Appendix A

Independent Adviser's Report for Teesside Pension Fund Committee

William Bourne **25th February 2021**

Market commentary

1. When I wrote in December, I was cautious about bond markets but generally expected the upward trend in equities to continue. Since the COVID crisis broke in March 2020 I have consistently argued that the scale of monetary and fiscal support makes economic recovery inevitable, providing substantial underpinning to equities.

2. Bond yields have risen further in recent months and the UK 10 year gilt is now trading at a yield of 0.7% compared to 0.4% in early December and 0.1% in August. By comparison the equivalent maturity US bond trades at a yield of 1.4% (0.9% in December, 0.5% at the low). **It is normal for bond yields to rise at this stage in the cycle and is fully consistent with economic recovery**.

3. Inflation expectations have gone up, with industrial commodities such as tin and copper particularly strong. However, there are few signs of inflation on the high street other than in food and I do not believe this is the harbinger of a major surge in either inflation or bond yields.

4. The major theme of the quarter has been harsher lockdown in many western countries to try and prevent health systems being overwhelmed. This contrasts with the steady return to normality in many Asian countries. The authorities have once again done their best to provide ample fiscal and monetary support, but industries such as airlines, hotels and retail remain under the cosh.

5. **In aggregate US companies have reported 2020 Q4 revenue 1% higher than one year earlier**, which is a reflection both of the support provided but also the scale of the economic recovery. 2020 earnings per share were 12% lower than 2019 but analysts expect a rise of 23% in 2021. There is less hard data from China but most companies seem to be reporting earnings growth despite COVID.

6. On the political front, President Biden's new administration is showing signs of reversing a number of Trump policies and working more collaboratively with other countries. However, it is too early to be confident what direction it will take and there are early signs of friction with China.

7. The UK BREXIT transition period ended on 31st December. While the worst case scenarios have been avoided, trade volumes have diminished dramatically. Financial services remain in limbo, without any agreement. The combination of this and COVID resulted in 2020 UK economic growth at -10%, the worst for 300 years. There will be some bounce-back as the pandemic recedes and new arrangements settle down, but despite the vaccination success UK growth is likely to lag the rest of the world.

8. China was first affected by the pandemic and looks to be first out. The authorities used markedly less stimulus in 2020 than other countries and remain roughly neutrally positioned. The economy grew by 2.3% in 2020, the only major economy to expand. As it is the engine of the region, I would expect other Asian economies broadly to follow the same path over the next few months and western

economies to recover after them. Already there are plenty of signs of a healthy increase in trade, such as container rates and the increase in industrial commodity prices.

9. Against this background many equity markets reached new highs. There has been a recent change in leadership away from US tech, with some stocks such as Tesla already 20% off their high. Central banks are still pumping money into the economy, not daring to take away the punchbowl from the party. The UK market was an exception, dragged down by the heavy 'old world' weightings in the FTSE 100 index.

10. **As the economy recovers, it is normal for investors to sell financial assets and invest in the real economy**. Financial markets are good at anticipating recovery but rarely do so well during it. I expect the same to happen this time and equity markets to peak at some point in 2021. If bond yields carry on rising to a level where they offer a positive real yield, investors may choose to allocate back to them. This may result in further selling of equities.

11. As last quarter real estate remains the asset class with most uncertainty hanging over it**.** Core quality assets, outside retail and travel, have been little affected and landlords have been able to collect 80% to 90% of their rent. Valuations and transaction volumes seem to have crept up in the last quarter as a degree of certainty returns. However, the renewed lockdown has intensified stress in the most affected areas and, as I said last time, at some point there will be substantial write downs. This will present both opportunities and risks for investors.

12. In the short term I would expect the current market environment broadly to continue, but we are in my view approaching a turning point. I expect bond yield curves to steepen further and equity markets to peak in 2021 as investors continue to shift from the growth stocks which have done so well to a broader market. My central expectation is that the steepening happens by long bond yields rising but it may be that that short rates move negative if super easy monetary policy continues.

Portfolio recommendations

13. As a consequence of the above, I expect equities in aggregate to return less than the actuarial expectation of 6.5%[1] over the next few years. The change in market leadership away from growth stocks should provide scope for Border to Coast to outperform the indices, which may mitigate this.

14. The Fund's heavy reliance on equities makes it vulnerable to a bigger sell-off. This is not my central scenario but is a possible outcome if bond yields rise more than I expect. Officers have discussed this at length with the Fund's advisers and a paper is being brought to the meeting separately with our combined recommendations.

[1] At June 2020 Aon's 10 year return forecast for Developed Markets ranged from 5.9% in the U.S. to 7% in the UK.

Linchpin Advisory Limited is a company registered in England and Wales, Company Number 11165480; registered address 4 Stirling House, Sunderland Quay, Culpeper Close, Medway City Estate, Rochester, Kent ME2 4HN; VAT registration number 322850029. This document is intended for professional investors, and nothing within it is or should be construed as constituting advice as defined by the Financial Conduct Authority. If you are in any doubt about this, please consult your legal advisor. The information contained has been obtained from sources believed reliable, but we do not represent that it is accurate or complete, and it should not be relied upon as such.