Appendix B

Investment report for Teesside Pension Fund
June 2021

Political and economic outlook

Bedding down the movement of goods after Brexit is being managed with the usual aplomb of this remarkably incompetent government. The situation in Northern Ireland has reached a critical state and God knows how they're going to manage without a good old British banger. In all seriousness the difficulties over the Northern Ireland border, the one in the middle of the Irish Sea and the one between Eire and Northern Ireland have to be sorted out in short order. Hopefully the upcoming G7 meeting will lead to a workable compromise on this very important issue.
Great work by the NHS and Kate Bingham on the Covid immunisation programme has broken the link between the covid virus and hospitalisations and death. However the Delta variant is of great concern as it is tending to infect younger unvaccinated people and while it is out in the population the chance of further mutations is very high. The unfortunate likely consequence will be that any delay in opening up to normality will have a serious impact on the UK economy.
Internationally, continuing tensions between China and most other countries is making life pretty uncomfortable. China's blatant disregard of international law greatly increases the chances of a war over Taiwan between the United States and China. The tensions are exacerbated by the United States' determination, albeit misguidedly, to try to retain its position as the world's number one economy and by China's determination to overtake it by any means fair or foul. International politics is destined to change significantly over the next few years. Totalitarianism is on the rise and democracy for many reasons is currently in decline.
Worldwide governments' stance towards economic policy remains the same as it has been for more than a decade in that it remains extremely

loose and additionally fiscal stimulus is on the rise. Up to now this has had no impact on traded goods inflation but has caused significant rises in asset markets especially equities and bonds but also property and other stores of value. It has also kept economic growth above what it otherwise would have been and fueled corporate profits but not wage inflation especially in the United States. Profit share as a percentage of GDP has risen to extremely high, almost certainly unsustainable levels.

Given where we are, the most disturbing economic number to come out recently has been the rise in annual inflation in the United States to 4.2% from 2.6% previously and from 1.4% in 2020. The Federal Reserve has announced that this is a blip and that inflation will decline when the economy returns to normal. I am not so sure. To put this in context I will use US data but the story is similar in most of the developed world. Since the global financial crisis of 2008 US bank reserves have risen by over 500% and M2 by about 300%. Consumer price inflation over the same period has risen by about 1.7% per annum. If the share of profits in GDP reverts to normal as it tends to over the long term there will be a shift of about 7% of GDP from profits to wages and hence prices. The impact on consumer prices will be significant. All this shift requires is an improvement in consumer confidence and there are signs that this is occurring to a significant extent, enough to cause a change in consumer behaviour.

Markets

Given the falling interest rates and bond yields equity markets have performed rationally not exuberantly and valuations are within the parameters that would be expected in the prevailing conditions and discount rates. However bond yields are showing signs of turning upwards which will make any further substantial gains in equity markets more difficult to achieve. In short bond prices are likely to fall and equities are unlikely to make progress and could well fall back from this level.

Property markets are beginning to show a bit of resilience as the pathway out of the pandemic becomes clearer. However there are indications that people's work patterns might not change that much from the previous pre pandemic behaviour which would also be supportive to commercial property. Uncertainty still prevails though which is likely to dampen enthusiasm and prevent any significant progress in this market.

Within the alternative space large infrastructure assets are beginning to look overpriced as demand for them has increased due to the weight of money being devoted to this area. Smaller projects are still showing attractive returns as the balance between supply and demand appears more equal. Likewise in private equity those investors prepared to search for smaller lot sizes are likely to see higher returns than at the upper end of the market. The private credit market shows better returns than conventional fixed interest but, depending on how the instrument is structured headway is likely to be difficult if interest rates do rise significantly.

Cash continues to remain unattractive except for facilitating portfolio adjustments.

Portfolio recommendations

Despite the team's best efforts the equity portion of the portfolio remains north of 75%. In an increasingly inflationary climate equities have become

less attractive. Other quoted asset classes are equally unattractive and should receive no further investment.
This leaves the alternatives portion of the portfolio with a huge amount of work to do and with a large investment requirement.
Borders to Coast will struggle to invest the amount of money that the pension fund has already committed to them and struggle even more to invest what is needed by the overall fund over the medium term. Furthermore they are not offering the wide spectrum of investment approaches which will serve the fund well over the longer term. Some of their chosen managers are working in very crowded marketplaces which will make attractive returns difficult to achieve. Although it will put the internal team under pressure I believe other alternative managers should be sought to work alongside Borders to Coast. In my opinion this is the only way we will come close to achieving the desired alternatives weighting as set out in our strategic asset allocation. Maybe Borders to Coast should be viewed as a preferred fund manager, as they already have been, but certainly not an exclusive one. If other manager's can do a better job, the pension fund should feel free to use them.

Peter Moon

9 June 2021