Investment report for Teesside Pension Fund
June 2023

Political and economic outlook

I read with horror in my last report that I had predicted that UK politics would become more conciliatory and productive. Despite the soothing, steering hand of Rishi Sunak there is a war raging within the Conservative Party. It beggars belief that Boris Johnson still has supporters within the Conservative Party who cannot see that he has done any wrongdoing at all. I can only think it is something to do with the education system.
The DUP members could not find it in their hearts to ratify the Northern Ireland Agreement which is disappointing given that it would have helped normalise politics and economic performance within the UK and EU.
All in all it looks as if the Conservative Party will have a long and difficult period in the run-up to the next general election. The polls suggest that the Labour Party will not have an easy ride either. You've got to wonder just who is going to benefit from the current political turmoil.
International politics continues to be difficult despite attempts by the U.S and Chinese governments to get onto a better footing. Recent economic performance in China has temporarily given the US the upper hand in the negotiations. Chinese rhetoric has become less bellicose but there are not a lot of signs of it becoming conciliatory.
Progress towards an end of the war in Ukraine appears to have slowed as the Ukrainian counter offensive struggles against the Russian defensive positions. Western democracies have to win this conflict however difficult it might be and it is going to be a long and costly endeavour.
Economic growth in most western economies has been satisfactory and the threat of recession has so far been avoided. The anaemic growth of the UK economy reminds me of its performance prior to joining the EU in 1973. Despite the rhetoric from the government I see little chance of the economy

getting on a higher growth trajectory despite all the talk of becoming a leader in Artificial Intelligence.

There is a major bottleneck in the developed economies , namely the supply of labour. Domestic labour is short in most western economies and immigration is being restricted which makes the circle difficult to square. This will prove to be a major impediment to the achievement of Central Bank's inflation targets. These targets were set in the period of globalisation and falling interest rates which made them easier to achieve; the reverse is now true. Targets now need to be raised to about 4% to accommodate this environment and to prevent over tightening of monetary policy, unfortunately this shift is unlikely to happen. The prospects for the UK are poorer than most economies with an increased likelihood of recession, more persistent inflation and higher real interest rates.

The drop in inflation will continue as supply issues are resolved from the aftermath of covid and the conflict in Ukraine but, over the medium term, will remain stubbornly above the current inflation target of 2%. Over the longer term Artificial Intelligence will help solve the labour shortages and hence the inflationary pressures within economies. With the benefits of the internet and now AI this has been a remarkable period for productivity growth within the world economy but it does bring with it uncertainties.

There has been a lot of talk of AI increasing long-term unemployment as workers are replaced by machines. History however indicates that increasing productivity (enabled by AI) will lead to higher employment levels and lower unemployment as workers are displaced into higher value added positions leading to greater earnings and consumption.

The past decades have been an extraordinary period of development and productivity growth through the internet and then AI which is bound to lead to increasing uncertainty and nervousness about economic development. History however suggests these developments will be beneficial to economies and to stock markets.

Markets

Real yields remain in negative territory and this will need to be rectified by either falling inflation or rising interest rates and bond yields. Inflation is falling worldwide and more slowly in the UK but it is likely that bond yields will need to rise over the medium term as inflation fails to fall as far as expected. Additionally because of the tight labour market the profit share in GDP is likely to continue to fall. This scenario is not beneficial for conventional fixed interest, index linked or equity markets and just about any other investment medium.

Most markets will struggle so I'll try and put them in some sort of a pecking order.

Conventional gilts are likely to struggle as inflation does not fall enough to restore a real return and interest rates have to climb to compensate investors resulting in falls in value.

Index linked are likely to move in the same direction as conventionals and have the added uncertainty of real interest rate changes.There is the potential for pressure to increase real interest rates which would undermine index linked values even further.

Falling profit share and rising real and nominal interest rates would indicate that equity markets or struggle to make further ground , indeed they're likely to decline somewhat, but not as much as fixed interest.

To continue the theme the economic environment is not beneficial to the overall property market but special opportunities are likely to arise.

Likewise most unquoted investments will probably find it hard to make progress as interest rates rise.

Clearly cash is unattractive as an investment with inflation running at over 8% and cash interest rates at about half that level.

Portfolio recommendations

The portfolio looks well set for the uncertain and more hostile conditions ahead with its underweight position in fixed interest and overweight position in cash.

The cash position should be run down as opportunistic investments become available in property and other inefficient markets where selective positions become available.

Essentially the recommendation is steady as she goes. This is not the time to be overconfident or brave.

Peter Moon

19 June 2023