Lincolnshire COUNTY COUNCIL
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Regulatory and Other Committee

Open Report on behalf of Pete Moore - Executive Director of Finance and Public Protection	
Report to:	**Pensions Committee**
Date:	**05 January 2017**
Subject:	**Independent Advisor's 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

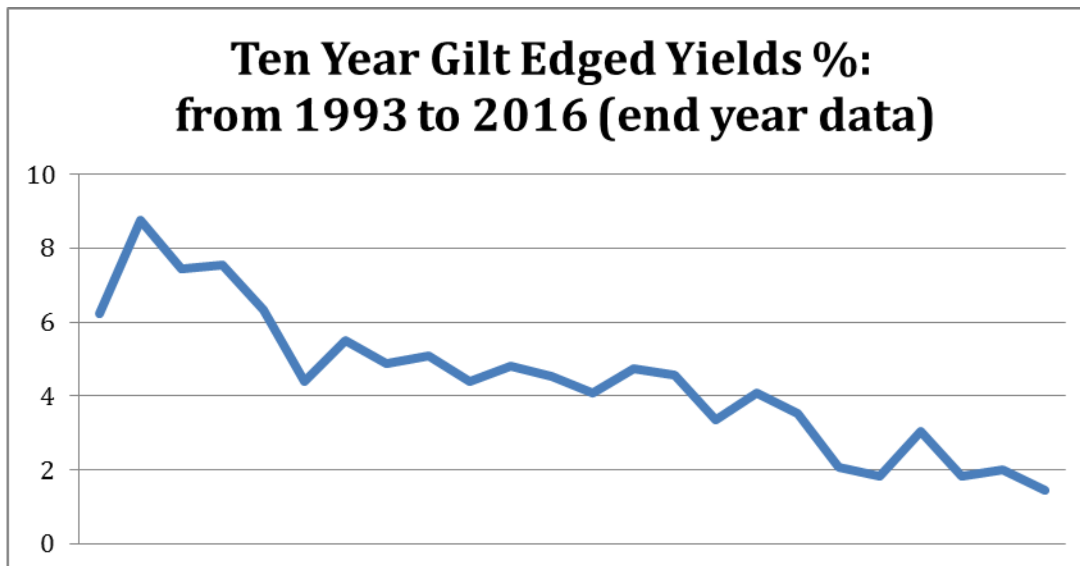
January 2017

Interest rates on the rise? Yes, but to what level?

Amid all the headline news about Brexit negotiations, President Elect Donald Trump, forthcoming elections in France and Germany, we should not lose sight of a possible change in the trend of interest rates. Both short term interest rates (e.g. Bank of England base rate) and longer term ones, such as those of British Government Gilt Stock, say of 10 years maturity.

Long Term Trends

The chart below shows 10 year gilt yields, annually, since the end of 1993. The peak yield in this period was almost 9% in 1994. The lowest point was 0.5% in the late summer of 2016, when the Bank of England Monetary Policy Committee cut its base rate to 0.25%. These recent low rates are without precedent in the 400 year old history of the Bank of England. The committee will be well aware of the dramatic effect that these low interest rates has had on the recent valuation of the LCC scheme’s pension liabilities.



The trend seen in the chart is very clear. It has been falling, more or less continuously, for the best part of 20 years. Interestingly (and this is only annual data), the financial crisis of 2008/09 hardly shows up as a material deviation from the continuing downward trend. On this chart, there is no sign of a reversal in the downward trajectory.

Why has the trend been downwards? Clearly the causes are of a long term nature. There are perhaps two significant ones. First, demographics – and in particular the ageing populations of the developed world (UK, USA, Western Europe and Japan). Many of these regions have birth rates which are incapable, without immigration, of sustaining the population at a stable level. Peak personal expenditure by age groups is between say ages 20 to 55. As the population ages, it becomes increasingly difficult to sustain economic growth at the level that it once was. An extreme example of this phenomenon is found in Japan.

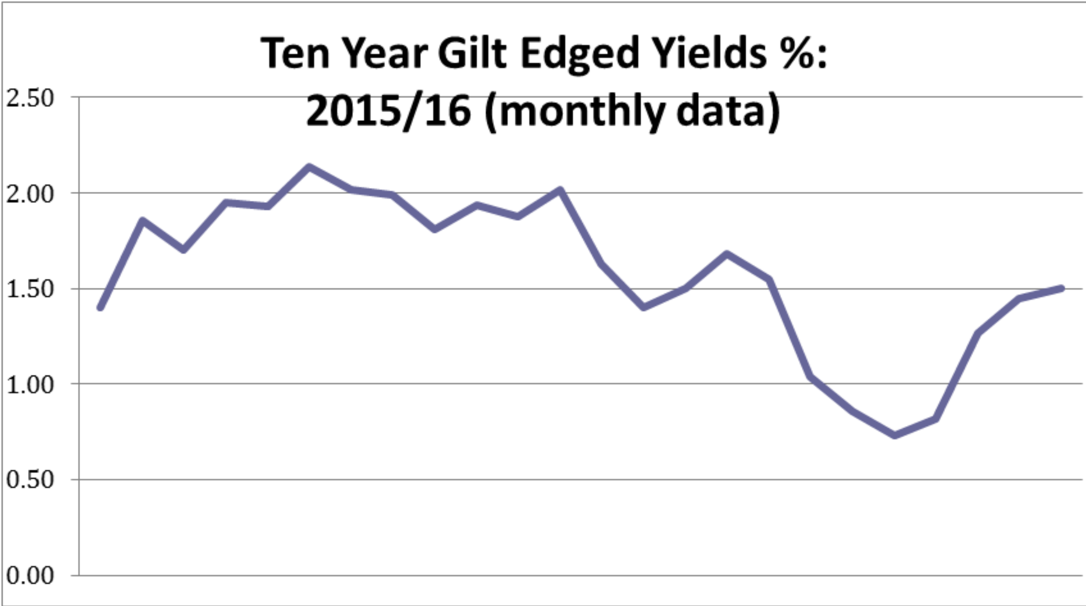
The second main cause is inflation. It too has been falling and is not unrelated to the lacklustre economic demand caused by the "adverse" demographic trends referred to above. Inflation in the UK has not been on a continuous downward trend; it had a low point in 2009 at the height of the financial crisis (when it was negative). It has been rising for about two years and (on an RPI basis) is now above 2%, exacerbated in recent months by the savage depreciation of the £ sterling.

Short term trends in interest rates

Of these two features (demographics and inflation), demographics cannot change trend materially in the near future, for obvious reasons. UK inflation will rise further in 2017 (maybe to 3%) as the sterling depreciation effect passes through. In the longer run, what happens to wage rates will be the key to future RPI. So why might there be a change in trend of longer term interest rates? One reason is what happens to very short term rates, e.g. Bank of England base rate and its US equivalent, the Fed funds rate. The Bank of England reduced its base rate to the amazingly low level of 0.25% in August 2016. In contrast, the US Federal reserve

increased the Fed funds rate by 0.25% in December 2016. Moreover, the Chair of the Fed indicated that two or three further rate increases are likely in 2017, because unemployment has reached a low level and the US economy is expanding at close to 3% per annum. Donald Trump, when he becomes President, is expected to further stimulate the US economy.

As the chart below for 2015/16 shows, UK 10 year gilt yields have been rising for some months and are now around 1.5%. So too have the equivalent US Treasury yields, which are already over 2.5%. Some market practitioners are convinced that a historic low point in longer term yields has already been passed. In the UK that is plausible, given the extreme low levels reached after the Brexit result and the Bank of England reduction in base rate. More relevant, however, is to what level might they rise?



Conclusion
My own view is that UK longer term interest rates cannot rise very far. Partly for demographic reasons and partly because inflation in the UK is likely to be well behaved, once the sterling depreciation effect has passed by mid 2017. Moreover, there are many pension schemes that will be "natural buyers" of gilts and other fixed interest stocks as prices fall and yields rise. If I have a caveat, it is that US Treasury bonds could be less well behaved and exert an upward influence on global bond yields.

Peter Jones
19th December 2016

Consultation

a) Have Risks and Impact Analysis been carried out??

Yes

b) Risks and Impact Analysis

The Pension Fund has a risk register which can be obtained by contacting the author of this report.

Background Papers

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