Lincolnshire
COUNTY COUNCIL
Working for a better future

:
**Regulatory and Other Committee**

| Open Report on behalf of Executive Director of Finance and Public Protection |
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| Report to: | **Pensions Committee** |
| Date: | **07 January 2016** |
| Subject: | **Independent Advisor's Report** |


**Summary:**

This report provides a market commentary by the Committee's Independent Advisor on the current state of global investment markets.


**Recommendation(s):**

That the Committee note the report.

**Background**

**INVESTMENT COMMENTARY**

**January 2016**

**Another lacklustre year for markets in 2015.**

For the second year running, global markets have shown little price change over the twelve months. Obviously there have been fluctuations, notably in equities in August and in December. And there are exceptions to this generality – emerging markets have had a poor year and commercial property worldwide has performed well. Commodity prices, notably oil, have fallen sharply, dragging down the share prices of oil and mining companies. The high yield bonds of such companies have been poor performers over credit worthiness worries.

**Short term interest rates**

The US Federal Reserve ("the Fed") finally announced an interest rate rise of 0.25% in mid December. Economically, this was probably not very significant though it carried important psychological implications, which will probably not become fully apparent until well into the first quarter of 2016. Key is how far and fast are future such increases. Accompanying the announcement of the December rate increase, Janet Yellen, the chair of the Fed, emphasised that future increases will be gradual and "economic data dependent" to use the market jargon. She also

said that the Fed did not intend to start reducing its huge investment in US government bonds that it bought as part of its Quantitative Easing programme following the Lehman Brothers crisis, until the rise in interest rates was "well under way". So probably not in 2016.

A rise in short term interest rates is sometimes thought to be detrimental to the price of equities. The evidence of the past is that central banks only increase rates when they are confident that their economy is growing strongly, that inflation is on a rising trend and that the labour market is tightening. Mrs Yellen emphasised that the Fed's view is that the US economy is performing well, and is expected to continue to do so. Unemployment has fallen to around 5% and the consumer seems increasingly confident. Inflation is expected to rise, gradually, towards the Fed's target of 2% per annum. So I doubt that this rate rise – on its own - is a negative for the US equity market. Markets expect further interest rate rises by the Fed in 2016, perhaps two or three, taking it to around 1%.

What implications does this have for the Bank of England and the other global central banks? Probably not a lot. The Bank of England has backed away from a rise in UK base rate in 2015, deeming the UK economy not quite strong enough. The growth in GDP is healthy enough – perhaps 2.5% in 2015 - but inflation (as measured by the Consumer Price Index) has been negative in recent months. Wage growth was surprisingly robust in mid summer, but has tailed away in recent months despite historically low levels of unemployment, by recent standards. As to the other central banks, especially the European Central Bank and the Bank of Japan, they are nowhere near to rate increases, either now or possibly in 2016.

In short, despite the Fed increase, globally monetary policy remains very loose and will support securities markets in 2016, in general. There are some adverse straws in the wind regarding such liquidity: the slowdown in Chinese exports in 2015 has resulted in China withdrawing some of its overseas money market investments, for example short term dollar, sterling and euro deposits. And the wealth funds of middle eastern oil producers such as Saudi Arabia, are experiencing similar patterns.

**Downside risks in 2016**

It is an old stock market adage that equity markets "climb a wall of worry" and only succumb when there are no worries remaining! There are plenty of worries to satisfy the most anxious – which in its way confirms that equities can indeed rise in the year ahead. Political risks that will remain throughout 2016 include the US Presidential election, middle eastern turmoil including the war against ISIS, and in the UK the likelihood of a referendum on withdrawal from the EU ("Brexit"). Inflation, almost everywhere, remains fickle and is likely to remain so: equities thrive on modest levels of inflation that permit companies "pricing power" for their products and services. The health, or otherwise, of the Chinese economy will not be far from investors' minds. And we should not forget the other emerging market countries, e.g. Brazil, Russia and South Africa, whose economies have had a torrid 2015.

An anxiety for the longer term, that is increasingly bothering economists and long term investors, is doubt surrounding the ability of central banks (principally the Fed) to raise interest rates substantially and to withdraw all of its Quantitative Easing support. In particular, surely the Fed cannot raise rates too quickly in 2016 and 2017 and risk aborting an economic recovery that remains somewhat fragile? The argument is that when the next recession occurs, say in the USA (as it was the first major global economy to recover), the central bank needs to be able to step in with measures to mitigate the downturn. What weapons will be at its disposal if interest rates are still low (under 3% say) and Quantitative Easing not largely unwound? It is not easy to see an outcome to this conundrum unless the US economy continues to expand at a healthy rate for an extended number of years.

**Summary**

Global equities and government bonds, in general, remain quite close to all time price highs. There have been price set backs in the past several years in both markets, but they have been in the nature of "jitters" and have not lasted long. Markets do not rise forever, as everyone is aware. Statistically and relying on historic norms, these markets are highly valued. Never before, however, has global liquidity been so high or so long lived; or indeed so globally co-ordinated by central bankers. It is this liquidity that has supported markets and, in my view, will continue to support them. Inevitably, there will be market wide falls – but once the fall has amounted to say 5% or more, I suspect the buyers will step in. Especially for global equities, which seem to me to offer more upside potential than bonds at their current very low yields. Could it be that markets in general will show little material change by the end of 2016, whatever transpires in between?

**Peter Jones**
**21st December 2015**

**Consultation**

**a) Policy Proofing Actions Required**

n/a

**Background Papers**

No background papers within Section 100D of the Local Government Act 1972 were used in the preparation of this report.

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