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REPORT PREPARED FOR

Dorset County Pension Fund - Pension Fund Committee

November 2019

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INVESTMENT OUTLOOK

Markets made modest gains in Q3 after a small wobble over the slowdown in global economic growth. The current quarter has continued this better tone, supported by relaxation of monetary policy in the US and EU, by some easing of tension in the US-China trade dispute and by renewed hope of a Brexit deal. Uncertainty has returned of course to UK assets with the announcement of a December general election though sterling , which has recovered a lot of ground and equities are holding firm so far.

The strength of equities this year- global equities up over 20%- seems at variance with the weakening economic outlook but markets are looking ahead as usual. This is mirrored to some extent in bond markets. Last quarter, we observed how bond yields had fallen yet again to exceptional low levels with talk of a global deflationary spiral. Yields are now off these lows. Yet again, central banks are expected to underwrite the economy and prevent such an outcome though they are running out of ammunition.

The key to markets therefore will be the economic data of the next few months, though the UK will be driven by the election result and the Brexit outcome.

ECONOMY

As we said in the last report, there is major divergence between the US and the rest of the OECD. The US slowdown has been muted and the Fed has indicated it will now pause on interest rate cuts after the third one this year. That suggests its stance is based on a mid-cycle correction rather than averting recession. The economic background is still quite supportive of Trump's re-election campaign with low inflation and full employment but that could change if manufacturing gets hit by reduced China exports.

Draghi's last act at the ECB was to lower rates further into negative territory and his successor is unlikely to change the direction of policy. With the German economy a wounded beast at present,

the outlook for Europe is grim with growth no better than 1-1.5%, which explains perhaps Merkel's desire to do a deal on Brexit. Interestingly, the new German finance minister has indicated a more flexible approach towards EU banking union, suggesting that deposit reinsurance might be something worth consideration. If Germany were to consider a fiscal stimulus, with a focus on infrastructure, following the UK parties' promises, there might be more grounds for optimism but the EU is too dependent on being rescued by the global economy.

The UK avoided recession in Q3 but is operating at stall speed with growth around 1%. Sterling was buoyed by the news that the government has agreed a new Brexit deal but that news has of course been somewhat dissipated by the major uncertainty regarding the election result. If Johnson wins a clear majority, then the deal could be passed by January at which stage negotiations on a trade deal commence. It seems optimistic that this can be achieved before the transition agreement expires at the end of 2020 and markets will doubtless start to agonise on the possibility of no agreement and a resort to WTO rules. If of course the election outcome is different, then forecasting becomes difficult but the current uncertainty will surely persist.

What is striking about both the major parties' pledges is the major fiscal boost promised, to an extent regarded as irresponsible by fiscal hawks. The share of public expenditure / GNP will rise from 38% to 41.5-43.5%, which will act as a strong old style Keynesian boost to the economy. The Bank of England will be watching with interest. It has just announced no change in interest rates but with a tight labour market and wages now rising in real terms by some 2%, it might be concerned about inflation. It is not inconceivable that rates could be rising in a year's time. That might depend on how sterling behaves. A fall based on a bad Brexit outcome and with fiscal stimulus might push inflation up well beyond the current 2%.

Elsewhere, China is slowing but still reporting 6% growth with the authorities' fine tuning the economy through active monetary policy. Japan continues to cruise slowly along with weak growth and weak inflation. The oil price has steadied at around $ 60/bbl and so inflationary pressures remain weak .The global deflation story described in the last report has not vanished. It is on hold.

MARKETS

Global equities rose some 4% in sterling terms in Q3, led by the US with emerging markets trailing. The UK rose only 1% and year to date is trailing global equities with total returns of 14% against 21%.with the US returning 25%. Sterling weakness accounted for some3-4% of the divergence but yet again the UK is underperforming. Small cap stocks have been especially weak with their dependence on the domestic economy. Interestingly, long dated gilts and index linked outperformed equities, the same as last year.

It may seem surprising that the S&P 500 is making new highs given the gloomy background and that global equities are back to the peak of early 2018 before trade concerns and Brexit hit sentiment.

It does suggest markets believe we can avoid global recession and/or a financial shock such as in 2008.The central bank support operation clearly help sentiment and the US economy is amazingly robust. The corporate profits story may be a clue. US earnings have declined for three consecutive quarters validating the weak market of 2018 but Q3 came in above expectations and market consensus is that the corporate earnings story will be positive in 2020, in the US at least. Market valuation is on the high side but not excessive. The trailing P/E in the UK is 16 for example. We seem to be having a fairly typical yearend rally but markets may be getting ahead of themselves and may be disappointed,

Exceptionally low interest rates – negative in Europe- drive asset prices higher of course. This has been seen in bond markets also. UK gilts will give something back in Q4 if yields stay higher- 10 year yields at 0.6% against 0.4%-but corporate bonds and high yield bonds have had a very good year with returns of 12-14%. Credit spreads may widen out of course if economic uncertainty picks up.

The only asset which has had a poor year is UK commercial property where capital values appear stalled but returns are sustained by the attractive rental yield. The yield advantage over gilts is exceptional now but that is not enough in itself to offset concerns such as Brexit and the decline of the High street, while industrial properties have performed so well their yield advantage is diminished.

ASSET ALLOCATION

The portfolio is well diversified and probably more conservative in its asset allocation than some in LGPS .A lower weighting to equities than some will have cost performance this year as diversified growth funds and multi- credit will not have done so well and nor has property. The move away from UK to overseas equities has undoubtedly helped over the last two years though hedging half the exposure has not helped when sterling has weakened. Its recovery in the current quarter will reverse the negative effect of the previous quarter.

The LDI allocation is of course a hedge but it has produced good returns over the years mainly because of the impact of falling gilt yields though there has been some gain from higher inflation. Now there is a threat to our inflation hedge because of the possible long term switch away from RPI to something called CPIH. This matters because the scheme liabilities are now in CPI rather than RPI which is used to hedge inflation risk. Forward markets are beginning to price in a possible switch which would mean potential losses on RPI swaps. Meanwhile, to confuse matters, the government continues to issue RPI index linked bonds. The conclusion in the short term is that it would be mistaken to increase the inflation hedge and there may be a case for reducing it or rebalancing the hedge to reduce the long duration hedge which is most vulnerable.

Shortly, the investment strategy will need to be reviewed as a consequence of the triennial actuarial valuation. It looks as though discount rates are falling some 0.5% which might, other things being equal, increase liabilities and deficits .As the scheme has derisked a fair amount, there is unlikely to be a significant realignment, though clearly the LDI hedging strategy will need review.

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RFOR FURTHER INFORMATION

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