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 Mar 18 - 31 May 18**	To 31 Mar 18 3 mths	12 mths
EQUITIES	*9.4*	-6.9	1.2
BONDS			
Conventional gilts	*0.7*	0.3	0.5
Index-linked gilts	*-0.3*	0.1	0.5
Credit	*0.3*	-1.2	1.2
PROPERTY	*0.6*	2.3	11.3
STERLING			
v US dollar	*-5.1*	3.7	12.2
v euro	*-0.1*	1.3	-2.4
v Japanese yen	*-3.1*	-2.1	7.1

Global	*31 Mar 18 - 31 May 18**	To 31 Mar 18 3 mths	12 mths
EQUITIES	*2.8*	-1.8	11.7
North America	*2.9*	-0.9	13.5
Europe ex UK	*2.9*	-3.0	4.0
Japan	*1.9*	-4.7	15.1
Dev. Asia ex Jap	*2.5*	-2.1	12.0
Emerging markets	*-1.4*	0.7	19.4
GOV'T BONDS	*-0.4*	0.1	1.5
HEDGE FUNDS	*0.1*	0.5	5.4
COMMODITIES	*5.4*	0.2	9.6

Total return in local currency ($ for Hedge Funds and Commodities)
* Returns to 30 April for property and hedge funds

Q1 18

Global economy

- Q4 economic data confirmed that global growth remained buoyant through to the year-end, although the UK continues to lag behind its peers. Japan continued its longest streak of growth since 1989, although initial estimates suggest growth had eased very slightly in Q4, as it had in the US and Eurozone.
- Survey evidence suggested that growth remained robust into the new year, although the outlook was clouded at the end of the quarter by early skirmishes in what might develop into a trade war between the US and China.
- Underlying inflation rates remained relatively stable in the major economies, although investors were briefly unsettled by higher-than-expected US wage growth in January.
- The UK saw more evidence that the peak in inflation has passed: CPI inflation fell from 3% to 2.7% in February.
- The US Federal Reserve, under a new Chairman, continued to tighten policy gradually, raising rates by another 0.25%.
- Although the yen was the strongest of the major currencies, sterling performed well, rising 2% in trade-weighted terms over the quarter.
- Oil prices pushed higher – Brent crude reached a three-year high of $70 a barrel. The impact of rising US production was tempered by declines in Venezuela, the prospect of renewed US sanctions on Iran and strong global demand.
- In contrast, industrial metals prices fell sharply – the main relevant commodity indices were down 7%.

Bond markets

- Global economic momentum and inflation concerns helped to push government bond yields higher at the start of the year. Inflation concerns receded later, particularly outside the US. Long-dated gilt yields fell over the quarter, although 10-year yields rose.
- Buoyant global growth supported credit markets at the start of the year. Yield spreads narrowed further in January, but ended higher over the quarter as a whole as concerns grew about tighter monetary policy and rising trade tension.

Equities

- Similar factors drove equity returns. Global indices rose strongly in January, but fell over the quarter as a whole. Sterling's strength further reduced returns to UK investors
- The best regional performance came from Emerging Markets, which extended their relative momentum of 2016 and 2017. Sterling's strength contributed to the underperformance of the UK market, because of the significance of foreign earnings.
- Technology remained investors' favourite sector, although the current travails of Facebook were putting this position under threat as the quarter closed. The worst performance came from Telecommunications – rising US rates may be undermining what is a preferred area for income investors. Despite the contrasting fortunes of the raw materials, both Oil & Gas and Basic Materials underperformed.

UK property

- The turn of the year brought little change for the UK commercial property market. Capital values and rents nudged higher. Once again, this was driven primarily by strong growth in Industrials, although there are some signs that the sector's rental growth may be flagging.

Q2 18 update

- Initially, economic data tended to confirm an easing of global economic momentum. In the US, this pattern has been reversed in recent weeks, although the apparent slowdown has been more persistent elsewhere. US economic resilience has helped to trigger a revival in the US dollar, which has been the strongest of the major currencies so far this quarter. Meanwhile, the weakness of short-term economic signals was enough to dissuade the Bank of England from raising UK rates in May.
- Brent crude rose further, touching $80 a barrel in mid-May, as the US withdrawal from the Iran nuclear deal raised the prospect of renewed sanctions and pressure on global oil supply.
- US 10-year government bond yields rose from 2.7% p.a. at the end of March to a seven-year high of 3.1% p.a. in mid-May. Much of this was reversed towards the end of May as political turmoil in Italy caused a short-term flight to safety.
- Equivalent UK and German yields, which had drifted a little higher, fell back below end-March levels. Yield spreads on Italian bonds relative to German bonds rose to almost 3% p.a., the highest since early 2013.
- Equity markets recovered from the downturn of the first quarter, although gains were pared back by the rising Eurozone tensions. UK equities led the pack – the boost from currency depreciation against the dollar has perhaps outweighed the impact of a dull domestic economic outlook. But a strong dollar has dampened sentiment in emerging markets, which have lagged behind developed markets.
- The latest monthly data from IPD suggest UK commercial property values are still rising in aggregate, although retail indices have turned down. Both Land Securities and British Land have struck a cautious note about the outlook in recent results announcements.

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 March 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%
Corporate earnings have been strong across all major markets over the past 18 months or so and forecasts are upbeat. The global economic background has been supportive, but we are more cautious about the outlook – there are some signs of slowdown and threats from trade and other geopolitical tensions; inflation is edging higher and the period of ever-easier monetary policy is increasingly distant. Trailing valuations improved as equity markets struggled at the start of 2018, while earnings continued to grow – the MSCI AC World Index end-March PE of 18.8. was the lowest for two years However, we would argue that such valuations are flattered by earnings that look extended in cyclical terms. Cyclically-adjusted PE ratios are still towards the top of their typical range. The US remains main source of overvaluation; valuations in Europe, UK and Emerging Markets much less stretched.	

PRIVATE EQUITY	10.0%
Private equity has also been supported by the recent economic background, but is at least as exposed to listed equity to either a deterioration of economic fundamentals or a devaluation triggered by higher interest rates. Fundraising by private equity funds remains high, which has increased the dry powder (uncommitted capital) available. This could continue to underpin stretched valuations – price and leverage multiples are higher than at the 2007 peak – or, more optimistically, give private equity managers the flexibility to exploit opportunities that arise during market dislocations. Alternatively, some managers claim to identify value opportunities in the secondary market to facilitate deployment of capital.	

REAL ASSETS AND INFRASTRUCTURE	6.0%
Demand for infrastructure remains very high. Despite ever-rising capital commitments, Preqin's latest survey suggests most investors in infrastructure are below existing target allocations, which are likely to rise. Assets across the risk spectrum continue to be highly bid; core operating assets with secure cash flows are particularly sought after. There is building evidence that managers are struggling to meet return objectives: transactions fell in 2017; some new funds carry a lower performance hurdle than typical in the past. Our relatively upbeat view is predicated on added-value implementation in deals with a degree of complexity or where managers have a competitive edge.	

PROPERTY	10.0%
Aggregate rental growth has drifted a little higher in 2018, but remains below 2% p.a. However, anecdotal evidence persists that deals are taking longer to agree and incentives increasing. Capital values have continued their steady upward progress in aggregate, although retail indices have started to drift lower. Investor demand remains strong: UK institutions became net buyers in Q4 17, although there are perhaps signs that overseas interest has peaked. Income yields have fallen below 5% p.a., low by historic standards in absolute terms and relative to equity dividend yields, but they continue to provide a reasonable buffer over gilt and corporate bond yields.	

INDEX-LINKED GILTS	5.0%

Real yields on long-dated index-linked gilts remain in the tight trading range of the last year. Even after adjustment for the gap between RPI and CPI, they remain well below equivalent US yields (which are still low by historic standards). The pressures that keep UK yields low – hedging demand, economic uncertainty, easy monetary policy – may well be sustained, but current valuations and the poor returns they imply for long-term investors remain the main reason for our cautious/negative view

CONVENTIONAL GILTS	2.0%

Global influences may have dominated this year's moves in gilt yields – rising in the wake of US economic resilience and monetary tightening, falling back in response to Eurozone political risk. But domestic influences are more important for the level: our reservations above on the implication for returns of current valuations apply to conventional gilts, too. There has been little overall change in the price of inflation protection implied by the gap between conventional and index-linked gilt yields. It seems fairly valued on average, but varies by maturity. Conventional gilts appear relatively cheap at medium maturities, but expensive at longer maturities.

INVESTMENT-GRADE CREDIT	2.0%

For the sterling corporate market the economic background remains supportive – decent global growth and subdued domestic growth offset by even more subdued monetary tightening. While current Eurozone tensions do represent a threat to this support, it has added to the widening of spreads that had taken place earlier in 2018. Valuations are by no means cheap, but now well clear of the historically expensive levels of late 2017. In contrast, yield spreads on asset-backed securities (ABS) have tightened considerably in 2018 and no longer offer a significant premium over equivalent corporate bonds. ABS are still worth considering as a diversification in low-risk portfolios.

OTHER CREDIT	3.0%

Strong corporate fundamentals, in particular in commodity sectors, are supporting forecasts of lower defaults in 2018 than in 2017, although stress is growing in the retail and US telecom sectors. More generally, if the Fed persists in tightening US monetary policy, default experience could deteriorate. New issues have been and remain typically light in covenant protection in the face of strong investor demand. Even after some widening in response to rising risk aversion in May, spreads remain low by historic standards. We think there is still relative value in private markets, although these have not been immune to the lowering of yield spreads or loosening of covenants. Other illiquid opportunities, such as real estate debt, could be considered as a further diversification to portfolios.

EMERGING MARKET DEBT (EMD)	3.5%

The macro-economic environment for many emerging economies remains solid, although inflation expectations are rising in some areas. Rising trade tension could be another threat and 2018 brings a potential increase in political uncertainty, with elections due in Brazil, Mexico, Colombia and Indonesia. More immediately, the institutional inflows that have driven the market rally since late 2016 are threatened by the recent strengthening of the dollar and rising US yields. This has taken the yield on leading diversified global indices from 6% p.a. to 6.5% p.a. in a few weeks. In the middle of the trading range of the last five years, this is still a more attractive valuation than many other asset classes.

INSURANCE-LINKED SECURITIES (ILS)	3.0%

The market continues to recover from the losses of 2017. The assessment of losses and collection of claims has brought few surprises. Investor demand does not seem to have been much affected by last year's experience. Assets under management have risen further in 2018 and the broad reinsurance market has seen continued oversupply. There have been modest price rises in areas affected by last year's losses, but more generally prices have been relatively flat. Valuations remain high by historic standards, but history may not be a particularly good guide in a much-changed market. We believe the market still offers opportunities, at the very least in terms of diversification benefit.

CASH	2.0%

There is still a lack of outstanding opportunities in asset markets. Risks to the recent benign period for the global economy add to our caution, but it is still primarily driven by generally high valuations and the depressing effect on returns of a return to more normal levels over the medium term. All of this argues, in our view, that this is a time to be de-risking and carrying more cash than normal.

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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