



Investment Update March 2015

Investment Headlines & Comment

- **CPI inflation** has hit zero in the UK, and may go negative for a while, but **RPI** is still positive.
- The **Euro** has now fallen by 25% from its peak against the £, and is now at levels last seen in late 2007.
- **Short-dated yields** are now negative in EIGHT European countries ... but at 22% in Greece.

Feature Section

This month we try to face the fact that things are now looking seriously odd in several bond markets, and we ponder the not-entirely-savoury implications. In our [December 2011](#) issue, we looked at the progression of 10-year Eurozone bond yields (it was around the time that Greek yields had risen to a whopping 32%). Over the years since then, repeated fudging allowed the Eurozone to continue unreformed. However, following the election in Greece, and this month's disclosure through the Financial Times of a [government letter](#) showing the level of financial tension between Germany and Greece, it seems that something in the system has simply got to give.

Figure 1a below shows the movements in 10-year bond yields over the period since mid 2013. Greek yields have continued to have a life of their own, whilst there has been a steady slumping in other countries' yields, occurring right across the board. German 10-year yields are now at 0.3%, and even "outliers" like Spain and Italy are on 10-year yields of 1.3%. In comparison, a 1.8% yield in the UK looks wonderful for Euro investors (and it probably doesn't have the worry for investors in Euro-denominated debt that their issuers might start rewriting their own rules, and that the Euro currency could go haywire). Note: The legends on the right hand side of each chart are in end-value order.

Figure 1a: 10-year yields

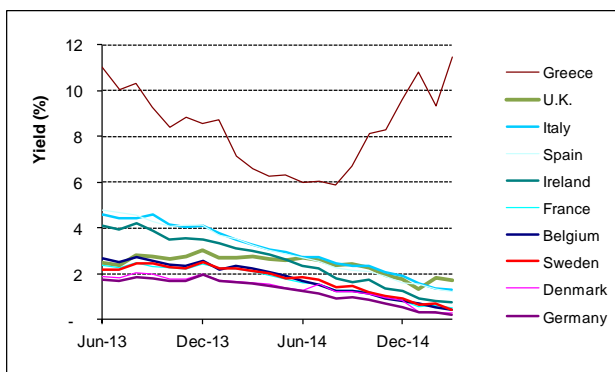
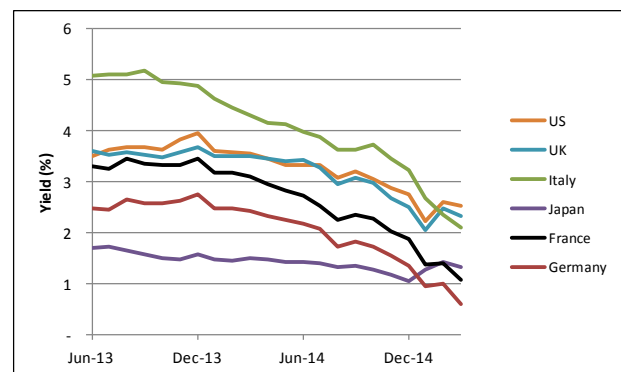


Figure 1b: 30-year yields



Source: FT Note: In Figure 1b, the FT's Japan data is 20 year for 2013 and 2014, but they switch to 30-year for 2015.

There are not that many countries which make significant use of long-dated government debt. The UK, the world's 3rd largest government bond market, is the most skewed to the long end – for example, the duration (weighted average term) of UK gilts is about 11 years, compared with 6 years for the US and 9 years for Japan (these being the largest and second largest government bond markets, respectively). The US market is currently roughly 5 times and the Japanese market is roughly 3 times the size of the UK market.

Figure 1b shows that there have been some pretty significant shifts in long-dated yields over the last year or so. Some of it may be put down to markets anticipating the launch of Quantitative Easing (QE) by the ECB in January 2015, and perhaps some of it can be ascribed to expectations of reduced future Eurozone inflation.

The fall for Italian long-dated debt from a 5% yield to a 2.1% yield is noteworthy, not least because the yield is now below that of the UK and the US. Coupled with the fall in German long-dated debt to a 0.6% yield, and 0.9% for France, this suggests that there is clear risk of prolonged deflation or general stagnation within the Eurozone, akin to that experienced by Japan over much of the last 20 years.

Perhaps surprisingly, Figure 1b shows a very similar progression for the long-dated US and UK yields. However, with US and UK long-dated *real* yields at 0.7% and minus 0.9% respectively, this apparently implies materially higher UK annual inflation (3.2% UK versus 1.8% US) ... although this is before the potential distortions from some UK institutional investors is factored in.



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 March 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	-1.7	4.7	6.6	10.6	8.3	7.7	7.9
Overseas Equities	2.9	7.9	20.2	14.6	10.2	10.0	8.1
US Equities	2.6	6.4	26.4	19.1	15.0	10.9	8.8
Europe ex UK Equities	2.9	10.8	6.8	13.1	6.7	8.4	10.0
Japan Equities	6.0	16.4	27.1	12.7	6.7	6.1	1.3
Pacific ex Japan Equities	3.7	9.5	20.0	9.4	6.8	12.8	7.5
Emerging Markets	2.6	7.4	13.1	3.2	2.5	11.5	7.3
UK Long-dated Gilts	3.4	4.1	27.0	10.0	11.8	8.1	8.9
UK Long-dated Corp. Bonds	1.9	5.0	21.6	11.8	10.7	7.3	-
UK Over 5 Yrs Index-Linked Gilts	4.2	3.3	21.1	8.9	10.8	8.6	8.4
High Yield (Global)	3.0	5.4	9.4	9.0	8.1	10.5	-
Overseas Bonds	3.4	3.2	7.6	1.0	2.1	5.9	5.3
Property *	0.9	3.3	18.6	11.0	10.5	5.8	8.5
Cash	0.0	0.1	0.6	0.6	0.7	2.5	4.1
Commodities £-converted	-3.0	-3.6	-33.0	-14.9	-7.6	-5.2	2.0
Hedge Funds original \$ basis *	1.9	1.7	3.5	5.1	5.0	5.1	8.8
Illustrative £-converted version *	-1.0	3.1	12.3	6.3	4.7	7.5	8.9
Euro relative to Sterling	-0.3	-6.7	-12.4	-4.6	-4.1	0.5	-
US \$ relative to Sterling	4.0	5.0	12.3	2.5	0.4	2.4	0.5
Japanese Yen relative to Sterling	3.8	5.0	-3.6	-9.6	-4.5	1.3	-1.2
Sterling trade weighted	-2.0	1.8	4.0	2.9	2.7	-1.3	0.4
Price Inflation (RPI) *	0.5	-0.2	1.0	2.3	3.2	3.1	2.8
Price Inflation (CPI) *	0.2	-0.6	0.0	1.5	2.4	2.6	2.1
Price Inflation (RPIX) *	0.5	-0.2	1.0	2.3	3.2	3.3	2.9
Earnings Inflation **	-1.0	2.7	1.1	1.2	1.8	2.0	3.3
All Share Capital Growth	-2.2	3.7	3.0	6.9	4.7	4.1	4.4
Net Dividend Growth	1.2	2.5	0.6	5.6	5.8	4.9	-
Earnings Growth	2.4	2.3	-8.2	-7.0	6.6	3.7	4.5

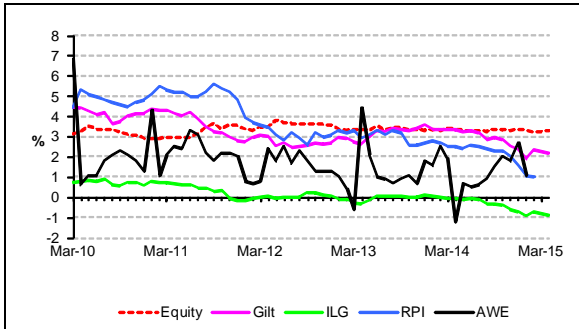
Note: All market returns are total returns for pension funds with income reinvested monthly. Indices used are as follows:

- 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.

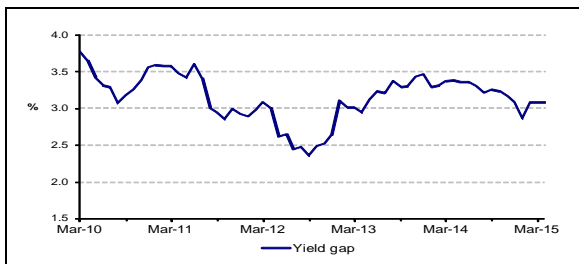


Yields and Yield Gaps

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.

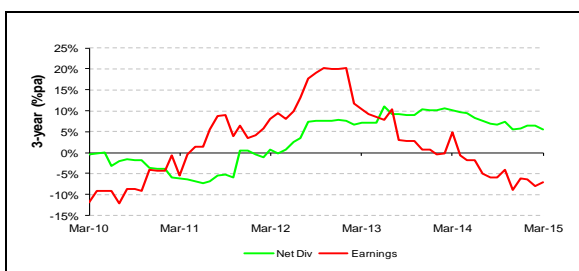
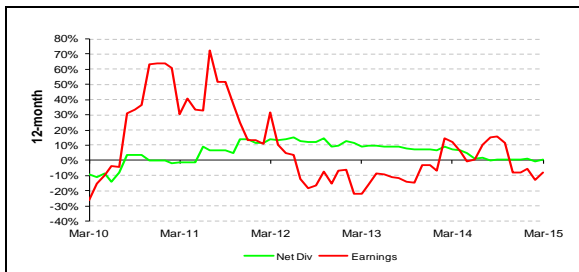


The gap gives a current expectation still just above 3% for longer-term inflation + risk premium for gilts, relative to index-linked gilts.

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]

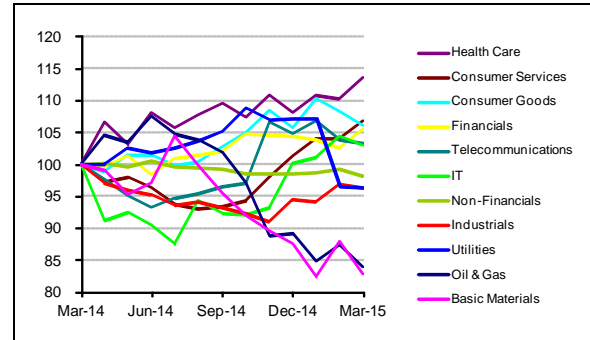
Figure 3: Dividend & Earnings Growth



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



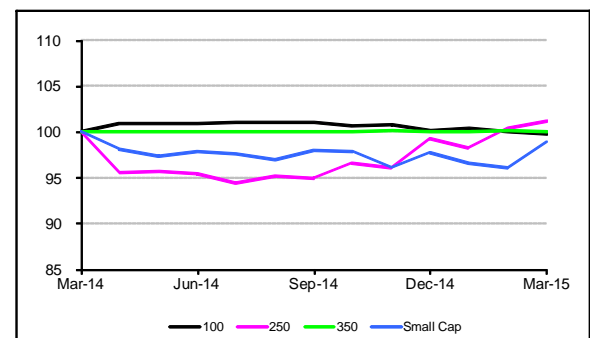
Note: Sector labels for relative lines are in end-value order

There was a rise this month in the rolling 12-month sector dispersion (from 24% to 31%).

(% absolute return)	1 mth	3 mth	12 mth
Oil & Gas	-5.6	-1.5	-10.5
Basic Materials	-7.3	-1.1	-11.8
Industrials	-2.1	6.7	2.7
Consumer Goods	-3.6	5.0	13.1
Health Care	1.2	10.0	21.1
Consumer Services	1.0	10.4	13.8
Telecommunications	-2.2	3.2	10.1
Utilities	-1.9	-5.9	2.6
Non-Financials	-2.6	4.3	4.7
Financials	1.2	5.8	12.4
IT	-3.1	7.6	9.8
All Share	-1.7	4.7	6.6

UK Equity Size Returns

Figure 4b: Size groups relative to All Share



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

FRS17 volatility indicator

Now discontinued, but available on request.



Bond market information

Figure 5: £ Non-Gilt Credit Margins

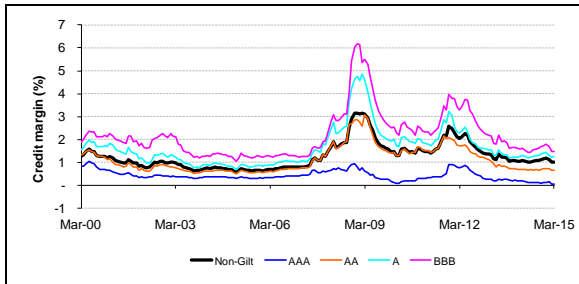


Table 2a: Over 15 Yr Corporate Yields & Margins

Month End	iBoxx Corp AA Y'ld (%)	FT 20 yr Gilt (%)	Margin (%)
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
Mar '15	3.08	2.20	0.88

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

Category	Mkt Val @ Mar 15 & 12, 09			Weight (%)
	1,217	1,012	587	
Gilts (37)	1,217	1,012	587	68.9
Non Gilts (1,019)	550	481	399	31.1
AAA (117)	99	126	142	5.6
AA (177)	93	60	60	5.3
A (353)	181	170	134	10.3
BBB (372)	176	125	61	10.0

Category	Mkt Val @ Mar 15, & 12		W't (%)	Dur'n (yrs)
	1,217	1,012		
Gilts (37)	1,217	1,012	68.9	10.9
< 5 Yrs (9)	291	307	16.5	2.9
5-15 Yrs (12)	396	318	22.4	7.0
> 15 Yrs (16)	530	388	30.0	18.2
Non Gilts (1,019)	550	481	31.1	8.4
< 5 Yrs (333)	153	125	8.6	2.7
5-15 Yrs (433)	235	208	13.3	7.7
> 15 Yrs (253)	162	148	9.2	14.7

£ Gilt Market “main” Issuance

- o £3.50bn 2% 2020 (1.35x, 1.41%, Jan 15)
 - o £3.02bn 2% 2025 (1.37x, 1.68%, new)
 - o £1.65bn 3½% 2068 (1.25x, 2.62%, Oct 14)
 - o £0.93bn 1¼% IL 2037 (2.00x, -0.62%, Oct 11)
- Note: Issuance amounts are nominals.

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

Category	Mkt Val (€bn)	Weight (%)
Sovereigns (320)	5,784	61.5
Non Sovereigns	3,620	38.5
AAA (552)	1,031	11.0
AA (525)	915	9.7
A (770)	834	8.9
BBB (838)	839	8.9

Category	Mkt Val (€bn)	Weight (%)
1 – 3 Yrs (804)	2,198	23.4
3 – 5 Yrs (689)	1,813	19.3
5 – 7 Yrs (653)	1,603	17.1
7 – 10 Yrs (567)	1,709	18.2
10+ Yrs (292)	2,080	22.1

Table 2f: Breakdown of £ Index-Linked Market

Category (Number of issues)	Mkt Val (£bn @ Mar 15 & 12)	W't (%)	Dur'n (yrs)
Gilts (24)	500 336	93.1	20.8
< 5 Yrs (3)	52 49	9.7	-
5 – 15 Yrs (6)	131 88	24.4	-
> 15 Yrs (15)	317 199	59.0	28.7
Non Gilts (40)	37 29	6.9	17.4

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

Month End	US (%)	Euro (%)	Sterling (%)
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
Mar '15	5.90	3.77	5.86

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

