October 2023

XPS Investment News

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

Quarter in brief

- The Bank of England ended its run of 14 consecutive rate rises in September as it voted to keep interest rates at 5.25% set in August
- Both the Bank of England and Federal Reserve warned that rates will remain 'higher for longer'
- High yield bonds were the best performer over the quarter despite rising default rates
- Aggregate UK DB pension scheme funding continues to rise thanks to falling liabilities

Duncan Maloney
Senior Investment Consultant

Click to watch
Duncan's October update

Corporate default rates are on the rise but credit markets remain sanguine

Falling inflation over the quarter may have signalled the near peak of interest rates around the globe but central bank policymakers have warned that interest rates are set to remain high for the foreseeable future.

The 12-month UK Consumer Prices Index (CPI) rate of inflation has fallen from 8.7% to 6.7% over the last 3 months. Prices are now rising at their slowest rate for almost 18 months. This was enough to prompt the Bank of England (BoE) to halt their run of 14 consecutive interest rate rises during September after most recently raising rates by 0.25% to 5.25% in August. However, the BoE did decide to increase the rate of quantitative tightening for the forthcoming year from £80bn to £100bn which would apply upwards pressure to gilt yields. Both the Governor of the BoE and the Chairman of the Federal Reserve (Fed) issued warnings that, despite hopes that interest rates had neared their peak, there is a long way to go in the fight against inflation before rates around the world would start to come down.

UK inflation exceeds the Euro area where the Harmonised Index of Consumer Prices fell to 4.3% in September and the US where CPI was 3.7% in August having risen slightly from its trough of 3.0% in June. Concerns over the potential for a recession brewing in the US continue to be hotly debated, with the US jobs market being a key focus. Weaker jobs data would lead to a softer stance by the Fed in relation to future rate rises.

Equity and corporate bond markets fared generally well over the third quarter in response to falling print inflation across major economies despite a setback in the final two weeks of the quarter resulting from central banks' "higher for longer" sentiment.

Global equities managed to deliver positive returns overall despite losing ground in August and September after a strong start to the quarter in July. However, this was primarily due to the depreciation of Sterling which boosted returns and flipped them into positive territory. UK equities were broadly flat in the first two months of the quarter but fared well in September to finish the period up, spurred on by encouraging inflation data and the Bank of England's surprise decision not to increase rates further in September.

Emerging market shares fared well, despite significant concerns over China, thanks to strong performance from tech stocks which make up a large proportion of emerging economies. China's property sector woes were compounded in September by the news that the chairman of Evergrande was under police surveillance and trading in its shares was suspended. Once the world's largest property developer, Evergrande is at the centre of the real estate crisis threatening to undermine the Chinese economy. Since it first defaulted on its debt in 2021 several other Chinese property developers have also struggled in the wake of the Chinese government's zero tolerance Covid approach and tight borrowing restrictions on property firms.

UK corporate bonds benefitted from a modest narrowing in spreads over the quarter, shaking off a slump in August. It remains uncertain how the expectation of interest rates remaining higher for longer will impact companies looking to refinance their debt in the coming years. High yield bonds had a strong September to cap a stand-out quarter for an asset class that had struggled when interest rates have been rising given the increasing cost of financing putting pressure on underlying companies. However, most of this performance resulted from US Dollar appreciation relative to Sterling which fed into the global high yield index return.

The general stability of credit spreads seemingly stands at odds with observed default rates which have risen substantially for both high yield and investment grade corporate bonds this year and are expected to continue to rise in the coming months.

It was a bumper quarter for aggregate UK DB pension schemes as the combination of moderate growth asset performance and falling liabilities saw funding on a low-risk basis reach new heights again at the end of September. Long dated gilt yields rose by 50 basis points over the quarter to heights last seen during the gilts crisis, whilst inflation expectations have been relatively stable. One year on from the crisis, pension schemes are better funded than ever before and are well placed to learn the lessons from the fallout of the infamous September 2022 'mini-budget'.

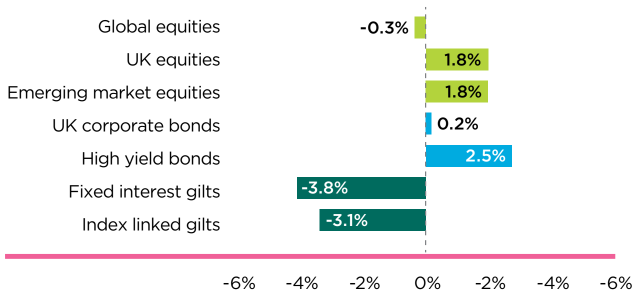
In case you missed it, **click here** to watch our recent webinar on how the LDI market has evolved since the gilts crisis.

The general stability of credit spreads seemingly stands at odds with observed default rates which have risen substantially.

Market returns

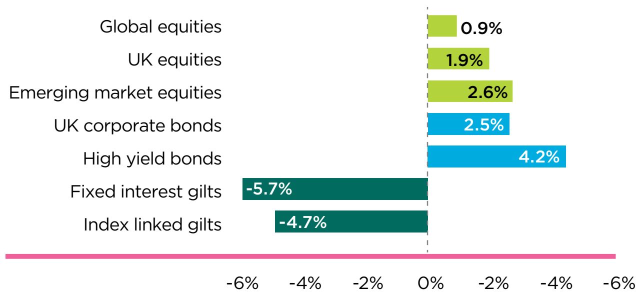
High yield bonds were the strongest performer over September and over the quarter on the whole

1 month to 30 September 2023



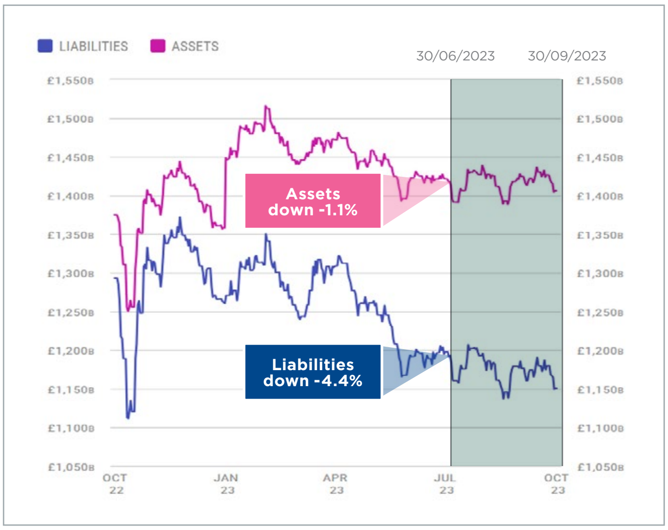
Source: Refinitiv

3 months to 30 September 2023

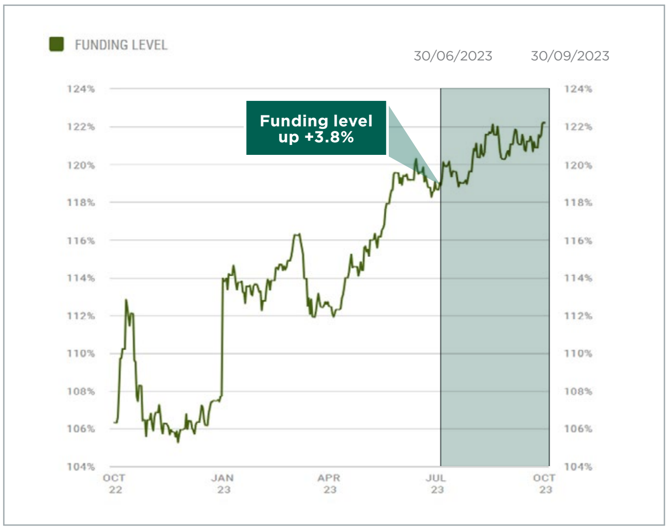


Source: Refinitiv

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 70% 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 Duncan Maloney:

Simeon Willis
Chief Investment Officer

t 020 3967 3895

e simeon.willis@xpsgroup.com

Duncan Maloney
Senior Investment Consultant

t 0161 388 3250

e duncan.maloney@xpsgroup.com

Alternatively, please speak to your usual XPS contact.

XPS Investment

Important information: Please note the information and opinions expressed herein do not take into account the circumstances of individual pension funds and accordingly may not be representative of the circumstances affecting your fund. This note, and the work undertaken to produce it, is compliant with TAS 100, set by the Financial Reporting Council. No other TASs apply. The note has been written on the basis that decisions will not be based on its contents. Appropriate advice should be obtained before any decisions are made. The information expressed is provided in good faith and has been prepared using sources considered to be reasonable and appropriate. While information from third parties is believed to be reliable, no representations, guarantees or warranties are made as to the accuracy of information presented, and no responsibility or liability can be accepted for any error, omission or inaccuracy in respect of this. This document may also include our views and expectations, which cannot be taken as fact. The value of investments and the income from them can go down as well as up as a result of market and currency fluctuations and investors may not get back the amount invested. Past performance is not necessarily a guide to future returns. The views set out in this document are intentionally broad market views and are not intended to constitute investment advice as they do not take into account any client's particular circumstances.

Please note that all material produced by XPS Investments is directed at, and intended solely for the consideration of, professional clients within the meaning of the Financial Services and Markets Act 2000 (FSMA). Retail or other clients must not place any reliance upon the contents.

This document should not be distributed to any third parties and is not intended to, and must not be, relied upon by them. Unauthorised copying of this document is prohibited.

© XPS Investment 2023. XPS Pensions Consulting Limited, Registered No. 2459442. XPS Investment Limited, Registered No. 6242672. XPS Pensions Limited, Registered No. 3842603. XPS Administration Limited, Registered No. 9428346. XPS Pensions (RL) Limited, Registered No. 5817049. XPS Pensions (Trigon) Limited, Registered No. 12085392. Penfida Limited, Registered No. 08020393. All registered at: Phoenix House, 1 Station Hill, Reading RG1 1NB. XPS Investment Limited is authorised and regulated by the Financial Conduct Authority for investment and general insurance business (FCA Register No. 528774).