REPORT PREPARED FOR

Worcestershire Pension Fund

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Independent Investment Adviser's report for the Pension Committee meeting

13 December 2019

Global overview

The Federal Reserve set the tone for the global economy over Q3 in its much-anticipated move of lowering rates. The Fed cut rates in July and September, lowering the target range to 1.75% - 2%. In Europe, the ECB also took measures to stimulate the economy by also cutting rates and re-starting its programme of quantitative easing. Meanwhile, global markets made slight gains, whereas emerging markets fared poorly as many were hit by the knock-on effects of the Fed's rate cut and continued US-China trade tensions. In the UK, Boris Johnson became Prime Minister and Brexit uncertainty continued.

GDP: US GDP is expected to grow 1.9% in Q3, as last quarter's GDP was revised up from 1.8% to 2.0%. This came as the consumer confidence index fell in August from 134.2 to 125.1, and as US-China trade tensions continued to cause concern.

In the UK, Q3 GDP growth is expected to be at 0.3%, despite the continued political uncertainty in the country. The slight reversal to positive this quarter was largely due to the services sector (which makes up approximately 80% of the UK economy), in particular film and television production. In the Eurozone, GDP growth is predicted to be 0.2% for Q3, as the ECB restarted quantitative easing in September amidst weakening growth in the region.

CPI: In Q3, inflation levels in the US stayed consistent with the end of the previous quarter, rising from 1.6% to 1.7%. The indices for housing, and food costs increased but were counterbalanced by falls in energy, used cars and trucks.

In the UK, the consumer price index fell from 2.0% at the end of Q2 to 1.7%; this is below the 2.0% target set by the Bank of England. This decline was driven by motor fuels, electricity, gas and other fuels, and second-hand cars. These moves were partly offset by increases in the costs of furniture, household appliances, hotel stays, recreation, and cultural items.

Central Banks: In Q3, central banks turned towards more dovish policies, with the Federal Reserve cutting rates twice, totalling a 50bp cut. At the same time, the ECB cut rates, for the first time since 2016, by 10 bps, further into negative territory to a record low of -0.5%, as well as restarting its quantitative easing programme. This will make it harder for the incoming ECB president Lagarde to further loosen monetary policies. Across the world, 43 central banks have cut interest rates a total of 67 times in Q3, compared to 26 cuts in Q2, and 19 in Q1. The Bank of England has held firm on interest rates as Brexit uncertainty continued to prevail.

Political Headlines: In the UK, Boris Johnson started his new role as Prime Minister, amidst claims that he would avoid at all costs requesting an extension to Brexit from the European Union. In the US, the main headline was the Federal Reserve cutting interest rates first in July then again in September. In Japan, Abe was re-elected as Prime Minister, while in Italy there was a split in the governing coalition between the Five Star and the Democratic Party.

Worcestershire Pension Fund

Quarter to end September 2019

Summary and Market Background

The value of the Fund in the quarter rose to £2.93bn, an increase of £64m compared to the end June value of £2.87bn. The Fund produced a return of 2.3% over the quarter, which was in line with the benchmark. The equity protection strategy provided a small positive contribution to returns, with the main positives being good performance from the alternative benchmark passive portfolio and from the Nomura Far East mandate. Over a 12-month period the Fund recorded a negative relative return against the benchmark of -0.6% (5.7% v. 6.3%). The Fund has performed close to benchmark over the three, five and ten-year periods, details of which can be found in Portfolio Evaluation Limited's report.

The equity protection strategy mandate with River & Mercantile was originally *implemented to secure some protection to the funding level* against a relatively significant fall in equity values, as seen in the fourth quarter 2018, up until after the next Triennial valuation in April 2019 (covering an 18-month period). This protection has now been extended until Q3 2020 to help manage the Fund’s risk profile ahead of the new funding period. Work on the strategic asset allocation review is now well advanced, which will be considered at the Pensions Committee meeting in December. This will include a review of the risks associated with the Fund's relatively high allocation to equities and how that can be mitigated in the future, alongside consideration of a further switch to other asset classes that will seek to maintain returns while reducing risk. The Hymans report has highlighted some asset classes that could be considered in the future, but which are currently unattractive due to their high relative valuations.

Emerging Markets assets have now been transitioned to LGPS Central and their appointed managers (BMO, Vontobel and UBS) and we have their first quarterly report. The transition of the Corporate Bonds mandate, currently managed by JP Morgan, to the LGPS Central sub fund (the appointed managers are Fidelity and Neuberger Berman) has been postponed until early 2020. This is due to the potential for higher than normal market volatility during the period leading up to the UK General Election and possibly afterwards.

Following the transition of the two Emerging Markets mandates to LGPS Central, the Fund effectively now has only two active equity managers. Nomura (Pacific) enjoyed a good quarter, with an outperformance of 1.8%. LGPS Central (Emerging Markets) just about managed an in-line performance during their inaugural quarter. JP Morgan (Bonds) had an outperformance of 0.1% against their benchmark.
The alternative passive strategies outperformed the total passive benchmark by 1.5% (4.9% v. 3.4%). Passive market equities outperformed the active equities group by 1.4% (2.7% v. 1.3%), which reflects in aggregate terms the regional market indices that they represent rising more than those in the active section of the Fund.

Equities

Over the course of Q3 2019, equity markets were a mixed picture: developed equity markets experienced broadly modest growth, helped by central bank action, while emerging market economies fared less well delivering a mix of low or negative returns. Moves by the Federal Reserve and the ECB helped to sustain UK and US equities. US company earnings are estimated to be overall in decline based on reports in earnings season.

UK: UK markets were slightly up in Q3 with the FTSE 100 up by 0.9% while the FTSE All-Share rose 1.2%, bringing its year to date returns to 14.3%. Defensive sectors performed well while more economically sensitive sectors such as financials underperformed. Some investors took advantage of sterling weakness and relative value opportunities in UK equities.

EU: The Euro STOXX 50 increased by 3.1% in Q3. Like other developed markets, the EU region made modest but positive gains over the quarter, boosted by the ECB's move to re-start quantitative easing. However, the knock-on effects of the US-China trade tensions, coupled with political uncertainty in the UK, Italy and Spain meant that equity markets' growth was not pronounced.

US: The US stock market made small gains over the quarter. The S&P 500 index ended Q3 up just 1.7%. Sectors including real estate, utilities and consumer staples performed relatively well while energy, materials and healthcare, the latter given the political sensitivities, performed poorly. Value stocks performed well, while Momentum stocks performed poorly.

Japan: While the Japanese equities market had a difficult start to the quarter, it picked up significantly in September. The Nikkei 225 was up 3.0% over Q3; this added to the positive year to date gains of 10.8%. As Abe was re-elected as Prime Minister, this sent a positive message reassuring markets of the continuation of Abe's policies.

China: The MSCI China Index fell by -4.4%. This came as the Chinese government attempted to counter the negative effects of the US-China trade tensions by boosting its economy with tax cuts, interest rate cuts and increases in government spending.

Emerging Markets: The MSCI Emerging Markets index was down -4.2% for Q3. Markets in Argentina fared particularly poorly after surprise primary election results worried investors about the future of their current pro-business government. The effect of the US-China trade war took its toll on emerging economies as well as global growth concerns. Although MSCI Emerging Markets index returns were poor during Q3, the year to date returns are still positive at 6.1% to the end of September.

Fixed Income

Government Bonds: In Q3, bond yields fell markedly due to global economic, low inflation and trade war concerns. A recovery followed in mid-September as the US and China indicated optimism with the planned resumption of talks in October. The 10-year US Treasury yield fell by 32 bps; the US yield curve temporarily inverted, for the first time since 2007, an indication of a possible slowdown approaching. ECB policy pushed bond yields down throughout the Eurozone with Greek three-month bonds offering negative yields. 10-year German and Japanese government bond yields both fell further into negative territory. In Britain, the UK 10-year yield fell by 34 bps. This was due, once again, to Brexit uncertainty.

Investment Grade Corporate Bonds: In Q3, IG corporate bonds outperformed government and high yield bonds: US investment grade bonds outperformed both US government and US high yield bonds; UK government, investment grade, and high yield bonds outperformed all of these. The Bloomberg Barclays US Corporate Investment Grade TR Index Unhedged returned 3.1%, bringing the year to date return up to 13.2%. The telecoms and utility sectors had strong performance. Whilst US corporate bond option-adjusted spreads were broadly unchanged, looser monetary policy from the Federal Reserve and the ECB have supported investor confidence in the commitment of central banks to the economy.

High Yield Credit: Whilst geopolitical uncertainty continues across the globe, high yield credit generally performed well during the third quarter. The Bloomberg Barclays US Corporate High Yield TR Index Unhedged returned 1.3% over Q3. US high yield spreads continue to be tighter than the historical average, tightening 5bp over Treasuries. Concerns over the possibility of defaults increasing due to the stage of the credit cycle remained, although corporate earnings seem to be resilient overall and the HY default rate remained low by historical standards.