

# **Dorset County Pension Fund - Pension Fund Committee**

MJ Hudson Allenbridge

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## Contacts

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## Investment Outlook

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Last year turned out to be a good year for risk assets with global equities producing returns of some 23% in sterling terms and UK equities, after a useful Q4 rally on the election result, returning 19%. Markets have paused the rally however in the current quarter, troubled first by the US-Iran flare-up and then by the corona virus outbreak in China. The global economy will undoubtedly take a hit from this given the importance of China now in the global economy.

That aside, there were hopes that the global economy might start to pick up this year, helped by continuing loose monetary policy, led by the Fed and that view is certainly priced into equity markets. The UK now has a Conservative government with a large majority which has successfully passed the Withdrawal agreement and in that sense much of the uncertainty which held the economy back has receded. However, the scope of the new trade agreement with the EU is far from clear and the government's decision to hold firm to the year end deadline raises the stakes and therefore the risks.

Consensus at present is that the corona virus threat is containable and therefore the world economy will suffer no more than a reduction of some 0.3% in global growth. If that is the case, markets will probably start to move ahead again on the basis that a year of modest growth and earnings growth is better than nothing. Yet again, the central banks are providing sufficient support to avert recession and to cushion any financial shocks that might come our way. After last year, though, returns are likely to be modest and short term risks high.

## Economy

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The corona virus is thought to be much more consequential for the global economy than the Sars epidemic of 2003 which peaked fairly quickly. This is because China now accounts for some 20% of the global economy compared to 8% then and is a crucial part of the global supply chain. A good illustration is the fall in the oil price to around the \$50/bbl level, the lowest for ten years. Latest estimates are that GNP growth in China could slip from 6% to 5%, with some 0.3% off global growth.

The effect should be less on the UK with its limited export exposure to China. Even so, any negative effect will be unwelcome for an economy which is only forecast to grow by some 1% this year and 1.5% next. The economy showed no growth in Q4 last year although December looked better and the housing market seems to be picking up as confidence improves. Confidence will be sensitive to the fluctuating news flow on the EU trade agreement and the government's hard line approach will not please industry if it leads to a WTO outcome while financial services hopes of achieving equivalence in terms of regulations would be disappointed.

What may change the economic forecasts for the better of course is the government's determination to raise public expenditure dramatically, not just through large infrastructure projects like HS2 which will take years to build but on current spending like police, education, etc. This gets to the key issue of prudence in public spending and whether the government will stick to the manifesto commitment to balance the budget and reduce overall spending, a tension which has led to the Chancellor's resignation. With low borrowing rates, borrowing to invest makes sense but markets will be less happy with a surge in current spending at this point in the business cycle.

Elsewhere, the Fed elected in January to leave interest rates unchanged and has indicated it is likely to keep them there for the rest of the year. The short term economic indicators continue to be healthy unlike Germany where industrial production fell 3.5% in December, the worst since 2009. GNP is expected now to fall some 0.4% for Q4, partly of course reflecting the woes in the auto industry. For a country running a budget surplus of 1-2% GNP, the solution is obvious, even if they don't need to run a deficit of 5% as President Trump has done.

This of course is election year in the US and that might rein in US policy a little to moderate some of the uncertainties. So far, we have had a more constructive approach to China on a trade agreement while the Middle East has quietened down for the time being. The strength of the dollar of course is displeasing to the president so mercantilism will never be far away.

## Markets

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Last year UK equities rose 4% in the final quarter and returned 19% for the year compared with 1.5% and 22% for global equities. Sterling rose some 4% against the dollar during the year so the returns from hedged overseas equities would have been stronger. Both UK gilts and index linked returned some 7%, better still at the longer end, reflecting the fall in nominal yields. For example, the benchmark 10 year gilt yield fell from 1.3% to 0.8%, having fallen to 0.6% at its lows, where it is currently trading Real yields, as reflected in index linked, have fallen by less, reflecting the fall in inflationary expectations, partly as inflation remains low but also because of the RPI wedge issue..

Year to date, equities are pretty well marking time, oscillating currently with the corona virus data from China. Corporate profits forecasts are mostly positive albeit in single figures but the scope for P/E multiple expansion is limited given the fairly high ratings markets trade on. As we argued last time, though, valuation is not excessive compared to previous market peaks, The UK and Japan are markets on a valuation discount where there could be buying interest while if China manages to control the virus, there could be a lot of catch up in China and Asian markets.

Credit risk has not subsided as an ongoing risk. Leverage is very high again in terms of balance sheets, lending criteria have relaxed [ so-called covenant light] and the duration of corporate bonds has increased as companies take advantage of low interest rates. Last year was good for corporate bonds and high yield, with double digit returns but spreads are very narrow again. With reduced liquidity in markets, a selloff could lead to large falls in traded bonds though private debt would be less vulnerable.

In terms of the RPI reform debate in the UK, the government has deferred the consultation to March and it seems limited to whether a move to CPIH should start in 2025 or 2030. Potential losses for holders of index linked are very large with estimates ranging from £90-£120bn according to which date. Lobbying will have to be hard but with the government having to issue a very large quantity of bonds to fund its public spending programme, hopefully it will try to ensure market goodwill. Compensation is unlikely but a move to redefine coupons on existing bonds as CPIH plus 0.70-0.8%, to reflect the so-called wedge, would seem to be a good compromise outcome. So far though there is little guidance. After the strong sell-off in Q4, prices have levelled off with the implied wedge trading around 0.4-0.5%, so there could still be considerable downside if the government plays hardball.

## Asset Allocation

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The 2019 valuation reduced the actuarial discount rate to 5.0% from 5.4%, roughly equivalent to gilts plus 3.3% or a real return of some 2.5%. That is the return we must seek from our assets and we are now engaged in a strategic review to ensure that our investment strategy will deliver that. Together with deficit recovery contributions, it should ensure that the deficit is removed over the recovery period and that as an open scheme all future liabilities can be met. With the funding ratio improved from 83% to 92%, the scheme is better placed but of course rising markets have been helpful over the period. Integral to the review will be a review of the LDI hedging strategy in the light of the challenge thrown by RPI reform

## For Further Information

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