JAGGER & ASSOCIATES

Investment Update
May 2014

Investment Headlines & Comment

- Unusually, all major asset markets recorded **positive returns** for both the latest month and 3 months.
- **Aviva** have poached a further manager from the **Standard Life** GARS team.
- Eurozone government bond yields continue to fall – the 10-year yield is now below 1.4% for Germany.

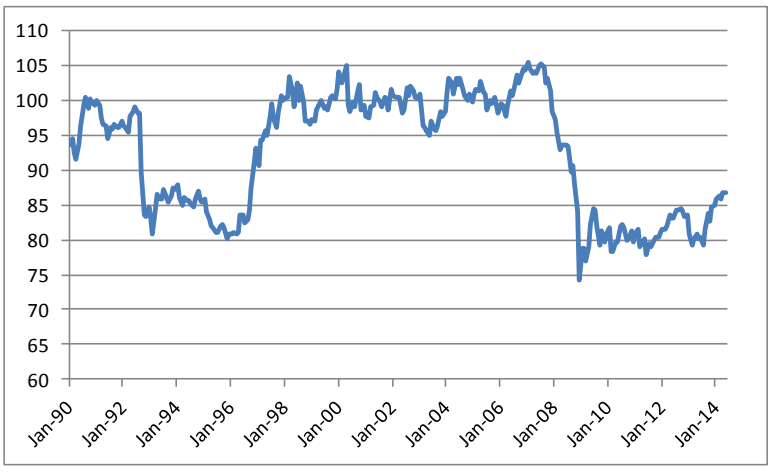
Feature Section

This month we take a look at the Sterling trade-weighted index. Readers may have spotted it was introduced into Table 1 near the currencies data, in our May 2013 edition, but we have yet to provide background on either the theory, or the Sterling index in particular.

For any given country, a trade-weighted index ("effective exchange rate") is a weighted average of exchange rates of foreign currencies, with the weight for each foreign country equal to its share in trade. It can be export-weighted, import-weighted, or total-external trade weighted, so what you want to use the index for is an important factor. Strictly, you probably want to focus on the "value added" by country X, rather than the "gross value", if you can get the data. Also, the value should include services as well as physical goods. The weights and set of countries should be allowed to change over time, to reflect changing trade patterns. Remarkably, this element only came in during the last 10 years for the Sterling version (prior to that, weights from 1989 applied). In the early 2000's, many observers argued that the index required modification, including HSBC's chief economist, who argued that the index understated Sterling's strength by around 5%. (*Source: The Times, March 2004*). Generally, the weighting method is geometric weighting ("nth root of a product of n items") rather than arithmetic weighting ("sum of n items, divided by n"). Those who are curious about the technicalities can go to the Bank of England's background notes (see pdf page 34).

If a country's trade-weighted index rises, then all other things being equal (for example, relative inflation rates), the purchasing power of that currency also rises (the currency strengthened against those of the country's or area's trading partners). This will reduce the cost of imports but will undermine the competitiveness of exports. Figure 1 shows the history for the Sterling index since January 1990. It is perhaps surprising that for much of the time, the index is pretty stable, with just occasional "jumps" up or down, rather than prolonged periods of momentum in either direction. The point about the pre-2005 data being weighted by fixed (and probably out-of-date) weights may be relevant. Also, adjustments are made to strip out the effects of missing-trader intra-community (MTIC) fraud - repeated importing and exporting of the same products, which otherwise would boost measured UK trade flows with the other countries involved (apparently, this happened in the early 2000s for some Eurozone countries).

Figure 1: Sterling trade-weighted index



Sources: Bank of England, FT

It is not obvious what a "natural" level should be for the index, and hence whether the current index level of around 87 is strong or weak. Figure 1 shows Sterling suffering during the recession of the early 1990s, gaining when the bank was given independence from political control in 1997, and then losing heavily in the "credit crunch".

The latest ("narrow index") weights were set in March 2014, with the main contributors being the Euro area having 46% weight, the USA 17.5%, China 9%, Japan 4% and Saudi Arabia 1%. Countries are included in the narrow index if their share of either UK imports or exports on average over the latest three-year period, exceeds 1%.

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 2014

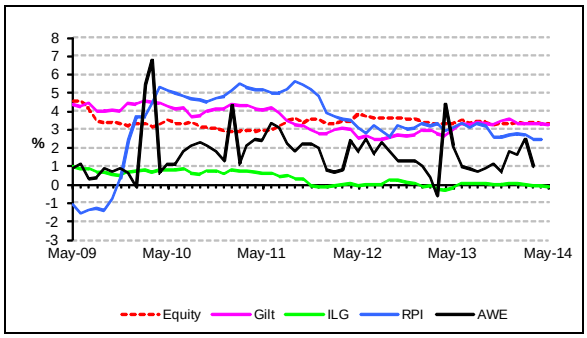
Asset Class	1 month (%)	3 months (%)	12 months (%)	3 years (% p.a.)	5 years (% p.a.)	10 years (% p.a.)	20 years (% p.a.)
UK Equities	1.4	0.9	8.9	9.2	14.0	8.9	8.1
Overseas Equities	3.1	4.0	6.3	8.9	13.4	9.3	7.0
US Equities	3.1	3.7	9.2	**14.5**	**17.5**	9.0	8.6
Europe ex UK Equities	2.3	3.2	12.5	6.5	11.5	9.8	**9.0**
Japan Equities	**4.9**	0.3	-3.3	6.0	5.8	4.2	**-0.5**
Pacific ex Japan Equities	4.0	6.4	-1.5	2.2	11.4	**13.3**	6.2
Emerging Markets	4.3	**7.0**	-5.4	**-2.0**	7.9	13.0	6.0
UK Long-dated Gilts	1.6	3.0	2.0	8.1	8.1	6.7	8.2
UK Long-dated Corp. Bonds	2.0	3.3	3.6	8.9	11.2	6.7	-
UK Over 5 Yrs Index-Linked Gilts	1.3	4.1	0.1	8.5	9.0	7.5	7.7
High Yield (Global)	1.5	2.1	-1.1	8.2	14.1	10.4	-
Overseas Bonds	1.1	1.3	**-5.5**	0.5	2.7	5.8	5.2
Property *	1.3	4.1	**14.9**	7.8	10.6	5.8	8.0
Cash	**0.0**	**0.1**	0.5	0.7	**0.7**	**2.8**	4.3
Commodities £-converted	0.5	0.6	-2.0	-2.9	2.6	0.3	3.5
Hedge Funds original $ basis *	-0.3	1.3	5.5	2.4	7.1	5.6	8.9
Illustrative £-converted version *	-1.6	-1.4	-2.8	2.0	4.4	6.1	8.3
Euro relative to Sterling	-0.9	-1.3	-4.8	-2.3	-1.5	2.0	-
US $ relative to Sterling	0.7	-0.1	-9.6	-0.6	-0.8	0.9	-0.5
Japanese Yen relative to Sterling	1.1	0.2	-10.3	-7.8	-2.1	1.7	-0.4
Sterling trade weighted	0.0	0.6	8.2	2.7	1.1	-1.7	0.1
Price Inflation (RPI) *	0.4	1.2	2.5	2.9	3.9	3.3	2.9
Price Inflation (CPI) *	0.3	1.1	1.7	2.4	3.1	2.7	2.1
Price Inflation (RPIX) *	0.4	1.3	2.6	3.0	3.9	3.3	2.9
Earnings Inflation **	2.7	8.4	1.0	0.5	2.0	2.9	3.7
All Share Capital Growth	1.0	-0.3	5.2	5.4	10.2	5.2	4.5
Net Dividend Growth	0.1	0.0	4.9	9.4	3.3	5.7	-
Earnings Growth	-2.9	-4.2	-0.5	-1.7	2.8	6.6	5.7

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

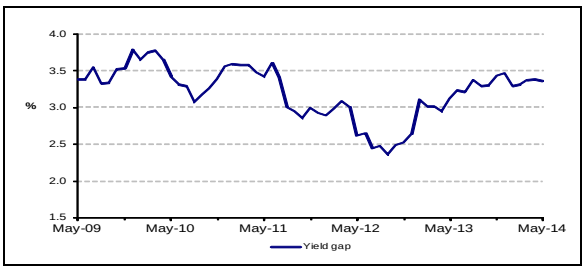
- *UK Equities (incl. dividends and earnings) – FT-A All Share.*
- *Overseas Equities (incl. regions) – blend of FT All-World / World subindices*
- *Emerging Markets from MSCI US $ based total return index (overall Index to 31 Oct 2001, Free Index from 1 Nov 2001 to take account of foreign investment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

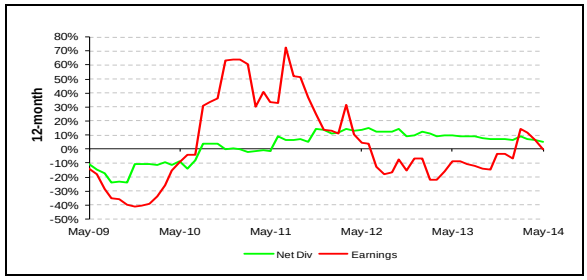


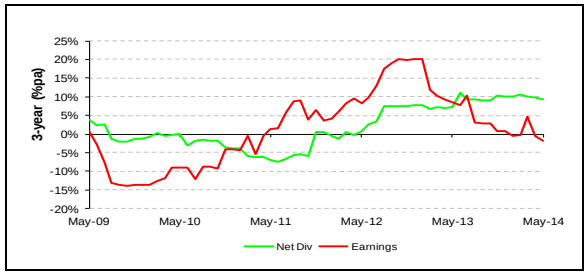
The gap gives a current expectation now just below 3.5% for longer-term inflation + risk premium for gilts, relative to index-linked gilts.

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

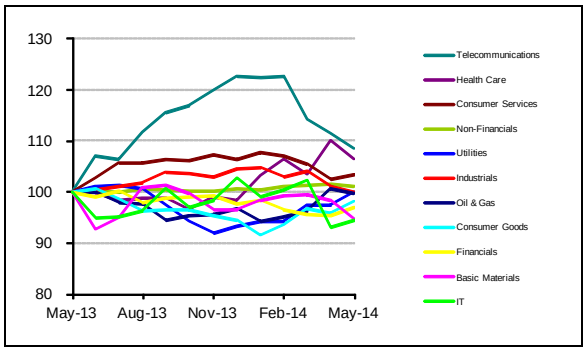




Sources for charts on this page:
Financial Times, Office for National Statistics, J&A

UK Equity Sector Returns

Figure 4a: Sectors relative to All Share



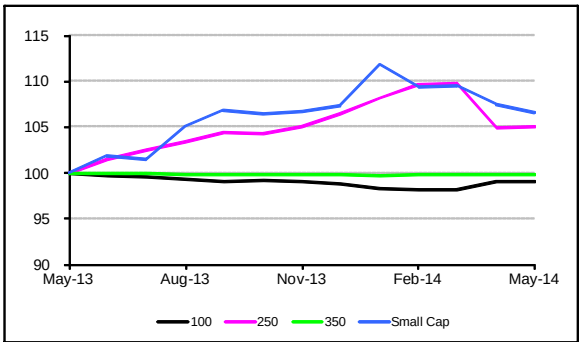
Note: Sector labels for relative lines are in end-value order

There was a further fall this month in the rolling 12-month sector dispersion (from 18% to 14%).

(% absolute return)	1 mth	3 mth	12 mth
Oil & Gas	0.4	5.7	8.5
Basic Materials	-2.4	-3.6	3.2
Industrials	0.2	-2.1	8.8
Consumer Goods	4.0	5.8	6.9
Health Care	-2.0	1.0	15.9
Consumer Services	2.2	-2.5	12.6
Telecommunications	-1.3	-10.8	18.1
Utilities	4.0	7.0	8.9
Non-Financials	0.8	0.7	9.9
Financials	3.0	1.4	5.5
IT	2.8	-5.3	2.8
All Share	1.4	0.9	8.9

UK Equity Size Returns

Figure 4b: Size groups relative to All Share



Mid Cap rose slightly and Small Cap fell more markedly, in relative terms this month.

FRS17 volatility indicator

Now discontinued, but available on request.

Bond market information

Figure 5: £ Non-Gilt Credit Margins

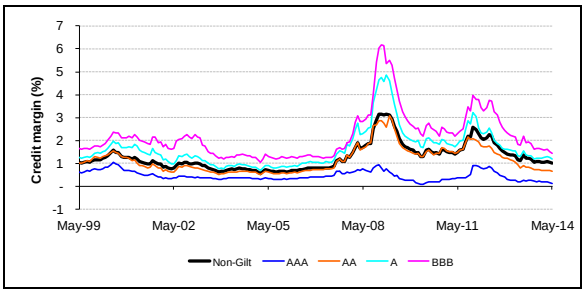


Table 2a: Over 15 Yr Corporate Yields & Margins

Month End	iBoxx Corp AA Y'ld (%)	FT 20 yr Gilt (%)	Margin (%)
Dec '13	4.37	3.57	0.80
Jan '14	4.19	3.34	0.85
Feb '14	4.17	3.35	0.82
Mar '14	4.25	3.35	0.90
Apr '14	4.17	3.34	0.83
May '14	**4.07**	**3.26**	**0.81**

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

Category	Mkt Val @ May 14 & 11, 08			Weight (%)
Gilts (38)	1,102	833	342	67.2
Non Gilts (1,045)	538	474	416	32.8
AAA (131)	103	129	158	6.3
AA (175)	88	75	62	5.4
A (356)	172	166	129	10.5
BBB (383)	174	104	64	10.6

Category	Mkt Val @ May 14, & 11		W't (%)	Dur'n (yrs)
Gilts (38)	1,102	833	67.2	9.7
< 5 Yrs (10)	310	246	18.9	2.8
5–15 Yrs (13)	382	284	23.3	7.2
> 15 Yrs (15)	410	303	25.0	17.2
Non Gilts (1,045)	538	474	32.8	7.9
< 5 Yrs (322)	154	122	9.4	2.7
5–15 Yrs (453)	231	212	14.1	7.6
> 15 Yrs (270)	153	140	9.3	13.8

£ Gilt Market "main" Issuance

- £2.18bn 4½% 2034 (2.00x, 3.24%, Aug 13)
- £1.27bn ILG 1/8% 2044 (1.93x, r.y -0.03%, Jul 13)
- £1.21bn ILG ¼% 2052 (2.56x, r.y -0.07%, Mar 14)
- A new 2045 gilt is going to be launched in June.

Note: Issuance amounts are nominals.

Tables 2d, 2e: € Market Size and Maturity (May 14)

Category	Mkt Val (€bn)	Weight (%)
Sovereigns (279)	5,092	59.5
Non Sovereigns	3,462	40.5
AAA (549)	1,046	12.2
AA (454)	766	9.0
A (785)	853	10.0
BBB (771)	797	9.3

Category	Mkt Val (€bn)	Weight (%)
1 – 3 Yrs (820)	2,209	25.8
3 – 5 Yrs (692)	1,740	20.4
5 – 7 Yrs (596)	1,466	17.1
7 – 10 Yrs (488)	1,560	18.2
10+ Yrs (242)	1,579	18.5

Table 2f: Breakdown of £ Index-Linked Market

Category (Number of issues)	Mkt Val (£bn @ May 14 & 11)		W't (%)	Dur'n (yrs)
Gilts (23)	407	269	92.4	19.3
< 5 Yrs (2)	44	22	10.0	2.6
5 – 15 Yrs (7)	126	104	28.5	9.4
> 15 Yrs (14)	237	143	53.9	27.7
Non Gilts (43)	33	25	7.6	16.9

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

Month End	US (%)	Euro (%)	Sterling (%)
Nov '13	5.67	4.54	5.79
Dec '13	5.67	4.52	5.75
Jan '14	5.63	4.41	5.65
Feb '14	5.37	4.16	5.50
Mar '14	5.40	4.11	5.45
Apr '14	5.31	4.01	5.39
May '14	**5.21**	**3.94**	**5.43**

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

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