Appendix A

Independent Adviser's Report for Teesside Pension Fund Committee

William Bourne **11th June 2021**

Market commentary

1. When I last wrote in February, I suggested that the global economy would continue to recover on the back of pandemic monetary and fiscal easing, and that equity markets would broadly continue upwards. I commented that as recovery happened it was normal for equities to perform less well and bond markets to perform poorly.

2. Bond yields have indeed risen (from 0.6% to 0.8% redemption yield for the 10-year gilt, and from 1.3% to 1.6% for the equivalent US Treasury), and many equity markets are either at or close to new highs. **I stress that this is normal behaviour at this stage of the economic cycle**. Within equity markets, value stocks, which are more sensitive to economic cycles, have continued to outperform and have now recovered about half the relative underperformance of the last ten years.

3. Central bank and governments around the world are continuing to provide very substantial monetary and fiscal support to ensure economic recovery. In 2020 the total amount of monetary easing was the equivalent of $30 trillion (£22 trillion), or roughly a third of global GDP. In 2021 there is likely to be a further $15 trillion. The authorities have erred on the side of safety at the risk of higher inflation. The surge in industrial commodity prices, including oil, is a clear sign that this strategy is working in economic terms, as I have predicted it would for a year now.

4. New variants of COVID-19 are continuing to put pressure on the world's ability to move on. While the vaccination strategy which the US and the UK have followed seems to be relatively effective in preventing deaths, it appears less so in preventing a third wave. The main impact is on the leisure and travel industries, where there is little pick-up while the global picture is so mixed.

5. **Headline inflation numbers have gone up**, boosted by higher agricultural and industrial commodities prices, as well as house prices in the U.K. The May U.S. consumer inflation number rose to 5.0%, the highest for 13 years. I still believe this is more likely to be a 'bump' as consumers start spending again after the lockdowns and not the start of a more sustained rise. However, it needs careful watching.

6. U.S. 2021 1st quarter earnings have come in much stronger than expected. It is no surprise that the comparison with COVID-affected 2020 1st quarter looks good, nor that tech stocks have been particularly strong, but most corporates have handsomely beaten analysts' expectations (e.g. Amazon's diluted earnings were 40% ahead).

7. The UK local elections in May resulted in a resounding victory for incumbents. This will provide increased stability in terms of policy, though the question of Scottish independence may be more prominent. The fall-out from BREXIT remains very unclear, and may depend more on what happens in

the German (September 2021) and French (April 2022) elections than any action or inaction in the U.K.

8. The big question is what happens next. In a normal cycle we would see bond yields rise (i.e. prices fall) further as the economy recovers and money is switched away from safe assets and into the real economy. The prospect of higher inflation would add further fuel. Equities would perform less well too – earnings might rise but valuations fall.

9. However, this cycle is not normal. The inflation impetus has until very recently been focused on financial assets and housing rather than the high street. Bond yields, while they have risen, are still very low by historic standards. The Bank of England borrowed 14.5% of GDP (over £300bn) in the 2020/21 financial year, a deficit only ever exceeded during the two World Wars. A rate rise in the U.S. is possible in response to inflation, but central banks are constrained how far they can raise rates.

10. For the last 15 months I have emphasized the scale of monetary support and how it has benefited financial assets. End-May data is for the first time showing a clear slackening of the pace. Equity valuations are high, albeit reduced a little by the strong earnings growth in areas such as tech. Investors now have relatively high exposure to equities in Europe and the U.S and Emerging Markets, but less so in Japan and Europe. **The likelihood that this long bull market will finally come to an end within the next twelve months is growing.**

11. In the longer term it is hard to see a painless exit from where we are today. The authorities are committed to ambitious spending programmes in order to 'level up' inequalities. Some of the financing will come from an increased tax take, both as the economy recovers and as a result of some targeted tax increases. Borrowing will take the strain for some time, but not for ever, and at some point in the future, governments will either need to restrain spending or let inflation reduce the real value of their debt (for the U.K. now 100% of GDP, the highest for 55 years).

Portfolio recommendations

12. The end to the bull market will only be postponed if a third wave of COVID frightens the authorities into resuming their monetary stimulus. Even that might be ineffective if investors look further down the track and are put off by levels of debt or the increase in inflation. The Committee agreed a new strategic asset allocation at the March meeting. In my view, given the high level of equities in the fund, **we should be looking to move to these revised allocations on an accelerated timescale**. A possible alternative is to revisit some form of equity protection strategy, even though we have decided against in the past.

13. The big problem always is where to put money coming out of equities. Areas which I consider to be relatively attractive in an emerging environment of economic recovery but higher inflation include core infrastructure, real estate debt, non-mainstream private equity and bond or credit strategies which rely on volatility rather than taking directional positions.

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