January 2023

XPS Investment News

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

Quarter in brief

- Major central banks increased interest rates further in December to fight above target inflation, although early signs inflation may have peaked
- Sterling appreciates versus the US dollar over the quarter detracting from Sterling returns on overseas investments and dampening positive equity returns
- Credit spreads tighten despite expected increase in defaults
- Lagged private market asset performance expected to decline to end of the year

Faye Clark
Head of Manager Research

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Faye's January update

Markets settle down and pension schemes end the year up

Following erratic gilt market movements at the start of the quarter in the wake of the UK mini-budget, the pension industry has successfully reverted back from an environment of panic and immediacy to one of composure, lifting its sights outwards towards the medium to longer term.

The dramatic change in funding positions, as well as changes in hedging levels and asset allocations, made it difficult for pension schemes to focus on long term strategic issues, particularly as long term planning involves detailed forecasting which comes into question when the starting position is moving on a daily basis. Now the dust has settled, pension schemes on the whole find themselves in a very favourable position; the aggregate funding level improved over the period with the average UK defined benefit scheme in a healthy surplus on a low-risk basis at year end.

Sterling staged something of a comeback over the 3 months rising by 8% from 1.12 to 1.21 versus the US dollar and also appreciating significantly versus the broad universe of local emerging market currencies. This provides reassurance in terms of an improving perception of the UK on the international markets, whilst detracting from the returns that a Sterling investor will have earned on unhedged US and emerging market investments. The UK continues to face certain structural and political challenges, however, which include public sector strikes by nurses, rail and postal workers and labour shortages, along with a current lack of a clear long term strategy from the government.

Inflation prints released globally continued to drive markets as investors assessed the likely extent of further monetary tightening required to slow inflation and reduce it to target levels. UK CPI inflation eased slightly, falling to 10.7% in November from a 41 year high of 11.1% in October. This figure was marginally better than expected. There remains hope that inflation will continue to fall but the potential for inflation to remain elevated remains present.

During the quarter, the Bank of England increased interest rates for the ninth meeting in a row at their December meeting, raising rates by a further 0.5% to 3.5%. The US Federal Reserve ('Fed') also raised rates by 0.5% at its December meeting to a range of 4.25-4.5%. This increase was lower than the 0.75% increase seen at the last four Fed meetings and followed a second successive reduction in US CPI. In Europe, the European Central Bank raised the deposit rate to 2%. Alongside interest rate rises, central banks have also been unwinding quantitative easing measures and reducing the amount of assets on their balance sheet, further tightening monetary policy.

Market expectations remain that the UK, US and Europe will continue to increase interest rates into 2023. This was also reflected by central bank policy statements reiterating that rates will need to rise further and likely remain high to get inflation down to expected levels, given the sustained challenges faced globally, including the war in Ukraine, related supply chain disruptions and the continued strength of labour markets.

Global developed equities posted positive returns over the quarter. This would have been stronger but for a sharp pull-back over December along with currency effects for unhedged Sterling investors, who saw returns meaningfully impacted due to the US Dollar weakening over the 3 months.

Emerging market equities also posted a marginal positive return, lagging developed market equities over the period. Following wide-spread protests against strict lockdowns, China suddenly lifted many of their Covid-related restrictions in place early in December but it is now believed to be battling a fresh challenge in the form of a significant Covid infection wave.

The global economy continued to see a deterioration in growth which is expected to continue in the New Year although markets are forward looking and tend to appreciate ahead of economic measures improving.

In bond markets, credit spreads tightened over the quarter for both investment grade and high yield bonds, despite an expectation of rising defaults this year and next, particularly in high yield. The market appears to be looking beyond this.

Private market assets, including private equity, private credit, infrastructure and property, which have lagged valuations, are widely expected to experience some level of write down in asset values to the end of the year through to March 2023. This expectation results from a delayed effect of the market pressures that have been observed in 2022 both in terms of a rising rate environment increasing the costs of debt and leveraged investments, as well as the fire sale of illiquid asset by pensions schemes to shore up their LDI strategies.

UK DB pension scheme funding levels were highly volatile in October during the gilts crisis but was much more stable over November and December. Over the quarter as a whole, a fall in liability values driven by both falling inflation expectations and rising yields combined with asset benefiting from modest equity returns and credit spreads tightening, which led to an improvement in the aggregate DB UK funding level.

All eyes will remain on policymakers as we move into 2023, specifically how they proceed to reduce inflation from this point alongside managing weak, and potentially negative, economic growth.

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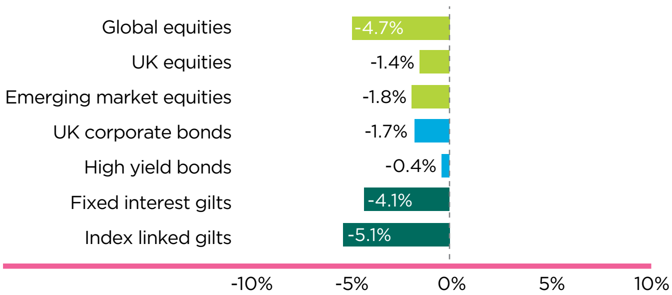
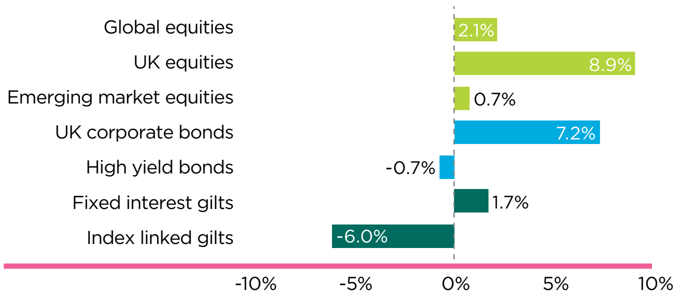
Market returns

1 month to 31 December 2022



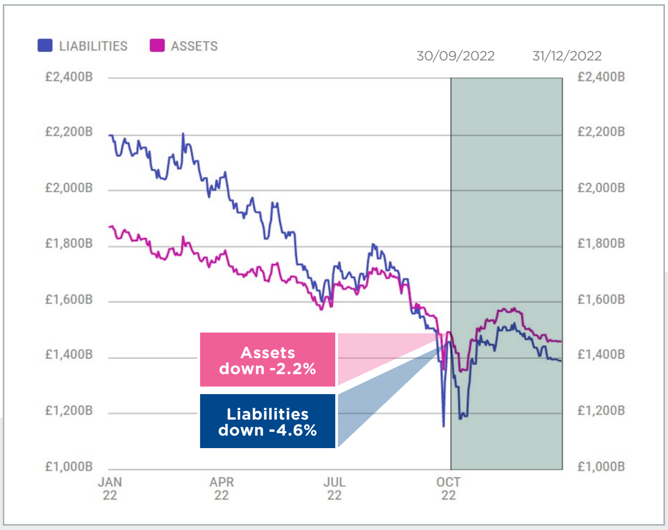
Source: Refinitiv

3 months to 31 December 2022

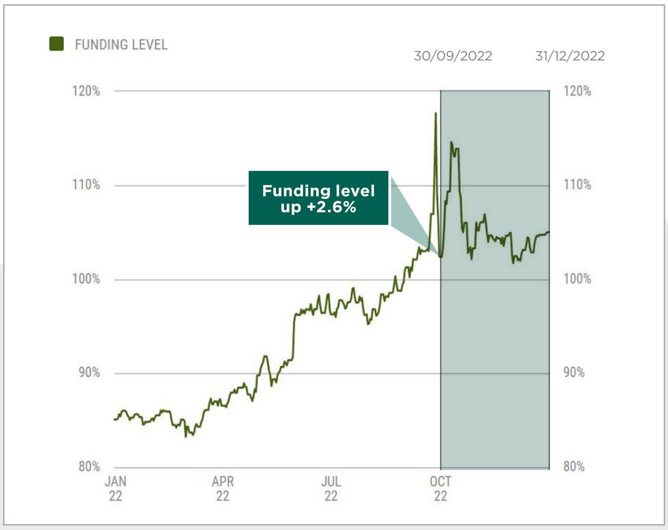


Source: Refinitiv

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		●		
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 Faye Clark:

Simeon Willis
Chief Investment Officer
t 020 3967 3895
e simeon.willis@xpsgroup.com

Faye Clark
Head of Manager Research
t 0113 521 6748
e faye.clark@xpsgroup.com

Alternatively, please speak to your usual XPS contact.

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