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Investment Outlook

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Dorset County Council Pension Fund
March 2014
Report of the Investment Adviser

Investment Outlook

The tone in markets remains positive in the new year despite an early correction in equities that was quickly reversed. Tapering has started in the US without a repeat of the selloff experienced last spring when it was first contemplated. Market concerns have focussed on emerging markets which lagged developed markets badly last year and many of the so-called BRICs continue to struggle.

The US is the only country so far preparing to bring this exceptional period of unorthodox monetary policy to an end and it is proceeding slowly. In the UK, despite growing confidence in the economic recovery and the happy coincidence of lower inflation numbers, the BoE is signalling strongly that it is far from tightening. Europe continues to struggle with deflationary forces while Japan continues to prime the monetary pump.

The more benign global economic outlook- assuming emerging markets do not spoil the party- should sustain equities at current valuation levels even if markets like the US look a little extended. Bond markets are likely to have another poor year as yield curves continue to normalise We expect a more subdued year for asset returns with headwinds likely to see corrections from time to time, without the prop of central bank relaxation if sentiment turns bad.

Economy

The US should grow some 3% this year, led by the consumer but there has been some softening of the numbers recently, especially employment growth so economic recovery cannot be said to be robust .Ms Yelled has taken over at the Fed and is likely to go slow on bringing QE to an end. The recent sounds from Congress are encouraging on the budget and on lifting the debt ceiling so with luck markets will be free from political uncertainty. The prospect of rising rates in the US has of course been one of the factors behind the emerging markets sell off but hopefully this will not be too destabilising.

The UK continues to surprise on the upside. The BoE has raised its forecast of growth this year to over 3% from 2.4% while inflation appears likely to start falling to around the 2% level, one that appears sustainable for now. Much has been said about the imbalance of the recovery with the consumer taking on more debt via the housing market but reports on business sentiment are so positive that we can expect a large rise in investment this year. The BoE has had to redefine its forward guidance because of this strength and the 7% unemployment target seems to have disappeared as a signal for higher policy rates. The first move in base rates is now assumed to be a year away and a return to 2% not until 2016/17. Much depends on the amount of slack in the economy which could be eroding faster than the Bank's models suggest.

In Europe, we had the important German Constitutional Court's decision on the ECB's game changer last year, so-called Outright Monetary Transactions, when the ECB promised to buy bonds on an unprecedented scale. While it never was required to do so, it is still a reserve power and so it is something of a relief that the German court, having expressed strong misgivings, passed the buck to the European court. It looks therefore that the ECB still has the weapons it needs to counter the threat of deflation. To date, it has not gone down the QE

routeas any bonds bought back have been offset by new shorter dated bonds, sterilising the effect on the money supply. The European economy is at least bottoming out as is the Japanese economy where the major devaluation of the yen caused by easier monetary policy has done as much as anything to stimulate the economy and raise inflation to 1% after years of flat or falling prices.

In emerging markets, one issue is the risk of a credit bubble in China and the authorities' belated attempt to rein it in without damaging confidence. The scale of this is extraordinary in terms of overall debt levels. Business investment is approaching 50% of GNP, well ahead of any other country's development experience. The other issue is a more common one in developing countries, namely overseas deficits and depreciating currencies, leading to domestic inflation and rising interest rates. Brazil, India, South Africa, Turkey and Indonesia are all struggling at present.

Lastly, we should note the current strength of sterling. Against the dollar, it started last year at 1.60, traded down to 1.50 and finished the year at 1.64 and continues to strengthen. A more muted rally against the euro has also taken place. This robustness has helped the inflation numbers of course but has been a surprise. Some forecasts take it over 1.70.

Markets

Last year was an excellent one for investors in the developed markets. To a sterling investor, global equities rose 21%, in line with the FT All Share, with the US rising 30%, Europe25% and Japan 55% though only 25% in sterling terms. In contrast, emerging markets were down 5% in sterling terms. UK gilts also showed a negative return of some 4%, with UK Index Linked and corporates showing slightly positive returns.

The benchmark 10 year gilt has continued to trade around the 2.7-2.8% level observed in the November report. If we decompose the yield curve and look forward from the 10 year level- the so-called forward curve- then yields are much closer to longer term fundamentals so it is the shorter end, up to 10 years, which will sell off the most as yields normalise. Either way, gilts do not look attractive yet and this limits enthusiasm for corporate bonds which have interest rate as well as credit risk Regarding the latter, spreads for investment grade bonds are not far off fair value now which explains why investors are looking for higher risk yield such as high yield or emerging market bonds or indeed loans which price off a floating rate basis.

We talked last time about the valuation basis of the US equity market and yet the market rose another 8% in Q4 and is still challenging new highs despite a recent sell-off. Many commentators always find reasons not to buy the US but now indeed may be the time to underweight it in favour of Europe, Japan and the Far East. All markets have recovered but valuations are more attractive elsewhere.

The big call across regions is whether to buy the emerging markets after such a correction. The valuation arguments are supportive on price- earnings, price- book, etc. with a significant discount now to developed markets. Timing is the issue as many countries are still struggling and the exodus of funds has been enormous and is continuing. That is why the evolution of US monetary policy is so relevant assuming the longer term case remains intact; it is tempting to consider building up exposure gradually.

Property

UK commercial property looks the most solid bet across asset classes. Last year, it returned some 9-10% and expectations are for similar returns this year. Recovery has been long awaited outside the Central London office market but it does seem to be broad based across the provinces and extending into industrial , with retail lagging somewhat. Rental income has stopped falling and will need to show recovery if falling yields are to be maintained.

Alternatives

Hedge funds had a better year last year, not before time. The HFR index of funds of funds rose some 7%, led by equity long- short managers with global macro funds lagging behind again. Managers' report more stable conditions and a move away from risk on- risk off driven by central bank positioning will make life easier in future. The main competition to hedge funds for the UK pension fund market these days, so- called Diversified Growth Funds- produced similar returns across the board though they diverge in approach. Against a cash benchmark, such alternative managers did what was required last year.

Asset Allocation

The big asset allocation call last year was clearly bonds versus equities and the scheme was well positioned in this respect though it runs less equity exposure than some Council funds. The Panel will be discussing the findings of the strategy review with its threefold focus on: further de-risking out of equities; a more efficient deployment within the alternatives space and whether to extend the inflation hedge.

The main constraint on the exercise is the return assumption of 6% in the actuarial valuation which the scheme must deliver on over time to meet the recovery period timetable given the recovery payments schedule. If that can achieved with less risk, then that would be a move in the right direction to deliver better risk- adjusted returns Alternatives should be considered in this light, therefore. At the same time, the inflation assumption in the valuation sets a benchmark for the inflation hedge: if liabilities can be hedged at or below this assumption, this reduces liability risk. If the deficit can be reduced over time with less volatility in both assets and liabilities, then that reduces the risk that council tax payers may have to increase contributions at some stage.

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