Market Backdrop

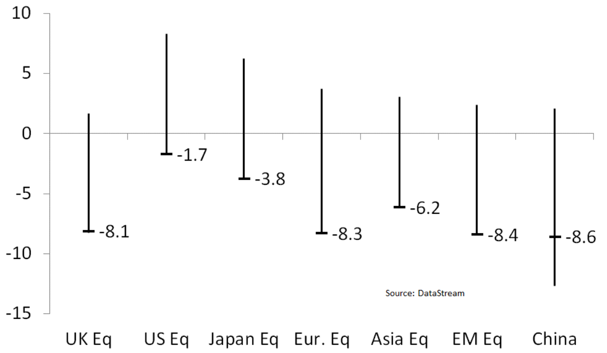
This note is intended to support discussion at the next meeting of the Local Pension Committee of the Leicestershire County Council Pension Fund.

Market Overview

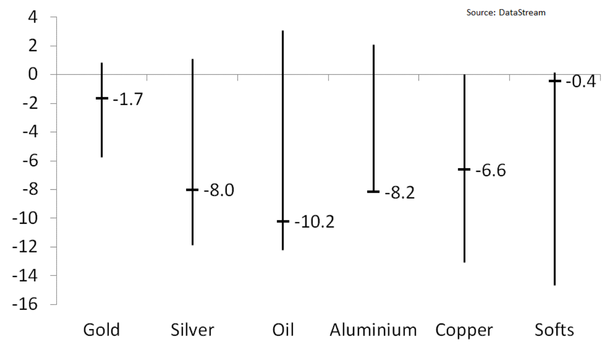
The figures below describe the % performance of various markets from the end of Q2, 2018 to the close on 24th October 2018; the charts also show the range of performance over that period.

Since the end of Q1, helped by a recovery in US activity and despite deepening concerns over trade tariffs, equity markets, had been making good progress; that was until the nervousness and profit-taking evident all summer in emerging markets took hold in developed markets. All equity markets are now registering falls over the review period and the calendar year.

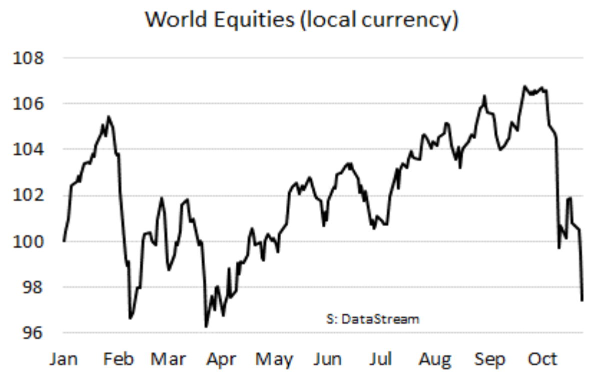
Equity: % change in prices (high, low, last)

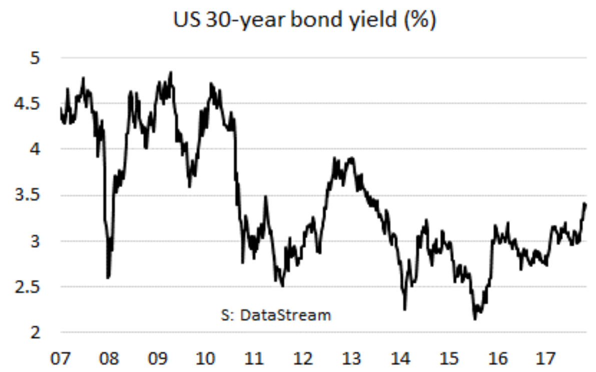


Commodity:



Reasons for the falls are neither hard to find nor, in most cases, new. Beyond geo-political tensions and trade disputes, the principal issue has been the repricing of US cash after the US Federal Reserve raised its policy rate an eighth time (to 2.25%); this has followed through into higher US bond yields. What spooked markets recently was the suggestion, from the Fed Chair, that several additional rate increases were needed

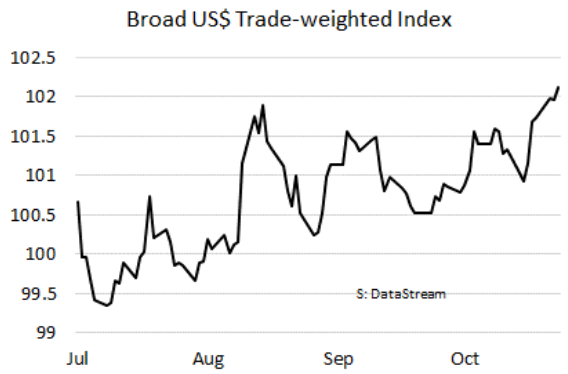




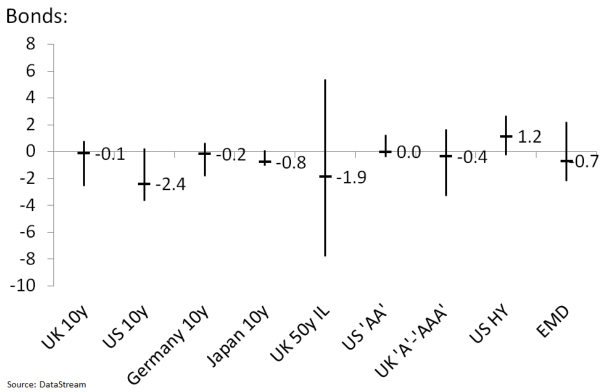
to complete the normalisation of US monetary policy. Also impacting investor sentiment has been the prospect of a divided US Congress after the up-coming mid-term elections and the challenge, offered by the new Italian Government, to the fiscal orthodoxy demanded by the European Commission; the EC has, for the first time, rejected a Budget proposed by a Member State. Add in concerns over the health of the Chinese economy – tariff-related or otherwise – and it is easy to see why risk-asset investors were tempted to protect gains.

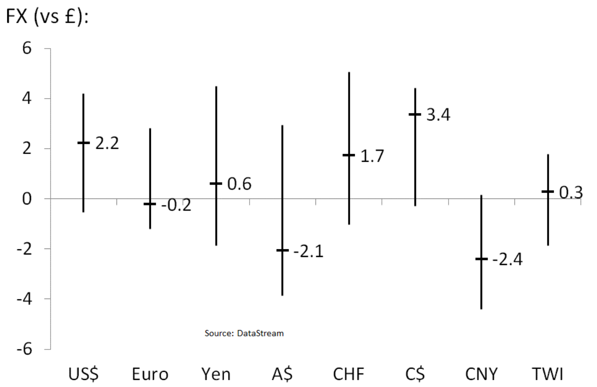
The US and Japanese markets fell least over the period. The US market has been supported by exceptionally strong economic data in recent quarters – US growth is running at around a 3-4% pace – and sharp improvements in corporate earnings – only in part attributable to Trump's tax give-aways. Japanese companies have also been delivering sharp profit increases and optimism remains strong that the Japanese economy is breaking free from the grip of deflation.

Commodity markets have been caught up in the risk aversion and buffeted by middle-Eastern political strains, trade tariffs and idiosyncratic factors such as the temporary shutting of the World's largest aluminium smelter (in Brazil) for environmental reasons. Nonetheless many commentators continue to promote commodities as a diversifier at this stage of the economic cycle. Despite all the angst and worries over future inflation, Gold has failed to perform; it is hard for Gold to gain when the US$ is strong, as it has been (chart opposite).

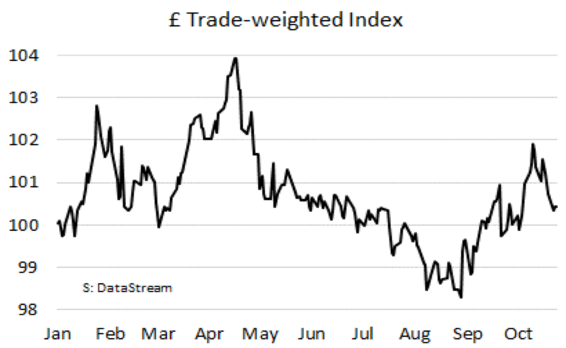


As mentioned earlier, bond markets have become part of the problem (for risk investors) and, for most of the period, registered reasonable falls; only when equities gave way did bond yields slip leaving the total return over the period just modestly down. Strong corporate performance, fewer concerns around defaults and virtually no new supply has boosted US high yield bonds. Trade worries, Fed tightening and a higher US$ have weighed on emerging bond markets. In general, conditions in credit markets remain normal.





The Pound trade weighted index (TWI) had slipped more than 5% since the middle of April but partially recovered as bigger issues commanded investors' focus; softer inflation data helped the bounce stall. The Bank of England's decision to raise base rates to 0.25% helped Sterling recover despite the ever-present *Brexit* overhang. On balance, investors continue to expect a deal to be done.



Consensus expectations – economic growth and inflation

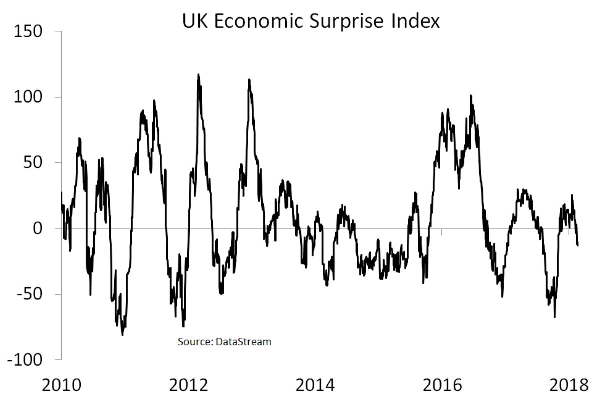
Mostly, and the US apart, changes in the economic outlook for 2018 (shown overleaf) see activity weakening; growth in 2019 is projected to continue slowing. Although the UK should see an improvement in 2019, it is expected to underperform both the EZ and US. These forecasts support growth assets.

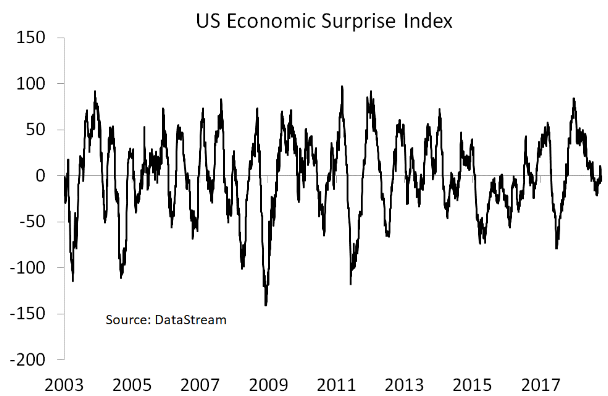
Table 1: Consensus forecasts – Real GDP growth (%)

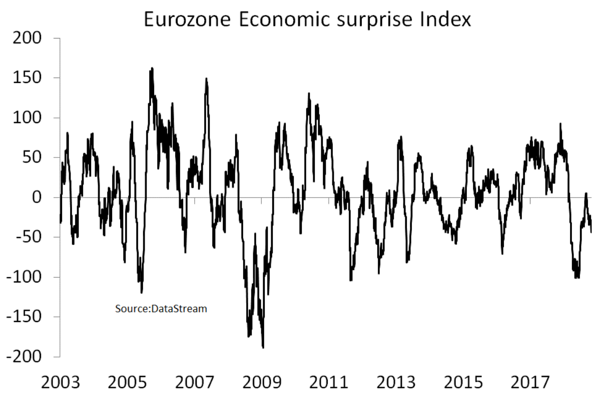
	2017	2018	Change ytd	2019	Change ytd
US	2.3	2.9	+0.3	2.5	+0.4
Eurozone	2.4	2.0	-0.1	1.8	-
UK	1.7	1.3	-0.1	1.5	+0.1
Japan	1.7	1.1	-0.2	1.1	+0.1
China	6.9	6.6	+0.1	6.3	+0.1

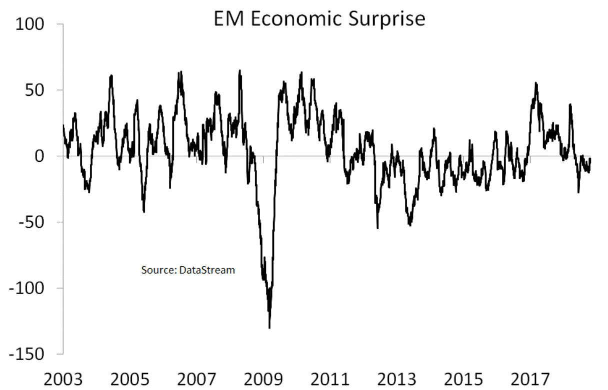
The superior performance of the US is, in part, due to the direct impact of President Trump's tax cuts. Significant 'second order' effects are evident as buoyant corporate and consumer confidence promote stronger investment and consumption, 'tech' investment is particularly strong. Only the housing market is evidencing any concern (see Commentary). The US Federal Reserve has 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.

Emerging economic data has recently proved disappointing relative to forecasts (charts below). Economists were slow to see the strong US economic growth this summer but have caught up.







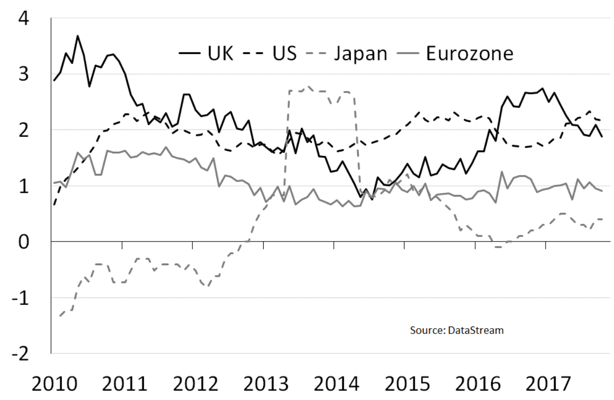


Inflation forecasts for 2018/19 continue to lift (Table 2 overleaf). The main take-away is however that inflation rates will, this year and next, remain contained and broadly consistent with central bank targets. While monetary policymakers are still keen to exploit the better economic backdrop (moderate and, mostly, synchronised growth) to move away from near zero (or negative) interest rates; only the UK and US (and Canada) have been able to achieve this. Unless higher oil prices 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	1.8	+0.4	1.7	+0.1
UK	1.6	2.5	-	2.1	-
Japan	0.0	0.9	+0.1	1.1	+0.1
China	2.1	2.1	-0.2	2.3	+0.1

Trends in core inflation rates in the major economies have been stable-to-softening (chart below); 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 US).

In the UK, the latest data (for September) saw headline retail and consumer price inflation slip (Chart 1) and, as the forecasts above imply, the current downtrend should continue. Input and output producer price inflation rates are stable (Chart 2).

Chart 1: UK inflation rates (%, yoy)

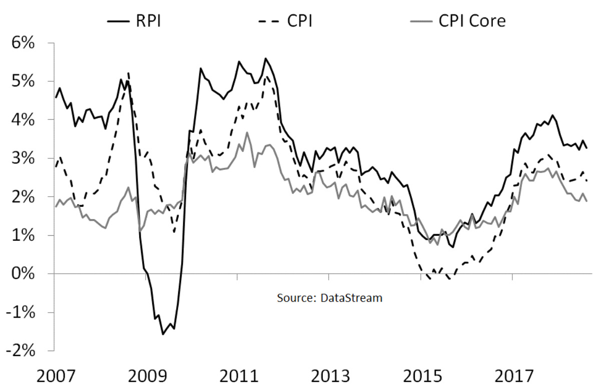
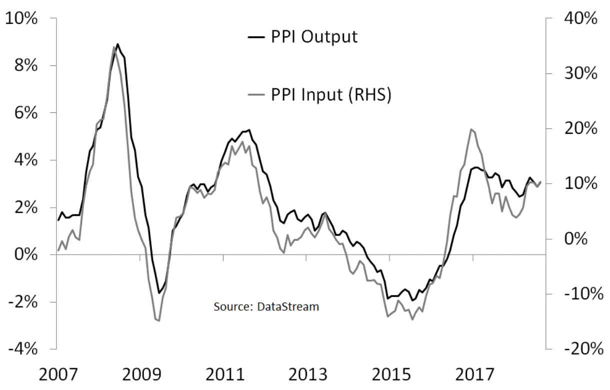


Chart 2: UK producer price growth (yoy)



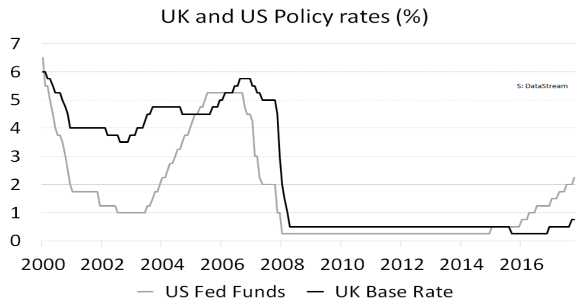
The major uncertainty in the UK – for both growth and inflation – of course remains the manner of the exit from the EU next spring. Forecasts inevitably are the average, formed of views that diverge markedly within a broad spectrum between a 'soft' *Brexit* to one that sees 'no deal'. On this basis, the average forecast outcome is probably the least likely. It is against this backdrop that the Pound has softened 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).

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 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 roughly one more 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.

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

	Latest	2018	2019	2020
US Fed	1.88	2.45	3.10	3.05
ECB	-0.40	0.00	0.15	0.60
BoE	0.75	0.75	1.10	1.60
BoJ	-0.10	-0.10	0.00	0.00



The US Federal Reserve validated market pricing by hiking rates again in September (into the range 2.00% to 2.25%). 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. The forecast profile for US interest rates sees them rising through 2019 but stabilising/ falling thereafter. Real US short term interest rates are still negative - just, leaving US monetary policy 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’ (lower) 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 modestly). This introduces the concept of a protracted pause at some stage and invites speculation as to the precise timing of the next down-turn (in US policy rates).

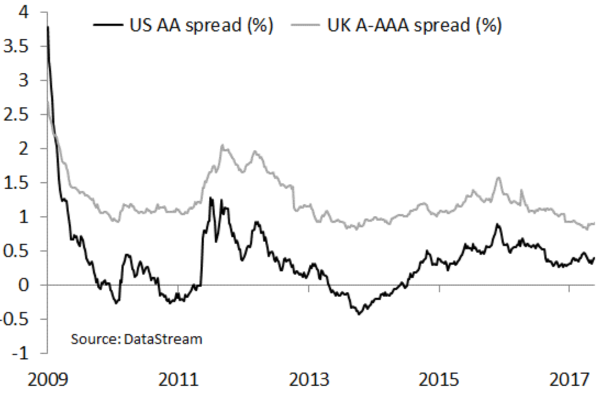
The outlook for longer dated nominal bond yields is shown in Table R2. US yields are expected to rise gently into 2019 driven by higher policy rates and by sustained, above-trend economic growth; higher US yields will drag other bond markets with them. Although nowhere will yields get ‘high’, US bonds are becoming more competitive relative to equities; at 3.4%, US yields would likely look attractive in absolute terms even allowing for the extra supply generated by Trump’s easier fiscal stance.

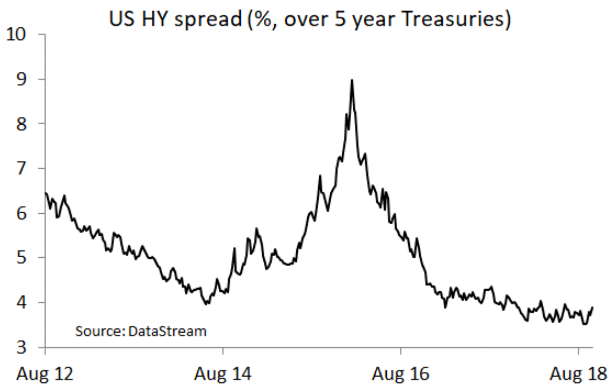
Table R2: Consensus forecasts – ten-year bond yields at year end (%)

	Latest	2018	2019	2020
US	3.1	3.2	3.4	3.5
Germany	0.4	0.6	1.1	1.4
UK	1.5	1.6	2.0	2.3
Japan	0.1	0.1	0.2	0.2

Non-Government Bonds

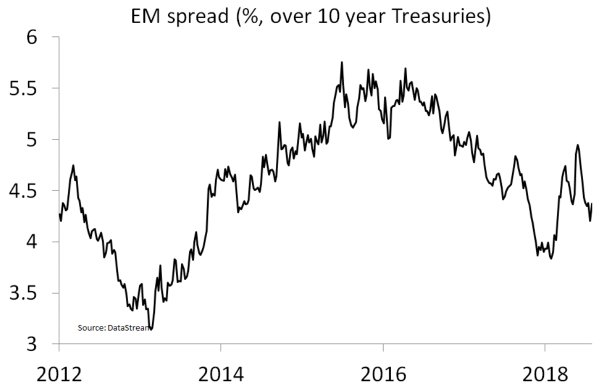
Offering much-needed support currently to equity markets, investment grade (IG) bond yield spreads remain tight; buoyed by excellent corporate earnings reports (hinting to low default rates) and despite higher US government bond yields. [Wider credit spreads would not be a helpful development in the current upheaval.] 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.

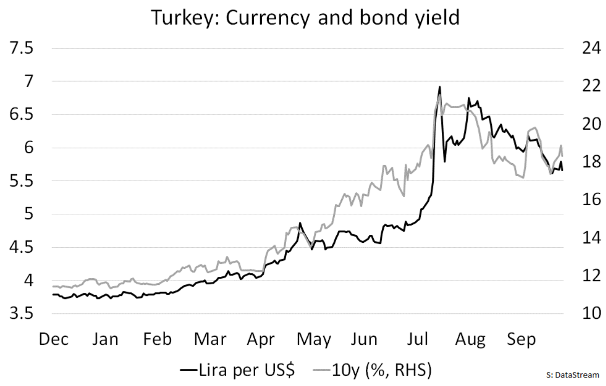




The same remains broadly true of high yield bonds where the yield spread (over US 5-year government bonds) remains around multi-year lows. The buoyant corporate earnings backdrop has improved the quality of US credit and combines with zero net new issuance to invite the conclusion that whatever might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

The blood-letting of the summer in emerging debt markets – after an excellent 2017 – has stopped, helped by the unexpected lift in Turkish short-term interest rates to 24%. The story for EMD remains that 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.

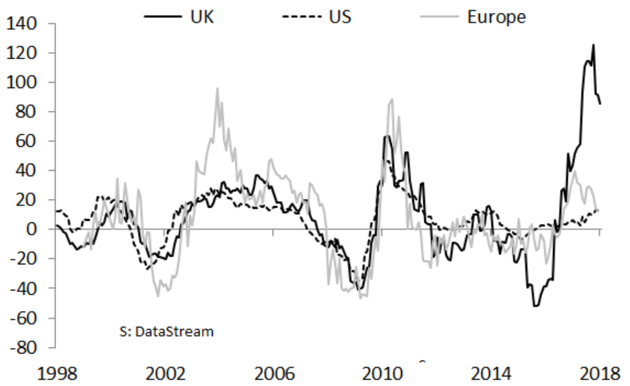


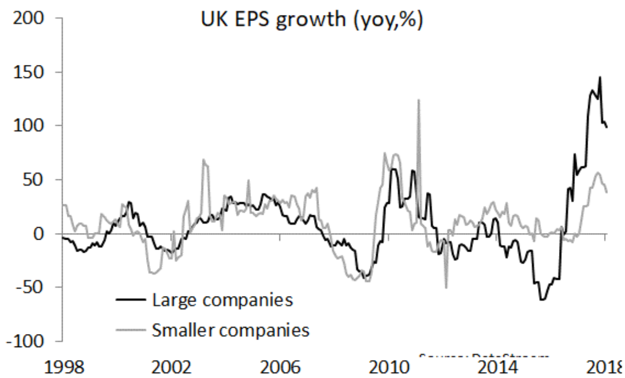


Equities

All year strong corporate earnings have supported markets in the face of an array of exogenous challenges. If (when) earnings start to weaken then equity markets will be even more vulnerable than they look currently. 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 and is now fading. U.S. corporate earnings have been boosted, in part, by tax reform.

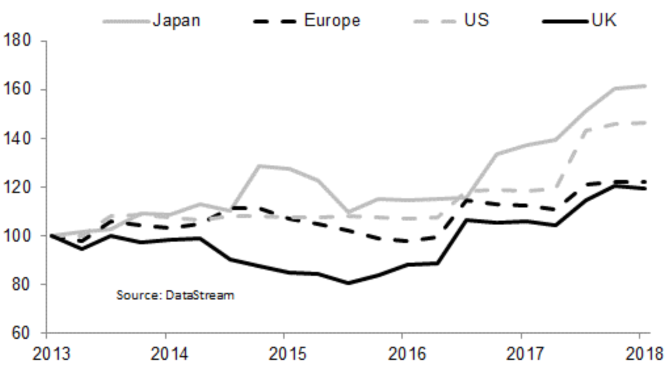
Charts E1: Experienced earnings per share growth





EPS forecasts for the next financial year confirm a generalised improvement including in Japan and the US (tax boosted). Analysts appear reluctant to discount a strong follow-through in Europe where the strength of the € and Italian fiscal policy are concerns. 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); remember, analysts are rarely pessimistic!

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

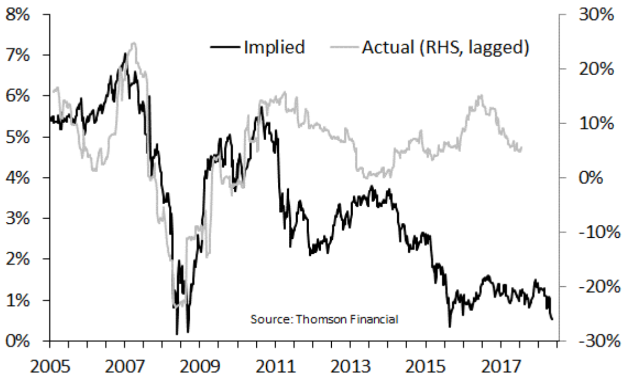
	UK	US	Japan	Europe
FY2	8% (+2%)	10% (u/c)	4% (-1%)	9% (+1%)
FY3	7% (-2%)	10% (u/c)	5% (+1%)	8% (-1%)

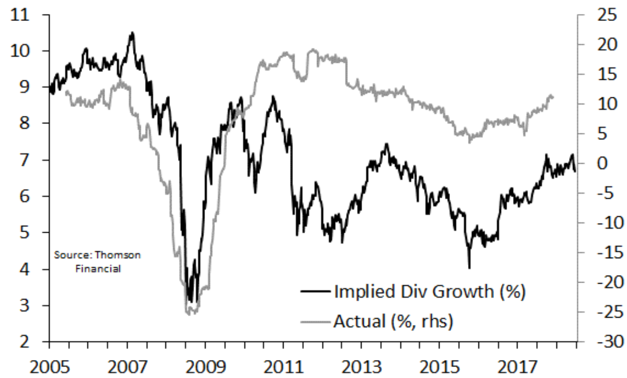
Equity Valuation

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 very 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 be better value than fixed income (gilts). This position could persist for some time.

In the US, equities have seen the breakeven dividend growth rate continue to lift (Chart E4) to levels that look less like as a foregone conclusion. US bonds have acquired a more competitive risk/reward balance with cash rates continuing to head higher; US cash now yields more than the equity market. Although no other developed market is in this position, the US represents more than 50% of global equities and thus dominates the behaviour of global indices.

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 similarly. 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 also remains very low, having fallen afresh – this is consistent with the modest economic growth outlook.

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

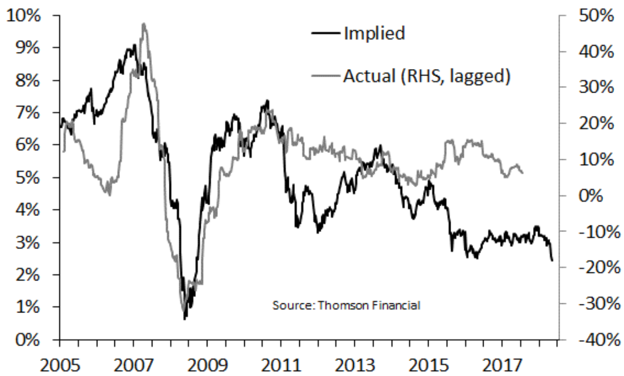
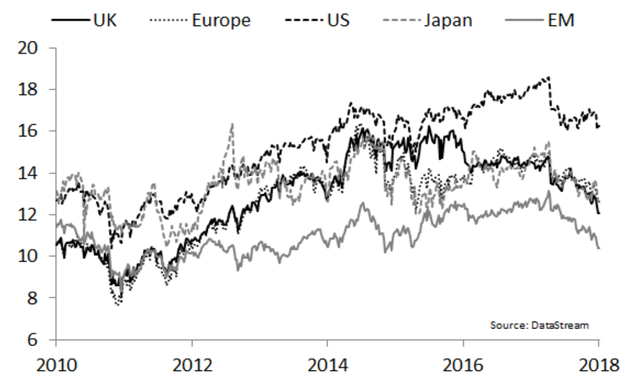


Chart E6: Regional PE ratios



Looking at PE ratios (Chart E6), valuations, having risen over 2017, have corrected materially since early February. Equity ratings, on a PE basis, are now less than the global historic average and are thus less challenging than they were, having been cheapened by strong earnings growth and the recent correction. While in all cases the level of valuation is within historic ranges; the same cannot be said for (non-US) government or corporate bonds.

Equity style update

Appetite to find clever ways of beating the equity market remains undiminished and 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'), minimum volatility and *quality* have outperformed during the current turbulence; the first two having languished in recent months as investors favoured growth. Momentum remains a prized theme but has seen some recent profit-taking.

Chart S2 captures the performance of small cap, growth and value themes. Highlighting worries about the outlook for the world economy *growth* has sold off recently; as a result, *value* has gained. The correction in smaller stocks has been severe (see next page).

Chart S1: Performance of equity styles (vs MSCI)

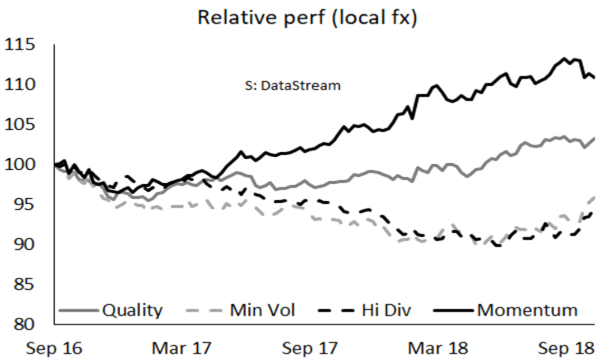
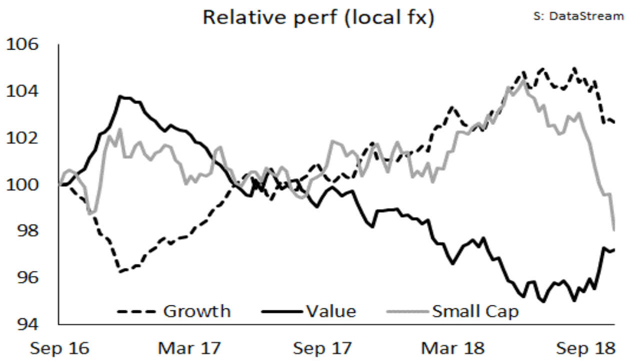
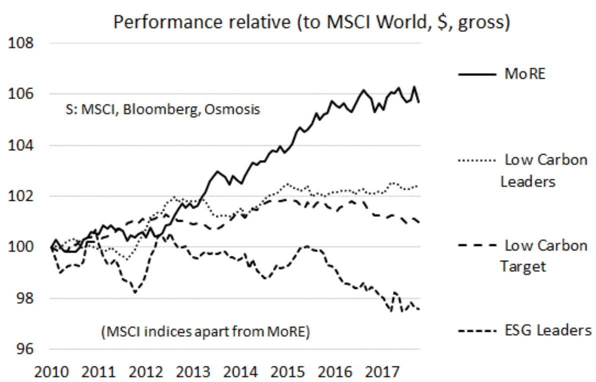


Chart S2: MSCI Growth vs Value relative



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' (as we are currently seeing).

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). [HSBC recently noted that, when looking to promote ESG investing, the 'E' drives excess returns. The chart opposite 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.

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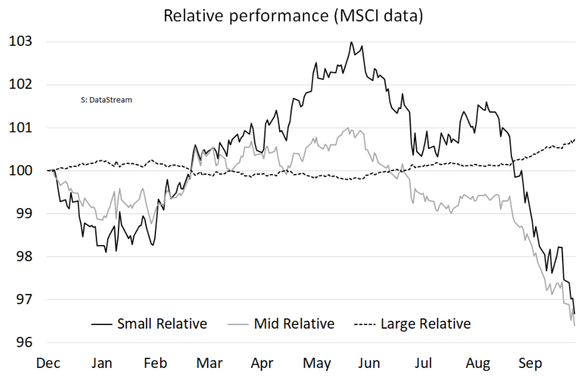
[1] In practice, this 'style' captures those stocks which tend to have high levels of free cashflow yields.
[2] As disclosed formally in their regular company reports. MoRE refers to Model of Resource Efficiency.
[3] Excess returns are perhaps to be expected; companies which minimise their input and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

Note: Size matters

Classically, an equity bear market is declared after the market falls more than 20%. While the recent bout of turbulence is short of any such declaration (UK and World equities are respectively 11% and 9% off their recent highs), stock-market darlings such as Fevertree (-30%) have breached the bear market threshold. Beyond the bloodletting in favoured momentum trades, there have been some significant developments related to size (market capitalisation).

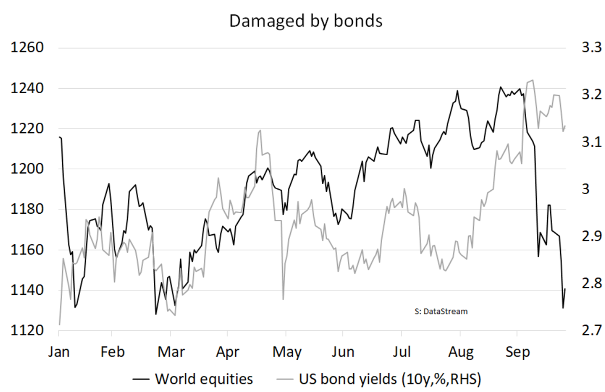
Since the end of 2003, small- and mid-cap stocks have outperformed the broad market by 30% and 14% respectively (MSCI data, local currency); this hasn't come in a straight line. The current market set-back has seen a sharp down-shift in the price of small- and mid-cap stocks relative to the broader market; smaller companies have lost just shy of 6% more than all stocks combined.



Outside of the mayhem of the GFC, there have been five similar episodes since the end of 2003. With only one exception these have occurred within the context of a broader sell-off (table). For the most part these drawdown periods have lasted slightly longer than the current move and the peak-to trough losses in relative performance suggest that the current downshift may be almost done. Encouragingly, the end of the slippage in small stocks has marked a turn in the broader market; the only exception was in early 2008 (but then we now know what was brewing!)

Start	May 2006	Jul 2007	Jul 2011	Mar 2014	Sep 2015	Jun 2018
End	Aug 2006	Jan 2008	Oct 2011	Oct 2014	Feb 2016	Now
Relative performance of small cap	-5.9%	-9.3%	-6.6%	-6.7%	-4.7%	-6.1%
Change in broad market	-5.8%	-7.6%	-16.7%	+0.3%	-6.4%	-5.4%
Change in market 3 months from End date	+8.6%	-6.0%	+9.9%	+6.4%	+9.3%	?

After the latest Fed hike – and the hint of more to come, risk markets are reacting to the prospect of tighter monetary conditions in the US economy; equities slumped after 10y US bond yields spiked to above 3.2% - worried by the size and speed of change.

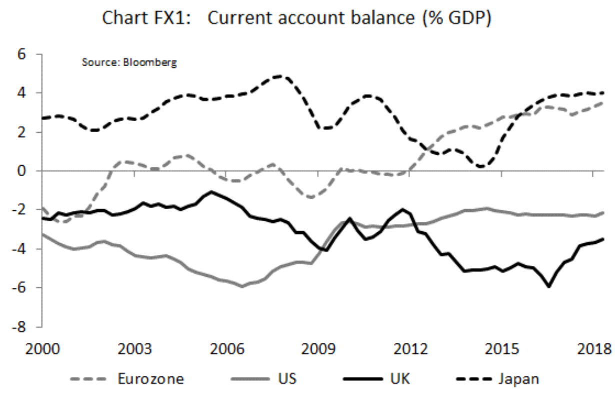


It is perfectly reasonable that smaller companies should react poorly against this backdrop – smaller companies feel the pinch (of a higher cost of capital) quicker. [They also lack the scope to massage profits using financial engineering.]

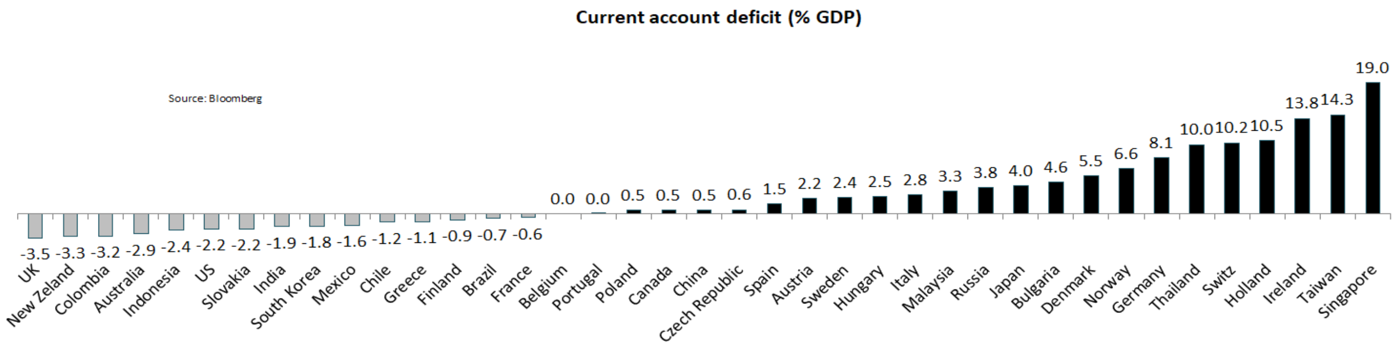
History has however shown – on either side of the GFC – that while these periods occur, they are short-lived; relative to history the bulk of the downshift is behind us. The Q3 earnings season has just started and should bring good news; the growth backdrop also remains supportive of equities. Fed Chairman Powell has let a little steam out of equity markets by his recent comments; this is constructive. Markets might worry that the Fed will make a policy mistake – worries alone shouldn't bring a broader bear market.

Currency markets

Current account imbalances exert a strong influence on currency trends when other, more fleeting, drivers subside and particularly during times of general financial stress. 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 while the UK's substantial current account deficit has improved, it remains, as % of GDP, significant and a global outlier (chart below); financing it could prove challenging if global markets became more cautious for a prolonged period i.e. 'strangers' become less generous.



The US is set to operate 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 but not while risk aversion is strong. In the meantime, a strong US$ is, unhelpfully, 'crowding out' the rest of the World.

£ is low (Chart FX2) and may languish around current levels. Extreme pessimism around *Brexit* however, the recent base rate hike and the challenges within Europe (led by Italian fiscal policy) could conspire to support the Pound – unless an early General Election is called. Otherwise, the outlook will be set by the US$ and, by association, the US economy (see Commentary).

Chart FX2: £ Trade-weighted Index

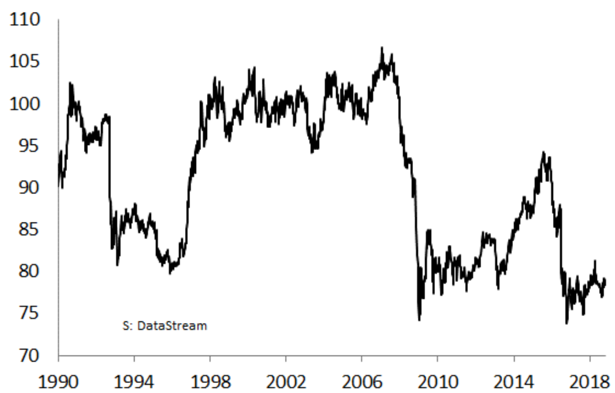
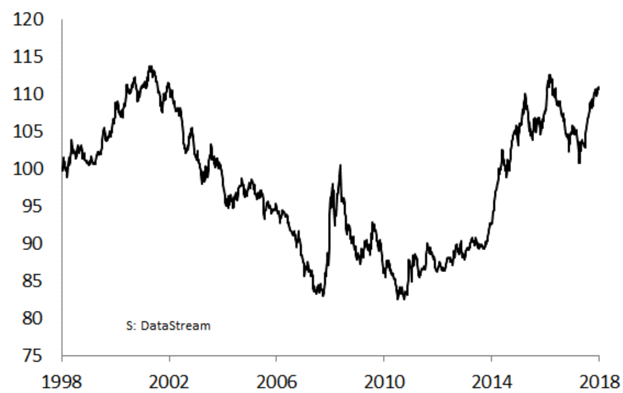
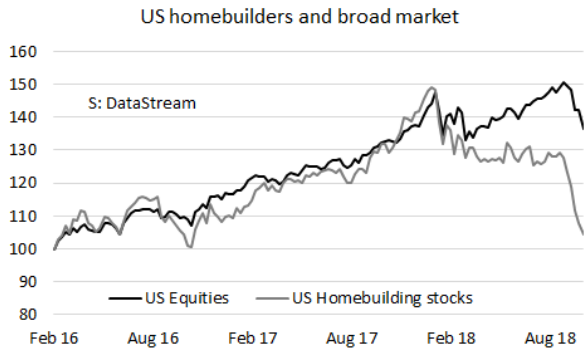


Chart FX3: US$ Trade-weighted Index

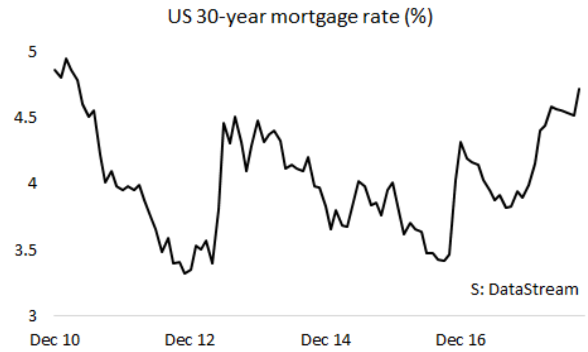


Commentary – Safe as houses

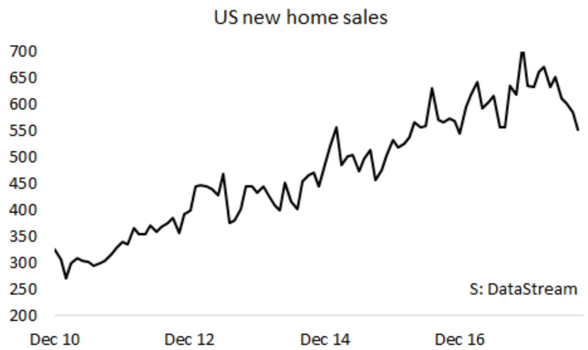
Readers will recall that investments related to (US) housing lay at the epi-centre of the Great Financial Crisis; investors are becoming concerned that we might be facing a more traditional, re-run. The financial system is certainly not awash, as it was in 2008/09, with myriad forms of (what proved to be) toxic derivative plays on US house prices. Nonetheless, the housing market remains important as a store of wealth, underpinning private consumption etc. While the US economy has been roaring ahead his year, the housing market has not. The broad US market has fallen 9% in the recent setback, companies exposed to US housing have seen their value fall by more than 30% since January.



The slump in housing stocks is being blamed on rising mortgage rates. Interestingly, although rates have certainly risen in recent months and they are only towards the top end of the range seen since the GFC, this has proved sufficient to see sales of new housing roll-over after several years of steady strength.



These changes are not lost on President Trump and he is becoming increasing vocal in his objection to the recent increases in US policy rates and those that the new Federal Reserve Chairman, Jerome Powell, has indicated are coming (as the US completes its normalisation of monetary policy). Recent decades have seen central banks able to operate independent of the government of the day, reassuring investors that bad long-term choices will not be made for political expediency.



The prospect of a clash between the US Administration and the Central Bank is another worry for investors currently. In a recent speech, Powell's predecessor, Janet Yellen, opined that while politicians were entitled to criticise the Fed, the President's attacks were coming during a strong recovery, she said, and it was "frightening" to think what the Administration's reaction would be if growth slows. "The bill is going to come due at some point — at a minimum, growth is going to slow to some sustainable level that will stabilise the unemployment rate, and eventually making it necessary for it to go up somewhat. None of that is going to be things that the Administration is going to like." If Trump prevails in the imminent US mid-term elections then he will likely be sufficiently emboldened to 'go after' the Fed (after all, he has gone after everyone else!).

The backdrop to markets has, for several decades, been set by declining short- and long-term interest rates. After the GFC this evolved into a strong aversion for cash. With yields in many centres negative, cash was trash. The next major investment regime will likely be defined by the return of cash as an investible asset – offering some level of return. When this happens, vast swathes of natural cash investors will return 'home' (from equity and various bond markets) and losses will have to be taken, unavoidably. With 47% of the World's developed economy nominal bond markets yielding less than 1% (24% are still on negative yields), it is easy to see why US cash rates, at 2% to 2.25%, are beginning to look attractive - provided the US housing market stops weakening.

Scott M Jamieson, October 2018

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