Appendix A

Independent Adviser's Report for Teesside Pension Fund Committee

William Bourne **28th February 2025**

Market Commentary

1. Six months ago I thought the environment for investors remained reasonably benign: growth was slow, but monetary and fiscal policy was in the main loose. Three months ago I maintained that stance, but I expected bond yields to move higher and thought the effectiveness of monetary policy was diminishing. Returns from assets generally might be expected gradually to reduce.

2. In practice, in early January 2025 bond yields reached the highest levels since the Global Financial Crisis (in 2008) before they rallied slightly. Investors worried about a tsunami of issuance against a background of low growth and higher than expected inflation. Equities, on the other hand, seemed to ignore the bad news and several markets have reached or are close to new highs.

3. Within days of reassuming power Donald Trump imposed tariffs on Mexico, Canada, and China, with the E.U. not far behind. So far the U.K. and Japan seem to have escaped. His preferred negotiating tactic seems to start with a thump from a big stick. It may work with allies, who have more to lose than gain by thumping him back; it is higher risk with China (whose initial response was relatively measured). That said, markets seem to have discounted much of the geo-political risk as 'known'.

4. Economic growth generally continues to slow. Except for the U.S.A and Spain, all western nations' growth rate is below 2%, and Germany's is negative. Emerging markets are showing stronger growth, though even China's is relatively pedestrian at 5%. State spending (e.g. defence, healthcare) is increasingly dominating consumption. This implies higher taxes, which will throttle back private consumption further. It is difficult to see how higher growth can be sustained in the long-term.

5. Some of the Chancellor's chickens are already coming home to roost. At the time of her Budget, I commented that the fiscal arithmetic was tight. Since then, growth has slowed, the cost of debt service has risen, and inflation is sticky at 3%. She has no head-room and will have to either increase taxes or reduce spending.

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6. The imposition of tariffs will increase producer inflation: if the U.S.A. could produce domestic steel more cheaply than China, it would already be doing so. Buyers will in the future inevitably pay more than they have previously for their U.S.A.-sourced (or China-sourced with tariffs) steel.

7. Central banks have continued to cut rates in the belief that the financial system's fragility and a relapse into recession pose greater danger than the risk of inflation staying higher for longer. The Federal Reserve has now cut rates by 100bps from the peak and the Bank of England by 75bps. It is uncertain whether this will have any positive impact on growth and how much further they will go.

8. I am slowly turning more negative about the medium-term prospects (i.e. out to ten years) for equities. My largest concern is about valuations. The U.S. Price to Earnings Ratio (one year rolling average) is 25x, above the peak of the dotcom bubble in 2000. It is also now about 25% higher than the global index PER, whereas until 2020 it always traded closely in line.

9. The optimists will explain this in terms of higher earnings growth prospects from U.S. mega-tech. I believe that there are significant risks, ranging from the sheer size of the companies (they need to eat the lunches of more and more competitors to maintain, let alone grow, their earnings) to the threats which tariff wars and anti-trust legislation bring.

10. As well as earnings disappointments, valuations are vulnerable to the impact of the recent rise in bond yields, which equity markets have largely ignored so far. Because the indices are dominated by the mega-tech companies, I therefore conclude that index returns from equities will be lower over the next five to ten years than they have been over the past.

11. The new Administration is giving some signs that it is committed to 'sound money' and will try to rein in the reliance on quantitative easing to solve all problems. If they are successful, that will probably mean lower inflation in the longer term, but a reversal of the asset price bubble of the past 15 years. However, it is still too early to take any portfolio actions on this front.

Portfolio recommendations

12. I have no recommendations to make on the portfolio's asset allocation. The focus over the next twelve months or so will inevitably be on the details of how the Fund can meet with the proposals in the Government's consultation. At the time of writing, we have not yet seen their response, but I expect the timeline to be extended, simply because they would be open to judicial challenge on the basis of unreasonableness if they do not. However, I do not expect many other changes to their proposals.

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