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 Sep - 16 Nov	To 30 Sep 18 3 mths	12 mths
EQUITIES	-6.4	-0.8	5.9
BONDS			
Conventional gilts	0.3	-1.7	0.6
Index-linked gilts	1.8	-1.2	1.3
Credit	-0.4	-0.4	0.2
PROPERTY	0.5*	1.7	9.9
STERLING			
v US dollar	-1.6	-1.2	-2.8
v euro	0.4	-0.7	-1.1
v Japanese yen	-2.2	1.3	-1.9

Global	30 Sep - 16 Nov	To 30 Sept18 3 mths	12 mths
EQUITIES	-6.3	4.8	11.6
North America	-5.8	7.0	17.1
Europe ex UK	-6.3	2.0	1.7
Japan	-10.2	6.3	11.7
Dev. Asia ex Jap	-7.5	0.3	6.0
Emerging markets	-4.7	0.5	3.5
GOV'T BONDS	0.0	-1.0	-0.6
HEDGE FUNDS	-2.6*	0.6	3.5
COMMODITIES	-4.7	-2.1	8.6

Total return in local currency ($ for Hedge Funds and Commodities)
*Property and Hedge Fund returns to 31 October 2018

Q3 18

Global economy

- Data releases confirmed a pick-up in global growth in the second quarter. The US, boosted by recent tax cuts, led the way, recording its highest quarterly growth for almost four years. Japan and the UK bounced back after a poor start to the year. The Eurozone has not recovered its momentum of 2017, but growth remained stable.
- The downward trend in UK CPI inflation was interrupted by an unexpected jump in August. Before that had been released, the Bank of England had, as expected, raised interest rates from 0.5% p.a. to 0.75% p.a., citing a limited degree of 'slack' in the UK economy.
- The Fed's preferred measure of inflation rose above its 2% target. US interest rates were raised again in September, the third time this year and the eighth since 2015.
- Oil prices rose again, as the US re-imposed sanctions on Iran; the Venezuelan economy imploded; and OPEC and Russia ignored US requests to increase output. Brent crude reached a 4-year high of $82 a barrel in September.
- Despite some Brexit-induced fluctuations, sterling ended the quarter only marginally lower on a trade-weighted basis. Moves among the major currencies were fairly subdued, while many emerging market currencies regained their composure towards the end of the period.

Bond markets

- Long-dated gilt yields rose over the quarter, matching similar moves in the US. The rise in index-linked gilt yields was a little less, perhaps reflecting August's inflation surprise and rising concerns about Brexit.
- UK investment-grade credit spreads tightened marginally over the quarter, mirroring moves in major overseas markets Speculative grade credit markets outperformed investment grade, as high yield bond spreads tightened markedly on both sides of the Atlantic.

Equities

- Equities continued to add to the gains of the second quarter, although global indices in local currency terms did not quite reach the highs of January . Returns to UK investors were again boosted by currency weakness, but the effect was more muted than it was last quarter.
- North America was again the best regional performer. The UK was the worst, underperforming global averages across most sectors, which may indicate that Brexit concerns were to blame. Emerging markets also underperformed but at least managed to produce positive total returns this quarter, following the 5% fall last time.
- Performance divergence across global sectors was relatively subdued and showed no consistent pattern. Perhaps surprisingly in a period of overall market strength, the best performer by some way was the defensive Health Care sector. This may have been nothing more significant than a short-term bounce after earlier underperformance.

UK property

- The UK commercial property market carried on with its steady advance - in August, the IPD Monthly Capital Growth Index had risen 5% over 12 months – a pace of growth that has persisted since late last year. Sector divergence has, if anything, increased: retail values have fallen over the last year, while industrial values are 16% higher.

Q4 18 update

- The preliminary estimate of UK GDP growth in the third quarter was 0.6%, the fastest for almost two years. The US had a second successive quarter of robust growth, but there was a slowdown in the Eurozone and China.
- Investors' concerns about the global economic outlook seem to be growing. The rise in government bond yields has come to a halt in recent weeks. Since the end of September, US 10-year yields have moved sideways, while equivalent UK and German yields have drifted slightly lower.
- The unexpected jump in UK inflation in August proved an aberration. Annual CPI inflation settled back to 2.4% in September and October. The Bank of England expects further downward progress to be slow and hinted that they might not cut rates even if Brexit proves disruptive.
- Oil prices edged a little higher in the first few days of the quarter, but have subsequently fallen sharply. Persistent concerns about the outlook for global growth were compounded when the US took a less draconian approach than expected to sanctions on Iran. Brent crude reached a peak of $86 a barrel, before plunging to $66 by the middle of November.
- Not surprisingly, energy has been the weakest equity sector so far this quarter, although information technology did little better as concerns about growth hit the market as a whole. Traditionally defensive sectors, utilities in particular, have been the most resilient in the downturn.

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 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%

The setback since the end of September has taken a little heat out of global equity markets, but we would still be aiming to be a little below rather than above neutral exposure. For the moment, the fundamental background remain favourable. Global economic growth is still on track, although the risks to the outlook are not trivial. The momentum of corporate earnings is strong, although the support of US tax cuts will soon wane. But valuations – at least those based on measures that are not flattered by the strong cyclical rise in earnings – are still above historic averages.

Any remaining valuation excess is primarily a US phenomenon. UK and emerging markets, for example, look relatively cheap on many measures. Of course, both face specific fundamental risks, although these may seem less important as investor sentiment cools towards the US. A downturn in trade would hit emerging markets harder than the developed world and sentiment may remain subdued while tensions escalate. But longer-term investors may increasingly see an opportunity to buy secular growth at an attractive price. The prospect of a no-deal Brexit wais expected to be a negative for UK economic growth. That certainly leaves scope for a bounce if the draft agreement can withstand the formidable tests it has to face. Even a harder version might bring the further depreciation in sterling that could underpin a market with a significant proportion of earnings denominated in foreign currencies.

PRIVATE EQUITY 10.0%

Private equity continues to perform strongly: buyout funds are outpacing venture capital funds and dispersion of returns across managers is increasing. Valuations have exceeded the peaks reached in 2007, but could be sustained by the high levels of committed capital awaiting deployment. Fundraising levels have slowed over the past year, but remain high, centred on North America. 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 increasingly selective about the managers they use and where capital is deployed.

REAL ASSETS AND INFRASTRUCTURE 6.0%

The strategic case is as strong as ever, indeed the defensive nature of core infrastructure looks attractive in a period of heightened economic risk. Short-term influences are also positive: there is little sign of any dampening of investor demand and undeployed capital in infrastructure funds remains at record levels. But this is increasingly reflected in higher prices. To some extent, the level of undeployed capital reflects managers' difficulties in finding deals that offer the returns they require. As we have noted before, there is some downward pressure on performance hurdles in new funds. There is some evidence of style drift in existing funds towards higher-risk projects. Listed infrastructure valuations are typically lower than valuations implied by recent unlisted transactions.

PROPERTY	10.0%

Annual rental growth is fairly stable, a little behind CPI inflation,which is broadly in line with longer-term averages. The reported figure may conceal some underlying weakness: incentives to secure new tenants seem to be increasing, while the travails of retailers may not have been fully reflected in index numbers. The industrial sector is still in favour but, even here, growth has been slowing. Meanwhile, yields drifter down closer to the lows of the last thirty years. A higher level of caution increases the relative attraction of long lease strategies. This is not really on valuation grounds, as yields look stretched here, too. But tenant quality is typically higher than in the market as a whole, while sector exposure is typically biased away from the retail sector and Brexit-sensitive London offices.

INDEX-LINKED GILTS	5.0%

Long-dated real yields have largely kept to the very tight trading range of the last year or so. As we have noted before, this is low relative to the Bank of England's assessment of a long-term neutral rate and equivalent US rates and drives our negative view. Of course, hedging demand is likely to remain a headwind against significant yield rises for a few years. On a shorter perspective, a background of unspectacular economic growth provides support. The perceived risks of a no-deal Brexit – lower growth and higher inflation in the short term – would, if anything, be positive for the market.

CONVENTIONAL GILTS	2.0%

The low level of real yields informs a cautious view here, too. Ultra-long maturities look particularly expensive, but shorter maturities offer a reasonable level of implied inflation protection and look more attractive than equivalent index-linked gilts. The current economic background is benign – subdued growth and inflation pressure, but Brexit risk is perhaps more of a concern here. A flight to safety by domestic investors might help, but a spike in inflation would not, while foreign demand (more important here than for index-linked) may wane.

INVESTMENT-GRADE CREDIT	2.5%

Valuation is respectable but unexciting – yield spreads on sterling investment-grade corporate bonds remain broadly in line with long-term median levels – and the health of corporate borrowers is sustained by the current economic background, despite the undoubted risks to the outlook. Brexit could push risk premiums higher, although the international spread of borrowers would dilute the impact on the market as a whole. Nevertheless, the arguments for diversification of low-risk bond portfolios is strengthened in current circumstances. That is more about diversifying risk than exploiting relative value. Overseas corporate bonds and UK residential mortgage-backed securities seem fairly valued compared to UK corporate bonds. Meanwhile, demand for senior real estate debt has pushed yield premiums to levels that represent fairly meagre compensation for the illiquidity often associated with such assets.

OTHER CREDIT	2.0%

The continuing strength of global corporate profits is a plus for speculative-grade corporate markets, although the effects of any slowdown would be more keenly felt than in investment-grade markets. Valuations remain stretched by historic standards and would do little to cushion the impact. The deterioration of covenenat protection in loan markets suggests losses may be a little higher than historic averages in the next cyclical downturn. Here, too, diversification to exploit other risk premiums seems increasingly appropriate – we think there are still suitable opportunities in asset-backed securities and private lending, nor do our concerns about senior real estate debt apply to speculative-grade equivalents.

EMERGING MARKET DEBT (EMD)	2.5%

The fundamental backdrop may be fraying in some emerging economies, as it is in some developed economies, but the immediate risks may have eased a little. There has been no recent intensification of conflict in the US-China trade war and emerging market currencies have been reasonably resilient even as the dollar has started to strengthen again. Index yields remain in the range largely occupied since the second-quarter sell-off – reasonable relative to their own history, but slightly less attractive compared to developed market yields, which have drifted a little higher.

INSURANCE-LINKED SECURITIES (ILS)	3.0%

The settlement of 2017's record losses has not sprung any unpleasant surprises in recent months and losses so far in 2018 have been below seasonal averages. Last year's experience has had little lasting impact on valuations. That means they seem stretched relative to longer-term history, but we think a focus on the experience of the last few years makes more sense – ILS assets under management doubled between 2010 and 2015. Yield spreads relative to equivalent corporate credit are not far off median levels over that more recent period. Investor demand remains strong.

CASH	2.0%

While global economic growth is robust and inflationary pressure appears subdued, our inclination is to nudge investment strategy in a more defensive direction. The generally high level of valuations across asset classes does not fully reflect the risks to the outlook that are coming increasingly to the fore. The setback to equity markets at the start of October is perhaps one illustration. This feels like a sensible time to hold more cash to exploit better buying opportunities in the future.

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19 November 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