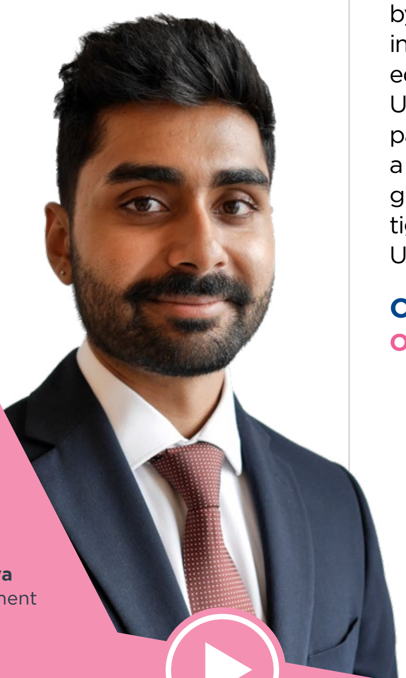
November 2023

XPS Investment News

Bringing you our market round-up and the latest news affecting UK pension scheme investments

Month in brief

- Israel-Hamas conflict escalates adding additional uncertainties to global markets
- Poor returns for global equities and bonds reflected 'higher for longer' interest rate expectations
- UK long dated gilt yields exceed heights of 2022 crisis for the first time
- Both the Federal Reserve and the Bank of England voted to leave interest rates unchanged in early November
- Aggregate UK DB pension scheme funding was largely flat in October but remains healthy



Adarsh Pandya
Senior Investment Associate

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Adarsh's November update

Deepening conflict in the Middle East compounds concerns of a nervous market

The World Bank has warned of destabilising food price increases as conflict between Israel and Hamas escalated dramatically over October. Fears of the conflict in the Middle East spreading more widely have only added to the plethora of geopolitical uncertainties currently facing investors.

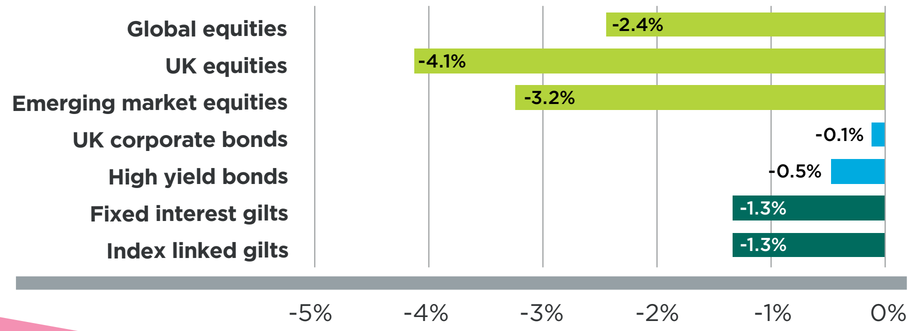
Both developed and emerging market equities experienced a sharp decline over October. Whilst of considerable humanitarian concern for all those affected, the conflict in the Middle East is unlikely to have been the primary driver of these market falls. Lacklustre third quarter earnings results in the US combined with an expectation that higher interest rates will be imposed by the US Federal Reserve – to get inflation back to target – contributed to equity markets spluttering in October. UK equities experienced even more pain than other equity markets, with a slowing jobs market and sluggish growth statistics being key signs that tight monetary policy is dragging on the UK economy.

The Federal Reserve ultimately voted to leave interest rates unchanged at their November meeting. A surge in US job creation had led to speculation earlier in the month that rates could increase once again after a pause in September. However, upwards pressure on US Treasury yields, driven by the widening US deficit, obviated the need for the Fed to raise interest rates at this meeting. The 10-year US Treasury bond yield had surged above 5% during the month before falling back slightly.

The continued sell off in global bond markets in recent weeks is widely regarded as an acceptance of central banks' 'higher for longer' rhetoric regarding the medium-term outlook for interest rates. The sell off has

October was a particularly bad month for UK equities

One Month to 31 October 2023



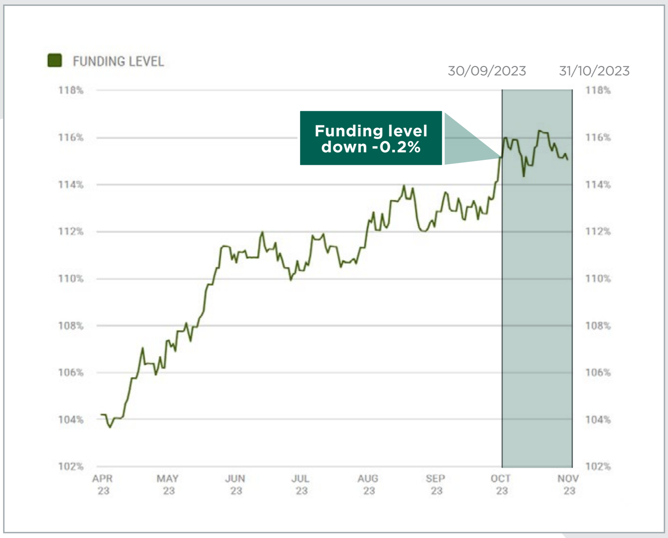
Source: Refinitiv Datastream

also witnessed long dated UK government bond yields exceeding the heights seen during the explosive gilt market crisis of 2022. Yields retreated slightly by the end of the month. The Bank of England voted to keep interest rates unchanged in early November despite inflation in the UK not reducing as quickly as seen in Europe or the US.

Elsewhere expectations are also rising that the Bank of Japan will relax its control over bond markets as the Yen hit a 33-year low and government bond yields reached a 10-year high. The central bank has been exercising an unconventional policy of 'yield curve control' – buying government bonds to hold yields below a target level – in an effort to bolster the strength of its currency. The Bank of Japan has been the only major central bank not to raise interest rates in the last 2 years despite inflation being above target for the past 18 months.

UK corporate bonds fared slightly better than equities but earned negative returns due to both rising gilt yields and rising credit spreads during October. Default rates have continued to rise over the course of the year. After a rally in the second quarter, high yield bonds also fell in October due to a moderate rise in spreads. With long-term inflation expectations unchanged over the month, fixed interest and index-linked gilts experienced a similar magnitude of losses.

The continued sell off in bond markets was again good news for aggregate UK DB pension scheme funding despite yields falling back to some extent at the end of the month. However, the poor performance of growth assets largely offset the impact on pension schemes with funding largely flat but still healthy on the whole.



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.

To discuss any of the issues covered in this edition, please get in touch with Adarsh Pandya.

Adarsh Pandya
Senior Investment Associate

t 01483 330 115 e adarsh.pandya@xpsgroup.com

Alternatively, please speak to your usual XPS Investment contact.

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