REPORT PREPARED FOR

Dorset County Pension Fund

Pension Fund Committee

November 2017

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INVESTMENT OUTLOOK

The contrast between the stability in equity markets and events in the political world remains striking. Since our last report, Japan and Germany have had elections, the first of which was market positive with Abe's re-election. In Europe, though, uncertainty is in the air with Mrs Merkel struggling to form a coalition, Brexit rumbling on and now Spain in turmoil. In contrast to the US, at least China is guaranteed strong leadership with the re-election of President Xi.

Calmness in equities can of course be misleading as 2007 proved and we have mentioned before some of the potential risks, notably those of monetary tightening and credit deterioration. The most significant policy change has been the ECB's announcement that QE will be extended into 2018, but the scale of bond purchases will be halved from the end of this year. Together with further rate rises likely in the US and the removal of the BoE's emergency rate cut last year, the long period of monetary stimulus is gradually coming to an end, with only Japan likely to persist. The stock of central bank liquidity totals some $15 trillion and has provided critical support to the global economy and of course financial markets. How will they cope without it?

ECONOMY

The IMF in its latest report commented favourably on the favourable economic outlook, notably in Europe and emerging markets, but it does warn of medium term vulnerabilities in the shape of elevated credit and equity risks. The European upswing seems well established now and although unemployment is still 9%, it has come down from 11%. Mr Draghi's decision to cut bond buybacks from €60 billion a month by half suggests confidence as well as German pressure but he is well short of the 2% target he set for CPI, to ensure deflation is well and truly defeated. The euro has lost a little ground on this announcement having been very strong against the dollar this year.

The US appeared to be growing modestly making the Fed's upward trajectory for interest rates slightly controversial but the announcement of Q3 GNP growth of 3% suggests another rate hike by year-end. The economy is close to full employment so the President's ambition to agree tax cuts with Congress may seem potentially inflationary if it accelerates consumer and business spending, suggesting more tightening of monetary policy. The dollar could be a beneficiary of this macro outlook therefore.

In the UK, the Autumn Budget will have political as well as economic implications with considerable pressure to ease up on austerity. The Chancellor has already moved in this direction by pushing back the date of budget surplus, but now the OBR warns that that may never happen. The economy has certainly slowed as consumers and business take a more cautious view while with CPI now up at 3%, real incomes have turned negative. Growth at 1.5% this year and next looks likely. There has been much comment on low productivity recently, which contributes to the slowdown, but of course it has helped the strong employment growth of recent years.

The debate on Brexit rages and there does seem to be progress on the agreement to have a transition period but disagreement on whether future trade agreement should be settled before or during this period, not to mention differences over financial contributions, etc. It would certainly be premature to write off the hard landing scenario though most involved seem to wish to avoid this outturn which would create stress in financial markets. Meanwhile, sterling has given up some of its recovery against the dollar.

MARKETS

Markets continued to progress in Q3 though at a slower rate. UK equities are the laggard with a quarterly rise of 2% and a year to date rise of 8%, well behind the 17% rise for the MSCI World index and the 28% rise in emerging markets, in sterling terms. The US continues to perform best of the developed markets despite long-running valuation concern and monetary tightening. US corporations keep reporting good profits figures, helped by some currency weakness while stock buybacks and special dividends keep investor interest strong.

Global equities are on a trailing price/earnings ratio of around 20-22, higher than historic averages but not so concerning as to trigger a major correction now that earnings are growing. Stock markets could continue to inch up on the back of this earnings growth but further multiple expansion would be a concern

Last quarter, we talked about the greater risk of a bubble in bond markets, notably in credit markets where spreads have narrowed in. Government bond yields are now off their lows of course. UK Gilts now yield 1.3% against 1.1% last time but they are well below US bond yields of 2.3% at the ten-year level. The expectation must be that the tapering of central bank support will force yields higher. Could this be a problem for some European countries who have depended on ECB purchases of their bonds? Could it be a problem for the UK too as some of that liquidity has been recycled into the gilt market?

The IMF warned about the compression of credit risk premia and the risk that credit spreads could widen out sharply if there is concern about economic slowing. Central bank buying has of course been behind this compression because of the liquidity it has created and investors search for yield. Short duration and high quality credits with good covenants would be the sensible response to these issues.

Commercial property continues the recovery from last year's second half sell-off. The underlying tone in the market appears solid and return expectations have moved back up for this year and next to the 4-5% target, suggesting some stability in capital values.

ASSET ALLOCATION

The strategy review has been completed and discussed. It aims to reduce the risk of the portfolio while maintaining the expected return. One of the decisions was to reduce corporate bonds in favour of multi- asset credit, which is more of a return-enhancing move and might seem to run counter to the above remarks about credit spread widening. The manager appointed however focuses on bank loans with short duration while security of loans is high and covenants strong so hopefully these concerns will be addressed.

Other recommendations will tend to reduce portfolio risk, such as switching some capital out of equities into diversified growth funds and increasing the inflation liability hedge over time. Marginal increases in infrastructure and private equity probably offset each other in risk terms while a higher allocation to property, a risk asset, is moderated by the intent to direct the capital to lower risk inflation linked high lease value properties.

There are of course timing issues given the imminence of pooling but if all the changes go through in a reasonable time frame, the portfolio should deliver better risk- adjusted returns. That should mean lower volatility over time in the funding ratio as we move to reduce the deficit.

For Further Information

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