QUARTERLY REVIEW PREPARED FOR

Oxfordshire Council Pension Fund

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OXFORDSHIRE PENSION FUND COMMITTEE – 10 MARCH 2017

OVERVIEW AND OUTLOOK FOR INVESTMENT MARKETS

Report by the Independent Financial Adviser

Economy

1. The UK economy has held up better than expected, with GDP growth of +0.6% in the third and the fourth quarters. In February the Bank of England raised its forecast of GDP growth in 2017 from 1.4% to 2.0%. UK inflation is beginning to rise from abnormally low levels as the effect of a weaker pound becomes apparent.

(In the table below, bracketed figures show the forecasts made in October)

Consensus real growth (%)						**Consumer prices latest (%)**
	2013	**2014**	**2015**	**2016E**	**2017E**	
UK	+1.7	+2.8	+2.3	+2.0 (+1.8)	+ 1.4	**+1.6**(CPI)
USA	+1.9	+2.4	+2.4	+1.6 (+1.5)	+ 2.2	+2.1
Eurozone	-0.4	+0.8	+1.5	+1.7 (+1.5)	+ 1.5	+1.8
Japan	+1.7	+0.3	+0.6	+0.9 (+0.6)	+1.2	+0.3
China	+7.7	+7.4	+6.9	+6.7 (+6.6)	+6.5	+2.1

Source of estimates: The Economist, February 11th 2017

2. The surprise victory by Donald Trump in the US Presidential Election was initially greeted with sharp falls in equity markets, but these were soon reversed in developed markets as investors concentrated on Trump's plans to cut taxes, deregulate energy, healthcare and financial services, and to offer tax incentives for infrastructure. The dollar strengthened to its highest level in 14 years on a trade weighted basis.

3. In his Autumn Statement on November 23, Philip Hammond confirmed that UK **government borrowing** would be much higher in each of the next 5 years than previously forecast. In total the additional borrowing required over the 5 years amounts to £122bn. This is largely due to slower GDP growth of 2.1% in 2016, 1.4% in 2017, 1.7% in 2018 and 2.1% in next two years, giving a cumulative reduction of 2.4% over the 5-year period. He has replaced George Osborne's target of achieving budget surplus in 20/21 with an upper limit on the deficit of 2% of GDP (and a forecast level of 0.7%) in 20/21. He hopes to balance the budget as soon as possible after 2020. Debt/GDP will peak at 90% in 2017/8. Among other measures, Hammond announced the

government is to spend £23bn on a **National Productivity Investment Fund**, to cover R&D, innovation in housing, rail &road, digital network etc

4. On December 14th, the US Federal Reserve raised the Fed Funds interest rate from 0.5% to 0.75% - the first increase since December 2015. They said they expect to make three more rises during 2017. The European Central Bank announced it would continue its programme of quantitative easing from April to December 2017, but at a reduced rate of €60bn per month, instead of the current €80bn.

5. The Italian Prime Minister, Matteo Renzi, resigned after a heavy defeat in the constitutional referendum on December 4th. His successor is the former Foreign Minister Paolo Gentiloni. In the French Presidential primaries, Francois Fillon gained the nomination of the centre-right party, eliminating ex-President Sarkozy from the race, but has since run into problems relating to his wife's past financial arrangements. With an independent candidate, M Macron, drawing increasing support, the outcome of the April/May election is highly unpredictable.

Markets

<u>Equities</u>

6. After the result of the US Election, most **equity markets** gained ground – with the exception of Pacific Basin and Emerging Markets which would be disadvantaged by the stronger dollar. Japan was helped by the weakening of the yen.

	Capital return (in £, %) to 31.12.16		
Weight %	Region	**3 months**	**12 months**
100.0	FTSE All-World Index	**+6.1**	**+26.2**
56.1	FTSE All-World North America	+8.4	+31.2
8.4	FTSE All-World Japan	+5.0	+20.0
11.3	FTSE All-World Asia Pacific ex Japan	+0.3	+24.6
15.3	FTSE All-World Europe (ex-UK)	+5.1	+15.3
6.2	FTSE All-World UK	+3.4	+14.3
8.8	FTSE All-World Emerging Markets	+1.8	+31.4

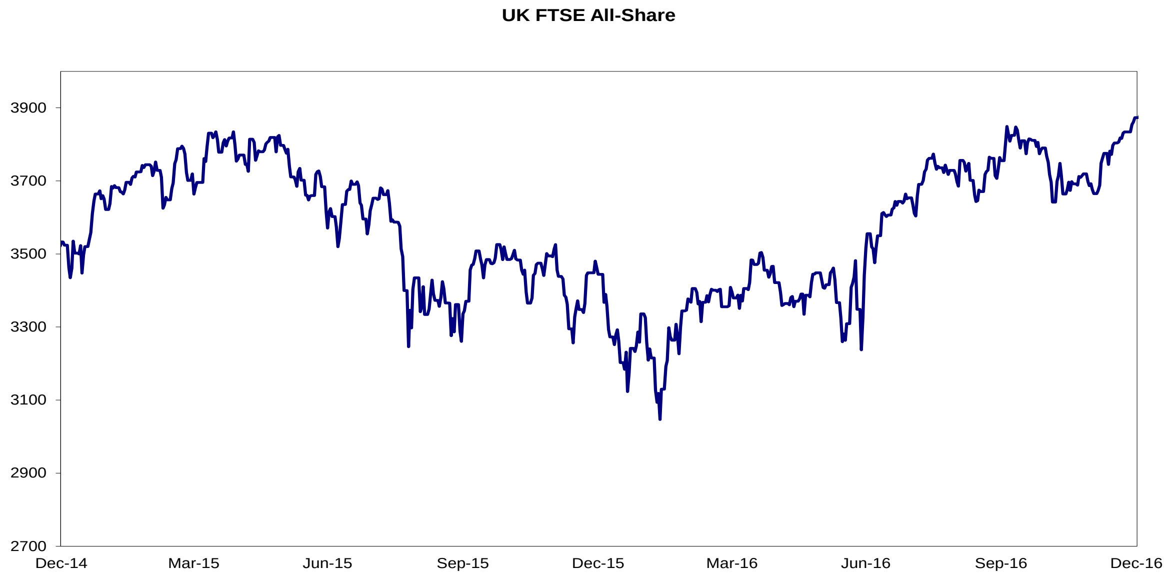
[Source: FTSE All-World Review, December 2016]

7. Within the UK market the mid-cap section was the weakest in the quarter and – by a wide margin – for the full year. These companies were seen as being more reliant on the domestic economy and not enjoying the boost to foreign earnings from £ weakness which many large-cap companies received.

(Capital only%, to 31.12.16)	3 months	12 months
FTSE 100	**+3.5**	**+14.4**
FTSE 250	**+1.2**	**+3.7**
FTSE Small Cap	**+3.4**	**+11.0**
FTSE All-Share	**+3.1**	**+12.4**

[Source: Financial Times]

8. The All-Share Index has surpassed its previous high from March 2015



9. The turnaround in energy and resource prices from the early days of 2016 propelled the Oil & Gas and Basic Materials sectors from the two bottom places in 2015 to the top two rungs in 2016. Relative to the All-World Index, Oil & Gas went from -20% to +20%, between 2015 and 2016, while Basic Materials went from -16% to + 17%. Conversely, the non-cyclical sectors were the weakest in 2016, having been very buoyant in 2015.

Capital return (in £, %) to 31.12.16		
Industry Group	**3 months**	**12 months**
Oil & Gas	+12.2	+46.8
Basic Materials	+ 9.3	+43.3
Technology	+ 4.7	+32.9
Industrials	+ 6.5	+32.1
Financials	+13.8	+26.8

FTSE All-World	**+6.1**	**+26.2**
Utilities	+ 1.0	+23.9
Telecommunications	+ 2.3	+22.0
Consumer Services	+ 4.4	+20.7
Consumer Goods	+ 0.7	+19.7
Health Care	-1.1	+10.1

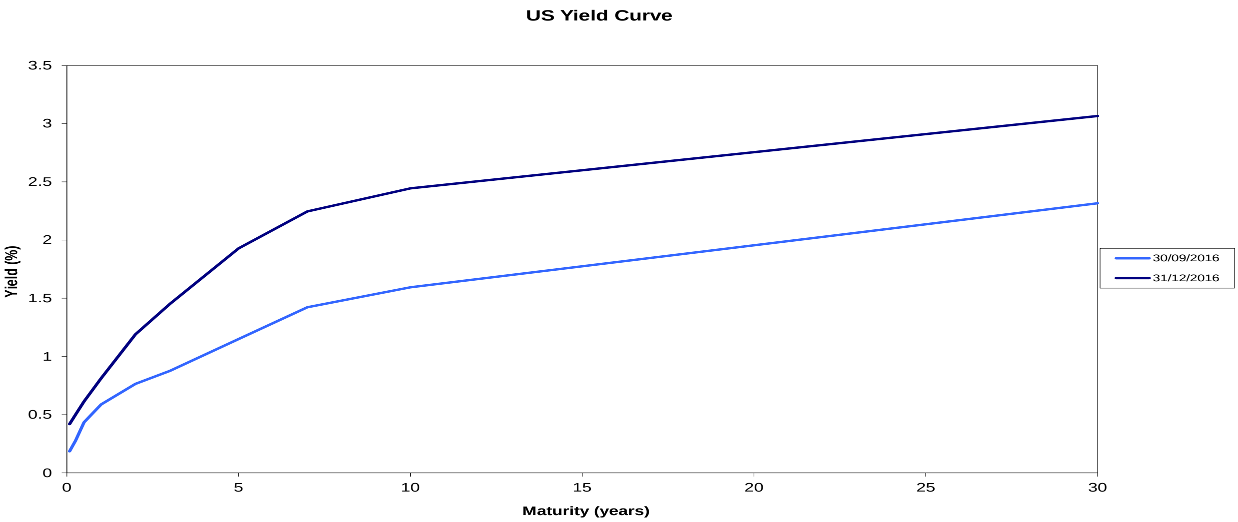
[Source: FTSE All-World Review, December 2016]

Bonds

10. **Government bond** yields rose sharply during the quarter, as markets began to price in the reflationary impact of Donald Trump's election, and the likely surge in new bond issuance. Apart from US bonds, however, the other three main bond markets all recorded sizeable falls in yield (i.e. gains in price) during the year 2016.

10-year government bond yields (%)					
	Dec 13	**Dec 2014**	**Dec 2015**	**Sept 2016**	**Dec 2016**
US	3.03	2.17	2.27	1.59	2.46
UK	3.04	1.76	1.96	0.75	1.24
Germany	1.94	0.54	0.63	-0.19	0.11
Japan	0.74	0.33	0.27	-0.08	0.04

11. US government medium – and long – dated bond yields have risen by almost 1% during the past quarter.

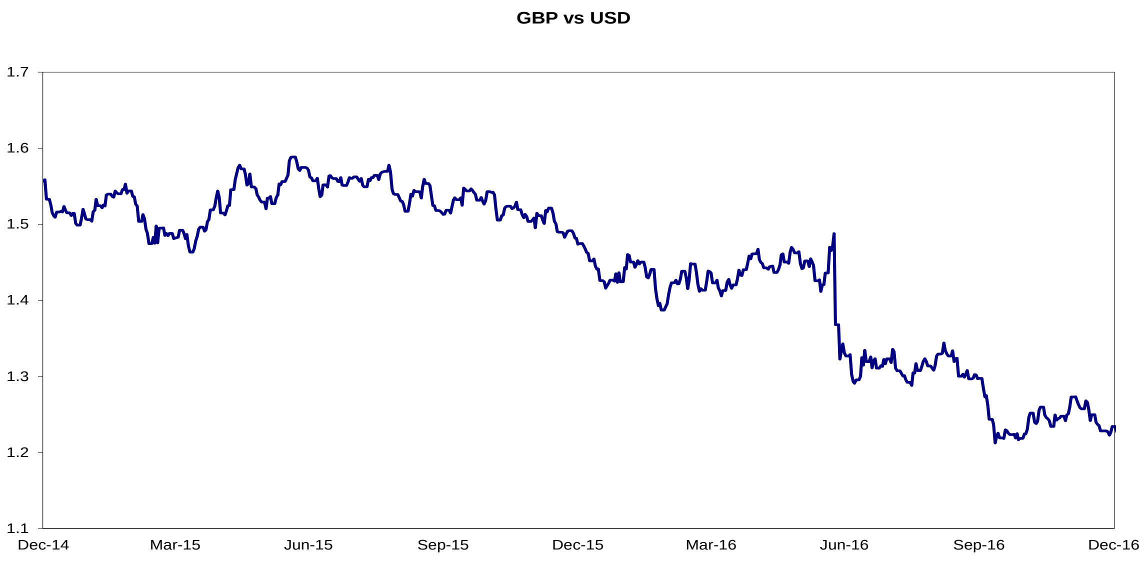


Currencies

12. The pound managed some brief rallies – at one stage reaching $1.27 – but the US Election and the interest rate rise pushed the dollar stronger against all the major currencies.

				£ move (%)	
	31.12.15	30.9.16	31.12.16	3m	12m
$ per £	1.483	1.299	1.236	- 4.8	-16.7
€ per £	1.359	1.156	1.172	+ 1.4	-13.8
Y per £	178.8	131.5	144.1	+9.6	-19.6

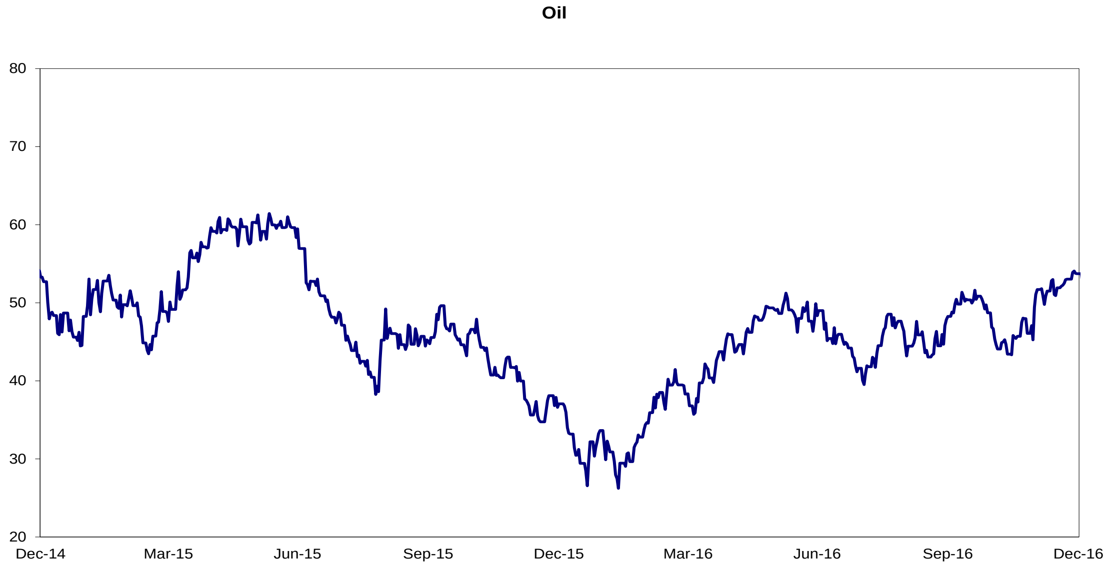
13. The pound has continued to weaken against the dollar



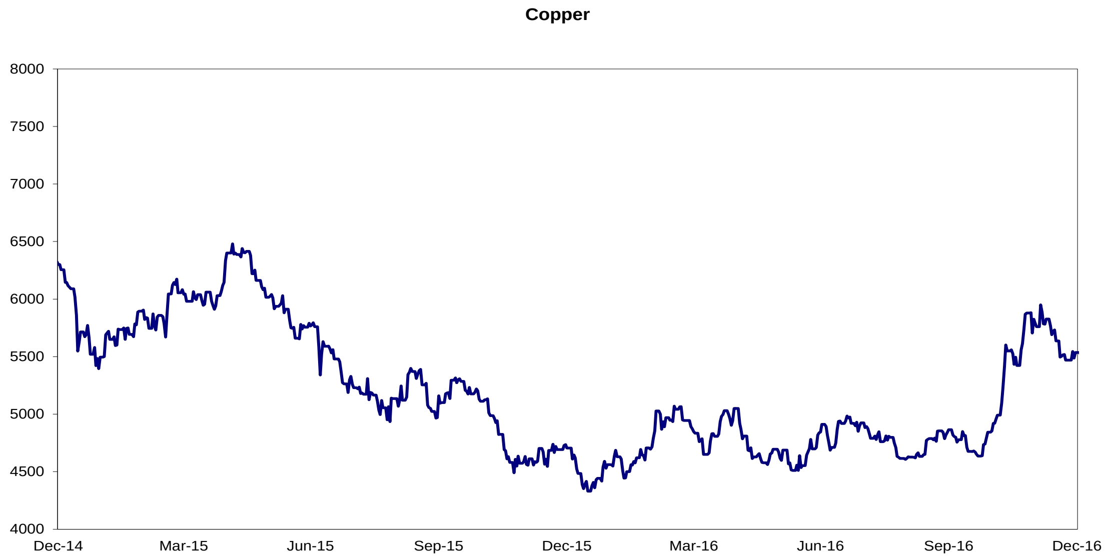
Commodities

14. The price of **Oil** (Brent Crude) rose above $50 in early December when the OPEC producers confirmed an agreement to cut output by 1.2m barrels/day, to be followed by the news that some non-OPEC countries would cut production by 0.5m b/d. Oil ended the year just below $57, for a gain of 50% (in dollar terms) during 2016. **Copper** spiked sharply – gaining 20% in the weeks after the US Election, on hopes for increased infrastructure spending in the US and revived demand from China. By contrast **Gold** weakened in response to higher US interest rates and the stronger dollar.

15. Oil has rallied strongly since early 2016 …..



……. and copper too since the US Presidential Election



<u>Property</u>

16. There was a slight rebound in the fourth quarter, after the post-Brexit setback, with Industrial property registering solid gains. The annual returns, however, show that there were declines in capital values in all sectors, with particular weakness in the Office and Retail sectors.

	3-month	12-month
All Property	+ 2.6%	+ 2.6%
Retail	+ 1.9%	+ 1.1%
Office	+ 2.2%	+ 1.0%
Industrial	+ 4.2%	+ 7.0%

[IPD Monthly Index of total returns, December 2016]

Outlook

17. The early weeks of Donald Trump's presidency have seen a flurry of Executive Orders, including the controversial ban on travellers from seven states entering the US, which has been stayed by the courts at the time of writing. The renunciation of the Trans-Pacific Partnership, and the new President's attitude to trade with China, are causing concern to the corporate sector, which is also awaiting details of the tax cuts and infrastructure spending promised before the inauguration. Equity markets have remained strong, apparently disregarding the possible downside of President Trump's trade policies.

18. The sharp rise in US – and other – government bond yields is more logical, and may well have further to run as inflation begins to return and funding requirements expand to meet the larger US budget deficit.

19. Uncertain times are ahead in Europe: the UK will trigger Article 50 by the end of March, and its negotiating position on withdrawal from the EU will gradually become clearer. It seems clear that the UK will leave the single market but the new relationship with the EU remains totally uncertain. With elections coming up in Holland, France and Germany, there is likely to be more upheaval within the European Union if anti-EU parties gain power.

20. With so many potential pitfalls looming, continuing caution on equity and bond markets seems the wisest course to adopt at present.

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[All graphs supplied by Legal & General Investment Management]