JAGGER & ASSOCIATES

Investment Update
September 2011

Investment Headlines & Comment

- More risk-asset turmoil. In local terms, **Emerging Markets** and **Commodities** fell the most.
- **Italy** has been downgraded – yields have started heading up again for them and for **Portugal**.
- **Gilt yields** fell again, giving a return of 14% in Q3 – but **credit margins** increased as a result.

Feature Section

One of the arguments used to justify the current negative real yields on index-linked gilts is a strong belief that inflation could be higher than expected, and/or that we could see significant spikes in it. We thought it might be interesting to look back and see just how much inflation expectations have varied over the last couple of decades. Fortunately, the Bank of England archive contains just such a dataset.

In Figure 1a, we have selected six past time points, with the Bank-derived implied curves from the gilts and index-linked gilts (ILGs) then in issue. Note each curve only starts from 2.5 years ahead of the time point, or the term of the next ILG maturing, if later. Similarly, each ends at 25 years ahead, or the term of the last ILG maturing if earlier. The curves are forward curves, i.e. the 1-year rates applying at future points, rather than spot curves (which would show the average rates expected over the next *n* years).

Looking at the curves gives a bit of an economic history lesson too. Back in December 1987, cash was earning 9%, and ILG real yields were at 4% (albeit the asset only started in 1982 and was seen as the poor relation of equities, which were doing 20% pa). Expectations were for high inflation for 7 or so years, then subsiding to longer term rates of about 3%. This was against a background of an economic boom, after the industrial turmoil of the early 1980s. By the end of 1992, after exiting ERM but with the UK still being in recession, cash was earning 7% (and had been at 15%), shorter term inflation expectations were lower, but longer term rates were running ahead of 5%, as the markets believed there would be less financial discipline outside of the ERM. (Some limited similarities with Greece and the Euro today perhaps?) To counter this, in 1992 an aim of 2.5% pa for inflation was introduced and in 1995 this became an explicit medium-term target with a +/-1% tolerance range.

Figure 1a: Inflation forward curves

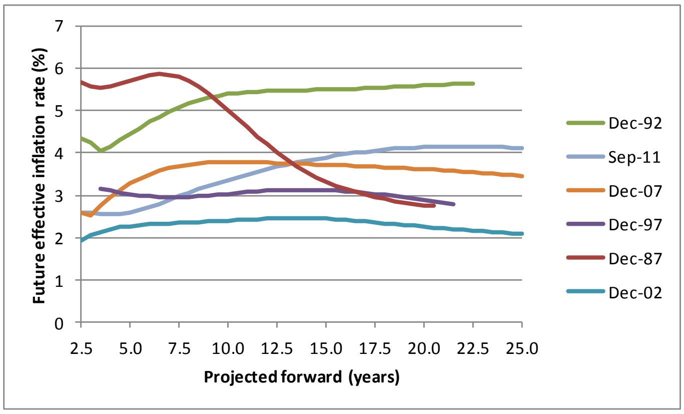
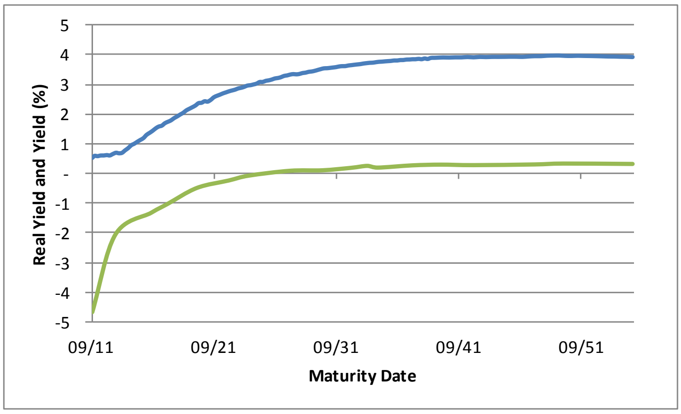


Figure 1b: Current spot yield curves



Sources: DMO, Bank of England, Jagger & Associates

By the end of 1997, with the pending arrival of the Euro (and purported economic convergence by its adherents), there had been 20 quarters of economic growth in the UK. Things had changed a lot and an inflation rate of about 3% was expected at all points (this is easily the steadiest curve out of the six shown). At this point, the market either believed that the Bank would slightly overshoot the 2.5% inflation target it was being set by the then Government, or else there was just a small positive risk premium. Either way, things looked good.

By the end of 2002, when the Bank had had its independence for 5 years, the short and long term pattern for inflation was at 2%, but there was a belief it might be slightly higher in the medium term. So, the market believed that the Bank could even *beat* the inflation targets it was being set by the Government. Things looked even better.

By the end of 2007, the curve had shifted up by about 1% at most durations – even before the credit crunch, the gilt market was concerned that the then Government was overspending and could not maintain control of inflation.

Thus we reach the final curve – "now". Do we believe the implied long-term inflation value? No, from Figure 1b, it seems more likely that there is a negative risk premium on ILGs, but that could stay for a while, if the Gadarene LDI rush continues.

J<u>AGGER</u> & A<u>SSOCIATES</u>

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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 <u>cannot</u> 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 September 2011

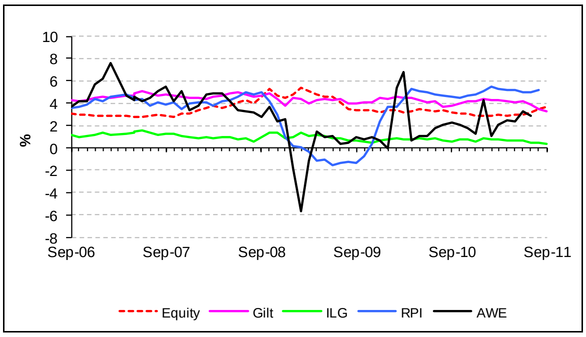
Asset Class	1 month (%)	3 months (%)	12 months (%)	3 years (% p.a.)	5 years (% p.a.)	10 years (% p.a.)	20 years (% p.a.)
UK Equities	-5.0	-13.5	-4.4	6.0	0.8	4.8	7.4
Overseas Equities	-5.5	-15.1	-4.9	5.9	3.0	4.6	6.9
US Equities	-2.9	-11.3	2.1	5.9	2.7	**2.4**	8.5
Europe ex UK Equities	-8.9	**-24.4**	-13.6	**0.8**	-0.3	5.6	8.3
Japan Equities	3.1	-3.1	1.9	4.6	**-1.3**	**2.4**	**0.3**
Pacific ex Japan Equities	-9.6	-17.9	-11.7	14.4	9.8	14.0	9.0
Emerging Markets	**-10.7**	-20.1	**-14.9**	11.4	9.1	**15.7**	8.9
UK Long-dated Gilts	**6.5**	**14.4**	11.2	10.7	6.7	6.6	**9.1**
UK Long-dated Corp. Bonds	3.0	6.4	3.8	11.1	4.5	6.2	-
UK Over 5 Yrs Index-Linked Gilts	4.5	7.8	**13.6**	8.8	7.8	7.7	8.1
High Yield (Global)	-0.5	-5.4	0.6	**18.8**	10.9	8.4	-
Overseas Bonds	3.0	6.0	6.2	13.7	**12.3**	7.0	7.6
Property *	0.6	1.9	8.8	1.4	-1.0	6.6	8.3
Cash	0.1	0.2	0.8	1.3	3.1	3.7	5.3
Commodities £-converted	-8.2	-9.0	4.1	-12.1	-1.8	2.9	3.6
Hedge Funds original $ basis *	-3.0	-3.8	6.9	3.4	4.1	6.5	11.2
Illustrative £-converted version *	-2.2	-2.8	0.9	7.4	7.3	5.3	11.4
Euro relative to Sterling	-2.6	-4.7	-0.6	3.0	4.9	3.3	-
US $ relative to Sterling	4.5	3.0	1.2	4.6	3.7	-0.6	0.6
Japanese Yen relative to Sterling	3.7	8.0	9.6	16.4	12.9	3.8	3.4
Price Inflation (RPI) *	0.6	0.4	5.2	2.8	3.5	3.1	2.9
Price Inflation (CPI) *	0.6	0.5	4.5	3.1	3.1	2.4	2.2
Price Inflation (RPIX) *	0.6	0.4	5.3	3.8	3.8	3.2	3.0
Earnings Inflation **	-1.3	0.6	2.9	1.7	2.5	3.2	3.7
All Share Capital Growth	-5.2	-14.3	-7.4	2.2	-2.7	1.3	3.8
Net Dividend Growth	0.3	4.9	6.9	-5.3	0.8	3.8	-
Earnings Growth	0.1	17.3	51.6	9.0	5.4	9.2	-

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

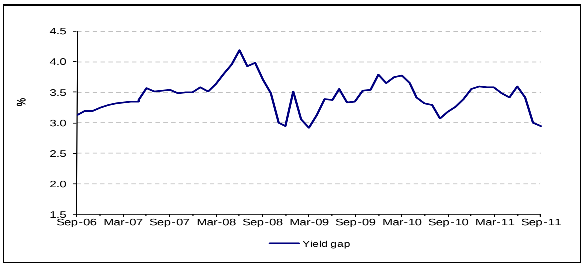
- *UK Equities (incl. dividends and earnings) – FT-A All Share.*
- *Overseas Equities (incl. regions) – blend of FT All-World / World subindices*
- *Emerging Markets from MSCI US $ based total return index (overall Index to 31 Oct 2001, Free Index from 1 Nov 2001 to take account of foreign investment 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 – Merrill Lynch Global, £ Unhedged*
- *Overseas Bonds – JP Morgan Traded Unhedged World ex UK*
- *Property – IPD Monthly 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.

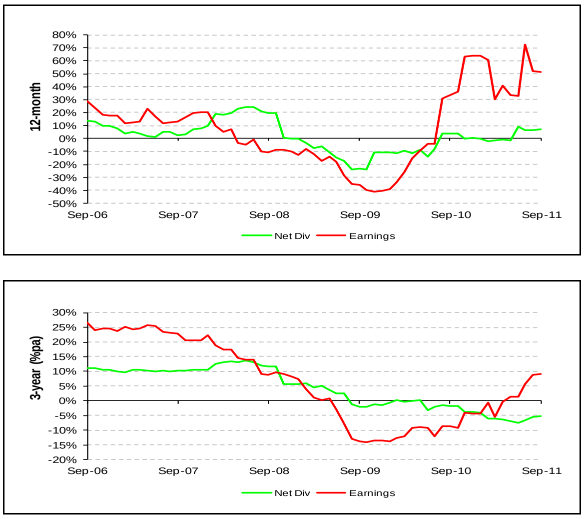


The gap gives expectations now <u>below</u> 3% for longer-term inflation + risk premium for gilts, relative to index-linked gilts.

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*]

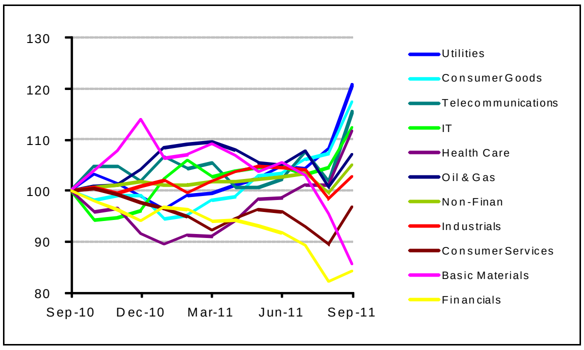
Figure 3: Dividend & Earnings Growth



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

UK Equity Sector Returns

Figure 4a: Sectors relative to All Share



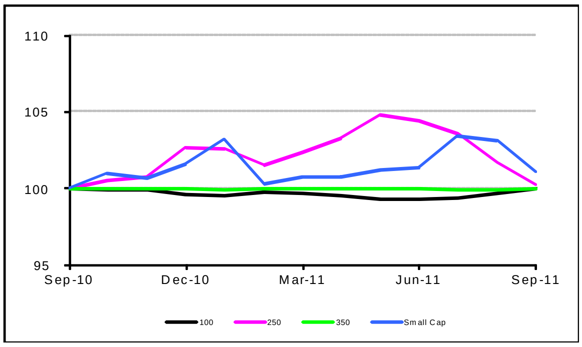
Note: Sector labels for relative lines are in end-value order

There was a marked rise this month in the rolling 12-month sector dispersion (up from 29% to 37%).

(% absolute return)	1 mth	3 mth	12 mth
Oil & Gas	-3.6	-11.8	2.4
Basic Materials	-18.7	-29.8	-18.2
Industrials	-5.4	-15.2	-1.9
Consumer Goods	-0.8	-1.7	12.3
Health Care	0.1	-1.9	6.9
Consumer Services	-2.0	-12.7	-7.5
Telecommunications	2.8	-2.1	10.5
Utilities	0.9	-0.4	15.4
Non-Finan	-4.4	-11.5	0.5
Financials	-7.2	-20.6	-19.6
IT	-2.8	-7.3	7.4
All Share	-9.4	-13.5	-4.4

UK Equity Size Returns

Figure 4b: Size groups relative to All Share



Mid and Small Cap fell markedly in relative terms this month.

FRS17 volatility indicator

Now discontinued, but available on request.

Bond market information

Sources: Barclays Capital, DMO, iBoxx, J&A, MLX

Figure 5: £ Non-Gilt Credit Margins

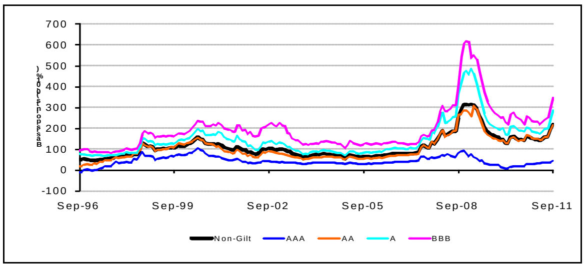


Table 2a: Over 15 Yr Corporate Yields & Margins

Month End	iBoxx Corp AA Y'ld (%)	FT 20 yr Gilt (%)	Margin (%)
Apr 11	5.26	4.14	1.12
May 11	5.26	4.06	1.20
June 11	5.54	4.21	1.33
July 11	5.21	3.87	1.34
Aug 11	5.30	3.68	1.62
Sep 11	**5.06**	**3.25**	**1.81**

Tables 2b, 2c: £ Market Size and Maturity

Category	Mkt Val (£bn @ Sep 11 & 09, 07)			Weight (%)
Gilts (34)	902	668	313	65.9
Non Gilts (1,015)	466	481	421	34.1
AAA (168)	128	150	157	9.4
AA (178)	78	66	63	5.7
A (385)	159	165	130	11.6
BBB (284)	101	97	68	7.4

Category	Mkt Val (£bn @ Sep 11, 09)		W't (%)	Dur'n (yrs)
Gilts (34)	902	668	65.9	9.6
< 5 Yrs (8)	236	201	17.2	2.9
5–15 Yrs (12)	318	213	23.3	7.1
> 15 Yrs (14)	348	254	25.4	16.5
Non Gilts (1,015)	466	481	34.1	7.7
< 5 Yrs (255)	116	153	8.4	2.6
5–15 Yrs (479)	207	192	15.1	6.8
> 15 Yrs (281)	144	136	10.5	12.9

£ Gilt Market "main" Issuance

- £4.89bn 1¾% 2017 (1.29x, 1.38%, prev Aug 11)
- £3.00bn 3¾% 2021 (1.99x, 2.76%, July 11)
- £1.00bn 4¾% 2030 (1.88x, 3.43%, Sept 10)
- £4.50bn 3¾% 2052 (1.89x, 3.76%, new)
- £0.90bn ILG ¾% 2047 (1.49x, r.y 0.39%, Sept 10)

Note: Issuance amounts are nominals.

Tables 2d, 2e: € Market Size and Maturity (Sep 11)

Category	Mkt Val (€bn)	Weight (%)
Sovereigns (251)	4,100	58.1
Non Sovereigns	2,963	41.9
AAA (661)	1,300	18.4
AA (445)	616	8.7
A (659)	677	9.6
BBB (466)	370	5.2

Category	Mkt Val (€bn)	Weight (%)
1 – 3 Yrs (803)	2,030	28.7
3 – 5 Yrs (665)	1,584	22.4
5 – 7 Yrs (427)	979	13.9
7 – 10 Yrs (372)	1,213	17.2
10+ Yrs (215)	1,257	17.8

Table 2f: Breakdown of £ Index-Linked Market

Category (Number of issues)	Mkt Val (£bn @ Sep 11 & 09)		W't (%)	Dur'n (yrs)
Gilts (17)	295	204	91.7	16.1
< 5 Yrs (2)	49	34	15.1	3.4
5 – 15 Yrs (4)	84	82	26.0	8.9
> 15 Yrs (11)	163	89	50.6	23.7
Non Gilts (48)	27	21	8.3	17.5

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

Month End	US (%)	Euro (%)	Sterling (%)
May 11	6.79	7.06	8.26
June 11	7.06	7.66	8.68
July 11	6.93	7.52	8.92
Aug 11	7.82	9.25	10.26
Sep 11	**8.65**	**10.58**	**11.27**

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