Government Actuary's Department

Investment News

Monthly Bulletin from the Investment & Risk Team

October 2014

Last Month in Brief

Early in September we saw the European Central Bank react to a continuing weak economic outlook and decide to cut its main interest rate from 0.15% to a further record low of 0.05% and to carry out "QE-lite" (see reverse).

Meanwhile, the Bank of England remained split (2 to 7) about whether to raise interest rates to 0.75% amidst mixed economic news. Second quarter growth in the UK was revised up to 0.9% but this was contrasted with manufacturing struggling with worries from the Eurozone. Unemployment also continued to fall but average wage growth remains at very low levels.

There were signs that China's growth is slowing with August data showing that factory output grew at the weakest pace in almost 6 years and total industrial enterprise profits fell by 0.6% from a year earlier.

The US dollar continued to rally with the US dollar index hitting a 4 year high at the end of the month. This comes off the back of growing speculation that a rise in interest rates is ebbing closer as the US economy continues its strong recovery.

Chart 1: Equity Indices

Equity markets fell at the end of September

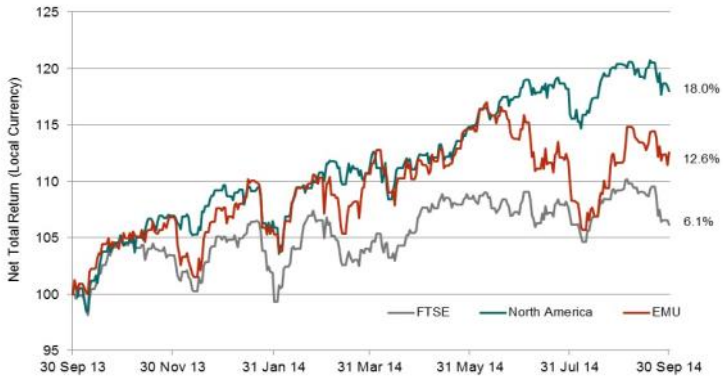


Chart 2: Sterling Credit Spreads

Spreads on lower grade bonds increased at the end of September

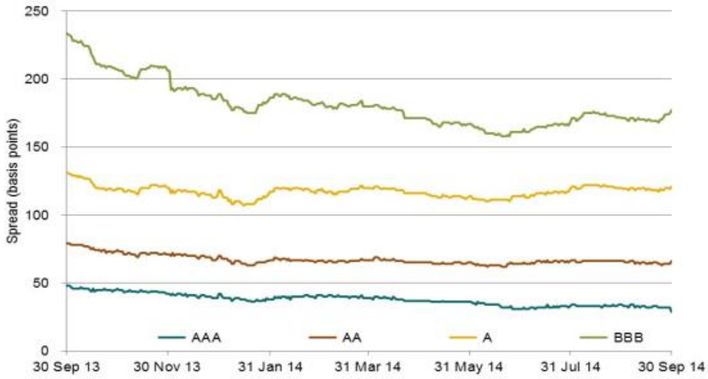


Chart 3: Gilt Yields

Gilt yields fluctuated during September

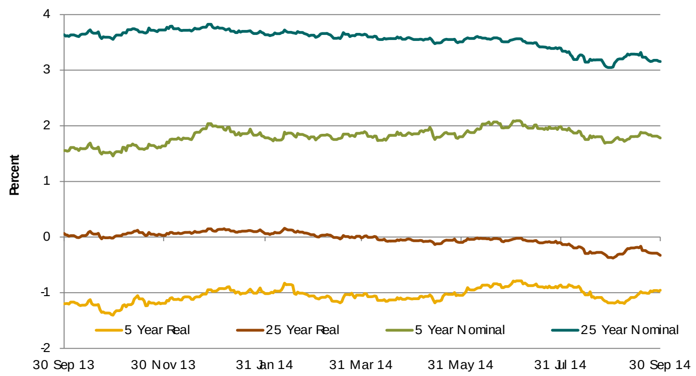
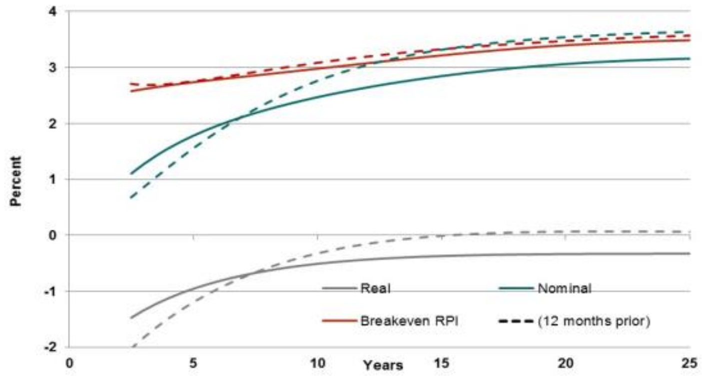


Chart 4: Gilt Spot Curves

Gilt yields remain upward sloping



Source: Financial Times, MSCI, Merrill Lynch Bank of America, & Bank of England

	Latest	Previous		Latest	Previous
CPI increase (annual change)	1.5%	1.6%	**Base rate**	0.5%	0.5%
PPF 7800 funding ratio	87.6%	90.5%	**QE Level**	£375bn	£375bn
Halifax house prices (monthly change)	0.1%	1.4%	**VIX (volatility) index**	16.31	12.09
IPD TR property index (monthly change)	0.9%	1.6%	**$/£ exchange rate**	1.62	1.66

For monthly published indices "Latest" and "Previous" refers to the two most recently published statistics, otherwise numbers are quoted as at the month end.

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Diverging Monetary Policies and the Impact on Markets

As we enter the fourth quarter of 2014, the monetary policies adopted by countries are becoming increasingly divergent. While the European Central Bank (ECB) is announcing further cuts in interest rates and further stimulus measures in the form of ‘QE-lite’, the US federal reserve is ‘tapering’ their monetary stimulus and in the UK a minority of the Monetary Policy Committee are calling for an interest rate rise. This has led to increased concern about the impact on exchange rates and has led some to warn that these divergent monetary policies have the risk of increasing uncertainties in global financial markets.

Box 1: What is Quantitative Easing

Quantitative Easing (QE) was first used in Japan from March 2001, following the 1990s asset bubble collapse, but was brought to prominence by its use by several countries after the financial crisis of 2007-08. QE is a monetary policy which, until recent years, had been viewed as unconventional. Even today it divides opinion and is largely considered a last resort to be used after interest rates (the traditional tool of the central banker) have reached their lower limits. The tactic involves the central bank purchasing securities, such as government bonds, from private institutions to increase the money supply. The increased demand drives up prices and hence those who sold the bonds are encouraged to use the proceeds to invest in or lend to other companies and individuals. This should help to boost the economy and increase inflation.

How Countries Differ

UK

Quantitative Easing in the UK began in early 2009 and was gradually increased to reach £375bn in total. The Bank of England bought gilts from financial institutions and whilst the effect of QE is impossible to accurately quantify, a BoE report suggested the first round of QE (£200bn) was “economically significant” and helped increase UK annual economic output by 1.5-2%. Although the Bank of England’s base rate remains at record low levels there are increasing expectations that it will be increased in the coming year (see Box 2).

US

The Federal Reserve (Fed) oversaw a programme of asset purchases which has, since 2008, increased its balance sheet from $1trillion to over $4trillion. These purchases have consisted of mortgage backed securities as well as government bonds. The size of the QE programme has continued to increase but the pace of the increase has been ‘tapered’ and it is expected that the Fed will stop adding to their holdings in October. However, they have indicated that interest rates will stay low for a considerable time.

Japan

Deflation in Japan started in the early 1990s and there have been various measures to try to eliminate it. Since 2013 Japan has undertaken a significant economic stimulus package referred to as “Abenomics”. Named after the Prime-Minister, Shinzo Abe, the package is made up of very aggressive measures to kick start growth, part of which is a huge programme of asset purchases which will amount to around $1.4trillion. These purchases are expected to be maintained well into 2015.

Europe

The ECB has been faced with mounting pressure to take action in light of a lack of economic growth and low, gradually falling inflation which some believe could turn into a destructive deflationary spiral. The ECB has previously resisted calls to undertake QE; however, at the beginning of September ECB chairman, Mario Draghi, announced a programme of bond purchases, colloquially referred to as ’QE-lite’ and a further cut in its benchmark interest rate to just 0.05%. Whilst full QE continues to be discussed by the ECB committee, the recently announced measures would be significantly more subtle than those undertaken in the US and Japan.

QE-lite will see the ECB purchase asset backed securities (ABSs) and covered bonds. However, the size of purchases has not been specified in advance and as the European ABS market is relatively small (Morgan Stanley estimate there to be €690bn of eligible assets), the initial purchases are likely to be limited in comparison to other programmes.

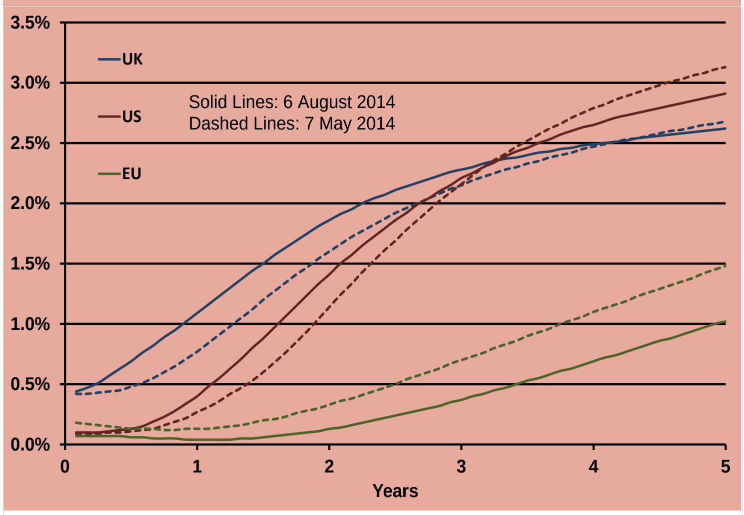
Impact on Markets

With QE in the US and UK coming to an end, many are questioning whether yields will now return to levels significantly higher than we have today - or whether we are now in a ’new normal’. There are also questions about how equity markets will react; QE is likely to have contributed to the equity market rallies seen in recent years and markets have been sensitive to unexpected announcements about the level of future QE. In particular there are concerns for emerging economies which saw increased capital inflows as a result of QE However, not all fear that the withdrawal of QE will lead to significant changes, instead believing that much is already priced in. What happens is likely to depend on whether a strong global economic recovery can take hold.

Box 2: Diverging Expectations of Future Interest Rates

Expectations of interest rates in major economies have continued to diverge and the Euro has depreciated significantly as expectations of the gaps between UK/US rates and the Euro area have continued to increase.

May 2014 vs August 2014 International Forward Rates



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