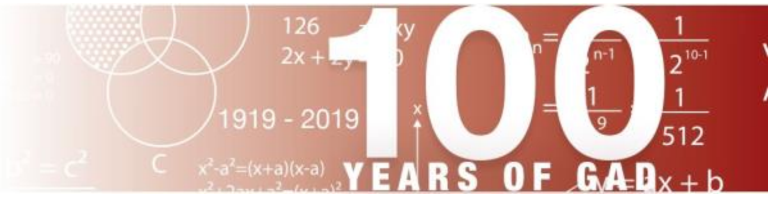
Government Actuary's Department

Investment News



Monthly Bulletin from the Insurance & Investment Team

February 2019

Last Month in Brief

US equities gained ground in January to recover a substantial part of the sharp falls seen in December. The US federal government was shut down on December 22, 2018 until January 25, 2019 (35 days), which was the longest U.S. government shutdown in history. The Federal Reserve left its headline rate unchanged, though highlighted a greater degree of flexibility in future rate decisions. Work is in progress towards a resolution to trade disputes with China which buoyed risk assets around the world.

UK equities performed well over the month, rising 4.2% (FTSE All-Share), although lagged global equities. Sterling strength was another headwind which held back the more internationally focused FTSE 100, which rose by 3.6%. The weaker performance compared to global equities was partly a function of the UK large caps having outperformed at the end of 2018. Sterling bounced back in January as hope built that the UK would avoid a "no-deal" Brexit.

UK inflation fell—driven mainly by falling petrol prices that reflect tumbling oil prices in recent months.

Chart 1: Equity Indices

All markets rose over the month, showing recovery from a significant downturn in the previous month.

Chart 2: Sterling Credit Spreads

Spreads steadily fell over the month.

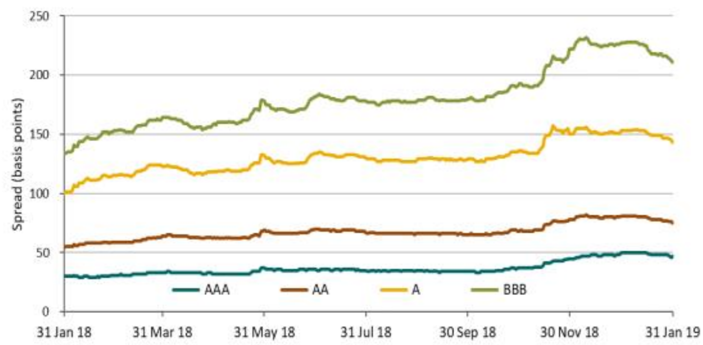


Chart 3: Gilt Yields

Real and nominal gilt yields for 5-year and 25-year bonds were mostly stable over the month before finishing slightly below start of month levels.

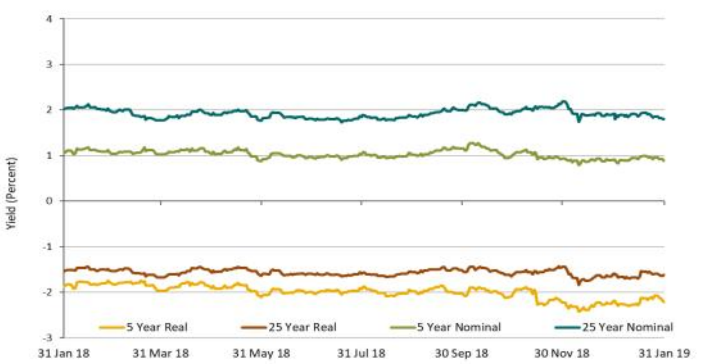
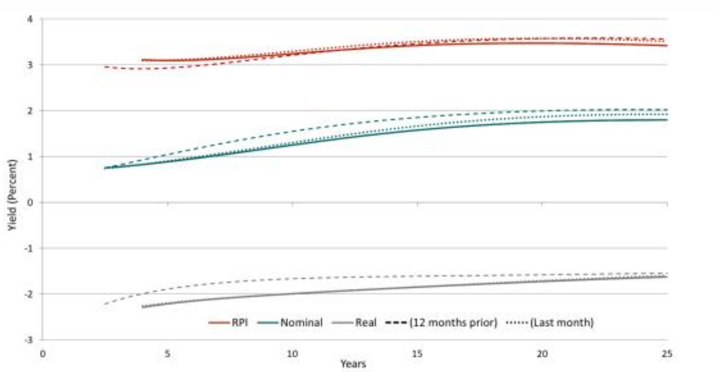


Chart 4: Gilt Spot Curves

The nominal and real gilt yields reduced over all durations this month.



Source: Bloomberg, Business Insider, MSCI, Merrill Lynch Bank of America and Bank of England.

	Latest	Previous		Latest	Previous
CPI (annual change)	2.0%	+2.2%	**Base rate**	0.75%	0.75%
PPF 7800 funding ratio	98%	100.9%	**$/£ exchange rate**	1.31	1.28
Halifax house prices (monthly change)*	-2.9%	+2.5%	**VIX (volatility) index**	16.57	25.42

** Halifax have recently changed their methodology for calculating the above figures so the figures may not be consistent with previous updates*

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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GDP and Investment Decisions

What is GDP, and what factors affect its growth?

Gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

GDP is comprised of the following components shown on the right side of the equation below:

$$GDP = C + G + I + (X\text{-}M)$$

Here, C represents aggregate consumer spending in the economy, G represents government expenditure, I represents aggregate investment level in the economy and (X-M) represents net exports, which are the exports less imports to foreign countries (this includes goods and services). An increase in any element on the right hand side of the equation will increase the GDP.

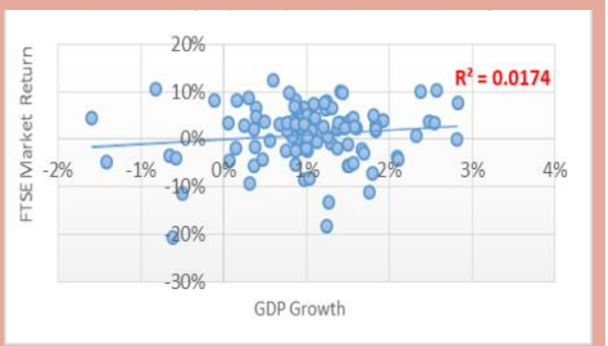
The main forces driving economic growth include the quantity and quality of labour and the supply of capital and raw material, as well as the level of productivity. Forecasts created by the Office for Budget Responsibility (OBR) show that the majority of future potential GDP growth will be brought about by productivity growth – which reflects higher output per unit of labour or capital than in the past. Technological innovation is the main factor that determines the productivity growth in an economy.

GDP as a driver of stock market investment decisions?

Investors are likely to be interested in the growth rate of GDP as it provides an overall indication of the relative performance of the economy – both in terms of historical performance and expectations for the future. Whilst both stock market returns and GDP growth are likely to depend on general levels of economic activity, the link between GDP and the stock market is less clear. The stock market broadly reflects the level of confidence in the performance of companies in the index and investors' views on prospects for certain sectors or the overall economy, whereas GDP will be driven by the subsequent impact on consumer and investment spending .

Therefore, the growth rate of GDP gives an indication of the relative performance of the economy over time, but in the short run, there is no definitive evidence that GDP growth affects stock market returns. Often, a certain level of GDP growth will be built into the prices in the stock market. If GDP growth progresses as expected, this will have little impact on the returns. However, it is where there are shocks to the economy and GDP under (or over) performs that there may be a more dramatic impact on short-term stock market returns.

Figure 1: Correlation between FTSE market return and GDP growth (1994–2018)



Source: Office of National Statistics

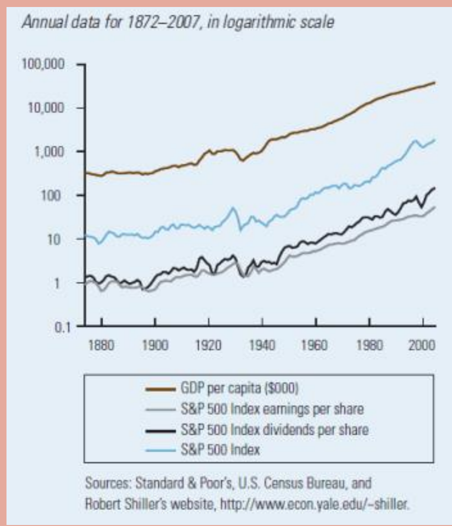
Figure 1 shows the quarterly historical FTSE market return and UK GDP growth which demonstrates very weak correlation between the two indices.

However, for long-term investors, the expectation of future GDP growth can play an important role in formulating investment strategies. Long-term stock market investors focus more on the growth in the fundamental components (fundamentals) of shares – such as corporate earnings per share and dividends per share, as well as changes in market valuations, such as the price/earnings (P/E) ratio.

There is evidence that stronger relationships exist between trends in these fundamentals and GDP growth.

Figure 2 shows how GDP per capita varies over the 120 years between 1880 and 2000 and how this compares to stock fundamentals and there is a common trend between these. Further, there is evidence that these fundamentals are also correlated with trends in inflation and productivity, both key underlying drivers of GDP. Hence it is likely that long-term GDP expectations will shape expected stock market returns and long-term strategies.

Figure 2: The US stock market, its fundamental components and the US economy over the long run.



Source: Vanguard

The effect of globalisation means that investment returns are no longer just dependent on the local economy but also on the global economy. Whilst this is likely to complicate the effect that GDP has on stock returns, increased globalisation also makes it more likely that economic prospects will be aligned.

Conclusion

Therefore, although GDP growth itself does not influence investors' decision making in the short-term, it gives a good indication how the economy is performing. Long-term investors should be aware of what is happening in the economy in terms of policies, technological innovation and, the level of potential GDP growth. Strong growth in GDP may lead to long term growth in the upwards trends fundamentals of stock returns.

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