Government Actuary's Department

INVESTMENT NEWS

MONTHLY NEWS BULLETIN
FROM THE INVESTMENT AND RISK TEAM

01

July 2014

Overview

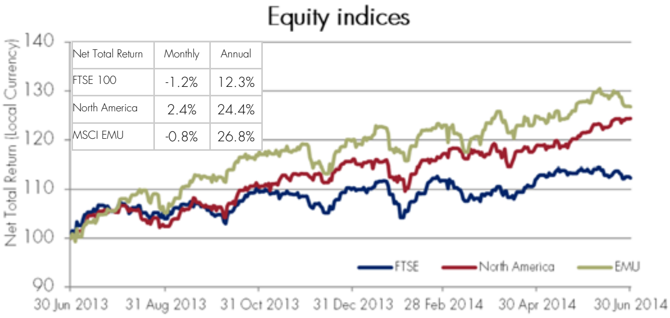
This month saw the ECB reduce their deposit rates below zero for the first time alongside other measures to stimulate the Eurozone. The rate of inflation in the region has remained at 0.5% for June, which is within the ECB President Mario Draghi's "danger zone" and well below the target level of 2%.

In the UK, there has been continued uncertainly around the timing of a potential BoE base rate increase. Mark Carney has suggested that "the start of that journey is coming nearer" but also referred to spare capacity in the economy and a lack of real wage rises as reasons not to act too soon. He has suggested any rate rises will take place in a "gradual and limited fashion" and that in the medium term rates are unlikely to rise above 2.5%. The pound has strengthened relative to both the Euro and the Dollar on the back of relatively strong economic data and the potential interest rate rise.

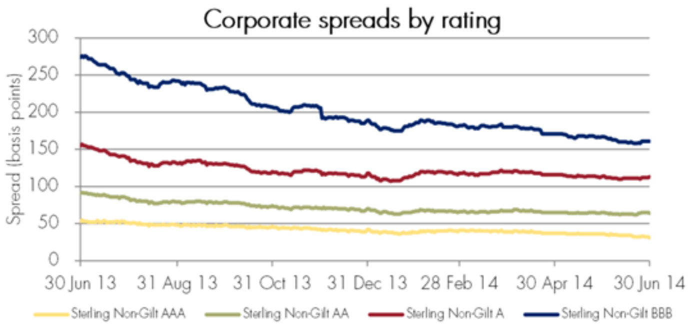
The price of oil rose during the month on the back of disruption in Iraq, putting some downward pressure on equities. However, this effect has been muted relative to historical unrest in OPEC nations.

House prices continued to rise but new mortgage approvals, especially at the riskier end of the market, decreased to their lowest level in a year as tighter affordability checks have come in to effect. Some commentators have suggested that these checks, along with other controls on mortgage lending, may temper the market if it threatens to overheat.

Equity markets saw mixed returns during the month



Credit spreads were largely unchanged over the month

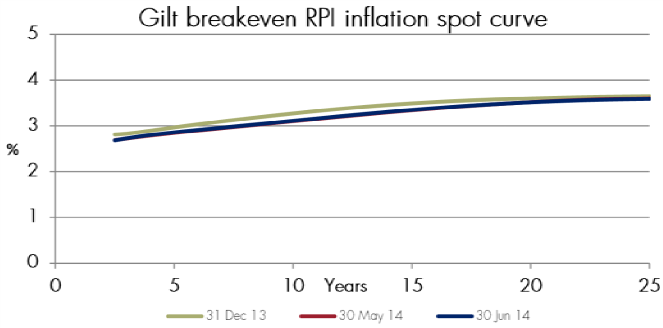


LATEST ECONOMIC NUMBERS

Current base rate	0.5%
Quantitative easing	£375bn
CPI (May %y/y)	1.5%
Halifax house prices (%m/m)	3.9%
PPF 7800 funding ratio	90.8%
$/£ exchange rate	1.71

Numbers as at the end of month unless stated

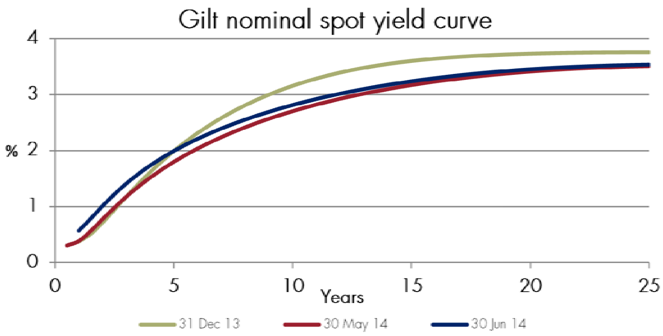
Breakeven inflation was largely unchanged this month



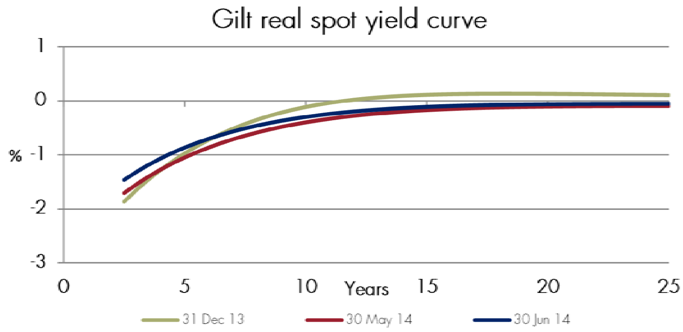
CALENDAR OF EVENTS AND DATA RELEASES

MPC interest rate	10th July
RPI/ CPI	15th July
UK Trade (May)	10th July
Labour Market Statistics	16th July
Minutes of MPC meeting	23rd July
GDP (Q2)	25th July

Nominal yields are largely unchanged this month



Real yields are largely unchanged this month



All chart data sourced to Bank of England, Merrill Lynch, Financial Times, MSCI & Standard and Poor.

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The 'Productivity Puzzle'

Since the financial crisis in 2008, the reasons behind the UK's sustained weak productivity growth have generated significant debate in what has been called a "productivity puzzle". This month the Bank of England (BoE) published a further article on the issue[1]. Below, we review some of their arguments and consider some possible implications for investment markets.

Productivity is measured as the value added from goods or services per hour of labour or worker. Productivity is still 4 percent below the levels seen before the 2008 financial crisis and the Bank of England estimates productivity is up to 16 percent lower than if the pre-crisis trends had continued. This is weak both in comparison to historical experience (see Box 1) and that of other countries (see Box 2).

Understanding productivity growth is key to the BoE's estimates of 'spare capacity' within the economy and hence the economy's ability to grow without causing inflationary pressures. It therefore influences the BoE's decisions about monetary policy including interest rates and quantitative easing.

Possible causes of low productivity

The BoE have suggested that the productivity puzzle is likely to be caused by a number of factors including measurement issues and cyclical reasons, such as employers holding onto labour during the recession. However, they also believe that it is likely other factors are having a persistent impact and hence lead to a more protracted weakness in productivity. These possible causes of a persistent impact on the level of productivity include:

> Reduced business investment, such as not refurbishing or replacing machinery or investing in new projects;

> Lack of investment in 'intangible capital', such as research and development, resulting in fewer new products and less innovation;

> Lack of working capital caused by a restriction in credit resulting in less efficient production processes;

> Employees being moved to less productive roles within firms such as generating business rather than production;

> High survival rates for firms, resulting in a high proportion of low-productive firms surviving the recession.

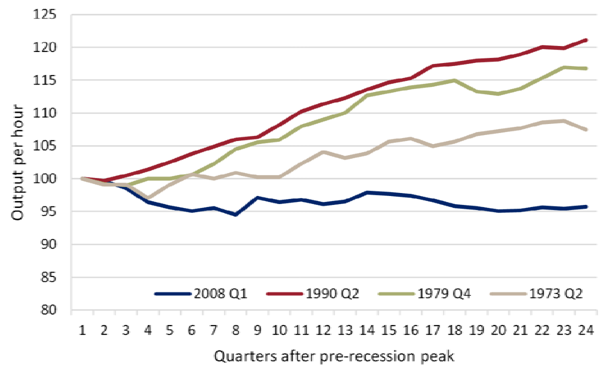
However the BoE also acknowledge that even when combined, these factors leave a proportion of the productivity puzzle unanswered.

Impact on investment markets

Sustainable economic growth largely relies on increased productivity and many would argue that the level of long-term real returns depends on increases in productivity. If these 'persistent factors' have led to a permanent reduction in the UK's productivity levels, this may impact on the returns achieved on assets such as equities. However, if productivity has been reduced by cyclical factors then when productivity returns to trend levels it may be expected that companies' earnings would also increase. However, there is unlikely to be a direct relation to share prices which depend on many other factors and markets' future expectations.

[1] http://www.bankofengland.co.uk/publications/Documents/quarterlybulletin/2014/qb14q2.pdf

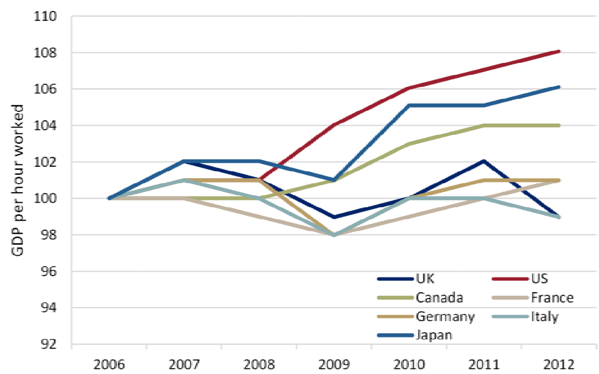
Box 1 — Productivity in the UK



Source: ONS

Productivity levels have remained broadly unchanged since the beginning of 2008. This is the longest period where productivity has not increased since the start of a recession.

Box 2 — International productivity levels



Source: ONS

Productivity growth in the UK is lower than other G7 economies. Of these 7 countries, only Japan, Canada and the US have seen significant productivity growth since 2008.

Contact Information

Colin Wilson
Technical Director
T: +44 (0)20 7211 2672
E: colin.wilson@gad.gov.uk

Matt Gurden
Investment & Risk Actuary
T: +44 (0)20 7211 3498
E: matt.gurden@gad.gov.uk

Andrew Jinks
Investment & Risk Actuary
T: +44 (0)20 7211 2655
E: andrew.jinks@gad.gov.uk

Chris Bull
Investment & Risk Actuary
T: +44 (0)20 7211 2739
E: christopher.bull@gad.gov.uk