

Performance over the quarter (local currency)

Market/Index	Performance over the quarter
FTSE 100	-11.69%
S&P 500	-9.92%
MSCI World	-9.53%
Dow Jones Euro Stoxx 50	-17.54%
Nikkei Dow 225	-18.18%
MSCI Emerging Markets	-11.32%
UK ten-year gilt yield	-0.15% p.a.*

* Change in gross redemption yield, which is an annualised yield
Source: Thomson Financial

The gloomy tone of global equity markets over the last quarter of 2007 intensified over the first quarter of this year, as equities recorded their worst quarterly performance since the third quarter of 2002. The fears that investors had regarding the likelihood of a US recession that drove prices lower towards the end of last year were exacerbated by weak economic data and drastic Fed action which involved cutting their policy rate by 2%. And as if the increased likelihood of a US-led global recession during 2008 wasn't bad enough news for investors in risky asset classes, the credit crunch continued to bite with ever increasing ferocity. Whilst the main victim was the world's fifth largest investment bank, Bear Stearns, the credit crunch also enveloped the hedge fund industry, which recorded large losses as some hedge funds folded. Meanwhile there were also further signs that the credit crisis was beginning to affect the real economy, including debt-strapped consumers in the UK. The net effect of these financial developments over the quarter was probably negative for a typical UK pension fund, as we explain in the next section of this review.

The impact on a typical DB pension scheme

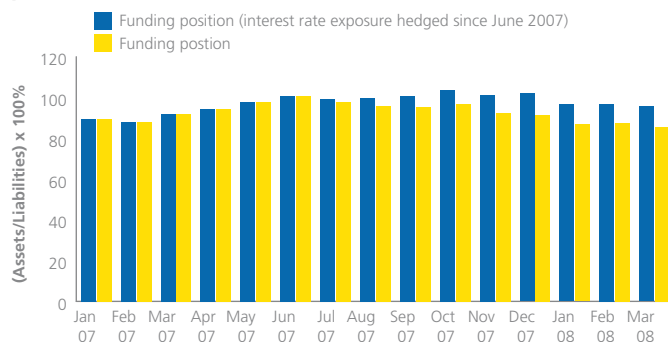
We have updated the fortunes of our representative Defined Benefit pension scheme. Just as a quick reminder of the scheme's financial situation: it started 2007 with a relatively conventional and conservative asset portfolio, comprising 60% UK equities, 20% gilts and 20% sterling corporate bonds, worth only 90% of the present value of its liabilities. We also assumed that the fund was cashflow neutral, in other words, pensions in payment minus current contributions were zero. The present values of future liabilities were discounted using the prevailing yield on AA-rated sterling corporate debt. So the valuation of this scheme's liabilities are comparable to the valuations that might be calculated using current accounting conventions for pension fund liabilities. The funding position shown in Chart 1 (represented by the light blue bars) evolves over time in line with relevant equity and bond market movements.

By the end of June 2007 the scheme had reached a funding level of just over 100%. There were two factors that played a part in this improvement in the scheme's finances. The first was the rise in the UK equity market's value. The second was the rise in the yield on AA corporate bond yields. The latter of these two factors actually had two partially offsetting effects. The rise in corporate bond yields over this period created capital losses on the notional corporate bond portfolio held by the scheme. But the more powerful impact was via the discounted value of scheme liabilities, which fell as bond yields rose.

However, as the light blue bars in Chart 1 show, the representative scheme's finances have deteriorated significantly since last June. The scheme's funding position has fallen to just over 85%, lower even than at its starting point in January 2007. This is because the benign financial market movements over the first half of 2007 have since gone into reverse. Equity markets have fallen, causing the scheme's asset portfolio to decline in value and the level of AA-rated bond yields have fallen too, causing the discounted value of the scheme's liabilities to rise. But which of these factors was the most powerful?

The dark blue bars in Chart 1 represent the results of a change in the scheme's risk management policy on its funding position since last summer. We suppose that the scheme is able to enter into an interest rate swap contract that effectively neutralises the risk posed to the value of the scheme's liabilities by changes in bond yields¹. The scheme therefore hedges this risk. Had the scheme opted for this strategy back in June, the funding position would still have deteriorated, but only to just over 95.5%. Therefore the performance of the asset portfolio would have only contributed to around a 5% decline in the funding ratio. This means that the falling bond yields were responsible for approximately 10% of the rest of the deterioration in the scheme's funding position over this period. And this also demonstrates the value of having a fairly well balanced asset portfolio.

Chart 1: Financial market impact on representative UK DB pension fund



Source: Fathom

¹ This is a simplification of such a strategy. We have not taken into account the cost of putting the swap into place, nor have we taken into account the impact on the asset portfolio of having to hold some of the scheme's assets as collateral against the swap positions. However, the basic impact would have been largely unchanged over this time period, since these two real world considerations would have had largely offsetting impacts on the scheme's position.

The example serves to illustrate the potential benefits of derivative products for pension schemes. However, we must remember that had the scheme put this hedging strategy into place in January 2007 then the investment outcome would have been different since the scheme would have benefited from the rise in equity values but would not have benefited from the fall in bond yields over the same period, as the derivative effectively locks the scheme into the prevailing bond yield.

The balance of risks have shifted

Last quarter we talked about the "risks of a policy error". At that time policy makers, like the Fed's Mr Bernanke and the Bank of England's Mervyn King, and their colleagues and peers around the world, were grappling with two different economic shocks. The rise in energy and food prices had put upward pressure on headline measures of inflation. The increases in these essential products had been driven higher by a combination of strong global demand and, in the case of energy prices, political tensions too. The seemingly natural response to this shock would, of course, be to raise rates, or at a minimum to leave them unchanged as the price shock washed through the economy.

But we argued that the situation was complicated by the existence of a second shock: the credit crunch and associated liquidity crisis which posed a significant downside risk to the real economy. The withdrawal of credit, or the increase in the price of that credit, from both creditworthy and unworthy alike, had the potential to disrupt household consumption and business investment plans, which, in turn, might lead to a decline in economic growth.

At the end of last year the Fed was focussing much more on the likely impact of the credit crunch. The Bank of England was clearly concerned about credit conditions, but not to the same extent as the Fed. Mr King and his colleagues were more worried about the surge in UK inflation gauges. Meanwhile the ECB seemed to be focussed almost exclusively on the upside risks to inflation rather than the downside risks to growth, which they felt were relatively small.

However, over the first quarter of this year it would seem that the focus of attention changed to become more firmly fixed on the downside risks to growth. This is not to suggest that central bankers have become less concerned about higher inflation, and, in particular, about the rise in inflation expectations. It's just that they only really have one bullet, interest rates, and when one has only one bullet it's normally impossible to hit two divergent targets.

The Fed cut rates by 2% over the quarter, had to organise a rescue of the world's fifth largest investment bank, and also had to pump more cash into the money markets in order to prevent a bad situation from becoming considerably worse. But this drastic action was not enough to save some of the world's largest hedge funds from failing.

In the UK, the government finally felt that it had no option but to nationalise the failed former building society, Northern Rock, after exploring the possibility of a private sector solution. And the Bank of England cut rates from 5.5% to 5.25%, in response to the emerging evidence that the global credit crisis was having an impact on the man and woman on the street. Many UK mortgage providers increased the rates applying to their mortgage offers, and withdrew many thousands of others. The worsening in mortgage terms is

also likely to affect current mortgage holders when their more attractive fixed rate deals struck two to three years ago come to an end.

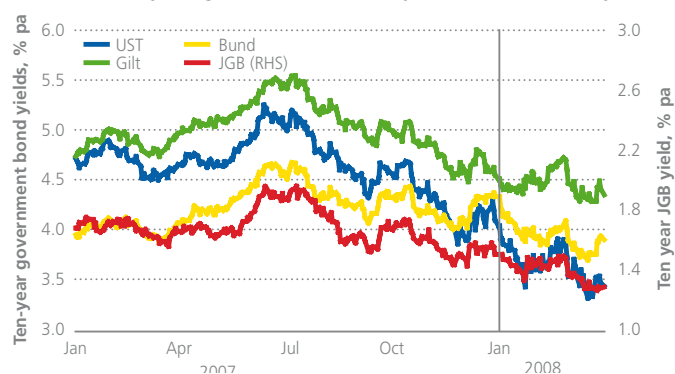
In Europe and in Japan, with lower levels of household indebtedness and with economies less reliant upon their housing markets than in the US and the UK, one might assume that these economies would be less affected by the worst effects of the credit crisis. But Japan, and the Eurozone's largest economy, Germany, rely heavily on exports and export growth. This means that both regions will be affected by any US recession, particularly if the dollar should weaken (and their currencies strengthen) further as a consequence.

At the end of last year the risks faced by the global economy were more evenly balanced between the upside risks to inflation and the downside risks to growth posed by the credit crunch. As it was less clear whether policy should be loosened or tightened, there was more chance of a policy error. Over the last quarter this balance has shifted decisively towards the need for looser monetary policy globally. The change in the focus to these downside risks to global growth over this quarter, compared to last, were reflected in financial market movements.

The financial market response

Chart 2 shows the yields on ten-year government bonds in the US, Germany, Japan and the UK. The peak in yields was last summer. Since that time the yields on these bonds have fallen considerably. The ten-year US Treasury yield experienced the greatest fall and by March 31st US government bonds were yielding only 3.43%, having fallen by 0.60% over this period. Ten year Bund and gilt yields fell by 0.43% and 0.15% respectively, while ten-year Japanese government bond yields fell 0.22% to 1.28%.

Chart 2: Ten-year government bond yields since January 2007

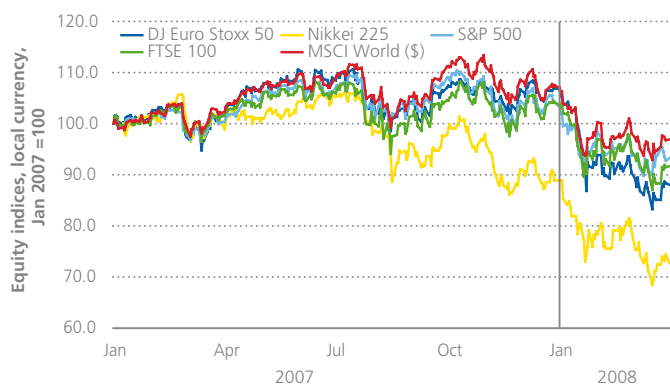


Source: Thomson Financial

Government bond yields at these very low levels reflect two things. First, what market participants call "a flight to quality" as investors generally shun risky asset classes in favour of technically, default-free government securities. But of course they also reflect the view of bond market participants' that these major economies are heading for a recession.

The flip side of these developments in government bond markets is clearly the poor performance of global equities. At the end of last year a number of commentators were wondering why global equity markets had not fallen further as many equity indices actually finished up in 2007, with the Japanese equity market being perhaps the major exception to this, as Chart 3 shows. But the slew of bad news over the last quarter finally took its toll on equity market valuations.

Chart 3: Equity indices since January 2007



Source: Thomson Financial

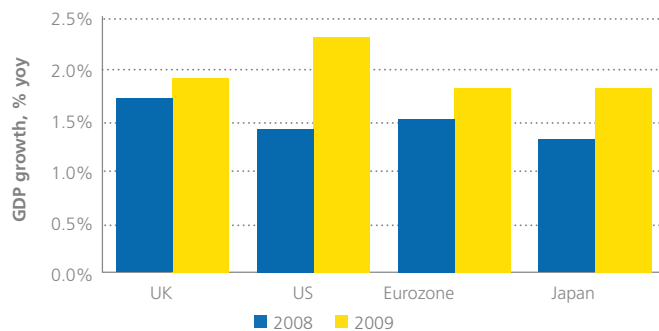
Of our selection of indices in Chart 3, despite falling by 10% over 2007, the Japanese market suffered the largest falls over the first quarter of this year with the Nikkei 225 declining by more than 18%. Meanwhile, the Dow Jones Eurostoxx 50, the FTSE 100 and the S&P500 fell by 17.5%, 11.7% and 9.9% respectively.

These falls reflect a combination of further downgrades to earnings estimates and a rise in the level of investor risk aversion, and are, therefore, broadly consistent with the moves seen in the government bond markets and the market for corporate bonds too.

The economic outlook

Despite the gloomy assessment of the future painted by financial market participants, the latest forecasts from Consensus Economics, which collates the forecasts of professional economists, suggest that economists at least see a relatively short slowdown ahead for the US economy and for the other G4 economies. The US economy is forecast to expand by just 1.4% over 2008 - a much lower increase than the US economy has achieved in recent years. Within 2008 they expect Q1 and Q4 to be particularly weak. But as Chart 4 shows they expect growth to be a much more respectable 2.3% over 2009; though this would still probably represent a sub-trend growth performance.

Chart 4: G4 growth forecasts

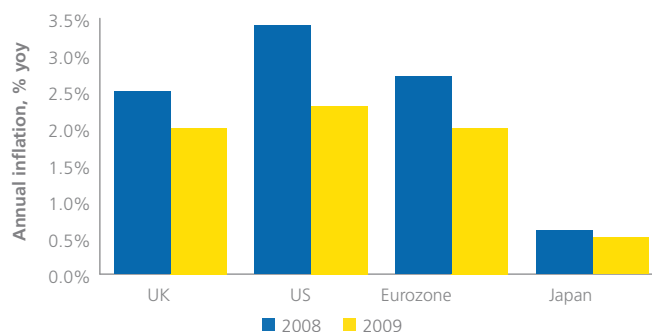


Source: Consensus Economics

Outside of the US, economists expect G4 growth in 2008 to be weakest in Japan. Perhaps most interestingly, given the precarious state of the UK's housing market and the associated very high levels of personal sector indebtedness, they still expect growth to be stronger in the UK than in Japan or the Eurozone. For 2009 they expect growth to recover but to a far lesser degree than they expect in the US. It is possible that this reflects the aggressive action that both the monetary and fiscal authorities have taken as the credit crisis has worsened.

In Chart 5 we present the economists' forecasts for consumer price inflation for 2008 and 2009. In the US, the UK and in the Eurozone consumer prices are expected to rise by more than the associated inflation targets (though the US has no formal target). The ongoing worry for the Fed, the Bank of England and the ECB is that the elevated levels of inflation do not affect inflation expectations to the degree that they then affect wage claims. The Consensus Economics forecast suggests that economists are fairly confident that inflation will moderate into 2009. But for as long as inflation remains at these levels throughout 2008 the risks of an albeit mild wage-price spiral will remain.

Chart 5: G4 inflation forecasts



Source: Consensus Economics

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