MJ HUDSON

REPORT PREPARED FOR

Dorset County Pension Fund - Pension Fund Committee

March 2021

Alan Saunders, MJ Hudson
alan.saunders@mjhudson.com

THIS DOCUMENT IS DIRECTED ONLY AT THE PERSON(S) IDENTIFIED ABOVE ON THE BASIS THAT THEY ARE A PROFESSIONAL INVESTOR OR PROFESSIONAL CUSTOMER. IT IS ISSUED BY ALLENBRIDGE. ALLENBRIDGE IS A TRADING NAME OF ALLENBRIDGEEPIC INVESTMENT ADVISERS LIMITED AND ALLENBRIDGE LIMITED WHICH ARE ALL APPOINTED REPRESENTATIVE OF ALLENBRIDGE CAPITAL LIMITED WHICH IS AUTHORISED AND REGULATED BY THE FINANCIAL CONDUCT AUTHORITY (FCA).

INVESTMENT OUTLOOK

A year on from the start of the pandemic, world equity markets , led by the US but including emerging markets , have just made new highs. In Japan, the Nikkei index has reached 30000 for the first time since 1990. The UK in contrast, while having a good Q4, continues to lag other equity markets and is still some 10% below the levels of a year ago.

What has led to this market exuberance? There is no doubt we are in a better place than at the time of the November meeting when the first confirmation that the vaccines work was just beginning to boost investor sentiment. Now their successful rollout in the UK and US in particular has revived animal spirits and the expectation that economies can rebound this year and perhaps quite quickly.

Vaccinations are not the whole story. The end to the protracted US presidential election saga and the promise of a second major stimulus package in the US together with a supportive Federal Reserve has been a positive coincidence of events while the UK and Europe managed at the last gasp to agree a post –Brexit trade deal. This positive news flow explains why we have not yet had the consolidation phase we suggested was overdue, in the last report, after the striking market recovery from April lows.

ECONOMY

In the UK, Q4 turned out rather better than expected with a 1% rise in GNP averting the expected W shape to the economy but of course that only postpones the fall into the current quarter because of the latest lockdown. With GNP falling 9.9% last year, the UK was by far the worst performing of the major economies and a 3% fall is expected in Q1. While wages held up, consumer spending fell dramatically as did business investment, leaving the public sector to act as a shock absorber for the economy, with the budget deficit widening out from an expected £50bn to approaching £400bn.

It is doubtful that the March budget will do much to offset that budget deficit through tax rises despite the Chancellor’s instincts as the economy is in too fragile a state still to risk any downside shocks. There can be hope though for quite a strong recovery in the second half of the year as consumers start to run down the massive savings they have accumulated over the last year. The speed of recovery will obviously depend upon factors like the easing of restrictions and the extension of the furlough and other interventions but also how firms respond to the Brexit trade deal. There are clearly logistics problems at present which will act as a dampener on growth while the important financial services sector has yet to find out whether the EU will accept equivalence on rules, without which the City will lose competitive advantage. It will still be 2022 before we get back to 2019 output levels with a rise in GNP of 5% forecast for the current year by the BoE.

One of the surprises in recent weeks has been the strength of sterling. Against the dollar, it has risen from 1.30 to 1.38 and rallied also against the euro. The dollar has in fact been generally weak, which will aid US economic recovery. Their economy fell 5% last year and will bounce back by at least that amount this year, certainly if the $1tr stimulus package passes through Congress. There are voices now, including Democrats, arguing that such a package is unnecessary and will stoke up inflation. Fed chairman Powell seems relaxed however and the Fed has already indicated it will tolerate inflation over and above the 2% target for some time.

At present, it stands at 1.4% and there is considerable slack in the labour market. This loose policy might explain dollar weakness which will be a help to recovery in emerging markets which are often linked to the dollar.

Major economies like Germany and Japan also recorded GNP falls of some 5% last year while Italy and Spain were close to 7/8%. China of course is already in recovery mode and one of the geopolitical issues facing President Biden will be the extent to which he maintains Trump's aggressive position on trade with China. Chances are that he will which may create increasing tensions with Europe and Germany in particular, similar to the current debate over Russia with Germany going ahead with its controversial Russian gas pipeline. A move back to multilateralism has been promised which would be market friendly and of course the big test will be the forthcoming dialogue on climate change.

MARKETS

The UK market had a good Q4 with a 12% recovery but still finished some 10% down on the year. In sterling terms, world equity markets rose 8% in Q4 and 13% for the year while the US rose 7% and 17% respectively, with information technology stocks up a remarkable 40%. For the year as a whole, Japan was up 11%, Europe ex UK 8% and emerging markets 6%.

We have remarked before on the speed of recovery and ascribed it to the major fiscal support offered in the major economies as well as the continuing monetary accommodation of the central banks. This has been compounded of course by the successful rollout of the vaccinations which sustained the rally into the new year. Can this be justified by the fundamentals? At first glance, that seems difficult with the implication that equities have been propelled by massive P/E expansion into overvalued territory, with the exception of some laggards like the UK.

Because of policy intervention, however, corporate earnings were not as badly affected as would be expected in such a recession. In the US, corporate profits in Q4 are coming in ahead of expectations and consensus for 2021 is a rise of some 20%, offsetting last year's fall. The P/E multiple for the market as a whole is around 22 against a long term average of 19, suggesting it is in the technology sector where valuations have pushed out too far. The technology sector could be said to be in bubble territory after such a run. This is beginning to be reflected in sector performance in the markets with so- called value stocks beginning to show some relative performance against growth stocks. That might partly explain recent revival in UK equities with their excessive reliance on old economy stocks like energy and mining.

While the US has provided the leadership over the last year, other markets may show some catch up this year assuming the global business cycle turns up sharply by the second half of the year. Germany, Japan and emerging markets could perform well on a global economic revival. The recent weakness of the dollar may help emerging markets also because they carry a lot of dollar denominated debt and also because commodities are priced in dollars which increases their competitiveness. Countries like South Africa and Brazil have underperformed technology led markets like Korea and Taiwan.

.

Where does that leave the UK? Potentially in catch up territory as the economy could revive quite strongly if consumers start to run down savings when confidence returns. Business too has preserved cash quite well and bankruptcies have been largely confined to retail and hospitality. A resumption of dividends, as the banks wish to do, would certainly help market sentiment.

Bond markets of course proved a safe haven last year. Gilts produced a total return for the year across all maturities of 8% and index linked 11%. Sterling corporate bonds also produced a return of some 8%, with a notable pick up in Q4 as spreads started to narrow in. The story so far in 2021 is very different as the gilt market is selling off. Yields on 20 year gilts have moved from 0.7% to 1.1% by mid February. The move in index linked has been a little less pronounced as inflation has moved out, from 3.3% to 3.4%, despite the negative decision on the RPI wedge. Corporate bond spreads have remained broadly unchanged to date.

Capital values in property probably fell up to 10% last year, offset to some extent by the running yield, though that has been reduced by rent deferrals in many of the worst affected sectors like retail and hospitality. It could well take two or three years before the market makes a proper recovery given all the uncertainties over home working, high street retail, etc. Logistics and industrial property have remained solid reflecting the rise of online shopping and the relative stability of manufacturing. With all its structural challenges, commercial property no longer looks as secure as in recent years. Investors are now looking at residential as a diversifier, whether private rental, social housing or co-ownership.

INVESTMENT STRATEGY

We now have a resolution of the RPI-CPI wedge issue which has been hanging over the inflation hedging LDI portfolio. Regrettably, the government has opted to offer no compensation to holders of index –linked bonds as they migrate across to CPIH from RPI though at least that will not be until 2030. Surprisingly, the price of inflation did not sell off and indeed rallied as institutions which had postponed buying because of the uncertainty entered the market. The scheme reduced its hedge from 40% to 30% to derisk its exposure which provided protection from further losses during this uncertainty but the recovery has probably brought us back to where we were. Despite the short term low inflation numbers, there is an increasing view that inflation must start to rise and that is reflected in the pricing of inflation swaps, suggesting a partial hedge would still seem warranted.

By the time of the meeting, the restructuring of the equity portfolio should have been completed. Part one saw a switch from UK to global equities in line with the recommended strategy. Importantly, we have kept the 50% hedge on this larger exposure and that proved sensible as sterling has appreciated in recent weeks. Phase two involves switching within the global portfolio, to increase the exposure to emerging markets and small cap stocks which does not have a currency dimension to it.

The strategy review reduced marginally the property exposure though that has not yet been implemented through property sales at last count. Within the allocation, there may be some merit in looking to diversify further into residential property, whether private rent , social housing , etc as these appear to be less cyclical and more likely to deliver inflation linked returns through rent reviews.

FOR FURTHER INFORMATION

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