CLWYD PENSION FUND

ECONOMIC AND MARKET UPDATE
PERIOD ENDING 31 DECEMBER 2018

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1 MARKET BACKGROUND
PERIOD ENDING 31 DECEMBER 2018

MARKET STATISTICS

Market Returns Growth Assets	3 Mths %	1 Year %	3 Years % p.a.
UK Equities	-10.2	-9.5	6.1
Overseas Developed	-11.0	-2.7	12.9
North America	-11.5	0.8	14.6
Europe (ex UK)	-11.0	-9.1	8.4
Japan	-12.4	-7.6	9.1
Asia Pacific (ex Japan)	-7.6	-8.7	12.9
Emerging Markets	-3.9	-7.6	14.8
Frontier Markets	-4.1	-15.3	5.9
Property	0.9	6.6	6.8
Hedge Funds**	-6.2	-6.2	1.8
Commodities**	-23.4	-15.5	-1.0
High Yield**	-3.9	-3.7	5.9
Emerging Market Debt	4.6	-0.4	11.2
Senior Secured Loans**	-4.9	-2.3	3.2
Cash	0.2	0.6	0.4

Market Returns Bond Assets	3 Mths %	1 Year %	3 Years % p.a.
UK Gilts (>15 yrs)	2.6	0.3	7.1
Index-Linked Gilts (>5 yrs)	2.0	-0.4	9.2
Corporate Bonds (>15 yrs AA)	1.4	-1.9	7.0
Non-Gilts (>15 yrs)	-0.5	-4.1	6.4

Exchange Rates: Change in Sterling	3 Mths %	1 Year %	3 Years % p.a.
Against US Dollar	-2.34	-5.85	-4.75
Against Euro	-0.77	-1.10	-6.36
Against Yen	-5.66	-8.30	-7.63

Inflation Indices	3 Mths %	1 Year %	3 Years % p.a.
Price Inflation – RPI	0.5	2.7	3.1
Price Inflation – CPI	0.5	2.1	2.2
Earnings Inflation*	0.2	3.4	2.8

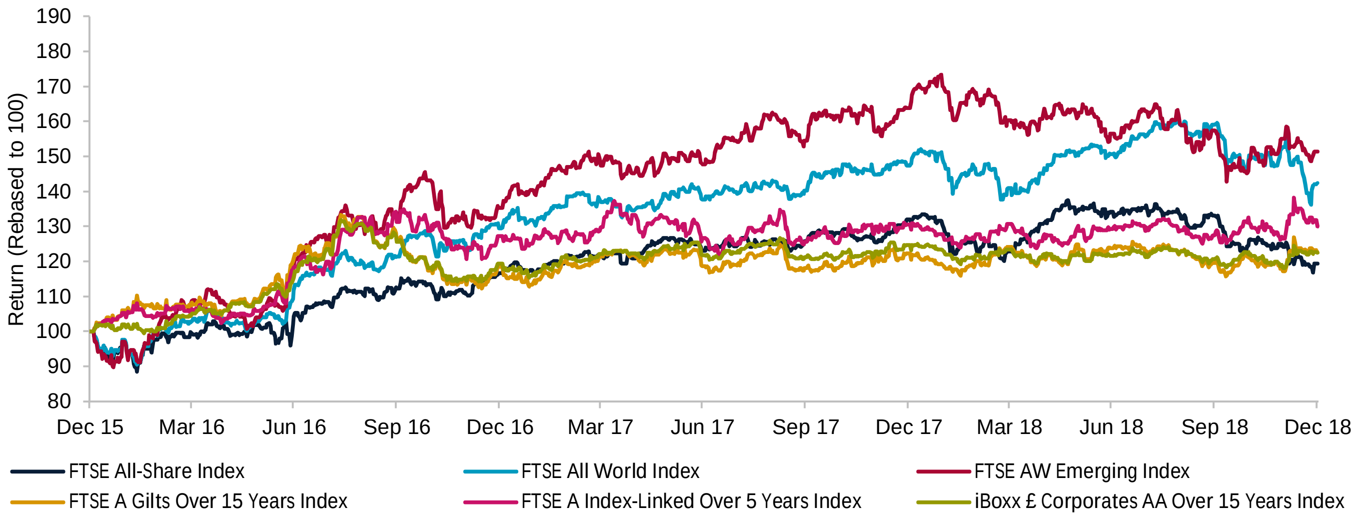
Yields as at 31 December 2018	% p.a.
UK Equities	4.46
UK Gilts (>15 yrs)	1.76
Real Yield (>5 yrs ILG)	-1.59
Corporate Bonds (>15 yrs AA)	2.77
Non-Gilts (>15 yrs)	3.36

Absolute Change in Yields	3 Mths %	1 Year %	3 Years % p.a.
UK Equities	0.66	0.87	0.76
UK Gilts (>15 yrs)	-0.10	0.08	-0.81
Real Yield (>5 yrs ILG)	-0.09	0.08	-0.88
Corporate Bonds (>15 yrs AA)	-0.04	0.33	-0.92
Non-Gilts (>15 yrs)	0.09	0.46	-0.64

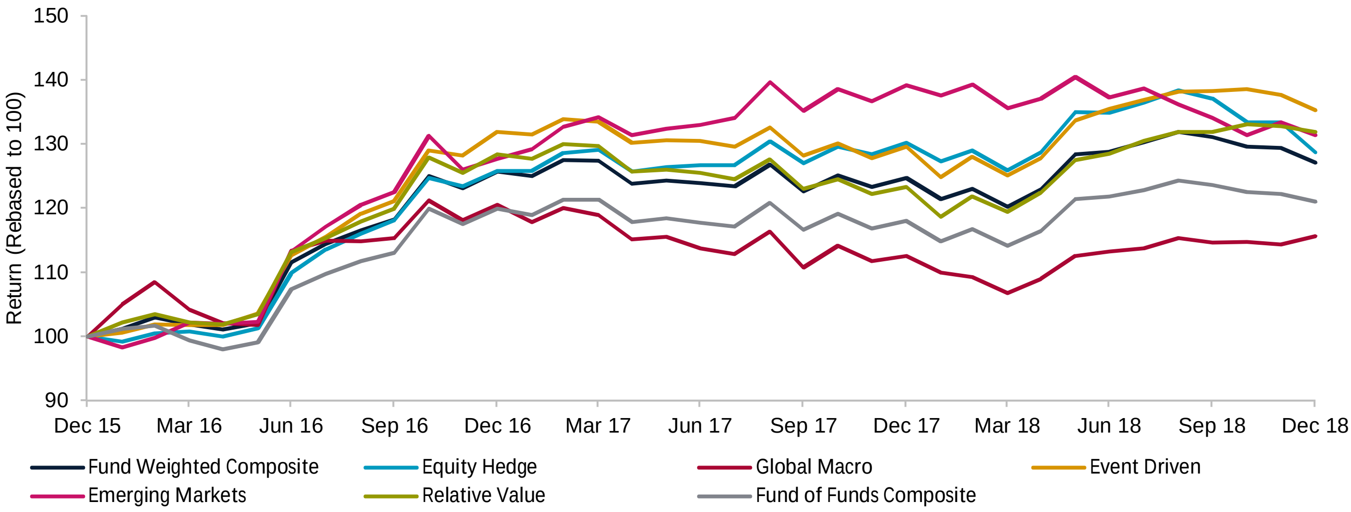
Source: Thomson Reuters.
Notes: * Subject to 1 month lag ** GBP Hedged

MARKET SUMMARY CHARTS

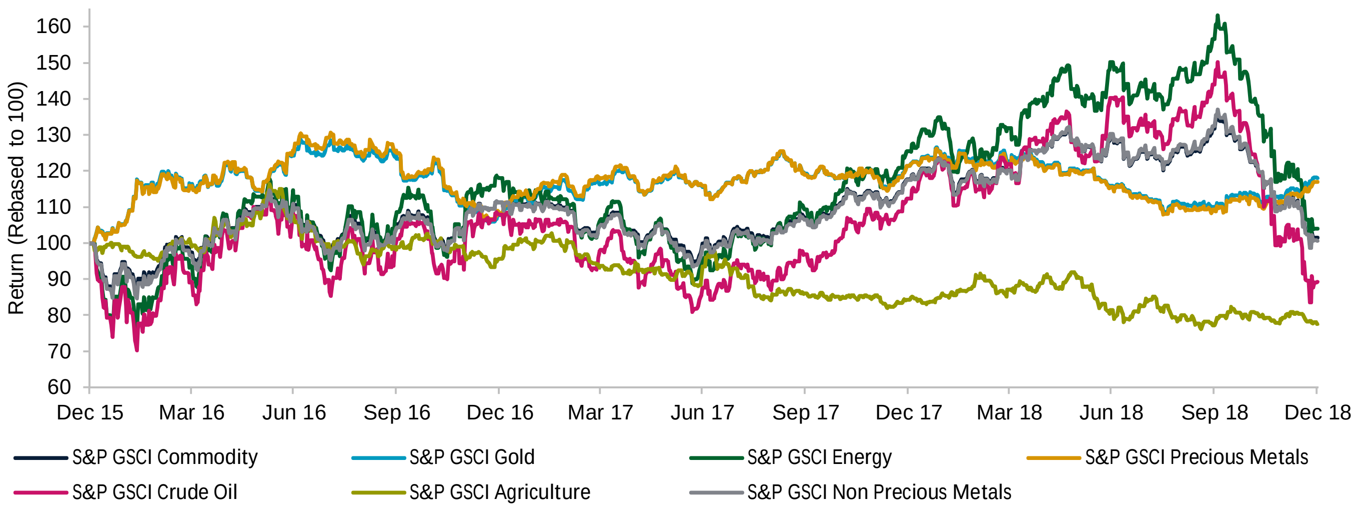
Market performance – 3 years to 31 December 2018



Hedge Funds: Sub-strategies performance – 3 years to 31 December 2018

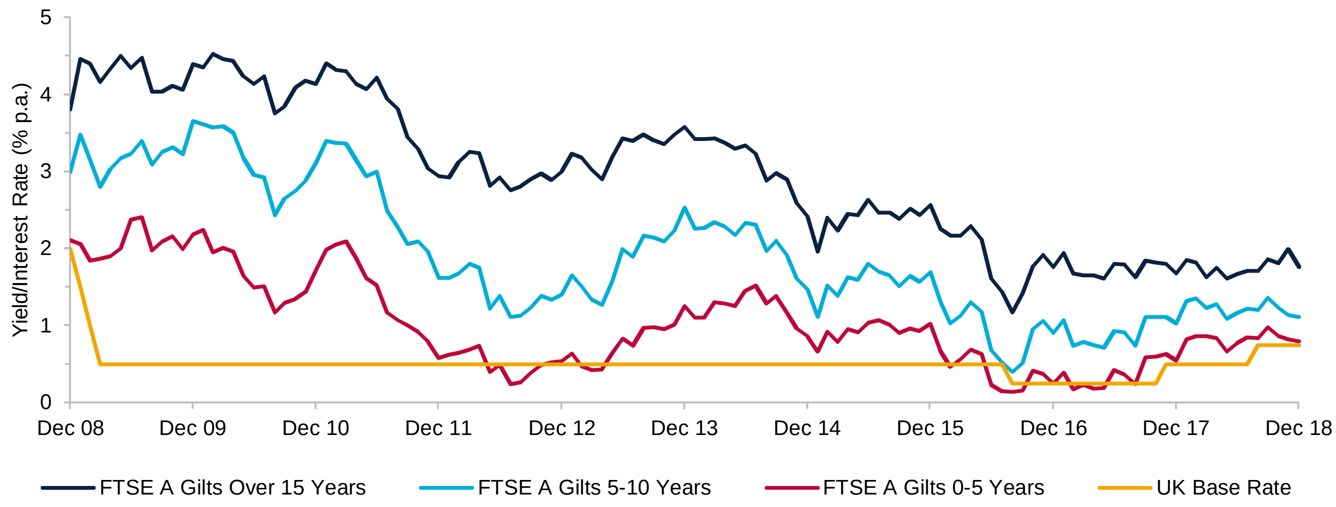


Commodities: Sector performance – 3 years to 31 December 2018

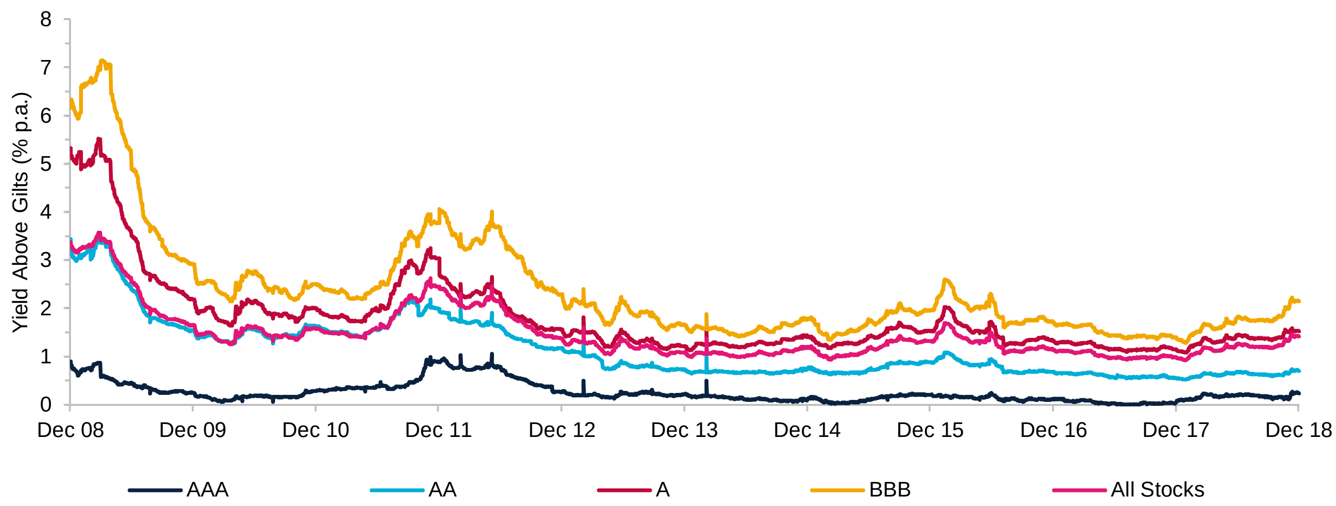


Source: Thomson Reuters

UK government bond yields – 10 years to 31 December 2018



Corporate bond spreads above government bonds – 10 years to 31 December 2018



Source: Thomson Reuters

2 ECONOMIC STATISTICS

Economic Statistics as at:	31 Dec 2018			30 Sep 2018			31 Dec 2017		
	UK	Euro[1]	US	UK	Euro[1]	US	UK	Euro[1]	US
Annual Real GDP Growth[2]	1.5%	3.0%	3.0%	1.4%	3.5%	2.9%	2.0%	4.1%	2.3%
Annual Inflation Rate[3]	2.1%	1.6%	1.9%	2.4%	2.1%	2.3%	3.0%	1.4%	2.1%
Unemployment Rate[4]	4.0%	7.9%	3.8%	4.0%	8.0%	3.8%	4.3%	8.7%	4.1%
Manufacturing PMI[5]	54.2	51.4	53.8	53.8	53.2	55.6	55.7	60.6	55.1

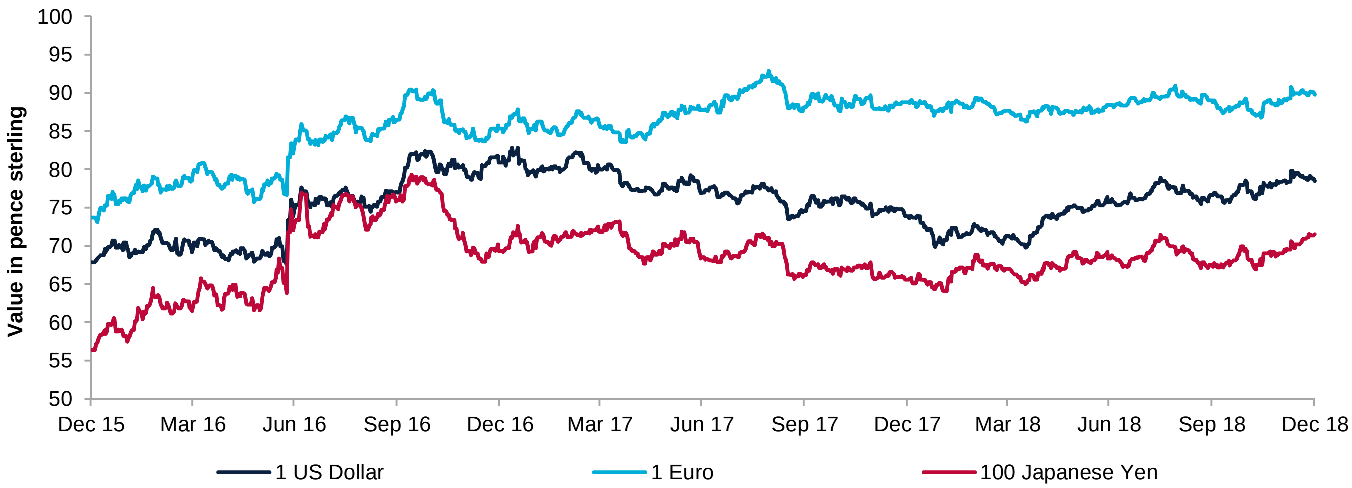
Change over periods ending:	3 months			12 months		
30 September 2018	UK	Euro[1]	US	UK	Euro[1]	US
Annual Real GDP Growth[2]	0.1%	-0.5%	0.1%	-0.5%	-1.1%	0.7%
Annual Inflation Rate[3]	-0.3%	-0.5%	-0.4%	-0.9%	0.2%	-0.2%
Unemployment Rate[4]	0.0%	-0.1%	0.0%	-0.3%	-0.8%	-0.3%
Manufacturing PMI[5]	0.4	-1.8	-1.8	-1.5	-9.2	-1.3

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	
	31 Dec 18	30 Sep 18	31 Dec 17	3 months	12 months
1 US Dollar is worth	78.52	76.68	73.92	-2.3%	-5.9%
1 Euro is worth	89.76	89.07	88.77	-0.8%	-1.1%
100 Japanese Yen is worth	71.57	67.51	65.62	-5.7%	-8.3%

Exchange rate movements – 3 years to 31 December 2018



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

3 MARKET COMMENTARY

INTRODUCTION

As the curtain came down on 2018 it will go down in history as a year investors will want to quickly forget. What started off with much promise and exuberance in equity markets rapidly dissipated by the final quarter, ending the year at significantly lower levels than at the start. The result was global markets slumping to their worst annual return in more than 7 years. Even a belated 'Santa rally' on Boxing Day proved short lived as daily gains of over 5% in US equities quickly evaporated before December was out.

The market pull back was largely driven by two on-going themes. Firstly the end and reversal of loose monetary policy combined with how quickly the Federal Reserve was going to raise interest rates and secondly, the prospect of a slower global economy, exacerbated by trade battles between US and China.

UNITED KINGDOM

- The FTSE All-Share Index dropped more than 10% during the fourth quarter, to post its worst yearly return since the global financial crisis a decade ago.
- Although such declines have broadly been in line with other equity markets globally, the UK market remains firmly under the Brexit cloud as the clock to 29th March 2019 continues to tick down without a deal.
- The lack of cohesion over the political landscape certainly hasn't helped proceedings over the period. Ironically a move meant to challenge Theresa May's leadership of the Conservative party, after receiving a vote of no confidence, may have actually boosted her own stock having fending off the contest with a backing of 200 to 117 (a winning margin that was actually bigger than the number of MPs who voted for her as PM initially).
- Looking ahead, the direction of the UK equity market remains on a knife edge. If the UK leaves the EU without a deal we would expect equities, in particular blue-chip stocks, to be highly volatile and continue to detract; although currency movements should, inferably limit this potential for losses.
- Conversely any deal, even if negative for the longer term economic outlook, is likely to provide a boost for the FTSE at least in the short term. However, after such a dramatic sell-off, UK equities are now trading significantly below their 5 year valuation averages and our view is the fundamentals remain supportive of UK equities at present levels.

NORTH AMERICA

- Confidence in US equities was shaken at the start of the fourth quarter in what proved to be a rather bruising October for investors, so bad it is now referred to as 'Red October'.
- The initial shock to the market occurred when Federal Reserve Chairman, Jay Powell, implied, during the first week in October, that interest rate rises in 2019 may be faster than the market had previously forecast, sending the 10-year US treasury yield spiralling to an eight year high of 3.26%. Consequently this triggered an abrupt repricing of US equities, notably in growth stocks which are vulnerable as yields rise as their future cash flows are discounted further.
- Mid-term elections also delivered control of congress to the Democrats, as the market expected. As a result, the implementation of pro-growth policies going forward is therefore likely to be somewhat more challenging.

- Unsurprisingly technology stocks which provided much of the excess returns during recent years lost significant value into the year-end with the ‘Faang’ stocks (Facebook, Apple, Amazon, Netflix and Google) combined market capitalisation losing more than 24%.
- The likes of Apple and Amazon’s $1 trillion valuation also proved to be a flash in the pan. Rather interestingly, Microsoft which now trades more like a utility stock, and a dominant name in the computing world for many decades toppled the new kids on the block to be crowned America’s most valuable company at the end of 2018.
- Nonetheless, every sector in the index ended the year lower except for the defensive duo of Utilities and Healthcare which posted tepid positive returns in 2018.
- Overall the returns for US equities in 2018 proved disappointing despite holding up considerably well compared to their international counterparts. After ending the first three quarters some 9% up (in USD terms), the S&P 500 recorded unwanted history by then ending 2018 in negative territory (-7%).
- This came after the index fell -7% in October, and the losses accelerated with the worst Christmas period since the December of the Great Depression in 1931 with a further drop of 7.8% during December.
- The US Equity market is under pressure to perform and has been hit by trade and political tensions, however, pressure is now beginning to be applied to those issues and we still believe that the economy has the ability to perform and deliver.

EUROPE (EX UK)

- Concerns of a global economic slowdown led to contagion across Europe in the fourth quarter. As a result, European equities gave back all of their third quarter gains and overall the Euro Stoxx 50 Index (blue-chip equities) declined by 15% in 2018. This was its worst yearly return since 2008.
- Unfortunately the corporate earnings season fizzled out with a number of disappointing results during October. Bellwether stocks in both Germany and France missed market forecasts, whilst a slowdown in China’s GDP numbers also negatively impacted the regions auto-makers who are especially sensitive to this data due to their large reliance on exports to the country.
- Political tensions remained high over the last quarter. France was the latest country to grapple with civil unrest as President Macron’s proposed tax rise on diesel and petrol backfired. This sparked widespread protests by the populist movement - the Gilets Jaunes (yellow vests) who succeeded in bringing many parts of Paris and other cities to gridlock and got a U-turn from the President.
- A slightly brighter note was the progress made late in December on Italy’s budget. After a 10 week standoff between Rome and Brussels, the European Commission approved a watered-down budget which will now constitute a deficit of 2.04% of Italy’s GDP. Although this was largely overshadowed by global events, this represents some much needed respite ahead of the UK’s exit from the European Union.
- Hopes of an economic recovery during the fourth quarter remained improbable, whilst forward looking indicators from the regions manufacturers and service providers highlight that confidence has been severely hit by the global slowdown and protectionist trade policies.
- Furthermore, without the aid of the European Central Bank’s stimulus programme (quantitative easing) that concluded in December, we expect a difficult backdrop for European equities over the near term.

JAPAN

- It was a dismal quarter for Japanese equities as the main index, the Nikkei 225, shed 12.9% over the period. As with other markets, the primary driver was external, as the prospect of further increases to US interest rates and the persistent trade tensions weighed heavily on investor sentiment in Japan.
- It is worth noting that whilst Japan has largely evaded conflict with President Trump over trade, we acknowledge the trade imbalances within sectors such as Autos could become a target for the Trump Administration in 2019.

- Internally, the picture of the Japanese economy remained largely unchanged. Having been besieged by natural disasters over the summer, recent economic data published in November pointed toward a speedy recovery.
- After disappointing inflation data in December, the Bank of Japan crucially reaffirmed its stance towards accommodative monetary policy with Governor Haruhiko Kuroda stating they would wait patiently until its inflationary goals have been achieved. There is also an ever tightening labour market which will help further progress towards its inflationary goals in 2019.
- Political stability is a significant positive for Japanese markets in 2019. With much uncertainly on the horizon globally, the reappointment of Kuroda and the snap election victory for Prime Minister Shinzo Abe last year mean they are both able to continue to pursue their stance of loose monetary policy and structural reform.

ASIA PACIFIC (EX JAPAN) / EMERGING MARKETS

- Both Asian and Emerging Markets suffered as concerns surrounding global growth and trade tariffs continue to dominate investor sentiment. Third quarter GDP numbers in China exacerbated such worries with quarterly annualised growth rates of 6.5%, China’s weakest quarterly rate since the financial crisis. The Chinese authorities’ initial response of lowering the cash reserve requirements for banks proved futile as markets brushed off such measures and continued to dramatically sell off.
- The FTSE Developed Asia Pacific ex Japan Index returned -7.6% over the fourth quarter, as export-led economies including South Korea, Malaysia and Taiwan also experienced sharp losses amid slower growth and a persistently strong US dollar. The significant fall in the price of Crude Oil over the quarter provided support to the net importers of this commodity which favoured Indonesian and Indian markets.
- The G20 summit was a missed opportunity to ease tensions and ended firm progress on trade tariffs in late November, although the delay in the implementation of the planned 1st January 2019 tariffs was welcomed. Politically, Russia, Turkey, Indonesia, Brazil and India have all contributed to the uncertainty through elections and populists policies.
- Underpinning the uncertain political backdrop, corporate earnings remain reasonably solid, providing a support level for a potential recovery and future growth. This is also supported by the predicted slower and more orderly rate of interest rate rises in the US.
- The Chinese market is trading at reasonably low valuations compared to history; in fact the Emerging Markets as a whole have traded higher than current values for 70% of the time in the past 25 years. Clearly the potential for continued near-term Emerging Market volatility is present, however, the potential for growth still exists and structural tailwinds remain intact over the medium to long term – more robust economic fundamentals, strong economic growth, favourable demographic trends and healthy corporate earnings growth.
- Market valuations suggest the negative market sentiment is overdone. With the recent sell-off, Emerging Market equities are back below their long-term average and trading at the largest discount to US equities in 14 years, offering an interesting entry-point on a longer-term view.

FIXED INCOME

- Whilst the volatility within equity markets has dominated many of the headlines over the last quarter, some of the most relatively dramatic moves have actually come from government bonds. More specifically within US Treasuries which are perceived to be the bellwether of government debt globally.
- Initially, 10 year Treasury yields, which move inversely to price, started to decline as Jay Powell (Head of the US Federal Reserve) commented that US interest rates were close to neutral.
- As concerns persisted regarding the potential for a slowdown in global economic growth, yields went from 3.24% during early November to hovering around 2.75% at year end.
- This is an unprecedented move when taking into consideration the Fed also hiked interest rates in December for the fourth time in 12 months. This market flight to safety was largely replicated, albeit not at the same

velocity, throughout developed markets over the last quarter with German Bund and UK Gilt yields ending lower.

- If there are any positives to come from the recent bout of volatility, it is the diminishing prospect of US Treasury yields racing away and a potential negative crowding out effect for the private sector. Taking into consideration the Fed's latest comments, which suggest a potential pause in their tightening cycle, it is our view that over the near term we are unlikely to see the 10 year yield make fresh highs.

ALTERNATIVES

- Hedge Funds endured a negative period, experiencing steep losses led by equity based strategies. Overall, Hedge Funds returned -5.8% in US dollar terms and -3.5% in Sterling terms, with weak performance across all strategies in US dollar terms. Equity Hedge were the worst strategies returning -8.3% (in US dollar) and -6.1% (in Sterling), Global Macro was the least negative, returning -1.9% in US dollars, but returned +0.5% in Sterling.
- Over the quarter, commodity markets decreased by -21.1% in Sterling terms (-22.9% in US dollar terms). Energy and Crude Oil had the highest declines over the quarter, Crude Oil decreased -36.5% in Sterling terms (-37.9% in US dollar terms), whilst Energy decreased by -32.0% in Sterling terms (-33.6% in US dollar terms). Precious Metals and Agriculture were the only sectors that had gains over the quarter.
- With Brexit continuing to produce uncertainty, the backdrop for the UK Commercial Property market remains subdued. Clearly with certain segments of the UK economy struggling, particularly the high street, a selected approach to sector allocation remains vital. Nonetheless, the UK economy generally is proving, thus far, to be rather resilient despite the politics with third quarter GDP numbers of 0.6% year on year. In November, UK Commercial Property capital values decreased by 0.4% and rental income posted a marginal fall of 0.2%. Despite this slowdown, the market returned 0.9% over the quarter and 6.5% over 12 months. The standout sector for 2018 was Industrial; with a rental growth of c.5%, the growth of this sector has been supported by the growth of online retailing which has boosted occupational demand by almost 30%. At the end of December, the annual property yield stood at 4.8%.

OUTLOOK

Although it has been a disappointing 2018 for markets, looking ahead we are not currently seeing concrete evidence that firmly points to a recessionary period. It is clear that the current economic cycle has been incredibly long – in fact the longest since the First World War, and there has been a notable slowdown in parts of the world, but we are not of the view that there is to be a global recession in the near term as leading indicators do not support this. An economic adage states, 'bull markets don't die of old age, they tend to get killed off by something first'. If this is to hold true this time around, our principal case would be central banks tightening too far and too fast. However, with Jay Powell's latest comments suggesting rates, for now, are on hold this threat has dissipated, particularly as the economic imbalances that one would normally associate with the end of an economic phase are currently absent.

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.

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

ANDREW MUNRO
Associate Consultant
+44 (0)161 931 4497
andrew_munro@jltgroup.com