Division(s): N/A

ITEM PF7E

PENSION FUND COMMITTEE - 25 AUGUST 2006

OVERVIEW AND OUTLOOK FOR INVESTMENT MARKETS

Report by the Independent Financial Adviser

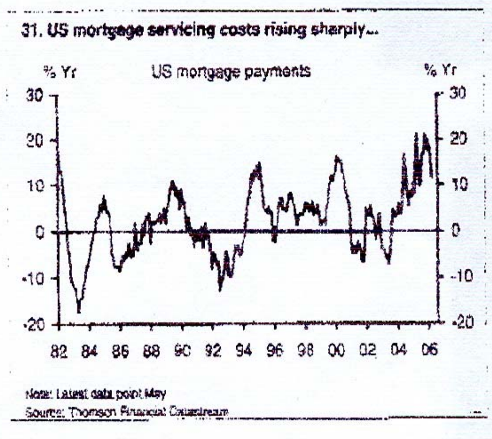
1. Economic growth in the developed world is expected to slacken as we move into 2007 as the following figures show:

	Actual	Forecast	
	2005 %	**2006 %**	**2007 %**
UK	1.9	2.5	2.1
USA	3.5	3.4	2.4
Eurozone	1.4	2.1	1.7
Japan	2.6	3.1	2.6

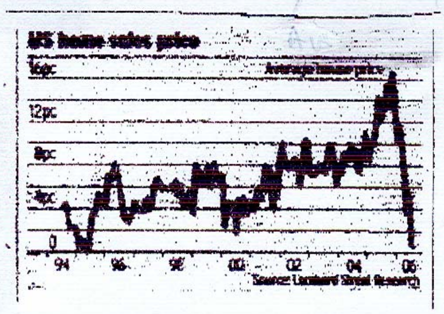
2. The delayed effect of rising short term official interest rates and the continuing level of high oil prices are now having an increasing impact. In the UK official interest rates have just been raised 0.25% to 4.75%, previously having been held at 4.5% for a year, and there will probably be another increase of 0.25% before the end of the year to restrain inflationary pressures. At the same time the fiscal position is deteriorating which will need to be corrected, while the high level of consumer debt, coupled with increased energy costs, are already having a restraining effect.

3. In the US, interest rates, which have risen from 1% in June 2004 to the current 5.25% are probably near their peak with possibly one, or even two more increases of 0.25%. As a result US mortgage payments have risen sharply and the US housing market has weakened substantially (see charts below).

US Mortgage Payments



US Housing Market



4. This, coupled with the high level of other consumer debt and higher energy costs, will slow consumer expenditure. While Eurozone economic growth has recovered this year, so has the inflation rate, currently reaching 2.5% compared with the European Central Bank (ECB) target of close to but under 2%, so the ECB has increased interest rates from 2% in December 2005 to the current 2.75% and they will probably peak in the region of 3.25% to 3.5%.

5. The Japanese economy has improved sharply from early in this decade and the latest quarterly official Tankan Survey of business sentiment shows that companies are much more optimistic. The Bank of Japan believes that Japan "is likely to expand for a sustained period."

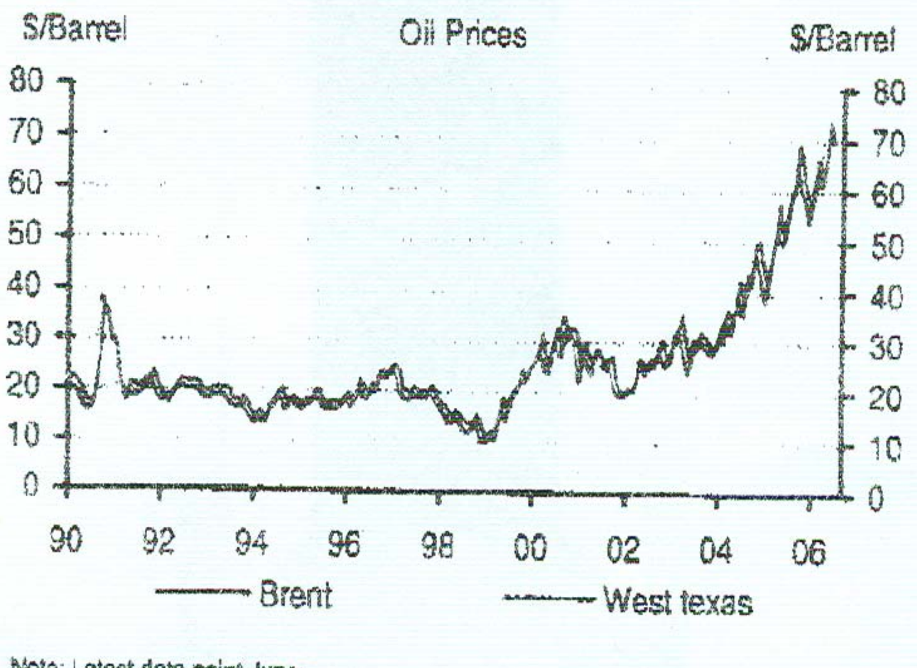
As a result the Bank of Japan ended its policy of flooding the domestic market with money earlier this year and in July lifted official interest rate from zero, at which it had been held for six years to combat deflation, to 0.25%. Economic growth could surprise on the upside.

6. Amongst developing economies the current rate of growth of 11.0% in China is clearly unsustainable and will have to be restrained. The monetary and administrative methods used so far have been ineffective and a firmer approach will have to be adopted with the outside risks of overkill.

7. In the rest of Asia growth will probably range between 4.0% in Taiwan and 7.0% in India.

8. Nevertheless, the price of oil (and gas) is a key influence on the rate of economic growth in most of the world. If the current level of crude oil prices remains around US$75 or rises appreciably world economic growth will be reduced further. While there are always those calling the price higher in any market after it has already risen sharply viz the stock market in 2000, there are indications that the oil price could begin to ease back. Oil prices are strongly influenced by developments in the refined products market, where there is refinery shortage through under investment. Currently supplies are tight because we are in the peak of the US driving season (US petrol consumption accounts for over 10% of world oil consumption and BP's Alaskan production being temporarily suspended). Prices have also been sustained by speculation in the oil futures market. Against this OECD crude oil stock piles are at their highest level for 20 years, while looking ahead slightly lower economic growth should help to moderate consumption and non-OPEC production should rise by 1.7 million barrels a day in 2007 compared with little increase in 2006. Thus many analysts and commentators, including BP, are looking for a price in the region of $40 to $50 in the medium term. Any fall in the price will be accelerated as speculators unwind their positions. (See oil price chart below.)

1. Oil prices back up again in April/early May and down again in June



Note: Latest data point June
Source: Thomson Financial Datastream

Markets

9. Where does this leave markets? From mid May to mid June equity markets in the western world fell by around 10%, those in emerging markets by nearer 25% and the Japanese market has also been very weak, since when there has been a recovery, cutting the fall by between a quarter and a half. On a fundamental basis the market is not expensive, with the UK market on a prospective end 2006 price/earning (PE) ratio of 12.4 falling to 11.7 in 2007, the US on 15.4 (against a 20 year average of 16.4) falling to an estimated 14.4 in 2007 and the Eurozone, on 12.1 falling to 11.0 in 2007. Further, company cash flows and balance sheets are generally strong, while continuing profit growth has pushed the share of profits of GDP to or near record levels in the UK and USA, to a 35 year high in Japan and increased it substantially in the Eurozone. However, it is difficult to see this trend continuing without interruption. Further, the bull market in the UK and Eurozone is approaching three and a half years old, from the low in March 2003, while in the US it is approaching four years, both of which are appreciably longer than the average bull run. Central banks are still in the mode of lifting interest rates, even though the peak is probably near and they are reducing liquidity, particularly in Japan. In the meantime the geo-political background is unsettled, particularly in the Middle East with its possible impact on oil prices. All this probably means that equity markets will continue to be volatile through the summer and autumn, when October can often be a treacherous month. So far the 5500 level has been held on the FTSE 100 index, but a correction of more than 10% - even approaching 20% - would provide a firmer base for a new bull run. A further downward revision of economic growth estimates for 2007, particularly in the USA if the sharp weakening of the housing market seriously impacts the consumer, could cause such a further correction. The Japanese market recorded its low at the same time as western markets in March/April 2003, had a three year bull run to April 2006 and then fell back 18%. It now looks poised for a new bull trend with the economy likely to surprise on the upside and profit growth strong. Asian and emerging markets would tend to follow any set back in western markets.

10. Bond yields are virtually unchanged since May and in the UK real yields on Government stock have declined with the rise in inflation.

Yield	**Sept 2005 %**	**Feb 2006 %**	**May 2006 %**	**August 2006 %**
Benchmark 10 year	**4.3**	**4.1**	**4.7**	**4.7**
4¼% Treasury 2055	4.1	3.7	4.1	4.1
Less inflation at say RPI	2.5	2.4	2.6	3.3
'Real' Yield	**1.6**	**1.3**	**1.4**	**0.8**
Treasury Index Linked Bonds 2055	1.1	0.5	1.0	0.8

11. Such low real yields cannot be justified when money in non-inflationary conditions is expected to earn about 2.5%. Moreover the yield on 2% UK index linked 2035 at 1.1% is seriously out of line with the US index linked 3.625% 2028 at 2.4%. Eventually, when UK yields move to a 'normal' level, present holders will sustain substantial capital losses, but anomalies in markets can persist for an inordinate time.

12. The huge rise in commodity prices, particularly metal prices, peaked in early May, the same time as equity markets peaked and then fell by between 25% and 33%. They then recovered, but are still between 20% in the case of lead and 5% in copper off their peak. There is probably still a lot of speculative money riding the commodity markets, particularly metals, and prices are likely to continue volatile for sometime. However, with mining companies investing heavily in new capacity, prices should in the longer term ease back. Commodity metal price charts are shown in the appendix.

13. The main trend in currency markets over recent months has been a weakening in the US dollar. Thus the US$ has moved from $1.37 against sterling at end March to the current $1.905 and against the Euro from $1.212 to $1.286 over the same period, whereas the movement against the Japanese yen has been surprisingly modest from yen 117.7 to yen 115.2. As yet the enormous US current account deficit, which is now around 7% of GDP, has not had the substantial impact on the US dollar exchange rate that would have been expected and it is another example that anomalies in the market can persist for an inordinate time.

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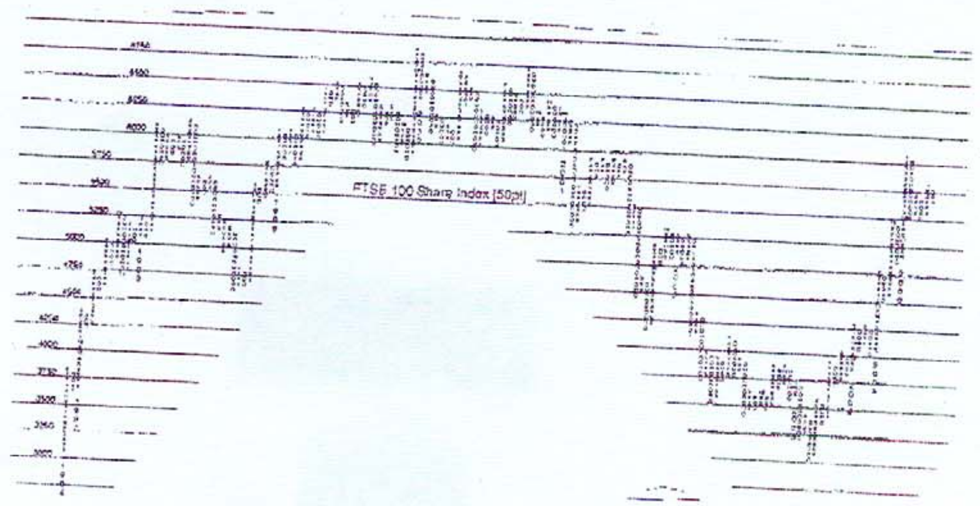
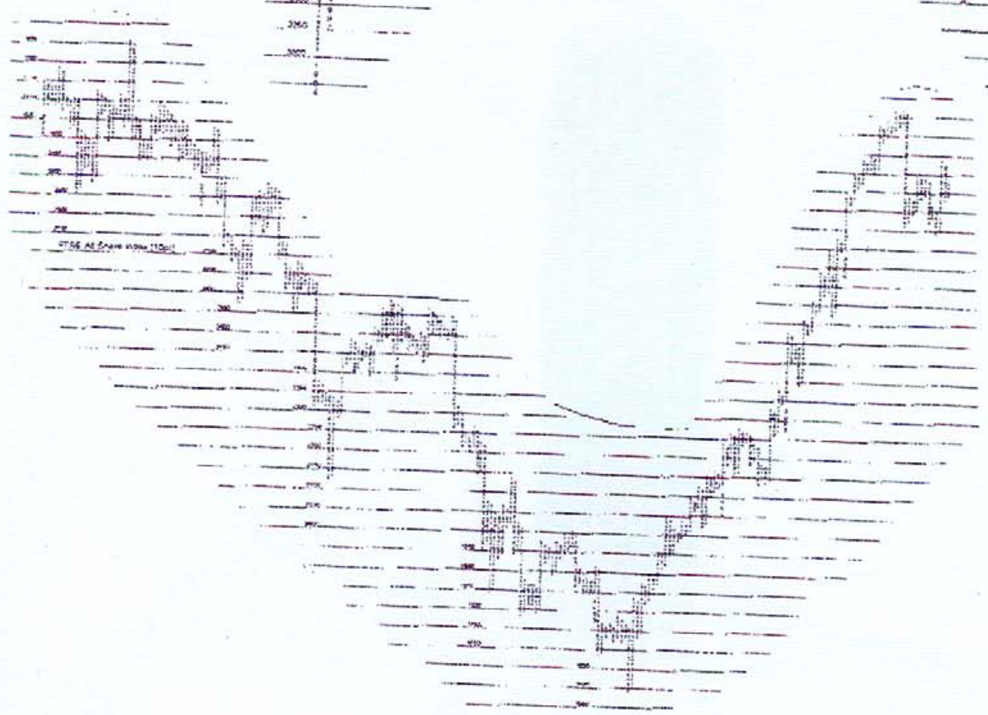
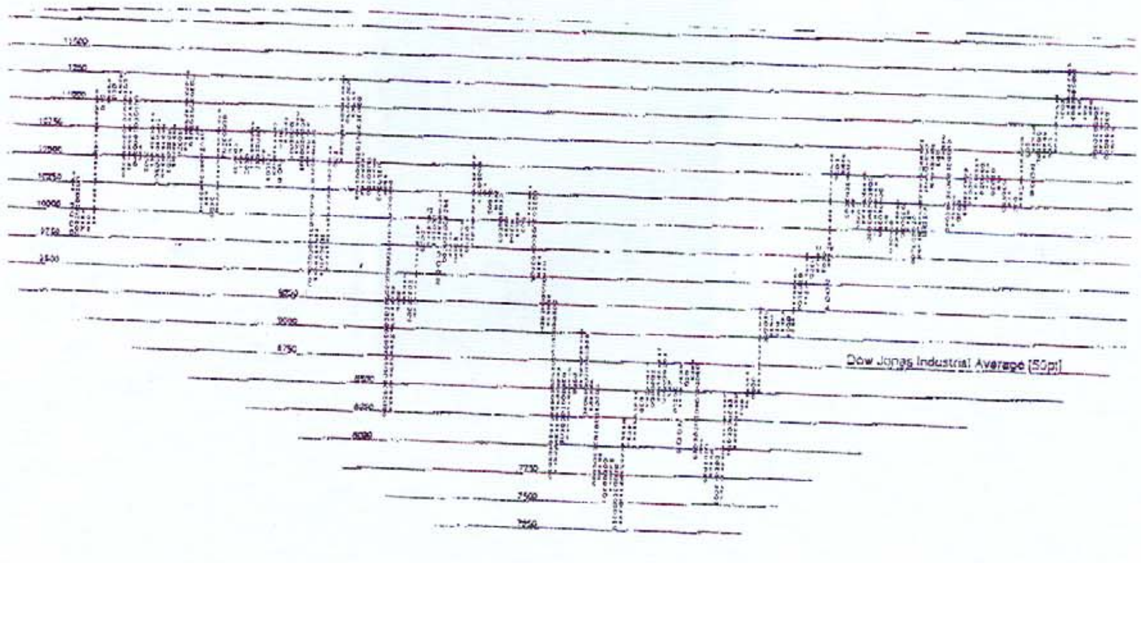
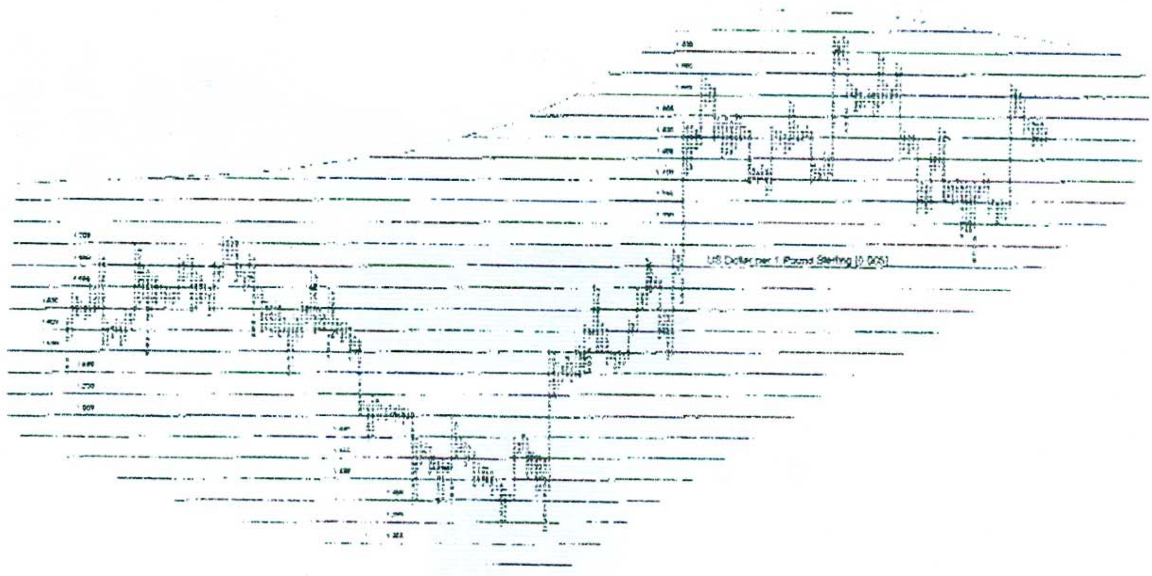
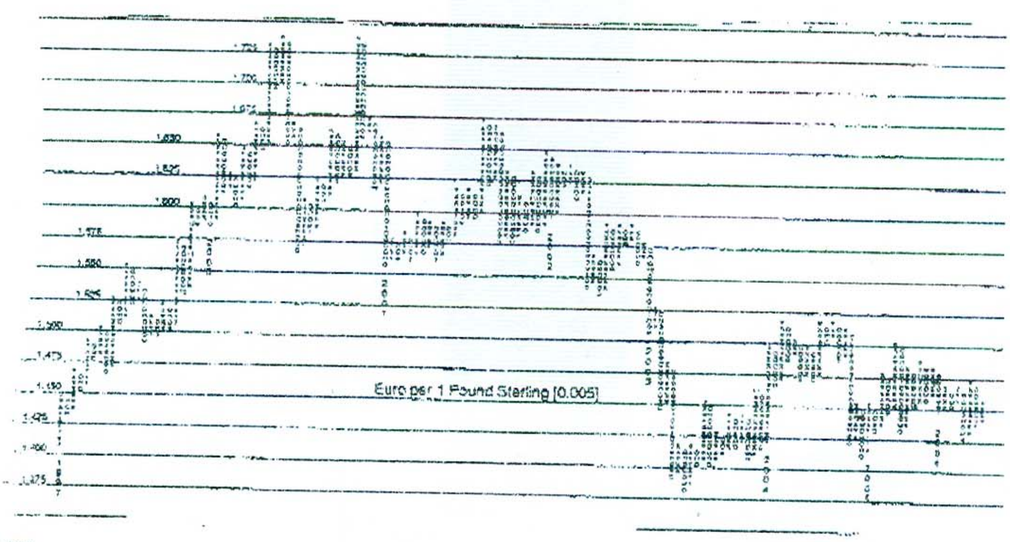
August 2006

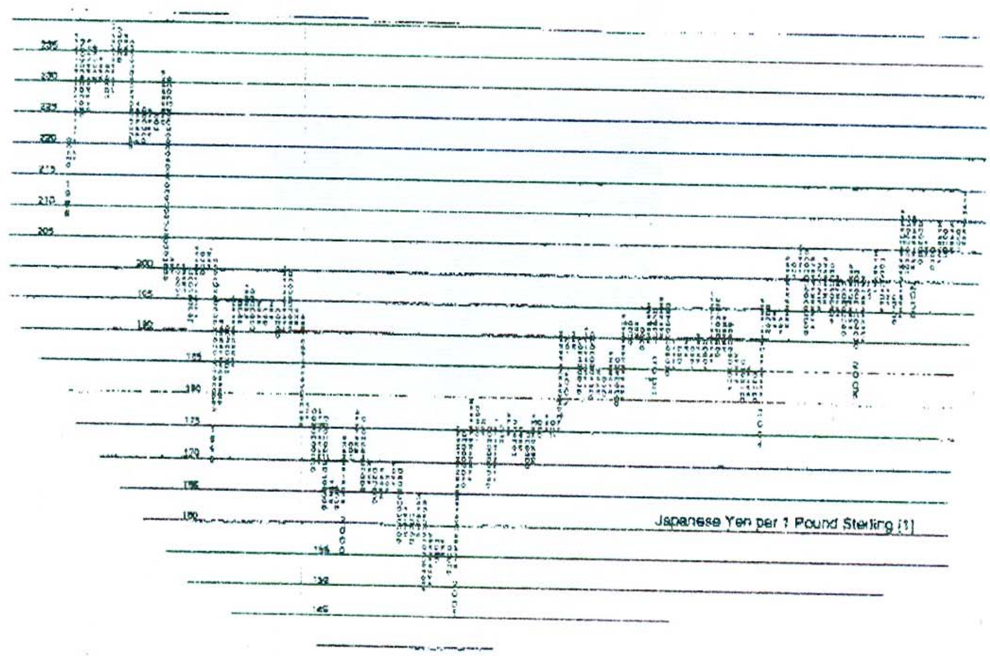

FTSE 100 Share Index [50pt]

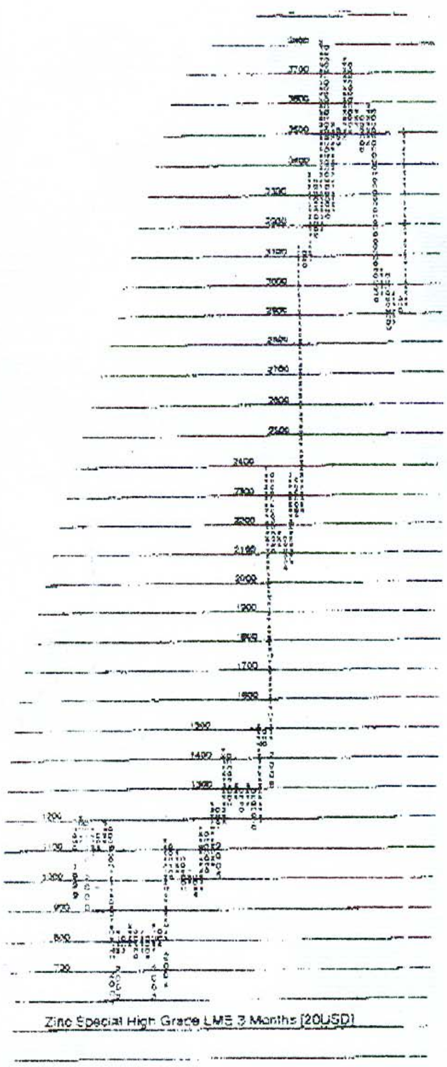

FTSE All Share Index [15pt]

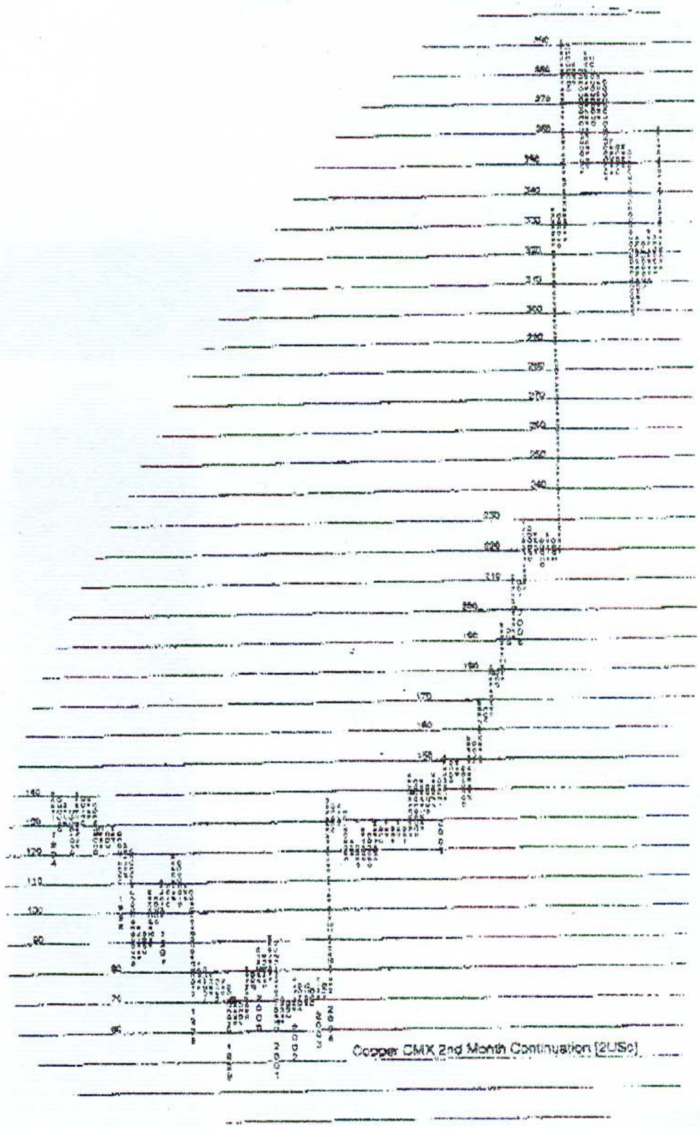

Dow Jones Industrial Average [50pt]

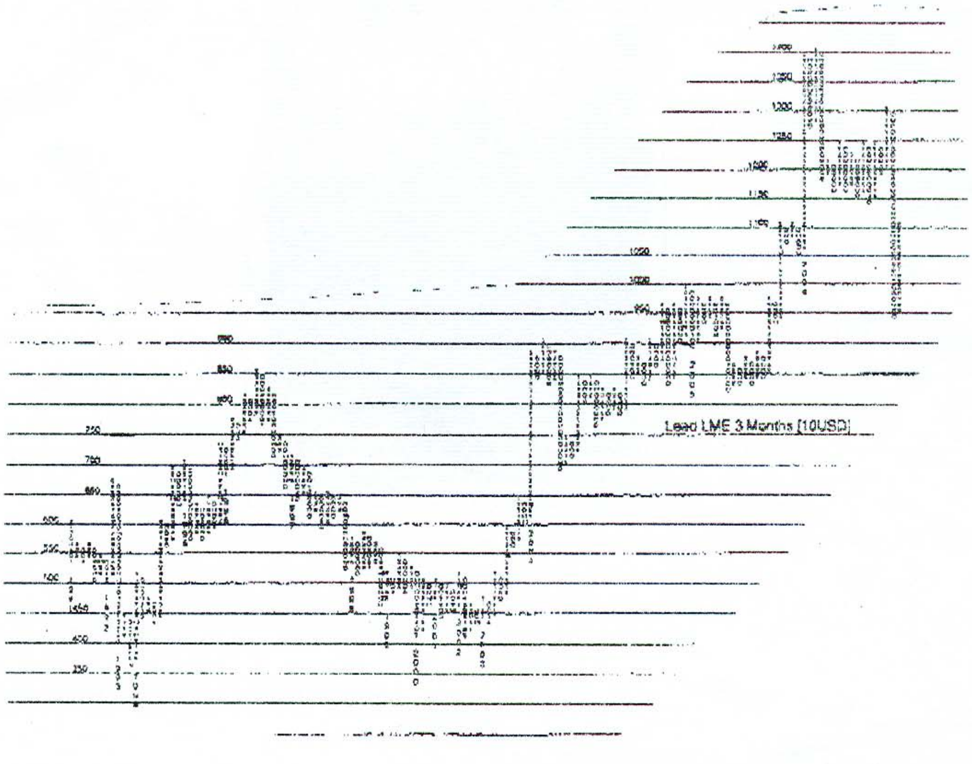

US Dollar per 1 Pound Sterling [0.005]


Euro per 1 Pound Sterling [0.005]


Japanese Yen per 1 Pound Sterling [1]


Zinc Special High Grade LME 3 Months [20USD]


Copper CMX 2nd Month Continuation [2USc]


Lead LME 3 Months [10USD]