Lincolnshire COUNTY COUNCIL
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Regulatory and Other Committee

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

Report to:	**Pensions Committee**
Date:	**22 March 2018**
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

March 2018

An uneasy truce between the "bulls" and the "bears".

2018 has started off on a roller coaster ride for both the equity and fixed interest markets, especially in the USA. As you will be aware, early January saw a strong rise in equity markets worldwide, followed by a slump globally amounting to a roughly 10% fall from the peak levels. In the US, roughly half that fall was regained, resulting in something of a stand-off between the bulls and the bears. In the UK and Europe however the upward bounce in February has been muted. The bulls have been on the sidelines. Yields in the global fixed interest markets have risen so far this year, but there has been no decisive break upwards in yields (fall in prices) as some bond bears have been predicting.

Economic prospects for 2018 continue to be favourable

Financial news has been very largely positive, with many economic growth forecasts being revised up above 2%: this is especially the case in Germany and Europe generally. The UK, of course, is an exception - but growth is still forecast to be above 1.5% in 2018, despite Brexit uncertainty.

Inflation continues to be well behaved (generally below 2%), allowing Central Banks to sit on the sidelines and not intervene to bring it back to levels they find acceptable. That said, wage inflation is starting to pick up, albeit modestly. In particular, in the USA, a number of major employers e.g. Wal-Mart have boosted wages utilising the windfalls they have derived from President Trump's tax cuts. Whether these wage rises are a "one off" phenomenon or more durable remains to be soon. In the short term the wage rises boost consumers' expenditure and hence economic growth.

Many commentators feel there remains "slack" in most global economies, with the exception being labour in the US, UK and Germany where the unemployment rate is below 5%, often historically a trigger point for higher wage demands. Prospects for rising equity profits remain excellent. So, the economic scenario remains largely benign and should provide significant support to equities at close to current levels.

Fixed interest markets

There is much less consensus about prospects for bond markets. The yields on US Treasury Bonds have risen this year from around 2.4% to 2.9%, before falling back again in recent days. The argument of the bears is that yields, globally, in all fixed interest markets are far too low and are only so low because of the Central Banks' huge purchases of such securities under Quantitative Easing ("QE"). The amounts purchased are around $US4.5trillion in the US and perhaps $US15billion globally. Truly astronomic quantities.

The US Federal Reserve has announced that it will begin a gradual programme to sell off bonds with a view to reducing its holdings to perhaps $US3trillion by the early 2020's. Since the US Treasury has the need to issue substantial amounts of bonds to finance the US Government's financial deficit (made worse by Mr Trump's ill-advised tax concessions), the pressure on bond markets and hence to higher yields (i.e. falling prices) is self-evident. Only the Bank of England is likely to follow suit in the next couple of years in initiating a selling programme; other Central Banks are still executing buying programmes.

So, there is currently an uneasy truce amongst investors in the US Treasury Bond market. Yields have risen, but not decisively so, as yet. Many participants see a 3% yield as a threshold. Cross over and bonds are then in a bear market. The counter argument of the bulls is that populations are ageing in many parts of the world (especially in the developed world, but in China as well). Demand for bonds to finance pensions for the ageing population will therefore remain high and offset the unwinding of QE. I can see yields moving higher, but in a measured fashion. A catastrophic collapse in bond prices (with a knock on effect on sharply lower equity prices) is not something that I expect. That would not be acceptable to Central Banks – which want orderly markets.

Conclusion

I do not expect to see the equity market move decisively upward: the bears will have been emboldened by the near 10% recent falls. But equally, the economic and financial background remains favourable to equity investment. It was notable that a 10% fall was sufficient to tempt buyers back into the market in February. The outlook for bond prices is more difficult to call – there are significant opposing forces of substantial magnitude.

Peter Jones
5th March 2018

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

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

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