BCPP Joint Committee

Date of Meeting: 9 March 2020

Report Title: Border to Coast Market Review

Report Sponsor: Border to Coast CIO – Daniel Booth

1 Executive Summary:

1.1 This report provides an overview of 2019 market performance and 2020 market pricing.

1.2 2019 witnessed strong asset returns across all asset classes; global equities (27%), UK government bonds (10%), high yield and EM bonds (12%). Positive returns were a function of falling interest rates and declining risk premiums and followed negative 2018 returns.

1.3 2020 market pricing is for a continuation of the last decade with continued low interest rates, mediocre growth and subdued inflation. Shift in policy responses means it is unlikely that the next decade will reflect the prior period.

1.4 This is the first such report to the Joint Committee and any feedback is welcomed.

2 Recommendation

2.1 That the report be noted.

3 Overview of 2019 Market Performance

3.1 Strong 2019 asset class returns followed on from weak 2018 performance:

Passive Total Return by Asset Class

Asset Class	Passive Total Return* 2019	Passive Total Return* 2018
Equities		
Global	27.4%	-6.6%
US Large Cap (S&P 500)	31.5%	-4.4%
US Large Cap Growth (Russell 1000 Growth)	29.9%	-1.5%
US Large Cap Value (Russell 1000 Value)	21.3%	-8.3%
US Small Cap (Russell 2000)	20.7%	-11.0%
Germany	28.2%	-15.7%
France	34.2%	-5.2%
Italy	36.0%	-10.7%
Spain	19.6%	-9.3%
Japan	22.7%	-13.0%
UK	19.9%	-7.5%
Canada	23.4%	-8.5%
Australia	25.0%	-1.8%
Emerging Markets (Unhedged)	18.9%	-14.2%
Government Bonds		
US	7.1%	0.8%
Germany	6.4%	4.7%
Japan	4.7%	3.3%
UK	10.4%	1.7%
Canada	5.1%	3.0%
Australia	11.0%	5.5%
Inflation-Linked Bonds		
US	8.8%	-1.5%
Germany	5.5%	3.5%
Japan	2.1%	0.6%
UK	8.0%	1.0%
Canada	8.7%	0.5%
Australia	9.6%	3.9%

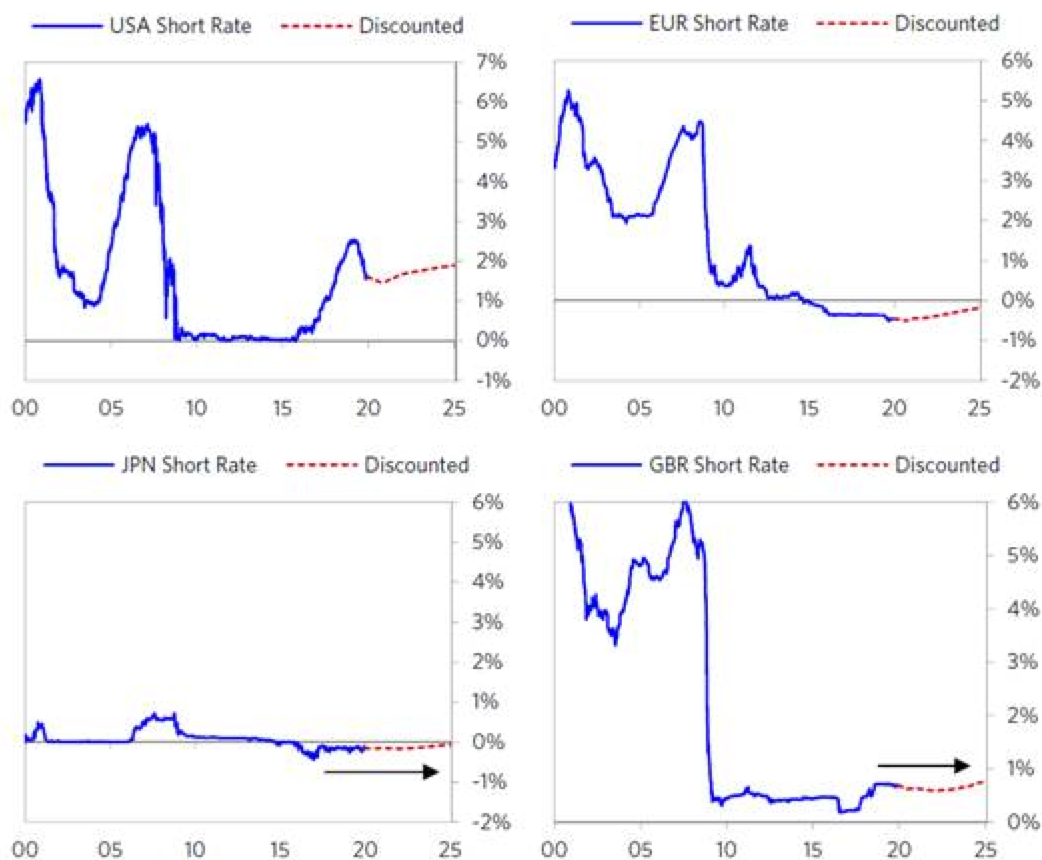
Asset Class	Passive Total Return* 2019	Passive Total Return* 2018
Corporate Bonds		
US	14.8%	-2.5%
Global	12.6%	-1.0%
High-Yield Bonds		
US	12.0%	-2.1%
Global	12.1%	-2.7%
Emerging Market Debt		
EMBI Plus	12.6%	-5.3%
Bond Aggregates (Bloomberg)		
US	8.4%	0.0%
Global	8.1%	1.8%
Commodities		
S&P-GSCI Commodity Index	10.4%	-13.8%
Bloomberg Commodity Index	2.6%	-11.2%
Crude Oil (Brent)	34.2%	-14.0%
Gold	18.3%	-2.6%
Other		
Hedge Funds (HFRX Global Index)	5.2%	-6.0%
US Real Estate (NAREIT)	25.2%	-4.1%
EUR vs USD	-6.3%	-7.3%
JPY vs USD	-2.3%	0.1%
EMFX vs USD	-2.0%	-6.0%
US Cash	2.4%	2.0%

*All returns are USD-hedged unless noted otherwise. All equity returns are MSCI indices unless noted otherwise.

3.2 2019 asset returns were driven by falling interest rates (increasing the present value of future cashflows) and declining risk premium (compensation required to hold risky assets).

3.3 **Interest Rates** witnessed a switch from a tightening to an easing of policy as Central Banks (especially US) pivoted due to ongoing weak inflation. US Fed was forecast to continue raising interest rates but actually delivered 3 interest rate cuts and the EU ECB restarted Quantitative Easing (bond purchasing program):

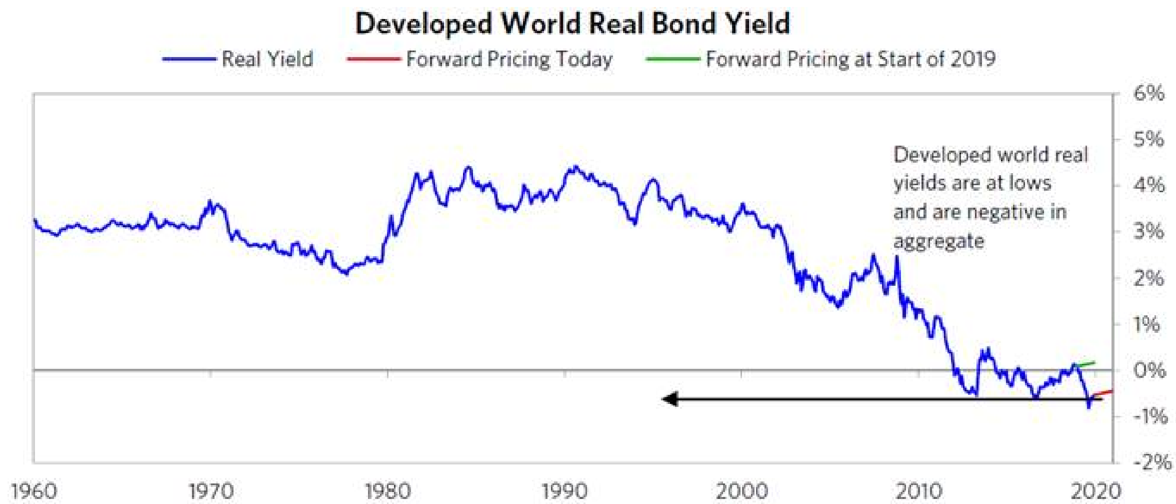
3.3.1 *Interest Rates* are now discounted to stay flat for a prolonged period (with the US Fed Reserve priced to ease 15 bps in 2020):



3.4 **Bond markets** rallied due to lower interest rates, weak inflation data and renewed Central Bank bond purchases.

3.4.1 *Developed World Nominal Bonds* are at secular lows (driven by low real yields and low inflation expectations) and are priced at stay around current levels:

3.4.2 *Developed World Inflation Linked Bonds* are at lows with negative yields which reflects the ongoing secular imbalance in the supply and demand for capital (i.e. excess liquidity):

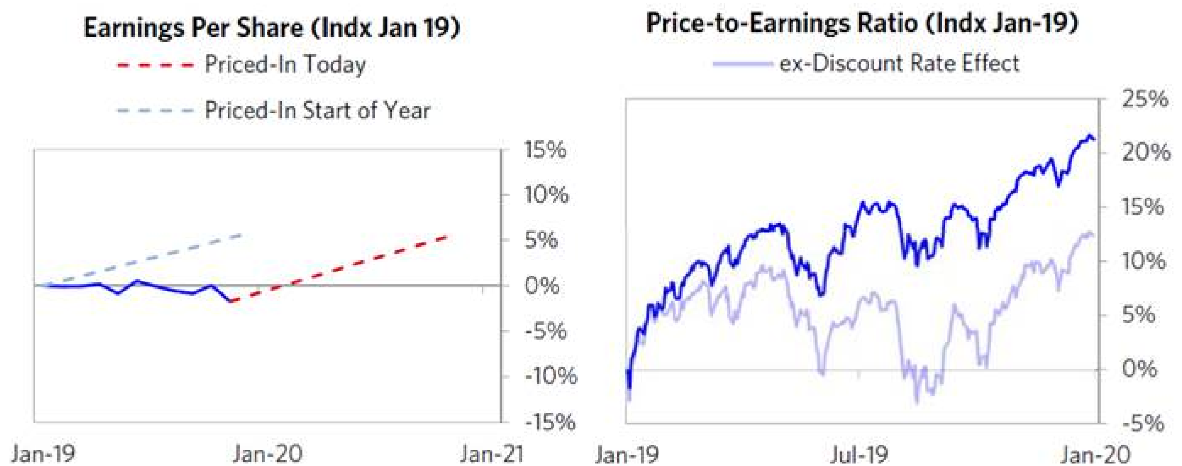


3.5 **Corporate spreads** tightened with abundant global liquidity (with high yield energy sector under more strain due to oversupply and higher debts).

3.6 **Global Equities** returns are a function of changes in:

a) current year earnings: flat 2019 annual earnings which was below expectation (negative)
b) future earnings expectations: unchanged future implied earnings (neutral).
c) interest rates: lower interest (discount) rates (positive) which boost present value of future cashflows
d) equity risk premium: decline in equity risk premium (positive) as investors demanded lower compensation for holding risky asset which boosted multiples paid.

3.6.1 2019 positive equity returns were a function of lower interest rates and price-earnings multiple expansion:



3.6.2 *Global Equity 27% return broken down into dividends (3%), price-earnings* multiple expansion (22%) and earnings per share growth (2%). World price-earning multiples increasing from ***13.4x** (start of 2019) to **16.5x** (end of 2019)* reflecting both lower interest rates (support higher multiples) and lower investor risk premium (investors happy to pay higher prices):

2019 MSCI Index Price Change

	Change in Price	Change in Fwd EPS	Change in Fwd P/E	Fwd P/E Start of Year	Fwd P/E Today
World*	24%	2%	22%	13.4	16.5
Dev World	25%	2%	23%	13.9	17.1
EM*	15%	-6%	22%	10.6	12.9

3.6.3 Opposite of 2018 when we witnessed strong corporate earnings growth but negative equity returns and the subsequent price-earnings multiple contraction representing an increase in the equity risk premium (as investor feared Central Bank liquidity reduction).

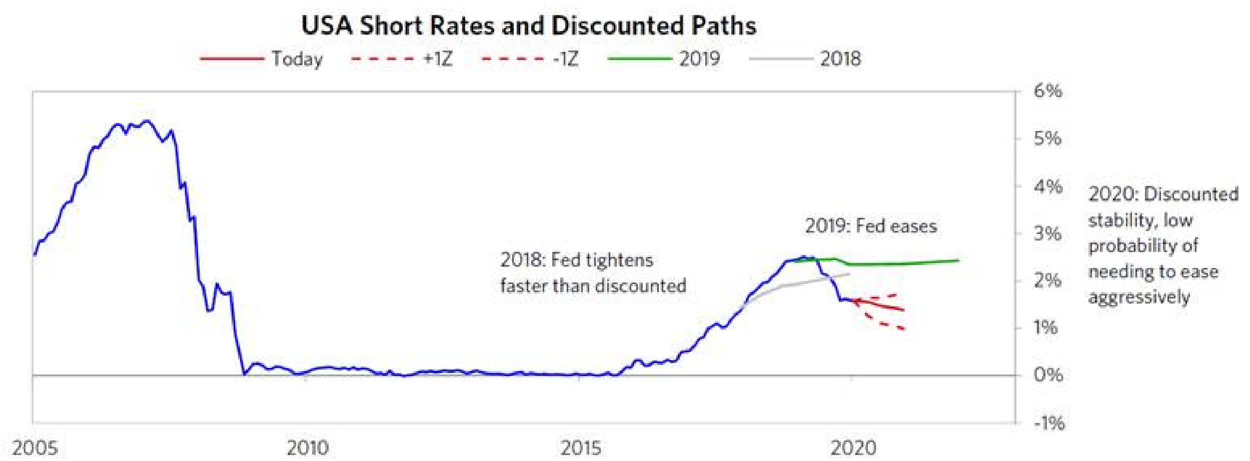
3.7 **Developed Market (DM) Currencies** were priced to appreciate versus USD (reflecting higher US IR) but saw a weakening EUR and a marginally strengthening GBP:

4 2020 Market Discounting

4.1 Asset returns are a function of *how events transpire* versus *market discounting* and *how the discounting changes* (so investors need to understand current market pricing).

4.2 Monetary Policy shift is fully discounted (with rates staying at secular lows due to low inflation rates) and it has taken markets 10 years to fully understand easy monetary policy required with a private sector deleveraging. When the Fed raised interest rates faster than expected (in 2018) this led to a slowdown in activity and prompt a subsequent reversal monetary policy to an easing (in 2019).

4.3 Interest Rate market is currently priced neither to tighten or ease rates (relatively rate stability as shown red / red dotted lines below):



4.4 Markets are priced for negative real rates and inflation to be below Central Bank targets despite easy monetary policy.

4.5 Markets are priced for mediocre growth with low discounted equity earnings growth, apart from US priced more normal earnings growth (as see via higher price-earnings multiples):

4.6 Low future expected asset returns are mainly a returns are mainly a function of low interest rates (cash) with expected excess return over cash more normal (slightly expensive).

4.7 Low interest rates continue to push money out on the risk curve with subsequent demand causing a rally in risk asset prices and a decline in yields (lowing expected future return).

5 Conclusion

5.1 Market pricing is consistent with a continuation of extremely easy monetary policy with low nominal and negative real interest rates leading to similar outcome of past relatively low inflation and low growth rates.

5.2 Stated arguments for continuation of an ongoing deflationary environment include:

a) excessive developed world debt levels

b) low aggregate demand (with constrained private sector borrowing).

c) low levels of productivity (partly underinvestment last decade)

d) low levels of labour market bargaining power (due to technological improvements and automation)

e) demographics (ageing population impacts on the above)

5.3 However, longer-term inflation risk may be under-priced by markets due to the beginning of changing underlying market conditions:

a) Renewed Quantitative Easing (expansion money supply) without offsetting commercial bank deleveraging (constant multiplier) as banks high tier 1 capital ratios.

b) Expansionary Fiscal Policies (expand money supply and especially risky if deficit monetarization occurs)

c) Ageing demographics causes a relative shift in power of labour versus capital leading to increasing unit labour costs (as limited local labour supply).

d) Reduced global supply side efficiency as increased global trade frictions. Particularly case for UK as BREXIT impacts from both reduced labour supply (increase unit labour costs) and increased trade frictions / costs.

e) Debt deflations typically end with inflationary (policy makers path of least resistance)

5.4 Market pricing is consistent with the environment of last decade: any switch to an alternative scenario not reflective of market pricing could cause large relative asset price changes (as there is a much lower hurdle for a surprise). Timeframe for a potential change to the environment remains unknown.

All charts courtesy of Bridgewater Associates.

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