Independent Adviser's Report for Nottinghamshire Pension Fund Committee

William Bourne **20th November 2023**

Market Commentary

1. Three months ago I wrote that inflation was declining, that interest rates would remain high, and that while I was braced for some market volatility, especially in currency markets, the environment was relatively benign for risk assets such as equities. There has been less volatility than I expected, though both the US$ and the Japanese yen have been the subject of some speculation.

2. Inflation continues to fall in most of the world but remains above the 2% level which many central banks target. The latest U.S. annual data point was 3.2%, that in Europe 4.3% and in the U.K. 4.6%. These are dramatically lower numbers than a year ago, but the conflicts in the Middle East and (on-going) in Ukraine may lead to slower reductions in the future than the market seems to expect.

3. The European Central Bank raised interest rates during the quarter to 4.5%, but for the time being most central banks have paused their programmes of rate rises. However, there are unlikely to be falls for some time to come until inflation is clearly under control. Central banks, except for the Bank of Japan, are likely to err on the side of caution.

4. Another reason why falls in interest rates look unlikely is that U.S. economic growth in the 3rd quarter came in at 4.9%, well above expectations. Non-farm payrolls (i.e., employment) was also higher. Consumption was robust, but the key driver seems to have been exports and inventory restocking. Other countries do not seem to have participated in the same way, and some surveys and indicators suggest that the GDP data overstates the U.S. recovery.

5. I suggested last time that bond yields would rise further. U.S. bond yields have risen to a current level of around 4.5% (ten year tenor) but have stabilized there. U.K. yields rose to a peak in October but have since fallen again. As a result the yield curve inversions I have noted over the last twelve months have reduced from nearly 100bps to around 40bps. Any inversion is still a recession indicator which cannot be ignored, but the reduction suggests a degree of normalisation.

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6. In Japan the Bank of Japan is now allowing 10-year yields to rise above 1%, signalling an end to its policy of using its balance sheet to control the yield curve. In my view this is a victory for market forces, showing that the authorities cannot repress bond yields indefinitely. The implication is that bond yields generally will rise further to reflect the worsening debt problems of western governments.

7. Higher bond yields create higher debt service costs for governments. The U.S. must finance or refinance around one third of its total stock of debt, or $11 trillion, over the next fifteen months. Much of this is likely to be at substantially higher rates than what was in place previously. The U.S. Fed seems to be reacting by financing more short-term and less by long-term bond issuance.

8. China, now the engine of growth for much of the world, showed some recovery, with year-on-year growth at a similar number to the U.S. This was despite more travails in the real estate sector, with another large developer, Country Garden, missing a bond payment. More than 50% of the largest 50 Chinese real estate developers have now failed over the past two years.

9. Over the twelve months to September 23, equity market indices have risen by between 14% (U.K.) and 30% (Europe and Japan). However, leadership has been narrow, and (for example) a lot of climate change equity strategies have underperformed substantially.

10. In contrast to equities, infrastructure, which is considered a good match for pension fund liabilities, has performed poorly in the last six months. There are specific concerns over the future profitability of renewable energy, as is evidenced by the Danish company, Orsted, cancelling two major U.S. offshore wind projects. More generally the realisation that interest rates and bond yields are going to stay higher for longer has hit valuations of future income streams. This can be seen across long-duration assets, but perhaps because of its very long-term nature infrastructure has been worst hit.

11. Geo-politics and politics remain a source of risk and disruption. While the increasing number of military confrontations may not directly affect markets, they suck up resources, capital, and labour and contribute to greater uncertainty. At the same time the next U.S. election is looming, which makes it even less likely that the current (or future) administration will take the fiscal actions necessary to cope with the ever-increasing budget deficit.

12. In the longer-term the greatest risk to the Fund remains that of higher inflation. However, in the nearer term, it is the damage caused to valuations of all asset classes by further rises in bond yields. So long as assets continue to deliver an income stream, the direct consequence will primarily be seen through lower funding ratios, but the secondary impacts could be considerable. The best defence the Fund has is broad diversification across a range of asset classes.