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:	**19 July 2018**
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 – July 2018

Preparing for the next global recession – some implications

It may seem strange to choose this as a topic, when no recession is imminent. Global growth is running at about 4% this year and is forecast to be much the same in 2019. The US economy is doing very well – perhaps expanding at around 3% per annum. China continues to grow at about 6% a year. Only Europe – including the UK – is disappointing: the anxieties around Brexit are probably responsible for the lacklustre growth in the UK, but recently the Eurozone economies have also disappointed, having seen their optimism around the turn of the year ebb away. Not all of the disappointment can be ascribed to the adverse weather in the first quarter of 2018.

Central bank responsibilities

The old adage about central bankers is that their role is to monitor the mood of the “party-goers” and to remove the “punch bowl” when they get over excited. They do that by raising short term interest rates (such as the US Fed Funds rate, UK bank base rate etc.) when their respective economies get overheated, when unemployment is very low and when inflation gets to a dangerous level.

By the same token, when economies are very weak, they need to step in and “provide more punch” to liven up the party and get it going. In 2009/10, for example, central banks aggressively reduced short term interest rates (to close to zero) and by means of Quantitative Easing, supplied huge amounts of credit to the banking industry worldwide, and, ultimately to commerce and to individuals. This eventually had the desired effect of stimulating their respective economies – so that the world now enjoys reasonable if not stellar growth and in many countries this has led to significant falls in unemployment.

Job done, you might say? The problem is that central banks have barely begun to remove the "punchbowl". The US Federal Reserve has begun to increase its short term interest rate from around 0.5% to 2%. It has slowly begun to withdraw Quantitative Easing by selling back to the banks and other financial institutions some of its huge holdings in US Treasury bonds. But it has scarcely made a material impact, to date. In the UK, base rate has risen from 0.25% to 0.50%, but the Bank of England has not started to address the selling of its large holdings in British Government gilts. So, these two Central Banks are only too well aware that they need to advance the process much further before there is a possibility of another recession. Another analogy might be that if you used a fire extinguisher to put out a fire, you need to replace it as soon as possible before there is another one.

Impact on markets

Markets have risen a long way since the depths of the recession nearly ten years ago. In many cases, especially in equities, that seems to me to be justified. Perhaps less so in the case of bonds, which are still trading close to historically unprecedented low yields. If, and when, the markets have a wobble, they will rapidly conclude, I think, that central banks are not as well equipped to ameliorate whatever worries stimulated the wobble. What might have been a wobble could turn into something more devastating. In short, the downside risks to both markets are and will remain high until central banks can take steps to remove the "punchbowl". But many central banks, for example the European Central Bank, are far from convinced that their economies are strong enough to permit a normalisation in interest rates, let alone absorb huge sales of the respective government debt.

Conclusion

I have not suddenly turned bearish on the prospects for global equity markets. But the process of "removing the punchbowl" has barely started in the USA and UK. It has not even commenced elsewhere, e.g. the Eurozone. Until it does, globally, the risk of an accident to markets will increase.

Peter Jones
25th June 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

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