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Leicestershire County Council Pension Fund Q4 2017 – Market Report

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Historic Returns for World Markets

	Q4 (%)	1 year (%)	3 years (%pa)
Citi WGBI Non-GBP TR	0.09	-2.04	6.83
FTSE 100 TR	5.02	11.95	9.56
FTSE 350 TR	4.99	12.91	9.92
FTSE Actuaries UK Idx-Lnk Gilts All Stocks TR GBP	3.52	2.34	8.01
FTSE Actuaries UK Conven Gilts All Stocks TR GBP	1.97	1.83	4.07
FTSE Actuaries UK Conven Gilts Over 15 Y TR GBP	3.65	3.32	7.00
FTSE All-Share TR	4.96	13.10	10.06
FTSE Japan TR	7.93	14.44	18.17
FTSE Small Cap TR	4.16	18.15	13.80
FTSE World Europe ex UK TR GBP	0.39	17.53	14.00
FTSE World ex UK TR GBP	4.97	13.45	15.72
LIBID GBP 7 Day	0.10	0.28	0.38
Markit iBoxx Sterling Non Gilts Overall TR	1.83	4.32	5.07
MSCI EM (Emerging Markets) TR GBP	6.62	25.83	14.80
MSCI Pacific ex Japan TR GBP	6.17	15.13	12.86
S&P 500 TR	5.77	11.29	16.80
Commodities	2.25	-1.03	-10.72
£ Trade Weighted Index	1.07	0.81	-3.94

	Q4 (%)	1 year (%)	3 years (%pa)
Euro	0.75	3.99	4.58
Japanese Yen	-0.90	-5.43	7.04
US Dollar	-0.82	-8.66	4.84

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

Source: Kames Capital as at 31 December 2017.

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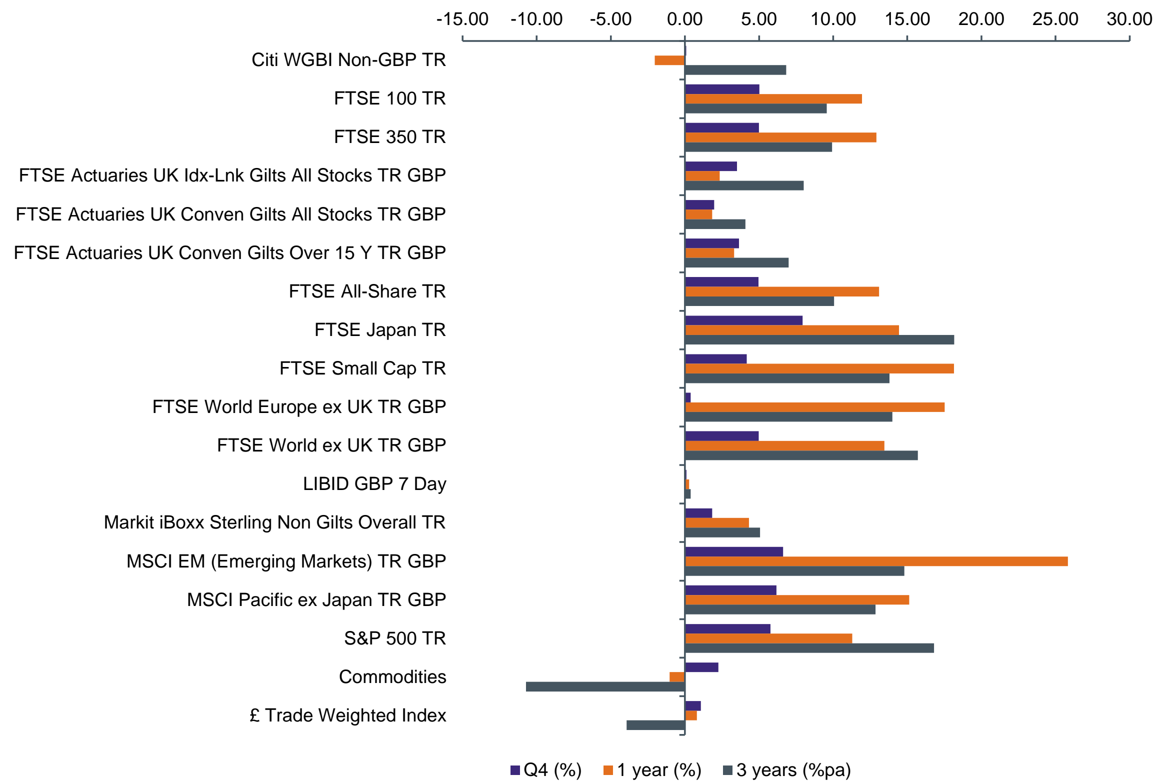
Historic Returns by Market Index



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

Source: Kames Capital as at 31 December 2017

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Market Review

UK equities

UK equities ended 2017 strongly with the FTSE All Share index up 4.96% for the fourth quarter and 13.10% for the year as a whole. Large-cap stocks produced the best returns over the fourth quarter, outperforming both their small and mid-cap counterparts. The picture for the year, however, was considerably different; mid-cap stocks were the clear winners with the FTSE 250 index up 17.78% compared to 15.61% for the FTSE Small-Cap index and 11.95% for the FTSE 100.

In sector terms, resource-related areas such as mining and oil & gas producers performed well over the quarter, as did food retailers, beverages, travel & leisure, software and mobile telecoms. These sectors, along with construction, financial services and non-life insurance also proved to be among the strongest areas over the year. The weakest sectors in the fourth quarter were defensive in nature (utilities, fixed telecoms and pharmaceuticals). General retailers and support services also struggled in relative terms. Those sectors of the market with exposure to the domestic UK economy tended to lag areas with exposure to international markets, specifically Asian and emerging markets.

The main economic news over the quarter was the Bank of England's decision on 2 November to increase interest rates for the first time in 10 years – the 0.25% rise brought the rate up to 0.5%. The Bank justified its decision by pointing to stronger global economic growth, record-low unemployment and Brexit-induced inflation. With average wage increases falling behind inflation, the UK consumer continued to feel the squeeze and retail sales figures were therefore somewhat lacklustre. Momentum stocks were in favour with those names that benefited from upgrades early in the period generally performing well over the quarter as a whole. Resource-related areas benefited from the continued rise in the oil price.

US equities

US equities performed well in the fourth quarter, with the S&P 500 rising 5.77% in sterling terms (6.64% in US dollars). The strong returns for the quarter mirrored what was a very strong year for US equities; the index was up 11.29% in sterling terms for 2017 as a whole and an impressive 21.83% in dollar terms.

An increased appetite for risk, together with strong third quarter earnings helped maintain the rally in US stocks. In December the Federal Reserve raised interest rates by 0.25%. At the same time it raised its growth forecast for 2018 to 2.5%. The positive backdrop was highlighted in strong corporate earnings and generally buoyant economic data. The market was also boosted by signs of progress (after a significant amount of uncertainty) on the government's much-discussed tax reforms.

Many of the best performing sectors were cyclical in nature, including financials and a particularly strong showing from technology stocks. Resource related areas also performed well given the rally seen in the oil price. In contrast, healthcare sectors came under pressure, including pharmaceuticals and biotechnology.

European equities

In the fourth quarter of 2017, the FTSE Europe ex-UK index increased by a modest 0.39% in sterling terms, which was significantly behind other major market returns. Over the year as a whole, however, the index was up 17.53% which was in line with the returns seen elsewhere within global equities.

At the beginning of the quarter, geopolitical crises hampered the markets' performance. Spanish stocks for example struggled as political tensions between Madrid and the regional Catalan government escalated. These tensions detracted from the markets attempt to react positively to strong German data and ongoing Central Bank support. As the period progressed, however, it was the turn of German politics to hamper progress as Chancellor Merkel struggled to form a new coalition government. A strong euro also conspired to dampen the market's progress, while the ECB reiterated its caution regarding the outlook for the economy.

In sector terms, the weaker sectors included pharmaceuticals, telecoms, general retailers and banks. On the positive side, oil & gas producers benefited from the rise in oil prices. Autos and technology (both hardware and software) also rallied.

Japanese equities

Over the fourth quarter of 2017 the FTSE Japan index rose by a robust 7.93% in sterling terms (8.91% in yen terms). The returns for the year as a whole were equally impressive with the index up 14.44% in sterling terms and 21.00% in yen terms.

The depreciating yen, along with the re-election of Shinzo Abe's coalition government early in the quarter, supported equity markets. Economic data continued to be buoyant and the earnings picture also highlighted an economy that is slowly emerging from the deflationary environment that had gripped it for so long. Similar to other major markets, cyclical sectors led the way over the quarter while traditional defensive areas were weaker in comparison.

In sector terms, resource-related area rallied, driven by the increase in the oil price. Software, autos and banks also performed well, given the positive economic backdrop. Defensive areas of the market such as tobacco, utilities and telecoms were among weaker sectors.

Asia (ex-Japan) equities

The MSCI AC Asia Pacific ex-Japan index rose 7.09% in sterling terms over the fourth quarter. This brought to an end a year in which the region made solid progress; the index finished up 25.43% in sterling terms for 2017 as a whole. The region continued to benefit from the 'pro-risk' sentiment that has underpinned the global stock markets.

Despite some concerns over the strength of the Chinese economy, growth remained relatively stable over the quarter. An increase in government regulations caused some concern; at the Communist Party Congress the government looked to address structural risks in the economy but also promised to focus on growth.

In regional terms, most markets performed well over the period, with Thailand, Korea, Indonesia and Singapore the best performers. India also performed well after the government acted to acted to recapitalise state-controlled banks. In sector terms, both consumer staples and discretionary areas were strong, as were autos, banks and technology.

Property

The UK economy grew by 0.4% in Q3 2017 according to the ONS, confirming a trend of slower growth that has been driven by weaker consumer spending and a squeeze on real household incomes. Whilst growth figures for the final quarter are not yet available, the UK is set to record its weakest economic expansion in a calendar year since 2012 despite evidence of a strengthening global economy. Encouragingly however, Brexit negotiations progressed at the end of the year with talks advancing to discussions over the UK's future trading relationship with the EU, although the complex nature and political sensitivities of talks means that significant uncertainties remain.

According to the IPD Monthly Index, the UK commercial property market completed the year with another healthy quarterly total return of 3.4% in Q4. Despite a decelerating economic backdrop, this translated to an above-trend full year return of 11.2% in 2017 which defied earlier expectations of a market slowdown from some commentators. Strong investment demand, especially from overseas investors based in the Middle East and Far East, has led to yield compression and supported capital values which have returned to pre-referendum levels. In addition the resilience of the economy, bolstered by stronger global growth, has helped underpin the occupational market with rental growth in 2017 measured at a respectable 1.9%, although there are variations across different sectors and regions.

The industrial sector delivered a remarkable total return of 6.4% in the final quarter of 2017, continuing a trend of outstanding performance which led to a full year return of 21.1% and the sector easily being the stand-out performer of the UK commercial property market. The twin drivers of strong occupier market demand (driven by the growth of e-commerce and the need for retailers to re-organise their supply chains), and low levels of supply led to industrial rental growth of 4.9% last year - the highest annual rate of growth in over 16 years – whilst yields have compressed further to remain at record lows. The office sector delivered a more modest quarterly return of 2.5% in Q4, and completed 2017 with an annual return of 8.5%. Regional office markets outperformed the central London office market with leasing conditions generally remaining robust in major cities outside of the capital, partly due to low levels of development activity. In contrast, central London office rents have come under downward pressure due to a combination of Brexit-related uncertainty for financial service occupiers and an increase in availability. The retail sector returned 2.0% during the quarter and 7.7%

over the full year, continuing a long-term trend of consistent underperformance which has now stretched back nearly seven years. The continuing growth in market share of on-line retail means that the structural challenges facing physical retail stores are unlikely to change over the medium term, with secondary retail centres in weaker or smaller towns remaining vulnerable.

Fixed Income

Bond markets performed well in the fourth quarter of 2017, bringing to an end another year in which the asset class generated positive returns for investors.

In the second half of 2017 the global economy experienced the most positive environment we have seen since the Great Financial Crisis. Growth was not only above potential, balanced and synchronised across developed and emerging markets, but also felt less dependent on ultra-stimulatory Central Bank policy.

Despite rising expectations, economic data consistently surprised to the upside. In particular, Europe and benefited from improving global dynamics, as reflected by the pick-up in trading activity. Brazil and Russia left behind their recessionary periods and are now well positioned to contribute to growth in the coming quarters.

Importantly for financial markets the strong growth was accompanied by a healthy but modest level of inflation; deflationary fears dissipated but inflationary concerns have not mounted.

Government bonds calm under pressure

Changes in government bond yields were surprisingly muted – over the year, 10-year US Treasuries and UK gilts traded in a relatively tight range with 10-year German bunds even tighter. It was in fact the narrowest trading range for government bonds in a number of years, reflecting the aforementioned opposing forces of robust growth but muted underlying inflation. The net result was a range-bound year for 'risk free' assets while their 'risky' cousins rallied throughout the year – an unusual dynamic.

Within this rather muted backdrop, there were periods of relative volatility. For much of the year government bond markets were mainly focused on the political stories of the moment. These included the French presidential election in Europe and Trump's ability to deliver the significant fiscal reforms he promised on his campaign trail. These issues, as well as others caused periods of short-term volatility in risk-free assets.

In the fourth quarter government bonds recovered from the more testing conditions they experienced in the previous quarter (which was due mainly to concerns over potential rate rises). Over the final three months of the year the iBoxx £ Gilts index increased 2.05%, bringing the return for the year to 0.30%. The UK index linked market also performed well over the quarter with the FTSE UK ILG index up 3.34%, but for the year as a whole inflation-linked assets came under pressure slightly with the index down by -0.04%.

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 Sep 2017	1.37	2.33	0.46	0.07	1.60	2.11	5.60	0.74	2.36
Yield, end Dec 2017	1.19	2.41	0.43	0.05	1.56	2.01	4.07	0.67	1.91
Change in yield	-0.18	+0.08	-0.03	-0.02	-0.04	-0.10	-1.53	-0.07	-0.45

Source: Bloomberg, as at 31 December 2017

Corporate bonds still in demand

Corporate bond markets also enjoyed a positive final quarter and, indeed, posted solid returns for the year as a whole; the iBoxx £ Non-Gilt index rose by 1.85% for the fourth quarter and by 2.43% for 2017. The high yield bond market enjoyed a robust final three months of the year with the Barclays Global High Yield (USDH) index increasing 1.57%. The asset class was clearly the star of the show for the year as a whole with the index up 7.26%.

The final quarter of 2017 (and the year) saw credit spreads make further progress, bolstered by a combination of supportive global macroeconomic data and an ongoing belief that central banks would err on the side of caution in terms of their withdrawal of monetary stimulus. In sector terms financials outperformed non-financials, with subordinated bonds among the strongest performers. The good performance of credit arrived despite a healthy new issue pipeline which was generally well digested by the market.

In the UK, the first rate hike in 10 years was greeted with much fanfare, but the ongoing travails around Brexit and concerns over the enduring health of the domestic economy dampened expectations that the MPC would follow up with a series of further hikes. Of more significance to credit markets was the surprisingly dovish comments and action from Mario Draghi in October, when he confirmed the ECB's commitment to its QE programme until at least September 2018, albeit at a reduced rate. There had been some concerns in markets

around the potential for a hard stop to the ECB's QE programme, and the ECB announcement saw credit spreads rally aggressively in the immediate aftermath.

A growing belief that President Trump would manage to effect some change to corporate and personal tax rates in the US acted as a further stimulant to risk markets over the quarter, with US credit markets also speculating that the potential ability for large swathes of the TMT sector (most notably Apple) to bring onshore cash trapped overseas would reduce supply in this sector, acting as a further technical support.

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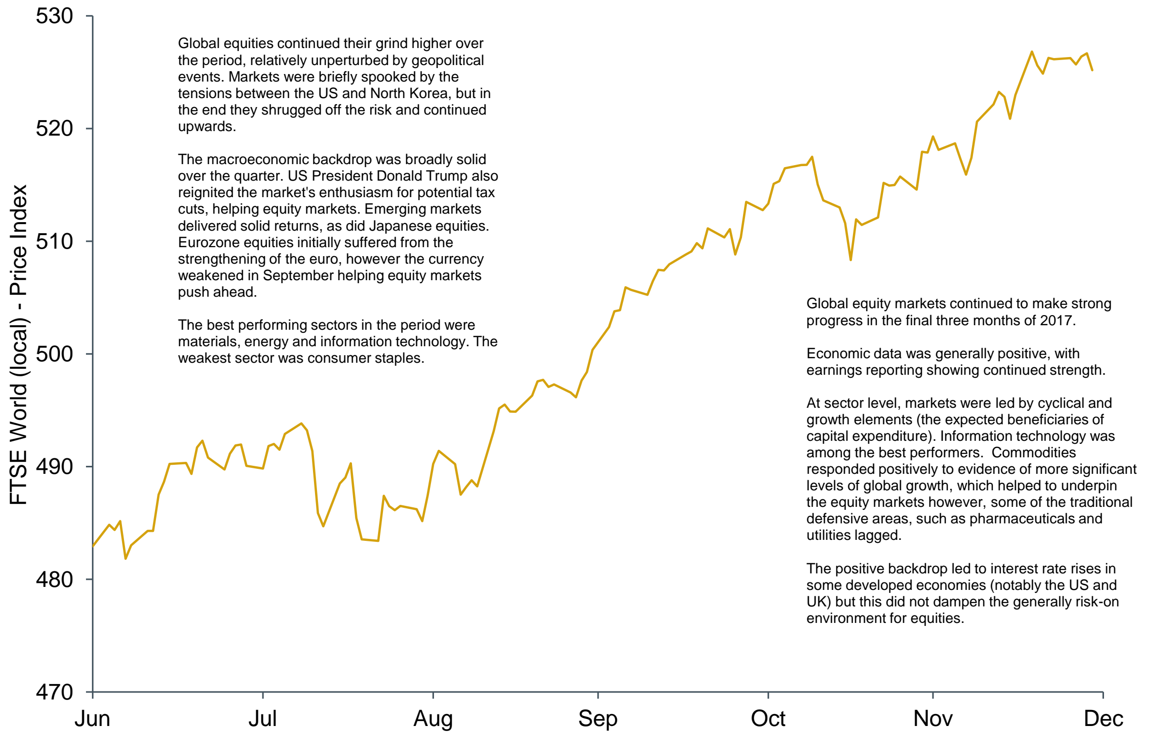
Key Market Movements

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

Global Equities (FTSE World Price Index)



Long Gilts (UK 30 year gilt)

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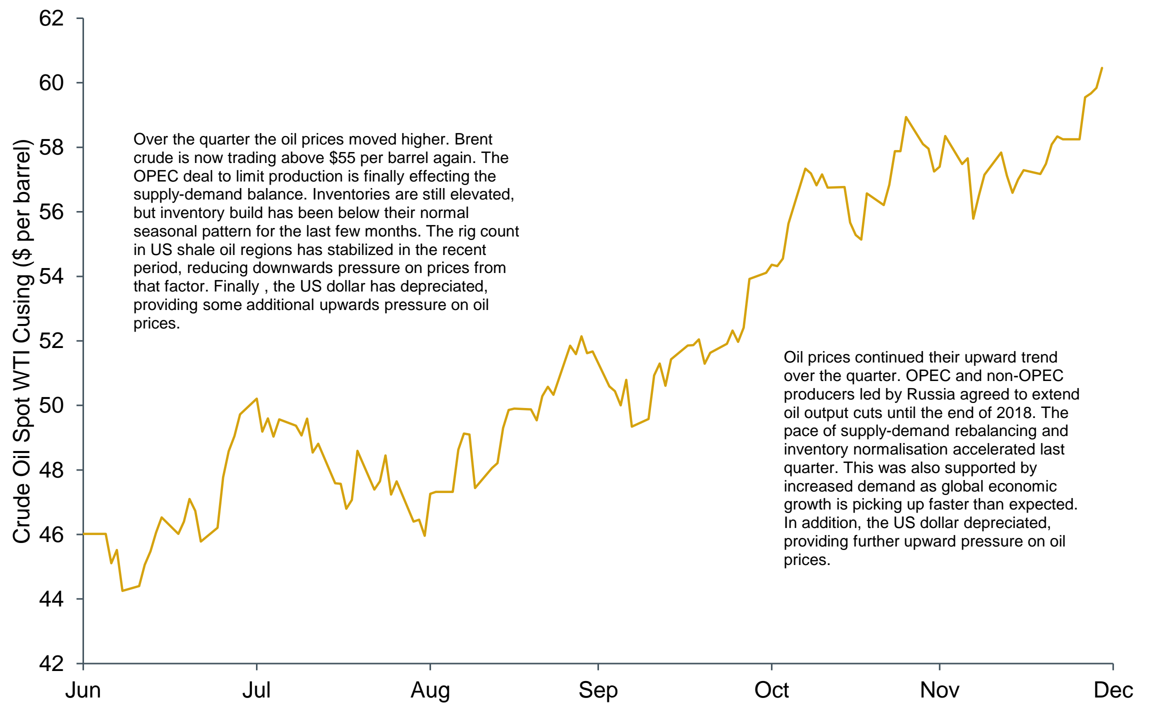
Oil Price (Crude Oil Spot WTI Cushing ($ per barrel))



UK Sterling (UK Sterling Trade Weighted Index)

Source: Datastream

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Quarterly Thought Piece

2017 was the first year since 2010 where global growth beat expectations

In 2017, economic activity has been broad-based and synchronised across both developed and emerging markets. Encouragingly, the composition of growth has been balanced. Domestic consumption was a key contributor with healthy employment and real disposable income along with lower savings. This was complemented by a boost in investment activity, something that has been lacking over the past few years (weak global productivity is a vivid reflection of this dynamic).

The positive momentum of global growth suggests a healthy 2018. However further positive surprises appear unlikely. Less activity in Asia, in particular China, is likely to exert downward pressure on growth. In Japan, GDP has been unsustainably high in recent quarters, at 1% above economic potential. We do expect growth in the eurozone will continue but the brisk pace of 2017 is unlikely to persist.

Overall, the macroeconomic environment remains positive, but the second half of 2017 might have been as good as it gets. Global growth is likely to be above 3% in 2018, but it has limited room to beat expectations.

Where will any surprises come from?

The upside surprise

A more forceful increase in investment is most likely. Since the global financial crisis, corporate capital expenditure has been subdued. A lack of confidence in the business sector along with plentiful 'cheap' labour has kept investments below pre-crisis levels. In light of increasing confidence, healthy profits and falling slack in employment, companies might finally gain the confidence to commit to investments. With readily available credit and elevated confidence, animal spirits might return to the corporate sector.

The downside surprise

The NAFTA negotiations are proving very challenging and could collapse. In 2016 there were US $2 trillion of trading flows between the US and Mexico-Canada, and China. A collapse of trading flows would be very negative for global growth, meaningfully increasing the risk of recession. This could also have an impact on the tax reforms in the US as legislators may not support the tax bill if negotiations breakdown.

The unknown

In recent years, monetary policy has been very predictable. The 'central bank put' has worked extraordinary well, providing support for risk markets and depressing volatility. As the economic cycle moves forward and financial stability considerations start playing a more meaningful role in central banks' decision-making, their reactions will become less predictable. In particular, the direction of the US Federal Reserve is uncertain. Although Yellen's replacement (Powell) represents 'continuity', with little slack in the employment market, likely higher inflation from the second quarter of 2018 and a better global environment, the removal of accommodation might take place at a faster pace than the market is expecting.

How would we position a typical global fixed income portfolio?

We prefer corporate over government bonds and therefore we have a bias towards credit.

Within corporates, given tight valuations, we are cautiously optimistic. In investment grade markets, we see most value in financials versus non-financials, especially in those banks and insurers with European exposure. In high yield we maintain a slightly below average allocation; we look for companies with very predictable cash flows, and we currently prefer BB and B-rated firms and have no exposure to CCCs. We remain very selective and as we move along the investment cycle and corporate fundamentals deteriorate, stock picking will become more prominent.

In government bonds we maintain a conservative approach. Our overall interest rate risk is towards the lower end of our historical range. We prefer the US versus Europe and the UK, and we see opportunities in inflation exposure (currently expressed in the US). Our yield curve position is neutral but in the medium term we maintain a flattening bias, especially in Europe.

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In emerging markets we have a light allocation as we do not think that, in broad terms, the asset class offers a compelling proposition. We are looking for idiosyncratic opportunities, with interest in alpha rather than beta propositions.

Juan Valenzuela
Investment Manager – Fixed Income

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