



MARKET & ECONOMIC REVIEW

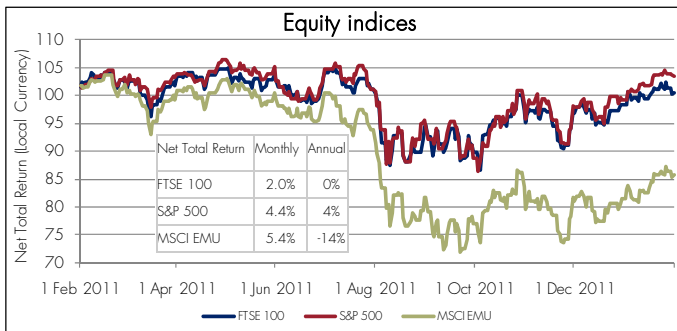
Overview

In January, equity markets continued their upward trend although events in the eurozone continued to influence markets. Greece held debt-swap talks with private investors; however, they failed to reach agreement on an arrangement which would have seen private investors left with just half of their capital.

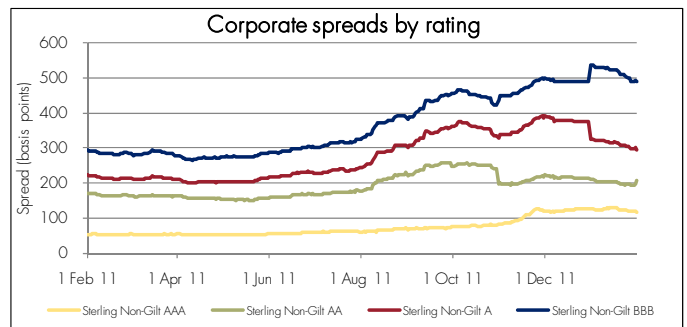
France lost its coveted AAA rating when S&P downgraded the credit ratings of nine eurozone countries. The credit rating of the eurozone's bailout fund (the EFSF) was also lowered, reflecting the reduced ratings of its guarantors. There was, however, some better news from Ireland where it was announced that its deficit had been reduced to below the target required to qualify for its bail-out programme.

In the UK, the annual increase in CPI fell to 4.2% pa and it's expected to fall further as last year's VAT rise drops out and energy prices fall. GDP in Q4 2011 was estimated to have shrunk by 0.2%, with growth likely to have suffered from the ongoing problems in the eurozone. It was estimated that GDP in the US grew by 0.7% in Q4 2011; however, beneath this favourable statistic there were concerns that it was supported by a build up in inventories which would not be sustainable.

Equity indices rose during the month



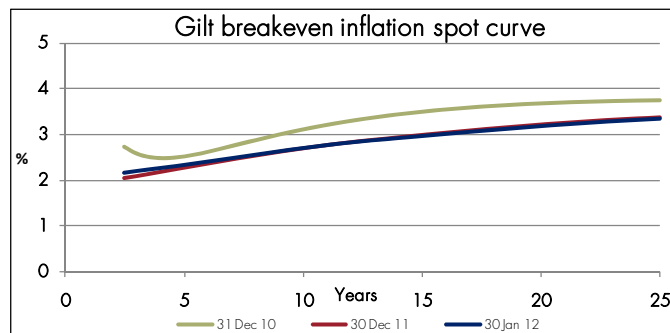
Credit spreads on lower quality bonds decreased this month



LATEST ECONOMIC NUMBERS

Current Base Rate	0.5%
CPI increase December (%/y)	4.2%
Halfax house prices Dec (%m/m)	-0.9%
IPD TR property index Dec (%m/m)	0.5%
UK total trade balance November	£2.6bn
VIX (volatility) index	19.4
\$/£ exchange rate	1.58
Numbers as at the end of month unless stated	

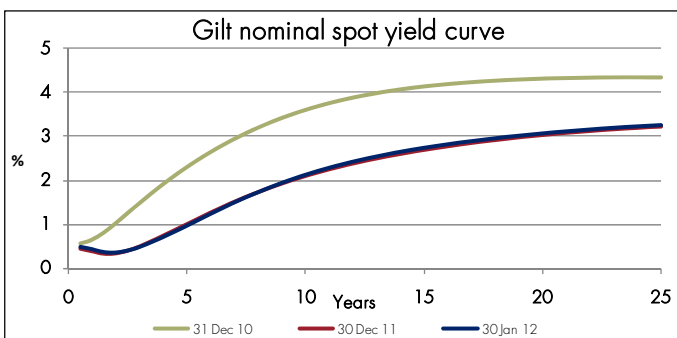
Breakeven inflation unchanged this month



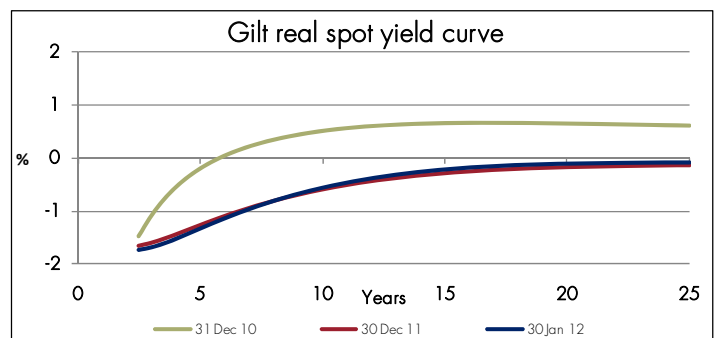
CALENDAR OF EVENTS AND DATA RELEASES

MPC interest rate announcement	9th Feb
UK Trade	9th Feb
Producer Price Index	10th Feb
RPI / CPI	14th Feb
Minutes of MPC meeting	22nd Feb
GDP Q4 (2nd estimate)	24th Feb

Nominal yields unchanged this month



Real yields unchanged this month





FOCUS ON—High Yield Bonds

With interest rates at record lows, investors are increasingly looking at ways to increase the return from their investments. In light of this, there has been increased interest by investors in lower quality, higher yielding debt. High yield bonds are those bonds whose credit rating is below BBB. These may either have been issued as high yield bonds or as higher rated investment grade bonds which were subsequently downgraded (these are known as fallen angels).

The category of high yield bonds now covers a wide range of bonds. Initially it only consisted of 'fallen angels'; however, during the 1980s, investment banks started to issue bonds from less credit worthy companies. These issues were often to finance M&A activities and leveraged buyouts in the US. The European market in high yield bonds is newer and smaller than its American counterpart with companies in Europe having traditionally relied more heavily on borrowing from banks. However, with bank lending remaining restricted, companies are increasingly looking for alternative sources of funding which may increase the supply of European high yield bonds. Sovereign debt may also be included under the label of high yield where it is issued by governments with lower credit ratings, such as those in emerging markets and now Portugal and Greece.

Risks

Like investment grade corporate bonds, high yield bonds normally pay regular interest payments and a final redemption payment. However, high yield bonds come with a greater likelihood of default and liquidity is typically lower, resulting in greater risks for investors. However, these risks have traditionally been well rewarded and high yield bonds have historically provided attractive risk adjusted returns.

Return Characteristics

The return characteristics of high yield bonds can be seen as sitting between those of investment grade corporate bonds and equity; however, the high yield bond category contains a broad range of securities. For better quality high yield bonds (ie BB rated bonds) a significant proportion of the yield will continue to be linked to the underlying government bond yield. However, the return on lower quality high yield bonds will have a much higher correlation with equities as the default risk of the issuer is of much greater importance.

Often pension schemes will use high yield bonds as a less risky substitute for equities (albeit with a capped upside return). In this role they provide useful diversification and have historically had a relatively low correlation with other assets classes. As an alternative to investment grade bonds or gilts they may provide some protection against changes in interest rates. However, high default rates create uncertainty in future cashflows, and high yield bonds typically have shorter maturities which can make liability matching difficult.

Current Conditions

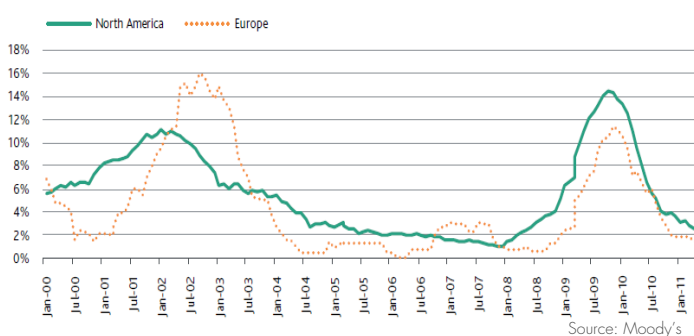
When assessing the attractiveness of high yield bonds, investors often look at the difference in yields compared to government bonds. These spreads have fallen from the peak seen at the height of the financial crisis but are still above long term averages, with investors pricing in higher than current default rates. High yield bonds could be expected to perform relatively well in low to moderate growth environments - if companies' profits are still sufficient to meet interest payments. However, a recession or other shock could cause defaults and large losses on high yield bonds. Contagion from a sovereign default in the eurozone remains a significant risk to bond holders. In addition, liquidity in the market remains low as banks continue to deleverage their balance sheets and provide limited liquidity to the over the counter market. This has caused an increase in the pricing volatility of bonds.

In summary, high yield bonds may provide a useful addition to an investor's portfolio, although the risks should be carefully considered together with the timing of any move. Investors should also ensure that they hold a diversified holding so are not exposed to large losses in the event of default by a single issuer.

Any material or information in this document is based on sources believed to be reliable; however, we can not warrant accuracy, completeness or otherwise, or accept responsibility for any error, omission or other inaccuracy, or for any consequences arising from any reliance upon such information. The facts and data contained are not intended to be a substitute for commercial judgement or professional or legal advice, and you should not act in reliance upon any of the facts and data contained, without first obtaining professional advice

Outlook for default rates

High yield bond annualized default rates, Europe vs North America



Default rates on high yield bonds saw a large peak in both the US and Europe at the beginning of 2010 before falling to the current below average levels; however, the outlook is very uncertain. Some commentators believe that the "bad apples" have now been removed leaving companies with a more sound financial footing. They predict that the default rate will remain low, helped by companies refinancing onto lower interest rates. However, others predict that default rates will rise as growth stalls and companies struggle to refinance the significant repayments that are due, given the restricted bank lending.

Contact Information

Colin Wilson
Technical Director
T: +44 (0)20 7211 2672
E: colin.wilson@gad.gov.uk

Matt Gurden
Investment & Risk Actuary
T: +44 (0)20 7211 3498
E: matt.gurden@gad.gov.uk

Andrew Jinks
Investment & Risk Actuary
T: +44 (0)20 7211 2655
E: andrew.jinks@gad.gov.uk

Chris Bull
Investment & Risk Actuary
T: +44 (0)20 7211 2739
E: christopher.bull@gad.gov.uk