



Investment Update August 2015

Investment Headlines & Comment

- Another bad month for **Emerging Markets**, with many other equity markets falling as a result.
- **Sterling** suffered against most major currencies, so **Overseas Bonds** performed best this month.
- Another peculiar month for **UK Equity** earnings (and again the data is being queried).

Feature Section

This month, amidst continuing low government bond yields (with the 2068 Index-Linked Gilt hitting a new low of -1.07% p.a. for its real yield this month), we return to our [May 2009](#) analysis of the profile of the combined UK “Gilt + Corporate Bond” market, to see how the markets have evolved and what effects these seemingly ultra-low yields are having.

Back in the mid 1990s, corporate bonds accounted for just over a quarter of the total UK bond market – by the late 1990s, this had risen to a third of the market, and by the time of our April 2001 issue, the corporate bond market was set to outgrow the gilt market, largely coinciding with the introduction of FRS17 for pension fund accounting. The “credit crunch” put paid to that growth as QE set about expanding the gilt market dramatically (although not expanding the conventional ownership). At the time of our May 2009 analysis, Gilts accounted for 60% of the market. The trend of gilt market expansion as a proportion of the overall market has continued since then, albeit more gradually (as government spending has gradually been reduced). Gilts are now 70% of the market, as shown by Figure 1a. Note that these datasets still include the Bank of England QE portfolio (which is fair, given that the portfolio is spread across the issuance range).

For much of the last 15 years, long gilts and long corporates combined were approximately a third of the market, but recently this figure has started to rise a little, as the UK Gilt market has continued to lengthen its maturity – as per Table 2c on page 4, the duration (weighted average term) is now 10.5 years, whereas back in the early 2000s it was below 8 years. Figure 1b shows the evolution of the mix within the “over 15 years” area has changed considerably over time – corporate bonds are now at their lowest (22%) as a proportion of this market area.

Figure 1a: All Dated conventional bonds

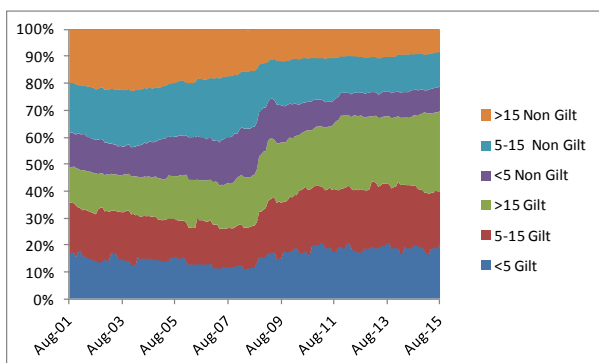
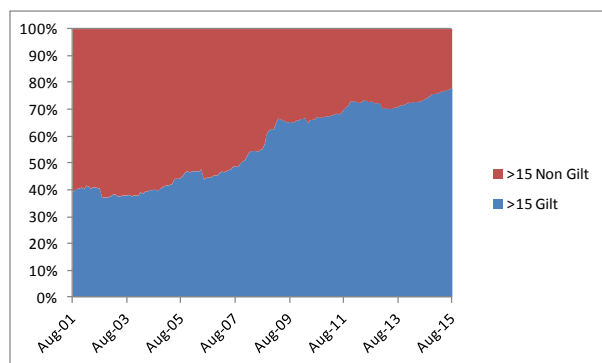


Figure 1b: Long Dated conventional bonds



Source: iBoxx

The *value* of long corporates has risen somewhat since our last analysis, as long-dated bond yields have fallen, but the number of bond issues has actually fallen from 293 in May 2009 to 245 as of August 2015. It is something of a surprise that corporate debt issuers are not taking greater advantage of low rates.

For those investors still using “aggregate” bond indices (i.e. ones weighted by the market capitalization of gilts and corporates), instead of going wholly corporate, they must either be expecting heavy corporate bond defaults (with poor asset recovery rates) or else they believe that gilt yields have further to fall.

If short-term interest rates finally start to rise, it will be interesting to see whether the Bank of England views it as a sensible opportunity to start realising some of the QE gilt portfolio (and the associated profit!).



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 August 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	-5.3	-8.6	-2.3	8.6	8.6	6.2	7.0
Overseas Equities	-5.4	-8.8	2.4	11.7	10.4	7.9	7.0
US Equities	-4.6	-6.7	8.3	15.7	15.9	9.0	7.7
Europe ex UK Equities	-5.6	-7.1	0.6	11.4	7.6	6.5	8.6
Japan Equities	-4.2	-7.2	13.9	14.4	7.9	4.6	0.9
Pacific ex Japan Equities	-8.7	-18.6	-11.8	3.2	3.4	9.2	5.8
Emerging Markets	-7.6	-18.0	-16.5	-1.0	-0.6	7.6	5.8
UK Long-dated Gilts	0.2	0.0	10.4	5.6	8.2	6.9	8.4
UK Long-dated Corp. Bonds	-2.1	-3.7	3.2	5.6	7.0	5.8	-
UK Over 5 Yrs Index-Linked Gilts	-0.7	-0.4	10.9	8.1	9.5	7.9	7.9
High Yield (Global)	-0.1	-3.8	2.4	5.9	7.0	9.1	-
Overseas Bonds	2.1	-0.1	0.8	-1.6	0.1	5.0	4.7
Property *	1.1	3.8	16.2	13.0	10.4	5.8	8.8
Cash	0.0	0.1	0.6	0.5	0.7	2.3	3.9
Commodities £-converted	1.8	-14.6	-36.9	-17.6	-7.1	-8.0	1.0
Hedge Funds original \$ basis *	-0.4	-1.0	2.6	6.0	4.7	4.9	8.2
Illustrative £-converted version *	0.4	-2.6	10.9	6.1	4.8	6.2	8.4
Euro relative to Sterling	2.8	1.4	-8.2	-2.8	-2.5	0.6	-
US \$ relative to Sterling	1.5	-0.8	8.0	1.1	0.0	1.6	0.0
Japanese Yen relative to Sterling	3.7	1.6	-7.4	-12.6	-7.1	0.7	-1.0
Sterling trade weighted	-2.3	0.3	4.9	3.0	2.4	-0.8	0.6
Price Inflation (RPI) *	-0.1	0.2	1.0	2.2	3.0	3.0	2.8
Price Inflation (CPI) *	-0.2	0.0	0.2	1.5	2.3	2.5	2.0
Price Inflation (RPIX) *	-0.1	0.3	1.1	2.3	3.0	3.2	2.8
Earnings Inflation **	0.3	-10.1	1.8	1.1	1.8	2.4	3.3
All Share Capital Growth	-6.0	-9.5	-5.6	4.9	5.0	2.6	3.5
Net Dividend Growth	-0.1	0.2	4.5	4.4	6.4	4.2	-
Earnings Growth	-7.1	-19.6	-24.2	-8.4	-0.9	0.5	2.9

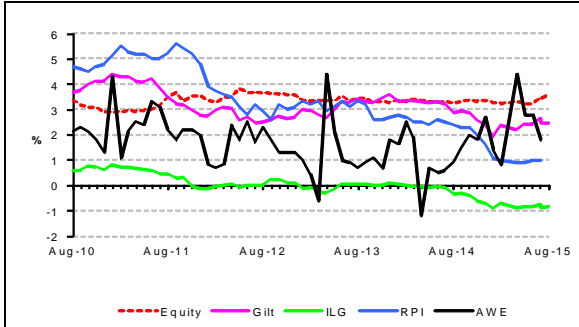
Note: All market returns are total returns for pension funds with income reinvested monthly. Indices used are as follows:

- 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.

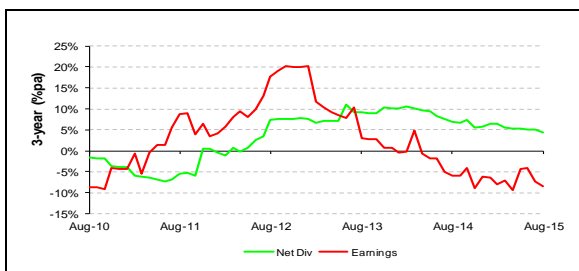
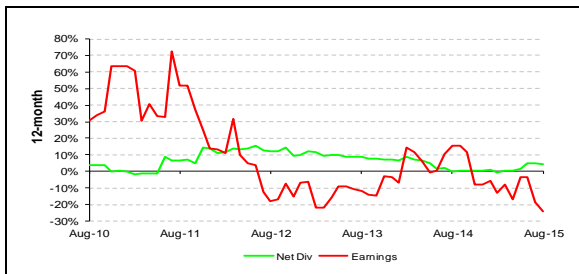


The gap gives a current expectation still near 3.5% for longer-term inflation + risk premium for gilts, relative to index-linked gilts.

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]

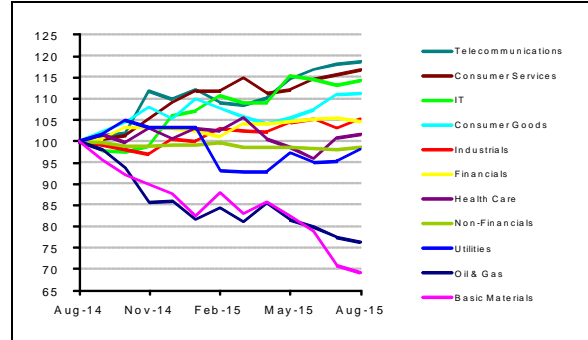
Figure 3: Dividend & Earnings Growth



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



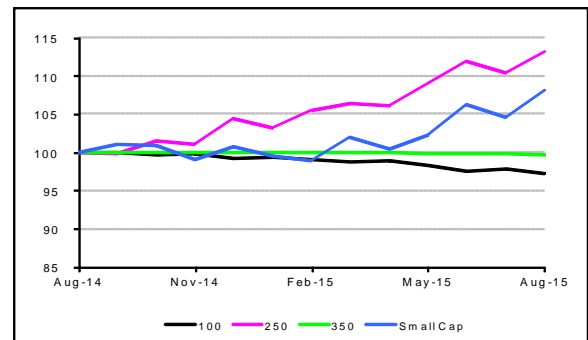
Note: Sector labels for relative lines are in end-value order

There was a modest fall this month in the rolling 12-month sector dispersion (from 54% to 50%).

(% absolute return)	1 mth	3 mth	12 mth
Oil & Gas	-6.9	-14.5	-25.6
Basic Materials	-7.6	-23.2	-32.5
Industrials	-3.2	-7.8	2.7
Consumer Goods	-5.0	-3.6	8.8
Health Care	-4.7	-6.0	-0.9
Consumer Services	-4.5	-4.6	14.1
Telecommunications	-4.8	-5.4	16.0
Utilities	-2.6	-7.8	-4.4
Non-Financials	-5.0	-8.6	-3.8
Financials	-6.3	-8.7	2.1
IT	-4.2	-9.4	11.7
All Share	-5.3	-8.6	-2.3

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

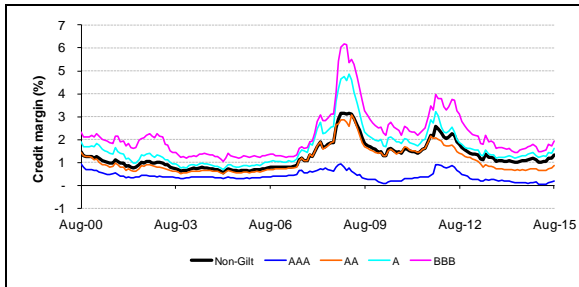


Table 2a: Over 15 Yr Corporate Yields & Margins

Month End	iBoxx Corp AA Y'ld (%)	FT 20 yr Gilt (%)	Margin (%)
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
Aug '15	3.61	2.49	1.12

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

Category	Mkt Val @ Aug 15 & 12, 09			Weight (%)
	Aug 15	Aug 12	09	
Gilts (38)	1,229	1,105	650	69.6
Non Gilts (1,037)	537	519	469	30.4
AAA (116)	100	139	149	5.6
AA (196)	97	65	69	5.5
A (345)	163	170	156	9.2
BBB (380)	177	145	92	10.0

Category	Mkt Val @ Aug 15, & 12		W't (%)	Dur'n (yrs)
	Aug 15	12		
Gilts (38)	1,229	1,105	69.6	10.5
< 5 Yrs (11)	361	279	20.4	2.9
5-15 Yrs (11)	344	382	19.5	7.2
> 15 Yrs (16)	525	444	29.7	18.0
Non Gilts (1,037)	537	519	30.4	7.9
< 5 Yrs (348)	162	138	9.2	2.6
5-15 Yrs (444)	228	217	12.9	7.6
> 15 Yrs (245)	147	165	8.3	14.3

£ Gilt Market “main” Issuance

- o £3.00bn 2% 2025 (1.37x, 1.98%, Jun 15)
 - o £1.64bn 4¼% 2036 (1.70x, 2.42%, Nov 13)
 - o £0.68bn 1/8% IL 2058 (1.61x, ry -0.93%, May 15)
- Note: Issuance amounts are nominals.

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

Category	Mkt Val (€bn)	Weight (%)
Sovereigns (319)	5,593	61.5
Non Sovereigns	3,505	38.5
AAA (555)	952	10.5
AA (559)	919	10.1
A (784)	816	9.0
BBB (886)	817	9.0

Category	Mkt Val (€bn)	Weight (%)
1 – 3 Yrs (770)	2,095	23.0
3 – 5 Yrs (725)	1,891	20.8
5 – 7 Yrs (686)	1,556	17.1
7 – 10 Yrs (597)	1,682	18.5
10+ Yrs (325)	1,874	20.6

Table 2f: Breakdown of £ Index-Linked Market

Category (Number of issues)	Mkt Val (£bn @ Aug 15 & 12)	W't (%)	Dur'n (yrs)
Gilts (25)	479 335	92.5	21.7
< 5 Yrs (3)	49 28	9.5	-
5 – 15 Yrs (7)	124 90	23.9	-
> 15 Yrs (15)	306 218	59.1	29.4
Non Gilts (38)	39 30	7.5	17.4

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

Month End	US (%)	Euro (%)	Sterling (%)
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
Aug '15	6.61	4.43	6.38

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

