Linchpin

Independent Adviser's Public Report for Nottinghamshire Pension Fund Committee

William Bourne **8th January 2020**

Market Commentary

1. In September I noted that there were numerous - mainly political - dark clouds around but that they seemed largely discounted by the market. I thought authorities were poised to cut taxes/raise spending significantly, and that central banks would react to trouble by easing monetary policy. I considered this a supportive background for markets generally.

2. In practice government bond yields have fallen sharply before recovering (eg. UK 10 year gilt yield almost halved from a peak 0.81% in July to a low of 0.41% but are now back at 0.76%). The markets at the time ascribed this to a fear the world would sink into Japanese style deflation and low growth but, in my view, there were significant technical factors at play as well which will keep yields low.

3. Central banks in many countries (US, Japan, Europe) are running looser monetary policy (the jargon for this is QE4) and politicians around the world are about to loosen fiscal policy as well. The UK election result has driven home the message that **governments of whatever colour need to get money into the pockets of those who have not done well in the last 10 years**.

4. Against this background, many investors have therefore concluded that **equities at current levels may be expensive but are less risky than, for example, government or corporate bonds**.

5. That is not to say that all is well. From a long-term perspective, huge imbalances remain between:
   - Rich and poor, especially the asset-rich and the asset-poor;
   - Nations with an export surplus and those without;
   - The indebted West (I include Japan) and China;
   - And corporates and institutions with cash piles and those struggling to find finance.

6. Central banks today are unable to return interest rates from today's near-zero or negative levels to more normal ones, as personal debt levels make the cost of doing so politically impossible. Such **ultra- low interest rates are therefore likely to remain in place for many years.** As Japan has discovered over nearly 30 years, the second-order consequences of this deflationary environment can be undesirable.

7. This combination of major long-term imbalances with the ineffectiveness of traditional monetary policy tools such as interest rates means that there will almost certainly be another global financial crisis at some point. However, markets are comfortable with today's policy mix of monetary easing from most central banks (though not yet the UK), the prospect of the end of austerity for political reasons, and modest economic growth. I therefore expect **the environment of low positive returns from both bonds and equities will continue until there is a catalyst big enough to change it**.

8. The next question to ask is what that catalyst might be. While I stress none of them are imminent, today my top candidates are:

   - Social - a retreat of market-oriented capitalism as a result of a swing to more extreme politics;
   - Political – a flare-up of a geo-political flashpoints (Iran, Russia, Hong Kong, China-US trade);
   - Financial – seizing up of corporate debt markets because of lack of suitable quality collateral;
   - Valuations – if they become unsustainable, markets will eventually correct sharply as in 1987.

9. Closer to home, the election has now been decided. Voters voted primarily to end uncertainty over Europe and perhaps against the radical agenda of Labour. UK markets reacted mildly positively to prospect of moving forward but, as with all negotiations, the path is unlikely to be smooth and there will be further uncertainty for many months over precisely what trade deal is struck with Europe. On the domestic front, the new Government has said it will focus on helping areas left behind over the last 30 years. This is likely to be positive for demand and ultimately markets.

10. Talk about global recession seems to be receding, though growth is clearly going to be muted and a downturn remains possible. If so, it may come out of China rather than the US (eg. Hong Kong 2019 growth is likely to be zero or lower) though I suspect the Chinese authorities will use the tools they possess as a centrally controlled economy to prevent that happening.

11. **In summary, there is not much change from four months ago**. Equity and bond prices remain high but will probably continue on a similar path in the short and possibly medium term until something knocks them off course. When that happens, there is scope for a considerable fall in equities.

RECOMMENDATIONS

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