REPORT PREPARED FOR

Dorset County Pension Fund

Pension Fund Committee

Investment Outlook

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Report of the Investment Adviser

Investment Outlook

Brexit continues to dominate the news agenda though as the September report indicated, the response of markets has been fairly relaxed as the economic fallout in the short term has proved modest. The US presidential election is the next major risk for markets though again the increasing likelihood of a Clinton victory has reduced market nerves. The other major concern to markets has been the prospect of a hard landing in China. There the authorities have succeeded in keeping growth going and are now trying to cut back lending to the property sector where the risks are concentrated.

Somewhat surprisingly, therefore, Q3 saw positive returns from equities but also from bonds as government bond yields fell and credit spreads narrowed. The response was global and not just in the UK. The collapse of sterling, which was the biggest market response to Brexit, meant that returns from overseas equities exceeded UK equity returns for a sterling investor .For the year to end September, though, the best returns came from UK gilts and index linked.

As we enter Q4, gilt yields have started to rise as UK inflation begins to respond to sterling weakness. It is too early to conclude that this is the start of a global pattern but we must be coming to the limits of Quantitative Easing and, in the UK at least, there is a suggestion that fiscal policy might have to take over from monetary policy in supporting the economy. Meanwhile, equities are holding on to their gains while the property market is stabilising.

Economy

In the UK, sterling has now fallen to the worst levels predicted in the event of Brexit. By end June, it had fallen from $1.50 to $1.31, now in late October it is at $1.21. This is a major correction and will raise domestic inflation. September CPI rose from 0.6% to 1.0% and some forecasts see this reaching 3% by end 2017. Given that wages growth is some 2%, a squeeze on real incomes lies ahead which will hit consumer spending and GNP growth. Together with the likelihood of lower private investment levels, offset in part by higher net exports, it is easy to see why consensus forecasts for GNP growth are lower by some 1-1.5% for 2017. Mr Carney has said though that he will look through the inflation numbers and not seek to tighten monetary policy at this stage.

The new chancellor has sensibly relaxed the fiscal policy target of balance by 2019/20 which is just as well. The new focus on infrastructure will not help in the short term so his Autumn Statement will be scrutinised for signs of fiscal stimulus. It is premature to recall the phrase stagflation but at present we seem to be taking a few steps in that direction. The lack of clarity on the Government's strategy on Brexit negotiations is not helping business sentiment and the further the strategy moves away from access to the Single Market, the more business will worry. The global mood on trade agreements is darkening at present as populist politicians and the electorate turn against globalisation. World trade growth has slowed markedly compared with output growth in recent years while the current TPP and the EU- Canada deals are finding ratification difficult .Signing new trade deals may not be so easy.

Elsewhere, the US Fed backed away from a rate increase at its September meeting and consensus now expects it for December, after the election. The economy is holding up well in terms of employment growth and a modest tightening should not be a problem. Europe and Japan continue to muddle along and are still dependent on QE support from the central banks. Mr Draghi has to

defend the policy in Europe, not least against his German critics. He claims, critically, that it has avoided the trap of deflation, the curse of the 1930's, and indeed inflation is picking up a little.

As we indicated in September, emerging markets are recovering with inflation beginning to fall and currencies improving. A surge in the dollar if the Fed tightens too quickly is a concern still but domestic recovery seems to be underway, commodity prices are strengthening and, critically, China is growing steadily.

Markets

In terms of market responses, the most surprising was that of the gilt market though it is now beginning to sell off but from very low yields. Before the referendum, 10 year yields were 1.5% and they fell down to 0.7% by end September. Obviously, the BoE cut base rate to 0,25% and provided support by buying bonds to provide liquidity but the extent of the fall is still surprising. Now yields have backed up to just over the 1% level. Real yields, as reflected in the index linked market, remain very negative so this reflects rising implied inflation, caused by sterling's fall. Index linked have been the star performer, both in Q3 and year to date, outperforming both gilts and corporate bonds. A further surprise was perhaps in the corporate bond market as credit spreads narrowed in, from 1.2% to 0.8% for longer dated AA credits .Looking forward, we should expect credit spreads to widen a little but how far gilt yields will rise is unclear.

Equities rose some 5% in Q3, with similar returns from UK and overseas equities. .All market rose in local currency terms, led by emerging markets but Japan and Europe are still down for the year as a whole. Currency hedging clearly had an effect on scheme returns. The scheme is unhedged on emerging market exposure but 50% hedged on developed markets so that will have reduced the gains.

Fund managers have struggled to keep up with markets this year. Styles that have seen positive returns are low volatility and dividend paying stocks while energy and raw material stocks that were out of favour have rallied on rising commodity prices. Our new focus on a factor approach to global equities has not come off yet but it is early days. Similarly, in the UK market, the lagged performance of mid-cap stocks has caused performance issues for active managers.

Looking forward, as we have argued before, valuations seems fairly rich though with the exception of emerging markets perhaps. The corporate earnings story is not supportive at present, especially in the US where we have seen six consecutive quarters of falling profits, influenced by the oil and gas sector. The profit cycle there is past its peak as margins come under pressure while elsewhere it has hardly taken off. The financial sector has of course been a big drag on overall earnings. If yield curves start to steepen, then that will be good for bank profitability .Despite this unhelpful background, most managers seem fairly constructive on equities. Doubtless, there will be a relief rally if Clinton wins but the Fed may dampen things with a December rate hike. It would be surprising if equities made further gains by year end.

We stated in the September review that the UK commercial property market had come to the end of its long bull run. Projections see some fall in capital values over the post Brexit period extending perhaps into 2018. Rental value growth still seems supportive and yields remain an attraction so there is no sense of the market cracking. Quality assets and those with a high lease value with inflation linkage will remain well supported. The attitude of foreign buyers is not yet fully understood and their response will shape the prospect of the overheated central London market.

Asset Allocation

Last time, we argued for a cautious approach and supported some trimming of risk assets given the rally seen since Brexit. There was also a focus on cash and collateral management. Further sterling weakness will require more cash calls but hopefully our inflation hedge will move the other way as inflation swaps start to rise. It is hard to see much value in asset classes at present though longer duration plays like infrastructure and private equity should prove resilient. Any strategic repositioning will have to wait upon our post- valuation strategy review.

For Further Information

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