Appendix B

Independent Adviser's Report for Teesside Pension Fund Committee

William Bourne **31st May 2024**

Market Commentary

1. Three months ago I reiterated my view that the main long-term risk to the fund remains inflation. In the short term the headline data has continued to fall, but if bond yields or inflation turn out higher than expected western governments will be under pressure from rising debt service costs.

2. Inflation has fallen from the 2022 peaks but is still well above the 2% target in place for most central banks. Among developed economies consumer inflation levels range from 2.6% (E.U.) to 3.4% (U.S.). China is the major outlier, where inflation is only just above zero. Services inflation seems to be the major driver, perhaps caused by labour shortages in some developed countries (e.g. the U.K.)

3. United States economic growth grew by 3.4% in 2023 but slowed in the most recent quarter. The U.S. economy has historically been on a higher growth path than other G7 countries, which may be one reason why its inflation data is higher. However, forward looking data (e.g. Purchasing Managers Indices) suggest that European economies may be improving in relative terms.

4. In contrast China, the world's other engine, has been struggling with deflation, despite relatively loose monetary conditions. 2023 economic growth was 5.2% after 3.0% in 2022. The last six months have seen a significant slowdown, but manufacturing activity data has ticked up more recently.

5. The Japanese yen reached a 34 year low against the USD. The Bank of Japan's policy of keeping interest rates low has led to a significant differential with the U.S. and the yen has become a favoured currency to borrow in. With interest rate cuts in the U.S. looking less likely, there are few catalysts in the short term to change this dynamic. However, the yen is about 30% undervalued in purchasing power parity terms (e.g. the relative prices of a McDonalds' burger).

6. A theme in my recent reports has been the cost of servicing the growing levels of public debt, about 16% of all expenditure for the U.S. and 11% for the U.K. Higher than expected bond yields or inflation would increase the pressure here, and force governments to reduce other expenditure or raise taxes.

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 of these more localised confrontations to the West will have an impact on both fiscal spending and also on inflation

— governments are rarely price sensitive, especially when it comes to military expenditure.

8. The combination of moderate growth (led by the U.S.), lowish inflation, and loose fiscal and monetary policy remains benign for investors in the short-term. The bond yield curve is still inverted, but much less so than at the beginning of 2024. After 15 months of rising markets, a correction would be normal, but I cannot see an immediate catalyst. Valuations are looking stretched in some areas such as tech. but remain reasonable in others (e.g. small cap., Europe, Japan, Emerging Markets).

9. Further out the storm clouds are gathering. The U.S. election has the capacity to be a major inflection point as well as introducing a period of uncertainty if there is a handover of power. The new President will have to deal with a primary deficit of 7% and rapidly increasing debt levels. Growth will be a mitigating factor, but bond markets are in my view likely to pick up on the risks to the US$ here.

10. In contrast to the U.S. the result of the U.K. election in July probably matters little; whatever its hue, the next government will have the same limited options to deal with the U.K.'s problems. Expect more spending and higher taxes, liberal monetary policy, and little of the strategic thinking which the country needs. For the LGPS the push towards pooling is more likely to accelerate than the reverse.

11. I therefore expect U.S. ten-year bond yields to test 5% (at the time of writing 4.6%) at some point over the next twelve months and perhaps go significantly higher. Theory says this should have a negative impact on valuations of other asset classes including equities. However, that may be muted by the sheer weight of money needing a home.

12. In the longer-term (much) higher inflation seems to me to be the inevitable consequence of fiscal incontinence and the growing reliance on short-term financing, especially in the U.S. We are effectively going to the magic money tree. This will have a negative impact on the Fund's future service costs and consequently on liabilities. I therefore recommend that the long-term strategic focus should remain on building up allocations to assets which will help to mitigate this risk. In my view (as I said last time) this includes Index Linked gilts.

13. The Fund also needs income from its investments to cover the gap between contributions and pension payments. Ensuring this income stream is securely in place under a range of possible scenarios (including higher inflation) should be the other major priority.

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