CLWYD PENSION FUND

ECONOMIC AND MARKET UPDATE
PERIOD ENDING 31 DECEMBER 2019

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1 MARKET BACKGROUND
PERIOD ENDING 31 DECEMBER 2019

MERCER

MARKET STATISTICS

Market Returns Growth Assets	3 Mths %	1 Year %	3 Years % p.a.
UK Equities	4.2	19.2	6.9
Overseas Developed	1.2	23.0	10.5
North America	1.4	26.5	12.4
Europe (ex UK)	0.9	20.5	8.7
Japan	0.2	14.8	6.7
Asia Pacific (ex Japan)	0.6	12.9	7.7
Emerging Markets	4.0	15.9	9.0
Frontier Markets	-0.6	3.8	1.8
Property	0.3	2.1	6.9
Hedge Funds[1]	2.4	9.3	4.3
Commodities[2]	7.8	14.8	0.4
High Yield[2]	2.5	12.3	4.9
Emerging Market Debt	-2.1	9.1	4.6
Senior Secured Loans[2]	1.9	8.5	2.7
Cash	0.2	0.9	0.6

Market Returns Bond Assets	3 Mths %	1 Year %	3 Years % p.a.
UK Gilts (>15 yrs)	-6.6	12.0	5.1
Index-Linked Gilts (>5 yrs)	-9.4	6.8	2.9
Corporate Bonds (O15 yrs AA)	-2.7	16.0	6.0
Non-Gilts (>15 yrs)	-2.0	17.4	6.0

Exchange Rates: Change in Sterling	3 Mths %	1 Year %	3 Years % p.a.
Against US Dollar	7.50	4.02	2.35
Against Euro	4.41	5.93	0.25
Against Yen	8.10	3.03	-0.04

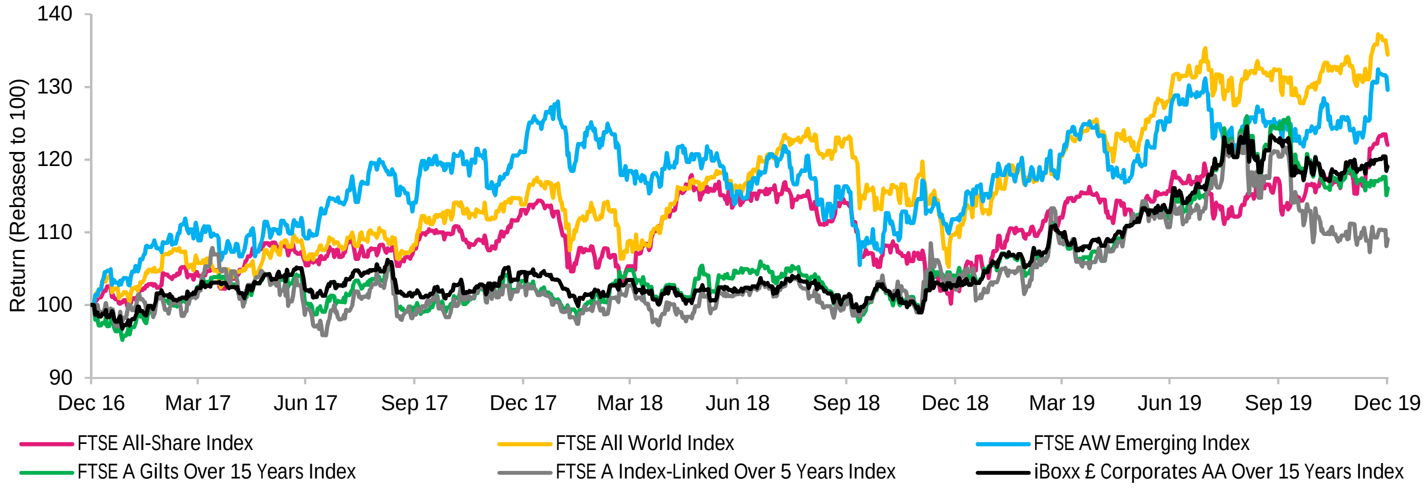
Inflation Indices	3 Mths %	1 Year %	3 Years % p.a.
Price Inflation – RPI	0.3	2.2	3.0
Price Inflation – CPI	0.0	1.3	2.1
Earnings Inflation[3]	0.2	3.2	3.0

Yields	% p.a.
UK Equities	4.09
UK Gilts (>15 yrs)	1.25
Real Yield (>5 yrs ILG)	-1.84
Corporate Bonds (>15 yrs AA)	2.00
Non-Gilts (>15 yrs)	2.52

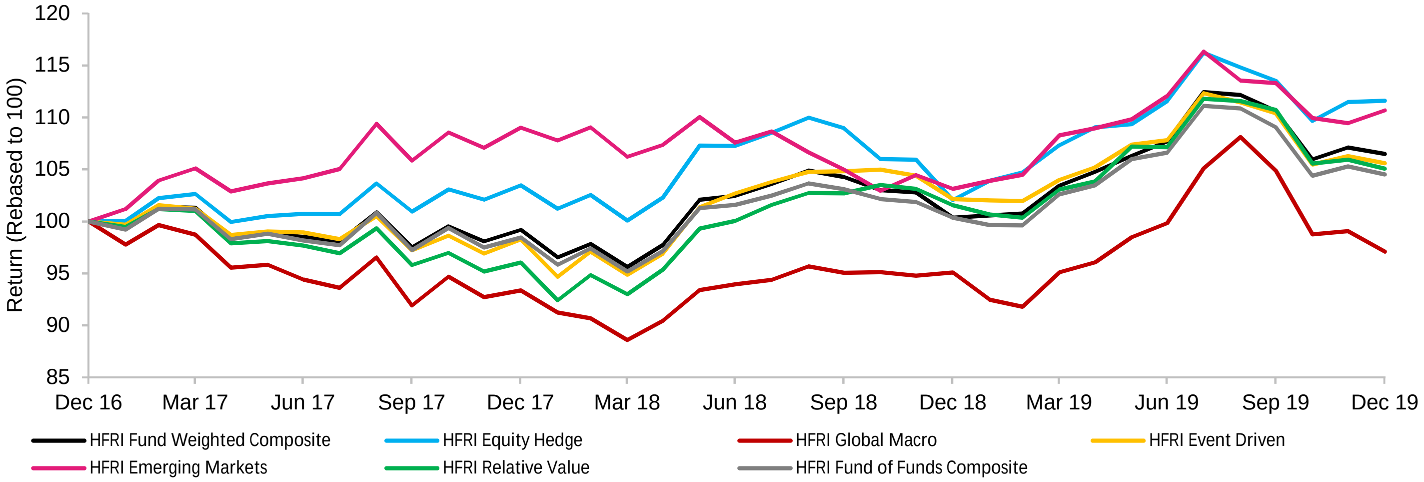
Absolute Change in Yields	3 Mths %	1 Year %	3 Years % p.a.
UK Equities	-0.12	-0.37	0.62
UK Gilts (>15 yrs)	0.34	-0.51	-0.51
Real Yield (>5 yrs ILG)	0.36	-0.26	-0.18
Corporate Bonds (>15 yrs AA)	0.19	-0.77	-0.62
Non-Gilts (>15 yrs)	0.18	-0.85	-0.50

Source: Refinitiv DataStream.
Notes: [1] Local Currency. [2] GBP Hedged. [3] Subject to 1-month lag.

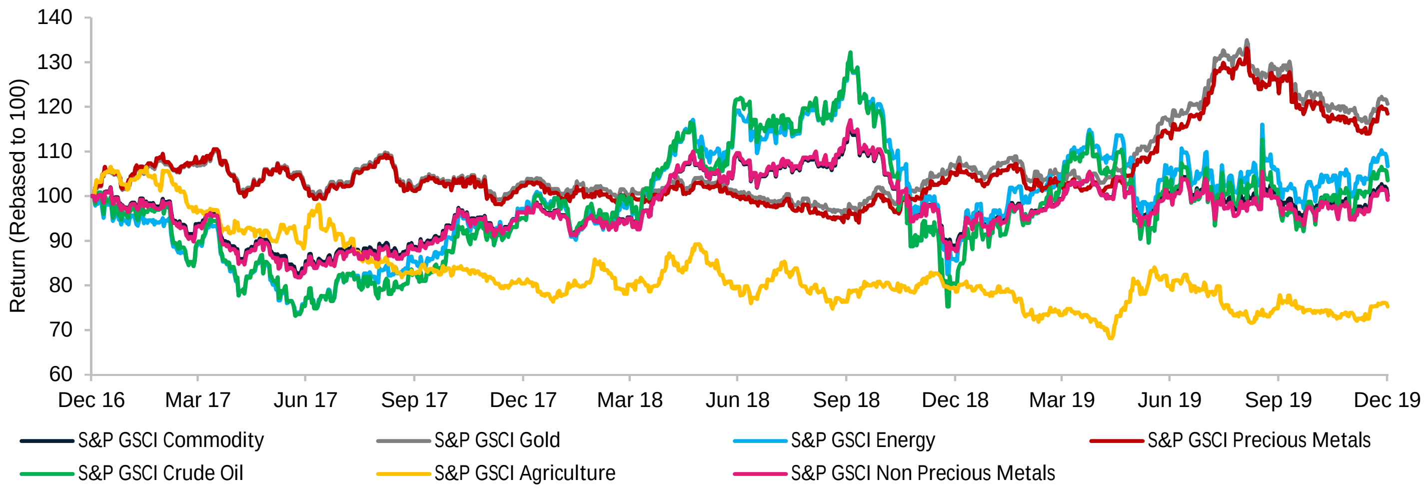
Market performance – 3 years to 31 December 2019



Hedge Funds: Sub-strategies performance – 3 years to 31 December 2019

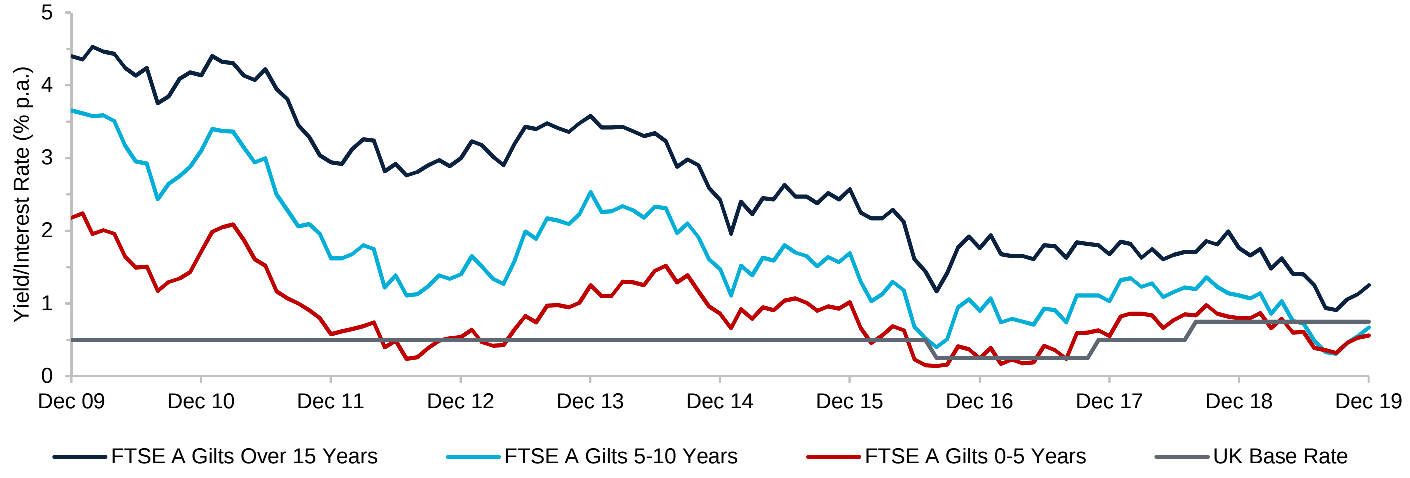


Commodities: Sector performance – 3 years to 31 December 2019

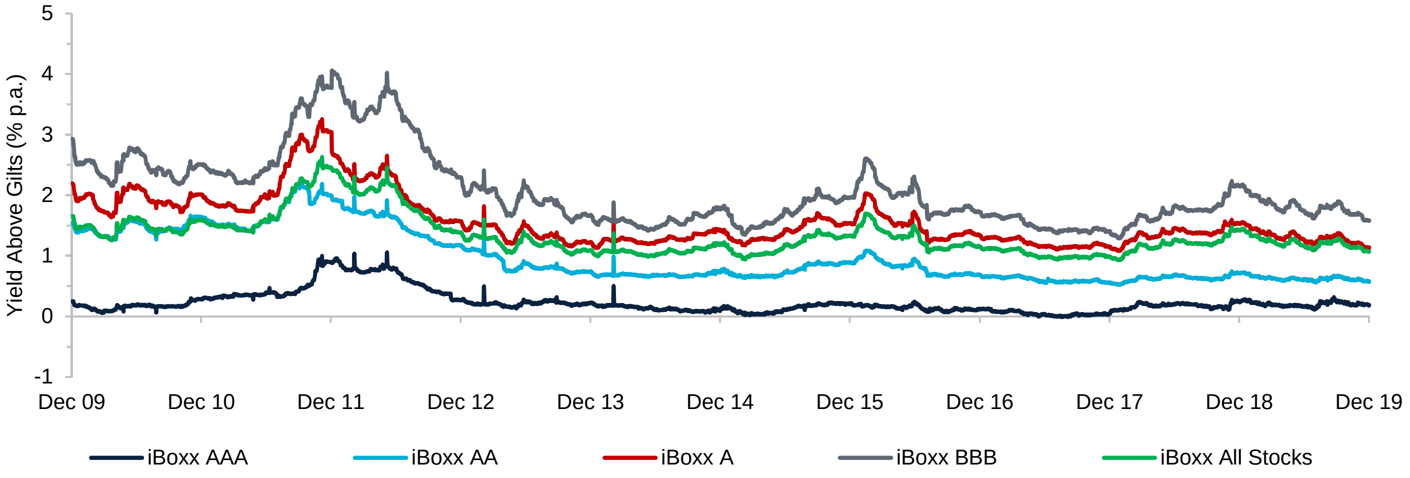


Source: Refinitiv DataStream

UK government bond yields – 10 years to 31 December 2019



Corporate bond spreads above government bonds – 10 years to 31 December 2019



Source: Refinitiv DataStream

2 ECONOMIC STATISTICS

Economic Statistics as at:	31 December 2019			30 September 2019			31 December 2018		
	UK	Euro[1]	US	UK	Euro[1]	US	UK	Euro[1]	US
Annual Real GDP Growth[2]	1.1%	3.0%	2.1%	1.2%	2.9%	2.3%	1.6%	2.8%	3.1%
Annual Inflation Rate[3]	1.3%	1.3%	2.3%	1.7%	0.8%	1.7%	2.1%	1.5%	1.9%
Unemployment Rate[4]	3.8%		3.5%	3.9%	7.6%	3.6%	4.0%	7.9%	3.8%
Manufacturing PMI[5]	47.5	46.3	52.4	48.3	45.7	51.1	54.3	51.4	53.8

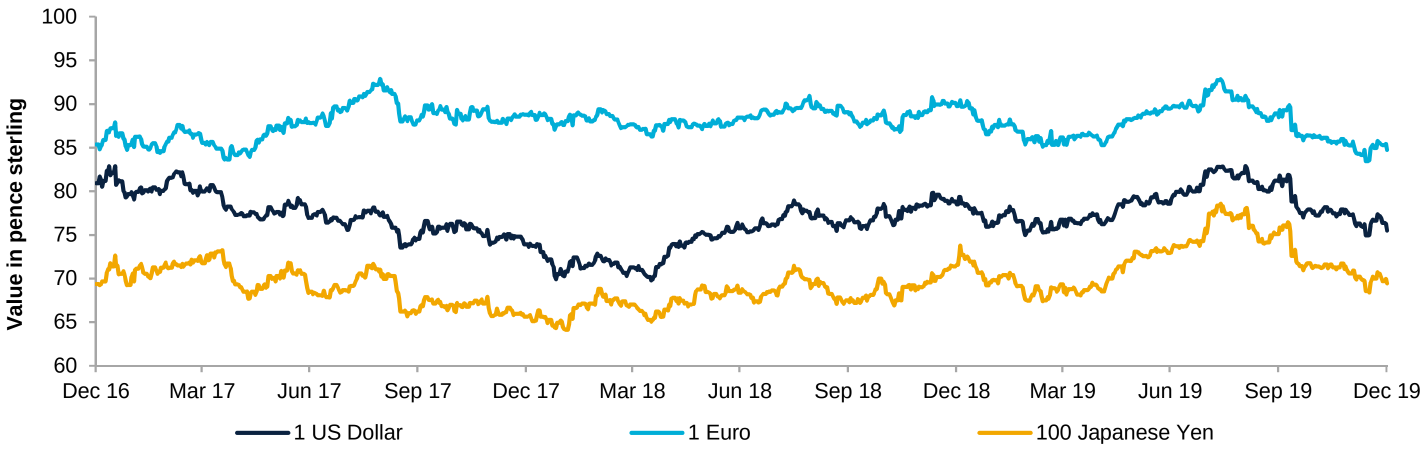
Change over periods ending:	3 months			12 months		
31 December 2019	UK	Euro[1]	US	UK	Euro[1]	US
Annual Real GDP Growth[2]	-0.1%	0.1%	-0.2%	-0.5%	0.2%	-1.0%
Annual Inflation Rate[3]	-0.4%	0.5%	0.6%	-0.8%	-0.2%	0.4%
Unemployment Rate[4]	-0.1%		-0.1%	-0.2%		-0.3%
Manufacturing PMI[5]	-0.8	0.6	1.3	-6.8	-5.1	-1.4

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

Exchange Rates:	Value in Sterling (Pence)			Change in Sterling	
	31 Dec 19	30 Sep 19	31 Dec 18	3 months	12 months
1 US Dollar is worth	75.49	81.15	78.52	7.5%	4.0%
1 Euro is worth	84.73	88.47	89.76	4.4%	5.9%
100 Japanese Yen is worth	69.46	75.09	71.57	8.1%	3.0%

Exchange rate movements – 3 years to 31 December 2019



Source: Refinitiv DataStream, Bloomberg.

3 MARKET COMMENTARY

INTRODUCTION

Equities performed better than anticipated in 2019. The majority of returns were a result of a ‘rebound rally’ from late 2018 when, in the span of three weeks, the S&P 500 Index dropped almost 16%. The ‘rebound rally’ paused in April when trade war tensions grew worse and has recently restarted in December as phase one of the trade deal was agreed between the US and China. Additionally, throughout the whole of 2019, global central banks have been shifting their stance from a tight interest rate policy to a more relaxed policy which has further supported equity prices.

Emerging market equities underperformed their developed market counterparts, posting 15.9% for the 12-month period to December. Emerging markets are more dependent on the manufacturing sector at the moment which, in turn, is heavily dependent on healthy supply chains. When supply chains come into question, amid trade war uncertainty and tariffs, the manufacturing sector suffers and so do the emerging economies (for example, Taiwan, South Korea and China).

UNITED KINGDOM

- With Brexit seemingly being cast aside following the decisive general election result in December, it was domestic stocks that benefited most, with the FTSE 250 outperforming the more internationally reliant FTSE 100 during the last few weeks of the year.
- Over the course of 2019 the Service sector held its own despite a slowdown in UK manufacturing. This helped the labour market remain in good shape with the unemployment rate close to a 50-year low and wage growth at c.4% p.a. which, in turn, helps consumption.
- This has translated to equity markets seeing a strong return from the FTSE All-Share Index. The majority of this however, came as part of the relief rally at the start of 2019 following the falls seen in the final quarter of 2018.
- Capital investment in the UK, by businesses, has been materially lagging global peers. The removal of some of the political uncertainties should allow for decision makers, who previously have been reluctant to commit, to push forward with investment.

NORTH AMERICA

- US equities produced a robust performance over the final quarter of 2019. During October, the Federal Reserve cut its interest rate for the third time in 2019 and signalled a likely monetary policy pause until data improved.
- Stocks also rose in both November and December on hopes of an initial ‘phase one’ trade deal with China.
- Investor sentiment was given further support over the period as economic data came in better than expected. Quarterly numbers showed that the US economy expanded at an annualised rate of 2.1%.
- Away from the improving geopolitical tensions, stocks were also boosted by Q3 earnings numbers as they beat expectations. Investors took encouragement that a c.75% of all businesses reporting exceeded analysts’ estimates.
- Information Technology was among the leading sectors together with cyclicals such as Industrials and Consumer Discretionary.

EUROPE (EX UK)

- Eurozone stocks entered a new dawn during the period as Christine Lagarde took over as president of the European Central Bank (ECB) from Mario Draghi. In her first speech of significance Lagarde signalled the need for governments to increase public investment, notably in sustainable projects, in order to boost economic activity. This message suggests that the ultra-loose monetary policy strategy, with ECB interest rates currently standing at -0.5%, may have reached its peak effectiveness.
- The ECB also resumed its quantitative easing programme (asset purchase programme) in November, with the purchase of €20bn a month, continuing for an indefinite period.

- European equities were elevated further in the final quarter of 2019, aided by a slightly improving economic picture. Notably the direction of travel in forward looking surveys, for both manufacturing and service, led sectors to improve from positions in the previous quarter.
- Economic growth in the Eurozone, having started to slow in mid-2018, disappointed further in 2019 as the global trade slowdown pushed German manufacturing into contraction.
- The slowdown is led by one subsector: German automakers, which came under intense pressure following the diesel emission scandal and the soft global economy. Eurozone, excluding German autos, is in reasonable shape, especially the Services sector.
- The labour market continues to improve as the economy continues to create jobs, keeping unemployment close to its lowest level in two decades, and wage growth is picking up.

JAPAN

- The Japanese economy came under pressure from slowing external demand as its industrial production shrank and capital expenditure growth stalled. Although the Manufacturing sector slowed, Services remained in decent shape.
- The labour market is in excellent form, with unemployment at close to all-time lows. That, however, has not resulted in higher wages, which is one of the reasons core inflation has remained stubbornly low.
- Despite a strong labour market, consumer confidence is weak and business sentiment has deteriorated. Also weighing on Japanese growth is the recent increase in Value Added Tax from 8% to 10%.
- Relative to the previous hike in 2014, the larger package of countermeasures (such as rebates for cashless transactions) should lead to a less severe consumption demand slump but may result in demand simply being brought forward, worsening the outlook for consumption in the second half of 2020.
- That said, Japanese stocks produced excellent returns for the period. October was a particularly strong month when the Japanese market rallied by 5%. Companies' earnings appeared to have turned a tide with the majority of results coming in line with market expectations after a sustained period of downward revisions by analysts.
- Market estimates for earnings look to marginally improve in the near term. Nonetheless, a lot will depend on the movements of the Yen. The direction of the currency whipsawed several times over the last quarter as trade negations lingered and the Hong Kong unrest escalated.

ASIA PACIFIC (EX JAPAN) / EMERGING MARKETS

- The distortion of global supply chains by the trade war and the ongoing global manufacturing slowdown, particularly in this region, delivered a challenging 2019. Amongst those particularly hit were Taiwan, South Korea and China.
- Subdued inflation and a recently rediscovered appetite by countries to ease financial conditions, allowed interest rates to be cut without devaluing their currencies. This has proved a positive step and should help benefit domestic businesses.
- Given the returns by western developed equity markets, it is not surprising that both Asia and emerging market equities struggled to keep pace over 2019.
- However, the low cost of capital, a possible depreciation in the US dollar, a de-escalating trade war and stimulus measures from key economies, such as China, should help emerging economies recover to around (or even above) longer term trend growth rates.

FIXED INCOME

- Global government bonds rallied strongly in 2019 as global growth slowed, inflation edged lower and global central banks were broadly in easing mode.
- The US 10-year government bond yield, for example, started the year at 2.7% and fell to as low as 1.5% before picking up to 1.9% at the time of writing.
- Moves of similar magnitude were also witnessed in the rest of the developed world. Significantly, in the US, long-dated bond yields fell by more than short-dated, leading to a so-called 'curve inversion', a popular indicator of an upcoming recession. This is looked at in conjunction with a number of other economic indicators (for example, confidence surveys), which so far have not confirmed the recessionary narrative. Recently, the curve has flattened and subsequently turned upwards, removing, or at least quietening, these recessionary fears.

- In the Eurozone, the ECB has largely run out of monetary ammunition. Mario Draghi suggested that it is time for governments to step in with fiscal easing. This is true for some countries, such as Germany, who have plenty of room to increase spending without creating huge budgetary imbalances. If this was to materialise, European government bond yields would rise. The Bank of Japan is unlikely to do much more besides extending its current stimulus.

ALTERNATIVES

- Hedge Funds posted negative returns in Sterling terms over the quarter. Overall Hedge Funds returned -3.7% in Sterling terms and 3.5% in US dollar terms. Equity Hedge were the best performing strategies, returning -1.7% (Sterling) and 5.7% (US dollar). Global Macro were the worst performing strategies over the quarter, returning -7.4% (Sterling) and -0.5% (US dollar).
- Commodities had a positive fourth quarter, returning 0.7% in Sterling terms (8.3% in US dollar terms). Crude Oil was the best performing commodity returning 5.6% (Sterling) and 13.5% (US dollar). Gold was the worst performing sector, returning -3.9% (Sterling) and 3.3% (US dollar). Precious Metals and Agriculture also declined in Sterling Terms over the quarter.
- Property returned 0.3% in the 3 months to 31 December 2019. Capital Values fell by 1.0% but this was supported by Rental Income which returned 1.3%. Falling Capital Values were dominated by the Retail sector which contracted substantially (-4.4%), the Industrial sector grew by 0.7% whilst the Office sector grew, albeit modestly by 0.3%. On an annual basis, overall Capital Values have diminished by 3.1%, however, Rental Income delivered a yield of 5.3%, propping up a positive return of 2.1% for the year.

OUTLOOK

The outlook for equity prices ultimately depends on two things: the cost of capital and earnings growth. In 2020, the former is likely to pick up as inflation rises slightly and central banks, particularly the Fed, disappoint the market by keeping rates on hold. Earnings will be largely a function of whether the trade tensions ease and allow the global economy to recover.

If the global economy improves, so should earnings growth, but if further tariffs are applied and trade tensions escalate, earnings may deteriorate. Regardless of whether the trade tensions ease, rising wage growth should continue to put some pressure on profit margins in the US and elsewhere.

4 MARKET STATISTICS INDICES USED

Asset	Index
Growth Assets	
UK Equities	FTSE All-Share Index
Overseas Developed Equities	FTSE AW Developed Index
North America Equities	FTSE AW North America Index
Europe (ex UK) Equities	FTSE AW Developed Europe (ex UK) Index
Japan Equities	FTSE Japan Index
Asia Pacific (ex Japan) Equities	FTSE AW Developed Asia Pacific (ex Japan) Index
Emerging Markets Equities	FTSE All Emerging Index
Frontier Markets Equities	FTSE Frontier 50 Index
Property	IPD UK Monthly Property Index
Hedge Funds	Credit Suisse Hedge Fund Index (Local Currency)
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	ICE BofA 3 Month LIBOR 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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