JAGGER & ASSOCIATES

Investment Update
April 2012

Investment Headlines & Comment

- Record low **German 10-year** yields (1.6%) but only 80% sold (of target) in a new 32-year bond.
- The **Pension Regulator** has stated that gilt yields should still drive pension valuations. Misguided?
- Dramatic contraction of **Scottish Widows'** equity staff, with a move to quant (or passive?) funds.

Feature Section

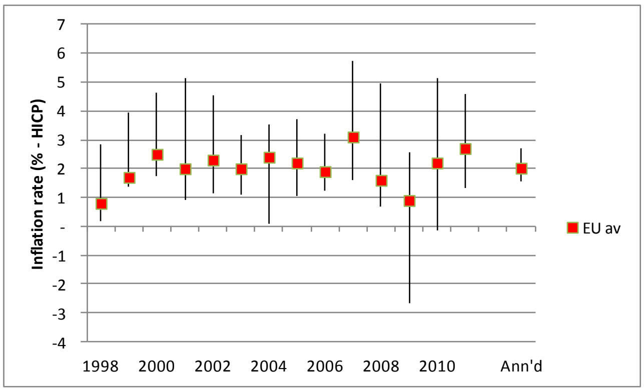
This month, marking the second anniversary of the launch of the European Financial Stability Facility (EFSF), and with Spain the latest Euro member to find markets beginning to doubt it, we thought we would consider how (or if) the European Central Bank (ECB) works, and the more general question of movements in European AAA yields. For example, the sterling spreads over gilts have increased on EIB AAA-rated 10-year bonds (from 0.2% in April 2010 to 0.5% in April 2011 to 1.2% in April 2012).

The ECB was founded in 1998, to 'replace' the then-17 central banks in the EU, and is 'owned' by the central banks of the 27 member states of the EU. The ECB's primary objective is unusually narrow - to maintain price stability, i.e. to keep inflation low, within the Eurozone (not the whole EU). It can do this through monetary policy (including issuing euro banknotes, and overall control of euro coinage), and through foreign exchange operations. Figure 1a shows the high / low / average inflation rates for the Eurozone members in each year and annualized over its lifetime (for those in since the beginning). The average yearly dispersion is 3.4%, but for those in since the start, the average spread is 1.1% p.a. The primary objective does not seem to have been achieved, although it has generally been the smaller (or new entrant) economies which have been outliers, and generally more volatile. Italian inflation has been the *least* volatile!

In May 2010, the 27 member states of the European Union agreed to incorporate the European Financial Stability Facility (EFSF). The EFSF's mandate is to safeguard European financial stability by providing financial assistance to Eurozone member states, for example through loans to countries in financial difficulties, and through actions in the primary (and sometimes secondary) debt markets. The EFSF is backed by €780bn of guarantee commitments from the Eurozone member states and has a lending capacity of €440bn. It is currently AAA rated by S&P. The newest mechanism from the ECB is Long Term Refinancing Operations (LTROs), maturing after periods ranging up to 3 years – prior to 2011, the longest term was for 1 year. In December 2011, loans were made at just 1% interest to European banks, with the ECB accepting loans from the banks' portfolio as collateral. €489bn went to 523 banks, but within this €325bn went to banks in Greece, Ireland, Italy and Spain. In February 2012, a further €313bn was loaned (this figure is net of existing ECB loans which were converted into the LTRO system).

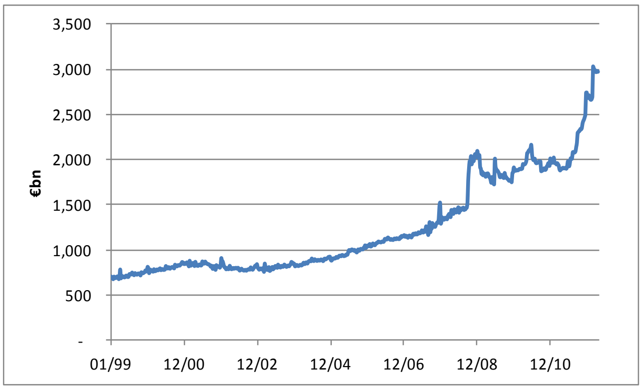
So what has this done to the ECB's balance sheet? Figure 1b shows it passed €3 trillion in March (although it has fallen slightly since then), overtaking the US Federal Reserve to become the world's most activist bank, and leading to concern that the ECB may now have lax views on inflation, and insufficient collateral for the loans made. The ECB's balance sheet is one-third of euro-zone GDP, bigger than the equivalents for the Federal Reserve (19% of U.S. GDP), and the UK (21% of U.K. GDP), although some within the ECB claim that it should only be measured on assets relating to monetary policy (i.e. excluding gold and currency reserves), and on that basis it is still smaller than the US and the UK.

Figure 1a: EU inflation dispersion (calendar years)



Source: Eurostat

Figure 1b: ECB balance sheet evolution



Source: ECB

In theory, the ECB could push for greater political and fiscal integration across the EU membership, making the member states clearly responsible for each others' debts, but things could conceivably go the other way (e.g. if Germany has had enough). The speculative attacks on EU sovereign debt have clearly shown the European Union's political and fiscal structural weakness. It seems increasingly bizarre that anyone would still consider joining the Euro!

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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 April 2012

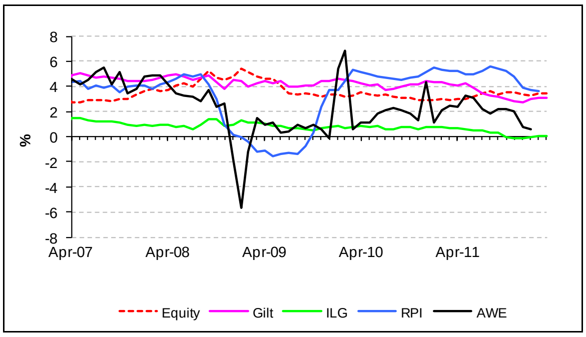
Asset Class	1 month (%)	3 months (%)	12 months (%)	3 years (% p.a.)	5 years (% p.a.)	10 years (% p.a.)	20 years (% p.a.)
UK Equities	-0.3	3.0	-2.0	15.0	1.3	5.3	7.9
Overseas Equities	-2.9	1.6	-3.0	12.8	3.9	5.2	8.0
US Equities	-2.2	**4.1**	7.6	15.8	5.6	3.9	8.6
Europe ex UK Equities	**-5.4**	-0.5	**-19.8**	6.6	**-2.0**	5.0	**8.9**
Japan Equities	-4.7	-0.1	-0.4	4.2	-1.2	**2.1**	**2.0**
Pacific ex Japan Equities	-1.2	-0.4	-7.6	16.6	8.9	11.8	**8.9**
Emerging Markets	-2.8	-1.6	-10.0	15.1	8.2	**13.0**	8.7
UK Long-dated Gilts	**0.7**	**-4.5**	**19.8**	10.5	8.7	7.1	**8.9**
UK Long-dated Corp. Bonds	0.0	-1.7	9.1	13.3	5.9	6.1	-
UK Over 5 Yrs Index-Linked Gilts	-0.4	-2.8	18.1	12.6	9.5	8.1	8.4
High Yield (Global)	-0.9	1.2	6.2	**17.0**	**12.4**	8.3	-
Overseas Bonds	-0.1	-3.5	6.5	3.7	12.1	6.7	7.2
Property *	0.2	0.9	6.6	11.2	-1.8	6.5	8.4
Cash	0.1	0.3	1.0	**0.8**	2.6	3.6	5.0
Commodities £-converted	-2.1	0.1	-8.2	9.9	1.4	3.5	4.3
Hedge Funds original $ basis *	-0.1	4.8	-2.3	9.4	2.6	6.2	10.5
Illustrative £-converted version *	-0.2	1.9	-2.0	5.5	6.9	5.0	10.9
Euro relative to Sterling	-2.2	-1.8	-8.4	-3.1	3.6	2.8	-
US $ relative to Sterling	-1.6	-2.8	2.7	-3.0	4.3	-1.1	0.4
Japanese Yen relative to Sterling	1.4	-7.2	4.3	4.0	13.0	3.7	3.1
Price Inflation (RPI) *	0.4	0.6	3.6	4.5	3.3	3.3	2.9
Price Inflation (CPI) *	0.3	0.4	3.5	3.6	3.2	2.6	2.2
Price Inflation (RPIX) *	0.4	0.6	3.7	4.6	3.9	3.3	2.9
Earnings Inflation **	4.7	8.0	0.6	2.2	1.1	3.1	3.9
All Share Capital Growth	-0.6	1.8	-5.4	11.2	-2.3	1.7	4.3
Net Dividend Growth	0.3	5.4	13.1	-0.2	2.2	4.3	-
Earnings Growth	-0.8	4.7	10.1	9.5	3.1	9.9	-

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

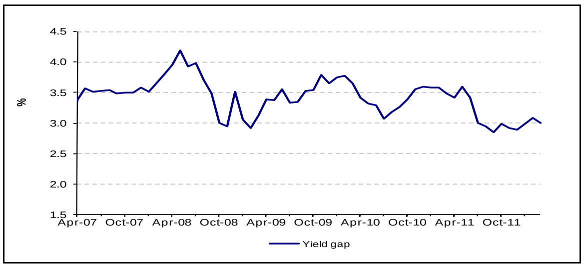
- *UK Equities (incl. dividends and earnings) – FT-A All Share.*
- *Overseas Equities (incl. regions) – blend of FT All-World / World subindices*
- *Emerging Markets from MSCI US $ based total return index (overall Index to 31 Oct 2001, Free Index from 1 Nov 2001 to take account of foreign investment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

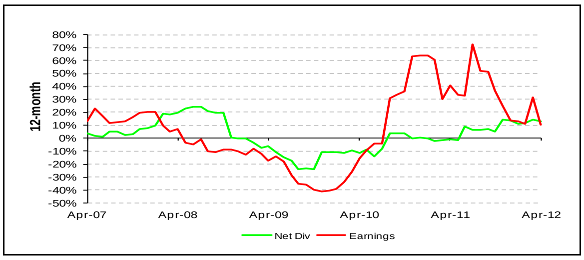


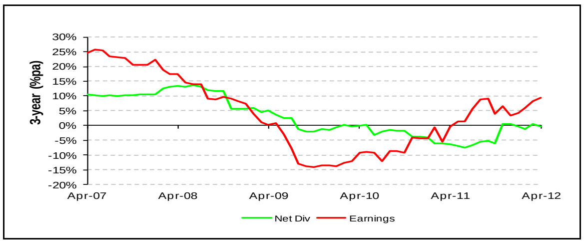
The gap gives expectations now at 3% for longer-term inflation + risk premium for gilts, relative to index-linked gilts.

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

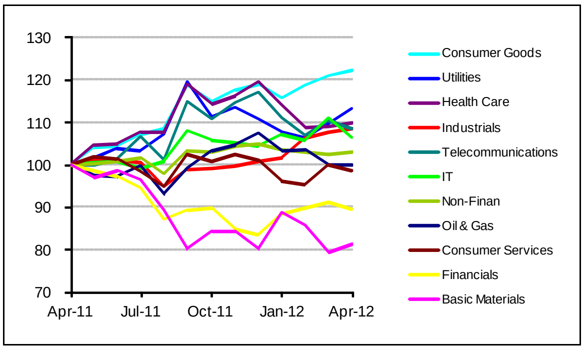




Sources for charts on this page:
Financial Times, Office for National Statistics, J&A

UK Equity Sector Returns

Figure 4a: Sectors relative to All Share



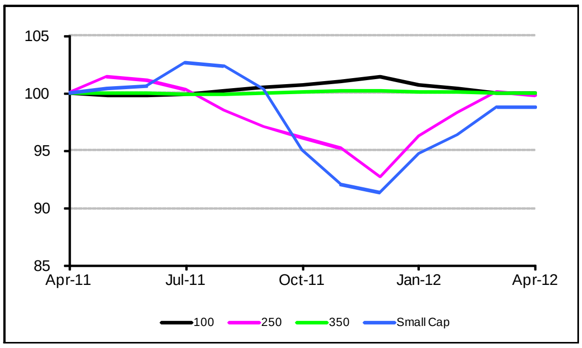
Note: Sector labels for relative lines are in end-value order

There was a slight fall this month in the rolling 12-month sector dispersion (down from 44% to 41%).

(% absolute return)	1 mth	3 mth	12 mth
Oil & Gas	-0.2	-0.2	-1.9
Basic Materials	2.2	-5.5	-20.3
Industrials	0.6	9.9	6.5
Consumer Goods	0.9	8.9	20.0
Health Care	0.3	-0.9	7.6
Consumer Services	-1.8	5.7	-3.4
Telecommunications	-2.0	0.8	6.4
Utilities	2.9	8.1	10.8
Non-Finan	0.2	2.6	1.0
Financials	-2.3	4.4	-12.3
IT	-4.3	2.2	4.3
All Share	-0.3	3.0	-2.0

UK Equity Size Returns

Figure 4b: Size groups relative to All Share



Small and Mid Cap were flat in relative terms this month.

FRS17 volatility indicator

Now discontinued, but available on request.

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Bond market information

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

Figure 5: £ Non-Gilt Credit Margins

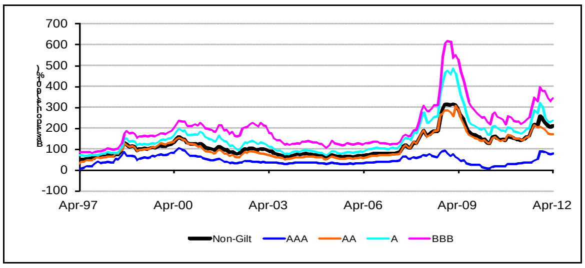

Table 2a: Over 15 Yr Corporate Yields & Margins

Month End	iBoxx Corp AA Y'ld (%)	FT 20 yr Gilt (%)	Margin (%)
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
Apr 12	**4.56**	**3.05**	**1.51**

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

Category	Mkt Val (£bn @ Apr 12 & 09, 06)			Weight (%)
Gilts (35)	990	596	297	67.3
Non Gilts (1,007)	481	404	374	32.7
AAA (159)	124	144	141	8.5
AA (142)	61	54	58	4.1
A (366)	169	136	114	11.5
BBB (340)	127	68	57	8.6

Category	Mkt Val (£bn @ Apr 12, 09)		W't (%)	Dur'n (yrs)
Gilts (35)	990	596	67.3	9.7
< 5 Yrs (9)	271	172	18.4	3.0
5–15 Yrs (11)	327	203	22.2	7.1
> 15 Yrs (15)	393	220	26.7	16.6
Non Gilts (1,007)	481	404	32.7	7.8
< 5 Yrs (270)	124	148	8.5	2.8
5–15 Yrs (457)	209	144	14.2	7.0
> 15 Yrs (280)	148	112	10.1	13.0

£ Gilt Market "main" Issuance

- £4.50bn 1% 2017 (1.37x, 1.15%, Mar 12)
- £3.57bn 4% 2022 (1.92x, 2.22%, Mar 12)
- £2.00bn 4¼% 2032 (1.39x, 3.02%, Nov 11)
- £4.75bn 3¾% 2052 (2.06x, 3.45%, Jan 12)
- £1.48bn ILG $^{1}/_{8}$% 2029 (1.70x, r.y -0.05%, Feb 12)

Note: Issuance amounts are nominals.

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

Category	Mkt Val (€bn)	Weight (%)
Sovereigns (258)	4,283	57.4
Non Sovereigns	3,179	42.6
AAA (595)	1,222	16.4
AA (424)	595	8.0
A (783)	906	12.1
BBB (535)	456	6.1

Category	Mkt Val (€bn)	Weight (%)
1 – 3 Yrs (860)	2,130	28.5
3 – 5 Yrs (736)	1,752	23.5
5 – 7 Yrs (372)	939	12.6
7 – 10 Yrs (415)	1,367	18.3
10+ Yrs (212)	1,273	17.1

Table 2f: Breakdown of £ Index-Linked Market

Category (Number of issues)	Mkt Val (£bn @ Apr 12 & 09)		W't (%)	Dur'n (yrs)
Gilts (19)	338	177	92.3	17.2
< 5 Yrs (2)	49	33	13.4	2.8
5 – 15 Yrs (4)	87	61	23.9	8.5
> 15 Yrs (13)	201	83	54.9	24.4
Non Gilts (47)	28	18	7.7	17.3

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

Month End	US (%)	Euro (%)	Sterling (%)
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
Apr 12	**6.68**	**8.58**	**9.47**

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