CLWYD PENSION FUND

ECONOMIC AND MARKET UPDATE
PERIOD ENDING 31 DECEMBER 2015

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1 MARKET BACKGROUND
PERIOD ENDING 31 DECEMBER 2015

MARKET STATISTICS

Market Returns Growth Assets	3 Mths %	1 Year %	3 Years % p.a.
UK Equities	4.0	1.0	7.3
Global Developed Equities	8.6	5.5	13.9
USA	9.6	6.9	18.8
Europe	5.9	5.5	8.9
Japan	12.5	17.6	14.7
Asia Pacific (ex Japan)	8.4	-3.5	2.5
Emerging Markets	3.5	-9.7	-3.3
Frontier Markets	1.5	-9.1	8.7
Property	3.1	13.8	14.6
Hedge Funds	3.8	4.9	7.1
Commodities	-14.3	-29.0	-21.2
High Yield	1.5	1.4	4.5
Emerging Market Debt	1.3	1.2	1.0
Senior Secured Loans	-0.1	3.8	5.1
Cash	0.1	0.5	0.5

Market Returns Bond Assets	3 Mths %	1 Year %	3 Years % p.a.
UK Gilts (>15 yrs)	-2.4	0.1	5.9
Index-Linked Gilts (>5 yrs)	-3.3	-1.2	6.4
Corporate Bonds (>15 yrs AA)	0.3	-0.2	5.9
Non-Gilts (>15 yrs)	0.5	-1.3	5.3

Exchange Rates: Change in Sterling	3 Mths %	1 Year %	3 Years % p.a.
Against US Dollar	-2.7	-5.5	-3.2
Against Euro	0.0	5.3	3.2
Against Yen	-2.3	-5.2	8.1

Inflation Indices	3 Mths %	1 Year %	3 Years % p.a.
Price Inflation – RPI	0.4	1.2	1.8
Price Inflation – CPI	0.2	0.2	0.9
Earnings Inflation*	0.0	2.1	1.5

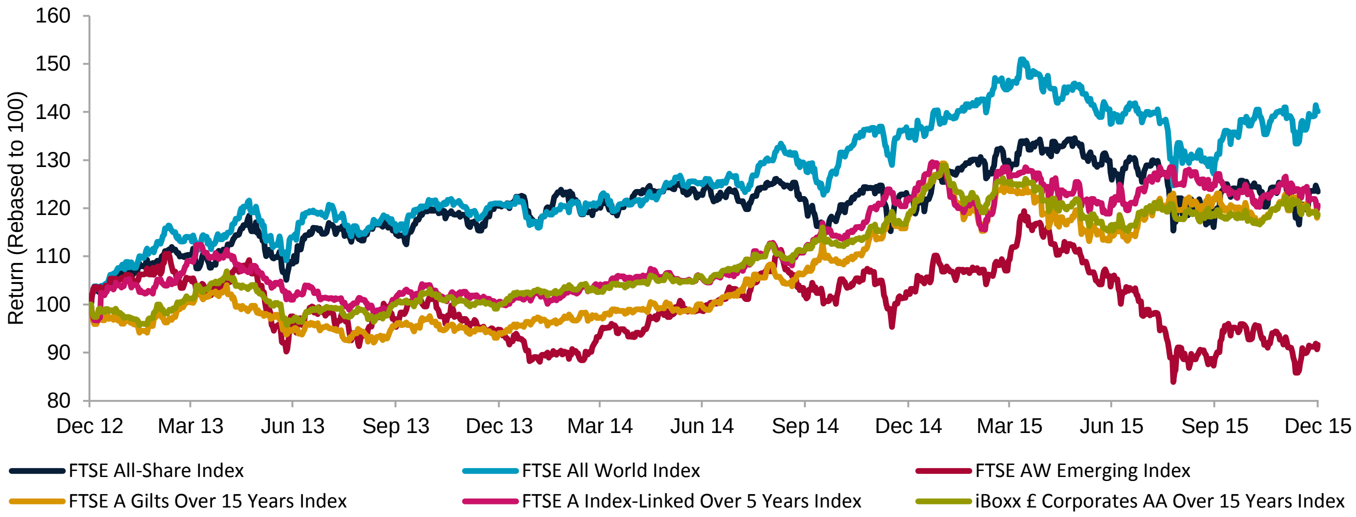
Yields as at 31 December 2015	% p.a.
UK Equities	3.70
UK Gilts (>15 yrs)	2.57
Real Yield (>5 yrs ILG)	-0.71
Corporate Bonds (>15 yrs AA)	3.68
Non-Gilts (>15 yrs)	4.00

Absolute Change in Yields	3 Mths %	1 Year %	3 Years % p.a.
UK Equities	-0.01	0.33	0.13
UK Gilts (>15 yrs)	0.19	0.15	-0.43
Real Yield (>5 yrs ILG)	0.13	0.06	-0.64
Corporate Bonds (>15 yrs AA)	0.05	0.27	-0.39
Non-Gilts (>15 yrs)	0.05	0.27	-0.22

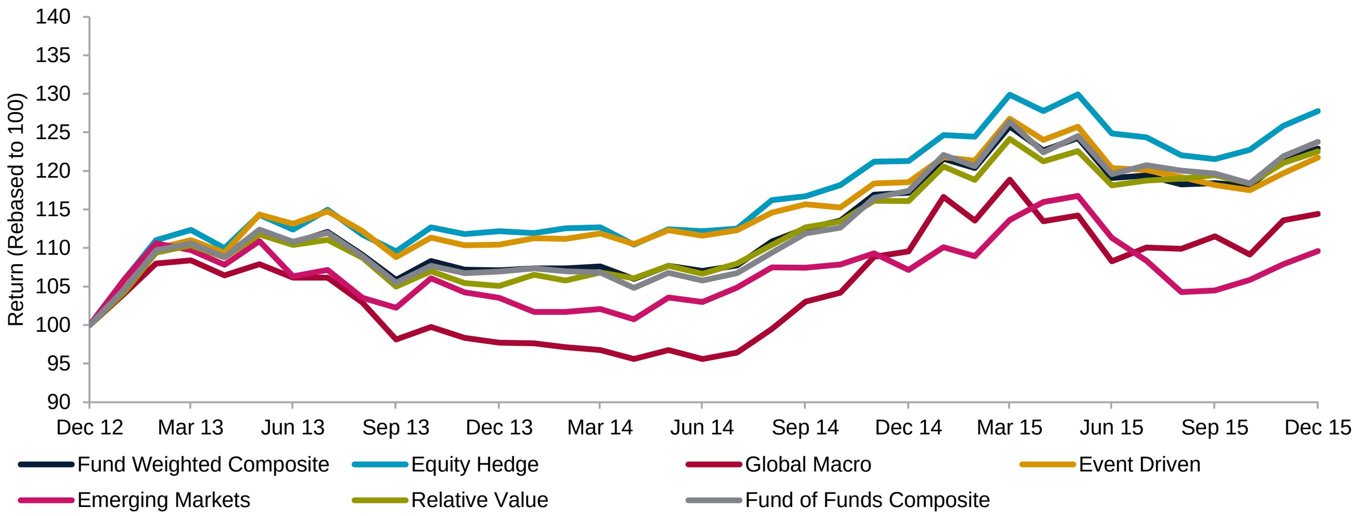
Source: Thomson Reuters and Bloomberg
* Earnings inflation is lagged by 1 month.

MARKET SUMMARY CHARTS

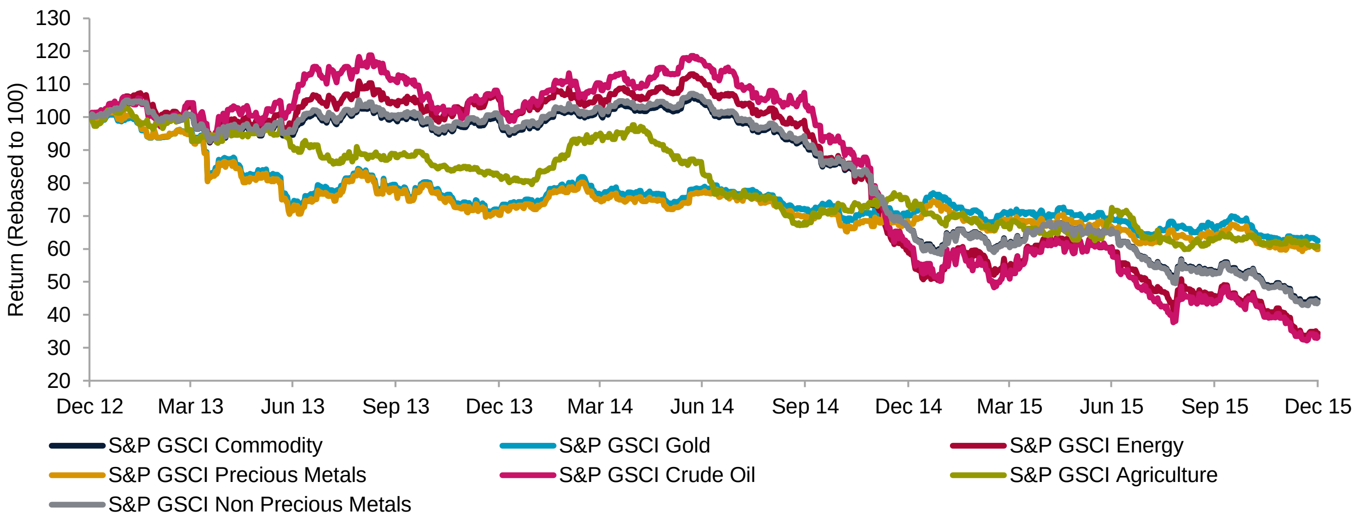
Market performance – 3 years to 31 December 2015



Hedge Funds: Sub-strategies performance – 3 years to 31 December 2015

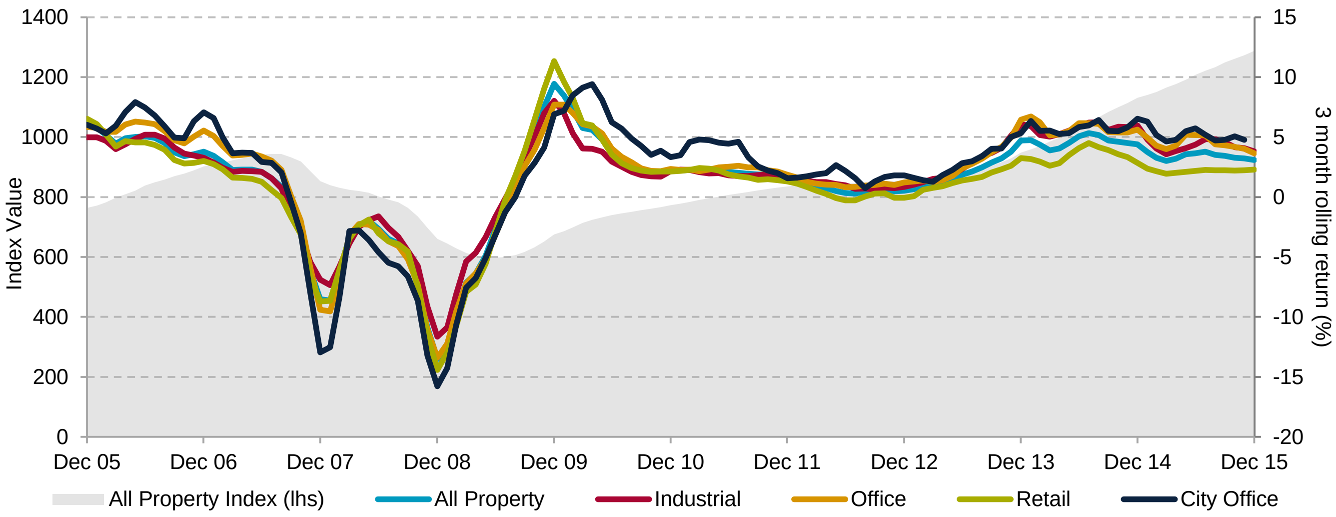


Commodity sector performance – 3 years to 31 December 2015

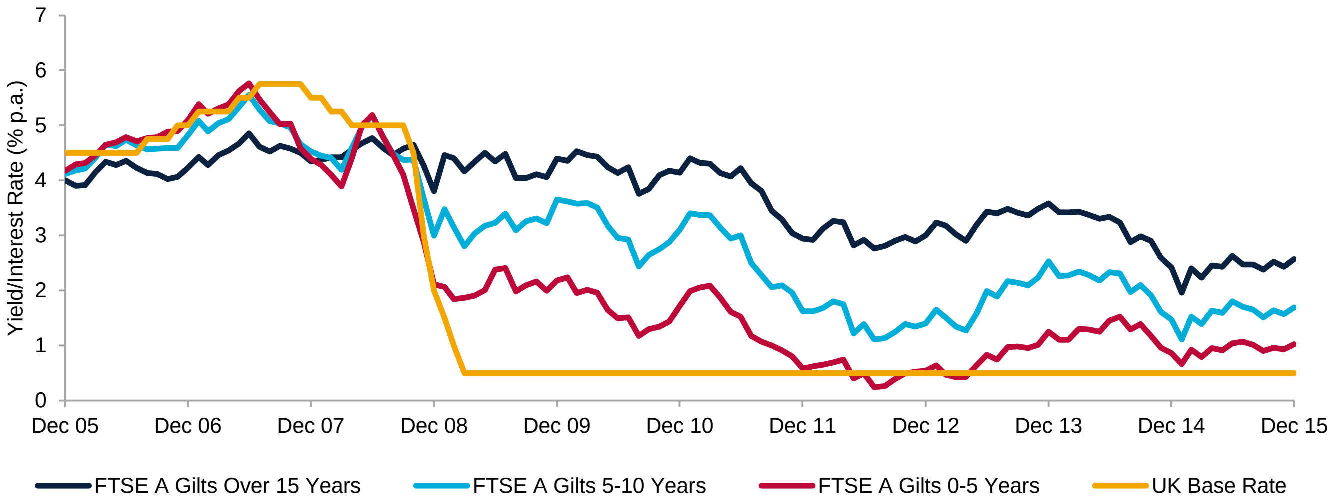


Source: Thomson Reuters

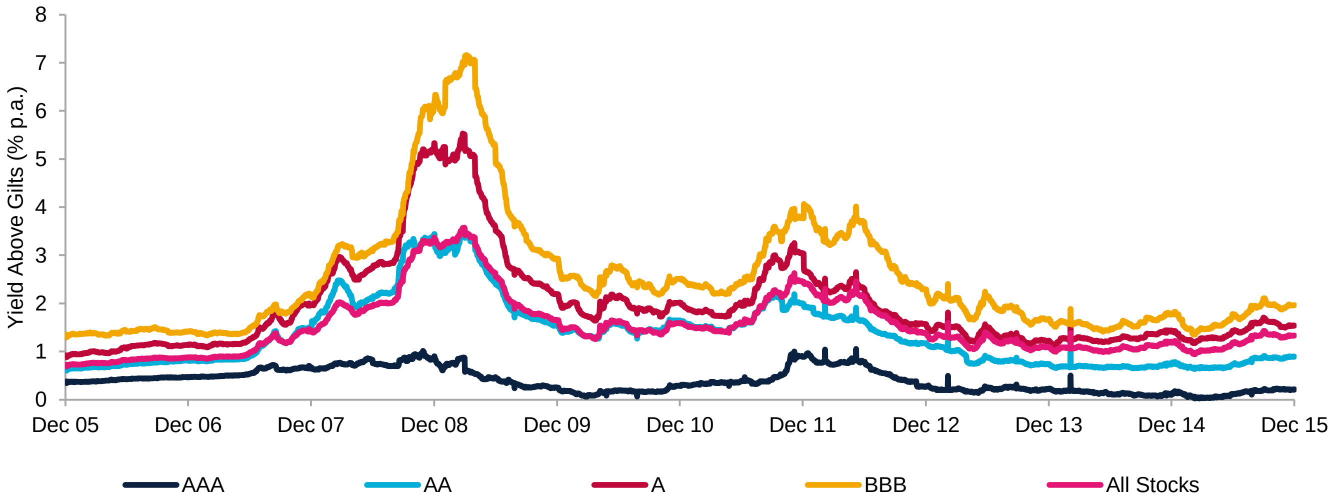
Property sector performance – 10 years to 31 December 2015



UK government bond yields – 10 years to 31 December 2015



Corporate bond spreads above government bonds – 10 years to 31 December 2015



Source: Thomson Reuters

2 ECONOMIC STATISTICS

Economic Statistics as at:	31 December 2015			30 September 2015			31 December 2014		
	UK	Euro[1]	US	UK	Euro[1]	US	UK	Euro[1]	US
Annual Real GDP Growth[2]	1.9%	2.9%	1.8%	2.1%	2.9%	2.1%	2.8%	1.7%	2.5%
Annual Inflation Rate[3]	0.2%	0.2%	0.7%	-0.1%	-0.1%	0.0%	0.5%	-0.2%	0.8%
Unemployment Rate[4]	5.1%	10.8%	5.0%	5.4%	11.0%	5.2%	5.8%	11.6%	5.7%
Manufacturing PMI[5]	51.9	53.2	51.2	51.6	52.0	53.1	52.8	50.6	53.9

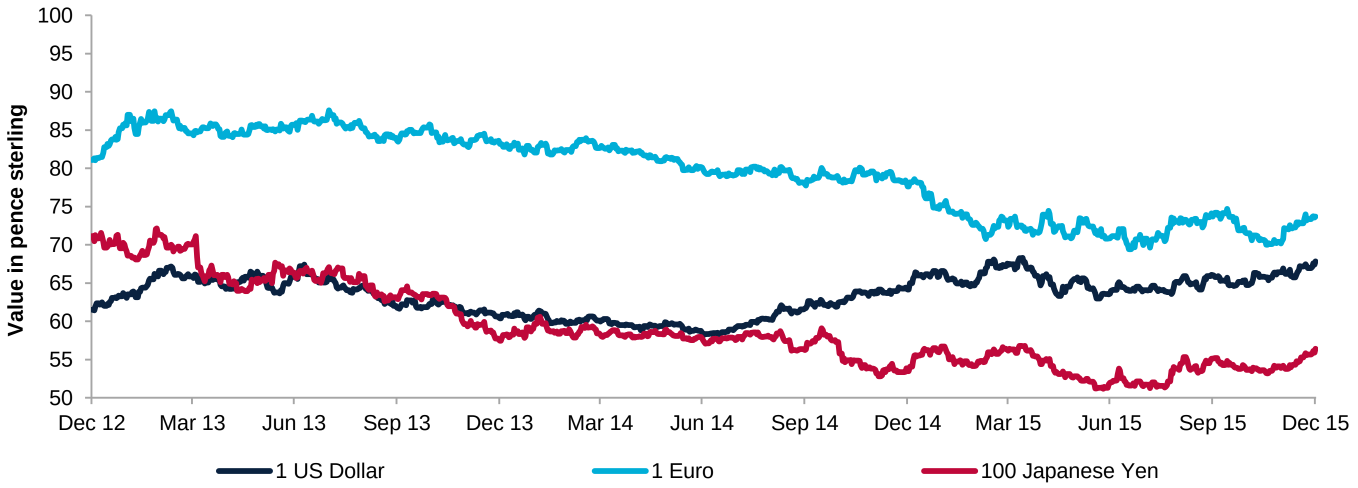
Change over periods ending:	3 months			12 months		
31 December 2015	UK	Euro[1]	US	UK	Euro[1]	US
Annual Real GDP Growth[2]	-0.2%	0.0%	-0.3%	-0.9%	1.2%	-0.7%
Annual Inflation Rate[3]	0.3%	0.3%	0.8%	-0.3%	0.4%	0.0%
Unemployment Rate[4]	-0.3%	-0.2%	-0.2%	-0.7%	-0.8%	-0.7%
Manufacturing PMI[5]	0.3	1.2	-1.9	-0.9	2.6	2.7

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, UK unemployment is lagged by 1 month. 5. Headline Purchasing Managers Index.

EXCHANGE RATES

Economic Statistics as at:	Value in Sterling (Pence)			Change in Sterling	
	31 Dec 15	30 Sep 15	31 Dec 14	3 months	12 months
1 US Dollar is worth	67.85p	66.02p	64.13p	-2.7%	-5.5%
1 Euro is worth	73.70p	73.69p	77.61p	0.0%	5.3%
100 Japanese Yen is worth	56.40p	55.12p	53.49p	-2.3%	-5.2%

Exchange rate movements – 3 years to 31 December 2015



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

3 MARKET COMMENTARY

INTRODUCTION

2015 was a year of two halves, with steady, if unspectacular, progress until June, and then rapid deterioration in the last six months.

There were very few bright spots. For investors in the UK small and mid-sized companies outperformed, as did (in sterling) the US, Europe and Japan. But Asia and Emerging Markets were significant fallers, and fixed income was very mixed, especially towards the year end.

As J P Morgan reported, 2015 saw US GDP rise 2.6%, Europe printed 560 billion euros (still rising), global inflation fell below 2% and China (despite all the headlines) added the economic equivalent of Indonesia to its GDP. But global manufacturing slumped, US capital expenditure fell, Japan faltered and the oil price dropped 25%.

The result was confusion.

The reasons – principally concerns over the Chinese economy and the course of interest rates in the US and elsewhere. The Greek crisis briefly regained the foreground in the summer but was resolved (temporarily?) to everyone's satisfaction – except, probably, the Greeks.

There was a vicious circle of falling commodity prices, due to lack of demand and oversupply, leading to more concerns about a Chinese slowdown, leading to further falls in commodity prices. This caused a full-blown Emerging Market crisis as falling export prices coupled with a strong US dollar proved a toxic mix.

After nearly a year of 'will they, won't they' the Federal Reserve finally raised interest rates in December. What happens next will be one of the main themes for investors in 2016. Suffice to say the reaction in markets was largely positive as the year-end approached, the first hurdle having at last been surmounted. However it did not change the 'growth v. no growth' argument that prevailed in the latter part of 2015 – and which continues into 2016.

UNITED KINGDOM

- Similar to the US, investors have been waiting all year for the Bank of England to increase interest rates by a token amount. However, unlike in the US, this now seems as distant a prospect as before.
- Falling oil prices and subdued wage growth means there are no current inflationary fears. Some economists still expect a small rise in rates in the first half of 2016, with 1% a likely target by year-end, mainly to stay in step with the US – but they are in the minority. Economic forecasts for both countries are similar, and with Europe perhaps performing more strongly, in the absence of any rate rise sterling could weaken, which would help the export sector.
- However, according to the Telegraph, a 0.25% rise in rates would add £297 per month to the cost of an average UK mortgage (and it is worth noting that the average outstanding mortgage is now 21% higher than before the 2007/8 crisis).
- So any rise in rates is not just an economic decision, but also a highly political one.
- And politics will almost certainly play a greater part in investors' thinking in 2016 than even in 2015 (when the unexpected Conservative victory provided a tonic to the market, albeit temporary). Local and London mayoral elections in May will give some indication of which way the wind is blowing, but overshadowing all will be the possibility of a European referendum this year.
- Euripides once wrote 'In case of dissension, never dare to judge till you've heard the other side'.

- And ‘Brexit’ will provide discussion, and dissension, in lorry-loads – quite enough to upset sterling and investors, both domestic and foreign. However, the Bank of England might not worry too much about a weakening currency, especially against the euro, if it provides some relief for hard-pressed exporters.
- This is for the future. Looking at the economic situation today the picture is rosier. The UK is the fastest growing country in the G7 with inflation close to zero and real wage growth being experienced. The monetary outlook is benign, with or without a rate rise.
- Equities have responded to this background in markedly different ways. Domestic companies in the 250 index have performed well, reacting to this good economic backdrop, whereas the main index has done poorly, weighed down by its exposure to exporters in general, and mining companies in particular.
- Going forward balance sheets need to be studied closely. Wage inflation is beginning to eat into margins, and hence profitability. There is some concern about the level of dividends being paid to shareholders, which in aggregate is at an all-time high relative to profits. Some mining companies have already cut or eliminated their dividends – there could be more to come.
- But relative to other equity markets around the world the UK still looks attractive, even if the headline index continues to suffer from its exposure to commodities.

EUROPE EX UK

- ‘And Doubt and Discord step ‘twixt thine and thee’ wrote Lord Byron.
- For once economics have taken a back seat as far as Continental Europe in general, and the Eurozone in particular, are concerned. The still growing refugee influx has led to the near breakdown in the Schengen agreement allowing free access throughout the zone. This in turn has resulted in a major political crisis throughout the region with recriminations on all sides. When the Oresund Bridge, an icon of European co-operation, has border controls re-imposed at both ends – in Denmark and Sweden – it shows how far matters have deteriorated.
- Additionally elections in the last few months in Portugal, now with an anti-austerity left wing government, and in Spain, with no stable government at all, have increased the pressure on Brussels to change policy.
- There seems little chance of this happening with a satisfactory resolution to the refugee crisis a distant prospect, and any change to the Eurozone’s economic policies equally unlikely.
- Quantitative Easing has so far not proved to be as effective as once hoped (or as has been experienced elsewhere), except that the currency has weakened by 10%, which was a key policy target. Recent announcements by the European Central Bank – another very small cut in interest rates and a slight extension of the bond-buying programme – left markets somewhat underwhelmed.
- However, monetary expansion is rapidly increasing, which should lead to higher asset prices and an even lower euro. Unemployment, 6% in Germany, remains at over 20% in Spain and Greece. But the Purchasing Managers’ Index (an indication of growth or otherwise throughout the Eurozone) is at an eighteen month high, consumer sentiment is improving and there is rising domestic demand across most of the region (France being the notable exception).
- Overall growth in 2016 is forecast to reach 1.8% (against a likely outcome of 1.5% in 2015). Not dramatic, and not enough to alleviate many of the outstanding problems, but at least it is positive.
- Under these circumstances many companies in Europe, both in and out of the Eurozone, continue to thrive. Those that are heavily reliant on exports to the developing world are suffering, but as a general rule the outlook is promising.

NORTH AMERICA

- ‘All things come to he who waits’, although it took nearly the whole of the year and investors’ patience was sorely tested at times.

- The Federal Reserve finally raised interest rates in December (by 0.25%), the first rate rise since 2006 and the likely start of a more prolonged cycle of increases. The effects will slowly spread throughout the economy, with credit (and mortgage) holders the first to see any impact.
- The Federal Reserve's target is a level of rates of 1% to 1.5% by the end of 2016, and 3% to 3.5% by 2018 (considered to be the new 'normal' level), but whether this target is achieved – in the short or long term – is one of the most important questions for this year.
- Markets are hoping the authorities haven't raised rates too soon. This is the first time ever that there has been an increase at the same time as the manufacturing index has been below 50 (indicating a contraction in the economy). Money has already been tight since Quantitative Easing was halted, with the dollar having risen 14% against its competitors since July 2014 – the steepest rise in modern times. With the European Central Bank, the Japanese and – very importantly – the Chinese still loosening their monetary policy, the Federal Reserve's move is still considered somewhat of a gamble.
- The Federal Reserve considers it more prudent to take action now before inflation picks up (although there are currently no signs of it doing so) which will give them more room for manoeuvre if the economy stalls. At the moment economic growth is on track, with personal consumption strong (representing two thirds of GNP) and wage growth steady. Job creation is the key – there have been over 8 million new jobs created in the past three years.
- However, according to Crossborder Capital's statistics the Federal Reserve is reducing liquidity to the markets at a time when US private sector liquidity – especially in the corporate sector – is itself slowing. So the rate rise is further tightening in a weakening economy – and therein lies the danger.
- Many US companies have been issuing debt to buy back their own shares, thereby increasing their earning per share and their share prices. There have been a few signs that this is coming to an end (even before the interest rate rise) which may have consequences for valuations. The first indication will be the profit figures for the fourth quarter of 2015 to be announced shortly. Revenues for many companies have already been under pressure, particularly from the strong dollar, for some time, but the results of this have often been hidden by the share buy-backs mentioned above. The upcoming figures will be studied very closely, to say the least.
- And finally, this is a Presidential election year. At the moment the front-runners are Hilary Clinton for the Democrats and Donald Trump for the Republicans (the latter a complete surprise, an unpleasant one for many in his party).There is a long road to travel before November (the first primary is later in January), and another Barack Obama could appear from nowhere. But both the two current leading candidates would cause considerable market nervousness if the likelihood grew of them winning in November.
- This could be another volatile year in the US stock market. All eyes, as usual, will be on the Federal Reserve, as investors wait for the next rate rise (in March?). Will the economy slow down as a result? Will the dollar continue to strengthen, with further effects on corporate profitability? Will the high yield debt market implode? And who will be the next President?
- These are not inconsiderable questions. The answers to the first three could all be 'No'. We will obviously know more as the year progresses.

JAPAN

- It has been three years since Mr Abe became prime minister and introduced his radical new programme of Quantitative Easing, coupled with an attempt to dismantle many of Japanese society's long-held traditions.
- The results have been mixed. The yen has weakened significantly, which was a prime policy target, thus benefitting many exporting companies. But GDP has risen only 0.8% each year on average, which is decidedly lacklustre. Forecasts for growth in the year to end March 2016 have been revised downwards (from 1.7% to 1.2%), inflation remains stubbornly low, exacerbated by the low oil price, and the overall debt burden continues to increase.
- But all is not as pessimistic as these numbers might suggest. Vital structural reforms – the 'Third Arrow' – are slowly, very slowly, being implemented. Efforts to encourage more women to join the workforce are progressing, as is the introduction of a Free Trade Zone throughout the Pacific Rim. The Government has also

been ‘persuading’ major companies to increase wages (and have raised the legal minimum wage themselves) with some success, and living standards are rising.

- Further announcements along these lines are expected later in 2016. One area where positive results have already been seen is Mr Abe’s attack on corporate governance. There is now a greater emphasis on maximising profits and benefitting shareholders, with higher dividends, than ever before. There are 1880 companies in the main stock market index which collectively are sitting on $650 billion in cash – equal to an economy the size of Switzerland. The Government wants this cash to be put to a more productive use.
- Corporate profits in the first half of the current fiscal year (to end September 2015) were mixed, with some manufacturing companies seeing weaker demand, especially from abroad. In aggregate company profit forecasts are down slightly on previous numbers – but still positive.
- This year Japan should continue to recover, albeit in fits and starts. The next sales tax increase (the last one led to a brief recession) has been postponed from October this year to April 2017, and for the first time will exclude food – which will cost 20% of the forecast revenue benefit. Better real wage growth and higher private consumption will benefit growth, and the possibility of another round of Quantitative Easing is high.

ASIA PACIFIC EX JAPAN / EMERGING MARKETS

- China has dominated world markets in 2015. Its economy and stock market have been the main talking points, overshadowing in many ways the Federal Reserve’s decision on interest rates (and even influencing that decision in September, when the expected rate rise was postponed for three months due to ‘global conditions’).
- For some time the Chinese authorities have been moving the economy from one that is manufacturing and export dependent to a domestic, consumer and service led, one. The direction of travel has been right, and still is, but it has been a very bumpy road. This rebalancing will continue with services now representing nearly 50% of the economy and responsible for 80% of the growth.
- There are still major problems. Chinese fixed investment has reached $5 trillion this year (greater than North America and Europe combined) and excess capacity is still huge. Capital outflows have been accelerating with over $1 trillion moving abroad in 2015. Export tariffs on steel – where China is responsible for half the world’s production – have been cut, leading to excess capacity being exported overseas.
- And over-riding everything, at least in investors’ minds, is the currency. The renmimbi’s real exchange rate has risen 30% since mid 2012 due to the strong dollar, to which it has been ‘informally’ pegged. A very small official devaluation last summer caused alarm, not far from panic, in the rest of Asia.
- The currency is now measured against a basket, rather than just the US dollar, but is still significantly overvalued. There is a real risk of a formal, major, devaluation which would export deflation to the rest of the global economy. This would almost certainly lead to further falls in commodity prices, and a possible repeat of the currency wars in Asia last experienced in the late 1990s.
- As a consequence of all this, the rest of the Pacific Region (excluding Japan) performed poorly in 2015 and non-Asian Emerging Markets did even worse, the latter weighed down additionally by the double whammy of falling commodity prices and a strong dollar.
- Sentiment remains poor. Whilst valuations overall might be beginning to look tempting after the fall, quality companies are still expensive. Weak demand, excess capacity, over-indebtedness and the prospect of a Chinese devaluation are headwinds that will take some considerable time to overcome. To reverse some, let alone all, of these negatives requires a level of world growth which nobody expects in the near future.
- China might provide a positive surprise in 2016, which would improve sentiment dramatically, but it is far too early to see any signs of this happening.

FIXED INCOME

- The fixed income market as a whole experienced a mixed year, ending 2015 little changed, but seeing significant volatility over the course of the twelve months. Exceptions were Emerging Market debt which traded sharply lower (particularly that denominated in local currency rather than US dollars), and ‘high yield’ bonds (generally known as ‘junk’) which came under pressure in the second half.

- Investment grade debt, especially US Treasuries, UK Gilts and German Bunds, are now trading at such low yields that they remain vulnerable to any further interest rate increases in the US. However global tensions, particularly in the Middle East, mean they will probably maintain their ‘safe haven’ status, at least for the time being.
- Valuations and liquidity are both a challenge in all markets. Sovereign wealth funds (the Norwegian being the most public example) have been trying to reduce their bond positions with difficulty.
- An early indicator of problems to come is the US high yield market. Standard & Poors have warned that over 50% of bonds issued by US energy companies are at risk of default, given the current oil price. If you add global commodity producers, especially the miners, it is obvious the outlook for the sector is dire, with possible knock-on consequences for the whole asset class.

ALTERNATIVES

- Hedge Funds (in sterling terms) returned 3.8% over the quarter, showing a significant improvement in performance when compared to the third quarter. Relative Value and Global Macro strategies both returned 2.6% and were the worst performing strategies over the quarter whilst the Emerging Markets strategy had the worst returns over 12 months and 3 years. Equity Hedge strategies were the strongest over the quarter with a return of 5.1%, and are the leading strategy over 3 years with a return of 8.5%. The performance of hedge funds has oscillated between positive and negative over the year due to the volatility and turbulence in financial markets.
- UK commercial property returned 3.1% over the quarter, and ended the year up by 13.8%, demonstrating another strong year for the UK property market. Capital values climbed by a further 7.8% over the course of the year as initial yields compressed to near 2007 peak levels. Despite a slowing in overall performance, Offices retook the lead as the top performing market sector, returning 3.6% over the quarter, and ending the year with a return of 18.2%. The Retail sector remained the weakest sector, returning 8.9%, whereas Industrials returned 17.3% over the last 12 months. Results for the quarter show signs of further price stabilisation while rental values continue to improve as business confidence picks up across the UK. As at the end of December 2015, the annual yield property yield stood at around 5.6%.
- Commodities returned -14.3% over the quarter, a slight improvement from the returns obtained last quarter. Energy prices continued to decline as oil prices weakened due to excess supply and concerns about weak demand. Coal and natural gas prices declined due to excess supply, high stocks, falling imports to China and India and policies to reduce coal consumption in power generation. Metal prices fell due to softening growth prospects in China and continued increases in supply. Despite an intensification of the El Niño weather pattern, agriculture prices fell over the quarter, reflecting higher stocks due to good crops from previous seasons. Precious metals prices fell marginally on weakening investment demand.

CONCLUSION

2015 was a difficult year for investors in almost all asset classes and 2016 is likely to be equally volatile.

For the first time since the financial crisis in 2007/8 the policies of the Federal Reserve, the Bank of England, the European Central Bank and the Bank of Japan (let alone the Chinese) are diverging. The US (and at some stage the UK) is tightening by increasing rates, the rest continue to ease.

These differences in policy direction raise several questions.

Will they lead to even greater dollar strength? If yes, commodity prices and Emerging Markets will come under further pressure. If no, prices could stabilise. Additional dollar strength could also choke off the US economic recovery.

Will oil prices remain low? According to Quilter the combination of falling oil and other commodity prices has led to a transfer of 1% of global GDP from producers to consumers.

How quickly will interest rates rise in the US? ‘Will they, won’t they’ has now become ‘how much, how often’. Markets were pleased with the December decision by the Federal Reserve, but there is a pertinent saying – be careful what you wish for. Have they tightened too soon?

Will the Chinese devalue the renmimbi? This is potentially the most important financial decision to be made in 2016.

Salvador Dali once said ‘What is important is to spread confusion, not eliminate it’. And global uncertainty is rife. Tension in the Middle East, the refugee crisis in Europe, Chinese decision making, and US interest rates are all worrying investors. The UK appears a haven of stability in this mix – and even here we have the ‘Brexit’ debate to contend with.

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