Independent Adviser's Report for Nottinghamshire Pension Fund Committee

William Bourne **16th May 2023**

Market Commentary

1. Three months ago I said that the risk of a recession seemed to have receded and policy-makers were managing to balance on their tight-rope of maintaining growth while bearing down on inflation. I commented that my personal view was more pessimistic, but that the consensus was against me.

2. Since then there have been a series of United States bank failures, starting with Silicon Valley Bank in California. Under the current fractional reserve banking system (i.e., where banks lend out a multiple of their deposits), all banks are reliant on maintaining trust. The loss of trust at SVB was caused by their holdings of long-term bonds, which have fallen substantially in value as yields have risen.

3. The United States Federal Reserve responded rapidly by confirming that all depositors at SVB would be covered by insurance so would lose no money. They did this because many SVB accounts comprised working capital for entrepreneurs and venture capital, who would immediately face a liquidity problem. If they failed, there would be numerous secondary effects on the economy. The Fed also expanded its balance sheet (i.e., renewed Quantitative Easing) massively to head off further bank failures.

4. The jury is still out on the latter, as three other U.S. banks have subsequently also failed and been taken over. The decision to guarantee all deposits has led to a debate on moral hazard and whether the state should act as a guarantor of last resort. Ultimately the burden falls on the taxpayer.

5. In Europe, for different reasons, Credit Suisse lost its depositors' trust and was taken over by UBS. The Swiss authorities disenfranchised shareholders in order to effect a rapid rescue, which inverted the normal credit hierarchy: equity holders received a return while AT1[1] bondholders did not.

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[1] Additional Tier Bonds were issued to provide additional capital at times of stress. They pay much higher rates of interest but in theory can be cancelled if, as here, the bank is subject to an extreme event. The case will certainly be subject to legal debate.

6. Inflation has continued to fall in most countries, partly because the price of energy has subsided. U.S. headline inflation is now below 5%. However, food price inflation remains very sticky, and as a result U.K. inflation still stands at over 10%. Markets continue to expect inflation to fall to the 2 to 3% range by the end of the year, but I note that it is still on a rising trajectory in Japan and parts of Europe.

7. Central banks are continuing their policy of raising rates to try to keep inflation down, but at the same time using their balance sheets to keep the financial system liquid and try and prevent more bank failures. Both bond and equity markets have risen in consequence, as some of this excess liquidity has flowed in their direction.

8. U.S. rates are now 5%, compared to 0.25% eighteen months ago. As a result the U.S. bond yield remains highly inverted (i.e., long term bonds yield less than short term ones), which is normally a firm predictor of a recession ahead. In this context the U.S. 1st Quarter corporate earnings showed a decline, the first since the onset of the COVID lockdowns. However, it is worth noting that the large tech stocks which dominate the market in the main beat their forecasts.

9. Looking forward, as last quarter, the fundamentals still look difficult. Growth in the west is at best going to be anaemic at around 1% over the next two years and a fall into recession is still possible. Emerging markets, led by China, will grow much faster, at about 4 to 5%, and their rate of growth will at the margin determine the overall outcome.

10. The uncertainty over the future course of inflation poses a conundrum for investors. If the authorities are right and it falls to levels around 2%, then cash and bonds provide a real return and yields are likely to fall too. Listed equities also historically do better in lower (but not very low) inflation environment valuations. On the other hand, the valuations of private assets have yet to be verified because of the lack of exit transactions, and there is room for disappointment.

11. If, however, inflation remains high, investors will look to purchase real assets such as real estate in order to provide some protection and will shun financial assets.

12. I do expect inflation to subside, while remaining higher in the U.K. than other countries because of the various supply side bottlenecks. I expect the extent of the rise in interest rates will inevitably tip western economies into recession at some point. However, central banks have made it clear they will use Quantitative Easing to offset the economic impact of financial crises while continuing to keep rates high. That probably swings the main scenario for financial markets closer to a benign one. While another major leg downwards is still possible, I have moved closer to the consensus in expecting markets to maintain their current levels.