



## Investment Update May 2013

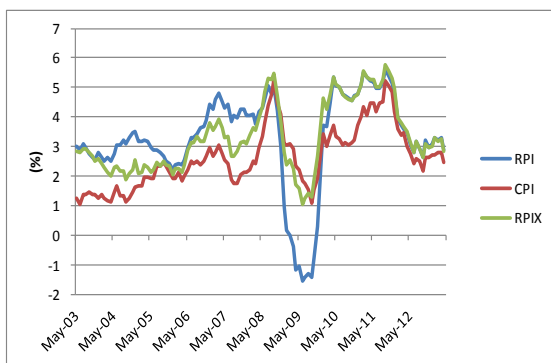
### Investment Headlines & Comment

- Western equity markets continue to rise but Eastern ones struggle.
- Europe's 12 month 42% return stands out – “what crisis?”
- Bond yields rise, perhaps as investors go back to equities?

**Feature Section** This month we look at the 82<sup>nd</sup> Bank of England [Inflation Report](#). Each report includes statistical projections for the next couple of years for CPI and GDP. Given the ranges of end points after two or three years, it is perhaps not surprising that the Bank does not try to project any further forward. So, how do their views now compare with their past views at May 2003 and May 2008?

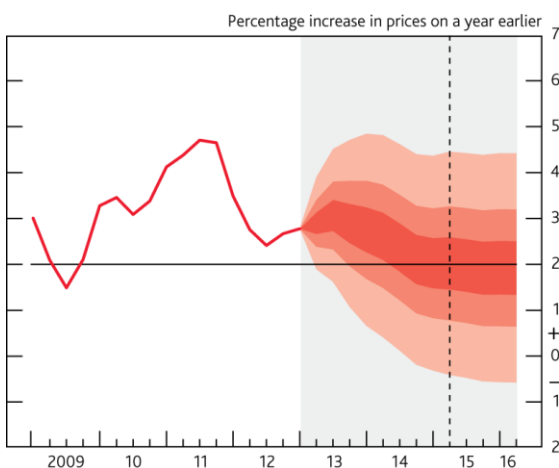
10 years ago, when base rate was 3.75%, the Bank's target was “RPIX”, inflation excluding mortgage interest payments, with a desired rate of 2.5% p.a. There was discussion of a potential move to CPI, with a desired rate of 2% p.a. At the time, the Bank thought “*the central projection for RPIX inflation falls back in the second half of 2003, dipping marginally below target by early 2004*”. As figure 1a shows, they had that broadly correct.

**Figure 1a: Actual 12-month RPI, RPIX and CPI**



Source: ONS

**Figure 1b: May 2013 CPI fan chart**

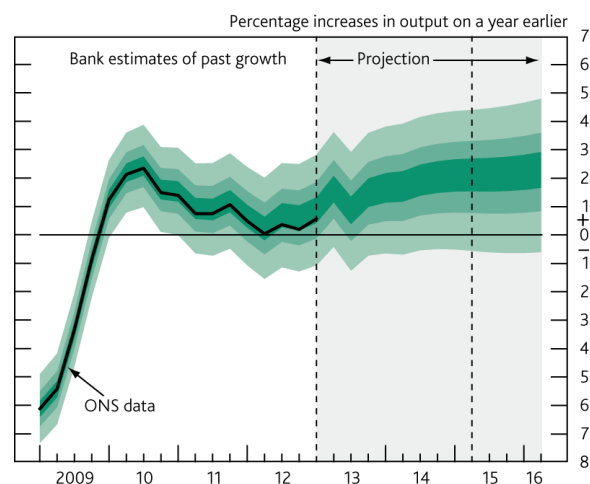


Source: Bank of England, assuming QE stays at £375bn  
Note: For Figures 1b and 1c, each colour set of bands represents 30% of outcomes. For bands with upper and lower components, 15% in each.

5 years ago, when base rate was 5%, the 2% CPI target was in place, but trade-weighted sterling had just fallen by about 10% in six months (worse was to come in December 2008). In the Bank's central projection, “*higher energy and import prices push inflation up sharply in the near term ... above 3% for several quarters ... back to around the 2% target in the medium term*”. Again, not too far out initially, but it did not anticipate the gyrations in 2009 and 2010, and there seemed to be persistent ‘unexpected results’.

After the “stress test” of the credit crunch, the [Stockton Review](#) tested this persistency (and other things) in October 2012. It found persistent over-prediction of output growth and persistent under-prediction of CPI inflation, and termed the Bank's record “marginally worse than that of outside forecasters”. Although it found the Bank's explanations persuasive, it felt there should be a shift from “best collective judgment” to “considering more fully views that diverge from the consensus”. (You have only to look at the ranges in the fan charts to see how much divergence there could be!)

**Figure 1c: May 2013 GDP fan chart**



As per Figure 1b, the latest pronouncement for CPI inflation is that it “*remains above the 2% target ... set to edge higher over coming months ... likely to stay above the target for much of the next two years ... fall back to around 2% in the latter part of the forecast period*”. Also, Figure 1c is interesting in that it shows no 12-month contraction in GDP since the credit crunch – any recession (two consecutive quarters of negative economic growth) has been quickly reversed.



**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 May 2013**

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	2.9	5.0	30.4	12.9	6.2	9.6	8.2
Overseas Equities	2.5	4.8	28.8	11.2	7.5	9.8	7.3
US Equities	<b>4.9</b>	<b>8.3</b>	29.3	<b>15.2</b>	11.3	8.7	<b>9.1</b>
Europe ex UK Equities	3.1	4.5	<b>42.0</b>	10.0	2.4	10.1	8.9
Japan Equities	<b>-3.2</b>	7.6	28.2	5.9	3.6	7.6	<b>0.1</b>
Pacific ex Japan Equities	<b>-1.6</b>	<b>-3.4</b>	22.9	8.7	8.3	15.8	8.0
Emerging Markets	0.1	<b>-3.3</b>	16.2	4.3	4.5	<b>16.3</b>	8.3
UK Long-dated Gilts	<b>-4.5</b>	0.8	<b>-2.4</b>	10.0	9.1	6.1	8.5
UK Long-dated Corp. Bonds	<b>-2.9</b>	3.7	10.6	10.6	9.9	6.2	-
UK Over 5 Yrs Index-Linked Gilts	<b>-3.5</b>	2.3	5.9	12.2	8.9	7.7	7.8
High Yield (Global)	1.8	2.1	19.0	10.9	<b>16.6</b>	10.6	-
Overseas Bonds	<b>-0.7</b>	<b>-2.8</b>	<b>-3.2</b>	1.7	9.4	5.6	5.8
Property *	0.5	1.2	2.8	6.3	<b>1.2</b>	5.6	8.5
Cash	0.0	0.1	0.6	<b>0.8</b>	1.4	<b>3.2</b>	4.6
Commodities £-converted	1.1	<b>-5.3</b>	4.6	3.3	<b>-9.1</b>	2.2	3.5
Hedge Funds original \$ basis *	0.7	1.8	6.5	3.8	2.8	6.8	9.6
Illustrative £-converted version *	<b>-1.8</b>	3.7	11.2	3.3	7.9	7.1	9.7
Euro relative to Sterling	0.9	<b>-0.8</b>	6.4	0.4	1.7	1.8	-
US \$ relative to Sterling	2.6	0.1	1.5	<b>-1.4</b>	5.4	0.8	0.1
Japanese Yen relative to Sterling	<b>-1.0</b>	<b>-8.6</b>	<b>-21.2</b>	<b>-4.8</b>	6.4	2.5	0.4
Sterling trade weighted	<b>-0.9</b>	1.2	<b>-3.5</b>	0.2	<b>-3.0</b>	<b>-1.7</b>	<b>-0.3</b>
Price Inflation (RPI) *	0.3	1.5	2.9	3.8	3.1	3.3	2.9
Price Inflation (CPI) *	0.2	1.2	2.4	3.3	3.2	2.7	2.2
Price Inflation (RPIX) *	0.3	1.5	2.9	3.9	3.7	3.3	2.9
Earnings Inflation **	3.9	9.0	<b>-0.9</b>	0.8	1.5	3.1	3.9
All Share Capital Growth	2.5	3.7	25.8	9.1	2.4	5.8	4.6
Net Dividend Growth	1.6	3.7	9.7	7.2	0.1	5.5	-
Earnings Growth	3.6	10.4	<b>-8.9</b>	8.4	<b>-0.2</b>	8.1	6.6

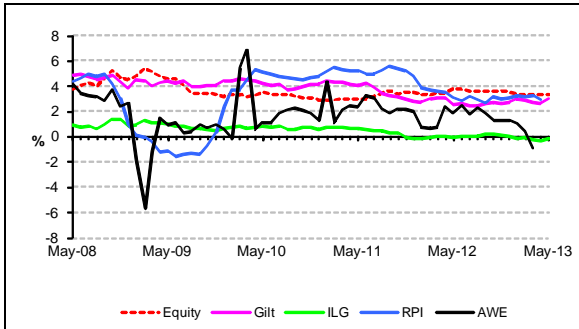
Note: All market returns are total returns for pension funds with income reinvested monthly. Indices used are as follows:

- 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.

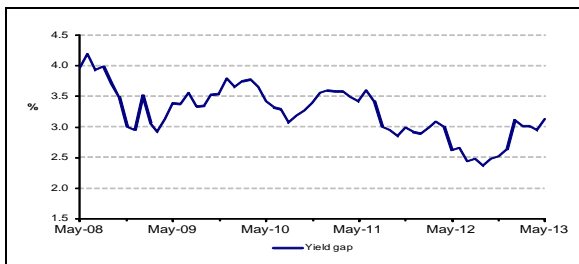


## Yields and Yield Gaps

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.

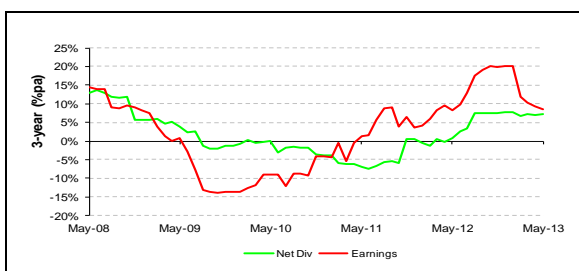
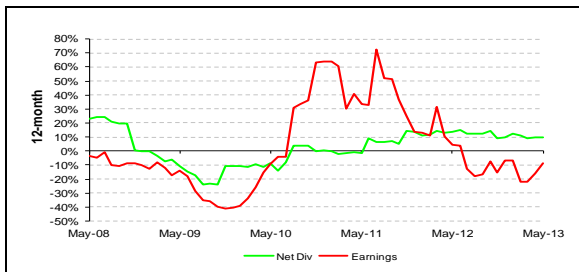


The gap gives a current expectation of just over 3% for longer-term inflation + risk premium for gilts, relative to index-linked gilts.

## 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]

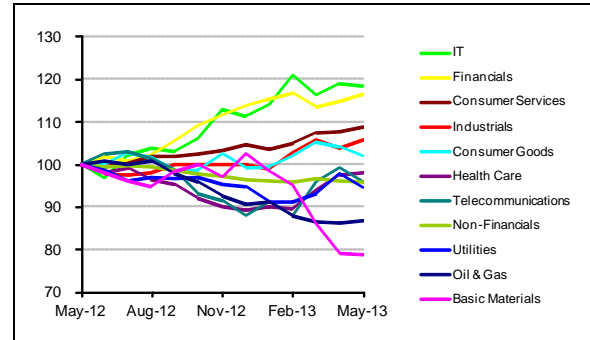
Figure 3: Dividend & Earnings Growth



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



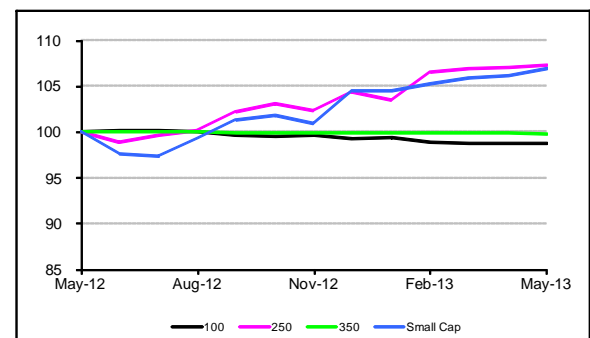
Note: Sector labels for relative lines are in end-value order

There was a large fall this month in the rolling 12-month sector dispersion (falling from 52% to 40%).

(% absolute return)	1 mth	3 mth	12 mth
Oil & Gas	3.4	3.7	13.2
Basic Materials	2.3	-13.1	2.7
Industrials	4.7	8.0	38.0
Consumer Goods	0.7	4.9	33.0
Health Care	3.7	15.2	28.1
Consumer Services	4.0	8.8	42.0
Telecommunications	-0.4	14.4	25.1
Utilities	-0.5	8.6	23.2
Non-Financials	2.5	5.0	25.0
Financials	4.3	4.8	51.9
IT	2.4	2.8	54.3
All Share	2.9	5.0	30.4

## UK Equity Size Returns

Figure 4b: Size groups relative to All Share



Mid and Small Cap rose in relative terms this month.

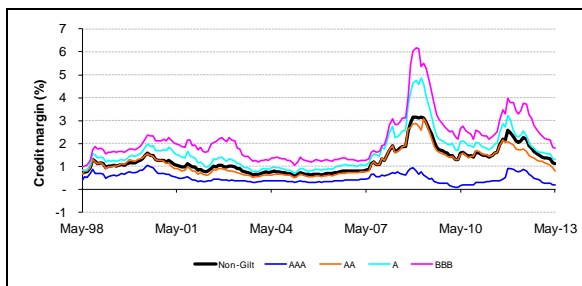
## FRS17 volatility indicator

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 (%)
Dec 12	4.03	2.71	1.32
Jan 13	4.26	2.99	1.27
Feb 13	4.18	2.94	1.24
Mar 13	4.01	2.76	1.25
Apr 13	3.75	2.63	1.12
May 13	<b>4.02</b>	<b>2.96</b>	<b>1.06</b>

**Tables 2b, 2c: £ Market Size (£bn) and Maturity**

Category	Mkt Val @ May 13 & 10, 07			Weight (%)
	May 13	May 10	07	
Gilts (36)	1,091	743	302	67.1
Non Gilts (1,026)	535	467	414	32.9
AAA (139)	111	141	149	6.8
AA (160)	84	74	66	5.1
A (359)	176	163	127	10.8
BBB (368)	164	90	68	10.1

Category	Mkt Val @ May 13, & 10		W't (%)	Dur'n (yrs)
Gilts (36)	1,091	743	67.1	9.6
< 5 Yrs (10)	315	206	19.4	2.8
5-15 Yrs (11)	369	283	22.7	7.3
> 15 Yrs (15)	407	253	25.1	16.9
Non Gilts (1,026)	535	467	32.9	8.1
< 5 Yrs (289)	144	133	8.9	2.9
5-15 Yrs (443)	217	203	13.3	7.3
> 15 Yrs (294)	174	131	10.7	13.4

**£ Gilt Market “main” Issuance**

- o £1.75bn 4¾% 2015 (3.06x, 0.38%, Oct 12)
  - o £5.22bn 1¼% 2018 (1.78x, 0.96%, Mar 13)
  - o £2.75bn 3¼% 2044 (2.00x, 3.29%, Apr 13)
  - o £1.17bn ILG 1/8% 2044 (1.84x, r.y -0.23%, Mar 12)
- Note: Issuance amounts are nominals.

**Tables 2d, 2e: € Market Size and Maturity (May 13)**

Category	Mkt Val (€bn)	Weight (%)
Sovereigns (272)	4,786	59.1
Non Sovereigns	3,311	40.9
AAA (535)	1,068	13.2
AA (377)	632	7.8
A (777)	889	11.0
BBB (696)	722	8.9

Category	Mkt Val (€bn)	Weight (%)
1 – 3 Yrs (814)	2,206	27.3
3 – 5 Yrs (731)	1,795	22.2
5 – 7 Yrs (435)	1,183	14.6
7 – 10 Yrs (460)	1,478	18.3
10+ Yrs (217)	1,435	17.7

**Table 2f: Breakdown of £ Index-Linked Market**

Category (Number of issues)	Mkt Val (£bn @ May 13 & 10)		W't (%)	Dur'n (yrs)
Gilts (21)	372	230	92.1	18.9
< 5 Yrs (2)	45	36	11.2	3.6
5 – 15 Yrs (5)	103	91	25.6	9.7
> 15 Yrs (14)	223	103	55.4	26.2
Non Gilts (43)	32	24	7.9	17.1

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

Month End	US (%)	Euro (%)	Sterling (%)
Jan 13	5.76	5.27	6.30
Feb 13	5.76	5.07	6.33
Mar 13	5.69	5.11	6.24
Apr 13	5.43	4.66	5.89
May 13	<b>5.64</b>	<b>4.73</b>	<b>6.12</b>

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

