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Leicestershire County Council Pension Fund Q1 2018 – Market Report

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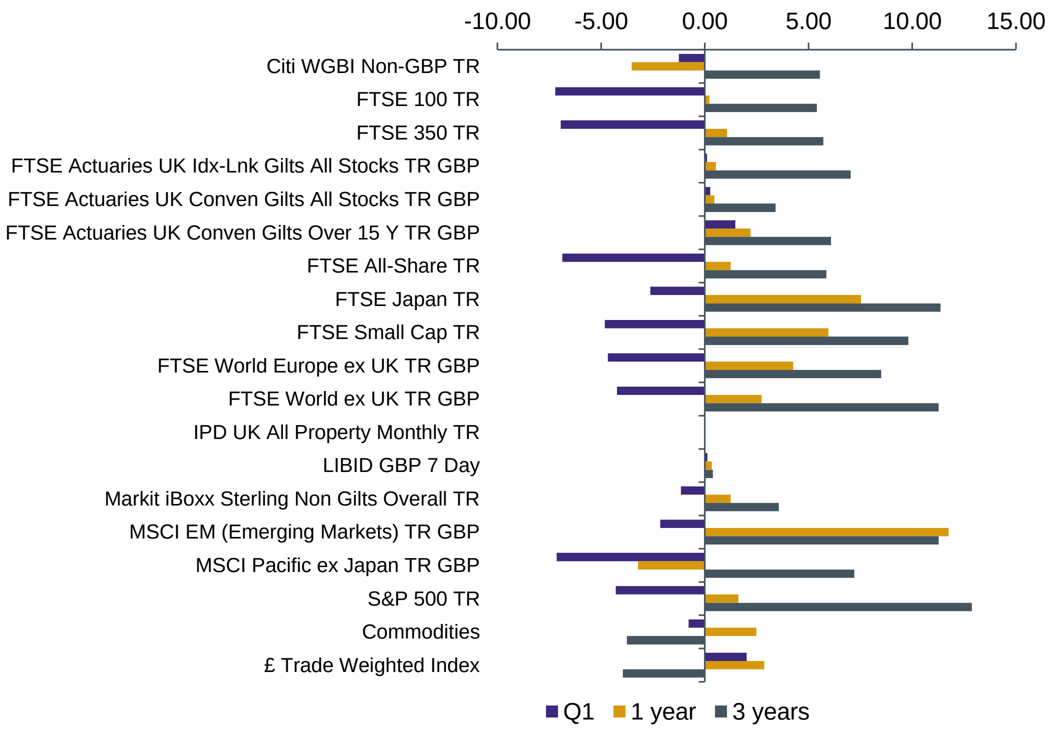
Historic Returns for World Markets

%	Q1	1 year	3 years
Citi WGBI Non-GBP TR	-1.25	-3.53	5.55
FTSE 100 TR	-7.21	0.22	5.40
FTSE 350 TR	-6.95	1.07	5.71
FTSE Actuaries UK I-L Gilts All Stocks TR GBP	0.10	0.53	7.03
FTSE Actuaries UK Conven Gilts All Stocks TR GBP	0.26	0.46	3.41
FTSE Actuaries UK Conven Gilts Over 15 Y TR GBP	1.47	2.21	6.09
FTSE All-Share TR	-6.87	1.25	5.86
FTSE Japan TR	-2.63	7.53	11.36
FTSE Small Cap TR	-4.82	5.95	9.81
FTSE World Europe ex UK TR GBP	-4.68	4.26	8.50
FTSE World ex UK TR GBP	-4.23	2.73	11.28
LIBID GBP 7 Day	0.12	0.34	0.38
Markit iBoxx Sterling Non Gilts Overall TR	-1.15	1.24	3.57
MSCI EM (Emerging Markets) TR GBP	-2.15	11.76	11.28
MSCI Pacific ex Japan TR GBP	-7.15	-3.23	7.20
S&P 500 TR	-4.30	1.61	12.88
Commodities	-0.79	2.49	-3.76
£ Trade Weighted Index	2.02	2.86	-3.96

	Q1	1 year	3 years
Euro	-1.24	2.50	6.61
Japanese Yen	2.14	-6.60	6.06
US Dollar	-3.57	-10.86	1.90



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

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Market Review

UK equities

The FTSE All Share bore the brunt of the equity market sell-off over the quarter. The index returned -6.87% in sterling terms. Large caps, as evidenced by the FTSE 100 returning -7.21%, led the fall. Overall though, the sell-off was broad-based, with small-cap stocks similarly feeling the pain.

Although UK economic growth was a notable point of weakness in the global economy, sterling strengthened as the Bank of England remained on its hiking trajectory. The Bank also upgraded its growth forecast for the economy. Despite the Bank's optimism, macroeconomic data in the UK was weaker, and we saw consumer confidence, retail sales and PMIs weaken over the period.

Some progress was made in the Brexit negotiations, with an initial agreement made on the transition period.

US equities

The US held up best in the market sell-off, with the S&P 500 delivering a return of -0.76%.

Macroeconomic data remained strong in the period, including a revision upward of GDP. Indeed, it was a stronger-than-expected US jobs report that sparked the global sell-off as the market began to price quicker-than-expected interest rate rises from the US Federal Reserve. The Fed did raise rates in the period, as expected.

President Donald Trump continued to immerse himself in geopolitics, sparking what looks to be the beginning on a trade war with China. The rhetoric, and action, escalated quickly over the period. If measures remain limited to what was already announced by the end of the quarter, then the fundamental impact on the US economy should be limited. However, a continued escalation of tensions could translate into broader implications for the US, and global, economy.

European equities

Europe was not immune to the market sell-off and the FTSE World Europe (ex-UK) index returned -3.42% in euro terms, or -4.68% in sterling terms.

Similar to the US, macroeconomic data was strong in the period. Some data points did soften, but remain at high absolute levels. Markets focused on the Italian elections over the period where the result was inconclusive, as expected. The elections did result in the Five Star Movement as the largest party, marking a contrast to other European elections where populism largely did not live up to the hype. Merkel also managed to form a government, forming a coalition with the SPD.

Japanese equities

Japanese equity markets, as measured by the FTSE Japan, returned -4.67% in yen terms.

The currency benefited from the flight-to-quality sparked by the market sell-off, and it continued to strengthen against major currencies. Economic data was reasonable over the quarter, but was softer than in other regions. Japanese markets were similarly influenced by the risk-off sentiment sparked by the jobs report in the US and the threat of a global trade war.

The region did benefit from an apparent softening of North Korean rhetoric. The elusive state surprised commentators with improved relations between itself and South Korea, as well as the West. A resolved area of uncertainty was the reappointment of Mr Kuroda as the Governor of the Bank of Japan – ensuring some continuity in the region.

Asia (ex-Japan) equities

The MSCI AC Asia Pacific (ex-Japan) index returned -4.10% for the quarter, joining global equity markets in the broad sell-off.

Markets saw a great deal of dispersion, in terms of performance, in the period. China, Thailand and Taiwan performed well, with solid macroeconomic data in the region. Indonesia dragged, as did the Philippines on deteriorating macroeconomic data and a weak currency.

The risk-off mood pervading markets served as a headwind for the region, as did the expectation of a tighter interest rate regime.

Property

The UK economy grew by 0.4% in Q4 2017, showing an ongoing trend of slower growth driven by subdued consumer spending and a squeeze on real household incomes. However, some positive progress has been made in negotiations over the UK's future trading relationship with the EU.

According to the IPD Monthly Index, the UK commercial property market delivered a strong quarterly total return of 2.3% in March 2018. This has produced an annualised total return of 11.3% over the 12 months to March, which is much stronger than anticipated by market commentators.

The property market continues to be underpinned by a robust occupational market, although ongoing signs of distress have been exhibited in the retail sector, with a number of high profile retailers proposing Company Voluntary Arrangements to their landlords.

The industrial sector in particular has continued to deliver exceptionally strong returns, with capital growth of 1.6% in the month of March alone.

Expectations for UK commercial property over the next few years are steady, if unspectacular. At the present time, the investment market remains strong, with a large weight of domestic and overseas capital targeting the sector and a limited number of investors seeking to liquidate their holdings. This can partly be explained by commercial property's attractive income return and an ongoing spread of circa 390 bps between property initial yields and 10-year gilts.

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Fixed Income

The first quarter of 2018 witnessed a marked increase in volatility across financial markets. Uncertainty about the general direction of G7 central bank policy, coupled with geopolitical concerns, were the main drivers of the challenging conditions for bond markets.

Initially, investors' positive view continued to strengthen, fuelled by growing optimism on the US economy aided by the Trump tax plan. From February onwards, however, an increase in protectionist trade policies from the White House led to a move away from the previous behaviour. The introduction of US tariffs, the deterioration of Russia's relationship with the UK, and the ever-present Brexit negotiations all weighed on market sentiment.

Government bonds outperform

Government bond markets came under pressure in January but recovered in the remainder of the quarter as the backdrop began to weaken. The FTSE UK Gilts All Stock index rose by 0.26% for the quarter, with long-dated bonds outperforming their short-dated counterparts. The UK indexed linked market also experienced a difficult start with the market falling over 2.5% in January before recovering. For the quarter as a whole the FTSE UK Index-Linked All stocks index was relatively unchanged.

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 as at end Dec 2017	1.19	2.41	0.43	0.05	1.56	2.01	4.07	0.67	1.91
Yield as at end March 2018	1.35	2.74	0.50	0.05	1.15	1.78	4.29	0.91	1.60
Change in yield	0.16	0.33	0.07	0.00	-0.41	-0.23	0.22	0.24	-0.31

Source: Bloomberg, at 31 March 2018

Corporate bonds under pressure

Corporate bonds underperformed government bonds over the quarter as investors turned more cautious from February onwards. The iBoxx GBP Non-Gilt index fell -1.17% over the period as a whole. A robust primary market saw a surplus of new issuance come to a market, with seemingly less appetite from investors to digest the additional supply. In sector terms bonds issued by financial companies underperformed non-financials. High yield and emerging market bonds also came under pressure given the overall cautious tone to markets. The Barclays Global High Yield (£) index fell -4.33%.

Political uncertainty in the US, the prospect of the ECB ending its quantitative easing programme (QE) and heavy supply have dented sentiment somewhat. To clarify, we expect the ECB to take note of the healthy levels of activity in the Eurozone and prepare the market for the removal of QE towards the end of the year.

Overall, though, we believe the global economic outlook remains benign. Global growth is robust, inflation is (in aggregate) moving higher, not lower, and central banks are on the path of normalising interest rate policy.

The main risk to our view is an escalation of the tension between the US and its trading partners, in particular China. While this outcome remains a possibility, it is not our central case. We believe the US stance is primarily a negotiating tactic.

Despite the volatility seen in government bond markets over the quarter, yield levels are relatively unchanged since the start of the year. While we expect government bond yields to rise further this year, the peak level will be lower than in previous cycles, given that government debt levels remain high. Within index-linked markets, valuations are compelling in the US in particular, given we expect inflation levels to increase.

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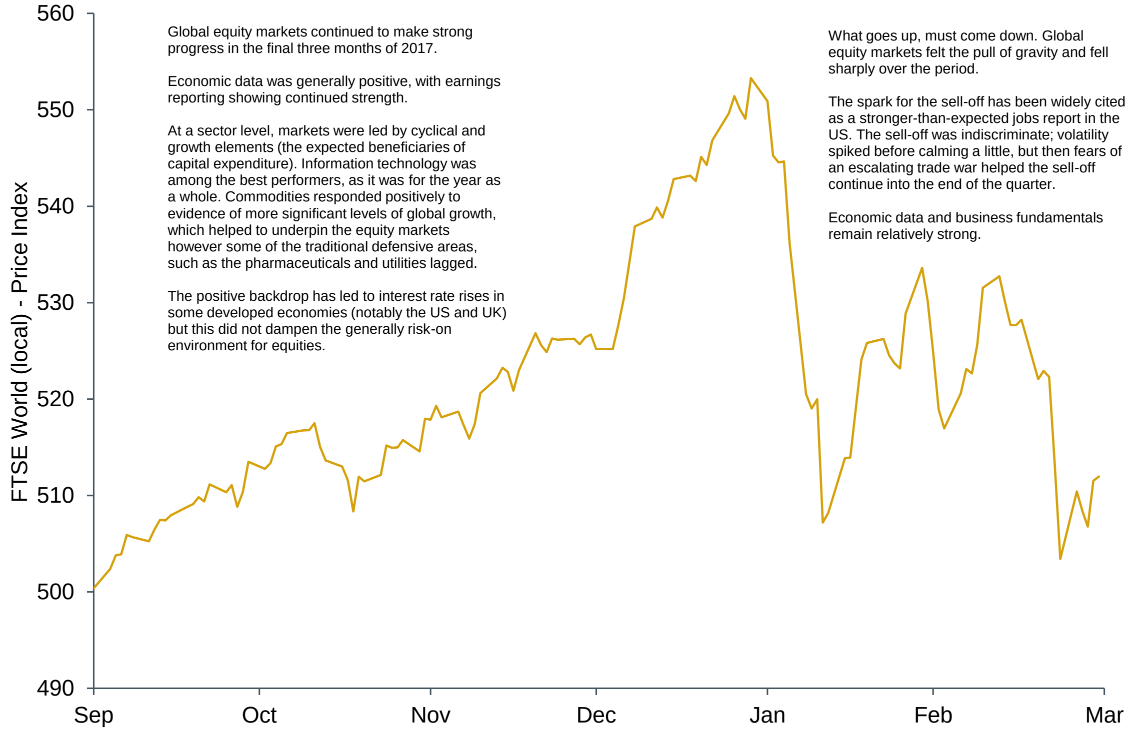
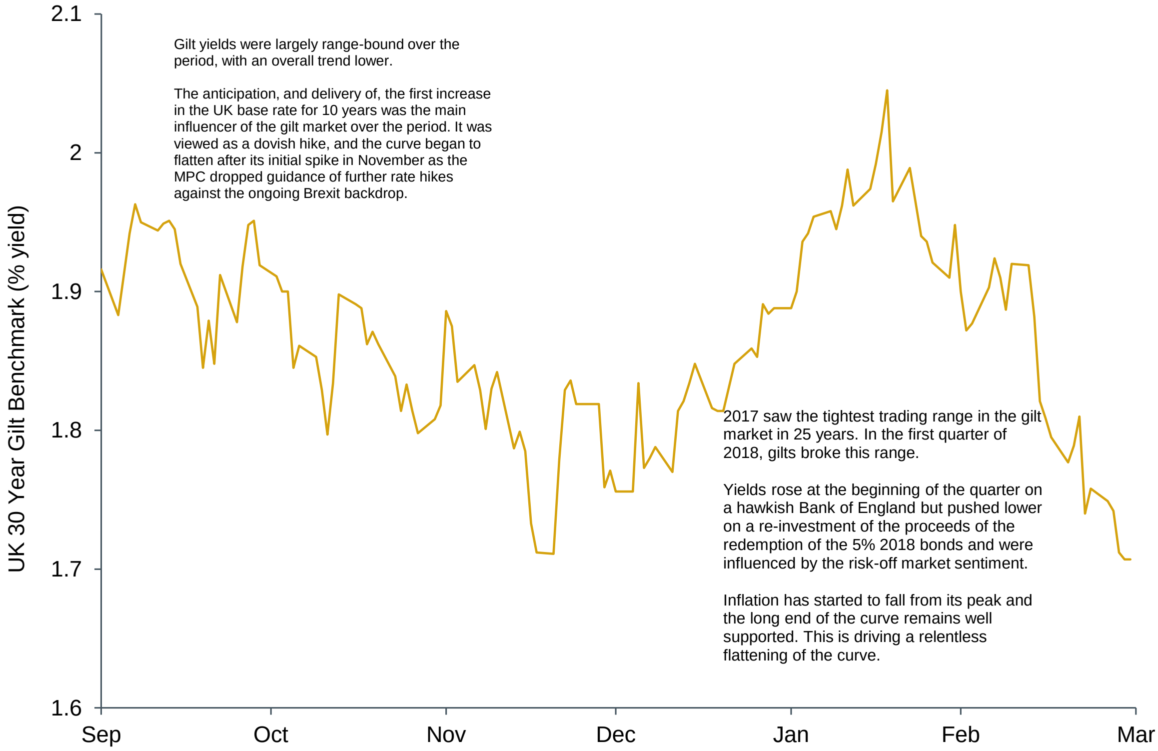
Key Market Movements

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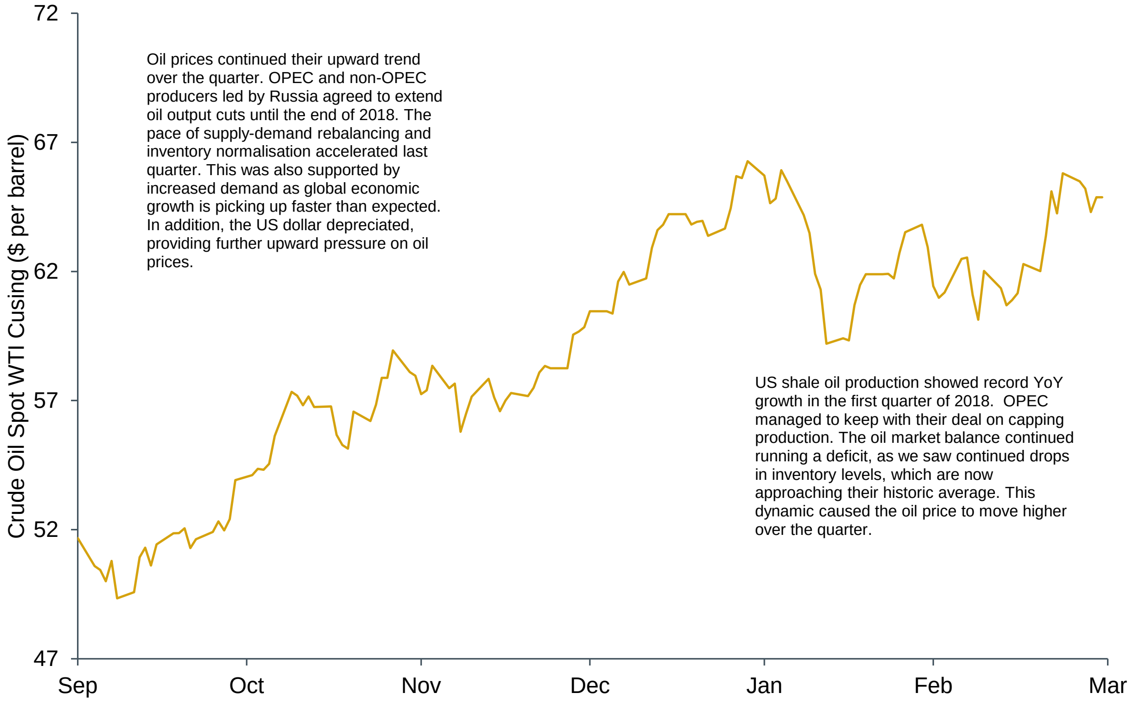
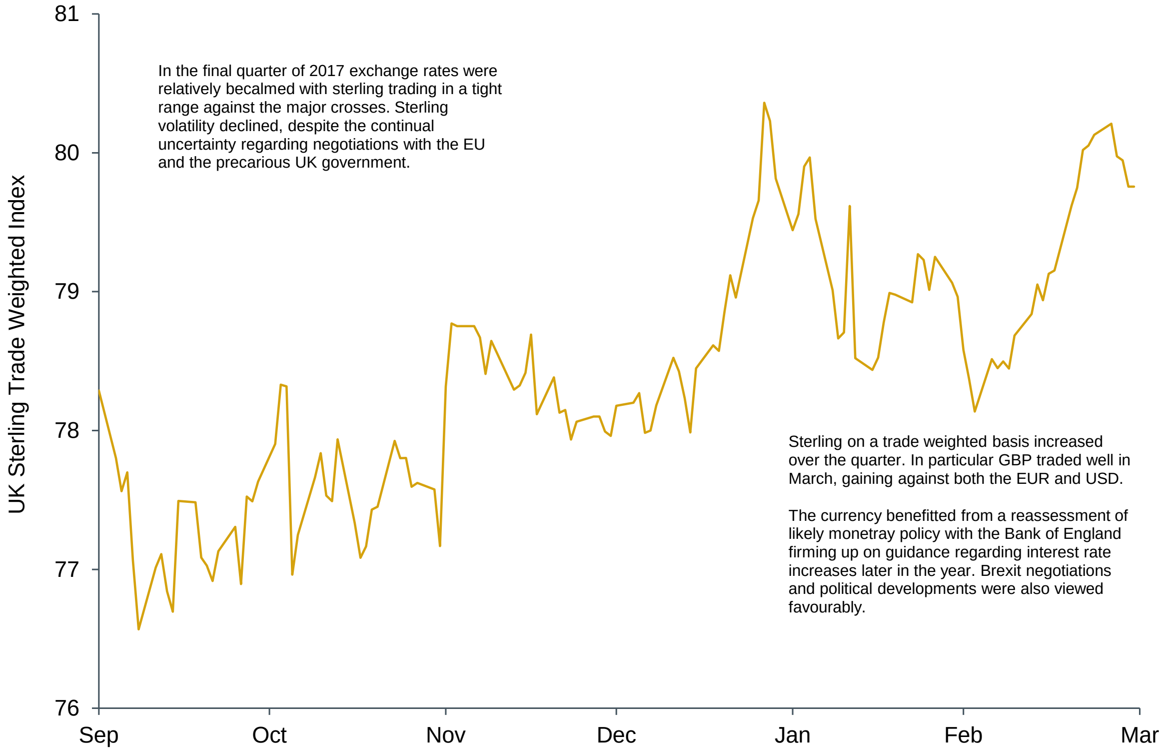
Oil Price (Crude Oil Spot WTI Cushing ($ per barrel))



UK Sterling (UK Sterling Trade Weighted Index)



Source: Datastream

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Quarterly Thought Piece - Trump's Tariffs

Those investors, keen to fret, had their sights set this year on the potentially damaging impact of tighter monetary policies in a relatively buoyant global economy. Might central banks feel compelled to get ahead of economic developments and act to slow growth? Legitimate as these worries are, the spectre now haunting risk markets is the prospect of a trade war between the US and the rest of the world as President Trump lives up to his promises and acts, by decree, to put America first.

The IMF has been quick to highlight that US trade tariffs threaten the economic prospects not just of those countries outside the US but also the US itself. Trump should remember that after George W Bush hiked steel tariffs in 2002 the number of employed Americans fell and some 200,000 American jobs were lost for reasons directly attributable to the period those tariffs were in place.

One of the problems in any conflict is that it invariably takes on a life of its own and will evolve unexpectedly. Retaliation from those countries initially impacted is almost certain but this often broadens out the dispute by targeting sectors in which the US is dominant (i.e. not the steel industry), or by deliberately favouring those nations with which America competes. Another unexpected consequence could be a rise in foreign ownership of US production as international players buy up capacity in the US (this happened in the 1980s after quotas were placed on Japanese car imports).

Protectionism can also sustain inefficiencies and hinder development. In a deal described by a US official as "visionary and innovative", the US and South Korea last week swiftly concluded the renegotiation of their bi-lateral trade arrangements with Korea agreeing to soften its safety and emission standards on 50,000 US-made cars each year.

Thankfully, it currently looks as though a full-scale trade war is unlikely. Trump's operating model is to shout loud and then row back on implementation. This is already happening quietly with exemptions around steel and aluminium tariffs, where NAFTA members are exempt, and where there is scope for a delay in implementation with the EU. Given that Korea currently only imports 11,000 US cars per year, the inference is that Trump can be cheaply bought off.

The situation may be tougher with China, and specifically in dealing with US intellectual property. It is to be hoped that the past pattern of Trump's behaviour wins out. If so, then equity investors may be near their peak in trade war angst. This presumes, however, that China and others will continue to be measured in how they respond to Trump's opening salvos. A darker prognosis would see the current spat as the opening gambit of a long drawn-out tussle between the US and China for global dominance; Trump's re-opening of Taiwan to US trips by US officials directly challenges Beijing's One-China policy.

Finally, it is worth remembering that none of this would be happening if the global recovery from the dark days of 2008/09 had been enjoyed by more people and widening inequality avoided. As Ben Bernanke guided fifteen years ago, protectionism via tariffs or through deliberate currency debasement should, as an attempt to arrest a decline in living standards, be tried only after everything else has failed. Trump's policy platform plays to a sizeable portion of the US population who feel that, for them, the Great Financial Crisis has yet to end.

Stephen Jones

Chief Investment Officer

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