Clwyd Pension Fund

Committee Report:

Economic and Market Update Q2 2014

Contents

Kieran Harkin

Director

St James's House, 7 Charlotte Street
Manchester, M1 4DZ

Phone: 0161 957 8016
Email: kieran_harkin@jltgroup.com

John Finch

Director

St James's House, 7 Charlotte Street
Manchester, M1 4DZ

Phone: 0161 253 1168
Email: john_finch@jltgroup.com

1 Market / Economic Data to 30 June 2014

Market Statistics

Yields as at 30 June 2014	% p.a.
UK Equities	3.27
UK Gilts (>15 yrs)	3.34
Real Yield (>5 yrs ILG)	-0.12
Corporate Bonds (>15 yrs AA)	4.17
Non-Gilts (>15 yrs)	4.44

Absolute Change in Yields	3 Mths %	1 Year %	3 Years %
UK Equities	-0.14	-0.26	0.28
UK Gilts (>15 yrs)	-0.09	-0.09	-0.88
Index-Linked Gilts (>5 yrs)	-0.02	-0.09	-0.60
Corporate Bonds (>15 yrs AA)	-0.13	-0.35	-1.37
Non-Gilts (>15 yrs)	-0.16	-0.24	-1.09

Market Returns Bond Assets	3 Mths %	1 Year %	3 Years % p.a.
UK Gilts (>15 yrs)	2.3	5.3	8.7
Index-Linked Gilts (>5 yrs)	1.1	4.3	7.8
Corporate Bonds (>15 yrs AA)	2.8	9.2	9.4
Non-Gilts (>15 yrs)	3.4	9.3	9.6

Market Returns Growth Assets	3 Mths %	1 Year %	3 Years % p.a.
UK Equities	2.2	13.1	8.9
Overseas Equities	2.6	9.4	8.5
USA	2.6	10.9	14.3
Europe	0.3	15.6	5.3
Japan	4.3	-1.7	5.7
Asia Pacific (ex Japan)	3.6	4.6	2.0
Emerging Markets	5.0	1.2	-2.2
Frontier Markets	9.3	21.2	10.5
Property	5.1	17.6	8.6
Hedge Funds	-0.6	-3.3	1.9
Commodities	0.1	-2.1	-1.9
High Yield	0.3	0.8	7.4
Emerging Market Debt	4.8	11.6	7.4
Senior Secured Loans	1.4	7.0	5.6
Cash	0.1	0.4	0.5

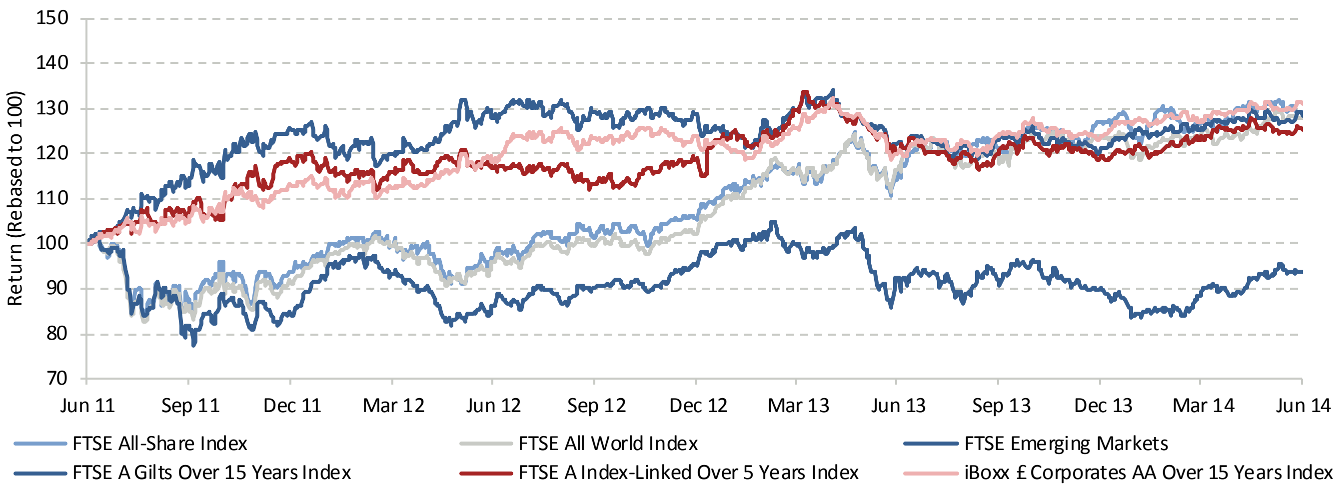
Change in Sterling	3 Mths %	1 Year %	3 Years % p.a.
Against US Dollar	2.6	12.7	2.1
Against Euro	3.2	7.0	4.1
Against Yen	0.9	15.0	10.1

Inflation Indices	3 Mths %	1 Year %	3 Years % p.a.
Price Inflation – RPI	0.6	2.6	2.9
Price Inflation – CPI	0.5	1.9	2.4
Earnings Inflation	0.2	0.7	1.2

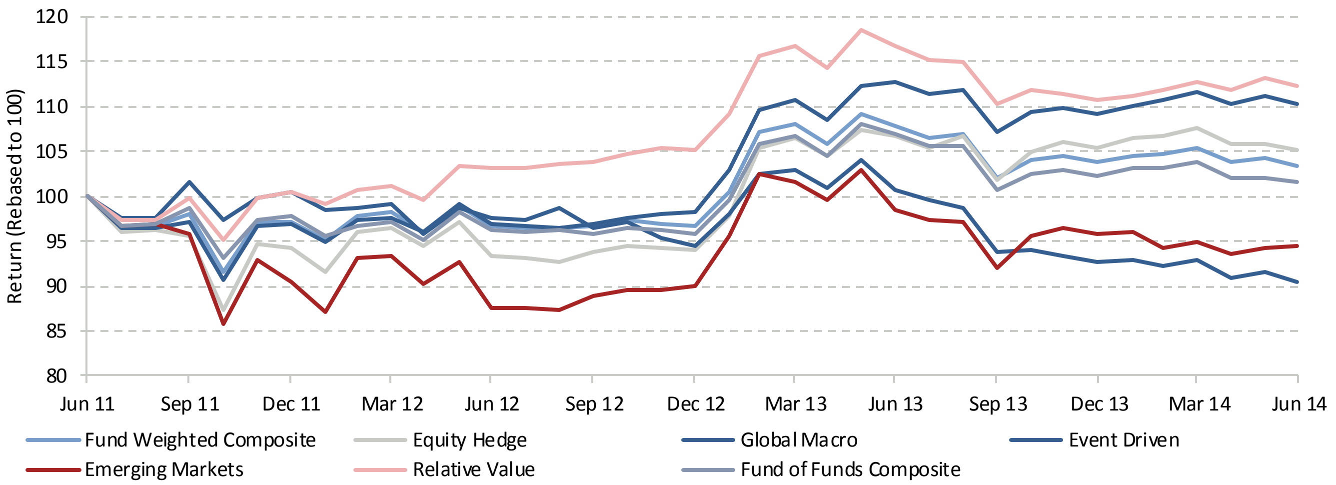
Source: Thomson Reuters and Bloomberg

Market Charts

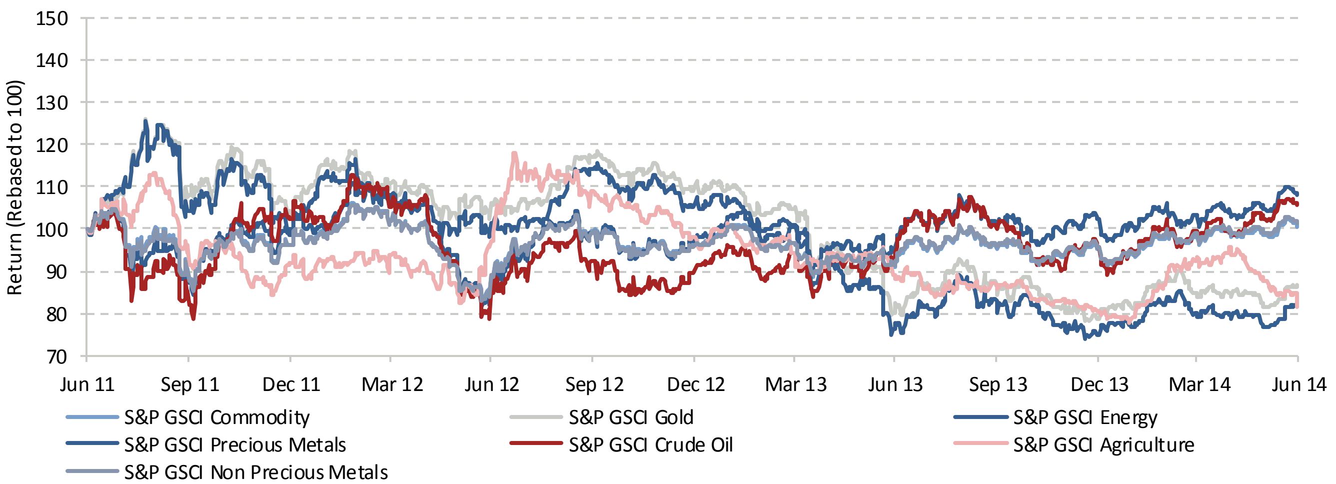
Market performance – 3 years to 30 June 2014



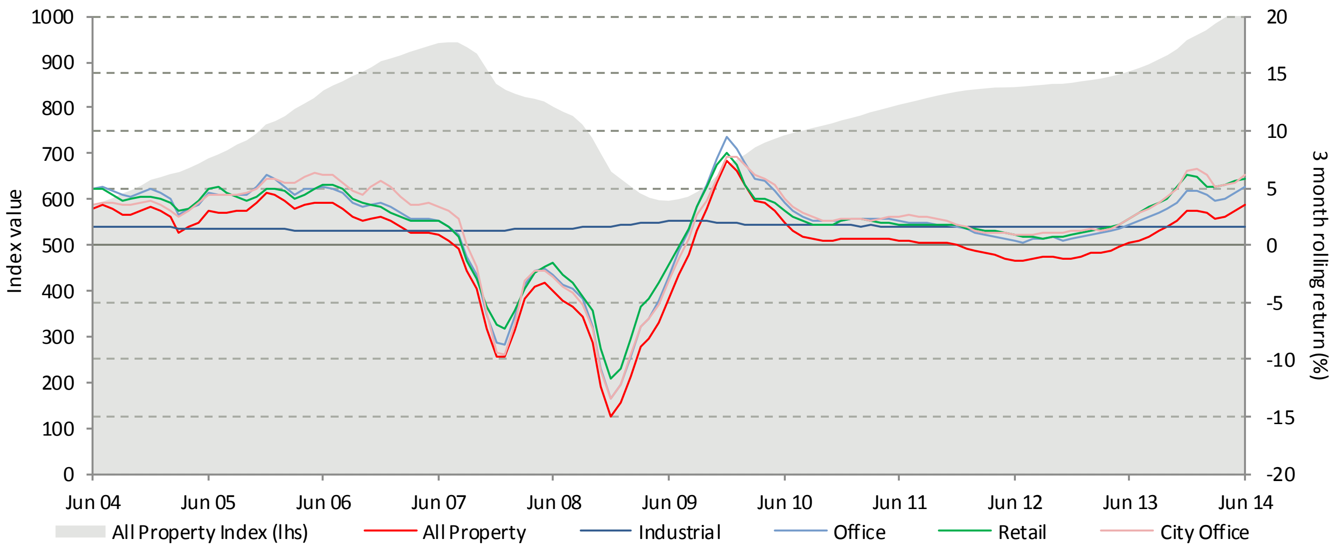
Hedge Funds: Sub-strategies performance – 3 years to 30 June 2014



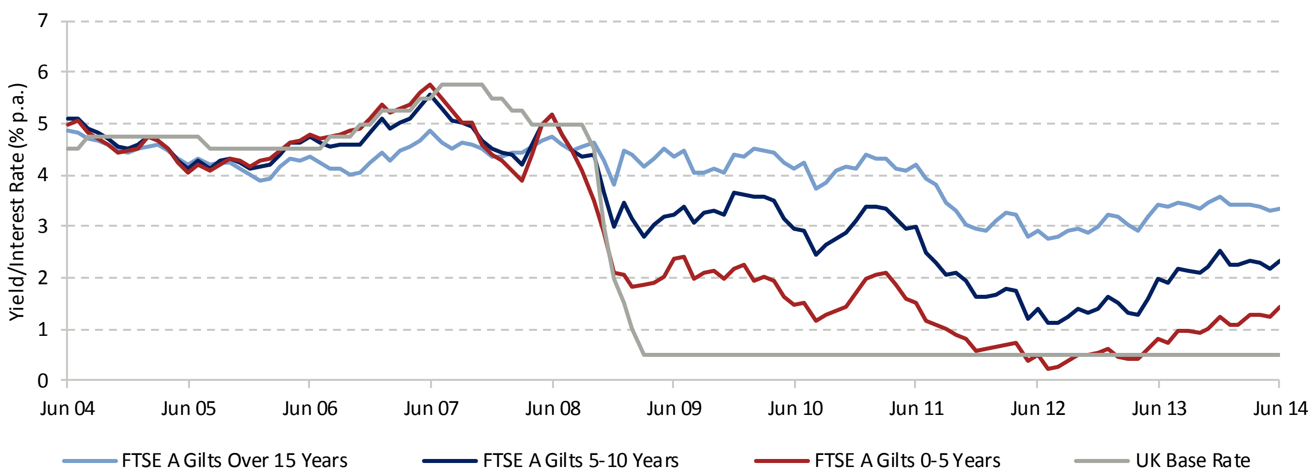
Commodity sector performance – 3 years to 30 June 2014



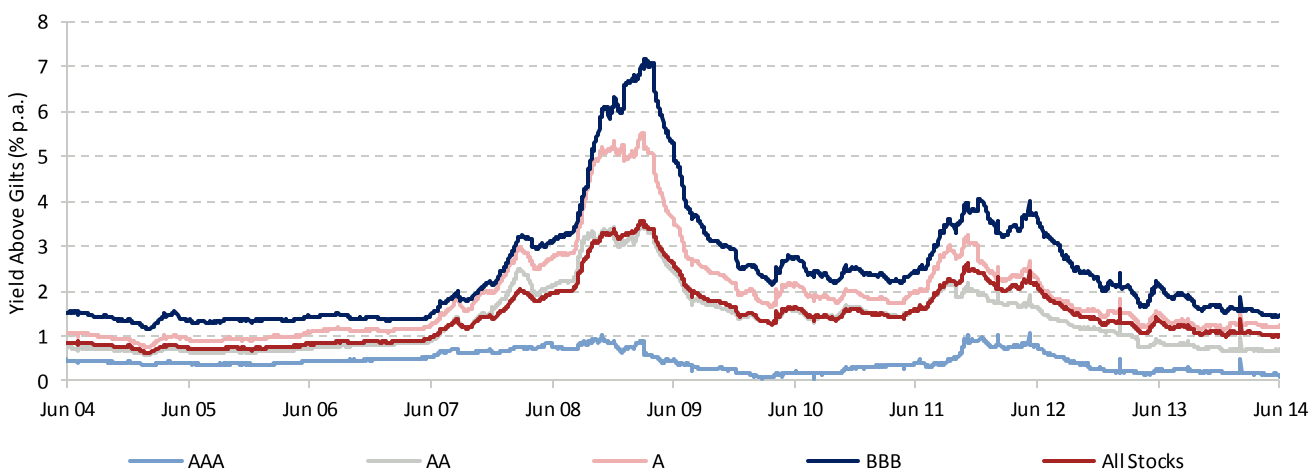
Property sector performance – 10 years to 30 June 2014



UK government bond yields – 10 years to 30 June 2014



Corporate bond spreads above government bonds – 10 years to 30 June 2014



Economic Information

Economic statistics

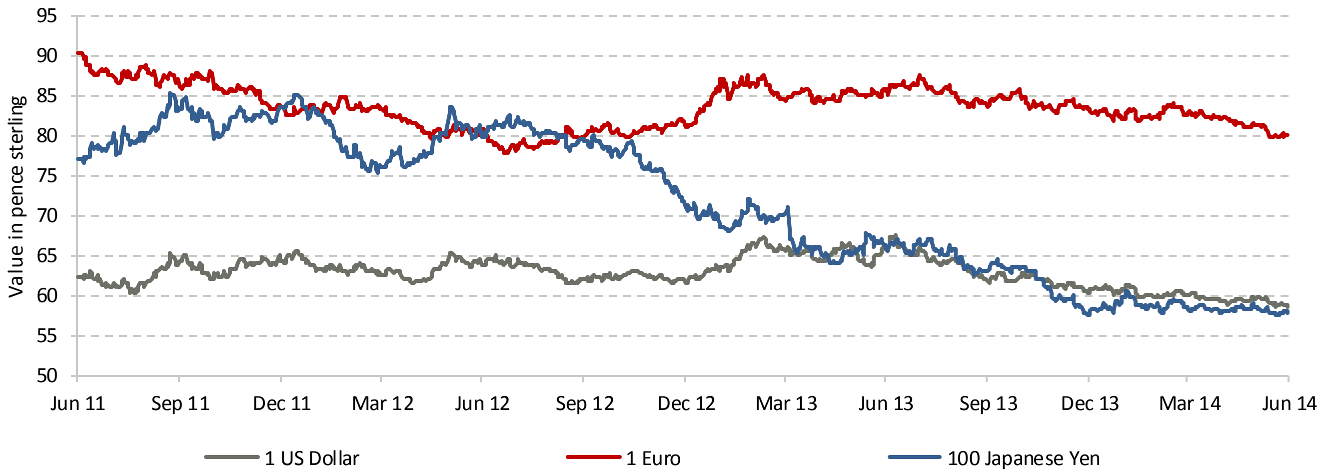
	Quarter to 30 June 2014			Year to 30 June 2014		
	UK	Europe[1]	US	UK	Europe[1]	US
Real GDP growth	0.8%	n/a	1.0%	3.1%	n/a	2.4%
Inflation change[2]	0.5%	0.2%	0.9%	1.9%	0.5%	2.1%
Unemployment rate at quarter-end	6.5%	11.6%	6.1%	6.5%	11.6%	6.1%
Previous rate (last quarter-end / 1 year ago)	*6.9%*	*11.8%*	*6.7%*	*7.8%*	*11.2%*	*7.6%*
Manufacturing PMI* at quarter-end	57.5	51.8	55.3	57.5	51.8	55.3
Previous PMI (last quarter-end / 1 year ago)	*55.3*	*53.0*	*54.9*	*57.5*	*48.8*	*50.9*

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

Exchange rates

Exchange Rates	Value in Sterling (Pence)			Change in Sterling	
	30 Jun 2014	31 Mar 2014	30 Jun 13	3 months	12 months
1 US Dollar is worth	58.48p	59.98p	65.93p	2.6%	12.7%
1 Euro is worth	80.07p	82.67p	85.70p	3.2%	7.0%
100 Japanese Yen is worth	57.73p	58.24p	66.37p	0.9%	15.0%

Exchange rate movements – 3 years to 30 June 2014



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

2 Market Commentary

Introduction

Market volatility has remained low for the second quarter in a row. Significant daily or weekly movements in the major indices have been few and far between, and a feeling of complacency seems to have taken hold of many investors' minds.

True economic surprises, positive or negative, have been largely absent. A good figure one month has often been offset by a poorer one the next, and vice versa. This has been apparent in both the developed and developing economies around the world.

Markets have been – and remain – fixated on interest rates, particularly when they are likely to rise, and the extent of any rise. Thus the regular pronouncements by the Federal Reserve, the Bank of England, the European Central Bank and the Bank of Japan have had a much greater market impact than most other factors.

Markets have concentrated on interest rates to the apparent exclusion of all else. Events in Ukraine and Iraq have been largely ignored (despite oil prices moving ominously higher).

Both the Federal Reserve and the Bank of England have been talking rates upwards, more stridently in the UK, with the ECB doing the reverse (discussed below). However, the Fed downplayed suggestions that rates in the US might rise anytime soon. For the first time since the financial crisis in 2008, Central Banks seem to be pursuing different policies, leading to even more unwillingness by investors to react decisively. George Bernard Shaw once said 'success does not consist in never making mistakes but in never making the same one a second time'. Some commentators are suggesting that the Fed is doing just that – repeating the mistakes of the past. Only time will tell.

United Kingdom

- The FTSE 100 rose by less than 2% in the first half of the year. Despite the lowest interest rates since 1694, abundant liquidity in the system and US markets at all-time highs, investors have been sitting on their hands. Why should this be the case?
- On the surface, the background is promising. Economic growth is accelerating, inflation is still low, interest rates are not expected to rise until late 2014 / early 2015 (and then not by much) and confidence has been rising.
- But this apparently rosy picture is hiding some problems. Earnings growth is lacklustre making the rerating of equity prices in 2013 look premature. Real wages in many parts of the country are still negative (although improving) yet consumer spending is rising. This is leading to sharply higher debt levels and a reduction in savings.
- And finally there is the 'property bubble' which is causing much angst amongst policy makers and politicians (not necessarily the same). The Bank of England is trying to 'micromanage' this area of economic activity, taking over responsibility from the Treasury. It would not be surprising if tensions arise between the two as the General Election approaches, but at the moment the measures being undertaken have the approval of all interested parties.
- All of this may still come to naught. It must be kept in mind that the Eurozone remains the UK's largest trading partner. The future across the Channel is much more important to the UK economy, particularly in the short term, than anything Mr Carney or the Coalition can do.
- Overall, whilst the market appears to be 'up with events', it does not feel like bubble territory. Profits in many areas are still growing, though not as much as originally forecast. Dividends are increasing so yields remain attractive.

Europe ex UK

- A famous quote from Ken Livingstone was 'If voting changed anything, they'd abolish it'. After the European elections in May showed a significant increase in the anti-Brussels vote (in one form or another) the prospects for changes to the system seem – nil. This has been confirmed by the proposed election of Jean-Claude Juncker as President of the European Commission. So from a political point of view the outlook for the Eurozone is the same as before.
- So will any further changes come from the European Central Bank?
- There is some economic growth across the continent but it is patchy, and numbers suggest it is also very fragile (France could well sink back into recession). Inflation remains near zero in the major economies, but some of the periphery (e.g. Greece) are already suffering deflation. Exports for the region have hardly changed, year-on-year, and youth unemployment is still nearly 24%.
- Mr Draghi, the head of the ECB, continues to deny that deflation, Japanese-style, is a potential problem. His latest measures to revive economic activity – negative interest rates (which has been successfully tried before by individual countries, e.g. Switzerland, but never continent-wide and never for very long) and cheap loans to banks to enable them to support small businesses – are perceived to be too little, too late.
- There is still talk of the possibility of Quantitative Easing, Anglo-Saxon style, but the political hurdles to surmount, especially in Germany, still seem to rule this out. European leaders are counting on a pick-up in global growth to lift demand, but this is unlikely to happen in the short term. The International Monetary Fund, admittedly with a less-than-stellar track record, has recently said the recovery in Europe 'is neither robust, nor sufficiently strong'.
- With this unpromising backdrop, why maintain holdings in European funds? There are several reasons. Europe is not just the Eurozone. Fund managers have a very large universe of companies to choose from, many of which continue to prosper. Profits and dividends have been growing, despite the absence of overall economic growth in the region.

North America

- Trying to understand the economic figures emanating from the USA was particularly difficult in the second quarter, following the extreme weather conditions experienced in many parts of the country in the first quarter. Revised numbers show the economy contracted by 2.9% - but was it caused just by the weather?
- There was a general expectation of a sharp recovery in growth in the second quarter, but some releases on housing sales (which fell by the most in 22 years) might suggest otherwise.
- But the stock market has ignored poor figures, hitting new highs. All eyes are on the Federal Reserve. The Chairman, Janet Yellen, is seen to be 'dovish', downplaying inflation concerns and looking more at the low wage growth in the economy rather than unemployment to justify the policy of 'lower for longer' (i.e. interest rates). 'Tapering' continues, with Quantitative Easing now 'only' $35bn a month, at which rate it will come to an end by Christmas (unless the economy goes into reverse, in which case we could see a fourth round of QE). No rate rise is anticipated before next year at the earliest.
- Markets have been buoyant on the back of this loose monetary policy, resulting in ample liquidity, corporate profitability that is rising (just) and reasonable equity market valuations. Share buybacks are near record levels (not necessarily a good thing – companies are not using their enormous cash reserves to invest for the longer term).
- The bull market is somewhat long in the tooth. Equity prices bottomed in March 2009 (equity valuations in October 2011). Merrill Lynch's Bull/ Bear Index neared extreme 'bull' levels, usually a sign that a pull-back is overdue.

Japan

- The Japanese market has been the laggard of the major indices in the first half of the year, despite rallying strongly immediately after the end of the quarter.
- The rise in the sales tax in April had a predictable effect – March retail sales rose 6.4%, April's fell 13.6% (the same happened in 1997, the last time sales taxes were increased).
- However, overall corporate profits rose strongly, as expected, in the fiscal year that ended in March and forecasts for next year should see upward revisions from current conservative levels as time goes on.
- The Bank of Japan has said it is 'happy' with trends in wages (increasing slowly but steadily) inflation (rising, but impacted by the tax increase) and the value of the yen. Further Quantitative Easing could be announced, but this has not yet been factored into the market.
- The key for markets going forward is Mr Abe's 'third arrow'. This entails long term structural reform of, amongst other things, corporate taxes, immigration and agricultural policies, and increasing the number of women in the workplace (to offset the effect of the ageing population). Here progress has been slow, and any proposed legislation could have a very positive effect.
- Domestic investors have been returning to the market, profits are growing sharply and valuations remain cheap. Many think Japan is a lost cause, but this could be overly pessimistic.

Asia Pacific ex Japan

- After a disappointing first quarter, Asian indices recovered in the second to show a modest overall gain over the period.
- For once, the greatest surprise did not come from China, but India. For the first time since 1984, a party, led by Narenda Modi, has won enough seats to govern without the support of others. Promising change, for once this may actually happen. The market, not unsurprisingly, reacted very positively.
- This set the stage for Indonesia's elections, in July. Additionally, military rule in Thailand is seen to have eliminated political risk – so there too, the markets have flourished.
- But China – and global interest rates – are still the most important factors. The Premier of China has said growth should be 'at least' 7.5% this year, but the underlying numbers are as confusing as ever. Factory orders have beaten estimates and are at a seven-month high. But against this the housing market is slowing down (overdue, and a longer term positive, but negative for consumer spending in the shorter term).
- China is still trying to avoid a financial crisis and structural reform has been promised, but information is patchy and suspicion remains. Elsewhere investment is picking up, profits and dividends are rising and yields are attractive.

Emerging Markets

- Indices have risen, helped by the unexpected result of the Indian election and a sharp recovery in the Russian market after the initial Ukraine crisis.
- Elsewhere there has been some stabilisation in the sector after the shocks of last year. Some economies are slowly adjusting, others (e.g. Argentina) are still in deep trouble. Liquidity remains tight and some currencies still look vulnerable against the US dollar.

Fixed Income

- Unusually the main Central Banks appear to be following different strategies for the first time since 2008.
- The Federal Reserve has a 'softly, softly' approach, continuing tapering, ignoring potential inflationary pressures (which the Chairman, Janet Yellen, has called 'noise') and are not expected to raise rates until 2015.
- The Bank Of England is more worried about 'asset price bubbles', especially in the residential property sector, and has hinted openly that a rate rise could be seen sooner rather than later – possibly the end of this year, but more likely early next (despite a General Election being due shortly thereafter).
- The European Central Bank is still tinkering, using negative interest rates as its latest weapon. The chance of a rate rise in the Eurozone is nil, that of Quantitative Easing, Anglo-Saxon style, is low but not zero.
- And the Bank of Japan is ploughing a lonely furrow, trying to kick-start an economy which has been moribund since the 90s. So where does all this leave bonds? Performance was better than expected in the first half of the year as the search for yield – any yield – and some flight to safety outweighed longer term concerns.
- Finally, it is worth noting that 56% of global GDP is concentrated in countries supported by zero interest rate policies. What will happen when rates rise?

Alternatives

- Hedge Funds were negative overall over the quarter (in sterling terms). All strategies in the index underperformed, Equity Hedge and Global Macro strategies were the worst performing whilst Relative Value and Event Driven strategies underperformed the least. Total hedge fund assets continue to increase at a rapid rate $30.5 billion in the second quarter of 2014 (to $2.8 trillion).
- In property, offices and industrials were the leading sectors whilst retail has continued to trail behind since the start of the capital value recovery in May 2013. Properties in outer London and industrials in the outer South-East were the strongest performing markets, while shops outside the South-East were weakest. Yields are continuing to compress as a result of increasing capital values, and at the end of June the annual yield stood at 6.8%.
- Commodities were flat overall in Q2. Industrial metals such as nickel and zinc led the index due to supply constraints in the internatoional market. Energy commodities were moderately up over the quarter. Agriculture, particularly grains and cotton had a very poor period, offsetting gains elsewhere in the index.

Conclusion

- George Soros once wrote 'Stock market bubbles don't grow out of thin air. They have a solid base in reality, but reality as distorted by a misconception'.
- There are many who are concerned that the developed markets are close to, or already in, 'bubble' territory. Earnings need to catch up with share prices to justify the price rises last year (and, in the US, this year too), but are struggling to do so.
- The 'reality' is that there is a danger of complacency setting in; the 'misconception' is that growth will continue, and even accelerate. There is little room for error. An external event (Iraq?) or a specific economic problem (rising oil prices?) could easily trigger a sharp reaction, as too could disappointing economic numbers in the US or elsewhere.
- The problems for investors are that cash earns nothing, and taking extra risk has not been rewarded by any extra return. This has been the case for some considerable time now, but a change anytime soon seems unlikely.
- The remainder of the year will be crucial. Quantitative Easing is targeted to end in the US (unless growth disappoints) with unpredictable results; rates may start to rise in the UK; anything could happen in Europe. And there still remain the ongoing crises in Ukraine and the Middle East.

JLT Employee Benefits

The St Botolph Building, 138 Houndsditch,
London EC3A 7AW
Tel: +44 (0)20 7528 4000
Fax: +44 (0)20 7528 4500