Division(s): N/A

PENSION FUND COMMITTEE – 25 JUNE 2010

OVERVIEW AND OUTLOOK FOR INVESTMENT MARKETS

Report by the Independent Financial Adviser

The Economy

1. The global economic recovery is in progress, even though the rate of growth in the developed economies in 2010 and 2011 is likely to be at below-trend rates. In the emerging world, by contrast, economic growth has already returned to its pre-2008 pace, and in some of these countries monetary policy is being tightened in order to avoid overheating.

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

Consensus real growth (%)						**Consumer prices (%)**
	2007	**2008**	**2009**	**2010E**	**2011E**	
UK	+3.0	+0.7	- 4.7	(+1.4) +1.3	+ 2.1	+ 2.7 (CPI)
USA	+2.0	+1.2	- 2.5	(+3.0) +3.1	+ 2.9	+ 2.0
Eurozone	+2.6	+0.8	- 3.9	(+1.4) +1.2	+ 1.4	+ 1.3
Japan	+2.0	- 0.2	- 5.3	(+1.5) +1.9	+ 1.6	- 1.0
China	+11.9	+ 9.0	+ 8.7	(+9.6) +9.7	+ 8.2	+ 3.5

[Source of estimates: The Economist, 01.05.10]

2. In his Budget speech on 24 March, Alistair Darling forecast that UK government borrowing would be £167bn in the current fiscal year, or 11.8% of GDP, falling to 11.1% in 2010/11 and to 8.5% in 2011/12. These were based on GDP growth estimates of 1 -1.5% in calendar 2010, and 3 – 3.5% in 2011. The latter is some way ahead of the consensus forecast shown in the Table above.

3. Although it is acknowledged that severe cuts in government spending, together with tax rises, will be required in order to achieve the declared aim of halving the fiscal deficit within four years, the subsequent General Election campaign produced very little detail from any of the major parties on where these measures would fall. The main area of public disagreement concerned the relatively small sum of £6bn which Labour intended to raise from a further increase in National Insurance contributions next year.

4. In Europe, the situation regarding the Greek government's difficulty in servicing its borrowings intensified, with the ripples spreading from government bond markets to weakness in the Euro and, in April, to the equity markets, where banks and other companies with exposure to Greek credits were marked down sharply. The creditworthiness of other heavily-indebted Southern European countries was also brought into sharp focus.

5. In early May, the IMF and the Eurozone governments proposed a €110 bn rescue package, to head off the threat of immediate bankruptcy, in exchange for the introduction of a severe austerity package by the Greek government. The consequent civil unrest in Athens has alarmed investors around the world, and raises questions on whether such draconian cuts can be delivered.

Markets

6. After a hesitant start to 2010, **equity markets** moved ahead strongly in March, to record solid gains for the quarter. All industrial sectors rose, with notable strength in Industrials and Consumer Services (both +13.8% in £), while laggard sectors were Oil & Gas (+4.5%), Telecoms (+3.4%) and Utilities (+2.1%).

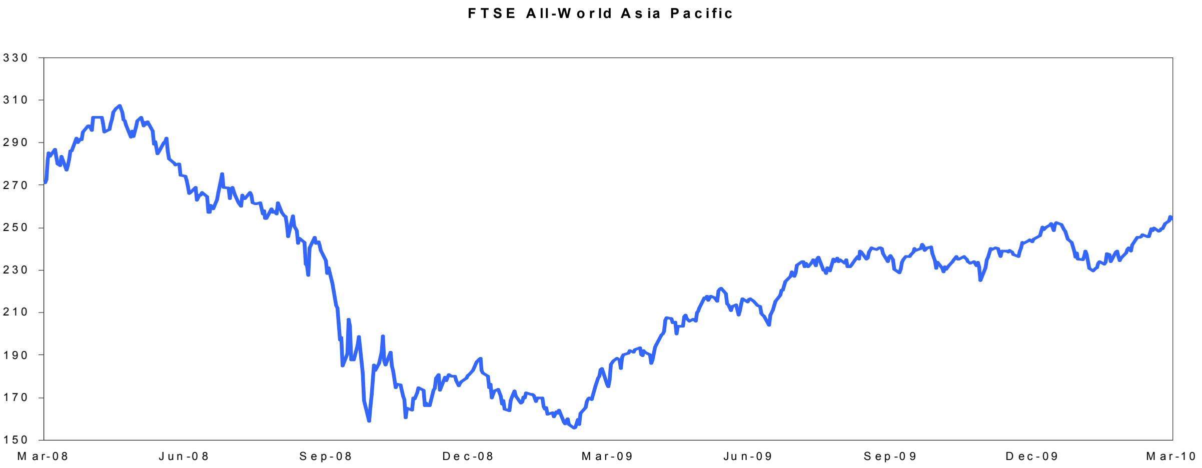
Capital return (in £, %) to 31.03.10	**3 months**	**12 months**
FTSE All-World Index	+ 9.3	+ 44.5
FTSE All-World North America	+11.9	+ 40.2
FTSE All-World Asia Pacific	+10.7	+ 48.2
FTSE All-World Europe (ex-UK)	+ 4.0	+ 44.7
FTSE All-World UK	+ 4.9	+ 45.4
FTSE All-World Emerging Markets	+ 8.8	+ 70.9

[Source: FTSE All-World Review, March 2010]

7. The strong rally of the past 12 months has lifted most equity markets to levels last seen in the summer of 2008, prior to the demise of Lehman Brothers. After the end of March, however, sentiment took a turn for the worse in most markets, as described in the final section of this report, so that those who believed that equities were being swept along on an ever-rising tide received a rude awakening.


S & P 500
1500
1400
1300
1200
1100
1000
900
800
700
600
Mar-08
Jun-08
Sep-08
Dec-08
Mar-09
Jun-09
Sep-09
Dec-09
Mar-10

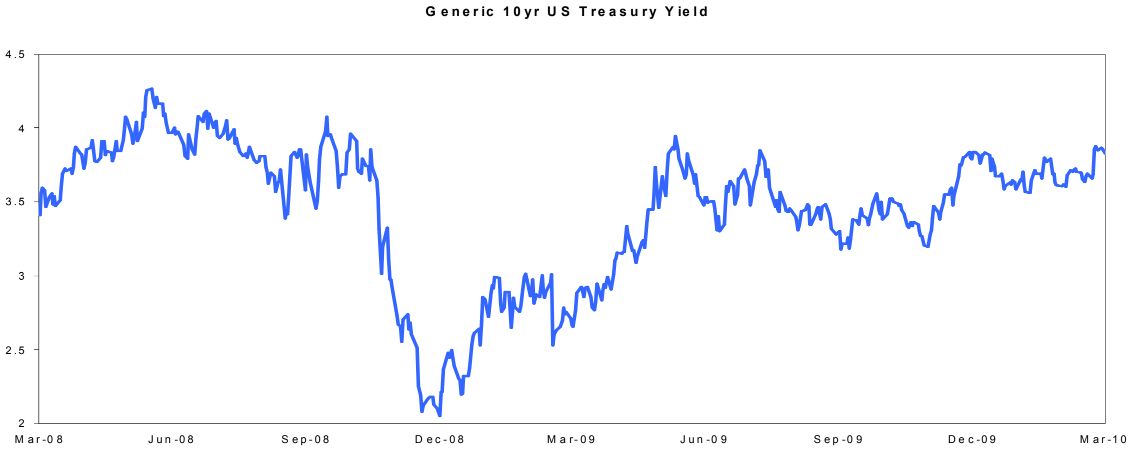

UK FTSE All-Share
3300
3100
2900
2700
2500
2300
2100
1900
1700
Mar-08
Jun-08
Sep-08
Dec-08
Mar-09
Jun-09
Sep-09
Dec-09
Mar-10

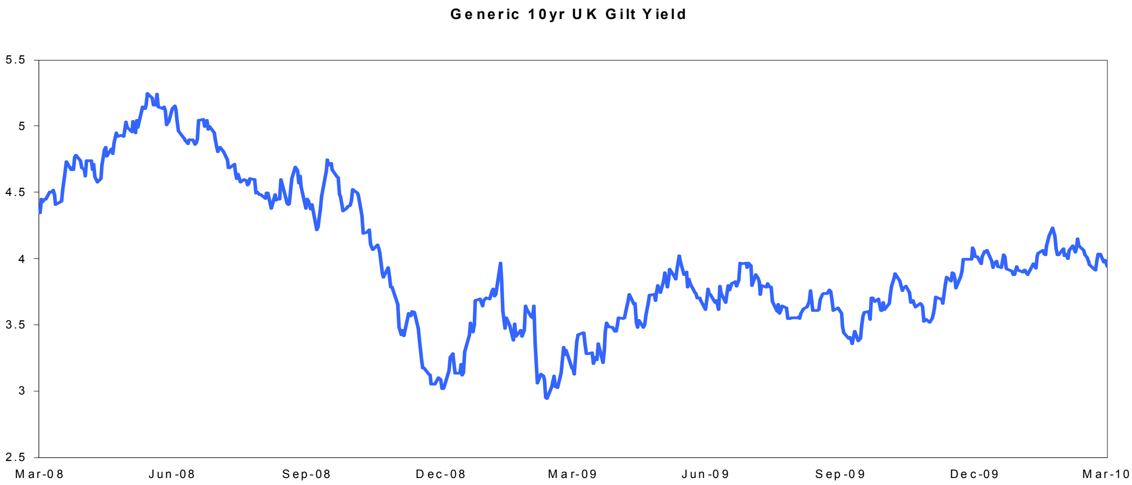

FTSE All-World Asia Pacific
330
310
290
270
250
230
210
190
170
150
Mar-08
Jun-08
Sep-08
Dec-08
Mar-09
Jun-09
Sep-09
Dec-09
Mar-10

8. There was little net movement in US or UK **government bond** yields during the quarter, although the problems in Greece caused bond investors to favour the stronger Eurozone borrowers, such as Germany, at the expense of Greece, Portugal and Spain.

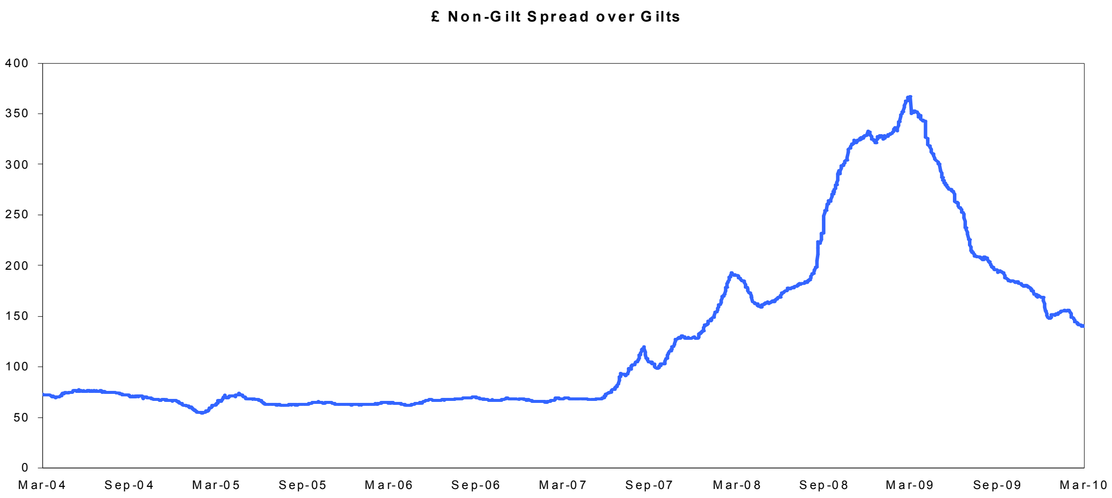
10-year government bond yields (%)	**Sept 2008**	**Dec 2008**	**Dec 2009**	**March 2010**
US	3.84	2.22	3.84	3.84
UK	4.46	3.02	4.01	3.95
Germany	4.04	2.95	3.40	3.09
Japan	1.48	1.18	1.29	1.41

[Source: Financial Times]





9. The spread on **UK Corporate Bonds** relative to gilts narrowed further, standing at some 150 basis points now as compared with over 350 basis points in March 2009.

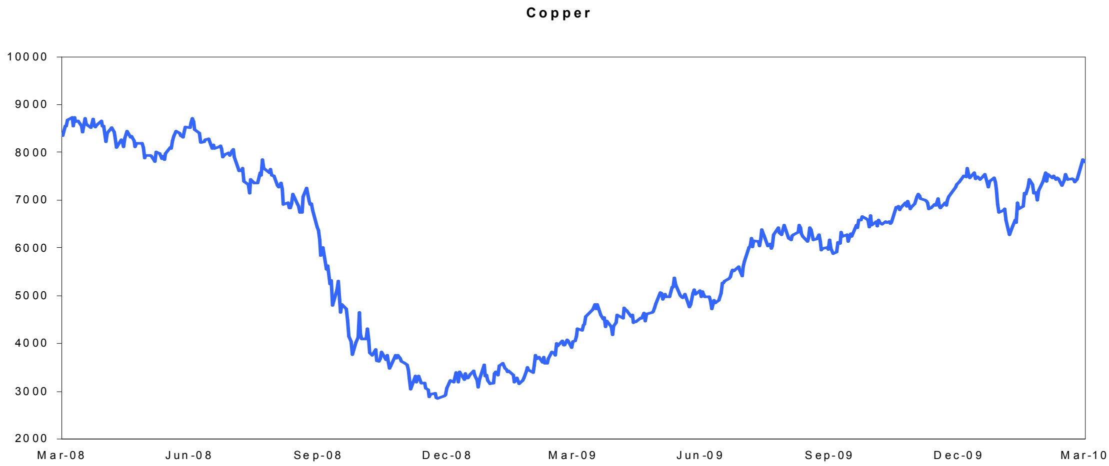


10. The recovery in **UK Property** values continued during the quarter, with the IPD All Property Monthly Index rising by some 6% on a total return basis. There were signs of stabilisation in office rental levels, after a long period of weakness, although retail and industrial rents are still edging lower. Several of the property pooled funds have reported sharp year-on-year price increases, although this usually reflects rebounds from heavy markdowns in 2008/09 when investor redemptions caused forced sales of properties.

Median fund returns to 31.03.10	**3 months**	**12 months**
Balanced Funds (n= 27)	+ 4.9%	+ 13.4%
Specialist Funds (n= 34)	+ 7.2%	+ 14.5%

[Source: IPD UK Pooled Property Funds]

11. In **Commodities**, Oil has continued to trade close to the $80 level, while Gold has fluctuated narrowly either side of $1100. (The strength of the $ has of course caused an increase in the price in £ or € terms). The Copper price rose to $8000 in March, but has since fallen back to $7000, on lower expectations for industrial demand.



12. In the **currency** markets, the dollar and yen were the strongest denominations, while the Euro was hit hard by worries about the effect that Greece's problems would cause. The Euro had fallen by 6% against the dollar by the end of March, and fell further as the Greek crisis intensified in April. Sterling also fell 6% against the dollar, to $1.517, on worries about the UK's deficit and the uncertainties of the forthcoming General Election.

Outlook

13. Sentiment in world equity and bond markets has deteriorated sharply since mid-April. The news that the Securities and Exchange Commission was pressing a civil suit for fraud against Goldman Sachs in connection with a collateralized debt obligations issue they led in 2007 reawakened memories of the credit crisis, and raised the spectre of further civil – or even criminal – actions against financial institutions. Meanwhile, the Greek debt crisis became increasingly serious as discussions over a rescue package appeared to stall, and credit ratings for Greece, Spain and Portugal were cut.

14. Against this background, equity markets fell by some 10% in late-April/early May, and the pound and Euro lost 5% in a week against the dollar. Sterling's move was also affected by the prospect of a hung parliament after the General Election.

15. The announcement early on 10 May of the € 750bn rescue package from the International Monetary Fund, the European Central Bank and the EU initially triggered a sharp rise in equities worldwide, and strength in the bonds of the weaker Eurozone members. Within a week, however, this euphoria had evaporated in the face of worries about the possible longer-term impact on European inflation from the injection of funds by the ECB. Equity markets declined once more, the Euro fell back to $1.25 (having started 2010 at $1.435) and the price of Gold surpassed the $1200 level.

16. In the UK, meanwhile, the General Election on 6 May had not produced an overall majority for any single party, but on 11 May the Conservatives and the Liberal Democrats were able to form a coalition government commanding an overall Commons majority of 80. Early announcements of spending cuts are expected, with the aim of reducing the fiscal deficit, and the Budget on 22 June is likely to include sizeable tax increases.

17. At the Interim Meeting, held in Oxford on 13 May, the latest valuation of the portfolio showed that the weights of all asset classes lay within their permitted ranges. In particular, Equities were 1.5% above their target, while Bonds were 0.3% below theirs. Uninvested Cash stood at £35m, or £20m above its £15m minimum level, but it was decided that with the unattractive near-term outlook for Equities, Bonds and Property, the £20m (equal to 1.8% of the total Fund) should be retained in liquid form.

18. With so many serious issues weighing on investors' minds, and with little likelihood of a speedy resolution to any of them, I maintain my cautious view on risk assets. If equities fall much further, I would recommend investing part of the cash balance into the equity markets, but there is no urgent need to do so.

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