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Leicestershire County Council Pension Fund Q2 2017 – Market Report

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Historic Returns for World Markets

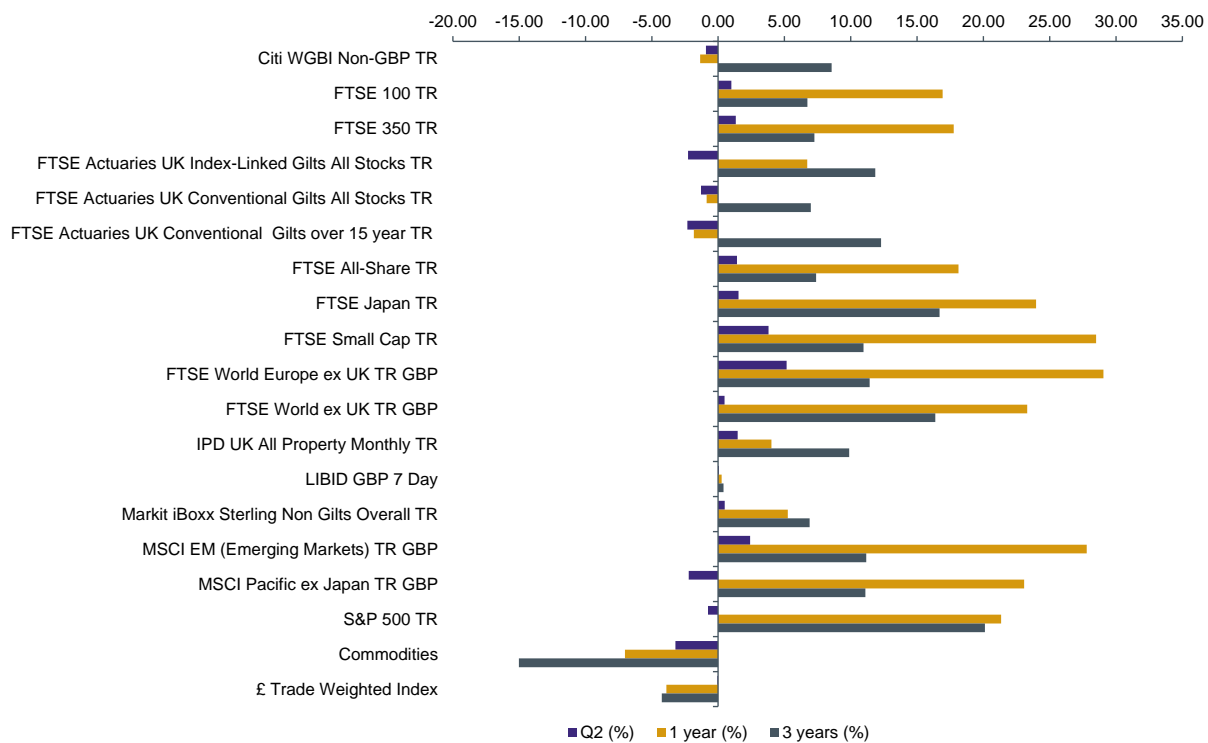
Index	Q2 (%)	1 year (%)	3 years (%)
Citi WGBI Non-GBP TR	-0.92	-1.36	8.56
FTSE 100 TR	1.00	16.92	6.73
FTSE 350 TR	1.33	17.76	7.26
FTSE Actuaries UK Index-Linked Gilts All Stocks TR	-2.27	6.72	11.85
FTSE Actuaries UK Conventional Gilts All Stocks TR	-1.29	-0.86	6.99
FTSE Actuaries UK Conventional Gilts over 15 year TR	-2.32	-1.83	12.29
FTSE All-Share TR	1.42	18.12	7.39
FTSE Japan TR	1.53	23.97	16.70
FTSE Small Cap TR	3.81	28.50	10.96
FTSE World Europe ex UK TR GBP	5.16	29.05	11.42
FTSE World ex UK TR GBP	0.48	23.31	16.37
IPD UK All Property Monthly TR	1.47	4.02	9.88
LIBID GBP 7 Day	0.06	0.26	0.41
Markit iBoxx Sterling Non Gilts Overall TR	0.49	5.26	6.90
MSCI EM (Emerging Markets) TR GBP	2.41	27.79	11.17
MSCI Pacific ex Japan TR GBP	-2.21	23.07	11.10
S&P 500 TR	-0.76	21.33	20.11
Commodities	-3.22	-7.02	-15.03
£ Trade Weighted Index	-0.06	-3.91	-4.25

Currency	Q2 (%)	1 year (%)	3 years (%)
Euro	2.66	5.66	3.12
Japanese Yen	-4.53	-6.03	5.87
US Dollar	-3.73	2.91	9.59

All returns are GBP currency, and returns over 1 year are annualised.

Source: Kames Capital as at 30 June 2017.

Historic Returns by Market Index



All returns are GBP currency, and returns over 1 year are annualised.

Source: Kames Capital as at 30 June 2017.

Market Review

UK equities

UK equities rose over the second quarter, with the FTSE All Share index up 1.42%. The period saw the FTSE 100 breach the 7500 level, establishing new all-time highs, before falling back at the end of the quarter. Markets also sold off after the minutes of the Bank of England monetary policy committee meeting showed a rise in support amongst committee members for a rate hike.

The main focus continued to be on politics, as Theresa May's call for a general election backfired and, despite winning the election, she was forced to enter into a pact with the DUP (Democratic Unionist Party).

Inflation picked up with the consumer price index (CPI) rising 2.9% in May, from 2.7% in April, and growing at the fastest rate since June 2013. On the other hand, and a sign of potential stagflation in the UK economy, retail sales volumes (including fuel) were disappointing in May with a rise of 0.9% year on year and a fall of 1.2% over the month. Both figures were some way below expectations and the annual growth rate marked the weakest growth since April 2013. Also on the weaker side were GDP figures. UK GDP growth was revised down from 0.3% in the first quarter of the year to 0.2%; this compared to the 0.7% growth in the final quarter of 2016. UK employment data remained robust however with the unemployment rate in the three months to the end of February stable at 4.7% and the employment participation rate rising to 74.6%, the joint-highest level since 1971.

In terms of sectors, healthcare equipment, financials (notably financial services, insurance and banks), mobile telecommunications and software were among the best performers. Meanwhile, basic materials, utilities, resources, pharmaceuticals and tobacco were all weaker.

US equities

The S&P 500 fell by 0.76% in sterling terms, but rose 3.09% in US dollar terms. Both the S&P 500 and the Nasdaq touched new all-time highs during the second quarter.

On the political front, while Donald Trump scored a success in the repeal of Obama's Affordable Care Act, the administration remained deeply mired in allegations of clandestine links with Russia. The abrupt sacking of FBI director James Comey did little to boost confidence, while reports that Donald Trump had disclosed classified information to the Russian foreign minister continued to dog his presidency.

Data was mixed. Inflation came in below expectations at 1.9% in May, down from 2.2% in April, with falling energy prices a key influence on May's figure. Retail sales fell by 0.3% month on month in May, showing the largest decline since January 2016, and contrary to consensus estimates which had predicted a rise. Meanwhile, US unemployment dropped to a new recent low of 4.3% in May, from 4.4% in April, marking the lowest rate for 16 years. Citing delays to Trump's planned cuts and infrastructure spending, the OECD cut its forecasts for US GDP growth for 2017 and 2018 to 2.1% and 2.4% respectively (down from 2.4% and 2.8%).

Remaining confident in the growing US economy and strengthening job market, the Federal Reserve raised rates in June for the third time in seven months and the second time this year with a further 0.25% increase and reiterated guidance for a further rate rise this year. They also signaled that they would begin to reduce the balance sheet, and thereby the level of liquidity in the system.

In terms of sectors, healthcare was the notable leader followed by industrials, financials and IT. All other major sectors declined in sterling terms, chief among them energy and telecommunications.

European equities

European equities were strong, with the FTSE Europe ex-UK index rising by 5.16% in sterling terms. Greece was the outstanding performer, up almost 30%. All countries rose in sterling terms.

Markets took comfort from political developments within Europe. After a tight first round in the French general election, Emmanuel Macron won convincingly in the second round, garnering approximately 65% of the popular vote. Markets were also relieved that euro-area finance ministers agreed to sign off on the next tranche of funds to Greece (approximately €8.5 billion) to help Greece meet bond redemptions due next month.

Economic data was largely positive. Eurozone GDP for the first quarter was revised higher from 0.5% growth to 0.6%. Gross capital fixed formation and exports rose more strongly than previously estimated and growth for 2017 was revised higher from 1.7% to 1.9%. The average reading for the second-quarter eurozone composite PMI was 56.4, up from 55.6 in the first quarter, and the best since the first quarter of 2011. Job creation and demand remained very strong, and eurozone investor confidence as measured by the Sentix index rose to a near 10-year high in June.

The eurozone CPI for May came in below expectations at 1.4% year-on-year growth, below that of April which marked 1.9% growth. This was the lowest rate of growth this year and largely reflected falling energy prices as well as lower telecom costs.

All sectors were positive, led by utilities and financials, the only exception being oil & gas.

Japanese equities

The FTSE Japan index rose by 1.53% in sterling, or 6.35% in local currency, terms.

In April, the IMF revised Japan's forecast growth rate of 0.8% for 2017 to 1.2%. Along with the UK, this was one of the largest single economy revisions made by the IMF. However, Japan's first quarter GDP growth was revised downward from the initial figure of 0.5% growth to 0.3%. This equated to an annualized growth rate of just 1.0%, down from 2.2% previously. The lowered figure largely reflected lower oil inventories rather than a fall in demand. Other weak data was evident with the core machinery orders for April which fell more than expected, by 3.1% over the month. This was the first fall in three months in the series.

On the positive side was industrial output which rose at the fastest monthly pace since June 2011, growing by 4.0% in April from March. The year-on-year growth rate rose to 5.7% in April versus 3.5% in March, led by rising demand for steel and other raw materials.

Japanese retail sales picked up in April at department stores and supermarkets with an aggregate 1.1% rise following on from a fall in March. However, overall household spending fell 1.4% during the month.

The Bank of Japan kept its monetary stance unchanged in June and, in the wake of the Federal Reserve statement regarding the tapering of US quantitative easing, reiterated its firm stance, largely as domestic inflation is still shy of the 2.0% target.

Regarding sectors, technology was the best performing sector followed by telecoms and consumer services. Oil & gas was by far the weakest sector.

Asia (ex-Japan) equities

The MSCI AC Asia Pacific ex-Japan index rose by 2.32% in sterling terms. The best performing market was China, followed by Korea, Taiwan and Indonesia, while Pakistan, Australia, Thailand and India were negative.

After several previous failed attempts, China at last obtained admission of its A shares index to the MSCI global and emerging-market benchmarks. Chinese shares hit an 18-month high as investors bought stocks in the knowledge that inclusion in the MSCI should improve demand from international investors and liquidity.

However, the ratings agency Moody's cut the sovereign rating for China for the first time in 30 years in May due to worries about economic slowdown and rising debts. Hong Kong also had its rating downgraded by Moody's. Chinese 10-year bond yields soared to their highest level in two years as a result, rising above the 3.5% level. Additionally, the financial authorities tightened regulations, in an effort to prevent excessive borrowing and speculation in markets. The actions unnerved investors and caused a sell-off in government bonds.

The IMF revised its forecast for Chinese GDP growth from 6.6% to 6.7% for 2017. GDP growth attained a reading of 6.9% for the first quarter of the year.

India's CPI marked a new record low, growing by just 2.18% year on year in May compared to 2.99% growth in April and well below consensus estimates. The main factor behind the slump in CPI was weaker food prices.

In Australia, business confidence, as revealed by the NAB Business confidence index, fell in May to 7, down from April's figure of 13.

In Korea, liberal politician Moon Jae-in was elected as the new president following the impeachment and imprisonment of the former president.

Technology led the way in terms of sector moves followed closely by consumer services. Oil & gas, basic materials and telecommunications were the weakest sectors.

Property

Economic growth in the UK weakened at the beginning of 2017 with figures from the ONS showing GDP growth slowed to 0.2% during the first quarter. Consumer spending, which has been the main driver of growth over the past few years, has slowed in particular with limited wage growth and rising inflation, largely as a result of the depreciation of sterling following last year's EU referendum, squeezing household finances despite record levels of employment.

In contrast to the wider economy, the UK commercial property market continued to defy expectations from some commentators of a slowdown with the IPD Monthly Index recording a robust total return of 2.5% during the quarter. This represented the third consecutive quarter of solid positive returns following a modest correction in capital values in the immediate aftermath of the vote to leave the EU. Investment demand, especially from Far East Asian investors, has remained resilient and supported valuation yields. However, rental growth has slowed to 0.4% year on year, as occupiers become more cautious due to economic and political uncertainties associated with Brexit. In certain markets, such as central London offices, bargaining power has shifted from landlords to tenants with evidence of declining rents and greater tenant incentives.

Industrials continued to be the best performing sector of the market by some margin with an exceptional total return of 4.6% in Q2 2017. Diminishing supply of vacant space and healthy tenant demand for both multi-let estates and larger logistics warehouses continues to drive positive rental growth, whilst the weight of money seeking industrial exposure has driven industrial yields down to 10 year lows. In the office and retail sectors, returns were more restrained but remained positive. The office sector returned 1.9% with regional offices outperforming central London. The retail sector returned 1.8% in the quarter and continues its long term trend of underperformance. Rental growth remains weak due to a structural oversupply of retail space, especially in secondary and non-core locations.

Uncertainty over the Government's ability to agree a successful trade deal with the EU during Brexit negotiations is likely to remain over the medium term. However, our outlook for the UK commercial property market continues to be for steady, if unspectacular, returns over the next few years. On a relative value basis, commercial property remains attractive with All Property's net initial yield of 5.3% continuing to represent a healthy spread in excess of 400bps over 10-year gilts. In addition, when compared with commercial property markets overseas, the UK does not look expensive in capital value or yield terms, providing support for international capital that has also benefited from the weaker pound. With little evidence of any major development or credit bubble that has triggered previous commercial property corrections, the latest IPF Consensus Forecasts – an industry average of return forecasts by agents, fund managers and researchers – projects a respectable total return of 5.2% over five years to 2021.

Fixed Income

Government bond markets came under pressure over the quarter and posted a negative return overall. Much of the action was concentrated in June when markets demonstrated their ability to react dramatically in response to central bankers' comments. As they have done of late, credit markets continued to grind tighter.

The main dilemma facing authorities and markets was once again inflation and the extent to which (if at all) it will rise in the future. As we explain below, central bankers are displaying somewhat erratic behaviour in expressing a robust view; their change of thinking towards the end of the quarter was clearly viewed as a significant U-turn.

It is worth pointing out that we have adopted for some time now, a cautious approach within fixed income. We have avoided, where possible, the riskier assets within the corporate bond sector and we have, in particular, limited our exposure to government bond markets where valuations are challenging.

Government bonds sell off

Through April and May government bond markets were mainly focused on the political stories of the moment, namely the French presidential election in Europe and increased scepticism of Trump's ability to deliver any significant fiscal reform in the US. The fear of a continuation of 'populism' in Europe initially brought a tone of caution to core European markets, but as the likelihood of a Macron victory increased and eventually came to fruition, yields gently began to rise. As political concerns fell away, macroeconomic data returned to the fore and the market did not fail to notice the disappointing US retail sales, manufacturing data and inflation figures. In contrast European economic data was relatively stronger, including an upside surprise in Italian GDP, strong PMI figures and solid business confidence figures in Germany.

Central banks continued to be a key driver of market behaviour. Antipodean bond markets performed well in April on a combination of mixed data and dovish tones from the Reserve Bank of Australia. In May the market interpreted ECB comments as dovish, while in the US the Federal Reserve mulled over the dynamics of running down its balance sheet. As expected, the Fed raised rates in June but surprised markets with the extent of the hawkish note that FOMC Members' subsequent speeches struck. Weak inflation was deemed transitory, despite negative year-on-year readings in each of the three months of the period. In what looked like a conspicuously concerted effort, the ECB, Bank of Canada and the Bank of England also moved into hawkish territory. Andy Haldane, the Bank of England's chief economist (and a noted dove) spoke of the withdrawal of emergency monetary policy, albeit with conditions.

The cumulative effect sparked a general sell-off in government bond markets which was primarily concentrated in shorter-dated bonds. Through all of this, the Bank of Japan left monetary policy unchanged. Japanese government bond yields, nevertheless, rose in sympathy with other bond markets but to a much lesser extent.

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 Mar 2017		1.14	2.39	0.33	0.07	1.65	2.31	6.90	1.00	3.95
Yield, end Jun 2017		1.26	2.30	0.47	0.09	1.52	2.15	5.36	0.90	3.01
Change in yield		+0.12	-0.09	+0.14	+0.02	-0.13	-0.16	-1.54	-0.10	-0.94

Source: Bloomberg.

Index Linked

Inflation markets overall performed poorly due to softer CPI data and a fall in commodity prices. The notable exception was a rally in New Zealand index-linked bonds following an upside surprise in their inflation report. The UK index-linked market rallied at first but sold off towards the end of the quarter in sympathy with broader rates markets. On poor CPI readings in the US, the US 10-year breakeven inflation rate trended down over the period ending at 1.72%, below the Fed's 2% target where it began at the end of March.

Investment grade

After displaying a measure of caution in April, due mainly to the French election and little attractive new issuance, investment grade markets continued to see their spreads grind tighter over the remainder of the quarter. Once the French elections were out of the way, credit spreads pushed aggressively tighter and financials outperformed non-financials as a pro-risk backdrop prevailed. May witnessed a heavy month of corporate new issuance, particularly in the US. Despite this significant supply pipeline, credit spreads continued to compress, driven by the same themes that dominated previous months. These themes included the ongoing appetite for yield against a backdrop of central banks squeezing prices higher. Overall, credit markets benefited from a stronger tone as the appetite for financial credit and particularly subordinated paper remained strong.

High yield

Global high yield markets performed well, with European high yield taking the lead. The Barclays Pan European High Yield index returned 2.33% in euro terms, and the Barclays US Corporate High Yield index returned 2.17% in US dollar terms. High yield credits largely ignored the political and central bank events that tested government bonds. Throughout April higher quality credits led outperformance, however in May in the US we returned to the recent trend of CCC and distressed credits outperforming. Conversely in Europe the higher quality single B names outperformed lower quality issues. High yield within emerging markets was a notable area of underperformance following corruption scandals in Brazil. Overall the market ground tighter, with some weakness in the energy sector influenced by the oil price. As central bank policy looks set to tighten, stock selection will increasingly take the lead on driving market returns.

Key Market Movements

The following charts provide a pictorial summary of key market movements during the six month period to end of June 2017.

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

Quarterly Thought Piece

S&P 500 – don't judge an index by its acronyms

There has been talk in the market recently about the S&P 500 index reaching new highs but with an increasing dependence on a handful of stocks, which happen to sit in the technology sector. These are more commonly referred to as FAANNMGs. Bankers love a good acronym and the somewhat clumsy FAANNMGs has, over time, come to represent the top stocks that are contributing the most to the S&P 500's returns. The stocks are Facebook, Amazon, Apple, Netflix, Nvidia, Microsoft and Google. For aesthetic purposes I suggest referring to Google by its parent company (Alphabet) and rearranging the names to create the more palatable NAFMAAN.

However we term it, creating a basket of stocks in such a way, and then attaching such importance to them, has led to a narrative where these stocks are seen as the only names lifting the index. With the market discussing where the S&P 500 is heading after such a strong run, this basket approach to examining performance is problematic and potentially misleading.

Just because the biggest stocks (by virtue of their size) contribute the most to the index that does not mean they have to contribute the most to an investor's portfolio. A 40-stock global portfolio can include smaller stocks that attract less flow for the bankers but can provide more absolute performance for a portfolio than anything within NAFMAAN. In a global context, whilst the seven horseman of the NAFMAAN are contributing 'all the return' of the index, there are 3993 other stocks that trade more than US\$10m per day that we can invest in. Many of these stock have performed very well and they are not always technology companies.

For the S&P 500, this is not a tech-driven 1999

Tech as a percentage of the S&P 500 has increased in recent years, but it is way below the peak of 1999 and this time valuations are in a normal range supported by real profits.

We shouldn't, therefore, discount NAFMAAN completely; they are not in an over-valued bubble. Software – and in particular internet-based software platforms – are the most mean repellent business models we have ever come across. Strength begets strength, scale begets scale, and cash flow begets cash flow. Absolute capital deployment by NAFMAAN has become vast (communications infrastructure, data centres and physical distribution infrastructure) yet these are still capital light, high-returning businesses in relative terms. On a free cash flow basis, technology yields over 4%, which is slightly more expensive than consumer staples but for more growth.

It is possible of course for software giants to be disrupted by new technology, but doing so is very difficult. Microsoft, for example, is so strong due to its scale and embedded products.

The fallacy of circular logic

There is another narrative fallacy here: that of circular logic. If a bank creates a basket of stocks and trades them as one homogenous 'thing' (an ETF for example), it is obviously going to distort short-term valuations and create inefficiencies. Indeed, the least liquid stock within the basket will be distorted the most.

Right now, we're told that NAFMAAN is a consensus 'long'. It's a crowded trade due for a rotation into cyclical or value or some other banker created basket. Maybe so, but when we dissect the stock specifics and valuations of the NAFMANN 'basket' we see two or three that we like a lot, three that we don't and one which we can take or leave.

As an active manager, I am part of a team that picks stocks. We pick stocks from a universe of around 4000 stocks that trade more than US\$10m per day. Regardless of market conditions, from the height of the 1999 tech bubble to the depth of the 2008/9 financial crisis, there have always been some stock prices going up and there have always been stock prices going down. Just because a few large stocks are driving the majority of index returns at any point in time, does not mean that they are the only thing that matter.

In the end, we don't really care what basket a stock is part of, what sector the MSCI says it is in or how much it contributes to the return of an index. We only care about what it contributes to our portfolio.

P.S - Tesla has gone up a lot recently and it's a big company now. Perhaps we should add that to the basket!?

Craig Bonthron
Investment manager, global equities.

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