Renfrewshire Council

Meeting Papers – Markets Update

- David Millar
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Markets Update

Market and Economic News
2019

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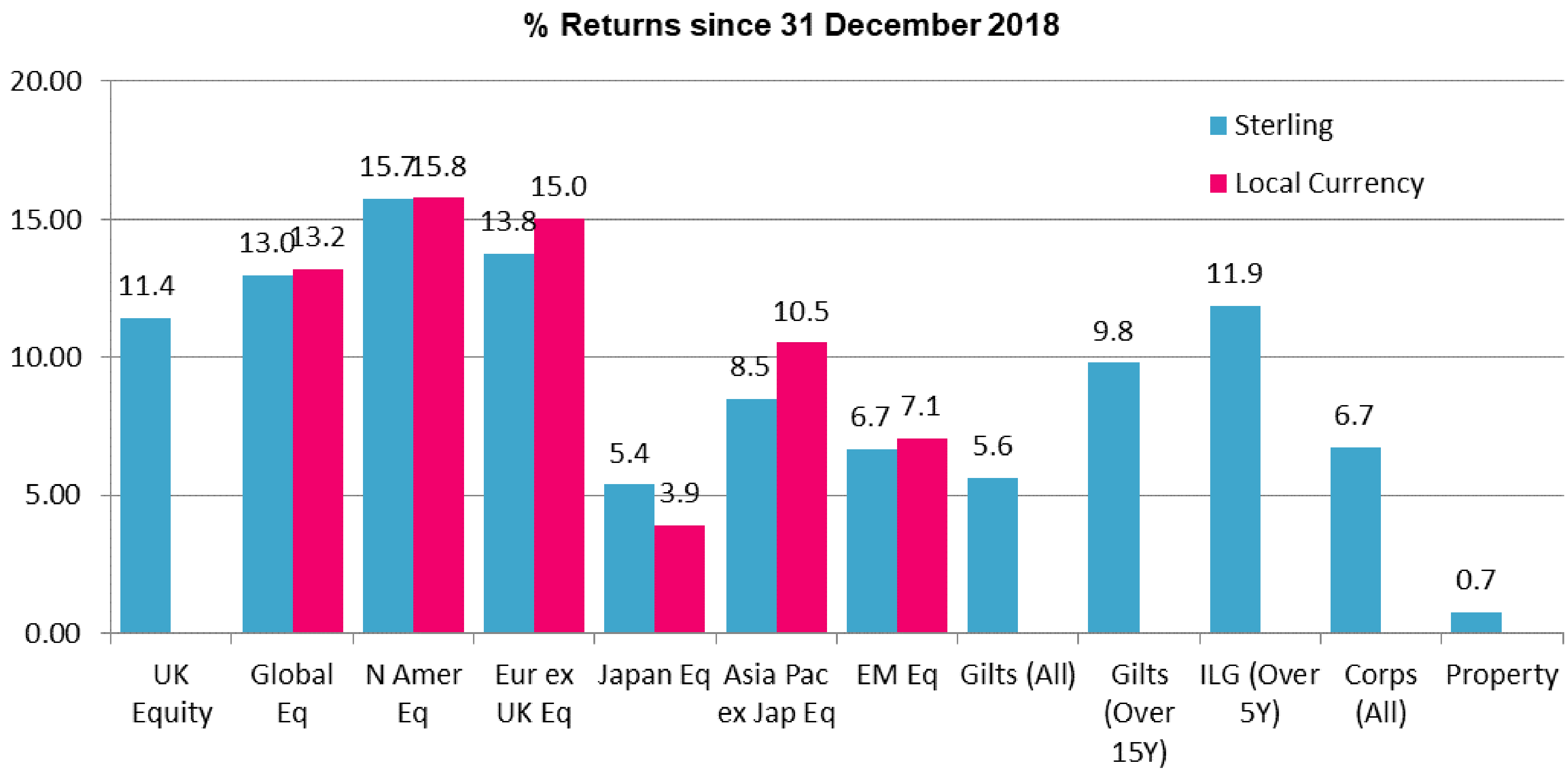
Markets in 2019



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Economic background

- US GDP growth re-accelerated in the first quarter, easily beating market expectations and resuming an increase in the year-on-year pace of growth. There were tentative signs of stimulus taking effect in China as the Chinese economy avoided slowing further in the first quarter. The slowdown in Europe also abated as Eurozone economy grew at the same pace as the previous 3-month period. The UK economy expanded 1.9% y-o-y in the first quarter of 2019, its fastest pace since Q3 2017.

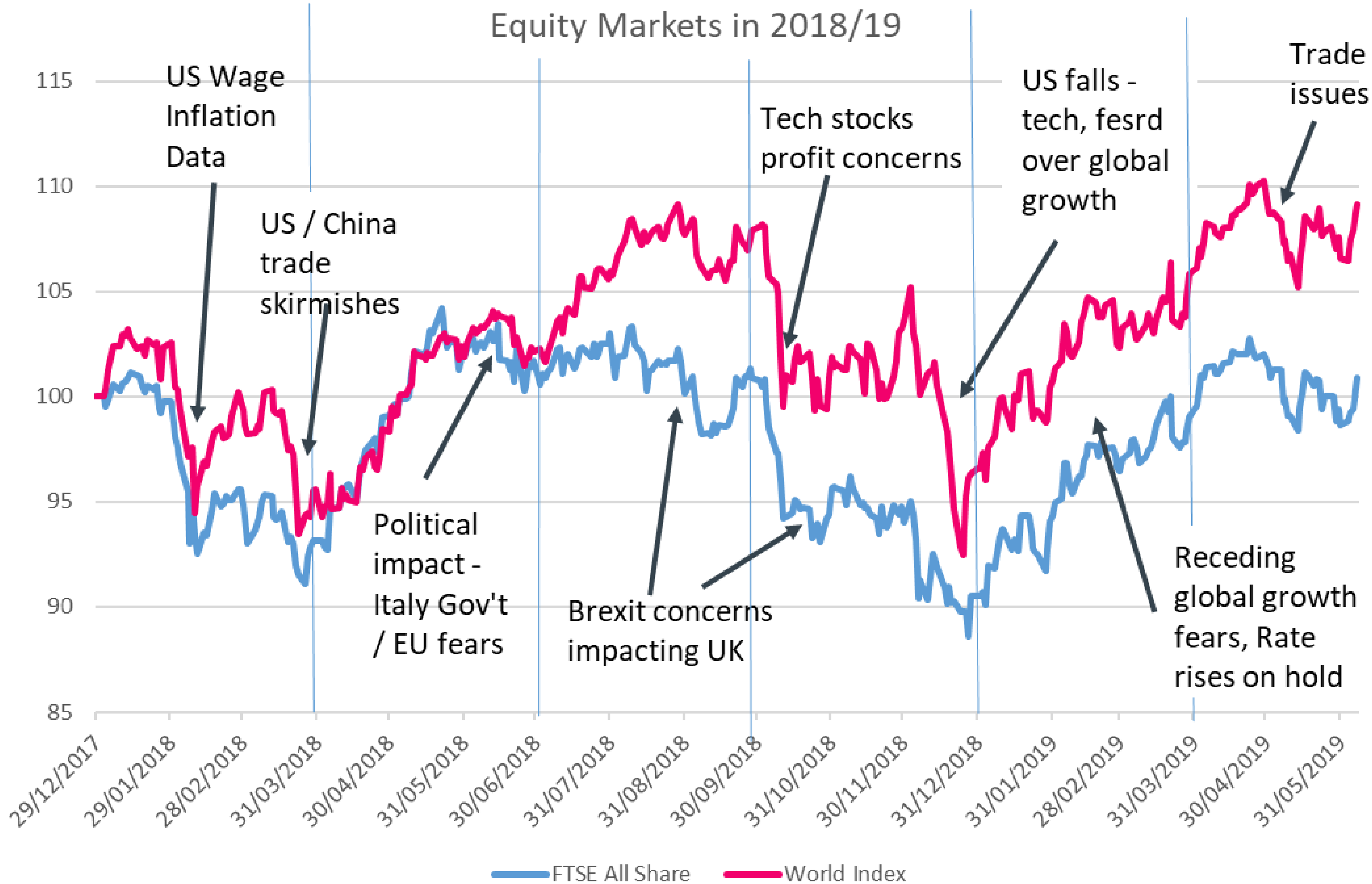
- Forecasts for global growth for 2019 continued to drift lower in April - amid an escalation in US tariffs on China and Mexico, recent data having undone some of the first quarter's optimism. The US manufacturing PMI remained in positive territory but was below both market expectations and the previous months' reading. The same measure in the UK moved in to contractionary territory for the first time since July 2016, primarily due to lower demand in Asia and Europe, while the European Manufacturing PMI remained in contraction territory for the fourth straight month.

- The year-to-date recovery in oil prices was derailed in May with Brent crude falling more than 10% over the month as global growth and US-China trade war weighed on the outlook. Headline inflation measures have risen, led by rebound in energy prices. Realised core inflation measures have remained more stable in the US and UK but have picked up in Europe and Japan.

- Rates markets continue to point to an even more dovish outlook than that adopted by central banks at the beginning of 2019 – market expectations, based on futures prices, are pricing in the possibility of two rate cuts in the US by the end of 2019, versus the pause in rate moves indicated by the Fed.

- Relative economic outperformance in the US and the apparent safe-haven appeal of the Japanese currency has seen the dollar and yen strengthen quarter-to-date, respectively. A resurgence in Brexit uncertainty saw sterling weaken markedly in trade-weighted terms over the same period.

Volatility Equities

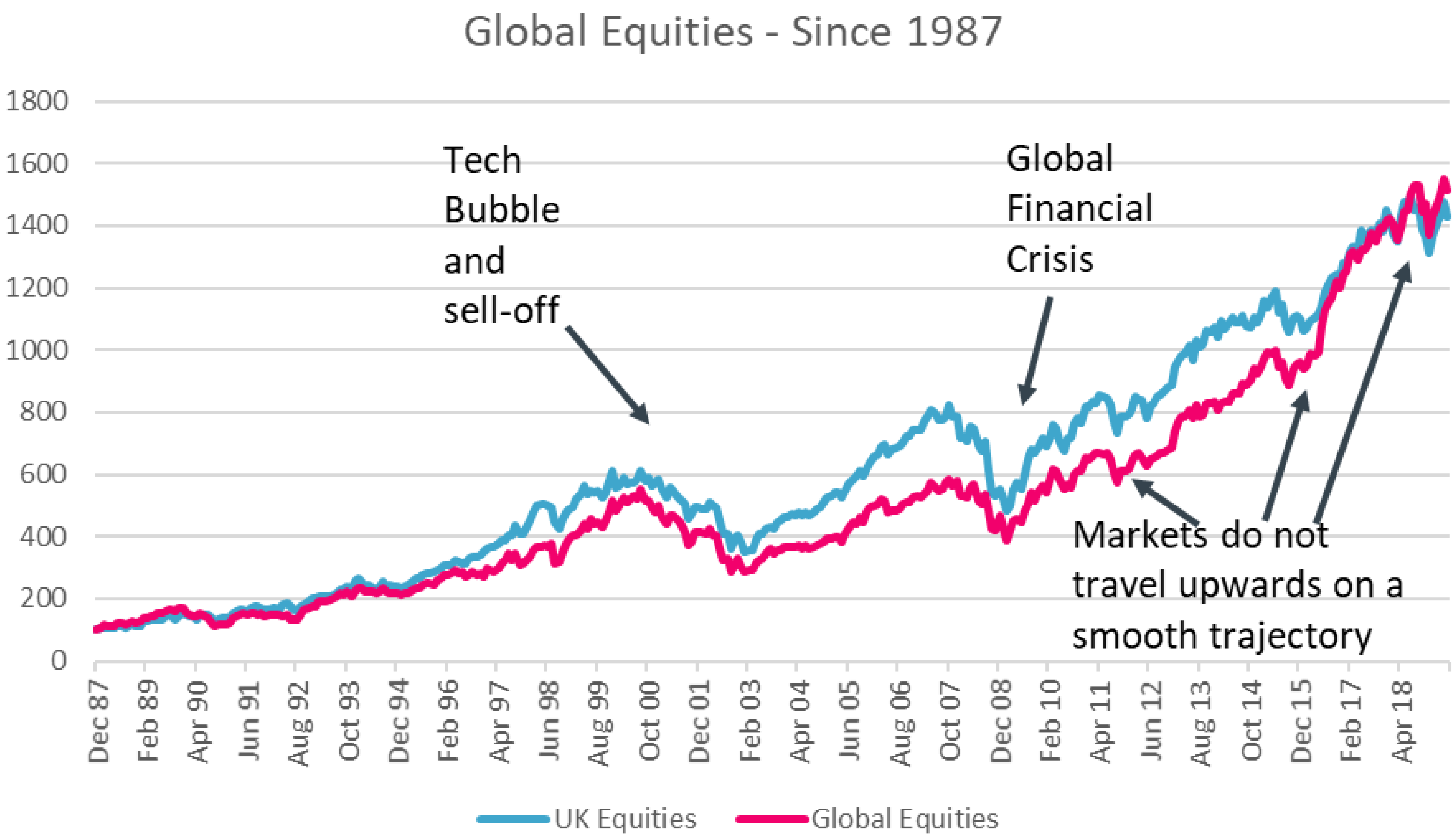


But still an upward trend through 2018 and 2019

Equities

- The equity market momentum of the first quarter of 2019 continued in April. Although the US market hit the headlines when it reached another all-time high in April, the equity rally was broad-based, with all major equity regions producing strong returns. However, the escalation in the US-China trade disputes in early May and subsequent concerns over the impact on global economic growth and trade, saw equity markets give back gains made during April.
- The change in market backdrop in May leaves quarter to date equity market trends less clear cut. However, in general, defensives areas of the equity market recovered some ground during May.
- First quarter earnings reports brought some assurances for equity investors, as overall the Q1 earnings reports came in better than consensus expectations.
- The strong recovery for equity markets in Q1 was driven by expectations for a more accommodative monetary policy from the Federal Reserve, renewed optimism over the Chinese economy and perceived progress in trade talks between the U.S and China. However, the imposition of tariffs from both sides and the broadening of the trade disputes to include Mexico has clouded the outlook for global trade. Whilst there is still much brinkmanship from both the US and China, the underlying issues are complicated and unlikely to be fully resolved in the near future.
- Looking ahead, the outlook for global economic growth and earnings will be key, given the overall global equity market valuation remains above historical averages.

But investing is a long term activity



…. And attempting to time the markets is very difficult

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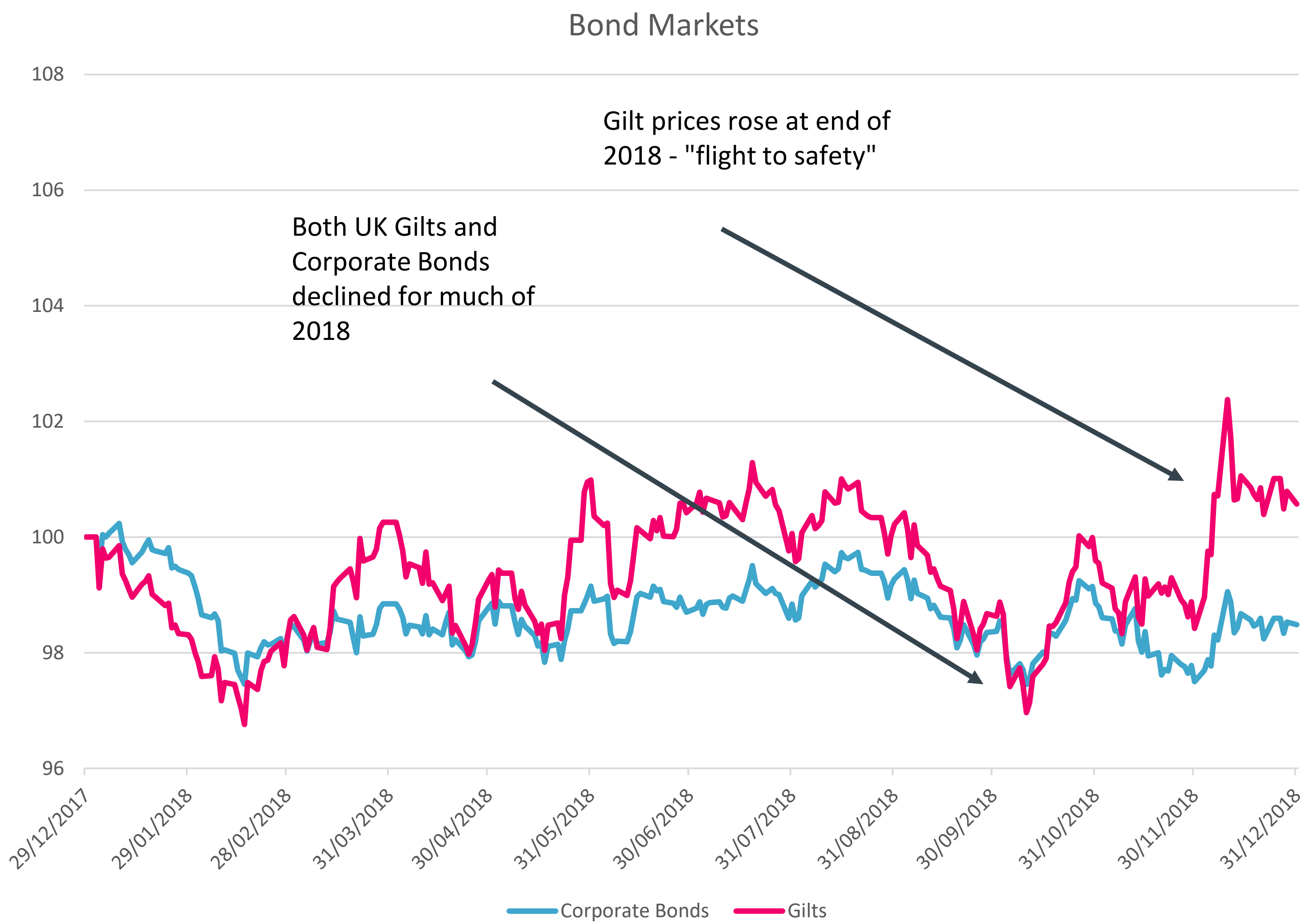
Bond Markets - 2018



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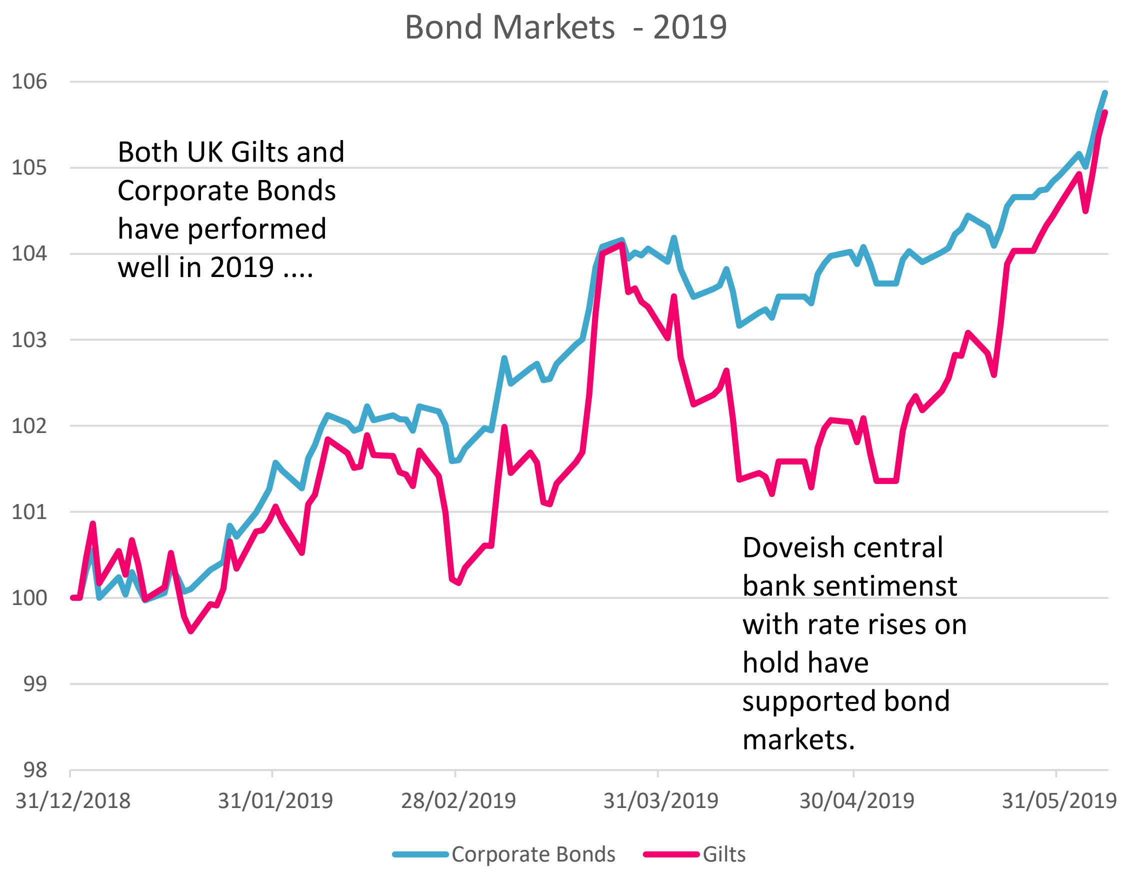
Bonds Update

- Bond yields fell sharply in May (prices rose) amid rising market expectations the Fed will ease policy this year to support growth as global trade tensions re-escalated, taking yields lower over the quarter. Existing concerns over growth and inflation forecasts have been exacerbated by the decision to raise tariffs on hundreds of billions of Chinese imports and the additional impact this could have on global growth.



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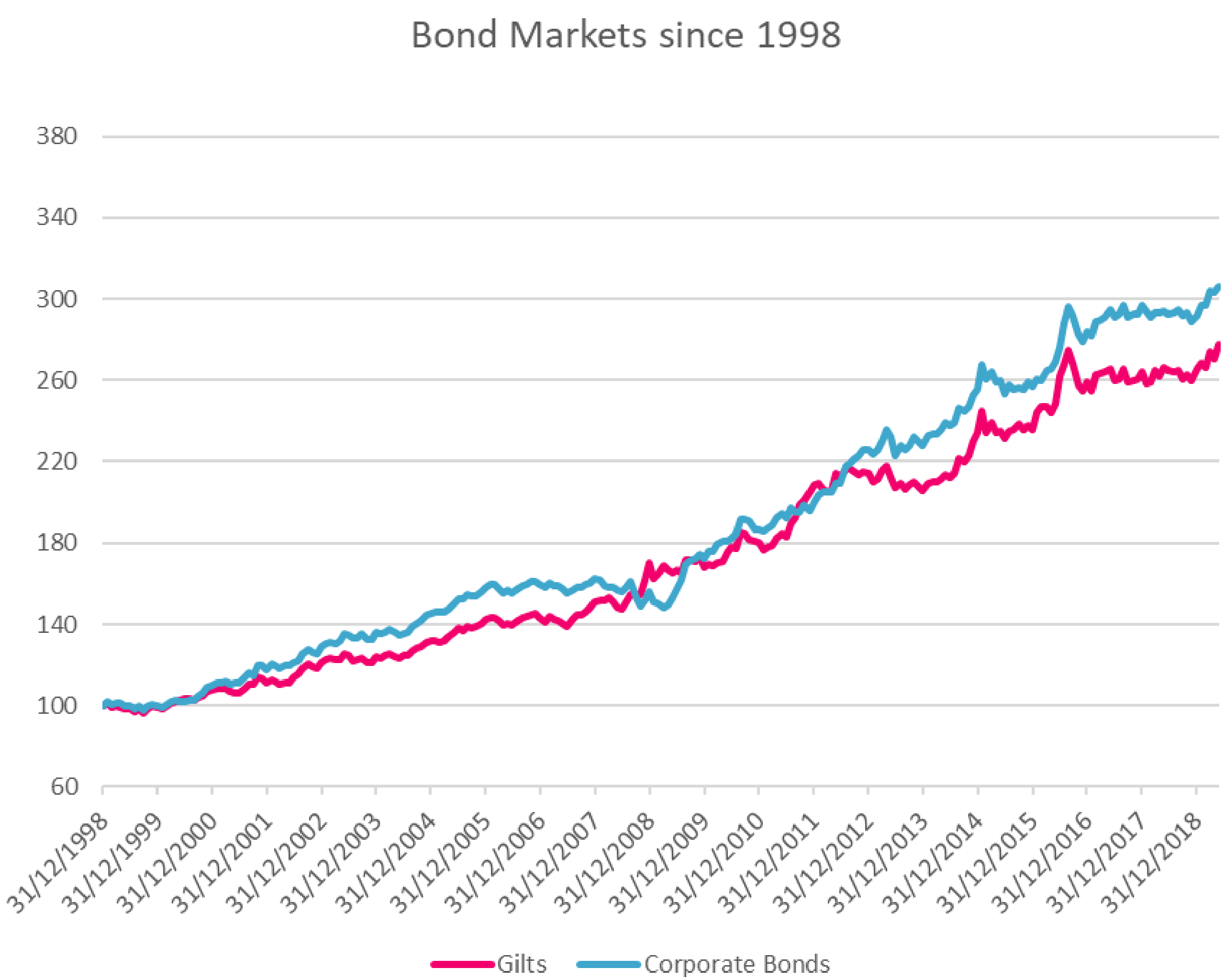
Longer term ….


Bond Markets since 1998
380
340
300
260
220
180
140
100
60
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Gilts
Corporate Bonds

Property

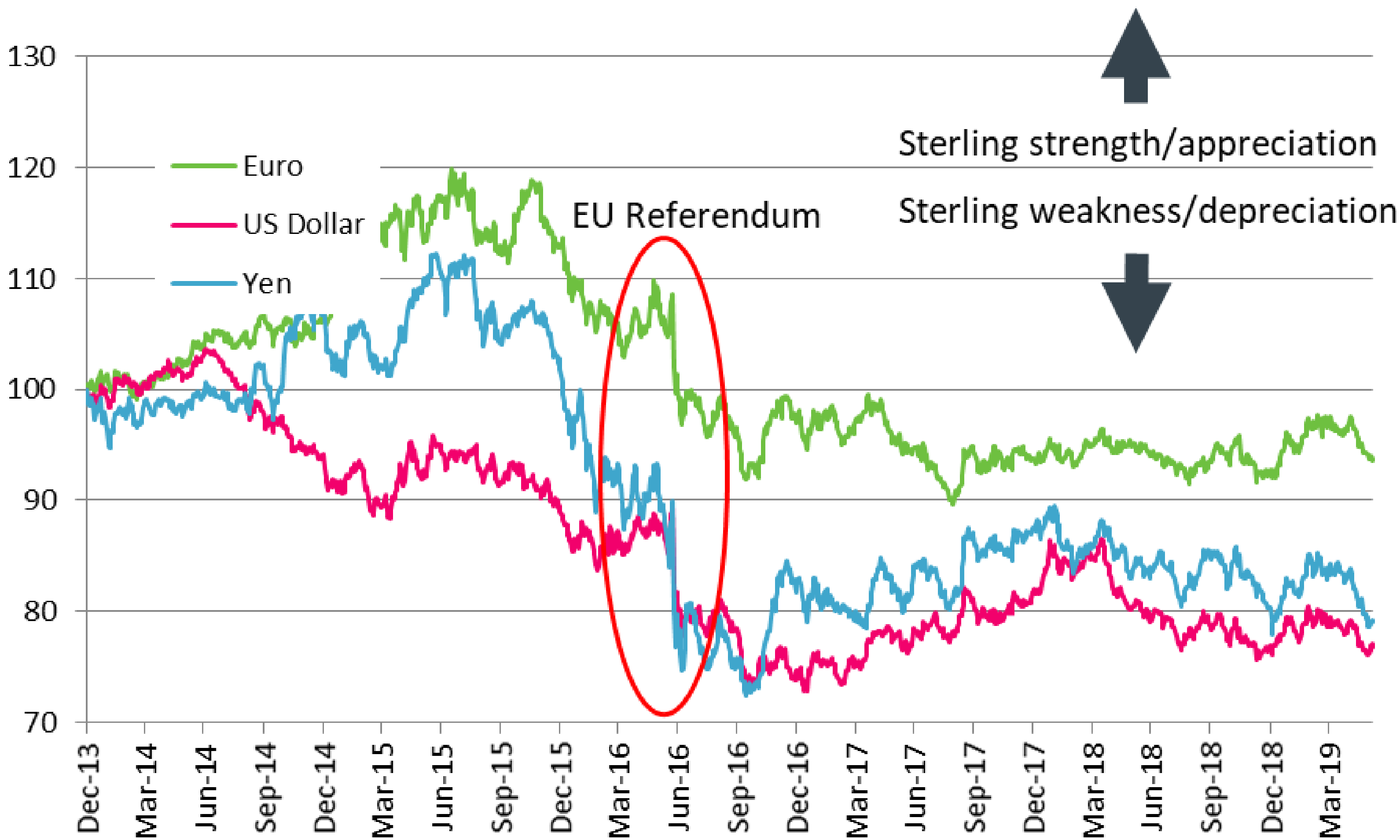
- UK property, as measured by the MSCI Monthly Index, continues to deliver marginally positive returns, 0.2% for the month of April 2019, with income and marginal rental growth compensating for 0.2% of capital declines (yield shift). Year to date property has delivered total returns of 0.7%.
- The retail sector continues to struggle from retailers reducing their space requirements, resulting in an extreme lack of buyers in the sector. Retail capital values continue to fall and are down 3.5% year to date.
- Industrial properties to service the logistic requirement of online retailers have been in great demand and relatively limited supply in recent years. At the end of December 2018 industrial yields reached their lowest point ever of 4.4% (reflecting higher capital values). It is now the only traditional sector experiencing continued capital growth but the pace of growth is slowing. Rental growth is slowing and yields have pushed out slightly this year, back to 4.5%.
- Despite continued rental growth in the office sector, capital values are down marginally year to date. Until the turn of the year, values in the sector had been on the rise since the setback in Q3 2016 following the vote on the EU Referendum.

Summary

- Strong market rally in 2019
- But some valuations looking a little stretched – potential for more “corrections”
- Consensus forecasts pointing to a more rapid moderation in global growth. Risks remain skewed to the downside - the fading fiscal stimulus in the US, escalation of US-China trade hostilities, Eurozone politics and Brexit all pose potential headwinds to global growth in 2019
- Returns can fluctuate at differing points of investment cycle
- Portfolio is well diversified and gains exposure to a wide range of countries/regions, sectors and assets
- Diversifying holdings in property, infrastructure funds, renewables etc

Thank you

Currencies



130
120
110
100
90
80
70
Euro
US Dollar
Yen
EU Referendum
Sterling strength/appreciation
Sterling weakness/depreciation
Dec-13
Mar-14
Jun-14
Sep-14
Dec-14
Mar-15
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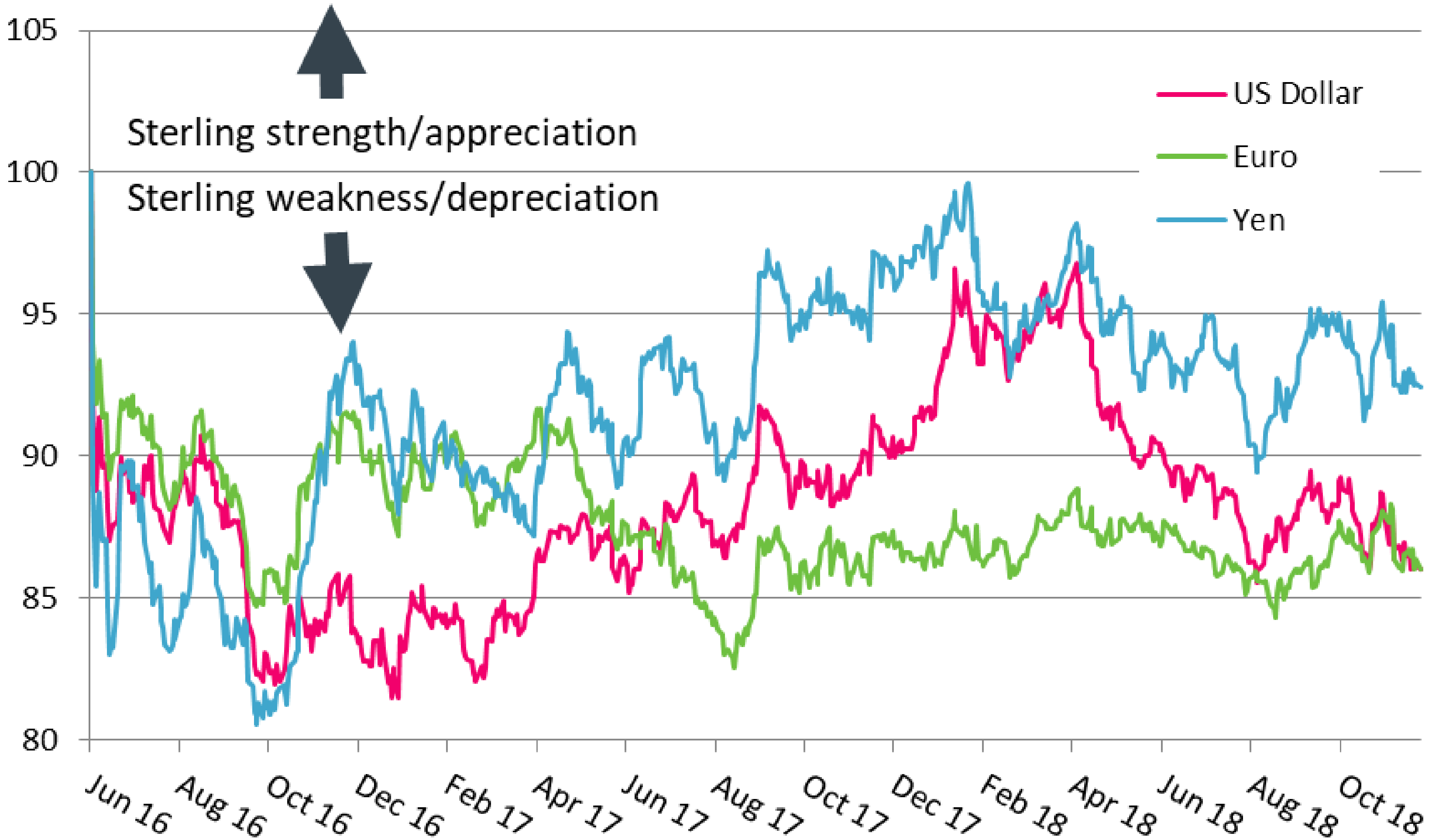
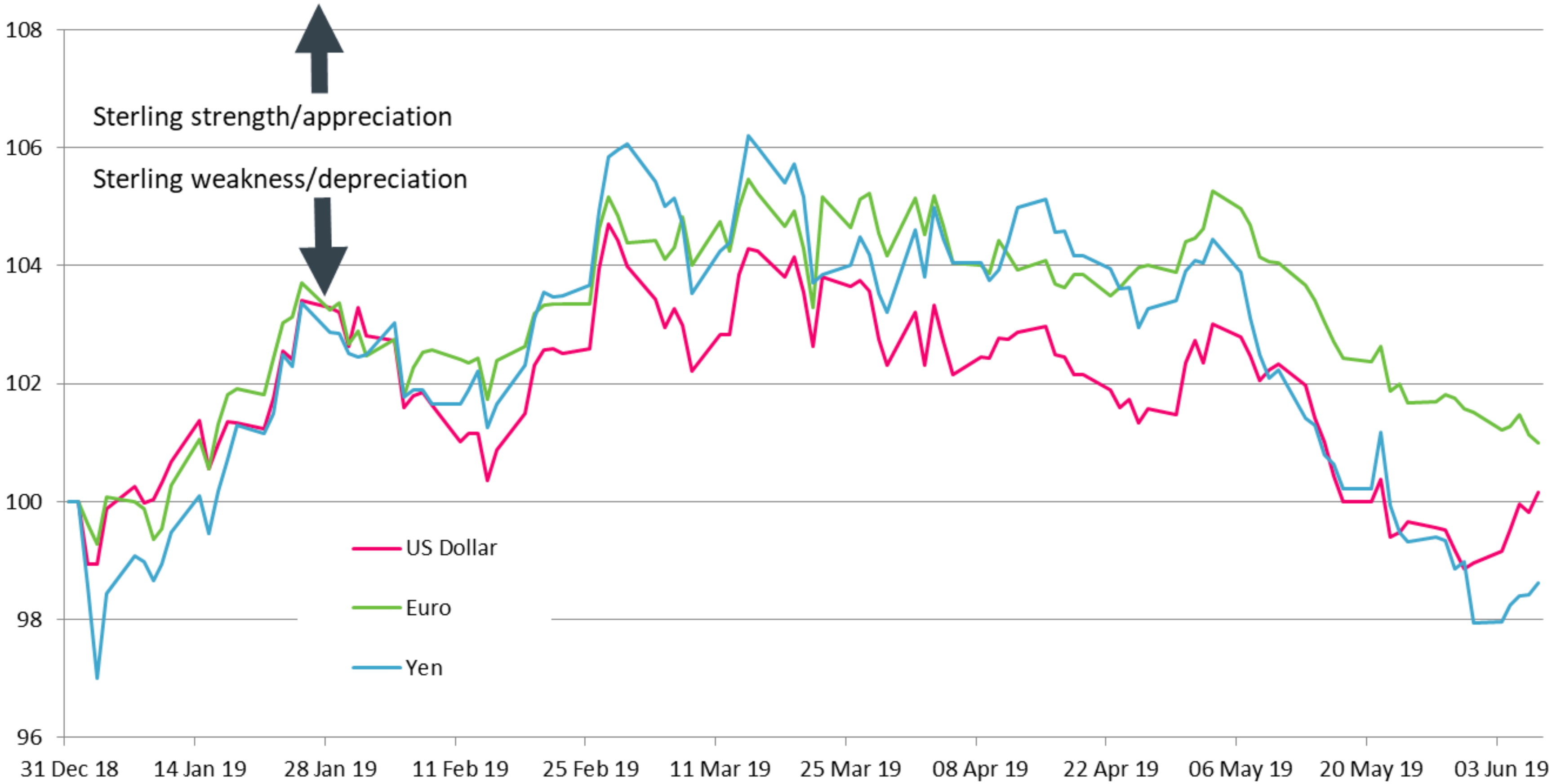
Mar-19

Currencies – Since EU Referendum



Currencies – 2019



Infrastructure

Looks to be attractive within the portfolio

Our view on valuations has been adjusted downward to reflect evidence of higher multiples through 2018. However, we believe technical drivers are strong and could underpin further revaluation.

FUNDAMENTALS **Neutral - attractive**

- An uncertain economic outlook is relatively favourable for long term infrastructure assets, which are typically less cyclically sensitive than other growth assets.
- In a subdued inflationary environment, contractual growth in income will be low in absolute terms but valuable relative to other assets.
- The cost of debt remains low as many asset owners have long term debt in place, and debt for new deals continues to be available from a wide variety of providers. However, debt levels have been increasing in certain sectors, which could start to reduce free cash flow.

VALUATION **Unattractive**

- Evidence from proprietary indicators suggests that, despite some retrenchment towards the end of the year, average valuations have pushed higher over the year as a whole.
- Data from on completed transactions relative to capital raised suggest it remains increasingly challenging to source attractively priced infrastructure assets.
- However, this is a diverse and illiquid market and value may still be found in certain areas, such as deals with a degree of complexity in implementation or where a manager has a competitive edge.

TECHNICALS **Attractive**

- Investor demand for infrastructure remains high. Data showed 2018 to be another record year of fundraising.
- This, combined with the significant reduction in completed deals, means dry powder (the amount of capital waiting to be deployed) remains very high.

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