JAGGER & ASSOCIATES

Investment Update
August 2016

Investment Headlines & Comment

- Another utterly remarkable month for **Index-Linked Gilts**.
- Still no sign of markets pricing for **inflation** to take off though.
- The **UK bank base rate** has been cut to 0.25%.

Feature Section

This month we outline the Bank of England's latest idea, and despair at the collateral damage that it is managing to cause in the process. Back in 2009, the Bank decided to use Quantitative Easing (QE) with a view to stimulating the economy. See our March 2009 and December 2009 issues for background (the latter shows the expanded profile across the gilt market).

The Bank has then sat on this Gilt portfolio, and seen its value appreciate significantly as gilt yields have fallen, but it has so far declined to start selling any of the gilts back into the market – even though there remains strong demand for long-dated Gilts, and increased long-dated yields would remove some of the artificially-induced pressure being placed on defined benefit pension funds and their sponsors, arguably to the detriment of younger employees (who are generally not accruing defined benefits).

At the beginning of August, the Bank decided to cut interest rates from 0.5% to 0.25%, but what is this likely to achieve? If things weren't working at negligible rates of 0.5% in terms of getting financial institutions to lend to businesses which wanted to borrow, then why is 0.25% going to be any better for that?

The Bank also decided to do another £60bn of QE on gilts, and announced that from September 2016 they would look to do £10bn of QE on corporate bonds. These corporate bonds were to be from "firms making a material contribution to the UK economy", but they were to exclude banks, building societies and insurance companies, and subsidiaries of these as well. The idea was to stimulate new issuance by companies. (Note that whilst the sterling non-gilt market is £584bn, as per table 2b on page 4, within that the sterling corporate non-financials market is only £231bn, so the Bank is potentially going to buy just over 4% of that market, although this is considerably less of that market than it has "acquired" under the Gilt QE scheme.)

The Corporate QE announcement promptly saw yields on investment grade corporate bonds contract by about 0.3% (the effect on the credit margin was less marked - see Figure 5 on page 4), even though purchases will only start in September. (**Ed:** Is it just me that sees an inverse parallel with Gordon Brown announcing that he was going to sell gold and getting less because the price fell in the meantime before he started? How much further will corporate bond yields move before the Corporate QE actually starts? How significant will the effect be on pension schemes as reported in company accounts? Will the accounting goalposts move?)

Meanwhile, the Gilt QE programme suffered some slight embarrassment in its first week, when it failed to meet its £1,170m target for buying Over 15 year gilts (it reached £1,118m, but in hindsight this might just be due to investors being slow off the mark to decide how they wanted to act in the new situation). (The Bank purchases gilts with a residual maturity of 3-7 years on Mondays; over 15 years on Tuesdays; and 7-15 years on Wednesdays. The updated spreadsheet of what they buy can be found at the Bank's Asset Purchase Facility – Gilts results page.)

Given how much pension funds and insurers have been willing to pay in order to have these long gilts in their portfolios, it would be a major surprise if there were many willing sellers (and the Bank is still issuing new tranches of long-dated debt, such as the issue of £1.25bn of the 4¼% 2055 Gilt this month, where buyers did not exercise the Post Auction Option). However, in the second week of the Gilt QE programme, over £3bn of long gilts were offered to the bank so it met its £1,170m target easily. In the third and fourth weeks, £1.8bn and £2.4bn respectively of long gilts were offered to the bank so QE supply continues to be rather variable.

Finally, a thought – just suppose some pension schemes start realizing some of their LDI portfolios to cash in on interest rate related profits. If they have done their LDI within leveraged pooled funds, they are not subject to tax, but if instead they had openly borrowed cash to buy the gilts (which is mathematically the same thing), there are circumstances where a 40% scheme sanction tax would have been involved. Not terribly consistent?!

JAGGER & ASSOCIATES

Investment Update

August 2016

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 August 2016

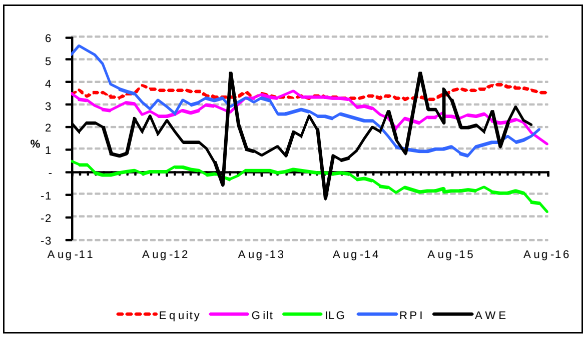
Asset Class	1 month (%)	3 months (%)	12 months (%)	3 years (% p.a.)	5 years (% p.a.)	10 years (% p.a.)	20 years (% p.a.)
UK Equities	1.9	9.0	11.7	6.4	9.5	5.8	6.8
Overseas Equities	1.7	16.1	27.8	14.1	14.2	9.4	7.8
US Equities	1.5	15.8	31.4	18.4	**19.7**	**11.7**	7.8
Europe ex UK Equities	1.8	11.6	15.9	8.5	10.0	6.1	9.2
Japan Equities	1.6	15.7	21.1	12.4	12.0	4.8	**2.0**
Pacific ex Japan Equities	3.2	22.7	**34.3**	10.3	8.3	10.6	6.7
Emerging Markets	3.9	24.6	31.8	7.3	4.4	8.2	7.0
UK Long-dated Gilts	5.6	20.6	31.3	**18.5**	13.5	9.4	**9.4**
UK Long-dated Corp. Bonds	6.1	20.4	30.8	15.6	12.9	8.3	-
UK Over 5 Yrs Index-Linked Gilts	**10.2**	**24.8**	27.7	16.5	13.0	9.8	9.0
High Yield (Global)	3.4	17.1	28.0	10.7	11.8	**11.7**	-
Overseas Bonds	0.3	15.0	30.1	8.5	4.9	8.4	5.8
Property *	**-2.3**	**-1.6**	5.5	13.3	9.7	4.3	9.0
Cash	0.0	0.1	**0.6**	**0.6**	**0.6**	**1.9**	3.6
Commodities £-converted	3.2	2.4	-7.3	-19.7	-11.8	-7.0	-0.9
Hedge Funds original $ basis *	1.9	2.7	0.0	3.1	2.7	3.8	7.3
Illustrative £-converted version *	2.6	13.3	17.5	7.8	7.2	7.4	8.1
Euro relative to Sterling	1.0	11.2	16.8	-0.1	-0.8	2.4	-
US $ relative to Sterling	1.4	11.1	17.4	5.7	4.4	3.8	0.9
Japanese Yen relative to Sterling	0.4	19.2	37.6	3.9	-1.7	5.1	1.1
Sterling trade weighted	-0.9	-10.2	-14.5	-1.1	-0.1	-2.7	-0.2
Price Inflation (RPI) *	0.1	0.8	1.9	1.8	2.3	2.9	2.8
Price Inflation (CPI) *	0.0	0.4	0.6	0.8	1.5	2.3	1.9
Price Inflation (RPIX) *	0.1	0.8	1.9	1.9	2.4	3.1	2.8
Earnings Inflation **	0.4	-9.9	2.1	1.6	1.4	2.1	3.2
All Share Capital Growth	1.2	7.8	7.6	2.7	5.7	2.1	3.3
Net Dividend Growth	1.2	1.2	5.3	3.2	6.1	3.7	-
Earnings Growth	-3.3	-4.5	-42.3	-20.4	-18.3	-7.2	-0.3

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

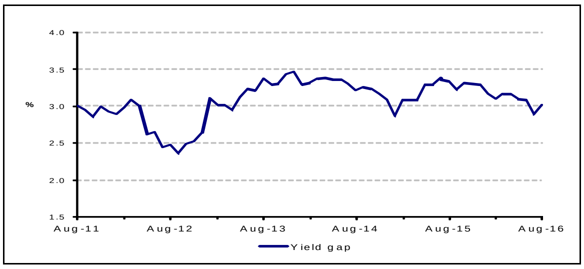
- *UK Equities (incl. dividends and earnings) – FT-A All Share.*
- *Overseas Equities (incl. regions) – blend of FT All-World / World subindices*
- *Emerging Markets from MSCI US $ based total return index (overall Index to 31 Oct 2001, Free Index from 1 Nov 2001 to take account of foreign investment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

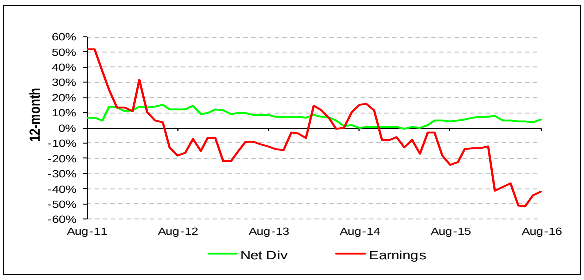


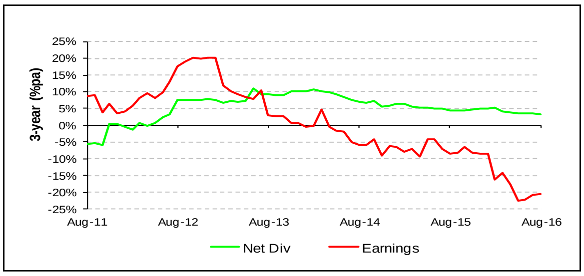
The gap gives a current expectation around 3% for longer-term inflation + risk premium for gilts, relative to index-linked gilts.

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

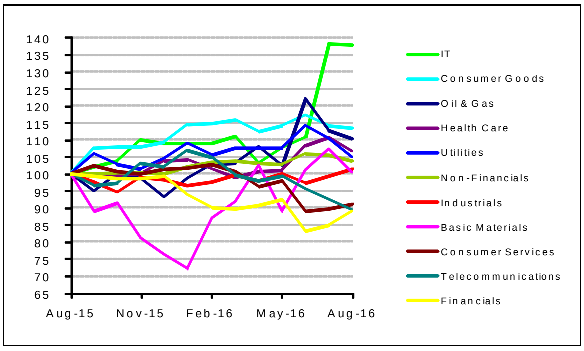




Note: Earnings data from mid 2015 onwards is under review by FTSE Russell as one-off events may be affecting the prospective P/E ratios

UK Equity Sector Returns

Figure 4a: Sectors relative to All Share



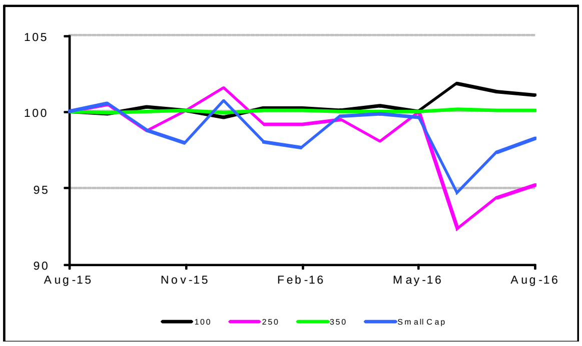
Note: Sector labels for relative lines are in end-value order

There was a slight fall this month in the rolling 12-month sector dispersion (from 56% to 49%).

(% absolute return)	1 mth	3 mth	12 mth
Oil & Gas	-0.1	17.7	23.5
Basic Materials	-4.5	23.1	12.3
Industrials	3.8	10.4	13.2
Consumer Goods	1.2	8.2	26.8
Health Care	-2.0	14.8	19.2
Consumer Services	3.2	1.2	1.7
Telecommunications	-1.5	-1.9	0.1
Utilities	-3.1	6.3	17.4
Non-Financials	0.4	10.3	16.2
Financials	6.9	4.9	-0.6
IT	1.5	39.4	54.0
All Share	1.9	9.0	11.7

UK Equity Size Returns

Figure 4b: Size groups relative to All Share



Mid and Small Cap continued to rebound in relative terms this month, whilst Large Cap fell 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

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

Investment Update

August 2016

Bond market information

Figure 5: £ Non-Gilt Credit Margins

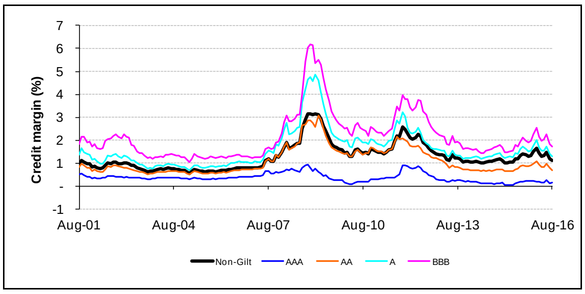


Table 2a: Over 15 Yr <u>Corporate</u> Yields & Margins

Month End	iBoxx Corp AA Y'ld (%)	FT 20 yr Gilt (%)	Margin (%)
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
Jul '16	2.29	1.50	0.79
Aug '16	**1.95**	**1.24**	**0.71**

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

Category	Mkt Val @ Aug 16 & 13, 10			Weight (%)
Gilts (39)	1,452	1,084	819	71.3
Non Gilts (1,010)	584	518	491	28.7
AAA (124)	114	106	147	5.6
AA (180)	99	83	75	4.8
A (339)	181	167	175	8.9
BBB (367)	191	161	95	9.4

Category	Mkt Val @ Aug 16 & 13		W't (%)	Dur'n (yrs)
Gilts (39)	1,452	1,084	71.3	12.0
< 5 Yrs (12)	395	332	19.4	2.8
5–15 Yrs (11)	391	354	19.2	7.7
> 15 Yrs (16)	665	399	32.7	20.1
Non Gilts (1,010)	584	518	28.7	8.5
< 5 Yrs (343)	168	147	8.2	2.6
5–15 Yrs (432)	241	206	11.8	7.6
> 15 Yrs (235)	176	165	8.6	15.5

£ Gilt Market "main" Issuance

- £2.50bn ½% 2022 (2.28x, 0.54%, new)
- £1.25bn 4¼% 2055 (1.70x, 1.21%, Jun 15)
- £0.95bn $^{1}/_{8}$% IL 2036 (1.61x, ry -1.72%, Jun 16)

Note: Issuance amounts are nominals.

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

Category	Mkt Val (€bn)	Weight (%)
Sovereigns (326)	6,031	60.9
Non Sovereigns	3,879	39.1
AAA (675)	1,074	10.8
AA (633)	1,060	10.7
A (819)	840	8.5
BBB (991)	906	9.1

Category	Mkt Val (€bn)	Weight (%)
1 – 3 Yrs (764)	2,044	20.6
3 – 5 Yrs (873)	2,072	20.9
5 – 7 Yrs (793)	1,699	17.1
7 – 10 Yrs (659)	1,908	19.3
10+ Yrs (355)	2,186	22.1

Table 2f: Breakdown of £ Index-Linked Market

Category (Number of issues)	Mkt Val (£bn @ Aug 16 & 13)		W't (%)	Dur'n (yrs)
Gilts (27)	645	361	93.9	23.5
< 5 Yrs (3)	51	44	7.4	-
5 – 15 Yrs (7)	146	99	21.3	-
> 15 Yrs (17)	448	217	65.2	30.6
Non Gilts (36)	42	31	6.1	17.6

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

Month End	US (%)	Euro (%)	Sterling (%)
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
Jul '16	6.01	3.72	6.27
Aug '16	**5.68**	**3.47**	**5.87**

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

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

Contact: Ground Floor, 14 Exchange Quay,
Salford Quays, Manchester M5 3EQ
Tel.: 0161 873 9350, Fax: 0161 877 4851
web: www.jaggerandassociates.co.uk ,
e-mail: enquiries@jaggerandassociates.co.uk

See our website for details of the investment consultancy services we provide to actuarial firms, pension funds, universities and other endowment funds, and charities.

Regulated by the Institute and Faculty of Actuaries in respect of a range of investment business activities.

Although every effort is made to ensure the accuracy of the figures contained in Update, we cannot accept any liability for loss as a result of their use. This publication should not be taken as formal investment advice for any particular institution – specific guidance should be sought from us.