# Investment News

## Monthly Bulletin from the Insurance & Investment Team

October 2017

## Last Month in Brief

The Governor of the Bank of England hinted that interest rates could rise in the "relatively near term" for the first time since July 2007, in a response to the inflation rate being persistently above the Bank of England's 2% target. Economists predicted that changes in policy could be determined as early as November 2nd, the scheduled date for Monetary Policy Committee's next meeting. Following the Governor's announcement regarding a potential interest rate rise in the near future, the pound rose against both the euro and the dollar.

The revised UK annual growth figure for Q2 fell to 1.5%, down from 1.8% in the first three months. This represented the weakest year-on-year expansion in more than four years. Economic data from the ONS revealed the services sector remained the key driver of growth to the UK economy, but growth was slower at a quarterly rate than in the second half of 2016. The construction and production sectors both contracted over the quarter. In contrast to the UK, the US economy grew faster than expected through the second quarter, with annual growth rates revised upwards for the second time to 3.1% according to The Commerce Department. The figures were boosted by a combination of higher consumer spending and state expenditure. The growth is, however, expected to slow in Q3 following the string of devastating hurricanes that have affected the US and Central America.

The OECD has predicted the UK economy will face slower growth over the coming year, with UK GDP growth slowing from the anticipated 1.6% in 2017 to just 1% in 2018. The forecasts were based upon the assumption that the UK would fail to agree upon a trade deal with the EU following Brexit negotiations. The OECD forecast would see the UK fall to the lowest position out of all the G7 countries.

Chart 1: Equity Indices
Equity markets rose over the month


Chart 2: Sterling Credit Spreads
Credit spreads were stable over the month

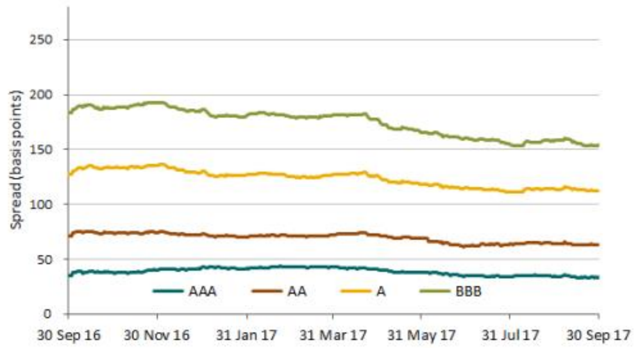



Chart 3: Gilt Yields
Real and nominal gilt yields increased over the month

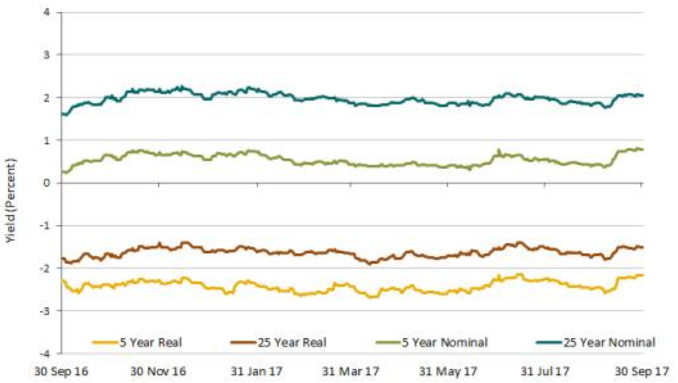
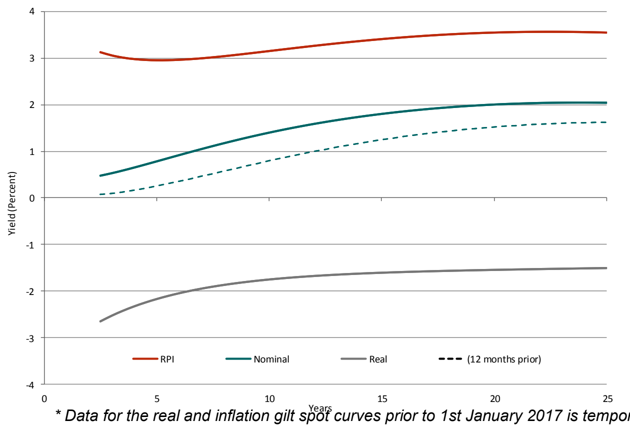



Chart 4: Gilt Spot Curves*
The yield curve was stable over the month




** Data for the real and inflation gilt spot curves prior to 1st January 2017 is temporarily unavailable from the Bank of England*

Source: Bloomberg, Business Insider, MSCI, Merrill Lynch Bank of America and Bank of England.

| | Latest | Previous | | Latest | Previous |
|---|---|---|---|---|---|
| **CPI (annual change)** | +2.9% | +2.6% | **Base rate** | 0.25% | 0.25% |
| **PPF 7800 funding ratio** | 87.6% | 89.4% | **$/£ exchange rate** | 1.34 | 1.29 |
| **Halifax house prices (monthly change)*** | 0.8% | 1.5% | **VIX (volatility) index** | 9.51 | 10.59 |

** Halifax have recently changed their methodology for calculating the above figures so the figures may not be consistent with previous updates*

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

**Government Actuary's Department, Finlaison House, 15-17 Furnival Street, London, EC4A 1AB Telephone +44 (0)20 7211 2601**

# Commodities: An Introduction

In the weeks surrounding the devastating arrival of Hurricane Harvey on US soil, much of the investment-related reportage focused on the storm's drastic impact on energy prices, particularly gasoline and oil - two cornerstones of the commodities market.

## What are Commodities?

In a broad sense, commodities are raw materials or agricultural products that can be bought or sold, such as gold, corn or oil. In an investment context, an important property of commodities is their *fungibility*; commodities of the same type are treated as being equivalent and interchangeable – for example, all No.3 Yellow Corn is considered to be identical in value and quality, no matter where or by whom it was produced.

Commodities come in two main types:

> 'Hard' commodities - extracted or mined, such as fossil fuels or precious metals.

> 'Soft' commodities - of agricultural origin such as grains and meat.

Due to their limited shelf life, soft commodities tend to be more volatile in price and riskier to hold than hard commodities. Conversely, hard commodities, such as gold, tend to be seen as safer, long-term investments.

Gold is particularly interesting because although it acts as a commodity, it is also held by central banks as a backing for currency, hence is also held as an asset. Because of this, the price of gold is often seen as reflecting investor confidence in a particular nation's economy. A recent example of this is illustrated in Figure. 1 – after a long rise attributed to a weak dollar and low interest rates, US gold prices fell back from a year-high $1349.29/troy ounce as new unemployment (down to just 5.9%) and consumer spending data (up to 2.8% through Q2) suggested a positive outlook. Investors responded by dipping their collective toes back into riskier waters, leading to a drop in demand (and thus in price) for gold.

**Figure 1: Gold Prices ($/troy ounce) Q3 2017**

Source: TradingView

## Investing In Commodities

Though it is possible to buy and sell commodities directly, the most common way to invest is through *futures*. Essentially, futures are contracts obligating a buyer to purchase, or a seller to sell, a particular commodity at an agreed fixed future date and price, e.g. 10,000 barrels of oil at $100 a barrel in 1 years' time. In some instances, futures are used by producers and consumers of commodities to hedge against price risk. In the example above, the seller of the oil is now protected from any downside fluctuations in price for the next year and is guaranteed a predetermined amount of income. The seller does, however, also miss out on any potential increase in prices.

Futures can be bought and sold by speculators for the sole purpose of making profits off said fluctuations. In these cases, actual delivery of the commodity in question usually does not occur as the trader closes their position before delivery. In the example above, a speculator might buy the oil futures contract before immediately selling it if the price of oil rises, thus turning a profit off the difference.

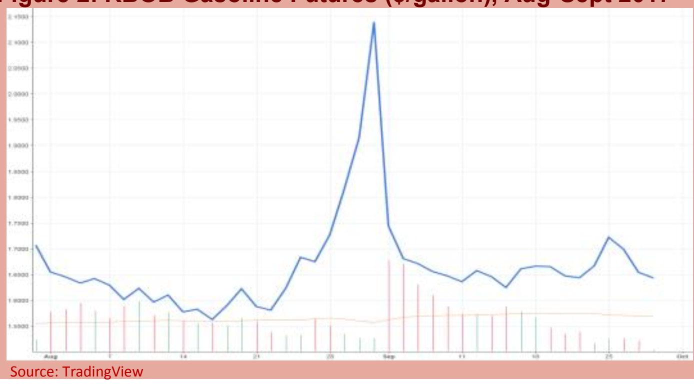
Because of the large purchase quantities typically associated with futures contracts, most buyers and sellers tend to be large asset managers or brokerages, but individuals can still gain access by investing in exchange-traded funds (ETFs). ETFs track the price of a particular commodity (or future) and can be traded in a similar way to equities, offering a more passive investment approach to individual investors.

## Risks and Rewards

Due to their 'real-world' origins, commodities can be highly volatile. Factors such as natural disasters, adverse seasonal weather or war can greatly affect supply and demand in very short spaces of time. This volatility attracts speculators aiming to make rapid short-term profits, but also adds an inherent risk to investing in such assets.

This is illustrated in the recent aftermath of Hurricane Harvey; the damage caused to major oil refining areas of Texas (with 16% of US refining capacity taken offline) led to a rapid spike in gasoline futures of around 20% (see Figure 2), peaking at $2.167/gallon. However, Figure 2 also shows an equally rapid decline back to pre-hurricane levels of around $1.700/gallon as refining capacity swiftly ramped back up post-disaster.

**Figure 2: RBOB Gasoline Futures ($/gallon), Aug-Sept 2017**



Source: TradingView

Investors looking for something more than an opportunistic 'quick buck' should be wary of such rapid fluctuations, but commodities can still be useful as part of a balanced strategy. As their pricing trends often diverge from those of the stock market, they can be employed to diversify heavily equity-based portfolios in order to offset and reduce risk. Recent rapid growth in the popularity of ETFs suggests that individual investors are increasingly buying into this approach.



Contact Information

Colin Wilson
Deputy Government Actuary
T: 020 7211 2672
E: colin.wilson@gad.gov.uk

Aidan Smith
Chief Actuary
T: 020 7211 2632
E: aidan.smith@gad.gov.uk

Andrew Jinks
Deputy Chief Actuary
T: 020 7211 2655
E: andrew.jinks@gad.gov.uk