Division(s):N/A

PENSION FUND COMMITTEE – 2 September 2011

OVERVIEW AND OUTLOOK FOR INVESTMENT MARKETS

Report by the Independent Financial Adviser

The Economy

1. Forecasts for UK and US GDP growth in 2011 have again been scaled back following disappointing Q2 numbers – just 0.2% growth for the UK and 0.3% for the US. In the Eurozone, meanwhile, extremely strong Q1 growth in Germany caused an upward revision to full-year estimates. The outlook for Japan this year is for a fall in real GDP as the effects on industrial output of the March 11 earthquake and tsunami become more apparent. Overall, the pace of recovery from the global recession of 2008/09 is clearly slower than in previous cycles, and there are even some forecasters predicting a return to recession in the US.

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

Consensus real growth (%)						**Consumer prices latest (%)**
	2008	**2009**	**2010**	**2011E**	**2012E**	
UK	+0.7	- 4.7	+1.6	(+1.6) +1.3	+1.9	+ 4.2 (CPI)
USA	+1.2	- 2.5	+2.9	(+2.9) +2.3	+2.9	+ 3.6
Eurozone	+0.8	- 3.9	+1.7	(+1.7) +1.9	+1.6	+ 2.5
Japan	- 0.2	- 5.3	+4.2	(+0.7) -0.6	+2.8	+ 0.3
China	+ 9.0	+ 8.7	+10.3	(+9.0) +9.0	+8.7	+ 6.4

[Source of estimates: The Economist, 06.08.2011]

2. Against the background of this ‘growth lull’, or ‘sticky patch’, the ability of governments and central banks to stimulate economies is becoming more limited. In the US, the second round of quantitative easing (‘QE2’) ending in June, with the Federal Reserve disinclined to embark on QE3. The European Central Bank raised its key interest rate by a further 0.25% on July 7th, to a level of 1.5%, in order to combat inflation, while in the UK and many other European countries, the need to rein in government deficits affords little room for any fiscal stimulus.

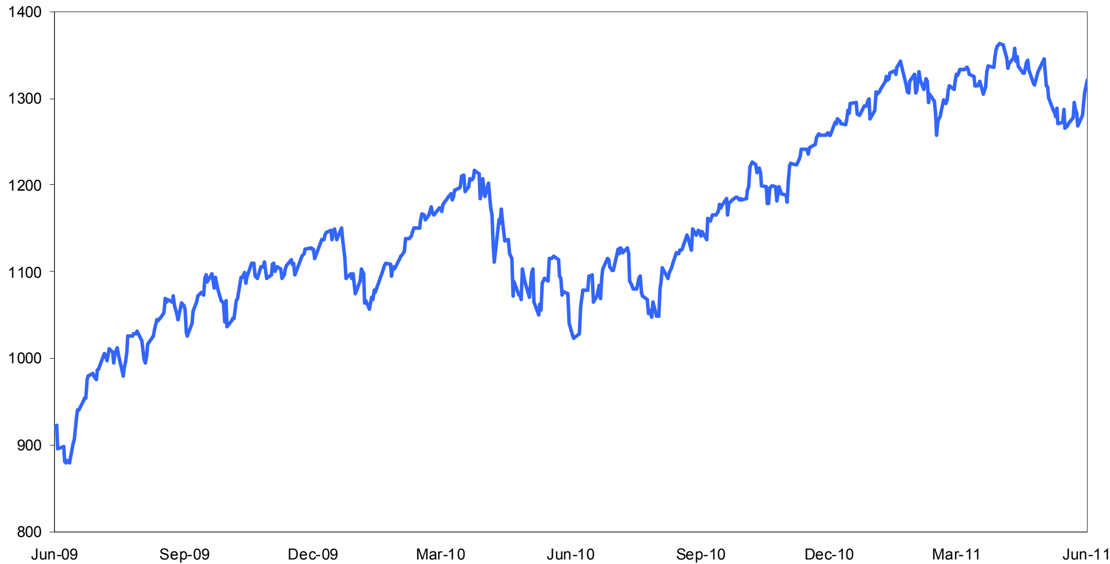
3. The Greek debt crisis continued to haunt markets during the quarter. The Greek government managed to pass the necessary austerity measures through parliament in June in the face of strikes, riots and protests outside. There followed a period of uncertainty until on July 21st European leaders agreed a second bailout for Greece. This involved a further €109bn in loans from the Eurozone, together with a request for private holders of €135bn of Greek debt to take a partial writedown on their holdings. Since European banks are the largest private holders of Greek debt, this depressed banks’ share prices. The situation in the sovereign debt market was exacerbated in late July when prices of Spanish and Italian government bonds began to slide on fears that they might also require a bail-out, which would have needed to be on a much larger scale than the Greek one. On August 8th the ECB started buying Spanish and Italian bonds, which brought those yields down sharply.

Markets

4. During the second quarter, **Equity** markets traded within a narrow range and a late-June rally restored most markets to their end-March levels, with the exception of Emerging Markets which fell slightly. In sectoral terms the more recession-proof sectors stood out – Healthcare (+7.4%), Consumer Goods (+5.1%), Consumer Services (+3.1%) – while Oil & Gas (-6.2%) and Financials (-3.5%) were the weakest areas.

Capital return (in £, %) to 30.06.11		
	3 months	**12 months**
FTSE All-World Index	- 0.7	+18.6
FTSE All-World North America	- 0.9	+19.3
FTSE All-World Asia Pacific	- 0.7	+12.3
FTSE All-World Europe (ex-UK)	+ 0.2	+25.1
FTSE All-World UK	+ 0.6	+20.7
FTSE All-World Emerging Markets	- 3.0	+14.3

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



5. Since the end of June, however, sentiment towards equities has totally changed because of worries engendered by the Eurozone debt crisis (see para 3), the negotiations on the US debt ceiling and signs of economic slowdown. Having moved sideways during the first three weeks of July, all equity markets have since fallen sharply. The changes between July 22 and August 8 have been:

FTSE All-World (£)	- 15.7%
FTSE All-Share (£)	- 14.8%
S&P 500 ($)	- 16.8%
Nikkei (Yen)	- 10.2%
DAX (€)	- 19.2%

6. **Government Bonds** in markets seen as safe havens (US, UK, Germany and Japan) all strengthened in the second quarter as concerns about the peripheral European bond markets grew. The spread on **UK Corporate Bonds** relative to gilts widened slightly, but the sector still gave a positive capital return for the quarter.

10-year government bond yields (%)					
	Dec 09	**Sept 10**	**Dec 10**	**Mar 11**	**June 2011**
US	3.84	2.52	3.34	3.45	3.16
UK	4.01	2.95	3.39	3.69	3.38
Germany	3.40	2.29	2.92	3.37	3.01
Japan	1.29	0.94	1.12	1.25	1.14

[Source: Financial Times]

7. In the febrile atmosphere of late July/early August, the 'flight to safety' led to further sharp falls in the yields (i.e. sharp price rises) on these government bonds. Between July 22 and August 8, the falls in yields on 10-year issues were:

   US Treasuries - 63 bps
   UK Gilts - 45 bps
   German Bunds - 56 bps
   Japanese JGB's - 9 bps

8. These moves took yields, apart from Japan, below the levels of September 2010 shown in the Table above. After the general relief that the US Administration had fashioned an eleventh-hour deal to increase the debt ceiling, the subsequent downgrading on August 5 by Standard and Poor's of US government debt from AAA to AA+ caused consternation. Ironically, the extreme weakness of equities on August 8 produced *gains* in US Treasuries as investors switched to less risky assets.

9. The return on **Property Funds** during the quarter essentially comprised the income return on property, and indeed there has been very little change in capital values during the past year.

Median fund returns to 30.06.11	**3 months**	**12 months**
Balanced Funds (n= 26)	+ 1.8%	+ 7.4%
Specialist Funds (n= 26)	+ 1.7%	+ 8.4%

[Source: IPD UK pooled property funds]

10. In **Commodities**, the Oil price traded lower in May and June after the US released part of its reserves to offset supply shortages from Libya, and WTI, shown below, ended the quarter below $100 per barrel. The price retreated to below $85 in early August as global economic forecasts were scaled back.

11. The Copper price fell back during May on reduced demand from China, but then rose once more when supply was restricted by the workers' strike at the Escondida mine in Chile. Meanwhile, Gold continued to trend upwards and reached $1500/oz by the end of June; in the subsequent market turmoil at the end of July, its reputation as a safe haven propelled the Gold price to almost $1700.

12. In **Currency** markets, the dollar recovered from its April slide and ended the quarter unchanged at $1.60 against sterling. It weakened by 2% against the Euro and by 2.5% against the Yen

Outlook

13. Several influences which had been worrying equity markets during the past year – economic slowdown, the Eurozone debt crisis, US budgetary policy and rising commodity prices – have converged in recent weeks to cause very rapid falls in equity markets, reviving memories of the atmosphere in 2008/9. The fear that bank lending will again dry up, this time because of write-offs they have had to take on European bonds, has precipitated very sharp falls in bank shares in Europe and also in the US.

14. An additional depressant on the UK market has been the outbreak of hooliganism on the streets of London and other cities, which induces further nervousness among investors. The immediate effect on the assets of the Pension Fund has been, I estimate, a depreciation of **£125m** (or **10%**) between June 30th and August 8th. With the situation changing from day to day, it is not feasible to make any significant changes to the Fund's asset allocation in the midst of such upheaval.

15. The relationship between equity and bond valuations has clearly altered considerably, with the recent 15% fall in equities and 5% rise in bond prices, but I am not recommending any additional purchase of equities at present because of the many economic and political uncertainties surrounding real assets.

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