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XPS Investment News

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

Quarter in brief

- **Global developed equities performed strongly over Q4 despite the discovery of Omicron, but emerging market equity performance lags**
- **The Bank of England raised the Bank rate to 0.25% to stem high inflation**
- **Gilt yields ended the quarter lower despite a sharp rise in December**

Adam Gillespie
Partner

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Adam's January update

Choppy gilt yields put pressure on pension scheme funding levels

Global developed equity markets ended the quarter strongly and appeared to brush off the short-lived late-November market pull back related to 'Omicron', a new COVID-19 variant.

Corporate earnings released in October highlighted continued corporate strength and resilience, particularly in the US where 82% of companies beat Q3 2021 earnings expectations, and economic data released was generally supportive, including employment data, where data for both the UK and US surprised on the upside. November's Flash Purchasing Managers Index survey indicated that the world's largest developed economies continued to grow at above-trend rates in the fourth quarter, albeit activity levels had decelerated slightly.

Risk markets sold off materially at the back end of November. Developed equities experienced their largest daily fall in over a year and credit spreads widened, reflecting an increased risk of default. However, during December expectations surrounding Omicron's threat appeared to ease, resulting in the third consecutive year of double-digit returns for developed equities.

Whilst COVID-19 cases globally continue to sky-rocket, hospitalisation numbers have yet to follow suit and initial data seems to support material vaccine and antibody effectiveness in helping people fight the virus.

Supply-side headwinds including rising energy prices, labour shortages and supply chain bottlenecks have been a consistent theme throughout 2021 and remained a feature in the fourth quarter. Combined with strong wage growth and consumer demand, these issues continued to push inflation higher over the period. 12-month UK CPI inflation hit 5.1% in November, its highest rate for a decade, Eurozone inflation was 4.9% in November and US CPI inflation hit 6.8%, its highest rate for nearly 40 years.

There's been a marked shift in language used by central banks away from use of the term 'transient' inflation, which was losing credibility given the likelihood of it not going away of its own accord. As a result, many central banks have communicated their intention to reduce crisis-era stimulus and tackle, what they now consider to be, more persistent inflation.

Key central bank policy changes announced over the quarter:

UK – Bank of England

- Raised interest rates from 0.1% to 0.25% at its December meeting, a month later than expected by the market, in its first increase in more than 3 years

US – Federal Reserve

- Expected to raise interest rates 3 times next year to leave them at between 0.75-1%
- Scaled back the size of its asset-purchase programme by $15bn a month in November. Expected to cease purchasing new assets by June 2022 although could be sooner

EU – European Central Bank

- Ruled out raising interest rates next year
- Plans to scale back its crisis bond-buying but committed to continue asset purchases for at least 10 months

Emerging market equities materially lagged developed market equities over the quarter. The emergence of Omicron is likely to have a larger impact on emerging market countries given their lower vaccination rates and expectations of higher US interest rates are likely to continue to impact foreign investment in emerging market stocks and bonds, particularly those that have borrowed heavily on international and domestic markets to fund their pandemic response.

In bond markets, credit spreads were relatively flat for the first part of the quarter, however they widened sharply upon initial Omicron fears in November. Since then investment grade credit spreads have tightened only slightly and remain around 0.1% higher than they were at the beginning of the quarter. High yield credit spreads tightened more sharply from their mid-quarter highs and ended the quarter below the level they started the period.

November saw world leaders meet in Glasgow at COP26 and agree a range of pledges which aim to limit global temperature rises. Whilst significant progress was made, for many the outcome fell short of expectations. That said, the price for carbon emission allowances increased by a staggering 27% over quarter 4, indicating that it will become increasingly expensive to emit carbon dioxide and other greenhouse gases going forwards.

Carbon Offset Credits

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As of 1 January 2022, the Sterling Overnight Index Average ('SONIA') replaced the London Inter-bank Offered Rate ('LIBOR') as the industry standard sterling benchmark reference rate. A replacement was required for LIBOR given its manifest shortcomings that emerged following the financial crisis in 2008. LIBOR will continue to exist but can no longer be used for new contracts.

Both fixed interest and index-linked gilt yields fell over October and November, subsequently rising sharply over December but still ending up lower over the quarter as a whole. This will have negatively affected pension scheme funding levels and introduced substantial funding level swings during the quarter for less well-hedged schemes. Consequently the estimated aggregate funding position of UK DB pension schemes on a long-term target basis fell over Q4 2021.

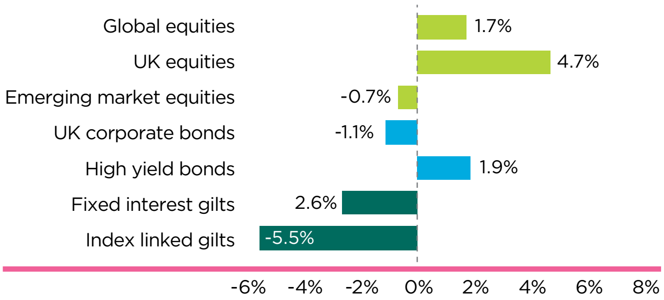
As attention turns to 2022, the primary focus is how central banks will thread a delicate balance between managing inflation and supporting the economy and jobs.

Underlying global growth remains strong but headwinds exist, particularly around supply-side issues, monetary policy tightening and inflation. XPS retains an unfavourable view on developed market equities, primarily driven by our view on the US where valuations are stretched, and see better value in emerging markets. However, our outlook generally remains modestly upbeat and we see various pockets of opportunities, particularly in credit asset classes and those that exhibit an inherent illiquidity and/or complexity premium.

As attention turns to 2022, the primary focus is how central banks will thread a delicate balance between managing inflation and supporting the economy and jobs.

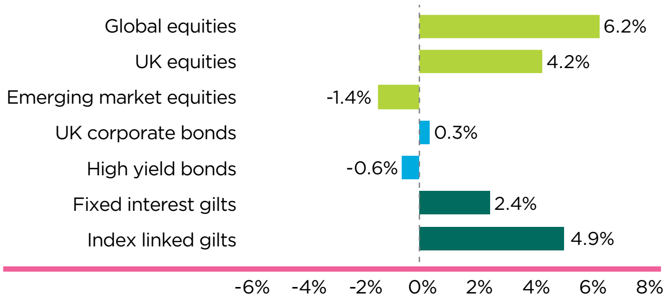
Market returns

1 month to 31 December 2021



Source: Refinitiv

3 months to 31 December 2021



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 60% 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		●		
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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