



Investment Update July 2016

Investment Headlines & Comment

- The volatility of late June has subsided, with many asset markets back to previous levels.
- However, **Sterling** remains down, **gilt yields** remain peculiar, and **property** still has exit penalties.
- The proposed sale of ARM to Softbank would reduce the **All Share IT weight** from 2% to 1%.

Feature Section This month we reach our 200th edition. Following on from last month's piece on the various market conditions applying in the aftermath of the Referendum, this month we revisit 10-year yields for European bonds, and 30-year yields for those that issue them on a regular basis. This follows on from our [March 2015](#) edition, and things have (of course) become even more baffling.

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 other countries' yields have shown a high degree of correlation. They have dropped by about 1% right across the board over the last 12 months, and several major Eurozone countries are now on near-zero or negative 10-year yields, implying something of a depressing time ahead (and renewing observers' interest in whether the political will for the Euro to exist is really worth its apparent economic cost). German 10-year yields are now at *minus* 0.18% (so lodging money in secure safes seems a better bet), and even "outliers" like Spain and Italy are on low 10-year yields of 1.1%-1.2%.

UK yields have also dropped over the last year, and are no longer the highest of the "non-Greek" yields, which they were a year ago. At their current 0.8%, they are now about 0.7% below the yields on comparable US government debt, but here the explanation for the low UK yields is probably a rush to (comparative safety) during the Brexit negotiations period. It also suggests that any eventual rise in cash rates is going to be pretty limited in the next few years.

Figure 1a: 10-year yields

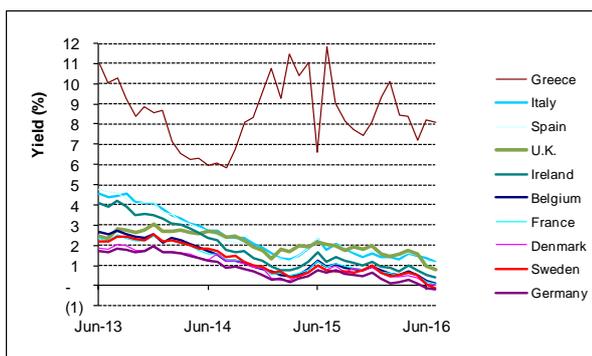
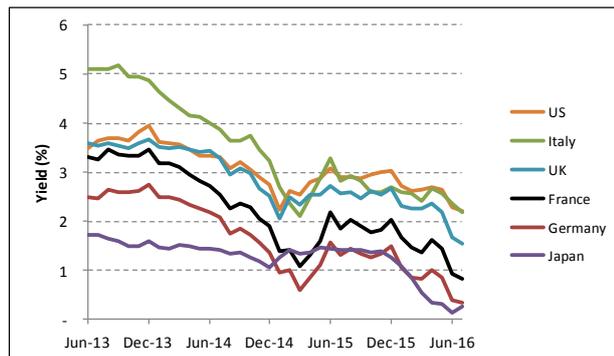


Figure 1b: 30-year yields



Source: FT, labels in end value order. Notes: 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 is the world's 3rd largest government bond market (with France and Germany very close behind). The UK market is the most skewed to the long end – for example, the duration (weighted average term) of UK gilts is about 11.6 years, compared with 6.6 years for the US and 10.1 years for Japan (these being the largest and second largest government bond markets, respectively). The US market is currently just over 5 times and the Japanese market is just over 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 three years or so. Some early parts of it may have been put down to markets anticipating the launch of Quantitative Easing (QE) by the ECB in January 2015, and similarly the more recent falls and perhaps some of it can be ascribed to expectations of reduced future Eurozone inflation. However, it does get you back to the question of whether central Eurozone governments are near to bust, yet cannot bring themselves to nudge some taxes up in a bid to get things in line – 30-year yields of 0.3% for Germany and 0.8% for France are quite remarkable, and suggest severe trouble ahead.

Figure 1b shows the long-dated US and UK yields have now de-coupled over the last 18 months or so (and long-dated US real yields remain well ahead of those in the UK). The distortions from some UK institutional investors are clearly increasing. Where those end is something we have worried about in recent previous issues ...



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 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	4.0	7.7	3.8	4.9	7.6	5.7	6.9
Overseas Equities	5.2	15.2	18.8	11.9	12.3	9.3	7.7
US Equities	4.5	16.8	23.4	15.9	18.2	11.6	7.7
Europe ex UK Equities	5.4	9.6	7.5	6.6	7.1	6.1	9.2
Japan Equities	7.3	13.7	14.1	10.3	9.9	4.6	1.7
Pacific ex Japan Equities	6.4	17.6	18.8	8.1	5.9	10.4	6.7
Emerging Markets	5.8	16.2	17.1	4.6	1.8	7.9	6.9
UK Long-dated Gilts	3.6	18.1	24.6	16.0	12.9	9.0	9.2
UK Long-dated Corp. Bonds	7.8	16.0	20.8	13.1	11.5	7.9	-
UK Over 5 Yrs Index-Linked Gilts	1.5	15.7	15.1	12.6	10.7	8.9	8.6
High Yield (Global)	3.3	14.1	23.8	8.5	10.2	11.3	-
Overseas Bonds	1.1	13.7	32.3	7.5	5.5	8.2	5.7
Property *	0.2	1.3	9.2	14.5	10.4	4.7	9.1
Cash	0.0	0.1	0.6	0.6	0.6	1.9	3.7
Commodities £-converted	-8.9	2.1	-8.5	-20.2	-12.5	-8.2	-0.9
Hedge Funds original \$ basis *	0.4	1.8	-2.4	2.9	2.4	3.6	7.1
Illustrative £-converted version *	9.3	9.5	14.9	7.3	6.2	7.0	7.9
Euro relative to Sterling	1.3	7.7	18.9	-1.3	-0.8	2.1	-
US \$ relative to Sterling	0.7	10.3	17.6	4.5	4.3	3.5	0.8
Japanese Yen relative to Sterling	0.8	15.2	42.1	3.1	-1.4	4.6	1.0
Sterling trade weighted	-1.5	-8.1	-15.7	0.1	0.0	-2.4	-0.2
Price Inflation (RPI) *	0.4	0.8	1.6	1.8	2.3	2.9	2.7
Price Inflation (CPI) *	0.2	0.4	0.4	0.8	1.5	2.3	1.9
Price Inflation (RPIX) *	0.4	0.8	1.7	1.8	2.3	3.1	2.8
Earnings Inflation **	-1.6	-2.6	2.2	1.9	1.9	2.3	3.3
All Share Capital Growth	3.9	6.8	0.0	1.3	3.8	2.0	3.5
Net Dividend Growth	0.0	0.8	3.9	3.4	6.2	3.7	-
Earnings Growth	-0.8	-14.4	-44.6	-20.8	-17.3	-6.6	-0.1

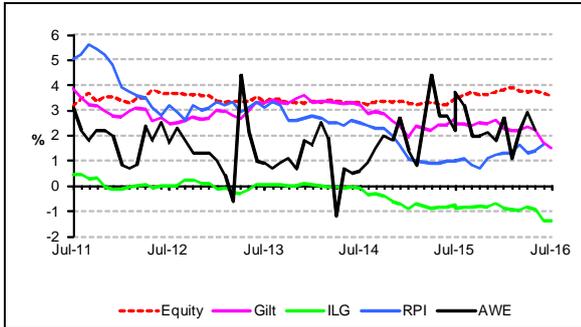
Note: All market returns are total returns for pension funds with income reinvested monthly. Indices used are as follows:

- 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.

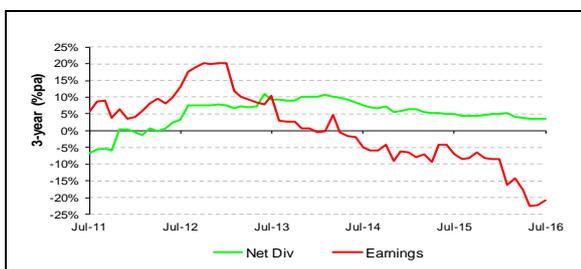
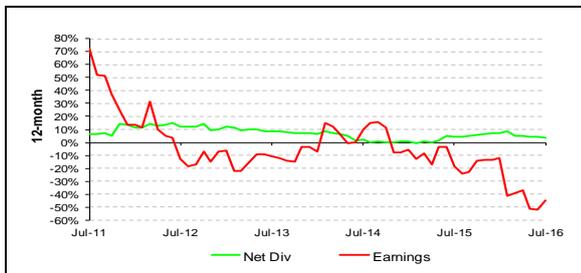


The gap gives a current expectation around 2.9% for longer-term inflation + risk premium for gilts, relative to index-linked gilts.

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]

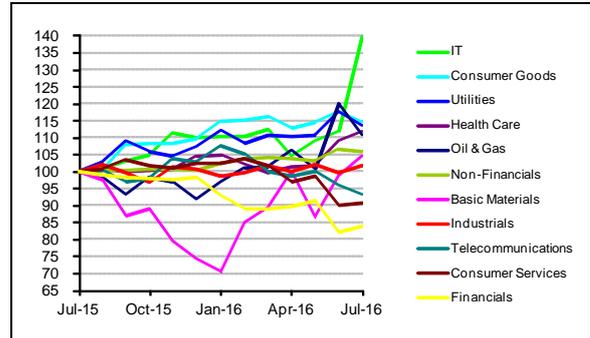
Figure 3: Dividend & Earnings Growth



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



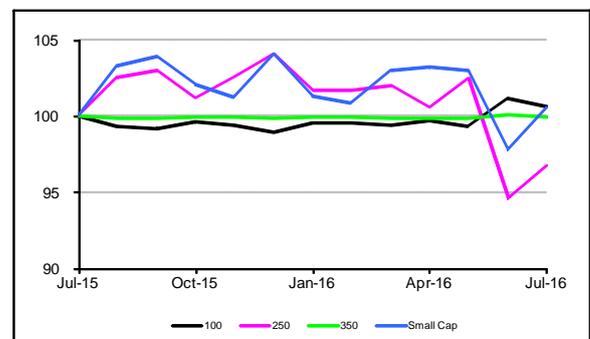
Note: Sector labels for relative lines are in end-value order

There was a rise this month in the rolling 12-month sector dispersion (from 39% to 56%).

(% absolute return)	1 mth	3 mth	12 mth
Oil & Gas	-3.9	12.3	15.1
Basic Materials	10.3	12.7	8.7
Industrials	6.2	9.5	5.6
Consumer Goods	1.2	9.2	19.0
Health Care	6.5	18.6	16.0
Consumer Services	4.8	0.5	-5.9
Telecommunications	0.8	1.8	-3.3
Utilities	0.6	10.6	17.9
Non-Financials	3.4	9.9	9.9
Financials	6.1	0.6	-12.8
IT	30.0	44.2	45.2
All Share	4.0	7.7	3.8

UK Equity Size Returns

Figure 4b: Size groups relative to All Share



Mid and Small Cap rebounded in relative terms this month, whilst Large Cap fell in relative terms.

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

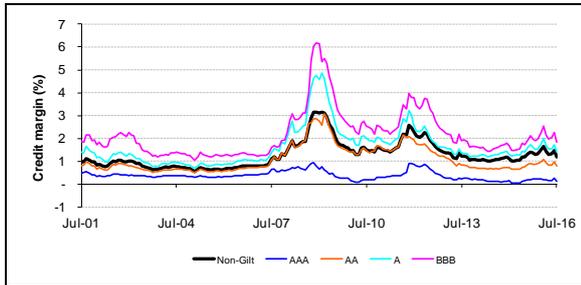


Table 2a: Over 15 Yr Corporate Yields & Margins

Month End	iBoxx Corp AA Y'ld (%)	FT 20 yr Gilt (%)	Margin (%)
Feb '16	3.61	2.18	1.43
Mar '16	3.33	2.21	1.12
Apr '16	3.28	2.34	0.94
May '16	3.13	2.18	0.95
Jun '16	2.73	1.72	1.01
Jul '16	2.29	1.50	0.79

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

Category	Mkt Val @ Jul 16 & 13, 10			Weight (%)
	Jul 16	Jul 13	Jul 10	
Gilts (39)	1,389	1,090	774	71.0
Non Gilts (1,010)	568	521	471	29.0
AAA (126)	113	106	142	5.8
AA (189)	99	83	72	5.1
A (327)	170	169	167	8.7
BBB (368)	186	163	90	9.5

Category	Mkt Val @ Jul 16 & 13		W't (%)	Dur'n (yrs)
Gilts (39)	1,389	1,090	71.0	11.7
< 5 Yrs (12)	388	315	19.8	2.8
5-15 Yrs (11)	380	375	19.4	7.7
> 15 Yrs (16)	621	400	31.7	19.7
Non Gilts (1,010)	568	521	29.0	8.4
< 5 Yrs (343)	167	148	8.5	2.6
5-15 Yrs (431)	235	208	12.0	7.6
> 15 Yrs (236)	166	166	8.5	15.2

£ Gilt Market “main” Issuance

- o £2.87bn 1½% 2021 (1.80x, 0.38%, Jun 16)
 - o £2.58bn 1½% 2026 (2.33x, 0.91%, May 16)
 - o £1.50bn 4¼% 2039 (1.50x, 1.64%, Nov 15)
 - o £0.50bn 4% 2060 (2.30x, 1.44%, Jan 16)
 - o £1.25bn 1/8% IL 2026 (2.01x, ry -1.58%, Apr 16)
 - o £2.50bn 1/8% IL 2065 (4.04x, ry -1.32%, Feb 16)
- Note: Issuance amounts are nominals.

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

Category	Mkt Val (€bn)	Weight (%)
Sovereigns (327)	6,060	61.1
Non Sovereigns	3,861	38.9
AAA (686)	1,117	11.3
AA (623)	1,011	10.2
A (819)	838	8.4
BBB (984)	896	9.0

Category	Mkt Val (€bn)	Weight (%)
1 – 3 Yrs (761)	2,045	20.6
3 – 5 Yrs (875)	2,068	20.8
5 – 7 Yrs (788)	1,733	17.5
7 – 10 Yrs (663)	1,878	18.9
10+ Yrs (352)	2,197	22.1

Table 2f: Breakdown of £ Index-Linked Market

Category (Number of issues)	Mkt Val (£bn @ Jul 16 & 13)		W't (%)	Dur'n (yrs)
Gilts (27)	582	362	93.8	22.6
< 5 Yrs (3)	51	44	8.2	-
5 – 15 Yrs (7)	139	101	22.4	-
> 15 Yrs (17)	392	217	63.2	29.9
Non Gilts (36)	38	31	6.2	17.3

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

Month End	US (%)	Euro (%)	Sterling (%)
Feb '16	7.62	5.48	7.20
Mar '16	6.95	4.39	6.67
Apr '16	6.41	4.00	6.51
May '16	6.41	3.99	6.45
Jun '16	6.36	4.13	6.79
Jul '16	6.01	3.72	6.27

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

