Government Actuary's Department

Investment News

Monthly Bulletin from the Insurance & Investment Team

July 2016

Last Month in Brief

Last month saw the result of the referendum on Britain's membership of the EU. The UK's vote to leave the EU caused various significant impacts on the markets. These impacts are discussed in more detail on the second page of this bulletin.

British inflation remained low with food prices seeing the biggest fall for over a year in June. However, depreciation of the pound has pushed up expectations of future inflation. The UK's GDP growth was 0.4% in the first quarter of the year; this was in line with economists' expectations and largely driven by growth in the service sector and decline in construction and industrial output. There was positive news in the UK labour market with the UK unemployment rate at its lowest level since October 2005 over February-April and average weekly earnings rising by 2.3% compared to the previous year; this was in part due to the introduction of the National Living Wage on 1 April 2016.

Elsewhere, in the Eurozone, GDP rose by 0.6% in the first quarter of 2016 compared with the previous quarter, with Eurozone unemployment falling to a 5 year low in May. However, the longer term impacts of the Brexit vote on the Eurozone economy are uncertain and yet to be felt. US growth increased to 1.1%, up from previous estimates for Q1, however the US Federal Reserve decided to keep interest rates between 0.25% and 0.5% due to uncertainty surrounding employment with job creation falling in May to its lowest level in more than 5 years.

Chart 1: Equity Indices

Equity markets suffered volatility due to the Brexit vote

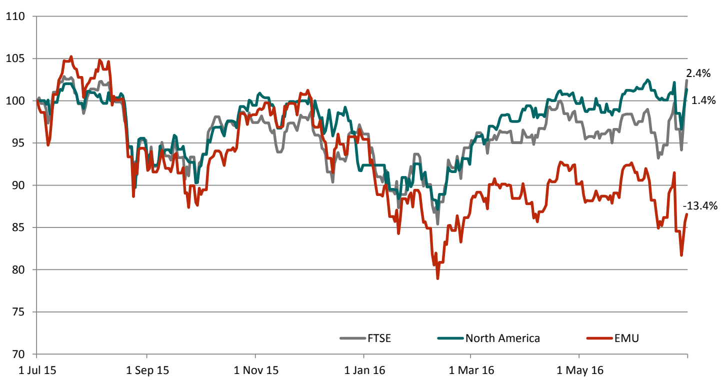


Chart 2: Sterling Credit Spreads

Credit spreads fell slightly and then rose dramatically

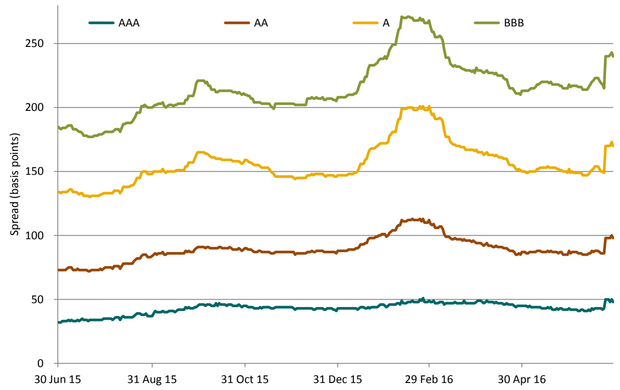


Chart 3: Gilt Yields

Gilt yields fell dramatically following the referendum result

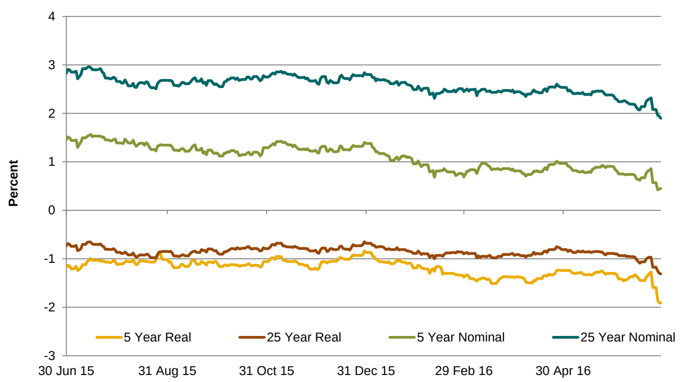
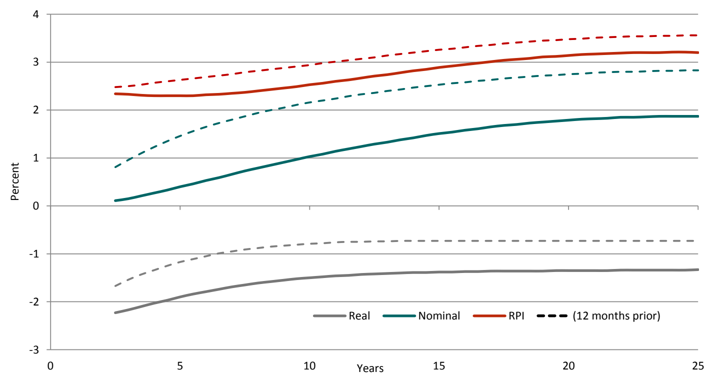


Chart 4: Gilt Spot Curves

Yields fell at all durations



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

	Latest	Previous		Latest	Previous
CPI increase (annual change)	0.3%	0.3%	**Base rate**	0.5%	0.5%
PPF 7800 funding ratio	81.5%	82.6%	**$/£ exchange rate**	1.34	1.46
Halifax house prices (monthly change)	1.3%	0.9%	**VIX (volatility) index**	15.63	14.19

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

The EU Referendum — the financial and economic effects

On the 23rd June a referendum was held on whether or not the UK should remain a member of the European Union. In a victory for the Leave campaign, the UK voted to leave the EU by 51.9% to 48.1%, with a turnout of 72.2%.

The referendum results triggered a turbulent and fast moving time for both the markets and British politics.

Short term impact

Although markets had been volatile and cautious before the referendum, most commentators agree that by polling day, markets had expected a 'Remain' victory — with equity markets rallying and the pound reaching a 2016 high. However, the vote to leave the EU has led to a period of volatility and uncertainty as the economic effects of the result and the UK's future relationship with the EU are currently unknown.

This was reflected in the markets as the pound fell to levels not seen for over 30 years, down from almost $1.50 to just over $1.32. Equity markets were also volatile (see Box 1) with the FTSE100 and FTSE250 closing 5.62% and 13.6% lower respectively on Monday 27th June.

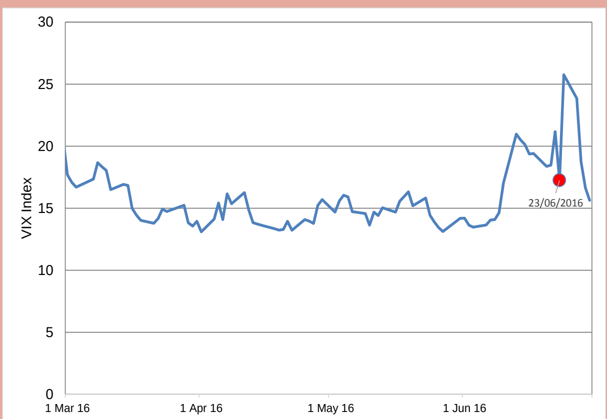
Despite these losses, the FTSE100 has since recovered and has reached pre-referendum levels, with defensive stocks in particular performing well and international exporting companies appearing more attractive with a weaker pound. The FTSE250 has not quite recovered to pre-referendum levels but has regained some ground.

The credit rating of the UK also suffered after the result. The UK has been downgraded from AA+ to AA by the rating agency Fitch, reflecting their forecast of an "abrupt slowdown" in short-term growth. The rating from the agency Moody is now "negative" (down from "stable") and the UK has also lost its AAA rating from S&P.

With uncertainty and volatility in markets, investors have looked towards safer assets which has led to pressure on government bond and gold prices. As a result of this 'flight to safety' and in spite of the downgrading of the credit rating, UK gilt yields fell to record lows — with 10 year gilt yields falling below 1% for the first time.

Box 1: The effect of the Brexit vote on equity volatility

The graph below shows the Volatility Index (VIX) since March 2016. This shows the implied volatility of option prices and is a measure of expected volatility in the market.



Medium and longer term impacts

The medium to longer term impacts caused by the UK's decision to leave the EU are uncertain.

According to a YouGov poll 49% of businesses felt pessimistic about the UK economy after the Brexit vote, with a number of companies already announcing that they will be reviewing their level of UK investment.

The Bank of England has announced that it is likely to cut its growth forecasts in its August inflation report and raised the possibility of interest rate cuts over the next couple of months.

In general the forecasts seem to indicate that the shock to the economy caused by the Brexit vote will continue for the medium term. However, the pledge by George Osborne to cut corporation tax in order to continue attracting business investment to the UK coupled with Mark Carney's announcement of the relaxation of capital requirements for banks shows a clear focus on stimulating the UK economy. How this will play out in the longer term remains uncertain.

Impact for institutional investors

For institutional investors, the result is likely to have short term impacts on solvency and funding levels. On the one hand, there may be pressure on institutional balance sheets from equity market volatility, higher inflation expectations and the increase in long term liabilities that results from the fall in gilt yields.

However this may be offset by the increase in value of overseas investments, caused by the fall in the pound, and the increase in the value of any bonds held.

In the short term, Trustees should continue to monitor funding levels and may wish to consider whether short term adjustments to investment strategies or tactical positions in particular stocks, sectors or markets might better protect the value of their portfolio or reduce volatility.

This is an uncertain time for institutional investors and it may take a while for the effects of the Brexit vote to become clear. The long term effects may depend on a number of factors such as Britain's future relationship with the EU and investor confidence in the UK economy.

In the more medium to longer term, Trustees' focus is likely to switch from shorter term tactical switches to a more strategic review of the investment strategy—in particular a review of the relative attractiveness of different asset classes and investment opportunities.

In addition, Trustees should also assess and keep under review the potential impact on sponsor covenant and whether there are any changes to the sponsor's profitability and ability to support the pension scheme in light of any changes following the Brexit vote.

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