REPORT PREPARED FOR

Dorset County Pension Fund

Pension Fund Investment Committee

Investment Outlook

July 2016

Alan Saunders
AllenbridgeEpic Investment Advisers Limited (Allenbridge)

alan.saunders@allenbridge.com
www.allenbridge.com

Investment Outlook

The first quarter started badly for equities and risk assets as evidence of a weakening in global growth at the end of 2015 came through. Encouraged by accommodating moves or guidance from the central banks and by better data, markets bounced back late February so that the US and UK finished the quarter in positive territory. With their weaker economic background, both Japan and Europe finished in the red but the star performer was emerging markets which rebounded strongly on the back of a weaker dollar and strengthening commodity prices, notably oil of course. Best returns from the quarter came though from gilts as yields fell sharply, causing more problems for pension fund deficits while corporate bonds saw spreads widening a little.

Now we are well in to the second quarter, sentiment has settled down but markets are really trendless at present. There is a more relaxed view on global growth while the Fed continues to take a dovish line on future interest rate rises. The risks to the outlook are obvious, Brexit in the short term and the unpredictable US election in the medium term while China and a growing support for protectionism or competitive devaluation appear longer term challenges.

The outlook for risk assets is not exciting therefore and this is unsurprising as we have had a long period of market recovery since the last bear market. Markets have run ahead of earnings so valuations do not offer much support while government bond yields are too low for comfort. Markets are not pricing in a shock from any of the above risk factors so cautions should be the order of the day. Stronger global growth is what we need at present but does not seem likely.

Economy

Globally, we seem still to be stuck in secular stagnation with moderate growth and weak inflation numbers. The US like the UK is growing around 2% and generating strong employment growth, the corollary of which is weak productivity growth. Inflation in the US appears to be picking up towards 2% and the FED would normally be moving towards its second rate increase but it is holding off. External factors are having an effect here with a weaker dollar potentially threatening the modest recovery in emerging markets. Bond markets in the US are not pricing in a move in the short term so a rate increase could provide an upset.

In the UK, the economy appears to have slowed in Q1 as companies defer decisions because of the referendum. Sterling weakened sharply but recovered some of the losses in the current quarter. While the polls suggest a narrow victory for the Remain camp, the economic risks are on the downside if the vote goes the other way. Short term, the consensus suggests a slowdown which could tip into recession while longer term, the period of protracted uncertainty while we extricate ourselves from treaty obligations and seek alternative trading arrangements would suggest a period of slow growth at best. A particular difficulty will be establishing access for exports from the service sector which accounts for half our exports.

In the UK, this backdrop suggests the BoE will hold off this year on raising interest rates. If the referendum vote goes against the government, it will face some policy dilemmas. The expectation is that sterling will weaken considerably, more against the dollar than the euro which would suggest a rate rise to counter the inflation risk. If the economy is weakening though, such a move could exacerbate the downside risk so they may hold off for a while.

Brexit of course poses a risk to the European economy as well. While Germany has grown steadily during recent years, other economies drag overall GNP growth down to the 1.5% level but there are some green shoots of recovery coming through in France and Italy. The ECB is of course on a major quantitative easing programme and is now buying corporate bonds as well as government bonds while offering negative interest rates on bank deposits with the central bank to encourage credit growth. At the same time, despite German protests, governments are being given more time to bring fiscal deficits down to below 3% of GNP.

Japan remains caught in deflation despite the efforts of simulative monetary and fiscal policy and the consequent weakening of the Yen. Part of Japan's problem is of course demographics with a declining work force capping potential GNP growth. Emerging markets are coming off the bottom. Their currencies bounced back in Q1 though are now giving up some ground. With the oil price back to $50/ bbl and recovery in iron ore and copper prices, the commodity story is not quite the disaster is has been. China too is trending around the 6.5% growth path the government is targeting with its latest round of accommodating monetary moves though the structural challenge of moving from an investment to a consumption economy seems far from resolution. As with developed markets, we have to accustom ourselves to slower growth from emerging markets than we grew accustomed to.

Markets

Long gilts produced a remarkable 8% return in Q1 and corporate bonds 3%, reflecting widening credit spreads. In contrast, UK equities were slightly negative. Sterling weakness softened the impact of weakness in Europe and Japan but emerging markets returned 8% in sterling terms, half of which came from currency gains. Property produced a subdued 1% return. As so often, the quarter was a story of risk off, risk on with no clear trend.

A major problem for equities is the corporate earnings picture. Global earnings, heavily weighted by US corporations, have been negative for twelve months and estimates are still being revised downward. Partly, this reflects the down-drag of the energy and resource sectors which have held the UK market back but these negative numbers will begin to drop out of the equation. Valuations really price in earnings recovery with global price/earnings at 19.0 and price/book at 2.1.

Sluggish macroeconomic forecasts suggest weak top line sales growth and limited margin improvement except for recovery stocks and value plays. Quality growth stocks with dividend paying capacity have been the place to be for the last few years but at some stage value stocks will take over. Likewise, we should expect to see emerging markets outperform developed markets at some stage, continuing the theme of the first quarter, but it seems a little early to anticipate that. Developments in Brazil lend hope to improved governance in a major economy while India continues to do well but China remains the key.

With 10-year gilt yields around the 1.5% level, gilts continue to disappoint those expecting mean reversion which would imply yields moving back to some 3%. Likewise with index linked gilts where real yields remain negative unlike in the US. Pension fund demand to hedge liabilities prevents the yield curve rising though the muted response of inflation to sterling weakness has not provided much fundamental reason for selling gilts. Corporate bonds should outperform gilts as spreads narrow in but returns will be muted. Increasingly, institutions are moving to non- sterling bonds or to alternative credit seeking to access the so-called illiquidity premium in such as high yield or private debt or even emerging market debt.

Finally, property continues to provide solid returns but after three years of double digit returns, we must expect to see single digit returns this year. Yields have little further to fall as we are at bull market levels in terms of price so much is dependent on rental income growth as well as running yield. Barring a Brexit vote, top of the market is expected to be next year.

Alternatives

The alternative credit investments mentioned above could be classified as alternative investments though we do not hold any currently.

We have two different types of alternative exposure at present. Our Diversified Growth manager times moves across markets according to short term tactical views and is judged as to how he produces returns over and above a cash benchmark. Hedge funds do a similar thing but at a greater fee and we no longer have exposure to them

The other category exploit an illiquidity premium as well as a skill premium. Private equity and infrastructure are both illiquid assets where we have to commit for a long time and where our allocations are drawn down over time. Private equity is a geared equity play where we should expect higher returns over time than quoted equities while infrastructure is also a long term investment where we are attempting to achieve a positive return in real terms. To the extent that infrastructure assets returns are inflation linked, we could regard them as a quasi-liability hedging investment.

Asset Allocation

The above analysis suggest we cannot expect a very exciting return from our growth assets this year. In order to reduce the deficit over time, we need to produce asset returns in excess of the liability returns set by the actuary .As we are not using a gilts plus benchmark, this can be done only by management alpha, by tactical asset allocation or by introducing new asset classes. This will be the subject of a strategy review after the valuation is complete.

We are of course also hedging the volatility in our liabilities caused by the risk of inflation exceeding the assumption made by the actuary on future inflation. To date, we have hedged some 20-25% of that inflation risk but have put further progress on hold following the upwards revision to liabilities following the last valuation. Restructuring the existing hedge to allow for the longer duration of the liabilities will get a better match and will also serve to reduce the leverage of the size of the hedge versus the capital we have allocated to LDI. This is necessary to ensure we do not need to access extra collateral from our growth assets in the event of a sharp fall in inflation. While welcome in terms of reducing future liabilities, such a fall would require us to post more collateral on the swaps that represent our hedges.

For further information, please contact Alan Saunders on 0207 079 1000 or at alan.saunders@allenbridge.com.