Invesco

Cashflow-Driven Investing Outlook

Invesco Investment Solutions | Q4 2021 | GBP

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1 Introduction

Summary

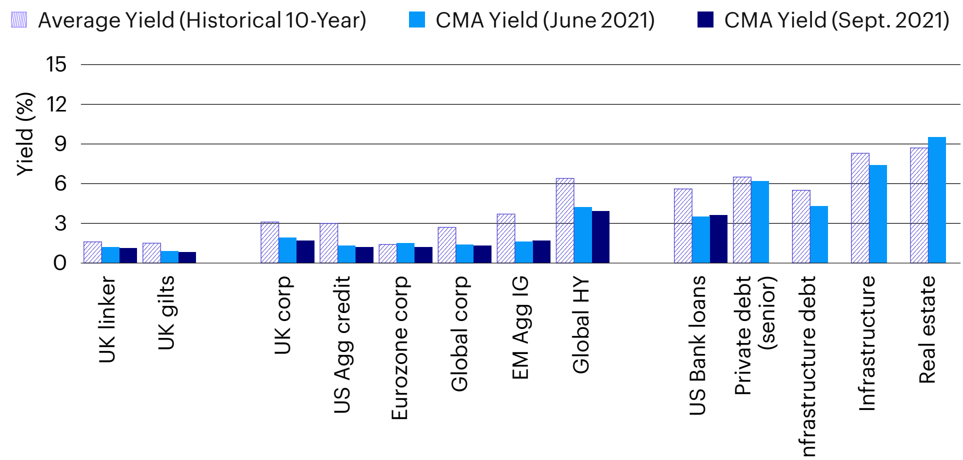
The global economy continues to grow at above trend rates and risk assets continued to grind higher over the quarter, buoyed by stronger than expected earnings. Inflation surprised to the upside and bond yields rose as a result, predominantly at shorter maturities. Investment grade credit spreads remain low, given the supportive financial conditions for strong companies. Our macro regime framework remained in expansionary regime, given above trend growth levels and improving global growth expectations.

Looking ahead, our expected returns from investment grade fixed income remain broadly unchanged; our return forecast for emerging market debt increased slightly and we raised our expectation for equity returns due to better than anticipated earnings and an improved outlook for the recovery from COVID-19.

Nevertheless, rates of growth will likely slow going into 2021 as job vacancies remain high due to shifting work patterns post COVID-19. This, coupled with an elevated level of uncertainty as economies open up unevenly means that financial conditions are likely to need to remain supportive for an extended period even if inflation remains elevated for a period of time. Central banks therefore face a difficult balancing act to control inflation without starving growth. The wide dispersion of inflation views leads us to expect higher than usual volatility of interest rate and inflation pricing, increasing the value of hedging.

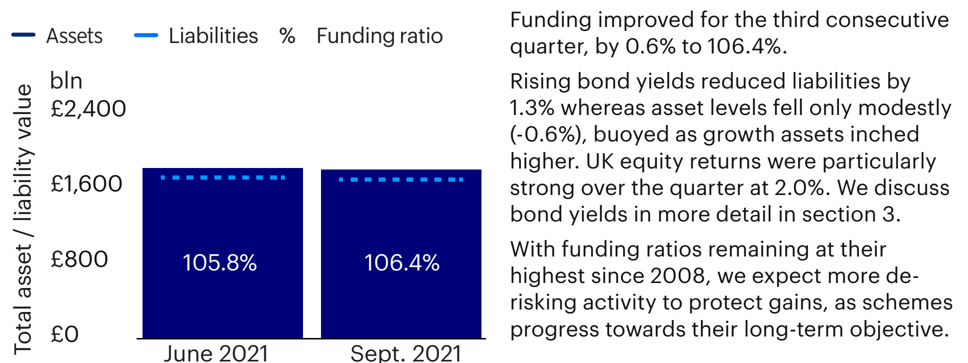
Finally, we have yet to see material compression in return premia from private markets and so the excess return available from private assets compared to public markets remains high. As a result, we believe that investors able to take liquidity risk are likely to be rewarded.

Asset class yield (GBP CMA) compared to historical average yield



Source: Invesco, estimates as of Sept. 30, 2021. Proxies listed in footer on page 3; These estimates are forward-looking, are not guarantees, and they involve risks, uncertainties, and assumptions. These estimates reflect the views of Invesco Investment Solutions, the views of other investment teams at Invesco may differ from those presented here.

Pension Protection Fund (PPF) funding level, change over quarter



Funding improved for the third consecutive quarter, by 0.6% to 106.4%.

Rising bond yields reduced liabilities by 1.3% whereas asset levels fell only modestly (-0.6%), buoyed as growth assets inched higher. UK equity returns were particularly strong over the quarter at 2.0%. We discuss bond yields in more detail in section 3.

With funding ratios remaining at their highest since 2008, we expect more de-risking activity to protect gains, as schemes progress towards their long-term objective.

Source: Pension Protection Fund (PPF S179 basis), Sept. 30, 2021.

Our private asset expected yields are represented by the CMAs of those asset classes in GBP.

2 CDI and the de-risking journey

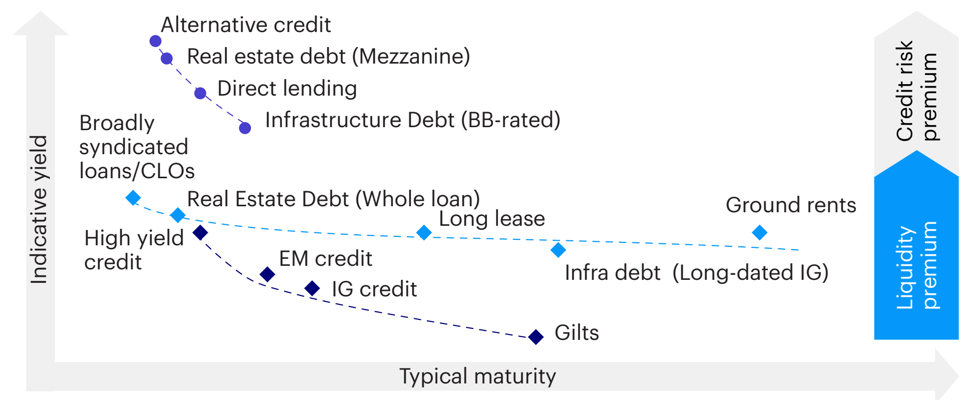
A Cashflow-Driven Investment (CDI) strategy aims to source and deliver a predictable stream of income while delivering sufficient yield to pay liabilities as they fall due. A CDI strategy's success can be measured to the extent it delivers sufficient income when it is needed – that is, assets can weather short-term volatility and don't need to be sold in a hurry.

This can be achieved by holding a mix of long-dated high quality assets held to maturity and higher yielding stable income assets managed with lower turnover. Many clients will adopt a "de-risking plan" to build up this portfolio over time.

A CDI strategy is relevant to any professional with responsibility for delivering a long term income strategy. CDI strategies combine traditional "growth" and "liability matching" objectives. The approach is therefore particularly relevant to Defined Benefit pension schemes as more cash is paid out each year, but where returns are still needed to reduce the deficit.

A broad range of assets can be incorporated within a CDI approach – we highlight the major strategies below:

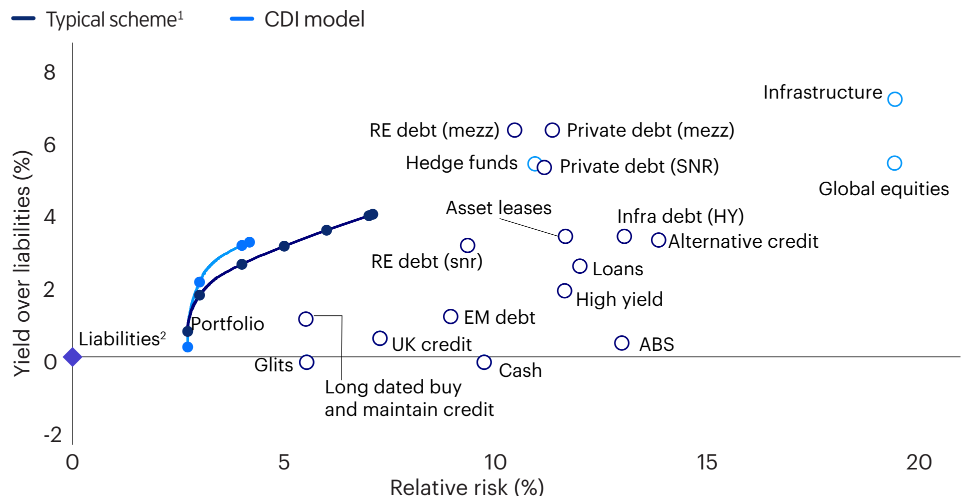
CDI fixed income toolkit



Source: Invesco Investment Solutions, as of Sept. 30, 2021. For illustrative purposes only.

By comparing the investment efficiency that is possible using typical asset classes (for schemes in the PPF 7800 index) and using a full CDI strategy, we show that **the CDI toolkit can reduce risk for a given expected return.**

A CDI approach can improve investment efficiency



Source: Invesco Vision, MSCI, PPF as at Sept. 30, 2021. See page 3 for further notes.

Risk measure shows forecast 1-year volatility of return relative to liabilities - this is just one of a range of measures needed to assess risk

1. **Typical scheme:** PPF Purple Book, as of Sept. 30, 2021.
Proxies are:
UK equity: MSCI UK - Daily;
Global equity: MSCI WORLD ex UK IMI - Daily;
UK Credit: Bloomberg Barclays Sterling Non-Gilts;
Hedge funds: Proxy - Hedge fund US HFRI FoF composite;
Global real estate: Direct real estate CMA income component (unleveraged), based on NCREIF property index;
Private equity: Proxy - Private equity US large buyout (De-smoothed);
UK gilts: Bloomberg Barclays sterling gilts;
UK linkers: ICE BofAML UK inflation-Linked gilt index;
Cash: Currency pound sterling;
2. **Liabilities:** representative cashflow profile with 19y duration and 13y inflation duration valued on a Gilts + 0% discount basis, and assumes a 72% funding level, interest rate hedge ratio and inflation hedge ratio on that basis.
3. **CDI strategy:** Proxies are:
Long-dated buy and maintain credit: Custom cashflows with c13y duration;
EM debt: Bloomberg Barclays EM USD aggregate: Investment Grade;
ABS: Bloomberg Barclays Non-Agency Investment Grade CMBS: Bbb Index;
High yield: Bloomberg Barclays global high yield;
Loans: Credit Suisse Leveraged Loan Index;
Private credit: IVZ proxy: Private credit: IVZ Proxy - US senior corporate (De-smoothed) unlevered;
RE debt: IVZ Proxy - Private credit US senior real estate (De-smoothed) unlevered;
Infra debt (HY): IVZ Proxy - Private credit US infrastructure HY (De-smoothed);
Asset leases: Proxy - Other Credit US aircraft leasing (De-smoothed);
Alternative credit: Proxy - Other credit US venture lending (De-smoothed);
Infrastructure: Proxy - Infrastructure US core (De-smoothed);
Global real estate: Direct real estate CMA income component (unleveraged), based on NCREIF property index.

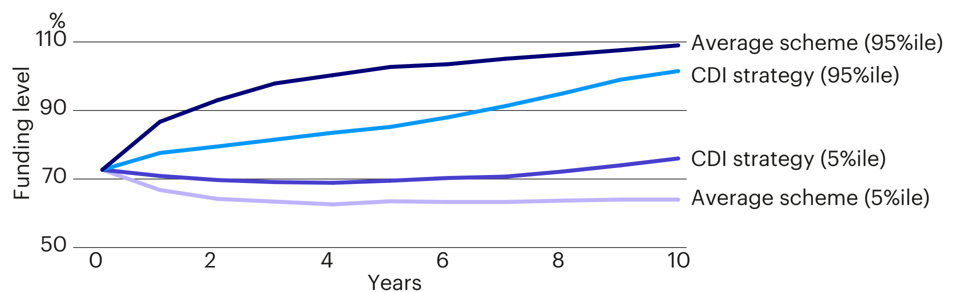
A CDI approach can reduce solvency uncertainty

We model two investment strategies: The first models the average asset allocation of schemes in the PPF 7800 index[1] and assumes de-risking proceeds as funding levels are hit to reach a low risk portfolio when fully funded on a low-risk basis[2]. The second models a CDI asset allocation holding a diversified mix of fixed income and real assets[3] and following the same trigger-based de-risking approach. We project asset values and deduct liability cashflows as they fall due.

The initial expected return of both strategies is the same. However the CDI strategy exhibits significantly less dispersion of future funding levels as while market volatility affects both strategies similarly in the early years, the CDI strategy delivers more certain cashflows over time, reducing the likelihood of a persistent deficit.

Modestly higher funding levels since last quarter have increased the starting point of the projection, increasing the probability of reaching full funding on a buyout basis within the 10 year period.

Solvency projection



Source: Invesco, Moodys, as of Sept. 30, 2021. Funding level on a low-risk basis[1]

Regulatory update

DB Code of Practice. Publication of the second consultation is expected this quarter. However, The Pension Regulator doesn't expect the new Code to come into force until late 2022 at the earliest.

Climate Change disclosures. Schemes with >£5bn in assets and with year-ends falling after 1 October will have seven months from year-end to produce and publish their annual Taskforce for Climate-related Financial Disclosures ("TCFD") reports. The first wave of reports is expected in July 2022.

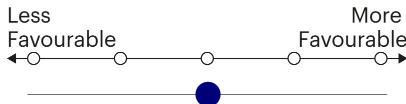
New sustainability disclosures. The UK Government has announced the forthcoming Sustainability Disclosures Requirements (SDRs) regime will comprise two main elements: global sustainability standards; and alignment with the UK Green Taxonomy. A regulatory Discussion Paper is expected in November.

Green gilts. The UK Government's first green bonds were issued in September (2033 maturity), plus a second in October (2053 maturity), the world's longest-dated sovereign green bond. Demand was particularly strong with combined orders of c£175bn for the £16bn issued. Further issues are planned next year.

LIBOR: The Financial Conduct Authority is consulting on proposals to require GBP and JPY LIBOR (1, 3 and 6-month) to continue to be published until the end of 2022, for use by legacy non-cleared contracts only. It will be calculated as a spread to the new risk-free rates.

3 Global market conditions*

Interest rates



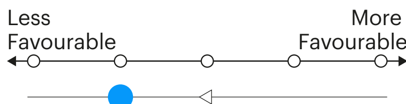
Strong demand for risk free assets and low long-term growth projections for developed economies kept long-dated rates anchored. Meanwhile, concerns grew towards the end of the quarter that COVID-19 money growth together with changes to cross-border supply chains may lead to longer-lasting inflation. The net effect was that developed government bond yields ended the quarter broadly flat (10y German, Japan and US yields at -0.2%, 0.1%, 1.5%), with UK rate expectations higher given the greater exposure to inflationary forces (10y UK yields rose to 1.0%).

We believe support for the wider economy will require loose financial conditions for a number of years. So while there is a need to control inflation in the short term (with the UK expected to begin to raise interest rates as early as November), central banks are likely to remain cautious about raising interest rates and more relaxed about temporary overshoots of inflation targets. As a result, we expect the number and extent of rate rises to be limited and quantitative easing asset purchases to be unwound only gradually, keeping longer-term rates from rising substantially.

Nevertheless, we expect higher rate volatility to continue until the outlook for inflation is clearer, increasing the value of hedging.

Taken together, the need for pension schemes to deliver additional returns together with the need to control leverage within LDI programmes means that we continue to favour “averaging in” to additional interest rate hedging while seeking to lock in gains in funding level when affordable.

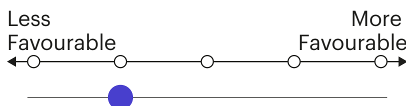
Inflation



The cost of inflation hedging jumped in September: A “transitory” bounce in inflation had been expected as economies re-open and as the impact of stagnant prices last summer drop out of year-on-year figures. However, investors became concerned that supply chain issues and staff shortages resulting from COVID-19 restrictions may give way to more permanent trade barriers or changes in working patterns. This was exacerbated by rising gas prices in Europe and particularly in the UK (where the gas futures price remains over 5 times 2016-2020 levels). As a result, 1-year UK inflation pricing rose some 2.2% over the quarter, increasing 20-year inflation pricing by 0.2%.

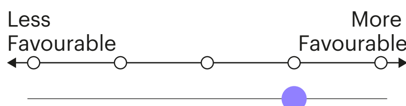
The UK is particularly exposed to the risk of Brexit-related disruption to supply chains, movement of labour and energy prices. This is likely to feed into some upward wage pressure. However, with linkers priced for inflation to overshoot the Bank of England’s target by 1.5% every year for the next 20 years, these risks are already well priced. We continue to favour “averaging in” to linker purchases to reach pension scheme’s hedge targets but to also seek cheaper ways to protect against inflation risk.

Credit risk premium



Low interest rates, structural demand and confidence in government support in future crises all point to investment-grade credit spreads remaining tight over the medium term. With upside (from further credit spread tightening) unlikely, we continue to favour a combined approach of phased growth of “buy and maintain” credit alongside higher-yielding strategies in order to target sufficient overall yield on the path to buyout or self-sufficiency.

Illiquidity premium



The excess return available from private assets compared to public markets remains high. The combination of record levels of private equity powder, a robust M&A environment, and a continued post-2008 retrenchment from middle-market lending by banks means the supply/demand balance continues to favour direct lenders.

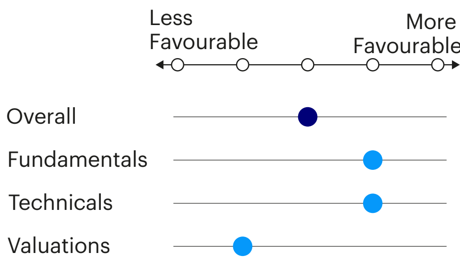
As a result, we believe that investors able to take liquidity risk are likely to be rewarded.

“More Favourable” indicates we are more likely to allocate new capital, whereas “Less Favourable” indicates we are inclined to be more selective and tactical in how we allocate new capital.

*These views reflect the views of Invesco Investment Solutions, the views of other investment teams at Invesco may differ from those presented here

Public debt

Gilts / LDI



Government bonds provide a large and liquid source of interest rate and inflation exposure to match residual liability sensitivity not provided by other assets. Exposure is typically leveraged to improve investment efficiency.

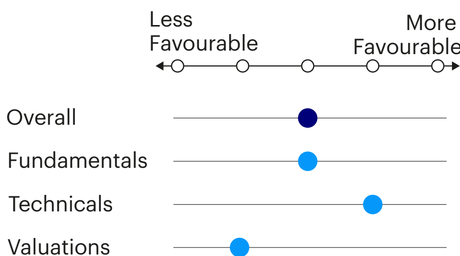
Long-dated gilt yields ended the quarter modestly higher as demand first drove 30y rates lower before concerns of persistent inflation spread to the long end (30y rose 0.1% to 1.4%).

Concerns that a temporary rise in inflation may prove more persistent sent real yields lower (10y real yield fell below -3%) and caused investors to price in earlier rate rises.

We expect higher real-yield volatility to continue until inflation expectations become more tightly anchored, increasing the value of inflation hedging. However, with linkers priced for inflation to overshoot the Bank of England's target by 1.5% every year for the next twenty years, these risks are already well priced.

We continue to favour "averaging in" to linker purchases to reach pension scheme's hedge targets but to also seek cheaper ways to protect against inflation risk.

Investment grade (IG) credit

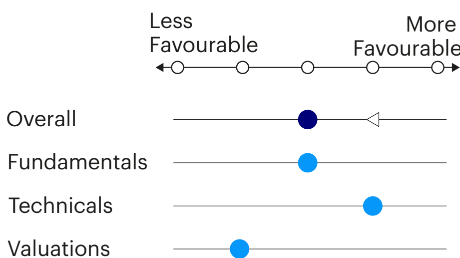


High quality bonds are a key source of duration and credit risk premia. Assets managed on a "buy and maintain" basis benefit from the yield enhancement from lower turnover and holding bonds to maturity.

Corporate bond spreads in developed markets again traded in a narrow range, ending the quarter almost unchanged. Sterling investment grade spreads outperformed, ending the quarter at 101bps. Credit spreads remain vulnerable to the risks of tighter financial conditions, slower growth and Chinese contagion. However, companies continue to see fundamentals improve given stronger earnings and high liquidity levels.

Looking ahead, low interest rates, structural demand and confidence in government support in future crises all point to investment-grade credit spreads remaining tight over the medium term, although we could see some near term widening if cost pressures or supply-chain issues prove significant or sustained. We continue to favour a combined approach of phased growth of "buy and maintain" credit alongside higher-yielding strategies in order to target sufficient overall yield on the path to buyout or self-sufficiency.

Emerging market IG (hard currency)

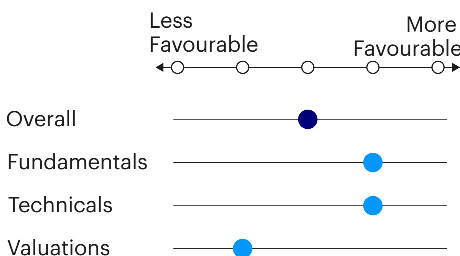


EM credit has offered a premium to developed economies for investors with strong credit research coverage. Hard Currency (USD) debt is less exposed to EM currency and emerging market interest rate fluctuations relative to liabilities.

Emerging market debt is sensitive to both the level and uncertainty of US interest rates. Uncertainty about US real interest rates has reduced return expectations for EM hard currency assets. EM countries face cross currents of higher debt levels, weaker growth and rising inflation, and a slowing China, but are supported by the cyclical outlook and higher commodity prices. For EM corporates, we see a more positive fundamental picture, despite the decelerating pace of the global trade recovery. Global liquidity remains generally favourable.

While we are therefore neutral on the asset class overall, it continues to deliver additional yield and diversification compared to a developed market-only investment grade portfolio.

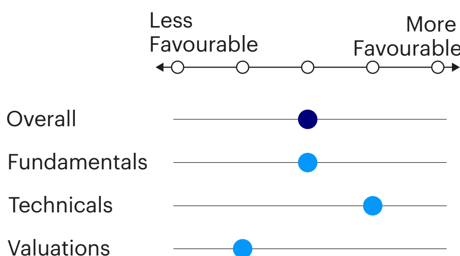
Global asset backed securities (ABS) IG



Asset-backed securities provide a large and diverse universe with the security of an underlying pool of assets, across mortgages, corporate loans, student loans, auto loans and others.

Fundamentals in most ABS sectors continue to provide positive tailwinds for credit conditions as improved employment conditions and ongoing recovery from COVID-19 allow firms to weather the waning of fiscal stimulus and unemployment benefits. While AAA ABS valuations remaining tight, we believe select lower-rated senior ABS are modestly attractive relative to corporate bonds.

Global high yield (HY)

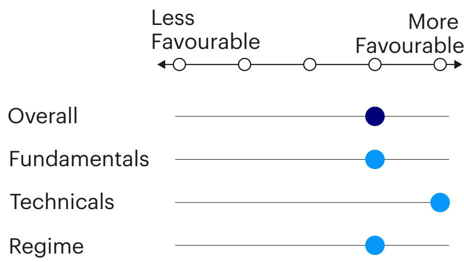


The HY debt market provides a key source of high income potential for clients with higher return targets, either as a small allocation within buy and maintain mandates or within a multi-sector approach.

Robust US economic growth, helped by a recovering global economy, has led to steadily improving HY credit fundamentals and rapidly declining default rates. Risk is skewed toward sustained higher inflation and there have been more frequent issuer comments regarding supply chain disruptions and higher input costs which could particularly impact more leveraged and lower rated companies. Strong credit research is therefore key to identify companies more likely to benefit from rating upgrades

Private debt

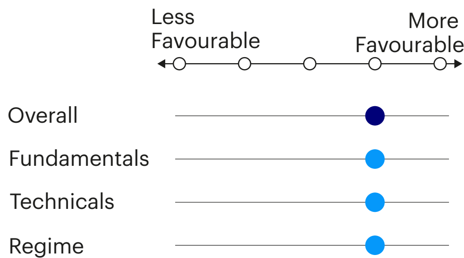
Senior secured loans (broadly syndicated)



Senior secured loans have delivered a stable level of income through the market cycle, with similar returns and lower volatility than HY bonds.

As lockdown measures unwind, robust fiscal stimulus, normalising economic activity, and the expenditure of pent-up savings create a potentially supportive earnings environment broadly. This dynamic has facilitated loan price recovery across the market and could lead to further price gains in COVID-19-battered sectors. Default rates have continued to decline in recent months and we expect a default rate of 3-4% in 2021. Strong demand from retail and institutional investor flows supported loan prices. Leveraged buyouts will likely continue to provide momentum, offsetting an uptick in refinancing activity. New issuance has also increased, but not enough to meaningfully tip the supply/demand balance.

Private debt (directly originated)

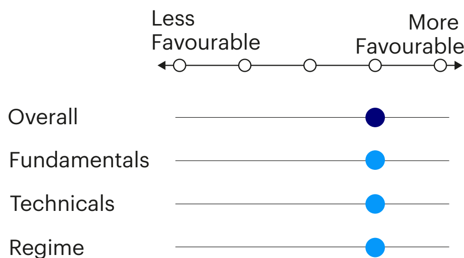


Yields in senior direct lending are derived to a greater extent from illiquidity / direct origination premia rather than credit risk, due to the strong level of covenants. This can provide investors access to attractive yields from relatively conservative assets with inherent downside mitigation.

All components of our alternatives framework (fundamentals, valuations and regime) are signaling "attractive," in our view.

Liquidity premiums remain high and creditor-friendly covenants exist for private market loans. Record levels of private equity dry powder, a robust M&A environment, and a continued retrenchment by banks from middle-market lending space continue to allow for attractive spreads relative to the high yield or syndicated leveraged loan markets.

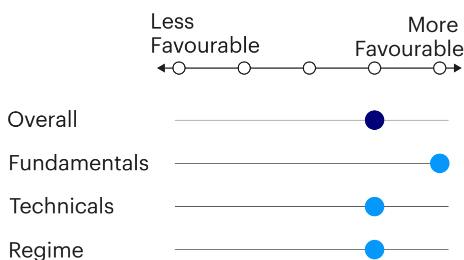
Private debt (distressed)



Distressed investing involves purchasing or restructuring debt from companies in or close to default. Lack of traditional funding sources together with the complexity of working a company out of distress provides opportunity for significant returns for the experienced distressed manager. Level and timing of cashflows are uncertain.

Distressed debt is currently yielding above-average spread over high yield bonds and is supported by similar dynamics to senior and second lien debt covered above, leading to our positive outlook. The swift return to a "low and stable" regime, which has historically supported high returns from private debt vintages, completes our strong outlook for this asset class.

Real estate debt



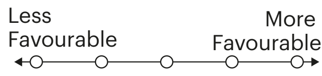
Real estate debt is a source of high and stable income with asset-backed protection. It can be attractive to pension funds and insurers seeking to deploy long-term capital without recourse to syndicated or securitised bank lending.

Current loan-to-value ratios are around the post-2008 average, indicating that investors are not relying on excessive leverage when deploying capital. Deals are being fairly valued and capitalised in our view.

Debt coverage, the income available to pay loan interest, has been rising, increasing resilience of the asset class. Real estate balance sheets are significantly healthier than 2008, contributing to our positive view of the asset class.

Alternatives

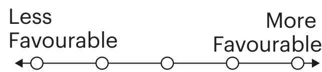
Real estate

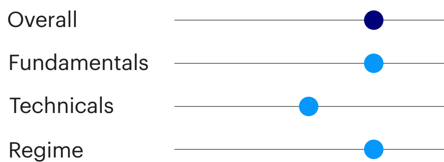


Real estate is by far the largest alternative asset class offering long-term, broadly inflation-linked income, as rent and land value tend to rise with inflation. Global diversification can improve risk-adjusted returns. Properties let on longer lease reduce exposure to capital values which can be volatile, but this can reduce the liquidity of the portfolio.

Real estate is currently attractive using our framework. While valuations for the sectors less affected by COVID-19 remain at pre-pandemic levels, existing structural transitions have been accentuated by the pandemic. Sectors exposed to global trade and passenger travel remain at depressed prices, leading to the potential for improved future returns for well-located assets within those sectors.

Infrastructure





In most global cities there has been an underinvestment in infrastructure, which has put significant strain on the existing assets and provides opportunities for long-term capital, often with inflation-linked income.

Infrastructure markets continue to show strong momentum into 2021. However, there was a considerable level of divergence with telecom infrastructure benefitting from robust increases in data traffic, but passenger transportation facing a headwind due to travel restrictions.

Deal values are near record highs as the demand for these assets has been filled by the private market. Significant private capital continues to flow into this area, albeit at a slightly slower rate more recently. We continue to see opportunities in this space but care must be taken to ensure capital is deployed at attractive returns.

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