Aon Investment Research and Insights

Interest rates – a change in path?

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Empower Results®

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By beginning to identify investment research and communicate ideas before they are needed we can shorten the implementation times for our clients and act in a timely way when opportunities are correctly priced.

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Summary

A combination of slowing global growth, US-China trade wars and Brexit are threatening to change the path of interest rates. Already this year, the US Federal Reserve has indicated that it intends to slow the pace of interest rate rises from previous forecasts, whilst in the UK, Brexit uncertainty continues to weigh on rates.

Against this backdrop, we argue that it is just as important as ever for pension schemes to re-evaluate their interest rate and inflation hedge programme in order to lock down the key risk of lower yields. In particular, clients expecting yields to increase and who have perhaps paused or slowed down increases in hedging, should re-examine their position.

A change in US central bank policy

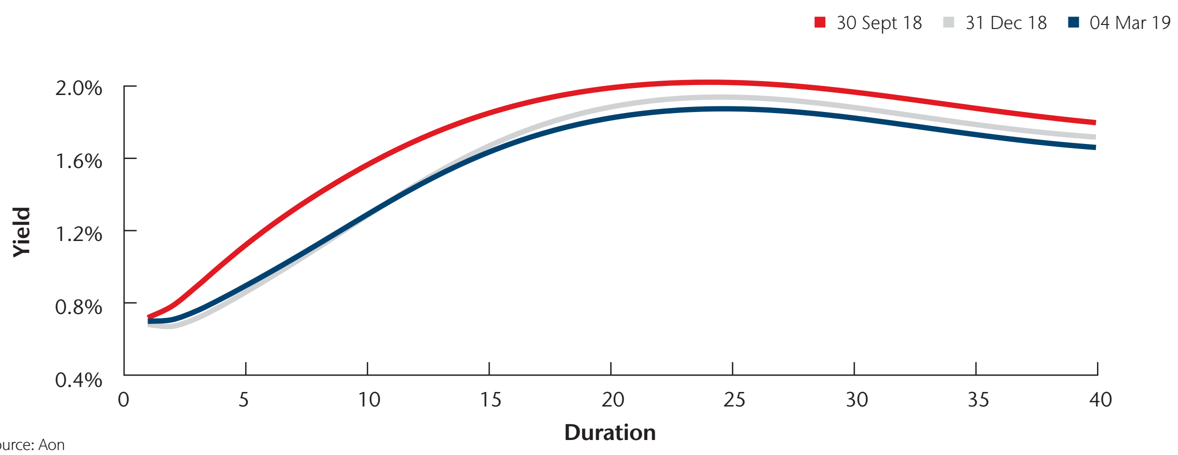
Earlier this year, the US Federal Reserve (the "Fed") surprised markets with its announcement that it will put any near-term interest rate rises on hold. Lower global growth forecasts and the ongoing trade war between the US and China both contribute to this change in approach.

Whilst this news was well received by equity markets, the announcement has kept global yields low and shifted market expectations to expect fewer (if any) Fed hikes in the short to medium term.

Indeed, we continue to see recent market behaviour as characteristic of a transition environment that has already moved us well beyond the best times for risk assets. The most likely end to this transition is a recession which typically results in bonds rallying and yields falling accordingly.

Additionally, in the UK, Brexit uncertainty intensified in Q4 2018 to put further downwards pressure on yields. Since September 2018, we have seen a fall in yields, particularly at the medium and long end.

Fixed interest gilt curve



Source: Aon

The Brexit threat

At the time of writing, there is still no clear consensus in Parliament over what sort of deal, if any, will be struck between the UK and EU.

Under a deal scenario, we believe the Bank of England may continue to increase interest rates, albeit we do not see significant upside to bond yields in this scenario.

Under an extension of Article 50, yields are likely to remain stable, although future uncertainty will remain over the medium term.

Alternatively, there is a range of possible 'no deal' outcomes, under each of these we see real yields falling, in some cases significantly. This is the key risk to any underhedged pension scheme.

Is now the right time to increase hedging?

A common challenge to increased hedging is the argument that 'rates must rise'. As already argued, slowing global growth and Brexit uncertainty have already begun to put downwards pressure on interest rates.

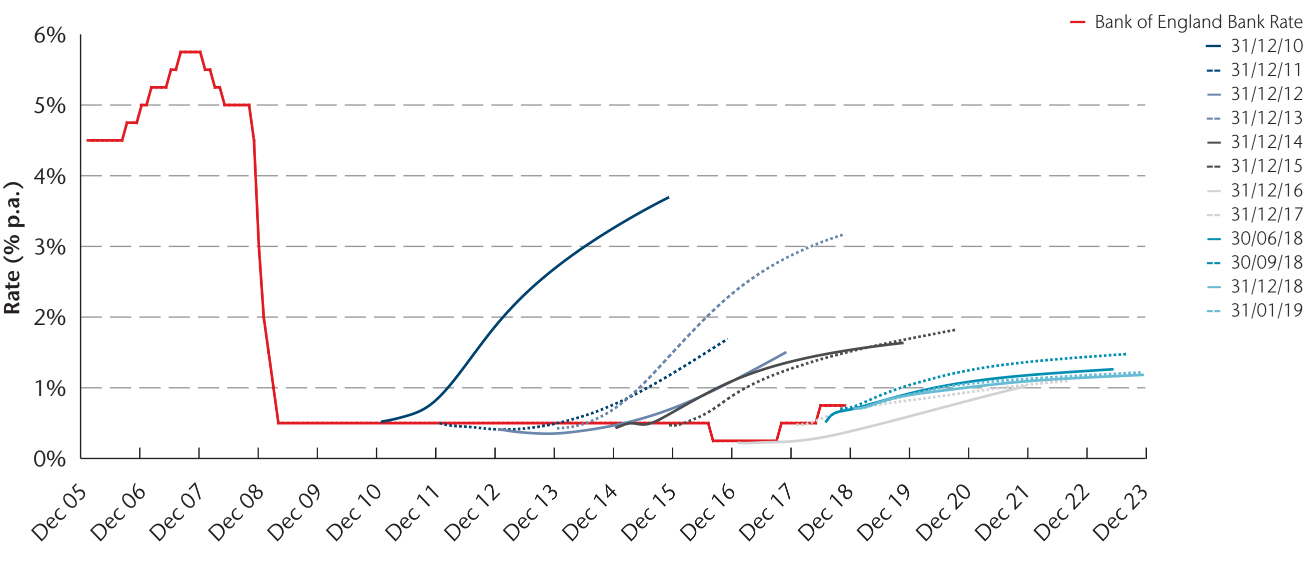
Even in the event that central banks restart their path towards 'normal' interest rates, the pace at which this happens is likely to be slower – therefore providing little upside potential for underhedged schemes.

Below we contend some of the common challenges around increasing hedge ratios.

'Rates will increase'

Markets have been arguing that interest rates will rise for many years; however, they have consistently been proved wrong as the chart below suggests.

Markets keep getting it wrong



Source: Bank of England Yield Curves, Aon

'There is upside in being underhedged'

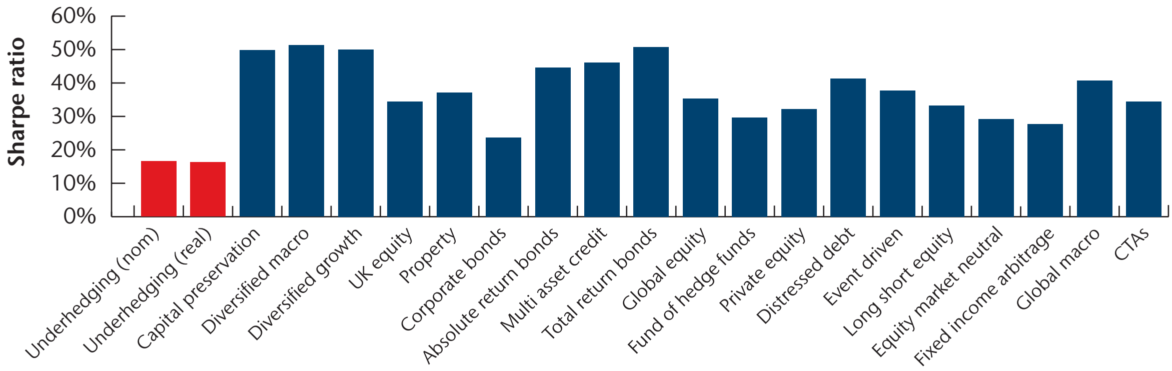
Many trustees argue that being underhedged will pay off if interest rates rise. Whilst this is true, this is only the case if interest rates rise *faster than market expectations*.

As with any potential return, this should be considered against the commensurate risk that is being taken.

Whilst underhedging does provide the potential for upside, this comes at a considerable risk.

The chart below shows that, from a risk/reward perspective, underhedging is a far less efficient source of return than other asset classes.

Efficiency of investment options



Source: Aon
Note: Return due to underhedging assumes nominal yields rise by 0.5% and real yields rise by 0.4%.

'Yields can't get any lower'

We have already seen a reversion in the upwards trend for yields over the last few months. And there is no guarantee that yields couldn't fall further.

Indeed – in the event of a no-deal Brexit we could see significant downwards pressure on yields.

We don't need to look far to find other developed nations with lower yields than the UK.

Historical yields on government bonds (10 year rate)

Source: FactSet

And Japan shows us that yields can continue on a downwards trajectory. The chart below plots Japan on the bottom axis and the rest of the world on the top axis, effectively comparing US and European bond markets with Japanese bonds 15 years ago.

Historical yields on government bonds (10 year rate) with Japan time-adjusted

Source: FactSet

How can I prepare?

For most schemes, we believe now is the time to pause and consider risks that have been left on the table. For the most part, schemes have been increasing their hedging levels over the last few years, but perhaps to not as high levels as they could.

There are a number of actions that trustees can take to ensure their schemes are prepared:

- **Increase hedging** – particularly for those schemes with low hedge ratios and/or which have not yet implemented a structured LDI solution.
- **Consider the appropriate mandate type** – as hedge ratios increase and schemes de-risk following years of strong equity returns, the proportion of assets allocated to LDI has increased. Now is a good time to consider whether your original LDI solution (profile fund, pooled buckets, bespoke) still remains optimal.
- **Re-negotiate fees** – LDI best-in-class solutions are constantly evolving and a regular suitability review is recommended. One feature we've seen recently is fee compression in LDI so we think there are double benefits currently available to achieve a better solution and to pay lower fees for any scheme that has not reviewed their LDI mandate in a while.

Conclusion

Whilst central banks are not yet reversing policy, there has been a definite slowdown in the pace of rate rises globally. This development, combined with Brexit risk in the UK, argues for high hedge ratios. Even if Brexit uncertainty wanes, broad market volatility will likely keep yield moves muted.

We therefore believe there is a strong case for trustees to consider:

- Increasing hedge ratios
- Reconsidering LDI mandate type
- Re-negotiating fees as part of both processes

We're here to empower results

For any further discussion, please get in touch with your Aon consultant.

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About Aon

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