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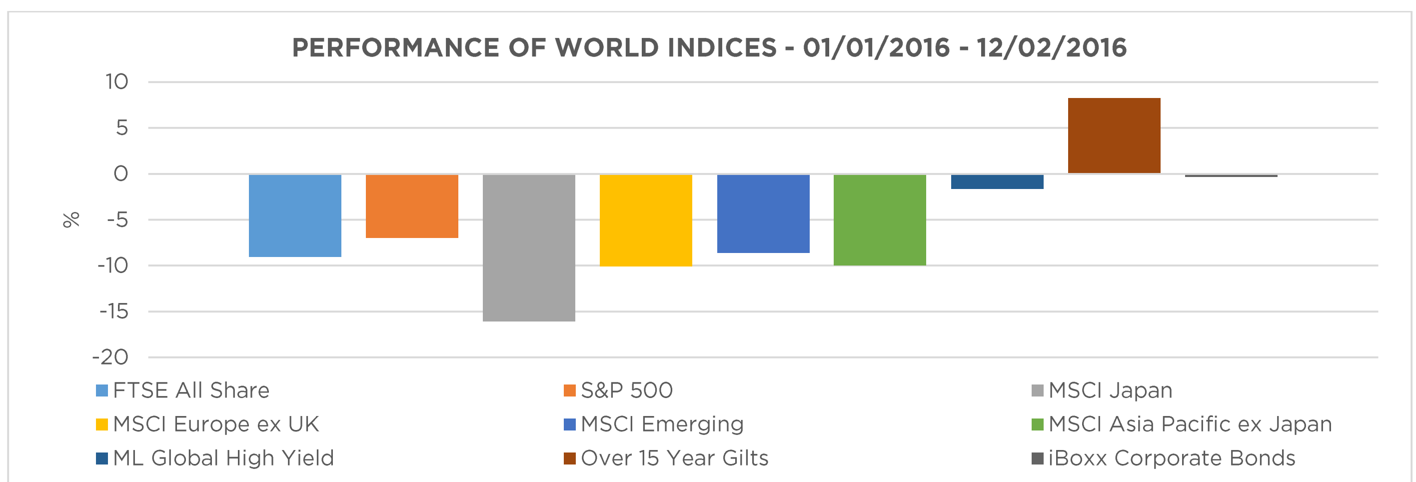
INVESTMENT CONSULTING

MARKET TURMOIL

Markets have had a torrid time since the start of 2016, with the worst global sell-off since 2008. The MSCI World Index fell 8.7% between the end of 2015 and 12 February 2016, whilst the MSCI Japan Total Return Index fell 16.1% before recovering earlier the following week.

Other markets have been affected to varying degrees, whilst investors have fled to 'safe haven' government bonds, driving prices higher and yields lower.



Source: FE Analytics

WHAT ARE THE REASONS FOR THE TURMOIL?

The market turmoil has been driven by a number of factors, including falling growth in China, the knock on impact in emerging markets, the resulting collapse in commodity prices (oil in particular), helped by a strong US Dollar.

Many of these factors were already in play during the latter half of 2015, and a number of additional factors have worsened the situation further.

Problems seemed to have appeared first in China, where concerns regarding growth turned into a rout of Chinese A-shares by Chinese investors. Foreign investors took fright at the Chinese Authorities' failed attempts to control the falls, the poor way in which the devaluation of the Renminbi was handled and the continued capital flight.

The increase in US interest rates in December served to boost the US Dollar and this has hurt emerging markets and commodity prices.

The actions of the central banks has led to a race to the bottom for interest rates in other parts of the world. Central Banks in Switzerland, Denmark, Japan the ECB and Sweden have adopted negative interest rate policies in order to avoid deflation and encourage growth. Some $6trn of Japanese and European debt now yields below zero.

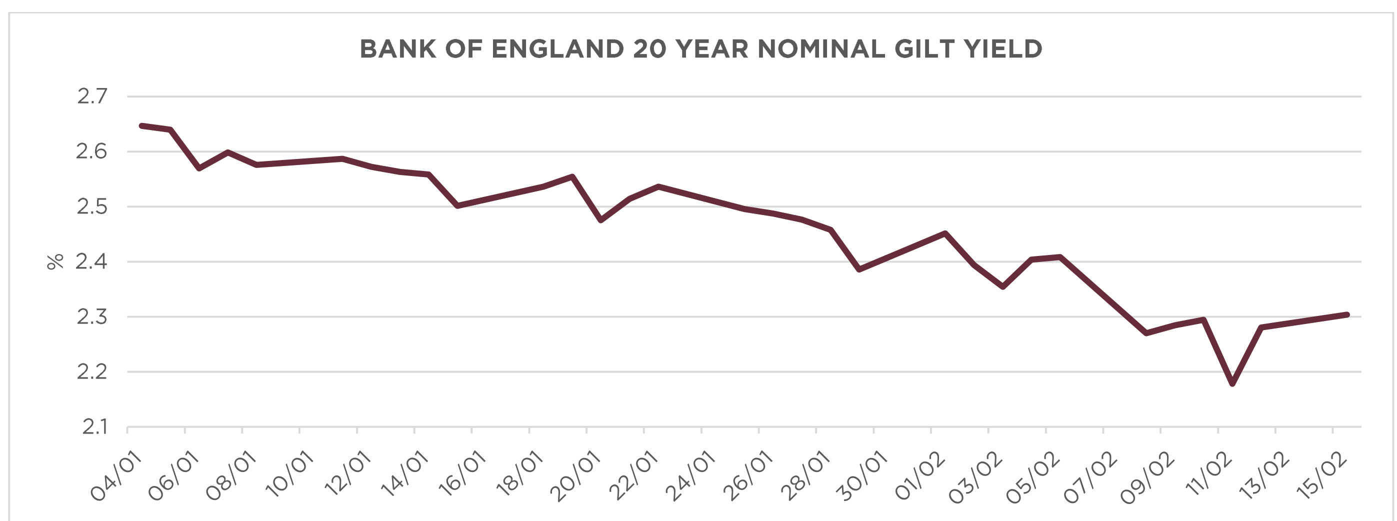
Negative interest rates and a flattening of the yield curve have squeezed banks' profit margins as banks have borne the brunt of the equity market sell-off. Bank shares have been further affected by the threat of loan defaults rising, particularly amongst miners and commodity producers.

The weak oil prices are not just hurting producers at the margins, such as shale gas producers. Some believe that the large equity market sell-off can be partly attributable to Middle Eastern sovereign wealth funds having to liquidate their holdings due to the sustained fall in oil prices.

The outlook for equities themselves has also deteriorated as P/E ratios had become stretched in a number of developed markets, particularly in the US where corporate earnings have been falling for the last three quarters.

Corporate Bond yield spreads over gilts have widened as the prospects of default have increased.

Investors have been piling into so-called safe-haven government bonds in the face of slowing inflation and slowing growth, and particularly those government bonds offering positive interest rates. As a result, UK gilt yields have fallen considerably.



Source: Bank of England

The fall in gilt yields reflects the longer term declining trend in gilt yields since the end of December 2014 when 20 year gilt yields reached 3.75%. The combined effects of lower equity prices and lower yields will have significant implications for pension scheme funding, particularly those schemes undertaking a triennial valuation this year.

What is the outlook?

The FTSE 100 fell almost 20% from last April compared to peak to trough falls of 33% in 1987, 48% in 2000 and 43% in 2008. The VIX Volatility Index remains elevated indicating that high levels of stress within the markets remain.

Whilst there is the potential for markets to fall further many of the fund managers we have spoken to believe that there are pockets of value starting to re-emerge as prices fall and they are taking selective positions to take advantage of this.

Many believe that markets have priced in a major world recession and that the significant further falls in share prices are unlikely. Indeed, prices have risen since the low of 12th February and the cyclically

adjusted P/E ratios in Europe and the UK are now lower than their long term averages. However, there seems little doubt that the global economy is weakening and lower growth rather than outright recession is expected.

What action should we take?

Pension Scheme Trustees are fortunate in being able to take a longer term view of the world and are generally advised not to disinvest in falling markets. In addition, missing even a handful of the best days in the market can seriously compromise long term returns.

Trustees should also consider taking advantage of recent market falls to rebalance their portfolio, by (for example) selling gilts and reinvesting these into growth assets such as equities. Rebalancing forces investors to sell assets at a higher price and buy assets at a lower price.

If you are considering implementing a strategic change to your asset allocation you should seek advice from your investment consultant regarding the timing of this move, particularly if you are disinvesting from equities, as you will effectively 'lock in' your losses if you sell at depressed prices.

In the longer term, we advocate diversifying your investment strategy to limit the impact of falling markets. Diversification is typically achieved at the asset class level, but should also be achieved through allowing the investment manager to take tactical asset decisions and by diversifying across investment managers.

Where our clients have invested in target return funds (including diversified growth/ absolute return funds), the impact of the market turmoil has been reduced.

We also advocate taking steps to manage the interest rate and inflation risks of your investment strategy taking into account the liability profile of your scheme.

If you would like to discuss the particular circumstances of your scheme, please contact your usual Broadstone Consultant or:

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16 FEBRUARY 2016

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