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Briefing note

Exploring investment opportunities in the current economic climate

Key messages:

- Markets have been expensive for years, with constant projections of low future returns.
- Recent rapid rises in inflation and interest rates and the ensuing market volatility have changed the market outlook markedly.
- Whilst there is plenty of risk out there, this volatility has presented a range of opportunities for investors.
- As a long-term investor, the LGPS has the ability to not only ride out these more difficult periods but capitalise on them for higher longer-term returns.

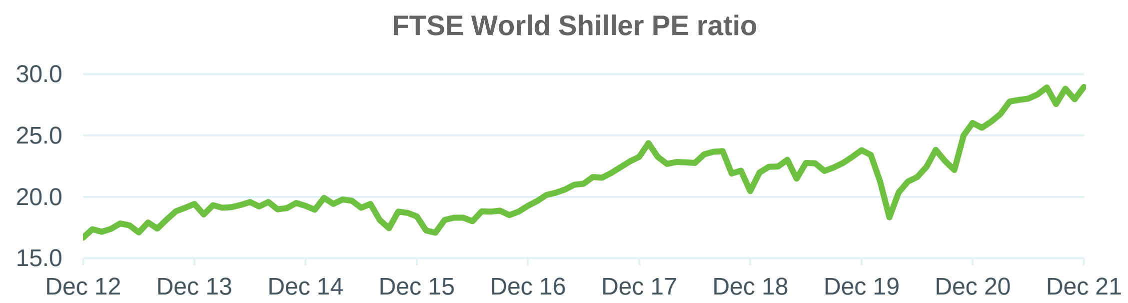
I recently attended the excellent LGC Investment Seminar Scotland 2022, where I was fortunate enough to be given the opportunity to present on the investment opportunities that I see in the market for the LGPS. For those who were unable to attend, I have provided a snapshot of my presentation below.

10 years of market doom and gloom

Over the last 10 or so years, up to the beginning of 2022, there's been a lot of doom and gloom around markets. This has been driven by how expensive everything has looked, leading to predictions of extremely subdued future returns.

Equity markets have been constantly reaching new highs and looking the most expensive they've been since just before the bursting of the Dot Com bubble. Chart 1 below shows the Price Earnings ratio for global equities, a measure of how expensive markets are, which has been climbing higher and higher, reaching almost 30 at the end of last year, far above its long-term average of c. 22.

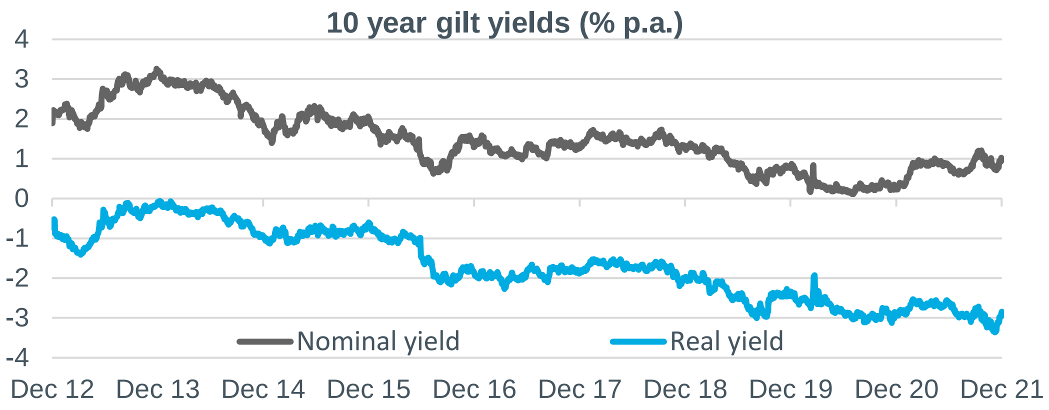
Chart 1



Source: Refinitiv Datastream

At the same time, gilt yields have been extremely low, and dropping lower, as shown by chart 2. Over this period, the 10-year nominal gilt yield rarely rose above 2% p.a., and only two years ago nearly turned negative, whilst the 10 year real gilt yield has been permanently negative over this period.

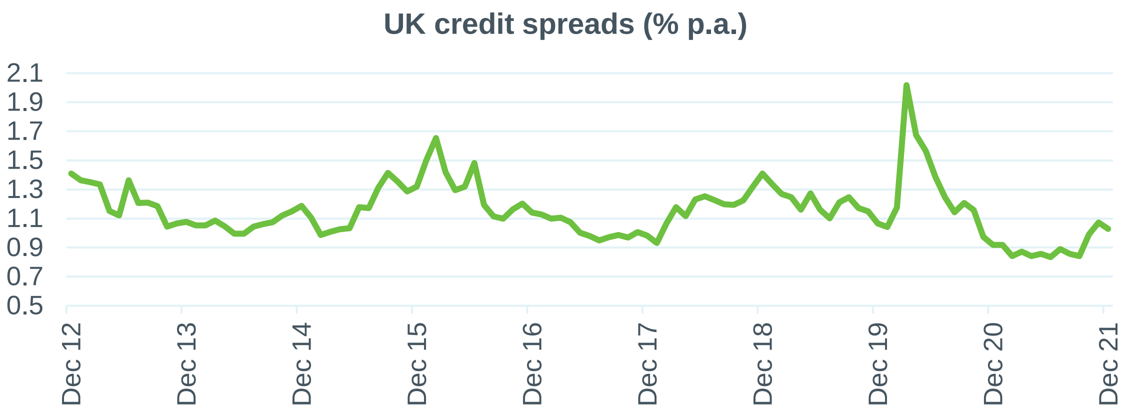
Chart 2



Source: Refinitiv Datastream

Add to this the fact that credit spreads have been incredibly tight, meaning not only are you getting a low yield on your bonds, but your additional reward for taking some credit risk has also been tiny, usually around only 1% p.a., as chart 3 shows.

Chart 3



Source: Refinitiv Datastream

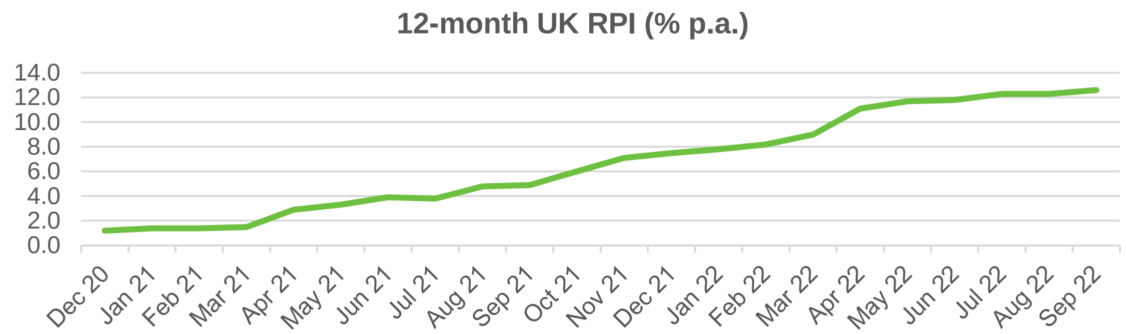
And I'm sure you've been used to your investment consultants bringing their asset class views to you every quarter over this period with absolutely nothing looking anything close to attractive, the heady heights of a neutral view being the most positivity we could muster for an asset class.

Then 2022 came around…

… and things changed very quickly. Doom and gloom still raged, but it was a different kind of doom and gloom.

For the first time in a very long time, inflation reared its ugly head. As chart 4 illustrates, since the end of 2020, UK RPI has rocketed from 1% to 12%, the highest level in 40 years.

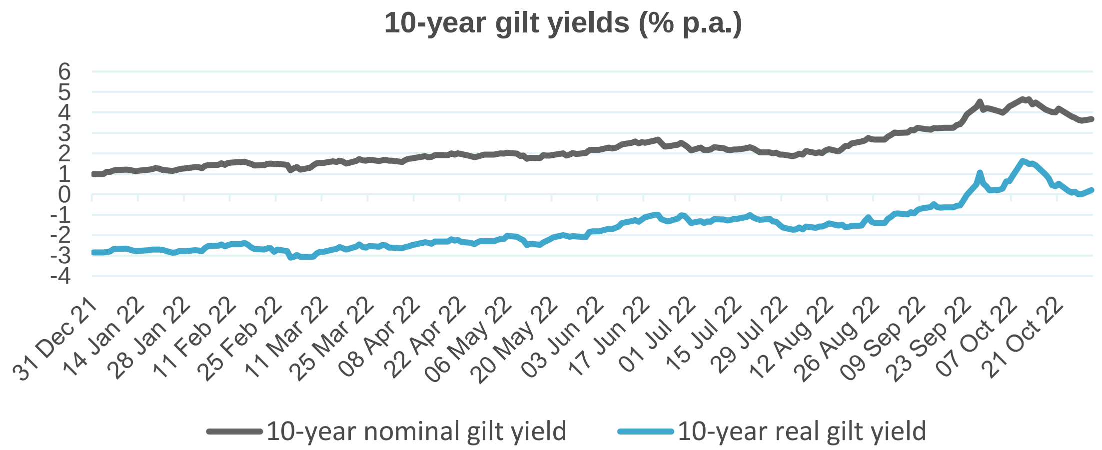
Chart 4



Source: ONS

In response, gilt yields have also exploded, with chart 5 showing the 10-year nominal yield rising from 1% p.a. at the start of the year rising to c. 4% p.a. today, and the real yield rising from -3% p.a. to over positive 1% p.a.

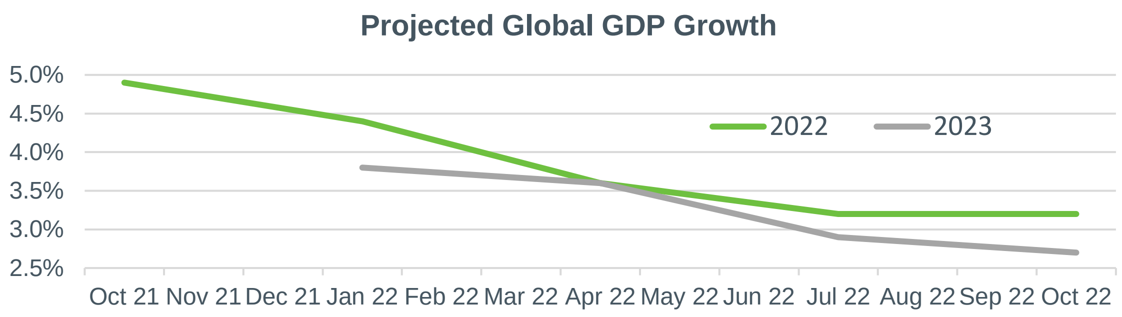
Chart 5



Source: Refinitiv Datastream

And as inflation and interest rates rage higher, we see global GDP growth projections continue to plumet (chart 6), as individuals and business are expected to have far less cash to pump into the economy.

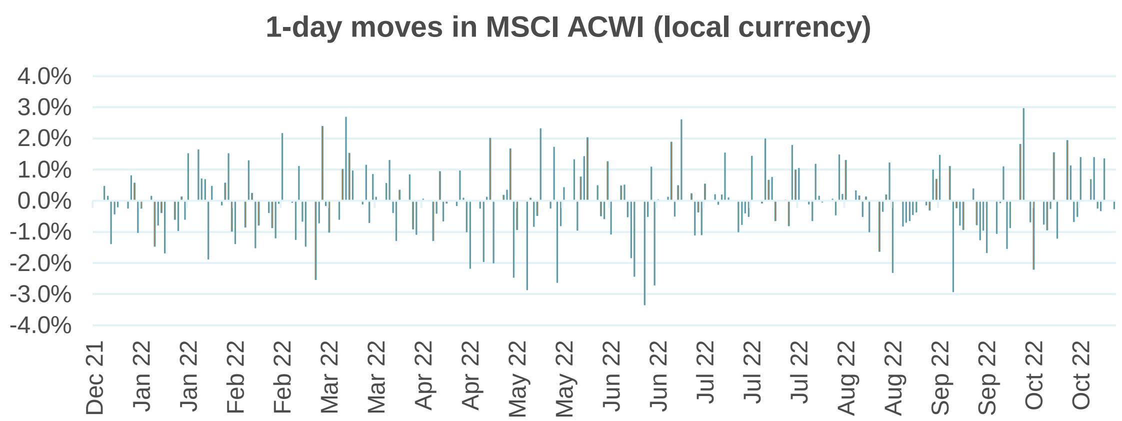
Chart 6



Source: Refinitiv Datastream

And all this leads to equity markets, after years of largely steady climbs, with only the briefest moments of sudden volatility, rediscovering their wild side. The blue lines chart 7 show the significant daily swings we've seen in global equities, with 20 trading days seeing single day swings of more than 2%. in the whole of 2021, we saw 3 of these.

Chart 7



Source: Refinitiv Datastream

Painful, but this is what was needed

This has led to some painful returns for investors, as shown by chart 8. UK bonds have been particularly hard hit, with long-dated gilts losing up to c. 40%. The one area of respite so far this year, UK commercial property, has now begun to turn over too.

Chart 8

Source: Refinitiv Datastream

However, as painful as this has been for your asset values, this is what was needed. There needed to be some kick to markets to get us out of this slow lull of lower and lower interest rates and inflation and subdued future returns. We needed some volatility to spark some life into markets and open up some opportunities.

And it's especially helpful when you are only very small allocators, if you allocate at all, to the worst performing areas of the market, like gilts, as the LGPS has been.

Reasons to be positive - bonds

So, despite all this doom and gloom, there are now reasons to be positive.

The steep climb in gilt yields so far this year means that you can now lend to the UK government at interest rates not seen in over a decade. Two years ago, when large parts of the nominal gilt market turned negative, investors would have gladly taken a yield of 4% p.a., from bonds far risker than gilts.

It's also a welcome change to now see positive yields from index-linked gilts, meaning you can now get paid to hold something that gives you some explicit inflation-linkage in its returns.

This is then reflected in UK corporate bonds, with their yields climbing from only 2% p.a. at the start of the year to over 6% p.a. And high yield bonds, with their yields now touching 10% p.a.

Yes, this reflects some increased risks out there in the market, there's no free lunch here, but surely going forward you're happier taking a yield from an investment grade corporate bond that only at the start of the year was more than you could get from high yield bonds.

And sticking with bonds, there are opportunities even further up the risk spectrum, within distressed debt.

These are the bonds of companies that are nearing insolvency or are in significant financial distress. Here, you take a position in the debt in the belief that the likelihood of the company turning themselves around is being underappreciated and the bonds are therefore undervalued.

This is of course very high risk as, if the companies don't turn it around, you stand to lose a large portion of your investment, however, if they do survive, the gains can be very large indeed.

And when are opportunities like this rife? When there is economic turmoil. The current economic conditions are putting a lot of businesses under stress, who you can then provide capital to, to support them through their difficult patch and make some attractive returns as your reward.

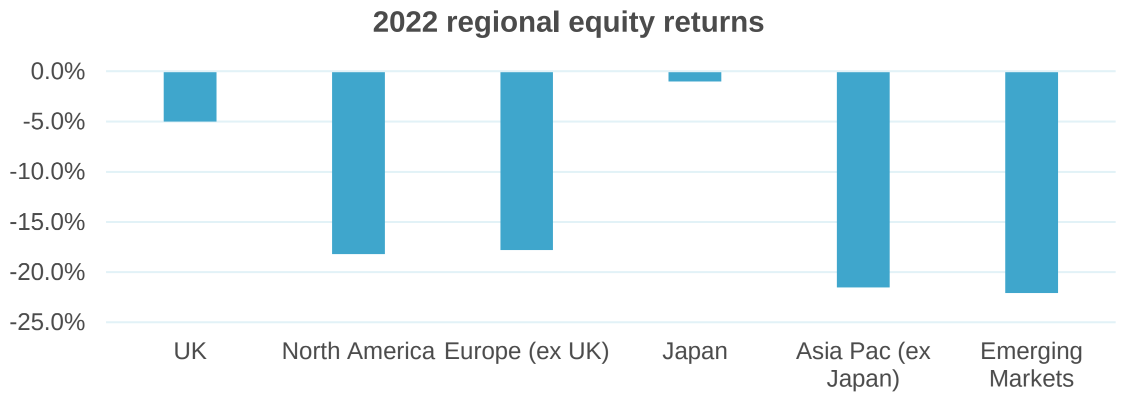
So plenty of opportunities arising in the bond markets after years of boredom and despair.

Reasons to be positive – equities

Equities are getting cheaper too. PE ratios have fallen by c. 20% so far this year, meaning future expected returns should reasonably be considerably higher than they were just at the start of this year.

But not all areas of the market have performed equally. In chart 9, we split out the performance of the major equity market regions and, as we can see, the UK and Japan have fared far better than the other major regions. So, take this into consideration about whether there are particular parts of the market that look a bit cheaper, or you have a bit more confidence in rebounding, whether that's particular regions, as shown here, or different styles or sectors.

Chart 9



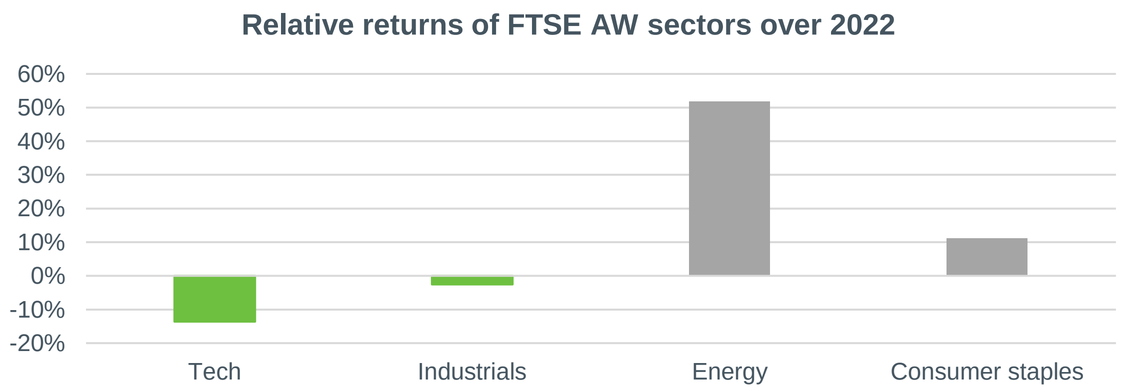
Source: Refinitiv Datastream

One particular investment style that may offer better value today is sustainable equities. After seeing some very strong returns in these types of funds in recent years, they have had a very difficult 2022.

They are a diverse set of funds, so they are hard so generalise, however, because of the nature of these funds, they generally have certain strong exposures that have really driven their underperformance of wider markets so far this year.

And that's shown by chart 10. Generally, they have overweight positions in the industries shown by the yellow columns, tech and industrials. These have both underperformed the market this year, tech by almost 15%.

Chart 10



Source: Refinitiv Datastream

They're also generally underweight the grey columns, energy and consumer staples. Being underweight energy this year has been disastrous for relative performance, as that industry has outperformed the index by more than 50%.

So we can see that generally, as much as you can generalise, because of their nature, they've been underweight the best performing areas of the market and overweight the struggling sectors.

So, is there perhaps an opportunity to now allocate to these types of funds at significantly more attractive price points?

You may ask why allocate to sustainable funds to get this exposure, rather than finding a cheaper method. These types of funds can also come with wider benefits, such as exposure to companies that will benefit from, and help to drive, a move to a more sustainable world. So, making money whilst doing good, something I'm sure a lot of Pensions Committees would be very happy for their Fund to do.

Reasons to be positive – real assets

Real assets are broadly defined as assets that help everyday economic activity to happen. So, things like property and infrastructure.

These asset classes are often able to provide some inflation protection, but still offer relatively high expected long-term returns, something that other asset classes, like index-linked gilts, do not offer. For example, in property, having rental agreements linked to inflation. In infrastructure, having assets where the cashflows are explicitly linked to inflation.

However, be careful. Not all real assets and real asset funds are equal and you should therefore review the inflation linkage within the assets. Has your property manager negotiated regular inflation uplifts into rental agreements with tenants? Are your infrastructure assets of the type that will provide this inflation protection for you?

If not, you may want to reconsider the structure of your allocations to these asset classes to look for further inflation protection whilst maintaining your required level of returns.

Opportunities abound

Markets are volatile. As a long-term investor, the LGPS has the ability to not only ride out these more difficult periods but capitalise on them for higher longer-term returns.

Being underweight, or even absent from, the worst hit areas of the market like long-dated gilts, means many LGPS Funds have avoided the most severe pain and now have an opportunity to allocate to them at much cheaper price points than seen in recent history.

So, make sure you're pressing your investment consultants and advisors on how you should be turning this market doom and gloom into investment opportunities for your Fund.

Iain Campbell

Senior Investment Consultant