Division(s): N/A

PENSION FUND COMMITTEE – 18 MARCH 2011

OVERVIEW AND OUTLOOK FOR INVESTMENT MARKETS

Report by the Independent Financial Adviser

The Economy

1. In revisions to initial data, GDP growth in the US and Japan turned out to be stronger than anticipated in the 3rd quarter, and estimates of growth the full year have been upgraded accordingly. In the UK, however, growth for the 4th quarter was reported to be - 0.5%, a disappointing result even after allowance is made for the bad weather. Although the Eurozone as a whole grew at a moderate pace, Germany's GDP grew at no less than 3.6% - its strongest for many years. The weakness of its main export markets in the euro area, however, is likely to mean much slower growth for Germany in 2011.
(In the Table below, the consensus estimates at the time of the December Committee are shown in brackets. Note that the consumer prices data now refers to the latest year in each case, rather than being a forecast)

Consensus real growth (%)						Consumer prices latest (%)
	2007	2008	2009	2010E	2011E	2010
UK	+3.0	+0.7	- 4.7	(+1.7) +1.6	+ 1.8	+ 4.0 (CPI)
USA	+2.0	+1.2	- 2.5	(+2.6) +2.9	+ 3.1	+ 1.5
Eurozone	+2.6	+0.8	- 3.9	(+1.6) +1.7	+ 1.5	+ 2.4
Japan	+2.0	- 0.2	- 5.3	(+2.9) +4.2	+ 1.5	0.0
China	+11.9	+ 9.0	+ 8.7	(+9.9) +10.3	+ 9.0	+ 4.6

[Source of estimates: The Economist, 12.02.2011]

2. The sovereign debt problems in the euro area, which had surfaced with the bail-out of Greece in May, engulfed Ireland in November and the Irish government was obliged to seek an emergency bail-out from the EU and the IMF which may require up to € 85bn. Sovereign bond markets did not react as joyfully as they had after the announcement of the Greek package, but there was good demand for the bond issued by the European Financial Stabilisation Mechanism to cover the Irish bail-out at the end of the year. Portugal and Spain also managed to issue bonds, albeit at wide margins above German debt.

Markets

3. The resolution of the Irish crisis, and the encouraging economic data from the US allowed **equity markets** to embark on their traditional December rally, and the bulk of the fourth-quarter gains were in fact registered in December alone.

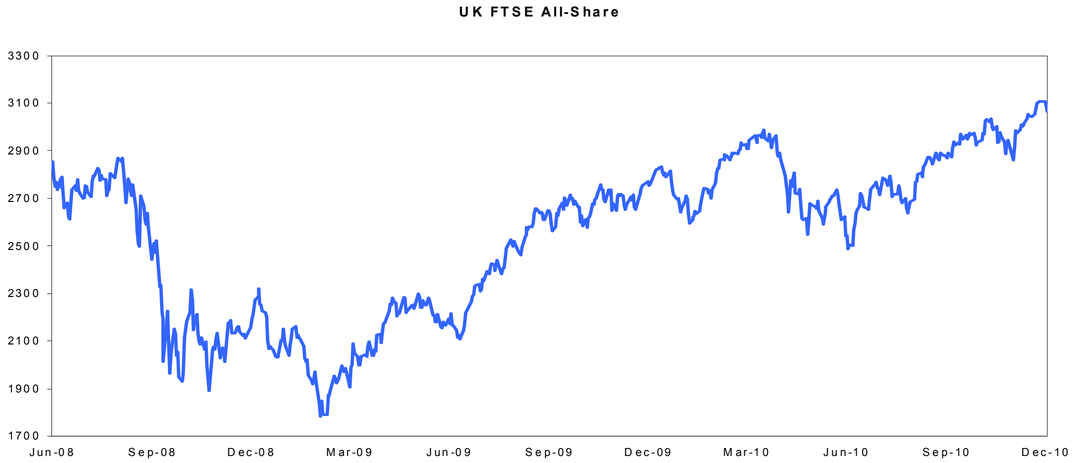
For the full year, it is noticeable how the UK and Europe have lagged other equity markets.

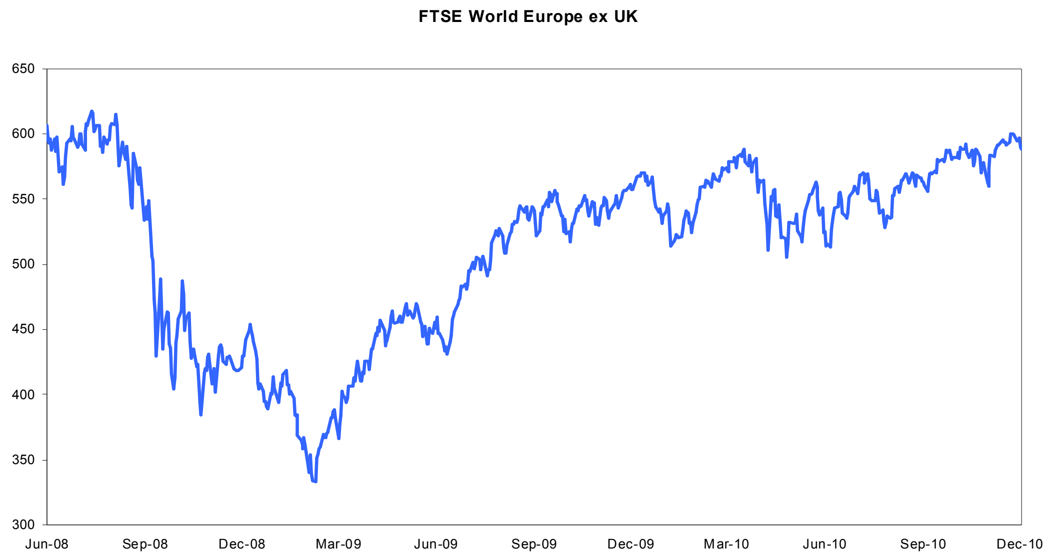
Capital return (in £, %) to 31.12.10		
	3 months	**12 months**
FTSE All-World Index	+8.9	+13.9
FTSE All-World North America	+11.0	+16.7
FTSE All-World Asia Pacific	+9.6	+19.1
FTSE All-World Europe (ex-UK)	+4.7	+3.2
FTSE All-World UK	+6.2	+8.5
FTSE All-World Emerging Markets	+7.7	+20.5

[Source: FTSE All-World Review, December 2010]

4. While all industrial sectors rose in the fourth quarter, the strongest growth came in the resource sectors – Basic Materials gained 17% and Oil & Gas 15%, reflecting the price rises in the underlying commodities. Industrials and Technology each gained 10%, while Utilities, Healthcare and Telecomms only gained 2 – 3%.

5. The rally which started in March 2009 has restored most equity markets to levels last seen in mid-2008, before the worst phase of the credit crunch began, as shown in the graphs below.





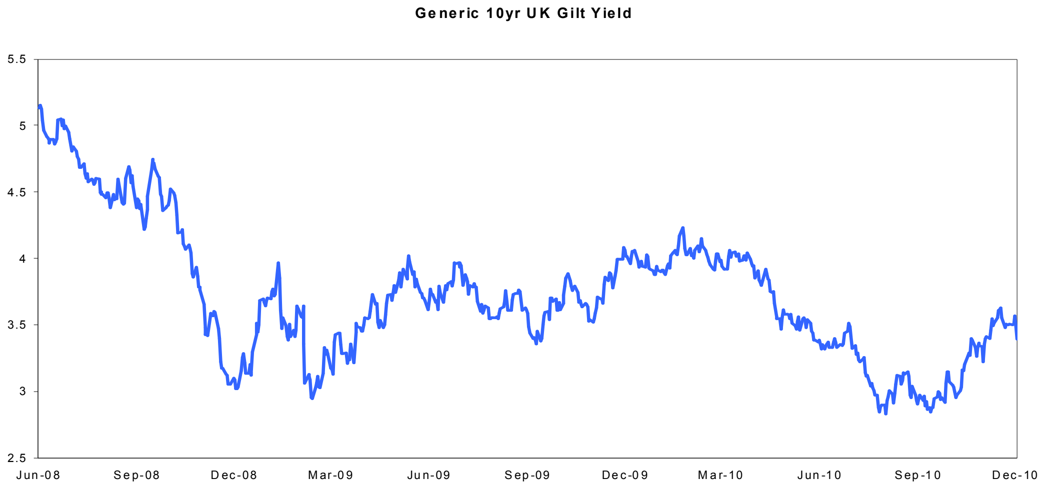
6. In the UK, there was a marked difference in performance between large-, mid- and small-cap equities during 2010. The rise in the FTSE 250 stocks was driven by bid activity and strong profit growth, while the FTSE 100 was held back by the lacklustre performance of Banks, Oil & Gas Producers and Utilities which feature more strongly in the FTSE 100 than in the FTSE 250.

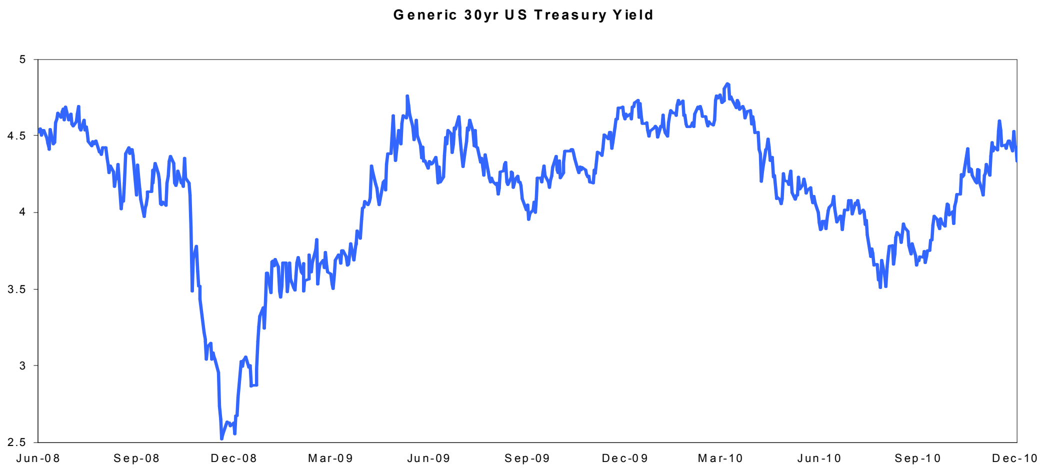
Index	**Capital return in 2010**
FTSE 100	+ 9.0%
FTSE 250	+24.2%
FTSE Small Cap	+16.3%
FTSE All Share	+10.9%

7. The boom in **government bonds** issued by US, UK, Germany and Japan, which had driven 10-year yields to extraordinarily low levels in September, came to an end as yields rose to more normal levels - while still permitting good capital gains for the full year. The 30-year US Treasury Bond yield rose from 3.7% to 4.4% during the fourth quarter, frustrating the Federal Reserve's intention to keep long bond yields low by means of its quantitative easing programme. Medium- and long-term yields in the US and Europe have continued to rise steadily during the first six weeks of 2011.

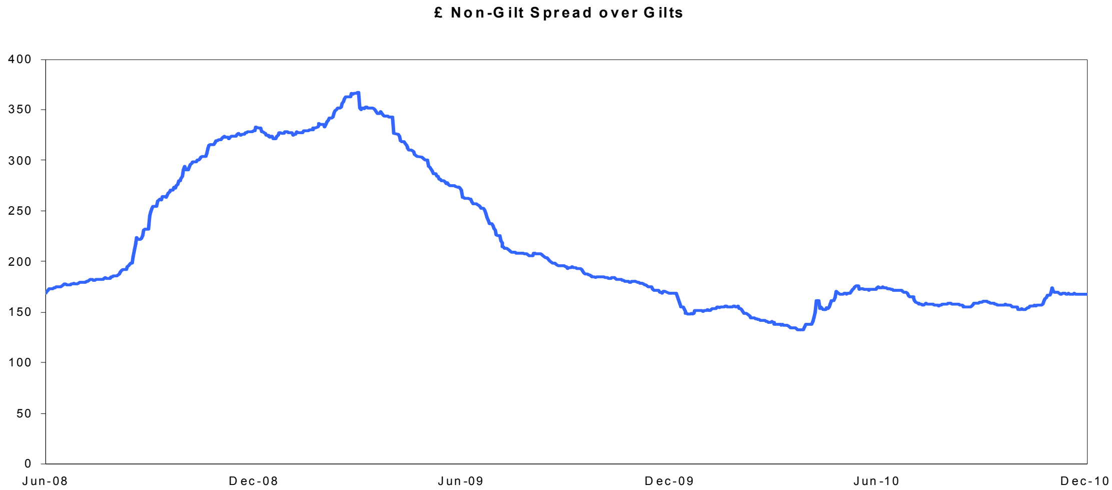
10-year government bond yields (%)				
	Dec 2009	**June 2010**	**Sept 2010**	**Dec 2010**
US	3.84	2.96	2.52	3.34
UK	4.01	3.35	2.95	3.39
Germany	3.40	2.58	2.29	2.92
Japan	1.29	1.09	0.94	1.12

[Source: Financial Times]





8. The yield spread on **UK Corporate Bonds** relative to gilts widened slightly, with a distinct two-tier market developing between Industrials (on narrow spreads) and Banks (on wide spreads). With the setback in gilt prices, corporate bond prices fell for the first time in the past six quarters.



9. Capital values in the **UK commercial property** market have begun to level off after an 18-month period of recovery, and most forecasters predict that returns from property in 2011 will be confined to income only, with no capital uplift.

Median fund returns to 31.12.10	**3 months**	**12 months**
Balanced Funds (n= 25)	+ 1.5%	+ 12.9%
Specialist Funds (n= 27)	+ 2.5%	+ 13.9%

[Source: IPD UK pooled property funds]

10. In **Commodities**, the price of gold rose by 7% in the quarter, while oil and copper prices continued their headlong rises – Brent Crude rising from $81 to $95 per barrel in the quarter, and copper reaching $9,500 per tonne after a similar 17% rise. Since the year-end, oil has risen further, on political uncertainty in the Middle East, while gold and copper have stabilised.

11. In **currency** markets, sterling slipped by 2% against the dollar, and by 3% against the yen, while gaining 1% relative to the euro.

Outlook

12. The renewed rally in equity markets since mid-2010 has lifted prices in several markets to almost double their low points in March 2009. While this has taken place against a background of extremely supportive monetary policy from central banks, the test to the resilience of equities will come when interest rate rises begin in developed markets.

13. Money markets are pricing in a 0.25% rise in UK rates in May, and while the present 4% annual rate of CPI inflation may indeed be due to higher commodity and food prices, as well as the VAT increase and a weak pound, it is hard to imagine UK base rate remaining at 0.5% for much longer

14. Bond markets have begun to adjust to the inflationary trend being seen in the UK (and also in Germany). The long-term rate of inflation implied by comparing the market yields for conventional and index-linked government bonds has risen since August 2010 from 2.5% to 3.2% in the UK, and from 1.5% to 2.3% in the US. The attraction of equities relative to bonds in these markets is no longer as clear-cut as it was last summer.

15. At the interim meeting held on January 25, the only rebalancing required was a switch of £10m from Cash to Fixed Interest.

16. Although the outlook for corporate profits in 2011 is still supportive of current equity ratings, the likely pressures from interest rates and raw material price rises, and the developing political situation in North Africa and the Middle East, induce caution about the scope for any further gains in equities for the remainder of 2011.

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