

## Investment Update August 2018



### Investment Headlines & Comment

- A rather weak month for UK and most European equities.
- However, the US equity market continues defying gravity.
- The UK's bank base rate rose to 0.75% at the start of the month.

### Feature Section

This month we consider the way that short-term cash rates have evolved over the last 15 years across 5 major currencies. All data is from the FT, with the same vertical scale on all four charts, and taken at 5-year intervals. It is interesting to note that at each August time point, for each currency, there was relatively little difference between the immediate cash rate and the rate at the 1-year point (i.e. no major short-term hikes or cuts in interest rates were being anticipated).

Back in August 2003, there was a reasonable dispersion in interest rates across the 5 currencies. The Sterling 1-year rate was almost 2% higher than the Euro rate, but it was “normal” by historical standards. Over the next few years, the UK base rate was increased to 5.75% in a bid to bring inflation under greater control.

For August 2008, it's worth factoring in where things had got to in the “credit crunch”. Northern Rock had failed, and Bear Stearns had been bought by JP Morgan, however the next headache (the bail-out of Fannie Mae and Freddie Mac) had not yet quite happened. US rates had yet to fall.

5 years on, in August 2013, with Quantitative Easing (QE) in full force, all of the cash rates had slumped to near-zero levels, in an attempt to provide stimulus to world economies. The US was the first to start raising rates, with seven ¼% rises so far.

Reaching the present day, we find the rates for three of the currencies in negative territory (a feature most financial models for interest rates used to work hard to avoid!), and only the US rates are anywhere near their historic levels. However, quite when UK rates will next rise (and what triggers it) is very much open to debate!

Figure 1a: August 2003

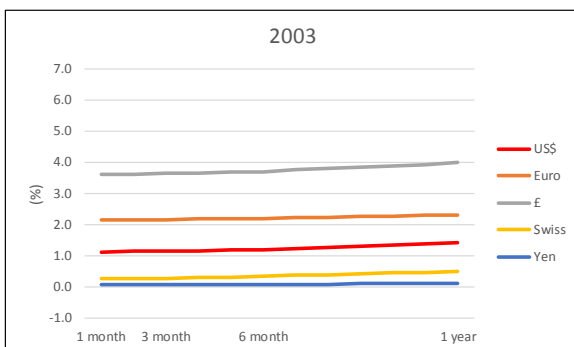


Figure 1c: August 2013

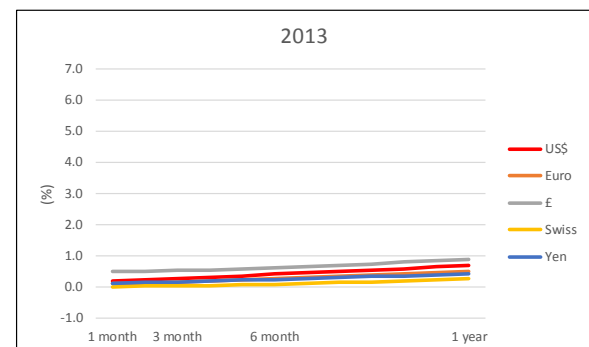


Figure 1b: August 2008

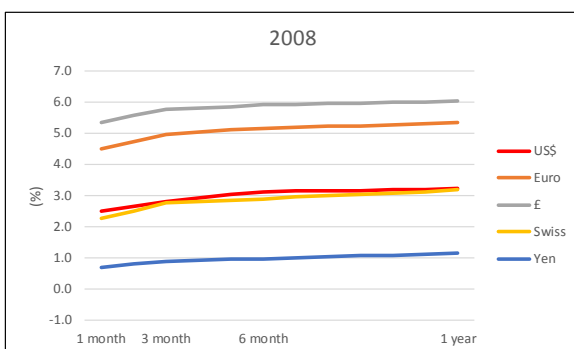
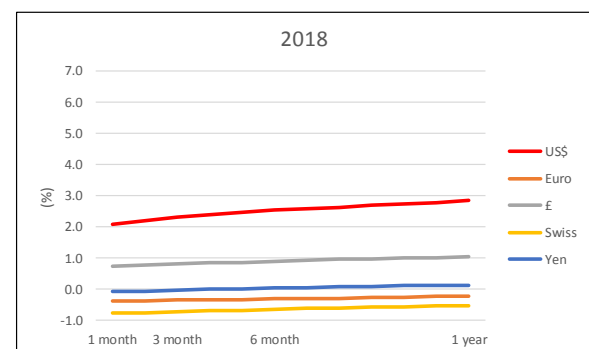


Figure 1d: August 2018





**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 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	<b>-2.8</b>	<b>-1.7</b>	4.7	10.2	7.6	7.5	6.1
Overseas Equities	2.0	6.2	11.3	19.5	14.7	11.4	8.7
US Equities	<b>4.2</b>	<b>10.2</b>	<b>18.6</b>	<b>22.6</b>	<b>18.4</b>	<b>14.7</b>	7.0
Europe ex UK Equities	<b>-1.5</b>	3.8	1.6	14.0	10.3	7.2	9.2
Japan Equities	1.0	0.2	8.5	15.4	12.5	8.5	6.5
Pacific ex Japan Equities	<b>-0.2</b>	<b>-1.2</b>	2.4	19.4	11.2	10.3	<b>12.3</b>
Emerging Markets	<b>-1.8</b>	<b>-2.2</b>	<b>-1.2</b>	18.3	9.2	7.4	12.1
UK Long-dated Gilts	0.1	<b>-1.5</b>	0.0	6.9	9.2	8.2	6.7
UK Long-dated Corp. Bonds	0.8	0.2	<b>-1.9</b>	7.5	7.9	8.1	6.8
UK Over 5 Yrs Index-Linked Gilts	<b>-0.7</b>	<b>-1.0</b>	<b>-1.8</b>	7.6	9.0	7.7	7.3
High Yield (Global)	0.7	3.5	0.4	12.7	8.7	11.9	8.2
Overseas Bonds	0.9	1.7	<b>-2.7</b>	8.4	4.6	6.0	5.5
Property *	0.6	2.2	10.7	8.2	11.8	6.9	8.5
Cash	0.0	0.2	0.5	<b>0.5</b>	<b>0.5</b>	<b>0.8</b>	<b>3.0</b>
Commodities £-converted	2.0	1.2	21.1	5.4	<b>-8.2</b>	<b>-7.7</b>	2.5
Hedge Funds original \$ basis *	0.5	1.0	5.1	4.0	4.3	3.8	6.4
Illustrative £-converted version *	1.2	6.0	5.7	10.2	7.4	8.1	7.6
Euro relative to Sterling	0.4	2.1	<b>-3.0</b>	7.1	1.0	1.0	-
US \$ relative to Sterling	0.9	2.4	<b>-0.9</b>	5.8	3.5	3.4	1.2
Japanese Yen relative to Sterling	1.9	0.3	<b>-1.6</b>	8.9	1.0	3.2	2.5
Sterling trade weighted	0.0	<b>-0.7</b>	4.3	<b>-5.4</b>	<b>-0.9</b>	<b>-1.4</b>	<b>-1.3</b>
Price Inflation (RPI) *	0.1	0.7	3.2	2.9	2.4	2.7	2.8
Price Inflation (CPI) *	0.0	0.4	2.5	1.9	1.5	2.2	2.0
Price Inflation (RPIX) *	0.1	0.7	3.3	3.0	2.5	3.0	2.9
Earnings Inflation **	1.3	<b>-9.5</b>	2.3	2.5	2.0	1.9	3.1
All Share Capital Growth	<b>-3.5</b>	<b>-2.7</b>	0.8	6.1	3.8	3.7	2.6
Dividend Growth	1.6	1.3	5.3	7.9	5.6	3.0	4.3
Earnings Growth	<b>-0.2</b>	3.1	92.1	18.9	8.0	3.1	4.8

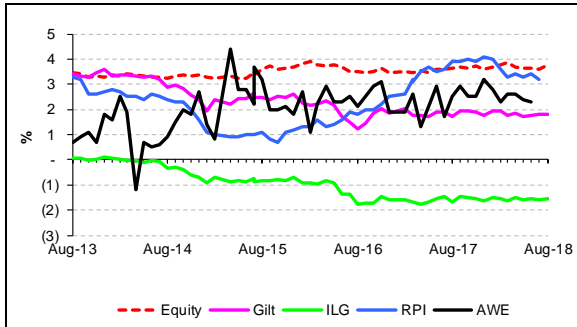
Note: All market returns are total returns for pension funds with income reinvested monthly. Indices used are as follows:

- 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.

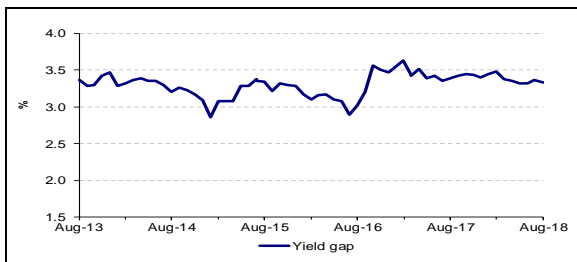


## Yields and Yield Gaps

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.

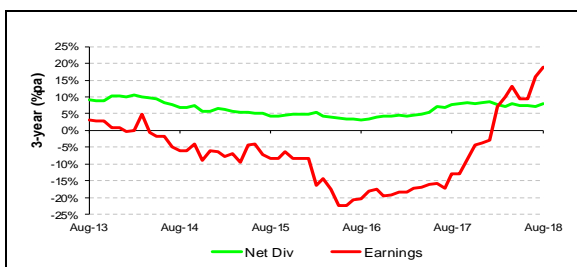
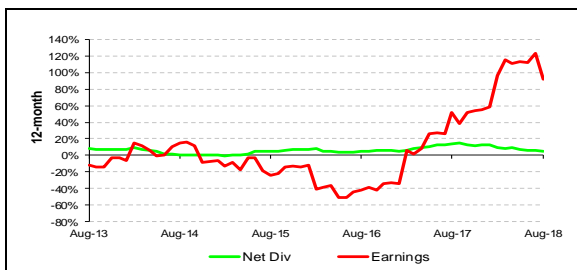


The gap gives a current expectation around 3.4% for longer-term inflation including the risk premium for gilts, relative to index-linked gilts.

## 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]

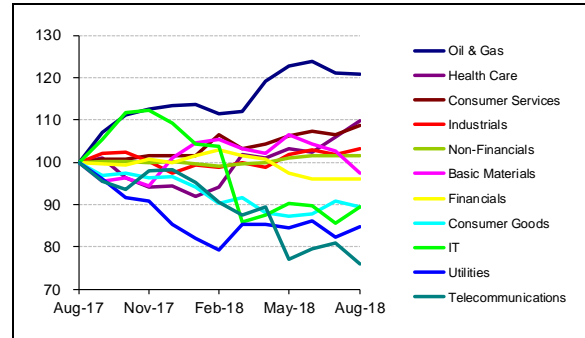
Figure 3: Dividend & Earnings Growth



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



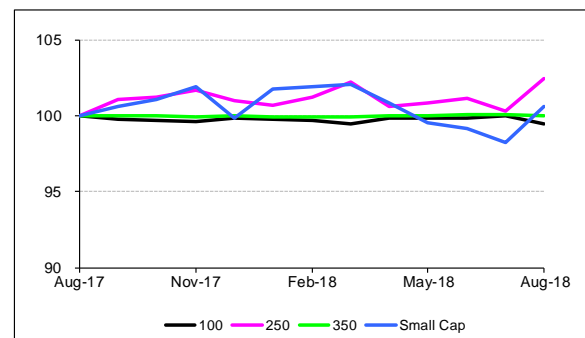
Note: Sector labels for relative lines are in end-value order

There was a slight rise this month in the rolling 12-month sector dispersion (from 42% to 45%).

(% absolute return)	1 mth	3 mth	12 mth
Oil & Gas	-2.9	-3.2	26.4
Basic Materials	-7.6	-10.0	1.9
Industrials	-1.5	-0.4	7.9
Consumer Goods	-4.1	0.7	-6.4
Health Care	0.6	4.5	14.8
Consumer Services	-0.7	0.7	13.9
Telecommunications	-8.6	-3.1	-20.5
Utilities	0.1	-1.4	-11.3
Non-Financials	-2.7	-1.2	6.2
Financials	-2.9	-3.2	0.4
IT	1.5	-2.5	-6.4
All Share	-2.8	-1.7	4.7

## UK Equity Size Returns

Figure 4b: Size groups relative to All Share



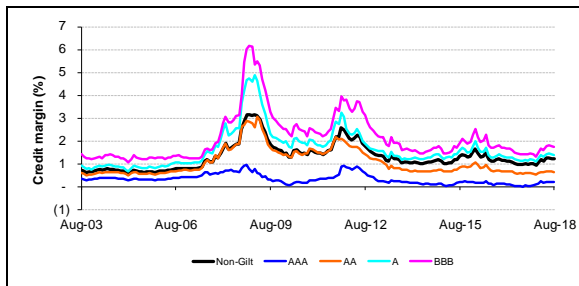
Mid Cap and Small Cap both rose in relative terms this month.

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 '18	2.56	1.74	0.82
Apr '18	2.65	1.85	0.80
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	<b>2.66</b>	<b>1.79</b>	<b>0.87</b>

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

Category	Mkt Val @ Aug 18 & 15, 12			Weight (%)
	Aug 18	Aug 15	Aug 12	
Gilts (42)	1,324	1,229	1,105	69.9
Non Gilts (1,079)	570	537	519	30.1
AAA (140)	114	100	139	6.0
AA (163)	81	97	65	4.3
A (343)	163	163	170	8.6
BBB (433)	212	177	145	11.2

Category	Mkt Val @ Aug 18 & 15		W't (%)	Dur'n (yrs)
Gilts (42)	1,324	1,229	69.9	12.0
< 5 Yrs (11)	349	361	18.5	2.7
5-15 Yrs (12)	359	344	18.9	7.8
> 15 Yrs (19)	615	525	32.5	19.8
Non Gilts (1,079)	570	537	30.1	7.9
< 5 Yrs (379)	186	162	9.8	2.8
5-15 Yrs (465)	239	228	12.6	7.4
> 15 Yrs (235)	145	147	7.7	15.4

**£ Gilt Market “main” Issuance**

- o £2.50bn, 1<sup>5</sup>/<sub>8</sub>% 2028 (2.25x, 1.46%, 0%, Jul 18)
  - o £1.10bn 1<sup>1</sup>/<sub>8</sub>% IL 2028 (2.29x, ry -1.79%, 0%, Jun 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.

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

Category	Mkt Val (€bn)	Weight (%)
Sovereigns (359)	6,130	59.3
Non Sovereigns	4,210	40.7
AAA (872)	1,200	11.6
AA (683)	1,058	10.2
A (975)	915	8.8
BBB (1,248)	1,037	10.0

Category	Mkt Val (€bn)	Weight (%)
1 – 3 Yrs (962)	2,296	22.2
3 – 5 Yrs (1,085)	2,159	20.9
5 – 7 Yrs (871)	1,738	16.8
7 – 10 Yrs (784)	1,895	18.3
10+ Yrs (435)	2,252	21.8

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

Category (Number of issues)	Mkt Val (£bn @ Aug 18 & 15)		W't (%)	Dur'n (yrs)
Gilts (30)	666	479	100.0	22.3
< 5 Yrs (3)	59	49	8.8	2.6
5 – 15 Yrs (8)	155	124	23.2	8.9
> 15 Yrs (19)	452	306	67.9	29.4

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

Month End	US (%)	Euro (%)	Sterling (%)
Mar '18	5.99	3.28	5.90
Apr '18	6.00	3.24	5.88
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	<b>6.02</b>	<b>3.61</b>	<b>5.68</b>

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

