

PENSION FUND COMMITTEE – 14 JUNE 2013

OVERVIEW AND OUTLOOK FOR INVESTMENT MARKETS

Report by the Independent Financial Adviser

The Economy

1. Growth in the 4th quarter of 2012 was negative for UK and the Eurozone, and only marginally positive in the US and Japan. China's growth dipped below 8% for 2012, and was provisionally reported as +7.7% (annualised) for the first quarter of 2013. Forecasts for 2013 and 2014 (see table below) show little improvement in developed economies' growth rates from last year.

(In the Table below, the consensus estimates at the time of the March Committee are shown in brackets).

Consensus real growth (%)						Consumer prices latest (%)
	2010	2011	2012	2013E	2014E	
UK	+1.6	+0.9	-0.1	(+0.9) +0.7	+1.5	+2.8 (CPI)
USA	+2.9	+1.7	+2.2	(+1.9) +2.1	+2.7	+1.5
Eurozone	+1.7	+1.5	-0.5	(-0.1) -0.5	+0.9	+1.2
Japan	+4.2	-0.7	+1.9	(+1.0) +1.3	+1.3	-0.9
China	+10.3	+9.2	+7.8	(+8.5) +8.4	+7.8	+2.1

[Source: The Economist, 04.05.13]

2. In the **UK** Budget on March 20th, George Osborne confirmed that the debt/GDP ratio was not expected to peak until 2017/18, while the slower GDP growth forecast would cause the annual fiscal deficit to plateau – instead of falling – between 2012 and 2014. In February, the Bank of England's Inflation Report accepted that CPI inflation would remain above its 2% target for the remainder of 2013 and would not be reined in by tighter monetary policy. The Bank's programme of Quantitative Easing (QE) has not been resumed,

despite the support of a minority of members of the Monetary Policy Committee (including the Governor).

3. **US** employment data for February looked positive, with higher non-farm payroll numbers, and unemployment falling to 7.7%, but the numbers for March were disappointing. With no agreement reached on the US fiscal package, automatic spending cuts of \$85bn took effect on March 1st. The Fed's QE programme of \$85bn/month remains in force.
4. In **Japan**, the new Prime Minister, Shinzo Abe, has pressed ahead with his radical new economic policy. The three strands are monetary stimulus to tackle deflation; fiscal stimulus to boost private demand; and structural reforms to boost growth. The newly-appointed Governor of the Bank of Japan, Mr Kuroda, has adopted the new inflation target of 2%, and in early April the Bank announced a monetary policy which aims to double the amount of money in circulation in two years, mainly by buying more long-term government bonds. This rate of expansion is twice as fast as that being pursued in the US by the Federal Reserve. The immediate reaction in markets was further weakness of the Yen, accompanied by gains in equities and bonds.
5. The Italian elections in late-February produced no clear winner, but the predominant support for anti-austerity candidates created nervousness in markets and Italian government bond yields rose. A greater shock within the **Eurozone** was the announcement of the terms of the bailout of Cyprus' banks in mid-March. Initially this included a levy on all deposits, even those below the insurance ceiling of €100,000. Amid a general outcry, the terms were soon amended so as to exempt small depositors but to impose a larger levy on bigger accounts in order to meet the €5.8bn required by the European authorities to accompany their own €10bn injection. The two main banks in Cyprus were also reorganised as part of the bailout. Fears that, in future, individuals' savings could be at risk have introduced a new element of uncertainty into markets. On May 2, the ECB announced a 25bps cut in its main interest rate, to 0.5%, in an attempt to stimulate economic recovery.

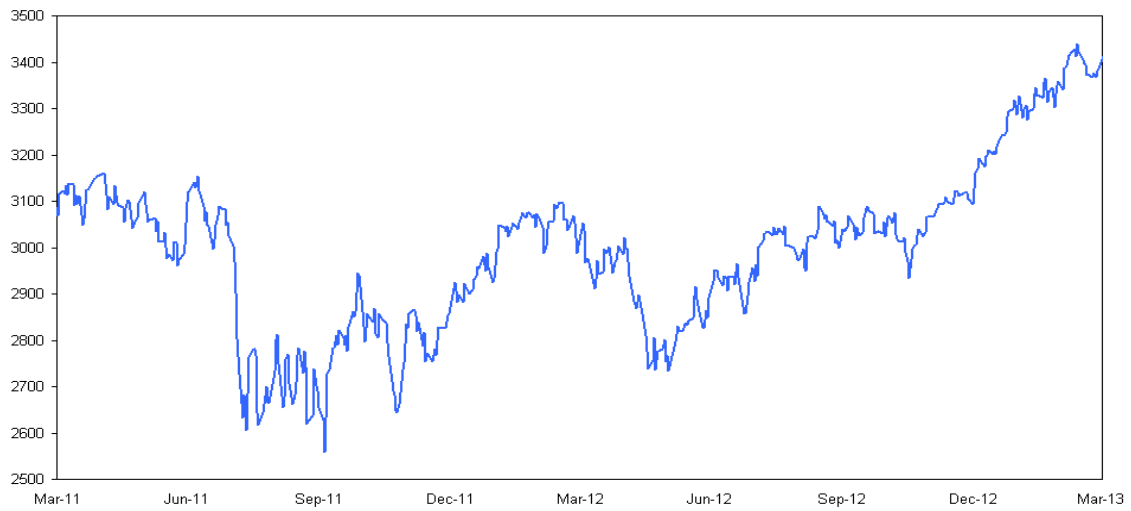
Markets

6. **Equities** enjoyed an extremely strong quarter, boosted by private sector flows from the fixed income and cash markets, and continued buoyancy as a result of the large QE programmes by Central Banks. Emerging Market equities, however, continue to lag behind other regions, as shown in the following table. US equities surpassed their previous high of 2007. During April, major regional indices were flat in sterling terms, except for Japan which gained 6%.

Capital return (in £, %) to 31.03.13			
Weight %	Region	3 months	12 months
100.0	FTSE All-World Index	+13.3	+13.8
50.3	FTSE All-World North America	+17.1	+16.6
8.4	FTSE All-World Japan	+18.4	+11.8
13.1	FTSE All-World Asia Pacific ex Japan	+8.2	+13.1
16.3	FTSE All-World Europe (ex-UK)	+ 9.1	+12.5
8.0	FTSE All-World UK	+ 8.8	+11.5
10.5	FTSE All-World Emerging Markets	+ 5.1	+ 4.0

[Source: FTSE All-World Review, March 2013]

UK FTSE All-Share



7. By global industrial sector, Basic Materials was far and away the weakest performer during the quarter, mainly on fears of a slowdown in the Chinese economy and the likely effect on demand for raw materials.

Capital return (in £, %) to 31.03.13		
Industry Group	3 months	12 months
Health Care	+21.3	+28.9
Consumer Services	+17.8	+24.6
Financials	+13.5	+20.0
Consumer Goods	+16.0	+17.7
Industrials	+14.0	+14.4
FTSE All-World	+13.3	+13.8
Telecommunications	+11.3	+10.6
Utilities	+12.4	+ 5.9
Oil & Gas	+10.3	+ 3.9
Technology	+10.9	+ 1.9
Basic Materials	+ 0.1	- 4.1

[Source: FTSE All-World Review, March 2013]

8. Within UK equities, the mid- and small-cap sections of the market once again outpaced the FTSE 100, and have now risen some 10 percentage points more than the large-cap index during the past year.

(Capital only %, to 31.3.13)	3 months	12 months
FTSE 100	+ 8.7	+11.7
FTSE 250	+12.5	+21.8
FTSE Small Cap	+11.3	+21.8
FTSE All-Share	+ 9.3	+13.2

9. At the start of the year, yields in the 'safe-haven' **Government Bond** markets rose, as investors moved into equities or other bond markets, but the inconclusive Italian election result and the eruption of the Cyprus crisis caused a flight back to quality, and yields ended the quarter little changed. Japanese bonds strengthened in anticipation of the BoJ's purchasing programme, disregarding the planned increase in inflation which is at the heart of the government's new economic policy. Italian 10-year government bonds rallied at the end of April, on the formation of a coalition government, to trade at below 4% - their lowest yield since October 2010.

10-year government bond yields (%)					
	Dec 09	Dec 10	Dec 2011	Dec 2012	Mar 2013
US	3.84	3.34	1.88	1.76	1.85
UK	4.01	3.39	1.98	1.85	1.78
Germany	3.40	2.92	1.83	1.32	1.29
Japan	1.29	1.12	0.98	0.79	0.57

[Source: Financial Times]

The 10-year Treasury yield in the US has now been below 2% almost continuously since March 2012.

Generic 10yr US Treasury Yield



Property

10. The commercial UK market remains sluggish. The total return on All Property was just 2.5% for the year to March [IPD Monthly Index] which implies a fall in capital values during the year. Office and Industrial each returned some 4%, while Retail returned only 0.7% in the year.

Currency

11. The main features of the currency markets were the continuing decline of the yen, on consideration of Japan's new monetary policy, and the weakness of the pound.

	31.12.12	31.03.13	£ move
\$ per £	1.625	1.518	- 6.6%
€ per £	1.233	1.182	- 4.1%
¥ per £	140.5	142.8	+ 1.6%

The pound dipped below \$1.50 briefly during March, but recovered to \$1.55 by the end of April.



Commodities

12. The oil price was flat during the quarter, but fell in mid-April when the disappointing China growth figures were announced. Gold, meanwhile, was slightly lower over the quarter, but then – together with other precious metals – fell very sharply in the second week of April. This was attributed variously to a reaction to economic data, Central Bank sales of gold or simply speculative activity.



Outlook

13. The surge in equity prices in recent months has removed much of the anomaly between equity and bond valuations which prevailed in autumn 2012. The QE programmes being operated by Central Banks – including, now, the Bank of Japan – are clearly driving down the yields of government bonds and freeing up money for investment elsewhere. However, the continuing sluggish economic growth in developed markets will bear down on the outlook for corporate profit growth for many companies. In my view, equity markets are likely to pause for breath for some months after their recent exertions.

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May 3rd, 2013