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Leicestershire County Council Pension Fund Q3 2017 – Market Report

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Historic Returns for World Markets

	Q3 (%)	1 year (%)	3 years (%)
Citi WGBI Non-GBP TR	-1.49	-5.89	7.55
FTSE 100 TR	1.82	11.20	7.70
FTSE 350 TR	2.11	11.72	8.36
FTSE Actuaries UK Idx-Lnk Gilts All Stocks TR GBP	-0.73	-3.79	9.67
FTSE Actuaries UK Conven Gilts All Stocks TR GBP	-0.45	-3.56	5.53
FTSE Actuaries UK Conven Gilts Over 15 Y TR GBP	-0.51	-6.30	9.53
FTSE All-Share TR	2.14	11.94	8.50
FTSE Japan TR	0.77	11.44	15.81
FTSE Small Cap TR	2.96	18.02	12.37
FTSE World Europe ex UK TR GBP	3.61	22.70	13.65
FTSE World ex UK TR GBP	1.71	15.74	15.72
IPD UK All Property Monthly TR	2.67	10.37	9.51
LIBID GBP 7 Day	0.06	0.24	0.39
Markit iBoxx Sterling Non Gilts Overall TR	0.09	-0.20	5.92
MSCI EM (Emerging Markets) TR GBP	4.60	19.00	12.13
MSCI Pacific ex Japan TR GBP	0.39	10.94	11.52
S&P 500 TR	1.16	14.84	18.01
Commodities	-3.22	-7.02	-15.03
£ Trade Weighted Index	-0.06	-3.91	-4.25

Currency	Q3 (%)	1 year (%)	3 years (%)
Euro	0.35	1.85	4.18
Japanese Yen	-3.36	-12.90	5.59
US Dollar	-3.18	-3.18	6.50

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

Source: Kames Capital as at 30 September 2017.

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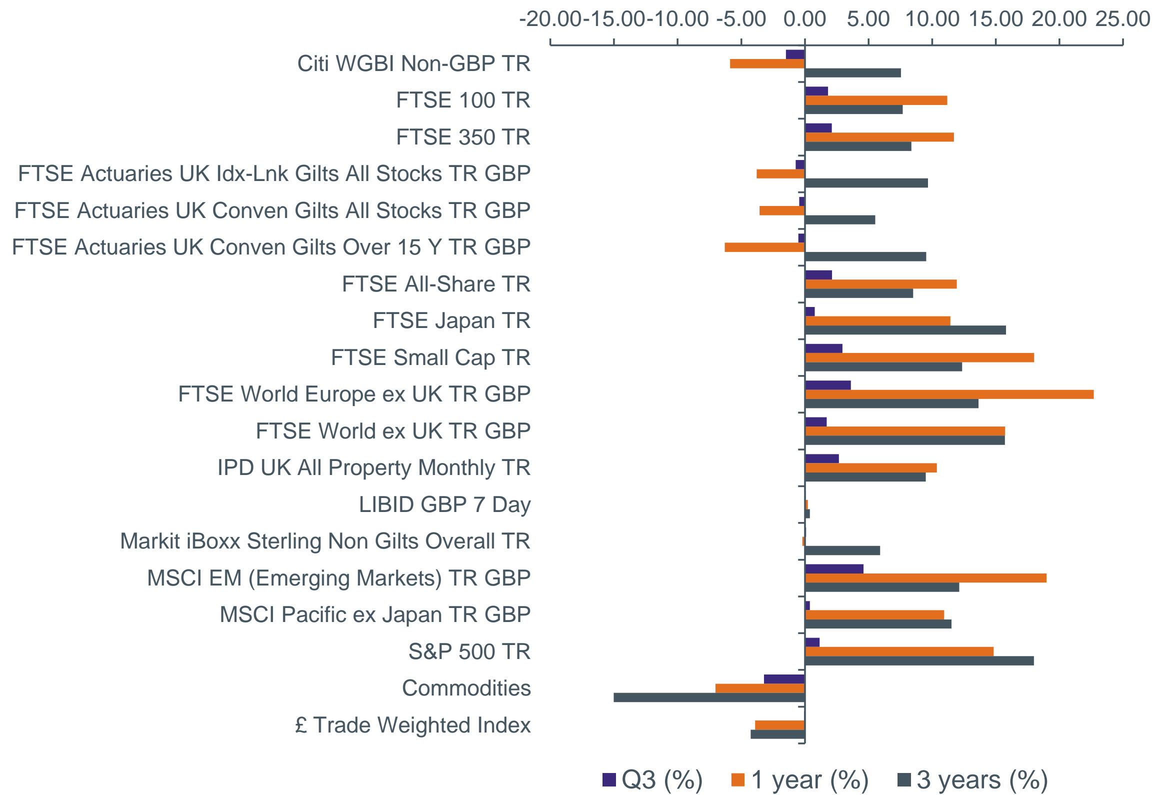
Historic Returns by Market Index



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

Source: Kames Capital as at 30 September 2017.

Market Review

UK equities

UK equities rose over the third quarter, with the FTSE All Share index up 2.14%. Small and mid-cap indices outperformed the large-cap FTSE 100.

Sterling recovered somewhat over the quarter, gaining ground in September.

Much attention was focused on rising inflation rates and the likely response of the Bank of England to that trend. Inflation rose ahead of expectations in August, with the Consumer Price Index up by 2.9%. In September, the Monetary Policy Committee meeting voted against raising interest rates. However, subsequent more hawkish statements from certain committee members caused a sell-off in UK government bonds.

The labour market remained very tight with unemployment falling further in the three-month rolling period to July, the lowest level since 1975. Meanwhile, UK trade data remained largely poor with the June figure showing a trade deficit of £4.6bn, the worst figure for nine months. Elsewhere, the most recent purchasing managers' index (PMI) figures showed the UK manufacturing PMI surprising on the upside in August with a strong reading of 56.9. New orders and export growth helped to boost the figure, the best for four months. However, the UK services PMI fell a little behind expectations in August.

In terms of sectors, industrial metals & mining was by far the strongest, benefiting from the rise in commodity prices, while oil & gas producers benefited from a recovery in the oil price. Beverages, general retailers, industrial engineering and software & computer services were also among the outperformers. Tobacco was the weakest sector followed by pharmaceuticals, media, technology hardware and mobile telecommunications.

Having outperformed in the previous quarter, domestically exposed stocks underperformed in the third quarter. Those exposed to North America also underperformed, to the benefit of those stocks with exposure to Europe and Asia.

US equities

US equities performed well in the third quarter, with the S&P 500 rising 1.16% in sterling terms, or 4.48% in US dollar terms.

The major indices, the Dow Jones, S&P 500 and Nasdaq all rallied, achieving new all-time highs over the quarter. The US dollar rallied towards the end of September after a weak period in the first two months of the quarter.

The most recent FOMC meeting in September concluded with the statement that the US Federal Reserve would begin to reduce its balance sheet from October and that another interest rate hike was likely before year-end, a somewhat more hawkish message than the markets had expected.

On the political front, there was further intrigue surrounding the Trump administration with the dismissal of the White House chief strategist, Steve Bannon. The President also had to face up to the public failure of his attempt to repeal the Affordable Care Act, after Congress voted it down.

Hurricane season began and the hurricanes, Harvey and Irma, wreaked havoc across the Caribbean and the southern US states. Retail sales and industrial production were both affected with lower readings than expected.

Preliminary US GDP for the second quarter of 2017 came in at 2.6% annualized growth, in line with expectations but double the rate of growth achieved in the first quarter. Meanwhile, unemployment levels remained just above multi-decade lows at 4.4% in August.

In terms of sectors, information technology was the strongest led by the semiconductor subsector. Energy, telecoms and materials were also strong. Consumer staples was the weakest sector led by the food, beverage and tobacco subsector.

European equities

Europe performed well in the third quarter, with the FTSE Europe ex-UK index rising by 3.61% in sterling terms. Norway was the leading single market, underpinned by rising oil prices. Italy was also strong while Greece was the weakest performer.

Euro currency strength was evident with the euro attaining a two-year high in August against a basket of currencies, with notable strength against sterling, before falling back later in the period.

In the political sphere, Angela Merkel won the German federal election on 24 September, but faced the immediate challenge of forming a workable coalition. Meanwhile, the nationalist AfD party are set to enter parliament for the first time with some 12.6% of the vote.

Eurozone GDP rose by 0.6% on a seasonally adjusted basis in the second quarter, or by 2.2% on an annualised basis, ahead of consensus expectation.

Other data also pointed to a robust eurozone economy, as the euro area manufacturing PMI for August came in at 57.4, a more than six-year high.

Sentiment indices, both business and consumer, generally improved across the euro area. The eurozone economic sentiment index rose in September to 113.0, ahead of expectations and the best figure for over 10 years.

Oil & gas, utilities and basic materials were the leading sectors over the quarter while consumer services brought up the rear impacted by a weak showing from the food & drug retailer subsector.

Japanese equities

The FTSE Japan index rose 0.77% in sterling terms, and by 4.27% in yen terms, over the third quarter.

The prime minister, Shinzo Abe, called a general election for October, at least a year before required, in an attempt to capitalize on recently improved poll ratings following the tensions with North Korea.

The June Tankan Survey exceeded expectations with a rise to a three-year high of +17 for large manufacturers. Large-sized non-manufacturing data came in at +23, in line with expectations.

There was cheering news in that core machinery orders rose by 8.0% month on month in July, giving the first rise in four months and the fastest rate of growth since January 2016. This followed a succession of weaker figures. The July figure was well ahead of forecasts and gives some hope to a subsequent rise in corporate capital expenditure.

The most recent PMI figures were mixed. Japan's services PMI achieved a figure of 51.6 in August, down from July's 52.0, and the weakest figure for six months.

Conversely, the Japanese manufacturing PMI rose in August albeit marginally to 52.2 from 52.1. New orders, output and employment all strengthened.

The country's GDP growth rate initially came in at 4.0% annualised growth but was later revised lower to 2.5% for the second quarter. Business spending was revised materially downward from an initial 2.4% quarter-on-quarter rise to just 0.5%.

Meanwhile, the Bank of Japan maintained its monetary policy and its commitment to a 2.0% inflation target.

Oil & gas was by far the strongest sector over the period. Industrials and basic materials were also notably strong, while utilities was the weakest sector.

Asia (ex-Japan) equities

The MSCI AC Asia Pacific ex-Japan index rose 2.66% in sterling terms.

The best performing individual market was China which benefited from positive sentiment regarding the economic outlook in spite of a downgrade to its sovereign rating. Standard & Poor's downgraded its debt one notch from AA- to A+ due to concerns over the amount of debt in the system.

In August, the International Monetary Fund raised their forecast for the Chinese economy, predicting an annual growth rate of 6.4% to 2020, and increase on the estimated 6.0%.

The latest inflation statistics showed the purchasing price index in China rising by 6.3%, well ahead of expectations and the July figure of 5.5%. The CPI rose 1.8% year on year in August, up from the previous reading of 1.4% in July.

In China, industrial production for August was behind expectations with a rise of 6.0% year on year, the weakest growth rate this year.

Elsewhere, the Korean economy continued to boom as witnessed by the 20% increase in exports recorded in July. India reduced its benchmark interest rate from 6.25% to 6.0%, the first cut in rates since September 2016. The move reflected the falling rate of inflation in India, down to 1.46% in June although the rate rose thereafter, up 3.36% in August.

The Bank of Indonesia surprised markets with a cut in rates of 0.25% to 4.50% in August on the back of falling core inflation and for the first time since October 2016.

Energy, materials and information technology were the strongest sectors while industrials and telecoms were relatively weak. Consumer staples and healthcare were the weakest.

Property

Since the market volatility of Q3 2016 in the aftermath of the EU Referendum vote, the UK commercial property market has delivered 12 consecutive months of positive capital performance.

This reflects robust levels of investment demand, driven in part by the relative attractiveness of the asset class, and the ongoing health of the majority of occupational markets. As we advance through the cycle and rental growth slows across the sectors, we expect returns to moderate from current levels but the environment is still supportive with income risks limited and loose monetary policy and low bond yields supporting pricing. Our expectation for the next 12 months is for returns to be driven by income rather than capital performance as rental growth slows and this feeds through to market pricing. Consensus forecasts suggest total returns over the period of between 5% and 7%.

At an occupational level, business defaults remain low and the majority of tenants remain committed to their existing property portfolios. The current cycle has not been characterised by excessive development of new space which supports our view that in most regional locations, rents will remain stable or offer some growth. Brexit risks will be most acute in central London offices, a market which already looks expensive by historic standards and where there does appear to be disconnect between market pricing and the outlook for fundamentals. We expect capital values in this sector to fall over the next 12 months as occupier uncertainty feeds through to the investment market but there is unlikely to be a collapse in asset pricing.

With the exception of central London offices, there is little to differentiate the return outlook for the different sectors. Stock selection will therefore be a stronger contributor to relative performance than sector or geographical factors.

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Fixed Income

It was a relatively quiet first two months of the third quarter as investors played a 'wait and see' game with central banks. The 'game' in question is the ongoing conundrum of inflation. The degree of inflationary pressures observed at a global level has undershot expectations, even as growth has been robust and employment levels have improved. This "conundrum" clearly taxed the US Federal Reserve in particular during the quarter, given headline US consumer price inflation continued to surprise to the downside. The European Central Bank also surprised markets by choosing to delay any decision on tapering their bond purchasing programme until nearer the end of the year. The market, as a result, pushed back expectations for the removal of monetary stimulus.

The backdrop changed, however, in September with some volatility injected back into bond markets. The driver of activity was once again central banks but on this occasion it was the Bank of England that led the way. At its September meeting, the Bank's monetary policy committee voted 7-2 in favour of unchanged rates but in its accompanying statements it indicated that the majority of members believed they may need to move rates higher in the coming months to bring inflation back towards target. When this message was echoed by Gertjan Vlieghe, a Committee member known for advocating lower interest rates, the market quickly moved to price in an expected interest rate rise as soon as November.

The US Federal Reserve also appeared to suggest that interest rate rises are on the horizon at its meeting as Janet Yellen presented a willingness to look through recent weak inflation figures and see positives on the growth side such as storm-related rebuilding. The Fed also announced they will start reducing the amount of bonds it holds on its balance sheet which it has accumulated over the quantitative easing programme, while optimism grew about President Trump's ability to implement his latest tax plan.

Government bonds under pressure

Most core government bond markets came under pressure given the above developments, with UK gilts in particular selling-off following the annoucement that rates may have to rise in the near future. Shorter-dated bonds bore the brunt of the sell-off and this move wiped out the small gains that UK gilts had experienced earlier in the quarter. US Treasuries followed a similar path with the market pricing in at least one more rate hike within the next year.

Inflation markets were challenged over the quarter, with inflation expectations moving lower at first. Consecutive weak consumer inflation prints dampened expectations in the United States, whilst a strengthening of the euro brought concerns that it would exert downward pressure on eurozone inflation. However, by the end of the quarter, there was a sense that the global economy was beginning to experience modest but healthy inflationary pressures as a reassessment of Trump's potential fiscal policy and healthier oil prices helped sentiment.

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 Jun 2017	1.26	2.30	0.47	0.09	1.52	2.15	5.36	0.90	3.01
Yield, end Sep 2017	1.37	2.33	0.46	0.07	1.60	2.11	5.60	0.74	2.36
Change in yield	0.11	0.03	-0.01	-0.02	0.08	-0.04	0.24	-0.16	-0.65

Source: Bloomberg, as at 30 September 2017

Corporate bonds still in demand

Corporate bond markets were not immune to the sell-off in their government bond counterparts, but over the quarter as a whole, they remained in demand by investors. The positive performance of corporate bonds, particularly financial bonds, was impressive given the large amount of new supply coming to the market. Solid macro data and improving employment along with modest inflationary pressures (despite September's noise) created a benign environment for risk assets. High yield was the strongest performing area over the quarter, with CCC-rated bonds outperforming. Similar to its investment grade cousin, it enjoyed the relatively benign backdrop in the early part of the quarter and remained robust during the slightly more volatile conditions in September.

Outlook

In terms of government bond markets, we expect the removal of supportive monetary policy to continue in coming quarters, given the macro outlook remains benign and core economies no longer require emergency policy rates. In light of the modest inflationary pressures, we expect a gradual reduction in support, but at a faster pace than is implied by the market which is likely to continue driving yields modestly higher in the last quarter of the year.

Our outlook for corporate bonds is in large part shaped by our (benign) expectations for interest rate markets. While central banks have been advocating for less supportive monetary policy in recent weeks, we continue to expect them to proceed with extreme care in terms of their willingness to remove this support. If our expectations are correct, then the extent to which government bond yields can move materially higher from their current levels should be relatively constrained. These conditions should continue to ensure a positive technical backdrop for corporate bonds.

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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 September 2017.

Global Equities (FTSE World Price Index)

Long Gilts (UK 30 year gilt)

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Oil Price (Crude Oil Spot WTI Cushing ($ per barrel))

UK Sterling (UK Sterling Trade Weighted Index)

Source: Datastream

Quarterly Thought Piece

QE or not QE?

In May 2003, Ben Bernanke – yet to become Chair of the US Federal Reserve - spoke to a group of economists in Tokyo. He suggested that they would have a better chance of escaping deflation if they targeted not just the prospective inflation rate but also the prevailing level of prices. He could scarcely have imagined that, fourteen years later, he would be offering the same insight to western central bankers. His language has changed with the concept of 'price level targeting' replaced by the more simplistic notion of 'make up' (prices should be allowed to rise unchecked until they have recovered to the level implied by the target trend inflation rate). The sentiment is however the same: resisting deflation requires new ways of thinking.

Critics of the approach worry that monetary policy might, when prices are above those implied by long term trends, have to be tightened when the economy is already slowing down i.e. monetary policy could become pro-cyclical. Unusually for a man so prescriptive, Bernanke's response is simple: 'make up' should only be applied when it suits. Perhaps making it up as you go along is a better description of the proposal.

This year has been a good year for investors. Against a backdrop of stable bond yields, equity markets have kicked-on bolstered by stronger corporate performance consistent with the well-balanced and reasonable healthy world economy. It has not just been investors who have been keen to exploit these conditions however; central bankers in the West are rushing to 'normalise' by withdrawing their various extraordinary monetary stimuli (whether by hiking rates or by reversing quantitative easing (QE)).

While policy change has been brewing, the European economy, boosted by previous currency weakness, by negative interest rates and the relief that several more adverse political outcomes were avoided, has seen its summer strength start to succumb to the higher euro buoyed, in part, by hopes of tighter monetary policy. In the US, the Fed, having raised rates four times, has revised down its equilibrium interest rate (despite recent economic strength); each time they tighten, the target they are aiming for comes down - hardly a sign of normalisation.

The Bank of Japan, hardened by long, bitter experience, are less inclined than their counterparts to take recent improvements on trust; too many times Japan has suffered from premature policy tightening. They have been very clear: QE, negative policy rates and fixing the level of longer term yields will continue; this despite the Japanese economy far surpassing predictions by growing strongly in Q2. Suggesting that this was not a flash in the pan, the data continues to beat forecasts.

A breakdown of Q2 growth reveals strength in the domestic economy – both consumption and capital spending were much stronger than expected while, unusually for Japan, external demand was a (modest) drag on performance. Japan's major companies are currently more confident than they have been for more than a decade, optimism matched by the OECD leading indicator for Japan while deflation has been avoided for a year. The Japanese economy is on a tear. This has been a long time coming but coming it is – and the full boost of the 2020 Olympics lies ahead.

Over the past three months Japanese equities have comfortably outperformed their American and European counterparts; that outperformance is accelerating. As recent work by UBS highlights, dividends from Japanese companies – currently on a par with those in the US - have been growing at twice the rate of their major international competitors and have, historically proved much more resilient. Given that company earnings in the past year have risen by nearly 15%, the prospect is for payouts to remain healthy. Small wonder that international investors are starting to rebuild weightings in a market they have long ignored.

A few months ago, Shinzo Abe's popularity had plunged and investors worried that Japan would suffer the political upheaval seen elsewhere. Now Abe looks set to come out of the imminent 'snap' election as the only incumbent politician to have his (her) position reinforced. Worries that *Abe-nomics* might come to an end are fading fast.

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The debate continues around how monetary policy should evolve. Equally unresolved is whether (and how) QE works. In recent weeks equity investors have expressed their views: they'd rather have QE than not. Japan looks well placed to remain the land of the rising equity market.

Stephen Jones

Chief Investment Officer

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