JAGGER & ASSOCIATES

Investment Update
November 2012

Investment Headlines & Comment

- **US TIPS** and **ILG** real yields are both negative to 2032 – cautious?
- Fringe **Euro** 10-year bond yields fall for 3 months - crisis averted?
- **Credit margins** and **equity volatility** indices fall – optimism?

Feature Section

This month we risk a little politics. Sometimes, it is hard to avoid it, particularly when it comes to questions of reconciling gilt market size and pipeline demand from maturing (or winding up) pension schemes. However, we start with the UK's national debt and annual deficit – going up or down?
A useful item is the Economic and Fiscal Outlook published by the Office for Budget Responsibility (OBR) but unless you like walls of data, it becomes rather daunting rather quickly, and there are many acronyms. It gets worse if you are trying to include or exclude one-off events (e.g. rescuing banks, or taking on the Royal Mail pension scheme's assets and liabilities), and it also depends on whether you are looking at the effect on short-term cashflow, or longer term debt.

Figure 1a: Public sector net borrowing

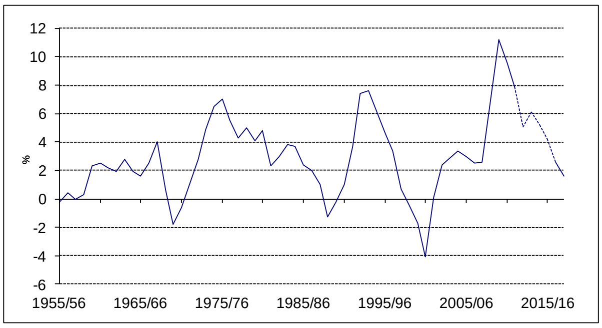
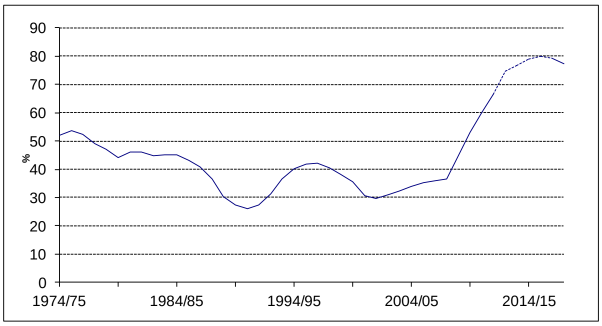


Figure 1b: Public sector net debt



Sources: *Office for Budget Responsibility, House of Commons Library*
Note: *Dotted lines from 2012 onwards are current OBR projections*

Public sector net borrowing (PSNB) is the amount of expenditure minus the total receipts taken in by the government (on an accruals basis) – if it stays positive for too long, it suggests a government or a country living beyond its means (ultimately requiring corrective action). It is customary to scale it as a proportion of Gross Domestic Product (GDP), in an attempt to allow comparison between different time points. Figure 1a shows the OBR's data (only available from 1955 onwards). It shows a reasonably cyclical pattern. The progression of the peaks' absolute values is interesting - £8bn in 75/76, £51bn in 93/94, £159bn in 09/10. In the years since then, the values have been £142bn (10/11) and £121bn (11/12), with the current year now projected to be down to £80bn in December's Autumn Statement so it seems fairly clear that the annual deficit is being gradually reined in, in both £ and %-of-GDP terms.

Public sector net debt (PSND) shows the cumulative effect of the PSNB, and is again usually shown as a proportion of GDP. The OBR's dataset starts in 1974. Figure 1b shows less of a pattern than Figure 1a, but you can see the way the debt was reducing in the mid 1990s until the Blair government's spending kicked in (with further increases once Gordon Brown took over in mid 2007). Again, the absolute values give pause for thought. At the low point in 1991, it was £151bn. By 01/02 it was £314bn, with the current year now projected to be £1,186bn in December's Autumn Statement, with further increases expected.

So how big a % of GDP should PSND be? A 2010 paper by Reinhart and Rogoff suggested a "threshold" of 90% for developed markets, but the Maastricht criteria for the Euro had an upper limit of 60%, and you might think that the figure for "core" or "stable" economies would be expected to be somewhat lower than that. However, economists are (unsurprisingly) not in agreement on this, and by extension, politicians are not in agreement either.

With a couple of adjustments, you get from the accruals-based PSNB to the cashflow-based Public Sector Net Cash Requirement, and from that to the Central Government Net Cash Requirement (CGNCR). If you add to this CGNCR for Redemptions (gilts reaching maturity and needing paying back to lenders) then you are more or less at the amount of gilts the DMO has to issue each year, as an Executive Agency of Her Majesty's Treasury. So, even if the picture looks good for PSNB and for short-term cashflow, a year of big redemptions can create a totally different impression. Cynics could trawl the DMO website (or back copies of *Update*) for the amount of gilt issuance which comes up for maturity in the last year of the current parliament. Out of £76bn maturing in 2014, £39bn was issued in 2009 alone – did the then Chancellor (Alistair Darling) know the game was up and line up a landmine against his replacement getting a 2nd term?!

Finally, our November 2006 issue flagged the issue of schemes reaching buyout funding level in the years to come having little incentive not to buy out, and so driving down long-dated yields. Even with the much expanded gilt market, the "insufficient supply" point still stands … but surely it couldn't ever be used to justify government over-spending?!

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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 30 November 2012

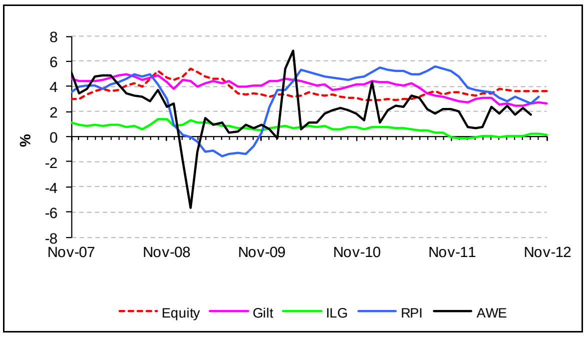
Asset Class	1 month (%)	3 months (%)	12 months (%)	3 years (% p.a.)	5 years (% p.a.)	10 years (% p.a.)	20 years (% p.a.)
UK Equities	1.8	3.9	12.1	8.7	2.4	8.1	7.9
Overseas Equities	1.9	3.0	12.1	7.9	4.0	7.8	7.2
US Equities	1.2	0.5	14.1	12.1	6.7	6.3	8.7
Europe ex UK Equities	**3.6**	7.5	12.9	2.3	-0.8	8.5	7.9
Japan Equities	2.8	1.9	1.6	1.7	-1.0	3.8	**0.6**
Pacific ex Japan Equities	2.8	**7.9**	16.6	8.6	5.4	14.5	8.6
Emerging Markets	1.8	5.8	9.6	5.5	3.6	**15.6**	8.5
UK Long-dated Gilts	1.6	-0.6	5.9	10.8	9.6	7.1	**9.0**
UK Long-dated Corp. Bonds	1.4	2.1	16.4	10.7	8.7	6.8	-
UK Over 5 Yrs Index-Linked Gilts	3.5	0.2	2.1	9.1	8.3	7.9	7.8
High Yield (Global)	1.6	3.6	**17.0**	**12.7**	**15.4**	10.7	-
Overseas Bonds	0.3	**-0.7**	1.2	4.1	11.4	6.5	6.1
Property *	0.3	0.7	3.1	10.5	**-1.5**	5.9	8.5
Cash	**0.0**	0.1	**0.9**	**0.8**	1.9	**3.4**	4.7
Commodities £-converted	2.0	-4.9	-2.6	3.9	-2.2	3.4	3.4
Hedge Funds original $ basis *	-0.3	1.9	2.7	4.0	0.9	6.7	10.0
Illustrative £-converted version *	-0.1	-0.9	2.9	4.7	6.1	6.4	9.9
Euro relative to Sterling	0.9	2.3	-5.2	-3.9	2.6	2.4	-
US $ relative to Sterling	0.5	-0.9	-1.9	0.8	5.1	-0.3	-0.3
Japanese Yen relative to Sterling	-2.6	-5.9	-7.6	2.3	11.5	3.7	1.8
Price Inflation (RPI) *	0.6	1.4	3.2	4.4	3.3	3.3	2.9
Price Inflation (CPI) *	0.6	1.4	2.6	3.6	3.4	2.6	2.2
Price Inflation (RPIX) *	0.5	1.4	3.1	4.4	4.0	3.3	2.9
Earnings Inflation **	-0.3	-2.9	1.7	1.9	1.9	3.1	3.5
All Share Capital Growth	1.4	3.1	8.1	5.0	-1.4	4.3	4.3
Net Dividend Growth	0.8	1.4	9.3	7.5	2.2	5.1	-
Earnings Growth	0.3	1.6	-15.2	20.0	-1.4	9.7	-

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

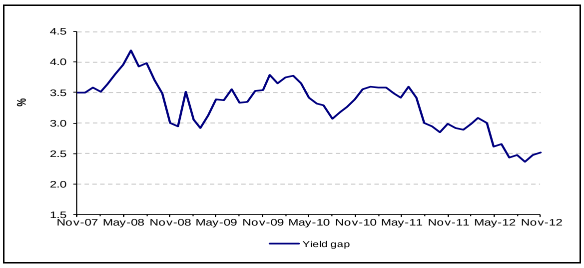
- *UK Equities (incl. dividends and earnings) – FT-A All Share.*
- *Overseas Equities (incl. regions) – blend of FT All-World / World subindices*
- *Emerging Markets from MSCI US $ based total return index (overall Index to 31 Oct 2001, Free Index from 1 Nov 2001 to take account of foreign investment 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.

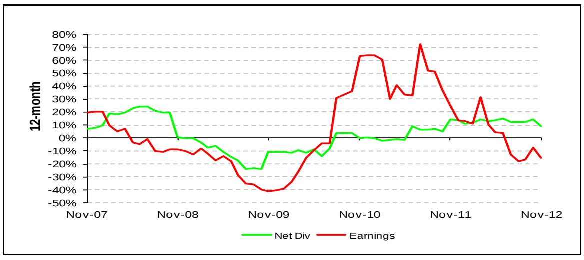


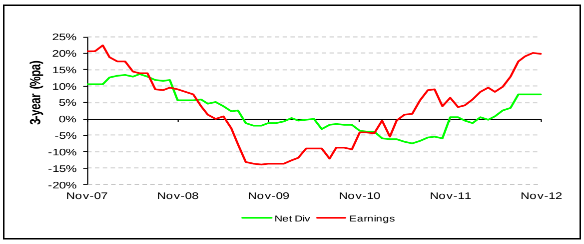
The gap gives a current expectation of 2.5% for longer-term inflation + risk premium for gilts, relative to index-linked gilts.

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

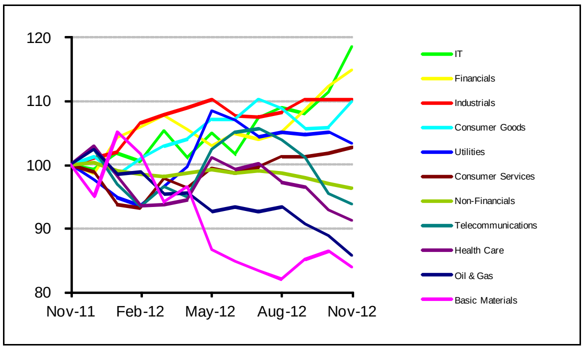




Sources for charts on this page:
Financial Times, Office for National Statistics, J&A

UK Equity Sector Returns

Figure 4a: Sectors relative to All Share



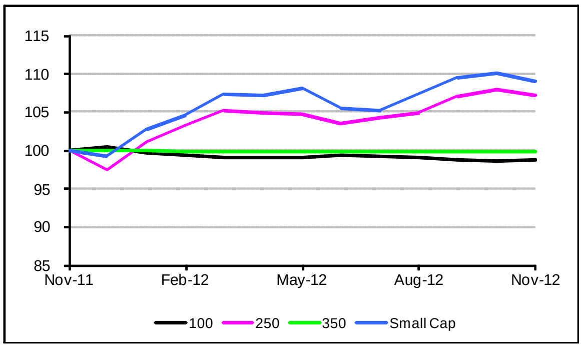
Note: Sector labels for relative lines are in end-value order

There was a rise this month in the rolling 12-month sector dispersion (up from 24% to 35%).

(% absolute return)	1 mth	3 mth	12 mth
Oil & Gas	-1.8	-4.7	-3.9
Basic Materials	-1.3	6.2	-5.9
Industrials	1.8	6.0	23.7
Consumer Goods	5.7	4.9	23.2
Health Care	-0.2	-2.7	2.2
Consumer Services	2.7	5.4	15.3
Telecommunications	-0.1	-6.2	5.1
Utilities	0.0	2.2	15.9
Non-Financials	1.1	1.5	8.1
Financials	4.0	13.5	28.8
IT	8.2	13.1	32.9
All Share	1.8	3.9	12.1

UK Equity Size Returns

Figure 4b: Size groups relative to All Share



Mid and Small Cap fell slightly in relative terms this month.

FRS17 volatility indicator

Now discontinued, but available on request.

Bond market information

Figure 5: £ Non-Gilt Credit Margins

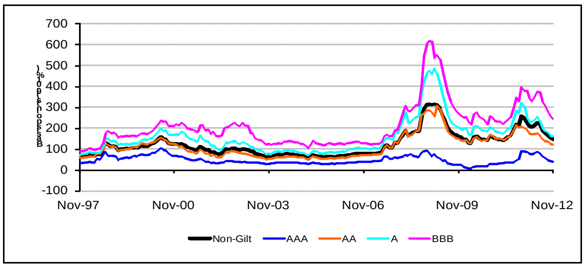


Table 2a: Over 15 Yr Corporate Yields & Margins

Month End	iBoxx Corp AA Y'ld (%)	FT 20 yr Gilt (%)	Margin (%)
June 12	4.20	2.68	1.52
July 12	3.86	2.47	1.39
Aug 12	3.86	2.50	1.36
Sep 12	3.98	2.60	1.38
Oct 12	3.98	2.72	1.26
Nov 12	**3.92**	**2.64**	**1.28**

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

Category	Mkt Val (£bn @ Nov 12 & 09, 06)			Weight (%)
Gilts (36)	1,115	705	327	67.6
Non Gilts (1,026)	535	487	415	32.4
AAA (171)	142	152	154	8.6
AA (150)	67	66	67	4.1
A (352)	177	169	126	10.7
BBB (353)	150	97	66	9.1

Category	Mkt Val (£bn @ Nov 12, & 09)		W't (%)	Dur'n (yrs)
Gilts (36)	1,115	705	67.6	9.8
< 5 Yrs (10)	305	206	18.5	2.8
5–15 Yrs (10)	358	232	21.7	6.9
> 15 Yrs (16)	451	267	27.3	16.9
Non Gilts (1,026)	535	487	32.4	8.0
< 5 Yrs (292)	145	153	8.8	2.7
5–15 Yrs (443)	217	195	13.2	7.2
> 15 Yrs (291)	172	139	10.4	13.5

£ Gilt Market "main" Issuance

- £4.50bn 1% 2017 (1.59x, 0.79%, prev. Sept 12)
- £3.57bn 1¾% 2019 (1.93x, 1.82%, Oct 12)
- £2.20bn 3¾% 2052 (1.72x, 3.22%, July 12)
- £3.25bn $^{1}/_{8}$% IL 2044 (1.82x, ry 0.33%, July 12)
- £0.90bn ¾% IL 2047 (1.75x, ry 0.29%, Jan 12)

Note: Issuance amounts are nominals.

Tables 2d, 2e: € Market Size and Maturity (Nov 12)

Category	Mkt Val (€bn)	Weight (%)
Sovereigns (261)	4,594	58.0
Non Sovereigns	3,332	42.0
AAA (578)	1,271	16.0
AA (346)	478	6.0
A (763)	893	11.3
BBB (676)	690	8.7

Category	Mkt Val (€bn)	Weight (%)
1 – 3 Yrs (851)	2,219	28.0
3 – 5 Yrs (727)	1,829	23.1
5 – 7 Yrs (389)	1,026	12.9
7 – 10 Yrs (452)	1,462	18.5
10+ Yrs (205)	1,391	17.6

Table 2f: Breakdown of £ Index-Linked Market

Category (Number of issues)	Mkt Val (£bn @ Nov 12 & 09)		W't (%)	Dur'n (yrs)
Gilts (21)	336	215	92.0	18.6
< 5 Yrs (2)	45	35	12.2	4.0
5 – 15 Yrs (5)	96	85	26.2	10.0
> 15 Yrs (14)	196	96	53.6	26.1
Non Gilts (43)	29	22	8.0	17.3

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

Month End	US (%)	Euro (%)	Sterling (%)
Jun 12	6.96	8.95	10.88
Jul 12	6.61	8.53	10.36
Aug 12	6.45	7.80	9.68
Sep 12	6.29	7.31	8.94
Oct 12	6.19	6.81	8.36
Nov 12	**6.13**	**6.36**	**8.02**

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

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