Investment trends

What may be in store for investment markets in 2024? Sandra Haurant finds out

Summary
- The past year or so has brought high interest rates and inflation, and a crisis in LDI.
- In 2024, we'll continue to see the effects of those events, with DB schemes far better funded now than in recent years.
- While markets are pricing in interest cuts, some forecasts suggest they may simply remain stable and only fall towards the end of the year.
- Falling inflation will bring a welcome change – but the legacy of high rates will continue to put pressure on DC schemes.
- The real estate sector could face challenges, with the potential of mezzanine investment making a comeback.
- ESG will continue to be a primary focus for schemes, becoming more crucial as they shift away from cutting carbon and towards impact investment and stewardship.

It's been a dramatic couple of years for pensions, with notable moments including a crisis in liability-driven investment (LDI) and record-breaking rises in interest rates. And this year promises its own share of important events. The US presidential elections are on the horizon and a General Election in the UK is on its way, too. Predictions are always difficult to make, but if there's one thing that can be safely said about 2024, it's that it will be a busy one for politics. But what else is in store for the markets and how will schemes fare?

Stability for interest rates

What goes up must come down – one day. But when it comes to interest rates, how soon will that day come? For now, the jury's out. "Markets are broadly pricing in early and frequent cuts to interest rates in 2024," says Payden & Rygel London managing director, Robin Creswell. "In our view, this seems premature; the market seems to be testing central bankers' resolve on this point, whilst central banks need to bolster their authority, as the guardians of low inflation."

In fact, says Creswell, on a six-month view, a further interest rate increase is still possible, even if it remains unlikely. And if rates do not rise, that does not mean they will necessarily come down: "Market participants appear to believe that the corollary to rising rates is falling rates, whereas a period of rate stability seems more consistent with ensuring the work of central banks is done," he adds.

Economic analysts Capital Economics agree; the firm expects the Bank of England to cut interest rates in late 2024, while it anticipates the US and ECB making cuts closer to the middle of the coming year.

Whatever happens, the effects of 2023's steep rate rises will linger on for some time in the pensions world. "The 5 per cent rise in Bank of England policy rates since December 2021, and similar increases in bond yields, have transformed defined benefit (DB) schemes out of all recognition," says Mercer partner and investment consultant, James Brundrett. Schemes, he

says, are now "better funded, with over 25 per cent in surplus and around 40 per cent smaller in size on aggregate," while average scheme maturity has fallen from 17 to 12 years.

It's not all down to rising bond yields, though – decreasing longevity and an older population have also played a part, Brundrett says, adding: "We see 2024, as a year when there will be more conversations about running schemes on, and the appropriate asset allocations and funding policies for delivering maximum value to all stakeholders."

Falling inflation

As for inflation, after stubborn highs, Mercer anticipates the consumer price index (CPI) "to fall back towards the 2 per cent target over 2024 and beyond", but when it comes to the defined contribution (DC) sector, Brundrett says heightened inflation of the past few years "will continue to cause significant drag on real returns delivered to DC members in most default options (now feeding through to annualised five- and seven-year figures)". As a result, Brundrett says: "In terms of the outcomes members are projected to receive in retirement, salary growth or inflation will be what matters most for those currently in their early or mid-career."

Highs and lows

When it comes to investment, one area that will continue to appeal to schemes is the top end of the bond market, says Capital Cranfield professional trustee, Mark Hedges, speaking in a personal capacity. "High-grade bonds are likely to be in demand, given current yields, and as DB schemes close in on buyout and attempt to create portfolios that reflect generic insurance companies' holdings."

At the other end of the scale, Hedges anticipates a tricky time for property – potentially opening the door to mezzanine investment (essentially a combination of debt and equity financing). "If the bottom of the real estate cycle has been reached, then perhaps the opportunity for mezzanine investors opens up," Hedges says. "In a market where loan-to-values (LTVs) have fallen and senior lenders are lending less and equity investors can't bridge the gap, the mezzanine investors can dictate whether deals happen or not and can control transactions; this worked well post-global financial crisis and maybe provides an opportunity, but investors will need to be very selective."

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ESG for all

The climate crisis has brought the importance of environmental, social and governance (ESG) into sharp focus, and emphasis for pensions has shifted from reducing the carbon footprint of a portfolio towards using funds to make a real impact on the world's survival chances, through impact investment and stewardship.

"The climate crisis is one of the most fundamental challenges the global economy faces, and despite recent momentum, action to tackle the climate crisis has so far been insufficient," says Cardano head of sustainability UK, Keith Guthrie. "As a result, climate change is now a widely established and socialised concept within financial markets, both as a financial risk due to transition and climate-related risks, and an investment imperative because of the way in which capital will support (or hinder) climate targets."

Within the UK, new financial developments are emerging in response to the crisis, such as biodiversity credits – a financial mechanism designed to help protect natural habitats. Capital Cranfield professional trustee, Bobby Riddaway, speaking in a personal capacity, says their introduction should "lead to more development of permanent meadows and nature parks across the UK, with a number of asset managers launching funds in this area".

Regulatory evolution will also put the pressure on firms to behave and to invest more responsibly. "The second wave of Taskforce on Climate-related Financial Disclosure reports for the largest schemes, and the first wave for the rest of the £1 billion schemes, will be published and then reviewed by The Pensions Regulator (TPR). This, combined with the launch of the recommendations of the Taskforce on Nature-related Financial Disclosures and the Taskforce on Social-related Financial Disclosures, offer the opportunity to look at sustainability reporting as a whole," says Riddaway.

These developments may be a gamechanger, he adds: "I really hope that we quickly get to a position where all pension schemes can report on sustainability and then concentrate their ESG efforts on engagements and stewardship."

But there is a need for more, and better, information. "ESG is going to continue to be an area firms are focusing on, as investments are aligned to achieve climate goals. However, there is a lack of data in the market to aid in decision making. We are seeing progress, but more work needs to be done," Brundrett says. "We expect more DB schemes to assign their climate objective investments, if they have not done so, and we expect to see a broad range of investments across credit portfolios to help the transition to net zero."

Written by Sandra Haurant, a freelance journalist