CLWYD PENSION FUND

ECONOMIC AND MARKET UPDATE
PERIOD ENDING 31 MARCH 2016

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1 MARKET BACKGROUND
PERIOD ENDING 31 MARCH 2016

MARKET STATISTICS

Market Returns Growth Assets	3 Mths %	1 Year %	3 Years % p.a.
UK Equities	-0.4	-3.9	3.7
Global Developed Equities	2.3	0.3	13.9
USA	3.7	4.2	13.6
Europe	1.0	-3.9	5.9
Japan	-4.3	-3.3	6.6
Asia Pacific (ex Japan)	4.6	-7.8	1.1
Emerging Markets	8.4	-8.8	-3.3
Frontier Markets	1.8	-9.3	4.1
Property	1.1	11.7	14.6
Hedge Funds	1.9	-0.7	4.0
Commodities	0.0	-26.3	-23.1
High Yield	6.6	2.5	3.7
Emerging Market Debt	5.0	4.2	3.4
Senior Secured Loans	1.0	2.4	4.5
Cash	0.1	0.5	0.5

Market Returns Bond Assets	3 Mths %	1 Year %	3 Years % p.a.
UK Gilts (>15 yrs)	8.2	4.0	8.6
Index-Linked Gilts (>5 yrs)	6.5	1.9	5.6
Corporate Bonds (>15 yrs AA)	5.2	-0.2	7.2
Non-Gilts (>15 yrs)	4.9	-1.3	6.7

Exchange Rates: Change in Sterling	3 Mths %	1 Year %	3 Years % p.a.
Against US Dollar	-2.5	-3.2	-1.8
Against Euro	-7.0	-8.8	2.2
Against Yen	-8.9	-9.3	4.2

Inflation Indices	3 Mths %	1 Year %	3 Years % p.a.
Price Inflation – RPI	0.2	1.6	1.6
Price Inflation – CPI	-0.2	0.5	0.7
Earnings Inflation*	1.0	2.4	2.0

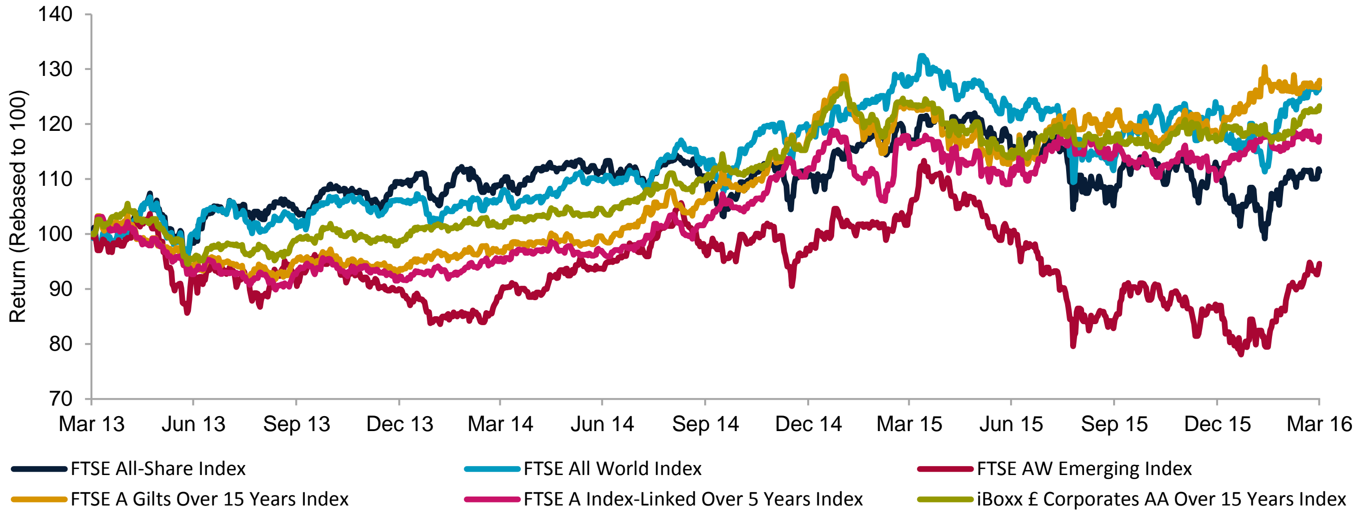
Yields as at 31 March 2016	% p.a.
UK Equities	3.77
UK Gilts (>15 yrs)	2.17
Real Yield (>5 yrs ILG)	-0.98
Corporate Bonds (>15 yrs AA)	3.36
Non-Gilts (>15 yrs)	3.71

Absolute Change in Yields	3 Mths %	1 Year %	3 Years % p.a.
UK Equities	0.07	0.44	0.42
UK Gilts (>15 yrs)	-0.40	-0.06	-0.85
Real Yield (>5 yrs ILG)	-0.27	-0.05	-0.55
Corporate Bonds (>15 yrs AA)	-0.32	0.25	-0.70
Non-Gilts (>15 yrs)	-0.29	0.34	-0.52

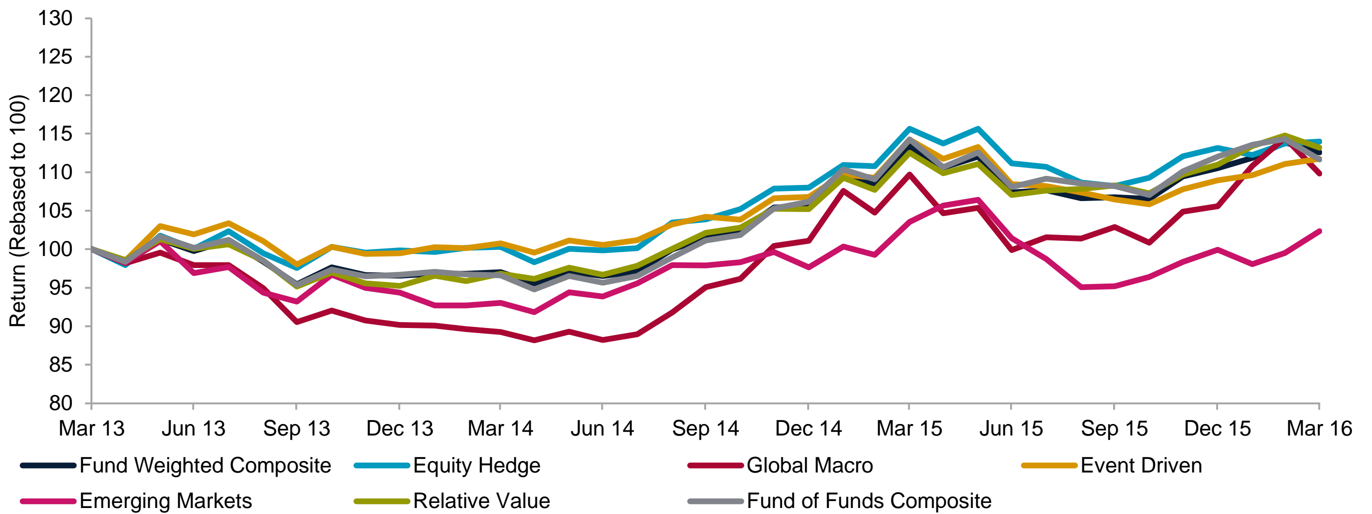
Source: Thomson Reuters and Bloomberg
Note: * Earnings inflation is lagged by 1 month.
All returns shown are in Sterling terms

MARKET SUMMARY CHARTS

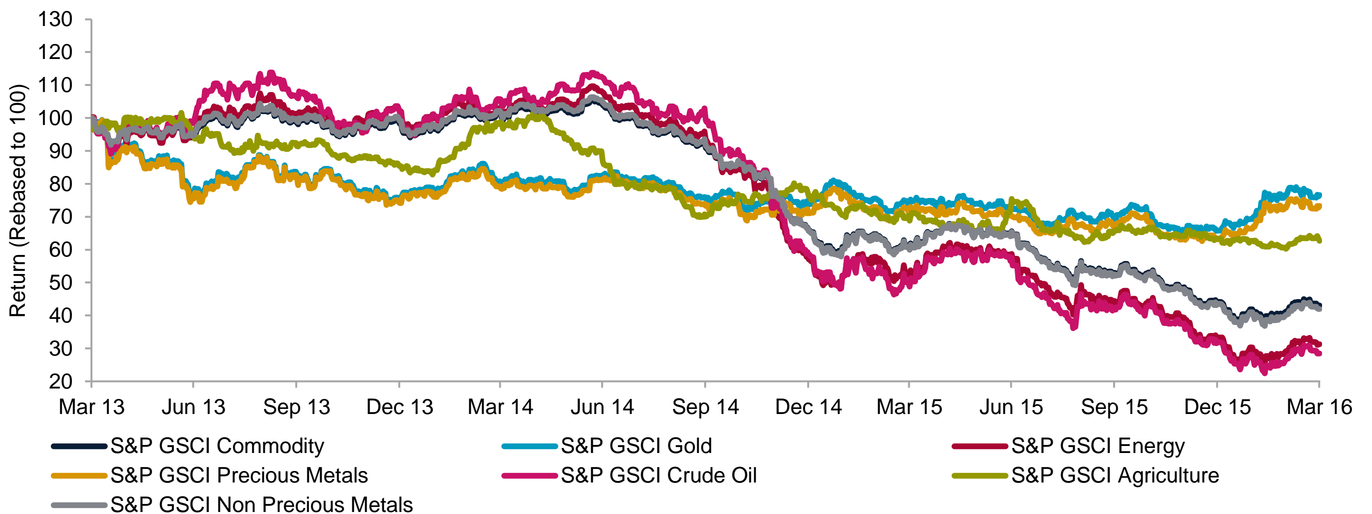
Market performance – 3 years to 31 March 2016



Hedge Funds: Sub-strategies performance – 3 years to 31 March 2016

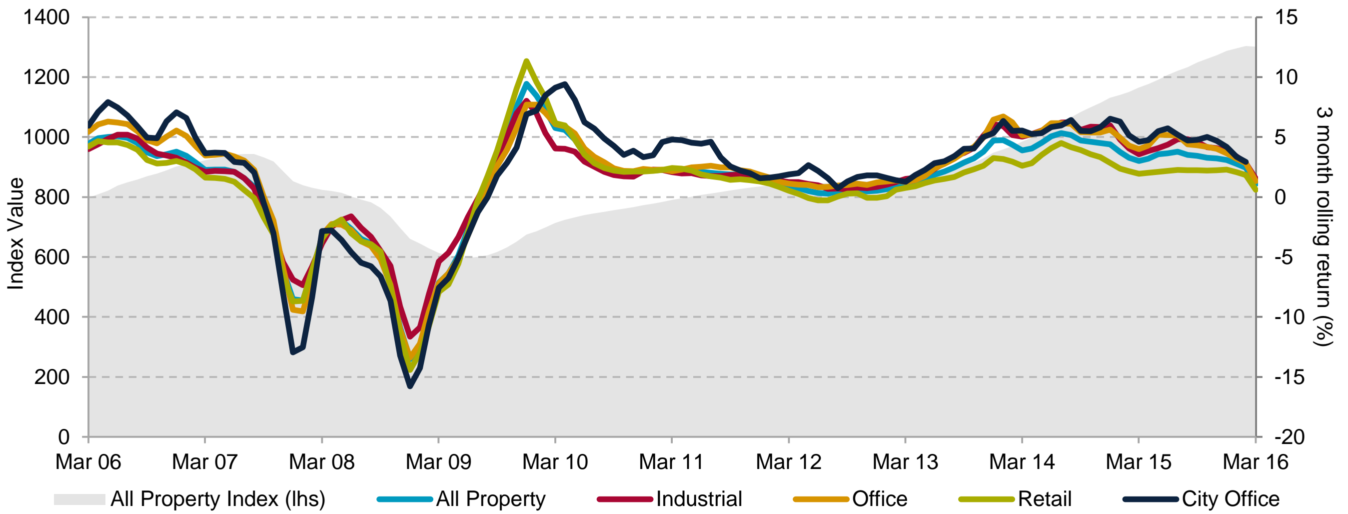


Commodity sector performance – 3 years to 31 March 2016

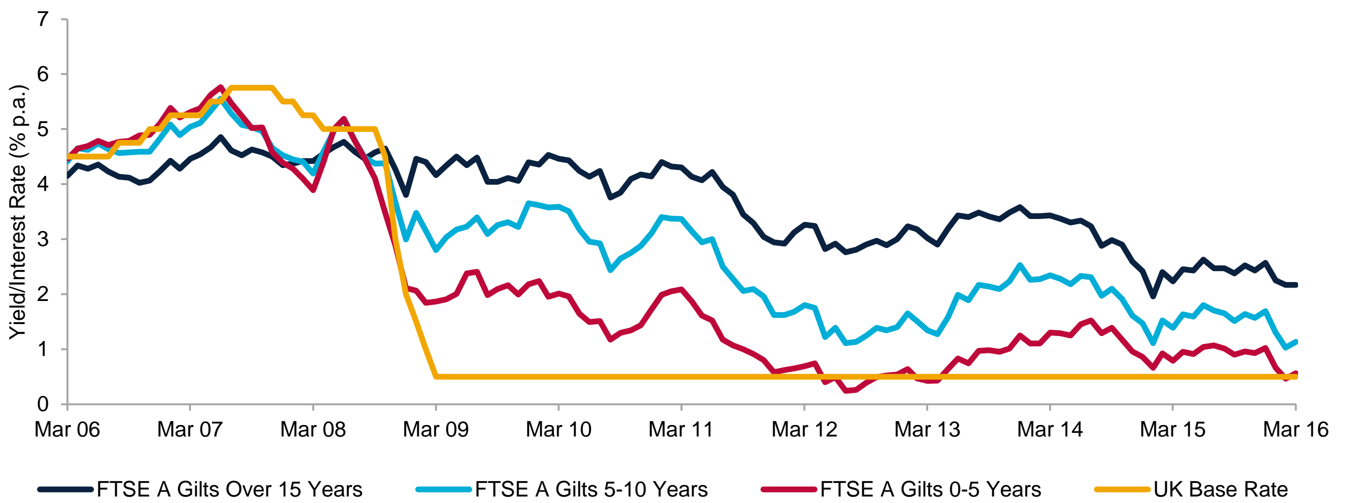


Source: Thomson Reuters

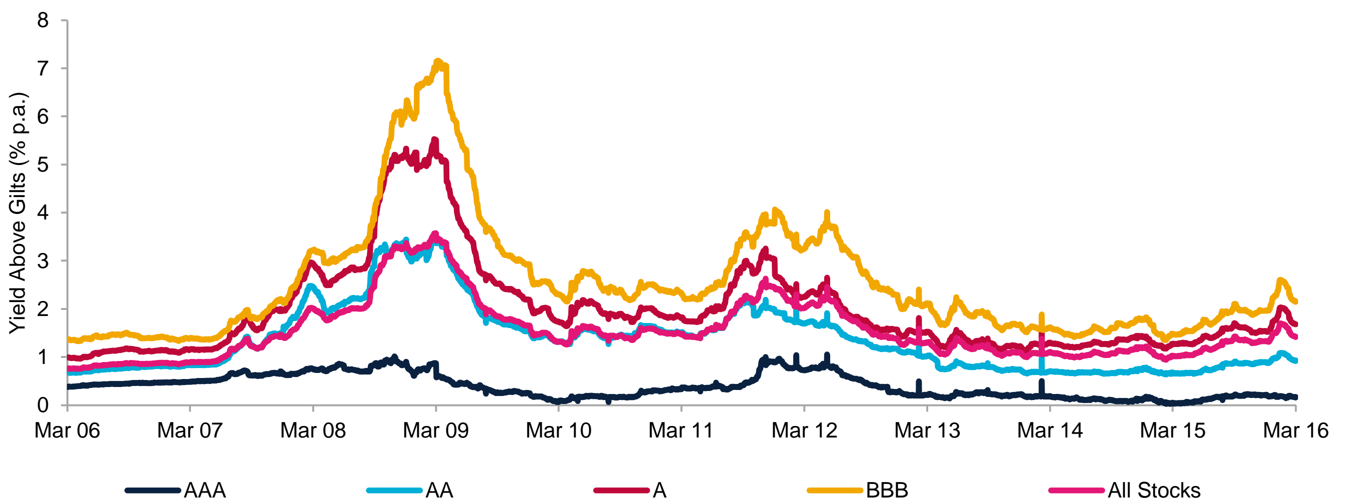
Property sector performance – 10 years to 31 March 2016



UK government bond yields – 10 years to 31 March 2016



Corporate bond spreads above government bonds – 10 years to 31 March 2016



Source: Thomson Reuters

2 ECONOMIC STATISTICS

Economic Statistics as at:	31 March 2016			31 December 2015			31 March 2015		
	UK	Euro[1]	US	UK	Euro[1]	US	UK	Euro[1]	US
Annual Real GDP Growth[2]	2.1%	2.9%	1.9%	2.1%	3.0%	2.0%	2.6%	2.0%	2.9%
Annual Inflation Rate[3]	0.5%	0.0%	0.9%	0.2%	0.2%	0.7%	0.0%	-0.1%	-0.1%
Unemployment Rate[4]	5.1%	10.5%	4.9%	5.1%	10.7%	5.0%	5.6%	11.4%	5.6%
Manufacturing PMI[5]	51.0	51.6	51.5	51.8	53.2	51.2	53.7	52.2	55.7

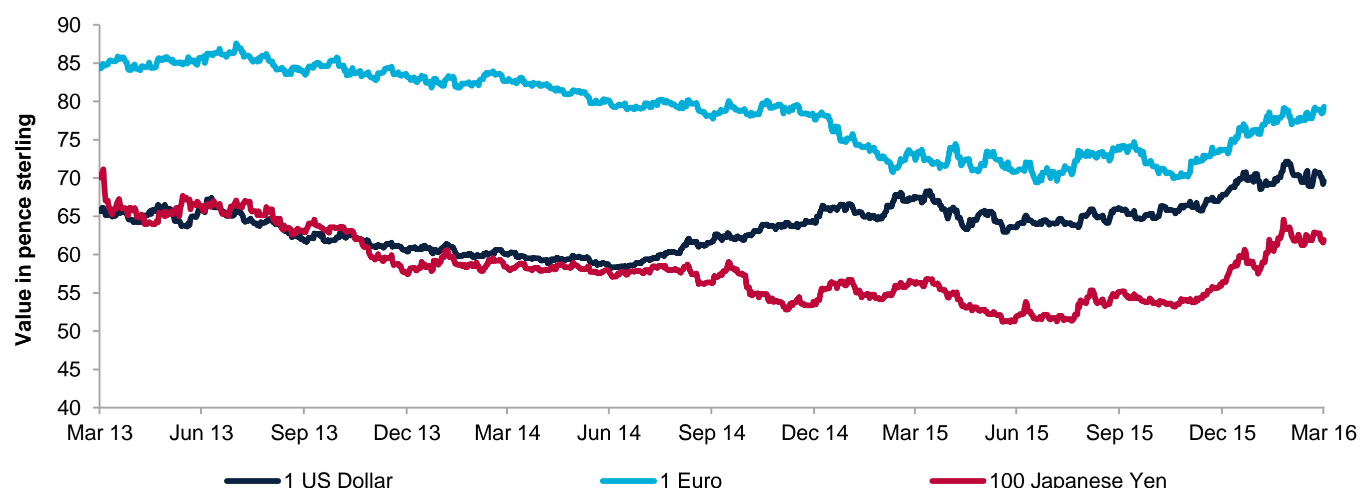
Change over periods ending:	3 months			12 months		
31 March 2016	UK	Euro[1]	US	UK	Euro[1]	US
Annual Real GDP Growth[2]	-0.1%	-0.1%	0.0%	-0.6%	0.9%	-0.9%
Annual Inflation Rate[3]	0.3%	-0.3%	0.1%	0.5%	0.0%	0.9%
Unemployment Rate[4]	0.0%	-0.2%	-0.1%	-0.5%	-0.9%	-0.7%
Manufacturing PMI[5]	-0.8	-1.6	0.3	-2.7	-0.6	-4.2

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 Mar 16	31 Dec 15	31 Mar 15	3 months	12 months
1 US Dollar is worth	69.57p	67.85p	67.36p	-2.5%	-3.2%
1 Euro is worth	79.29p	73.70p	72.35p	-7.0%	-8.8%
100 Japanese Yen is worth	61.90p	56.40p	56.17p	-8.9%	-9.3%

Exchange rate movements – 3 years to 31 March 2016



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

3 MARKET COMMENTARY

INTRODUCTION

‘Things are always better in the morning’ said Harper Lee in ‘To Kill a Mockingbird’. There were times in the first few weeks of the last quarter when this seemed unlikely as mild panic overcame investors and prices fell sharply.

This suddenly changed in mid-February, when most markets had recovered rapidly from their low. What caused the reversal?

A combination of a rebound in the oil price, diminishing fears of a US recession, some more encouraging comments from China and, not least, short covering and bargain hunting led to some extreme moves. For example, Anglo American more than doubled in price in just five weeks.

Once again the major Central Banks led the way. Statements from the People’s Bank of China (on currency), the Federal Reserve (suggesting no early interest rate rises), the Bank of Japan (which cut rates) and the European Central Bank (also cutting rates) all helped to ease investors’ concerns.

Overall the backdrop is not dissimilar to what has been seen for some time now. Consumer spending is holding up – in many areas at the expense of saving rates – but industry is still finding life challenging due to the slowdown in global trade.

In the last few weeks since the recovery in equity prices, markets have mainly moved sideways as investors await further news. But at least for the time being, they are heeding the words of an old Dalai Lama – ‘Choose to be optimistic, it feels better’.

UNITED KINGDOM

- The main indices finished the quarter little changed since the year end, despite the volatility seen in the meantime. As elsewhere, markets moved in line with the oil price and recovered when it also showed signs of doing so. But as the quarter ended, the growing possibility of a ‘No’ vote – Brexit – in the June referendum began to weigh on investors’ minds. This is discussed below.
- Looking first at the economic backdrop, the indicators are mixed.
- Growth in the UK economy is continuing, albeit at a relatively low level for this stage in the cycle (similar to the US). Core inflation remains low with no signs of any acceleration, wage increases are still muted and the chances of an interest rate increase this year are small (with one exception, mentioned below).
- There are problems, however. The savings ratio is at a record low of 3.8%, and household finances are in a worse state than before the 2007 crisis as consumers have been taking advantage of low interest rates to add to their debt. As a country Britain is sinking deeper into the red and living beyond its means. At 7% of GDP the current account deficit is now the largest peacetime shortfall since records began in 1772, and the highest among advanced economies. Consumption of imports is too high and will need to be reduced at some stage.
- Sir Walter Scott, in ‘Marmion’ penned the famous words ‘Oh, what a tangled web we weave, when first we practice to deceive’. Both sides of the argument are seemingly guilty of this. Those who wish to remain in the EU not surprisingly emphasise the benefits, particularly the economic benefits, of staying in and warn, often in apocalyptic terms, of the unknown dangers of leaving. Those who argue for a ‘No’ vote play down the dangers, and stress the advantages of regaining control of ones own actions.
- Whichever side of the argument one is on, it is obvious that a ‘No’ result will cause confusion in the short term, at least, and volatility in markets. Confidence will take a hit and sterling could weaken sharply – too sharply and

the Bank of England could be forced to increase interest rates sooner, and by a greater amount, than expected. Longer term will depend on the outcome of the negotiations on exit.

- But the final decision in June is likely to be an emotional one, not economic. Opinion polls – their reputation somewhat tarnished over the last few years – are suggesting the result will be very close. On the other hand bookmakers – whose track record is considerably better – are indicating a solid 'Yes' majority.
- What should a UK investor do in such a situation? It is pointless trying to second-guess the outcome. Not all UK companies will be hit by a 'No' vote. If sterling weakens, some will benefit. Exports will not disappear overnight. A 'Yes' outcome will settle the issue for another generation at least.
- Despite a few dividend cuts from higher profile companies, the yield on the UK market is still attractive - especially compared to elsewhere.

EUROPE EX UK

- The Eurozone recovery is continuing but at a very low level and showing no signs of acceleration. There are too many headwinds. The region is still suffering deflation, although there have been a few signs of a pick-up in prices but not enough to reach the 2% target. Core inflation, which strips out volatile items such as food and energy, has risen to 1%, the highest in six months.
- Consumers' propensity to spend is weak. As a group they are trying to reduce their debt, and additionally companies are reluctant to invest whilst the global background is uncertain. The European Central Bank has tried to provide further stimulus, reducing interest rates to record lows and increasing its bond purchases (including corporate debt for the first time), but there are few indications of any positive effect so far. The ECB has been hoping that countries would provide a fiscal stimulus to add to its monetary one, but again, to date, without success. Austerity still rules supreme in many areas.
- There is nothing new here. In contrast the headlines have been filled with political, not economic, problems. The refugee crisis continues to cause angst throughout the region, and despite the negotiated agreement with Turkey – yet to be fully tested, and already showing signs of breaking down – the onset of Spring and better weather will likely test the political will still further.
- This crisis, coupled with the recent terrorist attacks in Paris and Brussels, have encouraged the rise in anti-EU parties across the whole of the Eurozone. Immigration, not austerity, is now their leading cause. A (non-binding) referendum just held in the Netherlands has rejected a trade treaty with the Ukraine, on fears it might be a prelude to further EU integration, and further immigration from the East.
- Overshadowing everything, in the short term, is the possibility of 'Brexit'. Other countries on the Continent, not only those in the Eurozone, have parties just as eager to withdraw from the EU as the 'Out' supporters in the UK. They, too, would fancy their chances if the UK votes to leave. This is the greatest fear in Brussels.
- In the first quarter, markets in Europe were as volatile as elsewhere, with a sharp fall followed by a recovery, ending the quarter little changed from the year end.

NORTH AMERICA

- The US economy continues to grow, at a rather lacklustre 1% annualised rate. Demand has weakened, due mainly to the strong dollar, but job creation is still high, as recent figures have confirmed. Wage growth has yet to accelerate (many newly created jobs are low paid or part-time) but core inflation is rising and, all other things being equal, the Federal Reserve is expected to raise interest rates twice this year, to reach 1% by year end.
- But all other things are not equal. The Federal Reserve has shown its willingness in the last few months to take more account of the effect of its actions overseas, rather than stick to its official US remit. The expected rate rise in March was postponed (possibly another consequence of the Shanghai meeting) and the latest statement from the Federal Reserve have been far more 'dovish' in their implications.
- Resulting from this apparently more benign, outlook, global investors have been returning to the US market, believing it to be less volatile and more predictable. A certain amount of complacency has set in, which may be tested by the first quarter earnings announcements due shortly. Revenues for many companies have been

under pressure for some time, but profits have yet to respond due to accountancy changes. This could soon change.

- And then there is the forthcoming Presidential election.
- Donald Trump must at times feel like Julius Caesar in 'Carry On Cleo' – 'Infamy! Infamy! They've all got it in for me!' The Republican establishment is horrified at the thought of him winning the nomination in July, and trying everything to prevent this happening, so far with little effect.
- For the Democrats the race between Hillary Clinton and Bernie Sanders is less fractious – so far – and much closer than expected. However the likelihood of Mrs Clinton emerging as the nominee is still high.
- Should she go on to win the election in November, this could have serious implications for the market (depending, of course, on which party controls Congress). She does not like 'Big Business' – especially healthcare companies, which she accuses of profiteering – and is deeply suspicious of Wall Street. In theory, a Trump victory, however unlikely, would be more pro-business, but given some of his statements, even this is not a certainty.
- With the exception of the healthcare sector, which has recently been underperforming after a period of strong growth, markets have so far ignored the ongoing political debate. At some stage however, possibly from July when the nominees are finally confirmed, investors will have to take note – and react.

JAPAN

- The Bank of Japan surprised markets (some would say shocked) at the end of January by an additional cut in interest rates – into negative territory for the first time. The immediate results were dramatic, with the Bank index in Tokyo falling 26% in a fortnight (since recovered to a 15% loss) as investors were concerned over the effect on banks' profitability. However the positive effects are already being seen. Consumers are falling over themselves to take advantage of lower mortgage rates. Refinancing applications are up 250% on a year ago, and new home loan requests have risen 50%. The Government might not have appreciated the stock market reaction, but will be pleased by that of the man-in-the-street.
- GDP growth has been down-graded again to 0.8% (it was 1.1%), perilously close to yet another recession. Inflation remains stubbornly low at 0.4%. Mr Abe, like Mr Draghi in Europe, is determined to 'do what it takes' to get the economy moving again. Wage increases are crucial and the results of this year's Spring wage negotiations will be watched closely, with the government trying to persuade companies to use some of their vast reserves of cash to increase real incomes.
- In sterling terms the Japanese market fell over 4% in the first quarter, the worst performance of the major indices (in yen terms it fell even more). Ongoing structural reforms are taking time – as always in Japan – to show any benefits. However the reaction to the introduction of negative rates described above shows the Japanese consumer can move quickly if he wants to.
- The Japanese market requires patience, sorely tested over the years. Valuations are attractive, especially relative to other markets, dividends are increasing and high quality companies are proving their resilience. But yet again confidence is lacking. Some further indication that Mr Abe's reforms are working will be needed before the market regains the momentum seen last year.

ASIA PACIFIC EX JAPAN / EMERGING MARKETS

- 'Even the darkest night will end and the sun will rise' wrote Victor Hugo in 'Les Miserables'.
- Emerging Markets rose dramatically over the period under review, up 8% in the quarter – and up 18% from the bottom in February. Is this a false dawn or the start of a longer term recovery?
- The reasons are not difficult to find. Indications that the US dollar might be peaking (the Shanghai meeting again) and that commodity prices might be stabilising, if not yet increasing (oil being the exception) were enough to tempt investors back into the sector. The rally was led by South American markets, particularly Brazil (due to politics, not economics), but others followed – Asia Pacific rose nearly 5%. It is worth noting that over

two-thirds of the benchmark Emerging Market index is made up of countries that are net commodity importers, benefiting from lower prices. These include nearly all those in Asia.

- In the Pacific Region the value of the Chinese currency is the key, and there the signs are more promising than a few months ago. The Governor of the People's Bank of China has made it clear he was not looking to devalue the currency on a trade-weighted basis, and was comfortable with forecast economic growth figures. This has reassured investors, and companies, in the region.
- It is too early to tell if the fundamental story for Emerging Markets has changed, or whether the recent strong rally was just short covering and nothing more sustainable.

FIXED INCOME

- In mid-February there was a G20 meeting held in Shanghai at which, amongst other things, the Chinese outlined their attempts to reduce, and hopefully eventually stop, the massive capital outflows being experienced. This has led to the pressure on the Renminbi which has been the cause of so much concern since last summer.
- Whether by coincidence, or as a result of these measures, the outflows have fallen dramatically in February (and the early indications suggest the March figures will show a similar fall).
- There have been two major beneficiaries of the flood of Chinese cash – the leading government bond markets and the US dollar.
- The last time something similar happened was in 1985 (the 'Plaza Accord', named after the hotel in New York that hosted an equivalent meeting) and the trade-weighted dollar fell by more than 40% in the following three years.
- Has an equally important turning point for government bonds and the dollar been reached? Will the tide of money that has driven bond yields to all-time lows at long last be reversed? Only time will tell, but the Shanghai meeting in 2016 could turn out to be as important as the one in New York in 1985.
- All the major government bond markets have benefited from the inflow of liquidity mentioned above, the low interest rate environment experienced in recent years and the 'safe-haven' status we have often mentioned in the past.

ALTERNATIVES

- Hedge Funds (in sterling terms) returned 1.9% over the quarter, which was primarily due to a strengthening of the dollar against sterling as hedge funds returned -0.7% in dollar terms. Global Macro were the strongest strategies, returning 4.0%, whilst Equity Hedge returned 0.8% and were the worst performing strategies during this period. Over 3 years however, Equity Hedge were the leading strategies with a return of 4.5% p.a. Event Driven strategies had the worst returns over 12 months, returning -2.2%, whilst Relative Value was the strongest during this period, returning 0.6%. Hedge fund strategies with exposure to global equities produced strong gains at the end of the quarter as equities reversed steep losses from the first half of the quarter.
- UK commercial property returned 1.1% over the quarter, down from 3.0% recorded in the same period last year as the growth rate was weighed down by a decline in capital values. Over the quarter, capital values declined by 0.2%, as capital growth turned negative in March 2016 for the first time since April 2013. Industrials and Offices were the leading sectors over the quarter returning 1.5% and 1.3% respectively. Meanwhile, the retail sector continued to lag behind returning 0.6% over the same period. As at the end of March 2016, the annual yield property yield stood at around 5.5%.
- Commodities generated a flat return over the quarter, a significant improvement from the negative returns obtained last quarter, as most commodity indexes rebounded in February-March from their January lows on market sentiment and a weakening dollar. Energy prices continued to decline over the quarter, as oil prices dropped due to resilient oil production from countries that do not belong to the Organisation of the Petroleum Exporting Countries, expanding supplies from Iran and weak demand. Coal and natural gas prices declined due to oversupply. Despite the reversal of the downward trend in the prices of some agricultural commodities at the

end of the quarter, agriculture prices fell, marking the eighth consecutive quarterly decline. Metal prices declined on weakening growth prospects in China and increasing supplies whilst precious metals prices rose due to stronger investment demand.

CONCLUSION

Volatility has been the watchword in the first quarter with investors close to panic in the first few weeks, only to recover their nerve as time passed. Individual shares have bounced very sharply, but overall indices have hardly changed. The reasons for the reversal in mood have been mentioned above. Will they continue?

The oil price, with which in recent months markets appear to have been correlated, seems to have stabilised at these higher levels (the mid $30s at the time of writing). Forecasting future oil production is nigh on impossible, given the political ramifications of any change, but suffice to say at this price demand should be sustained and may even increase.

This assumes modest growth in developed market economies, with perhaps some more robust recovery in Emerging Markets – the latter a moot point at this early stage. After the recent Shanghai meeting the chances of a weakening dollar going forward have increased, which would suit the US, its exporting companies and, again, some of the more hard-pressed Emerging Market economies, whose exports would at last become more competitive.

This benign outcome could easily be derailed if the Federal Reserve, for whatever reason, decides to increase rates more rapidly, or more steeply, than markets currently expect.

The June referendum in the UK will almost certainly lead to nervousness amongst investors in the weeks beforehand (and the same will happen later in the year ahead of the Presidential election), probably both here in the UK, and in Europe, especially if the result is likely to be close.

It is difficult to see where economic growth can be accelerated – except perhaps in the Eurozone and Japan if the ongoing monetary stimuli work. So companies will have to continue playing the hand they have already been dealt, with the advantage still with the developed world over the developing (something that may change as the year progresses).

Finally, it is worth remembering a comment from Warren Buffett. ‘Look at market fluctuations as your friend rather than your enemy; profit from folly rather than participate in it’.

4 INDICES USED IN THIS REPORT

Asset	Index
Growth Assets	
UK	FTSE All-Share Index
Global Developed	MSCI World Index
USA	FTSE USA Index
Europe	FTSE AW Europe (ex UK) Index
Japan	FTSE Japan Index
Asia Pacific (ex Japan)	FTSE AW Asia Pacific (ex Japan) Index
Emerging Markets	MSCI Emerging Markets Index
Frontier Markets	MSCI Frontier Markets Index
Property	UK IPD Monthly Property Index
Hedge Funds	HFRI Fund Weighted Composite Index
Commodities	S&P GSCI TR Index
High Yield	Bank of America Merrill Lynch Global High Yield Index
Emerging Markets Debt	JPM EMBI Global Diversified Composite Index
Senior Secured Loans	Credit Suisse Western European Leveraged Loan Index
Cash	IBA GBP LIBOR 1 Week Index
Bond Assets	
UK Gilts (>15 yrs)	FTSE A Gilts Over 15 Years Index
Index-Linked Gilts ((>5 yrs)	FTSE A Index-Linked Over 5 Years Index
Corporate Bonds (>15 yrs AA)	IBoxx £ Corporate Over 15 Years AA Index
Non-Gilts (15yrs)	IBoxx £ Non-Gilts Over 15 Years Index
Yields	
UK Equities	FTSE All-Share Index (Dividend Yield)
UK Gilts (>15 yrs)	FTSE A Gilts Over 15 Years Index (Gross Redemption Yield)
Real Yield (>5 yrs ILG)	FTSE A Index-Linked Over 5 Year Index 5% Inflation (Gross Redemption Yield)
Corporate Bonds (>15 yrs AA)	IBoxx £ Corporate Over 15 Years AA Index (Gross Redemption Yield)
Non-Gilts (>15 yrs)	IBoxx £ Non-Gilts Over 15 Years Index (Gross Redemption Yield)
Inflation	
Price Inflation – RPI	All Items Retail Price Index (NADJ)
Price Inflation – CPI	All Items Consumer Price Index (Estimated NADJ)
Earnings Inflation	Average Weekly Index (Whole Economy excluding Bonuses)
Exchange Rates	
USD/EUR/JPY vs GBP	WM/Reuters 4:00 pm Closing Spot Rates

Notes: All the indices above are denominated in Sterling

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