Time for trustees to rethink fixed income?

There is always a lot on trustees' agendas. Funding levels, covenant risk, ESG issues, endgame planning and more are undoubtedly keeping schemes busy. But is fixed income asset allocation opportunity on the agenda?

In our view, now is the time to put fixed income back on the trustee agenda.

In recent years, record low interest rates have left investors feeling there is no alternative (TINA) to investing in risky assets such as equities in the search for yield and growth. However, TINA may be falling out of fashion as an asset allocation strategy.

For underfunded pension schemes, increasing equity exposure to generate returns has tended to be the preferred route to help close the funding gap. However, we think now is the time for UK pension schemes to revisit fixed income allocations, with fixed income offering improved returns compared to recent years while equity investors appear more and more concerned about higher inflation and slowing growth impacting company earnings.

Stagflation risks abound

Until recently, the case for equities was overwhelmingly strong, following the TINA narrative. Significantly higher inflation across the globe and the recovery in growth since the pandemic have driven central banks to tighten monetary policy. Good news for scheme liabilities (depending on hedge ratios, of course) but how long might this last?

Inflation is high across the board with the United States, Europe and emerging markets also facing significantly rising prices. But the story is different for each of these cases when you look at what is actually driving inflation. In the US, it's a classic story

of domestic demand pressures after the pandemic, wage pressures spilling over into the broader economy, a financing gap that has to be closed and oil prices rising significantly.

In Europe, however, it looks more like a classic supply-side shock. The output gap is still not closed but there are few signs of wage pressures hitting the broader inflation picture despite the spectacular rise in energy prices. Perhaps that is why the European Central Bank appears less hawkish than its US counterpart.

For the UK, stagflation risks abound, as noted in May's Monetary Policy Committee meeting. Despite voting through a 0.25% hike (with a third voting for 0.50%), the committee warned of 10% inflation rates and potential for a UK recession by the end of the year. Stagflation, sadly, is a central bank's worst-case scenario and the Bank is already struggling with two conflicting dynamics – fighting high inflation but also coping with worsening growth. Right now, the Bank of England is targeting inflation, but it could end up switching focus to growth sooner than the market expects.

Fixed income may benefit

In better news, we believe there are three main reasons for fixed income investors to remain positive.

First, while rate normalisation has been brutal and volatile, it could prove to be a positive long-term development. Long-term investors needed this rise in rates to make fixed income attractive again. One of the big constraints they faced was that yields were way too low, resulting in shifts into riskier assets to generate the returns required to meet scheme funding objectives.

Second, the market has already priced in a lot of future hikes, with some 150 bps of further tightening currently factored in over the next year. With the growth outlook becoming more uncertain and markets more volatile, it is increasingly questionable whether the Bank can deliver this level of hikes.

Third, some of the inflation spike caused by Covid-19 disruptions may prove to be temporary. With a slowdown of inflation coming through the removal of temporary shocks, there is a case to argue that some of those rate hikes are going to be priced out. While inflation is likely to get worse before it gets better, the impact of the disruptions will eventually recede. How long this takes will strongly influence the pace and size of future tightening. At some point, we may see the Bank switching from an inflation-fighting strategy to a growth-inducing one.

What does this mean for asset allocation? At the time of writing, for the first time in years, bond yields have risen above equity dividend yields in the US. We are not there yet in the UK, but the gap is closing. Alongside the lower volatility of bond returns, this may make fixed income more attractive than equity on a risk-adjusted basis. Given the higher allocation to equities compared to history, rebalancing portfolios favours a higher fixed income allocation which would likely help to manage portfolio volatility. This is good news for maturing schemes looking to de-risk their portfolios, whether they have an insurance or self-sufficiency endgame.

Attractive entry point?

From an asset allocation perspective, no longer is there no alternative to equities, as value is being restored in fixed income.

In our view, we believe now is a good time to consider (re)allocating to fixed income. Fixed income valuations have improved materially and are likely viewed as attractive for long-term investors. For instance, yields on UK investment grade corporate bonds have not been as high since early 2016. In addition, we believe the probability for further UK interest rates increases is lower than it was earlier in the year given the growing concerns over stagflation. Once we see some stability in interest rates, we may see the market adjust their expectations on future interest rates, which may benefit the fixed income total return outlook.

Of course, while pension scheme liabilities have benefitted from higher rates, the asset side for schemes with a significant equity allocation is likely to have deteriorated due to the recent drop in equity prices. That said, if the stagflation environment worsens, it may well prove to be more detrimental to equities than fixed income now that rates have risen well above their lows. For schemes that have been tactically overweight equities, it could be worth looking into rebalancing into fixed income.

Where do we see value from a return-generating perspective? European fixed income has been particularly hard hit, with value starting to appear across investment grade and high yield. Emerging market debt also shows some attractiveness, although prices have already come back to some extent.

It's been a busy year already and there's a lot on trustees' agendas. Is it worth adding fixed income to that agenda as we are starting to see 'income' returning to fixed income?

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