

Investment Update February 2015



Investment Headlines & Comment

- **UK CPI** 12-month inflation hits a record low, well under 2% target.
- More **Gilt** volatility – February saw reversal of January’s large gains.
- **Sterling** had a good month, rising on a trade-weighted basis.

Feature Section

This month we consider inflation and trends (or the lack of them) in the data.

Much mid-month excitement was generated when the Bank of England published its latest [Quarterly Inflation Report](#) as rolling 12-month CPI hit a new low, with the prospect of deflation looming in at least the short-term. See our [May 2013](#) issue for discussion of the Bank’s analytical tools.

Figure 1a shows rolling 12-month inflation for the 3 main UK measures, the mainstream RPI, the slightly newer CPI and the RPIX (excluding mortgage interest). Figure 1b shows the same data on the same vertical scale, on a rolling 3-year basis. Finally, Figure 1c shows the rolling 3-year gap between RPI and CPI, bearing in mind the Bank’s target of 2% for CPI (which has been in place since December 2003), and the general use of RPI within institutions (and Index-Linked Gilts).

Figure 1a: 12-month inflation

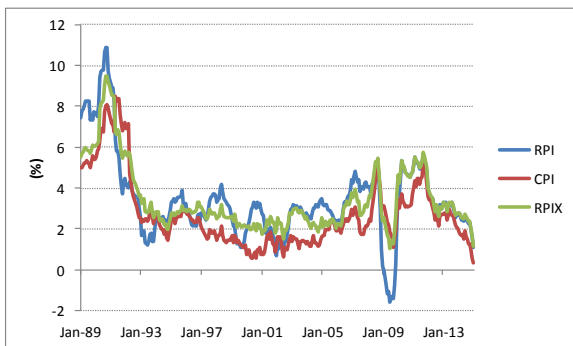


Figure 1b: 36-month inflation (annualized)

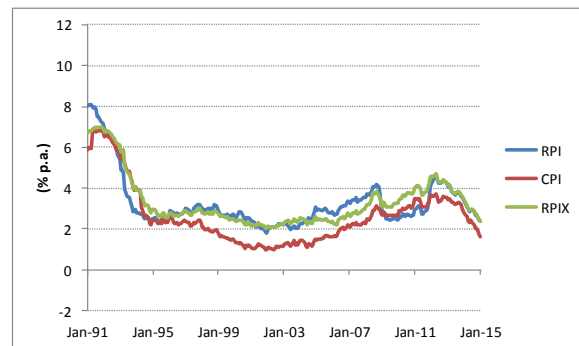
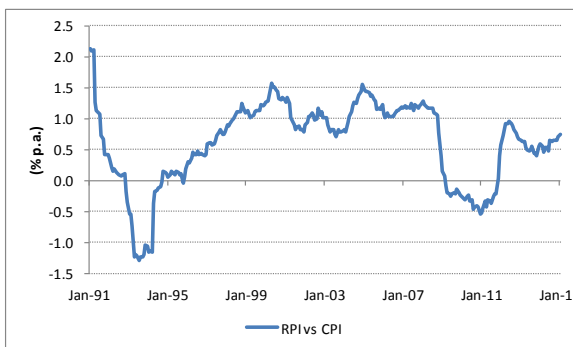


Figure 1c: 36-month (annualized) RPI v CPI



Source: ONS

Figure 1a shows that rapid movements in rolling 12-month inflation can occur from time to time, although their causes will be different. The Bank estimates that two-thirds of the gap between the current inflation rate and their 2% target is explained by sharp falls in food and energy prices (particularly oil). The balance of the gap is the result of subdued generalised inflationary pressures (low wage growth, and past unemployment levels).

Interestingly, Figure 1a also shows that the current headline-grabbing level of CPI is only fractionally below the levels it was touching in mid 2000, around the peak of the dot com bubble.

Figure 1b shows that trends in longer-term inflation can be quite pronounced (and act as a reminder of the time it takes for actions from changes in government to feed through). On a 3-year view, CPI is currently still about 0.4% p.a. below the 2% target. There was a long period in the mid 2000 decade when CPI was beneath the target.

Figure 1c gives a reminder that even though calculation methodology differences are expected to produce RPI values above those for CPI, there can be periods when their exposure to certain economic factors leads to the opposite outcome. However, the average rolling 3-year gap over the last 10 years has been 0.6% p.a., which seems plausible. Given the current market-implied RPI inflation of 3.1% p.a. shown in the second part of Figure 2 (on page 3), then if you think markets believe the Bank’s 2% CPI target is going to be met, and hence RPI ought to be 2.6% p.a., you might infer that current ILG real yields are distorted downwards by about 0.5% p.a. (with any further distorting factors in gilt markets affecting real and nominal yields equally).



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 28 February 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	3.7	4.7	5.6	10.9	10.1	7.8	8.3
Overseas Equities	2.5	3.4	18.5	13.8	11.1	9.7	8.0
US Equities	2.8	3.8	24.9	19.4	15.8	10.7	8.6
Europe ex UK Equities	3.4	2.1	4.5	11.8	7.6	8.0	9.8
Japan Equities	3.1	8.9	19.3	11.0	6.7	5.5	1.3
Pacific ex Japan Equities	0.1	3.9	18.7	6.9	7.6	12.1	7.2
Emerging Markets	0.2	0.3	14.3	1.1	3.7	10.6	7.0
UK Long-dated Gilts	-7.6	4.1	22.9	8.0	11.3	7.7	8.8
UK Long-dated Corp. Bonds	-5.2	5.3	18.9	10.7	10.9	7.0	-
UK Over 5 Yrs Index-Linked Gilts	-5.6	0.8	18.2	7.3	10.6	8.2	8.2
High Yield (Global)	-0.5	0.5	7.2	7.9	8.2	10.1	-
Overseas Bonds	-4.1	-0.2	4.5	-0.5	1.1	5.6	5.2
Property *	0.8	3.8	18.9	10.8	10.7	5.8	8.5
Cash	0.0	0.1	0.6	0.6	0.7	2.5	4.1
Commodities £-converted	3.5	-13.8	-30.4	-14.7	-6.6	-4.0	2.0
Hedge Funds original \$ basis *	0.3	0.8	3.8	5.3	4.8	5.2	8.8
Illustrative £-converted version *	4.1	7.4	13.6	7.0	6.1	7.6	9.1
Euro relative to Sterling	-3.4	-8.9	-12.0	-4.7	-4.1	0.5	-
US \$ relative to Sterling	-2.8	1.4	8.5	1.1	-0.3	2.2	0.1
Japanese Yen relative to Sterling	-4.5	0.6	-7.4	-11.2	-6.0	0.8	-0.9
Sterling trade weighted	2.8	5.1	5.6	3.8	3.1	-1.1	0.4
Price Inflation (RPI) *	-0.8	-0.9	1.1	2.4	3.2	3.1	2.8
Price Inflation (CPI) *	-0.9	-1.1	0.3	1.6	2.5	2.6	2.1
Price Inflation (RPIX) *	-0.9	-0.9	1.2	2.4	3.3	3.2	2.9
Earnings Inflation **	4.1	3.7	2.5	1.9	1.8	2.5	3.3
All Share Capital Growth	3.4	4.2	2.1	7.1	6.5	4.1	4.7
Net Dividend Growth	1.2	1.4	-0.7	6.4	5.6	4.8	-
Earnings Growth	0.7	-0.3	-12.7	-7.9	6.9	3.7	4.5

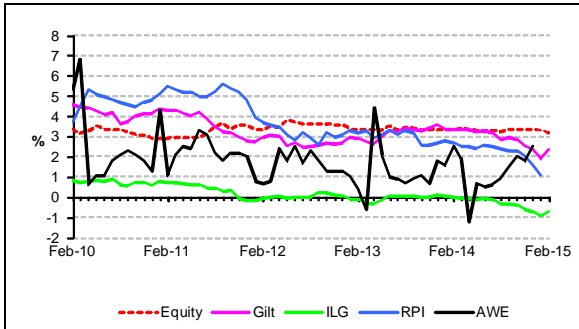
Note: All market returns are total returns for pension funds with income reinvested monthly. Indices used are as follows:

- 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.

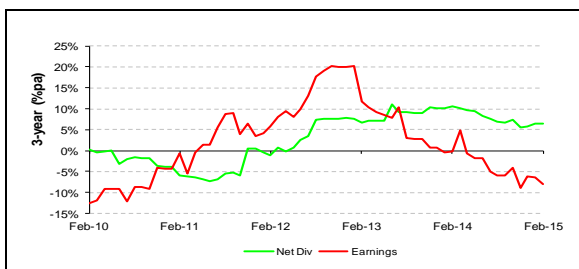
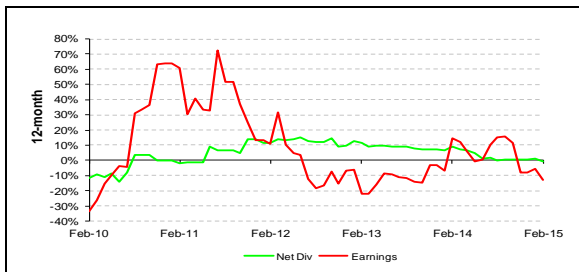


The gap gives a current expectation now just above 3% for longer-term inflation + risk premium for gilts, relative to index-linked gilts.

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]

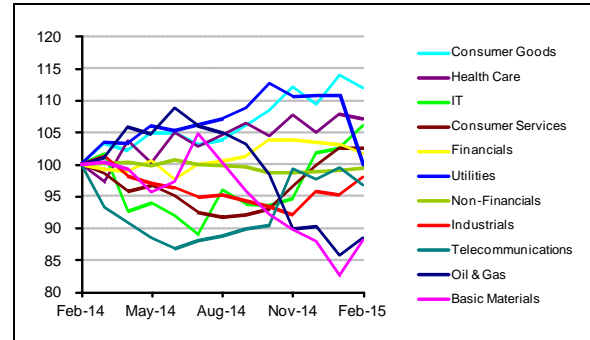
Figure 3: Dividend & Earnings Growth



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



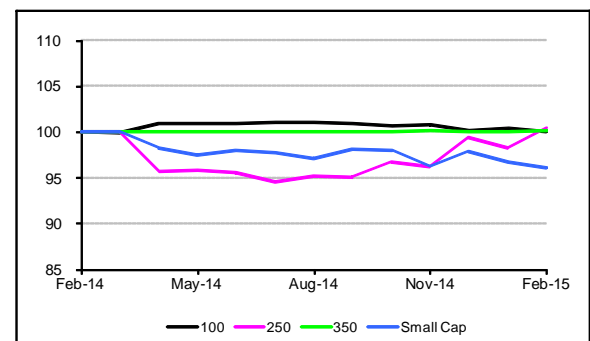
Note: Sector labels for relative lines are in end-value order

There was a fall this month in the rolling 12-month sector dispersion (from 33% to 24%).

(% absolute return)	1 mth	3 mth	12 mth
Oil & Gas	7.1	3.1	-6.6
Basic Materials	10.6	2.7	-7.1
Industrials	6.8	11.4	3.5
Consumer Goods	1.8	4.6	18.1
Health Care	3.2	4.3	13.2
Consumer Services	3.7	11.2	8.2
Telecommunications	0.9	2.1	2.2
Utilities	-6.5	-5.6	5.3
Non-Financials	4.2	5.5	5.0
Financials	2.4	2.6	7.3
IT	7.3	17.4	12.0
All Share	3.7	4.7	5.6

UK Equity Size Returns

Figure 4b: Size groups relative to All Share



Mid Cap rose but Small Cap fell in relative terms this month.

FRS17 volatility indicator

Now discontinued, but available on request.



Bond market information

Figure 5: £ Non-Gilt Credit Margins

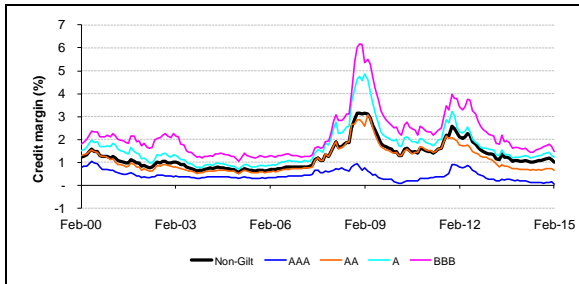


Table 2a: Over 15 Yr Corporate Yields & Margins

Month End	iBoxx Corp AA Y'ld (%)	FT 20 yr Gilt (%)	Margin (%)
Sep '14	3.80	2.95	0.85
Oct '14	3.76	2.85	0.91
Nov '14	3.53	2.55	0.98
Dec '14	3.38	2.38	1.00
Jan '15	2.82	1.93	0.89
Feb '15	3.22	2.37	0.85

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

Category	Mkt Val @ Feb 15 & 12, 09			Weight (%)
	1,198	1,021	545	
Gilts (37)	1,198	1,021	545	68.8
Non Gilts (1,017)	544	478	387	31.2
AAA (119)	98	122	142	5.6
AA (175)	92	60	55	5.3
A (352)	182	170	129	10.5
BBB (371)	172	126	59	9.9

Category	Mkt Val @ Feb 15, & 12		W't (%)	Dur'n (yrs)
	1,198	1,021		
Gilts (37)	1,198	1,021	68.8	10.8
< 5 Yrs (9)	292	307	16.8	3.0
5-15 Yrs (12)	394	320	22.6	7.1
> 15 Yrs (16)	512	395	29.4	18.1
Non Gilts (1,017)	544	478	31.2	8.4
< 5 Yrs (327)	148	123	8.5	2.7
5-15 Yrs (433)	234	205	13.4	7.7
> 15 Yrs (257)	162	150	9.3	14.6

£ Gilt Market “main” Issuance

- o £1.75bn 3½% 2045 (1.58x, 2.36%, Dec 14)
- o £1.20bn 1/8% IL 2024 (2.37x, -1.02%, Oct 14)
- o Both auctions had non-exercise of the post-action option to buy up to another 10% at the auction price.
Note: Issuance amounts are nominals.

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

Category	Mkt Val (€bn)	Weight (%)
Sovereigns (318)	5,725	61.3
Non Sovereigns	3,617	38.7
AAA (554)	1,032	11.0
AA (520)	908	9.7
A (771)	844	9.0
BBB (828)	833	8.9

Category	Mkt Val (€bn)	Weight (%)
1 – 3 Yrs (796)	2,187	23.4
3 – 5 Yrs (712)	1,862	19.9
5 – 7 Yrs (647)	1,604	17.2
7 – 10 Yrs (551)	1,696	18.2
10+ Yrs (285)	1,992	21.3

Table 2f: Breakdown of £ Index-Linked Market

Category (Number of issues)	Mkt Val (£bn @ Feb 15 & 12)	W't (%)	Dur'n (yrs)
Gilts (24)	480 337	93.3	20.4
< 5 Yrs (3)	52 49	10.1	-
5 – 15 Yrs (6)	130 88	25.2	-
> 15 Yrs (15)	299 200	58.1	28.5
Non Gilts (40)	35 29	6.7	17.3

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

Month End	US (%)	Euro (%)	Sterling (%)
Aug '14	5.32	3.94	5.63
Sep '14	5.80	4.05	5.87
Oct '14	5.59	4.08	6.27
Nov '14	5.83	3.91	6.19
Dec '14	6.16	4.00	6.15
Jan '15	6.07	3.81	5.83
Feb '15	5.72	3.63	5.84

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

