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 April 2015**
Subject:	**Independent Advisors 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

April 2015

2015 starts with surprises

In economic terms, 2015 started off with surprisingly good news out of the eurozone and patchy reports from the USA. The Q4 2014 economic growth rates in a number of European member states exceeded expectations (not least in Germany) and led to more optimistic forecasts for output in 2015 and 2016 in the eurozone. In part, this is a response to the sharp fall in the price of oil (of which most European states are wholly dependent on imports). Another significant factor is the sharp fall in the euro relative to other currencies, especially the US dollar and £ sterling, since early January. This will stimulate demand for exports from the eurozone. News from Asia and other emerging economies has generally disappointed.

The outcome in markets has been a strong showing in European equities (rises of close to 20% this year) and a more modest showing in most other markets such as the US and UK, though the latter two have recently tested or just exceeded all-time highs, without a decisive break upwards.

European Central Bank initiates QE (quantitative easing)

The markets have also adapted to the reality of the European Central Bank's ("ECB") long awaited program of bond buying as its policy response to the perceived need of the euro–economy for some form of monetary stimulation. This should have started four or five years ago (in parallel to initiatives in the USA and UK and in many other places around the globe) but was stymied by German intransigence. The purchases of some Euros 60 billion per month until late 2016 kicked off in mid-March. Markets of course have anticipated ECB actions, though initially they doubted that political resistance to its implementation could be overcome.

Whilst the ECB council was planning its QE programme, the Greeks elected a new government with a brief to scrap the austerity measures imposed on Greece by its creditors, in the main the International Monetary Fund and the EU. The negotiations of the Greeks with the EU and the German Government in particular have been tortuous and still await a meaningful resolution. Markets seem to accept that the possibility of Greece leaving (or being ejected from) the European currency union might not be quite so catastrophic for the future of the EU as it might have been two or three years ago.

The next move of interest rates – up or down?

The conundrum for markets is forecasting the direction of long term interest rates. A year ago, markets were convinced that the next move had to be upwards. That has proved spectacularly wrong, by and large. Rates on short term government securities in many European markets and in Japan have fallen and are now negative, in nominal terms. That seems bizarre! Why lend money knowing that you are going to get back less than your purchase price? Many institutions such as banks and insurance companies, have little choice but to invest in "matching" assets. And many investors are fearful of deflation in the longer term, i.e. prices actually falling, thus enhancing the value of fixed interest stocks in real terms.

The direction of interest rates is usually related to the direction of the economy. Rates rise as an economy expands and vice versa. The US and UK economies are certainly growing and interest rates have been edging up in 2015. There has seemingly been a recent change in trend economic growth in the eurozone. Before long therefore, European interest rates should start to rise, but thus far there is no sign.

Once interest rates start to rise, equity markets tend to be close to their peak. Not necessarily at their peak, but at a level from which significant further gains are unlikely. They could just "plateau".

The future of Quantitative Easing ("QE")

Overlaying the debate about the trends in global interest rates will be investors' perceptions of the withdrawal of QE. That is, central banks withdrawing – gradually to avoid panicking markets – the huge amounts of liquidity that they injected into their economies following the financial crash of 2008/9. This must happen sometime. When will it start, how quickly and over what time period? We can surmise that it will be sooner in the US and the UK and probably much later in the eurozone and Japan. We cannot know precisely and central bankers will respond only to evolving economic developments. Meanwhile all markets, equities, fixed interest and property are buoyed up by this abundance of money.

So, markets look "frothy". The temptation is therefore to deduce that they will fall in the near term. That has proven to be a false premise many times in the past. Like most other fund managers and advisors, I see no alternative but for the Lincolnshire fund to remain fully invested.

Peter Jones
23rd March 2015.

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.

This report was written by Peter Jones, who can be contacted on 01522 553656 or jo.ray@lincolnshire.gov.uk.