Independent Adviser's Report for Teesside Pension Fund Committee

William Bourne **10th October 2022**

Market commentary

1. In June I warned that a global recession was looking highly likely. Since then we have seen substantial interest rate rises and evidence of slowing economies almost everywhere.

2. Inflation data is showing some sign of peaking, principally because energy prices have eased off. IMF forecasts for 2022 consumer inflation are an average of 6.6% in developed and 9.5% in developing countries. Although central banks and bond markets are both forecasting that inflation will fall, the recent OPEC accord to cut oil production and sabotage of the Nordstream pipelines make it clear that inflation will be impacted by energy shortages for some time to come.

3. Central banks appear determined to tighten policy further to lower inflation rates. The European central bank has now raised rates to 1.25%, U.K. rates have risen to 2.25%, and U.S. rates are now 3.25%. Only Japan is maintaining rates at close to zero. The U.S. Federal Reserve has also withdrawn over 1 trillion dollars of liquidity from bond markets since the peak, which has the same impact as a much larger rate rise. It is no surprise that the US$ has been super strong, reaching 30- and 40-year highs against both the yen and sterling.

4. The Fed. has started to signal a slightly less aggressive approach to monetary policy and will certainly reverse course (the jargon word here is 'pivot') when they believe inflation is tamed. However, this is unlikely to be in the next six months.

5. The new U.K. government's financial statement unsettled the gilt market and sterling dramatically. After 15 years of governments largely relying on monetary policy to sustain the economy (i.e., Quantitative Easing), the Chancellor chose to throw the fiscal lever by announcing tax cuts and greater government spending. There is some merit in the underlying reasoning, but both the political and the markets' reaction forced a rapid U-turn on some of the measures.

6. Bond investors were upset by the sudden significant increase in borrowing and the insouciance with which the Chancellor refused to either let the Office of Budget Responsibility vet his plans or say how

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he planned to pay it back. The gilt sell-off was exacerbated by the U.K. private sector Defined Benefit pension funds' widespread investment in LDI (liability driven investment). The rise in bond yields forced them to liquidate collateral, largely held in the form of gilts, to cover margin calls on their leveraged positions, meaning that gilts sold off further and they had to liquidate more. The Bank of England had to stabilize gilt prices through a short-term emergency purchasing programme.

7. The table below gives current IMF growth forecasts for growth and inflation over the next 18 months. Since the spring of 2022 and 2023 growth forecasts have come down by 0.4% and 0.7% respectively, and the numbers for advanced economies' inflation have risen by 0.8% and 1%. Projected growth in the West is well below the trend at between 0.5% (U.K.) and 1.2% (Europe). The IMF comments that the risks to 2023 growth are skewed to the downside, especially in the U.K.

GDP Real Growth (%)	World	U.S.	China	E.U.	U.K.	Developing	***Inflation***
2020	-3.1	-3.4	2.2	-6.3	-9.3	-2.0	*3.2*
2021	6.1	5.7	8.1	6.8	7.4	6.8	*4.7*
2022	3.2	2.3	3.3	2.6	3.2	3.6	*8.3*
2023	2.9	1.0	4.6	1.2	0.5	3.9	*5.7*

Source: IMF July 2022 World Economic Outlook

8. Higher bond yields have put further pressure on equity valuations, and together with the likely global recession, a further leg down in equity markets is highly likely. However, if and when the Fed 'pivots', they may reverse course quite suddenly, as they did in December 2018 and March 2020.

9. In the longer term, the fog of uncertainty is slowly clearing. Interest rates and bond yields will stay higher, perhaps in the 2% to 5% range. Monetary policy will be used to relieve times of stress (e.g., the Bank of England's recent emergency package) but not as a semi-permanent feature. Governments will shift to fiscal policy to try and stimulate growth. Economic growth in the major economies will notwithstanding remain low. Globalisation is, if not in reverse, no longer moving forward. Tech continues to march on. Capital for investment or leverage is both more expensive and scarcer.

10. Investors such as the Fund who are providers of capital to private companies should therefore be well rewarded in the longer term. However, it is not clear that the same is true of investment into gilts, which are now explicitly being manipulated by the Bank of England (the jargon word here is 'yield curve control'). That means that investors are not receiving the return they should for the risk they are taking. While this may persist for a while, eventually the stresses will show up somewhere.

11. There are some positives from recent events: the UK government's decision to switch to fiscal policy is probably correct, even if the implementation was botched; the Chancellor has (I hope) learnt two lessons, first that he cannot buck the market, and secondly that the U.K. cannot act regardless of

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others; and the flaws in LDI, which I and others have long spoken about, have been exposed.

12. However, the immediate course of markets still looks challenging for all investors. The Bank of England is playing a dangerous game, as it is increasingly relying on short-term funding to finance the Government's budget. If it finds itself having to raise finance when markets are stressed, it may find itself forced to take unpalatable measures. Sterling will carry a risk premium for poor financial management, much as in the1970s.

13. The Fund's cash weighting will help mitigate the short-term damage and provide opportunities to invest at better prices but will not insulate it from market falls. The big question will be whether the allocation to bonds should be raised now that gilts yield more than the Fund's discount rate and investors can receive nearly 5% on the best-rated corporate bonds.

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