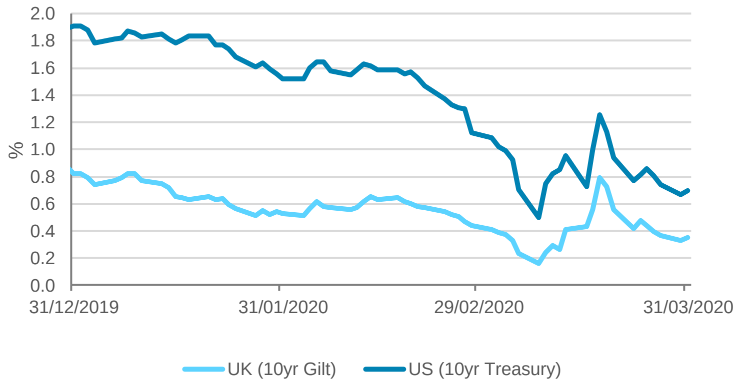
# Market Update as at 31 March 2020

Over the month of March, it was hard to avoid the financial consequences of coronavirus with all but the most secure asset classes (government bonds and gold) falling in value. However, conditions improved significantly over the final days of the month and further information is provided in this briefing.

**Gilt Yields**



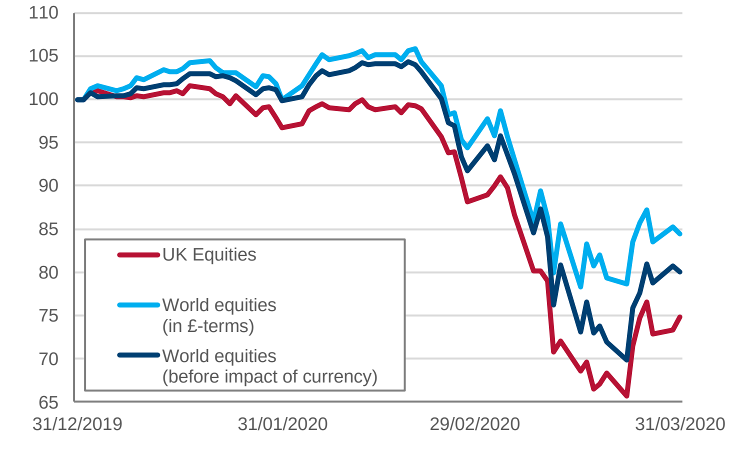

Gilt yields fell steadily over the first few weeks of the year - until 9 March whereupon conditions changed rapidly.

As equity markets crashed, many investors had to pay margin calls on derivatives and there was a sell-off of all liquid assets including government bonds. This resulted in gilt yields increasing dramatically, forcing the Bank of England (BoE) to take action.

On 19 March, the BoE cut interest rates to an all-time low and announced a huge programme of quantitative easing, which calmed the gilt market.

Global bond markets followed a similar pattern.

**Equity Markets**




As at 23 March, UK equities had fallen by 35% and World equities by 30% since the start of the year.

As investors took reassurance from the co-ordinated action being taken by central banks and governments, equity markets then bounced back strongly. UK and World equities both rallied by about 15% over the final days of the month.

There was a strong depreciation in the value of sterling in the middle of the month. For UK investors this currency movement acted to partially offset the impact of falling global equity values.

Investors in a currency hedged share class of global equities were subject to the full volatility of equity markets over the month.

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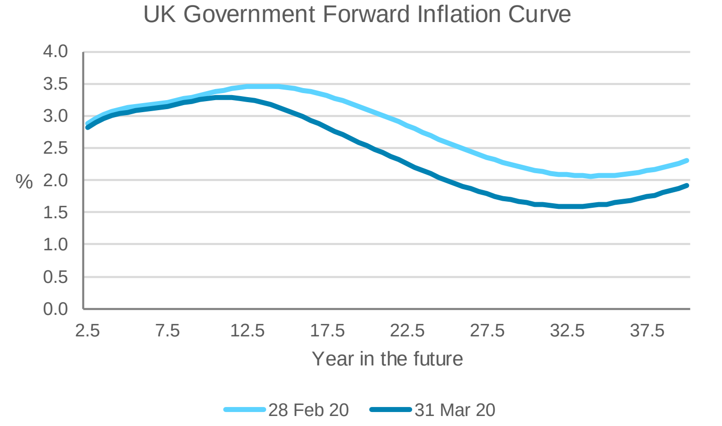
## Inflation



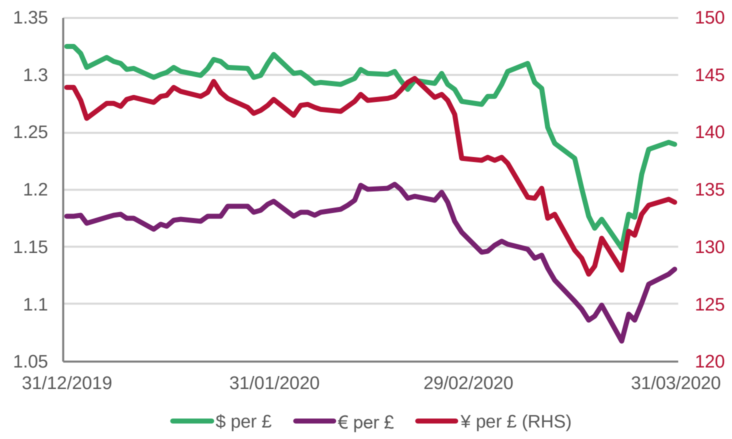

*These curves represent the expectation of future UK RPI inflation as priced into the gilt market.*

Expectations of long-term inflation fell over the course of March and this is likely to have been partly a reaction to the global economic slowdown that is now inevitable due to coronavirus.

In addition, the UK government is consulting on changing RPI in a way that would reduce future payments from index-linked gilts. Increasingly it is expected that this change will happen.

The impact of the RPI change on a scheme will depend on whether benefits are also linked to RPI or whether they are linked to CPI (which will not be changing). Many schemes have CPI linkage on deferred revaluation (shorter-term inflation) and RPI on pension increases (longer-term inflation). The impact for such a scheme is likely to be small but we recommend all schemes review their hedging position to assess the potential impact.

## Currency Markets




As investors sold liquid assets, a significant proportion of the proceeds were converted into US dollars. Consequently, sterling depreciated sharply over the first three weeks of March.

As relative calm returned to markets towards the end of the month, sterling started to regain strength. Nevertheless, against the dollar and the yen (both traditional safe-haven currencies), the pound weakened over the month as a whole.

## Credit Spreads


This chart shows the additional spread on sterling corporate bonds relative to gilt yields. The line spikes when corporate bonds are perceived to be risky.

Credit spreads increased in March 2020 as investors became concerned about companies defaulting on their loans.

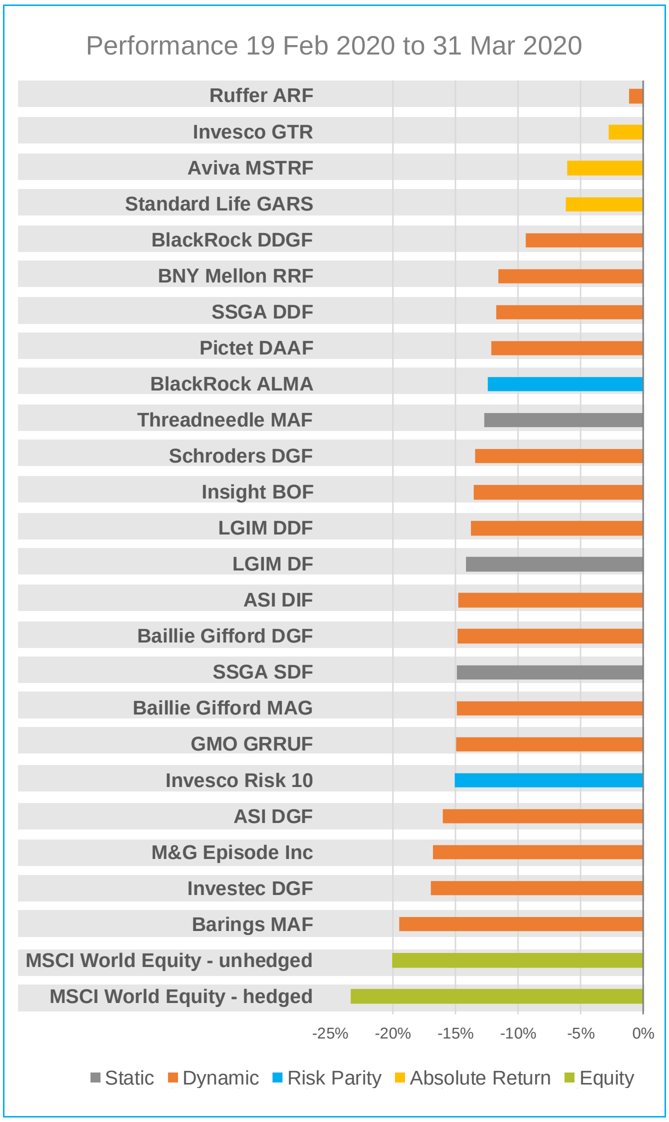
The chart starts in 2005 so that the current increase in corporate bond yields can be viewed in the context of the much larger increase that occurred during the 2008 financial crisis.

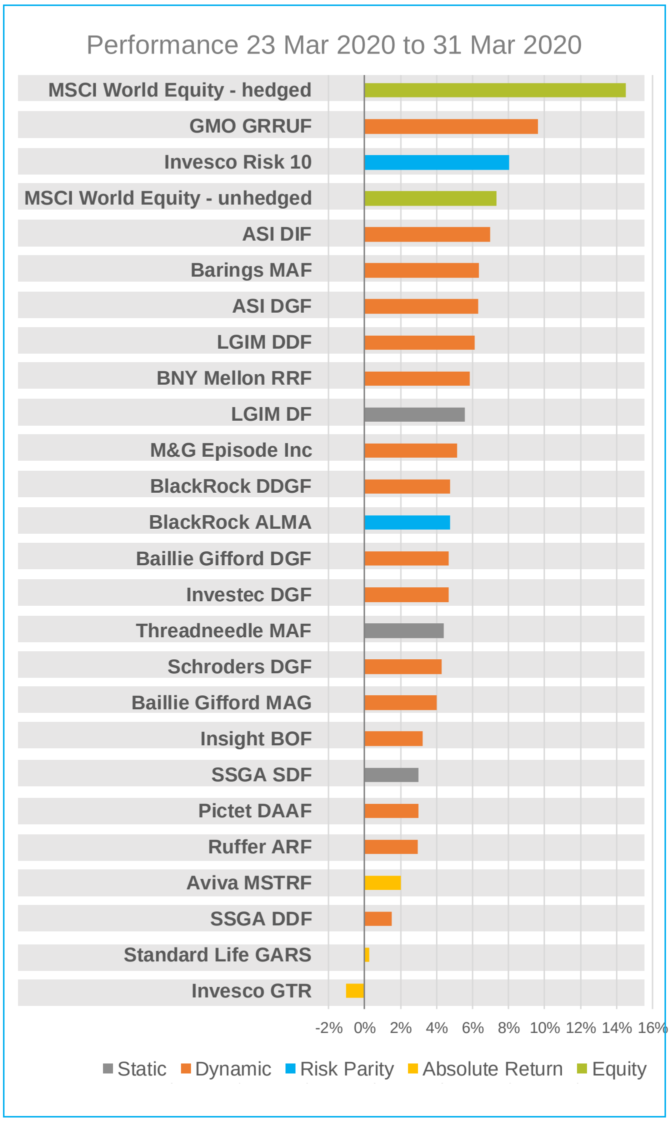
## Diversification Only Worked Initially

In the middle of March, we identified that Diversified Growth Funds (DGFs) and Diversified Credit Funds (DCFs) had held up much better than equities. Allocations to high quality bonds had helped the funds to achieve this. As gilt yields started to increase after 19 March, the performance of DGFs and DCFs started to deteriorate.

As with equities, DGF and DCF performance was positive over the final few days of the month. Although this is a very short period over which to assess performance, it is reassuring that none of the fund managers seem to have moved to such a defensive position that they missed out on the market rebound. Interestingly, the absolute return style funds, which had held up so well in the crash, were unable to generate much by way of positive returns in the more favourable conditions at the end of March.

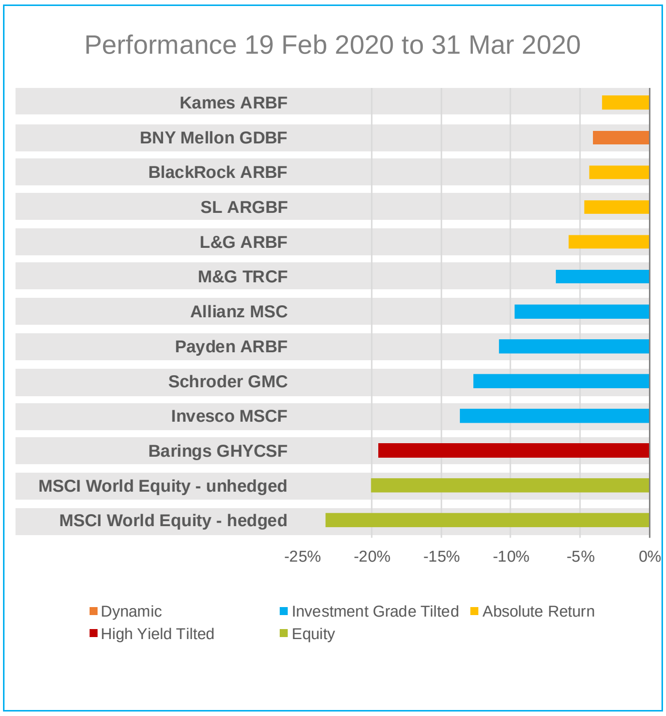
## Diversified Growth Funds

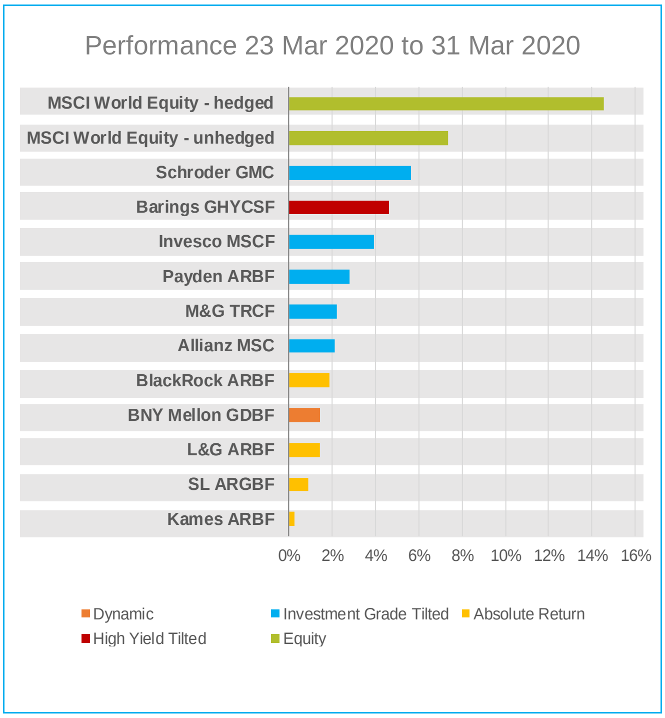



*Fund performance has been calculated from a price feed published by Thomson Reuters Datastream (the only exception being the SSGA funds where data has been sourced from SSGA's website). The performance of a scheme's actual DGF investments may differ slightly from the numbers presented in this update depending on the share class held.*

## Diversified Credit Funds




*Fund performance has been calculated from a price feed published by Thomson Reuters Datastream. The performance of a scheme's actual DCF investments may differ slightly from the numbers presented in this update depending on the share class held.*

## Liability Driven Investment Funds

The extreme volatility in gilt markets over the course of March proved to be challenging for Liability Driven Investment (LDI) funds. Many funds breached leverage rebalancing triggers but, in many cases, quickly fell back again before payments were processed.

These conditions proved to be an interesting test for LDI funds and our initial assessment is that, whilst all continued to operate as expected, the processes adopted by some managers were more robust than those of others. We are undertaking an immediate research exercise to establish the lessons that can be learned from this episode and we will be in touch with all clients who hold LDI shortly to provide a detailed assessment on our updated thoughts on the LDI market.

## Property Funds

Perhaps unsurprisingly in these volatile times, property funds are deferring all trades. However, this is not due to a clamour from investors to exit the market but rather a consequence of valuers being unable to place a value on property with any certainty. This means property fund managers are unable to establish a fair price at which to trade units.

The uncertainty over the true price of property portfolios is a consequence of:

- a lack of transactions in the property market meaning there is no up-to-date price information;
- valuers being unable to view properties due to lockdown restrictions.

Property fund managers will continue to publish prices and quarterly returns, however these should be treated with caution until normal trading conditions return. Only then will we be able to assess the true impact of coronavirus on the UK commercial property market.

We expect that, over the coming months, many tenants, particularly those in the retail and leisure industries, will request that rent is deferred. We expect that many property funds, acting as good landlords, will accept these requests particularly as supporting tenants in this way may reduce income in the short term but improve the long-term prospects for a fund.

We would expect long lease property funds, which typically have the highest quality tenants, to receive fewer requests to defer rent.

## Summary: Impact for Scheme Funding

Clearly March was not a good month for pension scheme funding. However, the impact might not have been quite as bad as imagined. The impact was mitigated by:

- Gilts yields finishing the month at similar levels to the position at the start (albeit with exceptional volatility in between);
- Inflation expectations falling;
- A strong rally in equity markets over the final days of the month;
- A depreciation in sterling acting to reduce losses on unhedged overseas investments.

With considerable uncertainty remaining as to how this crisis will evolve, we expect markets to remain volatile for the foreseeable future.

## *Further information*

For further information, please contact your usual First Actuarial investment consultant.