



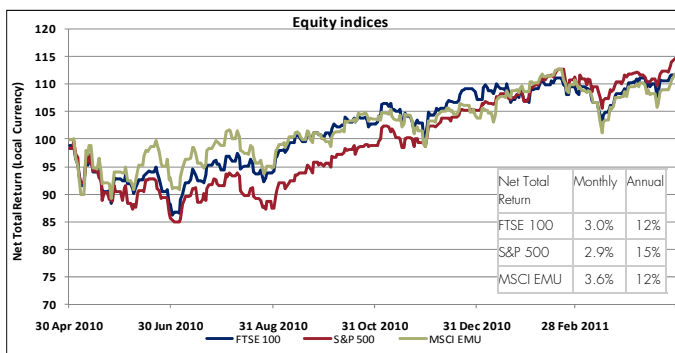
## MARKET & ECONOMIC REVIEW

### Overview

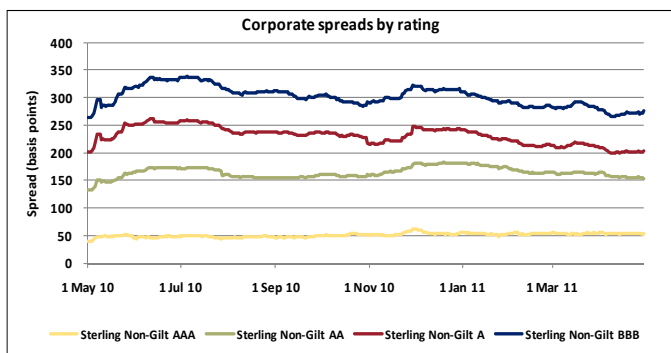
Markets continued to make a stuttering recovery as there were more worrying signs from Europe, America and Japan. Portugal followed Greece and the Irish Republic in asking the European Union for financial assistance. The bailout package is expected to be in the magnitude of €80bn. Shares fell heavily after S&P downgraded the long-term outlook of both the US and Japan from 'stable' to 'negative' - for the US this is the first negative outlook in nearly 70 years. S&P provided a strong warning about America's failure to tackle its bulging budget deficit shortly after Congress and the White House had scrambled through an 11th hour agreement to avoid a federal shutdown.

In the UK, initial estimates by the Office for National Statistics show that the UK economy grew by 0.5% in the first quarter of 2011, following the 0.5% contraction at the end of 2010. There was an unexpected fall in the level of inflation as measured by the Consumer Price Index. CPI decreased to 4%, down from 4.4% in the previous month mostly due to a fall in price increases on food and non-alcoholic drinks. Some commentators noted that the fall in inflation may dampen the pressure on the MPC to increase interest rates—which were once again left unchanged at 0.5%.

Equity markets recovered from a blip earlier in the month



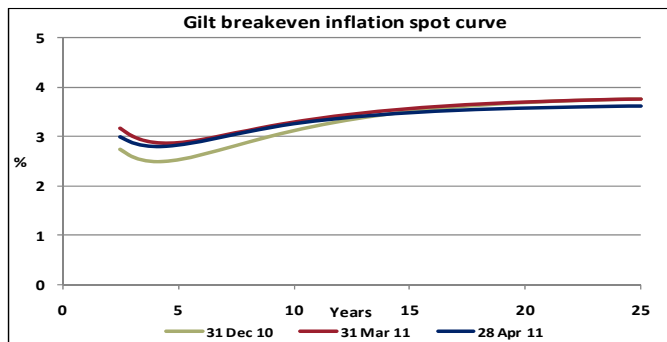
Credit spreads tightened over the month



### LATEST ECONOMIC NUMBERS

Current Base Rate	0.5%
CPI increase Mar (%y/y)	4.0%
Halfax house prices Mar (%m/m)	0.1%
IPD TR property index Mar (%m/m)	0.9%
UK Feb total trade balance	-£2.4bn
IX (volatility) index	14.75
\$/£ exchange rate	1.66
Numbers as at the end of month unless stated	

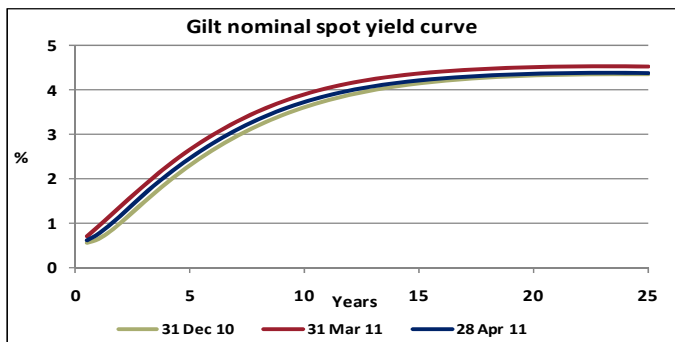
Breakeven inflation fell this month



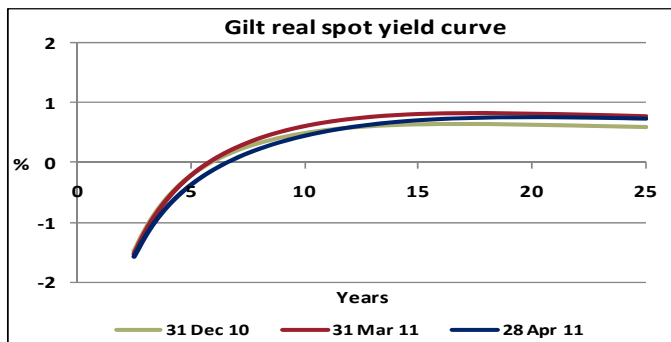
### CALENDAR OF EVENTS AND DATA RELEASES

MPC interest rate announcement	5th May
Producer Price Index	6th May
UK Trade	11th May
RPI/CPI	17th May
Minutes of MPC meeting	18th May
GDP Q1 (2nd estimate)	25th May

Nominal yields fell slightly this month



Real yields fell this month





## FOCUS ON—GILT REPOS

One feature of the recent financial crisis is that swap rate (the interest rate implied by derivative contracts such as interest swaps) has fallen below the yield on government bonds, following investors' concerns over the record levels of debt taken on by governments. Prior to the crisis, a so called 'negative swap spread' was considered by many to be mathematically impossible as it implies that investors believe that the likelihood of default of a private counterparty is less than that of the government. Since many pension schemes invest in swaps to hedge risks, a negative swap spread poses some unusual challenges for them. A number of commentators have suggested that they take advantage of the higher yield on government bonds, not only by directly investing in Gilts, but also through the use total return swaps and Gilt repos.

### What is a Gilt Repo?

A sale and repurchase agreement (or 'repo') is an agreement for one party to sell a financial instrument with an agreement to repurchase equivalent securities at some agreed point in the future. Repos were commonly used in equity markets in the early 1990s and the Bank of England established a Gilt repo market in 1996 with the aim of increasing the liquidity and efficiency of the Gilt market.

### How to invest?

Institutional investors can use repos to finance a larger holding of Gilts. For example a pension scheme could buy Gilts worth £33.3m. It could then enter into a Gilt repo with a bank – selling the Gilts and agreeing to buy them back at a future date. Using the proceeds from this repo, the scheme can buy more Gilts, enter another repo arrangement and repeat the process to end up with economic exposure of £100m of Gilts.

### Why invest?

Pension schemes which hedge their interest and inflation risks have typically done so using swaps. One of the reasons for this was that in the past, the real yield on swaps was higher than the real yield on Gilts – meaning that schemes could generate extra returns on the hedging assets. However, as discussed above, this is currently not the case. Investing in Gilt repos is therefore a way in which pension schemes can increase their exposure to Gilts in order to take advantage of the higher yield on government bonds.

There are also other advantages to using Gilt repos. Firstly, some schemes use Gilt rather than swap yields to place a value on their liabilities. If these schemes use Gilt repos as opposed to swaps to hedge their interest and inflation risks, then the protection afforded is better as the scheme's assets are a better match for their liabilities—in other words 'basis risk' is reduced. Secondly, using Gilt repos can increase a scheme's exposure to Gilts without having to liquidate other assets required for direct investment – in the example above, the scheme managed to get economic exposure to £100m of Gilts using only a £33.3m investment. This gearing effect frees up capital for the scheme to invest in return seeking assets such as equities.

### Governance

There are costs associated with investing in Gilt repos—the documentation process of entering a Gilt repo can be onerous and margins may be payable as the value of the underlying Gilts changes before the repurchase date. The use of Gilt repos by pension schemes is still relatively unusual with most schemes preferring to invest directly in Gilts and use futures contracts to increase exposure to returning seeking asset classes. However some investors have not been put off and this trend may be set to continue—the Pension Protection Fund has invested in Gilt repos to help hedge its liabilities. Some reports suggest that the pensions lifeboat fund has more than £1bn of Gilt repos making it one of the largest investors in repo market.

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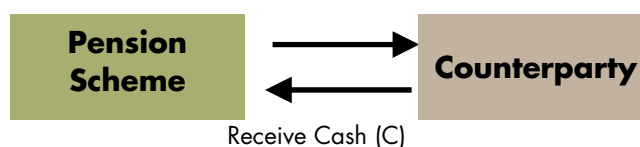
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### Mechanism of a Gilt repo

Inception

Sell Gilts



Maturity

Pays cash  
(C + repo interest)

