CLWYD PENSION FUND

ECONOMIC AND MARKET UPDATE
PERIOD ENDING 30 SEPTEMBER 2015

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1 MARKET BACKGROUND
PERIOD ENDING 30 SEPTEMBER 2015

MARKET STATISTICS

Market Returns Growth Assets	3 Mths %	1 Year %	3 Years % p.a.
UK Equities	-5.7	-2.3	7.2
Global Developed Equities	-4.8	2.1	11.5
USA	-3.2	6.1	14.9
Europe	-4.7	-1.8	9.5
Japan	-8.0	6.2	12.1
Asia Pacific (ex Japan)	-13.2	-8.0	1.6
Emerging Markets	-14.6	-13.3	-2.9
Frontier Markets	-7.1	-18.5	9.0
Property	3.4	15.3	13.7
Hedge Funds	-0.3	5.5	6.2
Commodities	-16.2	-37.7	-18.1
High Yield	-1.0	1.4	5.3
Emerging Market Debt	-1.7	-0.6	1.5
Senior Secured Loans	0.2	3.8	5.8
Cash	0.1	0.5	0.5

Market Returns Bond Assets	3 Mths %	1 Year %	3 Years % p.a.
UK Gilts (>15 yrs)	5.1	14.0	6.7
Index-Linked Gilts (>5 yrs)	2.3	11.8	9.4
Corporate Bonds (>15 yrs AA)	1.6	6.3	6.0
Non-Gilts (>15 yrs)	1.0	4.7	5.7

Exchange Rates: Change in Sterling	3 Mths %	1 Year %	3 Years % p.a.
Against US Dollar	-3.7	-6.6	0.1
Against Euro	-3.9	5.7	4.5
Against Yen	-5.7	2.0	15.4

Inflation Indices	3 Mths %	1 Year %	3 Years % p.a.
Price Inflation – RPI	0.3	0.8	2.1
Price Inflation – CPI	0.0	-0.1	1.3
Earnings Inflation*	0.0	2.5	1.4

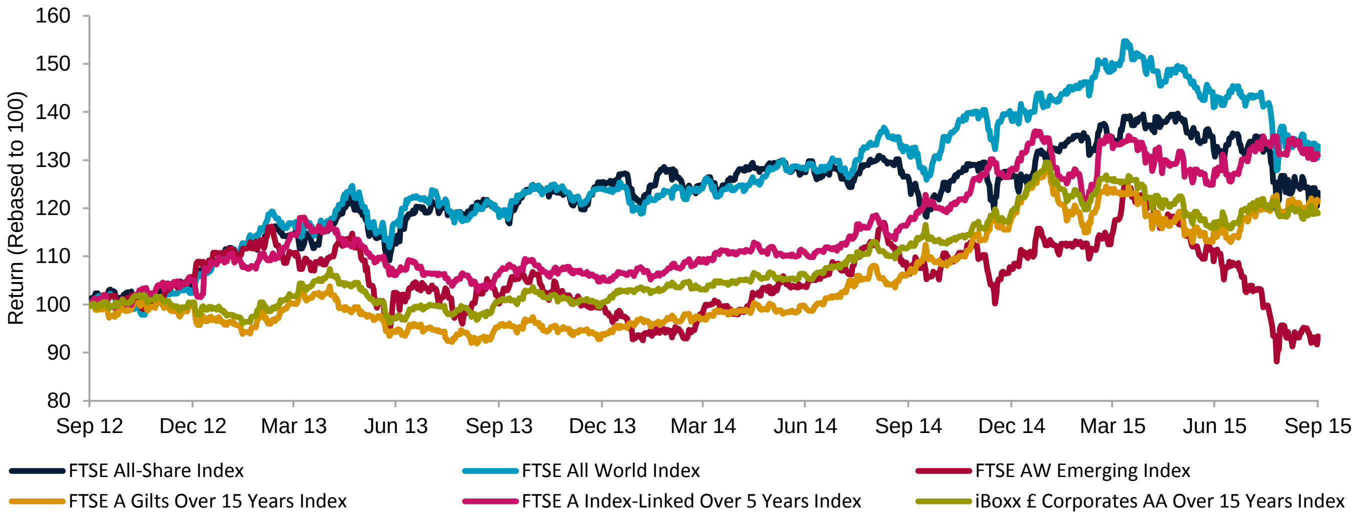
Yields as at 30 September 2015	% p.a.
UK Equities	3.71
UK Gilts (>15 yrs)	2.38
Real Yield (>5 yrs ILG)	-0.84
Corporate Bonds (>15 yrs AA)	3.63
Non-Gilts (>15 yrs)	3.96

Absolute Change in Yields	3 Mths %	1 Year %	3 Years % p.a.
UK Equities	0.25	0.37	0.07
UK Gilts (>15 yrs)	-0.25	-0.60	-0.52
Real Yield (>5 yrs ILG)	-0.08	-0.47	-0.93
Corporate Bonds (>15 yrs AA)	-0.06	-0.21	-0.39
Non-Gilts (>15 yrs)	-0.02	-0.20	-0.29

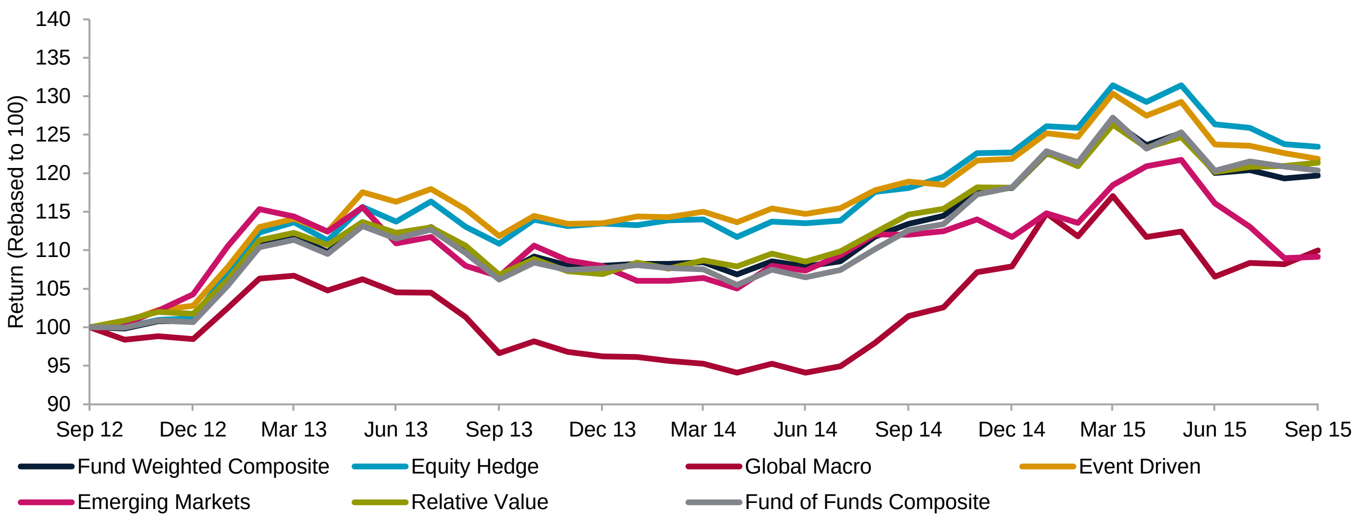
Source: Thomson Reuters and Bloomberg
* Earnings inflation is lagged by 1 month.

MARKET SUMMARY CHARTS

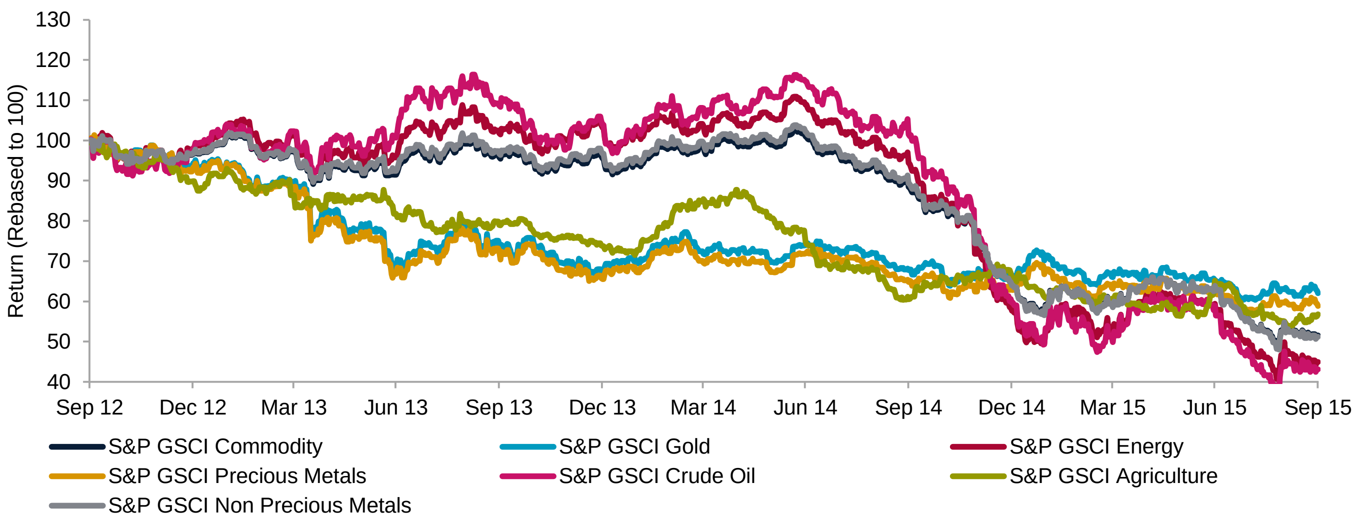
Market performance – 3 years to 30 September 2015



Hedge Funds: Sub-strategies performance – 3 years to 30 September 2015

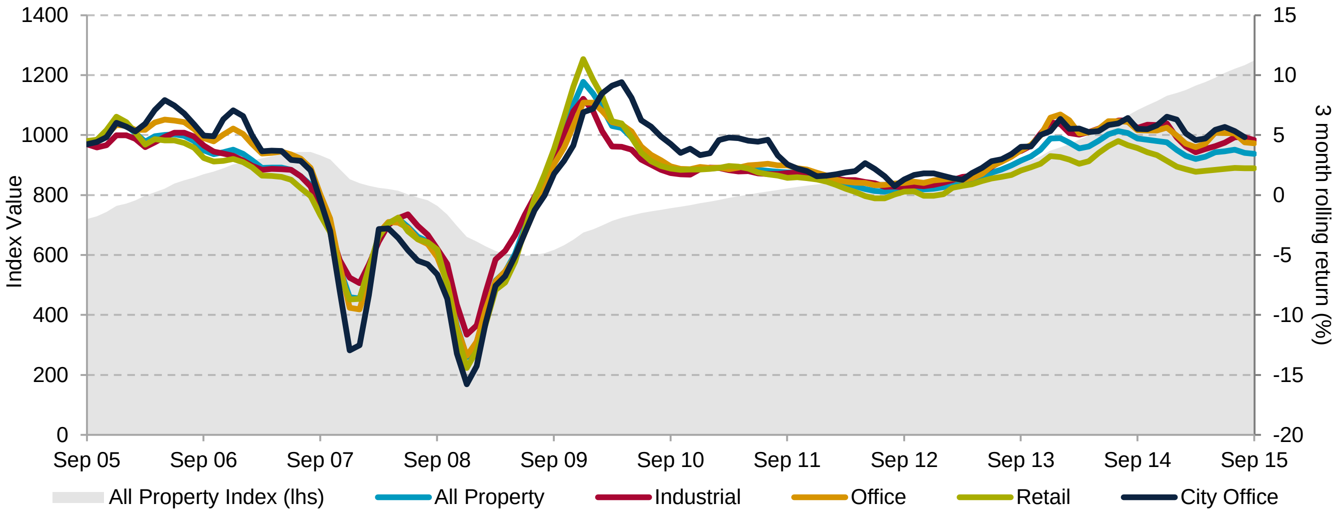


Commodity sector performance – 3 years to 30 September 2015

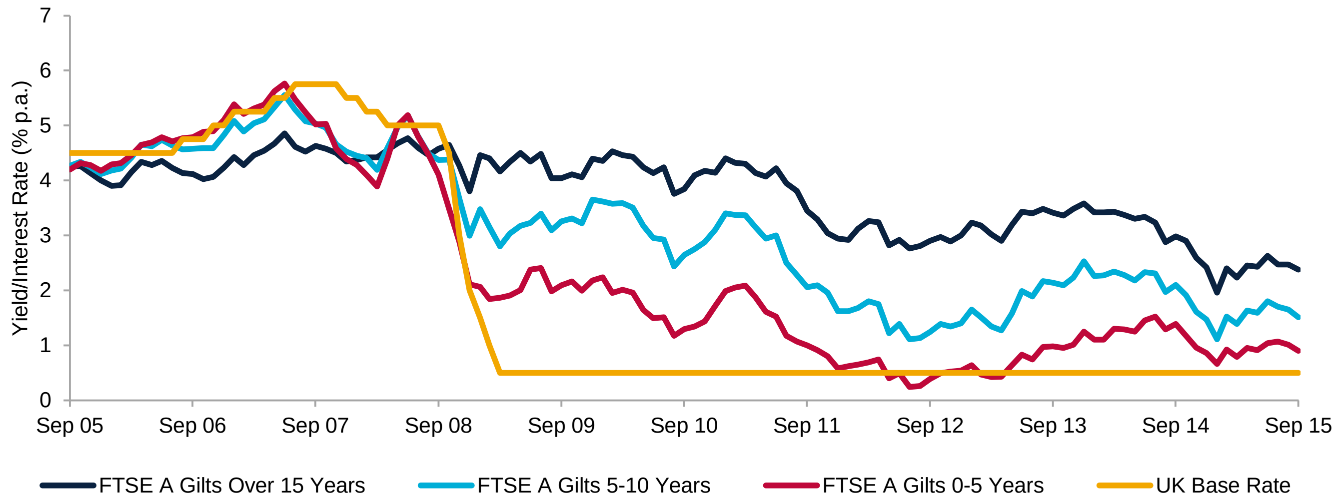


Source: Thomson Reuters

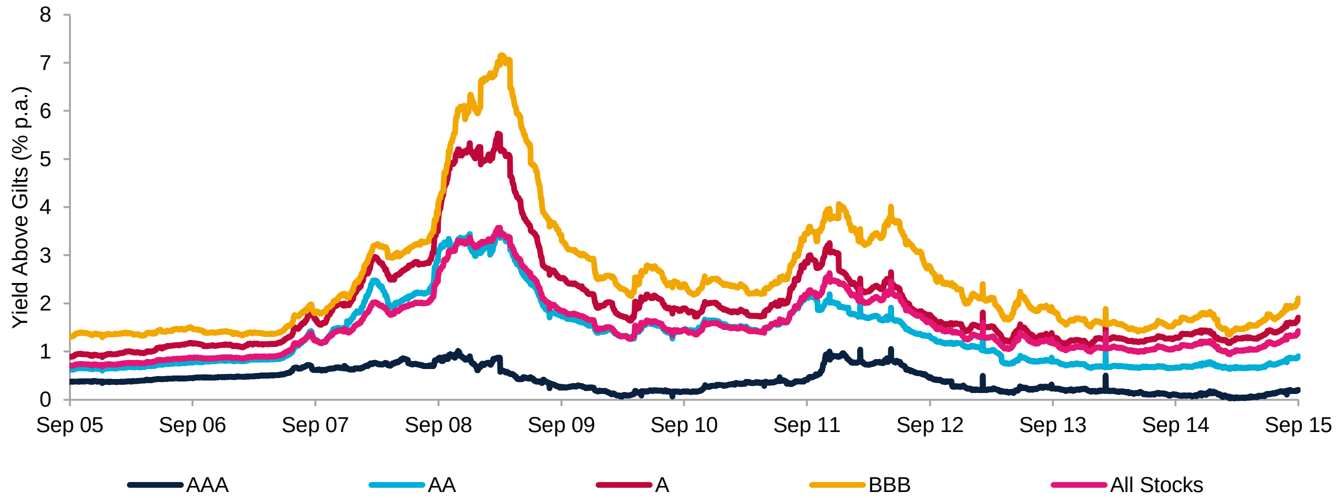
Property sector performance – 10 years to 30 September 2015



UK government bond yields – 10 years to 30 September 2015



Corporate bond spreads above government bonds – 10 years to 30 September 2015



Source: Thomson Reuters

2 ECONOMIC STATISTICS

Economic Statistics as at:	30 September 2015			30 June 2015			30 September 2014		
	UK	Euro[1]	US	UK	Euro[1]	US	UK	Euro[1]	US
Annual Real GDP Growth[2]	2.3%	2.8%	2.0%	2.4%	2.3 %	2.7%	2.9%	1.5%	2.9%
Annual Inflation Rate[3]	-0.1%	-0.1%	0.0%	0.0%	0.2%	0.1%	1.2%	0.3%	1.7%
Unemployment Rate[4]	5.4%	11.1%	5.2%	5.6%	11.2%	5.4%	6.0%	11.6%	6.1%
Manufacturing PMI[5]	51.5	52.0	53.1	51.4	52.5	53.6	51.6	50.3	57.5

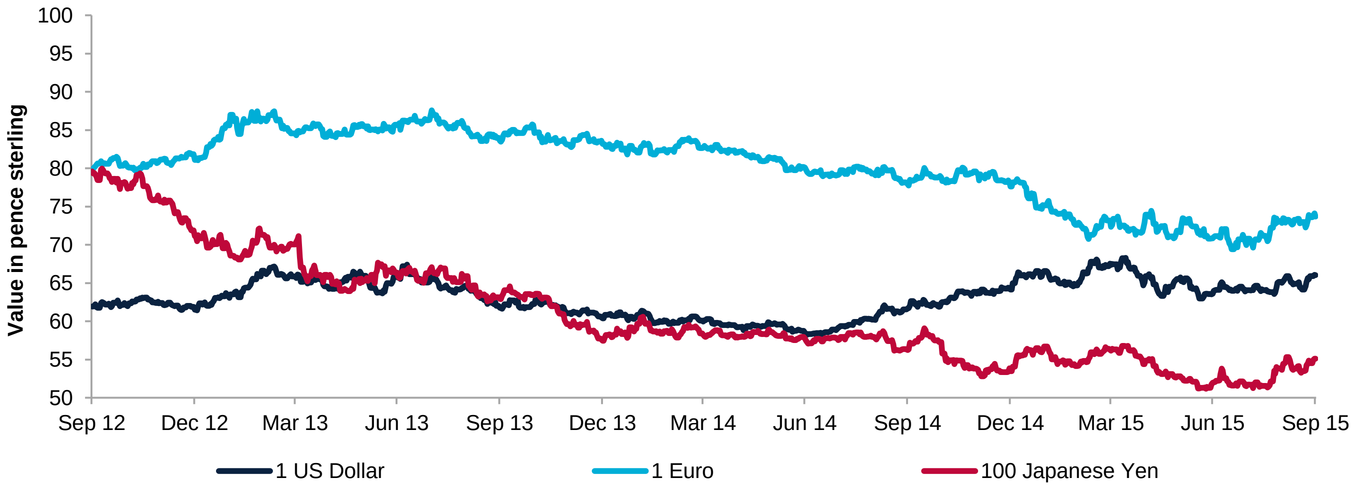
Change over periods ending:	3 months			12 months		
30 September 2015	UK	Euro[1]	US	UK	Euro[1]	US
Annual Real GDP Growth[2]	-0.1%	0.5%	-0.7%	-0.6%	1.3%	-0.9%
Annual Inflation Rate[3]	-0.1%	-0.3%	-0.1%	-1.3%	-0.4%	-1.7%
Unemployment Rate[4]	-0.2%	-0.1%	-0.2%	-0.6%	-0.5%	-0.9%
Manufacturing PMI[5]	0.1	-0.5	-0.5	-0.1	1.7	-4.4

Notes: 1. Euro Area 19 Countries. 2. Euro GDP is lagged by 1 quarter. 3. CPI inflation measure. 4. Euro unemployment is lagged by 1 quarter. 5. Headline Purchasing Managers Index.

EXCHANGE RATES

Economic Statistics as at:	Value in Sterling (Pence)			Change in Sterling	
	30 Sep 15	30 Jun 15	30 Sep 14	3 months	12 months
1 US Dollar is worth	66.02p	63.58p	61.68p	-3.7%	-6.6%
1 Euro is worth	73.69p	70.85p	77.92p	-3.9%	5.7%
100 Japanese Yen is worth	55.12p	51.96p	56.23p	-5.7%	2.0%

Exchange rate movements – 3 years to 30 September 2015



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

3 MARKET COMMENTARY

INTRODUCTION

‘Markets love volatility’ said Christine Lagarde, the head of the International Monetary Fund (IMF) in 2011. Investors might beg to differ, after just experiencing the worst quarter for equity returns since that very year.

‘The Great Fall of China’ was the press headline. The collapse in the Chinese stock market, and some worrying economic figures from Beijing, triggered a global market sell-off.

China was, and is, a convenient scapegoat, but there are other problems in the world economy that have been lurking in the background and which are just as important, perhaps more so.

Oil prices and other commodity prices have continued to fall, with oversupply greater than originally thought and demand still slowing. Share prices of many commodity stocks are at multi-year lows. For example, markets have never seen such a large appreciation of the US dollar at the same time as such a large surplus of oil. This has been greatly increasing the pressure on Emerging Market producers.

Also, first the Bank of International Settlements (BIS) and recently the IMF have warned – stridently – that debt levels are at extremes across the world, significantly higher than before the 2007/8 financial crisis. Offshore borrowing in US dollars stands at a record $9.6 trillion. Both the BIS and the IMF say that this leaves the global financial system extremely vulnerable to any monetary tightening by the US Federal Reserve, which will lead to a worldwide shortage of US dollars.

In September the Fed was widely expected to start the process of increasing interest rates to more ‘normal’ levels (although what nowadays is considered ‘normal’ is the major question). Despite the fact that their remit is supposedly domestic only, with taking account of overseas events usually outside its function, the Fed obviously viewed the market falls around the world with alarm, and chose to postpone any decision.

This proved a further disappointment to investors, and the quarter ended with another fall in equity prices. This is discussed below, but a small rate rise was then expected to occur in December – until the latest set of jobless figures in the US would seem to suggest the rise could be postponed yet again.

This has been a torrid time for markets, which shows few signs of easing in the short term.

And, for once, Greece has been ignored, overshadowed by the refugee crisis in Europe.

UNITED KINGDOM

- Mark Carney, the Governor of the Bank of England, recently said there was no immediate need to raise interest rates, thanks to disinflationary forces from abroad. Despite the sharpest drop in unemployment for forty years and a tighter labour market leading to stronger pay growth, there are as yet no signs of inflationary pressures.
- He also said in August that ‘developments in China are unlikely to change the process of rate increases from limited and gradual to infinitesimal and inert’. The domestic economic outlook was ‘benign’, he added. Early 2016 is the most likely starting point for the Bank’s process of ‘normalisation’ of rates. This matters more in the UK than in the US because of the direct – and immediate – effect on mortgage rates, and thus the consumer.
- The All-Share has fallen 3% over the year to the end of September, but nearly 6% over the quarter. The index is weighed down by energy and commodity stocks (over 20% of its market capitalisation) and this has hidden better news from domestically related sectors. But market liquidity has been poor, which has led to several days of unnerving falls in both the indices and individual stocks.

- The election of Jeremy Corbyn as leader of the Opposition has had little effect on the market – not surprisingly, this far from the next election. It could lead to problems in Parliament over time, with unexpected consequences, but so far the reaction from investors seems to be the right one.
- The equity market was in a trading range during the summer. It briefly broke downwards through the 6000 level on several occasions, but it has always bounced back rapidly.

EUROPE EX UK

- For once, Eurozone economies and bail-outs in Greece faded from the headlines across the summer.
- ‘No one leaves home unless home is in the mouth of a shark’ wrote Warsan Shire, the Somali-British poet. The refugee crisis has hit much of mainland Europe and has exposed many divisions hitherto hidden from view. Calls for unity have gone unheeded and, with winter quickly approaching and no sign of any lessening in the number of refugees, a solution is being sought with ever-increasing urgency.
- This humanitarian crisis has overshadowed economics (but not politics), but the Eurozone has been experiencing the same headwinds as the rest of the world. Growth across the region has been – and is forecast to be – minimal and inflation is back below zero.
- Markets are expecting the European Central Bank to launch another burst of Quantitative Easing soon, possibly before the end of the year. However monetary growth is already at its highest level since pre-crisis and some commentators have suggested the ‘official’ figures are hiding a more promising picture underneath.
- The Eurozone performed slightly better than expected in the first half of the year, as the weaker euro boosted exports and lower inflation helped consumer spending. All members of the eurozone saw some improvement, except France. Since then industrial production has been higher than forecast.
- It is impossible not to mention Greece. A third bail-out was agreed and the subsequent election called by Syriza returned the previous government, albeit now in a coalition. Very few outside Greece expect this bail-out to be any more successful than the first two, and difficult decisions still have to be made on debt write-downs, but for the time being the crisis has disappeared into the background, which is positive for all concerned.
- European equity markets experienced the same volatility as the rest of the world over the summer but in the end fell less than 1% in sterling terms. Earnings growth has held up, led by domestic companies but is more problematical in some areas that have been relying on growth in emerging markets.
- And then there was Volkswagen! The scandal which has engulfed the company will be very costly, it goes without saying, but it also has potential political consequences for the ‘Made in Germany’ label, so highly rated across the globe. Only time will tell.

NORTH AMERICA

- Much to the markets’ surprise there was no interest rate rise in September. For once the Federal Reserve decided its global responsibilities outweighed domestic concerns, and chose not to rock the boat in the midst of the China / Emerging Markets storm. Looking at just the US, it was generally accepted that the first rise was needed now – although this immediately came under question by poor jobless figures.
- Inflation is well under the target of 2% (currently it is 0.3%) but the unemployment level is now only 5.1% - where the Fed believes the economy is in balance (although this figure seems less ‘fixed’ than previously).
- When it eventually comes, it will be the first rate rise in more than nine years (0.25% since December 2008) but even so monetary policy will remain ‘accommodative’. The Fed is now not only looking at inflation and the jobs market, but also overall financial conditions.
- Elsewhere economic momentum has been building. Business confidence is rising, jobs are being created (despite what the most recent figures might suggest), wages are increasing as is consumer confidence and the housing market. However, the growth in the economy (2.7% year-on-year) is considered by many as sluggish at this stage in the recovery.
- The strong dollar is causing headwinds. Many export-dependent companies are experiencing flat revenues and earnings only showing growth by balance sheet manoeuvring. Companies are scaling back stock purchases

and are less able to issue bonds to buy their own shares, as hitherto. As a consequence, the US corporate bond market is suffering from a lack of liquidity.
- Falling oil prices are also leading to major problems for oil producers and the newer shale companies, where finances are deteriorating rapidly. Energy stocks represent 8% of the index and energy is its worst performing sector.
- Politics are also beginning to intrude. Hilary Clinton's accusation of 'profiteering' in the health care industry led to a dramatic sell-off, exacerbated by investors reducing their margin debt (from an all-time high) in those sectors that had previously shown the greatest upward momentum, for example biotech. The possibility of a Clinton v Trump election next year is beginning to concern investors – although there is still a long road ahead for them both.
- So far this year, earnings have largely kept up with valuations, which have been at the top end of their range – at least until the recent weakness in share prices. Should earnings begin to disappoint more widely, the market may take fright.

JAPAN

- The main Japanese index reached a high for the year in mid-August, but then fell to be down 8% over the quarter in sterling. However, it is still up 4.5% this year – the only major market to show positive returns.
- The culprits in August were the Chinese 'devaluation' of its currency – of which more below – and, more importantly, concerns about global growth.
- Growth in Japan has stalled, inflation has returned to zero (against a target of 2%), exports have weakened and industrial production has been disappointing. As Japan imports about 90% of its energy needs, the fall in inflation is not surprising, but the other economic statistics are proving worrisome.
- The Japanese government is expected to downgrade its forecasts, especially if the yen appreciates, and another round of Quantitative Easing is possible towards the end of the year.
- Mr Abe's popularity has also taken a hit recently. General MacArthur's post-war constitution only allowed Japan a 'self-defence force'. The Government's majority in both the Upper and Lower House has enabled them to change this for the first time. From now Japanese forces can act in 'collective self-defence' with its partners, and can fight overseas if necessary. The Japanese public has viewed this negatively, believing Mr Abe should be concentrating on the economy to the exclusion of all else.
- Corporate profits have remained positive, so far being unaffected by events overseas. Company forecasts are likely to be met, although, not surprisingly, upward revisions are few and far between.
- The market as a whole is looking at events abroad, not at domestic matters, and sentiment in the short term is poor.

ASIA PACIFIC EX JAPAN / EMERGING MARKETS

- China has apparently been the cause of all the global markets' woes in the last few months. Citibank has warned that a 'hard landing in China could lead to world recession next year and into 2017', with over 50% probability. Their estimate is for only 4% growth in the Chinese economy – against the official figure of 7% - and other analysts are following suit, lowering their forecasts.
- The figures being released by the Chinese authorities have certainly been disappointing. Investment is growing at the slowest pace in 15 years, with fixed asset investment the slowest since 2000. Industrial output and construction growth have also been weaker than expected.
- The renmimbi 'devaluation' – which caused such a panic in Asian markets – was in fact only 2% and is a bit of a red herring. Between 2007 and 2015, the currency has risen 52% in real terms against the US dollar which puts the 2% fall into context. However, markets now expect further devaluations, with China trying to boost exports at the expense of its competitors.

- The collapse in the Chinese stock market, which led to most of the negative press coverage, was not really a collapse at all, given its previous meteoric rise. Painful for its participants, many of whom were (and are) highly leveraged, the fall has probably more affected sentiment than the overall economy.
- The result is that investors now expect the authorities to launch their equivalent of Quantitative Easing in the near future – with unknown consequences (they are sure to be different to elsewhere).
- The rest of the Pacific Region’s stock markets have been hard hit by these events. The Asian index (in sterling) fell over 13% in the last quarter and is down over 10% for the year to the end of September.
- Valuations became close to the lows seen in 2008 and investors were very underweight the region. However earnings estimates are being reduced (and earnings have fallen 8% in US dollars in the last year).
- Investors were even more underweight in other Emerging Markets, where the problems resulting from falling commodity prices coupled with a rising US dollar seem insuperable in the short term. Add in to the equation debt levels (both government and corporate) that in many countries were higher than during the 2007/8 crisis and it is understandable that investors have been liquidating their holdings indiscriminately.

FIXED INCOME

- All eyes have remained on the major Central Banks, especially the Federal Reserve. The ‘will they, won’t they’ argument has persisted across the summer, with rate rises in the US (and the UK) expected sooner rather than later. The most important, in the US, is constantly being pushed out another quarter, for both internal and external reasons, leading to both confusion and disappointment.
- However, with oil prices still on a downward path (significantly so, according to Goldman Sachs), inflationary expectations have been lowered in much of the developed world, and the pressure for an early increase has been somewhat eased.
- Equity market volatility in the quarter has led bonds – particularly US Treasuries – to be yet again considered as safe havens, despite being expensive.
- The concern is that Central Banks, who are charged with ensuring the stability of the financial system, have by their policy of ultra-low interest rates led to a price bubble in many asset classes. A rate rise now may have more of a negative effect than if it had happened sooner.
- Since the end of 2006, collectively global Central Banks have printed the equivalent of US$ 11.3 trillion of extra liquidity (Source: Crossborder Capital), and somehow this has to be reduced.
- If global growth weakens, and company sales and profits come under pressure, there are also implications for the corporate bond sector, already suffering from a lack of liquidity in markets, and possibly pricing that fails to reflect underlying reality.

ALTERNATIVES

- Hedge Funds (in sterling terms) returned -0.3% over the quarter, showing an improvement in performance when compared to the second quarter. Emerging Markets (-6.0%) were the worst performing strategies over the quarter and also have the worst returns over 12 months and 3 years. Global Macro strategies were the strongest over the quarter with a return of 3.2%, and is the leading strategy over 12 months with a return of 8.4%. Hedge Funds have provided protection against falling equity markets, albeit returns were marginally negative over the quarter.
- The UK Property return declined marginally to 3.4% over the quarter, compared to 3.6% last quarter, as the market stabilised. Offices and industrials were the leading sectors, however, the returns from Offices in Central London declined. The retail sector continued to lag behind. As at the end of September 2015, the annual property yield stood at around 5.7%.
- Commodities returned -16.2% over the quarter, reversing the brief positive returns obtained last quarter. Energy prices declined as oil prices weakened due to continuing supply surpluses and anticipation of higher Iranian oil exports in 2016. Coal, natural gas and metal prices declined on continued weak demand and excess supply. Agriculture prices fell on comfortable supply prospects, despite fears that the El Niño weather pattern

may reduce supply. Precious metals prices declined on weakening investment demand which reflected expectations of a US interest rate hike and dollar appreciation.

CONCLUSION

Christine Lagarde said ‘Markets love volatility’. However Jeremy Grantham’s view is that ‘volatility is a symptom that people have no idea of the underlying value’. This is certainly true today.

There are several questions.

When is the Federal Reserve going to raise interest rates, by how much, and how quickly? The addition, possibly temporary, of ‘financial conditions’ to the Fed’s remit, makes this even more difficult to forecast, especially after the most recent jobless figures – which might suggest an increase later rather than sooner. Recently she said she ‘still expects a rate rise later this year, followed by a gradual pace of tightening elsewhere’, but this could easily change. Does the Yellen ‘put’ still apply? This means that if conditions worsen for whatever reason, will the Federal Reserve (and other Central Banks), come to the rescue yet again, like the cavalry? If they do, what ammunition can they use this time round?

With China slowing and Japan and Europe showing little growth, this leaves the US (and to a lesser extent the UK) as potential drivers of global growth. Will this be enough? It seems unlikely. Emerging Markets will not recover until either commodity prices reverse their falls or the US dollar weakens. Neither seems probable in the short term. However all is not doom and gloom. JP Morgan is still forecasting a quite respectable 3% World growth in 2015 (against 3.2% last year) and profits in many areas are still rising.

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