

April
2022

XPS Investment News

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Quarter in brief

- Equity and bond markets experience wild price swings, reflecting a prominent concern around Russia's invasion of Ukraine
- The Bank of England opted for back-to-back interest rate rises to combat the highest inflation rate seen for 30 years
- The US yield curve inverted, which has historically signalled an upcoming recession



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Simeon's April update

Russia's invasion of Ukraine compounds a volatile start to the year for markets

The quarter's news flow was dominated by the harrowing images coming from Ukraine following Russia's invasion towards the end of February. This rapidly deteriorating situation, combined with an already unsettled backdrop for the global economy, led to turbulent moves in markets, both up and down, highlighting the unpredictability of markets.

Following the invasion on the 24th February, the extent of the wider global direct and indirect economic impact of the war became more evident. Western economies announced a raft of unprecedented financial sanctions on Russia's economy, including the removal of several Russian banks from the SWIFT messaging system and sanctions on Russia's central bank and foreign exchange reserves. Russian companies' debt and equity have been removed from many global investment benchmarks as a result. The impact was further amplified by companies voluntarily distancing themselves from Russian corporate activity reflecting a higher degree of stewardship ethics than might have been witnessed in the past.

Russia has moved to try and support its economy, demanding that European importers of Russian natural gas pay in Roubles going forwards. It remains to be seen whether this attempt at supporting the Russian currency will ultimately work for Russia, although the Rouble's value has largely recovered from the dramatic falls witnessed in late February and early March.

Global equities dropped off sharply during the week or so following the invasion, but they had largely recovered these losses by the end of March. European and Emerging Market equities were the hardest hit but UK equities, which started the year with lower valuations than other regions, fared better.

It is impossible to predict how the situation will play out from here but markets appear to be coming to terms with the current situation. Whilst economic activity is expected to continue being disrupted, potentially to an even greater degree than currently, equity markets have recovered much of their losses.





The regions most affected include European economies which have close links to Russia and Ukraine, and those countries in northern Africa, Asia and the Middle East that rely heavily on wheat imports, of which Ukraine and Russia are large producers. Investors also remain wary of the slowdown in China's economic growth. This was heightened by a surge in Covid-19 cases in the country over March, which has led to its largest city, Shanghai, to be put into lockdown.

The war has compounded existing headwinds the global economy faced as the new year came in, such as supply-shortages, sky-rocketing inflation and slowing economic growth. One such example of this is rising commodity prices, which have put material upward pressure on inflation. The domestic price of energy in the UK has risen by 54% following the rise of the energy price cap in April.

A further important economic factor has been monetary policy. Central banks and governments moved to tighten policy more aggressively than previously expected to tackle surging inflation.

The Bank of England (BoE) raised interest rates at both Monetary Policy Committee meetings over the quarter, moving from 0.25% to 0.75% over the period, as inflation reached a 30-year high of 6.2% over the 12 months to February 2022. The Office for Budget Responsibility has predicted that CPI will rise to almost 9% by the end of 2022.

BoE and US Fed rate rises

BoE **increased**
benchmark interest
rate to

0.75%

US Fed **increased**
its benchmark
interest rate target
range to between

0.25% and 0.5%

High inflation is not just a local issue for the UK, 12-month US inflation reached 7.9% in February. The US Federal Reserve ('Fed') increased its benchmark interest rate for the first time since 2018, bringing the target range to between 0.25% and 0.5%, and with expectations for six further increases this year. EU inflation reached 7.5% in March and the European Central Bank indicated a policy shift towards monetary tightening but remains further behind in its tightening cycle than the UK and US.

The US yield curve 'inverted' over the last couple of days of March, meaning that the yield available on short term Treasury bills exceeds that of longer maturities. Typically, a US recession has followed an inversion of the US yield curve and it's considered a forward-looking indicator. Traditional backward-looking signs of economic activity remain robust however, so recession is far from inevitable.

Credit spreads widened materially, reflecting heightened risk aversion amongst investors. Inflation is largely unhelpful for corporate earnings as suppliers grapple with a rising cost base.

A combination of rising inflation and expectations of further meaningful tightening of monetary policy led to a marked increase in long dated gilt yields over the quarter. Whilst index-linked gilts outperformed their fixed interest counterparts, as inflation expectations rose over the period, this was more than offset by the rise in yields leading to sharp losses for both fixed and index linked gilt assets. However, this is generally a positive development for pension schemes, driving a significant fall in the value of UK DB pension scheme liabilities over the quarter.

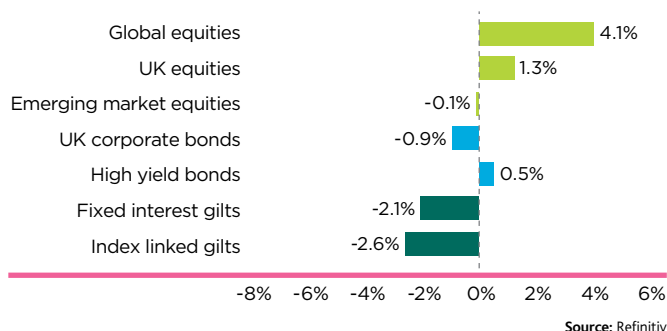
The combination of asset and liability movements has resulted in an improvement in the estimated aggregate funding position of UK DB pension schemes, as the fall in liability values was greater than the fall in asset values.



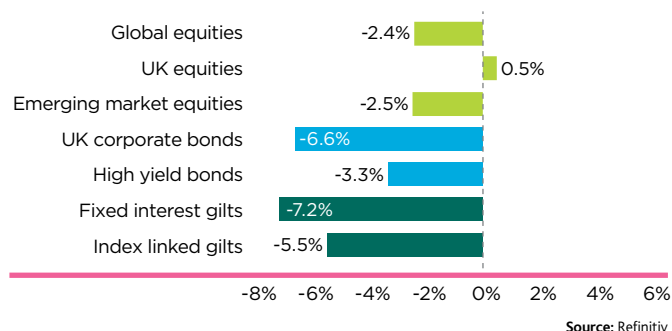
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Market returns

1 month to 31 March 2022



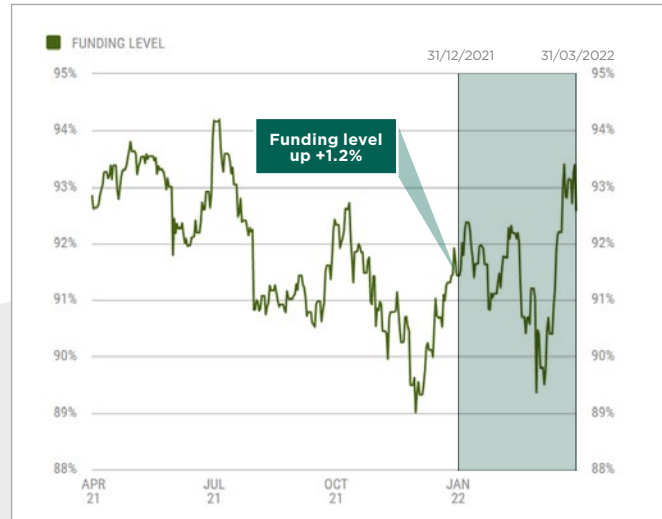
3 months to 31 March 2022



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 Kerry Foxall:



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