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Leicestershire County Council Pension Fund Q4 2018 – Market Report

Contents

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Historic Returns for World Markets

	Q4	1 year	3 years
FTSE WGBI Non-GBP TR	4.31	5.61	8.03
FTSE 100 TR	-9.64	-8.73	6.75
FTSE 350 TR	-10.25	-9.47	6.09
FTSE Actuaries UK Idx-Linked Gilts All Stocks TR GBP	1.87	-0.28	8.26
FTSE Actuaries UK Conven Gilts All Stocks TR GBP	1.92	0.57	4.08
FTSE Actuaries UK Conven Gilts Over 15 Y TR GBP	2.55	0.28	7.07
FTSE All-Share TR	-10.25	-9.47	6.12
FTSE Japan TR	-12.42	-7.58	9.06
FTSE Small Cap TR	-10.35	-9.52	6.90
FTSE World Europe ex UK TR GBP	-10.90	-9.45	8.39
FTSE World ex UK TR GBP	-10.96	-2.68	12.91
LIBID GBP 7 Day	0.18	0.58	0.42
Markit iBoxx Sterling Non Gilts Overall TR	0.14	-1.51	4.36
MSCI EM (Emerging Markets) TR GBP	-5.19	-8.92	15.11
MSCI Pacific ex Japan TR GBP	-5.70	-4.61	12.25
S&P 500 TR	-11.45	1.56	14.69
Commodities	-9.96	-12.99	-0.79
£ Trade Weighted Index	-1.48	-1.46	-5.21

	Q4	1 year	3 years
Euro	0.77	1.11	6.78
Japanese Yen	6.00	9.06	8.25
US Dollar	2.39	6.21	4.98

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

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Market Review

UK equities

The FTSE All-Share fell by -10.25% over the fourth quarter and finished 2018 down -9.47%. In size terms all areas of the market declined although large-cap companies (the FTSE 100 was down -9.64%) fared better than their small (FTSE Small Cap; -12.07%) and mid-cap (FTSE 250; -13.32%) counterparts.

Similar to other regional markets, UK equities were hit hard by fears about a slowdown in the global economy. The monetary tightening backdrop (particularly in the US), as well as the ongoing ‘trade war’ between the US and China, proved to be enough to ensure equity markets had one of their worst quarters in a number of years; the FTSE All-Share’s performance was the worst since quarter three of 2011.

The UK, however, also had to contend with a marked increase in concerns about the potential for a ‘no-deal’ outcome from the UK government’s Brexit negotiations (a parliamentary vote on Prime Minister May’s deal will take place mid-January). Concern about the political backdrop fed through to market returns with companies that are more exposed to the UK domestic economy, which tend to be small and mid-cap in stature, suffering more than larger companies with exposure to overseas earnings. Many of the more defensive sectors performed well including telecoms, beverages, pharmaceuticals and utilities. Tobacco and cyclicals sectors including aerospace, chemicals, general industrials, oil equipment & services and retailers underperformed.

US equities

US equities came under significant pressure over the fourth quarter of 2018, with the S&P 500 index returning -11.45%. The blame for the decline was attributed to a deteriorating growth outlook, increased geopolitical challenges (driven by populist pressures) and higher US cash yields. Poor as the equity markets were, they were nothing compared to the slump in oil prices which tumbled nearly 40% over the quarter on concerns related to increasing supply and faltering demand.

The US Federal Reserve raised rates in December (to 2.5%) but was more cautious in its tone as it looked towards 2019. Although monetary policy continues to tighten in the US, it remains broadly accommodative. Inflation everywhere appears contained with 2019 forecasts at, or below, policy targets.

The risk-averse backdrop, and particularly the ongoing dispute with China, was highlighted in sector returns. The dramatic fall in the oil price hampered the performance of resource-related sectors. The technology sector, meanwhile, was hit by a number of profit warnings (including Apple), which was largely due to weaker demand from China. Defensive sectors performed better but were not immune to the general sell-off.

European equities

The FTSE World Europe (ex UK) index fell -10.90% in the fourth quarter to finish what was a dismal year for global equity markets in general. Geopolitical challenges as well as the monetary tightening backdrop (particularly in the US) weighed heavily on the market. Fears about a slowdown in global growth, which were not helped by the ongoing ‘trade war’ between the US and China also contributed to the weak backdrop. Closer to home, France continue to struggle with protests while the ongoing Italian political crisis, and particularly the health of the country’s banks, also concerned investors.

In sector terms, defensive areas of the market such as utilities performed relatively well, while autos suffered due to slower demand. Towards the end of the quarter, the European Central Bank ended its quantitative easing programme, as expected, and also restated that interest rates would remain on hold for most of 2019.

Japanese equities

The Japanese equity market fell heavily in the fourth quarter of 2018 with the FTSE Japan index falling -12.42% in sterling terms (-17.38% in yen). Only five quarters since 1973 have delivered a poorer return and none since the Global Financial Crisis. At around -10.00% (yen terms) the market return in December was the worst December on record.

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The backdrop was driven by growing concerns around the outlook for the global economy resulting from tighter monetary conditions (attributable mainly to higher US short-term interest rates and widening credit spreads) and rising geopolitical risks (for which President Trump is mainly responsible). Japan is famously a trading nation and US moves to alter global trading relationships quickly become a problem. Another specific worry was associated with a weakening Chinese economy; in the most recent data, Japanese exports to China fell by 5.8%.

Unsurprisingly, given deteriorating sentiment, growth and momentum strategies underperformed. More successful tilts included defensive approaches including ‘value’, ‘minimum-risk’ and ‘higher yield’.

At a sector level, utilities performed well. The sector is often ignored by investors looking to grow their capital but when markets are falling, ‘boring’ quickly becomes an attractive feature. For similar reasons, real estate stocks also generally outperformed. The energy sector was among the weaker sectors as it was hit by demand concerns and a 40% decline in the oil price.

Asia (ex-Japan) equities

The MSCI Pacific ex Japan index fell -5.70% in sterling terms over the fourth quarter of 2018. While this was a significant decline, the region nonetheless outperformed other regional markets.

Among the weaker countries in the region were those that are more focused on exports, such as South Korea and Taiwan. Both countries were hampered by the steep falls seen in the technology sector. China also came under pressure as growth slowed despite efforts by the government to support the economy. One of the main drivers of the gloomy backdrop was the ongoing ‘trade war’ between the US and China which, combined with the US Federal Reserve’s US monetary tightening policy, led to increased concern among investors regarding the strength of the global economy.

In other areas, Hong Kong performed slightly better than many of its neighbours although it still fell over the period. Indonesia and the Philippines actually moved slightly higher with both countries benefiting from the lower oil price, given their dependence on importing oil.

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Fixed Income

Rates

Core government bond yields fell materially during the fourth quarter of 2018, with US, UK, German, and Japanese bond yields all finishing lower. This was a reversal from an environment of steadily rising yields seen in the previous quarter. Much of this can be attributed to investor fears that the US economy was slowing faster than anticipated due to a combination of tighter financial conditions and the negative impact of trade tariffs.

The quarter began with expectations of a Fed rate hike in December and at least 2 more to follow in 2019. By the end of the period the December hike was delivered but the shift in sentiment meant expectations of further hikes in 2019 were all but gone. This change in the macro outlook weighed heavily on risky assets with a major sell-off in global equity markets prompting a flight-to-quality into rates markets.

Beginning in October and continuing through all of the fourth quarter, equity markets fell sharply, which in turn helped government bonds to rally as a ‘lifeboat’ for equity investors. Inflation remains under control, with falling oil prices and softening macroeconomic data suggesting inflationary pressure will be muted in the coming months.

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 September 2018	1.57	3.06	0.47	0.13	1.50	3.15	4.18	1.00	1.88
Yield as at end December 2018	1.28	2.68	0.24	0.00	1.42	2.74	4.40	0.90	1.72
Change in yield	-0.29	-0.38	-0.23	-0.13	-0.08	-0.41	0.22	-0.10	-0.16

Credit

The fourth quarter saw a marked widening in credit spreads across all parts of the corporate bond market. Increased uncertainty about the global macroeconomic outlook, especially in the US, prompted a bout of weakness in all risky assets, including corporate bonds. In the UK, Brexit concerns increased significantly which added additional pressure on the corporate bond market as investors sought a larger premium to hold UK assets.

High yield bonds underperformed relative to investment grade bonds, as they were most affected by risk-off sentiment. This was despite a fall in supply – there was no US high yield issuance at all in December.

From a sectoral perspective, falling oil prices hurt oil & gas sector issuers, whilst bonds from insurance companies remained one of the worst performing areas of the market. In an overall weak market, collateralised debt and sub-sovereign issuers were among the better relative performers.

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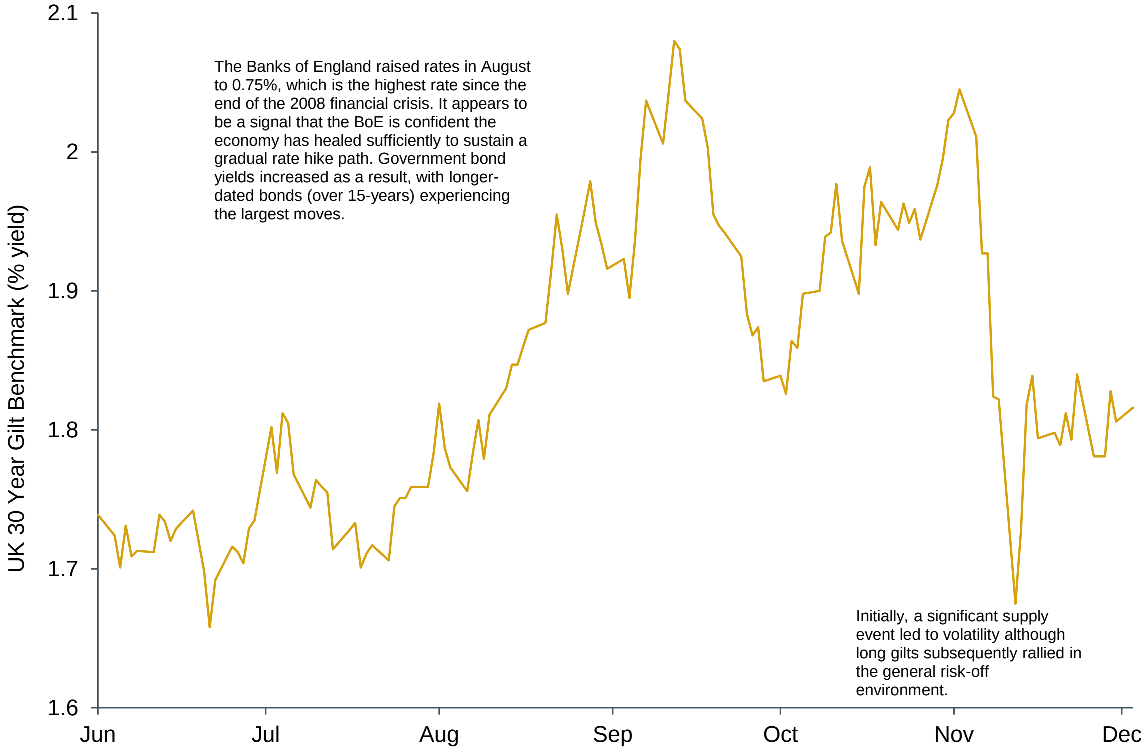
Key Market Movements

The following charts provide a pictorial summary of key market movements during the six month period to end of 31 December 2018.

Global Equities (FTSE World Price Index)

Long Gilts (UK 30 year gilt)



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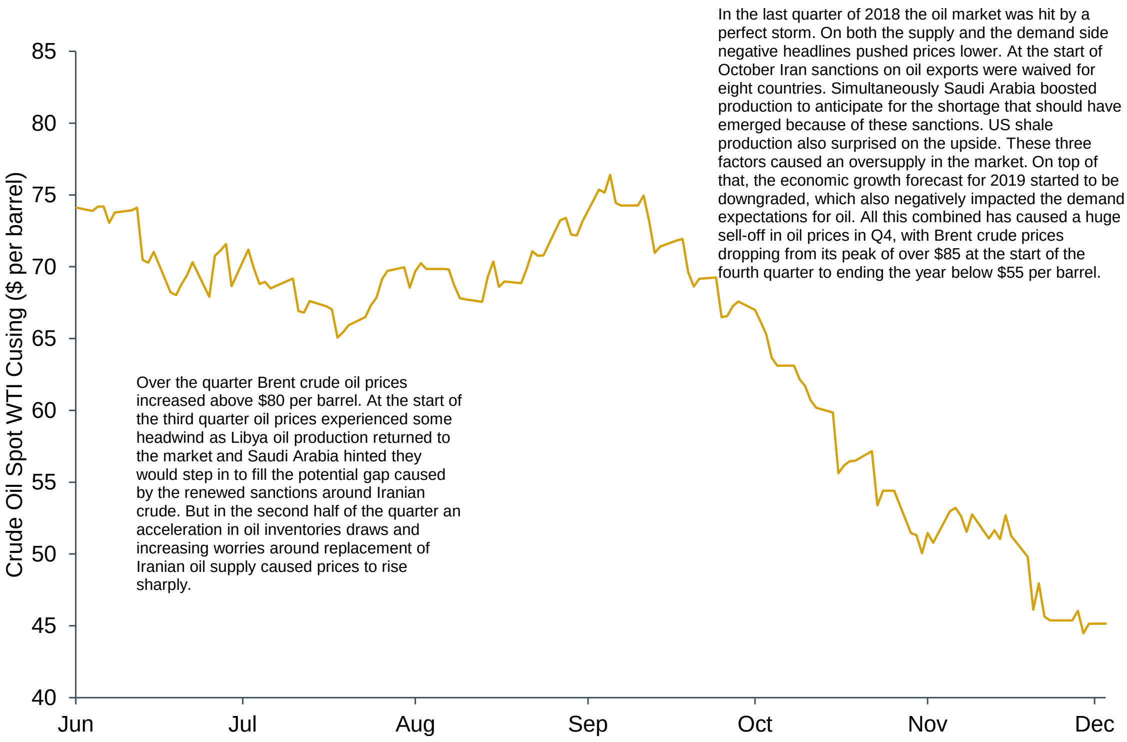
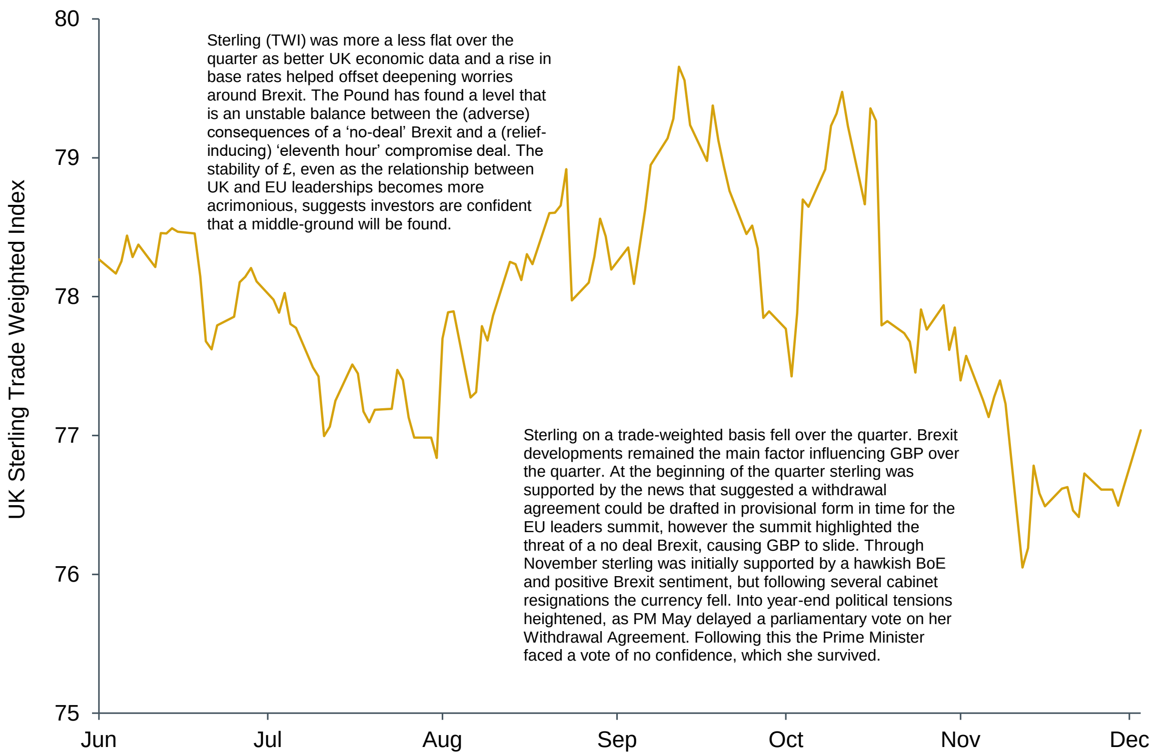
Oil Price (Crude Oil Spot WTI Cushing ($ per barrel))



UK Sterling (UK Sterling Trade Weighted Index)



Source: Datastream

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Quarterly Thought Piece – Brexit: Planning Mode

With the UK due to leave the EU at the end of March 2018, assessment of the investment implications of Brexit should, by now, have been relatively straight-forward. Unfortunately, with no clarity over the manner of our departure, we now have to conduct an exercise in 'adverse-scenario' planning.

Brexit is not like sterling's ejection from the ERM; the ramifications are likely to prove far-reaching and severe economic disruption is a clear possibility. It is a feature of the human spirit to dismiss worst-case scenarios as unlikely (or will happen to someone else!). Those tempted into denial would do well to remember that Syria welcomed 8.5 million tourists in 2010. Argentina and Turkey didn't look for surging inflation, a currency slump and collapsing demand but they got these nonetheless.

The nightmare scenario for a UK pension fund includes weak asset returns and domestic stagflation - a structural uplift in UK inflation and weak domestic economic activity (which raise the quantum of potential scheme liabilities and takes the discount rate lower). In part, this is already taking shape. Measures of longer-term expected UK inflation are rising even as actual prices are falling. At the same time, gilt yields are returning to historic lows and, as I write, global asset markets are experiencing upheaval unrivalled at this time of year other than during the Great Depression, WWII, the 1987 crash and the financial crisis of 2008 – bad company to keep. The implication is sadly predictable; the already-high cost of hedging a severe Brexit outcome is rising.

Whatever way you look at things, Brexit should lead to a higher level of inflation than would otherwise be the case. Higher costs – if wages rise to motivate a domestic workforce into the jobs hitherto apparently taken by lower-cost migrant workers or through increases in import prices from probable currency weakness. The messier Brexit, the higher the inflation that results.

Many pension schemes will already have some form of inflation hedging in place and, if these are established using overlay structures funded by LIBOR 'engines', may already be finding that these 'engines' are mis-firing, given the difficulties experienced this year. In a messy-Brexit scenario this is likely to continue and will need to be monitored. Otherwise funds are advised to hold as much – and as strong - indirect inflation exposure as possible through appropriate equities and other similar asset types.

Long duration nominal investments are hard to justify – beyond a possible spasm lower in yields if / when the economic outlook is judged to have deteriorated. They are already expensive (50-year gilt yields are around just 1.7%) and are vulnerable to pressure from trend higher inflation. Furthermore, across the globe populist pressures continue to build. Jeremy Corbyn is currently the bookies favourite to be our next Prime Minister – a lurch into the unknown that will terrify asset markets. In this scenario, pressure to fund higher public spending through (much) higher gilt sales will be considerable. A bad Brexit will probably lead to a general election that unleashes a protest vote that proves the bookies correct.

Taking the above together, the temptation to move assets offshore could prove irresistible. However, any switch out of UK risk markets is hard. On a range of metrics they appear cheap. Sadly, and as the much-publicised difficulties of UK retailing attest, apparent value may mask a value trap; hard to sell, hard to hold.

Overall, Parliament's failure means that pension funds, and UK business more broadly, are condemned to waste scarce resources on efforts to mitigate a range of adverse outcomes.

Stephen Jones, Chief Investment Officer

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Important information