

QUARTERLY REVIEW PREPARED FOR

Oxfordshire Council Pension Fund

Q2 2014

8 August 2014

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PENSION FUND COMMITTEE - 5 SEPTEMBER 2014

OVERVIEW AND OUTLOOK FOR INVESTMENT MARKETS

Report by the Independent Financial Adviser

Economy

1. The UK economy grew by 0.8% in each of the first two quarters of 2014, thereby restoring aggregate UK GDP to its peak level of 2008, although in per capita terms it is still more than 4% below its peak. Meanwhile US GDP surprised with a negative first quarter – possibly affected by the severe winter – and estimates for full-year 2014 growth were revised down by 0.7% by both the Federal Reserve and the IMF. The second quarter, however, appears to have produced healthy growth of 1% on the previous quarter. The sharp rise in the rate of inflation in Japan largely reflects the increase in consumption tax which came into force on April 1.

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

Consensus real growth (%)					Consumer prices latest (%)
	2012	2013	2014E	2015E	
UK	-0.1	+1.7	(+2.9) +3.1	+2.7	+1.9 (CPI)
USA	+2.2	+1.9	(+2.6) +2.0	+3.0	+2.1
Eurozone	-0.5	-0.4	(+1.2) +1.1	+1.6	+0.4
Japan	+1.9	+1.7	(+1.2) +1.4	+1.2	+3.6
China	+7.8	+7.7	(+7.3) +7.3	+7.0	+2.3

(Source of estimates: The Economist 9th August 2014)

2. In early June the European Central Bank cut its base rate from 0.25% to 0.15%, imposed a negative interest rate on central bank deposits, and announced a €400bn liquidity injection, in an effort to prevent deflation in the

Eurozone area. A week later, the Governor of the Bank of England said that the first rise in UK interest rates could be ‘sooner than markets currently expect’. This was interpreted as signalling a rate rise during 2014, and sterling appreciated in response.

3. In the US, the Federal Reserve has continued to reduce the level of Quantitative Easing (QE) by \$10bn each month. Recent employment data has shown a strong level of new jobs, but no rise in interest rates is expected until late-2015 at the earliest.
4. In the elections for the European Parliament in May, the extreme parties polled strongly in many countries, and in France the FN topped the poll, while the ruling Socialist party attracted only 14% of the vote. Further afield, India elected Narendra Modi of the BJP as Prime Minister, ending a long period of dominance by the Congress Party. He is seen as an economic moderniser, so the Indian stock market rose 15% on the result. In Thailand, the military declared martial law in May, and then took power in a coup days later. Markets in the region have taken this news calmly.
5. In Iraq the seizure of several key cities by ISIS forces, and the threats of escalation in the fighting with government forces, caused nervousness in the oil market on fears that supplies could be disrupted. The shooting-down of passenger airline MH17 over Eastern Ukraine on July 17th has resulted in a tightening of the sanctions imposed by the EU and the USA on Russia’s financial, energy and defence sectors.

Markets

6. **Equity** markets in general gained ground during the quarter, with the S&P 500 Index in the US reaching new highs, and Emerging Markets advancing under the lead of India, although developments in Iraq damaged sentiment during June.

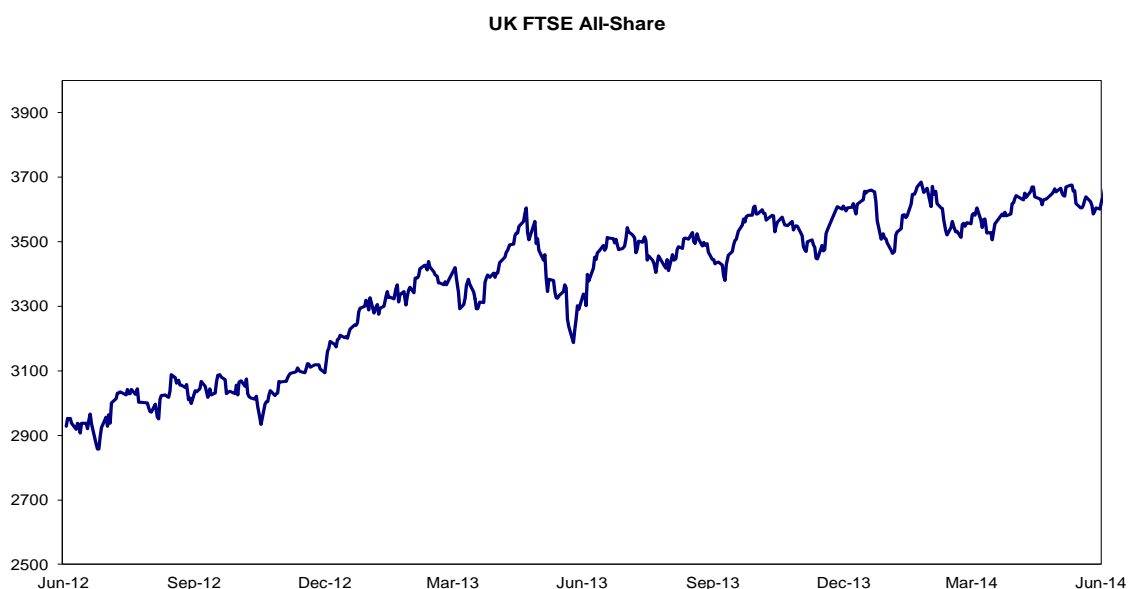
	Capital return (in £, %) to 30.06.14		
Weight %	Region	3 months	12 months
100.0	FTSE All-World Index	+1.8	+6.9
51.8	FTSE All-World North America	+2.4	+8.7
8.0	FTSE All-World Japan	+4.0	-3.6
11.7	FTSE All-World Asia Pacific ex Japan	+2.6	+1.6
17.4	FTSE All-World Europe (ex-UK)	-1.6	+12.0
7.9	FTSE All-World UK	+2.2	+8.3
9.2	FTSE All-World Emerging Markets	+3.7	-1.6

[Source: FTSE All-World Review, June 2014]

7. In the UK, the FTSE 100 Index out-performed the rest of the All-Share companies for the first quarter in two years.

(Capital only %, to 30.06.14)	3 months	12 months
FTSE 100	+ 2.2	+ 8.5
FTSE 250	- 3.4	+14.0
FTSE Small Cap	-0.7	+16.4
FTSE All-Share	+ 1.3	+ 9.4

The All-Share Index shows signs of having reached a plateau recently, after a steady rise since mid-2012 (see chart below).



8. By industrial sector there was little divergence, although Oil & Gas gained more than 8% as the oil price reacted to the situation in Iraq.

Capital return (in £, %) to 30.06.14		
Industry Group	3 months	12 months
Technology	+4.0	+17.5
Health Care	+1.9	+11.8
Oil & Gas	+8.3	+11.0

Industrials	+0.2	+9.2
FTSE All-World	+1.8	+6.9
Basic Materials	+1.1	+6.2
Utilities	+3.6	+5.4
Consumer Services	+0.2	+5.0
Financials	-0.2	+3.6
Telecommunications	+0.4	+0.9
Consumer Goods	+1.8	+0.9

[Source: FTSE All-World Review, June 2014]

9. **Government Bonds** continued their gains from the first quarter, most notably in Germany, although even Italian and Spanish government bonds were in demand, and – remarkably - their 10-year yields were equal to those on their US counterparts in mid-June. The yield spread of £ corporate bonds over gilts remained very narrow (see chart below). In July, there was evidence of investors selling high-yield bonds funds, and the Argentinian default at the end of July acted as a reminder of the risks of Emerging Market bonds.

10-year government bond yields (%)					
	Dec 11	Dec 12	Dec 2013	Mar 2014	June 2014
US	1.88	1.76	3.03	2.72	2.52
UK	1.98	1.85	3.04	2.73	2.68
Germany	1.83	1.32	1.94	1.57	1.25
Japan	0.98	0.79	0.74	0.65	0.57

[Source: Financial Times]

£ Non-Gilt Spread over Gilts



Currencies

10. Sterling continued to strengthen, on strong GDP numbers and the expectation of a base rate rise this year. At \$1.71 it has reached its highest level against the dollar for six years.

	31.03.14	30.06.14	£ move
\$ per £	1.667	1.710	+ 2.6%
€ per £	1.210	1.249	+ 3.2%
¥ per £	171.7	173.2	+ 0.9%

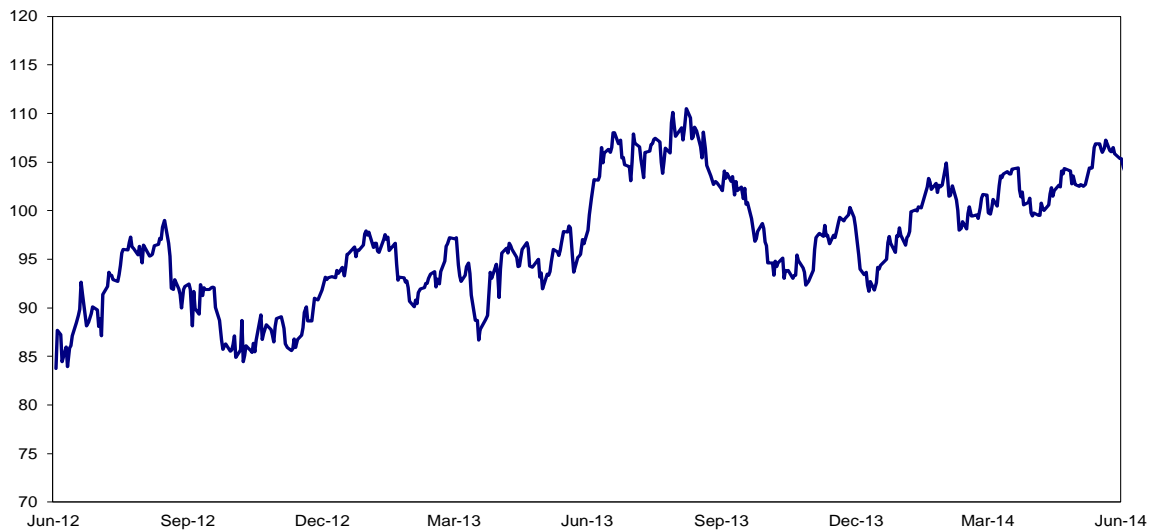
GBP vs EUR



Commodities

11. While the gold price gained just 2% in the quarter, copper recovered from its first-quarter weakness. The oil price rose sharply in June as worries about the impact of the fighting in Iraq heightened.

Oil



Property

12. The UK Property market has delivered extremely high returns in the past twelve months, with the pace of growth accelerating in the second quarter of 2014. The IPD UK Monthly Property Index to end-June 2014 shows 12-month total returns of :

All Property +17.6%

Retail + 12.5%

Office + 23.2%

Industrial + 22.3%

These returns derive mostly from higher property valuations, not from rising rental levels.

Outlook

13. During the second quarter, equity and bond markets continued to be propelled upwards by the artificially low interest rates being maintained by central banks, while investors' search for yield also attracted sizeable sums of money into the UK commercial property market. Several subsequent events have affected markets since the end of June: the Argentinian bond default, the need for a government/EU bailout of Portugal's largest bank (Banco Espirito Santo).
14. Meanwhile, geopolitical developments - notably Russia's increasing isolation over its activities in Ukraine, and the fighting in the Middle East – have dampened sentiment among investors. When combined with the impending tightening of monetary policy by UK and US central banks, the need for caution remains as strong as ever.

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August 8th, 2014

[All graphs supplied by Legal & General Investment Management]