CLWYD PENSION FUND

ECONOMIC AND MARKET UPDATE
PERIOD ENDING 30 JUNE 2017

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1 MARKET BACKGROUND
PERIOD ENDING 30 JUNE 2017

MARKET STATISTICS

Market Returns Growth Assets	3 Mths %	1 Year %	3 Years % p.a.
UK Equities	1.4	18.1	7.4
Global Developed Equities	0.3	22.3	16.0
USA	-0.7	21.6	19.9
Europe	4.6	28.7	11.2
Japan	1.5	24.0	16.7
Asia Pacific (ex Japan)	1.3	27.7	14.0
Emerging Markets	2.4	27.8	11.2
Frontier Markets	2.3	23.2	6.3
Property	2.5	5.1	10.3
Hedge Funds	-2.7	11.1	12.4
Commodities	-9.0	-6.4	-17.6
High Yield	-0.7	15.7	13.3
Emerging Market Debt	-0.5	10.7	5.4
Senior Secured Loans	1.1	7.3	4.7
Cash	0.1	0.3	0.4

Market Returns Bond Assets	3 Mths %	1 Year %	3 Years % p.a.
UK Gilts (>15 yrs)	-2.3	-1.8	12.3
Index-Linked Gilts (>5 yrs)	-2.4	7.1	13.2
Corporate Bonds (>15 yrs AA)	-0.3	5.5	11.1
Non-Gilts (>15 yrs)	0.4	7.3	10.5

Exchange Rates: Change in Sterling	3 Mths %	1 Year %	3 Years % p.a.
Against US Dollar	3.9	-2.8	-8.8
Against Euro	-2.6	-5.4	-3.0
Against Yen	4.7	6.4	-5.5

Inflation Indices	3 Mths %	1 Year %	3 Years % p.a.
Price Inflation – RPI	1.1	3.5	2.0
Price Inflation – CPI	0.8	2.6	1.0
Earnings Inflation*	1.6	2.4	2.4

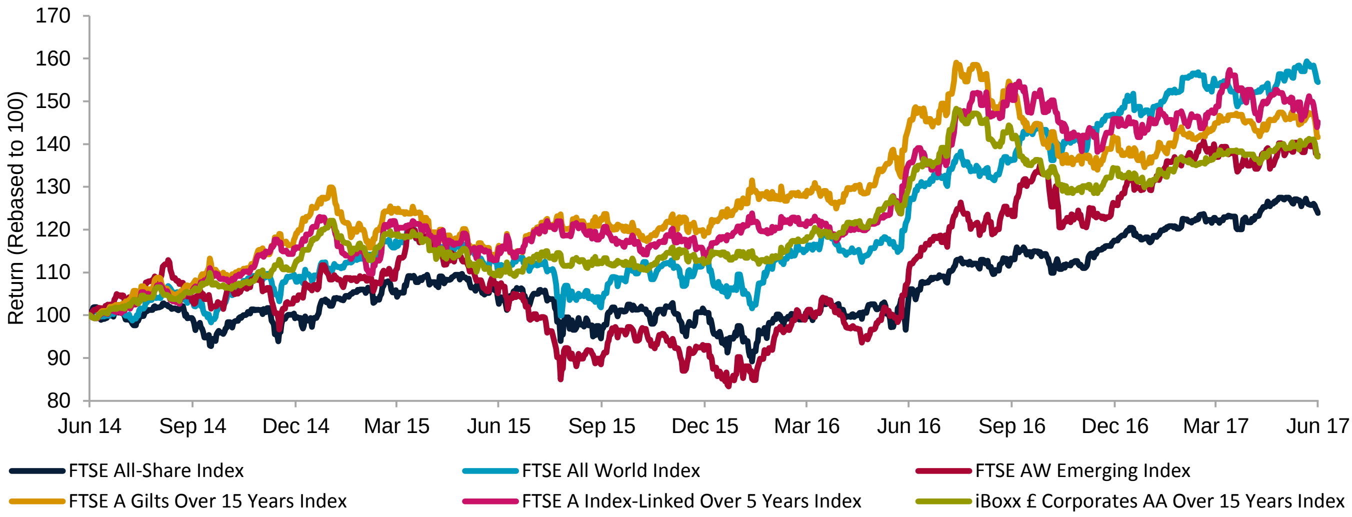
Yields as at 30 June 2017	% p.a.
UK Equities	3.61
UK Gilts (>15 yrs)	1.80
Real Yield (>5 yrs ILG)	-1.58
Corporate Bonds (>15 yrs AA)	2.57
Non-Gilts (>15 yrs)	2.94

Absolute Change in Yields	3 Mths %	1 Year %	3 Years % p.a.
UK Equities	0.14	-0.05	0.34
UK Gilts (>15 yrs)	0.15	0.19	-1.54
Real Yield (>5 yrs ILG)	0.14	-0.19	-1.46
Corporate Bonds (>15 yrs AA)	0.05	-0.19	-1.60
Non-Gilts (>15 yrs)	0.04	-0.25	-1.49

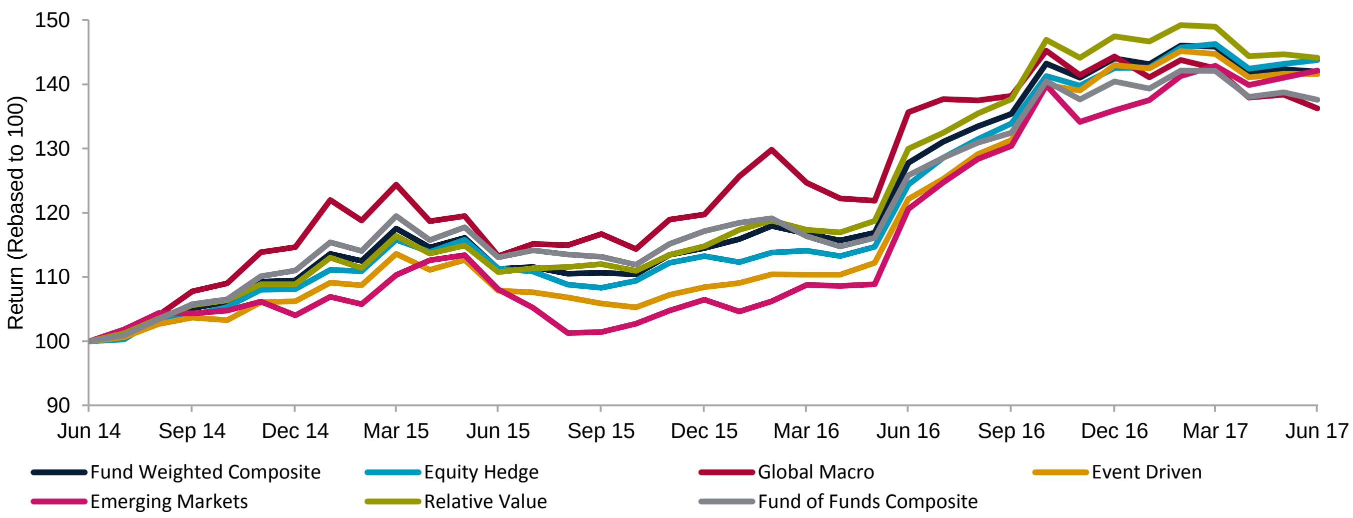
Source: Thomson Reuters and Bloomberg
Note: * Subject to 1 month lag

MARKET SUMMARY CHARTS

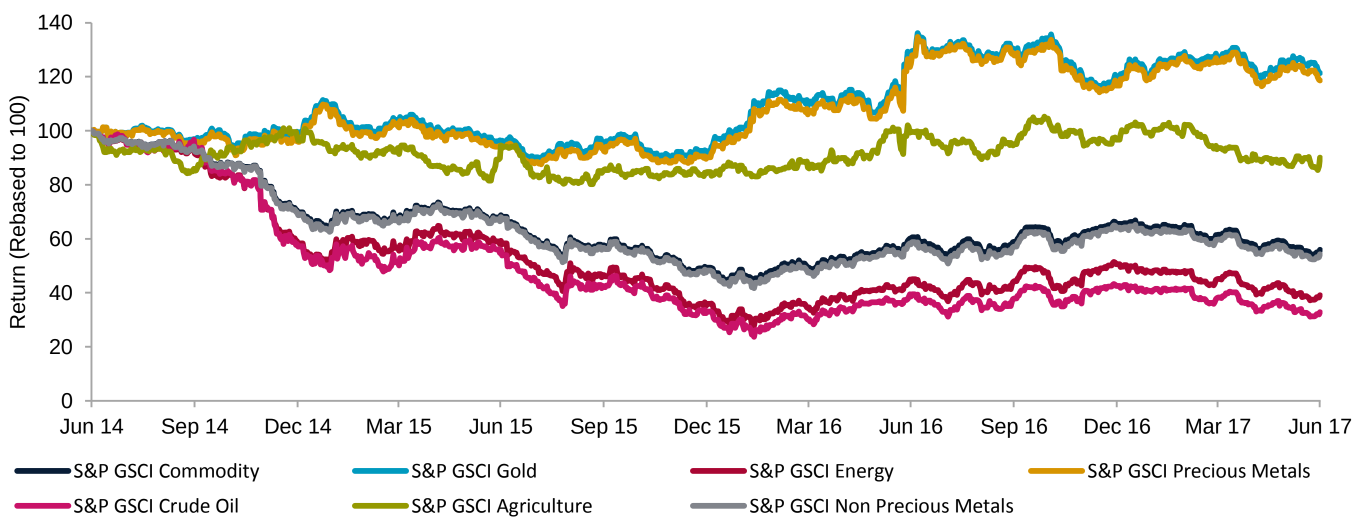
Market performance – 3 years to 30 June 2017



Hedge Funds: Sub-strategies performance – 3 years to 30 June 2017

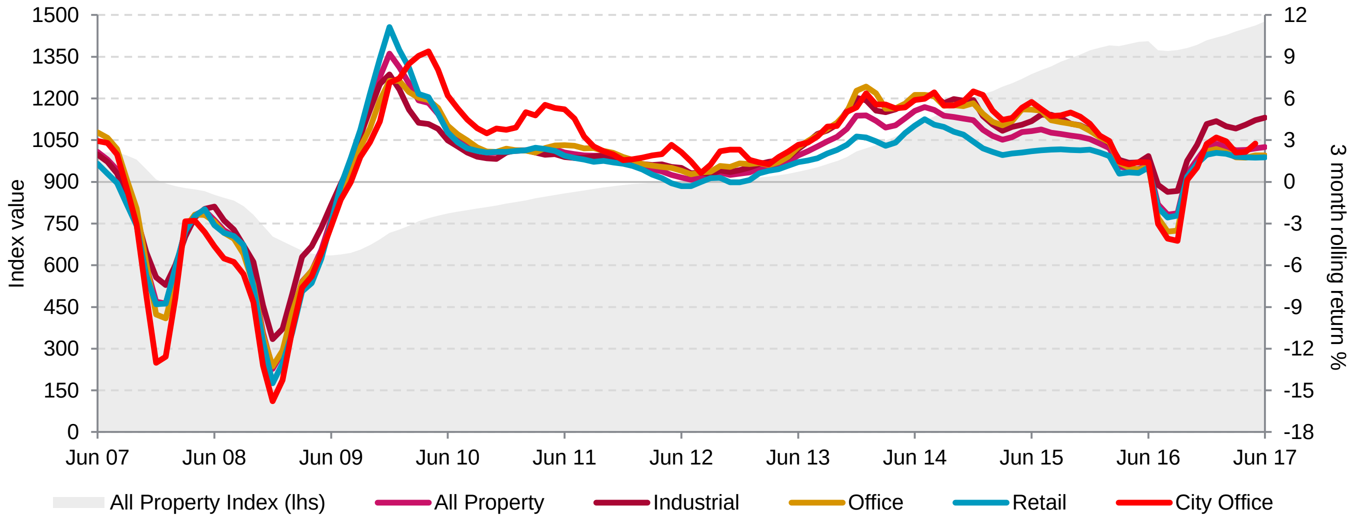


Commodities: Sector performance – 3 years to 30 June 2017

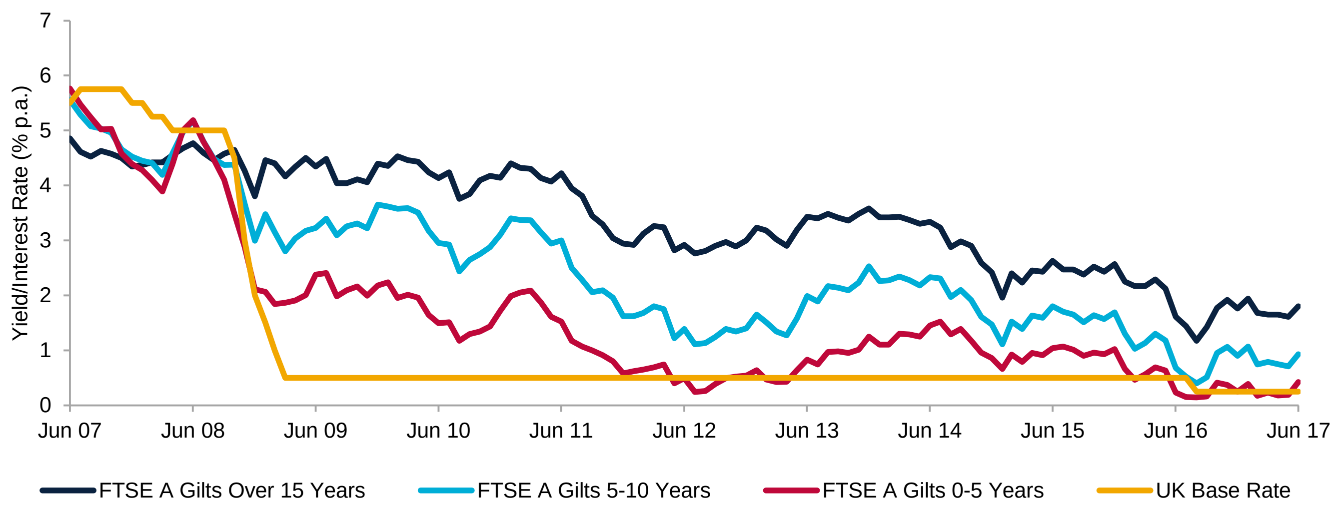


Source: Thomson Reuters

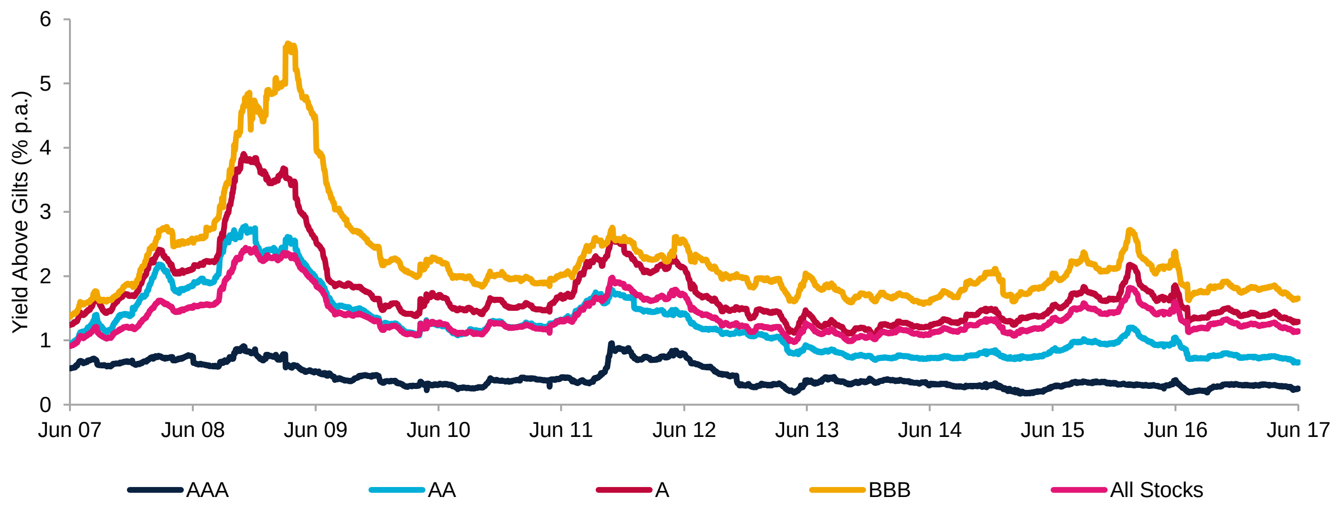
Property: Sector performance – 10 years to 30 June 2017



UK government bond yields – 10 years to 30 June 2017



Corporate bond spreads above government bonds – 10 years to 30 June 2017



Source: Thomson Reuters

2 ECONOMIC STATISTICS

Economic Statistics as at:	30 June 2017			31 March 2017			30 June 2016		
	UK	Euro[1]	US	UK	Euro[1]	US	UK	Euro[1]	US
Annual Real GDP Growth[2]	2.0%	2.6%	2.0%	1.9%	2.7%	1.8%	1.6%	2.7%	1.4%
Annual Inflation Rate[3]	2.6%	1.3%	1.6%	2.3%	1.5%	2.4%	0.5%	0.1%	1.0%
Unemployment Rate[4]	4.5%	9.2%	4.4%	4.7%	9.5%	4.7%	4.9%	10.1%	4.9%
Manufacturing PMI[5]	54.2	57.4	52.0	54.3	56.2	53.3	52.5	52.8	51.3

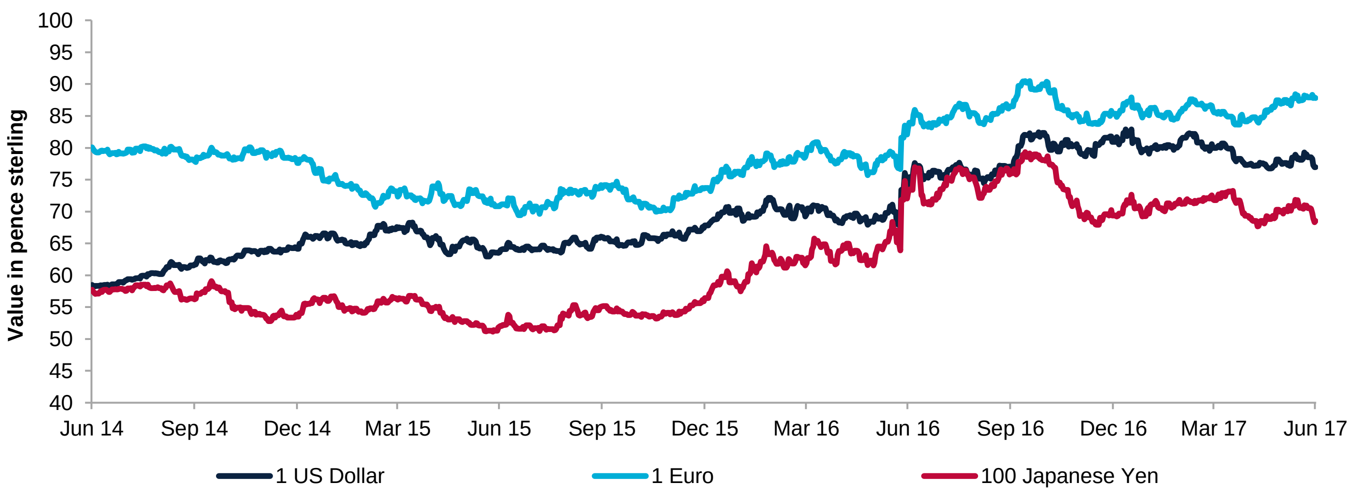
Change over periods ending:	3 months			12 months		
31 Mar 2017	UK	Euro[1]	US	UK	Euro[1]	US
Annual Real GDP Growth[2]	0.1%	-0.1%	0.2%	0.4%	-0.1%	0.6%
Annual Inflation Rate[3]	0.3%	-0.2%	-0.8%	2.1%	1.2%	0.6%
Unemployment Rate[4]	-0.2%	-0.3%	-0.3%	-0.4%	-0.9%	-0.5%
Manufacturing PMI[5]	-0.1	1.2	-1.3	1.7	4.6	0.7

Notes: 1. Euro Area 19 Countries. 2. GDP is lagged by one quarter. 3. CPI inflation measure. 4. 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 June 17	31 Mar 17	30 June 16	3 months	12 months
1 US Dollar is worth	76.99p	79.97p	74.81p	3.9%	-2.8%
1 Euro is worth	87.81p	85.54p	83.10p	-2.6%	-5.4%
100 Japanese Yen is worth	68.52p	71.77p	72.92p	4.7%	6.4%

Exchange rate movements – 3 years to 30 June 2017



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

3 MARKET COMMENTARY

INTRODUCTION

"Strong and Stable": that was the tag line, that was the pledge, that is what the UK General Election was meant to deliver. Instead, for the second year in a row there are many more questions than answers.

Will the Conservative/Democratic Unionist Party (DUP) coalition survive/succeed? Will there be a future minority Government? Will Theresa May remain as the Conservative Party leader and Prime Minister? Will the Labour Party move even further to the left with Jeremy Corbyn as leader? Will there be another General Election before Brexit negotiations are complete? Will there be another EU referendum?

These are just some of the British questions that remain unanswered, even now, although many seem unlikely, we will only find out the answers in the coming months. Time is of the essence of course, particularly as Brexit negotiations have formally commenced.

Where the result leaves these negotiations is uncertain. It is unlikely to be completely resolved in the short term; much has been talked about the approach to Brexit and whether it will be hard or soft? Could we see a cliff edge departure at the end of the two-year deadline following the triggering of Article 50?

A deal is possible to extend the timetable for Brexit, but this is dependent on the agreement of all 27 European Union (EU) members, let alone a coherent approach from a UK Government coalition. Talks with the EU started on 19 June, but the approach the UK will take throughout these talks has been left looking confused following the Election result.

With no party having an absolute majority, any possible coalition involving the Liberal Democrats or the Scottish Nationalist Party would have most likely have come at the price of another referendum (either EU or Scottish or both!); that however was seen as unpalatable to members of the two main parties. Instead the Conservatives have decided that the smaller DUP is the preferred choice of partner but at what price to the Government's austerity programme?

The immediate implication that this result will give impetus to a softer approach is not so clear; a weaker UK position gives greater power to those Eurosceptic Conservative MPs, and indeed to any with marginal positions. This is further complicated by the need to satisfy the DUP as a coalition partner.

To quote the Godfather Part 2 'Power is nothing without control' and it is hard to see any political personality wielding power or control at this point in time.

UNITED KINGDOM

- With the 2017 General Election aftermath and Brexit negotiations finally underway, political uncertainty remains high on risk agendas. Currency stability and controlled inflation are also weighing on UK performance.
- The annual UK inflation rate has continued to climb this year, mainly due to rising petrol and diesel prices, along with a pickup in food prices. Rising prices at factory gates, assisted by a weak Sterling also added to the inflationary pressure.
- The number of people unemployed has fallen considerably. The unemployment rate fell to 4.7% earlier in the year, its lowest level since the summer of 1975.
- The triggering of Article 50, initiating the UK's formal exit from the EU was already discounted and as expected the notification itself did not have any marked bearing on the asset class. However, the two years of negotiations which follow the enforcement of Article 50 are likely to have a significant impact on UK companies

and markets. Recurring spells of heightened market volatility are likely as the bargaining continues and as investors respond to, and anticipate, negotiating positions.

- The marked pick-up in inflation is a sign that Sterling's sharp depreciation in the wake of the UK's vote to leave the EU coupled with rising energy prices is becoming a cause for concern. While the prevailing inflationary pressures are still benign, the concerns around the impeding nature of accelerating inflation have already started to make headlines.
- With inflationary forces of the likes of rising prices of imported goods, lower interest rates and global commodity rallies at play, inflation can rise steeply. This in turn would erode the purchasing power of consumers and trigger a painful rise in input costs for UK plc, both of which are potentially negative for UK domestically focussed equities.
- The UK economy has been resilient but uncertainty remains surrounding its future relationship with the EU. Consumers are still spending but businesses have cut back on investment and hiring. As anticipated, inflation has moved sharply higher, which could add downward pressure on household spending in the coming months.

EUROPE EX UK

- The election of Emmanuel Macron as President of France in May and the election of Mark Rutte as Prime Minister of the Netherlands in March, both defeating Far Right candidates can be considered as a blow to the populist movement that has been manifesting across Europe over the past year. These election results have been positive for European investor sentiment and confidence.
- The European economy has continued its expansion with France and Germany delivering strong relative levels of growth. Employment levels have accelerated to the highest level in nearly 10 years, with all the 'big four' nations registering employment growth in the first half of 2017.
- The ECB left its benchmark refinancing rate unchanged at 0%. It also continued with its quantitative easing programme; however minutes of recent meetings suggest that the ECB is leaving the door open for potential tapering should market conditions improve in the future.
- Investors are finally appearing to pay heed to the group of analysts who have been cheering for European equities over the past few months. Strengthening economic data, improving manufacturing and consumer sentiment, rising employment levels along with steadily improving inflation are finally enticing investors to this region.
- Recent economic data in the euro-zone has been on a stronger footing, meanwhile monetary policy remains accommodative and corporate earnings could well be on course to deliver the first earnings growth in six years.
- Political risk is likely to take centre stage again later in the year with the general election in Germany.

NORTH AMERICA

- Rising domestic debt levels being seen in the US can be a significant headwind to economic activity. In a rising interest rates scenario, the interest payments on the outstanding debt would also increase and can create a hindrance to the growth of the economy as consumers would lower spending in order to provide for the higher interest costs.
- The Fed hiked the Federal Funds rate by 25 bps during its March and June meetings as anticipated, signalling that the economy is strong and growing. Fed policy makers are being pulled in two directions, with strong unemployment numbers but with a muted reaction from wages and prices.
- Equity markets have been on an upward trajectory, expecting reflationary policies from the Trump administration. The failed effort to pass some promised key changes have been instrumental in dampening the 'Trump trade'. Realisation has however dawned that President Trump may not be able to win support from the Republican Party to implement all of his election promises. Furthermore, while the Fed may be well placed to continue with rate hikes in 2017, expectations of a similar pace in 2018 can be seen clouding, particularly as they try to reduce its balance sheet size.

- A change in the Fed leadership could occur in 2018, which may impact the pace of rate hikes. Candidate Trump had been highly critical of the Fed's slow pace of tightening during his campaign.
- While equites are trading at high multiples to earnings, they remain marginally attractive in terms of earnings yield when compared to fixed income securities of similar risk, given historically low bond yields and spreads. This, along with improving macro-economic conditions in the US and an imminent turnaround in corporate earnings could help fuel further increase in asset prices. On the other hand, the lack of awareness towards evolving downside risks is a sign of market euphoria, which could lead to a correction in the near-term as the risks become apparent.
- The proposed tax reform, including lower taxes and a reduced regulatory burden could support US equity markets however implementation and detailed plans are both proving difficult and elusive. Inflationary pressures are beginning to build and faster than expected rate rises could slow economic growth.

JAPAN

- The prospects for Japanese equities are closely linked to the economic conditions in China and the US, which are its major trading partners. The global rebound in trade has been a key factor in providing strength in the region.
- There are sufficient cash holdings on Japanese company balance sheets, improving economic conditions and industrial production likely to increase in the coming months.
- Japanese companies posted increased profits through the latter part of 2016 and into 2017. Apart from the domestic economy, higher growth expectations in the US and China have also augured well for its exports so far in this calendar year. Dividends and share repurchases have also been on the rise in Japan over the recent years. In spite of the above, Japanese stocks have not witnessed a significant increase in their valuations.
- There are however considerable political and economic risks looming around the global economy. With the efforts to repeal Obamacare failing, there are growing concerns over whether the Trump administration's economic proposals would boost the US economy. On the other hand, worries about China's property bubble bursting, upcoming European elections and unstable oil prices can also draw investors to park their money in the Yen thereby detracting from Japanese equities. However, most of these concerns are of a short-term nature.
- Over the near-term, the Bank of Japan has reiterated its commitment to achieve their inflation target of 2% along with its intentions to maintain lower interest rates. This has had a beneficial impact on Japanese banks in particular. Easy monetary policy and fiscal stimulus for 2017, helped by a cheaper Yen will potentially drive forward corporate earnings and business investment.

ASIA PACIFIC EX JAPAN / EMERGING MARKETS

- Emerging Market (EM) equities have been supported by improved macroeconomic conditions, stable commodity prices and improved global economic activities. The strong EM equity returns were also backed by appreciating currency over the US Dollar and improved capital inflows.
- Stronger EM current account balances, improving growth, relatively controlled inflation, and well-managed US rate expectations have helped EMs currencies against the US Dollar and are expected to continue to do so.
- Countries such as India, Brazil and Russia saw a rapid expansion of their manufacturing activities as output and new orders inched upwards. Additionally, central banks in Brazil and Russia continue to cut their benchmark interest rates as inflation eased in both nations. South Africa, whose economy is struggling to adopt strong reforms, has seen a downgrade in its sovereign debt to junk status by Fitch and S&P, leading to business and consumer confidence taking a hit. In addition, Turkey continues to remain a major concern due to the political tensions surrounding the economy.
- In the recent talks between China and the US, both parties agreed to a "100-day plan" to ensure that they work on further strengthening their ties rather than hampering relations. Even if this cordial trade deal between China

and US doesn't pan out well, China is not expected to suffer too much as their exports to the US accounts for only 18% of its total exports.
- The risk of a sharp US Dollar rally is fading and growth is broadening out. Strong earnings growth is expected across many of the larger economies such as India and Mexico. Commodity prices continue to show signs of firming and the emerging economies as a whole have been successful in improving their economies, using measures to spur economic activities.

FIXED INCOME

- Persistent Sterling weakness and the rise in commodity prices are feeding through into headline inflation rates. Lower than anticipated wage growth is likely to mean lower consumer spending and consequently, potentially lower inflation – a key aspect the Bank of England (BoE) is keeping a close eye on, especially given the current inflation spike. The longer-term outlook will depend not only on the BoE's policy directions but also by the demand/ supply dynamics; however, in the short-term investors are still prepared to pay a high price for bonds that protect against inflation.
- A sustained and substantial overshoot of the BoE's 2% inflation target remains a concern. The ongoing economic resilience and above-target inflation expectations could mean pressure for the BoE to raise rates. That said, the uncertainties surrounding the UK's planned EU exit could reduce the probability of tightening quickly, but the recent split vote and the recent comments from Monetary Policy Committee members has added to potential expectations of an imminent rate rise.
- The divergence between UK and US yields is becoming more apparent, with interest rates in the US likely to continue to move higher over the next 12 months.
- The BoE's corporate bond purchase programme has come to a close and there appears to be no obvious signs of pressure on the asset class.
- A lack of new issuance means that order books are over subscribed as investors continue their appetite for yield. In addition, Quantitative Easing from the European Central Bank (ECB) has driven European yields to unattractive levels making Sterling corporate bonds a consideration.
- The US labour market continues to show signs of strength and headline CPI inflation is close to the Federal Reserve's (Fed) target. The impact of the new administration's economic policies remain uncertain at this stage but the Fed's economic projections have remained broadly unchanged with further interest rate hikes expected in the US in 2017.
- A recent firming in oil prices has benefitted US high yield as investors continue their search for yield in a low interest rate environment.
- Corporate profits seem to be in a cyclical upturn and have beaten most estimates over the first half of 2017; this bodes well for the credit conditions of most firms. Company balance sheets remain in relatively good shape and default levels are not an issue currently. The pro growth agenda in the US could also mean that the credit cycle is extended further, as infrastructure plans and tax reforms are eventually put into effect.

ALTERNATIVES

- Hedge Fund capital rose by $34.1 billion over the quarter, with total assets ending the quarter at $3.1 trillion. Investor inflows exceeded redemptions for the first time since Q3 2015. Global Macro strategies in particular received the highest level of inflow as investors increased allocations to funds with a strategic emphasis on non-directional and equity beta-reducing exposures, credit and multi-strategy for protection against rising rates. Hedge Funds (in Sterling terms) returned -2.7% over the quarter; this was primarily due to the depreciation of the US dollar against Sterling, as hedge funds returned 1.1% in US dollar terms. In Sterling terms, all strategies generated negative returns over the quarter, with Global Macro (-4.3%) displaying the worst performance.
- UK commercial property increased by 2.5% over the quarter. Capital values increased by 1.1%, whilst rental income continued to remain steady at 1.4%. All sectors posted positive returns; Industrials increased by 4.6%,

followed by City Offices which returned 2.6%. Office and Retail sectors grew by 1.9% and 1.8%, respectively. At the end of June, the annual property yield stood at 5.6%.

- Commodity markets worsened over the quarter, as three consecutive months of negative returns led to a total loss of 9.0%. All sectors declined; Energy (-13.5%) was the worst performing sector as Crude oil (-14.0%) was hampered by Russia's refusal to OPEC's production cut agreement to reduce market supply.
  Following the news that all US banks passed the Fed's stress tests, Gold suffered in June as investors moved away from perceived safe haven assets in search of yield. Prices for Non-precious metals (-9.2%), Precious metals (-5.5%), Gold (-4.5%) and Agriculture (-3.8%) all declined over the quarter.

CONCLUSION

It has been said many times before and will be said many times in the future: 'markets do not like uncertainty' and although the uncertainty from the Election and Brexit negotiations will cause volatility, the effect should be limited to the UK markets.

Market reaction since the UK General Election has been mixed, but relatively subdued. The FTSE 100 with its international revenue streams has been buoyed by the fall in Sterling, much as it was following the referendum vote last year. The more domestically focused FTSE 250 has fallen on the back of the uncertainty caused by the result.

Currency markets abhor instability and uncertainty. This was evident in the falls in Sterling following the Brexit referendum, pre-election opinion polls and indeed the Election result. The value of Sterling remains significantly down against the Dollar over the last twelve months.

Forecasts for shorter-term increases in inflation have been realised over 2017. Further weakening in Sterling could provide greater inflationary pressure. Long dated bond yields have continued to point to a muted view on future inflation. More worryingly for the UK economy, inflation is out-stripping wage inflation which could leave the UK economy in a perilous position as earnings and savings are eroded.

Bond yields could fall as investors seek a safe haven, but there is debate over what can be considered a safe haven. Over the medium-term, greater uncertainty over Brexit lends itself to a narrative of "lower for longer". However, recent Bank of England rhetoric has indicated a willingness to control inflation which could indicate an earlier than expected rise in UK interest rates, which would lead to the potential of increasing UK bond yields.

In general, we've seen strong resilience from equity markets to political instability. News flow on European, US and Chinese economic data is far more influential.

As Warren Buffet once said 'Never test the depth of the water with both feet'.

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 (ex UK)	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 (>15 yrs)	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 Earnings 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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