard in this respect.

3. The Russian invasion of Ukraine on 24th February was well anticipated. Apart from higher commodity prices it has not at the time of writing affected markets much. However, any escalation or unpredicted second-order events clearly have the potential to upset investor confidence considerably. In particular, **wars tend to be inflationary as they increase demand and reduce supply capacity**. The military (and governments) are less price sensitive than the private sector.

4. This comes on top of U.S. consumer inflation at the highest rate for over 30 years, 7.5% in January. The Bank of England expects U.K. inflation to peak at about 6% in April, before falling back to around 2%. Both banks are clearly on the warpath against inflation and have raised rates twice with the threat of more to come. However, political considerations may limit their ability to act in the future.

5. Bond yields have backed up considerably over the past few months in anticipation of more rate rises. The U.K. 10-year bond reached a yield of 1.6%, and is now trading at 1.3%, compared to a low of 0.1% in July 2020 and a 'normal' level of 3% to 5%. The US equivalent trades at 1.9% but has not yet reached pre-Covid levels. **Higher bond yields are the pivot of the changes happening in markets**, as they affect the current valuation put on the future income stream deriving from all investments.

6. This is the main reason for a 15% fall in the US NASDAQ 'tech' index between mid-December and late January, despite better than expected earnings in many, though not all, cases. At the other end of the spectrum, cyclical stocks (e.g. energy, financials) have outperformed indices substantially.

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7. **Almost all active managers underperformed in the quarter,** because they have tended for ESG reasons to be underweight commodities and fossil fuels in particular. It is a reminder that asking managers to take decisions on non-financial grounds is not without its risks.

8. For some time now I have said that it remains hard to see a painless exit in the longer term, and markets seem to be cottoning on. **Central banks are tightening policy to ward off higher inflation, but the risk of a policy error is considerable.** Either political considerations mean they are too slow to react to inflation and it remains higher than the 2% target, or they tighten too harshly and tip western economies into recession.

9. **In the background, the trends are now more inflationary than otherwise**. Greater government involvement in resource allocation tends to drive higher inflation. The outbreak of war in the Ukraine will exacerbate this. The fall in working age populations relative to dependents may drive up labour costs. Even the move to a carbon-free planet will involve substantial investment and reallocation of resources, which often leads to inflation.

10. Against this, demand is likely to be subdued as higher energy and food prices act as a tax on western consumers, while technology continues to continue to drive costs down. **The swing factor in the short-term, however, remains the behaviour of central banks, and whether they can balance controlling inflation while maintaining some economic growth.**

11. My best judgement at the moment is that there is about a 75% chance that long term inflation stays below 4%. Under these scenarios, the Fund's funding ratio may slip slightly but should remain not too far from its current level. Even the scenario of a policy error leading to recession and disinflation would in all likelihood lead to liabilities falling as well as asset valuations.

12. **The most difficult scenario is one where inflation is sustained at 5% or more, while growth is subdued – i.e. stagflation.** LGPS liabilities are linked to consumer inflation without a cap, and the only robust hedge, index-linked gilts, trade at a significant negative real yield - i.e. incur a large opportunity cost. Over the last few years, the Fund has started to build up weightings in assets such as infrastructure. While this is still work in progress, over time it will help to mitigate the inflation risk.

13. The major short-term risk, especially after recent events, is a fall in equity markets ahead of the next valuation on 31st March 2022. The fund has historically maintained a high weighting in public equities to generate sufficient growth to keep contribution rates lower. If markets do fall significantly, it is possible that this will lead the funding level to fall back close to 100%. In this context it is important to remember that the Fund invests for the long-term and that the actuary incorporates a considerable level of prudence when setting the discount rate. There should be no immediate reason for concern.

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