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Leicestershire County Council Pension Fund Q4 2015 - Market Report

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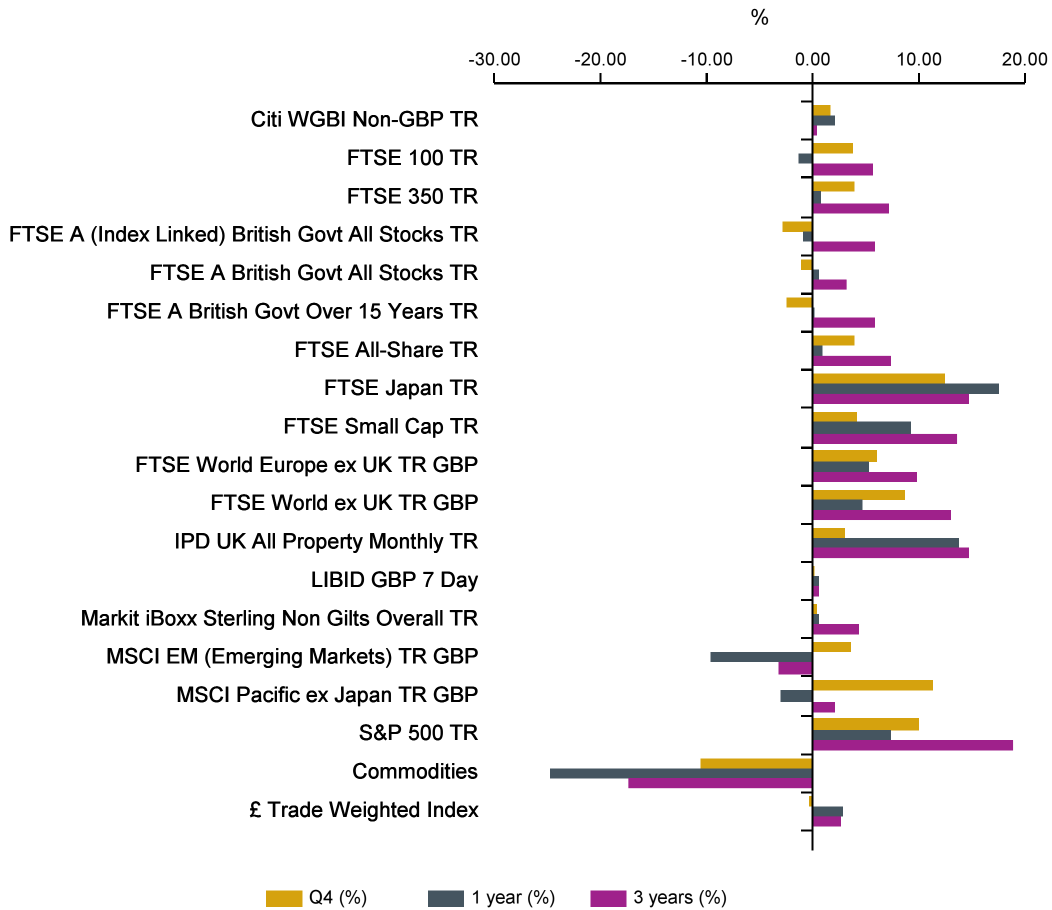
Historic Returns for World Markets

Index	Q4 (%)	1 Year (%)	3 Years (%)
Citi WGBI Non-GBP TR	1.71	2.12	0.34
FTSE 100 TR	3.71	-1.32	5.66
FTSE 350 TR	3.95	0.69	7.09
FTSE A (Index Linked) British Govt All Stocks TR	-2.89	-0.97	5.80
FTSE A British Govt All Stocks TR	-1.20	0.57	3.22
FTSE A British Govt Over 15 Years TR	-2.42	0.09	5.90
FTSE All-Share TR	3.95	0.98	7.27
FTSE Japan TR	12.50	17.58	14.71
FTSE Small Cap TR	4.07	9.17	13.50
FTSE World Europe ex UK TR GBP	6.07	5.35	9.72
FTSE World ex UK TR GBP	8.57	4.77	13.00
IPD UK All Property Monthly TR	3.09	13.82	14.63
LIBID GBP 7 Day	0.12	0.48	0.48
Markit iBoxx Sterling Non Gilts Overall TR	0.37	0.49	4.38
MSCI EM (Emerging Markets) TR GBP	3.52	-9.65	-3.32
MSCI Pacific ex Japan TR GBP	11.34	-3.04	2.09
S&P 500 TR	10.01	7.25	18.95
Commodities	-10.55	-24.70	-17.34
£ Trade Weighted Index	-0.40	2.73	2.68

Currency	Q4 (%)	1 Year (%)	3 Years (%)
Euro	0.01	-5.03	-3.14
Japanese Yen	2.32	5.44	-7.45
US Dollar	2.77	5.79	3.32

Index returns are reported in GBP to indicate sterling.
Source: Kames Capital as at 31 December 2015. All returns over one year are annualised.

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 31 December 2015. All returns over one year are annualised.

Market Review

UK Equities

UK equities climbed over the period, with the FTSE All-Share index returning 3.95%.

Early in the fourth quarter, UK equities were helped by largely positive domestic economic data, with industrial production and retail sales posting relatively good figures while unemployment continued to fall. At the same time, the market had to contend with significant concerns over the health of emerging markets (China in particular) and a steep fall in commodity prices.

Given this turbulent backdrop defensive sectors such as healthcare, telecoms and consumer goods all performed relatively well. Energy related sectors such as oil & gas and basic materials were very weak. Towards the end of the quarter expectations for an increase in base rates were pushed further out after the Bank of England voiced its concerns about the weak global backdrop. This in turn helped domestic sectors, and particularly smaller cap companies to perform well as the quarter came to a close.

US Equities

In the US, the S&P 500 index rose by 10.01% in sterling terms and by 7.04% in dollar terms.

The slow recovery in the US economy continued in the final three months of the year with economic releases generally positive. Non-farm payrolls for October more than doubled their September figures; the addition of 298,000 jobs easily beat expectations of 180,000. This was complemented by a further fall in the unemployment rate, down to 5.0% in October and November from 5.1% in September.

The improved backdrop led the US Federal Reserve to hint that it could raise base rates before the end of the year; the first rate rise since 2006 eventually arrived in December when the Fed raised the rate by 0.25%. At the same time the Fed acknowledged that the pace of future rate increases would be very gradual compared to previous cycles. These dovish comments were welcomed by investors.

In company news, technology stocks had a good quarter; Google's holding company Alphabet moved up on the announcement of a share buyback plan, and Microsoft, LinkedIn and Apple all benefited from positive earnings results. M&A activity remained buoyant with Pfizer and Allergan in the pharma sector agreeing to join forces. In November, Activision Blizzard secured the purchase of King Digital Entertainment, makers of the hugely successful Candy Crush Saga game.

European Equities

The FTSE Europe ex-UK returned 6.07% in sterling terms or 5.80% in euro terms.

Central bank policy was also to the fore in Europe, as markets awaited news on whether the ECB would announce further stimulus measures. Investors' expectations were, however, somewhat unrealistic and the measures announced by the ECB at its December meeting amounted to a modest extension of its existing QE programme, which proved to be a disappointment. Nevertheless, the expectation of further easing was enough to support European equities throughout October and November.

In economic news, some positive data was seen in the form of lowering unemployment (to 10.7% in October from 10.8% in September) and rising industrial and manufacturing production (to 0.6% and 2.2%, respectively, in October). At the same time, retail sales remained weak and consumer confidence levels were dismal.

In the corporate world, the alternative energy, beverage and tobacco sectors were among those to make positive contributions. In November, SABMiller was acquired by AB InBev in a massive £71 billion deal. As in other regions, commodity-related sectors struggled.

Japanese Equities

The FTSE Japan advanced by 12.50% in sterling terms by 9.95% in yen terms.

Despite gains in equity markets, Japanese policymakers lowered growth forecasts for the coming year, which central bank governor Haruhiko Kuroda said was "largely due to the effect of energy price falls". Estimates for GDP growth during the fiscal year to March 2016 were readjusted to 1.2% from 1.7%, and the date at which Japan hopes to reach its 2% inflation-rate target was pushed back by six months.

The Bank of Japan eschewed any changes to policy during its November meeting, as policymakers reiterated their belief that the country's recovery is proceeding as intended. Economic data added some encouragement: the inflation rate was elevated from its zero level, which exceeded expectations, and retail sales for the year to October rose to 1.8%, markedly better than the 0.1% contraction seen in previous readings. The unemployment rate continued to edge down, settling at 3.1% for October when 3.4% had been expected, though it bounced back up to 3.3% in November.

Further positives came in the form of third-quarter GDP growth that exceeded both expectations and initial estimates, as well as an increase in industrial production and an expansion in manufacturing production.

In company news, shares of Japan Post spiked in the wake of its large initial public offering. Retailers had a difficult period; Fast Retailing, for one, registered losses on missed expectations and disappointing profits. The healthcare sector was the most beneficial area over the quarter.

Asia Pacific ex-Japan Equities

Asian markets recovered significantly over the third quarter, with the MSCI AC Asia Pacific ex-Japan index returning 8.13% in sterling terms.

The People's Bank of China (PBoC) continued with easing measures in an effort to balance the economy after the summer's far-reaching market crash. Near the end of the October, the central bank cut the benchmark interest rate to 4.35% and decreased the reserve-requirement ratio demanded of banks by another 50 bps. Third-quarter GDP slipped slightly from the prior quarter but beat expectations, landing at 6.9%. This caused the PBoC to release a statement lowering 2016 growth expectations to 6.8%.

Coinciding closely with their central bank's announcement, Chinese markets reacted positively to the news of rate rises in the US. Indian markets also had a favourable response, offsetting some of the disappointment felt after the ECB failed to deliver significant stimulus increases. Central bank activity in the Pacific region was notably slow after a year of heavy activity: India, Korea, and Australia all kept rates even in December.

Elsewhere in the region, New Zealand experienced record highs in its domestic stock market, buoyed by the ongoing recovery in developed markets. In Australia, business confidence registered a sizeable jump from 1 in August to 6 in September in the wake of Malcolm Turnbull being elected prime minister. The country also received a welcome surprise in the form of falling unemployment, which came in at 5.9% for October; estimates predicted it would remain at 6.2%. The jobless rate then fell to 5.8% for November.

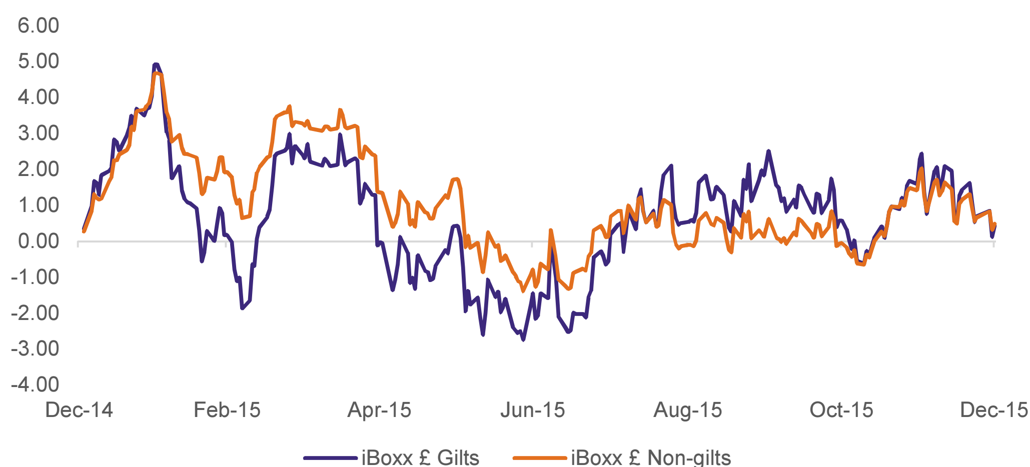
Property

The IPD monthly benchmark showed a 3.1% total return over the quarter ending 31 December. This was driven by both the income return and positive capital growth. The UK commercial property market continues to be buoyant and there is still good demand from investors. A high level of competition 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 positive and investors looking for higher returns are taking on increased risk in terms of lease length, location or tenant credit quality. There was more stock on the market during the quarter; however the best assets saw strong competition and competitive bidding.

Fixed Income

Government and corporate bond markets both finished in positive territory for 2015, with UK gilts (measured by the iBoxx £ Gilts index) increasing by 0.43% and the UK corporate sector (iboxx £ Non-Gilts) showing a similar rise of 0.49%. It would be easy to conclude from these returns that fixed income assets were relatively subdued in 2015. As the graph below highlights, however, this was not the case; both corporate and government bonds endured a turbulent 12 months with a number of key events dominating markets.

Fixed income volatile in 2015



Source: Markit.com

For most of the year investors focused on the same themes from previous years; the strength of the economic recovery (particularly in the US and UK), Central Bank policy activity (real or inferred) and the search for yield in a low interest rate/low inflation environment. For the period as whole, both the US and UK economies continued to improve although the pace of recovery was again slow. Monetary policy was, as in previous years, to the fore with the market receiving mixed messages about Central Bank intentions. However, we did see some concrete developments in the final quarter of the year.

Government bonds

The fourth quarter began with government bond markets continuing to wrestle with the divergent monetary policy stances from the two largest central banks. In Europe, investors had high expectations that the European Central Bank (ECB) would enhance its quantitative easing (QE) programme, which offered some support to global government bonds. At the same time however, a hawkish comment from the US Fed caused government bonds to sell off somewhat as markets priced-in a year-end rate hike.

At its December meeting, the additional measures announced by the ECB, which amounted to a modest extension of its existing QE programme, proved to be a big disappointment. Markets subsequently reacted negatively with government bond yields moving higher. In contrast, the Fed delivered exactly what was expected of it, with the first rate rise since 2006. Being so well flagged, this had little impact on market prices, but was undoubtedly symbolic nonetheless. The accompanying Fed commentary was pored over by investors, and appeared to suggest a slow but steady rise in rates from here. The end result of all the Central Bank navel-gazing was a shift higher in government bond yields, but still within a well-defined range.

Over the quarter as a whole, the iboxx £ Gilt index fell -1.37%. As the table below shows, yields in most core markets came under some pressure, as they adjusted to Central Bank activity.

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 Sep 2015	1.76	2.04	0.59	0.36	1.89	1.72	8.16	1.24	2.39
Yield at end Dec 2015	1.96	2.27	0.63	0.27	1.77	1.59	8.07	1.15	2.50
Change in yield	0.20	0.23	0.04	-0.09	-0.12	-0.13	-0.09	-0.09	0.11

Source: Bloomberg.

Investment grade

While the investment grade market produced a similar return to its government bond counterpart over 2015 as a whole, it produced a better return in the fourth quarter. The iboxx £ non-Gilts index returned 0.37% for the final three months of the year.

For most of 2015 the corporate sector looked through concerns about potential US interest rate rises and focused on the additional yield available within the asset class. Moreover, the market was not expecting a significant sell-off in the sector, mainly because rate rises will have to be implemented very gradually and the number of increases will be lower than in a ‘normal’ cycle for fear of bringing the fragile recovery to an abrupt end.

That is not to say the investment grade sector had an easy year or fourth quarter. At various points during the year a robust level of supply, particularly in Europe, weighed heavily on the market. M&A activity, which can be value destructive for bondholders, also remained a key theme and ensured there was a good deal of volatility at an individual bond level. In fact, idiosyncratic issuer risk proved to be a significant source of concern in the fourth quarter. Much of the turbulence was centred on issuers most directly impacted by a quicker-than-expected Chinese economic slowdown, with the large commodity producers the most obvious example.

At the start of the fourth quarter the ECB’s suggestion that it might announce an enhancement of its QE programme at its December meeting helped higher-quality euro bonds to outperform their international equivalents. However with the ECB subsequently disappointing investors, the rally seen in the investment grade sector leading up to the meeting unwound, causing European credit to weaken.

High yield

After a reasonably solid start to the year, the second half of 2015 proved a difficult period for risk assets, including high yield. The Barclays Global HY index returned -0.86% over the final three months of the year. US high yield underperformed Europe – the renewed crisis within the US energy sector was a key factor, but it was not helped by outflows around the expectation of a Fed rate hike at the end of the year.

December flows were driven by a combination of renewed weakness in energy after the OPEC meeting, the expected Fed move and year-end tax loss selling. The impact on the market was exacerbated by seasonally

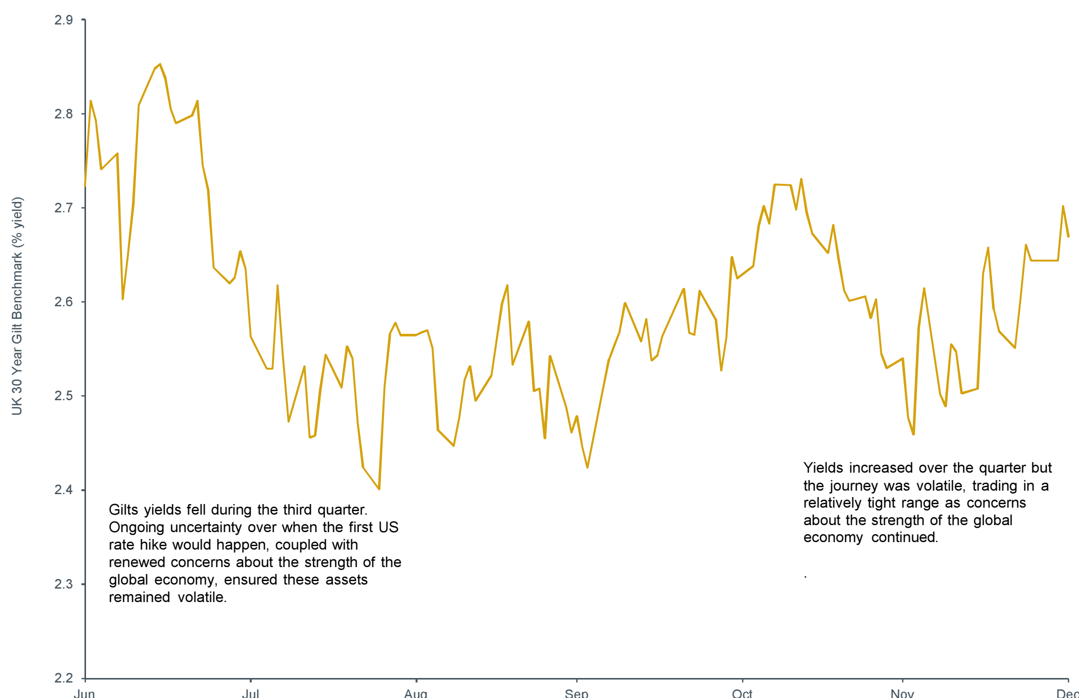
Key Market Movements

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

The consensus view for 2016 (and beyond) is that the economies of the developed world will grow, not dramatically so but to an extent sufficient to avoid the need for investors to consider how they might react to a recession. At the same time the prospect of the extra-ordinary expansionary monetary policies of recent years generating a pronounced surge in inflation is deemed remote – the collapse of energy prices has seen to that.

In reality the challenge is that the natural stall speed for economies has risen above zero. The reason for this is that the level of impediments to growth has risen substantially since the Great Financial Crisis (GFC). As a result the level of economic growth required before these headwinds begin to determine the economic outlook has risen.

Developments in the energy markets provide a useful illustration of the above. Crude oil prices have slumped (West Texas crude has fallen from $107 per barrel in mid-2014 to below $30 recently) despite global demand for oil increasing (by 2% in 2016 according to the IEA). In short, the level of demand growth required after the recent ‘oil rush’ in shale etc. in order for the producing companies to just break even has risen beyond that projected for the world. In this there is a metaphor for a raft of situations in the world financial markets e.g. pension funds (despite the good work done by asset markets, improvements in solvency levels have proved elusive).

Headwinds against economic growth include:

- the global debt burden – debt to GDP levels have risen steadily since the GFC as governments (and companies) have exploited ultra-low borrowing costs,
- China – it needs to detach itself further from the strong US$ to rebuild the competitive edge it has had for many years and to arrest the enormous capital outflows of recent quarters,
- energy prices – at current prices the year-on-year adjustments will remain deflationary until H2 and increase the likelihood of a deep contraction across the energy industry (one of the few drivers of corporate capital expenditures in recent years),
- EU worries – centred on the British referendum and the French Presidential election (in 2017) each has the potential to eclipse the problems represented by Greece and raze the EU edifice to the ground,
- policy error – emboldened by their recent success the US Fed tighten too quickly to bring the US expansion to an abrupt halt,
- defaults – developments in the US high yield bond market impact broader markets and encourage investors to reassess credit risks
- emerging markets – the funding problems evident in Brazil and South Africa deepen and spread, and
- the prospect of a highly populist next government in the US – Trump would extend the disturbance (to conventional thought) represented by Corbyn, Le Pen, Bernie Sanders, de Blasio: there's no doubt that there is very deep disillusion with the status quo.

In a sense there is nothing new in this; there are always headwinds. What, arguably, is different is that a material number of each of the challenges listed above have the potential to completely redefine the world economic outlook.

In recent years we have had to face crises surrounding problems of the scale of Greece. Each of the issues listed above has the potential to generate a threat to activity (consumer and corporate confidence) that eclipses the Greek tragedy.

The risk is that this is not fully appreciated by central bankers and that they fail to provide the additional ‘adrenalin rush’ to which developed economies have become accustomed (addicted). Eventually it will be realised however that monetary policy alone cannot solve the problems we face. A forceful fiscal response will be required – regardless of the impact on debt-to-GDP ratios – ‘funded’, perhaps, through the overt money approach discussed in the last report.

Beyond all this there is the threat of collective denial. The recent film – the Big Short – presents an account of the practices and build up to the GFC; although a drama, it should be a 'must view' for anyone charged with managing the money of others. Those active in markets at the time will attest all too clearly about the film's accuracy. Beyond the abuse of self-interest, the inability of apparently sensible people to challenge consensus should be the abiding memory.

Today's comfortable consensus of reasonable economic growth and discount rate normalisation stands to be challenged – both by the threats listed above and the self-interested determination that everything will be fine. Things are far from fine in the energy industry; why should they be any more secure elsewhere?

Those charged with investing to support long term liabilities are well advised to retain a defensive investment posture. A number of defensive asset exposures may have lagged the broad markets – what else should have been expected when free money is in infinite supply (QE). The merit of these exposures will come to the fore when market conditions deteriorate.

Scott Jamieson

Head of Multi-Asset Servicing

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