REPORT PREPARED FOR

Dorset County Pension Fund

Pension Fund Committee

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INVESTMENT OUTLOOK

Markets continued the positive momentum of last year into 2017, both in Q1 and so far in Q2. While there are now some doubts as to whether President Trump can deliver his pro-growth agenda of deregulation, tax cuts and infrastructure spending, the election of Macron in France and Merkel's better showing in Germany have been well received .In the UK, we are in the middle of an unexpected election which has pushed Brexit off the front pages for a while but markets have taken reassurance from the seeming consensus on the need for a transition arrangement to avert the risk of a cliff edge effect.

There has also been increasing evidence of improvements in the global economy, led by the underperforming Europe and emerging markets which, if US reported profits are any guide, has given some validity to the resilience of equity markets. Global liquidity remains of course the primary driver of the elevated asset prices we see all around us, created in particular by central bank asset purchases, which will begin to tail off at some stage.

What perhaps has been more surprising than the ongoing strength of risk assets like equities has been the lack of volatility in markets. They seem impervious to challenges but this cannot go on for ever. The risk most commentators flag is that of the US Federal Reserve raising rates quicker than the markets have priced in. With the dollar surprisingly losing all its strength gained since the election, markets clearly assume the Fed will go slowly still .

ECONOMY

With steady economic growth, the US is almost at full employment levels, at which point wages should start to take off causing central bank concern. This has not happened so far so the markets may have read it right in expecting only two more rate hikes this year. Given the president's weakening authority, the fiscal stimulus that we were expecting may not come to pass which would reduce inflationary risk but nor may the protectionist measures he was threatening to pass. Despite all the political excitement, though, markets remain calm.

In the UK, Q! GNP numbers showed a slowdown to 0.3% from the 0.6% growth of the preceding quarter, suggesting the post – Brexit bounce may have run out of steam. Manufacturing and business investment look good, helped by the pound's depreciation. The problem lies with consumer spending, the main motor to growth, where wages are now beginning to lag retail prices, indicating a squeeze on real disposable income. On the fiscal front, the election campaign has produced more public spending promises from the government and a deferral of the move back to budget surplus .Sterling has moved back to $1.30, partly reflecting dollar weakness but also a slightly more relaxed view on Brexit as the Prime Minister has spoken of the need for a transition period of at least two years.

The best economic news has come at last from Europe. Germany has been growing in line with the UK in recent years but the rest of the economy has lagged. Now, helped by the ECB's extraordinary bond buying QE programme, we see signs of perhaps sustainable growth in the other major economies. After recovering well from the 2008 crash, the European economies fell again in 2010 at the start of the euro crisis and have only just climbed back to the output levels of those years.. Even Greece is close to agreeing a third debt relief package, provided fellow Europeans are prepared to write down debt. President

Macron offers France supply side reform but also a challenge to Germany, namely that Europe moves to budgetary union to ensure the euro survives future challenges. Though economically sensible, politically it is a tall order for countries like Germany to accept as it means pooling of risk. Meanwhile, as the ECB has just warned, the accumulation of government debt leaves countries vulnerable to so-called tapering or slowing of QE support should interest rates spike up as a consequence.

Elsewhere, there are signs of emerging markets picking up, some revival in commodity prices, not least oil which is now over $50/bbl, and China being reasonably successful in cooling down its economy. It is too soon to talk of synchronised growth but almost ten years on from the market crash, the world economy is looking in better order. Political risks remain high but are seldom factored into market thinking.

MARKETS

Almost all asset classes reported positive returns in Q! and this has continued into the current quarter.UK equities produced 4%,overseas equities almost 6% in sterling and local currency with emerging markets at 9%.With gilt yields falling back again , bond returns were around 2% and UK commercial property recovered somewhat to record 2.5%. Sell in May and go away is an old stock market axiom so what are the chances of it coming true this year after such a strong run?

Surprisingly, gilt yields have fallen again, with 10 year yields down to 1,15%, having risen from a record 0.8% post Brexit to 1.4%. This is seriously out of line with the US equivalent , standing at 2.4%. The contrast is even more striking with real yields with index linked showing strongly negative yields. With CPI now reported at 2.7%, which suggests RPI at 3.5%, nominal gilt yields should be rising. The recovery in sterling has helped while the BoE's continuing purchase of corporate bonds provides support .Because of the latter, corporate bond spreads have fallen to levels that could be challenged if sentiment on the economy changes though default rates on investment grade bonds are always very low.

The buoyancy of equity markets has been tested once or twice recently, mainly because of politics in the US, suggesting the possibility of a Trump dump after the Trump bump to markets! So far, markets have proved resilient and strong US profits reports have underwritten the rally since November. Valuation, growth and momentum are the main drivers behind markets normally. Valuation provides the least support for the US at least which is why portfolios are switching to Europe, Japan and emerging markets. Growth is picking up and momentum remains good so the omens look quite good for the time being.

What might be the catalysts for a significant market correction? The Fed is likely to raise rates again in June but that is priced in: a faster rate of increase after that would unsettle markets, especially if the economy starts to slow without the Trump fiscal boost .In the UK. the risks of the Brexit negotiations starting badly is a potential concern though not perhaps of a global nature. An implementation of Trump's protectionist rhetoric would go down badly but he seems to be moving away from earlier threats. China is always mentioned but the authorities seem to be alert to the risks, especially the debt overhang.
Volatility measures rose briefly before falling back but they are a poor forecasting tool.

In conclusion, markets could remain at these more elevated levels for some time without going anywhere. The economic news flow is positive and gradually catching up with equities. The same is true of the UK commercial property market which has recovered nicely from the sell off around Brexit. Forecasts for this year suggest muted but positive returns with only slight weakness in capital values. In contrast to risk assets like equities, so- called diversifying assets or absolute return funds like DGFs or hedge funds have produced somewhat disappointing returns. Their time will come when markets correct.

ASSET ALLOCATION

The investment strategy review commissioned after the valuation will be discussed at the meeting. The starting point for any investment strategy discussion is the actuarial discount rate which is set at 5.4% and which scheme assets need to return if the deficit is to be closed over the recovery period, in conjunction with contributions from sponsors. This is a higher hurdle rate compared to that which would be suggested by the two alternative discount rates actuaries use, namely a gilts plus and an inflation plus approach. The consequence is that it requires a high commitment to equities which increase potential volatility. It also makes it more difficult to derisk the scheme as funding improves because that would lower the discount rate and raise liabilities, reducing the gains.

Such an analysis provides a good framework for discussing strategy. Agreement on conclusions regarding appropriate asset classes and asset allocation is the next stage. Working out a time line for implementation of any change will follow accordingly.

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