July 2022

XPS Investment News

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

Quarter in brief

- A second quarter in a row of back-to-back interest rate rises by the Bank of England saw long dated gilt yields climb by c.1% over the quarter.
- Growth markets rounded off a dismal first half of the year.
- The estimated aggregate funding position for UK DB pension schemes improved materially over the period.

Mark Minnis
Head of LDI Research

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Mark's July update

Gilt yields rise at their fastest rate since the 1990s as central banks scramble to combat surging inflation

Monetary policy response to rising inflation by major central banks globally triggered a series of sharp rises in government bond yields over the quarter. Risk assets continued to underperform in light of the ongoing conflict in Ukraine, global supply chain concerns and the looming threat of a global economic downturn.

Long dated gilt yields soared over the quarter, and finished c.1% higher than where they started it, continuing the trend seen since mid-December.

The Bank of England twice voted to raise the bank rate during the quarter. The Bank is treading the fine line between doing what's necessary to curtail skyrocketing inflation and avoiding tipping the UK economy into recession through increasing the cost of borrowing.

The Federal Reserve's decision to raise US interest rates by 0.75% at their June meeting was a larger increase than the market had anticipated earlier in the quarter and another material rise is also expected in July. US consumer confidence is at its lowest level since February 2021 as inflation expectations have dampened public opinion over the growth prospects for the world's largest economy.

Fears remain that traditional monetary policy may have a limited impact in controlling current inflationary pressures which have been largely driven by supply-side issues such as rising gas and oil prices resulting from Russia's continued invasion of Ukraine – factors out of the reach of the central banks. UK CPI rose to a 40-year high, increasing 9.1% year-on-year to May; this was an increase of 2.1% year-on-year from the figure in March. Eurozone inflation hit a record high of 8.6% in the year to June, increasing from 8.1% in May, and US inflation surprised on the upside, accelerating to 8.6% in May, their highest figure since December 1981.

Developed equity markets have suffered a miserable first half of the year, compounded by poor performance over Q2. The wide and varying implications of inflation created significant headwinds for the global economy, significantly dampening economic prospects. Many companies are likely to have been able to cushion the immediate impact of these headwinds, having started from a position of strength with large cash balances. However, uncertainty exists around how long it will take for global supply-side issues and inflation to be addressed.

Emerging market equities also performed poorly over the quarter largely due to their significant exposure to the Chinese market where the combination of rising coronavirus cases and greater government intervention in recent months has weighed heavily on performance. The outlook for Chinese equities is somewhat brighter, however, with interest rate cuts and increased government spending indicating more favourable growth conditions moving forwards.

This backdrop for risk assets also sent the value of cryptocurrencies tumbling over the 3 months to the end of June. Bitcoin lost over 50% of its value in the second quarter which saw its price fall below $20k for the first time since December 2020 – down from a record high of almost $70k in the final quarter of 2021. XPS continues to advise clients to avoid all cryptocurrencies due to their questionable fundamental value and our significant concerns over market integrity.

In bond markets – both investment grade and high yield corporate bond spreads continued to trend upwards, as they had done over the first quarter, reflecting investor sentiment that there exists a greater likelihood of rising corporate default rates as firms try to navigate a landscape of rising costs and falling consumer confidence in the current inflationary environment. Defaults have been very low, however, so any rise in defaults is starting from a low level.

UK DB pension scheme funding improvements over the first half of 2022 were driven by a material fall in long term liabilities. As at the end of June the average UK DB pension scheme had moved close to fully funded on a long term funding basis.

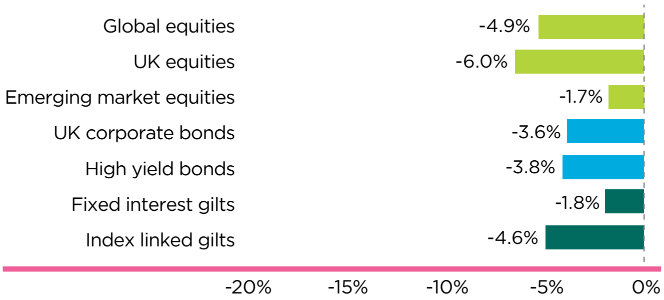
However the experience of different schemes has been very wide depending on the exposure to growth assets and hedging levels. Schemes with material levels of unhedged liabilities will have benefited disproportionately from the rise in yields, leading to substantial funding improvements above the average scheme. Some schemes, with high exposure to growth assets and high levels of hedging, will have experienced a deterioration due to the fall in equity and credit markets. It's important to note that hedging itself can neither create nor repair a deficit, so any deterioration in funding is due to the decline in growth assets.

Current conditions could present a great opportunity to implement de-risking. See our June investment briefing ***"Runaway yields – Is your LDI hedge still on track?"*** for more information for what you can do as a Trustee to respond to a rising interest rate environment and ensure that your Scheme is well positioned for the future. **Click here** to read more.

The average scheme has seen its funding position move into surplus. It's important to check your funding level and take action.

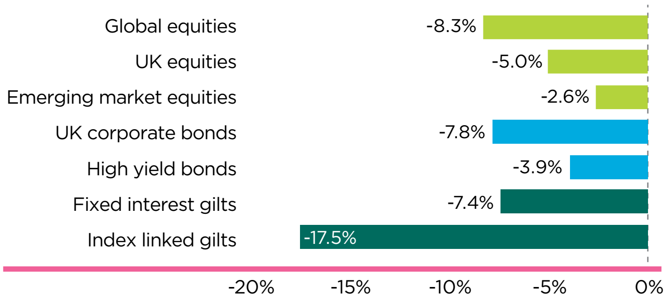
Market returns

1 month to 30 June 2022



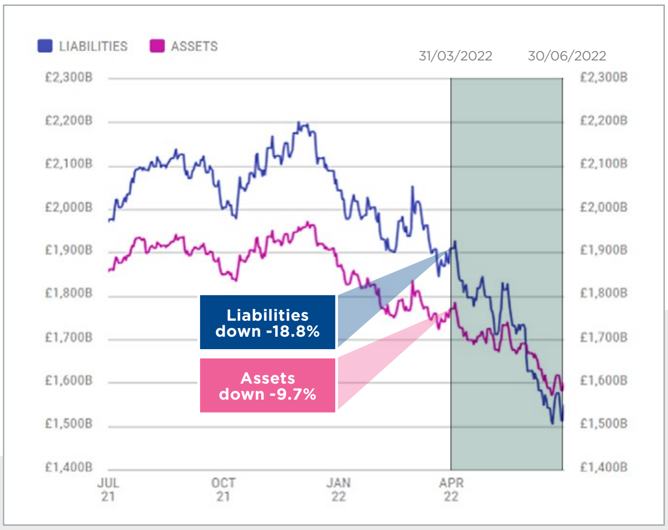
Source: Refinitiv

3 months to 30 June 2022

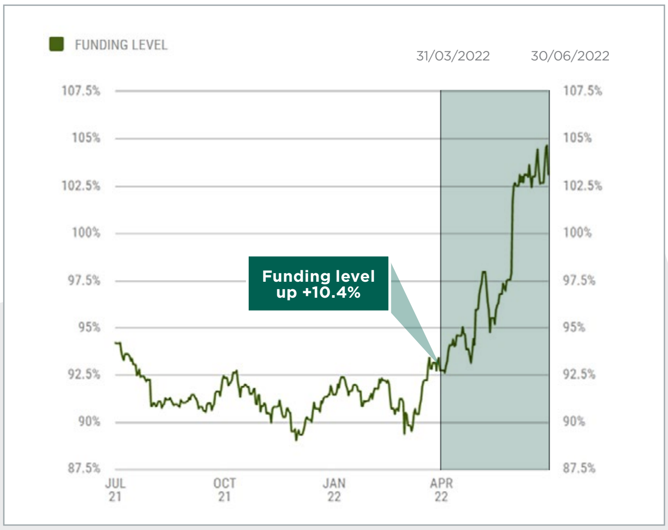


Source: Refinitiv

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		●		↑
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 Mark Minnis:

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