Clwyd Pension Fund

Committee Report:

Economic and Market Update Q1 2015

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1 Market / Economic Data to 31 March 2015

Market Statistics

Market Returns Growth Assets	3 Mths %	1 Year %	3 Years % p.a.
UK Equities	4.7	6.6	10.6
Global Developed Equities	7.6	19.7	15.6
USA	6.4	26.4	19.1
Europe	10.8	6.8	13.1
Japan	16.4	27.1	12.7
Asia Pacific (ex Japan)	9.5	20.0	9.4
Emerging Markets	7.4	13.2	3.2
Frontier Markets	2.0	8.7	13.5
Property	3.0	18.3	11.4
Hedge Funds	7.4	17.0	7.9
Commodities	-3.6	-33.0	-14.9
High Yield	5.4	9.4	9.0
Emerging Market Debt	2.0	5.6	5.4
Senior Secured Loans	2.4	4.1	6.6
Cash	0.1	0.5	0.5

Market Returns Bond Assets	3 Mths %	1 Year %	3 Years % p.a.
UK Gilts (>15 yrs)	4.1	27.0	10.0
Index-Linked Gilts (>5 yrs)	3.3	21.1	8.9
Corporate Bonds (>15 yrs AA)	5.2	21.8	11.3
Non-Gilts (>15 yrs)	5.0	21.6	11.8

Exchange Rates: Change in Sterling	3 Mths %	1 Year %	3 Years % p.a.
Against US Dollar	-4.8	-11.0	-2.4
Against Euro	7.3	14.3	4.8
Against Yen	-4.8	3.7	10.6

Inflation Indices	3 Mths %	1 Year %	3 Years % p.a.
Price Inflation – RPI	-0.2	0.9	2.2
Price Inflation – CPI	-0.4	0.0	1.5
Earnings Inflation*	0.7	1.6	1.4

Yields as at 31 March 2015	% p.a.
UK Equities	3.33
UK Gilts (>15 yrs)	2.23
Real Yield (>5 yrs ILG)	-0.93
Corporate Bonds (>15 yrs AA)	3.10
Non-Gilts (>15 yrs)	3.37

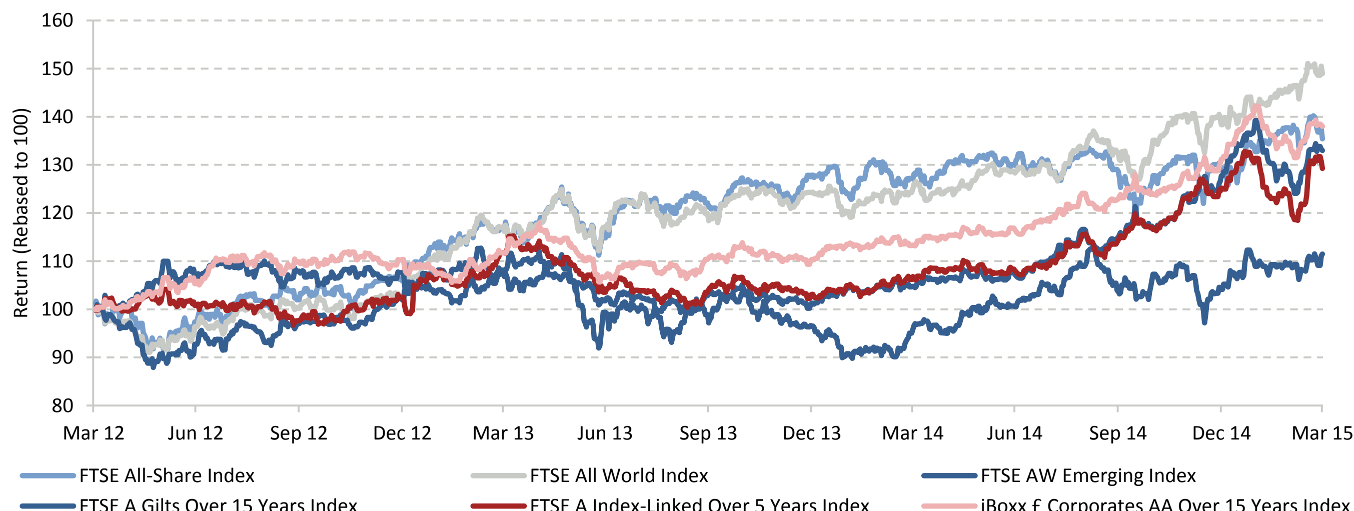
Absolute Change in Yields	3 Mths %	1 Year %	3 Years %
UK Equities	-0.04	-0.08	-0.12
UK Gilts (>15 yrs)	-0.19	-1.20	-1.03
Index-Linked Gilts (>5 yrs)	-0.16	-0.83	-0.82
Corporate Bonds (>15 yrs AA)	-0.31	-1.19	-1.52
Non-Gilts (>15 yrs)	-0.36	-1.22	-1.51

Source: Thomson Reuters and Bloomberg

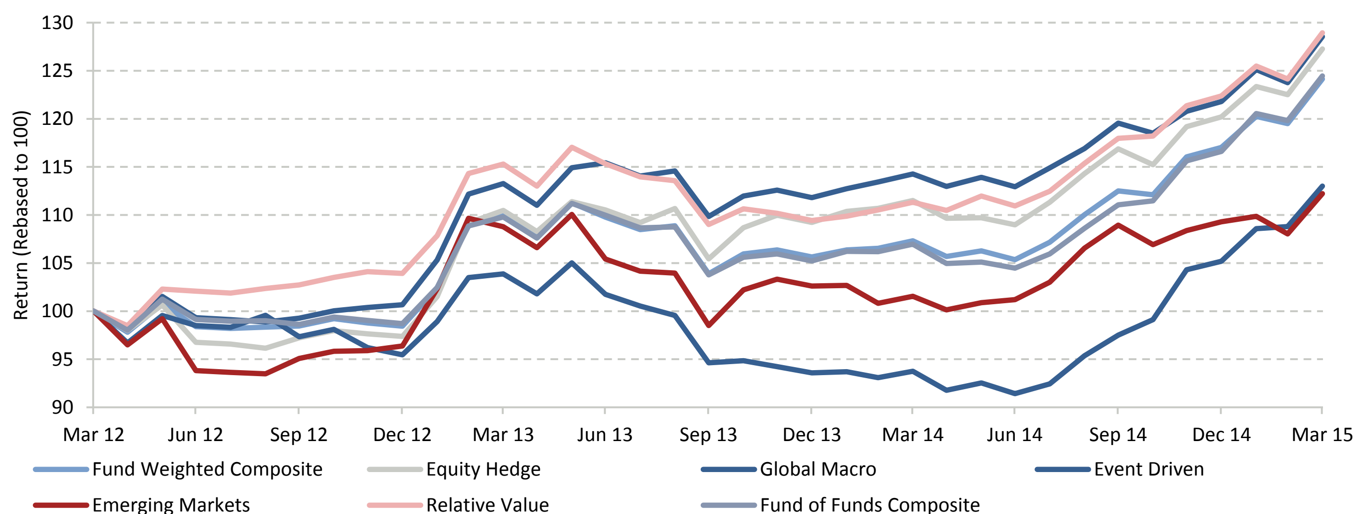
* Earnings inflation is lagged by 1 month.

Market Charts

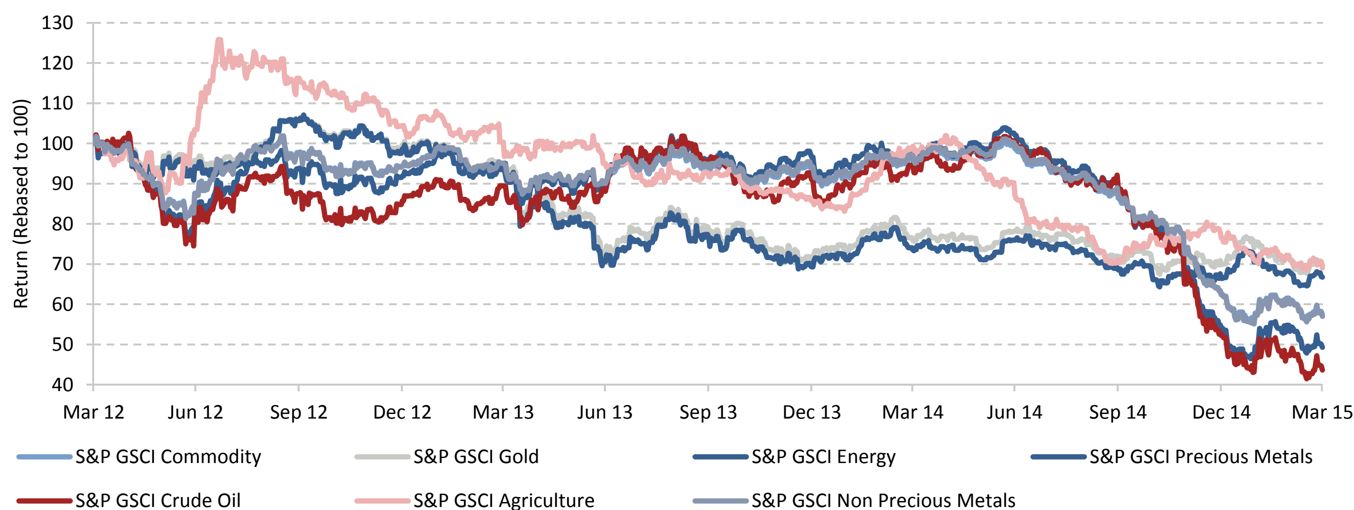
Market performance – 3 years to 31 March 2015



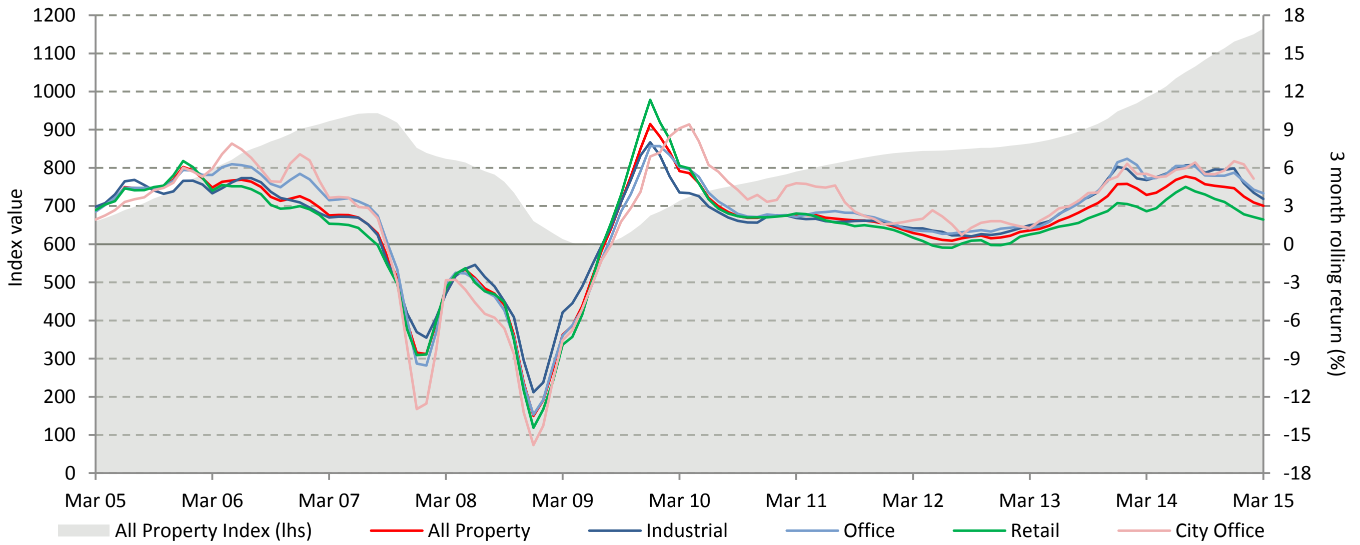
Hedge Funds: Sub-strategies performance – 3 years to 31 March 2015



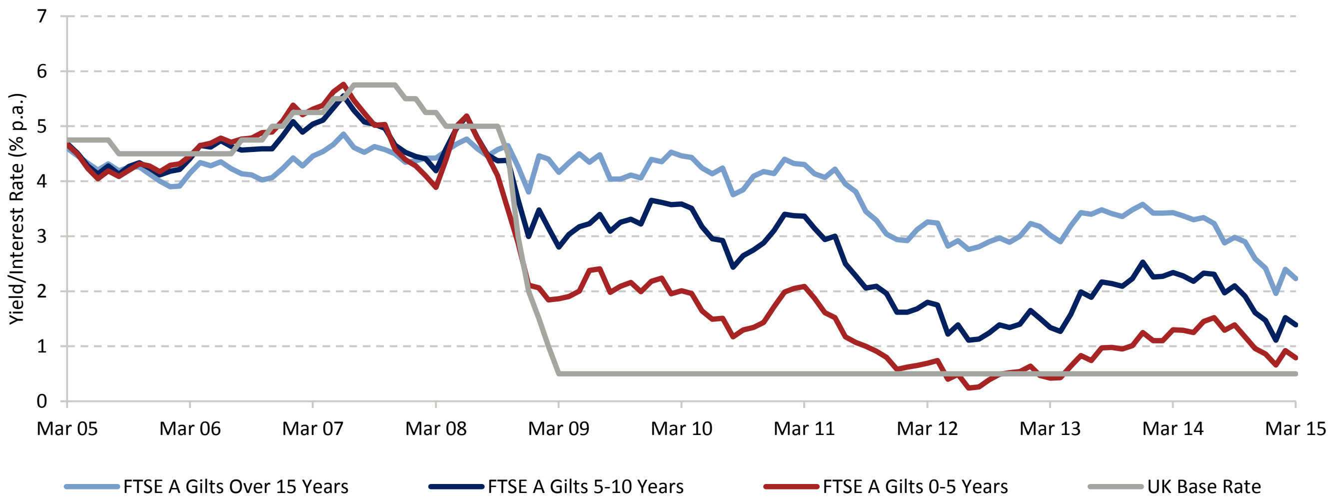
Commodity sector performance – 3 years to 31 March 2015



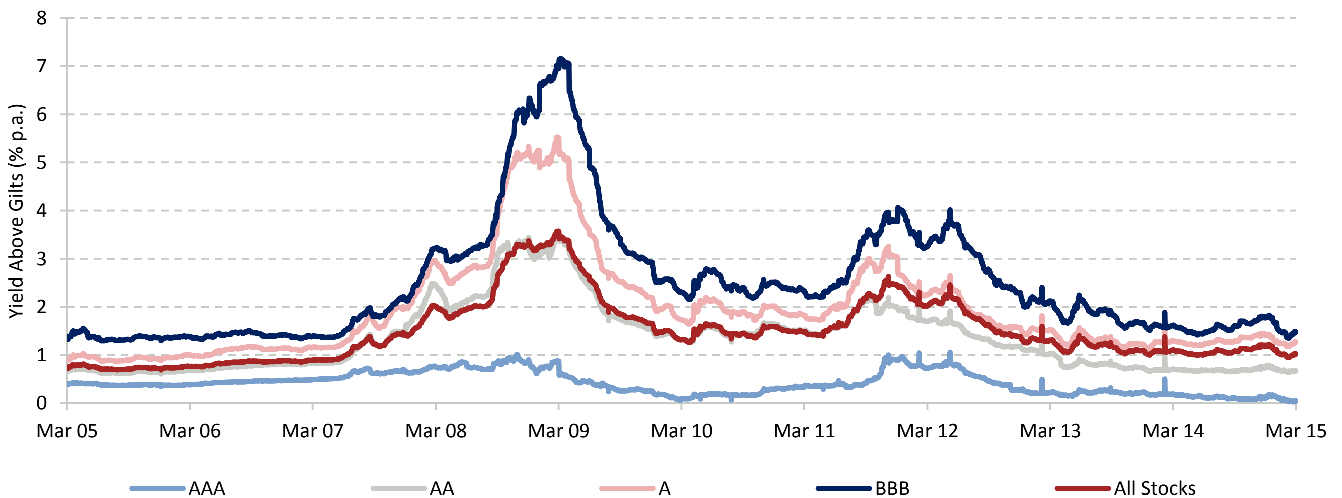
Property sector performance – 10 years to 31 March 2015



UK government bond yields – 10 years to 31 March 2015



Corporate bond spreads above government bonds – 10 years to 31 March 2015



Economic statistics

Economic statistics as at:	31 March 2015			31 December 2014			31 March 2014		
	UK	Europe[1]	US	UK	Europe[1]	US	UK	Europe[1]	US
Annual Real GDP Growth[2]	2.4%	1.8%	3.0%	3.0%	1.8%	2.4%	2.7%	1.5%	1.9%
Annual Inflation Rate[3]	0.0%	-0.1%	-0.1%	0.5%	-0.2%	0.8%	1.6%	0.5%	1.5%
Unemployment Rate	5.6%	11.3%	5.5%	5.8%	11.4%	5.6%	6.9%	11.7%	6.6%
Manufacturing PMI[4]	54.0	52.2	55.7	52.7	50.6	53.9	55.1	53.0	55.5

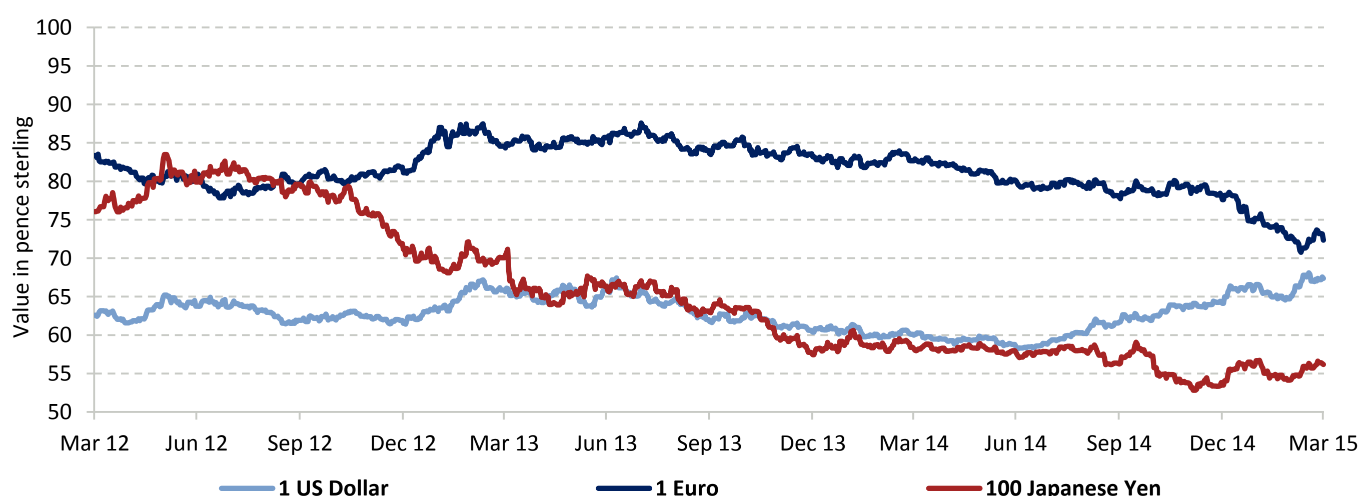
Change over periods ending: 31 March 2015	3 Months			12 Months		
	UK	Europe[1]	US	UK	Europe[1]	US
Annual Real GDP Growth[2]	-0.6%	0.0%	0.6%	-0.3%	0.3%	1.1%
Annual Inflation Rate[3]	-0.5%	0.1%	-0.9%	-1.6%	-0.6%	-1.6%
Unemployment Rate	-0.3%	-0.2%	-0.1%	-1.1%	-0.5%	-1.0%
Manufacturing PMI[4]	1.3	1.6	1.8	-1.1	-0.8	0.2

Notes: 1. Euro Area 19 Countries. 2. Euro GDP is lagged by 1 quarter. 3. CPI inflation measure. 4. Headline Purchasing Managers Index.
Source: Thomson Reuters, Markit, Institute for Supply Management, Eurostat, United States Department of Labor and US Bureau of Economic Analysis.

Exchange rates

Exchange Rates	Value in Sterling (Pence)			Change in Sterling	
	31 Mar 2015	31 Dec 2014	31 Mar 2014	3 months	12 months
1 US Dollar is worth	67.36p	64.13p	59.98p	-4.8%	-11.0%
1 Euro is worth	72.35p	77.61p	82.67p	7.3%	14.3%
100 Japanese Yen is worth	56.17p	53.49p	58.24p	-4.8%	3.7%

Exchange rate movements – 3 years to 31 March 2015



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

2 Market Commentary

Introduction

Markets generally were quietly positive in January and February, but since the beginning of March have begun to diverge.

The effect of Quantitative Easing can be strongly seen in Japan (equities up 16.4% in sterling terms over the quarter) and, recently, in Continental Europe (+10.8%). Asia's rise has been on the back of the increase in Japan.

However, concerns about the US economy and corporate earnings have limited the rise in the US equity index to 6.4% (albeit after briefly hitting new all-time highs) and in the UK, of course, the imminent election has apparently outweighed better economic news.

Albert Einstein once said he '*used to go away for weeks in a state of confusion*'.

Markets have been concentrating on the actions of Central Banks, on their pronouncements – especially the Federal Reserve – and the liquidity flowing from them.

Investors have been ignoring the prospects for deflation, the undeclared currency wars around the world (with every major country trying, officially or unofficially, to depreciate their currency against the US dollar), and rising volatility in bond markets.

Investors have also seemingly ignored the brinkmanship in Europe concerning Greece and the latest flare-up in the Middle East – between Yemen, Saudi Arabia and Iran – which has the potential to develop in something much more serious.

So a positive quarter, but with equity markets performing almost in a vacuum, rising because of low interest rates and Quantitative Easing in Japan and the Eurozone.

United Kingdom

- As this report is being written we are part way through the General Election campaign, making comments even more problematic than usual.
- First the good news – the economy is continuing to thrive.
- Factory orders are expanding at the fastest rate in eight months. Manufacturing has been growing every month for two years. Exporters have been seeing a rise in orders from the US, China, Germany and the Middle East. Inflation has reached zero (due to the falls in food prices and oil – both of major benefit to the consumer), with March seeing the weakest price growth since 1960. Job creation is continuing to rise.
- The overall economy grew in 2014 at the fastest pace for nine years (+2.8%) powered by the service sector and household spending (+3% is the current forecast for 2015). As a result the UK's top 100 companies briefly breached the previously unattainable 7000 level before falling back into its previous range.
- So is everything in the garden rosy? Not quite.
- The current – and future – problem is the trade deficit, which at 5.6% of Gross Domestic Product is the highest since records began in 1948.
- How to deal with this deficit is one of the major points of difference between the parties ahead of the election, with possibly profound effects on the market under the next government – of whatever hue.
- In 4 of the past 5 elections the index swung sharply in the three months after the election, not before. This time is unlikely to be different.
- The result is impossible to predict, with another coalition the most likely outcome at the time of writing. But who will combine with whom? And at what cost? All parties will be wary of a repeat of 2010, when the Liberal Democrats seized

the opportunity of being in power, only to see much of their popularity disappear as a result. Should UKIP win enough seats to be able to make demands, the price will be an early in-out referendum on European Union membership, which will unsettle investors even more. Should the Scottish National Party make a formal or informal agreement with the Labour Party, the constitutional consequences could be profound.

- The whole process could be messy – and time consuming. A minority government is a possibility. The last occasion was in February 1974, but Harold Wilson had the luxury of being able to call a second election in October which he then won with a small, but workable, majority. This is still an option, but the Fixed Term Act would somehow have to be repealed first.
- 'Foreigners slash gilts exposure at record pace' is a recent newspaper headline. This has always been the danger as the election approaches. Sterling, too, could come under severe pressure. Should this happen, the Bank of England's reaction will be key. In the past interest rates would have been raised to protect the currency. But in the modern world?
- The UK equity market is underpinned by rising corporate profits and dividends, and does not look overly expensive, but the election result could change this, at least in the short term.

Europe ex UK

- Quantitative Easing has been put in place in the Eurozone at a rate of £44bn per month, and is due to last until September 2016 – in theory. Interest rates are also expected to remain low for the same period (although, like the Federal Reserve, the European Central Bank has a history of raising rates too early – most recently in 2008 and 2011).
- So far the result has been the same as in the US, Japan and the UK. The currency has weakened, corporate profits are being forecast to rise – and equity prices have shot up to new highs (all-time highs in Germany).
- Only time will tell whether deflation, Japanese style, has been averted and whether economic growth will pick up from its current anaemic levels. If volatile elements, for example the oil price, are stripped out, 'core inflation' is the lowest ever. Some confidence surveys are showing signs of improvement as consumers become more optimistic, so perhaps 2015 will for once prove forecasts of growth to have been too pessimistic.
- Overriding everything is Greece, which investors in equities (and bonds) have been blithely ignoring on the expectation that 'it will be alright on the night' – another compromise will be agreed, postponing a resolution still further. However, there is no getting away from the fact that Greece appears bankrupt and has done since 2010, a default, which would be the first in a developed country, will come at some stage. 'Grexit' (Greece Euro exit) still has a high, and rising, probability.
- Who will blink first? The only radical left government in Europe in the modern era is flexing its muscles, now having discussions with Russia (and Iran, if rumour be true) on possible assistance. The geo-political consequences could be far reaching for NATO and the west. Russia (and the Orthodox Church) has been a ready ally since Tsarist times and the initial Greek independence, so this is nothing new.
- The European Central Bank, the International Monetary Fund and the German (and even more so, the Spanish) governments are all being hard-line on discussions. The Greeks have several significant repayments due in the near future (the first has been paid on schedule, somehow) and few surplus funds. Cash, where possible, is being used to pay wages and pensions, and, to quote Shaw again, '*a government that robs Peter to pay Paul can always depend on the support of Paul*'. In this instance Greece's creditors are Paul.

North America

- Everyone in the US has become a Fed-watcher, waiting with bated breath for the latest publication of Minutes or the latest speech from Janet Yellen (or one of her colleagues). All are trying to predict the timing of the first (small) interest rate rise, and opinions change almost daily.
- George Bernard Shaw once opined '*if all the economists were laid end to end, they'd never reach a conclusion*'.

- The facts on the economy are becoming less reassuring.
- Manufacturing growth slowed in March to its lowest pace in almost two years, partly due to the weather (always a ready excuse) but mainly due to the strength of the currency and still relatively weak growth abroad. New orders have been particularly affected, led by the rapid slowdown in the oil and gas industry. The most recent rise in the non-farm payroll was also much smaller than forecast, ringing more alarm bells.
- Corporate earnings estimates for 2015 have been reduced, and the first quarter figures – due shortly – may show a fall year-on-year for the first time since the 2008 crisis. They will be skewed by the energy sector, of course, where the fall in the oil price is having a severe impact (just the result the Middle Eastern countries that engineered the fall wanted, presumably).
- The fall in the oil price has had some beneficial effects on inflation, now nearing zero, and on the consumer. There has been a rise in consumer expenditure across the winter, but not significantly.
- With such a back-drop it seems most unlikely that interest rates will rise anytime soon, unless activity picks up again and recent numbers are an aberration. What worries markets and investors is that the Federal Reserve will increase rates too quickly, perceiving a problem that doesn't exist. The Fed's history doesn't help – this mistake was made in 1937 (and several times since) with disastrous outcomes on all occasions.
- The market is likely to become more volatile, especially if the upcoming results season proves disappointing, and the risks – at least in the short term – appear to have increased.
- In the long term Wall Street has usually been the most resilient equity market.

Japan

- The Japanese market was the best performer of the major developed regions in the first quarter of 2015, even denominated in Sterling, as continuing Quantitative Easing pushed up asset prices – as seen elsewhere. The Nikkei index has been regularly hitting new 15 year highs.
- Abenomics has been in place for two years. Share prices have doubled and the yen has depreciated significantly – both prime objectives for policymakers – but elsewhere the effect so far has been muted.
- Economic data remains mixed. Industrial production is rising, but so too is unemployment and retail sales have fallen. Overall economic growth forecasts have been downgraded.
- One bright spot is wages, which are showing a larger increase than last year (semi-annual bonuses have already been rising) which may lead the Japanese consumer to spend more as prices are also, slowly, going up.
- The principal beneficiaries of QE have been Japanese corporations, due to the depreciating currency. Exports have risen sharply and profits have followed. Companies are also beginning to reward shareholders with buybacks, higher dividends and takeover activity (many are sitting on vast amounts of cash, which the government is threatening to tax).
- Longer term the structural reforms we have mentioned in previous reports are, as expected, proving hard to implement although Mr Abe, after his election success in December, now has plenty of time to try.

Asia Pacific ex Japan

- There is an old stock market adage – if the dollar is strong, Asia is weak. The first quarter somewhat disproved this notion with the region's indices rising 10% in aggregate.
- Despite the rising dollar, and its effect on the overseas borrowings of many Asian countries and corporations, there has been room for several major Asian monetary authorities to cut interest rates. China, India and Indonesia are prime examples, all trying to boost their economies.

- The Chinese government has lowered its growth forecast for this year to 7%, and even this may be optimistic. The anti-corruption drive that has been hitting the headlines has not helped, with many state-owned enterprises being investigated leading to stagnation in business activity in some areas.
- The new Indian government's recent budget was well received and reform is beginning to accelerate. Throughout the region (including Japan) there is a realisation that Asia has been lagging in corporate governance and suffers from ingrained social attitudes, and governments are attempting to change both. It will take time but initial signs are encouraging.
- There are still concerns that an even stronger dollar, perhaps following an interest rate rise, could lead to a repeat of the 1997/98 crisis. Countries are in a better economic shape than then, but overseas indebtedness has also risen sharply that the situations need to be watched closely.

Emerging Markets

- The index as a whole rallied in the first quarter, up just over 7% (although this masks widely different performances from individual countries), as continuing Quantitative Easing in Japan and the initiation of QE in Europe overflowed into other markets. Sentiment was also helped by an easing of tensions in the Ukraine and a rally in the price of oil.
- Contrary to expectations, investors have also experienced monetary easing in many areas. China, India and Indonesia have been mentioned above, but Turkey and Russia have also followed suit. Others are in a position to do something similar.
- Exports have somewhat benefited from the economic growth being seen in the US and the UK, and if the Eurozone does pick up this year there could be an additional boost. The main problem is commodity prices, which show no signs of stabilising, let alone rising. Emerging Markets' currencies have weakened in the last year against the dollar, but as the Euro and the Yen have depreciated even more, competitiveness has actually declined. Exports have not risen as much as in the past under similar circumstances.

Fixed Income

- Bond markets (government and corporate) have experienced greater volatility of late as investors have reacted to every statement from the Central Banks in the US, the UK, Japan and – most importantly in recent weeks – the Eurozone. This volatility is likely to increase as the year progresses and interest rate rises in the US and the UK come closer.
- But when? In the US, conventional wisdom has expected the first increase in June. This was then pushed out to September. With the latest economic news proving somewhat disappointing, some commentators are now suggesting any rise could now be postponed until 2016.
- In the UK, the increase pencilled in for late 2015 could also be postponed – but this is likely to depend on the outcome of the General Election.
- The numbers are very strange. Four years ago, Irish 10 year bonds yielded 14%, now the yield is 0.8%. Finland, Germany and Switzerland, along with some companies in Europe, are issuing bonds at negative interest rates for the first time.
- And Greece seems closer to defaulting now than in 2011.
- An additional problem, already being seen in some markets is liquidity – or more specifically the lack of it. Changes to the rules have led to a reduction in the number of market-makers (who brought buyers and sellers together, and held bonds themselves as inventory to facilitate deals) and some asset managers are already finding it difficult to trade in any volume.
- Should investors reverse their stance and try to exit fixed income markets in any size, the result could be dramatic.

Alternatives

- Hedge Funds (in sterling terms) experienced a strong quarter with all strategies delivering positive returns. Global Macro was the best performing strategy, continuing its recent rally with a 3 month return of 8.5% and a 12 month return of 22.8% which helped to support a strong year of growth for hedge funds overall (+16.4%). Over the first quarter of 2015, hedge funds posted the highest quarterly performance since the first quarter of 2013.
- Despite a slowing in performance levels from Q4 2014, UK Property provided attractive returns over Q1 2015. Office and industrials were the leading sectors, particularly Offices in Central London, while the retail sector continues to lag behind. As at the end of March 2015, the annual property yield stood at around 6.0%.
- It was another volatile quarter for the commodity markets. Commodities registered a loss of 3.6% and 33.0% over the quarter and 12 months respectively. Continued dollar strength remained a major headwind for the commodities at large. The biggest casualty in the first quarter across the commodity spectrum was iron ore which fell more than 30% as new Australian supply came on board while the demand was already slack on back of a subdued Chinese property market. While the oil price struggled to find a floor, Gold was one of the best performing commodities, defying dollar strength to end the quarter flat.

Conclusion

We expect the global economic recovery to continue, albeit slowly, and possibly boosted by an eventual pickup in Eurozone activity.

With oil prices remaining low, there is little likelihood of any acceleration in inflation, so interest rates should remain at ultra-low levels in many countries. However, in both the US and the UK a rate rise is expected at some stage – the arguments are about timing, not direction. Markets are likely to continue to react, positively and negatively, to any hint from Central Banks of what they intend to do.

Wherever you look there are potential problems. Economic figures, and corporate profits in the US, could disappoint. In the UK, the election result could lead to a period of instability. The Eurozone still has to bite the bullet and come up with a solution to the Greek crisis (and potential deflation). And in Asia, growth forecasts in China and Japan need to be watched closely.

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