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Leicestershire County Council Pension Fund Q3 2015 - Market Report

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Historic Returns for World Markets

Index	Q3 (%)	1 Year (%)	3 Years (%)
Citi WGBI Non-GBP TR	5.77	2.54	-1.05
FTSE 100 TR	-6.13	-5.09	5.54
FTSE 350 TR	-5.79	-2.56	7.01
FTSE A (Index Linked) British Govt All Stocks TR	1.93	10.52	8.32
FTSE A British Govt All Stocks TR	3.12	8.21	3.49
FTSE A British Govt Over 15 Years TR	5.15	14.04	6.66
FTSE All-Share TR	-5.70	-2.30	7.21
FTSE Japan TR	-8.01	6.18	12.11
FTSE Small Cap TR	-3.44	5.19	14.57
FTSE World Europe ex UK TR GBP	-4.60	-1.21	10.40
FTSE World ex UK TR GBP	-5.33	1.29	10.72
IPD UK All Property Monthly TR	3.42	15.27	13.64
LIBID GBP 7 Day	0.12	0.48	0.48
Markit iBoxx Sterling Non Gilts Overall TR	0.91	4.47	4.95
MSCI EM (Emerging Markets) TR GBP	-14.63	-13.29	-2.88
MSCI Pacific ex Japan TR GBP	-12.73	-10.81	0.24
S&P 500 TR	-2.86	6.37	14.80
Commodities	-14.48	-26.01	-16.06
£ Trade Weighted Index	-2.53	3.05	2.61

Currency	Q3 (%)	1 Year (%)	3 Years (%)
Euro	4.02	-5.43	-2.56
Japanese Yen	6.08	-1.97	-11.51
US Dollar	3.83	7.02	2.15

Index returns are reported in GBP to indicate sterling.
Source: Kames Capital as at 30 September 2015. All returns over one year are annualised.

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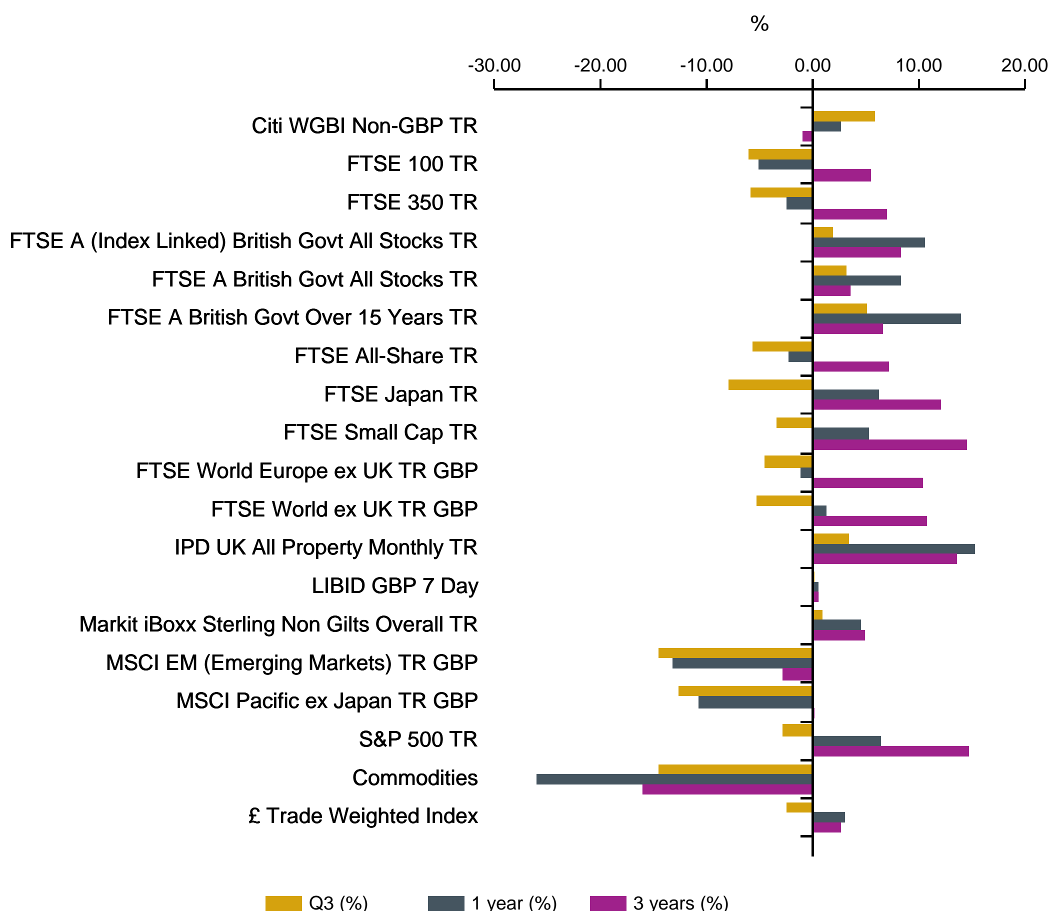
Historic Returns by Market Index

3 months, 1 year and 3 years (annualised)



Index returns are reported in GBP to indicate sterling.
Source: Kames Capital as at 30 September 2015. All returns over one year are annualised.

Market Review

UK Equities

The FTSE All-Share index fell -5.70% in the third quarter of 2015, however mid and small cap indices were less weak.

Against a backdrop of global volatility, weakened commodity prices and reduced demand, the best performing sectors within the FTSE All-Share were: non-life insurance which outperformed strongly, followed by food producers, leisure goods, tobacco and healthcare. The worst losses were experienced in the industrial metals & mining sector followed by automobiles, industrial engineering and oil & gas. Domestic-exposed stocks continued their strong out-performance at the expense of those exposed to Asia, Africa and Middle East and North America.

Mid-quarter economic news was mixed. Industrial production figures missed expectations revealing a slight rise of 0.8% year-on-year in July. As oil prices hit fresh lows, consumer-price inflation sank to 0%, down from 0.1% in July. In common with the Federal Reserve, the Bank of England (BoE) elected to keep interest rates on hold in September. Citing signs of weakness in manufacturing, the BoE also cut forecasts for GDP growth in the third quarter from 0.7% to 0.6%. On the upside, unemployment slipped slightly lower to 5.5% in August, with further evidence of wage growth.

US Equities

In the US, the S&P 500 index fell by -2.86% in sterling terms (or -6.44% in dollar terms), outperforming most other developed markets.

Positive economic data was recorded, with second-quarter GDP growth significantly outperforming that of the previous period. Following two upward revisions, the annualised growth rate was recorded at 3.9%, markedly above the weather-affected 0.6% increase seen in the first quarter. Consumer spending and housing contributed to the positive number.

The economic slowdown in China which adversely affected global markets, gave rise to suspicions that US rate rises would again be pushed out to later in the year. By the time of its announcement, the decision by the Federal Reserve (Fed) not to raise rates in September did not surprise markets. However, the dovish tone of the post-FOMC press conference did. Despite further improvement in the jobs market (unemployment reached 5.1% in August) and a degree of stability in the US economy, Fed Chair, Janet Yellen, cited a need to assess the impact of global market volatility before increasing rates. However, she also reiterated the possibility of very gradual rate rises starting before the end of 2015.

Sector returns were mixed, with retailing and utilities posting positive returns in local terms, while energy, materials, healthcare, financials and telecommunications showed negative returns. Media and technology companies had a challenging results season: Disney shares fell heavily, as results were poorly received and announcements from Apple, Microsoft, and Twitter all disappointed.

European Equities

The FTSE Europe ex-UK fell over the period, returning -4.60% in sterling terms.

At the start of the quarter, the Greek debt crisis was to the fore and the threat of a Greek exit from the eurozone influenced investors globally. Such an exit was avoided with bail-out terms agreed in July and Alexis Tsipras re-elected in September. The Greek stock market reopened in August to major falls.

Eurozone economic data was negatively affected by generally harsh conditions. After almost half a year of lingering just above zero, expectations are for the inflation rate to slip to -0.1% in September. Retail sales growth remained in positive territory, and euro-area consumer confidence reached -7.1 in September. However, second-quarter GDP growth was upwardly revised, coming in at 1.5% year over year. The European Central Bank continued with its €60-billion-per-month quantitative easing programme, and kept interest rates on hold.

Idiosyncratic risk impacted the European market towards the end of the quarter; Volkswagen shares fell dramatically when it was revealed that fuel-emission tests had been falsified and the impact spread across the sector. Elsewhere, Deutsche Bank announced the possibility of cutting up to a quarter of its workforce as the company reorganises, and Swedish retailer H&M saw its results affected by US dollar strength.

Japanese Equities

The FTSE Japan fell by -8.01% in sterling terms (and -13.28% in yen terms) over the quarter.

Second-quarter GDP growth was negative, at -1.2%, but exceeded initial estimates of -1.6%. However, the reduced demand from emerging markets saw a drop in Japan’s exports of 16% on an annualised basis. Unemployment remained low, though it moved up to 3.4% from August’s 3.3%. Monetary policy was held steady, with the Bank of Japan deciding against changing either rates or the pace of its quantitative-easing programme. However, the central bank’s governor noted that, despite what he considered gradual improvement in the economy, action would be taken if consumer price inflation seemed unlikely to reach the Bank’s 2% target.

In sector terms, only software & computing services provided positive returns with particularly heavy falls recorded in oil & gas, basic materials, industrials and telecommunications, as commodity prices and export markets declined.

Asia Pacific ex-Japan Equities

Asian markets fell significantly over the third quarter, with the MSCI AC Asia Pacific ex-Japan index losing -13.35% in sterling terms.

The region was the focus of investors’ attention during the quarter as market falls in China reverberated across the globe. After a one-day plummet, on 24 August, the People’s Bank of China moved again to cut both interest rates and the reserve-requirement ratio that Chinese banks must hold. The decision to weaken its currency prompted investors to worry about the pace of the country’s economic slowdown and the decline continued in September. Economic data, while often in positive territory, mostly missed expectations. Year-over-year industrial production increased by 6.1% in August from 6.0% in July, and retail sales strengthened as well. GDP growth held steady at 7% from the same quarter in 2014 – slow by Chinese standards but healthy on a global scale.

Other markets within the MSCI AC Asia Pacific ex-Japan index were hit hard by the slowdown in China. Australia, the second largest regional weighting after China within the index, fell -12.05%. Australian export prices and volumes continue to be struck by decreased demand from its largest export market. Meanwhile, in India, falling commodity prices, record low inflation (3.6% in August) and slower growth prompted the Reserve Bank of India (RBI) to reduce interest rates for the fourth time this year.

Property

The IPD monthly benchmark showed a 3.42% total return over the third quarter. This was driven by both income return and positive capital growth.

The UK commercial property market continues to be strong and there is still strong demand from investors. There has been a notable improvement in tenant demand over the last quarter and competition for space has placed upward pressure on rents.

Strong competition in the investment market has led to falling property yields once again with the IPD monthly index recording a further fall in net initial yields. Investor confidence has again been strong during the quarter, and investors looking for higher returns are taking on increased risk in terms of lease length, location or tenant credit quality.

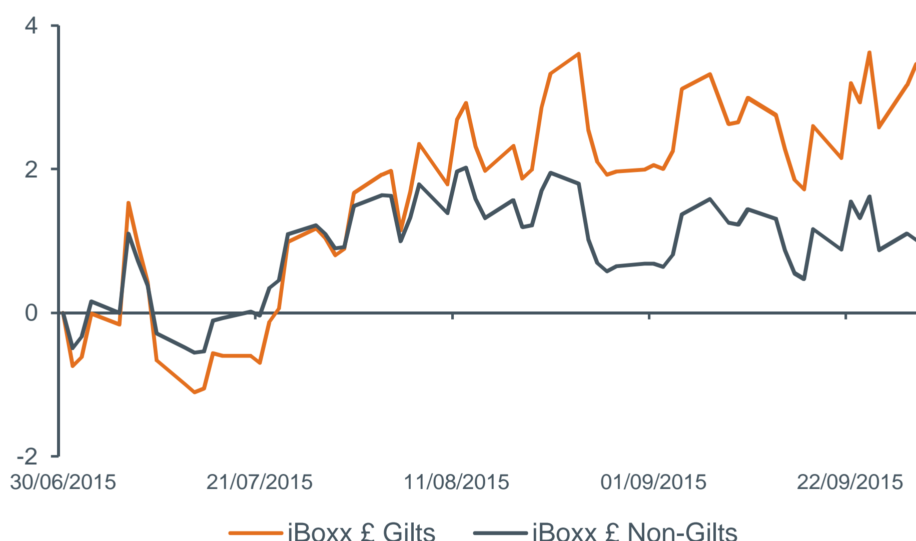
There is more stock on the market; however the best assets are seeing strong competition which is driving pricing.

Fixed Income

In recent quarterly reviews we have focused on the (albeit erratic) improvements in the global economy, and particularly in the UK and US. As we have tracked these improvements we have inevitably questioned when the easy monetary conditions that most economies and markets have enjoyed in recent years would begin to be removed. However, a combination of global and domestic economic concerns has always conspired to cause central banks (the US Federal Reserve in particular) to err on the side of caution and leave rates on hold.

During the third quarter of 2015, markets followed a similar script with initial fevered speculation surrounding the potential for the US Fed to raise rates at its September meeting soon giving way to concerns about the strength of the global economy. As we explain below, this backdrop ensured that bond markets ultimately enjoyed a positive, if volatile, third quarter.

A volatile but positive quarter for bonds



Source: Markit.com, total returns, percentage growth.

Government bonds – lower for longer?

Government bonds showed some weakness at the start of the period as the positive outcome to the latest instalment of the Greek debt crisis boosted riskier assets. The weakness however was short-lived as slightly disappointing economic data in the US and UK, coupled with further falls in commodity prices helped government bonds to rally.

While the softer economic backdrop caused some concern, it was nothing compared to the dramatic events unfolding in China from August onwards. The decision by the People's Bank of China to weaken its currency prompted investors to worry about the pace of the country's economic slowdown. These concerns were most clearly manifested in the steep falls witnessed in global equity markets. Bond yields, meanwhile, moved lower as investors pushed back their expectations of when both the US and UK central banks would start to raise rates.

By the time the Federal Reserve's September meeting arrived its significance as a potential cause of further volatility had diminished somewhat and the Fed's subsequent decision to leave rates unchanged had become expected in market pricing.

While government bonds rallied in the more risk-averse conditions, index-linked bonds underperformed. Ongoing uncertainty over when the first US rate hike would happen, coupled with renewed concerns about the strength of the global economy ensured these assets remained volatile although they still managed to produce a positive return. Overall, the iBoxx £ Gilts index returned 3.31% while the FTSE British (IL) Government All Stocks index returned 1.93%.

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 June 2015	2.02	2.35	0.76	0.47	2.30	2.33	14.99	1.65	2.98
Yield at end Sept 2015	1.76	2.04	0.59	0.36	1.89	1.72	8.16	1.24	2.39
Change in yield	-0.26	-0.31	-0.17	-0.11	-0.41	-0.61	-6.83	-0.41	-0.59

Source: Bloomberg.

Investment grade bonds under pressure

Investment grade bonds underperformed their government bond counterparts although overall the sector managed to produce a positive absolute return; the iBoxx Non-Gilt index returned 0.91% over the quarter.

Despite the small positive return, it was in reality a poor quarter for credit with spreads (the difference in yield offered on investment grade bonds compared to government bonds) widening significantly.

Much of the turbulence witnessed within the investment grade sector was centred on issuers most directly impacted by a quicker-than-expected Chinese slowdown, in particular the large commodity producers. For example, investment grade bonds issued by mining company Glencore came under pressure as commodity prices declined further. Idiosyncratic risk also hit the autos sector after news of Volkswagen's emissions scandal in September.

The other significant event of the quarter was concern over the potential level of new issuance coming to the market. This concern held credit markets back particularly at the start of the period although for the quarter overall issuance was less than first feared.

High yield – a difficult quarter

The global high yield market fell back over the period with the Barclays Global High Yield index returning -0.06% in sterling terms. Initially, high yield bonds came under pressure due to de-risking in the energy and metals sectors as investors became concerned about slowing demand, particularly from China. As the quarter progressed however, the high yield sector as a whole fell back as investors looked to re-price high yield bonds in the face of increased uncertainty about the path of monetary policy in the US.

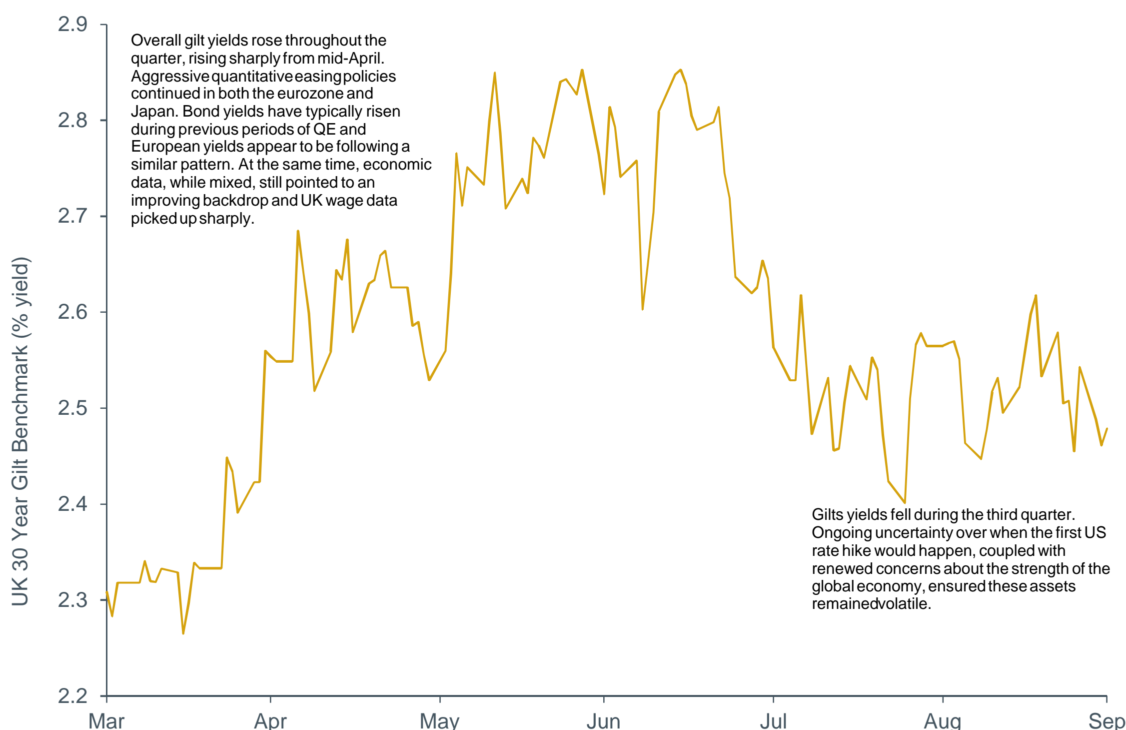
Key Market Movements

The following charts provide a pictorial summary of key market movements during the six-month period to end of September 2015.

Global Equities (FTSE World – Price Index)

Source: Datastream

Long Gilts (War Loans 3.5% Perpetual)

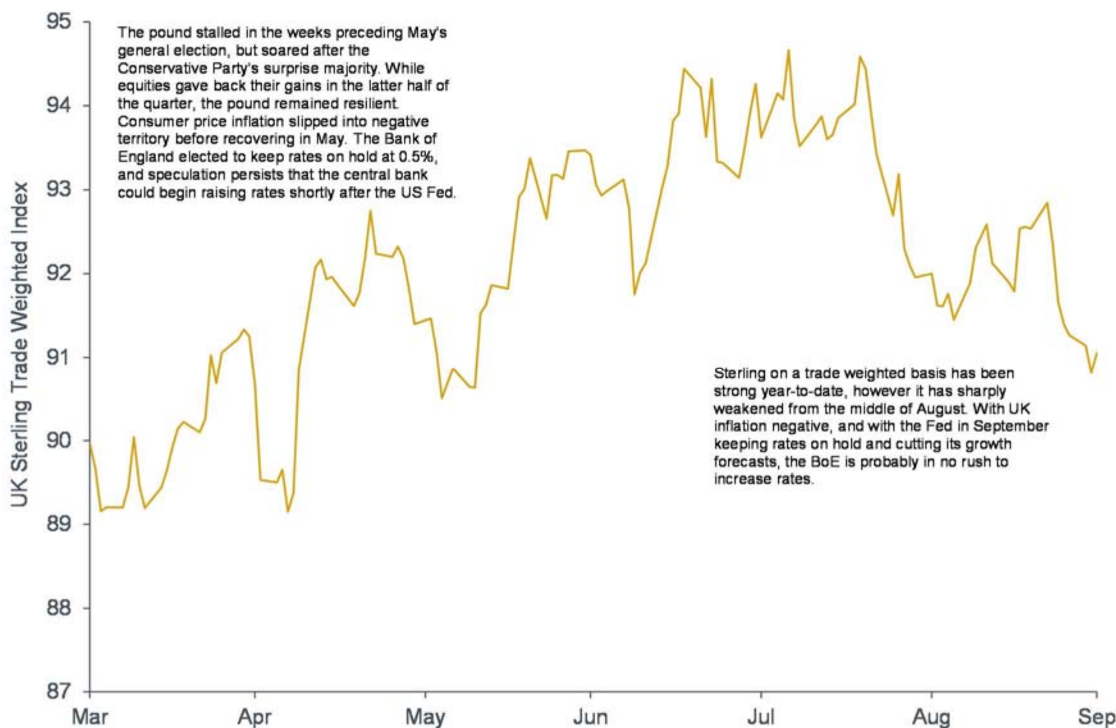


Source: Datastream

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

Source: Datastream

UK Sterling (UK Sterling Trade Weighted Index)



Source: Datastream

Quarterly Thought Piece

In 2013 the ex-Chairman of the FSA, Adair Turner, offered a new approach to monetary policy: Overt Money Finance (OMF). His analysis is long and detailed but well worth persevering with. As markets begin to conclude that all the monetary policy innovations of recent years have not restored the world economy to a well-balanced, self-sustaining expansion, the level of discussion surrounding OMF will increase significantly.

The gist of OMF is that, under certain conditions, it is appropriate for governments to finance budget deficits simply by printing more paper money, not through the stealthy purchase of existing government bonds in the manner of quantitative easing (QE), but openly.

In assessing the effectiveness (thus far) of QE, Turner reminds us that the approach relies on the effective transmission of all the cheap money through the banking/credit mechanism. As we have seen, making money cheap and plentiful to banks and owners of bonds has not resulted in a vibrant economic upswing; rather it has found its way into other financial assets. Indeed many now fear that this has created a bubble in the price of equities and property in particular that threatens to destabilise financial markets itself.

Under OMF, the cash is simply handed directly to taxpayers, with the expectation that by cutting out the ‘middle man’, it can be ensured that the money will be spent. As an illustration, it is possible to argue that the wave of PPI payments a few years ago were handed to people with a high propensity to consume and were of a scale (approximately 2% of UK GDP) to ‘kick-start’ a belated recovery in the UK. Turner, along with many other theorists, believes that the ‘helicopter drops’ of cash under OMF would operate in a similar manner, and improve activity.

Not long after the credit crunch, OMF was effectively employed in the US when the administration announced a one-off tax cut. As with PPI payments, the monies received were spent and the economy picked up: a further illustration of the potential of OMF. However, when the cash was gone, demand faltered afresh. OMF has to be perceived to be recurring to be effective.

In his thorough review of writings on the subject, Turner draws extensively on historical experience. He reminds us that funding government deficits through money creation is far from a new concept, having been actively advanced on several occasions over the last sixty years, and by many of the world’s economic luminaries. In 2003 it was the means Bernanke exhorted the Japanese to use to get inflation back into their system. Turner laments that they didn’t listen; had they done so he is convinced that Japan would now be enjoying faster nominal GDP growth and lower government debt ratios.

One of the common concerns about OMF is that it would lead to a Germany or Zimbabwe-style hyperinflation. Turner argues that by fine tuning the tax system, for example by taxing more heavily during the good times, the level of monetary stimulus ultimately required by OMF will be dimensionally smaller than through QE. Why? Because as mentioned, the intravenous application of cash will be much more effective than a process that inevitably depends on slow absorption. It is because of this scope for powerful small scale use that Turner believes that OMF needn’t lead to spiralling inflation.

Nonetheless, for the more orthodox amongst us, flushing funny money through the system is the policy of madmen. As such, the policy has become such a ‘taboo’ subject that it rarely receives the thorough assessment it merits. Indeed, Turner worried, failure to examine the strategy in full in a timely manner could lead to it being used in too heavy-handed a manner to be safe.

When examining the suitability of OMF in 2013, Turner cautiously mused that Japan was probably too far gone for OMF to be used safely without creating huge inflation risks. Since them Shinzo Abe has launched his own cunning plan to revive the Japanese economy and rid it of deflation. Akin to the US tax windfall, Abenomics looks like it is beginning to lose momentum. Japan may well be first to embrace full OMF, especially if the US dollar starts to weaken against the yen.

Turner has expressed doubts that the political institutions were in place to allow OMF to be applied in Europe. However, in recent years the ECB has employed techniques that would previously have been thought impossible. Draghi’s ‘whatever it takes’ could now more easily extend to OMF.

In the UK, Turner interestingly theorised that OMF could be too dangerous, because the economy has shown an unhealthy tendency toward higher inflation rather than genuine growth, and because the fabric of industry

may be unsuitable for delivering an attractive, supply side response to ‘funny money’-fuelled giveaways. So far, however, the UK has not seen inflation run riot; in fact, the opposite is the case.

The scene is not yet set for policymakers to be bold enough to embark on OMF (except, perhaps, in Japan). However, should the US Federal Reserve defer higher policy rates for an indeterminate period, markets will quickly muse over what the authorities might do when eventually, and unavoidably, the economy turns down. The application of OMF is a plausible extension of QE and while it might re-write all of the rule books, investors need to give advance thought to how it would impact asset markets.

Scott Jamieson

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