FOR ISSUE IN THE UK AND EU.
FOR PROFESSIONAL CLIENTS AND QUALIFIED INVESTORS ONLY.
NOT TO BE REPRODUCED WITHOUT PRIOR WRITTEN APPROVAL.
PLEASE REFER TO ALL RISK DISCLOSURES AT THE BACK OF THIS DOCUMENT.

Insight INVESTMENT

APRIL 2023

Irish PensionWatch
Q1 2023

HIGHLIGHTS

- The volatility observed in the UK government bond market during the autumn of 2022 created challenges for many UK pension schemes using LDI strategies. We outline the prevailing conditions that caused gilt yields to spike during 2022 before highlighting the properties that served some UK schemes well and which, if applied, may help bolster the resilience of Irish schemes.
- For investors seeking stable cash flows and exposure to real assets, we believe the listed infrastructure sector may offer a solution. We examine how recent changes in the sector may produce assets with greater resilience to changes in the economic cycle and how multi-asset strategies can benefit.
- The UK's progress on emissions reductions has exceeded its G7 peers, but maintaining this momentum is likely to prove challenging. Likewise, several policy gaps remain in certain areas that may lead to missed economic opportunities and impede further progress on the UK's net-zero targets, creating difficulties for defined benefit schemes holding large allocations to UK gilts.
- The rise in yields across fixed income markets created discomfort for many bond investors during 2022. However, we think compelling opportunities now exist across several fixed income asset classes. We outline our favoured trades and provide detail on less obvious allocations that we think may enhance overall portfolio resilience.
- As part of our recent Insight Summit, author and Professor of history Adam Tooze examines why the present political, economic and monetary environments seem beset by several crises, from the resurgence in inflation and macro financial turbulence, to the looming issue of political instability.

Market review and outlook

- Stronger than expected economic data led to upgrades to growth forecasts for 2023 in the US, UK and eurozone, albeit from previously low levels, while overall global growth forecasts received a boost from expectations of a release in Chinese pent-up demand following the decision to drop its zero-COVID policy. Meanwhile, forecasts for global growth in 2024 edged downwards.
- Irish government bond yields declined over the quarter, as nervousness around several banking institutions in the US and Europe during March overtook concerns about rising inflation during February.
- Although inflation is expected to decline sharply in 2023 and again in 2024, forecasts continue to edge upwards and suggest inflation remains above central bank targets.

LESSONS LEARNT FROM THE UK'S RECENT LDI ISSUES

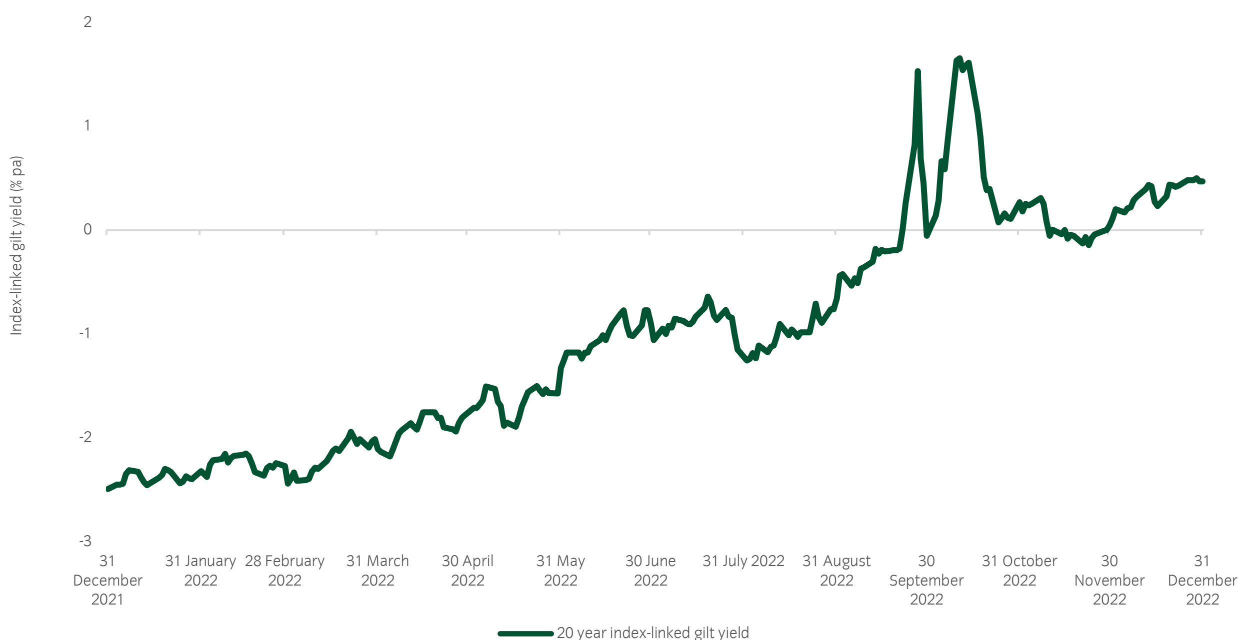
LESSONS LEARNT
FROM THE UK'S RECENT LDI ISSUES

The effect of the significant spike in UK government bond yields last autumn on UK defined benefit pension schemes using liability driven investments (LDI) created questions about the efficacy of LDI strategies.

The turbulent conditions experienced by the UK gilt market in the autumn of 2022 resulted from several factors which converged over a relatively short timeframe.

For example, a rapid rise in long dated UK government bond yields occurred as easy monetary conditions tightened over the course of 2022, such that long dated gilt yields rose by 3% during the first nine months of 2022.

Figure 1: Rising long-dated gilt yields during 2022[1]



Similarly, the Bank of England announced plans at its to begin quantitative tightening via gilt sales, to reduce the vast holdings purchased to finance the UK government's COVID-related spending. The following day, the now infamous mini budget revealed government plans to cut taxes and potentially large fiscal expenditure, requiring yet more gilt issuance in a market awash with UK government debt.

Combined, these factors created market dysfunction, with forced gilt sellers outnumbering willing buyers. As a result, many LDI funds were forced to de-lever by selling gilts into an already saturated market, thereby exacerbating the problem. Given this confluence of factors, in our view assigning blame for the market volatility to LDI schemes solely is misplaced. We believe the underlying market turbulence is better characterised as a liquidity issue rather than a specific LDI solvency problem.

That said, we think the UK's experience can prove instructive for Irish pension schemes in several ways. To read more about the outlook for Irish schemes and three core questions we think trustees and managers can ask themselves to mitigate the difficulties experienced by some UK schemes last autumn, click here.

[1] Source: Bloomberg and Insight, data as of December 2022

THE UK NET-ZERO TARGET FACES GROWING INVESTOR SCRUTINY IN 2023

The UK's progress on reducing emissions has been strong to date relative to G7 peers, but maintaining this momentum is likely to be challenging given the need to cut emissions from sectors such as property and manufacturing, where emissions reductions have so far been limited.

Key policy gaps in the UK include the need to address energy inefficiency in homes, aviation fuel emissions, and fossil-fuel supply and subsidies. Carbon pricing will need reform, as will policy to address the impact of net-zero targets on different UK industries.

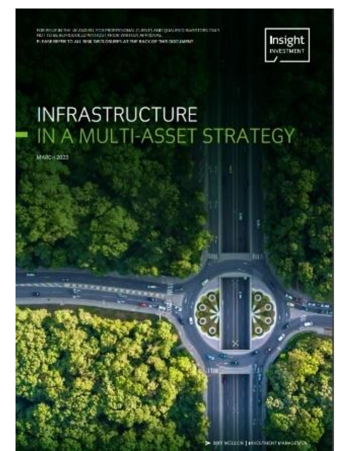
The UK government's recently published Independent Review of Net Zero points to economic opportunities being missed today because of challenges such as skills shortages and inconsistent policy commitment. Addressing these gaps is seen as imperative to maintaining the UK's competitiveness in a shifting global economy. The UK's progress against its net-zero targets is an issue of key importance to investors, both in terms of direct climate-related investment risks and alignment of financed emissions with investors' own net-zero targets.

The UK's journey towards net zero could have a direct impact on whether defined benefit pension schemes can achieve their net-zero targets. With large allocations to UK gilts, the progress of many pension schemes towards net zero will be closely tied to the UK's progress. Larger schemes will be required to report on their portfolio emissions, of which UK emissions will likely be a large part.

Engagement with sovereigns can present unique challenges for investors, but Insight has sought to engage with relevant UK bodies to highlight our concerns around its progress towards net zero. Given recent developments we have downgraded green gilts within our impact bond assessment framework (from dark green to light green) and are looking for further opportunities to engage on these issues.

To read further, click here.

INFRASTRUCTURE IN A MULTI-ASSET STRATEGY



With investors increasingly looking for real assets and stable cash flows, the listed infrastructure sector has grown rapidly. While providing global exposure, the regulatory framework and investor demand has led the UK market to be an attractive hub and focal point for listing of closed ended investment companies.

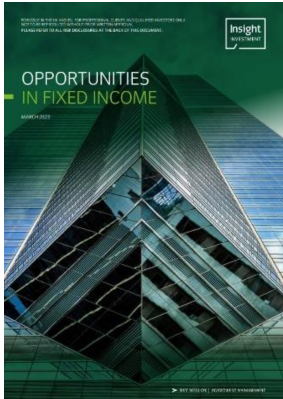
We believe this evolution is creating assets that fit well within a multi-asset strategy, particularly as they are more resilient to changes in the economic cycle. We have been shifting the composition of our holdings to take advantage of this opportunity.

Given a focus on social and environmentally supportive infrastructure, many of these assets are of natural interest to investors seeking to invest responsibly, but engagement is key to ensure their ESG goals are fulfilled.

Infrastructure has been core element of our multi-asset strategy for many years. We have focussed on the less economically sensitive parts of the infrastructure universe, concentrating on assets that produce stable long-term cashflows, often linked to inflation, that can have a low beta to global equities.

To read further, click here.

OPPORTUNITIES IN FIXED INCOME



Navigating the last fifteen months proved difficult for fixed income investors; yields across risk-free and credit markets forcefully shifted upwards for several well-established reasons, inflicting considerable losses on bond portfolios.

However, while this period represented a significant challenge for fixed income investors, we believe the resultant normalisation in yields potentially represents the best opportunity for fixed income investors to exploit in the preceding fifteen years.

We believe considerable opportunities exist to use credit to enhance income generation, and the potential to achieve long-term return objectives via income alone. Accordingly, we think investors can take advantage of the rise in yields rates and credit markets to enhance overall portfolio resilience, indicating how certain asset classes can help buy and maintain strategies meet their cashflow requirements.

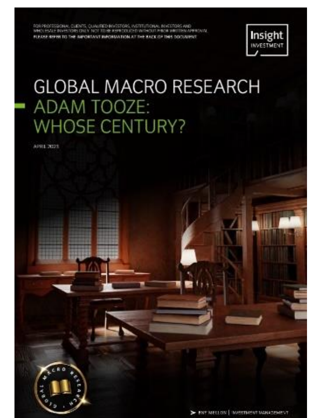
To read further about our favoured trades during 2023, click here.

GLOBAL MACRO RESEARCH – ADAM TOOZE: WHOSE CENTURY?

As part of our recent Insight Summit, we engaged Adam Tooze, the Kathryn and Shelby Cullom Davis Professor of History and the Director of the European Institute, Columbia University, to contextualise the present geopolitical and economic moment, which seems beset by disruption and volatility.

In this Global Macro Research piece, Tooze outlines how attempting to balance the effects of destabilising events and the measures employed to restore stability are both becoming increasingly monstrous, contextualising the rising tensions between the US and China, the destabilising nature of climate change and why financial repression may be one way to rebalance monetary balance sheets.

To read more about why we may be living between the end of Pax Americana and a new era, click here.



ECONOMIC REVIEW

Stronger than expected economic data led to upgrades to growth forecasts for 2023 in both the US, UK and eurozone, albeit from previously low levels. Global growth forecasts were further boosted by optimism about China, where pent up demand following the decision to drop the zero-COVID policy is expected to buoy economic activity. Forecasts for 2024 were edged downwards. Worryingly, although inflation is expected to decline sharply in 2023 and again in 2024, forecasts continue to edge upwards and suggest inflation remains above central bank targets.

Table 1: Consensus growth and inflation expectations

Growth (real GDP)		Consensus[1]		Change over Q4	
%	2022[F]	2023[F]	2024[F]	2023[F]	2024[F]
Ireland	11.3	2.7	2.5	1.5	0.1
United Kingdom	4.0	-0.4	0.9	0.6	0.0
United States	2.1	1.0	1.0	0.7	-0.3
Eurozone	3.5	0.5	1.2	0.6	-0.2
Japan	1.1	1.0	1.1	-0.2	0.1
China	3.0	5.3	5.0	0.5	0.0
Developed markets	2.7	0.9	1.3	0.4	-0.2
Emerging markets	3.2	4.1	4.4	0.2	-0.1
Global	**3.1**	**2.4**	**2.8**	**0.3**	**-0.1**

Inflation (CPI)		Consensus[1]		Change over Q4	
%	2022[F]	2023[F]	2024[F]	2023[F]	2024[F]
Ireland	8.0	5.3	1.7	0.0	-0.4
United Kingdom	9.1	6.5	2.4	-0.7	-0.1
United States	8.0	4.3	2.6	0.3	0.1
Eurozone	8.4	5.6	2.4	-0.5	0.2
Japan	2.3	2.3	1.2	0.5	0.2
China	2.0	2.3	2.3	0.0	0.1
Developed markets	8.8	5.5	3.0	0.2	0.2
Emerging markets	6.3	6.2	4.7	0.4	0.5
Global	**7.6**	**5.6**	**3.6**	**0.4**	**0.3**

F=Forecast [1]Bloomberg consensus forecast

Source: Insight Investment and Bloomberg. Data as at 31 March 2023

MARKET REVIEW

Table 2: Q1 2023 market review

		Market levels				Q1-2023
		31 Dec 20	31 Dec 21	31 Dec 22	31 Mar 23	change
Bond markets	Ireland 10 year (%)	-0.30	0.25	3.13	2.75	-0.38
	German 10 year (%)	-0.57	-0.18	2.57	2.29	-0.28
	France 10 year (%)	-0.34	0.20	3.12	2.79	-0.32
	Italy 10 year (%)	0.54	1.17	4.72	4.10	-0.62
	Spain 10 year (%)	0.05	0.57	3.66	3.30	-0.36
	US 10 year (%)	0.91	1.51	3.87	3.47	-0.41
	UK 10 year (%)	0.20	0.97	3.67	3.49	-0.18
	Japan 10 year (%)	0.02	0.07	0.42	0.35	-0.07
	JPM EMD yield (%)	4.22	5.72	6.86	6.59	-0.27
	iTraxx Europe 5 year spread (bp)	48	48	91	84	-6
	Bloomberg Barclays UK IG (bp)	112	113	193	191	-3
Money market rates	ECB overnight deposit rate (%)	-0.50	-0.50	2.00	3.00	1.00
	ECB overnight lending rate (%)	0.25	0.25	2.75	3.75	1.00
	UK base rate (%)	0.10	0.25	3.50	4.25	0.75
	US Fed target (%)	0 - 0.25	0 - 0.25	4.25 - 4.5	4.75 - 5.0	0.50
	SONIA (%)	0.04	0.19	3.43	4.18	0.75
Currency	EUR/USD	1.22	1.14	1.07	1.08	1.3%
	EUR/GBP	0.89	0.84	0.89	0.88	-0.7%
Equity (local currency terms)	Euro Stoxx 50 (TR)	7,695	9,491	8,590	9,807	14.2%
	FTSE 100 (TR)	6,175	7,314	7,657	7,930	3.6%
	S&P 500 (TR)	7,759	9,987	8,178	8,791	7.5%
	Topix (TR)	2,657	2,986	2,900	3,103	7.0%
	MSCI World Equity (€)	335	439	383	405	5.8%
	VIX	22.8	17.2	21.7	18.7	-13.7%

MARKET TECHNICALS

Bond markets experienced a busy start to the year, as corporates took advantage of a surge in investor demand for investment grade credit and tighter spreads to return to markets. This changed significantly in March as turmoil in the US and European banking systems impacted demand. Issuance in high yield remained at low levels.

Table 3: Credit issuance

Market		2020	2021	2022	2023 Q1
UK investment grade	£ bn	23.68	28.6	-3.0	11.8
Euro investment grade	€ bn	245.9	138.4	83.8	70.6
US investment grade	$ bn	1065.7	560.6	469.7	284.9
US high yield	$bn	137.7	129.5	-59.8	1.8

Source: Insight Investment, Bloomberg Barclays, Data as at 31 March 2023.

CREDIT OUTLOOK

- **Investment grade credit:** Both absolute yields and spreads remain at levels which suggest a significant amount of bad news is priced into markets. Although we expect further monetary tightening ahead, the peak in interest rates is likely to occur by mid-2023 and, at least in the US, the pace of tightening is slowing, and headline inflationary pressures appear to be moderating. The outlook for growth has softened but, unlike the global financial crisis, banks are well capitalised, and unemployment remains low. Many corporates have also insulated themselves from the rise in rates by extending their debt maturity profiles when rates were low. In aggregate, these factors should limit downgrade risks and allow the asset class to generate meaningful returns from income alone. At some stage in 2023, as investors become more confident about the peak level of interest rates, there is the potential for spreads to rally, further buoying returns.
- **Secured finance:** Although further central bank tightening is expected in 2023, the end of the rate cycle is now in sight. A robust labour market, increasing wages and excess savings built during the pandemic mean that consumers are well placed to weather a period of higher interest rates, especially in the US. In Europe, energy prices are subsiding, and fiscal support appears to have proved effective in limiting the economic fallout from the war in Ukraine. These factors have allowed markets to rally from the more extreme levels of undervaluation seen some months ago. Issuance remains light but could pick up in 2023 as various central bank funding schemes begin to unwind which could provide selective opportunities. We continue to favour issues with seniority in the capital structure, robust transaction structures that divert cashflow in the event of underperformance, and strong underwriting and servicing policies, all of which should act to insulate investors in even a severe economic downturn.
- **High yield credit:** Although growth is likely to be softer in 2023, and earnings reports are likely to reflect that outlook in the months ahead, high yield credit remains extremely well positioned relative to previous downturns. Just 5% of European high yield issuers have debt maturities in 2023, and 80% of the US high yield issuers have no material maturities until 2025. We expect default rates to gradually trend upward to around 3% in 2023, which would suggest a strong positive return over the year unless yields move meaningfully higher. With inflation appearing to have peaked, and central banks likely to shift to a more neutral tone by mid-year, markets appear to be pricing in a far more pessimistic outlook than we believe will occur. This leaves us tactically positive and seeking value in selective names and sectors that we believe have positive long-term fundamentals.

FIND OUT MORE

Institutional Business Development
businessdevelopment@insightinvestment.com
+44 20 7321 1552

European Business Development
europe@insightinvestment.com
+49 69 12014 2650
+44 20 7321 1928

Consultant Relationship Management
consultantrelations@insightinvestment.com
+44 20 7321 1023

@InsightInvestIM

company/insight-investment

www.insightinvestment.com

This document is a financial promotion/marketing communication and is not investment advice.

This document is not a contractually binding document and must not be used for the purpose of an offer or solicitation in any jurisdiction or in any circumstances in which such offer or solicitation is unlawful or otherwise not permitted. This document should not be duplicated, amended or forwarded to a third party without consent from Insight Investment.

Insight does not provide tax or legal advice to its clients and all investors are strongly urged to seek professional advice regarding any potential strategy or investment.

For a full list of applicable risks, investor rights, KIID risk profile, financial and non-financial investment terms and before investing, where applicable, investors should refer to the Prospectus, other offering documents, and the KIID which is available in English and an official language of the jurisdictions in which the fund(s) are registered for public sale. Do not base any final investment decision on this communication alone. Please go to www.insightinvestment.com

Unless otherwise stated, the source of information and any views and opinions are those of Insight Investment.

Telephone conversations may be recorded in accordance with applicable laws.

For clients and prospects of Insight Investment Management (Global) Limited: Issued by Insight Investment Management (Global) Limited. Registered office 160 Queen Victoria Street, London EC4V 4LA. Registered in England and Wales. Registered number 00827982. Authorised and regulated by the Financial Conduct Authority. FCA Firm reference number 119308.

For clients and prospects of Insight Investment Management (Europe) Limited: Issued by Insight Investment Management (Europe) Limited. Registered office Riverside Two, 43-49 Sir John Rogerson's Quay, Dublin, D02 KV60. Registered in Ireland. Registered number 581405. Insight Investment Management (Europe) Limited is regulated by the Central Bank of Ireland. CBI reference number C154503.

© 2023 Insight Investment. All rights reserved. IC3237