Trustee Tutor
Quarterly Investment Review
Q2 2008

Performance over the quarter (local currency)

Market/Index	Performance over the quarter
FTSE 100	-1.34%
S&P 500	-3.23%
MSCI World	-2.45%
Dow Jones Euro Stoxx 50	-7.59%
Nikkei Dow 225	7.63%
MSCI Emerging Markets	-1.58%
UK ten-year gilt yield	-0.78% p.a.*

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

Financial markets have been caught between two opposing shocks: commodity price-induced inflation and the credit crunch. As the news flow has tended to suggest one or the other is gaining the upper hand, market pricing has swung to reflect the newly held view. Having priced in rate cuts across the board in Q1, money markets are now pricing in a number of rate hikes pretty much everywhere. Arguably today's economic environment represents the biggest challenge that central bankers have had to face since the widespread adoption of inflation targeting. This challenging economic environment has created uncertainty for financial market participants and this has been reflected in both bond and equity markets over the last quarter.

The impact on a typical DB pension scheme

Again this quarter we have updated the financial fortunes of the representative scheme that we monitor. First, a quick reminder of the details of the fund which started in 2007 with a relatively conventional and conservative asset portfolio, comprising 60% UK equities, 20% gilts and 20% sterling corporate bonds, and worth 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 dark blue bars) evolves over time in line with relevant equity and bond market movements.

Perhaps a little surprisingly, given the way global equity markets have performed over the last quarter, the chart shows that the scheme's finances have actually improved since the end of March 2008. At the end of March the scheme was only funded to around 86%. However, by the end of the last quarter this funding level had risen to just over 90%. This may seem counter intuitive when the total return on UK equities over the quarter fell by just over 1.0% and bond yields rose, causing the capital value of the representative scheme's bond holdings to decline.

However, the answer to this conundrum is, of course, that the rise in bond yields over the quarter also meant that the discount rate applied to the liabilities also fell. The fifteen year sterling swap rate, which is a good proxy for this discount rate, was around 4.90% by the end of Q1 this year. But by the end of Q2 it had risen by around 0.50% to just over 5.40% (source: Thompson Financial 30 June 2008). This rise was enough to offset the fall in the capital values of both the bond and equity portfolios for this representative scheme.

To illustrate how powerful this discounting effect has been – at least in an accounting context – we have also calculated the scheme's funding position, holding the discount rate constant over the quarter. This is analogous to the fund using swaps at the end of Q1 to hedge the scheme's exposure to interest rates. The impact is shown by the light blue bars in Chart 1. Without the increase in the discount rate the pension scheme would now be facing a deficit of 16% instead of 10%.

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

Last quarter we showed how hedging interest rate risk at the end of Q4 last year would have benefited the scheme since the discount rate applied to pension scheme liabilities fell over that quarter. Had the scheme hedged its interest rate exposure at the end of Q1 this year it would not have benefited from this increase in bond yields.

Taken together these two quarters have demonstrated the investment context regarding the decision to hedge scheme interest rate exposure or not. Hedge at the right time and a scheme is protected from a generalised decrease in bond yields; hedge at the wrong time and it cannot benefit from an equivalent rise in yields. Which just goes to show that in the world of investment, timing is everything.

Two sides of the same coin?

As already noted, during the second quarter, financial markets were effectively caught between two seemingly opposing shocks: commodity price-induced inflation and a credit crunch. Having priced in widespread rate cuts at the end of March, markets moved to price in rate hikes pretty much across the board by the end of June.

Soaring energy and food prices, and a growing realisation that credit may have been too widely available for a number of years, are quite possibly two sides of the same coin. It is well recognised that increased globalisation and, above all, the integration of China into the world economy, led to a marked increase in the demand for oil and basic foodstuffs. But the shifting pattern of demand might also have set in motion a chain of events that culminated in the credit crunch. China's industry was well placed to take advantage of World Trade Organisation (WTO) membership, but her financial system struggled to keep up. To some extent, the same holds true for a number of oil exporters, who have found it difficult to manage the proceeds of their windfall gain. The need to invest such vast sums of money was clearly beyond the abilities of their own domestic banking systems. The result was what Fed Chairman Ben Bernanke has referred to as the global saving "glut". The need to export much of the recycled foreign currency, largely dollars, was a key factor behind the depression of global asset yields. The ensuing "search for yield" led to a boom in securitisations (packaging up the rights to future cash flows such as mortgage repayments), the full consequences of which are only just becoming clear.

If the emerging economies were the root cause of the two major challenges facing policy makers today, they may also be the solution. The best possible outcome probably involves the emerging economies taking prompt action to dampen demand, either by allowing their exchange rates to appreciate, by raising interest rates, or by some combination of the two. That would then relieve some of the pressure on global resources, though ideally not by too much, so that collectively the major economies are able to pull themselves out of the credit crunch having suffered a mild slowdown rather than a severe recession.

In the US, the Fed made one further 0.25% reduction in interest rates during the quarter taking the level down to 2%. For now at least, that is widely regarded as the trough. Although many would argue that the US is already in recession, it appears so far to be a mild one. Unemployment has only risen to 5.5% (source: Thompson Financial 30 June 2008) and data concerning the real economy do not look as bad as many economists had feared just a few months ago.

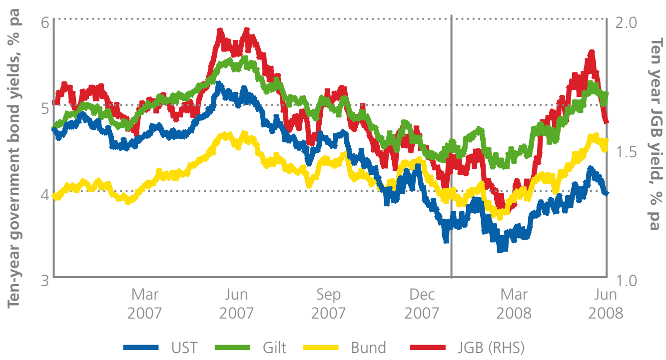
Euro area inflation rose further above target during the second quarter, reaching a provisional 4.0% in June (source: Thompson Financial 30 June 2008). And more of the recent increase is now expected to stick, with the mid point of the European Central Bank (ECB) projection for Consumer Price Index (CPI) inflation through to next year rising from a figure of 1.8% in the February Bulletin to 2.1% in May's. Against this background, the ECB Chairman Jean Claude Trichet signalled that a rate increase had been discussed at the June meeting.
[At the July meeting a quarter point increase was duly delivered].

In June, the Governor of the Bank of England had to write his second open letter to the Chancellor as CPI inflation in May had risen above 3.0%, this time to 3.3%. In his letter he stated that inflation was likely to rise sharply in the second half of the year, to above 4.0%. He also suggested that, were the Committee to seek to return inflation to the 2.0% target within twelve months, then that would produce unnecessary volatility in both economic output and unemployment. The path for UK interest rates will probably turn on whether or not employers succeed in brushing aside higher wage claims. If there are so-called second round effects then an increase in interest rates may be unavoidable, regardless of the slowdown in the real economy. By the end of the second quarter, financial markets were pricing in almost two 0.25% rate increases by the end of the year.

The financial market response

In Chart 2 we can see how government bond markets have struggled against the inflationary backdrop. Since the end of Q1, government bond yields have risen across the G4. The yield on ten year gilts rose by 0.78% over the quarter. While the yield increases on ten year US Treasuries, German government bunds and Japanese government bonds rose by 0.55%, 0.68% and 0.32% respectively over the same period.

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



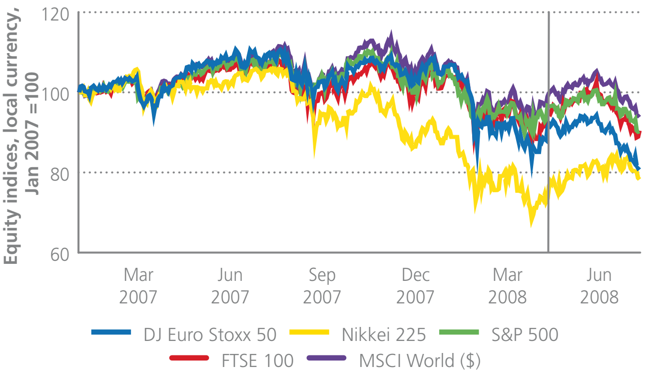
Source: Thomson Financial

The main factor behind the rise in yields has been the increase in oil and food prices that have together led to an increase in consumer price indices, and more worryingly for central bankers, a rise in inflation expectations too. To illustrate the extent to which these inflationary developments have led to financial market participants revising their collective view over the quarter, in the sterling money markets participants now believe that the Bank of England might consider raising interest rates this year, when the view in Q1 was that the next move in rates would be more likely to be down than up.

Despite the fact that equities are a claim on real assets, and therefore might be expected to be inflation proofed, equity markets also struggled to make headway over the quarter. This is probably because the markets came to the view that central bankers would not be able to cut rates to support their slowing economies because of the increase in many of their inflation gauges. So without this support corporate profit growth might be lower, and in addition, since macroeconomic uncertainties have risen, the risk premium that investors require from equities may have risen over the quarter too.

The S&P 500 index fell just over 3.2%, while the FTSE 100 fell by 1.3%. Both the Dow Jones Euro Stoxx 50 and the Nikkei Dow 225 declined by 7.6%. The MSCI's emerging markets equity index fell by almost 1.6%. The FTSE 100's performance relative to that of the other major developed market indices is explained by the relatively high exposure to the commodities industry which the index now embodies.

Chart 3: Equity indices since January 2007



Source: Thomson Financial

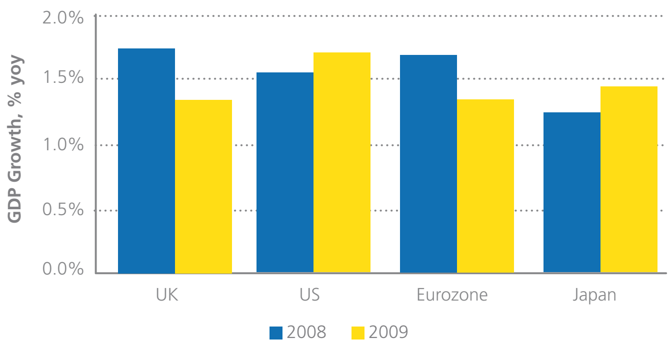
Taking a slightly longer term perspective, all of the indices presented in Chart 3 are well below their values prior to the start of the credit crunch last summer. The S&P 500 is now around 20% lower than it was back in July last year, which has prompted some commentators to claim that global equities are now firmly in the grip of a bear market.

The economic outlook

There has been a small improvement in sentiment regarding the prospects for US growth through 2008 during the past three months, perhaps because recent tax rebates are propping up expenditure, at least in the short-term. According to Consensus Economics, forecasts for US growth in 2008 have risen marginally over the last quarter from 1.4% to 1.5%. But the rapid economic recovery once pencilled in for next year has all but disappeared. The growth forecast for 2009 has dropped from 2.3% three months ago to just 1.7% in the June survey. Overall, the view seems to be that the US will avoid a severe recession, but that growth will be fairly weak for a number of quarters.

Outside of the US, growth prospects for 2008 have changed little during the past three months, though expectations for the Euro area improved moderately following a stronger-than-expected performance in Q1. The prospects for next year, however, have changed significantly. Expected growth rates in 2009 in the Euro area, Japan and the UK have all been revised down, by between 0.3 and 0.6 percentage points. The UK finds itself at the bottom of the heap, perhaps reflecting rapidly deteriorating prospects for the housing market, with forecast economic growth for next year of just 1.3%.

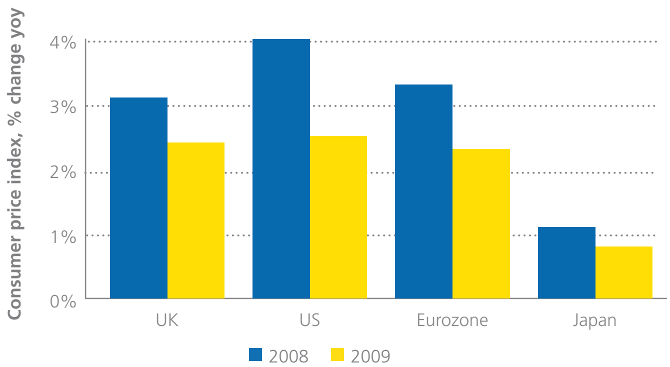
Chart 4: G4 growth forecasts



Source: Consensus Economics

Chart 5 shows projections for CPI inflation in 2008 and 2009. During the past three months, inflation expectations for 2008 have risen across the board by between 0.5 and 0.6 percentage points, as the prices of oil and other commodities have continued their relentless march upward. The US, possessing a central bank that has proved itself more concerned by the prospects of weaker growth than those of higher inflation, is a clear winner in the inflation stakes with an expected average rate of 4.0% this year. The Euro area and the UK are close behind, with figures of 3.3% and 3.1% respectively. In Japan, inflation is expected to average 1.1% (source: Consensus Economics 30 June 2008). If achieved, that would represent the highest reading in ten years. Inflation is expected to fall across the G4 next year as growth slows and policy, in some countries at least, is tightened.

Chart 5: G4 inflation forecasts



Source: Consensus Economics