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Leicestershire County Council Pension Fund Q4 2016 - Market Report

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Historic Returns for World Markets

Index	Q4 (%)	1 Year (%)	3 Years (%)
Citi WGBI Non-GBP TR	-3.84	21.89	9.37
FTSE 100 TR	4.32	19.07	5.78
FTSE 350 TR	3.88	16.85	5.98
FTSE A (Index Linked) British Govt All Stocks TR	-2.68	24.33	13.56
FTSE A British Govt All Stocks TR	-3.43	10.10	8.02
FTSE A British Govt Over 15 Years TR	-6.00	18.49	14.35
FTSE All-Share TR	3.89	16.75	6.05
FTSE Japan TR	5.11	22.68	13.99
FTSE Small Cap TR	4.04	14.29	7.96
FTSE World Europe ex UK TR GBP	4.81	19.69	8.08
FTSE World ex UK TR GBP	7.09	30.42	15.31
IPD UK All Property Monthly TR	1.34	1.41	11.31
LIBID GBP 7 Day	0.06	0.39	0.45
Markit iBoxx Sterling Non Gilts Overall TR	-2.58	10.65	7.64
MSCI EM (Emerging Markets) TR GBP	0.83	33.12	7.84
MSCI Pacific ex Japan TR GBP	2.31	28.82	9.75
S&P 500 TR	9.15	33.55	20.02
Commodities	2.55	11.40	-11.38
£ Trade Weighted Index	-0.53	-14.73	-3.24

Currency	Q4 (%)	1 Year (%)	3 Years (%)
Euro	-1.33	15.82	0.86
Japanese Yen	-8.73	23.02	6.49
US Dollar	5.13	19.28	10.25

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

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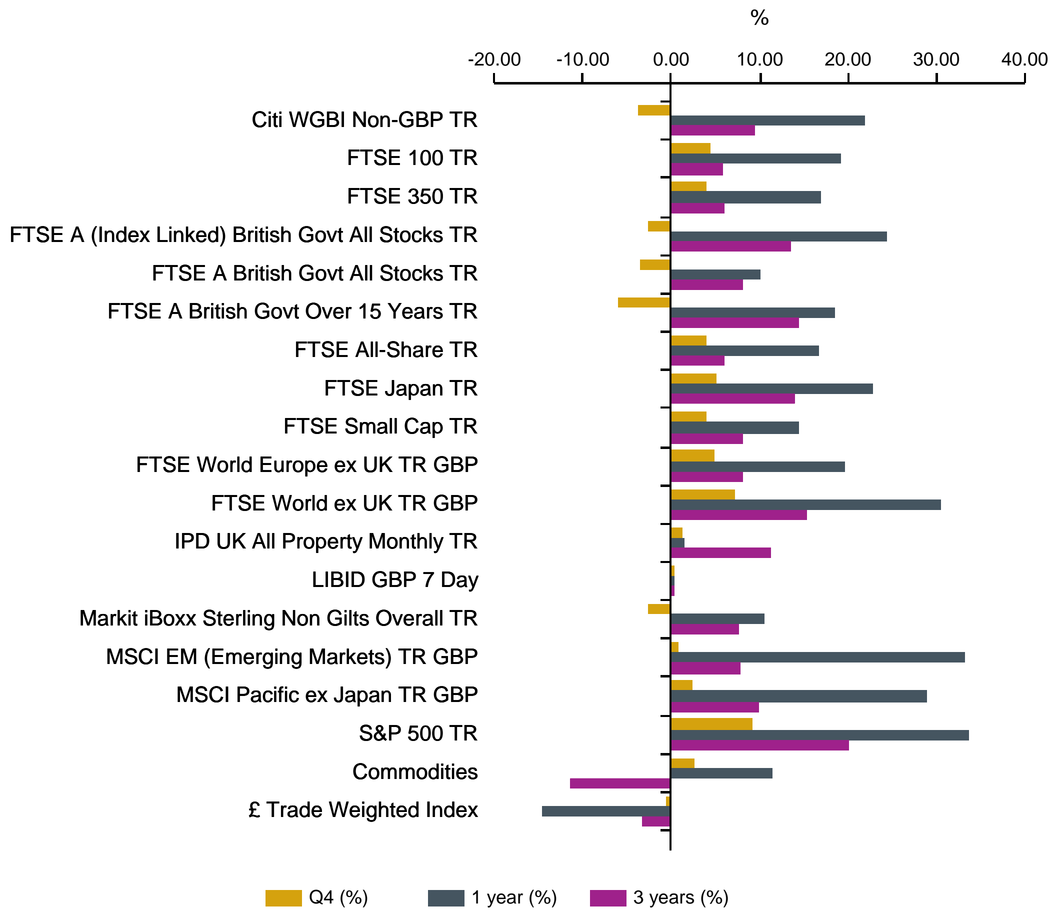
Historic Returns by Market Index

3 months, 1 year and 3 years (annualised)



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

Market Review

UK Equities

UK equities advanced over the period, with the FTSE All-Share index returning 3.89%. The FTSE 100 rose 4.32%, outperforming both the FTSE 250 and the FTSE Small Cap indices. At the end of the quarter, the FTSE 100 made a series of new all-time highs, breaking through the 7000 level.

Economic data continued mainly to surprise on the upside, a trend in evidence since the vote to leave the EU back in June. Consumer spending was buoyant while exports benefited from the weakness in sterling against major currencies. Employment data continued to tighten.

Inflation rates began to climb as higher commodity prices started to feed through into the economy and as the weaker pound lifted the price of imported goods. UK consumer prices rose 1.2% year on year in November, the highest rate of growth for around two years.

Politics was dominated by the speculation and noise around whether the UK was heading for a hard or soft Brexit. Prime minister May insisted that Article 50, which formally triggers the start of negotiations to leave the EU, would be invoked in March.

Industrial metals was by far and away the strongest sector while banks, oil & gas producers and mining were also firm. More defensive sectors such as tobacco and pharmaceuticals & biotechnology, as well as technology hardware & equipment, were weaker.

US Equities

The S&P 500 rose 9.15% in sterling terms but only 3.82% in US dollar terms over the quarter, highlighting the material impact of sterling weakness against the US dollar on returns for the sterling investor.

The market prospered in spite of, or rather in hindsight, because of, Donald Trump's victory in the US Presidential election. The view in the run-up to the election was that a Trump victory could be negative for markets. The opposite proved to be the case and the equity market seemed to take comfort initially from Trump's conciliatory and inclusive acceptance speech and ultimately from the view that Trump's policies would be expansionary and good for domestic America, with high expectations of strong infrastructure spending and job growth.

Economic data largely surprised on the upside with robust employment and housing data in evidence. The October housing start figure showed growth of 25.5% year on year, to 1.32 million units, the highest level for nine years.

The Federal Reserve (Fed) raised rates by 0.25% to 0.5% in early December, a move that had been widely anticipated. The Fed increased guidance for 2017 to three rate hikes from two, given the increasing tightness in the labour market, rising commodity prices and the expectation of higher inflation from Trump's policies. Bond yields rose markedly as a result and the US dollar rallied, achieving a 14-year high against major currencies.

In terms of sector moves, financials, particularly banks, was by far the strongest performer. Consumer staples and health care were relatively weaker.

European Equities

This was a good period for the European markets with the FTSE Europe ex-UK up by 4.81% in sterling terms.

Greece was the best performing country, up over 21%, followed by Italy, up over 15% in sterling terms.

European markets benefited from signs of a recovery in growth rates and improved confidence surveys. The eurozone economic sentiment index hit a 2016 high in October. The preliminary eurozone manufacturing purchasing managers index (PMI) came in at 54.9% for December, the highest level since April 2011. The European Central Bank announced that it would continue with its quantitative easing programme although at the same time it announced a tapering in the level of monthly bond purchases from €80bn to €60bn.

The political backdrop was dominated by the UK's impending split from the EU and what form that split might take, as well as elections and votes in countries such as Austria and Italy. Prime minister Renzi of Italy resigned following rejection by voters of his referendum on constitutional reform.

Italian banks were also in the spotlight. Banca Monte dei Paschi di Sienna (the country's third largest bank) failed to bridge its funding gap through private investment and began the process of government bailout. At the same time, Unicredit launched a €13bn rights issue, the largest in Italian history.

Oil & gas and financials were the strongest sectors while utilities, technology and health care were relatively weaker.

Japanese Equities

The FTSE Japan rose by 5.11% in sterling terms but by 15.16% in yen terms, underlining the marked weakness in the yen against sterling over the quarter.

The yen fell dramatically in November against the US dollar, from around the 105 level to 114, the largest drop in approximately 20 years. The Japanese market was buoyed by the weak currency which boosted the economy, specifically exporting companies.

The Bank of Japan continued with its unconventional efforts aimed at maintaining an upward-sloping yield curve and at targeting a zero percent yield on its 10-year government bond.

There was some comfort taken from inflation data and business survey data during the quarter.

Financials and oil & gas were the best performing sectors while health care and telecommunications both struggled.

Asia Pacific ex-Japan Equities

The MSCI Asia Pacific ex-Japan index posted a return of 2.31% in Sterling terms.

Australia was the best performer, up 5.92% and Thailand and Taiwan were both up around 3%, in sterling terms. On the downside were the Philippines, down 8.29% while China and Hong Kong were down 2.31% and 4.30% respectively.

Markets were unsettled by Donald Trump's sabre-rattling on trade issues and investors feared the potential escalation of a trade war with the US. Meanwhile, the US dollar rally caused concerns about the high level of US dollar-denominated debt in the region.

While perennial concerns around China's economic slowdown and the level of debt in its economy abounded, data releases from China abated some investor concerns as PMI and GDP data were largely within expectations.

In terms of sector moves, energy and materials were relatively strong while more defensive areas such as health care and telecoms were relatively weaker. Real estate also suffered.

Property

According to the IPD Monthly Index, the UK commercial property market completed a volatile year with a total return of 2.6% in 2016, comprising a 5.6% income return and a capital decline of 2.8% over the year. This fall in capital values was driven largely by an initial negative market response to the EU referendum result in the summer. However, investor confidence stabilised in Q4 and was reflected by a rise in All Property capital values of 1.1% in the final quarter. Encouragingly, whilst the pace of rental growth has slowed over the past 12 months, occupier markets appear to remain in reasonable shape with 2.0% rental growth recorded by IPD for the full year and representing the fourth consecutive year of rising market rents.

Industrials were the best performing sector in 2016 with a healthy total return of 7.0% over the year. Low vacancy rates and sustained occupier demand for both distribution sheds and multi-let industrial estates led to an acceleration of industrial rental growth towards the end of year and the sector appears well set to continue outperforming in 2017. In contrast, the office sector was the poorest performing sector with a total return of 1.0% in 2016. Investor confidence in Central London offices in particular was negatively affected by the referendum result with expectations of weakening occupier market demand given uncertainties for financial service firms over access to the EU single market. Retail sector returns continued to underperform in 2016 with IPD recording a total return of 1.1% and rental growth remaining weak due to the structural oversupply of retail space caused by the growth of internet shopping. Cost pressures on retailers as a result of higher input costs, business rates and labour costs are expected to squeeze retailer margins in 2017, which in turn is likely to limit rental growth potential in the sector.

Fixed Income

Fixed income markets produced solid returns in 2016 as a whole although the fourth quarter brought a very turbulent end to the year with most bond markets selling-off significantly.

As we explain below, the fall-out from 'Brexit', the US presidential election result, the usual uncertainty over Central Bank intentions and (lest we forget) some much-needed attendance to bond market fundamentals all played a part in the sell-off.

The Trump victory in the US presidential race, which concluded in November, wrong-footed investors and subsequently led to a reappraisal of policy direction. In previous reports we have highlighted the debate within markets about whether monetary policies need to be implemented in conjunction with other measures such as fiscal policies. There is evidence of this happening in some countries, and with Trump's victory these additional measures are a step closer to being implemented in the US although the extent to which he can implement the policies he alluded to on the campaign trail remains to be seen.

Government bonds under pressure

Government bond markets started the quarter on the back foot as investors began to reappraise the limits of monetary policy. With core markets already trading at extreme levels, and inflation expectations recovering from their commodity-induced lows, the scene was set for a re-pricing of core government bonds.

Concerns about a hard Brexit in the UK and uncertainty about where the European Central Bank was going with its QE programme also conspired to push yields higher. The US election in November brought further strain with US Treasuries selling-off sharply and bringing other bond sectors with it. The market was distinctly more subdued in December but the damage for the quarter was already done.

Given the volatile conditions, yields on 10-year government bonds in core markets increased as the table below highlights. UK government bonds, for example, returned -3.64% for the quarter although over 2016 as a whole the sector was up by 10.54%.

Index-linked bonds also came under pressure in the fourth quarter with the FTSE UK Index-Linked index returning -2.85%. Returns for the year however were very strong with the index up an impressive 23.39%.

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, end Sep 2016	0.75	1.60	-0.12	-0.09	0.88	1.19	8.19	0.33	3.31
Yield, end Dec 2016	1.24	2.44	0.21	0.05	1.38	1.81	7.02	0.75	3.75
Change in yield	0.49	0.85	0.33	0.14	0.50	0.63	-1.17	0.42	0.43

Source: Bloomberg.

Investment grade bonds outperform

Investment grade bonds outperformed their government counterparts in the fourth quarter; in total return terms the iBoxx £ Non-Gilts index returned -2.57%. Returns over 2016 as a whole were in line with the risk free asset class – the index returned a robust 10.66%.

The final quarter of 2016 saw the Bank of England commence its corporate bond buying programme in earnest. By year-end the Bank had completed close to £5 billion of purchases, around 50% of the £10 billion it had earmarked when it launched the programme. Were the Bank to continue the same pace in the New Year then it would complete its programme some 12 months ahead of schedule.

Investment grade bonds were given an additional boost after the election of Donald Trump as the next US president. Perceptions of Trump presiding over a pro-growth, anti-regulation administration have bolstered investor sentiment, and corporate bonds have been a clear beneficiary of this trend. The details around any future fiscal expansion may still be scant, but risk markets have largely been willing to assume the most positive of outcomes in terms of the ultimate prospects for improving corporate profitability.

High yield bonds

In sterling terms, the Barclays Global High Yield index returned 4.92% over the quarter, with little difference between the US and European high yield markets. Over 2016 as a whole however, US high yield was the clear winner; the Bank of America Merrill Lynch US High Yield index returned 17.49% compared to 9.07% for its European equivalent.

The recovery in commodity prices and the result of the US presidential election were the main drivers of the rally over the quarter. The energy sector continued to perform well and the Donald Trump's victory was seen as pro-growth with inflationary expectations subsequently increasing. In this environment, riskier assets rallied strongly.

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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 December 2016.

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

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Quarterly Thought Piece

On the reflation trade: what is it and will it last?

Following the rate hikes by Fed Chair Paul Volcker in the late 1970's, the global economy and capital markets have enjoyed slowly decreasing inflation, accompanied by a secular decline in real natural rates.

The financial crisis in 2008 turned this into a deflationary dip, causing interest rates to fall even further, in some instances to below zero. However, Donald Trump winning the US presidential election has instigated the so-called 'reflation trade', potentially reversing these multi-year trends. This article takes a closer look at this phenomenon and considers whether it will last.

The term 'reflation trade' basically stands for any assets (or combination of assets) which will benefit from reflation. The latter means a recovery phase in the economy, often after a period of contraction, whereby demand is stimulated by monetary and/or fiscal policies. In some cases, these 'reflationary' policies are complemented by policies which address the supply-side of the equation.

In the current situation, expectations of reflation are associated with Trumponomics. Trumponomics is the term to describe the expected economic policies of Trump. To recap, they primarily consist of the following:

- Demand economics, like tax cuts, tax credits, and tax holidays, including corporate cash repatriation. This will increase both personal and corporate incomes.
- Supply economics, like infrastructure spending, deregulation, and energy independence. This will benefit related sectors, particularly domestic ones, in combination with the next point.
- Political economics, like renegotiating trade agreements (including tariffs), modernising the military and overhauling immigration.

Apart from the aforementioned sectors, other assets that benefit from reflation include commodities, banks and value stocks. One reason why investors have been front-running Trump's inauguration by buying these assets is that some, if not most, of his policies have a high likelihood of being implemented, if only because the Republican party has a majority in both the House and the Senate. On the other hand, the timing and extent of their impact remains unclear - it is likely the policies will have a more delayed impact that is respectively muted, than is currently priced-in. The IMF, for example, remains cautious regarding the impact of Trumponomics: this week it increased its forecast for US growth by 0.1% (and 0.4% for 2018).

What probably worries investors most in terms of the reflation trade is the risk that bonds enter a bear market. However, there are a number of factors which offer 'checks and balances', particularly regarding the extent of yield rises.

First, while the US now looks to be in the driving seat, until recently Japan was driving other bond markets. Unfortunately, the Bank of Japan's (BoJ) policy announcement in September contained an inconsistency, namely its wish to control (e.g. steepen) the curve while specifying how much it would buy via its QE program. Late last year we got clarification of the BoJ's real goal: it announced its first ever fixed-rate bond purchase operation through which it basically offers to buy unlimited amounts of bonds at the short end of the Japanese government bond curve at fixed rates. Not only does this mean that the BoJ is intent on preventing any tantrums at all cost (which, by the way, is getting easier as it becomes the only buyer in the market). It also means that US and other global rates will be anchored due to spill overs from the BoJ's QE program.

Second, and going forward, an interesting aspect of the reflation trade will be the role of the Fed. Although Trump had criticised Janet Yellen during his campaign for her loose monetary policy, he would not want the Fed to hike his (e.g. infrastructure) plans dead in the water, so to speak. A further strengthening in the US dollar, particularly if combined with increasing bond yields, will add to any tightening by the Fed in that regard. Due to its triple mandate, which now includes financial stability, the Fed is data *and* market dependent. On that note, the generally reflexive dynamics between economies and markets has meant, for example, that previous central bank actions themselves, i.e. lowering rates, have had a self-fulfilling effect. Back to the Fed, it means it will find itself between a rock and a hard place if market turbulence is caused by bonds collapsing while inflation exceeds its 2% target.

Last, but not least, based on extensive research, including by the Fed and the Bank of England, the deflationary forces which drive the aforementioned decline in rates include (in order of impact) demographics, declining productivity growth, price deflation in capital goods (i.e. excess capacity), reduced public (e.g. infrastructure) investment, inequality, and the 'savings glut'. A more recent force is the relentless advance of technological disruption, including robotics and other forms of automation which is detrimental to wage inflation. Other forces, like demographics, add to this. For example, despite a tight labour market wages (and by extension inflation) in Japan are not responding as much as they might because women and older workers tend to have less bargaining power than prime-age males.

Personally, I do not expect trends in demographics, productivity and technology (nor the dogmatic beliefs of central bankers for that matter) to change much, even though the impact of the other forces may vary and even diminish over time. Consequently, rates are likely to remain range-bound, at least from an historic perspective. As far as the economic cycle is concerned, I continue to believe that stagflation is the most likely scenario going forward for Trump's first term, because we cannot buy growth with yet more debt (certainly not without real rates going up). Growth will remain muted because it is related to global trade which is jeopardised by Trumponomics. On that note, the IMF dedicated its recent World Economic Outlook to global trade. Among other things, its findings suggest that given the subdued global growth outlook, further trade reforms that lower barriers, coupled with measures to mitigate the cost to those who shoulder the burden of adjustment, would boost the international exchange of goods and services and revive the virtuous cycle of trade and growth.

Overall, this means that the reflation trade is 'capped', whereby the further yields increase the more they reflect credit risks, rather than a benign endogenous growth outlook.

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17 January 2017

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