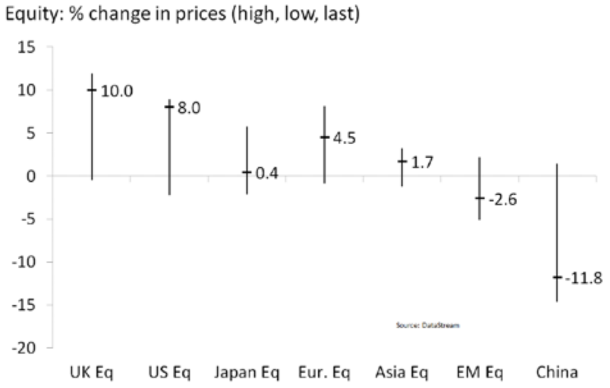
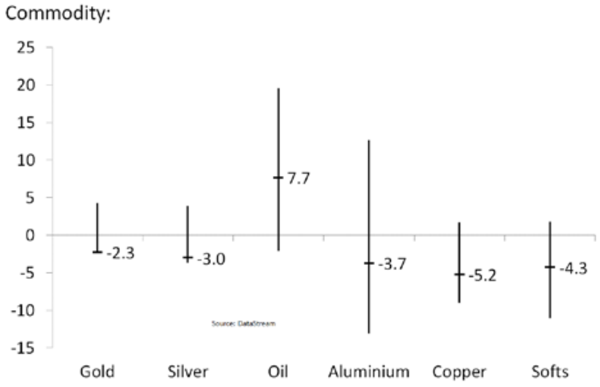
Market Backdrop

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

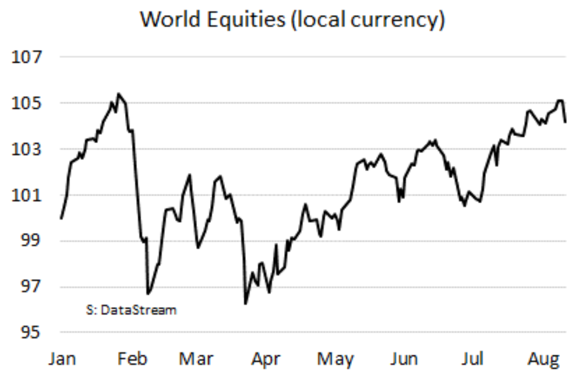
Market Overview

The figures below describe the % performance of various markets from the end of Q1, 2018 to the close on 10th August 2018; the charts also show the range of performance over that period.





Since the end of Q1 and helped by a recovery in US activity and despite deepening concerns over trade tariffs, equity markets, have made good progress. This has largely been a developed markets story with emerging markets, including China, registering losses. The progress since Easter is illustrated in evolution of a global equity index shown in the chart opposite. After an erratic start to the year, in aggregate equity markets have moved higher with few setbacks (see Commentary).

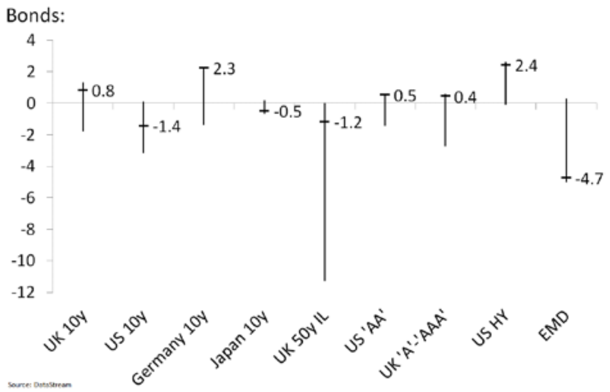


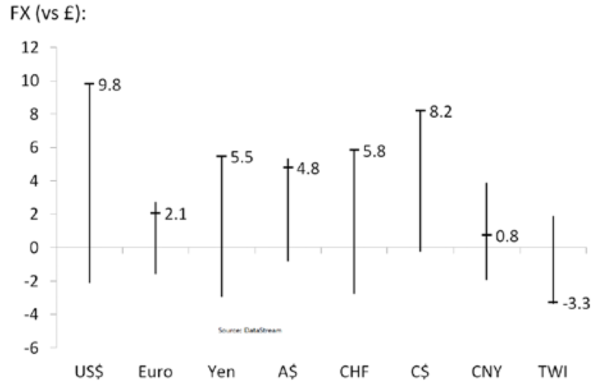
Gains were led by the UK and US, both of which closed around period highs. The UK All Share index moved ahead strongly recovering from a poor Q1, boosted by early strength in commodity prices, improving economic data (from a low base), weakness in the Pound and, for a period, some respite from *Brexit* worries. In the US, the news continues to be good. Economic growth has been very robust allowing the Federal Reserve to acknowledge the improvements by lifting policy rates even though price and wage pressures have been largely benign. Various emerging markets have fallen into the grip of a classic crisis that continues to roll through EM. Every major US tightening cycle has created issues somewhere; for the moment, the casualties are EM.

Throughout the period, companies have repeated their gains of Q1 posting solid progress in corporate earnings ahead of analyst forecasts; while Trump's tax cuts have generated a clear boost for US equities this is, by no means, the whole story.

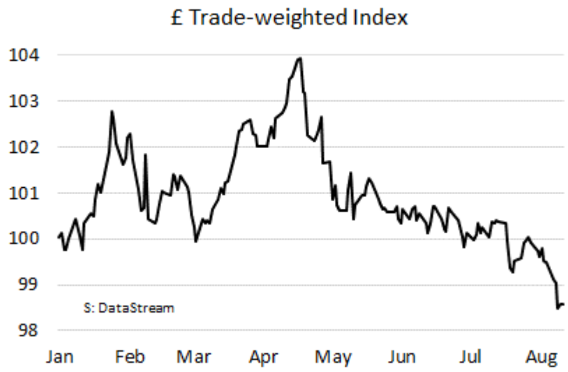
Selectively, commodity markets have seen performance vary even though many commentators promote commodities as a diversifier at this stage of the economic cycle. The oil price has been particularly strong helped by falling inventories and despite a higher number of US operating rigs. Industrial metal prices have been buffeted by inventory overhangs and threatened interruptions due to trade tariffs and sanctions. Despite rising geo-political risk and worries over inflation, Gold has failed to perform; it is hard for Gold to gain when the US$ is strong, as it has been.

Bond markets have held steady with yields are generally off their highs despite ongoing tightening by the US Federal Reserve; strong growth and a rising cash yield have been offset by muted inflation reports and rising price for safe-havens. Strong corporate performance has boosted US high yield bonds (on fewer concerns around defaults) while trade worries, positioning, Fed tightening and a higher US$ have weighed heavily on emerging bond markets.





The Pound trade weighted index (TWI) has slipped more than 5% since the middle of April initially as hopes for a base rate increase in May were undone by sluggish economic data. Thereafter, concerns around the eventual *Brexit* deal and the stability of the UK government (under Theresa May) took hold. By the time that the Bank of England eventually lifted base rates in August, the benefit of a 0.25% increase in yield was largely irrelevant. Sterling is not helped by the UK's exposure to emerging markets.



Consensus expectations – economic growth and inflation

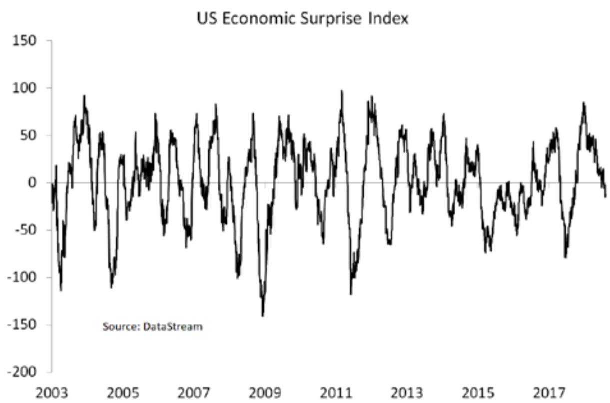
Mostly, and the US apart, changes in the economic outlook for 2018 see activity weakening; growth in 2019 is projected to continue slowing. Although the UK should see an improvement in 2019, it is expected to underperform both the EZ and US. These forecasts nonetheless still support ownership of growth assets.

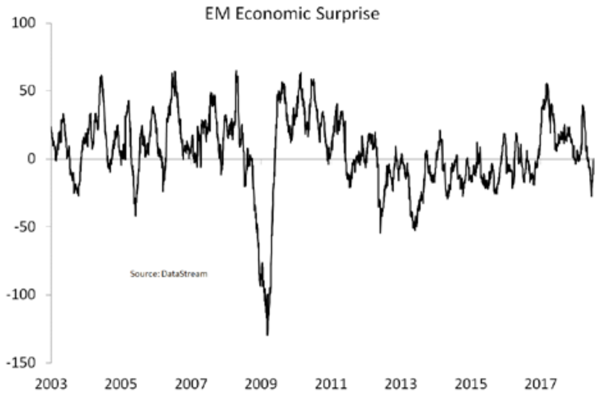
Table 1: Consensus forecasts – Real GDP growth (%)

	2017	2018	Change ytd	2019	Change ytd
US	2.3	2.9	+0.3	2.5	+0.4
Eurozone	2.4	2.1	+0.0	1.8	-
UK	1.7	1.3	-0.1	1.5	+0.1
Japan	1.7	1.1	-0.2	1.0	-
China	6.9	6.6	+0.1	6.3	+0.1

The superior performance of the US is, in part, due to the direct impact of President Trump's tax cuts. Significant 'second order' effects are evident as buoyant corporate and consumer confidence promote stronger investment and consumption, 'tech' investment is particularly strong. The US Federal Reserve have nonetheless confirmed that they don't believe that a laxer fiscal stance will lift America's potential growth rate (the equilibrium growth forecast remains at 1.8%); growth is simply being brought forward.

Some respite from £ weakness is possible in the near term given that the emerging UK economic data is starting to positively surprise (charts below). In the US, forecasters have caught up with events and now expect buoyant reports. In the Eurozone, the best that can be said is that the actual data is not as disappointing as it has been; the same is true in emerging markets.





Inflation forecasts for 2018/19 continue to lift (Table 2 overleaf). The main take-away is however that inflation rates will, this year and next, remain contained and broadly consistent with central bank targets. While monetary policymakers are still keen to exploit the better economic backdrop (moderate and, mostly, synchronised growth) to move away from near zero (or negative) interest rates; only the UK and UK have been able to achieve this. 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 and the ECB has already moderated its path to (policy) normalisation. Finally, and for the moment, the Bank of Japan looks likely to attempt some change in policy direction – if the (softening) economic data will let it!

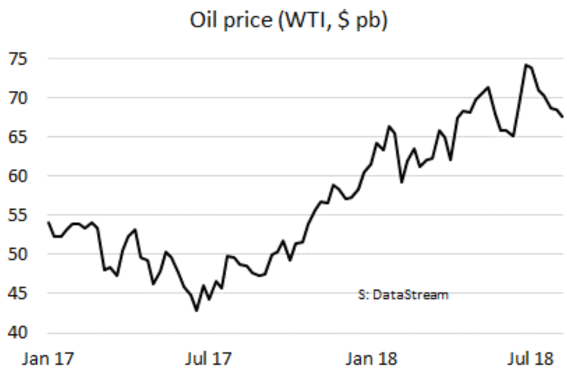
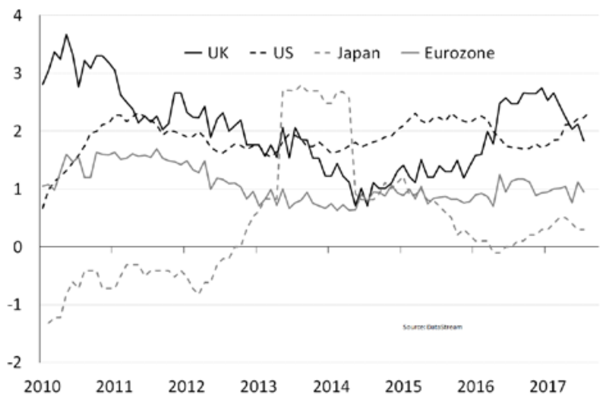


Table 2: Consensus forecasts – Inflation (CPI, %)

	2017	2018	Change ytd	2019	Change ytd
US	1.5	1.9	+0.2	2.1	+0.1
Eurozone	1.1	1.7	+0.3	1.7	+0.1
UK	1.6	2.5	-	2.1	-
Japan	0.0	1.0	+0.2	1.1	+0.1
China	2.1	2.3	-	2.3	+0.1



Trends in core inflation rates in the major economies have been stable-to-softening (chart opposite); only the US has seen increases, and these have tended to undershoot forecasts.

After lifting strongly following £ weakness in 2016/17, core inflation in the UK continues 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 continues to favour, all else equal, those UK companies which trade overseas (preferably in the US).

In the UK, the latest data (for June) saw headline retail and consumer price inflation 'roll over' (Chart 1) and, as the forecasts above imply, the current downtrend should continue. Input and output producer prices are also softening (Chart 2).

Chart 1: UK inflation rates (%, yoy)

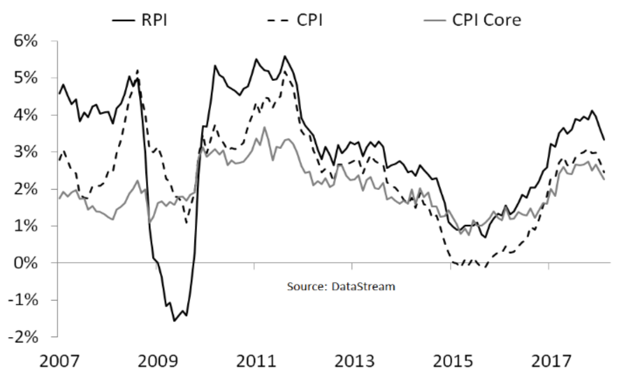
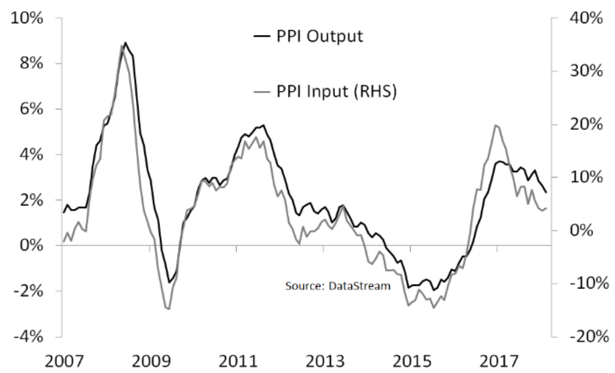


Chart 2: UK producer price growth (yoy)



The major uncertainty in the UK – for both growth and inflation – of course remains the manner of the exit from the EU next spring. Forecasts inevitably are the average, formed of views that diverge markedly within a broad spectrum between a 'soft' *Brexit* to one that sees 'no deal'. On this basis, the average forecast outcome is probably the least likely. It is against this backdrop that the Pound has slid and that the BoE has been keen to create some 'altitude' in base rates (such that any cut to stimulate demand, if needed, has some potency).

Trade Tariffs

The great unknown for investors currently is the economic and market impact of the trade tariffs, driven by the US. Currently, the US is collecting newly-imposed tariffs on $50bn of Chinese imports with the payments being collected at the US border. The Trump Administration has announced tariffs on a further $200bn of Chinese imports; these are currently being reviewed and may well be implemented before the end of September. [Offering some better news, it looks as though there will be a positive outcome from the NAFTA re-negotiations (albeit perhaps only between the US and Mexico).]

China has responded with a range of measures. These include retaliatory tariffs of 25% on US car imports. Together with previously announced measures, car imports from the US to China are now subject to a total of 65% import tariffs (this should be compared with a 15% tariff on imports from other countries). This means that cars exported to China from US plants (American or otherwise) will be on average 44% more expensive than cars exported from other plants outside US. Elsewhere, the Chinese currency has depreciated steadily over the summer. There is a natural limit on what China can do viz. a viz. US exports to China – the Chinese simply don't import enough; they can, however, allow their currency to become more competitive (inevitably inviting accusations of currency manipulation).

UBS have attempted to quantify the impact of the tariffs and concluded that global GDP growth will decelerate by around 1.1% led by the US (lowered by 2.4%) and China (by 2.3%). As a result, they foresee that US 10-year and 2-year bond yields will fall by 0.3% and 0.5% respectively; the bond markets are not positioned for such a move. The implication for equity markets is judged as possibly being severe, ranging from the US - down 21%, Europe - down 25% and Asia (ex-Japan) - down 24%. UBS also forecast that higher import prices (post-tariffs) will cascade through the supply chains and raise global inflation by about 0.33% in a Trade War scenario. The impact on US and China prices is, however, much larger (0.7% and 0.9% respectively); higher prices are expected to claim half of the growth reduction, the rest will come from supply chain disruption and knock-on effects (once a critical threshold of tariff disruption is reached). It is acknowledged that these outcomes are inherently difficult to model.

Having canvassed companies, UBS believe that 60% of companies will try to pass on costs to customers, 90% may cut capital spending and 26% might consider relocating production capacity away from the US to alternative locations (particularly true of companies in Asia). In a full-blown the Trade War scenario, global revenue growth could fall by more than 1% while capital investment could be reduced by up to 1.5%.

For the moment however it is hard to see any direct impact. In an analysis of the US job market and focusing on those industries more directly exposed to the trade (with China and the EZ), Goldman Sachs suggest that there has, yet, been no observable impact on hiring or capital investment. They do however detect concern among US analysts over export markets, imported inputs, and supply chain disruption - especially in the autos, clothing, freight, and machinery sectors. They also echo UBS's view that tariff costs will be passed on; there will still be a negative impact on profits in almost half of the market.

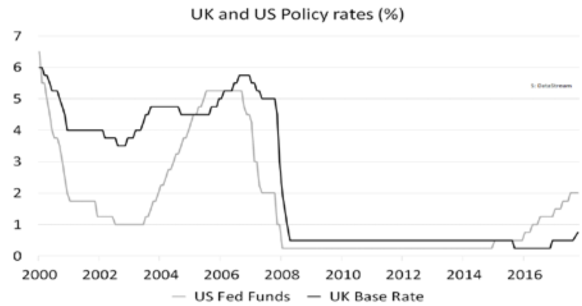
More positively, both UBS and GS expect that the negative effects of the trade war on costs and foreign sales will be temporary; normalisation is expected within a year.

Short and long-term interest rates

The current consensus forecasts for the main monetary policy settings are shown in Table R1 overleaf; away from Japan, rates are still perceived to be on the rise, albeit very slowly. Specifically, UK money markets currently discount no more hikes in base rates in the remainder of 2018 and just over one by end 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 fall afresh. Even in the US, rates remain very low by historical standards even though they have been increased several times,

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

	Latest	2018	2019
US Fed	1.88	2.45	3.05
ECB	-0.40	0.00	0.15
BoE	0.75	0.75	1.15
BoJ	-0.10	-0.10	0.00



The US Federal Reserve validated market pricing by hiking rates again in June (into the range 1.75% to 2.00%). Although the market is pricing at least one other increase this year, the outlook is clouded by the uncertain (negative) impact of the various trade tariffs imposed in recent months with, in recent weeks, some commentators suggesting that the Fed will 'pass' in December (having delivered another hike in September). Since in real terms, the US policy rate is still negative - just, 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 2.9% even allowing for the strong fiscal boost underway; monetary policy might be normalising, but this will still be to a 'new' normal. Longer term, policy rates in the US are expected to hit their equilibrium level in 2019 (when real growth in the US economy is expected to slow to 1.9%). 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 gently into 2019 driven by higher policy rates and by sustained, above-trend economic growth; higher US yields will drag other bond markets with them. Although nowhere will yields get 'high', US bonds are becoming more competitive relative to equities; at 3.4%, US yields would likely look attractive in absolute terms.

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

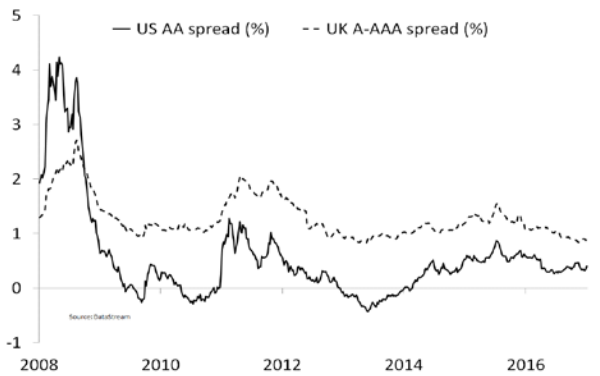
	Latest	2018	2019
US	2.9	3.1	3.4
Germany	0.3	0.7	1.1
UK	1.3	1.7	2.1
Japan	0.2	0.1	0.1

The Bank of England recently amended its guidance on unwinding QE, declaring that its stock of gilts will not be unwound until the policy rate is around 1.5%; the previous guidance has pointed to a 2% threshold. The justification offered is that, whereas in 2009 there was a sense that some banks couldn't cope with interest rates below 0.5%, 10 years on, UK banks and building societies have adjusted their models such that the Base Rate could fall to almost 0% without the policy being a net negative for the economy.

Over the past two years, the US Federal Reserve have lifted their policy rate several times and moved to reduce the QE holdings without disrupting either their bond market or the economy. Based on the aforementioned guidance, the BoE clearly believes that the UK banking system has evolved in the last decade in a way that allows the MPC enough flexibility over how it sets monetary policy to enable the UK to follow suit. And, for the argument that banks need a steeper yield curve to make money, again conventional wisdom should be treated with some healthy scepticism.

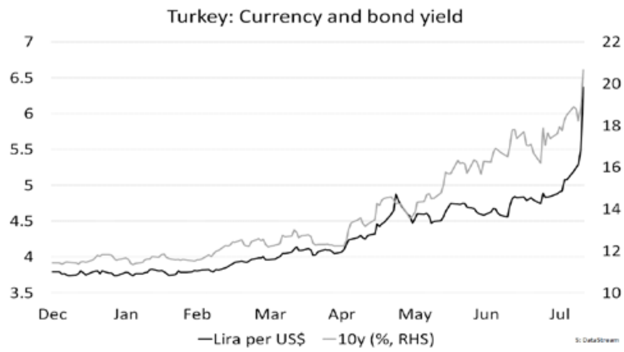
Non-Government Bonds

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



The same remains broadly true of high yield bonds where the yield spread (over US 5-year government bonds) remains around multi-year lows. The buoyant corporate earnings backdrop has improved the quality of US credit and invites the conclusion that whatever might define the next financial shock it is unlikely come from within the US non-government bond markets.

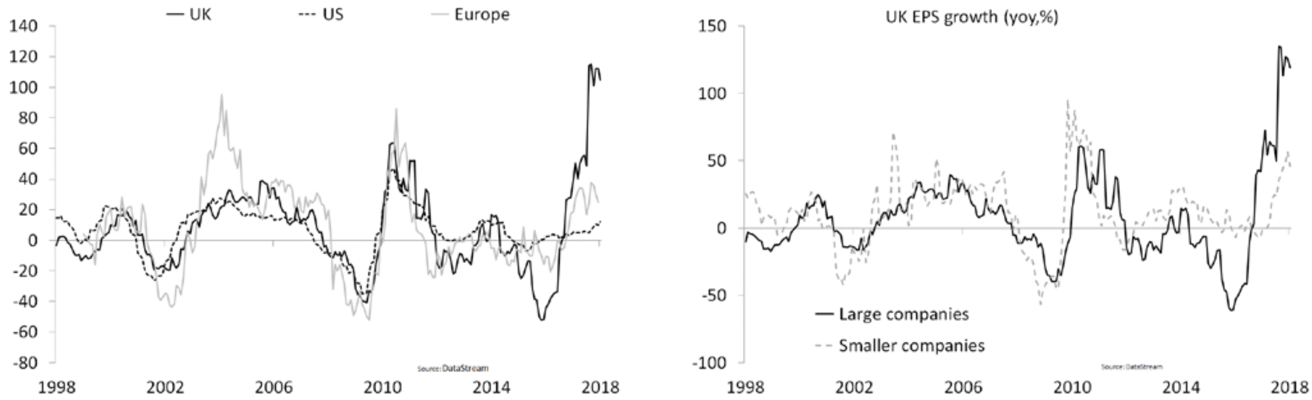
Regardless of which emerging market debt index is followed, the blood-letting – after an excellent 2017 – continues. Economic crises in Argentina and Venezuela have followed-through into Turkey (which is currently looking as though it could become a failed state) – and, to a lesser extent (thus far), Brazil, South Africa, Russia and India. The story is, as it has been many times before: countries which operate twin deficits – fiscal and external – are, ultimately, subject to the kindness of strangers (global funds with capital to invest). Occasionally, those 'strangers' become less indulgent – usually when US monetary conditions are being tightened – as now. This time, the situation is further complicated by trade tariffs and sanctions.



Equities

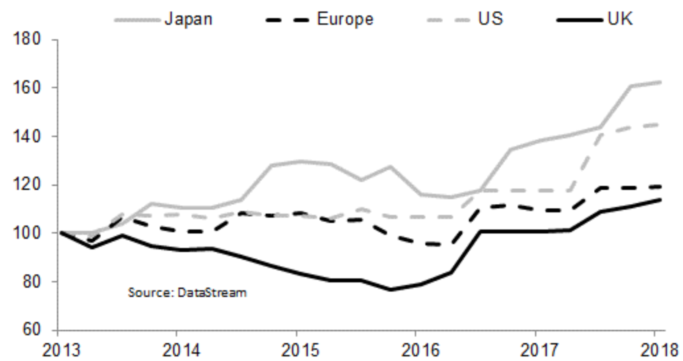
The chart (E1) below details how forecast earnings per share (EPS) for the UK, US, European and Japan equity markets have evolved over the past twenty years; they chime with the economic cycle. The impact of £ weakness in 2016 on the earnings of the larger UK companies, made more dramatic by being off 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 confirm a generalised improvement including 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 by comparison.

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



Looking beyond the next financial year, equity analysts remain reasonably optimistic (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)

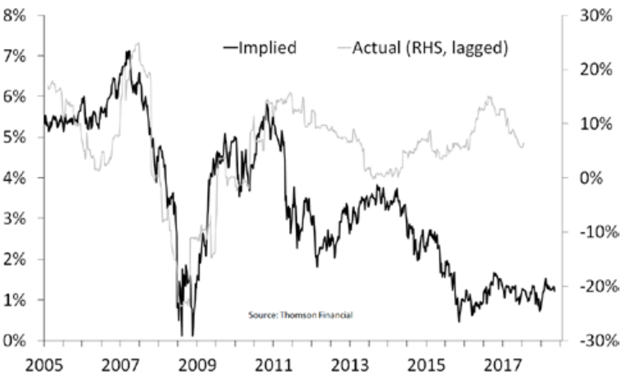
	UK	US	Japan	Europe
FY2	8% (+2%)	10% (u/c)	6% (+1%)	9% (+1%)
FY3	8% (-1%)	10% (u/c)	5% (+1%)	8% (-1%)

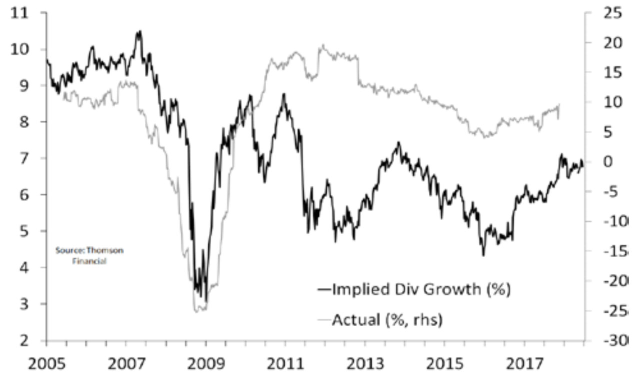
Equity Valuation

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 gilt 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 acquired a more competitive risk/reward balance especially with cash rates continuing to head higher. US cash now yields more than the equity market.

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, consistent with the modest economic growth outlook.

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

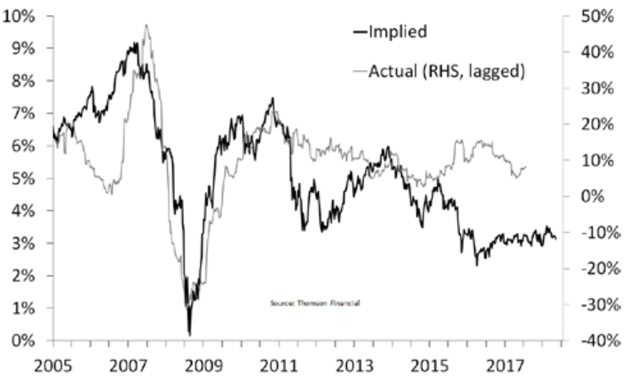
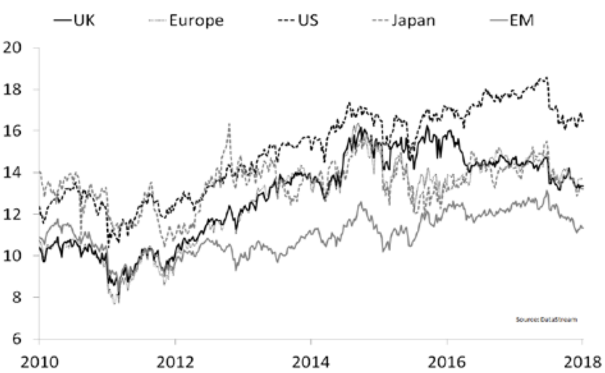


Chart E6: Regional PE ratios



Looking at PE ratios (Chart E6), valuations, having risen over 2017, have corrected materially since early February. Equity ratings, 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 developed equity markets remain resilient and enjoy decent returns unless wage growth starts to eat into profit margins and/or the EM crises /tariffs ‘bite’. Investor confidence however appears fragile.

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 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 has kept pace with Growth. Strong appetite for growth stocks has been reflected in the relatively poor performance of ‘unloved’ value stocks.

Chart S1: Performance of equity styles (vs MSCI)

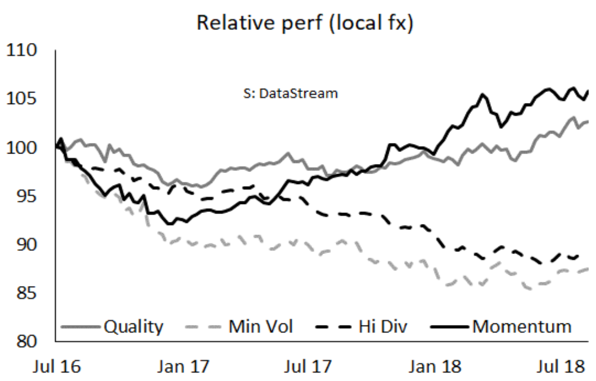
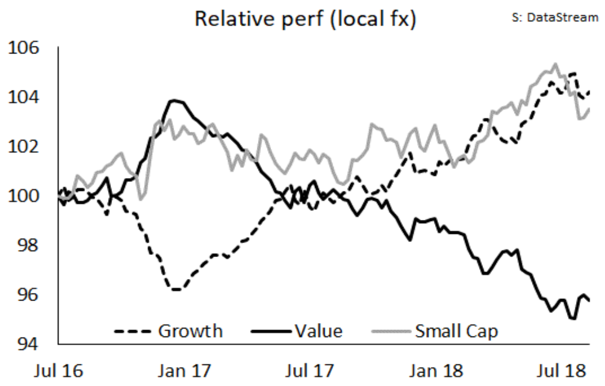
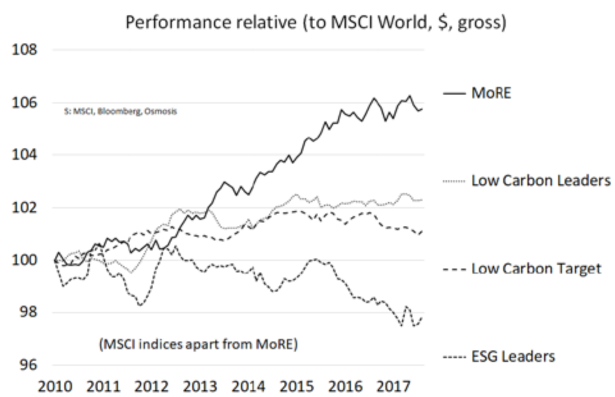


Chart S2: MSCI Growth vs Value relative



The strength of demand for growth and momentum played together with rising bond yields has seen investors mark-down income as an investment theme in both the US and Europe. Nonetheless the Fund is guided to sustain a strong weighting to equities characterised by robust dividend yields and solid dividend growth. Market conditions don’t always stay supportive of ‘risk’.

There are numerous ways of playing the sustainability theme; a preferred 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].



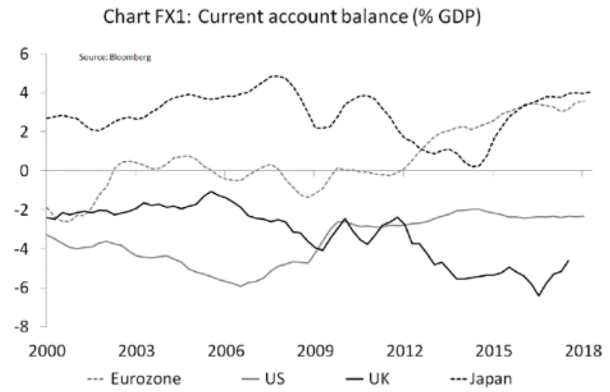
A resource efficient tilt to equities is an attractive alternative to a holding in a global equity passive index if implemented and superior to simply focusing on minimising a carbon footprint. A small cap momentum version would be ideal!

[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 developed market 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 strongly into reverse: economic activity in Europe and Japan initially slowed (partly due to adverse weather – *the Beast from the East*) and has since lagged badly. 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 emerging markets.

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'.



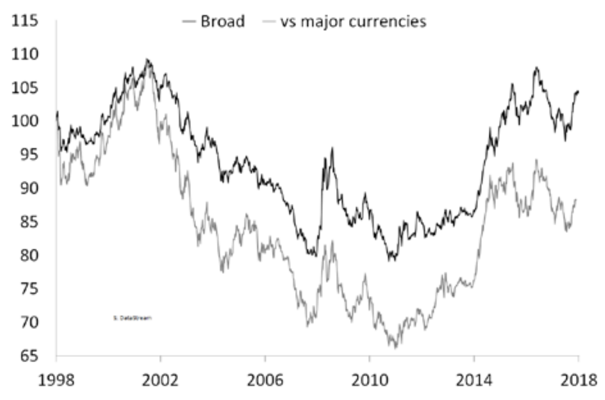
It should be noted that the UK's substantial current account deficit has improved recently but the deficit, as % of GDP, remains significant and financing it could prove challenging if global financial markets became much more cautious i.e. 'strangers' become less generous.

The UK has nonetheless been able to attract international capital despite the relatively low yields on offer. Higher yields in the US might have started to 'crowd' out the UK and £ has weakened accordingly. 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 should eventually 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 manifest *Brexit* uncertainty, the absence of fresh economic stimulus from fiscal policy and the relatively weak economic outlook (Table 1). Political developments in the UK have the potential to change the landscape for £ considerably and need to be watched.

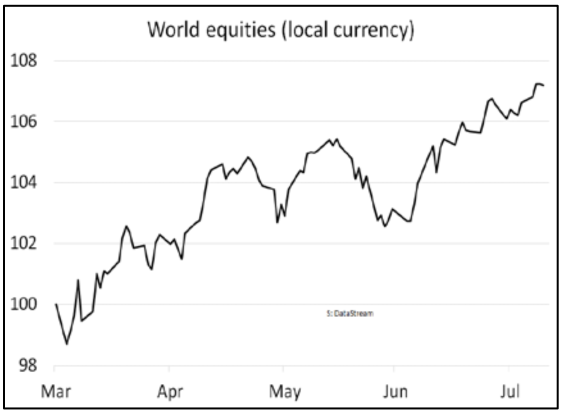
Chart FX2: £ Trade-weighted Index

Chart FX3: US$ Trade-weighted Indices

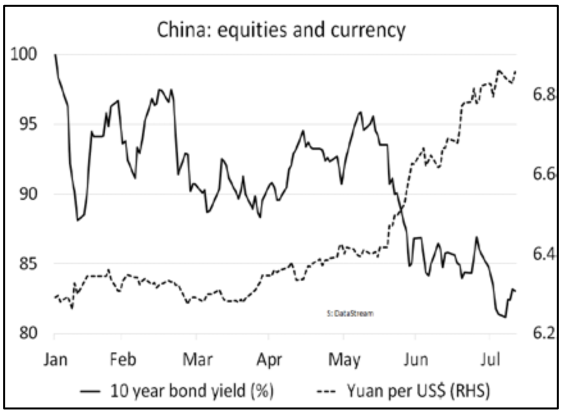


Commentary - Thinking big

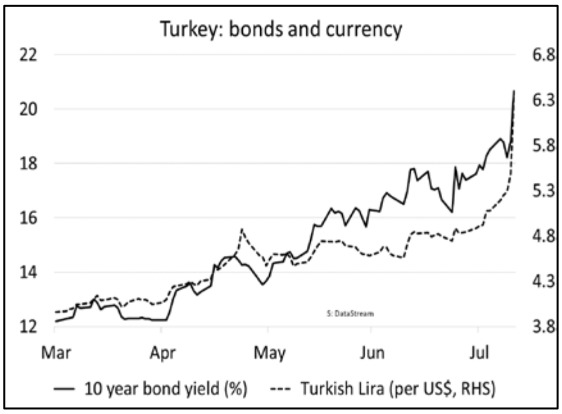
On the face of it, financial markets have been a joy. Since Easter, the World's equity markets have steadily moved higher with barely a hiccup, delivering gains on a par with the same period in 2017 – a time so benign, it is now generally seen as an aberration. What setbacks there have been, were driven by the latest wave of Trump tariffs. Yet and as a duck, beneath the surface some large, and worrying, moves are occuring. For the most part, the action has been stayed within emerging markets.



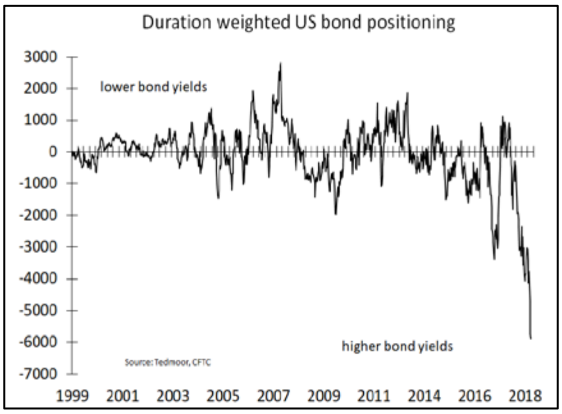
Chinese equities have slumped almost 20% since the end of January caught in a vice of weakening economic activity and escalating trade tensions with the US. At the same time, the Chinese currency has, by association or design, weakened sharply against the US$.



Just as China is significant in the emerging market equity complex, Turkish bonds are a material part of emerging market debt benchmarks. Rising Turkish fiscal and current account deficits have combined with dubious economic policies and adverse political developments – including a dispute with the, increasingly belligerent, US President, to induce an emerging market crisis the like of which we have seen many times before; these rarely end well.



Meanwhile, in (US) bond markets, pressure, from investors/traders, for (much) higher bond yields is at record levels. If the anticipated move in yields occurs then, not for the first time, bond markets could cause a sharp (negative) re-pricing of 'risk'.



At another time, investors would look upon these various strains with grave concern and would have priced a safety margin into all risk markets – developed equities included; not so this year. Not because the World has suddenly become less connected; globalisation, thanks to Trump, may probably have peaked but the World's economies and markets remain highly inter-connected. Rather it is because of two factors: buoyant corporate earnings and very impressive performance by the US economy.

2018 will go down as a great year for corporate earnings. Even allowing for the boost in the US from tax reform, companies have eclipsed analyst forecasts. The broader 'outside' world might well be fraught with challenges, but companies are prospering and, on balance, are voicing few concerns.

In recent years, investors, mindful of the Japan playbook of nearly thirty years ago, have agonised over the dominance of world equity indices by the US equity market. For the of moment, that dominance is proving a boon for investors. It takes a lot of non-US weakness to undermine US gains.

Of course, this has a dark side – which will be revealed dramatically when conditions in the US sour. In the meantime, however, and with Trump aggressively promoting *America First*, it is premature to bet against the US and, given the sheer weight of (US) money, global equity markets. Caution is certainly warranted but, the US apart, monetary policy everywhere remains highly accommodative. If the various pressures evidenced above look set to threaten financial markets, don't rule out policy becoming even easier. The US equity market continues to be preferred.

Scott M Jamieson, August 2018

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