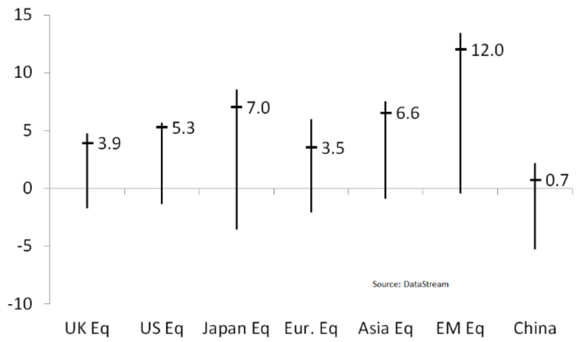
Market Backdrop

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

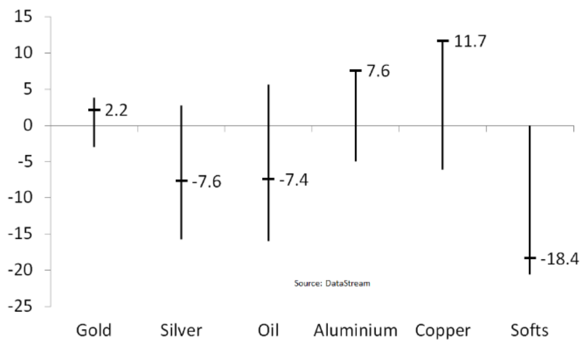
Market Movements

The figures below describe the % performance of various markets from the end of March 2017 to the close on 16th August 2017. Most equity markets have continued to deliver solid returns in 2017 consistent with a cautious optimism across investors. Market participants generally judge that stock markets are supported by an improving world economy and still benign monetary conditions despite apparently elevated valuations. The greatest challenge was judged to come from adverse political developments in Europe and the US; those threats have, thus far, failed to materialise. Across all markets, volatility remains low by historical standards.

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



Commodity:

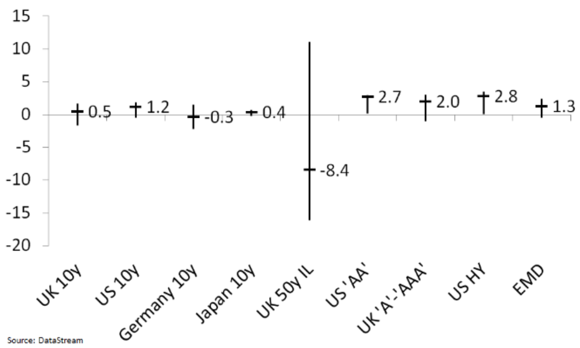


Regional performance was generally strong; China was the notable exception having been held back by tighter financial conditions imposed to subdue financial markets. Asia and Japan have both performed strongly supported respectively by the lower US$ and improving levels of domestic demand. Post Macron's victory in France, European equities have failed to keep pace with other markets. 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.

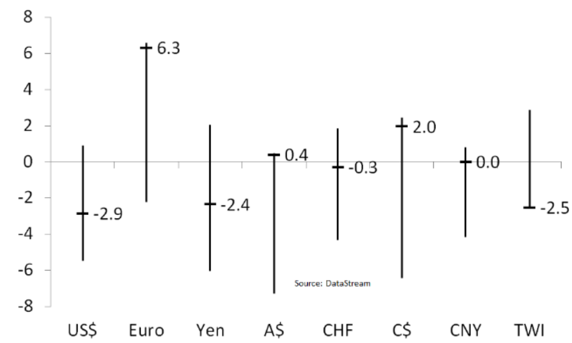
In commodity markets, industrial metals were initially underpinned by a healthy Chinese economy and the still-hoped-for Trump-inspired surge in US infrastructure spending. Oil prices are currently lower than at the start of the year on strong inventory and production levels; the OPEC production accord also looks increasingly likely to break. Gold lifted on a softer US$. 'Softs' have traded sharply lower on strong production.

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.

Bonds:



FX (vs £):



The Pound trade weighted index (TWI) ended the period lower burdened by a deteriorating political backdrop and the formal launch of *Brexit*. The € has been buoyed by Macron's victory and stronger economic performance.

Consensus expectations – economic growth and inflation

The consensus economic growth outlook for 2017 and 2018 has, out-with the US, firmed since the year end. The notable increases have occurred in Europe – where real time measures of economic performance have throughout Q2 and Q3 been strong, the UK which has improved on stronger consumer spending and from an admittedly low base, and, latterly, Japan where stronger domestic demand has driven growth. 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 appears to suggest that global growth will remain moderate.

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

	2016	2017	Change since end '16	2018	Change since end '16
US	1.6	2.1	-0.1	2.3	0
Eurozone	1.7	2.0	0.6	1.7	0.2
UK	2.0	1.5	0.3	1.3	0
Japan	1.0	1.4	0.4	1.0	0.2
China	6.7	6.7	0.2	6.3	0.2

The initial estimate of real US growth in the second quarter however is +2.6% which represents a reasonable rebound from the much slower performance of Q1; economists at the Atlanta Fed estimate that growth in the third quarter is running at a 3.9% annualised rate. Equivalent measures for the European economy show similar buoyancy (with +2.7% and +3.0% expected for Q2 and Q3 respectively). Given an improving outlook for Japan and resilience in the Chinese economy (despite clear credit tightening) there would be appear to be upside risks to the forecasts for most regions shown in the table above. Uncertainty surrounding the *Brexit* negotiations will likely ensure that the projections for the UK remain subdued, a viewpoint shared by the Bank of England which highlighted weak real disposable income growth as a particular concern.

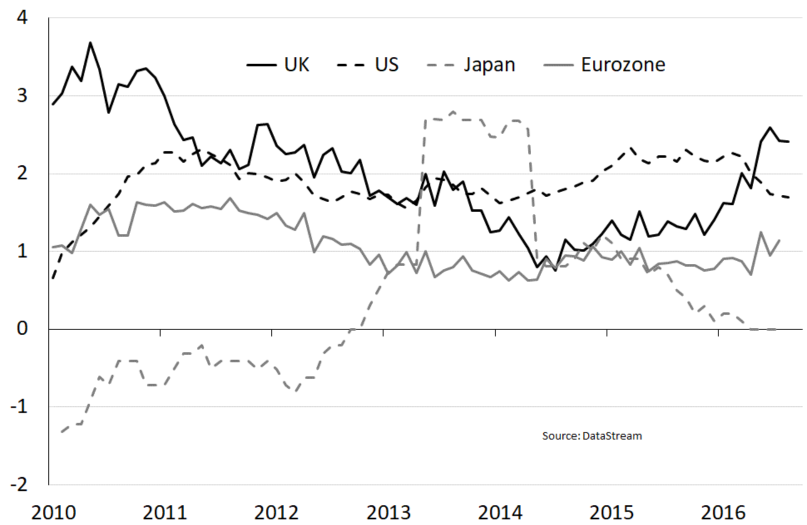
Despite this relatively rosy activity backdrop, the outlook for inflation in 2017 and 2018 is little changed (Table 2). The failure of inflation to prove stronger remains a conundrum defying policymakers and investors alike. Even in the US, where the Federal Reserve are hiking their policy rate, the guidance remains that increases will be gradual and that policy will remain accommodative for the foreseeable future – indeed given current inflation, the real policy rate is very low (see Page 4). That said, some central banks want to reverse their QE.

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

	2016	2017	Change since end '16	2018	Change since end '16
US	1.7	1.6	-0.3	1.8	-0.2
Eurozone	1.1	1.5	0.2	1.4	-0.1
UK	1.6	2.7	0.3	2.6	0.2
Japan	0.0	0.5	-0.1	0.8	-0.2
China	2.1	1.7	-0.5	2.2	0

On the ground, the benign level of core inflation rates in the major economies is shown in Chart 1. This can even be said to be true of 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, although evident, is starting to subside. 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). It is worth noting that Abe's popularity has fallen significantly this year (helped by being embroiled in a cronyism scandal) and it is generally thought that he will be re-elected. Among the possible explanations for still-low inflation are mis-measurement (an old favourite) and, more plausibly, the combined (and related) impact of online shopping and Amazon (the great price disrupter). With online US retail sales projected to surpass that through traditional outlets in the next two years and Amazon entering the food chain (through WholeFoods), these influences are unlikely to subside.

Chart 1: Core CPI rates (%, yoy)



UK headline retail and consumer price inflation rose strongly in Q2 but, as mentioned above, looks to be topping-out (Chart 2). Although £'s devaluation might see these rates rise further, input and output producer price rises look to be passing their peak (Chart 3). The rise in inflation has not been matched by higher wage, indeed there is no real wage growth.

Chart 2: UK inflation rates (%, yoy)

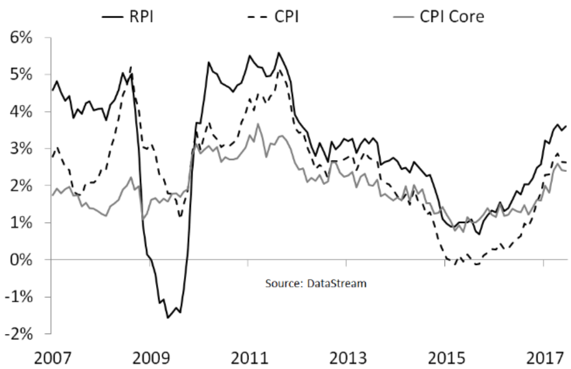
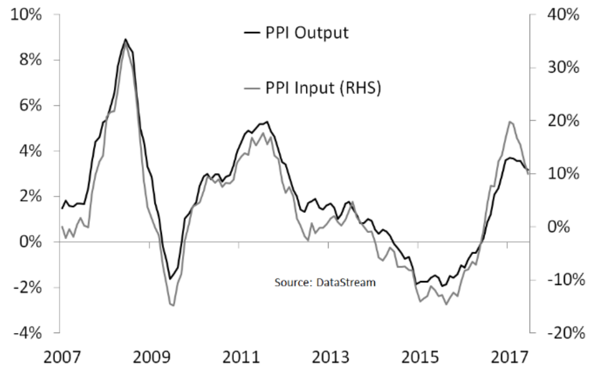


Chart 3: UK producer price growth (yoy)



Extending the point about Japan, experience of the post-GFC period suggests, and this is of interest for the UK, that currency-induced inflation doesn'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 remains more hamstrung than expected. The recent UK election hasn't altered the outlook.

Short and long term interest rates

Having raised their policy rate in June to 1.25%, the Fed are arguably almost halfway to their predicted equilibrium policy rate (of 3%). After the latest announcement, Janet Yellen reiterated while other rate hikes will be delivered this year – they judge the recent moderate US inflation to be a 'soft patch' - the Fed intend to keep monetary policy accommodative. They are, however, moving forward with plans to shrink their balance (reduce the volume of bonds they bought through various QE exercises); this has not troubled bond markets.

The current consensus forecast for the main policy settings are shown in Table R1 and the market-implied path of interest rates over the next few years is shown in the accompanying chart. Despite the recent strength in the European economy, policy everywhere outside the US is expected to broadly remain on hold and ultra-low interest will be with us for many years yet.

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

	2016	Latest	2017
US Fed	0.75	1.25	1.50
ECB	-0.40	-0.40	-0.40
BoE	0.25	0.25	0.25
BoJ	-0.10	-0.10	0.00

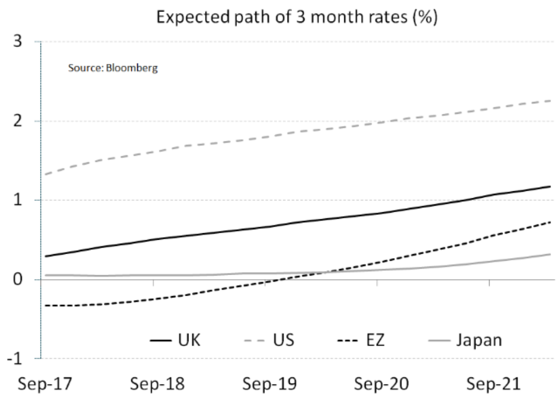


Table R2 provides a reminder of the current very low level of longer term government bond yields. Across all major markets, government bond yields remain below equity dividend yields.

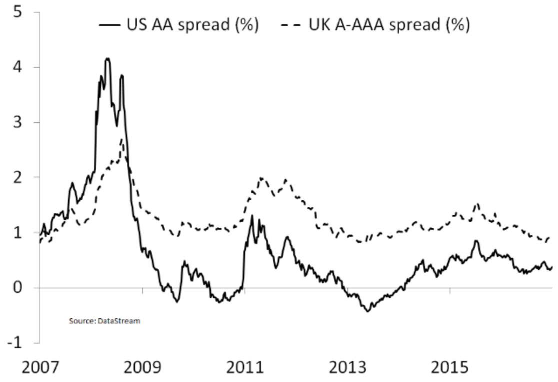
Table R2: 10-year bond yields and consensus forecasts at year end (%)

10 year	2016	Latest	2017
US	2.4	2.2	2.6
Germany	0.3	0.4	0.7
UK	1.4	1.1	1.3
Japan	0.0	0.0	0.1

Notwithstanding the changes seen in US policy 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 very tight as strong flows into (retail oriented) ETFs has kept demand for yield very strong; this has been particularly true in the UK. 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).



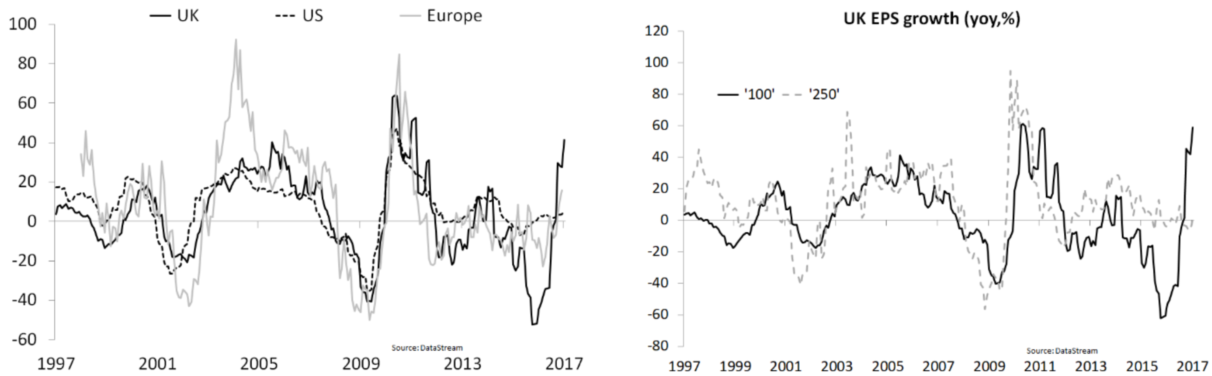
Regardless of which emerging market debt index is followed, all have recovered completely from the Trump-induced sell off last November. In a world of still wafer-thin, developed bond yields, investors continue to find EMD attractive – there is nowhere else to go for yield.

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

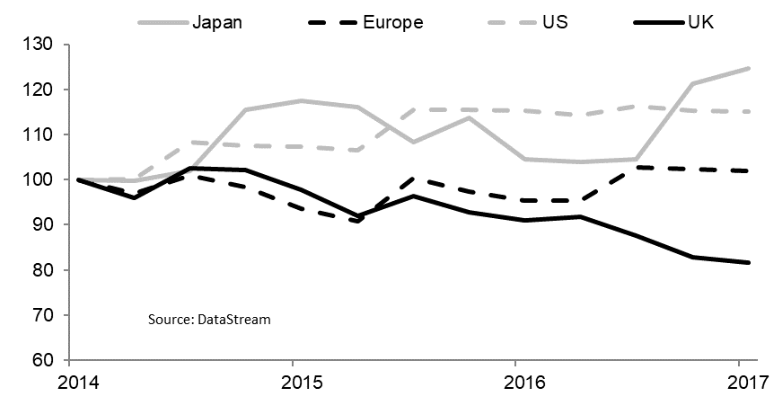
The chart below details how forecast earnings per share (EPS) for the UK, US, European and Japan equity markets have evolved over the past twenty years; unsurprisingly they chime with the economic cycle. Since the previous report, earnings growth has improved, consistent with the better readings on general activity levels. Larger companies in the UK are seeing the foreign earnings currency boost generated by last year's £ slump come through strongly.

Chart E1: Experienced earnings per share growth



EPS forecasts for the next financial year continue to be most positive in Japan while weakness is expected in the UK as the currency impacts wash through. In broad terms the Eurozone and the US are expected to flat-line (Chart E2).

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. Japan's recent gains are not expected to be maintained in the medium term.

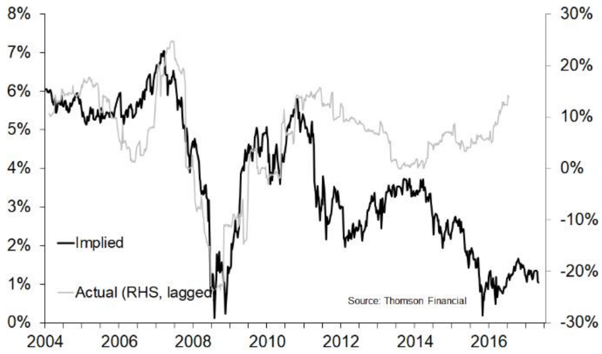
Table 5: Consensus EPS growth forecasts – second and third financial years with change from previous report (source: DataStream)

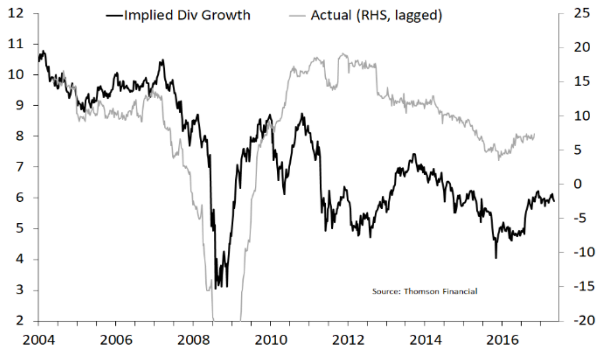
	UK	US	Japan	Europe
FY2	8% (0%)	11% (-1%)	5% (-3%)	9% (-1%)
FY3	9% (-1%)	10% (0%)	8% (-4%)	9% (0%)

Equity Valuation

A preferred means of assessing how attractively priced equities are, 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 always be uncertain but equity markets still offer better value than bonds.

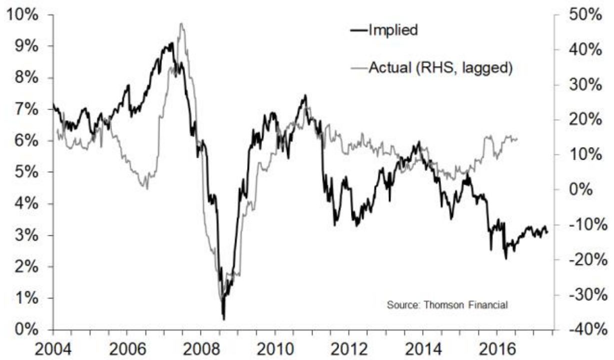
Charts E3 and E4: UK (FT All Share, left chart) and US (S&P Composite, right chart) implied dividend growth





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, if the recent broad economic upswing continues then, with central banks increasingly able to contain bond markets, equities could enjoy attractive relative returns – at least while investors expect there to be a strong correlation between growth and corporate profitability. Should the low level of inflation acquire a stronger market prominence then relative gains may be harder won.

Commentary

While falling short of declaring equity markets a ‘sell’, in a recent note to investors Howard Marks (of Oaktree) offered some observations and highlighted challenges facing investors today:

- we have some of the highest equity market valuations in history,
- the so-called complacency index is at an all-time high,
- a ‘can’t lose’ group of stocks [Facebook etc] has emerged,
- the movement of more than one trillion $s into value-agnostic investing [tracker funds],
- the lowest yields in history on low-rated bonds and loans,
- low yields on emerging market debt,
- the most fund raising in history for private equity,
- the biggest fund of all time raised for levered tech investing [Softbank] and
- billions in digital currencies whose value has multiplied dramatically.

He concluded that despite the above he was not currently inclined to liquidate his investments but knew that the time will come when he might need to act. Doubtless he would have found it a lot easier to move defensive if the cost of being defensive wasn’t so high: the returns from cash and bonds being so poor currently.

Meanwhile recent data highlights the growing importance of owning the correct (US) stocks. Over the past forty years the number of firms delivering half of the overall market earnings has shrunk by more than two-thirds while the actual dividend base has almost halved. Put differently, only 100 companies are responsible for delivering almost all market earnings and two-thirds of the dividends.

	# of firms accounting for 50% of:			Top 100 firms account for:		
	1975	**1995**	**2015**	**1975**	**1995**	**2015**
Earnings	109	89	30	48.5%	52.8%	84.2%
Assets	94	69	35	51.1%	56.5%	66.2%
Dividends	74	61	44	55.1%	60.6%	68.7%

When it comes to investment returns, slightly more than four out of every seven US stocks since 1926 have lifetime buy-and-hold returns, inclusive of reinvested dividends, less than those on one-month bonds. When stated in terms of lifetime ($) wealth creation, the entire gain in the U.S. stock market since 1926 is attributable to the best-performing four percent of listed companies.

Marks’ comments highlight the importance (or opportunity) for a discerning investor to avoid expensive over-hyped companies and generate outperformance and yet the population of truly outperforming companies able to deliver rewards to investors is shrinking. Choosing the correct stocks may never been more important and it may never have been more difficult.

Summary

The most significant developments of the past quarter included

- the reduction in political risk (associated with a distracted/ embattled Trump and the start of the Macron Presidency),
- the slide in longer term inflation expectations combined with the fresh fall in energy prices,
- the broad-based weakening in the US$ despite widening interest rate support and
- the desire across many major central banks to emulate the US Fed and move policy rates above the zero bound and/or reverse their quantitative easing programmes.

Risk asset markets have taken these developments as confirmation of the better and more stable economic conditions needed to sustain current equity valuations. While the yield curve flattening that has taken place often heralds more austere trading conditions, equity investors have been prepared to believe that policy will remain ‘behind the curve’. If headwinds emerge then confidence is high that interest rates can/will be eased.

Despite the strength of many equity indices, market leadership has generally come from defensive stocks especially those supported by strong balance sheets. This trend should continue while policymakers try to normalise monetary policy. Unless inflation expectations start to increase it is to be expected that the US$ may struggle to recover the ground recently lost; this should be to the benefit of emerging markets – local currency exposures could do well.

Overall and notwithstanding the challenges mentioned on the previous page, those cautioning against equity exposure need to provide investors with

an attractive alternative. Bond yields and short term interest rates remain far too low to be viable. Credit spreads remain tight by historical comparison and, for UK investors, property is best played perhaps on a specialist basis. Illiquid opportunities are continuing to emerge but, almost inevitably, these do not have capacity. Robust yield supported equity allocations should remain the kernel of the Fund’s liquid risk allocations.

The Pound remains cheap against almost all alternatives but the recent election and subsequent developments suggest that this is for good reasons. It is hard to see why the mis-valuation will disappear unless other currencies are beset by difficult trading conditions. For the moment, the € remains well supported as investors return to the area; that said, a € long is a consensus trade.

There are of course myriad potential problems lying in wait for investors. The Macron ‘bid’ to the € and a raft of European sentiment indicators could evaporate if/when the new President meets opposition to his labour market reforms. Thus far, credit tightening in China has had limited impact on equity markets or economic activity. Although the Chinese interbank system appears sound, appearances can be deceptive – especially in China. Strains across to Middle East and the Korean peninsula retain the potential to become globally disruptive. Finally, market sentiment could easily shift to seeing falling inflation expectations as a portent of doom.

Scott M Jamieson, August 2017

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