Investment News

Monthly Bulletin from the Investment & Risk Team

February 2015

Last Month in Brief

The BoE ended the split vote on whether to raise interest rates, voting unanimously to keep rates at 0.5% in light of low inflation and weak global economic growth. The ECB announced a much anticipated program of 'full' QE with inflation remaining negative and very low growth across all Euro member states, the Euro since fell by about 10% against the dollar. Meanwhile Mark Carney, governor of the BoE, spoke of the difficulties of monetary union without fiscal union, saying that the Eurozone need to 'share risks'.

UK growth for the final quarter of 2014 was lower than the three previous quarters leaving economist at odds over whether the 'slowdown' will be temporary or more prolonged. However, growth for the year remained the fastest since 2007 at 2.4% with IMF forecasting 2.7% for 2015. US growth continued to lead western economies despite being down from 5% p.a. to 2.6% p.a. between the third and fourth quarters of 2014. The US dollar continues to strengthen against other major currencies as investors expect strong economic performance to lead to a Federal Reserve decision to raise interest rates.

The results of the recent Greek general election have put the far-left party Syriza as the dominant power in a coalition government in the country. The party have pledged to renegotiate conditions on their bailout from the IMF, ECB and European Commission. It is unclear what the results from such discussions will be, leading to market uncertainty and a volatile spike in Greek sovereign debt yields.

Chart 1: Equity Indices

European and UK equities experienced gains during January

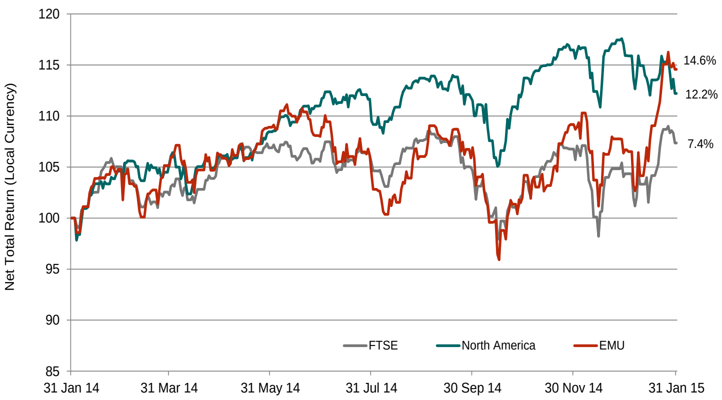


Chart 2: Sterling Credit Spreads

Credit spreads narrowed during January

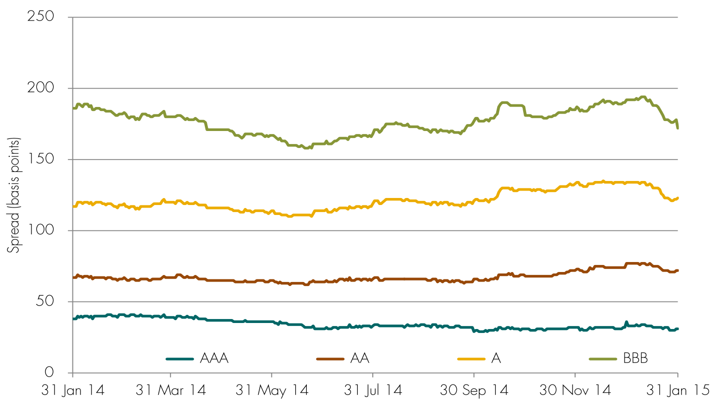


Chart 3: Gilt Yields

Gilt yields fell further

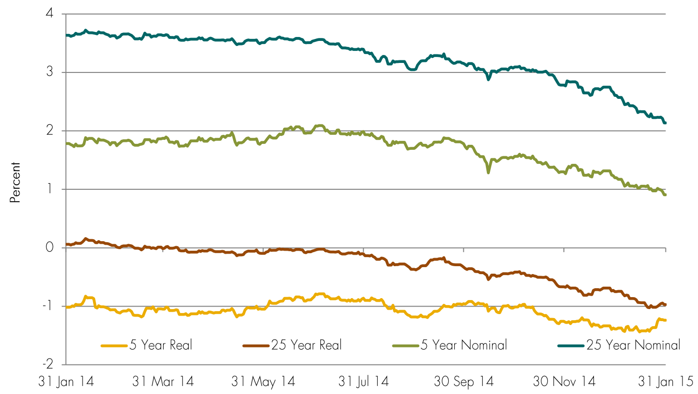
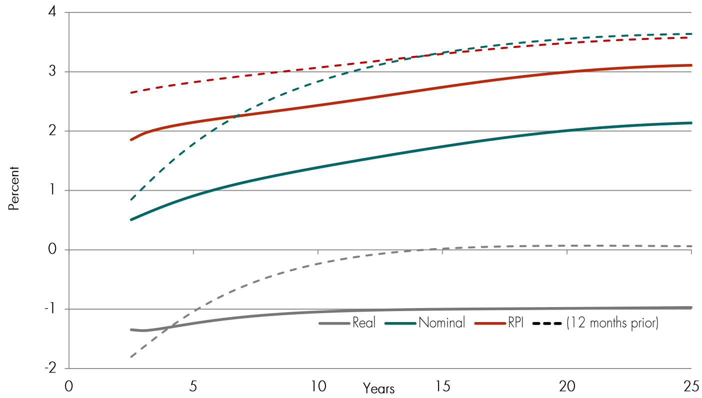


Chart 4: Gilt Spot Curves

The nominal yield curve flattened but remains upward sloping



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

	Latest	Previous		Latest	Previous
CPI increase (annual change)	0.5%	1.0%	**Base rate**	0.5%	0.5%
PPF 7800 funding ratio	82.3%	84.8%	**QE Level**	£375bn	£375bn
Halifax house prices (monthly change)	0.9%	0.4%	**VIX (volatility) index**	20.97	19.20
IPD TR property index (monthly change)	1.6%	1.3%	**$/£ exchange rate**	1.50	1.56

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

Government Actuary's Department, Finlaison House, 15-17 Furnival Street, London, EC4A 1AB Telephone +44 (0)20 7211 2601

ECB, QE and Deflation

January saw two key news stories on inflation. Firstly a review of inflation measures used in the UK was published (see Box 1) and secondly the European Central Bank (ECB) announced an extension to its existing asset purchase programme to try to boost inflation.

The ECB announcement involves monthly asset purchases of €60bn and will continue until at least September 2016. This month we look at the background to this announcement and the possible impact on the UK.

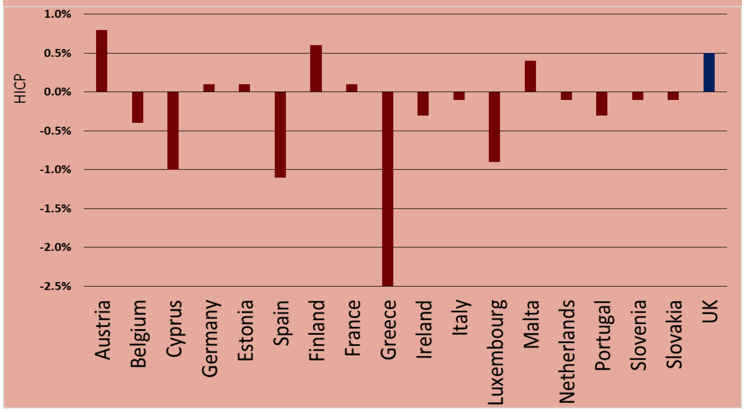
Background

The ECB has been under pressure to take more action to alleviate the sustained period of low economic growth experienced by the Eurozone since the 2007-08 global financial crisis.

Calls for action have intensified further as Euro area inflation turned negative in December for the first time since 2009. In part this has been caused by oil prices falling significantly over the last six months (see our November update) creating downward pressure on prices but it also reflects the continuing weak growth in the Eurozone.

Graph 1: Inflation in Eurozone countries

Percentage change over 12 months to January 2015



This reducing rate of inflation brings concerns about the potential damage that a period of deflation might cause. The ECB want to avoid deflation whereby spending is cut and growth stalls as consumers and businesses hold onto their cash with the expectation that prices will fall further.

Quantitative easing (QE) was adopted by a number of central banks in an attempt to address the issue of low inflation and low growth. The ECB resisted such intervention until September 2014 when an initial asset purchase programme was announced. This involved a limited range of assets leading to it being referred to as "QE-lite". The extension announced on the 22 January will purchase government bonds and is much larger than the previous programme.

Expected impact

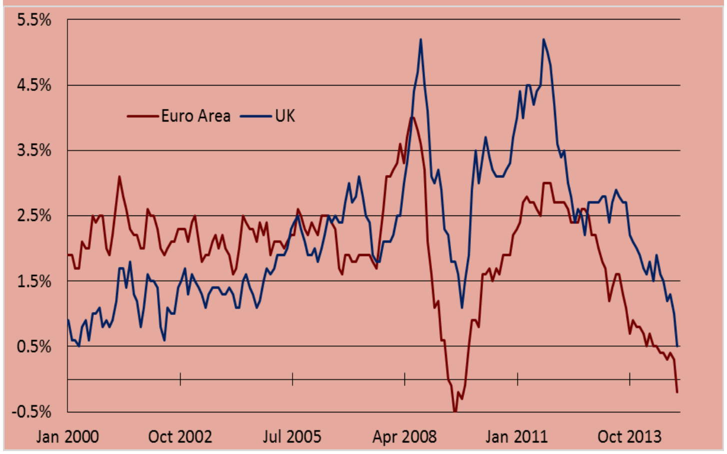
With this announcement the ECB hopes to increase inflation and boost the economy. In theory, this programme should increase the money supply which it is hoped will increase demand by encouraging spending. The ECB is hoping to raise inflation expectations and, by doing so, avoid a deflationary spiral by encouraging consumers to spend their cash rather than holding onto it.

The ECB announcement appeared to exceed many market participants' expectations. Following the announcement, the Euro fell to an 11 year low against the dollar and yields on Euro government bonds also fell.

UK position

Monetary policy in the Eurozone and announcements from the ECB can also impact on the position in the UK. As Britain's major export market, a slowdown in the Eurozone is a risk to the UK economy and its own recovery. It is therefore not just euro markets where the impact has been seen and UK gilt yields (as well as those of US bonds) also continue to decrease.

Graph 2: Euro area vs UK annual CPI inflation rate



Inflation in the UK has fallen to 0.5% with a risk of deflation if consumers begin to defer spending. Inflation has been gradually falling in recent years (see graph 2) and announcements by the ECB may place further downward pressure on prices.

Looser monetary policy in the Eurozone is likely to mean that the euro will become cheaper relative to the pound. This means that the imports from the Eurozone will become relatively cheaper placing downward pressure on the UK inflation rate.

Box 1: Measures of Inflation

In early January, a review by Paul Johnson into the use of consumer price statistics in the UK was published. This was commissioned by the UK Statistics Authority and concluded that there was "an unhelpful proliferation of price indices" and that CPIH (a CPI measure including housing) should be the primary focus. He therefore recommended scrapping RPIJ (a measure of RPI with an alternative method of construction) and a move away from RPI except where legal contracts demand it. Although the recommendations are not binding it increases the likelihood that in future CPIH instead of RPI will be used as a benchmark. This might include the issuance of CPI or CPIH linked gilts; however, first the Debt Management Office would need to be assured that there is sufficient demand for such instruments.

Contact Information

Colin Wilson
Technical Director
T: +44 (0)20 7211 2672
E: colin.wilson@gad.gov.uk

Matt Gurden
Investment & Risk Actuary
T: +44 (0)20 7211 3498
E: matt.gurden@gad.gov.uk

Andrew Jinks
Investment & Risk Actuary
T: +44 (0)20 7211 2655
E: andrew.jinks@gad.gov.uk

Chris Bull
Investment & Risk Actuary
T: +44 (0)20 7211 2739
E: christopher.bull@gad.gov.uk