

## Market Backdrop

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

## Market Summary

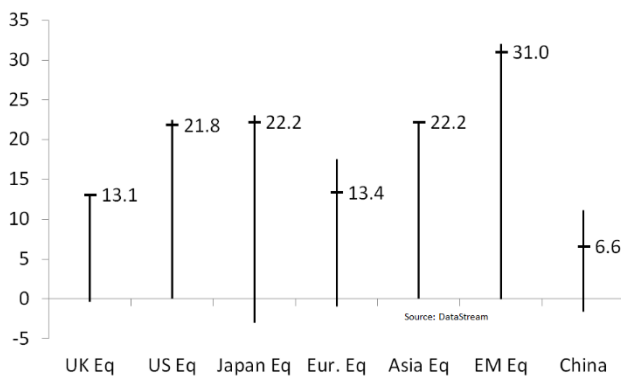
2017 proved to be another year of strong stock markets with global equities, in local currency, delivering a total return of 19.7%. The platform for this achievement was formed of stronger and more synchronised economic activity than expected across the globe, low inflation and the absence of serious political challenges, especially in the Eurozone. Selected central banks moved to tighten monetary policy but not to threaten the expansion, others gave notice that they intend to move away from the extra-ordinary monetary accommodation of the past decade. The US\$ gave back gains of previous years; this proved helpful as a strong dollar invariably starves much of the world of investment capital. Altogether, this enabled corporate profits to rise, supporting equity markets despite, as some perceive, lofty valuations.

Investors have entered 2018 in positive mood looking for this benign backdrop to continue and expecting a positive boost from the US tax reform completed at the end of 2017.

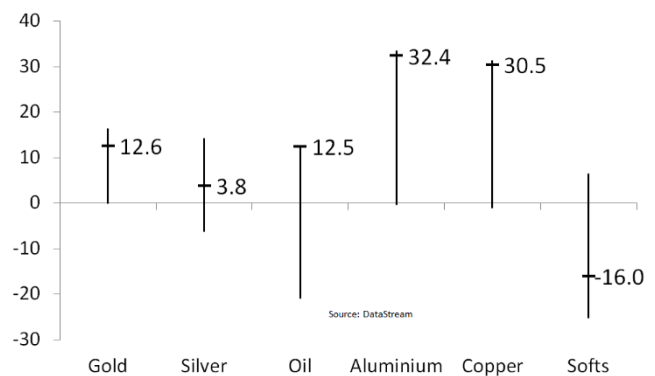
## Market Movements

The figures below describe the % performance of various markets from the end of 2016 to the end of 2017 and the range of performance over that period.

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



Commodity:



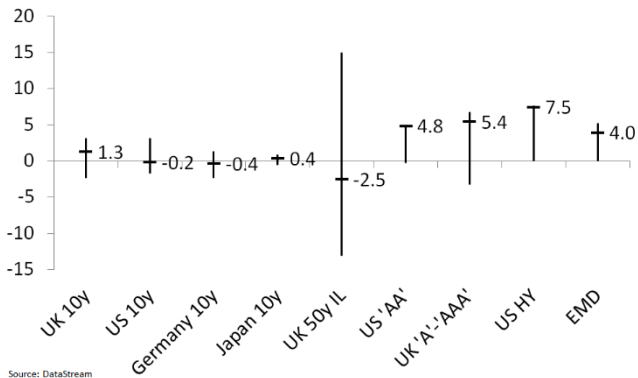
Equity markets did very well and were almost never behind the close of 2016. The steady progress was remarkable and illustrated by the US market which didn't have a month over which returns were negative – the first time that this has happened in at least 30 years. Measures of equity market volatility marked multi-decade lows. Emerging markets ultimately led the way helped by low price volatility, a steadily rising oil price and good global growth although China lagged as domestic credit tightening impacted sentiment. That France avoided appointing a right-wing President allowed investors to begin the rehabilitation of continental Europe as investible market.



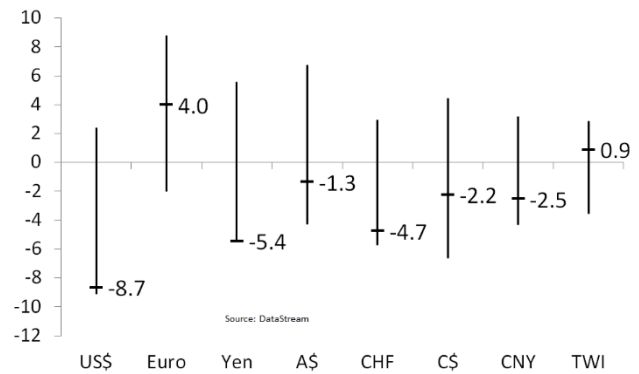
Repeated reports showing strong economic activity and rising appetite for risk boosted industrial commodities. Production constraints agreed by OPEC enabled oil, in the second part of 2017, to rise slowly and steadily despite still high stockpiles. Gold ultimately responded to a steadily weakening US\$.

Bond markets had been expected to see sharply higher yields over the course of 2017 on higher inflation and in response to the more extreme policy promises made by Donald Trump in his election campaign. In the event neither threat emerged and still low bond yields played their part in supporting risk markets. The low level of risk market volatility allowed credit spreads to tighten further – spreads are notably low – and emerging market debt enjoyed strong and sustained inflows. The UK index-linked market displayed its customary volatility ultimately to little net effect.

#### Bonds:



#### FX (vs £):



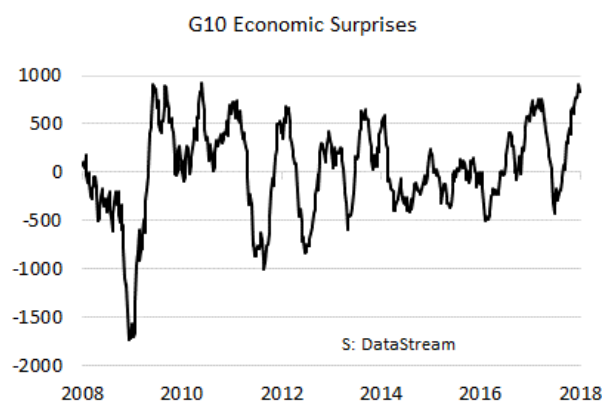
The Pound had a better year than many supposed going into 2017 with cheap valuation enabling it to absorb ongoing *Brexit* concerns and the surprise result of the snap General election<sup>1</sup>. The trade weighted index (TWI) ended the year marginally better an achievement that masked weakness against the Euro (particularly after the French election) and gains against most other currencies, the US\$ most notably.

#### The Outlook:

The consensus outlook for real economic growth in 2018 is being shaped by the more positive economic data over H1, 2017 than had been expected; the scale of economic surprises is at multi-year highs. This feeds through to a moderately solid global economic outlook for 2018 and 2019 with the US economy, benefitting from tax reform, expected to perform best over 2018 (trend US growth is estimated, by the US Federal Reserve, to be 1.8%). Growth, across the globe, is expected to be strongest in the first half – some forecasters see growth in the Eurozone over Q1 running at a remarkable 4+% annualised pace. Thereafter natural 'self-exhausting' cyclical factors and tighter monetary policies are expected to exert more influence. Growth in the UK is forecast to remain lack-lustre as *Brexit* worries and high levels of consumer debt combine with negative real wage growth to restrain activity.

Table 1: Consensus forecasts – Real GDP growth (%) (and economic surprise index – G10)

	2017	2018	2019
US	2.3	2.6	2.2
Eurozone	2.3	2.1	1.8
UK	1.5	1.4	1.4
Japan	1.7	1.3	1.0
China	6.8	6.5	6.2

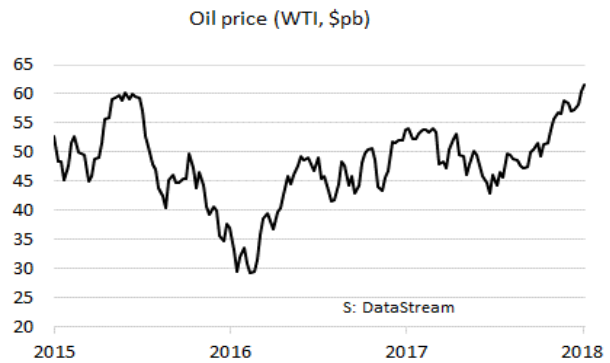


<sup>1</sup> Currencies are commented on further in another note

A strong outlook has not fed through to higher levels of forecast inflation despite the steady rise in energy costs over the past two quarters. For the most part, forecast inflation rates are around or below central bank target rates. This suggests that the strong deflation under-currents of the past decade are judged still present and implies that monetary policies, while they may undergo prudential tightening, will retain a 'soft' bias.

*Table 2: Consensus forecasts – Inflation (CPI, %) (and oil price)*

	2018	2019
US	1.7	2.0
Eurozone	1.5	1.6
UK	2.5	2.1
Japan	0.8	1.0
China	2.3	2.2



Important for all assets – especially bond markets, is the continued decline in terminal (or equilibrium) policy rates, shaped by the US Federal Reserve projections. The US equilibrium real policy rate is now just 0.8%. On this basis, low bond yields are here to stay.

The benign outlook for inflation and policy rates is vulnerable to a surprise change of view – most likely led by the US Fed and/or much stronger economic data in Q1 leading to fears of 'over-heating'.

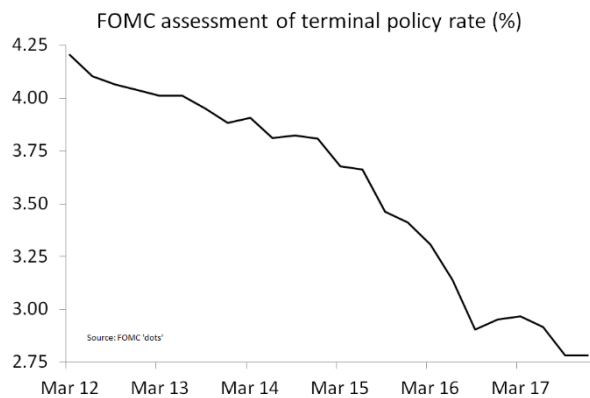


Table 3 guides that bond forecasters currently see yields rising steadily over the next two years. Relative to the equilibrium rate, US bond yields will be tightening monetary conditions in 2019. Nowhere will bond yields, in absolute terms, appear compelling.

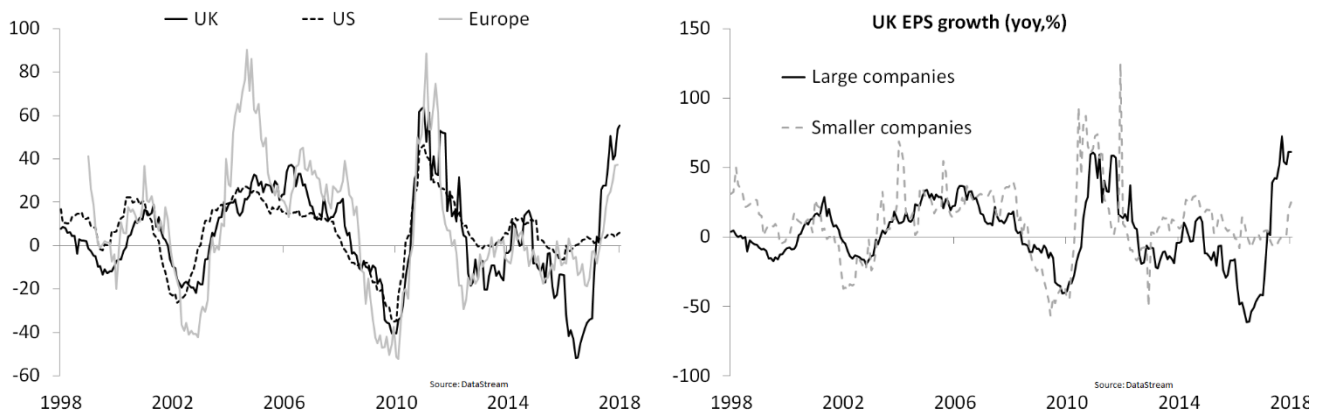
*Table 3: Consensus forecasts – ten-year bond yields at year end (%)*

	Latest	2018	2019
US	2.5	2.9	3.2
Germany	0.4	0.9	1.4
UK	1.2	1.7	1.8
Japan	0.1	0.1	0.1

## Equities

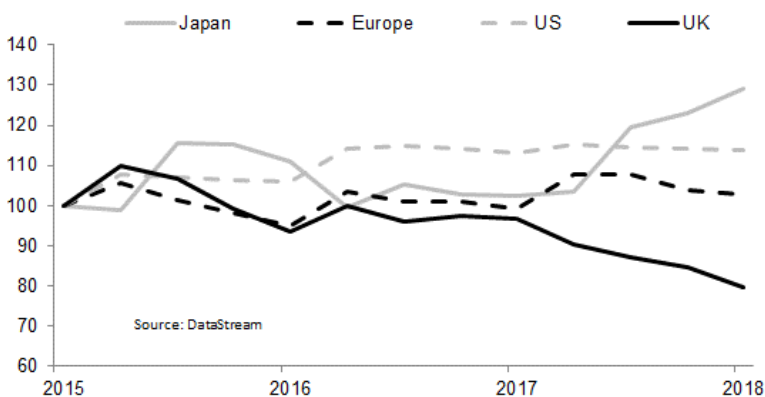
The chart below details how forecast earnings per share (EPS) for the UK, US, European and Japan equity markets have evolved over the past twenty years; they chime with the economic cycle. The boost to the earnings of larger UK companies from the currency devaluation of 2016 is clear to see. Equally, the upturn in activity in Europe has fed through strongly to company earnings there.

*Charts E1: Experienced earnings per share growth*



The latest EPS forecasts for the next financial year suggests the Japanese corporate earnings will strengthen sharply (helped by a lower Yen and the return of inflation) while elsewhere stabilisation is anticipated – this is likely too pessimistic given that the achievements in reforming US tax policy have yet to hit analysts' numbers. The UK outlook points to the currency boost fading quickly.

*Chart E2: Forecast earnings per share (next financial year, rebased to 100 in 2015)*



Looking beyond the next financial year, equity analysts generally remain optimistic (Table 4); although it should be remembered that analysts are rarely pessimistic.

*Table 4: Consensus EPS growth forecasts – second and third financial years with change from previous report (source: DataStream)*

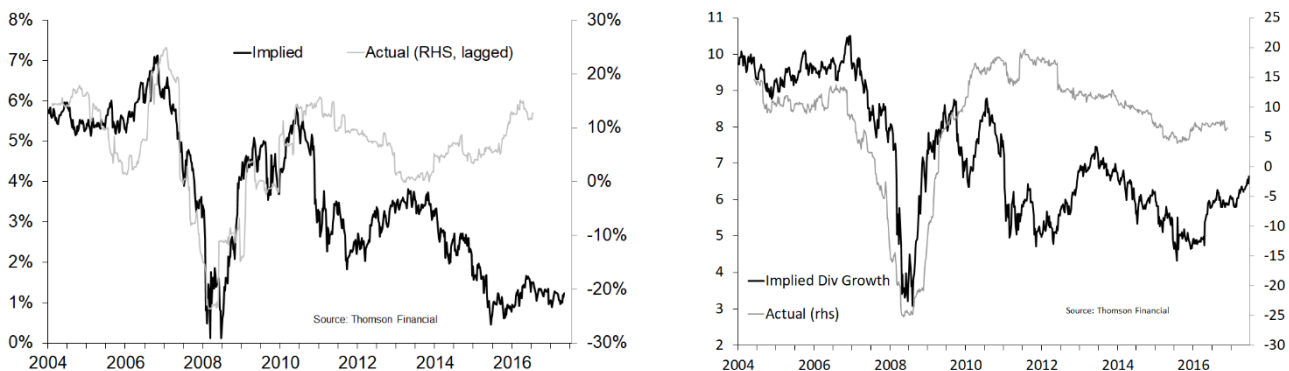
	UK	US	Japan	Europe
FY2	8% (1%)	12% (+1%)	5% (-1%)	9% (+1%)
FY3	8% (0%)	10% (0%)	8% (0%)	9% (0%)

## Equity Valuation

A preferred means of assessing how attractively priced are equities draws upon the implied level of dividend growth required to generate the same returns relative to the alternative of investing in bonds over the long term. In both the UK and US markets (Charts E3 and E4), the break-even level of long-term dividend growth looks to be modest in absolute terms and against what has been delivered in the past; low bond yields improve the comparison. If allowance is made for a risk premium – important given the uncertainties surrounding *Brexit*, then UK dividends may never grow but equities would still broadly offer better value than fixed income. This position could persist for some time. US equities have seen the breakeven dividend growth lift in recent months in response to higher bond yields of late and equity indices having repeatedly marked new all-time highs.

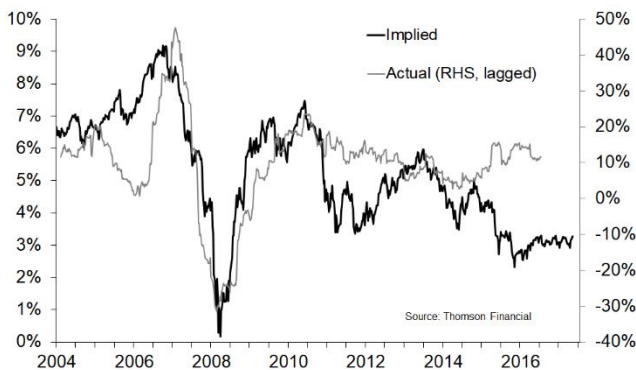
Overall, while the interest rate outlook may have become more uncertain, equity markets still offer better value than bonds though valuation support, relative to bonds, is deteriorating in the US.

*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 determined in the same manner as the broader 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.

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



*Chart E6: Regional PE ratios*

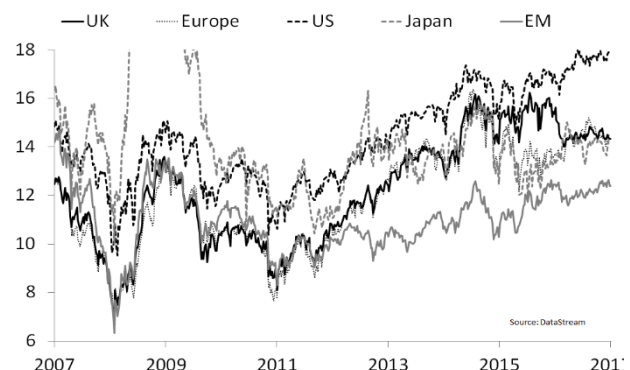
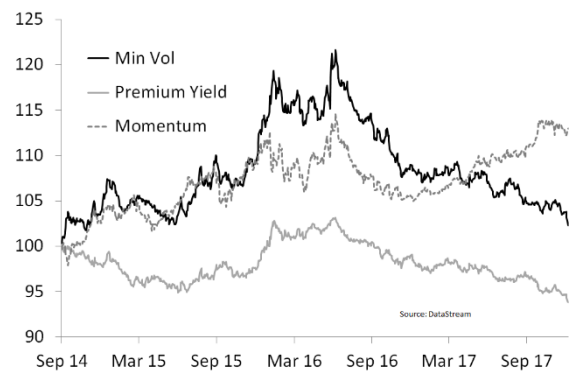
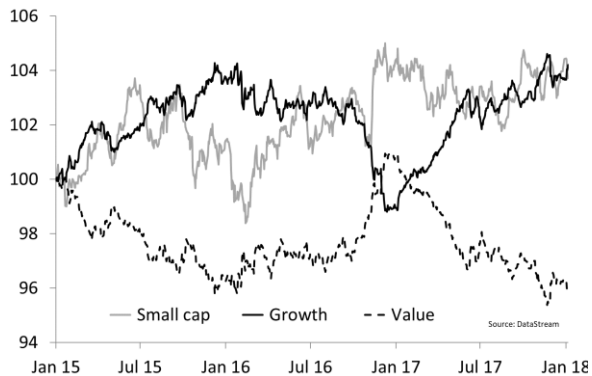


Chart E6 plots the main regional price-earnings (PE) ratios. These have been rising steadily in the US and EM (but from a much lower base). Elsewhere market gains have been matched by improvements in earnings to keep PEs stable. In all areas, PEs are considerably higher than they were several years ago.

The charts below plot the performance of several acknowledged styles relative to the broad global equity market. In recent quarters outperformance has come from smaller companies – often most leveraged into the economic cycle, growth stocks and stocks with positive momentum. *Value* stocks have lagged despite the better economic backdrop – recovery most likely needs higher bond yields. Minimum risk (vol) and higher yielding stocks are generally seen as defensive styles; unsurprisingly these continue to lag.



## Summary

No adverse surprises, solid synchronised growth, low inflation and accommodative central banks arguably combine to deliver a perfect backdrop for risk assets; it has certainly seemed this way since the last annual review of Fund strategy. 2017 was expected to suffer from numerous shocks, rising inflation and a less synchronised global economy. As these fears faded there was considerable scope for risk assets to perform well – and they did. Looking into 2018, while the supportive conditions look like continuing this must, to some extent, be discounted. Equity markets coming into 2017 needed good growth in corporate earnings to make progress, the same is true this year. With consumption strong in continental Europe, widespread evidence of a lift in capital investment and the prospect of some follow through from US tax reform, the balance of risk favours higher earnings per share but the delivery risks are naturally higher.

The notion of fair valuation in equities is notoriously hard to harden. In practice, valuation metrics model the behaviour of the dominant investor type. In decades past, longer term institutional investors controlled markets but their influence has waned considerably since the GFC. Retail investors, for who cash is a more natural asset (than it is for an institution), have become much more prominent. With this likely to be sustained (gain in importance) and with central banks keeping cash yields very low, the yields etc available on equities will likely remain attractive. [Only in the US and likely only later into 2018 is there any scope for cash to become competitive.]

Equities may appear expensive on various merits but the over-valuation is nothing compared to that on cash. While recession is avoided, equity markets can confound the institutional ‘wisdom’ and mark (much) higher levels. The flip-side is that retail investors can be quick to bail from positions if they get nervous. The low volatility of the past year has been helpful but is unlikely to endure. Beyond the unforecastable influence of populist driven political events, the oil market should be watch for what higher prices might do to lift inflation and put many of the supportive influences into reverse.

Scott M Jamieson, January 2018