Investment News

Monthly Bulletin from the Insurance & Investment Team

August 2016

Last Month in Brief

Last month saw the Bank of England hold the base rate at 0.5%, against expectations that rates would be cut. However on the 4th August the Bank cut interest rates to a new record low of 0.25% from the 0.5% they had remained at since 2009. They also announced an extra £60bn of quantitative easing and corporate bond purchases of up to £10bn. A new Term Funding Scheme worth up to £100bn was announced in which the Bank of England will lend money to banks at 0.25% in order encourage them to lend to businesses. The scheme is intended to help banks pass on the base rate cut to the wider economy.

In the US, the Federal Reserve took similar action in maintaining interest rates at between 0.25% and 0.5%. Policymakers said that short term risks to growth had subsided, leaving the door open to a rate rise later this year.

Elsewhere, Eurozone growth was dragged down by France, with a cooling to 0.3% growth over the quarter to June. The ECB chose to maintain its €80 billion per month bond buying programme amid increasing signs of concern about Italian banks. Share prices in the sector are down up to 75% over the year and remain volatile, with uncertainty reigning over how and whether the banks will be recapitalised.

Chart 1: Equity Indices

Equity markets rose over the month

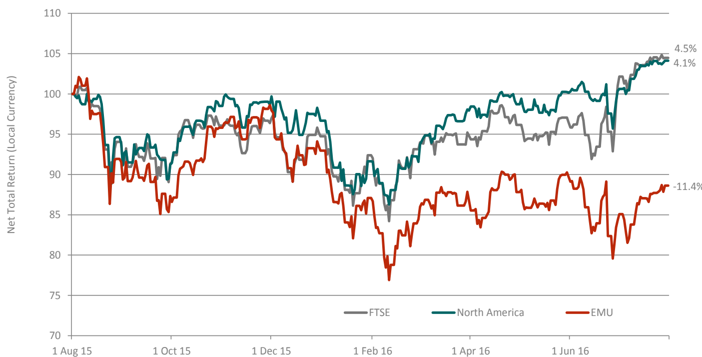


Chart 2: Sterling Credit Spreads

Credit spreads fell over the month

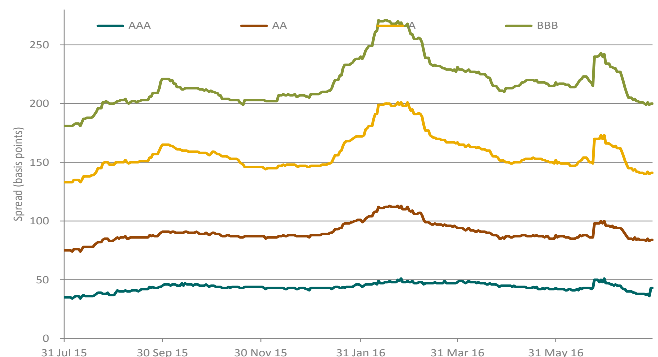


Chart 3: Gilt Yields

Gilt yields fell during the month

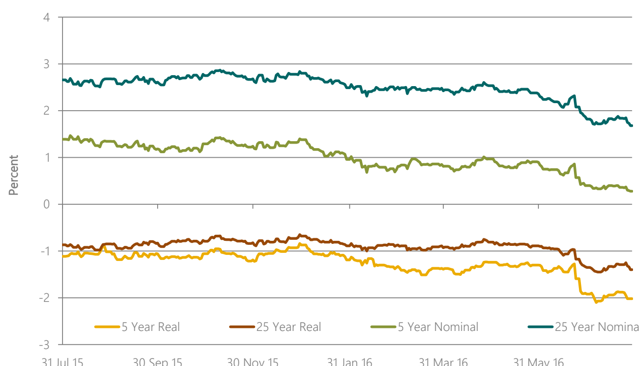
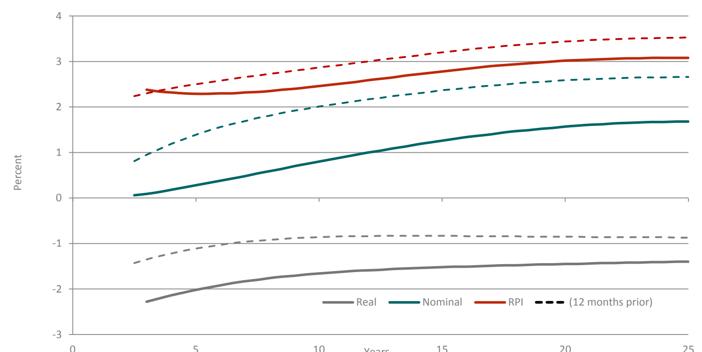


Chart 4: Gilt Spot Curves

Yield curves remained upward sloping



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

	Latest	Previous		Latest	Previous
CPI increase (annual change)	0.5%	0.3%	**Base rate**	0.5%	0.5%
PPF 7800 funding ratio	78.0%	81.5%	**$/£ exchange rate**	1.33	1.34
Halifax house prices (monthly change)	1.3%	0.6%	**VIX (volatility) index**	11.87	15.63

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

Long term index-linked gilts— negative yields and high demand

The real yield on long term index-linked gilts hit a record low at the end of July, as real yields of gilts with maturity in 2065 and 2068 stood at –1.43% and –1.45% respectively. Despite the drop in return, the July issue of index-linked gilts with 2065 redemption date was oversubscribed, raising over £5 billion for the Debt Management Office.

What are Index-Linked Gilts?

Index-linked gilts are securities issued by the UK Government, accounting for 25% of the UK Government debt within the gilt market. In exchange for the purchasing of an index-linked gilt, the government guarantees a series of interest payments known as coupons, which are adjusted in line with movements in RPI.

Initially gilts were issued with a maturity of 5, 10 or 30 years. However, in September 2005 the first 50 year gilt was sold, expiring in 2055. There are now gilts with even longer than 50 year terms, with the latest redemption date being in 2068.

Who buys Index-Linked Gilts?

There is a historic link between index-linked gilts and pension funds - when the UK first issued index-linked bonds in 1981, only tax-exempt pension funds could purchase them.

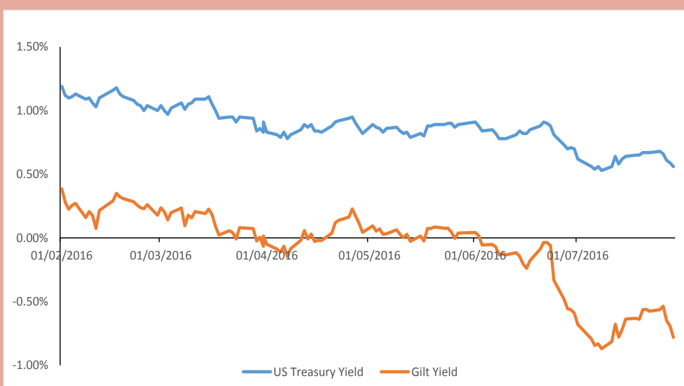
Although they are now open to a wider market, index-linked gilt purchases remain dominated by the pension industry, with an estimated 80% of the market owned by UK private sector defined benefit schemes.

Index-linked gilts offer secure, long-dated, periodic payments and mitigate the risk of RPI inflation and the volatility of equity markets.

Box 1: Yields on 30 year index-linked bonds, U.S. and UK

Real yields on U.S. and UK inflation linked bonds have both fallen over the past few months, showing an indication of a global slow down in growth. Gilt yields have fallen more dramatically over this period, reaching negative figures. An important difference between US and UK index linked bonds is that gilts are indexed in line with RPI, which has the possibility to go negative, whilst the US government bonds include a floor at 0 for inflation.

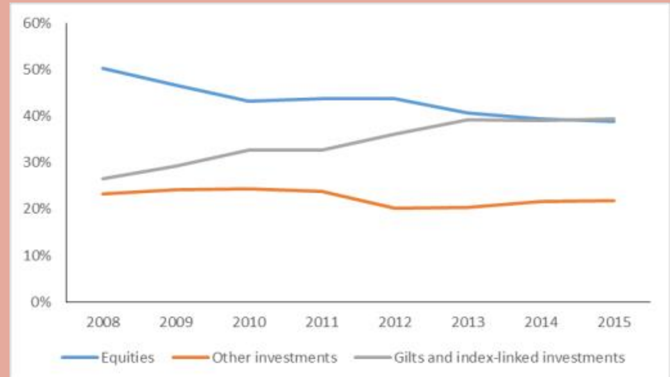
Sources: Debt Management Office and U.S. Department of the Treasury



Box 2: Asset allocation of pension schemes

The graph below shows the increasing percentage of gilts and index-linked investments as a method of funding pension schemes.

Source: PPF The purple book 2016



This makes them particularly appealing investments for pension schemes, who have long term liabilities. However, with the more recent advent of CPI linked pension indexation the inflation protection offered by gilts has worsened, with schemes less able to accurately match their liabilities.

Why have yields fallen?

In the wake of the EU referendum and the surrounding economic uncertainty, growth forecasts have fallen sharply. The detrimental effect on inflation and interest rate predictions has had a knock-on effect on the expected yields from index-linked gilts.

Announcements by the Bank of England of further quantitative easing and a cut in interest rates (to 0.25%) will further put pressure on gilt yields and may lead to yields falling further.

Despite this, government backed securities such as gilts still offer an attractive investment, as investors become more risk averse in times of uncertainty. This high demand has helped keep prices up, even with real yields going negative.

Impact on pension schemes

Low gilt yields spell trouble for pension scheme deficits where schemes haven't matched their assets and liabilities. The cost of new accrual has also risen significantly, and while some pension funds may be tempted to wait until yields increase again before investing, but it is not clear whether this will happen in the short term and many funds are revising down their expectations. Expected returns will also have fallen for asset classes other than bonds in this low interest environment.

Furthermore, buyout prices are closely linked to gilt yields, as any fall in yields pushes up the cost of securing payments for future liabilities for an insurer, spelling further bad news for pension schemes.

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