Investment report for Teesside Pension Fund
June 2022

Political and economic outlook

The war in Ukraine continues to drag on with Russia making gains in the east of the country. The atrocities being committed by Russia will have long-term impacts on world politics and the outcome of the war will have an even greater impact politically and economically. To my mind it is inconceivable that western powers would let Ukraine fall to Russia giving it control of a significant amount of the World's energy and food supply. Therefore if the West is unable or unwilling to supply sophisticated weapons in enough quantities (and this alone might be a lot enough) to ensure Ukraine victory the west itself may well find itself at War. Or to put it another way the West will be indefinitely held to ransom by Russia if it wins the war, a position not to be relished. This would be a significant shift in the scales of power since August of last year when the West quit Afghanistan. It is a position that no politician in the West could contemplate accepting, but I've been wrong in the past!
Politics across the globe doesn't seem to be in very good shape.Joe Biden doesn't seem to have much of a grasp on things in the United States. Our own prime minister is increasingly finding it difficult to decide fact from fiction and any compass, moral or otherwise is determinedly pointed to saving his own skin, a task in which, amazingly, his own party is acquiescent. European politicians are understandably finding the waters a bit choppy given the balancing act of energy supply and defeating Putin without humiliating him. Meanwhile the “strong” leaders in China and Russia continue to take advantage of this perceived weakness and indecision to consolidate power.
Now let’s look at the global economic situation. It is really difficult to make any sensible short-term predictions given the situation in Ukraine.

Furthermore the unprecedentedly rapid rise in inflation across the globe has thrown a spanner in the works.
Additionally it would only take a decision from Russia to cut off gas supplies to Europe to cripple that economy and that is not out of the question.
Nor is it inconceivable that Russia would cut Ukraine's food exports which would bring a significant humanitarian crisis (and coincidentally further inflationary pressures).
The rise in inflation has been 10 times faster than it was in the 1970s. This is caused in part by the rise of the unemployment at the beginning of covid and the subsequent very rapid recovery; by serious supply shortages as a result of covid and and the war in Ukraine; the build up of savings during the pandemic and a rapid decline in savings recently. Initially I thought this might be the beginning of a new period of stagflation as GDP growth appeared to be slowing but it's too early to tell. Job vacancy and unemployment data internationally would suggest we are not about to enter a period of stagflation. GDP growth could well surprise on the upside as could inflation with a strong jobs market as supply constraints. However I would expect inflation to fall all from over 10% to a 4% level over a couple of years. Low unemployment will accelerate wage increases and lead to labour's share in GDP rising making corporate earnings growth rather pedestrian at best.
We should expect high energy prices and high food prices to exert downward pressure on GDP growth over the short term and likewise increasing inflation pressures. However over the longer term the stability of the services sector and a return to real wage growth should support modest GDP growth.

Markets

The high and rising inflation rate will have a negative impact on fixed interest markets over the short term. Even over the longer term if inflation

settles back at about 4 percent this will still be negative for bond markets which are likely to fall from their current levels.
The uncertainties over corporate profitability will put pressure on other areas of the credit market.
Index linked Securities are likely to give modest returns over the next few quarters as we move closer to a positive real interest rate economy despite the higher inflation levels.
Cash over the short term is looking to give a return of about 10% negative.
I think we can safely say this is going to be a difficult period for non real assets.
Equity markets are likely to struggle against the headwinds of a declining share of corporate profits in GDP. This will be offset to some extent by the negative interest rate environment which will still exist over the medium term. Over the longer term inflation is beneficial for equities but not over the short term. We could therefore be in for a short period of declining equity markets. The pressure will continue as inflation subsides over the medium term and as we start to move towards a real positive interest rate scenario.
Valuations of equities will also be reduced by the higher interest rate environment but the impact will be modest compared to fixed interest markets.
The pressures within the property market remain similar to those that have existed since the start of the pandemic. In that offices will remain under pressure and warehouses will continue to flourish.
Alternative investments will continue to provide opportunities which are differentiated from, and uncorrelated with, equities in particular. As always there will be resource pressure issues related to the internal team.
Borders to Coast do not themselves seem to be adequately resourced either so are unlikely to relieve the pressure on the Teesside investment staff.

Portfolio recommendations

Uncertainty levels remain high, at levels similar to those seen back in February at the beginning of the Russian offensive against Ukraine. The unprecedented rise in inflation over a very limited period of time makes any short term forecasting of markets extremely difficult, in fact futile.

With that health warning I would expect our best chances of success to lie within the alternatives area. We should attempt to deploy some of our cash resources here although I know that will be difficult. Given current uncertainties, valuation levels should become more attractive.

I continue to be relatively neutral on equities but believe their valuation over the long term is attractive versus fixed interest where I remain negative. Rising interest rates will temper the valuation of equities but at the same time will reduce the real value of the fund's liabilities.

The property manager should continue to search for suitable properties for inclusion in the property portfolio.

Peter Moon

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