July
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XPS Investment News

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

Quarter in brief

- **UK CPI remained at 8.7% in May defying expectations that inflation would continue to fall**
- **The Bank of England raised the bank rate to 5% in June – the 13th consecutive increase by the central bank**
- **Inflation is falling in the US and the Federal Reserve voted not to raise rates towards the end of the quarter**
- **Aggregate UK DB pension scheme funding was on the rise over the quarter thanks to rising gilt yields in April and May**

Thomas Pawelski
Senior Investment Consultant

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Thomas' July update

Funding levels up on the quarter following interest rate rises to tackle stubborn UK inflation

The Bank of England had expected inflation to continue to fall over the summer of 2023 but data from the Office for National Statistics released in June showed that inflation remains sticky.

Hopes were that inflation would fall markedly once the April 2022 energy price cap rise fell out of the 12 month calculation, but they didn't fall far enough. 12-month CPI inflation to May was 8.7%, the same as April, and high wage growth in the UK labour market reinforced the deep rooted nature of concerns over rising prices.

Interest rates in the UK are now at their highest for 15 years following a 0.25% and 0.5% increase in May and June respectively to 5.0%. Governor of the Bank of England, Andrew Bailey, defended the decision warning that if the central bank did not continue to raise rates then "it could be worse later". At the end of June the market was predicting that interest rates will rise to 6.25% by early 2024, which has since increased to 6.5% and will need to remain higher for longer to bring inflation back to the 2% target. Despite the near-term inflationary picture worsening, long term inflation expectations actually fell over the quarter.

The UK remains a definite outlier in the inflationary pressures it is facing and the outlook in the US is more positive. US Inflation was down to 4% in the 12-months to May – its lowest level since 2021 and an 11th consecutive month of falling prices. The Federal Reserve chose not to increase interest rates at its June meeting citing the pace at which the central bank has increased rates from near-zero just 18 months ago to a range of 5.00 – 5.25% today. Chairman Powell said that the market's expectation of two further rate rises before the end of 2023 remained "a pretty good guess of what will happen" should the economy respond as expected.

Inflation in Europe dropped from 6.1% to 5.5% in May which was a bigger fall than expected. The European Central Bank (ECB) has been hawkish in its stance on inflation with different economies within the Eurozone experiencing variable rates of price increases. The ECB has signalled its intention to continue its tightening of monetary policy in response to “overlapping inflationary shocks” experienced since the end of the pandemic according to President Christine Lagarde.

Global equities posted a strong quarter for Sterling investors thanks to the strengthening of the Pound against the Dollar. UK stocks struggled however, hindered by contractionary monetary policy and the Oil sector experiencing a period of falling wholesale prices. Emerging market equities also posted negative returns.

Corporate bond credit spreads tightened over the quarter, but edged up slightly towards the end of June, reflecting a more cautious tone. In late June, Thames Water announced the CEO would be stepping down as the business faced the potential for renationalisation following issues with the magnitude of its debt, which many pension schemes would hold in their investment grade portfolios. The debt continues to trade with only modest widening of the spread.

Long-dated nominal and real gilt yields fell in June but had already risen sharply in April and May to finish the quarter up by over 0.5%. With inflation expectations falling slightly, aggregate UK DB pension scheme funding on a low risk basis was up significantly over the 3-month period despite more mixed returns from most growth asset classes. This improvement in funding sits in marked contrast to many pension scheme members, who will have seen the value of their benefits eroded by higher inflation, which has for some time now exceeded typical caps to benefits increases.

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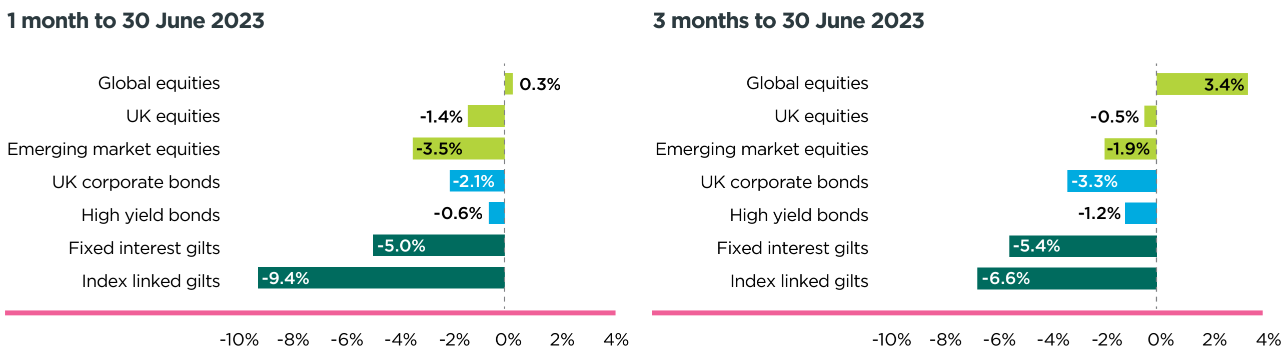
Market returns

Global equities posted strong returns for Sterling investors over the quarter



Source: Refinitiv

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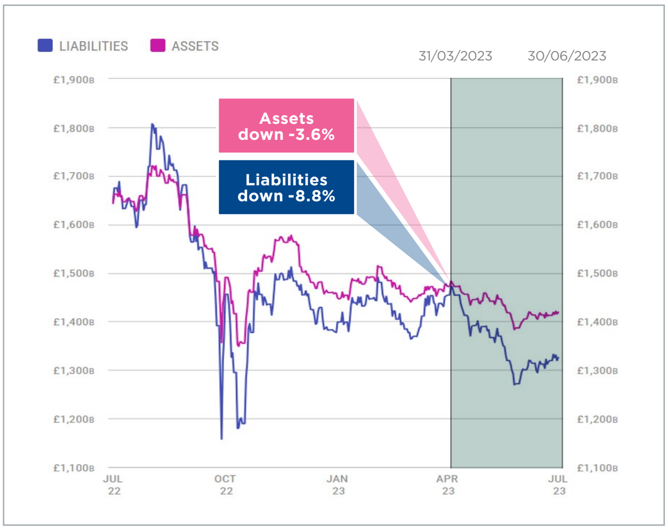
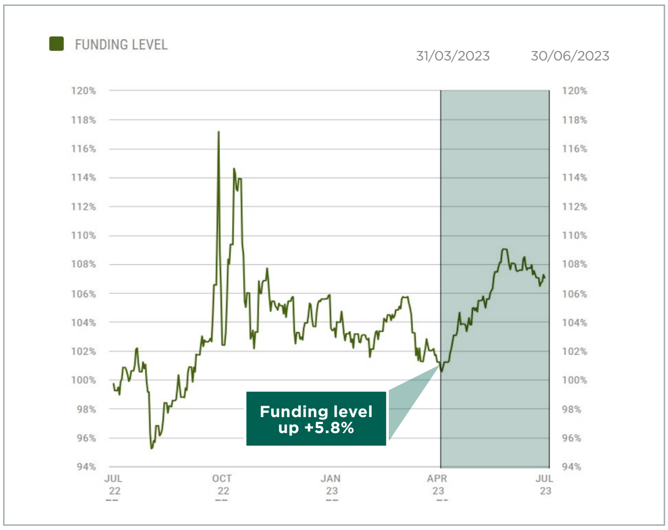
Asset and liability progression for the DB:UK universe



Funding level progression for the DB:UK universe



Source: XPS DB:UK | www.xpsgroup.com/services/xps-pensions/xps-dbuk-funding-watch

The charts above are based on data from The Pensions Regulator, the PPF 7800 Index and the XPS data pool. The assumptions used in the UK:DB long-term target basis include a discount interest rate of gilt yields plus 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		●		
Senior secured direct lending	●			
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 Thomas Pawelski:

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