



Investment Update March 2012

Investment Headlines & Comment

- **Greece** has achieved a 53.5% reduction deal for its bonds – yet there has been no real impact on their government bond yields. So, the market is still pricing for far worse to come.
- The **Royal Mail** pension scheme is being nationalised, cancelling 3% of the ILG market in the process. Wouldn't it be better to simply sell them slowly to other investors, given relatively low ILG supply?
- As demonstrated by the change in Table 2d this month, there have been a lot of **European downgrades** even at the AAA level – mostly financials, with insurers suffering in particular.

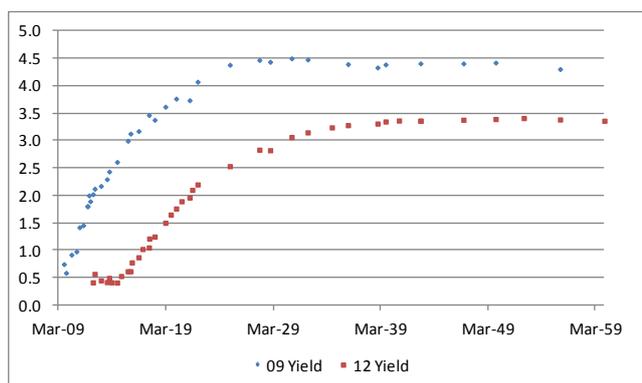
Feature Section

This month, we consider how quantitative easing (QE) has evolved over the last 3 years. QE started in March 2009 with a (now) trifling £75bn project, which led to some early gilt market volatility (see our *Update* for March 2009). We returned to the subject in December 2009 to see how it had affected both the Bank of England's balance sheet, and also the ownership of the gilt market.

As per the news item in last month's *Update*, QE3 is going to get the project to a whopping £325bn, and is being blamed for the depression of gilt yields (and hence increased annuity costs and DB pension reserves) so we thought it time to look at how QE3 updates the gilt market ownership. However, we also consider another project which has been running in parallel - the increasing use of the LDI market by pension schemes (see *Update* back in 2005 and 2006 for early discussion on this). Could it be that QE has been suppressing gilts at short and medium maturities, whilst LDI has had a comparable effect at longer maturities?

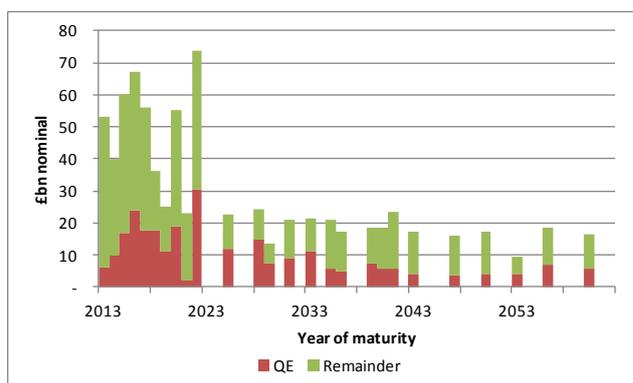
Figure 1a shows the gilt yield curve just before QE was announced in 2009, and as it is now. For gilts maturing in the 2010s decade, the typical fall in yields has been 2.1%, whereas for gilts maturing after 2030 it has been 1%. The former corresponds to a price rise of about 10% or so, but for the latter, it is a rise of upwards of 20%. Figure 1b shows the gilt market ownership profile in £bn nominal of the £267bn of QE that has been done so far (i.e. possibly another £58bn to go on top, expected to be completed by May 2012) – the weighted average term to maturity for the QE proportion is about 10 years, but for the remainder it is about 13 years.

Figure 1a: Gilt yield curves



Source: DMO

Figure 1b: Gilt market ownership



Sources: Bank of England, DMO

We understand the current Bank plan is to keep the QE gilts to maturity, which seems a little strange. There is an argument for the Bank selling the longer-maturity QE holdings back into the market – in theory, this might increase the yields involved slightly (good for pension funds, less good for the government issuing new debt), but as the data on page 4 of *Update* shows, the take-up of new long-dated issuance remains high so we doubt yields would rise significantly.

F&C's quarterly LDI survey suggests that some £7bn-£9bn of interest rate liabilities are hedged each quarter, although in Q3 11 this rose to £13bn and in Q4 11 it was £14bn. For the last 3 years, their survey total is £106bn. However, it is very difficult to estimate what percentage of these actions relates to a new hedge (i.e. where bonds not already held), a switch from a physical to derivative based hedge (i.e. moving from bonds to swaps), or a switch in the instrument or structure of a hedge. Also, we cannot be sure of the maturity of the liabilities being hedged, but it seems likely that it will be for longer maturities, and as such it is worth noting that £106bn is about 1/5th of the combined market value of over 15 year gilts and sterling corporates. Given a limit to the scale of 'natural' counterparties, it is thus likely that a lot of these actions have ultimately involved the purchase of these bonds, and hence the drop in longer-term yields?



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 March 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	-0.9	6.1	1.4	18.8	1.8	5.2	8.5
Overseas Equities	0.8	9.4	-0.3	17.0	5.0	4.9	8.0
US Equities	3.2	9.7	8.8	19.0	6.5	3.2	8.9
Europe ex UK Equities	-0.6	10.0	-11.8	12.8	0.1	5.3	9.0
Japan Equities	1.3	7.9	0.9	7.9	-1.0	2.9	1.8
Pacific ex Japan Equities	-3.1	9.6	-6.3	21.5	9.8	11.8	9.1
Emerging Markets	-3.4	11.0	-8.2	20.9	9.4	13.2	8.7
UK Long-dated Gilts	-2.0	-4.4	22.6	9.4	8.3	7.2	9.2
UK Long-dated Corp. Bonds	-1.1	0.5	12.3	13.1	5.7	6.3	-
UK Over 5 Yrs Index-Linked Gilts	-0.3	-2.0	21.1	12.6	9.5	8.2	8.5
High Yield (Global)	0.1	4.5	5.5	20.3	12.6	8.3	-
Overseas Bonds	-1.1	-3.7	5.4	2.5	11.9	6.8	7.1
Property *	0.3	1.1	7.3	10.2	-1.7	6.5	8.4
Cash	0.1	0.3	0.9	0.8	2.7	3.6	5.0
Commodities £-converted	-2.4	3.0	-5.9	9.1	1.4	3.6	4.4
Hedge Funds original \$ basis *	2.1	4.5	-2.1	10.1	2.9	6.4	10.5
Illustrative £-converted version *	0.9	2.9	-0.3	6.0	7.2	5.1	11.0
Euro relative to Sterling	-0.5	-0.2	-5.8	-3.5	4.2	3.1	-
US \$ relative to Sterling	-0.1	-2.8	0.3	-3.6	4.2	-1.1	0.4
Japanese Yen relative to Sterling	-1.7	-9.0	1.1	2.5	12.0	3.7	2.9
Price Inflation (RPI) *	0.8	0.6	3.7	4.3	3.4	3.3	2.9
Price Inflation (CPI) *	0.6	0.5	3.4	3.6	3.3	2.6	2.2
Price Inflation (RPIX) *	0.8	0.6	3.8	4.5	4.0	3.3	2.9
Earnings Inflation **	0.3	2.7	0.1	1.4	1.2	3.0	3.7
All Share Capital Growth	-1.4	5.1	-2.1	14.8	-1.8	1.6	4.8
Net Dividend Growth	3.4	3.0	14.1	0.7	2.1	4.3	-
Earnings Growth	-0.3	5.5	31.4	8.2	3.2	10.0	-

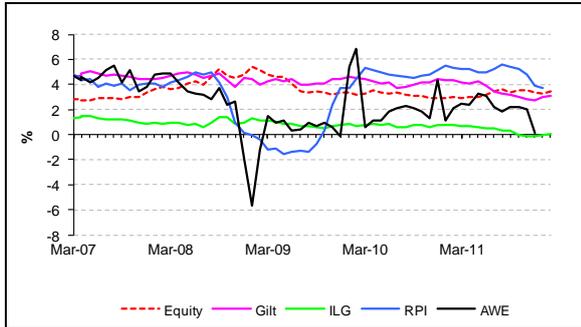
Note: All market returns are total returns for pension funds with income reinvested monthly. Indices used are as follows:

- 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.

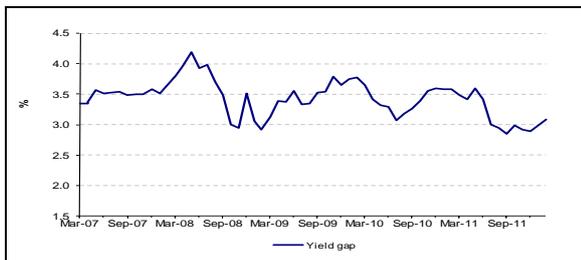


Yields and Yield Gaps

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.

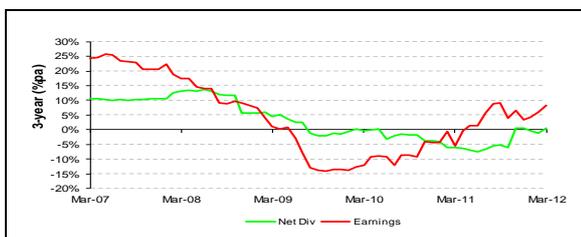
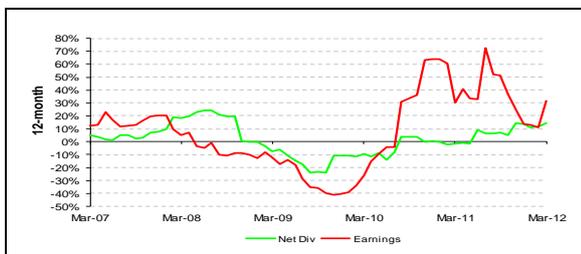


The gap gives expectations now just above 3% for longer-term inflation + risk premium for gilts, relative to index-linked gilts.

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]

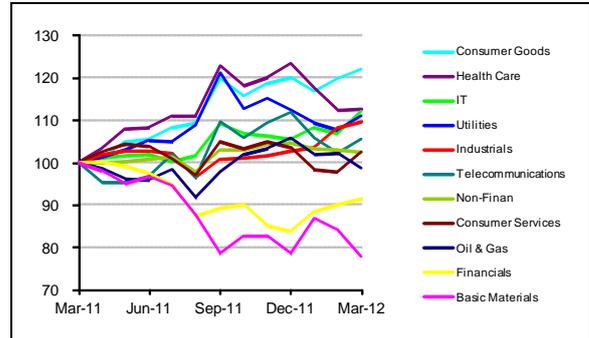
Figure 3: Dividend & Earnings Growth



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



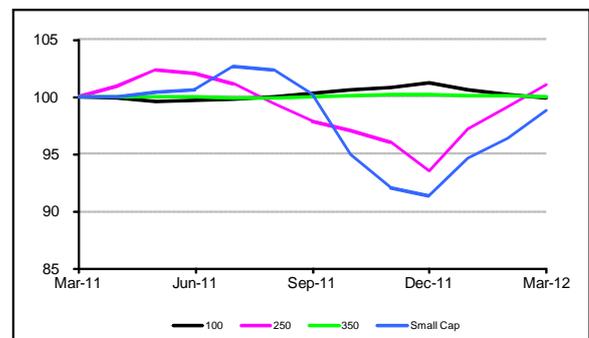
Note: Sector labels for relative lines are in end-value order

There was a slight rise this month in the rolling 12-month sector dispersion (up from 38% to 44%).

(% absolute return)	1 mth	3 mth	12 mth
Oil & Gas	-4.5	-1.1	-0.0
Basic Materials	-8.3	5.1	-21.2
Industrials	0.2	13.3	11.1
Consumer Goods	0.9	7.8	23.7
Health Care	-0.7	-3.2	14.1
Consumer Services	3.8	4.8	3.9
Telecommunications	2.2	-0.0	6.8
Utilities	2.1	5.0	12.7
Non-Finan	-1.4	3.8	3.9
Financials	0.8	16.0	-7.1
IT	3.8	12.6	13.6
All Share	-0.9	6.1	1.4

UK Equity Size Returns

Figure 4b: Size groups relative to All Share



Small and Mid Cap both rallied in relative terms this month.

FRS17 volatility indicator

Now discontinued, but available on request.



Bond market information

Figure 5: £ Non-Gilt Credit Margins

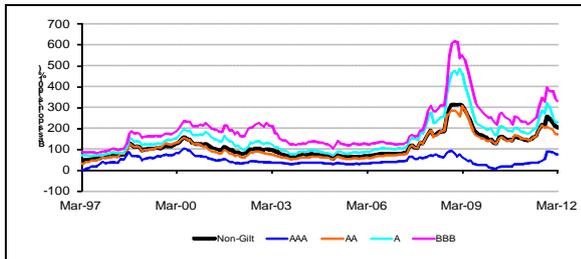


Table 2a: Over 15 Yr Corporate Yields & Margins

Month End	iBoxx Corp AA Y'ld (%)	FT 20 yr Gilt (%)	Margin (%)
Oct 11	4.89	3.19	1.70
Nov 11	4.81	2.95	1.86
Dec 11	4.63	2.78	1.85
Jan 12	4.55	2.75	1.80
Feb 12	4.47	2.95	1.52
Mar 12	4.57	3.09	1.48

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

Category	Mkt Val (£bn @ Mar 12 & 09, 06)			Weight (%)
Gilts (35)	1,012	587	301	67.8
Non Gilts (1,001)	481	399	379	32.2
AAA (160)	126	142	143	8.4
AA (140)	60	60	59	4.0
A (367)	170	134	116	11.4
BBB (334)	125	61	57	8.4

Category	Mkt Val (£bn @ Mar 12, 09)		W't (%)	Dur'n (yrs)
Gilts (35)	1,012	587	67.8	9.5
< 5 Yrs (10)	307	168	20.5	2.9
5-15 Yrs (10)	318	196	21.3	7.2
> 15 Yrs (15)	388	223	26.0	16.6
Non Gilts (1,001)	481	399	32.2	7.8
< 5 Yrs (267)	125	143	8.4	2.8
5-15 Yrs (454)	208	144	13.9	7.0
> 15 Yrs (280)	148	112	9.9	13.0

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

£ Gilt Market “main” Issuance

- £4.00bn 1% 2017 (1.95x, 1.19%, new)
 - £2.75bn 4% 2022 (2.07x, 2.18%, Dec 11)
 - £2.20bn 4½% 2042 (1.71x, 3.43%, Jul 08)
 - £1.01bn ILG ¾% 2034 (1.93x, r.y 0.04%, Jul 11)
 - £0.90bn ILG ⅝% 2042 (1.73x, r.y 0.06%, Aug11)
- Note: Issuance amounts are nominals.

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

Category	Mkt Val (€bn)	Weight (%)
Sovereigns (256)	4,277	57.5
Non Sovereigns	3,157	42.5
AAA (585)	1,186	16.0
AA (434)	620	8.3
A (772)	898	12.1
BBB (526)	453	6.1

Category	Mkt Val (€bn)	Weight (%)
1 – 3 Yrs (856)	2,128	28.6
3 – 5 Yrs (728)	1,732	23.3
5 – 7 Yrs (379)	916	12.3
7 – 10 Yrs (405)	1,377	18.5
10+ Yrs (205)	1,282	17.2

Table 2f: Breakdown of £ Index-Linked Market

Category (Number of issues)	Mkt Val (£bn @ Mar 12 & 09)		W't (%)	Dur'n (yrs)
Gilts (19)	336	176	92.2	17.3
< 5 Yrs (2)	49	33	13.5	2.9
5 – 15 Yrs (4)	88	61	24.0	8.5
> 15 Yrs (13)	199	82	54.7	24.7
Non Gilts (47)	29	18	7.8	17.4

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

Month End	US (%)	Euro (%)	Sterling (%)
Nov 11	8.10	10.98	11.69
Dec 11	7.48	11.08	11.43
Jan 12	6.99	9.40	10.21
Feb 12	6.65	8.36	9.40
Mar 12	6.78	8.12	9.27

