CLWYD PENSION FUND

ECONOMIC AND MARKET UPDATE
PERIOD ENDING 30 SEPTEMBER 2018

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1 MARKET BACKGROUND
PERIOD ENDING 30 SEPTEMBER 2018

MARKET STATISTICS

Market Returns Growth Assets	3 Mths %	1 Year %	3 Years % p.a.
UK Equities	-0.8	5.9	11.5
Overseas Developed	6.7	14.7	20.6
North America	8.5	20.3	22.8
Europe (ex UK)	3.2	2.5	15.1
Japan	5.0	13.9	18.6
Asia Pacific (ex Japan)	0.9	6.5	19.7
Emerging Markets	0.6	2.0	17.5
Frontier Markets	-3.2	-6.7	6.3
Property	1.6	9.1	7.5
Hedge Funds**	0.2	2.3	4.3
Commodities**	0.9	20.9	1.8
High Yield**	1.9	0.5	7.1
Emerging Market Debt	-0.6	-4.7	10.6
Senior Secured Loans**	1.7	3.3	4.1
Cash	0.2	0.5	0.4

Market Returns Bond Assets	3 Mths %	1 Year %	3 Years % p.a.
UK Gilts (>15 yrs)	-3.3	1.3	5.3
Index-Linked Gilts (>5 yrs)	-1.4	1.4	7.2
Corporate Bonds (>15 yrs AA)	-0.7	-0.4	6.6
Non-Gilts (>15 yrs)	-0.9	-0.7	6.7

Exchange Rates: Change in Sterling	3 Mths %	1 Year %	3 Years % p.a.
Against US Dollar	-1.2	-2.8	-4.9
Against Euro	-0.7	-1.1	-6.1
Against Yen	1.3	-1.9	-6.5

Inflation Indices	3 Mths %	1 Year %	3 Years % p.a.
Price Inflation – RPI	1.2	3.5	3.0
Price Inflation – CPI	0.7	2.7	2.0
Earnings Inflation*	0.9	3.2	2.5

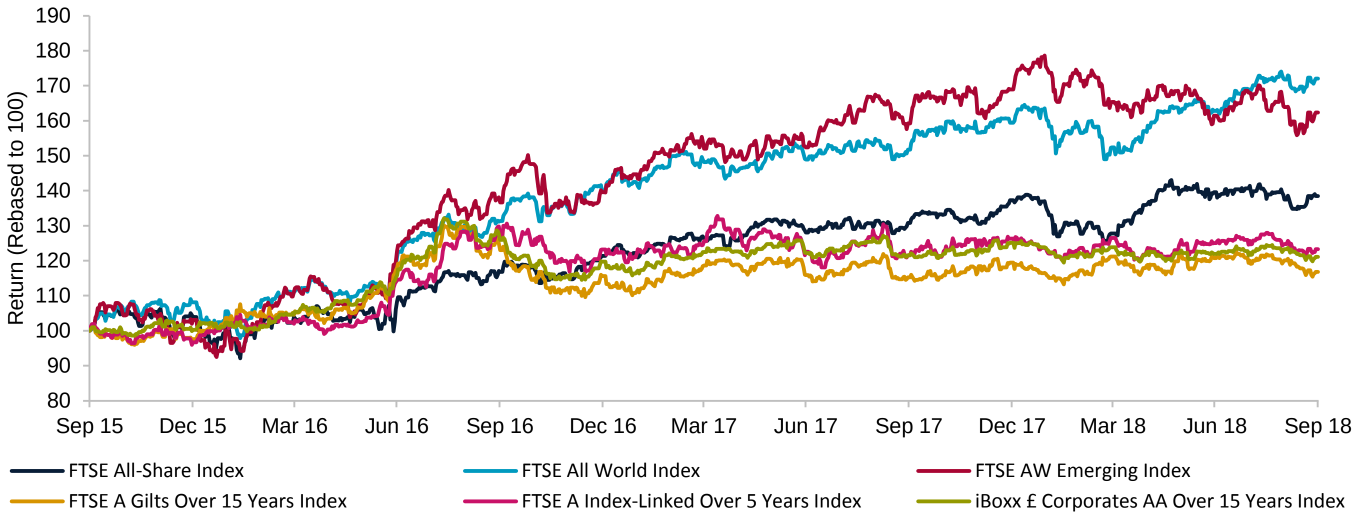
Yields as at 30 September 2018	% p.a.
UK Equities	3.80
UK Gilts (>15 yrs)	1.86
Real Yield (>5 yrs ILG)	-1.50
Corporate Bonds (>15 yrs AA)	2.81
Non-Gilts (>15 yrs)	3.28

Absolute Change in Yields	3 Mths %	1 Year %	3 Years % p.a.
UK Equities	0.16	0.12	0.09
UK Gilts (>15 yrs)	0.19	0.02	-0.52
Real Yield (>5 yrs ILG)	0.09	0.02	-0.66
Corporate Bonds (>15 yrs AA)	0.09	0.17	-0.82
Non-Gilts (>15 yrs)	0.12	0.23	-0.68

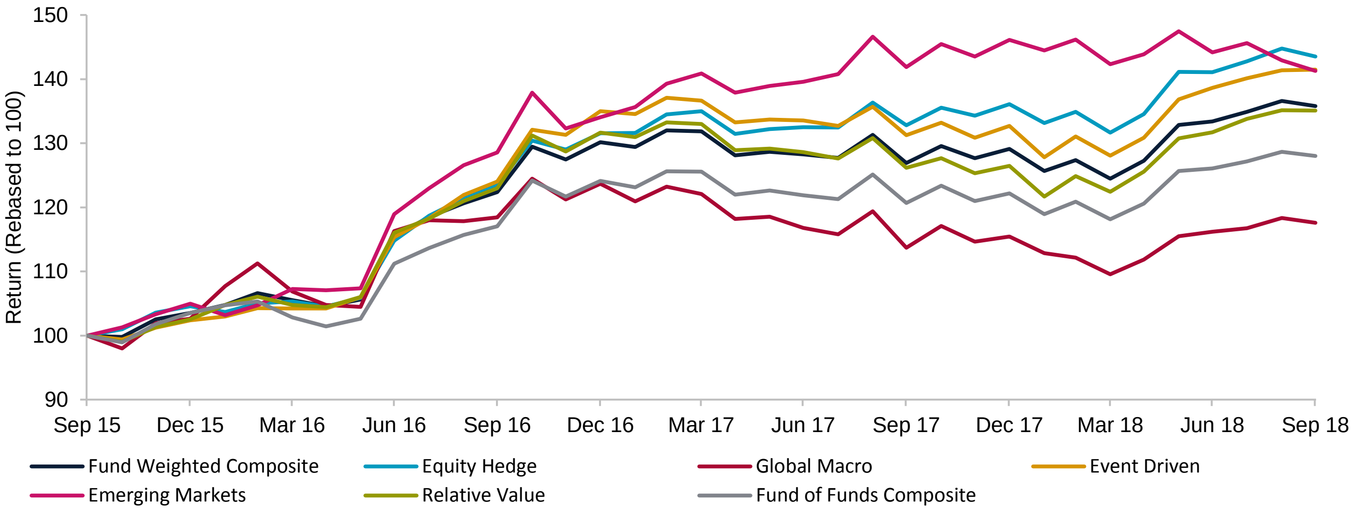
Source: Thomson Reuters.
Notes: * Subject to 1 month lag ** GBP Hedged

MARKET SUMMARY CHARTS

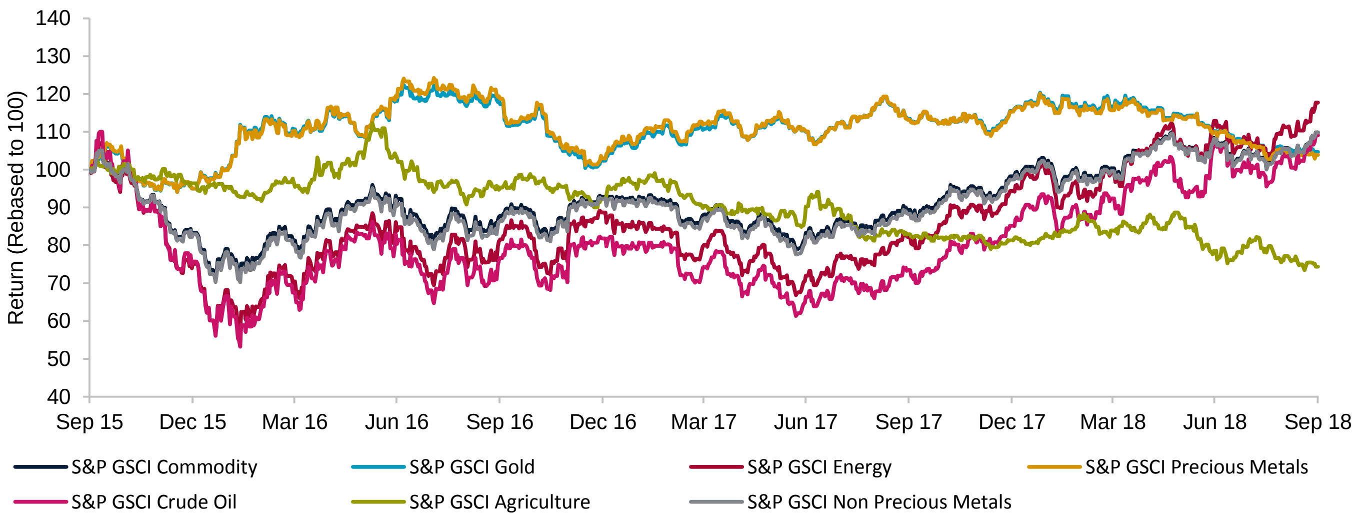
Market performance – 3 years to 30 September 2018



Hedge Funds: Sub-strategies performance – 3 years to 30 September 2018

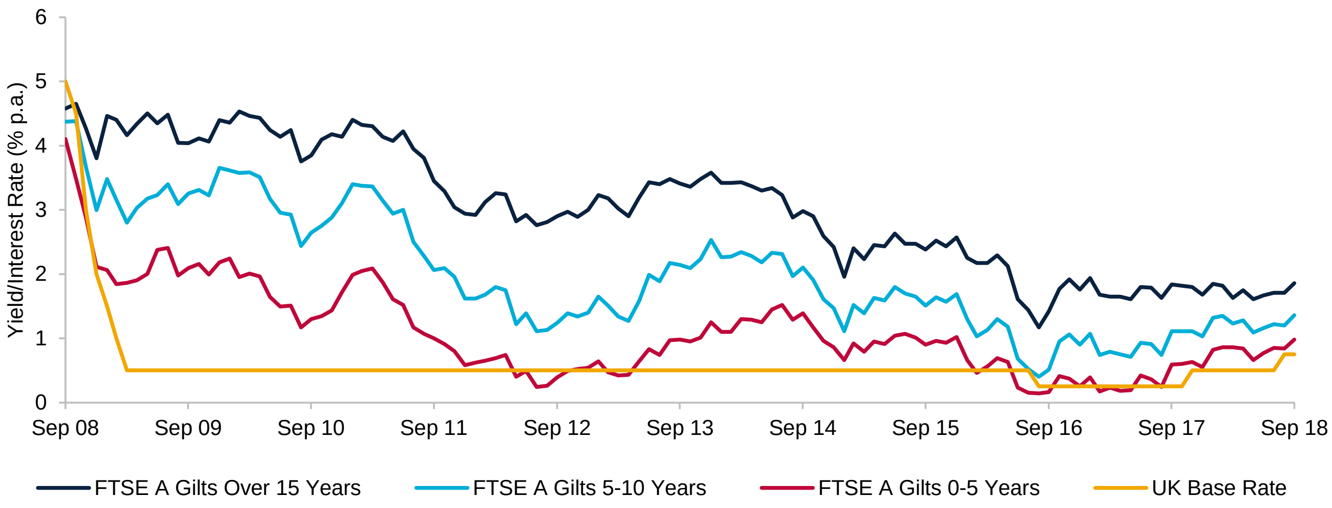


Commodities: Sector performance – 3 years to 30 September 2018

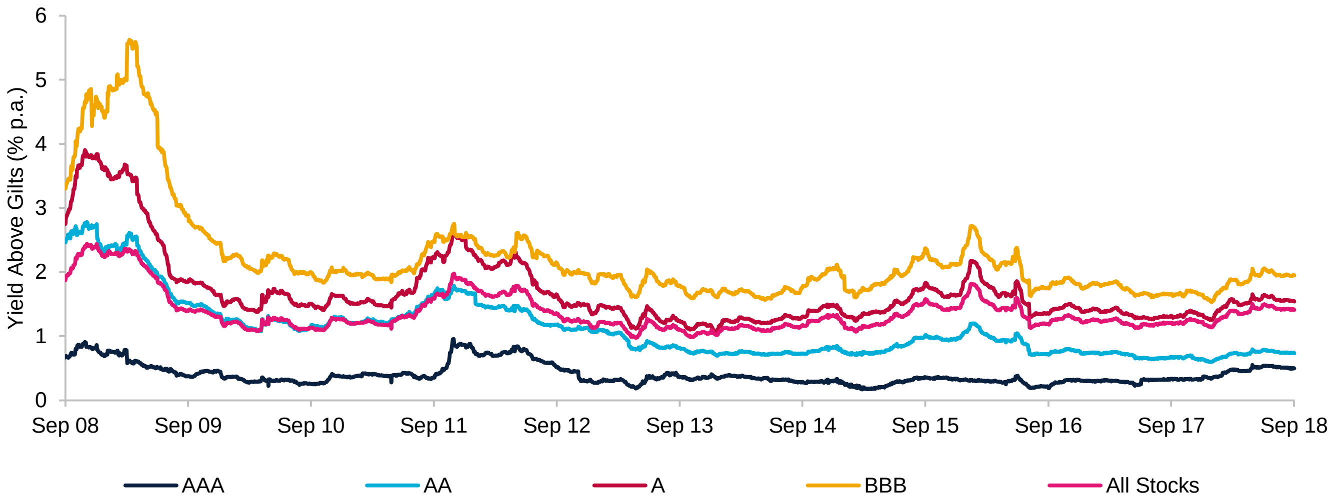


Source: Thomson Reuters

UK government bond yields – 10 years to 30 September 2018



Corporate bond spreads above government bonds – 10 years to 30 September 2018



Source: Thomson Reuters

2 ECONOMIC STATISTICS

Economic Statistics as at:	30 Sep 2018			30 June 2018			30 Sep 2017		
	UK	Euro[1]	US	UK	Euro[1]	US	UK	Euro[1]	US
Annual Real GDP Growth[2]	1.2%	3.5%	2.9%	1.1%	3.8%	2.6%	1.9%	3.6%	2.1%
Annual Inflation Rate[3]	2.4%	2.1%	2.3%	2.4%	2.0%	2.9%	3.0%	1.5%	2.2%
Unemployment Rate[4]	4.0%	8.1%	3.8%	4.2%	8.3%	3.9%	4.3%	9.0%	4.3%
Manufacturing PMI[5]	53.8	53.2	55.6	54.2	54.9	55.4	55.6	58.1	53.1

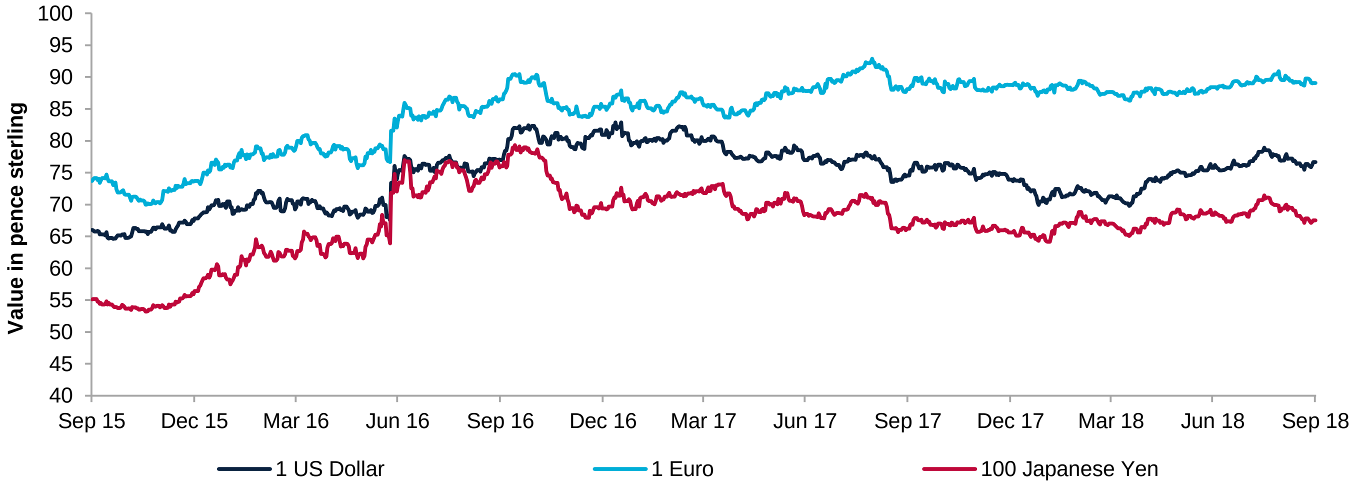
Change over periods ending:	3 months			12 months		
30 September 2018	UK	Euro[1]	US	UK	Euro[1]	US
Annual Real GDP Growth[2]	0.1%	-0.3%	0.3%	-0.7%	-0.1%	0.8%
Annual Inflation Rate[3]	0.0%	0.1%	-0.6%	-0.6%	0.6%	0.1%
Unemployment Rate[4]	-0.2%	-0.2%	-0.1%	-0.3%	-0.9%	-0.5%
Manufacturing PMI[5]	-0.4	-1.7	0.2	-1.8	-4.9	2.5

Notes: 1.Euro Area 19 Countries. 2. GDP is lagged by 3 months. 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 Sep 18	30 Jun 18	30 Sep 17	3 months	12 months
1 US Dollar is worth	76.68	75.74	74.54	-1.2%	-2.8%
1 Euro is worth	89.07	88.44	88.11	-0.7%	-1.1%
100 Japanese Yen is worth	67.51	68.38	66.22	1.3%	-1.9%

Exchange rate movements – 3 years to 30 September 2018



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

3 MARKET COMMENTARY

INTRODUCTION

Over the last three months, equities have broadly maintained their positive momentum from the second quarter. Nonetheless, it certainly hasn't been a clean sweep this time around. We have seen a divergence of returns as developed market stocks, with the exception of the UK market, topped the performance tables; whilst emerging markets, both debt and equity, have come under continued pressure.

Similar themes have dominated the direction of travel this quarter. Global economic growth continues at a robust rate; corporate balance sheets remain fairly healthy and earnings growth remains supportive of valuations. However, political rhetoric has remained elevated over protectionist trade policies, whilst currency volatility has rapidly increased and unsettled markets throughout. Moreover, in Europe, Italian politics have failed to appease tensions and provide the much needed unity across the European bloc ahead of Brexit next year.

UNITED KINGDOM

- From a data perspective the UK economy continues to show its resilience despite the political noise.
- Unemployment levels remain at multi-decade lows whilst quarterly economic growth has picked up throughout the year after a slow, weather affected start.
- Business surveys, whilst highlighting a somewhat cautious tone over Brexit, continue to show that both manufacturing and service led industries are still in expansionary territory. Furthermore, with the devaluation of Sterling since the UK voted to leave the EU, the market for mergers and acquisition has been fairly buoyant with buyers looking to take advantage of the somewhat depressed valuations.
- However, the fog above the UK market continues to thicken as Brexit negotiations fail to yield any clarity on the UK leaving the European Union come March 2019.
- The UK equity market rounded off the period 0.8% lower, significantly lagging almost all developed markets including our European neighbours. Unsurprisingly, the larger blue chip equities continue to be influenced daily by currency movements, politics and Brexit negotiations.

NORTH AMERICA

- It was a record breaking quarter for US equities on a number of fronts. Firstly, during the normally low-key summer month of August, the S&P 500 index reached a fresh intra-day record high.
- Furthermore, US stocks marked this period by setting the longest bull market (a rally without a 20% correction) in US stock market history. The current run exceeded the previous record, which was set during the dot.com era and stretched some 3,452 days without a major correction. At this point it is worth highlighting that although this is the longest bull run, the current streak has some way to go to topple the cumulative return delivered during the tech bubble in 2000-02 which yielded over 400%.
- The final landmark during August belonged to tech giant Apple which became the world's first publically traded trillion dollar company with online retailer Amazon joining the exclusive club shortly after in September.
- Such returns have been underpinned by remarkable corporate earnings, loose fiscal policy, in the form of corporate tax cuts, and for international investors some momentum in a rising US dollar.

- As the market had anticipated, the Federal Reserve raised interest rates for the third time this year in September by 0.25% to leave the short-term rate now standing at 2.25%. This was the 8th rate hike in the current economic cycle with the market expecting a further rise, the fourth in 2018, in December.
- Fed Chairman, Jay Powell, cited low unemployment, wage growth and stable inflation in an upbeat press conference.
- Moreover, the Federal Open Market Committee crucially removed their assurances that monetary policy will be ‘accommodative’ going forward. This marked a slight change on the Fed’s stance towards the outlook for monetary policy which had been in place since the end of the financial crisis; and most certainly suggests further tightening will follow to ensure the US economy does not overheat.
- The market, being forward looking, has already updated its forecasts for further interest rates hikes in 2019 and ahead.
- Whilst records typically only occur during the very last stages of a business cycle; to paraphrase Einstein, ‘it would be of unsound mind to do the same thing and expect a different result’. Conversely it would be wrong to follow averages and standardised lengths of stock market bull runs or business cycles given the gargantuan levels of support delivered to the US economy post the financial crisis.

EUROPE (EX UK)

- Despite political tensions returning during the third quarter, Europe (ex UK) equities managed to deliver a return of 3.2% return over the last three months. In turn, European stocks now stand in positive territory for 2018, recovering fully after the severe sell-off during Q1. These robust returns were even more impressive considering the continued difficult backdrop Europe faces, with the reduction and eventual end of their quantitative easing programme, together with the forthcoming departure of the UK from the European Union.
- As ever, the European political landscape has been fragile this quarter, therefore it has been particularly encouraging that corporate earnings across the Eurozone remained firm.
- To date, over half of the region’s large-cap companies have reported earnings updates between July and September, with more than 60% delivering revenue growth which exceeded analyst estimates. Furthermore, some 50% have also surpassed analysts’ forecasts on underlying earnings too, as profit margins slowly started to increase.
- At the end of September investors jitters over the Italian political situation proved justified. The newly formed populist coalition government surprised markets as Giovanni Tria, the country’s economic minister, delivered a budget deficit of 2.4% of GDP for 2019. This materially deviated away from Brussels’ guidelines and put further pressure on Italian debt at a time when spreads (the difference in the rate of borrowing) over German debt were already elevated. Equity markets reacted accordingly with a large sell-off in Italian banks and financial services stocks.
- Going forward, without an earnings tailwind to drive markets, political risks may again drive markets over the near-term and increase volatility. Nonetheless, with European equity performance materially behind their US counterparts, valuations are beginning to look relatively attractive once more. With investment returns being skewed towards the US year to date, Europe and other developed markets may be a beneficiary of a rotation away from the US should certain segments in America start to overheat.

JAPAN

- The third quarter has seen an exceptional run in Japanese equities with the main index returning 5.0%. This propelled Japan’s large-cap stocks to, once again, reach the heights set back in 1991. There are a number of factors that have supported these strong returns: US dollar vs Yen remained in a narrow trading range and a continuation of the ultra-loose monetary policy deployed by the Bank of Japan both ensured a fair tailwind for Japanese stocks.

- Furthermore, the political cloud has now cleared with the re-election of President Shinzo Abe as leader of the Liberal Democratic Party. This has helped to reduce uncertainty surrounding the administration's wider goal of improving corporate governance and company profitability in Japan.
- The market is now seeing material signs that governance reforms are starting to take effect and have a positive impact on corporate profitability. Notable improvements to capital efficiency and corporate net profit margins are coming through, with a number of analysts turning positive and upgrading company earning estimates going forward.
- Should the Yen continue to remain weak vs the US dollar, earnings per share growth will receive a tailwind boost as companies typically base their earnings assumptions on a stronger Yen than at the current level.
- Although external factors, including trade wars, are likely to drive short term sentiment in Japan, looking further ahead, foundations for structural reform have now been laid.
- Private consumption continues to rebound strongly while wage inflation looks encouraging, hitting 3.6% year-on-year in June – it's highest yearly increase in more than 20 years.

ASIA PACIFIC (EX JAPAN) / EMERGING MARKETS

- It has been a precarious period for emerging markets (EM) as they continued their sharp and indiscriminate sell-off during the third quarter. Two themes have dominated investors concerns; firstly, trade tensions have festered with persistent rhetoric, and secondly a number of constituents of the EM bloc also grappled with a currency crisis over the period.
- During the first week of July, Chinese equities, considered the driving force of EM and Asia, very much set the tone for the rest of the quarter as they endured heightened volatility and a severe stock market decline. Unsurprisingly, trade wars were once again a major root cause of investors' anxiety with focus surrounding the longer term impact of trade tariffs on the wider Chinese economy. Moreover, with President Trump's trade tariffs already outlining levies on half of Chinese imports, uncertainty over the remaining $200bn of imports still continues to unsettle markets.
- Before the impact of trade tariffs hit, market concerns were confirmed by mid July when China released gross domestic product (GDP) growth figures which slipped to 6.7% for the second quarter of 2018, its slowest pace since 2016. Whilst largely driven by slowing domestic demand and significant deleveraging, the decline was enough for the Chinese government to step in to stimulate their economy.
- Currency concerns exacerbated international investors weakening sentiment towards EM equities throughout this period. The Turkish Lira came under an extreme onslaught of selling as inflation spiralled higher and the independence of their central bank was brought into question again. Other currencies whose economies are particularly exposed to US dollar strength struggled, most notably South Africa, Brazil and China, as global liquidity and the Federal Reserve continued to tighten.
- With a number of EM equity markets already reaching bear territory (20% off previous peaks). Investors will be required to tread carefully as some countries are clearly more vulnerable to US trade tariffs and sanctions than others. Furthermore, a number of economies within the EM space have an enhanced ability to absorb higher interest rates and dollar momentum.

FIXED INCOME

- With anxieties rising around emerging markets, liquidity concerns and trade tensions during the third quarter, some developed market government bonds benefited from a slight degree of risk aversion.
- US 10 year treasuries briefly touched June levels with yields, which move opposite to price, hitting 2.86% from 2.96%. Meanwhile the US yield curve continued to flatten - which is where the borrowing costs over differing time periods get closer - over the period.

- Many commentators were quick to remind us that an inverted yield curve, which typically shows government two year borrowing costs higher than 10-year debt, has been, in the past, a reasonable indicator of an impending recession.
- With yields touching over 3% at the end of the quarter, 10-year US treasuries may actually start to appear attractive to some yield deprived international investors.
- In Europe, as is often the case, it was a tale of mixed fortunes. Italian bonds came under substantial pressure after the newly formed anti-establishment government surprised markets with additional spending plans at the end of September. Meanwhile the 10-year German bund yield dropped as low as 0.33% in August as political uncertainly from Italy mounted.
- During September, the European Central Bank (ECB) president Mario Draghi reaffirmed plans for policymakers to withdraw part of the stimulus they had deployed since the financial crisis. Furthermore, Mr Draghi highlighted his confidence that inflation, a key objective for the ECB, is projected to advance further over the near term as the tightening labour market helps push up wage growth.
- In markets we are starting to see that positive economic data actually increases borrowing costs of European governments as the market interprets this as confirmation that central bank policy will begin to tighten sooner and the previous employed backstop removed completely.
- Within developed markets, corporate balance sheets remain in robust health and we expect default rates to remain at low levels. Capital appreciation from this asset class will remain a difficult objective to achieve given the current environment. This was encapsulated by extreme weekly net withdrawals from global bond funds in the third quarter.
- As with emerging market equities, emerging market debt came under pressure during the quarter. Currency concerns continue to exacerbate as India, Indonesia, Turkey, South African, Korea and China, to name just a few, all experienced significant declines to their currency value.
- The US dollar is still very much the preferred currency when issuing bonds which automatically becomes more expensive to service should local currencies depreciate. Compounding this is the looming prospect of lower growth among a number of these countries when trade tariffs feed through.

ALTERNATIVES

- Overall, Hedge Funds returned 0.6% in US dollar terms and 1.8% in Sterling terms, as strong performance from Technology and Event-Driven strategies was partially offset by volatility associated with expectations for higher US rates, as well as trade and tariff volatility. Emerging Markets were the only strategy that declined over the quarter and 12 month period, returning -2.0% and -0.4%, respectively.
- Commodity markets gained by 2.6% in Sterling terms and 1.3% in US dollar terms over the quarter, as positive performance in August and September offset the falls seen in July. Agriculture was the only sector that gained in July following shortage concerns, drought conditions in Germany and the possibility of Ukraine setting limits on exports. This position was reversed in August and September as agriculture became the worst performing sector whilst energy posted the highest returns. Over the last 12 months, the majority of sectors posted double digit returns led by crude oil which returned 52.9% (in Sterling terms).
- As expected, the lack of progress with Brexit negotiations has somewhat dampened appetite for UK commercial property, which returned 1.6% over the quarter. Adding to these pressures is the concern surrounding struggling traditional bricks and mortar retailers, and their ability to swallow rising rents going forward as online competitors continue to disrupt this sector. Outside of prime commercial real estate in London, industrial units such as distribution warehouses continue to deliver robust returns and stable occupancy levels.

CONCLUSION

Naturally, the political landscape remains perilous and has the potential to derail returns over the short term. On the radar remains the US mid-term election during November. The fall out from this could be significant to markets as split houses may prove troublesome for the current administration to get a number of policies through.

4 INDICES USED IN THIS REPORT

Asset	Index
Growth Assets	
UK	FTSE All-Share Index
Overseas Developed	FTSE World (ex UK) Index
North America	FTSE North America Index
Europe (ex UK)	FTSE AW Developed Europe (ex UK) Index
Japan	FTSE Japan Index
Asia Pacific (ex Japan)	FTSE AW Developed Asia Pacific (ex Japan) Index
Emerging Markets	FTSE All Emerging Index
Frontier Markets	FTSE Frontier 50 Index
Property	IPD UK Quarterly Property Index
Hedge Funds	HFRI Fund Weighted Composite Index (GBP Hedged)
Commodities	S&P GSCI TR Index (GBP Hedged)
High Yield	ICE BoAML Global High Yield Index (GBP Hedged)
Emerging Markets Debt	JPM GBI-EM Global Diversified Composite Index
Senior Secured Loans	S&P Leveraged Loan Index (GBP Hedged)
Cash	IBA GBP LIBOR 7 Day 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	UK Retail Price Index (All Items NADJ)
Price Inflation – CPI	UK Consumer Price Index (All Items NADJ)
Earnings Inflation	UK Average Weekly Earnings Index (Whole Economy excluding Bonuses NADJ)
Exchange Rates	
USD / EUR / JPY vs GBP	WM/Reuters 4:00 pm Closing Spot Rates

Note: All indices above are denominated in Sterling unless stated otherwise.

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