

Investment Update January 2011



Investment Headlines & Comment

- The DMO is set to consult on issuing **CPI-based index-linked gilts** (ILGs are all currently RPI-based), which could make ILG indices rather more complicated.
- A €5bn **European Financial Stability Facility bond** attracted a record €45bn of bids by demand from Asian central banks and institutional investors in Europe.
- **US BB/B High Yield spreads** are narrowing – there is still a 3.5% margin over gilts but some Trustees may not think this enough versus investment grade.

Feature Section

In this month's *Update* we consider UK and US inflation-related investments, and whether there is an opportunity for UK investors worried about inflation but concerned that the pricing of UK index-linked gilts (ILGs) and inflation swaps is too extreme.

In the US, Treasury Inflation-Protected Securities (TIPS) are securities whose principal is tied to the US Consumer Price Index. With inflation, the principal increases. With deflation, it decreases. However, unlike UK ILGs, when TIPS mature, the US Treasury pays the original or adjusted principal, *whichever is greater*. Figure 1a shows the history of UK RPI and US CPI, the two relevant inflation indices. Figure 1b shows the relative inflation, for the UK versus US, together with the movement of the US Dollar versus Sterling, which shows an interesting degree of similarity over longer periods (as might be expected from purchasing power parity) but there is clearly large currency variation over shorter periods. Figure 1c shows the movement in yields for ILGs and TIPS (updating our Feb 03 and Nov 09 *Update* editions), and Figure 1d shows the current real yield curves (note the US has only issued TIPS with maturities up to 30 years).

Figure 1a: UK RPI and US CPI (rebased to 100)

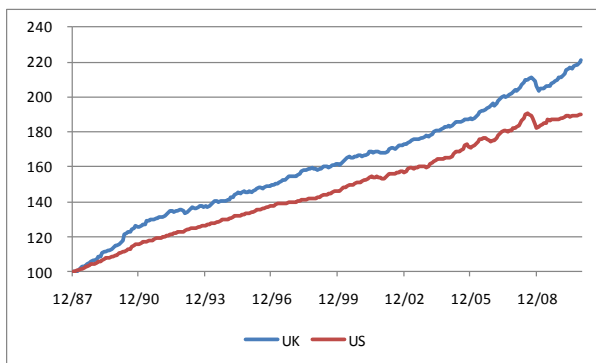


Figure 1c: Long ILG and Long TIPS yields (%)

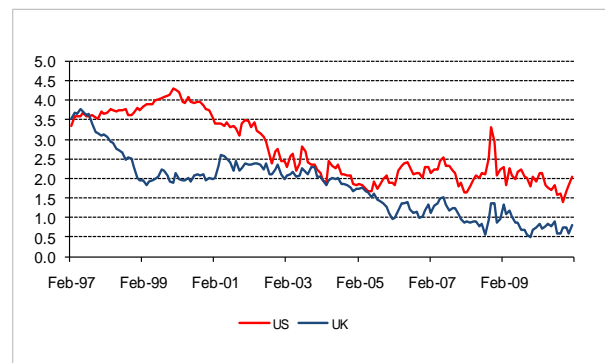


Figure 1b: UK relative to US

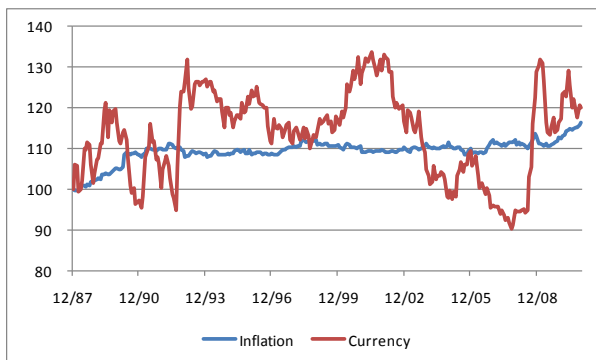
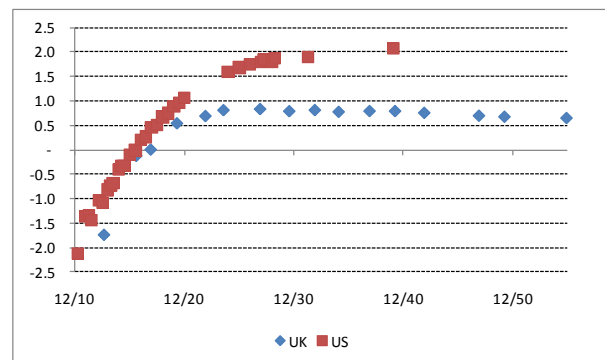


Figure 1d: Current real yield curves (%)



Sources: DMO, FT, ONS, US Treasury

Figure 1b shows two periods (one of which is current) where UK inflation moves markedly ahead, eroding the yield pick-up on TIPS. Figure 1c shows a material yield gap can exist for a while between US and UK real yields, and Figure 1d shows that this gap currently applies for index-linked bonds with terms to maturity of more than 10 years (albeit before deducting any cost of a rolling hedge back into Sterling, which cannot be pre-determined for long-term bonds or inflation-linked ones). The key for managers and Trustees is: "is this enough to cope with bursts of relative inflation?"



Asset Returns and Financial Measures [in Sterling unless marked otherwise]

The cells in bold with light shading show the best and worst performing asset classes from each column. The commodities and \$-based and unhedged-£-conversion hedge fund returns are excluded from that.

[NB Future returns cannot be inferred from this table alone, but coupled with other items within *Update*, readers can make inferences as to whether they should be higher or lower than the past returns shown below.]

Table 1: Investment Data to 31 January 2011

Asset Class	1 month (%)	3 months (%)	12 months (%)	3 years (% p.a.)	5 years (% p.a.)	10 years (% p.a.)	20 years (% p.a.)
UK Equities	-0.5	4.2	18.1	4.4	4.4	3.4	9.3
Overseas Equities	-0.8	6.6	20.5	7.5	6.0	2.9	8.8
US Equities	0.0	8.9	21.9	7.7	4.6	0.5	10.5
Europe ex UK Equities	2.7	4.7	15.5	3.6	6.0	3.9	10.1
Japan Equities	-2.2	9.9	13.3	4.1	-1.5	0.2	1.6
Pacific ex Japan Equities	-3.6	3.2	26.0	12.3	14.1	12.1	11.6
Emerging Markets	-4.9	1.3	22.8	11.3	12.4	13.3	11.9
UK Long-dated Gilts	-3.7	-3.7	3.8	4.3	2.7	4.5	8.6
UK Long-dated Corp. Bonds	-1.6	-3.4	5.2	5.2	2.3	5.4	-
UK Over 5 Yrs Index-Linked Gilts	-2.6	0.1	6.3	4.4	4.9	5.8	7.6
High Yield (Global)	0.2	1.8	15.2	19.9	11.6	7.6	-
Overseas Bonds	-2.4	-3.4	5.9	13.8	9.6	6.2	8.0
Property *	0.9	2.2	14.5	-3.2	0.2	6.5	7.9
Cash	0.1	0.2	0.7	2.4	3.6	4.0	5.7
Commodities £-converted	0.7	13.8	22.0	-5.4	-4.0	1.7	5.3
Hedge Funds original \$ basis *	3.1	5.4	10.3	2.3	5.9	6.9	12.4
Illustrative £-converted version *	2.5	6.1	13.8	10.7	7.9	6.4	13.6
Euro relative to Sterling	-0.1	-1.5	-1.3	4.8	4.6	3.0	-
US \$ relative to Sterling	-2.2	-0.2	0.0	7.5	2.1	-0.9	1.0
Japanese Yen relative to Sterling	-3.2	-1.8	10.7	17.2	9.7	2.6	3.4
Price Inflation (RPI) *	0.7	1.4	4.8	2.7	3.3	2.9	2.9
Price Inflation (CPI) *	1.0	1.7	3.7	3.2	2.9	2.2	2.3
Price Inflation (RPIX) *	0.7	1.4	4.7	3.8	3.6	3.0	3.0
Earnings Inflation **	-0.1	0.1	1.8	1.6	2.8	3.4	3.8
All Share Capital Growth	-0.6	3.7	14.4	0.5	0.8	0.0	5.5
Net Dividend Growth	0.1	-2.7	-0.3	-3.9	1.0	2.9	-
Earnings Growth	0.2	20.6	63.7	-4.4	4.4	6.1	-

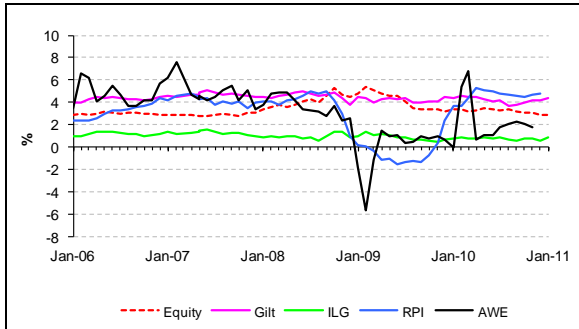
Note: All market returns are total returns for pension funds with income reinvested monthly. Indices used are as follows:

- UK Equities (incl. dividends and earnings) – FT-A All Share.
- Overseas Equities (incl. regions) – blend of FT All-World / World subindices
- Emerging Markets from MSCI US \$ based total return index (overall Index to 31 Oct 2001, Free Index from 1 Nov 2001 to take account of foreign investment restrictions), conversion to UK £ by J&A.
- UK Bonds – FT-A indices (Gilts Over 15 Years, ILG Over 5 Years)
- UK Corporate Bonds – iBoxx Non-Gilt Over 15 Year index (all credit ratings combined)
- High Yield – Merrill Lynch Global, £ Unhedged
- Overseas Bonds – JP Morgan Traded Unhedged World ex UK
- Property – IPD Monthly Index
- Commodities – GSCI Total Return, converted to UK £ by J&A
- Hedge Funds Composite – HFRI US \$ based total return index plus converted to UK £ by J&A. NB A smooth “cash+x%” return will only be shown in the base ‘hedged’ currency, here the US \$.
- Cash – an indicative index based on the three-month London Interbank Sterling mid-rate, calculated internally by J&A
- Price and earnings inflation – RPI, CPI, RPIX, and Average Weekly Earnings (whole economy, not seasonally adjusted, latest provisional data)
- Currency data – London close, from the Financial Times
- * denotes data lagged by 1 month, ** by 2 months – these reflect the later publication dates of these data items.

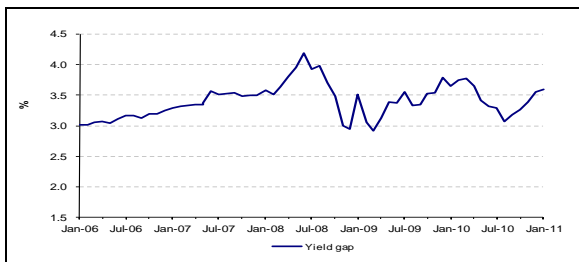


Yields and Yield Gaps

Figure 2: Yields, Inflation and Yield Gaps



The yield gap is a measure of expected average future inflation, derived as long bond yield minus ILG yield.

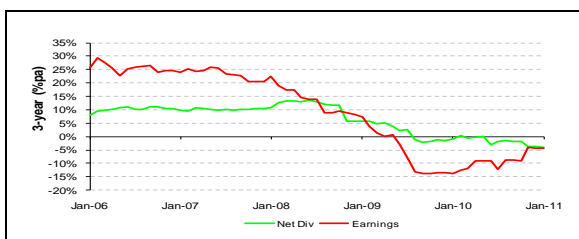
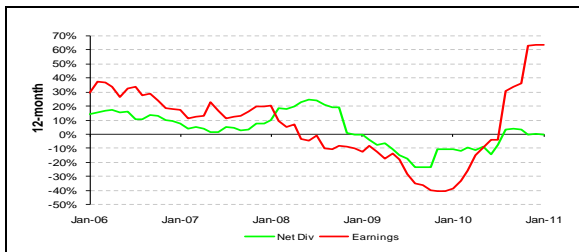


The gap gives expectations of just over 3.5% for longer-term inflation + risk premium for gilts, relative to index-linked gilts.

Growth in Earnings and Dividends

These charts show movements in rolling 12-month and 3-year dividend and earnings growth for UK Equities over the last 5 years. [NB the charts have different scales]

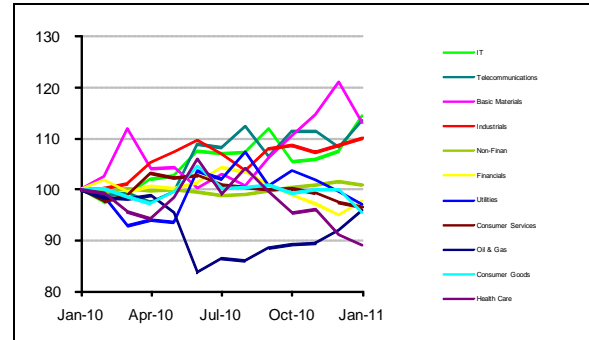
Figure 3: Dividend & Earnings Growth



Sources for charts on this page:
Financial Times, Office for National Statistics, J&A

UK Equity Sector Returns

Figure 4a: Sectors relative to All Share



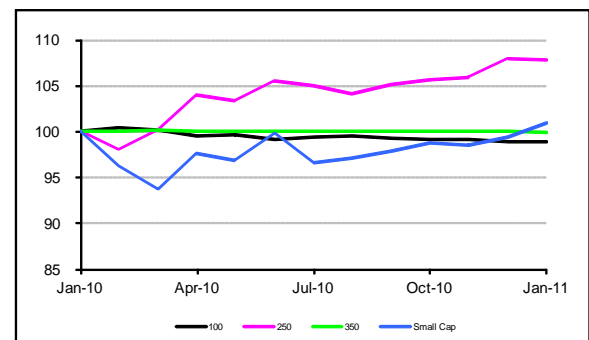
Note: Sector labels for relative lines are in end-value order

A slight fall this month in the rolling 12-month sector dispersion (down from 27% to 26%).

(% absolute return)	1 mth	3 mth	12 mth
Oil & Gas	3.6	11.9	13.2
Basic Materials	-7.1	6.6	33.5
Industrials	0.7	5.6	30.0
Consumer Goods	-5.2	0.1	12.6
Health Care	-2.8	-3.0	5.0
Consumer Services	-1.6	0.2	13.9
Telecommunications	4.4	6.1	34.1
Utilities	-3.0	-2.6	14.5
Non-Finan	-1.3	4.6	19.0
Financials	2.3	2.9	15.3
IT	5.8	13.1	35.2
All Share	-0.5	4.2	18.1

UK Equity Size Returns

Figure 4b: Size groups relative to All Share



Small Cap rose slightly in relative terms this month.

FRS17 volatility indicator

Now discontinued, but available on request.



Bond market information

Figure 5: £ Non-Gilt Credit Margins

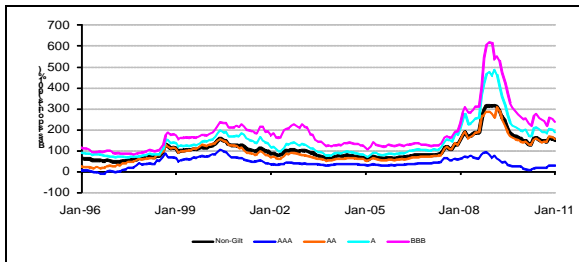


Table 2a: Over 15 Yr Corporate Yields & Margins

Month End	iBoxx Corp AA Y'ld (%)	FT 20 yr Gilt (%)	Margin (%)
Aug 10	4.75	3.67	1.08
Sep 10	4.89	3.77	1.12
Oct 10	5.17	4.01	1.16
Nov 10	5.42	4.13	1.29
Dec 10	5.35	4.14	1.21
Jan 11	5.50	4.39	1.11

Tables 2b, 2c: £ Market Size and Maturity

Category	Mkt Val (£bn @ Jan 11 & 09, 07)			Weight (%)
Gilts (34)	801	476	307	63.9
Non Gilts (1,017)	452	392	402	36.1
AAA (179)	125	147	146	10.0
AA (171)	70	57	63	5.6
A (390)	162	122	123	12.9
BBB (277)	96	63	67	7.6

Category	Mkt Val (£bn @ Jan 11, 09)		W't (%)	Dur'n (yrs)
Gilts (34)	801	476	63.9	8.7
< 5 Yrs (9)	252	136	20.1	2.8
5-15 Yrs (11)	273	157	21.8	7.2
> 15 Yrs (14)	276	183	22.0	15.7
Non Gilts (1,017)	452	392	36.1	7.4
< 5 Yrs (267)	125	139	10.0	2.6
5-15 Yrs (462)	193	144	15.4	6.8
> 15 Yrs (288)	134	110	10.7	12.7

Sources: Barclays Capital, DMO, iBoxx, J&A, MLX

£ Gilt Market “main” Issuance

- £3.02bn 3¾% 2020 (2.00x, 3.69%, prev Nov 10)
 - £2.48bn 4¼% 2036 (2.11x, 4.48%, Sep 05, yes 05)
 - £0.90bn ILG 1¼% 2032 (1.97x, r.y 0.75%, Oct 10)
 - £3.25bn ILG 1¼% 2055 (1.78x, r.y 0.71%, Nov 10)
- Note: ILG issuance amounts are nominals

Tables 2d, 2e: € Market Size and Maturity (Jan 11)

Category	Mkt Val (€bn)	Weight (%)
Sovereigns (255)	3,919	57.9
Non Sovereigns	2,851	42.1
AAA (651)	1,234	18.2
AA (427)	590	8.7
A (644)	675	10.0
BBB (436)	353	5.2

Category	Mkt Val (€bn)	Weight (%)
1 – 3 Yrs (711)	1,892	27.9
3 – 5 Yrs (692)	1,597	23.6
5 – 7 Yrs (432)	956	14.1
7 – 10 Yrs (346)	1,124	16.6
10+ Yrs (232)	1,202	17.8

Table 2f: Breakdown of £ Index-Linked Market

Category (Number of issues)	Mkt Val (£bn @ Jan 11 & 09)		W't (%)	Dur'n (yrs)
Gilts (16)	245	171	91.1	15.9
< 5 Yrs (1)	22	33	8.0	2.5
5 – 15 Yrs (5)	96	59	35.7	8.3
> 15 Yrs (10)	127	79	47.3	23.9
Non Gilts (49)	24	17	8.9	17.4

Table 2g: High Yield bond yields (BB-B indices)

Month End	US (%)	Euro (%)	Sterling (%)
Sep 10	7.31	7.16	8.56
Oct 10	7.04	7.10	8.67
Nov 10	7.40	8.21	9.70
Dec 10	7.24	7.53	8.60
Jan 11	6.95	7.39	8.55

