Q4 2020
Capital Markets Outlook

March 2021

Essex Pension Fund

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Overview of asset class views

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Overview of views

Equities	Further rises in global equities leaves valuation measures increasingly stretched versus history. However, there remains significant disparity in valuations by region and overall valuations do not look as expensive in the context of very low real yields. Q3 earnings have continued to outperform expectations and estimates for Q4 have risen. The bounce in earnings expected in 2021 would leave full-year earnings in 2021 above end-2019 levels. Given high valuations and near-term economic uncertainty, we retain a degree of caution, despite the fundamental improvement expected in 2021.
Investment grade credit	Despite a continued rise in leverage and fall in interest coverage, investment-grade spreads are now well below long-term median levels. Low central bank policy rates and government bond yields will likely provide ongoing technical support and fundamentals should improve as earnings recover in 2021, but very low spreads and yields may pose a headwind to returns going forward. Sterling investment grade spreads, on a ratings-consistent basis, have fallen well below long-term median levels and the premium relative to equivalent global credit is low relative to history. Given less recent central bank support, equivalently rated European ABS spreads have lagged the recovery in corporate credit spreads since the peak of market disruption at the end of Q1 and spreads relative to similarly rated corporate credit are attractive versus history.
Liquid Sub-investment grade debt	Central bank intervention has enabled companies to raise huge amounts of debt to see them through near-term disruption. This increase in leverage, coupled with falling profits, has resulted in lower interest coverage, despite a significant decline in yields. Although default rates have risen – to 8.4% in the last 12 months to November in the US high yield market – accommodative funding conditions have helped keep them well below the peaks of previous crises. However, it is likely defaults could remain elevated as companies lose government support. Nonetheless, global high yield credit spreads have retraced significantly since Q1 and are now well below longer-term medians. US leveraged loan spreads have also fallen but offer a premium relative to US high yield.
Private Lending	Transaction levels have returned to pre-COVID levels and, while pricing has also returned to pre-COVID levels, loans are typically being written with better lender protections meaning a better risk-adjusted return overall. The illiquidity premium to the loan market remains slightly compressed. More affected outstanding debt in public and private markets may create opportunities for new stressed/distressed and special situations financing strategies.
Core UK property	While transaction activity picked up following the easing of the initial lockdown, the market is continuing to face significant uncertainty as restrictions return. Fundamentals in the UK commercial property market remain weak to reflect to continued downside risk faced as the pandemic rages on while valuation and technical data remains underwhelming.
Long Lease Property	On an absolute basis, valuations remain less attractive than the wider property market, but they are supported by stronger fundamental and technical drivers.
Conventional gilts	Gilt yields remain well below our assessment of longer-term fair value - 3.0-3.5% p.a. for nominal yields. Economic recovery may drive today's very low yields higher but, while GDP remains below trend and unemployment elevated, 10-year nominal yields may be expected to rise no higher than 1.0-1.5% p.a.
Index-linked gilts	Despite the government's announcement that RPI will be aligned with CPIH (c.1% p.a. lower), with no compensation for index-linked gilt holders, implied inflation actually rose at longer terms as gilt yields rose more than index-linked gilt yields. Implied inflation looks expensive at terms up to around 25 years.

Economic background

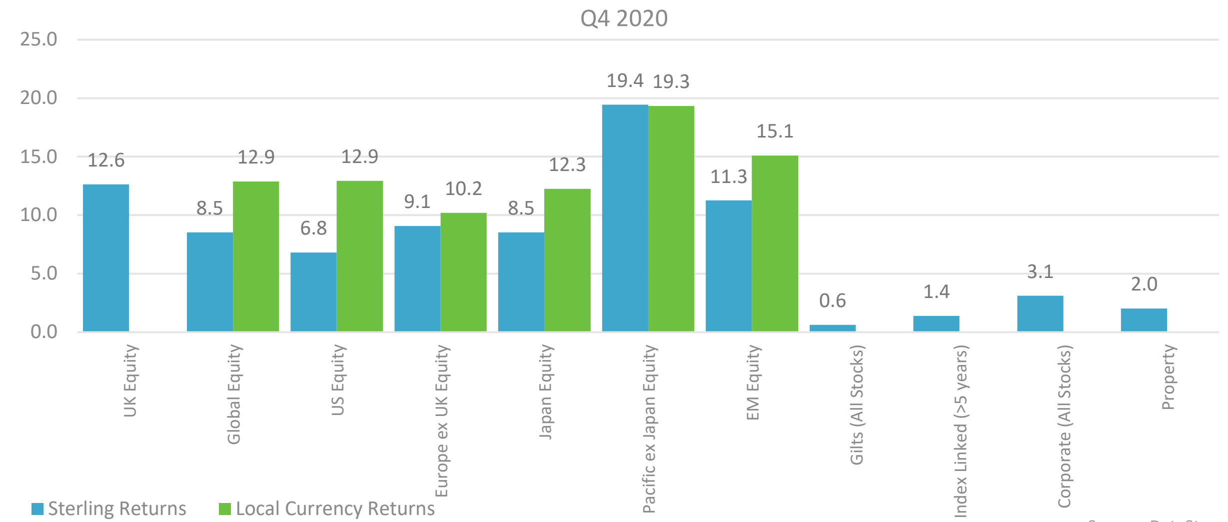
After falling sharply at the end of October as lockdown measures were re-imposed in Europe and the UK, a post-US election bounce in global equity markets was followed by a strong rally in November and December.

The announcement of effective vaccines meant investors could put near-term economic weakness in the context of a potential end to the crisis in 2021.

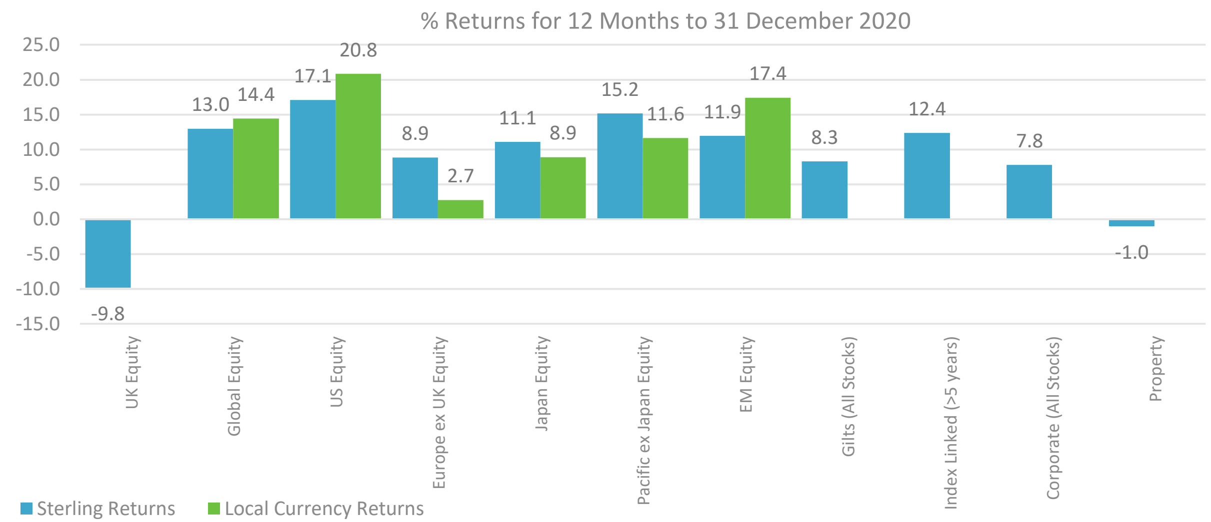
A pronounced rotation into more cyclical sectors and assets was evident. Oil prices rose 26.6% in Q4 and rising commodity prices were driven by strong demand for industrial metals in Asia. US government bond rose, but equivalent UK and European yields fell as their central banks increased purchases.

New infection rates rose significantly in Europe and the US, exceeding previous highs, with concerns over hospital capacity prompting governments to implement new stringent lockdown measures. Though cases continue to rise at a global level, it appears likely that many advanced economies could vaccinate a large proportion of their most vulnerable citizens in the first half of 2021.

Market Returns



Source: DataStream



Source: DataStream

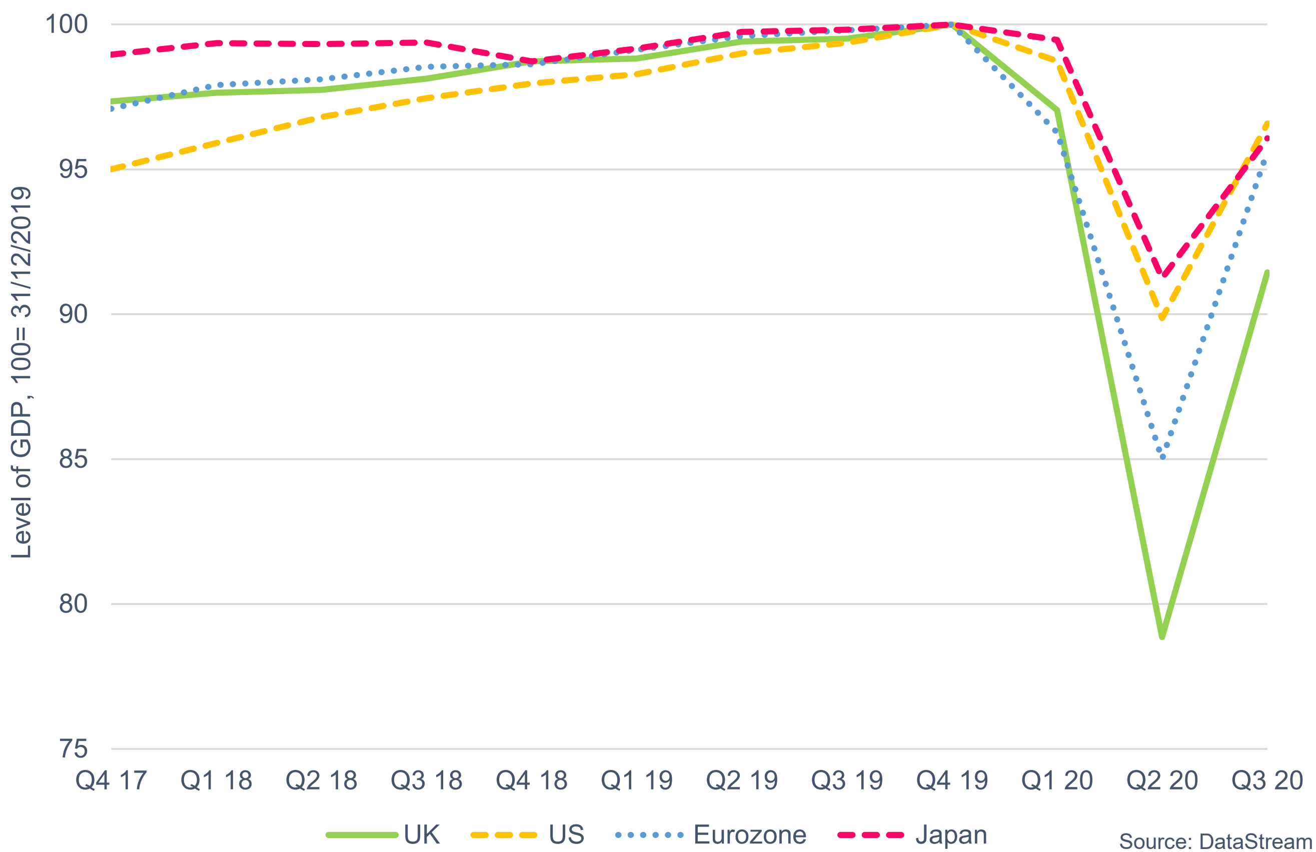
Latest estimates of Q3 GDP showed the initial rebound in activity was sharp as the major advanced economies emerged from lockdown: the US, eurozone, UK and Japanese economies grew 7.4%, 12.6%, 15.5%, and 5% respectively, over the quarter.

Even so, output has fallen since the end of 2019 by 3.5% in the US, 4.3% in the eurozone and the UK economy is 9.7% smaller than the final three months of 2019.

Consensus forecasts a 4.2% fall in 2020 global GDP followed by a 4.8% expansion in 2021, though output in the major advanced economies is not expected to reach pre-pandemic levels until at least 2022.

While vaccine developments have not altered the average projection (most forecasts already assumed social distancing would continue in to 2021 but fade over time as vaccine coverage expanded and therapies improved), we believe the risks to the outlook are now more balanced. Though cases continue to rise at a global level, it appears increasingly likely that many advanced economies could vaccinate a large proportion of their most vulnerable citizens early this year, potentially paving the way for a more permanent relaxation of restrictions.

GDP Growth

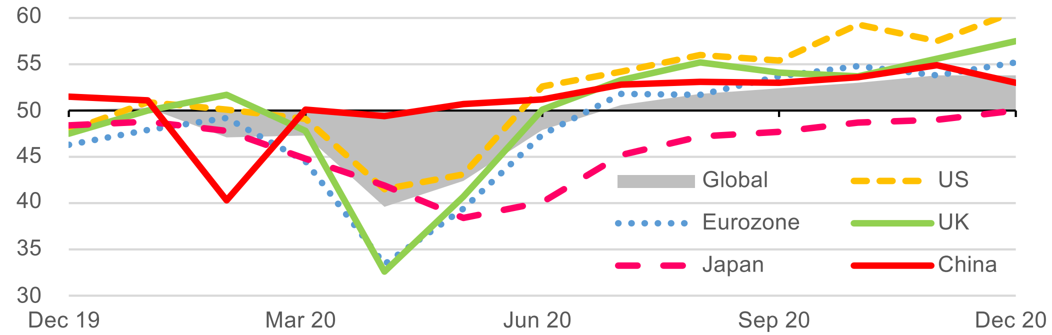


PMI surveys suggest a relatively modest slowdown at a global level. The global composite PMI remains at a level signalling expansion, supported by solid readings in the US, China and elsewhere.

Even in the Eurozone and UK, both manufacturing and services have held up far better than during initial lockdowns in spring and, given less impactful restrictions and a stronger external environment, manufacturing has been far more resilient than services. UK manufacturing has also likely benefited from a temporary boost from Brexit-related stockpiling.

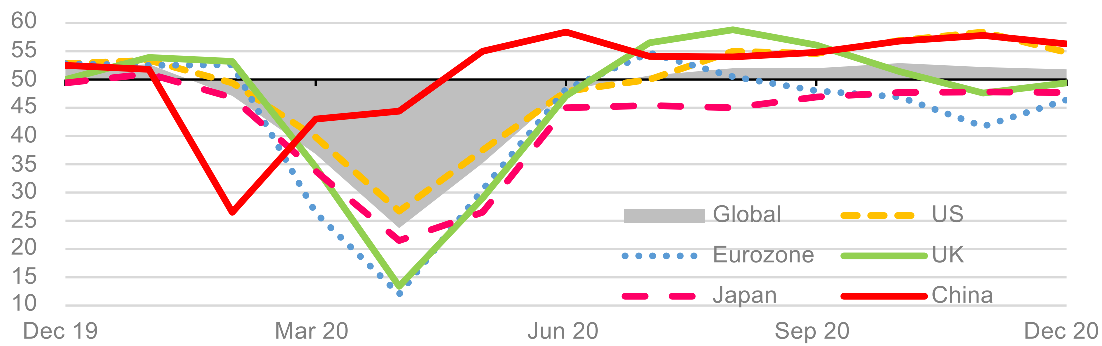
Employment at a global level remains well below pre-pandemic levels. US unemployment has fallen from April's 14.7% peak April to 6.7%, but gains stalled in December. Labour markets have been far more resilient in the UK and Europe, but the number of job cuts is rising despite the extension of government support schemes.

Manufacturing PMI



Source: Bloomberg

Services PMI



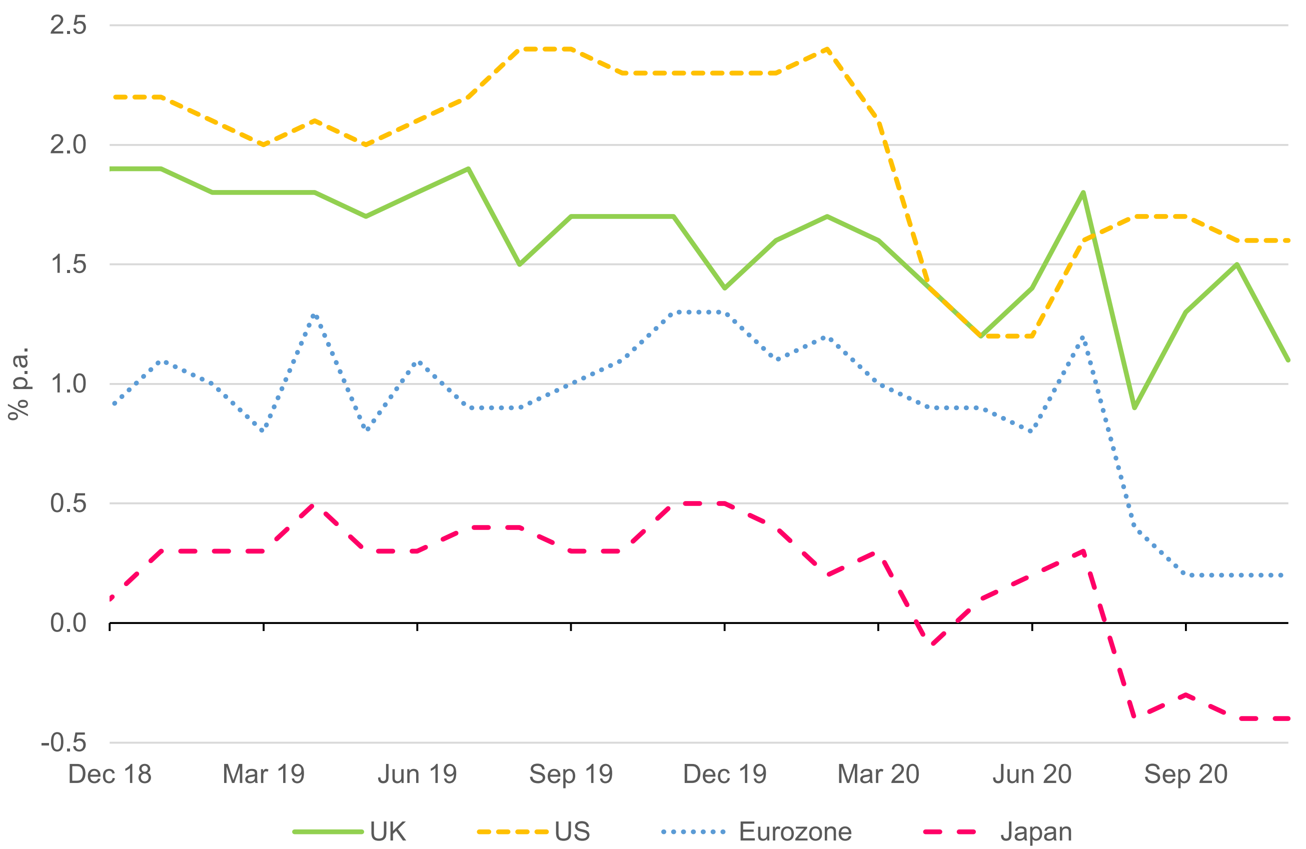
Source Bloomberg

UK headline inflation slowed more than expected in November, falling from 0.7% in October to 0.3% year-on-year in November. Prices of clothing, food and recreation fell as restrictions to curb the spread of coronavirus were re-imposed. Core inflation, which excludes volatile elements like alcohol and fuel, fell from 1.5% in October to 1.1% year-on-year in November.

Some commentators fear the release of pent-up demand when the pandemic subsides could lead to a surge in inflation. However, most are more sanguine when GDP remains well below trend and unemployment is expected to rise. The consensus estimate is for a fall in inflation this year to be followed by a modest increase in 2021.

While a sustained rise in inflation, and the subsequent need to raise interest rates, would represent a risk to economic recovery and asset prices, the resilience of supply during the pandemic and a return to normality that will probably be gradual suggest any inflation pressure will be limited and interest rates are likely to remain low for an extended period.

Core CPI Inflation



Source: DataStream

Asset class views

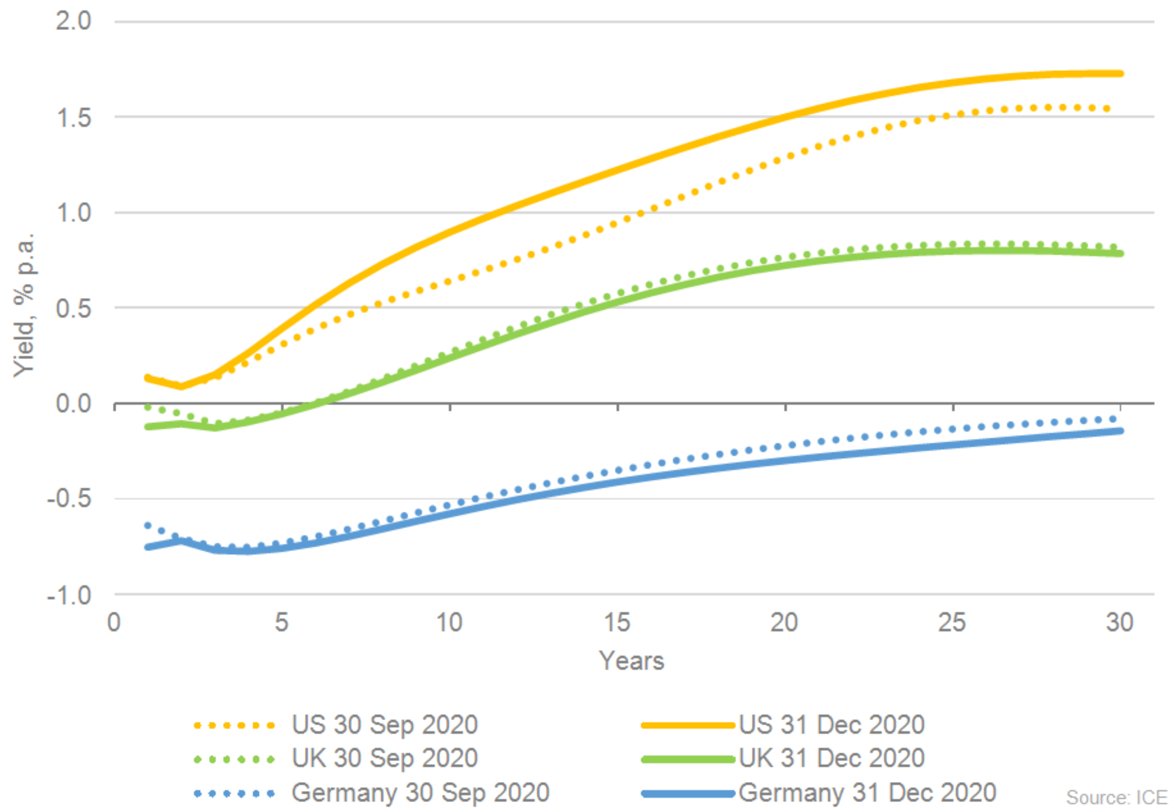
US 10-year Treasury yields rose 0.2% p.a. above end-September levels to 0.9% p.a. following positive vaccine news and as US congress agreed a pandemic relief bill which will extend many fiscal support measures announced earlier in the year.

The US yield curve steepened as growth and inflation expectations pushed up longer-term yields while shorter-dated yields remain anchored by very low interest-rate expectations.

10-year UK and German yields fell slightly as near-term economic weakness prompted their central banks to increase asset purchases.

The UK and German yield curves were little changed at longer-terms but fell at shorter terms reflecting lower interest-rate expectations.

Conventional government bonds



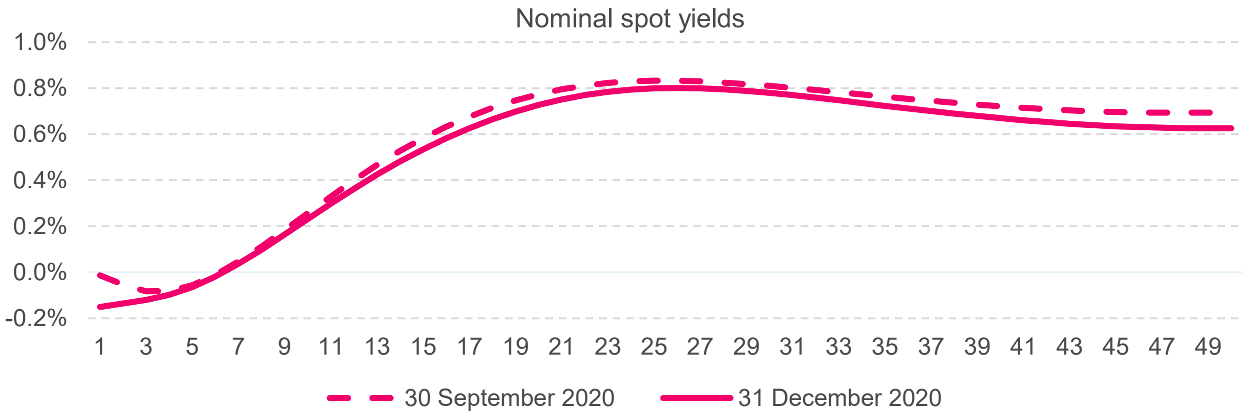
Source: ICE

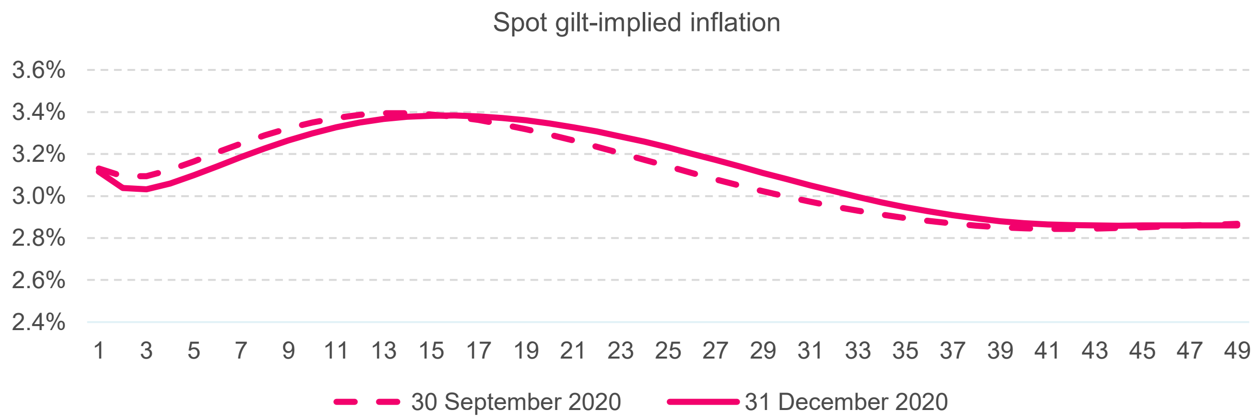
Above-trend growth expected in 2021 is set against near-term economic weakness and the potential implementation of negative interest rates. While some disruption is inevitable, a Brexit trade deal removes a degree of downside risk associated with the UK's departure from the EU.

Either way, very low yields are vulnerable to a less favourable fundamental background as growth and inflation recover and less technical support as monetary easing is replaced by short-term stability and longer-term tightening.

Despite the government's announcement that RPI will be aligned with CPIH (c.1% p.a. lower), with no compensation for index-linked gilt holders, implied inflation actually rose at longer terms as gilt yields rose more than index-linked gilt yields.

UK nominal gilt yields and gilt-implied inflation





	Fundamentals	Valuations	Technicals	Overall
Gilts	Neutral	Unattractive	Neutral	**Neutral to Cautious**
Index-linked gilts	Neutral	Unattractive	Neutral	**Neutral to Cautious**

Easier monetary policy in developed economies, alongside muted domestic inflation pressures, has allowed some emerging market central banks to cut rates and embark on asset purchases, improving the fundamental support to local currency markets.

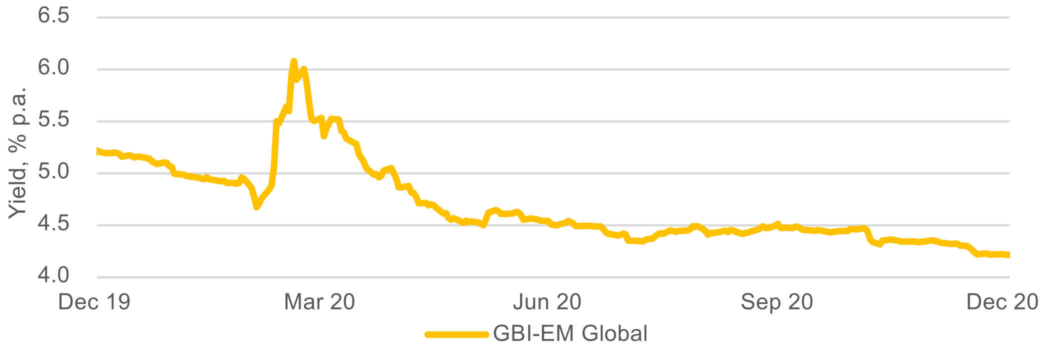
Local currency emerging market debt, as measured by the GBI-EM Traded Index, returned 9.6% in dollar terms as yields fell 0.3% p.a. and index currencies, in aggregate, rose against the dollar. Local currency real yields are now slightly below longer-term median, but currencies remain cheap relative to longer-term averages.

Yield spreads have compressed to longer-term median levels in hard currency markets however remain

Sovereign emerging market debt

Hard Currency spread

Local Currency yield



	Fundamentals	Valuations	Technicals	Overall
EMD (local)	Attractive	Neutral	Attractive	**Neutral – attractive**
EMD (hard)	Neutral	Neutral	Attractive	**Neutral – attractive**

Investment-grade corporate credit

Unusually for a period of financial stress, companies have been able to raise huge amounts of debt to see them through near-term disruption. This increase in leverage, coupled with falling profits, has resulted in lower interest coverage, despite a significant decline in yields.

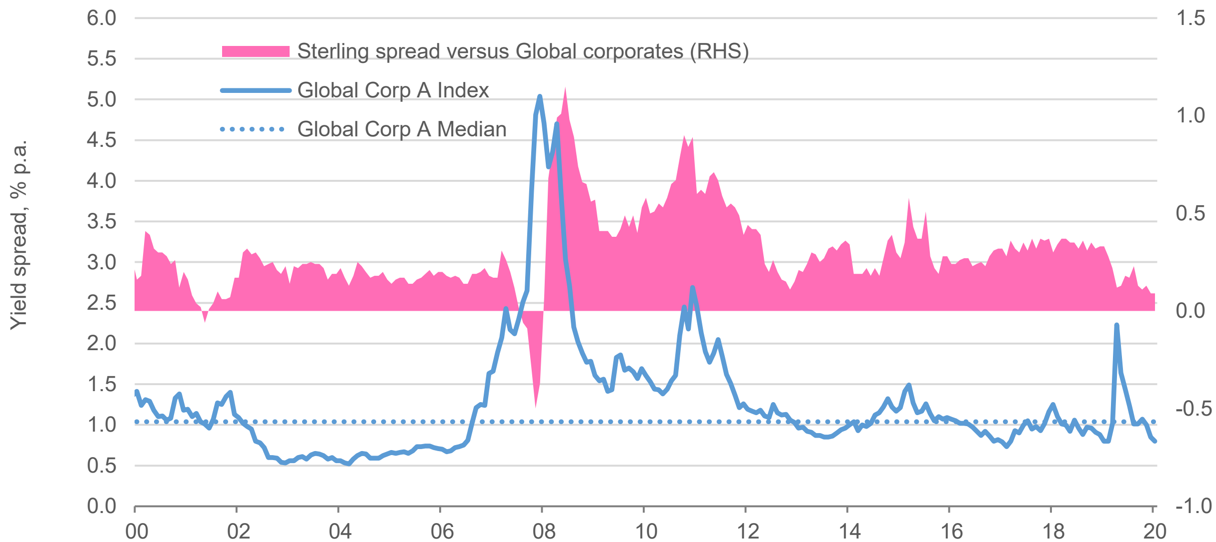
Low central bank policy rates and government bond yields will likely provide ongoing technical support and fundamentals should improve as earnings recover in 2021, but very low spreads and yields may pose a headwind to returns going forward.

Global investment grade spreads have re-traced all of the widening seen in Q1 and are now below long-term median levels. Sterling IG spreads are also well below median levels and the usual yield premium on UK corporate bonds over global comparators has diminished.

Overall, we remain watchful of spreads given their level relative to history and the challenging fundamentals.

Spreads (bps)	31 December	-3 Mth	-12 Mth	10-yr Median
US IG	**103**	144	101	**140**
Sterling IG	**113**	150	131	**152**
Euro IG	**93**	118	94	**123**

Global Corporate A-rated yield spreads versus equivalent Sterling yield spreads



Source: ICE

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

Central bank intervention has enabled companies to raise huge amounts of debt to see them through near-term disruption. This increase in leverage, coupled with falling profits, has resulted in lower interest coverage, despite a significant decline in yields.

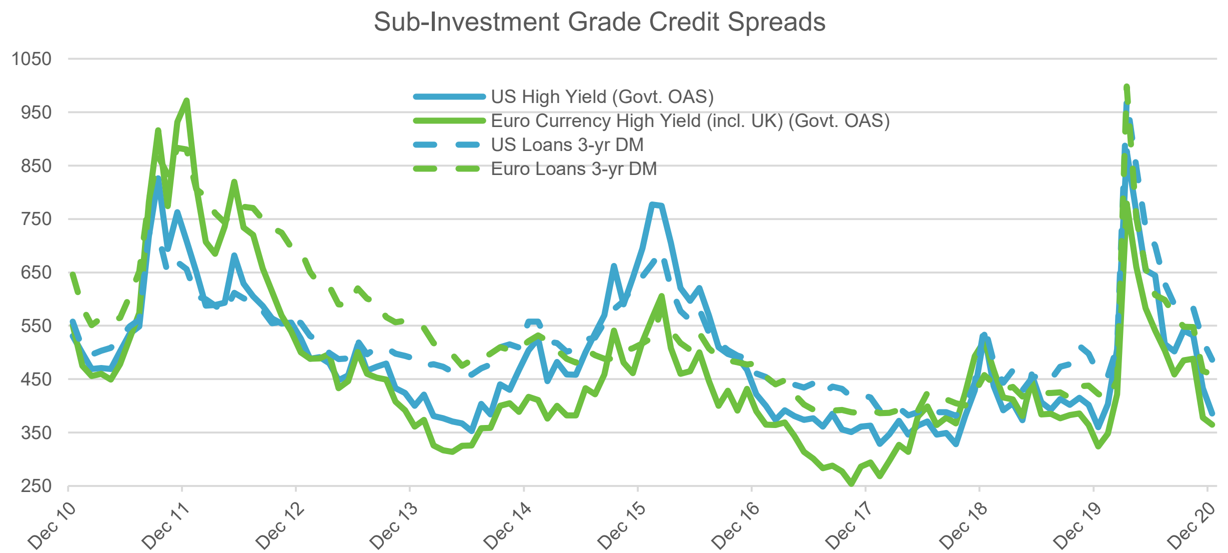
Despite US high yield default rates rising to 8.4% in the last 12 months to November, accommodative funding conditions have helped keep them well below the peaks of previous crises. However, it is likely defaults could remain elevated as government support wanes.

Global high yield spreads, on a ratings-consistent basis, are now well below long-term median levels. Whilst US leveraged loan spreads have also fallen (from 5.8% p.a. to 4.9% p.a) over the quarter, the premium on US leveraged loans versus US high yield is attractive relative to the post-Global Financial Crisis history.

Despite the fundamental backdrop deteriorating, private loans are typically being written with better lender protections meaning a better risk-adjusted return overall. The illiquidity premium to the loan market remains slightly compressed.

Speculative-grade credit yield

Spreads (bps)	31 December	-3 Mth	-12 Mth	10-yr Median
US HY	**386**	541	360	**469**
Euro Currency HY	**365**	485	324	**428**
US Loans 3-yr DM	**486**	579	461	**508**
Euro Loans 3-yr DM	**459**	548	423	**506**



Source: Bloomberg/BoA ML

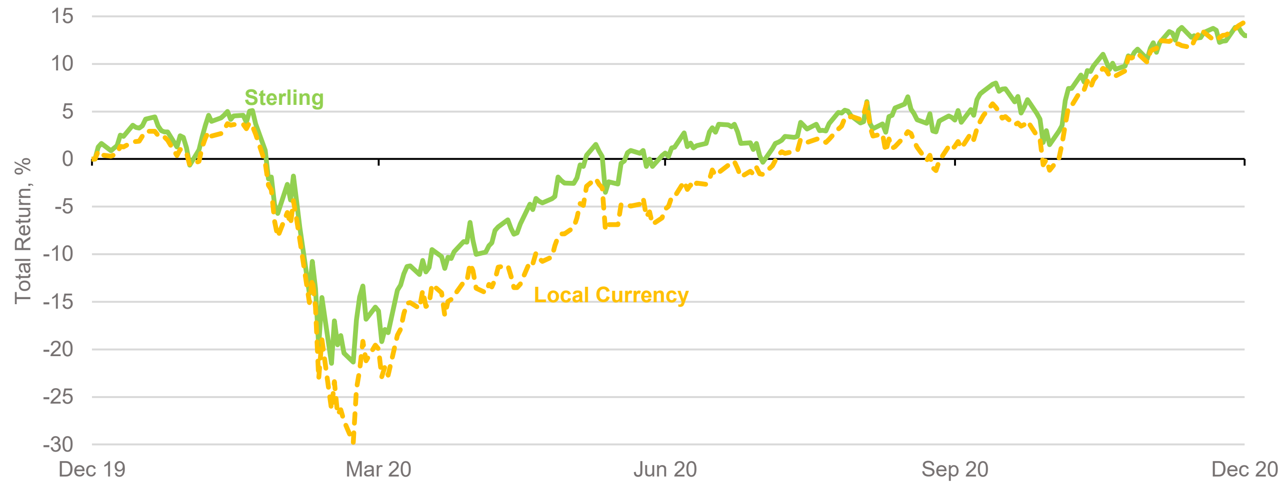
	Fundamentals	Valuations	Technicals	Overall
Liquid	Unattractive	Unattractive	Neutral	**Cautious**
Private	Unattractive	Neutral	Neutral	**Neutral to cautious**

After falling in October, global equity markets moved higher in November and December, with the FTSE All World returning 12.9% in Q4 and price levels rising close to all-time highs. Sterling strength weighed on returns for UK investors.

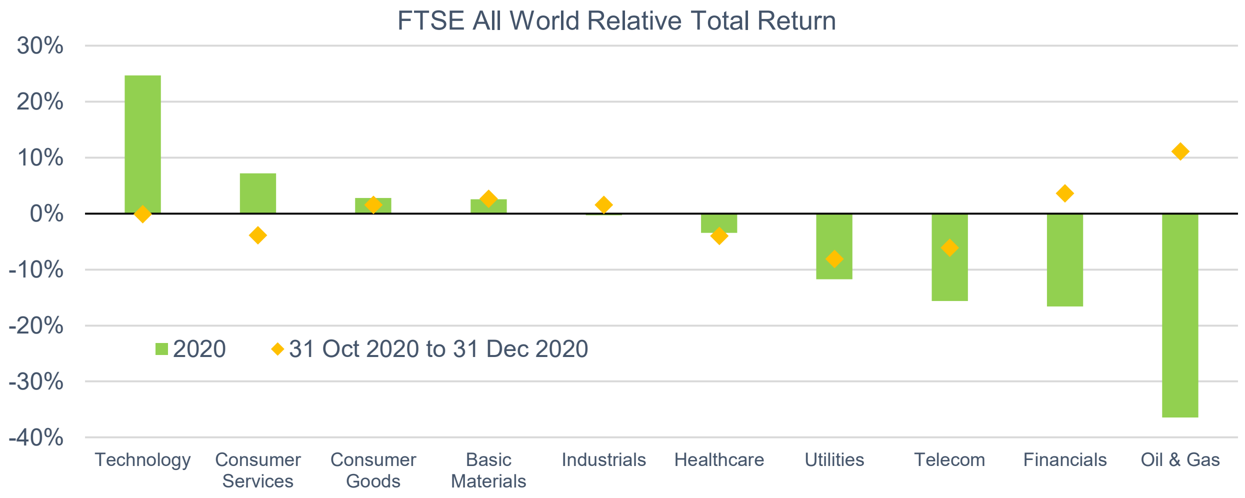
The pandemic-induced recession has been notable by its creation of winner and losers: "social distancing" stocks, mainly in the technology sector, have benefitted not only from their ability to grow earnings while most other stocks saw huge pressure on profits, but also from the decline in the discount rates used to ascribe a present value to their future earnings. Progress towards a vaccine has, to an extent, reversed this narrative since the start of November as cyclical sectors benefitted from improving economic sentiment.

Asian and Emerging Market equities outperformed, benefiting from renewed hopes of a cyclical recovery, a falling dollar and increasing global trade activity. The US election result, which alleviated some trade-war concerns, and the announcement of a large regional free-trade deal were also positive developments over the quarter.

Global equity returns



Total returns 31 Dec 2019 to 31 Dec 2020. Source: DataStream



Global equity valuations at, or near, record-high levels, however Q3 earnings have continued to outperform expectations and estimates for Q4 have risen. The bounce in earnings expected in 2021 would leave full-year earnings in 2021 above end-2019 levels. Given high valuations and near-term economic uncertainty, we retain a degree of caution, despite the fundamental improvement expected in 2021.

Valuations continue to mask stark divergences across sectors and regions. Cheaper valuations in regions such as Europe and the UK, with their higher-than-average cyclical exposures, may suggest there is further room for the value rotation to run. However, while rises in government bond yields are limited and gradual, longer-duration growth sectors, such as technology, may well remain in favour in spite of high valuations.

Vaccine rollouts should see significant pressure on COVID-19 laggards ease, but the disruption caused by the pandemic may accelerate longer-term trends. A rapid increase in technological adoption and efforts to de-carbonise the global economy would lend further fundamental support to the "winners" while weighing on old-economy cyclical sectors, such as oil & gas.

Global equities

Region (MSCI index)	P/E (trailing)		P/E (Shiller)		Price/Book		Price/Sales		EV/EBITDA		Dividend Yield (%)
	current	historic median	current	historic median	current	historic median	current	historic median	current	historic median	
World	28.4	18.6	25.0	21.5	2.9	2.2	2.0	1.3	14.2	10.0	1.8
US	32.1	18.3	32.1	20.5	4.4	2.6	2.6	1.6	16.3	10.8	1.5
EM	21.7	14.4	14.8	15.2	2.0	1.7	1.1	0.9	11.0	8.2	2.0
UK	17.6	14.1	12.7	15.0	1.6	1.9	1.2	1.2	8.9	7.7	3.3

As at 31 December 2020

	Fundamentals	Valuations	Technicals	Overall
Global equity	Neutral	Unattractive	Neutral	**Neutral to cautious**

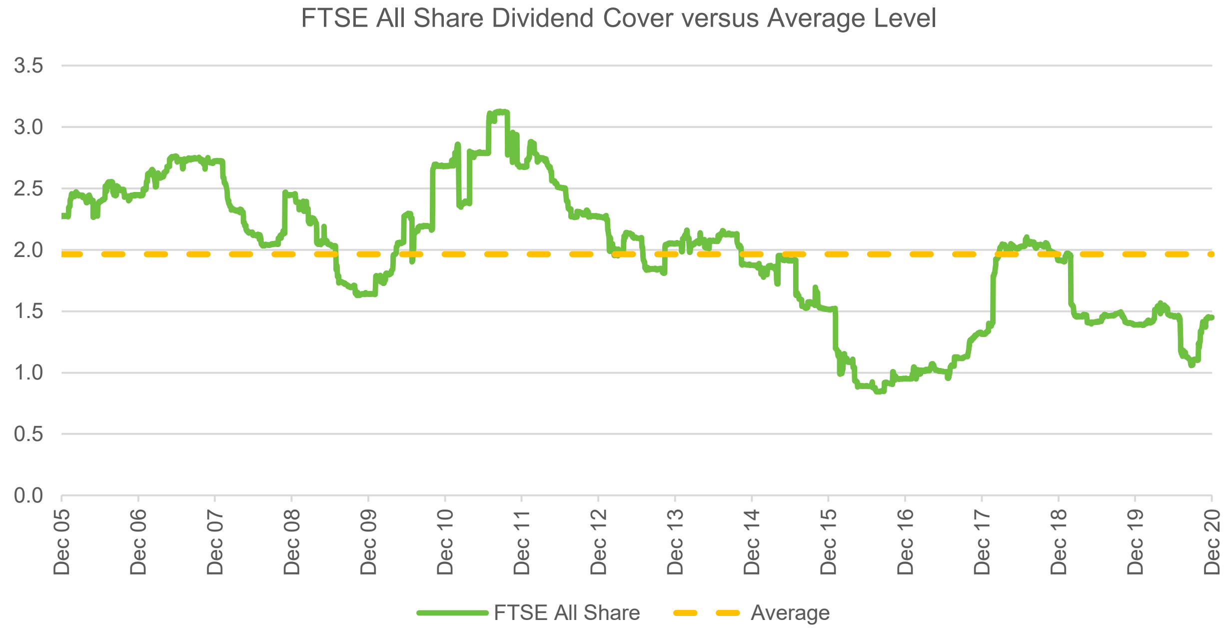
In spite of the near-term economic weakness owing to the re-imposition of restrictions, the UK equity market held its own largely due to its above-average exposures to oil & gas and financials.

Sterling strength following the Brexit trade deal weighed on some of these gains given the international earnings profile the UK market.

There remains a discount on UK equity valuations relative to global equities. However, sentiment towards UK equities remains poor, as both global economic growth rates slow and uncertainty over the impact of Brexit on the domestic economy lingers.

UK equities

Equity Market Data (Source: DataStream)	30 September 2020	31 December 2020
FTSE All Share Dividend yield	4.6	3.4
Dividend growth over the quarter	-5.8%	-15.6%
Dividend growth over the year	-12.5%	-26.4%
FTSE All Share P/E Ratio	20.6x	20.1x
Total Return over the quarter	-2.9%	12.6%
Total Return over the last 12 months	-16.6%	-9.8%



Source: DataStream

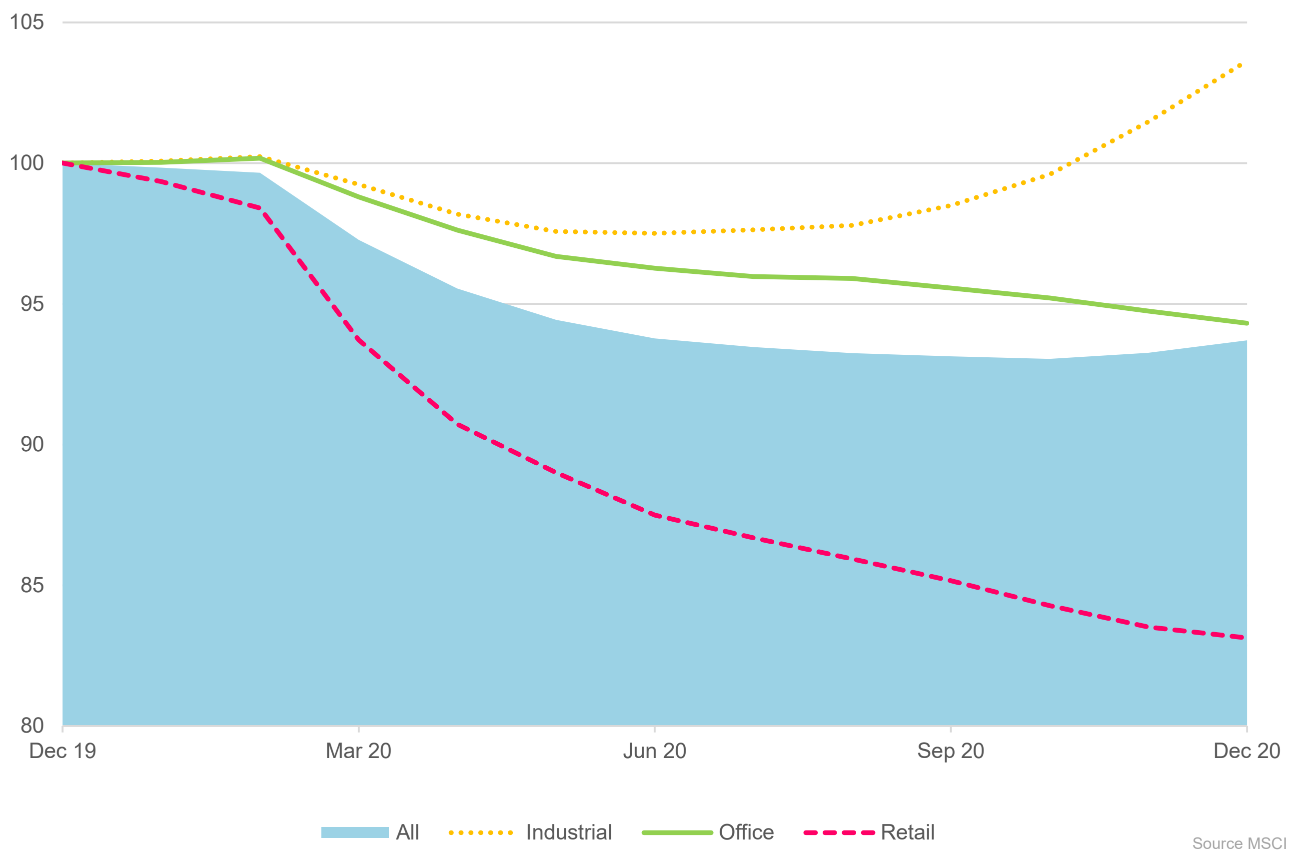
Property

The rolling 12-month total return on the index was -1.0% to the end of December, although the deterioration has moderated recently with monthly total returns being increasingly positive on a monthly basis since July.

Capital values, in aggregate, fell 6.3% over 2020.

The retail sector predominantly accounts for the overall decline in aggregate capital values, with the sector falling 16.9% fall over 2020. Capital values in offices fell 5.7% over 2020, with an increase in the level of decline over recent months. Industrial capital value growth is positive over the last year, having increased by 3.6%, with capital values rising on a monthly basis since July.

UK property – capital values



Source MSCI

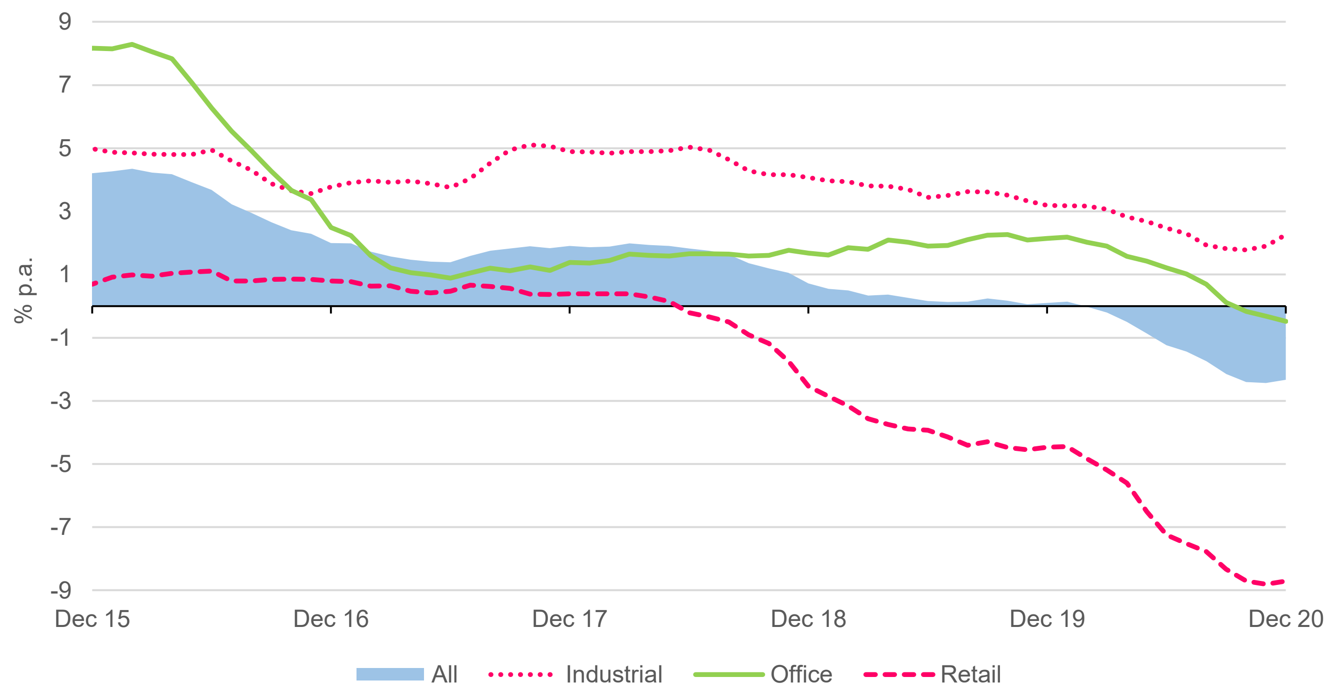
The month-on-month falls in rents that have occurred since February have levelled off and grew in December for the first time since September 2019, although aggregate rents have fallen 2.3% over 2020.

Vacancy rates have risen over the last year, with vacancies now 9.0% at the end of December compared with 7.6% a year earlier. This is led by the office sector where vacancy rates are 14.8% compared to 6.8% in industrials and 6.4% in retail.

Overall, transaction activity has picked up following the easing of the initial lockdown, but the market is continuing to face significant uncertainty as restrictions return. Fundamentals in the UK commercial property market remain weak to reflect to continued downside risk faced as the pandemic rages on while valuations remain underwhelming relative to historic levels. That said, the yield on offer looks more compelling when compared with other income assets.

On an absolute basis, long lease property valuations appear less attractive than wider property market but are supported by stronger fundamental and technical drivers.

UK property – rental growth



Source MSCI

	Fundamentals	Valuations	Technicals	Overall
Core	Unattractive	Unattractive	Unattractive	**Cautious**
Long Lease	Neutral to unattractive	Very unattractive	Neutral	**Neutral to cautious**

The economic impact of the pandemic is having a greater effect on the more GDP-sensitive sectors (airports, shipping, toll roads) of the infrastructure market. Less economically sensitive sectors such as utilities and social infrastructure remain in high demand as they provide essential services.

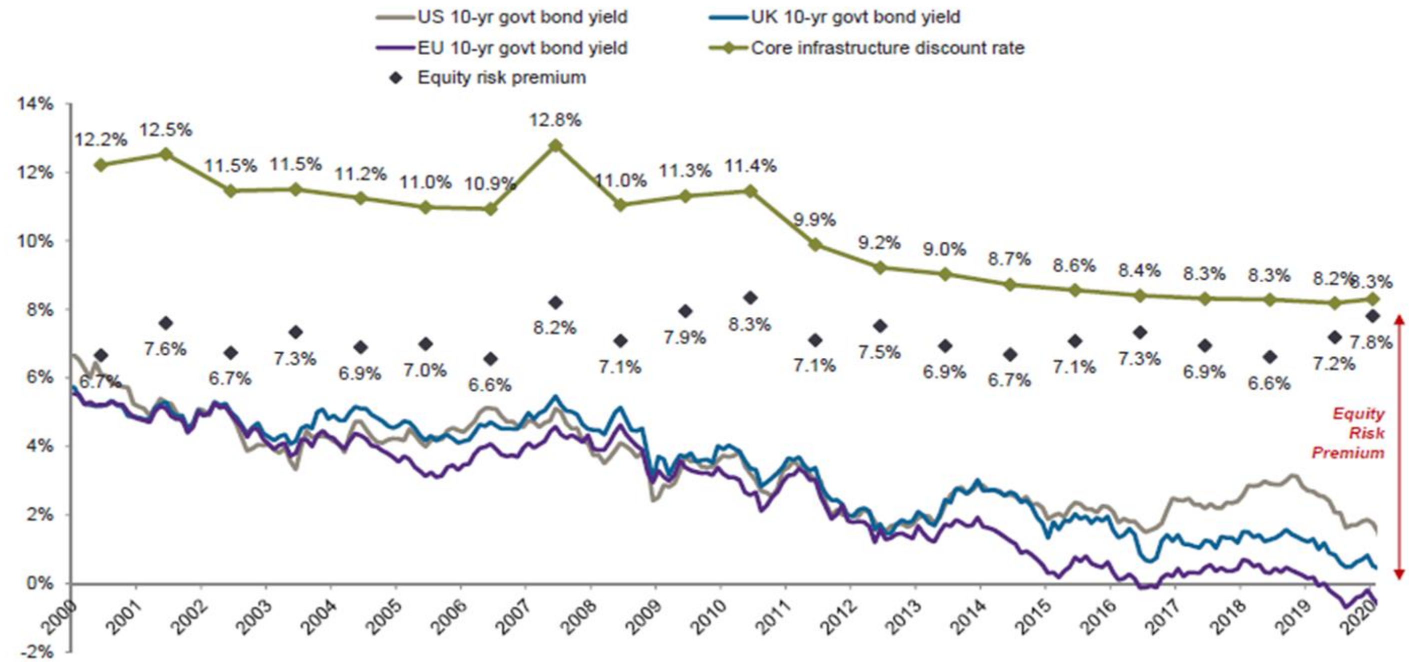
The pandemic has led to significant write-downs of some GDP-sensitive assets which has created some value opportunities, although overall transaction levels are suppressed so far this year.

Discount rates for core private infrastructure rose slightly in Q2 (latest data available) following a decade of continued falls. EV/EBITDA multiples for private infrastructure have fallen since the onset of the pandemic (led by the GDP-sensitive sectors) but remain at high levels relative to recent history.

Multiples for listed infrastructure have remained reasonably steady of late, although multiples are lower than those seen between 2014 and 2018.

Infrastructure

Estimates for core infrastructure discount rates vs. risk-free proxies



Source: JP Morgan

	Fundamentals	Valuations	Technicals	Overall
Infrastructure	Neutral	Attractive	Neutral	**Neutral to attractive**

Consensus forecasts

GDP growth (%)	2019	2020 forecast		2021 forecast	
		Sep 20	*June 20*	Sep 20	*June 20*
World	2.5	-4.6	*-4.7*	5.0	*5.2*
US	2.3	-4.4	*-5.6*	3.8	*4.4*
UK	1.3	-10.1	*-9.0*	6.5	*6.1*
Eurozone	1.2	-7.7	*-8.4*	5.5	*6.1*

Consumer prices (%)	2019	2020 forecast		2021 forecast	
		Sep 20	*June 20*	Sep 20	*June 20*
World	2.7	2.0	*1.9*	2.4	*2.3*
US	1.8	1.1	*0.8*	1.9	*1.8*
UK	1.8	0.8	*0.9*	1.5	*1.3*
Eurozone	1.2	0.4	*0.3*	1.0	*1.0*