PENSIONS INVESTMENT OUTLOOK

Challenges and opportunities

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Chris Iggo
AXA IM CIO, Core Investments,

Key points

- Driven by inflation fears, monetary policy will normalise during 2022, creating a challenge for portfolio allocations. Trustees may consider locking in gains as support is withdrawn
- This process could see the emergence of higher bond yields, which may prompt some to pursue a rotation out of equities and into higher-yielding credit
- Pent-up demand and the potential for moderating energy prices mean there may be some upside to the economic growth outlook
- The secular trend in real interest rates suggests a limited upside for bond yields. A cyclical peak in US Treasury yields between 3% and 4% would seem likely
- Megatrends like de-carbonisation, digitalisation and social responsibility will be disruptive to many industries, creating long-term growth opportunities

There are several uncertainties in the economic and market outlook that are important for pension funds. The most significant of these revolves around interest rates and whether the global economy is strong enough to cope with further potential COVID-19 related disruptions.

In comparison to, neither the global economy nor financial markets will receive the same kind of policy support this year. Central banks are already indicating a desire to 'normalise' monetary policy which in turn will reduce the space that governments have available to them to finance deficit spending.

As such, the stellar returns from global equity markets of the last two years are not likely to be repeated. Pension schemes have benefitted in their growth portfolios from these strong market returns. In many countries, this has improved funding ratios. At the start of 2022 trustees might want to consider locking in these gains.

> **"The central outlook for this year is for higher real and nominal bond yields reflecting the shift to a tighter global monetary stance and higher inflation expectations"**

Regarding the outlook for interest rates, there are numerous factors at play. The pandemic has disrupted the global economy by more than was originally thought when policymakers responded quickly to the lockdowns in early 2020.

Since then it has become clear that production and distribution and many parts of the services sector have been impacted by bottlenecks, supply shortages and ongoing staff shortages. The upshot of this has been a rapid increase in inflation. The severity of the rise caught central bankers by surprise – particularly as they had been trying for several years to engineer somewhat higher levels of inflation. Now the challenge is to set monetary policy accordingly when it is not clear whether today's inflation is transitory or potentially longer lasting.

Tightening policy and asset re-allocation

The latter now looks more likely. As such, monetary policy is set to become tighter. This is the message already received from several central banks including the Federal Reserve, the European Central Bank, and the Bank of England. The timing of rate increases in the US and the Eurozone is still somewhat uncertain, but it is increasingly clear that, at least in the US, the first rate hike will come sooner than any of us thought a few months ago.

Alongside higher rates, central banks are withdrawing from asset purchases. This could impact liquidity in bond markets, helping push real yields higher and corporate credit spreads wider. When we also consider that inflationary expectations have also increased, the result will be higher bond yields across the maturity spectrum.

Higher – rather than lower – bond yields might be good news for many pension-fund trustees and certainly active schemes will have the opportunity to invest in fixed income at higher yields over the coming months. Some re-allocation out of equity buckets into higher yielding credit is a trend we are potentially going to see in 2022, particularly for more mature and well-funded schemes.

Where inflation indexing is an issue, inflation-linked bonds are likely to continue to be attractive. As an asset class, inflation-linked bonds were one of the best performers within fixed income in 2021 and could continue to lead the way this year. Nominal bonds are at risk from central bank tightening.

However, there remains something of a bond conundrum. Given how quickly and how far inflation has risen over the last year, long-term bond yields remain low by historical standards. Just taking the example of the US, even if inflation settles down in the 3% to 4% range later in 2022, in the past that has been associated with much higher yields than those that marked the beginning of the year.

Rising yields

Once central banks stop buying bonds and rate hikes are delivered, bond yields should move higher. However, we must keep in mind that the secular trend has been for very low bond yields which could be related to demographics, reduced underlying economic growth and uncertainty about the future related to global factors like the pandemic and climate change.

Nevertheless, the central outlook for this year is for higher real and nominal bond yields reflecting the shift to a tighter global monetary stance and higher inflation expectations. The impact on corporate bonds is likely to be wider generic credit spreads. This also depends on what happens to global growth and equity market performance.

Economists continue to point to significant global potential demand and the need for industries to re-build inventories and re-purpose supply chains. Moreover, if energy prices do start to moderate, this will help household and corporate cash-flow. As such then, there remains some upside to the economic growth outlook even if there are more uncertainties. A year ago, it was all about fighting the pandemic.

Today, it is still about that as the risk of new variants of the COVID-19 virus has become very clear. But it is now about fighting inflation too. History tells us that bouts of inflation tend to end with aggressive monetary tightening and a subsequent shock to economic growth. With that risk in mind, the ability of global equities to deliver the kind of earnings growth seen since 2019 needs to be questioned. At the same time, higher bond yields shift the relative valuation between equities and bonds and could potentially require some de-rating in equity markets.

The longer-term view is a little clearer from an investment perspective. A multi-year wage price inflation spiral is unlikely in my view and the secular trend in real interest rates suggests that the upside for bond yields is somewhat limited. A cyclical peak in US Treasury yields between 3% and 4% would seem likely. Meanwhile, mega-trends like decarbonisation, digitalisation and social responsibility will be disruptive to many industries, creating long-term growth opportunities in equity markets.

The most pressing is the need to decarbonise the global economy and pension funds have a role to play in how capital is allocated and how they engage with their asset managers and investee companies. Green bonds offer the attractions of fixed income's risk profiles with the opportunity to finance the green transition and are likely to continue to grow rapidly as an allocation within pension funds of all kinds across the world.

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