



Investment Update February 2010

Investment Headlines & Comment

- **UK Equity earnings** jumped dramatically this month (see p2) - Utilities and Oil & Gas did very well, partly offset by Financials.
- **AAA bond margins** over gilts have narrowed dramatically (see p4) – the UK’s finances are not exactly admired by investors.
- **1-year RPI inflation** jumped again this month (see p3) – just how far will it overshoot, and when will it start to fall back?

Feature Section

This month’s feature updates our past analysis of European government debt (last seen in our January 2004 *Update*), prompted by the Greek government debt crisis.

How that is resolved will have a significant bearing on the future of the Euro and its members. Greece only makes up 2.7% of the Eurozone by GDP, but if Greece were to default, larger economies such as Italy, Spain and Portugal may follow (who, with Greece, represent 16% of the Eurozone’s GDP). The 10-year yields on Greek government debt are now at 6.4%, down slightly from a Euro-membership high of 6.9%, but the budget deficit stands at a (large) 12.7% of GDP and there are increasing reports that they will require a bailout from the European Commission.

The problems facing Greece predate the 2008 financial crisis and can be traced back to 2001 upon entering the Euro. Greece used currency swaps with artificially low exchange rates, issued by Goldman Sachs, to conceal the true magnitude of their debt; a practice that since has been made illegal. Entry into the Euro brought about many short term benefits for Greece, although they chose not to reduce their deficit during the subsequent boom period and in the longer term the currency swaps proved to be an expensive means of ‘borrowing’. It is still unclear to what extent Greece misled fellow Eurozone members, many of whom would resent contributing to a bail out after undergoing intense fiscal squeezes to service their own debt. Conversely, a default would be alarming news for Italy, Spain and Portugal, for whom it would push up the cost of borrowing further. The 10-year yields on government debt, which effectively represent the cost of borrowing, are show below in Figure 1a for various Eurozone nations and the UK. The gap in yields for countries in the Eurozone was relatively small until December 2008, after which yields diverged substantially.

Figure 1a: European Government Debt Yields

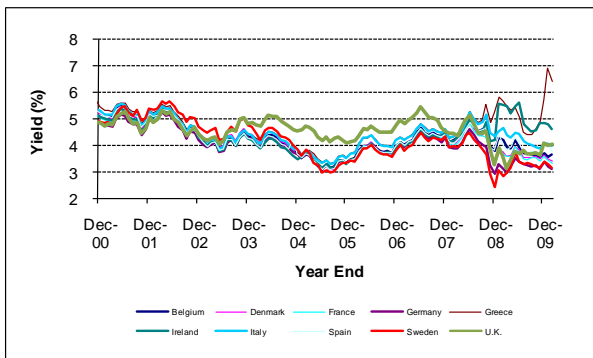
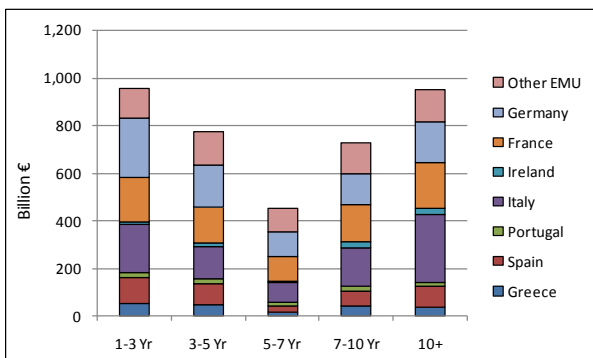


Figure 1b: European Government Debt Maturity



Source: JP Morgan

Note: Other EMU = Austria, Belgium, Finland and the Netherlands

Figure 1b shows the maturity profile of Greek debt, compared to the rest of the EMU. Greece has debt of around €20bn maturing in April and May this year; a key factor in their recovery will be whether they get sufficient uptake on new issues to restructure their debt. With an average duration of 5.3 years, the Greek government debt is much shorter dated than most other European countries; coupled with the restrictions from being in the Euro, this significantly reduces the available options for them to manage their debt.

It has been suggested that the UK may follow in the path of Greece, and the current UK deficit of 12.6% of GDP and record net finance deficit (for January) of £4.3bn may suggest we are also in an unstable position (with a further £18bn of gilts issued in February 2010 – see page 4). However, it should be noted that the UK was in a much better position heading into the credit crunch, with debt at around 60% of GDP and a much larger proportion of the UK debt is longer term (as illustrated in the tables on page 4), thus giving the UK much more flexibility to manage their debt.

“Helped” by the fact that Sterling has fallen in value as much as it has over the last two years (see page 2 for the marked falls this month), Britain’s competitiveness as an exporter has also significantly increased. Unfortunately for Greece, the single currency prevents them from following suit. Maybe commitments on going to Greece for 2010 holidays would help ...



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 28 February 2010

Asset Class	1 month (%)	3 months (%)	12 months (%)	3 years (% p.a.)	5 years (% p.a.)	10 years (% p.a.)
UK Equities	3.4	4.0	47.3	-1.3	5.6	2.4
Overseas Equities	6.8	6.8	50.0	4.0	8.3	1.9
US Equities	8.5	9.5	44.1	3.0	5.8	0.2
Europe ex UK Equities	2.4	-0.3	51.6	0.6	8.5	2.9
Japan Equities	6.5	11.7	25.1	-3.0	4.4	-2.3
Pacific ex Japan Equities	6.6	6.4	78.7	12.9	16.7	9.9
Emerging Markets	5.6	6.3	79.9	13.3	18.0	9.7
UK Long-dated Gilts	-2.3	-5.9	2.5	3.1	4.2	4.5
UK Long-dated Corp. Bonds	-1.7	-2.0	19.2	1.9	3.3	5.8
UK Over 5 Yrs Index-Linked Gilts	-0.9	-3.8	11.4	5.2	5.8	5.6
High Yield (Global)	5.0	11.5	51.7	15.3	11.9	7.5
Overseas Bonds	5.9	3.6	3.4	18.4	10.4	7.6
Property *	1.6	8.5	6.4	-8.9	1.1	6.2
Cash	0.1	0.2	1.0	4.0	4.4	4.6
Commodities £-converted	11.1	5.7	20.8	-0.3	-1.4	3.8
Hedge Funds original \$ basis *	-0.7	2.1	19.3	1.6	5.6	6.3
Illustrative £-converted version *	0.1	5.0	7.4	8.8	9.0	6.4
Euro relative to Sterling	3.4	-2.0	0.6	10.0	5.4	3.9
US \$ relative to Sterling	5.3	7.8	-6.4	8.8	4.8	0.4
Japanese Yen relative to Sterling	7.4	4.5	3.1	19.7	8.2	2.5
Price Inflation (RPI) *	0.0	0.9	3.7	2.6	2.9	2.7
Price Inflation (CPI) *	-0.2	0.6	3.4	2.9	2.7	2.0
Price Inflation (RPIX) *	0.0	0.9	4.6	3.4	3.2	2.8
Earnings Inflation **	3.9	4.5	1.2	2.8	3.3	3.4
All Share Capital Growth	2.9	3.3	41.8	-5.1	1.9	-0.9
Net Dividend Growth	3.2	3.3	-11.7	0.3	3.9	3.4
Earnings Growth	9.9	9.8	-33.6	-12.6	0.5	3.6

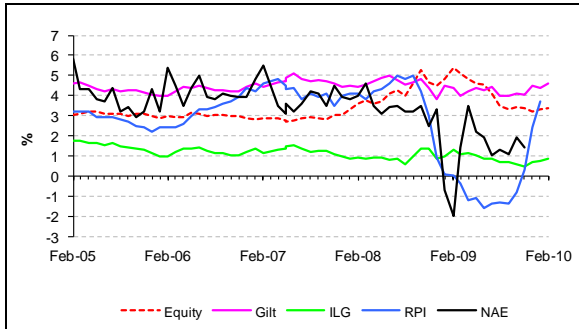
Note: All market returns are total returns for pension funds with income reinvested monthly. Indices used are as follows:

- UK Equities (incl. dividends and earnings) – FT-A All Share.
- Overseas Equities (incl. regions) – blend of FT All-World / World 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 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.

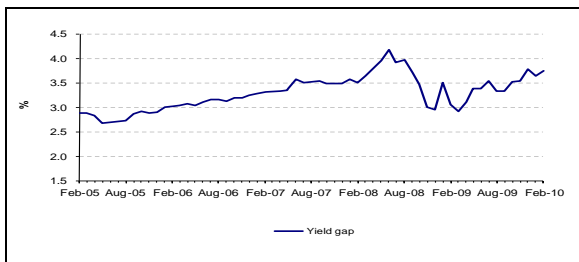


Yields and Yield Gaps

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.

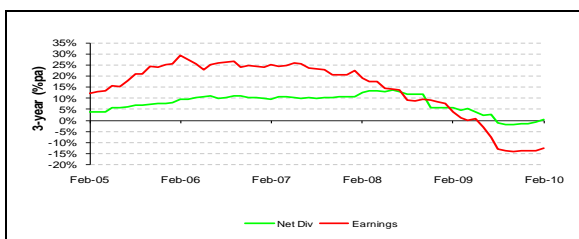
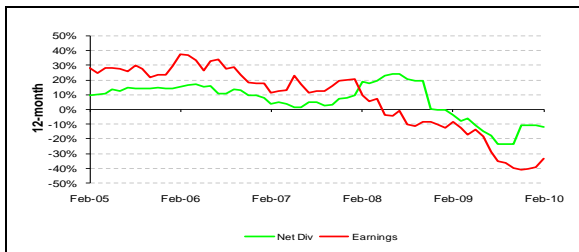


The gap gives expectations over 3.5% for longer-term inflation + risk premium for gilts, relative to index-linked gilts.

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]

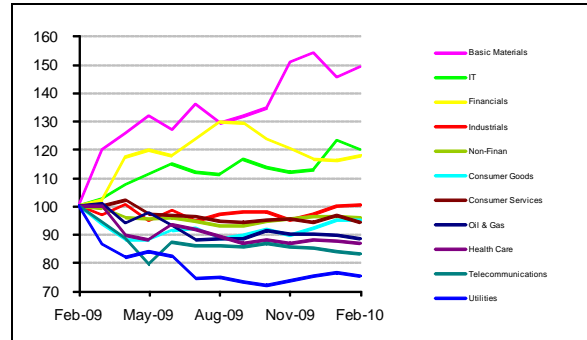
Figure 3: Dividend & Earnings Growth



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



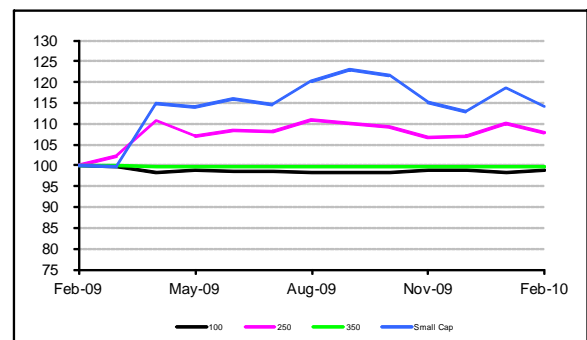
Note: Relative lines' labels for sectors in end-value order

A decrease this month in the rolling 12-month sector dispersion (down slightly from 76% to 74%).

(% absolute return)	1 mth	3 mth	12 mth
Oil & Gas	1.7	1.8	30.4
Basic Materials	6.0	2.9	120.2
Industrials	3.6	9.8	47.9
Consumer Goods	3.6	10.4	40.4
Health Care	2.6	4.2	28.2
Consumer Services	1.1	3.0	39.3
Telecommunications	2.1	1.0	22.3
Utilities	1.8	6.3	11.2
Non-Finan	2.8	4.7	41.5
Financials	5.1	1.9	73.9
IT	0.7	11.4	76.8
All Share	3.4	4.0	47.3

UK Equity Size Returns

Figure 4b: Size groups relative to All Share



Mid and Small Cap fell back in relative terms this month.

FRS17 volatility indicator

Now discontinued, but available on request.



Bond market information

Figure 5: £ Non-Gilt Credit Margins

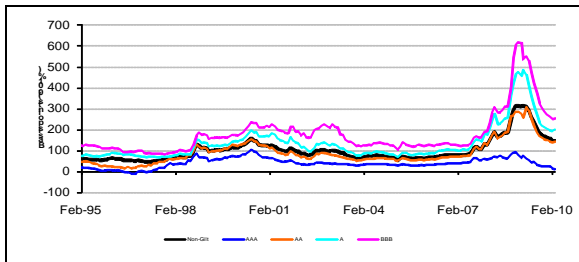


Table 2a: Over 15 Yr Corporate Yields & Margins

Month End	iBoxx Corp AA Y'ld (%)	FT 20 yr Gilt (%)	Margin (%)
Sep 09	5.38	4.01	1.37
Oct 09	5.45	4.08	1.37
Nov 09	5.34	4.03	1.31
Dec 09	5.58	4.46	1.12
Jan 10	5.46	4.38	1.08
Feb 10	5.63	4.58	1.05

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

Category	Mkt Val (£bn @ Feb 10 & 08, 06)			Weight (%)
Gilts (34)	704	352	301	60.1
Non Gilts (1,044)	468	414	379	39.9
AAA (187)	146	158	143	12.5
AA (197)	75	60	59	6.4
A (402)	165	128	116	14.1
BBB (258)	82	65	57	7.0

Category	Mkt Val (£bn @ Feb 10, 08)		W't (%)	Dur'n (yrs)
Gilts (34)	704	352	60.1	8.7
< 5 Yrs (10)	222	96	18.9	2.8
5-15 Yrs (10)	230	117	19.6	7.0
> 15 Yrs (14)	253	139	21.6	15.3
Non Gilts (1,044)	468	414	39.9	7.1
< 5 Yrs (282)	143	136	12.2	2.5
5-15 Yrs (478)	197	158	16.8	6.9
> 15 Yrs (284)	128	120	10.9	12.6

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

£ Gilt Market “main” Issuance

- £4.03bn 5¼% 2012 (3.12x, 1.66%, Sept 09)
- £3.00bn 5% 2018 (1.99x, 3.69%, Oct 08)
- £3.30bn 3¾% 2019 (2.25x, 4.13%, Jan 10)
- £2.16bn 4½% 2034 (2.08x, 4.50%, Nov 09)
- £4.50bn 4% 2060 (1.67x, 4.57%, Oct 09)
- £0.90bn ILG 1⁷/₈% 2022 (2.42x, r.y 1.19%, Apr 09)
- £0.40bn ILG ¾% 2047 (2.23x, r.y 0.67%, Aug 09)

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

Category	Mkt Val (€bn)	Weight (%)
Sovereigns (269)	3,915	57.4
Non Sovereigns	2,901	42.6
AAA (662)	1,319	19.4
AA (387)	564	8.3
A (653)	692	10.2
BBB (385)	326	4.8

Category	Mkt Val (€bn)	Weight (%)
1 – 3 Yrs (701)	1,901	27.9
3 – 5 Yrs (716)	1,664	24.4
5 – 7 Yrs (402)	934	13.7
7 – 10 Yrs (324)	1,132	16.6
10+ Yrs (213)	1,185	17.4

Table 2f: Breakdown of £ Index-Linked Market

Category (Number of issues)	Mkt Val (£bn @ Feb 10 & 08)		W't (%)	Dur'n (yrs)
Gilts (17)	214	162	90.7	14.3
< 5 Yrs (2)	35	23	14.9	2.6
5 – 15 Yrs (5)	85	72	36.1	8.9
> 15 Yrs (10)	93	67	39.7	23.7
Non Gilts (50)	22	16	9.3	17.3

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

Month End	US (%)	Euro (%)	Sterling (%)
Dec 09	8.17	8.89	11.70
Jan 10	8.09	8.10	10.44
Feb 10	8.23	8.74	10.74

