Month in brief
- Rising infection rates outside of China have legitimately spooked the markets, with global equities falling substantially
- Gilt yields have fallen further reflecting UK specific economic stagnation and the potential for central bank intervention
- Funding levels will have been dented by the market sell off and falling yields

Coronavirus: Implications for UK Pension Schemes

In this month’s market update we look, in detail, at the impact that significant market movements, attributed to Coronavirus, have had on UK pension schemes. We also explore the related economic issues that could arise and what, if anything, schemes can do in response.

Global equity markets fell materially over February. Having remained at, or close to, record highs for the majority of the month, they finished with their worst week since 2008. This sell-off was largely attributed to increasing concerns around the impact that Coronavirus could have on corporate earnings and economic growth, globally. Energy, financials and materials stocks were significant contributors to this price fall, whilst travel and leisure stocks were also particularly badly hit.

The market’s response to Coronavirus isn’t an over-reaction to a perceived risk of widespread mortality. That remains an extremely low probability event given modern healthcare and, more importantly, the scope for governments to enforce preventative actions. However, for as long as the rate of infection continues to increase, the detrimental economic impact is likely to rise at an alarming rate, due to the knock-on implications of the implementation of increasingly widespread preventative measures.

Index linked gilts were the strongest performer over the month

One Month to 29 February 2020

<table>
<thead>
<tr>
<th>Investment Type</th>
<th>Percentage Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Index linked gilts</td>
<td>1.8%</td>
</tr>
<tr>
<td>Fixed interest gilts</td>
<td>1.2%</td>
</tr>
<tr>
<td>High yield bonds</td>
<td>1.2%</td>
</tr>
<tr>
<td>UK corporate bonds</td>
<td>-0.8%</td>
</tr>
<tr>
<td>Emerging market equities</td>
<td>-2.0%</td>
</tr>
<tr>
<td>Global equities</td>
<td>-5.1%</td>
</tr>
<tr>
<td>UK equities</td>
<td>-8.9%</td>
</tr>
</tbody>
</table>

Source: Refinitiv Datastream
There are several distinct issues including:

1. **Lost output in China**
   Despite accounting for the greatest number of new cases globally, it appears that China has been successful in reducing the rate of new cases during February. This has been achieved through the adoption of its quarantining and contact policies, closing factories, isolating communities and confining people to their homes. Although these actions have been key to controlling the virus, they have come at the necessary cost of large scale disruption to China’s economic output. It is unclear how long these measures will need to remain in place for, and they could cast a lengthy shadow on future output from China. The OECD predicts that the closure of Chinese businesses and factories alone will dent global GDP growth by 0.5% this year.

2. **Global supply chain disruption**
   In addition to direct reduced output, there is also the compounding impact on the supply chain of other countries, hampering their productivity. Most of world trade is transported by ship. With container companies reducing sailings to China, backlogs at Chinese ports have increased. The impact of this is dependent upon a country’s reliance on China and the scale of their inventories, which varies across different industrial sectors. Sectors relying on the so called ‘just in time’ supply chain approach involving deliberately low inventory levels, such as autos and electronics, will be particularly affected.

3. **Scope for wide-spread preventative measures**
   There is a significant risk that relates to the spread of the infection outside of China, which still continues to rise at an exponential rate and is not yet under control. March will prove to be a critical month in this respect. Any region that experiences a large number of cases may need to adopt stringent preventive measures. We could have China’s story playing out in many countries, including the current areas of focus, namely Korea, Italy and Japan, among others. The US and UK are not immune to this disruption either.

4. **Central banking measures**
   China has announced various liquidity measures to support businesses in the wake of the crisis, and the Federal Reserve has cut rates by 0.5% in response to the downside risks that the spread of the disease poses. Some of the countries currently affected were struggling economically to start with, including Japan and Italy, who were both nearing recession, and this could tip them over the edge. Should the virus continue to spread, the Bank of England and ECB have both hinted at providing support if necessary, noting the exceptionally low ECB rate already in place.

5. **Unrelated global economic issues**
   Markets also face other significant challenges. Despite the bad news originating from the Emerging Markets, their equity markets fared better than the UK during February. Part of this is the flattering effect of a depreciating pound on overseas investments and part is because some of the Emerging Market losses had been experienced during January. GDP figures published showed that the British economy stagnated in the final quarter of 2019, as high political uncertainty weighed on business investment, consumer spending and manufacturing production. In this context, UK government bond yields have fallen materially since the start of the year.

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**What can pension schemes do?**

Given the combination of uncertain markets and central bank action leading to punitive cash interest rates, there is no simple answer. In this situation, pension scheme investors need to take a balanced approach to risk management and take a longer term perspective.

**Avoiding speculative risks and ensuring that scheme strategy is in line with your target allocations is a good place to start. This, however, is not a reason to take risk off the table.** Rewarded risk is the driver of long term returns and the current market concern reflects the most legitimate of rewarded risks - economic uncertainty.
Material falls in equity, coupled with a fall in gilt yields, would have led to a decrease in the funding level of a typical scheme over the month.

The typical scheme used has an assumed asset allocation of 27% equities, 34% corporate bonds, 11.6% multi-asset, 4.8% property and 22.6% in liability driven investment (LDI) with the LDI overlay providing a 50% hedge on inflation and interest rates. This example scheme was 80% funded in 2015.

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

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