Division(s): N/A

PENSION FUND COMMITTEE – 19 MARCH 2010

OVERVIEW AND OUTLOOK FOR INVESTMENT MARKETS

Report by the Independent Financial Adviser

The Economy

1. All of the major economies recorded positive GDP growth in the final quarter of 2009. The UK's provisional annualised figure of +0.4% was below expectations, and compared poorly with the +5.7% seen in the United States and +1.7% in the Eurozone. Forecasts for 2010 have been increased slightly since November – except for the UK – but there is still great uncertainty over how economies will react to the withdrawal, or reduction, of the massive fiscal and monetary stimuli introduced by governments and Central Banks in 2008/9.

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

Consensus real growth (%)					**Consumer prices (%)**
	2007	**2008**	**2009E**	**2010E**	**2009E**
UK	+3.0	+0.7	(- 4.4) - 4.7	(+1.4) +1.4	+ 2.9 (CPI)
USA	+2.0	+1.2	(- 2.5) - 2.5	(+2.5) +3.0	- 0.4
Eurozone	+2.6	+0.8	(- 3.8) - 3.9	(+1.2) +1.4	+ 0.3
Japan	+2.0	- 0.2	(- 5.7) - 5.3	(+1.4) +1.5	- 1.4
China	+11.9	+ 9.0	(+8.2) + 8.7	(+8.6) +9.6	- 0.6

   [Source: The Economist, 13.02.10]

2. China appears to be on track to return to its recent trend growth rate, but the Chinese authorities acted at the start of 2010 to restrict bank lending in order to reduce the risk of the economy overheating. India's Central Bank has also recently raised its reserve requirements.

3. While interest rates are expected to remain at their lowest levels for some months yet in the other major economies, several stimulus packages have run their course. The Bank of England, for instance, has paused its Quantitative Easing programme after purchasing £200bn of (mainly gilt-edged) bonds. The prospect of a 'double-dip' recession in the UK or Eurozone cannot be dismissed yet.

4. In the UK, the pre-Budget Report in December contained little to appease worries about the level of the fiscal deficit in the coming years, and any measures to reduce the deficit will now have to wait until after the General Election expected to be held on May 6th.

Markets

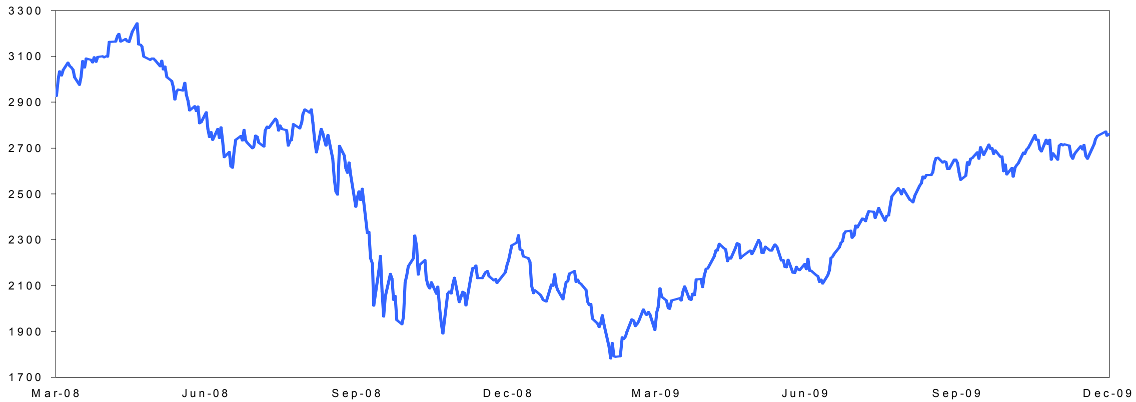
5. After their massive gains during the 3rd quarter, **equity markets** were far more subdued in the 4th quarter. After falling slightly in October, all regions recovered in November and December to record single-figure gains for the quarter, as shown in this Table.

Capital return (in £, %) to 31.12.09		
	3 months	**12 months**
FTSE All-World Index	+ 3.2	+17.8
FTSE All-World North America	+ 4.3	+12.1
FTSE All-World Asia Pacific	+ 1.3	+22.2
FTSE All-World Europe (ex-UK)	+ 0.5	+17.1
FTSE All-World UK	+ 5.4	+ 22.7
FTSE All-World Emerging Markets	+ 7.5	+58.7

[Source: FTSE All-World Review, December 2009]

N.B. The five geographical areas are sub-categories of the All World Index

6. Despite the very sharp gains, amounting to 50 – 60% from their March 2009 lows, markets are still significantly lower than they were in Spring 2008.

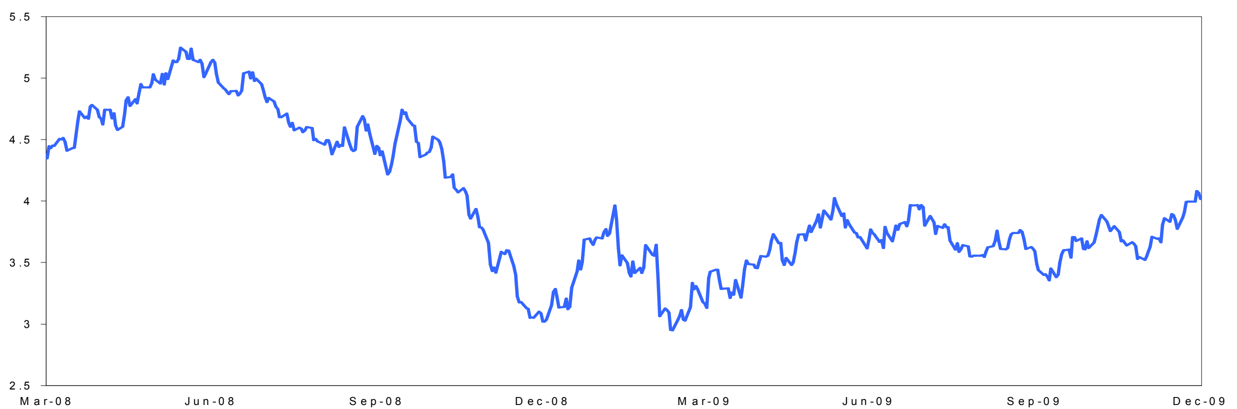


7. At the end of November, **government bond markets** were trading at their end-September levels, but sharp price falls ensued in December. The financial problems of several Dubai entities, which announced a 'debt standstill' at the end of November, reminded investors of the potential risks of sovereign debt, and attention then turned to other heavily indebted nations, such as Greece, Spain and Ireland. Some large bond investors, such as PIMCO in the US, pointed out the scale of new issuance which would be needed by the US and UK in the near future and yields on these government bonds rose sharply in December, resulting in a 4% price fall for the 10-year bonds. Yields in Germany and Japan, by contrast, remained stable.

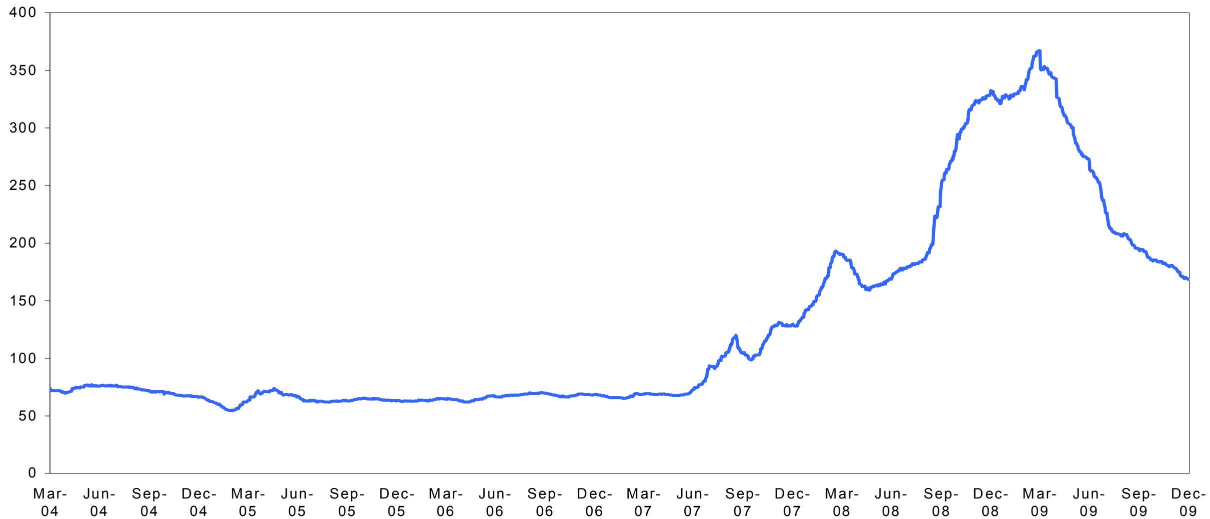
10-year government bond yields (%)				
	Sept 2008	**Dec 2008**	**Sept 2009**	**Dec 2009**
US	3.84	2.22	3.31	3.84
UK	4.46	3.02	3.59	4.01
Germany	4.04	2.95	3.23	3.40
Japan	1.48	1.18	1.30	1.29

[Source: Financial Times]

8. In the course of 2009, Treasuries and Gilts have experienced a complete change of sentiment, from being regarded as a safe haven after the upheavals of 2008 to being viewed with suspicion themselves at the end of the year.



9. The spread on **UK Corporate Bonds** relative to gilts continued to narrow, though at a slower pace than in the two previous quarters. In absolute terms, however, prices fell because of the setback in gilt prices described above.

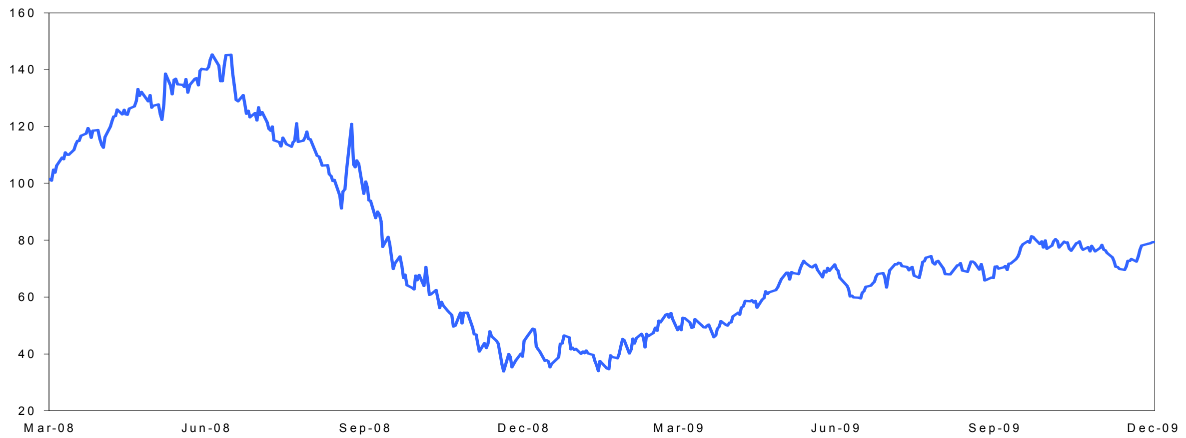


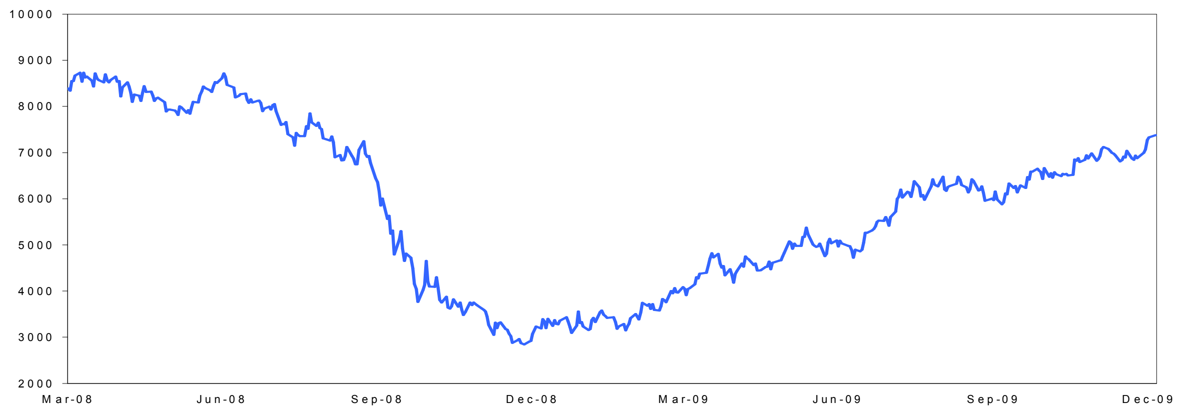
10. For the second successive quarter, **UK Property** values rose strongly. This rise was driven by the demand for prime commercial buildings, while values of secondary property continue to languish. Prime yields in the Retail and Office sectors reduced from 7% to 6%, on average, during 2009, but the rental market is weak in all sectors. The 12-month falls in rental levels were 6.9% in Retail, 13.0% in Offices and 4.9% in Industrials (IPD data).

Median fund returns to 31.12.09	**3 months**	**12 months**
Balanced Funds (n= 25)	+ 8.3%	+ 1.3%
Specialist Funds (n= 35)	+11.8%	- 1.8%

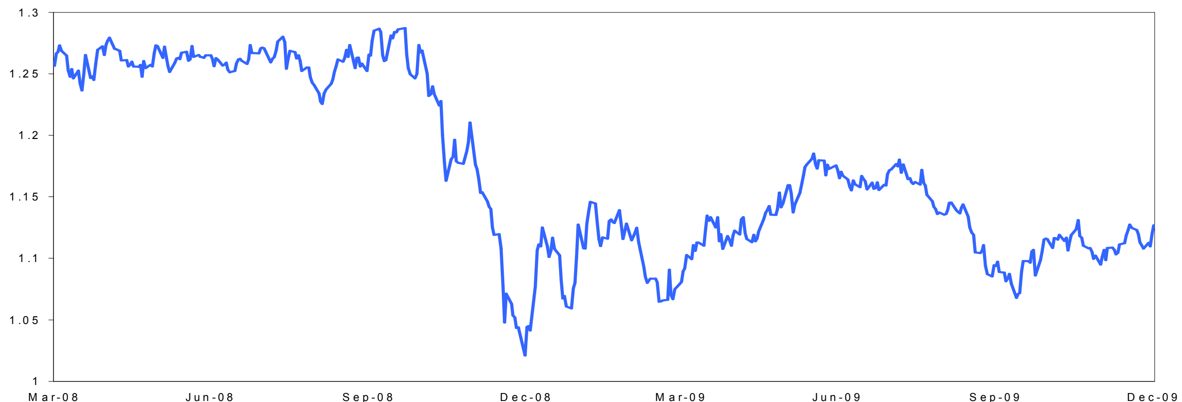
[Source: IPD UK pooled property funds]

11. In **Commodities**, the Oil price remained fairly static in the $75 – 80 range, while the Gold price retreated from its November peak of $1,200 to just below $1,100 at the end of the year. I am including a graph of the Copper price, as an illustration of the dramatic effects of the recession - and the subsequent recovery - on the prices of industrial metals.





12. Among **currencies**, sterling made gains of 1% and 2% against the dollar and the euro respectively during the quarter, although the dollar has strengthened by 3% against sterling and 4% against the euro in the first six weeks of 2010.



Outlook

13. After a confident start to 2010, equities worldwide have been hit by news of the tightening of credit in China, Greece's fiscal problems and President Obama's plans to restrict the trading activities of banks. The combined effect has been to cut equity prices by some 8% in the space of three weeks.

14. When the meeting was held in Oxford on February 8th to review the Pension Fund's current asset allocation, equity levels were close to those of end-September 2009. Although none of the asset class weights fell outside the ranges agreed at the September Committee, it was clear that the level of Cash was edging up to its 5% limit, by virtue of net inflows into the Fund.

15. It was decided to bring the Cash level down from £49m to £31m, by moving £18m to UBS' Overseas Equities portfolio. This switch would bring Overseas Equities slightly above their target weight of 32%, while UK Equities were similarly placed relative to their 31% target. As a minimum cash sum of £15m is retained to meet drawdowns or purchases of Private Equity, there remains some £16m which is intentionally held in cash at present.

16. Bearing in mind all the uncertainties around economic growth, corporate profits and sovereign risk, I believe it is prudent to maintain this cash balance as an insurance against further near-term setbacks in equity and bond markets.

RECOMMENDATION

17. **The Committee is RECOMMENDED to note this report.**

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March 2010