



## Investment Update October 2010

### Investment Headlines & Comment

- The UK's **net debt to GDP ratio** is now almost 65% (more than double its low value in 2002/03).
- The much-maligned “financial intervention” (aka banker rescuing) is only 7.4% of that.
- Table 1 (on page 2) now covers **20 years’ backdata** for most assets, instead of 10 years.

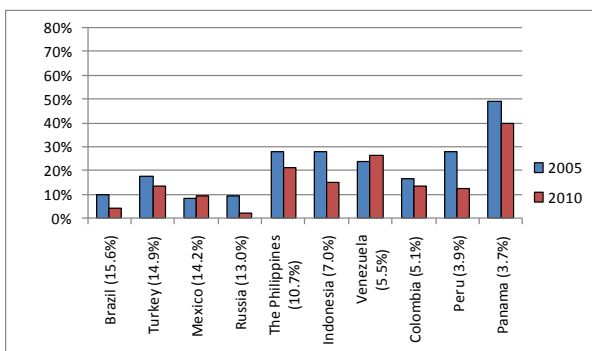
### Feature Section

Following on from last month’s Update, we now examine the returns offered by Emerging Market Debt (EMD) and consider if there are currently any benefits to investing in EMD for institutional investors, relative to other bond investments.

All data is sourced from JP Morgan unless stated otherwise. Figure 1a shows the Sovereign Gross External Debt to GDP ratios of the leading JP Morgan Emerging Market Bond Index Plus (EMBI+) countries (ordered by current weight), with the ratio as at the end of 2005, and estimated for 2010. These ratios have generally declined (= improved) over the past 5 years, mainly as a result of the GDPs of most of the countries in the index increasing significantly over the period whilst the level of external debt has remained fairly stable. The ratios also appear to compare favourably with those of the Developed markets – for example the UK Debt to GDP ratio is 65% (rising by 8% a year at the moment).

However the EMBI+ index does not include the domestic Sovereign debt of the Emerging Market countries. In default, there is usually no preference for local debt over external debt, or vice versa. The level of domestic debt for many Emerging Market countries has increased significantly over the past few years, partly in response to the development of local pension systems. Figure 1b shows the total (domestic plus external) debt to GDP ratios of the leading EMBI+ countries (in the same order as in Figure 1a), again with the ratio as at the end of 2005, and estimated for 2010. Most of the countries have much higher debt to GDP ratios than shown in Figure 1a, and the ratios have shown a much smaller reduction over the past 5 years, as the total level of debt of the emerging market countries has remained fairly stable.

**Figure 1a: EMBI+ Debt to GDP Ratios**



**Figure 1b: Total Debt to GDP Ratios**

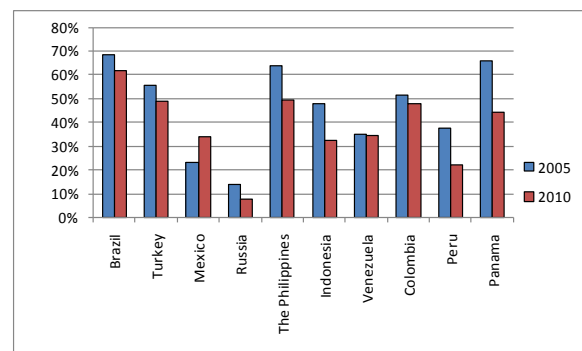
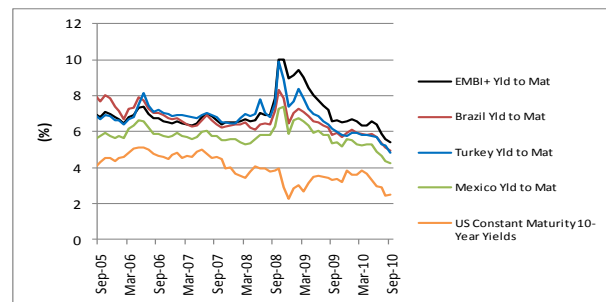


Figure 1c shows the yield to maturity of the EMBI+ index, along with that of the three largest issuers in the EMBI+ index, as well as the US Constant Maturity 10-Year Yield for comparison. The chart shows that the yield on the EMBI+ index has fallen over recent years and is now at around 5.4%, however this still represents a significant margin of around 3% over US Treasury yields (the EMBI+ index has a slightly higher duration of 13.1 years). From Table 2g (on page 4), even though BB/B rated corporate bonds yields have contracted rapidly since the credit crunch, they are still offering a much higher yield than the EMBI+ index.

**Figure 1c: EMD Yields to Maturity**



EMD has historically had a weak correlation of about 20%-30% with Developed Market Debt and therefore it could be seen as a diversifying asset class for those institutional investors that believe Emerging Markets will experience more stable growth in the future. However, that correlation has risen (now at 60%), there is still concentration of the index (as discussed in last month’s Update), and the question remains of whether the default risk on EMD has really reduced. So, an EMD portfolio may not appeal versus one based on rather more diversified High Yield holdings.



**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 October 2010**

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	2.5	9.0	17.5	-1.6	5.6	2.9	9.4
Overseas Equities	2.0	7.3	18.4	2.1	6.9	1.9	8.6
US Equities	2.4	6.0	20.3	2.4	4.1	-0.9	10.1
Europe ex UK Equities	<b>3.0</b>	9.4	11.0	-1.6	7.7	3.9	10.4
Japan Equities	0.4	1.8	7.6	-0.9	<b>-0.1</b>	<b>-1.9</b>	<b>0.8</b>
Pacific ex Japan Equities	1.1	<b>11.2</b>	25.9	4.8	17.4	12.7	11.6
Emerging Markets	1.4	9.9	<b>27.7</b>	5.1	<b>17.6</b>	<b>13.8</b>	<b>12.1</b>
UK Long-dated Gilts	<b>-3.5</b>	3.4	4.9	7.1	4.8	5.2	9.6
UK Long-dated Corp. Bonds	<b>-2.1</b>	4.4	10.2	6.6	4.2	6.4	-
UK Over 5 Yrs Index-Linked Gilts	<b>-1.6</b>	4.3	4.9	6.8	5.9	6.0	7.8
High Yield (Global)	1.2	4.7	22.1	<b>19.5</b>	11.9	7.9	-
Overseas Bonds	0.0	3.7	11.4	19.3	10.5	7.1	8.4
Property *	0.7	2.2	22.6	<b>-6.7</b>	1.0	6.5	7.7
Cash	0.1	<b>0.2</b>	<b>0.7</b>	2.8	3.8	4.2	5.8
Commodities £-converted	1.1	2.9	4.0	<b>-7.4</b>	<b>-5.9</b>	0.5	-
Hedge Funds original \$ basis *	3.5	5.1	7.4	0.9	5.2	6.0	12.2
Illustrative £-converted version *	0.9	<b>-0.3</b>	9.0	10.1	7.7	5.3	13.2
Euro relative to Sterling	0.3	4.5	<b>-2.9</b>	7.7	5.1	4.1	-
US \$ relative to Sterling	<b>-1.4</b>	<b>-2.1</b>	3.1	9.1	2.0	<b>-1.0</b>	1.0
Japanese Yen relative to Sterling	2.2	5.4	15.8	23.0	9.9	2.1	3.5
Price Inflation (RPI) *	0.4	0.5	4.6	2.7	3.1	2.8	2.8
Price Inflation (CPI) *	0.0	0.3	3.0	3.1	2.7	2.1	2.3
Price Inflation (RPIX) *	0.4	0.5	4.6	3.8	3.5	2.9	3.0
Earnings Inflation **	<b>-0.6</b>	<b>-0.5</b>	2.0	1.8	2.8	3.4	3.9
All Share Capital Growth	2.4	8.1	13.6	<b>-5.3</b>	2.0	<b>-0.5</b>	5.6
Net Dividend Growth	0.1	2.2	3.6	<b>-1.9</b>	2.0	3.3	-
Earnings Growth	<b>-1.3</b>	15.9	36.3	<b>-9.2</b>	1.4	4.7	-

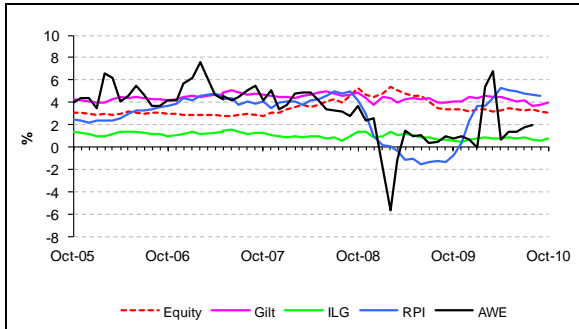
Note: All market returns are total returns for pension funds with income reinvested monthly. Indices used are as follows:

- 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.

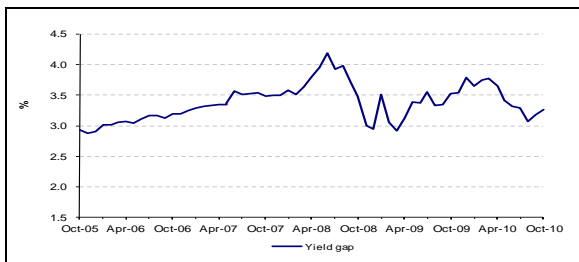


## Yields and Yield Gaps

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.

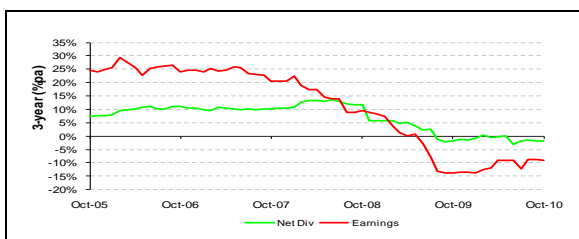
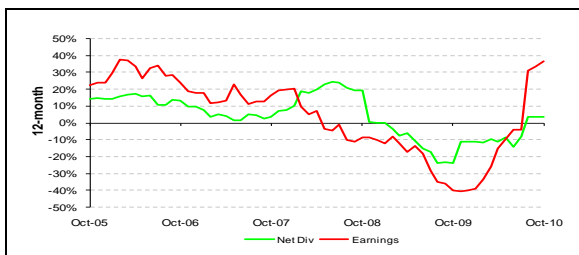


The gap gives expectations just over 3% for longer-term inflation + risk premium for gilts, relative to index-linked gilts.

## 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]

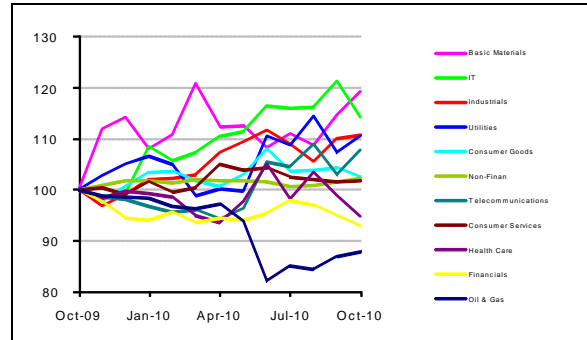
Figure 3: Dividend & Earnings Growth



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



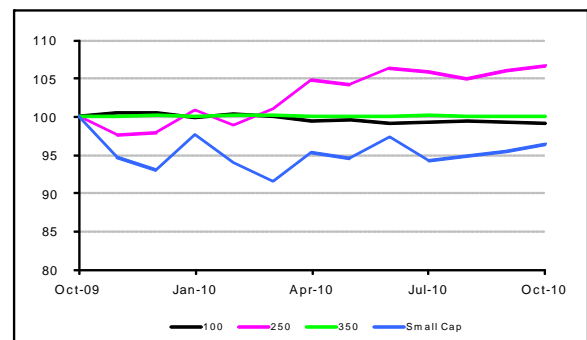
Note: Sector labels for relative lines are in end-value order

A rise this month in the rolling 12-month sector dispersion (up slightly from 29% to 32%).

(% absolute return)	1 mth	3 mth	12 mth
Oil & Gas	3.5	12.5	3.0
Basic Materials	6.6	17.0	40.1
Industrials	3.2	10.8	30.0
Consumer Goods	0.7	7.9	20.5
Health Care	-1.7	5.2	11.3
Consumer Services	2.9	8.3	19.7
Telecommunications	7.4	12.3	26.7
Utilities	5.7	10.8	29.9
Non-Finan	3.2	10.8	20.2
Financials	0.4	3.3	9.1
IT	-3.4	7.3	34.2
All Share	2.5	9.0	17.5

## UK Equity Size Returns

Figure 4b: Size groups relative to All Share



Mid Cap and Small Cap rose slightly in relative terms this month.

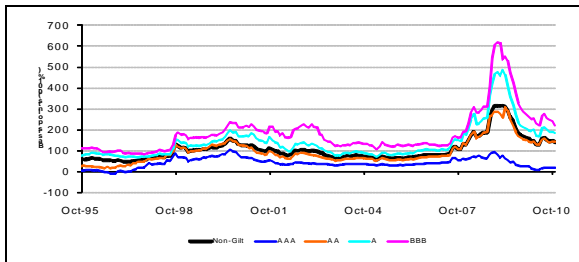
## FRS17 volatility indicator

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 (%)
May 10	5.39	4.25	1.14
Jun 10	5.25	4.10	1.15
Jul 10	5.29	4.18	1.11
Aug 10	4.75	3.67	1.08
Sep 10	4.89	3.77	1.12
Oct 10	<b>5.17</b>	<b>4.01</b>	<b>1.16</b>

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

Category	Mkt Val (£bn @ Oct 10 & 08, 06)			Weight (%)
Gilts (34)	816	446	320	62.5
Non Gilts (1,029)	489	399	407	37.5
AAA (181)	146	149	152	11.2
AA (179)	76	70	64	5.8
A (393)	169	119	124	13.0
BBB (276)	98	58	64	7.5

Category	Mkt Val (£bn @ Oct 10, 08)		W't (%)	Dur'n (yrs)
Gilts (34)	816	446	62.5	8.9
< 5 Yrs (9)	255	131	19.6	2.8
5-15 Yrs (11)	281	142	21.5	7.4
> 15 Yrs (14)	279	173	21.4	16.0
Non Gilts (1,029)	489	399	37.5	7.3
< 5 Yrs (266)	141	140	10.8	2.3
5-15 Yrs (476)	210	149	16.1	6.9
> 15 Yrs (287)	139	111	10.6	12.9

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

**£ Gilt Market “main” Issuance**

- £4.10bn 4¾% 2015 (1.97x, 1.69%, prev Apr 10)
- £3.26bn 3¾% 2020 (2.01x, 3.06%, Sept 10)
- £1.20bn 4¼% 2027 (2.15x, 3.66%, May 10)
- £5.00bn 4¼% 2040 (1.63x, 4.24%, June 10)
- £1.25bn ILG 1¼% 2032 (1.59x, r.y 0.71%, Apr 10)
- £0.93bn ILG 5/8% 2042 (1.96x, r.y 0.61%, Apr 10)

**Tables 2d, 2e: € Market Size and Maturity (Oct 10)**

Category	Mkt Val (€bn)	Weight (%)
Sovereigns (254)	4,020	57.8
Non Sovereigns	2,934	42.2
AAA (660)	1,307	18.8
AA (414)	598	8.6
A (622)	675	9.7
BBB (418)	355	5.1

Category	Mkt Val (€bn)	Weight (%)
1 – 3 Yrs (700)	1,874	27.0
3 – 5 Yrs (698)	1,657	23.8
5 – 7 Yrs (413)	998	14.4
7 – 10 Yrs (332)	1,154	16.6
10+ Yrs (225)	1,271	18.3

**Table 2f: Breakdown of £ Index-Linked Market**

Category (Number of issues)	Mkt Val (£bn @ Oct 10 & 08)		W't (%)	Dur'n (yrs)
Gilts (16)	235	159	90.7	15.4
< 5 Yrs (1)	21	32	8.2	2.7
5 – 15 Yrs (5)	97	54	37.4	8.5
> 15 Yrs (10)	117	73	45.1	23.5
Non Gilts (49)	24	16	9.3	17.6

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

Month End	US (%)	Euro (%)	Sterling (%)
Jul 10	7.70	7.83	9.59
Aug 10	7.74	7.73	9.29
Sep 10	7.31	7.16	8.56
Oct 10	<b>7.04</b>	<b>7.10</b>	<b>8.67</b>

