Independent Adviser's Report for Nottinghamshire Pension Fund Committee

William Bourne **25th August 2021**

Market commentary

1. When I last wrote in June, I suggested that a global recovery was now in place, but that was not necessarily a good environment for financial markets. I said there was a growing likelihood that the long bull market in equities (by some measures since 1981) would end over the next twelve months.

2. Recent headline economic numbers show a sharp recovery in most parts of the world, as might be expected after the unprecedented plunge in 2020. For example, both the U.S and the U.K. are forecast to grow by around 6 to 7% in 2021, though this is still not sufficient to take them back to 2019 levels of activity.

3. The one large economy on a different path is China. They took tougher countermeasures against the pandemic early on and their economy recovered sooner. However, in recent months there has been a slowdown and the Peoples' Bank of China has in fact eased policy in recent weeks. **China's actions over the next few months are likely to be a more important determinant of the course of the global economic recovery than the U.S.**

4. New variants of COVID-19 continue to put pressure on the world's ability to move on. Despite successful vaccination programmes in many countries, new strains have caused a third wave of infections, even in hitherto relatively unaffected countries such as China and Japan. While this has not, at least in the West, resulted in many deaths, it has knocked back confidence in the world's ability to return to normal. The travel and entertainment industries in particular have been affected.

5. The authorities continue to provide substantial monetary and fiscal support, but the level is decreasing in the West. There were some fears of a repeat of the 'taper tantrum' in 2013 when bond yields soared as the Fed tried to taper their support for the market. **In fact, against investors' expectations, government bond yields have fallen.** The U.S. 10-year bond has fallen from a 2021 high of 1.6% to 1.3%, and the U.K. equivalent from 1.0% to 0.6%. In my view the major reason for this is some 'stealth' tightening by the U.S. authorities - i.e. beginning to taper support without making it obvious. But it may also be down to investors' reduced appetite for risk as the recovery weakens.

6. Lower bond yields have resulted in a partial return to the 2020 investing environment. Tech and quality stocks have generally done well, buoyed yet again by good earnings figures. As a result, the U.S market has continued to rise, while other equity markets – and value stocks in particular - have gone sideways or moved down.

7. **Inflation is at the centre of investors' concerns**. It is not surprising that continuing easy money policies have led to asset prices, housing in particular, rising even further. But for the first time in twelve years a combination of supply side bottlenecks and Chinese demand for commodities, have led to a rise in high street inflation. U.S. consumer inflation rose by 5.4% in July, for the third month running the highest level since before the Global Financial Crisis in 2008/9.

8. The consensus view, at least among commentators, seems to be that this is the start of a period of higher consumer inflation. I am not so sure. Bond yields would normally rise to anticipate inflation but have been going in the other direction. There also remain many powerful disinflationary trends, such as technology, in place. That said, higher inflation is clearly the major risk which the Fund faces, because of its impact on our liabilities, and it is sensible to invest to mitigate it.

9. There are several possible scenarios from here. In a more optimistic one, the Chinese authorities will ease policy further and provide an engine for continued global economic growth. The Federal Reserve will continue to 'stealth' tighten and may even raise rates slightly. Inflation will return to the 2 to 2.5% level and investor confidence will provide some support for equities. In a less positive one, confidence and global economic growth tail off and investors are faced with either 'stagflation' if inflation rates remain high or Japanese-style disinflation if they fall back.

10. **Neither of the latter are comfortable places for equity investors**, which is why I believe the long bull market may be nearly over. Equities rarely do well in disinflationary periods, as it ratchets up the real value of debt. Today the West has high levels of private sector and increasingly government indebtedness. A squeeze on both investment and spending would be the likely consequence, with a negative impact on earnings.

11. If inflation remains high, the pressure will come on equity valuations rather than earnings, especially on the long-term growth tech stocks which dominate the US index. They are also under threat from governments' attempts to extract more money from them, whether through anti-trust actions (e.g. EU vs Apple, China vs Tencent and Alibaba) or higher taxation (the introduction of a sales-based minimum tax rate).

12. I said last time that it is hard to see a painless exit in the longer term from where we are today. The world badly needs higher interest rates so that money has a cost and borrowers' decision-making is rational. With 'free' money they fall into the same trap as Japan did in the 1990s where the level of indebtedness rises without generating a return from their borrowing. However, higher interest rates would cause an immense political cost at least in the West, which politicians do not yet wish to pay. **The best hope is probably that China engineers enough global growth to allow the West to raise interest rates.**

13. The Fund has a long-term investing horizon and is invested in a diversified manner in order to mitigate the risks of an extended decline in equity markets. There is a substantial cushion of prudence built into the Strategic Asset Allocation by the actuary, and we have been building up assets which provide some inflation protection for a number of years. **However, the Committee should be aware that in the more adverse scenarios the funding level might well fall.**