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XPS Investment News

Bringing you the latest investment news, insights and opinion from across the pensions industry

Quarter in brief

- Potential for stagflation sets the scene for a difficult economic environment for central banks to navigate
- Concerns over tightening of monetary policy spook fixed income markets
- Global equities pull back over September

Simeon Willis
Chief Investment Officer

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Simeon's October update

Stagflation on the horizon? Global supply chain issues stall recovery

September took the shine off what was initially looking to be a continuation of strong market performance that had been witnessed since March 2020.

Concerns over faltering global growth and a gradual realisation that global inflation may well not prove to be as temporary as central banks had predicted led to mixed returns for equities and bonds for the quarter.

Bottle necks in global supply chains and continued economic disruptions caused by the spread of the Delta Covid-19 variant contributed to hamper global economic growth and increase upwards pressure on prices. This was compounded by a number of sector and region specific issues.

Most major markets held up strongly in the face of these issues during the first couple of months of the quarter but pulled back sharply in September, most notably in light of concerns about tightening monetary policy.

Developed equity markets ended the quarter in positive territory but September was a choppy ride.

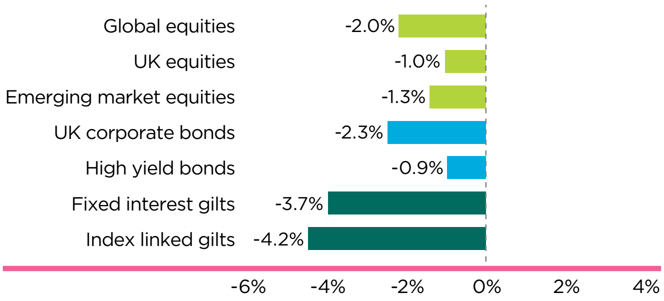
A general uptick in global demand for gas, combined with supply disruption, led to soaring prices. The UK's dependence on imported gas was exacerbated by a fire on an electricity power cable between the UK and France which will take months to repair, increasing the need for domestically generated electricity.

The furlough scheme ended in September which, at the end of July, was still supporting 1.6m people. This is expected to increase UK unemployment despite an estimated 1 million vacancies and high profile labour shortages in a number of key sectors including transport, construction, manufacturing, retail and hospitality. A shortage of HGV drivers in the UK, which has been attributed to working conditions and Brexit, has led to large scale petrol shortages, hampering mobility and the provision of core services.

Supply side challenges pose a direct threat to central bank inflation targets, and this has prompted the Federal Reserve and the Bank of England to both indicate a readiness to tighten monetary policy by increasing interest rates when needed. The first of these rises in both the US and UK are now widely expected in 2022, where only a few months back this had not been expected until 2024.

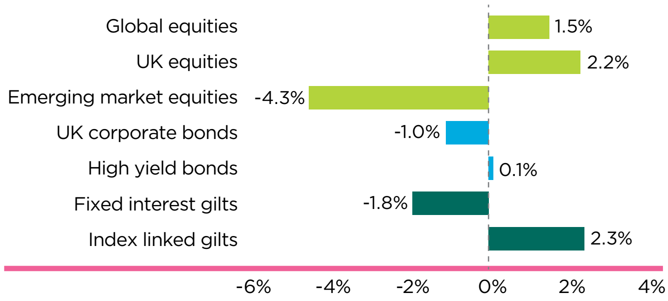
Market returns

1 month to 30 September 2021



Source: Refinitiv

3 months to 30 September 2021



Source: Refinitiv

Continued from page 1

The European Central Bank, however, has distanced itself from the possibility of tightening policy for the time being. This is due to Europe being further behind in terms of its recovery.

The market dynamics seen, in combination, create the potential for a stagflationary environment to rear its head. This describes a situation where economic growth stagnates but inflation persists. This may pose central banks with a difficult choice between putting up with above target inflation, or putting up with a recession. The Bank of England's primary objective is to target 2% CPI inflation but it's permitted room to balance this alongside supporting economic growth and jobs in the short term. This means a moderate inflation overshoot may be tolerated in the interest of avoiding a recession.

The perceived likelihood of raising rates sooner than previously expected prompted a significant fall in the value of fixed income assets over the quarter. Whilst unhelpful on the asset side, this is generally beneficial for defined benefit pension schemes as it reduces the value of their liabilities. However, a significant rise in long term inflation expectations has offset this benefit through an increase in inflation-linked liability values.

Both investment grade and high yield corporate bond spreads were largely unchanged over the quarter. Price movements in each market were driven by increasing interest rate expectations. Investment grade corporate bonds underperformed their high yield counterparts due to their increased sensitivity to moves in interest rate expectations; this is caused by their longer maturity on average.

Emerging market equities performed poorly over the quarter as a whole. In China, regulatory intervention, which would be generally considered excessive in western markets, wiped billions of dollars from the holdings of major international investors in companies such as Tencent and Alibaba. Uncertainty around the future of Chinese property developer, Evergrande, also made headlines and unsettled markets after the company failed to meet a deadline to re-pay debt obligations. In the Middle East, a humanitarian crisis unfolded in Afghanistan after the Taliban took control of the country.

The long awaited Conference of the Parties 'COP 26' is due to take place in November and there is a growing anticipation surrounding the potential policy action that will result. The UN's Intergovernmental Panel on Climate Change issued a bleak report stating that the world needed to act immediately and materially to reduce emissions, otherwise limiting global warming to either 1.5C or even 2C above pre-industrial levels by 2100 would be an impossibility.

The UK started down the path of green finance with the first green gilt issued to investors in September, which was ten times oversubscribed. The 12 year gilt issuance, worth £10bn, was the largest sovereign green bond issuance in the world to date and priced at a small estimated premium to conventional gilts. This was the first of two green gilt issuances totalling £15bn planned for this financial year, with the second to be issued mid-to-late October 2021.

The funding level of a typical pension scheme would have decreased over the quarter, owing to liability values increasing due to rising inflation which was not sufficiently offset by rising yields or growth assets over the period.

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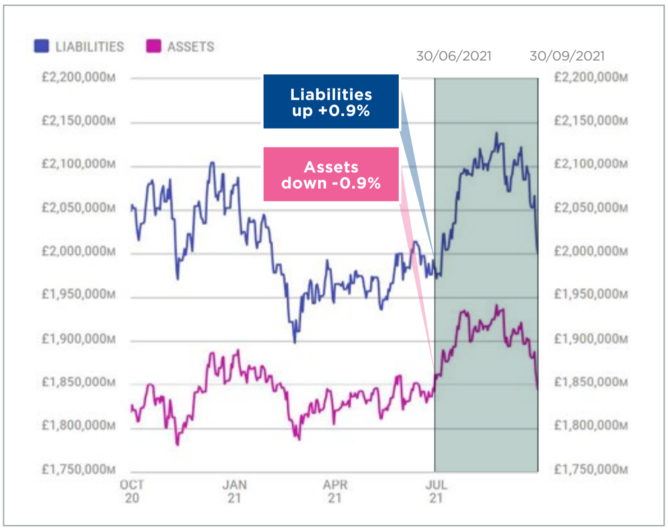
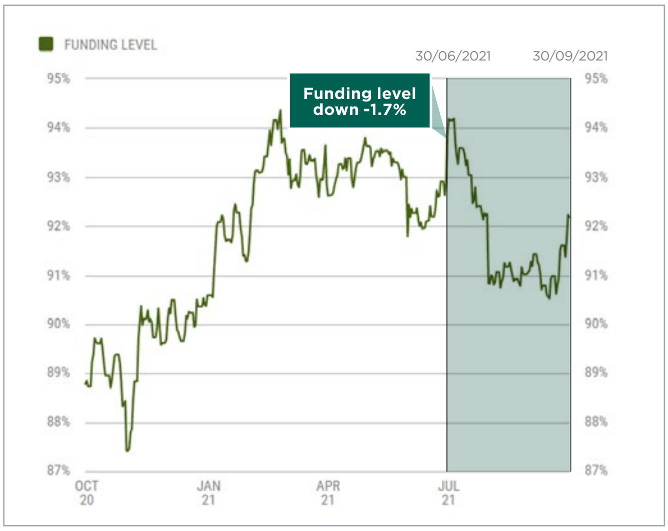
Asset and liability progression for typical scheme



Source: XPS DB:UK Funding Watch

Funding level progression for typical scheme



Source: XPS DB:UK Funding Watch

The graphs reflect XPS's funding tracker, DB:UK Funding Watch, which monitors the combined deficit and funding level of UK defined benefit (DB) pension schemes (i.e. all registrable schemes - including hybrids) on a long-term target basis using a discount rate of Gilts + 0.5%. The assumed asset allocation is 16.9% equities, 20.0% corporate bonds, 6.9% multi-asset, 5.1% property, 3.8% private markets and 47.3% in liability driven investment (LDI) with the LDI overlay providing a 60% hedge on inflation and interest rates.

XPS Investment asset class views

Asset class	Favourable	Neutral	Unfavourable	Movement
Developed equities			●	↓
Emerging market equities		●		
Investment grade corporate bonds			●	↓
High yield bonds		●		
Private debt	●			
Balanced property (UK)			●	
Long lease property	●			↑
Diversified private markets	●			
Secure income	●			
Private equity		●		
Equity option strategies	●			↑
Pensioner buy-in		●		
Cash			●	

Find out more

To discuss any of the issues covered in this edition, please get in touch with Simeon Willis or Steven Hickey:

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