Independent Adviser's Report for Teesside Pension Fund Committee

William Bourne **4th December 2023**

Market Commentary

1. Three months ago I wrote that inflation was declining and that interest rates would remain high. I was braced for some market volatility, especially in currency markets, but I thought the environment was relatively benign for risk assets such as equities. There has been less volatility than I expected, though both the US$ and the Japanese yen have been the subject of some speculation.

2. Inflation continues to fall in most of the world but remains above the 2% level which many central banks target. The latest data points were 3.2% in the U.S., 4.3% in Europe% and 4.6% in the U.K. The numbers are dramatically lower than a year ago, but the conflicts in the Middle East and (on-going) in Ukraine may lead to slower reductions in the future than the market seems to expect.

3. The European Central Bank raised interest rates during the quarter to 4.5%, but for the time being most central banks have paused their programmes of rate rises. However, central banks, at least in the West, are likely to err on the side of caution, and I do not expect any cuts imminently.

4. Another reason why interest rates are unlikely to fall is that U.S. economic growth in the 3rd quarter (annualized) came in at 5.2%, well above expectations. Non-farm payrolls (i.e., employment) were also higher. Consumption was robust, but the key driver seems to have been exports and inventory restocking. Other countries do not seem to have participated in the same way, and some surveys and indicators suggest that the GDP data overstates the U.S. recovery.

5. U.S. and bond yields rose to a level of around 4.5% but have since fallen back. The yield curve inversion I noted last time have reduced from nearly 100bps[1] to around 35bps. Any inversion is still a recession indicator which cannot be ignored, but the reduction suggests a degree of normalisation.

[1] Bps = basis points or 0.01 of a %, so 35bps = 0.35%

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6. In Japan the Bank of Japan has indicated it will allow 10-year yields to rise above 1% and signalled an end to its policy of using its balance sheet to control the yield curve. In my view this is a victory for market forces, showing that the authorities cannot repress bond yields indefinitely. The implication is that bond yields generally will rise further to reflect western governments' worsening debt problems.

7. Higher bond yields create higher debt service costs for governments. The U.S. must finance or refinance around one third of its total stock of debt, or $11 trillion, over the next fifteen months. Much of this is likely to be at substantially higher rates than what was in place previously. The U.S. Fed. seems to be reacting by relying more on short-term bills and less on long-term bond issuance.

8. China, now the engine of growth for much of the world, showed some recovery. Another large real estate developer, Country Garden, missed a bond payment. Despite the problems in the real estate sector, year-on-year growth is at a similar level to the U.S (albeit lower than historically).

9. Over the last twelve months, equity market index performance has varied considerably. Japan has risen by 21%, while the U.K. has fallen by 1% and China by 4%. Allowing for currency movements, the numbers are closer. In sterling terms, for example, Japan has risen by 9%, the U.S. by 10%, and China by 1%. Leadership has been narrow, with the large tech companies responsible for most of the index gains, and most active managers have underperformed the indices. Equity strategies focusing on climate change have generally done particularly badly.

10. Infrastructure, which is considered a good match for pension fund liabilities, has performed poorly in the last six months. There are specific concerns over the future profitability of renewable energy, as is evidenced by the Danish company, Orsted, cancelling two major U.S. offshore wind projects. More generally the realisation that interest rates and bond yields are going to stay higher for longer has hit valuations of future income streams. This can be seen across long duration assets, but perhaps because of its very long-term nature infrastructure has been worst hit.

11. Geo-politics and politics remain a source of risk. While the increasing number of military confrontations may not directly affect markets, they contribute to greater uncertainty. At the same time the next U.S. election is looming, which makes it even less likely that the current (or future) administration will take the fiscal actions necessary to cope with the ever-increasing budget deficit.

12. I remain braced for more volatility in markets. The gold price has reached an all-time high well above $2000 per ounce. I am not predicting a recession, but it remains a distinct possibility. The risk of global conflict has increased a couple of notches. And the U.S. (and U.K.) elections may lead to sharp changes in policy.

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