



Independent Adviser's Report for Nottinghamshire Pension Fund Committee

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Market commentary

1. In June I described a sea-change in markets. For the foreseeable future the Federal Reserve will need to delay normalization and keep monetary policy - at least in terms of interest rate levels and the size of their balance sheet – substantially looser than they had wanted. I doubted whether equity markets would embark on another major bull market, but suggested a prolonged bear market was unlikely, because the Fed and other central banks would respond by easing monetary policy.
2. Three months later this seems to be broadly the case. Markets have touched new highs, but not surged, while Government bond yields have fallen significantly (e.g. US 10 year bond yield is now 1.68%, UK 0.45%). The Fed. cut rates by 25bps in August, as recession fears grew. **The price of gold has risen by 20 % over the past year**, which I view as an appropriate response to the prospect of an increase in the supply of paper money.
3. **On the other hand, political risk has ratcheted up again.** At a global level Trump is pushing for further concessions from China, India and Pakistan are skirmishing, Japan and South Korea are locked in a separate dispute while tighter sanctions on Iran have pushed it to more confrontational actions in the Gulf. In Europe we wait to see whether BREXIT will take place, and who will fill Angela Merkel's role. **The question for markets is how much of this has already been factored into valuations.**
4. Global economic growth is undoubtedly slowing as we reach the top of a business cycle. Forward looking indicators such as business confidence and purchasing managers' indices are all pointing downwards in the US, and 2nd quarter growth fell from 3% to around 2%. The OECD's latest report suggests global growth will stabilize at a little over 3%, with the EU growing at around half that, and Emerging Markets about 1% higher. The most recent reports out of Germany, Japan, the UK and Italy suggest very little positive growth at the moment. Global trade volume growth, not surprisingly, is expected to slip from around 5% to just 4%.
5. US corporate earnings growth has fallen for the second quarter in a row, with companies as varied as Ford, Boeing, and Amazon all disappointing. Increasing trade friction and lower economic growth suggest this trend will also continue. The retail and airlines sector in particular has suffered a slew of bankruptcies, administration events, and defaults globally as buying habits change.
6. **The UK does seem to be facing particular problems.** Apart from the political uncertainty, and the seemingly unbreakable impasse over BREXIT, there seems to be little sense of strategy and the need to have allies in the world. Domestically, stronger than expected tax receipts will give the new Chancellor some room for manoeuvre. An autumn General Election is now a distinct possibility: the threat of a Corbyn/MacDonnell Government is probably one thing which could spook the broader UK stockmarket, and particularly infrastructure.

7. Bond yields have fallen, and if there are further rate cuts in response to economic or systemic weakness, I would expect that trend to continue at least for short and medium term bonds. I continue to be wary of some parts of the corporate bond markets for technical reasons.
8. I have for the past four years been warning of the dangers of inflation in the longer term. In a slow growth world where austerity is not a political option, other than default, inflation is the sole route left whereby western governments can reduce their debt levels. **In the short term, despite tight labour markets, there seems little sign of an inflation pick-up, perhaps because consumer demand for goods and services is low.** However, the advent of higher trade tariffs (or for the UK a deterioration in the terms of trade) might well change this.
9. In summary, equity and bond prices remain high, and there are plenty of dark clouds around. However, most are 'known unknowns' i.e. largely discounted by investors. Recession fears may drag markets down sharply, as happened in 2018Q4, but I expect that to result in further monetary and fiscal easing, which will limit the downside.

Manager reports

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Portfolio commentary

13. We are coming out of a period of unprecedented asset growth, which is most unlikely to continue. Even loose financial policy will only provide some downside protection. We should therefore expect asset growth to be moderate, with the potential for shocks from geo-politics, trade wars, and disappointing growth.
14. The diversified nature of the portfolio will provide some support, as many of the private assets in the portfolio (equity, infrastructure) should continue to deliver returns above our overall 6% return target. **However, the asset allocation should be reviewed following the actuarial valuation** to ensure that, given lower expected returns, it will in fact deliver the actuarial target.

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