Independent Adviser's Report for Nottinghamshire Pension Fund Committee

William Bourne **10th September 2020**

Market commentary

1. When I last wrote on 1st June, most countries were still in lock-down as a consequence of the COVID- 19 epidemic. I commented that there would inevitably be a sharp economic slow-down globally, but because of the scale of central bank and government responses I was optimistic that there would be meaningful recovery, if not immediately at least within the time scale of a normal recession. Against this background I thought that markets would continue to trend upwards unless a political shock threw them off course. I also said that our focus should be on the longer term implications of recent events and in particular on the course of inflation.

2. Public markets have indeed risen. UK 10-year gilt yields fell to a low of 0.1% (ie. the annual return on a £1,000 investment for the privilege of lending your money to the Government is £1), their lowest ever, and two year gilt yields at the time of writing stand at near zero. The US equity market (S&P 500), after falling 34% between January and March, now stands within 1% of its January all-time high. UK equities have not done as well because they are more weighted to oil and financials.

3. Private markets have been more difficult to evaluate because they only provide net asset value (NAV) estimates once every three, six or 12 months. In particular it is likely that some real estate NAVs will be marked down as the change in living styles (more on-line shopping and perhaps working from home) begins to affect the price of property.

4. The global economy is on course to fall around 5% in 2020 (IMF data). The IMF expects it to grow by 5.6% in 2021 on the back of the various stimuli. While unemployment has risen and will rise as government support for business is withdrawn, the political imperative in democracies is to get money into the hands of the 'have nots' - a theme I have mentioned in previous reports. They are much more likely to spend it and to spend it domestically because of the restrictions on travelling. The actions of governments can either help or hinder the economy, but I concur with the IMF view that we will see a global recovery over the next 12 months.

5. The UK economy fell by a headline 20% in the 2nd quarter, and has been slower to recover than other economies, partly because we were in lockdown for longer. A recent Bank of England report suggests that economic activity will only recover its 2019 level at the end of 2021. Despite this, the BoE has already eased off on monetary easing and the furlough model will be ending in October. Although the trade balance has benefited from lockdown (fewer holidays abroad, fewer purchases of motor vehicles), sterling has been in a long-term

downtrend for 35 years, reflecting the lack of consistent policy leadership much of the time. In my view, if the economy stagnates at this lower level or there are any political shenanigans, the risk of another lurch down in the exchange rate is growing.

6. The traditional response to a sterling crisis has been to raise interest rates, and there is plenty of scope to do that. However, I doubt the current Government, already on the defensive over its handling of the crisis, has the appetite to do that. The alternatives are to cut back the fiscal largesse already promised, to raise taxes significantly, or - less likely but not impossible - to reimpose some form of currency control. Any of these reactions would deepen or prolong the recession in the UK. The one ray of sunshine here is that it may concentrate minds when negotiating the post BREXIT regime because neither the EU nor the UK will want a further burden on their economies.

7. Last quarter I mentioned the following longer-term changes:
   - Global trade will be permanently lower as companies choose to diversify their supply chains.
   - The shift to the digital economy will accelerate - more working from home and on-line shopping.
   - Travel patterns will change – less business and leisure travel.
   - Inflation is inevitable, the question is whether sooner or later.
   - Greater acceptance of state intervention in lives (and less enterprise).
   - Changes in political norms, perhaps away from democracy to a less orderly world.

8. In my view all these remain in place. The first three will have most impact on individual companies and sectors. There will be winners and losers, but it is for the Fund's managers to navigate those waters. I will therefore focus my remaining comments in this report on the last three.

9. There is still a powerful long-term deflationary trend in place coming from technical innovations. Producer prices fell sharply (OECD data) in 2020 Q2 and CPI is still hovering around 0- to 1% in all major economies as a consequence of the downturn, albeit food inflation is higher. A retreat from globalisation and a move away from market capitalism (ie. greater state involvement) would both be inflationary in nature, but a sustained rise in inflation is in my view still a number of years away.

10. China and the US continue to move apart from each other. Both have good reasons to do business with each other, but China now considers itself as an equal to the US with its own sphere of influence. China has been successful in building capacity and know-how in many areas from rare earths to artificial intelligence, but the US remains well ahead in military sophistication. In the long-term I expect this to lead to a world of two super-powers and other countries will have to choose whose 'gang' they want to be in. In the short-term further friction is likely, especially if Trump wins the US election.

11. Returns from all risk asset classes are likely to be lower as free market capitalism is reined in. Bonds look more vulnerable than equities given their current valuations. However, unless the world falls into depression (ie. an L-shaped 'recovery'), which in my view is unlikely, this outcome is well within the bounds of actuarial prudence and should not precipitate any change of course for the Fund.

RECOMMENDATION/S

That members consider whether there are any actions they require in relation to the issues contained within the report.