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XPS Investment News

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

How long can market prices and infections rise in tandem?

Quarter in brief

- A surprisingly strong quarter for equity returns
- UK inflation falls further whilst Eurozone experiences deflation
- US election sets scene for a choppy fourth quarter

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Partner

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Nick's October update

Q3 2020 ended with the regrettable milestone that the global COVID-19 death toll had officially passed the 1 million mark. Since the falls in February and March, market prices have become decoupled from the impact of COVID on the real economy.

Continued international government and central banking policy action has propped up market prices combined with investor optimism around the anticipation of a vaccine. However, during September other global risks re-gained the attention of investors, including ongoing Brexit trade talks and the upcoming US Presidential election.

Global equities achieved strong positive returns over the quarter. Whilst the market experienced a loss over July, large gains over August and a marginal gain over September led equities into positive territory for Sterling investors. Equity volatility remained elevated throughout the period and in early September concerns also arose in relation to the elevated stock price valuations of technology stocks.

UK equities have fared much less well with falls over the September and the quarter as a whole.

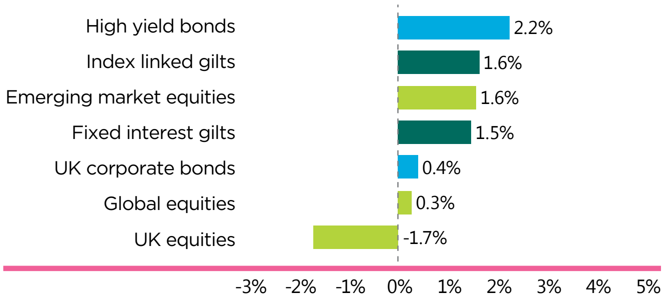
In the US, a political stalemate has prevented the implementation of fresh fiscal stimulus, but the Federal Reserve boosted its monetary response to the pandemic, projecting no interest rate increase until at least the end of 2023. Options markets have been pricing in an expected rise in the level of volatility around the 3rd November US election, with scope for considerable disruption, for instance if Biden were to win but Trump refused to recognise the outcome as being legitimate due to reliance on postal votes.

Emerging market equity prices have picked up, despite the worrying momentum that has been observed in terms of confirmed COVID infections in India, Brazil and Russia in particular. China has seemingly conquered the virus; it has very low levels of reported infections and GDP has picked up, reporting positive growth over the 12 months to 30 June. However, there is scepticism over the reliability of the infection data and some doubt that the virus could have been overcome so comprehensively.

Market returns

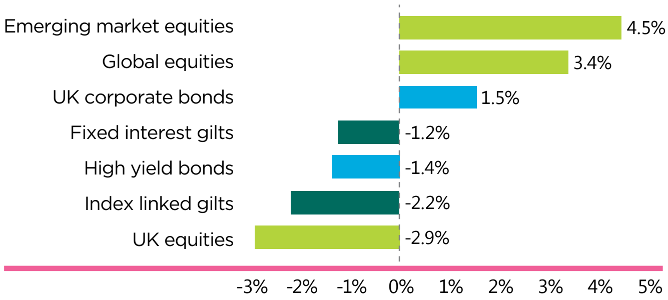
Asset returns ranked from highest to lowest

1 month to 30 September 2020



Source: Refinitiv

3 months to 30 September 2020



Source: Refinitiv

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UK unemployment figures released in September showed that the unemployment rate has started to rise but the expectation is for it to rise considerably more once the furlough scheme ceases at the end of October.

The UK Government introduced a new Job Support Scheme that will replace the furlough scheme when it ends. This changes the nature of support from targeting those who cannot work at all, to those who can work but only a fraction of the hours they would have normally.

The UK's pivotal trade talks with the EU hang in balance after Parliament passed the internal market bill. The bill compromises the UK's existing withdrawal treaty with the European Commission, potentially leading to a no-deal exit from the EU.

Investment grade and high yield corporate bonds both benefited from reduced risk aversion with spreads (i.e. the additional yield over a comparable government bond) reducing over the quarter, albeit rising slightly in September. In contrast to this some areas still offer elevated spread levels, including the Asset Backed Securities market, representing a potential area of opportunity.

Fixed interest and index linked gilt yields have remained suppressed. The scope for the Bank of England to use negative interest rates has been an area of great focus, with the bank rate currently at 0.1%.

Long term inflation expectations have not shifted materially unlike near term inflation which has fallen well below the Bank of England's 2% target.

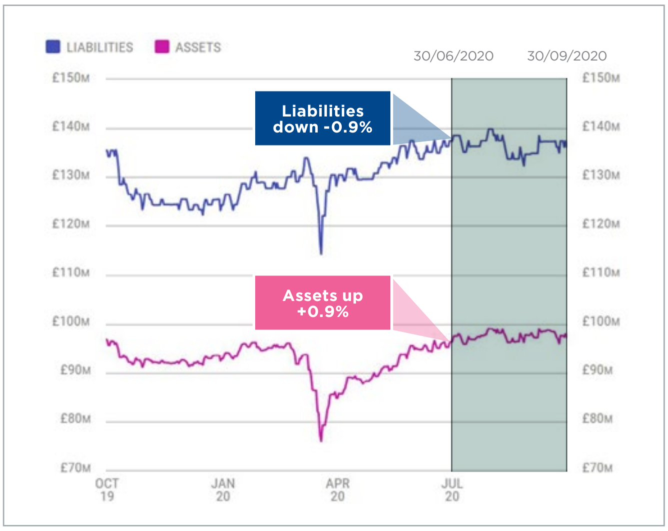
CPI Inflation reduced to 0.5% for the 12 months to end of August. This reflects 6 months of largely flat prices combined with prices falling during August. This fall may be attributed in part to measures such as the 'Eat Out to Help Out' scheme and a VAT cut for restaurants and hotels, amongst other sectors. Eurozone inflation slipped into deflation in August for the first time in 4 years.

The consultation on UK RPI reform closed for responses in August and we await developments, noting considerable industry support for a 'CPI + fixed wedge' method which would potentially be fairer overall than what has been tabled to date.

The funding level of a typical pension scheme would have increased over the quarter, owing to positive asset performance which outweighed relatively flat liability movements.

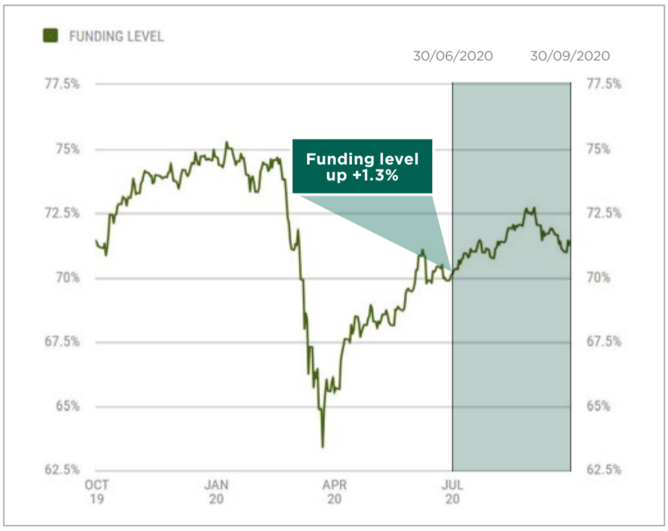
Long term inflation expectations have not shifted materially unlike near term inflation which has fallen well below the Bank of England's 2% target.

Funding level progression for typical scheme



Source: XPS Radar

Asset and liability progression for typical scheme



Source: XPS Radar

The typical scheme used has an assumed asset allocation of 24% equities, 33.8% corporate bonds, 12.6% multi-asset, 5% property and 24.6% in liability driven investment (LDI) with the LDI overlay providing a 60% hedge on inflation and interest rates. This example scheme was 80% funded in 2015.

XPS Investment asset class views

Asset class	Favourable	Neutral	Unfavourable	Movement
Developed equities			●	
Emerging market equities			●	
Investment grade corporate bonds	●			
High yield bonds		●		↑
Private debt		●		
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 Nick Harvey:

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