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REPORT PREPARED FOR

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INVESTMENT OUTLOOK

In my penultimate market report, it is pleasing to note that market conditions remain stable and that the uptrend in equities remains intact to the general benefit of the pension fund. This is despite growing concerns over rising inflation risk as economies recover and the likely policy response of central banks. When central banks start to unwind the massive liquidity they have injected into markets through quantitative easing and when they start to raise interest rates has been a question running through the last two quarterly reports. Bond yields have eased in recent weeks, suggesting markets are more relaxed now about the risk of a sudden and unwelcome tightening but also perhaps recognition of a recent easing in the pace of recovery.

The global economic recovery since the setback in Q1 this year has indeed been striking, in the UK, US and Europe. Even in the UK, which had the biggest fall in output last year, there is now hope that we will get back to pre-pandemic GNP levels by the end of this year, much quicker than expected. At the same time, inflation which had been expected to peak at 2.5% later this year, may now reach 4%. Both here and in the US, we are approaching the turn with regard to monetary policy.

While there was something of a consolidation in equities in May, global equities moved higher in June and July, despite the spread of the delta variant, helped obviously by positive sentiment over vaccine success but also much improved corporate earnings, dividend payment restoration and a rise in takeovers, notably in the undervalued UK market. China has been an exception with a sharp market fall as the authorities start to toughen regulations in some sectors. While consolidation would be welcome, equities should be able to hold on to these gains, barring an unexpected interest rate shock or further bad news on the spread of the delta variant.

ECONOMY

While the G7 leaders meeting in Cornwall may already be forgotten, it served as a reminder of the colossal fiscal support given to the global economy this time round compared to the great financial crisis when governments dragged their feet and left it to the central banks. Above trend GNP growth should continue well into 2022 meaning a much better unemployment outturn than would normally be expected, in the UK, for example, peaking at c 5%. The corollary to huge public sector deficits is of course huge private sector surpluses. At least the consumer sector is now running down its high savings ratio though business is yet to demonstrate a similar rise in investment as surpluses are spent on acquisitions, buybacks, etc. For decarbonisation to work, business will have to raise investment levels while consumers will have to spend more on energy bills, transportation, etc. For the other summit this year in the UK, the Glasgow summit on Climate Change, governments will need to show how they can navigate this transition which will inevitably mean more fiscal support when in theory finance ministers should be tightening fiscal policy.

A celebrated Federal Reserve chairman said that his job was to remove the punchbowl when the party was in full swing. The Fed and the BoE had seemed divided on this though the ECB has been quite clear that there will be no tightening this year. The critical issue is whether the upswing in inflation- over 5% in the US recently- is temporary or not, caused of course by supply shortages, rising input prices and an oil price back to $70/bbl. It looks as though the Fed is no longer so confident that the jump is easily reversible and it may well stop QE shortly, so- called tapering. However, it is very sensitive to market sentiment and will want to avoid a replay of the " taper tantrum " of 2013 when it tightened policy abruptly.

In the UK, the BoE has just redefined its policy to anticipate some modest tightening and has indicated an exit strategy for QE. This though is some way off and QE will only be unwound when interest rates reach 0.5%, instead of the previous 1.5% and that is not expected until 2024! Given that it expects inflation to reach 4% by year end, the highest since 2011, the Bank clearly assumes the inflation spike is temporary.

The OECD expects global growth this year of 5.8% and is probably being conservative but that is a big rise from the 4.2% it forecast at year end. The last report referred to the three fiscal bills President Biden is hoping to get passed and it now looks as through his infrastructure bill will get past Congress producing necessary longer term benefits. Growth of 5- 6% this year is possible but the UK will be the pacesetter with some 7% growth this year and 6% in 2022. Brexit effects are impossible to untangle in present circumstances. Within Europe, the southern economies are recovering faster but as with the UK this represents catchup on last year's falls. Japan remains something of a laggard but China is still growing fast, helped by some recent relaxation in central bank reserve requirements, definitely not a case of removing the punchbowl.

Currencies have remained fairly stable over the period with sterling shedding a little ground in favour of the dollar and the euro but holding up well.

MARKETS

Equities levelled off in June as concerns over the spread of the Delta variant spread but Q2 produced overall positive global equity returns with a rise of 7.5% in sterling terms, following the 4% in Q1. For the UK, the figures were 5.5% and 5% respectively with small cap shares rising 9%, continuing their strong outperformance. The US continues to lead the equity advance with some recovery in technology stocks, Europe performed in line with the global indices while emerging markets, led by China, lagged and Japan actually fell. In July, markets continued the consolidation but emerging markets lagged badly with a fall of 7%. China has taken a big hit with the tech index falling some 20% as the authorities increased regulations harshly on some sectors, sending a warning shot over the private sector. August has seen more consolidation.

Bond markets produced small positive returns as yields fell, presumably on fears that the Delta variant could derail the economic recovery as rising inflationary pressures would suggest yields should rise and bond prices fall. This has continued in Q 3, with 20 year gilt yields falling from 1.25% end June to 1.0% recently. With the price of inflation continuing to rise, to 3.6% from 3.3% at year end, this has meant quite a fall in real yields in Q3, benefitting the LDI hedges. The fall in bond yields has been more pronounced in the US and it is surprising to have strong equity and bond markets coexisting at this point in the cycle.

Growth stocks have benefitted though as lower bond yields imply lower discount rates of future earnings. Most likely, the equity market has got it right and economic recovery is secure, helped by Biden's stimulus packages and the Fed cutting the economy some slack in its interpretation of the inflation data. For that reason, we expect to see equities broadly hold on to the first half gains though that may have discounted much of the economic recovery to come through. Corporate earnings are coming out ahead of expectations, dividends are being restored and takeover activity is rising, notably in the UK and market sentiment remains positive.

UK commercial property showed another small positive return in Q2, consolidating the gradual recovery in this badly affected sector of the economy .Industrial property is the strongest sector still with rising rents and lower yields. Retail is polarised with supermarkets and retail warehouses holding up well while shopping centres and high street retail remain laggards. The office picture remains mixed.

INVESTMENT STRATEGY

The same comment as the last report. The portfolio is now broadly aligned with the agreed investment strategy following the major restructuring of the global equity portfolio in the first quarter. Any further changes would be relatively marginal, such as trimming the corporate bond portfolio or property. An area for discussion is whether to commit to a private debt allocation in addition to the existing multi-asset credit exposure. Similarly, the LDI portfolio has more than recovered the losses incurred over the RPI-CPI wedge issue. Hedging remains at around 30% of inflation risk and leverage has dropped markedly to just over 2.0 times, allowing for some increase in the hedge to be possible without more collateral or for collateral to be used elsewhere.

FOR FURTHER INFORMATION

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