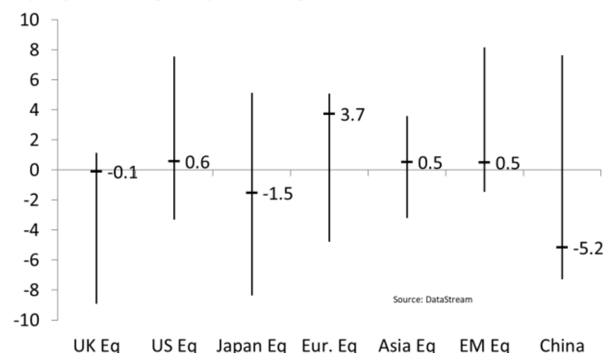
Market Backdrop

This note is intended to support discussion at the next 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 2017 to the close on 4th May 2018; the charts also show the range of performance over that period.

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



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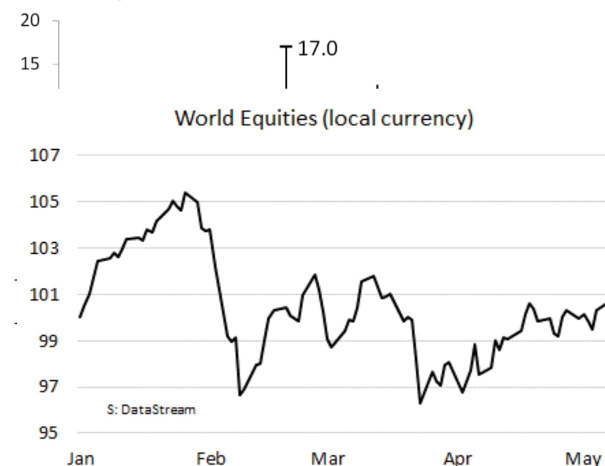
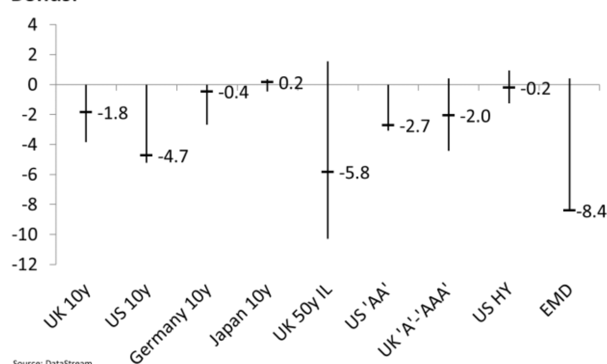


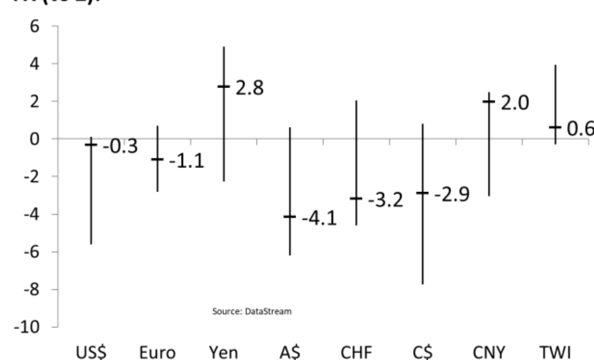
Year to date, equity markets appear to have made little progress. Except for Europe (higher) and China (lower), markets are broadly unchanged. The real story of the past five months is, however, better illustrated in evolution of global equities shown in the chart opposite. After a euphoric start to the year, markets fell sharply in February as trade war worries catalysed a bout of profit-taking in, what were generally sensed as, expensive equity markets. Although this blood-letting proved relatively short-lived, indices have yet to return to January's highs (in many cases, these were all-time highs). 2017 was noted for the complete absence of sharp market movements; 2018 has seen volatility return with a vengenace. During the period, some markets were particularly harshly treated, e.g. the UK's FT All Share index was almost 10% lower. The UK's problems are well-documented – Brexit, an aneamic economy and relatively high inflation – and this market finds it easy to lag behind others. Chinese markets have been hit by ongoing domestic credit tightening (intended to avoid a western style *Credit Crunch*) and fears about where Trump trade tariffs could lead.

Throughout the period, companies have managed to deliver earnings ahead of analyst forecasts – nowhere has this been more so than in the US, where Trump's tax cuts have generated an immediate boost. At the time of writing, this has been carried through into results released this quarter, although European results are showing signs of weakening as the Eurozone economy appears to have stalled.

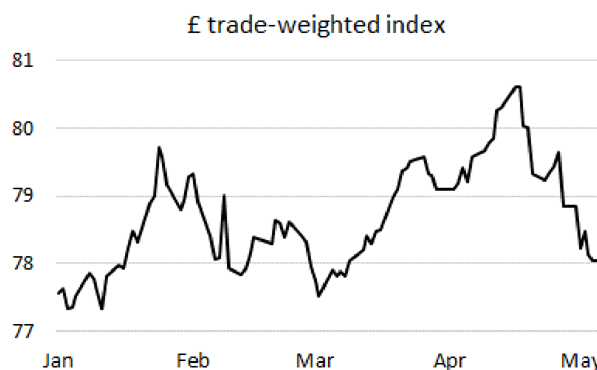
Selectively, commodity markets have performed better – a feature often seen at this stage of the economic cycle. The oil price has been particularly strong, helped by falling stocks and despite a sharp rise in the number of rigs operating in the US. Higher energy prices have boosted oil and gas company share prices and are only now beginning to emerge as a concern for the world economy (either through higher inflation or as a 'tax' on private sector consumption). Aluminium prices have been particularly volatile as Trump's Syria-related sanctions on Russian production have generated fears of shortages. Despite rising geo-political risk and worries over inflation, Gold has failed to perform.

Bond markets have moved lower although yields are generally off their highs (as inflation has failed to take off and despite ongoing tightening by the US Federal Reserve). The US bond market has seen the most severe back up (in yields) in developed economy markets while trade worries, extended positioning and, of late, a higher US$ have weighed heavily on emerging bond markets; 2018 has seen the worst start to emerging markets (EM) debt markets in fifteen years.





The Pound trade weighted index (TWI) ended the period 0.6% better, having been 4% better in mid-April. The sharp down-shift was powered by weaker inflation than expected, a slew of soft economic reports and concerns (around several factors including *Brexit)* voiced by The Bank of England's Mark Carney. Money markets had regarded a rate hike in May as certain. As those hopes evaporated, £ went lower.



Consensus Expectations – Economic Growth and Inflation

With the exception of the US and although forecasts have lifted, the outlook economic growth for 2018 is mostly for activity levels to weaken from the levels seen in 2017; growth in 2019 is projected to continue slowing. The UK is expected to underperform both the EZ and US. Nonetheless, these forecasts support ownership of growth assets.

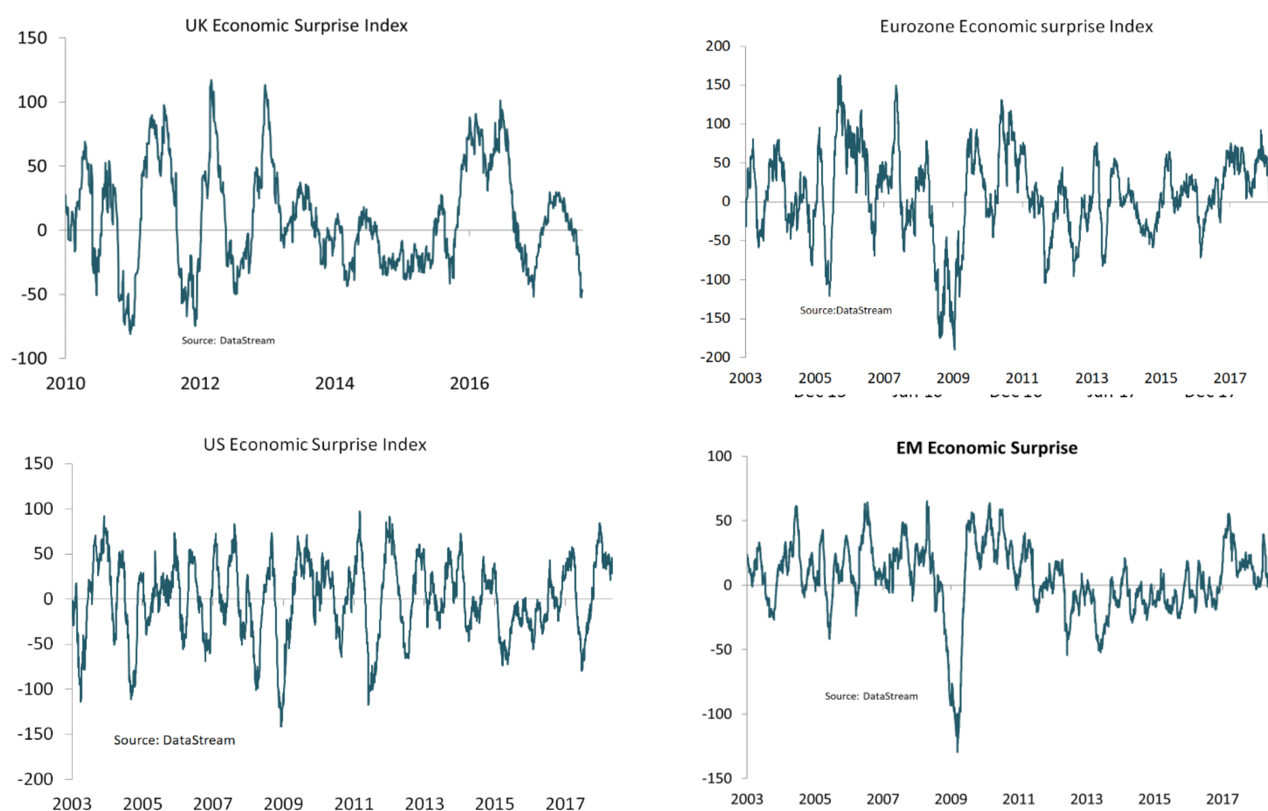
Table 1: Consensus forecasts – Real GDP growth (%)

	2017	2018	Change ytd	2019	Change ytd
US	2.3	2.8	+0.1	2.5	+0.2
Eurozone	2.4	2.3	+0.1	2.0	+0.1
UK	1.7	1.5	+0.1	1.5	-
Japan	1.7	1.3	-	1.0	-
China	6.9	6.5	-	6.3	-

The superior performance of the US is largely explained by the boost generated by President Trump's tax cuts. The US Federal Reserve has indicated it doesn't believe that a laxer fiscal stance will lift America's potential growth rate (currently judged to be 1.8%); growth is simply being brought forward.

In recent weeks, and as shown in the charts below, hard economic data and sentiment measures, across the globe, have sharply disappointed forecasts. In part, this can be explained by the heady optimism of forecasts around year-end, in part to adverse weather across Europe and in Japan, along with the uncertainty generated by trade actions on trade tariffs.

Inevitably, economists adjust their forecasts in response to recent data and so the economic releases should soon cease to disappoint. That said, the downside surprises have been most pronounced in the UK and Eurozone, and recovery is expected to be protracted. This is especially true in the UK where the growth pause, evident in very weak data in Q1 and a slew of adverse headlines surrounding 'the High Street', led the Bank of England to abandon its plan to raise base rates at their recent meeting. It has been weak European growth that has led to US$ strength in recent weeks.



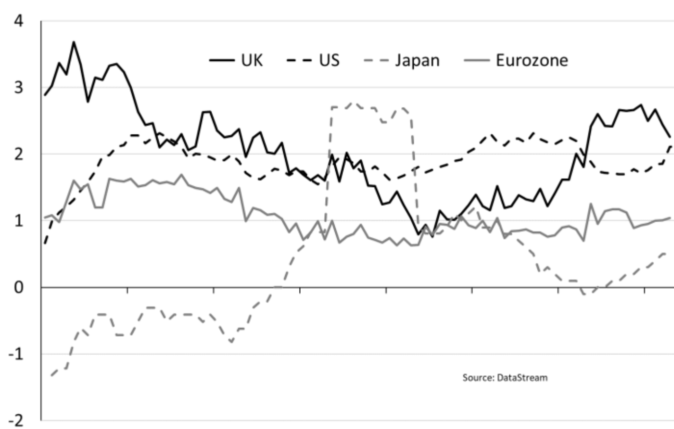
Inflation forecasts for 2018/19 have generally lifted in recent months (Table 2 overleaf). The main take-away remains that inflation rates will, this year and next, remain contained. Monetary policymakers are keen to exploit the better economic backdrop (moderate and, mostly, synchronised) to move away from near zero (or negative) interest rates. Unless higher oil prices (chart opposite) lead to faster price increases than is expected, some central banks may find themselves unable to raise their policy interest rate. This could prove to be a serious problem come the next recession.

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

	2017	2018	Change ytd	2019	Change ytd
US	1.5	1.9	0.2	2.1	0.1

Eurozone	1.1	1.5	0.1	1.5	-0.1
UK	1.6	2.5	-	2.1	-
Japan	0.0	1.0	0.2	1.0	-
China	2.1	2.3	-	2.3	0.1

After a period of stability, trends in core inflation rates in the major economies are changing (chart opposite). Inflation (excluding food and energy) in Japan and the US has increased; this has been particularly welcome in Japan. There is a consensus building across commentators that deflation in Japan has ended; having operated through several 'false dawns', the Bank of Japan is being more guarded. Price trends appear stable in Europe.



After lifting strongly following £ weakness in 2016/17, core inflation in the UK has started to ease (and faster than was expected). One benefit from this has been that wages in the UK have started to rise in real terms, though it will be many years before purchasing power is restored to pre-GFC levels. The general economic environment favours, all else equal, those UK companies which trade overseas.

In the UK, the latest data saw higher levels of headline retail and consumer price inflation maintained (Chart 1). Although most components of UK price data continue to see prices rising, Charts 1 and 2 indicate the pace by which price trends are rolling-over.

Chart 1: UK inflation rates (%, yoy)

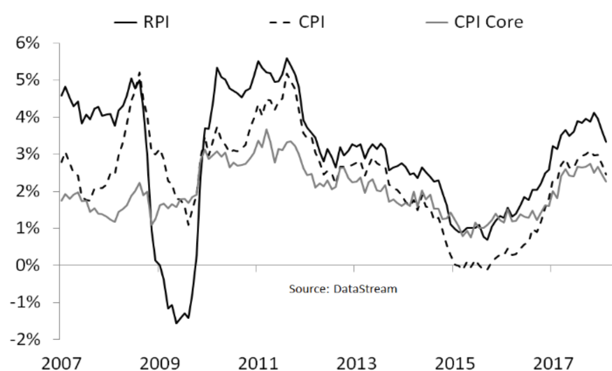
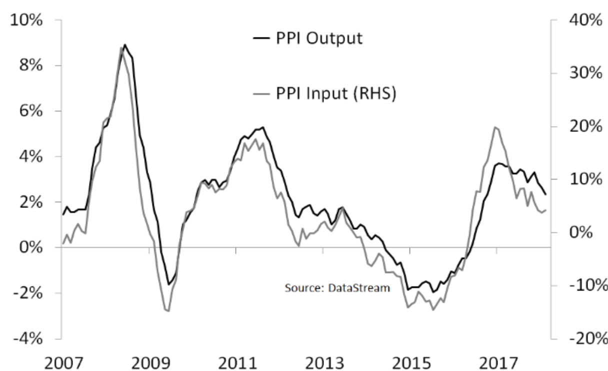
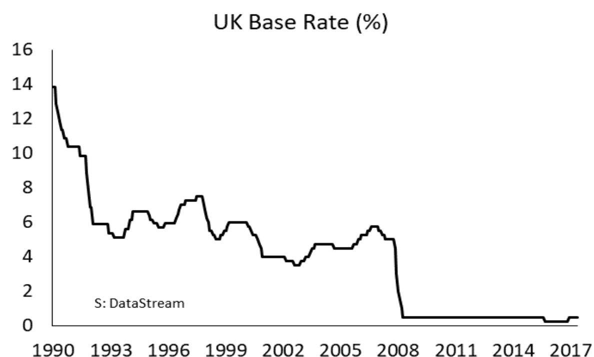


Chart 2: UK producer price growth (yoy)



Short and Long-Term Interest Rates

The current consensus forecasts for the main monetary policy settings are shown in Table R1 below; away from Japan, rates are perceived to be on the rise, albeit very slowly. Specifically, UK money markets currently only discount one hike in base rates in the remainder of 2018 and another in 2019. This is consistent with the weak growth and easing inflation outlook. At the turn of the decade, and more than twelve years since the *Credit Crunch,* official UK interest rates will still be exceptionally low relative to history (chart).



An adverse *Brexit* could easily see base rates flat-line at 0.5% or fall afresh.

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

	Latest	2018	2019
US Fed	1.63	2.40	3.00
ECB	-0.40	0.00	0.30
BoE	0.50	0.80	1.15
BoJ	-0.10	0.00	0.00

The US Fed validated market pricing by hiking rates in March (to between 1.5% and 1.75%). The market currently expects US policy rates to increase another three times this year. In the context of the past forty years, US interest rates are still low. Since, in real terms, the policy rate is still negative, US monetary policy remains accommodative, favouring growth assets (subject to price). FOMC members recently confirmed that they judge the neutral policy rate still to be 2.8% even allowing for the fiscal boost; monetary policy might be normalising, but this will be to a 'new' normal. Longer term, rates in the US are expected to hit their equilibrium level in 2019. This introduces the concept of a protracted pause at some stage and invites speculation as to the timing of the next down-turn (in policy rates).

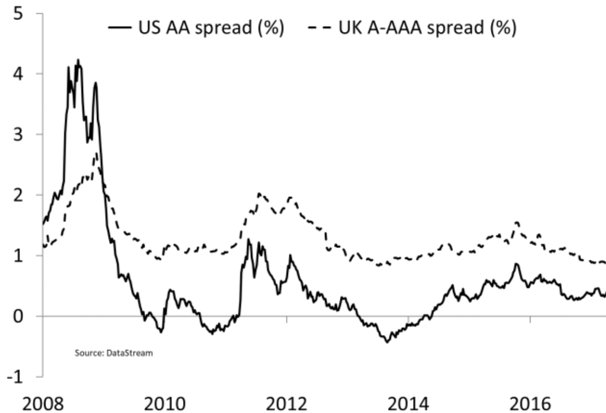
The outlook for longer dated nominal bond yields is shown in Table R2. US yields are expected to rise steadily into 2019, driven by higher policy rates and on sustained above-trend economic growth; higher US yields will drag other markets with them. Although nowhere will yields get 'high' (although at 3.5%, US yields would likely look attractive), US bonds are becoming more competitive relative to equities (Page 8).

Table R2: Consensus forecasts – ten-year bond yields at year end (%)

	Latest	2018	2019
US	3.0	3.2	3.5
Germany	0.6	0.9	1.4
UK	1.4	1.8	2.1
Japan	0.0	0.1	0.2

Non-Government Bonds

Investment grade (IG) bond yield spreads remain tight; buoyed by excellent corporate earnings reports (hinting to low levels of likely defaults) and despite higher bond yields (in the US). At current levels, yield spreads need to rise substantially to make them a compelling investment. That said, retail demand for IG bond funds has remained strong helped by ongoing asset purchases by the European Central Bank (as it implements QE).



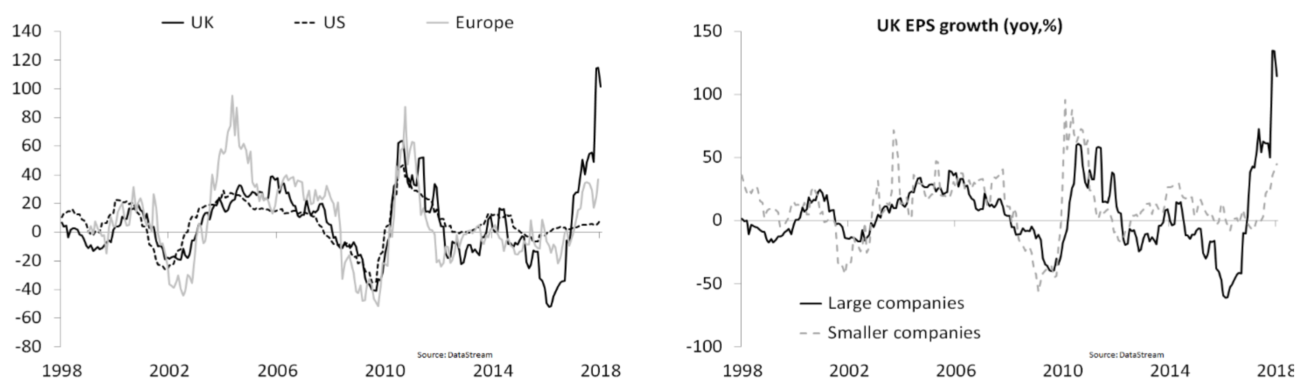
The same remains true of high yield bonds where the spread is around multi-year lows. Energy related credits represent a significant proportion of the HY market. The higher oil price has materially improved the outlook for these bonds, and invites the conclusion that whatever might define the next financial shock, it is unlikely to come from within the US credit markets.

Regardless of which EM debt index is followed, all performed well through 2017. After a strong start to the year, EMs (equities and bonds) have borne the brunt of the higher US$ and rising US bond yields. EM bond yield spreads look as they may have recently bottomed (at low levels). As is generally the case, EM economies face a raft of idiosyncratic influences. These include: Russia (US sanctions), Turkey (politics), Argentina (a full-blown crisis of confidence), Brazil (elections), and Mexico (the prospect of a left wing government).

Equities

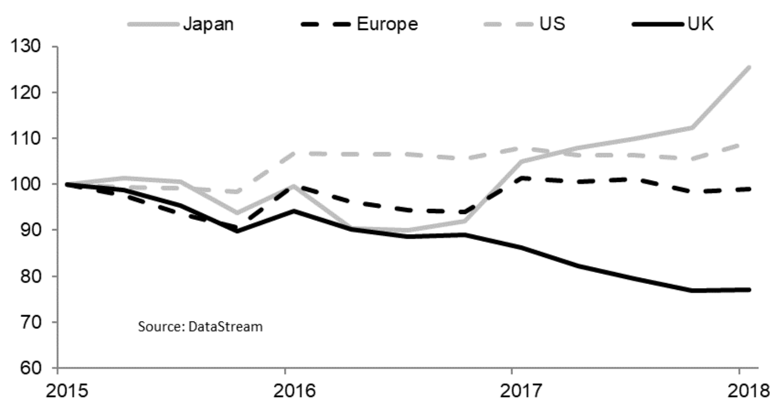
The chart (E1) below details how forecast earnings per share (EPS) for the UK, US, European and Japan equity markets have evolved over the past twenty years; they chime with the economic cycle. The fading, but significant, impact of £ weakness in 2016 on the earnings of the larger UK companies, made more dramatic by being off a low base, is clear to see. Note that U.S. corporate earnings will be boosted by tax reform (not yet fully apparent in the data).

Charts E1: Experienced earnings per share growth



EPS forecasts for the next financial year point to an improvement in Japan (where the recent earnings season has been very strong) and the US (tax boosted). Analysts appear reluctant to discount a strong follow through in Europe where the strength of the € is a concern. From current levels, the UK outlook remains poor.

Chart E2: Forecast earnings per share (next financial year, rebased to 100 in 2014)



Looking beyond the next financial year, equity analysts generally remain optimistic despite a modest markdown (Table 5); it should be remembered that analysts are rarely pessimistic.

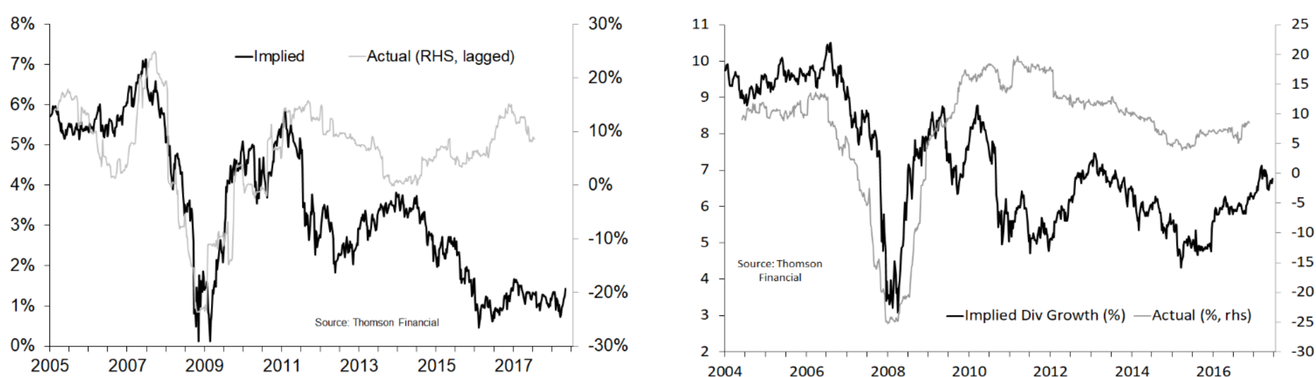
Table 5: Consensus EPS growth forecasts – second and third financial years with change from previous report (source: DataStream)

	UK	US	Japan	Europe
FY2	6% (-1%)	10% (u/c)	5% (-3%)	8% (u/c)
FY3	8% (u/c)	11% (u/c)	4% (-5%)	9% (+1%)

Equity Valuation

A preferred means of assessing the relative valuation of equities draws upon the level of dividend growth required to generate the same returns relative to the alternative of investing in bonds. In the UK market (Chart E3), the implied breakeven level of long-term dividend growth looks to be modest in absolute terms and against what has been delivered (low bond yields) help 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. In the US on the other hand, equities have seen the breakeven dividend growth continue to lift (Chart E4) to levels that are starting to look less like as a foregone conclusion; US bonds have become much more competitive in terms of risk/reward balance, especially with cash rates continuing to head higher.

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 UK FTSE 250 is determined in the same manner as the broader market. Here, and until recently, the path of actual dividend growth has been more consistent with the evolution of the breakeven rate (Chart E5). The hurdle for smaller companies to be competitive remains low and consistent with the modest economic growth outlook.

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

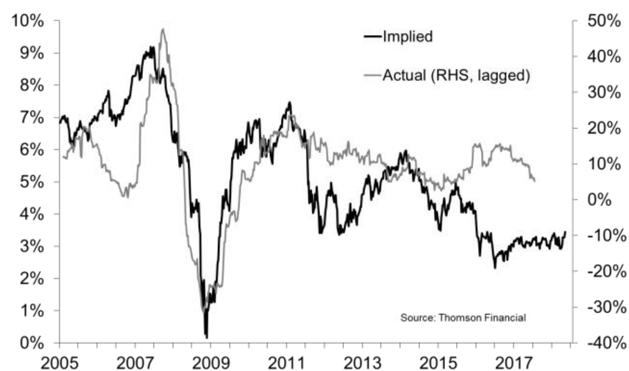
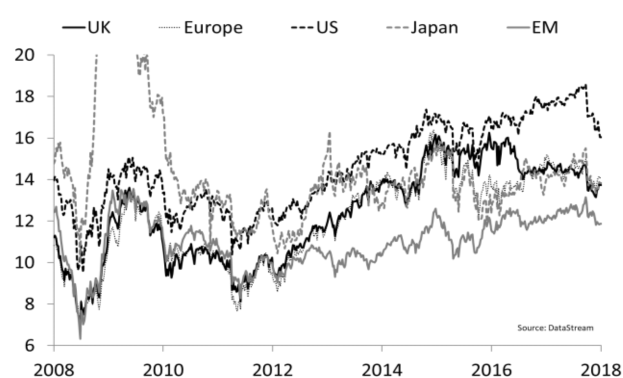


Chart E6: Regional PE ratios



Looking at PE ratios (Chart E6), valuations having risen over 2017 have corrected materially since early February. Equity valuations, on a PE basis, are less challenging than they were and have been further cheapened by strong earnings growth. In all cases the level of valuation is within historic ranges – albeit towards the upper end; the same cannot be said for (non-US) government or corporate bonds.

Regardless of how it is delivered, if the global economy continues to grow, then equity markets should rebound from the recent weakness to enjoy decent returns unless wage growth starts to eat into profit margins. Investor confidence has, however, taken a strong knock and will take time to recover.

Equity Style Update

Appetite to find clever ways of beating the equity market remains undiminished and so the pursuit of lower cost *smart betas* is still strong (and the cost of playing these themes via ETFs continues to fall). These are style filters no smarter than was the designation, thirty years ago, of *value* and *growth*. Chart S1 updates on the relative performance of four common global *smart betas*: quality, high dividend yield, momentum and minimum volatility[1] (risk). Yield ('Hi Div') and volatility have languished in recent months as investors favoured a growth perspective even after the recent correction. Momentum remains a prized theme.

Chart S2 captures the performance of small cap, growth and value themes. Gyrations in small cap (largely driven by weightings in the US), have reflected the markets' changing assessment of whether Trump will be able to deliver on his election promises; now delivered, small cap is outperforming. Strong appetite for growth stocks has been reflected in the relative poor performance of value stocks.

Chart S1: Performance of equity styles (vs MSCI)

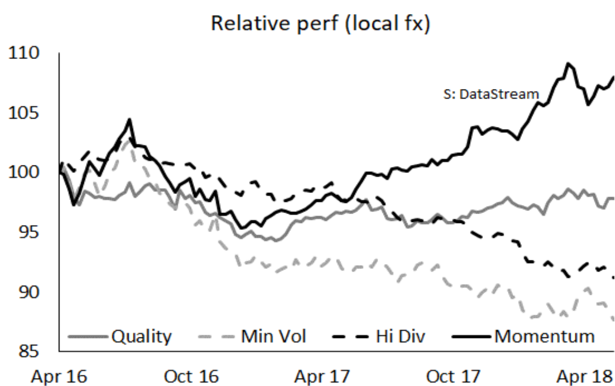
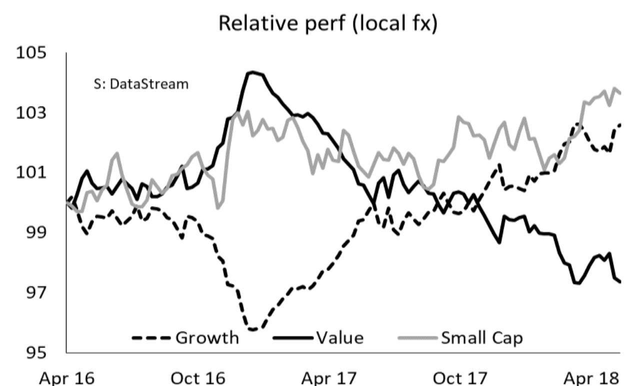
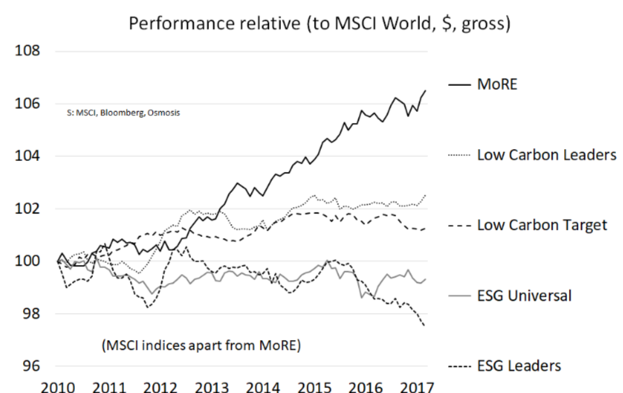


Chart S2: MSCI Growth vs Value relative



The strength of demand for growth and momentum plays together with rising bond yields, and has seen investors mark-down income as an investment theme in both the US and Europe. Nonetheless, the Fund may consider sustaining a strong weighting to equities, characterised by robust dividend yields and solid dividend growth. As we have recent seen, market conditions don't always stay supportive of 'risk'.

There are numerous ways of playing the sustainability theme. An example is one that favours those companies that are demonstrably better[2] at managing their water and energy inputs and waste outputs (MoRE). The next chart plots the relative performance of this portfolio (relative to the MSCI) alongside several other indices. Thus far, the more complete approach (water, waste and energy via MoRE) has delivered superior and more stable excess returns[3].



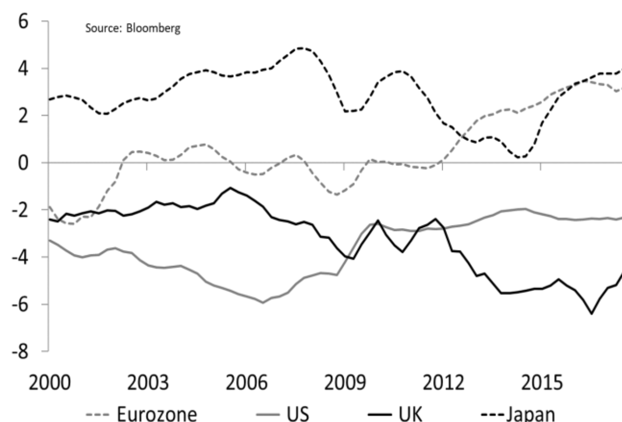
A resource efficient tilt to equities is an attractive alternative to a holding in a global equity passive index implemented, and superior to simply focusing on minimising a carbon footprint.

[1] In practice, this 'style' captures those stocks which tend to have high levels of free cashflow yields.
[2] As disclosed formally in their regular company reports. MoRE refers to Model of Resource Efficiency.
[3] Excess returns are perhaps to be expected. Companies which minimise their input and output costs (associated with waste, water and energy) are probably better managed companies.

Currency Markets

Recent currency swings have been driven less by overt policy manipulation and more by growth contrasts. In 2017, the € rose in line with unexpectedly strong levels of real economic growth, while the US economy initially lagged forecasts. The associated rebalancing has benefitted the world economy; however, this year the situation has swung into reverse: economic activity in Europe and Japan has ground to a halt (partly due to adverse weather – *the Beast from the East*). The US$ has bounced in recent weeks (Chart FX3). Another significant influence has been Trump's anti-free trade stance, which is beginning to generate concern around surplus currencies and EMs.

Consistent with the growth transfer is the operation of external deficits and lower surpluses; current account imbalances exert a strong influence on currency trends when other, more fleeting, drivers subside. Chart FX1 highlights the strong creditor nature of the Eurozone and Japanese economies, as well as the UK's need to attract international capital inflows to 'balance the books'.



It should be noted that the UK's substantial current account deficit has improved recently, but the deficit, as % of GDP, remains significant and financing it could prove challenging if global financial markets became much more cautious.

The UK has been able to attract international capital despite the relatively low yields on offer. Higher yields in the US could emerge to 'crowd' out the UK; if so, £ would need to weaken. That said, the US is set to operating substantial 'twin' deficits (fiscal and external), the scale of which could easily challenge the ability / willingness of the rest of the world to finance. All else equal, these deficits will put downward pressure on the US$, even allowing for the steady increase in US interest rates.

£ is still low (Chart FX2) but may languish around current levels given the *Brexit* overhang, the absence of fresh economic stimulus from fiscal policy, the relatively weak economic outlook (Table 1) and the recent 'pass' in base rates. Political developments in the UK have the potential to change the landscape for £ considerably and need to be watched.

Chart FX2: £ Trade-weighted Index

Chart FX3: US$ Trade-weighted Indices

Commentary

After a very benign 2017, volatility has returned to equity markets in 2018 and with a vengeance. After a very buoyant start – the best start to a year in decades –investor optimism (complacency) was challenged by slowing economic momentum(especially in Europe) and rising geopolitical risk (North Korea and the Middle East). While geopolitical tensions may be easing, at least in respect of North Korea, they are being replaced by concerns associated US President Trump's 'coming good' on his promises to re-write America's trade relationships with the World. While the rest of the World expresses concern, the latest polls suggest that Trump's popularity in the US remains solid; perhaps pre-disposed to doing his own thing, there seems no reason for him to temper his action. Trade-related angst looks set to persist.

Since January's peak in enthusiasm, markets have contrived to disappoint the bulls and frustrate the bears. Strong corporate earnings reports have been met with indifference as conviction has grown that the end of the cycle is in sight – according to a recent survey, over 70% of respondents now think the economy is "late cycle". In the recent Conference Board survey of US individual investors, a (small) majority now expect the stock market to be lower in a year's time.

While in this more cautious mode, markets have been looking for a new narrative. The strong synchronised global recovery, which enjoyed so many adherents earlier this year, has not materialised. Growth momentum has slowed everywhere but much more markedly outside the US. With employment and interest rates continuing to rise, the US economy continues to normalise. Although the US budget deficit is expected to rise this year, it is none the less striking that April saw the largest fiscal surplus on record. Such has been the transformation in the US energy industry over the last few years that the US is nearly self-sufficient in energy, and the recent rise in the oil price produces as many winners (including much of the high yield US bond market) as losers. The same, of course, is not true of advanced economies outside the US.

While not yet established, it is well worth considering whether the new market narrative, when it emerges, might involve the surprise return of the currency market as apex predator. The last financial crisis involved queues outside banks, the previous one a speculative collapse in stocks. It's been some years since the popular image of a Central Banker was an ashen faced functionary facing the media while the currency plunged, rather than a sober suited adult patiently addressing the excesses of the free market.

Were this to happen, retrospect would reveal it to have been hiding in plain sight. The cryptocurrency mania is well documented and much discussed. The habit of questioning the fundamental underpinnings of any currency is well established, as is the practice (and the means) of currency speculation.

Where does the thought experiment take us? One direction is an EM currency crisis with echoes of 1998. A number of EM currencies are already under pressure, the Turkish Lira, the Argentine Peso and, more recently, the Indonesian Rupiah. This time the big prize is the HK$ peg – with China the biggest EM of them all.

Another direction is that of a resurgent USD dominating the international economic and financial agenda as it did during the 1980s. In the event of an economic downturn outside the US, this would be reinforced by the political difficulties of implementing the next stage of QE –something which would be bitterly resisted by Germany. FX volatility has been very subdued recently, but 40-50% + moves in major currency crosses have happened many times in the past. In this scenario, managing exchange rates come to dominate international economic policy, as the Louvre and Plaza accords show.

Scott M Jamieson, May 2018

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