Independent Adviser's Report for Teesside Pension Fund Committee

William Bourne **5rd June 2026**

Market Commentary

1. When I last reported in February, I was less positive about equities than I had been for many years, even though the U.S.'s war with Iran had not yet broken out. Despite this conflict and what ought to be a toxic combination of higher bond yields, higher inflation, and sentiment swinging away from rate cuts to rate increases, the S&P has risen nearly 10%.

2. Markets have been surprisingly calm despite the decision by the U.S. and Israel to initiate a war against Iran. The closing of the Straits of Hormuz, at the mouth of the Persian Gulf, has resulted in higher prices for oil, gas, fertiliser and a number of other important commodities. It is also costing the U.S. about US$1bn each day, in other words adding 1% onto their primary deficit every eight months or so. But while bond market yields have risen, equity markets have largely ignored all of this.

3. Kevin Warsh has been appointed the new Federal Reserve chair. He faces a daunting combination of challenges: the growing primary deficit, rising inflation, rising bond yields, and a fragile U.S. financial system. While he may wish to deliver Trump lower interest rates, that may prove impossible.

4. U.S. consumer Inflation rose sharply in March and April, mainly because of higher fuel and energy prices. It now stands at 3.8% compared to 2.4% three months ago. Other countries saw smaller rises, so that Europe, Japan, and the U.K. all have inflation of around 3%. China's has nudged up to 1.2%.

5. Bond yield curves have steepened: longer yields have risen, but the short end has held steady in the (fading) hope that Warsh might cut interest rates. Reasons for the rise in yields are not hard to find, but it's worth noting that they will inevitably result eventually in higher debt service costs. That is already prompting some governments (e.g., the U.S.), to find ways to suppress yields.

6. The U.K. has been indulging in its own favourite vice: seeing if the Prime Minister can be loosened from his seat. After the local election results where Labour and Conservative parties did poorly against the new challengers, a potential leadership challenge to Keir Starmer has emerged. This will almost certainly be negative for markets, because investors will fear a swing to the left will lead to higher bond yields, higher taxation, and lower growth.

7. With all this bad news around, the question is why the markets have been so strong. One reason is that corporate earnings growth, driven by the tech sector, have again exceeded expectations. 2026 Q1 is coming in as one of the strongest seasons ever, with 12 month aggregate earnings growth about 18% at the time of writing. Demand for AI services as companies try to reposition themselves is one cause, and profits from higher energy prices another. But it is not just the U.S. – Europe's has also come in strongly.

8. The economic outlook is also probably not as bad as some had feared. Recessionary talk is fading, but growth rates in the west remain low compared with history. The rise in defence spending has boosted some countries, such as Poland, but the economic growth rate in much of Europe remains at around 1%. Even the U.S.'s forecast growth rate in 2026 is only 2.3% (IMF estimate).

9. A third core reason for the strength of equity markets is probably that the U.S. monetary policy has erred on the side of liberality. The US Treasury (NB more than the Federal Reserve) have been pumping money into the system, albeit not through traditional ways such as cutting interest rates. Their rationale may be that they don't want a financial crisis at the same time as they are fighting a war. The question is how much longer, under Warsh, will the Federal Reserve be willing to do that.

10. Bond yields have been rising gently. Obvious explanations why include i) rate cuts are less likely ii) the resurgence of inflation fears and iii) deteriorating (American) government finances. But all these are 'known' unknowns, and I don't expect a dramatic further increase in yields, if only because governments cannot afford higher debt service costs.

11. Index linked gilts offer a higher real yield than the Fund's real discount rate (nominal 4.25% less assumed inflation 2.7% = 1.55%). So far in 2026 the real yield for ILGs of around 15 to 25 years duration has been well above this and ranged as high as 2.3%. As they provide the best match against unexpectedly high inflation, there is a good argument for building up weightings.

Portfolio Recommendations

12. My view remains that equity markets are close to a major turning point. I expect this to unfold over the next few months, but if investors are already positioned for it, it may take more time . Bond yields ought to rise further, but central banks and governments will try to suppress them.

13. Investment implementation has now largely moved to Borders To Coast. The Committee's focus should be on how best to hold them to account. In particular their main equity funds have been struggling over the past three years. They are not alone in this, and part is down to the narrowness of market leadership. However, it is a concern.