Government Actuary's Department

Issue 6 - June 2019

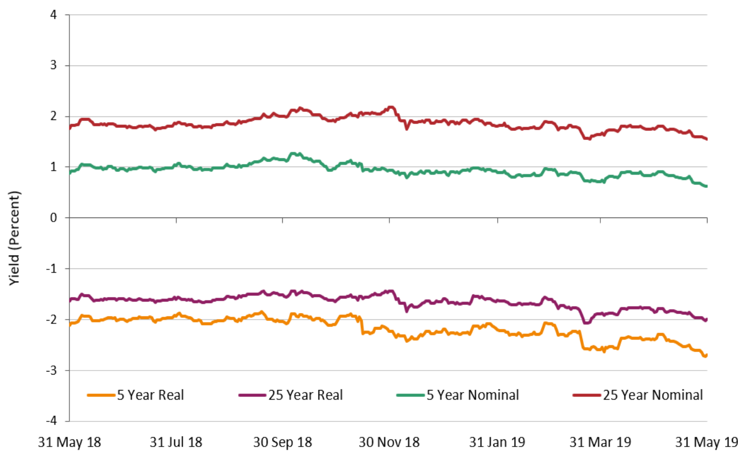
Investment Bulletin

This month in brief

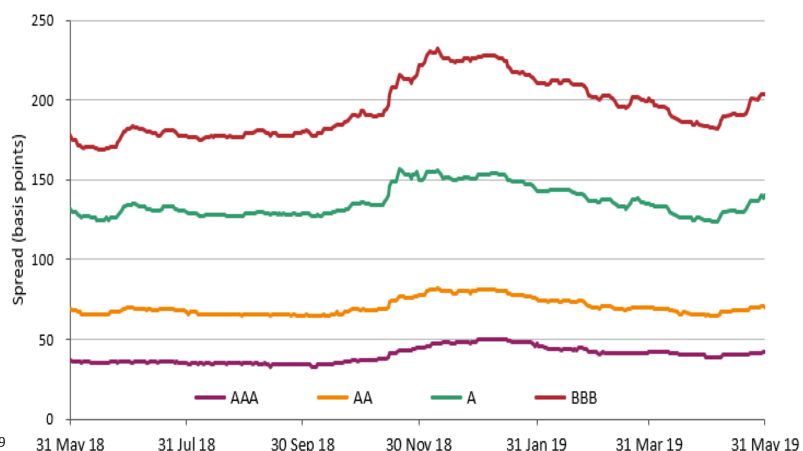
This month the National Audit Office published the Whole of Government Accounts for 2017/18. The report highlights an increase in government income of £40 billion with total government income for 2017/18 up at £761 billion from £721 billion in the previous year. This brings total government income up to 35% of GDP. The expenditure on public services increased by £54 billion with a total expenditure of £815 billion. This is largely due to an increase in staff costs and government purchases, alongside a less significant increase in debt interest.

Following in the steps of several FTSE 100 companies, Vodafone cut its dividend by 40% this month. The cut will likely drop it from the top 10 dividend paying companies in the FTSE 100, from a position of 5th to a predicted 11th. These recent dividend cuts of high profile companies may cause investors to question if other companies will follow suit as profits continue to stagnate. Despite these cuts, on aggregate, FTSE 100 dividend growth is forecast at 3% for the year. However, this 3% increase will be a substantial drop in comparison to 15% growth in 2018.

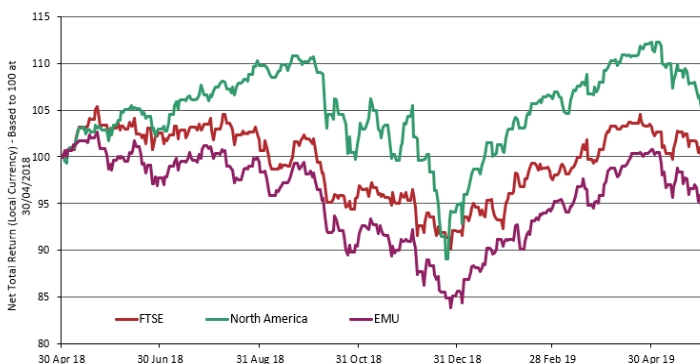
Real yields and nominal yields on short and long term bonds fell over the month.



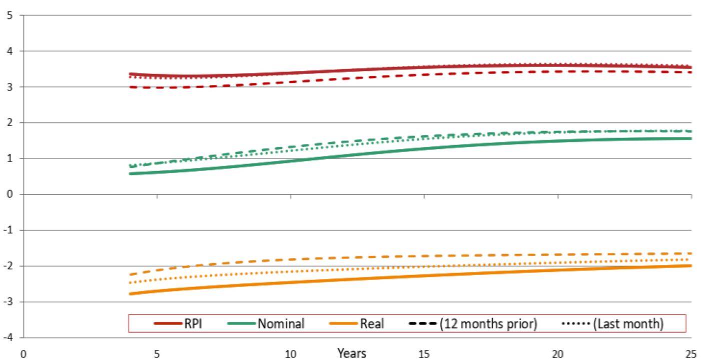
Credit spreads of higher rated bonds rose over the month following a 5-month period of falling.



All equity markets fell over the month.



Real and nominal yields are slightly lower than last month.



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May 2019

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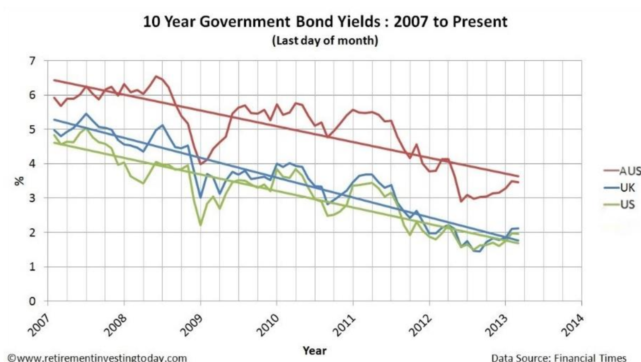
Following on from last month's article on low interest rates, and as part of a series of articles on the slowdown in global growth, this month we discuss quantitative easing.

What is quantitative easing?

Quantitative easing (QE) is one of the monetary policies that has been widely used to boost economies following the global slowdown. It involves the large-scale purchase of assets – usually government bonds – by a central bank, such as the Bank of England. QE is intended to stimulate economic growth by providing more liquidity in the banking sector which in turn allows them to provide easier and cheaper credit for companies and households. In addition, QE impacts on the relative pricing of gilts and the cost of a government's fiscal stimulus, which might have further impacts on economic growth.



This is because QE reduces the supply of government bonds, which raises their price, and decreases their yield. As such, one key indicator of the impact that a QE program has is the reduction in government bond yields, as shown in the graph. Since government bonds become less desirable at a lower yield, QE should have the effect of encouraging financial firms, such as insurance companies and pension firms, to invest spare funds in the economy. In effect firms are encouraged to invest in "higher risk" assets, such as co-corporate bonds, household loans and equities, to promote real growth in the economy.

Further, falling yields have the effect of lowering the cost of government borrowing, which may allow a government to provide further fiscal stimulus at a lower cost.

Where has quantitative easing been used, has it worked and what happens when it ends?

The Bank of Japan (BoJ) was the first to embark on a large-scale QE program in 2001 and following the global recession of 2007 the US, UK and Eurozone implemented similar policies. The current level of QE in the UK stands at £435 billion, up from £375 billion in June 2013 when we first discussed its specific impact on UK financial markets and pension schemes.

Whilst there is general consensus that the UK's QE program has contributed to a reduction in long term interest rates, opinions on whether it has boosted the economy are more divided. There are studies which find that insurers' and pension funds' holdings of co-corporate bonds have increased following QE purchases.

Quantitative easing was intended to be a temporary measure. When it ends, the central bank begins to sell back those bonds acquired during the period of quantitative easing, which causes yields on government and other bonds to rise. If the economy is sufficiently recovered, the impact of higher interest rates should only dampen growth. However, there are concerns that ending quantitative easing during a period of weak growth could risk the economy going back into recession. Further, raising interest rates on government bonds will make it more difficult for the government to service its debt if the economic recovery has not been sufficient to see a fall in general debt levels.

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