Lincolnshire
COUNTY COUNCIL
Working for a better future

Regulatory and Other Committee

Open Report on behalf of Executive Director of Finance and Public Protection

Report to:	**Pensions Committee**
Date:	**09 October 2014**
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

October 2014

Global equity markets edge higher.

Global markets have edged higher in the last quarter- albeit reluctantly, led by the USA, which recently reached an all-time high. The economic news has been perfectly acceptable in the US and the UK but much less good in Europe where the growth rate continues to deteriorate. The central banks of the world have generally continued their easy money policy, whilst in the US and the UK, they have been warning that interest rates will probably need to rise in 2015. Fixed interest markets have seen prices little changed in response. Investors seemingly agree with the bankers that growth in the world economy remains fragile, that there is not going to be an abrupt reversal of such policies and that equities are the least bad place to be invested. Hence, the reluctance to push equities decisively higher.

Other indicators that are often correlated with improving economic prospects are inclined to be mildly negative. The obvious one is the rate of inflation in the principal global economies; these have declined pretty much everywhere in the last

few months. Commodity prices have also been weaker; a particularly sensitive one is the oil price. This has fallen the best part of 10% in the past quarter (despite worries about continuity of supply because of Arab conflicts). A range of other commodities have also fallen similar amounts.

All in all, investors have little confidence in a robust economic future, outside the US and the UK, and are concerned about how durable it is in those two countries beyond 2015.

Opportunities for equities to fall?

All of the above having been said, it is fair to say that markets have had plenty of opportunities to be “spooked” into a significant set-back. There was a bout of jitters in late July, but short lived. The list of opportunities embraces a range of outbreaks of violence in the Arab world, the Ukraine, the Ebola outbreak in West Africa, the Scottish independent vote, to name a handful. Of these, perhaps the Isis uprisings are the most worrying because they are spreading broadly across the Muslim community to include large parts of North Africa as well as the Arab world, without any clears means of reversal.

Prospects for 2015.

As 2014 draws to a close, investors will, I think, begin to focus their attention more specifically on the coming rises in interest rates in the US and the UK. These are the two countries where forecast economic growth in that year is likely to be around 3%. Globally, the recovery remains fragile, but what separates the US and UK from the rest of the world is that they are the only two regions where unemployment is falling. As yet though, there is no sign of wage inflation above price inflation in either country. But central bankers never forget the old adage that their prime role is “to take away the punch bowl before the party gets out of hand”. So they will act as pre-emptively as they dare. The US Federal Reserve does also have a duty to promote adequate economic growth as well as to control price inflation.

Herein lies the core of the dilemma that investors will have to contend with in 2015. There will be a difficult transition from equity markets that have been driven, for some five years, by burgeoning liquidity to one that will depend on economic performance and specifically on growth in company earnings. It goes without saying that there are absolutely no precedents for this. Markets will hope that the judgement of the Fed and of the Bank of England is exemplary, in this respect. Opportunities for mis-judgements and false steps are obvious, though.

Confidence in continuing economic growth in the US and the UK beyond 2015 will be tied to prospects in the rest of the world. Inter-global trade is very important to global economic activity. Signs here are not especially encouraging. Emerging markets (dominated by China, Russia, India and Brazil) have struggled this year with little sign of any improvement. A recent IMF report suggested that long term economic prospects for Emerging Markets have fallen from 7% per annum to 5% per annum. Still robust, admittedly, but a significant reduction in their contribution to global economic activity.

In Europe, the news on inflation and growth is disappointing. More worrying is the lack of any political consensus on what to do about it. The intellectual bankruptcy of the European Union is becoming a major cause for concern. Neither higher growth nor higher inflation will support European equities in 2015: only abundant central bank liquidity. Investors are confidently relying on the fact that Mr Draghi is far too frightened to remove the “punch bowl”; after all, there is no party!

In summary, the potential for a significant setback in equity markets is rising. It is not yet, in my view, probable.

A positive feature of markets.

Now that the Lincolnshire Pension Fund’s actuarial valuation is complete, attention of the committee will turn to asset allocation. Since the financial crisis of 2008/9, equity markets have been driven largely by “macro events” rather than “micro matters”, as is usually the case. The good news is that there is a trend back towards normality. In particular, the correlation of individual stocks to the market indices has started to fall back from the unprecedentedly high levels of the past several years. That means that there will be more opportunities for individual stock picking and hence for active equity management.

On the subject of asset allocation, members may have noticed the recent news that the California Public Employees Retirement System (“Calpers”) has announced that it is ceasing to invest in hedge funds, seemingly, on cost grounds. It is not only in the UK that increased attention is being devoted to the fund management costs of public sector schemes. The long awaited LGPS review by DCLG will anyway focus the committee’s attention on costs of investment, as well as the financial benefits of diversification of assets.

Peter Jones
25th September 2014.

Conclusion

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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