Independent Adviser's Report for Teesside Pension Fund Committee

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Market commentary

1. When I last wrote in early September, I expected markets to recover on the back of the massive monetary and fiscal easing put in place in most countries after the COVID-19 epidemic. I thought economies were likely to follow, albeit not necessarily immediately. I continued to view inflation as the main long-term risk to the Fund's solvency.

2. Equity markets and most risk assets have returned to pre-epidemic levels, despite the onset of a second COVID wave. However, there has been huge divergence between the winners, largely tech stocks such as Apple, and hard-hit stocks such as airlines, shops and leisure. The latter failed to recover meaningfully from their lows, at least until a very sharp rally in early November when a possible vaccine was announced.

3. The major theme of the quarter has been a renewed form of lockdown in many countries to try and prevent health systems being overwhelmed. The authorities have once again done their best to provide ample fiscal and monetary support, but a steady stream of retail, leisure, and travel businesses have failed, unable to cope with another pause in trading, while others have chosen to make widespread redundancies.

4. The world's economy has recovered from its lows of the second quarter when many countries were in lockdown, but to date the rebound is lacklustre. The OECD's current estimate is for a 4.4% decline in the global economy in 2020 and a rise of around 5.1% in 2021. The U.K. pattern has been similar, albeit with a steeper fall and correspondingly greater recovery. The long-term OECD estimate is a global growth rate of 3.5%, not markedly changed from before the crisis. Their inflation forecast is also steady at 3.2%, although current levels in most advanced economies are below 2%.

5. The major event of the quarter was the US election. The result is still not fully formalized, but it is clear to most observers that Biden has won a convincing victory over Trump. However, the Democrats will not have a majority in the Senate, which will restrict the power of the new Administration to do anything radical. Equity markets took a positive view of this.

6. **The UK economy remains vulnerable because of BREXIT**. Six weeks before the transition period ends, there is still little clarity whether or not there will be an agreement over trade and services. A big problem is the likely lack of reciprocity between the UK and the EU on financial services. Markets have discounted some of the risks, but the potential for a worse outcome is still present. On the slightly more positive side, because of BREXIT the Chancellor is likely to tread gently in raising taxes.

7. Although attention is focused on equity markets, **bond markets will probably provide the first signs of any change in the market environment**. UK 10 year gilt yields have risen from a low of 11bps in the summer to 40bps, and their US equivalent from 50bps to 94bps. There are few signs of inflation on the High Street today, so I view this move as mainly a technical correction from the extreme yield low in the spring. There may be some volatility in UK index-linked gilts over the next few months, as it looks inevitable that the Government will rebase the payment from RPI to CPI, roughly 1% lower.

8. Private markets in 2020 are perhaps the dog which hasn't (yet) barked. In March I and others were predicting some distress in private credit in particular. However, the Federal Reserve flooded the credit markets with easy money, and so far hedge funds, private equity and private credit have shown remarkably few signs of problems, certainly compared to investors' experience in the Global Financial Crisis in 2008/9. Managers have managed their liquidity (i.e. ability to pay out redeeming investors on time) better this time round, but I shall still be surprised if there are not some upsets.

9. **Real estate remains the asset class with most uncertainty hanging over it.** Landlords have been able to receive the majority of rent owed except for in the retail and leisure industries, but generally commercial property valuations are beginning to be marked down in the more affected segments. The renewed lockdown has intensified stress in areas such retail, leisure, and travel, and at some point there will be substantial write downs here. This will present both opportunities and risks for investors.

10. In the short term I would expect the current market environment to continue because of the support provided by central banks and governments. There are some signs that we are approaching a turning point: the very narrow market leadership, the extreme valuations of some stocks, and the rise in bond yields. However, unless there are external political shocks, **I expect the catalyst for a major change to be a shift in inflation expectations leading to higher bond yields**. At the moment that does not look imminent.

11. That implies that market returns from equities and private markets will continue to be broadly in line with actuarial expectations. I am cautious about the outlook for bonds and at least in the short term for real estate.

Portfolio recommendations

12. The independent advisors are reviewing the Strategic Asset Allocation set in 2018 with Officers, and a paper on this will be brought to the March 2021 meeting.

13. The major area of uncertainty is over the real estate portfolio and the impact of lifestyle changes which may follow in the aftermath of the COVID-19 epidemic.

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