Division(s): N/A

PENSION FUND COMMITTEE – 3 DECEMBER 2010

OVERVIEW AND OUTLOOK FOR INVESTMENT MARKETS

Report by the Independent Financial Adviser

The Economy

1. The progress of GDP growth in the major developed economies continues to be patchy. Third quarter data from the United States of 0.5% quarter on quarter growth was below expectations, although the UK growth rate of 0.8% was well ahead of the 0.4% figure expected. Forecasts for US and Japanese growth in 2011 have also been scaled back since the previous report. In China, by contrast, the central bank has *raised* interest rates in order to curb inflationary tendencies.

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

Consensus real growth (%)						**Consumer prices (%)**
	2007	**2008**	**2009**	**2010E**	**2011E**	**2010E**
UK	+3.0	+0.7	- 4.7	(+1.4) +1.7	+ 1.8	+ 3.0 (CPI)
USA	+2.0	+1.2	- 2.5	(+3.0) +2.6	+ 2.3	+ 1.6
Eurozone	+2.6	+0.8	- 3.9	(+1.2) +1.6	+ 1.3	+ 1.6
Japan	+2.0	- 0.2	- 5.3	(+3.2) +2.9	+ 1.3	- 0.9
China	+11.9	+ 9.0	+ 8.7	(+9.9) +9.9	+ 8.6	+ 3.0

[Source of estimates: The Economist, 06.11.10]

2. Speculation during the summer centred on whether the Federal Reserve would decide to embark on a second round of quantitative easing (dubbed QE2) with the aim of stimulating the US economy. The disappointing data on growth and employment finally persuaded the Fed to announce in early November a programme of up to $600bn of purchases of Treasury bonds over eight months.

3. In the UK, attention was focused on the Chancellor’s Comprehensive Spending Review scheduled for 20 October. This would provide details of the coalition government’s spending cuts which had been announced in aggregate in the June Budget. Despite moderating the public spending cuts by some £2bn per annum, the Chancellor‘s measures still implied a 12.7% real cut in spending by 2014-15. Two proposals of significance for Local

Government Pension Schemes were the switch from RPI to CPI for inflation-linking of benefits, and the probable increase in employee contributions when the final Hutton Report is published.

4. While the Greek sovereign debt crisis faded from the headlines – perhaps temporarily – attention turned to other heavily-indebted members of the Eurozone, and the yield premium on Spanish, Portuguese and Irish debt widened sharply. There were fears that the healthier European economies – notably Germany – would refuse to contribute to future packages to bail out the weaker credits.

Markets

5. The slide in equity markets, which started in April and resulted in a 10-15% fall in prices, came to an end early in July, and in the subsequent rally shares had recouped most of the losses by the end of September as investor sentiment improved. Later in the autumn, most indices surpassed their April 2010 highs, to reach levels last seen in mid-2008. Ironically, one of the triggers for this strength was the expectation that the Federal Reserve would inject liquidity into the system in order to stimulate the flagging US economy.

Capital return (in £, %) to 30.09.10		
	3 months	**12 months**
FTSE All-World Index	+ 8.1	+ 7.9
FTSE All-World North America	+ 5.3	+ 9.6
FTSE All-World Asia Pacific	+ 6.9	+10.1
FTSE All-World Europe (ex-UK)	+13.0	- 1.0
FTSE All-World UK	+12.7	+ 7.7
FTSE All-World Emerging Markets	+11.1	+20.3

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

6. All ten global industrial sectors rose during the quarter. The strongest were Basic Materials (+14%) - spurred by the rise in metals prices - and Telecommunications (+12%), while Health Care, Technology and Utilities each gained just 4 – 6%.

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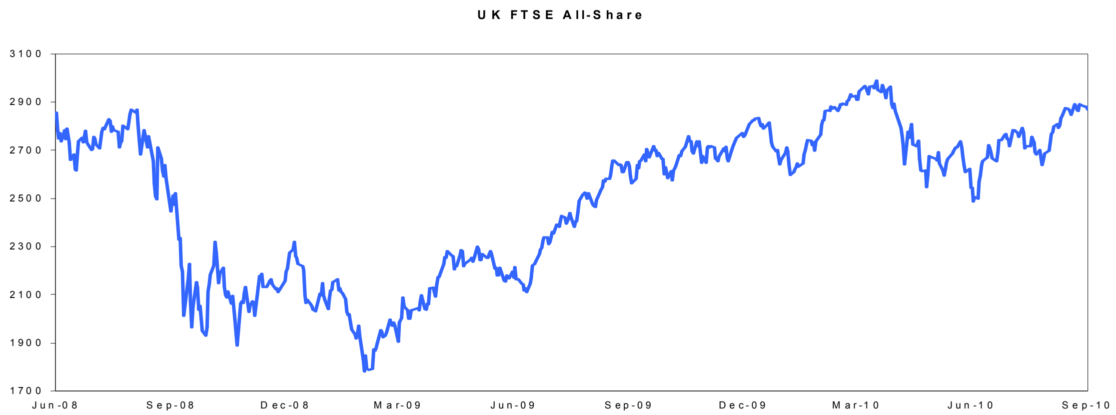
UK FTSE All-Share
3100
2900
2700
2500
2300
2100
1900
1700
Jun-08
Sep-08
Dec-08
Mar-09
Jun-09
Sep-09
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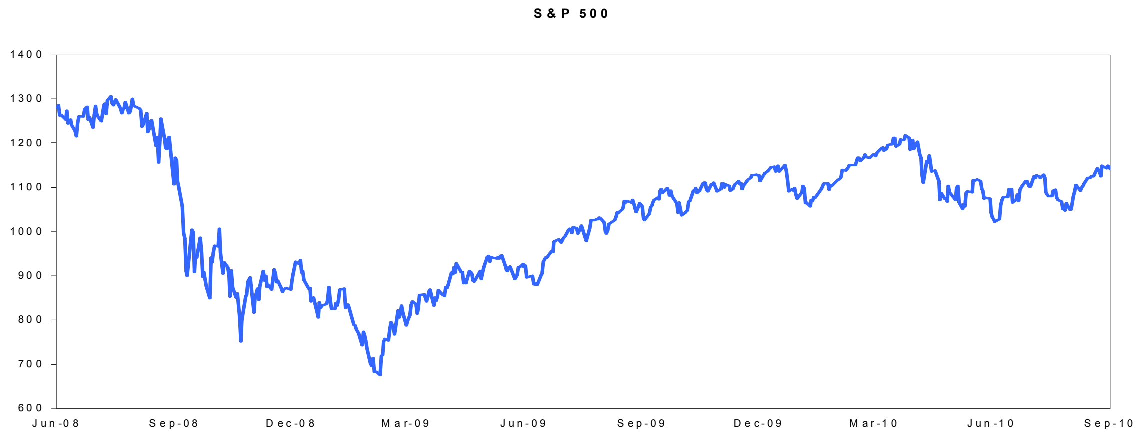
Mar-10
Jun-10
Sep-10


S&P 500
1400
1300
1200
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1000
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Jun-08
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Mar-10
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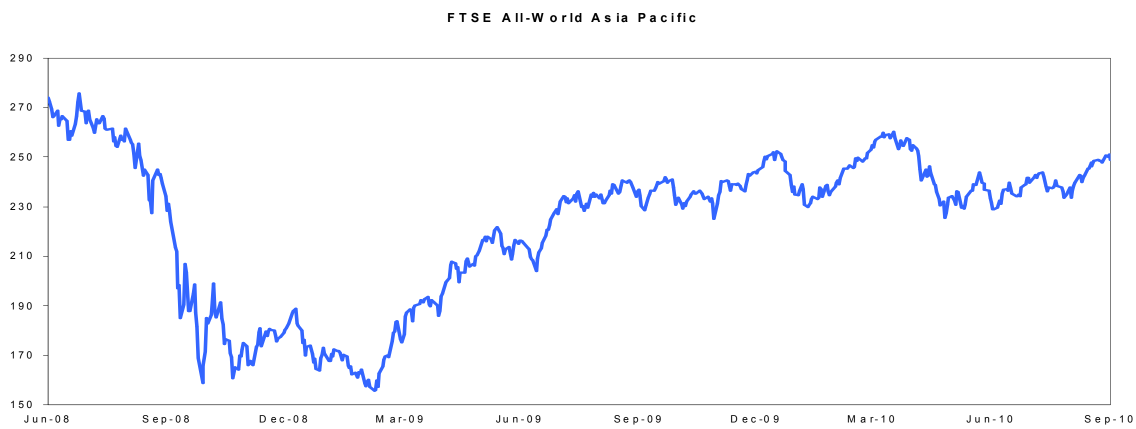
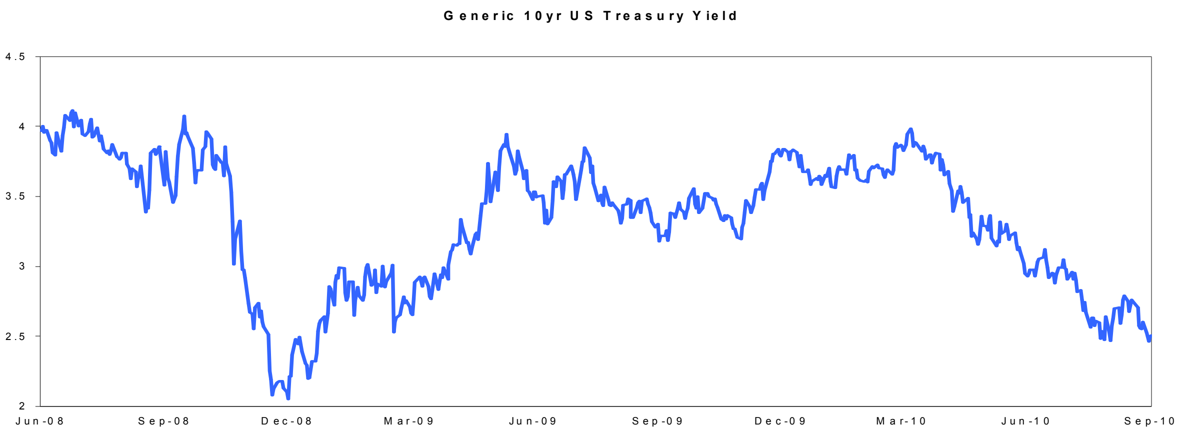
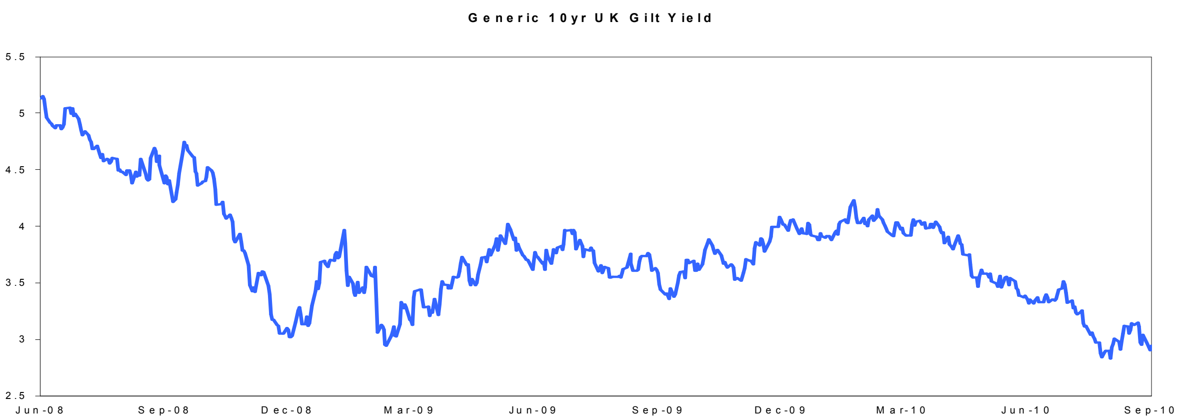

FTSE All-World Asia Pacific
290
270
250
230
210
190
170
150
Jun-08
Sep-08
Dec-08
Mar-09
Jun-09
Sep-09
Dec-09
Mar-10
Jun-10
Sep-10

7. The second-quarter surge in **government bond** prices in the US, UK, Germany and Japan continued in the third quarter, with sharp falls in the yields as shown in the table below.

10-year government bond yields (%)				
	Dec 2008	**Dec 2009**	**June 2010**	**Sept 2010**
US	2.22	3.84	2.96	2.52
UK	3.02	4.01	3.35	2.95
Germany	2.95	3.40	2.58	2.29
Japan	1.18	1.29	1.09	0.94

[Source: Financial Times]





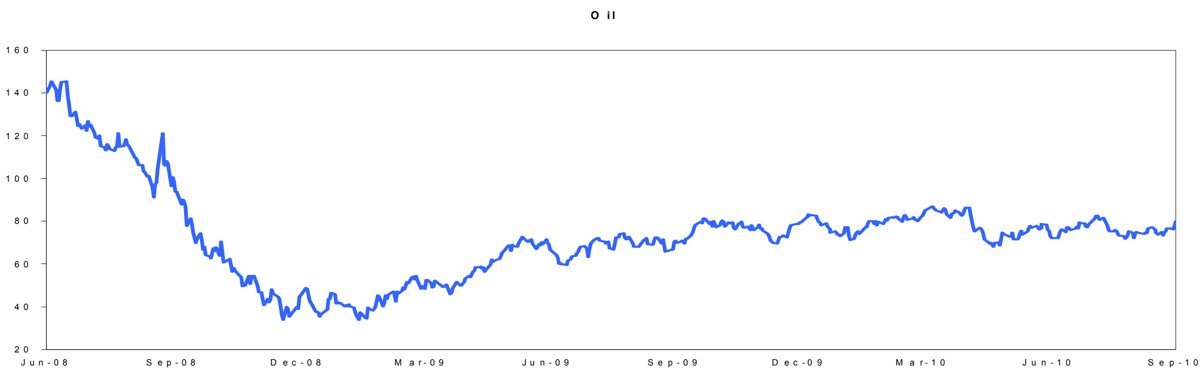
8. The spread on **UK Corporate Bonds** relative to gilts narrowed slightly during the quarter, giving good absolute returns on this sector of the portfolio.

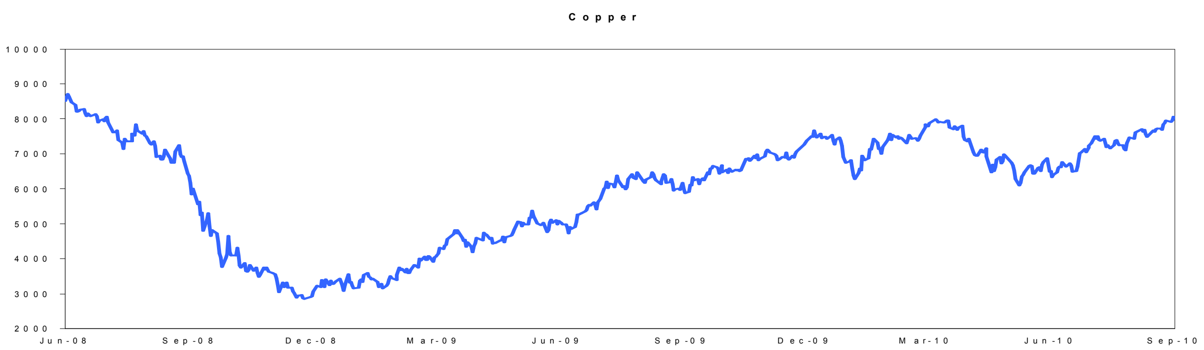
9. Values in the **UK Property** market have started to level off after their strong growth since the summer of 2009, although rental levels are sluggish and secondary properties are still not attracting much interest from investors.

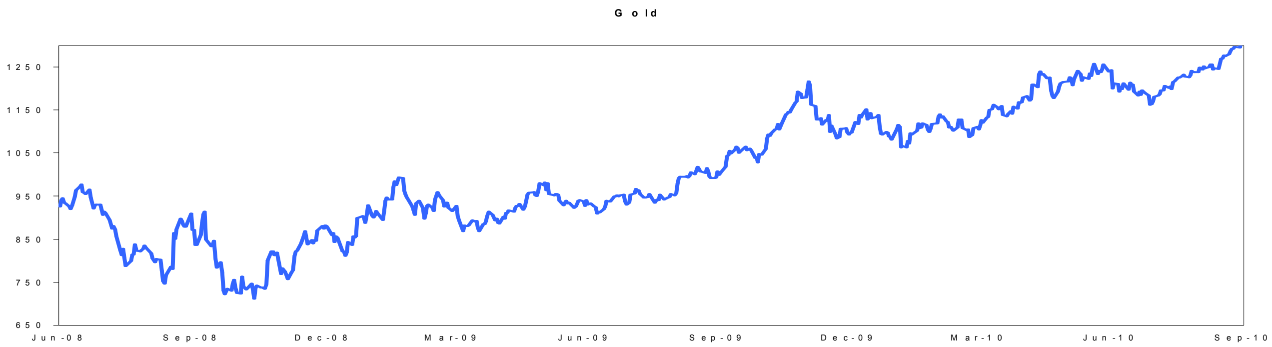
Median fund returns to 30.09.10	**3 months**	**12 months**
Balanced Funds (n= 27)	+ 1.9%	+ 18.4%
Specialist Funds (n= 31)	+ 2.0%	+ 26.7%

[Source: IPD UK pooled property funds]

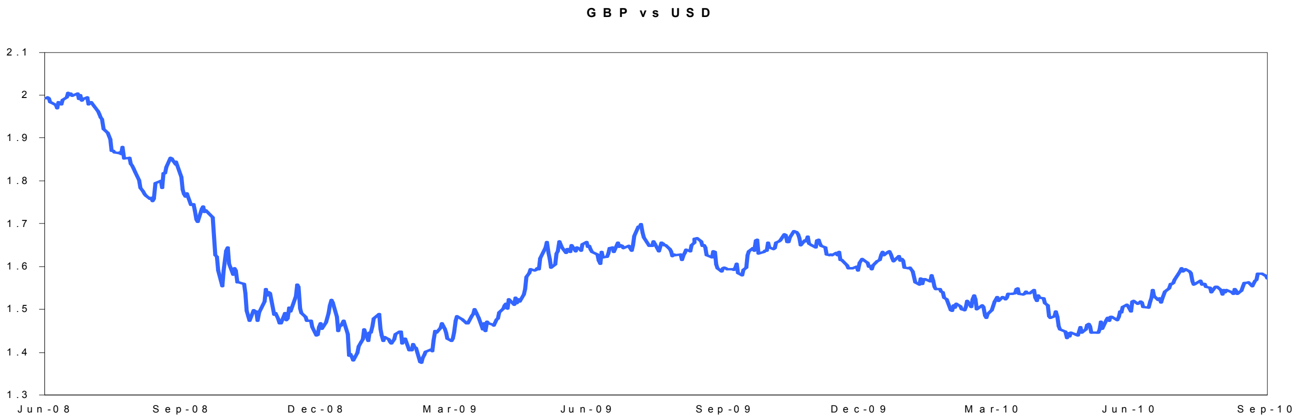
10. In **Commodities**, the oil price remained stable around the $80/barrel level, while copper and gold both appreciated further during the quarter (albeit in depreciated $ terms – see paragraph 11). Gold rose by 5% during the quarter to $1309/oz, and has since risen to $1400, on fears of monetary easing by central banks, and signs that some monetary authorities planned to become net buyers of gold.

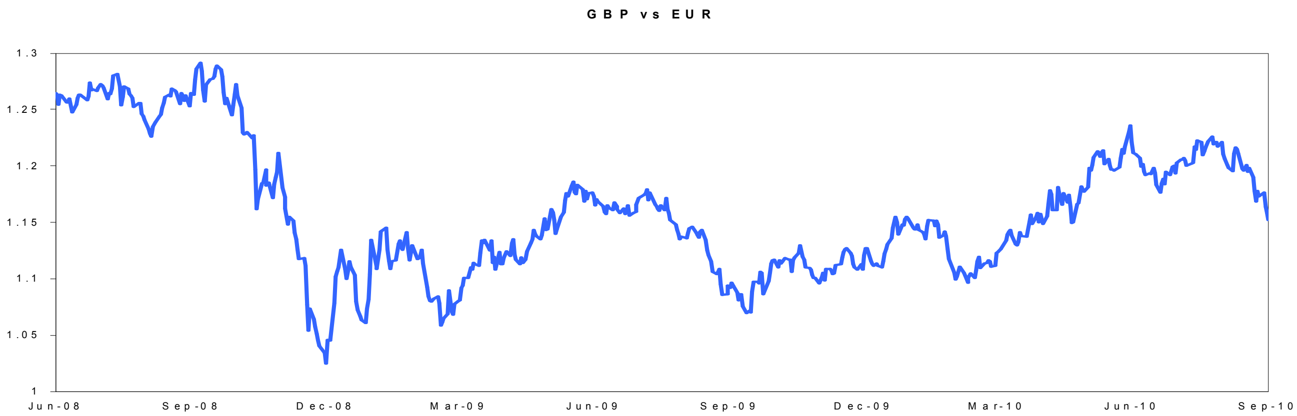






11. The feature of **currency** markets during the quarter was the weakness of the dollar. It lost 5% against the pound and the yen, and 10% against the euro, during the quarter, on fears of quantitative easing by the Federal Reserve. It then weakened further, when the Fed announced QE2 early in November. The Japanese authorities had earlier intervened to try to prevent the yen rising beyond Y83 per $, but with limited success.





Outlook

12. The sharp rally in equities during the third quarter was not based on any improvement in the global economic outlook, but rather on the anticipation – subsequently confirmed – that the US authorities would need to inject further liquidity into markets as a stimulus to GDP growth via increased lending.

13. At the same time, prices of industrial metals have risen strongly, on rising demand by China and other Asian producers, but this carries with it the threat of higher consumer prices in the West. With Western governments already introducing austerity programmes to pare their fiscal deficits, this further squeeze on consumer spending would be most unwelcome.

14. The substantial rises in equity markets over the past 18 months have been justified by the strong gains in corporate profits since the credit crisis. Earnings per share in the US, Europe and Asia ex-Japan are expected to rise by 35 – 40% in 2010, with a further rise of 10-15% in 2011. Even so, 2010 price/earnings averages of 11-12 in Europe and 13 – 14 in US and Asia ex-Japan are below historic averages. If profits do indeed grow as expected in 2011, then prospective multiples for 2011 do not make equities look expensive.

15. While medium- to long-term government bond yields in US, UK, Germany and Japan still look extremely low on any prospective view of likely inflation levels, they are attractive as secure, liquid assets to Central Banks, clearing banks, insurers and pension funds seeking to match their liabilities. It is on these grounds, as well as providing insurance against deflation, that they have been in such demand.

16. While changes in sentiment, or unexpected events, can always cause sudden fluctuations in equity markets, the Fund's present position of holding a high equity content, and a low cash balance, looks justified on fundamental grounds.

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November 2010