INVESTMENT NEWS

MONTHLY NEWS BULLETIN
FROM THE INVESTMENT AND RISK TEAM

GAD

3 June 2013

MONTHLY UPDATE

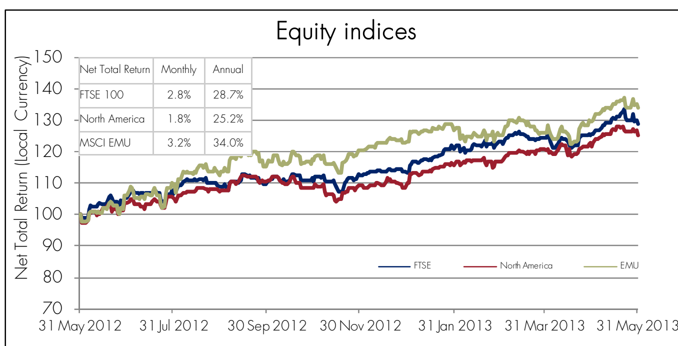
Overview

There were a number of positive economic indicators this month. The FTSE 100 grew strongly in the first half of the month hitting a 13 year high, closing just 130 points short of the all-time record set in 1999. Since the beginning of the year the index had risen by more than 15%. However, investor sentiment may have shifted somewhat as some of those gains have since been lost and the market remains volatile.

CPI inflation fell for the first time since September to 2.4%, driven mainly by cheaper fuel and transport costs. Presenting his final inflation report as governor of the Bank of England, Sir Mervyn King announced that a recovery for the UK economy is now “in sight”. He revised upwards his own growth forecast for the first time since the financial crisis five years ago, expecting growth of 1.2% over 2013. He now expects CPI inflation to drop to the 2% target within two years. The CBI also revealed encouraging figures, forecasting growth of 0.3% this quarter and 0.4% for the next two quarters.

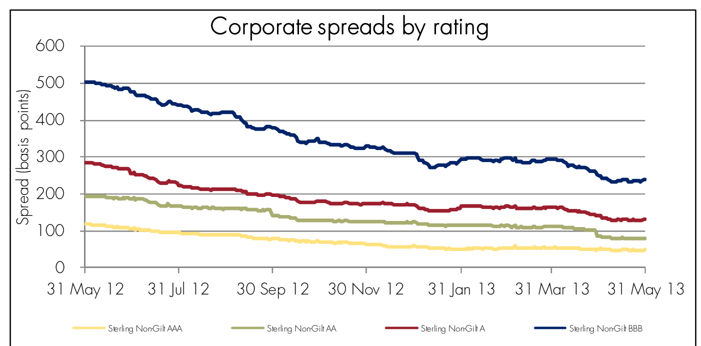
Meanwhile, the government continues with its deficit reduction programme. Ahead of the spending review next month, the chancellor George Osborne has announced agreements with seven government departments. The cuts total around 20% of the target of £11.5bn savings in 2015, and represent between 8% and 10% of the department budgets.

Equity markets grew over the month



Net Total Return	Monthly	Annual
FTSE 100	2.8%	28.7%
North America	1.8%	25.2%
MSCI EMU	3.2%	34.0%

Credit spreads narrowed slightly over the month

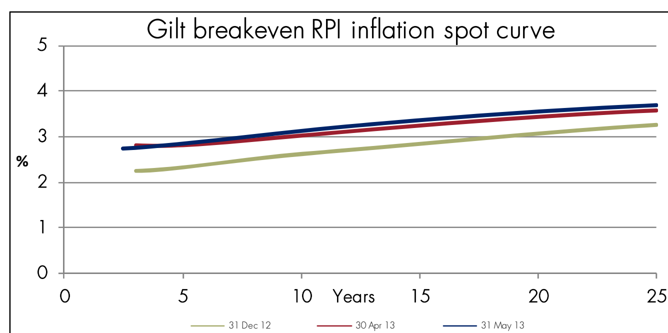


LATEST ECONOMIC NUMBERS

Current base rate	0.5%
Quantitative easing level	£375bn
CPI increase Apr (%y/y)	2.4%
Halifax house prices Apr (%m/m)	1.1%
IPD TR property index Apr (%m/m)	0.5%
PPF 7800 funding ratio	81.5%
VIX (volatility) index	16.3
$/£ exchange rate	1.56

Numbers as at the end of month unless stated

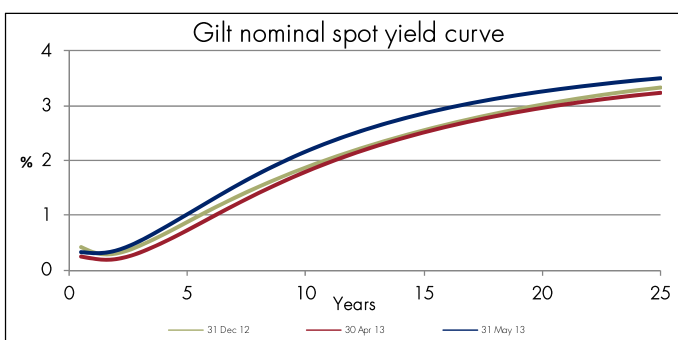
Breakeven inflation increased this month



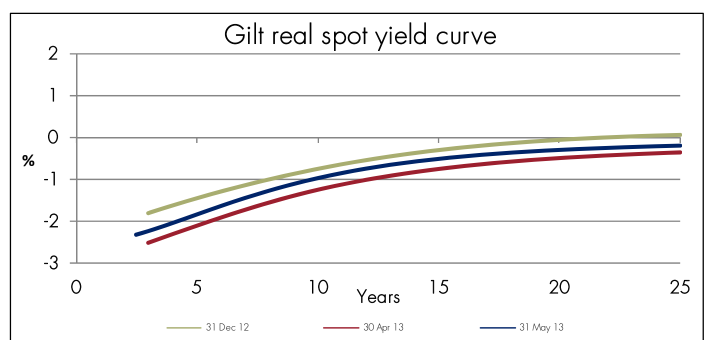
CALENDAR OF EVENTS AND DATA RELEASES

MPC interest rate announcement	6th June
UK Trade	7th June
Producer Price Index	18th June
RPI / CPI	18th June
Minutes of MPC meeting	19th June
UK GDP (Q1 final est.)	27th June

Nominal yields increased this month



Real yields rose slightly this month



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

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The Impact of Quantitative Easing

The gradual recovery since the financial crisis of 2007 has led to governments and central banks adopting unconventional policies. In the UK, the Bank of England has now kept the base interest rate at an all time low of 0.5%pa for over four years. The bank also injects money directly into the economy through its programme of quantitative easing (QE), which now stands at a value of £375bn. This month we consider different views on what impact the QE programme has had so far.

What is Quantitative Easing?

In a response to a fall in demand from businesses and consumers, the QE programme was designed to inject money into the economy and stimulate spending in order to help avoid inflation falling significantly below target. When undertaking QE a central bank makes a large purchase of assets from investors, usually government bonds. The money used to purchase these assets is created electronically by the central bank.

The Bank of England's Monetary Policy Committee voted to start the process in 2009 by authorising £200bn worth of asset purchases, mostly medium and long dated gilts. That represented nearly 30% of outstanding gilts held by the private sector and around 14% of annual nominal GDP[1]. This was later followed by further purchases of £75bn in 2011 and £100bn in 2012.

The impact on financial markets

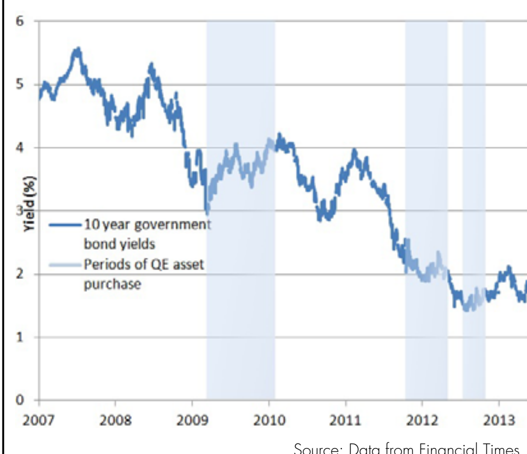
Since the majority of the Bank's asset purchases were conventional gilts, the effects should impact on the gilt market; Box 1 shows how 10 year gilt yields have fallen since the start of the QE programme. However, the impact of QE cannot be measured directly, and so estimates of the effects are necessarily uncertain. JP Morgan have recently published a paper[2] which suggests that during phases of asset purchase 10 year gilt yields were around 150 basis points lower than their 'natural' levels, although reverted back once the asset purchases were complete. Further, that paper suggests the impact on index-linked gilt yields may have been similar.

Direct changes in the level of investor confidence are even more difficult to isolate. Nevertheless, an article by the Bank of England reviewing the impact of QE policy[1] found circumstantial evidence to suggest that confidence did increase during the time that asset purchases were taking place, from both survey-based measures and market implied 12-month forward FTSE100 expectations.

To the extent that investors regard them as substitutes for conventional gilts, demand for alternative investments such as equities, corporate bonds and foreign assets, might be expected to increase. That may lead to inflated prices and a suppressed sterling exchange rate. Indeed, following QE announcements between 2009-10, sterling investment grade corporate bond yields fell by a total of 75 basis points, broadly preserving spreads over gilts[1].

Inflation expectations might also be expected to rise. Gilt breakeven inflation fell in late 2008 before subsequently rising following the onset of QE[1]. However, any direct impact would be compounded with changes in inflation risk premia and general market functioning.

Box 1 - UK Gilt Yields and QE



Source: Data from Financial Times

The graph above shows how gilt yields changed during the periods that QE was taking place. In fact, the gilt market might be expected to react when relevant asset purchases are announced rather than implemented. Indeed, the Bank of England have found that yields, fell by 75 basis points in March 2009, when the programme was first announced1.

The impact on pension schemes

The discount rate used by defined benefit pension schemes is often linked to gilt yields, so QE may directly impact their reported funding positions. Conversely, the value of scheme assets may have been boosted by the asset purchases. Nevertheless, JP Morgan estimated that during the first round of QE scheme funding levels fell by as much as 16 percentage points[2], corresponding to an increase in the aggregate deficit of UK pension schemes of £150bn. Further, the extent of any impact may not have been constant through time—schemes conducting their valuations around September 2009 may have seen the biggest reduction in their funding level. However, if the analysis is correct, the impact of the second round of QE purchases may have been more subdued. Members of defined contribution schemes looking to purchase an annuity would also be affected by falling yields through less favourable annuity rates. The long term impact as QE is unwound remains to be seen.

[1] "The United Kingdom's quantitative easing policy: design, operation and impact", Bank of England Quarterly Bulletin 2011Q3

[2] "Not drowning by waving? Quantitative easing and UK pension schemes", JP Morgan Asset Management.

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