Appendix A

Q3 2021
Capital Markets Outlook

November 2021

Essex County Council

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HYMANS ROBERTSON

Overview of asset class views

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.

Summary views

	Equities	Sterling IG debt	Liquid Sub-IG debt	Private lending	UK Property	Long Lease Property	Gilts	Index-linked gilts
Fundamentals	N → A	N	N	N	N	N	N → U	N → U
Valuation	U	U	U	N *(relative)*	U	U	N → U	U
Technicals	N	N	N	N	N	A	N	N
Overall view	Neutral	Cautious	Cautious	Neutral to Cautious	**Neutral to Cautious**	**Neutral**	Neutral to cautious	Cautious
Previous quarter	Neutral	Cautious	Cautious	Neutral to Cautious	Cautious	Neutral to Cautious	Neutral to cautious	Cautious

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.

Overview of views

Equities	The earnings recovery shows little sign of flagging yet, but valuation multiples based on cyclically-adjusted earnings remain stretched versus history. Perhaps the only lens through which global equity valuations do not look exceptional is that of real yields.
Investment grade credit	Spreads in investment-grade markets remain well below long-term median levels given strong technical support from central bank purchases, improving fundamentals and robust corporate earnings. Current valuations warrant caution as recent fundamental improvements are already reflected in spreads and future downside risks remain. Long-duration, low spread, investment-grade credit markets are susceptible to potential rate rises, particularly if inflation turn out to be less transitory than thought. We continue to have a preference for ABS which offer an attractive spread premium and provide insulation against interest-rate volatility.
Liquid Sub-investment grade debt	The rebound in growth and earnings is improving the fundamental backdrop with leverage levels falling and interest coverage increasing. Defaults and distress levels continue to decline, and defaults are expected to remain below long-term average levels over 2021 and 2022. However, our cautious view is predicated on spreads which are well below long-term median levels and are already fully pricing in the more favourable environment. We have a preference for loans over high yield given the more attractive valuations.
Private Lending	A post-Covid rebound in earnings has improved fundamentals with most managers taking assets off watchlists. Valuations remain neutral, relative to traded loan spreads, but given loan spreads are below long-term median levels we retain some caution. There remains a very high level of activity in the market with most managers achieving high levels of deployment over the quarter, which is expected to continue in Q4.

Overview of views (cont.)

Core UK property	The fundamentals for the UK property market have improved of late, principally from a stronger occupier market. The recovery in transaction activity continues to gather pace although it remains too early to conclude that this will be sustained despite tentative improvements in fundamentals.
Long Lease Property	On an absolute basis, valuations appear less attractive than wider property market but are supported by marginally stronger fundamentals as are less exposed to the most troubled sectors. Improved market fundamentals may create a more bullish outlook for the sector, although it is still at an early stage.
Conventional gilts	The pace at which markets now imply interest rates will rise over the next few years does not feel unreasonable. Although the risks still seem skewed to an even faster pace, which would be bad for bond markets. The shorter end of the gilt market looks reasonable, however longer-dated yields remain expensive.
Index-linked gilts	We see inflation pricing at terms between 10 and 30 years as being the most expensive. In the context of near-term inflation risks, implied inflation up to 10 years is perhaps less expensive than at first glance.

Portfolio positioning

- Economic momentum may have eased, but the global economy is forecast to grow at a healthy pace. Concerns about coronavirus have diminished, but supply-side risks and China's economic slowdown have intensified.

- Though central banks are adopting a slightly less accommodative stance, financial conditions are easy and negative real yields are expected to persist for some time. However, even a moderate rise in real yields could pose a challenge, with an obvious potential trigger being interest rate increases in response to persistence in current inflationary pressures.

    - The risk of a faster pace of rate rises leaves us cautious on bond markets in general. Front-end nominal yields continue to look more fairly valued than longer-term yields. Implied inflation looks expensive across all maturities, but particularly so between 10 and 30 years. Implied inflation up to 10 years is perhaps less expensive in the context of near-term inflation risks.

    - It is becoming increasingly difficult to identify attractive opportunities in credit markets – certainly in absolute terms, but increasingly also relative to risk-free alternatives. Within investment-grade markets, we favour asset-backed securities over corporate bonds, while loans and hard-currency emerging market debt look less stretched than high-yield bonds.

    - Equity and property valuations reflect a lot of good news and valuations lean heavily on low bond yields. However, positive earnings momentum and relative value still lend short-term support to equites, which we prefer to bonds and property (where any improvement in fundamentals is more tentative).

    - Given the absolute level of valuations across most asset classes, we still advocate holding elevated levels of cash.

Economic background

HYMANS ROBERTSON

Global equities gave up earlier gains in September as investors weighed easing economic momentum, continued supply chain disruptions, higher inflation, and the prospect of fading monetary support.

UK bond yields rose, and prices fell, as upside inflation surprises led to expectations of earlier rate rises.

Despite fears over a potential default by Evergrande, a heavily indebted Chinese property developer, global investment grade spreads were little changed and speculative-grade spreads rose only marginally.

Rising oil demand, and low global natural gas inventories, maintained pressure on energy prices.

Market Returns

UK	Q3 21	Q2 21	YTD
EQUITIES	2.2	5.6	13.6
BONDS			
Conventional gilts	-1.8	1.7	-7.4
Index-linked gilts	2.3	3.6	-0.7
Credit	-1.0	1.7	-3.4
PROPERTY	4.6	3.9	11.1
STERLING			
v US dollar	-2.4	0.1	-1.4
v Euro	-0.1	-0.8	4.1
v Japanese yen	-1.9	0.6	6.6

GLOBAL	Q3 21	Q2 21	YTD
EQUITIES	-0.2	7.1	13.5
North America	0.3	8.8	15.4
Europe ex UK	0.3	7.2	16.4
Japan	5.0	0.1	14.8
Dev. Asia ex Japan	-4.2	5.5	7.2
Emerging Markets	-5.6	4.1	2.3
Government Bonds	0.1	0.7	-1.8
High Yield	0.2	2.4	3.3
Gold	-0.3	3.6	-7.2
Oil	4.4	18.5	51.4

Returns to 30 September 2021

*Global Equity and Government Bond returns - Local Currency; High Yield, Gold and Oil - USD.

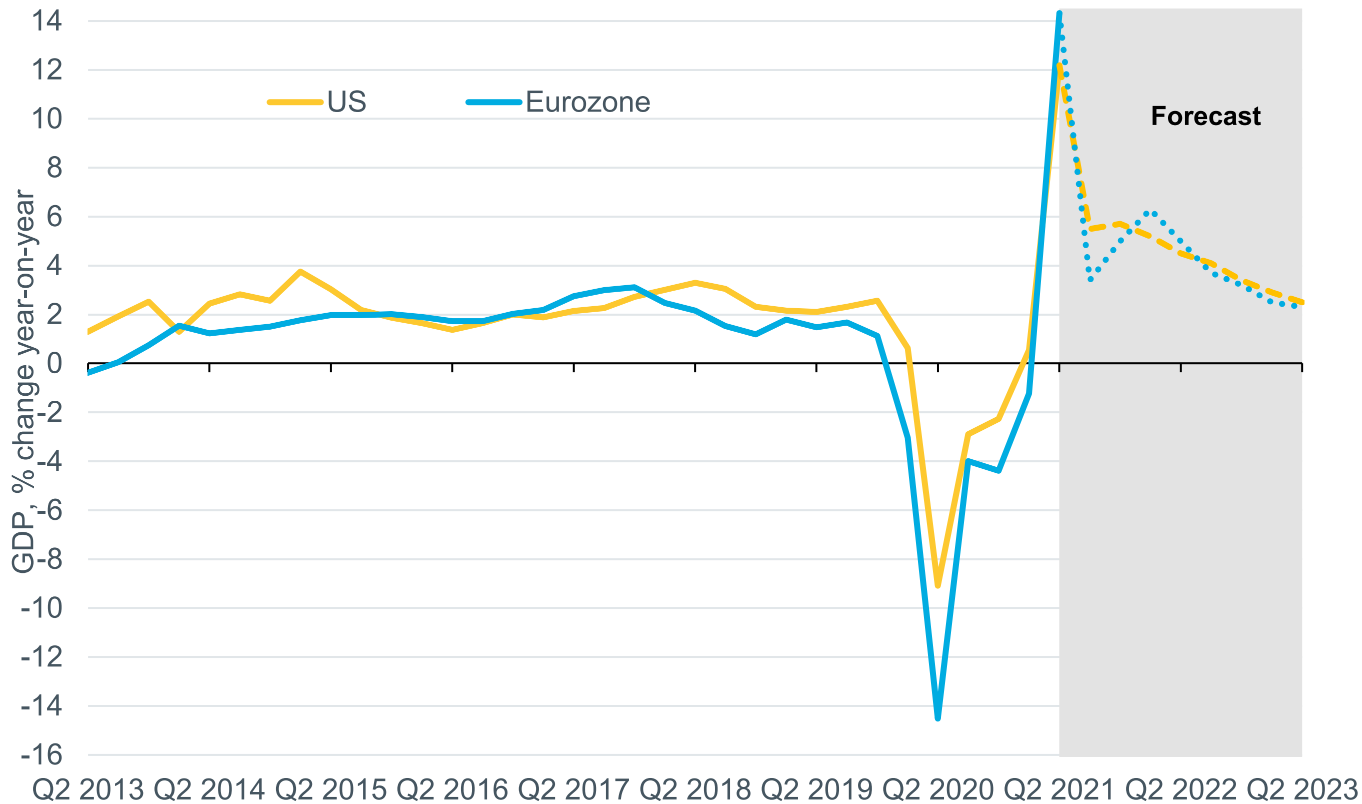
Source: DataStream

Growth momentum has started to ease as the initial impact of re-opening late last year fades.

Q2 likely represented a peak in the quarterly pace of global growth with strong growth figures released in Q3 across the major advanced economies.

US output increased 1.6% in Q2, regaining pre-pandemic levels; the eurozone economy expanded by 2%, exceeding expectations, as the recovery gained momentum; and, the UK's upwardly revised expansion of 5.5% left UK output at the end of Q2 just 3.3% below its level in the fourth quarter of 2019, before the pandemic struck.

GDP Growth

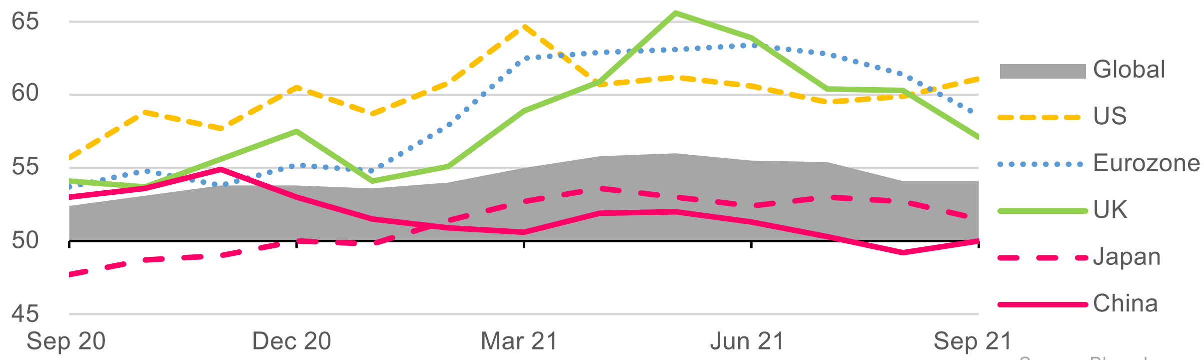


PMI data for US, UK, and eurozone suggest that, while the overall rate of expansion remains solid, the pace of growth eased over Q3, reflecting a combination of peaking demand, supply chain disruptions and labour shortages.

Demand in the service sector has been impacted by the Delta variant spread and, while manufacturing has seen far more resilient demand, factories face growing problems in sourcing supplies and labour to meet orders.

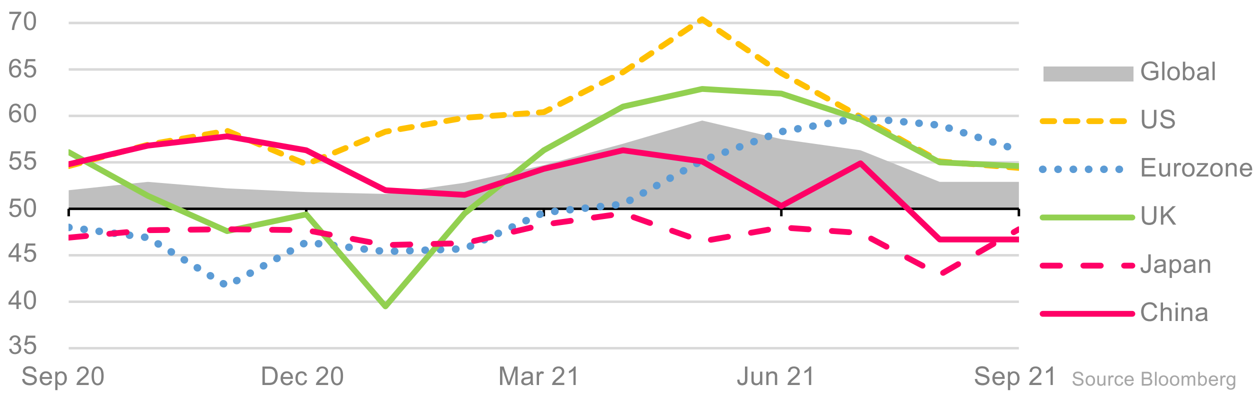
Despite businesses reporting difficulty in filling vacancies and an ongoing fall in unemployment on both sides of the Atlantic, employment at a global level remains well below pre-pandemic levels.

Manufacturing PMI



Source: Bloomberg

Services PMI



Source Bloomberg

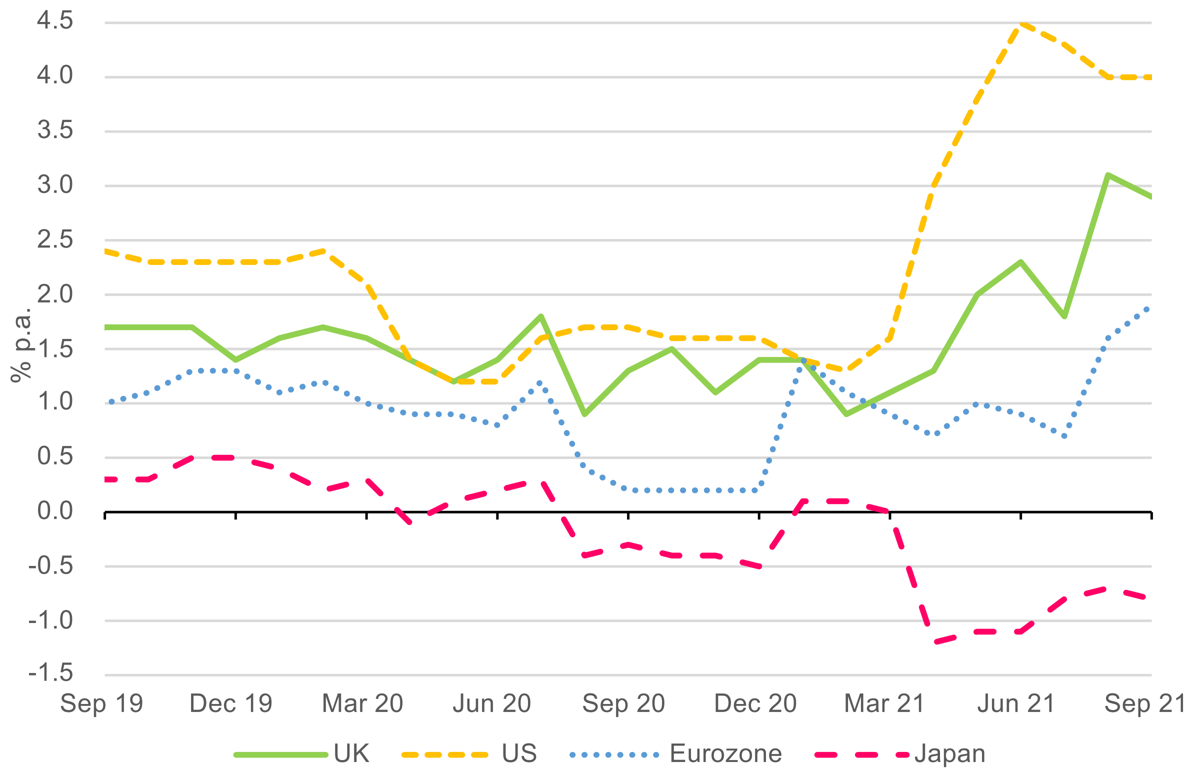
Simultaneously, supply constraints are pushing prices higher and inflation pressures are evident in many economies.

Rising gas and oil prices are driving up headline measures but even core inflation, which excludes those prices as well as food, is exceeding central bank targets in the major advanced economies.

While most forecasters still expect the inflationary spike to prove transitory, inflation forecasts, for this year and next, continue to see upwards revisions.

Consensus forecasts annual US headline CPI inflation will fall to 2.5% by Q3 2022. Expectations are that UK headline CPI inflation will peak at 3.6% year-on-year in Q1 2022, but consensus forecasts it will moderate to 2.6% by Q3 2022.

Core CPI Inflation



Source: DataStream

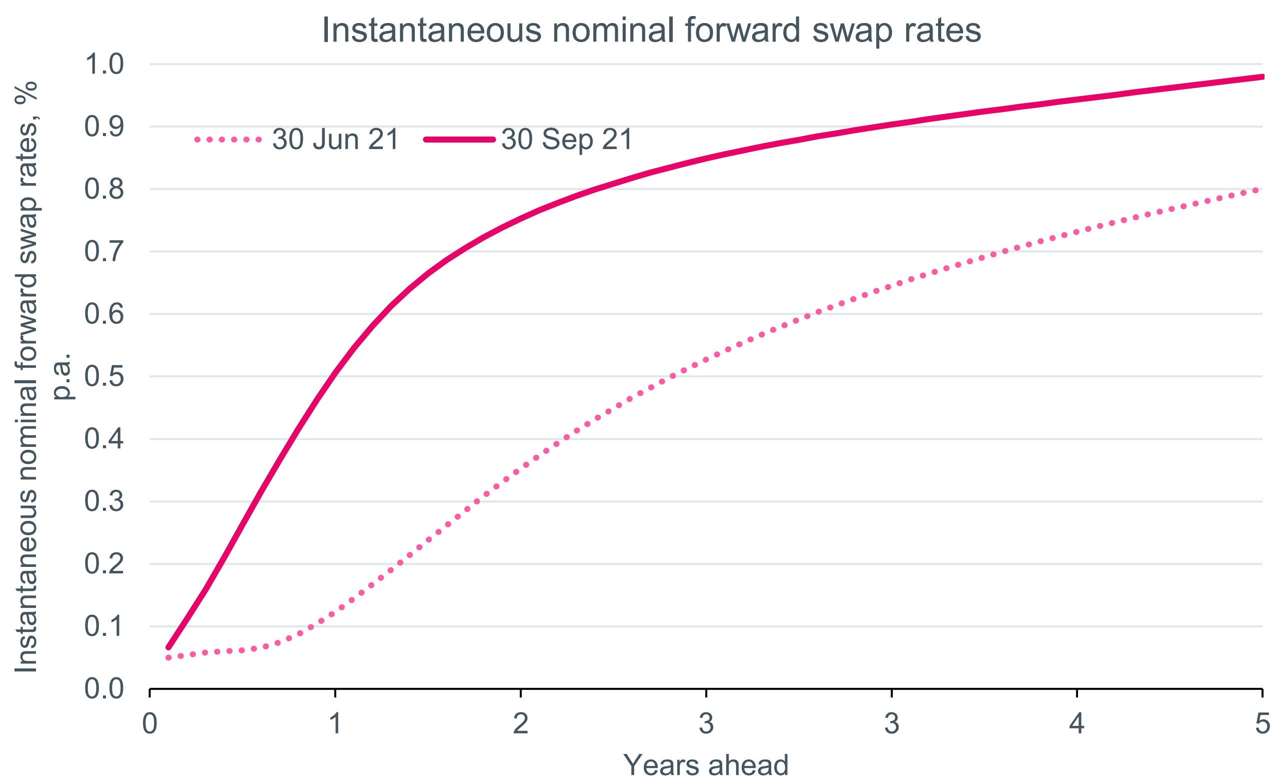
Asset class views

UK gilt yields rose 0.3% p.a. in Q3, with steep rises coming in the wake of the Bank of England's September meeting.

A combination of strong growth and high inflation, even if it is temporary, has resulted in indications from central banks that rates will rise a little faster than previously thought and markets have adjusted accordingly (see chart).

The pace at which markets now imply interest rates will rise over the next few years does not feel unreasonable. Although the risks still seem skewed to an even faster pace – which would be bad for bond markets – we do not think the shorter end of the gilt market is particularly expensive.

Conventional government bonds



	Fundamentals	Valuations	Technicals	Overall
Gilts	Neutral to Unattractive	Neutral to Unattractive	Neutral	**Neutral to Cautious**

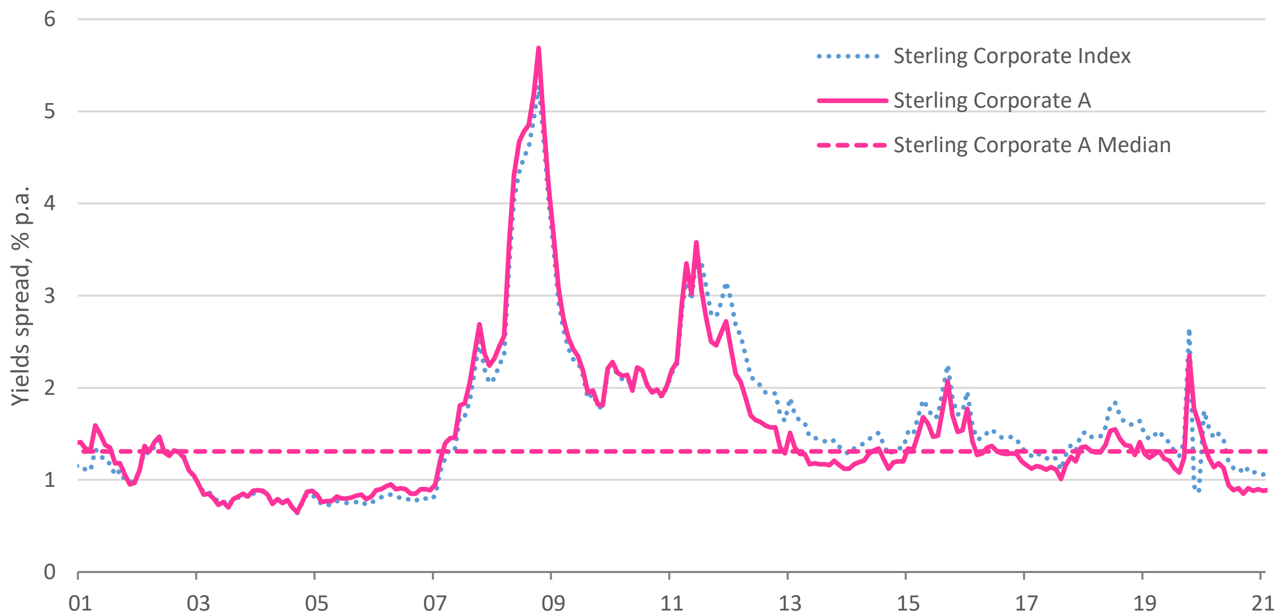
Investment-grade corporate credit

Global investment-grade spreads were little changed in Q3. Sterling investment grade spreads moved marginally tighter over the quarter whilst US and Euro spreads moved marginally wider.

Strengthening corporate finances provide a strong fundamental backdrop for credit markets: defaults and leverage levels are falling, interest coverage is rising, and liquidity is plentiful. As a result, upgrades to credit ratings increasingly outweigh downgrades.

Long-duration, low spread, investment-grade credit markets are susceptible to potential rates volatility and increases if the factors behind the recent rise in inflation turn out to be less transitory than thought.

Spreads (bps)	30 Sep	-3 Mth	-12 Mth	10-yr Median
US IG	**89**	86	144	**135**
Sterling IG	**104**	106	150	**149**
Euro IG	**85**	84	118	**118**



Source: ICE

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

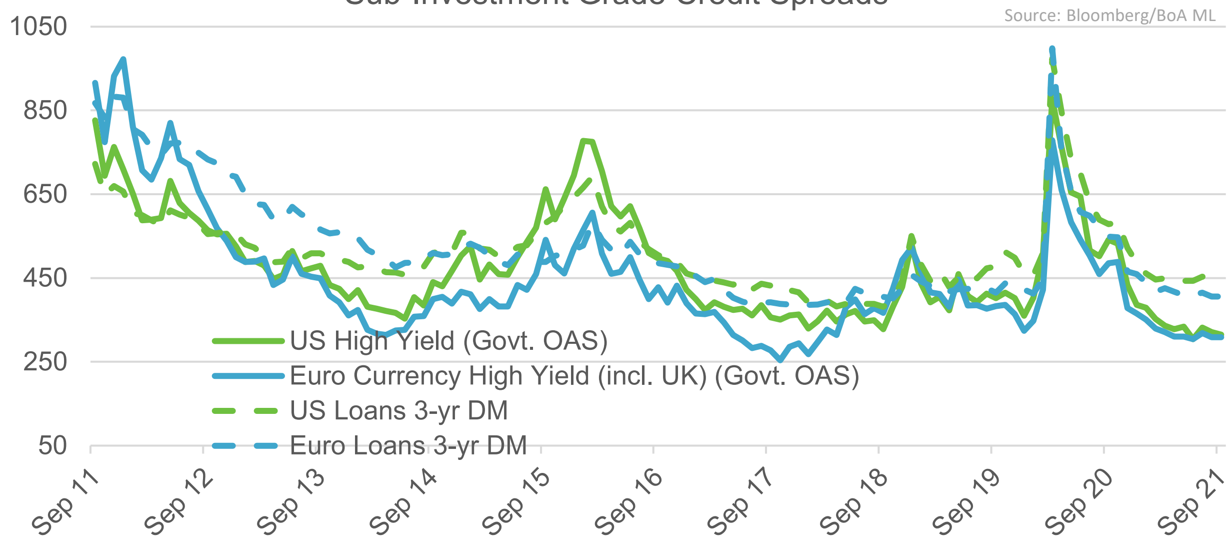
Global speculative-grade spreads fell 0.3% p.a. to 3.5% p.a. and are now below end-2019 levels and in-line with the lows of January 2020.

The rebound in growth and earnings is improving the fundamental backdrop with leverage levels falling and interest coverage increasing. Defaults and distress levels continue to decline, and defaults are expected to remain below long-term average levels over 2021 and 2022.

In private debt, a post covid-19 rebound in earnings has improved fundamentals. Valuations remain neutral, relative to traded loan spreads, but loan spreads well below long-term median levels still gives us cause for caution.

Speculative-grade credit yield

Spreads (bps)	30 Sep	-3 Mth	-12 Mth	10-yr Median
US HY	**315**	304	541	**446**
Euro Currency HY	**309**	304	485	**405**
US Loans 3-yr DM	**438**	443	579	**498**
Euro Loans 3-yr DM	**406**	410	548	**492**



	Fundamentals	Valuations	Technicals	Overall
High yield	Neutral	Unattractive	Neutral	**Cautious**
Loans	Neutral	Neutral to unattractive	Neutral	**Neutral to Cautious**
Private debt	Neutral	Neutral *(relative)*	Neutral	**Neural to cautious**

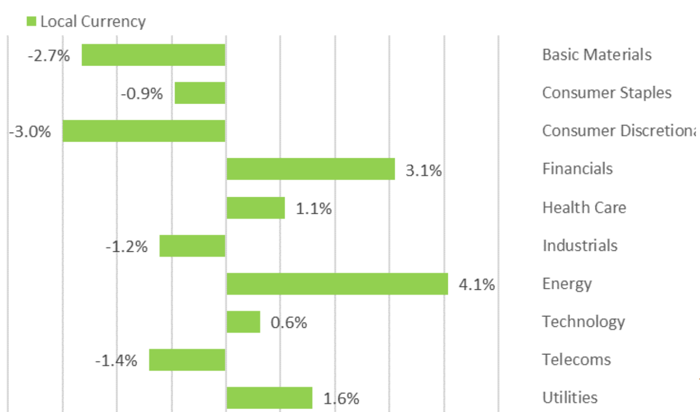
Despite a stellar Q2 earnings season, volatility increased, and global equities handed back all of their gains in September as markets weighed easing economic momentum, the prospect of fading monetary support, and a potential debt shock in China.

There was a rotation in sectoral performance in September relative to earlier in the quarter. Surging energy prices propelled the energy sector to the top of the performance rankings. Financials also outperformed following the rise in yields in September. Basic materials, consumer staples and consumer discretionary underperformed.

Global equity returns

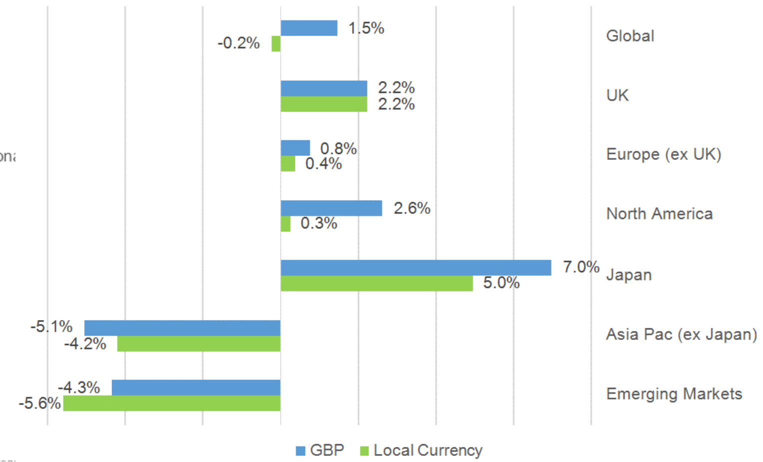
Total returns 30 Jun 2020 to 30 Jun 2021. Source: DataStream

Relative Q2 equity sector performance



Global Sector returns relative to FTSE All World Index 30 Jun 2021 to 30 Sep 2021. Source: Datastrea

Q2 Regional Equity performance



Total returns 30 Jun 21 to 30 Sep 21. Source: DataStream

The stellar earnings recovery shows little sign of flagging so far, but traditional valuation metrics are stretched versus history, leaving little scope for disappointment.

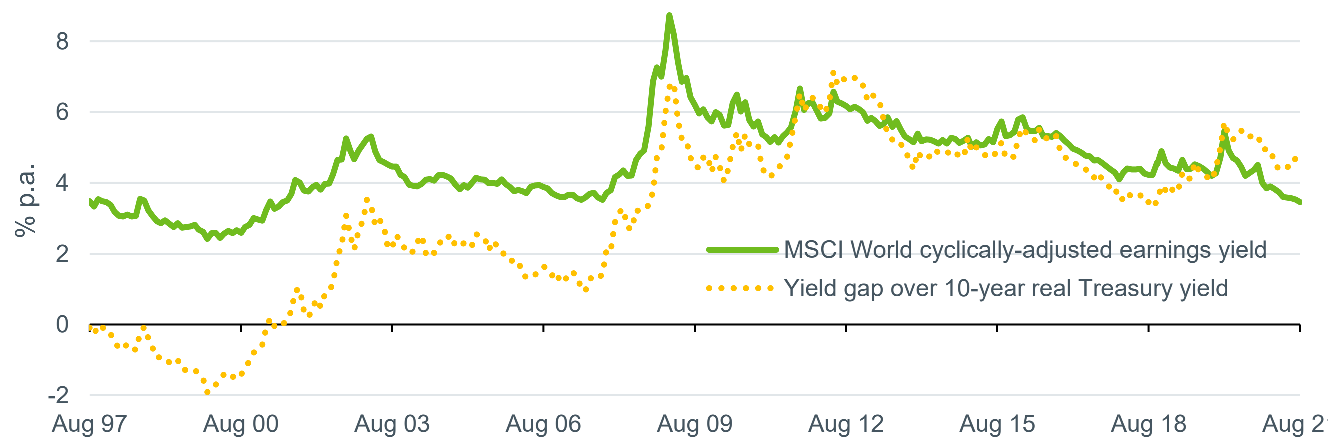
Perhaps the only lens through which global equity valuations do not look bloated is that of real yields. The chart shows the global equity earnings yield, based on the average inflation-adjusted earnings of the previous 10 years, and the gap between this earnings yield and the 10-year real US treasury yield.

On this basis, equities look no more or less expensive than post-crisis averages. However, this may simply be comparing one expensive asset class with another. Even a moderate rise in real yields, to levels seen as recently as 2019, would considerably narrow the risk premium on offer.

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	22.8	18.7	28.9	21.6	3.2	2.2	2.0	1.3	14.2	10.0	1.7
US	25.9	18.4	37.1	20.9	4.7	2.6	2.6	1.6	16.3	10.8	1.4
EM	15.1	14.5	15.8	15.5	1.9	1.7	1.1	0.9	11.0	8.2	2.2
UK	17.8	14.2	14.4	14.9	1.8	1.8	1.2	1.2	8.8	7.7	3.7

MSCI World and AC World cyclically adjusted price-to-earnings ratio



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

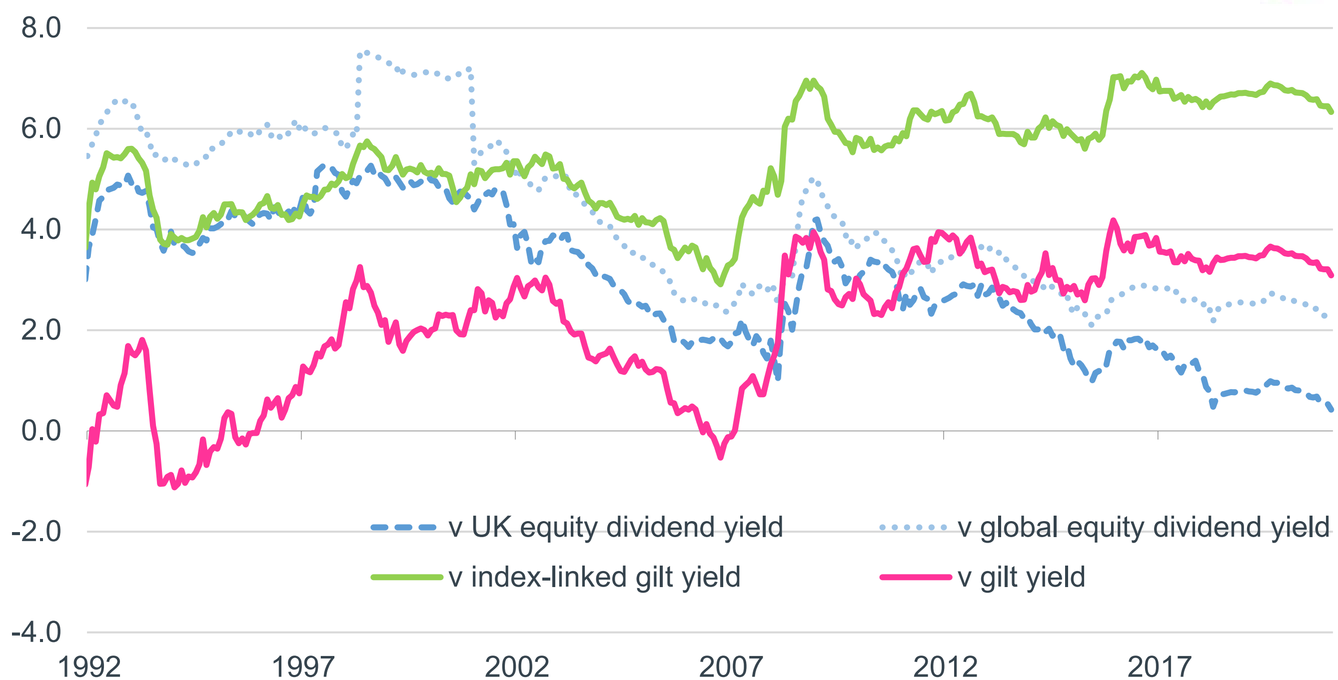
Capital values in the UK industrial and retail commercial property sectors have continued to edge higher in recent months; values in the office sector have changed little. Over the last 12-month period, only the buoyant industrial sector has seen a rise in capital values.

Property fundamentals have continued to improve in recent months, with tenant demand increasing for the first time since 2017 in Q2, according to the RICS quarterly UK commercial property survey .

Nominal annual rental growth across property sectors, in aggregate, has been increasing since February, but has still not caught up with the rising pace of inflation. However, initial (current income) and reversionary (full rental) yields remain very low versus history.

UK property

UK property initial yield



Source: MSCI

Core	Neutral	Unattractive	Neutral	**Neutral to Cautious**
Long Lease	Neutral	Unattractive	Attractive	**Neutral**

Appendix

Asset class views framework

The views are intended to give a guide to our views on markets over the medium term; although they are updated quarterly, they are not intended as tactical calls.

The views reflect our expectations of absolute returns and assume no constraints on the investment decisions. In practice, they need to be interpreted in the context of the strategic framework within which individual funds are managed.

Fundamentals

These are the underlying economic drivers of an asset class which impact returns. Examples of fundamental factors include earnings, rents, inflation, interest rates, defaults, and leverage levels.

Valuation

Valuation is concerned with the price the market places on the relevant fundamentals and how that compares with history and/or our view of fair value.

Technicals

These are shorter-term factors that may tend to move markets back towards or further away from fair value. These are often factors which impact the supply/demand balance and include asset flows, issuance, investor confidence, central bank intervention, and geopolitical risk.

Risk warnings

General risk warning

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 an overseas 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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