Government Actuary's Department

Investment News

Monthly Bulletin from the Investment & Risk Team

February 2016

Last Month in Brief

January continued the trend of 2015 with countries struggling to kick start the global economy as UK GDP grew at its slowest rate since mid 2013. A similar trend was seen in the US economy with growth slowing sharply. This news, alongside downward pressure from commodities prices, principally oil, and uncertainty in China have led to significant falls in equity markets.

The Bank of Japan surprised investors by introducing a negative interest rate of -0.1% in a move designed to encourage commercial banks to use their reserves to lend to businesses in order to overcome the country's economic stagnation. Such a move has been previously taken by the European Central Bank to keep the EU economy afloat during the Eurozone economic crisis.

The exchange rate for the Pound against other international currencies continued to worsen during January. Sterling has been losing ground against the Euro since November and January saw its longest downward streak since the Euro was introduced in 1999. The fall has been particularly pronounced against the US Dollar, reaching the lowest rate since mid 2010. The US Federal Reserve's decision to raise interest rates in December and the Bank of England's decision not to follow suit has been a significant driver of this fall.

Chart 1: Equity Indices

Equity markets continued to fall in January

Chart 2: Sterling Credit Spreads

Credit spreads increased during the month

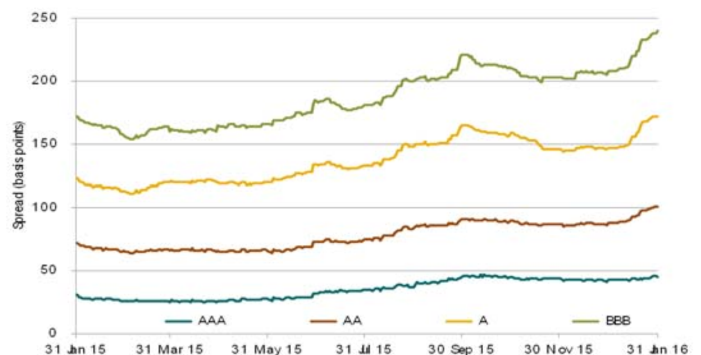


Chart 3: Gilt Yields

Gilt yields remained fell during the month

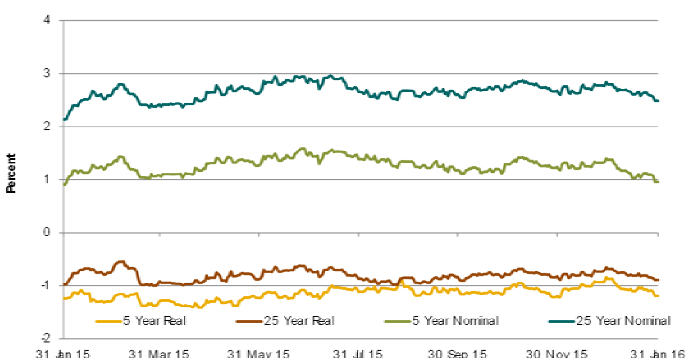
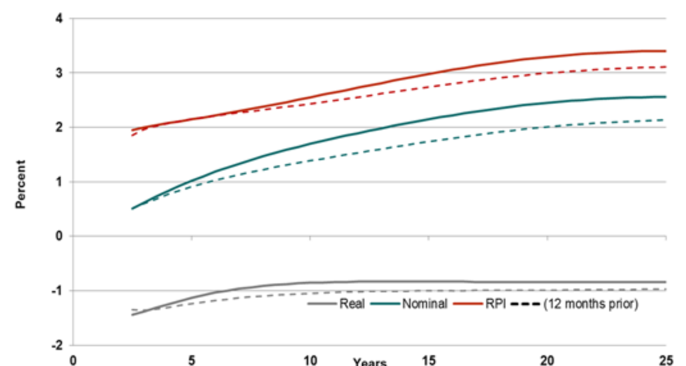


Chart 4: Gilt Spot Curves

Yield curves remain upward sloping



Source: Financial Times, MSCI, Merrill Lynch Bank of America, & Bank of England

	Latest	Previous		Latest	Previous
CPI increase (annual change)	0.2%	0.1%	**Base rate**	0.5%	0.5%
PPF 7800 funding ratio	84.9%	83.4%	**$/£ exchange rate**	1.42	1.48
Halifax house prices (monthly change)	1.7%	2.7%	**VIX (volatility) index**	20.2	18.21

For monthly published indices "Latest" and "Previous" refers to the two most recently published statistics, otherwise numbers are quoted as at the month end.

Stock Market Control Mechanisms

In January a form of stock market control known as a 'circuit-breaker' was brought under the spotlight after its high profile introduction to, and subsequent retraction from, the Chinese stock markets. The circuit-breaker mechanism introduced in China enforced a 15 minute break in trading following a 5% fall (or rise) in price. Upon a further 2% fall (or rise) (to a total 7% for the day) the markets would close for the rest of the trading day. The China Securities Regulatory Commission (CSRC) introduced the mechanism, based on the value of the CSI 300 index (which comprises 300 blue-chip stocks traded on the Shenzhen and Shanghai exchanges), on Monday 4th January. The halt to trading was triggered on the Monday, and again on the Thursday, after which the CSRC suspended the controls.

Why use controls?

For many investors, regulators and governments, stock market volatility and uncertainty are undesirable. Although market controls typically apply to both market increases as well as market falls, it is large falls in value that are of most concern and more commonly considered.

The introduction of circuit-breakers theoretically allows the market a cooling off period during periods of severe investor uncertainty and loss of confidence. During this break—it is hoped—investors have time to consider their positions and hence limit panic selling leading to irrational stock valuations. If the market continues to fall then trading is ceased for the day to prevent losses leading to potentially damaging market crashes. The Chinese government is particularly worried about volatility in its stock prices and currency value and has shown a willingness to intervene in the financial markets (for example, artificially weakening the Renminbi to keep its exports competitive).

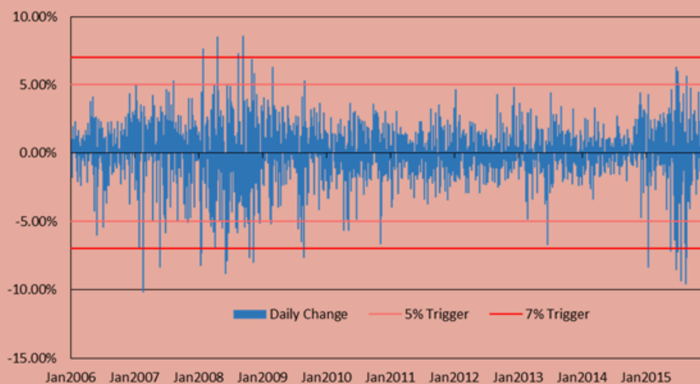
Potential problems

The Chinese markets are very volatile in comparison to London and New York, with the CSI 300 having around 3 times the volatility of the S&P500. Unlike European and North American markets, where a large proportion of the stock market is owned by well informed, institutional investors, the investors in China whose trading activity influences market prices are individual investors who often have little training or access to information. Some argue, this adds to volatility and increases the likelihood of market hysteria and panic selling.

The cost controls on the Chinese exchanges, therefore, could be seen as too narrow. For instance, a 5% swing of the value of the CSI 300 can happen fairly frequently (see box 1) where as such changes rarely occur on the main UK and US markets.

Many analysts and observers of the events on the 4th and 7th of January suggest that the market enacted a phenomenon known as the 'magnet effect'. The magnet effect describes the tendency of market participants to begin to panic as the index level reaches the break threshold and sell quickly in a rush to offload their stock before the rest of the market. This leads to the price accelerating towards the limit, which has the opposite impact to what was desired. This is commonly used as an argument against circuit-breakers by opponents of the controls.

Box 1: Chinese Stock Market Volatility



The chart shows the daily change in the CSI 300 last 10 years. The CSI 300 would have triggered the break at least 62 times in the last 10 years and would have closed the market at least 21 times.

Box 2: Uses of circuit breakers outside China

China is not the only country to use circuit breakers in their stock markets. Notable others are Japan, Korea and the USA have all adopted controls in the past:

> The New York Stock Exchange (NYSE) introduced circuit breakers in 1988, following Black Monday where the Dow Jones Industrial Average (followed by many other major markets) fell by over 22% in one day. The breaks and closures were triggered by an absolute fall greater than a pre-specified number of points on the index.

> In 1997 NYSE replaced these with an updated percentage based trigger as the market had grown to a level where market breaks were increasingly frequent. The settings for the current system trigger a break at 7% and then again at 13%, a 20% fall is required for a full closure. Under this system, the circuit breaker has never come in to play.

> In the USA and Canada (as well as China) individual-stock circuit breakers are widely used. For example, in China, a single stock can only move by 10% from day to day.

Other Controls

There are alternative methods that governments can use to manage price fluctuations. The Chinese government have used a number of methods to control markets, for example a 6-month ban on share sales from large shareholders (those with a 5%-or-larger holding in a company).

The Chinese are not unique in their market intervention. For example, some European countries banned short selling during the 2012 debt crisis to prevent prices from being forced down. In 1992, in a similar manner to a recent move by the Chinese government, Japan tried to prevent a market slide by buying stocks with public funds.

Meanwhile, proponents of free financial markets argue against any intervention from government, instead advocating that prices should be allowed to fluctuate unrestrained to reach their true, fair level.

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