



## Investment Update October 2016

### Investment Headlines & Comment

- Another poor month for **Sterling**, now at credit crunch levels.
- **Nominal yields** for UK, European and US government bonds all rose.
- Current and future expectations of **inflation** increased slightly.

### Feature Section

This month we have another look at Sterling in the UK's post-Referendum world. There continues to be a material divergence between those seeing Brexit as an opportunity and those predicting disaster, and at the moment currency markets are siding with the latter.

Figure 1a shows the history of the trade-weighted index for Sterling, whereas Figure 1b shows the relative movements in the US Dollar, Japanese Yen and the Euro over the period since the Euro came into existence. The severity of the post-Referendum drop by Sterling mirrors that seen around the time of the credit crunch, and the trade-weighted is at or near its low over the last 25+ years. Versus the main individual currencies, the noticeable thing is that the last few months have been the first period that all three have gone in the same direction with similar severity – in the past, there was rather less correlation.

Figure 1a: Trade-weighted Sterling

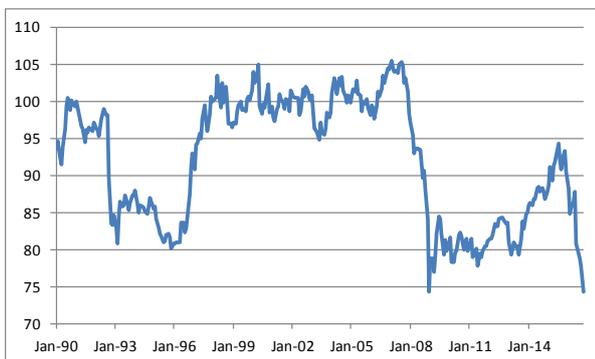
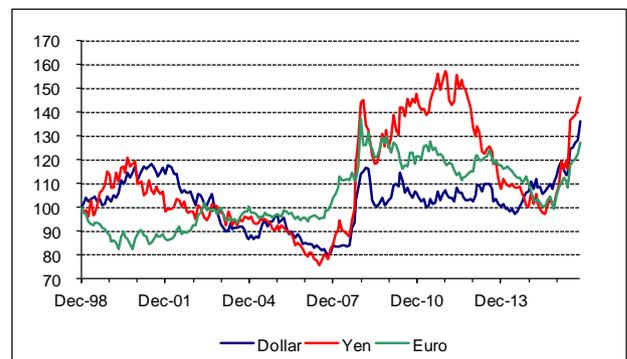


Figure 1b: US Dollar, Yen and Euro vs Sterling

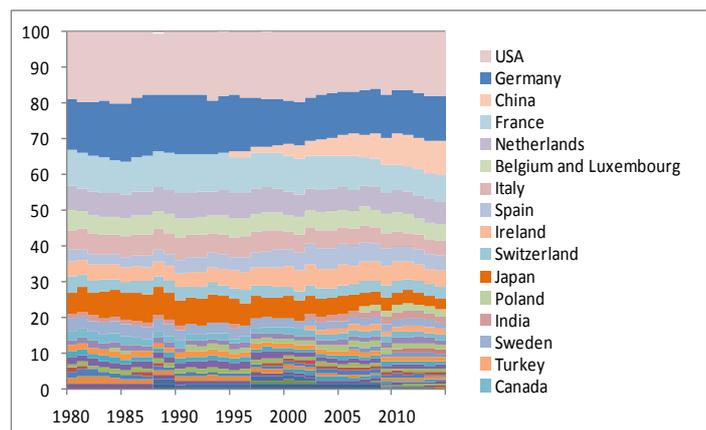


Sources: Bank of England, FT

The scale of the Yen movement in 2016 is interesting, because in 2008 it was the result of hedge funds having to unwind positions and thus buying a lot of Yen, rather than being an aversion to Sterling. There is no equivalent reason in 2016. Now, whilst most commentators could explain the US Dollar movement, can anyone do the same for the Euro? We last looked at European 10- and 30-year bond yields in our [July 2016](#) issue, and things remain pretty much as peculiar as they were then. There continues to be a spread of about 2% between German and Italian 30-year yields, and even the French 30-year yield is 0.5% ahead of the German one.

In our [May 2014](#) issue, we considered the Sterling trade-weighted index. The country weightings get revised annually in the first quarter – see the Bank's [2016 announcement](#), for example, although note that this has to use 2014 data as the latest worldwide set (so publication lags can have an effect on the UK's index). Countries are included in the narrow index if their share of either UK imports or exports on average over the latest three-year period exceeds 1%. Figure 1c shows a strata chart of weights since 1980, ordered by end-year weights (and the legend stops part way down because of the number of small weightings involved). The Euro zone countries are not shown together, so that the underlying dispersion is clearer, but we can note that their combined weight is now 48% (down from a past high of 53%).

Figure 1c: Weightings in the trade-weighted index



Source: Bank of England



**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 2016**

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	0.6	4.2	12.2	5.3	9.5	5.5	6.7
Overseas Equities	4.9	8.3	31.2	14.5	15.4	9.6	8.1
US Equities	4.4	7.0	32.0	<b>19.0</b>	<b>20.0</b>	11.7	8.1
Europe ex UK Equities	3.9	7.5	20.5	7.4	11.5	6.1	<b>9.3</b>
Japan Equities	<b>8.0</b>	12.9	31.4	14.7	14.5	5.9	<b>3.0</b>
Pacific ex Japan Equities	4.8	10.7	37.5	10.4	10.1	10.7	7.0
Emerging Markets	6.7	<b>13.2</b>	<b>38.7</b>	7.7	6.7	8.6	7.8
UK Long-dated Gilts	<b>-6.5</b>	<b>-5.9</b>	17.5	13.1	9.0	7.9	8.6
UK Long-dated Corp. Bonds	<b>-6.0</b>	<b>-3.9</b>	18.7	10.4	9.6	7.0	-
UK Over 5 Yrs Index-Linked Gilts	<b>-0.7</b>	8.6	27.5	15.0	11.7	9.5	8.8
High Yield (Global)	6.2	11.4	38.3	13.3	12.9	<b>12.3</b>	-
Overseas Bonds	3.2	5.3	35.9	10.7	6.1	8.9	6.1
Property *	0.2	<b>-2.3</b>	3.1	12.6	9.5	4.0	8.9
Cash	0.0	0.1	<b>0.5</b>	<b>0.5</b>	<b>0.6</b>	<b>1.8</b>	3.6
Commodities £-converted	4.8	13.5	9.1	<b>-14.7</b>	<b>-9.6</b>	<b>-4.8</b>	<b>-0.4</b>
Hedge Funds original \$ basis *	0.6	3.0	5.0	3.2	4.4	3.8	7.1
Illustrative £-converted version *	1.5	6.0	22.4	11.0	8.3	7.7	8.1
Euro relative to Sterling	3.8	6.6	25.5	2.0	0.8	3.0	-
US \$ relative to Sterling	6.4	8.7	26.5	9.6	5.7	4.6	1.5
Japanese Yen relative to Sterling	2.5	6.1	45.3	7.1	<b>-0.4</b>	5.7	1.9
Sterling trade weighted	<b>-4.2</b>	<b>-6.6</b>	<b>-20.0</b>	<b>-3.5</b>	<b>-1.6</b>	<b>-3.3</b>	<b>-0.8</b>
Price Inflation (RPI) *	0.2	0.7	2.0	1.7	2.2	2.8	2.8
Price Inflation (CPI) *	0.2	0.5	0.9	0.7	1.4	2.3	1.9
Price Inflation (RPIX) *	0.2	0.8	2.2	1.8	2.2	3.1	2.8
Earnings Inflation **	<b>-1.7</b>	<b>-1.3</b>	2.0	2.0	1.8	2.2	3.2
All Share Capital Growth	0.3	3.1	8.1	1.7	5.7	1.8	3.3
Net Dividend Growth	2.1	3.1	6.3	4.1	6.8	3.6	-
Earnings Growth	0.3	5.6	<b>-41.6</b>	<b>-17.5</b>	<b>-15.0</b>	<b>-6.2</b>	0.3

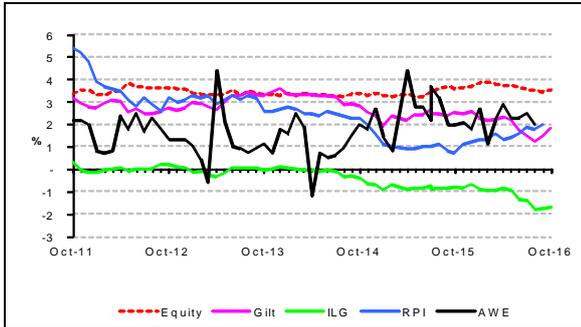
Note: All market returns are total returns for pension funds with income reinvested monthly. Indices used are as follows:

- 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.

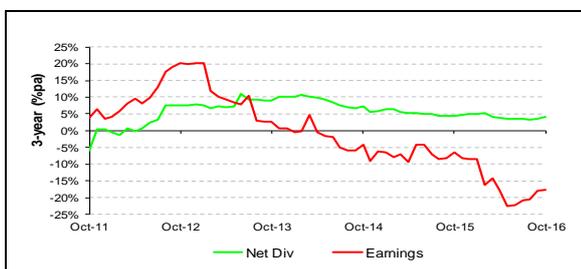
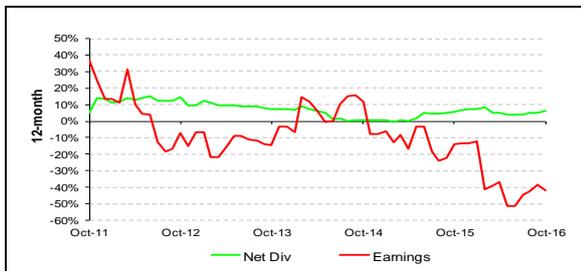


The gap gives a current expectation around 3.5% for longer-term inflation + risk premium for gilts, relative to index-linked gilts.

## 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]

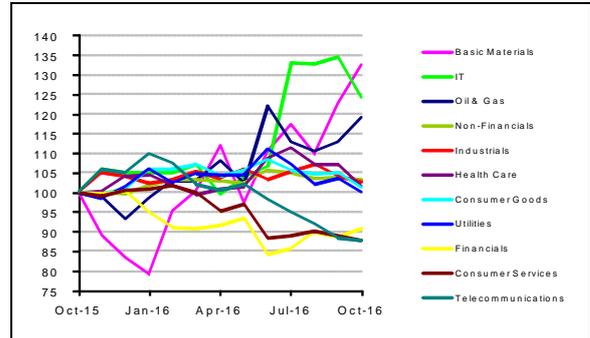
Figure 3: Dividend & Earnings Growth



Note: Earnings data from mid 2015 onwards is under review by FTSE Russell as one-off events may be affecting the prospective P/E ratios

## UK Equity Sector Returns

Figure 4a: Sectors relative to All Share



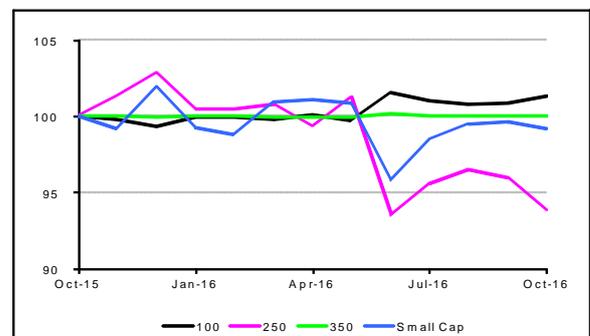
Note: Sector labels for relative lines are in end-value order

There was a fall this month in the rolling 12-month sector dispersion (from 49% to 45%).

(% absolute return)	1 mth	3 mth	12 mth
Oil & Gas	6.2	10.1	33.7
Basic Materials	8.5	17.6	48.6
Industrials	-1.0	1.5	15.1
Consumer Goods	-3.1	-0.1	13.6
Health Care	-4.7	-5.1	13.8
Consumer Services	-0.8	2.7	-1.5
Telecommunications	-0.2	-3.9	-1.5
Utilities	-2.7	-2.7	12.4
Non-Financials	-0.1	2.4	15.9
Financials	2.8	10.2	1.8
IT	-7.2	-2.9	39.4
All Share	0.6	4.2	12.2

## UK Equity Size Returns

Figure 4b: Size groups relative to All Share



Mid and Small Cap fell in relative terms this month.

## FRS17 volatility indicator

Now discontinued, but available on request.

Sources for charts on this page:

Financial Times, Office for National Statistics, J&A



## Bond market information

Figure 5: £ Non-Gilt Credit Margins

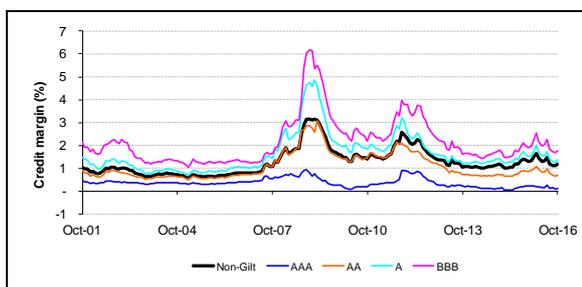


Table 2a: Over 15 Yr Corporate Yields & Margins

Month End	iBoxx Corp AA Y'ld (%)	FT 20 yr Gilt (%)	Margin (%)
May '16	3.13	2.18	0.95
Jun '16	2.73	1.72	1.01
Jul '16	2.29	1.50	0.79
Aug '16	1.95	1.24	0.71
Sep '16	2.21	1.46	0.75
Oct '16	<b>2.63</b>	<b>1.85</b>	<b>0.78</b>

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

Category	Mkt Val @ Oct 16 & 13, 10			Weight (%)
	Oct 16	Oct 13	Oct 10	
Gilts (39)	1,322	1,067	816	70.2
Non Gilts (1,020)	561	529	489	29.8
AAA (125)	110	106	146	5.8
AA (179)	94	86	76	5.0
A (344)	173	169	169	9.2
BBB (372)	185	168	98	9.8

Category	Mkt Val @ Oct 16 & 13		W't (%)	Dur'n (yrs)
Gilts (39)	1,322	1,067	70.2	11.5
< 5 Yrs (11)	377	297	20.0	3.0
5-15 Yrs (11)	348	357	18.5	7.7
> 15 Yrs (17)	596	413	31.7	19.2
Non Gilts (1,020)	561	529	29.8	8.2
< 5 Yrs (343)	167	149	8.8	2.5
5-15 Yrs (437)	233	215	12.4	7.5
> 15 Yrs (240)	162	166	8.6	15.0

## £ Gilt Market "main" Issuance

- o £2.82bn ½% 2022 (2.32x, 0.33%, Sep 16)
  - o £2.50bn 1½% 2026 (2.01x, 1.08%, Sep 16)
  - o £2.00bn 1½% 2047 (2.24x, 1.49%, Sep 16)
  - o £4.00bn 2½% 2065 (4.45x, 1.60%, Apr 16)
  - o £0.85bn 1/8% IL 2036 (2.05x, ry -1.85%, Aug 16)
- Note: Issuance amounts are nominals.

Tables 2d, 2e: € Market Size and Maturity (Oct 16)

Category	Mkt Val (€bn)	Weight (%)
Sovereigns (326)	5,924	60.7
Non Sovereigns	3,836	39.3
AAA (704)	1,107	11.3
AA (613)	1,006	10.3
A (820)	830	8.5
BBB (1,007)	894	9.2

Category	Mkt Val (€bn)	Weight (%)
1 – 3 Yrs (762)	2,033	20.8
3 – 5 Yrs (888)	2,147	22.0
5 – 7 Yrs (779)	1,588	16.3
7 – 10 Yrs (669)	1,859	19.0
10+ Yrs (372)	2,133	21.9

Table 2f: Breakdown of £ Index-Linked Market

Category (Number of issues)	Mkt Val (£bn @ Oct 16 & 13)		W't (%)	Dur'n (yrs)
Gilts (27)	639	381	94.0	23.3
< 5 Yrs (3)	51	45	7.5	-
5 – 15 Yrs (7)	145	107	21.4	-
> 15 Yrs (17)	443	230	65.2	30.4
Non Gilts (36)	41	32	6.0	17.4

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

Month End	US (%)	Euro (%)	Sterling (%)
May '16	6.41	3.99	6.45
Jun '16	6.36	4.13	6.79
Jul '16	6.01	3.72	6.27
Aug '16	5.68	3.47	5.87
Sep '16	5.63	3.57	5.97
Oct '16	<b>5.70</b>	<b>3.43</b>	<b>6.09</b>

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

