Open Report on behalf of Andrew Crookham, Executive Director - Resources

Report to:	**Pensions Committee**
Date:	**14 July 2022**
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 2022

"Stagflation". What is it?
Can the UK – and the rest of the World - avoid it?

What is it?

Stagflation is the combination of little or no economic growth (i.e. in the actual volume of goods and services produced) and high price inflation. It has not been seen in the UK for the best part of 50 years. It is dangerous because any action by a Central Bank (e.g. the Bank of England) to rein in inflation by raising interest rates is likely to exacerbate the weakness in the real economy. Central Bankers around the globe are only too well aware of the pitfalls that could attend an unwise action by them. Raising interest rates too quickly could easily send an economy into a downwards spiral. Equally no or inadequate action on interest rates risks embedding inflation into the expectations of consumers – and especially the labour force – and lead to pressure for higher wages. Unemployment in most countries is at multi year lows and job vacancies at multi year highs.

It is important to note – as Christine Lagarde, the Chairman of the European Central Bank keeps reminding us – that raising interest rates in Europe has only a limited effect on some prices. In particular higher interest rates will have virtually no effect on energy prices, which reflect global supply and demand. On the other hand, such raises may well

influence local discretionary expenditure – such as eating out, holidays, durable goods purchases etc. Committee members will only be only too well aware that sharply higher prices can have a devastating effect on the finances of the less well off, who have little or no spare resources to compensate.

In summary, Central Banks will need the "wisdom of Solomon" or a substantial amount of "good luck" to successfully negotiate the challenges ahead.

How likely is stagflation?

The views of economists naturally vary. Making any forecast just now is difficult, such is the amount of uncertainty generated globally by Covid, the supply chain problems, the war in Ukraine and its associated energy crisis and the critical situation in China.

Growth around the world in the first half of 2022 was virtually zero, for seemingly temporary reasons. And inflation rates were very high – around 9% in the USA and in the UK - and rather lower but still too high elsewhere. Inflation rates are expected to fall, possibly sharply, in 2023.

Some economic recovery is expected in the remainder of 2022, perhaps to 3% or 4%. Is this plausible? In the USA and UK, the respective Central Banks have already started raising interest rates. Fed Funds rate (the US equivalent of our Base Rate) is already 1.75%. It is expected to rise to over 3% by the end of 2022. Base rate in the UK is currently 1.25% and could be say 2% by year end. The effect of these sharp increases on consumers and businesses is uncertain.

Markets

Stock markets have, not surprisingly, been erratic against such a scenario as set out above. The underlying assumption of institutional investors seems to be that the Central Banks will successfully negotiate the perils that could lie ahead. And thus that inflation will be brought under some measure of control without inducing a recession, i.e. a contraction in economic output.

At the time of writing, the US equity market has fallen a significant amount since its highs in January 2022. The broadly based S&P index is down about 20% whilst its "high tech" equivalent has fallen about 25%. The main UK index is down only 10%. Markets remain very thin and poorly traded – leading to volatile price movements day to day. These are the circumstances that engender sharp price rises or sharp price falls, as events unfold. The last few days have witnessed some buyers coming back to the markets. Institutional cash flows remain positive and the cash has to be invested somewhere – even in uncertain times.

Bond markets have seen substantial price falls this year, leading to income yields that are more attractive than for several years. US Treasury 10 year bonds offer over 3% per annum, and the UK gilt equivalent around 2.5%. Many corporate bonds, fearful of a recession taking hold, have had a torrid time, such that their yields now offer reasonable

returns in relation to their risks. Bonds generally, therefore, now seem to offer returns, which may be attractive, compared to equities – circumstances that have not prevailed for some time.

Conclusion

I am sceptical that global Central Banks can successfully negotiate the pitfalls posed by “stagflation”. To that extent, I am cautious about the still high levels of equity markets. That said, volumes of trading in markets are so low that vicious price movements, in either direction, are likely in the months ahead. The arguments are thus finely balanced.

Peter Jones
30 June 2022

Consultation

a) Risks and Impact Analysis

The Pension Fund has a risk register which can be obtained by contacting the Head of Pensions.

Background Papers

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

This report was written by Claire Machej, who can be contacted on 01522 553641 or claire.machej@lincolnshire.gov.uk.

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