Independent Adviser's Report for Nottinghamshire Pension Fund Committee

William Bourne **6th February 2023**

Market Commentary

1. In December I said that while there was greater clarity about the future, the immediate course of markets looked challenging and that a global recession was quite likely. My pessimism has not yet been justified. Equity markets have risen, and while growth has slowed, recent data suggests a shallow recession at worst.

2. Central bank policy has shifted. While both the Federal Reserve and the Bank of England raised rates again to 4.75% and 4% respectively, they signalled that further interest rate rises will be more muted. The Federal Reserve is also expanding its balance sheet again to counter the harsher effects of higher rates on fragile parts of the financial system. At the same time the Bank of China has eased monetary policy substantially, presumably to cope with the impact of their COVID lockdowns.

3. One major consequence of this has been a reverse in the US dollar's fortunes. I commented last time that it had been very strong, but the Trade Weighted US $ index has now fallen 7.5% in three months. This has benefited Emerging Markets in particular.

4. Inflation rates continue to fall in most countries, but the immediate outlook for 2023 remains relatively high. For example, the IMF's latest forecast[1] is 7.3% in 2022, 4.6% in 2023 and 2.6% in 2024. Bond markets continue to price in longer term inflation at around 3%, and the Bank of England has publicly said it expects inflation to be at around 2% by the end of 2024. Food and groceries inflation is currently running much higher, at 10%+ globally.

5. There has been a significant improvement in economic data and forecasts generally. For example, the IMF's forecast[2] upgraded growth for most countries. They expect global 2023 growth to be at 2.2%, tilted towards China and emerging markets. This is still low compared to history, but 0.2% higher than their October forecast. The outlier remains the U.K. which the IMF downgraded by 0.9% and

[1] IMF World Economic Outlook Update, January 2023

[2] ibid

expects uniquely to undergo a shallow recession. Against this general optimism, there is anecdotal evidence of job losses, lower spending and companies struggling to refinance debt.

6. Equities have again been remarkably resilient and the UK FTSE100 (heavy in oil and financial stocks) managed to reach an all-time high. US earnings grew about 4% in 2022 despite a decline, albeit less than expected, in the fourth quarter. Valuations are close to the post-2008 average, but higher than longer term norms[3]. Equity investors may be pinning their hope on a revival of Chinese growth.

7. Not all is rosy, however. Bond yields have fallen over the past three months and the U.S. bond yield curve, which is a traditional and usually reliable signal of recession ahead, is substantially inverted. I suspect this inversion is to do with the fragility of short-term corporate lending markets, a theme I have commented on in the past, but it may still be accurate in warning of an economic slow-down.

8. Fundamentals still look difficult, with low growth in most western countries, a likely worsening of the situation in Ukraine, sticky inflation, and increased friction and costs on the supply side. As one example of the latter, the cost of 'on-shoring' production of high-end semi-conductor chips in the U.S. is about 50% higher than doing so in Taiwan. Even large tech companies, who might be considered less affected by fundamentals, are laying off staff (e.g. Google, Amazon).

9. If inflation comes down as expected, cash will begin to deliver a positive real (i.e. after inflation) return. That will make it easier for the pension fund to deliver its target return, but the higher cost of money will also mean a greater level of risk in investing generally. The opportunities for investors will come where companies need to refinance themselves, whether via the stockmarket, debt markets, or private markets. However, investors will need to show discrimination in the prices they pay, and corporate defaults will be more common.

10. The U.K. finds itself the laggard among developed countries, as the Bank of England acknowledges. This is down to a combination of the aftermath of the autumn LDI fiasco (higher bond yields, less trust), BREXIT (more trade friction, higher inflation), labour unrest (lost growth, more uncertainty), and the lack over many decades of a long-term strategy at government level. From a financial perspective, the main implication is likely to be a higher risk premium on U.K. assets.

11. My personal view is more negative than the current market one. Policy-makers so far have managed to balance on their tightrope, but the risk that the economic optimism proves ill-founded and the world falls back into recession has not gone away. While I shall not be surprised by another leg down in markets, I have to say that the consensus today is against me.

[3] S&P 500 Price to Earnings ratio is 17x, compared to long-term average 14x (Factset 31/1/23)