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## PENSION FUND COMMITTEE – 5 JUNE 2020

### OVERVIEW AND OUTLOOK FOR INVESTMENT MARKETS

#### Report by the Independent Financial Adviser

#### Economy

1. As the severity of the coronavirus epidemic became apparent during February, one country after another closed large parts of its economy, restricted cross-border travel and confined residents to their homes. Latest reports estimate that the US economy contracted by 1.2% quarter-on-quarter, while the Eurozone is estimated to have contracted by some 5% and the UK by 2%. In China, where the outbreak started, Q1 GDP fell by 7.5% q/q. Estimates for the full year 2020 shown in the table below are inevitably based on assumptions about when restrictions will be lifted, and the response of companies and consumers to the new environment. On May 7<sup>th</sup>, the Bank of England published a scenario in which the UK economy would experience a 14% fall in 2020, followed by a 15% rise in 2021.

[Source of estimates: Economist Intelligence Unit, May 9<sup>th</sup>, 2020]

Consensus real growth (%)						Consumer prices latest (%)
	2016	2017	2018	2019	2020E	
<b>UK</b>	+2.0	+1.6	+1.4	+1.4	-4.7	+1.5 (CPI)
<b>USA</b>	+1.6	+2.3	+2.9	+2.3	-3.5	+1.5
<b>Eurozone</b>	+1.6	+2.3	+1.9	+1.2	-6.0	+0.4
<b>Japan</b>	+0.9	+1.7	+0.7	+0.7	-5.2	+0.4
<b>China</b>	+6.7	+6.8	+6.6	+6.1	+1.0	+4.3

2. The Federal Reserve cut the US interest rate by 0.5% on March 3<sup>rd</sup>, and then by a further 1% on March 15<sup>th</sup>, to reach the 0 – 0.25% range. Meanwhile the Bank of England cut the UK interest rate from 0.75% to 0.1% in two steps in mid-March. Alongside these rate cuts, both central banks announced the resumption of Quantitative Easing and measures to permit banks to increase their lending. The European Central Bank kept its interest rate unchanged but increased its programme of QE and offered cheap finance to banks.
3. As the potential impact of the pandemic on economic activity became clear, governments hastily introduced massive fiscal injections to support companies, furloughed workers, the self-employed and small businesses. The UK Budget delivered by the new Chancellor Rishi Sunak on March 11<sup>th</sup> was overtaken within days by emergency packages to lessen the impact of coronavirus. Current estimates show a fiscal deficit in the UK reaching 10% of GDP this year – compared with an earlier target of 2%.

4. Amid the increasing concern over coronavirus, the oil market was thrown into turmoil on March 9<sup>th</sup> when Russia and Saudi Arabia failed to agree on production cuts, and the Saudis announced a sharp reduction in the oil price and an increase in daily production. The official oil price fell sharply, to levels not seen for 10 years, and at one point in April the price of WTI crude for May delivery went negative because of the lack of storage space for oil.

## Markets

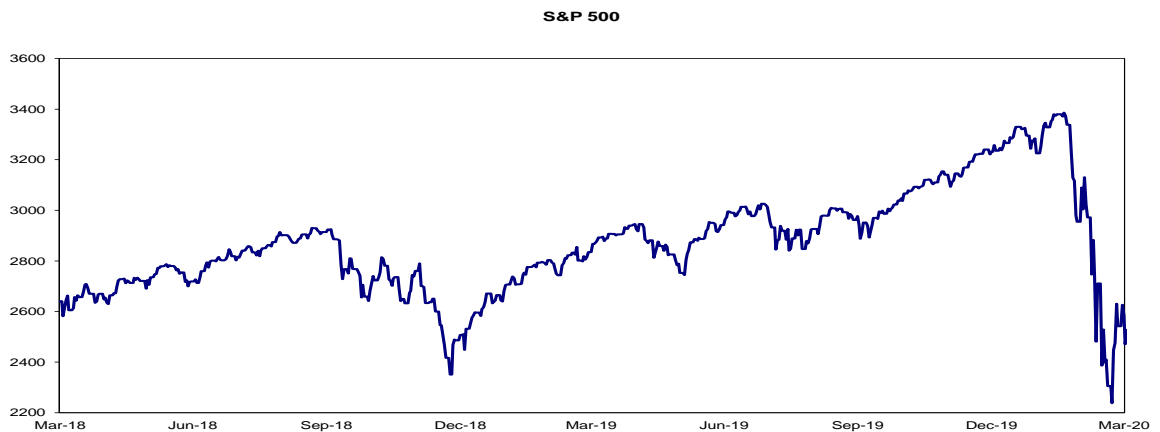
### Equities

5. After trading sideways for the first six weeks of the year, equity markets lurched downwards, losing more than 30% in the next six weeks. Daily index moves of more than 5% – in either direction – became commonplace, but the period from March 23<sup>rd</sup> until the end of the month saw rallies of 15% in the major equity markets, with a further 9% rise in the All-World Index during April. Once again the UK market lagged behind all overseas regions.

	<b>Capital return (in £, %) to 31.3.20</b>			
<b>Weight %</b>	Region	<b>3 months</b>	<b>12 months</b>	<b>36 months</b>
<b>100.0</b>	<b>FTSE All-World Index</b>	<b>-16.5</b>	<b>-8.6</b>	<b>-0.8</b>
58.0	FTSE All-World North America	-14.9	-4.7	+9.0
8.1	FTSE All-World Japan	-12.1	-4.6	-2.7
12.9	FTSE All-World Asia Pac ex Japan	-16.2	-13.9	-10.5
14.2	FTSE All-World Europe (ex-UK)	-18.5	-11.0	-10.2
4.6	FTSE All-World UK	-25.1	-22.0	-22.9
10.6	FTSE All-World Emerging Markets	-19.4	-15.7	-11.8

[Source: FTSE All-World Review, March 2020]

6. US Equities have given up all the gains made since the start of 2019.



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7. The oil price shock was responsible for the heavy fall in the Oil & Gas sector, while the cyclical sectors performed poorly on the slowdown in global economic activity.

	<b>Capital return (in £, %) to 31.3.20</b>		
<b>Weight %</b>	<b>Industry Group</b>	<b>3 months</b>	<b>12 months</b>
19.2	Technology	- 6.3	+11.6
12.7	Health Care	-6.0	+4.0
3.5	Utilities	-10.1	-4.1
11.9	Consumer Services	-13.1	-5.0
11.3	Consumer Goods	-13.9	-7.6
2.9	Telecommunications	-11.8	-7.6
<b>100.0</b>	<b>FTSE All-World</b>	<b>-16.5</b>	<b>-8.6</b>
11.9	Industrials	-20.2	-12.4
19.1	Financials	-25.2	-18.4
3.7	Basic Materials	-23.3	-21.1
3.8	Oil & Gas	-40.2	-43.1

[Source: FTSE All-World Review, March 2020]

8. The FTSE 100 index was badly affected by its heavy weightings in Oil & Gas and Financials, while the mid- and small-cap sections were hit by the closure of retail and leisure businesses and the weakness of the domestic manufacturing sector. Over the 1- and 3-year periods the three sections of the market have performed remarkably similarly.

<b>(Capital only %, to 31.3.20)</b>	<b>3 months</b>	<b>12 months</b>	<b>36 months</b>
<b>FTSE 100</b>	<b>-24.8</b>	<b>-22.1</b>	<b>-21.9</b>
<b>FTSE 250</b>	<b>-31.0</b>	<b>-21.0</b>	<b>-20.4</b>
<b>FTSE Small Cap</b>	<b>-28.4</b>	<b>-21.5</b>	<b>-21.5</b>
<b>FTSE All-Share</b>	<b>-26.0</b>	<b>-22.1</b>	<b>-22.1</b>

[Source: Financial Times]

UK FTSE All-Share



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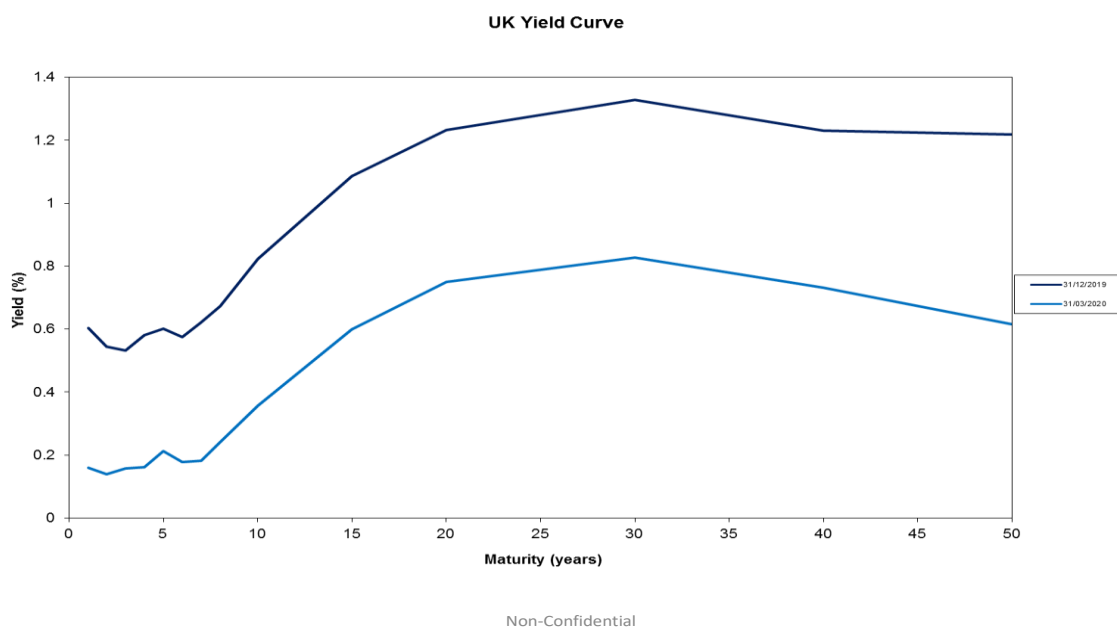
## Bonds

9. While government bond yields fell significantly in response to the economic slowdown and the cuts in base rates, corporate bonds weakened on fears that falls in corporate profits would lead to downgrades to previously investment-grade bonds. Corporate bond markets were shored up by central bank purchases as part of their QE programmes.

<b>10-year government bond yields (%)</b>	<b>Dec 2017</b>	<b>Dec 2018</b>	<b>Sept 2019</b>	<b>Dec 2019</b>	<b>Mar 2020</b>
<b>US</b>	2.43	2.68	1.68	1.92	0.69
<b>UK</b>	1.23	1.14	0.41	0.73	0.35
<b>Germany</b>	0.43	0.24	-0.58	-0.19	-0.48
<b>Japan</b>	0.05	-0.01	-0.23	-0.02	0.01

[Source: Financial Times]

10. UK gilt yields fell sharply at all durations



## Currencies

11. The pound lost ground after its rally at the end of 2019, while the dollar and yen were the strongest of the major currencies.

				<b>£ move (%)</b>	
				<b>3m</b>	<b>12m</b>
	<b>31.3.19</b>	<b>31.12.19</b>	<b>31.3.20</b>		
\$ per £	1.303	1.325	1.240	-6.4	-4.8
€ per £	1.161	1.180	1.130	-4.2	-2.7
Y per £	144.2	144.0	133.9	-7.0	-7.1

## Commodities

12. The oil price dived from the combined effects of the price war between Saudi Arabia and Russia and the sharp reduction in economic activity worldwide. Meanwhile, gold continued its recent appreciation, possibly being seen as a safe haven in uncertain times.

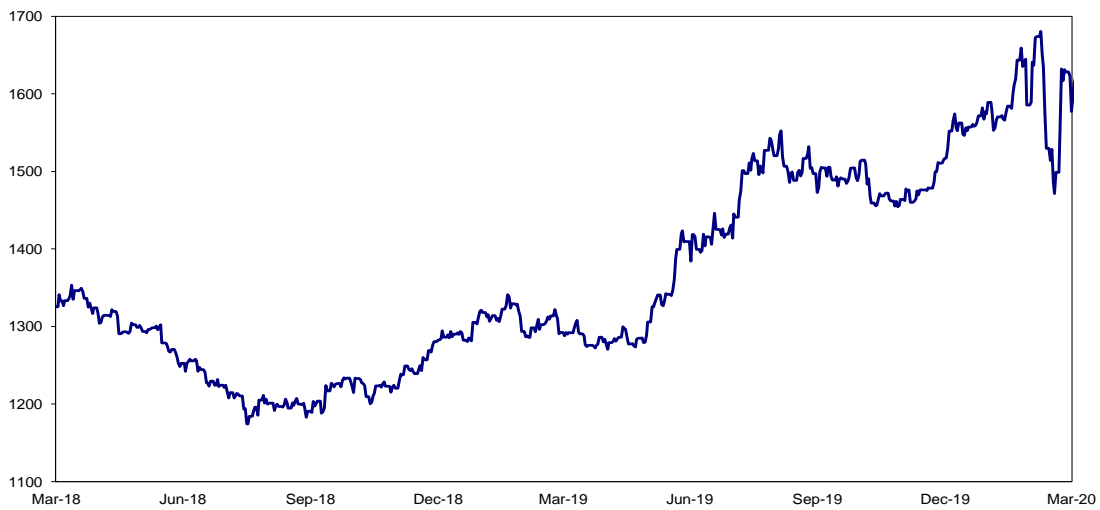
<b>(\$)</b>	<b><u>31.3.19</u></b>	<b><u>31.12.19</u></b>	<b><u>31.3.20</u></b>	<b><u>3m (%)</u></b>	<b><u>12m</u></b>
<b>Gold</b>	<b>1295.1</b>	<b>1514.7</b>	<b>1618.3</b>	<b>+ 6.8</b>	<b>+25.0</b>
<b>Brent crude</b>	<b>67.6</b>	<b>66.0</b>	<b>26.4</b>	<b>- 60.0</b>	<b>- 61.0</b>

**Oil**



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**Gold**



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**Property**

13. The lack of transaction activity in the property market, combined with the uncertainties over rent payments, has meant that property valuations have in effect been temporarily suspended. Institutional property managers have generally frozen transactions in their funds because of the difficulty in establishing fair prices for investors buying or selling units.

## Outlook

14. The coronavirus pandemic has caused lockdowns all over the world, with normal economic activity severely curtailed. For some sectors – airlines, hotels, leisure and non-essential retail – the shutdown has been almost total, and it will be many months before activity in these sectors returns to anything like normal levels. For some companies the interruption to business will lead to them to become insolvent, and there will inevitably be significant increases in the level of unemployment even after the pandemic has subsided.
15. Government spending in order to alleviate the effects of the pandemic is creating ballooning fiscal deficits which will be funded initially by massive bond issuance and in time by higher taxation. Quantitative Easing by central banks will absorb part of the new government debt, but institutional investors will also need to increase their holdings. Corporate debt, which saw a sharp narrowing of spreads in 2019, has been badly impacted by the pressure on corporate profits, although QE has propped up the market and some companies have been able to ease their situation by issuing new equity to institutions.
16. Without knowing the duration or the depth of the coronavirus emergency, it is impossible to make realistic estimates of profits (or losses) for many companies this year, so that any valuation measure must be largely guesswork. Looking beyond 2020, investors will need to distinguish between those companies which have been permanently damaged by the crisis and those able to resume trading at close to pre-crisis levels. Interest rates will remain very low for the foreseeable future, but even this may not be sufficient to save some heavily-indebted companies.

**Peter Davies**

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**May 13<sup>th</sup>, 2020**

[Graphs supplied by Legal & General Investment Management]

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