Clwyd Pension Fund

Committee Report:

Economic and Market Update Q4 2014

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1 Market / Economic Data to 31 December 2014

Market Statistics

Yields as at 31 December 2014	% p.a.
UK Equities	3.37
UK Gilts (>15 yrs)	2.42
Real Yield (>5 yrs ILG)	-0.77
Corporate Bonds (>15 yrs AA)	3.41
Non-Gilts (>15 yrs)	3.74

Absolute Change in Yields	3 Mths %	1 Year %	3 Years %
UK Equities	0.03	0.09	-0.15
UK Gilts (>15 yrs)	-0.56	-1.16	-0.52
Index-Linked Gilts (>5 yrs)	-0.40	-0.80	-0.52
Corporate Bonds (>15 yrs AA)	-0.42	-1.01	-1.27
Non-Gilts (>15 yrs)	-0.41	-0.89	-1.08

Market Returns Bond Assets	3 Mths %	1 Year %	3 Years % p.a.
UK Gilts (>15 yrs)	11.2	26.1	6.9
Index-Linked Gilts (>5 yrs)	9.4	21.4	7.1
Corporate Bonds (>15 yrs AA)	6.7	18.9	9.3
Non-Gilts (>15 yrs)	6.6	19.0	10.2

Source: Thomson Reuters and Bloomberg

Market Returns Growth Assets	3 Mths %	1 Year %	3 Years % p.a.
UK Equities	0.6	1.2	11.1
Overseas Equities	4.9	12.2	15.1
USA	8.9	20.3	20.4
Europe	-1.4	-1.4	12.8
Japan	1.6	2.7	9.9
Asia Pacific (ex Japan)	3.2	10.0	9.4
Emerging Markets	0.4	7.9	4.8
Frontier Markets	-9.0	13.9	13.8
Property	4.4	19.3	10.5
Hedge Funds	4.0	10.8	5.7
Commodities	-24.8	-28.9	-13.0
High Yield	1.5	6.1	8.7
Emerging Market Debt	-0.6	7.4	6.1
Senior Secured Loans	-0.1	2.3	7.4
Cash	0.1	0.5	0.5

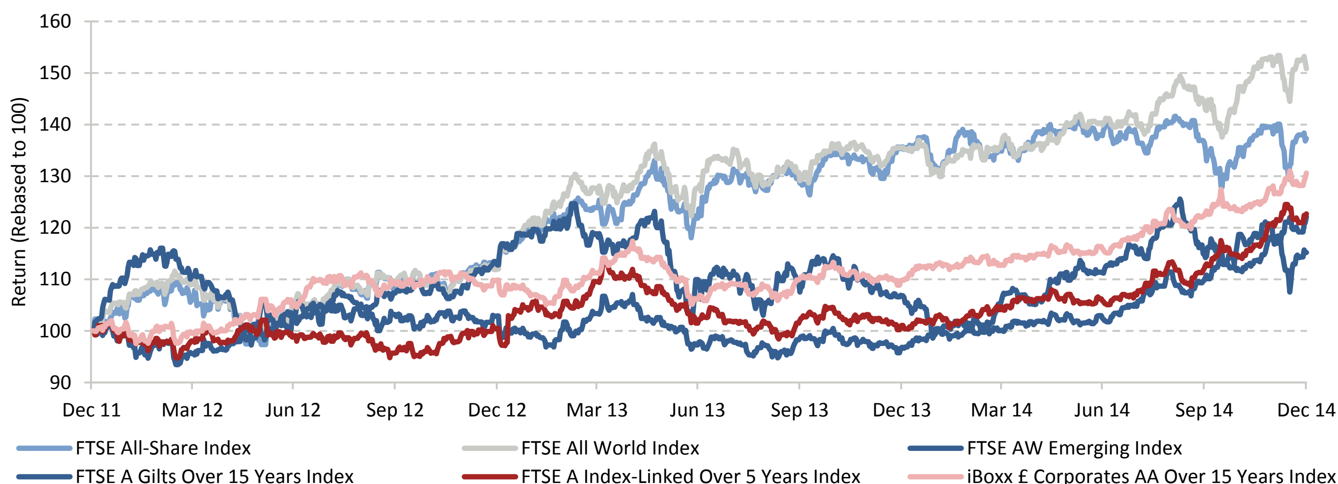
Change in Sterling	3 Mths %	1 Year %	3 Years % p.a.
Against US Dollar	-3.8	-5.9	0.1
Against Euro	0.4	7.2	2.5
Against Yen	5.1	7.4	16.1

Inflation Indices	3 Mths %	1 Year %	3 Years % p.a.
Price Inflation – RPI	0.0	1.6	2.5
Price Inflation – CPI	-0.2	0.5	1.7
Earnings Inflation*	1.0	1.8	1.4

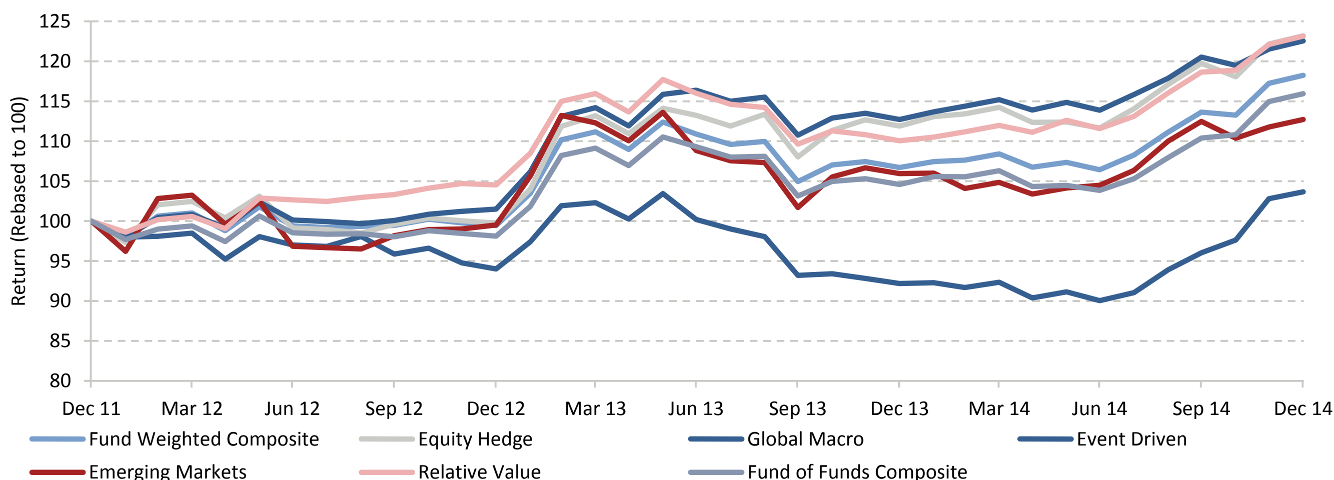
* Subject to a 2 month lag

Market Charts

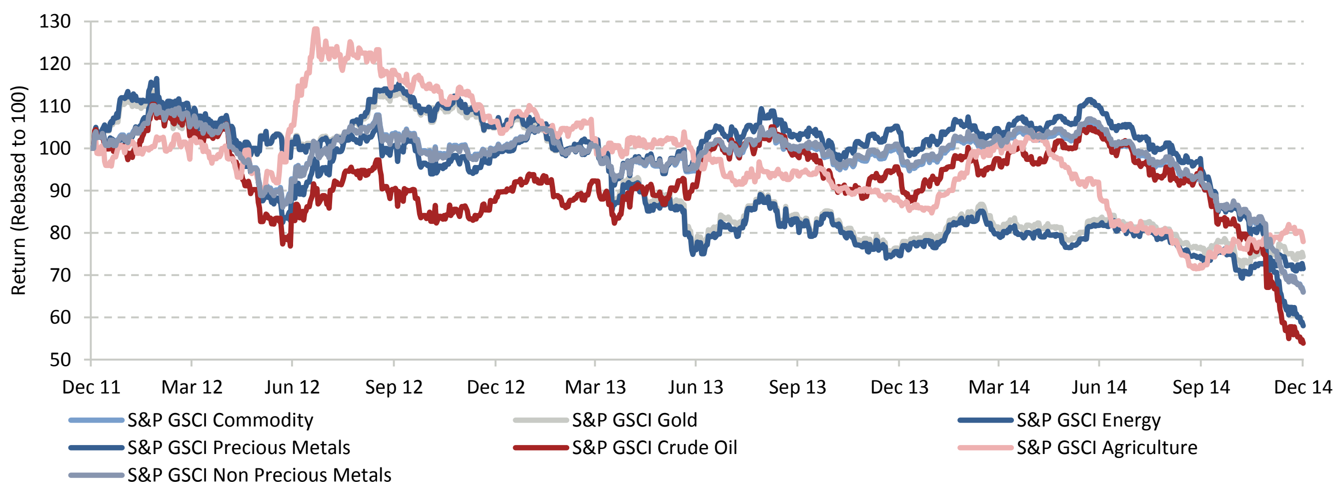
Market performance – 3 years to 31 December 2014



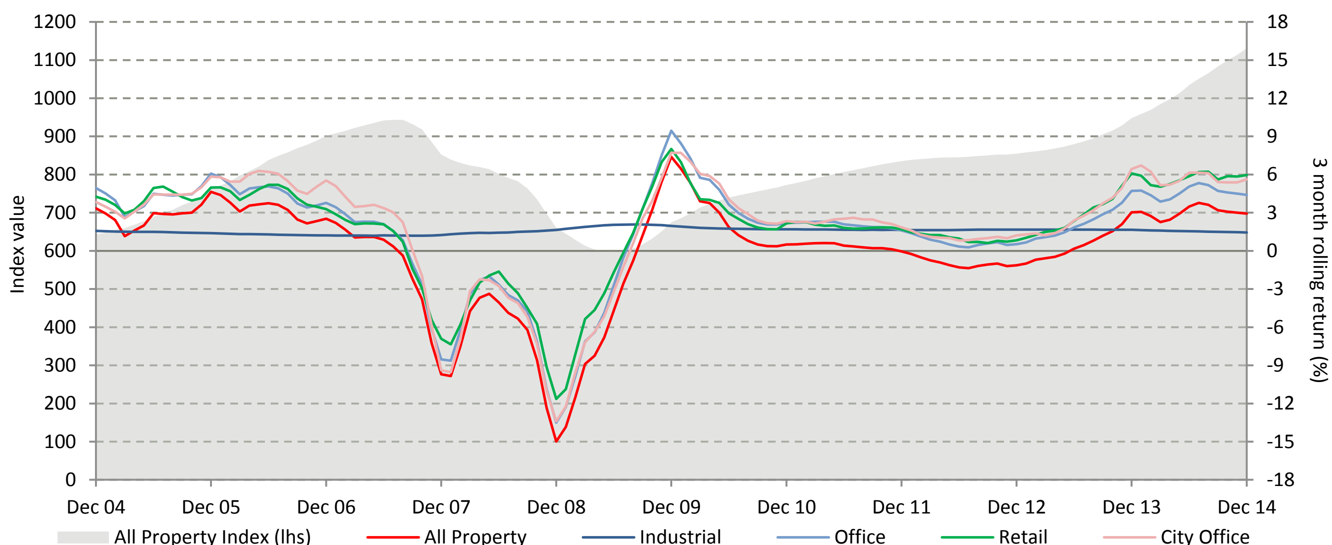
Hedge Funds: Sub-strategies performance – 3 years to 31 December 2014



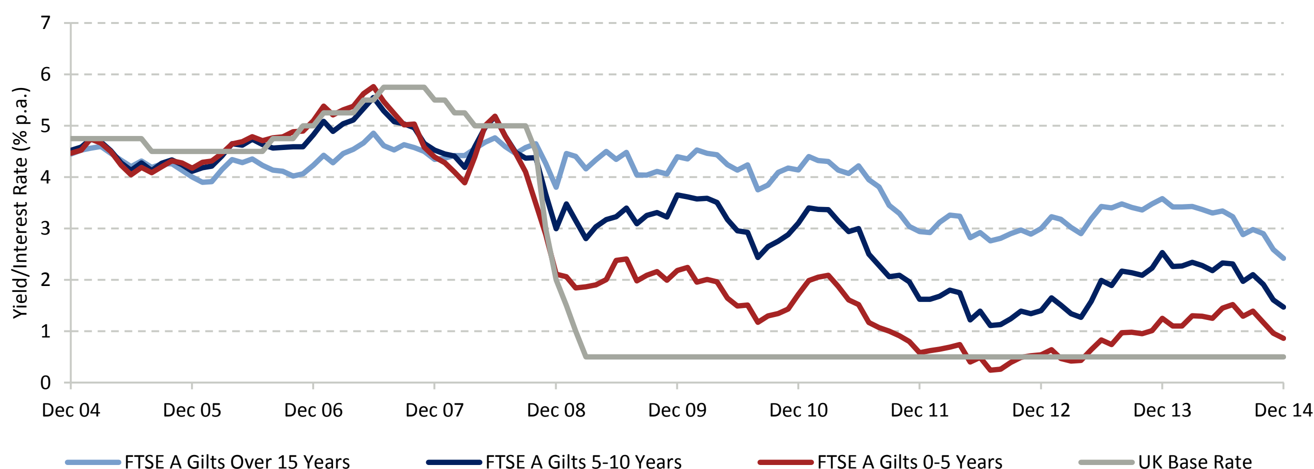
Commodity sector performance – 3 years to 31 December 2014



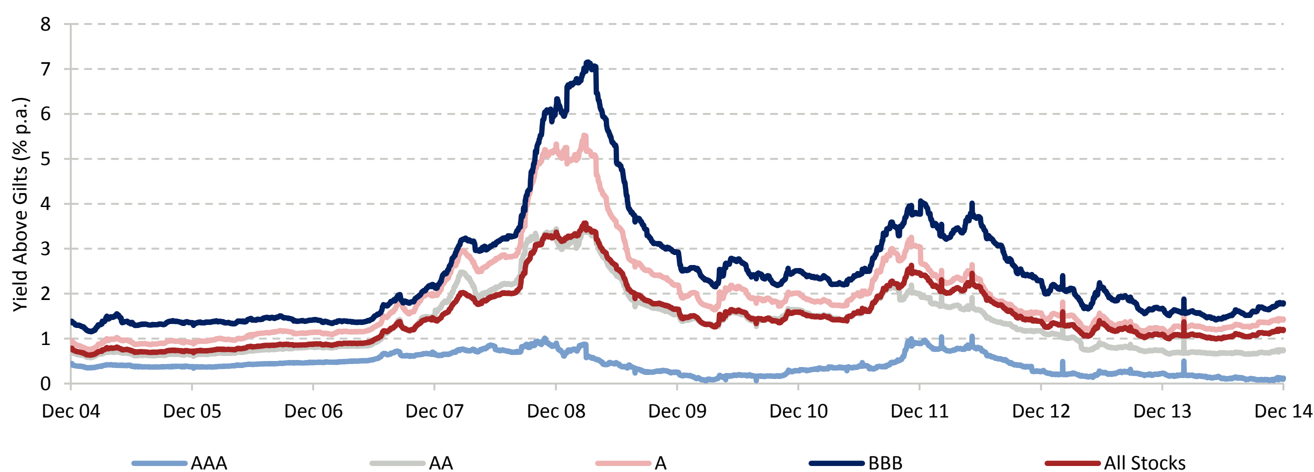
Property sector performance – 10 years to 31 December 2014



UK government bond yields – 10 years to 31 December 2014



Corporate bond spreads above government bonds – 10 years to 31 December 2014



Economic Information

Economic statistics

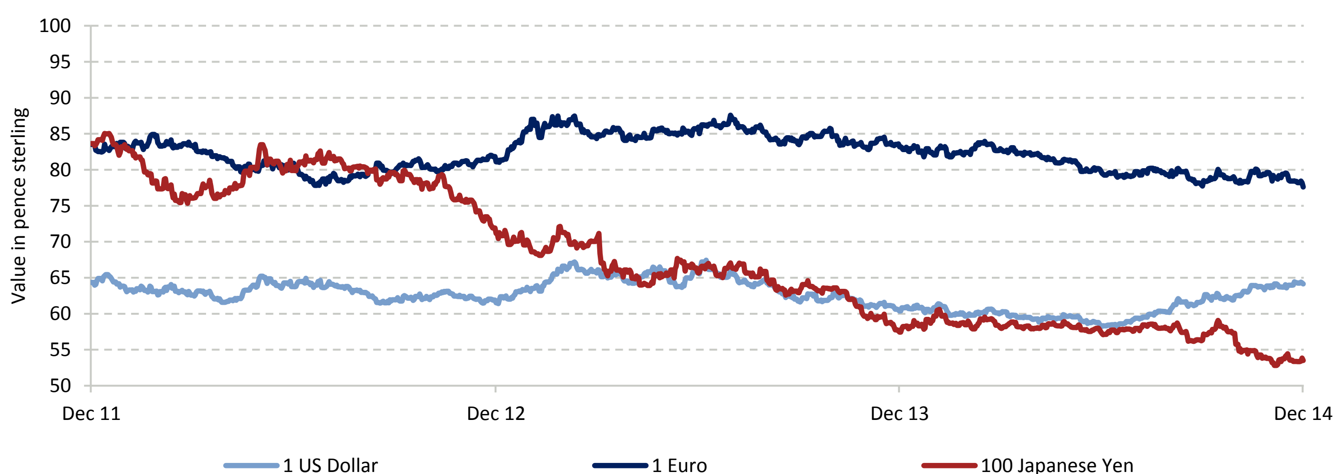
	Quarter to 31 December 2014			Year to 31 December 2014		
	UK	Europe[1]	US	UK	Europe[1]	US
Real GDP growth[3]	0.7%	n/a	0.9%	3.0%	n/a	2.3%
Inflation change[2]	-0.2%	-0.3%	-1.4%	0.5%	-0.2%	0.8%
Unemployment rate at quarter-end	6.0%	11.5%	5.6%	6.0%	11.5%	5.6%
Previous rate (last quarter-end / 1 year ago)	*6.3%*	*11.5%*	*5.9%*	*7.1%*	*11.1%*	*6.7%*
Manufacturing PMI* at quarter-end	52.5	50.6	53.9	52.5	50.6	53.9
Previous PMI (last quarter-end / 1 year ago)	*51.6*	*50.3*	*56.6*	*57.3*	*52.7*	*57.0*

(1) EU changing composition area; (2) CPI inflation measure; (3) GDP to 30 September 2014. *PMI = Purchasing Managers Index

Exchange rates

Exchange Rates	Value in Sterling (Pence)			Change in Sterling	
	31 Dec 2014	30 Sep 2014	31 Dec 2013	3 months	12 months
1 US Dollar is worth	64.13p	61.68p	60.38p	-3.8%	-5.9%
1 Euro is worth	77.61p	77.92p	83.19p	0.4%	7.2%
100 Japanese Yen is worth	53.49p	56.23p	57.44p	5.1%	7.4%

Exchange rate movements – 3 years to 31 December 2014



Source: Thomson Reuters, Markit, Institute for Supply Management, Eurostat, United States Department of Labor and US Bureau of Economic Analysis.

2 Market Commentary

Introduction

2014, in sterling terms, was the year of the USA. Asia ex Japan also performed well, but this was largely due to recovering performance lost in 2013. Elsewhere – almost nothing, with the UK, Europe and Japan flat for the year (Japan's returns being negatively affected by the weakness of the yen).

The result was that overall portfolio returns were positive, the magnitude being determined mainly by the weighting in the USA, and that in turn was influenced by the risk tolerance of the individual investor. So for 2014, 'Modified rapture', as Nanki-Poo says in 'The Mikado'.

Why the disparity in equity returns? The US equity market, although widely perceived as being 'up with events' earlier last year, benefited from steadily improving economic figures, ample liquidity (despite the ending of Quantitative Easing in the autumn) and a stronger dollar drawing in foreign investors. The latter were not only attracted by the increasing fundamental strength of the market, but also looked upon it as a safe haven in times of troubles elsewhere.

And as the year reached its end, the troubles have been mounting. The collapse in the price of oil, to levels not seen for many years, has partly been caused by a weakness in demand worldwide, but has mainly been engineered by some oil producers refusing to cut supply (which most analysts believe is for geo-political reasons rather than economic ones). Lower oil prices are the equivalent of a tax cut for many countries and a boost to growth, but the fall also adds to the downward trajectory of inflation being seen almost everywhere in the developed world.

Not everybody is a winner. Russia is the prime example of a loser in such a situation. Exacerbated by economic sanctions imposed over Ukraine, the economy – and more particularly the currency – is in free-fall. The consequences of this are likely to be one of the themes in 2015.

A Eurozone crisis is also potentially re-emerging (has it ever gone away?) led again by Greece. This is discussed further below, but markets have taken fright by the possibility of a repeat of the convulsions of 2011 – supposedly behind us.

With the US returning to military action in the Middle East to counter the threat of additional territorial gains by the Islamic State, involving other nations – including the UK – in its wake, the world has suddenly become a more dangerous place.

Investors have experienced two sharp corrections in equity markets during the last quarter, one in October when prices quickly recovered, and another in December, where the recovery has been patchier. As this document is being written, the accelerating fall in the oil price has been the primary cause of a third setback in prices with the outcome currently uncertain. But increasing volatility does not augur well for 2015.

United Kingdom

- It was a year of two halves for the market, which rose 5% in the first six months, only to lose nearly all its gain in the second half.
- This was despite a domestic backdrop that was quite encouraging. Economic growth accelerated (second only to the US of major economies), inflation continued to fall as did unemployment, and real wages finally began to rise.
- But not everything in the garden was rosy. Both the budget and current account deficits have remained stubbornly high. Internationally, the continuing weakness of the Eurozone economies – the UK's largest trading partner – belatedly began to have an effect on corporate profits. (Russian sanctions are having a more indirect affect). And in the last few months the weakness in commodity prices in general, and oil in particular, has weighed heavily on several large components of the FTSE 100 Index.

- As mentioned above, interest rates are expected to remain at current levels for the foreseeable future (even if recent minutes of the Monetary Policy Committee suggest greater disagreement on timing that hitherto) unless the Federal Reserve – and the European Central Bank – by their actions force the Bank of England's hand.
- However, in the short term sterling, gilts and probably equities will be influenced more than anything by the election campaign. Harold Wilson said 'a week is a long time in politics', and UK markets now have four months to ponder that statement. The outcome – a clear Conservative or Labour victory, or another coalition with all sorts of possible combinations of parties – is totally uncertain at this early stage. As each week passes, investors – particularly foreign investors – are likely to become increasingly nervous.
- Equity valuations are close to their long term average and, even with the uncertainty, look attractive relative to fixed income, based on their yield, if nothing else. Earnings are also forecast to grow in 2015, albeit by less than 10%. Dividends, however, could come under pressure in some areas (oil majors, food retailers, for example).
- So we would expect a volatile few months ahead.

Europe ex UK

- 'Words! Words! Words! I'm so sick of words!'. Many investors in Europe would echo Eliza in 'My Fair Lady' as, throughout 2014, the European Central Bank (or more particularly its head, Mario Draghi) has said a lot, but has made few meaningful policy changes.
- Negative interest rates and purchases of asset-backed securities have had little noticeable effect, except on the value of the euro, which has weakened significantly over the course of the year.
- Economic growth has been negligible, inflation has continued to fall with deflationary fears rising in everybody's minds (even, at last, in Mr Draghi's – after months of denial) and, as already mentioned, the euro has weakened. This would normally be considered a benefit, especially for exporters, but the economic sanctions on Russia have had a far greater impact on the Eurozone – in particular Germany – than elsewhere.
- The collapse in the oil price, should it continue, will also be a benefit in the longer term, but in the short term is only exacerbating the fall in inflation and the threat of deflation.
- And to cap it all, the totally unexpected forthcoming election in Greece has returned to the limelight many of the problems of 2011/12 which policymakers had thought they had put behind them. 'Grexit' – Greece leaving the euro, either voluntarily or involuntarily, is again on the agenda – even if still unlikely. Anti-euro parties (not necessarily anti-EU) have been making gains across the continent, and should Greece set a precedent – and it works – others may try to follow.
- We have been here before, of course, and in theory economies, and the Eurozone as a whole, are better protected against contagion than in 2011. This is the official line from Brussels and Berlin. But in practice? Hence investors' concern, and it is no surprise that markets did nothing last year.
- However, the cavalry is expected to arrive, in the form of full-blown Quantitative Easing. The timing is awkward (just before the Greek election) but markets will be disappointed – to put it mildly – if another month goes by without real action. Whether the Germans will agree, is still a moot point, but deflationary fears are now so prevalent throughout the region and growth forecasts are so low that realism must surely overcome their doubts. If not, the prospects for Europe are grim.
- Churchill once said 'Success is the ability to go from one failure to another with no loss of enthusiasm'. Should the ECB finally agree to Quantitative Easing, equity markets will rally and bond yields will sink even more. But whether it will work is still the trillion euro question. Will it turn out to be yet another failure – too little too late? Only time will tell.
- The events of the next few months of 2015 will concentrate the minds of investors generally (and voters – there are elections due in both Spain and Portugal).

North America

- The US equity market performance in 2014 far outstripped all other major markets (even in sterling).
- The economy, at last, appears to be accelerating. Unemployment has been falling steadily, wage growth has been picking up, banks – whilst still somewhat cautious – are lending more, and the consumer is seeing the benefit of falling oil prices.
- However, the fall in the price of oil is a double-edged sword. With the on-going development of shale, the US was heading to be the world's largest producer of oil, but should the price remain at current levels for any length of time much of the new development becomes uneconomic. US energy companies have issued over $500 billion in debt since 2010, and the repayment of much of this is becoming problematic at these prices. There could be severe pain ahead.
- Economic growth, despite being partially distorted by increased military spending (to fund the return of US forces to the Middle East) and expenditure on healthcare, seems to have broken out of its 'growth but unexciting' mode. Consumer sentiment has followed and is now at the highest it has been for some time.
- This puts the Federal Reserve in a quandary. There is now a clear case for interest rates to rise in 2015 from the current 'emergency' levels to somewhere towards 'normal'. The discussion, and the timing, is now about what level is 'normal'. Inflation remains subdued (and the oil price fall will make it decline further) but some commentators believe the official figures hide what is really happening in the economy – that inflationary pressures are building up more quickly than figures suggest. So unless the economy is blown off course by some unexpected event, markets are factoring in a rate rise, however small, sooner rather than later.
- The market has been looking fairly fully valued for some time, but after each (brief) correction in the autumn it has rapidly bounced back to hit new highs, on both domestic and foreign buying. But certainly volatility is increasing.
- Forecasters' consensus is still for double-digit earnings growth in 2015, but given the strong dollar (affecting exports) and the resulting pressure on margins this may turn out to be overly optimistic. The key remains the timing of the rate rise.
- There is an old market adage – don't fight the Fed – and this still applies.

Japan

- The Japanese equity market's positive performance in 2014 has been negated for most foreign investors by the sharp fall in the yen, which has been frustrating.
- The year has been dominated by Abenomics – the attempt by Mr Abe's government to kick-start the economy and end twenty years of deflation (the 'lost decades' possibly threatening the Eurozone).
- It started well, with inflation and wages rising, and the yen falling. But then the rise in sales taxes in the spring led to the economy returning to recession over the summer. So the Bank of Japan announced another, massive, round of Quantitative Easing in the autumn (and the government postponed the next rise in taxes to at least 2017) and this, temporarily at least, has given the economy another boost.
- It has also led to a further weakening of the yen, to such an extent that it is potentially becoming a political problem – especially in Asia. HSBC has been warning for some time that the fall may become uncontrollable, with effects across the region (especially in China) reminiscent of the currency crisis of 1997/98.
- Mr Abe then called an early election in November, winning a renewed mandate for his policies. He now has four more years to try and implement the structural reforms (the 'third arrow') he needs to compliment the economic reforms already in place. And the Bank of Japan is likely to do more Quantitative Easing if necessary.
- The oil price fall has helped. Japan imports nearly all of its energy requirements and the fall – equivalent to a massive tax cut – is worth about 1% in extra growth.
- Corporate fundamentals are healthy. The fall in the yen has benefited exporters. However there are now signs companies are cutting prices (in yen) to increase market share abroad – thus exporting even more deflation to the rest of the world, and increasing the political risk.
- Strong earnings growth and the weaker yen should support the equity market in 2015. But until the yen stabilises – at whatever level – it is difficult for foreign investors (unless they hedge the currency) to reap the full reward.

Asia Pacific ex Japan

- Markets generally performed relatively well in 2014, recovering much of the underperformance of the previous year. There have been exceptions, but investors have regained some confidence in the region over the course of the year.
- The oil price fall is a major boost to economic growth. South Korea, for example, imports 97% of its energy and the fall will add nearly 3% to growth in 2015. But against this is its effect on inflation. The problem of deflation has already been evident nearly everywhere (Chinese PPI – producer price inflation – has now been negative for 32 months). The fall in the yen is the main culprit, now exaggerated by the fall in the price of energy, leading to other currencies, especially the Chinese yuan, becoming overvalued.
- There is a danger of a currency war – competitive beggar-my-neighbour devaluations – developing. Coupled with the strong US dollar, which is again causing problems for those countries with massive overseas debts (for example, Indonesia) there is an increasing concern of a repeat of the crisis of the late 90s.
- With overall growth subdued, overcapacity in China leading to lower export prices and a strengthening dollar, it is difficult to find arguments to increase weightings in the region at this stage. However many companies, if not countries, are still flourishing – increasing profits and, more importantly, dividends.
- With yields available of over 5%, investors are being paid to wait until the outlook is clearer.

Emerging Markets

- Emerging Markets experienced some recovery from the underperformance of 2013, but it has been very country specific. A combination of dollar strength and commodity price weakness is a major negative for the sector as a whole.
- In China the economy has been slowing. Its currency is indirectly pegged to the US dollar so is now looking very expensive against its major competitors, particularly Japan, and the temptation must be to devalue (officially or unofficially).
- Emerging Markets have also borrowed over 9 trillion US dollars, which as one commentator recently said is 'a currency they cannot print and do not control'. This amount has tripled in the last ten years.
- Of course the main story amongst Emerging Markets in the last few months has been Russia. The fall in the oil price, plus the West's sanctions has led to a 50% fall in the currency and real economic hardship (energy represents 25% of GDP and 70% of exports). The sanctions may be eased as the Eurozone is suffering the consequences of the ban on many exports, but the oil price fall could be with us for some time. The concern is how Russia might react in the coming months.
- There are positives. Not all countries are performing poorly and Emerging Markets – in aggregate – still represent half of the world economy. Investors are now underweight the sector, valuations are not expensive (currently at a 31% discount to the World Index) and earnings are still growing in many areas.
- But whilst the dollar continues to strengthen (and any rate rise this year should underpin that strength), and commodity prices remain under pressure it is difficult to see where any outperformance of the sector is likely to arise. Some countries, and companies, will continue to do well but investors will have to be selective. New leaders in India, Mexico, Indonesia – and even China – are implementing reforms which should be positive in the longer term (if they work, but at least there seems to be a greater impetus for change this time).
- So are the negatives already in the price? As we have often said in the past, Emerging Market indices do not reflect Emerging Markets reality, due to their constituents (heavily weighted to commodity and financial shares). However, many Emerging Market funds can avoid these pitfalls.

Fixed Income

- Fixed income investments were significantly stronger in 2014 than the consensus expected last January. There were exceptions – high yield and emerging market debt were both more volatile – but as a general rule government debt saw yields falling further and prices rising.
- The search for yield – any yield, however small – by investors holding plentiful amounts of cash was one reason for the performance. Another was the 'safe-haven' status offered by US Treasuries, UK Gilts and German Bunds (with knock-on effects on other European bond markets, even those in economic difficulties). And finally it became increasingly obvious as the year progressed that any rise in interest rates would happen later rather than sooner.
- As usual, in 2015 everything will depend on the actions of the various Central Banks. Markets are expecting the first rate rise in the US by mid-year. In the UK this seems less likely, especially with an election due in May (the UK consumer is much more geared to interest rate changes than his American counterpart). Japan may, or may not, launch another round of Quantitative Easing.
- In the short term the key is the European Central Bank. If – and it still is a big if – the ECB initiates Quantitative Easing, US style, yields could fall still further (they are already at levels not seen since the 14th Century). This is what investors are expecting.
- However, in the longer term the Federal Reserve will influence global fixed income markets more than anyone else by the timing of its rate rise later in the year. This could lead to greater volatility – and weakness in prices – than we have seen previously.

Alternatives

- Hedge Funds (in sterling terms) generally experienced a good quarter. All strategies delivered positive returns; Global Macro (+7.9%) and Relative Value (+5.0%) were the best performing strategies. Emerging Markets (+0.2%) and Event Driven (+1.7%) produced the lowest returns over the quarter. Global Macro strategies continued their recent rally, leading a 12 month return of 12.5% which helped to support a strong year of growth for hedge funds overall (+10.8%).
- Property valuations continued to increase over the quarter, causing yields to depress further. Office and industrials were the leading sectors, particularly Offices in Central London, while the retail sector is still lagging behind. As at the end of December, the annual property yield stood at around 6.2%.
- Commodity markets deteriorated severely over the quarter, registering a loss of 24.8% and 28.9% over 12 months (the largest falls since the global financial crisis). The declines were a result of a strengthening US dollar and a slowdown in the global economy, especially in Europe and China. Crude oil and energy sectors were the hardest hit, as weak demand was coupled with an increasing supply of crude oil. The price of gold tumbled as investors flocked out of the sector. Falling Chinese demand affected industrial metals, particularly zinc and nickel.

Conclusion

One of Warren Buffet's many truisms is 'Investing is simple, but not easy'.

Looking at markets today it is difficult to find many positives.

The fall in the price of oil leads to winners, but also losers, and it is the latter that are weighing on equity prices in the short term. Energy stocks, of all types, are major components of many indices – and they are suffering. Some countries – Russia, Venezuela, Iran, for example – are particularly hard hit, and the political consequences are unpredictable. The boost to worldwide economic growth is being ignored.

But markets are not looking at fundamentals. Investors' eyes are firmly fixed on the major Central Banks, particularly, in the short term, the European Central Bank. Will they, won't they? Quantitative Easing is like a drug, and markets are hooked. Should the ECB continue to do nothing, prices are likely to fall as the expectation of action is so prevalent. If the ECB does act, the resulting flood of liquidity will provide another 'fix' – if it works.

Looking at individual areas, the US still has its attractions, despite last year's rise. The UK has an election in May which is likely to hold the market back (unless the ECB acts) until the result is known. Both the currency and gilts may come under pressure if foreign investors begin to get nervous. The Eurozone has to contend with a lack of economic growth and deflation, but some companies still flourish. In Asia, Japan will follow its own path – with possible growing geopolitical consequences – and the rest of Asia will look to China.

Despite this somewhat unhelpful backdrop, equities remain the investment of choice providing the markets move as expected. Cash is not an option, earning nothing. Bonds are unlikely to repeat their unexpected performance of last year. Equities give some return from income and the second half of the year should provide a better environment for capital growth.

But the next six months could be an interesting ride!

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