Linchpin

Independent Adviser's Report for Nottinghamshire Pension Fund Committee

William Bourne **25th February 2022**

Market commentary

1. I 'called' the top of equity markets last June, suggesting that they were unlikely to rise further and there was scope for considerable downside. Over the ensuing six months, equity markets staggered on while economic growth slowed and bond yields rose. Since the New Year we have seen an acceleration both in the rise in bond yields and the swing away from tech and towards value stocks. Indices have therefore fallen by around 10%.

2. U.S. economic growth rebounded in the 4th quarter, but much of this came from companies rebuilding inventories. Growth elsewhere also exceeded expectations, but because of the Omicron variant, December and January data is weakening. **In general, economies have now reached or exceeded their 2019 levels of activity,** though the U.K. is a laggard in this respect.

3. The Russian invasion of Ukraine on 24th February was well anticipated, and apart from higher commodity prices has not at the time of writing affected investors' confidence much. However, second-order events clearly have the potential to upset markets considerably. In particular, **wars tend to be inflationary as they increase demand and reduce supply capacity**. The military (and governments) are less price sensitive than the private sector.

4. This comes on top of U.S. consumer inflation at the highest rate for over 30 years, 7.5% in January. The Bank of England expects U.K. inflation to peak at about 6% in April, before falling back to around 2%. Both banks are clearly on the warpath against inflation and have raised rates twice with the threat of more to come.

5. Bond yields have backed up considerably in anticipation of more rate rises. The U.K. 10-year bond is now trading at a yield of 1.44%, compared to a low of 0.11% in July 2020. The US equivalent trades at 1.96% but has not yet reached 2018 levels. **Higher bond yields are the pivot of the changes happening in markets**, as they affect the current valuation put on the future income stream deriving from all investments.

6. This is the main reason for a 15% fall in the US NASDAQ 'tech' index between mid-December and late January, despite better than expected earnings in many (but not all) cases. At the other end of the spectrum, cyclical stocks (e.g. energy, financials) have outperformed indices substantially.

7. **Almost all active managers underperformed in the quarter,** not just Schroders, because they have tended for ESG reasons to be underweight commodities and fossil fuels in particular. It is a reminder

that asking managers to take decisions for non-financial reasons is not without its risks.

8. Evergrande's (and other Chinese real estate developer) defaults have had little impact on broader credit markets, where spreads remain close to historic lows. For example, the non-investment grade bond spread over Treasuries is 7.3%, compared to 19.5% in March 2020 and 34% at the peak of the Global Financial Crisis. Asian corporate bond spreads have fallen since November, suggesting investors have confidence that the Chinese authorities are managing the situation effectively.

9. For some time now I have said that it remains hard to see a painless exit in the longer term, and markets seem to be cottoning on. **Central banks are tightening policy to ward off higher inflation, but the risk of a policy error is considerable.** Either political considerations mean they are too slow to react to inflation and it remains higher than the 2% target, or they tighten too harshly and tip western economies into recession.

10. **In the background, the trends are now more inflationary than otherwise**. Greater government involvement in resource allocation tends to drive higher inflation. The outbreak of war in the Ukraine can only exacerbate this. The fall in working age populations relative to dependents may drive up labour costs. Even the move to a carbon-free planet will involve substantial investment and a new allocation of resources, which often leads to inflation.

11. Against this, demand is likely to be subdued as higher energy and food prices act as a tax on western consumers, while technology continues to continue to drive costs down. **The swing factor in the short-term, however, remains the behaviour of central banks, and whether they can balance controlling inflation while maintaining some economic growth.**

12. My best judgement at the moment is that there is about a 75% chance that long term inflation stays below 4%. Under these scenarios, the Fund's funding ratio may slip slightly but should remain not too far from its current level. Even if there is a policy error leading to recession, while asset prices would fall, it is likely that liabilities would too.

13. **The most difficult scenario is one where inflation is sustained at 5% or more while growth is subdued – i.e. stagflation.** LGPS liabilities are indirectly linked to consumer inflation without a cap, and the only robust hedge, index-linked gilts, trade at a significant negative real yield - i.e. incur a large opportunity cost.

14. Despite the troubling events of the last few days, I do not advise any change to the Fund's long-term strategy. It is rarely right for long-term investors such as the Fund to react to short-term movements in markets. The Fund pursues a policy of investing across a diverse range of assets in order to mitigate risks including inflation, and lower returns from equity and bond markets generally. The actuary also incorporates a level of prudence when setting the discount rate and return target.

15. If markets fall sharply at the time of the next valuation on 31st March 2022, the funding level may be lower than in 2019, but in my estimation the Fund remains well positioned to pay pensions in full and on time.