



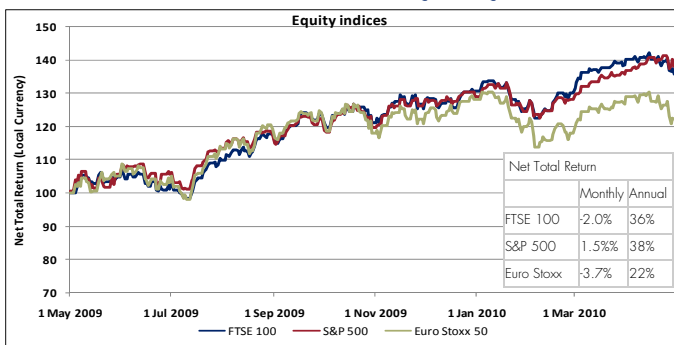
MARKET & ECONOMIC REVIEW

Overview

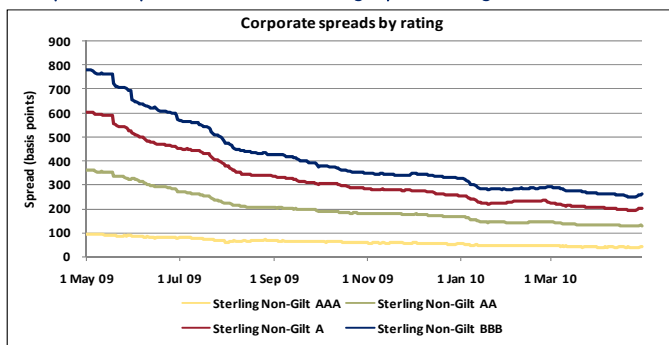
Despite a positive start for the FTSE 100, its 6 week winning streak came to an end. Shares fell after fraud allegations were made against Goldman Sachs and airline share prices fell after European flight bans were imposed due to volcanic ash. Finally, towards the end of the month, the downgrading of Greek debt to the sub-investment grade of BB+ by S&P led to large falls in global stock market prices. Portuguese and Spanish debt were also downgraded to A- and AA respectively. Although the EU and IMF had pledged to support Greece, the market feared that debt may be restructured due to the unpopularity of a bailout in Germany and protests about austerity measures in Greece.

March inflation was higher than many analysts expected with annual RPI inflation reaching 4.4% and CPI 3.4%. This was in part caused by rising petrol prices, with a strong dollar and an increase in the price of oil. The Bank of England still expect inflation to fall; however, the monetary policy committee minutes hint at inflation worries and this increases the chances of an early interest rate rise.

World markets fell on news of a downgrading of Greek debt



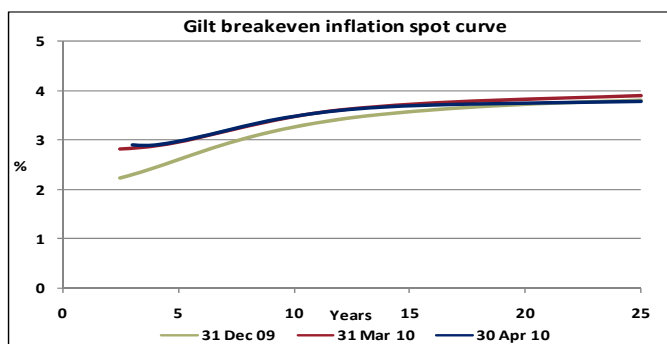
Corporate spreads remained largely unchanged



LATEST ECONOMIC NUMBERS

Current Base Rate	0.5%
RPI increase Mar (%y/y)	4.4%
Halifax house prices Mar (%m/m)	1.1%
IPD TR property index Mar (%m/m)	2.2%
UK Feb total trade balance	-£2.1bn
VIX (volatility) index	22.1
\$/£ exchange rate	1.52
Numbers as at the end of month unless stated	

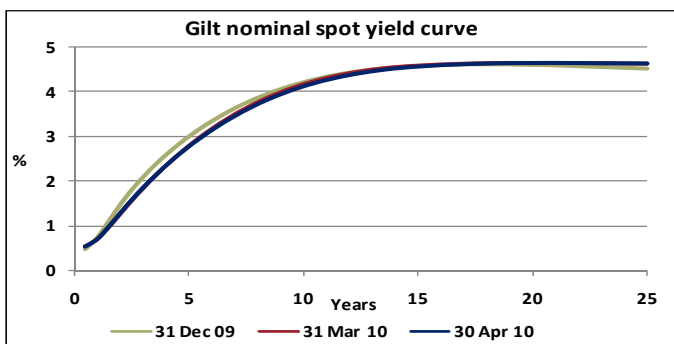
Implied inflation expectations fell this month at longer terms



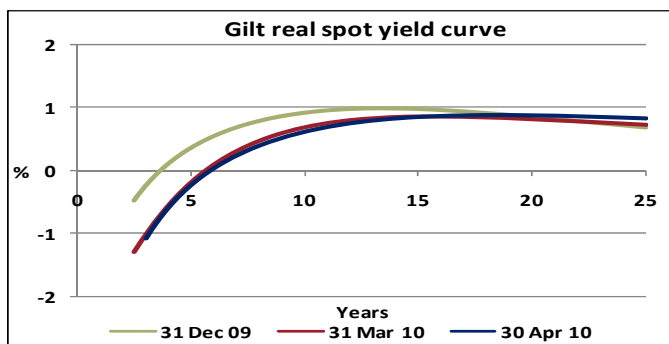
CALENDAR OF EVENTS AND DATA RELEASES

MPC interest rate announcement	10th May
BoE inflation report	12th May
UK Trade	13th May
RPI/CPI	18th May
Minutes of MPC meeting	19th May
GDP Q1 (2nd Estimate)	25th May

Nominal yields remained relatively unchanged



Real yields rose for longer term gilts





Non-Bank Lending: a long-term investment opportunity?

UK businesses have historically relied on bank finance, especially compared to those in the US (see figure 1). In fact UK borrowers have had a competitive advantage in raising bank finance due to the many international banks operating out of the City of London. The banks in turn were able to obtain cheap funding from the capital markets (partly because a benchmark-driven approach to bond investing meant that there was an incentive for fund managers to acquire new debt issuance from large, highly rated, issuers).

The credit crunch, increasing bank capital requirements and associated balance sheet deleveraging mean that all this has changed. This potentially creates new opportunities for bond-style investment, with scope for enhanced returns.

At the same time, the Government is looking to capital markets to fund its increased deficit and provide finance for much-needed infrastructure and social housing investment. Again, institutional investors such as pension funds and insurance companies able to make long-term investments may be able to capitalise on the opportunity this creates.

So what exactly might the resulting assets look like and what, if any, hurdles need to be overcome to enable investors to participate?

Asset characteristics

A variety of structures are possible to facilitate appropriate investment. For example, funds could be set up by fund managers to make loans directly to SMEs (small and medium sized enterprises). Investors would then be able to make allocations to these funds, perhaps with a minimum lock-in period. Alternatively, financing may be in the form of tradable bonds or the private placement of debt. New institutions could be set up to compete directly for business where existing banks are no longer active.

From the investors' perspective, the resulting assets could be floating-rate, fixed-rate or inflation-linked and with a variety of maturities. Key characteristics are likely to include a relatively long term (certainly in comparison to traditional bank lending), which may or may not be an attractive feature for different types of investor. Yields should also be attractive relative to risk, resulting in a relatively high risk-adjusted expected return. However, importantly, assets are likely to be less liquid than the traded bank debt that might previously have been held, potentially resulting in problems with mark-to-market valuation of assets. Furthermore, the heterogeneous nature of these assets means that there are unlikely to be meaningful benchmark indices which investors can use to judge the relative performance of their asset managers.

Investor challenges

Investors will have to ask themselves whether or not potential asset illiquidity is a sufficient issue to prevent their participation in the non-bank lending market. For a long-term buy-and-hold investor who intends to hold an asset until maturity this may not be a problem. However, there is a danger that short-term focussed solvency regulation will have a major impact. The outcome of the recent heated, and as yet unresolved, debate about the potential inclusion of an "illiquidity premium" within the Solvency II regulations for European insurers will be critical in this regard.

Furthermore, investors must decide how they will respond to the probable lack of external credit ratings and a lack of return benchmarks. Many assets will have known coupons and principal repayments on set dates. Cashflows and absolute returns are often more important to investors than returns relative to an index, even if these are not how performance is traditionally measured.

Overcoming these challenges may be hard for the investment industry in practice. Fund managers will be reluctant to invest significant resource in suitable investment offerings until they are confident of demand. Conversely, investment consultants may need to be able to analyse fund manager's offerings before they are able to recommend them to institutional clients. Furthermore, decision-makers within these institutions may feel that their "governance budgets" are fully stretched and that they are unable to consider additional asset classes for investment. Nevertheless, the potential rewards for the investors and for the country justify the effort. As a recent commentator put it: "who will fund Britain's future?"

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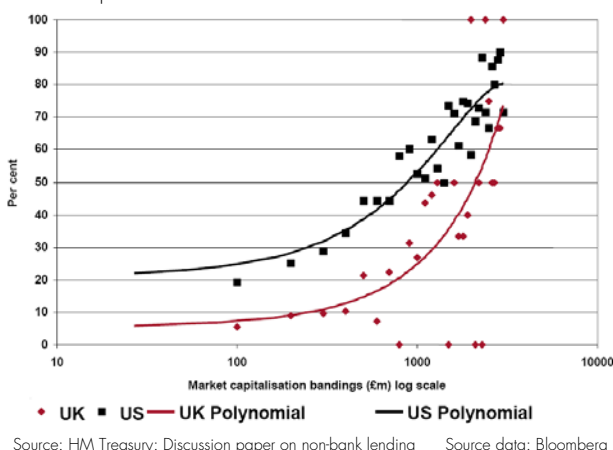
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Figure 1 Per cent of firms with bond market issuance compared to market capitalisation



Source: HM Treasury: Discussion paper on non-bank lending Source data: Bloomberg