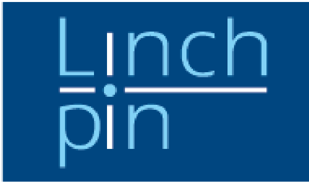

Independent Adviser's Report for Nottinghamshire Pension Fund Committee

William Bourne **17th November 2022**

Market Commentary

1. In September I warned that a global recession was looking quite likely. Since then, we have seen substantial interest rate rises and evidence of slowing economies almost everywhere. Only in the U.S has there been some evidence of higher employment and the economy doing better.

2. Central banks have continued to tighten policy further to lower inflation rates. The European Central bank has now raised rates to 1.25%, U.K. rates have risen to 3%, and U.S. rates are now 4%. Only Japan is maintaining rates at close to zero, and there are some signs of movement even there. The U.S. Federal Reserve has also withdrawn over 1 trillion dollars of liquidity from bond markets since the peak, which has the same impact as a much larger rate rise. It is no surprise that the US$ has been super strong, reaching 30- and 40-year highs against both the yen and sterling.

3. **The hawkish stance of central banks has had some success in lowering inflation**. October CPI fell back to 6.2% in the U.S. as energy prices came down, but remains at 11% in the U.K., albeit the core rate excluding food and energy was 6.5%. Central banks and bond markets are both forecasting that inflation will fall (e.g., the Office for Budget Responsibility's forecast for the UK is 9% in 2022 and 7.4% in 2023), but there is clearly a risk that it may remain higher for longer.

4. The Fed. has started to signal a slightly less aggressive approach to monetary policy and will certainly reverse course (the jargon word here is 'pivot') when they believe inflation is tamed. The Bank of England may be slower, as it has more need to regain credibility.

5. The short-lived Truss Government's financial statement unsettled the gilt market and sterling dramatically. Despite a rapid U-turn by its successor, the episode has brought to light both how fragile the government's finances are and how thin the UK gilt market is. The Chancellor's Autumn statement raising taxes and cutting spending by a combined £55bn underlined that.

6. The gilt sell-off was exacerbated by the U.K. private sector Defined Benefit pension funds' widespread investment in leveraged LDI (liability driven investment) strategies. The rise in bond yields forced

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them to liquidate collateral, largely held as gilts, to cover margin calls. The Bank of England stepped in to stabilise gilt prices through a short-term emergency purchasing program. Gilt yields have subsequently fallen from the 5% peak to around 3.2% at the time of writing, but the BoE purchases have left a large overhang of stock which they at some point, will need to sell in the market. The Fund has no exposure to LDI and very limited exposure to gilts.

7. **A global recession remains highly likely**, probably more pronounced in Europe than the U.S., as consumer spending is under a substantial squeeze from higher interest rates, higher taxes, and higher energy prices. The Bank of England expects it to last for at least a year.

8. One consequence of the combination of higher bond yields and a recession is a higher likelihood of company failures. Low cost of capital has for 15 years allowed ailing companies to struggle on or be refinanced, but that has changed. Early casualties in the U.K. were Made.com and Joules.

9. FTX Exchange was a casualty of a different sort. The third largest crypto currency exchange was effectively a Ponzi scheme. Millions of investors, among them some large institutions, have lost ~~most~~ all of their money.

10. Equity markets so far have been remarkably sanguine about all the negative news. U.S. corporate earnings per share have continued to rise, albeit at the lowest rate since COVID. Investors may also be starting to bet on a Fed pivot in the next few months. However, in my view a further leg down in equity markets is almost inevitable.

11. Geo-politics are back with a vengeance. The passing of the Chips and Science Act makes it clear that **the U.S. now views China as its main economic and leadership competitor** and will take whatever measures are needed to try and thwart its progress. The continuing war between Russia and Ukraine continues both to put upward pressure on food and energy prices.

12. Despite this, in the longer term the fog of uncertainty is slowly clearing. Interest rates and bond yields will stay higher, perhaps in the 2% to 5% range. Monetary policy will be used to relieve times of stress (e.g. the Bank of England's recent emergency package) but not as a semi-permanent feature. Economic growth in the major economies will notwithstanding remain low. Globalisation is, if not in reverse, no longer moving forward. Big Tech continues to march on, but there are now losers (Meta, Twitter) as well as winners. Capital for investment or leverage is both more expensive and scarcer.

13. The last of these means that investors such as the Fund who are providers of capital to private companies should, so long as they show discrimination in investing, be adequately rewarded in the longer term. The same may not be true of lenders to governments. The Bank of England is manipulating the level of yields (the jargon word here is 'yield curve control') and investors are not receiving the return they should for the risk they are taking. While this may persist for a while,

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eventually the stresses will show up somewhere.

14. **My main scenario remains benign in the longer term**, but the immediate course of markets looks challenging for all investors. The combination of recession, geo-political confrontation, and a less supportive monetary environment means that valuations of all assets are likely to come down. Worse outcomes are possible if company earnings collapse or the financial system comes under stress. The Fund's cash weighting will help mitigate the short-term damage and provide opportunities to invest at better prices but will not insulate it from market falls.

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