# CLWYD PENSION FUND

## ECONOMIC AND MARKET UPDATE
## PERIOD ENDING 30 SEPTEMBER 2016

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# 1 MARKET BACKGROUND
# PERIOD ENDING 30 SEPTEMBER 2016

## MARKET STATISTICS

| Market Returns Growth Assets | 3 Mths % | 1 Year % | 3 Years % p.a. |
|---|---|---|---|
| UK Equities | 7.8 | 16.8 | 6.6 |
| Global Developed Equities | 8.0 | 30.6 | 14.6 |
| USA | 7.0 | 34.2 | 19.3 |
| Europe | 9.1 | 21.8 | 8.0 |
| Japan | 12.1 | 31.3 | 12.2 |
| Asia Pacific (ex Japan) | 12.4 | 38.2 | 10.7 |
| Emerging Markets | 12.3 | 36.7 | 7.4 |
| Frontier Markets | 5.7 | 18.2 | 7.9 |
| Property | -2.3 | 4.2 | 12.9 |
| Hedge Funds | 5.9 | 22.3 | 11.0 |
| Commodities | -1.4 | 2.4 | -16.2 |
| High Yield | 8.3 | 31.6 | 12.3 |
| Emerging Market Debt | 4.0 | 16.2 | 8.2 |
| Senior Secured Loans | 3.1 | 5.7 | 4.7 |
| Cash | 0.1 | 0.4 | 0.5 |

| Market Returns Bond Assets | 3 Mths % | 1 Year % | 3 Years % p.a. |
|---|---|---|---|
| UK Gilts (>15 yrs) | 4.2 | 23.0 | 16.0 |
| Index-Linked Gilts (>5 yrs) | 11.0 | 27.0 | 16.0 |
| Corporate Bonds (>15 yrs AA) | 8.8 | 26.0 | 14.2 |
| Non-Gilts (>15 yrs) | 10.1 | 25.8 | 13.6 |

| Exchange Rates: Change in Sterling | 3 Mths % | 1 Year % | 3 Years % p.a. |
|---|---|---|---|
| Against US Dollar | -2.8 | -14.2 | -7.1 |
| Against Euro | -3.9 | -14.8 | -1.1 |
| Against Yen | -4.1 | -27.5 | -6.1 |

| Inflation Indices | 3 Mths % | 1 Year % | 3 Years % p.a. |
|---|---|---|---|
| Price Inflation – RPI | 0.7 | 2.0 | 1.7 |
| Price Inflation – CPI | 0.5 | 1.0 | 0.7 |
| Earnings Inflation* | 0.4 | 2.3 | 2.0 |

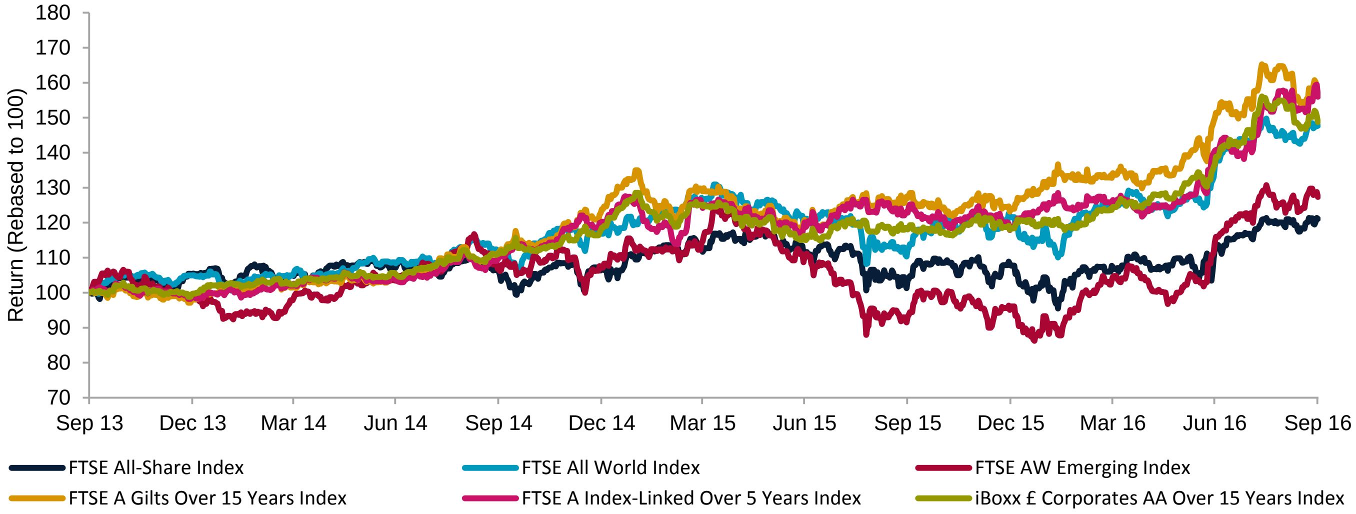
| Yields as at 30 September 2016 | % p.a. |
|---|---|
| UK Equities | 3.46 |
| UK Gilts (>15 yrs) | 1.42 |
| Real Yield (>5 yrs ILG) | -1.79 |
| Corporate Bonds (>15 yrs AA) | 2.22 |
| Non-Gilts (>15 yrs) | 2.60 |

| Absolute Change in Yields | 3 Mths % | 1 Year % | 3 Years % p.a. |
|---|---|---|---|
| UK Equities | -0.20 | -0.25 | 0.05 |
| UK Gilts (>15 yrs) | -0.19 | -0.96 | -1.99 |
| Real Yield (>5 yrs ILG) | -0.40 | -0.95 | -1.75 |
| Corporate Bonds (>15 yrs AA) | -0.53 | -1.40 | -2.09 |
| Non-Gilts (>15 yrs) | -0.59 | -1.36 | -1.91 |

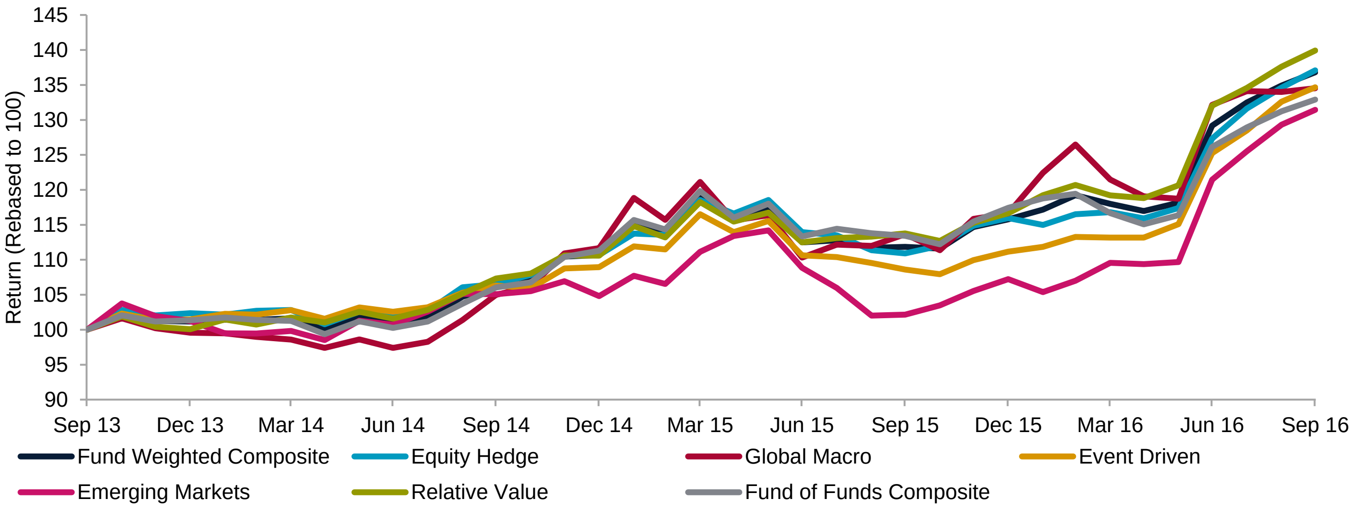
**Source**: Thomson Reuters and Bloomberg
**Note:** * subject to 1 month lag

# MARKET SUMMARY CHARTS

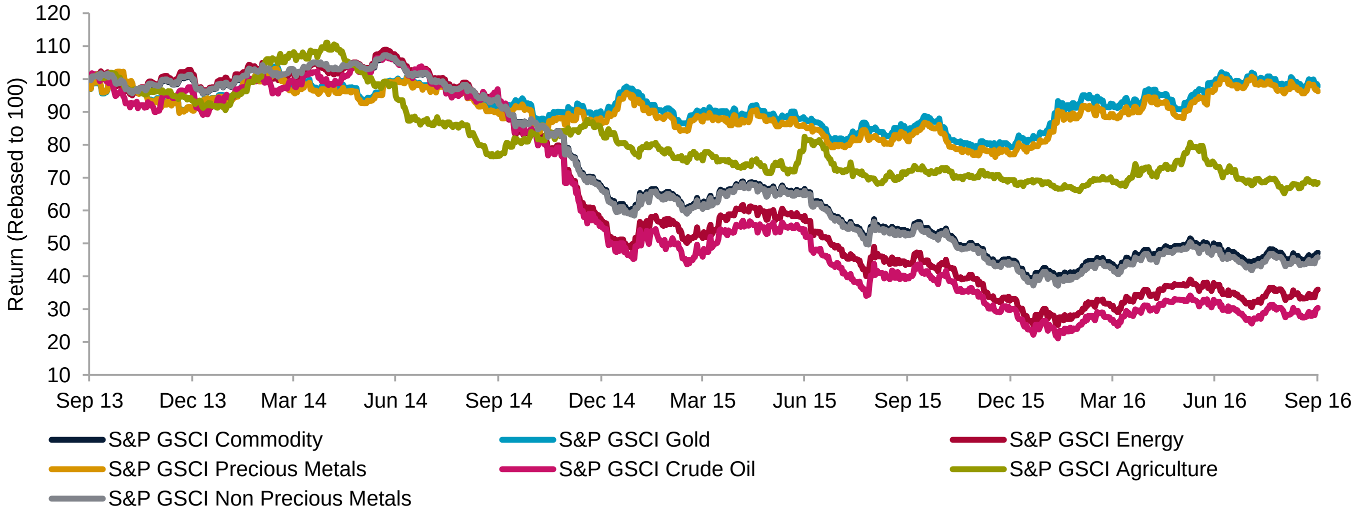
## Market performance – 3 years to 30 September 2016




## Hedge Funds: Sub-strategies performance – 3 years to 30 September 2016

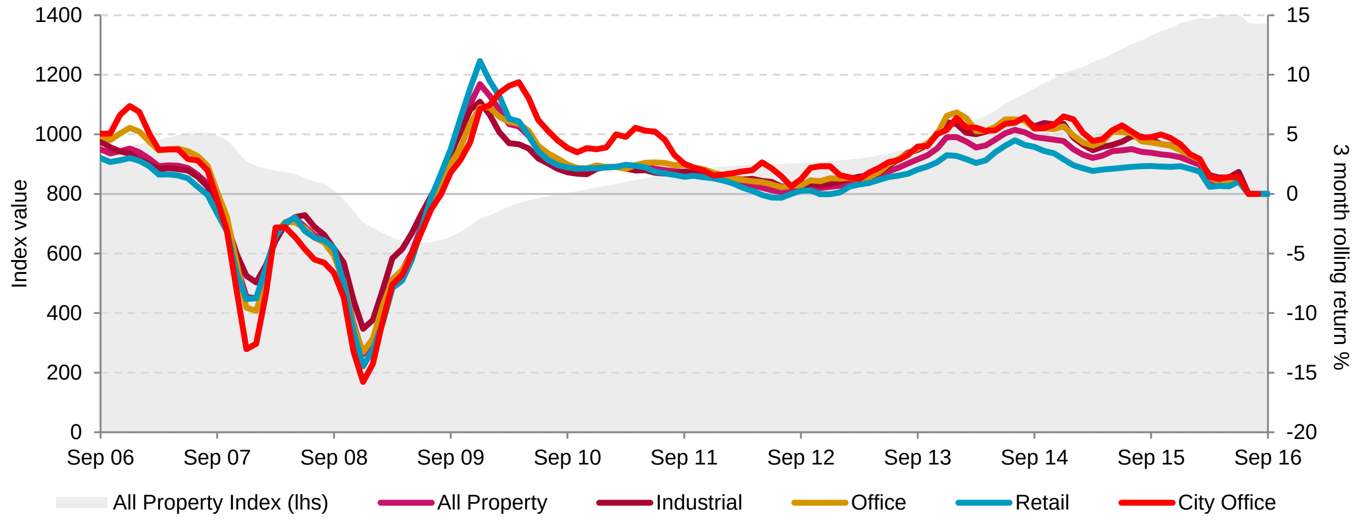



## Commodity sector performance – 3 years to 30 September 2016

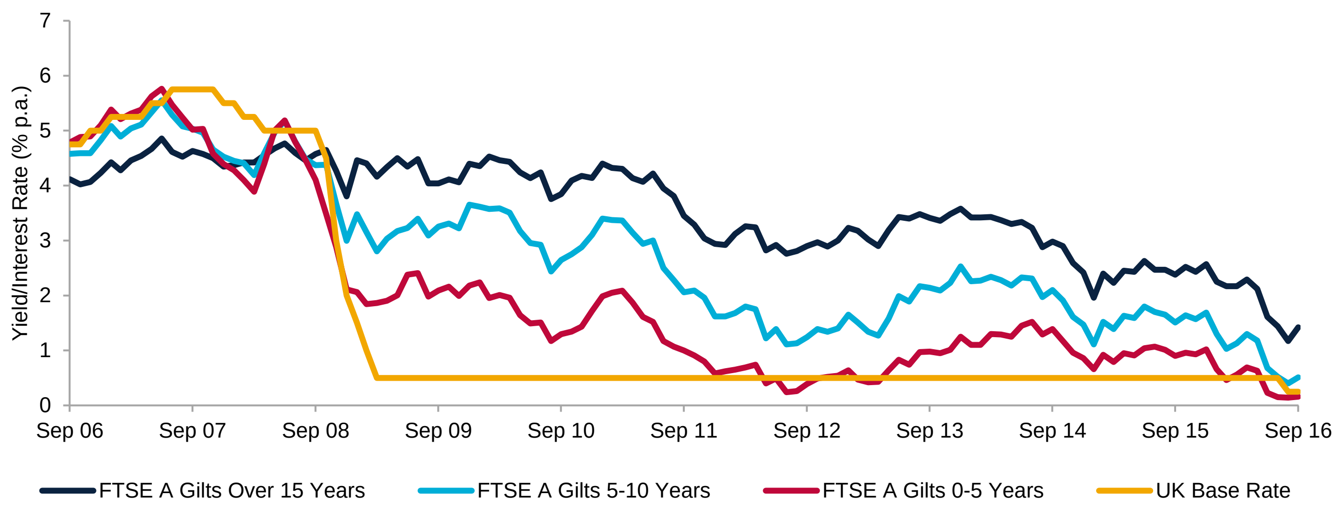



**Source**: Thomson Reuters

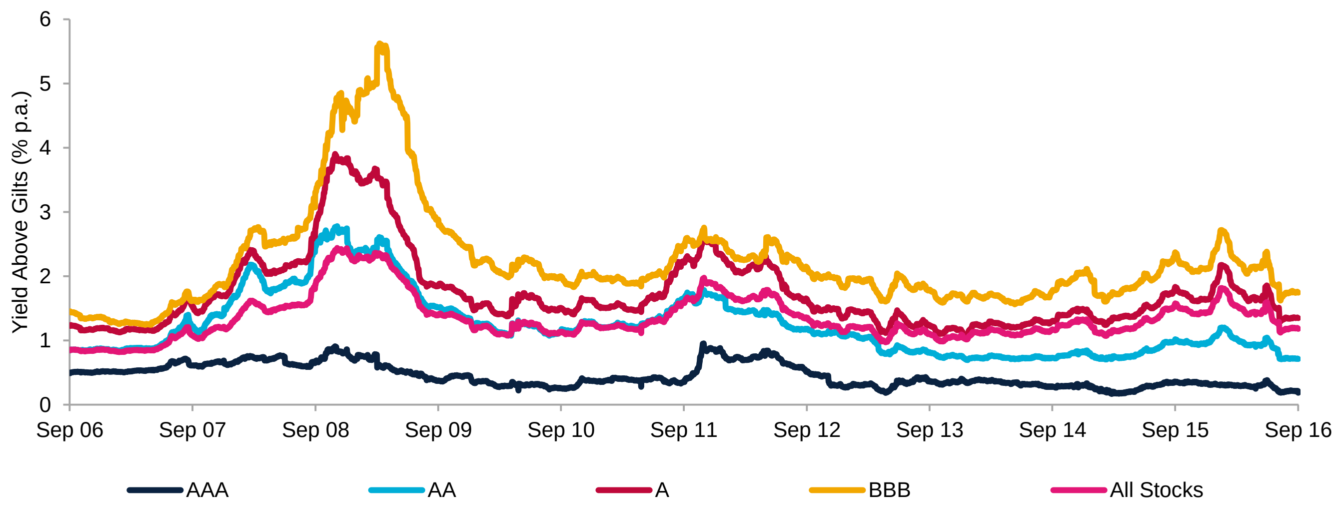
## Property sector performance – 10 years to 30 September 2016




## UK government bond yields – 10 years to 30 September 2016




## Corporate bond spreads above government bonds – 10 years to 30 September 2016




**Source**: Thomson Reuters

# 2 ECONOMIC STATISTICS

| Economic Statistics as at: | 30 Sep 2016 | | | 30 June 2016 | | | 30 Sep 2015 | | |
|---|---|---|---|---|---|---|---|---|---|
| | UK | Euro[1] | US | UK | Euro[1] | US | UK | Euro[1] | US |
| Annual Real GDP Growth[2] | 2.1% | 2.6% | 1.3% | 1.9% | 2.8% | 1.6% | 2.4% | 3.1% | 3.0% |
| Annual Inflation Rate[3] | 1.0% | 0.4% | 1.5% | 0.5% | 0.1% | 1.0% | -0.1% | -0.1% | 0.0% |
| Unemployment Rate[4] | 4.9% | 10.1% | 4.9% | 4.9% | 10.3% | 4.9% | 5.4% | 11.0% | 5.2% |
| Manufacturing PMI[5] | 55.4 | 52.6 | 51.5 | 52.1 | 52.8 | 51.3 | 51.5 | 52.0 | 53.1 |

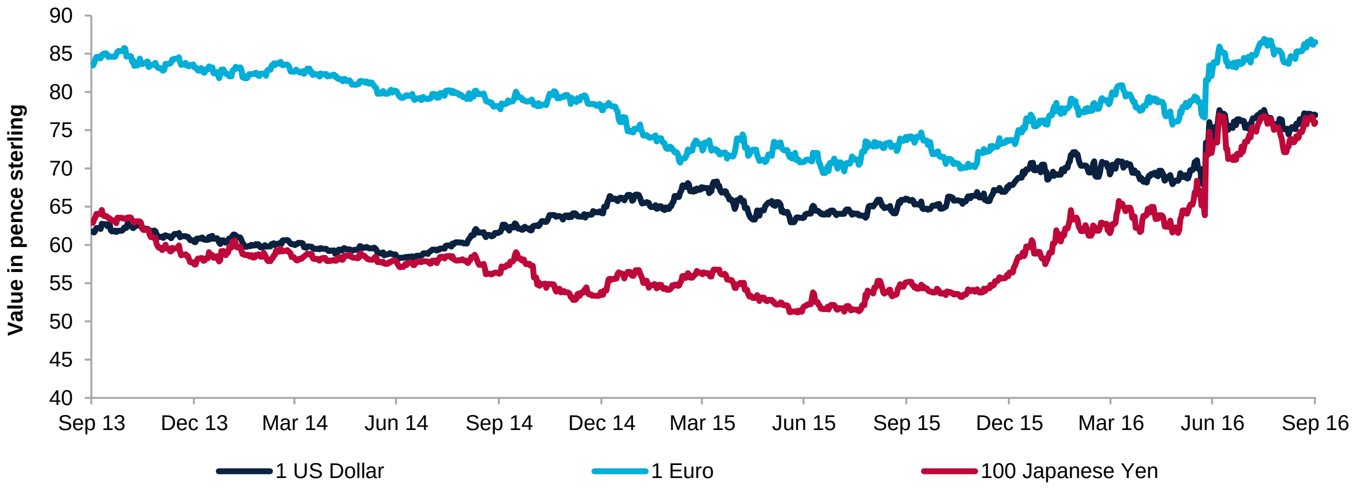
| Change over periods ending: | 3 months | | | 12 months | | |
|---|---|---|---|---|---|---|
| 30 Sep 2016 | UK | Euro[1] | US | UK | Euro[1] | US |
| Annual Real GDP Growth[2] | 0.2% | -0.2% | -0.3% | -0.3% | -0.5% | -1.7% |
| Annual Inflation Rate[3] | 0.5% | 0.3% | 0.5% | 1.1% | 0.5% | 1.5% |
| Unemployment Rate[4] | 0.0% | -0.2% | 0.0% | -0.5% | -0.9% | -0.3% |
| Manufacturing PMI[5] | 3.3 | -0.2 | 0.2 | 3.9 | 0.6 | -1.6 |

**Notes**: 1. Euro Area 19 Countries. 2. GDP is lagged by 1 quarter. 3. CPI inflation measure. 4. Euro unemployment is lagged by 1 quarter, 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 16 | 30 Jun 16 | 30 Sep 15 | 3 months | 12 months |
| 1 US Dollar is worth | 76.98p | 74.81p | 66.02p | -2.8% | -14.2% |
| 1 Euro is worth | 86.51p | 83.10p | 73.69p | -3.9% | -14.8% |
| 100 Japanese Yen is worth | 76.02p | 72.92p | 55.12p | -4.1% | -27.5% |

### Exchange rate movements – 3 years to 30 September 2016




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

# 3 MARKET COMMENTARY

## INTRODUCTION

A full quarter has elapsed following the UK's decision to leave the EU. Britain has a new Prime Minister in Theresa May and it has recently been announced that Article 50 will be triggered by March 2017, starting a formal two year negotiation period.

The UK equity market fell sharply after the vote, but has since recovered and driven higher. Sterling has been a major casualty, falling sharply on Brexit uncertainty and a quick lowering of interest rates by the Bank of England. The FTSE 100 has, however, benefitted immensely from the currency weakness, with the overseas earnings of the constituents receiving a boost from the fall in Sterling.

Gilts have experienced a strong quarter overall, but signs of exhaustion have crept in during September – something we haven't seen for many months.

Political events around the globe continue to grab our attention, in particular those in the US, where a Presidential election is almost upon us. The US electorate go to the polls in November; history tells us that equity markets are usually unaffected by the outcome, but this could be one of the exceptions.

The continued flow of Central Bank liquidity is providing fuel for equity markets, but the continual effects of monetary policy are now being questioned.

There are frailties, particularly among European Banks, and Japan has used up almost all of its ammunition to drive reform and investment. One key question is, how will risk assets react when the central bank liquidity 'drug' is withdrawn?

Fundamentals are being ignored and that is of concern, but many would say that fundamentals have been ignored for many a year.

Interesting decisions again lay ahead and uncertainty remains, but markets, both equity and fixed interest, have surfed the liquidity wave.

## UNITED KINGDOM

- Brexit understandably continues to dominate conversations and media attention in the UK. At the time of writing the last review, there was a much higher level of political uncertainty in the UK. Things have settled slightly since Theresa May became Prime Minister and selected her Government. The opposition have re-confirmed their leader, Jeremy Corbyn, but still appear to be in disarray.
- Mrs May has now confirmed that Article 50 will be invoked by March 2017. Upon this announcement, markets once again reacted with Sterling falling and global companies in the FTSE 100 rising on the back of a beneficial weakness in Sterling to their earnings.
- There can be no doubt that the UK equity market and Sterling are still very Brexit sensitive despite the recent rise in the equity markets.
- The Bank of England base rate has been cut to 0.25% in what could now be considered by many as a knee-jerk Brexit reaction.  The annual UK inflation rate (CPI) has risen marginally and the increase can primarily be attributed to items that typically respond quickly to exchange rate movements, such as fuel and alcoholic drinks.
- UK equities performed well in August and held ground in September as the market upheavals of June and July moderated. The Bank of England launched a series of monetary easing measures in the wake of economic

uncertainty following the UK's vote to leave the European Union. Investors however, continued to look for indications of the Brexit impact.

- Since the day of the EU referendum vote, the FTSE 100 has prospered. The index was initially hit hard in the first couple of trading sessions following the vote, but took less than a week to recover its losses. Also, the domestically focused FTSE 250 index recovered, and is above its pre-Brexit trading level.
- The ongoing weakness in Sterling could well help the FTSE 100 hold on to its gains. The interest rate cut and an expanded stimulus package, in all likelihood, should help leading shares, and keep the pressure on Sterling. But with the continuing political uncertainty and the prospect of some crucial negotiations between the UK and the EU about their future association, there is likely to be continuing volatility in the market.
- The FTSE 100 represents the largest companies in the UK by market capitalisation, but they do not necessarily reflect the strength of the UK economy. The lack of exposure to the UK has shielded many large cap stocks, largely due to the fall in Sterling. The FTSE 100 (an index measured in Sterling but with a substantial proportion of US Dollar earnings and dividends) has increased substantially since June 24, as the market has revalued shares higher, pricing in greater earnings from the currency uplift.
- The advantages of a weaker currency, accommodative monetary policy and potential interest rate cuts in the near future, should be supportive of the UK equity markets.

## EUROPE EX UK

- Amongst the big four nations, Germany witnessed a deceleration in growth with output rising at the slowest pace in fifteen months. Spain posted encouraging data with the growth rate rising to a two month high. France finally moved into expansionary territory with growth accelerating to a ten month high. Initial indicators are signalling that the period of sustained job creation over the past eight years might finally be ending. The rate of employment growth slowed to a three month low backed by a slowdown in hiring, by both manufacturers and service providers. Germany, Italy and Spain experienced a slowdown in employment growth rates while France posted job losses.
- The current market conditions might portray an illusion of calmness with volatility nearing all time lows. However, a range of political risks, lacklustre economic growth and a fragile banking system threaten to disrupt the tranquillity in the markets.
- A host of political events are brewing across the Eurozone, with the Brexit vote having encouraged right-wing parties in the Netherlands and France who want to follow in the UK's footsteps and leave the EU. Italy is a hotbed for concern with the constitutional referendum to be held this autumn taking centre stage. This, coupled with the teetering banking sector could have the capacity to inflict some damage.
- Investors, who are already erring on the side of caution after the Brexit vote are now increasingly becoming concerned on the health of Europe's banking sector. Banks are being dragged down by weak earnings, high levels of non-performing loans and a negative rate environment. While the ECB has tried to calm the markets by conducting stress tests, investors are clearly reading between the lines.
- Concerns over Deutsche Bank's finances and the company's ability to handle a large US Department of Justice fine of £14bn have put further pressure onto the banking sector.
- The Eurozone continues to post strong data on the macroeconomic front, however the potential political risks facing the region threaten to derail the current market rally. The ECB continues to use almost every tool at its disposal in order to support the economy and support inflation. These efforts are appearing to yield results with inflation moving further into the positive territory since June.
- The short term performance of Eurozone equities will continue be dependent on the resilience of EU companies to potentially volatile political and economic conditions.
- It is unlikely that the European economy will escape completely unscathed over the coming months.

## NORTH AMERICA

- The US is deep into election campaigning season ahead of the November Presidential elections. This is undoubtedly the major local and indeed global topic and much has been said and written about the potential candidates. Historically, the change in President has had little effect on markets and their valuations but could this time be different?
- The US market has had a strong third quarter and potential interest rate rises will be important when assessing the short term value of the asset class. The tone of the Federal Reserve speakers has been key and every word monitored for an indication of their intentions. Macroeconomic data, particularly those in the employment market, have remained strong. While this started to build up a case for a rate hike, the latest macroeconomic releases possibly indicate that the level of improvement that was gauged by previous releases may have been inadequate. Key data points include the lower than expected non-farm payroll data, manufacturing data (which pointed towards the fact that the turnaround in the manufacturing sector may not be as robust as expected and the picture for non-manufacturing industries may not be as rosy) and consumer sentiment data (which has slumped in the last few months) released by the University of Michigan.
- Despite these recent data releases, the US economy is showing signs of improved life. Improving employment numbers and better than expected earnings could drive a potential rise in interest rates in the latter part of this year, although the chances of this appear to be reducing. Nonetheless the equity market may react to any indication of a rate hike.
- Some concerns remain that valuations are rich, but the high quality and more defensive nature of the US market makes it attractive to hold and arguably supports a higher than average valuation to the rest of the world.
- With all these mixed signals, the S&P500 continues to maintain its record levels. Fundamentals are not driving this market - the central bank liquidity push is fuelling this “risk-on” environment.

## JAPAN

- Japanese equities have seen massive outflows this year and domestic investors have invested record amounts of money in foreign assets. Despite this the Yen has appreciated significantly this year.
- Despite the poor performance of Japanese exports this year, equities have continued to rise, albeit at a subdued pace compared to other global indices.
- The combination of a strong currency, low inflation and weak macroeconomic numbers are proving detrimental for Japanese equities. Japan faces large challenges, namely deteriorating demographics, which have sapped productivity growth and a government debt burden that amounts to c.229% of GDP. Despite low interest rates, companies are holding cash rather than investing it because the demand outlook is so poor. The slowdown in China and falling energy prices have exacerbated the underlying structural weaknesses that are keeping economic growth and inflation low.
- The challenges facing Japan would indicate that more stimulus measures are warranted from the authorities, but the Bank of Japan is approaching the limits of known policy effectiveness. There is a high probability that the next move from the Bank of Japan or Prime Minister Abe will be bold or that Abe honours his promise on meaningful fiscal stimulus action in the autumn, which could prove beneficial in the near-term for Japanese equities.

## ASIA PACIFIC EX JAPAN / EMERGING MARKETS

- Emerging markets have had a strong run off of their lows and have attracted a significant amount of assets. The high levels of inflow have been mainly on account of higher returns offered by emerging markets, stabilising commodity prices and also improved macroeconomic fundamentals in the emerging markets.
- Fading concerns over China’s growth following the stabilisation of the economy in the second quarter also buoyed investor sentiment. The outlook for India’s economy remains favourable - the passing of the Goods and

Services Tax (GST) bill is being viewed as a sign of commitment to reform and fiscal consolidation. Elsewhere, with the recent appointment of a business friendly President, the business climate in Brazil has been optimistic.

- Also, tensions between Russia and the West have eased to an extent. The Mexican economy too saw improved GDP growth and also received assurance from the Mexican Central Bank about the recovering economy that buoyed market sentiments.
- Recent cabinet changes in Indonesia increase the prospects for reforms such as anti-corruption measures. Supportive monetary policy, fuel price deregulation and infrastructure spending is also likely to support the Indonesian market in the months to come.
- On the flip side, the South African market has fallen with the Rand depreciation amplifying declines. This was a result of press reports that the Finance Minister was set to face charges related to his former role as Chief of the South Africa Revenue Service.
- We continue to believe that Emerging Market equities will remain attractive in the medium-term owing to stabilising commodity prices, recovery in China's growth momentum as well as waning risks in other countries, especially in Latin America.
- However, in the long term, the geo-political tensions in Turkey continue to be a concern. In addition, if the US Federal Reserve raises rates, a subsequently rising US Dollar will prompt further fund flows out of emerging markets and exacerbate already existing problems faced by companies with US Dollar debt. Concerns over a slowdown in China continue to remain a dominant factor in the trends affecting the Asia Pacific region. Weak external demand and US policy normalisation are expected to be headwinds for the economies in this area.
- Emerging markets are trading at a significant discount and continue to look attractive versus their developed market peers on a pure valuation basis. In the short-term, the rally in emerging markets is likely to continue because of the weaker US Dollar and improved data from China. Investors' sentiment towards the area has improved and if currencies continue to gain ground and we see some firming in commodity prices, we could see this asset class attracting further capital inflows.

## FIXED INCOME

- Fixed income assets have broadly delivered exceptionally strong returns in 2016 so far, however the last month of this quarter has seen a reversal in valuations. Sterling denominated bonds have seen pressure following Brexit as foreign investors consider the implications of a weaker Sterling.
- Gilts however still remain a significant beneficiary of flights to safety, as investors digest the implications of Brexit. Yields remain low and capital prices show little value at these levels, but further interest rate cuts, an extension of the Quantitative Easing programme or even further debt issuance could all be catalysts for gilt prices to rally.
- From a corporate perspective, Company balance sheets remain in relatively good shape and default levels are not an issue currently. Since the announcement of the stimulus package by the Bank of England, corporate bond yields have fallen significantly.
- Given the demand for safe haven assets combined with the bond purchases by the Bank of England and extraordinarily low interest rates, we expect to see gilt yields relatively compressed for some time to come.
- Demand is strong for index-linked gilts, with very little liquidity particularly on shorter dated issues. The outperformance of index-linked gilts when compared to conventional gilts can be attributed to the increasing expectations of an inflation tick-up in the coming months.
- With the involvement of Central Banks, any additional increase in inflation above the Bank's target would require a response, which may restrict the returns from index-linked gilts.
- Increasing oil production and higher inventories in the US could impose some downward pressure on oil prices, which may consequently increase default rates in the high yield market.
- The global economy continues to face headwinds with investors taking a flight to safety in the aftermath of Brexit. Global bond markets experienced a significant move upwards but the rumblings of a second US interest rate rise are growing, given the strength in the labour market.
- European bonds remain supported by European Central Bank (ECB) buying whilst a rising Euro will likely prove a headwind for inflation expectations.

- The Bank of Japan's bond-buying programme and negative interest rate policy have driven valuations into expensive territory.  Action by the Bank of Japan – including a pledge to aim for an overshoot of its inflation objective and adopting a 0% target for 10-year bond yields – appears to have had a short-lived effect which has left the big picture unchanged.  Scepticism about the effectiveness of unconventional central bank actions remains very much in the backdrop.

## ALTERNATIVES

- Hedge Fund capital rose to a record level of $2.972 trillion over the quarter, beating its previous record of $2.969 trillion set in the second quarter of 2015. The record total capital level was partially offset by the fourth consecutive quarter of investor outflows, as redemptions increased to $28 billion, the largest quarterly outflow since the second quarter of 2015. Investor outflows and liquidations were concentrated in several of the industry's largest and most well established firms.  Hedge Funds (in Sterling terms) returned 5.9% over the quarter; this was primarily due to the US dollar strengthening against Sterling, as hedge funds returned 2.9% in US dollar terms. In Sterling terms, Emerging Markets (+8.2%) were the strongest strategies, whilst Global Macro (+1.8%) were the worst performing.
- UK commercial property declined 2.3% over the quarter, the first quarterly decline since June 2009. The negative return over the quarter was mainly due to a reduction in capital values, which decreased by 3.6%. Rental income generated by the properties returned 1.4%. All sectors posted negative returns; Industrials declined by 0.7%, followed by retail and office sectors which decreased by 2.4% and 3.5% respectively. City offices were the worst performing sector, declining by 4.3%. As at the end of September, the annual property yield stood at 5.5%.
- Commodity prices continued to rise in the third quarter from their lows in early 2016. Within the energy sector, coal prices surged 30%, reflecting strong import demand and tightening supply in China following restrictions on production aimed at reducing pollution. Natural gas also increased by 21%, largely due to developments in the US; strong demand for air conditioning, falling production and increased exports to Mexico and South America. The agricultural price index remained virtually unchanged, however, the components of the index varied considerably. Metals prices continued to rebound from first quarter lows on supply constraints, rising demand and falling stocks. Precious metals prices rose 8% on the back of strong investment demand following the US Federal Reserve's delay of an expected interest rate increase. The Commodities index shown in the market background statistics is Sterling based and the return has been impact by the sharp depreciation of Sterling relative to the US$.

## CONCLUSION

Warren Buffet once stated "I will tell you how to become rich. Close the doors. Be fearful when others are greedy. Be greedy when others are fearful".

Undoubtedly challenges lay ahead, political uncertainties are prevalent both in the developed and the emerging world and central banks can change the investment landscape in an instant.

Brexit discussions will of course impact UK investors and the impact of changes in Sterling must be considered strongly at present, particularly when assessing overseas denominated assets and earnings.

# 4 INDICES USED IN THIS REPORT

| Asset | Index |
|---|---|
| **Growth Assets** | |
| **UK** | FTSE All-Share Index |
| **Global Developed** | MSCI World Index |
| **USA** | FTSE USA Index |
| **Europe** | FTSE AW Europe (ex UK) Index |
| **Japan** | FTSE Japan Index |
| **Asia Pacific (ex Japan)** | FTSE AW Asia Pacific (ex Japan) Index |
| **Emerging Markets** | MSCI Emerging Markets Index |
| **Frontier Markets** | MSCI Frontier Markets Index |
| **Property** | UK IPD Monthly Property Index |
| **Hedge Funds** | HFRI Fund Weighted Composite Index |
| **Commodities** | S&P GSCI TR Index |
| **High Yield** | Bank of America Merrill Lynch Global High Yield Index |
| **Emerging Markets Debt** | JPM EMBI Global Diversified Composite Index |
| **Senior Secured Loans** | Credit Suisse Western European Leveraged Loan Index |
| **Cash** | IBA GBP LIBOR 1 Week 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 (15yrs)** | 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** | All Items Retail Price Index (NADJ) |
| **Price Inflation – CPI** | All Items Consumer Price Index (Estimated NADJ) |
| **Earnings Inflation** | Average Weekly Index (Whole Economy excluding Bonuses) |
| **Exchange Rates** | |
| **USD/EUR/JPY vs GBP** | WM/Reuters 4:00 pm Closing Spot Rates |

Notes: All the indices above are denominated in Sterling

## CONTACT

KIERAN HARKIN
Director
+44 (0)161 957 8016
kieran_harkin@jltgroup.com

ANTHONY KERSHAW
Senior Consultant
+44 (0)161 253 1157
anthony_kershaw@jltgroup.com

ANTHONY WRAY
Consultant
+44 (0)161 253 1121
anthony_wray@jltgroup.com