QUARTERLY REVIEW PREPARED FOR

Oxfordshire Council Pension Fund

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**Peter Davies**

**AllenbridgeEpic Investment Advisers Limited (Allenbridge)**

Peter.Davies@allenbridge.com
www.allenbridge.com

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# PENSION FUND COMMITTEE – 2 SEPTEMBER 2016

# OVERVIEW AND OUTLOOK FOR INVESTMENT MARKETS

## Report by the Independent Financial Adviser

## Economy

1. Although US GDP quarterly growth in Q2 was below expectations at +1.2% annualised, strong employment numbers in June and July have increased the possibility of a rise in the Fed Funds rate being announced in September. Forecasts for UK growth were being reduced by the Bank of England and the OECD in advance of the EU referendum.

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

| **Consensus real growth (%)** | | | | | | **Consumer prices latest (%)** |
|---|---|---|---|---|---|---|
| | **2013** | **2014** | **2015** | **2016E** | **2017E** | |
| **UK** | +1.7 | +2.8 | +2.3 | **+1.6 (+2.0)** | **+0.5** | +0.5(CPI) |
| **USA** | +1.9 | +2.4 | +2.4 | +1.7 (+2.0) | +2.0 | +1.0 |
| **Eurozone** | -0.4 | +0.8 | +1.5 | +1.5 (+1.4) | +1.1 | +0.2 |
| **Japan** | +1.7 | +0.3 | +0.6 | +0.5 (+0.6) | +0.9 | +0.5 |
| **China** | +7.7 | +7.4 | +6.9 | +6.5 (+6.5) | +6.3 | +1.9 |

[Source of estimates: The Economist, August 6th, 2016]

2. The surprise result of the UK's referendum on EU membership on June 23rd was a win for the Leave campaign by a margin of almost 4%. The consequences were immediate and far-reaching:
   - David Cameron announced he would step down as Prime Minister. After a tumultuous selection process, Theresa May was installed as Prime Minister on July 13th.
   - George Osborne was replaced as Chancellor of the Exchequer by Philip Hammond – having already abandoned the target of producing a fiscal surplus in 2019/20. Theresa May mentioned the possible issuance of infrastructure bonds. The Chancellor will set out government policy in the Autumn Statement.
   - Sterling fell sharply, from almost \$1.50 late on June 23rd to \$1.32 the next day. After dipping below \$1.30, it has since traded in the 1.30-1.33 range.
   - The UK stockmarket indices had fallen by some 6% by June 27th, but then recovered strongly in the following weeks as the new government emerged.

- Most of the Labour Party front bench resigned their posts, and a vote of no confidence in Jeremy Corbyn was passed by a 4:1 majority among Labour MP's. Corbyn is being opposed by Owen Smith in a leadership contest to be decided in September.

3. On August 4th, the Bank of England cut the UK base rate from 0.5% to 0.25%, the first change in over seven years. They also announced a resumption of Quantitative Easing, with a plan to buy £60bn of UK gilts and £10bn of investment-grade bonds during the next six months. The Governor also announced a new £100bn Term Funding Scheme for banks, aimed at helping them to lend to households and businesses at low rates of interest. The Bank has reduced its GDP growth forecasts for the UK by a cumulative 2.5% over the next two years, and estimates that 250,000 jobs may be lost as a result of the post-referendum slowdown.

## Markets

Equities

4. Equity markets moved steadily upwards during the quarter as interest rates remained low. The £-returns for overseas markets shown in the table below are enhanced by the weakness of sterling after the referendum.

| | **Capital return (in £, %) to 30.6.16** | | |
|---|---|---|---|
| **Weight %** | Region | **3 months** | **12 months** |
| **100.0** | FTSE All-World Index | **+7.8** | **+11.0** |
| 55.9 | FTSE All-World North America | +9.7 | +18.2 |
| 8.3 | FTSE All-World Japan | +8.6 | +5.5 |
| 11.4 | FTSE All-World Asia Pacific ex Japan | +7.1 | +3.3 |
| 15.2 | FTSE All-World Europe (ex-UK) | +2.1 | +2.8 |
| 6.6 | FTSE All-World UK | +5.0 | -0.4 |
| 8.8 | FTSE All-World Emerging Markets | +8.1 | +0.6 |

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

5. All industrial sectors rose – in sterling terms – during the quarter, with Oil & Gas showing notable gains as the price of oil recovered.

| Capital return (in £, %) to 30.6.16 | | |
|---|---|---|
| **Industry Group** | **3 months** | **12 months** |
| Utilities | +11.1 | +27.8 |
| Consumer Goods | + 8.0 | +19.6 |
| Technology | + 4.4 | +17.7 |
| Telecommunications | + 8.8 | +16.0 |
| Consumer Services | + 5.4 | +15.4 |
| Industrials | + 7.8 | +13.9 |
| Health Care | +13.5 | +12.1 |
| **FTSE All-World** | **+ 7.8** | **+11.0** |
| Oil & Gas | +16.4 | +7.2 |
| Financials | + 4.5 | - 0.9 |
| Basic Materials | + 8.3 | -1.3 |

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

6. Following the referendum, large-cap stocks recouped their initial falls within a few days, as the majority of their revenue is derived from overseas; mid-cap stocks, however, remained weak as they are more reliant on the domestic economy. Sectors such as housebuilding and financials were particularly weak.

| (Capital only %, to 30.6.16) | 3 months | 12 months |
|---|---|---|
| **FTSE 100** | **+ 5.3** | **-0.3** |
| **FTSE 250** | **-3.9** | **-7.2** |
| **FTSE Small Cap** | **-1.6** | **-4.4** |
| **FTSE All-Share** | **+3.5** | **-1.5** |

[Source: Financial Times]

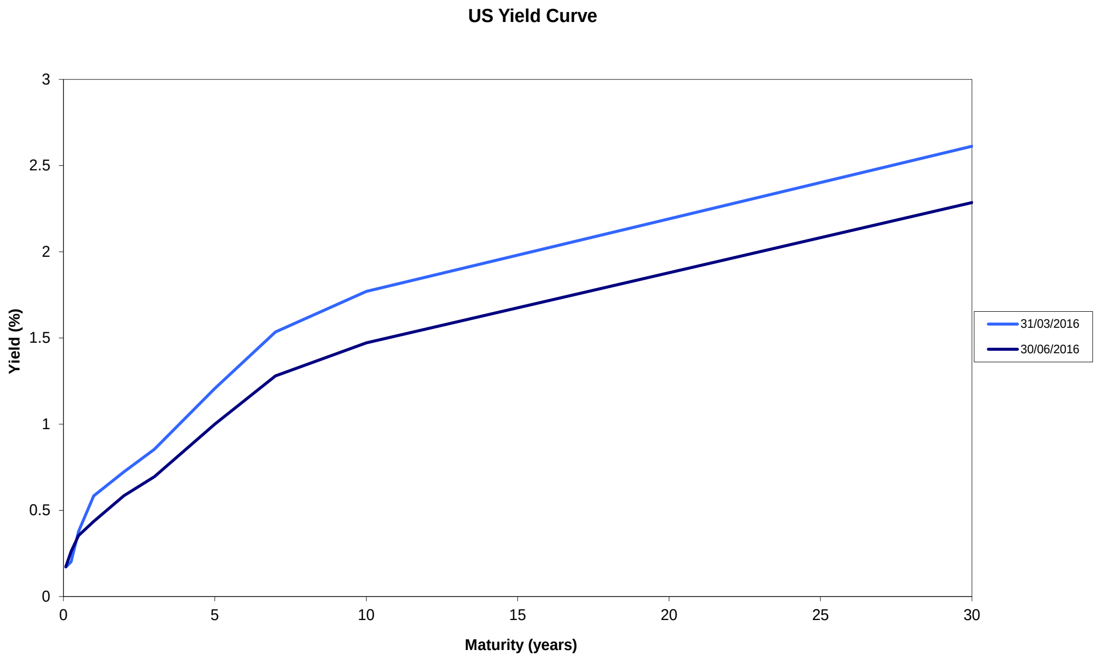
Bonds

7. Government bond yields continued to fall sharply, with German bunds going into negative territory.

| 10-year government bond yields (%) | | | | | |
|---|---|---|---|---|---|
| | Dec 13 | Dec 2014 | Dec 2015 | Mar 2016 | June 2016 |
| US | 3.03 | 2.17 | 2.27 | 1.81 | 1.46 |
| UK | 3.04 | 1.76 | 1.96 | 1.54 | 1.00 |
| Germany | 1.94 | 0.54 | 0.63 | 0.15 | -0.13 |
| Japan | 0.74 | 0.33 | 0.27 | -0.05 | -0.23 |

[Source: Financial Times]

US Treasuries strengthened further at all durations on the deferral of an interest rate rise by the Federal Reserve.

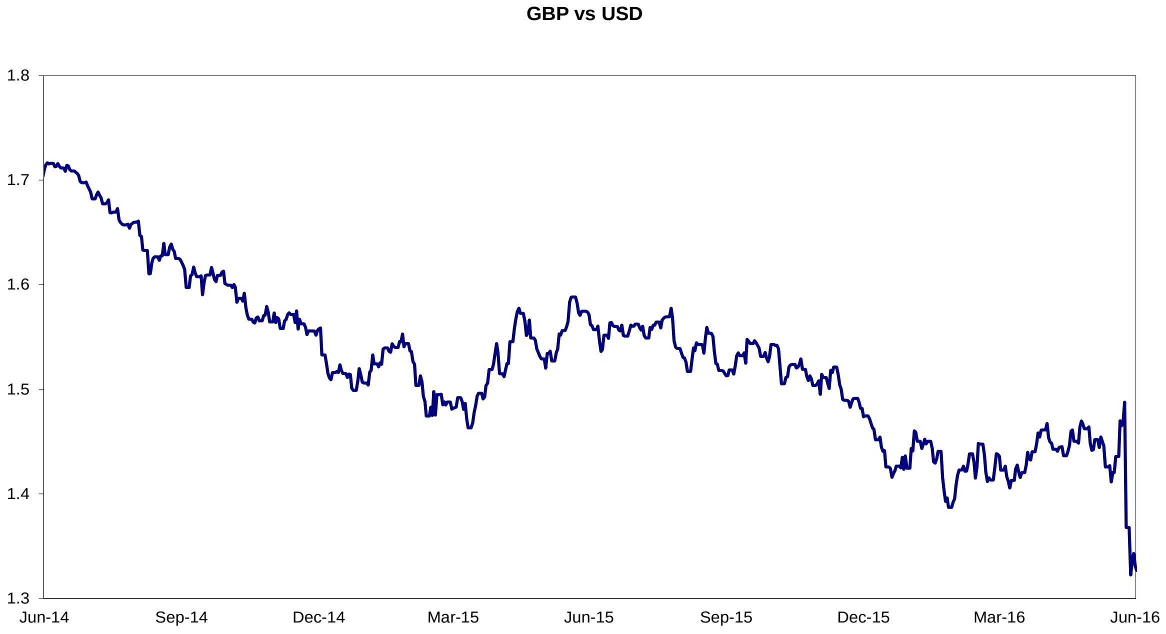


## Currencies

8. Prior to the referendum sterling had fluctuated between \$1.38 and \$1.50, depending on the outcome being forecast by the latest opinion polls. After the result, sterling fell by some 13% against the dollar. Its weakness against the yen has been even more pronounced.

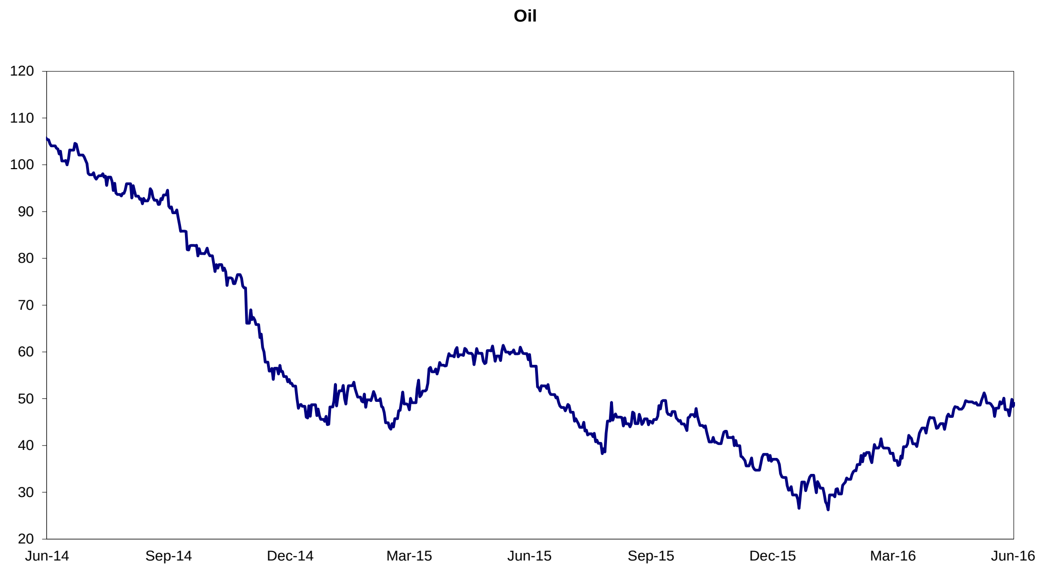
| | | | | £ move (%) | |
|---|---|---|---|---|---|
| | **30.6.15** | **31.3.16** | **30.6.16** | **3m** | **12m** |
| \$ per £ | 1.573 | 1.437 | 1.337 | - 7.0 | -15.0 |
| € per £ | 1.412 | 1.261 | 1.203 | - 4.6 | -14.8 |
| Y per £ | 192.4 | 161.5 | 137.1 | -15.1 | -28.7 |

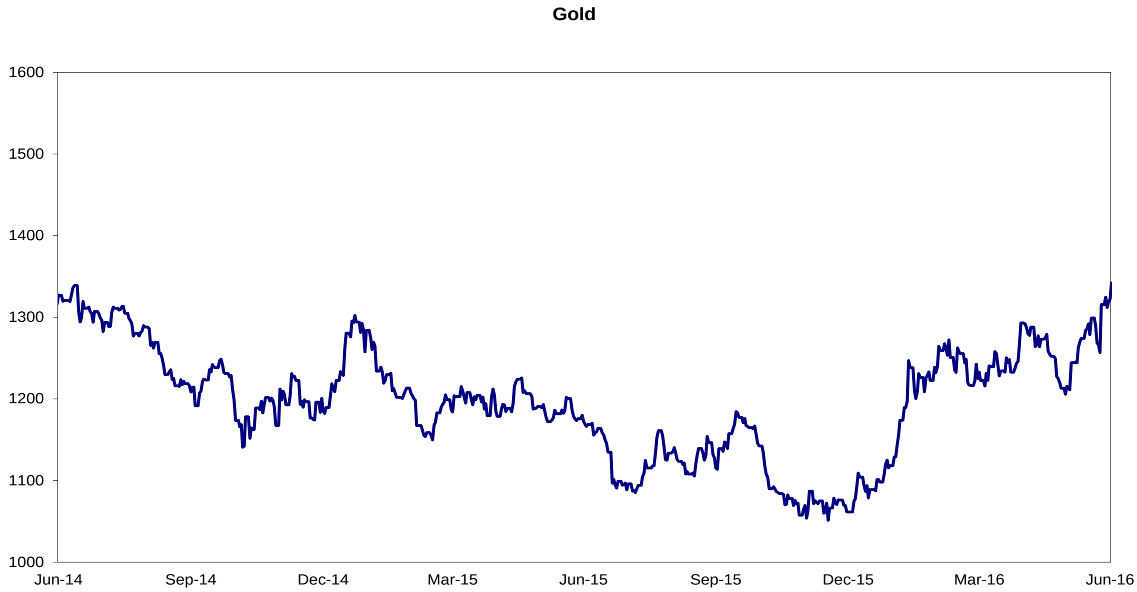
[Source: Financial Times]




## Commodities

9. The oil price stayed above $40 during the quarter, and ended the period at $50, before falling back in July. Gold gained 7%, to reach its highest level in over two years.






## Property

10. While the official second-quarter figures for UK property returns showed a continuation of the slowing growth seen in the first quarter, attention was focused on the actions of the largest open-ended property funds. After experiencing gradual withdrawals by retail investors prior to the Referendum, they then faced an accelerating pace of redemption requests after the result was announced. Most of the open-ended funds reduced their prices by 5% or more, using a ‘fair value adjustment’, but then seven of the largest funds froze withdrawals in order to allow themselves time to sell sufficient assets to meet the redemption requests. This overhang of properties, together with expectations of a less buoyant office letting market post-Brexit, will depress property valuations in the coming months.

| | **3-month** | **12-month** |
|---|---|---|
| **All Property** | **+ 1.3%** | **+ 9.2%** |
| **Retail** | **+ 1.0%** | **+ 6.4%** |
| **Office** | **+ 1.1%** | **+10.8%** |
| **Industrial** | **+ 1.8%** | **+12.2%** |

**[IPD Monthly Index of total returns, June 2016]**

## Outlook

11. The decision by the UK to leave the EU has altered the short-term outlook for the UK economy. The Bank of England has felt the need to take measures to stimulate the economy, and while the immediate reaction has been a 2% rise in UK equities and a 15bps fall in the 10-year gilt yield, the negative effects of Brexit have yet to come through to corporate profits. The likely slowdown in consumer spending, together with the higher cost of imported goods and services, will impact many UK companies with a domestic focus. For companies with predominantly overseas revenues, the weakness of sterling has given an initial boost, but the effects of the UK's revised trading arrangements have yet to be felt.

12. There has been no lessening in geo-political tension, with the resumption of the Syrian conflict, the abortive coup by the Turkish military, and terrorist acts being perpetrated in Nice, Rouen and in several sites in Germany.

13. The US Presidential Election in November will see Donald Trump, for the Republicans, opposing Democrat Hillary Clinton. In a campaign which has already confounded most pundits, it would be unwise to make any firm predictions of the result, but markets would be more comfortable with a Democrat victory.

14. Equity markets have strengthened as interest rates have fallen, but as the latter are a response to slowing economic growth I believe that equity markets look fully valued at current levels. Meanwhile, UK Property looks set to give back some of the exceptional gains made in the past three years.

**Peter Davies**
**Senior Adviser – AllenbridgeEpic Investment Advisers**

**August 8th, 2016**

[All graphs supplied by Legal & General Investment Management]