Clwyd Pension Fund

Committee Report:

Economic and Market Update Q1 2014

Contents

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1 Market / Economic Data to 31 March 2014

Market Statistics

Yields as at 31 March 2014	% p.a.
UK Equities	3.41
UK Gilts (>15 yrs)	3.43
Real Yield (>5 yrs ILG)	-0.10
Corporate Bonds (>15 yrs AA)	4.29
Non-Gilts (>15 yrs)	4.60

Absolute Change in Yields	3 Mths %	1 Year %	3 Years %
UK Equities	0.13	0.06	0.45
UK Gilts (>15 yrs)	-0.15	0.41	-0.87
Index-Linked Gilts (>5 yrs)	-0.13	0.33	-0.73
Corporate Bonds (>15 yrs AA)	-0.13	0.24	-1.24
Non-Gilts (>15 yrs)	-0.03	0.37	-0.93

Market Returns Bond Assets	3 Mths %	1 Year %	3 Years % p.a.
UK Gilts (>15 yrs)	3.4	-3.1	8.7
Index-Linked Gilts (>5 yrs)	3.6	-4.4	9.0
Corporate Bonds (>15 yrs AA)	2.7	1.5	8.8
Non-Gilts (>15 yrs)	2.7	1.1	8.9

Market Returns Growth Assets	3 Mths %	1 Year %	3 Years % p.a.
UK Equities	-0.6	8.8	8.8
Overseas Equities	0.7	6.8	7.6
USA	1.2	11.3	13.3
Europe	2.4	15.7	6.1
Japan	-6.0	-1.6	4.3
Asia Pacific (ex Japan)	0.4	-6.5	0.8
Emerging Markets	-0.7	-10.8	-4.3
Property	3.9	14.0	7.6
Hedge Funds	1.0	7.2	4.7
Commodities	2.3	-7.9	-4.7
High Yield	2.2	-0.7	7.6
Emerging Market Debt	3.7	0.6	7.1
Senior Secured Loans	0.6	7.0	5.0
Cash	0.1	0.4	0.5

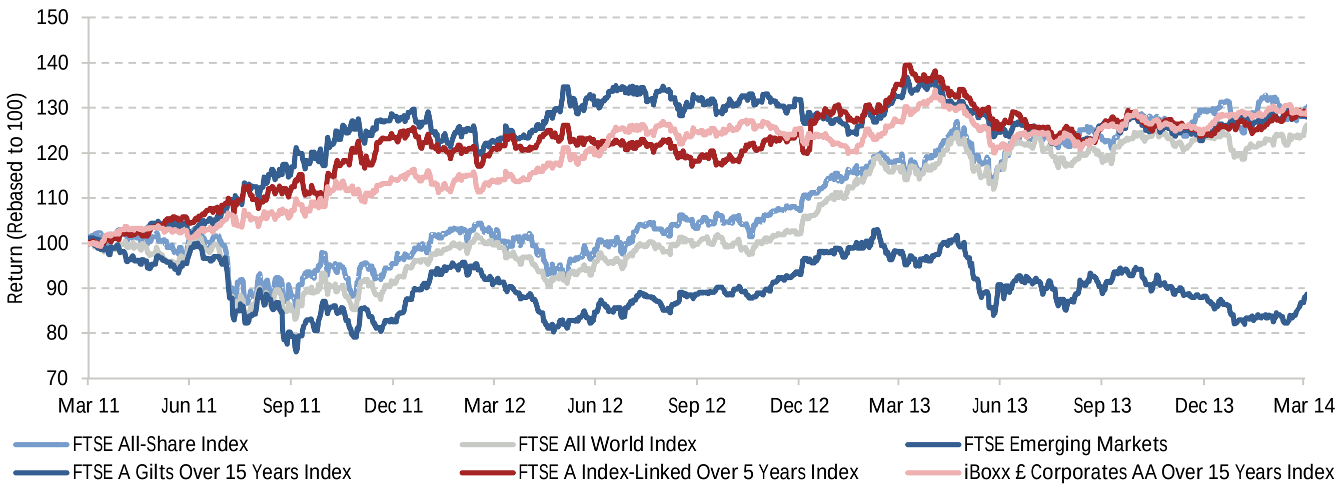
Change in Sterling	3 Mths %	1 Year %	3 Years % p.a.
Against US Dollar	0.7	9.8	1.3
Against Euro	0.6	2.3	2.3
Against Yen	-1.4	20.3	8.9

Inflation Indices	3 Mths %	1 Year %	3 Years % p.a.
Price Inflation – RPI	0.6	2.5	3.1
Price Inflation – CPI	0.1	1.6	2.6
Earnings Inflation	-0.3	1.0	1.2

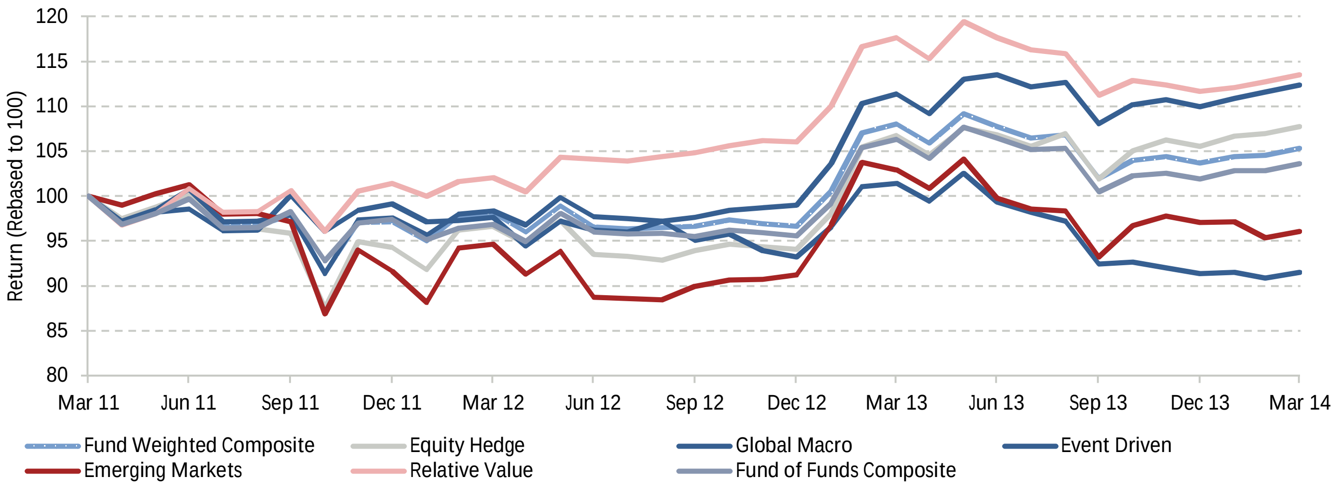
Source: Thomson Reuters and Bloomberg

Market Charts

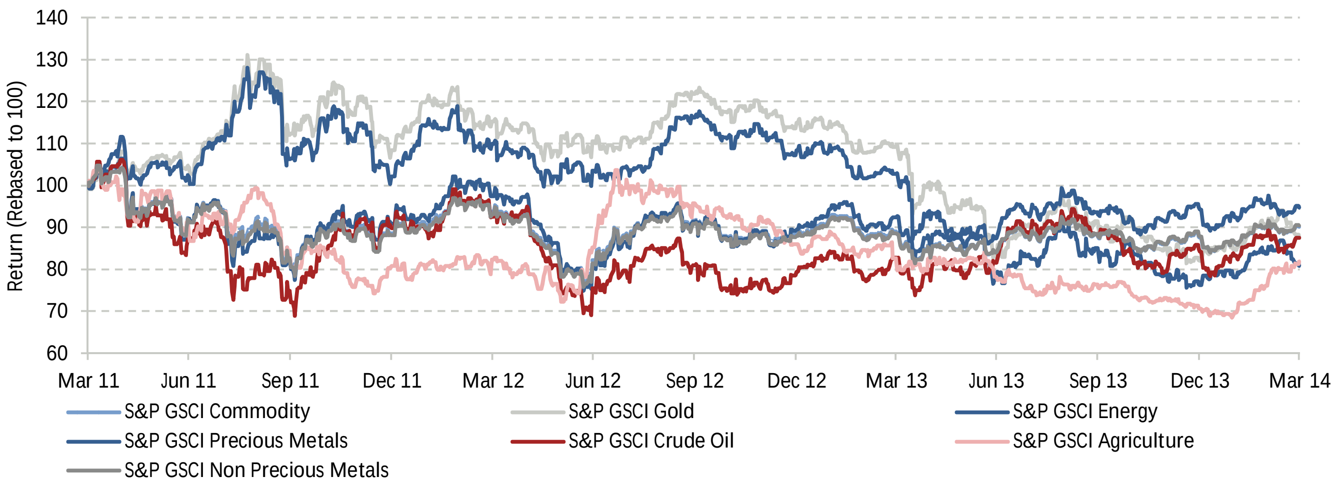
Market performance – 3 years to 31 March 2014



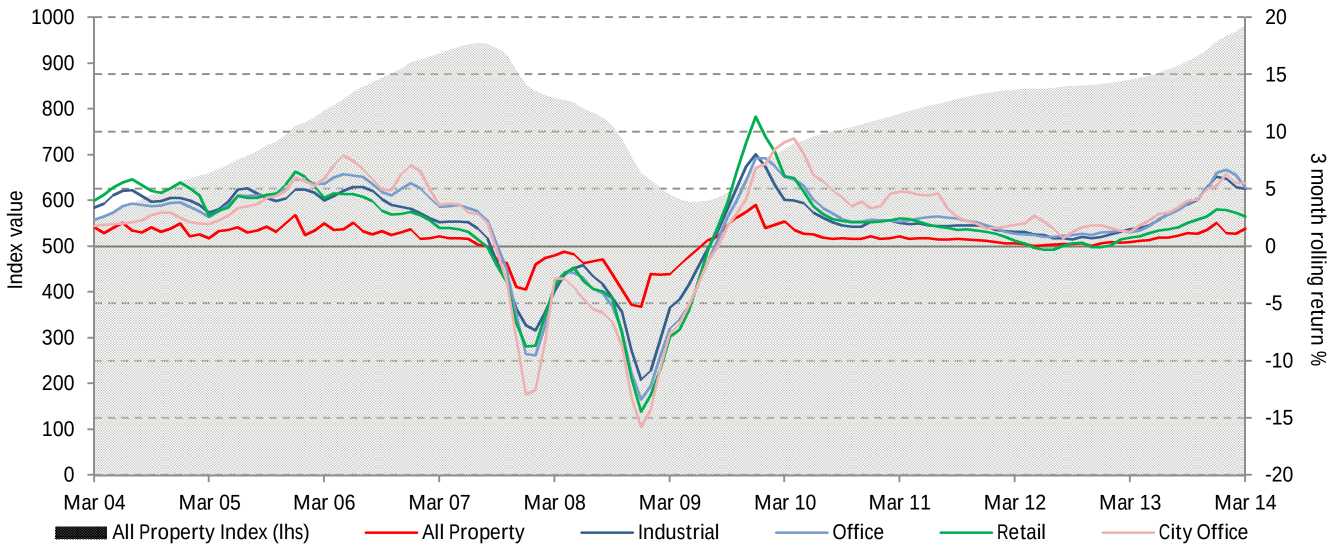
Hedge Funds: Sub-strategies performance – 3 years to 31 March 2014



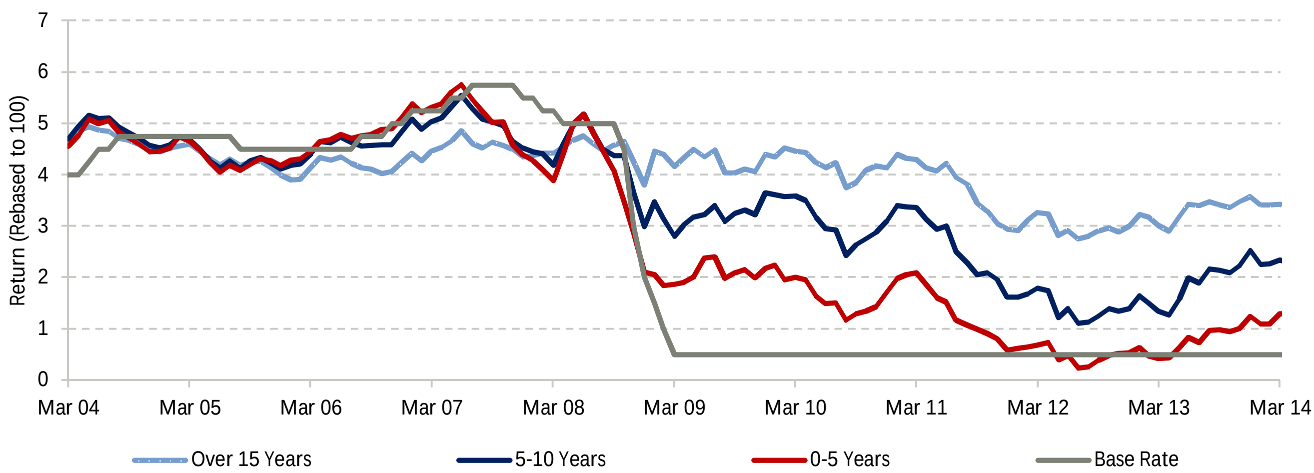
Commodity sector performance – 3 years to 31 March 2014



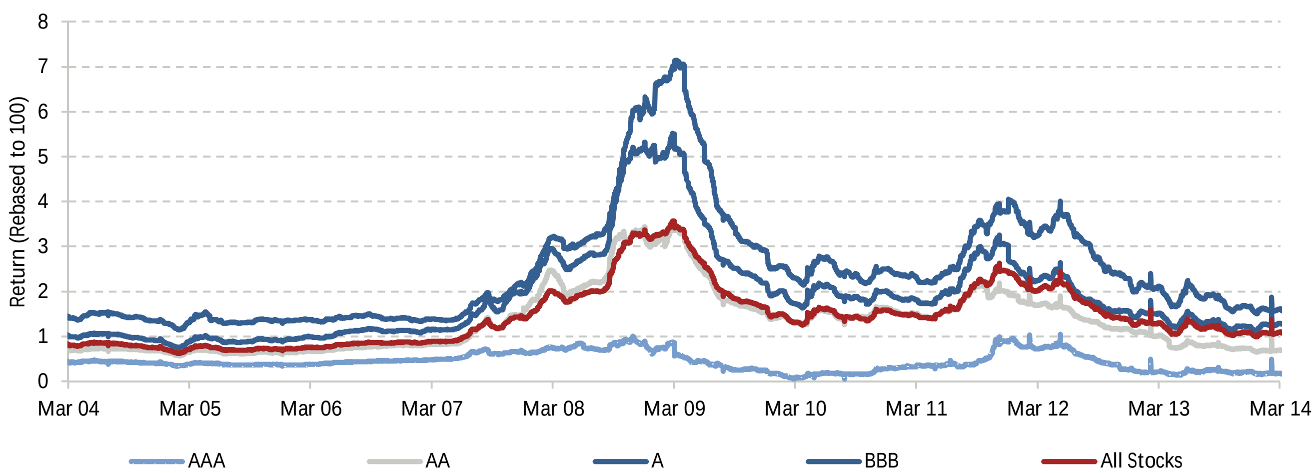
Property sector performance – 10 years to 31 March 2014



UK government bond yields – 10 years to 31 March 2014



Corporate bond spreads above government bonds – 10 years to 31 March 2014



Economic Information

Economic statistics

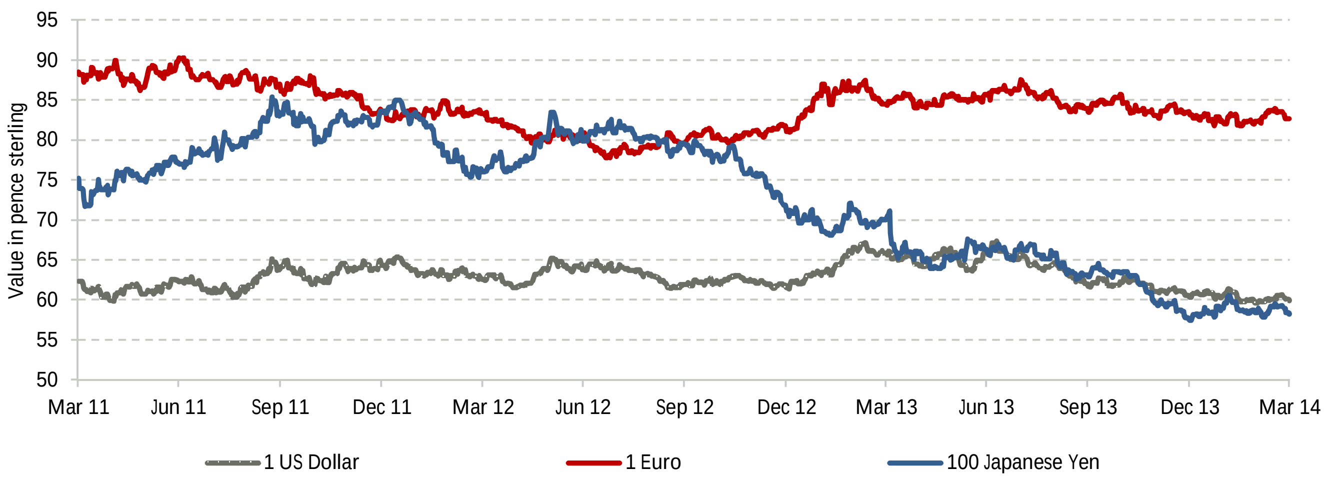
	Quarter to 31 March 2014			Year to 31 March 2014		
	UK	Europe[(1)]	US	UK	Europe[(1)]	US
Real GDP growth	0.8%	n/a	0.0%	3.1%	n/a	2.3%
Inflation change[(2)]	0.1%	0.1%	1.4%	1.6%	0.5%	1.5%
Unemployment rate at quarter-end	6.9%	11.8%	6.7%	6.9%	11.8%	6.7%
Previous rate (last quarter-end / 1 yr ago)	*7.1%*	*11.8%*	*6.7%*	*7.9%*	*12.0%*	*7.6%*
Manufacturing PMI* at quarter-end	55.3	53.0	54.9	55.3	53.0	54.9
Previous PMI (last quarter-end / 1 yr ago)	*57.3*	*52.7*	*57.0*	*48.3*	*46.8*	*51.3*

(1) EU changing composition area; (2) CPI inflation measure. *PMI = Purchasing Managers Index

Exchange rates

Exchange Rates	Value in Sterling (Pence)			Change in Sterling	
	31 Mar 14	31 Dec 13	31 Mar 13	3 months	12 months
1 US Dollar is worth	59.98p	60.38p	65.86p	0.7%	9.8%
1 Euro is worth	82.67p	83.19p	84.57p	0.6%	2.3%
100 Japanese Yen is worth	58.24p	57.44p	70.05p	-1.4%	20.3%

Exchange rate movements – 3 years to 31 March 2014



Source: Thomson Reuters, market, Institute for Supply Management, Eurostat, United States Department of Labor, US Bureau of Economic Analysis.

2 Market Commentary

Equities - Introduction

The first quarter of 2014 saw little overall movement in equity markets worldwide (with the exception of Japan).

After the rises in developed markets' equities seen in 2013, the falls in January were not unexpected. Many investors had felt at the end of last year that the re-rating of prices in 2013 had gone a little too far, and a period of consolidation was due.

But these falls were quickly recovered in February, with new index highs being reached in some areas, before largely marking time in March. However it has been noticeable that all of this has been achieved on relatively low volume, indicating that investors generally are unwilling to commit themselves too much – in either direction. A 'wait-and-see' attitude prevails, which showed no signs of coming to an end at the end of the quarter.

All of this happened – or more correctly, didn't happen – despite a background, described in more detail below, that was, and is, potentially quite negative. Markets did not ignore events in the Ukraine, or worrying economic numbers from China, the Eurozone and the US, but remained surprisingly calm. This may seem somewhat irrational, but as John Maynard Keynes once said – 'markets can remain irrational longer than you can remain solvent'.

United Kingdom

- The UK stock market has followed the pattern elsewhere in the first quarter, falling in January, recovering in February and moving sideways in March. Expectations of a larger fall (from profit-taking after last year's rises) were not realised and, as in the US, volumes remained low.
- The economy has continued to recover, albeit with some on-going concerns over the residential property market, inflation is still low and interest rates are unlikely to rise anytime soon. There is a growing argument over this, with some forecasters expecting a small rise in rates sooner than the market is anticipating.
- The budget, at the end of the quarter, was in some respects revolutionary, but outside the pensions industry did little to change the bigger economic picture. (In the much longer term it could have a significant effect on both the stock market and, possibly, property, depending on whether Lamborghinis are the preferred pensioners' purchase or not).
- Earnings are the key to the UK market's future progress, as they are in the US. After last year's rises, equity prices appear to discount an increase in profits that seems unlikely to materialise unless world growth accelerates. Momentum has to be seen to increase.
- Three known 'events' on the horizon at the quarter-end will almost certainly have a bearing on the market – the European elections in May, the yes / no vote in Scotland in September, and – a little further off – the General Election in May 2015. In market terms the Scottish vote is unique, with any reaction to the result going either way impossible to forecast, but it is sure to lead to some nervousness over the summer.

Europe ex UK

- Given the geo-political background, it is somewhat surprising that Europe has been the best performing region over the quarter – just.
- As events in the Ukraine have unfolded a sharp correction in European markets might have been expected. This has not happened. It has been obvious from the start that it was in neither side's interests (Russia or the Eurozone) to escalate the situation. Ukraine's ownership of the Crimea happened yesterday in the time-line of Russian history, and the rest of Europe was well aware of this.
- But the American historian, Barbara Tuchman, once wrote 'War is the unfolding of miscalculations'. There has always been the possibility – which still exists – of something going accidentally wrong (the law of unintended consequences writ large).
- Sanctions will be an irritant (they are not usually anything more), but will also have the beneficial effect of accelerating Europe's attempts to reduce its dependency on Russian gas. If that succeeds, the longer-term consequences for Russia could be far-reaching.
- But whilst the world watches the Ukraine, the rest of Europe has continued as before. There is another (young) prime minister in Italy – committed to roll back some of the austerity measures imposed to satisfy Brussels – and now another (again young) prime minister in France, resolved to do the same. The European elections in May were the first time everybody across the Eurozone had the opportunity to give a verdict on 'austerity'.
- But will they have any effect. The European Central Bank continues to do nothing to alleviate the situation. Inflation across the region continues to fall, deflation is already a fact in the peripheral nations, but the ECB refuses to accept that the Eurozone might be repeating the mistakes of Japan in the 1990s. Quoting Barbara Tuchman again – 'Learning from experience is a faculty almost never practiced'.
- Luckily companies across the area have continued to prosper. However, as elsewhere, earnings need to be watched closely. Growth in profits in 2014 must continue to justify current price levels.

North America

- The S&P 500 Index has hit new highs over the quarter, continuing the rise seen in 2013. Corporate earnings growth was largely positive and whenever the economic news disappointed, this was blamed on the unusually bad weather in the Mid-West and East of the country experienced over the period. There is a widespread expectation that any downturn in activity in the first quarter will be recovered in the second.
- The trade deficit in the last quarter of 2013 was the lowest since 1999, and import growth is close to zero. Inflation is falling and the economy is recovering. The Federal Reserve, whilst maintaining its tapering policy (suggesting that all quantitative easing will cease later this year), has also indicated that interest rates are unlikely to rise until late 2015 at the earliest.
- However, some commentators are more wary of this seemingly benign background. Earnings in particular are viewed with suspicion as there is a lack of momentum in many areas. Profits need to grow more quickly to support current equity price levels. This requires an accelerating overall economic growth worldwide, which doesn't look likely at the moment.
- There have also been a few worrying signs of 'irrational exuberance' returning to the market, especially in the technology and biotechnology sectors. There has been a succession of high-profile new issues, not all of which have performed well, which have revived memories of the excesses of 1999/2000. This may be just a temporary aberration, but needs to be watched closely.
- Overall the US equity market does not look expensive, but needs something more to push it to higher levels. For the time being it is being treated as an equity 'safe-haven' by overseas investors, especially as the US dollar looks cheap against other major currencies. Events, such as the crisis in the Ukraine, have also accentuated this safe-haven status.

Japan

- The Japanese market stands out from the rest of the developed world, having fallen sharply in the first quarter – after being one of the best performing major markets last year.   Have we seen yet another false dawn or has this been just a correction in a continuing bull market?
- "Abe"-nomics was, and is, revolutionary. The aim is not only to drag Japan out of its twenty year deflationary spiral but also to change Japanese society. Neither can be achieved overnight.
- The first target was the yen, which has fallen over 25% from its highs. This has already had a major beneficial effect on corporate profits which more than doubled in the last year (and which rose 39% in the fourth quarter alone). To say the least this growth is underpinning equity market valuations.
- The correction in the first quarter appears just that – a correction. Investors became concerned about China, emerging markets growth and the Ukraine – and took some profits. They were also aware of the fact that sales taxes were being increased in Japan in April, and were worried this might once again impact consumer confidence.
- The yen has also temporarily regained its safe-haven status, but the authorities have proved they will continue to inject liquidity if this looks likely to become more permanent.
- As the first quarter has shown, it is difficult for any market to act in isolation all the time. But Japan is in a better position than elsewhere to manage its own destiny (perhaps the Eurozone could too, if it was willing).

Asia Pacific ex Japan

- As has been the case for many months now, China has been the driver of performance in the region, with other emerging markets not far behind.
- The first quarter in China is always difficult to interpret because of the effects of Chinese New Year.
- Many commentators are suggesting that the slowdown in the economy is gathering pace, whereas others believe that this is overly pessimistic.
- The reversal of credit growth in China being engineered by the authorities is already leading to slower industrial production growth. Retail and property sales are also slowing. The Renmimbi has been weakening, with serious knock-on effects in the rest of the region. And Chinese private capital, whenever possible, is moving offshore – emphasising the lack of confidence in the domestic market.
- What does this mean for the rest of the region? Asia ex-Japan equities have been underperforming the developed world for well over a year and valuations are now discounting a lot of bad news. Profits and dividends are still growing for many companies. But sentiment is almost universally negative (suggesting we might be nearing the end of the relative underperformance?). Until there is some news from China that is considered positive, markets are likely to languish, although opportunities still exist – and with yields of over 5% available, investors are at least being paid to wait for better times.

Emerging Markets

- The Federal Reserve's tapering programme continued to have a deleterious effect on emerging markets around the world, albeit less so in the first quarter of 2014 than last year.
- Slower global growth, a strengthening US dollar, lower hard commodity prices (ex gold) and reduced liquidity are all headwinds that developing countries are finding difficult to weather.
- Many investors have reduced their exposure to the sector, preferring the more predictable developed markets in the short term. Valuations have fallen, and now look attractive (relative to the recent past).
- One of the principal positive arguments for longer term investors is the rapid growth of the middle class (or the aspiring middle class) in many countries, with the propensity to spend, this benefiting many companies who sell to this

sector. But even this is under pressure in the short term. For example, in India, people have seen the rupee fall by 10% in the last year plus inflation also of 10%.

Fixed Income

- Fixed income investments remain expensive. This is particularly true of government backed securities, e.g. UK gilts. Bonds issued by companies still offer a small pick-up in yield, but credit quality is the key in this sector.
- Both the Federal Reserve and the Bank of England have made it clear that official interest rates will be kept as low as possible for as long as possible. The European Central Bank is following a different course but may be forced to change tack in the near future.
- This all remains the consensus view – everybody is negative. Despite this, the first quarter has actually been a positive one for the sector, as government bonds in particular regained (temporarily, one would imagine) their 'safe-haven' status during the crisis in Ukraine.
- As before the risks are on the downside – especially for Emerging Market debt, beset by both potentially rising interest rates and a stronger US dollar.

Alternatives

- Hedge Funds were more muted in than last quarter, but generally positive. Event Driven and Equity Hedge strategies led the way, with Merger & Acquisitions and high profile activist campaigns driving the gains. Emerging Market strategies continued to detract although Global Macro strategies finally posted positive returns following a period of poor performance. Total hedge fund assets increased by $26.3 billion (to $2.7 trillion) in the first quarter of 2014, as investors allocated the most 'new capital' to the industry since Q2 2011.
- Property continues its growth story with a 19th successive quarter of positive performance and index levels currently at an all time high. Four quarters of encouraging capital growth coupled with a steady income yield has led investors returning to the UK property market. City offices provided the largest source of return, however commercial property in the rest of the UK is showing signs of a recovery and growth.
- Commodities were positive overall in Q1, this was led by agriculture as concerns over poor weather conditions such as drought in Brazil boosted the sector, and the precious metal sectors as Gold rose as tensions developed in the Ukraine.

Conclusion

- The first quarter was a non-event in most markets. Investors have largely been sitting on their hands, waiting. But waiting for what? They have been watching the crisis in Ukraine unfold, not panicking, but wary. A resolution, suitable to all parties, is hoped for, but may not happen. In the meantime, markets will continue to be nervous.
- As for some time, they have been following the statements of the major Central Banks. None have changed their stance, although there were small signs that the European Central Bank might be inching towards some sort of quantitative easing. Tapering will continue, but not accelerate, and interest rates will stay low.
- They have been eyeing corporate profits with some concern, to see whether growth in 2014 justifies the valuations being placed on individual equities (and markets).
- And finally they have been waiting for more positive news from China – so far with disappointment.
- At the moment the future looks cloudy rather than thunderous.

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