Leicestershire County Council

Meeting: **Local Pension Committee**

Date/Time: **Friday, 2 September 2016 at 9.30 am**

Location: **Guthlaxton Committee Room, County Hall, Glenfield.**

Contact: **Mr. M. Hand (Tel. 0116 305 6038)**

Email: **matthew.hand@leics.gov.uk**

AGENDA

	Item	Report By	Marked
1.	Minutes of the meeting held on 22 June 2016.		(Pages 5 - 8)
2.	Question Time.		
3.	Questions asked by members under Standing Order 7(3) and 7(5).		
4.	To advise of any other items which the Chairman has decided to take as urgent elsewhere on the agenda.		
5.	Declarations of interest in respect of items on the agenda.		
6.	Summary Valuation of Pension Fund Investments and Investment Performance of Individual Managers.	Director of Corporate Resources	(Pages 9 - 12)
7.	Brexit and Impact on Asset Values.	Director of Corporate Resources	(Pages 13 - 18)
8.	Market Update.	Kames Capital	(Pages 19 - 32)
9.	Market Guidance.	Independent Investment Advisor	(Pages 33 - 42)
10.	Dates of Future Meetings.		

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11.	Any other items which the Chairman has decided to take as urgent.		
12.	Exclusion of the Press and Public. The public are likely to be excluded during consideration of the remaining items on the agenda in accordance with Section 100(A)(4) of the Local Government Act 1972 (Exempt Information).		
13.	Kames Active Value Property Unit Trust/Opportunity Pool. (Exempt under paragraphs 3 and 10 of Schedule 12A)	Director of Corporate Resources	(Pages 43 - 50)
14.	Kames Capital Quarterly Report. (Exempt under paragraphs 3 and 10 of Schedule 12A)	Fund Manager	
15.	Kempen Capital Management Quarterly Report. (Exempt under paragraphs 3 and 10 of Schedule 12A)	Fund Manager	
16.	Aspect Capital Quarterly Report. (Exempt under paragraphs 3 and 10 of Schedule 12A)	Fund Manager	
17.	Stafford Timberland Quarterly Report. (Exempt under paragraphs 3 and 10 of Schedule 12A)	Fund Manager	
18.	KKR Quarterly Report. (Exempt under paragraphs 3 and 10 of Schedule 12A)	Fund Manager	
19.	Kleinwort Benson Investors Quarterly Report (Exempt under paragraphs 3 and 10 of Schedule 12A)	Fund Manager	
20.	Ruffer Quarterly Report. (Exempt under paragraphs 3 and 10 of Schedule 12A)	Fund Manager	
21.	Pictet Quarterly Report. (Exempt under paragraphs 3 and 10 of Schedule 12A)	Fund Manager	
22.	Millennium Global Quarterly Report. (Exempt under paragraphs 3 and 10 of Schedule 12A)	Fund Manager	
23.	IFM Investors Quarterly Report. (Exempt under paragraphs 3 and 10 of Schedule 12A)	Fund Manager	
24.	Delaware Investments Quarterly Report. (Exempt under paragraphs 3 and 10 of Schedule 12A)	Fund Manager	

25.	JP Morgan Quarterly Report.	Fund Manager
	(Exempt under paragraphs 3 and 10 of Schedule 12A)	
26.	Aviva Investors Quarterly Report.	Fund Manager
	(Exempt under paragraphs 3 and 10 of Schedule 12A)	
27.	Legal and General Investment Manager Quarterly Report.	Fund Manager
	(Exempt under paragraphs 3 and 10 of Schedule 12A)	
28.	Ashmore Quarterly Report.	Fund Manager
	(Exempt under paragraphs 3 and 10 of Schedule 12A)	

TO:

Leicestershire County Council

Mr. G. A. Hart CC (Chairman)
Mr. S. J. Hampson CC
Mr. Max Hunt CC
Mr. K. W. P. Lynch CC
Mr. P. C. Osborne CC

Leicester City Council

Cllr Deepak Bajaj and Cllr Lynn Moore

District Council Representatives

Cllr. Malise Graham MBE
Cllr. Chris. Frost

University Representative

Mr. J. Shuter

Staff Representatives

Mr. R. Bone
Mr. N. Booth
Ms. J. Dean

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Agenda Item 1

Minutes of a meeting of the Local Pension Committee held at County Hall, Glenfield on Wednesday, 22 June 2016.

PRESENT:

Leicestershire County Council

Mr. Max Hunt CC
Mr. K. W. P. Lynch CC
Mr. S. J. Hampson CC
Mr. P. C. Osborne CC

District Council Representative

Cllr. Malise Graham MBE

University Representative

Mr. J. Shuter

Staff Representatives

Mr. R. Bone
Mr. N. Booth
Ms. J. Dean

449. Election of Vice Chairman.

That Mr. P. C. Osborne CC be elected Vice Chairman of the Local Pension Committee for the period ending with the date of the Annual Council meeting in May 2017.

(Mr. P. C. Osborne CC in the Chair)

450. Minutes of the previous meeting.

The minutes of the meeting held on 27th May 2016 were taken as read, confirmed and signed.

451. Question Time.

The Chief Executive reported that no questions had been received under Standing Order 35.

452. Questions asked by members.

The Chief Executive reported that no questions had been received under Standing Order 7(3) and 7(5).

453. Urgent Items.

There were no urgent items for consideration.

454. Declarations of Interest.

The Chairman invited members who wished to do so to declare any interest in respect of items on the agenda for the meeting. No declarations were made.

455. Exclusion of the Press and Public.

RESOLVED:

That under Section 100(A) of the Local Government Act 1972 the public be excluded from the meeting for the following item of business on the grounds that it involved the likely disclosure of exempt information as defined in paragraphs 3 and 10 of Part 1 of Schedule 12(A) of the Act.

- Investment Pooling Within the Local Government Pension Scheme – Approval of the LGPS Central Investment Pool’s Submission to Central Government

456. Investment Pooling Within the Local Government Pension Scheme - Approval of the LGPS Central Investment Pool's Submission to Central Government.

The Committee received an exempt report by the Director of Corporate Resources which provided an update on progress in respect of the pooling of investments within the Local Government Pension Scheme (LGPS) and sought approval for the business case for the LGPS Central investment pool and budgeted programme costs for the period up to 31st March 2018. A copy of the report marked ‘8’ is filed with these minutes. The report was not for publication by virtue of Paragraphs 3 and 10 of Part 1 of Schedule 12(A) of the Local Government Act 1972.

RESOLVED:

a) That the LGPS Central investment pool’s business case for submission to the Department for Communities and Local Government be approved, including the draft responsible investment framework and other annexes which form the basis of the submission required by central government by 15th July 2016;

b) That the LGPS Central investment pool budget up to 31st March 2018, as detailed within the appendix to the report, be approved.

(The meeting then returned to public session)

457. Investment Pooling Within the Local Government Pension Scheme - Approval of the LGPS Central Investment Pool's Structure and Operator Model.

The Committee received a report by the Director of Corporate Resources which provided an update on progress in respect of the pooling of investments within the Local Government Pension Scheme (LGPS) and sought approval for the use of a Financial Conduct Authority (FCA) regulated and authorised structure for the LGPS Central investment pool and the creation/building of an operator of the pool. A copy of the report marked ‘9’ is filed with these minutes.

Arising from discussion the following points were noted

- The formation of the LGPS Central investment pool, of which Leicestershire Pension Fund would be one of eight members, would lead to initial set up costs that would increase overall costs in the very early years. There would also be one off costs associated with assets being sold and reinvested with investment managers appointed by the pool. Over time it was expected that the merging of assets would realise substantial savings through avenues such as economies of scale and reductions in management fees;

- Whilst not immediately, there remained a possibility that a national infrastructure platform for the LGPS would be launched which would allow Funds from all eight pools to gain more cost effective access to the asset class;

- A FCA regulated and authorised structure would provide a robust arrangement to manage the investment pool which complied with Government criteria. It was proposed that a new operator to run the pool be created rather than buying or renting services from an existing one. Whilst this approach would lead to additional costs initially, it would allow for maximum flexibility and be more cost effective than the other options in the long term;

- Whilst the 89 LGPS Funds were being encouraged to form pools and combine assets, each Fund would remain a separate entity. The Local Pension Committee would continue to set Leicestershire Pension Fund's Asset Allocation and overall investment strategy.

RESOLVED:

That the structure for the LGPS Central investment pool be a Financial Conduct Authority (FCA) authorised one with an operator for it to be created and built.

10.00 – 10.50am CHAIRMAN
22 June 2016

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Agenda Item 6

Leicestershire County Council

LOCAL PENSION COMMITTEE – 2ND SEPTEMBER 2016

REPORT OF THE DIRECTOR OF CORPORATE RESOURCES

SUMMARY VALUATION OF PENSION FUND INVESTMENTS AND INVESTMENT PERFORMANCE OF INDIVIDUAL MANAGERS

Purpose of Report

1. To present to the Committee a summary valuation of the Fund's investments at 30th June 2016 (attached as an appendix to this report), together with figures showing the performance of individual managers.

Summary Valuation

2. The total market value of investments at 30th June 2016 was £3,368.8m compared to £3,158.6m at 31st March 2016, an increase of £210.3m. In the three month period non-investment related net cash inflows amounting to £4.0m were received. After adjusting for non-investment related cash flows the Fund value increased by £206.3m, or 6.5%, due to changes in the value of investments.

3. The total returns of various indices since 31st March 2016 were as follows:-

	Local Currency %	**Converted to Sterling %**	**Return with 50% hedge %**
UK Gilts	+6.2	+6.2	+6.2
UK Index-Linked	+9.8	+9.8	+9.8
UK Equities	+4.7	+4.7	+4.7
North American Equities	+2.6	+10.3	+6.4
European Equities	-0.4	+4.4	+2.0
Japanese Equities	-7.7	+8.8	+0.6
Pacific (Ex Japan) Equities	+1.8	+7.8	+4.8

4. The current split of investments over sectors is as follows:-

	30th June 2016		**31st March 2016**
	£m	**%**	**%**
UK Equities	273.5	8.1	8.3
Overseas Equities	1,359.9	40.4	40.7
Targeted Return/Credit/Opportunity Pool	819.3	24.3	25.1
Private Equity	128.2	3.8	3.8
Property	288.6	8.6	9.3
Cash	27.7	0.8	0.3
Inflation-Linked Assets	476.0	14.1	12.2
Active and Passive Currency	(4.4)	(0.1)	0.3
	3,368.8	**100.0**	**100.0**

5. The investment performance of the individual managers is laid out in the tables below, over various periods. For most managers the benchmark performance quoted is based on indices, for targeted return managers the benchmark is cash + 4% p.a. and for Millennium the benchmark is 1.5% p.a.

3 months

Manager/Portfolio	Actual (%)	B/mark(%)	Relative (%)
Legal & General (passive global equities)	+7.6	+7.6	-
Aviva Investors (property)	+2.0	+0.1	+1.9
Aspect Capital (managed futures)	-2.1	+1.1	-3.2
Delaware (emerging market equities)	+9.5	+8.2	+1.3
Kleinwort Benson (equity dividend)	+8.0	+8.6	-0.6
Kempen (equity dividend)	+6.1	+8.6	-2.7
Ruffer (targeted return)	+4.5	+1.1	+3.4
Pictet (targeted return)	+5.5	+1.1	+4.4
Ashmore (emerging market debt)	+14.6	+11.1	+3.5
Millennium (currency)	-0.9	+0.4	-1.3

One year

Manager/Portfolio	Actual (%)	B/mark(%)	Relative (%)
Legal & General (passive global equities)	+10.6	+10.6	-
Aviva Investors (property)	+8.9	+7.2	+1.7
Aspect Capital (managed futures)	+14.6	+4.4	+10.2
Delaware (Emerging market equities)	+9.1	+3.5	+5.6
Kleinwort Benson (equity dividend)	+14.6	+13.3	+1.3
Kempen (equity dividend)	+15.5	+13.3	+2.2
Ruffer (targeted return)	+1.3	+4.4	-3.1
Ashmore (emerging market debt)	+26.0	+20.7	+5.3
Millennium (currency)	-1.4	+1.5	-2.9

Three years (performance per annum)

Manager/Portfolio	Actual (%)	B/mark(%)	Relative (%)
Legal & General (passive global equities)	+10.1	+10.0	+0.1
Aviva Investors (property)	+14.8	+12.5	+2.3
Aspect Capital (managed futures)	+11.0	+4.4	+6.6
Delaware (Emerging market equities)	+4.4	+2.7	+1.7
Ruffer (targeted return)	+5.2	+4.4	+0.8
Kleinwort Benson (equity dividend)	+10.0	+10.6	-0.6
Kempen (equity dividend)	+8.0	+10.6	-2.6
Millennium (currency)	+1.1	+1.5	-0.4

Five years (performance per annum)

Manager/Portfolio	Actual (%)	B/mark(%)	Relative (%)
Legal & General (passive global equities)	+8.8	+8.7	+0.1
Aviva Investors (property)	+9.6	+8.5	+1.1
Delaware (Emerging market equities)	+1.1	-0.2	+1.3
Ruffer (targeted return)	+6.2	+4.5	+1.7
Millennium (currency)	+1.1	+1.5	-0.4

Equal Opportunities Implications

6. The matters referred to in this report have no identifiable equal opportunities implications.

Recommendation

7. It is recommended that the Committee notes the report.

Background Papers

None.

Officer to Contact

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APPENDIX

PENSION FUND INVESTMENTS AS AT 30TH JUNE 2016

	Market Value £	Value %	Benchmark %	Variance %
Equities				
United Kingdom	273,493,207	8.12	8.10	0.02
Overseas:				
Global dividend-focused	264,760,190	7.86	8.00	-0.14
North America	489,640,627	14.53	14.20	0.33
Europe (Ex UK)	203,793,059	6.05	6.10	-0.05
Japan	102,974,801	3.06	3.00	0.06
Pacific (Ex Japan)	104,072,424	3.09	3.00	0.09
Emerging Markets	194,683,795	5.78	6.10	-0.32
Total	1,359,924,896	40.37	40.40	-0.03
Private Equity	128,240,456	3.81	4.00	-0.19
Property				
Direct Holdings*	95,300,000	2.83	4.00	-1.17
Indirect Holdings	193,271,967	5.74	6.00	-0.26
Total	288,571,967	8.57	10.00	-1.43
Alternative Investments				
Fauchier	690,127	0.02	0.00	0.02
Pictet	87,789,417	2.61	3.00	-0.39
Ruffer	225,338,777	6.69	7.00	-0.31
Credit Opportunities	157,020,043	4.66	5.00	-0.34
Aspect	135,286,885	4.02	4.00	0.02
Emerging Market Debt	92,044,510	2.73	2.50	0.23
Opportunity pool	121,150,154	3.60	3.50	0.10
	819,319,913	24.32	25.00	-0.68
Commodities	0	0.00	0.00	0.00
Inflation-Linked Assets				
Global Government Index-Linked Bonds	242,716,773	7.20	7.50	-0.30
Infrastructure @	160,814,737	4.77	3.00	1.77
Timberland	72,462,308	2.15	2.00	0.15
	475,993,818	14.13	12.50	1.63
Cash on Deposit	27,698,807	0.82	0.00	0.82
Unrealised Profit On Currency				
Active	-868,554	-0.03	0.00	-0.03
Passive	-3,573,692	-0.11	0.00	-0.11
Total	-4,442,246	-0.13	0.00	-0.13
TOTAL	**3,368,800,818**	**100.00**	**100.00**	**0.00**

Direct Property Holdings*		
Retail	13,465,000	14.13
Retail Warehouses	19,695,000	20.67
Offices	24,500,000	25.71
Industrials	16,855,000	17.69
Leisure (Hotels/Health Club)	18,010,000	18.90
Farms	2,775,000	2.91
	95,300,000	100.00

@ infrastructure includes $90m that was held in cash awaiting an investment that was made on 1st July 2016

LOCAL PENSION COMMITTEE – 2ND SEPTEMBER 2016

REPORT OF THE DIRECTOR OF CORPORATE RESOURCES

BREXIT AND IMPACT ON ASSET VALUES

Purpose of the Report

1. To provide information to the Committee in respect of the short-term impact of the UK's decision to leave the European Union on the value of the Fund's assets. A summary of action taken by the Fund in the run-up to the referendum is also included.

Background

2. In February 2016 the Prime Minister announced that, in line with an election manifesto promise, a referendum in respect of the UK's continued membership of the European Union (EU) would be held on 23rd June 2016. The referendum would be a straightforward remain/leave vote and the outcome of the referendum would be advisory only; it did not legally bind the government to the outcome, although there was a clear expectation that the outcome would be honoured.

3. When campaigning commenced opinion polls suggested that there was a meaningful majority in favour of remaining in the EU, and the odds at bookmakers reflected this. During the campaign there were inevitable swings in opinion polls, although the bookmakers always had odds that remained significantly weighted towards remain, and investment markets were volatile depending on the latest news and opinion polls. Investors hate uncertainty more than anything else and this volatility was fully expected.

4. The outcome of the referendum came as a shock to almost everyone, with 51.9% of voters favouring the UK leaving the EU. Given the uncertainty that this outcome gives to both the UK and also the rest of the world, the initial reaction of markets was sharp falls in equity prices, a significant devaluation of sterling (by about 10%) and a flight towards the safety of bonds. This reaction is entirely logical and could have been predicted if the outcome of the referendum had been known in advance; however, if the outcome had not been a shock the result would have been factored into markets already.

Action taken in lead up to referendum

5. The Fund's strategic benchmark includes a 50% hedge back to sterling of the currency exposures that come as a result of overseas equity holdings. The currency risk that overseas equity holdings bring is 'accidental' – it is the equities that the Fund is seeking exposure to, and not the currency – and as a result the default position is to reduce some of this risk by hedging half of the currency exposure.

6. The Fund does not, however, have a ‘blanket’ 50% hedge on this currency exposure. Kames Capital manages the currency exposures actively and takes account of their view of ‘fair value’ and also correlations with other assets when implementing the actual hedge. There have been occasions when they have maintained a 100% hedge to the Euro (believing that it will weaken relative to Sterling) whilst simultaneously having no hedge in the US Dollar.

7. In the immediate lead up to the referendum Kames Capital formed the view that markets were far too relaxed about the probability of a remain vote. They felt that if this was the outcome there would be a relatively small rally in Sterling (perhaps 1 – 2%), but that this would soon dissipate given their view that Sterling would remain under pressure as a result of the twin budget and balance of payments deficits. A leave vote, whilst not expected, would be likely to bring a significant devaluation of Sterling. In effect, for a vote with a binary outcome (remain/leave) there were far-from binary outcomes for sterling.

8. The manner in which Kames Capital carry out currency hedges means that the profit/loss positions are ‘marked-to-market’ on a daily basis, and a cash adjustment is made to reflect the revised position. From a practical perspective if sterling were to depreciate significantly when hedges were in place, the Fund would need to find cash to reflect the loss. Given that the Fund holds relatively small amounts of cash – there is no cash in the strategic asset allocation of the Fund – this would require the sale of assets. As it would be a leave vote that brought about the sterling depreciation, and as it could reasonably be assumed that this outcome would bring market chaos and significant falls in the value of most assets, finding the cash to make good the payment required for the losses on the forward foreign exchange transactions would mean selling assets in difficult market conditions at depressed prices. Clearly this was not an attractive option.

9. Given Kames’ views it was agreed that it was sensible, from a risk-management perspective, to take off all currency hedges and this was done just over a week before the referendum. Sterling then rallied in the week leading up to the referendum and it looked as if the action taken would turn out to be sub-optimal, despite the fact that it had neutralised a significant risk to the Fund. The outcome of the vote and the depreciation of sterling made the move look like something of a masterstroke, although it should be stressed that the action was mainly a risk-management issue and there was never any strong view that there would be a leave vote.

10. It is not really possible to calculate how much the decision to take off all the currency hedges saved the Fund, as there would not have been default (50% hedged) positions in each currency anyway. But *if* the default hedge had been in place, a loss of circa £65m would have been made. In reality this actually means that the value of the Fund’s overseas equities would have increased by £130m as a result of the currency impact (i.e. not including any equity market movements), but this would have been offset by a £65m currency hedge loss.

11. In mid-June the Fund was beginning preparations to fund a $90m investment in the JPMorgan Infrastructure Investments Fund, which would bring the Fund’s investment up to the higher benchmark level of 5% that was agreed at the January 2016 Annual Strategy Meeting of the Committee. Given the discussions with Kames that took place about the currency hedge it was considered sensible to take action

to purchase the US$ in advance of the referendum, despite the fact that the 'drawdown' was not due until the beginning of July. This action meant that the cost of purchasing the dollars was £4.7m less than it would have been if the purchase would have been made shortly before the payment was required, which would have been the normal procedure.

Impact of referendum outcome onto asset values

12. In the immediate aftermath of the referendum equity markets across the world fell sharply, with the UK and Europe being particularly badly hit. Within a week, however, most equity markets had started to rise towards their previous levels and they have continued this rise since. At the time of writing this report (11th August) most equity markets are close to – or above – their post-referendum levels, and the currency impact on overseas equities means that the sterling value of these assets is now much higher than it was prior to the referendum. At the end of July the value of the passive equity portfolio managed for the Fund by Legal & General Investment Management (which includes all geographic regions, including the UK) was almost 12% higher than the value at the end of May, the Fund's two 'dividend-focused' global equity portfolios are 13% up from the end of May, and the specialist emerging market equity portfolio is 18% higher. To date, Brexit has actually been positive for equities, but there are clearly risks ahead and it will take a good few years until it is possible to be able to analyse the long-term impact of the decision.

13. The Fund has a relatively low exposure to UK equities in comparison to many other UK pension funds, and they account for only about 20% of all quoted equity holdings (including the weighting that is included within the global equity portfolios). Although the UK equity market has performed much better than might have been considered possible given the referendum outcome (partly assisted by the boost to earnings that many of the largest UK-listed companies will receive from the fact that the majority of these earnings are in overseas currencies), its increase between the end of May and the end of July has 'only' been 7%.

14. Of the Fund's other assets, most have done well post-referendum. The Fund is mainly exposed to overseas infrastructure assets so has benefitted from currency gains, although capital values are also generally higher in local currency terms. Timberland and private equity will also have benefitted from currency gains, and index-linked bonds have produced returns of around 15% between the end of May and the end of June. The only major negative has been UK property.

15. The Fund has a 10% benchmark exposure to UK property and there was plenty of publicity in the immediate aftermath of the referendum about the wave of redemption notices that pooled property funds had received from investors wanting to get their money out of the asset class. Most of this selling pressure appears to have come from individual, rather than institutional, investors and most managers have mechanisms in place to protect remaining investors from the need to sell assets at 'firesale' prices in order to meet the redemption requirements.

16. Whilst the press coverage was rather sensationalist, there is no doubt that there will be properties that require selling in the coming months and years. Economic facts dictate that if there are more sellers than buyers, prices will fall to a point at which the two are in balance and there is realism in the commercial property market that prices will fall. Valuers have not yet, however, marked down prices to any significant

extent as there is a lack of transactional evidence to justify this – it is probable that this will emerge in due course and that prices will face a slow and steady decline in the months ahead. Although the Fund's property holdings have not yet suffered any meaningful reduction in value it is highly likely that this will happen. This does not, however, appear to be another post Global Financial Crisis-type situation when prices fell by about 30% from peak-to-trough.

17. The general feeling within the property market is that prices may well fall 10% and this this will come via a gradual trickle-down rather than in big chunks. This is, however, just a forecast and only time will tell whether it has any basis in reality. With about £300m of property assets, it does not seem unreasonable to suggest that price falls of about £30m will come through in due course and that current valuations do not reflect reality.

18. Because the Fund has a number of investments in illiquid assets where the valuations take some time to receive, it is only currently possible to estimate an asset value at the end of July but it is expected to be almost £3.5bn. This is an increase of just over 10% from the value at the end of May.

Impact onto liability values

19. The assets of a pension fund exist for one reason only – to pay the benefits due to individual members. The value of these future benefits takes into account a number of things but one key factor is gilt yields, which are the starting point for assessing the Fund's future investment return. Future investment returns are important as they will pay for some of the benefits and if they are likely to be lower than previously expected it means that more money is needed now to pay for the benefits. Although it is a little complicated, with other things being equal, a fall in gilt yields (which has occurred post-referendum) increases the value of the Fund's current liabilities.

20. Therefore although the Fund has seen a significant increase in asset values in recent months, it will have also seen a significant (although somewhat lower) increase in its liabilities. As it is almost impossible to manage these liabilities there is no real point in trying to estimate the impact on the Fund's value. This liability increase is only mentioned to bring some balance to the matter – a £350m increase in assets over two months does not mean that the Fund's deficit has shrunk by this amount.

Recommendations

21. The Committee is recommended to note this report.

Equality and Human Rights Implications

22. None specific to this report.

Background Papers

None

Officers to Contact

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Agenda Item 8

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KAMES CAPITAL

Leicestershire County Council Pension Fund Q2 2016 - Market Report

KAMES CAPITAL

Contents

Historic Returns for World Markets	**3**
Market Review	**5**
Key Market Movements	**10**
Quarterly Thought Piece	**12**

KAMES CAPITAL

Historic Returns for World Markets

Index	Q2 (%)	1 Year (%)	3 Years (%)
Citi WGBI Non-GBP TR	11.48	32.07	6.95
FTSE 100 TR	6.54	3.80	5.32
FTSE 350 TR	4.90	2.34	5.79
FTSE A (Index Linked) British Govt All Stocks TR	9.79	14.85	10.86
FTSE A British Govt All Stocks TR	6.18	13.50	8.12
FTSE A British Govt Over 15 Years TR	11.76	24.09	14.95
FTSE All-Share TR	4.70	2.21	5.85
FTSE Japan TR	8.76	7.75	8.02
FTSE Small Cap TR	-0.62	-1.53	8.20
FTSE World Europe ex UK TR GBP	4.20	6.05	7.66
FTSE World ex UK TR GBP	8.90	15.52	11.96
IPD UK All Property Monthly TR	1.10	8.95	14.33
LIBID GBP 7 Day	0.12	0.49	0.48
Markit iBoxx Sterling Non Gilts Overall TR	4.30	8.97	7.41
MSCI EM (Emerging Markets) TR GBP	8.38	3.86	3.03
MSCI Pacific ex Japan TR GBP	8.27	9.86	5.56
S&P 500 TR	10.16	22.34	16.44
Commodities	12.71	-13.48	-10.63
£ Trade Weighted Index	-5.10	-13.61	0.17

Currency	Q2 (%)	1 Year (%)	3 Years (%)
Euro	4.82	17.30	-1.02
Japanese Yen	17.79	40.32	3.18
US Dollar	7.52	17.65	4.29

Index returns are reported in GBP to indicate sterling.
Source: Kames Capital as at 30 June 2016. All returns over one year are annualised.

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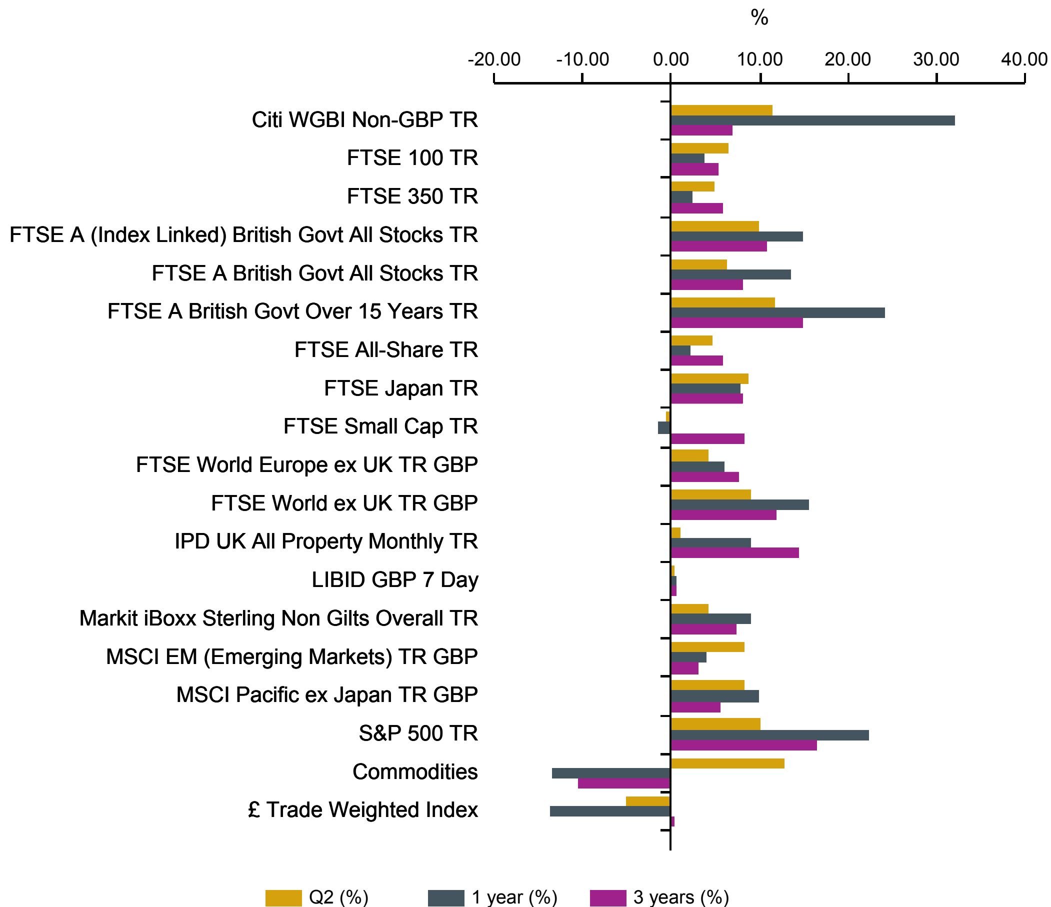
Historic Returns by Market Index

3 months, 1 year and 3 years (annualised)



Index returns are reported in GBP to indicate sterling.
Source: Kames Capital as at 30 June 2016. All returns over one year are annualised.

Market Review

UK Equities

UK equities advanced over the period, with the FTSE All-Share index returning 4.70%.

GDP growth for the first quarter of 2016, which came in at 0.4%, declined slightly from the figure registered in the final three months of 2015, and inflation slipped slightly by quarter-end as well. The approaching referendum on the UK's membership in the European Union (EU) cast its shadow over most of the quarter, but the Bank of England (BoE) remained supportive, keeping interest rates steady at 0.5%.

In late June, markets were surprised and reacted negatively when the UK voted to leave the EU. Global markets also reacted sharply, and sterling hit lows against the US dollar not seen in more than three decades. The result also ushered in a period of upheaval in British politics, as key figures abandoned their posts in the aftermath of the vote; not least, David Cameron announced his resignation, heralding a Tory leadership campaign. However, the UK market rose in June; the FTSE 100 quickly erased its losses as investors went in search of bargains. However, this resilience should not be a surprise given the index has a heavy weighting to US dollar earning and given the defensive nature of the businesses within the index. Further support came from the BoE, which suggested that it could introduce new stimulus measures. Certain economic figures were also encouraging: unemployment fell to 5.0% in April, its lowest since 2005, and retail sales climbed steadily (year on year) over the period.

As for individual sectors, oil & gas performed markedly better than other areas. Basic materials also finished the quarter strongly, as did the utilities sector, likely due to its defensive nature in a climate of political and economic uncertainty. Laggards included consumer services and financials.

US Equities

In the US, the S&P 500 index rose by 10.16% in sterling terms. Most of this gain was down to the pound's weakness versus the dollar; in US dollar terms the index rose 2.46%.

Economic newsflow in the US was broadly upbeat, with an upward revision to first-quarter GDP growth (1.1%) and significantly increased new-home sales in April. The positive outlook was reflected in the University of Michigan's consumer sentiment survey, which rose to 94.7 in May from 89.0 in April, and slipped only slightly in June.

In terms of monetary policy, the US Federal Reserve maintained interest rates, but amended its language slightly to suggest that a mid-year rate rise was not out of the question. Chair Janet Yellen suggested that an interest-rate rise would "probably" be appropriate "in the coming months". Her case was strengthened by a steep drop in the unemployment figure, which fell to 4.7%, a figure not seen in nearly a decade.

However, markets dropped sharply in the days following the UK's decision to end its membership of the EU, experiencing the worst falls in 10 months and temporarily erasing year-to-date gains. This, coupled with depressed hiring figures, led the Fed to re-examine the macro environment; the bank eschewed rate rises in June and minimally decreased its forecast for 2016 growth, lowering it from 2.1% to 2.0%. It did, however, continue to signal that two rate increases will happen before 2017. Elsewhere, both industrial and manufacturing production fell over the year to May, but business confidence – as measured by the ISM manufacturing purchasing managers' index (PMI) – stayed buoyant, exceeding estimates by rising to 51.3 from April's reading of 50.8.

At a sector level, energy rose strongly. Telecommunication services also proved robust. Information technology was the weakest sector, though still achieved a positive return in sterling terms.

European Equities

The FTSE Europe ex-UK rose by 4.20% in sterling terms, with the pound's weakness boosting returns from overseas equities; the index was down -0.63% in local-currency terms.

While the European Central Bank (ECB) acknowledged early in the quarter that growth was "tilted to the downside", it also put a positive spin on things by revealing the opinion that inflation would improve by year-end. Markets were supported by rising consumer and business sentiment together with a slight increase in first-quarter GDP growth. This improved mood was, in part, driven by the actions of the central bank, which introduced a corporate bond buying programme with a June start date. Progress in negotiations between Greece and its creditors provided an additional lift for sentiment. The International Monetary Fund said it would examine a debt-relief deal offered to Greece by Eurogroup ministers and, depending on its findings, decide before the end of the year whether to join the bailout.

European equity markets were naturally shaken in late June by the UK's decision to leave the EU. But prior to that decision − which analysts expect will curb the eurozone's advancement somewhat – positive data was seen in the form of a return to inflation. Consumer prices in the area rose by an estimated 0.1% over the year to June, the first positive reading since January, boosted by more stable oil prices. Both industrial and manufacturing production registered improvements; the former beat expectations to bounce 2.0% over the year to end April, while the latter expanded as a result of stronger exports. Sovereign debt in some of Europe's peripheral countries also experienced gains as a result of the Brexit turmoil: yields on 10-year Spanish, Italian, and Portuguese bonds fell on the prospect that the ECB could take steps to calm European markets.

Japanese Equities

The FTSE Japan rose by 8.76% in sterling terms, but fell -7.67% in local currency terms.

Participants in the Japanese market continued to worry about the lasting vigour of the yen. Hopes that the Bank of Japan would counteract the climb with additional quantitative easing failed to come to fruition, which only served to boost the currency further. A 0.5% expansion in GDP was recorded in the three months to March, up from a contraction of 0.3% in the last calendar quarter of 2015. The figure was helped by greater spending by both the Japanese government and consumers. In future, the latter group should be encouraged by Prime Minister Shinzo Abe's announcement during the month that his government's planned rise in sales tax has been postponed until late 2019. However, this also gave the impression that the economic benefits of Abenomics might not be taking hold as well as was hoped.

The Japanese equity market was hit hard in the hours following the confirmation of Britain's exit from the EU; the Nikkei closed nearly 8% lower on 24 June, experiencing its worst single-day loss since 2011, before recovering into the month-end. As for broader economic data, unemployment held steady at 3.2% in April, but wage growth slowed. Elsewhere, a continuously strong yen dented Japanese exports, and a more than ¥40 billion deficit was recorded for May as Japanese products became more expensive in overseas markets. Consumerism at home slowed as well, with retail sales falling by 1.9% over the year to May.

The telecommunications sector was strong over the quarter, one of the few to achieve a positive return in yen terms. Financials was a notable laggard, particularly the financial services and life insurance subsectors.

Asia Pacific ex-Japan Equities

Asian markets advanced during the quarter, with the MSCI Pacific ex Japan index returning 8.27% in sterling terms. As with many other indices, most of this gain was due to the weakness of the pound against overseas currencies. In local currency terms the index rose 1.76%.

Chinese policymakers continued to worry about a lack of growth in their region as GDP growth slipped from 6.8% to 6.7% in the first quarter. Though the People's Bank of China refrained from taking steps to stabilise the Chinese currency, they did inject massive sums of cash into the system in an effort to increase liquidity and ease corporate tax strains. The yuan slipped against the US dollar on speculation that the US Fed could move to raise interest rates sooner rather than later. Concerns over stunted growth in China continued into June. The country's manufacturing PMI reading fell to 48.6 in June from 49.2 in May; any figure below 50 indicates a contraction. Inflation slipped back as well, dipping to 2.0% in May after spending three months steady at 2.3%; lower food prices were a determining factor in the fall. While the People's Bank of China held rates and avoided any other quantitative-easing measures during the month, the gloomy data led to speculation that further central bank activity will be deemed necessary in the coming months.

In April, Indian policymakers cut the benchmark interest rate to 6.5% from 6.75%, which had been widely expected. Indeed, India was one of a number of Asian markets which rose in response to favourable economic data in the period. Indian GDP growth reached 7.9% year over year, while industrial production enjoyed a similar rate of expansion, increasing by 7.37% in March from a negative reading in February. Thailand's economy expanded by 0.9% from 0.8% in the prior quarter, when a slight contraction had been predicted. Showing only short-lived concern about the UK's vote to leave the EU, stock markets in India, Indonesia, Thailand, and the Philippines all ended the quarter up. Australia benefited from the surging price of gold as investors turned to the metal as a refuge from Brexit fears.

Property

The IPD monthly benchmark showed a 1.10% total return over the quarter ending 30 June 2016.

The UK commercial property market showed a slowdown in the period prior to the referendum, with notably less investment activity caused by market uncertainty. In some sectors this led to a cooling in pricing as investors held off making decisions and the market lost momentum.

When the UK voted to leave the European Union on 23 June, this marked the beginning of a period of economic and political uncertainty. Financial markets responded to the result quickly and negatively.

Investors who were concerned about the market after Brexit chose to withdraw their investments from property, causing several of the open ended, daily traded, property funds to suspend redemptions. These excessive outflows have now largely abated and the market has calmed. Some of these funds are now seeing positive inflows again as investors see opportunity in the market and view property as an attractive investment with an income return.

As property valuations are backward looking and evidence based, values at the end of June have not reflected the full impact of the Brexit vote. As a result, managers of daily traded, open ended, property funds, which are open to retail investors, have made market value or redemption price adjustments in an attempt to ensure that all investors are treated fairly.

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Fixed Income

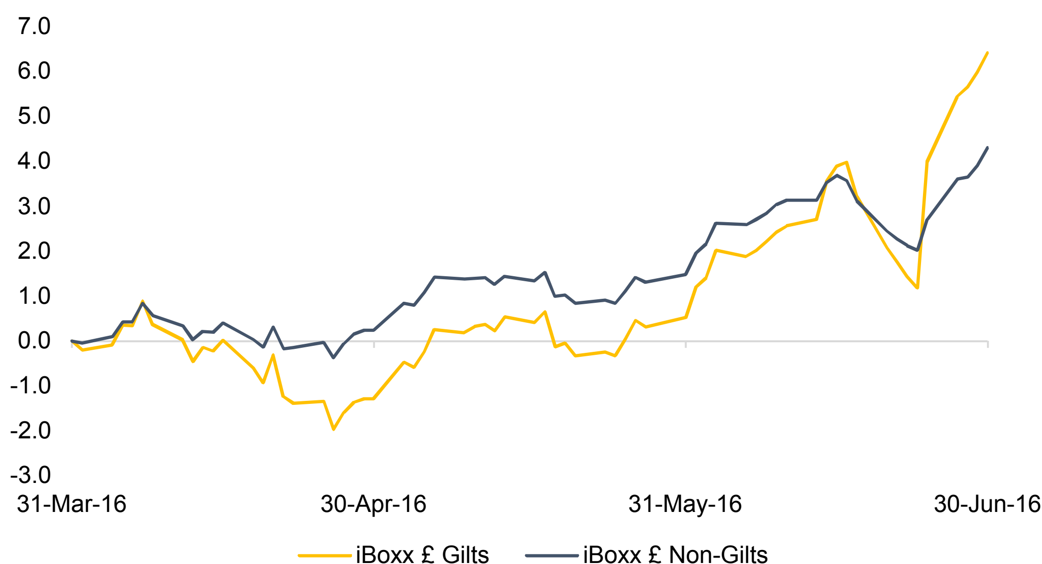
The second quarter of 2016 was, by any measure, an eventful period. Clearly, the most significant development was the UK referendum on European Union membership, which resulted in a vote to leave. Given the seismic shock this had on the political and economic landscape, it would be easy to forget that the vote actually took place as the quarter was coming to an end.

In the first two months of the period, bond markets performed in a similar manner to previous quarters. Supportive Central Bank activity coupled with ongoing concerns about the global economy generally dictated the direction of travel. This left government bond markets in particular trading within a relatively well-defined range. At the same time the corporate bond sector took comfort from a modest but healthy supply line, ongoing strong demand and the European Central Bank's decision to extend its quantitative easing programme to include select corporate bonds.

This rather subdued backdrop changed in June, with signs that investors were moving into 'risk-off' mode, which in turn supported government bonds. Initially, the increased caution was due to a very disappointing US jobs report for May, but the looming UK referendum quickly became the central cause of investor anxiety.

The date of the referendum (Thursday, 23 June 2016) is sure to find a permanent place in history text books. The electorate's decision to bring to an end the UK's 43-year relationship with the EU caused a political earthquake. The impact on financial markets, at least initially, was equally strong, although some assets fared much better than others. Sterling was the main loser as it weakened dramatically against both the US dollar and the euro. In contrast, the clear winners were index-linked assets and core government bonds, in both June and the quarter as a whole. Corporate bond markets – both investment grade and high yield – came under some pressure in June but also enjoyed strong returns for the quarter although both assets were some way off the stellar returns seen in their government bond counterparts.

Strong returns from fixed income



Source: Markit, total return, percentage growth

Government bonds – record low yields

The outcome of the referendum caused government bonds in the US, UK, Germany and Japan to reach record lows. At the same time yields increased in the peripheral regions of Europe as investors' shunned their higher-risk profile.

The strength of the move into the perceived safety of core assets was also due to the expectation that Central Banks would once again have to step in to calm markets. In the UK, this belief was strengthened when Bank of England governor Mark Carney announced a £250 billion facility which commercial lenders could call upon if they were facing liquidity struggles. A potential cut in interest rates during the summer was also suggested.

The resultant move in yields for the quarter as whole left UK gilts up over 6%, with longer-dated bonds (15-year and over) posting a very impressive return of over 11%. The performance of index-linked gilts was also strong, returning almost 10%.

Table 1: 10-year yield movements in core and European periphery benchmark bonds

	Core government bonds				Peripheral Europe				
Country	UK	US	Germany	Japan	Spain	Italy	Greece	Ireland	Portugal
Yield at end March 2016	1.42	1.77	0.15	-0.03	1.43	1.22	8.48	0.73	2.93
Yield at end June 2016	0.87	1.47	-0.13	-0.22	1.16	1.26	8.18	0.52	2.99
Change in yield	-0.55	-0.30	-0.28	-0.19	-0.27	0.04	-0.30	-0.21	0.06

Source: Bloomberg.

Investment grade bonds

Investment grade bonds also performed well over the quarter; in total return terms the iBoxx £ Non-Gilts index returned 4.30%.

In sector terms, financials (particularly banks and insurance companies) performed well in the first two months of the quarter and generally outperformed non-financials. This pattern reversed in June with financials coming under pressure from the referendum result. Banks and insurance companies were among the weakest areas (relative to other corporate bond sectors) and Italian banks bore the brunt of the pain, although large household banking names in the UK were also affected.

Despite the relative weakness in financials, corporate bonds overall rallied in tandem with their government bond cousins, although to a much lesser extent. The main source of support was, again, the realisation that Central Banks would be forced to keep interest rates ‘lower for much longer’ in order to combat not only an ongoing fragile global economic backdrop but also the effects of the UK’s vote to leave the EU. This realisation served as a reminder that investment grade bonds would remain an attractive option for investors seeking yield in a low interest rate environment.

It is also worth noting that while financial bonds struggled in June compared to other bond sectors, by the end of the quarter they had recovered some of their poise. Moreover, there were some indications that, to date, the fall-out from the UK’s referendum vote was perhaps not as severe as expected.

High yield bonds

The Barclays Global High Yield index returned 4.43% over the quarter, with US high yield clearly outperforming its European equivalent.

In April and May the high yield market performed strongly as commodity prices (specifically oil) continued to rise and investment flows showed signs of life. The decline in volatility allowed more issuers to come to the primary market with both the US and Europe seeing the greatest volume of issuance. However, new-issue volumes still remained substantially lower than at the same point in 2015.

As an asset class, global high yield bonds performed relatively well following the EU referendum result, with the market seeing a valuation decline of around 1.5% only. This reflects the market’s light exposure to UK corporations (around 6%) and its tendency to be dominated by domestic US and multi-national issuers.

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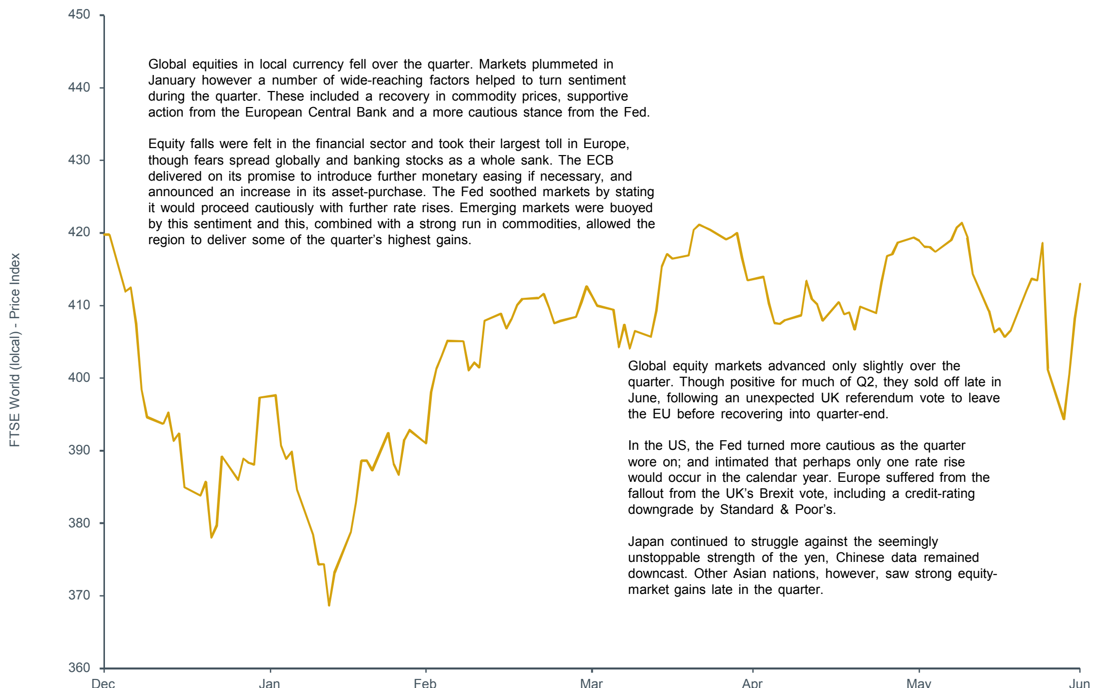
Key Market Movements

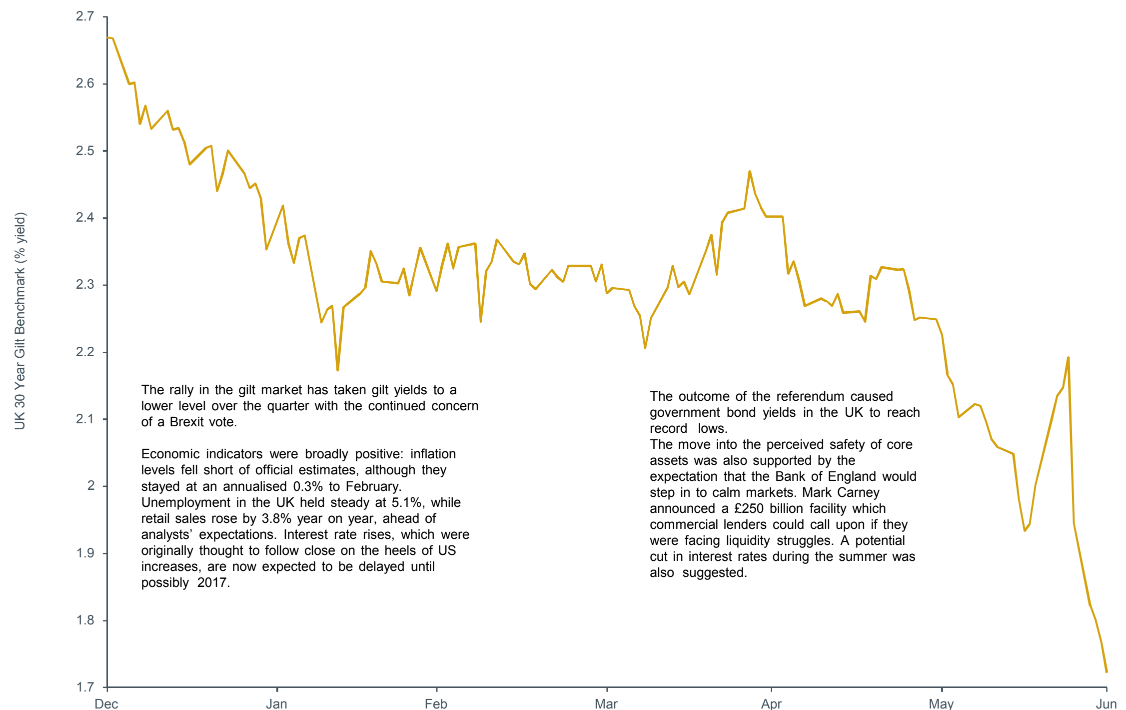
The following charts provide a pictorial summary of key market movements during the six-month period to end of June 2016

Global Equities (FTSE World – Price Index)



Source: Datastream

Long Gilts (War Loans 3.5% Perpetual)



Source: Datastream

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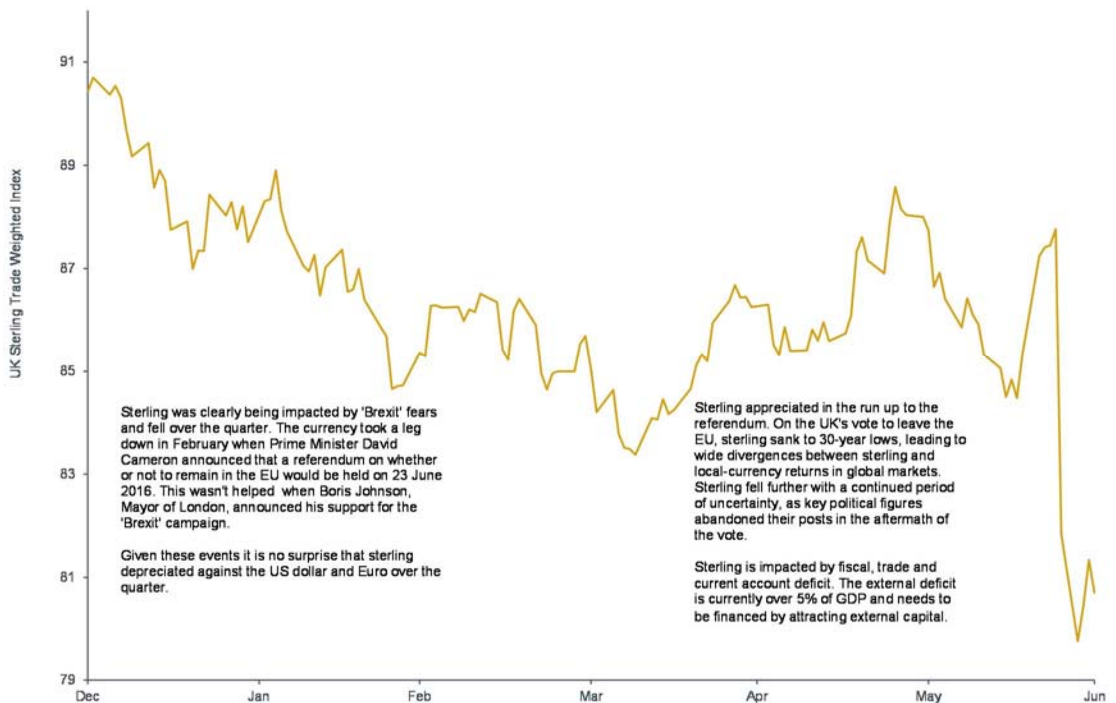
Oil Price (Crude Oil Spot WTI Cushing ($per barrel))

Source: Datastream

UK Sterling (UK Sterling Trade Weighted Index)



Source: Datastream

Quarterly Thought Piece

On Thursday 23 June 2016, the UK signalled its intention to sue for divorce from its collective EU partners. Although their relationship with the UK had become increasingly strained, EU members never thought it would come to this. It remains to be seen if a settlement can be arrived at amicably.

Ahead of the Referendum various examples were given of countries which found the process of reaching trade agreements with the EU unduly lengthy. The UK is the fifth largest economy in the world and a major destination for EU output; its negotiating position should prove to be significantly stronger than the likes of Norway or Greenland.

The initial financial market reaction to the UK Referendum result proved to be more muted than most commentators suggested. We were consistent with many in the market in adopting a broadly neutral position in our balanced funds ahead of an event, the outcome of which none could call.

The Referendum result has exposed strong divisions within the UK. The decision to leave the EU was more strongly supported, for example, by that portion of the population that owned fewest assets and so was least exposed to the revaluation of asset prices generated by quantitative easing (QE) and the evaporation of interest rates. These are the people who are at the wrong end of the iniquitous redistribution of wealth that has occurred in recent years. They have cried ‘enough’ and, in doing so, have echoed the call of many across the developed world.

Recent months have seen a growing demand for a more holistic approach to economic reflation – one that goes beyond monetary policy to embrace powerful fiscal action. So far, that clamour has been ignored not least because politicians have found themselves tied to a platform of debt reduction. Brexit could provide the excuse for a radical – and global – policy change, one which delivers money to the masses. Echoing the words of Keynes, we would not be surprised if Brexit proved to be the fact that allows politicians to change their minds. If so then this would be a significant input to our investment thinking.

It is clear that changes to monetary policies are now close to being ineffective; when negative interest rates don’t lead to stronger consumption and corporate investment then what else can you do? There is no incentive to borrow (to invest/spend) today when the expected future path of interest rates suggests that ultra-low interest rates are here to stay. Near-zero borrowing costs ‘kick-start’ activity when there is a sense of scarcity - that sense is missing. ‘Low for long’ has been a credit market theme for a while. ‘Low forever’ is a theme that is developing and looks set to define all financial markets for the rest of this decade. In this scenario long-duration bonds remain attractively priced.

A powerful fiscal policy effort that targets a sharp increase in the money available to those with a high propensity to spend will directly fuel a lift in consumer spending and reinforce the influence of ultra-low borrowing costs. Such policies have been tried before, such as in the US and Japan, but these tended to be one-off measures which failed to generate a self-sustaining lift in consumption and economic activity. What could be tried now is a combination of higher wages, lower taxes and infrastructure investment. In combination these policies will have a better chance of working.

The enduring impact is likely to be an increase in the trend rate of price growth (inflation). The challenge is for this to happen in a way that doesn’t erode corporate profitability – a weaker corporate sector employs fewer workers who, in aggregate, spend less. This isn’t an easy balancing act to master but is one which governments need to master (most likely by lowering company taxation). If successful, the foundation for a more supportive environment for real assets generally will have been laid.

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Overall then the Referendum result will, as a minimum, inevitably generate a ‘punctuation point’ for the UK economy. Individual and company plans will be put on hold until the dust clears - if enough of us choose to do nothing for a while then a recession will result. This will induce a policy response – the Bank of England has said as much - that will hopefully (if it involves fiscal actions), prove potent. We believe this could support equity markets generally although it will be important to ensure that the stock-by-stock implementation is finessed appropriately. Under this scenario, a higher run-rate for inflation is in prospect and we will look to capture this in ways that aren’t already prohibitively expensive. For those investors able to access it, the outlook for gold has improved markedly.

Sterling looks likely to continue to trade weakly on the foreign exchanges as some safe-haven premium is lost and until politics in the UK become less confused. One of the challenges in the existing arrangement has been that the Eurozone needs a stronger, more cohesive fiscal and political platform if it is to survive. These were pre-conditions that the UK found very difficult to support. Therefore, on one level the outlook for the Eurozone is improved by the UK leaving the EU. If recent events, however, catalyse a fundamental reassessment of the viability of the Eurozone from within, then a weak euro is inevitable (or could generate a material and global systemic threat). If this occurs then a stronger sterling/euro exchange rate is possible.

Stephen Jones
Chief Investment Officer

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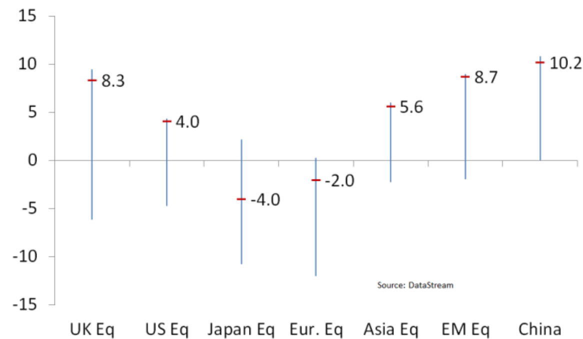
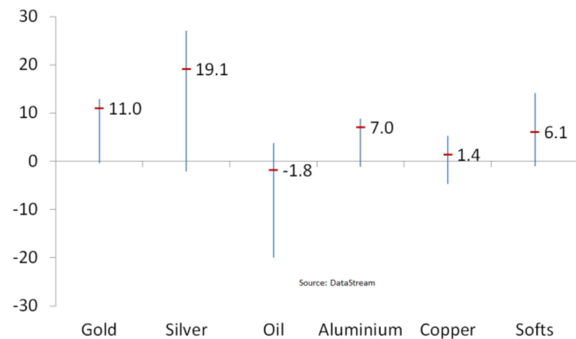
Market Backdrop

This note is intended to support the discussion at the upcoming meeting of the Pension Fund Management Board of Leicestershire County Council Pension Fund.

Market Movements

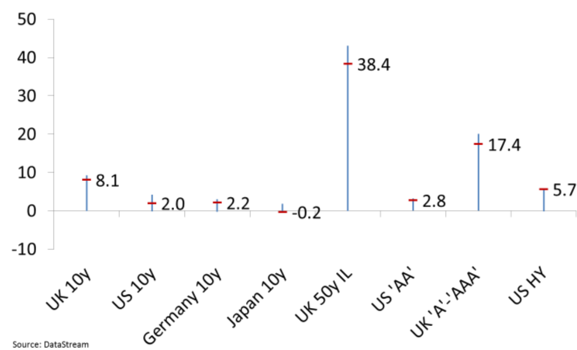
The figures below describe the % performance of various markets from the date of the last meeting to 19 August 2016.

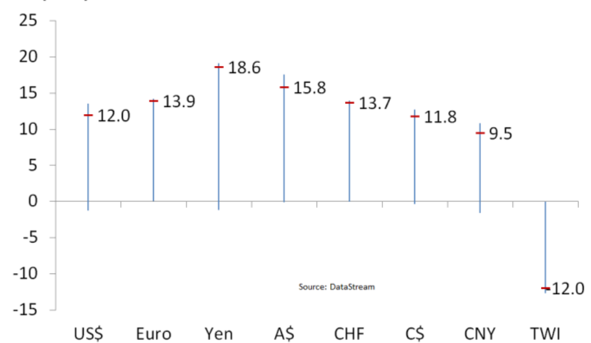




Equity markets generally traded in a 10-15% range hitting their lows on the day of the UK Referendum result; since then, Japan and Europe apart, indices have moved to reach period highs. The UK market, supported by currency depreciation and a sense of relief, has posted strong gains. Supported by easing credit conditions Chinese equities have also performed well.

Commodity markets have been mixed. The environment was positive for precious metals (built out of the return of more expansionary policies in Europe, Japan and now the UK). Softs rose mostly on weather effects. Oil prices have traded in a 25% range hitting a low point just 3 weeks ago before rallying strongly on hopes that stockpiles will start to reduce.





The UK apart, bonds generally traded in ranges and delivered performance consistent with their historic norms. Despite standing on already very low yield levels and fuelled by the easier monetary stance being adopted by the Bank of England, the gains on ultra-long UK index-linked bonds and corporate credit were spectacular. US high yield returns were led by the recovery in sentiment within the energy related portion of that market.

The Pound trade weighted index (TWI) fell sharply following the Referendum across the board as traders absorbed the prospect of a recession in H2 and the 'compensation' arguably required to offset the UK's external deficit. Safe-haven attributes (particularly its current account surplus) saw the Japanese Yen rise sharply (hitting Japanese equities)

Consensus expectations – economic growth and inflation

The economic outlook as we entered 2016 was broadly constructive. Growth in the US and UK was expected to stabilise (at levels above trend potential) and modest increases in activity were expected in Europe (as the supportive conditions of 2015 persisted) and also in Japan (as policy stimulus was added).

The first table below details the latest consensus forecasts[1] for real growth across the major economies for 2016 and 2017. The changes to these forecasts over 2016 are detailed; with the exception of China, expectations for 2016 have experienced a broad write-down. The constructive tone has gone.

The UK economy is judged to be impacted quite heavily by the decision to leave the EU even though there is no timetable for departure; the impact is seen most clearly in the forecasts for 2017 when very limited growth is expected. It is this backdrop and survey evidence pointing to increases in unemployment that has encouraged the Bank of England to ease monetary conditions. The current account deficit remains the key point of weakness for the UK.

The US economy in Q1 repeated the lacklustre performance of the fourth quarter of 2015 to register growth at an annualised rate of just 0.8% and initial estimates for Q2 suggest growth of just 1.2% with only consumer demand supporting activity.

The Japanese economy continues to be highly dependent on fresh policy stimuli; Japanese policymakers have surprised markets in the past year with their lack of new measures. Some adjustments have been announced – most notably the deferral of the next VAT hike until ahead of the Tokyo Olympics (when Games-induced activity is expected to be strong). The recent success for the ruling party in the Upper House elections is being followed by a fresh wave of *Abenomics*. Investors will hope that the impact lasts longer than the previous package particularly in terms of lifting wages but, with the fiscal stimulus suggested to be limited to 1% of GDP, there is scope for disappointment.

Chinese growth rates have stabilised in response to fresh policy relaxation, a (slightly) lower exchange rate and higher levels of public spending. The challenges facing China (in its Property and credit markets) remain acute; currency devaluation is set to remain a central part of their remedial efforts.

Table 1: Consensus forecasts – Real GDP growth (%)

	2015	2016	Change since end 2015	2017	Change since end 2015
US	2.4	1.5	-1.0	2.2	-0.2
Eurozone	1.5	1.5	-0.2	1.2	-0.5
UK	2.2	1.5	-0.8	0.6	-1.6
Japan	0.6	0.5	-0.6	0.7	0.1
China	6.9	6.5	0	6.3	0

The world economy remains 'tired'. Debt levels have grown since the crisis of 2008/09, demographic trends are lifting provision costs with plunging solvency levels drawing capital away from more productive uses and surplus capacity has been added when shrinkage was required. Central bankers have made various calls to governments to support their efforts through a more expansionary set of fiscal policies; hitherto these calls have been ignored. The new UK Government, working to support the domestic economy through the spasm of *Brexit,* may prove to be the major economy to deliver fiscal support (to the relaunch of QE and lower base

[1] Based on a range of forecasts provided by economists to Bloomberg as at 19 August

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rate). Overall, a growth surge looks highly unlikely but a period of better reports is possible. More than anything, the world still needs a faster pace of economic growth.

The outlook for inflation in 2016 is for prices in the EU to rise at a marginally slower pace - this is consistent with the slower GDP growth rates expected (Table 2). The sharpest adjustment for 2016/17 has occurred in Japan where inflation forecasts have been slashed; a far cry from the much heralded 2% target of *Abe-nomics*. The reasons for the downshift are principally the unexpected and (for Japan) unwelcome rise in the Japanese Yen and, related, the weaker path of economic growth. In the US the outlook has changed little due, in part, to the resilient labour market – jobs are still being created. UK inflation in 2017 is expected to get a lift from the weaker exchange rate.

Table 2: Consensus forecasts – Inflation (CPI, %)

	2015	2016	Change since end 2015	2017	Change since end 2015
US	1.3	1.7	0.1	1.8	0
Eurozone	0.1	0.3	-0.7	1.3	-0.2
UK	0.1	0.7	-0.6	2.2	0.4
Japan	0.8	-0.1	-0.9	0.7	-1.3
China	1.5	2.0	0.3	2.0	0

The main take-away remains that inflation, this year and next and out-with the UK, is not expected to attain central bank targets. It will be interesting to learn whether the UK experiences a significant period of import-led inflation; long term UK history suggests that it will. International experience since the GFC suggests otherwise.

While projected inflation rates (many years ahead) may cause central bankers some concern, actual inflation is unlikely to be a problem and should not influence the general asset strategy for the Fund. That said, some specific measures may be required if the fiscal taps are turned on.

Short and long term interest rates

Arguably, the most significant interest rate market development in 2016 has involved policymakers in the UK and the US (in particular). Markets have not given the US Federal Reserve permission to validate their projected profile for the Fed Funds Rate - expectations of higher US policy rates in 2016 have all but evaporated, and any thoughts of a rate hike in the UK have been dashed following the recent 0.25% cut in base rates (Table 3).

Table 3: Consensus forecasts – main policy setting at year end (%)

	2015	Latest	2016	2017
US Fed	0.38	0.38	0.65	1.25
ECB	-0.30	-0.40	-0.40	-0.40
BoE	0.50	0.25	0.15	0.15
BoJ	0.10	-0.10	-0.10	-0.20

In Europe, policy rates have been moved further into negative territory. While the actual EZ rate is not at the low maintained in Switzerland (-0.75%), the ECB have suggested that it will be difficult to move lower. Given the problems of the Italian banking industry, further reductions are possible.

Longer term bond yields have fallen sharply this year (Table 4). Ten-year yields in Europe and Japan have breached zero and 33% of all hard currency bonds are now on negative yields; the proportion in Europe is 49%. **None of this supports the idea that bond markets will soon normalise.**

Table 4: Consensus forecasts – Ten year government bond yield at year end (%)

	2015	Latest	2016	2017
US	2.3	1.58	1.65	2.19
Eurozone	0.6	-0.03	-0.02	0.37
UK	1.9	0.62	0.84	1.15
Japan	0.3	-0.08	-0.19	-0.10

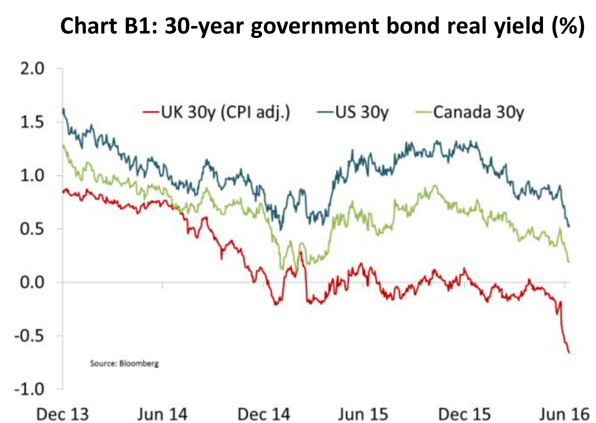
A striking feature of bond markets this year has been the rapid acceleration in the downshift in long duration yields. The plunge in long yields in Germany and Japan has brought 0% into reach which would have been unimaginable even just a few quarters ago. *Brexit* may have exacerbated the move but the trend was already in place. Markets in the US and UK maintain a broad premium to the EZ and Japan but it is to be supposed that if the MPC and Fed were to relaunch QE then the lower levels would become a market target.

These moves have been fully reflected in the inflation-protected bond markets (Chart B1). The yield on ultra-long UK index-linked bonds is now minus 1.5%. To illustrate the impact of this, consider that the price of the longest dated UK IL bond is currently 232. If inflation were to be zero for the next 52 years then the Government of the day will give you back just under 105. That's just 45p in the £; mind you, will have received about 6p in interest, in total, between now and 2068!

Unless inflation is going to return with a vengeance - and with all the monetary accommodation of recent years that cannot be discounted, the real yield markets are in a bubble. The problem with bubbles is that valuation considerations have long since gone – there is little fresh challenge to real yields of -2.5% from those that can be levelled at -1.5% (but the consequences on the likes of pension funds are significantly different).

The time will come for a career-defining sale of government bonds. The trick will be to know when that is!

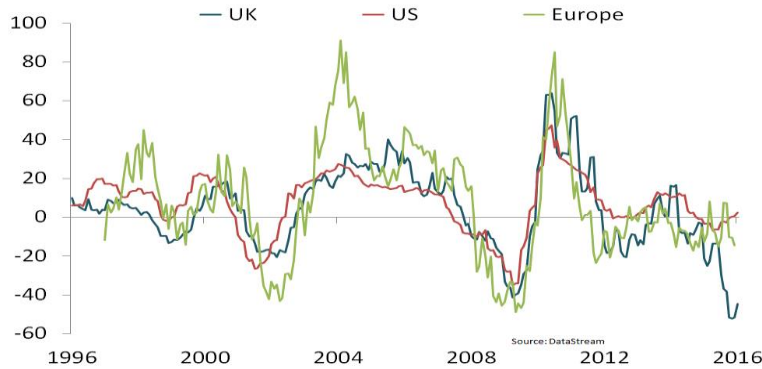
Chart B1: 30-year government bond real yield (%)



Equities

In assessing the outlook for equity markets it is useful to examine the trend in consensus forecast earnings per share (EPS). The chart below details how the EPS for the UK, US, European and Japan equity markets have evolved over the past twenty years; they chime with the economic cycle. Generally, corporate profits growth since the end of the GFC has been much less spectacular than the lift in indices would suggest. The slip in £ looks to be allowing some recovery in earnings – apparently at Europe's expense. Falling earnings has been an issue in the US in recent quarters; a return to rising eps has recently taken place.

Chart E1: Experienced earnings per share growth



Looking beyond the next financial year, equity analysts generally remain optimistic (Table 5); although it should be remembered that analysts are rarely pessimistic and that they failed to spot the weakness shown in Chart E1. In Japan, estimates have risen (after previous weakness); elsewhere estimated growth has consolidated.

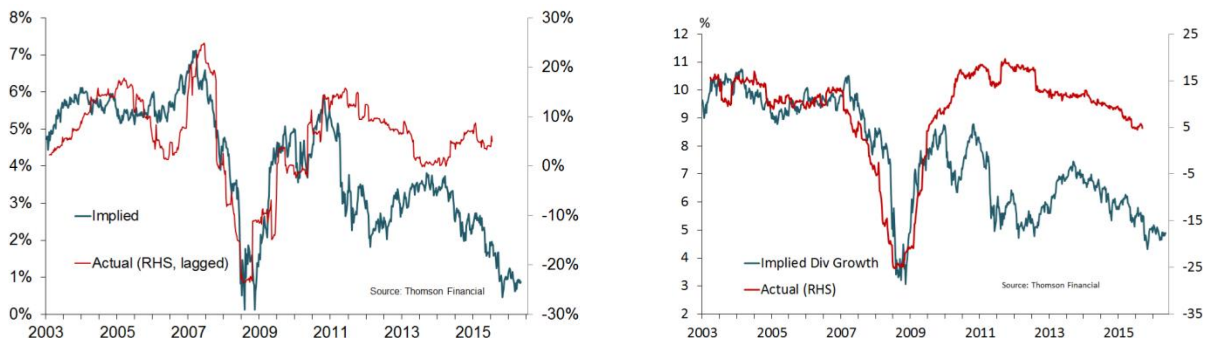
Table 5: Consensus EPS growth forecasts – second and third financial years with change from previous quarter (source: DataStream)

	UK	US	Japan	Europe
FY2	16% (u/c)	13% (-1%)	10% (+1%)	13% (-1%)
FY3	13% (+1%)	12% (-1%)	8% (+1%)	11% (u/c)

There are numerous ways of valuing equity markets. A preferred measure is the implied level of dividend growth required to break-even relative to the alternative of investing in bonds (Charts E2 and E3). In both the UK and US market the required level of long-term dividend growth looks to be modest in absolute terms and against what has been delivered.

The earnings backdrop may recently have been challenging but equity markets should still be preferred to bonds.

Charts E2 and E3: UK (FT All Share, left chart) and US (S&P Composite, right chart) implied dividend growth



Foreign currency markets

Competitive currency devaluation has become a dominant feature of the FX landscape in recent years as attempts to revive domestic economies from within have floundered/failed. The associated growth rebalancing has merit while those economies being competed against are able to take the strain. As 2016 has shown it became increasingly clear that the UK and the US were struggling to carry the burden of supporting global growth. Consistent with the growth transfer is the operation of external deficits/ lower surpluses. Unfortunately those seeking external demand support – the Eurozone and Japan - already operate substantial current account surpluses (Chart F1); this is where the competitive devaluation logic fails. One of the consequences is that when risk appetite falls sharply investors rush to acquire the currencies of surplus nations i.e. the Euro and Japanese Yen. Following *Brexit* the Yen has been particularly strong (the € was too close to the event to be regarded as a safe-haven).

June 23rd marked the day when much changed for the UK. The decision to leave the EU saw £ fall sharply on the foreign exchanges (Chart F2). The external deficit has long been a significant weakness for the UK and one best addressed by a slower domestic economy and a lower currency. Pre-*Brexit,* these conditions were very difficult to generate (for economic and political reasons). The Referendum result has effectively catalysed a 'fast-track' process of adjustment that will initially prove painful but should ultimately restore a better balance to the economy. Whether the overall level of the economy is higher or lower will depend on myriad factors not least the 'divorce' settlement that the country eventually reaches with the EU. In the meantime one thing seems clear: the Bank of England will strive to underwrite currency weakness by keeping policy loose and maintain the significant pricing edge that the UK would now seem to hold (Chart F3).

Chart F1: Current account deficits (% of GDP)

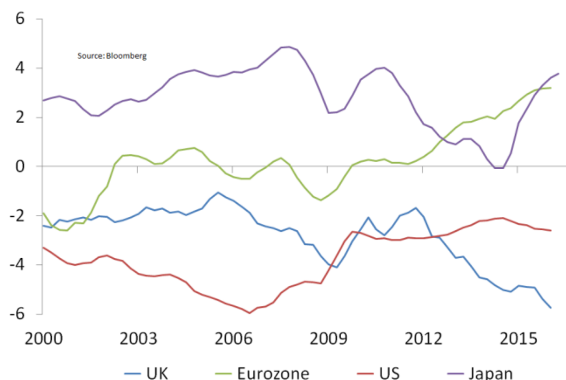


Chart F2: £ Trade-weighted Index

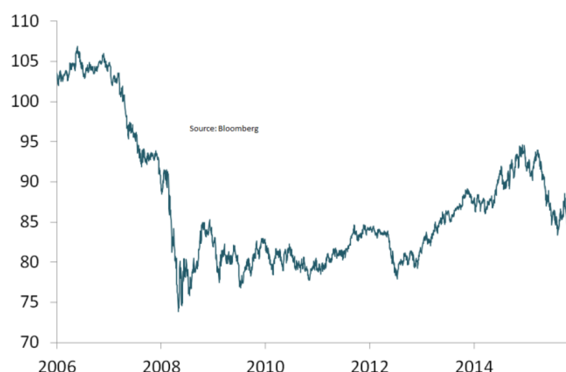
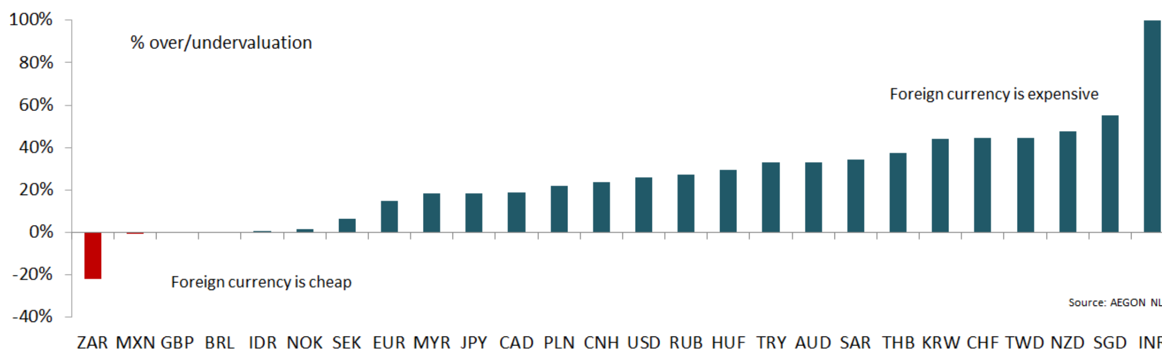


Chart F3: FX valuation vs £ (on PPP basis)



Note: Under PPP a trend or neutral exchange rate is derived and evolved according to shifts in inflation rate differentials. Spot currency levels are then compared against this neutral exchange rate – where the inflation adjusted cost in goods and services should be equivalent in both countries. On this basis, the Indian Rupee is currently very expensive relative to £ while the South Africa Rand is very cheap. It must be remembered that valuation measures such as PPP are of little use in determining market movements in the near term. Currencies can and do remain misaligned for extended periods.

Gold

As the currency of last resort and the ultimate store of value, Gold was held as an investment for millennia and obviously long before our modern system of financial and investment markets. Not generating any yield and being hardly portable, its use within a modern balanced portfolio has diminished significantly in the decades past and now few investors, comparable to the PF, maintain any exposure.

Standing back, the investment case has three forms: as a return enhancer, as a diversifier and as a risk mitigant in times of market stress. Gold has proved to be most useful when not maintained as a core holding in a balanced portfolio. If economies and markets are thought to be headed for some significant turbulence then a weighting is advisable, especially when the defensive alternative of government bonds are so expensively rated – holding UK 50 year index-linked guarantees a real loss of around 50%.

The price of gold has enjoyed a recovery in recent months. This has been accompanied by an increase in the quantity of gold held by Gold ETFs (Chart G1). A similarly strong relationship exists between Gold and the aggregate market value of gold mining companies (as captured by a miner ETF – Chart G2).

Chart G1: Gold and holdings in Gold ETFs

Chart G2: Gold and a gold miner ETF

This turn in Gold has chimed with the progress in long dated US real yields – confirmation that investors have inflation protection in mind (Chart G3). Further, and until recently, Gold has traded inversely with the broad value of the US$: when the paper currency of last resort falls out of favour, investors turn to Gold (Chart G4).

Chart G3: Gold and US real yields (%)

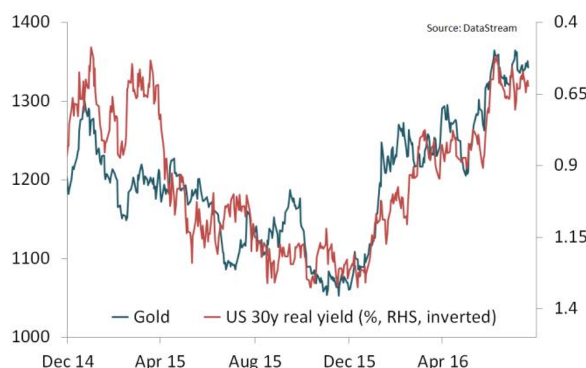
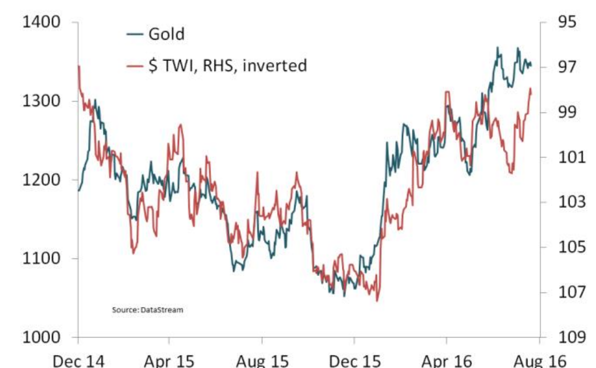


Chart G4: Gold and the US$



Those who currently favour holding Gold typically believe that inflation will surge (in a belated response to QE etc) or that a monetary disorder, that envelops the US economy, lies ahead. In either of these scenarios it is highly likely that Gold will rise in value – perhaps appreciably. If neither scenario develops - and monetary policies aren't tightened, then Gold should flat-line. That said, the holding cost of Gold – while interest rates are at current levels – is close to zero.

Given the current backdrop some exposure to Gold remains warranted; Gold 'miners' are a leveraged means of acquiring proxy exposure. A stronger $ could be a problem.

Style Focus

Appetite to find clever ways of beating the equity market remains undiminished and so the pursuit of so-called *smart betas* is strong. In reality these are style filters no smarter than was the designation, thirty years ago, of *value* and *growth*. Chart S1 describes the relative performance of three common *smart betas*: (traditional) value, high dividend and minimum volatility (risk). Markets continue to reward defensive strategies.

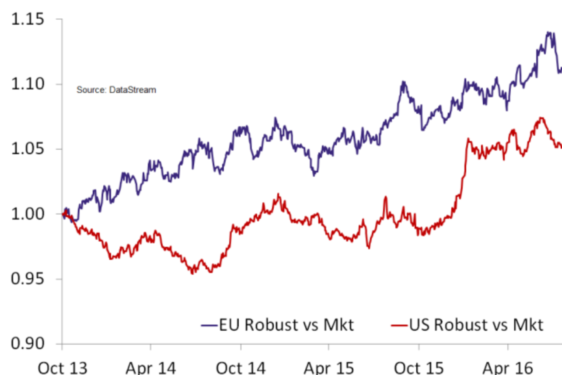
Value has struggled for several years and continues to do so. The 'blame' lies in the need for higher levels of global economic activity to restore corporate performance to a number of erstwhile 'valuable' (cheap) companies. Higher yielding companies have continued to perform consistent with the yield declines seen across bond markets; many of these companies have acquired the designation of 'bond proxies'.

The low risk style remains the standout performer. In ETF form this spans over 300 companies from across the globe with lower than average trailing volatility. Styles derived on trailing price performance normally work well on paper and rather less so in practice; Min Vol has, thus far, defied that generalisation. ['Min vol' typically captures companies with a high free cash flow yield.]

Chart S1: Recent performance of three global equity styles (vs MSCI AC)

A preferred style is a variation of the higher yield style – those companies with a long track record of growing dividends across multiple economic and market cycles; not high yield but robust (or resilient) payers[2]. In recent quarters, proven dividend payers have performed well in Europe; when conditions across the broader market have been tough, investors have favoured the more secure companies. The attractions of resilient dividend stocks have been increased by *Brexit.* In the US, the improvement in the robust style that occurred when it became clear that the FOMC would not easily be able to deliver on their projected policy path has continued. As markets moved to highs recently, investor sentiment toward more growth oriented companies has improved and brought some consolidation in yield themed strategy performance (Chart S2).

Chart S2: Recent performance of 'robust' yield payers in Europe and US (vs local market)



The Fund is recommended to sustain a strong weighting to equities characterised by robust dividend yields.

[2] Recall that the Fund maintains exposure to two global resilient-dividend-themed equity strategies.

Feature: Brexit

The UK Referendum has catalysed a very British revolution, the effects of which are only just starting to emerge. This is happening at a time when almost all financial commentators judge equity markets to be expensive or very expensive; although higher valuation multiples can be argued because of the very low level of interest rates, the deterioration evident in corporate profitability (Chart E1) is hard to ignore and challenging to share prices. Almost all shocks to the status quo in markets involve an initial negative reaction. *Brexit* has occurred at a time when the deflation pressures on the world economy were already strong. Bad policy reactions now could easily turn this drama into a crisis. Fortunately, the initial policy response has been encouraging and (much) lower bond yields have delivered strong support to risk markets.

A sample of the forecast impact on the UK economy from it ceasing to be in the EU prepared ahead of the vote is given Chart A. Inevitably, the range of suggested outcomes is wide but the negative bias is clear. Early readings on consumer and corporate sentiment, post the vote, point to a mild recession over H2, 2016; it is premature, however, to conclude too much from readings that may simply reflect knee-jerk reactions.

Fearful of a sharp deterioration in the UK labour market, the Bank of England has recently halved the base lending rate (to 0.25%), restarted asset purchases (of gilts and corporate bonds) and launched a fresh and substantial 'funding for lending' programme. Arguably, they are recognising a key lesson of the post-GFC era: policy moves initiated too late or too timidly are wasted. That doesn't necessarily mean that the eventual out-turn will be any better but it is surely worth trying to be more pro-active. The sharp £ currency devaluation (Chart F2) has created the platform for a fast-track attack on the UK's dreadful external deficit (Chart F1). It would have been a huge disappointment if the Bank of England had failed to act to try to lock in this competitive improvement.

Chart A: Impact of a 'leave' vote for the UK economy

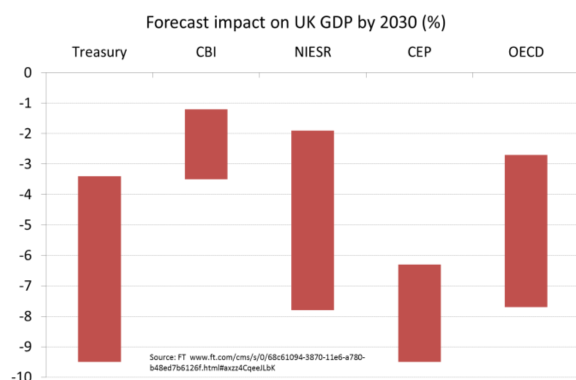
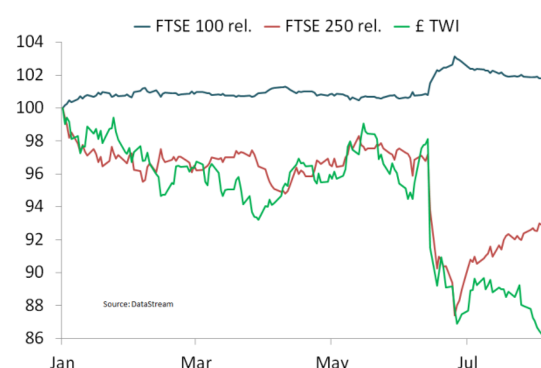


Chart B: UK Large cap, small cap vs All cap and £



At the time of writing the broad UK equity market is 7.3% higher than the close on June 23rd, a change broadly comparable with international indices (in local currency terms). On a narrower basis there has been a huge divergence between small cap and large cap stocks (shown relative to the FT All Share) – Chart B; small caps are more exposed to the domestic economy and investors have moved swiftly to anticipate a mild recession. Curiously the scale of the relative underperformance of small caps initially matched the downshift in £ (which has bolstered the earnings outlook for the more internationally oriented large caps).

Two of the major possible consequences of *Brexit* involve Europe and UK fiscal policy. If the UK's move eventually catalyses similar votes across other member states in the EU and renewed strains emerge within the Eurozone then the continued existence of the € would be in doubt. The way in which the EU deal with the problems in the Italian banking system and that government's plan to inject capital will likely prove a useful test of support for the EU from within.

More positively, if the change of administration in the UK marks an end to the age of austerity – with the government embarking on a fiscal expansion the like of which central bankers have been requesting - then investor attitudes to domestic corporate exposure would quickly become much more positive than the initial

reaction captured in Chart B. The rising optimism surrounding fiscal relaxation is evident in the improvement in the relative performance of '250' stocks in recent weeks.

My wish-list post-*Brexit* would be complete if means are found to relieve the destructive pressure on pension funds and insurance companies from the relentless plunge in long duration bond yields.

There are bargains to be had in UK domestic plays especially if fiscal policy is loosened; sector baskets bought on 'bad days' may be the best way to exploit these.

Summary

Risk markets are enjoying the boost that comes from (much) lower long term discounts rates without yet having to face the hard evidence as to why those rates have fallen. It is to be hoped that we are either at or near the point where electorate unrest forces governments to heed the pleas of central bankers: support our ever more imaginative monetary efforts through fiscal policy. In this sense we may be at the 'make or break' point in the post-GFC era. Against this backdrop risk markets have had a better summer than has been their norm; over the Autumn delivery on policy expectations will prove critical.

One of the features of H1, 2016 has been that despite strong risk rallies, defensive investments (bonds, resilient equity yield plays, gold etc) have conceded little ground. If this continues to be the case then it should be clear that deep underlying concerns remain. In the year ahead these will probably involve some or all of the following:

- China – credit, property bubbles and the means by which it detaches itself further from the strong US$,
- energy prices – the oil price has very recently rolled over, sustained weakness would be a problem,
- EU worries – centred on longer term impact of the British referendum result, challenges within the Italian banking system (as a test case for any new-found EU flexibility) and the French Presidential election (in 2017),
- policy error – emboldened by the level of equities and some better data, the US Fed tighten too quickly
- defaults – there emerges a 'tail' to the impact of low oil prices in the US high yield bond market.

Darker scenarios involve investors starting to penalise those markets and economies grown dependent of unbridled quantitative easing and also the highly problematic process by which cash investors try to transition back to their natural habitat from corporate bonds, equities and property. Hopefully, these prove problems for another day.

Scott M Jamieson, August 2016

Footnote: This note is intended to complement other reports prepared for the PFMB. I welcome comments to the email below on how it might evolve to best support the meeting.

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Agenda Item 13

By virtue of paragraph(s) 3, 10 of Part 1 of Schedule 12A
of the Local Government Act 1972.

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