CLWYD PENSION FUND
ECONOMIC AND MARKET UPDATE
PERIOD ENDING 31 DECEMBER 2017

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1 MARKET BACKGROUND
PERIOD ENDING 31 DECEMBER 2017

MARKET STATISTICS

Market Returns Growth Assets	3 Mths %	1 Year %	3 Years % p.a.
UK Equities	5.0	13.1	10.1
Global Developed Equities	4.8	12.4	15.4
USA	5.7	11.5	16.7
Europe	0.5	16.9	14.3
Japan	7.9	14.4	18.2
Asia Pacific (ex Japan)	7.5	23.4	15.3
Emerging Markets	6.6	25.8	12.1
Frontier Markets	4.8	20.9	10.6
Property	3.4	11.2	9.1
Hedge Funds	1.8	-0.8	9.3
Commodities	9.0	-3.4	-3.0
High Yield	-0.1	0.6	11.8
Emerging Market Debt	-1.5	5.4	6.7
Senior Secured Loans	0.6	4.1	5.1
Cash	0.1	0.3	0.4

Market Returns Bond Assets	3 Mths %	1 Year %	3 Years % p.a.
UK Gilts (>15 yrs)	3.6	3.3	7.0
Index-Linked Gilts (>5 yrs)	3.9	2.5	8.9
Corporate Bonds (>15 yrs AA)	2.9	4.5	7.6
Non-Gilts (>15 yrs)	3.1	5.9	7.4

Exchange Rates: Change in Sterling	3 Mths %	1 Year %	3 Years % p.a.
Against US Dollar	0.8	9.5	-4.6
Against Euro	-0.7	-3.8	-4.4
Against Yen	0.9	5.7	-6.6

Inflation Indices	3 Mths %	1 Year %	3 Years % p.a.
Price Inflation – RPI	1.1	4.1	2.6
Price Inflation – CPI	0.8	3.0	1.6
Earnings Inflation*	0.4	2.4	2.5

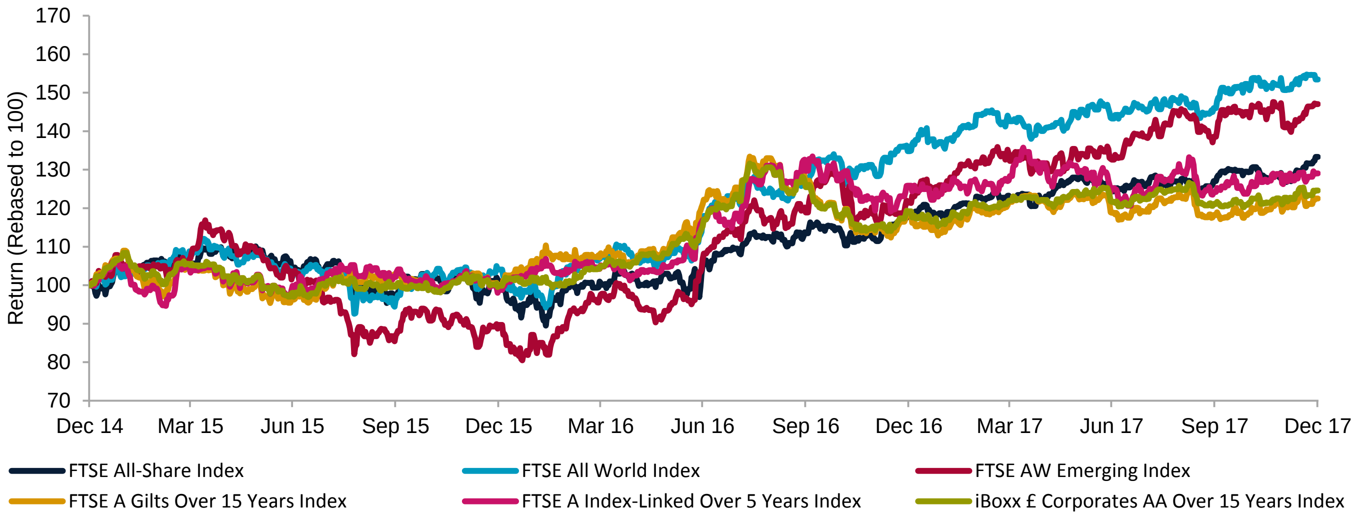
Yields as at 31 December 2017	% p.a.
UK Equities	3.59
UK Gilts (>15 yrs)	1.68
Real Yield (>5 yrs ILG)	-1.67
Corporate Bonds (>15 yrs AA)	2.44
Non-Gilts (>15 yrs)	2.90

Absolute Change in Yields	3 Mths %	1 Year %	3 Years % p.a.
UK Equities	-0.09	0.12	0.22
UK Gilts (>15 yrs)	-0.16	-0.08	-0.74
Real Yield (>5 yrs ILG)	-0.15	0.00	-0.90
Corporate Bonds (>15 yrs AA)	-0.20	-0.18	-0.98
Non-Gilts (>15 yrs)	-0.15	-0.11	-0.84

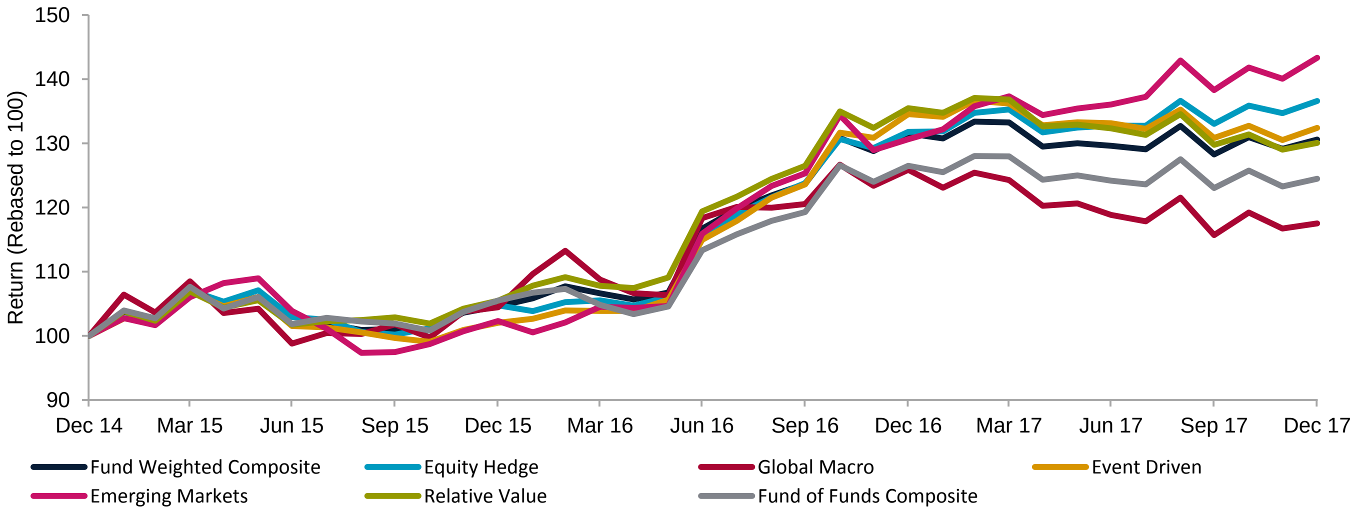
Source: Thomson Reuters and Bloomberg
Note: * Subject to 1 month lag

MARKET SUMMARY CHARTS

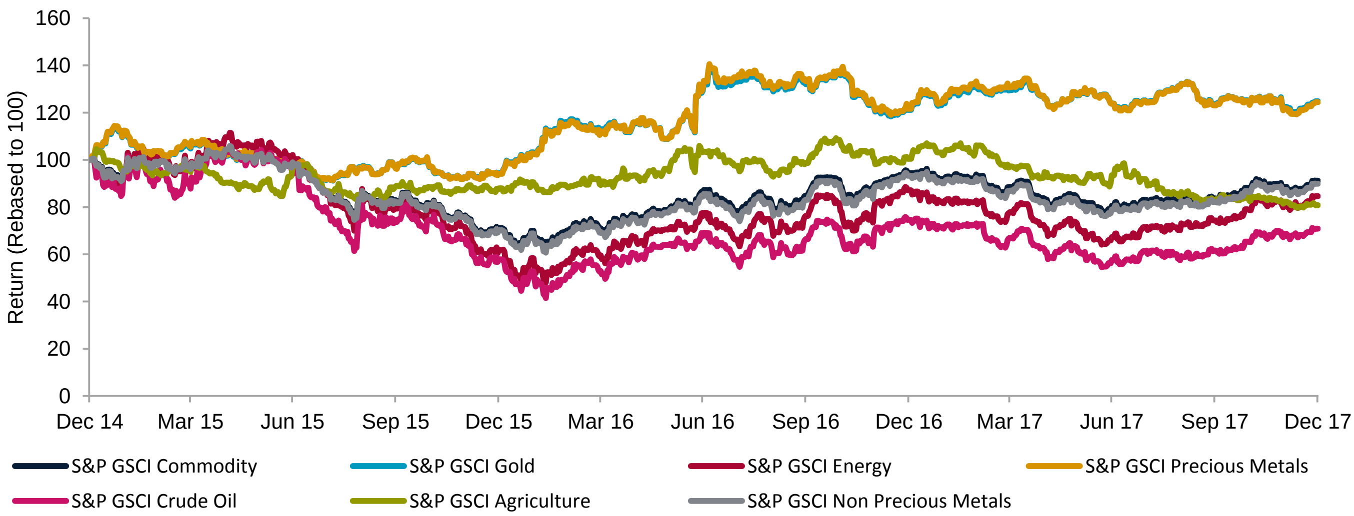
Market performance – 3 years to 31 December 2017



Hedge Funds: Sub-strategies performance – 3 years to 31 December 2017

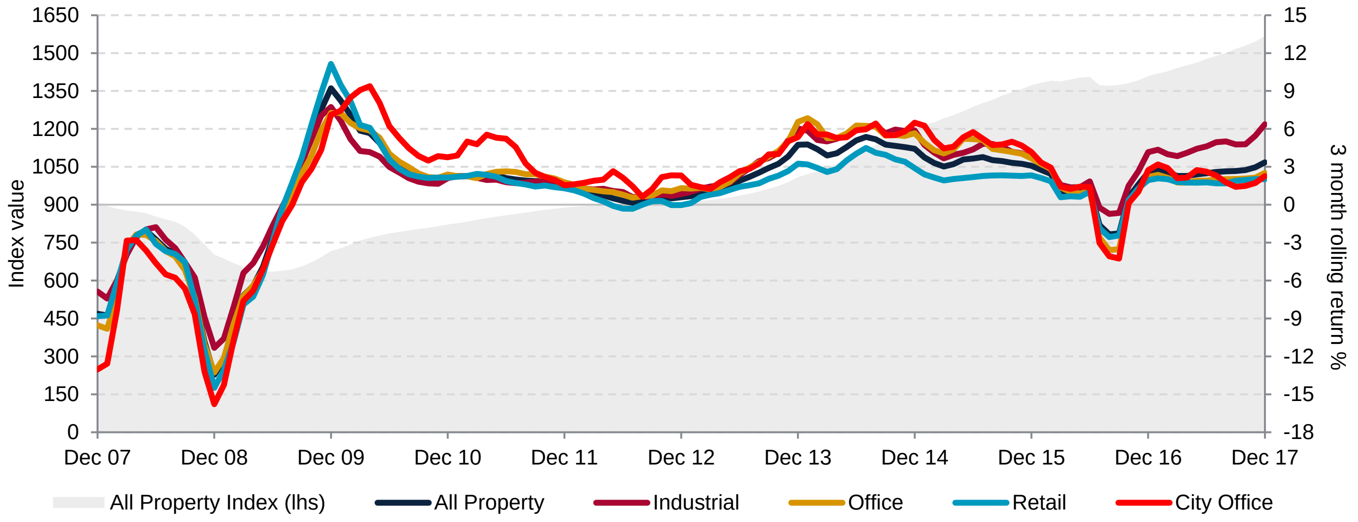


Commodities: Sector performance – 3 years to 31 December 2017

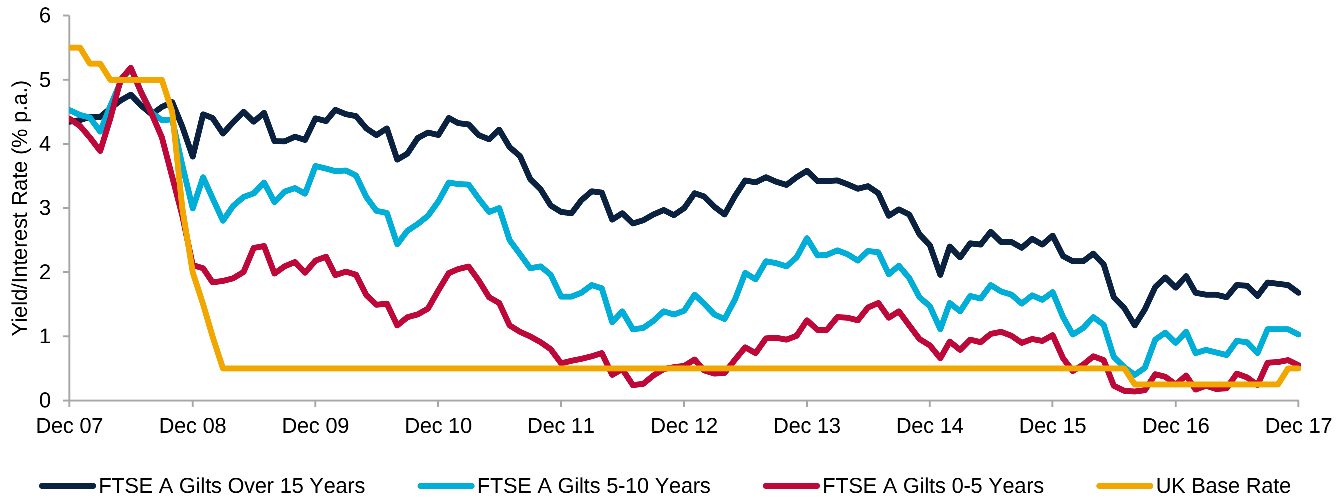


Source: Thomson Reuters

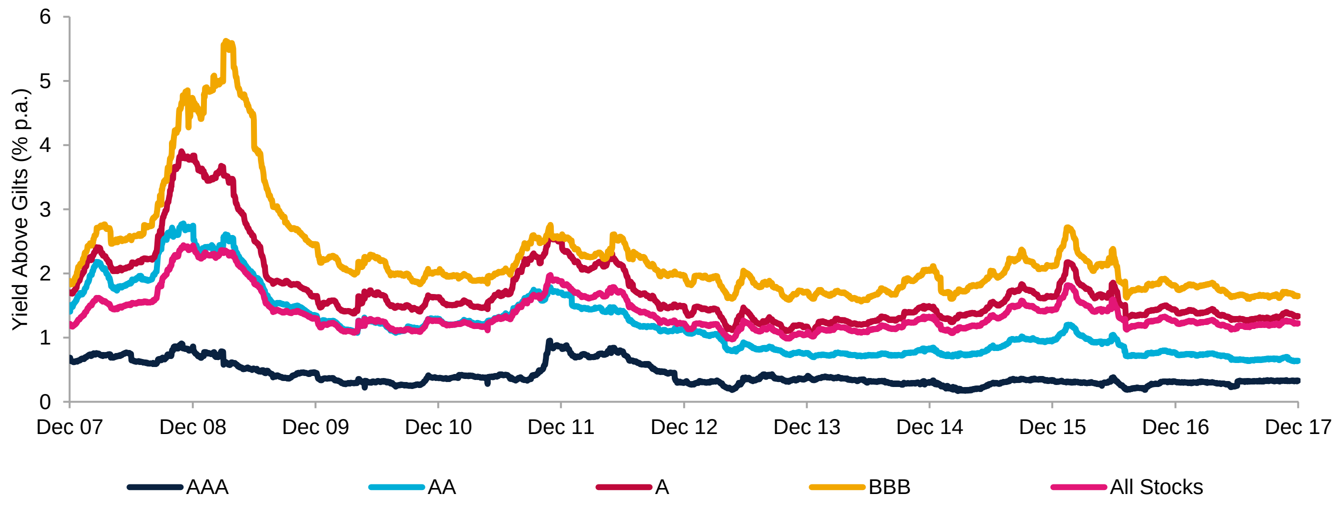
Property: Sector performance – 10 years to 31 December 2017



UK government bond yields – 10 years to 31 December 2017



Corporate bond spreads above government bonds – 10 years to 31 December 2017



Source: Thomson Reuters

2 ECONOMIC STATISTICS

Economic Statistics as at:	31 December 2017			30 September 2017			31 December 2016		
	UK	Euro[1]	US	UK	Euro[1]	US	UK	Euro[1]	US
Annual Real GDP Growth[2]	1.7%	4.1%	2.3%	1.9%	3.6%	2.2%	2.0%	2.4%	1.5%
Annual Inflation Rate[3]	3.0%	1.4%	2.1%	3.0%	1.5%	2.2%	1.6%	1.1%	2.1%
Unemployment Rate[4]	4.3%	8.7%	4.1%	4.3%	9.0%	4.3%	4.8%	9.8%	4.7%
Manufacturing PMI[5]	56.2	60.6	55.1	56.0	58.1	53.1	55.8	54.9	54.3

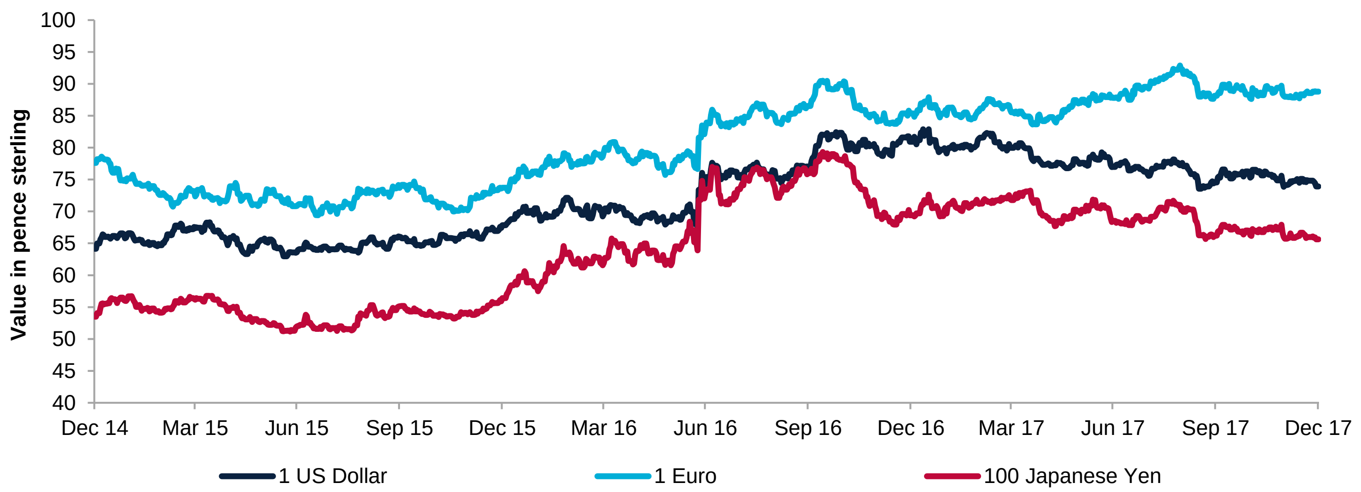
Change over periods ending:	3 months			12 months		
31 December 2017	UK	Euro[1]	US	UK	Euro[1]	US
Annual Real GDP Growth[2]	-0.2%	0.5%	0.1%	-0.3%	1.7%	0.8%
Annual Inflation Rate[3]	0.0%	-0.1%	-0.1%	1.4%	0.3%	0.0%
Unemployment Rate[4]	0.0%	-0.3%	-0.2%	-0.5%	-1.1%	-0.6%
Manufacturing PMI[5]	0.2	2.5	2.0	0.4	5.7	0.8

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	
	31 Dec 17	30 Sept 17	31 Dec 16	3 months	12 months
1 US Dollar is worth	73.92p	74.54p	80.93p	0.8%	9.5%
1 Euro is worth	88.77p	88.11p	85.36p	-0.7%	-3.8%
100 Japanese Yen is worth	65.62p	66.22p	69.39p	0.9%	5.7%

Exchange rate movements – 3 years to 31 December 2017



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

3 MARKET COMMENTARY

INTRODUCTION

2017 turned into the second consecutive positive year for growth investors, with strong returns having been delivered across a broad range of asset classes and investment strategies. It is worth noting that returns were concentrated at the beginning and end of the year, with relatively unexciting second and third quarters in between.

Many economists were somewhat surprised by the positive outcome of equity markets for 2017. At the start of the year, numerous investment professionals were concerned that the combination of political instability and economic uncertainty would lead to increased financial market volatility and disappointing investment returns. However, the year did not work out that way.

The current market cycle has been a long and gradual economic expansion and despite the frequently occurring low market volatility across asset classes, investors have found themselves preoccupied by external factors.

At the start of 2017, market participants were distracted by a seemingly populist political outlook and although ultimately, neither global growth worries nor political fears materialised, the market continued its upward momentum in the face of these concerns.

UNITED KINGDOM

- The UK economy was resilient over the final quarter of 2017 but uncertainty remains surrounding its future relationship with the European Union.
- As anticipated, inflation has moved higher, which could add downward pressure on household spending in the coming months.
- Without a tailwind from sterling weakness, the market appears to be lacking the momentum in earnings to drive outperformance.
- However, valuations are reasonable compared with other equity markets and corporate results have been broadly in line with expectations.

EUROPE EX UK

- European equities had a flat quarter. Economic data in the euro-zone continues to paint a positive picture, including higher business confidence readings, strong PMI’s and an up-tick in GDP growth.
- However, the investment market failed to follow this trend in the final quarter, although the full year numbers for 2017 are encouraging.
- Growth in the region is likely to be encouraged by a backdrop of persistently low borrowing rates and high equity prices.
- The outlook for the euro-zone remains positive with monetary policy remaining supportive and global demand in good health.

NORTH AMERICA

- US equities experienced a good final quarter. The proposed tax reforms, lower taxes and a reduced regulatory burden are likely to provide a substantial boost to corporate earnings.
- However, implementation and detailed plans are both proving difficult.
- Investors have low expectations on the ability of the Trump administration to push through these policies and therefore upside surprises on the fiscal front are a real possibility.

JAPAN

- Japanese equities were the sterling outperformer of the quarter.
- Japan is showing strong earnings growth and benefitting from solid growth momentum behind the economy.
- From a valuation perspective, these are attractive compared to historical averages and other markets.
- Yen weakness, as a result of the Bank of Japan retaining ultra-accommodative monetary policy, will also provide a boost to the region.

ASIA PACIFIC EX JAPAN / EMERGING MARKETS

- Over the course of the year, momentum for economic growth has been passed from the advanced economies to emerging markets, and global trade continues to grow strongly, which creates a supportive backdrop.
- Specifically in Asia, the improving fundamentals of emerging markets has had, and should continue to have, a positive impact on the economies in this region because of the trade linkage.
- Resilient domestic demand, which is being driven by public spending initiatives, stable commodity prices and accommodative monetary polices are supporting most of the regions.
- Headwinds for this region in 2018 include US policy normalisation and a more protectionist stance from President Trump, however, there are many positive factors attracting investors to this region.
- Broader emerging market equity has performed well over the quarter as the risk of a sharp US Dollar rally has faded and growth is broadening out.
- Relative to their developed market peers, emerging equities offer an attractive valuation discount and strong earnings growth is expected across many of the larger economies such as India, Mexico and South Africa.
- However, the outlook for Asia is dependent on US trade policies and the degree of monetary tightening.
- Emerging economies as a whole have been successful in improving their economies, using measures to spur economic activities.
- Broadly speaking, there are reasons to be confident about the outlook for emerging market economies.
- However, a central worry has been the build-up of leverage, especially dollar debts, in many emerging economies. This remains a key vulnerability and a critical issue to track.
- For the time being, decent growth trends imply that the outlook remains reasonable, but the build-up in total economy leverage over the last ten years in many emerging markets (especially markets like China, Brazil, Turkey, Mexico, and Russia) is an important economic risk factor that investors need to watch. Any deterioration in global conditions, or the realisation of a much more aggressive US Federal Reserve tightening cycle, could trigger some adverse dynamics – even if, in most instances, we still believe that policymakers have sufficient tools (monetary, fiscal, exchange rate) to manage against shocks.

FIXED INCOME

- Within US government bonds, the key driver of returns has been the US employment market – which continues to tighten whilst economic growth remains robust.
- The outlook for US fiscal policy remains a key source of concern for monetary policy makers while significant uncertainty exists about President Trump's legislative program and its timetable.
- The Federal Reserve also raised interest rates once over the quarter, bringing the total to three during 2017.
- Within European bonds, robust economic growth is expected to continue in the Eurozone, which should reduce any spare capacity and support a gradual recovery in inflation.
- The European Central Bank has maintained its forward guidance on interest rates and they are expected to remain at current levels until 2019. The reduction in the asset purchase program was interpreted as continuing a loose fiscal policy program by markets, because it was kept open-ended in order to preserve policy flexibility.
- In Japan, government bonds have been driven by the Bank of Japan's bond-buying program and negative interest rate policy which has put 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.
- In the UK, there has been a sustained and substantial overshoot of the Bank of England's 2% inflation target and this remains a concern. The ongoing economic resilience and above-target inflation caused the Bank of England to raise rates in October back to the pre Brexit level.
- The uncertainties surrounding the UK's political backdrop, together with Brexit, could reduce the probability of any further tightening anytime soon but if capacity constraints continue to build, the Bank of England may well be obliged to raise rates again.
- UK corporate bonds have been delivering returns, company balance sheets remain in relatively good shape and default levels are not an issue currently. 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 has driven European yields to unattractive levels making sterling corporate bonds relatively appealing for investors. Concerns are building, amongst bond investors, that spreads have tightened to such a degree that further upside to price, looks challenging and that the risks are skewed to the downside.
- Potential policy error, in the form of aggressive rate rises, will add to downward pressures. A slowdown in consumer spending and higher inflation could also consequently increase the yield spread over government bonds.
- The outlook for global credits is trickier. Fundamentally, a regime of good growth and relatively low inflation points to a benign credit outlook.
- It is likely that credit defaults and downgrades will remain low for now. Yet a lot of this good news is already priced in and the pay-off and potential reward for taking credit risk seems limited.
- Current market pricing indicates that even a slight deterioration in the data, or an inflationary spike, could create difficult trading conditions and meaningful price movements.

ALTERNATIVES

- Hedge Funds (in Sterling terms) returned 1.8% over the quarter. Emerging Markets was the key driver, returning 3.1% followed by Equity Hedge which posted gains of 2.6%. Global Macro (1.5%), Event Driven (1.2%) and Relative Value (0.4%) also generated positive returns. The performance of hedge funds in US dollar terms was positive (8.7%) over the year, driven by the acceleration of the US economy, performance of global equities and improvement of investor tolerance. However, the depreciation of the US dollar against Sterling over the same period led to a decline of -0.8% in Sterling terms.

- UK commercial property continued its upward trajectory over the quarter, returning 3.4%. Rental income remained unchanged at 1.3%, however, capital values increased by 2.0%. All sectors posted positive returns; Industrials increased by 6.4%, followed by Offices which returned 2.5%. Retail and City Offices sectors grew by 2.0% and 2.3%, respectively. At the end of December, the annual property yield stood at 5.5%.
- Commodity markets gained 9.0% over the quarter, largely driven by strong price rises in the crude oil and energy sectors which returned 15.0% and 13.9%, respectively. In November, crude oil prices surged following a fall in supply. Petroleum prices also gained as Organisation of the Petroleum Exporting Countries (OPEC) and non-OPEC producers agreed to extend production cuts in 2018. Additionally, an explosion of a pipeline in Libya's largest oil port boosted performance as supply was impacted. Agriculture continued to decline as negative returns (in Sterling terms) were posted in October, November and December.

CONCLUSION

Total returns were surprisingly strong across a whole variety of asset classes over the quarter and indeed, 2017. The environment has been one of economic growth, low inflation, and in line with corporate profits.

Looking forward, investors face some key questions. Can this current economic environment continue? Can central banks afford it? What are the growth expectations for economies? Finally, where could the next drivers of growth originate?

The forces that have driven the global economy; low inflation, supportive policy, and strong corporate profits appear to be beginning to wane, and the scope for a much better than expected economic environment in 2018 seems more limited.

Growth trends are still continuing across the advanced economies and emerging markets – and recession risk appears low for now. The typical factors that drive recessions, significant monetary tightening, economic imbalances, and geopolitical shocks are not established at the moment and there is no evidence in global leading economic indicators of an imminent downturn.

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	IPD UK 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	Retail Price Index (All Items NADJ)
Price Inflation – CPI	Consumer Price Index (All Items 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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