

January
2024

XPS Investment News

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

Quarter in brief

- The Federal Reserve shifted its tone from hawkish to dovish over the quarter but the Bank of England and European Central Bank refused to declare victory over inflation
- Global equity markets recorded their best year since 2019 following a blistering two-month rally in the fourth quarter
- UK gilts rallied strongly in November and December causing aggregate UK DB pension scheme funding to fall
- World leaders reached an historic agreement to transition away from fossil fuels at COP28 which came to a close in December

The beginning of the end in the fight against inflation? Or still too soon to tell?

All eyes remain firmly locked on major central banks heading into 2024 as messaging over when interest rates may start to come down began to diverge over the fourth quarter. Dovish comments from Federal Reserve (Fed) Chairman, Jerome Powell, sparked a 'Santa Claus rally' for equities and bonds towards the end of the quarter.

After a languid October, the final two months of the fourth quarter were much more positive for investors. The quarter began with the US Federal Reserve warning that interest rates would remain "higher for longer" than many had hoped in the battle to quell inflation. However, by the final meeting of the year in December, Chairman Powell had declared that the benchmark rate was "likely at or near its peak for this tightening cycle". This marked a sharp pivot in messaging from the Fed over the space of just a few months and interest rate swap markets are now pricing in six rate cuts by the Fed in 2024 compared with just three at the beginning of the quarter.

However, the Bank of England (BoE) and European Central Bank (ECB) stuck to their official lines in messaging to the market that there remains a long way to go to get inflation back to their respective targets. Despite the UK Consumer Prices Index falling from 6.7% to 3.9% between September and November, and some mixed messages in November from the Chief Economist around potential rate falls during 2024, BoE Governor Andrew Bailey has left the door open to further rate rises if necessary and expects interest rates to be kept high for "an extended period of time".

Inflation in the UK remains stubbornly higher than in the EU where the Harmonised Index of Consumer Prices across the region had fallen to 2.4% by November, almost 2% lower than at the start of the quarter. However ECB President Christine Lagarde warned that "we should absolutely not lower our guard" against inflation after the ECB maintained its benchmark deposit rate at a record-high of 4% in December.

Daniel Carpenter
Partner



Click to watch
Daniel's January update

Despite mixed messaging from the major central banks over the quarter, global equity markets performed strongly over November and December and revelled in a 'Santa Claus rally' in the final trading days of the year. UK equities were also positive over the quarter but have faced stronger inflationary headwinds than most major developed economies over 2023. Revised figures in December also showed that the UK economy was on the brink of recession after GDP contracted in the third quarter of 2023.

Emerging market equities, heavily reliant on the performance of China, were positive but also lagged. China has seen significant outflows of foreign investment over 2023 due to the combination of a limping real estate sector and falling consumer and business confidence. Despite a thawing of relations with the US following the meeting of Presidents Biden and Jinping in November, geopolitical risks remain a key deterrent from the Chinese market as the Chinese government ramps up its pursuit of the reunification of Taiwan.

UK corporate bonds enjoyed a strong quarter thanks to the combination of falling interest rates and tightening

credit spreads. Global high yield bonds, highly sensitive to expectations of future borrowing costs in the US, benefitted from growing expectations of significant interest cuts in 2024. Whilst US and European high yield default rates picked up over 2023 compared to 2021 and 2022, they are currently at levels that don't look out of place compared to long term averages.

With gilt yields falling dramatically over the quarter, aggregate UK DB pension scheme funding on a low risk basis dipped as liabilities grew by more than assets. Funding continues to remain healthy in aggregate and the extent that schemes will have been negatively impacted will be highly dependent on the extent to which their liabilities are hedged.

The 28th Climate Change Conference of the Parties (COP28) summit drew to a close in the United Arab Emirates in December. Despite some controversy, and significant 11th hour redrafting, the final agreement brought new cross-country agreements around fossil fuels and sector pledges to address climate change. You can read more about the key outcomes and implications for investors [here](#).

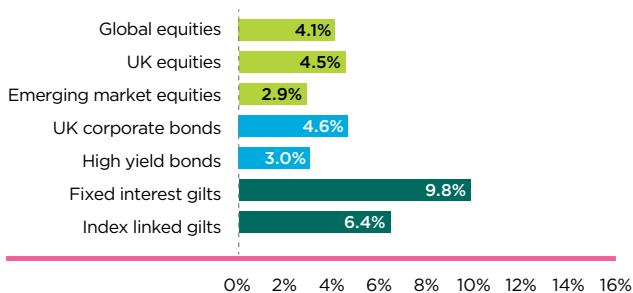


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Market returns

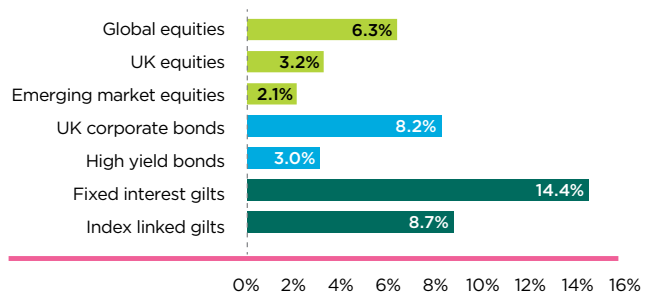
Equities and bonds performed well in Q4 driven by a rally in December

1 month to 31 December 2023



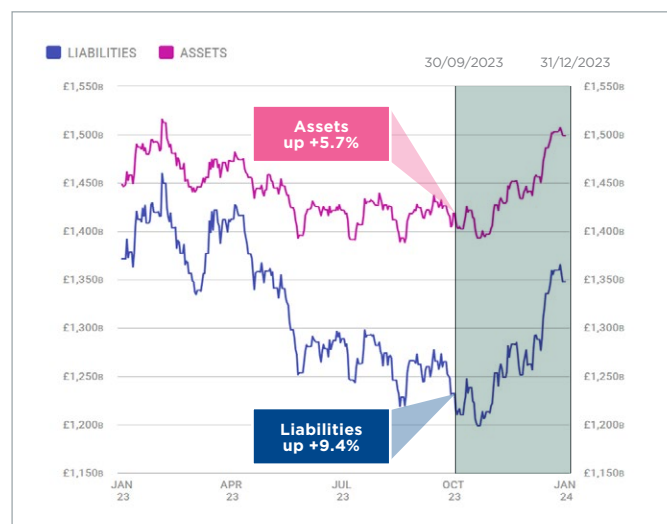
Source: Refinitiv

3 months to 31 December 2023

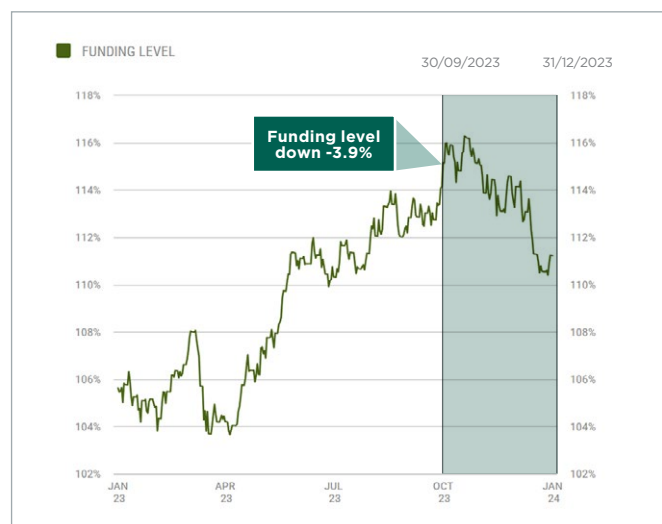


Source: Refinitiv

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 Daniel Carpenter:



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