INVESTMENT NEWS

GAD

01

MONTHLY NEWS BULLETIN
FROM THE INVESTMENT AND RISK TEAM

1 July 2013

MONTHLY UPDATE

Overview

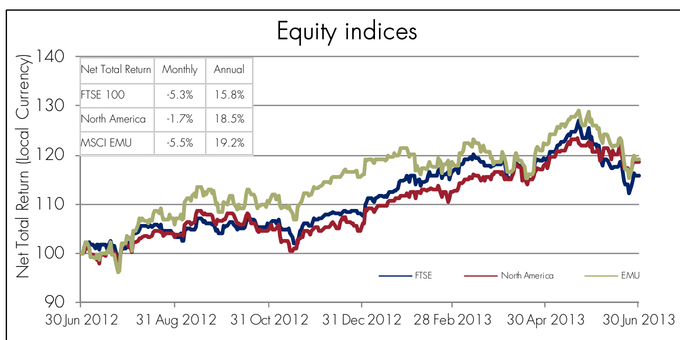
Revised data from the Office for National Statistics showed that the UK economy avoided a double dip recession in 2012. However, the recession of 2008/9 was worse than previously estimated with GDP declining by 7.2% rather than the previous estimate of 6.3%. As a result, output is now 3.9% lower than the pre-crash peak compared with the previous estimate of 2.6%.

The US Federal Reserve has kept interest rates on hold and maintained the pace of its quantitative easing programme. However, investors have become concerned that the Fed's $85bn-per-month programme may begin winding down leading to a fall in stock markets across the globe. The FTSE 100 ended the month around 5% lower, reversing strong growth seen in May.

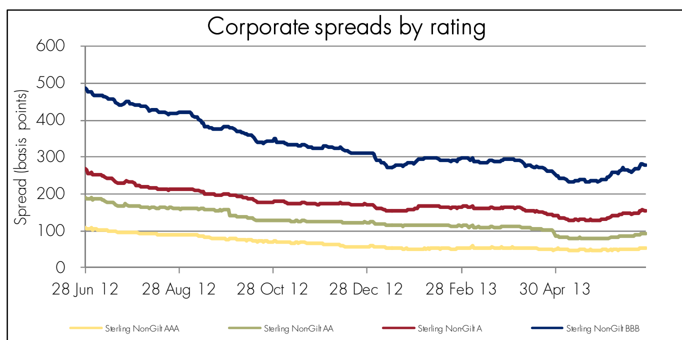
The Government has announced the results of its 2015-16 spending review, including a cap on welfare payments. The Department of Transport must fund 9% in day-to-day savings, but will also receive an increase in its capital budget to £9.5bn. The Chancellor has promised the largest programme of investment in the road network for 50yrs, and in the rail network since the Victorian age.

After 22 years at the Bank of England, 10 of them in charge, Sir Meryvn King will be replaced as governor by Mark Carney at the start of July. What impact the change of governor will have remains to be seen.

Equity markets declined over the month



Credit spreads increased over the month

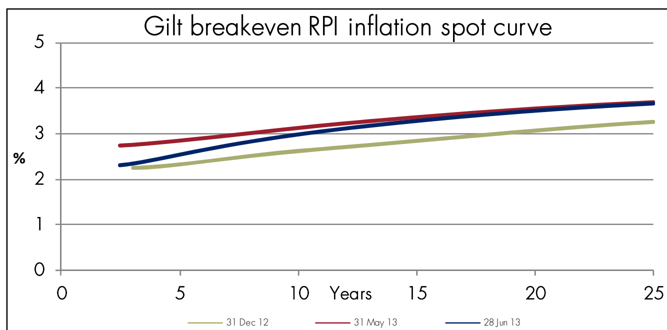


LATEST ECONOMIC NUMBERS

Current base rate	0.5%
Quantitative easing level	£375bn
CPI increase May (%y/y)	2.7%
Halifax house prices May (%m/m)	0.4%
IPD TR property index May (%m/m)	0.6%
PPF 7800 funding ratio	85.9%
VIX (volatility) index	16.9
$/£ exchange rate	1.52

Numbers as at the end of month unless stated

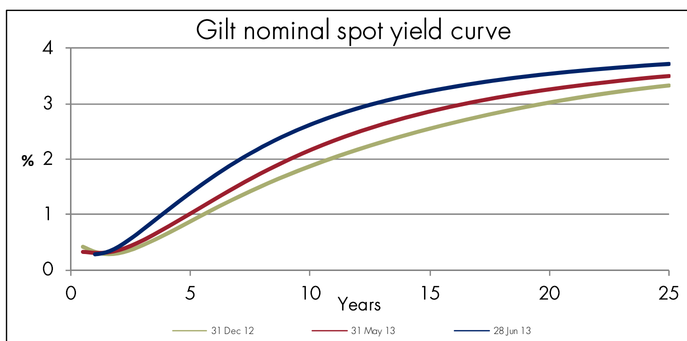
Breakeven inflation fell this month



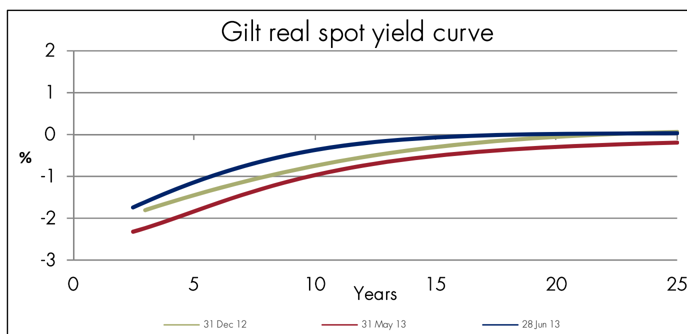
CALENDAR OF EVENTS AND DATA RELEASES

MPC interest rate announcement	4th July
UK Trade	9th July
Producer Price Index	16th July
RPI / CPI	16th July
Minutes of MPC meeting	17th July
UK GDP (Q2 first est.)	25th July

Nominal yields increased this month



Real yields increased this month



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

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Demography and investment markets

Increasing life expectancy presents challenges to defined benefit pension schemes due to the need to pay benefits for longer, which can be exacerbated by any inflation linkage. Many schemes now use hedging strategies such as longevity swaps or buy-ins and buy-outs to manage their risk exposure, as we discussed in a previous update. However, there may be wider economic and investment market impacts from demographic changes for institutional investors to consider.

Changing demographics

Medical advances over the last century have led to significant increases in life expectancy in both developed and developing countries. Coupled with declining birth rates, this has led to an ageing population in every country across the globe, apart from 18 countries designated as 'demographic outliers' by the UN[1]. This ageing alters the balance between different cohorts of the population, in particular between those of working age and retired dependants (see Box 1).

Most developed countries have already benefited from the 'demographic dividend' that arises from larger working age populations that arise before birth rates fall and whilst life expectancy increases (ie the 'baby boomers'). What is uncertain is what future impacts will materialise as this population bulge reaches retirement.

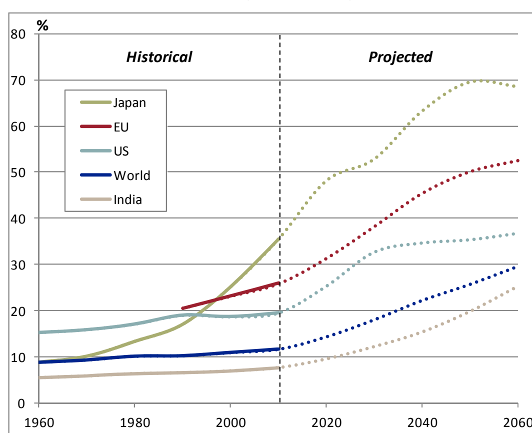
Economic impacts

The most publicised impact of an ageing population is the increase in age-related spending, such as state pensions, healthcare and long term care. The Japanese government estimates that ageing adds roughly 0.2% of GDP to its social security bill each year. It is argued that this trend increases the burden on the working population which may dampen future economic growth prospects and in turn reduces expected returns on assets that show strong correlation to GDP growth (for example equities). Indeed, studies[2] in the US have shown strong correlation between population dependency ratios and price/earnings ratios of the US stock market. However, ageing populations may have wider impacts.

For example, changing demographics can have an impact on government finances and the cost of raising that finance. Whilst few countries face imminent problems from ageing populations which lead directly to rating downgrades, shifting demographics have contributed to negative outlooks for sovereign debt ratings, especially in countries that have struggled to pass policy reforms. In addition, ageing populations can lead to changes in saving rates which can lead to doubts as to where funding for government debt will come from (since savings rates often decline in retirement).

The population bulge approaching retirement represents a cohort with significant wealth and whose investment and consumption decisions can have large knock on effects for the wider economy and investment markets. Indeed, as the baby boomers reach retirement, they may transition between assets that reflect their changing risk and liquidity preferences. For example, they may transition away from equities to bonds in their retirement funds and may look to release equity locked away in property. The extent and potential impact of these demographic changes is contested amongst commentators.

Box 1 - Old age dependency ratio



Source: Eurostat

The graph above shows the population aged 65 and over as a percentage of the population aged between 15 and 64. It highlights the ageing populations in developed countries that have begun to emerge over the last 50 years, and the extent to which this ageing is expected to accelerate over the coming 50 years.

Mitigations and government policies

Like most economic arguments and forecasts, it will be impossible to isolate and quantify the impact that demographic changes have on economic prospects and investment markets. It is possible that investors might change their behaviour should the issues and risks above materialise—for example bonds might lose their appeal to those approaching retirement if yields are suppressed by global ageing and economic stagnation. In addition, current and future national and international policies may yet play a key role in mitigating some of the risks and issues discussed above. For example, no one is sure of the full economic impacts of increasing retirement ages and increased labour market participation at older ages.

[1] UN Human Development Report 2005

[2] 'Boomer Retirement: Headwinds for US Equity Markets' , Zheng Liu and Mark M Spiegel

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