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Leicestershire County Council Pension Fund Q1 2016 - Market Report

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Historic Returns for World Markets

Index	Q1 (%)	1 Year (%)	3 Years (%)
Citi WGBI Non-GBP TR	10.12	9.83	2.18
FTSE 100 TR	0.07	-5.26	2.42
FTSE 350 TR	-0.38	-4.12	3.51
FTSE A (Index Linked) British Govt All Stocks TR	5.67	1.74	5.08
FTSE A British Govt All Stocks TR	4.92	3.25	4.64
FTSE A British Govt Over 15 Years TR	8.21	4.03	8.55
FTSE All-Share TR	-0.41	-3.92	3.67
FTSE Japan TR	-4.26	-3.25	6.58
FTSE Small Cap TR	-1.40	1.62	8.85
FTSE World Europe ex UK TR GBP	0.58	-4.16	6.49
FTSE World ex UK TR GBP	3.21	0.39	9.03
IPD UK All Property Monthly TR	1.08	11.69	14.61
LIBID GBP 7 Day	0.12	0.49	0.48
Markit iBoxx Sterling Non Gilts Overall TR	3.16	0.45	4.87
MSCI EM (Emerging Markets) TR GBP	8.45	-8.80	-2.38
MSCI Pacific ex Japan TR GBP	4.43	-6.56	-1.02
S&P 500 TR	3.93	5.13	13.87
Commodities	0.34	-19.66	-16.92
£ Trade Weighted Index	-5.96	-5.51	2.01

Currency	Q1 (%)	1 Year (%)	3 Years (%)
Euro	7.58	9.59	-2.12
Japanese Yen	9.75	10.20	-4.03
US Dollar	2.55	3.28	1.85

Index returns are reported in GBP to indicate sterling.
Source: Kames Capital as at 31 March 2016. All returns over one year are annualised.

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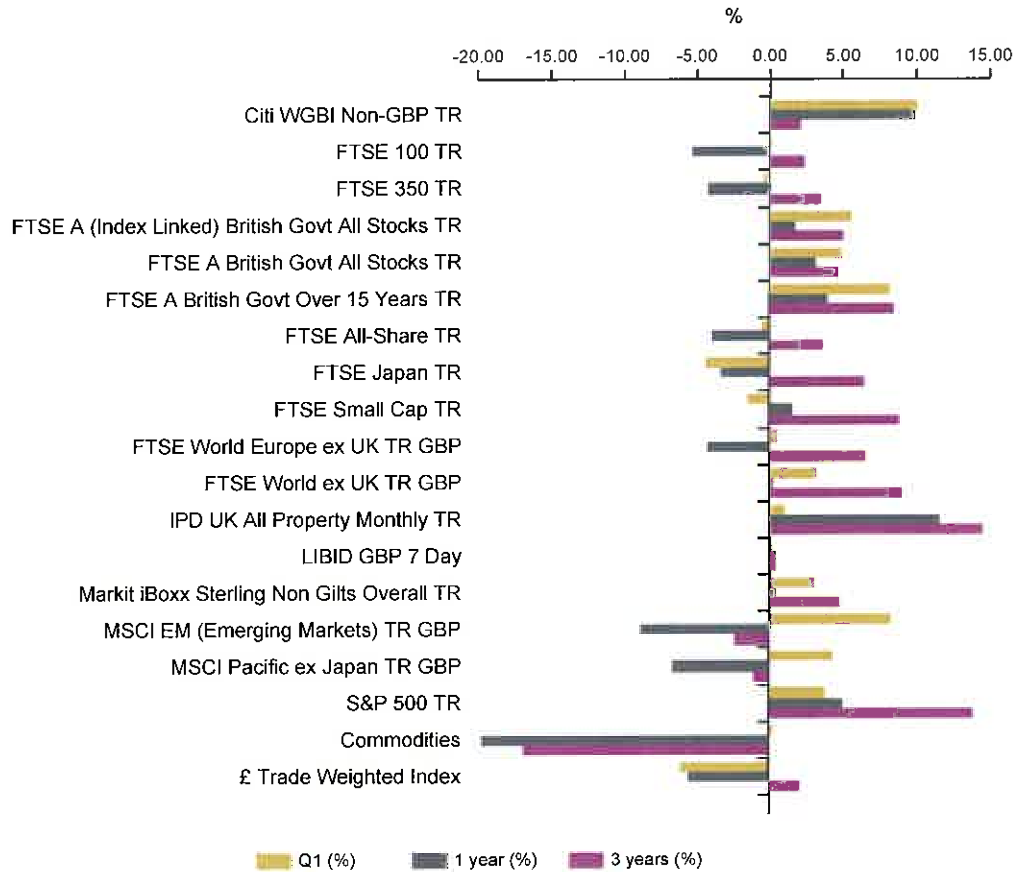
Historic Returns by Market Index

3 months, 1 year and 3 years (annualised)



Index returns are reported in GBP to indicate sterling.
Source: Kames Capital as at 31 March 2016. All returns over one year are annualised.

Market Review

UK Equities

UK equities slipped over the period, with the FTSE All-Share index returning -0.41%.

While many other developed markets advanced in the first quarter, the UK was held back over concerns about the nation leaving the European Union (EU), one of its key trading partners. In February, Prime Minister David Cameron announced that a referendum on whether or not to remain in the EU would be held on 23 June 2016. This depressed both equities and sterling, and prompted a warning that this weakness was likely to persist in advance of the vote. Further negative news came in the form of an admission by the Bank of England that the fiscal outlook for the UK had deteriorated since the previous quarter.

For all that, economic indicators were broadly positive: inflation levels fell short of official estimates, although they stayed at an annualised 0.3% to February. Unemployment in the UK held steady at 5.1%, while retail sales rose by 3.8% year on year, ahead of analysts' expectations. Interest rate rises, which were originally thought to follow close on the heels of US increases, are now expected to be delayed until possibly 2017.

US Equities

In the US, the S&P 500 index rose by 3.93% in sterling terms and 1.35% in US dollar terms.

US equities had a generally favourable quarter, but like all other developed markets, were unable to completely escape the effects of an oil price that hovered below $30 per barrel in January, making the first month of the year particularly challenging. The holiday retail season also proved disappointing; an unusually warm winter compared with recent years dampened consumers' drive to purchase cold-weather apparel and retail sales actually contracted in December.

This poorer data encouraged the Fed to proceed with caution. Chair Janet Yellen took a dovish approach to interest rates, indicating that the Fed's policymakers would raise rates according to the pace of the US economic recovery. Estimates regarding the number of 2016 interest rate rises were reduced from four to two, and authorities also lowered their expectations for inflation (from 2.0% by the end of the 2016 to 1.2%).

These communications boosted US equities, as did rising oil prices and encouraging data on the unemployment rate, which stood at 4.9% in January and February. GDP growth for the fourth quarter of 2015 was revised up to 1.4%, helping to stave off fears that the economy could fall into recession.

At a sector level, telecommunications rose strongly. Verizon Communications and AT&T had a particularly lucrative quarter. Utilities also proved robust, while banks struggled, caught up in the quarter's widespread fears about the global financial sector.

European Equities

The FTSE Europe ex-UK returned 0.58% in sterling terms.

European equity markets had a difficult start to the quarter: stocks were shaken by news of Britain's upcoming EU referendum, and they suffered further in the bank sector sell-off in February. Frightened by the global outlook for persistently low inflation levels and depressed commodity prices, investors sold out of financial stocks in droves. In Italy, authorities intervened to support the country's domestic banks, fearing a collapse in the financial sector.

However, things began to turn around later in the period as the oil price rallied and the ECB introduced further easing measures that included pushing the benchmark interest rate to zero. The bank did assert, however, that it had no intention of driving the interest rate into negative territory in the future. The bank's monetary stimulus was also adjusted, increasing the value of monthly assets purchased from €60 billion to €80 billion, and euro-denominated corporate bonds became eligible for inclusion. This led European equity markets to rise in March. At a sector level, stocks that were reliant on commodity prices generally did well, with significant gains for industrials and oil & gas. Financials, namely banks, were the biggest laggards, although healthcare, particularly pharmaceuticals and biotechnology, also had a difficult quarter.

On a macro level, unemployment in the eurozone met expectations by falling to 10.3% in February. Inflation, however, returned to negative levels.

Japanese Equities

The FTSE Japan returned -4.26% in sterling terms over the quarter, with losses even more pronounced in local currency terms at -12.77%. Investors fretted over disappointing economic releases and broader fears that the government's 'Abenomics' policies were not producing the desired results.

The Bank of Japan (BoJ) swiftly took action, surprising markets by pushing the benchmark interest rate to negative levels in late January. The BoJ considered the move a way to demonstrate to the public its commitment to raising inflation rates, which remain worryingly low. The central bank also reiterated in an accompanying statement that it would consider further easing measures if they were deemed to be necessary. Given that retail sales fell heavily in the following month (from -0.4% in January to -2.3% in February), there was speculation that any future stimulus measures could be aimed specifically at consumers.

As for economic indicators, the inflation rate did creep up during the period, rising to 0.3% in the year to February. Industrial production data was also bleak, dropping from a 3.7% month-on-month rise in January to a 6.2% fall in February. Manufacturing production also followed a downward trajectory.

As with most regions, the Japanese financial sector was the hardest hit in the first quarter. However, in a divergence from its developed-market counterparts, commodity-facing sectors continued to fare poorly, with oil & gas, basic materials, industrials and the automobiles sectors all falling.

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Asia Pacific ex-Japan Equities

Asian markets advanced during the quarter, with the MSCI AC Asia Pacific ex-Japan index returning 4.43% in sterling terms.

Markets around the world continued to stay focused on China, and in an effort to alleviate increasing global fears, the People's Bank of China (PBoC) allowed the renminbi to depreciate. However, this had a negative effect and investors grew more bearish, fearing falls in other currencies. In January, authorities opted to cancel use of the new 'circuit-breaker' system (designed to halt trading when stocks fall too low) just days after its introduction. After it was triggered twice, officials began to feel that the system could be serving to heighten investor anxiety rather than soothe it. As the quarter wore on, the PBoC continued to remain supportive. In February, the central bank enacted further economic stimulus, this time by decreasing the domestic banks' reserve-requirement ratio (RRR), which had already been cut multiple times over the course of a year. However, despite the stimuli, China's 2016 growth outlook was lowered to a range of 6.5%-7.0%.

Other central banks in the Asia-Pacific region followed suit in increasing supportive measures: Bank Indonesia cut rates in both February and March, and the Reserve Bank of New Zealand cut interest rates for the fifth time in less than 12 months. The latter cited weaker demand from China – a major trade partner of New Zealand – as a reason for its accommodative measures. The move proved supportive to domestic stocks.

Property

The IPD monthly benchmark showed a 1.1% total return over the first quarter. This was driven by both income return and positive capital growth.

During the quarter SDLT (stamp duty land tax) was increased in the budget thereby impacting property pricing, with capital values being adjusted downwards across the market to reflect the increased purchase costs.

The UK commercial property market has shown a slow down over the first quarter of 2016, with less investment activity from UK institutions caused by uncertainty in the market over the EU Referendum. In some sectors this has led to a cooling in pricing as investors are holding off on decisions and the market has lost some of the momentum of 2015.

Despite this there is still competition for certain assets, although investment volumes are down.

There were certain properties on the market that did not sell at their higher quoted prices and as a result have been re-priced, presenting a buying opportunity.

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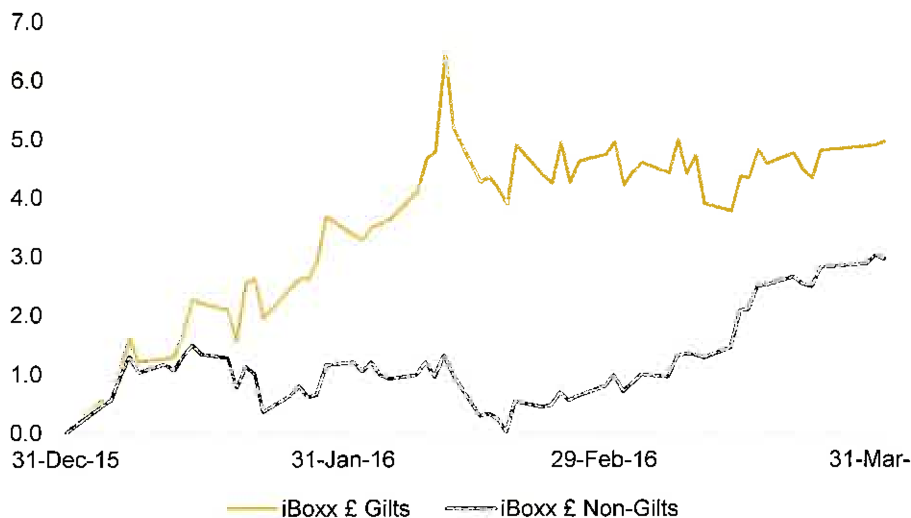
Fixed Income

Both government and corporate bond markets enjoyed a positive start to the year, although the healthy returns were accompanied by a significant amount of volatility. Once again, central bank activity played a key role with the European Central Bank (ECB) announcing further easing measures in order to stimulate the economy.

This description of the market environment may by now sound familiar, given it is almost word-for-word how we summarised the first quarter of 2015. These similarities remind us that we live in a world where markets continue to be manipulated by central bank intervention. At the same time, the macroeconomic themes that have dominated in recent years remain in place. In the first three months of 2016 swings in commodity prices, concerns over a lack of growth, particularly in emerging markets, and signs of recovery in the US were once again all to the fore.

A positive quarter for bond markets



Source: Markit

Government bonds – safe haven rally

The year began with attention firmly on China and commodity price weakness. These themes drove the market for the first six weeks of the quarter to such an extent that by mid-February core government bonds had fallen in yield by around 0.5% at the 10-year maturity point. The rally was given further impetus by the Bank of Japan's decision late in January to cut its official interest rate to -0.10%, the first time the Bank had ever moved into negative territory.

From the middle of the period, however, markets turned sharply with government bonds losing some ground, at least initially. The drivers of the u-turn were threefold. First, the European Central Bank announced in February its intention to expand its quantitative easing measures, which it subsequently implemented at its March meeting. Second, the US Federal Reserve suggested it would reduce the rate at which it would increase rates during 2016. Third, commodity prices improved after core OPEC members committed to an April meeting and a review of production quotas. At the same time, continued demand for metals helped most hard commodity prices move upward.

Despite the u-turn in markets government bonds still posted a healthy return for the quarter with the iBoxx £ gilts index rising by an impressive 5.2%. Index-linked markets also rallied, particularly in the US, as inflation expectations increased in line with the more dovish comments from the US Federal Reserve and the additional policy measures announced by the ECB. The FTSE UK Index Linked All Stock index rose 5.67% over the quarter.

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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 Dec 2015	1.96	2.27	0.63	0.27	1.77	1.59	8.07	1.15	2.50
Yield at end Mar 2016	1.42	1.77	0.15	-0.03	1.43	1.22	8.48	0.73	2.93
Change in yield	-0.54	-0.50	-0.48	-0.30	-0.34	-0.37	+0.41	-0.42	+0.43

Source: Bloomberg.

Investment grade bonds

Corporate bonds also performed well over the quarter; in total return terms the iBoxx £ Non-Gilts index returned 3.2%.

The year opened with risk assets under significant pressure, taking investment grade bonds in particular to levels that factored in a moderate global recession. With government bonds rallying strongly, the difference between government bond yields and corporate bonds yields widened materially with bonds issued by financial companies at the forefront of the punishment.

Towards the end of February there were some signs of a tentative rally in the corporate bond sector and this became more visible as we moved into March. The catalysts for the improving picture were largely as mentioned in the government bond section above. The further easing measures announced by the ECB were particularly impactful, given the Bank extended its asset purchases programme to include investment grade corporate bonds. This announcement alone led to a significant re-pricing of corporate bond risk as investors reacted positively to the news. By the end of the quarter most sectors had rallied strongly although financial bonds, particularly in the banks and insurance sectors, were not as strong as other areas.

High yield bonds

The high yield bond sector enjoyed a strong start to the year with the Barclays Global HY index rising 6.8% in sterling terms (4.1% in US dollars). The sector followed a similar path to its investment grade cousins, with high yield bonds under pressure for the first half of the quarter before rebounding strongly from mid-February onwards. This resulted in the US high yield sector outperforming its European counterpart for much of the period. Financial bonds, particularly in Europe, lagged the general rally, with the additional tier-1 (AT1) sector coming under pressure given its higher-risk characteristics.

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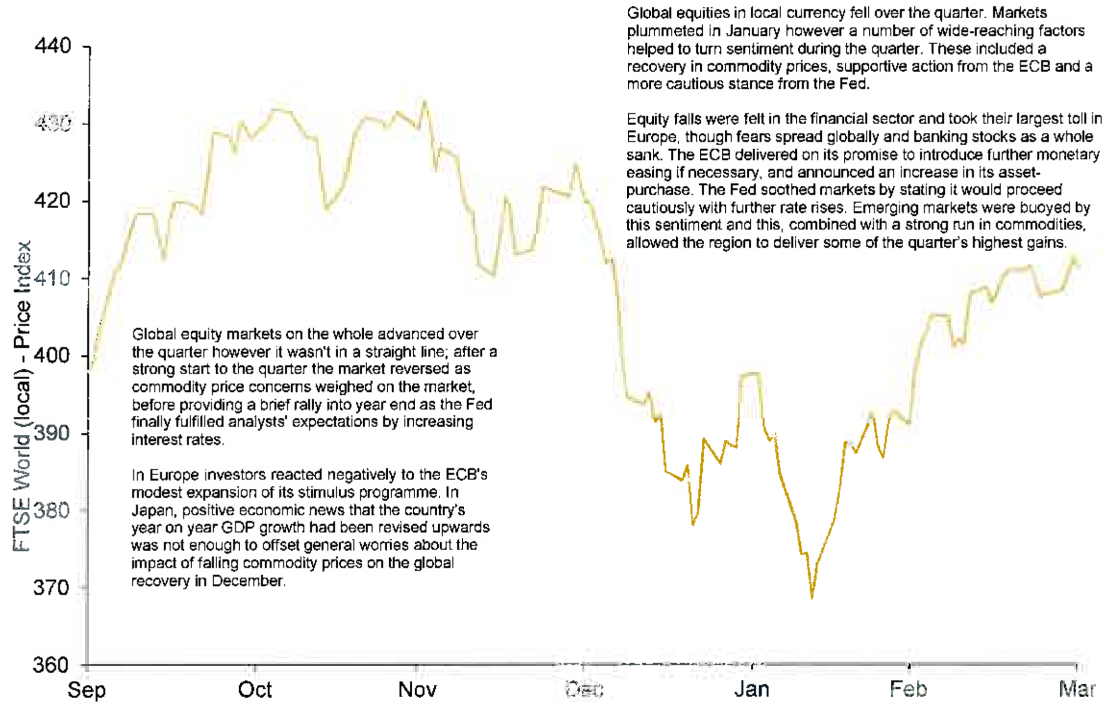
Key Market Movements

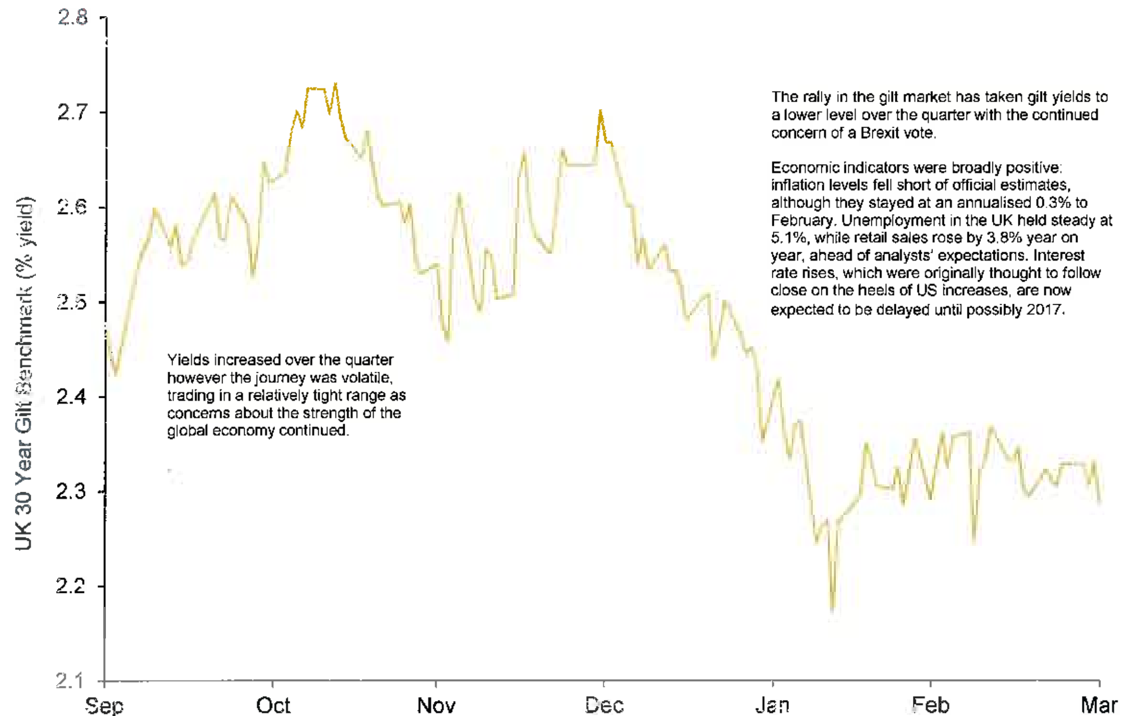
The following charts provide a pictorial summary of key market movements during the six-month period to end of March 2016.

Global Equities (FTSE World – Price Index)



Source: Datastream

Long Gilts (War Loans 3.5% Perpetual)



Source: Datastream

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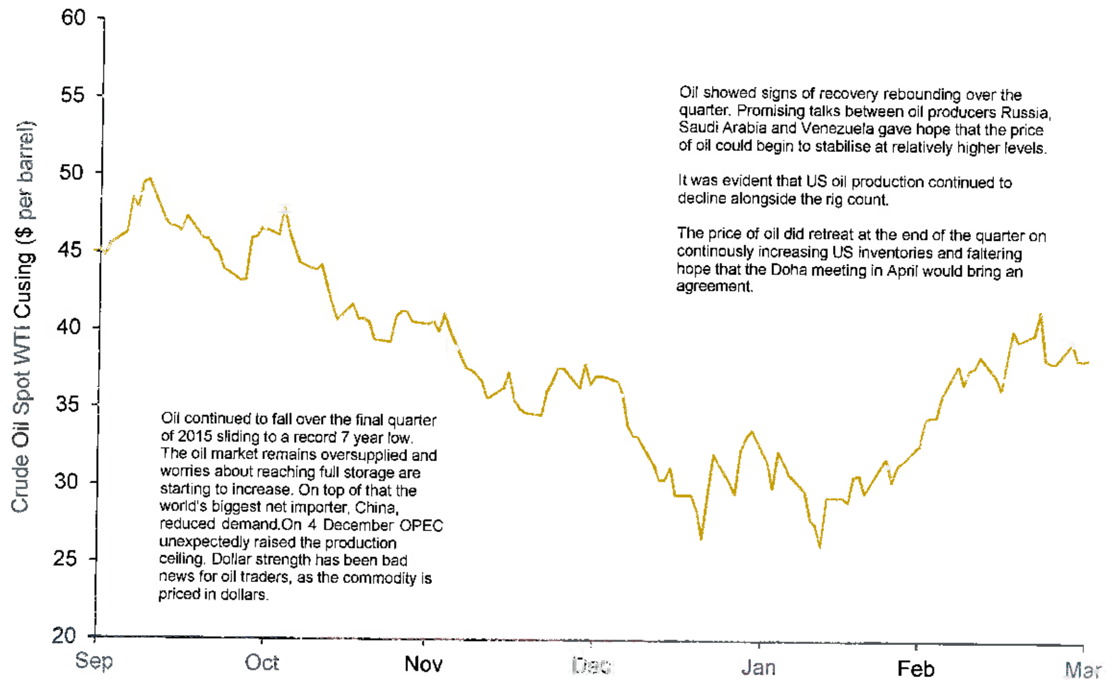
Oil Price (Crude Oil Spot WTI Cushing ($per barrel))



Source: Datastream

UK Sterling (UK Sterling Trade Weighted Index)

Source: Datastream

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Quarterly Thought Piece

Perspectives: Helicopter Money

"Let us suppose now that one day a helicopter flies over this community and drops an additional $1,000 in bills from the sky, which is, of course, hastily collected by members of the community. Let us suppose further that everyone is convinced that this is a unique event which will never be repeated."

Milton Friedman
The Optimum Quantity of Money, 1969

Milton Friedman's concept of 'helicopter money' has inspired many economists and policymakers. In this article I will highlight some of the more recent interpretations, consider the conditions for its effectiveness and explain why it has again become a hot topic.

When Friedman introduced his idea, he intended to optimise monetary policy and support economic growth by raising demand. He actually had two proposals, one deflationary (known as the Friedman Rule) and one inflationary (helicopter money). In this article, I will focus on the latter.

Types of helicopter money

Three main variations of helicopter money have been discussed in recent times:

1. **The Bernanke helicopter**: Discussed by former chairman of the US Federal Reserve, Ben Bernanke, it involves transfers to households and businesses through a tax cut or rebate, coupled with incremental purchases of government debt. It is effectively a tax cut financed by money creation. He recently re-visited this topic in his blog and concluded that under "certain extreme circumstances" it may be the "best available alternative".

2. **The Woodford helicopter**: Discussed by leading monetary economist Michael Woodford, it centres on a version of flexible inflation-targeting, in which the central bank commits future monetary policy to a permanently higher nominal target (such as the path of nominal GDP). This involves various tools within that framework, including permanent increases in the monetary base using fiscal transfers.

3. **The Turner helicopter**: Discussed by former FCA chairman Lord Adair Turner, 'Overt Monetary Financing' means the Treasury issues interest-bearing debt, which the central bank purchases, holds and perpetually rolls-over (buying new government debt whenever the government repays old debt). The central bank also returns the interest income it receives as profit to the Treasury. Importantly, the central bank must credibly communicate and commit to this perpetual rollover in advance.

A key shared element among the various types of helicopter is a consolidated view of the balance sheets of both the central bank and the Treasury. Clearly, this arrangement can jeopardise the independence of a central bank. In terms of destinations for the money, helicopter drops can involve financing one or more of:

- Tax cuts or rebates
- Increased public expenditure e.g. on infrastructure
- Public debt write-offs
- Bank recapitalisations.

Lessons from history

There have been – often notorious – examples of helicopter money, such as in the Weimar republic, Hungary and Zimbabwe. In these cases, these experiments led to hyperinflation. But even the Bank of England has a rich history of directly funding the government. For example, until 2000, it regularly used money creation to finance part of the government's spending by way of an overdraft facility, called 'The Ways and Means Advance'.

There are a couple of more recent examples that are closer in spirit to helicopter drops, particularly of the 'Bernanke' type, albeit without the explicit direct funding via central banks.

The first is from the Netherlands where, in January 1998, the then finance minister Gerrit Zalm introduced his 'Zalmsnip'. This consisted of a tax cut of 100 guilders (today's equivalent: €45.38) per household per year to compensate for a general increase in local (municipal) taxes. Due to a budget surplus, the government had some fiscal leeway and increased its contribution to the municipalities, which were responsible for the implementation of this measure. Most municipalities chose to deduct the Zalmsnip from the property tax assessment, while others implemented it through a reduction in charges for waste collection or sewerage. As this measure was more a compensation for higher charges than a real boost to income its effect remains unclear. It was abolished in early 2005.

In the US, both Presidents Clinton (2001) and Bush (2008) issued tax rebate cheques, amounting to a maximum of $600 and $1,200 respectively. In the first instance, households reportedly spent 50-70% of their 'Clinton cash', while this decreased to one-third of the 'Bush cash', with the remainder instead saved or used to reduce debt. This suggests that the timing of the drop relative to economic developments matters in terms of how the money is spent.

Again, although these recent examples are not pure helicopter drops, they provide an operational template whereby these measures are extended via direct funding via the respective central banks.

Conditions for success

In terms of its impact, Buiter (2014) argued that there are three conditions that must be satisfied for helicopter money to be effective (i.e. to always boost aggregate demand):

1. There must be benefits from holding fiat money (a currency not backed by any physical commodity, such as gold) other than its financial rate of return. For example, as a precautionary move, people keep some money in cash to pay bills, even though it earns a zero rate of return.

2. Fiat money is not redeemable, and is perceived as an asset by the holder but not as a liability by the issuer. In other words, a transfer of this money is not 'balance sheet neutral' for the economy as a whole, but rather permanently increases the money base.

3. The price of money is positive. This means that in order to buy something (e.g. a good) you need to hand over a positive amount of units of money. Stated differently, if the price of money were zero then for any (even very large) amounts of money one could buy nothing. Importantly, the price of money is not necessarily equivalent to the interest rate.

The question of whether the economy would remain stuck at the zero-lower bound without helicopter money becomes a moot point. In the view of its advocates, helicopter money, enacted in a collaborative way by a country's central bank and treasury, could raise aggregate demand and thus lift the economy from levels associated with the zero-lower-bound. That's all that counts.

Will the helicopters take-off?

The fact that flying them is actually being discussed suggests that this is no longer taboo. Friedman's starting point for considering a helicopter drop is the situation where a central bank has already lowered its rate to the zero-lower bound and actually needs higher inflation. Although it varies across regions, deflationary forces remain prevalent within the global economy, while many interest rates are close to or even below zero. So the conditions for considering helicopter money are roughly present. Specifically, the combination of deflation and zero interest rates points to the risk of a liquidity trap, making monetary policy ineffective and thus in need of fiscal support.

However, the debt overhang means that government finances are still dominated by budget cuts and austerity. As Stanley Fisher recently remarked:

"Certainly, it is easier for a central bank to change its policies than for a Treasury or Finance Ministry to do so, but it remains a pity that the fiscal lever seems to have been disabled."

What could change this, of course, is further serious deterioration in the economic outlook and/or another financial crisis.

A note of caution

So why are critics - including myself - afraid of helicopters? The answer lies in Friedman's second sentence in our introductory quote.

> *"Let us suppose further that everyone is convinced that this is a unique event which will never be repeated."*

The danger is that governments become used to money drops. Critics also point out that certain policies, such as negative interest rates, erode depositors' trust in banks, which is the broader issue in our fiat currency system.

Anecdotally, for example, the sale of safes have increased in Germany and Japan since negative interest rates were introduced. This goes beyond private individuals - the German insurer Munich Re announced that it has stored a seven-figure sum of cash in its vaults to test how it could avoid paying negative rates.

Moreover, critics point out that monetary policies have actually contributed to the predicament the global economy finds itself in, and that helicopter money is only the most extreme of a succession of bad medicines.

On a number of occasions I have previously highlighted that these policies, and the thinking behind them, are based on a flawed mechanical perspective on the economy and markets. On that note, although Friedman initially states that money is "an extraordinarily efficient machine", his later comments suggest that fiat money doesn't operate as such. Specifically, because:

"It is so pervasive, when it gets out of order, it throws a monkey wrench into the operation of all the other machines."

Unfortunately, as expressed by Bernanke, for example, circumstances may dictate that policymakers start their engines and prepare for take-off.

Scott Jamieson

Head of Multi-Asset Investing

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