Independent Adviser's Report for Teesside Pension Fund Committee

William Bourne **13th June 2023**

Market Commentary

1. Three months ago I said that the risk of a recession seemed to have receded and policy-makers were managing to balance on their tight-rope of maintaining growth while bearing down on inflation. I wrote just before the failure of Silicon Valley Bank in California, and subsequently of several other mid-sized U.S. banks. Under the current fractional reserve banking system (i.e., where banks lend out a multiple of their deposits), all banks are reliant on maintaining trust. The loss of trust at SVB was caused by falls in the valuations of their supposedly 'safe' assets i.e., long-term U.S. government bonds.

2. The United States Federal Reserve responded rapidly by confirming that their deposit insurance would cover all depositors at SVB in full. They did this because of the potential secondary effects on the economy of SVB stopping overnight. Many SVB accounts comprised working capital for entrepreneurs and venture capital, who would immediately face a liquidity problem if their accounts were frozen. However, it has led to a debate on moral hazard and whether the state should act as a guarantor of last resort for all deposits. Ultimately the burden falls on the taxpayer.

3. The Fed at the same time expanded its balance sheet (i.e., renewed Quantitative Easing or QE) massively to head off further bank failures. This policy, as between 2010 and 2020, acts to support markets, as excess liquidity not needed in the real economy tends to flow to financial assets. In my view this is why equity markets have been resilient in recent months.

4. In Europe, for different reasons, Credit Suisse lost its depositors' trust and was taken over by UBS. The Swiss authorities disenfranchised shareholders in order to affect a rapid rescue, which inverted the normal credit hierarchy: equity holders received a return while AT1[1] bondholders did not.

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[1] Additional Tier Bonds were issued to provide additional capital at times of stress. They pay much higher rates of interest but in theory can be cancelled if, as here, the bank is subject to an extreme event. The case will certainly be subject to legal action.

5. Inflation has continued to fall in most countries, partly because the price of energy is subsiding. The latest U.S. headline inflation datapoint is 4.7%, the Eurozone 6.1% and the U.K. 8.7%. Food inflation still looks very sticky, as we know from supermarket pricing, and the destruction of the Nova Kakhovka dam in Ukraine is likely to exacerbate that. So I expect inflation only to come down slowly.

6. Private assets are beginning to experience the same valuation falls as publicly quoted markets already have.[2] Commercial real estate is in the eye of the storm right now, as the profile of demand for office and retail space has changed radically since the COVID lockdowns. Secondary space which is not compliant with increasing strict sustainability regulations has seen substantial valuation write-downs.

7. Looking forward, as last quarter, the fundamentals still look difficult. We are approaching the cyclical peak of the interest rate cycle but can still expect one or two more rises to come. U.S. bond markets are unambiguously forecasting a recession, although in my view central bank largesse (i.e. QE) may be sufficient to head that off. However, economic growth in the west is at best going to be anaemic at around 1% over the next two years. The eventual outcome will probably be decided by i) how much further rates rise ii) whether demand from emerging markets, led by China, recovers faster.

8. Politics still has plenty of scope to disrupt markets. U.S. politicians have come to an agreement to raise their debt ceiling, but the next U.S. presidential election campaign will start to gear up quite soon. In the U.K. Boris Johnson and his ilk continue to hog the headlines and a U.K. election is due by January 2025. Finally, the war in Ukraine seems to be reaching a pivotal point.

9. In the short-term, my view is that the outlook is more benign for markets, principally because it is becoming clear that central banks will use QE to ward off any sign of problems in the financial system. This cannot end happily, given the ever-increasing indebtedness of western governments and the difficulty central banks are experiencing in withdrawing QE. But in the short-term I expect equity markets to continue to trend sideways.

10. I finally make a comment about index linked bonds, which provide the best mitigation against the risk of rising inflation. 18 months ago the real interest rate on them was -3%, too high a price to pay for its inflation hedging capability. However, the yield today is 1%, which means investors receive a return as well as the inflation hedge. It makes them once again investable. The yield may rise further, but in my view strong consideration should be given to starting an allocation to this asset class. In the longer term, I would propose a weighting of at least 10%, but I would propose starting off with a minimum of 3%. If cash is not available, I would suggest that funding comes from equities.

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[2] Unlike listed markets, which are marked to market every day, the only sure valuation comparator is through transactions. These have reduced in number across private equity, debt, and real estate, and valuation ranges are unusually high today.