Linch pin

Appendix A

Independent Adviser's Report for Teesside Pension Fund Committee

William Bourne **27th November 2024**

Market Commentary

1. Three months ago I said that the environment remained reasonably benign for markets in general. I thought that growth would remain slow, especially in China, and suggested that a Trump victory would be the more disruptive to markets. Despite cuts in interest rates, I was worried that U.S. bond yields would test 5% at some point soon. In practice the U.S. S&P 500 index welcomed the clarity of the election result and what is perceived as a more pro-business Administration, and rose to a new high. Bond yields, after falling, rose to test the levels they reached in October 2022.

2. The U.K. budget, as expected, raised taxes on business substantially in order to fund current and future public investment. The Chancellor relaxed her fiscal rules slightly to allow more borrowing. One change has been to include LGPS assets and liabilities into the Government's 'assets' on which the calculations are done. Her hope is that over time the extra public investment will 'crowd in' (her phrase, not mine) private investment and generate growth.

3. Many commentators are sceptical that this will happen except in the very long-term, and note that the Office of Budget Responsibility's own forecasts are for growth below 2%. The key factor, as ever, is how wisely the extra money is spent.

4. She also has a narrow path to tread to avoid upsetting the bond markets, as she needs them to finance or refinance £300bn in the next financial year and about £1.5trillion over the next five years. The combination of higher bond yields following the budget and some expectation of a rate cut at the short end has been to return the bond yield to a more – if not yet completely - normal shape i.e. longer maturities yielding more than shorter ones.

5. In this context I note that the bond markets' expectation of inflation five years out, calculated as the difference between conventional and index linked yields on gilts of similar maturity, has jumped by about 60bps in the U.S. and 40bps in the U.K. They now stand at 2.5% and 3.5% respectively.

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6. Donald Trump won a clear and resounding victory in the U.S. Presidential election. As the Republican Party also control the Senate and the House of Representatives, he has a mandate to implement his policies. The world can expect substantial trade tariffs, lower energy prices, and less willingness to be involved in external problems. For equity markets, the positives of cheaper energy, lower taxes, and less regulation are counterbalanced by the negative of protectionism.

7. We can also expect a relatively loose fiscal stance, though less financial support for Ukraine and Israel may partially compensate. This will also put upward pressure on U.S. bond yields, albeit the Federal Reserve will try to prevent them rising too high because of the impact of higher yields on the cost of servicing the U.S.'s debt. Higher U.S. bond yields are likely to be passed through to other markets.

8. Both the U.S. and the U.K. central banks cut rates by 25bps, though the tones used differed. The Bank of England suggested there will be further cuts, while the Fed. emphasised it wanted to tread carefully. The driving force behind these cuts is no longer the path of inflation, but softness in the global economy and the fragility of the financial system.

9. The Chinese economy continues to struggle despite a further US$1.4trn fiscal boost, the majority of which was debt forgiveness. The prospect of much higher U.S. tariffs will add a further headwind. Chinese producer prices have deflated over the past two years and CPI for 19 months. This is likely to be to keep inflation in the rest of the world down, at least in the short term.

10. Geo-political risk remains elevated, with the focus most obviously on what a Trump administration means for both the conflicts in Ukraine and Lebanon/Gaza.

11. The authorities continue, as they have done over the past 30 years, to use monetary policy as a salve for economic and financial market problems. However, the effectiveness of quantitative easing is reducing, which increases the risks for investors in the short to medium term. We should be prepared for lower returns and more volatility from our portfolio of assets.

12. The Government announced its detailed proposals for the LGPS and a consultation. They include a greater role for pools including strategic asset allocation, new requirements to work with local authorities (such as the Tees Valley Combined Authority) to finance local investment, and incorporating the recommendations of the 2021 Good Governance review.

13. Middlesbrough Borough Council will remain responsible for the administration of the fund, but there will be significant change in the Pension Fund Committee's responsibilities on the investment side. They will be restricted to setting the high level objectives and to local and ESG considerations. A deadline for pooling all assets by March 2026 has been set.

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