Independent Adviser's Report for Nottinghamshire Pension Fund Committee

William Bourne **17th August 2022**

Market commentary

1. In May I warned that the chances of stagflation, i.e. lower growth and sustained inflation, were getting higher and that this was not a comfortable environment for pension funds.

2. The most pressing problem for the authorities is inflation. The latest data shows no sign of consumer inflation peaking, and the IMF forecasts that advanced economy inflation in 2022 will average 6.6% and developing economies 9.5%. June consumer inflation was 9.1% in the U.S. and 9.4% in the U.K. Japan is the only exception, where inflation remains at around 2%.

3. Central banks and bond markets are both forecasting that inflation will fall sharply on the back of the much tighter monetary policy conditions (i.e. interest rate rises). However, the supply blockages in food and energy caused by the war in Ukraine may well result in it remaining stickily high.

4. Europe is especially hostage to restrictions on gas flowing through the Nordstream1 pipeline. At the time of writing, the flow is 20% of normal volumes, which is exactly the level at which Germany will run out of gas in spring 2023. It is hard to believe that the Russian decision to cut supplies to this level is coincidental.

5. Elsewhere countries are adjusting to the new normal, looking to increase energy production from renewables, nuclear power, and fossil fuels. It will take time to put this in place and energy prices are likely to remain elevated for some time to come. The bigger problem is food inflation. Here a combination of Russia's blockade, lack of rain in Europe, and the higher costs of energy required to produce fertilizer is likely to result in inadequate supplies for at least the next 12 months.

6. The authorities appear determined to tighten policy to lower inflation rates. The E.U. central bank has finally raised its core interest rate above zero, U.K. rates have risen to 1.75% after the most recent rise, while U.S. rates are now 2.5%. The U.S. Federal Reserve has also withdrawn over 1 trillion dollars of liquidity from bond markets.

7. The Fed. has started to signal a slightly less aggressive approach to monetary policy and will certainly reverse course when they believe inflation is tamed. It is likely that the West at least is already in recession, but even so, I doubt they are ready to change direction in the next six months. The table below gives current IMF growth forecasts for growth and inflation over the next 18 months.

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GDP Real Growth (%)	World	U.S.	China	E.U.	U.K.	Developing	*Inflation*
2020	-3.1	-3.4	2.2	-6.3	-9.3	-2.0	*3.2*
2021	6.1	5.7	8.1	6.8	7.4	6.8	*4.7*
2022	3.2	2.3	3.3	2.6	3.2	3.6	*8.3*
2023	2.9	1.0	**4.6**	1.2	0.5	3.9	*5.7*

Source: IMF July 2022 World Economic Outlook

8. Since the April IMF report 2022 and 2023 growth forecasts have come down by 0.4% and 0.7% respectively, and the numbers for advanced economies' inflation have risen by 0.8% and 1%. Projected growth in the West is well below the trend at between 0.5% (U.K.) and 1.2% (Europe). The IMF comments that the risks to 2023 growth are skewed to the downside, and I agree. If Chinese growth fails to meet the 4.6% forecast (highlighted in the table), the numbers will look even grimmer.

9. In the first half of 2022, the U.S. equity market experienced its second worst January to June fall ever, as sky-high valuations corrected. Since then, markets have recovered ground: possible reasons for hope are that the sell-off has gone too far; resilient corporate earnings; or anticipation that the Fed will change tack soon. For example, U.S. companies' 2nd quarter earnings were about 10% higher than in (admittedly COVID-affected) 2021. But even within the same industry, there have been different experiences(e.g. Credit Suisse vs Citibank, Alphabet (Google) vs Microsoft.

10. Consumers are clearly in for a hard time: their disposable income will fall as more goes to food and energy; governments will be looking to find a way to raise money from the tax base and higher interest rates will result in larger mortgage payments. There will be some positive offset from greater public and private investment. For example, in the U.K. the Government is focusing on infrastructure but is also going to have to invest in other areas such as national defence and security. I suspect the level of 'on-shoring' i.e. bringing production back to the U.K. will also increase.

11. These may well be the long-term trends to follow, but in the short-term, I doubt they will be in place in time to prevent another leg down in equity markets, particularly if I am right about low economic growth. It would be normal behaviour if bond yields were to fall back further (i.e. prices rise) as investors look for safe havens.

12. Closer to home, Boris Johnson's resignation had little impact on markets. However, the choice of his successor may be more important. Truss seems to be prepared to gamble on higher growth based on tax cuts and more borrowing. Sunak would provide more comfort to markets as, despite his largesse over COVID, he is seen as – more financially responsible, but at the time of writing looks unlikely to win.

13. As I commented last quarter, the Fund should brace itself for lower returns over the next few years, and quite probably negative real returns from listed equities (53.5% allocation) at a time when the cash pay-outs to pensioners will be rising faster with inflation. However, the policy the Fund has taken over the last seven years of steadily diversifying into private markets such as infrastructure will help to mitigate both the risks of lower growth and higher inflation.

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