



## Investment Update November 2020

### Investment Headlines & Comment

- A major “vaccine relief” rally this month, Italy and Spain both up over 20% (in local terms).
- The EU has begun to issue “[social bonds](#)” – the €17bn issue was a whopping 14x subscribed.
- The UK is to start issuing “[green bonds](#)” in 2021, with the aim of having a suite of them.

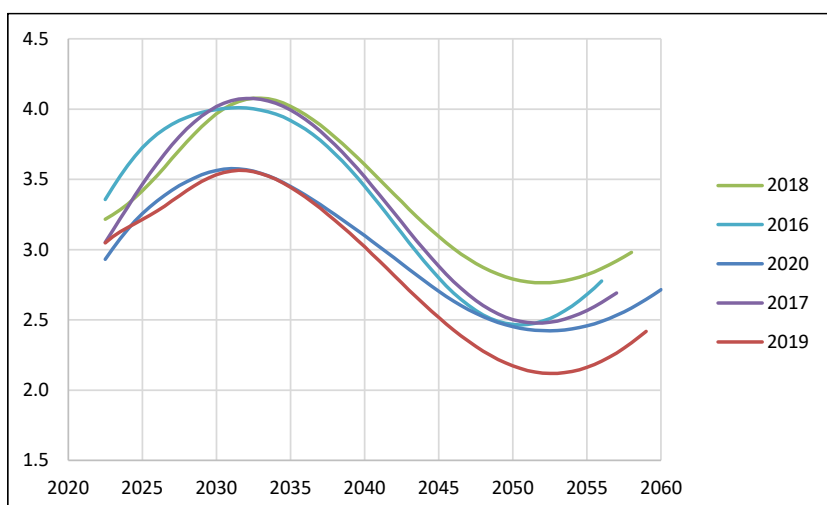
### Feature Section

This month we consider the prospects for UK inflation, following on from the confirmation of RPI moving to CPIH from 2030 – see our [February 2020](#) issue for more background on this, and the extent to which prospective RPI inflation would be lower as a result. As things stand, no compensation is to be paid to index-linked gilt (ILG) holders, but this position may be tested in the law courts in due course. CPIH-based RPI is likely to be around 0.25% p.a. higher than CPI.

The “standard” source for prospective RPI data is the [Bank of England’s 40-year curves](#) generated from the gilt and ILG markets. This dataset is used by pension actuaries in their valuations, albeit sometimes with a modest deduction to reflect the comparative scarcity of index-linked gilts relative to conventional gilts. It’s an interesting (and open) question as to how much that deduction should vary at each future maturity point. A separate (further) deduction is often made to approximate CPI, in the absence of CPI-based ILGs.

In our [August 2020](#) issue, we noted the potential distortion of the gilt market by the Quantitative Easing programme. It seems fair to ask whether that distortion extends through to the implied inflation outputs. Figure 1 below shows the forward rates (i.e. year-by-year) as at 30 November for each year from 2016 through to 2020. Across the 20-year period, inflation is currently projected to average out at 3.4% p.a. and for the 40-year period, it averages out at 3% p.a. Both are well above the 2% p.a. CPI target, particularly given the change of RPI to CPIH in 2030, which suggests distortions may well be present. For those wondering why the curves in Figure 1 do not start “now”, bear in mind the next ILG maturity is in November 2022, and after that it will be March 2024. There are quite a few years in the next few decades where there are no maturing ILGs, so that quirk on not having short-term estimates will keep recurring.

**Figure 1: Forward inflation rates as at 30 November**



One thing to note is that the curves are remarkably similar in general shape across the years in which the projection is made.

Also, market prices imply investors expect a major pick up in RPI over the next couple of years from the latest (low) 12-month figure of 1.3%. For each projection, 2030 or just after seems to be the recurring “peak”, albeit with the expected level varying according to the year the projection is made, and 2050-2055 seems to be the recurring “low” point.

If the 2020 projection is used unadjusted, how far out is a “Figure 1” inflation-linked liability relative to the 2% p.a. CPI target or the 2¼% p.a. CPIH estimate? If we are charitable and assume the 10-year projection is accurate, but divergence applies from that point onwards, then by 2040, the cumulative projected RPI exceeds target CPI by 58% and CPIH estimate by 55%. By 2050, the gaps are 70% and 62% respectively. (If you take the view that the 10-year projection itself is an over-estimate, the gaps are even worse.) This prompts the question of whether there is serious over-valuation of inflation-linked liabilities going on, with knock-on consequences for decisions by sponsoring employers. Which values should Trustees believe?



**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 30 November 2020**

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	12.7	6.6	<b>-10.3</b>	<b>-0.6</b>	4.1	5.9	4.5
Overseas Equities	8.7	6.5	13.1	10.5	14.7	12.1	7.1
US Equities	8.1	4.7	15.9	<b>14.4</b>	<b>17.2</b>	<b>16.1</b>	6.0
Europe ex UK Equities	<b>13.7</b>	7.4	6.5	5.3	10.4	8.7	7.7
Japan Equities	8.6	<b>12.0</b>	8.9	5.3	10.7	9.0	3.7
Pacific ex Japan Equities	6.1	9.8	<b>18.2</b>	7.5	14.4	8.1	<b>10.4</b>
Emerging Markets	5.8	7.6	15.1	5.8	13.8	5.6	10.0
UK Long-dated Gilts	<b>-0.7</b>	1.1	8.2	8.5	8.4	9.0	6.9
UK Long-dated Corp. Bonds	3.0	4.1	10.6	8.7	9.1	8.9	7.3
UK Over 5 Yrs Index-Linked Gilts	0.1	2.7	9.7	6.7	8.5	9.1	7.4
High Yield (Global)	1.4	3.8	4.4	5.7	10.1	8.3	8.2
Overseas Bonds	<b>-2.0</b>	1.3	5.2	5.0	7.2	4.0	5.2
Property *	0.4	0.9	<b>-2.5</b>	3.1	4.5	7.5	7.1
Cash	0.0	<b>0.0</b>	0.4	0.6	<b>0.5</b>	<b>0.6</b>	<b>2.4</b>
Commodities £-converted	8.5	4.0	<b>-25.4</b>	<b>-8.2</b>	<b>-2.4</b>	<b>-7.0</b>	<b>-3.7</b>
Hedge Funds original \$ basis *	0.2	1.6	4.0	2.6	3.8	3.5	4.9
Illustrative £-converted version *	0.2	3.1	4.1	3.5	7.6	5.7	5.6
Euro relative to Sterling	<b>-0.5</b>	0.4	5.1	0.6	5.0	0.7	1.9
US \$ relative to Sterling	<b>-3.1</b>	<b>-0.1</b>	<b>-3.1</b>	0.5	2.4	1.6	0.3
Japanese Yen relative to Sterling	<b>-2.9</b>	0.8	1.8	2.9	5.9	<b>-0.6</b>	0.6
Sterling trade weighted	1.1	<b>-0.5</b>	<b>-2.0</b>	<b>-0.1</b>	<b>-3.4</b>	<b>-0.4</b>	<b>-1.1</b>
Price Inflation (RPI) *	0.0	0.0	1.3	2.2	2.5	2.7	2.7
Price Inflation (CPI) *	0.0	0.0	0.7	1.5	1.7	1.9	2.0
Price Inflation (RPIX) *	0.0	0.0	1.5	2.3	2.7	2.8	2.8
Earnings Inflation **	1.2	3.0	2.4	3.1	2.9	2.2	2.9
All Share Capital Growth	12.4	6.0	<b>-12.9</b>	<b>-4.2</b>	0.3	2.2	0.9
Dividend Growth	<b>-7.8</b>	<b>-13.0</b>	<b>-23.4</b>	<b>-4.3</b>	0.7	4.0	3.5
Earnings Growth	5.1	5.4	<b>-25.3</b>	<b>-2.8</b>	<b>-1.5</b>	<b>-2.7</b>	1.6

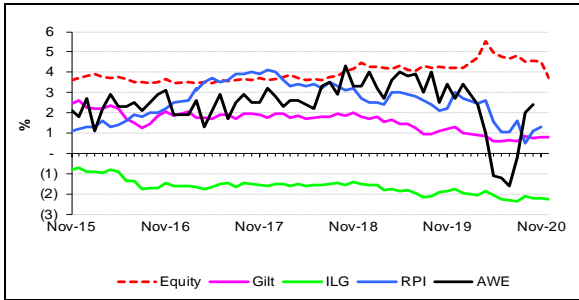
Note: All market returns are total returns for pension funds with income reinvested monthly. Indices used are as follows:

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

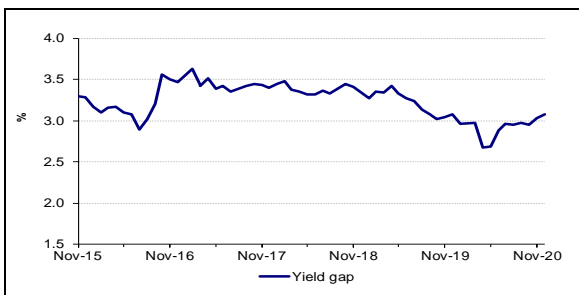


## Yields and Yield Gaps

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.

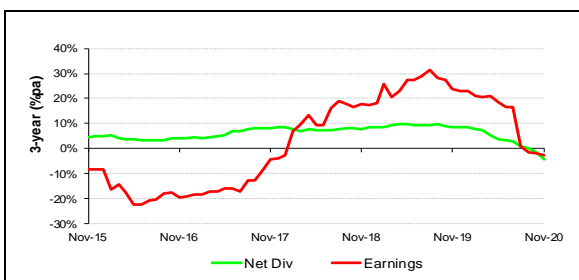
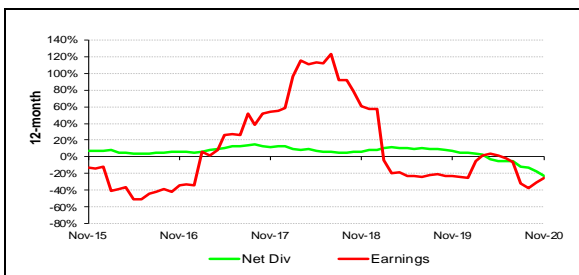


The gap gives a current expectation around 3.1% for longer-term inflation including the risk premium for gilts, relative to index-linked gilts.

## 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]

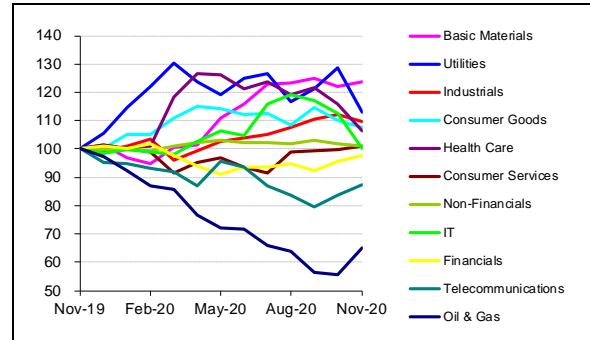
Figure 3: Dividend & Earnings Growth



Note: Earnings data from mid-2015 onwards is no longer reliable as one-off events may be affecting the prospective P/E ratios

## UK Equity Sector Returns

Figure 4a: Sectors relative to All Share



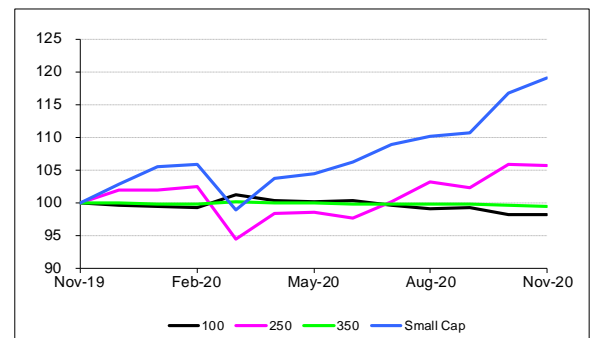
Note: Sector labels for relative lines are in end-value order

There was a marked fall this month in the rolling 12-month sector dispersion (down from 73% to 59%).

(% absolute return)	1 mth	3 mth	12 mth
Oil & Gas	31.6	8.7	-41.8
Basic Materials	14.2	6.8	10.8
Industrials	10.3	8.7	-1.5
Consumer Goods	10.1	5.8	-3.4
Health Care	3.6	-4.7	-4.5
Consumer Services	14.1	8.9	-9.4
Telecommunications	17.9	11.3	-21.6
Utilities	-0.8	3.3	1.5
Non-Financials	11.8	5.5	-9.6
Financials	15.4	9.9	-12.3
IT	0.4	-10.2	-10.0
All Share	12.7	6.6	-10.3

## UK Equity Size Returns

Figure 4b: Size groups relative to All Share



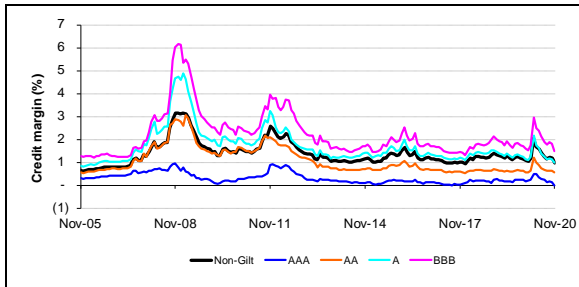
Within the UK Equity market rally, Small Cap rose in relative terms this month, but Mid Cap fell very slightly in relative terms.

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 (%)
Jun '20	1.45	0.64	0.81
Jul '20	1.37	0.60	0.77
Aug '20	1.60	0.86	0.74
Sep '20	1.53	0.74	0.79
Oct '20	1.65	0.79	0.86
Nov '20	<b>1.52</b>	<b>0.82</b>	<b>0.70</b>

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

Category	Mkt Val @ Nov 20 & 17, 14			Weight (%)
	Nov 20	Nov 17	Nov 14	
Gilts (48)	1,762	1,344	1,207	72.2
Non-Gilts (1,167)	679	575	555	27.8
AAA (145)	134	113	105	5.5
AA (156)	86	88	94	3.5
A (370)	191	161	179	7.8
BBB (496)	268	213	176	11.0

Category	Mkt Val (£bn @ Nov 20 & 17)	W't (%)	Dur'n (yrs)
Gilts (48)	1,762	1,344	72.2
< 5 Yrs (12)	417	403	17.1
5-15 Yrs (13)	501	353	20.5
> 15 Yrs (23)	843	588	34.6
Non-Gilts (1,167)	679	575	27.8
< 5 Yrs (431)	231	187	9.5
5-15 Yrs (500)	283	238	11.6
> 15 Yrs (236)	164	150	6.7

**Tables 2d, 2e: € Market Size and Maturity (Nov 20)**

Category	Mkt Val (€bn)	Weight (%)
Sovereigns (403)	7,605	59.6
Non-Sovereigns	5,154	40.4
AAA (994)	1,409	11.0
AA (797)	1,187	9.3
A (1,253)	1,132	8.9
BBB (1,711)	1,426	11.2

Category	Mkt Val (€bn)	Weight (%)
1 – 3 Yrs (1,267)	2,660	20.8
3 – 5 Yrs (1,325)	2,478	19.4
5 – 7 Yrs (1,013)	2,053	16.1
7 – 10 Yrs (866)	2,191	17.2
10+ Yrs (687)	3,377	26.5

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

Category (Number of issues)	Mkt Val (£bn @ Nov 20 & 17)	W't (%)	Dur'n (yrs)
Gilts (28)	805	642	100.0
< 5 Yrs (3)	70	59	8.7
5 – 15 Yrs (8)	200	150	24.8
> 15 Yrs (17)	535	433	66.5

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

Month End	US (%)	Euro (%)	Sterling (%)
Jun '20	5.96	4.05	5.88
Jul '20	5.11	3.69	5.62
Aug '20	4.98	3.45	5.32
Sep '20	5.33	3.66	5.47
Oct '20	5.29	3.62	5.32
Nov '20	<b>4.65</b>	<b>2.85</b>	<b>4.47</b>

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

**£ Gilt Market “main” Issuance**

- o During the expanded gilt issuance programme, there is insufficient space here to list all the auction / tender exercises, so please click [here](#) for the details.

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. No PAOF applies for tender or syndication cases.

