Appendix 1

REPORT PREPARED FOR

Dorset County Pension Fund

Pension Fund Committee

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Alan Saunders
Allenbridge

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

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INVESTMENT OUTLOOK

Equity markets made further gains in Q2 after the positive start to the year in Q1 and are holding on to these gains so far in Q3. The gradual recovery in the global economy provides support of course though the recent sabre rattling between North Korea and the US has produced some challenge to sentiment. More fundamental concerns like the tightening of monetary policy by the US Federal Reserve or the possible start of tapering by the ECB over quantitative easing have not yet troubled markets. Over the period, the dollar has been weak and the euro strong.

In the UK, the unexpected June election weakened the government and complicated the task of delivering Brexit. Preliminary discussions with the EU over financial transfers, Ireland and residency rights are not yet resolved but it looks as though the government will request an interim or transitional period of some two years while seeking a new trade deal and that it will not remain in the single market or customs union. The market has taken some reassurance from the increased emphasis on economics and the reduced likelihood of a hard Brexit.

After such a long bull run, it is natural to ask what could cause a market correction or even a crash. It is now ten years since the first cracks appeared which signalled the financial crisis. The major market setbacks of 1987, 1994, 2001 and 2007 all had different causes. The risks are clearly there, especially in the US which has led the economic recovery and where risk assets like equities and credit appear fully valued. Elsewhere, this is not the case but clearly contagion can lead to a mass sell-off. That is why the task of the Fed in normalising monetary policy without destabilising markets is so critical.

ECONOMY

There has been little change to the global macro outlook since our last report which noted the gradual move to a synchronised economic upswing, though the UK appears to be slowing against the trend. Whatever the pace of the recovery, inflation is showing few signs of responding, encouraging policy makers to slow any monetary tightening.

In the US, economic activity has picked up after a weak Q1 but the economy is only growing moderately and inflation is subdued. This is probably why the dollar has been so weak as markets factor in slower tightening. The fiscal stimulus that was expected from President Trump now looks remote with the infrastructure bill showing very little new federal spending. Recent focus has been on the new administration’s talk of rolling back the post-crisis regulations on the banks, which would seem to undermine the effort to make the banking system better able to withstand the next financial shock. The protectionist scare seems though to be on the wane, a more positive development.

Sterling has been weak against the euro but has held its own against the dollar recently. The Bank of England has not yet reversed the emergency help and rate cut provided post the referendum but the MPC seems to be moving in that direction. The inflation picture certainly warrants a move with CPI around the 2.7% level and likely to go close to 3% but the real economy is softening because of the squeeze on real disposable income. Last year’s collapse in sterling has not produced the gains to net trade that had been hoped for and manufacturing output looks sluggish. Forecasts are being lowered to around 1.6% for the year but despite that, unemployment has fallen to 4.4%, the lowest level since 1975 remarkably.

Little by little, the government’s evolving policy on Brexit is coming through with talk of a transitional arrangement before a new trade deal kicks in. The timetable seems very tight to agree the terms of exit by March 2019, the nature of the transition and the scope of the eventual free trade deal all before 2022, the date of the next election. This will mean continuing uncertainty with consequences for business investment and economic activity.

In Europe, activity continues to pick up and the crisis seems to be finally over, so much so that markets are awaiting a statement from Draghi of the ECB as to when it will start to throttle back on the amount of bond buying, so-called tapering. The process of removing support from markets will be slow and not without risk to the new found stability.

Emerging markets have been the strongest performers so far this year and this reflect confidence that, with some exceptions like South Africa, growth is on an improving trend. Commodity prices are off the lows and EM currencies have recovered much of recent lost ground. Sentiment has been improved by events in the US too, i.e. the slow rate of Fed tightening and the reduction in protectionist rhetoric from the White House. China remains a tail risk if the attempts by the authorities to bring the economy under control backfire but so far the economy is maintaining a 6% expansion.

MARKETS

"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." That was the comment in our last report and not much has changed except that markets have inched higher. Valuation looks rich in the US but reasonable elsewhere and earnings growth and price momentum remain positive for equities.

If there is a bubble, it is probably in bond markets as Mr Greenspan suggested recently. That certainly remains the case in the UK where ten year gilt yields continue around the 1.1% level. This raises difficult decisions for pension funds wishing to hedge out liability risk. In the US and Europe, government bond yields are moving back to more sensible levels so from a US perspective, the concern might be more in credit markets with corporate bond spreads narrowing in. Investment grade corporate bonds now yield some 3% and high yield bonds around 5%, close to recent lows. This demonstration of risk appetite mirrors what is happening to US equities of course. Floating rate paper like loans might be a better bet therefore at these levels.

Emerging market equities have been the star performer in the year to date with returns over 20% while the UK has lagged the other developed markets at the low end of the 5-10% range they have delivered. Companies continue to support share prices with buybacks and dividend increases in the US while elsewhere it is more a story of profits recovery. This benign environment looks well set to continue barring an external shock. Apart from geopolitical developments, there are the usual suspects: too rapid rate tightening by the Fed; trouble in the credit markets caused by rising bad loans and weak lending covenants; and some mistakes by Chinese policymakers. None of these look immediate threats though North Korea has a concerning element of unpredictability about it. It would seem sensible on a balanced judgement to avoid running an excessive risk position in equities and credit at present in anticipation of some correction if not of a crash.

Much the same could be said of UK commercial property where the market has recovered from the post-Brexit sell off. Fundamentals look rather strained given the extended bull market preceding that. Even so, no more than a subdued period for the market is forecast but it will to some extent be a hostage to the Brexit negotiations, certainly as far as the London office market is concerned.

ASSET ALLOCATION

The external consultant's report on investment strategy drew attention to the relatively high rate of return of 5.4% required as a consequence of the actuarial discount rate. That implies a higher risk tolerance than would be expected in a corporate pension scheme for example and therefore a greater emphasis on real assets like equities and property. The strategy report attempted to deliver

that but with a reduced level of risk or volatility and subsequent iterations to the initial recommendations still predict that outcome.

It should be emphasised that all such exercises are model driven and rely on assumptions concerning future returns, volatility and correlations across asset classes that may prove invalid. Importantly, in combination, the proposed asset allocation suggests about a 50% probability of delivering the required return.

The final recommendations are discussed in detail in a separate report on the agenda. It is a balanced scorecard but one designed to deliver the relatively high required return while reducing volatility and therefore fluctuations in the funding ratio. The ultimate objective is of course to fund the deficit over the agreed time period in conjunction with sponsor contributions without too many surprises on the way.

For Further Information

For further information, please contact Alan Saunders on 020 7079 1000 or at alan.saunders@allenbridge.com