

Investment News

Monthly Bulletin from the Insurance & Investment Team

September 2016

Last Month in Brief

Following the result of the referendum, the Bank of England's monetary policy committee voted to decrease the base rate to 0.25% on the 4th of August, the first change since 2009. This, along with an announcement of £60bn additional quantitative easing, led to a further weakening of the pound and a boost to equity markets, although much of the impact of the decision was already priced in. Low short-term interest rates, along with economic uncertainty have led to government bond yields falling across the board as prices are pushed up to record highs.

Across the Atlantic, Janet Yellen, chair of the Federal Reserve, said that the case for an increase in US short-term interest rates has strengthened, following stronger jobs growth and expectations of robust economic growth and a return to the 2% inflation target. Treasury bond yields rose as investors began to speculate a rate rise as soon as September.

The European Commission in Brussels made a potentially significant ruling to force Apple to pay €13bn in tax to Ireland as it judged that Apple had been granted preferential treatment by the Irish tax authorities. Although this is not the first such ruling by the Commission, it is the most high profile and may lead to a further period of uncertainty for business in Europe as the political and tax environment becomes less clear.

Chart 1: Equity Indices

Equity markets rose over the month

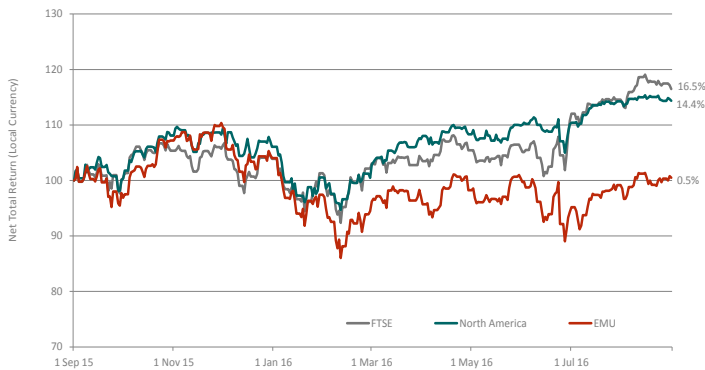


Chart 2: Sterling Credit Spreads

Credit spreads fell over the month

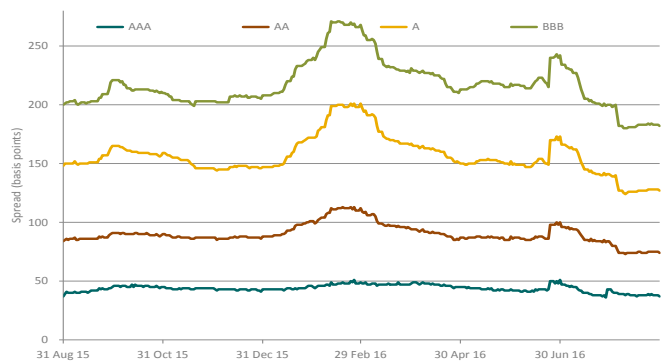


Chart 3: Gilt Yields

Gilt yields fell during the month

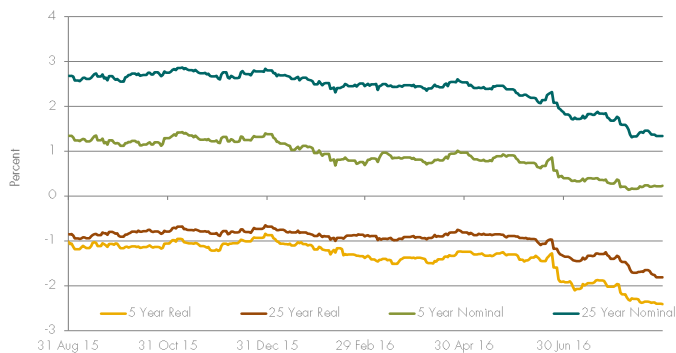
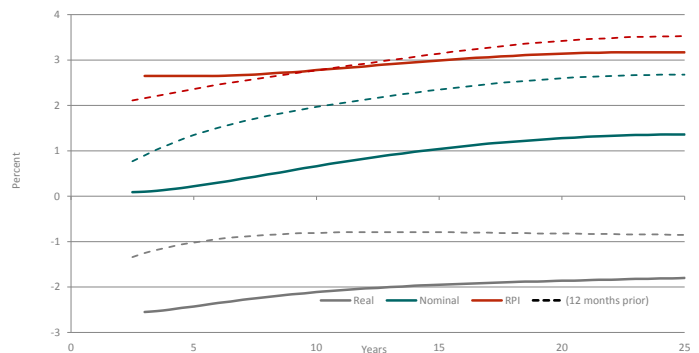


Chart 4: Gilt Spot Curves

Yield curves remained upward sloping



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

	Latest	Previous		Latest	Previous
CPI increase (annual change)	0.6%	0.5%	Base rate	0.25%	0.5%
PPF 7800 funding ratio	77.4%	78.0%	\$/£ exchange rate	1.31	1.33
Halifax house prices (monthly change)	-1.0%	1.3%	VIX (volatility) index	13.42	11.87

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

Emerging market debt

Following recent events, low interest rates have pushed investors into different asset classes in search of returns. One such asset class, which previously may have been considered to be too risky or too poorly understood for many, is emerging market debt.

Key Features

Emerging market debt ('EMD') is debt issued in less developed countries such as Brazil, India, Indonesia and Mexico. Whilst the term covers debt issued by corporates operating in these countries, it primarily covers debt issued by governments. EMD can be issued in 'hard currencies' (such as the US Dollar or Euro) or, alternatively, the local currency of the country issuing the debt.

Since EMD describes bonds and bond-like investments, it has many of the appealing properties of government and investment grade corporate bonds. In particular, the structured cashflows can be valuable to investors who have predictable costs, such as a pension fund paying pensions.

However, given that EMD is issued by less developed countries, investors should be aware of the increased exposure to economic and political risks. These countries typically have lower levels of GDP per capita and less sophisticated financial markets. This is, though, balanced against high (albeit volatile) growth; relatively high levels of investment in business and infrastructure; and accommodative regulation and government policy. As a result of these risks, emerging market debt is generally viewed to be high risk, with a diverse range of potential credit quality.

Investors can access such debt through managed funds, where investment managers use their expertise and research to find bonds offering good value. Alternatively, large organisations may be able to invest directly.

Risk and return considerations

As compensation for the additional risk, yields on EMD are typically much higher than yields on government bonds issued by more developed countries (see box).

Whilst yields are higher, investors should be aware of the risks—in particular the higher risk of the issuer defaulting on repayments. Higher additional yields available on EMD are offset by the potential impact of defaults, for example the Argentinian government defaulted on their debt in 2001, resulting in large capital losses to investors.

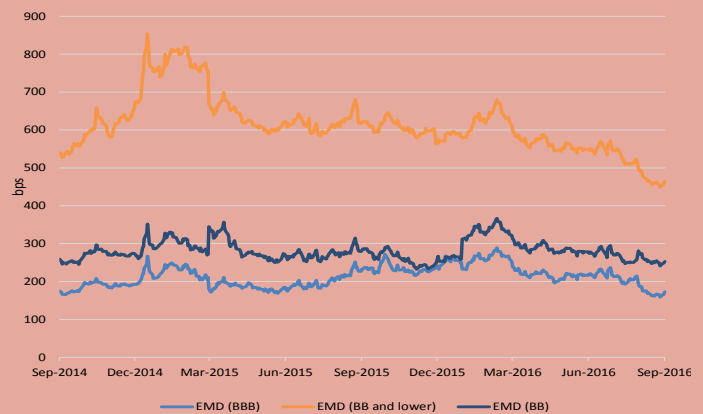
In addition, a key advantage of emerging market bonds is that they offer some diversification from typical asset classes (often economic factors which cause UK based securities to fall in value are different to those which cause fluctuations in EMD). This can be attractive to investors as it leads to less volatile overall investment portfolios.

Another potential consideration for investors is liquidity. Whilst EMD is generally regarded as much less liquid than gilts or investment grade corporate debt, there are signs that liquidity is improving (EMD liquidity conditions in July were the strongest in five years according to CrossBorder Capital). In addition, whilst this risk deters some investors from investing in these bonds (which forces prices down),

Any material or information in this document is based on sources believed to be reliable; however, we can not warrant accuracy, completeness or otherwise, or accept responsibility for any error, omission or other inaccuracy, or for any consequences arising from any reliance upon such information. The facts and data contained are not intended to be a substitute for commercial judgement or professional or legal advice, and you should not act in reliance upon any of the facts and data contained, without first obtaining professional advice relevant to your circumstances. Expressions of opinion may be subject to change without notice.

Emerging Market Debt Spreads

The chart below shows the spreads (the difference between the yield on Emerging Market Debt and the yield on US Treasuries) for Emerging Market Debt with different credit ratings.



Source: BofA Merrill Lynch

Yields on lower credit ratings are higher but are likely to be offset by higher expected losses from default.

long-term buy-and-hold investors, who do not require high levels of liquidity, can benefit from this in terms of higher yields.

There are a host of other risks and constraints which investors need to consider before investing in EMD. For example: the foreign exchange risk, especially where bonds are not issued in dollars; or the extent to which solvency capital requirements may limit an investors ability to invest in EMD.

Outlook

Investors should be mindful that EMD covers a broad range of debt and that return prospects can vary significantly, and change quickly, depending on the issues and risks prevalent in the issuing country or corporation.

For example, falling oil prices have recently put pressure on Venezuela's ability to meet obligations on its sovereign debt. However, the IMF has revised upwards their overall growth forecasts for the emerging markets which mean that some investors are more optimistic about EMD prospects more generally.

This economic growth not only increases the attractiveness of EMD (as lenders are more likely to meet repayments), it also increases the potential size of the market and the opportunities available to investors (as countries have more capacity to issue more debt). This is perhaps best shown in the huge growth in the size of the market—which has increased from \$2.4trn in 2000 to \$14.8trn in 2014 (Ashmore, 2015).

In summary, emerging market debt is a feasible alternative to traditional asset classes for many institutional and individual investors and the volume traded of such debt has increased as more emerging economies get access to the capital markets. However, with the higher expected returns offered by EMD, investors must understand and accept the additional risks incurred as part of their wider portfolio.

Contact Information

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

Aidan Smith
Chief Actuary
T: +44 (0)20 7211 2632
E: aidan.smith@gad.gov.uk

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

John Plevin
Investment & Risk Senior Trainee
T: +44 (0)20 7211 3422
E: john.plevin@gad.gov.uk