JAGGER & ASSOCIATES

Investment Update

January 2014

Investment Headlines & Comment

- **Emerging Markets** have had a torrid time over the last 12 months relative to developed markets.
- The recovery in **UK Commercial Property** is speeding up, after a capital rise of 1.5% in a month.
- **F&C** is being bought by Bank of Montreal (BOM) to become their European centrepiece.

Feature Section

This month we consider two pronouncements from the Bank of England, on interest rates and on the scenario of an independent Scotland keeping Sterling.

In our August 2013 issue, we considered the Bank of England's **"forward guidance" plan** to link rises in interest rates to falls in the unemployment rate. We noted that the fall in unemployment required to trigger an initial move in interest rates was not that great, but the Bank seemed to think it could take a period measured in years. With that fall having now been almost achieved in six months, the Governor of the Bank of England has rather moved the goalposts by saying in a speech at Davos that the Bank will not be raising rates after all, leading to falls in Gilt (and Corporate Bond) yields this month, and falls by Sterling against the US Dollar and Japanese Yen as well.

The Governor believes it is too soon to raise interest rates because the economy is not strong enough. "If we were to change interest rates, the economy has to have enough momentum to withstand it," he has said. "There are still a lot of people looking for work, and the excess capacity in firms means there is additional slack." So, an "evolved" forward guidance policy is to be announced, probably using more economic variables, with its initial indications expected around the time the Bank unveils the quarterly Inflation Report in mid February. (The uncharitable might muse that this is of course assuming they can come up with a plan by then, preferably one which lasts longer than the last one.)

One arguable side effect of this Davos speech was that in the last week of January, **a new tranche of ILG 2068** ended up being sold on a real yield of 0.07% p.a., which is astonishingly low for a c.55-year index-linked gilt. In these peculiar (LDI-distorted?) times, investors' bids for ILG 2068 meant the DMO could have shifted £12.5bn of it, but they settled on a tranche of £4.75bn. It must be some very risk-averse investors who would regard buying at that real yield as constituting risk reduction. The real yield on US Treasuries looks very different with their 20-year real yields at about 1% p.a. (and their 30-year real yields at about 1.3% p.a.). With ILG 2068 having a duration (= weighted average payment term) of over 52 years, the potential loss to its investors if UK real yields revert upwards is considerable.

Meanwhile, the Governor went on to make a speech in Edinburgh on the economics of currency unions. (Our December 2011 edition contained some commentators' thoughts on this for the Eurozone. The Governor's approach was rather more rooted in economic theory.) He was very clear that any arrangement to retain Sterling in an independent Scotland would need to be negotiated between the Westminster and Scottish Parliaments - the Bank of England would simply implement whatever monetary arrangements were put in place. From his conclusions: "*If such deliberations ever were to happen, they would need to consider carefully what the economics of currency unions suggest are the necessary foundations for a durable union, particularly given the clear risks if these foundations are not in place. Those risks have been demonstrated clearly in the euro area over recent years, with sovereign debt crises, financial fragmentation and large divergences in economic performance. The euro area is now beginning to rectify its institutional shortcomings, but further, very significant steps must be taken to expand the sharing of risks and pooling of fiscal resources. In short, a durable, successful currency union requires some ceding of national sovereignty. It is likely that similar institutional arrangements would be necessary to support a monetary union between an independent Scotland and the rest of the UK.*"

Seen by some as a 'quiet demolition' of the Scottish nationalists' case for independence with a currency union, the speech does reinforce the UK Treasury's view that it is highly unlikely that such an agreement could be reached between independent Scotland and the rest of the UK.

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 January 2014

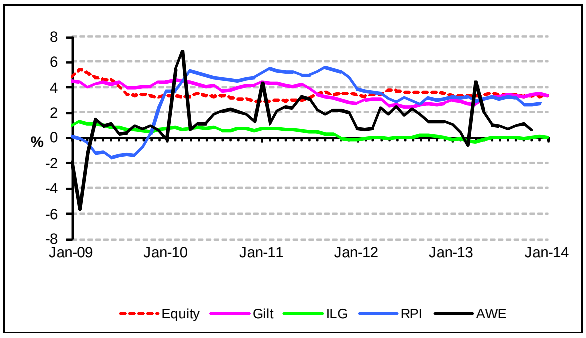
Asset Class	1 month (%)	3 months (%)	12 months (%)	3 years (% p.a.)	5 years (% p.a.)	10 years (% p.a.)	20 years (% p.a.)
UK Equities	-3.1	-2.0	10.1	8.5	15.0	8.5	7.1
Overseas Equities	-3.2	-3.1	9.3	7.3	13.8	8.4	6.6
US Equities	-2.6	-0.2	**17.6**	**13.1**	**16.3**	8.3	8.0
Europe ex UK Equities	-3.2	-3.5	9.8	5.3	12.5	8.7	**8.4**
Japan Equities	-3.1	-3.8	14.0	3.7	5.7	4.7	**-0.1**
Pacific ex Japan Equities	-4.3	-9.3	-8.0	0.2	15.1	**11.8**	5.1
Emerging Markets	**-5.7**	**-11.1**	**-13.0**	**-3.8**	12.2	11.5	5.1
UK Long-dated Gilts	**3.1**	0.2	0.6	9.4	7.6	6.3	7.1
UK Long-dated Corp. Bonds	2.6	-0.2	4.6	9.5	10.9	6.1	-
UK Over 5 Yrs Index-Linked Gilts	1.8	-1.0	-2.1	9.2	8.2	7.2	6.9
High Yield (Global)	0.9	-0.9	2.6	7.9	15.3	9.9	-
Overseas Bonds	2.5	-3.0	-5.3	0.6	**0.6**	5.5	5.0
Property *	2.1	**4.7**	10.9	7.1	7.5	5.7	8.3
Cash	0.0	0.1	0.5	0.7	0.8	**3.0**	4.4
Commodities £-converted	-0.9	-2.7	-10.1	-3.1	2.8	1.5	3.3
Hedge Funds original $ basis *	1.1	3.5	9.1	3.2	7.8	5.7	8.8
Illustrative £-converted version *	0.0	1.2	7.1	1.3	5.1	6.5	8.2
Euro relative to Sterling	-1.4	-3.0	-4.2	-1.4	-1.6	1.9	-
US $ relative to Sterling	0.8	-2.2	-3.5	-0.8	-2.6	1.0	-0.5
Japanese Yen relative to Sterling	3.9	-6.0	-13.7	-7.8	-5.0	1.4	-0.1
Sterling trade weighted	1.1	3.9	6.2	2.1	1.8	-1.6	-0.1
Price Inflation (RPI) *	0.5	0.6	2.7	3.5	3.5	3.3	2.9
Price Inflation (CPI) *	0.4	0.6	2.0	3.0	3.1	2.7	2.2
Price Inflation (RPIX) *	0.5	0.6	2.8	3.6	3.9	3.4	2.9
Earnings Inflation **	-0.3	-0.7	0.6	1.3	1.4	2.7	3.3
All Share Capital Growth	-3.1	-2.5	6.4	4.7	11.0	4.8	3.5
Net Dividend Growth	-0.2	0.5	6.7	10.1	3.4	5.6	-
Earnings Growth	-3.0	10.0	-6.7	-0.4	-0.3	7.1	6.4

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



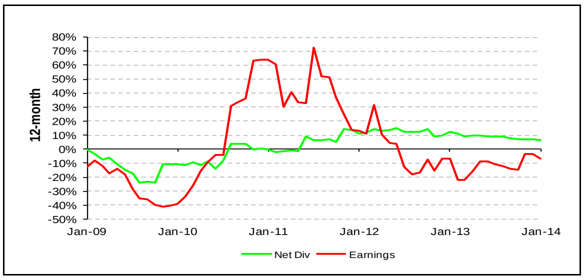
The yield gap is a measure of expected average future inflation, derived as long bond yield minus ILG yield.

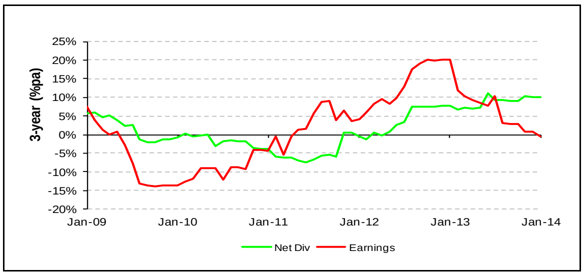
The gap gives a current expectation now falling back from 3.5% for longer-term inflation + risk premium for gilts, relative to index-linked gilts.

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

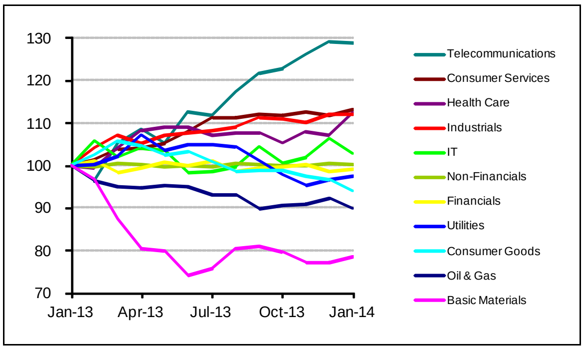




Sources for charts on this page:
Financial Times, Office for National Statistics, J&A

UK Equity Sector Returns

Figure 4a: Sectors relative to All Share



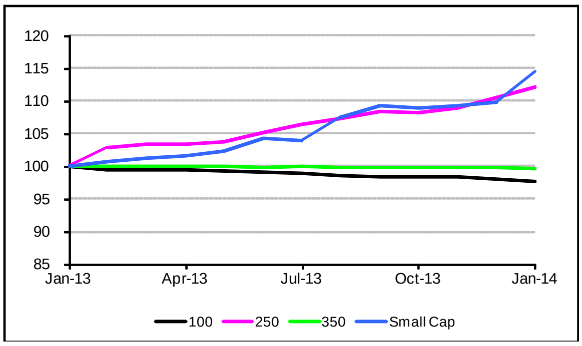
Note: Sector labels for relative lines are in end-value order

There was a fall this month in the rolling 12-month sector dispersion (from 60% to 50%).

(% absolute return)	1 mth	3 mth	12 mth
Oil & Gas	-5.6	-3.0	-1.1
Basic Materials	-1.2	-3.3	-13.4
Industrials	-2.8	-0.8	23.6
Consumer Goods	-6.0	-7.1	3.3
Health Care	1.7	4.9	23.8
Consumer Services	-1.8	-0.7	24.8
Telecommunications	-3.3	2.8	41.9
Utilities	-2.2	-2.1	7.5
Non-Financials	-3.2	-1.8	10.4
Financials	-2.5	-2.6	9.2
IT	-6.4	0.2	13.1
All Share	-3.1	-2.0	10.1

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.

Bond market information

Figure 5: £ Non-Gilt Credit Margins

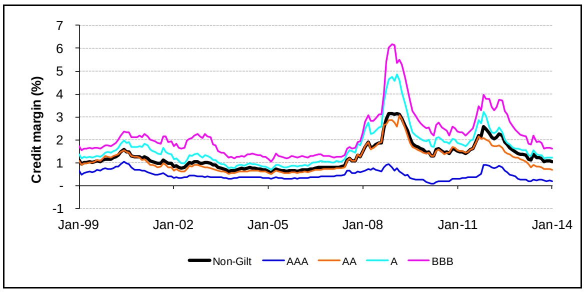


Table 2a: Over 15 Yr Corporate Yields & Margins

Month End	iBoxx Corp AA Y'ld (%)	FT 20 yr Gilt (%)	Margin (%)
Aug '13	4.35	3.42	0.93
Sep '13	4.27	3.34	0.93
Oct '13	4.13	3.29	0.84
Nov '13	4.28	3.44	0.84
Dec '13	4.37	3.57	0.80
Jan '14	**4.19**	**3.34**	**0.85**

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

Category	Mkt Val @ Jan 14 & 11, 08			Weight (%)
Gilts (38)	1,091	801	347	67.8
Non Gilts (1,021)	518	452	416	32.2
AAA (126)	99	125	155	6.2
AA (168)	87	70	61	5.4
A (349)	165	162	131	10.3
BBB (378)	167	96	67	10.4

Category	Mkt Val @ Jan 14, & 11		W't (%)	Dur'n (yrs)
Gilts (38)	1,091	801	67.8	9.5
< 5 Yrs (10)	300	252	18.7	2.7
5–15 Yrs (13)	399	273	24.8	7.1
> 15 Yrs (15)	392	276	24.4	17.1
Non Gilts (1,021)	518	452	32.2	7.9
< 5 Yrs (305)	146	125	9.1	2.8
5–15 Yrs (447)	223	193	13.9	7.5
> 15 Yrs (269)	148	134	9.2	13.6

£ Gilt Market "main" Issuance

- £3.57bn 2¼% 2023 (1.67x, 2.87%, Nov 13)
- £2.20bn 3¼% 2044 (1.88x, 3.59%, Nov 13)
- £1.46bn ILG $^{1}/_{8}$% 2029 (2.12x, r.y 0.17%, Jul 13)
- £4.75bn ILG $^{1}/_{8}$% 20**68** (2.63x, r.y. **0.07%**, Sept 13)

Note: Issuance amounts are nominals.

Tables 2d, 2e: € Market Size and Maturity (Jan 14)

Category	Mkt Val (€bn)	Weight (%)
Sovereigns (278)	4,928	59.5
Non Sovereigns	3,358	40.5
AAA (527)	1,012	12.2
AA (444)	735	8.9
A (755)	830	10.0
BBB (767)	781	9.4

Category	Mkt Val (€bn)	Weight (%)
1 – 3 Yrs (790)	2,166	26.1
3 – 5 Yrs (727)	1,801	21.7
5 – 7 Yrs (527)	1,333	16.1
7 – 10 Yrs (499)	1,544	18.6
10+ Yrs (228)	1,442	17.4

Table 2f: Breakdown of £ Index-Linked Market

Category (Number of issues)	Mkt Val (£bn @ Jan 14 & 11)		W't (%)	Dur'n (yrs)
Gilts (23)	386	245	92.3	19.2
< 5 Yrs (2)	44	22	10.5	2.9
5 – 15 Yrs (6)	105	96	25.1	8.9
> 15 Yrs (15)	237	127	56.6	26.9
Non Gilts (43)	32	24	7.7	17.0

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

Month End	US (%)	Euro (%)	Sterling (%)
Jul 13	5.96	5.06	6.22
Aug 13	6.16	5.09	6.32
Sep 13	6.06	5.04	6.19
Oct 13	5.66	4.64	5.85
Nov 13	5.67	4.54	5.79
Dec 13	5.67	4.52	5.75
Jan 14	**5.63**	**4.41**	**5.65**

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

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