CLWYD PENSION FUND

ECONOMIC AND MARKET UPDATE
PERIOD ENDING 30 JUNE 2018

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1 MARKET BACKGROUND
PERIOD ENDING 30 JUNE 2018

MARKET STATISTICS

Market Returns Growth Assets	3 Mths %	1 Year %	3 Years % p.a.
UK Equities	9.2	9.0	9.6
Overseas Developed	7.0	9.4	15.9
North America	10.0	12.5	18.1
Europe (ex UK)	3.7	2.9	12.1
Japan	3.2	9.3	13.5
Asia Pacific (ex Japan)	4.4	6.0	14.7
Emerging Markets	-2.4	5.9	10.9
Frontier Markets	-11.9	-1.2	6.7
Property	2.0	9.7	7.6
Hedge Funds**	0.4	4.0	2.7
Commodities**	7.7	27.6	-5.6
High Yield**	-0.6	0.5	4.8
Emerging Market Debt	-4.8	-3.9	8.1
Senior Secured Loans**	0.0	2.1	2.8
Cash	0.1	0.4	0.4

Market Returns Bond Assets	3 Mths %	1 Year %	3 Years % p.a.
UK Gilts (>15 yrs)	-0.4	4.2	8.3
Index-Linked Gilts (>5 yrs)	-1.2	2.0	8.5
Corporate Bonds (>15 yrs AA)	-1.5	-0.2	7.4
Non-Gilts (>15 yrs)	-1.4	0.1	7.4

Exchange Rates: Change in Sterling	3 Mths %	1 Year %	3 Years % p.a.
Against US Dollar	-5.9	1.6	-5.7
Against Euro	-0.9	-0.7	-7.1
Against Yen	-2.0	0.2	-8.7

Inflation Indices	3 Mths %	1 Year %	3 Years % p.a.
Price Inflation – RPI	1.1	3.4	2.8
Price Inflation – CPI	0.8	2.4	1.8
Earnings Inflation*	1.3	2.6	2.4

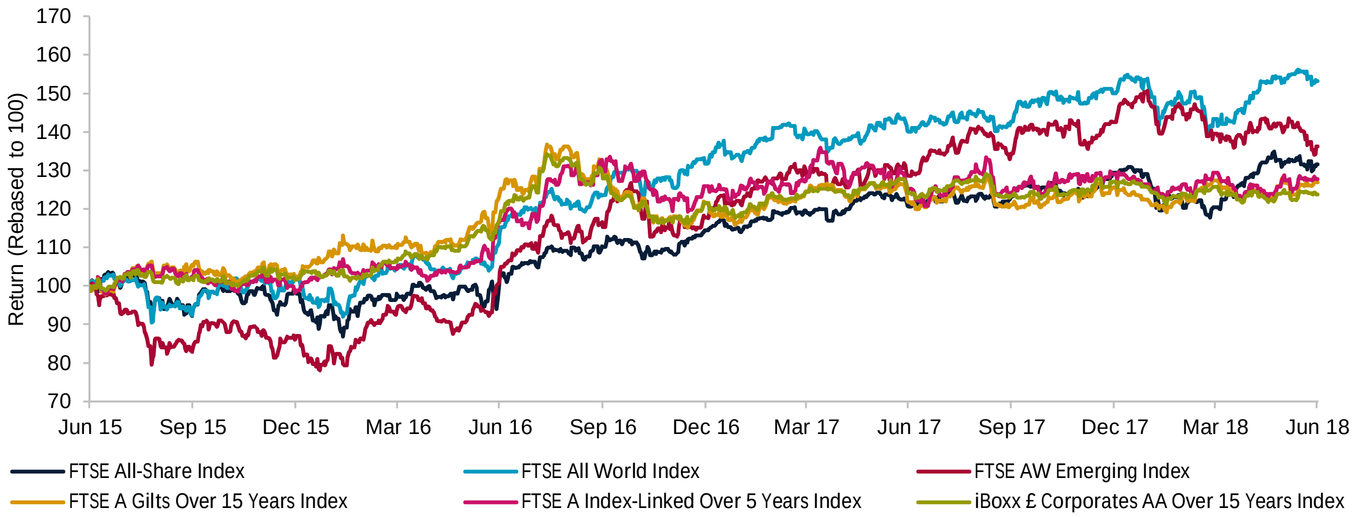
Yields as at 30 June 2018	% p.a.
UK Equities	3.64
UK Gilts (>15 yrs)	1.67
Real Yield (>5 yrs ILG)	-1.59
Corporate Bonds (>15 yrs AA)	2.72
Non-Gilts (>15 yrs)	3.16

Absolute Change in Yields	3 Mths %	1 Year %	3 Years % p.a.
UK Equities	-0.21	0.03	0.18
UK Gilts (>15 yrs)	0.04	-0.13	-0.96
Real Yield (>5 yrs ILG)	0.07	-0.01	-0.83
Corporate Bonds (>15 yrs AA)	0.15	0.16	-0.96
Non-Gilts (>15 yrs)	0.13	0.22	-0.82

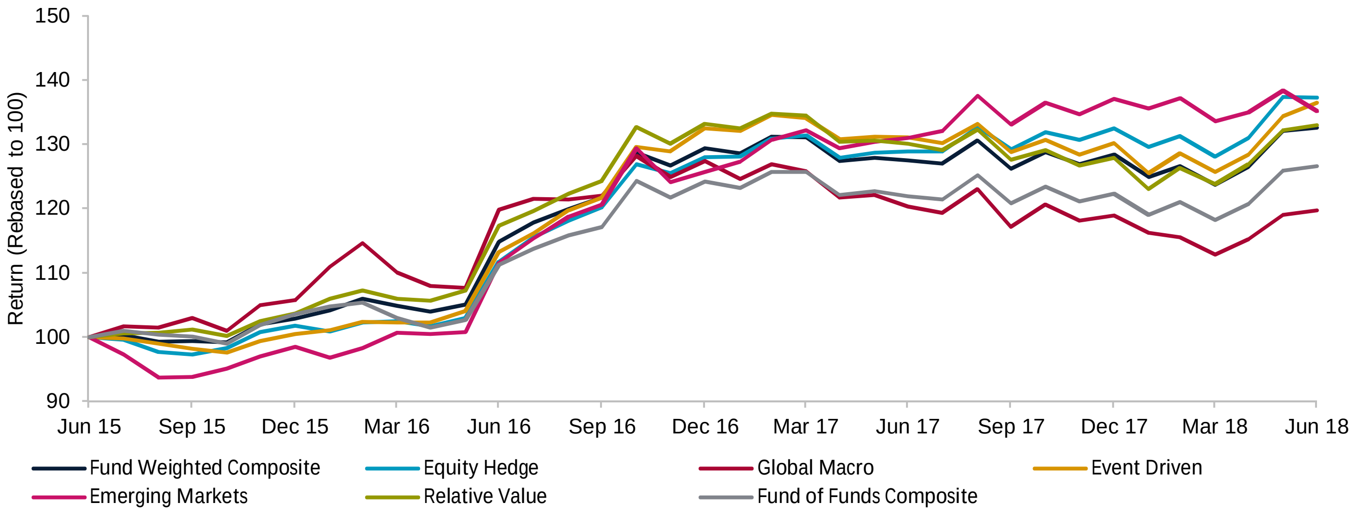
Source: Thomson Reuters.
Notes: * Subject to 1 month lag ** GBP Hedged

MARKET SUMMARY CHARTS

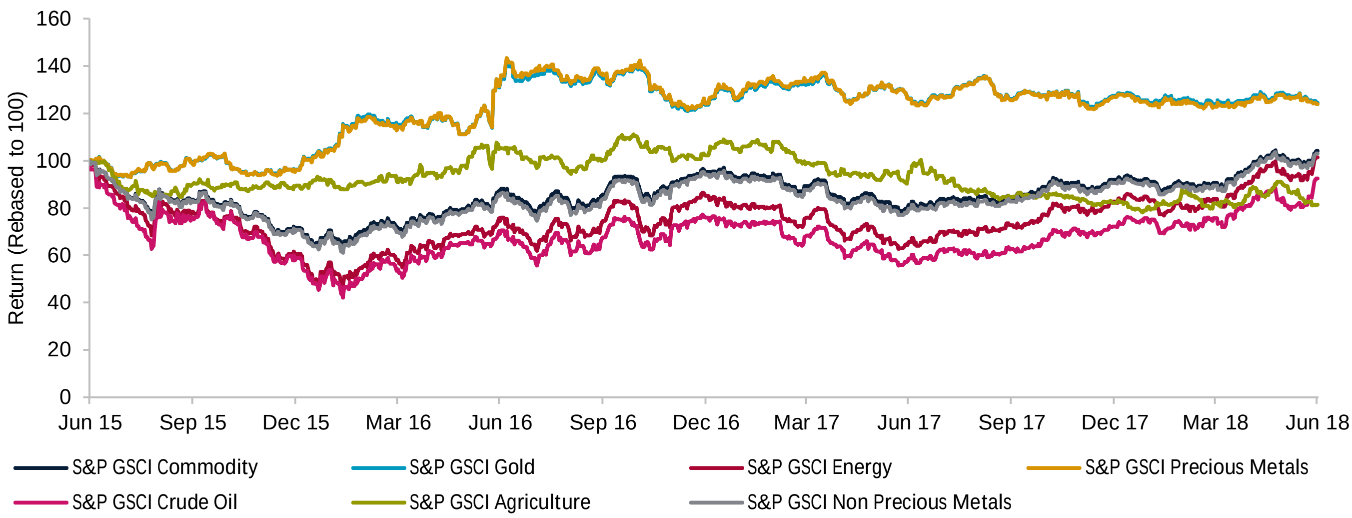
Market performance – 3 years to 30 June 2018



Hedge Funds: Sub-strategies performance – 3 years to 30 June 2018

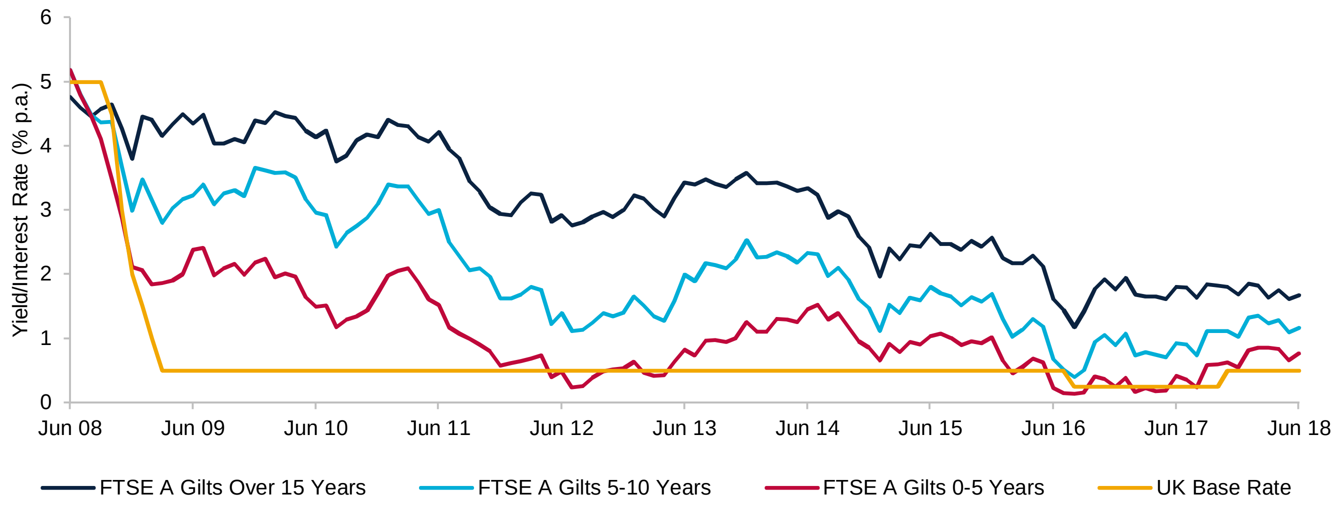


Commodities: Sector performance – 3 years to 30 June 2018

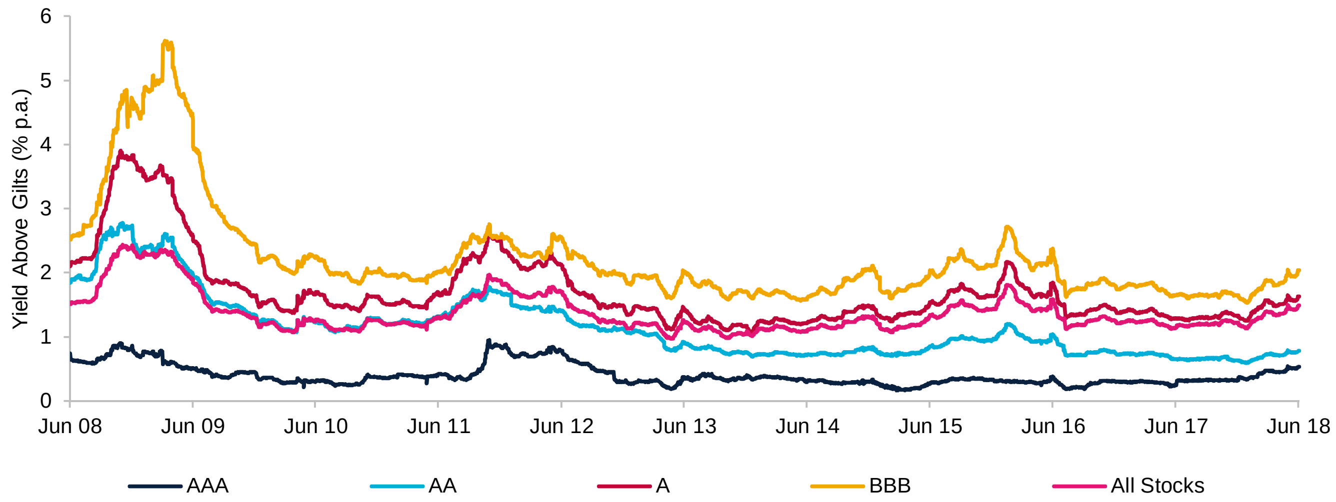


Source: Thomson Reuters

UK government bond yields – 10 years to 30 June 2018



Corporate bond spreads above government bonds – 10 years to 30 June 2018



Source: Thomson Reuters

2 ECONOMIC STATISTICS

Economic Statistics as at:	30 June 2018			31 March 2018			30 June 2017		
	UK	Euro[1]	US	UK	Euro[1]	US	UK	Euro[1]	US
Annual Real GDP Growth[2]	1.2%	0.0%	2.6%	1.3%	4.0%	2.5%	1.8%	2.7%	1.9%
Annual Inflation Rate[3]	2.4%	2.0%	2.9%	2.4%	1.3%	2.4%	2.7%	1.3%	1.6%
Unemployment Rate[4]	4.2%	8.3%	3.9%	4.2%	8.6%	4.1%	4.5%	9.1%	4.3%
Manufacturing PMI[5]	54.4	54.9	55.4	54.9	56.6	55.6	54.2	57.4	52.0

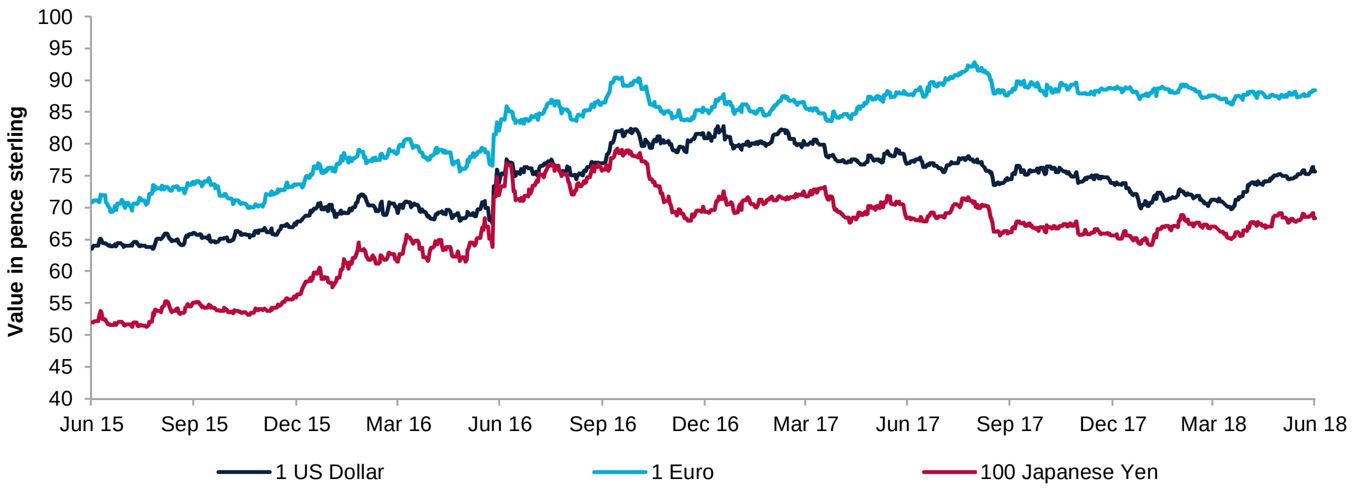
Change over periods ending:	3 months			12 months		
30 June 2018	UK	Euro[1]	US	UK	Euro[1]	US
Annual Real GDP Growth[2]	-0.1%	-4.0%	0.1%	-0.6%	-2.7%	0.7%
Annual Inflation Rate[3]	0.0%	0.7%	0.5%	-0.3%	0.7%	1.3%
Unemployment Rate[4]	0.0%	-0.3%	-0.2%	-0.3%	-0.8%	-0.4%
Manufacturing PMI[5]	-0.5	-1.7	-0.2	0.2	-2.5	3.4

Notes: 1.Euro Area 19 Countries. 2. GDP is lagged by 3 months. 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 Jun 18	31 Mar 18	30 Jun 17	3 months	12 months
1 US Dollar is worth	75.74p	71.29p	76.99p	-5.9%	1.6%
1 Euro is worth	88.44p	87.67p	87.81p	-0.9%	-0.7%
100 Japanese Yen is worth	68.38p	67.03p	68.52p	-2.0%	0.2%

Exchange rate movements – 3 years to 30 June 2018



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

3 MARKET COMMENTARY

INTRODUCTION

In a reversal of the first quarter, equity markets moved upwards to recover their losses from February and March. However, this has also caused equity market volatility to remain elevated. The reasons for the heightened volatility of markets remain similar to the first quarter of this year: the continued threat of trade wars, a tech sector recovery (instead of a rout), and rising interest rates. Major equity indices ended the quarter higher with the exception of emerging markets which are still carrying a loss for 2018.

The economic backdrop is continuing to hold firm in developed markets, with more and more signs that we are entering a new and later phase of the market cycle.

Rising US interest rates, the potential ending of European quantitative easing (QE) and a robust global corporate earnings season indicate that the short term noise and aggressive corrections seen in the US and UK equity markets in Q1 appear to be temporary setbacks rather than capitulation. Strong economic fundamentals remain despite the political backdrop and the expected stress of trade wars.

UNITED KINGDOM

- The UK equity market gained 9.2% since the start of Q2 and is up 1.7% since the start of this year. This has had the effect of restoring the gains made in 2017 which had been lost in the first quarter of the year.
- The realisation that a global protectionist trading environment has clearly dawned with sectors such as steel and aluminium already having tariffs applied to them, but so far this has had a limited impact on UK equities because of the UK's import-heavy economy. The tariffs will undoubtedly have a detrimental impact on the UK steel sector as the proposed tariff includes a 25% import tax on steel. These could be the opening shots of a more aggressive trade war and a taste of things to come.
- Ongoing concerns continue to surround the timetable and outcome of the Brexit negotiations. Uncertainties persist regarding the UK's relationship with the rest of the world post March 2019, causing businesses to delay their spending plans. In addition, the average consumer has begun to tighten their belts, with discretionary spending falling and leaving the high street shops struggling to compete with goods on the internet.
- The value of sterling compared to the US dollar has fallen 5.9% during the quarter as the realisation of the UK leaving the EU with a 'no deal' became more apparent. The growing possibility of the Prime Minister being unseated continues to reverberate. In all likelihood this will not occur until well after the UK officially leaves the European Union.

NORTH AMERICA

- The US equity market has gained 10% since the start of the second quarter and is up 5.4% since the start of the year. A mix of robust fundamentals and the current administration's statement that they are not seeking a trade war but are looking to negotiate trade deals gave the market a boost in the second quarter on hopes that diplomacy would prevail.
- Much of the recovery in US markets has been from the tech sector where investors sought stocks that had been sold during the first quarter following the data breaches and the possibility of increasing regulation in the

sector. Financials, as a sector, could however benefit in the future as the administration is keen to deregulate which could inspire investor confidence in this asset class.

- In May, China and the US held talks about trade and have reiterated that further talks will be held as both sides look to avoid a full blown trade war. Although tariffs have been imposed on both sides, the market has taken the willingness of participants to talk before tariffs are imposed as a positive. Although this might not avoid a trade war, it does signal an openness to avoid one if possible.
- Concerns remain surrounding the US fiscal deficit and the impact future interest rate rises will have on the economy. There is also an unease surrounding the progress of President Trump's protectionist trade policies and foreign policy agenda. However, the fundamentals of the US are robust with unemployment at record lows, inflation not moving ahead at a pace the consumer is finding uncomfortable and there is an environment that is supportive of rising interest rates. This coupled with the benefits of the tax reform are providing opportunities with both consumer and business confidence at record high levels.

EUROPE

- The European market returned 3.7% over the quarter and although this helped recover some of the losses from the first quarter, this asset class is still down year to date.
- Politics and tariffs dominated the investment thoughts of market participants. A populist coalition headed by Giuseppe Conte ended months of talks and took up the President's offer to form a government in Italy. The concerns that investors had about such a government were short lived with many pre-election promises kicked down the road or in the case of leaving the Euro, dropped (instead seeking to reform from within).
- With QE in the Eurozone thought to have added 0.75% to the GDP for each of the last 3 years and its impact on inflation, which is close to but below 2%, the European Central Bank (ECB) announced they would be ending their QE program later this year. By September the buying program of €30bn of assets a month will be reduced to €14bn of assets a month and will end completely by the end of the year. However, the ECB have acknowledged recent soft data relating to the region by confirming that interest rates will not be increasing for a sustained period, as they still look to continue a supportive economic environment.
- The tariffs imposed by the US on steel and aluminium (among other items) from the EU have triggered a like for like action, with Harley Davidson being just one of the big names targeted. Europe is likely to be less impacted by a trade war than other regions due to large volumes of internal EU trade and service led economies.
- The fundamentals still appear to be healthy, a view supported by the ECB's decision to end its QE program. However, there are concerns about the impact that a 'no Brexit deal' with the UK will have on the region. A move from larger, exporting companies into more EU domestically focused offerings will be worth considering in the not too distant future should a full blown trade war erupt.

JAPAN

- The Japanese equity market rose 3.2% during the quarter. This was during a period which saw a net $5bn move out of investment funds in one week in April as investors favoured emerging markets due to their attractive returns and frustration at the slower than expected pace of shareholder-friendly polices to come into force.
- The equity market has reacted well to the stabilisation of political concerns and structural reforms, together with the continuation of ultra loose monetary policy.
- Japan tends to be thought of as being export driven and so will be negatively affected by tariffs and trade wars. However, exports actually represent less than a quarter of stock market earnings and so returns are much more domestically reliant.

ASIA PACIFIC EX JAPAN / EMERGING MARKETS

- The emerging markets have fallen during the second quarter by 2.4%. China, the largest emerging market economy fell as it struggled with both trade tariffs and a stronger dollar; whilst President Trump continues to weigh-in on their trade surplus with the US. Political turmoil has also been seen in countries such as Turkey, where voices from the central banks have been asking the Fed to be more mindful of interest rate rises; such is their impact on emerging markets.
- A significant distinction between today and the late nineties is that many emerging market currencies are now free-floating vs USD; meanwhile USD indebtedness across the Asian region is less problematic as local businesses have switched to issuing local currency debt.
- An emerging market crisis is not something that we believe to be likely at this stage as equity volatility across the asset class has been driven as much by trade tensions as that of tighter financial conditions. Corporates continue to deliver strong earnings growth and, in the Asian region, sit on relatively healthy balance sheets.

FIXED INCOME

- Within US government bonds, the key driver of negative returns over Q2 has been the US employment market – which continues to tighten whilst economic growth remains robust. The pace of US economic growth slowed only slightly in Q1 but accelerated in Q2. US 10-year Treasury yields, which move conversely to its price, rose from 2.74% to 2.86% over the quarter. Yields rose early in the quarter, touching a seven-year high in mid-May, as growth and inflation expectations continued, before risk aversion led to a significant pull back.
- The US Federal Reserve (Fed) raised interest rates and kept to its hawkish tone at its June meeting and signalled one further interest rate hike in 2018, (with the risk of two). There is potential for Treasury yields to rise further over the next twelve months. 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.
- In Europe, Italy's debt market proved the most volatile, as Italian 10-year yields increased from 1.79% to 2.68% as the formation of a populist coalition government in May raised concerns over Italy's future relationship with Europe. This uncertainty did have an impact on peripheral Europe, however, German bunds saw high demand for their safe haven status.
- There remains considerable uncertainty around the UK Government's economic outlook and measuring the impact of the eventual departure from the EU remains the main challenge. However, with the labour market at 42-year lows and pay growth accelerating, the Bank of England is unlikely to tolerate above target inflation for too long. Trade wars could increase the demand for safe haven assets in the short term.
- Within the UK, corporate balance sheets remain in relatively good shape and bond default levels are not an issue currently. Concerns are building that spreads (the difference between corporate bond and Gilt yields) have tightened to such a degree that further upside (to price) looks challenging and that the risks are skewed to the downside. With further US rate rises expected in 2018, and possibly in the UK, this only adds to the concern that yields could rise from here. With growing divergence in monetary policy between the US, Europe, Japan and the UK, the cost of hedging overseas holdings is likely to rise because of currency fluctuations, therefore making UK corporate bonds potentially more attractive for Sterling investors.

ALTERNATIVES

- In US dollar terms, hedge fund capital ended the quarter at a new record level for the eighth consecutive quarter with investors reversing strategy flow trends witnessed in the first quarter. Allocation of new capital was given to Equity Hedge strategies whilst being redeemed from Macro strategies. Relative Value Arbitrage and Event Driven strategies also showed small outflows. Returns fell in the range of 1.3% to 8.5% with Emerging

Markets being the poorest and Event Driven being the strongest performers respectively. The strong performance in Technology and Event-Driven strategies was partially offset by trade and tariff volatility which occurred in the latter stages of the quarter. Over the year to date, all funds bar Global Macro demonstrated positive performance in a range of 2.2% to 6.5%. Global Macro had a return of 0.5% over this period.

- Commodity markets gained 7.7% over the quarter, up 27.6% from the same point last year. In general, commodities decreased over the quarter, with the only exception being Crude Oil which saw a 22.3% increase over the quarter, the strongest performing commodity this period. Conversely, agriculture was the worst performing commodity, down 0.5% despite positive returns in the first two months of the quarter.
- Returns from the UK Commercial Property sector remain subdued and the prospects for the future remain uncertain given concerns around demand should the UK experience a hard Brexit, but the asset class has been relatively stable. This stability reflects strong demand from overseas investors for offices in London, attracted by the fall in prices in foreign currency terms. The income on offer remains attractive versus other asset classes. However, the risks are elevated should conditions turn recessionary in the UK and political uncertainty persists.

CONCLUSION

To reiterate what was stated after the previous quarter, it is vitally important to have a sensible investment strategy to drive through the ups and downs of the investment market in such an investment environment. Political risk remains elevated with Brexit and protectionist agendas at the fore. Equity markets and currencies have, and will react to news flow, both positive and negative, but change brings opportunity.

4 INDICES USED IN THIS REPORT

Asset	Index
Growth Assets	
UK	FTSE All-Share Index
Overseas Developed	FTSE World (ex UK) Index
North America	FTSE North America Index
Europe (ex UK)	FTSE AW Developed Europe (ex UK) Index
Japan	FTSE Japan Index
Asia Pacific (ex Japan)	FTSE AW Developed Asia Pacific (ex Japan) Index
Emerging Markets	FTSE All Emerging Index
Frontier Markets	FTSE Frontier 50 Index
Property	IPD UK Quarterly Property Index
Hedge Funds	HFRI Fund Weighted Composite Index (GBP Hedged)
Commodities	S&P GSCI TR Index (GBP Hedged)
High Yield	ICE BoAML Global High Yield Index (GBP Hedged)
Emerging Markets Debt	JPM GBI-EM Global Diversified Composite Index
Senior Secured Loans	S&P Leveraged Loan Index (GBP Hedged)
Cash	IBA GBP LIBOR 7 Day 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	UK Retail Price Index (All Items NADJ)
Price Inflation – CPI	UK Consumer Price Index (All Items NADJ)
Earnings Inflation	UK Average Weekly Earnings Index (Whole Economy excluding Bonuses NADJ)
Exchange Rates	
USD / EUR / JPY vs GBP	WM/Reuters 4:00 pm Closing Spot Rates

Note: All indices above are denominated in Sterling unless stated otherwise.

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