INVESTMENT NEWS

MONTHLY NEWS BULLETIN FROM THE INVESTMENT AND RISK TEAM

2 October 2013

MONTHLY UPDATE

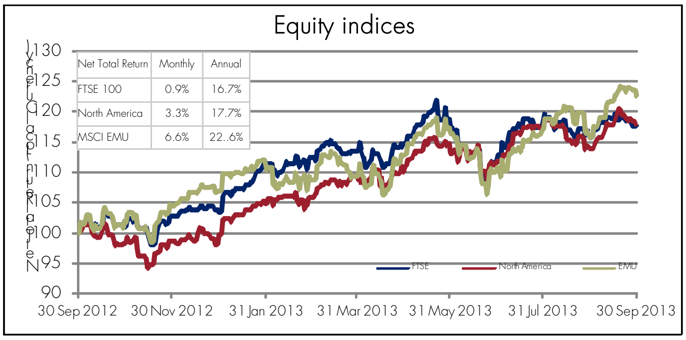
Overview

UK GDP growth has been confirmed at 0.7% for Q2, placing it as the strongest quarterly expansion since the second quarter of 2010. Other indicators are also showing signs of improvement with CPI inflation continuing to edge lower, consumer confidence reaching a six year high and the first rise in productivity in the UK labour market in two years. The Bank of England has revised its third-quarter growth forecast from 0.5% to 0.7%, whilst the OECD has now almost doubled 2013 UK growth predictions to 1.5%.

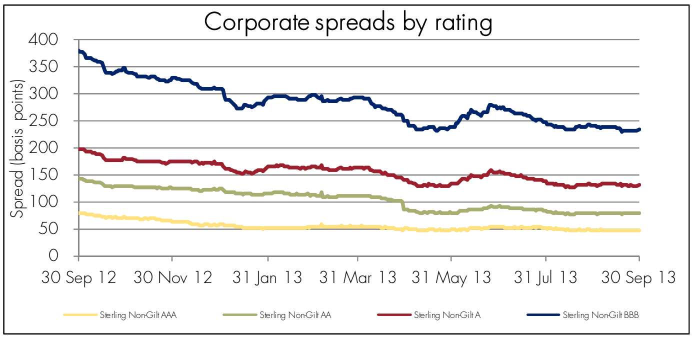
Following the uncertainty last month, the US Federal Reserve made a surprise decision to continue with its $85bn a month Quantitative Easing (QE) programme due to concerns about unemployment and continued recovery. Following the announcement, global bond yields fell, equity markets rallied and the Dollar weakened, especially against the Pound which was buoyed by Mark Carney's rejection of the need for further QE in the UK.

There was a muted response from markets immediately following the 'partial shutdown' of the US government after the two houses of Congress failed to reach agreement. Many commentators suggest that this reflects the higher level of concern the markets have over the 17 October deadline for extending the US debt ceiling.

Equity markets rose over the month



Credit spreads narrowed slightly this month

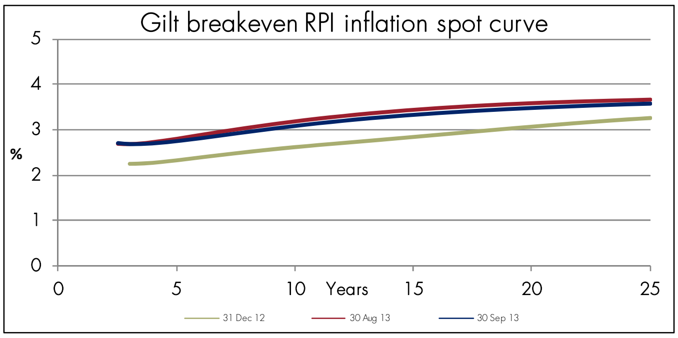


LATEST ECONOMIC NUMBERS

Current base rate	0.5%
Quantitative easing level	£375bn
CPI increase August (%y/y)	2.7%
Halifax house prices August (%m/m)	0.4%
IPD TR property index August (%m/m)	0.9%
PPF 7800 funding ratio August	90.8%
VIX (volatility) index	16.6
$/£ exchange rate	1.62

Numbers as at the end of month unless stated

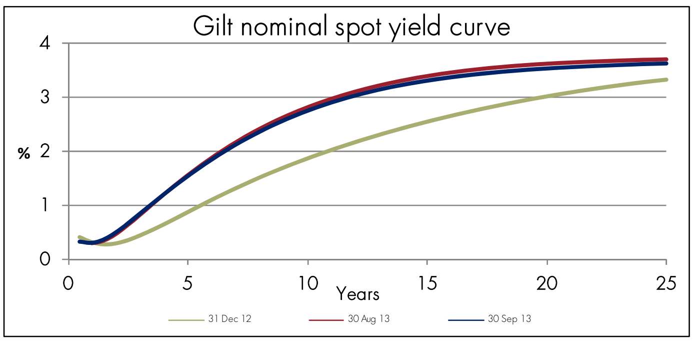
Breakeven inflation decreased slightly



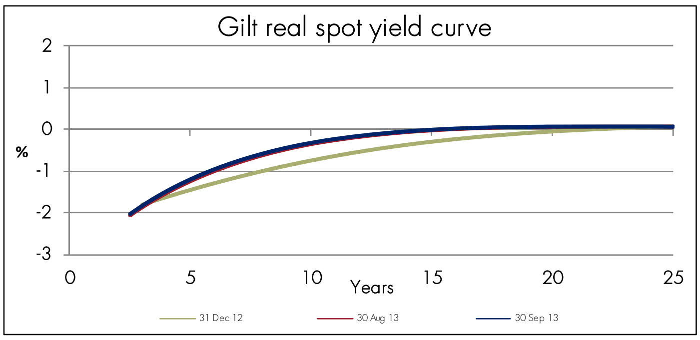
CALENDAR OF EVENTS AND DATA RELEASES

UK Trade	9th Oct
MPC interest rate announcement	10th Oct
Labour Market Statistics	16th Oct
RPI / CPI	15th Oct
Minutes of MPC meeting	23rd Oct

Nominal yields decreased slightly this month



Real yields were mainly unchanged this month



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

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What is Securitisation?

Securitisation has been used for decades; however, the rapid growth in the securitisation markets has been blamed by some as having a key role to play in the 2008 financial crisis. Securitisation is the practice of converting the expected income stream from a pool of assets by selling a repackaged combination of the assets to investors. Combining assets in this way can create financial instruments with risk/return profiles that may not otherwise have been available in the marketplace. The assets underlying these securitised products are those expected to provide a regular income stream to the asset holder, such as bonds, mortgage portfolios and other loan books. They are often illiquid, unmarketable assets; for example credit card loans, aircraft leases and car finance, and in some cases can be more exotic such as film revenues or album royalties. The return paid to investors in the securitised products comes from the cashflows generated by the underlying assets. The securitisation process therefore provides a way to sell the assets to investors and convert the future cashflows into immediate funding for the originating company, who provided the original loans (or other products). For the investor, they provide exposure to a wide range of assets, with the risk normally diversified across a large number of individual assets, and without exposure to the risk of bankruptcy of the originating company.

Types of securitisation

There are a range of names given to the securities produced by securitisation including:

> Asset backed securities - either used as a broad term to describe any security backed by a pool of assets or sometimes more specifically those backed by consumer loans

> Mortgage backed securities - securitisation issues backed by either residential or commercial mortgages

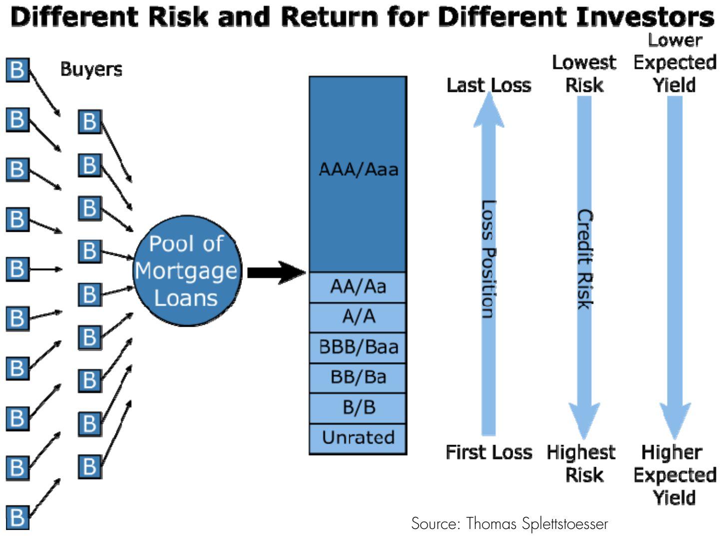
> Collateralized debt obligations - securitisations backed by debt, originally corporate bonds but also debt from other securitisations.

Structure

A portfolio of assets is usually transferred to a Special Purpose Vehicle - a separate limited company which is bankruptcy remote from the originator of the assets. This Special Purpose Vehicle then issues securities to investors.

Securitisations are often tranched (sub-divided) into securities with differing seniorities (see Box 1). Tranching allows the most senior tranche to be paid first and hence have a low likelihood of default. However, the cashflows on the more junior tranches may be very uncertain. The tranched nature of securitisations allows the securities to be marketed to a wide range of investors with differing risk appetites.

Box 1—The tranching of debt



Source: Thomas Splettstoesser

Securitisations often result in multiple tranches of debt with different payment terms. These will have different levels of risk and expected returns and be awarded different credit ratings.

Characteristics

There are two main criticisms associated with securitisations

> The separation of the bearer of risk from the institution originating the loans may diminish the responsibility felt, and care taken, by the originator. For example securitisations may have played a part in the weakening in US mortgage underwriting standards and the resulting "sub-prime" crisis.

> The complexity of the product creates challenges regarding transparency and the ability for potential investors to understand all the relevant information. In recent years several lawsuits have been launched over the communication of the risks in securitisations including against credit rating agencies who had awarded high credit ratings.

However for investors who understand the risks, the tranched nature means that they can provide a good match to their specific risk appetites and investment time horizons. In addition they often provide yields in excess of corporate bonds of the same credit rating.

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