



Investment Update November 2008

Investment Headlines & Comment

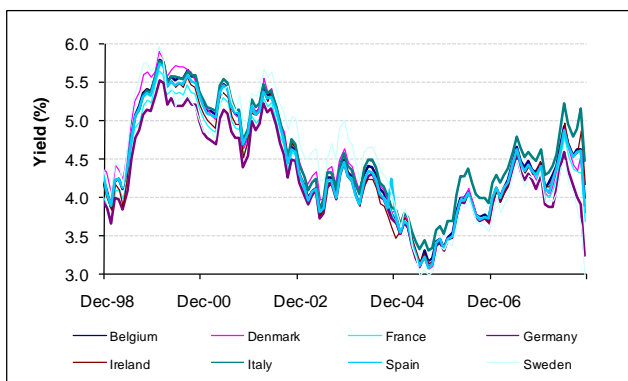
- Even with modest losses over the month as a whole, there was high daily **volatility**. **Credit spreads** have also moved out even further.
- Major **gilt issuance** in this month's pre-budget, most of it maturing in the next 10 years. See below for more on this.
- Significant fund manager redundancies have been announced at **Fidelity** – it seems likely that other cases will follow.

Feature Section

The announcement in the Pre-Budget Report of increased government borrowing coincides with a significant reduction in the bond markets' expectations for future inflation (see page 3 for how rapidly sentiment has moved). The borrowing for the current financial year started at £80bn, and was pushed to £110bn by the bank recapitalization process, but has now gone to a staggering £146bn. This is followed by similar-sized issuance profiles for the next three years after that.

It is mostly short and medium dated gilts that are intended to be issued for the increased 08/09 borrowing, which has understandably left some long-term investors (such as pension funds) somewhat aggrieved. There has to be a question as well on whether there will be enough natural buyers for these short and medium gilts. Already there are signs of yields on new tranches of existing gilts having to be some 0.1% higher to get them into the market. However, in the short-term, the markets data on page 2 shows there have been strong returns from gilts and overseas bonds as a result of the drop in expectations for future inflation. (The astonishing sterling returns from unhedged overseas government bonds over the last 12 months owe much to US \$ and Japanese Yen movements.)

Figure 1: Government bond yields



Source: JP Morgan

Meanwhile, the German government has recently had its fourth failure in issuing 10-year Bund debt – people may not have noticed the first three earlier this year, but as supply issues have come to the fore, the fourth failure is a cause for concern. Elsewhere, the Italian government has failed to sell as much of a short bond as it wanted to, with only €1.4bn being sold. In the UK, we are currently facing a future peak of 57% for debt as a proportion of GDP but Italy is already at 103% (and rising), and Greece is close behind – this suggests they could really struggle to finance their borrowing. In turn, this is leading to divergences in bond yields for some European countries (see Figure 1, which covers the period since the Euro went live), and there is arguably a strain on holding the euro currency system together for some of its members.

Incidentally, that strain makes it all the more remarkable that some pro-euro campaigners here are trying to use the argument of Sterling's current weakness and the Euro's relative strength as a reason for joining! The three countries with the most divergence from the majority, on 10-year yields, are Italy, Ireland and Greece (the last of these is not in Figure 1 as it is not in the JP Morgan index).

There is a further point to watch. The increased government issuance will have an impact on "aggregate indices" (i.e. government bonds + non-government bond combined) – for example, back in the early 1990s, the sterling corporate bond market was pretty small relative to the gilt market, but our July 2001 issue noted the corporate market had expanded to be the same size as the gilt market. Over the next few years, the proportion for the corporate market continued to increase. It peaked at 58% in June 2007, and then fell back, initially because of corporate spreads widening, but more recently because of high gilt issuance. The proportion is now 46% (see page 4), and it is likely to reduce materially over the next few years, so the yield on the indices will fall. It is thus possible to argue that investors should simply hold corporate bonds, and no government bonds at all, but the fear of the unknown on future default (and recovery) rates may deter some from this approach.

Finally, the Debt Management Office have introduced mini-tenders, for issuing small tranches of bonds under a more compact process than is involved for normal gilt auctions. Generally, these mini-tenders are for £250m or so, but this month there was one for £1.25bn ... but against the current gilt market size, maybe a billion is a "mini" amount after all!



Asset Class Returns

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 this.

[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 November 2008

Asset Class	1 month (%)	3 months (%)	12 months (%)	3 years (% p.a.)	5 years (% p.a.)	10 years (% p.a.)
UK Equities	-1.7	-24.8	-32.2	-4.8	3.3	1.0
Overseas Equities	-1.5	-21.7	-25.2	-3.7	3.6	1.5
US Equities	-2.4	-16.6	-16.9	-4.8	1.2	-0.1
Europe ex UK Equities	-2.0	-28.2	-34.6	-2.1	6.0	2.1
Japan Equities	3.9	-10.8	-15.1	-6.7	2.9	1.4
Pacific ex Japan Equities	-1.6	-30.3	-41.2	-0.8	8.0	6.2
Emerging Markets	-2.5	-34.0	-41.5	-1.3	10.4	9.6
UK Long-dated Gilts	6.3	4.0	8.2	3.4	6.1	4.7
UK Long-dated Corp. Bonds	2.7	-7.9	-8.2	-3.1	2.1	4.0
UK Over 5 Yrs Index-Linked Gilts	-2.2	-14.5	-4.5	2.1	5.2	4.8
High Yield (Global)	-3.3	-17.8	-10.0	-3.7	0.6	2.2
Overseas Bonds	9.7	21.7	41.7	12.3	8.2	6.3
Property *	-3.8	-7.1	-20.0	0.3	6.7	8.6
Cash	0.4	1.4	6.0	5.6	5.2	5.1
Commodities £-converted	-10.2	-36.3	-12.3	-6.9	4.1	9.5
Hedge Funds original \$ basis *	-6.0	-12.9	-17.5	2.6	5.0	8.4
Illustrative £-converted version *	3.5	6.7	6.1	5.7	6.0	8.8
Euro relative to Sterling	5.4	2.5	15.9	6.7	3.5	-
US \$ relative to Sterling	5.5	19.0	34.2	4.1	2.3	0.8
Price Inflation (RPI) *	-0.3	0.6	4.2	4.0	3.6	2.8
Price Inflation (CPI) *	-0.3	0.9	4.5	3.0	2.5	1.8
Price Inflation (RPIX) *	-0.3	0.5	4.7	3.7	3.1	2.7
Earnings Inflation **	0.0	-1.6	3.1	3.8	3.8	3.9
All Share Capital Growth	-2.3	-25.6	-35.0	-8.0	-0.1	-2.1
Net Dividend Growth	-13.4	-13.4	0.6	5.8	7.8	4.1
Earnings Growth	1.9	4.6	-8.7	9.0	16.1	6.9

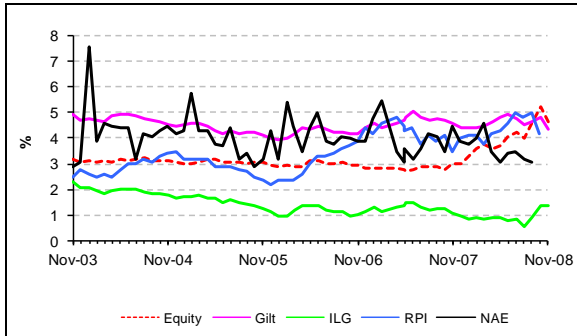
Note: All market returns are total returns for pension funds with income reinvested monthly. Indices used are as follows:

- 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 – Barclays Capital 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 the National Average Earnings Index (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.

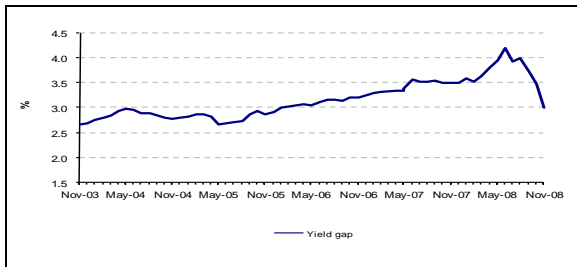


Yields and Yield Gaps

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.

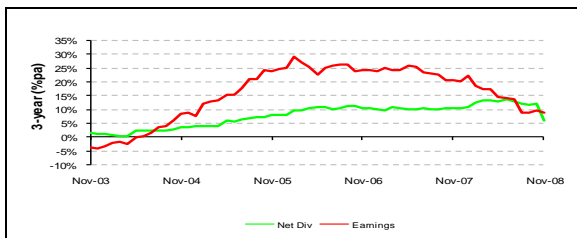
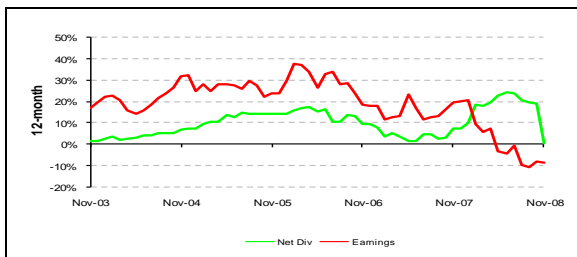


The gap has dropped dramatically this month, suggesting reduced expectations of longer-term inflation + risk premium for conventional bonds, relative to index-linked.

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]

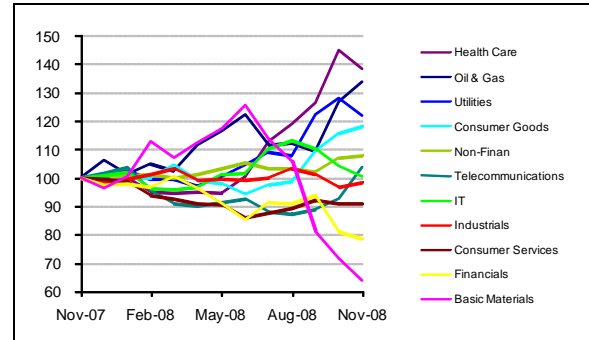
Figure 3: Dividend & Earnings Growth



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



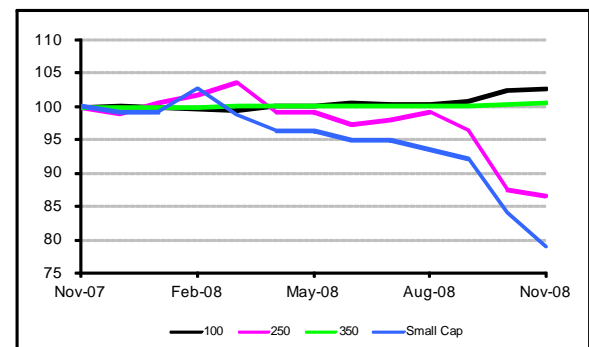
Note: Relative lines' labels for sectors in end-value order

Basic Materials have fallen back further this month.

(% absolute return)	1 mth	3 mth	12 mth
Oil & Gas	3.9	-10.4	-9.4
Basic Materials	-12.4	-54.7	-56.7
Industrials	-0.2	-28.4	-33.3
Consumer Goods	0.4	-10.3	-19.9
Health Care	-6.1	-12.4	-6.1
Consumer Services	-1.6	-23.3	-38.4
Telecommunications	10.3	-10.6	-29.8
Utilities	-6.4	-15.1	-17.4
Non-Finan	-0.8	-21.4	-26.9
Financials	-4.8	-35.2	-46.8
IT	-5.3	-33.3	-31.9
All Share	-1.7	-24.8	-32.2

UK Equity Size Returns

Figure 4b: Size groups relative to All Share



Small and Mid Cap suffered again this month.

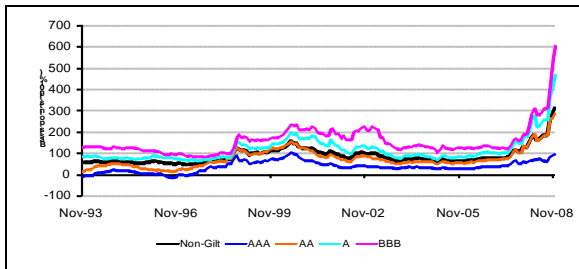
FRS17 volatility indicator

Now discontinued, but available on request.



Bond market information

Figure 5: £ Non-Gilt Credit Margins



£ Gilt Market “main” Issuance

- £2.25bn of 4¾% 2030 (1.37x, yield 4.95%, prev Aug 08)
- £1.25bn of 4¼% 2055 (1.86x, yield 4.35%, “mini tender”)
- £3.50bn of 4¾% 2015 (1.53x, 3.99%, Oct 04 – yes, 04!)
- £4.00bn of 3¼% 2011 (2.37x, 3.12%, new)
- £3.00bn of 4½% 2019 (1.60x, 4.14%, Sep 08)
- £3.75bn of 5% 2012 (1.59x, 3.11%, Jul 08)
- £0.70bn of ILG ¾% 2047 (2.00x, r.y. 0.94%, Jun 08)

Table 2a: Over 15 Yr Corporate Yields & Margins

Month End	iBoxx Corp AA (%)	FT 20 yr Gilt Yield (%)	Margin (%)
Jun 08	6.63	4.98	1.65
Jul 08	6.51	4.76	1.75
Aug 08	6.33	4.55	1.78
Sep 08	7.17	4.65	2.52
Oct 08	7.42	4.83	2.59
Nov 08	7.05	4.37	2.68

Tables 2d, 2e: € Market Size and Maturity (Nov 08)

Category	Mkt Val (€bn)	Weight (%)
Sovereigns (241)	3,341	60.7
Non Sovereigns	2,161	39.3
AAA (619)	1,115	20.3
AA (403)	465	8.5
A (530)	407	7.4
BBB (244)	174	3.2

Category	Mkt Val (€bn)	Weight (%)
1 – 3 Yrs (588)	1,541	28.0
3 – 5 Yrs (510)	1,237	22.5
5 – 7 Yrs (359)	755	13.7
7 – 10 Yrs (377)	943	17.2
10+ Yrs (203)	1,025	18.6

Tables 2b, 2c: £ Market Size and Maturity

Category	Mkt Val (£bn @ Nov 08 & 06, 04)			Weight (%)
Gilts (29)	466	327	274	53.7
Non Gilts (1,116)	403	415	331	46.3
AAA (236)	153	154	127	17.6
AA (238)	71	67	48	8.2
A (394)	118	126	97	13.6
BBB (234)	58	66	54	6.7
Not rated (14)	2	3	5	0.3

Table 2f: Breakdown of £ Index-Linked Market

Category (Number of issues)	Mkt Val (£bn @ Nov 08 & 06)		W't (%)	Dur'n (yrs)
Gilts (14)	155	133	90.6	13.3
< 5 Yrs (2)	30	21	17.5	3.6
5 – 15 Yrs (4)	53	61	31.0	8.9
> 15 Yrs (8)	72	51	42.1	20.5
Non Gilts (56)	16	13	9.4	15.5

Category	Mkt Val (£bn @ Nov 08, 06)		W't (%)	Dur'n (yrs)
Gilts (29)	466	327	53.7	9.3
< 5 Yrs (9)	133	96	15.3	2.5
5–15 Yrs (9)	149	118	17.1	7.1
> 15 Yrs (11)	184	113	21.2	15.9
Non Gilts (1,116)	403	415	46.3	6.6
< 5 Yrs (338)	141	115	16.2	2.4
5–15 Yrs (470)	150	164	17.3	6.7
> 15 Yrs (308)	112	136	12.9	11.9

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

Month End	US (%)	Euro (%)	Sterling (%)
Jul 08	10.51	12.54	12.64
Aug 08	10.41	12.45	12.57
Sep 08	12.55	15.55	17.16
Oct 08	16.83	21.72	18.89
Nov 08	19.11	24.03	22.56

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