INVESTMENT NEWS

MONTHLY NEWS BULLETIN
FROM THE INVESTMENT AND RISK TEAM

GAD

1 February 2013

01

MARKET & ECONOMIC REVIEW

Overview

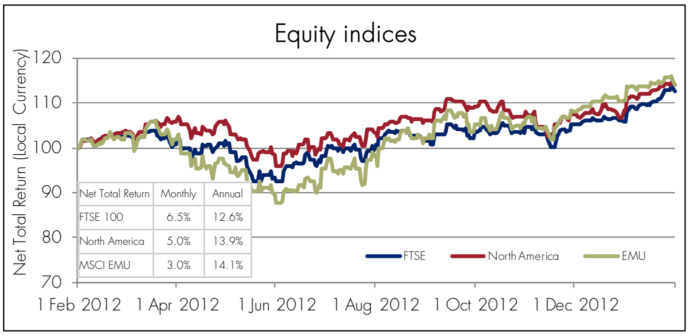
Equity markets rallied strongly in January. During the month the FTSE 100 reached its highest levels since May 2008 and it recorded its biggest January gain since1989. Index linked gilt prices also rose after the National Statistician concluded that the formula of the RPI index would not be changed. Further details about this decision can be found in our article on the next page.

Data releases showed that UK GDP fell by 0.3% in the fourth quarter of 2012 yet unemployment continued to fall to 7.7%. Hence, the "productivity puzzle" about why output per worker keeps declining, and its implications for future productivity, continues to grow.

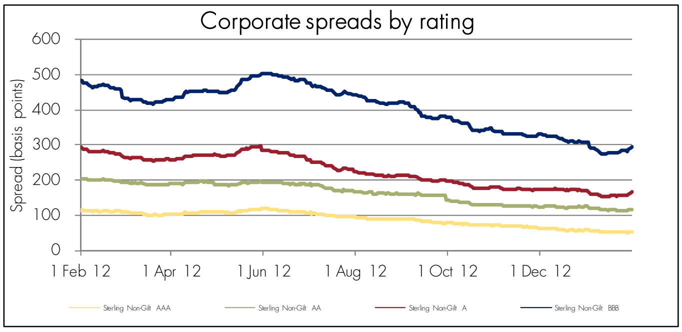
UK retail sales fell in December with analysts seeing the figures as "disappointing but not catastrophic". HMV, Blockbuster and Jessops all entered administration as creditors sought to take advantage of higher cash levels and lower stock following the Christmas period.

The Bank of Japan announced that they would double their inflation target to 2%. However, after a period of almost 20 years of low inflation or falling prices it is likely to require aggressive monetary loosening to meet this target and the Bank of Japan has announced open-ended asset purchases from 2014.

Equity markets rallied strongly in January



Credit spreads ended the month slightly lower

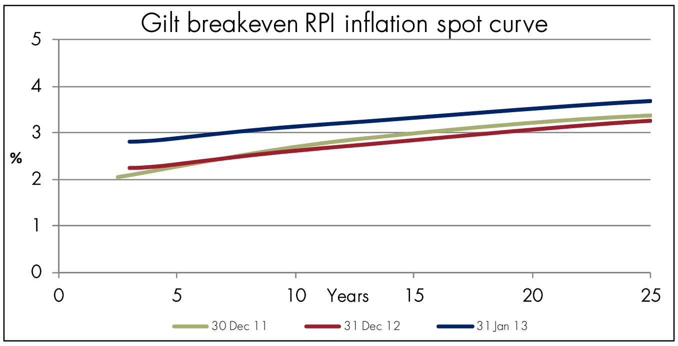


LATEST ECONOMIC NUMBERS

Current base rate	0.5%
Quantitative easing level	£375bn
CPI increase Dec (%y/y)	2.7%
Halifax house prices Dec (%m/m)	1.3%
IPD TR property index Dec (%m/m)	0.3%
PPF 7800 funding ratio	81.3%
VIX (volatility) index	14.3
$/£ exchange rate	1.59

Numbers as at the end of month unless stated

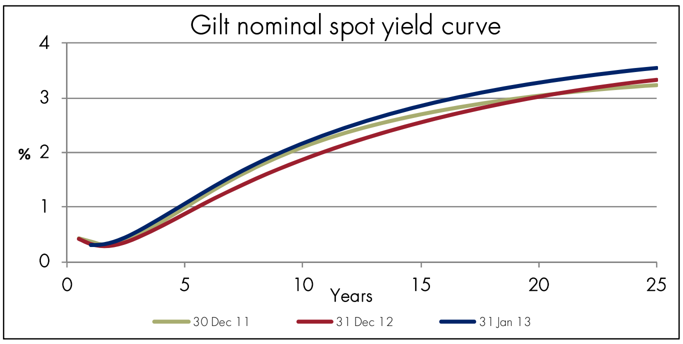
Breakeven inflation increased significantly this month



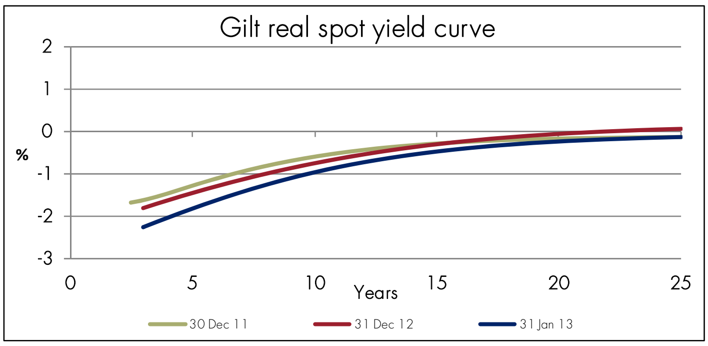
CALENDAR OF EVENTS AND DATA RELEASES

UK Trade	7th Feb
MPC interest rate announcement	7th Feb
Producer Price Index	12th Feb
RPI / CPI	12th Feb
Minutes of MPC meeting	20th Feb
UK GDP Q4 (1st estimate)	27th Feb

Nominal yields increased this month



Real yields fell this month



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

INVESTMENT NEWS

02

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FROM THE INVESTMENT AND RISK TEAM

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RPI formula remains unchanged

On the 10 January, following a consultation on options for changing the formula of the RPI index, the National Statistician announced that the index would not be changed. This came as a surprise to many market participants with index linked gilt prices rising sharply following the news. An additional index will be published but RPI will continue to be used for indexation of gilts and for those pension schemes who currently use it. The National Statistician also recommended changes to the measurement of private housing rents but the impact of these changes is not expected to be as significant.

Background

Since 2010, when a change in price collection methodology increased the formula effect between RPI and CPI, the Office for National Statistics (ONS) has been working to understand the differences between the indices. The formula effect accounts for a large part of the difference and is caused by the way in which prices are aggregated at the first stage of construction of the price indices. This aggregation combines price movements of relatively similar goods or services, for example the price movements of apples of different varieties or origin. At this level there is typically no information on consumer expenditure and hence a formula is needed to average prices using an unweighted approach. There are different ways to do this; RPI uses Carli and Dutot formulae for this aggregation whereas CPI uses Dutot and Jevons formulae. The differences between these measures can sometimes produce large differences in the results. The ONS concluded that the continued use of the Carli formula in RPI should be reconsidered given its propensity to have an upward bias.

The ONS therefore consulted on 4 options:

Option 1 - no change

Option 2 - stop using the Carli formula at the elementary aggregate level for clothing only

Option 3 - stop using the Carli formula at the elementary aggregate level for all items in the RPI

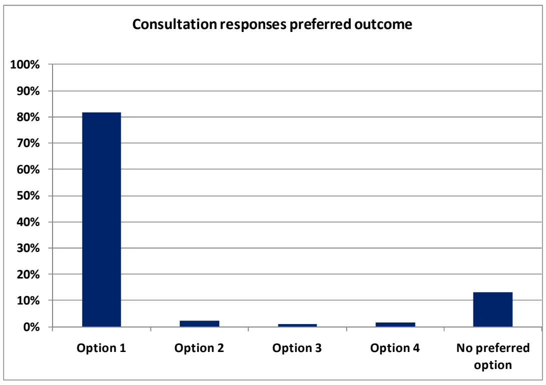
Option 4 - align the formulae used in the RPI at the elementary aggregate level with those used in the CPI

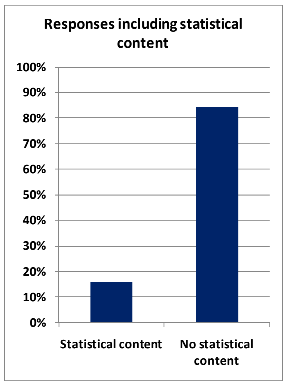
Outcome

The overwhelming number of responses to the consultation were for there to be no change; with most of the responses being based on non-statistical objections (see Box 1). The National Statistician decided to retain the Carli formula as, although it would not have been chosen were the ONS constructing a new price index, there was "significant value" in maintaining the continuity of the index. As the Carli formula does not meet international standards a new index using the Jevons formula will be produced from March 2013, known as RPIJ.

Box 1: Consultation responses

Over 80% of the responses were in favour of retaining the existing RPI methodology. However, most of the responses did not address statistical issues about the choice of formulae but were primarily concerned about the impact that changing RPI could have, for example, on the return from NS&I index-linked savings and index-linked gilts or on pension income.





Source: ONS

Impact

The outcome appeared to be relatively unexpected by the markets which had been pricing in at least some change and a reduction in future RPI inflation. Index-linked gilt prices rose following the announcement, with breakeven inflation increasing by around 0.3%. The introduction of the new RPIJ index will have no initial impact. Although in future it may be used, perhaps being adopted by pension schemes where the Trustee's have a choice of inflation measures, it is not clear who will adopt it instead of the longer standing RPI and CPI alternatives.

Those with investments in index-linked gilts or swaps will benefit from the decision. However, the losers are likely to be sponsors of pension schemes which provide RPI linked pensions who may have hoped that a change could have reduced future RPI inflation to levels closer to that of CPI. The funding level of pension schemes paying benefits linked to RPI are likely to have fallen from the levels immediately prior to the announcement, although this will be offset to the extent that RPI-linked investments were held. The announcement brings an end to the uncertainty that has surrounded RPI and provides greater certainty about the future long term gap between RPI and CPI.

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