Independent Adviser's Report for Teesside Pension Fund

William Bourne **3rd March 2023**

Market Commentary

1. In December I said that while there was greater clarity about the future, the immediate course of markets looked challenging and that a global recession was quite likely. My pessimism has not yet been justified. Equity markets have risen, and whilst growth has slowed, recent data suggests a shallow recession at worst.

2. Central bank policy has shifted. Both the Federal Reserve and the Bank of England raised rates again to 4.75% and 4% respectively and signalled that further interest rate rises will be more muted. The Peoples' Bank of China has eased monetary policy substantially, presumably as a way of escaping their COVID lockdowns, and the Bank of Japan has also substantially expanded its balance sheet against the renewed threat of deflation.

3. Inflation rates continue to fall in most countries, but the immediate outlook for 2023 remains relatively high. For example, the IMF's latest forecast[1] was 7.3% in 2022, 4.6% in 2023 and 2.6% in 2024. Bond markets continue to price in longer-term inflation at around 3%, and the Bank of England has publicly said it expects inflation to be at around 2% by the end of 2024. Food and groceries inflation is currently running much higher, at 10%+ globally. Japan yet again remains the exception, where inflation is below their 2% target.

4. There has been a significant improvement in economic data and forecasts generally. For example, the IMF's forecast[2] upgraded growth for most countries. They expect global 2023 growth to be at 2.2%, tilted towards China and emerging markets. This is still low compared to history, but 0.2% higher than their forecast in October. The outlier remains the U.K., which the IMF downgraded by 0.9% and expects uniquely to undergo a shallow recession. Against this general optimism, there is anecdotal

[1] IMF World Economic Outlook Update, January 2023

[2] ibid

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evidence of job losses, lower spending and companies struggling to refinance debt.

5. Equities have reacted to the better news and easier monetary policy and the U.K. FTSE100 (heavy in oil and financial stocks) has reached an all-time high. U.S. earnings will decline in 2003, but investors seem to be looking through the dip to a reacceleration in 2024. Valuations are close to the post-2008 average, although higher than longer term norms[3]. Equity investors may be pinning their hope on a revival of Chinese growth.

6. Not all is rosy, however. Bond yields have fallen over the past three months and the U.S. bond yield curve, which is a traditional and usually reliable signal of recession ahead, is substantially inverted. This inversion is partly because of demand for collateral in very short term corporate lending markets but it may still be accurate in warning of an economic slowdown.

7. Fundamentals still look difficult, with low growth in most western countries, a likely worsening of the situation in Ukraine, sticky inflation, and increased friction and costs on the supply side leading to earnings downgrades. As one example of the latter, the cost of 'on-shoring' production of high-end semi-conductor chips in the U.S. is about 50% higher than in Taiwan. Even large tech companies, who might be considered less affected by fundamentals, are laying off staff (e.g., Google, Amazon).

8. The U.K. finds itself the laggard among developed countries, as the Bank of England acknowledges. This is down to a combination of the aftermath of the autumn LDI fiasco (higher bond yields, less trust), BREXIT (more trade friction, higher inflation), labour unrest (lost growth, more uncertainty), and the lack over many decades of a long-term strategy at government level. From a financial perspective, the main implication is likely to be a higher risk premium on U.K. assets.

Recommendations

9. If inflation comes down as expected, cash will begin to deliver a positive real (i.e., after inflation) return. That will make it easier for the pension fund to deliver its target return, but the higher cost of money will also mean a greater level of risk in investing generally. The opportunities for investors will come where companies need to refinance themselves, whether via the stock market, debt markets, or private markets. However, investors will need to show discrimination in the prices they pay, and corporate defaults will be more common.

10. The Fund's relatively high equity weighting has stood it in good stead over the past six months. I do not recommend any changes at this time.

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[3] S&P 500 Price to Earnings ratio is 17x, compared to long-term average 14x (Factset 31/1/23)

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