PENSION FUND COMMITTEE – 8 MARCH 2013

OVERVIEW AND OUTLOOK FOR INVESTMENT MARKETS

Report by the Independent Financial Adviser

The Economy

1. The UK economy contracted by 0.3% in the December quarter, while the US economy was flat quarter on quarter, but still recorded GDP growth of 2.2% for the year. Compared with their pre-crisis peaks in 2008, US and Germany had slightly higher output in Q3 2012, while UK, France, Italy and Japan had still not recovered to peak output level. Forecasts for 2013 continue to show weak growth - except in China.

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

Consensus real growth (%)						Consumer prices latest (%)
	2009	2010	2011	2012	2013E	
UK	- 4.7	+1.6	+0.9	(-0.2) -0.1	(+1.1)+0.9	+ 2.7 (CPI)
USA	- 2.5	+2.9	+1.7	(+2.1) +2.2	(+1.9)+1.9	+1.7
Eurozone	- 3.9	+1.7	+1.5	(-0.5) -0.5	(NIL) -0.1	+2.0
Japan	- 5.3	+4.2	-0.7	(+2.1) +1.9	(+0.9)+1.0	-0.1
China	+ 8.7	+10.3	+9.2	(+7.8) +7.8	(+8.6) +8.5	+2.5

[Source: The Economist, 08.02.13]

2. In the Autumn Statement on December 5th, George Osborne revealed weaker forecasts for UK economic growth and confirmed that he would miss his target of reducing the share of public debt in national income by 2015-16. The cuts in public sector spending are now expected to continue until 2018.

3. In the United States, the much-vaunted ‘fiscal cliff’ was averted – or at least deferred – by a New Year’s Eve deal in Congress under which households with incomes under $450,000 will continue to benefit from the Bush tax cuts,

although the 2% increase in payroll tax will go ahead. The decision on spending cuts was postponed until the end of February, and debate on the debt ceiling deferred until later in the year.

4. In Japan, the currency had been weakening since a General Election was called, on the expectation that the LDP, under Shinzo Abe, would return to power. The December 15th result did indeed show a massive victory for the LDP over the DPJ, and Mr Abe wasted no time in announcing that he wanted the Bank of Japan to adopt an inflation target of 2%, instead of 1%, and to ease monetary policy. In addition he planned to reflate the economy by means of fiscal stimulus and public-works programmes. Although the Bank of Japan has supported the policy rather half-heartedly, it is expected that a new Governor, to be appointed in March, will be more in tune with the Prime Minister.

5. Sentiment in financial markets towards Spain and Italy has been much stronger, and the yields on their sovereign bonds have fallen considerably since the ECB President Mr Draghi's famous pledge in July to do "whatever it takes" to preserve the Euro. Political risk persists, however, with Italian elections imminent, allegations of corruption at the highest levels in Spain, and street demonstrations in several European capitals protesting against the austerity programmes being imposed.

Markets

6. **Equities** ended the year strongly, except in the US where 'fiscal cliff' worries dominated sentiment. Once this cloud had passed, all markets rose sharply in January, recording gains of 5 - 7% in sterling terms, and in many cases reached their highest levels since 2008. Within the UK equity market there was a wide dispersion between the performance during 2012 of the FTSE 100 and the other sectors:

FTSE 100	+ 5.8%
FTSE 250	+22.5%
FTSE Small Cap	+24.4%

7. The Table below has been expanded to show the % weighting of each region in the FTSE All-World Index, as at the end of 2012, to illustrate their relative importance in a Global Equity portfolio.

	Capital return (in £, %) to 31.12.12		
Weight %	**Region**	**3 months**	**12 months**
100.0	**FTSE All-World Index**	**+ 2.0**	**+ 8.8**
48.2	FTSE All-World North America	-1.4	+8.2
7.1	FTSE All-World Japan	+4.9	+0.9
14.3	FTSE All-World Asia Pacific ex Japan	+5.1	+13.8
17.7	FTSE All-World Europe (ex-UK)	+7.6	+12.8
8.2	FTSE All-World UK	+3.0	+6.4
11.5	FTSE All-World Emerging Markets	+4.7	+9.1

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

8. The following Table shows the variation in returns across the industry groups during 2012. The strength of Financials will have wrong-footed many investment managers, while Basic Materials (notably the Mining sector) suffered a second consecutive weak year.

Capital return (in £, %) to 31.12.12		
Industry Group	**3 months**	**12 months**
Financials	+7.5	+19.9
Consumer Services	+1.6	+14.2
Industrials	+5.0	+10.7
Health Care	-0.5	+10.3
Consumer Goods	+3.9	+9.8
Technology	-4.0	+7.8
Basic Materials	+4.1	+1.7
Telecommunications	-5.1	-1.3
Oil & Gas	-3.1	-3.7
Utilities	-1.9	-6.0

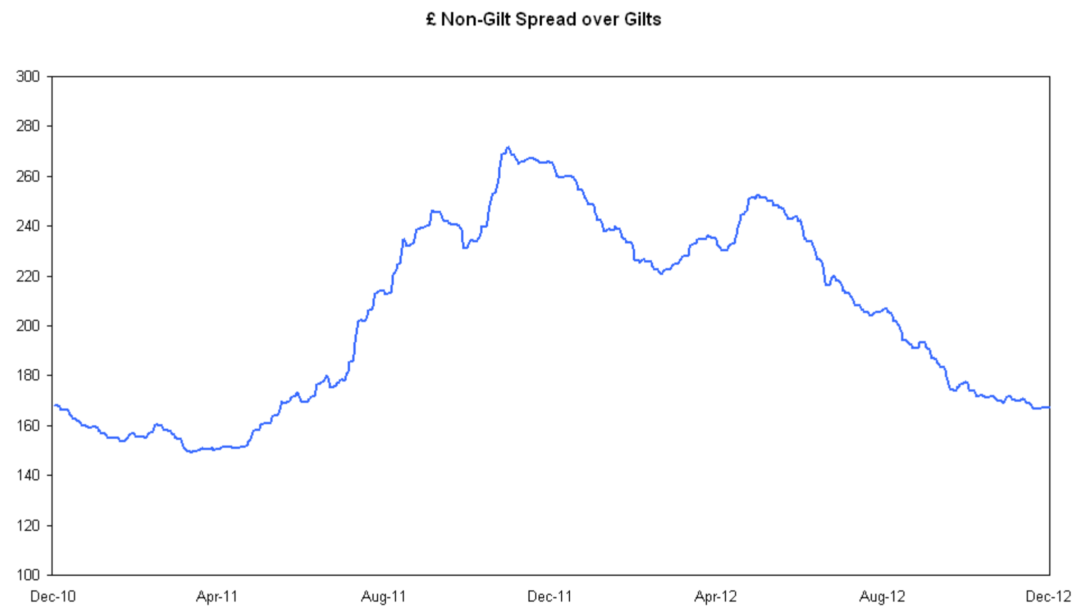
[Source: FTSE All-World Review, December 2012]

9. The 'safe-haven' **Sovereign Bonds** were little changed during the quarter, but in January they weakened as investor interest moved towards equities. Yields on Spanish and Italian bonds have fallen by some 200 bps since the summer of 2012, because of the ECB's declared intention to support those bonds if the government were to approach the ECB for a bailout.

10-year government bond yields (%)					
	Dec 09	**Dec 10**	**Dec 2011**	**Sept 2012**	**Dec 2012**
US	3.84	3.34	1.88	1.64	1.76
UK	4.01	3.39	1.98	1.72	1.85
Germany	3.40	2.92	1.83	1.46	1.32
Japan	1.29	1.12	0.98	0.77	0.79

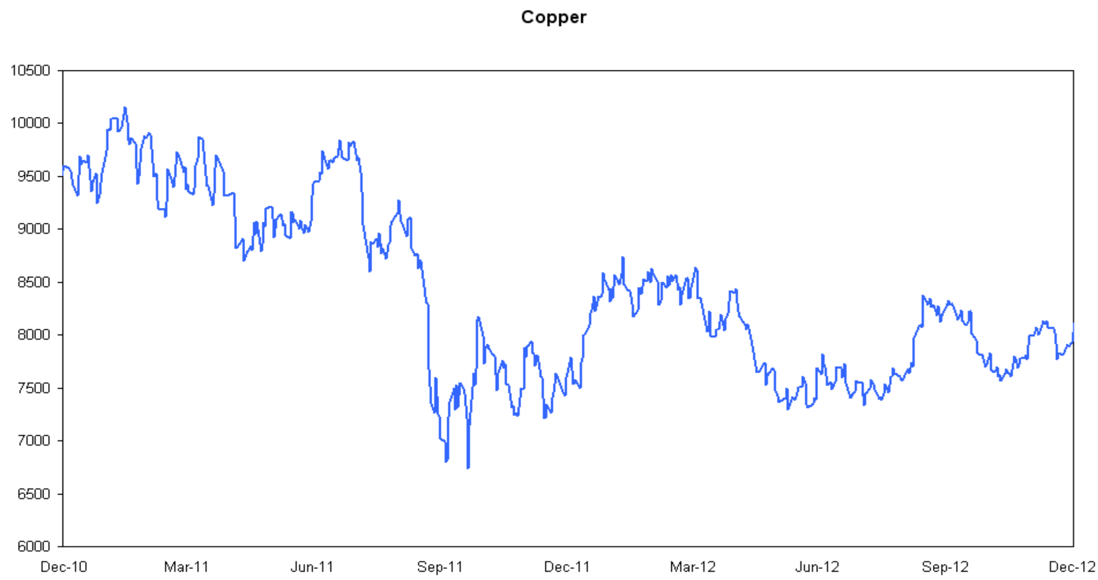
[Source: Financial Times]

10. **Corporate Bonds** have performed well recently, with yield differentials against government bonds falling sharply, as shown in the graph below.



11. The drift in **UK Commercial Property** values continued. A full-year total return of just 2.4% (IPD UK Quarterly Property Index) translates to a fall of some 3% in capital values. Offices were the best performing sector (+4.1%) followed by Industrials (+2.9%) and Retail (+1.5%).

12. Among **Commodities**, the Oil price remained flat over the quarter, while Gold fell by 7%. Copper weakened in November, but then rallied as more positive news was published on Chinese manufacturing levels.



13. The most dramatic development in **Currencies** was the depreciation of the Yen. Anticipating the election as Prime Minister of Shinzo Abe, whose pro-growth policies were well known, investors sold the Yen to the extent that it moved from 78/$ to 87/$ in December, and to 92/$ in January. The other feature of the fourth quarter was the rise of the Euro against all the major currencies. The strength of sterling during 2012 is shown below:

	31.12.11	**31.12.12**	**£ move**
$ per £	1.554	1.625	+ 4.6%
€ per £	1.197	1.233	+ 3.0%
Y per £	119.6	140.5	+17.5%

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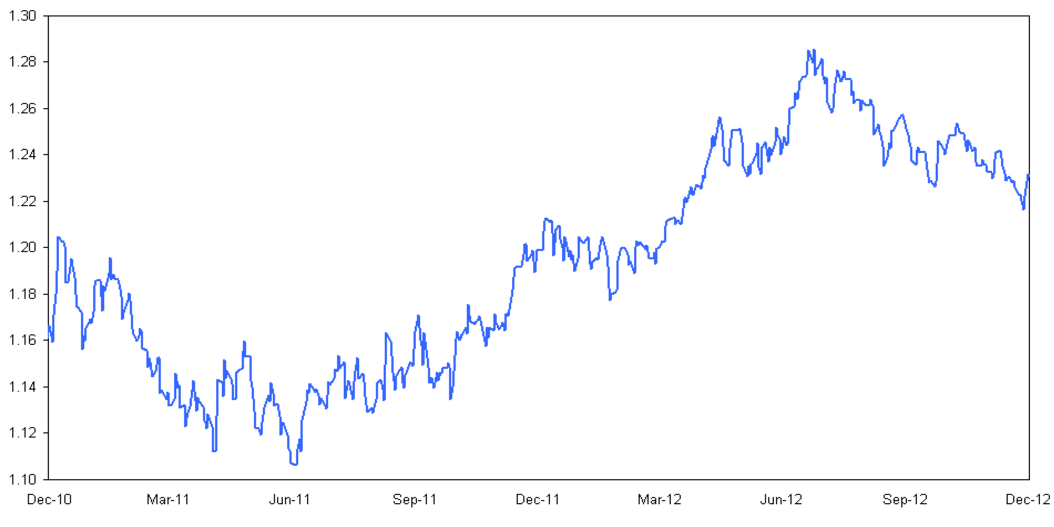
GBP vs JPY

GBP vs EUR



Outlook

14. My previous report listed the three clouds overhanging the equity markets as the US ‘fiscal cliff’, Spain and Italy, and the outlook for China’s GDP growth. In the event, the worst-case outcome for each of these three situations has – so far – been averted, and equity markets have gained more than 5% in January by way of response. At the same time yields on ‘safe-haven’ bonds have risen by around 0.25% in January.

15. One cause of this movement appears to have been the re-direction of retail investment flows from fixed-income to equity funds, as reported in the US, and this trend has further to run. Although the recent equity market rally could be stopped in its tracks by negative developments in the three areas mentioned above – or by other unforeseen events – equities still look good value relative to government bonds, and I expect the recent out-performance of equities to persist during 2013.

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February 11th, 2013