Global Connections
Pension Portfolio's Review Zurich Offshore – January 2017

Introduction

The purpose of this report is to provide a summary of the pension investment performance of the funds associated with the following plans, when compared to the sector average, on a quarterly and inception basis, also taking into account the recent Brexit:

- The International Offshore Retirement Benefits Plan (IntRBP)

The market commentary below provides a review of the events affecting the performance of the asset classes across the markets between September 2016 and December 2016.

Market Commentary*

The second half of 2016 was a generally positive one for investors, which came as a relief after the travails of the previous six months, and also, perhaps, as something of a surprise given the political background.

Overview

Everyone was slowly getting used to the idea of the UK no longer being a part of the European Union when the year's second major political upset occurred as Donald Trump prevailed in the US presidential election. Yet again, not only were opinion pollsters confounded by the result, but also market strategists.

An expected fall in equity markets failed to materialise, with investors instead focusing on the promise of fiscal stimulus to promote growth. The world's largest and most influential equity market in the United States hit new all-time highs, with financial and industrial shares leading the way. The UK's FTSE 100 Index also broke new ground, returning almost 10% in capital terms over the period under review, and over 15% for the whole year.

UK balanced portfolio returns continued to be flattered by a weaker pound and a very strong dollar, although government bonds finally succumbed to gravity and gave back a substantial part of the gains achieved in the first half of the year. The UK's benchmark 10-year gilt yield hit an all-time low of 0.51% in August as talk of "secular stagnation" reached a crescendo and the Bank of England re-started its Quantitative Easing programme while at the same time cutting the base rate to a new all-time low of 0.25%. As it became apparent that the UK economy was not falling off a post-referendum cliff, the gilt yield climbed back to 1.5% before ending the year at 1.24%.

The pound remains hostage to political influences, not least the outcome of the UK's negotiations with the EU over its relationship once Brexit actually happens. For all the noise being generated on the subject, it must be remembered that the UK remains very much in Europe for now, Article 50 has not been triggered, and there is no formal timetable for departure. Perhaps of greater concern is the lack of a clear plan from the government, leaving both financial and business investors in the dark.

It remains to be seen whether Mrs May is playing a canny game of poker or just waiting to see what turns up. The benefit of the pound's fall accrues mainly to overseas earners and exporters, although no real dent has yet been made in the UK's persistently large trade deficit, leaving sterling vulnerable to further weakness despite its now more reasonable relative valuation. The bad news is that import prices will rise, and this, combined with resurgent commodity prices, means that the headline inflation rate will also rise sharply in the first half of 2017. That threatens to put real incomes under pressure, which could reduce domestic consumption.

Unlike 2015, markets ended 2016 on the front foot, taking the view that deflationary pressures are finally easing and that the risk of systemic failure is also abating. Whether or not that turns out to be the case lies very much in the hands of both politicians and central bankers, so, not for the first time recently, we enter a new year expecting positive returns, but with insufficient confidence to place aggressive bets.

Key Influences

2016 was a year that will go down in history as one of the least predictable. Even those who correctly forecast the poll results generally failed to grasp the implications for markets. This unpredictability arises from the fact that we are going through a period of regime changes on several fronts, and these are likely to continue to influence politics, economies and financial markets for some time to come.

We have identified four specific shifts, but they are all inter-related. The strongest theme, and the one that underpinned Donald Trump's victory and the win for the Leave campaign, has become widely described as "populism", although there is much semantic debate about the use of the word in this situation. What can be agreed upon is that a broad swathe of the developed economy populace feels that it has been disadvantaged by, for example, post-financial crisis monetary policy and globalisation. Gains from financials assets have accrued to the few who already owned them; wages have remained stagnant as jobs have either been shifted overseas or performed more cheaply by immigrant labour.

Even if this is not the whole story – industrial automation has been another powerful force – it is sufficiently strong to have created a voter backlash against current governments when an alternative has been offered. Thus we have a very literal regime change in the US with Donald Trump heading to the White House on a ticket promising a strong spending boost to the economy and to "Make America Great Again".

This introduces the second regime change, which is the passing of the reflationary baton from monetary policy to fiscal policy. Even before the rise of Mr Trump, central bankers were beginning to question the efficacy of monetary policy in revitalising demand. Furthermore, they were also concerned about the more pernicious effects of zero and negative interest rate policies, such as the formation of asset bubbles, poor allocation of capital, and the detrimental effects on the profitability of banks.

This came to a head when both the Bank of Japan and the European Central Bank cut interest rates to below zero and financial sector shares came under extreme pressure. Central bank heads were not shy in suggesting that governments should share some of the burden, and opportunistic politicians were quick to jump on the bandwagon. So far, of course, we are very much in the "promise" stage of this shift, and it will be interesting to see exactly which policies Mr Trump will be able to get through Congress. However, there is a strong sense that governments across the world are less in thrall to austerity than they have been, and investors have sent supportive messages with their reactions.

From an investment perspective, the monetary-to-fiscal shift has created strong demand for equities at the expense of government bonds, our third regime change. This is an entirely logical reaction. Growth is ultimately the life blood of the equity market; we can't rely on perpetually rising valuations for returns. Meanwhile, promised fiscal stimulus reduces the deflationary threat that pushed bond yields to all-time lows, whilst also increasing the potential supply of government bonds. The fourth and final regime change is taking place within the equity market, where sector leadership has rotated markedly since the summer.

The winners in the new world are financial and cyclical stocks. Financials benefit from higher interest rates and a steeper yield curve, cyclicals from the growth boost. Bond proxies, high yielders and steady growth stocks are the relative losers in this environment, even if their underlying businesses remain sound.

There are at least a couple of risks in this new environment. One is that many of these policy promises fail to come to fruition, thus disappointing on the growth front. Another is that they are too successful, igniting an inflationary fire that will need to be put out with punitively high interest rates – a return to the old "boom and bust" model that has been absent since the financial crisis. Then there are Mr Trump's more contentious protectionist views to be dealt with, which brings us back to the populism that might well influence the outcome of elections in 2017 in the Netherlands, France and Germany.

Other factors will continue to lurk in the background (and sometimes leap into the foreground). Investors will remain on tenterhooks in the build up to central bank meetings, especially those of the US Federal Reserve, which appears committed to raising interest rates. China will continue to dominate headlines from Asia. We continue to expect a slower sustainable growth path in that country, but one that doesn't trigger a "hard landing".

Conclusion and Outlook

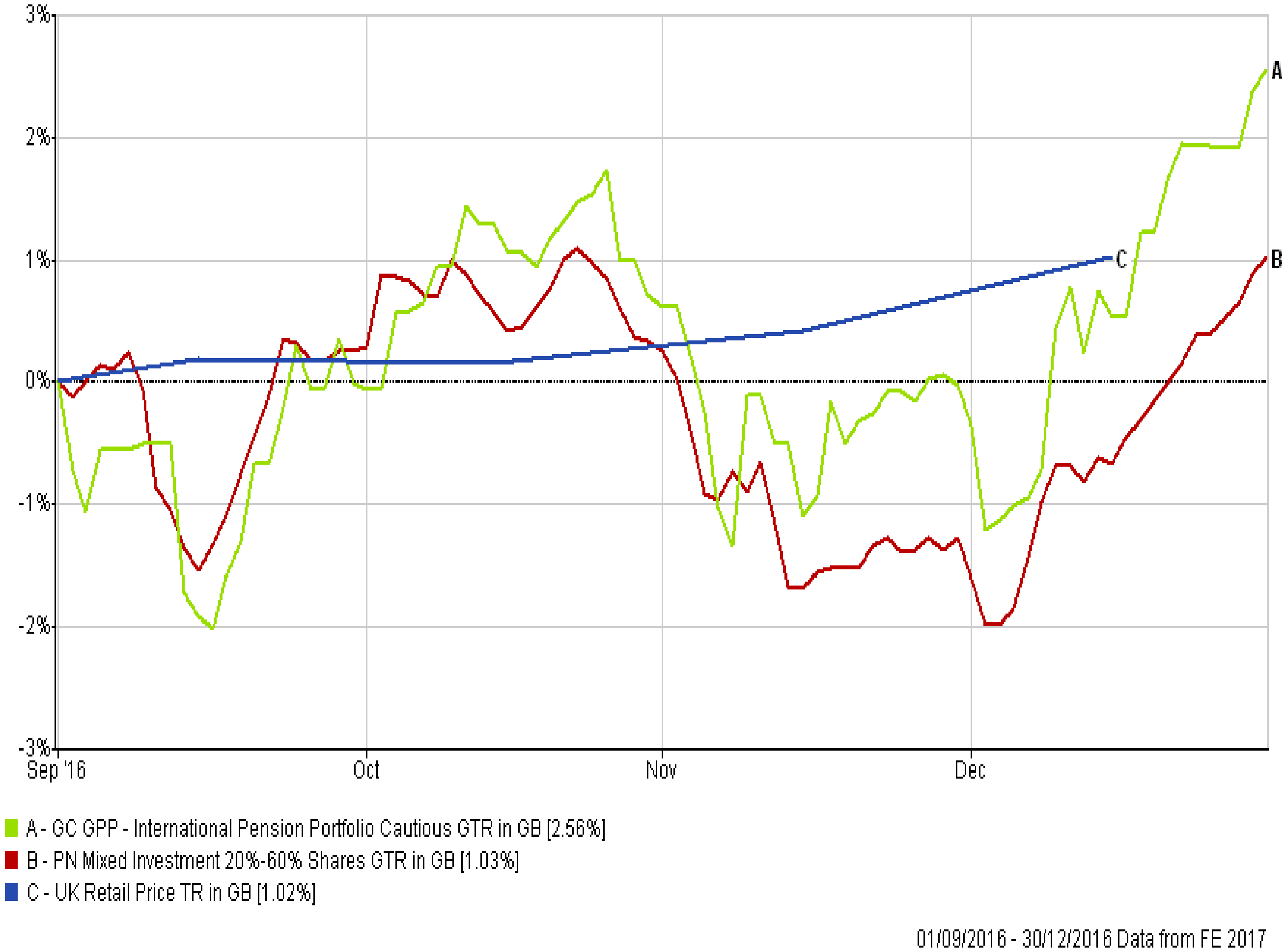
There is no doubt that 2016 turned out better than we expected in terms of investment returns, even if there were unforeseen results such as those of the EU referendum and the US election. For UK investors returns were flattered by the fall in the pound, and that is not something we would want to rely on (or even wish for) to enhance future returns. Far from undermining our confidence, the events of 2016 have strengthened our belief in a robust asset allocation process, as we balanced potential rewards against possible risks.

Heading into 2017 we see risks and opportunities to be evenly balanced, reflected in a neutral asset allocation stance. On the one hand there is the reflationary political influence which will continue to be supported by relatively loose monetary policy; on the other there is the political risk of populism and anti-globalisation which might manifest itself again in more unexpected election results which could prove more disruptive given their location in the heart of the euro zone.

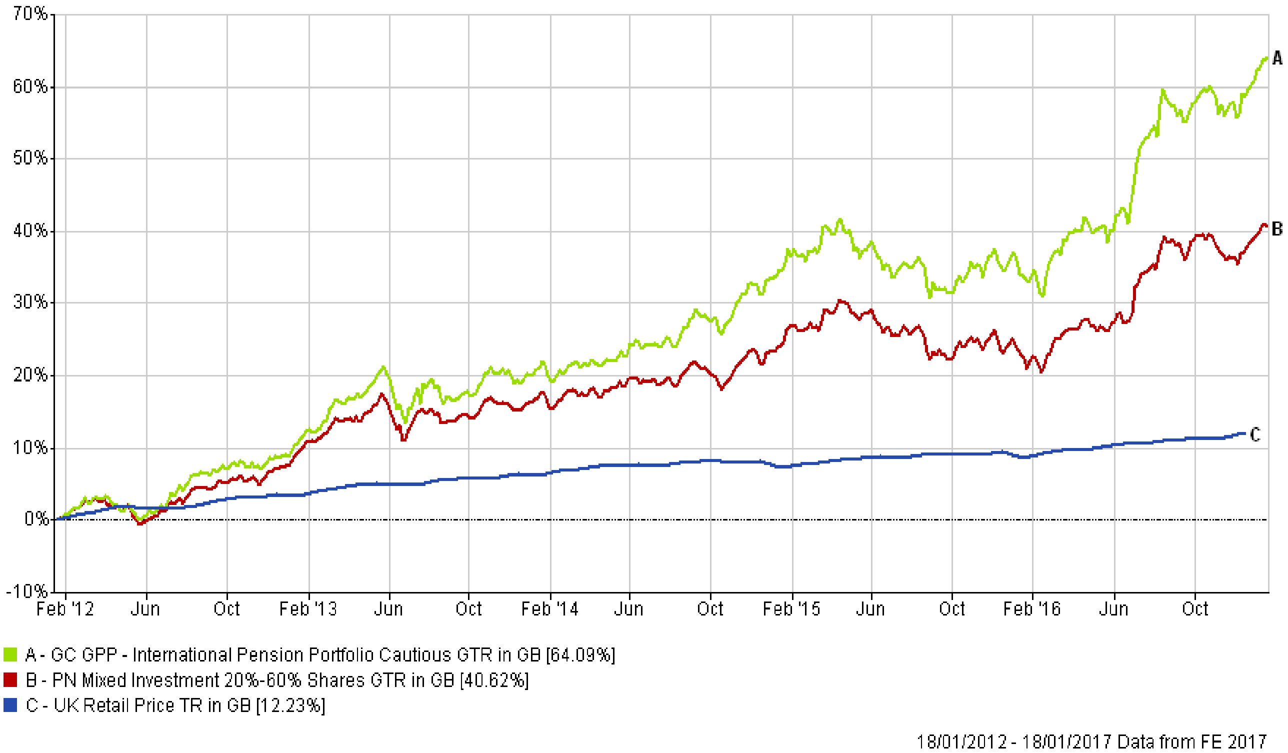
A rising US interest rate environment also creates uncertainty, although we continue to believe that the Federal Reserve will not over-tighten (in the knowledge that there are commentators who think that the Fed will be more aggressive in response to Trump's policies). China remains high on the doom-mongers' list of possible accidents, but the proximity of the Communist National Party Congress and unveiling of the latest five-year plan in the autumn suggests that the government will keep the plates spinning. However, we would be surprised if the threat from at least one of these concerns did not cause markets to wobble at some point, and we will be ready to take advantage of such weakness if we feel that worries are overdone.
*Investec

The International Offshore Retirement Benefits Plan (IntRBP)

The scheme uses the Cautious Lifestyle fund portfolio as the default option and the performance of the portfolio over the quarter, against the benchmark is as follows:



The performance of the portfolio since February 2012, against the benchmark is as follows:



Annualised Performance %

	1m	3m	6m	1yr	Ann. 3yr	Ann. 5yr	Ann. 10yr
Portfolio GC GPP - International Pension Portfolio Cautious GTR in GB	**3.49**	**2.94**	**7.43**	**22.83**	**10.46**	**10.41**	
Sector PN Mixed Investment 20%-60% Shares GTR in GB	**2.19**	**1.27**	**4.76**	**15.37**	**6.11**	**7.06**	**4.59**
Index UK Retail Price TR in GB		**0.87**	**1.40**	**3.21**	**1.88**	**2.33**	**2.85**

The fund has returned a growth rate of around 10.41% per annum over the last 5 years against a sector average of 7.06% pa.

The fund mix of the portfolio is as follows:

Fund	% allocation
Blackrock Developed World Index (IPP)	40%
Blackrock UK Credit Bond Index (IPP)	50%
Sterling Money Market	10%
Total	**100.00%**

Summary

The information, graphs and tables in this report confirm that the Default funds for both schemes are performing very well and are providing annualised returns well in excess of the sector average, with the funds selected being generally in line with the investment risk parameters which were agreed with Global Connections prior to the implementation of the schemes.

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