Government Actuary's Department

INVESTMENT NEWS

MONTHLY NEWS BULLETIN
FROM THE INVESTMENT AND RISK TEAM

01

4 February 2014

MONTHLY UPDATE

Overview

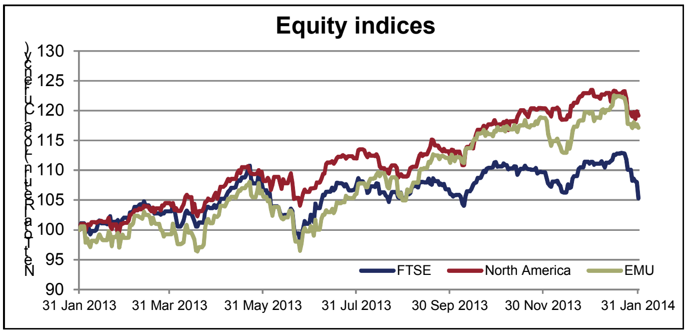
There were a number of positive economic indicators this month. Unemployment continued to fall - now down to 7.1 percent, and the pound climbed to its highest level against the US dollar since 2011. The FTSE 100, with its 30th birthday this month, remained volatile. It increased at the start of the month, but overall ended the month 5.5 percent down since the end of December.

The International Monetary Fund revised its estimate of growth for the UK economy to 2.4 percent for 2014. This was a half percent increase on its previous estimate of 1.9 percent. This forecast puts the UK economy out in front of any other major European economy.

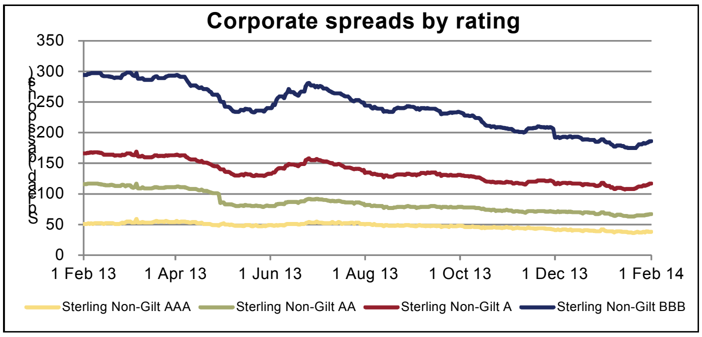
The monetary policy committee met this month and has shown no indication of raising interest rates. The original trigger to consider doing so was an unemployment rate of 7 percent. It was projected that this target would not be achievable until at least 2015. Some commentators have speculated that the hesitancy to raise the interest rate may be due to worries of slowing any momentum gained towards economic recovery. The committee also voted to keep the stock of assets purchased under its bond-buying stimulus program unchanged at £375 billion.

This month has also brought the worst selloff in emerging-market currencies in five years. Argentina's Peso has led the decline, falling by 12 percent in one day. Other poor performers include the Turkish Lira and South Africa's Rand. The decrease in currencies follows closely the Federal Reserve's announcement of tapering off monetary stimulus, which increased confidence in the US dollar.

Equity markets fell towards the end of the month



Credit spreads were largely unchanged over the month

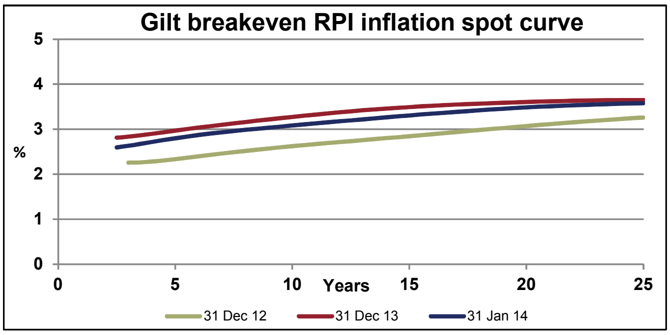


LATEST ECONOMIC NUMBERS

Current base rate	0.5%
Quantitative easing level	£375bn
CPI increase December (%y/y)	2%
Halifax house prices Dec (%m/m)	-0.6%
IPD TR property index Oct (%m/m)	2.1%
PPF 7800 funding ratio end Oct	97.6%
VIX (volatility) index	18.4
$/£ exchange rate	1.64

Numbers as at the end of month unless stated

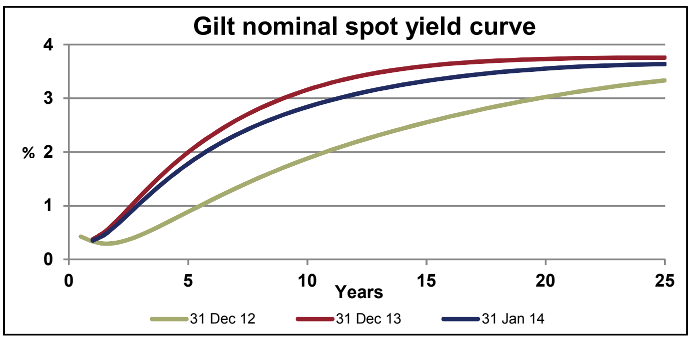
Breakeven inflation decreased marginally this month



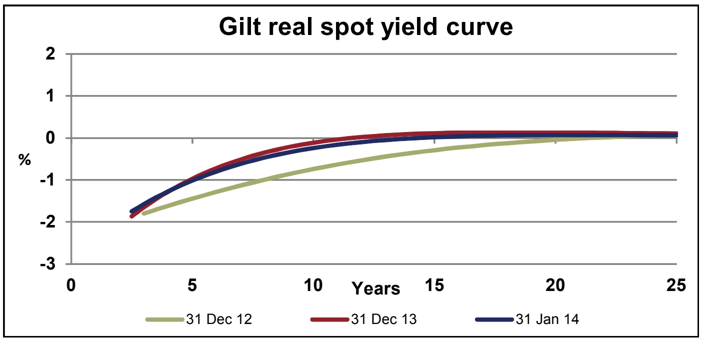
CALENDAR OF EVENTS AND DATA RELEASES

MPC interest rate announcement	6th Feb
UK trade Dec 2013	7th Feb
BoE Inflation Report	12th Feb
RPI / CPI	18th Feb
Labour Market Statistics	19th Feb
Minutes of MPC meeting	19thFeb
UK GDP (Q4 Second estimate)	26th Feb

Nominal yields have decreased this month



Real yields decreased marginally this month



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

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Is Deflation A Threat?

Risks

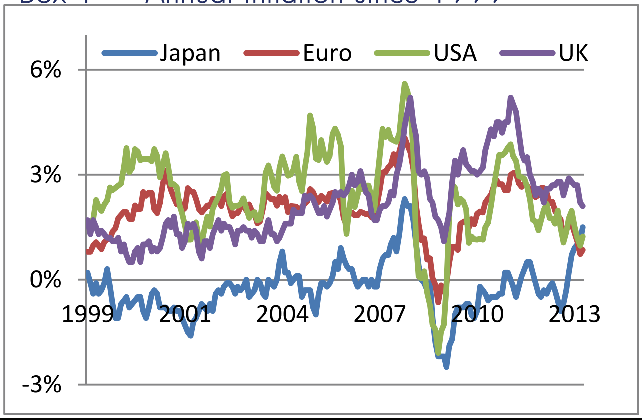
The continual rise of prices, or inflation, is a reality that most of us assume to be true in any economy. Despite usually being valid, this assumption may not always hold. This is demonstrated in the phenomenon known as deflation. Deflation is an ongoing reduction in the price of goods which, despite sounding like a good thing, can lead to significant damage to an economy.

The expectation of falling prices causes consumers to hoard their cash and wait for a better deal. This results in lower demand, causing the economy to slow and prices to fall. This self-fulfilling cycle of expectation can trap countries in a deflationary spiral for years.

As prices decrease, the purchasing power of a unit of currency increases. This results in the value of any existing debt strengthening, thus putting a higher financial strain on the borrower. This worsened financial position means the borrower is less likely to spend and so demand is pushed down even further.

On a national scale, countries are forced to find a higher level of funds to pay for the increasing real value of their debt. This forces them to divert revenue away from other goods and services, further hurting demand. This cycle is fuelled by the fact that the government's revenue will be decreasing due to deflation.

Box 1 — Annual inflation since 1999



Japan

In the past 15 years Japan has suffered greatly from deflation. Falling prices, declining sales and job losses have all contributed to stagnant growth for the period. Recently though, Japan has made progress in its efforts in halting deflation through the use of a three pronged approach known as "Abenomics". This strategy involves printing money as well as easing monetary policy to encourage higher spending and future growth. With more money in circulation the value of the yen falls and so makes the products produced in Japan relatively cheap and more competitive to other countries. This increases Japan's exporting presence and further adds to economic growth.

Critics argue that by exporting at such low prices Japan is effectively exporting its deflation to the rest of the world. This is due to the increased downwards pressure on the prices of competing countries. With other countries following suit and lowering prices the result has been a fall in the currencies of many developing countries. This ongoing battle of prices has effectively resulted in a currency war.

It is also argued that, assuming Abenomics is successful, the increase in prices may exceed the gains in wages. This would reduce the purchasing power of the citizens of Japan and lower the support for economic reform.

Interestingly, despite a recent history of deflation, Japan still holds an unemployment rate of only around 3 and a half percent.

Eurozone

The possible threat of deflation has been discussed recently due to a period of disinflation across the Eurozone. Disinflation or lower than expected inflation results in debt costing more in real terms than anticipated. This results in countries having to divert more revenue to pay for debt than they originally intended. This becomes more problematic when considering the fact that the weakest European economies have the highest debt and lowest inflation.

A positive aspect of disinflation is that prices will be increasing more slowly than elsewhere in the world, and so making exports more competitive.

USA

In recent years the USA's inflation has remained positive and below the 2% target. This may not continue to be the case due to the tapering off of quantitative easing. The USA's quantitative easing programme was designed to inject money into the economy and stimulate spending in order to help avoid inflation falling significantly below target. With this strategy starting to wind down the threat of deflation may return.

UK

It has been argued that the weakened pound has been one of the leading recovery aids in the UK economy when weathering the recession. The pound has since gained momentum and strengthened, meaning that UK exports are less competitive. This may have helped contribute to inflation levels falling to their lowest levels in several years. They are also expected to continue falling as utility companies pass on the government's environmental tax cuts.

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