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CLWYD PENSION FUND
ECONOMIC AND MARKET UPDATE
PERIOD ENDING 31 MARCH 2018

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1 MARKET BACKGROUND
PERIOD ENDING 31 MARCH 2018

MARKET STATISTICS

Market Returns Growth Assets	3 Mths %	1 Year %	3 Years % p.a.
UK Equities	-6.9	1.2	5.9
Global Developed Equities	-4.7	1.8	10.6
USA	-4.2	1.8	12.7
Europe	-4.4	4.3	8.8
Japan	-2.6	7.5	11.4
Asia Pacific (ex Japan)	-4.4	6.0	10.2
Emerging Markets	-2.2	11.8	11.3
Frontier Markets	1.4	13.7	10.4
Property	1.9	10.8	8.7
Hedge Funds	-3.4	-5.4	5.5
Commodities	-1.5	1.5	-2.3
High Yield	-3.8	-4.9	8.4
Emerging Market Debt	1.5	0.7	5.8
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)	1.5	2.2	6.1
Index-Linked Gilts (>5 yrs)	0.1	0.7	7.8
Corporate Bonds (>15 yrs AA)	-1.0	1.1	5.4
Non-Gilts (>15 yrs)	-1.4	1.9	5.2

Exchange Rates: Change in Sterling	3 Mths %	1 Year %	3 Years % p.a.
Against US Dollar	3.7	12.2	-1.9
Against Euro	1.3	-2.4	-6.2
Against Yen	-2.1	7.1	-5.7

Inflation Indices	3 Mths %	1 Year %	3 Years % p.a.
Price Inflation – RPI	0.1	3.3	2.7
Price Inflation – CPI	0.1	2.5	1.7
Earnings Inflation*	0.5	2.9	2.3

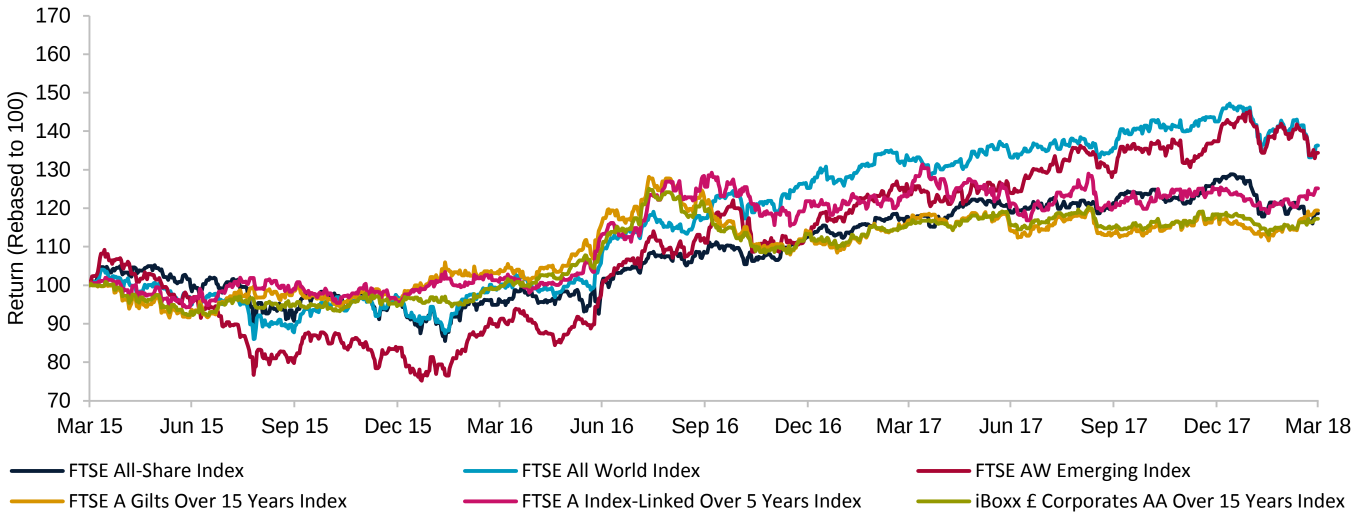
Yields as at 31 March 2018	% p.a.
UK Equities	3.85
UK Gilts (>15 yrs)	1.63
Real Yield (>5 yrs ILG)	-1.66
Corporate Bonds (>15 yrs AA)	2.58
Non-Gilts (>15 yrs)	3.03

Absolute Change in Yields	3 Mths %	1 Year %	3 Years % p.a.
UK Equities	0.26	0.38	0.52
UK Gilts (>15 yrs)	-0.05	-0.02	-0.60
Real Yield (>5 yrs ILG)	0.01	0.06	-0.73
Corporate Bonds (>15 yrs AA)	0.14	0.06	-0.53
Non-Gilts (>15 yrs)	0.12	0.13	-0.35

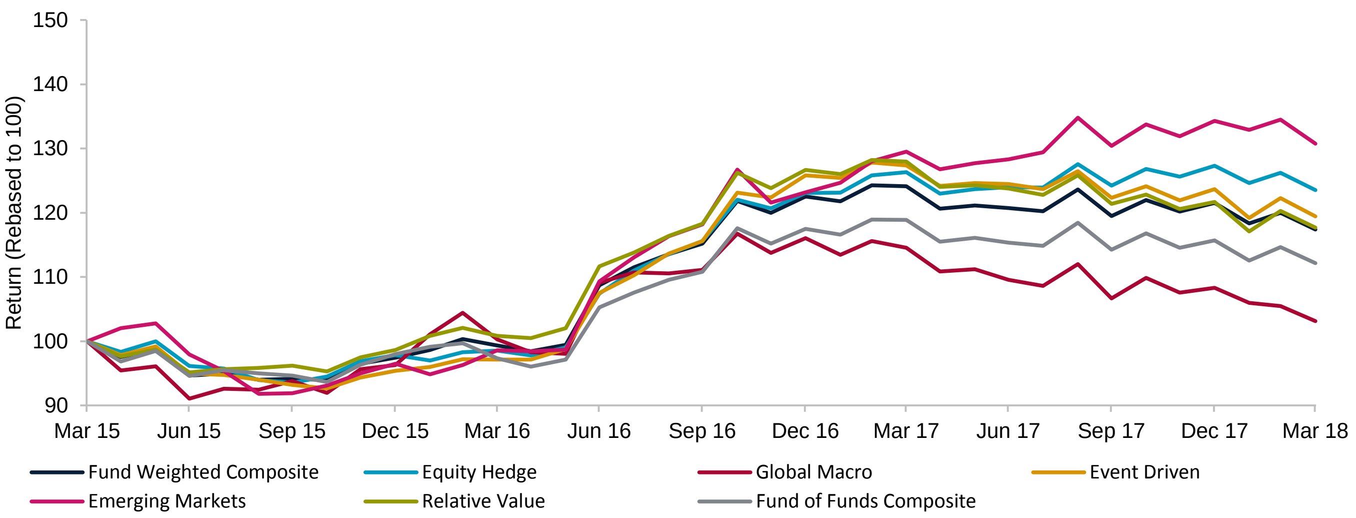
Source: Thomson Reuters and Bloomberg
Note: * Subject to 1 month lag

MARKET SUMMARY CHARTS

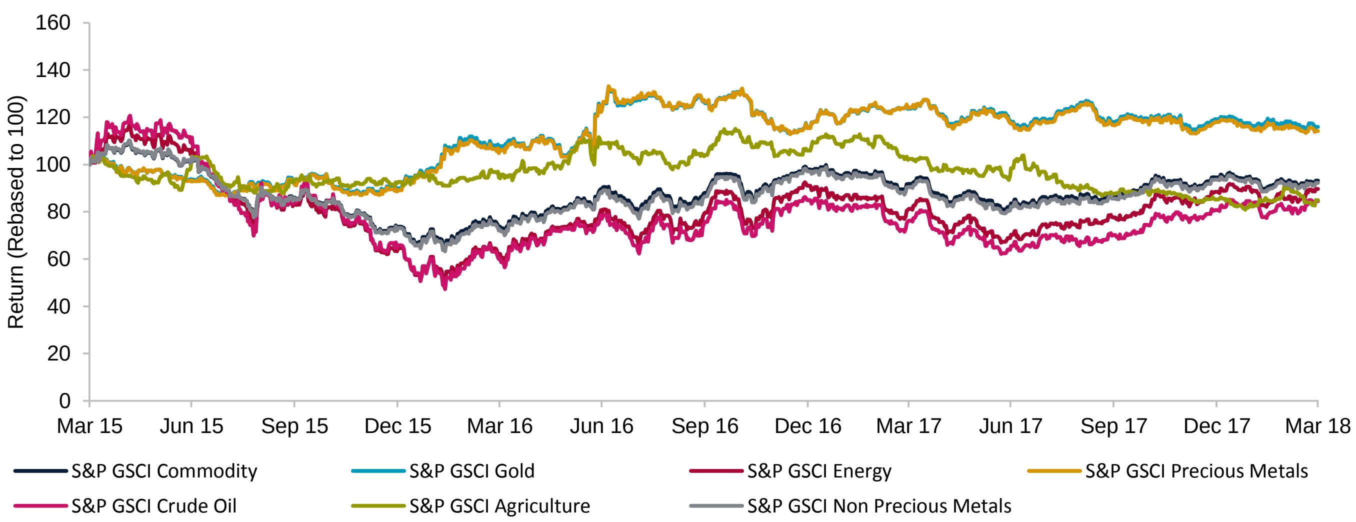
Market performance – 3 years to 31 March 2018



Hedge Funds: Sub-strategies performance – 3 years to 31 March 2018

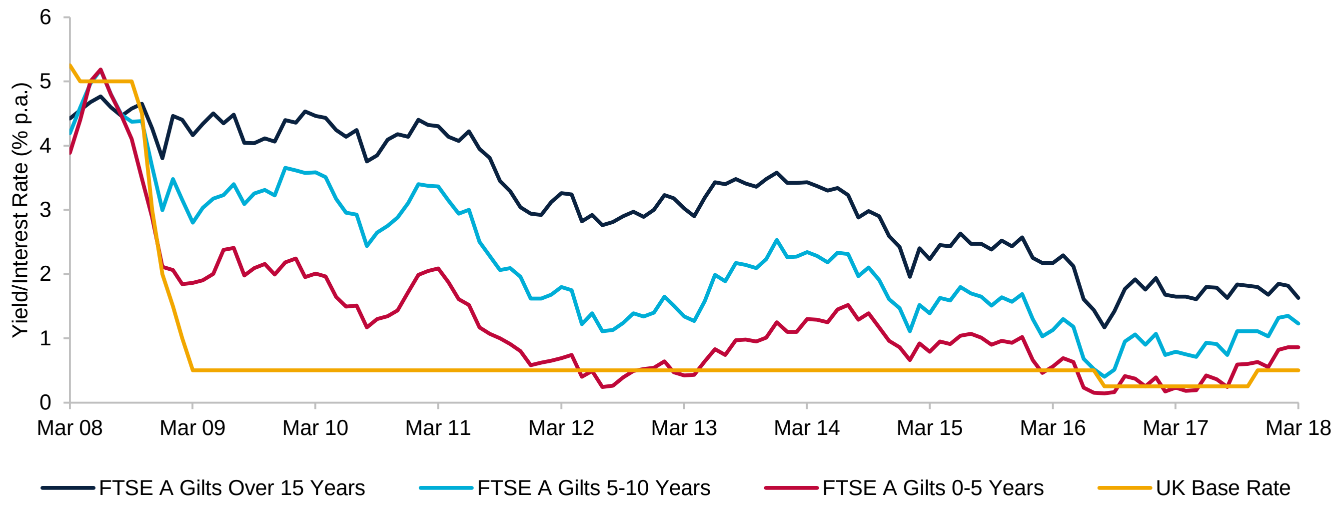


Commodities: Sector performance – 3 years to 31 March 2018

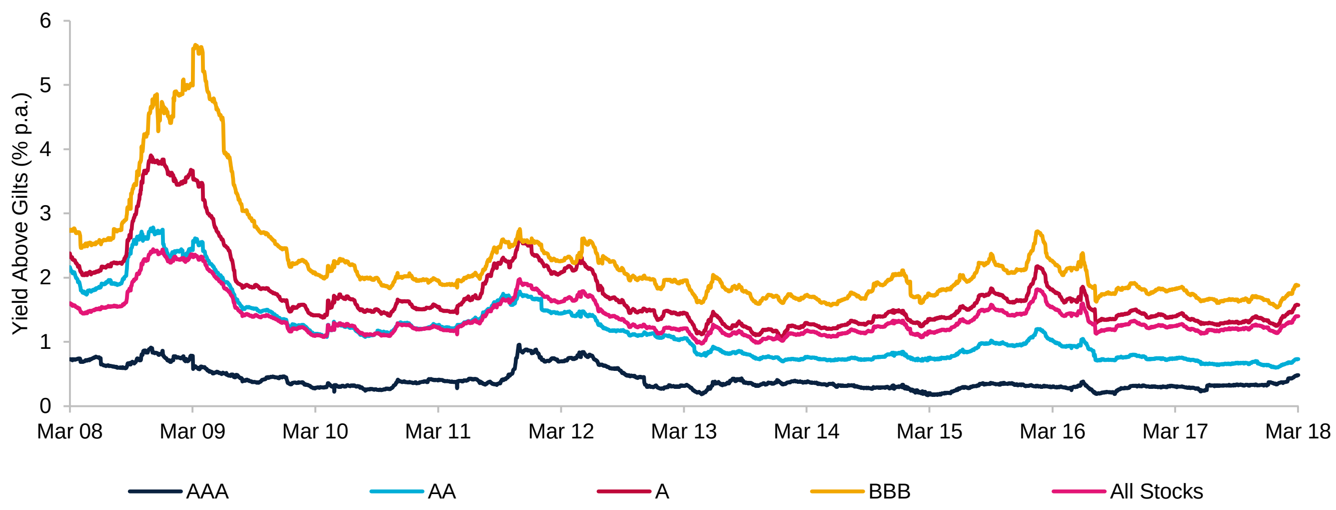


Source: Thomson Reuters

UK government bond yields – 10 years to 31 March 2018



Corporate bond spreads above government bonds – 10 years to 31 March 2018



Source: Thomson Reuters

2 ECONOMIC STATISTICS

Economic Statistics as at:	31 March 2018			31 December 2017			31 March 2017		
	UK	Euro[1]	US	UK	Euro[1]	US	UK	Euro[1]	US
Annual Real GDP Growth[2]	1.4%	4.0%	2.6%	1.8%	4.1%	2.3%	2.0%	2.7%	1.8%
Annual Inflation Rate[3]	2.5%	1.3%	2.4%	3.0%	1.4%	2.1%	2.3%	1.5%	2.4%
Unemployment Rate[4]	4.2%	8.5%	4.1%	4.3%	8.7%	4.1%	4.7%	9.5%	4.7%
Manufacturing PMI[5]	54.9	56.6	55.6	56.2	60.6	55.1	54.3	56.2	53.3

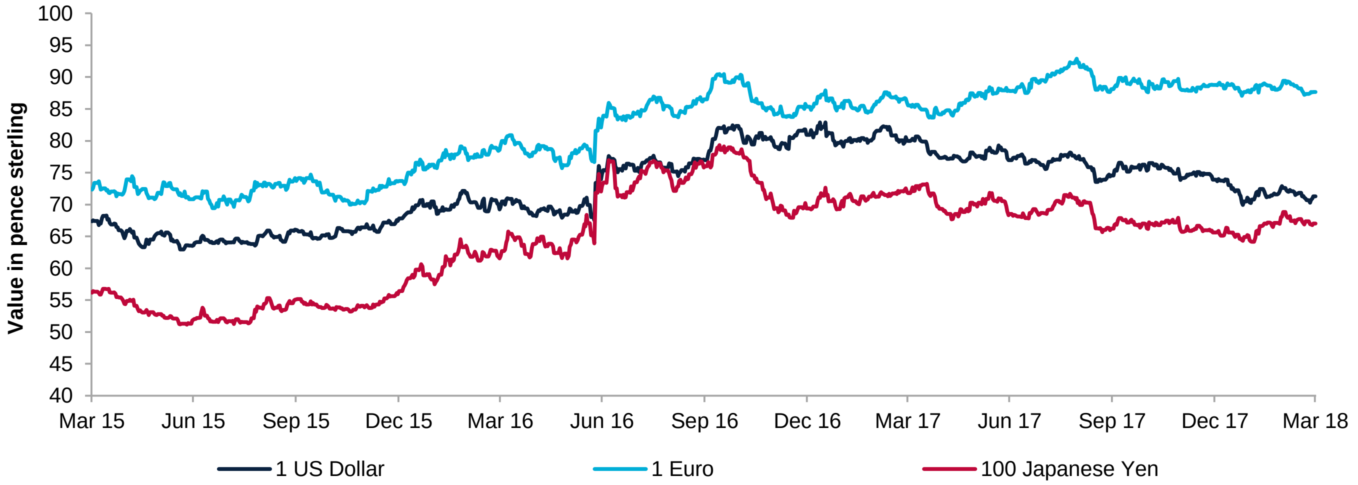
Change over periods ending:	3 months			12 months		
31 March 2018	UK	Euro[1]	US	UK	Euro[1]	US
Annual Real GDP Growth[2]	-0.4%	-0.1%	0.3%	-0.6%	1.3%	0.8%
Annual Inflation Rate[3]	-0.5%	-0.1%	0.3%	0.2%	-0.2%	0.0%
Unemployment Rate[4]	-0.1%	-0.2%	0.0%	-0.5%	-1.0%	-0.6%
Manufacturing PMI[5]	-1.3	-4.0	0.5	0.6	0.4	2.3

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	
	31 Mar 18	31 Dec 17	31 Mar 17	3 months	12 months
1 US Dollar is worth	71.29p	73.92p	79.97p	3.7%	12.2%
1 Euro is worth	87.67p	88.77p	85.54p	1.3%	-2.4%
100 Japanese Yen is worth	67.03p	65.62p	71.77p	-2.1%	7.1%

Exchange rate movements – 3 years to 31 March 2018



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

3 MARKET COMMENTARY

INTRODUCTION

It's been a busy start to 2018 – trade wars, a tech rout and rising interest rates have caused global financial market volatility to increase. Major equity indices ended below their January peaks and have decreased for the year to date. The long term impact of some of these events has yet to be quantified. In the short term however the impact is clear, investors are becoming more wary of markets.

The US political situation adds to overall economic uncertainty - it has the potential to over inflate the economy. For now, the economic backdrop is holding firm, yet signs that we are entering a new phase of the market cycle are appearing. We have seen rising yields, sharp equity corrections and indicators that inflation risks are becoming more prevalent. Volatility has picked up across most asset classes and the episodes of equity market volatility indicate that the returns of 2017 are unlikely to be a feature of 2018 and the number of potential outcomes ahead for the market has certainly increased.

This year is proving more familiar to investors with long memories; equity market volatility has risen to levels more consistent with previous investment markets. So far this year, we have witnessed a greater divergence of returns across and within asset classes. Rising interest rates are a challenge for both bond and equity markets, and valuations remain elevated across most markets. However, earnings growth is a powerful driver for equities, and we still see an attractive risk/reward trade off.

UNITED KINGDOM

- The UK equity market has fallen 6.9% since the start of the year giving back over half the gains that it made over 2017. It is the UK equity market's worst first quarter performance since the start of 2009, during the height of the financial crisis. The UK was also the laggard of the developed equity markets over the quarter.
- Investment market concerns surrounding the timetable and the outcome of the Brexit negotiations remain a dominant market theme. Despite reasonable progress being made with concessions on both sides, the herculean effort that is yet to be completed to produce a workable agreement fuels market insecurities. As a result of the uncertainty, the UK economy is expected by the IMF to grow by c.2% in 2018, the slowest growth rate among the G7.
- The prospect of a global protectionist trading environment has added to the concerns of the UK investment market. US President Donald Trump announced tariffs on steel and aluminium in March which caused global consternation. Whilst the UK reduced the immediate direct impact on domestic firms by negotiating a temporary exemption - the concern remains that if a reciprocal trade war erupted between China and the US then everybody would lose as the prices of goods would rise, creating further impetus to the inflationary environment.
- The strengthening of Sterling also hindered UK market progress; it is already up 4% against the US dollar in 2018. That said, the prospect of higher interest rates clears the path for better returns on cash held in Sterling. The market has already priced in a May rate rise and more could follow this year as the Bank of England walks the fine line between controlling the rate of inflation whilst encouraging economic growth. For UK based international companies, revenues are received in foreign currency, and this money is worth less when converted back into pounds when Sterling is stronger.

NORTH AMERICA

- The US equity market fell circa 6.5% over the quarter with the majority of the decline coming in March as President Trump announced a more protectionist trade policy, which included significant tariffs on steel and aluminium.
- Some market commentators have blamed the trigger for recent falls on data that showed wages growing at 2.9%, hence the heightened concern about inflation - and the possibility of more rapid rate rises. However, this should be considered in the wider context of US corporate valuations which occurred before the protectionist announcement. Shares, had perhaps, run too far ahead and a correction was needed, particularly in the technology sector. On a more positive note, global economies are experiencing some growth while tax cuts in the US may further brighten the outlook for company expansion.
- In the longer-term, above-trend economic growth, a buoyant labour market and strong earnings growth leads us to have a positive outlook for US equities. Stock selection has been positive in this asset class, particularly in light of the corporate repatriation of earnings after the recent tax breaks offered by the US administration. This provides a solid foundation for equities. US tax and spending plans have encouraged a degree of earnings growth, which was already gaining traction on the back of longer term economic strength.

EUROPE

- The European market declined over the quarter by 4.5%, this was caused by, among other factors, the strength of the Euro which acts as a headwind for exporters; however, there are other factors that can support ongoing earnings growth in the region including strong Purchasing Managers Indices and an increase in GDP growth. 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 overall with monetary policy remaining supportive and global demand in good health. Corporate earnings should be reasonably supported by the improvement in the macro data and the region still offers value compared to other markets.
- However, inflation is likely to continue to build because capacity is in short supply in Europe and unemployment is falling. Tight capacity means companies either need to expand in order to produce greater volumes, or they can raise their prices. Tighter labour markets may mean workers try to demand higher wages. However, inflation remains below the European Central Bank's target.
- The introduction of tariffs on steel and aluminium by the US adds an element of uncertainty to the picture, though it remains unclear how this will unfold in Europe. Nonetheless, we see global growth continuing. This, combined with the improved pricing environment and robust domestic demand, can support ongoing positive growth in Europe.

JAPAN

- Japanese equities are exhibiting strong earnings growth and benefitting from a solid well structured economy. Japan was the best performing of the developed market equities over the quarter. From a valuation perspective, Japanese stocks are attractive compared to historical averages and other markets. Yen weakness, as a result of the Bank of Japan retaining ultra-accommodative monetary policy also provides a boost to the region.
- In terms of policy implications, the Bank of Japan is likely to maintain the view that the Japanese economy remains steady against a backdrop of a strong global economy. Markets expect the reappointment of the current Bank of Japan Governor, Haruhiko Kuroda, whose term ends in April. This should allow the Bank of Japan to provide more clarity on the monetary policy outlook. The Yen continued to strengthen due to a combination of a weaker dollar and risk aversion.

ASIA PACIFIC EX JAPAN / EMERGING MARKETS

- The improving fundamentals of emerging markets have had a positive impact on the economies in the Asia Pacific region partly due to trade links. The region held up relatively over the first quarter albeit posting a negative return of minus 4.6%.
- Resilient domestic demand, which is being driven by public spending initiatives, stable commodity prices and accommodative monetary polices are supporting most of the countries in the region. US interest rate policy normalisation and a more protectionist stance from US President Trump are potential headwinds for economies in this area however, there are many positive growth factors attracting investors to this region. The outlook for Asia is heavily dependent on US trade policies and the degree of monetary tightening.
- Like most asset classes today, emerging market stocks are not cheap and although the emerging markets fell over the quarter, the region showed an impressive level of resilience. Emerging market stocks are trading close to their historical norm, both on an absolute basis and relative to developed markets.
- While investors have historically looked at relative valuations and US dollar fluctuations as some indication of expected emerging market performance, overall, the best case for emerging market equities generally ties back to global growth. Therefore, if emerging markets are expressing a view on global growth, they should be more inclined to outperform developed markets when industrial commodities are rising.
- The risk of a sharp dollar rally faded over the quarter and growth is broadening out. Relative to their developed market peers, emerging market 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 (subject to electoral change). Emerging economies as a whole have been successful in improving their economies, using measures to encourage economic activities.

FIXED INCOME

- Rising interest rates and tighter monetary policies are firmly on the global agenda. The US Federal Reserve in particular has been clearing the path for hiking interest rates and many investors expect at least three further rate hikes this year.
- In the UK, the Bank of England raised its interest rates for the first time in a decade back in November 2017. In other parts of the world, the European Central Bank and Bank of Japan have begun telegraphing their plans to withdraw from their respective quantitative easing programmes.
- Many investors are therefore expecting government bond yields to rise due to the inverse relationship between yields and prices (as yields increase, prices fall); as a result of this investors have become nervous about some fixed income investments.
- As interest rates tend to rise in anticipation of stronger economic growth, some fixed interest assets, which are more sensitive to economic growth, can still perform well. As corporate fundamentals usually also improve, this provides a boost to company profits and improves the creditworthiness of borrowers, supporting their corporate bonds.
- The variation in performance of these assets, combined with the fact that most returns have been positive during rising yield environments, underlines the importance of asset allocation during times of rising rates. If investors can combine sensible asset allocation with an awareness of credit assets behaviour when rates rise, then they potentially, may be able to add value even when credit markets are challenging, and the natural inclination may be to sell.

ALTERNATIVES

- Hedge funds posted narrow gains in US Dollar terms, as strong performance in January partially offset the impact of market volatility which was caused by increasing trade and tariff tensions later in the quarter. However, the appreciation of Sterling over the period led to a decline in Hedge Funds of -3.4% over the quarter, as all strategies generated negative returns. Over the 12 months to 31 March 2018, all strategies declined with the exception of Emerging Markets which returned 1.0%. Investors reduced exposure to equity market beta in in favour of M&A-focused Event-Driven exposures and fixed income-based Relative Value Arbitrage strategies over the period.
- Commodities markets were down 1.5% over the quarter; however, an upward trend in the monthly returns was experienced. Crude oil led performance over the quarter whilst gold was the worst performer over the period. Precious metals, non-precious metals and agriculture all posted negative returns in Sterling terms.
- The prospects for the UK commercial property sector remain uncertain given concerns around a hard Brexit, but the asset class has been relatively stable. This stability reflects strong demand from overseas investors for offices in London and other major British cities, attracted by the fall in prices in foreign currency terms. The Brexit referendum fallout has certainly caused capital depreciation but the income on offer remains attractive versus other asset classes.

CONCLUSION

In this investment environment it is vitally important to have a sensible investment strategy to drive through the ups and downs of the investment market. A more mixed asset performance is expected in 2018 after another year of unusually low equity market volatility and solid returns.

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.
*The IPD Quarterly Property Index has been used to calculate the performance between 31 December 2017 and 31 March 2018.

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