Capital Markets Outlook Q1 2019

Essex Pension Fund

June 2019

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For and on behalf of Hymans Robertson LLP

1.1 Core asset class views: summary

Some form of technical recovery from the sell-off at the end of 2018 would not have been unusual, but the scale of the rally is perhaps a little more surprising. A much more benign monetary outlook has now been fully discounted in market, though the slowing global growth that prompted the dovish tilt perhaps has not been. Potential progress on US-China trade tariffs and economic stimulus in China may help avoid the more protracted slowdown feared at the end of 2018, but a coordinated upswing looks unlikely at this stage in the economic cycle and risks to the outlook remain. And while some market valuations had edged backed into relatively neutral territory towards the end of 2018, most are again looking at least a little stretched after the rally.

As a consequence, we would continue to advocate holding a little more cash than usual. We continue to prefer equities to property in growth-orientated portfolios and would advocate diversifying credit portfolios, potentially at the expense of trimming speculative-grade credit exposures.

Reflecting this, there are a couple of tweaks to our overall views:

- We have downgraded our overall assessment of liquid speculative credit to 'Cautious' reflecting our shift in assessment of valuations from Neutral to Unattractive.
- Our overall assessment of IG ABS is Neutral reflecting the slight improvement in technicals in Q1 with low issuance and continued demand providing support in the short term. Our overall assessment reflects our more positive outlook for shorter duration assets.

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

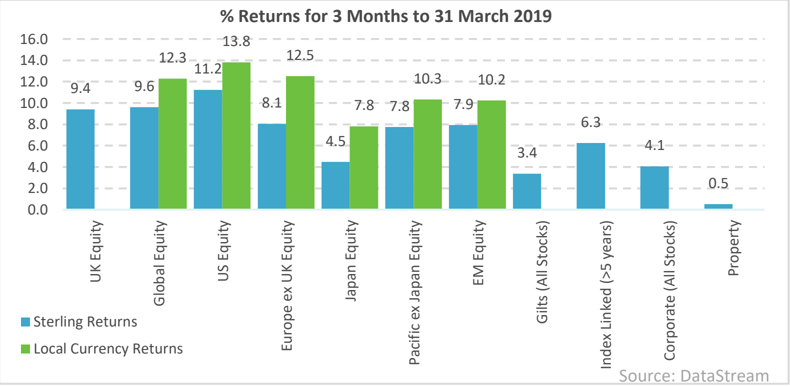
F/V/T ratings: VU – very unattractive; U – unattractive; N – neutral; A – attractive; VA – very attractive
Overall ratings: Negative, Cautious, Neutral, Attractive, Positive
Green signifies positive change since last quarter. Red signifies negative change since last quarter.

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	• Slowing global growth and rising cost pressures on corporate margins mean the backdrop for equities look less benign than it has been in recent years. • The Q1 rally leaves most global equity valuation metrics above historical averages, but not quite into our 'neutral-unattractive' range. • There has been a minor downgrade to technical factors, owing to downward revisions and poorer visibility for earnings growth forecasts.
Sterling non-government bonds	• The rally in Q1 has taken sterling corporate spreads, on a like-for-like basis, down in line with long term median levels. • The technical picture has improved slightly, but our overall view remains cautious as result of a continued negative outlook for underlying risk-free returns.
Liquid Sub-investment grade debt	• Following the fourth quarter sell-off, speculative-grade credit spreads rallied strongly in Q1, returning spreads well below long-term medians. • Having lagged the rally in high yield, loans have reigned some attraction over similar rated bonds. • The current benign default environment is likely to continue through 2019, supported by central banks move to more dovish policy. However, the more dovish turn has been prompted largely by concerns over slowing growth and earnings momentum, to which this market is typically quite sensitive.
Private Lending	• The direct lending market continues to offer an attractive illiquidity premium relative to traded markets. • There has been some deterioration in covenants, including some "cov-lite" issuance, in the private corporate debt market. But in general, the key maintenance financial test covenants remain in place. • The market has seen an increase in deal flow year on year as direct lenders continue to increase their market share.
Core UK property	• Property yields remain close to historic lows and appear stretched relative to UK and Global equities. • Sector divergence remains stark and prospects for the retail sector continue to deteriorate.
Long Lease Property	• The average absolute income yield on a selection of leading long-lease property funds remains as low as it has ever been over the last 10 years. • Demand for long, secure income streams remains high with long lease funds still having queues in place.
Infrastructure	• Evidence from proprietary indicators suggests that, despite some retrenchment towards the end of the year, average valuations have pushed higher over the year as a whole. • Investor demand for infrastructure remains high. Data from Preqin and Infrastructure Investor showed 2018 to be another record year of fundraising.
Conventional gilts	• Sharp falls in gilt yields over the quarter keeps valuations at very unattractive levels. • While hedging demand and economic uncertainty are likely to keep downwards pressure on yields, they have moved to levels which are very low versus even a very recent history, shading down our technical assessment for index-linked gilts. • Relatively high implied inflation – rising above c.3.6 % p.a. between 15 and 20 years – suggests conventional gilts are more attractive for terms up to around 25 years
Index-linked gilts	• Index-linked gilt yields remain well below equivalent US yields and the BoE's long-term assessment. • Longer-dated index-linked gilts continue to offer better relative value than shorter dated issues, given the higher implied inflation and lower yields out to 25 years.
Cash strategies	• This feels like a sensible time to hold some cash as 'dry powder' to exploit better buying opportunities in the future.

2.1 Market Background



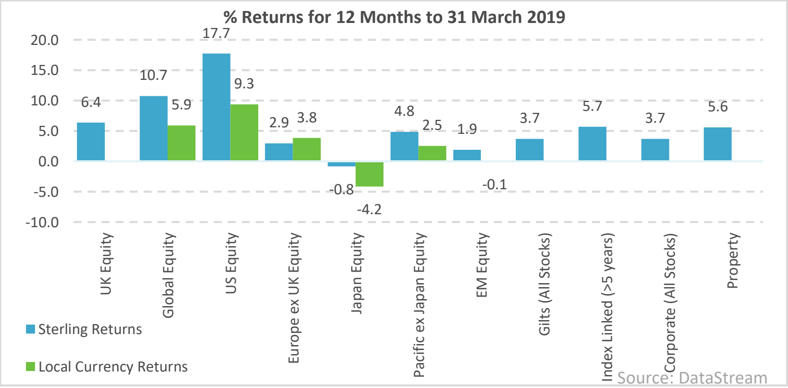
Global GDP growth continued to slow in the fourth quarter with consensus forecasts being revised downwards for 2019. Despite a slowdown in US GDP growth, the US has proved more resilient compared to Europe where the German economy has stalled, and Italy has fallen into a recession for the first time since early 2013. In the UK, Brexit risk continued to hamper business investment with GDP growth decelerating to 0.2% in Q4 from 0.7% in Q3 2018.

Brent crude stabilised at around $67 towards the end of the quarter, compared to $53 at the end-2018, but its sharp decline in the fourth quarter of 2018 has weighed on inflation expectations – consumer price inflation expectations for 2019 have been revised lower in most major developed economies except Japan.

The slowdown in global growth and continued absence of inflationary pressures has seen central banks adopt a more dovish stance with the Federal Reserve suggesting that no further rate hikes will take place this year and the ECB indicating no interest rate hikes until 2020. The rhetoric from central banks and slowing global growth saw conventional and index-linked gilt yields fall over the quarter with UK real yields hitting record lows.

Credit markets rebounded strongly from the sharp declines at the end of last year, perhaps an indication that investors are more relieved by the perceived end to monetary tightening than they are concerned by the slowdown in global economic growth. Sub investment grade credit markets outperformed investment grade markets as they benefited from signs of positive developments in the US-China trade talks, some stabilisation in oil-prices, and negative net issuance. Leveraged loan spreads tightened less than high yields spreads as the high yield market benefitted from fading expectations of the future Fed rate rises which have reduced the relative demand for floating rate instruments.

Despite signs of global growth slowing, the new year has brought a more optimistic tone across equity markets. Following their worst quarterly decline since 2011 in Q4 18, stock markets have rebounded strongly with global equities up 12.3% in local currency terms. North America was the best performing region, whilst Japanese equities lagged as the market's high exposure to global trade continued to weigh on sentiment. The FTSE All Share returned 9.4% over the quarter despite the strength of sterling being a headwind for the globally exposed larger cap names in the index. At a sector level, the bounce back in risk assets reversed the trend seen in Q4 as cyclical stocks outperformed more defensive sectors.



The beginning of 2019 has seen rental growth remain flat, across all sectors, in the UK property market. Property rents increased marginally in February following two months of small declines. The growth in industrial capital values, which is now slowing, remains insufficient to offset the falling capital values in the retail and office markets.

2.2 Key market data

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

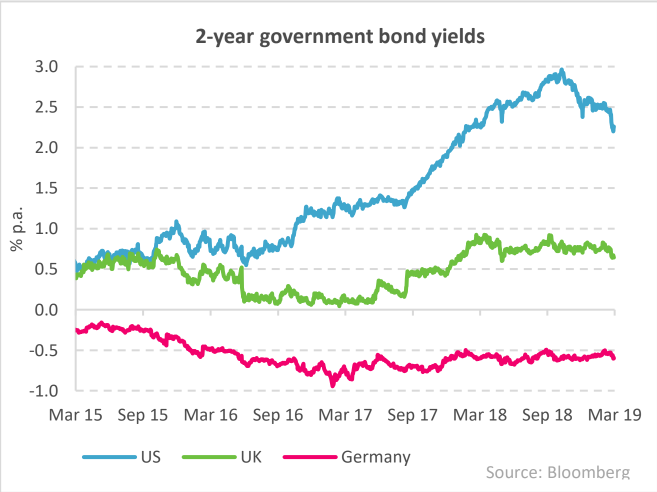
	31.03.18	30.06.18	30.09.18	31.12.18	31.03.19
UK Equity yield	3.9%	3.6%	3.8%	4.5%	4.2%
UK Equity P/E ratio (FTSE)	12.8x	13.6x	12.9x	11.7x	16.3x
Over 15 year gilt yield (p.a.)	1.6%	1.7%	1.9%	1.8%	1.5
Over 5 year index-linked gilt yield (p.a.)	-1.7%	-1.6%	-1.5%	-1.6%	-1.9%
iBoxx Over 10 year Non-gilt yield (p.a.)	2.9%	3.0%	3.2%	3.2%	2.8%

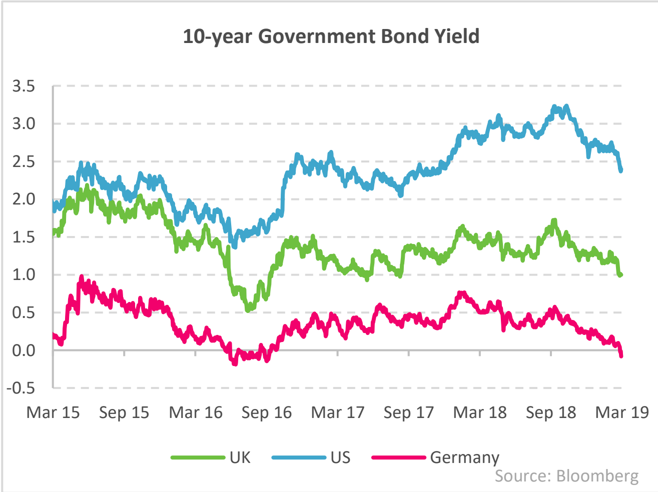
Source: DataStream

	Year to 31.03.18	Year to 31.03.19	Quarter to 30.06.18	Quarter to 30.09.18	Quarter to 31.12.18	Quarter to 31.03.19
FTSE All Share	1.3%	6.4%	9.2%	-0.8%	-10.3%	9.4%
Global Equity	2.9%	10.7%	6.9%	5.7%	-10.5%	9.6%
Over 15 year gilts	2.2%	4.7%	-0.4%	-3.3%	2.6%	6.0%
Over 5 year index linked gilts	0.7%	5.7%	-1.2%	-1.4%	2.0%	6.3%
All Stocks Non-Gilts	1.2%	3.7%	-0.1%	-0.4%	0.1%	4.1%
IPD Monthly Index	11.3%	5.6%	2.2%	1.7%	1.1%	0.5%

Source: DataStream.

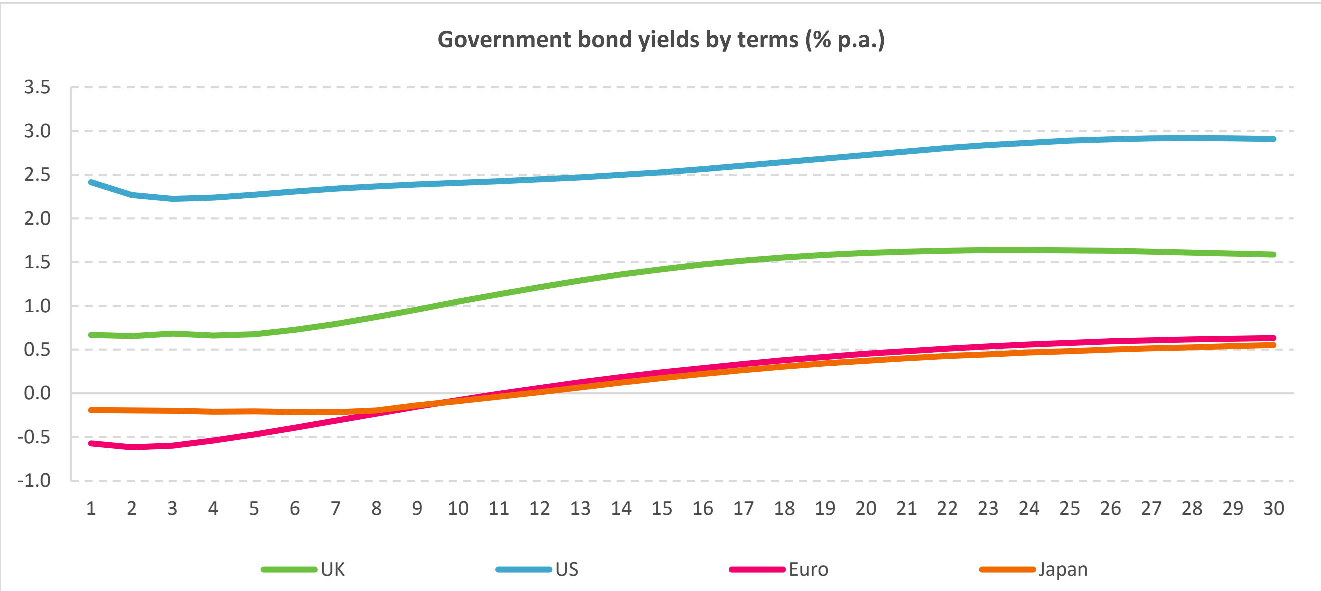
3.1 Global Bond Markets



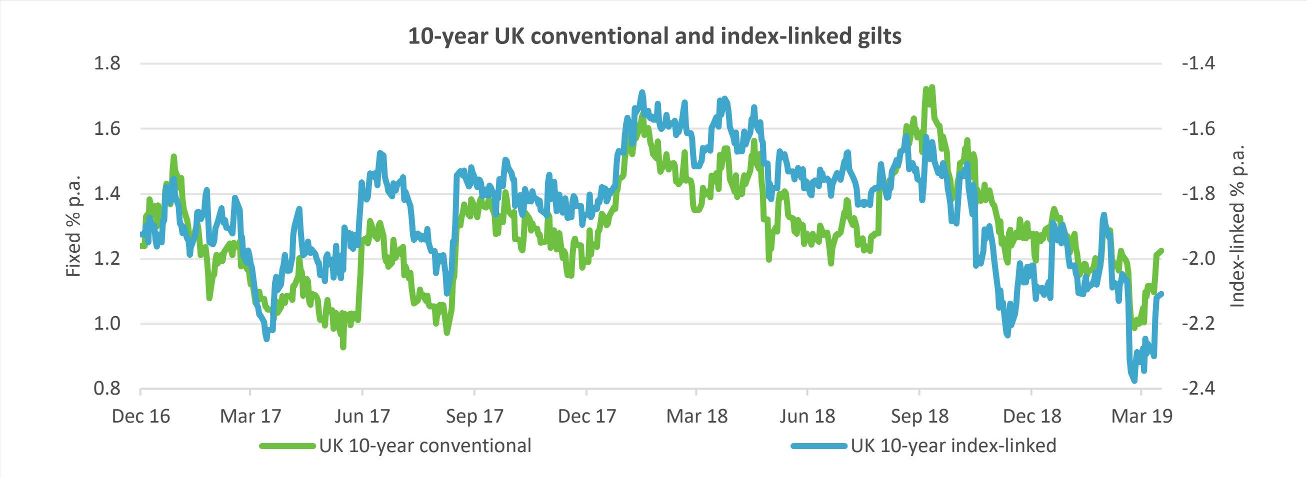


Global sovereign bond yields have fallen sharply this year, amid concerns over economic growth and inflation forecasts, and the more dovish stances by central banks. The median of the Fed forecasts provided by each member of the Federal Open Markets Committee now indicate no further rate hikes in 2019 – derivatives markets actually imply a rate cut. The European Central Bank ended its QE purchases at the end of 2018 but has since announced a new injection of cheap liquidity for banks and has pushed out rate hikes until 2020. The Bank of England hinted that a disorderly Brexit would prompt a rate cut – a contrast to last year's emphasis on the risk that sterling depreciation and consequent inflationary pressure might require an increase.

During the quarter there was little dispersion in the direction of yield movements: US 10-year Treasury yields and equivalent UK gilt yields fell around 30bps, while 10-year bund yields turned negative for the first time since October 2016. The yield curve inversion in the US – three-month yield on treasury bonds rose higher than 10-year yields in March - underlines the growing caution among investors around economic growth prospects.

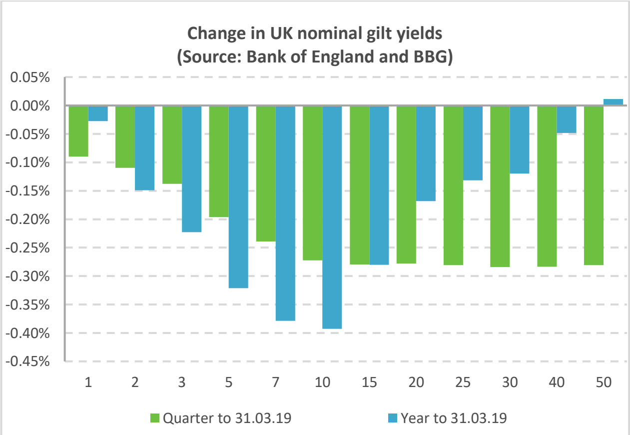


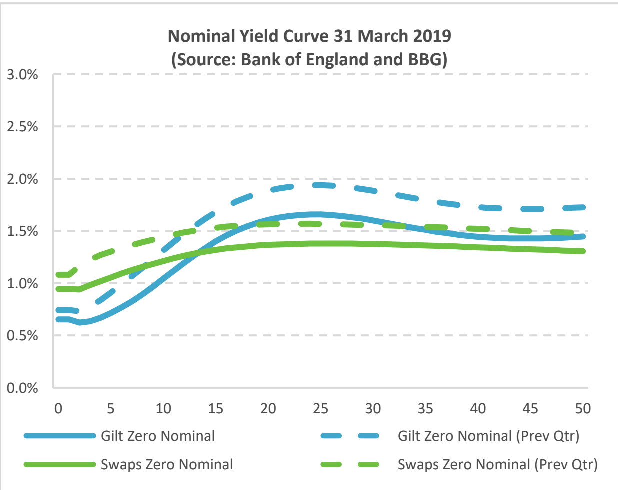
3.2 UK Interest Rates

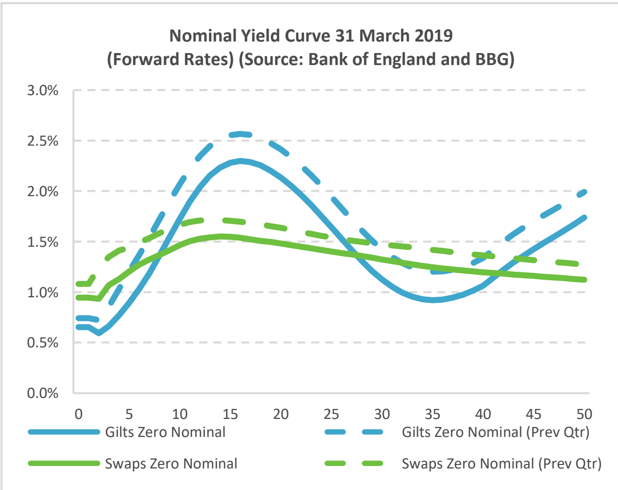


UK gilt yields fell significantly over the quarter with 10-year gilt yields returning to levels last seen in the second half of 2017.

While hedging demand continues to keep downward pressure on yields, there is little long-term value offered by current yields, even allowing for a "new Normal" characterised by lower future growth and interest rates. Gilt yields and forward rates are well below our assessment of neutral levels at all maturities and as such we maintain our very unattractive assessment on valuations.





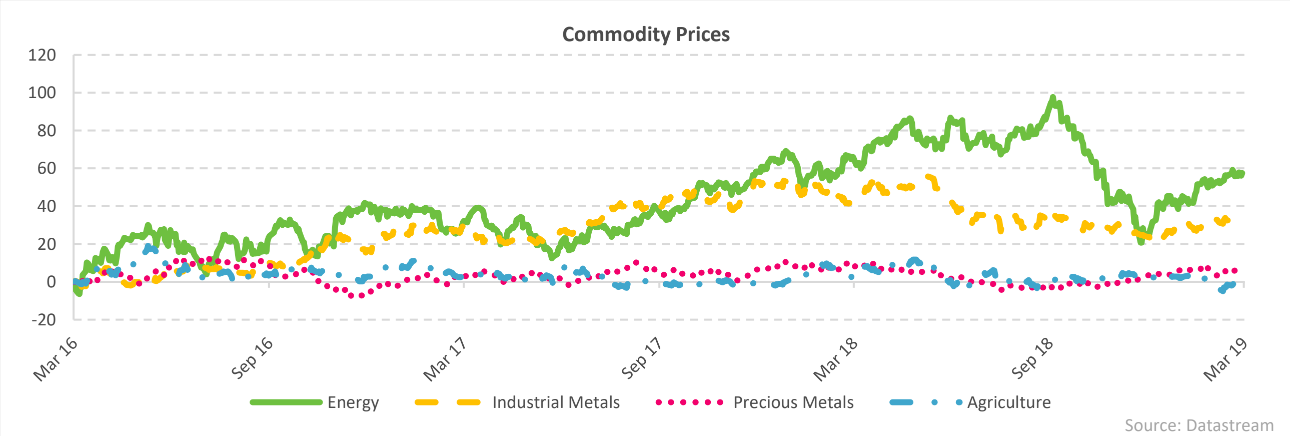


There is still significant variation by maturity in forward-dated gilt yields and we would continue to bias exposure away from the most expensive long maturities when hedging interest rates.

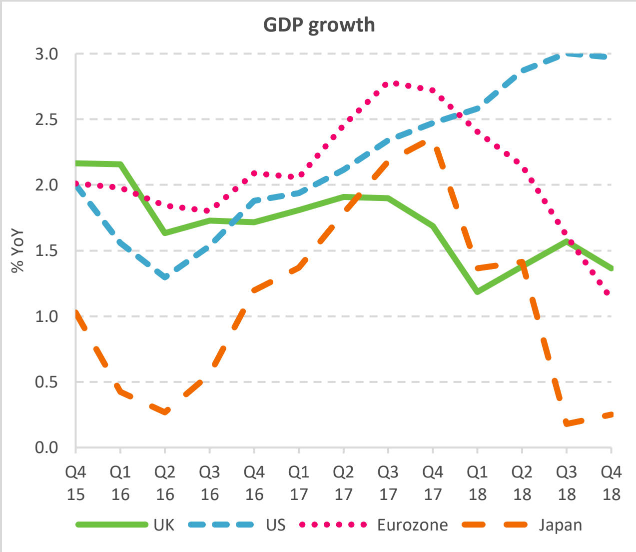
Overall	Fundamentals	Valuations	Technicals
Cautious to negative	Neutral	Very unattractive	Neutral

3.3 Inflation and real rates

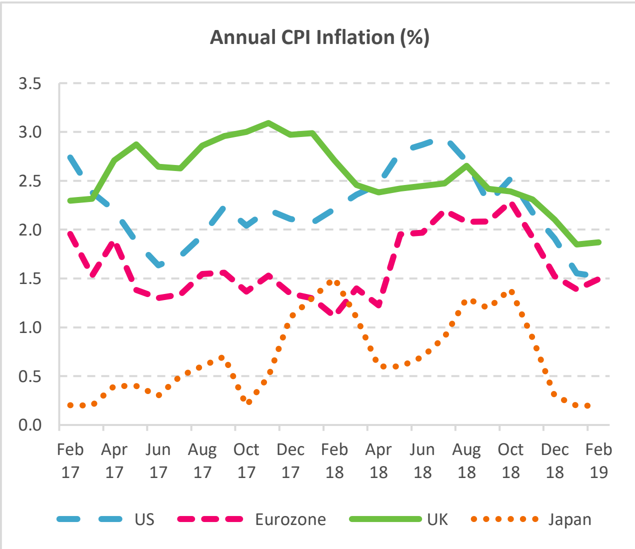
Commodities posted positive returns over Q1 with Energy leading the way following a rebound in the oil price. Industrial metals also moved higher amid positive sings emanating from US-China trade talks.



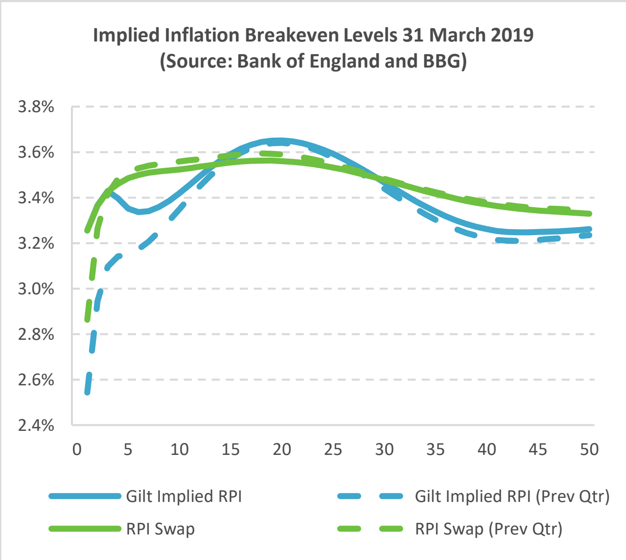
Consensus forecasts for 2019 have fallen further in the first quarter, with material downwards revisions to both inflation and growth forecasts pointing to a more rapid moderation in global growth. Whilst US quarterly GDP growth slowed over the fourth quarter, the economy has been relatively resilient compared to Europe where the German economy has stalled, and Italy has fallen into recession for the first time since early 2013. Hints from recent upbeat manufacturing PMI data in the US and China also support this contrast with Europe, where manufacturing data now points towards contraction.

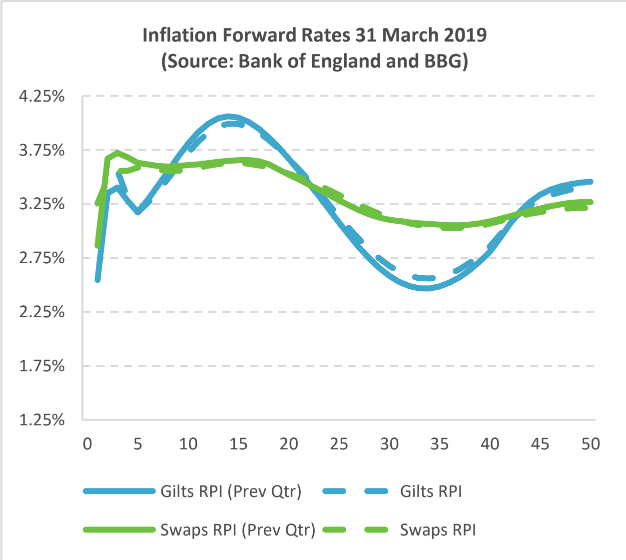


Political indecision exposes the UK to the risk of a more pronounced slowdown. Heightened economic uncertainty surrounding arrangements post-Brexit and the possibility of a disorderly exit seems to be causing a deferral of investment. While the manufacturing PMI in the UK has remained positive, possibly due to pre-Brexit stockbuilding, the PMI for services (which accounts for 80% of Britain's GDP) has fallen below a reading of 50, indicating contraction, for the first time since the brief post-referendum dip in July 2016.



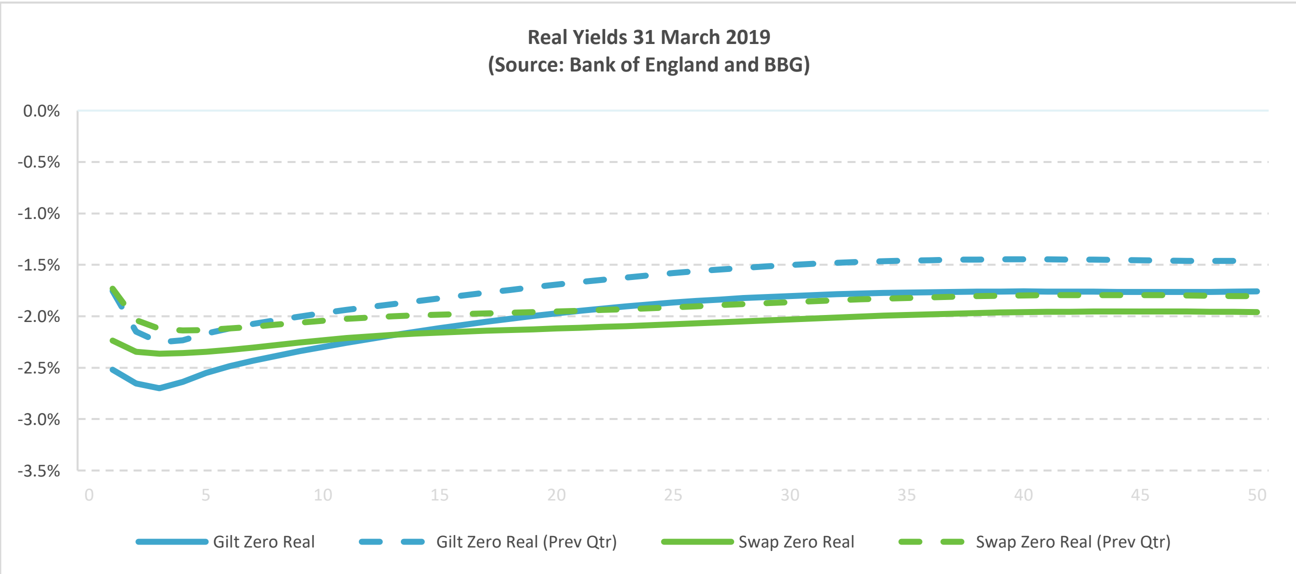
Despite a sharp recovery in oil prices in the first quarter, consumer price inflation expectations for 2019 have also been revised lower in most major developed economies, with the exception of Japan. Realised core inflation has remained stable in the US, Eurozone and the UK but there is the risk that positive real wage growth across these regions could feed in to broader inflation measures.





Index-linked gilts continue to look expensive with yields remaining well below equivalent US yields and behind the BoE's long-term assessment. Relatively high implied inflation – rising above 3.6 % p.a. between 15 and 20 years - suggests conventional gilts are more attractive for terms up to around 25 years, with index-linked gilts offering better relative value thereafter.

Heightened Brexit-related uncertainty and downward revisions to short-term growth forecasts are likely to keep downward pressure on yields, however the scale of the rally in Q1 leaves scope for a short-term correction. This leads us to shade down our technical assessment of index-linked gilts to neutral, in-line with conventional gilts.



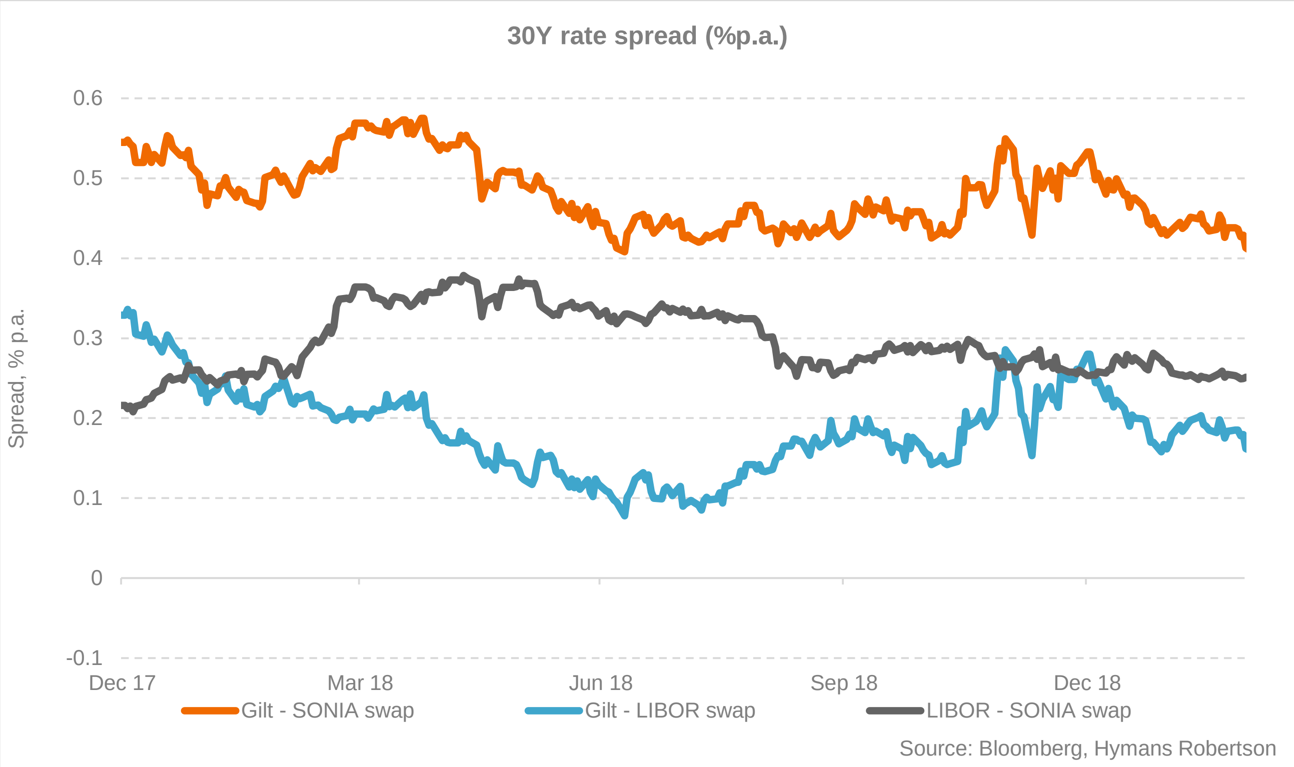
Overall	Fundamentals	Valuations	Technicals
Cautious to negative	Neutral	Very unattractive	Neutral

Note: ILG (rather than inflation) rating

3.4 Gilt-swap z-spread

LIBOR Swap Spreads* (Source: BoE and Bloomberg)	10 Years		20 Years		30 Years	
	31 Dec	31 Mar	31 Dec	31 Mar	31 Dec	31 Mar
Nominal (bps)	13	17	-32	-24	-33	-23
Real (bps)	-7	7	-26	-15	-36	-23

*Estimates using zero curves.



Although the LIBOR-SONIA spread has been fairly stable over the past two quarters, long dated gilts have become more expensive (z-spreads have tightened) relative to SONIA and LIBOR swaps over the last quarter. However, we do not see a strong case to suggest this is the beginning of a longer-term trend.

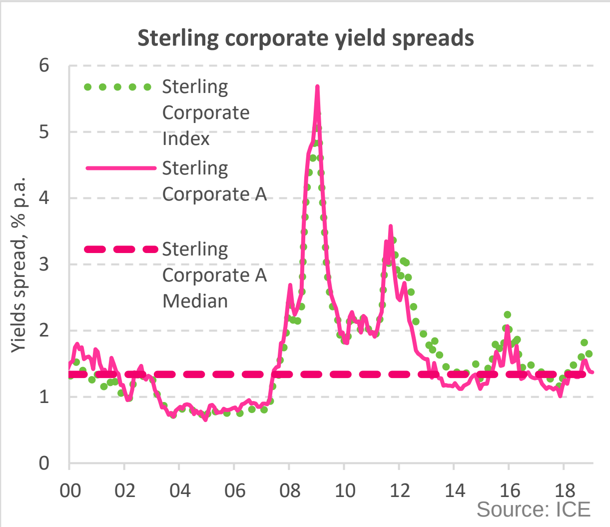
LIBOR swap rates have a credit premium over SONIA swap rates, so modest positive gilt z-spreads (vs LIBOR) mean holding gilts relative to swaps as hedging instruments appears attractive, but potential repo roll risk detracts from the relative attractiveness of unfunded gilts. Gilts currently yield c.15-25 bps over LIBOR swaps.

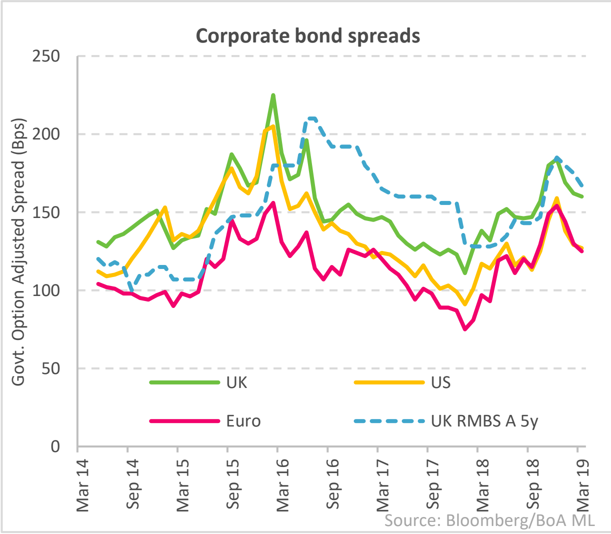
Overall	Fundamentals	Valuations	Technicals
Neutral to attractive	Neutral	Neutral to attractive	Neutral

3.5 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)
31 December 2018	144	153	172
31 March 2019	123	135	149
Median spread over last 5 years	123	120	138
Average spread over last 5 years	125	122	142
Median spread over last 15 years	134	123	146
Average spread over last 15 years	145	134	174

[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.





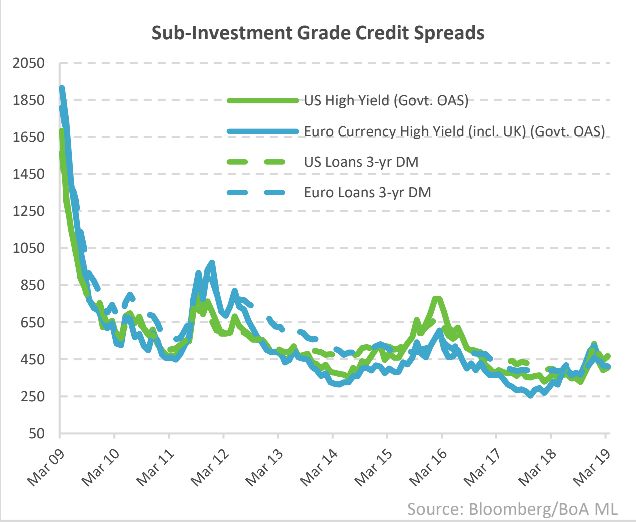
The rally in sterling investment grade credit markets over the quarter has brought spreads down in line with long term medians and as a result we have shaded our view down to neutral on a relative value basis. The technical picture has improved slightly following a more dovish positioning by the Fed and new cheap liquidity from the ECB which has supported positive flows in to the asset class in 2019, having been negative over 2018. Despite a modest improvement in technicals, our overall view remains cautious because of our negative outlook for underlying risk-free returns.

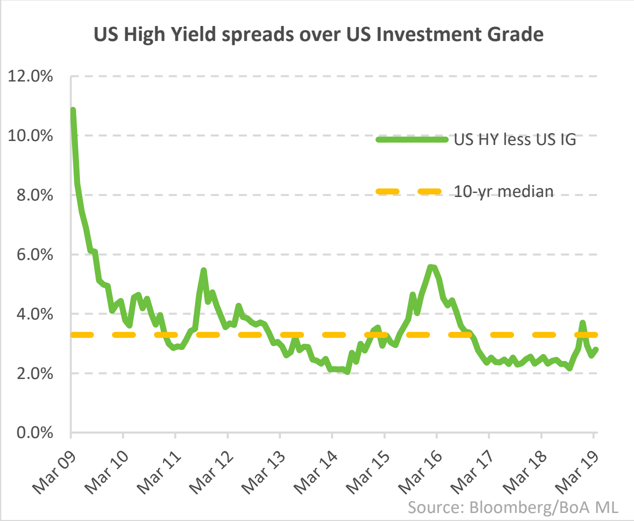
Our overall assessment of IG ABS is neutral reflecting the slight improvement in technicals in Q1 with low issuance and continued demand providing support in the short term. Our marginally more positive overall assessment (relative to IG credit) reflects our preference for shorter duration assets.

The fundamental background for real estate debt remains more positive than for corporate credit. Banks and insurers remain active investors in this portion of the real estate debt market providing ample demand for higher quality issuance. However, demand for high quality debt keeps illiquidity premiums at unattractive levels.

	Overall	Fundamentals	Valuations	Technicals
Credit	Cautious	Neutral	Neutral	Neutral to unattractive
ABS	Neutral	Neutral	Neutral to attractive	Neutral
RED	Cautious	Neutral to attractive	Unattractive	Neutral

3.6 Sub Investment Grade Corporates and Emerging Market Debt



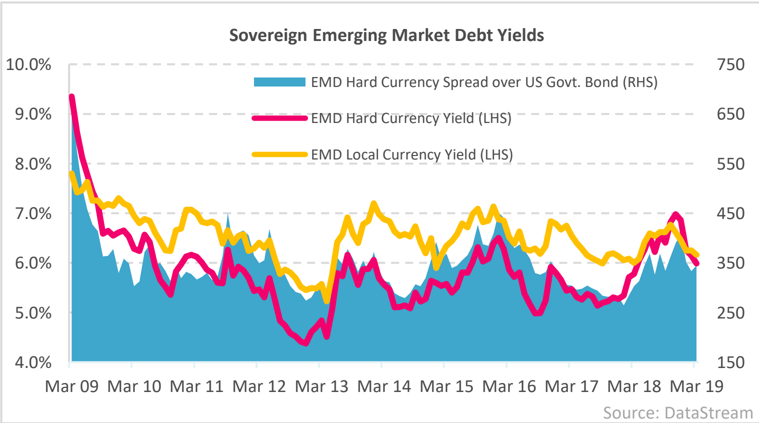


Following the fourth quarter sell-off, speculative-grade credit spreads rallied strongly in Q1, returning spreads on a like-for-like basis well below long-term medians. The sharp rebound has been sufficient to shift our valuation assessment form neutral to unattractive. Investor demand for high yield turned positive in Q1, after a prolonged period of outflows in 2018, reflecting a change in sentiment from central banks. However, the more dovish turn has been prompted largely by concerns over slowing growth and earnings momentum, to which this market is typically quite sensitive. Such concerns coupled with unattractive valuations have led us to downgrade our overall view to cautious.

There is increasing fundamental divergence between the high yield market – where leverage levels continue to fall and debt affordability (as measured by the number of times earnings covers interest payments) has reached decade-high levels – and the leveraged loan market – where valuations relative to the high yield market are in-line with long-term medians but leverage is higher, debt affordability is lower and protections for lenders continue to decline. This does not apply to the same extent in private credit markets, both in corporate and commercial real estate lending, where investors benefit from better risk-adjusted credit spreads and structural protections for lenders. This is reflected in a more positive overall view on private markets relative to traded sub investment grade credit markets.

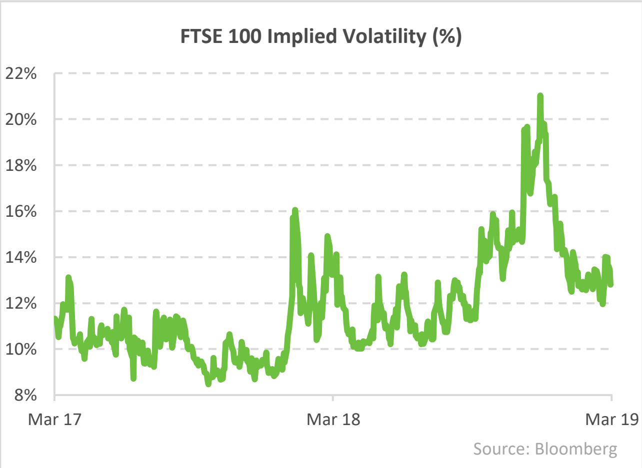
	Overall	Fundamentals	Valuations	Technicals
Public markets	**Cautious**	Neutral	Unattractive	Neutral to unattractive
Private markets	**Neutral**	Neutral to attractive	Neutral	Neutral
EMD	**Neutral**	Neutral to attractive	Neutral	Neutral to unattractive

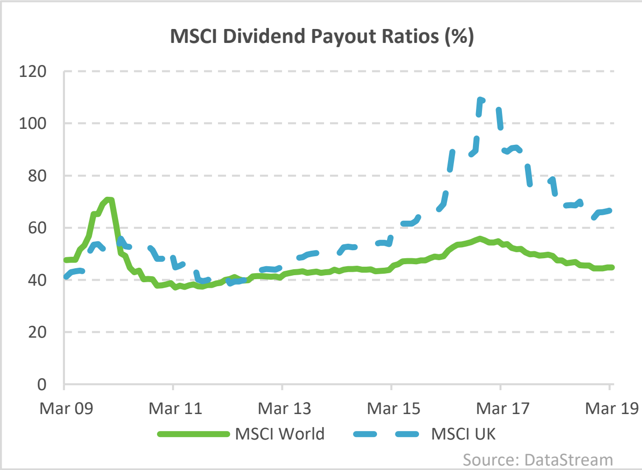
Our overall view remains unchanged for EMD. Growth rates from the major economies have moderated in line with a global growth slowdown but inflation remains low. Yields remain attractive although slightly less so given rally in Q1 and we have moved our valuation assessment to neutral. Currencies, relative to the US dollar, are cheap. Short term risks have marginally improved with dovish comments from the Fed helpful for sentiment.



3.7 UK Equity Market

Equity Market Data (Source: Datastream)	31 December 2018	31 March 2019
FTSE All Share Dividend Yield	4.5%	4.2%
Dividend growth over the quarter	4.5%	2.4%
Dividend growth over the year	8.1%	12.0%
FTSE All Share P/E Ratio	11.7x	16.3x
Total Return during the quarter	-10.2%	9.4%
Total Return over the last 12 months	-9.5%	6.4%

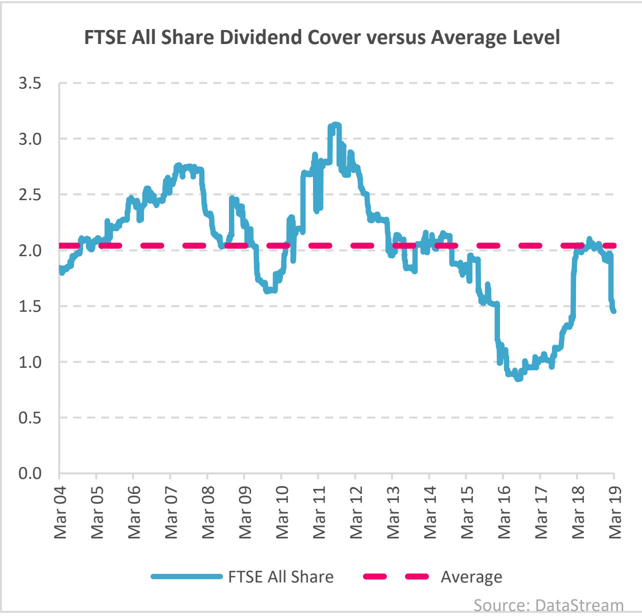




UK equities underperformed global indices, as a stronger Sterling was a headwind for the internationally-exposed larger cap names in the index. There was little impact from the ongoing Brexit uncertainty between the larger cap FTSE 100 index and the more domestically focussed FTSE 250.

UK equity valuations remain cheap relative to other regions and are around historic long-term median levels. However, sentiment towards UK equities remains poor, as Brexit uncertainty lingers.

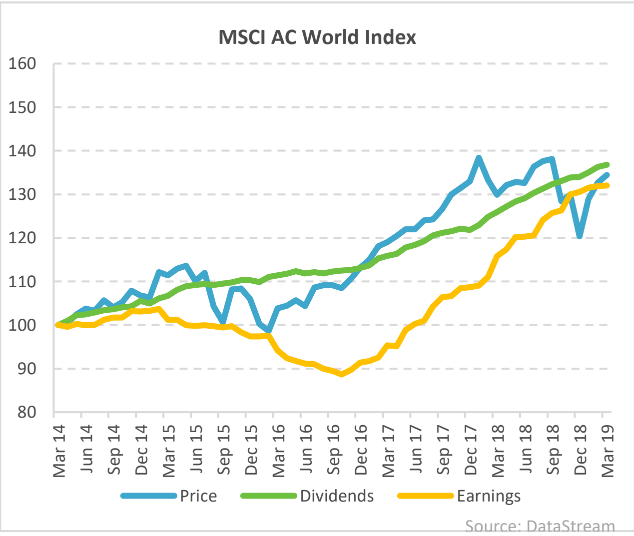
Relative to government bonds, UK equity dividend yields remain close to record highs despite falling over the quarter. However, there are potential questions over the sustainability of these dividends with dividend cover falling markedly over the quarter.

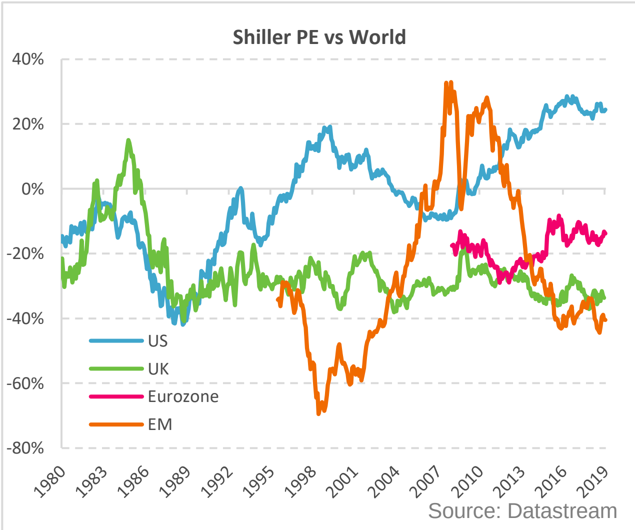


3.8 Overseas Equity Markets

MSCI index valuations as at 31 March 2019

	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	**17.8**	17.7	**22.7**	21.4	**2.4**	2.1	**1.6**	1.3	**10.4**	9.7
US	**20.2**	18.0	**28.2**	20.1	**3.4**	2.3	**2.0**	1.6	**11.7**	10.6
EM	**13.1**	14.4	**13.5**	15.7	**1.6**	1.7	**1.2**	1.2	**8.7**	7.6
UK	**14.4**	14.2	**15.3**	15.0	**1.7**	1.8	**1.1**	1.2	**7.6**	7.7





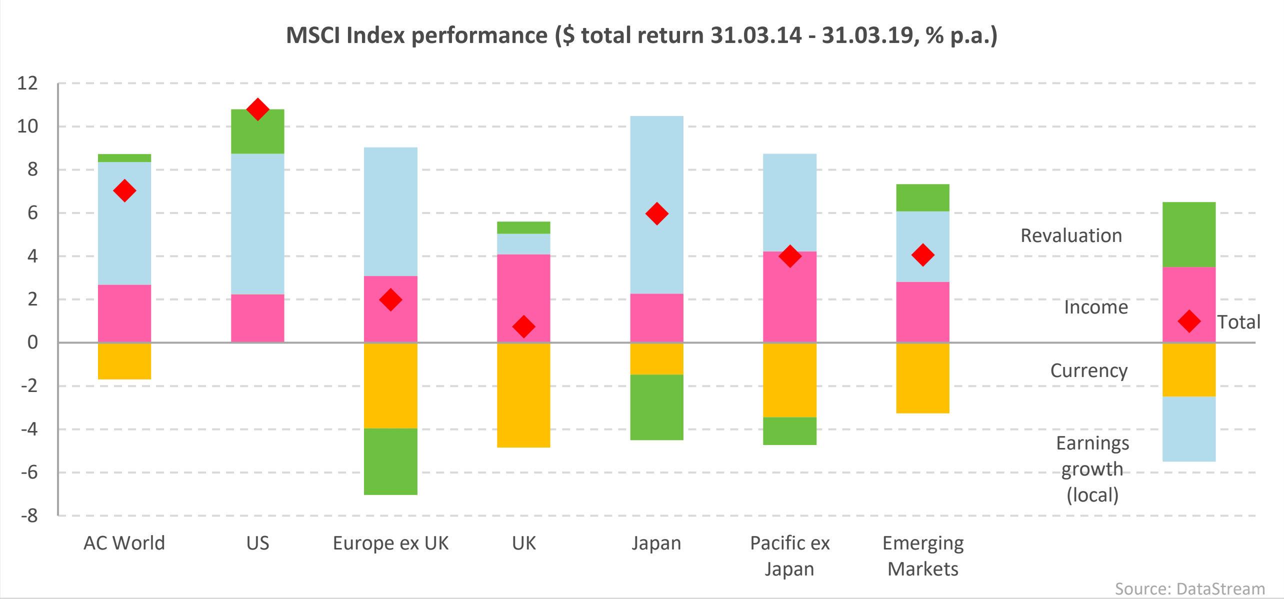
The new year saw a strong rebound across global equity markets, following the sharp sell off in Q4 18. Equity markets brushed aside the softening economic data and muted inflationary pressures that were the underlying cause for the Federal Reserve's change in tone. The Q1 rally leaves most global equity valuation metrics above historical averages, but not quite into the 'neutral-unattractive' range. The significant shift in expectations regarding further US interest rate hikes has alleviated some of the concerns over equity valuations.

Investor sentiment has recovered following the equity volatility in Q4. However, the ongoing uncertainty over the global trade disputes continues to impact investor sentiment for those regions and sectors most exposed to global trade. Earnings growth forecasts for 2019 have been revised sharply lower in recent months. Whilst the pace of downgrades has started to level off, earnings momentum remains negative. Furthermore, given the uncertain economic backdrop, earnings visibility has reduced considerably.

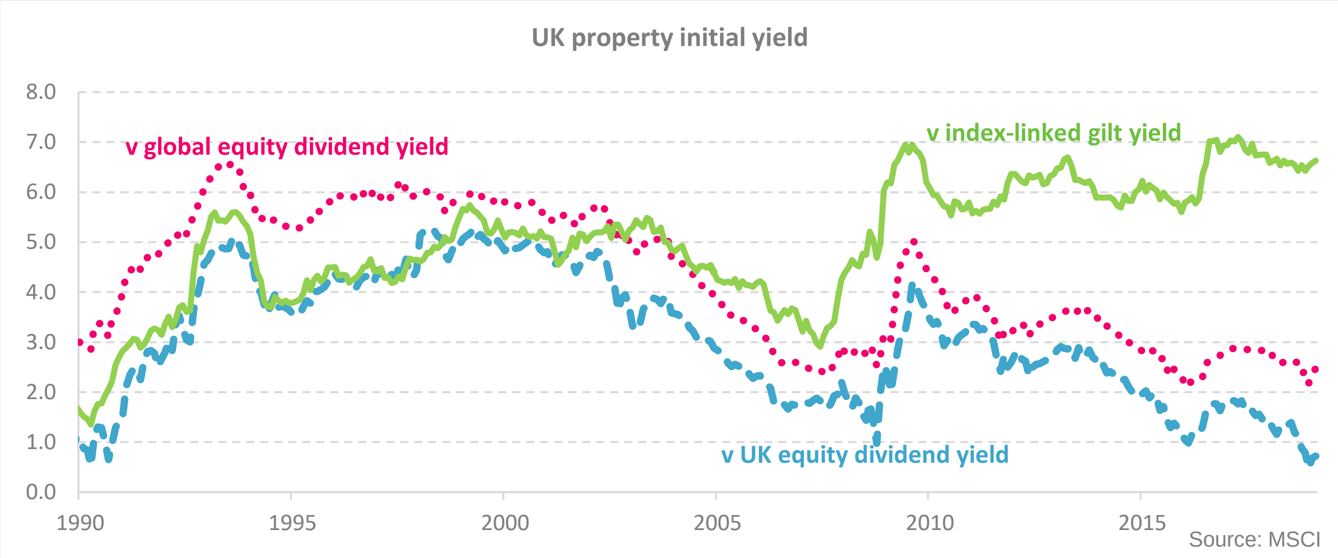
Our overall assessment remains at neutral. Whilst global equity valuations have risen following the Q1 rally, they remain just inside neutral territory. There has been a minor downgrade to technical factors, owing to downward revisions and poorer visibility for earnings growth forecasts.

Overall	Fundamentals	Valuations	Technicals
Neutral	Neutral	Neutral	Neutral to unattractive

Significant regional disparity remains a feature of global equity valuations – the UK and Emerging Markets usually trade at a discount to global averages, but look cheap even allowing for that; the US typically commands a premium valuation, but still looks expensive.



3.9 Property



UK Property

Yields remain close to historic lows, in both absolute terms and relative to equity, but some short-term indicators point to further headwinds: survey evidence suggests that occupational demand is on the wane and incentives to new tenants are rising, while investment transaction activity has fallen off in recent months. Sector divergence remains stark and prospects for the retail sector continue to deteriorate.

Overall	Fundamentals	Valuations	Technicals
Cautious	Neutral to unattractive	Very unattractive	Neutral

Long Lease Property

The average absolute income yield on a selection of leading long lease property funds is as low as it has ever been over the last 10 years. Demand for long, secure income streams remains high from pension funds and other investors and, to some extent, this demand is insensitive to relative value. We don't believe the long lease sector is likely to perform too differently from the broad market over the longer term.

Overall	Fundamentals	Valuations	Technicals
Neutral to cautious	Neutral	Very unattractive	Attractive

Infrastructure

Our view on valuations has been adjusted downward to reflect evidence from proprietary indicators, suggesting that average valuations pushed higher over the year. However, we believe technical drivers are strong and could underpin further revaluation. Investor demand for infrastructure remains high. Data from Preqin and Infrastructure Investor showed 2018 to be another record year of fundraising.

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.