

Investment Update September 2012



Investment Headlines & Comment

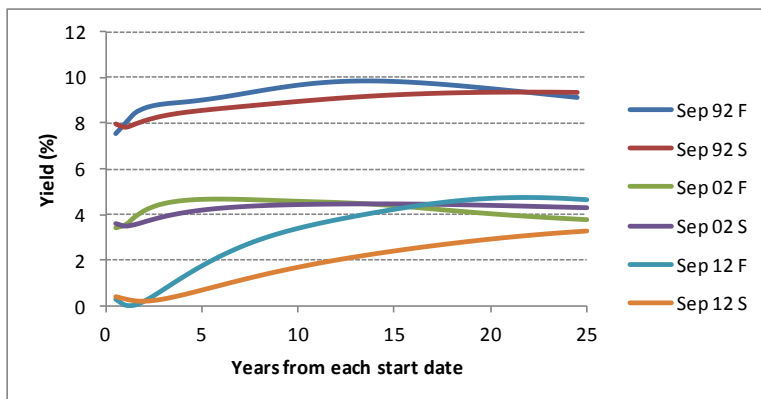
- The **Federal Reserve QE3** has been launched – a third round of economic stimulus, but it relies on mortgages getting issued in the US, for conversion into securities for the Fed to buy.
- A subset of **Standard Life's** absolute return (GARS) team is moving to **Invesco Perpetual** with a view to developing their multi-asset capabilities, not necessarily copying the GARS product.
- **Corporate bond spreads** over gilts have narrowed this quarter, producing the strongest relative return since Q3 2009. However, the dispersion of spreads by rating remains very wide (see p4).

Feature Section

This month we consider something at first glance uninteresting - spots and forwards. If yield curves (or real yield curves) are fairly flat, then you do not see much variation in their usual annualized (spot) and less-usual year-by-year (forward) versions. However, current bond market conditions, with steeply upward sloping yield curves, give quite a contrast, and the forward curves give a better indication of when current market levels are expected to change. All data is from the Bank of England website, not DMO prices. (The variation in inflation forward curves over time is in our September 2011 *Update*, to which this is a companion note.)

The charts below use data at the end of September in 1992, 2002 and 2012, with the F and S suffixes being for Forward and Spot curves respectively. Two background points. The horizontal axes are cut off at 25 years because that is the limit of the Bank of England data, although clearly it should be possible to use longer-dated gilts and index-linked gilts to continue the projection of the curves (which DMO data might permit). Also, the “gaps” at the left-hand side of Figure 1b simply reflect the absence of index-linked gilts maturing in the early years after each chosen September.

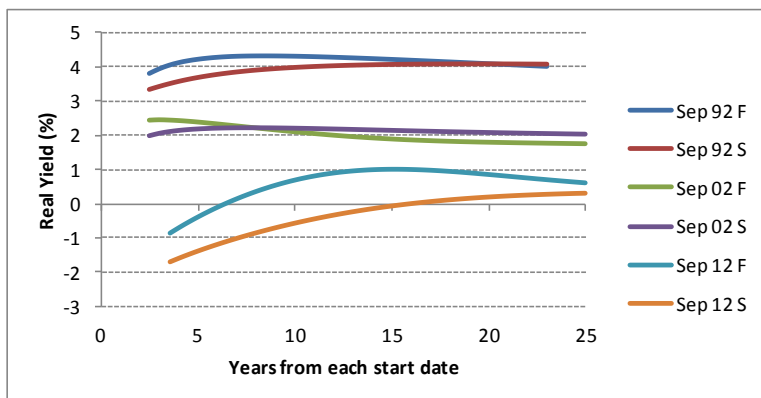
Figure 1a: Nominal Yields



From Figure 1a, it is clear how nominal yields dropped at all durations, for both spot rates and forward rates, over the 10 years from 1992 to 2002. Interestingly, there has been a much more limited move in longer-term nominal rates over the subsequent decade, but the shape has changed substantially.

It is a little strange that the current forward and spot curves for nominal yields both start decreasing before increasing, but this reflects the quirk that certain countries with “strong” finances are able to borrow at *negative* nominal rates for their shorter-dated debt, such is the fear of other government bond markets for some investors. The current spot rate for the next 5 years is around 0.5% p.a., the forward rate in 5 years’ time is about 2% p.a.

Figure 1b: Real Yields



From Figure 1b, it is clear how real yields dropped at all durations, for both spot rates and forward rates, over the 10 years from 1992 to 2002. In contrast with nominal yields, there has been a further marked move in real yields over the subsequent decade, in some cases bigger than over the previous decade and the shape has changed substantially too.

The current peculiar situation of negative real yields applies until 16 years’ time if using spot rates, but from a forward rate perspective, things head into positive territory in about 7 years’ time. Incidentally, the 20+ year inflation rate currently settles at 3% p.a., but with the underlying year-by-year rate rising steadily and ultimately going over 4%.



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 September 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	1.1	4.7	17.2	8.0	1.7	9.0	8.3
Overseas Equities	1.6	3.9	17.4	7.3	3.5	9.1	8.0
US Equities	0.9	3.3	25.6	12.7	6.1	8.0	8.9
Europe ex UK Equities	1.7	6.6	12.5	-0.2	-1.6	9.8	9.0
Japan Equities	0.7	-3.6	-5.2	-0.7	-1.7	3.5	1.2
Pacific ex Japan Equities	4.2	6.7	16.2	7.3	4.7	15.3	9.4
Emerging Markets	4.3	4.7	13.2	5.6	3.8	17.0	9.6
UK Long-dated Gilts	-1.3	1.1	13.0	10.7	10.1	6.7	9.2
UK Long-dated Corp. Bonds	0.0	6.3	15.4	10.4	8.5	6.3	-
UK Over 5 Yrs Index-Linked Gilts	-3.7	-3.2	5.0	9.3	8.3	7.3	7.8
High Yield (Global)	0.4	2.7	15.9	11.7	14.3	11.0	-
Overseas Bonds	-0.6	-0.3	-0.9	4.3	12.2	6.6	6.8
Property *	0.2	0.5	3.9	11.9	-2.1	6.0	8.5
Cash	0.1	0.2	1.0	0.8	2.1	3.4	4.8
Commodities £-converted	-3.1	8.3	8.8	6.2	-0.9	3.1	4.1
Hedge Funds original \$ basis *	0.9	2.1	0.4	4.5	1.8	6.5	10.2
Illustrative £-converted version *	-0.4	-1.0	2.9	5.4	6.8	6.2	11.4
Euro relative to Sterling	0.4	-1.5	-7.5	-4.5	2.7	2.4	-
US \$ relative to Sterling	-1.7	-2.9	-3.5	-0.3	4.9	-0.3	0.5
Japanese Yen relative to Sterling	-1.0	-0.4	-4.4	4.5	13.3	4.3	2.7
Price Inflation (RPI) *	0.4	0.2	2.9	4.3	3.2	3.3	2.8
Price Inflation (CPI) *	0.5	0.2	2.5	3.4	3.3	2.6	2.2
Price Inflation (RPIX) *	0.4	0.2	2.9	4.3	3.9	3.3	2.9
Earnings Inflation **	-2.0	-0.1	1.5	2.1	2.0	3.0	3.5
All Share Capital Growth	0.9	3.7	13.0	4.4	-2.0	5.2	4.7
Net Dividend Growth	0.3	2.3	12.4	7.6	2.6	5.0	-
Earnings Growth	2.0	-5.8	-16.7	19.1	-0.8	9.5	-

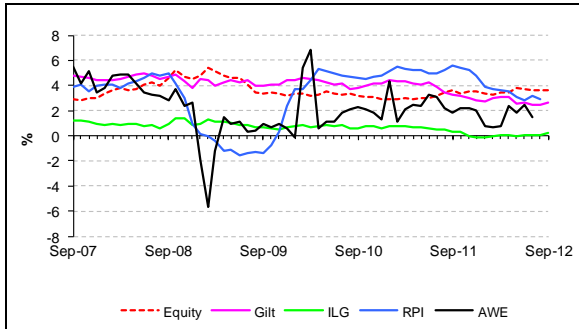
Note: All market returns are total returns for pension funds with income reinvested monthly. Indices used are as follows:

- 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.

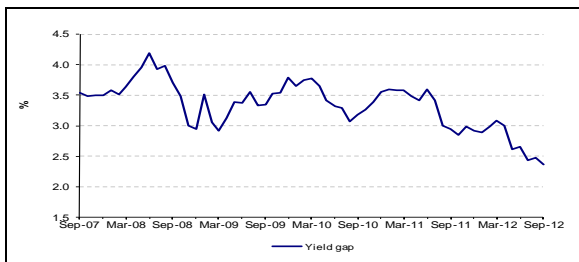


Yields and Yield Gaps

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.

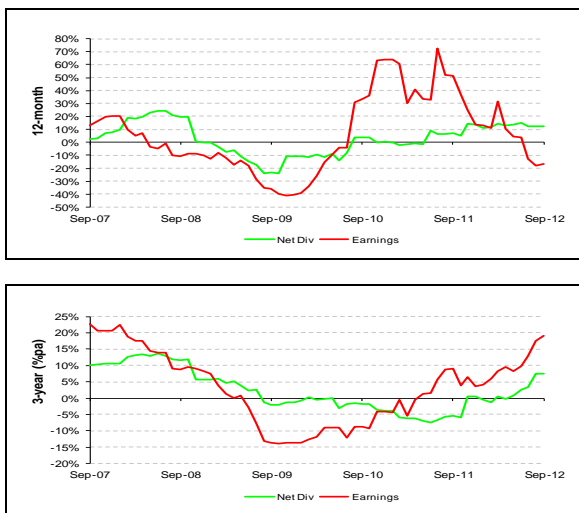


The gap gives expectations still down below 2.5% for longer-term inflation + risk premium for gilts, relative to index-linked gilts.

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]

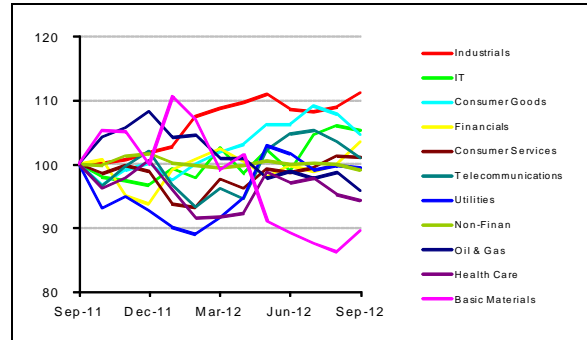
Figure 3: Dividend & Earnings Growth



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



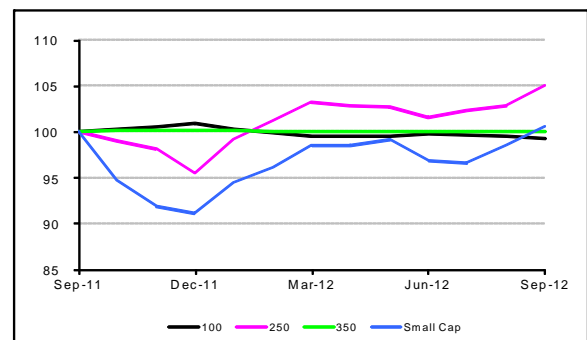
Note: Sector labels for relative lines are in end-value order

There was a sharp fall this month in the rolling 12-month sector dispersion (down from 41% to 22%).

(% absolute return)	1 mth	3 mth	12 mth
Oil & Gas	-1.9	1.5	12.4
Basic Materials	4.8	5.0	4.9
Industrials	3.1	7.2	30.3
Consumer Goods	-1.9	3.2	22.7
Health Care	0.2	1.8	10.5
Consumer Services	1.0	7.3	18.6
Telecommunications	-1.5	0.7	18.2
Utilities	0.9	2.5	16.7
Non-Finan	0.2	3.8	16.2
Financials	4.4	8.4	21.2
IT	0.3	11.4	23.4
All Share	1.1	4.7	17.2

UK Equity Size Returns

Figure 4b: Size groups relative to All Share



Mid and Small Cap rose in relative terms this month.

FRS17 volatility indicator

Now discontinued, but available on request.

Bond market information



Figure 5: £ Non-Gilt Credit Margins

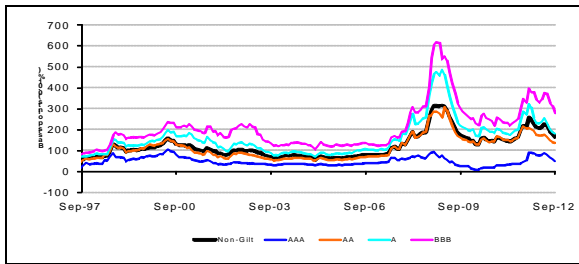


Table 2a: Over 15 Yr Corporate Yields & Margins

Month End	iBoxx Corp AA Y'ld (%)	FT 20 yr Gilt (%)	Margin (%)
Apr 12	4.56	3.05	1.51
May 12	4.18	2.54	1.64
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

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

Category	Mkt Val (£bn @ Sep 12 & 09, 06)		Weight (%)
Gilts (36)	1,097	668 310	67.6
Non Gilts (1,021)	525	481 395	32.4
AAA (170)	140	150 149	8.7
AA (151)	66	66 64	4.1
A (345)	171	165 119	10.6
BBB (355)	147	97 59	9.1

Category	Mkt Val (£bn @ Sep 12, & 09)		W't (%)	Dur'n (yrs)
Gilts (36)	1,097	668	67.6	9.8
< 5 Yrs (10)	292	201	18.0	2.7
5-15 Yrs (11)	365	213	22.5	7.0
> 15 Yrs (15)	439	254	27.1	16.8
Non Gilts (1,021)	525	481	32.4	7.9
< 5 Yrs (291)	143	153	8.8	2.7
5-15 Yrs (447)	216	192	13.3	7.1
> 15 Yrs (283)	165	136	10.2	13.4

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

£ Gilt Market “main” Issuance

- o £4.93bn 1% 2017 (1.51x, 0.80%, July 12)
 - o £3.83bn 1¾% 2022 (1.82x, 1.83%, July 12)
 - o £1.75bn 4½% 2042 (1.52x, 2.95%, May 12)
 - o £1.35bn ¾% IL 2034 (1.55x, ry 0.13%, May 12)
 - o £4.00bn ¼% IL 2052 (2.00x, ry 0.36%, new)
- Note: Issuance amounts are nominals.

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

Category	Mkt Val (€bn)	Weight (%)
Sovereigns (259)	4,472	57.9
Non Sovereigns	3,250	42.1
AAA (563)	1,243	16.1
AA (345)	475	6.2
A (767)	903	11.7
BBB (635)	629	8.2

Category	Mkt Val (€bn)	Weight (%)
1 – 3 Yrs (845)	2,211	28.6
3 – 5 Yrs (714)	1,744	22.6
5 – 7 Yrs (379)	981	12.7
7 – 10 Yrs (429)	1,421	18.4
10+ Yrs (202)	1,364	17.7

Table 2f: Breakdown of £ Index-Linked Market

Category (Number of issues)	Mkt Val (£bn @ Sep 12 & 09)		W't (%)	Dur'n (yrs)
Gilts (19)	324	204	91.9	18.1
< 5 Yrs (1)	28	34	7.8	3.7
5 – 15 Yrs (4)	88	82	25.1	8.1
> 15 Yrs (14)	208	89	59.0	24.3
Non Gilts (45)	29	21	8.1	17.1

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

Month End	US (%)	Euro (%)	Sterling (%)
May 12	7.16	9.31	10.63
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

