REPORT PREPARED FOR

Oxfordshire Council Pension Fund

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PENSION FUND COMMITTEE - 6 SEPTEMBER 2013

OVERVIEW AND OUTLOOK FOR INVESTMENT MARKETS

Report by the Independent Financial Adviser

Economy

1. The UK reported growth of +0.6% in the second quarter – better than many had predicted – and estimates for the full year have been increased slightly. In the US, the monthly jobs data has beaten expectations in April – June, with a slight setback in July. The Federal Reserve has raised its estimates of GDP growth to 2.45% this year and 3.25% in 2014, which are better than consensus estimates (see table below). Japan also saw a stronger economy than expected in Q1, but the Eurozone remains becalmed, and China looks to be achieving slower growth than in recent years.

(In the table below, bracketed figures show the forecasts at the time of the June Committee)

Consensus real growth (%)	2010	2011	2012	2013E	2014E	Consumer prices latest (%)
UK	+1.6	+0.9	-0.1	(+0.7) +1.0	+1.7	+2.9 (CPI)
USA	+2.9	+1.7	+2.2	(+2.1) +1.7	+2.7	+1.8
Eurozone	+1.7	+1.5	-0.5	(-0.5) -0.6	+0.8	+1.6
Japan	+4.2	-0.7	+1.9	(+1.3) +2.0	+1.7	+0.2
China	+10.3	+9.2	+7.8	(+8.4) +7.5	+7.3	+2.7

[Source: The Economist 10.8.13]

2. The statements from the Federal Reserve Bank have had the greatest impact on Equity and Bond markets. On May 22nd, their minutes showed that several members of the committee were envisaging a 'tapering' of the rate of Quantitative Easing (QE) if the US economy continued its recovery. While not new, this reminded markets that the buoyancy of markets had been due partly to the massive injections of liquidity from central banks. Equity and bond markets both fell quite sharply on this news. In late June the Fed was more explicit about its intentions, saying that it expected to slow its rate of monthly purchases by the end of 2013, and cease completely by mid-2014 if the US economy grew as expected. This caused a further setback in equity and – more particularly – bond markets.

3. In early May the European Central Bank reduced its base rate from 0.75% to 0.5% in an effort to stimulate economic growth. The new Governor of the Bank of England, Mark Carney, in one of his first statements, said that the markets' expectation of a rise in interest rates during the next two years was misplaced. He then amplified this guidance in early August by pledging to keep base rate at 0.5% until UK unemployment falls to a level of 7% from its current 7.8%. The Bank's own forecasts do not expect this to happen until mid-2016. He also said, however, that this policy on interest rates would be altered if inflation was threatening to get out of control.

4. News from China has also affected sentiment in markets, most notably in the Pacific and Emerging markets. A weak Manufacturing Purchasing Managers Index reading in May coincided with the Fed's first statement on QE in May, and the June reading was also disappointing. Finally, late in June interbank rates in China rose very sharply as there appeared to be signs of a credit crisis in the banking system. It was only a few days later that the Chinese central bank stepped in to normalise the situation.

5. In Japan, Prime Minister Abe launched the third of his economic 'arrows', this one dealing with structural reform. Observers were initially unimpressed by the lack of detail in the announcement, but his comfortable win in the Upper House election in July has given the LDP and its coalition partner a majority in both Houses of the Diet.

Markets

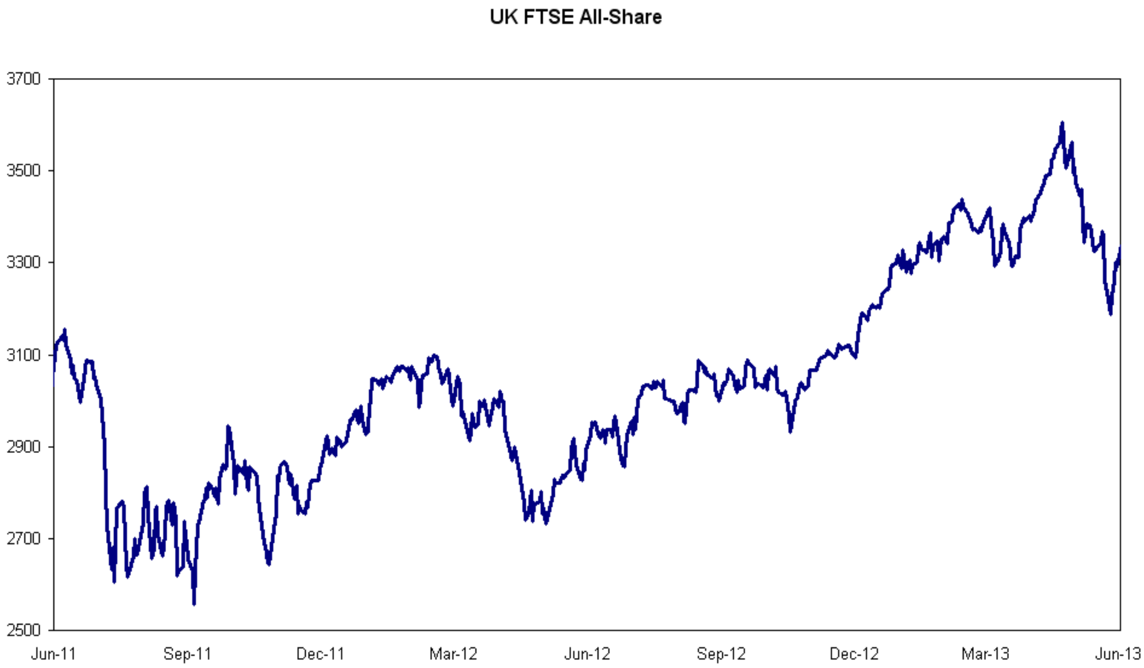
6. **Equities** had advanced steadily during April and May – with several indices reaching their highest levels since 2008 – but the May 22nd news from the Federal Reserve (see paragraph 2) caused a sharp setback everywhere. Most notably, the Japanese equity market fell by 7% the following day, on fears that rising bond yields would inflict heavy losses on the portfolios of regional banks. By the end of June, and after the second statement from the Federal Reserve, most equity markets had surrendered their earlier gains and registered slight losses for the quarter. (See table below).

	Capital return (in £, %) to 30.06.13		
Weight %	**Region**	**3 months**	**12 months**
100.0	**FTSE All-World Index**	**-1.0**	**+18.1**
51.5	FTSE All-World North America	+1.7	+20.8
8.8	FTSE All-World Japan	+4.2	+23.5
12.1	FTSE All-World Asia Pacific ex Japan	-8.4	+9.9
16.3	FTSE All-World Europe (ex-UK)	-1.9	+22.4
7.8	FTSE All-World UK	-4.0	+12.1
9.7	FTSE All-World Emerging Markets	-8.8	+3.9

[Source: FTSE All-World Review, June 2013]

7. Emerging Markets continued to be the weakest region for equities. In part this was caused by the weakness of the Japanese yen, which threatened the competitiveness of exports from, for example, South Korea. The slowdown in China's economy led to a fall in commodity prices, which in turn affected the profitability of commodity producers

in the Emerging Markets. The street protests in Turkey and Brazil in June, followed by the ousting of the Egyptian President in July, reminded investors of the political risks involved in Emerging Markets.



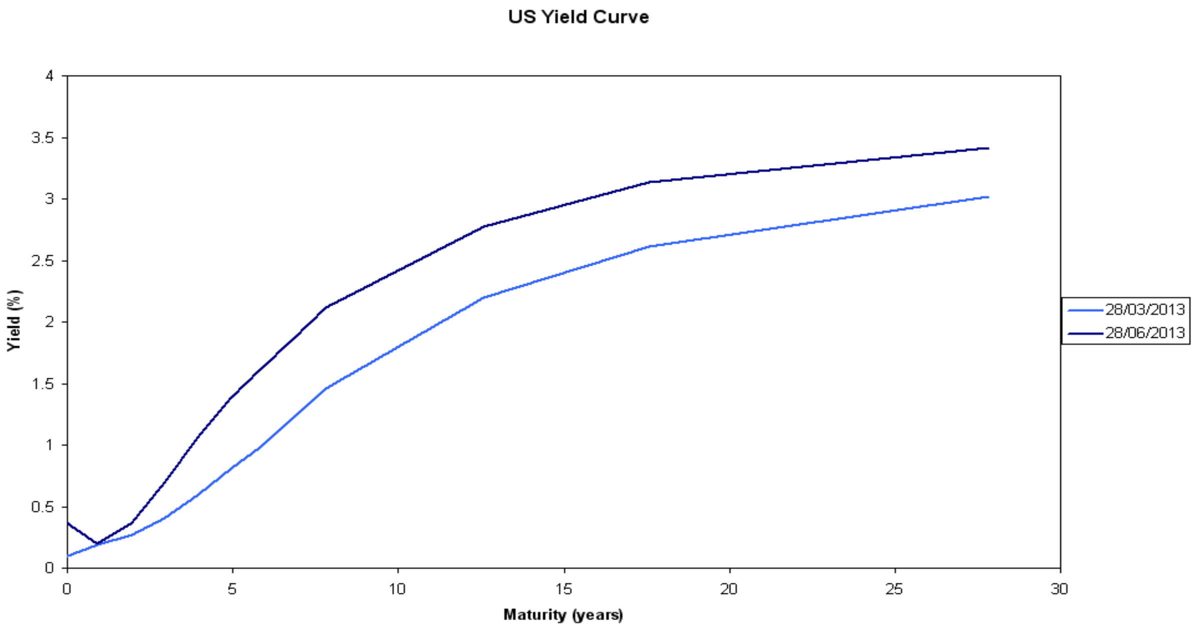
8. Looking at the performance of the different industry groups during the quarter, the weakness of commodity prices inevitably dragged down the Basic Materials sector, which is by far the worst performer over the past 12 months also. The strong rise in the Technology sector during the quarter was driven by the 18% gain from the Software & Computer Services sub-group.

Capital return (in £, %) to 30.06.13		
Industry Group	**3 months**	**12 months**
Health Care	+2.4	+28.5
Financials	-0.6	+27.1
Consumer Services	+1.8	+26.8
Industrials	-0.6	+21.2
Consumer Goods	-0.3	+21.1

FTSE All-World	**-1.0**	**+18.1**
Technology	+7.9	+10.5
Telecommunications	+1.2	+9.9
Utilities	-2.3	+3.9
Oil & Gas	-4.1	+8.4
Basic Materials	-10.8	-4.4

[Source: FTSE All-World Review, June 2013]

9. **Bond markets** fell heavily after the May 22nd Fed announcement, and yields continued to rise for the rest of the quarter. This effect was even more pronounced in the corporate and high-yield bond markets, which had previously been driven to extremely high levels as investors searched for yield. Worries about the peripheral Eurozone bond markets resurfaced when the Portuguese Finance Minister resigned his post after disagreements about the depth of the austerity programme. There was a marked upward shift in US government bond yields at all durations as shown in the graph below.



10. The table below shows that 10-year government bond yields in US, UK and Germany rose by 44 – 64 basis points during the quarter. A rise of 0.5% in the yield on a 10-year bond results in a fall of about 4% in its price.

10-year government bond yields (%)					
	Dec 10	**Dec 11**	**Dec 12**	**Mar 13**	**Jun 13**
US	3.34	1.88	1.76	1.85	2.49
UK	3.39	1.98	1.85	1.78	2.45
Germany	2.92	1.83	1.32	1.29	1.73
Japan	1.12	0.98	0.79	0.57	0.86

[Source: Financial Times]

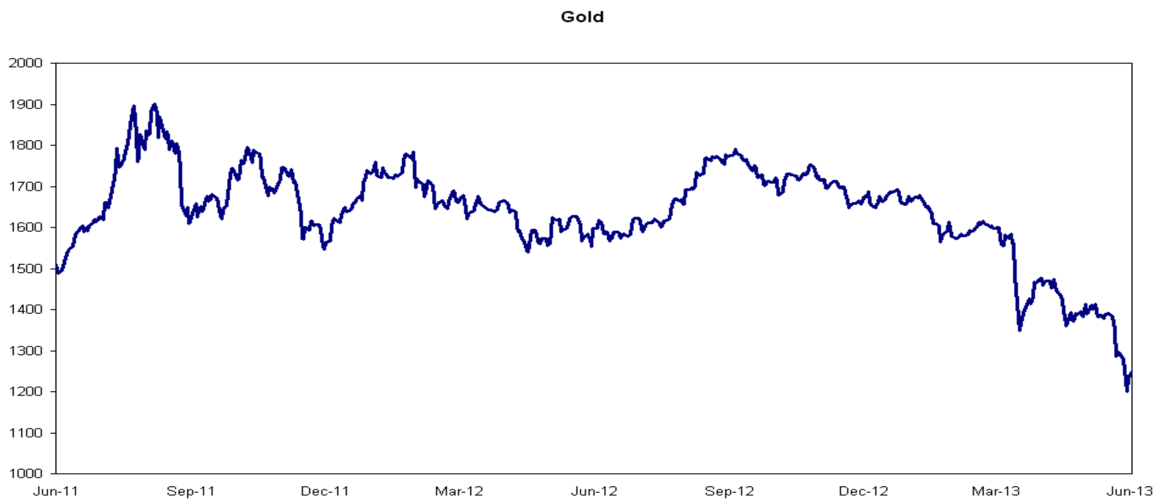
Currencies

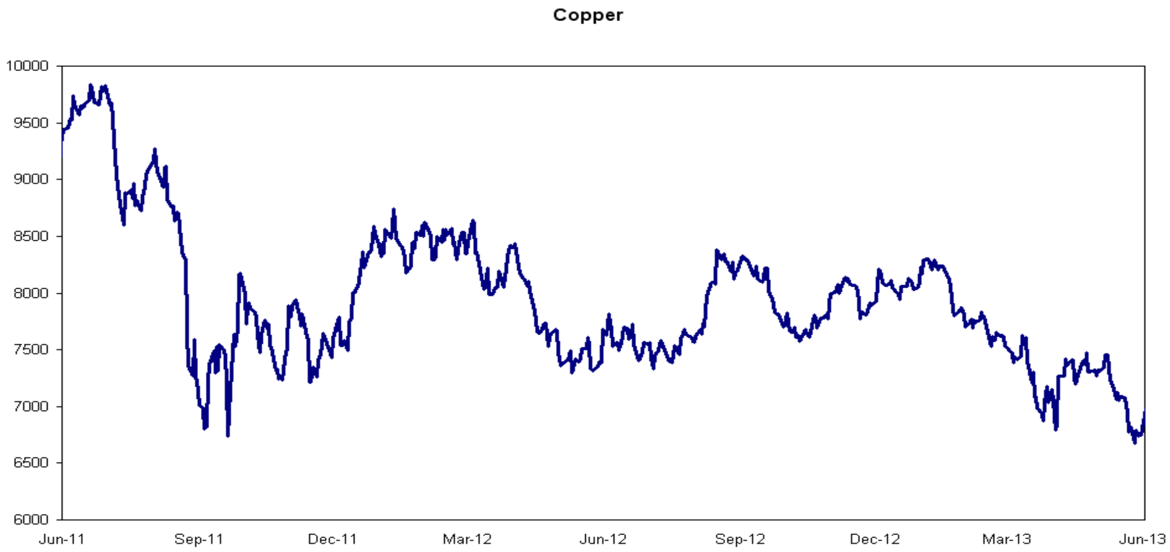
11. The yen continued to weaken against the dollar, crossing the psychologically significant level of 100 per $ in May, and ending the quarter close to this level after fluctuating in the range 95-104 per $. Emerging Market currencies began to weaken on the fall in commodity prices, notably Brazil (-17%), Chile (-14%) and Mexico (-11%) relative to the dollar.

	31.03.13	**30.06.13**	**£ move**
$ per £	1.518	1.517	unch
€ per £	1.182	1.167	- 1.3%
Yen per £ (see graph below)	142.8	150.7	+ 5.5%

Commodities

12. The **gold** price fell 25%, from $1600 to $1200 per oz, during the quarter. The decline was sparked initially by the Federal Reserve's May statement about the likely tapering of QE, as investors saw less need to hold an inflation hedge in the form of gold. The sell-off gathered pace during June, with heavy selling of Exchange Traded Funds (ETFs) used by private investors as a play on the gold price. **Copper** also fell to a 3-year low, on prospects for reduced demand from China. In the **oil** market, the price of Brent Crude fell by some 7% during the quarter.





Property

13. The sluggishness of UK Commercial Property values is shown in the IPD Monthly Index data to end-June. The total return (including rental income) for the 12 months averaged just 4.1%. By sector the total returns were:

Offices	+6.0%
Industrial	+5.4%
Retail	+2.4%

The total return for the second quarter, however, was +1.9% -- which represented a slightly improved rate of growth.

Outlook

14. In July equity markets recovered most of the ground they had lost since the Federal Reserve's first statement on tapering Quantitative Easing on May 22nd. Government bond markets have also stabilised at yields some 0.7% above their lowest levels. Now that investors have become used to the idea that QE by the US will end during 2014, their focus has turned to the outlook for Chinese economic growth. If this can hold above 7.5% this year and next, many of the worst fears for commodities and Emerging Markets will have been allayed. Assuming China maintains this level of growth, I expect equities to trade in their recent range for the remainder of 2013. Bond yields, meanwhile, could move higher if growth in the US brings QE to an earlier end than currently envisaged.

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[All graphs sourced from Legal & General Investment Management]