



Independent Adviser's Report for Teesside Pension Fund Committee

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15th September 2024

Market Commentary

1. My report in June focused mainly on the longer-term threats to the Fund. I said I expected bond yields to test 5% at some time in the next 12 months, but I thought the immediate future was benign for markets generally. In fact bond yields have fallen and equity markets have in fact traded upwards, albeit with some considerable air-pockets downwards at times (e.g. Japan down 20% in two days).
2. The U.K. election, as expected, produced a Labour Government, which has lost no time in highlighting the problems the country faces. However, the level of government debt constrains what they can do. The desired strategy seems to be to promote growth through investment, but the Chancellor needs to raise taxes in order to do this without raising debt levels. She may be deliberately depressing expectations, but we should be braced for significant fiscal contraction in her Budget in November.
3. They are therefore leaning on private sources of wealth, including the LGPS, to help finance their desired investment. The Chancellor has accordingly announced a pensions review to accelerate consolidation and scale across pensions, reduce the "fragmentation and inefficiencies" in the LGPS in particular, and encourage investment into the U.K. They believe that the creation of larger and better resourced entities through further consolidation will help achieve their objective.
4. **This has the potential to put significant pressure on the Fund's fiduciary duty to its pensioners.** To restate the obvious, individual investments should deliver an appropriate return for the risk taken, and statutory guidance is that we should consider what level of risk we consider appropriate when we construct the portfolio. The Government's political agenda comes second to that.
5. In my view the new Government will not find it easy to generate higher private sector growth. Spending on defence, health and social care may well flatter the economic data, but the tight fiscal situation means it will be counterbalanced by lower domestic consumption and private investment. The U.S. has still now succeeded in generating growth at pre-COVID trend rates - the latest quarter saw annualised growth of 2.8% - but that seems to be subsiding. Other countries are struggling to generate much, if any growth.

6. The Bank of England cut interest rates by 25bps, citing inflation at below its target level. The Federal Reserve is expected to follow next week. However, both made it clear that the arguments for further cuts are finely balanced. **Further rate cuts are likely to be driven by weakening growth in the West rather than lower inflation** and will not act as a positive signal for corporate profits.
7. The Chinese economy continues to stagnate with inflation close to zero. The People's Bank of China made a larger than expected cut to a range of official interest rates in order to try and boost growth. In complete contrast, the Bank of Japan raised rates, albeit from very low levels, in July. This prompted a sudden reversal in the Japanese yen (one reason for the sharp fall in the equity market in August) as short sellers closed their positions.
8. There was a sharp sell-off in the large U.S. tech stocks on the back of disappointing earnings from Tesla and operational issues at Microsoft. Given the supportive monetary environment, this feels like a necessary correction rather than a major turning point, but the Magnificent Seven large tech stocks trade on high valuation multiples and are vulnerable to future earnings disappointment.
9. Geo-politics is cited today by many as their major concern, but markets are generally good at discounting the 'unknown knowns' such as an escalation in one of the current military conflicts. In my view a Trump victory, albeit less likely following Biden's withdrawal, would be disruptive, as it is likely to mean movement in the tectonic plates which Russia, China, and the U.S. figuratively sit on. The consequence may well be a further lurch to de-globalisation. A Harris victory means more continuity, but the markets do not have much visibility on what she stands for, and that could cause nervousness.
10. Markets have benefited from loose monetary policy over much of the last 4 years, albeit it has been implemented through expanding central bank balance sheets rather than lower interest rates. Any problem, such as the collapsing of Silicon Valley Bank and Credit Suisse, has been met with more Quantitative Easing. This stance is unlikely to change dramatically given the low levels of growth. **I therefore remain reasonably positive about the prospects for risk assets in general.**
11. The main risk in my view comes from China falling into a deflationary trap and exporting that to the rest of the world. Their recent interest rate cut is a good sign that the authorities are taking action, but that is no guarantee of success.
12. In the longer-term higher inflation remains in my view the inevitable consequence of fiscal incontinence and the growing reliance on short-term financing, especially in the U.S. The disappointing results of the U.S. bond auctions in early August were a signal that investors are not unaware of this.