



Investment Update March 2023

Investment Headlines & Comment

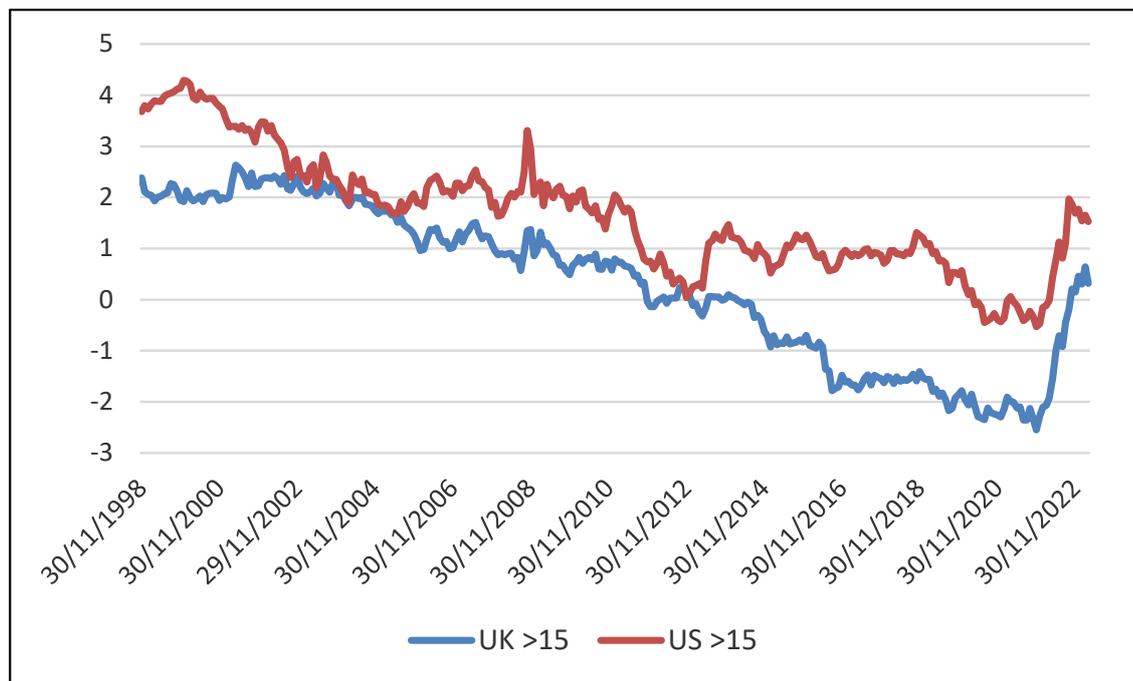
- A good month for gilts, as nominal and real yields fell, but credit margins widened.
- There was an unexpected increase in inflation, with a resulting UK base rate rise.
- [LDI guidance](#) from the Bank of England seems likely to lead to lower leverage being involved.

Feature Section

This month we consider how long-dated real yields have moved both in the UK and the US. In our [September 2016](#) edition, we outlined the case for using US TIPS instead of Index-Linked Gilts, and since then currency-hedged pooled funds have become available.

Figure 1 shows the progression of the Over 15 year real yields for UK and US government debt. There have been times when the two series were very close, such as in the early 2000s and the early 2010s. The greatest divergence was in the later part of the 2010s, most likely due to the UK pension industry's obsession with Liability Driven Investment. The peak gap was a whopping 2.9% p.a. in October 2018. Both markets were significantly affected by the global rise in nominal interest rates in 2022, with the UK having a greater rise than the US. However, there still remains a current gap of about 1.2% p.a., which might be thought to provide evidence that Index-Linked Gilts remain rather expensive.

Figure 1: Long-dated real yields



Sources: FT, S&P

Although there are no Index-Linked Gilts in the Bank of England's Quantitative Easing portfolio, there is clearly the potential for real yields to be affected as the portfolio is unwound. So far, only £20bn (nominal) has been released, with £817bn still to go. The laudable intention is to do it at a rate that doesn't disrupt the gilt market, but the risk of increased nominal and real yields seems clear. Set against that though is the increased speed with which many defined benefit (DB) pension schemes are now entering into partial or complete annuity purchases, so that demand may dampen the effect in the short-term at least.

The really interesting questions are long-term ones, namely who will be the natural owners of UK government debt after the DB pension sector has gone? What yields will they require in order to be owners?



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 March 2023

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	-3.0	2.9	2.8	13.8	5.0	5.8	8.2
Overseas Equities	1.1	4.4	-1.2	16.1	10.4	11.2	10.9
US Equities	1.4	4.8	-2.4	18.5	13.8	14.4	10.1
Europe ex UK Equities	0.9	8.6	8.7	15.1	7.6	8.6	11.8
Japan Equities	2.0	3.3	2.0	7.9	4.1	7.7	7.5
Pacific ex Japan Equities	0.3	0.8	-3.0	10.4	4.4	6.4	11.5
Emerging Markets	0.8	1.1	-4.6	8.3	2.0	4.5	11.0
UK Long-dated Gilts	5.6	3.2	-29.5	-16.3	-6.3	0.6	3.6
UK Long-dated Corp. Bonds	2.5	3.2	-23.2	-8.4	-3.5	1.8	4.1
UK Over 5 Yrs Index-Linked Gilts	7.8	5.6	-30.0	-9.0	-4.0	1.7	4.9
High Yield (Global)	-1.0	0.8	1.8	4.7	4.2	5.5	8.1
Overseas Bonds	1.4	0.3	-2.1	-5.0	0.7	1.8	3.9
Property *	-0.3	-3.7	-12.8	1.8	2.8	7.1	6.5
Cash	0.4	1.0	2.9	1.1	1.0	0.7	2.0
Commodities £-converted	-3.3	-7.6	-4.3	30.6	7.6	-1.9	0.4
Hedge Funds original \$ basis *	-0.6	1.7	-0.1	7.4	4.8	4.6	5.8
Illustrative £-converted version *	1.0	0.0	10.8	9.3	7.5	7.0	7.1
Euro relative to Sterling	0.6	-0.7	4.3	-0.1	0.1	0.4	1.2
US \$ relative to Sterling	-2.2	-2.8	6.3	0.1	2.5	2.1	1.2
Japanese Yen relative to Sterling	0.3	-3.4	-2.8	-6.6	-1.9	-1.4	0.7
Sterling trade weighted	0.7	2.0	-2.7	0.6	-0.2	-0.1	-1.0
Price Inflation (RPI) *	1.2	1.7	13.8	7.7	5.6	3.9	3.6
Price Inflation (CPI) *	1.2	0.9	10.4	5.6	4.0	2.7	2.7
Price Inflation (RPIX) *	1.1	1.3	12.9	7.5	5.5	3.9	3.6
Earnings Inflation **	-1.5	3.8	5.2	4.9	4.5	3.2	3.1
All Share Capital Growth	-3.5	1.9	-0.9	10.1	1.3	2.1	4.5
Dividend Growth	0.4	1.9	14.4	-4.6	-0.1	2.8	4.1
Earnings Growth	27.7	48.5	12.6	8.6	0.9	3.6	5.7

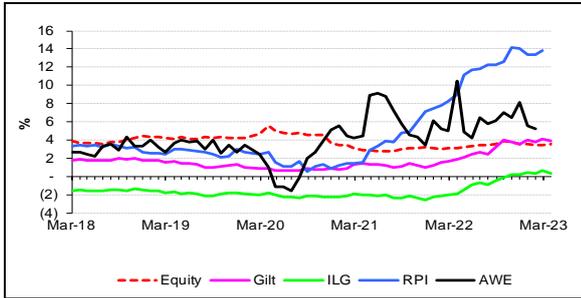
Note: All market returns are total returns for pension funds with income reinvested monthly. Indices used are as follows:

- 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.

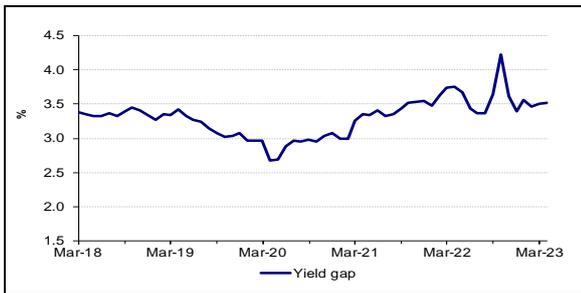


Yields and Yield Gaps

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.

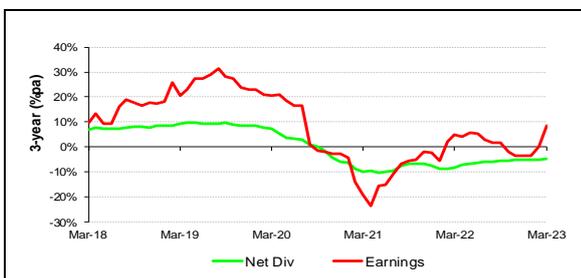
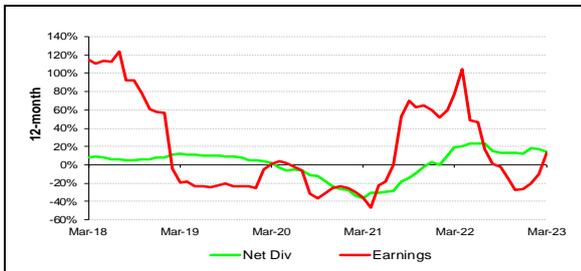


The gap gives a current expectation of around 3.5% p.a. for longer-term inflation including the (unknown) risk premium for gilts, relative to index-linked gilts.

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]

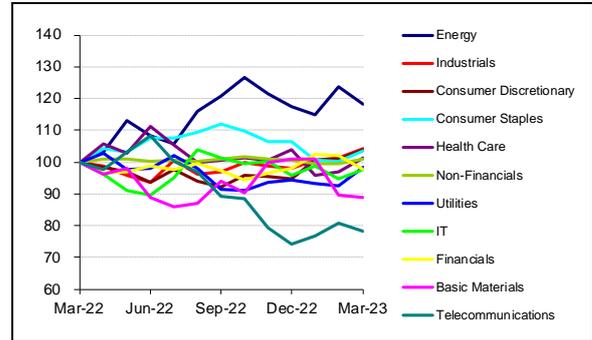
Figure 3: Dividend & Earnings Growth



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



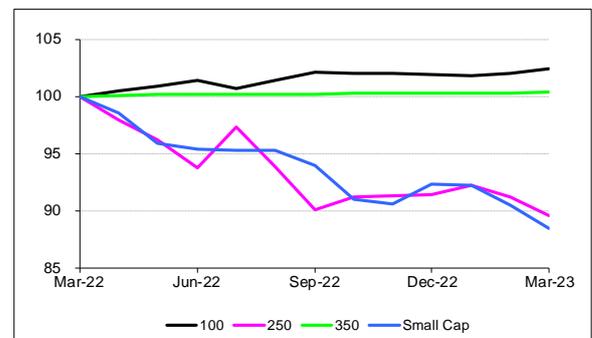
Note: Sector labels for relative lines are in end-value order

There was a marked drop this month in the rolling 12-month sector dispersion (down from 53% to 40%).

(% absolute return)	1 mth	3 mth	12 mth
Energy	-7.6	3.3	21.3
Basic Materials	-3.5	-9.2	-8.6
Industrials	-0.1	9.4	7.1
Consumer Staples	0.2	0.0	6.2
Health Care	1.1	0.3	3.9
Consumer Discretionary	-0.2	13.1	6.8
Telecommunications	-6.2	8.5	-19.8
Utilities	3.2	7.2	1.1
Non-Finan	-1.6	3.1	3.5
Financials	-7.4	2.5	0.1
IT	-0.1	4.8	0.4
All Share	-3.0	2.9	2.8

UK Equity Size Returns

Figure 4b: Size groups relative to All Share



This month, Mid Cap and Small Cap both fell relative to the All Share.

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



Bond market information

Figure 5: £ Non-Gilt Credit Margins

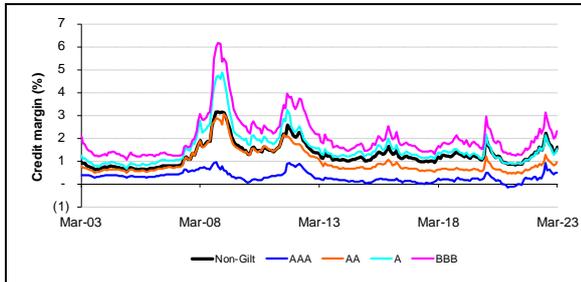


Table 2a: Over 15 Yr Corporate Yields & Margins

Month End	iBoxx Corp AA Y'ld (%)	FT 20 yr Gilt (%)	Margin (%)
Oct '22	4.68	3.82	0.86
Nov '22	4.26	3.54	0.72
Dec '22	4.72	4.02	0.70
Jan '23	4.40	3.77	0.63
Feb '23	4.81	4.14	0.67
Mar '23	4.67	3.84	0.83

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

Category	Mkt Val (£bn @ Mar 23 & 20, 17)			Weight (%)
	2017	2020	2023	
Gilts (57)	1,425	1,467	1,382	72.2
Non-Gilts (1,214)	548	629	559	27.8
AAA (142)	113	138	108	5.7
AA (155)	73	83	88	3.7
A (410)	153	177	169	7.8
BBB (507)	209	230	193	10.6

Category	Mkt Val (£bn @ Mar 23 & 20)		W't (%)	Dur'n (yrs)
Gilts (57)	1,425	1,467	72.2	10.0
< 5 Yrs (14)	449	277	22.8	2.8
5-15 Yrs (16)	449	439	22.7	8.0
> 15 Yrs (27)	527	751	26.7	17.8
Non-Gilts (1,214)	548	629	27.8	6.1
< 5 Yrs (504)	256	217	13.0	2.8
5-15 Yrs (484)	202	270	10.2	6.9
> 15 Yrs (226)	90	142	4.5	13.7

Tables 2d, 2e: € Market Size and Maturity (Mar 23)

Category	Mkt Val (£bn)	Weight (%)
Sovereigns (477)	6,736	57.3
Non-Sovereigns	5,030	42.7
AAA (1,170)	1,590	13.5
AA (813)	984	8.4
A (1,479)	1,111	9.4
BBB (2,001)	1,345	11.4

Category	Mkt Val (£bn)	Weight (%)
1 – 3 Yrs (1,520)	2,823	24.0
3 – 5 Yrs (1,577)	2,663	22.6
5 – 7 Yrs (1,102)	1,858	15.8
7 – 10 Yrs (945)	1,968	16.7
10+ Yrs (796)	2,455	20.9

Table 2f: Breakdown of £ Index-Linked Market

Category (Number of issues)	Mkt Val (£bn @ Mar 23 & 20)		W't (%)	Dur'n (yrs)
Gilts (31)	595	745	100.0	16.8
< 5 Yrs (4)	96	93	16.1	2.5
5 – 15 Yrs (9)	202	184	34.0	9.4
> 15 Yrs (18)	297	467	50.0	26.4

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

Month End	US (%)	Euro (%)	Sterling (%)
Nov '22	7.86	6.72	10.07
Dec '22	8.17	7.11	10.32
Jan '23	7.48	6.47	9.54
Feb '23	7.97	6.76	9.46
Mar '23	7.75	6.85	9.93

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

£ Gilt Market “main” & “Green” Issuance

- £4.50bn, 3½% 2025 (2.08x, 4.15%, 0%, Jan 23)
- £3.50bn, 4½% 2027 (2.27x, 3.75%, 0%, Feb 23)
- £3.75bn, 3¼% 2033 (2.42x, 3.50%, 25%, Feb 23)
- £3.13bn, 3¾% 2038 (2.41x, 4.14%, 25%, Nov 22)
- £0.74bn, 1/8% IL 2051 (2.40x, 0.84%, 13%, Oct 22)
- £2.46bn, 3¾% 2053 (2.71x, 3.86%, 23%, Jan 23)
- £2.50bn, ½% 2061 (2.81x, 3.82%, 25%, Oct 22)

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.

