HYMANS ROBERTSON

Capital Markets Outlook Q1 2018 & Q2 to date

Essex County Council Pension Fund

June 2018

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For and on behalf of Hymans Robertson LLP

1.1 Introduction

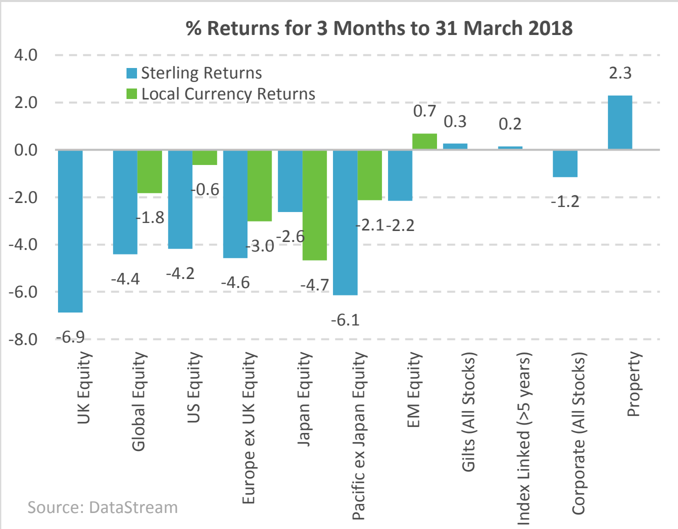
As background to the Investment Tables the majority of this note focuses on Q1 2018 (Section 1.3 onwards). However we have also provided comment on the markets over the year to date in the next section.

1.2 Market Summary to 14 June 2018

Equities	• Global equity indices have struggled to maintain any progress so far in 2018. A strong rise in January as investors focused on the buoyancy of global growth was more than reversed later in Q1 by short-term concerns about inflation and some mixed signals from data releases. • A subsequent rally as economic optimism returned was capped at the end of May by rising political tension in Europe. • Corporate earnings have been strong across all major markets over the past 18 months or so and forecasts are upbeat. However, we are more cautious about the outlook and would argue that earnings already look extended in cyclical terms. • Since the end of the quarter equity markets have recovered and have shown strong performance over the year to date.
Sterling non-government bonds	• Yield spreads narrowed further in January, but subsequently widened, first as concerns grew about tighter monetary policy and rising trade tension, latterly reflecting Eurozone tensions. • Spreads are now above the expensive levels of late 2017, although that partly reflects a deterioration in average credit quality. • Yield spreads on asset-backed securities (ABS) have tightened considerably in 2018 and no longer offer a significant premium over equivalent corporate bonds. ABS are still worth considering as a diversification in low-risk portfolios. • Since the start of the year corporate bonds have returned around negative 1%.
Sub-investment grade debt	• Strong corporate fundamentals, in particular in commodity sectors, are supporting forecasts of lower defaults in 2018 than in 2017, although stress is growing in the retail and US telecom sectors. More generally, if the Fed persists in tightening US monetary policy, default experience could deteriorate. • Even after some widening in response to rising risk aversion in May, spreads remain low by historic standards. • The relative advantage of direct corporate lending still exists, but it is beginning to look less compelling with flows into private corporate lending inevitably leading to lower yields. Sourcing transactions at the right price will prove to be more challenging. We believe there are compelling opportunities elsewhere, for example real estate debt, where an illiquidity premium can be earned. • High yield bonds have returned 0.7% since the start of 2018.
UK property	• Income yields have fallen below 5% p.a., low by historic standards in absolute terms and relative to equity dividend yields, but they continue to provide a reasonable buffer over gilt and corporate bond yields.
Infrastructure	• There is evidence that managers may be finding it more difficult to secure deals. • Our valuation assessment is predicated on managers who are able to secure core infrastructure assets on current income yields of 5-7% p.a. by focussing on deals with a degree of complexity.
Conventional gilts	• Global influences may have dominated this year's moves in gilt yields – rising in the wake of US economic resilience and monetary tightening, falling back in response to Eurozone political risk. • Current valuations and the poor returns they imply for long-term investors remain the main reason for our cautious/negative view of this asset class. • Demand for gilts to hedge pension and insurance liabilities remains strong. • Nominal gilt yields over 2018 have remained relatively flat.

Index-linked gilts	• Inflation protection remains very expensive, particularly in the UK where the demand for index-linked gilts is greater than the supply. • We expect real yields to closely follow nominal yields over 2018, with higher levels of inflation already baked into pricing. • Any increase of cash rates earlier than expected has the potential to impact the short-end of the curve, however, ongoing demand for index-linked gilts by UK institutions should continue to dampen the potential for real yields to rise.
Cash strategies	• With many assets looking stretched on valuation, managers will look to benefit from market corrections. • Active currency and interest rate calls may remain challenging given the lack of political predictability. • Cash provides flexibility to capture more attractive buying opportunities.

2.1 Market Background to 31 March 2018



The global economy ended 2017 in fairly fine fettle despite quarter-on-quarter growth slowing marginally in Q4. The UK, struggling to match the strong showing of 2016, continued to lag. Business conditions, as reflected in PMI manufacturing surveys, have perhaps cooled a little in 2018 without threatening to fall to levels consistent with contraction.

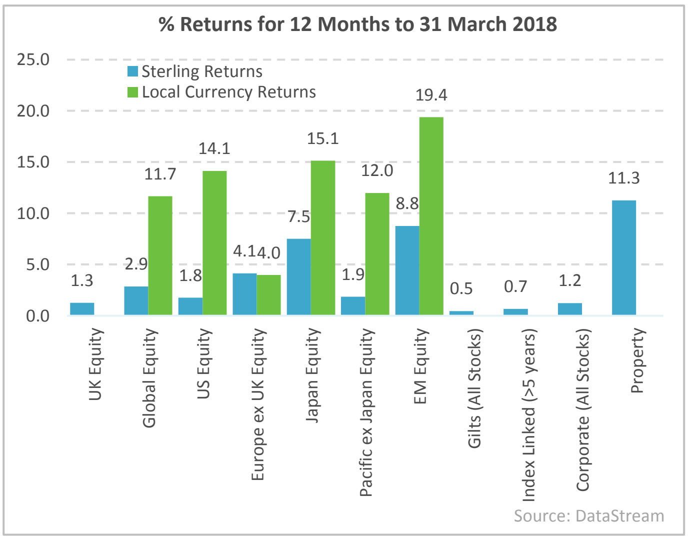
Underlying inflation rates remained relatively stable in the major economies, although investors were briefly unsettled by higher-than-expected US wage growth in January. UK CPI inflation fell from 3% to 2.7% in February. Even so, there is speculation that interest rates may rise in May. The US Federal Reserve, under a new Chairman, continued to tighten policy gradually raising rates by another 0.25%.

Global economic momentum and inflation concerns helped to push government bond yields higher at the start of the year. Inflation concerns receded later, particularly outside the US. Long-dated gilt yields fell over the quarter, although 10-year yields rose.

Oil prices pushed higher – Brent crude reached a three-year high of $70 a barrel. The impact of rising US production was tempered by declines in Venezuela, prospects of renewed US sanctions on Iran and strong demand. In contrast, industrial metals prices fell sharply – relevant indices were down 7%.

Buoyant global growth supported credit markets at the start of the year. Yield spreads narrowed further in January, but ended the quarter higher as concerns grew about tighter monetary policy and rising trade tension.

Similar factors drove equity returns. Global equity indices rose strongly in January, but fell over the quarter as a whole. Sterling's strength further reduced returns to unhedged UK investors. The best regional performance came from Emerging Markets, extending the relative momentum of 2016 and 2017. Sterling's strength contributed to the underperformance of the UK market, because of the significance of foreign earnings.



Technology remained investors' favourite sector, although the current travails of Facebook were putting this position under threat as the quarter closed. Telecommunications was the worst performer – rising US rates may be undermining what is a preferred area for income investors.

The turn of the year brought little change for the UK commercial property market. Capital values and rents nudged higher. Again, this was driven primarily by strong growth in Industrials, although there are some signs that the sector's rental growth may be flagging.

2.2 Key market data

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

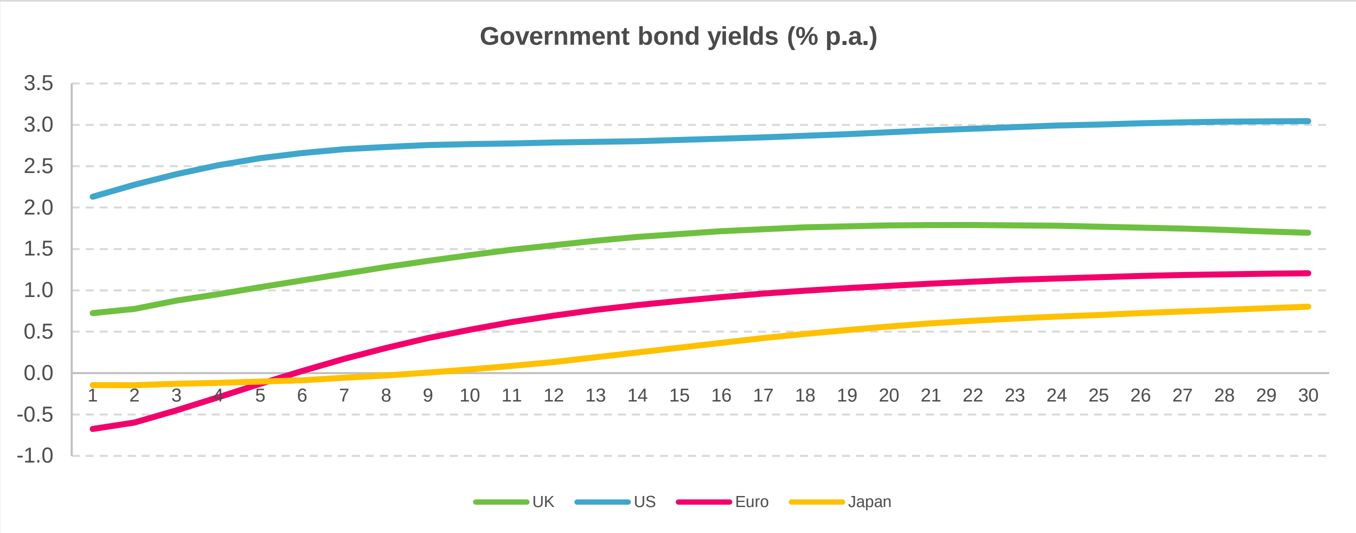
	31.03.17	30.06.17	30.09.17	31.12.17	31.03.18
UK Equity yield	3.5%	3.6%	3.7%	3.6%	3.9%
UK Equity P/E ratio (FTSE)	28.3x	27.5x	24.4x	21.2x	12.8x
Over 15 year gilt yield (p.a.)	1.7%	1.8%	1.8%	1.7%	1.6%
Over 5 year index-linked gilt yield (p.a.)	-1.7%	-1.6%	-1.5%	-1.7%	-1.7%
iBoxx Over 10 year Non-gilt yield (p.a.)	2.8%	2.8%	2.9%	2.8%	2.9%

Source: DataStream

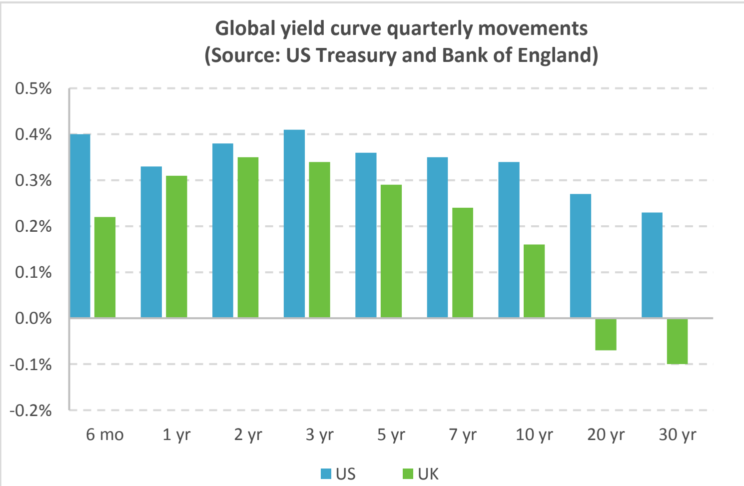
	Year to 31.03.17	Year to 31.03.18	Quarter to 30.06.17	Quarter to 30.09.17	Quarter to 31.12.17	Quarter to 31.03.18
FTSE All Share	21.9%	1.3%	1.4%	2.1%	5.0%	-6.9%
Global Equity	33.1%	2.9%	0.5%	1.9%	5.1%	-4.4%
Over 15 year gilts	12.3%	2.2%	-2.3%	-0.5%	3.7%	1.5%
Over 5 year index linked gilts	22.0%	0.7%	-2.4%	-0.8%	3.9%	0.2%
All Stocks Non-Gilts	9.2%	1.2%	0.5%	0.1%	1.8%	-1.2%
IPD Monthly Index	3.8%	11.3%	2.5%	2.7%	3.4%	2.3%

Source: DataStream

3.1 Global Bond Markets



Global economic momentum and inflation concerns helped to push government bond yields higher at the start of the year. US yields led the way with the Federal Reserve raising its benchmark interest rate from 1.5% to 1.75% following strong US wage growth data. In Europe, government bond yields rose sharply at the beginning of the quarter, but retreated in March following dovish comments by the ECB.



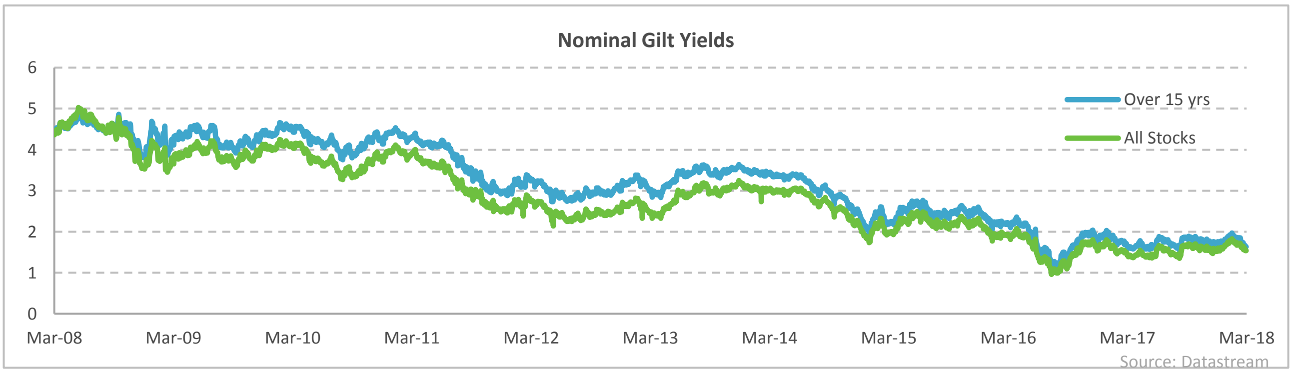
In the UK, yields on longer dated gilts fell, as the Bank of England kept interest rates on hold whilst signalling a potential rate rise in May. However, 10-year gilt yields were still up 16bps over the quarter.

The mixture of solid growth and stable inflation has allowed central banks to stick with their modest tightening bias. The ECB remains on course to finish its QE programme in September; the course of US monetary policy seems little affected by the advent of a new Chair, Jerome Powell – interest rates were raised by another 0.25% p.a. in March. In the UK interest rates remained unchanged in March, although strong labour market data and accelerating wage growth have increased the likelihood of a rate rise in May.

On a relative value basis, UK gilts are yielding more than German and Japanese government bonds, but are more than 1% p.a. lower than US Treasuries at nearly all durations. Higher yields in the US likely reflect a combination of how much further ahead the US is in relation to its interest rate cycle, and of course, the concerns surrounding Brexit and future corporate investment in the UK.

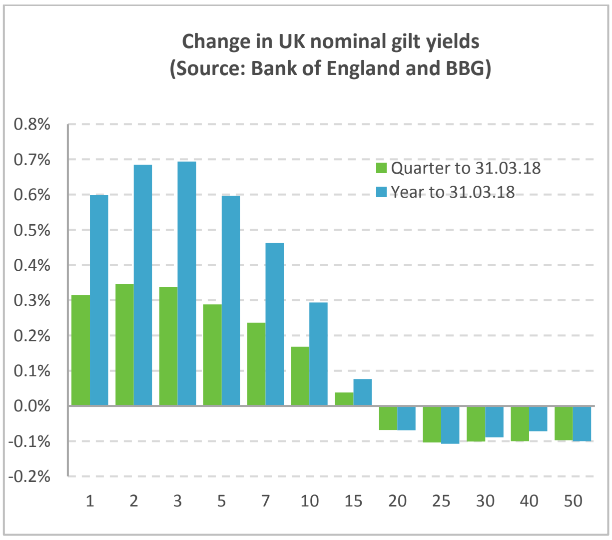
US Treasury rates are now above 2.5% beyond 5 years. Long-term rates are over 3%, suggesting normalisation is now well priced into the US curve. This is very different for the UK market as discussed in the next sub-section.

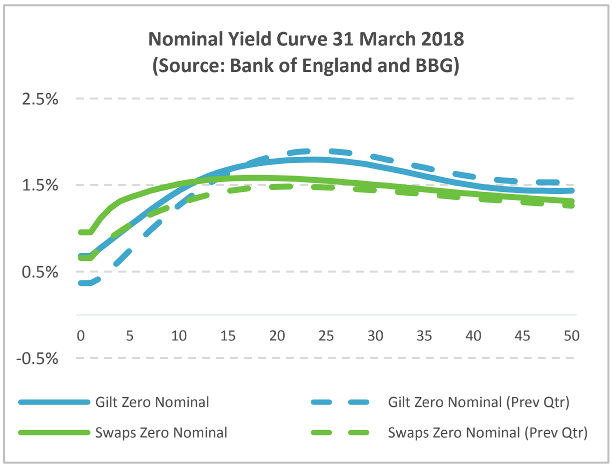
3.2 UK Interest Rates

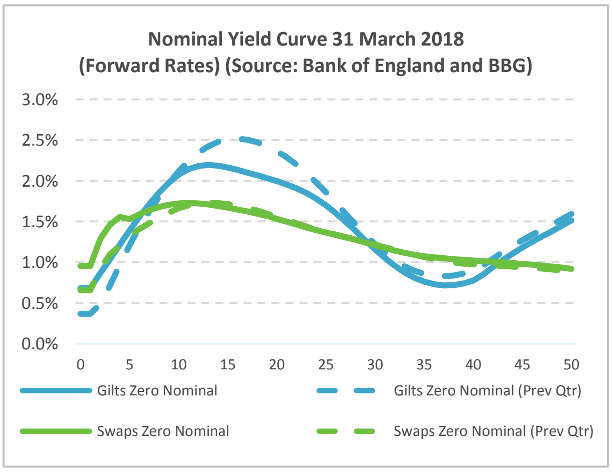


With 10-year yields around 1.4% p.a., we are still reluctant buyers of gilts, albeit a little less reluctant than we were when they were 1.2% p.a. at the end of 2017. This modest rise is consistent with what has been happening in other major markets.

Strong demand for gilts to hedge pension and insurance liabilities from limited supply continues to provide strong technical support. However, we note this demand will peak at some stage. Our latest research paper attempts to work out when that peak will occur and discusses the impact it may have on the market. https://www.hymans.co.uk/news-and-insights/research-and-publications/research/the-age-of-peak-ldi-report/.





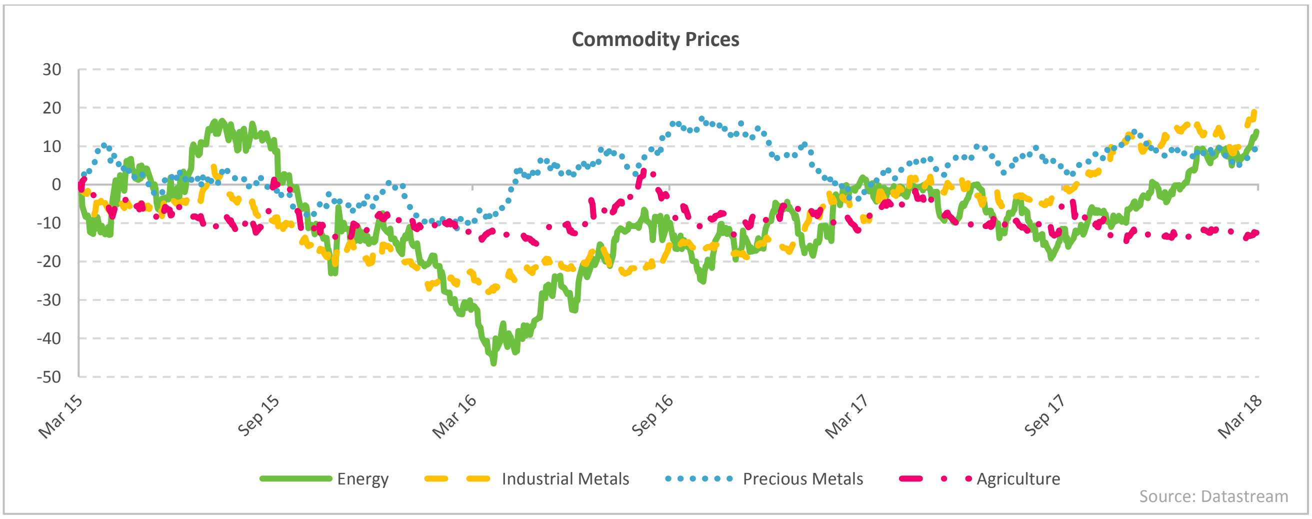


The flattening of the yield curve exacerbates an issue we have highlighted before: the very low level of future interest rates implied by gilt prices – forward gilt yields are below 1.5% p.a. beyond 30 years. Where de-risking involves increase to interest rate hedging programmes, we still recommend adopting a flexible approach.

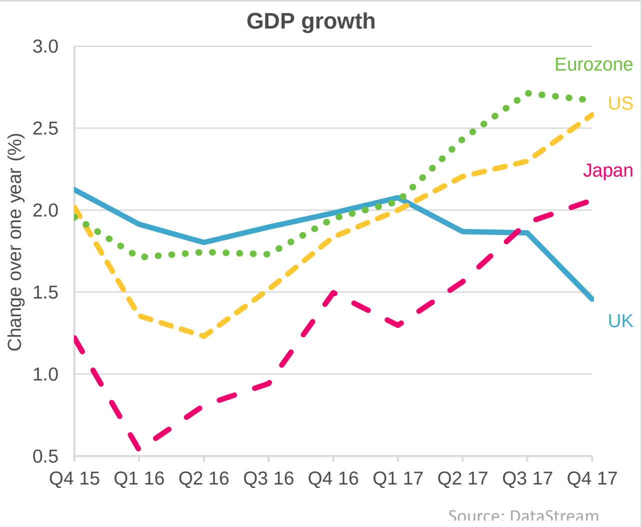
Fundamentals	Valuations	Technicals
Neutral	Unattractive	Neutral to Unattractive

3.3 Inflation and real rates

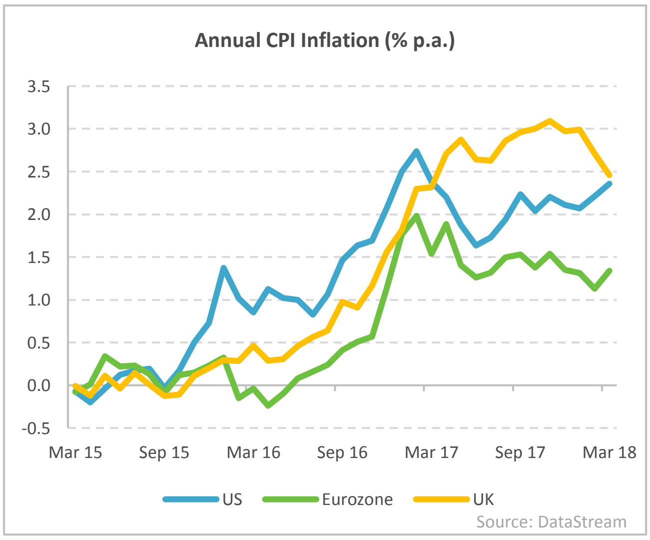
Oil prices pushed higher – Brent crude reached a three-year high of $70 a barrel. The impact of rising US production was tempered by declines in Venezuela, prospects of renewed US sanctions on Iran and strong demand. In contrast, industrial metals prices fell sharply – relevant indices were down 7%.



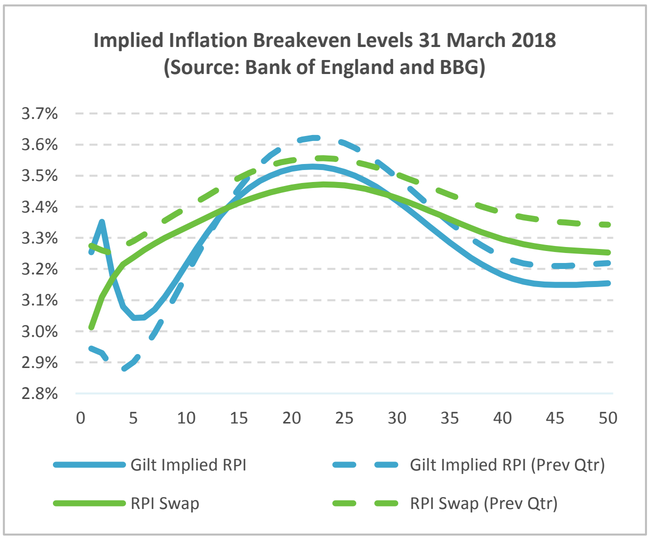
Q4 economic data confirmed that global growth remained buoyant through to the year-end although the UK continues to lag behind its peers - the UK's Q4 growth was the lowest in the G7. UK growth forecasts for 2018 have been revised up 0.1% to 1.6%. Meanwhile US growth forecasts for 2018 and 2019 remain upbeat (2.8% and 2.6%, up 0.3% and 0.4% respectively) and Europe is forecasted to rise at 2.4%, up from 2.1% three months ago.

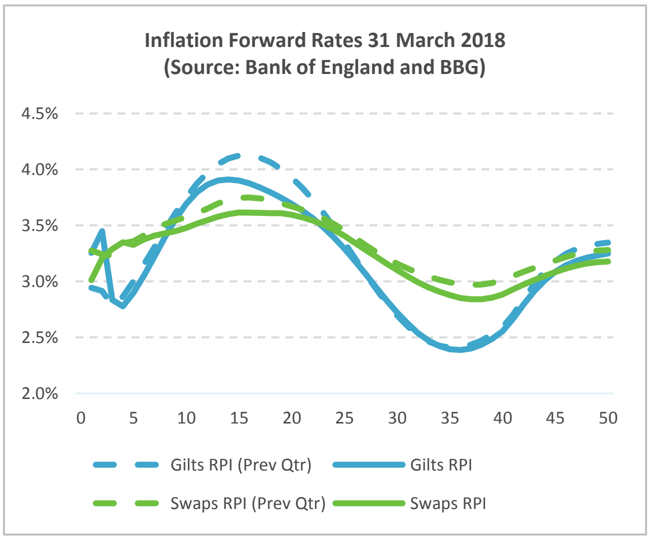


Business conditions, as reflected in PMI manufacturing surveys, have perhaps cooled a little in 2018 without threatening to fall to levels consistent with contraction. There has been nothing this year to match the concern that a US recession might be imminent that marked the start of last year, although rising trade tension between the US and China has clouded the outlook in recent weeks.



A more immediate concern for markets has been the possibility that the longevity of the upturn in growth would stoke inflationary pressure. So far, the evidence is scant. Core inflation in the US and Eurozone has changed little since the middle of 2017 and it has edged above zero in Japan. The UK saw more evidence that the peak in inflation has passed: CPI inflation fell to 2.5% p.a. in March. Even so, there is speculation that interest rates may rise in May.

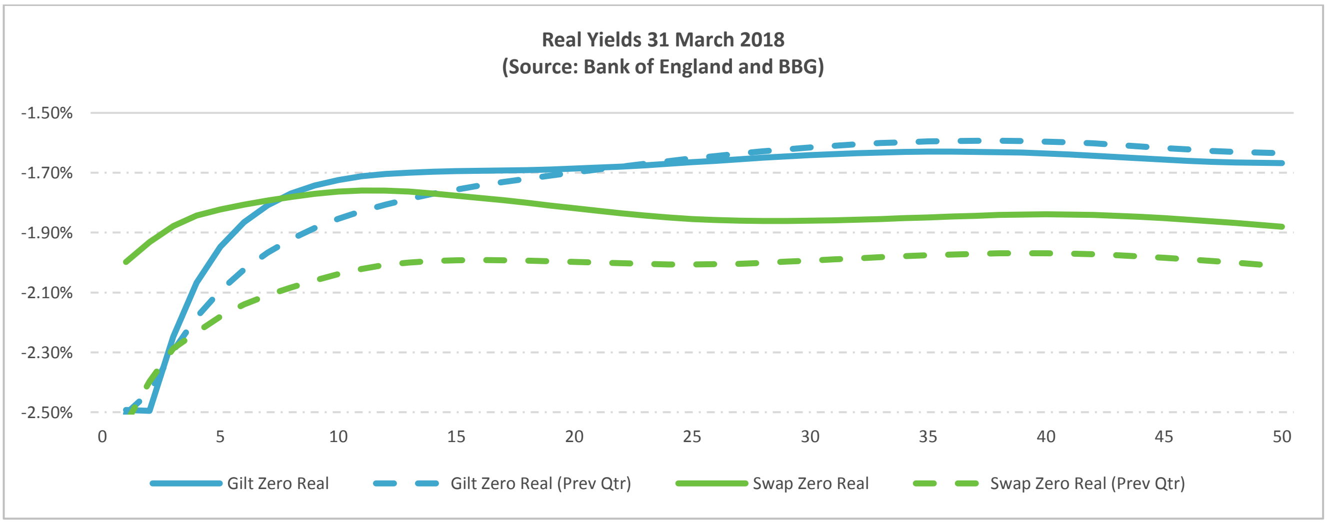




Our view remains largely unchanged from last quarter. With both inflation expectations and nominal yields stabilising towards the end of 2017, real yields on government bonds moved broadly sideways.

The UK remains expensive relative to global inflation linked markets: real yields on ILG (after allowing for RPI assumed to be c.1% pa higher than CPI) are yielding slightly less than their German equivalents, and are more than 1% pa lower than US TIPS. Across the term structure, gilt inflation pricing remains above 3% up to 25 years, with forward inflation falling to 2.5% between 30 and 40 years. However, this is also where forward nominal rates are very low, i.e. real yields remain low across the curve.

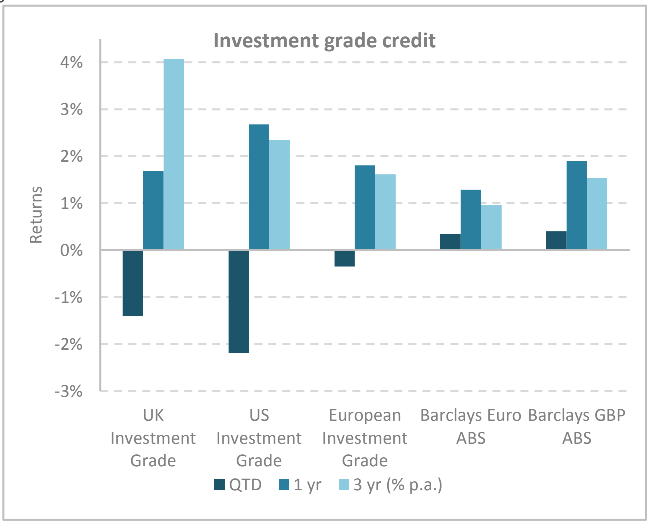
We expect real yields to continue to closely follow nominal yields over 2018, with higher levels of inflation already factored into pricing.

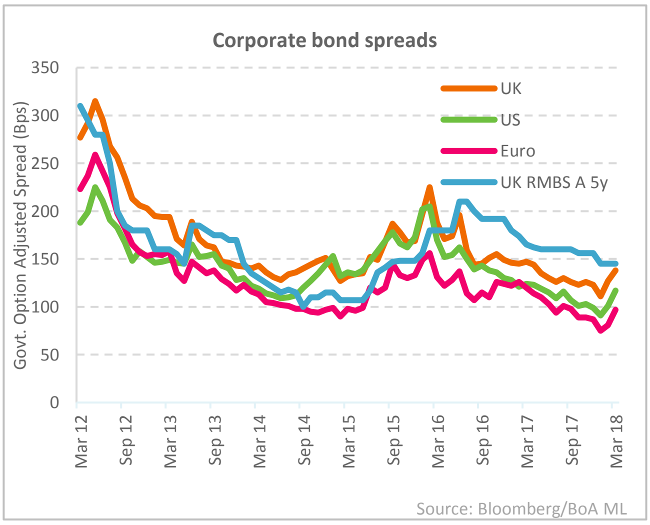


3.4 Investment Grade Credit

ML Non-Gilts Spreads over Gilts (Source: Datastream)	Sterling Non-Gilts (bps)	Sterling Non-Gilts Over 10 Years (bps)	Global Broad Market Corporate (bps)
31 December 2017	101	107	117
31 March 2018	117	126	141
Median spread over last 10 years	152	132	171
Average spreads over last 10 years	169	150	200

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.





A buoyant global economy has been good for credit markets, helping to minimise default levels. Forecasts suggest that defaults will be lower in 2018, as the effect of the fall in oil prices in 2014 and 2015 on indebted energy companies fades further.

Of course, one consequence of the favourable background has been to drive yield spreads down to historically low levels. Spreads widened in the first quarter: modest tightening at the start of the year as economic optimism mounted was more than unwound as the optimism waned. Despite widening, valuations still remain below long term averages especially for shorter dated maturities and at current levels, room for spread tightening is limited, leaving coupon income as the main source of return.

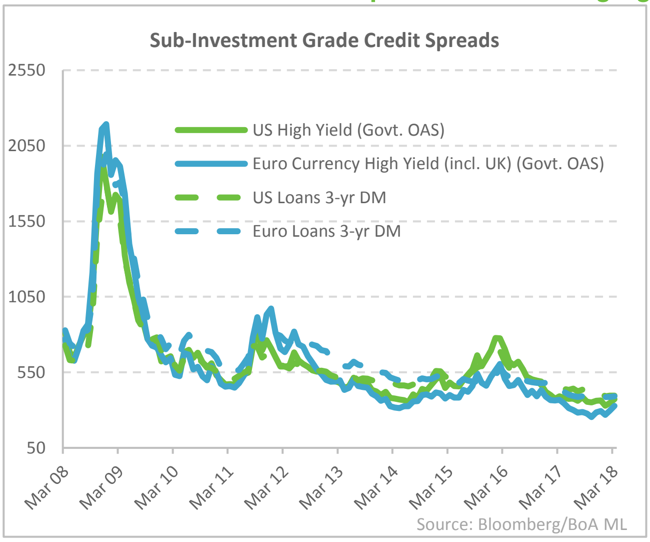
The exception to spread widening is the UK ABS market. Low unemployment rates in UK and Netherlands and falling unemployment rates in Europe are positive for ABS and new issues are heavily oversubscribed despite a healthy pipeline. The end of the UK TFS may ultimately lead to this tightening reversing.

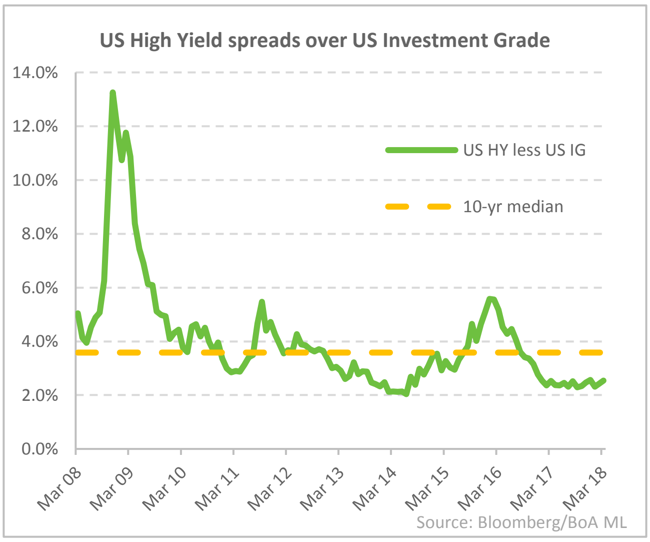
In terms of relative value, UK IG corporate offers spread premium over US and European IG, but it is difficult to see this premium narrowing given Brexit uncertainty. The main risk to future returns from UK IG corporate remains the direction of gilt yields, rather than any expectation of a material widening of credit spreads.

Technicals are currently supportive for IG bonds as the carry trade remains compelling. The ECB's purchase programme will continue until September 2018 and with continued weak inflation numbers looking set to continue for the foreseeable future, it seems unlikely the ECB will withdraw the stimulus quickly.

Fundamentals	Valuations	Technicals
Neutral to attractive	Unattractive	Neutral

3.5 Sub Investment Grade Corporates and Emerging Market Debt

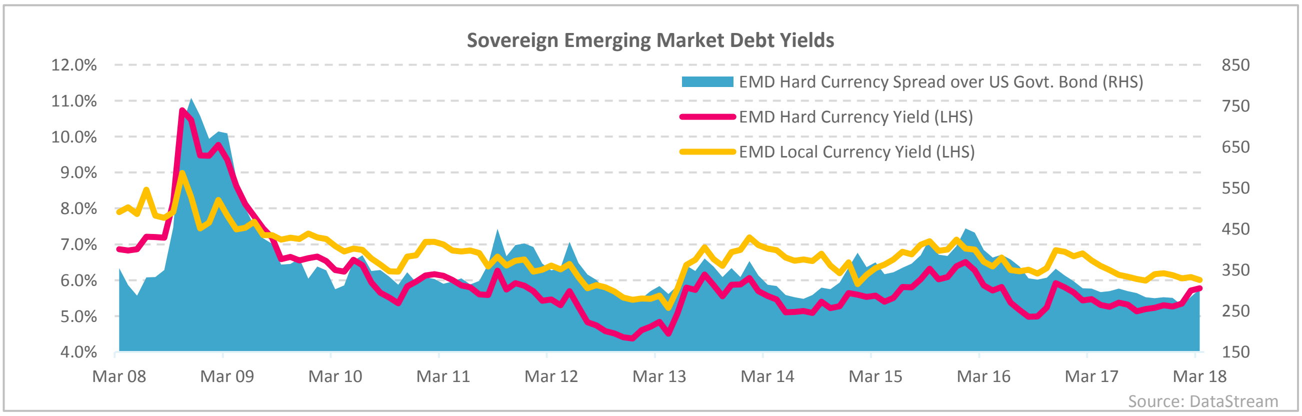




Despite the increased volatility in Q1 2018 causing high yield spreads to widen over the period, valuations for both the high yield and loan markets continue to look expensive on a historic basis. That said, corporate fundamentals remain firm, leverage levels remain stable and interest coverage in general has increased. Furthermore, default levels remain below historic levels in Europe and are improving in the US as conditions in the commodity sector continues to recover.

The relative advantages of direct lending is beginning to look a little less compelling following spread compression and indications that the this market has become more borrower friendly. That said, the level of spread compression has been far less than the traded markets. The direct lending market experienced record capital raised in 2017 ($54bn) up over 40% from the previous high recorded in 2015. Increased competition is likely to put pressure on lending terms and sourcing transactions in 2018. We believe real estate debt can offer both some diversification of underlying risk and the possibility of enhanced returns to an illiquidity premium. Relative to pre-crisis levels, loan margins continue to be higher and LTVs lower.

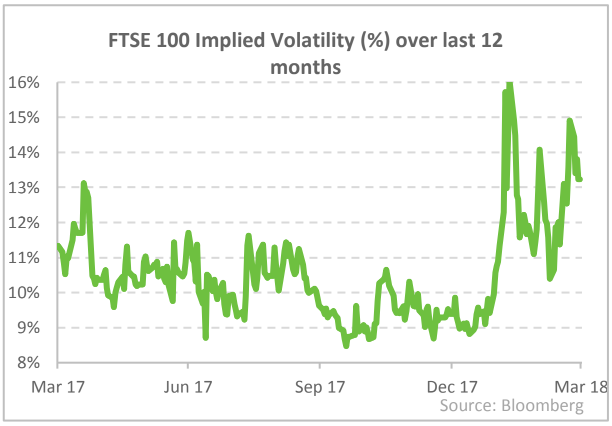
	Fundamentals	Valuations	Technicals
Public markets	Neutral to attractive	Unattractive	Neutral
Private markets	Neutral to attractive	Neutral	Neutral

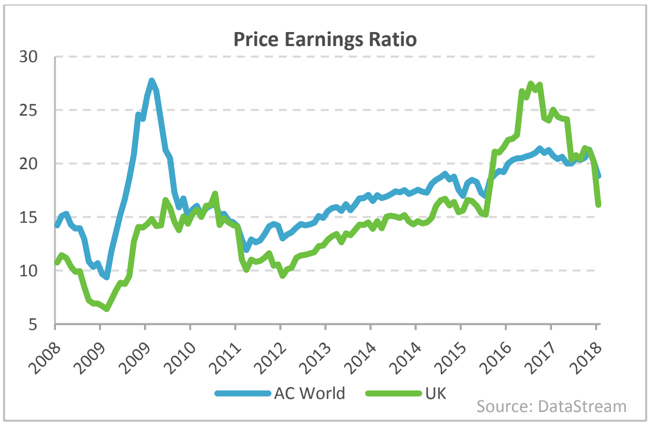


Emerging market debt (EMD) continues to offer attractive spreads relative to developed markets. The macro-economic environment for Emerging Markets continues to be solid, with GDP growth improving and lower inflation across many countries. The risk of protectionism has re-surfaced, with the US government announcing details of a raft of tariffs on Chinese imports.

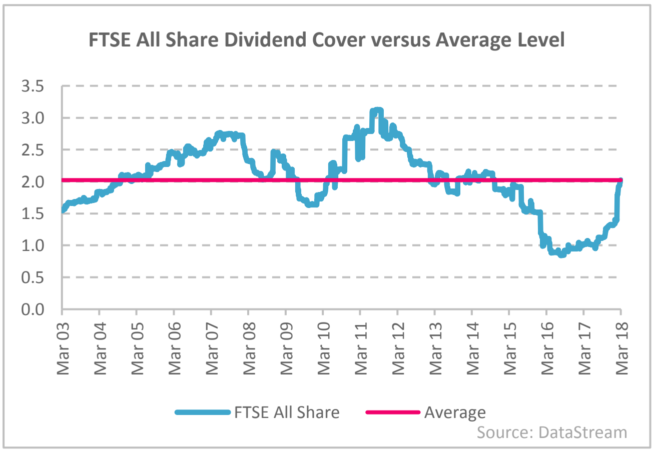
3.6 UK Equity Market

Equity Market Data (Source: Datastream)	31 December 2017	31 March 2018
FTSE All Share Dividend Yield	3.6%	3.9%
Dividend growth over the quarter	1.7%	-1.1%
Dividend growth over the year	12.8%	8.3%
FTSE All Share P/E Ratio	21.2x	12.8x
Total Return during the quarter	5.0%	-6.9%
Total Return over the last 12 months	13.1%	1.3%





The first quarter of 2018 saw a return of volatility in equity markets, with equities recording their first negative quarterly performance since Q3 2015. Equity markets started the quarter strongly and were rising until late January when they sold off following concerns over the course of interest rates. This sell-off lasted nearly two weeks before markets settled and then rebounded. A second sell-off occurred in mid-March following concerns over the potential for a trade war between the US and China.

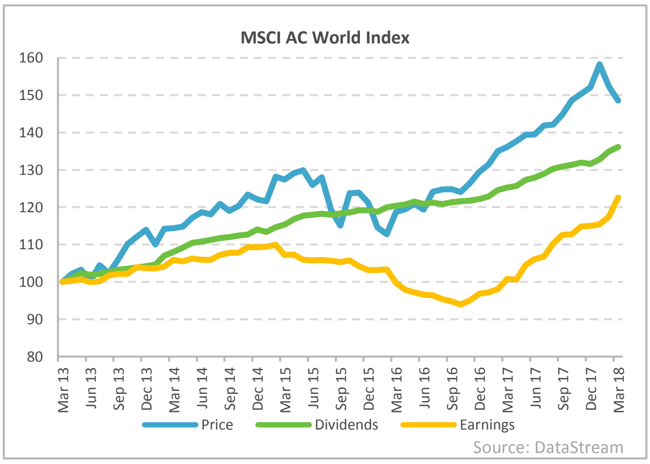


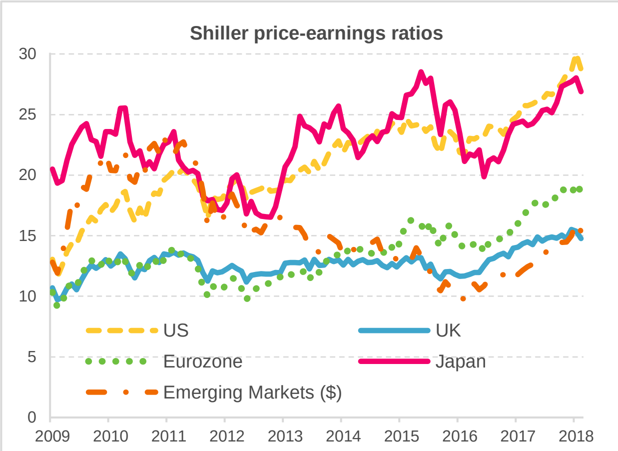
The poor return on UK equities was in part due to the strengthening of sterling over the quarter, providing a headwind for the UK's larger, more globally-focused names, which derive a high proportion of their revenues overseas.

A 10% fall in UK equities from January’s peak to March’s trough has improved valuations, and dividend cover is back to historic average levels. Relative to historic levels and to global equities, the UK market P/E does not look unreasonable.

3.7 Overseas Equity Markets

Equity Market Data (Source: Datastream)	31 December 2017	31 March 2018
Dividend Yield	2.3%	2.4%
Total Return during the quarter (£)	5.1%	-4.4%
Total Return during the quarter (Local)	5.6%	-1.8%
Total Return over the last 12 months (£)	13.8%	2.9%
Total Return over the last 12 months (Local)	20.3%	11.7%

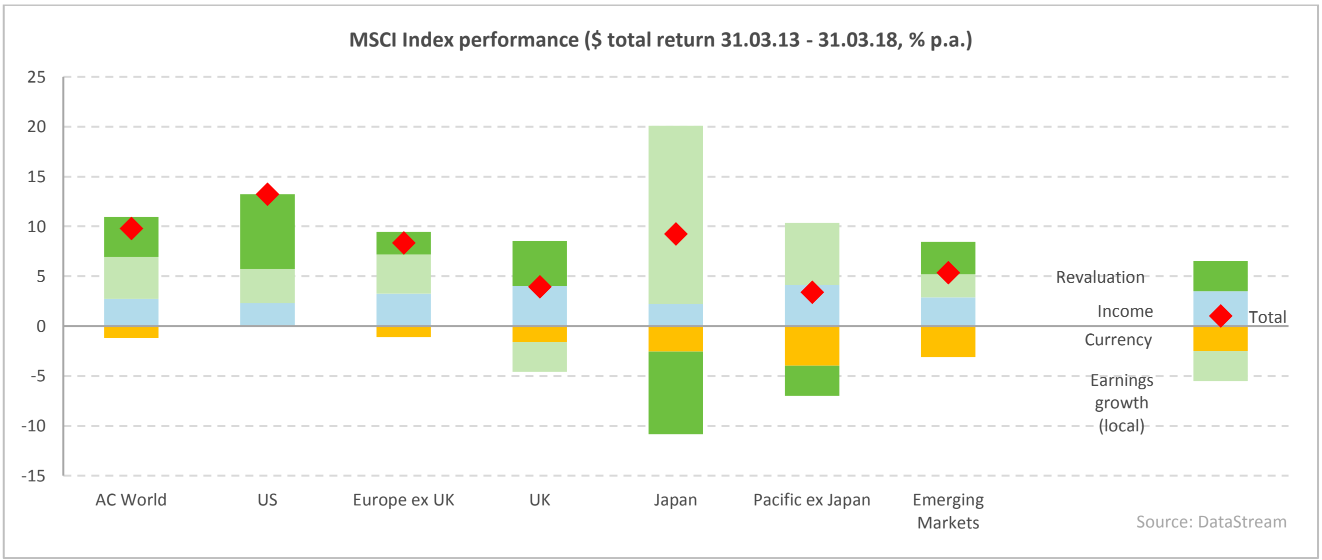




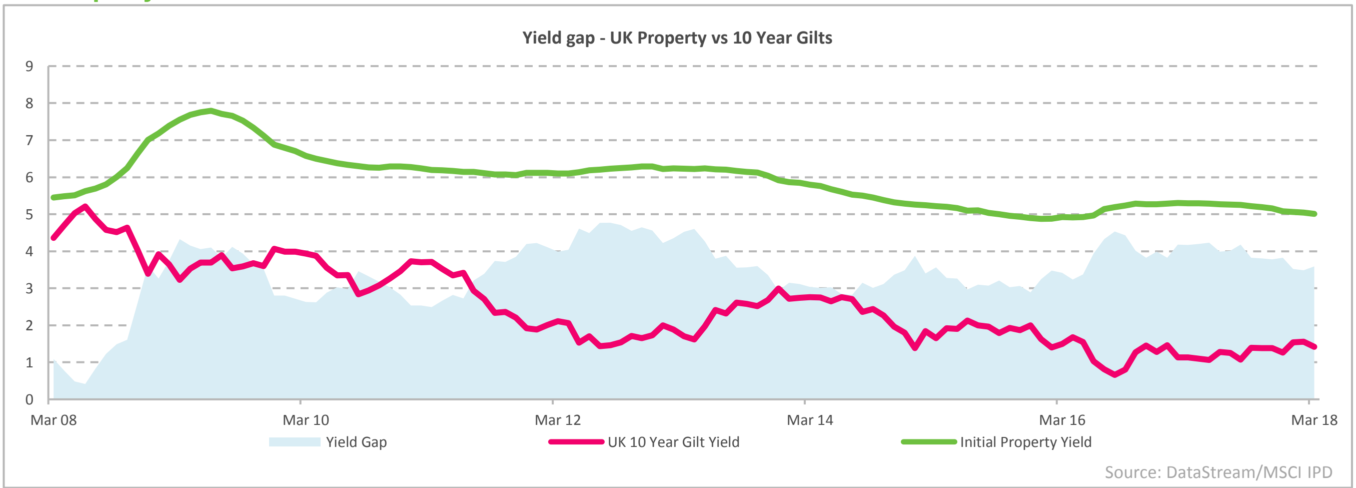
Synchronised global economic growth has supported equity markets over the past 18 months. However, there are questions over the sustainability of current growth rates as the interest rate cycle progresses. The recent US-China trade disputes have added to this uncertainty. Corporate earnings have been strong across all major markets over the past year. However, the short term noise from the US tax reforms has made it more difficult to determine the underlying growth rate for the Q4 reporting season.

The very positive equity sentiment from last year has been hit over the last quarter by concerns over valuation levels (in some areas) and the sustainability in global growth momentum. The “Shiller” price-earnings ratios chart attempts to look through cyclical variations by using the average of the last 10-years’ EPS adjusted for inflation. On this measure, the correction in equity markets has only done a little to improve valuations. The US (accounting for over half of global indices) may be mainly to blame for the level valuation, but valuation in other major developed markets are at or close to post-crisis highs. Emerging markets, despite their relative strength of the last two years, still look less stretched relative to their own recent history.

Fundamentals	Valuations	Technicals
Neutral	Neutral to unattractive	Neutral



3.8 Property



UK Property

In aggregate, capital values and rents continue to edge higher and Industrials continue to drive most of the growth. Anecdotal evidence suggests bargaining power continues to ebb from landlords to tenants in some office and retail markets. Current yields remain low relative to their long term average, but continue to provide a reasonable absolute level of income and a buffer relative to gilts and corporate bonds to absorb rate rises to an extent.

Fundamentals	Valuations	Technicals
Neutral to Unattractive	Neutral to Unattractive	Attractive

Infrastructure

There is building evidence that managers may be finding it tougher to secure deals that will meet return objectives. Annual transactions fell in 2017 for the first time in a decade (Preqin Global Infrastructure reports a drop of 6% drop by number and 8% by value) despite record levels of dry powder. Performance hurdles in some new funds are at lower levels than has been typical in the past.

That said, we continue to see fund managers who are able to secure core infrastructure assets on current income yields of 5%-7% p.a. by focusing on deals with a degree of complexity in implementation or on deals where they have a competitive edge (e.g. through consolidation of fragmented markets). Our valuation assessment is predicated on this type of added-value implementation.

Fundamentals	Valuations	Technicals
Neutral to Attractive	Neutral	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