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OXFORDSHIRE COUNCIL PENSION FUND – 7 DECEMBER 2018

OVERVIEW AND OUTLOOK FOR INVESTMENT MARKETS

Report by the Independent Financial Adviser

Economy

1. While US economic growth continues to be strong, estimates for other regions are being revised downwards. China's 3rd quarter growth rate of 6.5% year – on –year was the lowest since 2011. The IMF recently revised down its estimates for global growth in 2018 and 2019 from 3.9% to 3.7% for each year.
(In the table below the bracketed figures show the forecasts made in August)

Consensus real growth (%)						Consumer prices latest (%)
	2015	2016	2017	2018E	2019E	
UK	+2.3	+2.0	+1.6	+1.3 (+1.3)	+1.4	+2.4(CPI)
USA	+2.4	+1.6	+2.3	+2.9 (+2.8)	+2.5	+ 2.7
Eurozone	+1.5	+1.6	+2.3	+2.1 (+2.2)	+1.8	+ 2.1
Japan	+0.6	+0.9	+1.7	+1.1 (+1.1)	+1.2	+ 1.3
China	+6.9	+6.7	+6.8	+6.6 (+6.6)	+6.2	+ 2.3

[Source of estimates: The Economist, October 6th, 2018]

2. On August 2nd the Bank of England increased the interest rate from 0.5% to 0.75%, its highest level since 2009, and on September 26th the Federal Reserve raised US interest rates once more by 0.25%, to the 2 – 2.25% range. A further rise in US rates is expected in December, given the strong labour market data coming from the US.
3. US trade policy has constantly been in the headlines. A trade deal with Mexico and Canada was signed at the end of September, to replace NAFTA. The imposition of tariffs by US and China on each others' exports escalated as more categories of goods were earmarked by each country, and the US imposed trade sanctions on Iran after withdrawing from the Iran nuclear deal. Pressure was building on many countries to review their contacts with Saudi

Arabia after a US-based journalist was murdered at the Saudi consulate in Istanbul in October.

4. In the UK Budget on October 29th, the Chancellor published OBR forecasts showing UK growth at 1.3% this year, rising to 1.6% in 2019, but the falling back to 1.4% in 2020 and 2021. Although the government's borrowing requirement is expected to be £11.9bn *less* than previously estimated this fiscal year, with progressively bigger improvements in future years, the actual deficit will not narrow significantly as spending on the NHS will increase by £7.4bn in 2019/20 rising to £27.6bn in 2023/4. With the introduction of higher personal tax bands being brought forward by one year, the fiscal deficit will still be running at more than 1% of GDP in 2021/2. There was an underlying implication that a new Budget would be required if the Brexit negotiations were to result in no deal.
5. The new Italian government's plan to run a fiscal deficit of 2.4% of GDP – compared with a previous promise of just 0.8% – provoked consternation in the EU, and caused a widening of the yield spread of Italian government bonds relative to bunds. After electoral setbacks in Bavaria and Hesse, Angela Merkel announced she would step down as leader of the CDU party in December, and from the post of Chancellor in 2021.

Markets

Equities

6. Overseas Equities advanced strongly during the quarter, led again by the US market, while UK equities weakened slightly. Emerging Markets have lagged Developed Markets by a wide margin over the past year, due to the impact of the strong dollar on the balance sheets of Emerging Market companies and to the slowdown in China. The subsequent market movements in October are described in paragraph 9.

	Capital return (in £, %) to 30.9.18		
Weight %	Region	3 months	12 months
100.0	FTSE All-World Index	+5.0	+10.7
56.8	FTSE All-World North America	+8.0	+18.0
8.3	FTSE All-World Japan	+4.1	+11.4
12.0	FTSE All-World Asia Pacific ex Japan	-1.0	+2.2
14.8	FTSE All-World Europe (ex-UK)	+2.9	-0.8
5.7	FTSE All-World UK	-1.7	+1.6
9.4	FTSE All-World Emerging Markets	-0.6	-0.9

[Source: FTSE All-World Review, September 2018]

7. Health Care and Technology were the strongest sectors during the quarter, prior to their setbacks in October.

Capital return (in £, %) to 30.9.18			
Weight %	Industry Group	3 months	12 months
15.6	Technology	+7.6	+27.1
11.4	Consumer Services	+5.3	+20.8
11.2	Health Care	+11.7	+16.4
6.6	Oil & Gas	+3.1	+16.3
100.0	FTSE All-World	+5.0	+10.7
13.0	Industrials	+6.4	+9.2
4.5	Basic Materials	0.7	+5.5
21.2	Financials	+3.2	+3.6
10.9	Consumer Goods	+1.1	+0.6
2.9	Utilities	+1.0	-0.4
2.7	Telecommunications	+5.2	-4.0

[Source: FTSE All-World Review, September 2018]

8. After a negative quarter, the UK equity market is showing only marginal gains over the past year, and is lower than its level at the end of 2017.

(Capital only%, to 30.9.18)	3 months	12 months
FTSE 100	-1.7	+1.9
FTSE 250	-2.5	+2.2
FTSE Small Cap	-1.0	+1.9
FTSE All-Share	-1.8	+1.9

[Source: Financial Times]

UK FTSE All-Share



Internal

9. In October equity markets experienced sharp falls, and high volatility, as the 10-year US government bond yield rose above 3%, reaching 3.2%. Together with worries about the escalation of tariffs being imposed by US and China, equities recorded falls of 5% or more during October, as shown in this table. At one stage in late October the S&P 500 index was showing a fall of 10% from the all-time high it had reached in September.

Capital return (in £, %) to 31.10.18	
Region	1 month
FTSE All-World Index	- 5.6%
FTSE All-World North America	-5.1%
FTSE All-World Japan	-6.9%
FTSE All-World Asia Pacific ex Japan	-8.4%
FTSE All-World Europe (ex-UK)	-6.1%
FTSE All-World UK	-5.1%
FTSE All-World Emerging Markets	-5.7%

[Source: FTSE All-World Review, October 2018]

10. Some of the sharpest falls were seen in the previously thriving Technology sector, with Industrials, Oil & Gas and Basic Materials also very weak.

Capital return (in £, %) to 31.10.18	
Industry Group	1 month
Technology	-7.2%
Consumer Services	-6.3%
Health Care	-4.7%
Oil & Gas	-7.6%
FTSE All-World	-5.6%
Industrials	-8.6%
Basic Materials	-7.3%
Financials	-4.3%
Consumer Goods	-3.6%
Utilities	+1.2%
Telecommunications	-2.3%

[Source: FTSE All-World Review, October 2018]

Bonds

11. Prices of 10-year government bonds fell (and yields accordingly rose), and in particular the yield on the 10-year Treasury exceeded 3%. This has not been driven by higher expected inflation, but rather by the increase in the real yield on the bond.

10-year government bond yields (%)					
	Dec 2015	Dec 2016	Dec 2017	June 2018	Sept 2018
US	2.27	2.46	2.43	2.84	3.04
UK	1.96	1.24	1.23	1.28	1.44
Germany	0.63	0.11	0.43	0.30	0.47
Japan	0.27	0.04	0.05	0.03	0.12

[Source: Financial Times]

US Treasury Generic 10 Year



Internal

Currencies

12. Sterling oscillated either side of \$1.30 during the quarter, depending on whether or not the prospects for an orderly Brexit were thought to be improving. The range of movements between the three major currencies has been narrow over the year.

	30.9.17	30.6.18	30.9.18	£ move (%)	
				3m	12m
\$ per £	1.342	1.320	1.304	-1.2	-2.8
€ per £	1.135	1.131	1.123	-0.7	-1.1
¥ per £	151.0	146.2	148.1	+1.3	-1.9

Commodities

13. The Oil price rose 5% in the quarter, on fears that supplies from Iran may be restricted when the US-imposed sanctions come in to force. At \$83/barrel at the end of September, Brent crude stands 50% above its price one year ago. Meanwhile the gold price has continued to drift lower – possibly as a reaction to the strong dollar and rising US interest rates.



Internal

Property

14. Industrials continued to lead the way within the UK property market, while Retail is extremely weak, and sentiment depressed, following the store closures announced by several renowned High Street names. Some of the largest listed UK Property companies are trading at 30% discounts to stated NAV, implying that the market expects further downgrades in property valuations.

	3-month (%)	12-month
All Property	+ 1.7	+ 9.9
Retail	+ 0.1	+ 3.9
Office	+ 1.8	+ 8.0
Industrial	+ 3.5	+20.8

[MSCI UK Monthly Index of total returns, September 2018]

Outlook

15. US equity markets have finally reacted to the move in the 10-year bond yield above 3% and the prospect of slower corporate profits growth next year once the effect of the recent corporate tax cuts has worn off. The impact of the mid-term election results - where the Democrats regained control of the House, but the Republicans consolidated their control of the Senate - will not be known until the new Congress is formed, but the initial reaction of US equities has been positive.

16. Of broader concern is the development of the trade tariffs threatened by US and China. If no agreement is reached, and the maximum range of tariffs imposed, there could be severe effects on world trade, higher input costs for US and Chinese companies and negative consequences for corporate profitability and consumer prices.
17. For the UK, the uncertainty regarding the outcome of Brexit negotiations with the EU remains the big cloud on the horizon, both for its impact on the UK economy and the possible realignment of the domestic political landscape. There are many reasons to expect continued volatility in global equity markets.

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[Graphs supplied by Legal & General Investment Management]

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