PENSION FUND COMMITTEE – 7 DECEMBER 2012

OVERVIEW AND OUTLOOK FOR INVESTMENT MARKETS

Report by the Independent Financial Adviser

The Economy

1. The UK economy grew by a provisional 1.0% in the September quarter, after three negative quarters, although the incidence of special events, such as the Diamond Jubilee and the Olympics, may have distorted the data. The latest annual CPI figure of +2.2% was flattered by the timing of fuel price rises in 2011, and will rebound once this year's rises have taken place. A report on the progress of the deficit reduction programme will be covered in the Chancellor's Autumn Statement on December 5th.

2. The US economy has continued to grow steadily, helped by an upturn in housing starts, while the official unemployment rate has fallen below 8%.The Eurozone remains in recession, with sharp falls in Spanish and Italian GDP; Germany is the only one of the larger countries expected to grow this year. China has reduced its GDP forecast to below 8%, while its territorial dispute with Japan is affecting Japanese vehicle exports to China. Most forecasts for 2013 have been adjusted downwards recently.

   (In the Table below, the consensus estimates at the time of the September 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) -0.2	+1.1	+ 2.2 (CPI)
USA	- 2.5	+2.9	+1.7	(+2.1) +2.1	+1.9	+2.0
Eurozone	- 3.9	+1.7	+1.5	(-0.5) -0.5	NIL	+2.5
Japan	- 5.3	+4.2	-0.7	(+2.3) +2.1	+0.9	-0.3
China	+ 8.7	+10.3	+9.2	(+8.2) +7.8	+8.6	+1.9

[Source: The Economist, 10.11.12]

3. Central Banks maintained their official interest rates at low levels and continued to employ monetary measures in order to stimulate economic growth. The Federal Reserve announced in September that it would buy $40bn of mortgage-backed securities each month until there was "an ongoing sustained improvement in the labour market". The Bank of England, however, will not be renewing its Quantitative Easing programme in November.

4. Mario Draghi, President of the ECB, had said in July that he would do "whatever it takes" to preserve the Euro, and in September he announced a policy of 'outright monetary transactions' (OMT) under which the ECB would buy shorter-dated government bonds, provided the government in question had requested help and agreed to the imposition of fiscal conditions. To date neither Italy nor Spain has made such a request, but the yields on their bonds have fallen significantly in recent months and the sense of crisis in the Eurozone has – for the moment -- subsided.

5. On November 6th President Obama was re-elected for a further four years. There was an immediate fall in US equity markets because of uncertainty about whether he would be able to reach an agreement with a Republican-controlled House of Representatives to avert the imminent 'fiscal cliff' whereby tax cuts expire and public spending cuts come into force at the start of 2013. The gravity of this situation is underlined by the Congressional Budget Office's forecast that the combination of these two factors would reduce US output by 3% in 2013, and increase unemployment by around 1%.

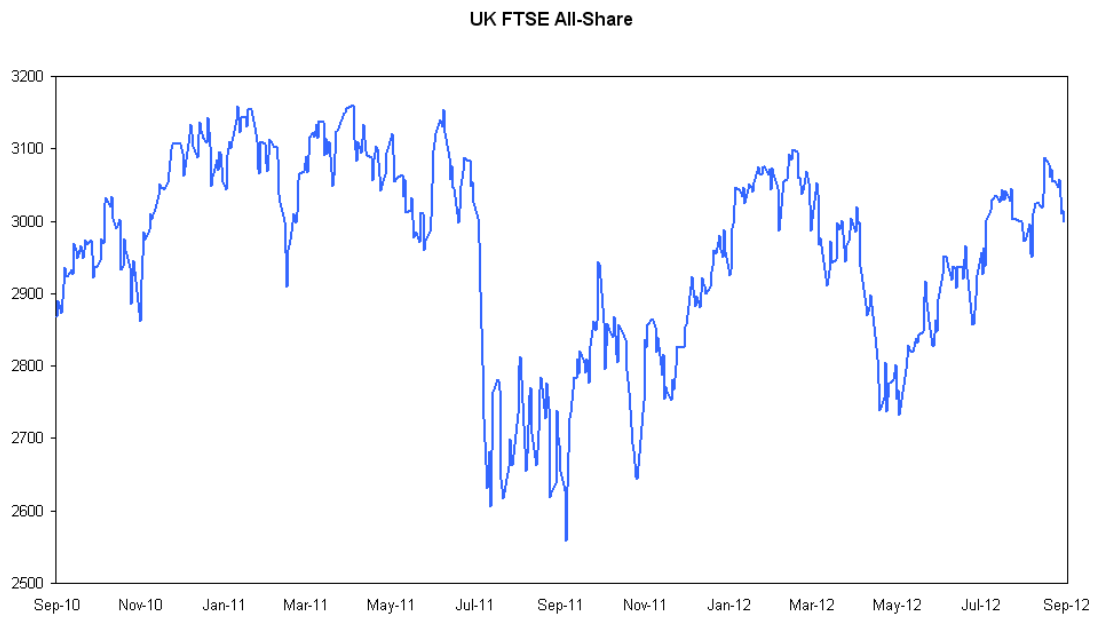
Markets

6. **Equities** recorded gains across all regions, except for Japan, which is also the only region showing a year-on-year decline. The US Federal Reserve's announcement in mid-September of a further programme of QE caused a sharp rise in US equity indices, which touched 4-year highs before falling back slightly at the end of the quarter. There was little divergence by sector, with Oil &Gas (+6%), Financials (+5%), Consumer Services and Health Care (each +4%) being the strongest, and only Utilities (-3%) producing a negative return. Markets ended October very close to their end-September levels.

Capital return (in £, %) to 30.9.12		
	3 months	**12 months**
FTSE All-World Index	**+ 3.3**	**+ 14.0**
FTSE All-World North America	+ 3.0	+ 21.4
FTSE All-World Japan	- 4.5	- 7.4
FTSE All-World Asia Pacific	+ 1.9	+ 5.0
FTSE All-World Europe (ex-UK)	+ 6.2	+ 7.9
FTSE All-World UK	+ 3.2	+ 12.2
FTSE All-World Emerging Markets	+ 3.6	+ 8.2

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

The UK equity market has still not regained the levels reached in the first half of 2011.

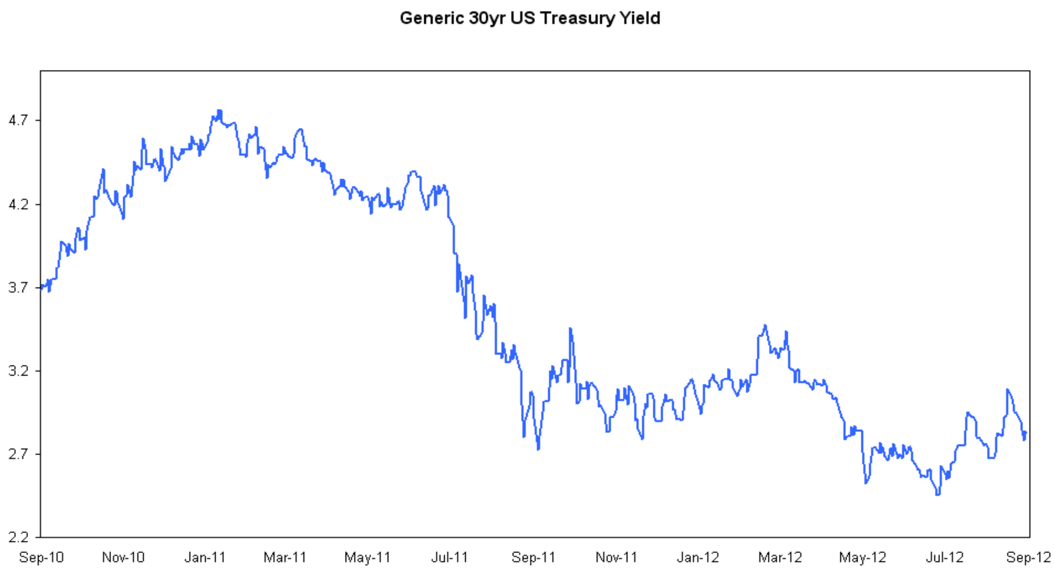


7. Yields on the ‘safe-haven’ **bonds** remained at historically low levels, while the spread on Italian and Spanish sovereign bonds relative to Germany narrowed after Mr Draghi’s undertaking to support the Euro. In the UK, corporate bond spreads relative to gilt yields narrowed.

10-year government bond yields (%)					
	Dec 09	**Dec 10**	**Dec 2011**	**June 2012**	**Sept 2012**
US	3.84	3.34	1.88	1.66	1.64
UK	4.01	3.39	1.98	1.75	1.72
Germany	3.40	2.92	1.83	1.60	1.46
Japan	1.29	1.12	0.98	0.84	0.77

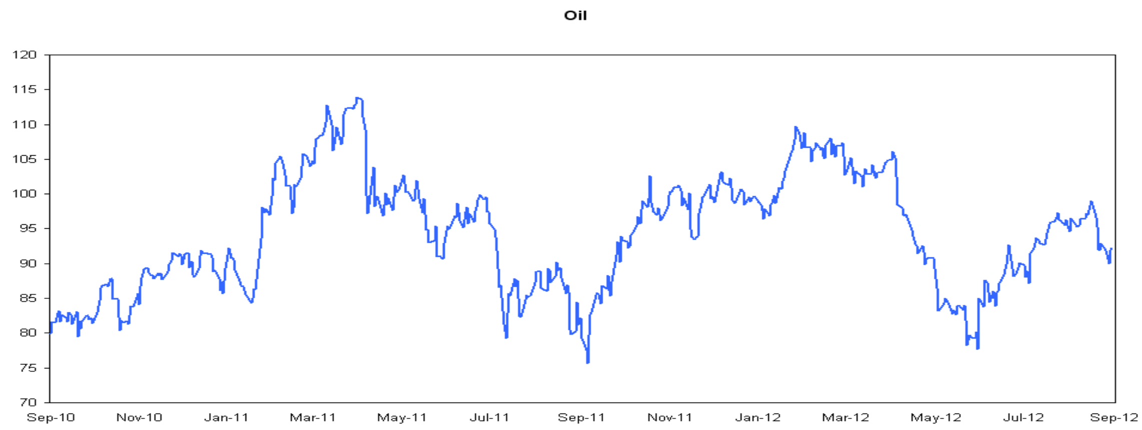
[Source: Financial Times]

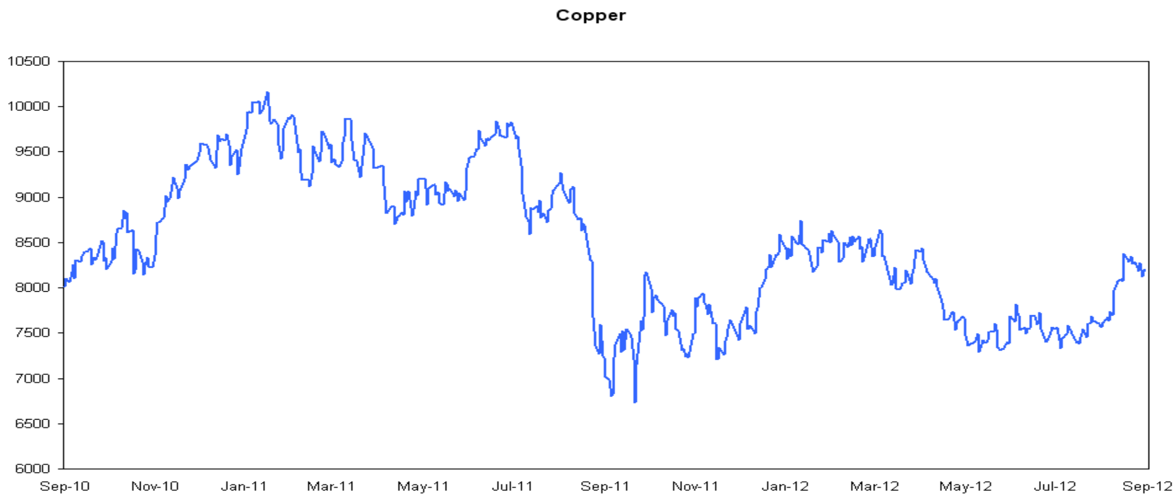
The long-dated US Treasury yield remains below 3%.



8. Values of **UK Commercial Property** continue to drift lower, with the total return of 3.3% for the past year well below the income return of some 6% (IPD UK Quarterly Property Index). Retail was the weakest sector, giving just 2.2% total return, amid the failure of several well-known outlets – most recently Comet.

9. In **Commodities,** the Oil price recouped most of its 2nd- quarter decline before retreating in October. Copper spiked upwards in September, but then gave up all of this rise on fears of a global economic slowdown led by China. Gold advanced steadily to a level above $1700/oz.





10. Among **Currencies**, the dollar weakened relative to the other major denominations - by 1.5% against the euro, 2.5% against the yen and 3% against the pound.

Outlook

11. In the next few weeks, investors will be paying close attention to the negotiations in the United States on the 'fiscal cliff' issue, with fears that deadlock here could damage sentiment on the scale of summer 2011 when the US credit rating was lowered following an earlier budgetary stalemate. In Europe, the problems of Italy and Spain will surely return to the headlines if a bailout for either country looks necessary. Looming in the background is the fear that fiscal tightening throughout Europe (including the UK) will choke off any hopes of an economic recovery in the region, and cause even higher levels of unemployment.

12. If the worst-case scenarios in the US and Europe can be averted, and China returns to an 8%+ growth rate in 2013 as forecast, there should be a positive reaction in equity markets, which already look cheap on a yield comparison relative to government bonds.

Peter Davies

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