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Leicestershire County Council Pension Fund Q3 2018 – Market Report

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Historic Returns for World Markets

	Q3 (%)	1 Year (%)	3 years (%)
FTSE WGBI Non-GBP TR	-0.31	1.34	7.13
FTSE 100 TR	-0.66	6.08	11.76
FTSE 350 TR	-0.84	5.90	11.41
FTSE Actuaries UK Idx-Lnk Gilts All Stocks TR GBP	-1.21	1.34	6.55
FTSE Actuaries UK Conven Gilts All Stocks TR GBP	-1.73	0.62	3.00
FTSE Actuaries UK Conven Gilts Over 15 Y TR GBP	-3.28	1.35	5.31
FTSE All-Share TR	-0.82	5.87	11.44
FTSE Japan TR	4.97	13.90	18.54
FTSE Small Cap TR	-0.09	5.12	12.34
FTSE World Europe ex UK TR GBP	3.10	2.01	14.87
FTSE World ex UK TR GBP	6.66	14.73	20.62
LIBID GBP 7 Day	0.16	0.50	0.40
Markit iBoxx Sterling Non Gilts Overall TR	-0.36	0.16	4.44
MSCI EM (Emerging Markets) TR GBP	0.28	2.43	18.53
MSCI Pacific ex Japan TR GBP	0.71	7.40	18.63
S&P 500 TR	9.05	21.31	23.29
Commodities	-0.07	5.82	-5.23
£ Trade Weighted Index	-1.87	1.03	-5.73

	Q3 (%)	1 year (%)	3 years (%)
Euro	0.72	1.09	6.52
Japanese Yen	-1.27	1.96	6.99
US Dollar	1.24	2.88	5.11

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

Market Review

UK equities

The FTSE All Share ended the third quarter with a negative total return of -0.49%, with the FTSE 100 outperforming the FTSE Small Cap with returns of -0.38% and -2.55% respectively.

The relatively poor performance of the market through the quarter was a product of multiple headwinds. Some economic indicators moved slowly in the right direction, with quarterly GDP expectations increased by 0.1%, a PMI uptick in September from 52.8 to 53.8, and moderate CPI & real wage increases signalling an economy that is undergoing growth. However, market sentiment was depressed by the continuing absence of progress in Brexit discussions. As the time available for the negotiations tick away we are no closer to clarity on what the outcome will be, and as such equity markets have been in a state of torpor. Domestic concerns are only compounded by international trade being under threat.

An August Bank of England rate increase took interest rates to 0.75%, the highest level since March 2009. The MPC cited rising household spending after an “erratic” first quarter and forecast “modest” growth, falling unemployment, and CPI remaining close to target for the coming months. They remained equivocal on forward guidance due to Brexit uncertainty.

US equities

US equities continue to be the strongest performing market, with the S&P 500 ending the third quarter up 9.05% in sterling terms. The technology sector yet again was one of the top performers over the quarter. Consumer confidence and business confidence reached all-time highs and corporate earnings were strong. The White House’s fiscal loosening continues to have a positive effect on growth. Despite the tariff action on US-China trade, as well as NAFTA renegotiation and a rising oil price, the US bull market endures. One sector that performed poorly was auto manufacturers, as the effect of tariffs on costs and demand begin to show on balance sheets.

The Fed raised rates in September, and is expected to hike rates once more this year. The description of monetary policy as “accommodative” is no longer present, but the Fed is careful to stress a desire not to over-raise rates. Chairman Jerome Powell noted that low unemployment of 3.9% has not had a noticeable inflationary effect.

European equities

The FTSE World Europe Ex UK Index grew by 3.10% (in sterling terms) during the third quarter. After steady returns in August, markets sold off somewhat during early September, but rallied towards the end of the period to finish with gains. Corporate earnings are growing and capital expenditure has begun to increase market-wide. Tech stocks, like their US counterparts, were some of the best performers. The overall expectation is that Europe is at an earlier stage of the cycle than the US, and valuations are reflecting that confidence.

Internal politics was a weak point over the quarter, as the Italian government and the EU disagreed over the proposed Italian budget, stoking qualms over the future relationship between the bloc and the third-largest economy in the single currency. Ratings agencies lowered their evaluations of Italian government debt to below investment-grade. Italian banks remained under pressure and performed especially poorly.

Trade fears that have been a feature during most of 2018 continued to have a negative effect on European exporters. The supposed tariff “truce” has faltered and rhetoric is not very conciliatory from Brussels or the White House. The ongoing trade fracas has dampened sentiment worldwide, and Europe is no exception. Manufacturing PMI is trending downwards and many major firms have expressed concerns. Vehicle manufacturers and their suppliers have suffered from investor concerns over their exports. Post-Brexit trade uncertainty also had an effect on firms with significant exports to the UK.

The ECB left rates at 0%, and announced that QE purchases will cease by the end of December 2018. Their forward guidance that rates would not be expected to rise until at least summer 2019 was unchanged. Inflation was steady around 2.1% through the quarter.

Japanese equities

The FTSE Japan Index rose 4.97% in sterling terms. Industrials, pharmaceuticals, and electronics firms were generally the best performers, showing growth in earnings and benefiting from rising consumer and capital expenditure economy-wide.

Macroeconomic indicators were broadly positive. Inflation continues to tick upwards towards the Bank of Japan target of 2%, though this is now forecast to take longer than expected. Unemployment is at lows of 2.3%, prompting increased capital expenditure and wage growth which are expected to provide a further boost to performance. The BoJ left rates at -0.1% and this is not forecast to change for some time. Likewise, the Bank's stimulus package continues apace, and they will continue purchasing bonds to keep 10Y government debt at around 0% yield.

Fears that trade disruption will reach Japan's shores have caused some exporters, especially auto manufacturers, to underperform. The yen, considered a "safe haven" currency, appreciated during the quarter's increased worldwide volatility which also hurt exporter performance.

Asia (ex-Japan) equities

The MSCI AC Asia Pacific ex-Japan index finished the third quarter down -0.10% in sterling terms. This rather subdued performance was in stark contrast to the strong returns seen from US equity markets over the period.

The slight decline Asian equities was mainly due to the ongoing impact of US-inspired trade tariffs and a strong dollar. In China, where the equity market fell slightly, there were signs of a slowdown in the economy, with macroeconomic data weaker than expected. The disappointing data resulted in the Central Bank announcing a series of measures to support the economy. India also struggled slightly with rising inflation and currency weakness the main culprits.

On the positive side, Australian equities benefited from a relatively decent returns from its technology sector. Malaysia and Thailand also performed well.

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Fixed Income

Market

Some common trends from earlier in the year persisted as trade disruption fears were sustained unabated through the third quarter. Coupled with regional emerging market volatility there were periods of concern in markets that pushed yields down. However strong economic data from the EU and especially the US meant prevailing sentiment has been pro-risk, pushing global yields to new heights by the end of September. The Fed hiked rates again, and Chairman Jerome Powell has left the hawkish forward guidance unchanged. The Bank of England also increased interest rates to 0.75% while the Bank of Japan allowed a wider yield range on debt, which quickly rose. Yield curves have been flattening for a number of months and this generally continued through the quarter, though some steepening was seen at the end of September.

Government bond yields up across the board

Government bond prices fell worldwide during the quarter, with US, UK, German, and Japanese yields all finishing higher than in July. The majority of this was driven by strong US performance, and the 3rd Fed hike in a year also contributed to pushing US 10-year yields above 3%, and other government debt followed suit. The expectation is of a further Fed hike in 2018 and three more in 2019. Specific emerging market instability caused a moderate flight to safety in August, which drove yields down, but in September this reversed when fears of emerging market contagion reduced. Italian bond yields climbed significantly as budgetary disagreements with the EU were not resolved. The Bank of Japan allowed a wider range in yields on their debt, which freed 10-year yields to climb to 0.13%.

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 June 2018	1.28	2.86	0.30	0.04	1.32	2.67	3.93	0.81	1.78
Yield as at end September 2018	1.57	3.06	0.47	0.13	1.50	3.15	4.18	1.00	1.88
Change in yield	0.29	0.20	0.17	0.09	0.18	0.48	0.25	0.19	0.10

Credit

Yields rose in most credit markets, but spreads outperformed. UK investment grade spreads were steady, and US IG spreads fell 0.14%. Total returns were moderately negative thanks to rising yields, with the Markit iBoxx £ Non Gilts Overall returning -0.47%. Positive data and continued growth drove some demand away from bond markets as investors looked for greater returns, though there was still enough for new issuance to be almost fully subscribed.

High yield performed better than investment grade bonds, as demand for products offering high returns outstripped already high new issuance in the sector, pushing yields lower. High yield differed from other credit in benefiting from the risk-on sentiment at the end of the quarter. US high yield especially saw positive returns, with the Bloomberg Barclays U.S. Corporate High Yield index showing 2.45% total returns. The equivalent European index returned 1.76%.

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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 30 September 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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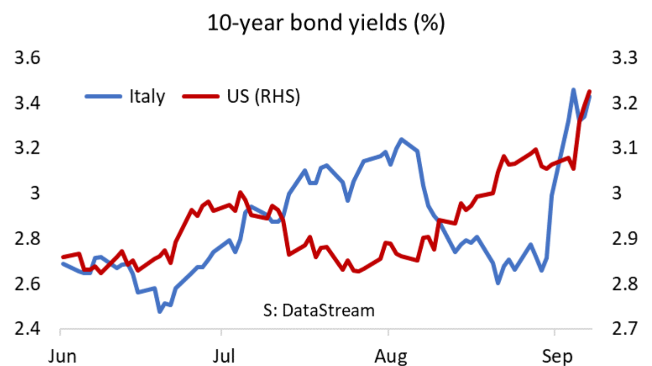
Quarterly Thought Piece - A Tale of Two Bond Markets

Rising bond yields have been one of the strongest features in markets this summer. For a number of years, investors anticipating yield normalisation, have instead had to come to terms with ever lower levels. Not now. Yields on either side of the Atlantic have recently risen sharply, but the underlying drivers couldn't be more different.

In the US, 10-year bond yields have risen through resistance levels, which has encouraged many to believe that the multi-decade bull market is over. It has taken two quarters of economic data running at more than twice the trend growth rate, the lowest unemployment rate in nearly 40 years and eight hikes in US policy rates to raise yields (to the giddy height of around 3.3%!). This may be troublesome for bond bulls, but it is a good news story for everyone else.

In Italy, government bond yields have also moved to 3.3% (and beyond) but the story could hardly be more different. Here, worries around future credit-worthiness are raising the cost of capital as the new government, in the draft of its first Budget, challenges eurozone fiscal disciplines. The spike in long-term interest rate costs, caused by nervous bondholders, has been enough, if sustained, to force the government into unwanted austerity measures (if the budget deficit as a percentage of GDP is to remain compliant with Maastricht limits).



Bond markets move on various factors - some good, some bad - and the implications for other markets, in part priced off long-term yields, can be markedly different. Higher US bond yields are validating the strong US economic growth story without, yet, becoming a problem. In Italy, nervous bond investors have raised the cost of capital to almost six times that of Germany – as if German manufacturers didn't have enough going for them!

Higher bond yields are generally seen as a problem for equity markets. Recent increases are much more of a problem in Italy than they are in the US.

Stephen Jones, Chief Investment Officer

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