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 Sep 17 - 31 Oct 17**	To 30 Sep 17 3 mths	12 mths
EQUITIES	*1.9*	2.1	11.9
BONDS			
Conventional gilts	*0.3*	-0.5	-3.6
Index-linked gilts	*0.9*	-0.7	-3.8
Credit	*0.5*	0.1	-0.2
PROPERTY		2.7	10.4
STERLING			
v US dollar	*-1.0*	3.3	3.3
v euro	*0.4*	-0.3	-1.8
v Japanese yen	*-0.1*	3.5	14.8

Global	*30 Sep 17 - 31 Oct 17**	To 30 Sep 17 3 mths	12 mths
EQUITIES	*2.7*	4.4	19.1
North America	*2.3*	4.5	18.4
Europe ex UK	*2.3*	4.2	21.5
Japan	*5.7*	4.3	27.9
Dev. Asia ex Jap	*3.9*	2.7	18.2
Emerging markets	*3.4*	7.6	19.1
GOV'T BONDS	*0.3*	0.3	-2.4
HEDGE FUNDS		1.8	5.9
COMMODITIES	*3.0*	2.4	8.5

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

Q3 17

Global economy

- Reports confirmed the momentum of global growth had increased in Q2. Japan recorded its best quarterly growth in two years, the US bounced back from a sluggish Q1 and the Eurozone maintained its recent revival. However, UK growth of 0.3% was disappointing.
- The US Federal Reserve announced its intention to start unwinding its long-standing QE programme; from October onwards, as its holdings of government bonds and mortgage-backed securities mature, it will limit the amount that is reinvested.
- The rise in UK CPI inflation paused at the start of the quarter, but September's reading of 3.0% was the highest for over five years.
- Despite above-target inflation, the Bank of England held UK interest rates at 0.25% p.a. However, the Governor indicated after September's Monetary Policy Committee that rates would rise soon unless economic conditions deteriorated.
- Sterling was under pressure for most of the quarter until markets moved to price in a UK rate rise in 2017. Over the quarter as a whole, sterling was ahead of the yen and US dollar and roughly in line with the euro.
- Oil prices surged – Brent crude rose from $48 a barrel to a two-year high of $59 a barrel. Confidence in supply was hit by weather disruption in the US and political uncertainty in Kurdistan, while demand in Asia was unexpectedly strong.
- The series of Atlantic hurricanes and two Mexican earthquakes caused the first noticeable wobble in insurance-linked markets since Superstorm Sandy hit the east coast of the US in October 2012.

Bond markets

- The change in interest rate expectations following Mark Carney's comments caused gilt yields to rise sharply in the final weeks of the quarter, reversing what had been a fairly steady decline over the quarter.
- Credit markets had an uneventful period, although yield spreads, in general, tightened a little more over the quarter.
- Buoyant economic conditions and a weak US dollar boosted emerging markets. Yields on the major local currency debt indices fell close to their lowest levels for over four years.

Equities

- Global equity indices had another strong quarter. Improving corporate earnings and positive economic momentum more than offset growing concerns over equity valuations and rising political tension in the Korean peninsula. The strength of sterling meant that returns to UK investors were more modest.
- The best regional performance, in local currency terms, came from Emerging Markets, in demand for the same reasons as equivalent debt markets. UK equities underperformed again as sterling strengthened.
- Commodity price strength pushed Oil & Gas and Basic Materials to the top of the global equity sector performance table. Defensive stocks – Telecoms, Healthcare, and Utilities – lagged the overall market rally.

UK property

- UK property values, as measured by the IPD Monthly Index, are now back at pre-referendum levels. Rental growth is showing early signs of a modest upturn, perhaps marking the end of the downturn since the start of 2016. Of the major sectors, industrials continue to show the strongest momentum in both capital values and rents.

Q4 17 update

- Initial estimates of Q3 growth added to evidence of the robust momentum of the global economy. Compared to a year previously, output has risen by 2.2% in the US and 2.5% in the Eurozone. Despite a slightly better-than-expected quarterly figure, the equivalent figure for the UK is 1.5%.
- As had seemed increasingly likely, the Bank of England raised interest rates from 0.25% p.a. to 0.5% p.a. at the start of November.
- About a week earlier, the ECB had confirmed its, equally widely expected, intention to start tapering its QE programme, cutting its monthly purchase of bonds from €60bn to €30bn at the start of 2018.
- In both cases, investors seemed reassured that further tightening of monetary policy would be no more serious than they expected. 10-year government bond yields in the UK and Eurozone have fallen by about 0.1% p.a. since the announcements.
- Yield spreads in credit markets remained around recent lows.
- Oil prices continued to rise. Brent crude breached $60 per barrel towards the end of October.
- Sentiment in equity markets remained buoyant. Although forecasts have been falling (as usual) and growth has slowed since Q2, underlying earnings in the US seem set to rise around 3% - 4% in Q3.

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 September 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%
We have seen a resurgence in earnings but valuations look expensive relative to history on a long-term P/E basis (Shiller) and traditional P/E basis. Further momentum in earnings growth is required to justify current prices. The recent strength in equity markets, an uncertain global economic and market outlook, coupled with a lack of volatility, might suggest now is a good time to underpin current holdings with some protection.	

PRIVATE EQUITY	10.0%
Valuations remain high in both primary and secondary markets: average purchase price multiples are at levels higher than those seen in 2007, boosted by buoyant debt markets. Looking ahead, it is likely that moderate macroeconomic growth will continue to support these stretched multiples, although this could quickly reverse if rates rise more quickly than expected.	

REAL ASSETS AND INFRASTRUCTURE	6.0%
Core infrastructure assets continue to be in high demand globally: by mid-2017 fundraising was already higher than the record levels set in 2016. Operational assets with secure, contractual cash flows are well bid: indicative yields on regulated assets are c5% p.a. (assuming leverage in a range 50-70%). More supply may come to market, from the UK and US, but we expect it to take some time for any projects to become investable.	

PROPERTY	10.0%
There are some continued signs of improvement in the fundamental background. Aggregate rental growth, as measured by the IPD Monthly Index, is drifting higher, but still failing to keep pace with rising UK inflation. Against that, there is anecdotal evidence that leases are taking longer to agree and tenants are seeking greater incentives to sign deals. This is true particularly in office and retail sectors – the underlying momentum in industrials continues to be greater.	

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. The valuation comments in the next section apply here, too. The approach of Brexit has not had an obvious influence yet, but it 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.	

INDEX-LINKED GILTS	5.0%
Valuation remains the main reason for our negative view. Long-dated index-linked gilt yields may be close to the highs of last year's trading range but, around -1.5% p.a., are still very low by historic standards. Even allowing for a discount of roughly 1% p.a. reflecting the linkage of to RPI rather than CPI, it means index-linked gilts still represents very expensive insurance. Equivalent US yields of +1% p.a. provide a yardstick for pricing in a less distorted environment.	

INVESTMENT-GRADE CREDIT	2.0%

In the sterling investment-grade market, yields relative to gilts are little better on a like-for-like basis than in the halcyon days of the mid-2000s. An upward bias in global government bond yields may not completely undermine the hunt for yield, but it might start to chip away at the foundations. Although they have performed well recently, we still see relative value in high-quality, floating-rate asset-backed securities.

OTHER CREDIT	3.0%

Corporate fundamentals in general remain steady, and default levels outside of commodity sectors remain below historic averages. The current upturn in global growth should help to sustain that in the short term, but yield sprerads are very low by historic standards and give little protection against the possibility that current conditions are not sustained over the next business cycle. We would be looking to take less pure credit risk than usual, but illiquid areas such as direct corporate lending still look relatively attractive.

EMERGING MARKET DEBT (EMD)	3.5%

EMD has been one of the best performing asset classes and has been supported by investors' ongoing hunt for yield, with strong local currency flows into the market. Economic and financial conditions (most of all a weaker 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 (ILS)	3.0%

The market has wobbled after a costly US hurricane season – catastrophe bond prices have fallen and ILS funds suffered losses. Our view had been that the ILS market was fully valued, but it will not be clear whether events have been sufficient to push up reinsurance pricing significantly until the main contract renewal season at the turn of the year.

CASH	2.0%

A less certain background for government bonds has not done much to take the momentum out of other markets that benefited from the long decline in risk-free yields. It is no easier to find value in financial markets than it was three months ago. Our bias is to reduce investment risk and holding some additional cash can play a part in that.

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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

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.