Appendix B

Independent Adviser's Report for Teesside Pension Fund Committee

William Bourne **1st March 2024**

Market Commentary

1. Three months ago I said that the main risks to the fund were higher inflation in the longer term, and higher bond yields in the short term. I have not changed this view, but both have declined since I last reported. I also commented that geo-politics and politics remain a source of risk and disruption, and the latest events in the Red Sea and Jordan bear that out.

2. U.S. inflation has stabilised around 3% but is still above the 2% target. U.K. consumer inflation remains higher at 4%. Deflation in China, where high street inflation stands at -0.8% and producer prices at -2.5% year on year, is an important factor. However, wage cost growth in the West remains significantly higher (e.g., U.K. is growing at 8%, U.S. at 4%) which may spark a resurgence in inflation.

3. The Federal Reserve said that it could see up to 75bps of interest rate cuts in 2024, which prompted falls in bond yields and a stock market rally. Much of the rise in markets has come from the Magnificent Seven big tech stocks (Meta, Microsoft, Nvidia, Apple, Alphabet, Amazon, and Tesla) as they reported earnings above expectations, and Meta paid its first dividend. Most active managers have underweight positions in these stocks, and have consequently underperformed the index.

4. United States economic growth grew by 2.5% in 2023 after a stronger second half. Non-farm payrolls (i.e., employment) rose by 353,000 to an all-time high, considerably higher than expected. It underlines the fact that the U.S. economy seems to be on a better path than most of the rest of the world. Correspondingly, interest rate cuts may be slower than the market expects.

5. In contrast China, the world's other engine, has been struggling with deflation, despite relatively loose monetary conditions. The preliminary estimate of 2023 economic growth was 5.5% after 3.0% in 2022, but manufacturing activity has now fallen for four months with both domestic consumption and exports weakening. Evergrande (the second largest real estate company) went into administration.

6. A recent theme in my reports has been the growing levels of public debts as politicians struggle to keep expenditure and revenue in balance. The U.S. duly announced its largest ever issue of new public debt ($70bn) to take place in April. The Federal Reserve is increasingly relying on shorter-term

financing, which will need to be refinanced sooner rather than later.

7. Geo-politics remains a source of risk, but markets have so far not been greatly disrupted even when there has been a threat to oil supply security, as in the Red Sea. However, the cost to the West of these more localised confrontations will have an impact on both fiscal spending and also inflation: governments are rarely price sensitive, especially when it comes to military expenditure.

8. Politics is likely to be increasingly important over the next twelve months. Trump's campaign has built substantial momentum, but the pending legal court cases make the Presidential election result hard to read. The Democrats consolidated their hold on the Senate (now 51 out of 100 seats), which will act as a counterbalance should Trump win.

9. I remain reasonably positive about the outlook for equities and risk assets in the shorter term. The combination of moderate growth (led by the U.S.), subdued inflation, and governments who ahead of elections are likely to keep fiscal policy reasonably loose is quite benign. The liquidity background is also looser than the focus on interest rates in newspaper headlines suggests.

10. The impact of higher bond yields is the most likely risk to this scenario. Markets will at some point wake up to the volume of money printing required as a result of governments' fiscal incontinence. Market theory suggests longer-term bond yields should rise substantially in response, but that would increase the cost of servicing debt significantly. The authorities will probably therefore look to find ways to cap bond yields, such as reducing supply by relying more on short-term instruments to finance expenditure, or forms of financial repression.

11. The question is at what level will bond yields settle. I expect the current benign environment to continue throughout 2024. But at some point the U.S. ten-year bond yield, today standing at 4.2%, will test 5% again and perhaps rise higher. If sustained, that should cause markets more concern.

12. In the longer term higher inflation seems the inevitable consequence of ever-increasing government spending and the growing reliance on short-term financing. This will have an adverse impact on the Fund's future service costs. I therefore recommend that the strategic focus should remain on building up allocations to assets which will provide some mitigation to this long-term inflation risk.

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