Appendix A

Independent Adviser's Report for Teesside Pension Fund Committee

William Bourne **15th September 2023**

Market Commentary

1. When I wrote in June I said the outlook had changed from an expectation of recession to a more benign outlook. My principal reason was the response of the U.S. Federal Reserve to the regional bank collapses such as Silicon Valley Bank in March. Central banks substantially loosened monetary policy by expanding their balance sheets at the same time as they continued to raise interest rates to combat inflation.

2. Three months later that broadly seems to have been the case. The U.S. has so far avoided recession, with GDP growth around 2%, while the U.K. and Eurozone are showing almost zero growth. Chinese growth has underwhelmed but is still positive. Japanese growth exceeded expectations but is still relatively modest at about 1% over the last 12 months.

3. More importantly, inflation is clearly coming down in most countries. The U.S. inflation rate in August ticked up but still stood at 3.7% compared to 8% ten months ago. There are some notable exceptions, however. China's consumer index is close to deflation as producer prices fall and the economy falters. In contrast, inflation in Japan, where the central bank's primary objective is to eradicate any deflationary psychology, has risen to around 3%. Finally, labour and supply side constrictions mean that U.K. inflation remains higher at around 7%.

4. Central banks have continued to raise rates, albeit at a much slower pace than previously. The bond yield curve in most of the West is as a result steeply inverted (i.e., you get paid more for lending money to the Government short term rather than long term). This is often seen as a predictor of recession, but this time round I suspect it has more to do with financial repression - i.e. regulators forcing pension funds and insurance companies to buy long-dated government bonds.

5. Although inflation expectations are subsiding, bond yields may have further to rise from the current 4 to 4.5% range. Governments (U.S., and the U.K. in particular) have to issue a lot of debt; if the economy starts to recover, we can expect money to move back to the real economy and away from

safe havens such as gilts; and the term premium[1] is at an all-time low.

6. The rise in bond yields has already impacted the pricing of a range of assets. As two examples, U.K. house prices, where variable (i.e., short term) mortgage rates are a major input, are around 5% lower than they were 12 months ago; and the valuations of infrastructure assets, which are priced off long term gilts, have seen 10 to 15% declines. Further rises would likely exacerbate these trends.

7. In this context we should note two important signals. Fitch, a major credit rating agency, downgraded U.S. Treasuries from AAA to AA+ on account of the rising public debt. As U.S. Treasuries are used as the risk-free asset in all financial theory, this may have secondary effects on all financial asset pricing. Secondly, after a considerable tussle with market speculators, the Bank of Japan is now allowing 10-year yields to rise from 0.5% to 1% (compared to the U.K. and U.S. above 4%). This may seem trivial, but my take-away is that even large central banks recognize they cannot completely buck the market.

8. Equities have remained fairly resilient through this cycle of rising rates. One explanation is that investors are looking towards the next cyclical earnings upswing. An alternative one is that the indices in 2023 have been dominated by the 'Magnificent Seven', seven large U.S. tech. stocks such as Amazon and Google. A third is that markets think interest rates are close to a peak and will start to come down.

9. The U.K. remains in its own rather uncomfortable place with inflation expected to stay stubbornly higher. The Bank of England will have to issue around £240bn of gilts in this financial year, £100bn more than last year. U.K. equities are relatively cheap, reflecting the higher risk premium which investors require on U.K. assets following the events of the last few years.

10. If global inflation falls towards target levels, which is probably the consensus now, this environment is relatively benign for risk assets such as equities. However, there is scope for negative surprises: bond yields are likely to rise further; central banks may err by over-tightening to ensure they bring inflation down; Chinese deflation is worrying; geo-politics are unstable, especially with a U.S. presidential election only 15 months away; and the war in Ukraine is seemingly moving into a new phase.

11. I therefore expect markets to be volatile in the shorter term, which from experience often begins with currency markets. The big question for the Fund will be when and how to start de-risking by allocating to government bonds, and in particular index-linked, which remain the best match for future liabilities.

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[1] The term premium is the extra return investors receive for being willing to lock in today's return for the long-term. It should theoretically be arbitraged away to zero, but currently stands at an extreme level of -1.5%. While there are some good fundamental reasons behind this, at some point it will revert to a more neutral level.

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