Market Report

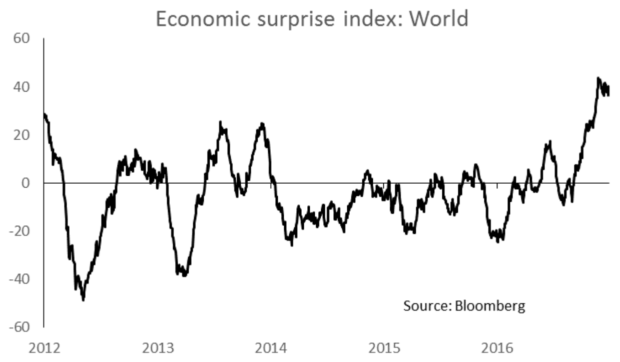
This note is intended to support the discussion at the upcoming Local Pension Committee meeting of the Leicestershire County Council Pension Fund.

Overview

The first table below updates on consensus real economic growth estimates as compiled by Bloomberg; expectations on the pace of growth in 2017 across the world have been revised upward in recent months. By the standards of recent decades these forecasts aren't that impressive. Viewed against the experience of recent years they have been enough to strength 'animal spirits' across asset markets and, importantly, in companies (many business sentiment surveys have reached multi-year highs).

	2016	2017		2018	
GDP growth (% p.a.)	Actual	Consensus	Change past Q	Consensus	Change past Q
US	1.6	2.3	0.2	2.3	0.2
Eurozone	1.7	1.5	0.2	1.5	0.0
UK	2.0	1.4	0.5	1.3	-0.2
Japan	1.0	1.0	0.2	0.9	0.2
China	6.7	6.5	0.1	6.2	0.2

The UK was arguably the first economy to challenge both the malaise of H1, 2016 and the Brexit spasm; the US economy also performed well in Q3 (+3.5% annualised pace). Driving the latest upgrades has been an almost unending succession of economic data prints in excess of forecasts all across the globe; surprises have become the norm. Notably this has included Europe where activity levels are as high as they have been for several years and in China (and thus allowing those most worried about China's credit excesses to postpone the perceived day of reckoning). Together these developments has reflected an impressive synchronised upswing. Real time, various '*nowcast*' measures suggest that the current pace of growth in the US lies between 2.2% (Atlanta Fed) and 3.1% (NY Fed); suffice to say that the US economy is running on or above the full year projection. In Europe growth is judged to be running at a 3% annualised pace.

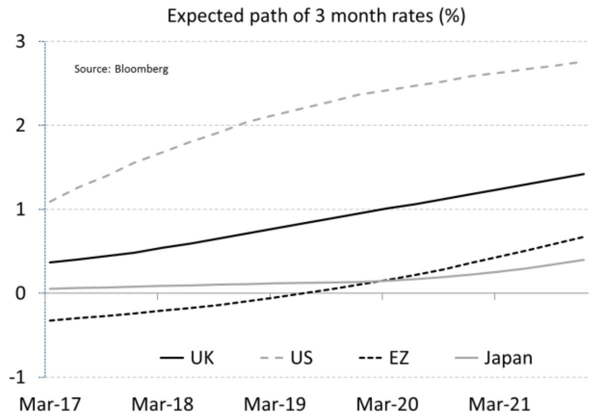


This has been reflected in upward revisions to inflation forecasts (table below) although the base effect from the recovery in oil prices that occurred from the Spring of 2016 is also a strong factor. The impact of the slump in £ is reflected by the change to the 2018 estimate of UK inflation although +2.6% fully a year after a major currency slump suggests inflationary pressures remain relatively modest.

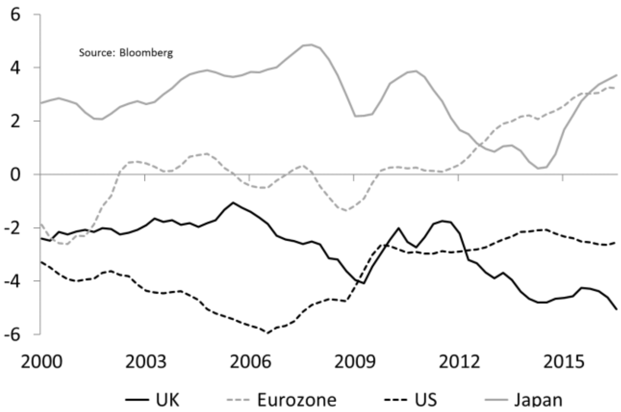
	2016	2017		2018	
Inflation (% p.a.)	Actual	Consensus	Change past Q	Consensus	Change past Q
US (Core PCE)	1.7	1.8	0.0	2.0	0.0
Eurozone	1.1	1.5	0.2	1.5	0.0
UK	1.6	2.5	0.2	2.6	0.4
Japan	0.0	0.6	0.1	0.9	-0.1
China	2.1	2.2	0.2	2.3	0.1

Overall, the growth and inflation outlook has encouraged the belief that the era of deflation has ended and that we have entered a period of reflation; having waited a long time for this, investors have embraced the change. The turnaround in sentiment has proved astonishingly rapid and is vulnerable to delivery risks. A factor behind the malaise of recent years has been the unwillingness of companies to invest. It remains to be seen if managements are prepared to act upon their newfound confidence. Possible changes to US public spending and corporate taxes will be key. Trump has a lot to live up to!

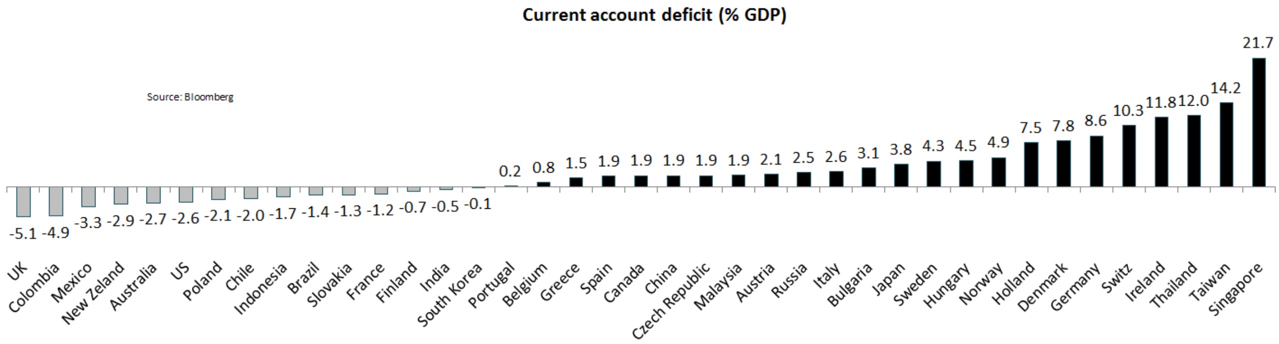
This changed perspective is reflected in the outlook for short-term interest rates. All major economies are now judged to have a rising rate profile albeit that the absolute level of rates is still expected to remain very low by historic standards. The Federal Reserve's latest estimate of the terminal policy rate in the US is 3%. Three US rate increases are expected in 2017. Given the current mood across markets, these increases will be seen as validating the jump in sentiment rather than as an attempt to cap the recovery. Failure to raise rates will therefore induce doubt in the minds of investors. Elsewhere the risk is that changes in the US force other central banks to tighten policy when they shouldn't.



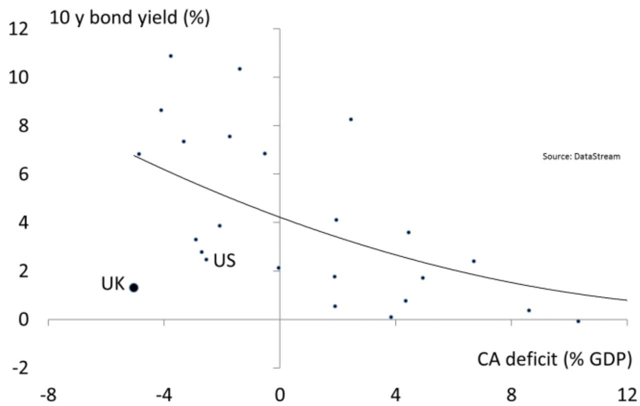
Challenges for non-US policymakers vary. In Europe, the ECB could soon run out of bonds to buy in their QE programme; with growth strong, the Bundesbank may anyway be keen to end such policies. If so, then the scale of the Eurozone current account surplus (chart opposite) could put unwelcome pressure on the €.



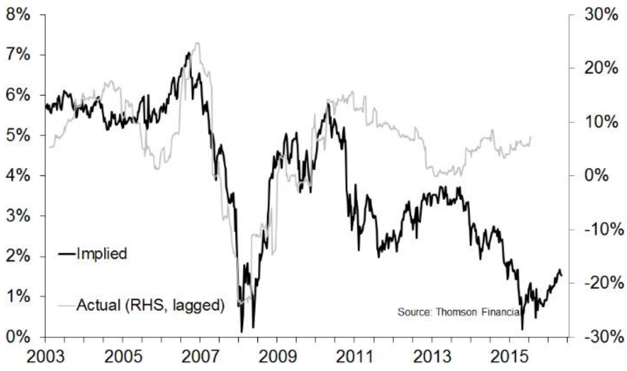
In the UK the opposite concern applies; the UK is in the ignominious position of having the largest current account deficit of any established economy. A healthy global economy (exhibiting a strong appetite for UK goods and services) would be a godsend for this country. Thankfully, £, on any econometric basis, looks cheap.



If £ is cheap, the same cannot be said for UK gilts; relative to the scale of external finance that the UK needs to attract to 'balance the books', international comparison suggests that gilt yields remain far too low. Concerns around the manner of the UK's exit from the EU may see gilts retain a defensive premium but this isn't a cheap market. Those looking for value in stabilising assets should focus on US bonds.



On equities, it is worth noting that currently a discounted future dividend assessment suggests that, for the UK (shown opposite) and other markets, the level of future dividend growth required to breakeven with the alternative of investing in bonds, remains very low by historic standards. This should, if the global economy is indeed improving, offer strong support to equity investment.

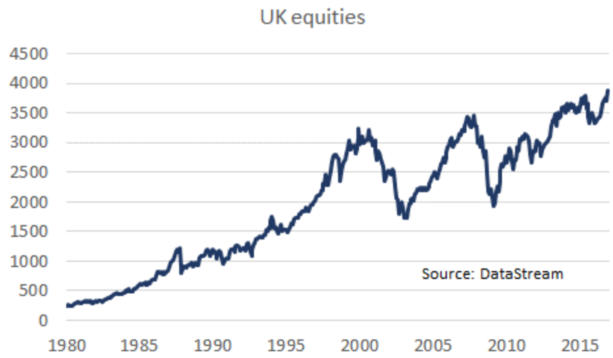


The remainder of this note attempts a longer term assessment of the prospects for equity markets. The positive outlook offered may be difficult for the Pension Fund to embrace fully – given the challenge that the inevitable equity market corrections could place upon, already strained, sponsor contribution rates. It does nonetheless suggest that the bar, against which alternatives (to investing in equities) are pursued should be assessed, is quite high.

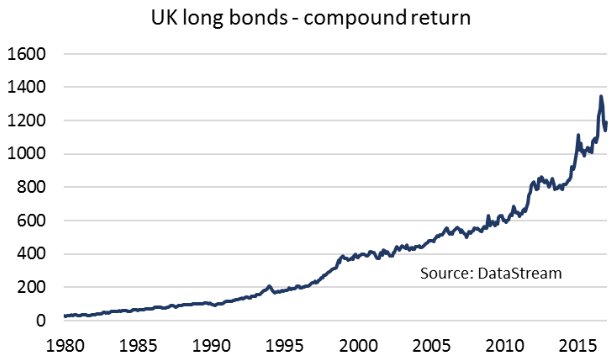
This argues against investing unduly in stabilising assets at this time; (much) better opportunities for doing so should present themselves. It doesn't suggest that simply investing in broad market aggregates will prove optimal. There are many misalignments that should correct in value portfolios and in EM. The still-subdued rate outlook should also prove highly supportive of resilient yield themed equity programmes.

Discussion: 'Stocks for the long run'

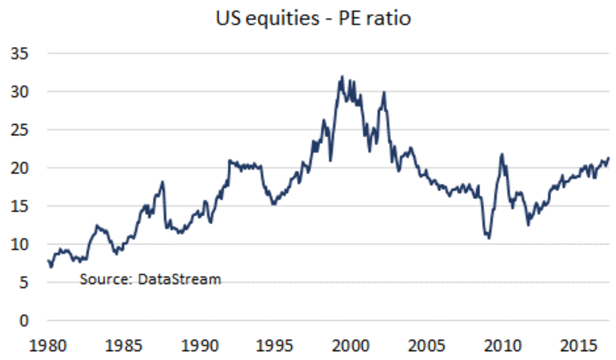
Last August I mused over when the equity bull market might start. The suggestion that equity markets were on their knees and about to turn was, of course, there to be challenged by the facts: indices had already seen very strong gains from the depths plumbed in the immediate aftermath of the Global Financial Crisis and were arguably back 'on track' (chart opposite). This was not denied. The proposition however was that, relative to bond markets and given the level of shorter term interest rates, equities, as a long term investment medium offering solid protection against value erosion caused by inflation, had woefully underachieved. UK equities have returned 7% since that argument was made.



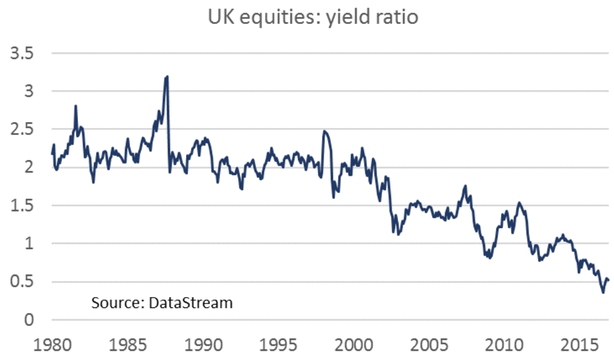
Developments since August have, arguably, made more important the question that we might still be at the foothills of a very strong multi-year equity bull market is considered. The contention is of course not that equities are risk free; there will always be testing periods of market angst. The outlook is, however, firmly for an era of equity market performance capable of emulating the returns seen from bond markets in recent decades. Equities have been good investments in recent years. Remembering the words of Randy Bachman – *you ain't seen nothing yet*.



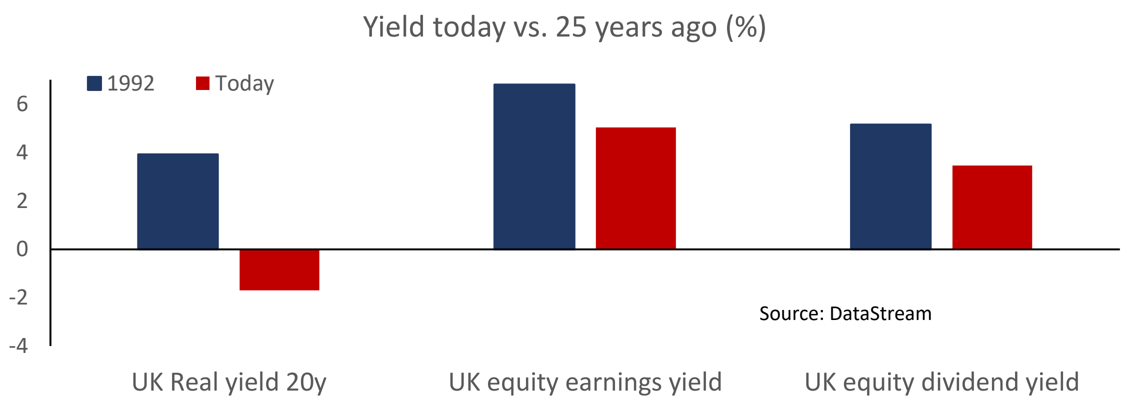
The strongest challenge offered against the suggestion that equity markets might currently be a compelling buy is generally based on valuation: price earnings ratios (PEs) are as high as they have been for a decade and higher than for all of the 20 years preceding the dotcom era. That is beyond challenge however dotcom itself showed that when conditions are favourable – as they now could be, equity ratings can rise significantly further. It should also be remembered that valuation constraints were often offered as an argument against continuing declines in bond yields. They were to prove to be no obstacle whatsoever against a move which would eventually see yields on the longest dated UK gilts almost touch 1%.



Thirty years ago a favoured valuation metric was the ratio between bond and equity yields. This comparison was favoured because it had shown stability – when gilt yields were around 2.5 times those on equities, you bought gilts, when the ratio was below 2, you bought equities. Valuation measures are invariably framed by mean reversion arguments around relationships that have previously shown some stability. The metric was ignored once it ceased to work. Other favoured ‘rules’ e.g. the Rule of 20 (PE ratio + yield = 20) were also to fall by the wayside.



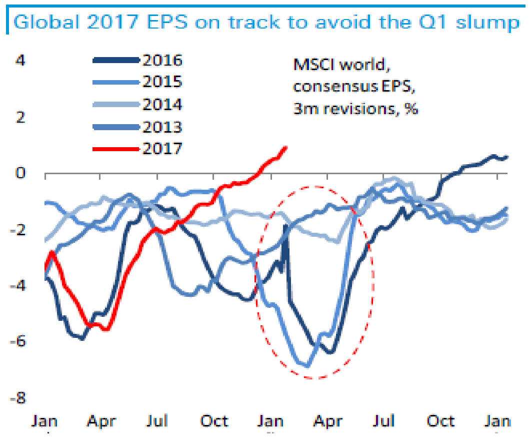
Actually inflation-linked bond yields, rather than nominal bond yields, are more relevant reference “risk-free rate” for valuing equities. Despite absolute equity valuations being above historic norms, the following chart suggests that shift over the last quarter of a decade has been extremely modest compared to bond markets.

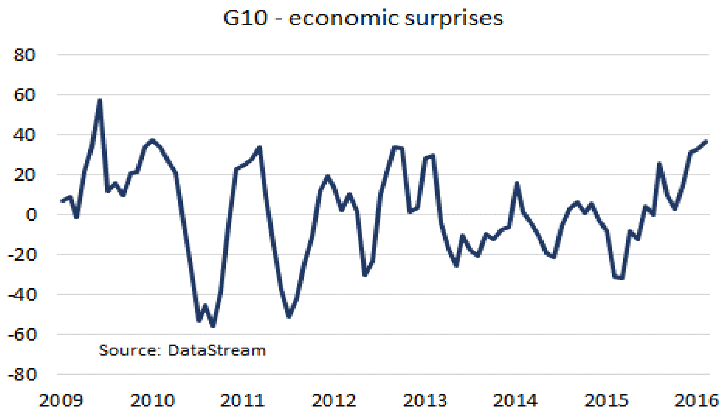


If beauty is in the eye of the beholder, then the assessment of *value* is no less subjective. The most relevant valuation metric is that which captures the behaviour of the category of investor dominating the market at that time. A generation ago long term institutional investors not yet impacted by balance sheet or solvency considerations freely selected between equities and bonds; small wonder that a comparison of equity yields with those available on long duration bonds makes sense. Pension funds etc. however have a frame of assessment that is different from corporates and also from retail investors. The dotcom burst began the decline in the dominance of equity market by institutional investors; institutional metrics began to lose their predictive power.

In recent years the strongest buyers of equities have been corporates themselves. For them 'value' is based on arguments associated with tax and short term debt yields. Looking forward it will be retail investors that are likely to emerge as the dominant category of investor. In that scenario comparison of dividend yields with cash yields may be most important. [I have always favoured a utilitarian approach – do the foreseeable returns/ income streams generated by an investment meet my needs after allowing for the likely risks involved?]

A more material problem for those trumpeting equities in recent years has been the difficulties that companies have faced in growing their earnings. Forecasts of future corporate profits having often started well only to be relentlessly pared back; not now. Currently and for the first time in many years, the profits outlook has improved, not diminished (chart overleaf).





An oft-mentioned concern involves the quality of earnings; particularly given the appetite of some companies to adopt sometimes-dubious accounting tricks. In a year of surprises, arguably the most significant development in 2016 was the synchronised global economic upswing which, as the year progressed, saw successive economic releases exceed expectations. The current solid progress on earnings is therefore underpinned by economic strength across the world (embracing even Europe where the real GDP growth rate for the first half of this year is remarkably expected to breach 3%). The shift away from monetary stimulation to fiscal support – strongly in the case of the US, is, ironically, coming at a time when uber-easy monetary policies looked to be gaining traction. For the first time in a decade, macro-economic policies look capable to delivering a period of above trend economic growth – a real world development that delivers the strongest challenge to those wary of investing in equities. Encouraged by these developments it is likely that corporate capital investment will increase and, in so doing, add resilience to the improvement in earnings; the outlook for corporate profits has improved. Trump's likely assault on US corporate tax rates offers yet another prop to future company earnings.

Regulatory tightening has been a significant constraint on the financial sector and, by extension, the real economy – although admittedly demand for credit has hitherto been weak. The period of punitive taxation and enfeeblement in the US looks, led by Trump, to be easing. To ensure that their banks remain competitive policy makers across the world will have to echo these moves.

Funds flow for equities has been very poor for a long time. By compulsion (due to tighter capital requirements) and inspired by 'rear view' caution, most large investors are still looking to ways to secure equity-like returns from anywhere but the equity market. Many of these have merit and are generally characterised by a valuation vs. liquidity risk trade off. There will – soon perhaps - come a time for simplifying things and to buy equities.

Investors have already begun to question whether bond investments – in their myriad forms – should be the magnet for cash that they were. It will take time – and ironically higher index levels – to entice many institutional investors to re-engage with markets; individual investors are likely to move first. Longer term the unavoidable growth of DC pensions arrangements must see investors favouring sensible equity risk-taking. In the short term the flood of monies being transferred out of DB pension schemes (£10bn in the UK at the last count) is not, other than at the margin, going into bond investments – this capital is headed to equity markets.

In recent years a favourable dis-inflationary backdrop, supported by an austerity drive, ensured that the multi-decade bond bull market defied prediction in its extent and duration. Austerity is out and central bank talk is now about allowing reflation (inflation) to take hold. Equities have become the ultimate unloved investment and yet, suitably selected, equities remain the most appropriate long-term investment and currently offer a premium real yield to boot.

Strong challenges to holders of equity risk are always going to emerge but, in the bigger picture, the tide (of austerity and disinflationary) has turned. Suffice to close by declaring that currently, as perhaps never before for a generation, the biggest risk associated with equity markets is not owning them.

Scott Jamieson, March 2017