

## Investment Update August 2017



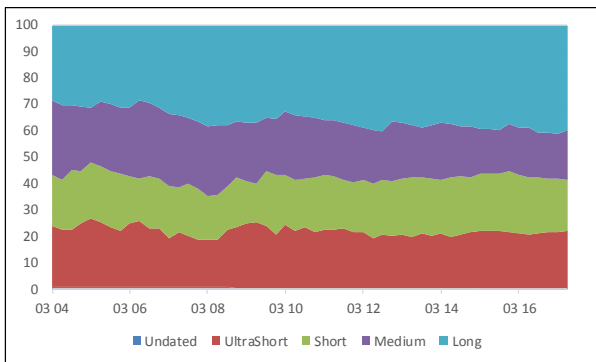
### Investment Headlines & Comment

- A poor month for **Sterling** sees it nearing its all-time low in trade-weighted terms.
- The real yield on **Index-Linked Gilts** falls, albeit with no sign of increased future inflation.
- However, **nominal gilt yields** remain higher than they were after the Brexit result in 2016.

### Feature Section

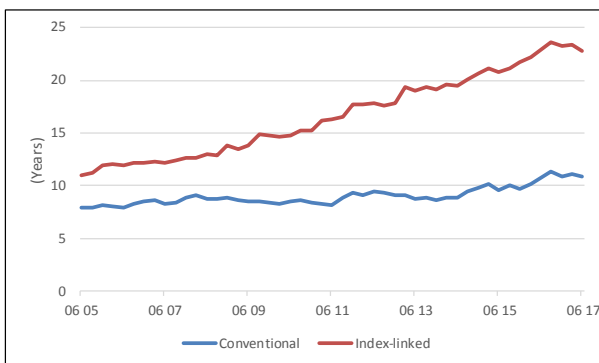
This month, we take a look at the evolution of the UK's government bond market. The latest [quarterly review](#) from the Debt Management Office (DMO) makes for interesting summary reading, with the [annual review](#) giving more detailed analysis (covering the DMO's activities for the 12 months to 31 March 2017).

**Figure 1a: Maturity profile**



Source: DMO

**Figure 1b: Duration progression**



Source: DMO

Figure 1a shows the maturity profile of the overall market (i.e. conventional and index-linked combined) over the last 13 years. The short dated element has been pretty constant at around 40%, but the medium-dated element has reduced over time, with a corresponding increase in the long-dated element. We touched on the maturity of the UK market relative to other government bond markets in our [March 2015](#) issue, which showed the gilt market to be the longest-dated of all the developed countries' bond markets. The market is now more than *three times* the size that it was 10 years ago in the "credit crunch" financial crisis, with the quantitative easing (QE) element now at £435bn. Given the continuing budget deficit, and no sign of QE bonds being sold back into the market, we think the market will expand and mature further over the next few years.

Figure 1b shows how the weighted average terms ("duration") of the market's components have evolved over time. This is partly due to the fall in yields (and real yields) over the period, but mostly due to the change in the issuance profile leading to the growth in longer-dated bonds, particularly for the index-linked market, where the duration has more than doubled over the last 12 years. The average maturity term of gilts has risen from 12 years to 15 years, whereas for index-linked gilts (ILGs) it has risen more markedly from 13 years to 24 years.

The knock-on effect is that if there is any bursting of the current "bond bubble", large losses will arise on the index-linked gilt market. (To be fair, there could also be large gains, but we have been in bizarre pricing territory for ILGs for most of the last 3 years.)

It is interesting to note from page 21 of the annual review that a third of the auctions in the period saw no use being made of the Post Auction Option Facility (PAOF). Gilt-Edged Market Makers (GEMMs) have obligations to make markets, which make it unlikely that new tranches of gilts will not find buyers (e.g. see the demand multiples we record on page 4 each month), but that is not the same as ensuring good (or even reasonable) prices – so the declining use of the PAOF may be taken as an indication of GEMMs and investors finding gilts to be rather expensive.

This might appear to be at odds with the continuing increase in demand for Liability Driven Investment (LDI) by defined benefit pension schemes (for example, as demonstrated in KPMG's latest annual LDI survey). We last outlined our concerns on the LDI area in our [May 2016](#) edition but the madness of crowds appears to continue to prevail in the UK. Looking at the resulting yields versus those in the US, we have 10-year gilt yields at 1.09% versus US Treasuries at 2.13%, and 30-year gilt yields at 1.70% versus US Treasuries at 2.73%, so arguably the long end of the gilt market is some 20% over-valued as a result of the LDI mindset (and it's much much worse for the index-linked area).



**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 2017**

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	1.4	<b>0.0</b>	14.3	7.7	10.4	6.0	6.4
Overseas Equities	2.9	4.1	20.1	16.3	16.4	10.0	7.9
US Equities	2.7	3.3	18.4	<b>19.0</b>	<b>19.2</b>	12.6	8.0
Europe ex UK Equities	3.0	3.5	25.9	13.7	15.1	6.7	8.5
Japan Equities	2.4	3.3	17.0	17.3	16.2	6.9	3.8
Pacific ex Japan Equities	3.2	7.6	23.7	13.6	12.8	9.4	8.2
Emerging Markets	4.6	<b>9.4</b>	<b>27.0</b>	11.8	10.2	7.5	8.2
UK Long-dated Gilts	3.4	0.2	<b>-6.9</b>	10.5	7.5	8.8	8.0
UK Long-dated Corp. Bonds	2.3	1.0	<b>-3.3</b>	9.3	8.3	8.4	-
UK Over 5 Yrs Index-Linked Gilts	<b>5.1</b>	0.4	<b>-0.7</b>	12.0	9.9	9.5	8.5
High Yield (Global)	2.7	2.5	11.4	13.5	11.1	<b>12.8</b>	-
Overseas Bonds	3.6	3.0	0.6	9.7	4.5	8.5	5.9
Property *	0.8	2.6	8.4	10.0	10.6	4.0	<b>8.8</b>
Cash	<b>0.0</b>	0.1	0.3	<b>0.5</b>	<b>0.5</b>	<b>1.4</b>	<b>3.3</b>
Commodities £-converted	1.5	1.6	4.3	<b>-15.2</b>	<b>-11.6</b>	<b>-5.3</b>	<b>-1.0</b>
Hedge Funds original \$ basis *	1.1	1.6	7.1	3.1	4.9	3.1	6.5
Illustrative £-converted version *	<b>-0.4</b>	<b>-0.3</b>	7.8	12.0	8.6	7.6	7.6
Euro relative to Sterling	3.2	6.2	8.5	5.2	3.1	3.2	-
US \$ relative to Sterling	2.3	<b>-0.2</b>	1.6	8.8	4.3	4.6	1.2
Japanese Yen relative to Sterling	2.7	0.6	<b>-4.5</b>	6.7	<b>-2.6</b>	5.1	1.6
Sterling trade weighted	<b>-3.0</b>	<b>-3.8</b>	<b>-5.2</b>	<b>-5.2</b>	<b>-2.4</b>	<b>-3.3</b>	<b>-1.3</b>
Price Inflation (RPI) *	0.2	0.8	3.6	2.2	2.4	2.8	2.8
Price Inflation (CPI) *	<b>-0.1</b>	0.3	2.6	1.1	1.5	2.4	2.0
Price Inflation (RPIX) *	0.2	0.8	3.9	2.3	2.5	3.2	2.8
Earnings Inflation **	1.4	<b>-9.3</b>	2.8	2.5	1.8	2.0	3.2
All Share Capital Growth	0.7	<b>-1.0</b>	10.2	3.8	6.5	2.2	3.0
Net Dividend Growth	2.1	3.5	13.3	7.6	6.3	4.5	-
Earnings Growth	16.2	14.7	51.6	<b>-12.8</b>	<b>-7.6</b>	<b>-4.4</b>	1.6

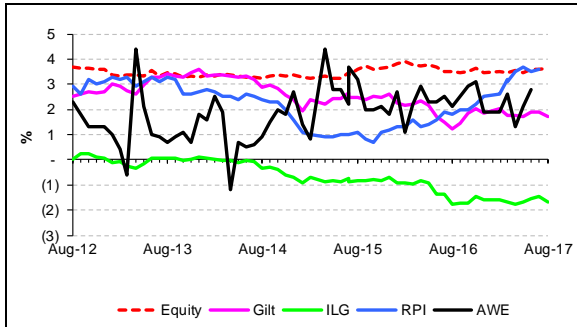
Note: All market returns are total returns for pension funds with income reinvested monthly. Indices used are as follows:

- 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 – MSCI IPD UK Monthly Property 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.

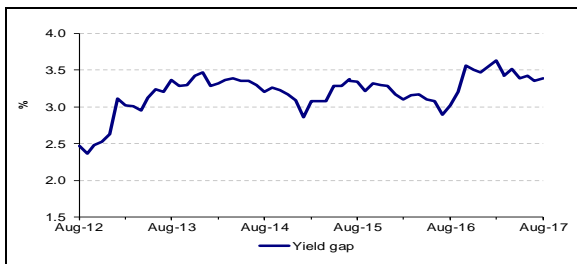


## Yields and Yield Gaps

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.

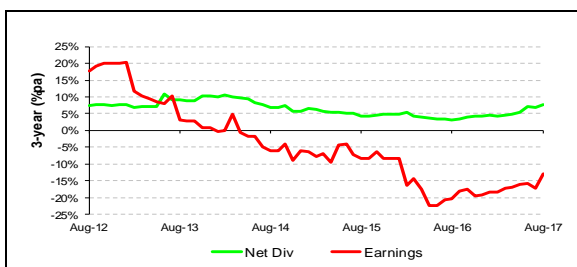
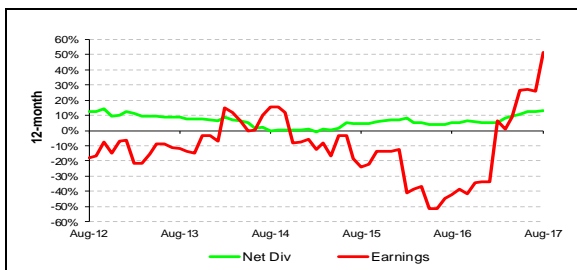


The gap gives a current expectation around 3.4% for longer-term inflation + risk premium for gilts, relative to index-linked gilts.

## 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]

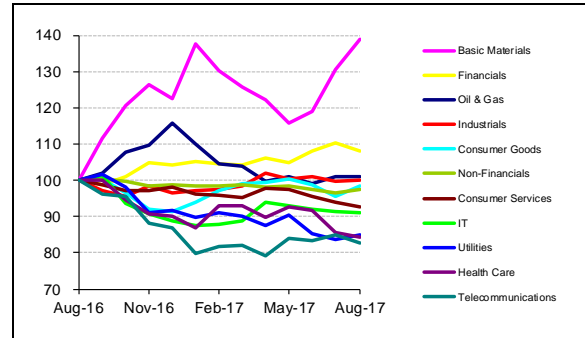
Figure 3: Dividend & Earnings Growth



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



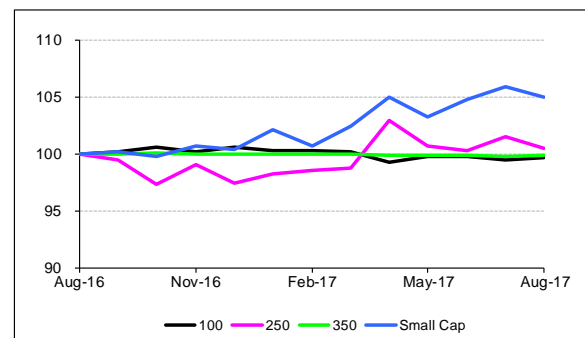
Note: Sector labels for relative lines are in end-value order

There was a rise this month in the rolling 12-month sector dispersion (from 43% to 56%).

(% absolute return)	1 mth	3 mth	12 mth
Oil & Gas	1.2	0.0	15.3
Basic Materials	7.9	19.9	58.8
Industrials	1.5	-0.5	14.2
Consumer Goods	4.4	-1.9	12.4
Health Care	-0.1	-9.1	-3.7
Consumer Services	-0.2	-5.0	5.7
Telecommunications	-1.2	-1.2	-5.4
Utilities	2.7	-6.0	-3.0
Non-Financials	2.2	-1.1	11.3
Financials	-0.7	3.2	23.6
IT	0.8	-2.0	3.9
All Share	1.4	0.0	14.3

## UK Equity Size Returns

Figure 4b: Size groups relative to All Share



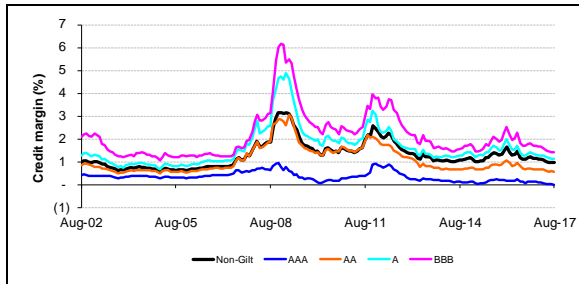
Mid Cap and Small Cap fell in relative terms this month.

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 (%)
Mar '17	2.50	1.76	0.74
Apr '17	2.50	1.75	0.75
May '17	2.41	1.71	0.70
Jun '17	2.55	1.89	0.66
Jul '17	2.53	1.88	0.65
Aug '17	<b>2.38</b>	<b>1.72</b>	<b>0.66</b>

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

Category	Mkt Val @ Aug 17 & 14, 11			Weight (%)
	Aug 17	Aug 14	Aug 11	
Gilts (41)	1,358	1,181	874	70.1
Non Gilts (1,039)	579	554	469	29.9
AAA (132)	112	104	126	5.8
AA (171)	90	94	78	4.6
A (324)	164	179	163	8.5
BBB (412)	213	177	103	11.0

Category	Mkt Val @ Aug 17 & 14		W't (%)	Dur'n (yrs)
Gilts (41)	1,358	1,181	70.1	11.9
< 5 Yrs (11)	380	344	19.6	3.0
5-15 Yrs (12)	380	383	19.6	8.2
> 15 Yrs (18)	598	454	30.9	20.0
Non Gilts (1,039)	579	554	29.9	8.2
< 5 Yrs (369)	181	162	9.3	2.8
5-15 Yrs (448)	246	231	12.7	7.7
> 15 Yrs (222)	152	160	7.8	15.5

**£ Gilt Market “main” Issuance**

- o £3.16bn ¾% 2023 (2.90x, 0.64%, Jul 17)
  - o £2.25bn 1¼% 2027 (2.56x, 1.27%, Jul 17)
  - o £1.00bn 1/8% IL 2026 (2.94x, ry -1.85%, Jun 17)
- Note: Issuance amounts are nominals.

**Tables 2d, 2e: € Market Size and Maturity (Aug 17)**

Category	Mkt Val (€bn)	Weight (%)
Sovereigns (341)	5,949	59.5
Non Sovereigns	4,055	40.5
AAA (800)	1,162	11.6
AA (629)	1,017	10.2
A (870)	857	8.6
BBB (1,162)	1,019	10.2

Category	Mkt Val (€bn)	Weight (%)
1 – 3 Yrs (821)	2,163	21.6
3 – 5 Yrs (1,010)	2,137	21.4
5 – 7 Yrs (809)	1,693	16.9
7 – 10 Yrs (759)	1,826	18.3
10+ Yrs (403)	2,185	21.8

**Table 2f: Breakdown of £ Index-Linked Market**

Category (Number of issues)	Mkt Val (€bn @ Aug 17 & 14)		W't (%)	Dur'n (yrs)
Gilts (28)	668	437	100.0	22.7
< 5 Yrs (3)	51	44	7.6	1.7
5 – 15 Yrs (7)	152	132	22.7	8.3
> 15 Yrs (18)	465	261	69.6	29.8

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

Month End	US (%)	Euro (%)	Sterling (%)
Mar '17	5.43	3.42	5.59
Apr '17	5.30	3.23	5.49
May '17	5.24	3.10	5.30
Jun '17	5.32	3.09	5.42
Jul '17	5.21	2.97	5.35
Aug '17	<b>5.28</b>	<b>3.00</b>	<b>5.33</b>

Sources: DMO, FTSE, iBoxx, J&A, MLX

