January
2021

XPS Investment News

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

Quarter in brief

- UK agrees post-Brexit trade deal with the EU, avoiding 'no-deal' cliff edge
- Countries begin immunising their populations against COVID, providing hope that the end of the pandemic is in sight
- Joe Biden defeats Donald Trump in the US elections and is set to become US President

Adam Gillespie
Partner

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Adam's January update

Markets rally to cap off one of the most extraordinary years in history

The last quarter of 2020 painted a mixed backdrop for global economies, but despite this, most investment markets delivered positive returns.

Having returned negatively over October, equity markets performed well over the last two months of the quarter to finish it with strong positive returns. This was particularly true for November, with the promise of a vaccine and Joe Biden's defeat of Donald Trump in the US Presidential Election, global equities had their strongest month in more than 10 years. Emerging market equities continued to fare well and outperformed developed market equities over the period.

Over the year, both global and emerging market equities finished with double digit returns, rebounding strongly from their March lows. UK equities on the other hand, had their worst year since 2008, losing 9.8% over the period.

A post-Brexit trade deal between Britain and the EU was announced the day before Christmas, meaning that the 'no-deal' cliff edge feared by UK businesses was avoided. Whilst the deal ensures no tariffs or quotas on most goods, the deal is limited in scope given that it is focussed on the export of goods only, and does not cover services. Most businesses expect a significant increase in red tape and HM Revenue & Customs estimate that the customs declarations required will cost businesses £7bn a year in new paperwork. Sterling hit its highest level of the year against the dollar on the final day of 2020 after the deal was approved by MP's, which will have detracted from the returns on overseas investments for UK investors who haven't currency hedged.

Global economic output will again have been materially dented by the tightening of COVID restrictions over the period, but markets largely focussed on the positive sentiment associated with, firstly, the announcement that effective vaccines have begun to be rolled out at pace and, secondly, the significant further stimulus measures announced by governments and central banks.

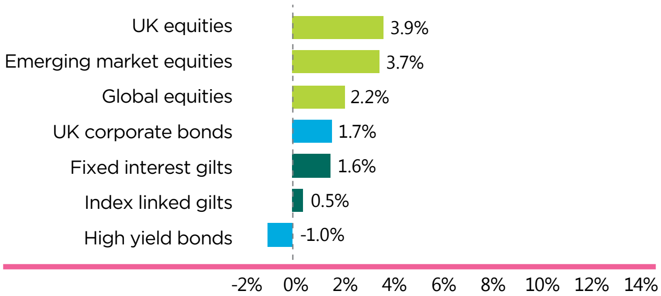
This further stimulus included:

> the UK Government extending its furlough and emergency loan schemes and the Bank of England extending quantitative easing;

Market returns

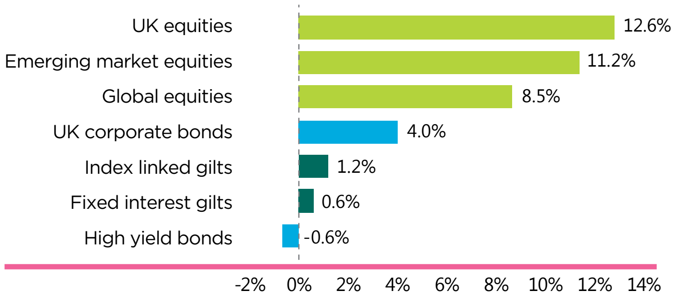
Asset returns ranked from highest to lowest

1 month to 31 December 2020



Source: Refinitiv

3 months to 31 December 2020



Source: Refinitiv

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> in the US, Congress agreeing a new $900bn stimulus package and the US Federal Reserve extending its debt purchases programme, agreeing to keep buying at least $120bn of debt per month for the foreseeable future; and

> in the EU, the ECB promising to buy €500bn more bonds and increasing the size of its pandemic emergency purchase programmes.

Investment grade corporate bond markets were flat over October but returned positively over November and December leading to a strong positive return for the quarter. Sterling investment grade corporate bond spreads are now generally lower than they were at the beginning of 2020. High yield corporate bonds also benefitted from a sustained narrowing of spreads but currency detracted from returns to sterling investors. Some areas of credit markets still offer attractive spread levels, including Asset Backed Securities and private credit markets, representing areas of potential opportunity.

Fixed and index-linked gilt yields oscillated materially over the quarter but ended not far from where they started. The conversation around the potential for negative interest rates in the UK has continued.

In late November the Government announced that it is to proceed with aligning the Retail Price Index ('RPI') with the Consumer Price Index including owners' occupied housing costs ('CPIH') from 2030 onwards. It appears that the forward looking market level of RPI already reflected this news well before the announcement. Paradoxically, this lead to schemes with CPI linked benefits suffering from a sharp rise in their CPI assumption, as the market level of RPI did not step down to offset the reduced expected 'wedge' between RPI and CPI from 2030 onwards.

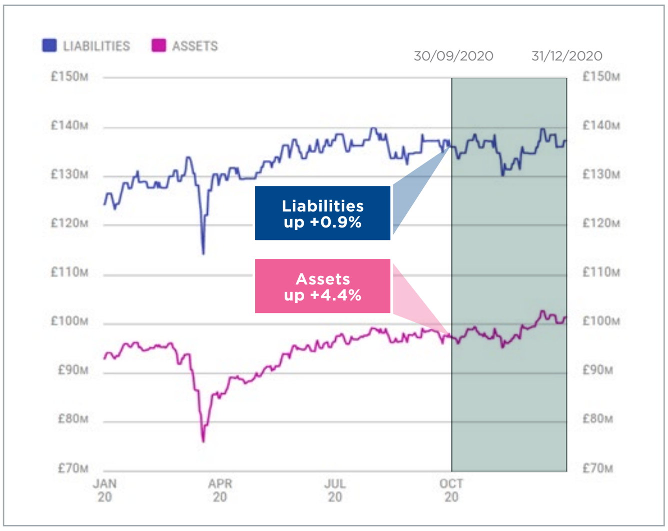
The funding level of a typical pension scheme would have increased over the quarter, owing to strong positive asset performance which outweighed positive liability movements.

As attention turns to 2021 concerns are expected to increase over the longer term impact of the significant levels of government support extended this year and corresponding rise in global debt levels, and how businesses will fare when this support gets removed.

Over most of last year we witnessed a market largely dislocated from the challenging real world that we have all been experiencing. For the coming year, once the vaccine has been rolled out more widely and as daily life hopefully improves, the scope for the markets to see matters differently remains ever present. XPS retains an unfavourable view on a lot of risky asset classes particularly developed market equity and property, but sees opportunities in some more niche areas of credit.

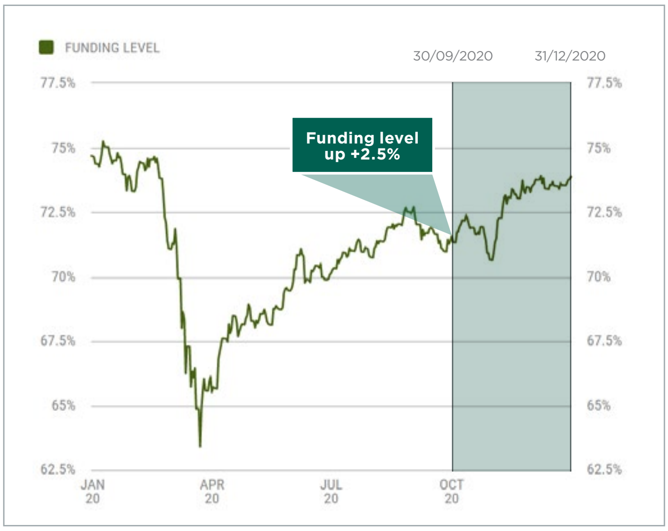
Over most of last year we witnessed a market largely dislocated from the challenging real world that we have all been experiencing. Looking to 2021 there is scope to see dislocation in the other direction, where daily life improves but market returns disappoint.

Asset and liability progression
for typical scheme



Source: XPS Radar

Funding level 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 Adam Gillespie:

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