

## Overview

# Markets, macro and strategic portfolios

LCP investment update  
to 31 December 2022

- Our **market commentary** looks at the prospects of a widespread economic recession. However, with inflation having seemingly peaked, and supply chain pressures easing, there is perhaps the hope of an outturn better than the one expected only a few weeks ago. Our **asset commentary** focuses on bonds, noting the impact of Central Banks' monetary tightening programmes and the aftermath of the UK's so-called 'mini-budget' ([pages 2-3](#)).
- Our central case in the **macroeconomic scenarios** is for inflation to remain above target and recession (probably mild) in many major economies. We have made a few changes to our **asset views**. We've upgraded protection strategies and downgraded secured loans ([pages 4-5](#)) to reflect the potential impact of a global recession on these assets.
- In our **strategic portfolio**, part of the redemption proceeds from the Scheme's illiquid holdings is used to maintain investment returns, by investing in listed infrastructure and synthetic equities. The balance of the proceeds is being used to top up the collateral pool supporting the LDI portfolio, reducing leverage within the scheme ([pages 6-7](#)).
- Our **ESG issues** consider the anti-ESG movement in the US, COP-15, as well as the importance of considering climate change within your investments and what you can do about it ([page 8-9](#)).



# Market commentary – background

## Global outlook

Like parachutists, policymakers the world over have been trying to engineer a “soft landing”. Until very recently though, the ground seemed to be approaching rather too quickly, whatever the adjustments made to the steering lines. Just weeks ago, IMF head (Kristalina Georgieva) predicted recession in 2023 for a third of the world economy. But, with good news on inflation (see opposite), supply chain pressures easing and stronger recent economic data, the IMF has turned more optimistic. A merely bumpy rather than a crash landing would be deemed a result.

Three years after the start of China’s oppressive zero-covid restrictions, mass protests and discontent forced the CCP to bring the policy to an abrupt and chaotic end. Short term turbulence lies ahead, given the country’s low vaccination rate, strained healthcare system and the likely impact of the mass migration of infected city dwellers to rural family homes to celebrate lunar new year. While a human tragedy may well now unfold, unseen and unremarked, the policy “shift” (screeching U-turn more like) was largely well received by markets, with expectations of a rebound in economic growth; not necessarily an unalloyed good, given its potentially inflationary impact, particularly within energy markets.

US midterm results disappointed Republicans, though they still took control of the House of Representatives; with a split Congress, debt ceiling standoffs and government shutdowns loom, as does a more challenging outlook for President Biden.

Priministerial veteran (well, compared to the last incumbent at

least) Rishi Sunak faces a tough economic outlook – November’s OECD report has UK growth of -0.4% (2023) and 0.2% (2024). Not the worst – Russia faces a bleaker outlook.

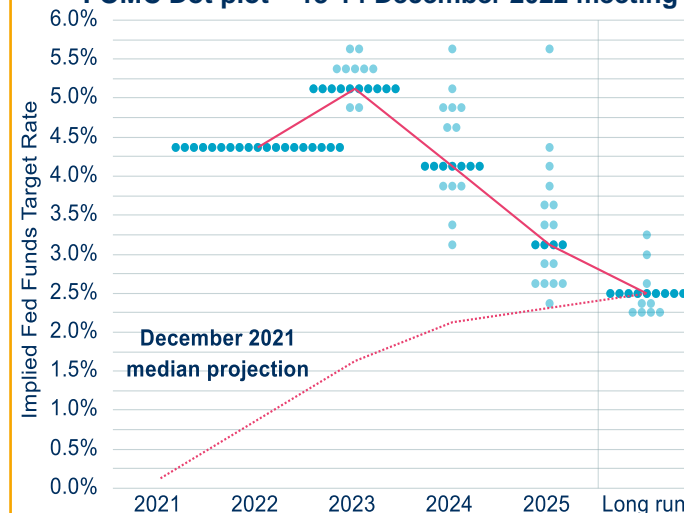
## Interest rates and inflation

Inflation appears to be falling at last, with major economies including the UK, US and Germany all producing inflation prints below their respective peaks. But declaring victory now would be premature. Inflation remains way above central bank targets (typically 2%), worryingly so in the services sector. Although prices are edging down, while labour market conditions remain tight and pay is lower in real terms, it’s no surprise to see that workers have the motivation and confidence to strike. The UK (and others) are experiencing some of the highest levels of industrial action in decades.

In their war on inflation, central bankers seem to see the fall in inflation as the end of the beginning rather than the beginning of the end. Certainly, their messaging remains “hawkish” overall on policy rates with further increases signposted, if at a slightly slower rate. The Fed’s most recent rate hike brought US base rates to 4.25-4.50%, a level last seen 2007, though the increase (0.5%) was lower than the 0.75% rises at three prior meetings. The BoE and ECB also hiked to 3.50% and 2.50% respectively. A year after the first major central bank (BoE) raised rates, the last major holdout (BoJ) finally pivoted towards (ever so slightly) tighter monetary policy, relaxing its iron grip on the level of Japanese Government Bond yields and triggering a sharp sell-off. For a long time a side show, Japanese monetary policy now merits closer attention.



FOMC Dot plot – 13-14 December 2022 meeting



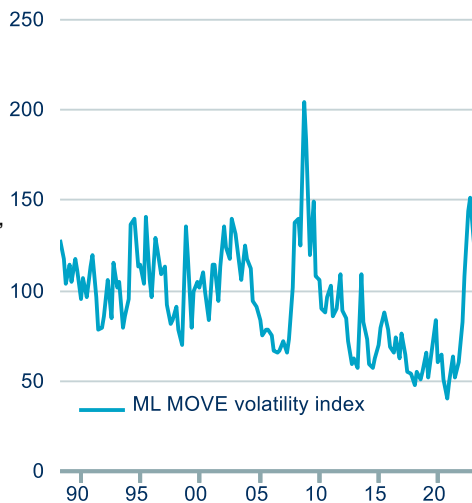
- [Listen to our Investment Uncut episode: Gilts, LDI, DB pensions and what’s next](#)
- [Watch our on-demand webinar: Gilt market volatility - important actions to consider for DB Scheme investment strategies](#)



# Market commentary – asset class performance

## Bond performance

Inflation may have peaked, but remains high. It may not fall quickly to central bank targets since there's a chance that after a relatively rapid descent in 2023, prices prove "stickier" in 2024, especially if the Fed and others press pause too soon on their rate hiking cycle. Uncertainty remains high – despite falling somewhat over Q4, the MOVE index (which tracks volatility in US treasury bonds) remains at levels last seen during the 2008/9 Global Financial Crisis.



The UK gilt market settled down over the latter half of Q4 2022 – thank goodness – following the turmoil that first erupted on 23 September (where were you when it started?) following the then chancellor's disastrous mini-budget. Yields eventually stabilised as a result of BoE intervention (a £19bn emergency bond purchase scheme – from which it made an estimated £3.5bn profit) – as well as political change: newly appointed Chancellor Jeremy Hunt's reassuring bedside manner proved invaluable in soothing jittery investors' frayed nerves. As calm returned the BoE became the first major bank to start quantitative tightening, selling £750m of gilts from its £850bn stockpile (the aim is to sell down c£80bn pa). The losses (indemnified by the Treasury) the Bank may incur on the sales of bonds purchased at record low yields, and their potential impact on government finances, are yet to really generate the headlines they deserve. In the 3 months to 31 December 2022, while UK real gilt yields rose, UK nominal gilt yields fell at shorter maturities and rose at longer maturities.

The European Central Bank is expected to start its quantitative tightening program in March 2023. However, widening spreads between Germany and other countries bonds (namely Italy) could prove problematic. German-Italian 10-year bond spreads rose back above 200bps following the ECB's December rate hike.

Credit spreads tightened over the quarter as investor risk sentiment improved, but the rise in interest rates can be expected to provide a headwind for businesses with floating rate debt or a need to refinance, raising default and downgrade risks.

## Equity performance

Q4 2022 brought some much needed relief for equity markets with the MSCI World Index returning 7.6% (local currency), albeit still down 15.6% YoY. The UK market outperformed (yes, you read that right) with the FTSE All Share Returning 8.9% QoQ following a sharp rebound in investor sentiment post the reversal of Liz Truss' mini-budget and Andrew Bailey's (BoE Governor) suggestion that not as many rate rises as expected may be needed.

Asia Pacific ex Japan also performed strongly, boosted by the end of China's zero COVID policies and news of support for ailing Chinese property developers.

BoE = Bank of England; MSCI = Morgan Stanley Capital International; YoY = year-over-year; QoQ = quarter-over-quarter

### Value vs growth returns (local currency)

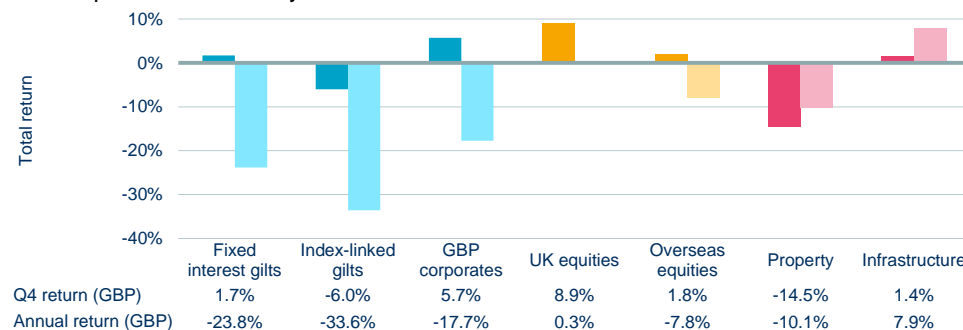


At a style level, value massively outperformed growth both over the quarter and throughout the year with November producing one of the widest margins of relative monthly outperformance since 1978. The outperformance of value stocks over growth stocks broke the latter's 10-year dominance.

## Alternative assets performance

Europe breathed a sigh of relief after a warmer-than-expected winter (to date at least) led to a c20% reduction in EU consumption of natural gas over the period August-November (relative to 2017-2021), precipitating a Q4 c61% drop in prices. The prospect of a rebound in Chinese demand for commodities has the potential to turbocharge prices – here's hoping for an early spring.

Rising interest rates hit the UK property market hard this quarter, with capital values down around 15% over the period (down c13% for the year). The industrial sector, which has been the strongest performer for over recent years, had the furthest to fall, and experienced a fall in capital values of c21% over 2022. By contrast, infrastructure benefitted from high inflation over 2022 reflecting the ability of underlying companies to pass on inflationary costs.





## Economic scenarios

### Central case: above target inflation and recession in many major economies

- Inflation peaks and starts to moderate, but remains above central bank targets throughout 2023. Central banks continue raising interest rates, with rates peaking in most major economies by the middle of the year. The risk of policy mistakes, as central banks try to balance the need to control inflation without impacting growth too much, remains high.
- Many regions experience a downturn in economic activity, but the degree of severity varies markedly. US conditions remain relatively benign, with a mild recession possible as a robust employment outlook gives way to some jobs market softening. The UK suffers a more sustained downturn, characterised by both labour market shortages and elevated food and energy prices. These factors also impact the wider European economy, where recession is mild but lengthy. The cost of living remains challenging for households, and consumer and business confidence is weak.
- Limited initial disruption following China’s re-opening. Chinese economic growth rebounds and new policies supports the property market. The upturn is supportive for global growth, and a services led recovery in China limits the potential upward pressure on commodity prices from higher demand. Growth and inflation vary significantly across emerging market economies given significantly different Chinese / broader macroeconomic exposures.
- The war in Ukraine continues and economic sanctions on Russia remain in place, with the possibility of further escalation of the West’s measures and possible subsequent economic retaliation from Russia such as the threat of a total gas supply cut. Europe is less reliant on Russian gas following supply restructuring.

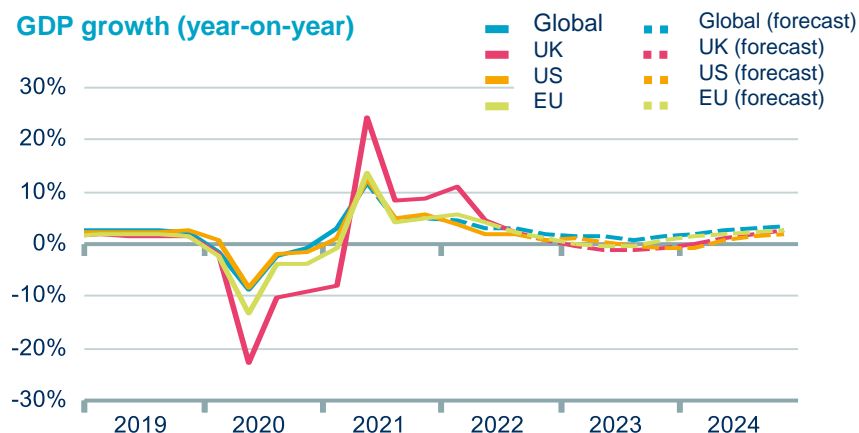
### Downside: 1970s style stagflation

- Central banks start their rate cutting cycles too early, resulting in 1970s style stagflation with sustained inflation accompanied by a prolonged recession and high unemployment in many large economies. Inflation expectations increase markedly, with a wage / price spiral developing, each pushing the other upwards in turn.
- China’s growth, following the re-opening of the economy, is impacted by various sub-variants of Coronavirus resulting in supply chain bottlenecks which further exacerbate inflationary pressures.
- The crisis in Ukraine escalates further, with heightened fears that the conflict spreads beyond Ukraine’s borders leading to increasingly severe economic sanctions on Russia. There is further upwards pressure on energy prices as a total gas supply cut is implemented by Russia.

### Upside: inflation pressures ease and economic growth stabilises (soft landing)

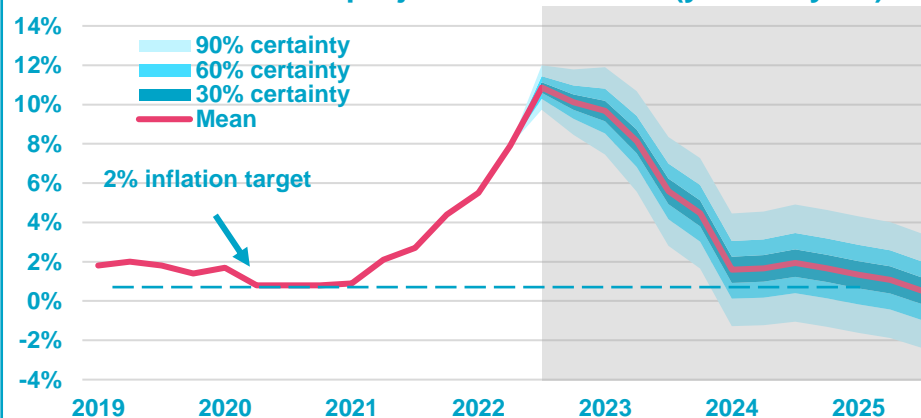
- Labour shortages ease as companies adapt their business models to service demand in more innovative ways. Inflation falls back to central bank targets during 2023, as monetary policy is effective in controlling inflation and inflation expectations subside towards central bank targets.
- The US avoids recession, and contraction in the UK and Europe is mild. China’s re-opening is smooth and boosts global growth, while energy price stabilisation supports the recovery in Europe.
- There is a boost to business and consumer confidence given improving economic sentiment.

### GDP growth (year-on-year)



Source: Refinitiv Datastream

### CPI Inflation projection for the UK (year-on-year)



Source: Bank of England, November 2022.

### Ask your consultant

- What do you currently see to be the largest risk to my portfolio?
- How will my portfolio be impacted by changes in interest rates and inflation expectations?
- Can you model economic scenarios and their impact on my portfolio?



## Asset class views

Our views of attractiveness over the medium-term (2 to 3 years) is informed by our central case economic scenario for the next 12-18 months.

### Changes to our view

↑ Protection strategies ++ (from +)

↓ Secured loans – (from +)

#### Equity

Equities – climate-tilted +

Equities – emerging +

Equities – global developed +

Equities – small cap +

Equities – UK +

Private equity – –

#### Real assets

Listed infrastructure +

Unlisted Infrastructure +

Long-lease property –

Property – global –

Property – global listed –

Property – UK commercial – –

#### Credit

Asset-backed securities ++

Corporate bonds +

High yield debt +

Multi-asset credit +

Opportunistic credit +

Short duration  
buy & maintain credit +

Absolute return bonds –

Emerging market bonds –

Private credit –

Secured loans –

#### Absolute return

Protection strategies ++

Diversified growth funds –

(Fund of) hedge funds – –

The above present a broad range of investment opportunities. Please note that some of the asset classes shown may not be directly relevant for your scheme (ie for DC and private wealth investors). The views do not take account of the availability of assets or scheme-specific circumstances. Please contact your investment consultant to discuss the most appropriate approach.

### We have upgraded equity protection strategies from + to ++

- Using equity derivatives can allow investors to “re-shape” their exposure to equities to better suit their needs. For example, equity options can be used to provide a layer of downside equity protection. Investors could choose to pay a premium to obtain the protection, or could alternatively pay away upside above a particular threshold to fund the desired downside protection.
- Not only can the pattern of returns be “re-shaped” using equity options, they can also be far more capital efficient than investing in equities directly. This may be particularly attractive to investors who need to free up capital or are short on liquidity, eg those that wish to retain or increase exposures to illiquid assets and / or those that have additional capital requirements to support interest rate and inflation hedges (eg UK DB pension schemes).
- Adding to the attractiveness of equity downside protection is the uncertain short-term economic outlook and the potential for a deeper recession – either globally or regionally – than expected. Having protection can give investors the confidence to retain an allocation to equities, which we expect to be good investments over longer timeframes.

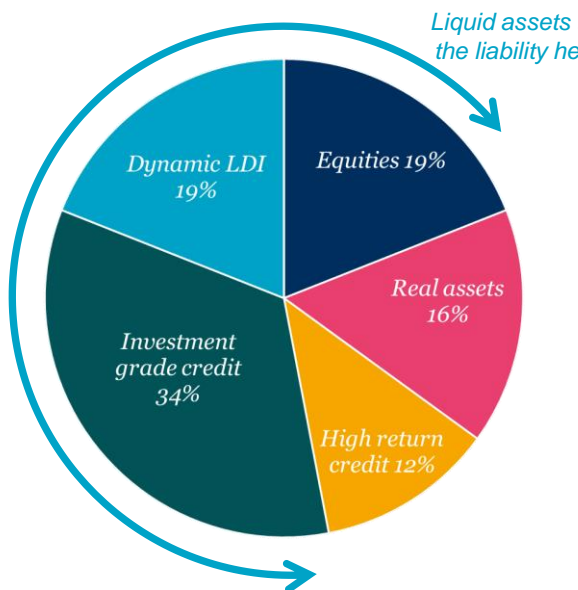
### We have downgraded secured loans from + to –

- Secured loans are debt instruments issued by companies with, on average, credit ratings that are below investment grade. The interest rate payable on the loan is commonly a floating rate which rises and falls as the loan’s benchmark cash rate, such as LIBOR, rises and falls.
- As interest rates have risen, companies have had to pay higher cash amounts to the holders of loans. This is likely to stress to some extent their ability to finance the payments and / or finance their operational business.
- The amount of loan debt that matures, and needs to be refinanced, in the next five or six years is substantial – and significantly higher than the amount of fixed rate high yield bond debt due to mature over the same period.
- Yields available on fixed rate high yield debt are in line with those available on secured loans. In our view, high yield bonds appear lower risk than secured loans due to the fixed rate nature of the payments and the maturity profile.
- We have, therefore, downgraded secured loans to ‘–’, reflecting our view that there are more attractive ways to access the higher risk parts of the debt markets.



## Strategic portfolio

Our strategic portfolio highlights the latest ideas from LCP’s investment strategy and research teams and how these ideas can be brought together to construct an efficient asset portfolio.



Expected return: Gilts + 2.3% pa  
 Liability hedge ratio: 100% of assets including future deficit contributions  
 Unhedged currency exposure: 25% of assets

| Portfolio  | %         | Change |
|--|-----------|--------|
| <b>Investment grade credit</b>                             | <b>34</b> | -      |
| Enhanced ESG long dated buy & maintain credit <sup>1</sup> | 6         | -      |
| Asset-backed securities <sup>1</sup>                       | 7         | -      |
| Net-zero transition short duration credit <sup>1</sup>     | 3         | -      |
| Synthetic credit overlay <sup>1</sup>                      | 18        | -      |

| Portfolio  | %         | Change    |
|--|-----------|-----------|
| <b>Equities</b>  | <b>19</b> | <b>+3</b> |
| Synthetic equity protection <sup>1</sup>   | 15        | +3        |
| Low carbon global equities   | 4         | -         |
| Emerging market equities   | -         | -         |
| <b>Real assets</b>   | <b>16</b> | <b>-5</b> |
| Unlisted infrastructure  | 5         | -5        |
| Listed infrastructure  | 3         | +3        |
| Unlisted global property   | 3         | -2        |
| Long lease property  | 5         | -1        |
| <b>High return credit</b>  | <b>12</b> | -         |
| Opportunistic credit   | 6         | -         |
| Private credit   | 3         | -         |
| Infrastructure debt  | 3         | -         |
| Emerging market debt   | -         | -         |
| Multi-asset credit   | -         | -         |
| <b>Dynamic LDI<sup>1</sup></b>   | <b>19</b> | <b>+2</b> |
| The cash and gilts within the bespoke fund supporting the LDI and synthetic exposures can withstand a c.4.1% rise in yields. Allowing for other assets held within the collateral waterfall in the bespoke fund (ie including ABS and short duration credit), the strategy can withstand a c.5.4% rise in yields. The use of long dated buy and maintain can also be used to further support the LDI allocation. |           |           |

### Asset allocation changes we've made

- As outlined in our previous update, we had previously placed redemption requests on some illiquid holdings. Consistent with market practice for those funds, we have now received partial redemption proceeds from unlisted infrastructure and global property.
- To maintain investment returns, proceeds from the illiquid assets were used to reallocate assets to listed infrastructure (see our rationale below), and synthetic equities, which have the added benefit of downside protection – which may prove useful in a recessionary period. The remaining proceeds were used to top up the collateral pool supporting the LDI portfolio, reducing leverage within the Scheme. As a result, the LDI portfolio can now sustain a **c4.1% yield rise**. This is at the upper end of the level suggested in [The Pensions Regulator's guidance](#) to DB pension schemes issued in November. Including short dated credit and asset-backed securities, the **total yield shock that can be sustained is now c5.4%**, an increase of around 0.9% from the end of last quarter.

### Real assets

- As outlined, we have reduced our allocation to unlisted infrastructure in favour of listed infrastructure. We have a positive view of infrastructure as an asset class (both listed and unlisted funds).
- We believe that the market environment remains favourable for infrastructure. The essential nature of infrastructure ie utilities, power generation and toll roads means that revenues are expected to be resilient in a more recessionary environment. Alongside this, infrastructure has historically delivered strong returns during a high inflation environment, benefiting from the inflation-linked nature of the underlying assets.
- While a listed exposure is generally more volatile than unlisted infrastructure funds (as valuations are marked-to-market on a daily basis), it provides higher levels of liquidity. The features of listed infrastructure also mean that it is often more resilient than global equities in periods of market volatility and higher inflation. As such, we believe the higher allocation to listed infrastructure maintains diversification in the portfolio while increasing liquidity, without materially impacting expected returns.

### Enhanced ESG and Net-Zero Credit

- We have reconfigured the long dated buy & maintain credit as an **Enhanced ESG** mandate as we believe longer dated credit assets align with a need for **even greater focus on sustainability-related issues**.
- Issues such as accounting scandals (G), environmental disasters or net zero transition risks (E) or poor labour standards (S) can ultimately impact a company's creditworthiness.
- We note that this mandate sits within the bespoke fund and can therefore be used as last resort as additional LDI collateral after the exhaustion of cash, short dated credit and ABS.

<sup>1</sup>Assets all held within a single bespoke fund and used to support the hedging exposures. Expected return based on LCP's latest asset class assumptions, and are available upon request.

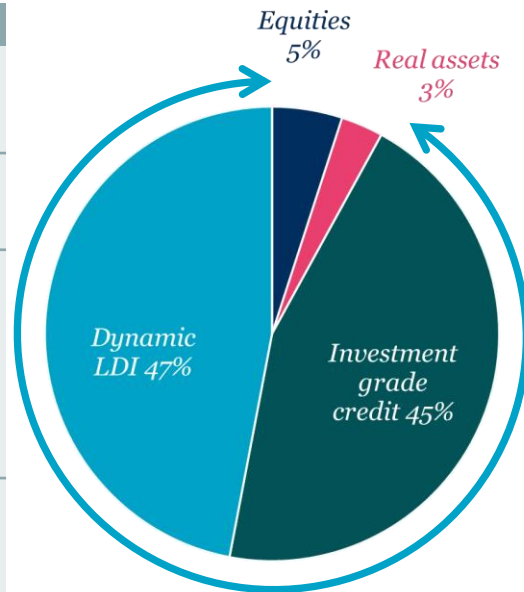


## Low-dependency strategic portfolio

Our low-dependency portfolio is appropriate for well-funded and/or significantly mature schemes, and has also been designed to provide flexibility to take advantage of buy-out opportunities. This portfolio is designed to be consistent with the low dependency investment allocation, and in particular “Fast Track”, as outlined in the TPR’s draft new funding code.

| Portfolio  | %         |
|--|-----------|
| <b>Equities</b>  | <b>5</b>  |
| Low carbon global equities   | 5         |
| <b>Real assets</b>   | <b>3</b>  |
| Listed infrastructure  | 3         |
| <b>Investment grade credit</b>   | <b>45</b> |
| Enhanced ESG long dated buy & maintain credit <sup>1</sup>   | 30        |
| Asset-backed securities <sup>1</sup>   | 10        |
| Net zero transition short duration credit <sup>1</sup>   | 5         |
| <b>Dynamic LDI<sup>1</sup></b>   | <b>47</b> |
| The cash and gilts within the bespoke fund can withstand a c.8% rise in yields. Allowing for the other assets held within the collateral waterfall within the bespoke fund (ABS and short duration credit), the strategy can withstand a c.10% rise in yields. The use of long dated buy and maintain can be used to further support the LDI allocation. |           |

<sup>1</sup>Assets that are held within a single bespoke fund and used to support the hedging exposures.



Assets that are used to support the liability hedging exposures (92%)

Expected return: Gilts + 1.2% pa  
 Liability hedge ratio: 100% of assets  
 Minimal unhedged currency exposure

### Ask your consultant

- How does the funding code consultation impact my current investment allocation and the investment allocation I should be heading towards?
- Am I in the position to consider an insurance transaction and if so how should I position my portfolio to prepare for this?

Watch our Webinars: [The new DB funding code – the good, the bad and the \(potentially\) ugly](#) on demand to learn more about the proposal and our follow-up [The new DB funding code – a whole new world for covenant advice](#).

## The Pensions Regulator’s funding code consultation

The second UK pension scheme funding and investment code consultation was released in mid December. Despite not yet being written into law, this is a significant development in the pension space and will impact every UK DB pension scheme.

Once the new funding code has been finalised, we expect most schemes will be required to set out their low-dependency investment allocation and set out a journey plan for the investment strategy to transition towards this portfolio. Given every scheme will be required to do this, and not every scheme may wish to use insurance solutions, we have also taken the opportunity to remove the reference we previously had opposite to partial buy-in assets, to make the presentation of the portfolio applicable to every scheme. For those that already have/intend to have partial insurance solutions, the portfolio opposite could be considered the strategy for the uninsured members.

Under the draft code, the low dependency investment allocation must be in place for significantly mature schemes, and must have the following investment characteristics:

- broadly cashflow matched, with significant (an expectation of at least 90%) interest rate and inflation hedging;
- highly resilient, with a low allocation to growth assets (with an example of 15% provided); and
- a limit of 4.5% change in funding level in a modelled one year 1-in-6 year stress event.

Furthermore, in addition to the above requirements, to meet the new “Fast Track” requirements in complying with the above requirements, the low dependency investment allocation should also have a stressed funding level change of no more than 1.9%, under a prescribed formula, which encourages further hedging and risk reduction.

Therefore, when setting the allocation for our low-dependency strategic portfolio, we decided that the portfolio should:

- hedge 100% of liability interest rates and inflation sensitivities;
- target an investment return of at least gilts + 1.0% pa, whilst meeting risk limits;
- maintain a low level of leverage in the LDI portfolio, with an appropriate level of assets to support the LDI portfolio; and
- have a material allocation to credit assets, to provide contractual income.

Our resultant portfolio targets an investment return of gilts + 1.2% pa, with an 8% allocation to growth assets. Although this expected return is higher than the required, we note that the Pensions Regulator’s low dependency example portfolio includes a 15% allocation to growth assets. The portfolio also meets the low dependency investment allocation’s risk test, with a 1-in-6 stressed funding level causing less than a 2% deterioration to the funding level, as well as within the Fast Track stress limit.



## Fallout from the ESG backlash in the US

An 'anti-ESG' movement in the US has been gaining momentum.

Linked to this movement, there have been several recent noteworthy events:

- Some states have introduced anti-ESG or pro-fossil fuel policies. For example, Florida's state pension fund can no longer consider ESG factors when making investment decisions. In state governor Ron DeSantis' (who might run for President in 2024) rather flowery language, ESG policies "are dead on arrival in the state of Florida".
- Several funds have been blacklisted by the Texas Comptroller based where the investment manager is a member of NZAMI (Net Zero Asset Managers initiative). In December, Vanguard, the US-based (mostly retail) investment manager quit NZAMI, citing a desire to speak "independently on matters of importance to our investors". Odd. On climate change, we'd have thought a collective voice was far more powerful.
- Several Republican politicians have written to members of Climate100+ (the collaborative climate engagement group of asset owners and managers) while also launching an investigation into its legality.

Proponents of the actions and views described above often argue that so called 'ESG investing' is at odds with the fiduciary duty to maximise financial returns, or that it violates US anti-trust laws. We'll leave the legal arguments to others. We agree there is a fiduciary duty to maximise financial returns. The best way to do that is to consider as broad a range of a factors as possible which might impact the risk and return characteristics of a potential investment. These days, that has to include ESG matters.

This story has legs – more a marathon than a 100m dash – as responsible investment becomes a much more politically charged issue. Expect to see continued pressure on asset managers to "clarify" their position on 'ESG investing', especially those with a significant US presence. Prepare for some high wire linguistic gymnastics.

So, what can investors do? Continue to monitor managers to ensure the manager's policies and actions remain consistent with their own responsible investment objectives.

### Ask your managers

- Has your approach to responsible investment or stewardship been challenged over the last six months, by whom, and how have you responded?
- Are your sponsorship and lobbying efforts in the US and elsewhere consistent with your own stated policies on ESG issues?

## COP15 driving action on biodiversity

In Montreal, during the final days of 2022, almost 200 countries agreed a new global biodiversity framework at COP15, the biennial UN biodiversity summit. This included a headline target to conserve 30% of the world's surface by 2030.

Significant action is required over the next few years to meet this goal. Biodiversity is declining at an alarming rate – according to WWF research, wild animal populations have declined 69% in around 50 years. Investors should be considering this risk – a World Economic Forum report in 2020 estimated that over half of the world's GDP is dependent on nature.

The good news is that there are already initiatives in the pipeline to help investors address this issue including:

- the **Taskforce on Nature-related Financial Disclosures (TNFD)**, which has published a draft framework for disclosing nature-related risks and opportunities. It's due to be finalised in September 2023.
- **Nature Action 100**, a global asset owner and investment manager initiative aimed at spurring corporate action to reduce nature and biodiversity loss through engagement. The official launch is due in Spring 2023.

Looking ahead, some aspects of the TNFD framework may be integrated into company and investor disclosure requirements as countries begin to act on nature in order to meet their goals. We also expect to see more investment opportunities specifically aligned with nature positive goals.



In the meantime, investors should ensure they understand their managers' approaches to considering nature related risks and opportunities.

### Ask your managers

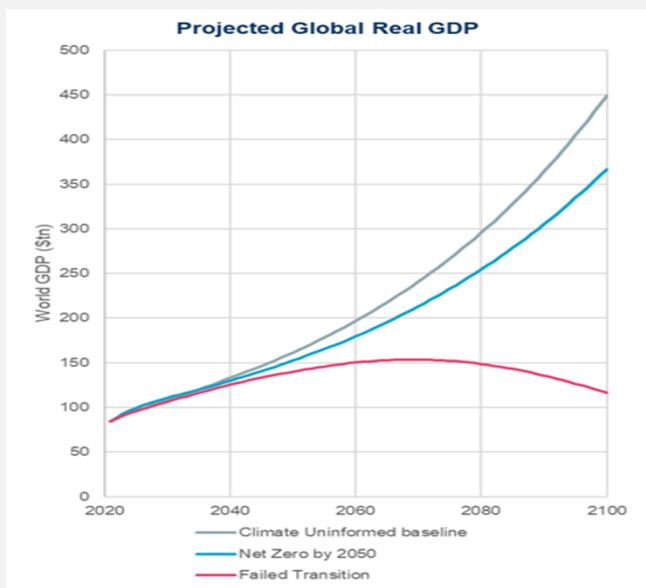
- How do you consider nature related risk within the portfolio at present? Are you expecting to evolve your approach in the year?
- Are you expecting to take part in Nature Action 100, if not, then why?



## Are you properly considering climate risk?

The end of the century is less than one lifetime away – by that time global assets could have fallen 30%. Widespread scheme failure is not unthinkable in worst case scenarios.

- Modelling long-term climate risk is extremely difficult, particularly at a company level, but what we do know is that it is the **greatest systemic risk society faces – at an environmental, economic and financial level.**
- Since it is a cross-cutting risk, **all investors – including pension schemes – are exposed to its potential impacts.** Some risks appear out of a seemingly clear blue (ok, maybe sometimes slightly overcast) sky – think of the impact on gilts and LDI strategies of the recent mini-budget. Investors could be forgiven, to some extent at least, for not having fully addressed such an outturn in their contingency planning. Climate change is different.
- It's both more readily foreseeable and likely much greater in magnitude. Some pension schemes will have incurred losses in responding to the gilts crisis – a few £billion in aggregate perhaps. Whatever it was, it's dwarfed by the potential impact on asset values of climate change, with one estimate of \$43 trillion – you can't afford, literally, to be caught out by it.



## What can you do about it?

**Impact investing could be a key way to protect strategies from the worst case climate scenarios.**

- Much of the climate-related focus to date has been on regulatory-driven reporting of portfolio emissions. But you could argue that's a bit of a spectator sport and not **enough by itself to make a real and lasting impact.** As an investor, **you're a player and have power** to influence things. Many clients have set climate as a 2023 stewardship priority – have you?
- **The IPCC has voiced concerns over the use of ESG tilted funds (perhaps more akin to spectating than playing) as these types of ESG strategies “do not yield meaningful social or environmental outcomes”.**
- ESG screens and low carbon index funds may reduce portfolio emissions today, but **do not necessarily reduce long-term climate risks.** By paving the way to net zero, active management and impact investing could be key in protecting strategies (and skiing trips) from worst-case climate risks.

### What is impact investing?

Impact investing is based on three key principles: **intentionality**, **additionality** and **measurability**.

It involves investing in **solutions to climate change** and other ESG issues in a **real, measurable** manner, and is essential to prevent the worst consequences of climate change.

**Importantly – it's not just for equities.**

### European weather: Winter heat records smashed all over continent



**Some parts of the Swiss Alps hit 20 degrees Celsius... in January**

### Ask your consultant

- How can I challenge my existing investment managers to best meet my stewardship requirements and effect real change?
- Of the asset classes we hold, which offer credible impact funds?
- Can we see an impact investment manager?
- How much would you recommend allocating to impact funds?



## Economic and market data

### Equities

|                                  | QTD (to 23/01/23) | 3M (to 31/12/22) | 1Y (to 31/12/22) |
|----------------------------------|-------------------|------------------|------------------|
| Global equities (local)          | 5.5%              | 7.5%             | -15.3%           |
| Global equities (unhedged, GBP)  | 3.2%              | 2.1%             | -7.3%            |
| UK equities                      | 4.6%              | 8.9%             | 0.3%             |
| US equities (local)              | 5.0%              | 7.2%             | -19.3%           |
| Emerging market equities (local) | 7.0%              | 7.0%             | -13.5%           |

### Bond performance

|                                  | QTD (to 23/01/23) | 3M (to 31/12/22) | 1Y (to 31/12/22) |
|----------------------------------|-------------------|------------------|------------------|
| Over 15yr fixed gilts            | 4.1%              | -1.8%            | -40.1%           |
| Over 15yr index-linked gilts     | 4.2%              | -12.8%           | -46.9%           |
| GBP corporate bonds (all stocks) | 3.2%              | 6.2%             | -17.8%           |

### Gilt yields

|                    | 31/12/2022 | 30/09/2022 | 31/12/2021 |
|--------------------|------------|------------|------------|
| 5 year gilt yield  | 3.7%       | 4.3%       | 0.8%       |
| 10 year gilt yield | 3.8%       | 4.2%       | 1.0%       |
| 15 year gilt yield | 4.1%       | 4.2%       | 1.2%       |

### Credit spreads

|                         | 31/12/2022 | 30/09/2022 | 31/12/2021 |
|-------------------------|------------|------------|------------|
| GBP non-gilts           | 1.6%       | 2.0%       | 1.0%       |
| Global investment grade | 1.5%       | 1.8%       | 1.0%       |
| Global high yield       | 5.1%       | 6.1%       | 3.7%       |

### Alternatives

|                             | 1M (to 31/12/22) | 3M (to 31/12/22) | 1Y (to 31/12/22) |
|-----------------------------|------------------|------------------|------------------|
| Property (data to 30/11/22) | -5.5%            | -13.6%           | -3.4%            |
| Infrastructure (listed)     | -3.1%            | 1.4%             | 7.9%             |

### Currencies

|          | 31/12/2022 | 30/09/2022 | 31/12/2021 |
|----------|------------|------------|------------|
| \$ per £ | 1.21       | 1.12       | 1.35       |
| € per £  | 1.13       | 1.14       | 1.19       |

### Real GDP growth

|          | 2023  | 2022 | 2021 |
|----------|-------|------|------|
| World    | 2.2%  | 3.1% | 5.9% |
| UK       | -0.4% | 4.4% | 7.5% |
| US       | 0.5%  | 1.8% | 5.9% |
| Eurozone | 0.5%  | 3.3% | 5.3% |
| Japan    | 1.8%  | 1.6% | 1.6% |
| China    | 4.6%  | 3.3% | 8.1% |

### Inflation

|                | 2023 | 2022 | 2021  |
|----------------|------|------|-------|
| UK (CPI)       | 6.6% | 8.9% | 2.6%  |
| US (PCE)       | 3.5% | 6.2% | 4.0%  |
| Eurozone (CPI) | 6.8% | 8.3% | 2.6%  |
| Japan (CPI)    | 2.0% | 2.3% | -0.2% |
| China (CPI)    | 2.2% | 2.0% | 0.8%  |

### Policy interest rates

|          | 31/12/2022 | 30/09/2022 | 31/12/2021 |
|----------|------------|------------|------------|
| UK       | 3.50%      | 2.25%      | 0.25%      |
| US       | 4.50%      | 3.25%      | 0.25%      |
| Eurozone | 2.00%      | 0.75%      | -0.50%     |

Source: Bloomberg, Refinitiv Datastream, FTSE, ICE BofA, IPD, OECD, Bank of England, Federal Reserve, ECB



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