Independent Adviser's Report for Nottinghamshire Pension Fund Committee

William Bourne 25th May 2022

Market commentary

1. For twelve months I have warned of the potential for falls in equity and bond markets and said that it was hard to see a return to normality without pain somewhere. **Nearly three months on, both bond and many major equity markets have fallen substantially.**

2. Russia's war on Ukraine, as expected, has poured fuel on the inflationary fire. The impact has been most obvious in energy and food costs, but second order effects are beginning to come through too. Ukraine, Russia and Belarus are between them major producers of a range of commodities which are material to our lives: grain, fertiliser, oil, gas, lithium, and platinum. **As a result, consumer inflation levels are now at 10% in the US, 9% in the U.K. and 7% in Germany, the highest for forty years**. Japan is the major outlier where inflation remains in the 0 to 2% range.

3. After inventory build-up led to a better 4th quarter, the U.S. economy contracted by 0.4% in the 1st quarter of 2022. On the other side of the world, the Chinese economy is reeling from the combination of the wholesale lockdowns imposed to try and combat the latest COVID wave. 2022 growth may be no more than 4%, the lowest since the country emerged from Maoism in 1981.

4. Central banks have continued to raise interest rates, and U.S and U.K. rates are now at 1%. As a result, U.S. ten-year bond yields rose above 3%, within the 3% to 5% range where they have over the very long term normally traded. While they have fallen back to 2.8% at the time of writing, the era of negative nominal yields seems to have largely passed even in countries such as Japan.

5. Credit spreads (i.e. the difference between corporate and government bond yields) are widening, a warning indicator of trouble ahead. Investors are now being paid nearly 3.5% for AAA (the safest) corporate debt in the U.S. At the lowest end, junk bonds are yielding 13% compared to about 7% at the low in 2021.

6. As I pointed out last time, higher interest rates and bond yields are the pivot of the changes happening in markets. In the currency markets, they have led to a stronger US$ and a weaker Japanese yen in particular. In equity markets, most tech stocks have been vulnerable to any hint that future earnings growth might slacken off.

7. Roughly 50% of the stocks in the U.S. NASDAQ index are down more than 50% from their 2021 highs, and 25% are down more than 75%. Large tech is not immune: Netflix lost over 40% of its value in just a few weeks; and Twitter has been bid for by Elon Musk, but at a price some 25% lower than its peak.

While the U.S. S&P index fell for seven weeks in a row and is down 18% from its end 2021 high, it is worth noting that many tech companies have met earnings forecasts, and that the march of tech has not slowed down. The falls are coming from valuation contraction rather than weaker earnings.

8. Value stocks, particularly those associated with energy production, continue their recovery relative to growth. For example, BP's earnings were at a ten-year high. Value generally has now recovered nearly half the ground lost relative to growth since 2009.

9. Crypto-currencies have also fallen by 50% (Bitcoin) or more since their end-year highs. The high-profile US$40bn failure of Luna and its stablemate Terra has highlighted the flaws in the model. Digital money will continue to evolve but is likely to be more regulated in the future.

10. Closer to home, political threats continue to rumble round Europe. The conflict in Ukraine seems to be settling into a longer-term war in the eastern half of the country. This will add further to inflationary pressures, as the military are not price-conscious, as well as forming a less stable background for markets generally. The local elections in the U.K., and in particular Sinn Fein's position as the largest party in Northern Ireland point to more volatility too.

11. The social divisions in Europe were also laid clear in the French election, despite Macron's comfortable victory. The divide between the haves and have-nots mirror those made clear in the U.K.'s BREXIT referendum in 2016. Politicians will have to respond, and **the pendulum is likely to start swinging back towards labour (i.e. the workforce) and away from capital (i.e. shareholders and investors**). That may well be a healthy move but will again add to inflationary pressures.

12. Higher food and energy prices act as a tax on discretionary spending, even without the Chancellor's tax rises. Military spending will consume a larger part of the government's expenditure. Unless the Federal Reserve makes an abrupt change in direction, as they did in late 2018, a recession seems inevitable.

13. **I therefore think the odds of stagflation, i.e. lower growth and sustained higher inflation, are now significantly higher than the 25% I ascribed in February**. This is a difficult environment for investors generally. Companies who are either running 'old' business models (e.g. high street retail) or who have high levels of debt are particularly vulnerable. Their assets and employees may be taken over by new owners (e.g. private equity), but shareholders will be losers. The newsagent, McColl's, problems are just an early example.

14. We should brace ourselves for lower returns over the next few years, and quite probably negative real returns. This combined with high inflation is uncomfortable for LGPS funds, because liabilities are indirectly linked to consumer inflation without a cap, and the only robust hedge, index-linked gilts, trade at a real yield of around minus 1.5 to 2% - i.e. incur a large opportunity cost.

15. The result may well be a lower funding level for a period, but I remind readers that the Fund's investment horizon is long, and periods of poorer performance are inevitable. The best defence is diversification: in this respect government and investment grade bond yields are returning towards a level when we may wish to at least consider a higher allocation as part of the Fund's strategy.