CLWYD PENSION FUND

ECONOMIC AND MARKET UPDATE
PERIOD ENDING 31 DECEMBER 2016

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1 MARKET BACKGROUND
PERIOD ENDING 31 DECEMBER 2016

MARKET STATISTICS

Market Returns Growth Assets	3 Mths %	1 Year %	3 Years % p.a.
UK Equities	3.9	16.8	6.1
Global Developed Equities	7.2	29.0	15.1
USA	9.0	33.4	19.7
Europe	5.4	21.2	8.0
Japan	5.1	22.7	14.0
Asia Pacific (ex Japan)	0.9	28.7	11.0
Emerging Markets	0.8	33.1	7.8
Frontier Markets	5.7	23.0	8.4
Property	2.6	2.6	11.8
Hedge Funds	6.4	25.9	12.9
Commodities	11.2	32.8	-12.5
High Yield	5.6	36.9	13.8
Emerging Market Debt	0.0	32.9	4.8
Senior Secured Loans	1.6	7.4	4.5
Cash	0.1	0.4	0.4

Market Returns Bond Assets	3 Mths %	1 Year %	3 Years % p.a.
UK Gilts (>15 yrs)	-6.0	18.5	14.4
Index-Linked Gilts (>5 yrs)	-3.0	27.4	15.2
Corporate Bonds (>15 yrs AA)	-5.0	19.4	12.3
Non-Gilts (>15 yrs)	-5.3	18.5	11.7

Exchange Rates: Change in Sterling	3 Mths %	1 Year %	3 Years % p.a.
Against US Dollar	-4.9	-16.2	-9.3
Against Euro	1.3	-13.7	-0.9
Against Yen	9.6	-18.7	-6.1

Inflation Indices	3 Mths %	1 Year %	3 Years % p.a.
Price Inflation – RPI	0.8	2.5	1.8
Price Inflation – CPI	0.8	1.6	0.8
Earnings Inflation*	0.3	2.7	2.2

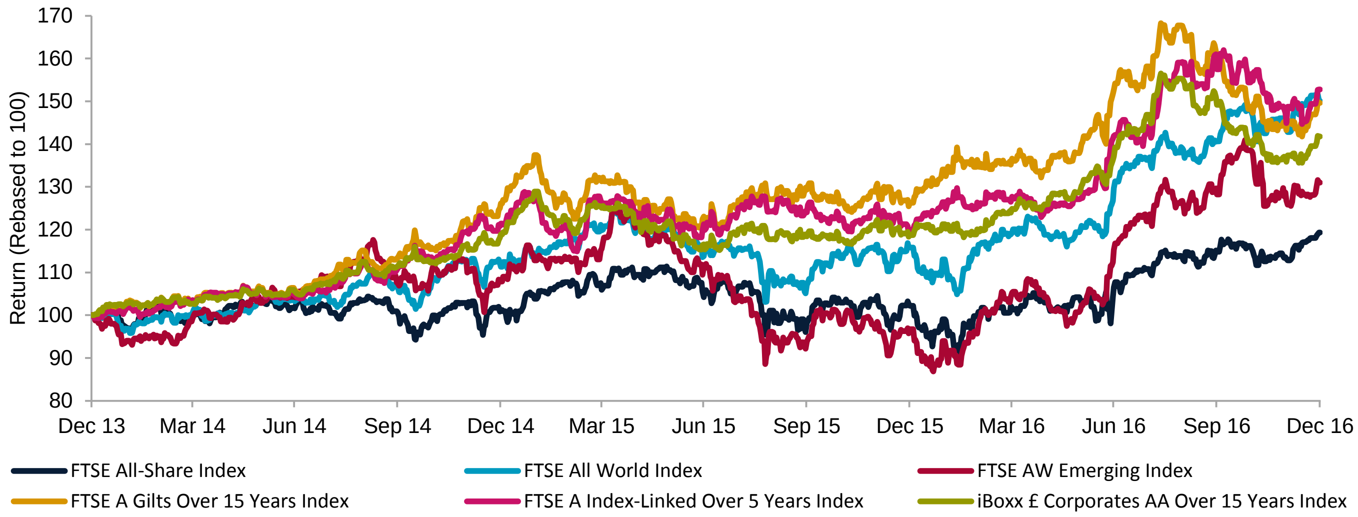
Yields as at 31 December 2016	% p.a.
UK Equities	3.47
UK Gilts (>15 yrs)	1.76
Real Yield (>5 yrs ILG)	-1.67
Corporate Bonds (>15 yrs AA)	2.62
Non-Gilts (>15 yrs)	3.01

Absolute Change in Yields	3 Mths %	1 Year %	3 Years % p.a.
UK Equities	0.01	-0.23	0.19
UK Gilts (>15 yrs)	0.34	-0.81	-1.82
Real Yield (>5 yrs ILG)	0.12	-0.96	-1.70
Corporate Bonds (>15 yrs AA)	0.40	-1.06	-1.80
Non-Gilts (>15 yrs)	0.41	-0.99	-1.62

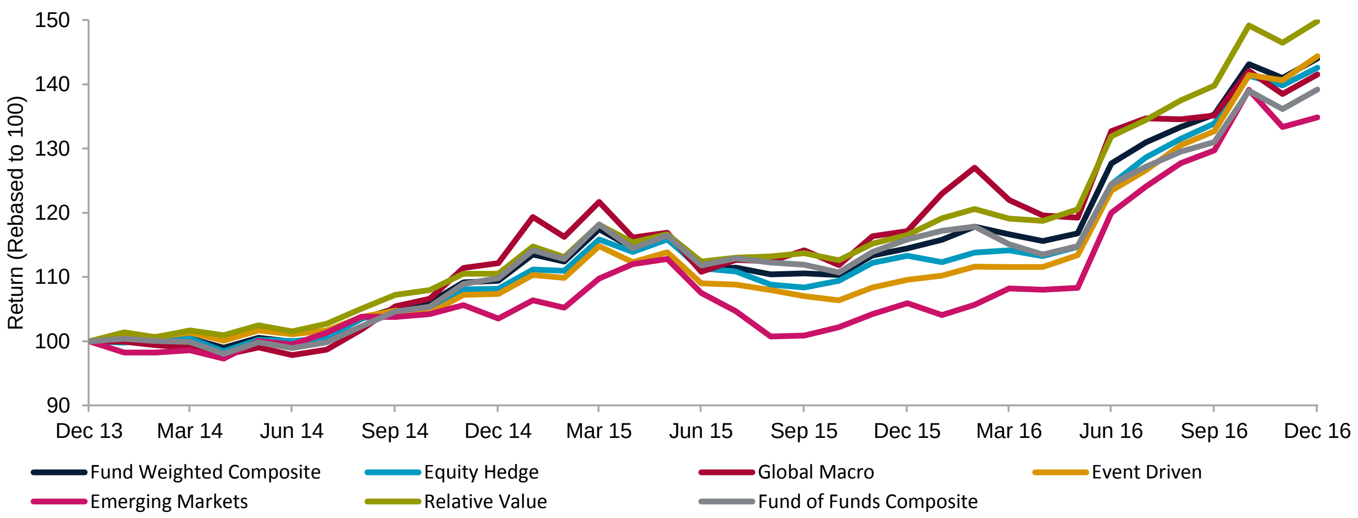
Source: Thomson Reuters and Bloomberg
Note: * subject to 1 month lag

MARKET SUMMARY CHARTS

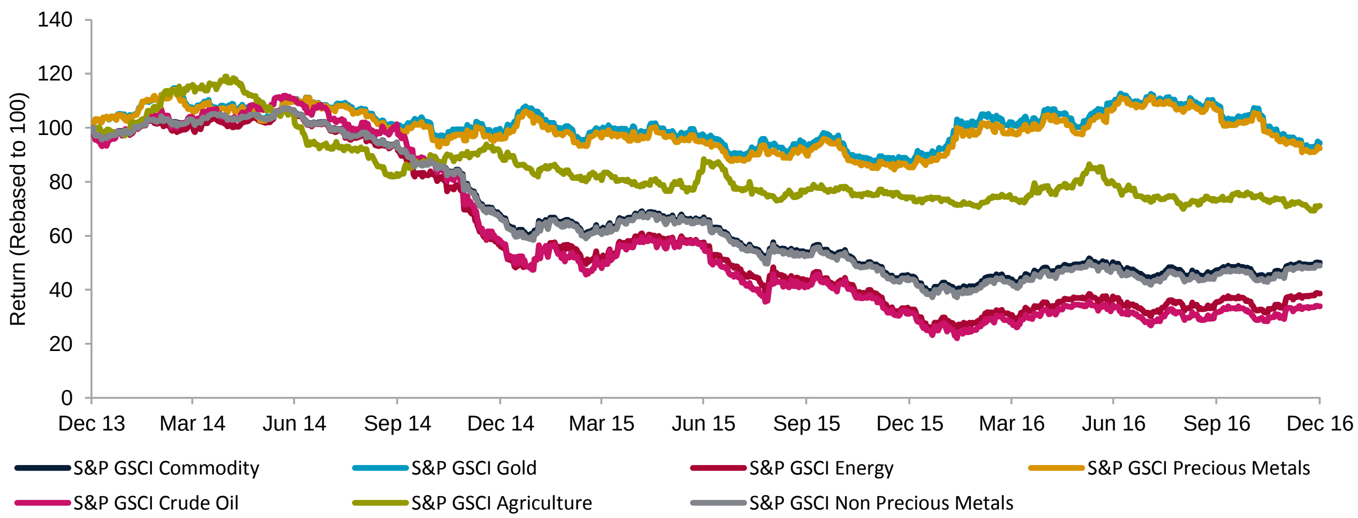
Market performance – 3 years to 31 December 2016



Hedge Funds: Sub-strategies performance – 3 years to 31 December 2016

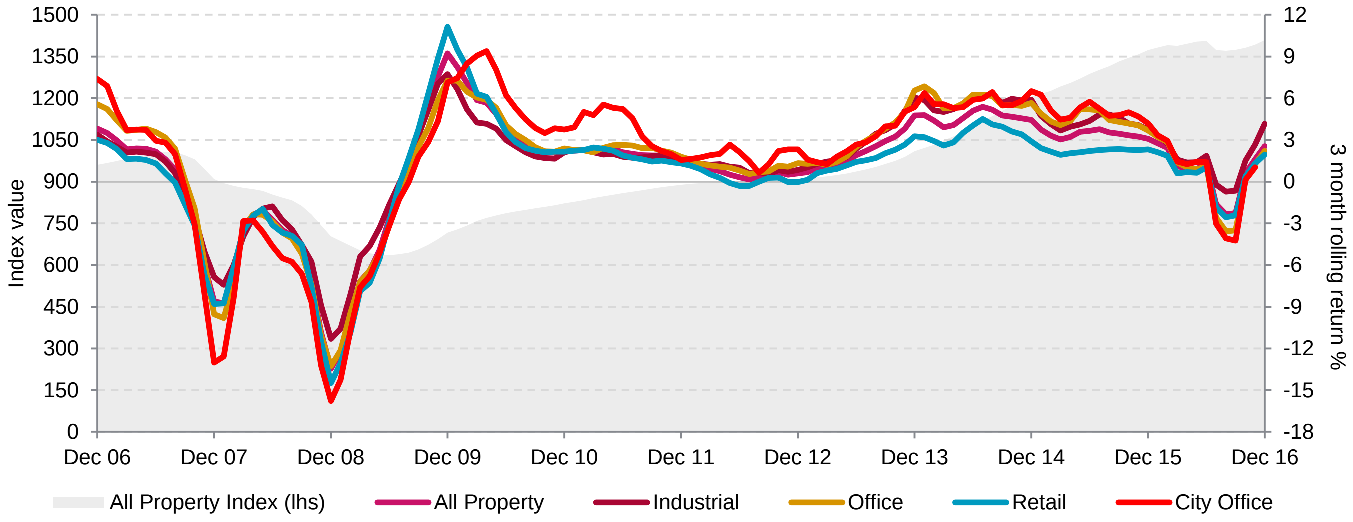


Commodity sector performance – 3 years to 31 December 2016

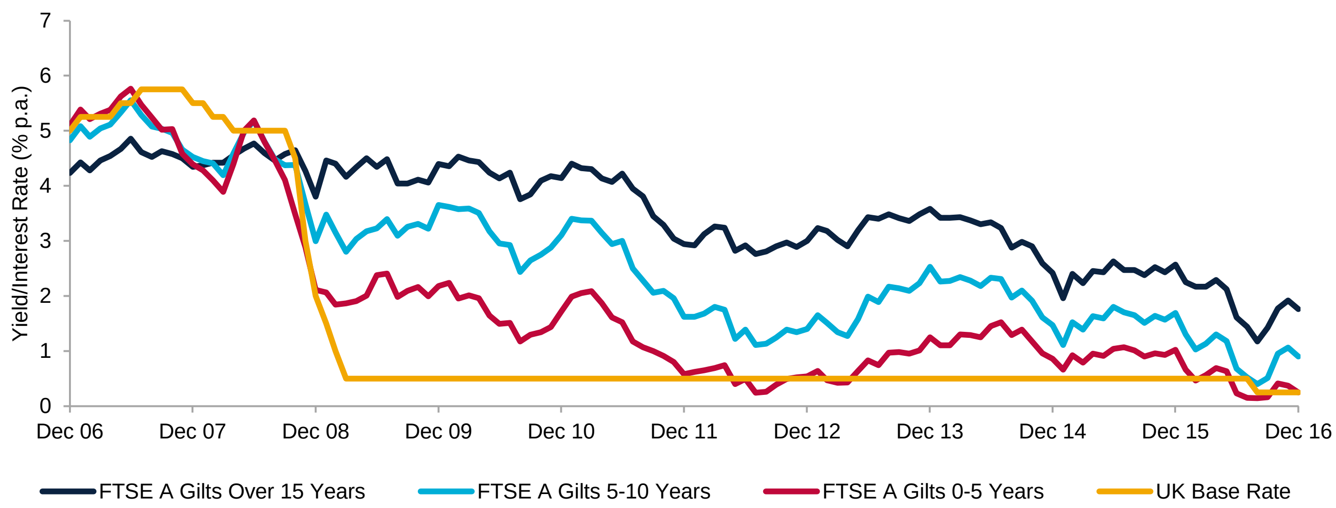


Source: Thomson Reuters

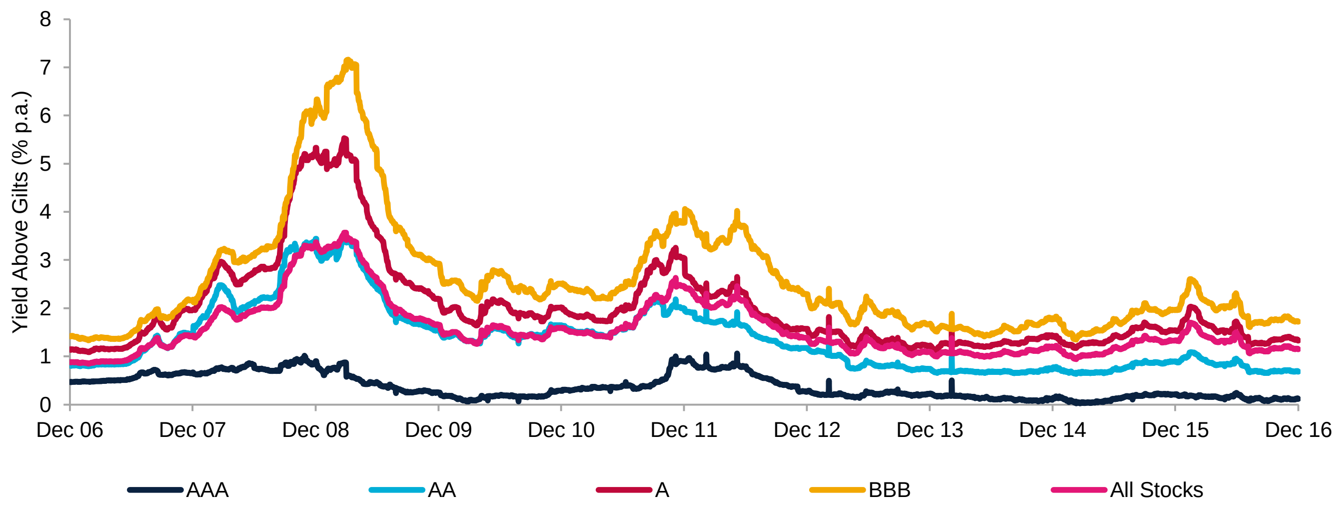
Property sector performance – 10 years to 31 December 2016



UK government bond yields – 10 years to 31 December 2016



Corporate bond spreads above government bonds – 10 years to 31 December 2016



Source: Thomson Reuters

2 ECONOMIC STATISTICS

Economic Statistics as at:	31 Dec 2016			30 Sep 2016			31 Dec 2015		
	UK	Euro[1]	US	UK	Euro[1]	US	UK	Euro[1]	US
Annual Real GDP Growth[2]	1.5%	1.7%	1.4%	2.2%	2.7%	1.7%	1.7%	3.3%	1.9%
Annual Inflation Rate[3]	1.6%	1.1%	2.1%	1.0%	0.4%	1.5 %	0.2%	0.2%	0.7%
Unemployment Rate[4]	4.8%	10.0%	4.7%	4.9%	10.1%	4.9%	5.1%	10.7%	5.0%
Manufacturing PMI[5]	56.1	54.9	54.3	55.5	52.6	51.5	51.4	53.2	51.2

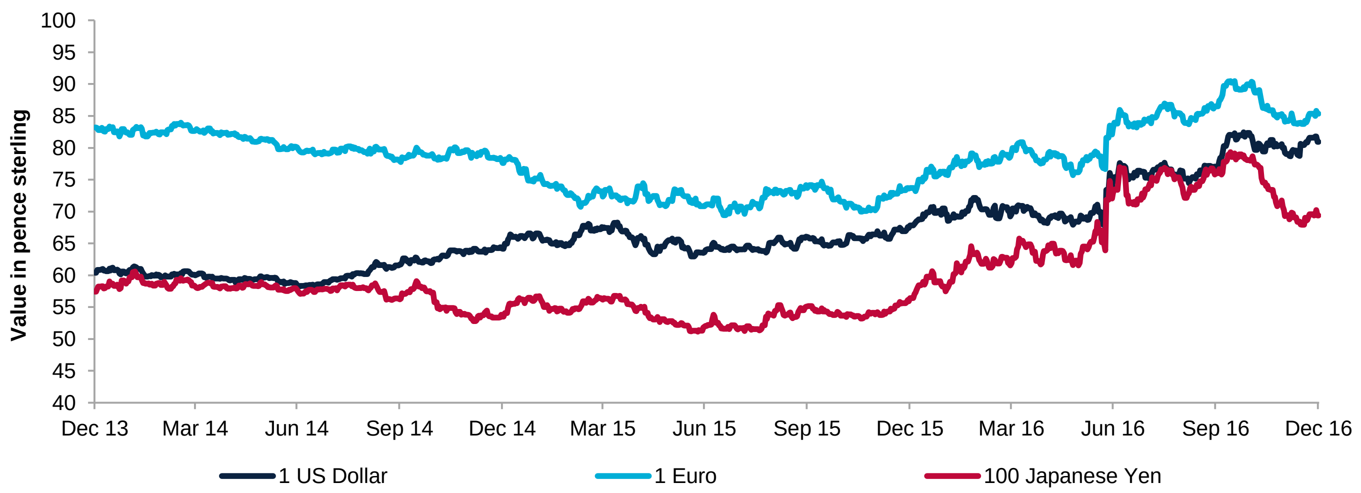
Change over periods ending:	3 months			12 months		
31 Dec 2016	UK	Euro[1]	US	UK	Euro[1]	US
Annual Real GDP Growth[2]	-0.7%	-1.0%	-0.2%	-0.1%	-1.6%	-0.4%
Annual Inflation Rate[3]	0.6%	0.7%	0.6%	1.4%	0.9%	1.3%
Unemployment Rate[4]	-0.1%	-0.1%	-0.2%	-0.3%	-0.7%	-0.3%
Manufacturing PMI[5]	0.6	2.3	2.8	4.7	1.7	3.1

Notes: 1. Euro Area 19 Countries. 2. GDP is latest published available figures 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	
	31 Dec 16	30 Sept 16	31 Dec 15	3 months	12 months
1 US Dollar is worth	80.93p	76.98p	67.85p	-4.9%	-16.2%
1 Euro is worth	85.36p	86.51p	73.70p	1.3%	-13.7%
100 Japanese Yen is worth	69.39p	76.02p	56.40p	9.6%	-18.7%

Exchange rate movements – 3 years to 31 December 2016



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

3 MARKET COMMENTARY

INTRODUCTION

'In America, anybody can be President. That's one of the risks you take' said Adlai Stevenson II, who was twice defeated by Dwight Eisenhower in his bids to become president in the 1950s. Extremely relevant 60 plus years later where Donald Trump rose from a no-hoper to President elect in a matter of months.

2016 was definitely a year of surprises with both Brexit and the US election providing results which just prior to each event, would have provided you with handsome odds. Once again the prediction accuracy of opinion polls came into serious question and one thing is for sure, we are definitely entering a different era when it comes to populist uprising.

A well-publicised call by RBS in January 2016 to 'sell everything ahead of a cataclysmic crisis' backfired immensely as despite a number of troublesome events, several markets ended the year on all-time highs. It was fair to say that several market commentators and participants shared that initial pessimism, however 2016 proved to be a positive year despite the perceived headwinds that arose.

We have yet to see resolutions to many of the events of 2016. Brexit is still a long way from any kind of clear outcome and Mr Trump is yet to be inaugurated. There are issues in other regions too. Populism is on the rise in Europe, China and Russia have growing policy ambitions, the Syrian conflict continues with no solution in sight and the ISIS threat looms globally.

Henry Ford once said 'When everything is going against you, remember that the airplane takes off into the wind, not with it'.

We enter 2017 with plenty of unknowns and indeed plenty to consider. The US president could provide a source of further surprises to both the positive and negative and governing by 'tweet' could become an interesting new paradigm. Europe has its challenges, particularly on the political front with elections scheduled for the Netherlands, France, Germany and potentially Italy.

UNITED KINGDOM

- A weaker Sterling continues to provide a tailwind for large cap multinationals, as revenue growth is revised higher. From a macro perspective, the post Brexit economic data has been mostly positive, but there has been little 'hard data' to go on.
- The real impact of Brexit is yet to be felt. 2017 could see the economy slow down markedly. Business investment and capital expenditures have experienced sharp falls over the past few months and this could lead to cuts in employment. As anticipated, inflation has started creeping higher, which could add downward pressure on household spending.
- That said, accommodative monetary policy and potential fiscal support from the government via infrastructure spending should be supportive of equity markets if enacted.
- The ECB has warned that UK shares are relatively expensive and more vulnerable to a crash than equities in most other major global markets. Figures in its Financial Stability Review report, published in November, showed that the UK was the most overvalued market in October, followed by the US, Europe and Emerging Markets.
- An environment of high inflation with low growth seems to be brewing in the UK. The labour market is tight with the unemployment rate very close to multi-decade lows and wage growth consistently beating expectations. All of this, coupled with a lack of coordination between monetary and fiscal policies, could prove a potential

headwind for UK equities exposed to the domestic economy. Also, if a scenario of continued Sterling strengthening was to play out, UK equities with global exposure, which have been reaping the benefits of a plunging currency for quite some time now, would struggle to find a friendly breeze to sail through.

- Additionally, with inflationary forces from rising prices of imported goods, lower interest rates and global commodities rally at play, inflation has the potential to rise steeply. Besides, with OPEC reaching a landmark deal to reduce oil output, it is likely that the output cut will help shrink a supply glut, which has depressed oil prices for more than two years. This in turn will erode the purchasing power of British consumers and trigger a painful rise in input costs for UK plc - both potentially negative for UK equities.
- Looking ahead to 2017, there are several challenges that may force a reassessment of the asset class. One of them is the dearth of overall corporate profit growth, which would have seen another year of stagnancy in 2016 had there been no significant devaluation in Sterling. The underlying earnings outlook for 2017 therefore is a key factor to watch out for - simply not relying on the relative weakness or otherwise of the currency. In addition, the political brinkmanship between the UK and its European counterparts has become more complicated and time-consuming. Without doubt, given 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. Moreover, the reappearance of inflation, coupled with the ongoing uncertainty around Brexit, might put a brake on UK employment levels and investment intentions, further moderating activity in the domestic economy.

EUROPE EX UK

- The shock of Brexit to the Eurozone economy could be significant, with the IMF cutting its growth forecasts in the wake of the result. The Italian banking issue continues to cause concern, which has the potential to spill over into the broader economy.
- Expectations for European companies' earnings in 2016 were reduced post-Brexit, putting annual profits on course for their fourth decline in five years. Financials have withstood the worst of the sell-off in Europe, as margins are squeezed further amid the negative interest rate policy, which is being adopted.
- Political risk is likely to take centre stage in the region with general elections in the Netherlands, France and Germany this year.
- The Eurozone is in for a long and gruelling election season, which was kicked off by the recently concluded constitutional referendum in Italy, leading to the ousting of Prime Minister Matteo Renzi. In a departure from the response to Brexit and Trump's election win, markets remained relatively tranquil as investors looked past the political turmoil in Italy.
- The prospect of rising instability in Italy does not bode well for its teetering banking sector, especially the beleaguered Monte Dei Paschi Di Siena (MPS) which is in the midst of a complex recapitalization exercise. A power vacuum in Italy and jittery financial markets will make life difficult for MPS. Any failure in MPS' EUR 5 billion recapitalization might deal a severe blow to other banks like UniCredit SpA which is expected to seek EUR 7 billion in fresh capital to bolster its balance sheet. This could have a knock on effect on the already fragile European banking sector.
- The ECB, in its December meeting, announced the extension of its Quantitative Easing (QE) programme until November 2017, at the pace of EUR 60 billion a month, down from the current pace of EUR 80 billion a month. A weaker Euro, as a result of the QE extension, might boost exports, giving Europe a much needed shot in the arm.
- Looking past the shroud of political uncertainties surrounding Europe, the current valuation levels in the Eurozone might be an opportunity for investors to pick up equities at attractive valuations. Rising commodity prices, a rebound in Emerging Markets and a supportive ECB also make the case for an earnings rebound in 2017 more compelling.
- The road ahead for European equities is littered with obstacles in the form of a taxing election calendar and a struggling banking sector.

NORTH AMERICA

- US equities have continued to rally to all time highs despite valuations remaining stretched. As mentioned in the summary, we expect there to be both negative and positive surprises from the incoming President.
- Economic data continues to paint a relatively positive picture of the US economy, including upward revisions to GDP, a tight labour market and also signs that wage growth is picking up.
- President-Elect Donald Trump, has promised tax cuts and higher spending, particularly on infrastructure and defence. This combination suggests stronger domestic activity.
- The repatriation of overseas earnings could also be a boost for US equities, especially if US corporates implement share buyback strategies, while the proposed one-off tax charge may contribute to the government's spending budget.
- Macroeconomic data released in the final quarter of 2016 has continued to throw a positive overtone, although inflation levels still remain below the Federal Reserve's target level of 2.0%. However, an upwardly revised GDP growth rate and overall improving indicators may lead to further hikes in interest rates which could tighten conditions and ultimately lead to a slowing of growth.
- The valuation of the S&P 500 is way above longer term historical averages. However, the valuation levels when translated in terms of earnings yields make equities still look attractive in comparison to yields of US corporate bonds and a much better source of yield compared to US government bonds.

JAPAN

- The appreciating Yen has been a headwind for corporate margins for much of the year, however, given more fiscal stimulus there is potential up side for the economy next year. The Exchange Traded Fund buying programme by the Bank of Japan (BoJ) could limit significant moves to the downside.
- Over the near-term, the BoJ has reiterated its commitment to achieve its inflation target of 2% along with its intentions to lower real rates by moving interest rates further into negative territory. In light of these developments, a case could be made for the Yen to depreciate in the coming months, which would be beneficial for Japanese equities.
- The Yen has depreciated significantly post the US elections primarily due to an unabated Dollar rally on the back of increased inflation expectations and rising yields in the US. If inflation expectations do indeed pick up and the unemployment rate remains steady at current levels in the US economy, the Federal Reserve might be prompted to increase the pace of tightening interest rates which would only add to the US Dollar's strength. In addition, fiscal stimulus in Japan is likely to boost domestic growth and inflation expectations. This, when viewed in conjunction with consolidating oil prices, could widen the current account deficit of Japan, thus further suppressing the Japanese Yen.
- The outflow from Japanese equities was overdone for much of 2016. Improved growth prospects and the possibility of an earnings revival will potentially prompt the foreign investors to return to Japanese equities. The BoJ is likely to continue with its asset purchase program to the tune of JPY 6 trillion. It will not need to cut back its asset purchase program in a bid to keep 10-year yield at zero percent as increased inflation expectations would mean that yields do not fall dramatically. On the contrary, in an environment of rising yields, the BoJ would need to accelerate its asset purchase to maintain the 10-year yield at around 0%. This will keep the market awash with liquidity. The GPIF, the largest public pension fund, has room to buy equities of around 3.1 trillion Yen to reach its target of a neutral domestic equity weighting. In addition, the BoJ has reiterated its commitment to overshoot the inflation target of 2%. This places Japan in a unique situation as it would be the only major developed economy where both fiscal and monetary policies are accommodative in nature. Confluence of foreign inflows, ongoing asset purchases by BoJ and GPIF would bode well for Japanese equities.
- Since Japan is the second largest trading partner of the US, improving growth prospects in the US would likely serve it favourably. However, if protectionist policies come to the fore, it might negatively impact Japanese exports. In addition to this, protectionist policies, coupled with a strong US Dollar, would likely cause outflow from the Chinese economy (Japan's largest trading partner).

ASIA PACIFIC EX JAPAN / EMERGING MARKETS

- November saw huge capital outflows from the Emerging Markets primarily due to the victory of Donald Trump in the US presidential election and the increased possibility of an interest rate hike by the Federal Reserve. A strengthening US Dollar along with a sharp rise in rates of US fixed income markets, has hurt Emerging Market equities and currencies. China, Brazil and Mexico were amongst the most adversely affected as their relations with the US have not been all that amicable.
- The improving fundamentals of Emerging Markets should have a positive feed through to the economies in this region because of the trade linkages. Nevertheless, the cloudy outlook for China continues to remain a dominant factor in the trends affecting the Asia Pacific region. US policy normalisation is expected to be a headwind for economies in this area.
- Investor sentiment towards the area remains positive and growth momentum is improving relative to developed markets. While the economic backdrop in China remains opaque, the People’s Bank of China is likely to remain accommodative, with further fiscal support expected. Commodity prices have shown signs of firming, including an agreement between the OPEC and non-OPEC members to cut production output.
- The prospect of tighter US monetary policy, a stronger Dollar and fears of higher trade tariffs under the new US Administration, mean the near-term outlook now looks a little more uncertain. While Emerging economies are in a much better shape compared to the 2013 taper tantrum, we believe volatility levels may increase.
- Falling inflation expectations within some of the countries in the universe could lead to more policy easing or potentially fewer rate increases. However, both geographical allocation and security selection remain crucial for this asset class given the diverse range of political risks in Emerging economies.
- The fundamental picture in Emerging Markets continues to brighten, given that GDP growth is expected to recover this year and current account balances are improving. However, the victory for Trump has led to an upward revision for inflation expectations in the US, causing rising US Treasury yields and Dollar strength.
- Emerging Markets are trading at a significant discount and continue to look attractive versus their developed market peers on a pure valuation basis. 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.
- As of now, there remains ambiguity over Donald Trump’s campaign promises and real policy action.
- Several Central Banks (Indonesia, India and South Korea) have intervened directly or indirectly to protect their respective currencies. In addition, inflation levels are under control or declining which has prompted Central Banks to reduce interest rates in the last few months to support growth. Foreign exchange reserves continue to be healthy in many economies. Growth in Brazil and Russia has been improving, following a recessionary situation a year ago. Indonesia continues to post healthy growth aided by strong domestic growth and pro-market reforms. Also, China may not be affected extensively by Trump’s trade policy given its policy flexibility.

FIXED INCOME

- Fixed income assets have seen strong returns in 2016 but were tempered somewhat in the final quarter. Sterling denominated bonds have continued to see pressure following Brexit, particularly as the currency weakened on significant uncertainty.
- UK Government Bonds have seen rising yields on the back of rising inflation expectations, which has led to them weakening and losing capital value. Uncertainty surrounding Brexit, corresponding policy decisions and geopolitical changes may trigger further volatility in the bond market. The evolution of political outcomes in Europe and clarity in policy decisions in the US will set the path of long term interest rates and the outlook for the fixed income asset class in the near to medium term.
- UK company balance sheets remain in relatively good shape and default levels are not an issue currently. Contrary to the Bank of England’s intentions, there has been a rise in the cost of borrowing for companies as gilt yields have increased amid stronger UK economic growth and rising inflation expectations.
- A firming in oil prices has benefitted the high yield market, particularly in the US which has a high energy bias, as investors continue their search for yield in a low interest rate environment.

- Expansionary fiscal spending under the new US presidency is likely to mean higher yields for bonds in an economy where employment is almost at its peak. US Treasuries are exposed to interest rate increases, along with inflationary risks as the Federal Reserve allows the economy to build.
- European Bonds remain supported by the European Central Bank buying; however, yields are vulnerable to changes in rhetoric from the bank.
- The Bank of Japan's (BoJ) bond-buying programme and negative interest rates have driven valuations expensive. Action by the BoJ – including a pledge to aim for an overshoot of its inflation target 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 for the third consecutive quarter, surpassing the $3 trillion milestone for the first time. Total assets increased by $46.8 billion over the quarter, ending the year at $3.02 trillion. Over 2016, the total hedge fund industry capital increased by $121 billion, the largest annual increase since 2014. The growth of hedge fund assets occurred against a challenging backdrop of continued investor withdrawals, as redemptions totalled $18.7 billion over the quarter. In Sterling terms, all strategies generated positive returns over the quarter, 12 month and 3 year periods to the end of December 2016. Event Driven were the strongest strategies over the quarter and 12 month period as they returned (+8.8%) and (+31.8%) respectively.
- UK commercial property gained 2.6% over the quarter, driven by an increase in capital values of 1.1% and 1.4% in rental income. In a reversal of last quarters negative performance which was affected by investor sentiment on the back of Brexit and new stamp duty reforms, all sectors posted positive returns; Industrials increased by 4.2%, followed by city offices which returned 2.7%. Office and retail sectors grew by 2.2% and 1.9%, respectively. At the end of December, the annual property yield stood at 5.6%.
- Commodity prices for most industrial sectors continued to rise in the quarter, whilst most agricultural prices declined. In the energy sector, coal prices surged 38%, on strong demand and supply tightness in China resulting from government efforts to reduce coal capacity. Crude oil prices rose 7% over the quarter, following agreements by both OPEC and non-OPEC producers to reduce output by nearly 1.8 million barrels per day in the first half of 2017. Non-precious metals prices rose by 7% due to strong demand in China and tightening supply, notably for zinc and lead due to the closure of several large mines in Australia, Canada and Ireland. Precious metals fell on weakening demand due to a rising dollar and higher real interest rates. The agricultural index declined by nearly 3%, led by declines in its beverage and food components.

CONCLUSION

There are many forks in the road ahead, where important decisions will have widespread impacts on global economies and investment markets. Never has the world felt so intertwined with local (albeit national) decisions having such widespread implications. It is important not to look at one strand in isolation, we must examine how those strands are all woven together.

It is always important to set out the threats to asset classes and investments, but opportunities do exist even when impending doom is predicted or when election results don't go the way they are expected to. 2016 is a classic example of this. Whether 2017 continues this trend remains to be seen, however global growth is gradually creeping upwards and interest rates in some parts of the world are starting the path to normalisation. Some equity markets are, at the time of writing, near or at all-time highs, but as Richard Branson once said 'Records are there to be broken, it is in man's nature to continue to strive to do just that'.

Political risk is of course high across the globe, with some important decisions already taken in 2016, many more will have to be made in 2017. One would argue that unusually the developed world faces the most challenges on this front, however ramifications will be felt far and wide.

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 GBI-EM 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

Note: All indices above are denominated in Sterling.

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