JAGGER & ASSOCIATES

Investment Update
August 2013

Investment Headlines & Comment

- **Bank base rate** now expected to stay at 0.5% until unemployment falls to 7% (see feature below).
- **Sterling** rallied however, as the markets decided rates would rise sooner than the Bank expected.
- **Property** capital values have risen for the second month after two years of gradual declining.

Feature Section

This month we consider some of the implications of the Bank of England (BoE)'s "forward guidance" plan announced this month, linking the bank base rate to unemployment rates (albeit subject to some get out clauses). The BoE's aim is to reduce economic slack, provided this does not entail material risks to either price stability or financial stability, with the key feature being the base rate staying at 0.5% until unemployment has reduced. The unemployment measure the BoE proposes to follow is the Labour Force Survey headline measure, with a threshold of 7% unemployment before they will consider increasing the base rate, and before they start to unwind the gilt portfolio built up through Quantitative Easing (QE). They state that there is scope for QE to be increased if necessary.

The BoE has stated that the policy ceases if any of three 'knockouts' happen: first, a belief that it is more likely than not, that CPI inflation 18 to 24 months ahead will be 0.5% or more above the 2% target; second, if medium-term inflation expectations no longer remain sufficiently well anchored; finally, if there is a significant threat to financial stability that cannot be contained by the substantial range of mitigating policy actions currently available.

These three criteria are of course highly subjective. For the CPI one, see the inflation fan chart in our May 2013 issue of *Update* for showing how often CPI has been over 2.5% and how a material proportion of the inflation expectations were still above it. The updated chart in the latest Inflation Report suggests this probability is about 35%, so it may not take much to get to a situation of being "more likely than not" … this BoE announcement might be for a rather short lived policy!

The latest Labour Force Survey covers the period from March to May 2013. Its summary findings are that the employment rate for those aged from 16 to 64 was 71.4%. There were 29.71 million people in employment aged 16 and over. The unemployment rate was 7.8% of the economically active population. There were 2.51 million unemployed people, down 72,000 from a year earlier - useful context, given that we estimate the 7% threshold in the new policy corresponds to a further reduction by 250,000 or so. However, we note that the BoE does not think the point would be reached until at least the third quarter of 2016. (Interestingly, the equivalent policy in the US, launched in late 2012, is based on a 6.5% unemployment rate.)

The startling bit from the UK's Labour Force Survey (startling to the Editor at least) is the data on inactivity. (The ONS states that "economically inactive people" are those who are not in employment but do not meet the internationally accepted definition of unemployment because they have not been seeking work within the last four weeks and/or they are unable to start work within the next two weeks.) The inactivity rate for those aged from 16 to 64 was up at 22.5%, down 0.4% from a year earlier. Equivalently, there were 9.04m economically inactive people aged from 16 to 64, down 144,000 from a year earlier. Within this 9.04m, you find 2.28m students, 1.38m who had retired before age 65, 2.26m for those looking after families, a thumping 2.04m people on long-term sick leave, and a remarkably large 1.07m who are simply termed "other". Against that background, an independent Bank policy that revolves around getting 250,000 into employment seems slightly secondary to politicians tackling the last two of these inactivity statistics?

UK Equities did not respond much to this new policy from the BoE, but over the weeks after its launch, gilt yields rose in rejection of it. Other doubters emerged as well. The Institute of Economic Affairs commented "*The level of unemployment is mainly determined by a range of factors such as labour market regulation, the benefits system, tax rates and so on. To try to use monetary policy to reduce unemployment when inflation is already above target is playing with fire and could lead us down the road that we followed in the 1970s. This move also calls into question the independence of the Monetary Policy Committee and the Bank of England's ability to fulfil its statutory duties.*" As ever, economists fail to agree on anything.

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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 31 August 2013

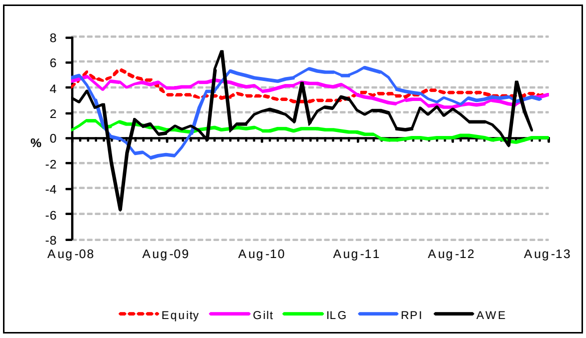
Asset Class	1 month (%)	3 months (%)	12 months (%)	3 years (% p.a.)	5 years (% p.a.)	10 years (% p.a.)	20 years (% p.a.)
UK Equities	-2.2	-0.8	18.9	12.0	7.4	8.9	7.6
Overseas Equities	-4.1	-2.4	19.6	12.1	8.1	8.4	6.7
US Equities	**-4.7**	-1.0	22.4	**18.3**	11.1	7.7	8.3
Europe ex UK Equities	-3.7	-1.4	25.2	9.3	4.2	9.1	8.4
Japan Equities	-4.0	-1.5	**27.7**	7.7	4.6	4.8	**-0.5**
Pacific ex Japan Equities	-2.8	-6.7	9.9	5.8	9.4	**12.7**	7.0
Emerging Markets	-3.6	**-8.7**	3.5	1.2	5.6	**12.7**	7.2
UK Long-dated Gilts	-1.1	-3.9	**-7.1**	5.4	7.3	6.1	7.4
UK Long-dated Corp. Bonds	-0.7	-3.9	-0.2	5.8	8.3	5.9	-
UK Over 5 Yrs Index-Linked Gilts	-0.4	-5.2	2.1	8.3	6.3	7.4	7.2
High Yield (Global)	-2.6	-3.1	12.0	9.8	**15.1**	9.6	-
Overseas Bonds	-2.4	-1.8	-3.2	**0.7**	7.5	5.6	5.3
Property *	**0.8**	**2.1**	4.7	6.0	2.3	5.6	**8.5**
Cash	0.0	0.1	0.5	0.8	**1.1**	**3.1**	4.5
Commodities £-converted	1.3	6.5	0.4	7.4	-7.2	1.9	3.7
Hedge Funds original $ basis *	1.4	0.4	8.6	4.8	3.3	6.2	9.2
Illustrative £-converted version *	1.5	3.1	12.2	5.9	8.9	6.8	9.1
Euro relative to Sterling	-2.6	-0.3	7.4	1.0	1.1	2.1	-
US $ relative to Sterling	-2.0	-2.0	2.7	-0.2	3.3	0.2	-0.2
Japanese Yen relative to Sterling	-1.8	0.9	-18.1	-5.3	5.4	2.0	0.1
Sterling trade weighted	2.8	1.6	-3.2	-0.1	-1.9	-1.6	-0.3
Price Inflation (RPI) *	0.0	0.1	3.1	3.7	2.9	3.3	2.9
Price Inflation (CPI) *	-0.1	-0.1	2.7	3.2	2.9	2.7	2.2
Price Inflation (RPIX) *	0.0	0.1	3.2	3.8	3.5	3.3	2.9
Earnings Inflation **	1.1	-6.9	0.6	2.1	1.7	3.0	3.5
All Share Capital Growth	-2.8	-1.8	14.7	8.1	3.5	5.1	4.1
Net Dividend Growth	1.9	2.3	8.8	9.2	0.6	5.7	-
Earnings Growth	-4.6	-11.5	-11.9	3.0	-1.5	6.6	6.1

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



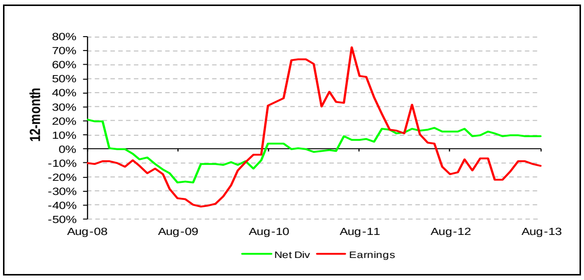
The yield gap is a measure of expected average future inflation, derived as long bond yield minus ILG yield.

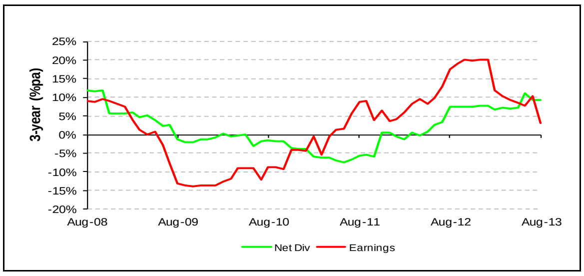
The gap gives a current expectation of now clearly over 3% for longer-term inflation + risk premium for gilts, relative to index-linked gilts.

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

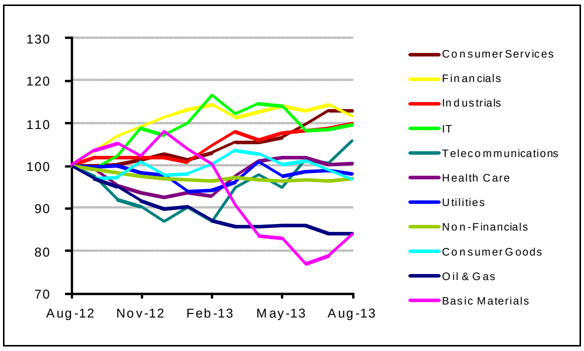




Sources for charts on this page:
Financial Times, Office for National Statistics, J&A

UK Equity Sector Returns

Figure 4a: Sectors relative to All Share



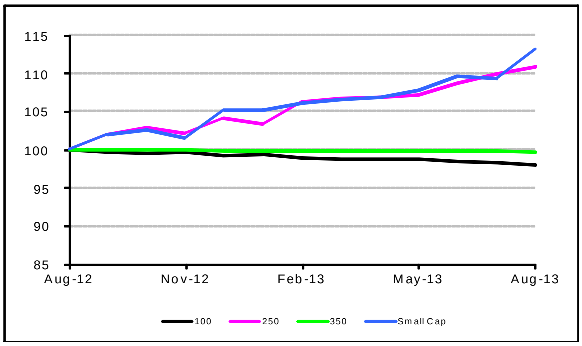
Note: Sector labels for relative lines are in end-value order

There was a fall this month in the rolling 12-month sector dispersion (from 38% to 29%).

(% absolute return)	1 mth	3 mth	12 mth
Oil & Gas	-2.3	-3.1	-0.1
Basic Materials	3.8	0.0	-0.6
Industrials	-1.4	1.1	30.6
Consumer Goods	-4.4	-4.5	14.9
Health Care	-1.8	-2.1	19.7
Consumer Services	-2.3	4.9	34.2
Telecommunications	2.7	10.8	25.8
Utilities	-2.8	-0.1	16.8
Non-Financials	-1.5	-0.1	15.4
Financials	-4.5	-2.9	32.7
IT	-1.2	-4.6	30.5
All Share	-2.2	-0.8	18.9

UK Equity Size Returns

Figure 4b: Size groups relative to All Share



Mid Cap and Small Cap both rose in relative terms this month.

FRS17 volatility indicator

Now discontinued, but available on request.

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Bond market information

Figure 5: £ Non-Gilt Credit Margins

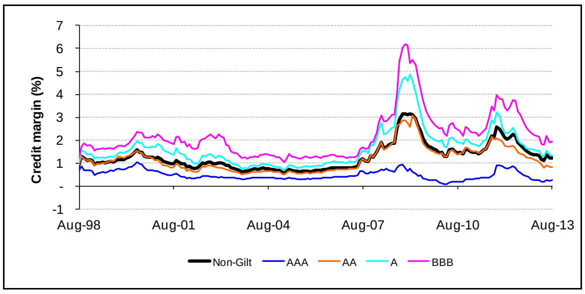

Table 2a: Over 15 Yr Corporate Yields & Margins

Month End	iBoxx Corp AA Y'ld (%)	FT 20 yr Gilt (%)	Margin (%)
Mar '13	4.01	2.76	1.25
Apr '13	3.75	2.63	1.12
May '13	4.02	2.96	1.06
Jun '13	4.47	3.30	1.17
Jul '13	4.29	3.27	1.02
Aug '13	**4.35**	**3.42**	**0.93**

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

Category	Mkt Val @ Aug 13 & 10, 07			Weight (%)
Gilts (38)	1,084	819	316	67.7
Non Gilts (1,025)	518	491	420	32.3
AAA (136)	106	147	156	6.6
AA (162)	83	75	63	5.2
A (357)	167	175	130	10.4
BBB (370)	161	95	68	10.1

Category	Mkt Val @ Aug 13, & 10		W't (%)	Dur'n (yrs)
Gilts (38)	1,084	819	67.7	9.3
< 5 Yrs (11)	332	215	20.7	2.7
5–15 Yrs (11)	354	316	22.1	7.2
> 15 Yrs (16)	399	289	24.9	16.7
Non Gilts (1,025)	518	491	32.3	7.8
< 5 Yrs (298)	147	137	9.2	2.7
5–15 Yrs (437)	206	211	12.8	7.2
> 15 Yrs (290)	165	143	10.3	13.2

£ Gilt Market "main" Issuance

- £4.93bn 1¼% 2018 (1.37x, 1.41%, Jun 13)
- £2.25bn 4½% 2034 (1.48x, 3.52%, Aug 12)
- £1.79bn ILG $^{1}/_{8}$% 2019 (1.83x, r.y -0.89%, new)
- £1.41bn ILG ¾% 2034 (1.85x, r.y 0.08%, Sep 12)

Note: Issuance amounts are nominals.

Tables 2d, 2e: € Market Size and Maturity (Aug 13)

Category	Mkt Val (€bn)	Weight (%)
Sovereigns (275)	4,730	59.5
Non Sovereigns	3,217	40.5
AAA (535)	1,032	13.0
AA (380)	631	8.0
A (742)	819	10.3
BBB (720)	734	9.2

Category	Mkt Val (€bn)	Weight (%)
1 – 3 Yrs (793)	2,160	27.2
3 – 5 Yrs (710)	1,759	22.1
5 – 7 Yrs (446)	1,166	14.7
7 – 10 Yrs (481)	1,454	18.3
10+ Yrs (222)	1,406	17.7

Table 2f: Breakdown of £ Index-Linked Market

Category (Number of issues)	Mkt Val (£bn @ Aug 13 & 10)		W't (%)	Dur'n (yrs)
Gilts (21)	361	237	92.1	18.6
< 5 Yrs (2)	44	21	11.3	3.3
5 – 15 Yrs (5)	99	97	25.4	9.4
> 15 Yrs (14)	217	120	55.5	26.0
Non Gilts (43)	31	25	7.9	16.9

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

Month End	US (%)	Euro (%)	Sterling (%)
Mar 13	5.69	5.11	6.24
Apr 13	5.43	4.66	5.89
May 13	5.64	4.73	6.12
Jun 13	6.26	5.36	6.64
Jul 13	5.96	5.06	6.22
Aug 13	**6.16**	**5.09**	**6.32**

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

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