Division(s): N/A

PENSION FUND COMMITTEE – 4 DECEMBER 2009

OVERVIEW AND OUTLOOK FOR INVESTMENT MARKETS

Report by the Independent Financial Adviser

The Economy

1. In the quarter to September, several of the world's major economies registered a slight quarter-on-quarter growth in GDP, although this was not the case in the UK, where the 0.4% fall represented its sixth consecutive quarterly decline. The table below shows that the consensus estimates of 2009 growth for all economies except the UK have improved since my last report, as have the projections for growth in 2010. (The consensus estimates at the time of the September Committee are shown in brackets).

2. China is now included in the table, to show how it has been able to maintain growth at a high rate; it will shortly overtake Japan as the world's second largest national economy.

Consensus real growth (%)					Consumer prices (%)
	2007	**2008**	**2009E**	**2010E**	**2009E**
UK	+3.0	+0.7	(- 3.7) - 4.4	(+1.1) +1.4	+ 2.0 (CPI)
USA	+2.0	+1.2	(- 2.7) - 2.5	(+2.0) +2.5	- 0.4
Eurozone	+2.6	+0.8	(- 4.4) - 3.8	(+0.6) +1.2	+ 0.4
Japan	+2.0	- 0.2	(- 6.1) - 5.7	(+1.0) +1.4	- 1.2
China	+11.9	+ 9.0	(+7.2) + 8.2	(+7.6) +8.6	- 0.8

Source: The Economist (31.10.09)

3. While the estimates for 2010 are now fully 1% above those made in the spring, they still fall short of trend growth, so that the level of capacity utilisation will fall further, and unemployment rates are expected to continue moving upwards – reaching 10% in the US and Eurozone, and 9% in the UK.

4. When combined with higher savings rates, and the inevitable fiscal tightening, it is likely to be some time before private consumption becomes a supportive factor in the US and Europe.

5. Interest rates remain almost everywhere at their lowest levels, and governments have continued to support ailing financial institutions, as well as providing short-term targeted stimuli e.g. through "cash for clunkers" or car scrappage schemes. Central banks meanwhile have pumped money into their banking systems by means of quantitative easing (QE). It still remains to be seen whether the banks are able to supply credit to the private sector on

acceptable terms, and, looking ahead, how the financial system will cope with the eventual reversal of QE.

6. It is widely believed that the Bank of England's programme of purchases of gilt-edged stock – for which the limit has just been raised to £200bn – has, besides its supportive effect on gilt prices, also been one of the factors driving equity markets higher in recent months.

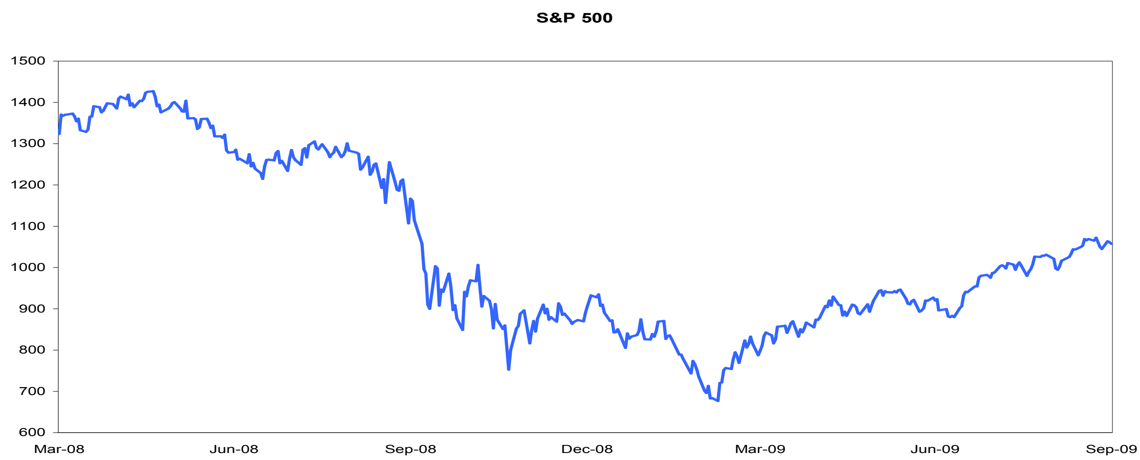
Markets

7. World **equity markets** continued their strong recovery in the third quarter, and registered gains on a scale which has not been seen in the developed markets for many years. As shown in the table below, UK equities rose in line with the global average of 21%, while Continental Europe significantly faster and the US slightly slower. Emerging Markets again surged ahead, and all regions ended September 2009 at a higher level – in sterling terms – than they had ended September 2008.

Capital return (in £, %) to 30.09.09		
	3 months	**12 months**
FTSE All-World Index	+21.0	+ 9.4
FTSE All-World North America	+18.6	+ 1.9
FTSE All-World Asia Pacific	+18.0	+24.2
FTSE All-World Europe (ex-UK)	+29.2	+11.3
FTSE All-World UK	+21.0	+ 5.3
FTSE All-World Emerging Markets	+24.3	+30.6

[Source: FTSE All-World Review, September 2009]

8. The following graphs show the movements of US, UK, European and Asian markets during the past eighteen months. Measured from their lows of early March 2009, these four indices had risen by 56%, 48%, 62% and 52% respectively by the end of September. In October they retreated marginally.




UK FTSE All-Share
3300
3100
2900
2700
2500
2300
2100
1900
1700
Mar-08
Jun-08
Sep-08
Dec-08
Mar-09
Jun-09
Sep-09

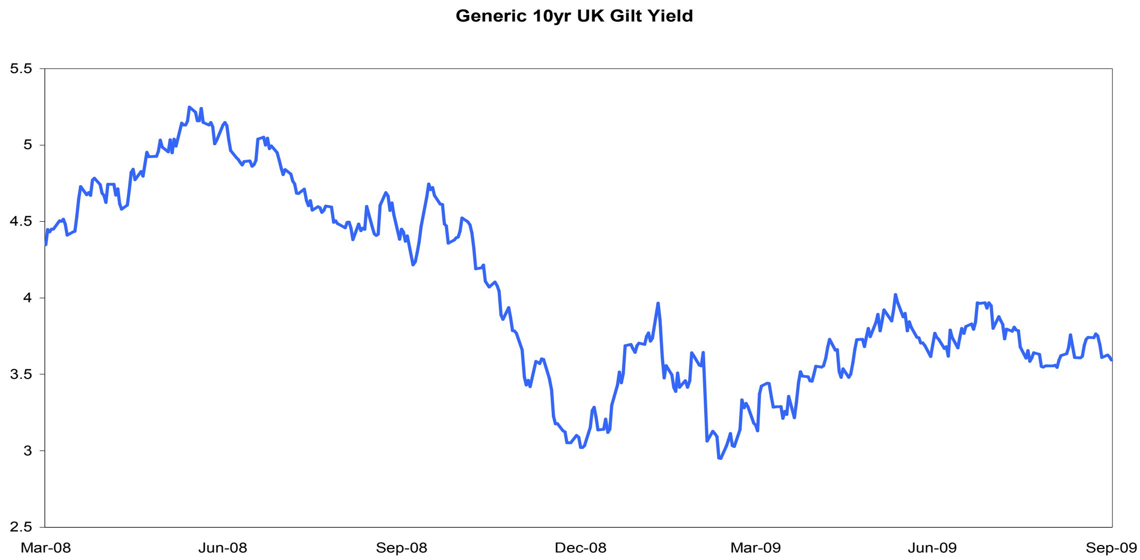

FTSE World Europe ex UK
750
700
650
600
550
500
450
400
350
300
Mar-08
Jun-08
Sep-08
Dec-08
Mar-09
Jun-09
Sep-09


FTSE All-World Asia Pacific
330
310
290
270
250
230
210
190
170
150
Mar-08
Jun-08
Sep-08
Dec-08
Mar-09
Jun-09
Sep-09

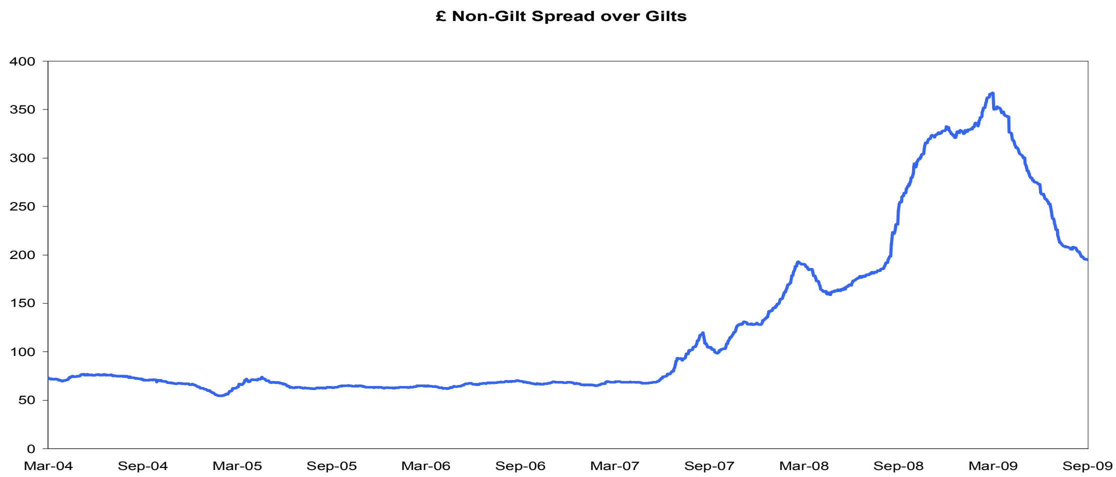
9. As noted above, **government bonds** have remained firm under the influence of QE, together with the mild outlook for inflation in present economic circumstances.

10-year government bond yields (%)				
	Sept 2008	**Dec 2008**	**June 2009**	**Sept 009**
US	3.84	2.22	3.52	3.31
UK	4.46	3.02	3.69	3.59
Germany	4.04	2.95	3.38	3.23
Japan	1.48	1.18	1.35	1.30

[Source: Financial Times]



10. The **UK corporate bond** market, meanwhile, enjoyed a very strong quarter. The Iboxx Sterling Non-Gilt Index gained 8.9% as the spread between corporate bonds and gilts fell from 270bps to 195 bps, reflecting the general sentiment that the risk of further corporate bankruptcies had reduced.

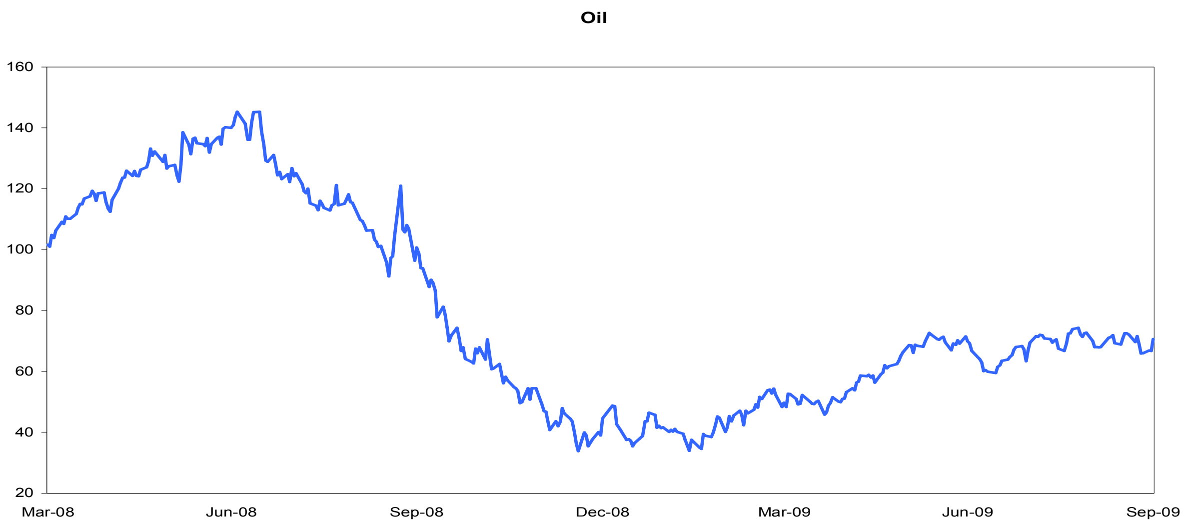


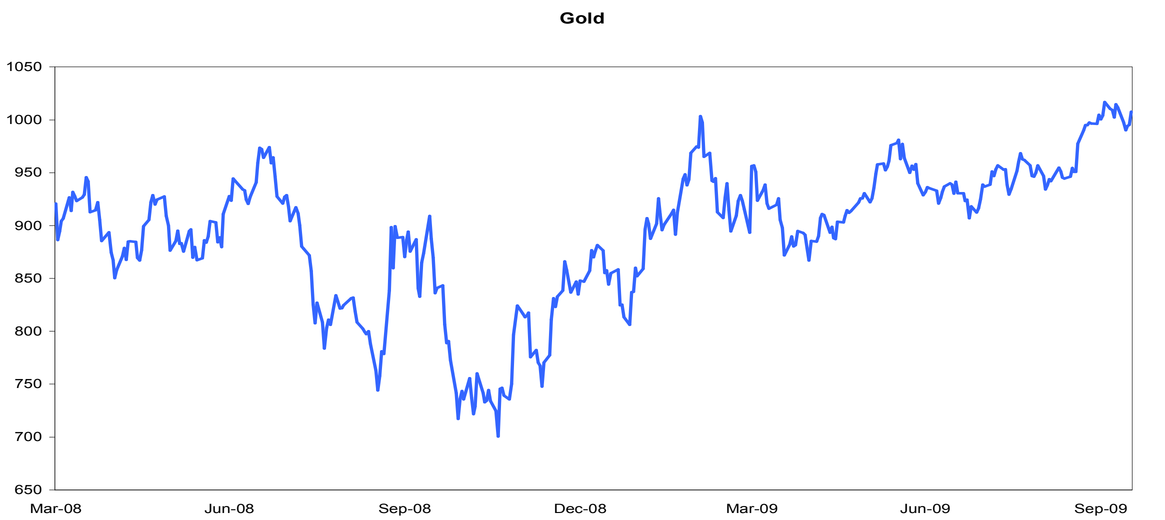
11. **UK Property** values rose for the first quarter in over two years. Yields on commercial property have fallen slightly in each of the past four months, although rental levels are also weakening. Despite strong investment demand being reported for prime office and retail sites, there is known to be a large overhang of property which could be put on the market by the banks who have lent on it, and this supply could choke off any recovery in prices.

Median fund returns to 30.9.09	**3 months**	**12 months**
Balanced Funds (n= 26)	+2.5%	- 20.4%
Specialist Funds (n= 35)	+3.3%	- 29.7%

[Source: IPD UK pooled property funds]

12. In the **Commodities** sector, oil has remained stable at around the $70 per barrel level, whereas gold has established a price above $1,000 per ounce. Since the end of September the price of gold has passed through the $1,100 level on the news that India's Central Bank had purchased 200 tonnes of gold from the IMF.





13. In the **currency** sphere, the Euro has strengthened steadily against both the pound and the dollar, ending the quarter at $1.46 and £0.914. These represent gains of 4% and 7% respectively during the quarter.

Outlook

14. In accordance with the decisions taken at the Strategic Asset Allocation Review [Item PF12E at the September Committee], the Pension Fund's end-September position was reviewed at a meeting held on 10 October to see whether the proportion in any asset class lay outside its prescribed range. In the event, Bonds had reached 19.3%, which is 1.3% above the top of their range. As both UK and Overseas Equities were below their target levels, it was decided to sell 2.3% from Bonds and reinvest 1.8% in Overseas Equities (with UBS) and 0.5% in UK Equities (with Legal & General). These transactions were carried out at the end of October. The effect was to bring UK and Overseas Equity weightings very close to their target levels, while leaving Bonds 1% above their target weight.

15. The Cash held in the Fund – other than the sums held by fund managers awaiting investment – amounted to some £42m. While a minimum of £15m has to be retained to meet drawdowns and possible purchases in the Private Equity sector (as agreed in May 2009), there still remained some £27m (or 2.7% of the Fund) available for investment.

16. Considering the rapid rise in equity markets over the previous six months, and the continuing uncertainty over economic recovery, there is an expectation that markets will fall back at some point. I recommended that this cash be held back for the present, in order that the Fund can take advantage of any fall back to levels where they offer better value to the investor.

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