Adapting to meet a lower growth outlook

Derek Steeden and Paul Jackson consider how pension schemes' investment portfolios can respond to the changing economic environment

Following a year characterised by inflation, aggressive central bank hiking and geopolitical turmoil, it was clear to many that the outlook for 2023 would hinge on inflation. Specifically, had it peaked? And, if so, when would central banks start slowing, pausing and ultimately reversing rate hikes.

Some of the challenges in the banking sector underscore the policy tightrope that central banks face: They must think as much about financial stability as inflation. Further tightening means the risk of an earlier and potentially deeper recession. But if central banks do not hike rates, inflation moderation going forwards may not be satisfactory enough.

In turn, this would force the resumption of a more aggressive and/or lengthier tightening cycle, which could threaten financial stability further, prolonging the time before an economic recovery could start.

It will be 12-18 months before we know for sure whether the central banks got it right. In the meantime, an estimated £60-90 billion of defined benefit pensions will have been paid, a similar amount transferred to insurance companies and £30-50 billion new defined contribution assets invested[1]. How can pension schemes adapt?

Our base case scenario

Our views on asset allocation reflect our thinking that we're now in the 'contraction phase' of the economic cycle. The global economy, simply put, is entering a period in which economic output declines.

We think the US Federal Reserve interest rates will likely be lower in 12 months (even if they rise in the meantime), European rates little changed and that major Asian policy rates could be marginally higher.

Underpinning our projections for the next 12 months are the following views:

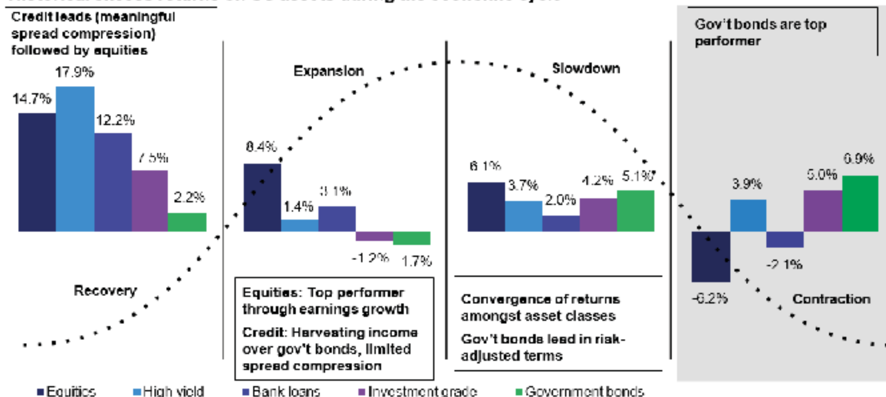
- Global economic growth continues to slide, with China an obvious exception
- Global inflation will fall but remain above many central bank targets
- Commodities struggle as the global economy slows (except agricultural products)
- The US dollar weakens as the Federal Reserve ends its rate increases

In this contraction environment equities have historically struggled, with government bonds performing strongly, closely followed by investment grade assets. Should recessionary concerns rise and interest rate expectations fall, defined benefit schemes' funding gains will fall and bulk annuity pricing rise (all else equal). Defined contribution members seeking to buy an annuity could see the income they can purchase fall from a combined equity fall and bond gain, with the impact more mixed for funds in steady state with a diversified mix of assets.

Alternative scenarios

We see three other potential challenges that could up-end our base case.

Historical excess returns on US assets during the economic cycle



Notes: Index return information includes back-tested data. **Returns, whether actual or back tested, are no guarantee of future performance.** Annualised monthly returns from January 1970 – December 2021, or since asset class inception if a later date. Includes latest available data as of most recent analysis. Asset class excess returns defined as follows: Equities – MSCI ACWI – US T bills 3 Month, High Yield – Bloomberg Barclays HY - US T-bills 3-Month, Bank loans – Credit Suisse Leveraged Loan Index – US T-bills 3-Month, Investment Grade – Bloomberg Barclays US Corporate – US T bills 3 Month, Government bonds – FTSE GBI US Treasury 7-10y – US T bills 3 Month. For illustrative purposes only.
Sources: Invesco Investment Solutions' proprietary global business cycle framework and Bloomberg LP

[1] *Source: Office for National Statistics as at 31 September 2021*

1) Deeper financial stability issues

The prolonged period of low interest rates shaped how many investors, especially some banks, measured risk. Resulting decisions will have been many and varied, but a common theme is that large and sudden changes in interest rate expectations were simply not in the data set – whether smaller US banks deciding not to hedge duration risk when investing customer deposits or pooled LDI funds when setting governance processes.

The US now has additional deposit guarantees to stem bank runs and the Bank of England have issued their advice on higher LDI liquidity buffers. But we suspect these may be a case of learning too specifically and central banks may not have foreseen all potential problems.

2) Persistent inflation

Our view that inflation is likely to moderate could be wrong. Limited and specific trade barriers such as semiconductors, grain and oil could become more widespread and permanent if geopolitical tension in Eastern Europe and between the US and China deepen. Aggressive interest rate hikes could become unavoidable despite the recessionary impact. We believe such a dramatic scenario would benefit the US dollar and US assets. We suspect that Asia (including China and Japan) could be sheltered to some extent under such a scenario due to their low inflation, thus allowing their equity markets to outperform.

In this scenario, exposure to real assets will be important. Index-linked gilt yields have risen dramatically in the last 12 months and now offer positive real returns at some maturities. Nevertheless, most DC and DB schemes aspire to growing assets above inflation. Real estate is a key source of real returns, but careful thought to the fund vehicle used is essential to manage liquidity risks as well as ensuring the client base is not overly concentrated towards pension schemes who might wish to exit at the same time.

3) Challenges around diversification

2022 may have been a poor year for traditional diversification, with a 60/40 equities/bonds portfolios having the worst annual performance for a century to October 2022. But we may not be out of the woods yet – if a second wave of interest rate hikes in 2024 do turn out to be required to tame inflation, bond and equity returns could again be simultaneously challenged.

In this environment, alternative investment strategies may be needed to enhance portfolio diversification, by increasing exposure to alternative sources of returns such as specialist underwriting, investment in harder-to-access fields or smaller enterprises.

For portfolios in decumulation, a close focus on sequencing risk is vital. Portfolios which continue to pay out through negative performance struggle to recover as the lower residual balance must work harder to recover the loss. Cash and short-duration investment grade assets are clearly a key part of the toolkit, but they are unlikely to keep pace with inflation and can simply bring forward the time at which losses are crystallised. Holding bonds to maturity can provide material defence against sequencing risk as mark-to-market movements are not crystallised, allowing the credit spread to be earned to maturity.

Whatever the future holds, we expect to see continued focus on appropriate governance for this new world, with a greater focus on simplification, specialisation and collaboration between stakeholders.

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In association with

Investment risks

The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested.

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