



Investment Update July 2015

Investment Headlines & Comment

- A rather bad month for **Emerging Markets and Commodities**.
- **Sterling bond yields** have started falling again.
- **UK Equity earnings** fall sharply (but the data is being questioned).

Feature Section

This month we update our past features on High Yield debt default rates, using the Standard & Poors [annual survey](#), which now covers data to the end of 2014.

We last looked at this in our [March 2013](#) edition, which followed on from items in 2011, 2008 and 2002.

Figure 1a: Average *Cumulative* Default Rates (%)
(Extracts from “Table 24” in S&P)

Time	1 year	5-year	10-year
Investment grade	0.11	1.03	2.24
AAA	0.00	0.36	0.74
AA	0.02	0.35	0.82
A	0.07	0.57	1.51
BBB	0.20	1.95	4.06
High Yield	3.87	15.49	21.97
BB	0.76	7.71	13.74
B	3.88	18.70	25.91
CCC/C	26.38	46.28	50.73
All ratings	1.50	6.20	9.15

Source: Standard & Poor’s (also for the Figures below)

Figure 1a shows historical default rates averages across global corporate bonds in 1-, 5- and 10-year versions. The dataset covers 1981-2014 (and the 5- and 10-year figures use rolling sets of overlapping periods, not successive distinct ones), but it does not show comparable recovery rate statistics. However, as per our Figure 5 (on page 4) for Sterling investment grade bonds, actual default rates have been below those priced into yields, even if with no recovery. For example, over the last 5 calendar years, the iBoxx All-Dated Non-Gilts Index returned 8.2% p.a. vs 6.8% p.a. for the FT-A All-Dated Gilt Index (which has longer maturity). Over 10 years, the position is matched with 5.9% p.a. for both. Over 15 years, it is 6.5% p.a. vs 5.9% p.a. (Ideally, you would make the comparison over a period of similar start and end yields, likewise for credit margins, to avoid distortions from these factors.)

Figure 1b shows 2014’s moves in isolation (row = start rating, column = end rating). For investment grade it was a good year, with very few bonds falling into sub-investment grade, and more going the opposite way with upgrades. Most bonds retain the same credit rating at the end of the year as at the start, hence a dominant diagonal for the figures in bold, but note the extent of the 1-year rating downgrades for AAA bonds (relating to just 4 issuers). Eventually there is a sharp decline on the CCC row, reflecting a greater instability for bonds that have got that close to the edge. There were only two defaulted entities in 2014 that S&P initially rated investment grade, and the time between first rating and date of default averaged 15.9 years. Figure 1c gives an alternative way of looking at the 1-year data from

Figure 1b: Global Credit Rating Transitions % in 2014 in isolation
(Extracts from “Table 20” in S&P, with D = Default, N.R. = not rated)

	AAA	AA	A	BBB	BB	B	CCC	D	N.R.
AAA	78.95	21.05	-	-	-	-	-	-	-
AA	-	96.31	2.15	-	-	-	-	-	1.54
A	-	0.85	93.80	2.56	0.23	-	-	-	2.56
BBB	-	-	2.93	91.04	2.22	-	-	-	3.81
BB	-	-	-	3.94	84.93	4.11	0.09	-	6.93
B	-	-	-	0.06	3.97	79.65	2.81	0.77	12.74
CCC	-	-	-	-	-	7.14	51.10	17.03	24.73

Figure 1c: Profile of individual year default percentages
(Extracts from “Table 4” in S&P)

	AAA	AA	A	BBB	BB	B	CCC
Min	-	-	-	-	-	0.25	-
Max	-	0.38	0.39	1.02	4.22	13.84	49.46
Average	-	0.02	0.07	0.20	0.76	3.82	25.27

Figure 1a, with the minimum and maximum 1-year default rates by credit rating, which in turn renews the question on what level of deduction it might be prudent to make from investment grade bond yields in actuarial valuations. For example, the average cumulative investment grade 10-year default rate is 2.24%, and the worst is 4.12% (from “Table 31”, for the 10 years to 1991, when the market was much smaller than now). So, there still does not seem to be a

reasonable case for making a deduction of more than, say, 0.4% p.a. from the yield as an allowance for future defaults. (If you do not yet hold the bonds, or expect to reinvest maturing proceeds, there may be an argument for reducing the yield for the risk that credit margins contract before you buy the bonds, but that remains quite a separate issue.)



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 July 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	2.4	-2.2	5.4	11.4	9.8	6.9	7.4
Overseas Equities	1.6	-2.9	12.7	14.0	11.2	8.3	7.3
US Equities	2.8	-0.2	20.1	17.9	16.4	9.2	7.9
Europe ex UK Equities	4.2	-2.0	8.8	14.8	8.2	7.0	9.1
Japan Equities	1.3	-1.0	18.3	15.3	8.7	5.6	1.1
Pacific ex Japan Equities	-4.3	-12.4	-0.9	5.8	5.4	9.7	6.3
Emerging Markets	-6.2	-14.2	-6.0	1.1	1.0	8.2	6.2
UK Long-dated Gilts	3.1	0.4	17.3	5.3	9.9	7.1	8.5
UK Long-dated Corp. Bonds	3.0	-1.3	10.7	6.6	9.0	6.3	-
UK Over 5 Yrs Index-Linked Gilts	3.2	0.7	18.2	8.5	10.8	8.2	8.0
High Yield (Global)	0.3	-3.0	4.9	6.1	7.4	8.9	-
Overseas Bonds	1.4	-3.6	0.9	-2.6	0.5	4.7	4.6
Property *	1.4	3.6	16.7	12.6	10.3	5.8	8.7
Cash	0.0	0.1	0.6	0.5	0.7	2.3	4.0
Commodities £-converted	-13.4	-17.2	-38.0	-16.7	-8.2	-7.1	1.1
Hedge Funds original \$ basis *	-1.3	0.3	2.3	6.4	5.1	5.2	8.4
Illustrative £-converted version *	-4.2	-5.4	11.2	6.3	4.1	6.5	8.5
Euro relative to Sterling	0.0	-2.9	-10.6	-3.4	-3.2	0.3	-
US \$ relative to Sterling	0.8	-1.5	8.1	0.1	0.1	1.2	0.1
Japanese Yen relative to Sterling	-0.5	-4.9	-10.2	-14.1	-6.8	0.2	-1.6
Sterling trade weighted	0.8	3.3	6.5	3.9	2.8	-0.5	0.8
Price Inflation (RPI) *	0.2	0.7	1.0	2.3	2.9	3.0	2.8
Price Inflation (CPI) *	0.0	0.5	-0.1	1.6	2.3	2.5	2.0
Price Inflation (RPIX) *	0.2	0.7	1.1	2.3	3.0	3.2	2.8
Earnings Inflation **	-1.2	-3.8	2.6	1.8	1.9	2.5	3.3
All Share Capital Growth	2.3	-2.9	1.9	7.7	6.1	3.3	3.9
Net Dividend Growth	0.2	2.0	4.7	5.0	6.8	4.3	-
Earnings Growth	-13.3	-2.1	-18.6	-7.2	3.8	2.0	3.5

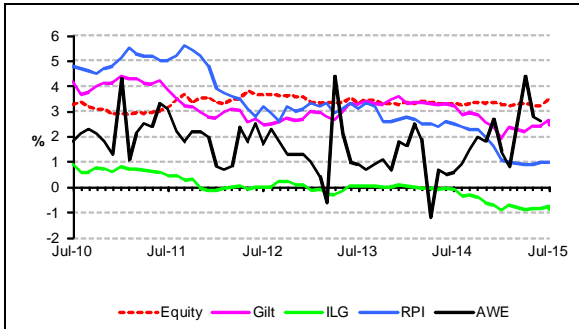
Note: All market returns are total returns for pension funds with income reinvested monthly. Indices used are as follows:

- 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.

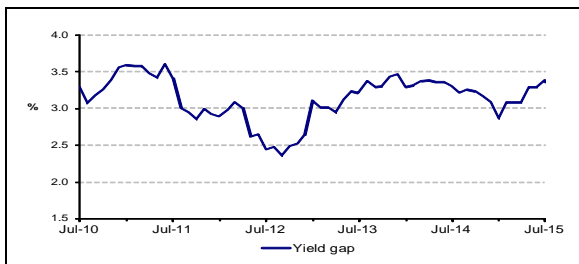


Yields and Yield Gaps

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.

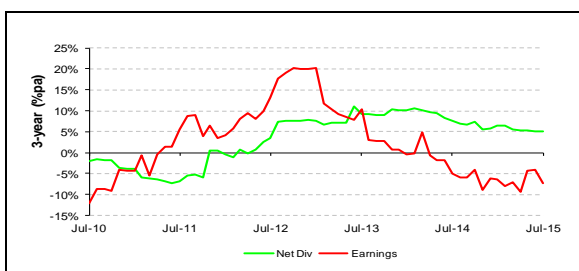
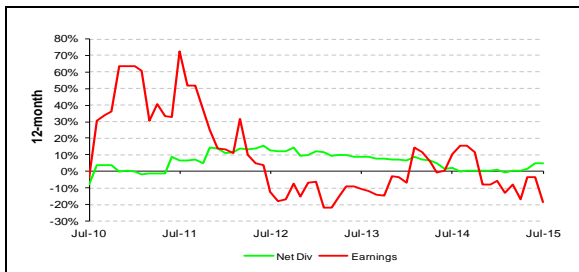


The gap gives a current expectation now almost at 3.5% for longer-term inflation + risk premium for gilts, relative to index-linked gilts.

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]

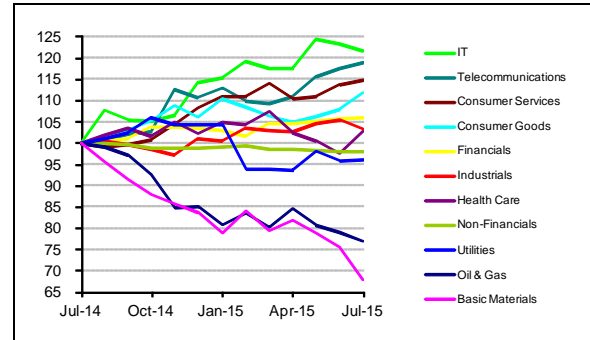
Figure 3: Dividend & Earnings Growth



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



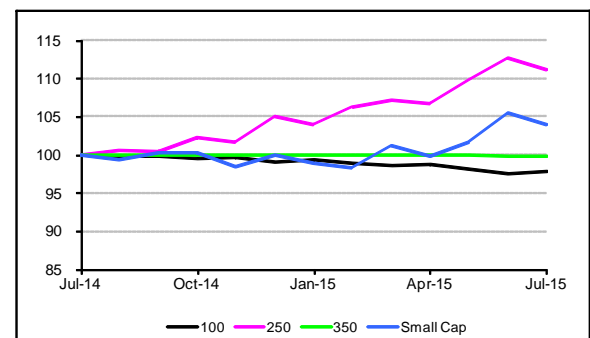
Note: Sector labels for relative lines are in end-value order

There was a rise this month in the rolling 12-month sector dispersion (from 43% to 54%).

(% absolute return)	1 mth	3 mth	12 mth
Oil & Gas	-0.6	-11.3	-19.2
Basic Materials	-7.9	-19.1	-28.6
Industrials	0.3	-1.5	8.9
Consumer Goods	5.9	4.2	17.8
Health Care	7.7	-2.0	8.2
Consumer Services	3.5	1.8	21.1
Telecommunications	3.7	5.0	25.5
Utilities	2.6	0.3	1.3
Non-Financials	2.3	-2.6	3.3
Financials	2.7	-0.9	11.8
IT	1.1	1.3	28.4
All Share	2.4	-2.2	5.4

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

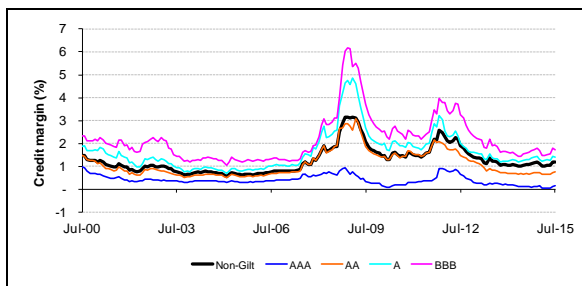


Table 2a: Over 15 Yr Corporate Yields & Margins

Month End	iBoxx Corp AA Y'ld (%)	FT 20 yr Gilt (%)	Margin (%)
Feb '15	3.22	2.37	0.85
Mar '15	3.08	2.20	0.88
Apr '15	3.30	2.44	0.86
May '15	3.30	2.43	0.87
Jun '15	3.65	2.65	1.00
Jul '15	3.45	2.49	0.96

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

Category	Mkt Val @ Jul 15 & 12, 09			Weight (%)
	Jul 15	Jul 12	09	
Gilts (38)	1,214	1,080	620	69.2
Non Gilts (1,041)	542	516	455	30.8
AAA (115)	99	138	145	5.6
AA (194)	96	64	65	5.5
A (346)	166	171	154	9.5
BBB (386)	180	143	89	10.3

Category	Mkt Val @ Jul 15, & 12		W't (%)	Dur'n (yrs)
	Jul 15	12		
Gilts (38)	1,214	1,080	69.2	10.5
< 5 Yrs (10)	328	275	18.7	2.8
5-15 Yrs (12)	370	369	21.1	7.0
> 15 Yrs (16)	516	436	29.4	17.9
Non Gilts (1,041)	542	516	30.8	8.0
< 5 Yrs (349)	161	137	9.2	2.6
5-15 Yrs (447)	231	215	13.1	7.6
> 15 Yrs (245)	150	164	8.5	14.4

£ Gilt Market “main” Issuance

- o £4.12bn 2% 2020 (1.71x, 1.61%, May 15)
- o £1.92bn 3½% 2045 (1.89x, 2.73%, Jun 15)
- o £4.00bn 3½% 2068 (3.88x, 2.74%, Mar 15)
- o £1.50bn 1/8% IL 2026 (1.61x, ry -0.61%, new)

Note: Issuance amounts are nominals.

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

Category	Mkt Val (€bn)	Weight (%)
Sovereigns (321)	5,661	61.5
Non Sovereigns	3,539	38.5
AAA (548)	959	10.4
AA (566)	932	10.1
A (788)	825	9.0
BBB (882)	823	9.0

Category	Mkt Val (€bn)	Weight (%)
1 – 3 Yrs (786)	2,145	23.3
3 – 5 Yrs (701)	1,853	20.1
5 – 7 Yrs (685)	1,580	17.2
7 – 10 Yrs (599)	1,688	18.4
10+ Yrs (334)	1,933	21.0

Table 2f: Breakdown of £ Index-Linked Market

Category (Number of issues)	Mkt Val (£bn @ Jul 15 & 12)		W't (%)	Dur'n (yrs)
Gilts (25)	482	354	93.1	21.8
< 5 Yrs (3)	50	49	9.6	-
5 – 15 Yrs (7)	124	89	24.0	-
> 15 Yrs (15)	308	216	59.5	29.5
Non Gilts (38)	36	30	6.9	17.5

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

Month End	US (%)	Euro (%)	Sterling (%)
Jan '15	6.07	3.81	5.83
Feb '15	5.72	3.63	5.84
Mar '15	5.90	3.77	5.86
Apr '15	5.72	3.74	5.84
May '15	5.71	3.76	5.77
Jun '15	6.10	4.23	6.11
Jul '15	6.20	4.08	6.06

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

