Investment News

Monthly Bulletin from the Investment & Risk Team

December 2015

Last Month in Brief

In November, the Chancellor of the Exchequer announced the results of the Government Spending Review in his Autumn Statement, which signals the direction of fiscal policy in the UK for the next five years. Among significant announcements was the scrapping of tax credit cuts, and the maintenance in real terms of the police budget. This extra spending is to be funded by the OBR's £27 billion positive revision of public finances over the next five years, due to higher expected tax revenues and lower debt interest payments.

The US and UK both saw significant announcements regarding the future direction of monetary policy. In the US, the minutes of the Federal Reserve's October meeting suggested that the condition for a rate rise are likely to be met by the time of their December meeting. In the UK however, the Bank of England's monetary policy committee kept rates at their historic low of 0.5% and said that interest rates are not likely to rise until the end of 2016.

Indicators of the UK's economic performance generally remained strong, as unemployment fell to 5.3% in October. The Purchasing Managers' Index (PMI) business survey also indicated that all sectors of the economy grew during the month of October.

Chart 1: Equity Indices

Equity markets ended the month higher

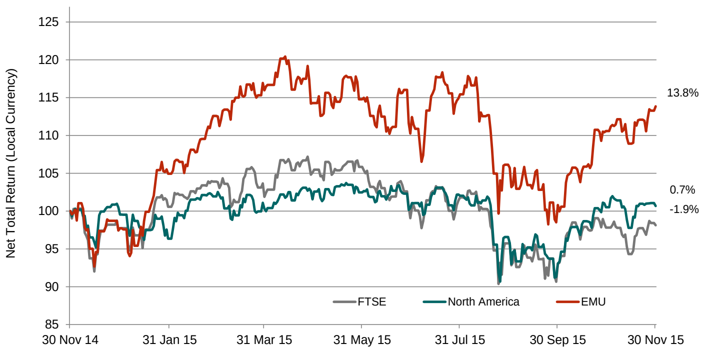


Chart 2: Sterling Credit Spreads

Credit spreads were flat during the month

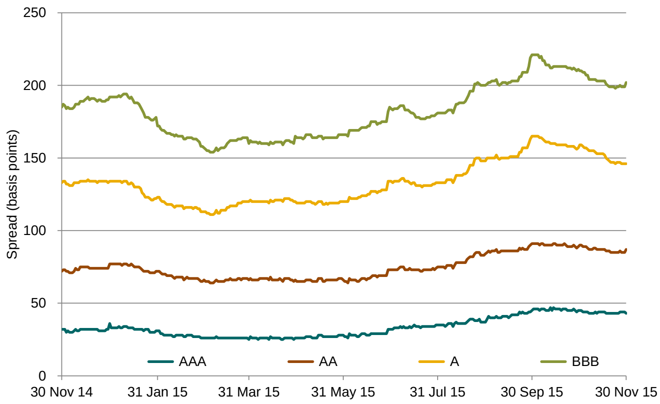


Chart 4: Gilt Spot Curves

Gilt yields fell during the month

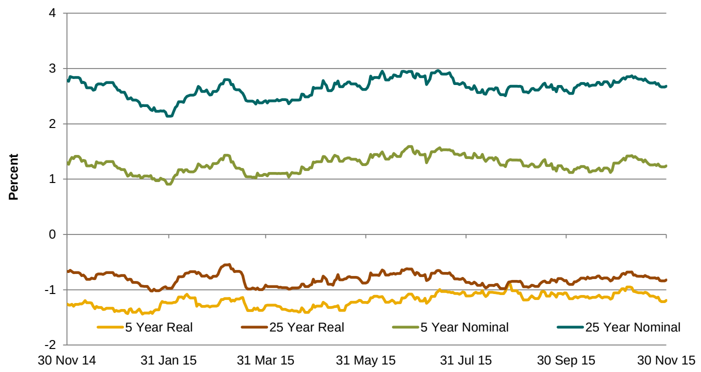
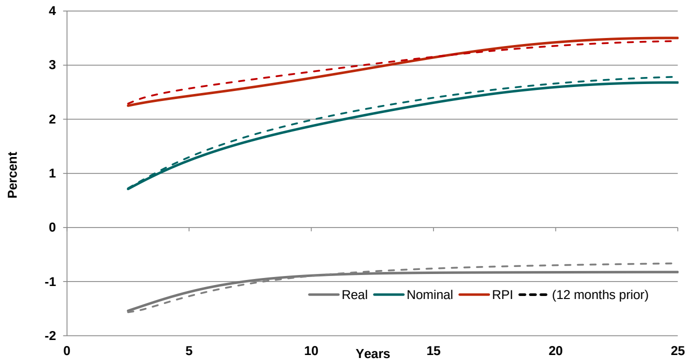


Chart 4: Gilt Spot Curves

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)	-0.1%	-0.1%	**Base rate**	0.5%	0.5%
PPF 7800 funding ratio	82.7%	79.9%	**$/£ exchange rate**	1.51	1.54
Halifax house prices (monthly change)	1.1%	-0.9%	**VIX (volatility) index**	16.13	15.07

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

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Climate change and long-term investing

The 2015 United Nations Climate Change Conference is taking place in Paris from 30 November to 11 December. The objective of the conference is to achieve, for the first time in over 20 years of UN negotiations, a binding and universal agreement to tackle climate change. The overarching goal is to reduce greenhouse gas emissions to limit the global temperature increase to 2°C above pre-industrial levels (see Box 1).

Consequences of the conference

The Paris conference could have significant implications for future government policy around the world, in particular policy related to energy generation and usage. Investors are increasingly being warned about the risks to future returns posed by climate change. These risks arise not only in the energy sector, where coal, oil and gas producers might be expected to come under increasing pressure from alternative energy sources, but also in wider areas such as the property and insurance sectors where more extreme weather events could have material implications for returns.

Climate change is however a long term issue, with changes in the climate occurring over decades and the impact of any agreements, such as that being sought in the Paris conference, unlikely to be seen for many years. Long term investors, such as pension funds, should be considering how, and the extent to which, climate change factors should be allowed for within their investment process.

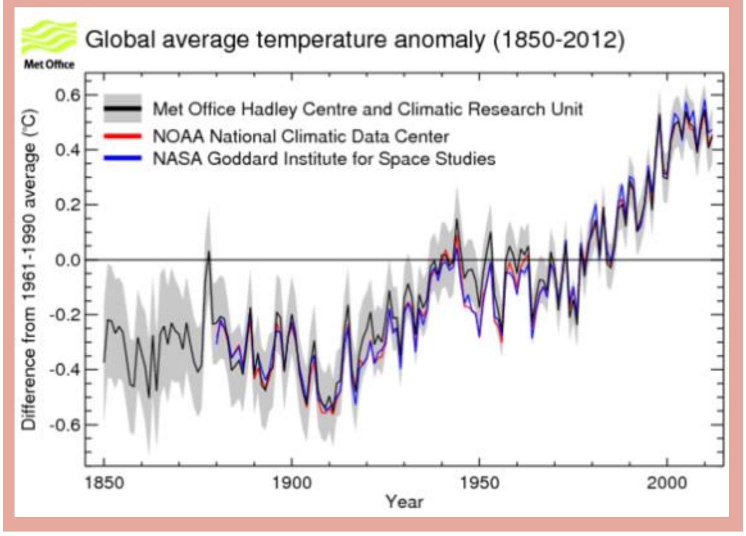
Investment considerations

Whilst climate change is widely considered a serious problem for the world to address and it is easy to focus on the downside implications for investment, it is likely that there will also be opportunities arising from climate change initiatives. Increasing interest in renewable energy sources, new technologies and alternative construction methods could all provide potential to generate strong returns for investors but come with the risk that other options will surpass them.

Consideration of the impact of climate change needs to go beyond just thinking about the implications for different market sectors. The outlook for global GDP growth, and hence the returns that are likely to be available from different investment markets, are unlikely to be insulated from the impact of climate change and the policies adopted to manage it. Many different views have been expressed regarding the potential impact on global GDP growth; however there is general consensus that the impact will be negative. The 2006 Stern Review, prepared by economist Nicholas Stern for the UK government, proposed the cost of acting to reduce global emissions to be 1-2% of GDP compared to damage costs of 5-20% of GDP if the problem is ignored. Due to climate change occurring faster than predicted, in 2008 Stern said the cost was likely to be higher.

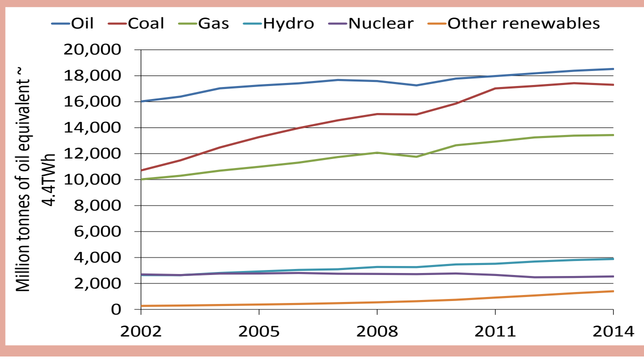
Box 1: Global temperatures

This chart from the Met Office highlights the fairly rapid increase in global average temperature since the end of the 1970s. Since then temperatures have risen by over 0.5°C, although they have been more stable over the last 7-8 years.



Box 2: Energy generation

Since the Kyoto Protocol came into force in 2005, with the objective to fight global warming by reducing greenhouse gas concentrations in the atmosphere to “a level that would prevent dangerous anthropogenic interference with the climate system”, global energy generation has changed with a noticeable increase in renewable generation.



Responsible investors

Climate change is an area in which investors should be seeking to actively engage with the companies they invest in, to ensure climate issues are not ignored. The 2012 Kay Review of UK equity markets and long-term decision making, highlighted the predominance of a short-term perspective in the management of public companies and the misalignment of incentives in the equity investment chain, the latter issue encouraging shareholders to sell their holdings rather than engaging with the company.

By increasing focus on long-term value creation, rather than short-term price gains, companies are more likely to address serious long-term issues such as climate change. The current focus on quarterly reporting and short-term performance creates significant challenges for companies trying to invest in a strategy that will protect or enhance their business in the changing world in which we live. Investors can only hope to encourage companies to change their approach if they are willing to invest for the long term and engage with the company at a strategic level.

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