PENSION FUND COMMITTEE – 7 SEPTEMBER 2012

OVERVIEW AND OUTLOOK FOR INVESTMENT MARKETS

Report by the Independent Financial Adviser

The Economy

1. The prospects for economic growth this year have dimmed further in recent months, most notably in the **UK**, where the economy has contracted in each of the last three quarters. The growth forecasts included in the March Budget now look decidedly optimistic. In the **US**, the unemployment rate in July edged up to 8.3%, despite improving numbers for non-farm payrolls.

   The severity of the recession is evident from data showing that, in Q1 2012, US and Germany reported GDP slightly above their peaks of 2007/08, while output in the UK was still 4% below its peak, and Japan and the Eurozone as a whole were more than 2% below peak levels. [Source: FT July 11, 2012]

   The one positive development in the quarter has been the easing of inflation rates worldwide, partly attributable to the falls in raw material prices.

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

Consensus real growth (%)						Consumer prices latest (%)
	2009	2010	2011	2012E	2013E	
UK	- 4.7	+1.6	+0.9	(+0.4) -0.2	+1.3	+ 2.4 (CPI)
USA	- 2.5	+2.9	+1.7	(+2.2) +2.1	+2.0	+1.7
Eurozone	- 3.9	+1.7	+1.5	(-0.5) -0.5	+0.3	+2.4
Japan	- 5.3	+4.2	-0.7	(+1.8) +2.3	+1.4	-0.1
China	+ 8.7	+10.3	+9.2	(+8.3) +8.2		+2.2

[Source: The Economist 04.08.12]

2. The Bank of England announced in June that it would supply liquidity to the banking system at low rates, and started the 'Funding for Lending' programme, under which banks would receive up to £80bn in cheap funding on the

condition that the money was lent on to businesses and individuals. In July the Bank also announced a further £50bn of Quantitative Easing, to be spread over the next four months. Among other stimulus measures, the Federal Reserve extended its 'Operation Twist' in the Treasury market, the ECB cut interest rates by 0.25% in July, and China eased interest rates twice – the first time it had cut rates since 2008.

3. The main concerns for markets continue to be the problems within the Eurozone. The re-run **Greek** election in June produced a narrow win for the New Democracy Party, which averted the spectre of the government rejecting the bailout terms; the coalition, however, is still wrestling with the problem of how to find the massive spending cuts demanded by the EU and IMF as part of the second bailout. **Spain** came under the spotlight in early June when it received assistance of up to €100bn specifically for its banking sector. Denials that it would need a sovereign bailout were met with scepticism by the bond markets, where yields on Spanish 10-year bonds leapt to 6.8%. Early in August, however, the Spanish Prime Minister admitted that he would consider terms which may be proposed by the ECB. **Italy**, meanwhile, continued to resist any assistance from European institutions.

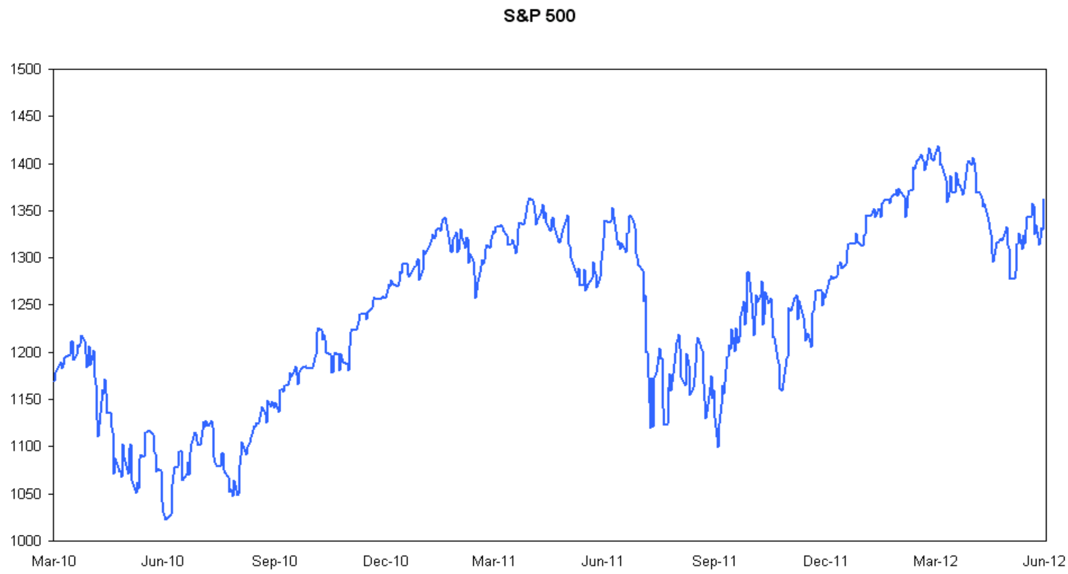
Markets

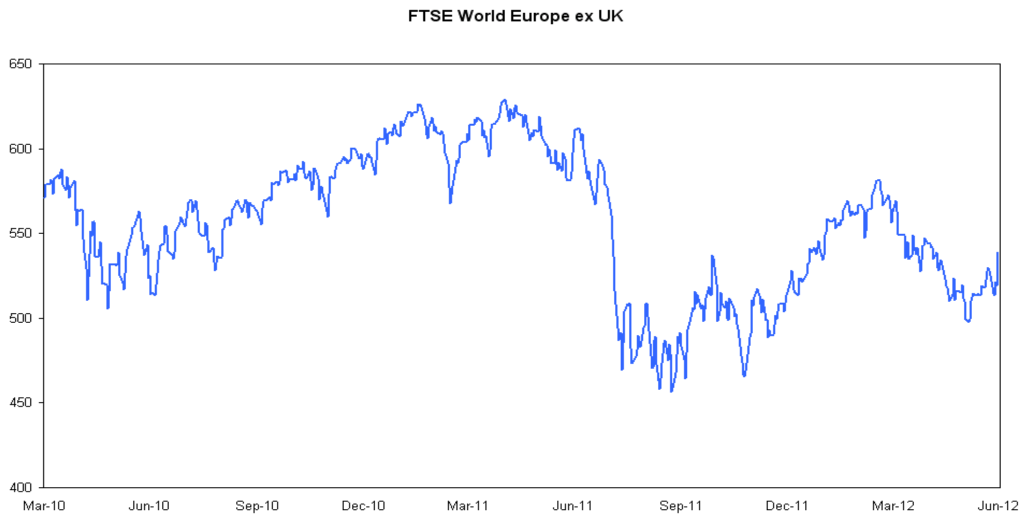
4. All **Equity** markets fell during the quarter, notably Continental Europe on worries about the Eurozone. A sharp rally at the end of June, when the Spanish and Italian situations appeared close to being resolved, improved the numbers for the quarter, and July saw further gains of 1-2%.

Capital return (in £, %) to 30.6.12		
	3 months	**12 months**
FTSE All-World Index	**-4.6**	**-6.8**
FTSE All-World North America	-1.9	+3.5
FTSE All-World Japan	-5.6	-9.2
FTSE All-World Asia Pacific	-5.7	-11.2
FTSE All-World Europe (ex-UK)	-9.8	-23.5
FTSE All-World UK	-3.5	-6.3
FTSE All-World Emerging Markets	-8.6	-16.4

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

5. In sectoral terms, the strongest performers were the defensive areas of Health Care (+2.7%), Telecomms (+1.8%), Consumer Services (unch) and Utilities (-0.9%). The slowing world economy, and in particular the prospects for China, translated into declines of 10.6% in Basic Materials and 8.1% in Oil & Gas. The 6.2% fall in Financials was partly due to the LIBOR case and negative news from JP Morgan. The strength of US equities relative to Continental European equities in the past two years is shown in these two graphs.



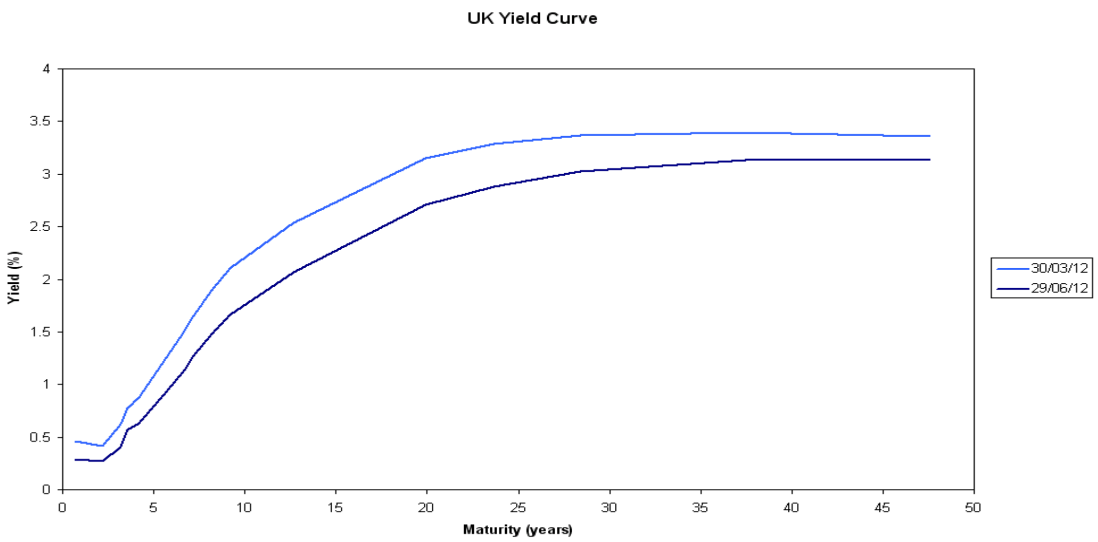


6. Prices continued to rise sharply in the 'safe-haven' **Government Bond** markets during the quarter. The yield reductions in UK and US bonds shown below imply a capital gain of some 4% during the period. By the end of July, US and UK 10-year yields were below 1.50%, while Bunds yielded just 1.30%. At these levels, it seems that investors are buying these bonds for security and not for return. UK Corporate Bonds still gave a positive return in the quarter, despite a slight widening in the yield gap against gilts.

10-year government bond yields (%)					
	Dec 09	**Dec 10**	**Dec 2011**	**Mar 2012**	**June 2012**
US	3.84	3.34	1.88	2.21	1.66
UK	4.01	3.39	1.98	2.21	1.75
Germany	3.40	2.92	1.83	1.82	1.60
Japan	1.29	1.12	0.98	0.99	0.84

[Source: Financial Times]

The fall in yields at all durations between March and June is shown in this graph of the UK yield curve



7. In the **UK Property** market, capital values have continued to decline slowly, so that the total return achieved in the past year has been lower than the income return, with the Retail sector being notably weak. The median Balanced Property Fund has gained 4.1% in the past 12 months, and the median Specialist Fund 4.5%.

Periods to 30.6.12	**3 months return**	**12 months return**	**Current yield**
UK Commercial Property	+0.3%	+5.9%	6.3%
- **Office**	+0.8%	+6.4%	6.1%
- **Industrial**	+1.0%	+5.9%	7.2%
- **Retail**	-0.3%	+3.0%	6.1%

[Source: IPD UK Monthly Property Index via UBS]

8. Among **Commodities** the most significant move was the 20% fall in the **Oil** price, taking Brent below $100/bbl and WTI below $85.This was driven by fears of a slowdown in global demand, combined with an increase in output by Saudi Arabia. The **Copper** price had also been weaker on the expectation of slower growth in China, but then rose slightly when the Chinese announced interest rate cuts in June. The price of **Gold** fell some 7% in the quarter.

9. In **Currency** markets, the Euro continued to weaken, losing 5% against the dollar and 3% against sterling as the sovereign debt crisis in the Eurozone persisted. The Euro fell a further 3% in July. Meanwhile the Yen rose steadily against both the dollar and the pound.

Outlook

10. Equity investors remain nervous about the sluggish rates of GDP growth in developed markets and the uncertain outlook for the Eurozone if bailouts for Spain and Italy become necessary. The recent falls in oil and commodity prices have eased the rate of consumer price inflation and, if sustained, will lower the cost of raw materials for industrial companies. The real benefit to equity markets will only accrue when economic growth picks up without the need for repeated infusions of Central Bank assistance.

11. While the outlook for 2012/3 remains generally subdued, it is hard to imagine that the equity/bond relationship will remain distorted for much longer. When the UK equity market, for example, yields a (well-covered) 3.7%, but 10-year gilts yield only half as much, the prospective returns from equities look far more attractive than those from bonds.

Peter Davies

Independent Financial Adviser

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