**January 2016,**
**Scott Jamieson,**
**Head of Multi-Asset Investing**

# Market Backdrop

## Introduction

This note is intended to support the discussion at the annual strategy review of the Leicestershire County Council Pension Fund (LCCPF). It will summarise developments over 2015 and review consensus economic and market expectations for the period ahead.

## Consensus expectations – growth and inflation

The first table below details consensus forecasts[1] for real growth across the major economies for 2016 and 2017. If the consensus proves incorrect the likely direction of error is suggested. Also shown is the expected out-turn for last year together with the consensus forecast for 2015 taken one year ago.

With the exception of Europe, economic growth underperformed in 2015 despite the fall in the price of oil which was expected to buoy consumer spending through lower fuel bills. European activity exceeded expectations as QE delivered improved credit conditions and a weak € supported external demand.

For the US, external demand was lower than expected as the contraction in the oil and gas sector hit job growth. In the UK a strong currency kept growth contained but at 2.4% was very respectable in an international context. The Japanese economy has shown itself to be highly dependent on fresh policy stimuli; Japanese policymakers disappointed markets in 2015. Chinese growth is starting to falter under the burden of the currency peg (to a very strong US$), the natural maturing of its economy, contraction and defaults within the credit sector and weak global markets for its products.

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

| | 2015 | 1 year ago | 2016 | Risk[2] | 2017 | Risk |
|---|---|---|---|---|---|---|
| **US** | 2.5 | 3.0 | 2.5 | ↓ | 2.4 | ↓ |
| **Eurozone** | 1.5 | 1.1 | 1.7 | | 1.7 | |
| **UK** | 2.4 | 2.6 | 2.2 | ↓ | 2.2 | ↓ |
| **Japan** | 0.6 | 1.0 | 1.1 | | 0.7 | ↓ |
| **China** | 6.9 | 7.0 | 6.5 | | 6.3 | ↓ |

The outlook for growth is broadly constructive. US and UK growth is expected to stabilise (at levels above trend potential) and modest increases in activity are expected in Europe (as the supportive conditions of 2015 persist) and Japan (as policy stimulus is added). China is the black spot as the trend in growth continues lower.

In recent years economists have generally proved too optimistic on growth overestimating the extent and durability of the final demand response to cheaper credit and lower energy bills; consumers have tended to increase savings rates. Meanwhile the corporate sector, across the globe, has persistently disappointed on capital expenditure. Fiscal policies are generally being tightened and this should ensure that, once again, error terms to growth are downward. That said, the world economy is still growing. Perhaps the biggest risk comes from weakening emerging economies.

The story on inflation is similar to growth – expectations for 2015 have generally not been delivered due to lower oil prices (Table 2). Agricultural commodity prices also fell sharply last year.

---

[1] Based on a range of forecasts provided by economists to Bloomberg
[2] Likely direction of a materially different result from expectation

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

| | 2015 | 1 year ago | 2016 | Risk | 2017 | Risk |
|---|---|---|---|---|---|---|
| **US** | 1.3 | 1.7 | 1.6 | ↑ | 1.8 | ↑ |
| **Eurozone** | 0.1 | 0.6 | 1.0 | ↑ | 1.5 | |
| **UK** | 0.1 | 1.3 | 1.3 | ↑ | 1.9 | ↑ |
| **Japan** | 0.8 | 1.5 | 0.8 | ↑ | 2.0 | ↑ |
| **China** | 1.5 | 2.0 | 1.7 | | 2.0 | |

As these price falls wash out of the data, headline consumer price inflation (CPI) is projected to return to around core levels. The forecasts remain below the policy target; projected inflation rates (further out) may put pressure on central banks to raise policy interest rates, actual inflation is not expected to be a problem.

## Short and long term interest rates

Policymakers in the US and UK are expected to remain on the path toward 'normalisation' – the restoration of a positive real cash interest rate (Table 3).

**Table 3: Consensus forecasts – main policy setting at year end**

| | 2015 | 1 year ago | 2016 | Risk |
|---|---|---|---|---|
| **US Fed** | 0.37% | 0.95% | 1.25% | ↓ |
| **ECB[3]** | -0.30% | -0.10% | -0.30% | ↓ |
| **BoE** | 0.5% | 1.00% | 1.00% | ↓ |
| **BoJ[4]** | 360T | | 440T | ↑ |

This is far from the first year that normalisation has been forecast; it is the first after one of the major central banks having actually tightened (the US Federal Reserve). As a result changes to the forecasts are biased to the downside (in terms of policy tightening). While the US Fed may feel emboldened by their ability to raise rates without causing a more pronounced weakening in their economy (and thus be tempted to raise rates further), the pressure from a higher dollar will likely keep the more hawkishly minded in check.

The UK's BoE may be tempted to follow suit, given that wages are growing. With Sterling however still elevated, with fiscal policy remaining tight and with the EU referendum looming moving base rates higher, beyond a token gesture, looks unlikely.

The ECB and Bank of Japan remain firmly in easing mode and financial markets continue to reward those easing policy; indeed further stimuli look likely.

Longer term bond yields largely reflect the expected path of short term interest rates and inflation (Table 4).

[3] Deposit rate
[4] Target for monetary base, trillions of Yen

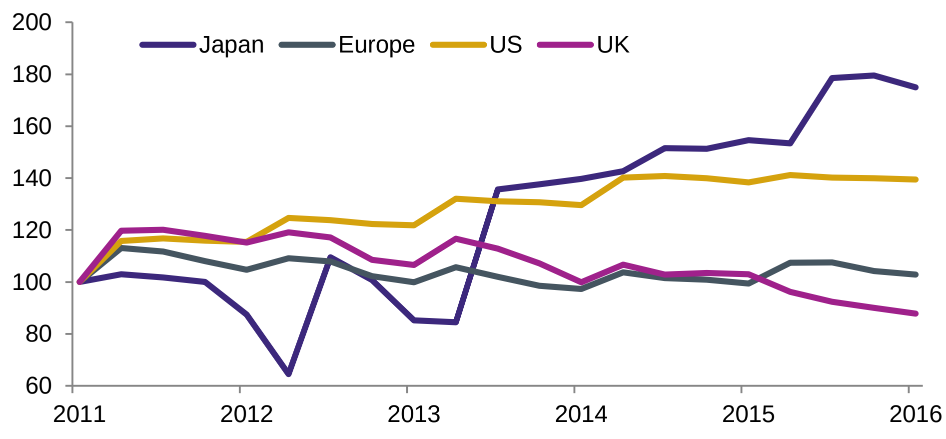
**Table 4: Consensus forecasts – Ten year government bond yield at year end (%)**

| | 2015 | 1 year ago | 2016 | Risk |
|---|---|---|---|---|
| **US** | 2.3 | 3.0 | 2.8 | ↓ |
| **Eurozone** | 0.6 | 1.1 | 1.0 | |
| **UK** | 1.9 | 2.8 | 2.5 | ↓ |
| **Japan** | 0.3 | 0.6 | 0.5 | |

## 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 the how the EPS for the UK, US, European and Japan equity markets have evolved over the past five years.

**Chart 1: Forecast earnings per share (next financial year)**




Source: DataStream

Earnings in the US have increased steadily over the past five years (supported by reasonable economic growth and the early restoration of health to the US banking system). That said, earnings are projected to 'flat-line' in 2016.

After some initial erratic performance the earnings outlook in Japan has improved markedly in recent years – this is 'Abenomics' in action. Once again some moderation is expected next year. In Europe corporate performance has been 'flat-lining' for some time. Although macro-economic policy has turned more forceful it is premature to conclude that this will feed through to higher earnings.

In the UK EPS have been softening for upwards of five years. Based on company statements, this weakness has been due to poor demand in Europe, the slump in commodity prices and the high level of £. Looking to 2016, Europe is expected to perform better, commodity prices are perhaps nearing a bottom and £ is unlikely to strengthen further.

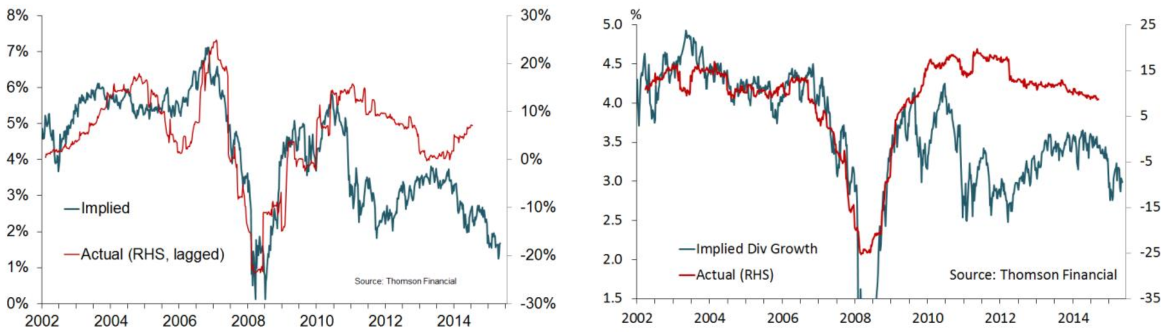
Looking beyond the next financial year equity analysts are optimistic (Table 5). Although it should be remembered that analysts are rarely pessimistic, developed equity market earnings are expected to grow at a healthy pace and faster than nominal economic growth.

**Table 5: Consensus EPS growth forecasts – second and third financial years (%)**

| | UK | US | Japan | Europe |
|---|---|---|---|---|
| **FY2** | 5.1 | 6.8 | 8.8 | 6.5 |
| **FY3** | 13.6 | 12.8 | 8.0 | 11.6 |

There are numerous ways of valuing equity markets. A preferred measure is the implied level of dividend growth required to break-even with the alternative of investing in government bonds (Charts 2 and 3). In both markets the required level of long-term dividend growth looks to be modest in absolute terms, against what has been delivered and finally also in nomimal terms. Equity markets should still be preferred to bonds.

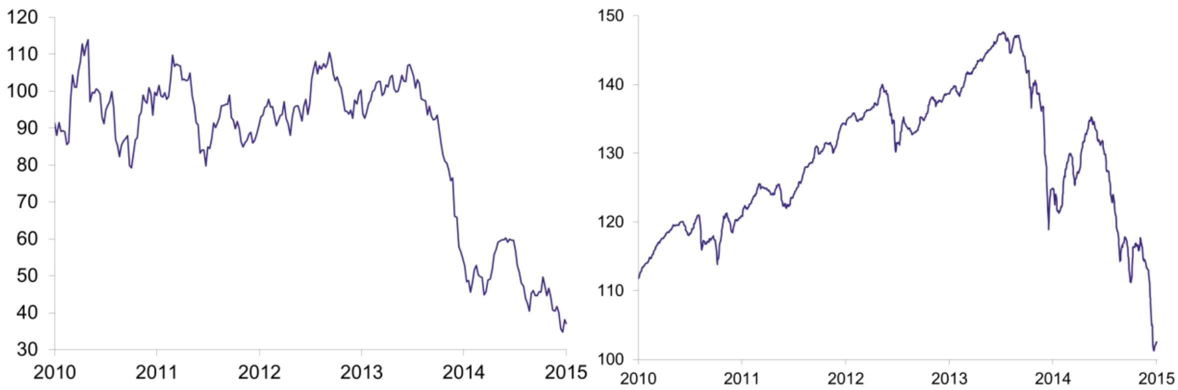
**Charts 2 and 3: UK and US implied dividend growth**




## Oil Prices

The slide in energy prices over the past 18 months (Chart 4) has been both an unexpected and significant 'shock' to the world economy. In market terms the most significant consequence has perhaps been the slump in energy-related high yield corporate bonds (Chart 5). The rate of defaults now implied suggests substantial weakness in the energy sector in the US; this will have a material impact on overall capital expenditure within the US economy.

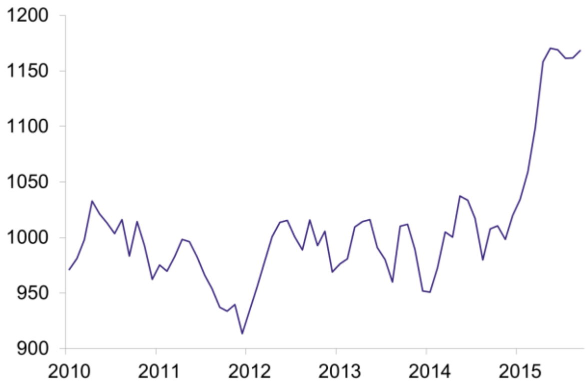
**Charts 4 and 5: Crude oil price (WTI, $ per barrel) and US High Yield energy index (total return)**

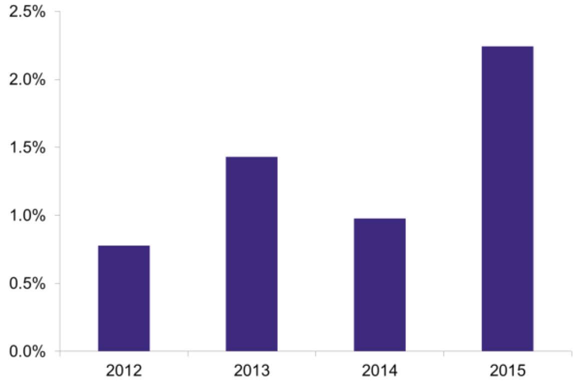



Source: Bloomberg

The fall in energy prices has been fuelled by a surge in oil stocks (Chart 6) despite resilient demand (Chart 7). Higher oil prices will require oil production to fall; capacity reduction can be both a long and painful process. Investors – and policy makers - look unlikely to be challenged by higher energy costs in 2016.

**Charts 6 and 7: OECD Oil stocks (million barrels) and World demand (yoy growth)**




Source: IEA

Summary

To the majority of economists the period ahead looks as it has often done at this time of year: economic growth will be reasonable without being remarkable, policy interest rates should rise gently - normalising - and while bond yields should also increase, the changes will be modest. Few see inflation lifting to the degree that would warrant aggressive rate hiking, indeed inflation rates are projected to remain at, or below, the policy target.

In past years (since the Global Financial Crisis) something has generally emerged to thwart this relatively comfortable scenario; last year it was Greece, China and oil. It is not coincidence that the error term has always been to the downside – the World remains debt obese and employment light. Behind all this there is an ever deepening demographic problem/crisis raising the cost of old age support.

In the year ahead headwinds may come from:

- China – it needs to detach itself further from the strong US$;
- Energy prices – at current prices the year-on-year adjustments will remain deflationary until H2;
- EU worries – centred on the British referendum and the French Presidential election (in 2017);
- Policy error – emboldened by their recent success the US Fed tightens too quickly;
- Defaults – developments in the US high yield bond market impact broader markets and
- Emerging markets – the funding problems evident in Brazil and South Africa deepen and spread.

Overall the likelihood is that 2016 will see the world avoid recession – easily, interest rates and bond yields will again fail to validate (rising) expectations while equities should deliver the best performance albeit in a volatile manner. In another low return year, ‘best’ may simply be due to the dividend payments.

Darker scenarios involve investors starting to penalise those markets/economies grown dependent on 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.

## Important information

This document relates to the currency hedging programme provided by Kames Capital plc. The programme will be subject to the terms of an investment management agreement between Kames Capital plc and a pension fund selecting the programme (or if the pension fund already has an investment management agreement in place with Kames Capital plc, this may be updated in conjunction with the pension fund to provide for the programme) and subject to such disclaimers, notices, warnings or separate agreements, including those set out below, as Kames Capital plc may communicate to you or agree with you in writing.

THE CONTENT OF THIS DOCUMENT IS DESIGNED FOR THE PROFESSIONAL PENSION FUND MARKET. IF YOU ARE NOT AN INVESTMENT PROFESSIONAL OR A PERSON PROFESSIONALLY INVOLVED IN OR HAVING RESPONSIBILITIES RELATING TO PENSION FUND MANAGEMENT YOU SHOULD NOT ACT UPON IT.

This document is directed only at persons having professional experience in matters relating to investments falling within article 19 of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 and high value entities or trusts falling within article 49 of that Order. Consequently, Kames Capital plc has not approved the content of this document for the purposes of section 21 of the Financial Services and Markets Act 2000. No other person should act upon this document or any information contained in it. Kames Capital plc has procedures in place to ensure that no instrument or investment activity referred to in this document is available to any other person.

The content of this [document] has been prepared solely for information purposes. Any statements, forecasts, past performance data, estimates or projections included in the document are for illustrative purposes only and may be provided by Kames Capital or third parties. Any view, opinions or statements made in or in relation to this document should not be interpreted as recommendations or advice. Past performance is not a guide to future performance. The value of investments and the income from them may fall as well as rise and there is no guarantee that the programme will achieve the objectives described in this [document].

No investment advice or tax advice is being given in this document. Nothing in this document should be regarded as an offer to provide investment services or products or as a comment on the merits of engaging in any investment transaction or activity or an inducement to do so. The content of this document is subject to change and correction without notice.

Kames Capital does not represent that (i) the content of this document; (ii) any investments or investment services referred to in this document; or (iii) any oral or written statements provided by or made by Kames Capital or persons connected with it are suitable for or relevant to you.

Kames Capital is an AEGON Asset Management company and includes Kames Capital plc (Company Number SC113505) and Kames Capital Management Limited (Company Number SC212159). Both are registered in Scotland and have their registered office at 3 Lochside Avenue, Edinburgh Park, Edinburgh, EH12 9SA. Kames Capital plc is authorised and regulated by the Financial Services Authority (FSA reference no: 144267). Kames Capital plc provides segregated and retail funds and is the Authorised Corporate Director of Kames Capital ICVC, an Open Ended Investment Company. Kames Capital Management Limited provides investment management services to AEGON, which provides pooled funds, life and pension contracts. Kames Capital Management Limited is an appointed representative of Scottish Equitable plc (Company Number SC144517), an AEGON company, whose registered office is 1 Lochside Crescent, Edinburgh Park, Edinburgh, EH12 9SE (FSA reference no: 165548).