CLWYD PENSION FUND

ECONOMIC AND MARKET UPDATE
PERIOD ENDING 30 SEPTEMBER 2017

TABLE OF CONTENTS

1 MARKET BACKGROUND
PERIOD ENDING 30 SEPTEMBER 2017

MARKET STATISTICS

Market Returns Growth Assets	3 Mths %	1 Year %	3 Years % p.a.
UK Equities	2.1	11.9	8.5
Global Developed Equities	1.6	15.0	15.4
USA	1.2	15.0	17.9
Europe	3.9	22.6	13.6
Japan	0.8	11.4	15.8
Asia Pacific (ex Japan)	1.8	15.8	13.7
Emerging Markets	4.6	19.0	12.1
Frontier Markets	4.7	21.9	5.5
Property	2.7	10.4	9.5
Hedge Funds	-1.0	3.8	10.1
Commodities	3.8	-1.4	-14.3
High Yield	-0.4	6.3	12.4
Emerging Market Debt	1.2	6.9	6.5
Senior Secured Loans	1.0	5.1	4.9
Cash	0.1	0.2	0.4

Market Returns Bond Assets	3 Mths %	1 Year %	3 Years % p.a.
UK Gilts (>15 yrs)	-0.5	-6.3	9.5
Index-Linked Gilts (>5 yrs)	-0.8	-4.2	10.8
Corporate Bonds (>15 yrs AA)	-0.5	-3.5	8.9
Non-Gilts (>15 yrs)	-0.1	-2.7	8.6

Exchange Rates: Change in Sterling	3 Mths %	1 Year %	3 Years % p.a.
Against US Dollar	3.3	3.3	-6.1
Against Euro	-0.3	-1.8	-4.0
Against Yen	3.5	14.8	-5.3

Inflation Indices	3 Mths %	1 Year %	3 Years % p.a.
Price Inflation – RPI	1.0	3.9	2.2
Price Inflation – CPI	0.8	3.0	1.3
Earnings Inflation*	0.2	2.2	2.4

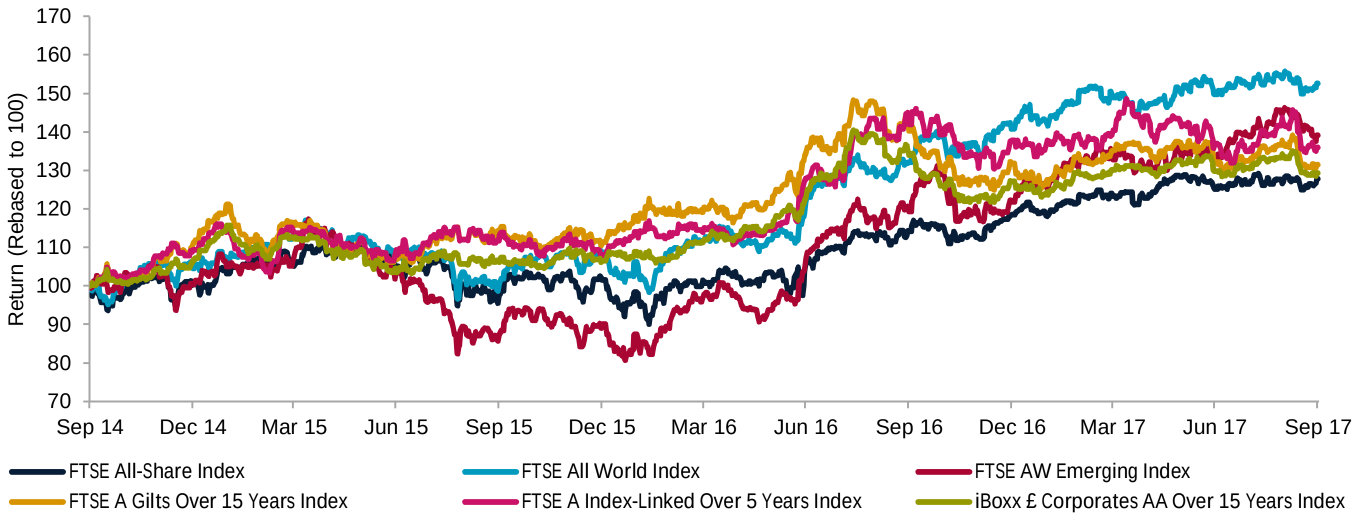
Yields as at 30 September 2017	% p.a.
UK Equities	3.68
UK Gilts (>15 yrs)	1.84
Real Yield (>5 yrs ILG)	-1.52
Corporate Bonds (>15 yrs AA)	2.64
Non-Gilts (>15 yrs)	3.05

Absolute Change in Yields	3 Mths %	1 Year %	3 Years % p.a.
UK Equities	0.07	0.22	0.34
UK Gilts (>15 yrs)	0.04	0.42	-1.14
Real Yield (>5 yrs ILG)	0.06	0.27	-1.15
Corporate Bonds (>15 yrs AA)	0.08	0.42	-1.19
Non-Gilts (>15 yrs)	0.11	0.45	-1.10

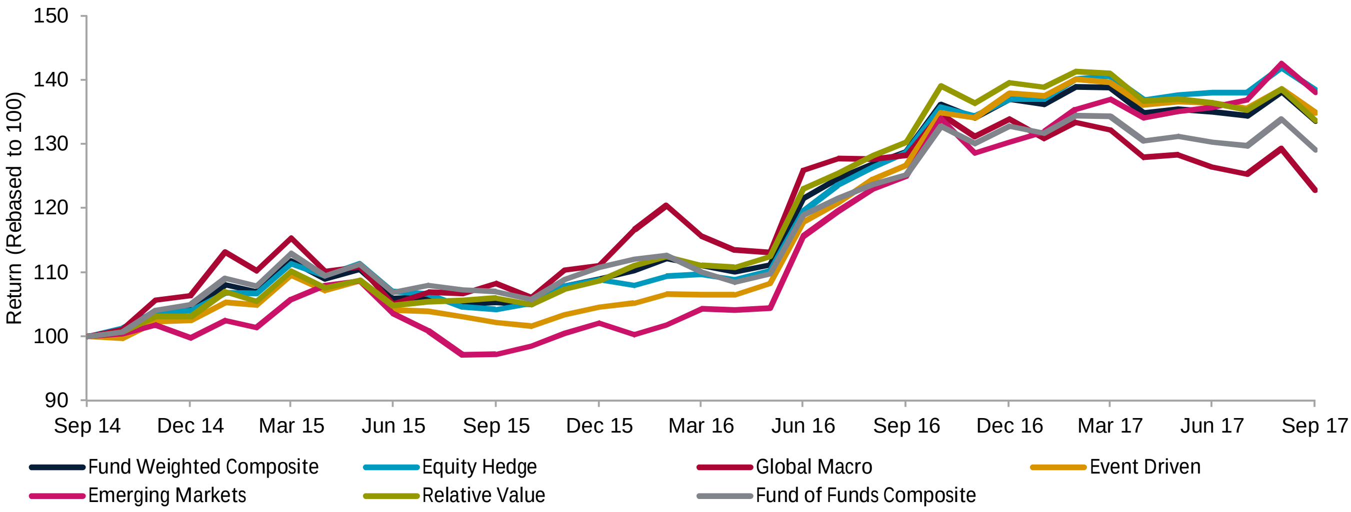
Source: Thomson Reuters and Bloomberg
Note: * Subject to 1 month lag

MARKET SUMMARY CHARTS

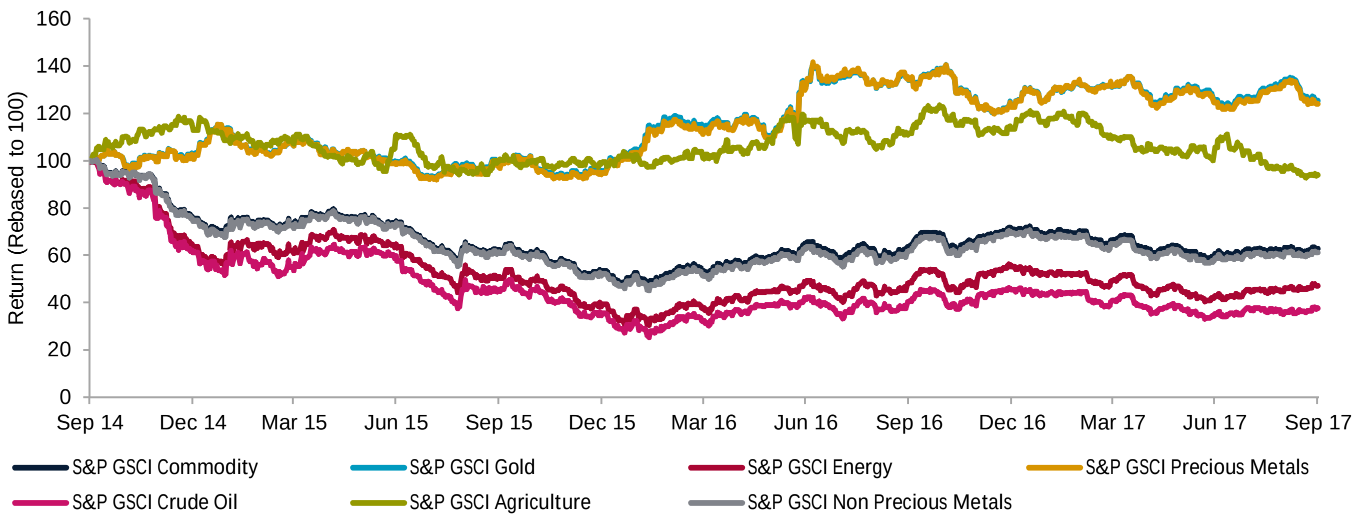
Market performance – 3 years to 30 September 2017



Hedge Funds: Sub-strategies performance – 3 years to 30 September 2017

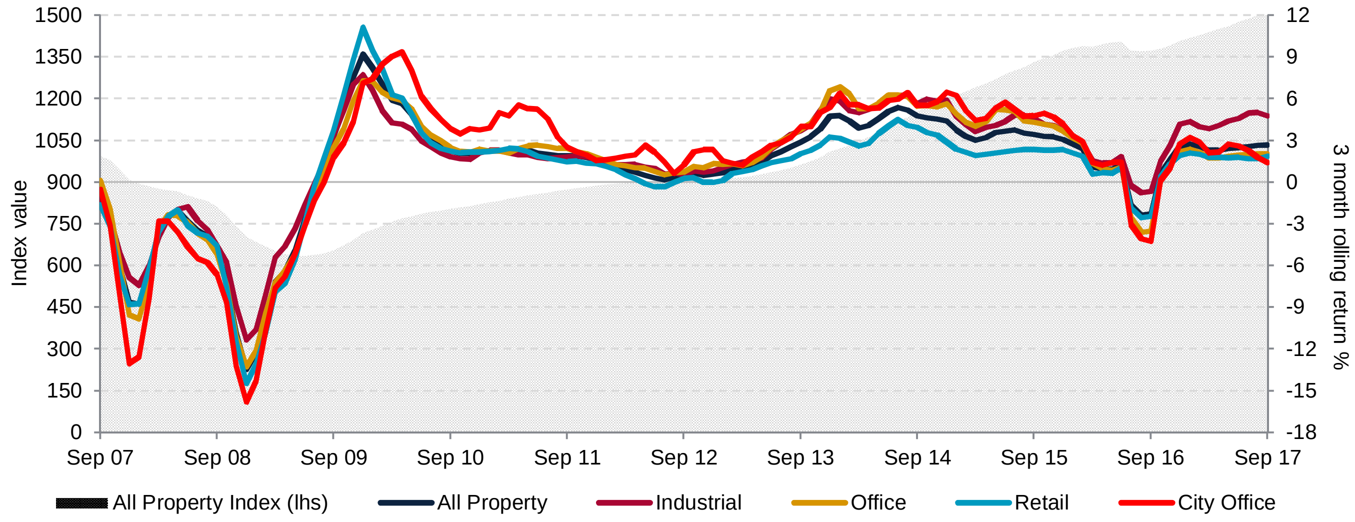


Commodities: Sector performance – 3 years to 30 September 2017

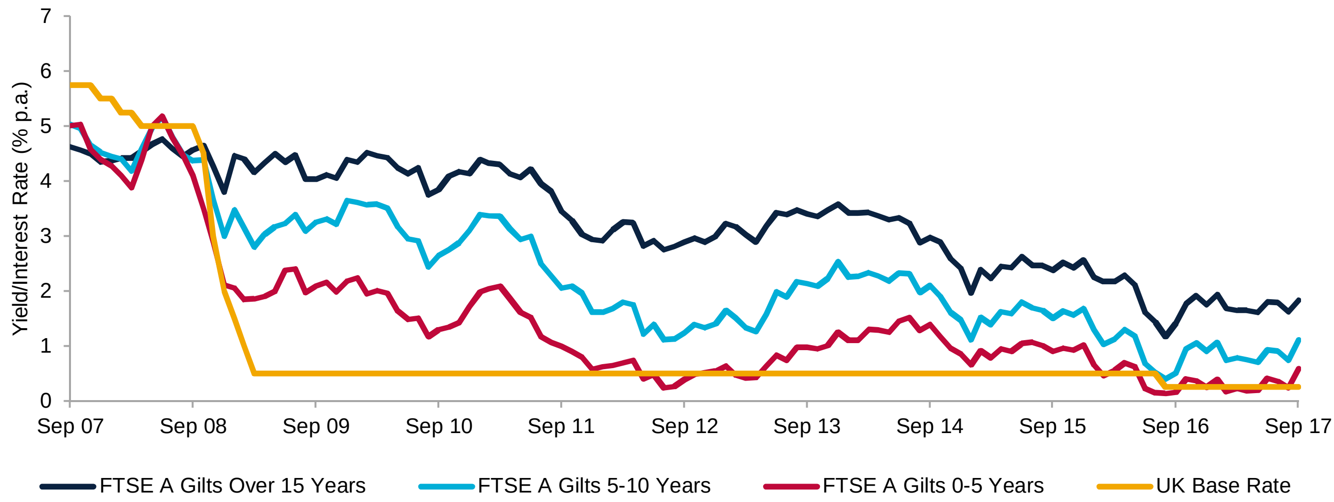


Source: Thomson Reuters

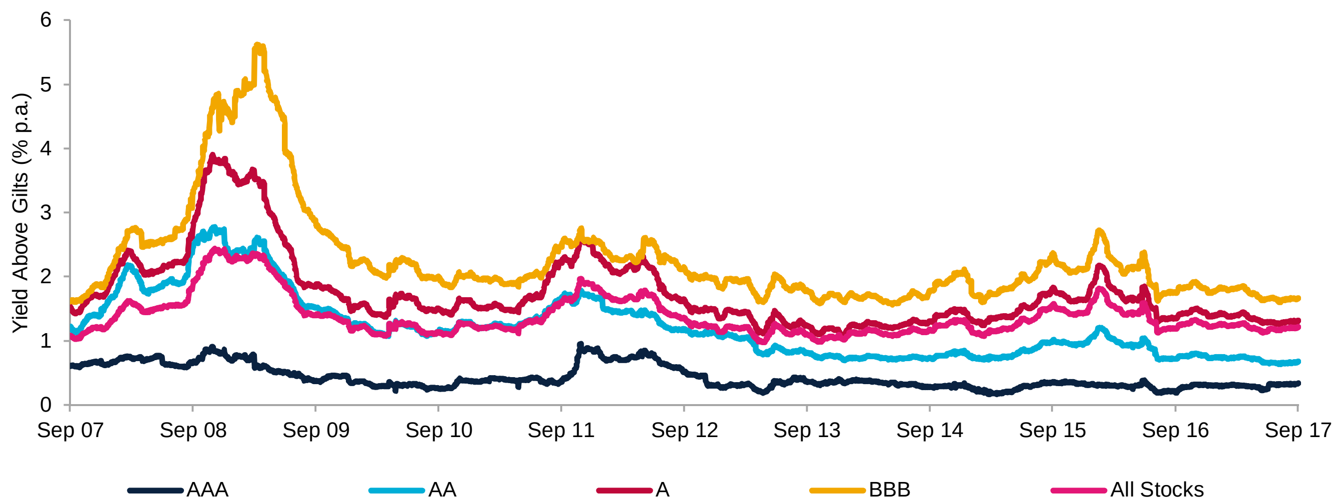
Property: Sector performance – 10 years to 30 September 2017



UK government bond yields – 10 years to 30 September 2017



Corporate bond spreads above government bonds – 10 years to 30 September 2017



Source: Thomson Reuters

2 ECONOMIC STATISTICS

Economic Statistics as at:	30 Sept 2017			30 June 2017			30 Sept 2016		
	UK	Euro[1]	US	UK	Euro[1]	US	UK	Euro[1]	US
Annual Real GDP Growth[2]	1.5%	3.4%	2.2%	1.8%	2.7%	2.0%	1.8%	2.6%	1.2%
Annual Inflation Rate[3]	3.0%	1.5%	2.2%	2.6%	1.3%	1.6%	1.0%	0.4%	1.5%
Unemployment Rate[4]	4.3%	9.0%	4.3%	4.5%	9.2%	4.4%	5.0%	9.9%	4.9%
Manufacturing PMI[5]	56.0	58.1	53.1	54.2	57.4	52.0	55.6	52.6	51.5

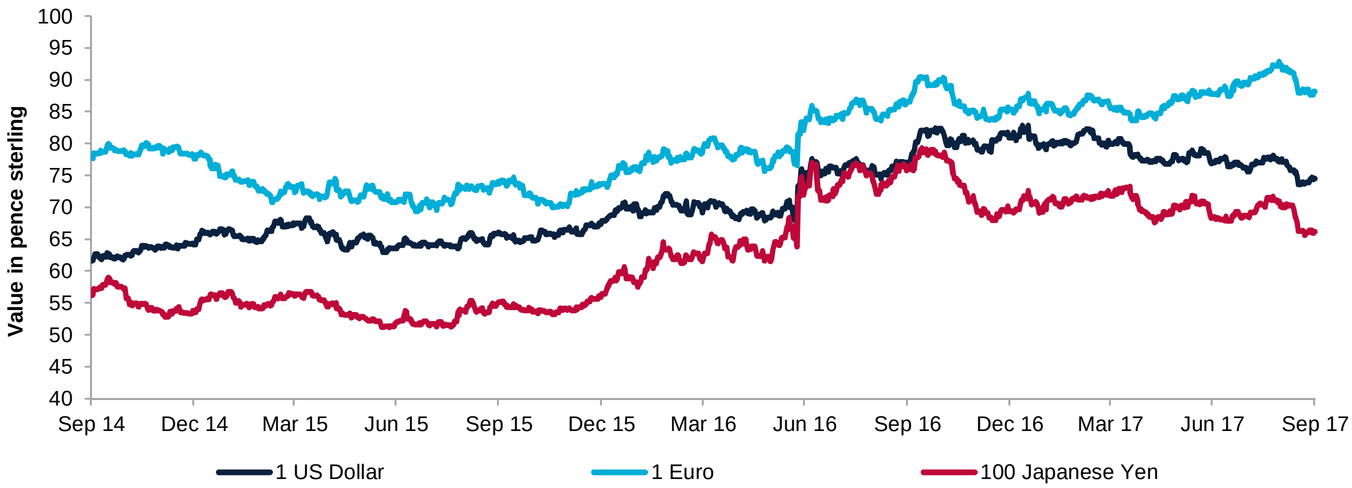
Change over periods ending:	3 months			12 months		
30 Sept 2017	UK	Euro[1]	US	UK	Euro[1]	US
Annual Real GDP Growth[2]	-0.3%	0.7%	0.2%	-0.3%	0.8%	1.0%
Annual Inflation Rate[3]	0.4%	0.2%	0.6%	2.0%	1.1%	0.7%
Unemployment Rate[4]	-0.2%	-0.2%	-0.1%	-0.7%	-0.9%	-0.6%
Manufacturing PMI[5]	1.8	0.7	1.1	0.4	5.5	1.6

Notes: 1. Euro Area 19 Countries. 2. GDP is lagged by one quarter. 3. CPI inflation measure. 4. 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	
	30 Sept 17	30 June 17	30 Sept 16	3 months	12 months
1 US Dollar is worth	74.54p	76.99p	76.98p	3.3%	3.3%
1 Euro is worth	88.11p	87.81p	86.51p	-0.3%	-1.8%
100 Japanese Yen is worth	66.22p	68.52p	76.02p	3.5%	14.8%

Exchange rate movements – 3 years to 30 September 2017



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

3 MARKET COMMENTARY

INTRODUCTION

“Getting rich is easy. Staying rich is harder” – Donald Trump. It does feel odd to be quoting President Trump to illustrate a sound point in investment practice; however, this particular comment rings true.

We have enjoyed extraordinary investment returns as UK investors since February 2016 and the trajectory of these returns has continued upwards, however, the quantum of the returns has slowed considerably. We have been moving into an environment of increasing uncertainty over the third quarter of this year, as markets continue to hit highs and investors continue their search for ever more elusive capital returns. That said, global investment conditions remain stable - with the outlook for global growth from the International Monetary Fund (IMF) unchanged at 3% in 2017. This, combined with a stabilisation in global energy prices appears to have subdued official measures of inflation and allowed for economic activity to progress.

The clear political risk that markets have been facing over the last few years appears to be waning. Whilst markets may have got the election outcome that they desired from the German elections in September when Angela Merkel returned as Chancellor, this was not the emphatic victory that the EU needed from Germany. The right wing AfD’s strong showing in the German polls, particularly in the former East Germany, has brought renewed attention to the shifting political sands of Europe, reinforcing the sentiment that we must not take the current political framework for granted. Political concern this quarter focussed on the Pacific Rim with North Korea rattling cages – particularly trying to involve the US in armed conflict and intimidate South Korea as well as Japan with the potential that the North Koreans may have developed the technology to utilise nuclear weapons.

In terms of central bank activity, markets have priced in a December interest rate rise in the US albeit qualified by the concern some market participants have that rate rises may be pushed back to later in 2018. The US Federal Reserve (Fed) is expected to be cautious with their rate rising program as the consequences for progressing too quickly and tightening monetary conditions too much would destroy a vast amount of the careful work that they have done over the last few years to recover the US economy. In the UK, the Monetary Policy Committee (MPC) has been sounding keen on interest rate rises which has lead to a challenging market environment for UK Government Bonds. The MPC voted to increase interest rates by 0.25% to 0.5% in November. The European Central Bank (ECB) has also begun to make noises regarding the potential tapering of Quantitative Easing (QE), however, Japan remains committed to supporting the market with this type of liquidity.

UNITED KINGDOM

- The third quarter of this year has not been uneventful. The political disarray left by the General Election result has failed to resolve itself and the idea of the Labour Party ‘war gaming’, a run on Sterling and progress, or lack thereof, from the Brexit negotiation team, leaves many participants in the market feeling profoundly uncomfortable. Political uncertainty remains high on risk agendas for UK investors alongside currency stability and inflation.
- UK inflation has climbed this year, mainly due to rising petrol and diesel prices earlier in the year, along with a pickup in food prices. Rising prices at factory gates, assisted by a weak Sterling also added to the inflationary pressure. Although these factors appear to be stabilising, inflation still remains meaningfully higher than the Bank of England’s (BoE’s) base rate. Inflationary wage pressures remain subdued; however, its potential impact on the UK economy is a growing concern for the BoE’s Monetary Policy Committee. The inflation outlook in the UK, although having some upward pressure is becoming more mixed. The longer-term implications of Brexit remain unknown, but a slowdown in economic activity in the UK appears to be a strong

possibility. As a result, easing cost pressures and a reduction in labour market tightness should limit inflation's overshoot. The unemployment rate in the UK has remained fairly steady at 4.7% which is a boost for the economy however, the quality of the jobs created and available remains hotly debated.

- The European Union (EU) Brexit negotiations continue apace – this does not seem to be a pace that suits either side or indeed, UK equity markets. Recurring spells of heightened market volatility are likely to continue as investors respond to, and speculate over negotiating positions. UK valuations look reasonable when compared to other investment markets and we have seen a raft of analysts revise their earnings expectations up given economic data releases that have beaten expectations. However, without the impetus provided by the weakness of Sterling, the UK equity market is struggling to find the momentum to continued outperformance.
- Markets have weathered a steady stream of surprises from the 2015 election, the EU referendum, the US election, the recent General election and the European elections this year. There has been a real divergence in performance of stocks that are UK focussed from those that are internationally focussed. Sterling has played a big part in this and the latter will tend to rise on the back of any fall in the currency and vice versa.

EUROPE EX UK

- The key election in Europe this quarter was Germany and the keen anticipation of the event kept European markets preoccupied for most of the period. The positive impact on markets from the relection of Angela Merkel to the position of Chancellor and thus a Federalist to the heart of the EU, has ensured an element of stability. That said, the strong showing from populist movements on both sides of the political spectrum should not be underestimated and may cause a degree of moderation in the political agenda that the German government pursues, particularly in light of the various separatist movements that are underway at the moment.
- The European economy has continued its growth momentum into the third quarter with strong returns from core European countries in spite of a degree of weakness in the Euro. GDP expectations for the year remain consistent at 2.3%. Employment levels have continued to improve albeit from a low base and now sit at 9.1%.
- The ECB continued to leave its benchmark refinancing rate unchanged at 0%. They have proceeded with their quantitative easing programme, however, members continue to suggest that they are searching for methods to implement a form of tapering in 2018.
- Solid economic data, gradually improving manufacturing and consumer sentiment and rising employment levels along with steadily improving inflation are combining powerfully to make the area one of the favoured investment markets of 2017. Europe delivered the strongest performance of any of the developed equity markets this quarter. This positive momentum was not unexpected as the building blocks for this success have been carefully put in place.
- Political risk is likely to return when Italy announces its election in 2018. However, the solid economic data coupled with rising energy prices means European equities are attractively priced at the moment. Economic data in the euro-zone continues to paint a positive picture, including higher business confidence readings, strong PMI's and an up-tick in GDP growth. Growth in the region is likely to be encouraged by a backdrop of persistently low borrowing rates and high equity prices.
- The outlook for the euro-zone remains positive with monetary policy likely to remain supportive and global demand in good health at the moment.

NORTH AMERICA

- Continuing rising domestic debt levels, the collapse of President Trump's replacement program for Obamacare and the lack of clarity regarding the US Tax regime changes have moderated US investment growth over Q3.
- The Fed held the Federal Funds rate to 1.25% this quarter as anticipated, after a rate hike in March which signalled a degree of confidence in the growth trajectory of the US economy. Fed policy makers are being pulled in two directions, by their key economic indicators with employment data remaining positive, however, wage inflation remains relatively subdued. Janet Yellen, Fed Chair has indicated that the Fed intends to raise interest rates in the fourth quarter and this normalisation of monetary policy may temper corporate profit

margins and limit earnings growth. In a rising interest rates scenario, the interest payments on the outstanding debt would also increase and could create a hindrance in growth of the economy as consumers may lower spending in order to pay for the higher interest costs.

- US Equity markets have been on an upward trajectory, albeit with a noticeable flattening over Q3. Investors are continuing to expect market friendly policies from the Trump administration and the continuing failure of the administration to pass some promised key election pledges have moderated market exuberance for President Trump. His struggle to win support from the Republicans to implement all his election promises especially the sight this quarter of John McCain, fresh from major surgery, turning up to vote against the Trump administration - this was particularly powerful. The proposed tax reforms, including lower taxes and a reduced regulatory burden could support the equity market, however, implementation and detailed plans are both proving difficult and elusive. Inflationary pressures are beginning to build and faster than expected rate rises could slow economic growth. Furthermore, while the Fed may be well placed to continue with rate hikes in 2017, expectations of a similar pace in 2018 can be seen clouding, particularly as it tries to reduce its balance sheet.
- The US equity market is currently trading at high multiples to earnings but they are marginally attractive in terms of earnings yield. This, along with improving macro-economic conditions in the US and an expected turnaround in corporate earnings could help fuel further increases in asset prices. A surprise could come to the equity market as expectations of President Trump and his team are so low that any positive move could cause a positive market shock.

JAPAN

- Japanese equities are closely linked to the economic success of their neighbours. The global rebound in trade has been a key factor in providing strength in the region. However, they have delivered a positive investment return to Sterling investors over the quarter in the face of a series of headwinds, not least their obstreperous regional problem child – North Korea practicing firing warheads onto Japanese sovereign territory.
- Analysts are revising up their earnings expectations for the Japanese equity market as corporates continue to deliver strong earnings growth. High levels of competition are also helping alongside good economic momentum. Cash holdings on Japanese firms' balance sheets remain higher than many would like however, this may be a benefit should the Yen weaken. This, combined with loose fiscal policy from the Bank of Japan (BoJ) leads to a relatively positive outlook for the asset class.
- Over the near-term, the BoJ has reiterated its commitment to achieve their inflation target of 2% along with its intentions to maintain lower interest rates. This has had a beneficial impact on Japanese banks in particular. Easy monetary policy and fiscal stimulus for 2017, helped by a cheaper Yen will potentially drive forward corporate earnings and business investment leading to a positive view on the region.
- Towards the end of September, Shinzo Abe called a snap general election which should take place in late October – this move is designed to provide stability during a period where Japan is facing national demographic decline and increased regional tensions. Markets received this move well and have priced in the election promises that Mr Abe has made to the Japanese electorate.

ASIA PACIFIC EX JAPAN / EMERGING MARKETS

- Emerging Market equities have had a good quarter, outperforming developed markets comfortably. This has been supported by improved macroeconomic conditions, stable commodity prices and solid corporate global economic activities. The strong Emerging Market equity returns were also supported by a benign US Dollar and improved capital inflows.
- Emerging market equities are continuing their recent run of robust performance, lifted by another positive corporate results season. Latin America led and Asia lagged, though China continued to deliver positive returns helped by strong factory data. The South Korean investment market fell only a small amount, indicating that markets currently do not believe the geopolitical risks related to North Korea are dramatically elevated. The Brazilian government announced proposals to privatise state-owned assets. While, in China, a group of

strategic shareholders including internet giants Alibaba, Baidu and Tencent were invited to acquire 35% of telecom operator China Unicom (diluting the Chinese state to 37%). This bodes well for continued reform of China's state-owned enterprises.

- The biggest geopolitical issue of the quarter was North Korea, whose missile tests led to renewed tensions with the US. The situation has changed, and medium-term risks are higher on the Korean peninsula. Meanwhile, US policy is to "lean on" China in the hope it can rein in North Korea. This appears sensible, but it is not clear how long this attitude will last.
- The asset class is supported by global growth improvements, especially for key sectors such as Asian technology. The risk of a sharp US Dollar rally has faded and growth is broadening out. Relative to their developed market peers, emerging equities offer an attractive valuation discount and strong earnings growth is expected across many of the larger economies such as India, Mexico and South Africa. The outlook for Asia is dependent on US trade policies and the degree of monetary tightening however. Emerging economies as a whole have been successful in improving their economies, using measures to spur economic activities.

FIXED INCOME

- Credit markets saw Europe outperform the US over the quarter, while the higher quality investment grade bonds outperformed the more risky high yield bonds. Company balance sheets remain in relatively good shape and default levels are not a market concern currently. Developed market government bonds generally rallied across the board as did emerging market bonds over the quarter. It should be noted that returns were generally muted or negative over the quarter.
- A lack of new bond issuance means that order books are over subscribed as investors continue their appetite for yield. In addition, Quantitative Easing from the ECB has driven European yields to unattractive levels making Sterling corporate bonds an alternative consideration for investors.
- The risks to the Fixed Income asset class include the end of QE, which could be getting nearer and it is impossible to fully chart the effect of central bank's tapering as the plan is a work in progress. The challenge for central banks is to find different ways to protect asset prices and ensure a liquid market.
- Over the short-term, concerns remain that spreads have tightened to such a degree that further upside looks challenging with any future interest rate rises adding pressure to the downside. A slowdown in consumer spending and higher inflation could also prove a drag on performance.
- The markets expect the Fed to raise rates in December, supported by this higher growth and higher inflation. For the 10-year U.S. Treasury, the same forces that kept rates tight over the last three months are still present. The markets expected only a modest rise in rates, to 2.75%, by the fixed interest market.
- Turning to US high yield - corporate profitability looks quite good at the moment as do earnings. Even though yields are low, spreads are attractive when compared to default levels, which are nearing 1%. Europe also is appealing to fixed interest investors. There has been a lot of growth but there is also value from a currency that has re-valued; corporate profit remains high.
- The deflationary economic forces in Europe have been replaced by reflationary ones, with headline Consumer Price Inflation (CPI) rising over recent months. Market speculation of a tapering of QE next year have gained ground as the ECB views the economic growth outlook as broadly balanced. The prospects for withdrawal of policy stimulus however, would require a sustained rise in inflation requiring an increase in underlying CPI which so far remains more muted. It is probably precipitous for the ECB to signal the timing of a rate rise despite significantly improving macroeconomic data.
- The BoJ's bond-buying programme and negative interest rate policy have driven valuations into expensive territory. Action by the BoJ, including a pledge to aim for an overshoot of its inflation objective and adopting a 0% target for 10-year bond yields, appears to have only had a short-term effect, which has left the overall situation unchanged.
- Emerging market bonds also remain good value. Yields are relatively high, and in many countries inflation is coming down, allowing central banks to ease fiscal conditions. Most importantly, the emerging markets offer something that the developed markets are not at the moment - positive real yields.

ALTERNATIVES

- Hedge Fund capital rose to $3.15 trillion over the quarter, as economic growth prospects improved despite continued geopolitical risks. Investor inflows were positive, with Global Macro strategies in particular continuing to receive the most inflows. Hedge Funds (in Sterling terms) returned -1.0% over the quarter; this was primarily due to the depreciation of the US dollar against Sterling, as hedge funds returned 2.3% in US dollar terms. In Sterling terms, Emerging Markets and Equity Hedge returned 1.9% and 0.4%, respectively. All other strategies generated negative returns over the quarter, with Global Macro (-2.8%) displaying the worst performance.
- UK commercial property continued to increase over the quarter, returning 2.7% compared to 2.5% the previous quarter and 2.3% at the end of Q1 2017. Thus, the slowdown following Britain's decision to exit the European Union appears to be fading, albeit the returns are slightly below those recorded prior to the Brexit vote. Over the quarter, both capital values and rental income rose by 1.3%. All sectors posted positive returns; Industrials increased by 4.8%, followed by Offices which returned 2.0%. Retail and City Offices sectors grew by 1.9% and 1.4%, respectively. At the end of September, the annual property yield stood at 5.6%.
- Commodity markets gained 3.8% over the quarter, largely driven by strong performance from the Energy sector which returned 10.4%. In July, an Energy Information Administration report stated that US crude oil inventories had decreased by a larger amount than expected, therefore resulting in an increase of 6.5% over the month. Oil prices gained by 7.0% over the quarter, driven by declining inventories due to strong demand, as well as improved compliance between Organisation of the Petroleum Exporting Countries (OPEC) and non-OPEC producers. Agriculture experienced losses over July, August and September, therefore leading to a total loss of -11.0% over the quarter. However, cotton and livestock gained in August and September, respectively, driven by a decrease in supply following Hurricane Harvey. Over the last 12 months, all sectors were negative.

CONCLUSION

The global economic outlook for the next few months has become more mixed. The positives include a modest case for economic growth across major economies, a strong underlying trend in corporate earnings and the prospect of US tax reform. Elements of caution are required as markets navigate elevated risk asset valuations and any remaining investor enthusiasm, slowing global growth and slowing inflation momentum, combined with monetary tightening or liquidity withdrawal from major central banks.

The majority of companies who have reported results continue to beat earnings expectations. This continues to suggest that an economic expansion is continuing globally, albeit at a slower pace and that profits are finding support beyond cost-cutting efforts. With volatility low, despite some geo-political tensions, investors will remain focused on the trajectory of earnings growth. For markets to advance further, we will need to see increased confidence that this trend will be sustained.

Globally, central banks remain in a mostly dovish mood; and even with balance sheet normalisation in the US and tapering of quantitative easing in Europe, policy around the world is still loose when compared to history. Rates are set to rise, but only slowly. Equity returns in this stage of the economic cycle are typically positive unless financial conditions tighten sharply. The slow pace of rate normalisation and lack of inflationary pressure create a good environment for investment.

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 (ex UK)	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 GBI-EM 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 (>15 yrs)	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 Earnings Index (Whole Economy excluding Bonuses)
Exchange Rates	
USD / EUR / JPY vs GBP	WM/Reuters 4:00 pm Closing Spot Rates

Note: All indices above are denominated in Sterling.

CONTACT

KIERAN HARKIN
Director
+44 (0)161 957 8016
kieran_harkin@jltgroup.com

NICK BUCKLAND
Senior Consultant
+44 (0)207 528 4188
nick_buckland@jltgroup.com

ANTHONY WRAY
Consultant
+44 (0)161 253 1121
anthony_wray@jltgroup.com

NATALIE ZANI
Associate Consultant
+44 (0)161 253 1124
natalie_zani@jltgroup.com