PENSION FUND COMMITTEE – 3 June 2011

OVERVIEW AND OUTLOOK FOR INVESTMENT MARKETS

Report by the Independent Financial Adviser

The Economy

1.The most significant change in the 2011 forecasts has been in Japan, where the disaster of the earthquake and tsunami of 11 March, and the consequent disruption to industrial production, is expected to reduce GDP growth to just 0.7% this year. The UK reported preliminary growth of +0.5% in Q1 – reversing the contraction in the previous quarter – but the comparison with the US economy makes poor reading. The US grew by 0.7% in Q4 2010, and then by 0.4% in Q1 2011, so that its output now stands 0.6% above its pre-crisis level, whereas the UK's output is still 4% *below* its pre-crisis level.

Consensus real growth (%)						Consumer prices latest (%)
	2008	2009	2010	2011E	2012E	
UK	+0.7	- 4.7	+1.6	(+1.8) +1.6	+1.9	+ 4.0 (CPI)
USA	+1.2	- 2.5	+2.9	(+3.1) +2.9	+3.1	+ 2.7
Eurozone	+0.8	- 3.9	+1.7	(+1.5) +1.7	+1.7	+ 2.7
Japan	- 0.2	- 5.3	+4.2	(+1.5) +0.7	+2.3	0.0
China	+ 9.0	+ 8.7	+10.3	(+9.0 +9.0	+8.7	+ 5.4

[Source of estimates: The Economist, 30.04.2011]

2. In the UK Budget on 23 March, George Osborne stuck to his plans for reducing public sector borrowing this year, although the annual figure for the next five years will be £10bn higher than previously forecast, largely because of the effects of higher inflation. This is now officially expected to be 4.5% in 2011 (instead of 3%) and 2.5% in 2012 (cf 1.9%). The Chancellor also cut his GDP growth forecasts to 1.7% this year, 2.5% in 2012 and 2.9% in the two subsequent years. The weakness of the UK economy has so far delayed the rise in interest rates expected from the MPC, even though opinion amongst its members is divided. By contrast, the European Central Bank raised its rate from 1% to 1.25% on 7 April to counter the risks of inflation, and China continued to increase interest rates and bank reserve ratios in order to curb inflation.

3. Portugal became the third EU country to request a bail-out, following in the footsteps of Greece and Ireland. On 6 April, Portugal's outgoing prime minister confirmed that a rescue from the EU and the IMF was needed – a move that had been priced in by the bond markets once the government's latest austerity package had been voted down in the Portuguese parliament. The size of the bail-out was later announced as €78bn.

Markets

4. Popular uprisings in North Africa, and later in the Middle East, have caused concern to **Equity** markets, not least because of the sharp rise in oil prices which has resulted. The leaders of Algeria and then Egypt were forced to relinquish power in the face of public demonstrations, and in Libya Colonel Gaddafi's violent response has brought in NATO forces to protect the population. Meanwhile other autocracies – Bahrain and Syria – have experienced opposition from populations dissatisfied with their lack of democratic rights.

5. In Japan, equities fell by 15% in the two days after the tsunami, but regained half of this loss in the final two weeks of March. In addition to the immediate effects on nuclear power generation, the restrictions on the supply of conventional power to factories have severely disrupted production of cars, electronic goods etc. Japan's industrial production fell by 15.3% month-on-month in March. Other markets have recouped the falls seen immediately after the tsunami.

Capital return (in £, %) to 31.3.11		
	3 months	**12 months**
FTSE All-World Index	+1.5	+5.7
FTSE All-World North America	+3.0	+7.4
FTSE All-World Asia Pacific	-3.5	+3.9
FTSE All-World Europe (ex-UK)	+5.5	+4.7
FTSE All-World UK	+0.3	+3.7
FTSE All-World Emerging Markets	-1.5	+9.1

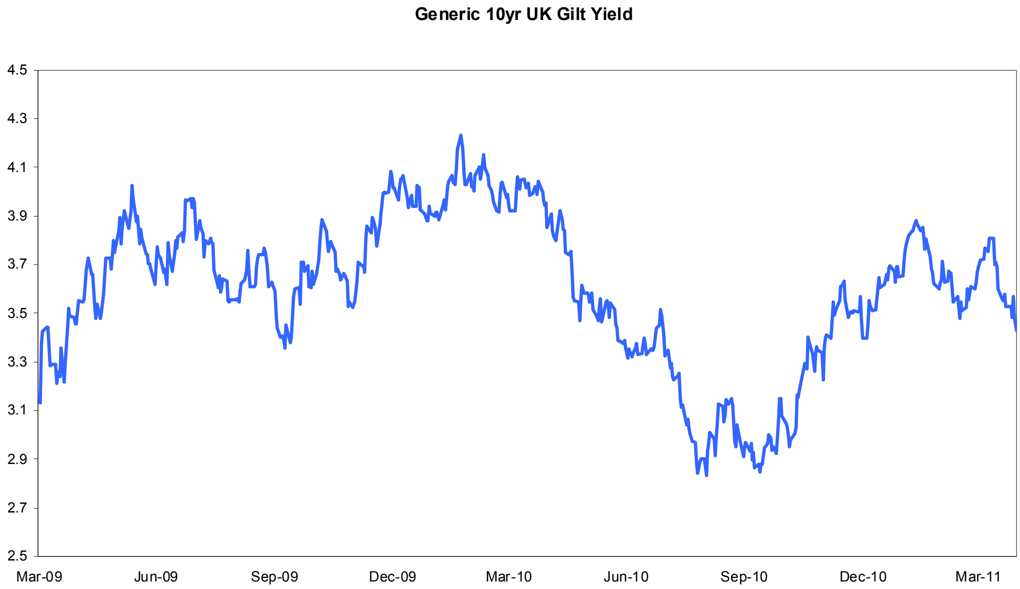
[Source: FTSE All-World Review, March 2011]

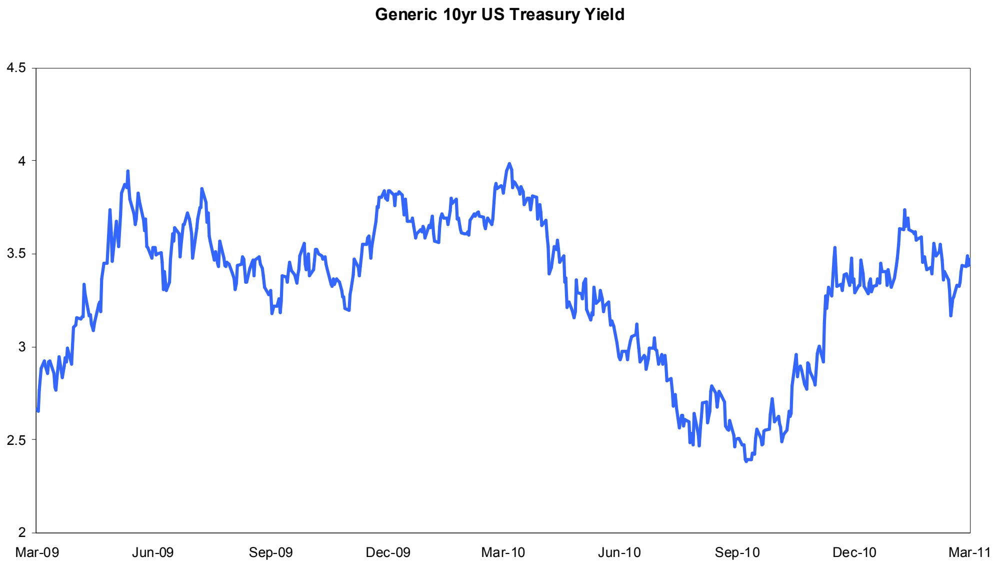
6. The only industrial sector to show a significant move during the quarter was Oil and Gas which rose by 11%, while Industrials and Telecommunications each gained 3%.

7. **Government Bonds** in the major developed markets weakened slightly during the quarter, although the 10-year yields shown below still look low in real terms when the higher levels of near-term inflation are factored in. The yield spread on **UK Corporate Bonds** relative to gilts narrowed slightly during the quarter.

10-year government bond yields (%)				
	Dec 2009	**Sept 2010**	**Dec 2010**	**Mar 2011**
US	3.84	2.52	3.34	3.45
UK	4.01	2.95	3.39	3.69
Germany	3.40	2.29	2.92	3.37
Japan	1.29	0.94	1.12	1.25

[Source: Financial Times]





8. There has been a 0.6% rise in capital values of **UK Commercial Property** during the quarter, according to the IPD Monthly Index. When added to the estimated income of 1.7%, this produced an average total return of 2.3% for the quarter. The return on Retail was slightly above this figure, Office and Industrial slightly below. For the year to end-March, the total return on commercial property is estimated at +10.7%. (By sector this splits out as Office +11.4%; Retail+ 10.7%; Industrial + 9.3%). The pooled property fund data which I normally show in this report have not yet been published.

9. In **Commodities**, Oil rose sharply in price on fears that supply from Libya would be disrupted by the civil unrest there. The price of Brent Crude rose by 25% to $117 per barrel during the quarter, and to $126 at end-April, reacting also to the weakness of the dollar. The price of Gold was stable at $1420 per oz during the quarter, but rose to over $1500 in April. Copper soared to over $10,000 per tonne in early March, but then fell sharply as demand from China appeared to falter, and had slipped below $9,000 in early May.


Oil
120
110
100
90
80
70
60
50
40
30
20
Mar-09
Jun-09
Sep-09
Dec-09
Mar-10
Jun-10
Sep-10
Dec-10
Mar-11


Gold
1500
1400
1300
1200
1100
1000
900
800
Mar-09
Jun-09
Sep-09
Dec-09
Mar-10
Jun-10
Sep-10
Dec-10
Mar-11

10. In **currency** markets, sterling gained 2% against the dollar, and 5% against the yen, but weakened by 3% relative to the euro during the quarter. In April, however, the dollar slipped by a further 4% against sterling (to \$1.67/£) and the euro (to \$1.48/€), as the Federal Reserve continued its easy money stance.

GBP vs EUR

Outlook

11. Equity markets have been remarkably resilient in recent months against a background of political unrest in the Middle East and North Africa, the sharp rise in oil prices, and continuing sluggish growth in Western economies. The UK and US central banks are still operating loose monetary policies, in order to stimulate their economies, but in time they will have to adjust interest rates upward to more normal levels.

12. When this happens, the initial effect on equities is likely to be negative, while yields on medium-dated bonds could also rise, to maintain the slope of the yield curve. With the tight fiscal policy being pursued in the UK, and its effect on employment and consumer spending, I remain cautious about the prospects for any gains in equities before the end of 2011.

13. At the interim meeting held on 4 May , it was decided to make no changes to the portfolio, as all asset classes were within their target ranges, and the level of cash was close to its minimum level of £10m.

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