Independent Adviser's Report for Nottinghamshire Pension Fund Committee

William Bourne **20th May 2024**

Market Commentary

1. Three months ago I reiterated my view that the main long-term risk to the fund remains inflation. In the short term the headline data has continued to fall, but if bond yields or inflation turn out higher than expected western governments will be under pressure from rising debt service costs.

2. The Chancellor produced a balanced Budget in March with forecasts of a small primary (i.e. excess of income over current expenditure) surplus by 2028-9. However, there will be little impact on the overall level of debt, and his forecasts are heavily reliant on forecasts, in my view optimistic, that inflation and bond yields will stay low over the next five years.

3. Inflation is falling from the 2022 peaks, but is still well above the 2% target in place for most central banks. Among developed economies consumer inflation ranges from 2.4% (E.U.) to 3.4% (U.S.). China is the major outlier, where inflation is only just above zero. Services inflation seems to be the major driver, perhaps caused by labour shortages in the U.S. and U.K.

4. United States economic growth grew by 3.4% in 2023 but slowed in the most recent quarter. The U.S. economy has historically been on a better path than other G7 countries, which may be one reason why its inflation data is higher. However, forward looking data (e.g. Purchasing Managers Indices) suggest that European economies may be improving in relative terms.

5. In contrast China, the world's other engine, has been struggling with deflation, despite relatively loose monetary conditions. 2023 economic growth was 5.2% after 3.0% in 2022. The last six months have seen a significant slowdown, but manufacturing activity data has ticked up in the last couple of months. Evergrande (second largest real estate company) finally went into administration.

6. The Japanese yen reached a 34 year low against the USD. The Bank of Japan's policy of keeping interest rates low has led to a significant differential with the U.S. and the yen has become a favoured currency to borrow in. With interest rate cuts in the U.S. looking less likely, there is little catalyst in the short term to change this dynamic. However, the yen is about 30% undervalued in purchasing

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power parity terms (e.g. the relative prices of a McDonalds' burger).

7. A theme in my recent reports has been the growing levels of public debts as politicians struggle to keep expenditure and revenue in balance. The cost of servicing debt is an increasing part of expenditure, about 16% for the U.S. and 11% for the U.K. If either bond yields or inflation are higher than expected, these numbers will rise substantially and put pressure on government budgets.

8. Geo-politics remains a source of risk, but markets have so far not been greatly disrupted even when there has been a threat to oil supply security, as in the Red Sea. However, the cost of these more localised confrontations to the West will have an impact on both fiscal spending and also on inflation — governments are rarely price sensitive, especially when it comes to military expenditure.

9. Donald Trump's route to becoming the Republican Party candidate for the Presidential election is now looking clearer, though the current court case still means uncertainty. We do not (at the time of writing) know who will be the vice-presidential candidates. This is relevant, given the age of the two likely contenders.

10. The combination of moderate growth (led by the U.S.), low inflation, and loose fiscal and monetary policy remains benign for investors. The bond yield curve is still inverted, but much less so than at the beginning of 2024. After a year of rising markets, a correction may well be expected but I cannot see an immediate catalyst. Valuations are looking stretched in some areas such as tech. but remain reasonable in others (e.g. small cap., Europe, Japan, Emerging markets).

11. Further out the storm clouds are gathering. There will inevitably be uncertainty at the time of the U.S. election, which will be exacerbated if the result is disputed. The new administration will have to deal with a primary deficit which is out of control and rapidly increasing debt levels. Higher growth will help, but bond markets are in my view likely to pick up on the risks here.

12. I therefore expect U.S. ten year bond yields to test 5% (at the time of writing 4.42%) at some point over the next eighteen months and perhaps go significantly higher. Theory says this should have a negative impact on valuations of other asset classes including equities. However, that may be muted by the sheer weight of money needing a home.

13. In the longer-term (much) higher inflation seems to me to be the inevitable consequence of fiscal incontinence and the growing reliance on short-term financing, especially in the U.S. We are effectively going to the Magic Money Tree. This will have a negative impact on the Fund's future service costs and consequently on liabilities. I therefore recommend that the long-term strategic focus should remain on building up allocations to assets which will help to mitigate this risk.

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