Independent Adviser's Report for Teesside Pension Fund Committee

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1. When I last wrote in June, I suggested that a global recovery was now in place, but that was not necessarily a good environment for financial markets. I said there was a growing likelihood that the long rising market in equities (by some measures since 1981) would end over the next twelve months.

2. Recent headline economic numbers show a post-COVID recovery in most parts of the world, as might be expected after the unprecedented plunge in 2020. For example, both the U.S. and the U.K. are forecast to grow by around 6 to 7% in 2021, though this is still not sufficient to take them back to 2019 levels of activity. However, recent indicators of business momentum are clearly slowing down, suggesting that the recovery has already reached its peak.

3. The one large economy on a different path is China. They took tougher countermeasures against the pandemic early on and their economy recovered sooner. However, in recent months growth has slowed down and the Peoples' Bank of China has in fact eased policy over the past few months, most recently in association with the likely insolvency of real estate developer Evergrande. **China's actions over the next few months are likely to be a more important determinant of the course of the global economic recovery than the U.S.**

4. New variants of COVID-19 continue to put pressure on the world's ability to move on. Despite successful vaccination programmes in many countries, new strains have caused a third wave of infections, even in hitherto relatively unaffected countries such as China and Japan. While this has not, at least in the West, resulted in many deaths, it has knocked back confidence in the world's ability to return to normal. The travel and entertainment industries have been particularly affected.

5. The authorities continue to provide substantial monetary and fiscal support but are now on the path of reducing it. For example, in the U.K. the Chancellor has raised NI contributions, which is effectively a tax rise, and the Bank of England's monetary policy is now no more than neutral.

6. This tapering of support has led some to fear a repeat of the 'taper tantrum' in 2013 when bond yields soared. This year, against investors' expectations, government bond yields have been falling over the summer. In my view the major reason for this is some 'stealth' tightening by the U.S. authorities - i.e. beginning to taper support without making it as obvious as the Bank of England. But it may also be down to investors' reduced appetite for risk as the recovery weakens.

7. Lower bond yields have resulted in a partial return to the 2020 investing environment. Tech and quality stocks have generally done well, buoyed yet again by good earnings figures. As a result, the U.S. market has continued to rise, while other equity markets – and value stocks in particular - have

gone sideways or fallen. The Chinese market has been weakest, affected by both slowing growth but also the likely insolvency of Evergrande.

8. **Inflation is at the centre of investors' concerns**. It is not surprising that easy money over 12 years has led to asset prices, housing in particular, rising even further. But supply-side bottlenecks in a wide range of commodities from natural gas through petrol to carbon dioxide have - for the first time since 2008 - led to a rise in high street inflation. U.S. consumer inflation rose by 5.3% in August, close to a 20-year high. The Bank of England is now forecasting 4% inflation in the U.K.

9. The consensus view, at least among commentators, seems to be that this is the start of a sustained period of higher consumer inflation. I am not so sure. Bond yields would normally rise to anticipate inflation but have been going in the other direction. There also remain many powerful disinflationary trends, such as technology, in place. That said, **higher inflation is clearly the major risk which the Fund faces, because of its impact on our liabilities, and it is sensible to invest to mitigate it.**

10. There are several possible scenarios for markets from here. In a more optimistic one, the Chinese authorities will ease policy further and provide an engine for continued global economic growth. The Federal Reserve will continue to 'stealth' tighten and may even raise rates slightly. Inflation will return to the 2 to 2.5% level and investor confidence will provide some support for equities.

11. In a less positive one, confidence and global economic growth tail off and investors are faced with either 'stagflation' if inflation rates remain high, or Japanese-style disinflation if they fall back. **Neither of these are comfortable places for equity investors**, which is why I believe the long rising market may be nearly over. Disinflation ratchets up the real value of debt, squeezing both investment and spending, with a negative impact on earnings. If, on the other hand, inflation remains high and long bond yields rise, the pressure will come on equity valuations rather than earnings, especially on the long-term growth tech stocks which dominate the US index.

12. Equities are also under threat from governments' attempts to extract more money from them, whether through anti-trust actions (e.g. EU vs Apple, China vs Tencent and Alibaba) or higher taxation (the introduction of a sales-based minimum tax rate).

13. I said last time that it is hard to see a painless exit in the longer term. The world badly needs higher interest rates so that money has a cost and borrowers can make rational decisions. With 'free' money they fall into the same trap as Japan did in the 1990s where debt levels rise without generating a return from the borrowing. However, higher interest rates would cause an immense political cost in the West, which politicians do not yet wish to pay. **The best hope is that China eases policy and engineers enough global growth to allow the West to raise interest rates.**

14. The Fund remains heavily weighted to equities. While the process of diversification away from equities continues, it is important that the Fund does not overpay for in-demand assets such as infrastructure. The substantial cushion of prudence built into the Strategic Asset Allocation by the actuary and the Fund means that there is little risk to the payment of pensions even in the more negative scenarios. However, the Committee should be aware that the funding level might well fall.