Independent Adviser's Report for Nottinghamshire Pension Fund Committee

William Bourne **11 March 2021**

Market commentary

1. When I last wrote in December, I was cautious about bond markets but generally expected equities for the time being to carry on gently upwards. Since the COVID crisis broke in March 2020 I have consistently argued that the scale of monetary and fiscal support makes economic recovery inevitable, providing substantial underpinning to equities.

2. Bond yields have risen further in recent months and the UK 10 year government gilt is now trading at a yield of 0.6% compared to 0.4% in early December and 0.1% in August. By comparison the equivalent maturity US bond trades at a yield of 1.3% (0.9% in December, 0.5% at the low). **It is normal bond yields to rise at this stage in the cycle, and is fully consistent with economic recovery**.

3. Inflation expectations have gone up, with industrial commodities such as tin and copper particularly strong. However, there are few signs of inflation on the high street and I do not believe this is the harbinger of a major surge in either inflation or bond yields.

4. The major theme of the quarter has been harsher lockdown in many western countries to try and prevent health systems being overwhelmed. This contrasts with the steady return to normality in many Asian countries. The authorities have once again done their best to provide ample fiscal and monetary support, but industries such as airlines, hotels and retail remain under the cosh.

5. **In aggregate US companies have reported 2020 Q4 revenue 1% higher than one year earlier**, which is a reflection both of the support provided but also the scale of the economic recovery. 2020 earnings per share were 12% lower than 2019, but analysts expect a rise of 23% in 2021. There is less hard data from China but most companies seem to be reporting earnings growth despite COVID.

6. On the political front, President Biden's new administration is showing signs of reversing a number of Trump policies and working more collaboratively with other countries. However, it is too early to be confident what direction it will take and there are early signs of friction with China.

7. The UK BREXIT transition period ended on 31st December. While the worst case scenarios have been avoided, trade volumes have diminished dramatically. Financial services remain in

limbo, without any agreement. The combination of this and COVID resulted in 2020 economic growth at -10%, the worst for 300 years. We can expect some bounce-back as the pandemic recedes and new arrangements settle down, but despite the vaccination success UK growth is likely to lag the rest of the world.

8. China was first affected by the pandemic and looks to be first out. The authorities used markedly less stimulus in 2020 than other countries and remain roughly neutrally positioned. The economy grew by 2.3% in 2020, the only major economy to expand. As the engine of the region, I would expect Asian economies broadly to follow the same path over the next few months and western economies to recover after them. Already there are plenty of signs of a healthy increase in trade, such as container rates and the increase in industrial commodity prices.

9. Against this background equity markets, except for the UK, have reached new highs. There has been some change in leadership away from the US and tech, but it is not yet a major shift. Central banks are still pumping money into the economy, not daring to take away the punchbowl from the party. The UK is still being dragged down by the heavy 'old world' weightings in the FTSE 100 index.

10. **As the economy recovers, it is normal for investors to sell financial assets and invest in the real economy**. Financial markets are good at anticipating recovery but rarely do so well during it. I expect the same to happen this time and equity markets to peak at some point in 2021. If bond yields carry on rising to a level where they offer a positive real yield, investors may choose to allocate back to them. This may result in further selling of equities.

11. I commented last quarter that real estate remains the asset class with most uncertainty hanging over it**.** Core quality assets, outside retail and travel, have not been too affected and landlords have been able to collect 80 to 90% of their rent. Valuations and transaction volumes seem to have crept up in the last quarter as a degree of certainty returns. However, the renewed lockdown has intensified stress in the most affected areas and, as I said last time, at some point there will be substantial write downs. This will present both opportunities and risks for investors.

12. In the short term I would expect the current market environment broadly to continue but we are, in my view, approaching a turning point. I expect to see bond yield curves steepen and equity markets to peak in 2021 as investors shift from the growth stocks which have done so well to a broader market. My central expectation is that the steepening happens by long bond yields rising, but a possible alternative is that short rates move negative if super easy monetary policy continues.

13. Market returns from listed equities over the next few years may therefore underperform the actuarial target (6.7% including Private Equity). The Fund should gain some protection through the diversification into other assets such as infrastructure undertaken over the last few years. The actuary has built a level of prudence into his modelling, and in my view the Fund remains well positioned against a somewhat uncertain future.

RECOMMENDATION

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