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Leicestershire County Council Pension Fund Q2 2018 – Market Report

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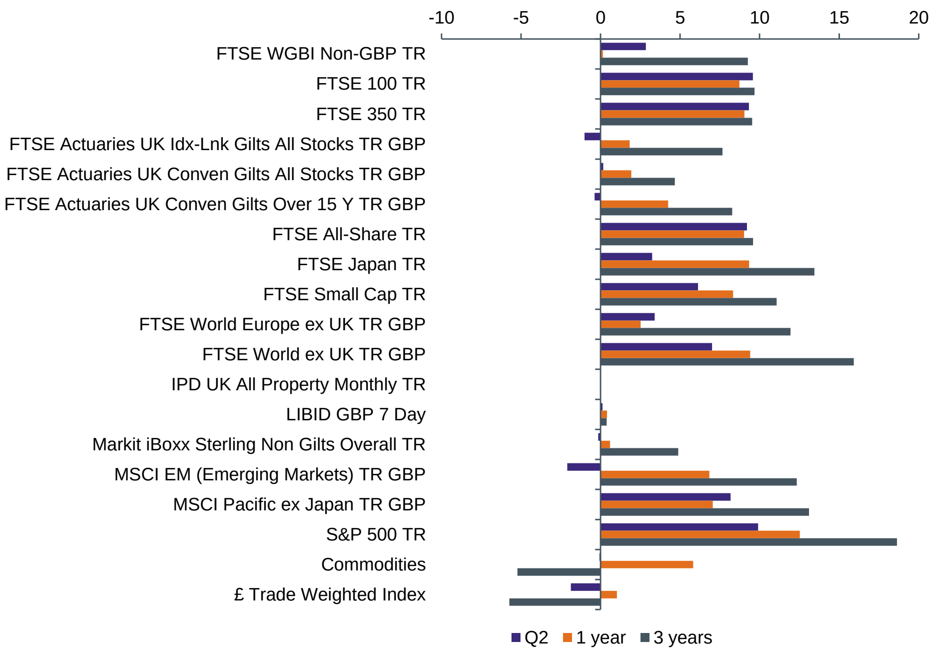
Historic Returns for World Markets

	Q2 (%)	1 year (%)	3 years (%)
FTSE WGBI Non-GBP TR	2.85	0.14	9.26
FTSE 100 TR	9.58	8.73	9.67
FTSE 350 TR	9.32	9.05	9.53
FTSE Actuaries UK Idx-Lnk Gilts All Stocks TR GBP	-1.00	1.83	7.66
FTSE Actuaries UK Conven Gilts All Stocks TR GBP	0.16	1.93	4.67
FTSE Actuaries UK Conven Gilts Over 15 Y TR GBP	-0.37	4.24	8.28
FTSE All-Share TR	9.20	9.02	9.58
FTSE Japan TR	3.24	9.34	13.44
FTSE Small Cap TR	6.13	8.33	11.07
FTSE World Europe ex UK TR GBP	3.40	2.52	11.94
FTSE World ex UK TR GBP	7.00	9.41	15.92
LIBID GBP 7 Day	0.12	0.40	0.38
Markit iBoxx Sterling Non Gilts Overall TR	-0.15	0.60	4.88
MSCI EM (Emerging Markets) TR GBP	-2.09	6.84	12.34
MSCI Pacific ex Japan TR GBP	8.18	7.06	13.11
S&P 500 TR	9.90	12.53	18.63
Commodities	-0.07	5.82	-5.23
£ Trade Weighted Index	-1.87	1.03	-5.73

	Q2 (%)	1 year (%)	3 years (%)
Euro	0.87	0.72	7.67
Japanese Yen	2.02	-0.20	9.58
US Dollar	6.25	-1.61	6.00



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

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Market Review

UK equities

The FTSE All-Share increased by 9.20% in the second quarter of 2018, with the FTSE 100 outperforming its small-cap counterpart.

The UK equity market bounced back strongly in the second quarter led by large cap names and oil & gas producers in particular. In economic terms, conditions in the UK reflect a Brexit overhang with confidence impacted by the problems in traditional retailing. Over the quarter, however, the strength in UK equities occurred despite weakening domestic economic growth and reflected strong exposure to the oil & gas and basic materials sector, and the importance of dollar earnings. The Bank of England did not deliver a May rate hike, which had been expected, and this benefited those companies (predominantly large-cap) that generate earnings overseas, given sterling weakened.

While the overall picture for the quarter was one of robust returns across most sectors, there were periods of volatility. This was particularly the case towards the end of the period when concerns over escalating trade tariff rhetoric (and action) raised investors' concerns, which resulted in some weakness within financial sectors as well as other areas.

US equities

In the second quarter of 2018, the S&P 500 index increased by 9.90% in sterling terms (3.43% in dollars).

The US continues to benefit from buoyant corporate confidence and fiscal easing; cuts in income tax as well as corporation tax has helped to boost growth. Although monetary policy continues to tighten in the US (the Fed expects to make two more hikes this year), it remains accommodative. While corporate earnings boosted markets the positive backdrop was kept in check somewhat by concerns over rising trade tensions between the US and its trading partners (principally China) and the rising oil price.

In sector terms, technology continued to perform strongly, alongside energy and commodity-related areas in general. Traditionally defensive sectors such as utilities also did well. Financials, and banks in particular, were more subdued in comparison to many other areas.

European equities

The FTSE World Europe ex UK index was up 3.40% in sterling terms over the second quarter of 2018. Compared to other core markets, the eurozone was relatively subdued although it continued to show steady growth. As with other core regions, commodity-related sectors performed well, given the rise in oil prices and the general lack of concern about inflation.

A key development over the period came from the ECB, which announced the timetable for the end of its QE program (by year-end) but also that official interest rates would remain on hold for at least another 12 months.

Political developments were also to the fore, with concerns over Italy's future relationship with the euro block, given the difficulties the country had faced in forming a new government (a coalition government was eventually formed). Italian banks came under particular pressure, with the broader banks sector proving to be one of the poorest performers over the period.

Ongoing trade tariffs activity, inspired by President Trump's 'America First' policies, were also a key feature, with trade concerns intensifying towards the end of the quarter. The autos sector suffered as a result, given the potential for tariffs in this area of the market. In contrast, the technology sector continued to advance and, along with energy, was one of the best performers overall.

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Japanese equities

The FTSE Japan finished the second quarter up 3.24% in sterling terms (1.20% in yen). As with other markets an escalation of trade tariffs and currency moves, combined to limit the progress of Japanese equities over the period.

The impact of global trade tensions was clearly seen in the performance of sectors that rely heavily on exports; the autos sector for example was one of the worst performers over the quarter alongside the industrial and technology hardware sectors.

Domestically, the Japanese economy remains in relatively good shape with corporate earnings generally robust. Over the quarter, however, weaker economic data was disappointing (GDP for the first quarter fell, quarter-on-quarter, and consumer confidence was also lower).

Asia (ex-Japan) equities

The MSCI Asia Pacific ex Japan index increased by 8.18% in the second quarter of 2018.

The region was hit not only by geopolitical concerns in the shape of the ongoing trade tariffs but also from the strength seen in the US dollar. Both of these developments limited the region's ability to keep up with robust rally seen in global equities.

Australia was among the strongest performers, buoyed by the rally in commodity prices, while global trade uncertainty hampered the progress of both South Korea, Thailand and Taiwan. Malaysia struggled due to domestic political volatility. Meanwhile China found support in accommodative policies from its Central Bank, but it was clear that domestic growth was slowing while the uncertain geopolitical landscape also led to a weak ending to the quarter.

In sector terms, materials and energy were among the strongest areas, while traditional defensive areas such as utilities also performed well. Technology finished in positive territory but did not show the strength seen in other western developed markets. The banks sector posted a negative return, given the concerns around interest rates.

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Fixed Income

The second quarter saw a continuation of the trends seen earlier in the year, with heightened risk aversion dominating markets. A combination of factors influenced markets, including an escalation in trade tariffs prompted by President Trump's protectionist policies. These policies led to growing fears over the impact any retaliatory action would have on global economic activity.

At the same time, the US Federal Reserve maintained its rhetoric on interest rate which pointed to more hikes to come. In Europe, the new coalition government in Italy was generally not taken well by investors which again led to 'risk-off' behaviour. Economic data in Europe continued to show a distinct lack of inflation.

Government bonds mixed

As the table below highlights, the performance of government bond markets were mixed, with 10-year US Treasury yields rising while in the UK, Germany and Japan, 10-year yields fell.

During the period US 10-year yields briefly surpassed the 3% before falling back slightly, while Italian government bonds rose sharply, given the political developments in the country. The FTSE UK Gilts All Stock index returned 0.16% for the quarter, with long-dated bonds outperforming their short-dated counterparts. Index-linked assets generally performed well, particularly in the US although the UK Index-Linked sector was more subdued with the FTSE UK Index-Linked market returning -1.16%.

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 March 2018	1.35	2.74	0.50	0.05	1.15	1.78	4.29	0.91	1.60
Yield as at end June 2018	1.28	2.86	0.30	0.04	1.32	2.67	3.93	0.81	1.78
Change in yield	-0.07	0.12	-0.20	-0.01	0.17	0.89	-0.36	-0.10	0.18

Source: Bloomberg, as at 30 June 2018

Corporate Bonds under pressure

Investment grade corporate bond markets came under pressure over the quarter, given the generally risk-off tone to markets. The iBoxx GBP Non-Gilt index fell -0.15% as corporate bonds struggled. The corporate bond market also had to contend with a significant level of new issuance which had a meaningful impact on market prices. In sector terms bonds issued by financial companies were hampered by the risk aversion mentioned above.

The high yield sector was a stronger performer in relative terms with the US high yield market outperforming its European counterpart. The Barclays Global High Yield (£) index returned 3.94% over the quarter.

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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 June 2018.

Global Equities (FTSE World Price Index)

Long Gilts (UK 30 year gilt)

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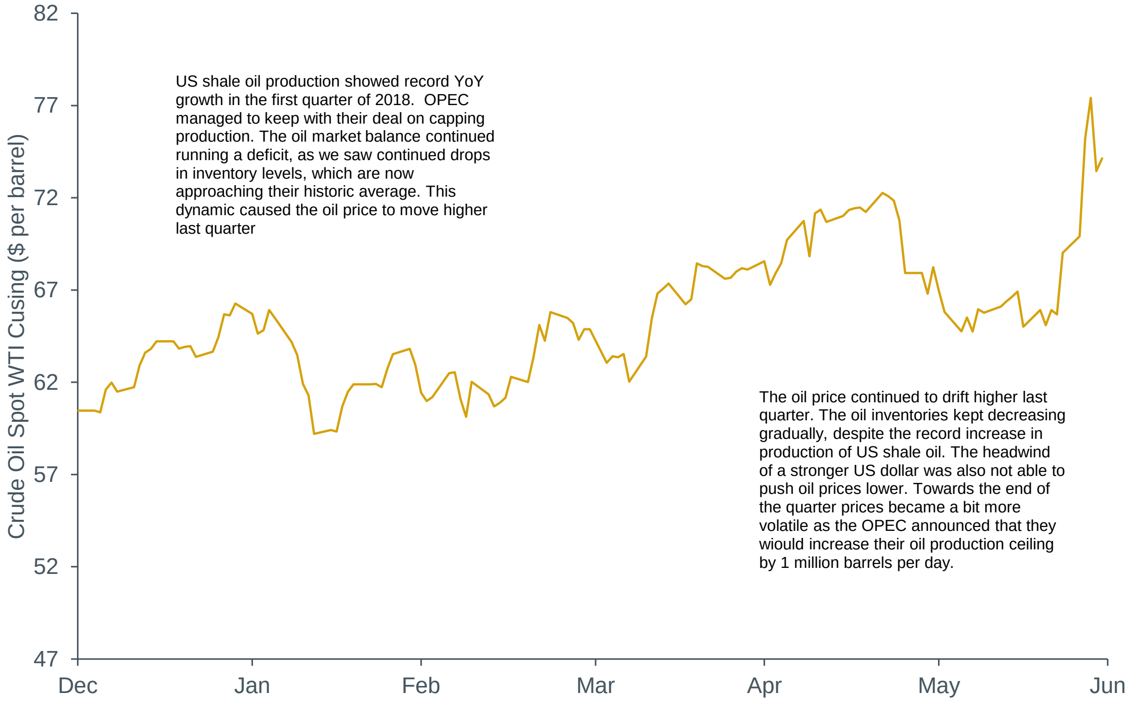
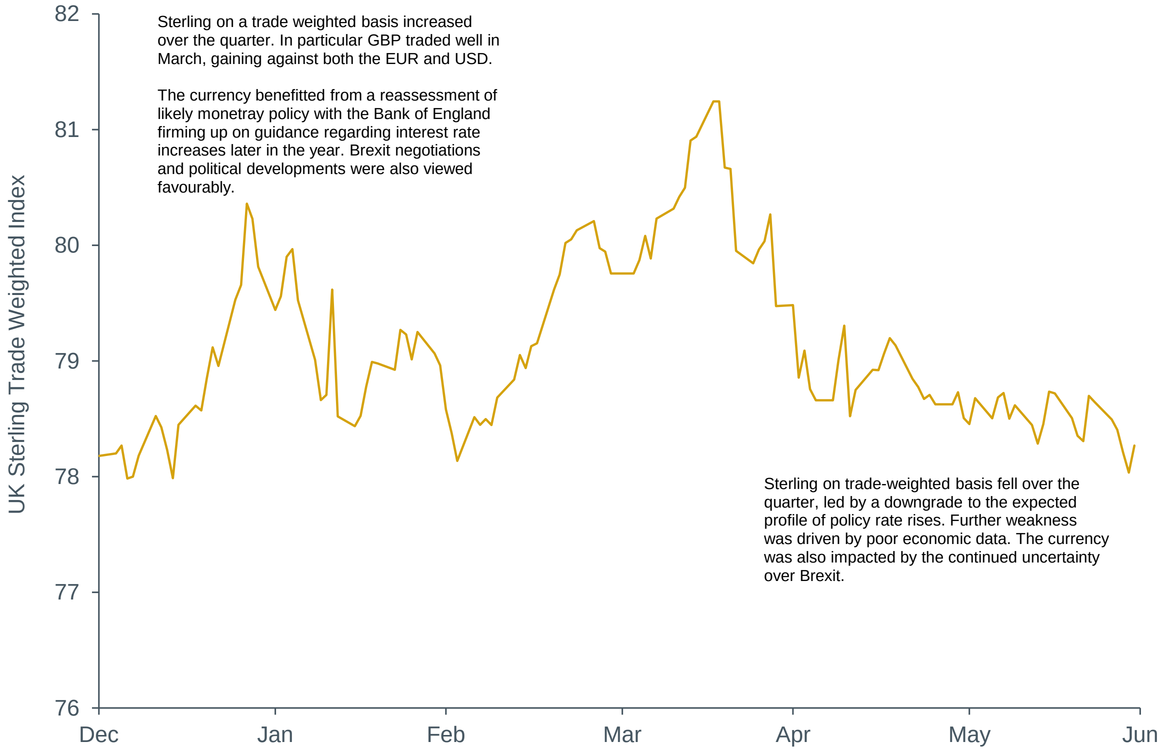
Oil Price (Crude Oil Spot WTI Cushing ($ per barrel))



UK Sterling (UK Sterling Trade Weighted Index)



Source: Datastream

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Quarterly Thought Piece – Brexit 2 years on

Many feared that a vote for Brexit would destabilise asset markets and lead to sustained sharp falls generally. In reality, the bigger threat from the UK referendum lay in the potential for similar polls elsewhere in the Eurozone. In the immediate aftermath of the vote it quickly became clear that copy-cat polls were not going to happen and investors quickly recovered their composure. Optimism for a stable and prosperous future further improved in 2017 after France opted not to elect Marine Le Pen and, therefore, not to challenge the EU.

More recently, however, with the populist movement in Italy once again calling the Eurozone into question, we are seeing those threats coming to the fore. Two years may seem like a lifetime in financial markets but, in the broad sweep of history, it is but the blink of an eye.

Brexit is no different from any other potentially significant market development; investors need to evaluate the risks and opportunities, what is discounted and what portfolio adjustments are necessary to skew outcomes in their favour.

Ahead of the EU referendum we adjusted our client portfolios, lifting sterling hedges. We judged that markets were failing to accurately price all the outcomes; investors were convinced of a ‘stay’ vote when all the available real-world information suggested that the result was too close to call. These hedges were later reinstated having preserved considerable value. Active management places upon us the responsibility for taking significant active decisions which we do not shirk from.

Currently, Brexit is negatively influencing UK markets. Everyone is aware that change is coming − in what form no one knows. Uncertainty is rarely a positive. According to survey data, UK equities are the most contrarian, unloved asset class available. The negative economic impacts of Brexit are the most obvious cause of investor aversion to UK equities. There is also the significant fear that a messy EU divorce could lead to an extreme Labour government. In Italy, Five Star and Lega promise an administration that would challenge everything that has gone before. In the UK, the prospect of radical change is every bit as real under Jeremy Corbyn. Given the UK’s large external deficit, if global financiers went on a ‘buyers strike’ (of UK assets), the upheaval could be immense.

In our asset allocation, we are underweight UK government bonds. We see scope for modest positive surprises on the UK economy, should Brexit concerns diminish. But at the other extreme, we judge that the ultra-low yield levels offer very poor value in an international context. We are, however, fully weighted in UK equities. We recognise that UK-listed companies are a better play on the global economic conditions, especially commodities, than they are on the UK domestic economy. We sense that global investors are also being too ‘broad brush’ in avoiding domestically-exposed UK stocks and we are selectively exploiting industry trends and the return of positive real wage growth. For example, we currently favour elements of the building materials sector (there is cross-party support for building more houses) and food retailers (where earnings are starting to recover). At the same time we are avoiding the likes of traditional non-food retailers and utilities (on Corbyn and Labour government risk).

Returning to the current situation in Italy, whether you take the hard-line view that Italy’s problems are of its own making and it should get on with solving them, or that the rigid structure of Eurozone condemns peripheral Europe to underachievement, surely few can argue that change is needed if the Eurozone is to break free from regular existential threats. Sadly, with positions seemingly polarised and entrenched, pragmatism may be in short supply. Undoubtedly, 2017 was characterised by unprecedented market calm. It may yet prove to have been the eye of the (Eurozone) storm and investors need to rediscover the importance of creating a balance within their portfolios if they are to survive the occasional storm. The rise in US bond yields earlier this year created defensive value for more uncertain times; the Italian drama subsequently unlocked that value. There are always trades that offer a defensive utility; we have just had to look a bit harder in recent years!

The currency markets can display the quickest and sharpest reaction to uncertainty, often going too far − sterling’s collapse following the Brexit vote was a classic example. Currency markets, by nature, always offer a full palette of risk-on and risk-off opportunities and we continue to manage assets with foreign exchange as an important part of our investment toolkit. As the fallout from Brexit widens, this is unlikely to change.

Stephen Jones, Chief Investment Officer, 14 June 2018

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Important information