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

Report to:	**Pensions Committee**
Date:	**01 December 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 discuss the report and consider whether any further information is required.

Background

Investment Commentary – December 2022

Has the rate of Inflation peaked? How will markets react?

The rate of inflation might well have peaked, both in the UK and globally. And if it has not, it should do so in the next several months. Wholesale gas prices have fallen substantially from their high point in the late summer – and oil prices have weakened somewhat. All being well, the northern hemisphere should just about get through the coming winter without severe energy blackouts. Some load shedding (where large industrial enterprises are denied supply for a period of hours at peak times) should, hopefully, enable private consumers to manage without interruption.

Markets

Equity markets were seemingly poised, in late summer, to rise once they were convinced that inflation rates (especially in the USA) had peaked and would fall rapidly. Pronouncements from most of the world's Central Banks have poured scorn on that idea. Bankers have repeatedly emphasised that their key objective is to achieve their target inflation rates within a reasonable time period – and for most that is a target of around 2%. Most headline inflation rates are still close to 10%. Avoiding a recession seems not to be in Bankers' remit.

Attention is also focussed on unemployment, which continues to run at historically low levels. Until this shows some signs of increasing, Central Banks will be fearful of excessive wage settlements, which could well embed themselves into more general inflationary expectations. And of course, some supply chain shortages remain – which heighten fears that high inflation will remain "sticky".

In September and October, many equity markets fell more than 10% - in a reversal of their previous optimism. That seemed principally to be based on listening to recent pronouncements from Central Banks that short term interest rates are likely to be "higher for longer". In turn, that led to falls in government bond markets, notably in the UK, spooked by the former Chancellor's "mini budget". So, markets are presently in a somewhat fragile state, although there has been some buoyancy in recent weeks.

Economic prospects

Many commentators (and I include myself) are of the view that it will be next to impossible to avoid a global recession in 2023, in view of higher domestic energy charges, rising supermarket bills, soaring mortgage interest rates and increased housing rents. These effects are not confined to the UK but are widespread in the developed world. The debate is more about how deep and for what duration. The International Monetary Fund, for example, is of the opinion that a global downturn can be avoided. A shallow but short-lived recession might well allow markets (both equity and bonds) to regain their poise, if inflation were thought likely to fall quickly. But anything approaching a slump would certainly have a more devastating effect on equities, with the fear that price inflation might vanish to be replaced by price falls. Such a scenario could well, of course, lead to government bond markets regaining their poise: but that might well not spill over into corporate bonds, if default rates were to rise significantly.

Government bond markets

The falls in these markets in 2022 have been astonishing and committee members may well be unaware of their magnitude. For example, 30 year UK Gilt Edged Stock (a direct obligation of the UK government) offered a yield of somewhat over 1% per annum in January and is now about 3.5%. The price fall amounts to about 40%. At their low point in price, after the previous Chancellor's mini budget, the fall reached an amazing 50%, exacerbated by some pension funds being 'forced sellers" to finance their cash needs under their Liability Driven Investment ("LDI") contracts. This latter fall completely dwarfed the falls in most equity markets.

Institutional cash flows

Institutional cash flows remain robust. Are these government yields now sufficiently attractive to tempt buyers into bond markets on a large scale? On one measure, compared to the current rates of inflation of around 10%, clearly not. There is a substantial loss in real, inflation adjusted, terms. If inflation were to fall rapidly towards targets of say 2% - then maybe. Many commentators think inflation will be "sticky" in 2023, averaging maybe 4% (albeit on a falling trend). Central Banks would probably respond with short term interest rates of say 5% per annum. If government bond markets are not yet sufficiently attractive, where does the cash go? One possibility is alternatives, especially private equity. But these are notoriously slow to lower their valuations to reflect the changed economic circumstance and, in particular, the falls in equities and bonds. That only leaves quoted equity markets. So, in spite of sentiment towards them being fickle, I suspect most developed global equity markets are close to forming a base.

Postscript: UK Chancellor's Autumn Statement

Mr Hunt gave his statement very close to my deadline for the submission of this report. The package was wide ranging – in order to spread the burden of tax increases and benefit upgrades as broadly as possible. He expects a recession in the UK in 2023. A succinct summary of the measures is therefore difficult, especially so soon after the announcement. The markets took the package calmly – as was no doubt one of the Chancellor's objectives. I will report more fully when we meet in December.

Conclusion

Peter Jones
18th November 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.

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