Independent Adviser's Report for Teesside Pension Fund Committee

William Bourne **16th June 2022**

Market commentary

1. For twelve months I have warned of the potential for falls in equity and bond markets, and said in March that it was hard to see a return to normality without pain somewhere. **Nearly three months on, all bond and many major equity markets have fallen substantially.**

2. Russia's war on Ukraine, as expected, has poured fuel on the inflationary fire. The impact has been most obvious in energy and food costs, but second order effects are beginning to come through too. Ukraine, Russia and Belarus are between them major producers of a range of commodities which are material to our lives: grain, fertiliser, oil, gas, lithium, and platinum.

3. As a result, the US consumer inflation level for May hit 8.6% and are at similar levels in most of the western economies. Japan is the major outlier where inflation remains in the 0 to 2% range. **We are probably close to the inflationary peak, and the question now is where it will settle when it moderates.** The U.S. Federal Reserve is forecasting 4.3% inflation in December 2022 and 2.7% in 2023. Anywhere much above 2% is probably bad for financial assets in the long-term.

4. Global growth is slowing. After a better 4th quarter, the U.S. economy contracted by 0.4% in the 1st quarter of 2022. The UK economy also dropped for the second quarter in succession. The biggest factor in the slow-down is the Chinese economy, which for the last ten years has been responsible for 75% of global growth. It is reeling from the lockdowns imposed to try and combat the latest COVID wave: 2022 growth will be the lowest since the country emerged from Maoism in 1981.

5. The Fed. raised rates by 75bps in June, the most for nearly 30 years, in an attempt to throttle inflation psychology back. As a result, U.S. ten-year bond yields have risen to 3.4% (compared to a low of 0.5% in 2020) and are now back within the 3% to 5% range where they have over the long term normally traded. The era of negative nominal yields has passed, even in countries such as Japan.

6. Credit spreads (i.e. the difference between corporate and government bond yields) are widening, a warning indicator of trouble ahead. Investors are now being paid 4% to buy AAA (the safest) corporate debt in the U.S. At the lowest end, junk bonds are yielding 15% compared to about 7% at the low in 2021.

7. As I pointed out last time, higher interest rates and bond yields are the pivot of the changes happening in markets. While the U.S. S&P index fell for seven weeks in a row and is down more than 20% from its end 2021 high, it is worth noting that many tech companies met earnings forecasts, and that the

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march of tech has not slowed down. Investors are placing a lower value on their earnings' streams because of the change in bond yields. That said, if there is a recession ahead, there may well be another leg down as earnings forecasts are downgraded.

8. Closer to home, political threats continue to rumble round Europe. The conflict in Ukraine seems to be settling into a longer-term war in the eastern half of the country. This will add further to inflationary pressures, as the military are not price-conscious, as well as forming a less stable background for markets generally. The uncertainty over Boris Johnson's position and the tussle with the E.U. over the Irish border suggest more volatility too.

9. The social divisions in Europe were also laid clear in the French presidential election, despite Macron's comfortable victory. The divide between the haves and have-nots mirror those made clear in the U.K.'s BREXIT referendum in 2016. Politicians will have to respond, and the pendulum is likely to start swinging back towards labour (i.e. the workforce) and away from capital (i.e. shareholders and investors). That may well be a healthy move but will again add to inflationary pressures.

10. **The odds of a full-blown global recession in 2023 are very high**. China, the engine of growth over the last ten years, is sputtering and the U.S. Fed. seems to see a recession as a necessary evil in order to bear down on inflation.

11. If this happens, investors will find themselves in an environment of negative growth and relatively high inflation, where corporate earnings and valuations will both be under pressure. Companies who are either running 'old' business models (e.g. high street retail) or who have high levels of debt will be the most vulnerable. Their assets and employees may be taken over by new owners (e.g. private equity), but shareholders will be losers. The newsagent, McColl's, problems are just an early example.

12. Investors should brace themselves for lower returns over the next few years, and quite probably negative real returns. This, combined with high inflation, is uncomfortable for LGPS funds, because liabilities are linked to consumer inflation without a cap. Index-linked gilts, the only robust hedge, trade at a real yield of around minus 1.0%. This opportunity cost is lower than it has been over the last few years, but is still significant in the context of an open and active fund. Infrastructure and real assets provide a much better return but are unlikely to provide full mitigation if U.K. inflation is sustained above about 5%.

13. The Fund is likely to experience a lower funding level for a period, as a result of its choice to maintain a relatively high equity weighting. I remind readers that the Fund's investment horizon is long, and periods of poorer performance are inevitable. It is almost certainly wrong to reduce equities now at these lower levels, but when the result of the March 2022 actuarial valuation is ready, it may be time to consider whether or not some further de-risking is appropriate.

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