Investment report for Teesside Pension Fund October 2022

Political and economic outlook

On the whole both political and economic fortune's for the world are looking decidedly less rosy as the year progresses. The supply and demand imbalances are looking to be more persistent and embedded than was thought even a year ago. The temporary blip in inflation has become a self-perpetuating beast. The problem for central bank's is how to bring inflation under control without crippling huge swathes of the world economy. We are clearly not in a stagflationary environment, the commodity, energy and labour markets are all dangerously tight meaning that high inflation Is here for some time to come.
High energy prices and the rising cost of borrowing feeding into mortgage rates has acted like a huge tax increase on the average person. Not only that but these two key components have pushed core inflation up substantially. It is going to take careful economic management and political skill to bring this phase to a happy ,or even satisfactory, conclusion. A word of comfort though is that the IMF , no less, does not expect a wage price spiral to develop.
I'll briefly mention the chancellor's mini statement but won't dwell on it as you probably have heard and read quite enough analysis on the subject. Suffice to say the tone and content of the statement is enough to unsettle financial markets for some considerable time to come. This will have a damaging impact on the future performance of the UK economy as if it didn't have enough headwinds to contend with.
Pension funds have not been immune from the market turmoil. Those with Liability Driven Investment strategies have seen a significant increase in their liabilities which has resulted in forced sales of gilt edge stocks and other assets. I seem to remember that portfolio insurance failed to work in

the market slump of 1987. This time around sizable moves in the gilt market, but not to my mind extreme or inappropriate, have led to significant problems for pension funds. This does not look like a problem which will go away easily given the size of UK pension fund holdings in gilts. Fortunately your fund has not got involved in financially engineered products that don't work, you have kept things simple. However it does not mean that the fund is immune from the force selling of other assets as the crisis deepens.
The most influential driver on economics and markets remains the war in Ukraine. Despite the recent gains made by Ukraine it is an increasingly serious situation where Russia could cause immense economic damage globally, not to mention the threat of nuclear war.

Markets

It looks as if we are entering a period of relatively high inflation which might already have peaked but which is likely to remain above central bank targets over the medium term. We are also looking forward to a period of re-entry to an era of more normal interest rates and less accommodative monetary and fiscal policies. This is unchartered territory for both central banks and politicians alike, clearly nothing can go wrong. As I've already mentioned there are other considerable uncertainties.
Fixed interest securities are in negative yield territory which is a position they are likely to be in for some time as central bank's are unlikely to be able to respond adequately to the current inflation pressures. This means there is likely to be further pressure on fixed interest prices.
Fears that economies may be moving into recession will also put pressure on corporate profitability is not good news for credit markets either.
Index-linked would appear to offer some value in an inflationary environment however if we are on a trend to more persistent real positive

interest rates rather than negative then this could be a very volatile asset class to hold without any certainty of a decent positive return.
Real cash returns will be awful over the medium term, better returns might be found in safe cash alternatives.
Equity markets will also struggle in this environment. Equities don't like high or rising inflation but they do like negative interest rates which are likely to be here for some time. Corporate profits are due to fall as a percentage of national income but in an inflationary climate that does not mean that nominal profits will necessarily fall. However given the severity of the energy price rises and potential interest rate increases the consumer will feel a substantial squeeze on real incomes. Many will not be able to cope with a squeeze of this nature and will cut back on consumer expenditure marketly. Assistance from the government will undoubtedly be necessary. Developing markets which are less highly geared than the developed markets are likely to perform better during this period.
Within the property market selective purchases could produce positive outcomes but with the level of uncertainty on all fronts it might be better to keep the powder dry.
Similarly purchases in the alternative market could produce reasonable returns if carefully selected given the variety of investment types.

Portfolio recommendations

This genuinely is one of the most difficult periods in which to make portfolio recommendations. Political uncertainty in every respect is at a near time high and economic uncertainty as we move towards more

conventional economic policies and a normal interest rate environment, argue against putting forward any recommendations.
However :-
Bonds are between a rock and a hard place and should be avoided.
Index-linked I think,on balance, should be avoided for the time being as well.
Given the negative real interest rates real assets such as equities should be considered although the ride will not be easy. Most other assets are giving negative yields currently, equities at least have a chance over the longer term of producing positive real returns as do alternative investments.
The same argument applies to property.
In conclusion it's likely to be a rough time for the portfolio whatever action we take.

Peter Moon
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