Regulatory and Other Committee

Open Report on behalf of Pete Moore, Executive Director of Finance and Public Protection

Report to:	**Pensions Committee**
Date:	**5 October 2017**
Subject:	**Independent Investment Advisor's Report**

Summary:

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

Recommendation(s):

That the committee note the report.

Background

Storm clouds gathering over stock markets?

Since we last met, the mood of investors in markets, both equities and fixed interest (e.g. government bonds), has become more pessimistic. More of them appear to believe that the storm clouds are gathering. And yet, a number of the global equity markets, principally the US equity market, are again reaching all-time highs, having risen since mid-summer. The UK has not quite managed to achieve that, perhaps because of rising uncertainty over the Brexit negotiations.

Why the increase in pessimism? Some commentators point to valuation measures, especially of equities. In purely statistical terms, equities are dear as measured by the familiar dividend yields and price earnings ratios. And most companies have achieved rising profit margins - which could be vulnerable to increases in wages and competition. There are those too who look at historical precedents for the length of bull markets: most have been rising since the market troughs in 2009. So the bull markets can certainly said to be “mature”.

The global economy

And yet, a lot is going right for the global economy, which is currently growing at about 3.5% per annum. For the first time since the financial crisis ten years ago, there is a synchronisation of growth around the world. The USA, China, Germany and the UK have all been growing for several years. Recently they have been joined by other European nations. The “stand out” economies are those of Ireland and Spain. But other counties previously thought of as sclerotic are showing signs of robust growth. France is notable but lesser economies such as Greece, Italy and Portugal have recently come to the party.

Changing attitudes of global Central Bankers

This synchronisation is enabling central bankers (e.g. the US Federal Reserve, the Bank of England, the European Central Bank) to reconsider their easy money policy. You will remember that this had two prongs: very low short term interest rates and Quantitative Easing ("QE" for short) consisting of purchases by the central banks of huge amounts of their own government and other bonds - in order to drive down long term interest rates and thus ultimately to stimulate economic growth and lower unemployment in their respective economies. For example, the amount of such bonds on the balance sheet of the US Federal reserve amounts to a staggering US$4.5 trillion (4.5 million million). During 2017, the central banks have progressively, starting with the US Federal Reserve, concluded that their unprecedented measures were coming to fruition. The most recent convert is the European Central Bank. Thus, there is the prospect of some rise in short term interest rates (the USA has already increased three times to over 1%) and the withdrawal of QE, reducing the amount of bonds held. A hugely important topic for markets is exactly how this withdrawal of QE is managed. Handled badly, it could certainly panic markets, both government bond and the corporate bond markets but also global equities.

Central bankers have nurtured the global economy through an extremely difficult period. The last thing that they want to do is to act hastily or rashly. In particular, the withdrawal of QE will be handled, in my view, with the utmost delicacy. The influence of central bank actions over markets has been the single most important factor since the global crisis. Will it change? Yes, but only very slowly. Their influence will, in my view, be a dominant theme in market analysis for the next several years.

Investors expecting long term interest rates to skyrocket (and hence bond prices to fall sharply) are, I am sure, going to be disappointed. Inflation around the world is too well behaved – sluggish even - for that (I include the UK, once the effect of sterling's depreciation after the Brexit vote works through the system). And the ageing of the populations of the developed western world means there is large unsatisfied demand for fixed interest securities. Will such yields drift up? I suspect only modestly and gradually.

Equity prospects

Statistically, equity markets are close to being fully valued. I am doubtful that matters. What central banks will do is much more important. Will equities rise far from here? The mood amongst a growing segment of investors suggests not. But will equity markets fall far? Whilst they are vulnerable, they still appear to offer higher returns and better value than bonds. Any sharp fall will, I suspect, see "cheap buyers", burdened by uncomfortably high cash balances. For the Lincolnshire County Council pension scheme, global equities still seem to me to offer better value than other types of investment.

Peter Jones
22nd September 2017

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.

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