PENSION FUND COMMITTEE – 16 March 2012

OVERVIEW AND OUTLOOK FOR INVESTMENT MARKETS

Report by the Independent Financial Adviser

The Economy

1. The forecasts for growth in UK and Continental Europe during 2012 show these regions teetering on the edge of recession, despite all the monetary stimuli implemented since the previous recession. Global GDP growth for 2011 has been estimated at +3.8% (+5.2% in 2010), with the IMF predicting a further slowdown to 3.3% in 2012. Clearly most of the growth is coming from China and the developing markets. Good recent data from the US on housing starts and new job creation offer a slightly more optimistic outlook there, but we need to see several more months of improvement before the trend can be confirmed.

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

Consensus real growth (%)						Consumer prices latest (%)
	2008	2009	2010	2011E	2012E	
UK	+0.7	- 4.7	+1.6	(+0.9) +0.9	(+1.1) +0.2	+ 4.2 (CPI)
USA	+1.2	- 2.5	+2.9	(+1.7) +1.7	(+1.8) +2.0	+ 3.1
Eurozone	+0.8	- 3.9	+1.7	(+1.6) +1.5	(+0.4)+0.7	+ 2.7
Japan	- 0.2	- 5.3	+4.2	(-0.5) -0.7	(+2.2) +1.6	- 0.4
China	+ 9.0	+ 8.7	+10.3	(+9.0) +9.2	(+8.6) +8.6	+ 5.6

[Source: The Economist 04.02.12]

2. The Greek sovereign debt crisis continued to exert a strong influence on market sentiment. Concerns over the possibility of a default on Greek bonds were compounded by fears that Italy – a far bigger borrower – could be faced with similar problems in servicing its debt, and the effect this might have on the solvency of commercial banks and the Euro itself. The replacement of the Greek and Italian Prime Ministers in November by technocrats Lucas Papademos and Mario Monti was expected to reduce the political dimensions of the situation and pave the way for the introduction of austerity programmes in both countries. By early February, Greece was still being pressed by the Eurozone to implement steeper cuts than it had proposed – and guarantee no revocation by a new government – before the €130bn bailout could be granted.

3. The European Central Bank made a further cut in its interest rate, from 1.25% to 1%, in December, and then announced a ‘long-term refinancing operation’ (LTRO) under which it would offer an unlimited amount of 3-year loans to Eurozone banks at just 1% with generous terms on collateral. Almost €500bn of this facility was immediately taken up by the banks and, by removing the threat of a liquidity crisis, caused a positive turnround in sentiment towards the banking sector. A further round of LTRO is expected at the end of February. By early February, yields on Spanish and Italian government bonds had fallen significantly, indicating a (possibly temporary) lessening of fears of default. Portuguese yields, however, remained at very elevated levels.

4. In the UK Autumn Statement on November 29th, the Chancellor revised the 2011 GDP growth forecast down to 0.9% (compared with the 2.3% he had forecast in June 2010). With slow growth also predicted for 2012, the target date for eliminating the structural fiscal deficit will move from 2014/5 to 2016/7 or later. Nevertheless, the UK budget deficit will fall to 8.4% of GDP in the 2011/2 year, which compares favourably with the 11.2% deficit recorded in 2009/10. The annual rate of inflation is declining and will receive a further fillip when the January 2011 VAT increase drops out of the annual comparison. CPI inflation is expected to be within its 1 – 3% target range by autumn 2012.

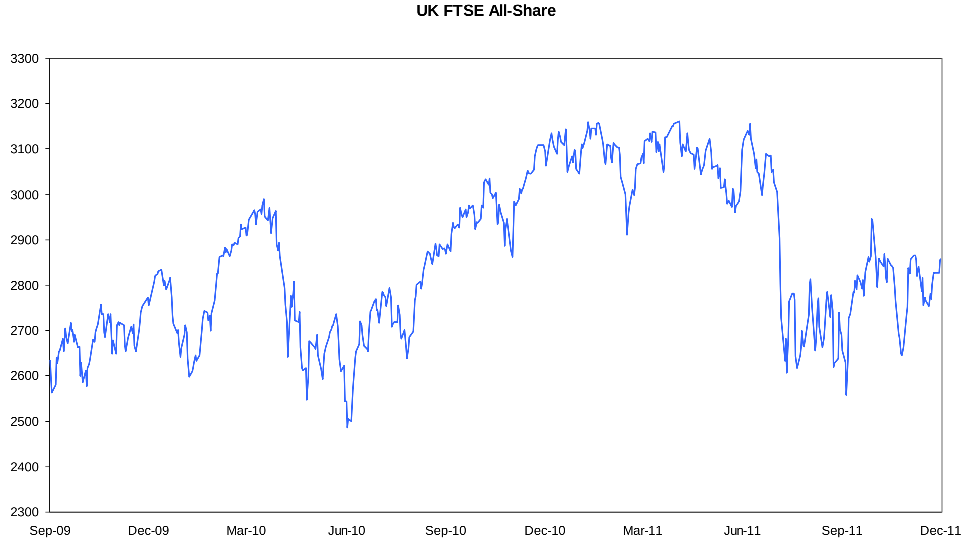
Markets

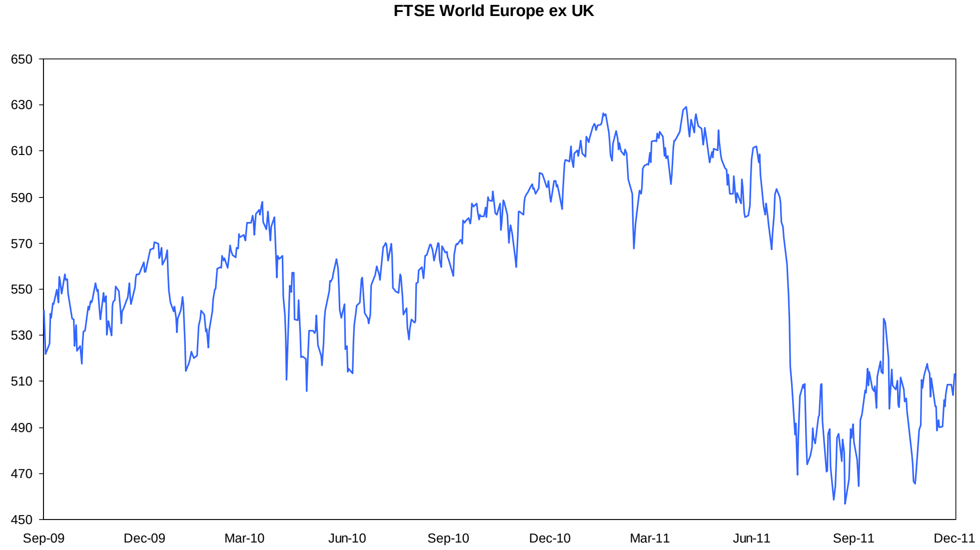
5. In October, **Equity** markets recovered strongly from their falls in the third quarter, and – despite a bout of weakness in mid-November – maintained their end-October levels until the end of the year. In December, US markets took heart from good numbers for housing starts and Q3 GDP growth, followed by a temporary extension of the payroll tax cuts. This late rally enabled the US to record the smallest fall of any of the major equity markets for 2011. US and UK equities significantly out-performed Continental Europe, Japan, Asia and Emerging Markets over the year.

Capital return (in £, %) to 31.12.11		
	3 months	**12 months**
FTSE All-World Index	**+6.8**	**-9.1**
FTSE All-World North America	+10.6	-0.9
FTSE All-World Japan	- 3.8	-14.9
FTSE All-World Asia Pacific	+1.0	-16.5
FTSE All-World Europe (ex-UK)	+3.0	-18.0
FTSE All-World UK	+8.5	-5.7
FTSE All-World Emerging Markets	+3.7	-20.7

[Source: FTSE All-World Review, December 2011]

In the fourth quarter, Oil & Gas was the strongest industrial sector (+14%), followed by Consumer Services and Industrials (each +9%); by contrast Utilities and Telecoms each gained just 2%, and Financials 4%.

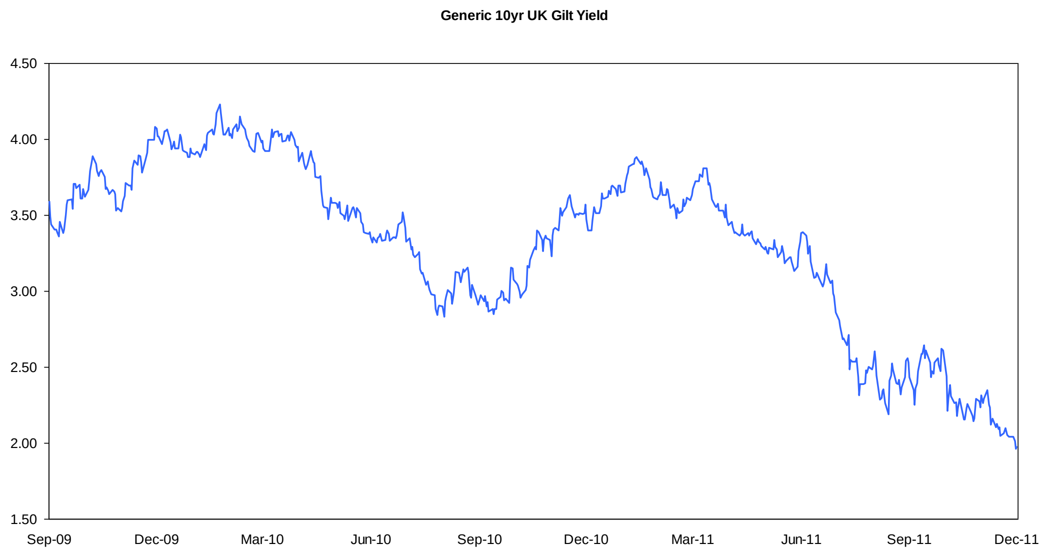


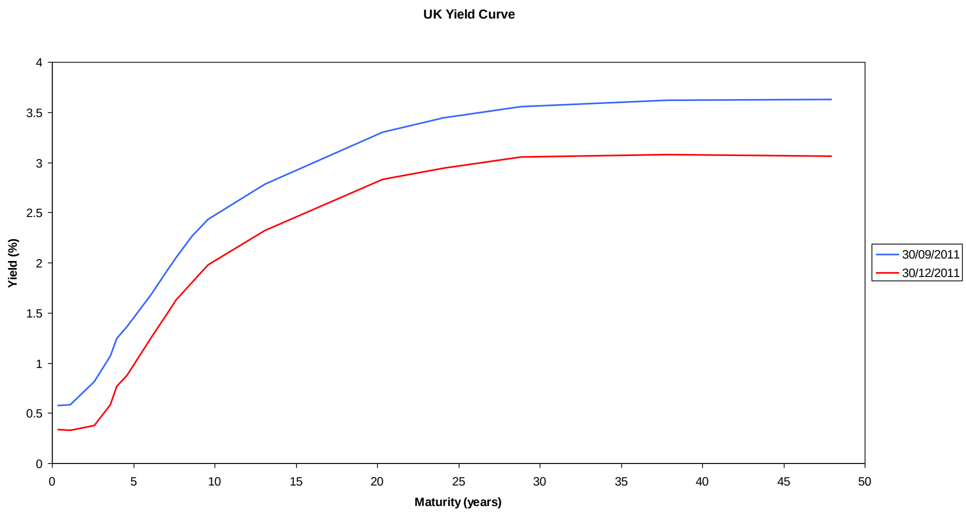


6. The strength of **Government Bonds** in the 'safe-haven' countries continued, despite a brief setback in German Bunds after the disappointing result of a bond auction in late-November. The Quantitative Easing programme operated by the Bank of England (which is being extended by £50bn between February and May) and the Federal Reserve's 'Operation Twist', contributed to the demand for government bonds in these countries, pushing medium-term yields to levels which are likely to guarantee a *negative* real return on bonds held until maturity. Meanwhile the margin between UK Corporate Bonds and Gilts widened during the quarter.

10-year government bond yields (%)					
	Dec 09	**Sept 10**	**Dec 10**	**Sept 2011**	**Dec 2011**
US	3.84	2.52	3.34	1.93	1.88
UK	4.01	2.95	3.39	2.42	1.98
Germany	3.40	2.29	2.92	1.89	1.83
Japan	1.29	0.94	1.12	1.03	0.98

[Source: Financial Times]





7. Equity markets started the New Year on a strong note, gaining some 4% on average during January, as Financials rebounded in response to the LTRO initiative, and in early February the UK and US equity markets reached levels last seen in July 2011.

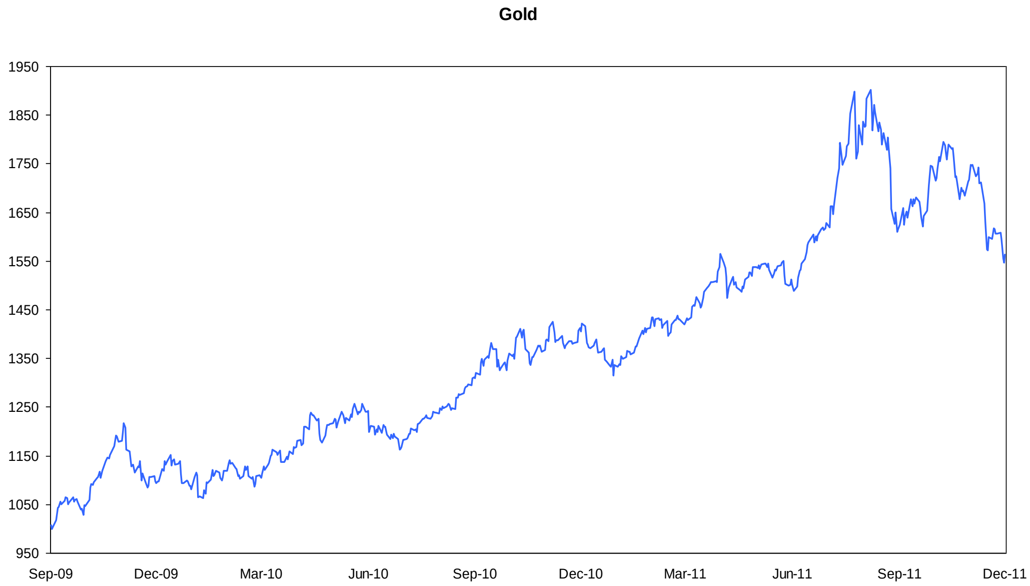
8. **Property** funds continued to give returns in line with their income yield, implying that capital values have remained flat. For the year 2011, the average total returns were:

Balanced Property Funds	(n=26)	+6.8%
Specialist Property Funds	(n=30)	+7.4%

[Source: AREF/IPD UK Pooled Property Fund Index]

9. Among **Commodities**, Oil continued its sharp rise of October, ending the year just below $100/bbl (WTI measure). Gold, meanwhile, declined by 10% in December as investors sold down the largest exchange traded fund specialising in the commodity, but it then recouped all of this fall during January.


Oil
120
110
100
90
80
70
60
Sep-09
Dec-09
Mar-10
Jun-10
Sep-10
Dec-10
Mar-11
Jun-11
Sep-11
Dec-11


Gold
1950
1850
1750
1650
1550
1450
1350
1250
1150
1050
950
Sep-09
Dec-09
Mar-10
Jun-10
Sep-10
Dec-10
Mar-11
Jun-11
Sep-11
Dec-11

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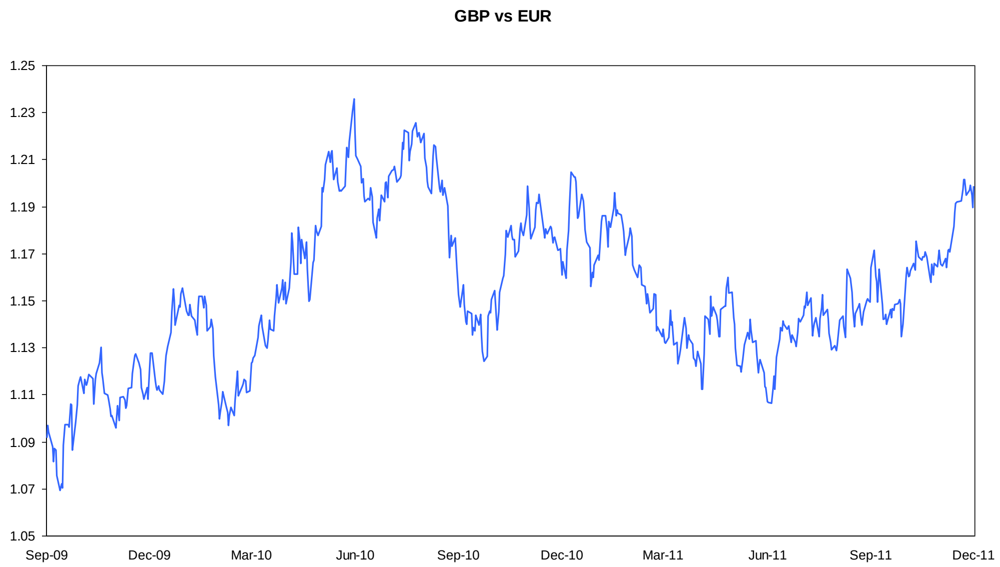
10. In the major **Currencies** there was virtually no net change during the quarter in the Sterling, Dollar and Yen cross-rates, but the Euro weakened by some 3% against each of the other three currencies, extending its weakness of the previous quarter.



Outlook

11. While equity markets have rebounded strongly since October, and recouped their sharp falls of July - September, there still remain several areas of uncertainty which could curtail the rally. The second bailout of Greece has yet to be confirmed, and the domestic reaction to the severe budgetary cuts being demanded could well turn ugly. The French Presidential Election in April looks likely to see the replacement of M Sarkozy by the Socialist candidate, with the prospect of a less business-friendly administration there. While the lack of any significant GDP growth in Europe this year is widely accepted, any slowdown in China or the Pacific region would have a severe impact on many companies who derive much of their growth from trading with that region.

12. ‘Safe haven’ government bond could continue trading at current low yields for several months yet, as Western Central Banks maintain interest rates at minimum levels and supply liquidity to markets by Quantitative Easing or by means of cheap finance. Returns currently available on such bonds look unattractive

13. Against this background, I remain cautious on the near-term prospects for equities, and would not recommend further purchases until the outlook for the Eurozone becomes clearer.

Peter Davies

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February 10th, 2012