



Independent Adviser's Report for Teesside Pension Fund Committee

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Market Commentary

1. When I last reported, I said that market resilience was largely down to easy monetary policy. The U.S. has now started cutting interest rates too, and markets have accordingly continued to rise. I also said that at some point we should brace for market volatility, and I have not changed that view.
2. The Federal Reserve has cut interest rates twice, despite inflation well above the formal 2% target. The reason given is the slowing economy, but it is hard to avoid the conclusion that **central banks are increasingly relaxed with inflation at 3%, perhaps even 4%**. It helps indebted governments too because it reduces the real value of their debt piles.
3. However, 3% or 4% inflation is significantly different from 2% for consumers – and pension funds. At 2% inflation the real value of money declines by just over a third over 15 years. At 3% it falls by over 50%. At 4% it reduces by 80%. Pension fund liabilities will (other things being equal) rise similarly. In practice inflation stood at 3.0% in December in the U.S. 3.8% in the U.K and 2.1% in the E.U. As last time, the big exception is China, which is now firmly in deflationary territory.
4. The U.S. 2Q economic growth was revised up to 3.8%. Some of this is a bounce-back after two relatively weak quarters, but consumption and investment were both stronger than expected. Economic growth elsewhere has been anaemic, with the E.U., U.K. and Japan all growing at about 1%.
5. The U.S. Senate's failure to agree a funding settlement shut down the federal government for six weeks. A temporary solution is in place until the end of January. This must have a negative impact on U.S. activity going forward, but markets may not care if it is used as a reason for more rate-cuts.
6. The new Federal Reserve Chair will surely be in Trump's camp, but markets have taken this in their stride. The risk for markets is that a loss of central bank independence will result in higher bond yields. In the short term, however, a more political Chair may just mean easier monetary policy.

7. There has been some progress over tariffs. The U.S. have come to an agreement with a range of countries, including China (temporarily), Japan, the E.U. and the U.K. **In all cases tariffs are now higher than they were, albeit not as high as Trump's initial threats.** However, he has lashed out at Switzerland and India. Trump's willingness to use tariff threats to amend other parties' behaviour seems firmly engrained, and we can expect more sudden changes going forward.
8. **In aggregate higher tariffs will be bad for global prosperity.** They contravene the bedrock principle of economics that trade benefits both parties. The private sector, whether consumers or producers, must in the end pay for them. The U.S. may win in the short term, but not in the longer term. The uncertainty also impacts corporate behaviour – it is harder to invest when the rules keep changing.
9. The U.K. budget saw significant net tax rises, as expected and was therefore broadly welcomed by the gilt markets. But there was some scepticism whether it would engender any real growth or solve the nations long-term financial problems.
10. Easy monetary policy and the Artificial Intelligence mania have continued to boost equity market valuations, though there was a sell-off in November. Earnings (and rises in markets) were driven by a small number of large tech stocks and there was little growth in the rest of the market. Japanese equities performed well, as the first female Prime Minister was elected.
11. There has been a flicker of improvement in China, with upticks in manufacturing and exports leading to expected 2025 growth of 4.8%. The Shanghai Composite index is up nearly 30% from its April low. But China's problems are more deep-rooted than just the economic cycle and growth is being held back by i) the indebted property sector ii) tight monetary policy to avoid a devaluation of the yuan.
12. Although the last seven months since the Liberation Day low have been good for equity investors, there are signs of stress below the surface. For example, the reverse repo rate (the rate at which U.S. corporates borrow overnight) spiked to the highest since 2008 in early November.
13. The authorities' reaction to trouble remains the same as previously: print money in one form or other. This is a short-term palliative, albeit beneficial in the short term for financial investors. But there will be a reckoning at some point in the future.

Portfolio Recommendations

14. We are back to an environment of quantitative easing. For the time being this is benign for assets, but there will be a reckoning sooner or later. I believe that eventually (much) higher inflation is almost inevitable unless politicians grow a backbone, and we should look for ways to mitigate that risk. The Fund's equity weighting is lower than it has been historically, and I believe that is appropriate.