

## Investment Update October 2015



### Investment Headlines & Comment

- A strong month for equity markets, particularly **Germany** and **Japan** with double-digit local returns.
- A rare instance of the **HFR index** recording a negative 4<sup>th</sup> consecutive month for June 2015 to Sept 2015.
- A record £22bn of orders for a **new 50-year gilt** (but the DMO only issued £4.75bn, yield 2.56%).

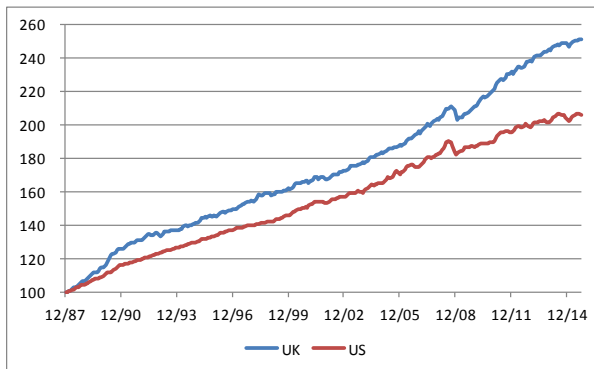
### Feature Section

This month we revisit our [January 2011](#) article on UK and US inflation-related investments, as the divergence in real yields on their respective inflation-linked government bonds has widened out to be at or near historic record levels.

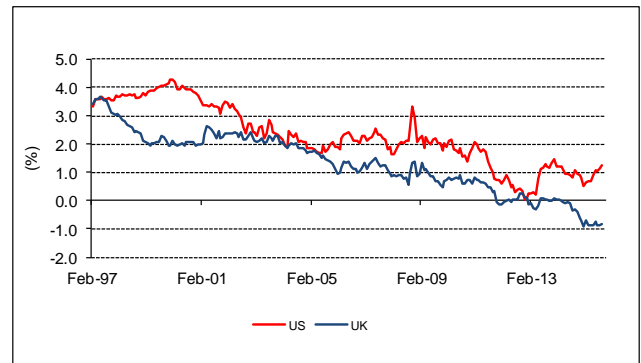
Figure 1a shows the history of UK RPI and US CPI, the two relevant inflation indices (see the 2011 item for their relevance). Figure 1b shows the relative inflation, for the UK versus US, together with the movement of the US Dollar versus Sterling, which shows an interesting degree of similarity over long periods but there is clearly large currency variation over shorter periods. The data for the last 27 ¾ years has seen UK RPI 0.7% p.a. ahead of US CPI, which incidentally implies the two countries' CPI versions being pretty much the same, and thus might allow UK real yields to be lower by roughly this amount. Over the same period, the US Dollar has strengthened by about 0.8% p.a. against Sterling, which gives a neat illustration of "[purchasing power parity](#)" in action.

Figure 1c shows the movement in yields for ILGs and TIPS (updating our Feb 03 and Nov 09 *Update* editions), and Figure 1d shows the current real yield curves (note the US has only issued TIPS with maturities up to 30 years). The gap between the real yields is pretty stark (note that TIPS only go to 2045 so far), and well above the 0.7% pa identified in the previous paragraph.

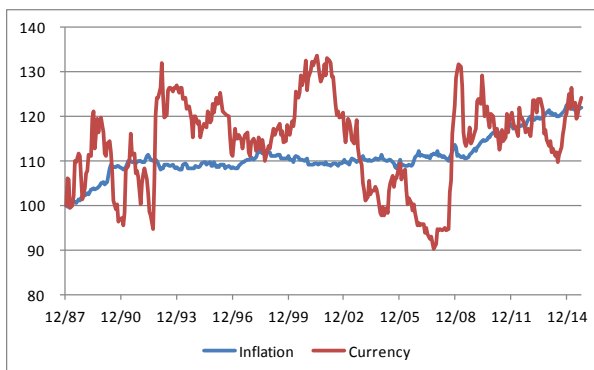
**Figure 1a: UK RPI and US CPI (rebased to 100)**



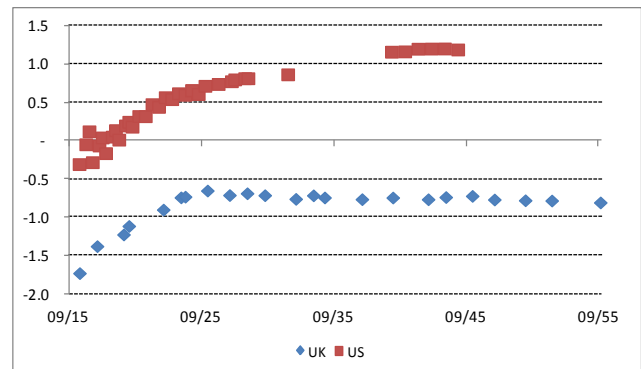
**Figure 1c: Long ILG and Long TIPS yields (%)**



**Figure 1b: UK relative to US**



**Figure 1d: Current real yield curves (%)**



Sources: DMO, FT, ONS, US Treasury

It seems fair to ask whether some (or even much) of the apparent distortion is related to the UK having a greater onus on its institutions to hedge, both for insurers' solvency, and for pension schemes through many adopting LDI-driven approaches.



**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 October 2015**

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	4.7	<b>-3.6</b>	3.0	8.5	7.1	6.4	7.0
Overseas Equities	5.8	<b>-1.9</b>	4.5	12.6	9.2	8.0	7.2
US Equities	6.1	0.0	8.6	<b>17.8</b>	<b>15.0</b>	9.4	7.8
Europe ex UK Equities	5.0	<b>-4.0</b>	4.5	10.6	5.4	6.6	8.7
Japan Equities	<b>7.9</b>	<b>-2.0</b>	14.7	15.7	7.9	3.8	<b>1.4</b>
Pacific ex Japan Equities	5.4	<b>-4.4</b>	<b>-6.8</b>	3.1	2.3	<b>9.6</b>	6.1
Emerging Markets	5.0	<b>-4.4</b>	<b>-11.1</b>	<b>-1.1</b>	<b>-1.8</b>	7.5	6.2
UK Long-dated Gilts	<b>-2.1</b>	<b>-0.2</b>	9.7	6.2	9.1	6.9	8.3
UK Long-dated Corp. Bonds	<b>-0.3</b>	<b>-2.2</b>	3.9	5.3	7.6	5.9	-
UK Over 5 Yrs Index-Linked Gilts	<b>-1.1</b>	<b>-1.9</b>	8.5	8.9	9.5	7.7	7.9
High Yield (Global)	1.0	<b>-0.3</b>	0.5	5.1	6.3	9.1	-
Overseas Bonds	<b>-2.1</b>	2.5	0.7	<b>-1.2</b>	0.2	5.3	4.6
Property *	1.3	<b>3.4</b>	<b>15.3</b>	13.7	10.6	5.7	<b>8.9</b>
Cash	0.0	0.1	0.6	0.5	0.7	<b>2.2</b>	3.9
Commodities £-converted	<b>-1.7</b>	<b>-4.8</b>	<b>-35.7</b>	<b>-17.5</b>	<b>-9.6</b>	<b>-7.8</b>	0.6
Hedge Funds original \$ basis *	<b>-1.3</b>	<b>-4.0</b>	<b>-1.5</b>	3.9	3.3	4.2	7.8
Illustrative £-converted version *	0.2	<b>-0.3</b>	5.5	6.2	4.1	5.9	8.1
Euro relative to Sterling	<b>-3.0</b>	1.0	<b>-8.7</b>	<b>-3.8</b>	<b>-3.8</b>	0.6	-
US \$ relative to Sterling	<b>-1.9</b>	1.1	3.6	1.4	0.7	1.4	0.1
Japanese Yen relative to Sterling	<b>-2.7</b>	3.7	<b>-3.7</b>	<b>-11.6</b>	<b>-7.1</b>	1.0	<b>-0.7</b>
Sterling trade weighted	2.2	<b>-1.5</b>	5.7	3.4	3.0	<b>-0.8</b>	0.6
Price Inflation (RPI) *	<b>-0.1</b>	0.3	0.8	2.1	2.9	3.0	2.8
Price Inflation (CPI) *	<b>-0.2</b>	0.0	<b>-0.2</b>	1.3	2.2	2.5	2.0
Price Inflation (RPIX) *	<b>-0.1</b>	0.3	0.9	2.1	2.9	3.2	2.8
Earnings Inflation **	<b>-1.3</b>	<b>-1.1</b>	3.1	1.5	1.8	2.3	3.3
All Share Capital Growth	4.5	<b>-4.6</b>	<b>-0.5</b>	4.8	3.5	2.7	3.6
Net Dividend Growth	0.8	0.7	5.7	4.4	6.5	4.2	-
Earnings Growth	5.4	0.3	<b>-13.9</b>	<b>-6.4</b>	0.8	1.1	3.3

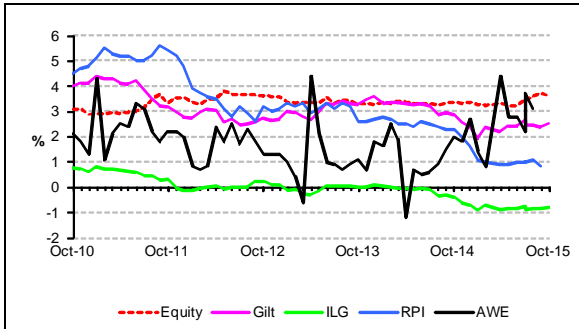
Note: All market returns are total returns for pension funds with income reinvested monthly. Indices used are as follows:

- 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.

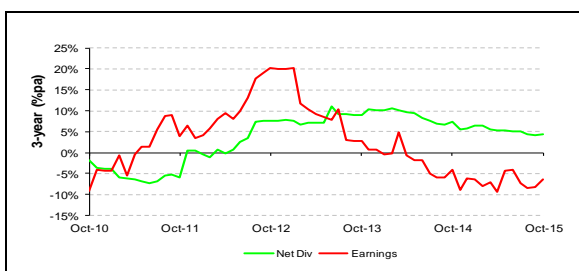
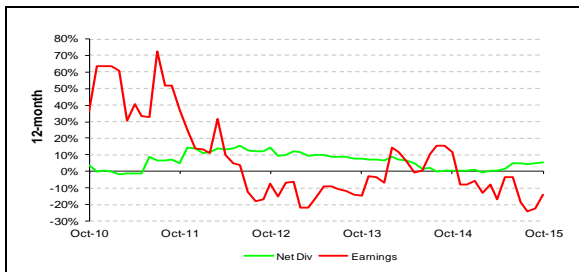


The gap gives a current expectation around 3.3% for longer-term inflation + risk premium for gilts, relative to index-linked gilts.

## 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]

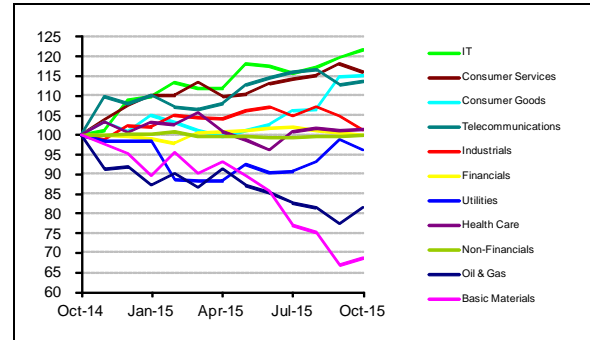
Figure 3: Dividend & Earnings Growth



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



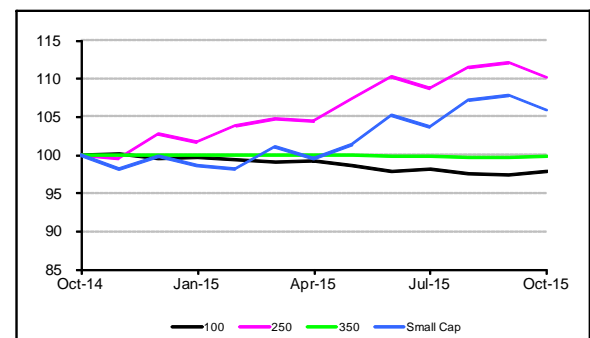
Note: Sector labels for relative lines are in end-value order

There was a slight fall this month in the rolling 12-month sector dispersion (from 55% to 53%).

(% absolute return)	1 mth	3 mth	12 mth
Oil & Gas	10.4	-5.2	-16.1
Basic Materials	7.4	-14.0	-29.2
Industrials	1.2	-7.0	4.2
Consumer Goods	5.1	4.6	18.8
Health Care	4.8	-3.3	4.3
Consumer Services	2.9	-1.9	19.6
Telecommunications	5.6	-5.6	17.0
Utilities	1.6	2.1	-1.1
Non-Financials	4.9	-2.9	3.0
Financials	4.0	-5.6	3.0
IT	6.5	1.2	25.3
All Share	4.7	-3.6	3.0

## UK Equity Size Returns

Figure 4b: Size groups relative to All Share



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

## FRS17 volatility indicator

Now discontinued, but available on request.



## Bond market information

Figure 5: £ Non-Gilt Credit Margins

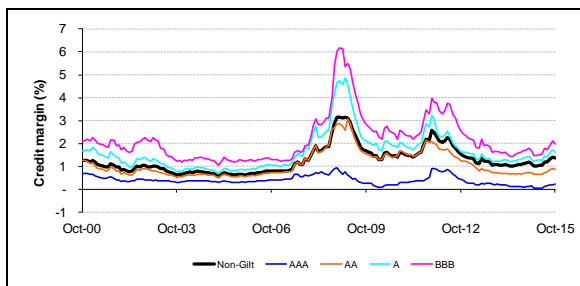


Table 2a: Over 15 Yr Corporate Yields & Margins

Month End	iBoxx Corp AA Y'ld (%)	FT 20 yr Gilt (%)	Margin (%)
May '15	3.30	2.43	0.87
Jun '15	3.65	2.65	1.00
Jul '15	3.45	2.49	0.96
Aug '15	3.61	2.49	1.12
Sep '15	3.59	2.39	1.20
Oct '15	<b>3.66</b>	<b>2.53</b>	<b>1.13</b>

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

Category	Mkt Val @ Oct 15 & 12, 09			Weight (%)
	Oct 15	Oct 12	09	
Gilts (38)	1,200	1,091	666	69.3
Non Gilts (1,037)	530	529	482	30.7
AAA (116)	97	139	150	5.6
AA (195)	96	66	66	5.6
A (333)	155	176	165	9.0
BBB (393)	182	149	98	10.5

Category	Mkt Val @ Oct 15, & 12		W't (%)	Dur'n (yrs)
	Oct 15	12		
Gilts (38)	1,200	1,091	69.3	10.6
< 5 Yrs (11)	350	305	20.2	3.1
5-15 Yrs (11)	325	347	18.8	7.2
> 15 Yrs (16)	525	438	30.4	17.7
Non Gilts (1,037)	530	529	30.7	7.8
< 5 Yrs (345)	158	142	9.1	2.5
5-15 Yrs (452)	229	217	13.2	7.5
> 15 Yrs (240)	144	170	8.3	14.2

## £ Gilt Market "main" Issuance

- £4.40bn 1½% 2021 (1.49x, 1.31%, Sep 15)
  - £3.30bn 2% 2025 (1.68x, 1.82%, Sep 15)
  - £1.50bn 4½% 2034 (2.02x, 2.36%, Jan 15)
  - £4.75bn 2½% 2065 (4.61x, 2.56%, new)
  - £1.50bn 1/8% IL 2026 (1.96x, ry -0.77%, Jul 15)
- Note: Issuance amounts are nominals.

Tables 2d, 2e: € Market Size and Maturity (Oct 15)

Category	Mkt Val (€bn)	Weight (%)
Sovereigns (321)	5,702	61.5
Non Sovereigns	3,564	38.5
AAA (577)	974	10.5
AA (582)	948	10.2
A (790)	821	8.9
BBB (902)	821	8.9

Category	Mkt Val (€bn)	Weight (%)
1 - 3 Yrs (773)	2,050	22.1
3 - 5 Yrs (755)	1,990	21.5
5 - 7 Yrs (721)	1,610	17.4
7 - 10 Yrs (600)	1,651	17.8
10+ Yrs (323)	1,965	21.2

Table 2f: Breakdown of £ Index-Linked Market

Category (Number of issues)	Mkt Val (£bn @ Oct 15 & 12)		W't (%)	Dur'n (yrs)
Gilts (25)	481	332	93.5	21.6
< 5 Yrs (3)	49	28	9.6	-
5 - 15 Yrs (7)	125	90	24.4	-
> 15 Yrs (15)	306	214	59.5	29.4
Non Gilts (38)	33	29	6.5	17.1

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

Month End	US (%)	Euro (%)	Sterling (%)
May '15	5.71	3.76	5.77
Jun '15	6.10	4.23	6.11
Jul '15	6.20	4.08	6.06
Aug '15	6.61	4.43	6.38
Sep '15	7.21	5.14	6.58
Oct '15	<b>6.68</b>	<b>4.52</b>	<b>6.40</b>

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

