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	*31 Dec 17 - 22 Feb 18**	To 31 Dec 17 3 mths	12 mths
EQUITIES	-4.9	5.0	13.1
BONDS			
Conventional gilts	-2.1	2.0	1.8
Index-linked gilts	-2.9	3.5	2.3
Credit	-1.9	1.8	4.3
PROPERTY	0.7	3.4	11.2
STERLING			
v US dollar	3.0	0.8	9.5
v euro	0.4	-0.7	-3.8
v Japanese yen	-2.2	0.9	5.7

Global	*31 Dec 17 - 22 Feb 18**	To 31 Dec 17 3 mths	12 mths
EQUITIES	0.1	5.6	20.3
North America	1.2	6.5	21.4
Europe ex UK	-1.3	0.1	14.9
Japan	-3.8	8.9	21.0
Dev. Asia ex Jap	-1.2	6.5	23.6
Emerging markets	3.8	6.1	27.4
GOV'T BONDS	-1.4	0.5	1.3
HEDGE FUNDS	2.7	2.3	7.1
COMMODITIES	2.0	7.3	10.1

Total return in local currency ($ for Hedge Funds and Commodities)
* Returns to 31 Jan for property and hedge funds

Q4 17

Global economy

- Q3 data confirmed continued robust growth in the US, Eurozone and Japan. UK growth in Q3 was ahead of estimates, but remains sluggish at 0.4%. Survey evidence suggested the global economy maintained momentum in the final quarter.
- Inflation across most developed economies was stable, particularly based on 'core' measures - excluding food and energy. However, headline UK CPI inflation rose above 3% for the first time in 6 years, forcing Mark Carney to write a letter to the chancellor explaining the overshoot of the 2% target.
- Oil prices continued to rise, with Brent crude finishing the year at $67 a barrel, the highest price since 2015. Industrial metals were again strong over the quarter – broad price indices for the sector rose over 30% in 2017.
- As almost universally expected, the Bank of England's Monetary Policy Committee increased interest rates by 0.25% p.a. to 0.5% p.a. in November.
- There was little surprise about the tightening of monetary policy announced elsewhere – a tapering of quantitative easing in the Eurozone and another US interest rate rise.
- There were no significant exchange rate movements among the major currencies over the period. Sterling was barely changed in trade weighted terms.

Bond markets

- Long-dated gilt yields (both conventional and index-linked) drifted lower over the quarter, finishing 2017 little changed from the end of 2016.
- Credit spreads finished close to end September levels. Some company-specific disappointments from a few major issuers did cause a wobble in the high yield market in particular, but sentiment recovered quickly
- Yields on emerging market debt indices drifted a little higher. Currency weakness against the US dollar further undermined returns during the quarter, but the impact had been unwound by the end of the year.
- The insurance-linked market weakened in response to the consequences of the Atlantic hurricane season. However, the widening of yield spreads on catastrophe bonds in Q4 did no more than reverse the falls since Q2.

Equities

- Global equity indices had another strong quarter, bolstered by a continued positive economic outlook. Sentiment was also boosted by the agreement of significant reductions to US corporate tax rates, although the performance of the US equity market was unexceptional over the quarter.
- The best regional equity performance came from Japan, which is now enjoying its longest economic expansion since the 1990s. European equities underperformed – economic conditions remain buoyant, but the strength of the euro over the last two years is increasingly seen as likely to depress future profits growth.
- As might be expected in a market rally, defensive stocks – Healthcare, Telecommunications and Utilities – lagged. The best performers – Basic Materials, Technology and Consumer Services – are typically beneficiaries of economic strength.

UK property

- UK commercial property values, as reflected in the IPD UK Monthly Index, have risen further. The very gentle acceleration of the pace of the rise, evident throughout 2017, has persisted. The industrial sector continues to outstrip both office and retail sectors in terms of both total return and rental growth.

Q1 18 update

- The latest growth estimates for Q4 2017, together with recent business surveys, suggest that the global economic expansion remained robust through the end of 2017 and into 2018.
- Investors were unsettled by US employment numbers, which showed unexpectedly high growth in average hourly earnings of 2.9% in the year to January.
- The prospect of faster tightening in monetary policy to counteract budding inflationary pressure dragged down bond markets. US 10-year government bond yields rose to 2.9% p.a., their highest level for four years. 10-year gilt yields returned to levels that obtained in the months leading up to the EU referendum.
- Equity markets made a strong start to the year – at their peak in late January, global indices had risen over 5% in local currency terms. However, they too reacted badly to the possibility of faster-than-expected increase in interest rates and the earlier gains had been wiped by the end of the first week in February.

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 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%

Strong growth in corporate earnings had underpinned the rise in global equity markets since late 2016. There were perhaps signs that prices had become detached from this fundamental support at the start of 2018. Valuation support had been missing for rather longer. Even after the recent market correction, the price-earnings ratio on the MSCI AC World Index is high by historic standards. Equity markets were boosted by falling bond yields while earnings were struggling after 2011 – the price-earnings ratio rose from around 12 to over 20. But equity valuations have barely changed since the middle of 2016, while global government bond index yields have risen from 0.8% p.a. to 1.6% p.a.

PRIVATE EQUITY	10.0%

Average purchase price multiples and leverage multiples remain at levels higher even than those seen in 2007. Moderate economic growth could continue to support these stretched multiples, but private equity is at least as exposed to listed equity to either of a deterioration of economic fundamentals or a devaluation triggered by higher interest rates. In both cases, high levels of 'dry powder' (committed capital still to be drawn down) could give private equity managers the flexibility to exploit opportunities that arise during market dislocations.

REAL ASSETS AND INFRASTRUCTURE	6.0%

According to a recent Preqin survey, there is increasing competition for infrastructure, particularly for assets with existing, secure cash flows. Income yields on regulated assets have reduced to around 5% p.a. (assuming leverage in the range 50-70%). Investor demand is strong: by mid-2017, fundraising had already surpassed 2016's record; in addition, some large institutional investors are increasing direct allocations. Supply is unlikely to have any impact on current valuations of operational assets: although there has been plenty of talk about the increase in the supply of projects, action seems as distant as ever.

PROPERTY	10.0%

There are continued signs of improvement in the fundamental background for property. Rental growth, as measured by the IPD Monthly Index, is drifting higher, although still failing to keep pace with inflation. Against that, there is anecdotal evidence that leases are taking longer to agree and tenants are seeking greater incentives to sign deals. But valuations are demanding. Reversionary (rental) yields are at 10-year lows reached around the end of 2015. Initial yields (based on income actually received) have not fallen back as far, as the stronger rental growth of mid-2014 to mid-2016 is crystallised in rent reviews.

INDEX-LINKED GILTS	5.0%

The main reason for our negative view relates to valuation. Long-dated index-linked gilt yields may be as high as they have been since the middle of 2016, but they are still very low both by historic standards and relative to the US, which provides a yardstick for pricing in a less distorted environment.

CONVENTIONAL GILTS	2.0%

There is no glaring anomaly between conventional gilt yields and real index-linked yields – inflation protection is reasonably priced on average. Relative value does vary a lot by maturity. The inflation protection offered by index-linked gilts looks relatively expensive between 10 and 20 years. The gilt market still seems to be mainly driven by global factors. But the approach of Brexit still has the potential to affect short-term sentiment. The strength of domestic demand can perhaps be taken for granted; foreign demand could be more fickle.

INVESTMENT-GRADE CREDIT	2.0%

In the sterling market, yield spreads over gilts have not been affected by the recent turbulence in markets. On a like-for-like basis they are no better than the pre-crisis lows of the mid-2000s. In general, valuations are at a level where we would be looking to take less pure credit risk than usual.

OTHER CREDIT	3.0%

Corporate fundamentals are steady, and default levels outside of commodity sectors remain below historic averages. Current global economic momentum is helpful, but valuations provide little cushion against any deterioration in conditions over the next business cycle. We have a bias to look for value in risk factors other than credit. Illiquid areas such as direct corporate lending still look relatively attractive. Strong demand has resulted in further erosion of covenant protection in traded bond and loans markets; better protection can be negotiated in private markets.

EMERGING MARKET DEBT (EMD)	3.5%

Yields on local currency indices are expensive relative to their own history, but still look much less stretched in absolute terms than most other bond markets. The recovery in EM currencies against the US dollar over the last two years probably both encouraged and reflected renewed capital inflows to EMD. These only picked up in earnest in Q3 2017 and one estimate suggests only 20% of outflows between 2010 and 2015 have returned.

INSURANCE-LINKED SECURITIES (ILS)	3.0%

The market weakened in response to the consequences of the Atlantic hurricane season, but the widening of yields spreads on catastrophe bonds leaves them as expensive as they had ever been until 2017. A well-capitalised reinsurance market seems to have absorbed 2017's global catastrophe losses of around $135bn with only modest price increases. Nevertheless, the relative value of catastrophe bonds and other insurance-linked securities has improved and they are still worth considering as diversifying investments.

CASH	2.0%

Current conditions still argue, in our view, for carrying less investment risk than normal. An above-benchmark holding in cash is one straightforward option. There is little evidence of a deterioration in global economic conditions, but increasingly that offers central banks more opportunities to normalise monetary policy. Higher risk-free yields can easily undermine valuations in other asset classes as effectively as improving fundamentals can buttress them.

Prepared by:

Graeme Johnston, Partner
William Marshall, Partner
27 February 2018

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

Please note the value of investments, and income from them, may fall as well as rise. This includes equities, government or corporate bonds, and property, whether held directly or in a pooled or collective investment vehicle. Further, investments in developing or emerging markets may be more volatile and less marketable than in mature markets. Exchange rates may also affect the value of an overseas investment. As a result, an investor may not get back the amount originally invested. Past performance is not necessarily a guide to future performance.