Note: Market Outlook

This note is addressed to the Local Pension Committee of the Leicestershire County Council Pension Fund (the 'Fund') as part of the general review of the Fund's investment strategy. The note provides an economic and high level market outlook appropriate to that review. The form of the note is to capture current market thinking and to consider areas where the consensus may prove incorrect.

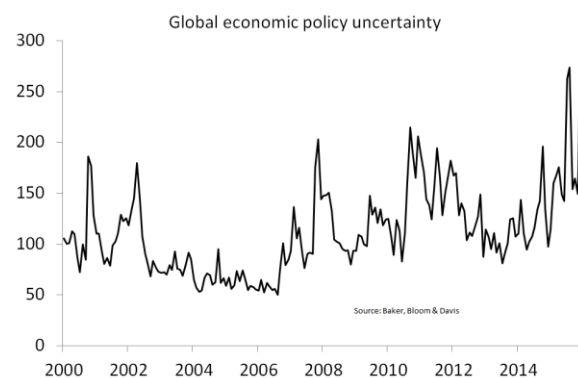
Economic Backdrop

The table below details the real economic growth outlook based on consensus data collated by Bloomberg. The projected growth rates for 2016 and 2017 are shown along with changes to the consensus that have occurred over the year; for the first time 2018 forecasts are available.

Notwithstanding the heady optimism that has gripped financial markets in the wake of Donald Trump's victory in the US Presidential Election, the story of 2016 generally is one in which economic growth within developed markets disappointed; nowhere more so than in the US. The decision of the UK to leave the European Union is most evident in the forecast of a slowing economy in 2017 – slower than both the US and Eurozone; relative improvement in 2018 is not expected. In contrast, 2017/18 for the US is expected to show that the economy will return to growth slightly above trend (according to the US Federal Reserve trend economic growth is 1.8% p.a.). Relative to the pace of activity observed in Q3, 2016 (and the +2.5% p.a. suggested by real-time measures for Q4) this may seem slightly disappointing however the stronger growth of H2 simply makes good the growth lost in H1. Even without the promise of the sharp fiscal expansion that lay at the heart of Trump's campaign, this has provided the platform for the Federal Reserve to raise rates. Japan's economy has struggled to grow – something that isn't expected to change (despite the recent sharp slide in its currency).

GDP growth (% p.a.)	2015	2016		2017		2018
		Consensus	Change past Year	Consensus	Change past Year	Consensus
US	2.4	1.6	-0.9	2.2	-0.2	2.3
Eurozone	1.5	1.6	-0.1	1.4	-0.3	1.5
UK	2.2	2.0	-0.3	1.2	-1.0	1.3
Japan	0.6	0.9	-0.2	1.0	0.4	0.9
China	6.9	6.7	0.2	6.5	0.2	6.1

Growth forecasts often prove inaccurate (as 2016 illustrates); the likelihood of material forecast errors in 2017/18 looks high. The challenge facing those tasked with projecting the economic outlook has – arguably – rarely been stronger; this is captured in the chart opposite. Uncertainty surrounding economic policy formulation across the globe is higher than it has been for many years. This is led by the UK and Europe – both of which have to confront the UK's departure from the European Union. Further, while economic policies generally matter more than political developments, should Le Pen triumph in France and Merkel lose in Germany then the (adverse) impact on corporate and consumer confidence across the Eurozone (and beyond) would be significant. Uncertainty is further fuelled by the potential for a sharp and substantial change to US fiscal and trade policy (which, by extension, has lifted uncertainty around Chinese economic policy).



Market participants (as opposed to economists) probably judge that the downbeat outlook for the UK is too pessimistic (economists generally expected a *Brexit*-induced slowdown to already be hitting the UK). This could be generating complacency that threatens current UK asset prices (UK equities recently hit an all-time high). The resilience of the UK economy in H2, 2016 however has been part of a lift in economic activity across the globe which was not expected (and which was driven by low bond yields, the improvement in commodity prices and ongoing job creation). Much as was the case a year ago, the US economy is entering 2017 with an

above-trend growth momentum. It took the unprecedented (equity) market turbulence of last January to slow activity; that vulnerability likely remains. Beyond a market-induced slowdown, probably the major risk facing the US comes from the housing market where sharply higher mortgage rates are likely to slow activity. That said, the promise of a sharp fiscal expansion will bolster confidence.

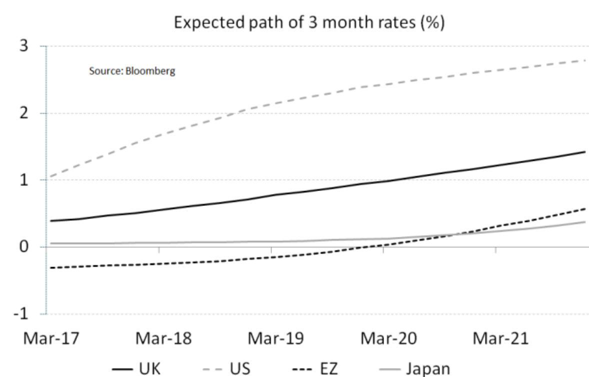
While uncertainties may surround the actual level of growth rates, it seems likely that the relative rates i.e. the US growing more rapidly than the UK, Europe or Japan, are much more likely to prove accurate. In broad terms therefore the US economy looks likely to prove more supportive of real assets with non-US markets being more supportive of nominal assets such as bonds (subject to price!)

The next table echoes the one above but this time applies to rates of inflation. Here economists correctly foresaw that US inflation in 2016 would be marginally below the central bank target (2.0%) but estimates were much too high in the UK, Europe and Japan. Everywhere current levels of inflation are either unlikely to induce a material tightening in monetary policy (the US) or require monetary policy to remain accommodative. A healthier economy should ensure that the 1.9% core inflation rate projected for the US is 2017 is broadly correct but there is downside risk to the Eurozone estimate of 1.3% (notwithstanding the rise in oil prices above $50pb). The failure of *Abenomics* (in Japan) to lift inflation to 2.0% is confirmed in the forecasts; the structural deflationary forces (led by an ageing population) are reasserting themselves.

	2015	2016		2017		2018
Inflation forecasts (% p.a.)		Nov Actual	Change in forecasts over 2016	Consensus	Change past Year	Consensus
US (Core PCE)	**1.3**	**1.7**	**0.1**	**1.9**	**0.1**	**2.0**
Eurozone	**0.0**	**0.6**	**-0.8**	**1.3**	**-0.2**	**1.5**
UK	**0.0**	**1.2**	**-0.7**	**2.4**	**0.6**	**2.5**
Japan	**0.8**	**0.1**	**-1.0**	**0.6**	**-1.4**	**1.0**
China	**1.4**	**2.3**	**0.3**	**2.2**	**0.2**	**2.2**

It is the UK where the changes have perhaps been more profound. *Brexit* has induced a sharp slide in £ which is lifting import prices (evident in sharply higher producer price inflation). The Office for National Statistics has guided that this has not yet fed through to consumer prices; this is what is driving the 2.4% and 2.5% inflation forecast for 2017 and 2018 respectively. A one year surge (due to base effects) is likely to ensure that the estimate for 2017 is more secure than the 2018 figure; much will depend on how £ reacts once Article 50 (to begin the process to leave the EU) is invoked.

The money markets' interpretation of the growth and inflation outlook is shown in the chart opposite (which depicts the expected path of short term interbank interest rates). European and Japan rates are expected to remain zero (or lower) for the rest of the decade. If correct, then Japanese rates will have been at or below 1% for more than 25 years. On one level this provides food for thought for those that expect interest rate normalisation, on another it underscores the appetite, in America and elsewhere, to now approach things differently. In the US the market expects that rates will rise slowly, but steadily, to a terminal rate around 3%. The chart makes clear, as a corollary, the degree of adjustment possible should Trump's economic plans fail to stimulate activity and US rates converge back to the global norm. In the UK support from a lower currency and an element of fiscal expansion (though short of what has been promised in the US) is expected to allow (require?) rates to rise (but not above 1% until the next decade); this profile looks wrong and the average of quite different scenarios. If inflation lifts as projected by economists (especially in 2018) then markets will look for more compensation than is currently priced. If £ weakens too much (under the burden of a still expanding external deficit) then defensive measures to protect the currency could see rates rise sharply. If *Brexit* goes badly then rates will remain stuck at current levels (or may fall further). In short, the forward curve of UK rates represents an unstable equilibrium.

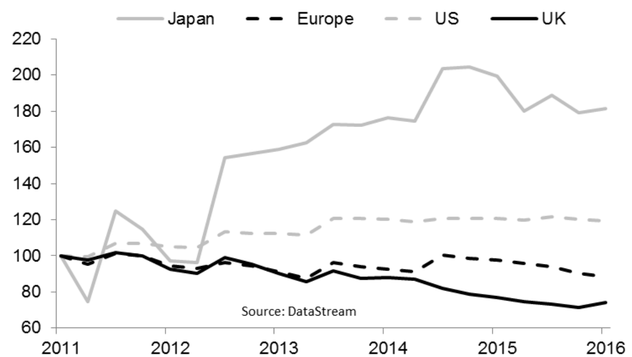


Overall the outlook is for more-of-the-same (subdued inflation, moderate growth) but with the possibility of a Trump induced policy 'shock' (the nature of which is currently very hard to determine but should be a lot clearer by mid-year). Risk markets look currently to giving Trump the benefit of the doubt; retaining doubt about the benefits is appropriate.

The potential read-through from the above on expected year-end risk-free bond yields is shown below (again is based on data collated by Bloomberg). Despite the weakness in bond prices in the latter part of 2016 (Gilt yields rose 0.5% and US Treasuries 1% in Q4), the forecasts broadly restore the levels that existed a year ago (with gilt yields down a touch on *Brexit* and treasury yields up a touch on *Trump*). The Bank of Japan has declared its determination to maintain 10-year yields at 0%; economists expect that the BoJ will be successful. A sharp rise in bond yields would be a surprise.

10y rates (%)	2015	2016	Latest	2017
10y US treasuries	2.3	2.4	2.5	2.7
10y German bunds	0.6	0.3	0.2	0.6
10y Gilts	2.0	1.4	1.3	1.6
10y JGB	0.3	0.0	0.0	0.0

In recent years bonds have appealed to investors because of the possibility for strong capital performance, not their yield; such a strategy is under threat. Key is whether equities emerge as a competitive alternative. For this and when valuations appear demanding by historic standards, an improvement in the earnings outlook is required. Sadly, as the chart opposite suggests, currently there is no earnings growth momentum (chart plots projected FY1 Earnings Per Share growth). While analysts expect a more positive platform in later years there is little evidence to support the accuracy of such forecasts (analysts tend to be perpetual 'bulls', wedded to +10% forecast growth rates). What is needed is a healthier pace of economic activity and this is where Trump's reflationary programme is crucially important. The risk to non-US equity markets is that Trump's programme contains the threat of protectionist measures intended to ensure that the US prospers even if at the expense of the rest of the world.



EPS (yoy change)	UK	US	Japan	Europe
FY2	15%	13%	11%	13%
FY3	13%	12%	8%	11%

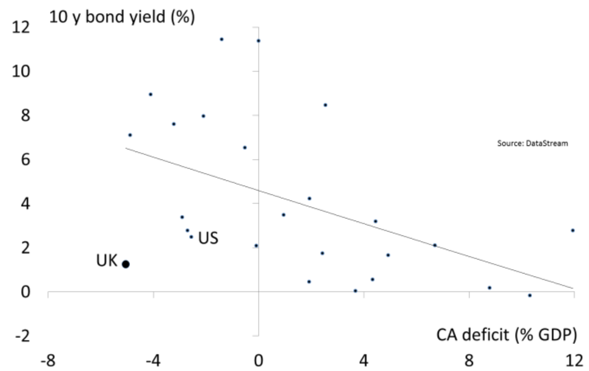
That said, if economies can manage modest growth then companies should be able to grow their dividends at a pace sufficient ensure that equities offer value relative to bonds. [The chart opposite plots the history of the dividend growth rate needed for UK equities to be equivalent value to bonds; the current 1% shouldn't be that demanding. A similar conclusion can be drawn from the equivalent US comparison although the rise in US bond yields has raised the bar for US dividend growth to the level of actual Dividends Per Share change in recent years.]

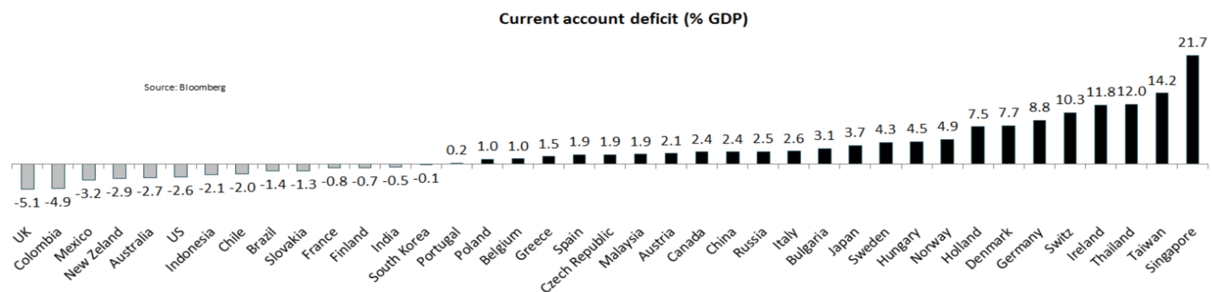
Finally on equities, the chart opposite could be judged a curiosity. It compares, over the long term, the relationship between the average US institutional fund allocation to US equity markets with the subsequent ten-year return (% p.a.). The inference is clear: US equity markets look set to return around 6% p.a. over the next decade. It also implies, after allowing for equity market levels in 2007 and 2008, double digit returns from US equities over 2017/18. This would imply a durable Trump 'feel-good' factor – this is not impossible.

The *real-world* backdrop for bond investors remains supportive: debt levels are too high, excess capacity remains, demographic pressures are driving real yields lower, technology-driven price disruption continues apace, final demand for credit remains subdued, limited compelling priced attractive alternatives and, outside the US, low yields remain part of the policy *answer*.

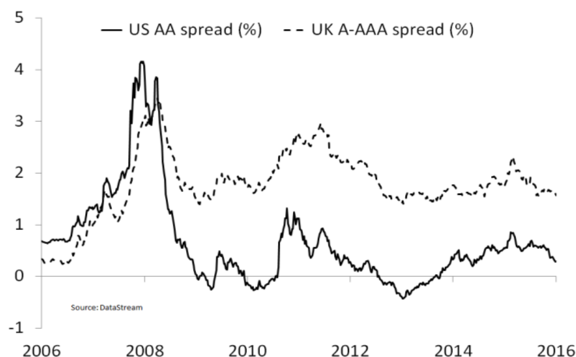
The challenge could come from a move, led by the US, away from monetary stimulation to fiscal expansion (that sees budget deficits balloon). Absent that challenge then bonds retain attractive defensive merits.

In such a scenario it looks less likely that Gilts will prove to be the superior defensive play. Gilt yields already reflect an inferior economic outlook and the UK's need to attract external capital (to balance a yawning current account deficit) remains acute; in this context, gilt yields increasingly look too low (see chart opposite).



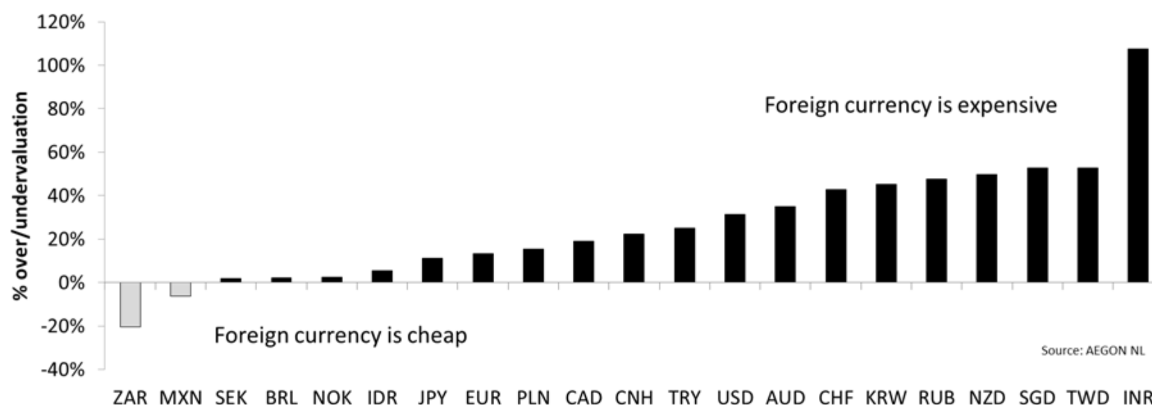


Away from government bonds, credit spreads contain little margin for any increase in corporate defaults; spreads having narrowed materially since Q1 2016 when the global economy looked to be stalling. In the UK the excess corporate bond yield fell after the Bank of England relaunched quantitative easing (incorporating buying of £10bn UK corporate bonds after *Brexit*). A more exaggerated move occurred in the US late in 2016 on the belief that the Trump-induced growth revival would materially lessen the threat of corporate failure.



Spreads on High Yield bonds look similarly tight. Non-government bond exposure should be taken away from the liquid markets, where the cost of (illusory) liquidity is high.

The slide in £ in 2016 has left the Pound looking cheap, particularly against its major trading partners (chart below). The reasoning behind the fall is easily understood. The UK has a very high external dependency on external capital and following the country's decision to leave the 'shelter' of the EU, in a manner that leads to an uncertain economic future, global investors need to see a price discount. Whether the 13% fall in £'s trade weighted value since the Referendum is sufficient compensation will remain to be seen. Purchasing power parity (PPP) metrics suggest that it should prove enough (unless the outlook for the UK deteriorates further).



Conclusion

For many years key in shaping market forecasts has been not to fall into the trap of expecting interest rates and bond yields to return to the levels of the period prior to the Great Financial Crisis of 2008/09. Remedial measures (for dealing with the aftermath of the GFC) were limited to monetary policy. Debt levels were still very high (and growing) while excess capacity and demographic pressures were maintaining dis-inflationary pressures. The challenge facing policy makers has been without precedent so, perhaps reasonably, their response had to be unprecedented – and so it was.

Perhaps the most significant developments over 2016 has been the broad acceptance that a different approach (to cutting interest rates etc) was needed and the pace at which something different is being embraced. In this sense we could be in the midst of a regime change capable of bringing to multi-year bond bull market to an end. At such times focusing too much on details (e.g. have bond yields risen too quickly and/or are equities cheap or dear?) risks missing the point: investing behaviours learned in the years since the GFC (and before) may prove inappropriate for the years ahead.

Monetary policy alone was never likely to lead to normalisation (as commonly understood) and fiscal expansion was the logical next (last available?) step. To be considered there needed to be fundamental political shifts – a new broom. To be credible, the fiscal experiment needed to occur within a major economic block (otherwise markets would move to penalise the profligate); the US is the ultimate petri dish. Trump's policy platform promises to use massive debt finance to fuel an above trend expansion that lifts 'blue collar' incomes and puts America first. This could prove a problem for shareholders (especially those of non-US companies) but it certainly disadvantages those currently owning long duration bonds – many of whom are not natural bond holders. If the experiment fails then we know what happens to bond yields etc – we've lived through this. If it succeeds then we have no model for what lies ahead. Current bond yields – government and non-government - offer poor compensation for a more expansionary fiscal approach and protectionism.

Biased to believe, equity investors are currently doing what they do best; travelling with the hope that Trump's programme will be enacted and will benefit everyone. Deprived of alternatives, they should prove willing to give Trump's policies time to work unless events in Europe (led by the French election) prove overwhelming. If, into the end of 2017, hopes are dashed then a much more extreme set of policies could emerge (negative

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interest rates, the widespread adoption of QE along with a sharp rise in public spending) is likely. Despite the general rise in government debt (as a % of GDP), bond yields had fallen because issuers were judged to remain credit-worthy. If politicians embrace unfunded fiscal expansion then this could force government credit risk premia higher; that will be messy and best avoided.

The above challenges are significant but in the meantime the world enters the year ahead in reasonable shape – as was the case last year. Economic growth has reasonable momentum across a broad base and policies remain supportive. Corporates and consumers appear moderately confident of the future and confidence goes a long way in the modern economy. Some will see this, somewhat ironically, as evidence that monetary policy was finally working; it isn't - not with the vigour and durability needed.

Real assets should be preferred though at the higher yield levels bonds have some defensive appeal – the optimism of last year was quickly undone by Chinese devaluation, fresh weakness in oil, a sharp reaction to higher (US) interest rates and ineffective policy developments in the EZ and Japan; variations on these risks remain. Bonds will always retain tactical utility; yield movements over 2016 should ensure that the best defensive bond market is in the US (especially if the epicentre of any market setback involves worries over the outlook for the US economy). £ is cheap but may remain so until the 'fog' around Article 50 etc begins to lift.

In January China enters the year of the Rooster. Over the course of 2017 we will find out whether this marks a new dawn for the rest of us and if bonds leave the era of the bull. If they do then the impact will be substantial.