Market update

Introduction

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

Market returns

UK	*30 Jun 17 - 31 Jul 17**	To 30 Jun 17 3 mths	12 mths
EQUITIES	1.2	1.4	18.1
BONDS			
Conventional gilts	0.3	-1.3	-0.9
Index-linked gilts	-1.3	-2.3	6.7
Credit	0.7	0.5	5.3
PROPERTY		2.5	5.1
STERLING			
v US dollar	1.5	3.9	-2.8
v euro	-1.8	-2.6	-5.4
v Japanese yen	-0.2	4.7	6.4

Global	*30 Jun 17 - 31 Jul 17**	To 30 Jun 17 3 mths	12 mths
EQUITIES	1.8	3.2	19.9
North America	1.9	2.8	17.9
Europe ex UK	0.6	2.7	22.5
Japan	0.3	6.4	31.9
Dev. Asia ex Jap	1.5	4.6	22.8
Emerging markets	4.9	3.8	18.7
GOV'T BONDS	0.1	0.6	-3.0
HEDGE FUNDS		0.8	5.8
COMMODITIES	1.2	-0.5	0.9

Total return in local currency ($ for Hedge Funds and Commodities)
* No index data after 30 June for property and hedge funds

Q2 17

Global economy

- The economic weather followed a similar pattern to Q1. Survey data continued to point to decent momentum in global growth. This was generally reflected in hard data from the Eurozone and Japan, but there were signs that any rebound from disappointing Q1 growth in the UK and US might be subdued.
- The Federal Reserve raised US interest rates again in June, to a range of 1-1.25% p.a., ignoring unexpected weakness in short-term inflation data. They also indicated their intention to start unwinding their QE programme later in the year.
- Headline inflation in the UK continued to rise on the back of last year's fall in sterling. May's UK CPI inflation of 2.9% p.a. was as high as it has been for over five years.
- Despite rising inflation, the BoE has held rates at 0.25% p.a., citing the moderation in pay growth. However, three members of the MPC (out of 8) voted for a rate rise in June, and markets have adjusted to imply a better than evens chance of a rate rise before the end of the year.
- Within currency markets, the euro strengthened against the US dollar and the yen. Sterling fared relatively well in spite of post-election uncertainties towards the end of the quarter.
- Brent crude fell from $53 to $48 a barrel over the quarter, erasing most of the gains that followed OPEC's announcement of an output cut last November. Increased production in the US continued to offset the impact on global oil supply of OPEC's cut.

Bond markets

- Gilt yields rose over the quarter. A rise after the announcement of the election in mid-April had been quickly unwound, but yields rose again at the end of June as investors grew more concerned about the possibility of tighter monetary policy.
- Sterling investment-grade credit markets had another good quarter relative to gilts – yield spreads on AA-rated bonds hit their lowest levels for over 12 years.
- Across global credit markets, lower-rated credit led the gains. In the US corporate credit market, the yield premium on speculative grade BB-rated bonds relative to investment-grade AA-rated bonds is as low as it has been since the early days of the credit crunch.

Equities

- Global equity indices rose over the quarter, establishing new all-time highs in June, while levels of volatility implied by options markets fell to new lows. However, sterling's strength towards the end of June offset earlier gains.
- The best regional performance came from Japan and Europe, both perhaps boosted by their robust economic momentum. In addition, the election of Emmanuel Macron as President of France allayed concerns about European political uncertainty. The US struggled against disappointing economic data and failure of the new administration to deliver the tax reforms and infrastructure spending that had encouraged investors in the wake of the Presidential election.
- Global equity sector performance was once again dominated by the weakness of Oil & Gas. Outperformance from the Healthcare sector reflected the more general outperformance of growth stocks relative to value stocks – a reversal of the trend of late 2016.

UK property

- UK property values continued to edge higher in Q2, but remain a little below pre-referendum levels. The strongest gains are still coming from the industrial sector, where rental growth is also slightly ahead of a modest overall rise.

Q3 17 update

- According to initial estimates of GDP growth, the UK economy continued to struggle in Q2, while the US economy bounced back (though not as strongly as expected a few months ago). Eurozone Q2 growth was at a similar pace to the US, sustaining the momentum of the previous two quarters.
- Oil prices rose in July, helped by unexpected falls in US inventories. Brent crude reached $52 per barrel, its highest level since May, before retreating at the start of August on news of increased OPEC production.
- The statement issued after the US Federal Reserve's monetary policy meeting in July was interpreted as pointing to the start of the unwinding of QE as early as September or October.
- However, the US dollar has remained under pressure as interest rate rises are seen as less likely in the short term. Investors are evenly divided as to whether there will be any further rises this year.
- The short-term weakness in government bond markets continued at the start of July, but quickly faded. 10-year yields in the US, UK and Germany settled back around end-June levels.
- Yield spreads in credit markets narrowed again. Spreads on AA-rated sterling bonds have dipped close to the best levels achieved in the years before the credit crunch.
- Equity markets pushed higher – the evidence of profits reports suggested sustained momentum in global earnings growth. Emerging markets, which typically benefit from dollar weakness, led the latest gains.

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 30 June 2017. 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%
An upturn in global earnings growth, coupled with equity investors' willingness to put a positive spin on economic data has underpinned the latest leg of the rally. Our view remains that the earnings growth we have seen, and a lot more beside, is required to justify recent valuation levels rather than further strength. We remain unconvinced that the breadth or strength of earnings growth will be sufficient to offset the valuation strains imposed by rising risk-free yields. (We certainly don't think earnings growth will be broad or strong if risk-free yields don't rise.)	

PRIVATE EQUITY	10.0%
The primary market remains stretched and prices are high in secondary markets, where existing unspent commitments have been swollen by investors seeking to put record levels of distributions back to work. It does appear that secondary supply is rising to meet demand, however, with many investors taking the opportunity to rationalise their private equity portfolios. We think this use of the secondary market to make portfolios more manageable makes sense, as long as it is allied with a strategic programme of regular commitments across the market.	

REAL ASSETS AND INFRASTRUCTURE	6.0%
Investor demand for infrastructure shows no sign of slacking – already in 2017 fundraising is higher than the record levels set in 2016. Hopes of increased supply, from the US in particular, have been deferred. Secure operational assets are highly bid, particularly the large assets attractive to the "mega" funds that raised capital in 2016. Implementation is therefore very important: value can still be found by investors who have a competitive angle in a particular deal (for example, in restructuring assets they already own) or in deals with a degree of complexity to implementation.	

PROPERTY	10.0%
Recent trends remain in place. Aggregate rental growth is slowing, although stabilising (at a rate below inflation) might now be a better description. The level of income received is growing more quickly as rent reviews take place. But capital values are again edging higher at a slightly faster rate, and so valuations become a little more stretched. Yield margins over bond markets remain healthy, but equities provide a tougher comparison. Nevertheless, the scale of underperformance against global equities over the last year argues against any disproportionate reduction in exposure.	

CONVENTIONAL GILTS	2.0%
Shifting perceptions about the outlook for global monetary policy, the vagaries of Brexit negotiations and the path of UK inflation have provided (and will doubtless continue to provide) plenty of scope for short-term speculation. The net effect this year has been to leave the gilt yield curve barely changed. So, it is the implication of a peak in interest rates of under 3% p.a. that continues to underpin our negative view. Long-dated forward reinvestment rates around 1% p.a. argue that long-term investors (more precisely, those with no need to hedge) should stay short.	

INDEX-LINKED GILTS	5.0%

Real yields have edged a little higher this year, but the rationale for a negative view on conventional gilts still holds good here. The relative attractions of index-linked have improved a little, but as has been the case for much of the time in recent years, it is shorter maturities that look to offer the best relative value.

INVESTMENT-GRADE CREDIT	2.5%

Spreads are little better on a like-for-like basis than in the halcyon days of the mid-2000s. As for credit markets in general, we think it is worthwhile exploring the possibility of returns to factors other than credit risk. The yield spreads on ABS compare favourably with those on traditional corporate bonds for those willing to accept the more complex structures involved.

OTHER CREDIT	2.0%

It seems plausible that concerns about financial instability in the wake of the reach for yield lie behind the beginning of the end of QE and credit markets may be particularly exposed to the start of the unwinding of programmes. Valuations are, in any case, at a level where we would be looking to take less pure credit risk than usual – it seems increasingly worthwhile to sacrifice liquidity in favour of credit quality. We still value the strategic diversification offered by credit markets and are comfortable with investment in short-dated instruments in current circumstances.

EMERGING MARKET DEBT (EMD)	2.5%

Investors' renewed enthusiasm for emerging market risk since late last year has pushed yields on the main local currency indices to their lowest levels since the start of 2015. They have only been significantly lower in the last frenzy of enthusiasm for emerging markets between mid-2012 and mid-2013. Economic and financial conditions (most of all the weak US dollar) remain supportive and yields relative to developed markets are still healthy, but a degree of caution is appropriate after a rally of this scale.

INSURANCE-LINKED SECURITIES	3.0%

The evidence from recent transactions is of stable reinsurance prices – a contrast to the falls of recent years. Consistent with this, there seems to have been little further narrowing of yield spreads on catastrophe bonds – a contrast to the ratcheting down of spreads in credit markets. Even though valuations are still stretched relative to historic norms, these recent relative movements reinforce the strategic case for insurance-linked securities as a diversifier in income-focused portfolios.

CASH	2.0%

Almost all assets have done well in a difficult economic environment in recent years, but we are increasingly doubtful that can be sustained or that everything will do well if the economic environment improves. The case for holding more cash than normal to protect some capital, even at the expense of a mismatch to long-term strategic requirements, has only strengthened in recent months.

Prepared by:

Graeme Johnston, Partner
William Marshall, Partner
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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