PENSION FUND COMMITTEE – 2 DECEMBER 2011

OVERVIEW AND OUTLOOK FOR INVESTMENT MARKETS

Report by the Independent Financial Adviser

The Economy

1. The scaling down of GDP growth forecasts in US, UK and Europe has continued during the past quarter, as official output data and surveys of industry sentiment show disappointing trends. Even in China, there is increasing concern about the effects on banks and developers of the slowdown in the housing boom. Meanwhile consumer price inflation in Western economies remains above target levels as the increased prices of fuel, commodities and food are reflected in the indices.

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

Consensus real growth (%)						Consumer prices latest (%)
	2008	**2009**	**2010**	**2011E**	**2012E**	
UK	+0.7	- 4.7	+1.6	(+1.3) +0.9	+1.1	+ 5.2 (CPI)
USA	+1.2	- 2.5	+2.9	(+2.3) +1.7	+1.8	+ 3.9
Eurozone	+0.8	- 3.9	+1.7	(+1.9) +1.6	+0.4	+ 3.0
Japan	- 0.2	- 5.3	+4.2	(-0.6) -0.5	+2.2	nil
China	+ 9.0	+ 8.7	+10.3	(+9.0) +9.0	+8.6	+ 6.1

[Source: The Economist 5.11.11]

2. In late-September the Federal Reserve announced a plan to rebalance its portfolio of Treasury bonds by selling $400bn of shorter-term issues and re-investing the sum in longer-term Treasuries. This operation (dubbed 'Twist') is intended to push down longer-term interest rates. In early October the Bank of England announced another round of quantitative easing (QE) in which it would buy a further £75bn of gilts, to add to the £200bn it had purchased in earlier programmes in 2009-10. On November 3 the European Central Bank, under its new president, cut the interest rate from 1.5% to 1.25%.

3. The forecast of just 0.9% growth in UK's GDP in 2011 – compared with the 1.7% estimated in the March Budget – is likely to show government finances under an increased strain when the Autumn Statement is

delivered on November 29th. With little scope for any further monetary easing, it is expected that room will be found in public spending budgets in order to generate some economic stimulus.

Markets

4. The economic slowdown, combined with fears about the Eurozone debt situation, caused a sell-off in all equity markets, combined with strong demand for 'safe haven' government bonds. During the third quarter, all **Equity** markets fell sharply, with notable weakness in Continental Europe and Emerging Markets. In sectoral terms there was a clear division between the economically-sensitive sectors (Basic Materials, Oil & Gas, Industrials, Financials) which each lost 20 – 25%, and the more recession-proof areas (Consumer Goods and Services, Telecomms, Utilities and Technology) which each fell 7 – 10%.

Capital return (in £, %) to 30.09.11		
	3 months	**12 months**
FTSE All-World Index	-15.5	-7.3
FTSE All-World North America	-12.2	-0.5
FTSE All-World Asia Pacific	-13.8	-9.4
FTSE All-World Europe (ex-UK)	-24.7	-16.6
FTSE All-World UK	-13.8	-7.7
FTSE All-World Emerging Markets	-20.0	-17.7

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

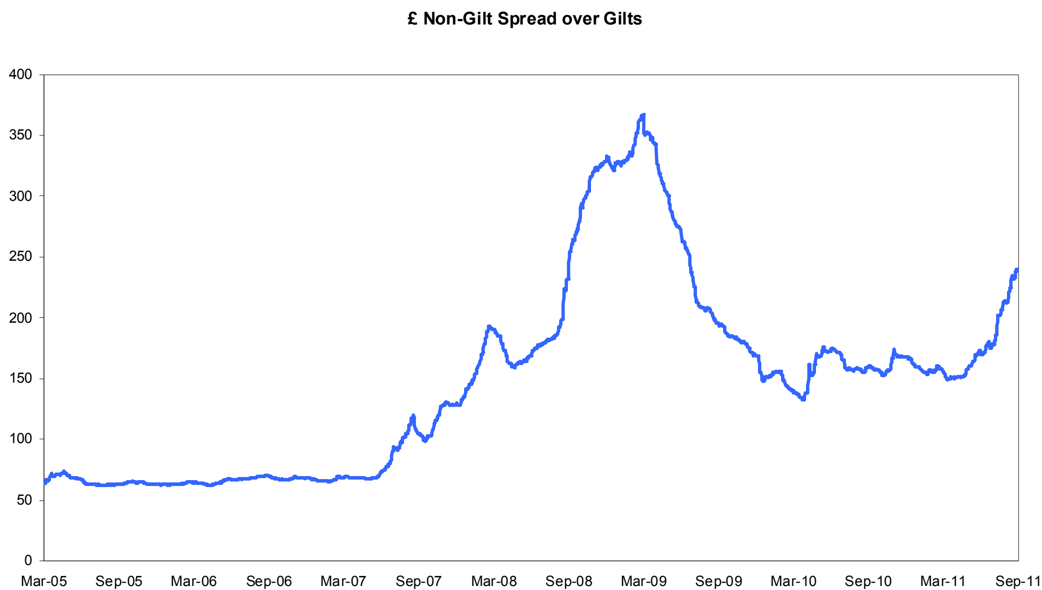
5. The demand for safe haven **government bonds**, combined with Central Bank stimulus programmes, pushed yields to unprecedentedly low levels in US, UK and Germany. The yield shift on gilts in the quarter, shown in the

table below, equates to a 9% rise in the price of a 10-year bond with a 3.5% coupon.

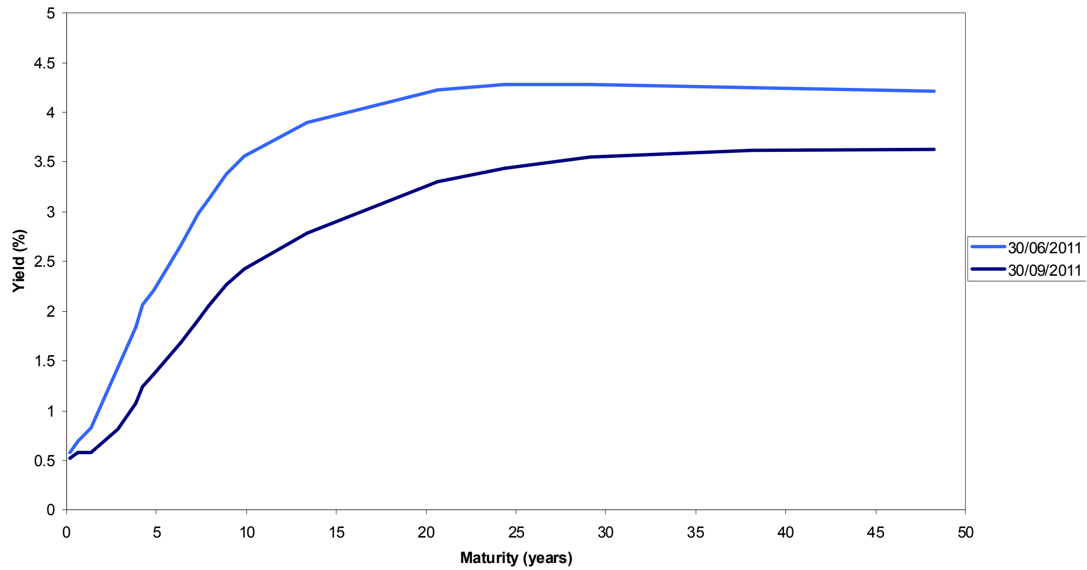
10-year government bond yields (%)					
	Dec 09	**Sept 10**	**Dec 10**	**June 2011**	**Sept 2011**
US	3.84	2.52	3.34	3.16	1.93
UK	4.01	2.95	3.39	3.38	2.42
Germany	3.40	2.29	2.92	3.01	1.89
Japan	1.29	0.94	1.12	1.14	1.03

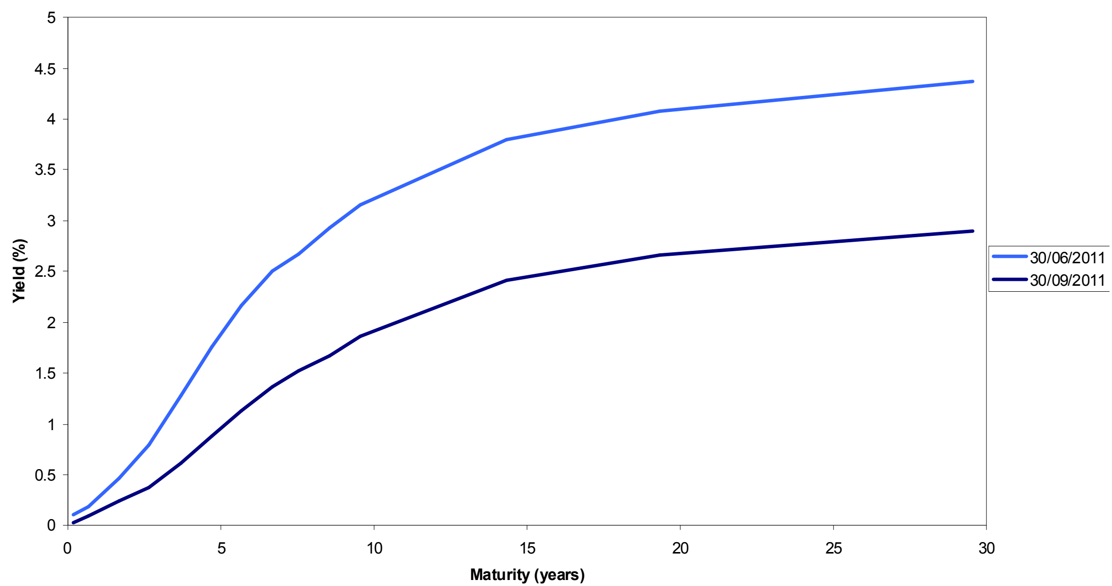
[Source: Financial Times]

The spread on **UK Corporate Bonds** relative to gilts widened during the quarter.



6. The sharp fall in government bond yields was seen at all durations, as shown in these graphs of the UK and US yield curves at September 30th compared with June 30th .





7. From early October, equity markets staged a strong rally while bonds retreated slightly. The main factor behind this move was the increasing confidence that the Greek debt crisis would be resolved, if only temporarily, and that contagion would not engulf Italy. When the ‘comprehensive package‘ was announced by European leaders on

October 27th, Western equity markets stood 12 - 15% higher than they had three weeks earlier. However, this euphoria did not last; the news that the Greek government planned to call a referendum on the fiscal package before it could be agreed created renewed uncertainty and sent equity markets tumbling 5% in the space of two days at the start of November. The renewed fears about Italy were reflected in the soaring interest-rate differential between Italian and German government bonds.

8. As in recent quarters, the average **Property** fund showed very little capital appreciation. While the returns on Balanced Funds were narrowly bunched, the Specialist Funds showed a much wider dispersion, with weakness in those specialised in shopping centres or industrial property.

Median fund returns to 30.09.11	**3 months**	**12 months**
Balanced Funds (n= 26)	+ 1.6%	+ 7.0%
Specialist Funds (n= 26)	+ 0.8%	+ 7.2%

[Source: IPD UK pooled property funds]

9. There was huge volatility in the prices of **Commodities** during August and September. At one point Gold exceeded $1,900 per oz, having ended June at $1,512, but heavy selling from Chinese investors, hedge funds and others pushed it down to $1,614 at the end of September. The price of Copper also fell sharply as forecasts of industrial output in China were revised downwards.

The fall in the Oil price (WTI measure) from $95 to $80 during the quarter provided one piece of good news for consumers, although by the end of October it had risen again to $93.

9. In **Currency** markets the Euro was weak, because of the uncertainty surrounding the future of the single currency, and it fell 5% against

sterling and by 7% against the dollar – which rallied strongly in September. The Yen, meanwhile, was the strongest of the four major currencies, rising 5% against the dollar, despite the best efforts of the Bank of Japan to restrain it. The Swiss Central Bank took an even harder line, announcing that it had entered the foreign exchange market to prevent the Swiss Franc strengthening beyond 1.20 per €.

Outlook

10. All markets have been characterised by extreme volatility, with daily moves of more than 2% in equities becoming commonplace, and commodities fluctuating even more widely. Although the equity markets' focus on Eurozone debt may appear to be a slim pretext for such volatility, the consequences of the crisis are far-reaching. The 'voluntary' write-down of 50% on Greek debt which banks have agreed to will deplete their capital, which they are required to replenish as part of the agreement. The collapse of MF Global, an interdealer-broker was partly caused by worries about the value of its large holdings of Eurozone sovereign debt. In Belgium the government's rescue of Dexia Bank has revived uncomfortable memories of the 2008 crisis, when banks which could no longer attract wholesale funding had to be rescued by government support.

11. The slowing pace of the global economic recovery casts a shadow over prospects for government finances and for corporate profits. While faster economic growth would clearly be the most desirable means of alleviating the debt position of the troubled European countries, such growth would need to be achieved during a period of fiscal austerity and would, by its nature, be a lengthy process. Against this background it is easier to foresee continuing problems in the Eurozone which will dampen any optimism on the course of world equity markets.

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