PENSION FUND COMMITTEE – 1 JUNE 2012

OVERVIEW AND OUTLOOK FOR INVESTMENT MARKETS

Report by the Independent Financial Adviser

The Economy

1. Forecasts of growth in 2012 point to a continuing slow recovery from the financial crisis, with positive signals being followed by disappointing data. In the **US**, for example, a sequence of good monthly job creation numbers was brought to an end by a low figure of 115,000 for April. In the **UK**, hopes of a strong start to the year were dampened by a surprisingly poor initial estimate of a 0.2% fall in GDP for the first quarter. **Eurozone** forecasts are being revised up slightly, but it is noticeable that only France and Germany are seeing improving growth, while Italy, Holland and the periphery are all seeing downgrades in growth forecasts. The official forecast for **China**’s growth was reduced to 7.5% early in March, but it should also be noted that China has managed to wage a successful campaign against domestic inflation, and has ample scope to stimulate the economy if necessary. Growth in **Japan** is on an improving trend, underpinned by capital spending to repair the devastation caused by last year’s earthquake and tsunami.

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

Consensus real growth (%)						**Consumer prices latest (%)**
	2009	**2010**	**2011**	**2012E**	**2013E**	
UK	- 4.7	+1.6	+0.9	(+0.2) +0.4	+1.7	+ 3.5 (CPI)
USA	- 2.5	+2.9	+1.7	(+2.0) +2.2	+2.3	+2.7
Eurozone	- 3.9	+1.7	+1.5	(-0.7)* -0.5	+0.7	+2.7
Japan	- 5.3	+4.2	-0.7	(+1.6) +1.8	+1.8	+0.5
China	+ 8.7	+10.3	+9.2	(+8.6) +8.3		+3.6

(* Eurozone prior estimate for 2012 growth corrected from previous report)

[Source: The Economist 04.05.12]

2. Immediate worries over the Greek sovereign debt crisis were eased by the agreement in February on the terms for a bailout under which the EU and IMF would lend Greece €130bn in return for an austerity package, while private sector holders of Greek debt agreed to a restructuring which amounted to a significant writedown in the value of their holdings.

3. The European Central Bank instigated a second ‘long-term refinancing operation’ (LTRO) at the end of February, for a similar amount (€530bn) and on the same terms as the initial round in December. While this has given a short-term boost to confidence in the banking sector, it is clear that much of the finance has been deployed by banks in buying their own sovereign bonds, allowing foreign investors to sell but storing up potential trouble if these bonds themselves fall in value.

4. Markets will be watching closely how the election of Francois Hollande as President of France will affect France’s co-operation with Germany in the handling of the debt crisis, while the outcome of the Greek election raises the possibility that a new government will renounce the bailout terms recently negotiated. The fall of the Dutch government in April, because the coalition partners disagreed on the austerity measures, was another reminder that there can be political obstacles impeding the implementation of fiscal cuts. Several influential commentators believe that the current emphasis on austerity in Europe will only exacerbate the crisis, and that measures to stimulate growth need to be introduced if economic recovery is to be achieved.

5. The UK Budget on March 21st included official forecasts of GDP growth of 0.8% in 2012 and 2.0% next year, while CPI inflation was forecast at 2.8% this year, falling to 1.9% in 2013. There was little change in the estimates of fiscal deficit from those in the Autumn Statement, namely 8.3% in 2011/12 falling to 7.6% in 2012/13. The Budget attracted strong criticism, however, for the reduction in the top rate of income tax, the freezing of pensioners’ tax-free allowances and the plan to limit the tax reliefs offered on large charitable donations.

Markets

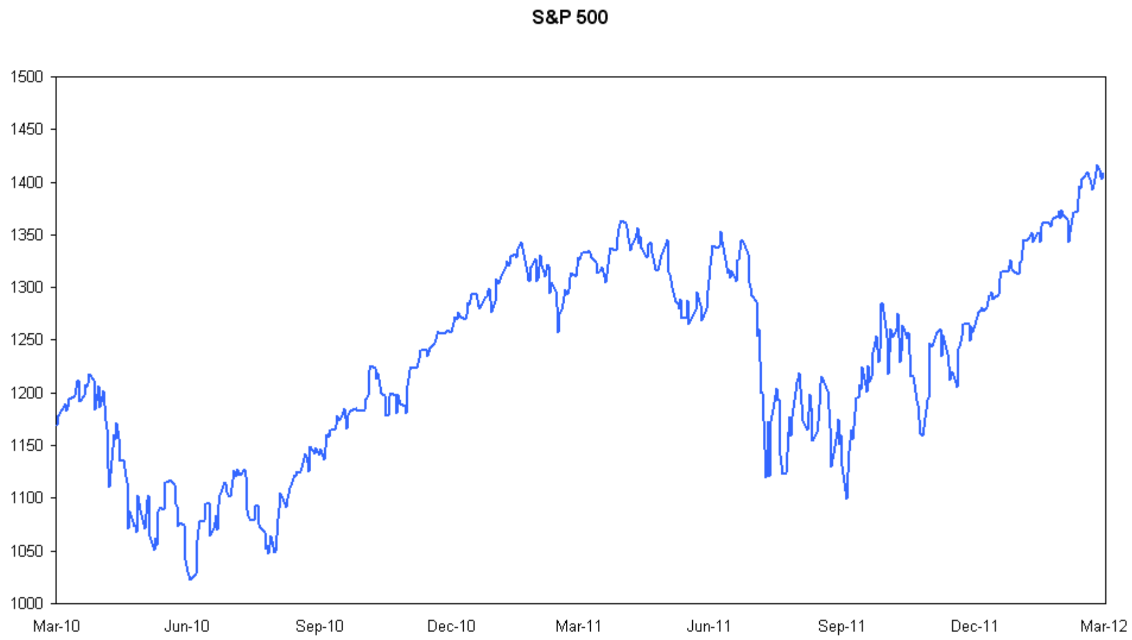
6. **Equity** markets continued the rally which had started in October, and recorded significant gains during the quarter. In the US, the S&P 500 Index has risen more than 25% in the past six months. Strong rebounds were seen in Continental Europe and Emerging Markets, which had been the weakest areas during 2011. Sentiment in Europe was boosted by the agreement on the terms of the Greek debt restructuring and by the second round of LTRO.

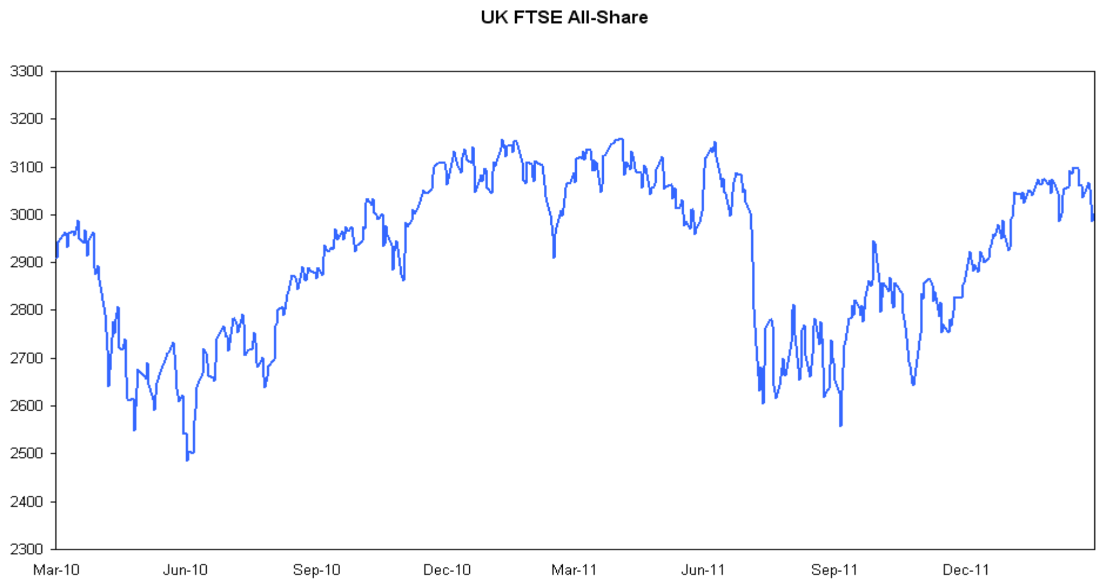
In the UK market, there was a sharp divergence between the performance of the largest companies (FTSE 100 +3.5%) and the remainder (FTSE 250 and FTSE Small Cap indices both +14.2%).

Capital return (in £, %) to 31.3.12		
	3 months	**12 months**
FTSE All-World Index	**+8.3**	**-2.9**
FTSE All-World North America	+8.7	+4.6
FTSE All-World Japan	+6.8	-1.4
FTSE All-World Asia Pacific	+8.1	-6.4
FTSE All-World Europe (ex-UK)	+9.4	-15.0
FTSE All-World UK	+3.8	-2.3
FTSE All-World Emerging Markets	+10.2	-11.3

[Source: FTSE All-World Review, March 2012]

In global sector terms, Technology (+17.3%), Financials (+13.3%) and Industrials (+10.3%) were strong, while Telecommunications (-0.7%), Utilities (-0.3%) and Oil & Gas (+2.2%) lagged.



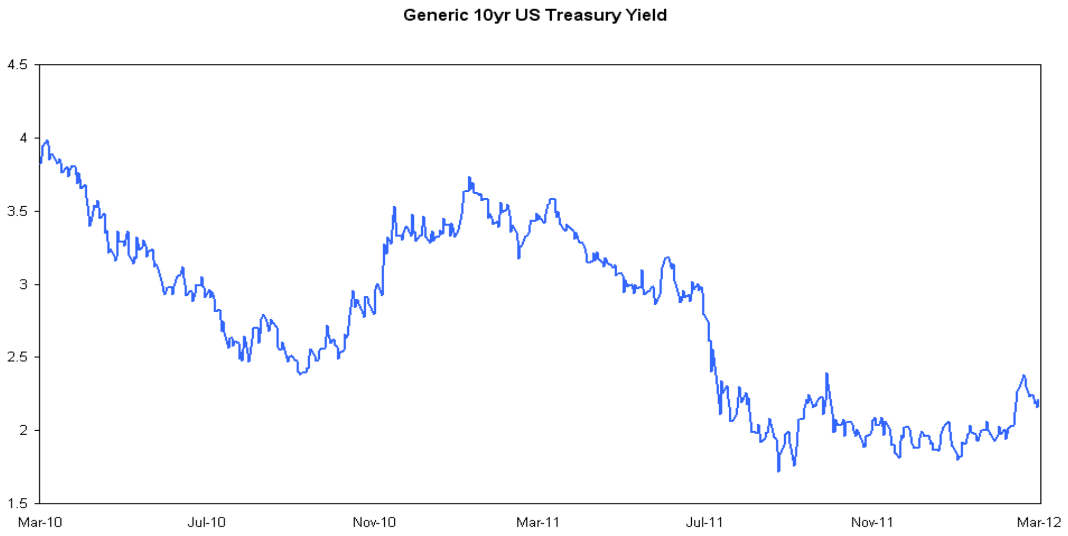


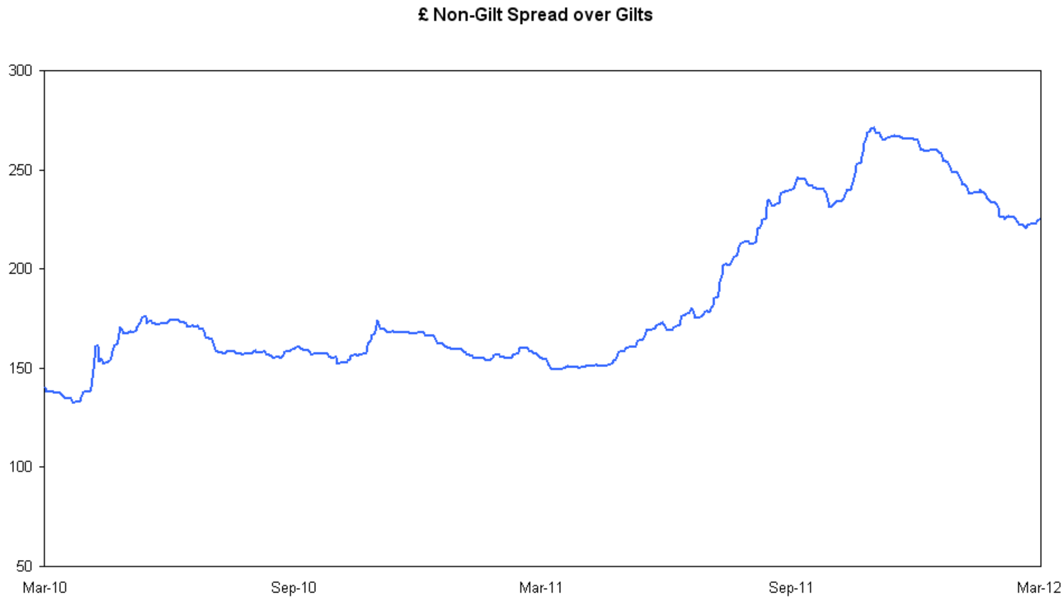
7. Within the ‘safe-haven’ **Government Bond** markets, US and UK yields increased during the quarter, though by the end of April they had regained

their end-2011 levels. German bonds, meanwhile, continued to be in demand, and their 10-year yield had fallen as low as 1.67% at the end of April. The spreads on French and Dutch bonds widened relative to Bunds on political uncertainty, while yield spreads on peripheral Eurozone bonds also widened after initially narrowing on the Greek bailout agreement. UK corporate bonds strengthened as the yield gap with gilts narrowed.

10-year government bond yields (%)					
	Dec 09	**Dec 10**	**Sept 2011**	**Dec 2011**	**Mar 2012**
US	3.84	3.34	1.93	1.88	2.21
UK	4.01	3.39	2.42	1.98	2.21
Germany	3.40	2.92	1.89	1.83	1.82
Japan	1.29	1.12	1.03	0.98	0.99

[Source: Financial Times]



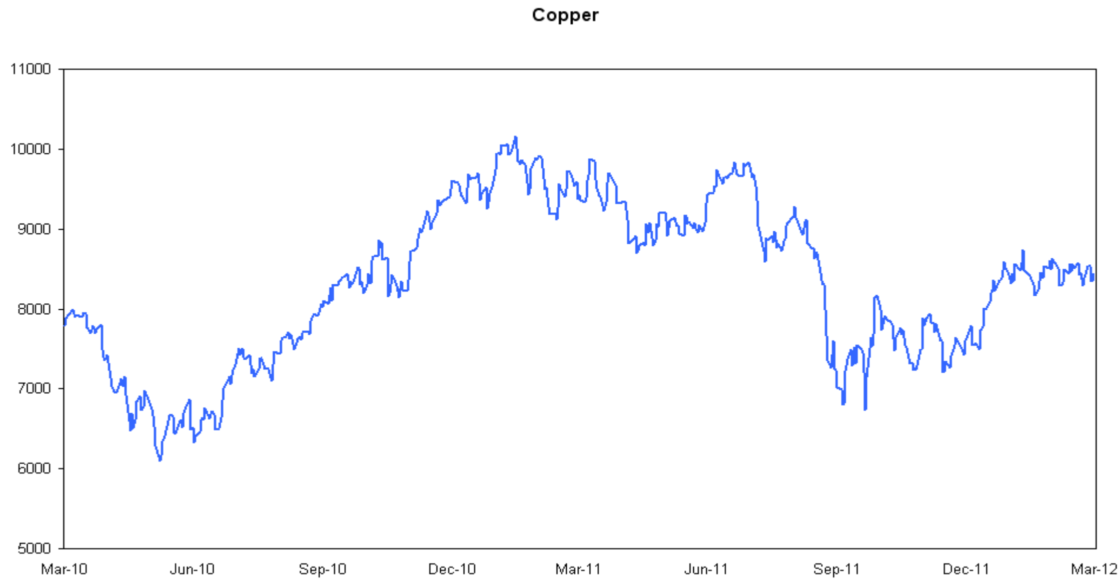


8. Capital values of **UK Commercial Property** have remained flat during the past year, with the rental yield accounting for virtually all of the returns achieved, as the following table of total returns shows.

	3 months return	**12 months return**	**Current yield**
UK Commercial Property	+0.9%	+6.6%	6.2%
- **Office**	+1.1%	+8.2%	6.0%
- **Industrial**	+1.2%	+6.7%	7.0%
- **Retail**	+0.5%	+5.2%	6.0%

[Source: IPD UK Monthly Property Index]

9. In **Commodities**, the Oil price was stable at around $100/bbl on the WTI measure, although Brent crude rose by 10% to $122/bbl. Copper appreciated sharply in January and February, but fell back in March on worries of a slowdown in Chinese demand; Gold followed a similar path.



10. The main feature in **Currency** markets was the weakness of the Yen, after the Bank of Japan's statement in mid-February that it would add Y10trn ($120bn) to its asset-buying programme while adopting a 1% 'goal' for inflation. This policy shift caused an immediate 5% fall in the yen against the dollar, with a further 2% depreciation to Y82/$ by the end of March. Elsewhere, the pound rose by 3% against the dollar during the quarter, and was unchanged relative to the euro at €1.20.

Outlook

11. Hopes that the Greek bailout in February had at least bought time for Greece to reform its economy, have been dashed by the voting in the Greek elections where pro-bailout coalition parties lost their majority. If the bailout package is indeed revoked, the earlier worries of a break-up of the Eurozone will return in full force. This renewed uncertainty is likely to be negative for Continental European equities, and for peripheral sovereign bonds, while reinforcing the demand for 'safe-haven' government bonds. If, however, the election of M Hollande as French President causes a shift in emphasis from austerity to growth in European policy, markets may react positively.

12. Government Bond yields in US, UK and Germany are still at historically low levels, and are likely to rise as economic growth returns. Globally, equities should be supported by the gradual recovery in the US and by still-buoyant growth in China and the Emerging Markets. Despite the inevitable short-term volatility which equities display, I still feel that the Pension Fund's high exposure to equities is appropriate on a medium-term view.

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