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	30 June - 13 August	To 30 June 18 3 mths	12 mths
EQUITIES	0.4	9.2	9.0
BONDS			
Conventional gilts	0.2	0.2	1.9
Index-linked gilts	1.8	-1.0	1.8
Credit	0.7	-0.1	0.6
PROPERTY		2.2	10.9
STERLING			
v US dollar	-3.2	-5.9	1.6
v euro	-1.0	-0.9	-0.7
v Japanese yen	-3.2	-2.0	0.2

Global	30 June - 13 August	To 30 June 18 3 mths	12 mths
EQUITIES	2.2	2.8	11.2
North America	3.8	3.7	14.4
Europe ex UK	1.9	2.6	3.9
Japan	-2.5	1.2	9.6
Dev. Asia ex Jap	-0.9	1.3	8.5
Emerging markets	0.6	-3.7	10.7
GOV'T BONDS	-0.3	-0.2	0.7
HEDGE FUNDS		0.1	4.7
COMMODITIES	-5.2	3.1	13.6

Total return in local currency ($ for Hedge Funds and Commodities)

Q2 18

Global economy

- GDP numbers confirmed that the pace of global growth had slowed in Q1. Subsequent data and survey evidence suggest that expansion remains intact, with the US recovering momentum but the slowdown persisting elsewhere.
- UK CPI inflation fell further, to 2.4% in May. The Bank of England pulled back from a rate rise in May, but a split vote in June has increased speculation about a rise in August.
- In contrast, higher energy prices drove headline inflation higher in both the US and Eurozone. The rise in underlying inflation was more modest, but no barrier to a further rate rise from the US Federal Reserve or confirmation that the ECB would end its QE programme at the end of 2018.
- Oil prices were again strong. Brent crude rose more than 10%, peaking just above $80 a barrel in May, the highest level since late 2014. A production increase agreed by OPEC in June had little short-term effect on prices.
- US dollar strength was the main feature of foreign exchange markets. Sterling was the weakest of the major currencies, falling 2% in trade-weighted terms.

Bond markets

- Long-dated gilt yields, both conventional and index-linked, were little changed over the quarter. A rise at the start of the period, when a possible rate rise and US economic acceleration dictated investor sentiment, was reversed later, as trade tension raised concern about the outlook for growth.
- UK credit spreads widened a little over the quarter from historically low levels. This was in line with the pattern in global credit markets.
- Dollar strength was a catalyst for foreign investors to reduce their exposure to emerging markets (EM). Local currency debt was particularly hard hit – broad EM debt indices were down around 5% in sterling terms over Q2.

Equities

- EM equities also suffered from the strength of the dollar and were down 2.4% in sterling terms over Q2.
- In contrast, developed market equities bounced back from the downturn in Q1. Global indices (including EM) had returned over 5% by mid-June, before falling back a little as trade conflict intensified. Sterling weakness considerably increased returns to UK investors.
- Currency was also a factor in the very strong recovery of UK equities, which saw a reversal of the relatively severe setback in Q1. The market generates a substantial proportion of revenue overseas.
- Unsurprisingly given the strength of oil prices, the strongest sector performance over Q2 came from Oil & Gas. The worst performance came from Financials, where the changing shape of the US yield curve – short rates rising more than long rates – is typically unfavourable for global banks.

UK property

- In aggregate, the UK commercial property market carried on with its steady advance, but sector divergence remained marked. Based on IPD Monthly indices, capital values in the Retail sector were a little lower in May than they had been at the end of the year, while they were 5% higher in the Industrial sector.

Q3 18 update

- Initial estimates of Q2 growth reinforced the view that the global economy had shaken off the torpor of the start of the year. The US recorded its fastest quarterly growth for almost four years, the UK picked up from near-standstill and Japan returned to positive growth. The Eurozone and China slowed modestly.
- As almost universally expected, albeit not universally welcomed, the Bank of England raised its Bank Rate from 0.5% p.a. to 0.75% p.a. The Bank of Japan made some tweaks to its monetary policy, but these proved even less of a tightening move than had been expected.
- Higher interest rates did little to support sterling, which has continued to weaken as concerns about a “no-deal Brexit” have increased.
- Gilt markets were reassured by the glacial pace of future tightening suggested by the Bank of England. Yields are little changed from end-June levels, as is the case for equivalent US and German bonds.
- Yield spreads on Italian government bonds relative to German bonds have climbed back towards May’s high’s, but spreads on other peripheral markets have been more stable.
- Equity markets have pushed higher – the US, buoyed by economic strength, has led the way, although there have been early signs that the upgrading of corporate earnings forecast has ended for the moment.
- It was business as usual for UK commercial property at the start of Q3. The IPD Monthly Index recorded a modest rise in capital values in July, with industrial strength offsetting retail weakness.

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 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 equities have clawed their way back above year-end levels, although they remain short of January's highs. (Sterling weakness casts things in a better light for unhedged UK investors.) This has done little to change our thinking on the offsetting influences on the outlook. Reported earnings continue to rise in aggregate and in most regions – in terms of a strong dollar, emerging market earnings have started to struggle. However, this is mainly a reflection of the coordinated global growth of the last year or so, and valuations are more stretched than we would like to cover the risks to the economic outlook.

Global averages continue to conceal considerable regional variations. Valuations look more stretched in the US; despite the favourable fundamentals, we would be particularly cautious here. The US market has traded on premium valuations for most of the last twenty years, but that premium looks very high by historic standards. On a long-term perspective, emerging markets look more interesting – valuations are lower and earnings are less stretched – although selling pressure from foreign investors has been more important in recent months. A similar long-term case could still be made for the UK, where domestic economic uncertainty is also high. But, as a star performance in the second quarter after a poor first quarter demonstrates, if the risks are reflected in currency weakness, that can be positive for a not-very-domestic domestic market.

PRIVATE EQUITY 10.0%

Private equity continues to perform strongly amid a supportive economic environment, with buyout funds outpacing venture capital funds. These has been increased dispersion amongst the returns delivered by individual managers, so good manager selection is more important than ever. Fundraising levels have slowed over the past year, but remain high. The resulting high levels of dry powder (uncommitted capital awaiting deployment) could sustain the market's stretched valuations, which have exceeded the peaks reached in 2007, but could also allow private equity managers to exploit market dislocations caused by spikes in volatility. Some private equity managers claim to identify pockets of value within the secondary market, although there is also evidence of high pricing here. Investors will have to be very selective about where capital is deployed.

REAL ASSETS AND INFRASTRUCTURE 6.0%

There are characteristics of infrastructure assets that we find appealing in current circumstances. The defensiveness of many assets – where revenues are unaffected or relatively insensitive to broad GDP trends – seems increasingly useful as global growth stabilises and trade-related risks rise. Where assets provide contractual growth in income, often in real terms, that provides some protection against gradual inflationary pressure. Although global monetary policy is tightening gradually, the cost of debt remains low and interest cover is typically strong. But valuations are high: record levels of unspent commitments suggest managers are struggling to find assets that meet their return objectives. We continue to believe that a selective approach is increasingly appropriate, one focused on deals with a degree of complexity or where managers can demonstrate a competitive edge.

PROPERTY	10.0%

Three months is a short time in the UK commercial property market and the background is much as it was last time. In aggregate, rents are rising modestly and so, a little less modestly, are capital values. In both cases, the pace has eased a bit since the turn of the year – something that is true of all the major sectors. However, divergence across the sectors remains marked. In the retail sector, rental and capital value indices were lower in June than at the end of 2017; the equivalent industrial indices were 2% and 7% higher, respectively. The income yield on industrials is now a full percentage point below the retail yield – a more-than-generous recognition of changing shopping patterns. The overall income yield has dipped under 5% p.a.: the argument for property increasingly has to emphasise diversification rather than relative value.

INDEX-LINKED GILTS	5.0%

Real yields on long-dated index-linked gilts (relative to RPI) have stayed between -1.5% p.a. and -1.7% p.a. for most of the last year. Relative to CPI this would be about 1% p.a. higher, still well short of equivalent US yields (close to +1% p.a.) and the Bank of England's relatively downbeat assessment of a long-term neutral rate (+0.5% p.a.). Economic uncertainty may well keep downward pressure on yields in the short term; so, over the next few years at least, will hedging demand, although we may be nearing the peak here. But we can see little value in index-linked gilts as a discretionary long-term investment.

CONVENTIONAL GILTS	2.0%

Conventional gilt yields may have traded in a wider range than index-linked yields over the last year, but it is still the underlying level of real yields that is, in our view, the key determinant of value. We can see little more long-term value in conventional gilts than in index-linked. In terms of the price inflation protection implied by the gap between conventional and index-linked gilt yields, the variation by maturity is still the most interesting aspect. Conventional gilts are not cheap, but for those needing to hedge, they offer better relative value at medium maturities, and are more expensive at longer maturities.

INVESTMENT-GRADE CREDIT	2.5%

Although the current background of decent global growth and rising corporate profits remains good for credit markets, investors have made some allowance for the risks to the outlook – Brexit, EU politics, trade tensions and modest tightening in monetary policy. Yield spreads on sterling investment-grade corporate bonds have continued to drift a little higher; they might still not look particularly attractive, but they are as high as they have been for two years and broadly in line with long-term median levels. We continue to advocate diversification of low-risk bond portfolios into asset-backed securities (ABS), where appropriate. The yield premium on ABS relative to comparable corporate bonds has narrowed in 2018, but is still around the average of recent years.

OTHER CREDIT 2.0%

Here, too, the support of favourable economic conditions has been undermined by growing concerns about the outlook. There has been some widening of yield spreads in high-yield bond markets, but they remain expensive relative to longer-term history. Our bias is still to look for returns to factors other than pure credit risk. However, loans markets have proved relatively resilient in recent months and their relative appeal has diminished a little. Where even greater illiquidity can be tolerated, we would consider investment in private markets – both direct corporate lending and real estate debt – although these have not been immune to yield compression and weakening of covenants. We also see relative value in the 'complexity' premium available from structured credit, particularly CLOs.

EMERGING MARKET DEBT (EMD) 2.5%

The divergence between the current economic situation and the perceived risks to the outlook are perhaps most stark here. In general, emerging economies are performing reasonably well. High-profile outliers, such as Argentina and Turkey, are not a major part of the main indices. But a less liberal trade environment represents a real long-term risk. Valuations stack up well against other asset classes – a yield of close to 7% on the main local currency global EMD index is above long-term averages. However, short-term sentiment, driven by trade risks and capital outflows as the dollar strengthens, has dominated in recent months and we suspect may persist for a while.

INSURANCE-LINKED SECURITIES (ILS) 3.0%

Loss development and claims collection from 2017 catastrophe events continue to proceed in an orderly fashion. While April saw some deterioration from losses resulting from Hurricane Irma, loss estimates have typically remained below initial projections and often retained by large insurers. Insured losses in the first half of 2018 were approximately $21bn, compared to an average of $35bn over the last decade. Expectations of market-wide rate increases following 2017's losses dissipated during the mid-year property catastrophe renewals. In some cases, pricing declined. Valuations look stretched relative to longer-term history, There is a 'new normal' in reinsurance pricing – insurance-linked securities funds grew by a factor of 5 between 2010 and 2015. Comparing current valuations with their long-term history – they look demanding – is, in our view, increasingly unhelpful. On a shorter view, the yield premium on catastrophe bonds relative to comparable corporate credit is not far away from the average of the last four years.

CASH 2.0%

Although the downturn in global growth has not persisted, the tailwinds of accelerating growth and loose monetary policy are not what they were. Valuations remain high for most asset classes and that implies low returns over the medium term. We therefore continue to be cautious on markets and holding more cash than normal is one element of an overall strategy of reducing investment risk.

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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