HYMANS ROBERTSON

Q4 2023
Capital Markets Outlook

Essex Pension Fund

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Market background

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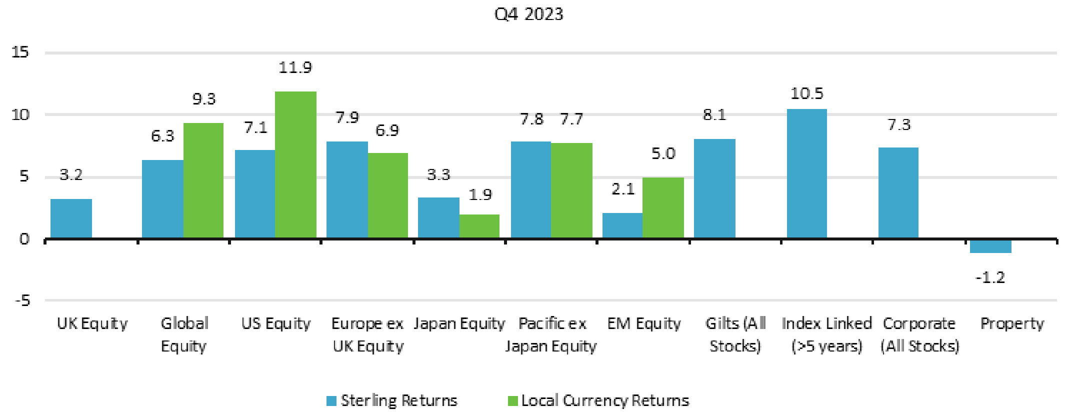
Market Returns

The global economy continued to grow at a decent pace in Q3, mainly due to the ongoing resilience of the US economy and a stimulus-driven pick-up in Chinese growth. Nonetheless, global GDP growth is still expected to slow to a subdued pace in 2024, with particularly weak growth expected in the eurozone and UK.

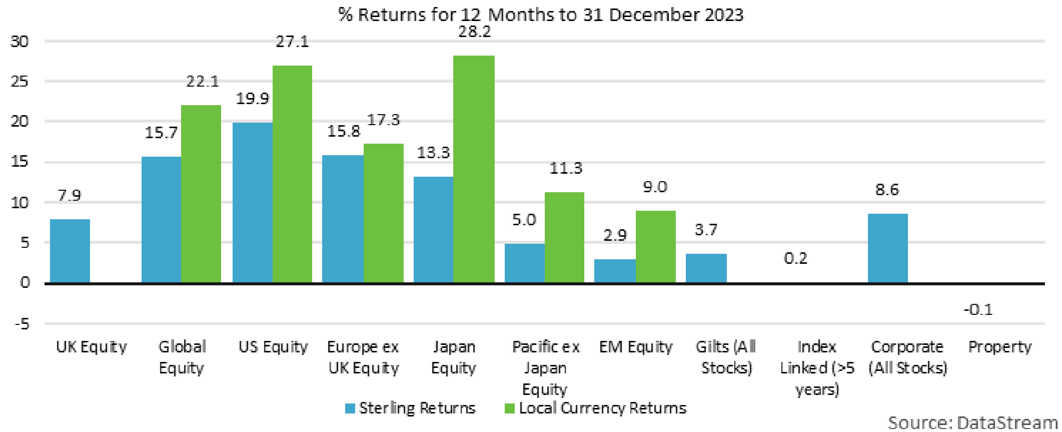
Inflation fell more than expected across major advanced economies in Q4, boosting investors' hopes of earlier and larger rate cuts than previously expected.

The US Federal Reserve (Fed) boosted these expectations in mid-December as its revised policy projections revealed it will likely cut rates in 2024.

With the above economic backdrop, sovereign bond prices rose as yields fell. Meanwhile, equity markets rallied, delivering their best annual return since 2019.



Source: DataStream



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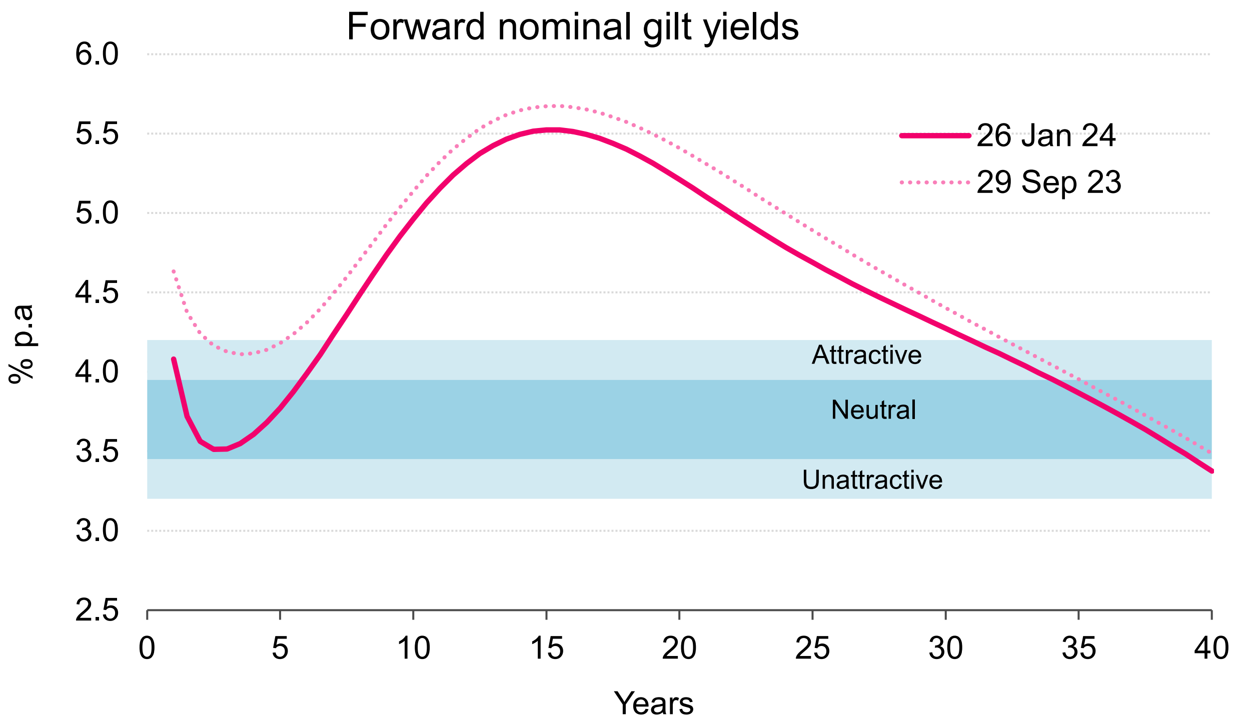
Asset class views

Conventional government bonds



Despite the recent rally, longer-term forward nominal yields look very elevated versus our long-term fair value, underpinning our attractive assessment of nominal yields.

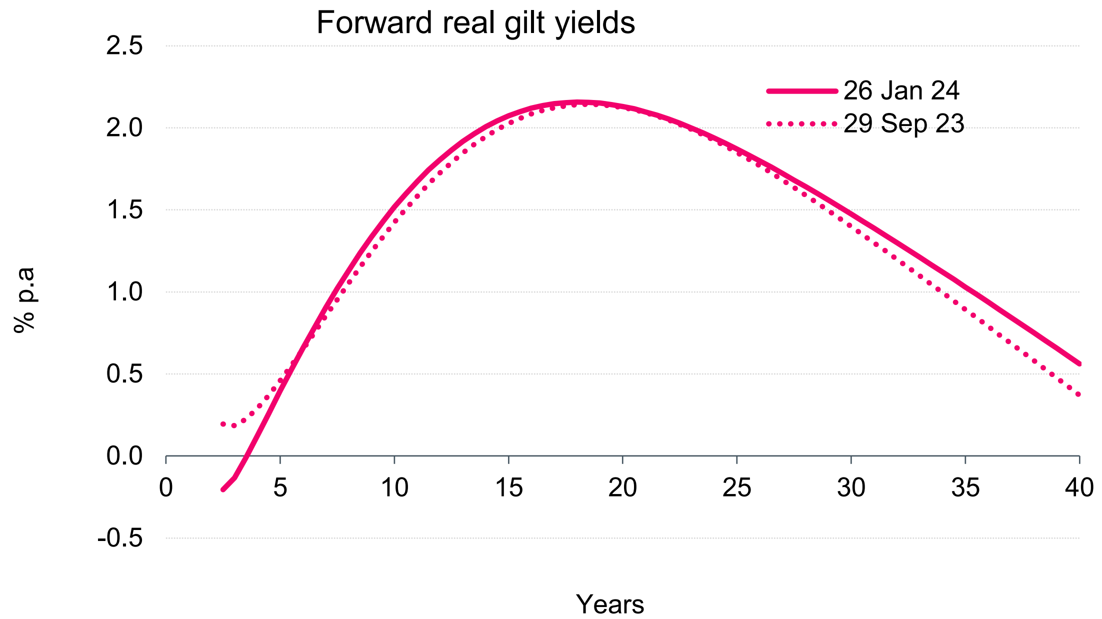
BoE's gilt sales and increased new supply provide for a fragile technical backdrop for conventional gilts. However, an easing of inflation concerns, and weak growth should improve sentiment towards the asset class.

	Fundamentals	Valuations	Technicals	Overall
Nominal gilts	Neutral-Attractive	Attractive	Unattractive	**Neutral-Attractive**

Index-linked government bonds

Given the decline in nominal yields, relative to real yields, implied inflation has cheapened. Allowing for elevated near-term inflation and slightly above-target inflation over the medium to long-term, the cost of long-term inflation hedging is now only slightly above our assessment of fair value.

We remain neutral on the technical backdrop for linkers, noting that they were not included in the BoE's asset purchase program and so are not being sold as part of quantitative tightening. While net supply is increasing, institutional demand should be supportive.



	Fundamentals	Valuations	Technicals	Overall
Index-linked gilts	Neutral-Attractive	Neutral-Attractive	Neutral	**Neutral-Attractive**

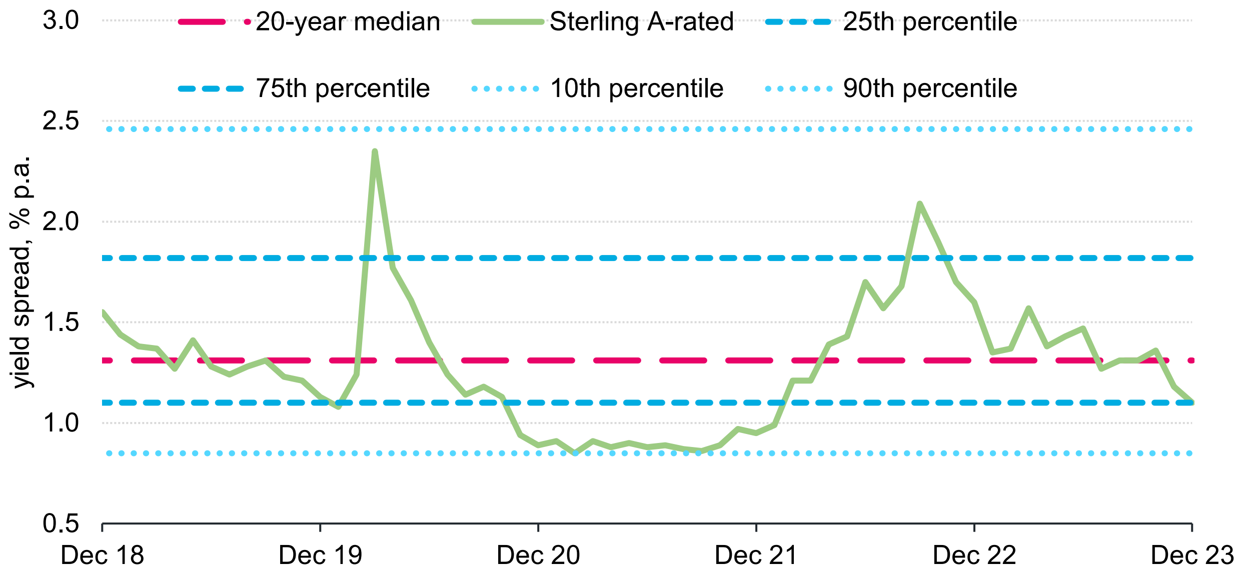
Investment-grade corporate credit

Markets are pricing in the benign default and downgrade outlook. Spread tightening towards the end of 2023 means global credit spreads are now slightly below long-term median levels. Sterling credit spreads look increasingly tight leading to a slightly more cautious stance.

Institutional demand for high-quality investment-grade assets lends a degree of technical support.

Trailing 12-month ratings drift remains negative as the number of “notch” downgrades in investment grade is higher than the number of upgrades. However, the value of rising stars (bonds upgraded from speculative to investment-grade) continues to outweigh that of fallen angels.

Spreads (bps)	31-Dec	-3 Mth	-12 Mth	10-yr Median
US A IG	**88**	107	114	**100**
Sterling A IG	**110**	131	160	**128**
Euro A IG	**120**	133	138	**97**



	Fundamentals	Valuations	Technicals	Overall
Global IG credit	Neutral-Unattractive	Neutral-Unattractive	Neutral	**Neutral-Cautious**
Sterling IG credit	Neutral-Unattractive	Unattractive	Neutral	**Cautious**

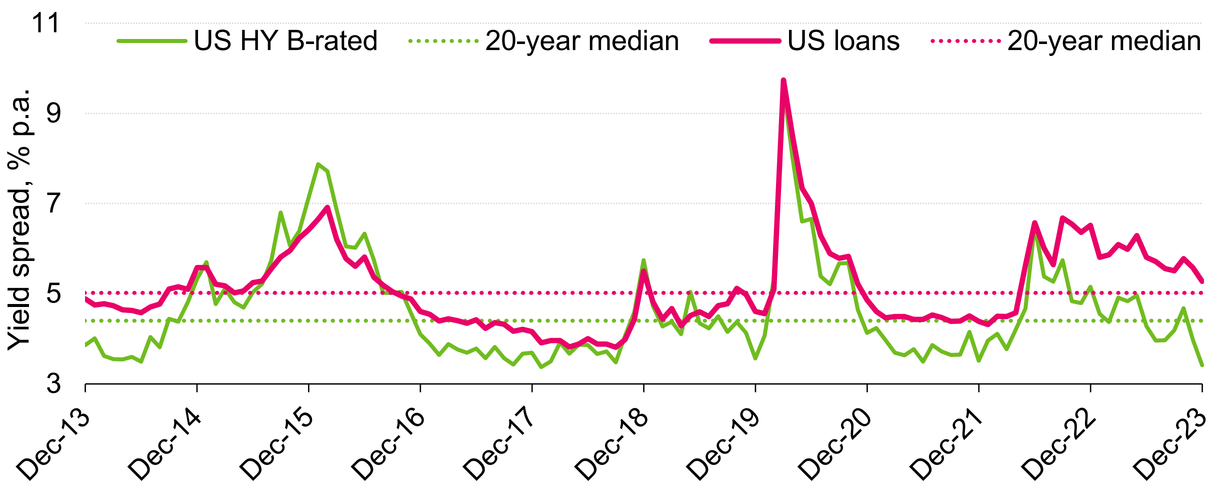
Speculative-grade credit

Improvements to the fundamental outlook are more than reflected in credit spreads, which have fallen well below long-term median levels. Global developed market speculative-grade bond spreads are now below the 25th percentile of their long-term history.

As with investment-grade credit markets, valuations look far more stretched in US relative to Europe.

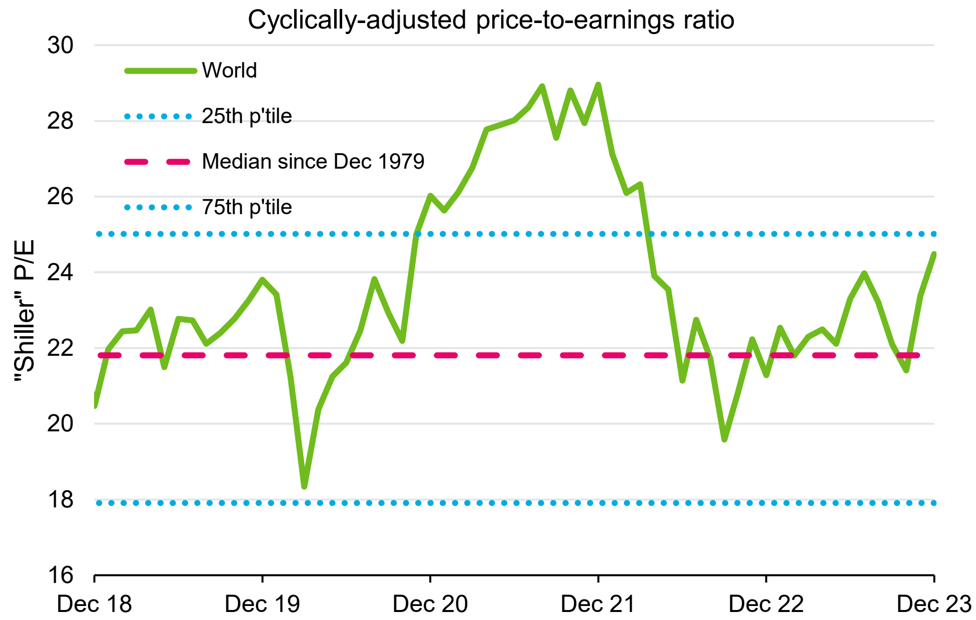
Credit upgrades and the repayment of debt incurred during the pandemic have provided technical support to the high yield markets.

Spreads (bps)	31 Dec	-3 Mth	-12 Mth	10-yr Median
US HY	**339**	403	481	**406**
Euro Currency HY	**411**	459	515	**400**
US Loans 3-yr DM	**528**	551	652	**487**
Euro Loans 3-yr DM	**561**	521	710	**483**



	Fundamentals	Valuations	Technicals	Overall
High yield	Neutral-Unattractive	Unattractive	Neutral	**Cautious**
Loans	Neutral-Unattractive	Neutral	Neutral	**Neutral-Cautious**

Global equities



	Fundamentals	Valuations	Technicals	Overall
Global equity	Neutral-Unattractive	Neutral-Unattractive	Neutral	**Neutral-Cautious**

Market performance in Q4 2023 has driven cyclically adjusted valuations higher, which now look elevated relative to long-term averages.

Weaker inflation will most likely allow the major central banks to reduce interest rates in 2024, but the market appears to have already discounted a large extent of the likely easing. We do not anticipate further dramatic falls in interest rates and yields to drive equity multiple expansion over the medium term. This leaves valuations more dependent on fundamentals and earnings growth.

Valuations are not particularly cheap when adjusting for the new discount rate reality: the spread between the MSCI World's cyclically adjusted earnings yield and current US 10-year real yields (our proxy "equity risk premium") is well below long-term median levels. Overall, equities still look slightly expensive relative to bonds.

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Regional equities

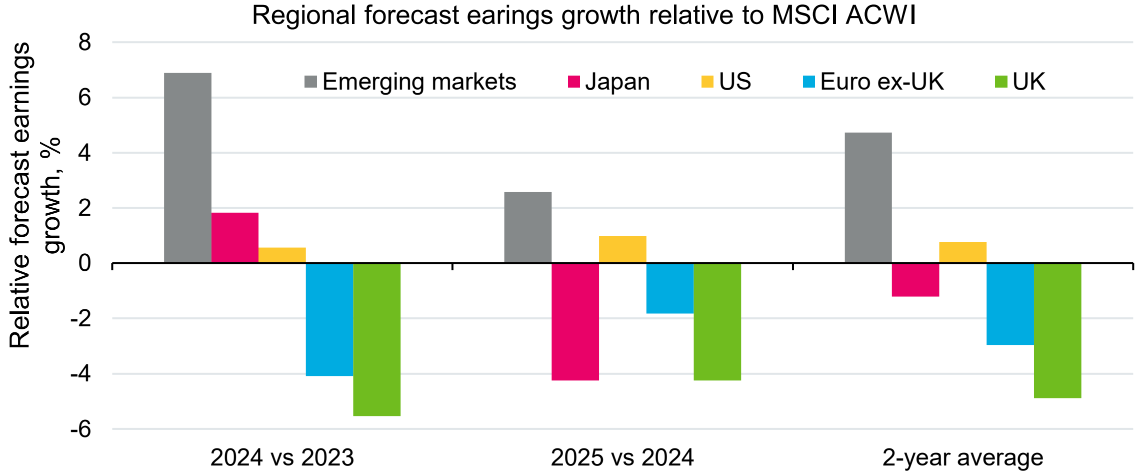
The underperformance of emerging markets over the past few years leaves valuations looking cheap relative to developed markets.

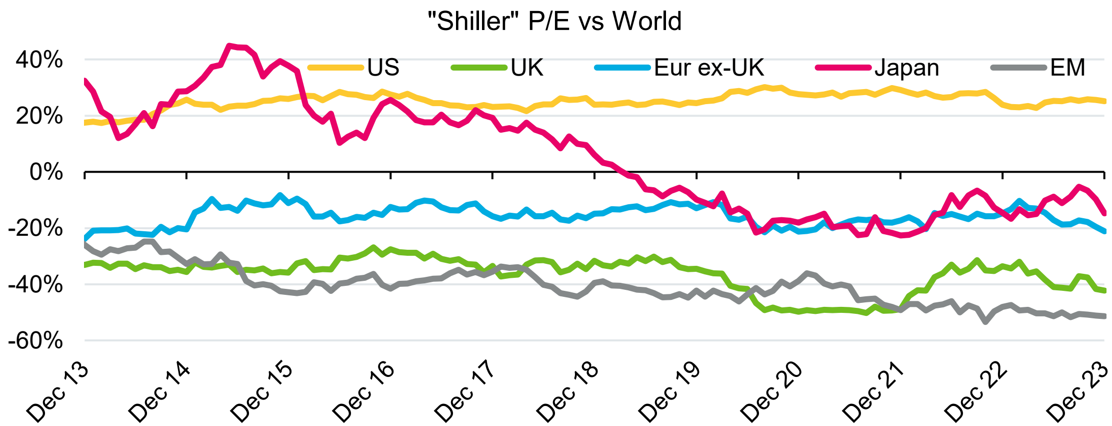
Furthermore, emerging markets are forecast to experience the strongest earnings growth among the major equity regions in 2024 and 2025.

Despite outperformance in 2023, Japanese equities still look relatively cheap, while relative earnings growth forecasts, and ongoing upgrades to those forecasts, remain supportive.

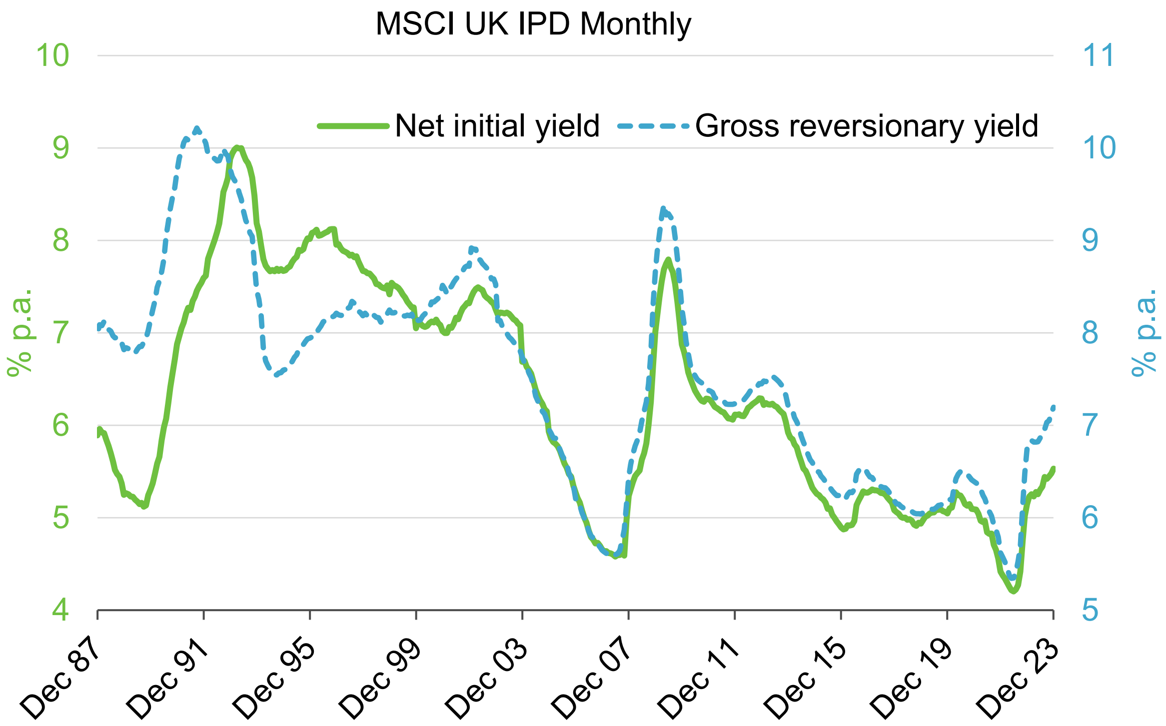
US valuations are high, but look slightly less stretched in the context of usual premium commanded by the tech-heavy market and derive support from relatively strong potential earnings.

We're most cautious on European and UK equities, where a relatively poor earnings outlook may more than offset the ostensible cheapness of these markets.





UK Property



From a valuation perspective, given the 24.4% fall in MSCI UK Monthly Property Capital Value Index since its June 2022 peak, and decent nominal rental growth over the same period, net initial yields, based on current rental income, have risen to 5.5% pa.

Gross reversionary yields, based on estimated rental value, have risen to 7.2% pa, highlighting the increasing potential from asset-management opportunities.

From a fundamental perspective, as inflation has fallen sharply, real rental growth has risen, slightly improving the fundamental outlook for UK commercial property.

On a longer-term view, we expect tenant demand for quality, and more energy and environmentally efficient buildings, to attract tenants and command higher rents. We feel that tenants and owners will increasingly focus on achieving higher EPC and green standards which may cause a bifurcation in the market in the future.

	Fundamentals	Valuations	Technicals	Overall
UK property	Neutral-Unattractive	Neutral	Unattractive	**Neutral-Cautious**