REPORT PREPARED FOR

Dorset County Pension Fund

Pension Fund Committee

Investment Outlook

September 2016

Alan Saunders
AllenbridgeEpic Investment Advisers Limited (Allenbridge)

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

Report of the Investment Adviser

Investment Outlook

The UK referendum result in favour of Brexit came right at the end of the second quarter and the repercussions are still with us. The immediate consequence was a selloff in sterling and equity markets globally, not just UK shares. In contrast, paradoxically, UK gilts rose strongly. While sterling remains some 10% below the levels before the referendum, equities have rallied strongly, led by FTSE 100 stocks which will benefit from a weaker sterling. Property has been the other asset class affected in a negative direction though valuations have yet to settle down. All in all, therefore, markets have remained reasonably composed after the initial shock.

Globally, this was the big event and was regarded as a risk factor by most global institutions, including the US Fed. We remain in a slow growth world with low inflation and a lower for longer environment for official interest rates. The Fed has paused on its tightening while the BoE has cut rates by a quarter and resumed QE on a precautionary basis. Emerging markets seem to be picking up a bit and oil prices have nudged back to the $50/ bbl level.

Market sentiment therefore is fairly settled at present but the recovery in equities has taken them to a level that needs fundamental support from corporate earnings rather than just the continuing dependence on central bank easing of monetary policy. Meanwhile the extraordinary fall in gilt yields post Brexit threatens the UK corporate sector with even bigger pension fund deficits.

Economy

It is too soon to assess the impact of the Brexit vote on the UK economy with the data so far being fairly mixed. The expectation was that orders would fall in anticipation of slowing demand and to some extent that has happened in the industrial sector. Construction and housebuilding also seem to be weaker but, while mortgage applications are down, house prices are holding up so far as is consumer spending judging by July retail sales. Certainly, there was reasonable momentum in the economy in Q2 before the referendum with unemployment falling to a low of 4.9% so a slowing rather than a sharp correction is likely. The Bank’s prompt action will assist in this respect.

The consensus has been that GNP growth will be lower by 1% pa for the next two years. Longer term direction will depend on the nature of trade agreements signed up and the extent to which we lose access to the Single Market, not least in the services sector. The risk of a hard landing has not gone away, especially if we are left with only WTO rules to go by for manufacturing and no services agreements in place after the two year exit period.

Another uncertainty is the extent to which inflation rises as a result of sterling weakness. This will eat into consumer real incomes and slow spending. There is debate on the future direction of sterling itself, the canary in the coal mine, so to speak. At $1.31, it has fallen a long way from $1.50 but many forecasts saw it falling to $1.25, especially as monetary policy starts to diverge. Against the euro, however, at 1.17, sterling may have touched bottom.

In the US, the Fed has been divided on the case for further rate rises but now seems to have come down in favour of at least one more hike of 0.25% this year. More positive evidence of the strength of the economy has been coming through with strong consumer spending and labour market gains. Earlier in the year, the Fed hesitated because of the weakness in global markets, now it has been holding back over concern the dollar would respond positively to a rate hike and that would weaken the domestic economy. However, if employment growth continues strongly, it will have to move because of inflation risk.

Elsewhere, Europe continues to stumble along, with growth slowing in Q2. While Germany grew, France and Italy were flat. The ECB has no choice but continue with large scale buying of bonds, now including corporate bonds. The position mirrors that in Japan where the BoJ has reaffirmed its commitment to QE. In the emerging world, though, things are looking better. While the statistics may be challenged, China official date reported on trend 6.7% growth in Q2 while India is growing at over 7% and both Indonesia and the Philippines are growing at over 5%. The Asian economic success story seems to be back on track though China still has to accomplish a restructuring away from a debt laden investment led economy.

Markets

While UK equities recovered from the sharp sell-off post the referendum, gilts out performed equities in the quarter and for the first half of the year. Year to date, gilts have returned 11% and index linked 9% against 2% for UK equities while overseas equities, helped by sterling's fall, returned some 9.5%. UK commercial property, which has performed so well for three years, produced a similar return to UK equities, around 2.5%. In Q2, the fall in gilt yields produced a 6% return against a positive 3.5% for UK equities. Within overseas equities, US and emerging markets performed best.

There has also been quite a pronounced disparity between large cap stocks represented in the FTSE 100 index and medium sized companies in the FTSE250 index, reflecting the greater domestic bias of the latter. This is logical given the prevailing assumption that exporters and those with overseas earnings will do well from sterling depreciation.

The gilt market reaction can be explained perhaps by BoE buying, by a flight to risk adverse assets and by recessionary fears but the scale of it is surprising. 10 year gilt yields have fallen from parity with US bond yields around 1.7% to 0.7% though we are not yet down to German bund levels at minus 0.1%. Longer dated gilt yields fell less, at some 0.5%, but that is enough to do further damage to pension fund deficits.

The recovery in global equities takes them back to earlier highs and leaves them looking somewhat rich in valuation terms unless the corporate earnings story starts to pick up. US corporate earnings remain under pressure while there is little sign yet of emerging market earnings recovery despite better news in stock markets. Most likely, equities will trend sideways at these more elevated levels, with central bank support underwriting them though asset purchases. The exception of course is the US where too rapid a move by the Fed would scare markets globally and lead to an emerging market sell-off. The other risk in the US is the November election. A Trump victory, though unlikely, would be taken badly because of his protectionist rhetoric. World trade growth is stuttering at present as it is.

A more cautious attitude seems appropriate therefore at present with regard to risk assets. This applies to corporate bonds as well as equities as spreads to government bonds could widen out if there are growth concerns though default risk seems low. Government bonds seem the worst place to go of course with risk of losses if yields start to rise, though that would have been said last year and the year before - which leaves property.

Property

Unfortunately, the property bull market appears to be coming to its end after three years of double digit growth. There was much press coverage of the wide spreads on open ended property funds post Brexit, designed to forestall redemptions in an illiquid market. Evidence of actual transactions seems to suggest a fall in capital values of some 3%, much less than the fund write-downs. Expectations seem to suggest another fall of 3% by year end which, allowing for yield and some rental growth, suggest a total return of around zero for the year as a whole.

Forecasting into next year and beyond is clearly difficult but a safe bet would be to assume some further slippage of values next year which would offset a 5% yield so another year of zero total returns could be in store. Long dated high lease values should be less sensitive while Central London offices should be more sensitive.

Asset Allocation

All this suggests a rather unexciting near term outlook for asset classes and portfolio returns. On a tactical basis, there is a case for trimming back holdings of risk assets like equities and corporate bonds where they have gone overweight.

At times of dislocation in markets, experience such as that of 2008 suggests attention must be paid to issues such as cash management and collateral management, i.e. that sufficient cash is available to meet commitments. In the fund's case, that means managing exposures on hedging strategies designed to reduce volatility where movements go the wrong way, i.e. currency hedges and inflation hedges. Had we been hedging interest rate risk, the fund would have been receiving collateral as interest rates have fallen. The fund is protecting itself against the risk of inflation rising: while inflation has risen at the short end, long dated RPI swaps have fallen so the fund has to deliver collateral.

The fund remains in good shape but following the triennial valuation, it would be sensible to conduct a strategic review as in previous years.

Alan Saunders
Senior Adviser

For Further Information

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