INVESTMENT NEWS

MONTHLY NEWS BULLETIN
FROM THE INVESTMENT AND RISK TEAM

GAD

2 September 2013

MONTHLY UPDATE

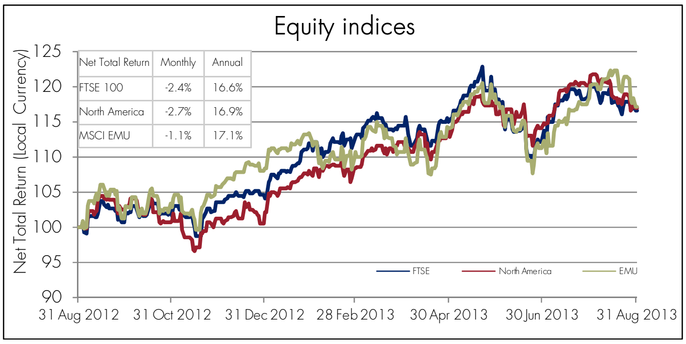
Overview

With the UK experiencing its warmest summer since 2006, it was fitting that there were a number of positive economic indicators released this month. UK Q2 GDP was revised up slightly from 0.6% to 0.7%, inflation edged down and an index measuring manufacturing activity rose to its highest level for two and a half years. In addition a number of organisations increased their forecasts for UK economic growth. Mark Carney, in his first public speech as Governor of the Bank of England, outlined how he expected a "solid, not stellar" recovery.

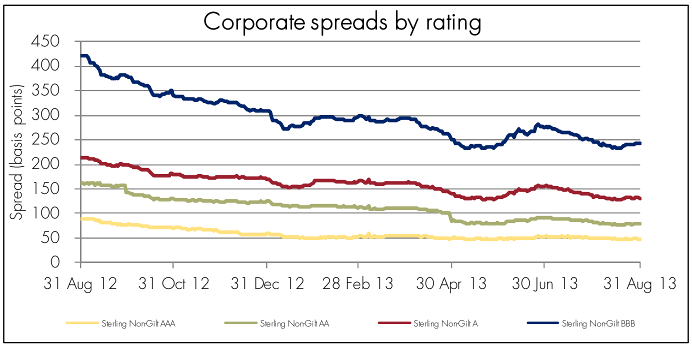
Monetary policy continued to make the news with the Bank of England issuing "forward guidance" for the first time (see overleaf). There continued to be uncertainty about the speed with which the US would bring an end to their QE programme, with the Federal Reserve minutes suggesting that there was disagreement about when tapering should begin. With many market participants believing that tapering may start within months, the US dollar strengthened against many emerging market currencies. The Indian rupee was particularly hit, falling to a record low against the dollar amid concerns for the countries growth prospects and large current account deficit.

Data showed that the Eurozone had emerged from the recession with better than expected Q2 GDP growth of 0.3%; however, this was largely thanks to the German and French economies. Growth in other countries, including Italy and Spain, remained elusive and there was speculation about the need for further haircuts on Greek debt.

Equity markets fell over the month



Credit spreads were largely unchanged this month

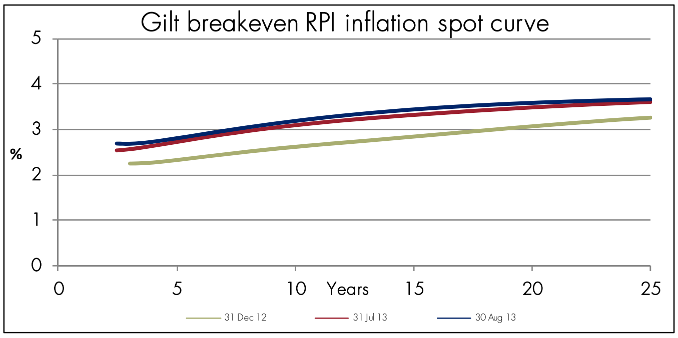


LATEST ECONOMIC NUMBERS

Current base rate	0.5%
Quantitative easing level	£375bn
CPI increase July (%y/y)	2.8%
Halifax house prices July (%m/m)	0.9%
IPD TR property index July (%m/m)	0.8%
PPF 7800 funding ratio August	90.7%
VIX (volatility) index	17.01
$/£ exchange rate	1.55

Numbers as at the end of month unless stated

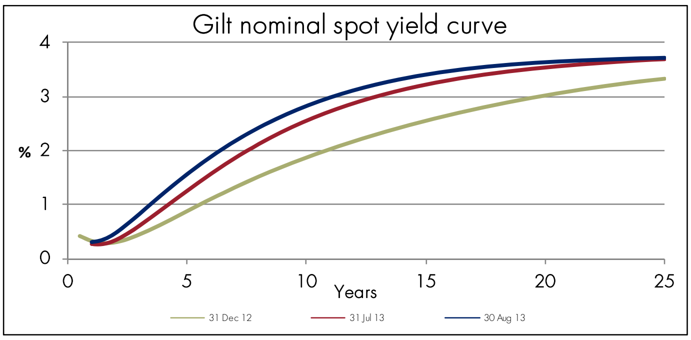
Breakeven inflation increased slightly



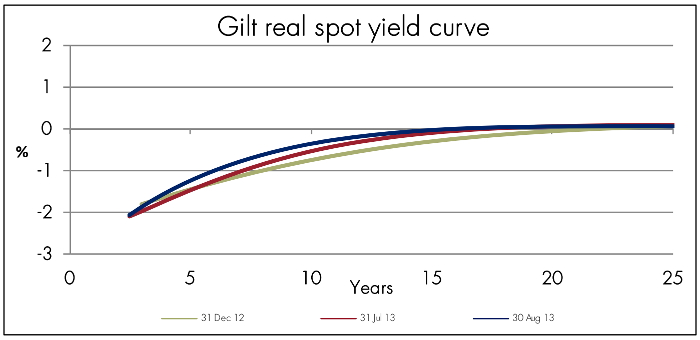
CALENDAR OF EVENTS AND DATA RELEASES

MPC interest rate announcement	5th Sept
UK Trade	6th Sept
Labour Market Statistics	11th Sept
RPI / CPI	17th Sept
Minutes of MPC meeting	18th Sept
UK GDP (Q2 third est.)	26th Sept

Nominal yields increased this month



Real yields generally increased slightly this month



All chart data sourced to Bank of England, Merrill Lynch, Financial Times, MSCI & Standard and Poor.

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What is Forward Guidance?

This month saw the introduction of 'forward guidance' by the Bank of England. For the first time, instead of just providing the Bank Rate for the month ahead, the Monetary Policy Committee (MPC) also gave explicit guidance about the level of future interest rates. Although new to the UK, forward guidance has previously been used in other countries, notably the US and Canada.

What was announced?

The MPC announced that they do not intend to either raise the Bank Rate from its current level of 0.5% or to reduce the level of quantitative easing at least until unemployment has fallen below 7%. However, this guidance would cease to hold if any of three 'knockouts' are breached. These are if:

- 18 to 24 months ahead CPI inflation is expected to be 0.5% above the 2% target
- medium-term inflation expectations no longer remain sufficiently well anchored
- it is believed that the monetary policy is creating threats to financial stability that cannot be contained by other policy actions

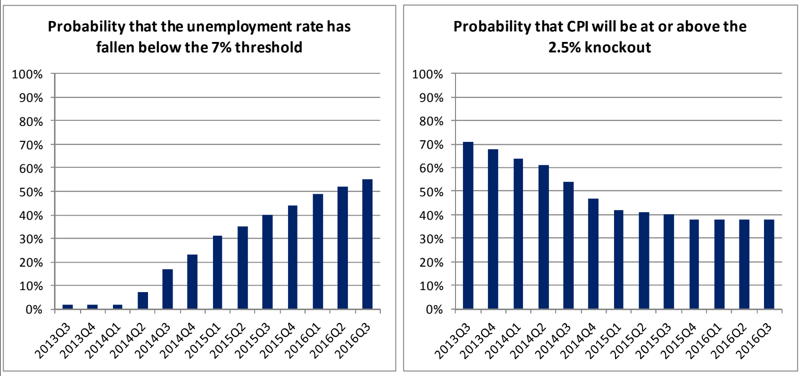
It was also stressed that unemployment falling below the 7% threshold would not automatically result in the Bank Rate being increased.

Implications

With unemployment currently at 7.8%, the guidance suggests that investors should not expect interest rates to rise until there has been a sustained economic recovery and a marked decline in the unemployment rate. In their inflation report also published this month, the Bank of England's central projections was for unemployment to remain above 7% until mid-2016 and that inflation will gradually fall towards 2% (see Box 1). On these projections it is therefore expected that the Base Rate will not be raised until mid-2016.

Market reactions to the announcement appeared to be limited, suggesting that the content of the guidance was not too surprising. Although Sterling initially fell after the announcement this was more than reversed by the end of the day. There were also only very small changes in gilt yields and swap rates.

Box 1 - Bank projections of unemployment and inflation



Source: BoE Inflation Report Aug 2013

The Bank expects, in the central case, for unemployment to remain above 7% until mid 2016 and for inflation to fall. However, the graphs above show the probabilities that the Bank attaches to the thresholds being breached.

The use of forward guidance elsewhere

The Bank's Governor Mark Carney has previously used forward guidance when he was Governor of the Bank of Canada and forward guidance has also been used by the US Federal Reserve. Since 2008 the Fed has used phrases such as that it expects interest rates would remain low "for some time" and in 2011 was more explicit about the timescale saying "at least through mid-2013". In December 2012, this was further developed with explicit guidance linked to unemployment and inflation. The European Central Bank has been less eager to adopt forward guidance. However, in July they did state interest rates would remain at or below current levels "for an extended period of time" although later clarified that this was conditional on their obligation to maintain price stability.

Why use forward guidance?

In the March Budget, with interest rates at record low levels but with economic recovery remaining muted, the Bank of England was provided with the additional tool of forward guidance. Forward guidance can provide greater clarity about a central bank's monetary policy stance and in particular on its view about the appropriate trade-off between inflation and supporting a recovery. If forward guidance provides confidence that interest rates will remain low then it can put downward pressure on longer-term interest rates and hence lower the cost of borrowing. Individuals' and businesses' expectations about future interest rates are key to their decisions about borrowing and spending. Providing more certainty about how interest rates may change in future can encourage greater spending and investment and help improve broader financial conditions.

Like quantitative easing, forward guidance provides another monetary policy tool to be tried given the exceptional economic circumstances; however, the effectiveness of forward guidance in changing markets' expectations is not yet clear. Some commentators have cautioned that care needs to be taken in the use of forward guidance to ensure that it does not increase uncertainty about inflation or place too much emphasis on a narrow subset of economic data.

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