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QUARTERLY REVIEW PREPARED FOR

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OXFORDSHIRE PENSION FUND COMMITTEE – 13 MARCH 2015

OVERVIEW AND OUTLOOK FOR INVESTMENT MARKETS

Report by the Independent Financial Adviser

Economy

1. The US economy slowed to growth of +0.6% in the fourth quarter, while the UK's 0.5% gain also represented a slowing from the previous rate of growth. The Eurozone economies remained sluggish, while Japan contracted for a second successive quarter and China's growth rate looked likely to slow down. The fall in oil prices reduced rates of inflation globally, but whereas the annual UK core rate (excluding energy, food and alcohol) was +1.3%, the negative inflation in the Eurozone was symptomatic of weak demand in the region.

(In the table below, bracketed figures show the forecasts at the time of the report to the December Committee)

Consensus real growth (%)					**Consumer prices latest (%)**
	2012	**2013**	**2014E**	**2015E**	
UK	-0.1	+1.7	(+3.0) +2.7	+2.6	+0.5 (CPI)
USA	+2.2	+1.9	(+2.2) +2.4	+3.3	+0.8
Eurozone	-0.5	-0.4	(+0.8) +0.8	+1.2	**-0.6**
Japan	+1.9	+1.7	(+0.9) +0.3	+1.1	+2.4
China	+7.8	+7.7	(+7.3) +7.3	+7.1	+1.5

[Source of estimates: The Economist 7th February, 2015]

2. In his **Autumn Statement** on December 3rd, George Osborne forecast UK GDP growth of 3.0% in 2014, but the estimates for the following five years were slightly lower than previously forecast, and all below 2.5%. CPI inflation is expected to remain in the 1-2% range throughout 2015 and 2016. The fiscal deficit in the 2014/15 tax year is expected to be £91.3bn (5% of GDP, and some £5bn larger than previously forecast) and to fall each year until a surplus of £4bn is achieved in 2018/19. The Debt/GDP ratio was forecast to peak at 81% in 2015/16. Notable changes announced in the Statement included an immediate revamp of Stamp Duty rates, and restrictions on the banks' ability to offset past losses against future tax.

3. The coalition's planned reduction in the fiscal deficit is predicated on cutting public spending by 1% of GDP each year, while increasing tax receipts by 0.1% of GDP each year. The Labour Party criticised the scale of these spending cuts, and indicated that, if elected, they would cut spending by only 0.6% of GDP per annum. This difference in approach looks likely to be one of the main themes of the forthcoming General Election campaign.

4. In mid-November, **Japan**'s GDP was announced to be -0.4% for the third quarter, thereby confirming a recession, and shortly afterwards Prime Minister Abe announced he would defer the second stage of the consumption tax increase from October 2015 to April 2017. He also called a snap election for December 14th, which, in the face of opposition disarray, confirmed the LDP's standing in the Diet.

5. The most dramatic – and unexpected – development has been the steep fall in the price of **oil**. A barrel of Brent Crude halved in price (from $112 to $57) during the second half of 2014, and ended January at $52. The causes have been a mix of slowing demand and inflexible supply. Within the OPEC group, the low-cost producers (Saudi Arabia, Kuwait, Qatar and UAE) have decided to maintain their production levels, knowing that this will force the price of oil downwards. Their motivation may be to make life difficult for the shale oil producers of North America, whose profitability – and in some cases viability – is severely affected by such a sharp reduction in market prices. The death of King Abdullah of Saudi Arabia on January 23rd created more uncertainty about the OPEC producers' future policy on oil supplies. While cheaper fuel is beneficial for private and industrial consumers, it is deeply negative for countries relying on oil exports, notably Russia, Nigeria and Venezuela.

6. The plunging oil price dealt a further blow to the **Russian** economy, already weakened by the imposition of trade sanctions earlier in the year. After raising interest rates from 9.5% to 10.5% on December 11, ostensibly to combat inflation, the Russian Central Bank suddenly increased the rate to 17% at midnight on December 15, in an attempt to defend the rouble which had fallen to R66 per $. The following day the rate fell further - to 77 per $ - before rebounding to the 55 level on heavy buying from the Russian Central Bank. After the interest rate was cut to 15% at the end of January, the rouble weakened to R70 per $.

7. The political situation in **Greece** has reawakened concerns about the future of the Eurozone. On December 29th the Greek parliament failed to elect a president, forcing an early election on January 25th. This resulted in a victory for the far-left populist party Syriza, led by Alexis Tsipras, who formed a coalition government with the right-wing Independent Greeks party. Mr Tsipras had advocated revoking most of the conditions attached to Greece's bail-out: he would end austerity, scrap asset sales and seek to repudiate half of Greece's debt. This will bring him into conflict with the ECB.

8. On January 15th the **Swiss** National Bank surprised markets with the news that it was abandoning the currency cap against the Euro, which had prevented the Swiss Franc appreciating beyond SFr1.20 per € since 2011. A

massive surge in the Swiss Franc took it to 0.85 /€, before it closed the day at 1.04/€. Deprived of support from the SNB, the Euro weakened to $1.15 – its lowest level for eleven years. In two days the £ moved from SFr 1.55 to just SFr 1.29, but then rallied to end the month at SFr 1.38.

9. On January 22nd, the European Central Bank announced it would embark on a €60bn per month programme of Quantitative Easing – purchasing assets including government and private sector bonds – from March 2015 until at least September 2016, in an effort to stimulate the Eurozone economies.

Markets

10. The movements of **equity** market indices for the quarter as a whole conceal a volatile period, where prices fell by some 10% in the month to mid-October (as described in my previous report), before recovering, and then underwent a smaller correction in early December. UK, European and Emerging Markets lagged the other regions, while almost the entire gain in the All-World Index was attributable to North America's rise.

	Capital return (in £, %) to 31.12.14		
Weight %	Region	**3 months**	**12 months**
100.0	FTSE All-World Index	**+4.0**	**+8.5**
54.9	FTSE All-World North America	+7.7	+17.1
7.8	FTSE All-World Japan	+1.5	+0.7
11.6	FTSE All-World Asia Pacific ex Japan	+2.7	+6.6
15.6	FTSE All-World Europe (ex-UK)	-1.7	-4.4
7.2	FTSE All-World UK	-0.8	-2.9
8.9	FTSE All-World Emerging Markets	+0.0	+4.7

[Source: FTSE All-World Review, December 2014]

11. Within the UK equity market, only the 'mid-cap' FTSE 250 Index gained ground during the quarter or, indeed, during the year as a whole.

(Capital only %, to 31.12.14)	**3 months**	**12 months**
FTSE 100	**- 0.9**	**-2.7**
FTSE 250	**+4.6**	**+0.9**
FTSE Small Cap	**-0.3**	**-1.5**
FTSE All-Share	**+0.0**	**-2.1**

[Source: Financial Times]

12. By sector, Oil & Gas and Basic Materials were dragged down by the falling prices of oil and commodities, while all the other sectors (with the exception of Telecommunications) registered solid gains during the quarter.

Capital return (in £, %) to 31.12.14		
Industry Group	**3 months**	**12 months**
Health Care	+6.7	+24.1
Technology	+6.9	+23.4
Utilities	+5.7	+15.9
Consumer Services	+10.7	+11.9
FTSE All-World	**+4.0**	**+8.5**
Financials	+5.6	+8.2
Consumer Goods	+6.4	+7.2
Industrials	+4.7	+5.8
Telecommunications	-0.1	+0.8
Basic Materials	-3.3	-5.3
Oil & Gas	-12.8	-10.9

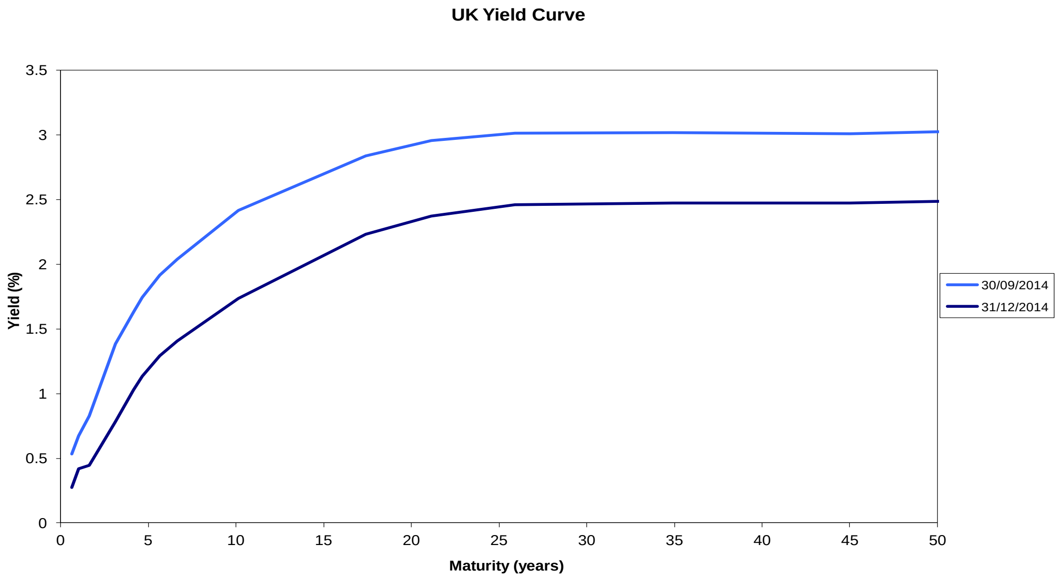
[Source: FTSE All-World Review, December 2014]

13. **Government bond** markets in the 'safe haven' economies strengthened further, and yields have fallen substantially during 2014 in all these markets as shown in the table below. Amid investors' worries about the outlook for Greek bonds (see para 7) and possibly other peripherals, the security of German, UK or US government bonds became increasingly attractive, and 10-year yields on UK and US government bonds fell by 0.5% in January 2015 – equivalent to a 3-4% gain in price. Lower inflation has also contributed to the demand for fixed-coupon bonds by increasing the real yields.

10-year government bond yields (%)					
	Dec 11	**Dec 12**	**Dec 2013**	**Sept 2014**	**Dec 2014**
US	1.88	1.76	3.03	2.49	2.17
UK	1.98	1.85	3.04	2.43	1.76
Germany	1.83	1.32	1.94	0.95	0.54
Japan	0.98	0.79	0.74	0.53	0.33

[Source: Financial Times]

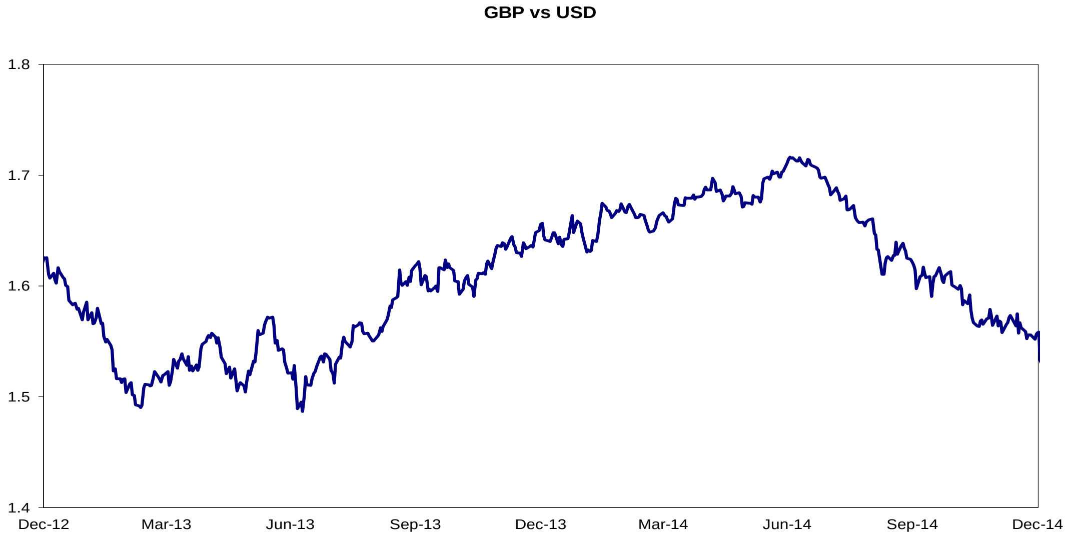
14. In the UK, yields continued to reduce at all durations, as shown below.



Currencies

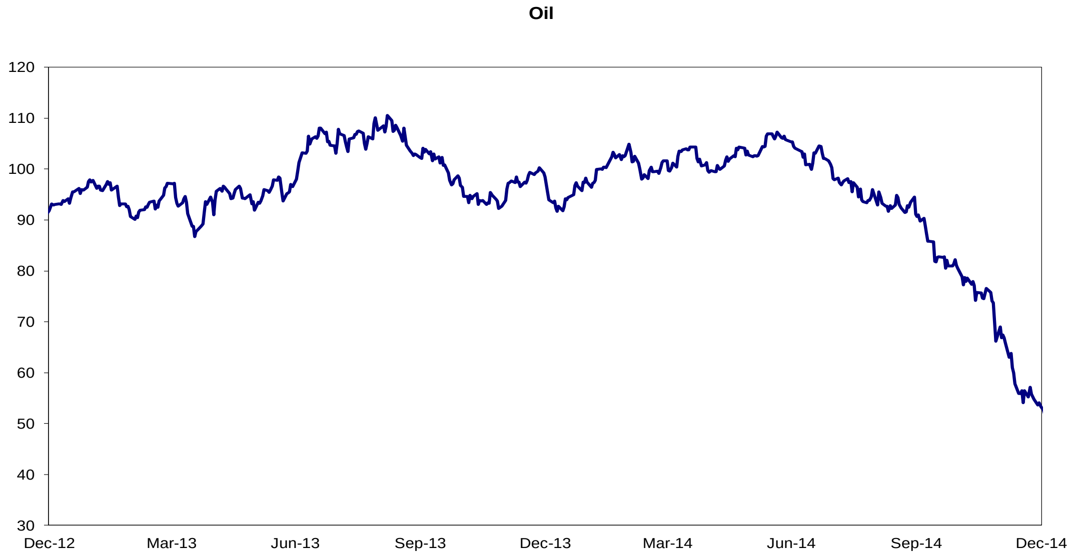
15. The yen fell after the Bank of Japan embarked on its enhanced QE policy, while the pound fell against the dollar (see graph below) as it became clear that the first UK interest rate rise would be delayed until at least the final quarter of 2015.

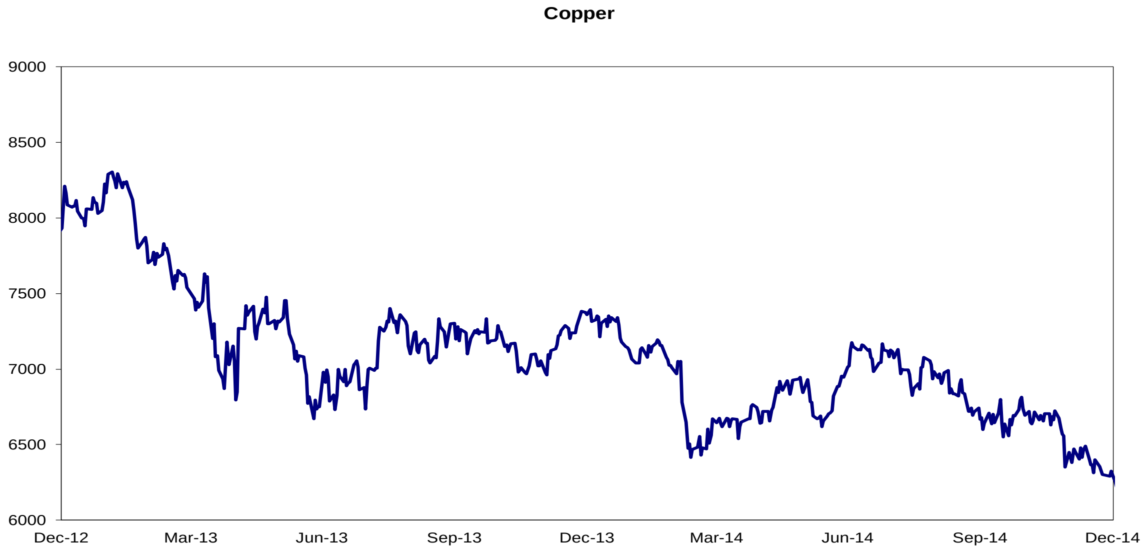
				£ move	
	31.12.13	**30.09.14**	**31.12.14**	**3m**	**12m**
$ per £	1.656	1.621	1.559	- 3.8%	- 5.9%
€ per £	1.202	1.283	1.289	+ 0.5%	+ 7.2%
Y per £	174.1	177.8	186.9	+ 5.1%	+ 7.4%



Commodities

16. The sharp fall in oil prices has been described in para 5, but the price of copper also weakened on the expectation of lower demand from China.





Property

17. The UK property market has maintained its strong momentum of the past eighteen months, with returns, as measured by the IPD Monthly Index, especially strong in the Office and Industrial sectors.

	3-month	**12-month**
All Property	**+4.4%**	**+19.3%**
Retail	**+2.8%**	**+14.1%**
Office	**+5.6%**	**+24.3%**
Industrial	**+6.0%**	**+24.4%**

[IPD Monthly Index of total returns, Dec 2014]

Outlook

18. The sharp fall in the oil price should be of benefit to consumers, by boosting their spendable income, and to those companies whose input costs are significantly related to the price of oil. Clearly there are other companies (e.g. those reliant on oil exploration) who are suffering from the new regime, and will continue to do so while the price remains depressed. Oil-exporting countries (including several Emerging Markets) are also under pressure, just as oil-importing countries are beneficiaries. Overall, the boost to consumer spending should be positive for global economic growth in 2015.

19. The ECB's decision to start a programme of Quantitative Easing has delivered a boost to equity and bond markets, but the election of Syriza in Greece has

created renewed uncertainty about Greece's place in the Eurozone – and the possible consequences for other members if Greece were to default on its debts or to leave the single currency.

20. While the lower level of inflation makes lower bond yields more sustainable, and in turn emphasises the attractions of equity yields, there are also many reasons to remain cautious on the outlook for equities during 2015.

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[All graphs supplied by Legal & General Investment Management]