Appendix A

Independent Adviser's Report for Teesside Pension Fund Committee

William Bourne **1st December 2022**

Market Commentary

1. In October I warned that a global recession was looking quite likely. Since then, we have seen substantial interest rate rises and evidence of slowing economies almost everywhere. It is only in the U.S. that there has been some evidence of higher employment and perhaps some resilience.

2. Central banks have continued to tighten policy further to lower inflation rates. The European Central bank raised rates in November to 2%, U.K. rates have risen to 3%, and U.S. rates are now 4%. It is well to remember that twelve months earlier the equivalent rates were 0%, 0.1% and 0.25% respectively. Only Japan is maintaining rates at close to zero, and there are some signs of movement even there.

3. **The hawkish stance of central banks has had some success in lowering inflation**. October CPI fell back to 6.2% in the U.S. as energy prices came down, but remains at 11% in the U.K., albeit the core rate excluding food and energy was 6.5%. Central banks and bond markets are both forecasting that inflation will fall (e.g. the Office for Budget Responsibility's forecast for the UK is 9% in 2022, and 7.4% in 2023), but there is clearly a risk that it may remain higher for longer.

4. Bond yields fell back from their highs in early October, and the yield curve is virtually flat (i.e. 3 month bills yields almost the same as 30 year bonds). This is normally an indication of a recession ahead. The Bank of England in the U.K. will need to issue some £350bn of gilts over the next two years to finance or refinance government debt. There are also around £835bn of gilts purchased as part of quantitative easing over the past ten or so years overhanging the market. I struggle to see how the market can absorb all this at current interest rate levels. I therefore expect bond yields to rise.

5. FTX Exchange, (the third largest crypto currency exchange), went into administration in November, and the secondary repercussions are still reverberating. Millions of investors, among them some large institutions, have lost most of their money. Two of the biggest tech firms, Twitter and Meta (i.e. Facebook) also fell from grace. Following the takeover by Elon Musk, the former's business model is being wrenched in a different direction. Meta suffered a 50% decline in net earnings as it invests for a different world.

6. Geo-politics is back with a vengeance. The passing of the Chips and Science Act makes it clear that **the U.S. now views China as its main economic and leadership competitor,** and will take whatever measures are needed to try and thwart its progress. The continuing war between Russia and Ukraine

continues both to put upward pressure on food and energy prices.

7. Equity markets so far have been remarkably sanguine about all the negative news. U.S. corporate earnings per share have continued to rise, albeit at the lowest rate since COVID. Investors may also be starting to bet on the Federal Reserve changing direction ("pivoting" is the jargon word here) and starting to ease policy again.

8. Valuations of most private assets (infrastructure, private equity) have not yet fully discounted the events of the last twelve months, though their liquid counterparts are trading at large discounts relative to their previous history. That suggests the market expects private valuations to fall too.

9. I note the resilience of equity markets and the slightly better news from the U.S. However, bond markets are more pessimistic, and the monetary environment is as tight as it was before the Global Financial Crisis. I therefore anticipate that valuations of all assets are likely to fall. Worse outcomes are possible if the financial system comes under stress. The Fund's cash weighting will help mitigate the short-term detriment and provide opportunities to invest at better prices, but it will not be able to insulate it from market falls.

Recommendations

10. Despite this, as I said two months ago, the longer-term outlook for investors like the Fund who are providers of capital to private companies is not bad. The coming shake-out is likely to provide attractive opportunities for investors with capital to deploy, although investors will need to show discrimination and discipline when investing.

11. The current Strategic Asset Allocation is a reasonably diversified portfolio on the premise that the Fund wishes to continue to take some investment risk to try and keep contributions low. I do not propose any changes to it at the top level.

12. The biggest question is likely to be how to invest the 15% allocated to bonds/debt and cash. Over the last few years this has largely been held in cash. I do not favour UK gilts at current yields, mainly because of the financing predicament the U.K. Government finds itself in. However, there may be opportunities elsewhere in credit such as investment grade corporate bonds, which are currently yielding between 5% (AAA- the best credit) and 7% (BB - the lowest credit still considered investment grade).

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