



Investment Update December 2011

Investment Headlines & Comment

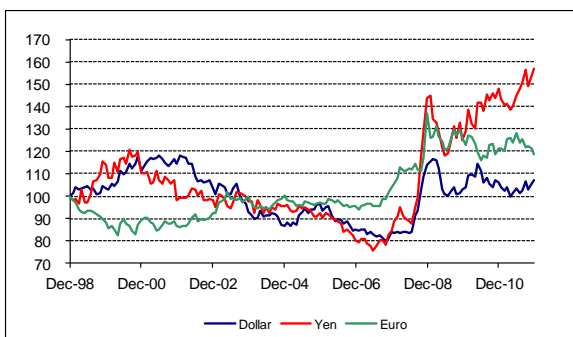
- S&P has placed the **European Union's** AAA credit rating on "credit watch negative".
- The **Eurozone's main banks**, could have their ratings cut after that potential downgrade.
- Meanwhile, **US TIPS'** real yields have fallen by 1% in 2012, and **10-year Gilts** are below 2%.

Feature Section

This month, we consider where the Euro has got to, and how things might unfold over the next few months. It was always a case of "political will" versus "economics probably won't" but you do have to wonder whether "political will" is making things far worse than they need be.

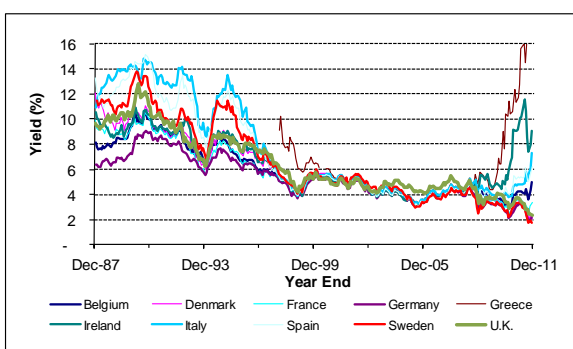
As a (comforting) start point, Figure 1a shows the movement in US Dollars, Japanese Yen and Euro relative to Sterling since December 1998 (when 'live' rates for the Euro started to be published). Since it started, the Euro is still some 20% higher than Sterling and 10% higher than the US Dollar, and the chart shows it has traded in a comparatively narrow range against Sterling for most of the post-credit-crunch period. However, from Figure 1b (which does include a couple of comparator non-Euro-linked cases in Sweden and the UK), you can see that even ignoring Greece, the recent dispersion of yields is akin to the pre-Euro profile from the late 80s and early 90s. As for just how truncated the vertical axis is for Figure 1b, Greece currently has 10-year yields at **32%**. So, assuming (say) a 40% recovery rate, this implies the market is ascribing a 33% probability of "default" *in the next year alone*, and over 50% in the next two years.

Figure 1a: Currencies versus Sterling since Dec 98



It is worth referring back to comments made by Alan Brown in 2003 (then of State Street, although writing in a personal capacity in the World Economics journal) for the implications of a "one-size-fits-all" monetary policy. He noted that "As economic conditions change, countries need to adjust. Adjustment can take seven basic forms through shifting exchange rates or interest rates, changes to taxation policy, through transfer payments, through changes to the price (wage rates) or supply (mobility) of labour and finally, through changes to output and associated employment. When two countries are not part of a common currency area, all of these things can shift relative to each other."

Figure 1b: European 10-year yields
NB The vertical axis is truncated!



Within a common currency area, exchange rates cannot shift and nor can interest rates. Taxation differences also need to be minimal (although not zero). In principle, transfer payments are possible (e.g. Germany subsidises Greece) and labour mobility is possible (e.g. the population of southern Portugal moves to Belgium), but in practice there are limits to what separate countries' citizens will accept! So, output and employment bear the brunt.

As Alan Brown's paper noted, "without a self-correcting mechanism like transfer payments, a single monetary policy is ... pro-cyclical and destabilising. Countries growing fast and in danger of overheating face low or negative real interest rates and have no restraint except possibly unpopular tax rises — and how do you raise taxes in a democracy if the government is already in surplus as

Sources: FT, JP Morgan (Fig 1a: Sterling fixed at 100)

Ireland was in 2000/01? On the other hand, countries in recession face too high real interest rates and are further pushed into sub-potential growth." He concluded "the design of the [Eurozone] economy is not irredeemably bad, but it is certainly sub-optimal, and it has a strong tendency to punish economies when they are at their weakest."

It is of interest to note his more recent conclusion in a Debt Dynamics paper in 2011 for Schrodgers: "It increasingly appears that the Eurozone must either move forward to something approaching full fiscal union, or pull back by redrawing the boundaries of the Eurozone to encompass only a hardcore of countries close (in every sense of the word) to Germany." The former seems unlikely, so we must expect the latter ... if politicians can swallow their pride.



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 2011

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	0.8	8.4	-3.5	12.9	1.2	4.8	8.1
Overseas Equities	0.9	7.2	-6.9	9.6	3.6	4.2	7.4
US Equities	2.1	11.9	2.5	11.3	4.7	2.4	8.7
Europe ex UK Equities	-1.9	3.3	-15.0	3.3	-1.0	4.6	8.8
Japan Equities	2.1	-3.6	-12.9	-0.8	-2.0	2.5	0.5
Pacific ex Japan Equities	1.1	4.4	-14.8	18.0	8.5	11.9	9.3
Emerging Markets	0.0	4.7	-17.5	17.9	7.6	13.4	9.3
UK Long-dated Gilts	1.9	9.6	26.3	9.3	8.8	7.4	9.5
UK Long-dated Corp. Bonds	2.5	3.7	12.0	11.4	5.3	6.2	-
UK Over 5 Yrs Index-Linked Gilts	2.6	9.8	23.3	12.4	9.7	8.5	8.6
High Yield (Global)	3.2	5.6	3.4	20.5	12.1	8.2	-
Overseas Bonds	2.2	0.0	7.4	2.2	13.0	7.3	7.5
Property *	0.5	1.8	8.5	6.0	-1.3	6.6	8.4
Cash	0.1	0.3	0.9	0.9	2.9	3.7	5.2
Commodities £-converted	-0.2	9.2	-0.4	4.7	1.8	4.9	4.8
Hedge Funds original \$ basis *	-1.0	-2.3	-1.6	8.2	2.7	6.1	10.8
Illustrative £-converted version *	1.6	1.1	-2.6	7.3	7.4	5.1	11.4
Euro relative to Sterling	-2.4	-3.0	-2.5	-4.8	4.4	3.2	-
US \$ relative to Sterling	1.2	0.3	0.8	-2.1	4.7	-0.7	0.9
Japanese Yen relative to Sterling	2.1	0.4	6.2	2.9	14.3	4.8	3.4
Price Inflation (RPI) *	0.2	1.0	5.2	3.4	3.5	3.2	2.9
Price Inflation (CPI) *	0.2	0.9	4.8	3.3	3.2	2.5	2.2
Price Inflation (RPIX) *	0.2	1.1	5.3	4.2	3.9	3.3	2.9
Earnings Inflation **	-0.2	-1.3	2.1	1.6	2.5	3.2	3.6
All Share Capital Growth	0.8	7.7	-6.7	9.0	-2.4	1.3	4.5
Net Dividend Growth	-0.4	3.5	13.6	0.5	1.8	4.2	-
Earnings Growth	-9.0	-10.9	13.6	3.5	3.7	8.5	-

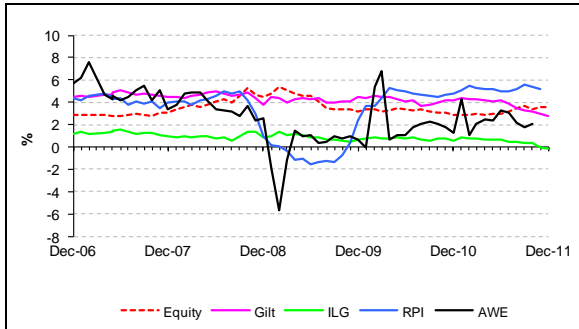
Note: All market returns are total returns for pension funds with income reinvested monthly. Indices used are as follows:

- 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.

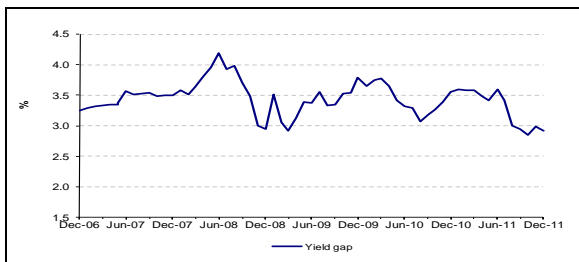


Yields and Yield Gaps

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.

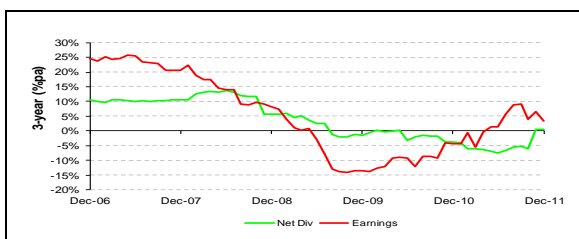
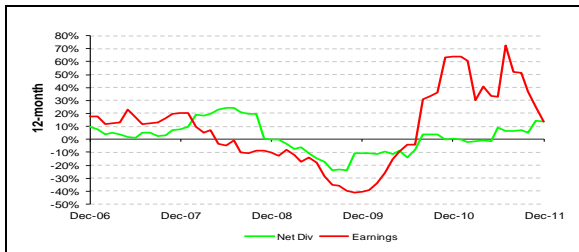


The gap gives expectations still just below 3% for longer-term inflation + risk premium for gilts, relative to index-linked gilts.

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]

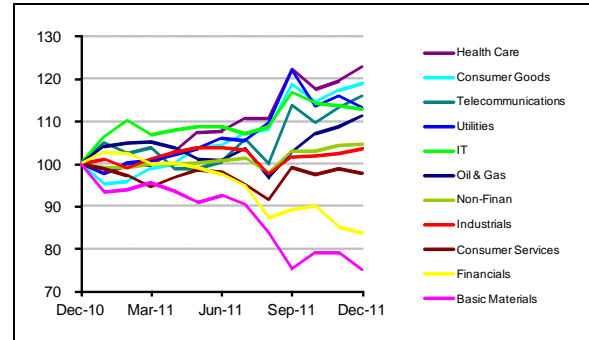
Figure 3: Dividend & Earnings Growth



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



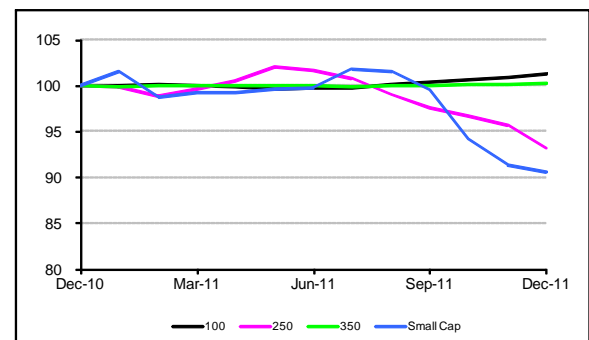
Note: Sector labels for relative lines are in end-value order

There was a sharp rise this month in the rolling 12-month sector dispersion (up from 34% to 48%).

(% absolute return)	1 mth	3 mth	12 mth
Oil & Gas	3.3	17.3	7.5
Basic Materials	-4.1	8.3	-27.5
Industrials	1.9	10.3	0.0
Consumer Goods	2.1	8.7	14.8
Health Care	3.7	9.0	18.7
Consumer Services	-0.3	7.1	-5.5
Telecommunications	3.2	10.6	12.0
Utilities	-1.6	0.4	9.2
Non-Finan	1.2	10.2	1.2
Financials	-0.7	1.6	-19.2
IT	0.1	4.8	9.0
All Share	0.8	8.4	-3.5

UK Equity Size Returns

Figure 4b: Size groups relative to All Share



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

FRS17 volatility indicator

Now discontinued, but available on request.



Bond market information

Figure 5: £ Non-Gilt Credit Margins

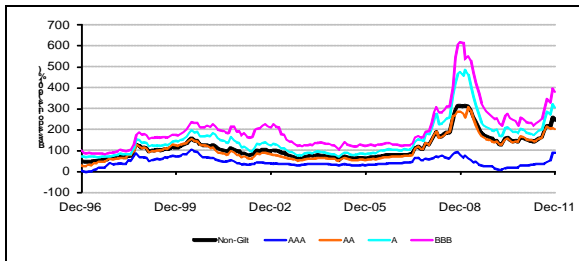


Table 2a: Over 15 Yr Corporate Yields & Margins

Month End	iBoxx Corp AA Y'ld (%)	FT 20 yr Gilt (%)	Margin (%)
July 11	5.21	3.87	1.34
Aug 11	5.30	3.68	1.62
Sep 11	5.06	3.25	1.81
Oct 11	4.89	3.19	1.70
Nov 11	4.81	2.95	1.86
Dec 11	4.63	2.78	1.85

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

Category	Mkt Val (£bn @ Dec 11 & 09, 07)			Weight (%)
Gilts (35)	999	693	340	67.9
Non Gilts (1,011)	472	461	420	32.1
AAA (170)	129	139	152	8.8
AA (151)	68	60	63	4.6
A (385)	168	163	133	11.4
BBB (305)	107	95	69	7.3

Category	Mkt Val (£bn @ Dec 11, 09)		W't (%)	Dur'n (yrs)
Gilts (35)	999	693	67.9	9.9
< 5 Yrs (9)	279	205	19.0	2.9
5-15 Yrs (11)	324	234	22.1	7.2
> 15 Yrs (15)	396	254	26.9	17.1
Non Gilts (1,011)	472	461	32.1	7.7
< 5 Yrs (268)	124	142	8.4	2.6
5-15 Yrs (463)	200	187	13.6	6.9
> 15 Yrs (280)	148	132	10.1	13.1

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

£ Gilt Market “main” Issuance

- £4.00bn 1¾% 2017 (1.27x, 1.13%, prev Oct 11)
 - £3.30bn 3¾% 2021 (1.61x, 2.38%, Oct 11)
 - £3.30bn 4% 2022 (1.77x, 2.21%, Aug 10)
 - £0.75bn 4¼% 2027 (2.81x, 2.64%, Jun 11)
 - £1.92bn 4¼% 2040 (1.98x, 3.29%, Jul 11)
 - £0.95bn ILG 1¼% 2032 (2.03x, r.y 0.00%, Jan 11)
- Note: Issuance amounts are nominals.

Tables 2d, 2e: € Market Size and Maturity (Dec 11)

Category	Mkt Val (€bn)	Weight (%)
Sovereigns (251)	4,120	58.1
Non Sovereigns	2,975	41.9
AAA (643)	1,274	18.0
AA (407)	589	8.3
A (699)	724	10.2
BBB (484)	388	5.5

Category	Mkt Val (€bn)	Weight (%)
1 – 3 Yrs (828)	2,072	29.2
3 – 5 Yrs (659)	1,598	22.5
5 – 7 Yrs (394)	926	13.1
7 – 10 Yrs (395)	1,302	18.3
10+ Yrs (208)	1,199	16.9

Table 2f: Breakdown of £ Index-Linked Market

Category (Number of issues)	Mkt Val (£bn @ Dec 11 & 09)		W't (%)	Dur'n (yrs)
Gilts (19)	334	211	92.1	17.3
< 5 Yrs (2)	49	35	13.6	3.1
5 – 15 Yrs (4)	87	83	24.1	8.8
> 15 Yrs (13)	197	93	54.4	24.6
Non Gilts (47)	29	21	7.9	17.9

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

Month End	US (%)	Euro (%)	Sterling (%)
Aug 11	7.82	9.25	10.26
Sep 11	8.65	10.58	11.27
Oct 11	7.62	9.05	10.31
Nov 11	8.10	10.98	11.69
Dec 11	7.48	11.08	11.43

