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BOE rate hikes, the UK mini-budget and a recession on the horizon
What should pension scheme trustees do?

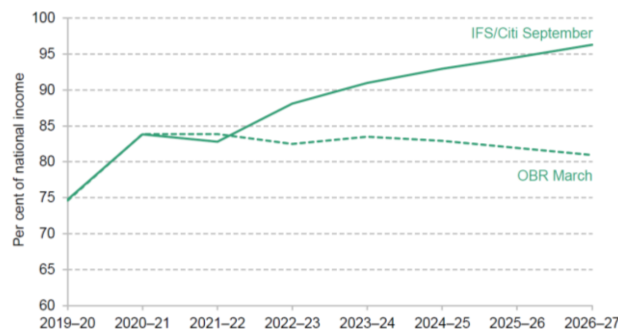
The Bank of England (BOE) raised the Bank Rate by 50 bps to 2.25% on Thursday last week. The BOE noted at the time that that the recently announced Energy Price Guarantee likely reduces and brings forward the peak in Consumer Price Inflation to just below 11% in October. The BOE's Monetary Policy Committee did however highlight that Chancellor Kwasi Kwarteng's "growth plan", unveiled on Friday in his mini-budget, would provide further fiscal stimulus to the UK economy. The BOE's November projections, which will account for the expected impact of the mini-budget will ultimately determine the magnitude of further rate hikes. Recent market projections were that the BOE would raise rates to 3.5% by the end of 2022 and as high as 4.75% by July 2023. However, if market rumours around the time of writing this article turn out to be true, there could be an emergency announcement from the BOE later this week. The intervention could just be a verbal intervention to calm the markets, or could involve an unscheduled increase in interest rates.

Both prior to the announcement of the mini-budget and post the announcement, UK gilts sold off with the 10-year bond yield hitting a fresh cyclical high of 3.88% and the 20-year bond yield reaching 4.003%. In addition the Pound Sterling has fallen from just below 1.15 to just above 1.07 to the US Dollar over the past week (with an overnight low of 1.038). The UK Gilts yield curve has also inverted which often (but not always) portends a recession within the following 18-24months.

The term "mini-budget" is somewhat of a misnomer given that the chancellor's "growth plan" is a large change in direction for macroeconomic policy. Kwasi Kwarteng announced the biggest tax cutting package since 1972 funded by borrowing at a time of high inflation. He confirmed Liz Truss's leadership campaign promises and reversed the recent rise in national insurance, cancelled the planned rise in corporation tax, and permanently abolished the additional tax rate charged on high earners. The government is also promising a wave of deregulation reforms, including planning relaxations for enterprise zones and low tax investment zones. The government's stated aim with this combination of tax cuts and deregulation is to make the UK more competitive and spur investment and economic growth.

Both the UK currency and government bond markets have reacted negatively to this change in direction of fiscal and macroeconomic policy by the government. Approaches that involve increases in government borrowing in the hopes of generating economic growth have not always worked. The government's plan is to cut taxes to boost growth and to fund those tax cuts with more government borrowing in the short term, with the higher GDP expected to increase overall tax revenue despite lower tax rates. This increase in government borrowing comes at a time when the cost of that borrowing is increasing. To illustrate this, consider that back in January the government could borrow for a 5 year period at interest rates below 1%, and that cost of borrowing has risen to 4.1% by the close on Friday. And while interest rates worldwide have risen over the course of this year, the 50bps rise in the 5 Year Gilt Yield on Friday is harder to explain by referring to what is happening elsewhere, and is largely due to the Government's new economic policies. The reason that investors are thus far judging these policies negatively, is not so much to do with the borrowing to freeze our energy bills, because at least in theory that borrowing should be temporary, but rather that on top of that the government has reversed recent personal tax and national insurance increases, and the scheduled increase in corporation tax, and introduced some additional tax cuts. Many commentators and market participants are now questioning the sustainability of the UK's public finances. This is because the last official government forecast for national debt as a percentage of national income back in March was forecast to peak just below 85%, and gradually decline somewhat over the next 5 years. However the Institute for Fiscal Studies (IFS) now forecasts that UK national debt as a percentage of national income will continue to rise to over 95% over the same period. However, despite this increased projection, the UK debt to GDP ratio remains the second lowest among the G7 countries.

UK National Debt as a % of National Income



Source: https://ifs.org.uk/publications/reversing-nics-and-corporation-tax-rises-would-leave-debt-unsustainable-path

At the same time many leading economic indicators are pointing to the possibility of a recession in the next 12 months, if we are not already in one. Tighter monetary policy, as well as low consumer and business confidence are all contributors to the gloomy outlook. Given the level of inflation and how late central banks have been in tightening monetary policy, there is a risk that they tighten monetary conditions too aggressively (i.e.. make a policy error) as they tighten into a slowing global economy. On the other hand, there is also the possibility that inflation has peaked and declines materially in the coming months, which would mean central banks can end their tightening cycles more quickly than currently expected. In this scenario financial conditions would improve, yields might move lower across the curve, and risk assets would likely begin to recover.

There is therefore the possibility that central banks engineer a soft landing, and avoid inducing a recession, or that the recession is shallow and short lived. However, the probability of a deeper recession has increased, and the confluence of a stronger dollar, tight monetary policy, and heightened geopolitical tensions may mean there is a risk that a fairly deep and protracted recession could be on the cards. The depth of a recession may however be muted somewhat by the fiscal stimulus provided by the chancellor's mini-budget. Depending on the severity of a recession, there is also the possibility that at some point the BOE resumes quantitative easing, which would also bring down gilt yields at the long end of the curve.

Given these risks, from a strategic perspective, pension trustees should be considering taking the following actions, given that now is not the time to be taking unnecessary risk:

- Recession fears may drive longer dated gilt yields lower as the market prices in future central bank cuts [and/or the return of QE]. Have you taken action to consider how you can lock in recent funding improvements by reducing risk within your portfolio?

- There will be pockets of opportunities for those that have the risk budget and the dry powder to move quickly. Do you know how much risk you are taking, and whether you have room to take advantage of potential opportunities?

- Lock in gains from foreign currency exposure. Note: Your scheme's liabilities are in pound sterling so rising gilt yields and a falling currency are both positives from a funding level perspective, and at worst neutral for UK DB schemes
- Do you have a strategic framework to take advantage of de-risking and re-risking opportunities?

- How would the employer covenant be impacted by a recession?

- Despite the volatility, the impact on equity markets has been relatively limited so far, in relation to the fall of liability values. Have you reassessed your risk appetite and any potential capital preservation options?

- Are there ways to increase your diversification across and within asset classes/geographies/risks/funds, whilst not overcomplicating your investment strategy?

- Have you recently considered your scheme's time horizon and illiquidity risk?

- What is your schemes net cashflow position, and are you in a position where you will not be a forced seller of assets to fund outflows? This is particularly important to review at the moment given that LDI leverage rebalancing events may have drained the scheme's liquid stable assets.

- Are you aware of the more attractive buy-in pricing available at the moment, and have you prepared for a potential transaction to be able to quickly take advantage of any opportunities?

In general: In a storm, opportunities present themselves. Those trustees that are engaged with their funding and investment strategy, and ready to act quickly, will come out of this in a stronger position than others. Make sure that you have a plan for how you are going to respond if and when markets do move quickly. Make sure you are in a position to ride out any short term volatility, and take advantage of any opportunities.

If you would like to discuss any of these matters further, please get in touch with your usual contact at Cartwright.

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