MJ HUDSON
Allenbridge

Dorset County Pension Fund

Pension Fund Committee

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Contents

Contacts

Alan Saunders

Senior Adviser
+44 20 7079 1000
alan.saunders@mjhudson.com

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Investment Outlook

After a positive start, risk assets suffered a significant correction during the first quarter though they have subsequently recovered. The February sell-off was the fourth such event since the financial crisis and was precipitated by concerns over the pace of Fed tightening in the US as well as rising trade tensions created by the US administration. Market indices are currently close to year end levels so it is fair to say that volatility has returned to markets after some years of stability and rising prices in equities and credit. All underwritten by central banks massive injection of liquidity,

Anticipation of a reversal of this monetary easing has to be an issue for markets. Already US ten-year treasury yields are back to 3%, the highest in seven years, the dollar is recovering from its earlier weakness posing some challenge to emerging markets and there are signs of softening in some leading global economic indicators.

In the last report, we indicated that there at last seems to be some coordinated global economic recovery reaching out to all regions. That remains the case though growth may start to slow and markets are likely to be more restrained as the outlook becomes more challenging. Volatility may remain and the reduction in market liquidity could mean more sharp moves such as we saw in February.

Economy

There are some signs that the global cyclical upturn is peaking, especially with regard to manufacturing surveys. Consumer and business confidence seems fairly strong though and after a slow first quarter growth should remain above trend this year. The US is certainly closest to so-called late cycle but Trump's tax cuts has given a boost to demand, especially through higher investment. Overall GNP has been lifted by some 1.5% by the tax cuts but this does mean the budget deficit is close to hitting legal limits so there may have to be some offsetting public spending cuts. Meanwhile, given full employment, the Fed cannot take any risks with inflation so monetary tightening will continue. Fed funds has risen to around 1.5% and could be 2.5% over the next year with possibly more to come. This will impact markets.

While growth in the US is expected at some 2.5%, no better than 1.5% is expected in the UK. The better news is that inflation is falling back, now at 2.5% and real wages are just positive again. No real progress has been made over Brexit though a White paper is promised before the end of June and the EU summit. Squaring the circle to define the government's position is proving difficult and may lead to a delayed departure from the customs union assuming the EU agrees. The increasingly hawkish nature of the US on trade and sanctions does not augur well for future trade deals as protectionism appears on the rise. A hard Brexit outcome would be badly received by markets if that is the case.

Elsewhere, Europe is expected to show somewhat slower growth this year, around 2.5%, caused by the strength of the euro which will hit exports. Japan operates below the radar these days but has been on its longest growth phase for some years, albeit growth is in the range 1.5-1.7%. At last, consumption and investment are supporting the economy.

Emerging markets certainly picked up steam last year with domestic growth supporting exports, boosted by rising commodity prices. China is attempting a controlled slowdown as it seeks to moderate the credit boom but should still deliver 6% growth. The growing trade war with the US is a concern and US demands are unreasonable so this is an issue. There are also grounds for concern over the dollar's recent resurgence given the large dollar denominated debts of some countries and companies. Argentina is having to renegotiate with the IMF again while Turkey has seen significant currency weakness. Raising interest rates to defend their currencies is not a popular move.

Looking ahead, the main issue for financial markets is likely to be the slowing of global liquidity growth as central banks start to shrink balance sheets swollen by years of QE. Even the ECB and the BOJ are likely to have stopped asset purchases by the end of this year so rising budget deficits will have to be funded by the markets, suggesting rising bond yields, as we have seen in the US. Central banks, with the exception of the US, have not started raising interest rates – and the UK recently surprised by not doing so – but that may start next year as they seek to normalise policy.

Markets

The first quarter was negative for equities with the UK down some 6% and overseas equities down some 4%, exacerbated by sterling strength. The US, for example, was down less than 1% in dollars but 4% in sterling. Long gilts and UK property produced positive returns but widening credit spreads reduced the returns from corporate bonds and especially high yield bonds.

UK gilts continue to trade in the 1.4-1.5% range for ten-year gilts with the gap widening with US treasuries. Breakeven inflation rates have eased a little in response to better numbers but index linked or real yields remain strongly negative, again in contrast to US Tips. Corporate bond spreads widened a little but remain tight and there must be a risk they will widen out further on weak economic data. That applies still more to high yield of course even though default rates remain low. There is rising concern in the US about rising corporate leverage and weakening loan covenants so high yield and leveraged loans on private equity deals, for example, should be treated with caution.

Sentiment in equities recovered quite quickly from the Q1 sell-off which turned out to be a correction of some 10% rather than the start of a bear market as some had feared. US corporate earnings have come through strongly supporting market recovery but there is no doubt the shine has come off the technology sector with disclosures of misuse of personal date challenging the whole sector, not just Facebook. Valuation has been helped by earnings and the cooling of the Bull Run. For developed markets as a whole, excluding emerging markets, the trailing P/E is now under 20 while projected earnings growth of some 10-15% will bring it to more acceptable levels. Emerging markets still trade on a discount despite their outperformance of the last two years with the trailing P/E just under 15.0. Earnings growth remains in double figures but the recent rise in the dollar could weaken sentiment and begin to reverse capital flows which are important for emerging markets.

Equities, especially developed markets, are not cheap therefore but able to sustain current levels, barring shocks like excessive fed tightening, escalating trade tensions or geopolitics. Above, we referenced rising leverage in the credit markets as a concern. The other structural factor that should concern equity investors is diminishing liquidity in markets as investment banks have withdrawn from market making A wave of selling could lead to much sharper sell-offs as we saw in Q1 . We must expect more volatility in markets, now that central banks are no longer buyers of last resort and reduced market liquidity is not a good thing.

The UK has been a laggard for over two years but has bounced back sharply recently. The recent fall in sterling, back to 1.35 against the dollar, has benefitted large cap sentiment and boosted the FTSE 100 index to over 7700. Brexit remains the biggest risk and uncertainty suggesting modest upside on a relative basis. That is also true of the UK commercial property market which has surprised on the upside over the last eighteen months. Industrial has been the star performer, comfortably outperforming retail and office. Yields are low suggesting the market is at or near a cyclical high. Rental growth has been supportive but may weaken with the economy. Overseas buying has been a support but sterling is no longer so cheap.

Asset Allocation

The Strategy Review has been approved and is now being implemented, subject to the complications caused by pooling. This has impacted the proposed allocations to absolute return and also to illiquids like private equity and property. Rebalancing back to strategy should still take place where necessary to reduce risk. The review of the pooled assets propositions is taking place now including global equity and illiquids. The completion of the LDI mandate refresh has taken some time but is nearing completion.

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8 Old Jewry, London EC2R 8DN, United Kingdom | +44 20 7079 1000 | London@MJHudson.com | mjhudson.com | mjhudson-allenbridge.com

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