Market update

Introduction

This paper, which is addressed to the Investment Advisory Panel and Pensions Committee of the West Midlands Pension Fund, provides a short economic and market commentary.

Market returns

UK	*31 Dec - 14 Feb*	To 31 Dec 18 3 mths	12 mths
EQUITIES	*7.4*	-10.2	-9.5
BONDS			
Conventional gilts	*1.9*	1.9	0.6
Index-linked gilts	*2.4*	1.9	-0.3
Credit	*2.2*	0.1	-1.5
PROPERTY	*0.2**	1.1	7.5
STERLING			
v US dollar	*0.3*	-2.3	-5.9
v euro	*1.7*	-0.8	-1.1
v Japanese yen	*1.3*	-5.7	-8.3

Global	*31 Dec - 14 Feb*	To 31 Dec 18 3 mths	12 mths
EQUITIES	*8.8*	-12.4	-7.4
North America	*9.9*	-13.4	-4.7
Europe ex UK	*7.7*	-11.9	-10.5
Japan	*6.6*	-17.4	-15.3
Dev. Asia ex Jap	*9.3*	-8.6	-9.1
Emerging markets	*6.6*	-6.4	-8.7
GOV'T BONDS	*0.7*	2.1	1.0
HEDGE FUNDS	-	-4.3	-3.2
COMMODITIES	*5.9*	-11.6	-10.6

Total return in local currency ($ for Hedge Funds and Commodities)
*Property returns to 31 January 2019

Q4 18

Global economy

- GDP data confirmed US growth remained strong in the third quarter, though a little lower than the second quarter. Though still unspectacular, UK growth reached its fastest quarterly pace in almost 2 years while Eurozone growth slowed to 1.6% year-on-year. Japanese growth saw its sharpest quarterly contraction in several years and Chinese growth fell to 6.5% in the third quarter, its slowest quarterly pace in almost a decade.
- Headline inflation fell in most regions but remains above core measures in the UK, Eurozone and Japan. Core and headline inflation are now broadly in line in the US.
- As expected, the Fed raised interest rates for the fourth time this year in December. However, it pared back forecasts of rises in 2019. The ECB unanimously agreed to end its 4-year QE programme at its December meeting.
- After peaking in October, oil prices plummeted in the second half of the quarter as the US granted waivers to buyers of Iranian crude even as Russia and Saudi Arabia upped production to meet anticipated shortfall. A deal agreed between OPEC member countries and Russia in December to limit supply did little to stem falling prices.
- As uncertainty surrounding a Brexit deal continued, sterling drifted lower over the quarter but has remained fairly steady in trade-weighted terms. The main feature of currency markets over the quarter has been a strengthening yen.

Bond markets

- Sterling investment-grade credit yield spreads rose significantly and, despite Brexit uncertainty, this was not out of line with moves elsewhere.
- Speculative-grade credit yield spreads rose more than investment-grade counterparts. The US high yield market was particularly hard-hit given the falling oil price and exposure to the oil and gas sector in this market.

Equities

- Global equity markets took a sharp turn lower at the start of the fourth quarter as US government bond yields climbed to 3.2%. Declines resumed in December as tighter monetary policy and concerns over the sustainability of the pace of global growth came to the fore.
- Japan was the worst performing region as yen strength and slowing growth in Europe and China weighed heavily on exporters. North America also marginally underperformed global indices while Emerging markets were the best performing region. Returns to UK investors were less negative given renewed sterling weakness.
- Performance divergence across global sectors showed defensive stocks, such as utilities, performed strongly as markets fell while more growth orientated and cyclical sectors, such as technology and industrials, underperformed. Oil and gas was the worst performing sector as a result of declining oil prices.

UK property

- The pace of growth of the UK commercial property market continued to slow in the first two months of the fourth quarter and capital values fell in November. Retail sector capital index values had fallen 3.9% in the 12-months to the end November versus a 1.9% fall for the 12-month period to the end of September. The equivalent Industrial sector index showed capital growth slowing from 15.1% year-on-year in September to 13.6% in November.

Q1 19 update

- GDP growth in the final quarter was sluggish, at 0.2%, in the UK and Eurozone. US numbers have been delayed by the Federal shutdown, which is expected to be only a marginal drag on a more robust performance, but one that will reflect a further slowdown from the peak in Q2.
- Oil prices have rebounded a little in the new year: Brent crude rose over $60 a barrel from year-end lows of $53. Earlier oil price weakness is depressing headline inflation numbers – annual UK CPI inflation fell below the official 2% target in January for the first time in two years.
- Monetary tightening has slipped further down central bank agendas. The US Federal Reserve confirmed its more balanced view on the need for future interest rate rises, while the latest Bank of England Inflation Report took no issue with market expectations of one more interest rate rise in the next three years.
- Consistent with the subdued economic background, UK and German government bond yields have drifted a little lower so far in 2019. Perhaps buoyed by some upbeat manufacturing survey data, equivalent US yields are unchanged from year-end levels.
- The favourable monetary policy background seemed to be more of a focus than economic slowdown for global equity markets, which rebounded strongly at the start of the year, recouping much of the falls of the previous quarter. In similar vein, yield spreads in credit markets reversed some of their recent widening.
- The release of December's IPD Monthly Index suggested UK commercial property finished 2018 with its lowest quarterly return for over two years. In aggregate, both capital values and rents fell, as growth in offices and industrials failed to offset an accelerating decline in the retail sector.

Asset class outlook

The tables below summarise our broad views on the outlook for various assets. Each shows the relevant target weight in the Strategic Investment Allocation Benchmark as at 31 December 2018. These will not add to 100%, as the tables do not cover the allocations to the cash flow matching portfolio and special opportunities.

EQUITIES 48.0%

Global earnings growth, which has been boosted by the cyclical economic upswing and fiscal stimulus over the last two years, is expected to fall back towards long-term average levels in 2019. Consensus earnings growth estimates for 2019 are currently reasonable at around 7%, with a narrow range between the main regions.

The impact of ongoing trade disputes has so far been mainly to undermine investor sentiment, but could soon start to undermine corporate profitability. An uncertain economic backdrop – it is not clear that there will be a straightforward resolution to the disputes – considerably reduces the transparency of the earnings outlook.

In the wake of the market downturn in the final quarter, valuation measures – even those insensitive to the cyclical behaviour of earnings – were no worse than long-term averages. This inclines us to take a more neutral overall stance to equities. There is still a significant disparity across regional equity valuations. UK and Emerging Markets are below historical averages, whilst US equity valuations remain at a premium.

PRIVATE EQUITY 10.0%

Overall, private equity continues to perform well, but we think investors must be increasingly selective about investment, both in terms of manager selection – the dispersion of returns across managers is increasing – and where to commit capital. Valuations are stretched beyond the peaks reached in 2007 and pricing is high even in areas, such as small and mid-market companies and the secondary fund market, where some managers claim to identify pockets of value. But technical support remains strong. Fundraising levels have slowed over the past year, but remain high, particularly in North America, and the aggregate level of capital commitments still to be deployed has risen further.

REAL ASSETS AND INFRASTRUCTURE 6.0%

Indirect evidence suggests that infrastructure valuations are stretched. Data on completed transactions, relative to capital raised, suggest it is becoming increasingly challenging to source attractively priced assets. But technical drivers are strong and could underpin further revaluation. Funds that reached final close in the first three quarters of 2018 raised, on average, 22% more than target. In a diverse and illiquid market, value may still be found in certain areas, such as deals with a degree of complexity in implementation or where a manager has a competitive edge.

PROPERTY 10.0%

At the end of 2018, the yield premium of property over equities was as low as it had been in over 30 years and in absolute terms property yields remain close to historic lows. And it is on valuation grounds that we are becoming increasingly cautious on the outlook. Annual rental growth continues to drift lower – still positive in aggregate and by no means extreme in real terms relative to history, but the fall in retail rents is accelerating. The technical picture is mixed. Outside the retail sector, the market remains relatively liquid, with quarterly investment volume remaining significantly above the 10-year average. But recent survey evidence suggests occupier demand has fallen further, while space availability and the level of inducements offered to tenants continue to rise.

INDEX-LINKED GILTS	5.0%

A Brexit-induced wobble took real yields to 18-month lows in mid-December, but it was rapidly reversed and yields are back in the middle of the recent trading range. Brexit uncertainty (for the short term, and possibly beyond) and hedging demand (at least over the next few years) should keep a fairly tight lid on yields, but we believe they are very unattractive on a long-term view, even in a "new normal" environment of subdued growth and inflation.

CONVENTIONAL GILTS	2.0%

In absolute terms, we think conventional gilts are unattractive, too. As before, it is the low level of real yields that is key. The attractions relative to index-linked continue to vary. The Brexit wobble noted above did briefly raise the relative attraction of conventional gilts to index-linked, as implied inflation rose across the yield curve, but the effect has been largely reversed. In our view, that means the comparison varies significantly with maturity. Conventional gilts look more attractive than index-linked across much of the yield curve. However, the extremely low level of nominal reinvestment rates reverses the relative attractions at longer maturities beyond 30 years or so.

INVESTMENT-GRADE CREDIT	2.5%

Valuations had edged towards attractive levels, but a rally at the start of 2019 has taken spreads back to more neutral levels. The fundamental outlook is perhaps a little less supportive as corporate earnings growth subsides and global growth looks a little more fragile, but a slowdown in monetary tightening will help to keep interest coverage at current high levels. There is little evidence of a Brexit effect in sterling markets, perhaps because the issuer base is well diversified geographically. In absolute terms, the low level of underlying risk-free rates argues for a cautious stance and a preference for lower-duration assets – floating-rate ABS rather than corporate bonds, for example. Senior real estate debt still looks to offer insufficient compensation for illiquidity.

OTHER CREDIT	2.0%

The comments above on economic risks and monetary mitigation apply equally to liquid speculative-grade markets. Here, valuations really only struggled back to neutral levels at the end of 2018 and spreads have fallen back below long-term medians at the start of this year. We are less cautious on direct corporate lending, where covenant protection remains better and illiquidity premiums are at reasonable levels. We think speculative-grade real estate debt markets offer better opportunities than investment-grade equivalents, reflecting lower competition for investment as high capital requirements reduce the attractiveness of these assets for banks and insurance companies.

EMERGING MARKET DEBT (EMD)	2.5%

Reported numbers on growth and inflation show no significant deterioration across the major constituents of EMD indices and the picture from recent manufacturing surveys is no worse than mixed. But the market remains exposed to the risk of continuing trade tension and, more generally, global economic uncertainty. Valuations are reasonable, although a strong start to 2019, in terms of both lower yields and currency strength against the US dollar, make them a little less attractive.

INSURANCE-LINKED SECURITIES (ILS) 3.0%

Despite a relatively quiet first half, 2018 proved to be the second year in a row of heavy catastrophe losses. The position was compounded by some "loss creep" from 2017 as settlements of the extreme hurricane season progressed. In the January 2019 reinsurance round, significant premium increases were largely restricted to programmes affected by recent losses, particularly in US wildfires. Catastrophe bond valuations have been relatively stable – spreads are broadly in line with equivalently rated corporate bonds – and demand from institutional investors remains robust. However, a degree of caution is warranted in a market where a difficult fundamental background has not been matched by higher prospective returns.

CASH 2.0%

Market moves in the final quarter of 2018 may have been an over-reaction in terms of the available evidence of global economic slowdown, but for most asset classes any corrections came from extended valuation levels. The risks to a moderating pace of growth remain skewed to the downside. The fading fiscal stimulus in the US, potential escalation of US-China trade hostilities, Eurozone politics and Brexit all pose potential headwinds to global growth in 2019. We would therefore be happy to keep a little bit of cash in reserve to exploit any further corrections.

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For and on behalf of Hymans Robertson LLP

Notes

Market returns

Percentage total returns in local currency ($ for Commodities and Hedge funds). Source: Datastream; indices as shown below.

Equities		**Bonds**	
UK	FTSE All-Share	Conventional gilts	FTSE-A UK Gilts All Stocks
Overseas (developed)	FTSE World	Index-linked gilts	FTSE-A UK Index Linked Gilts All Stocks
Emerging Markets	FTSE All-World	UK credit	iBoxx Non Gilts All Maturities
Property	IPD Monthly	Overseas Government	JP Morgan Global
Hedge Funds	DJ CS Hedge Fund/Core Hedge Fund	**Commodities**	S&P GSCI Light Energy

General Risk Warning