Division(s): N/A

PENSION FUND COMMITTEE – 3 SEPTEMBER 2010

OVERVIEW AND OUTLOOK FOR INVESTMENT MARKETS

Report by the Independent Financial Adviser

The Economy

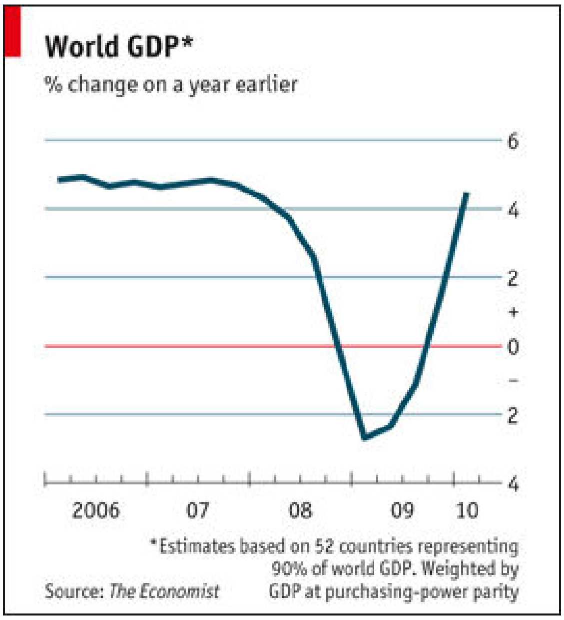
1. Growth forecasts for Western economies this year have remained steady, while Japan is expected to recover faster than previously expected. Recent data from the United States, however, has shown a slowdown in second quarter GDP growth to 2.4% annualised, from 3.7% in the first quarter, as well as a disappointing rate of private sector job creation in July. The Fed has responded by deferring the monetary tightening it had planned.

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

Consensus real growth (%)						**Consumer prices (%)**
	2007	**2008**	**2009**	**2010E**	**2011E**	**2010E**
UK	+3.0	+0.7	-4.7	(+1.3) +1.4	+1.9	+3.0 (CPI)
USA	+2.0	+1.2	-2.5	(+3.1) +3.0	+2.8	+1.7
Eurozone	+2.6	+0.8	-3.9	(+1.2) +1.2	+1.3	+1.5
Japan	+2.0	-0.2	-5.3	(+1.9) +3.2	+1.6	-0.9
China	+11.9	+9.0	+8.7	(+9.7) +9.9	+8.3	+3.0

[Source of estimates: The Economist, 07.08.10]

The extent of the fall – and subsequent recovery – in global GDP during the past four years is shown in this graph from The Economist.



2. In his first Budget as UK Chancellor on 22 June, George Osborne announced plans to cut spending and raise taxes with the aim of reducing the Public Sector Borrowing Requirement from £149bn in 2010/11 to £37bn (or 2% of national income) in 2014/15. These measures would further tighten the fiscal programme of the outgoing Labour government which had planned to reduce PSBR to 4% of national income in 2014/15.

3. The coalition's plan envisages spending cuts by unprotected government departments of 25% by 2014/15, with additional savings coming from reductions in welfare spending. Tax increases will include raising the rate of VAT from 17.5% to 20% in January 2011.

4. The emergency measures announced in May by the IMF, the ECB and the EU, involving a €750bn rescue package to allow Greece to roll over its debt obligations, has taken the immediate pressure off the Euro, but is generally seen as a temporary fix. The real test will be whether the heavily-indebted Eurozone members can push through the fiscal measures needed to reduce government debt significantly.

Markets

5. After extending their first-quarter gains during the first part of April, **equity markets** turned down sharply in the face of a number of separate events: Goldman Sachs' problems with the US regulators; the Eurozone crisis triggered by the threat of a debt default by Greece and, potentially, other Eurozone members; and the catastrophic explosion and oil spill from a BP rig in the Gulf of Mexico. By the end of June, all equity markets had experienced sharp falls, as shown in the following Table, ending four successive quarters in which equities had advanced.

Capital return (in £, %) to 30.06.10		
	3 months	**12 months**
FTSE All-World Index	-11.5	+ 20.7
FTSE All-World North America	-10.8	+ 23.6
FTSE All-World Asia Pacific	- 8.1	+ 21.5
FTSE All-World Europe (ex-UK)	-16.1	+ 13.7
FTSE All-World UK	-13.4	+ 15.7
FTSE All-World Emerging Markets	- 7.5	+ 34.6

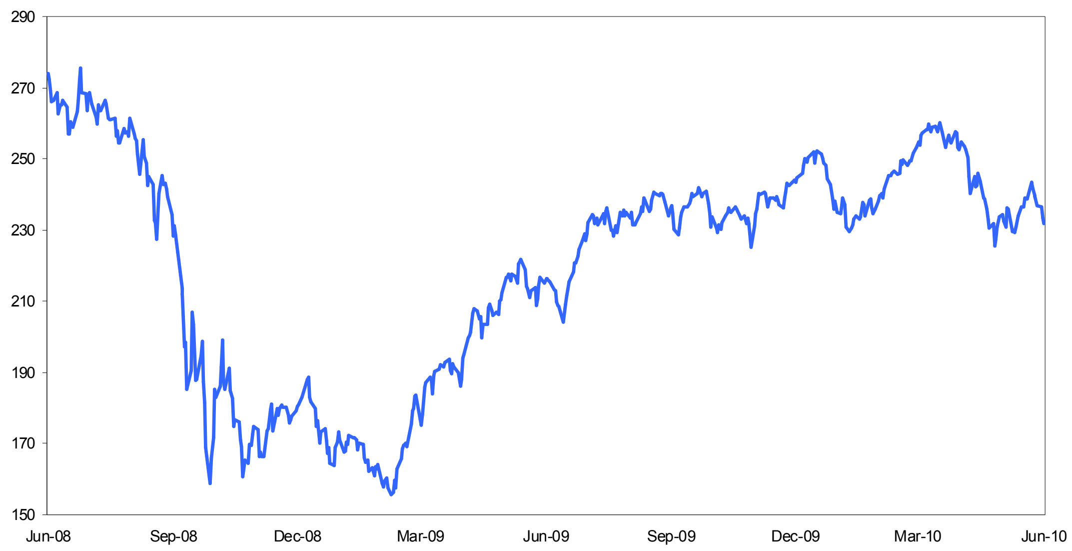
[Source: FTSE All-World Review, June 2010]

6. The weakest sectors were Oil & Gas (significantly affected by BP), Basic Materials and Financials, which all fell by 14 – 15%. Even the most resilient sector – Consumer Goods – fell 6.5%.

S&P 500

UK FTSE All-Share

FTSE All-World Asia Pacific



7. There was strong demand for those **government bonds** seen as 'safe havens' by investors worried about the risks in peripheral Eurozone markets. US, UK, German and Japanese government bonds all appreciated sharply.

10-year government bond yields (%)				
	Dec 2008	**Dec 2009**	**March 2010**	**June 2010**
US	2.22	3.84	3.84	2.96
UK	3.02	4.01	3.95	3.35
Germany	2.95	3.40	3.09	2.58
Japan	1.18	1.29	1.41	1.09

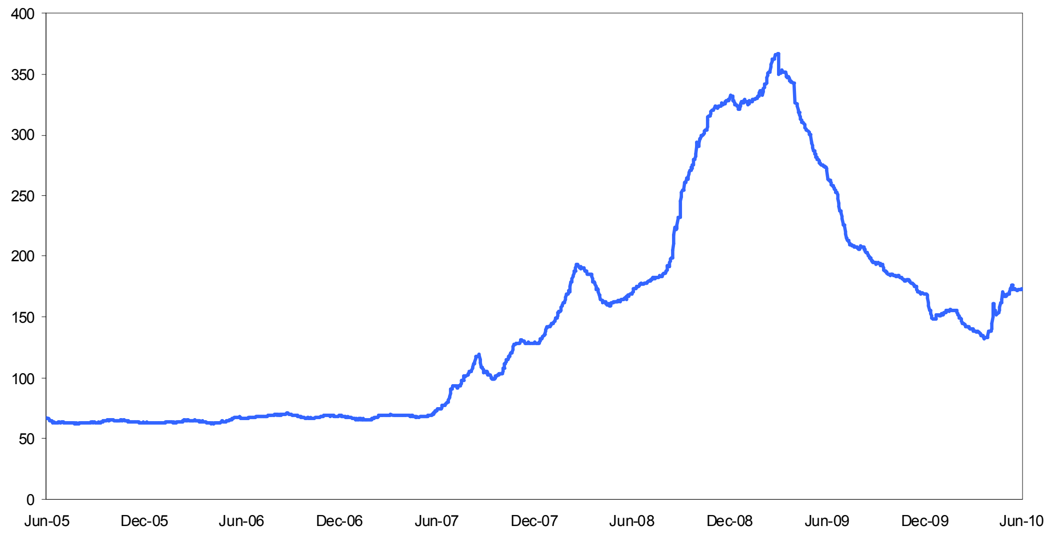
[Source: Financial Times]

Generic 10yr US Treasury Yield

Generic 10yr UK Gilt Yield

8. The spread on UK corporate bonds relative to gilt-edged widened slightly, but because of the strength of gilts, absolute yields still fell during the quarter, and corporate bond prices were stable.

£ Non-Gilt Spread over Gilts

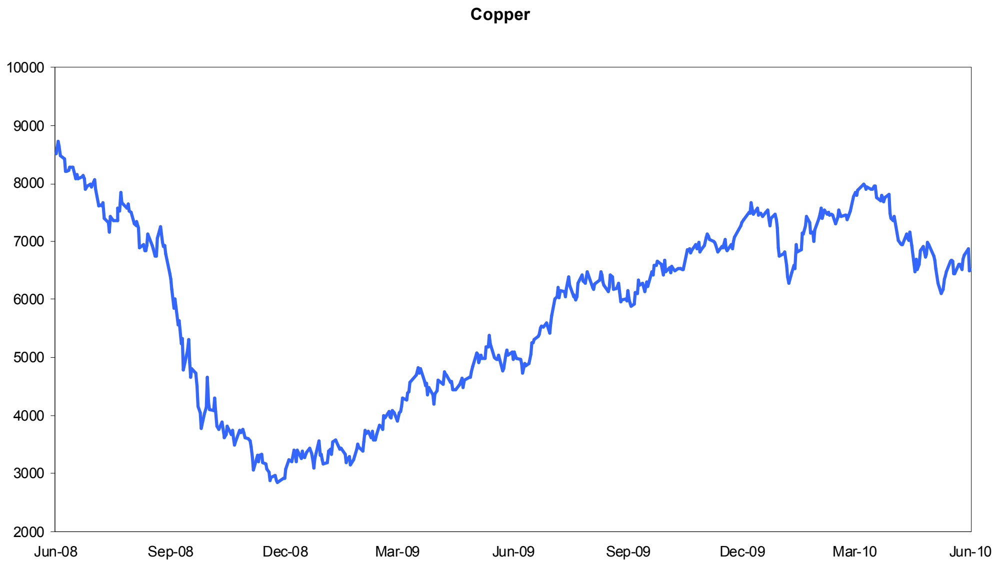


9. **UK Property Funds** reported steady single-digit gains during the second quarter, amid signs that new money is being committed to this sector, and very few funds are still dealing with redemptions from their investors. As previously noted, the specialist funds, which are usually more heavily-geared than balanced funds, have reported some spectacular gains from their depressed levels of mid-2009.

Median fund returns to 30.06.10	3 months	12 months
Balanced Funds (n= 25)	+ 3.0%	+ 19.3%
Specialist Funds (n= 34)	+ 3.4%	+ 29.9%

[Source: IPD UK pooled property funds]

10. Within **commodities**, the oil price (Brent crude) retreated from its peak of $86 in April to end the quarter at $75 per barrel, while the copper price displayed a similar pattern. Gold, by contrast, ended the quarter at $1240 per oz, a rise of 11% since the end of March.



11. The main features of the **currency markets** were the weakness of the Euro and the strength of the Yen. Amid worries about the future of the Eurozone should Greece default, the Euro lost nearly 10% against the dollar during the quarter, although it recouped half of this in July. The yen rose steadily against the dollar, reaching a 15-year peak level during July. The pound, meanwhile, was flat against the dollar during the second quarter, but has gained ground since then, and almost reached $1.60 in late July.

PF6


GBP vs EUR
1.3
1.25
1.2
1.15
1.1
1.05
1
Jun-08
Sep-08
Dec-08
Mar-09
Jun-09
Sep-09
Dec-09
Mar-10
Jun-10


GBP vs USD
2.1
2
1.9
1.8
1.7
1.6
1.5
1.4
1.3
Jun-08
Sep-08
Dec-08
Mar-09
Jun-09
Sep-09
Dec-09
Mar-10
Jun-10


GBP vs JPY
220
210
200
190
180
170
160
150
140
130
120
Jun-08
Sep-08
Dec-08
Mar-09
Jun-09
Sep-09
Dec-09
Mar-10
Jun-10

Outlook

12. The latest employment and GDP growth data from the US has reminded us all that a resumption of pre-crisis levels of growth is by no means certain. Even if the feared 'double-dip recession' does not happen, there is still a real threat of sluggish growth this year and next.

13. While this threat remains, central banks are committed to keeping in place stimulative monetary measures – in the form of low interest rates and quantitative easing, for example – for some months yet. The longer-term question still remains whether Western economies will be able to return to trend growth when these measures are reduced or even withdrawn.

14. The scale of public spending cuts planned by the UK government during the next five years seems bound to increase the level of unemployment and dampen consumer spending. There is still a lively debate amongst economists, as well as politicians, as to whether the additional cuts will further delay economic recovery.

15. Despite this dull outlook for economic growth, there are nevertheless worries that inflation will rise to uncomfortable levels. The Bank of England expects CPI to remain above its target level during 2010, even before the price-effect of the VAT increase in January 2011.

16. Government bond markets in US, UK, Germany and Japan are clearly reflecting the recessionary outlook – *10-year* yields of 2.5% in Germany, 2.75% in US and just over 3% in the UK do not leave much margin for any inflationary upturn before 2020, and appear unattractive in my opinion.

17. Equity markets, by contrast, are incorporating a more optimistic view of economic growth – not least in the Asia-Pacific region – and the resurgence of corporate profits in the current year. Company-specific news can still cause a sharp reaction in share prices, as in the case of BP, so that stock-picking remains as crucial as ever.

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