Government Actuary's Department

Investment News

Monthly Bulletin from the Investment & Risk Team

July 2015

Last Month in Brief

After negotiations to extend its bailout collapsed, Greece became the first developed country to default on an IMF loan as it missed its end-of-June deadline to repay €1.5bn. Tight capital controls were imposed and negotiations were adjourned at the announcement of a referendum on the question of whether or not the country should accept bailout terms previously proposed by the European Commission, the ECB and the IMF. European markets declined sharply at the announcement, then remained fairly stable in the last week of June before rising slightly into July. Greeks responded to the Sunday 5 July referendum with a resounding "no". Subsequently, German bond yields fell while Spanish and Italian yields rose as investors flocked to apparently safer investments amid fears that such a result will render Greece's exit from the Eurozone more likely. Bailout discussions have resumed and are ongoing at the time of writing.

UK CPI inflation was announced as being (just) positive again in May 2015, ending a brief spell of negative inflation following announcements in April. Food, motor fuels and transport services are thought to have contributed most to this, with offsetting negative effects coming from recreation and culture. The BoE again voted unanimously to maintain interest rates at 0.5%, although a member of the Monetary Policy Committee, Martin Weale, later in the month commented that there may be a need to raise this rate as early as August, citing rising wages and low unemployment.

Chart 1: Equity Indices

Equity markets generally ended the month lower

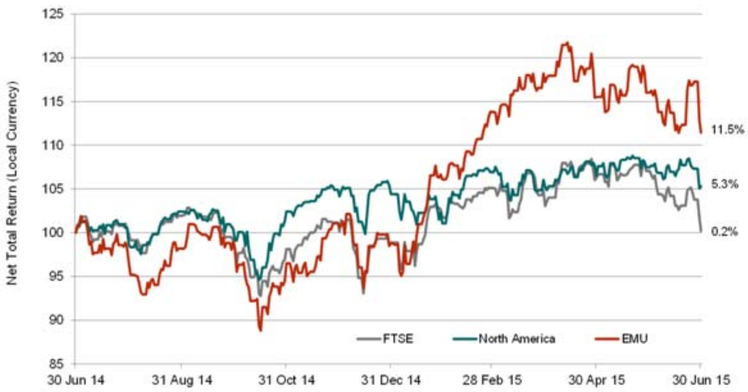


Chart 2: Sterling Credit Spreads

Credit spreads increased very slightly

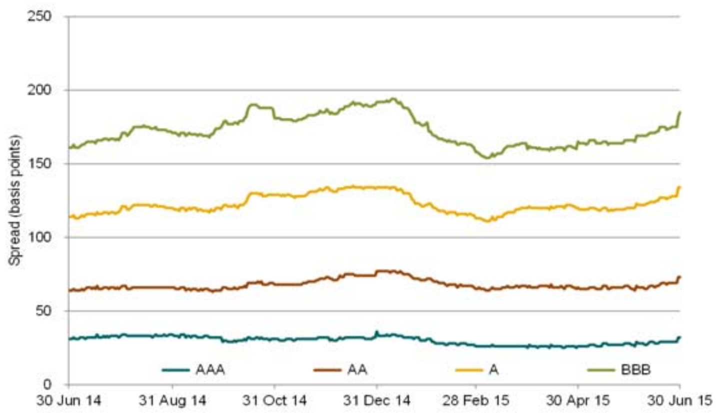


Chart 3: Gilt Yields

Yields increased slightly over the month

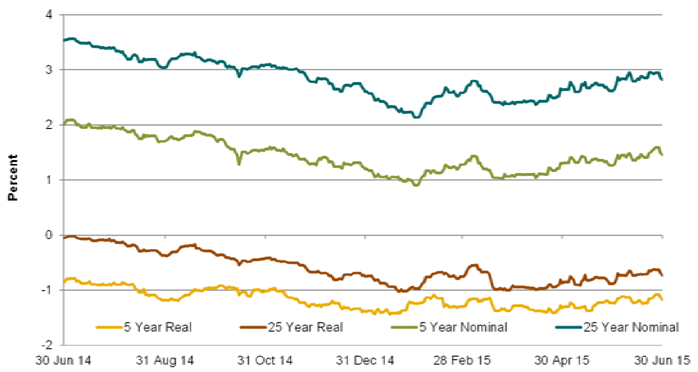
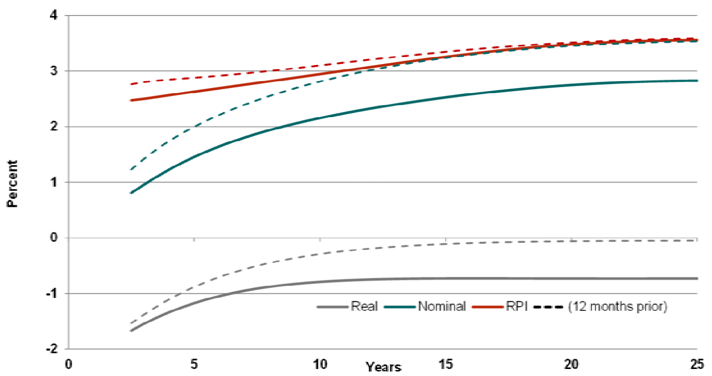


Chart 4: Gilt Spot Curves

Yield curves remain upward sloping



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

	Latest	Previous		Latest	Previous
CPI increase (annual change)	0.1%	-0.1%	**Base rate**	0.5%	0.5%
PPF 7800 funding ratio	84.1%	84.0%	**QE Level**	£375bn	£375bn
Halifax house prices (monthly change)	-0.1%	1.6%	**VIX (volatility) index**	18.23	13.84
IPD TR property index (monthly change)	1.2%	1.0%	**$/£ exchange rate**	1.57	1.53

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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Office for Budget Responsibility's Fiscal Sustainability Report

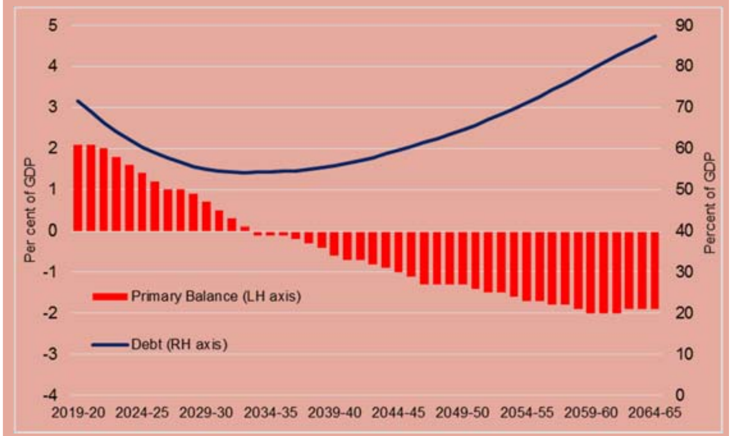
In June the OBR published its annual Fiscal Sustainability Report (FSR). The report considers the sustainability of the UK's public finances over the longer term by considering the fiscal impact of past and potential future government activity. The FSR is a far-reaching report analysing issues such as the impact of falling oil prices on North Sea tax revenues, the sale of government assets, Private Finance Initiatives and longer-term demographic trends.

Key findings

The report analyses the impact of past - and future - public sector activity on the level of public sector net debt (PSND) over the next fifty years. As the population ages and upward pressures are brought to bear on the associated costs (health, state pensions, long-term social care) the report finds that, under current policy, government revenues will remain roughly stable and so the budget deficit will widen, putting PSND on an unsustainable trajectory.

According to the National Accounts, PSND was £1.5tn at the end of 2014-15 (80.4% of GDP). Under the OBR's central projections, assuming unchanged government policy, this is expected to be close to 90% of GDP by 2065 (see Box 1).

Box 1: Central projection of the primary balance and PSND



Source: OBR

Under OBR's central projections, the primary balance (ie government receipts less non-interest spending) is positive until 2031-32 and hence PSND falls. As the population ages and costs rise, however, the primary balance becomes negative and PSND is projected to increase substantially over the projection period.

The sustainability of public finances

The OBR stresses the uncertainty in the projections and the importance of the assumption of unchanged government policy. In practice, future governments are likely to take corrective action to ensure the sustainability of the public finances.

However, the projections are helpful for illustrating the impact of key drivers on public finances. For example, FSR quantifies the future tax rises and/or spending cuts that may be required by future governments to achieve various sustainability criteria (see Box 2).

Box 2: Indicators of sustainability

The report identifies two measures of what it means for the fiscal position of the country to be sustainable.

The inter-temporal budget gap

> Based on the ability of the government to meet its future obligations, sustainability is achieved if the government will raise enough revenue to cover both non-interest spending and to service *and eventually pay off* its outstanding debt over an infinite time horizon.

> It is measured as the immediate and permanent increase in taxes (or cut in spending) required to meet future obligations.

> Though considered a rigorous measure, it has limited use as a practical guide to policy if governments don't intend to eliminate their debt entirely.

> Assuming that policy over the next five years evolves as currently announced, FSR 2015 quantifies the inter-temporal budget gap for the UK at 2020-21 to be 1.9% of GDP.

The fiscal gap

> The fiscal gap is measured as the immediate and permanent change in the primary balance needed to achieve a given debt:GDP ratio over a given timescale.

> There is no consensus regarding the optimal debt:GDP ratio and timescale. Furthermore, various policy settings could close the fiscal gap, not all of which may be deemed optimal.

> FSR 2015 quantifies a fiscal gap at 2020-21 of 1.1% in order to return the debt:GDP ratio to the pre-crisis level of around 40% by 2064-65, ie a permanent increase in taxes (or cut in spending) of £20bn (in today's terms) would be required.

How does this impact institutional investors?

FSR highlights the challenges that future governments will face from an ageing population and demographic pressures. These pressures are likely to impact on many macro-economic factors including not only taxes and government spending but also growth, employment and the supply and demand of gilts. As a result, it might be useful for institutional investors to consider the key messages of the FSR when setting long-term return expectations and assumptions on the future path of gilt yields.

The FSR also highlights how future governments might engage in other financial transactions that alter the range of investments available to investors. Examples considered in the FSR 2015 include the sale of the student loan book, the sale of Northern Rock mortgage assets and the sale of the government's remaining stake in Lloyds.

There are, however, large uncertainties involved with such long-term projections and small changes to assumptions can have large effects on the cumulative projections over five decades. Care should therefore be taken when drawing conclusions from such projections.

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