Regulatory and Other Committee

| Open Report on behalf of Executive Director of Finance and Public Protection |
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| Report to: | **Pensions Committee** |
| Date: | **16 July 2015** |
| Subject: | **Independent Advisors Report** |

**Summary:**

This report provides a market commentary by the Committee's Independent Advisor on the current state of global investment markets.

**Recommendation(s):**

That the Committee note the report.

**Background**

**INVESTMENT COMMENTARY**

**July 2015**

**Are interest rates finally on the increase?**

Interest rates, believe it or not, have been falling for over 30 years now, from peaks in the 1980's. This has pretty much been a global phenomenon, with Japan perhaps a few years ahead of the western world. By interest rates I mean both short term rates and long term ones (bonds with maturities of 20 years or longer). Members will be only too well aware of how low short term bank deposit rates now are. They have reached levels so close to zero as to be unimaginable only a few years ago. In terms of pension funds though, it is the long term government bond rate that underpins valuations of virtually all investible assets, be they equities, commercial property, alternatives etc. The future trajectory of the major government bond markets of the world (US treasury bonds, UK gilt edged, German "bunds") will thus remain a key driver of pension fund valuations.

**Recent news on the economy**

So far, 2015 is not turning out as the forecasters expected. Perhaps that is not so surprising – economic events often confound us. Consensus views at the start of 2015 were that the US and UK economies would continue to expand at a healthy pace, perhaps as high as 3% per annum, whilst the European economy would remain moribund. China, and indeed the rest of the emerging market bloc (Brazil, Russia etc), would struggle to maintain momentum. The oil price was expected to stay low and inflation almost everywhere around the globe virtually non-existent.

Reality however is that the European economy has shown an encouraging upturn in 2015, which seems sustainable. At the same time the US and the UK have faltered, the former adversely influenced by another hard winter on the Eastern seaboard of the USA. Europe might well grow by more than 1% in 2015, with Spain especially and also Italy showing some welcome growth. The US and UK will still achieve something over 2% growth. Also confounding the pundits, the oil price has started to rise and was recently as high as $70 a barrel, compared to a low point of around $45 late last year. This will have important implications for global inflation. In recent months, fears have arisen of deflation (ie falling prices) taking hold, especially in Europe. Such fears now look mis-placed. Notwithstanding the changing market perception as to trends in global inflation, there are few signs that Central Bankers are about to raise short term interest rates and to start to withdraw the excess liquidity with which they have flooded global financial markets. But, with the improving global economic background, such moves will inevitably come, maybe starting in late 2015 or early 2016.

**Pervasive influence of Central Banks' "Quantitative Easing"**

The central banks of the USA and the UK (the Fed and the Bank of England) started their Quantitative Easing programmes some five years ago and have finished actively buying government and other high grade debt of their respective countries. The European Central Bank and the Bank of Japan came much later to their respective programmes, which look set to continue well into 2016. All of these programmes, combined, have undoubtedly been the main underlying cause of the amazing fall in global interest rates, both long and short. Logically, the ending of such programmes should lead to a rise in yields. And indeed that is what markets are expecting. As ever, markets anticipate the actual event. And that is what has happened in the last few months. A seemingly seminal moment was when German bonds reached a virtually zero yield in (late April) and abruptly reversed, with prices falling sharply: ie yields rising.

An often overlooked factor in the sharp fall in interest rates has been the competition to buy secure long term investments. Supply (ie new issues) by governments has continued at a high level. But, of course, central banks have been avid buyers of those bonds. So also have a range of financial institutions (banks, insurance companies and some pension schemes) that are obliged, either by regulation or by prudential risk strategies to buy those self same bonds. The result has been a "squeeze", driving yields very low.

**Conclusion**

Should we expect a rapid unwinding of these processes in the months and years ahead? My own view is probably not. Those financial institutions will remain keen buyers of bonds. A combination of yet tighter financial regulation and the ageing of the populations of the developed world make that unlikely. I suspect it might intensify the buying as yields increase. That is not to say that there will not be market “sell offs”: inevitably there will be. But I suspect these to be relatively short lived in terms of duration and rises in yields (ie falls in prices).

If fixed interest yields rise, what are the implications for other financial assets – especially equities and commercial property (where the great bulk of the Lincolnshire pension fund assets are invested)? Their prices will fall. But again, I feel the fall will be constrained. Will funds be tempted to switch from equities into bonds as yields rise? Maybe, but I doubt it will be either widespread or sustained.

The key metric for your scheme is the size of the actuarial deficit on the fund. As interest rates have fallen in the past few years, scheme assets have risen in value. But, the liabilities have risen even faster. So the deficit, the difference between the two, has worsened. When interest rates start to rise, hopefully, this process will unwind. Your deficit should fall and the scheme become better funded.

**Peter Jones**
**30th June 2015**

**Conclusion**

**Consultation**

**a) Policy Proofing Actions Required**

n/a

**Background Papers**

No background papers within Section 100D of the Local Government Act 1972 were used in the preparation of this report.

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