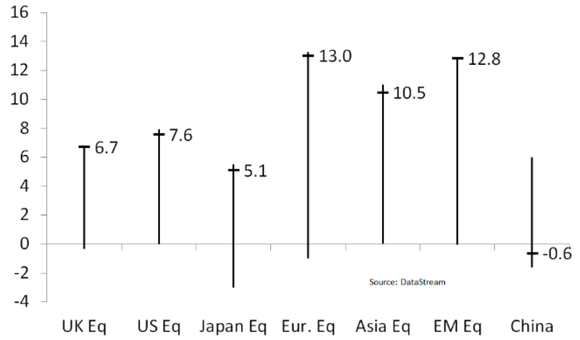
Market Backdrop

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

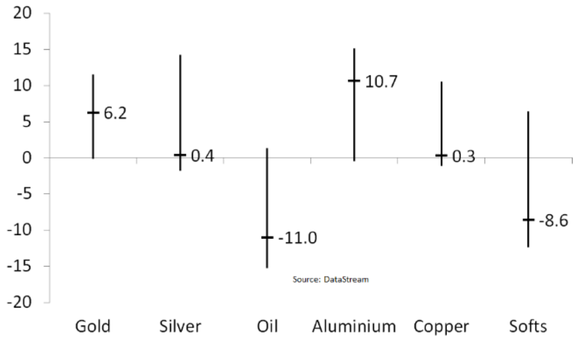
Market Movements

The figures below describe the % performance of various markets from the end of 2016 to the close on 13th May 2017. Equity markets have, thus far, delivered solid returns in 2017 consistent with the thesis that stock markets had the potential to move higher supported by an improving world economy and still benign monetary conditions despite apparently elevated valuations. The greatest challenge lay in possible adverse political developments in Europe and the US; those threats have, thus far, failed to materialise. Across all markets, observed volatility remains low by historical standards.

Equity: % change in prices (high, low, last)



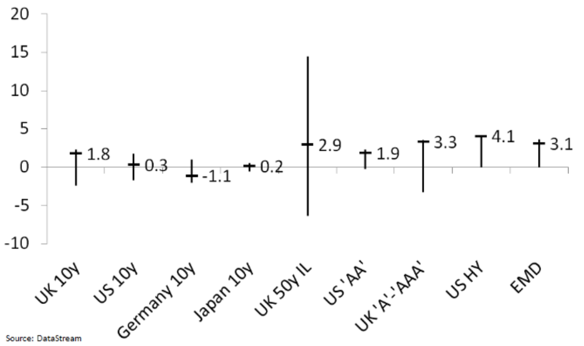
Commodity:



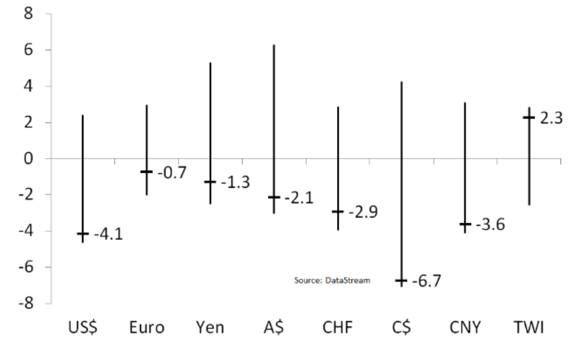
Regional performance was strongest in Asia and EM; along with the out-performing Asian block, they rose more than 10%. Underpinned by a more stable bond market than many had expected, a feature of the period has been that most regions never closed below their year-end level. The Chinese market is the notable exception, held back by tighter financial conditions imposed to subdue financial markets.

In commodity markets, industrial metals were initially underpinned by the apparently healthy Chinese economy and the hoped-for surge in US infrastructure spending. A more moderate Chinese outlook and slow (no) progress in the US has seen prices slip back; while oil prices are currently lower than at the start of the year on strong inventory levels and production. Precious metals have lifted on a generalised rise in inflation and on a softer US$. 'Softs' have generally traded lower on strong production.

Bonds:



FX (vs £):



Bond markets were generally calm except for ultra-long UK index-linked bonds – where prices have again been very volatile. That most bond markets (government and corporate) should have seen prices hold steady (gain) on the period has confounded forecasters (many of whom had expected a Trump-induced rout especially against the backdrop of rising inflation). EMD markets have shed many of the Trump-related fears.

The Pound trade weighted index (TWI) ended the period firmer despite the formal launch of *Brexit.* Consistent with the firmness of bonds, safe-haven FX (e.g. Yen) had gained; those gains reversed once it became clear that Macron would win the French election.

Consensus expectations – economic growth and inflation

The consensus outlook for 2017 and 2018 has firmed slightly since the year end with no region seeing downgrades in estimates of real economic growth. The notable increases have occurred in Europe – where real time measures of economic performance have, throughout Q1, been strong – and the UK which has seen the last vestiges of the expected *Brexit* malaise shed for 2017 (but retained for 2018). Although the US is expected to grow above trend (estimated by the FOMC to be 1.8% p.a.), the overall outlook for the rest of 2017 and into 2018 is for global growth to remain moderate.

Table 1: Consensus forecasts – Real GDP growth (%)

	2016	2017	Change since end '16	2018	Change since end '16
US	1.6	2.2	0	2.3	0
Eurozone	1.7	1.3	0.3	1.6	0.1
UK	2.0	1.7	0.5	1.3	0
Japan	1.0	1.2	0.2	1.0	0.2
China	6.7	6.6	0.1	6.3	0.2

Challenging the above rosy outlook first quarter growth in the US was just 0.6% (annualised rate) on soft consumer demand and an inventory drawdown. It is not unusual for Q1 US activity levels to be both subdued and followed by a more upbeat performance; economists at the Atlanta Fed estimate that growth in the second quarter is running at a 3.6% annualised rate. Equivalent measures for the European economy show similar buoyancy (with +3.2% and +3.5% expected for Q2 and Q3 respectively). Uncertainty surrounding the *Brexit* negotiations will likely ensure that the projections for the UK remain subdued, a viewpoint recently shared by the Bank of England which highlighted weak real disposable income growth as a significant concern.

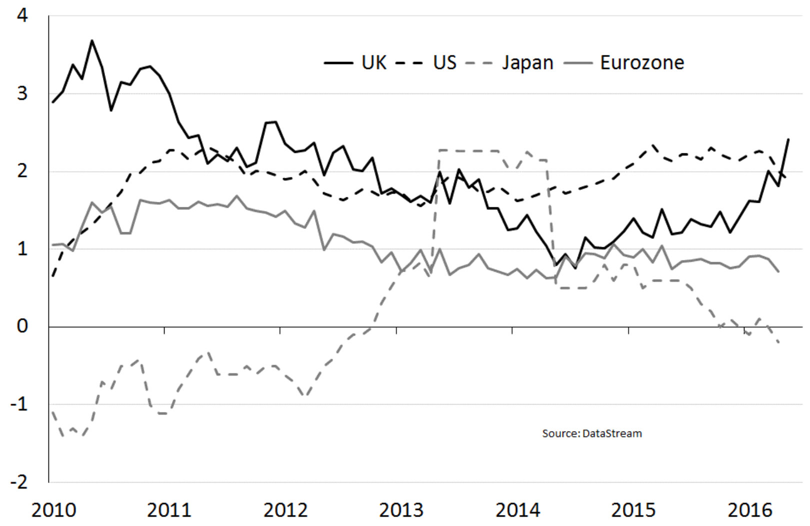
The outlook for inflation in 2017 and 2018 has hardened a little with all rates projected to be above those recorded in 2016 (Table 2). The main take-away remains that while inflation, this year and next, is projected to move towards or above central banks targets, policymakers are unlikely to react. Even in the US, where the Federal Reserve are hiking their policy rate, the guidance remains that increases will be gradual and that policy will remain very accommodative for the foreseeable future – indeed given current inflation, the real policy rate is very low (see Page 4).

Table 2: Consensus forecasts – Inflation (CPI, %)

	2016	2017	Change since end '16	2018	Change since end '16
US	1.7	1.8	-0.1	2.0	0
Eurozone	1.1	1.6	0.3	1.5	0.0
UK	1.6	2.6	0.2	2.6	0.1
Japan	0.0	0.6	0.0	0.9	-0.2
China	2.1	2.0	-0.2	2.2	0

On the ground, core inflation rates in the major economies have started to fall (Chart 1). This excludes the UK where the impact of the recovery in energy costs (feeding through indirectly into the core rate) and the sharp fall in £ seen in 2016, are evident. Japan's inflation problem remains the lack of it – policymakers there have gone quiet on Abe's promise, made in 2012, of delivering a 2% inflation rate; a reminder, if it were needed, that high(er) inflation rates are not easily generated (beyond one-off jumps caused by base effects – most recently by oil). Although the US Federal Reserve are raising interest rates threats to higher inflation are hard to find.

Chart 1: Core CPI rates (%, yoy)



Although the data for March indicated a pause, data on UK headline retail and consumer price inflation has risen sharply in recent months. Although £'s devaluation could see these rates rise further, input and output producer price rises look to passing their peak (Chart 3) – they too saw the latest data suggest that the surge is ending. The rise in inflation has not been matched by higher wage, indeed there is now no real wage growth.

Chart 2: UK inflation rates (%, yoy)

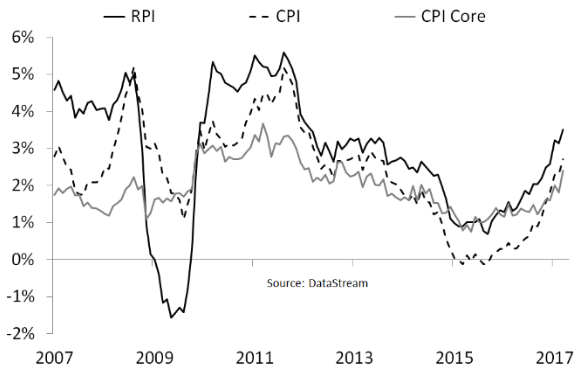
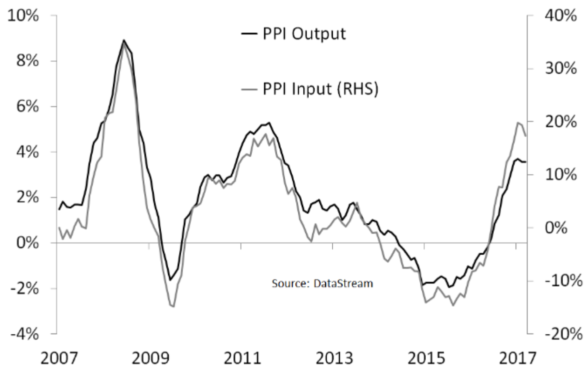


Chart 3: UK producer price growth (yoy)

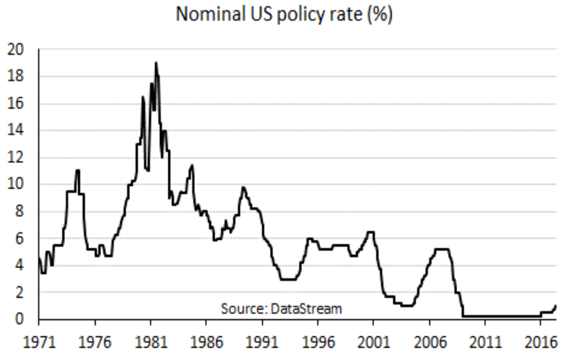


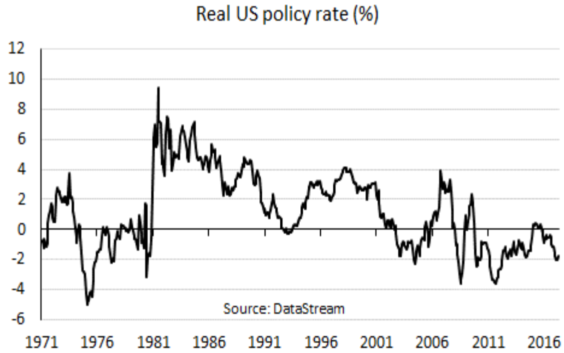
Extending the point about Japan, experience of the post-GFC period suggests, and this is of interest for the UK, that currency-induced inflation won't lead to an enduring inflation problem.

Overall, while projected inflation rates (many years ahead) may cause central bankers some concern, it remains that actual inflation in the period ahead is unlikely to be a problem and should not influence the general asset strategy for the Fund. That said, some specific measures may be required if the fiscal taps are turned on. The UK has, thus far, failed to expand fiscal policy and Trump appears more hamstrung than expected. The upcoming UK election has the potential to alter the fiscal outlook especially if Hammond is replaced as Chancellor.

Short and long term interest rates

Having raised their policy rate in December to 0.75%, the Fed hiked again in March (to 1%). In the context of the past forty years, US interest rates are still effectively zero and, in real terms, remain very accommodative. In March FOMC members reviewed their projection for the terminal policy rate. Despite the recent lift in inflation and the start of the (presumed expansionary) Trump Presidency, they kept their predicted equilibrium policy rate at 3%. After the announcement Janet Yellen made clear that while other rate hikes will be delivered this year – they are not being influenced by the soft economy in Q1 - the Fed intend to keep monetary policy accommodative.





The current consensus forecast for the main policy settings are shown in Table R1. Despite the recent strength in the European economy, policy everywhere outside the US is expected to broadly remain on hold.

Table R1: Consensus forecasts – main policy setting at year end (%)

	2016	Latest	2017
US Fed	0.75	1.00	1.50
ECB	-0.40	-0.40	-0.40
BoE	0.25	0.25	0.25
BoJ	-0.10	-0.10	0.00

Longer term, although in the US the expected uptrend in rates is clear the expected profile remains very gradual. Overall and including the US, investors expect no material lift in interest rates this decade. If correct, then we will soon be looking at a near-zero interest rate backdrop lasting a generation.

Table R2 reminds of the current very low level of longer term government bond yields. Across all major markets government bond yields remain below equity dividend yields.

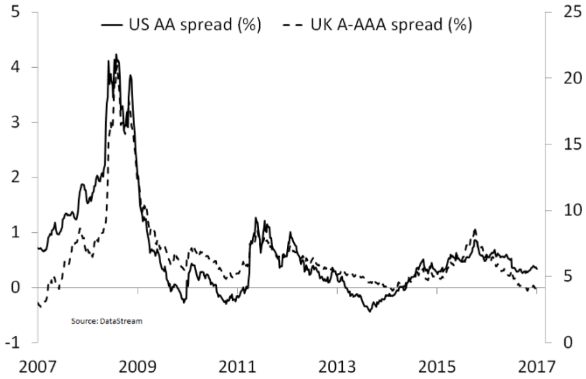
Table R2: 10-year bond yields and consensus forecasts at year end (%)

10 year	**2016**	**Latest**	**2017**
US	2.4	2.3	2.8
Germany	0.3	0.4	0.7
UK	1.4	1.1	1.5
Japan	0.0	0.0	0.1

Notwithstanding the potential change in US interest rates, the outlook remains that bond markets will not see yields return to levels generally regarded as 'normal' (around 4-5%).

Non-Government Bonds

Investment grade bond spreads remain tight although, at the margin, have started to lift; a greater increase would be required to make them compelling. The same is true of high yield bonds where the spread is little off multi-year lows. Corporate bonds are enjoying the support that the government markets have delivered through 2017 thus far; neither market is concerned about the prospect of the US Federal ending their practice of reinvesting redeeming bonds held on their balance sheet (the result of past QE programmes).



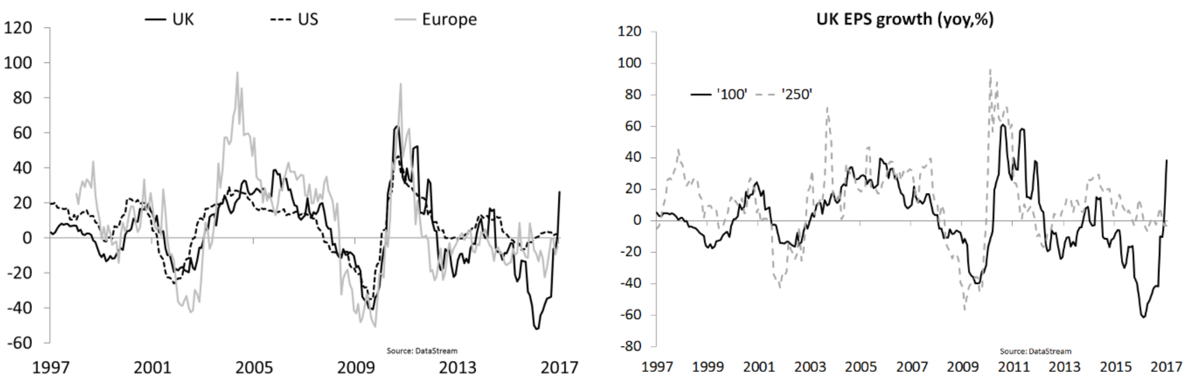
Regardless of which emerging market debt index is followed, all have recovered completely from the Trump-induced sell off last November. In a world of still wafer thin developed bond yields, investors continue to find EMD attractive – there is nowhere else to go for yield.

Within the array of available bonds out-with developed government bond markets, emerging market exposures remain the most attractive; active selection is to be preferred.

Equities

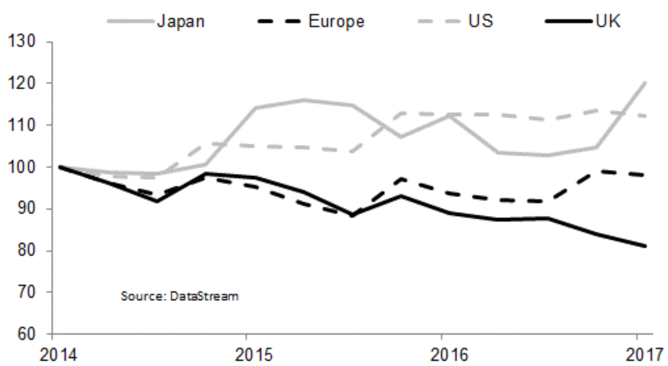
The chart below details how forecast earnings per share (EPS) for the UK, US, European and Japan equity markets have evolved over the past twenty years; unsurprisingly they chime with the economic cycle. Since the previous report the prospects for earnings growth in the EU and US have converged around zero. Larger companies in the UK are starting to see the foreign earnings currency boost generated by last year's £ slump.

Chart E1: Experienced earnings per share growth



EPS forecasts for the next financial year register an improvement in Japan while weakness is expected in the UK as the one-off currency impact washes through. In broad terms the Eurozone and the US are flat-lining (Chart E2). The UK outlook is weak.

Chart E2: Forecast earnings per share (next financial year – FY1, rebased to 100 in 2014)



Looking beyond the next financial year, equity analysts generally remain optimistic (Table 5); although it should be remembered that analysts are rarely pessimistic and that they failed to spot the weakness of recent years shown in Chart E1. Only Japan returns to being more of a 'jam tomorrow' market. The enthusiasm for longer term UK equity earnings growth, created by £ devaluation, has slipped away sharply.

Table 5: Consensus EPS growth forecasts – second and third financial years with change from previous report (source: DataStream)

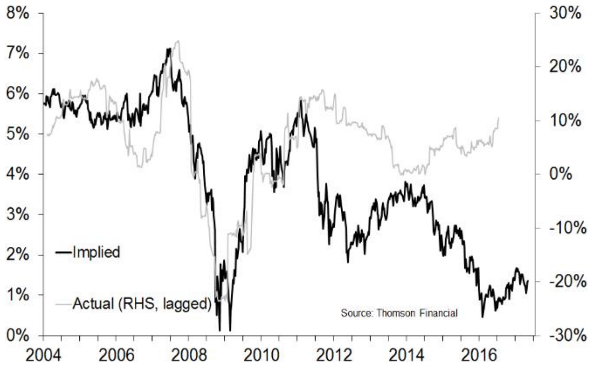
	UK	US	Japan	Europe
FY2	8% (-12%)	12% (0%)	8% (-4%)	10% (-4%)
FY3	10% (0%)	10% (-2%)	12% (+4%)	9% (-2%)

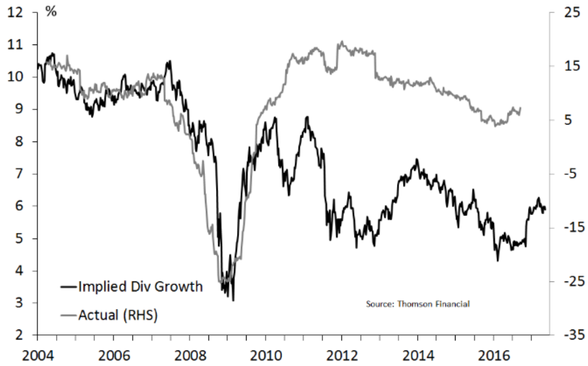
Equity Valuation

A preferred means of assessing how attractively priced are equities is the implied level of dividend growth needed to break-even relative to the alternative of investing in bonds. In both the UK and US markets (Charts E3 and E4) the required level of long-term dividend growth looks to be modest in absolute terms and against what has been delivered in recent years; the recent fall in bond yields has improved the comparison. If allowance is made for a risk premium then UK dividends may never grow but they would still offer better value than fixed income.

The earnings outlook for companies may be uncertain but equity markets still offer better value than bonds.

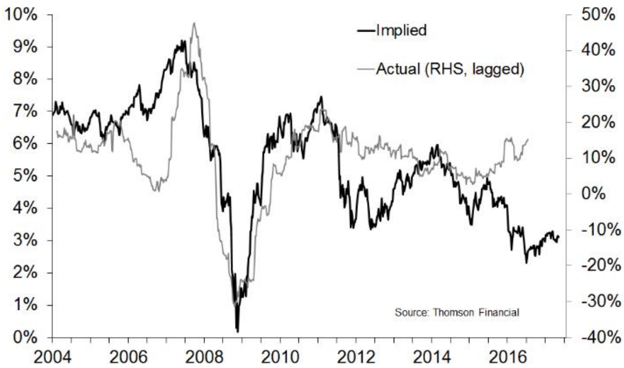
Charts E3 and E4: UK (FT All Share, left chart) and US (S&P Composite, right chart) implied dividend growth





The implied outlook for the more domestically focused FTSE 250 is as it is for the broader UK market. Here the path of actual dividend growth has been more consistent with the evolution of the breakeven rate (Chart E5). The chart also suggests that there may be some poor news on actual dividends to absorb in the near term. **Should the fiscal spigot ever open then there may be bargains to be had in UK domestic plays; sector baskets bought on 'bad days' may be the best way to exploit these.**

Chart E5: UK (FTSE 250 Index), implied div. growth

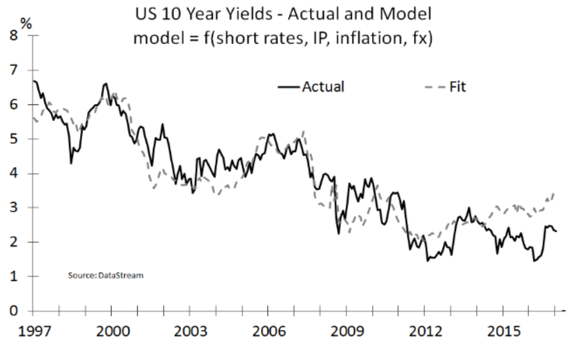


However delivered and ignoring the soft performance of the US economy in Q1, if the recent broad economic upswing continues then, with central banks increasingly able to contain bond markets, equities could enjoy strong returns – at least while investors expect there to be a strong correlation between growth and corporate profitability.

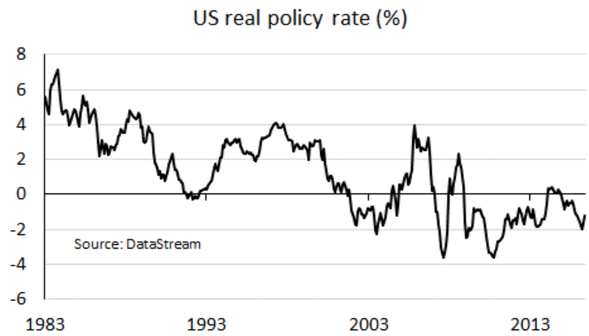
Why are yields so low?

In a recent FT article, John Authers mused on why bond yields remain so low. He laid the blame at the door of pension funds and scepticism around the resilience of the global economic upswing of recent quarters.

Looking first at the “low” level of bond yields it is possible to draw comparison between US bond yields and a range of ‘real world’ factors - the policy interest rate, the pace of industrial production and inflation and also shifts in the exchange rate; historically these factors have provided a good ‘explanation’ of longer term bond yields. This approach suggests that US 10y yields should today be around 3.3% - they are currently 2.3%. Yields may today be low but they shouldn’t be ‘high’.



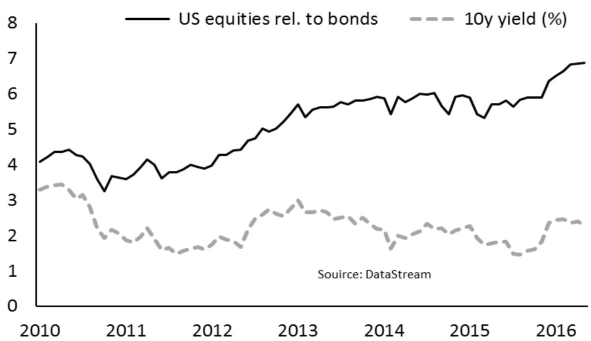
The most statistically significant influence has been the policy interest rate set by the US Federal Reserve. The first most significant explanation therefore for the current low level of bond yields is that the policy rate is just 1% or, importantly, 1.7% less than the current pace of headline consumer price inflation. The problem with applying historical norms to the present (future) is that the present (future) may not be as the past. Since the GFC the policy rate has generally been negative whereas the opposite was the case pre-GFC. While it is often folly to contend that *this time it’s different*, the Fed themselves believe that the equilibrium real policy rate is now 1% - the average real rate over the 25 years prior to the GFC was double that. It is worth noting again that the current real policy rate (-1.7%) is very accommodative – comforting equity investors.



Fuelling doubt about the current economic strength is the observation, in the US at least, that the economy is hardly on a tear. Indeed, if the Q1 growth rate is sustained, then the growth outlook is for ‘flat-lining’ around 2% (consistent with the Fed’s estimate of US trend economic potential).

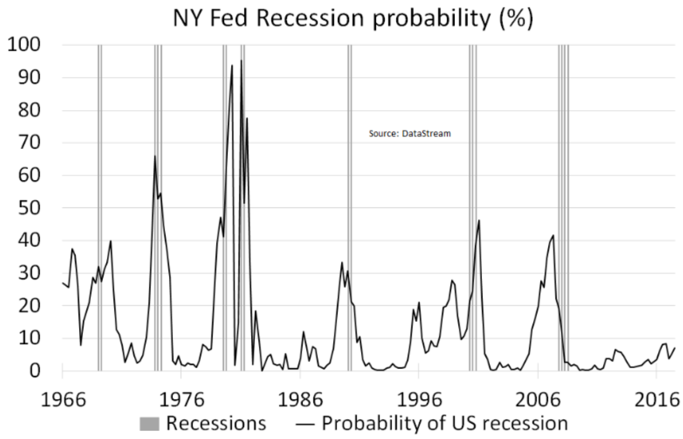
US long bond yields are therefore perhaps 0.5-1% lower than norms based around economic data might suggest – a gap that may close only after the Fed has tightened the policy rate rate. [It is unlikely that those who judge yields currently to be out of kilter will form a different view if bond yields rise to 3%.] Remember as time passes, the post-GFC experience increasingly becomes the norm.

Auther’s point on pension fund buying is undeniably correct. These bonds must be bought out of something; the higher that equities rise, the easier it is for Trustees etc to fund bond purchases. If equities are supported by low bond yields, then this might seem a perverse circularity. Why this should change however while *cash remains trash* is unclear.



Summary

It is hard to access the financial media these days and not find repeated assertions that equities, relative to historic norms, are expensive. The focus in previous years was on the richness of bonds. These are both the flip side of the bigger point – cash remains a very unattractive asset, especially in real terms. Except for the US, nowhere is cash likely to become attractive other than on a transitory basis (and then, on a lucky call around a bout of risk aversion). Even in the US, if the equilibrium real interest rate on cash is around 1%, as the Fed suggest, then a bearish slant on equities requires a negative outlook on corporate profitability. Such a perspective is possible especially if the US enters a recession but the likelihood of that happening, based on the behaviour of the interest rate markets, in the next twelve months is very low. Just as markets seem to have adjusted to a new neutral level of bond yields so too might they have to come to terms with elevated price earnings multiples.



Scott M Jamieson, May 2017

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