

Investment Update February 2020



Investment Headlines & Comment

- Concerns over disruption from the Covid-19 virus led to local falls in many equity markets.
- Sterling had a poor month, and nominal gilt yields fell, with ultra-long yields now below 1%.
- Over £25bn of offers for the 2071 gilt tranche at a yield of 0.93% - is it financial insanity?

Feature Section

This month we consider the forthcoming consultation on changes to the Retail Prices Index (RPI) which was announced last September. At that time, this triggered a rise in Index-Linked Gilt (ILG) yields of around 0.2%, because of expectations of lower inflation under a CPIH-based measure relative to the current RPI approach (although some observers infer that there were also anticipatory rises ahead of the announcement). The change was proposed to be introduced at some point between 2025 and 2030. However, some investors (e.g. the fund manager Insight) are now claiming a real yield rise of 1% would be more appropriate (with a consequent large fall in many ILG prices) which they have based on the year-on-year data from 2010 onwards – but is that figure a plausible prospective amount?

The ONS has extended the CPIH dataset back to 1988, although it does not form part of “official” National Statistics prior to 2004. However, we have used that longer dataset to generate the following charts.

Figure 1a: Rolling 12-month measures

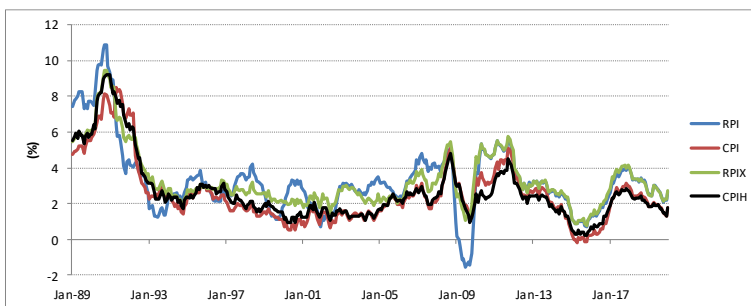


Figure 1b: Rolling 36-month measures

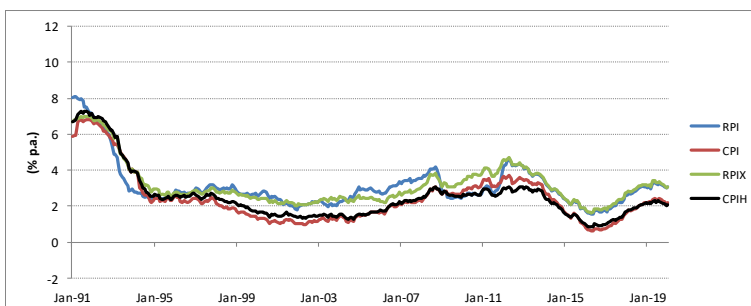
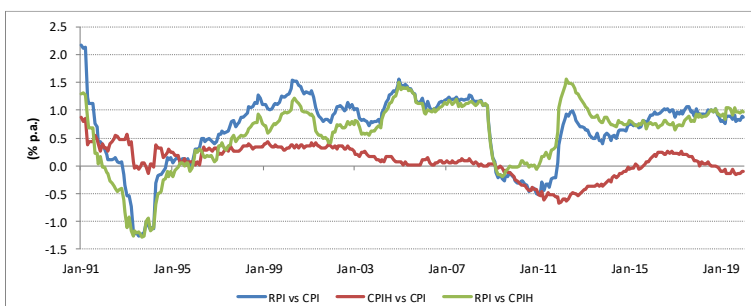


Figure 1c: Rolling 36-month differences



Source: ONS

The rolling 12-month data in Figure 1a acts as a reminder that inflation now often oscillates, with a burst of high or low inflation followed by the opposite, rather than being persistently high (or persistently low).

Once you move to rolling 36-month data, as per Figure 1b, that oscillation gets largely smoothed out, although the impact of extreme events (e.g. the period after the credit crunch) can still be significant.

Figure 1c is probably the most interesting of the charts, because it shows very little stability in the gap between RPI and CPIH. However, whilst a future 1% difference appears high, a 0.2% shift appears low, so perhaps a 0.5% shift is a more reasonable assumption.

Now, if there *were* pre-announcement yield moves, then we can infer that shift may already be priced in. The tricky bit is if it isn't, or the actual shift is bigger, or if it is smaller (e.g. because the Government moves RPI towards “CPIH plus a margin”) – these outcomes have very different effects on ILG pricing, the first two scenarios being negatives, and the third being a positive.

Welcome to betting on a Government ...



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 29 February 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	-8.9	-8.9	-1.4	1.5	3.6	6.8	4.6
Overseas Equities	-4.9	-4.4	9.4	6.8	10.7	10.9	6.3
US Equities	-5.2	-4.0	12.9	9.0	13.4	14.6	5.2
Europe ex UK Equities	-5.6	-6.0	6.9	5.3	7.3	7.4	7.2
Japan Equities	-6.4	-7.8	4.5	2.5	8.1	7.4	2.4
Pacific ex Japan Equities	-1.3	-1.5	4.3	4.4	7.7	7.7	8.8
Emerging Markets	-2.2	-1.7	2.6	4.4	7.1	5.4	7.5
UK Long-dated Gilts	2.1	5.9	21.0	7.3	8.2	9.8	7.1
UK Long-dated Corp. Bonds	-1.0	4.2	19.3	7.1	7.3	9.1	7.4
UK Over 5 Yrs Index-Linked Gilts	2.0	4.7	14.3	4.8	8.1	9.3	7.4
High Yield (Global)	1.5	1.9	10.3	4.1	9.4	8.8	8.1
Overseas Bonds	4.7	4.5	13.3	3.6	7.1	4.0	5.8
Property *	0.3	0.4	2.2	6.7	7.2	9.0	7.8
Cash	0.1	0.2	0.8	0.6	0.6	0.6	2.6
Commodities £-converted	-5.5	-11.5	-11.6	-4.8	-4.3	-5.4	-0.9
Hedge Funds original \$ basis *	-0.4	2.6	6.4	4.0	3.5	4.1	5.2
Illustrative £-converted version *	0.1	0.7	6.1	2.4	6.2	6.2	6.3
Euro relative to Sterling	2.3	0.9	0.5	0.2	3.5	-0.4	1.7
US \$ relative to Sterling	3.2	1.3	4.1	-0.9	3.9	1.8	1.1
Japanese Yen relative to Sterling	3.7	2.8	7.5	0.4	6.0	-0.2	1.2
Sterling trade weighted	-2.3	-0.9	-1.1	0.8	-2.7	0.1	-1.3
Price Inflation (RPI) *	-0.4	0.1	2.7	3.1	2.6	2.9	2.8
Price Inflation (CPI) *	-0.3	-0.1	1.8	2.2	1.7	2.1	2.1
Price Inflation (RPIX) *	-0.4	0.1	2.8	3.1	2.7	3.0	2.9
Earnings Inflation **	2.7	2.4	2.7	3.1	2.6	2.1	2.8
All Share Capital Growth	-9.5	-9.7	-5.5	-2.4	-0.4	3.0	1.0
Dividend Growth	0.4	0.8	3.5	7.9	7.4	6.5	4.9
Earnings Growth	2.9	2.2	-5.7	20.9	2.0	4.4	4.0

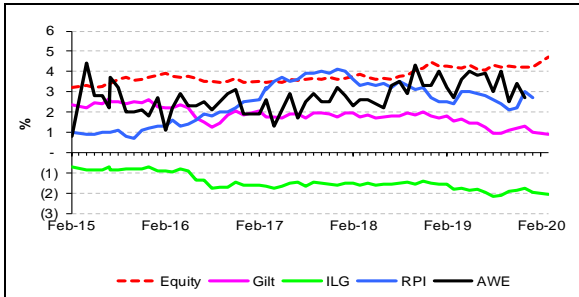
Note: All market returns are total returns for pension funds with income reinvested monthly. Indices used are as follows:

- 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.

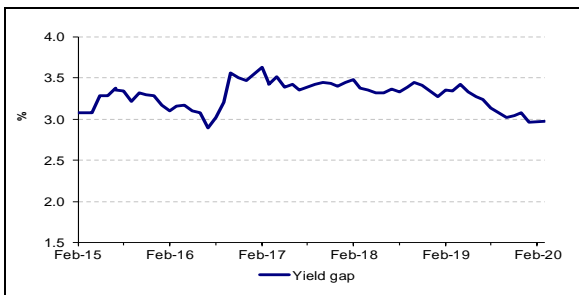


Yields and Yield Gaps

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.

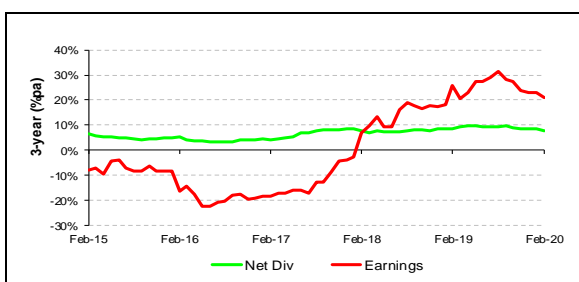
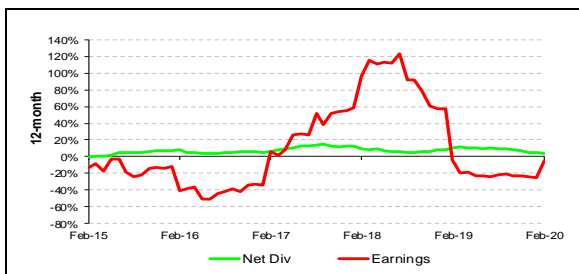


The gap gives a current expectation around 3.0% for longer-term inflation including the risk premium for gilts, relative to index-linked gilts.

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]

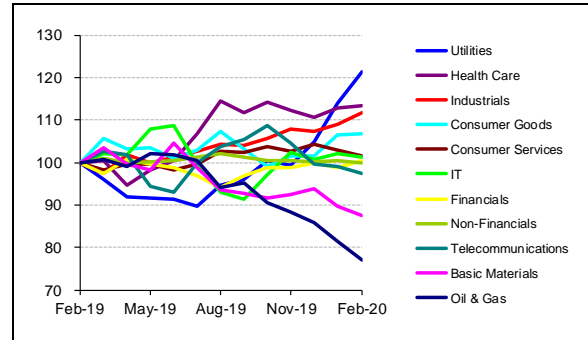
Figure 3: Dividend & Earnings Growth



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



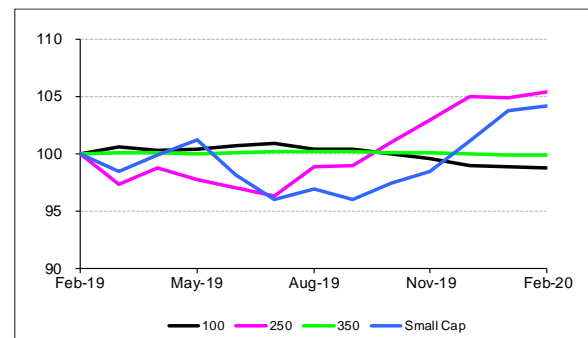
Note: Sector labels for relative lines are in end-value order

There was a rise this month in the rolling 12-month sector dispersion (from 36% to 44%).

(% absolute return)	1 mth	3 mth	12 mth
Oil & Gas	-14.0	-20.8	-24.2
Basic Materials	-10.9	-13.8	-13.7
Industrials	-6.6	-5.6	10.1
Consumer Goods	-8.8	-4.3	5.1
Health Care	-8.2	-7.9	11.9
Consumer Services	-10.1	-9.9	0.0
Telecommunications	-10.5	-15.2	-4.1
Utilities	-3.0	11.1	19.5
Non-Financials	-9.4	-9.5	-1.6
Financials	-7.5	-7.4	-1.1
IT	-9.7	-9.9	-0.3
All Share	-8.9	-8.9	-1.4

UK Equity Size Returns

Figure 4b: Size groups relative to All Share



Mid and Small Cap both rose slightly 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

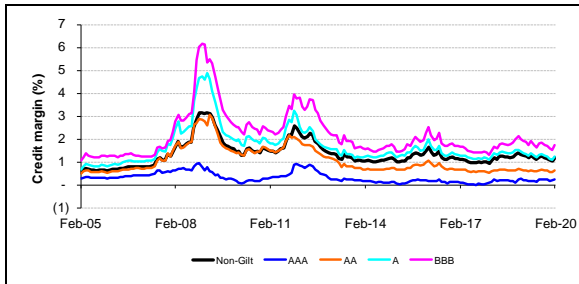


Table 2a: Over 15 Yr Corporate Yields & Margins

Month End	iBoxx Corp AA Y'ld (%)	FT 20 yr Gilt (%)	Margin (%)
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
Jan '20	1.66	1.00	0.66
Feb '20	1.69	0.91	0.78

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

Category	Mkt Val @ Feb 20 & 17, 14			Weight (%)
	Feb 20	Feb 17	Feb 14	
Gilts (42)	1,439	1,376	1,068	68.5
Non Gilts (1,164)	661	556	523	31.5
AAA (158)	137	107	100	6.5
AA (165)	87	87	86	4.1
A (358)	186	169	169	8.9
BBB (483)	250	192	168	11.9

Category	Mkt Val (£bn @ Feb 20 & 17)		W't (%)	Dur'n (yrs)
Gilts (42)	1,439	1,376	68.5	13.5
< 5 Yrs (9)	278	378	13.2	2.7
5-15 Yrs (12)	431	375	20.5	7.8
> 15 Yrs (21)	730	623	34.8	21.0
Non Gilts (1,164)	661	556	31.5	8.0
< 5 Yrs (418)	222	156	10.6	2.7
5-15 Yrs (514)	281	242	13.4	7.4
> 15 Yrs (232)	158	157	7.5	16.4

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

Category	Mkt Val (€bn)	Weight (%)
Sovereigns (369)	6,901	58.7
Non Sovereigns	4,859	41.3
AAA (968)	1,314	11.2
AA (778)	1,187	10.1
A (1,178)	1,081	9.2
BBB (1,542)	1,278	10.9

Category	Mkt Val (€bn)	Weight (%)
1 – 3 Yrs (1,146)	2,448	20.8
3 – 5 Yrs (1,284)	2,403	20.4
5 – 7 Yrs (967)	1,921	16.3
7 – 10 Yrs (843)	2,000	17.0
10+ Yrs (595)	2,989	25.4

Table 2f: Breakdown of £ Index-Linked Market

Category (Number of issues)	Mkt Val (£bn @ Feb 20 & 17)		W't (%)	Dur'n (yrs)
Gilts (29)	775	631	100.0	21.9
< 5 Yrs (4)	94	34	12.1	2.8
5 – 15 Yrs (8)	184	148	23.8	10.4
> 15 Yrs (17)	497	448	64.2	29.8

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

Month End	US (%)	Euro (%)	Sterling (%)
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
Jan '20	5.23	2.90	4.84
Feb '20	5.64	3.29	5.15

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

£ Gilt Market “main” Issuance

- o £3.27bn, 1½% 2026 (1.74x, 0.44%, 1%, Feb 17)
- o £3.44bn, 7/8% 2029 (2.16x, 0.51%, 6%, Jan 20)
- o £0.40bn, 1¾% 2057 (3.88x, 0.86%, n/a, Feb 19)
- o £2.50bn, 1½% 2071 (**10.12x**, 0.93%, n/a, Oct 18)
- o £0.80bn IL 1/8% 2036 (2.54x, ry -2.26%, 0%, Oct 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. No PAOF applies for tender or syndication cases.

