Lincolnshire COUNTY COUNCIL
*Working for a better future*

**Regulatory and Other Committee**

| **Open Report on behalf of Executive Director of Finance and Public Protection** |
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| Report to: | **Pensions Committee** |
| Date: | **08 January 2015** |
| 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 2015**

**2014 in hindsight**

Investment markets performed modestly in 2014. Global equities were up by about 5% (in sterling terms), largely because of the strong performance of Wall Street, even after the December setback. Other equity markets were little changed, with Europe and the emerging markets being generally lower. Fixed interest markets confounded the sceptics and generally provided positive returns – especially long dated securities. So, investment portfolios typically showed slightly higher valuations.

Global economic performance was decidedly mixed: the USA and UK did quite well, growing at around 3%, whilst almost everywhere else disappointed. The significant surprise of the year was the fall in commodity prices, especially the price of crude oil, which collapsed from $115 in the summer to around $60 by late December, a fall of no less than 45%.

The fall in the oil price was initially treated as a reaction to a global over-supply of crude oil, triggered by ample supplies from the US shale oil fields. More recently, concerns have emerged that it is as much a reaction to “under-demand” from a global economy that is losing its growth momentum. And hence leading to doubts about the more optimistic economic growth forecasts for 2015.

**What could go right for markets in 2015? And what wrong?**

The global economy will certainly grow in 2015, perhaps at around 3%: say 5% in emerging markets, driven by their strong demographic profile and around 3% in the USA and UK. Europe is forecast to grow but by no more than 1% and Germany is expected to remain lacklustre, albeit positive. Inflation everywhere will be very modest and in many regions, notably the Eurozone, will turn negative, in part reflecting lower oil prices. Central bankers will remain concerned to see some modest level of positive price inflation, fearing lower prices could be the harbinger of a 1930's style depression. Given such anxieties, the chances of any material financial tightening by central bankers or governments are pretty remote, in my view.

The effects of the fall in the oil price, if it endures, are profound. It alters the balance of political power away from oil producers (especially the "renegade" ones, such as Iraq, Iran, Libya, Venezuela, even Russia) in favour of the developed nations of the western world. More particularly, it increases the purchasing power of citizens the world over. Thus, there is the potential for the global economy to surprise on the positive side.

**And what could go wrong?**

A significant worry for markets in 2015 will be the actions (rather than the rhetoric) of central bankers, especially the US Federal Reserve and the Bank of England. Both need to make the difficult transition from Quantitative Easing ("QE", i.e. supplying ample liquidity on a grand scale in order to promote economic growth) to a measured withdrawal of that liquidity. They will want to raise interest rates as soon as they dare, but the collapse in the oil prices gives them a dilemma. Is deflation, because of lower oil prices, a greater threat than an economy that grows above expectations?

There are going to be "second order effects" from lower oil prices. Not all of these are obvious yet. An example is that the global oil industry will become notably weaker financially and some of the more highly indebted companies in the oil sector will experience difficulties in repaying their loans. The global banking sector will be weaker as a result. Yet, if economic growth is to surprise on the upside, banks must play their part. Healthy economic growth is hugely dependent on banks being willing and able to lend freely.

If interest rates do start to rise in the USA and the UK, the potential for a sharp change in trend has been made much more likely by the efforts of bank regulators to make large banks "proof against failure". The markets in fixed interest stocks (especially government securities) used to be highly liquid: but no longer. Regulators have required that such inventories of stocks, when held by banks, be supported by significant additional capital, which is no longer available. If interest rates do rise in 2015 (and they may not) they could do so very rapidly and lead to sharp falls in asset values. The equity markets would not be immune.

Other anxieties centre around "trade wars" – or perhaps more precisely "currency wars". Japan has been indulging in a competitive devaluation of the yen in an attempt to stimulate its moribund economy and to lift its inflation rate. Were other nations to follow suit (China, for example), that would have the ability to spook markets.

Here at home, politics in the form of the general election will influence markets. Expectations are that no party will have sufficient control to get significant legislation through parliament. The new government, weak or strong, of whichever political hue, will need to reduce government borrowing, either by lower expenditure or higher taxes. The economic effects of such moves will raise investors' anxieties, however essential they are. And the possibility of a referendum on the UK remaining a member of the European Union will influence market sentiment, perhaps negatively.

**Market prospects**

All markets, both equities and fixed interest, seem fully valued to me – and to most market participants. I do not expect to see large positive returns in either of these markets. If all securities are so highly valued, surely sellers will emerge? Only if there is an alternative that offers capital protection and a reasonable return: at present, cash – the traditional alternative - does not. The possibility of a significant and rapid fall in markets is quite possibility. To that extent, to borrow an analogy, markets will "tip toe on egg shells" into 2015.

Peter Jones
17th December 2014

**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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