

Investment report for Teesside Pension Fund March 2023

Political and economic outlook

Is politics entering a more conciliatory and productive era in the UK and Europe? The Prime Minister appears to have turned his back on the divisive and fatuous and potentially harmful period of his immediate predecessors. Rishi Sunak is taking the responsibilities of his position seriously and seems intent on trying to take the country forward. He has improved our relationship with the European Union which has enabled a workable agreement on Northern Ireland to be agreed. The behaviour of the Democratic Unionist party and their acceptance or not of the agreement will definitively show if we are entering a more conciliatory and productive era. We can only hope the DUP will see you fit to ratify the agreement and allow Stormont to start functioning again. There is clearly a lot at stake for relations between the UK and Europe and for the prospects for the UK economy.

Elsewhere world politics remain volatile and rather worrying. Relationships between America and China which appeared to be improving after the recent meeting between Presidents Biden and Xi Jinping stumbled somewhat after balloons carelessly went off course and strayed over U.S. territory. It is difficult to assess the impact of a dispute between China and Taiwan on the world economy. We have seen the impact of recent electronic chip shortages on just about every sector of manufacturing, the impact of Taiwan going offline would be devastating across the globe.

The resolve of NATO and the West seems to be holding in the conflict in Ukraine which is just as well as this is a conflict that western democracies are not in a position to lose. In the near future the aid given to Ukraine will need to be increased substantially to bring the fighting to an end within an acceptable time scale and for humanitarian reasons. Naturally this brings

with it the risk of a nuclear conflict but unfortunately that cannot be eliminated.

As I have said previously, the reality of post industrialised economies with larger service sectors has reduced the likelihood of significant recessions, smaller more diverse sectors are more resilient than larger interdependent ones. After a quarter of negative growth most economies have shown relatively strong growth for the past three quarters. The exception has been the UK economy which has shown pretty anaemic growth but at least it has avoided recession. It is noteworthy that the action of Central Banks has had little or no effect on the course of economic activity worldwide. So although Central Banks may in future have an impact on financial markets they are unlikely to determine the course of economic activity.

We are entering a period where core inflation will stay above central banks targets. Inflation though is likely to trend down as energy shocks dissipate and supply constraints are resolved. Eventually, it is likely that developed economies will settle down with interest rates around the five percent level and inflation at three or four percent.

After an extended period of squeeze workers should be in the ascendant with wages taking a larger percentage of national income which is a further factor in inflation remaining above the target rate.

Markets

Rising interest rates and profits falling as a share of national income is not a recipe for rapidly rising stock or bond markets. However stock markets have had a fall and inflation levels are declining so in all likelihood markets will tread water and maintain their value. Developed economies are likely to struggle to get their finances under control which may be good for economic growth in the short term but is likely to restrict rises in markets.

The environment for stock markets could well be described as neutral which implies little action one way or the other.

The prospects for bond markets are slightly worse than for equity markets and I believe prices will continue to trend down albeit slowly as central banks continue to tighten monetary conditions. As the outlook for profits becomes more uncertain corporate bond spreads over government bonds will tend to increase so prices will tend to fall here too. In addition the negative real yield environment is unhelpful for bonds to meet the fund's return targets.

Within the property portfolio stock selection will be vital to enable the fund to show an adequate return over the medium term. It is an imperfect market where decent investment opportunities should arise to enable this to be achieved.

The rising interest rate environment has made returns more difficult to attain within the alternative investment market. It has also restricted the opportunity set available to investment managers. However it is an enormous universe of differing investment types so good managers should always be able to find investments and strategies which will meet our return requirements. We are moving to a level of investment in alternatives which represent the upper limits, and beyond, of our investment strategy.

However, while we maintain a high liquidity cushion that gives us flexibility to cover unexpected demands on cash it might be acceptable to make further investments in this area over the short term.

Our high cash position which is giving negative real returns remains an anomaly in a high inflation environment, however it does bring a modicum of comfort in volatile and uncertain markets. On balance I would expect our cash position to fall as real investment opportunities become available.

Portfolio recommendations

Predictably my recommendations have not changed very much from previous reports, my only excuse is that we are a long-term fund and as you know I have a preference for real assets as the best tool to cover our liabilities. That doesn't mean I don't believe in diversification, I do, but it has to be, in my opinion, appropriate notification. Therefore the fund needs to start by looking at the expected return on the assets and choosing the most appropriate asset mix which has the best chance of meeting the funds actuarial liabilities. This explains why the fund has been skewed to equities, property and other real assets over the long term.

So this leads me to conclude that conventional government fixed interest and index linked securities should be avoided. Corporate bonds are likely to fare worse than government bonds as the covenant is weaker.

As you will have gathered from the report, equities in the developed markets will struggle to make any significant progress. The developing economies are in much better financial shape and I think opportunities could arise in stock markets here despite the slowdown in China.

The more imperfect markets of alternatives and property are likely to throw up investment opportunities suitable for the fund which means cash balances should be allowed to decline modestly over the next quarter or two.

Peter Moon
3 March 2023