



Investment Update December 2019

Investment Headlines & Comment

- A good month for UK Mid and Small Cap Equities.
- Sterling continued its rally. Gilt yields rose slightly.
- Credit margins have narrowed, back to levels from early 2018.

Feature Section

This month we reflect on issues arising from this month's General Election result. A Corbyn spending spree may have fallen away (for now, at least), but there are indications of increased expenditure plans by the newly-elected Government, not least away from the usual south-east recipients. How much scope do they have, and might past orthodoxies be facing a challenge?

Some readers may recall we last looked at the UK's debt and deficit in our [October 2018](#) issue. Figure 1a 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 2020/21, albeit before the new Government's spending increases), but there would still be at least £96bn of new issuance to add to the £413bn of reissuance over the next 5 years.

Figure 1b shows how the Debt to GDP ratio is affected by the projected borrowing – for example, it now has the ratio for the 2023/24 year at 73%, a level last seen in the 2011/12 year. Figure 1c shows the interest that is being paid on the debt portfolio as % of GDP. In £ terms it is now c.£40bn, but in % terms, it is set to be pretty static for the next few years at around 1.7%. The drop from the levels seen in the 1970s reflects the way that much of the current gilt market has been issued during the last 10 years at a time of markedly lower nominal gilt yields. Figure 1d looks at how the overall gilt interest rate has varied as a % of public sector net debt (this is a new chart, in case readers are wondering!).

Figure 1a: Public Sector Net Borrowing

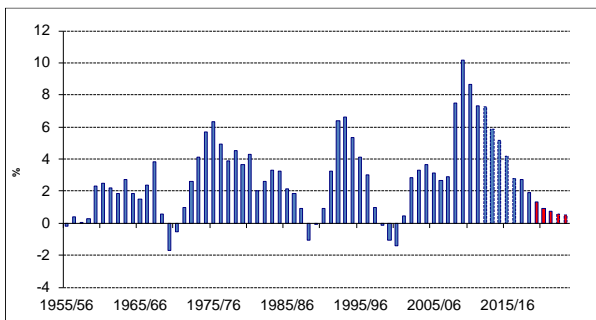


Figure 1c: Interest to GDP Ratio

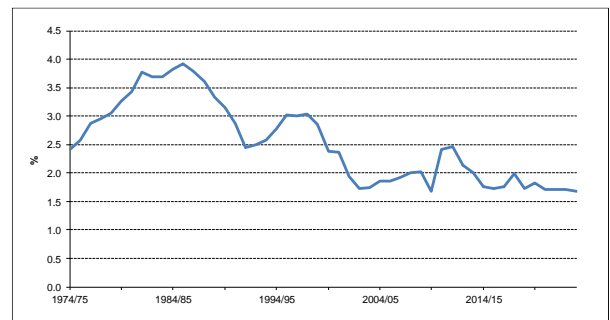


Figure 1b: Debt to GDP Ratio

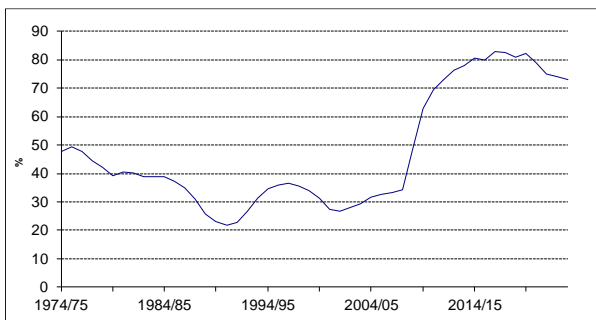
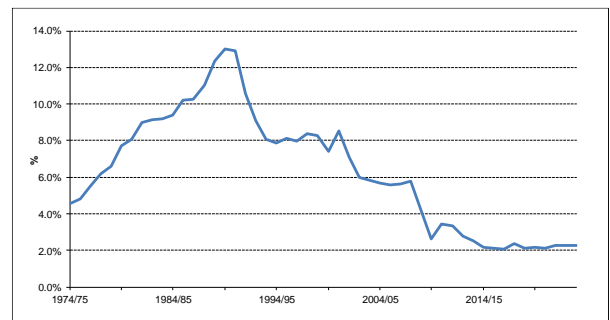


Figure 1d: Interest to Debt Ratio



Sources: DMO, OBR

In the past, conventional wisdom held that high ratios in Figure 1b were unsustainable and a recipe for disaster (although people didn't agree on just how high the tipping point was). However, given that disaster has not yet ensued at the ratios experienced in the UK since the credit crunch, perhaps the focus needs to shift to putting caps on the % figures in Figures 1c and 1d. So, for example, taking into account current targets for CPI inflation, it might be deemed acceptable if the interest % stayed below 2% of GDP, and then allowing for CPI/RPI differences (and a small positive real yield for investors, not that one of those has been around for a while), it might be deemed acceptable if the interest % stayed at or below 3% of the debt portfolio. On these measures, an increase in public spending might now be viewed as reasonable?



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 December 2019

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	3.3	4.2	19.2	6.9	7.5	8.1	4.8
Overseas Equities	1.1	1.4	22.6	10.6	13.0	11.9	6.5
US Equities	0.6	1.6	26.6	12.7	15.3	15.8	5.6
Europe ex UK Equities	1.2	1.2	21.2	8.8	10.5	7.9	7.2
Japan Equities	-0.3	0.2	14.8	6.7	11.9	9.2	2.5
Pacific ex Japan Equities	3.2	2.8	14.5	8.9	9.9	8.3	8.6
Emerging Markets	5.0	4.1	14.3	9.4	9.5	6.1	8.2
UK Long-dated Gilts	-2.4	-6.6	12.0	5.1	6.6	8.7	6.7
UK Long-dated Corp. Bonds	-0.6	-2.0	17.4	6.0	6.9	8.6	7.2
UK Over 5 Yrs Index-Linked Gilts	-1.9	-9.4	6.8	2.9	6.5	8.5	7.0
High Yield (Global)	-0.3	-3.8	9.3	4.2	9.4	9.3	8.1
Overseas Bonds	-2.2	-7.7	1.5	1.5	5.7	4.1	5.4
Property *	0.0	0.4	2.3	7.3	7.7	9.5	7.9
Cash	0.1	0.2	0.8	0.6	0.6	0.6	2.6
Commodities £-converted	4.5	0.8	13.1	0.0	-1.2	-3.5	0.7
Hedge Funds original \$ basis *	1.1	1.6	5.8	4.3	3.2	4.0	5.5
Illustrative £-converted version *	1.2	-4.4	4.4	3.1	7.2	6.5	6.6
Euro relative to Sterling	-0.6	-4.2	-5.6	-0.2	1.8	-0.5	1.6
US \$ relative to Sterling	-2.4	-7.0	-3.9	-2.3	3.3	2.0	1.0
Japanese Yen relative to Sterling	-1.6	-7.5	-2.9	0.0	5.4	0.4	0.7
Sterling trade weighted	0.7	4.9	4.7	1.4	-1.7	0.0	-1.1
Price Inflation (RPI) *	0.2	-0.2	2.2	3.1	2.5	3.0	2.8
Price Inflation (CPI) *	0.2	0.1	1.4	2.3	1.6	2.2	2.0
Price Inflation (RPIX) *	0.2	-0.2	2.3	3.1	2.6	3.1	2.9
Earnings Inflation **	-0.3	-1.0	2.4	3.1	2.8	2.2	2.9
All Share Capital Growth	3.2	3.3	14.2	2.7	3.5	4.3	1.3
Dividend Growth	0.2	0.4	4.7	8.5	7.6	6.9	4.7
Earnings Growth	-0.9	-5.7	-24.0	23.0	1.3	5.1	3.8

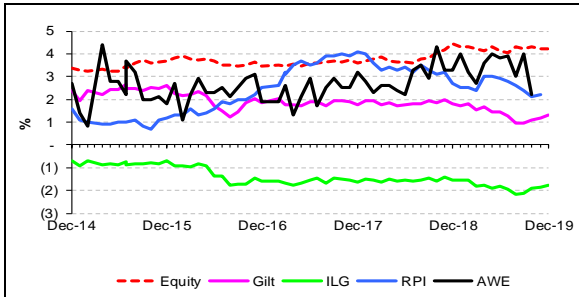
Note: All market returns are total returns for pension funds with income reinvested monthly. Indices used are as follows:

- UK Equities (incl. dividends and earnings) – FT-A All Share.
- Overseas Equities (incl. regions) – blend of FT All-World / World sub-indices
- 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 – MLX 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.

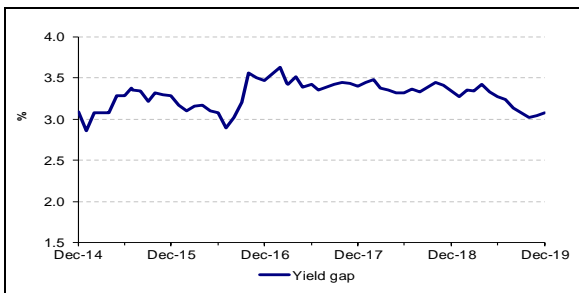


Yields and Yield Gaps

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.

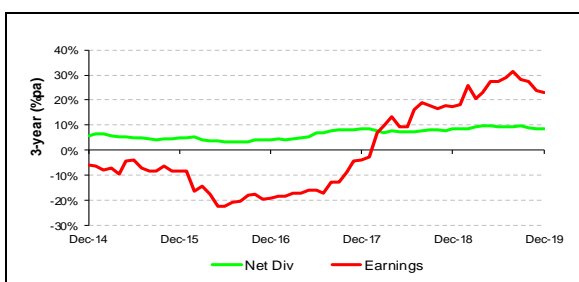
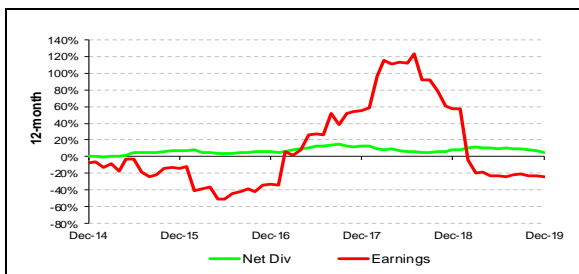


The gap gives a current expectation around 3.1% for longer-term inflation including the risk premium for gilts, relative to index-linked gilts.

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]

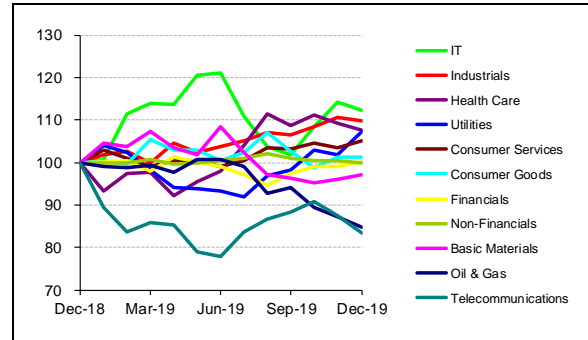
Figure 3: Dividend & Earnings Growth



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



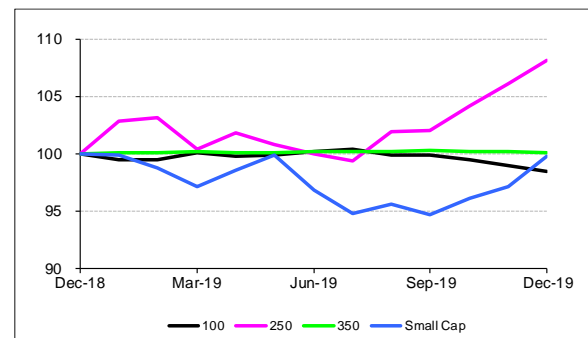
Note: Sector labels for relative lines are in end-value order

There was a slight fall this month in the rolling 12-month sector dispersion (from 32% to 29%).

(% absolute return)	1 mth	3 mth	12 mth
Oil & Gas	0.3	-6.2	1.0
Basic Materials	4.6	5.1	15.8
Industrials	2.8	7.5	30.9
Consumer Goods	3.3	2.6	20.5
Health Care	1.8	3.1	28.3
Consumer Services	4.9	6.0	25.2
Telecommunications	-1.6	-1.7	-0.8
Utilities	8.9	13.6	27.7
Non-Financials	2.9	3.1	19.1
Financials	4.4	7.2	19.4
IT	1.6	14.6	33.7
All Share	3.3	4.2	19.2

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

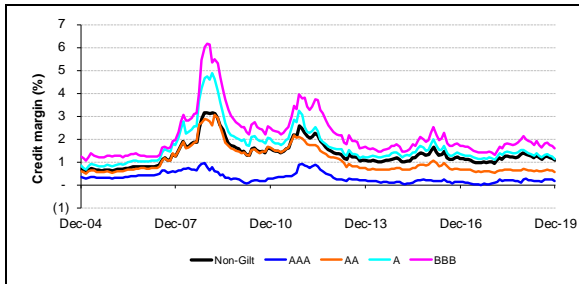


Table 2a: Over 15 Yr Corporate Yields & Margins

Month End	iBoxx Corp AA Y'ld (%)	FT 20 yr Gilt (%)	Margin (%)
Jul '19	2.08	1.27	0.81
Aug '19	1.80	0.97	0.83
Sept '19	1.80	0.95	0.85
Oct '19	1.91	1.10	0.81
Nov '19	1.94	1.18	0.76
Dec '19	1.99	1.30	0.69

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

Category	Mkt Val @ Dec 19 & 16, 13			Weight (%)
	Dec 19	Dec 16	Dec 13	
Gilts (42)	1,381	1,341	1,065	68.2
Non Gilts (1,162)	643	559	516	31.8
AAA (159)	133	110	104	6.6
AA (174)	88	92	84	4.3
A (354)	179	169	164	8.9
BBB (475)	242	187	164	12.0

Category	Mkt Val (£bn @ Dec 19 & 16)		W't (%)	Dur'n (yrs)
Gilts (42)	1,381	1,341	68.2	12.8
< 5 Yrs (10)	310	378	15.3	2.7
5-15 Yrs (12)	402	359	19.9	7.9
> 15 Yrs (20)	670	605	33.1	20.5
Non Gilts (1,162)	643	559	31.8	7.8
< 5 Yrs (414)	215	165	10.6	2.6
5-15 Yrs (515)	277	236	13.7	7.4
> 15 Yrs (233)	151	158	7.5	16.1

Tables 2d, 2e: € Market Size and Maturity (Dec 19)

Category	Mkt Val (€bn)	Weight (%)
Sovereigns (363)	6,646	58.3
Non Sovereigns	4,758	41.7
AAA (952)	1,284	11.3
AA (769)	1,163	10.2
A (1,142)	1,045	9.2
BBB (1,535)	1,267	11.1

Category	Mkt Val (€bn)	Weight (%)
1 – 3 Yrs (1,131)	2,467	21.6
3 – 5 Yrs (1,266)	2,378	20.8
5 – 7 Yrs (965)	1,874	16.4
7 – 10 Yrs (834)	1,940	17.0
10+ Yrs (565)	2,746	24.1

Table 2f: Breakdown of £ Index-Linked Market

Category (Number of issues)	Mkt Val (£bn @ Dec 19 & 16)		W't (%)	Dur'n (yrs)
Gilts (29)	729	617	100.0	21.6
< 5 Yrs (4)	94	34	12.8	2.9
5 – 15 Yrs (7)	152	146	20.9	9.9
> 15 Yrs (18)	483	437	66.3	28.9

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

Month End	US (%)	Euro (%)	Sterling (%)
Jul '19	5.66	3.22	5.57
Aug '19	5.60	3.10	5.52
Sept '19	5.49	3.11	5.48
Oct '19	5.54	3.17	5.38
Nov '19	5.45	3.08	5.25
Dec '19	5.15	2.92	4.94

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

£ Gilt Market "main" Issuance

- £3.16bn, 2% 2025 (2.39x, 0.56%, 15%, Jan 17)
- £3.16bn, 7/8% 2029 (2.23x, 0.74%, 15%, Nov 19)
- £2.08bn, 13/4% 2049 (2.08x, 1.29%, 4%, Nov 19)
- £0.50bn IL 1/8% 2048 (2.64x, ry -1.83%, 0%, Sep 19)

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.

