November 2022

Broken Britain?

Having had three Prime Ministers and four Chancellors this year, the Sunak/Hunt partnership offers a degree of stability as we head towards Christmas. That said, Downing Street remains a poisoned chalice as a pending recession and fragile political unity offer limited policy latitude to the incumbents. The fallout from "Trussonomics," which culminated in the near-collapse of several large UK pension funds, will also have wider implications as global policymakers and investors learn lessons from the turmoil.

Until recently, few people had heard of "liability-driven investing" (LDI) and fewer still understood the significant role it plays in the UK's £2 trillion defined benefit (DB) pension industry. That all changed after Kwasi Kwarteng's 23rd September "mini-budget" in which he pledged £45bn of unfunded tax cuts. This followed hard on the heels of the household energy price cap, a two-year Government commitment to limit the impact of sharply higher energy prices. This open-ended subsidy to consumers and businesses was estimated to cost over £90bn or 3% of GDP (source: Cornwall Insight).

With the UK economy heading towards recession, pro-growth policies could have merit. However, the timing of the tax cuts, which heavily favoured higher earners, was political suicide given the growing number of Brits facing financial hardship. In addition, the lack of detail over how the support package would be funded spooked markets that were already wrestling with 10% inflation and elevated sovereign borrowing. Kwarteng's proposals risked driving the UK government debt-to-GDP ratio to a crippling 100% and beyond.

Investors recoiled from this ill-considered assault on the UK's creditworthiness and credibility, prompting a collapse in sterling. On 26th September, in overnight Asian trade, the pound briefly flirted with parity against the US dollar. It touched a 40-year low after a 24% peak-to-trough loss for the year. UK bond markets were similarly roiled, with gilt yields surging at an unprecedented pace; the 30yr yield spiked from 3.5% to 5% in just a few days, triggering a 30% price loss. It was

this seismic decline in traditionally “safe haven” assets that brought many of the UK’s 5,200 DB pension funds to their knees.

DB schemes pay their retired members an annual pension depending on the employee’s length of service and their final salary. They began using LDI strategies about 20 years ago to protect against falling interest rates. Lower bond yields pose a twin threat to DB providers. They reduce the cashflows from the fund’s bond investments and they raise the present value of the defined payouts to retirees. Pension liabilities are valued by discounting future pension payments back to a present value, using a discount rate. This rate is linked to the relevant UK gilt yield. As yields fall, the present value (or cost) of future liabilities rise (and vice versa). As bond yields fell over the last 20 years, this left DB schemes in deficit; they did not have enough assets to cover their future pension commitments. To remedy this, they sought greater contributions from their corporate sponsors and embraced higher risk/return investments, with LDI strategies being a prime example.

LDI involves the pension fund buying an interest rate swap to gain a derivative-based exposure to UK gilts. Via the swap the pension fund receives a fixed rate payment from the derivative counterparty, for a set period of time that matches their future liabilities. In return they pay out a variable rate (based on prevailing market yields) until the swap matures. In a falling rate environment, the swap can be highly profitable. The added bonus for the pension fund is that the swaps typically employ three times leverage, meaning they can buy £100 worth of gilt exposure using just £33 of capital. The surplus capital can then be invested in other, riskier assets in pursuit of higher long-run returns; a trait that became increasingly valuable as QE drove bond yields to multi-decade lows. This “hunt for yield” also encouraged pension funds to embrace alternative, illiquid assets like commercial property and private equity, which in turn used leverage to amp up returns.

LDI schemes also help by neutralising interest rate volatility; another key attraction for pension fund managers. If bond yields rise, the swap value falls, as the pension fund pays out a higher variable rate than the fixed rate it receives. However, the higher yield also reduces the present value of the fund’s future liabilities by an equal amount, as a higher discount rate is applied to future pension payments. In orderly markets, the net impact of rising or falling bond yields should be nil.

The problem occurs when bond yields rise quickly, as they did in late September. In this instance, the swap value fell dramatically, triggering margin calls that required the pension fund to transfer additional capital to the swap counterparty (typically a large asset manager or an investment bank). Although the commensurate fall in the value of future liabilities offset the declining swap value, a chronic cashflow imbalance emerged. The benefit of lower future liabilities is many years away, whilst the need to honour margin calls was immediate.

Pension funds were thus forced to panic sell assets to meet cash calls. They ditched their most liquid holdings, including gilts and index-linked bonds, but this sparked a negative spiral. As bond prices fell (and yields rose), the swap contracts declined further, triggering more margin calls and even more bond sales.

Although other assets, like equities, corporate bonds and commercial property funds came under pressure, this UK sovereign debt “doom loop” forced the Bank of England (BoE) to step in to prevent a complete collapse in bond prices and the inevitable economic damage that would follow. As we

have often noted, with such a grossly over-indebted economy, growth is very sensitive to the cost of capital.

Just days before it was due to commence its quantitative tightening program (selling the bonds held on its balance sheet) the BoE U-turned, pledging to buy up to £65bn of long-dated gilts and index-linked debt. In addition, the BoE allowed pension funds to join the commercial banks in accessing its repo facility, which enables institutions to pledge their bond holdings as collateral with the Central Bank in exchange for short-term cash loans; we expect this facility to remain, forming a key source of pension fund liquidity. By moving fast, the BoE helped to restore order. Indeed, it only had to buy £19bn worth of bonds before the emergency program ended in mid-October. UK gilts have since recouped all of their “Kwasi crash” losses and sterling is trading back above U$1.10.

So what can we learn from this debacle? As rates rise, risks to financial stability are clearly intensifying and many over-leveraged investors will buckle. Any asset or investment strategy that relies on short-term debt appears vulnerable, with property and private equity particularly exposed. On a more positive note, the BoE’s intervention reinforces our long-held view that, despite all their hawkish rhetoric, Central Banks will act if markets become dysfunctional or the monetary “plumbing” ruptures. As further fragilities are exposed and the real economy continues to slow, there are now signs that the global rate tightening cycle is drawing to a close.

Finally, the turmoil in UK currency and bond markets piques our interest; many sterling assets now screen as cheap on various long-term valuation metrics. UK straight and index-linked gilts are more attractive after their near-death experience. Pension funds are keen buyers at current yields, no doubt reassured by the BoE’s willingness to intervene whenever the need arises. Similarly, the pound is cheap on both a purchasing power parity and real effective exchange rate basis, although this will not make it immune to any meaningful global market fracture or geopolitical upset. The US dollar remains the ultimate currency haven.

As for UK equities, past bear markets saw cheaper valuations at the lows, tempering any blanket enthusiasm. However, the mid and small cap indices are now down 25-30% from their late 2021 highs, with multiple underlying names looking attractive for the patient, long term investor. This is doubly so for dollar-based investors, given the slide in sterling. Indeed, with private equity funds sitting on vast amounts of “dry powder”, M&A activity is likely to pick up as we head into 2023.

Policy Matrix Summary

The matrix below is a summary of our current 12-24 month outlook for the various equity, bond and commodity markets that we monitor. It shows areas where we are either positive or negative; for all other asset classes, we have a neutral view. It is not intended as anything other than a high-level guide on where we stand at this time.

12-24 Month view	Overall	Equities	Bonds	Alternatives
+	Alternatives	Gold Miners China A Shares UK Small Companies Japan ESG & Impact funds	Inflation-linked US Treasuries	Gold, Volatility Strategies
–		European US	European Japanese	

All performance numbers show % changes except for bond yields which show yield changes.

	31st Oct 22	-1 Mth	-3 Mth	-12 Mth
CURRENCIES (VS USD)				
GBP	1.1469	2.7%	-5.8%	-16.2%
CHF	0.9987	-1.4%	-4.9%	-8.6%
AUD	0.6399	0.0%	-8.4%	-14.9%
JPY	148.7100	-2.7%	-10.4%	-23.3%
EUR	0.9882	0.8%	-3.3%	-14.5%
BOND YIELDS (10 yr)				
UK	3.51	-0.58	1.65	2.47
US	4.05	0.22	1.40	2.50
Germany	2.14	0.03	1.33	2.25
Australia	3.76	-0.13	0.70	1.67
Japan	0.24	0.00	0.06	0.15
EQUITIES				
US. S&P 500 (USD)	3,871.98	8.0%	-6.3%	-15.9%
UK. FTSE 100 (GBP)	7,094.53	2.9%	-4.4%	-2.0%
MSCI Eur ex UK (Local)	1,432.05	7.1%	-4.6%	-15.6%
Japan. Topix (JPY)	1,929.43	5.1%	-0.6%	-3.6%
China. Shangai Comp (RMB)	2,893.48	-4.3%	-11.1%	-18.4%
HK. Hang Seng (HKD)	14,687.02	-14.7%	-27.1%	-42.1%
Australia. All Ords (AUD)	7,054.81	5.6%	-1.7%	-7.6%
MSCI Pac ex Jap (USD)	1,143.28	0.5%	-13.2%	-24.2%
MSCI World (USD)	2,547.72	7.1%	-7.2%	-19.8%
MSCI World (GBP)	2,221.59	4.0%	-1.6%	-4.3%
COMMODITIES				
Oil (WTI)	86.53	9.9%	-7.8%	21.3%
Gold	1633.56	-1.6%	-7.5%	-8.4%

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Authorized and regulated by the Financial Conduct Authority, registered office 29 Queen Anne's Gate, London SW1H 9BU. Registered Number 07602886

Published and distributed outside the UK by **Bentley Reid & Co Limited**
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