JAGGER & ASSOCIATES

Investment Update
June 2016

Investment Headlines & Comment

- **Real and nominal gilt yields** drop by about 0.5% in a month.
- **10-year bond yields** turn negative in Germany and the Netherlands.
- **Sterling** weakens, and there was material intra-month volatility.

Feature Section

This month we quote from a certain 1939 film – "*Toto, I've a feeling we're not in Kansas anymore*". Data is from iBoxx, the FT, and the Bank of England.

First, Figures 1a and 1b show all- and long-dated corporate and government fixed interest yields for the last 3 years (and the real yield on government bonds as well). From these, it is clear that corporate bond yields have been comparatively stable, and it is recent government bond yields that have been more volatile. If investors have been tactically "fleeing to safety" in Gilts this month, would they really have been going into the long-dated end or just all- or shorter-dated?

Figure 1a: All-dated bond yields

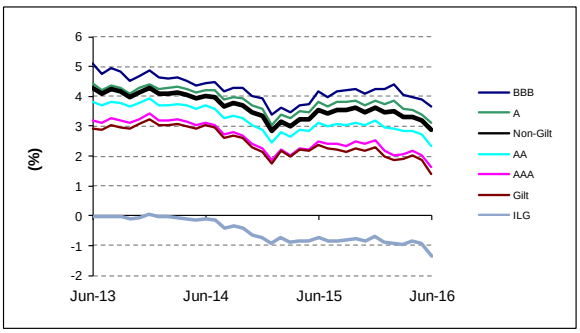
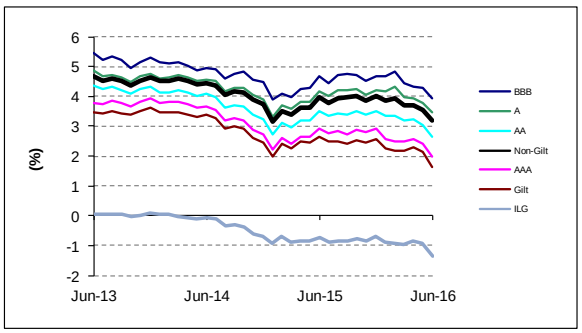


Figure 1b: Long-dated bond yields



Next, have a look at implied year-by-year inflation from comparing these nominal yields against real yields on gilts. With UK all- and long-dated real yields both at -1.4%, Figure 1c shows comparatively stable inflation, with no sign of intervening inflation spikes, and no sign of longer-term inflation picking up. Figure 1d shows the progression of Sterling on a trade-weighted basis, instead of all the US Dollar focus – it has only dropped to the level seen 3 years ago.

Figure 1c: Implied 1-year forward inflation

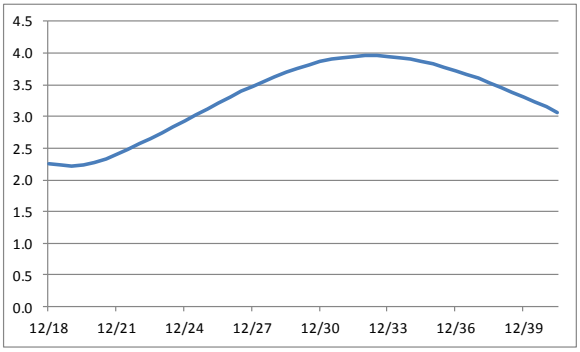


Figure 1d: Trade-weighted Sterling

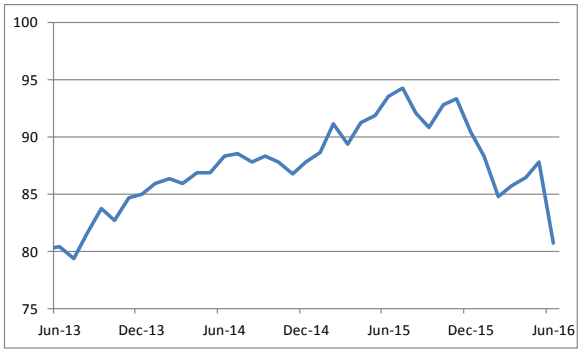
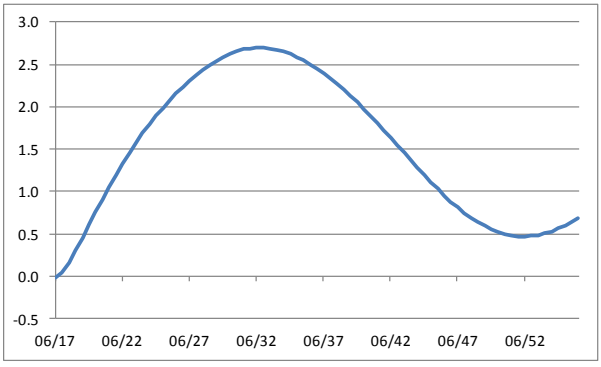


Figure 1e: Implied 1-year forward rates



Finally, Figure 1e shows the year-by-year projection of future interest rates from the current gilt yield curve (the published N-year gilt yield is essentially the annualized equivalent of the combined first N entries in the chart).

It appears "reasonable" (aka explainable) over the first 15 years, implying cash interest rates are going to be pretty slow in rising, and also suggesting they will fall to zero by June of next year.

However, rather than stay at a "typical" level, it then anticipates a major prolonged reversal - it is a bizarre shape. It seems to be further evidence of the long-dated area of UK gilts being over-priced due to external distortion.

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 30 June 2016

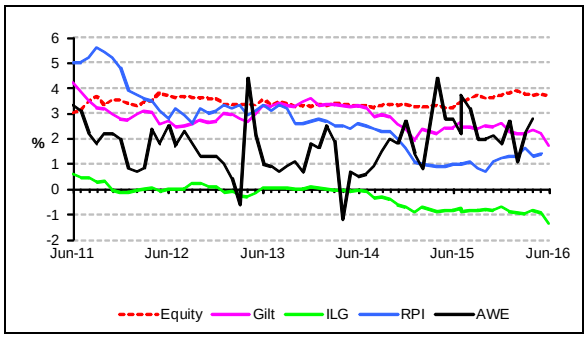
Asset Class	1 month (%)	3 months (%)	12 months (%)	3 years (% p.a.)	5 years (% p.a.)	10 years (% p.a.)	20 years (% p.a.)
UK Equities	2.8	4.7	2.2	5.9	6.3	5.4	6.7
Overseas Equities	8.6	9.0	14.8	11.7	10.2	8.7	7.2
US Equities	9.1	10.3	21.4	**16.2**	**16.2**	**11.0**	7.3
Europe ex UK Equities	4.1	4.4	6.3	7.3	4.5	5.6	8.8
Japan Equities	6.1	8.8	7.8	8.0	8.7	3.7	**1.1**
Pacific ex Japan Equities	11.7	8.5	6.8	6.6	4.2	9.7	6.1
Emerging Markets	13.3	8.4	3.9	3.0	**0.2**	7.3	6.2
UK Long-dated Gilts	10.3	11.8	24.1	15.0	13.1	8.9	**9.0**
UK Long-dated Corp. Bonds	5.3	8.3	15.4	11.2	10.6	7.2	-
UK Over 5 Yrs Index-Linked Gilts	11.6	11.1	17.0	12.2	11.1	9.1	8.5
High Yield (Global)	9.7	**12.3**	20.2	8.2	9.2	**11.0**	-
Overseas Bonds	**13.4**	11.8	**32.7**	7.6	5.2	8.1	5.8
Property *	0.6	0.9	10.4	14.6	10.4	4.8	8.9
Cash	**0.0**	**0.1**	**0.6**	**0.6**	0.6	**2.0**	3.7
Commodities £-converted	9.0	21.1	-13.0	-16.4	-10.8	-7.2	-0.7
Hedge Funds original $ basis *	0.4	3.5	-4.0	2.3	2.1	3.5	7.0
Illustrative £-converted version *	1.1	-0.9	0.7	3.7	4.6	6.2	7.4
Euro relative to Sterling	8.7	4.8	17.4	-1.0	-1.7	1.9	-
US $ relative to Sterling	8.9	7.5	17.7	4.3	3.7	3.3	0.8
Japanese Yen relative to Sterling	17.7	17.8	40.3	3.2	-1.1	4.4	1.1
Sterling trade weighted	-8.0	-5.8	-13.7	0.1	0.7	-2.2	-0.2
Price Inflation (RPI) *	0.3	0.8	1.4	1.6	2.2	2.9	2.7
Price Inflation (CPI) *	0.2	0.6	0.3	0.6	1.5	2.3	1.9
Price Inflation (RPIX) *	0.3	0.8	1.5	1.7	2.2	3.1	2.7
Earnings Inflation **	-9.0	1.4	2.8	1.4	2.2	2.4	3.3
All Share Capital Growth	2.5	3.5	-1.5	2.2	2.6	1.7	3.2
Net Dividend Growth	0.0	0.5	4.1	3.5	6.8	3.4	-
Earnings Growth	-0.3	-18.0	-51.5	-22.3	-15.0	-6.4	-0.1

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

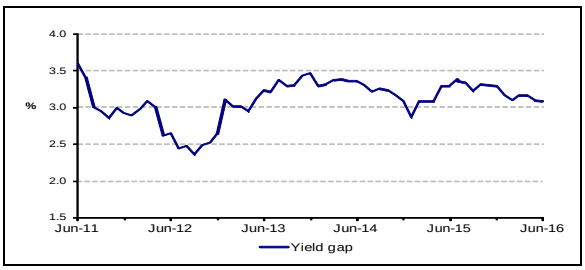
- *UK Equities (incl. dividends and earnings) – FT-A All Share.*
- *Overseas Equities (incl. regions) – blend of FT All-World / World subindices*
- *Emerging Markets from MSCI US $ based total return index (overall Index to 31 Oct 2001, Free Index from 1 Nov 2001 to take account of foreign investment 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.

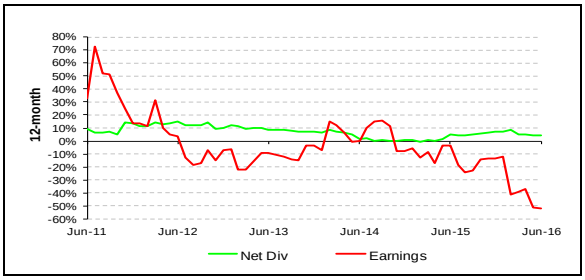


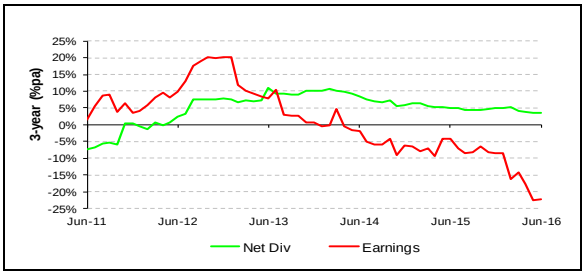
The gap gives a current expectation around 3.1% for longer-term inflation + risk premium for gilts, relative to index-linked gilts.

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

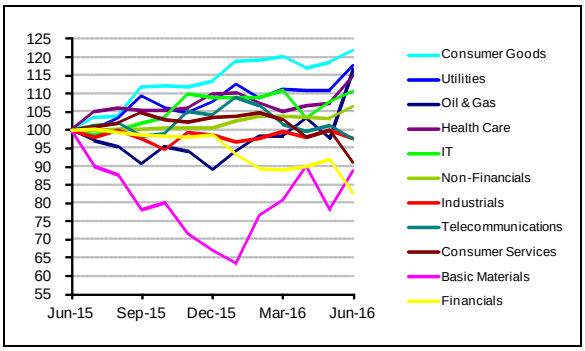




Note: Earnings data from mid 2015 onwards is under review by FTSE Russell as one-off events may be affecting the prospective P/E ratios

UK Equity Sector Returns

Figure 4a: Sectors relative to All Share



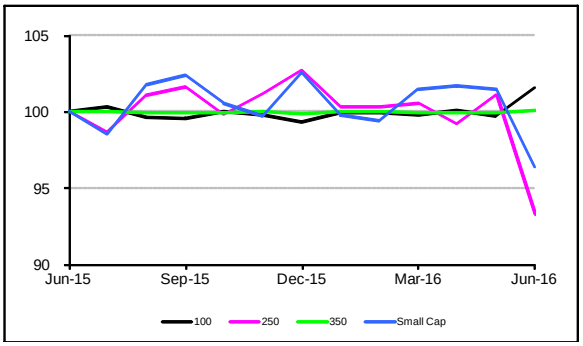
Note: Sector labels for relative lines are in end-value order

There was a fall this month in the rolling 12-month sector dispersion (from 46% to 39%).

(% absolute return)	1 mth	3 mth	12 mth
Oil & Gas	22.7	24.1	19.1
Basic Materials	16.9	15.3	-9.3
Industrials	0.2	2.4	-0.3
Consumer Goods	5.6	6.0	24.5
Health Care	10.0	14.5	17.3
Consumer Services	-6.4	-7.5	-7.1
Telecommunications	-1.2	0.4	-0.6
Utilities	9.1	10.9	20.3
Non-Financials	6.2	7.1	8.7
Financials	-7.4	-3.0	-15.6
IT	5.6	4.3	12.9
All Share	2.8	4.7	2.2

UK Equity Size Returns

Figure 4b: Size groups relative to All Share



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

FRS17 volatility indicator

Now discontinued, but available on request.

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

Bond market information

Figure 5: £ Non-Gilt Credit Margins

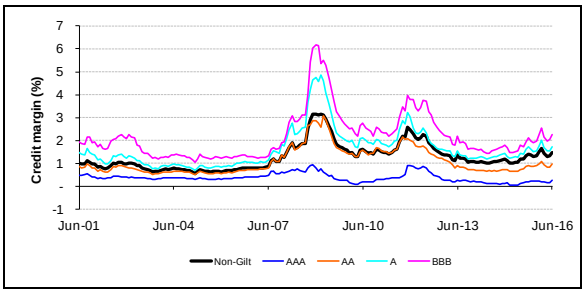


Table 2a: Over 15 Yr Corporate Yields & Margins

Month End	iBoxx Corp AA Y'ld (%)	FT 20 yr Gilt (%)	Margin (%)
Jan '16	3.52	2.27	1.25
Feb '16	3.61	2.18	1.43
Mar '16	3.33	2.21	1.12
Apr '16	3.28	2.34	0.94
May '16	3.13	2.18	0.95
Jun '16	**2.73**	**1.72**	**1.01**

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

Category	Mkt Val @ Jun 16 & 13, 10			Weight (%)
Gilts (39)	1,357	1,066	760	71.3
Non Gilts (1,015)	547	514	469	28.7
AAA (125)	109	105	141	5.7
AA (190)	96	82	75	5.0
A (330)	163	170	164	8.6
BBB (370)	178	157	89	9.4

Category	Mkt Val @ Jun 16 & 13		W't (%)	Dur'n (yrs)
Gilts (39)	1,357	1,066	71.3	11.6
< 5 Yrs (11)	352	313	18.5	2.8
5–15 Yrs (12)	407	363	21.4	7.5
> 15 Yrs (16)	598	390	31.4	19.6
Non Gilts (1,015)	547	514	28.7	8.1
< 5 Yrs (339)	159	146	8.4	2.6
5–15 Yrs (438)	232	205	12.2	7.5
> 15 Yrs (238)	155	163	8.2	14.8

£ Gilt Market "main" Issuance

- £3.16bn 1½% 2021 (1.60x, 0.86%, May 16)
- £1.71bn 4¼% 2046 (1.37x, 2.09%, Jul 10)
- £0.90bn $^{1}/_{8}$% IL 2036 (1.75x, ry -0.97%, Mar 16)

Note: Issuance amounts are nominals.

Tables 2d, 2e: € Market Size and Maturity (Jun 16)

Category	Mkt Val (€bn)	Weight (%)
Sovereigns (329)	5,998	61.2
Non Sovereigns	3,800	38.8
AAA (683)	1,103	11.3
AA (613)	993	10.1
A (806)	821	8.4
BBB (981)	882	9.0

Category	Mkt Val (€bn)	Weight (%)
1 – 3 Yrs (756)	2,067	21.1
3 – 5 Yrs (874)	2,055	21.0
5 – 7 Yrs (777)	1,699	17.3
7 – 10 Yrs (653)	1,822	18.6
10+ Yrs (352)	2,154	22.0

Table 2f: Breakdown of £ Index-Linked Market

Category (Number of issues)	Mkt Val (£bn @ Jun 16 & 13)		W't (%)	Dur'n (yrs)
Gilts (27)	574	354	93.8	22.7
< 5 Yrs (3)	50	44	8.2	-
5 – 15 Yrs (7)	137	98	22.4	-
> 15 Yrs (17)	386	212	63.1	30.1
Non Gilts (36)	38	30	6.2	17.3

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

Month End	US (%)	Euro (%)	Sterling (%)
Dec '15	7.51	5.13	6.51
Jan '16	7.81	5.21	6.80
Feb '16	7.62	5.48	7.20
Mar '16	6.95	4.39	6.67
Apr '16	6.41	4.00	6.51
May '16	6.41	3.99	6.45
Jun '16	**6.36**	**4.13**	**6.79**

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

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