Regulatory and Other Committee

Open Report on behalf of Executive Director of Finance and Public Protection

Report to:	**Pensions Committee**
Date:	**06 October 2016**
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

September 2016

Biggest financial experiment in world history….?

"We are part of the biggest financial experiment in world history and the consequences are yet unknown".

So wrote Lord Rothschild earlier this summer. It is difficult to disagree – because interest rates in the world have never, ever, been so low as they are today. UK base rate at 0.25% is well below what anyone would have thought remotely possible, even a few years ago. So what is the "experiment"? More particularly, what will be the outcome? What are the implications for the investments of the Lincolnshire fund?

The "experiment"

The origins of the experiment, as members know well, lie in the Lehman crisis of 2008/9 that brought in its wake an economic recession, sharp falls in stock markets and other asset prices and a reduction in inflation rates. It coincided with inflated debt levels of governments, companies and many private individuals. And especially with the weakened health of the global commercial banking industry, hard hit by the fall-out from Lehman. Borrowing more, especially by governments, to stimulate the economy and to grow out of the recession seemed not to be an option and most governments around the world were unable or unwilling to use it, as they would have done in past economic crises. In effect, there was a political vacuum with governments not responding positively and proactively, as they should have done. Austerity became the dominant global theme. Into the vacuum, stepped the Central Banks of the world, principally the US Federal Reserve, the Bank of England, the Bank of Japan and the European Central Bank.

These Central Banks had several related objectives: to strengthen their commercial banks and avoid as far as possible any banks closing their doors; to stimulate their economies to reduce the harmful effects of recession, e.g. on unemployment, and lastly to avoid falls in the pricing levels in their economies; in effect to promote inflation to stave off falling prices which were so harmful in the great recession of the 1930's. To achieve these ends, direct financial assistance was provided to commercial banks, short term interest rates were cut sharply and "Quantitative Easing" made its debut – central banks buying securities, mainly government debt, on a truly enormous scale to drive down long term interest rates and drive up asset prices. Like all other pension schemes, the assets of the Lincolnshire pension scheme have benefitted greatly, but the liabilities have increased as long term interest rates have fallen.

Have Central Banks succeeded? Hardly, would be my interim judgement. The US Federal Reserve has been most successful and the US commercial banks are now much stronger. The US economy is growing, unemployment has been falling for several years, inflation is rising modestly and the Fed has been brave enough to start raising its short term interest rate, with another seemingly expected in 2016. The UK has not been as successful; the banking industry remains weak, but the economy is growing. Inflation was already picking up before the Brexit inspired fall in the £ Sterling. But the base rate has just been cut again. The Bank of Japan was an enthusiastic promoter of the measures pioneered in the US but the Japanese economy has not really responded; perhaps because the Japanese demographics are so unhelpful to growth and inflation. The European Central Bank has been dragged reluctantly to the party and its success has been limited, so far. The Germans are the main advocates of austerity and have curtailed efforts of the ECB.

The outcome

Were there to be an end of term report, "must do better" might be the overall judgement. Effort good, results disappointing. In 2008/9, Central Banks would have expected to have completed their tasks by now, the global economy would be in a significant recovery phase and inflation would be well above zero and probably rising. They would have expected to be selling off some of the securities they had bought as part of Quantitative Easing. There is, however, no end in sight to Central Bank intervention. The forces of recession, low growth and stable prices has proved too strong for even the combined might of all the world's Central Banks acting in a co-ordinated fashion. The political vacuum referred to earlier has largely not been filled by governments.

What is most worrying is that the power of Central Bank measures seems to be reducing in effectiveness. The addict, so to speak, needs a bigger fix to achieve the previous outcome! This view is becoming more widely appreciated in stock markets, and no doubt elsewhere around the globe.

Market prospects

We face a future, perhaps, where neither governments nor Central Banks can effectively promote economic growth and hence meet the aspirations of the vast mass of electorates, especially younger ones. Corporate profits - a principal driver of stock market appreciation- look moribund. Yet, all types of securities have made substantial gains in the past 5 years, as the table below shows:

Type of Security	Price appreciation over past 5 years
UK equities	37%
Global equities	64%
UK gilts	45%
UK corporate bonds	45%
Index linked gilts	75%

Most stock prices are close to all-time highs. Very many commentators, myself included, see everything as expensive and heavily dependent on continuing Central Bank support for their economies. Is there a "bubble" in prices? Maybe, but optimists for global economic growth (and hence appreciation of stock market prices) are very thin on the ground. Bubbles usually occur when a majority of investors are committed optimists.

So how will the experiment end? Hopefully, not in tears. We need still to rely on the diminished powers of Central Banks to intervene. There can be no end to the experiment any time soon. But stock markets can certainly become disillusioned. That may already be starting. If prices do fall back, falls of say 10% to 20% can be readily absorbed – we saw that in the first quarter of 2016. Anything larger, I suspect, will see Central Bank action, though of what type – or effectiveness - is not at all clear.

LGPS Actuarial Valuation

Into this "experiment", meanwhile, the triennial valuation of the Lincolnshire fund as at March 2016 falls due. Setting an appropriate actuarial basis will not therefore be easy.

Peter Jones
19th September 2016.

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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