Independent Adviser's Report for Teesside Pension Fund Committee

William Bourne **1st December 2021**

Market commentary

1. When I last wrote in September, I warned that financial markets look increasingly vulnerable to a fall. I suggested that the key to what happens will be the reaction of Chinese authorities to the slowdown in their economy. If they choose to ease policy in order to generate growth, that will help global recovery. If they choose to focus on stability, that suggests a more muted trend in global economic growth. The spurt in inflation creates extra dangers in both these scenarios.

2. U.S. consumer inflation data showed a 6.2% annualised rise in October, the highest since 1990. The surge in oil and gas prices was the major input, caused by a mixture of demand from China, limited investment in new capacity, and some manipulation of supply by Russia. But other supply-side blockages, such as shipping container shortages and changes in work habits, are also playing a part.

3. The trajectory of global economic growth is slowing down. US growth figure (on an annualised basis) fell 2% in the 3rd quarter, down from 6.7% previously. U.K. growth slowed to 1.3% and has only just recovered to the pre-COVID level of activity. China's economy only grew by 0.2% quarter on quarter over the same period, and 4.9% from the period a year earlier. This reflects both their earlier recovery in 2020 and the slowing down this year. The Japanese economy contracted slightly.

4. The staging of COP26 in Glasgow has put the focus on the transition to a lower carbon planet. There is increasing alignment among investors around Net Zero by 2050 as a target. However, this does not mean that all countries and all companies will be net zero; some will still emit carbon, and others will have to move to negative emissions. Between 20% and 50% of power will be generated from fossil fuels even in 2050; and substitutes for plastics and cement, for example, are yet to be identified.

5. The latest COVID-19 variant, called Omicron, has led to new shutdowns and restrictions in many parts of the world. Government actions may turn out to be over-compensating for their previous slowness to act but, justified or not, the new uncertainty will have an impact on consumer behaviour generally. Businesses in areas such as entertainment, tourism and travel will be particularly impacted.

6. The authorities withdrew monetary and fiscal support earlier in the year, but in response to the slowing economy and the new Omicron COVID variant have relaxed policy recently. This may explain why central banks have not raised interest rates. On the other hand, the UK autumn budget firmly put the burden of paying for the Government's largesse on the taxpayer, both corporate and individual. Disposable income will therefore be squeezed, which may affect consumer spending negatively too.

7. Markets continue to be remarkably sanguine about events. Bond yields rose during the last three months in anticipation of a rise in interest rates but have fallen back since. Western equity markets paused earlier in the summer, but reached new highs in the autumn after better than expected earnings numbers.

8. Behind this lies the assumption, correct over 25 years, that central banks will yet again ride to the rescue if the problems get worse. Markets are dominated by the heavy skew (60% in total, 70% of Developed Markets) to the U.S., and within that to tech and consumer tech stocks, which may be less affected by a traditional economic downturn. Private equity managers have also been deploying their capital to bid for and acquire a swathe of quoted companies across the world (e.g. in the U.K. there have been offers, not all successful, for Metro Bank, TSB, William Morrison, and Meggitt). All this has been supporting western markets.

9. In contrast, Asian and Emerging Markets, where Chinese policy is now the dominant influence, have gone sideways over the last 12 months. The well-flagged defaults in the Chinese property sector (Evergrande etc) contributed to weaker performance as well as the slowing economy and a resurgence in COVID prevalence.

10. Corporate bond markets have showed some recent jitters on the back of worsening news. Investment grade bonds are implicitly backed, at least temporarily, by the Federal Reserve's underwriting. The rise in yields is therefore principally in junk bonds, not helped by the risk of contagion from Evergrande etc. Paradoxically, any further bad news here may drive central banks to pursue easier policy and help other financial assets.

11. One important question for investors is whether the current inflation level will be sustained or is simply a short-term blip. Energy prices look set to remain high and supply side bottlenecks from COVID and (for the UK) BREXIT are adding to the inflationary pressures. The authorities have little room for manoeuvre if these continue to build, and the risk of a policy error is growing.

12. Public equity markets have so far been resilient, but it remains hard to see a painless exit in the longer term. If policy is kept loose, the excess stimulus will probably continue to flow into markets for the time being. However, that cannot be continued forever. I think it is more likely that central banks err on the side of raising interest rates too soon to counter inflation, and consequently tip western economies into recession.

13. The Fund remains heavily weighted to public equity markets, where investors would normally see a background of rising inflation and falling growth as negative. The Fund is in the process of diversification, which will reduce the downside risk from a major fall in equity markets, but as previously noted this will take time to complete. However, the Committee should note that the Fund is well funded and the risk to pension payments is limited even in the more negative scenarios.