



Investment Update October 2022

Investment Headlines & Comment

- A recovery month for Sterling and some UK government and corporate bonds.
- Inflation stayed stubbornly high, leading to a marked interest rate rise post-month-end.
- The first £750m of QE was sold back into the market just after the month end.

Feature Section

This month we follow on from last month’s item, by looking at the ongoing fallout from September’s unfunded UK Fiscal Statement. What had started as general market turbulence took on a whole new hue, as the speed of yield movements coupled with the leverage used for defined benefit pension schemes within Liability Driven Investment (LDI) led to, quite frankly, chaos.

Normally, if an LDI contract is in danger of breaching its operation range, there is a notice period for a scheme to provide additional funding. If it does not provide that, the scheme has to accept that its hedging gets reduced, which would actually be to its benefit in a period of falling prices, but also rather painful if the hedging reduction was inflicted on the scheme just before prices started to recover. However, if that additional funding involves selling assets (instead of using any existing cash), that sale process involves settlement periods of a few days, and that was not a luxury available this time, such was the speed and scale of market movements. What asset generally has the shortest settlement period? Answer: UK Government debt ... and hence schemes selling those seemingly created the downward price spiral that the Bank of England spent the first half of the month trying to avert.

There were also moves by some pooled LDI funds to reduce the degree of leverage they were prepared to run with, leading to associated demands on schemes to provide the additional collateral. In particular, any schemes with less

liquid assets such as property found themselves going overweight in them as they repeatedly realized other growth assets first, and thus they needed to rebalance at the next available dealing point. At least one major pooled property fund has since found itself suspending its month-end dealing, such was the scale of redemption requests, something which it had not had to do even during the 2000’s “credit crunch”.

Figure 1a: Index-Linked

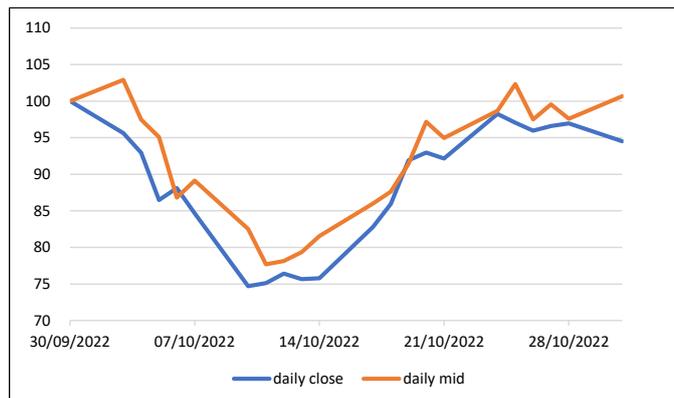


Figure 1b: Conventional

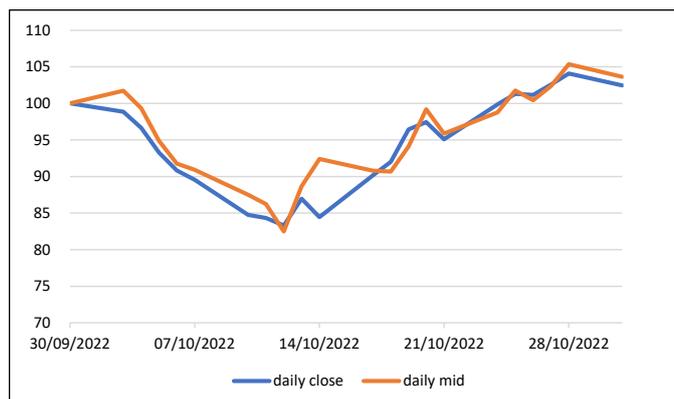


Figure 1a shows the total return index for Over 5 Year Index-Linked Gilts across the month, both for close of business pricing and for 12 noon pricing. Figure 1b shows the total return index for Over 15 Year Conventional Gilts across the month, again both for close of business pricing and for 12 noon pricing. All have been rebased to start values of 100. (For reference, the Prime Minister’s resignation was announced on the afternoon of 20 October.)

The Index-Linked index dropped by c.25% over the first two weeks (after losing “only” 8% across September). Things were bad but not as dramatic for conventional gilts. Both markets rallied in the month’s second half as the mini Budget got quickly dismantled, but this rally would have been painful for any schemes having seen their hedging reduced.

Source: Legal & General

Ed: Did the outgoing Prime Minister show any contrition for the havoc her policy created? Not that I saw.



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 2022

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	3.1	-4.6	-2.8	2.3	2.4	6.2	7.2
Overseas Equities	2.7	-2.3	-4.4	9.8	9.1	12.7	10.4
US Equities	4.7	-0.5	-0.5	14.3	13.5	16.5	8.7
Europe ex UK Equities	4.4	-2.9	-14.2	3.2	3.2	8.6	11.6
Japan Equities	-0.6	-4.7	-9.6	1.0	2.1	9.5	6.7
Pacific ex Japan Equities	-6.7	-10.9	-16.2	1.5	1.5	6.5	10.5
Emerging Markets	-6.0	-9.1	-17.5	-0.3	0.1	4.6	10.3
UK Long-dated Gilts	2.4	-19.9	-37.4	-14.0	-5.2	0.8	3.8
UK Long-dated Corp. Bonds	5.3	-17.8	-36.0	-11.6	-4.2	1.5	4.0
UK Over 5 Yrs Index-Linked Gilts	-5.5	-20.3	-36.5	-10.6	-4.1	2.7	5.0
High Yield (Global)	-1.0	0.6	-1.5	1.4	2.9	6.5	8.8
Overseas Bonds	-4.0	-3.7	-5.0	-3.0	0.2	1.9	4.2
Property *	-2.3	-4.1	13.5	7.8	7.2	9.0	7.6
Cash	0.3	0.7	1.4	0.6	0.7	0.6	2.0
Commodities £-converted	3.5	1.2	48.5	18.7	11.5	0.4	1.8
Hedge Funds original \$ basis *	-2.4	-0.7	-5.9	6.1	4.5	4.6	5.7
Illustrative £-converted version *	1.7	8.0	13.6	9.7	8.4	8.5	7.5
Euro relative to Sterling	-2.2	2.4	1.7	-0.1	-0.4	0.7	1.5
US \$ relative to Sterling	-3.0	5.7	19.1	4.0	2.9	3.4	1.5
Japanese Yen relative to Sterling	-5.6	-5.0	-8.7	-6.5	-2.5	-2.8	0.6
Sterling trade weighted	2.9	-1.9	-4.8	-0.5	0.0	-0.7	-1.3
Price Inflation (RPI) *	0.7	2.2	12.6	6.1	4.8	3.6	3.4
Price Inflation (CPI) *	0.6	1.6	10.1	4.5	3.5	2.5	2.6
Price Inflation (RPIX) *	0.6	2.0	12.4	6.2	4.8	3.7	3.5
Earnings Inflation **	-0.6	0.8	5.8	4.5	4.0	2.9	3.0
All Share Capital Growth	3.0	-5.6	-6.1	-1.0	-1.2	2.5	3.5
Dividend Growth	0.3	3.9	12.6	-5.5	-0.7	2.8	3.9
Earnings Growth	-11.1	-11.2	-15.2	-1.8	5.3	-0.6	4.6

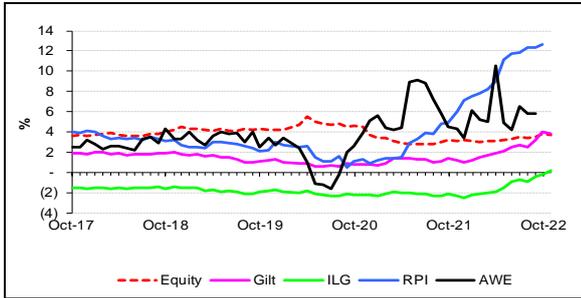
Note: All market returns are total returns for pension funds with income reinvested monthly. Indices used are as follows:

- 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.

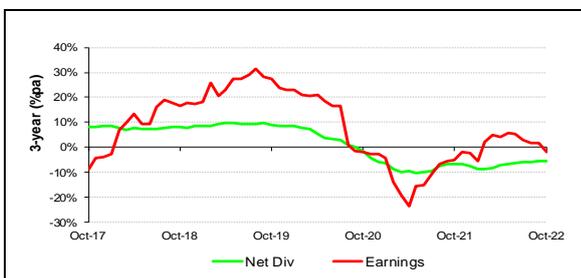
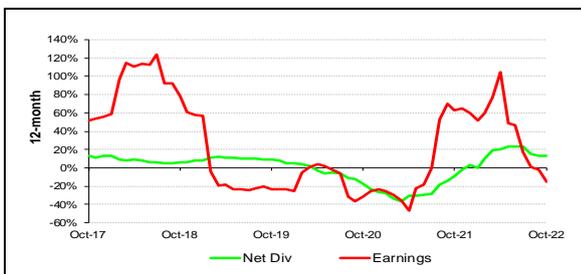


The gap gives a current expectation of around 3.6% p.a. for longer-term inflation including the (unknown) risk premium for gilts, relative to index-linked gilts.

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]

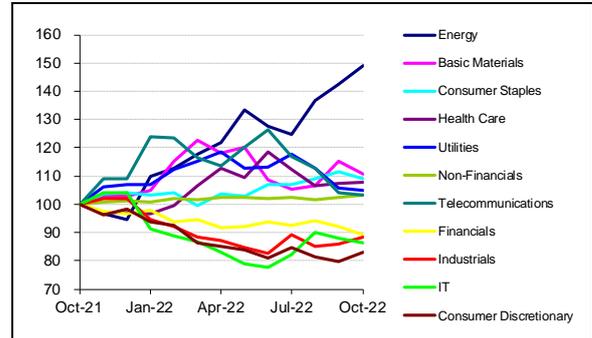
Figure 3: Dividend & Earnings Growth



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



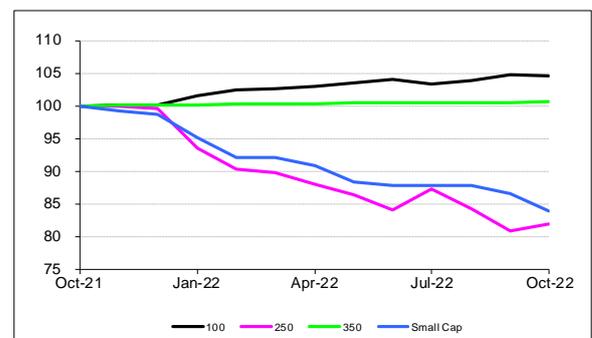
Note: Sector labels for relative lines are in end-value order

There was a small rise this month in the rolling 12-month sector dispersion (up from 65% to 66%).

(% absolute return)	1 mth	3 mth	12 mth
Energy	7.8	14.1	44.8
Basic Materials	-1.1	0.0	7.4
Industrials	6.5	-5.1	-13.9
Consumer Staples	1.0	-2.8	6.1
Health Care	3.8	-8.2	5.0
Consumer Discretionary	7.3	-6.5	-19.4
Telecommunications	2.3	-15.8	0.2
Utilities	2.5	-15.0	2.1
Non-Finan	4.0	-3.7	0.4
Financials	0.1	-7.8	-13.2
IT	1.3	0.0	-16.2
All Share	3.1	-4.6	-2.8

UK Equity Size Returns

Figure 4b: Size groups relative to All Share



This month, Mid Cap rose relative to the All Share but Small Cap fell.

Sources for charts on this page:
Financial Times, Office for National Statistics, J&A



Bond market information

Figure 5: £ Non-Gilt Credit Margins

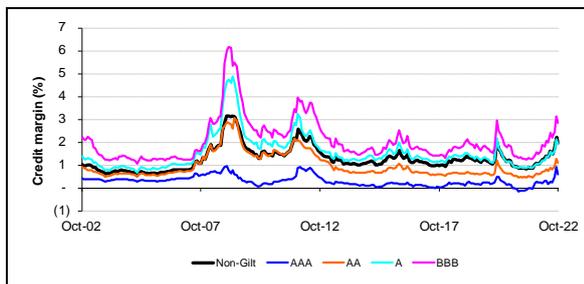


Table 2a: Over 15 Yr Corporate Yields & Margins

Month End	iBoxx Corp AA Y'ld (%)	FT 20 yr Gilt (%)	Margin (%)
May '22	3.40	2.46	0.94
Jun '22	3.78	2.66	1.12
Jul '22	3.45	2.45	1.00
Aug '22	4.18	3.20	0.98
Sep '22	5.07	4.03	1.04
Oct '22	4.68	3.82	0.86

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

Category	Mkt Val (£bn @ Oct 22 & 19, 16)			Weight (%)
	Oct 22	19	16	
Gilts (53)	1,350	1,404	1,322	71.5
Non-Gilts (1,220)	538	640	561	28.5
AAA (147)	119	132	110	6.3
AA (159)	72	87	94	3.8
A (401)	145	180	173	7.7
BBB (513)	202	241	185	10.7

Category	Mkt Val (£bn @ Oct 22, 19)		W't (%)	Dur'n (yrs)
Gilts (53)	1,350	1,404	71.5	10.4
< 5 Yrs (11)	381	311	20.2	2.7
5-15 Yrs (16)	457	398	24.2	7.8
> 15 Yrs (26)	512	694	27.1	18.3
Non-Gilts (1,220)	538	640	28.5	6.2
< 5 Yrs (494)	251	211	13.3	2.8
5-15 Yrs (494)	197	277	10.5	7.0
> 15 Yrs (232)	90	153	4.8	13.8

Tables 2d, 2e: € Market Size and Maturity (Oct 22)

Category	Mkt Val (£bn)	Weight (%)
Sovereigns (451)	6,600	58.1
Non-Sovereigns	4,761	41.9
AAA (1,115)	1,470	12.9
AA (785)	973	8.6
A (1,426)	1,056	9.3
BBB (1,939)	1,261	11.1

Category	Mkt Val (£bn)	Weight (%)
1 – 3 Yrs (1,462)	2,736	24.1
3 – 5 Yrs (1,448)	2,487	21.9
5 – 7 Yrs (1,051)	1,853	16.3
7 – 10 Yrs (970)	1,865	16.4
10+ Yrs (785)	2,421	21.3

Table 2f: Breakdown of £ Index-Linked Market

Category (Number of issues)	Mkt Val (£bn @ Oct 22 & 19)		W't (%)	Dur'n (yrs)
Gilts (32)	602	760	100.0	16.7
< 5 Yrs (4)	94	104	15.6	1.5
5 – 15 Yrs (9)	191	156	31.6	8.5
> 15 Yrs (19)	318	500	52.8	26.0

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

Month End	US (%)	Euro (%)	Sterling (%)
Jun '22	8.21	7.00	9.10
Jul '22	7.03	5.92	8.50
Aug '22	7.64	6.51	9.07
Sep '22	8.69	7.85	11.39
Oct '22	8.21	7.37	10.86

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

£ Gilt Market “main” & “Green” Issuance

- £4.37bn, 4¹/₈% 2027 (2.08x, 4.80%, 25%, new)
- £3.75bn, 1% 2032 (2.50x, 4.12%, 25%, Aug '22)
- £3.50bn, ½% 2029 (1.96x, 3.76%, 0%, Aug '22)
- £4.06bn, 1% 2032 (2.42x, 4.11%, 25%, Oct '22)
- £0.90bn, ½% IL 2039 (2.46x, 0.07%, 12%, Aug '22)
- £3.13bn, 1¼% 2051 (2.13x, 4.41%, 25%, Aug '22)
- £1.11bn, ½% IL 2051 (2.75x, 1.55*%, 23%, Jul '22)
- £2.50bn, ½% 2061 (1.97x, 3.37%, 0%, Oct '21)

Note: Issuance amounts are nominals. The second % figure in each row is the yield or real yield. The third % 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 Green Gilt (Gr), tender or syndication cases.

