Independent Adviser's Report for Nottinghamshire Pension Fund Committee

William Bourne 9th February 2024

Market Commentary

1. Three months ago I said that the main risks to the fund were higher inflation in the longer term, and higher bond yields in the short term. I have not changed this view, but both have declined since I last reported. I also commented that geo-politics and politics remain a source of risk and disruption, and the latest events in the Red Sea and Jordan bear that out.

2. Inflation has continued to fall in most of the world, by more than expected in the United States in particular. Deflation in China, where consumer inflation stands at -0.8% and producer price inflation at -2.5% year on year, is an important factor. However, wage cost growth in the West remains significantly higher (e.g., U.K. is growing at 8%, U.S. 4%) which may spark a resurgence in inflation.

3. The Federal Reserve said that it could see up to 75bps of interest rate cuts in 2024, which prompted falls in bond yields and a stock market rally. It became apparent that any rate cuts were likely to be later in the year, but that did not stop the U.S. stock market going to a new high as Amazon reported better than expected earnings, and Meta for the first time paid shareholders a dividend. Elsewhere central banks made little changes to interest rates.

4. United States economic growth grew by 2.5% in 2023 after a stronger second half. Non-farm payrolls (i.e., employment) rose by 353,000 to an all-time high, considerably higher than expected. It underlines the fact that the U.S. economy seems to be on a better path than most of the rest of the world. Correspondingly, interest rate cuts may be slower than the market expects.

5. In contrast China, the world's other engine, has been struggling with deflation, despite relatively loose monetary conditions. The preliminary estimate of 2023 economic growth was 5.5% after 3.0% in 2022, but manufacturing activity has now fallen for four months with both domestic consumption and export weakening. Evergrande (second largest real estate company) finally went into administration.

6. A recent theme in my reports has been the growing levels of public debts as politicians struggle to keep expenditure and revenue in balance. The U.S. duly announced its largest ever issue of new

public debt ($70bn) to take place in April. It is increasingly relying on shorter-term financing, which will need to be refinanced sooner rather than later. If (as I expect) bond yields rise further the cost of debt service is likely in due course to put pressure on government budgets.

7. Geo-politics remains a source of risk, but markets have so far not been greatly disrupted even when there has been a threat to oil supply security, as in the Red Sea. However, the cost of these more localised confrontations to the West will have an impact on both fiscal spending and also on inflation — governments are rarely price sensitive, especially when it comes to military expenditure.

8. Politics is likely to be increasingly important over the next twelve months. Trump's campaign is building momentum, but the pending legal court cases make it hard to read what might happen in the Presidential election. The Democrats consolidated their hold on the Senate (now 51 out of 100 seats) which will act as a counterbalance should Trump win.

9. I remain reasonably positive about the outlook for equities and risk assets in the shorter-term. The combination of moderate growth (led by the U.S.), moderate inflation, and governments who ahead of elections are likely to keep fiscal policy reasonably loose is quite benign. The liquidity background is also looser than the newspaper headlines which focus on interest rates suggest.

10. The impact of higher bond yields is the most likely risk to this scenario. Markets will at some point wake up to the fiscal incontinence of governments, especially the U.S., and the sheer volume of refinancing required. Market theory suggests longer-term bond yields should rise substantially in response, but the authorities cannot afford to let that happen because of the cost of servicing their debt. They will probably therefore look to find ways to cap bond yields, such as relying on short-term instruments or forms of financial repression.

11. The question is at what level will bond yields settle. It is quite possible that the current environment will continue throughout 2024, which is reasonably benign for other asset classes. However, at some point I expect the ten-year bond yield to test 5% again, and perhaps rise higher. That might cause markets more concern if it is sustained.

12. In the longer-term (much) higher inflation seems to me to be the inevitable consequence of ever-increasing government spending, especially in the U.S., and the growing reliance on short-term financing. We are effectively going to the Magic Money Tree. This will have a negative impact on future service costs and consequently on liabilities. I therefore recommend that the strategic focus should remain on building up allocations to assets which will provide some mitigation to this long-term inflation risk.