



Investment Update October 2018

Investment Headlines & Comment

- A poor month for equity markets, particularly in the Far East and Emerging Markets.
- The initial drops in the first half of October were countered slightly at the month end.
- Heavy demand for the second auction of the 2071 gilt, but well below levels seen in May.

Feature Section

This month, in the light of the 2018 Budget, we revisit the UK's government debt and deficit positions. We last looked at this in our [November 2017](#) issue.

Figure 1a shows the redemption profile of the gilt market, including those purchased under the Asset Purchase Facility (APF, aka the QE bit). Interestingly, £127bn (nominal) of the QE portfolio will have already matured by the end of the current tax year, but thus far it has actually been reinvested in further QE purchases, rather than letting the QE portfolio reduce. The latest [quarterly review of the APF](#) shows the reinvestment of the small maturity proceeds from the gilt which matured in July 2018. It will be interesting to see the action on the larger £17.8bn maturing in March 2019.

Of the £354bn (nominal) QE that continues (which has a market value of around £435bn), £102bn matures before the next "scheduled" General Election, and will thus eventually get reissued to new investors (instead of reinvested by the Bank), within an overall expected £276bn of reissuance. Figure 1b updates the profile of the Public Sector Net Borrowing (PSNB) Requirement as a % of Gross Domestic Product (GDP) – it shows a declining deficit (down to below 1% of GDP by 2022/23), but there will still be £82bn of new issuance to add to the £276bn of reissuance.

Figure 1c shows how the Debt to GDP ratio is affected by the revised projected borrowing – for example, it now has the ratio for the 2019/20 year at 82.8% instead of the previous projections of 77.2% (in 2016) and 86.1% (in 2017). The extent of this variability acts as a reminder of how difficult even short-term projections can be. Finally, Figure 1d shows the interest that is being paid on the debt portfolio as % of GDP. In £ terms it is now c.£40bn, but is no longer projected to fall (presumably anticipating a rise in gilt yields for the reissuance portfolio). It is then expected to rise to £47bn by 2023/24 (and as mentioned last year, that interest cost could then rise sharply through the impact of Corbynomics, such as utility re-nationalisations, if there is a change of governing party).

Figure 1a: Gilt portfolio redemption profile

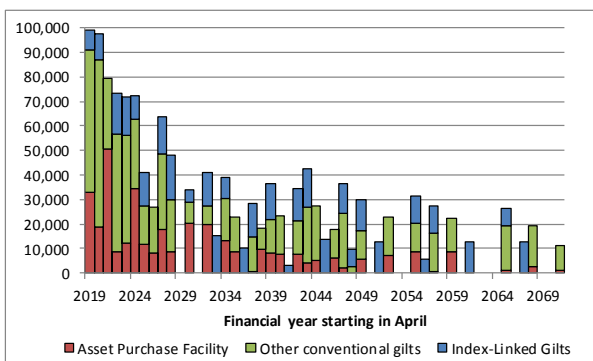


Figure 1c: Debt to GDP ratio

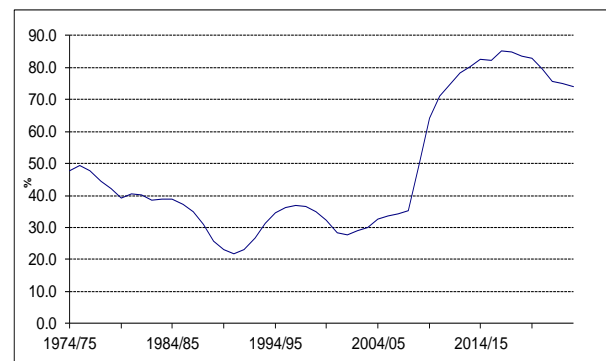


Figure 1b: Public Sector Net Borrowing

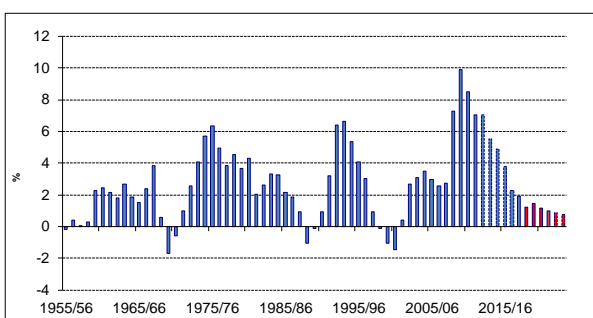
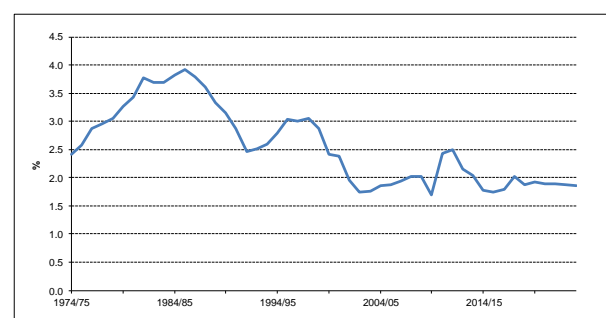


Figure 1d: Debt Interest relative to GDP



Sources: DMO, OBR



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 2018

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	-5.2	-7.2	-1.5	7.8	5.5	9.9	5.7
Overseas Equities	-5.6	-3.6	4.1	15.9	12.3	13.3	7.7
US Equities	-5.0	-0.8	11.4	18.8	16.4	16.0	6.4
Europe ex UK Equities	-6.0	-7.7	-5.1	11.0	7.1	9.9	8.2
Japan Equities	-6.9	-3.2	0.3	12.9	10.6	9.7	5.6
Pacific ex Japan Equities	-8.4	-10.1	-8.4	13.5	7.5	13.0	10.0
Emerging Markets	-6.8	-9.2	-8.7	13.9	5.9	10.8	10.8
UK Long-dated Gilts	1.2	-1.5	2.0	6.5	8.2	8.3	6.4
UK Long-dated Corp. Bonds	0.5	-0.7	-0.9	7.0	6.8	9.1	6.8
UK Over 5 Yrs Index-Linked Gilts	3.1	1.1	3.5	8.7	8.9	9.3	7.3
High Yield (Global)	0.3	1.5	3.1	13.1	8.8	13.8	8.4
Overseas Bonds	1.1	0.6	1.7	8.1	4.8	4.9	5.1
Property *	0.6	1.7	9.9	7.8	11.6	7.4	8.4
Cash	0.1	0.2	0.7	0.5	0.5	0.7	2.9
Commodities £-converted	-3.9	1.6	15.9	7.6	-6.6	-4.5	2.2
Hedge Funds original \$ basis *	-0.2	0.6	4.0	5.4	4.1	4.6	6.9
Illustrative £-converted version *	-0.6	1.8	7.0	10.7	8.7	7.9	8.3
Euro relative to Sterling	-0.4	-0.6	1.1	7.4	0.9	1.2	-
US \$ relative to Sterling	2.1	2.7	3.9	6.5	4.7	2.4	1.4
Japanese Yen relative to Sterling	2.7	1.8	4.6	8.9	1.8	1.0	1.5
Sterling trade weighted	-0.4	0.0	-0.6	-5.7	-1.2	-1.2	-1.1
Price Inflation (RPI) *	0.0	0.9	3.3	3.1	2.4	2.7	2.8
Price Inflation (CPI) *	0.1	0.8	2.4	2.1	1.5	2.2	2.0
Price Inflation (RPIX) *	0.0	0.9	3.3	3.2	2.5	3.0	2.9
Earnings Inflation **	-0.8	-0.1	3.2	2.6	2.4	1.9	3.0
All Share Capital Growth	-5.4	-8.2	-5.2	3.9	1.7	6.0	2.2
Dividend Growth	0.6	3.3	5.5	8.1	6.0	3.2	4.4
Earnings Growth	1.7	1.4	78.4	16.5	8.7	3.0	4.8

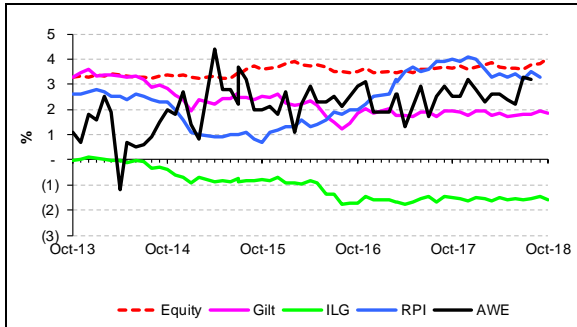
Note: All market returns are total returns for pension funds with income reinvested monthly. Indices used are as follows:

- 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.

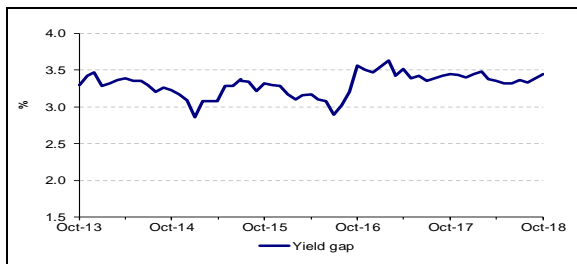


Yields and Yield Gaps

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.

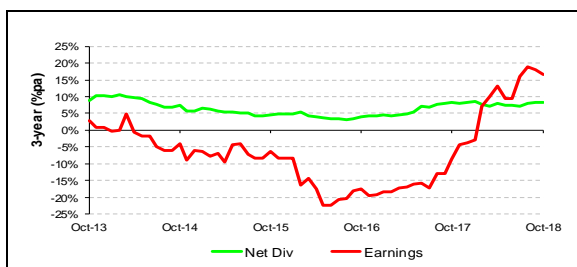
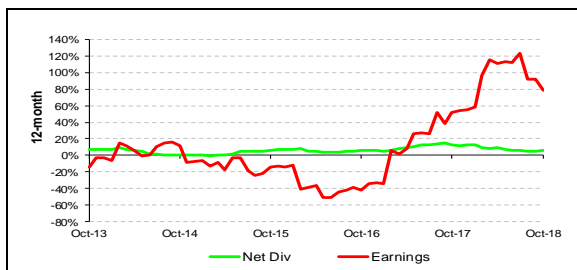


The gap gives a current expectation around 3.5% for longer-term inflation including the risk premium for gilts, relative to index-linked gilts.

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]

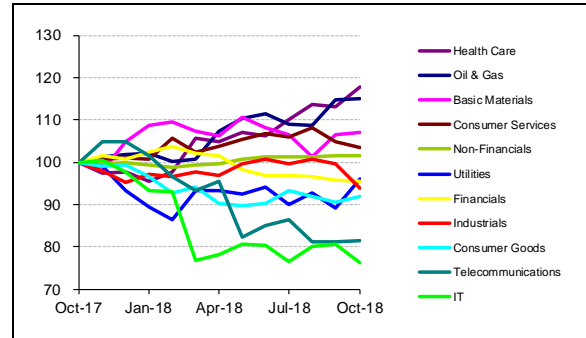
Figure 3: Dividend & Earnings Growth



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



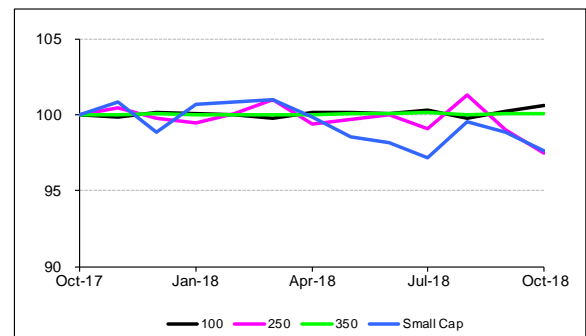
Note: Sector labels for relative lines are in end-value order

There was a modest rise this month in the rolling 12-month sector dispersion (from 39% to 42%).

(% absolute return)	1 mth	3 mth	12 mth
Oil & Gas	-4.8	-1.8	13.4
Basic Materials	-4.7	-6.8	5.4
Industrials	-10.7	-12.5	-7.6
Consumer Goods	-3.8	-8.4	-9.4
Health Care	-1.3	-0.7	15.9
Consumer Services	-6.6	-9.3	1.9
Telecommunications	-4.9	-12.5	-19.8
Utilities	2.2	-0.8	-5.3
Non-Financials	-5.2	-6.7	0.1
Financials	-5.3	-8.4	-5.9
IT	-10.4	-7.7	-25.0
All Share	-5.2	-7.2	-1.5

UK Equity Size Returns

Figure 4b: Size groups relative to All Share



Mid Cap and Small Cap both 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

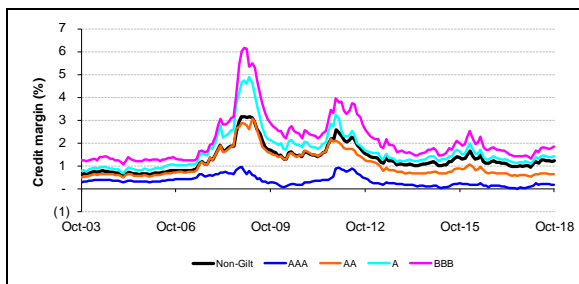


Table 2a: Over 15 Yr Corporate Yields & Margins

Month End	iBoxx Corp AA Y'ld (%)	FT 20 yr Gilt (%)	Margin (%)
May '18	2.64	1.72	0.92
Jun '18	2.70	1.76	0.94
Jul '18	2.70	1.79	0.91
Aug '18	2.66	1.79	0.87
Sep '18	2.79	1.93	0.86
Oct '18	2.74	1.86	0.88

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

Category	Mkt Val @ Oct 18 & 15, 12			Weight (%)
	Oct 18	Oct 15	Oct 12	
Gilts (42)	1,289	1,200	1,091	69.3
Non Gilts (1,091)	572	530	529	30.7
AAA (146)	117	97	139	6.3
AA (165)	82	96	66	4.4
A (343)	162	155	176	8.7
BBB (437)	210	182	149	11.3

Category	Mkt Val @ Oct 18 & 15		W't (%)	Dur'n (yrs)
Gilts (42)	1,289	1,200	69.3	12.0
< 5 Yrs (11)	346	350	18.6	2.9
5-15 Yrs (11)	336	325	18.1	7.9
> 15 Yrs (20)	606	525	32.6	19.5
Non Gilts (1,091)	572	530	30.7	7.7
< 5 Yrs (385)	190	158	10.2	2.7
5-15 Yrs (472)	241	229	13.0	7.4
> 15 Yrs (234)	140	144	7.5	15.3

Tables 2d, 2e: € Market Size and Maturity (Oct 18)

Category	Mkt Val (€bn)	Weight (%)
Sovereigns (361)	6,125	59.0
Non Sovereigns	4,253	41.0
AAA (880)	1,200	11.6
AA (706)	1,076	10.4
A (996)	918	8.8
BBB (1,289)	1,058	10.2

Category	Mkt Val (€bn)	Weight (%)
1 – 3 Yrs (986)	2,385	23.0
3 – 5 Yrs (1,119)	2,110	20.3
5 – 7 Yrs (893)	1,739	16.8
7 – 10 Yrs (790)	1,900	18.3
10+ Yrs (444)	2,243	21.6

Table 2f: Breakdown of £ Index-Linked Market

Category (Number of issues)	Mkt Val (£bn @ Oct 18 & 15)		W't (%)	Dur'n (yrs)
Gilts (30)	680	481	100.0	22.2
< 5 Yrs (3)	59	49	8.7	2.5
5 – 15 Yrs (8)	158	125	23.3	8.8
> 15 Yrs (19)	463	306	68.0	29.3

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

Month End	US (%)	Euro (%)	Sterling (%)
May '18	6.10	3.55	6.10
Jun '18	6.17	3.69	5.69
Jul '18	6.06	3.51	5.65
Aug '18	6.02	3.61	5.68
Sep '18	6.02	3.58	5.78
Oct '18	6.45	3.91	5.84

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

£ Gilt Market "main" Issuance

- £3.00bn, 1% 2024 (1.73x, 1.30%, 0%, Sept '18)
- £5.25bn, 1⁵/₈% 2071 (5.39x, 1.92%, n/a, May '18)
- £1.10bn IL 1¹/₈% 2028 (2.19x, ry -1.72%, 0%, Aug '18)

Note: Issuance amounts are nominals. The first % figure in each row is the yield or real yield. The second % figure is the additional amount taken up under the Post Auction Option Facility (PAOF), as a % of the amount of the issue. PAOF does not apply for syndication cases.

