Independent Adviser's Report for Nottinghamshire Pension Fund Committee

William Bourne **18th August 2023**

Market Commentary

1. When I wrote in May I had changed my view from an expectation of recession to one of growth flatlining. My principal reason was that the response of central banks to regional bank (e.g., Silicon Valley Bank) collapses in the U.S. They substantially loosened monetary policy by expanding their balance sheets at the same time as they continued to raise interest rates to combat inflation. This was a more benign scenario for financial markets than the previous regime of tightening.

2. Three months later that broadly seems to have been the case. The U.S. has so far avoided recession, with GDP growth around 2%, while the U.K. and Eurozone are showing almost zero growth. Chinese growth has slowed down in the most recent quarter but is still positive. Japanese growth exceeded expectations but is still relatively modest at about 1% over the last 12 months.

3. More importantly, inflation is clearly coming down in most countries. The U.S. inflation rate in July stood at 3% compared to 8% nine months ago. There are some notable exceptions, however. China has fallen into deflation as the economy falters. In contrast, inflation in Japan, where the central bank's primary objective is to eradicate any deflationary psychology, has risen to around 3%. Finally, labour and supply side constrictions mean that U.K. inflation remains higher at around 7%.

4. Central banks have continued to raise rates, albeit at a slower pace than previously. The bond yield curve in most of the West is as a result steeply inverted (i.e., you get paid more for lending money to the Government short term rather than long term). This abnormal condition is impacting the pricing of a range of assets. As two examples, the Halifax index of U.K. house prices, where variable (i.e., short term) mortgage rates are a major input, it is now 2.4% lower than it was 12 months ago; and the valuations of infrastructure assets, which are priced off long term gilts, have seen 10 to 15% declines.

5. One question is whether bond yields have further to rise from the current 4 to 4.5% range. While inflation expectations are subsiding, there are good fundamental and technical reasons for expecting yields to rise further. Governments (U.S., and the U.K. in particular) have to issue a lot of debt; if the economy starts to recover, we can expect money to move away from safe havens; and the term

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premium[1] is at an all-time low. In my view there is scope for further volatility in bond yields both on the upside (more likely) and the downside.

6. In this context we should note two important signals. Fitch, a major credit rating agency, downgraded U.S. Treasuries from AAA to AA+ on account of the rising public debt. As U.S. Treasuries are used as the risk-free asset in all financial theory, this may have secondary effects on all financial asset pricing. Secondly, after a considerable tussle with market speculators, the Bank of Japan is now allowing 10-year yields to rise from 0.5% to 1% (compared to the U.K. and U.S. above 4%). This may seem trivial, but suggests that even large central banks recognize they cannot completely buck the market.

7. Equities have remained remarkably resilient through this cycle of rising rates. One explanation is that investors are looking towards the next cyclical earnings upswing. An alternative one is that the indices are dominated by the big U.S. tech. stocks which are, at least in aggregate, still expanding their markets. A third is that markets think interest rates are close to a peak and will start to come down.

8. The U.K. remains in its own rather uncomfortable place. I note in particular that government debt is now 100% of annual GDP, having been around 40% for much of my lifetime. The Bank of England will have to issue around £240bn of gilts in this financial year, £100bn more than last year. U.K. equities are relatively cheap, possibly reflecting the higher risk premium which investors require on U.K. assets following the events of the last few years.

9. If inflation falls towards target levels, which is probably the consensus now, in the medium-term this environment is relatively benign for risk assets such as equities. However, there is scope for some negative surprise in the shorter term: Chinese deflation is worrying; bond yields are likely to rise further; central banks are likely to err by over-tightening to ensure they bring inflation down; geo-politics are unstable, especially with a U.S. presidential election only 15 months away, and the war in Ukraine seemingly moving into a new phase.

10. I therefore expect markets to be volatile in the shorter term, which from experience often begins with currency markets. U.K. gilts at 4.5% offer a good real yield if inflation comes down to the Bank of England's 2% target, but I believe they will trade at higher yields over the next couple of years, and inflation may be slower to come down. That said, there will come a time to allocate more to bonds, as they represent the best match for the Fund's future cash liabilities. But in my view it is not quite yet.

[1] The term premium is the extra return investors receive for being willing to lock in today's return for the long-term. It should theoretically be arbitraged away to zero, but currently stands at an extreme level of -1.5%. While there are some good fundamental reasons behind this, at some point it will revert to a more neutral level.

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