Capital Markets Outlook Q4 2017

Essex Pension Fund

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For and on behalf of Hymans Robertson LLP

Initial Comments on post year end volatility

After a relatively benign 2017 with asset markets continuing their strength, the end of January/beginning of February 2018 has seen both an increase in volatility and some high profile corporate issues with both Carillion and Capita facing challenges.

At the time of writing (7 February) equity markets (as measured by the FTSE 100) had fallen some 8% since the market highs reached in mid-January. Although significant in terms of short term volatility, this should be considered in the context of the multi-year strength of equity markets. Further, we view this as a reality check that equity markets are risky, experience volatility and must be considered in a long term perspective. It also strengthens our resolve around implementing de-risking at opportune times (as the ISC are discussing).

The abrupt turn in sentiment suggests some market participants may have forgotten the realities of equity investment, after the incredibly low levels of volatility throughout 2017. The acceleration in the sell-off in US equities also suggests that many investors have sought to lock-in recent profits and sell their holdings in case markets fall further, exacerbating the sell-off.

In the absence of any specific triggers, many commentators have been searching for data points, such as strong US wage inflation data, to explain the recent market moves. Although strong US wage inflation data (alongside record low unemployment) would suggest a buoyant backdrop for equity markets, it is the secondary impact on interest rates that have caused concern for investors. US 10-year yields are as high as they have been for four years and haven't sustained significantly higher levels since the middle of 2011. However, while there has clearly been a change to market sentiment, it would be premature to suggest that the fundamental backdrop has changed. The US wage inflation statistic is just one data point and some have highlighted the rise in minimum wage in several US states and an unusual drop in hours worked as potential distorting factors. That said, US monetary policy over the last year has reflected a view in the Federal Reserve that the fall in US inflation was a temporary phenomenon. Last year bond yields tended to rise ahead of monetary policy changes and then drift back lower, as investors were reassured by short-term inflation numbers. The current behaviour of bond yields might be better portrayed as a greater alignment of view between investors and central bankers, rather than a sudden change to the economic outlook. Of course, should inflation expectations start to rise sharply then equity markets (and of course bond markets) would be vulnerable.

Closer to home, UK gilt yields have risen to levels higher than any witnessed in 2017 over short-to-medium durations. However, at longer durations yields are broadly in line with the levels seen at the end of Q3 17.

In summary, the increase in yields and sell-off in equity markets does not appear, at this stage, to reflect any significant change to the fundamental market backdrop. Both movements suggest a short-term market correction, rather than a longer-term market collapse.

In relation to Capita and Carillion, the impact in terms of investment is small (pre the latest news they were less than 0.2% and 0.1% of the FTSE All Share respectively and therefore much less in the global equity approach adopted by Essex). Where we would envisage a greater impact is in relation to admitted bodies in the Fund supported by the covenant of these employers. We would therefore advise consideration of this by the PSB.

Further update to mid-March

Key market indicators:

- There has been upward revision of global growth prospects and employment data has also been robust. Hence, as spare capacity continues to be used up, wage inflation is expected to pick up.

- Given the Fed's dual mandate – inflation target of 2% (as measure by Personal Consumption Expenditures "PCE") and low unemployment target – investors are concerned about Fed's reaction to this backdrop. In other words, the pace and magnitude of base rate hikes and monetary policy tightening is uncertain.

UK company news:

- Investors are becoming increasingly nervous about bonds of high street retailers and food outlets as pressure mounts from online competition and rising input costs. New Look and Prezzo are amongst the high-profile names in "distressed" territory. Both companies are in the process of undergoing "company voluntary arrangement" where lower rents are being negotiated with their respective landlords.

US vs China trade war:

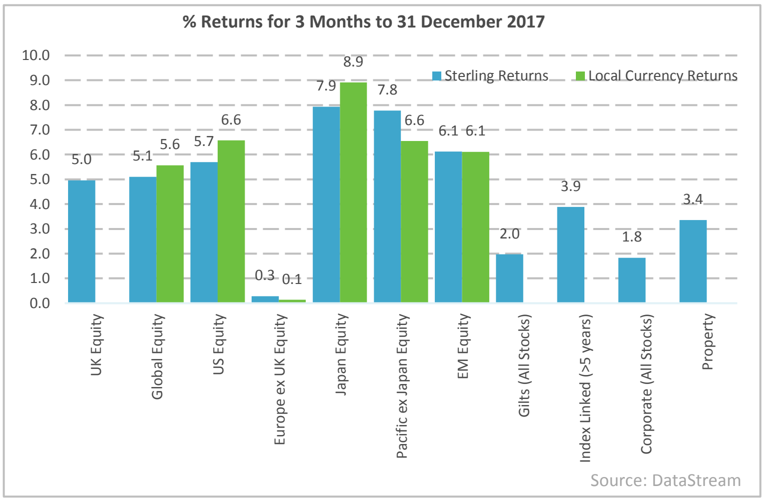
- On the campaign trail, Trump stated he wanted high tariffs on all Chinese goods – 45% in some cases.
- Early signs of this protectionist stance was demonstrated in Trump's administration's recent proposal of a 25% tariff on steel imports and a 10% tariff on aluminium imports from China.
- Despite the headline figures, aluminium and steel exports account for 0.02% of Chinese GDP so will not have a material impact on Chinese economy (Canada is likely to be impacted the most from Trump's new tariffs).
- However, these changes could be the prelude for a 'tit-for-tat trade war' with material losers on both sides.
- Ultimately, higher import costs are likely to lead to lower profits for companies unless they are passed onto the end consumer where they will be subject to higher prices.

Markets

- Since the initial bout of volatility, markets have broadly traded sideways (but with continued volatility). The impact on UK investors in overseas assets has been offset to a degree by sterling weakness.
- Gilt yields are marginally higher than where they started the year.

Market Background for Q4 '17

Economic conditions were supportive of investment markets over the final quarter of 2017: inflation stabilised, corporate earnings continued to rise and indicators suggested that global economic expansion, if anything, was picking up pace. Q3 data confirmed robust growth in the US, Eurozone, and Japan whilst UK growth remained sluggish at 0.4% (albeit still ahead of expectations).

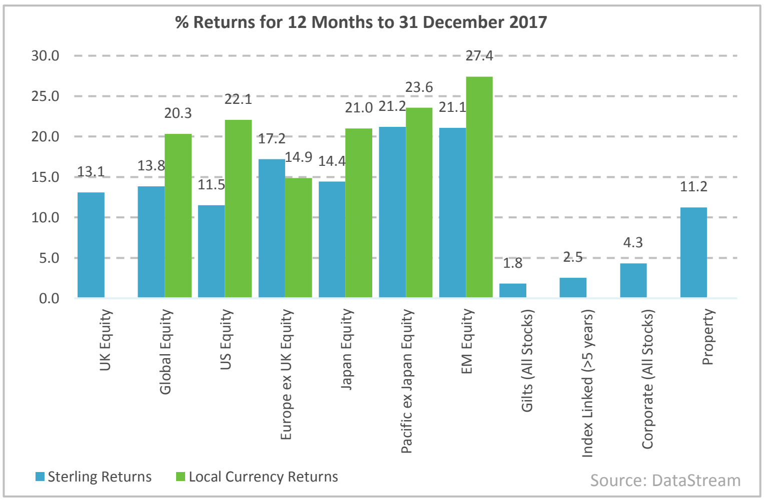


As almost universally expected, the Bank of England's Monetary Policy Committee increased interest rates by 0.25% p.a. to 0.5% p.a. despite sluggish UK economic conditions. There was little surprise about the tightening of monetary policy announced elsewhere – a tapering of quantitative easing in the Eurozone and another US interest rate rise.

Oil prices continued to rise with Brent crude finishing the year at $67 a barrel, the highest price since 2015. Industrial metals were also strong over the quarter – broad price indices for the sector rose over 30% in 2017.

Global equity indices had another strong quarter, bolstered by a continued positive economic outlook. Sentiment was also boosted by the agreement of significant reductions to US corporate tax rates. The best regional equity performance came from Japan which is now enjoying its longest economic expansion since the 1990s. European equities underperformed – economic conditions remain buoyant, but the strength of the euro over the last two years is increasingly seen as likely to depress future profits growth. As might be expected in a market rally, defensive stocks – Healthcare, Telecommunications and Utilities – lagged. The best performers – Basic Materials, Technology and Consumer Services – are typically beneficiaries of economic strength. This has been a familiar trend over 2017 with growth stock significantly outperforming value stocks.

In fixed income, government bonds posted positive returns over the quarter. Long-dated gilt yields (both conventional and index-linked) drifted lower over the quarter, finishing 2017 little changed from the end of 2016.



Credit spreads finished close to end September levels. Some company-specific disappointments from a few major issuers did cause a wobble in the high yield market in particular, but sentiment recovered quickly.

UK commercial property values, as reflected in the IPD UK Monthly Index, have risen further. The very gentle acceleration in the pace of the rise, evident throughout 2017, has persisted. The industrial sector continues to outstrip both office and retail sectors in terms of both total return and rental growth.

Key market data

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

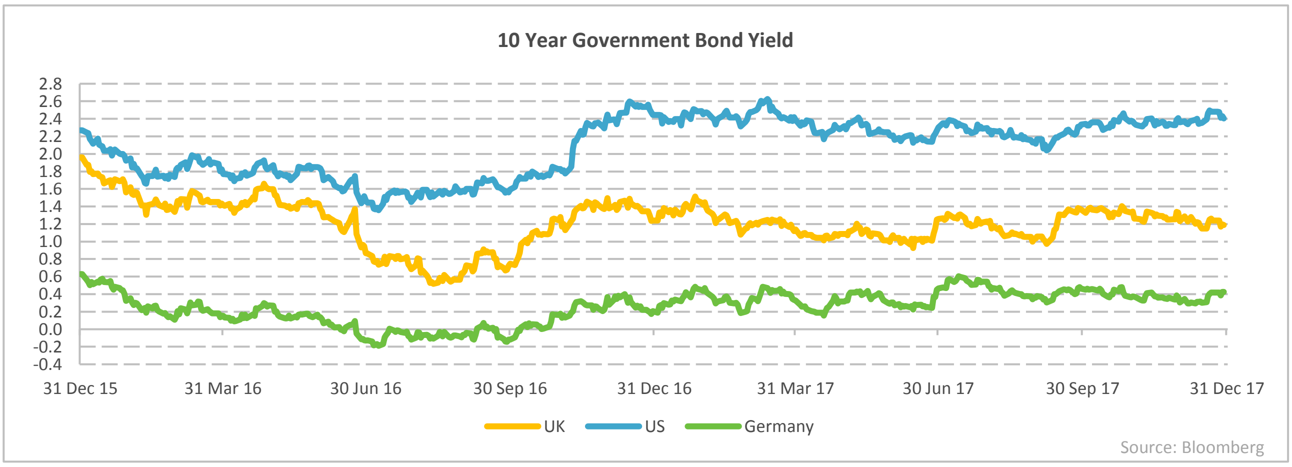
	31.12.16	31.03.17	30.06.17	30.09.17	31.12.17
UK Equity yield	3.5%	3.5%	3.6%	3.7%	3.6%
UK Equity P/E ratio (FTSE)	30.3x	28.3x	27.5x	24.4x	21.2x
Over 15 year gilt yield (p.a.)	1.8%	1.7%	1.8%	1.8%	1.7%
Over 5 year index-linked gilt yield (p.a.)	-1.7%	-1.7%	-1.6%	-1.5%	-1.7%
iBoxx Over 10 year Non-gilt yield (p.a.)	2.9%	2.8%	2.8%	2.9%	2.8%

Source: DataStream

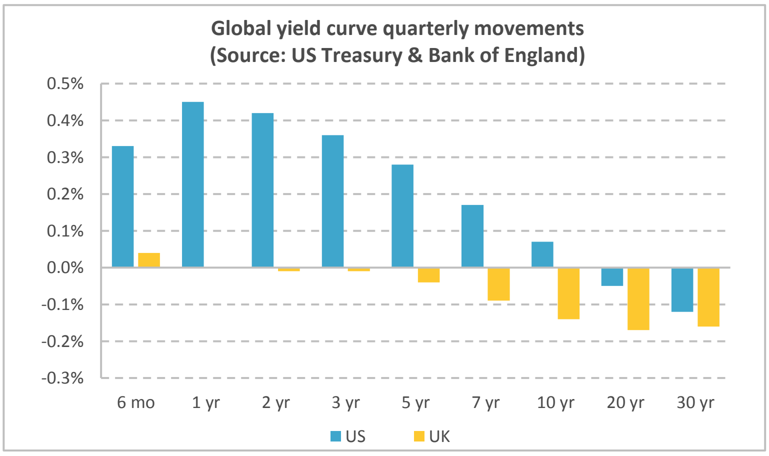
	Year to 31.12.16	Year to 31.12.17	Quarter to 31.03.17	Quarter to 30.06.17	Quarter to 30.09.17	Quarter to 31.12.17
FTSE All Share	16.8%	13.1%	4.0%	1.4%	2.1%	5.0%
Global Equity	29.6%	13.8%	5.8%	0.5%	1.9%	5.1%
Over 15 year gilts	18.5%	3.3%	2.6%	-2.3%	-0.5%	3.7%
Over 5 year index linked gilts	27.4%	2.5%	2.0%	-2.4%	-0.8%	3.9%
All Stocks Non-Gilts	10.6%	4.3%	1.9%	0.5%	0.1%	1.8%
IPD Monthly Index	2.6%	11.2%	2.3%	2.5%	2.7%	3.4%

Source: DataStream

Global Bond Markets



There was a divergence in movements of 10-year sovereign bond yields over the quarter - US yields rose, UK yields fell and European yields moved sideways.

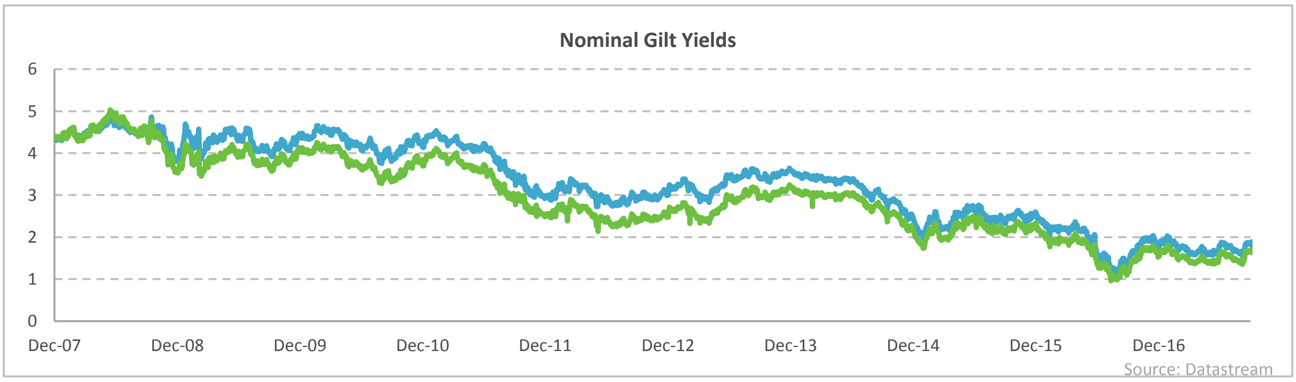


Inflation pressures, outside of the UK, remain subdued, however the expectation is that influences currently acting to depress inflation may not persist. Hence, there was little surprise about the tightening of monetary policy from the major central banks over the quarter.

As expected, the Bank of England's Monetary Policy Committee raised interest rates by 0.25% p.a. to 0.5% p.a. in November 2017. In the US, the Federal Reserve again raised its benchmark interest rate and began its programme of 'quantitative tightening' as economic conditions remained robust. The ECB also announced plans to taper its quantitative easing programme and there was even some speculation that the Bank of Japan may take its foot off the monetary accelerator during 2018.

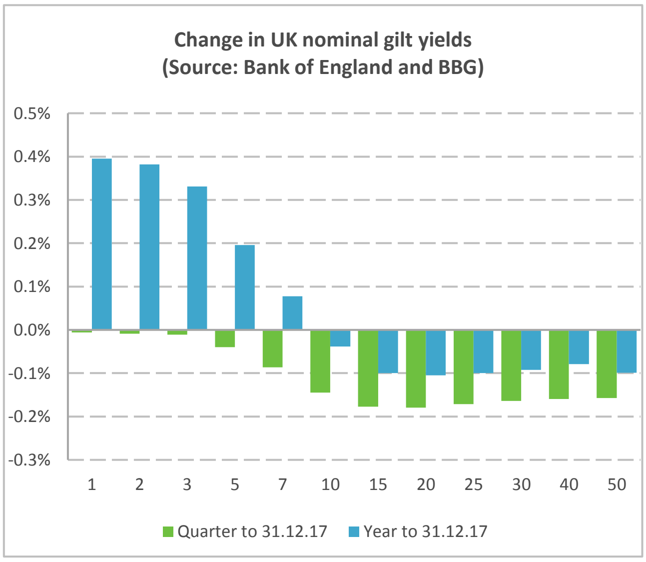
Normalisation of monetary policy is now the default as long as economic conditions remain reasonably robust. One question is where normalisation lands – there are signs that US expectations are to normalise at yields around 3%. Previous expectations suggested normalisation to c4%. That would suggest limited expectation of further increases in long-dated US Government yields.

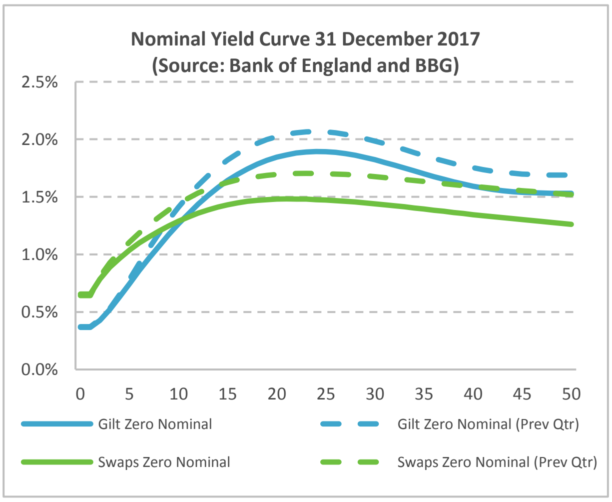
UK Interest Rates

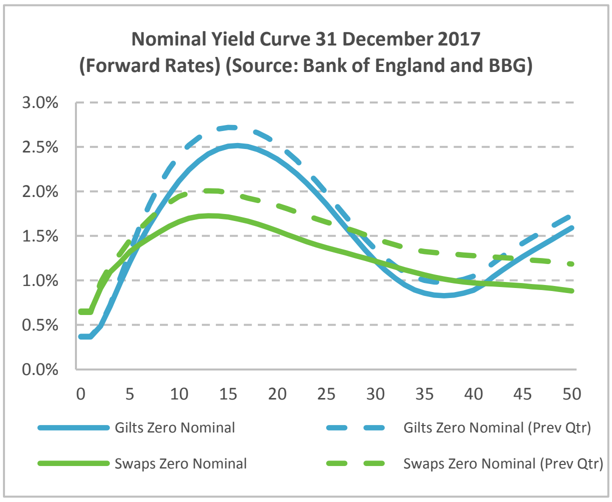


The Bank of England's token increase in UK base rates, from 0.25% to 0.5%, took place in November as expected, justified on the basis that the UK economy was seeing increased inflationary pressures and low unemployment.

Gilts yields have ended 2017 much as they started the year and with probably just as much, if not more, Brexit uncertainty it is unlikely the BoE will raise rates much in coming months. Following the rate rise, Mark Carney struck a dovish tone and suggested only two more rate rises may be needed over the next three years, which caused gilt yields to fall marginally over the quarter as markets priced in rates remaining lower for longer.



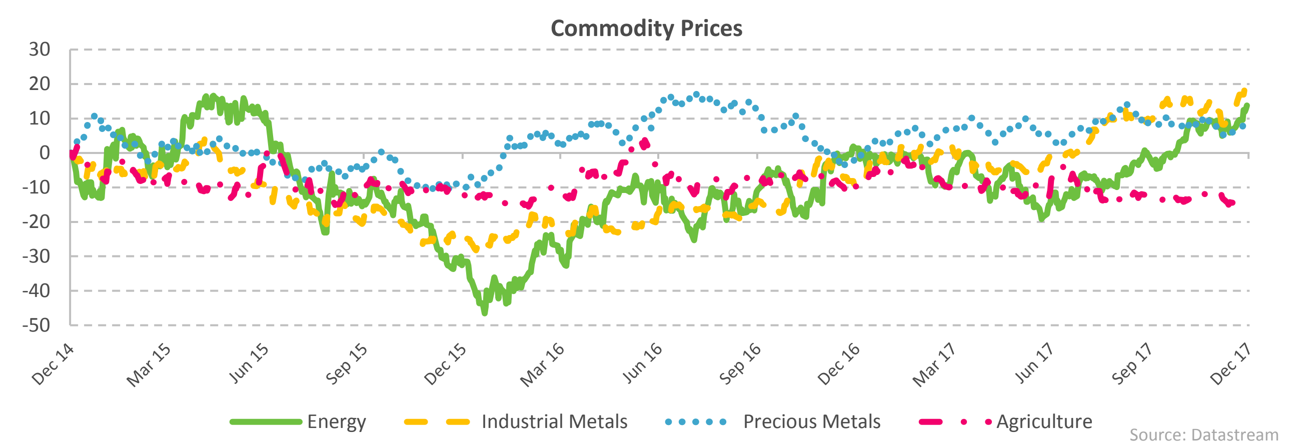




Those concerned with hedging programmes should focus on the anomalies in the yield curve and on the relationship between conventional and index-linked yields as much as the absolute level of yields. Nominal forward gilt yields continue to suggest that there is better value in the medium maturity portion of the gilt curve (10-20 years) than very long maturities (30-50 years).

Inflation and real rates

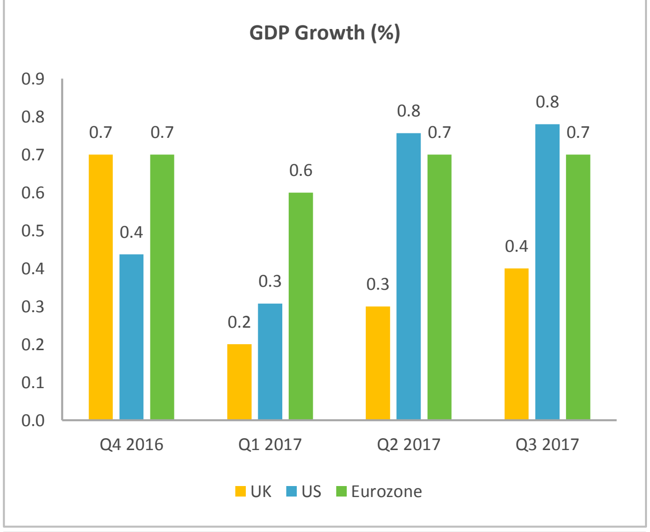
Commodity prices continued to rise over the quarter, underpinned by a rally in energy and industrial metal. Oil prices continued to rise, primarily driven by an agreement among OPEC members, with Brent crude finishing the year at $67 a barrel – the highest price since 2015.

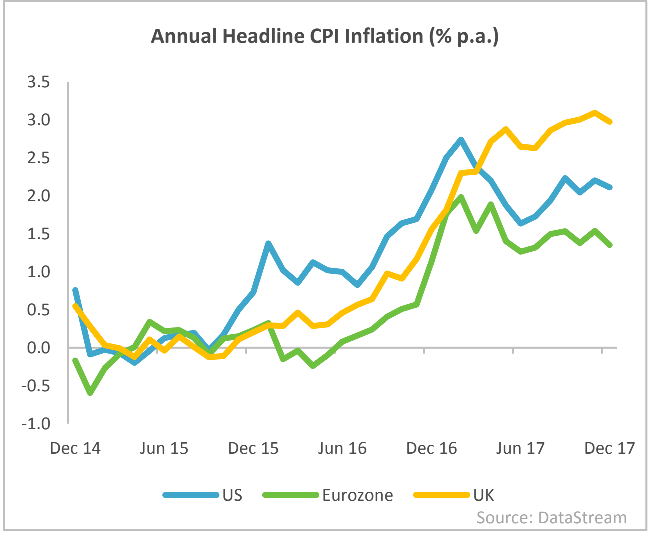


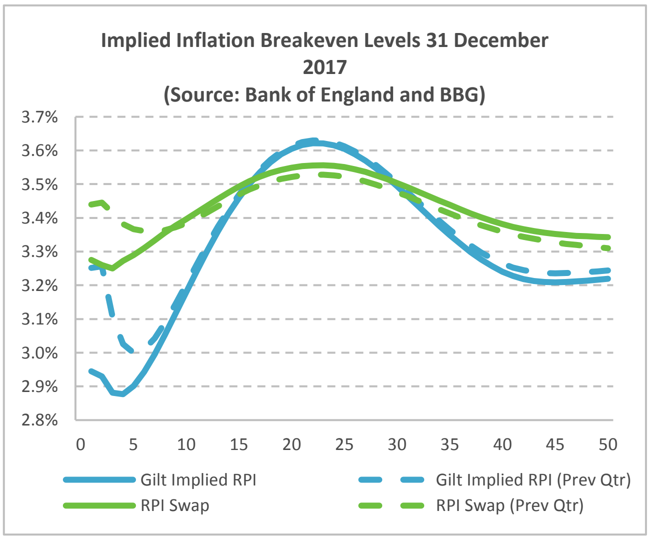
Third quarter GDP figures confirmed robust growth in the US, Eurozone and Japan. The US sustained the 3% annualised growth of the previous quarter, the equivalent number for the Eurozone was 2.5% but that has been sustained for a year now. Japan's seventh successive quarter of growth marked its longest expansion since the 1990s. UK growth was also ahead of expectations, but remains sluggish at 0.4% for Q3. More timely indicators – business surveys, economic surprise indicators – suggest that underlying momentum has remained intact into the new year.

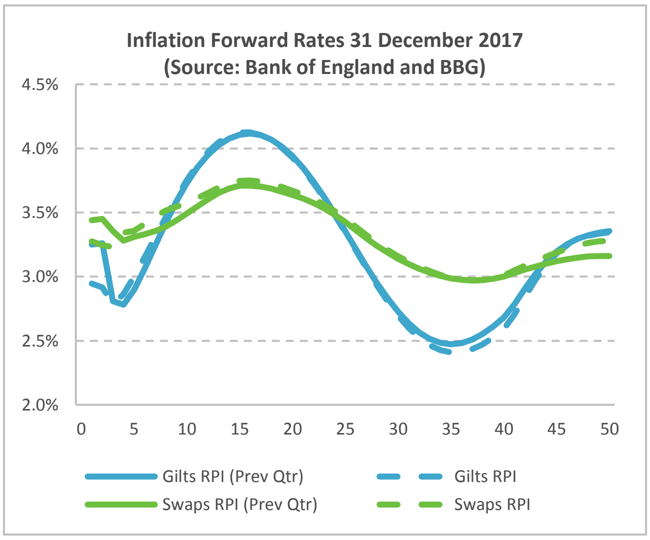
Meanwhile, inflation pressures outside of the UK, remain subdued, particularly where based on core measures (i.e. excluding food and energy). Headline UK CPI inflation rose above 3% for the first time in six years, forcing Mark Carney to write a letter to the Chancellor explaining the overshoot of the BoE's 2% target.

Below-target inflation seems to be a waning concern for central bankers. The potential distorting effects of extreme monetary accommodation on financial markets may be of greater importance as risk premiums remain compressed. In the US and Eurozone at least, there is a view that influences currently acting to depress inflation may not persist.



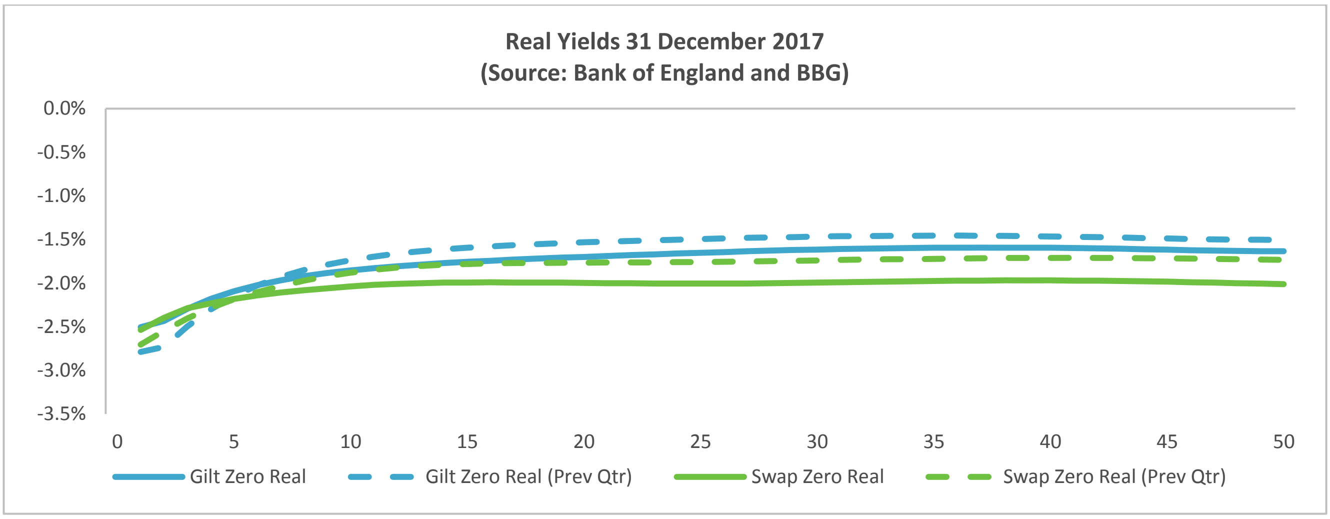






Real yields moved sideways over the quarter and remain very low relative to long-term history. In absolute terms, even allowing for uncertainty about the long-term outlook for the UK economy, real yields on index-linked gilts still reflect hedging demand rather economic fundamentals. Protecting against inflation is expensive, especially in the UK where the demand for index-linked gilts is higher than the supply. Real yields on index-linked gilts (after allowing for RPI assumed to be c.1% p.a. higher than CPI) are yielding less than their German equivalents, and are more than 1% p.a. lower than US Treasury Inflation Protected Securities (TIPS).

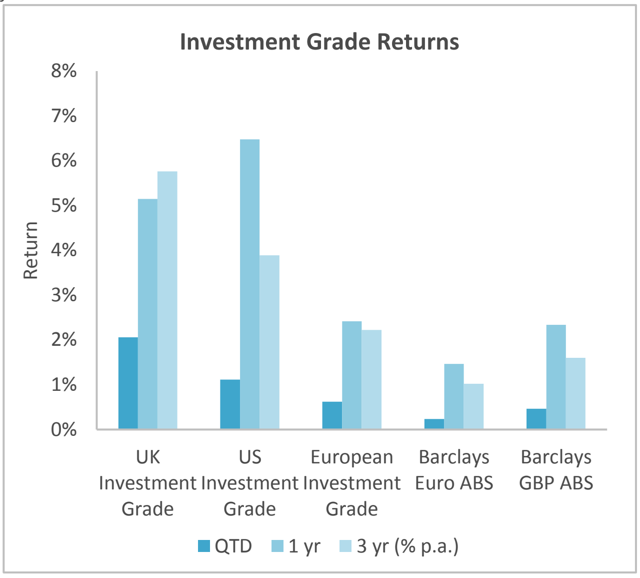
We expect real yields to continue to closely follow nominal yields over 2018, with higher levels of inflation already factored into pricing. An earlier than expected increase in base rates is likely to have an impact, particularly at the short-end of the curve. However, we believe there is likely to be sufficient demand from UK institutions to dampen the potential for real yields to rise.

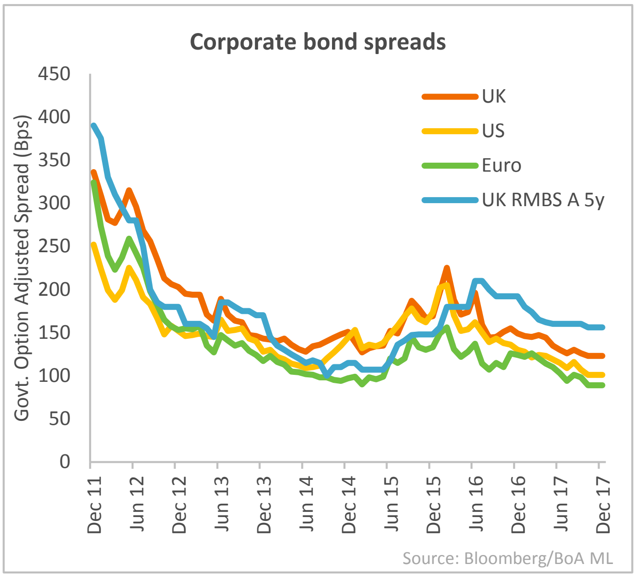


Investment Grade Credit

ML Non-Gilts Spreads over Gilts (Source: Datastream)	Sterling Non-Gilts (bps)	Sterling Non-Gilts Over 10 Years (bps)	Global Broad Market Corporate (bps)
30 September 2017	103	106	119
31 December 2017	101	107	117
Median spread over last 10 years	155	134	175
Average spreads over last 10 years	171	152	203

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.



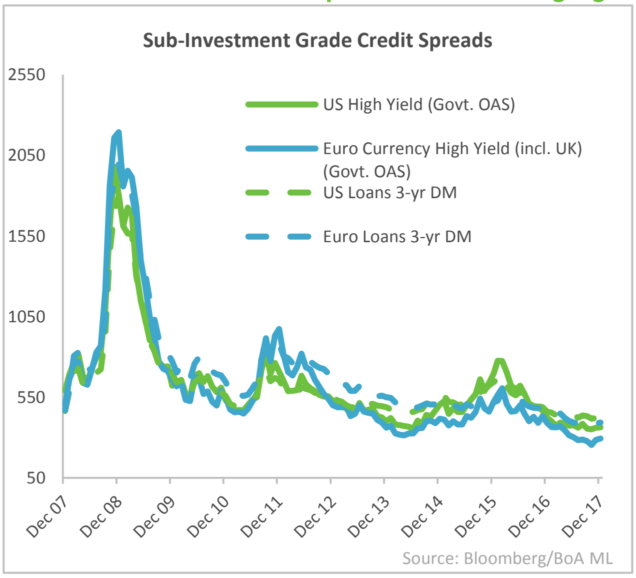


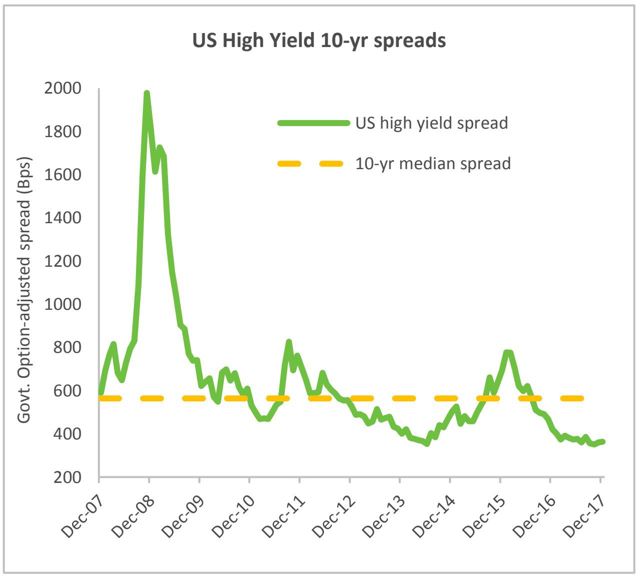
Corporate bonds capped an impressive year with another positive quarter. Current global economic momentum remains a positive for corporate bonds, but marginally tighter spreads over the final quarter has left valuations below longer-term averages. At current levels, room for further spread tightening is limited, leaving coupon income as the main source of return. Absolute yields are also unattractive given the low starting risk-free rate. We note that UK credit spreads offer a slightly higher premium over the US and Europe, but Brexit uncertainty is likely to maintain this premium.

While corporate bonds may look expensive, corporate fundamentals remain reasonably supportive. The ECB and BoE have both shifted to a dovish stance and markets are pricing in a gradual rate hiking by the Federal Reserve. Whilst the macro-economic background remains robust the fundamental background should support current spreads.

Technicals are currently supportive for corporate bonds as the carry trade remains compelling. However, although the ECB will continue to purchase bonds until September 2018, market focus has moved on to the potential impact on spreads of the eventual withdrawal of this technical support. The ECB have left their options open on the timing of any eventual withdrawal, anxious that tapering will not prove to be disruptive. Looking forward, issuance will be an important factor in 2018 as central banks buying fades.

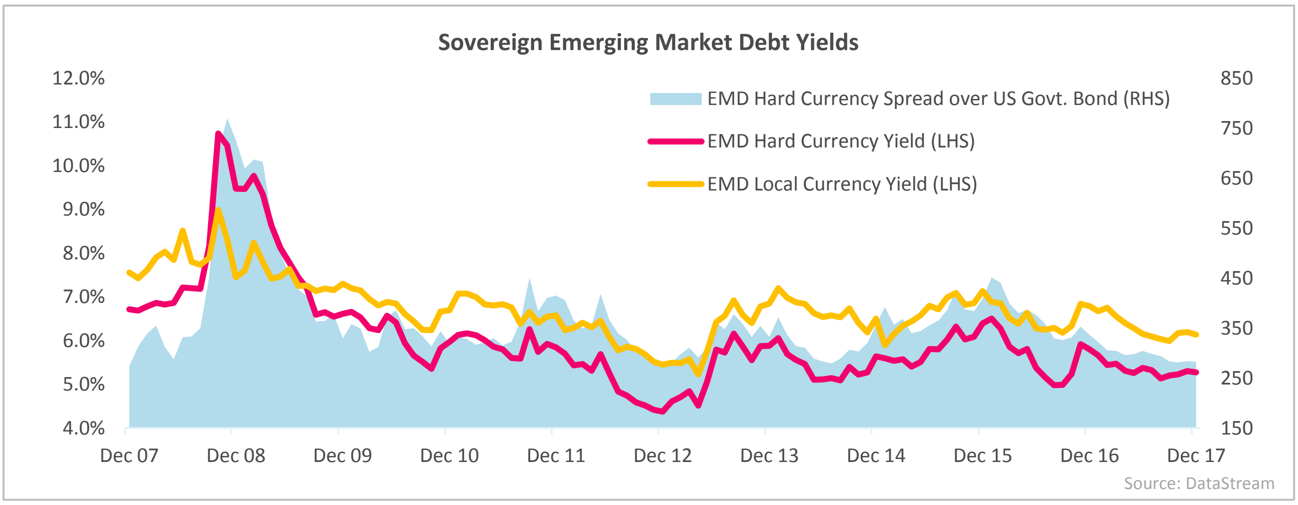
Sub Investment Grade Corporates and Emerging Market Debt





Company-specific disappointments from a few major issuers caused a wobble in the high yield market, but sentiment recovered quickly. Despite significant spread compression over the year, corporate fundamentals remain firm as the strong earnings trend continues. Default levels remain below historic levels in Europe and are improving in the US as conditions in the commodity sector continue to improve on the back of sustained price rises, particularly within the energy sector.

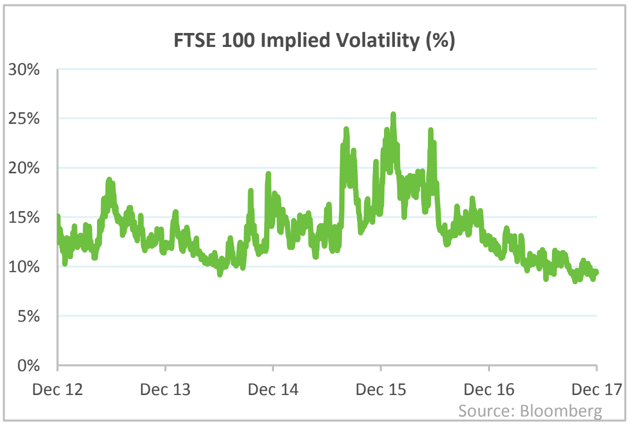
The strength of demand has resulted in further erosion of the level of covenant protection in traded bond and loans markets. We see relative value in traded loans over high yield reflecting that this market has lagged in 2017 and is offering a spread premium over the high yield market. Overall, we have a preference for private markets, where better protection can be negotiated. This market, in general, has continued to benefit from stricter covenants than those available in the traded market (where the market is now predominantly covenant-lite); this fundamentally increases the credit quality of the loans held by increasing recoveries.

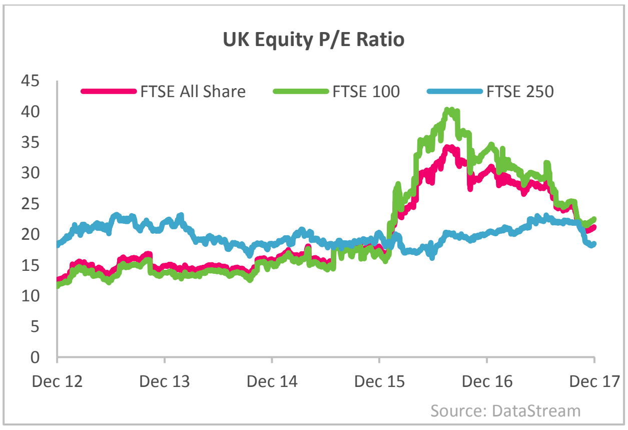


Emerging market debt (EMD) had a mixed quarter, although delivered impressive returns for the calendar year. While EMD would struggle in the short term if economic conditions deteriorate, on a longer perspective yields still look much less stretched in absolute terms than most other bond markets.

UK Equity Market

Equity Market Data (Source: Datastream)	30 September 2017	31 December 2017
FTSE All Share Dividend Yield	3.7%	3.6%
Dividend growth over the quarter	3.2%	1.7%
Dividend growth over the year	14.7%	12.8%
FTSE All Share P/E Ratio	24.4x	21.2x
Total Return during the quarter	2.1%	5.0%
Total Return over the last 12 months	11.9%	13.1%

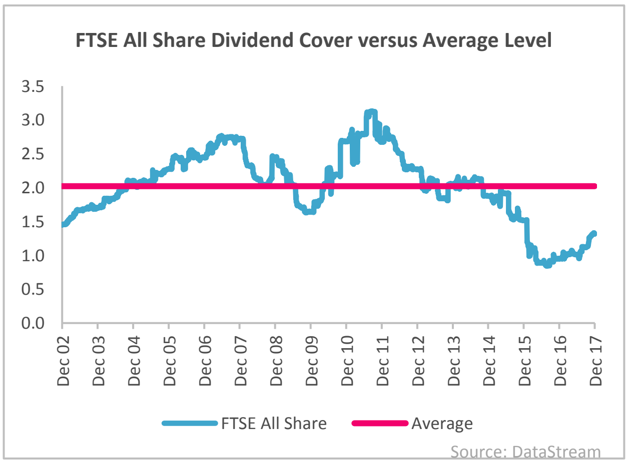


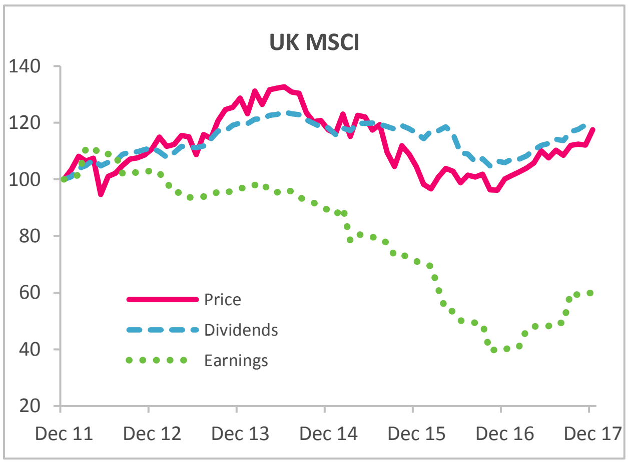


Impressive returns from mining and oil companies helped UK equities finish the year strongly, with the FTSE All Share Index delivering a return of 5% over the quarter.

Whilst global equity prices and earnings have tracked each over 2017, the resurgence of UK earnings has outstripped prices resulting in UK P/E ratios moving more in line with the rest of the world. That said, UK equities still look expensive relative to historic levels. As earnings struggled for a few years until late 2016, the main justification advanced for equity revaluation was the fall in bond yields. But global bonds yields have been rising since the middle of 2016 are now back to the levels of two years ago. Meanwhile, almost none of the equity revaluation has unwound.

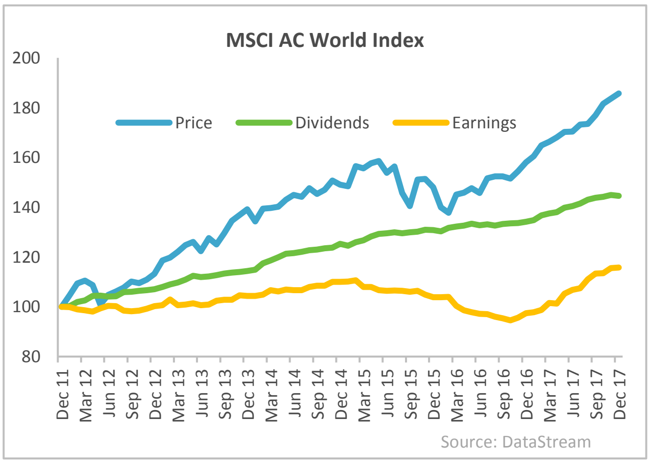
Low implied volatilities may mean that structured equity and outright downside protection can provide the opportunity to implement protection strategies relatively cheaply for those who wish to retain some exposure to potential short-term upside in equities.

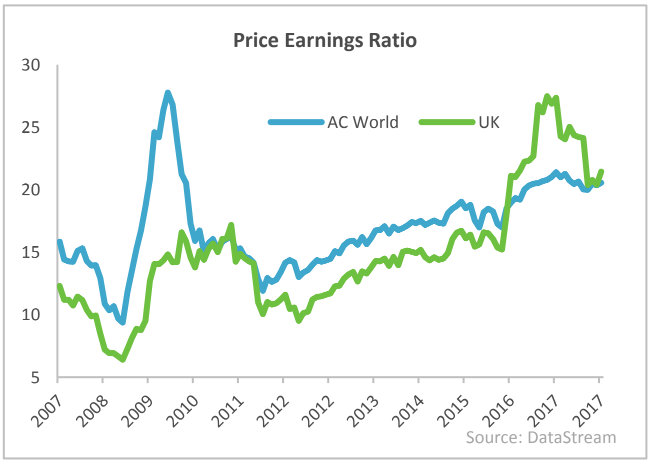




Overseas Equity Markets

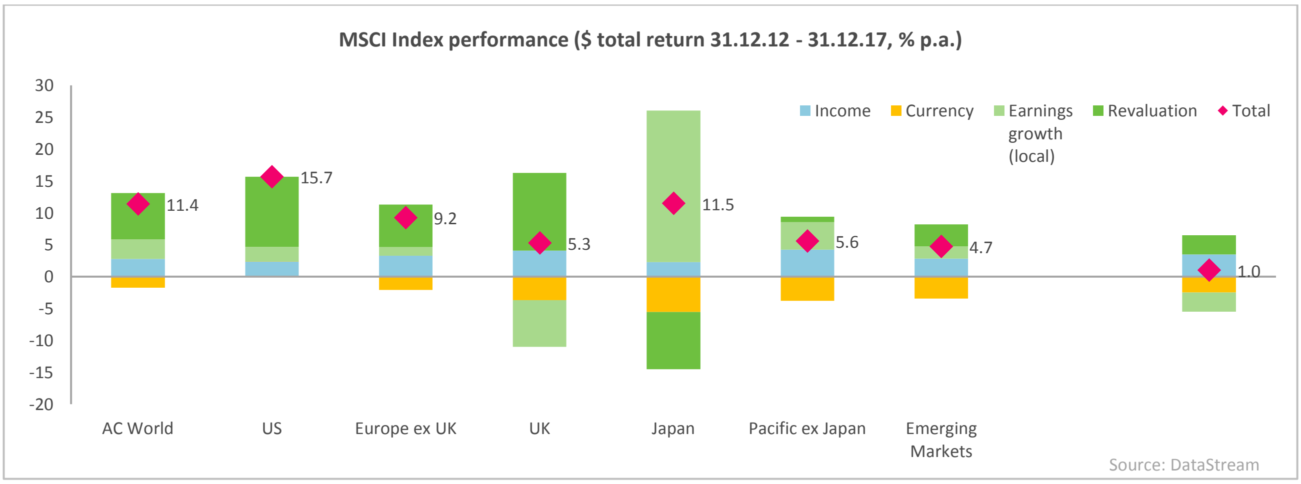
Equity Market Data (Source: Datastream)	30 September 2017	31 December 2017
Dividend Yield	2.4%	2.3%
Total Return during the quarter (£)	1.9%	5.1%
Total Return during the quarter (Local)	4.4%	5.6%
Total Return over the last 12 months (£)	15.5%	13.8%
Total Return over the last 12 months (Local)	19.1%	20.3%



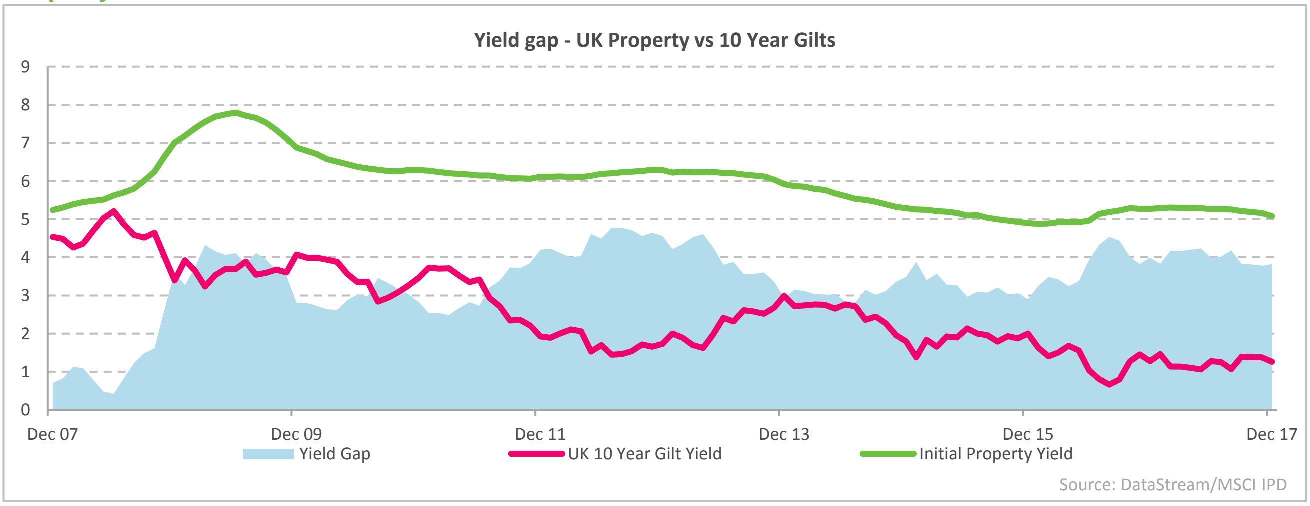


Synchronised global growth and relatively low levels of inflation provided a supportive backdrop for global equities over the quarter, delivering a return of 5.6%. Investor sentiment has been boosted in the short-term by the passing of the US tax reforms, however this may be tested as the Federal Reserve continues to unwind its QE program.

Earnings growth continues to emerge although equity valuations remain high relative to history. Momentum could easily push equities higher in the short run – it is not difficult to find examples of greater exuberance in the past – however, the longer-term outlook continues to concern us. There remains pockets of relative value across regions, with Emerging Markets and Europe looking particularly attractive relative to the US.



Property



UK Property

The post-referendum recovery in commercial property remains in place. Indeed, growth in capital values has extended the very modest acceleration evident throughout 2017. Rents are still rising modestly, although it is more difficult to detect any acceleration here. Some sub-sectors, prime industrial in particular, are experiencing higher rental growth due to tight supply whilst other sectors continue to be burdened by structural vacancies e.g. High street retail outside of Central London.

Infrastructure

Infrastructure assets with contractual, inflation linked income have the ability to provide somewhat predictable income based returns. The secure income becomes increasingly attractive as inflation ticks up. Even assets with income correlated to GDP can have reasonably predictable cash flows due to the essential nature of services provided. Infrastructure markets are underpinned by a significant need for reinvestment in aging infrastructure in developed economies and by continued global growth. Whilst there may be uncertainty on the sustainability of growth, infrastructure spending is essential to support future economic growth and infrastructure assets are defensive by nature so should be more immune to any tail off.

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.

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