



Investment Update December 2021

Investment Headlines & Comment

- A good month for many equity markets in local terms, China being a notable exception.
- A poor month for UK Government conventional and index-linked bonds.
- Sterling finished the year strongly, as a UK interest rate rise was implemented.

Feature Section This month, following on from last month's review of the UK's Index-Linked Gilt (ILG) market, we now consider how global inflation-linked markets have developed. There are now six government markets in the relevant JP Morgan index, although it is fair to say that the USA and the UK are by far the two dominant players.

Figure 1 summarises the various markets as at 31 December 2021, based on JP Morgan estimates published on 22 December 2021. (Modified duration = weighted average term of remaining payments on the bonds.)

Figure 1: Global Government Index-Linked Bond Markets

Country	Number of issues	Market value (USD bn)	Modified Duration (years)	Average Real Yield (% p.a.)
France	16	302	8.95	(1.67)
Germany	5	107	9.62	(2.11)
Italy	11	210	8.25	(0.65)
Spain	5	84	6.97	(1.50)
United Kingdom	32	1,164	21.40	(2.45)
United States	45	1,763	8.17	(0.89)

Source: JP Morgan

Readers may be struck by the contrast of the comparatively high number of issues yet a relatively low duration for the United States in Figure 1. The US Treasury Inflation Protected Securities (TIPS) market began in 1997. It is interesting as it effectively splits into two distinct markets. The first, the dominant part with a value of around \$1.4trn, looks to have evolved into having up to four bonds maturing in each calendar year, in the middle of January / April / July / October (although there are some quarters which did not get established). In the first section, the shortest dated one matures in January 2023, the longest in April 2032.

The second part of the TIPS market, with a value of around \$0.36trn currently consists of just one bond per calendar year, maturing in February from 2040 through to 2051. There is thus something of a gap for much of the 2030s decade. The reason for this is the policy change in 2009 by the US Treasury, moving from building up 20-year TIPS to building up 30-year TIPS instead. (Ed.: Bit of a shame about the resulting gap if an investor now has, say, a 15-year inflation-linked liability to protect.)

The UK is easily the longest-dated inflation-linked bond market, and demonstrably has the most negative average real yield. Unless the UK is going to suffer dramatically higher inflation than the level the Bank of England is tasked with delivering, the conclusion has to be that ILGs are incredibly expensive. In past editions we have made the case that this mainly arises because of the pension fund industry's near obsession with Liability Driven Investment (LDI). When we last looked at the UK and US markets in our [September 2016](#) edition, we put forward the case for using hedged US inflation-linked debt as a return-seeking alternative to ILGs. The argument still applies (and there are now hedged pooled funds available).

German inflation linked debt first emerged in 2006, using European inflation, rather than the German index. Implied future Eurozone inflation is considerably lower than implied UK inflation, which could either indicate just how much trouble the Eurozone is in, or how overstated prospective UK inflation is – or both.



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 December 2021

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	4.7	4.2	18.3	8.3	5.4	7.7	6.2
Overseas Equities	1.6	6.2	20.0	18.9	13.2	14.5	9.2
US Equities	1.6	9.6	28.0	23.8	16.5	18.2	8.0
Europe ex UK Equities	3.6	4.7	17.6	15.4	10.3	11.6	10.1
Japan Equities	-0.4	-4.9	2.5	9.3	6.7	10.2	6.3
Pacific ex Japan Equities	0.0	-0.7	-0.1	10.9	9.0	9.6	10.7
Emerging Markets	-0.4	-1.7	-1.3	9.1	8.3	7.3	10.3
UK Long-dated Gilts	-5.0	5.6	-7.3	5.7	4.1	5.9	6.6
UK Long-dated Corp. Bonds	-3.2	2.6	-5.8	8.3	5.2	7.3	6.7
UK Over 5 Yrs Index-Linked Gilts	-6.1	5.4	4.2	7.7	5.0	7.0	7.8
High Yield (Global)	-0.7	-1.2	2.3	5.4	3.9	8.0	8.1
Overseas Bonds	-3.0	-1.6	-5.7	0.5	0.9	2.4	4.8
Property *	2.2	5.8	16.5	5.3	7.1	8.3	7.6
Cash	0.0	0.0	0.1	0.4	0.5	0.5	2.1
Commodities £-converted	5.1	1.1	41.6	5.8	0.9	-4.2	0.3
Hedge Funds original \$ basis *	-2.0	-0.9	13.9	9.5	7.0	5.6	5.9
Illustrative £-converted version *	1.5	3.0	14.9	8.1	5.8	7.5	6.3
Euro relative to Sterling	-1.3	-2.3	-6.2	-2.2	-0.3	0.0	1.6
US \$ relative to Sterling	-2.3	-0.5	0.9	-2.0	-1.8	1.4	0.4
Japanese Yen relative to Sterling	-3.7	-3.5	-9.5	-3.6	-1.6	-2.6	1.0
Sterling trade weighted	1.4	1.7	4.5	2.3	1.2	0.2	-1.0
Price Inflation (RPI) *	0.7	2.2	7.1	3.4	3.4	2.8	3.0
Price Inflation (CPI) *	0.8	2.1	5.1	2.3	2.5	1.9	2.2
Price Inflation (RPIX) *	0.8	2.3	7.2	3.5	3.5	2.9	3.1
Earnings Inflation **	0.5	0.1	4.0	3.5	3.4	2.6	2.9
All Share Capital Growth	4.5	3.7	14.5	4.6	1.7	3.9	2.6
Dividend Growth	0.9	2.0	2.9	-7.4	-0.7	2.6	3.4
Earnings Growth	-1.4	7.9	59.8	-2.3	18.0	0.8	4.6

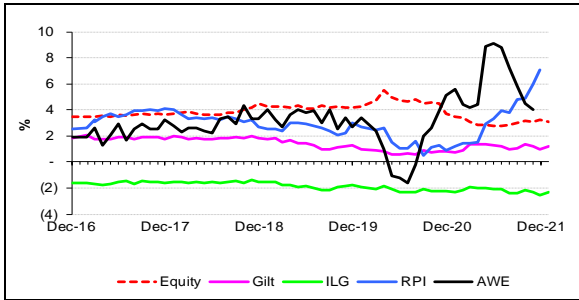
Note: All market returns are total returns for pension funds with income reinvested monthly. Indices used are as follows:

- UK Equities (incl. dividends and earnings) – FT-A All Share.
- Overseas Equities (incl. regions) – blend of FT All-World / World sub-indices
- 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 – ICE Global, £ Unhedged
- Overseas Bonds – JP Morgan Traded Unhedged World ex UK
- Property – MSCI IPD UK Monthly Property 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.

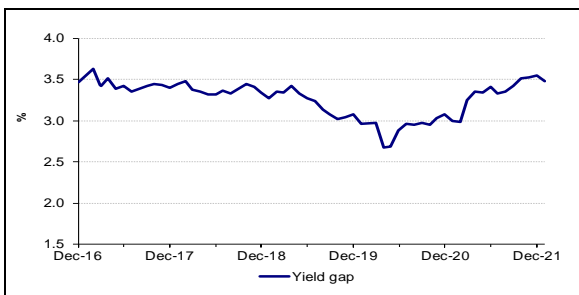


Yields and Yield Gaps

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.

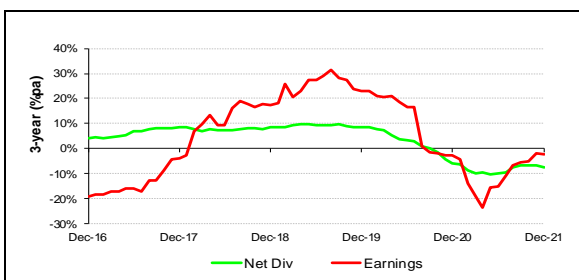
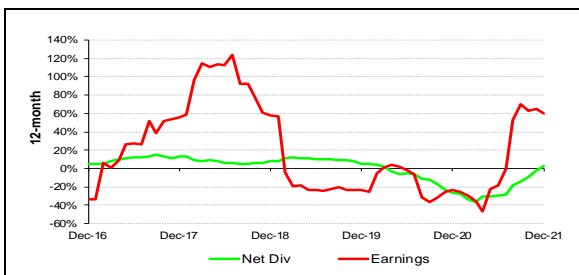


The gap gives a current expectation around 3.5% for longer-term inflation including the risk premium for gilts, relative to index-linked gilts.

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]

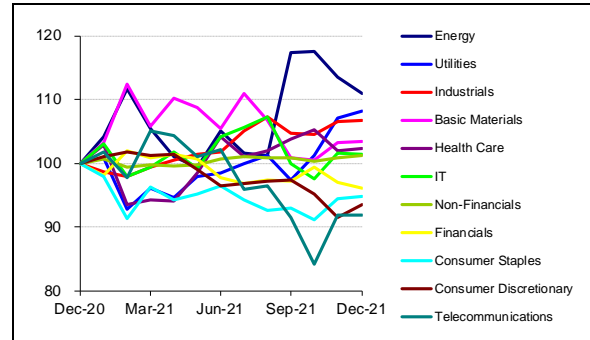
Figure 3: Dividend & Earnings Growth



Note: Earnings data from mid-2015 onwards is no longer reliable as one-off events may be affecting the prospective P/E ratios

UK Equity Sector Returns

Figure 4a: Sectors relative to All Share



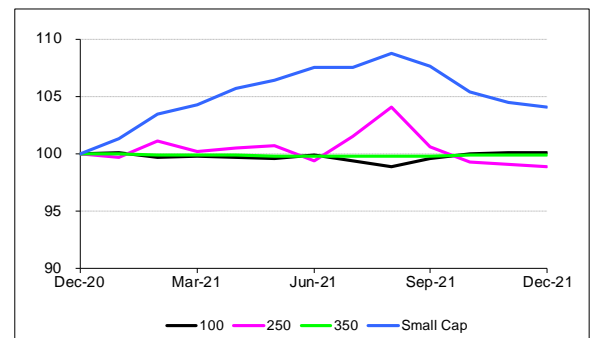
Note: Sector labels for relative lines are in end-value order

There was a small drop this month in the rolling 12-month sector dispersion (falling from 20% to 19%).

(% absolute return)	1 mth	3 mth	12 mth
Energy	2.3	-1.5	31.3
Basic Materials	4.9	6.9	22.4
Industrials	4.8	6.2	26.2
Consumer Staples	5.0	6.1	12.1
Health Care	5.0	2.6	21.0
Consumer Discretionary	7.1	0.1	10.6
Telecommunications	4.5	4.5	8.6
Utilities	5.7	15.7	28.0
Non-Finan	4.9	4.5	19.7
Financials	3.8	3.2	13.7
IT	4.5	5.6	19.9
All Share	4.7	4.2	18.3

UK Equity Size Returns

Figure 4b: Size groups relative to All Share



This month, Mid Cap and Small Cap both fell relative to the All Share.

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



Bond market information

Figure 5: £ Non-Gilt Credit Margins

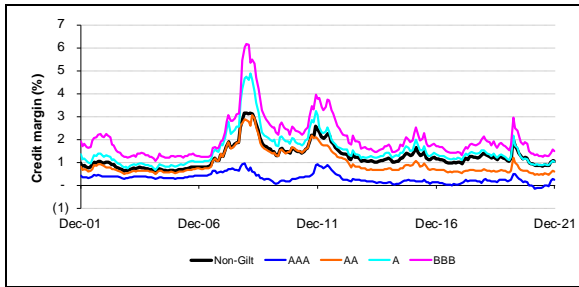


Table 2a: Over 15 Yr Corporate Yields & Margins

Month End	iBoxx Corp AA Y'ld (%)	FT 20 yr Gilt (%)	Margin (%)
Jul '21	1.62	1.00	0.62
Aug '21	1.65	1.07	0.58
Sep '21	2.01	1.39	0.62
Oct '21	1.78	1.19	0.59
Nov '21	1.64	1.00	0.64
Dec '21	1.89	1.20	0.69

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

Category	Mkt Val (£bn @ Dec 21 & 18, 15)			Weight (%)
Gilts (54)	1,812	1,323	1,211	73.2
Non-Gilts (1,192)	662	569	525	26.8
AAA (136)	129	119	100	5.2
AA (146)	80	83	91	3.2
A (386)	189	153	155	7.6
BBB (524)	265	215	179	10.7

Category	Mkt Val (£bn @ Dec 21, 18)		W't (%)	Dur'n (yrs)
Gilts (54)	1,812	1,323	73.2	12.9
< 5 Yrs (13)	447	350	18.1	2.9
5-15 Yrs (15)	535	347	21.6	8.2
> 15 Yrs (26)	831	626	33.6	21.3
Non-Gilts (1,192)	662	569	26.8	7.8
< 5 Yrs (444)	242	187	9.8	2.9
5-15 Yrs (514)	271	243	11.0	7.4
> 15 Yrs (234)	149	139	6.0	16.6

Tables 2d, 2e: € Market Size and Maturity (Dec 21)

Category	Mkt Val (€bn)	Weight (%)
Sovereigns (434)	7,684	58.7
Non-Sovereigns	5,414	41.3
AAA (1,010)	1,388	10.6
AA (783)	1,298	9.9
A (1,341)	1,177	9.0
BBB (1,945)	1,551	11.8

Category	Mkt Val (€bn)	Weight (%)
1 – 3 Yrs (1,356)	2,755	21.0
3 – 5 Yrs (1,343)	2,616	20.0
5 – 7 Yrs (1,061)	2,099	16.0
7 – 10 Yrs (943)	2,271	17.3
10+ Yrs (810)	3,357	25.6

Table 2f: Breakdown of £ Index-Linked Market

Category (Number of issues)	Mkt Val (£bn @ Dec 21 & 18)		W't (%)	Dur'n (yrs)
Gilts (32)	875	675	100.0	21.3
< 5 Yrs (4)	91	59	10.4	2.4
5 – 15 Yrs (9)	223	160	25.5	9.7
> 15 Yrs (19)	561	456	64.1	29.0

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

Month End	US (%)	Euro (%)	Sterling (%)
Jul '21	4.23	2.60	4.18
Aug '21	4.18	2.58	4.18
Sep '21	4.25	2.69	4.32
Oct '21	4.40	2.94	4.65
Nov '21	4.73	3.14	4.84
Dec '21	4.46	2.99	4.80

Sources: DMO, FTSE, iBoxx, ICE, J&A

£ Gilt Market “main” Issuance

Ed.: We can finally return to the “normal” layout!

- £2.25bn, 1% 2032 (2.23x, 0.92%, 0%, new)
- £1.88bn, 1¼% 2051 (2.42, 0.87%, 25%, Sep 21)

Note: Issuance amounts are nominals. The second % figure in each row is the yield or real yield. The third % figure is the additional amount taken up under the Post Auction Option Facility (PAOF), as a % of the amount of the issue. No PAOF applies for tender or syndication cases.

