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INVESTMENT OUTLOOK

The June report noted the strong rally that was underway in risk assets like equities after the dramatic bear market of Q1. In Q2, UK equities rose 10% but were still some 17% below year end levels at end June. Helped by weakness of sterling, global equities rose some 20% and were back to year end levels in sterling terms. At the time of writing in mid -August, US equities have now regained year end levels in dollar terms, a remarkable turnaround whereas UK equities are just managing to hold onto Q2 gains. A similar rebound has been seen in credit markets with corporate bond spreads continuing to narrow.

The massive hit to the global economy in Q2 has now been captured by the GNP data, with the UK performing badly with a fall of 20% and others like the US and Japan reporting falls of 10% and 7% respectively. However, there is clear evidence in the UK and elsewhere of recovery in output, starting in May and June as the lockouts were gradually relaxed. To that extent, the recovery to date has a V shape but of course it is early in the process and the current rise in infections, whether localised as in the UK or national as in the US may dampen the recovery if restrictions are reimposed or consumer confidence evaporates .

The recovery in markets could be said to be rational in discounting this economic revival but does assume there will not be a setback in the third or fourth quarters. These strange times have been notable also for a rally in the gold price and a fall in the dollar in recent weeks reflecting a loss of confidence in US financial assets with the impending US presidential election adding to the uncertainty. It is hard to see equities making much leeway under the circumstances.

ECONOMY

Mapping the trajectory of the UK economy is hard of course at present with a large range of uncertainty but it does appear the economy is doing rather better than expected, thanks to the government's extraordinary range of interventions. The BoE has suggested GNP rises of 18% and 3% in Q3 and Q4 to leave the economy 7.5% down on last year much better than its previous forecast. . At year end, output would still be 5% lower than a year ago and it would take all of 2021 to get back to end 2019 GNP levels. Meanwhile, unemployment is likely to rise from 3.5% to 7-8%.

There will be debate as to whether the furlough scheme should be extended to prevent a worse outcome and a year end relapse. The Chancellor's view is that that would be unsustainable given that this year's budget deficit could now be over £300bn, the worst since WW11, taking the debt/GNP ratio over 100%. No one is questioning the need for a Keynesian fiscal response to offset the rise in consumer and business savings as spending stops but how much further should it go? The BoE is of course financing the resulting deficit indirectly by buying gilts through the market via its greatly enhanced QE programme. Although they have risen slightly, gilt yields remain the lowest for well over a hundred years so at present the deficits are affordable. Even sterling has picked up, though not against the euro.

The US eased lockdown measures earlier with resulting earlier economic recovery but also a recurrence of high infection rates which are now causing the recovery to stall. Congress is accordingly putting together a new 1 trillion fiscal support package, on top of the 2.5tr already committed, but agreement is proving difficult. Government debt is now well over 100% of GNP. The employment data have been fairly encouraging with unemployment dropping from 11% to 10% as employers start to rehire but if Congress cannot agree a new unemployment benefits package to replace the expiring one, then consumer spending will take a hit. Consensus forecasts are for a GNP fall of some 5% for 2020, a better outturn than the UK though ,without the furlough scheme, unemployment could be higher.

In Europe, the EU governments confirmed the 750bn euro rescue package for the weaker states but had to increase the amount of loans rather than grants to achieve agreement. The EU has revised down its forecasts for GNP growth this year to a fall of 8%, with expectations of 10-11% falls for Italy and Spain, offset by 6% for Germany. A rebound of 5% is expected for next year for the area. Elsewhere, Japan is struggling with its worst quarterly downturn, badly affected by the collapse in world trade growth but China, down only 3% in Q2, at least is showing signs of a reasonable recovery.

So much for the consensus view or base case. It is of course easy to contemplate worse outcomes and governments have a difficult set of decisions to make about maintaining the extraordinary level of fiscal support given that monetary policy cannot do much more with current low interest rates and increased QE. Even assuming the consensus view prevails, there will be major sectoral dislocation with areas like travel, airlines and hospitality badly affected. Manufacturing can revive more quickly than services which leaves the UK more vulnerable. With the unwelcome spectre of rising unemployment likely to restrain wages growth, there should be no short term inflation worries but longer term, the major injection of liquidity could see prices rising.

MARKETS

The June report highlighted the major rally that was taking place in Q2 in global equities. As in recent years, the UK market has been left behind by other markets, notably the US which has led the way. Even so, the UK, which fell 25% in Q1, recovered some 10% in Q2 but with the FTSE 100 consolidating around the 6100 level, the market is still some 17% below year end levels. That though is a good recovery from the 4900 level reached at the low in mid- March.

In contrast, the US rallied some 22% in Q2 in sterling terms, helped by sterling weakness. July saw a standstill but the market has risen again in August and is now in positive territory for the year.In sterling terms, as at mid -August, global equities are up 4%, with most regions broadly flat but the US showing a 6% gain. The speed of recovery in US equities has of course been marked by strong sector divergence , as we remarked in June, but it is extraordinary .It has been the sharpest rally since the 1929 crash. On average, it takes some four years to go from peak to trough and back to previous peak again. This time it has taken six months from February to August.

Given the unhappy infection data still rampant in the US, this looks surprising but it may have something to do with a weaker dollar which will help exports. Bad news on the economic data would challenge the bull market sentiment while failure to agree in Congress on the support package would be unwelcome. Whether the market is banking on a Biden victory in the poll is hard to read. Emerging markets have done well when the dollar is weak and indeed they have picked up recently, led by China, though many large EM counties are now in the eye of the pandemic storm.

The moderation in UK equities therefore might seem more appropriate but the market is struggling to make further progress against a bad news flow. Compared with the US, it has a poorly balanced sectoral composition, with high dependency on resource stocks and finance and very little exposure to technology. A relentless litany of dividend cuts has not helped sentiment either. Gilts of course have outperformed equities this year with gains of some 8% but gilt yields are now beginning to rise, with 20 year yields moving from 0.6% to 0.8% , having started the year at 1.3%. Index linked have done less well with yields for similar duration moving from minus 2.0% to minus 2.3%, reflecting the fall in inflationary expectations during the year which makes index linked less attractive. While uncertainty over the RPI-CPI wedge remains, there was a strong recovery in the price of inflation in Q2, which benefitted the LDI hedge.

Corporate bonds have joined in this recovery in risk assets though UK corporate binds underperformed gilts in the first six months of the year. However, spreads have narrowed in further in the current quarter so that may now be reversed. Currently, they stand at 155bp , against 175bp at end June and 125bp at year end. High yield spreads have been much more volatile of course. Little by little, light is being shed on commercial property valuations but there has been no sign of recovery yet, in areas like retail and offices and many property companies have reported rental payments down by 50% in recent months which does not augur well for valuations. With few transactions, in contrast to the residential market, it is still hard to be certain about how far prices have fallen but a negative return for the year is likely.

Drawing this all together, it is impossible to avoid the conclusion that the relief rally we have seen in risk assets has gone far enough for the time being on the evidence available. This applies especially to the US and if Wall Street stumbles, other markets will follow. Back in March, when I issued an interim report, it seemed appropriate to remind the Committee that equities always recover and do so before confirmation from the data. The rally has gone much further than I anticipated of course and it would be reassuring to see a prolonged period of consolidation in markets until we have a clearer picture of the economic recovery. More likely, markets will be volatile and, as with the UK recently, marked by a lack of trend. We should be grateful for what we have received!

INVESTMENT STRATEGY

The strategic review conducted by Mercers has now been concluded and will be presented to the Committee. As I have commented before, the actuarial discount rate of 5% is a high hurdle to cross, requiring as it does a bias to risk assets, notably equities, with their higher expected returns which will increase the volatility of the portfolio.

The funding ratio will have recovered substantially in Q2 so any changes agreed will be from a stronger base than a few months ago. Apart from the recovery in our equity portfolio, there was a strong recovery in the LDI portfolio which offset the losses of Q1, as inflation pricing recovered. Though the hedge has been reduced and leverage is low, we are still at risk should the government decide to scrap RPI without compensation.

Against its peers, the portfolio is probably a little underweight equities and overweight commercial property. A decision to increase equities and to diversify more into global equities would seem sensible despite the recent market strength, given sectoral concerns over the UK market. The portfolio has done well from its property exposure over the years but for obvious reasons, there are long term structural challenges for the sector now and there may be other real but illiquid assets like infrastructure that might be a safer bet.

FOR FURTHER INFORMATION

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