REPORT PREPARED FOR

Dorset County Pension Fund

Pension Fund Committee

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Alan Saunders
AllenbridgeEpic Investment Advisers Limited (Allenbridge)

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

INVESTMENT OUTLOOK

After the shock Brexit vote, markets have had to digest the equally surprising victory of Donald Trump in the US presidential election race. In both cases, markets have not exhibited the negative responses that most risk analyses had suggested beforehand. The strong momentum in the UK economy has continued into the new year, supporting the rally in equities, but gilts have now sold off and sterling has remained weak though it is now stabilising.

President Trump's victory has opened up a Pandora's box of potential outcomes. Initial equity market response has been positive because of the expansionary effects of major tax cuts and massive increases in infrastructure and defence spending which sounds like an old-fashioned Keynesian fiscal stimulus. Down the track, ominously, stands the spectre of protectionism and rising tariffs with planned trade agreements already being torn up. Downside risk is potentially considerable but how much is implemented is yet another of the uncertainties markets must adjust to.

In any case, we are dealing with a very unfamiliar world looking forward in many ways. Some are calling this the end of the post war consensus on global capitalism based upon free trade and mobility of labour. In some ways, it is a delayed response to the financial crisis of recent memory as electorates respond strongly to the perceived failures of leaders to raise living standards across the income spectrum. The US and UK may be near full employment but real incomes have not risen for middle and low income households. Mr Trump in particular has tapped into this but with a programme that may prove very damaging to the global business cycle longer term.

ECOMOMY

In the US, the economic expansion continues with inflation beginning to pick up to the Fed's 2% target. While the Fed increased interest rates at the end of last year, they will move slowly this year, at least until they gauge how expansionary the budget will be. The issue is how quickly inflation will pick up via wages as employment levels are now high. Higher interest rates will tend to boost the dollar of course which will affect exports, the antithesis of Trump's wish to restore the US manufacturing base at the expense of imports. For the time being, the economy should remain strong with business investment likely to rise and consumers happy to borrow. At some stage, the Fed may start to reverse QE to reduce its balance sheet.

In the UK, we have had the Autumn statement and the government has given greater clarity to its Brexit objectives since our last report. The former confirmed a more relaxed approach to reducing the budget deficit and the better GNP growth forecasts now from the Bank- growth last year and this year of 2%- will help tax revenues. The Bank of England reduced interest rates and provided liquidity in the summer and shows no sign of following the US in terms of an upward trajectory for interest rates given the uncertain background. Sterling has been rocky but has recovered to the 1.25 level against the dollar which of course means higher inflation as importers pass on the higher dollar costs of imports. Inflation could well rise from near 2% to 3% by year end but the Governor has said he can live with that so long as wages remain subdued. The subsequent squeeze on real incomes would put pressure on consumer spending, offset hopefully in part by an improvement in the net trade balance.

On Brexit, the government has, for better or worse, decided to leave the single market in order to avoid freedom of movement and the jurisdiction of the ECJ. Europe remains our biggest market, far larger than the US in terms of exports so the risks are clear. Tariffs are not the real issue as these are low in trade in manufactured goods between developed markets, typically 5% or less. The problems arise with non-tariff barriers, i.e. regulations, standards, etc. designed to offer consumer, employee and investor protection. These are reckoned to be around an equivalent figure of 20% and take much longer to negotiate. And of course, are critical to services, which account for half our exports and 80% of GNP. Whatever the final destination, it is important to arrange a transitional period to avoid a cliff edge that would deter business from investment.

Brexit is a risk to Europe too though exports to the UK are much less as a percentage of GNP than is the reverse case for the UK. Meanwhile, the European recovery appears to be proceeding and even inflation is picking up with 1.8% GNP growth and 1.8% inflation recorded for last year. Business and consumer confidence surveys are showing a better picture at last. The ECB will however continue with its policy of buying bonds until so- called escape velocity in the economy is clearly evident. Elsewhere, Japanese recovery continues in its muted fashion with the central bank also pursuing an aggressive QE strategy while emerging markets are picking up, helped by some recovery in commodity prices. China continues to muddle through, successfully maintaining expansion at 5-6%, while trying slowly to resolve the imbalances in the economy.

MARKET

In the last report, we assumed a relief rally in the event of a Clinton victory but argued that markets would struggle to make further progress. In the event, led by the US, equities rose strongly after Trump's shock win on a favourable interpretation of the impact of proposed tax cuts, deregulation and increased government spending programme. The S&P rose 8% in Q4, the FTSE 100 by 3.5% and the MSCI World Index by 6.6% in sterling terms, helped by further sterling weakness. Moreover, the rally has continued into the new year though it now shows signs of consolidation. Last year was a year of strong returns for a sterling investor with global equities up some 25% in sterling terms, though only 5% in dollar terms.

In the bond markets, though, the opposite happened in Q4 with government bond yields rising as investors began to worry about the inflationary consequences of Trump's programme and the likely tightening of monetary policy. US ten year yields rose from 1.5% to 2.4% while gilt yields, which had already risen to 1.0% in our last report, have traded through year end around 1.4%. Gilt yields are still lower than a year ago, and returns were positive for the year. Index linked yields have not begun to rise, [suggesting the sell -off in nominal gilts was all about rising inflationary expectations] and returned some 27% for the year. Corporate bonds also produced double digit returns.

Stronger economic growth forecasts are essentially good for equities and bond negative. Consensus forecasts expect modest further yield rises and negative returns from gilts in the near term but do not suggest ten year gilt yields rising above the 2% level they were at a year ago, similarly, we should expect modest returns from investment grade corporate bonds. We are still some way though from an environment of full mean reversion, meaning a more typical yield curve for this stage of the cycle, reflecting the lingering influence of QE

Led by the US, company earnings per share forecasts are being revised upwards encouraged by hopes of greater macro momentum, with leadership coming from sector like financials and energy that should benefit from Trump. The rally in markets has discounted this and valuations remain elevated. The higher multiple on US earnings has made Europe and Japan look relatively attractive while the UK has a valuation discount appropriate for the risks of Brexit. Emerging markets were the top performer last year reducing some of their attractions currently and they remain vulnerable to a scenario of rising US interest rates and a stronger dollar.

While momentum has slowed, equities could remain well placed in the short run and could absorb the likely gradual pace of Fed tightening in the months ahead. They will become unnerved though about any escalation of protectionist rhetoric and a period of volatility may be ahead of us. However, though this bull market is long in the tooth, the seeming improvement in near term economic growth could take it higher before the eventual sell-off.

UK commercial property finished last year with total returns of some 2% with Q4 showing a stabilisation after the Q3 sell off post Brexit. Expectations are for a similar low return this year with the high running yield of 5.5% absorbing modest falls in capital values. Open ended fund pricing has returned to normal removing some of the anxiety from the market. Clearly, the better than expected progress of the economy has helped sentiment and overseas buyers are still showing interest, encouraged by the collapse of sterling. Holding up better than expected!

ASSET ALLOCATION

In the event, the cautious approach we advocated in our last report was somewhat misplaced given the rally in equity markets though it proved valid for property and bond markets. The repricing of inflation has been beneficial to our inflation hedging programme after the concerns of a quarter ago when we paid away collateral on the fall in the price of inflation.

The strategic review following the triennial valuation is now taking place. The discount rate used in that valuation sets the return required from the strategic asset allocation. A different discount rate approach would suggest a different asset allocation and it might be worth exploring further these divergences as we move closer to pooling and experience more comparison with other schemes. The consultant chosen will bring a fresh pair of eyes to our existing strategy and will also examine the validity of a liability hedging commitment as part of that strategy.

For Further Information

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