Capital Markets Outlook Q3 2019

Essex Pension Fund

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For and on behalf of Hymans Robertson LLP

1.1 Core asset class views: summary

A slowdown in global growth is well established and broad-based, as the trade conflict between America and China takes its toll on the world economy. Global central banks are turning more accommodative to help prevent a more protracted slowdown but traditional, and in some cases not-so traditional, monetary policy toolkits are looking increasingly bare. Until now, manufacturing has borne the brunt of the slowdown, most likely as a direct result of the trade wars, but there are signs the contagion is spreading to the services sector.

While sovereign bond market yields were marked significantly lower reflecting the gloomier outlook, valuations on risk assets, in general, potentially reflect economic outcomes that may increasingly be viewed as optimistic rather than a reasonable base case. The deterioration in the economic outlook is beginning to impact credit and equity market fundamentals, without any commensurate impact on valuations, and we are growing more cautious here as a result. As such, we would continue to advocate holding a little more cash than usual.

	Equities	Sterling investment grade debt	Liquid Sub investment grade debt	Private lending	UK Property	Long Lease Property	Gilts	Index-linked gilts
Fundamentals	N → U	N	N → U	N → U	N → U	N	N	N
Valuation	N	N	U	N	U	VU	VU	VU
Technicals	N	N	N	N	U	N	N	N
Overall view	Neutral to cautious	Cautious	Cautious to negative	Neutral to cautious	Cautious	Neutral to cautious	Cautious to negative	Cautious to Negative
Previous quarter	Neutral	Cautious	Cautious	Neutral	Cautious	Neutral to cautious	Cautious to Negative	Cautious to Negative

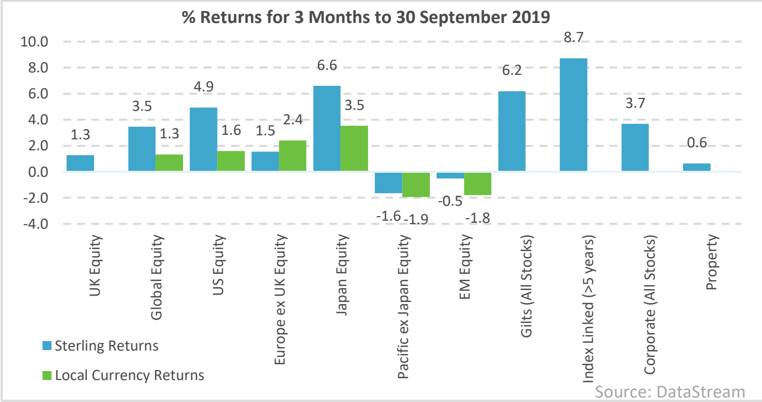
F/V/T ratings: VU – very unattractive; U – unattractive; N – neutral; A – attractive; VA – very attractive
Overall ratings: Negative, Cautious, Neutral, Attractive, Positive
Green signifies positive change since last quarter. Red signifies negative change since last quarter.

The ratings are intended to give a guide to our views on the prospects for markets over a period of around three years; although they are updated quarterly, they are not intended as tactical calls. The ratings reflect our expectations of absolute returns and assume no constraints on investment discretion. In practice, they need to be interpreted in the context of the strategic framework within which individual schemes are managed. The property rating ignores purchase transaction costs, i.e. relevant for current holders of property.

The table below provides a high-level overview of our key observations for each asset class.

Equities	• A sharp slowdown in the manufacturing sector and some signs of weakening in services suggests a less supportive backdrop for equity markets as we move towards 2020. • Valuations remain at the lower end of neutral, however there remains a significant disparity in regional views. • Equity sentiment would be vulnerable if central bank policy turned to be less accommodating than markets are expecting.
Sterling non-government bonds	• Global corporate spreads remain near long-term median levels but our overall rating is driven by our view on underlying risk-free yields. • The continued search for yield is a positive technical in the short-term. • We continue to prefer floating-rate credit assets, such as Asset Backed Securities as we think underlying risk-free returns will be better for floating-rate assets than fixed rate.
Liquid Sub-investment grade debt	• The deterioration in economic outlook is beginning to impact credit market fundamentals. Leverage has drifted higher while interest coverage has fallen in 2019, and high yield defaults are forecast to rise. • Valuations look stretched, particularly in the high yield market and we have concerns that investors are not being rewarded for the deterioration in fundamentals.
Private Lending	• The direct lending market continues to offer an attractive illiquidity premium over the traded market. • Despite the presence of covenants in direct lending markets, we have shaded down our fundamental view in line with liquid speculative-grade markets.
Core UK property	• Property yields remain close to historic lows and appear stretched relative to equities, although remain attractive relative to government bonds. • Significant sector divergence remains, with retail remaining weak. Office rental growth has been more volatile than the other sectors, but increasing overall on a 12 month basis.
Long Lease Property	• Valuations remain stretched, but demand for long-term secure income streams remains high from pension funds and other investors.
Infrastructure	• Evidence from proprietary indicators suggests that valuations remain high. • Technical drivers remain strong and investor demand is high. The uncertain economic outlook is a positive fundamental for long-term infrastructure assets.
Conventional gilts	• Continued falls in gilt yields over the quarter keeps valuations well below our assessment of neutral levels at all maturities. • However, downbeat economic news, hedging demand and uncertainty, both domestic and global, may prevent a rise in UK yields in the short-term.
Index-linked gilts	• Index-linked gilt yields remain well below equivalent US yields and the BoE's long-term assessment. • Implied inflation is lower for longer dated index-linked gilts, but uncertainty over changes to RPI may lead to further weakness.
Cash strategies	• This feels like a sensible time to hold more cash than usual to try and exploit better buying opportunities in the future.

2.1 Market Background



The ongoing trade war between the US and China, and its disruption to external demand and global supply chains, particularly in the manufacturing sector, continued to impact global growth. Consensus forecasts still suggest most major economies will avoid technical recession next year but GDP growth for many countries has slowed.

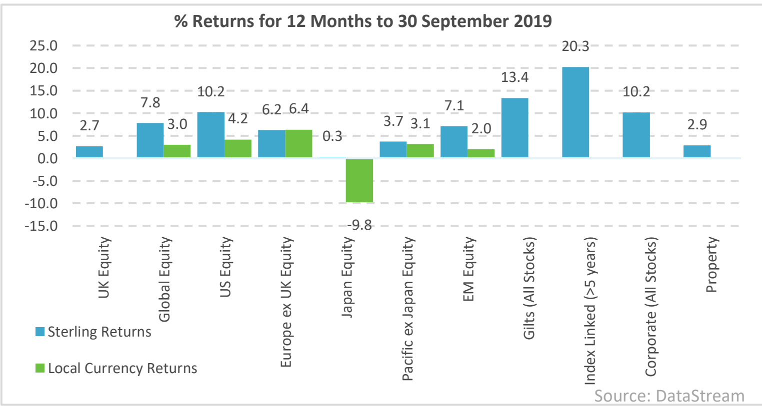
UK GDP growth is expected to achieve a modest recovery in Q3, however forecasts have slumped, with increasing downside risk posed by acute Brexit uncertainty and its negative impact on business investment. The US economy has continued to outperform its developed market peers, but its manufacturing PMI fell to its lowest level since June 2009 in September.

Inflation pressures remain elusive despite real wage growth on the back of low unemployment. In-line with the weaker economic backdrop and subdued inflationary environment, sovereign bond yields were marked significantly lower over the quarter. UK Implied inflation fell at longer maturities, but rose at shorter terms potentially reflecting fears of a near-term spike in inflation on the back of a potential post-Brexit sterling depreciation coupled with concerns over future RPI methodology affecting long-term RPI. Despite prices spiking significantly, following an attack on Saudi production facilities, oil prices ended the quarter around 9% lower.

Investment-grade credit spreads continued to move in lock-step over the period across the US, Europe and Sterling markets and finished the period broadly unchanged. Global high yield spreads were also little changed over the quarter, though leveraged loan spreads have moved wider as interest rate cuts have made floating-rate assets less attractive to prospective investors.

Global equities ended the period in marginally positive territory as the impact of global trade relations and softening economic data was ultimately outweighed by central bank policy and supportive corporate earnings. Sterling-denominated returns were enhanced by the currency's continued depreciation amid the ongoing Brexit saga. Trade-weighted dollar was up c.3.1% over the quarter and Yen strength appears to remain a feature in-line with a bid for safe assets.

Japan was the top performing region in both local currency and Sterling terms. This was in part a reversal of some the poor performance from the first half of the year, as well as the improved performance of value investing. Asia Pacific (ex-Japan) and Emerging Market equities continued to lag global equities as the ongoing trade tensions weighed on investor sentiment.



Within UK property marginal positive rental growth and return from income compensated for capital declines.

2.2 Key market data

The tables below provide a summary of key financial indicators over recent periods:

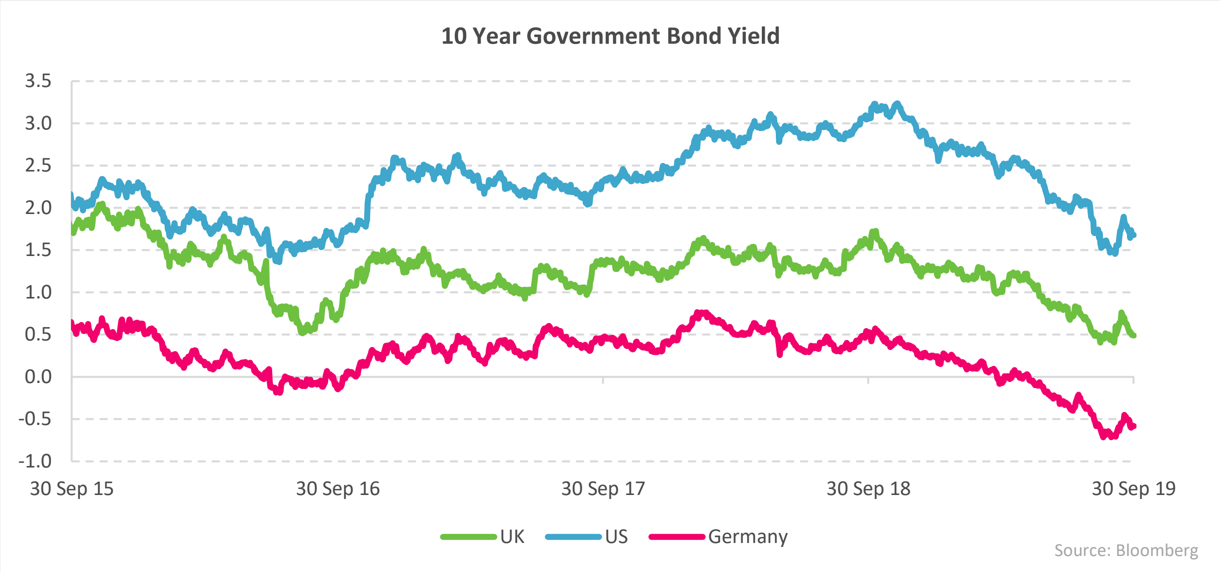
	30.09.18	31.12.18	31.03.19	30.06.19	30.09.19
UK Equity yield	3.8%	4.5%	4.2%	4.1%	4.2%
UK Equity P/E ratio (FTSE)	12.9x	11.7x	16.3x	17.1x	16.1x
Over 15 year gilt yield (p.a.)	1.9%	1.8%	1.5%	1.4%	0.9%
Over 5 year index-linked gilt yield (p.a.)	-1.5%	-1.6%	-1.9%	-1.9%	-2.2%
iBoxx Over 10 year Non-gilt yield (p.a.)	3.2%	3.2%	2.8%	2.7%	2.3%

Source: DataStream

	Year to 30.09.18	Year to 30.09.19	Quarter to 31.12.18	Quarter to 31.03.19	Quarter to 30.06.19	Quarter to 30.09.19
FTSE All Share	5.6%	2.7%	-10.3%	9.4%	3.3%	1.3%
Global Equity	13.4%	7.8%	-10.5%	9.6%	6.2%	3.5%
Over 15 year gilts	1.3%	23.0%	2.6%	6.0%	2.0%	11.0%
Over 5 year index linked gilts	1.4%	20.3%	2.0%	6.3%	2.0%	8.7%
All Stocks Non-Gilts	0.2%	10.2%	0.1%	4.1%	2.0%	3.7%
IPD Monthly Index	9.9%	2.9%	1.1%	0.5%	0.6%	0.6%

Source: DataStream.

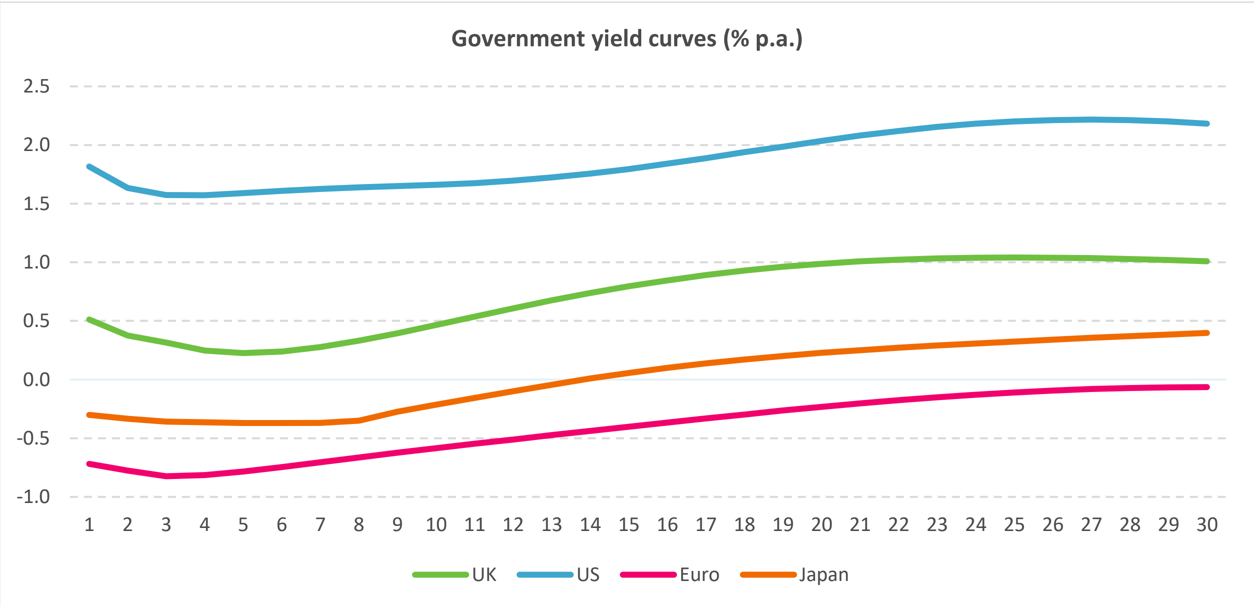
3.1 Global Bond Markets



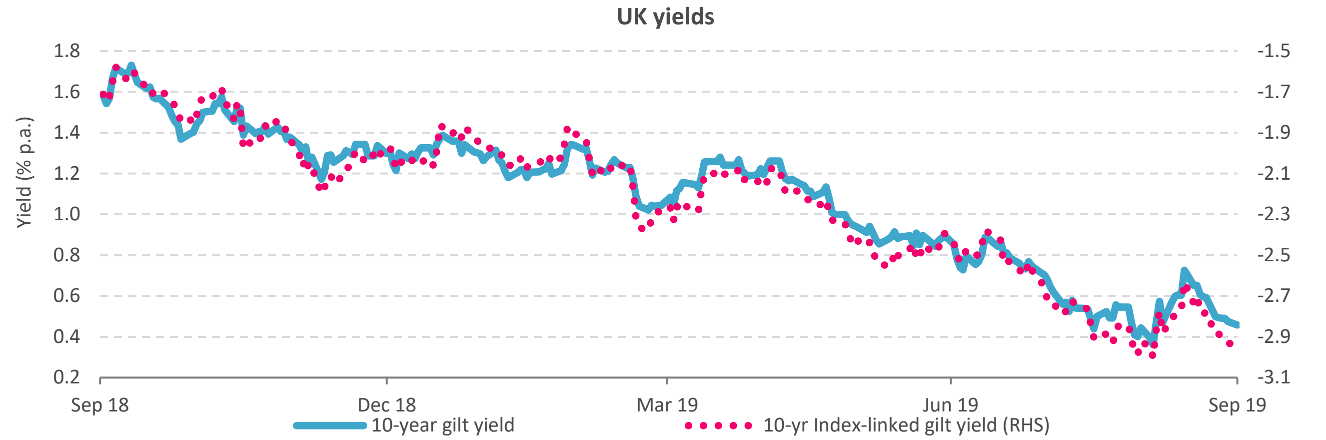
Against the weaker economic backdrop and with inflationary pressures still largely absent, the shift towards more accommodative monetary policy is now well established – 60% of central banks cut rates in Q3. Global sovereign bond yields continued their slide, touching record low levels in the UK and Germany in August. US and UK 10-year nominal yields both fell around 0.35% p.a. over the quarter, while equivalent German bund yields slipped 0.24% p.a. further in to negative territory.

While rate cuts may help buoy consumer sentiment and potentially prevent a deeper economic slowdown, the potential effectiveness may be questioned, given there is little headroom to deliver the level of monetary stimulus seen in previous downturns.

Inflation expectations, as implied by the difference between the yields on nominal and inflation-linked bonds of the same maturity, continued to fall in the US as real yields fell to a lesser extent than nominal yields. The opposite was true in the front end of the curve in the UK – spot implied inflation rose at terms of up to around 15 years, but fell at longer terms.



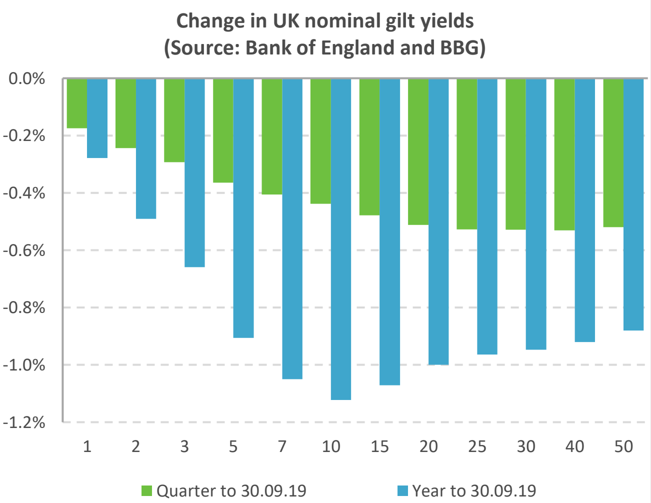
3.2 UK Interest Rates

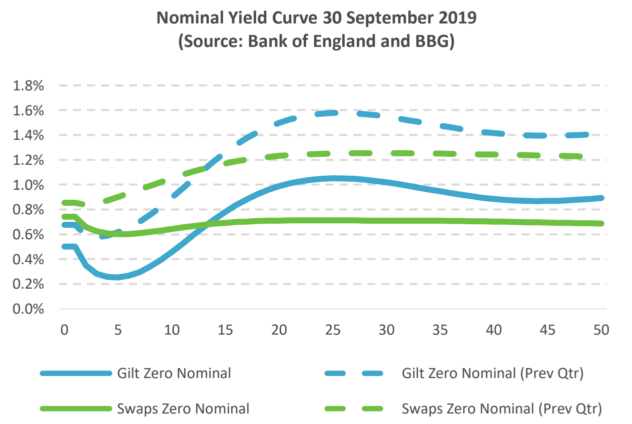


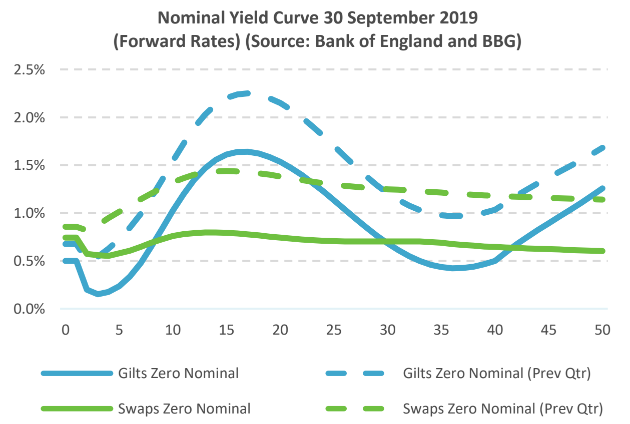
Source: Bank of England

Recent downgrades to UK GDP growth forecasts, now 1.2% for 2019 and 1.1% in 2020, improves the fundamental support for gilt markets, but forecasts are subject to heightened Brexit-related volatility.

Continued falls in gilt yields over the quarter keeps valuations at very unattractive levels. While economic growth uncertainty, both domestic and global, and hedging demand may prevent a rise in UK yields in the short term, we continue to see little medium-term value offered by current yields.



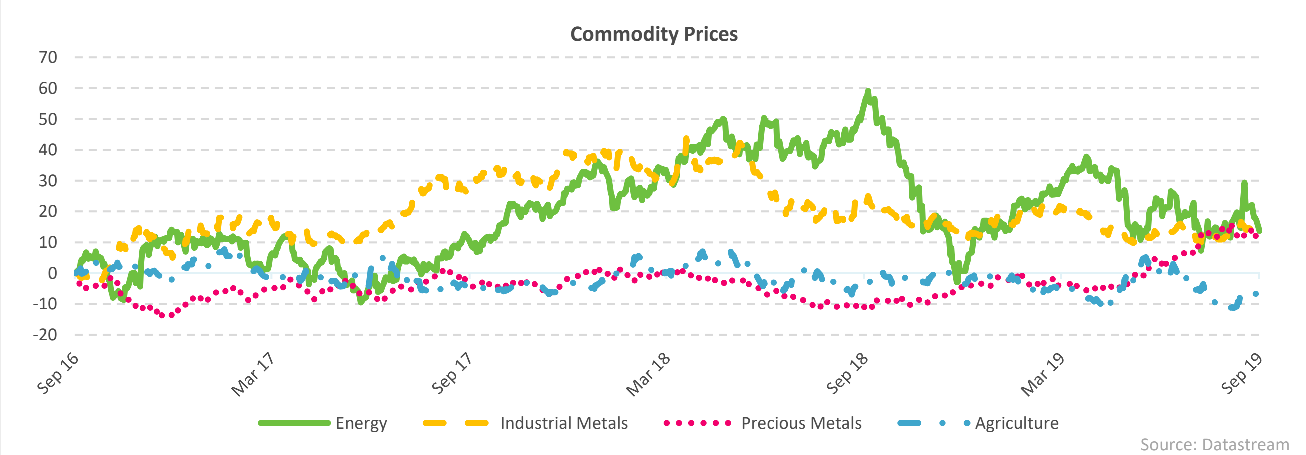




Overall	Fundamentals	Valuations	Technicals
Cautious to negative	Neutral	Very unattractive	Neutral

3.3 Inflation and real rates

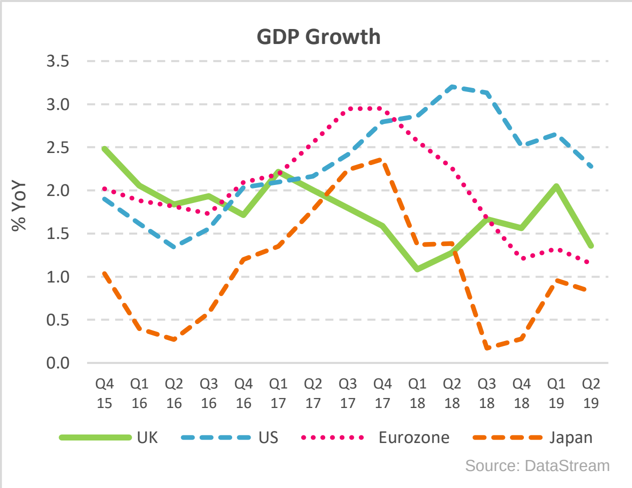
Commodities posted negative returns, amid a strengthening US Dollar. The Energy sector was the biggest detractor as oil prices sold off during the quarter.

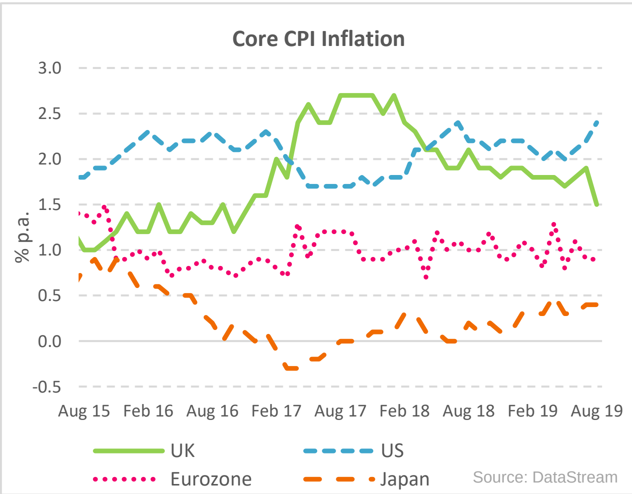


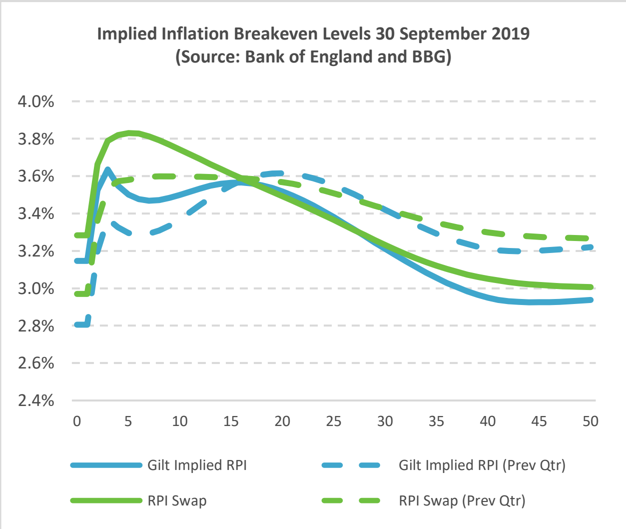
The ongoing trade dispute between the US and China, and its disruption to global supply chains, continues to impact both realised and forecast global growth. The US economy is expected to continue to outperform but, here too, a slow-down is expected. The German economy may enter technical recession in Q3, following Q2's contraction and a continued plunge in activity in its critical manufacturing sector. Though the UK is expected to avoid entering technical recession in Q3, following the expected contraction in Q2, forecasts have slumped, reflecting acute Brexit uncertainty and increasing evidence of its negative impact on business investment.

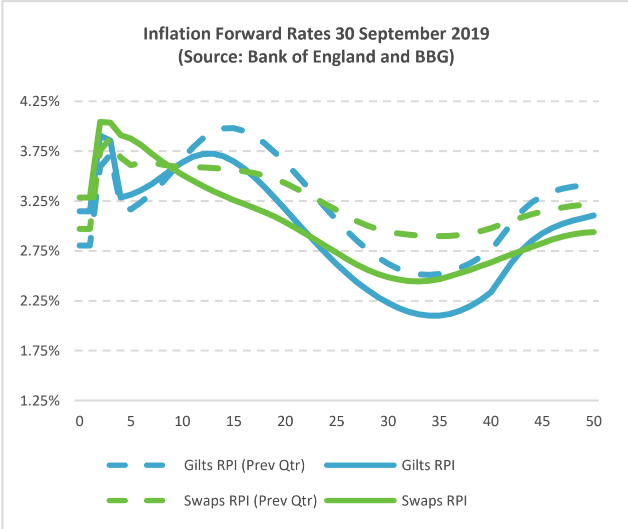
Highlighting the weakness in investment and trade, the Global Manufacturing PMI has continued to drift lower and is now below 50 (indicating contraction). Notably, these indices in the US and Germany have fallen to their lowest levels in a decade in Q3. The avoidance of a further slowdown in global growth may become increasingly dependent on the health of the consumer which, so far, has been supported by buoyant labour markets and household spending.

Real wage growth, on the back of generally low levels of unemployment has continued to move higher in the US, but the impact of rising wages on broader inflation measures remains elusive. Forecasts indicate CPI-inflation around target in the US and UK over the next couple of years, but significantly below target in the Eurozone.





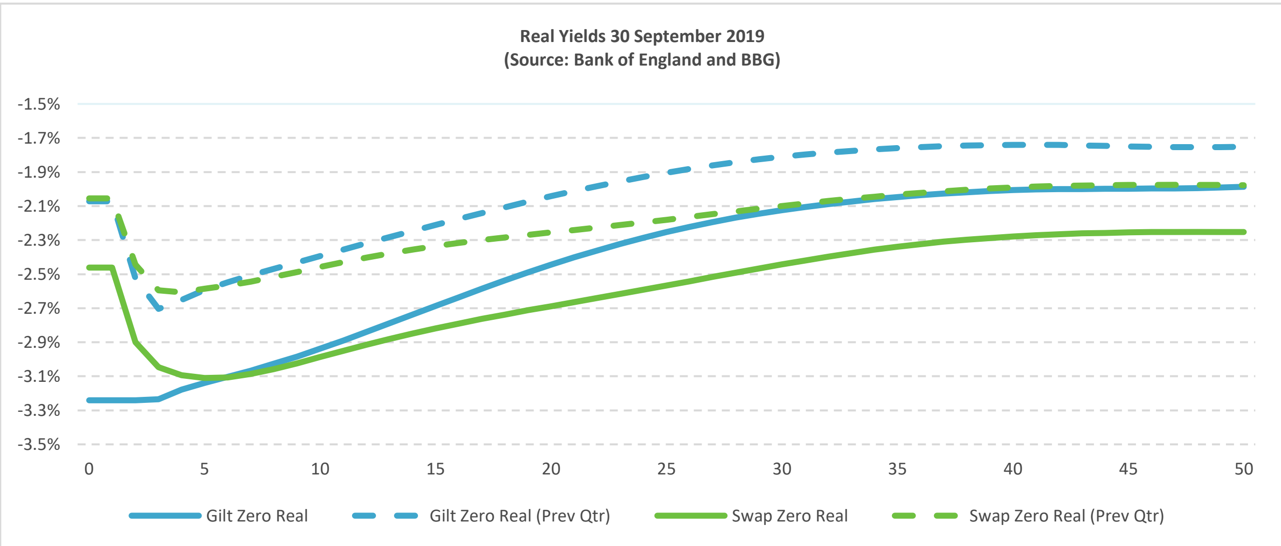




UK implied inflation (the difference between conventional and index-linked gilt yields) has fallen at longer-terms but remains elevated at the short end, potentially reflecting fears of a near-term spike in inflation on the back of potential post-Brexit Sterling depreciation.

A steeper fall in implied inflation at longer terms reflects moves in nominal yields, but also captures the Government's response to the House of Lords report, which recommended statistical deficiencies with RPI be "fixed", pushing down longer-term implied inflation, resulting in upwards pressure on real yields. Regardless, the variation in inflation pricing by term remains a notable feature of UK gilt markets.

While long-term implied inflation is lower, uncertainty over future RPI methodology makes it less obvious index-linked gilts offering better relative value at ultra-long maturities.



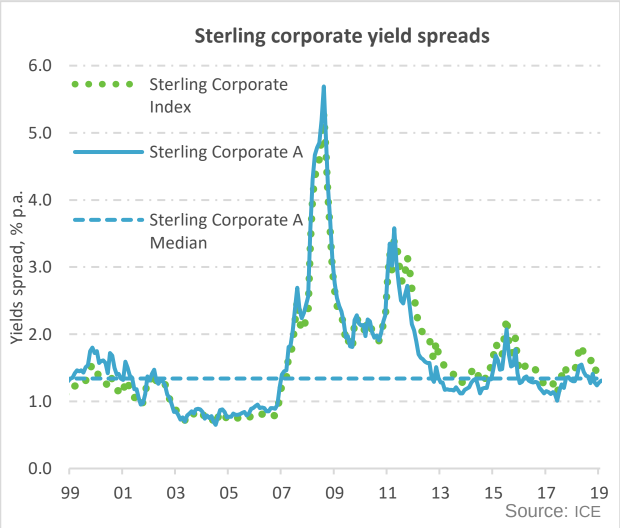
Overall	Fundamentals	Valuations	Technicals
Cautious to negative	Neutral	Very unattractive	Neutral

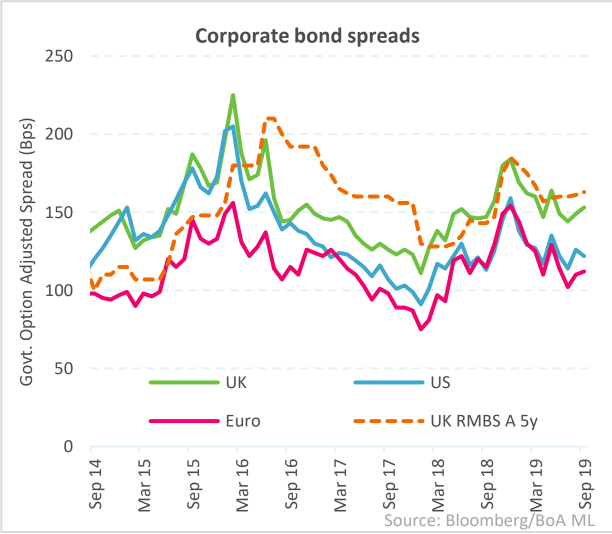
Note: ILG (rather than inflation) rating

3.4 Investment Grade Credit

ML Non-Gilts Spreads over Gilts (Source: Datastream)	Sterling Non-Gilts (bps)	Sterling Non-Gilts Over 10 Years (bps)	[1]Global Broad Market Corporate (bps)
30 June 2019	113	128	137
30 September 2019	120	139	146
Median spread over last 5 years	121	125	141
Average spread over last 5 years	124	125	143
Median spread over last 15 years	134	126	147
Average spread over last 15 years	146	136	175

[1] iBoxx corporate bonds. Note: Spreads on financials, non-financials and the broad corporate market are calculated using iBoxx indices. All other spreads are calculated using Merrill Lynch indices.





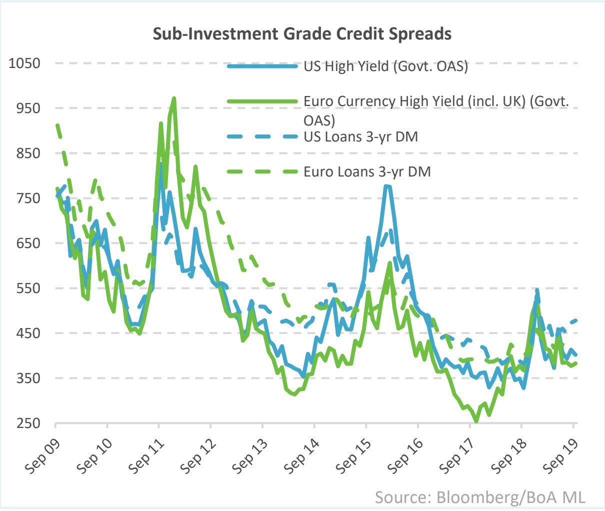
Global investment-grade credit spreads moved in lock-step over the period across the US, Europe and Sterling markets. Spreads continue to hover around long-term medium levels; our overall cautious rating reflects our views on levels of underlying risk-free yields rather than views on spread levels. Fundamentals remain intact for now whilst lower underlying government bond yields underpin lower debt costs for corporates. However, if companies respond by increasing leverage, credit quality may suffer. We have upgraded our technical assessment to neutral as investors continue to search for yield in credit markets.

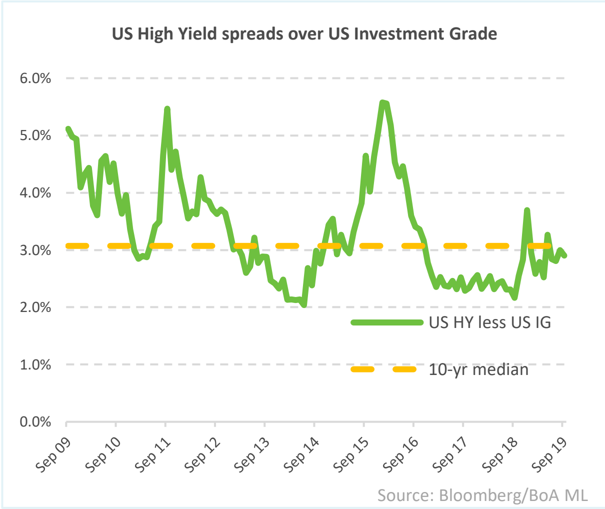
While investment-grade asset backed security (ABS) spreads are also in line with longer-term median levels, our overall view is more positive than for corporates primarily because we think underlying risk-free returns will be better for floating-rate than for fixed-rate assets.

Investment-grade real estate debt continues to offer a reasonable spread premium over BBB-rated corporate credit. Loan-to-values remain conservative (well below pre-crisis levels) and lending discipline remains more robust in this market than in the corporate lending markets.

	Overall	Fundamentals	Valuations	Technicals
IG corporate bonds	**Cautious**	Neutral	Neutral	Neutral
ABS	**Neutral**	Neutral	Neutral	Neutral
RED	**Neutral**	Neutral	Neutral	Neutral

3.5 Sub Investment Grade Corporates and Emerging Market Debt

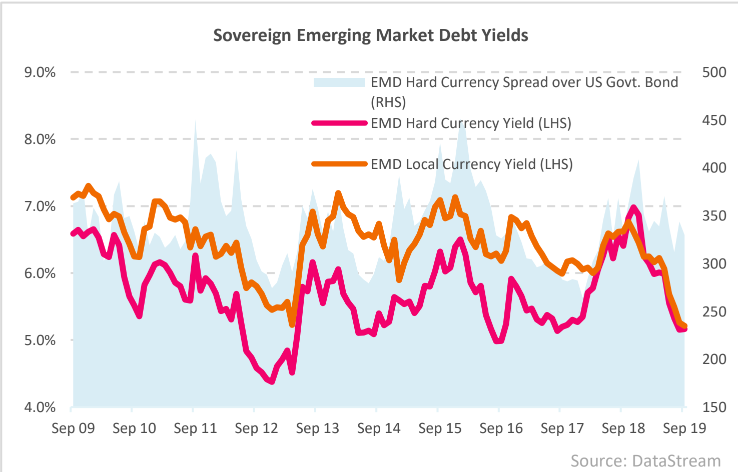




Speculative-grade credit spreads, particularly the higher quality portion of the high yield market, remain at levels which offer increasingly scarce reward, given the deteriorating fundamental backdrop. Leverage has drifted higher while interest coverage has fallen in 2019, and importantly high yield defaults are forecast to rise. As a result, we have downgraded our overall view to Cautious-Negative. We note that slightly better valuations in loans markets versus high yield are balanced against poorer credit fundamentals, and active multi-credit managers will have flexibility to allocate to less unattractive areas in markets.

We continue to prefer private credit markets, both in corporate and commercial real estate lending, where investors benefit from an illiquidity premium and structural protections for lenders. We have shaded down our fundamental view in-line with liquid speculative-grade markets as there has been some deterioration in covenants, however in general the key maintenance financial test covenants remain in place.

Local currency EMD real yields have continued to fall this year as nominal yields have rallied, in response to looser monetary policy in developed markets. Rate cuts from numerous Emerging Market (EM) central banks may provide a headwind for EM currency appreciation but the main index constituents remain slightly cheap based on longer-term averages versus the dollar. Yield spreads on hard currency indices remain around longer-term median levels.

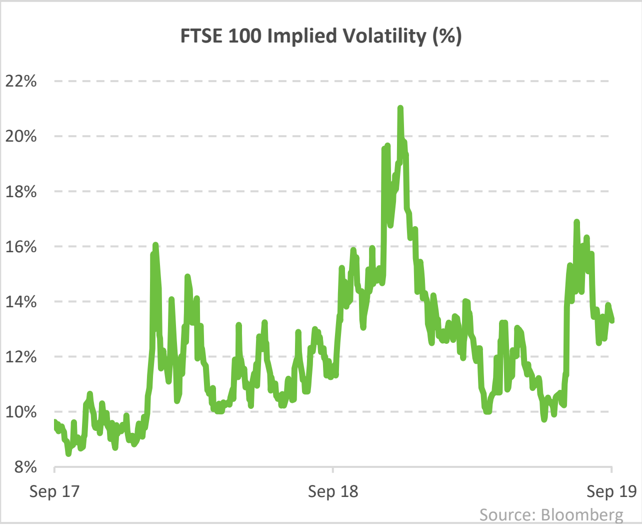


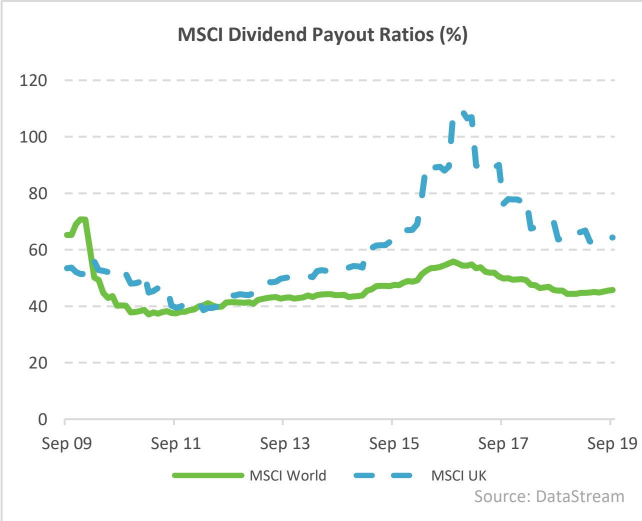
Further loosening of global financial conditions is a positive development for the flow of funds into EM assets as the higher yields in EM prove attractive. Whilst GDP growth has moderated, inflation remains relatively low.

	Overall	Fundamentals	Valuations	Technicals
Public markets	**Cautious to negative**	Neutral to unattractive	Unattractive	Neutral
Private markets	**Neutral to cautious**	Neutral to unattractive	Neutral	Neutral
EMD	**Neutral**	Neutral	Neutral	Neutral

3.6 UK Equity Market

Equity Market Data (Source: Datastream)	30 June 2019	30 September 2019
FTSE All Share Dividend Yield	4.1%	4.2%
Dividend growth over the quarter	-0.2%	2.1%
Dividend growth over the year	9.5%	9.0%
FTSE All Share P/E Ratio	17.1x	16.1x
Total Return during the quarter	3.3%	1.3%
Total Return over the last 12 months	0.6%	2.7%

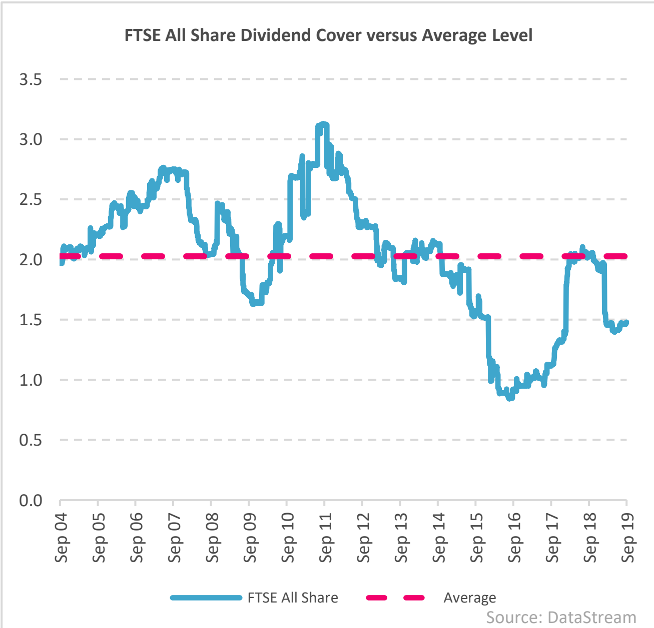




UK equities were impacted by global slowdown concerns and the ongoing Brexit uncertainty, returning 1.3% over the quarter. Within the market, the more domestically focused FTSE 250 Index outperformed the FTSE 100 Index, after parliamentary action decreased the probability of a no-deal Brexit.

The discount on UK equity valuations relative to global equities remains modestly wider than the historical average. The UK equity market has been cushioned from the ongoing Brexit uncertainty by a combination of its international exposure and the falling currency. However, significant political risks continue to drive outflows from the asset class and deter investors from the historically low valuations.

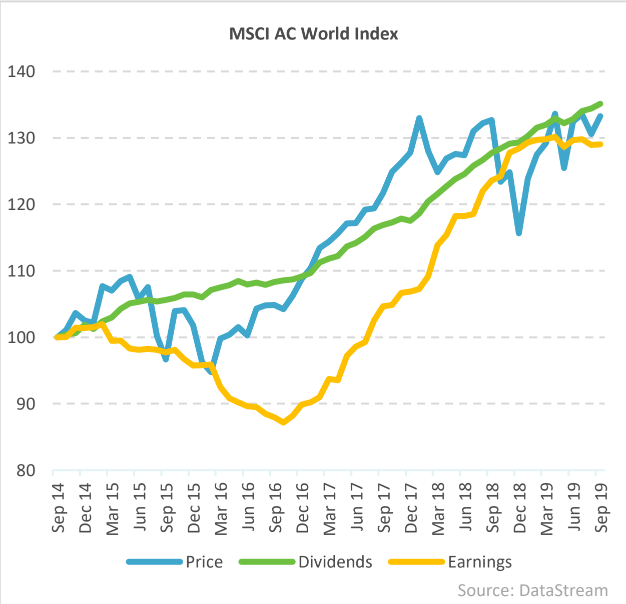
Relative to government bonds, UK equity dividend yields remain close to record highs as dividend payments from UK companies have continued to climb, some of which has been inflated by sterling weakness. As global growth slows, there will be questions over whether companies can maintain these dividends.

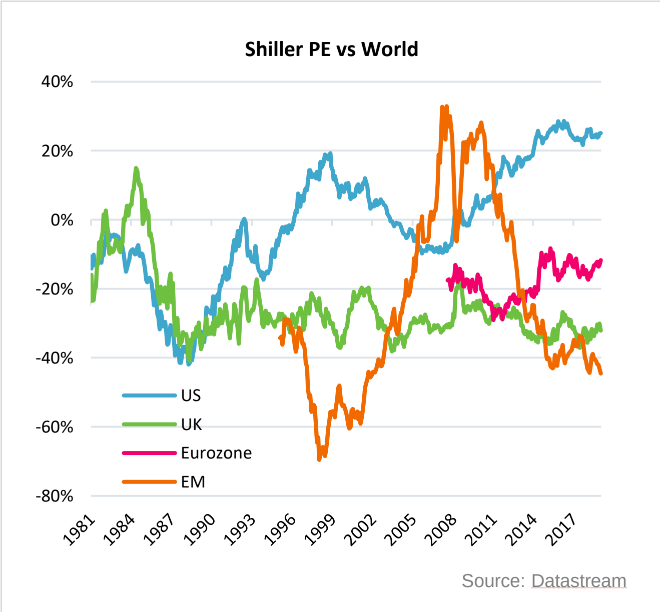


3.7 Overseas Equity Markets

MSCI index valuations as at 30 September 2019 *(Source: Bloomberg, DataStream)*

	P/E (trailing)		P/E (Shiller)		Price/Book		Price/Sales		EV/EBITDA	
	Current	Historic Median	Current	Historic Median	Current	Historic Median	Current	Historic Median	Current	Historic Median
World	**18.6**	17.9	**22.1**	21.4	**2.4**	2.2	**1.7**	1.3	**11.1**	9.8
US	**21.1**	19.1	**27.7**	20.2	**3.4**	2.6	**2.1**	1.6	**12.7**	10.7
EM	**13.2**	13.8	**12.3**	15.6	**1.6**	1.7	**1.1**	0.9	**9.0**	8.0
UK	**13.8**	14.3	**15.0**	15.0	**1.7**	1.9	**1.1**	1.1	**7.8**	7.6



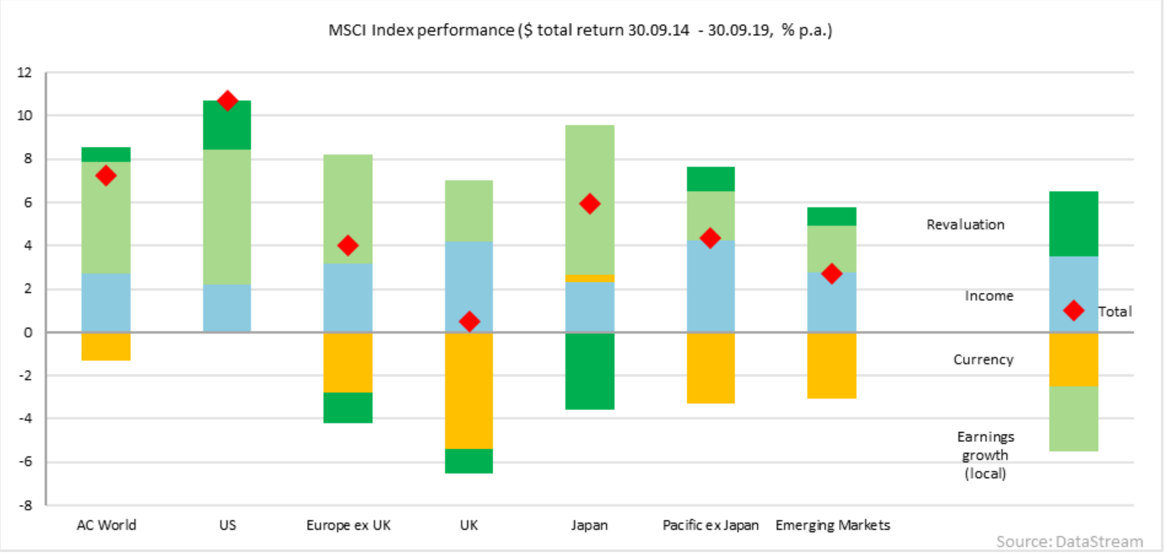


Consistent with the recent deterioration in global economic momentum, corporate earnings have come under pressure this year. While year-on-year earnings growth remains positive, the quarterly earnings growth rate has turned negative this year. Despite this, equity markets have performed well, partly in recognition of the tough year-on-year comparators of 2018 and the fact that earnings have come in above consensus forecasts. However, these forecasts have been steadily revised lower throughout the year. Consensus earnings expectations for 2020 currently point to sharp rebound of around +10% for global equities. We believe these forecasts look optimistic against a backdrop of weakening economic data and the impact of ongoing global trade disputes.

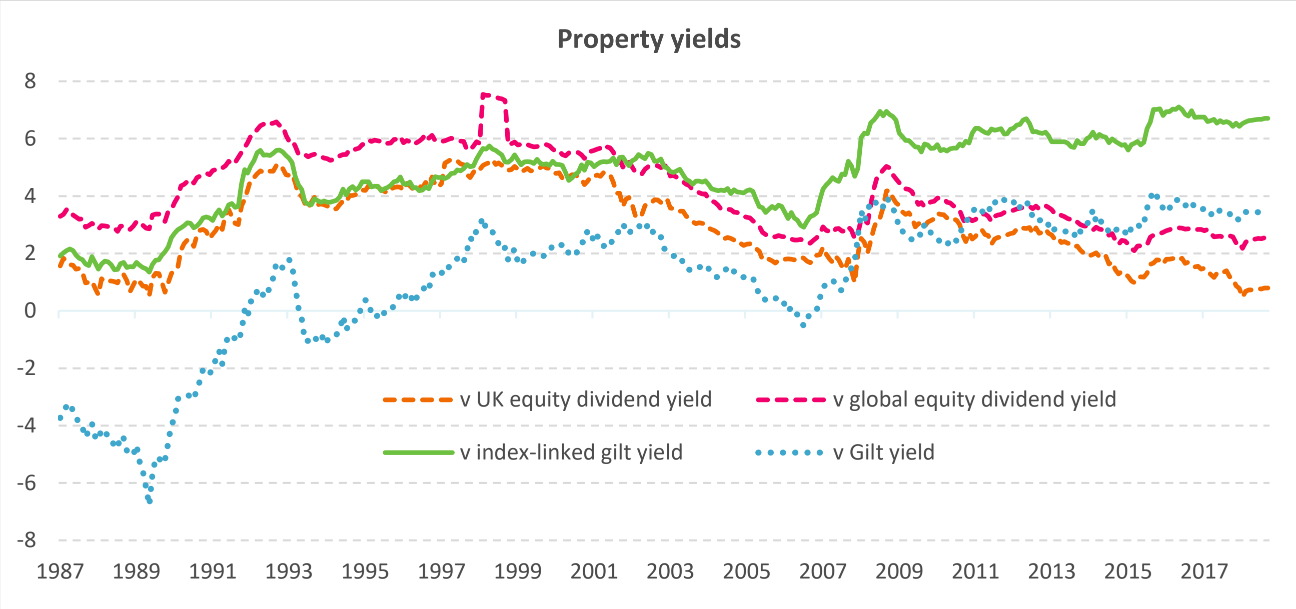
The significant shift in monetary policy has so far offset the impact of the concerns over the global economic slowdown. However, equity markets could prove vulnerable in the event that central banks do not maintain the current policy easing stance. If the economic backdrop proves less supportive then current equity valuations, whilst undemanding by historical comparison, may not reflect the rising risk to earnings. As such, we have downgraded our assessment of fundamentals, and our overall view, to reflect the more uncertain outlook.

Overall	Fundamentals	Valuations	Technicals
Neutral to cautious	Neutral to unattractive	Neutral	Neutral

By the end of Q3, the core global equity valuation metric (World Shiller P/E) remained slightly above long-term median levels. Overall global equity valuations conceal a wide regional disparity, with US equity valuations expensive by historical comparison whilst UK and emerging market equity valuations look more compelling. That said, if the global outlook continues to deteriorate, we expect the more cyclical economies (e.g. Europe ex UK, Japan and EM) to be impacted more than those markets with a more defensive earnings profile, such as the US.



3.8 Property



UK Property

Despite some very gradual yield expansion over recent quarters, absolute initial yields and reversionary yields remain low versus long-term history. Yields are at their lowest since the financial crisis relative to UK equity dividend yields. However, property yields look more compelling when compared to gilts and index-linked gilts.

Fundamentals and technical remain weak, although they have stabilised of late. Investment volumes remain below their 5 and 10 year average this year ahead of any Brexit outcome. This is the situation across all sectors and represents further weakening on the previous quarters where alternatives were above their 5 year quarterly averages.

Overall	Fundamentals	Valuations	Technicals
Cautious	Neutral to unattractive	Unattractive	Unattractive

Long Lease Property

Valuations look more stretched for properties with longer leases, however demand for long, secure income streams remains high from pension funds and other investors. Long lease funds still have queues in place, and while secondary market pricing has started to come down from offer price for some funds, others funds have experienced limited pricing movement.

Overall	Fundamentals	Valuations	Technicals
Neutral to cautious	Neutral	Very unattractive	Neutral

Infrastructure

Our view remains unchanged for infrastructure – valuations remain high, but technical drivers are strong and could underpin further revaluation. The uncertain economic outlook continues to favour long-term infrastructure assets which are typically less sensitive than other growth assets.

Overall	Fundamentals	Valuations	Technicals
Neutral to attractive	Neutral to attractive	Unattractive	Attractive

Notes and Risk Warnings

Please note the value of investments, and income from them, may fall as well as rise. This includes equities, government or corporate bonds, and property, whether held directly or in a pooled or collective investment vehicle. Further, investments in developing or emerging markets may be more volatile and less marketable than in mature markets.

Exchange rates may also affect the value of any investment. As a result, an investor may not get back the amount originally invested. Past performance is not necessarily a guide to future performance.

Private equity investments, whether held directly or in pooled fund arrangements carry a higher risk than publicly quoted securities; the nature of private equity pooling vehicles makes them particularly illiquid and investment in private equity should be considered to have a long-time horizon.

Hymans Robertson LLP has relied upon third parties and may use internally generated estimates for the provision of data quoted, or used, in the preparation of this report. Whilst every effort has been made to ensure the accuracy of such estimates or data, we cannot accept responsibility for any loss arising from their use.