Compound Interest.

PIC's Quarterly Update

Q2 2023 • Issued 12 July 2023

Introduction.

Thank you for opening this second issue of *Compound Interest*, our series which looks at the feedback loop that exists between the assets that sit within the UK's £6 trillion savings system and the impact this has on the wider economy; how the unintended consequences of public policy and regulation drive these flows; and what this means for government borrowing and the UK's capacity to invest in much-needed infrastructure.

This quarter saw three main economic themes which have real implications for defined benefit pension schemes. First, the extent to which inflation is becoming ingrained, compared to twelve months previously where it was described as merely transitory. Bank of England Governor, Andrew Bailey, admitted there are *"very big lessons to learn"* after the central bank failed to forecast the recent rise and persistence of inflation. Second, how the combination of sustained inflation and thirteen consecutive rises in interest rates have not yet resulted in the UK's economy slamming into reverse. Most observers are expecting a recession, that hasn't happened. Finally, the steep rise in gilt yields and their impact on corporate borrowing costs.

In this issue our experts take a close look at the impact inflation has on long term pension investing strategy; how the recent increases in energy costs have influenced long-term funding plans for the transition to renewable energy; as well as at the consequences of the rise in gilt yields to levels not seen since the height of the LDI crisis following the mini-budget.

Topics in this issue include:

- What does inflation mean for defined benefit pensions?
- What does inflation mean for the transition to net zero?
- How does the rise in gilt yields affect the pension risk transfer market?
- How can long term infrastructure investments still deliver social value despite the impact of inflation on the construction industry?

On a personal note, I've also started to film a series of short explainer videos about some of these issues. The most recent one asks why did insurance companies like PIC with pensions to pay have a better LDI crisis than defined benefit pension schemes? You can watch it here.

We'd love to hear from you too. If you have any feedback on this edition, or suggestions for future issues, please do get in touch with the team.

Rob Groves
Chief Investment Officer, PIC

Who we are and what we do.

PIC's purpose is to pay the pensions of its current and future policyholders. Our purposeful investment strategy is carefully constructed to provide the cashflows to match all future pension payments over the coming decades.

The best way to do this is by investing in very secure assets like UK government and high-grade corporate bonds, and the infrastructure the UK needs. Our appetite for risk is low and our timeframe for success is measured over decades, not the next four quarters.

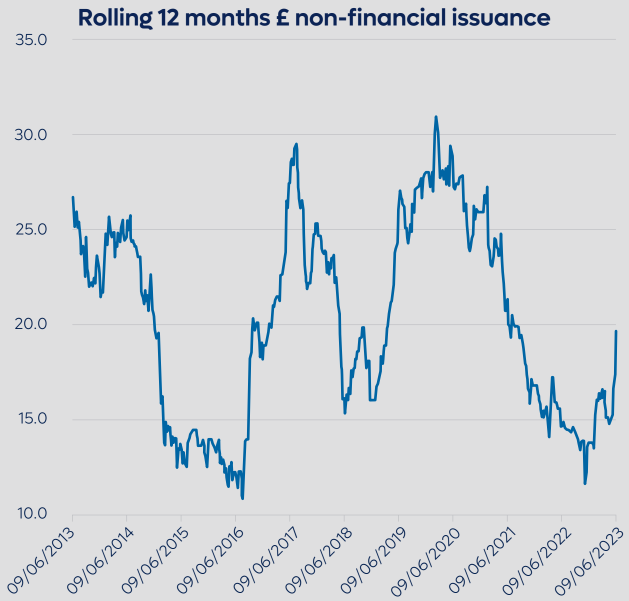
Of a total portfolio in excess of £40 billion, PIC has already invested more than £11 billion in UK productive finance assets such as social housing, renewable energy, urban regeneration projects, and the UK's universities. The best way for us to secure future pension cashflows is by investing in assets that have lots of social value, because what makes sense for society also helps us achieve our long-term aims.

There are still more than £1.5 trillion of defined benefit pension scheme pension promises sitting on UK corporate balance sheets. This figure continues to weigh on UK PLC, and those whose retirements could be poorer than expected, should their employer fail.

Q2 charts at a glance.

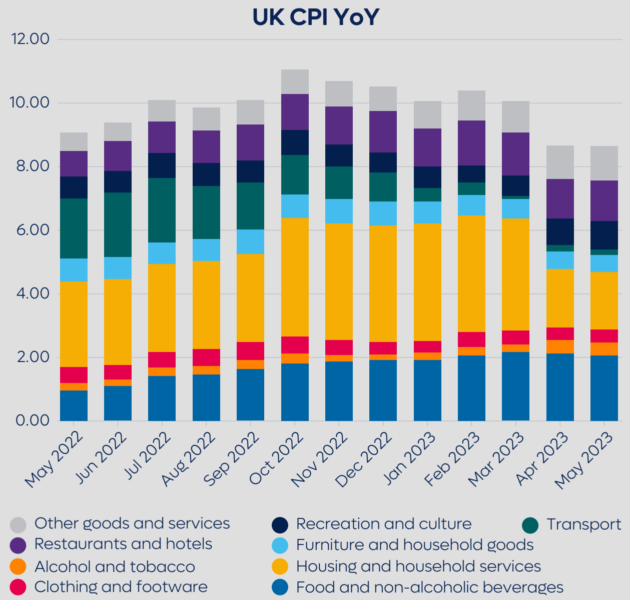
Key data this quarter

Illustration 1: Corporate issuance is significantly lower now that rates are higher, compared to rates at post-Covid levels.



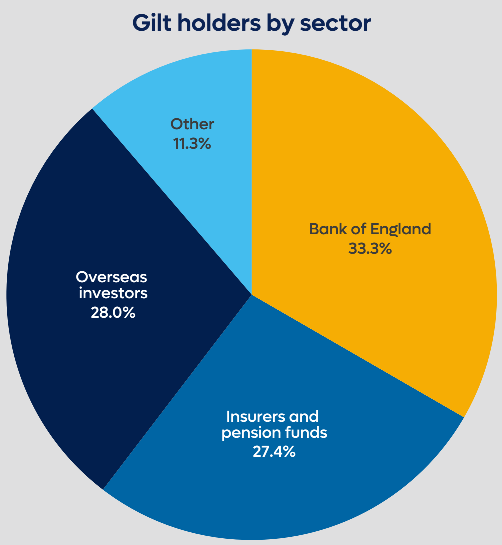
Source: Barclays

Illustration 2: UK inflation - significantly above the Bank of England's 2% target and May's UK CPI (the Consumer Price Index) was 8.7%.



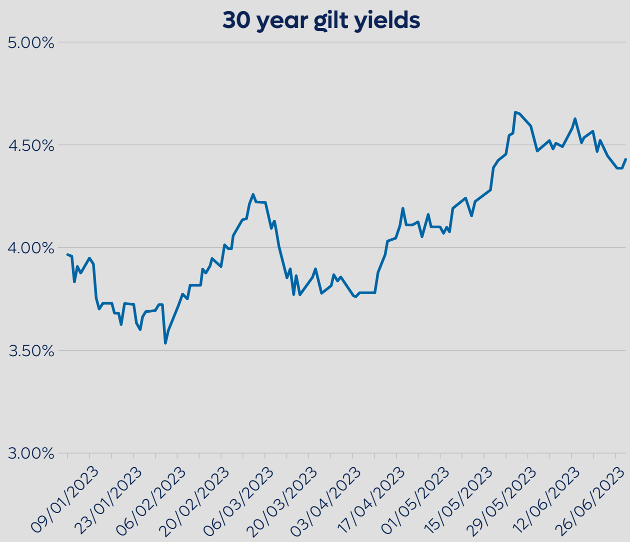
Source: www.ONS.gov.uk

Illustration 3: Overall yields are important in the pensions buyout market, as that drives the decisions for de-risking i.e., schemes reducing exposure to assets selected for growth and increasing exposure selected to match the pensions they need to pay out.



Source: Gov.uk

Illustration 4: The Treasurer recently borrowed £4 billion for two years at the highest rate it has had to pay for two-year money for nearly quarter of a century. If pension funds are persuaded to put their cash elsewhere will gilts become even less attractive?

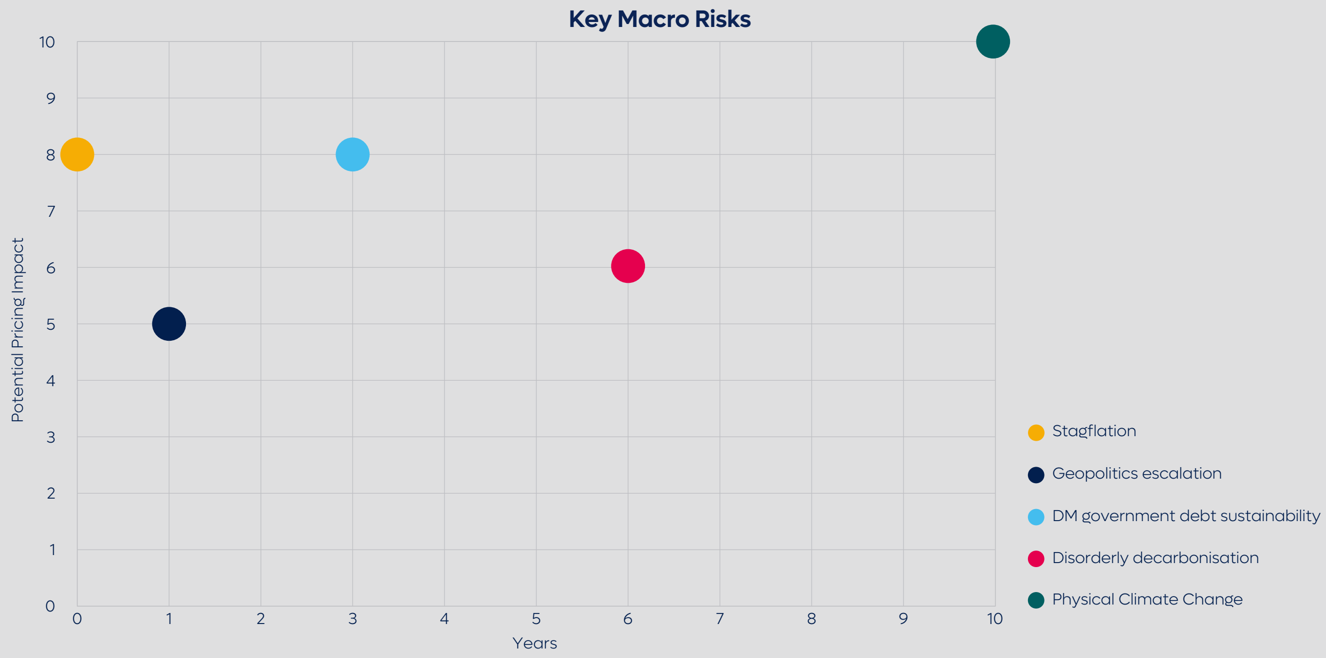


Source: Bank of England

Looking forward

The following are the risks we see on the horizon. Whilst forecasting is imprecise, horizon scanning is an exercise that helps us zoom out a bit and ensure we are not missing the mega-themes.

Illustration 5



Source:

Stagflation

The risk that even though economies are growing slowly if at all, that inflation might be sticky.

Geopolitics escalation

The risk that there are increased, economic, financial, technological sanctions between US and China and other leading economies.

Developed markets' government fiscal sustainability

The increased cost of an ageing population (pensions, healthcare, social care) is not currently forecast to be met by increased government revenue.

Disorderly decarbonisation

The risk (perhaps catalysed by a climate event) that countries rapidly adopt renewable and shun carbon-based energy.

Physical climate change

The risk that climate events could cause unexpected and significant damage to physical infrastructure.

Read on to understand what is happening in the pension risk transfer market, by Mitul Magudia, PIC's Head of Business Development

There is no sign of momentum slowing in the pension risk transfer market.

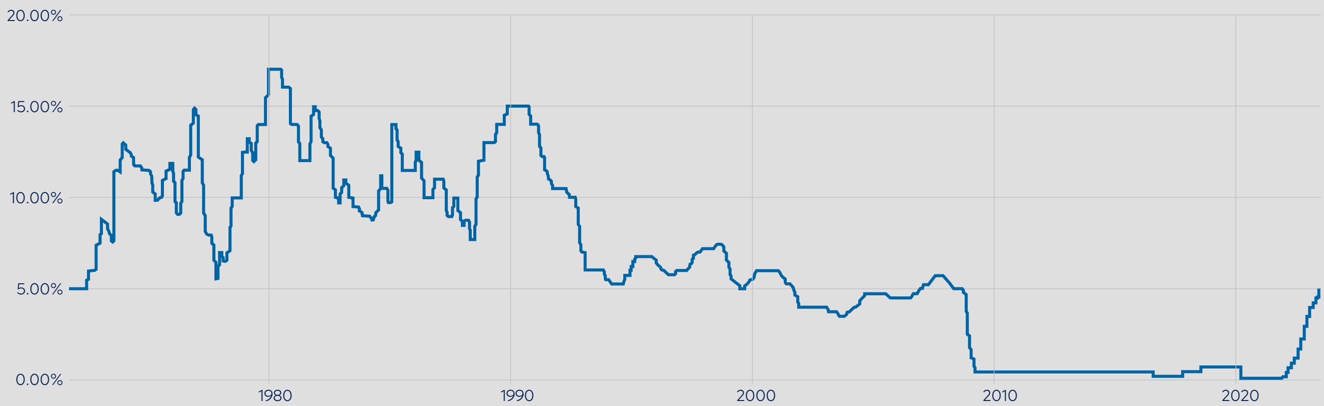
By Mitul Magudia, Head of Business Development

- The movements in rates and improved funding positions will present many defined benefit pension scheme trustees with fresh decisions to consider, including defining their long term objectives and ultimate end game.
- Does the scheme have a plan to deal with any illiquid assets ahead of a buyout or buy-in?
- Is the current investment strategy appropriate and can the trustees lock in any funding gains made?

Following the sharp rise in rates, particularly during the second half of 2022, many trustees have been able to use the first half of 2023 to prepare their scheme for the bulk annuity market.

Their much improved funding positions suggest a wave of demand will propel the bulk annuity market to a record year.

Illustration 6



Source: Bank of England

As noted elsewhere in this document, gilt yields have risen to levels above those seen at the height of October's LDI crisis. Schemes that already have, or are due to come to market, will likely benefit from current market conditions.

And with headlines focussing on higher borrowing costs and increased core inflation, a significant shift away from a "higher-rate" environment is not expected in the immediate future and trustees will have a longer period to consider their improved funding position.

Around two thirds in a recent survey (67%) said they expected to undertake a final insurance transaction within the next five years, while 18% said this would be at least ten years away[1].

Around half (49%) said they had reviewed their investment strategy last year, while a similar percentage (46%) said they would revisit their liability hedging approach and one quarter (26%) said they had revisited their long-term strategies.

Whilst higher yields are beneficial for scheme funding positions, they do have implications for corporate sponsors. As explained in the next section, rising rates directly affect scheme sponsors, with corporates, including banks and utilities, making the news due to the shifting economic conditions.

The exact depth and length of any future recession is of course unknown but the expected strain on many corporates caused by the cost of financing their debt, rising wage demands, and the impact on consumer spending of the cost of living crisis could have a material impact on some corporate covenants.

[1] Reference: Lane Clark & Peacock's (LCP) annual, *"Chart your own course"* report

What does inflation mean for the pensions industry?

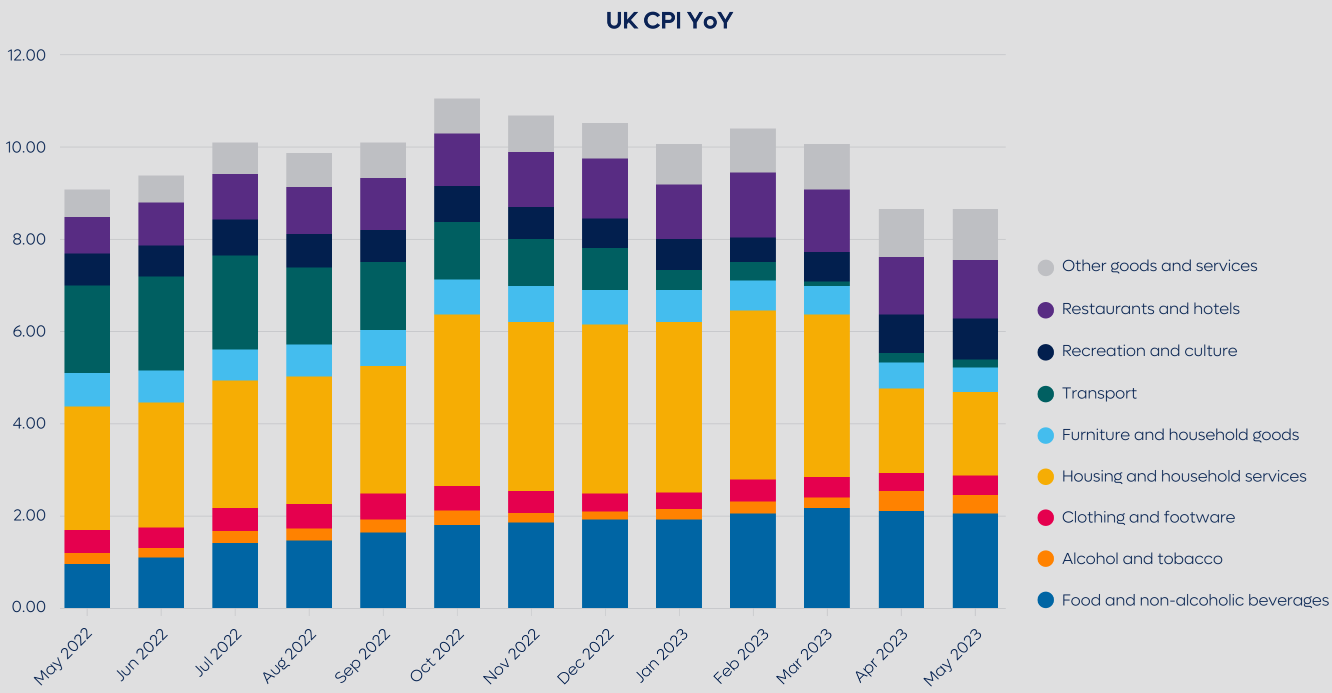
By Hartej Singh, Head of Public Credit

- Inflation remains persistently over the Bank of England's 2% target.
- Long term interest rates have edged higher not only because of higher inflation and interest rates but also because central banks who had been large buyers of government debt have halted their purchase programmes.

UK inflation is significantly and stubbornly above the Bank of England's 2% target and May's UK CPI (Consumer Price Index) was 8.7%, down from a peak of 11.1% in October.

News over recent months suggests food inflation and prices of other goods are starting to subside, but there is some evidence that the inflation of services like transport, phone bills, and the cost of leisure activities is ticking up at an increasing rate.

Illustration 7



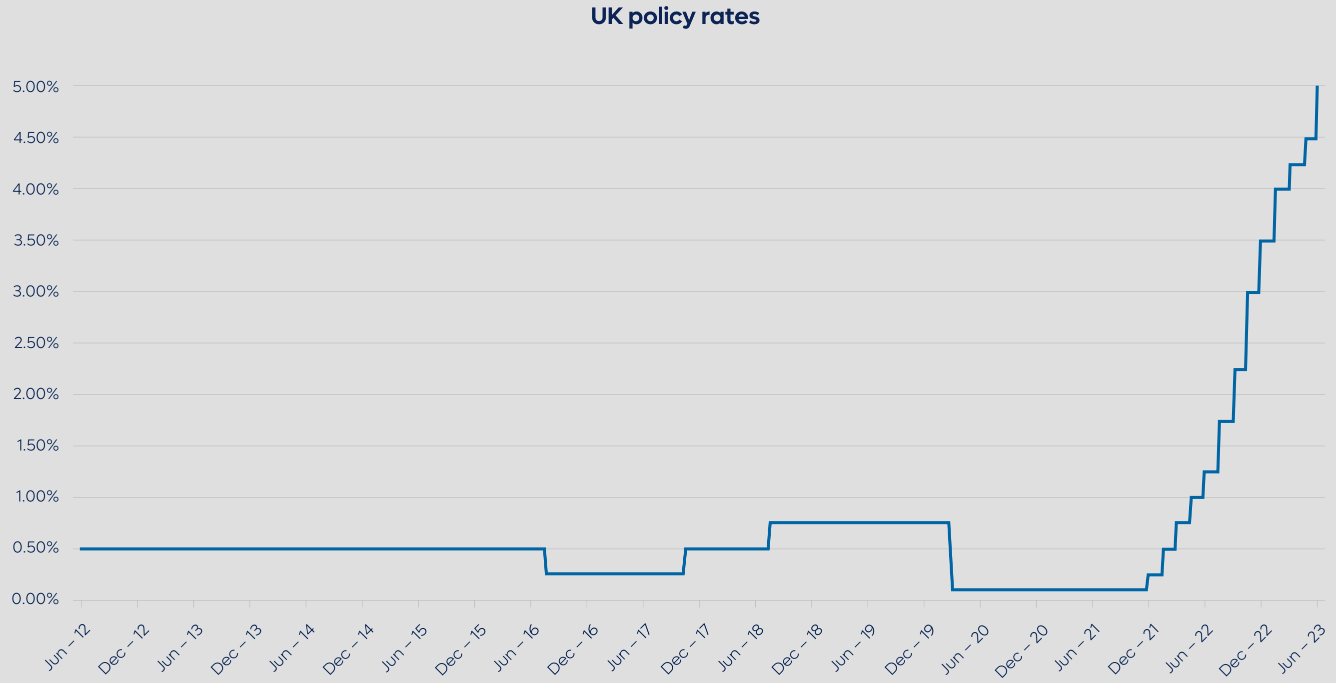
Source: www.ONS.gov.uk

According to the *Big Issue* the recent price rises on food and utility bills impacted c.15% of the total bills facing a low income household, whereas it is c.10% of a high income household's bills. The increased cost of living and reduced labour force has meant that many employees have lobbied for pay rises that meet or exceed inflation, hence the increase in collective bargaining and strikes. This impact on the lowest income groups is the reason that fighting inflation has become the driver of monetary policy.

According to the Monetary Policy Committee's meeting notes on 21 June 2023 for the recent hike in rates to 5.0%: *"The second-round effects in domestic price and wage developments generated by external cost shocks were likely to take longer to unwind than they had done to emerge".*

Higher rates have winners and losers. Inflation is a reduction in the purchasing power of your money. This impacts everyone, but mostly the less well off. Borrowers are also worse-off, affecting businesses, the government, and individuals alike. Individuals in the UK have mortgages as a significant portion of their total debt, and mortgage rates have increased notably. Mortgages are sensitive to the Bank of England's Base Rate as borrowing tends to be for short periods in the UK between two and five years.

Illustration 8

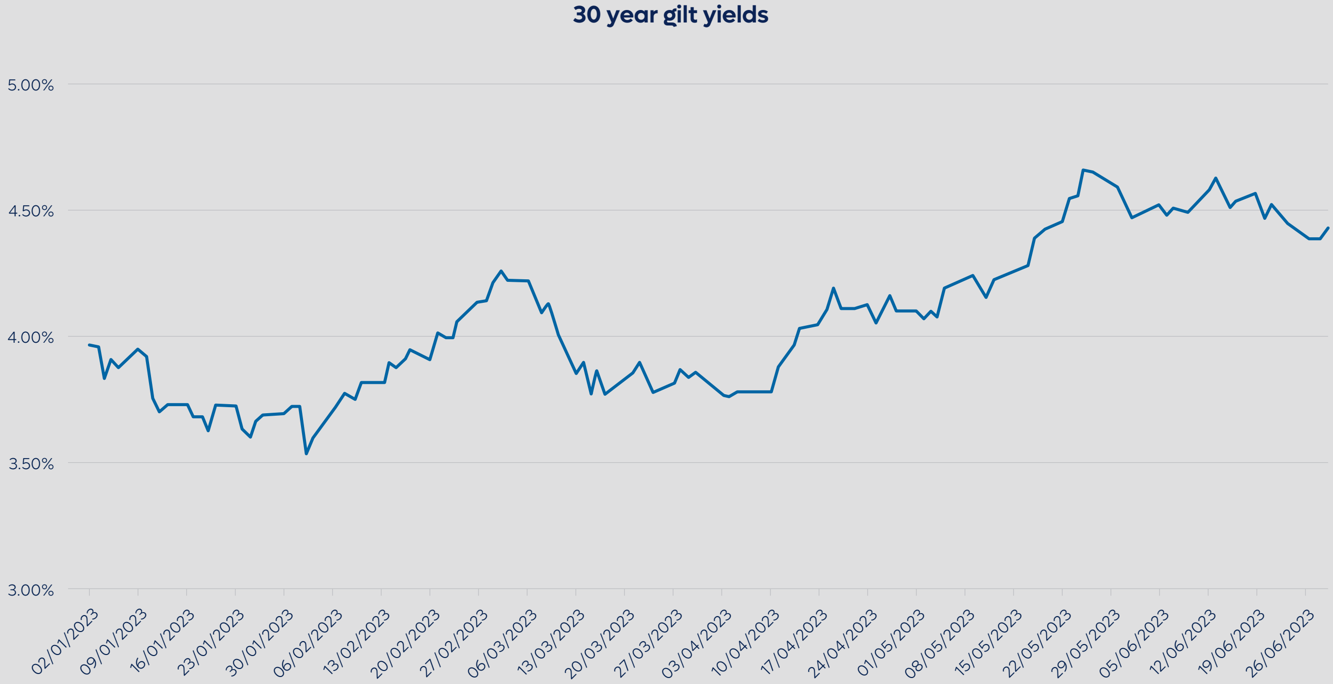


Source: Bank of England

Savers are now better off, and this includes both individuals and savings institutions like pension funds, who are able to achieve a higher rate of return. Long term interest rates have edged higher not only because of higher inflation and interest rates but also because central banks who had been large buyers of government debt have halted their purchase programmes.

One question is: given the government is running a deficit, who will be the purchasers of government bonds? Overall yields are important in the pensions buyout market, as that drives the decisions for de-risking i.e., schemes reducing exposure to assets selected for growth and increasing exposure selected to match the pensions they need to pay out.

Illustration 9



Source: Bank of England

Broadly speaking higher rates should slow the economy down. Whereas cheap borrowing can encourage people to spend or invest given the small additional cost of taking on debt, expensive borrowing will dissuade people to borrow to spend or invest. Mortgages in particular which in the UK tend to be fixed for a short term (2-5 year fixed rates) versus the continent and the US (20-30 years) which open up individuals to a significant increase in mortgage expense and therefore a decrease in disposable income.

The related decrease in spending and investment activity due to higher rates is feared to have economic headwinds. Most recently, Thames Water, through a mixture of high debt loads and challenging operational performance saw the exit of its CEO and speculation that it might require government assistance. Higher rates are likely to challenge many businesses, especially those that rely on high leverage. This might tip the economy into recession.

What happens next?

- Whilst the Bank of England forecasts inflation in the UK to meet its 2% target by the end of 2024, it is likely that interest rates will be the key lever they have to ensure that inflation does not spike again. This could well mean higher rates for longer.
- The higher long-term yields that we see now benefit pension schemes and their de-risking plans. Whilst governments are expected to continue borrowing, some corporates might be dissuaded from borrowing at these higher rates.
- Higher yields create tougher financing conditions which cause issues for existing corporate borrowers who wish to refinance. PIC expects a more challenging environment to lead to increased rating agency downgrades and for the very weakest borrowers actual defaults.

Read on to understand the view from Florence Carasse, Head of Infrastructure, PIC Capital

Focusing on the transition needs support from governments, including more policy certainty and transparency, and prioritisation of infrastructure investments.

By Florence Carasse, Head of Infrastructure, PIC Capital

- The recent increase in the cost of energy is a tailwind for the transition in the long term with renewable energy proving to be the cheapest form of energy we have.
- Investment in renewables makes more sense than ever but is constrained by current market dynamics.
- Investing in new technologies to mitigate renewable energy intermittency and enable large flows to the grid is critical.
- Clear, sustained policy direction by governments is essential to securing long-term investment by institutional investors.

Investing in renewables, and the energy sector more generally, is currently a challenge for long term institutional investors, even ones, like PIC, which have a strong track record in this sector, where we have invested more than £1bn in the renewable energy sector to date.

There is much discussion within governments, the press, asset managers as well as suppliers about the shape of the future energy mix. It is by no means a clear path to follow, innovations continue to come forward, but at the same time clearer government policy and support would go a long way to enabling greater investment.

Recent global events have impacted not only the cost of energy but also put energy security back as a high priority, both of which can go hand in hand with plans for the renewable energy transition.

Inflation is talked about in all sectors, but we have seen this starkly in the energy sector. So, as an insurer with long-term pensions to pay, we are thinking creatively about how to solve the many challenges to investing in renewables on a sustainable basis, as we seek to de-carbonise our portfolio and help de-carbonise the wider economy in the context of an orderly transition towards net zero.

Regulatory regimes previously put in place by the UK government in solar and offshore wind, created a secure framework that enabled PIC and other investors that need long-term investment cashflows, to invest into the sector.

However, as the market has become more established, investors seeking returns as well as environmental benefits have led to the market becoming awash with funds from banks and green investors, to the extent that we have seen loosening contractual protections. This increases risk to the point that it becomes challenging for us and our peers to invest, because we need certainty of cashflows. One could argue that more money into the sector, is a net positive, but as the majority of this money is not long-term in nature, this may lead to refinancing problems in the future, now that we're in a higher interest rate environment.

As the market has matured, more renewable projects are exposed to fluctuating power prices rather than contractual fixed price "off-take" agreements. Whilst this is the natural next step for the market, the volatility of electricity prices has made it more difficult to structure an investment that provides the secure, long-term cashflows we need.

Anticipating regulatory change, via Solvency UK for example, we do hope that there may be some scope to invest in cashflows that are not entirely fixed and the renewable energy market is a great example of where we would then be able to deploy these funds.

Emerging technologies in the sector, especially in terms of storage or grid efficiency, are key to supporting renewable growth and this is an area we care about as long-term investors. These asset classes are in their infancy in terms of the ability to invest at a risk level that is suitable to pay our pension promises.

Governments could help resolve some of these problems, for example by underwriting severe risks which investors like PIC cannot take, in such unproven technologies. The one certainty in the sector is that large sums of money are required to build out the level of renewable energy that the world needs to enable the transition from fossil fuels. The Thames Tideway model, whereby government supported the construction phase and provided a strong regulatory framework during operations, is a good example of UK Government intervention which opened up this very difficult project to long-term investors for the common good. This structure could also be used for new nuclear projects, such as Sizewell C. Potentially it might also help accelerate the development of the carbon capture and battery storage sector. Both are vital to enabling long-term investors to support the energy transition.

The importance and resilience of the electricity grids across the world also needs special consideration, as more pressure is put on them through the conversion to electricity. We know that this is restricting not only new connections from renewable sources but also the building of new cleaner, energy efficient homes. No single organisation has the answers to these challenges, but as a growing business with a need for long-term investments, what we do have is an ability to invest at scale within a supportive sector for the mutual benefit of the industry, greater energy security and policyholders.

As an investor we have pledged to support the transition to net zero by 2050, we recognise the need to support businesses that we invest in both now and in the future on their journey. Part of this puzzle is also investing in clean assets which will give a boost on that journey as well as investing in transition assets.


Source: Getty Images

What happens next?

- The UK's energy security and transition to net zero is a key focus for us as long-term investors, and we will keep working with relevant stakeholders to make sure we are supporting the provision of affordable, reliable, and, where possible, renewable energy to help power the UK's economy.
- Focusing on domestic energy usage is key to the transition. Fuel poverty may have abated slightly with the reduction in energy tariffs over the last three months, but supporting households to budget their electricity and water consumption more effectively in the future is of social as well as environmental value.
- PIC will continue to focus on sector improvements like the electrification of rail networks where the benefits of introducing new infrastructure and rolling stock deliver cleaner, quicker, and cheaper services.

Read on to learn what Max Cawthorn, Head of PIC Capital Strategy, believes is the effect of inflation on the social value impacts of infrastructure investments

Long-term pension fund infrastructure investments can still deliver social value despite inflation.

By Max Cawthorn, Head of PIC Capital Strategy

- Institutional investors' focus on social considerations has broadened in recent years, with growing scrutiny on the creation of social value, partly as a result of the pandemic and cost of living crisis.
- Greater global demand for raw materials could result in higher construction cost inflation.
- Construction company insolvencies highest since 2008.

Investing in local regeneration projects presents an ideal opportunity to support the government's growth agenda and create positive social outcomes, for example through job creation, and support into the local economy.

One such investment is PIC's £130 million investment in Miller's Quay, the cornerstone scheme at Wirral Waters, one of the UK's largest brownfield regeneration projects. In June, we held its topping out ceremony, the phase of the development marking the highest point of construction. Once completed in 2025, 500 sustainable waterfront apartments will replace the derelict brownfield site that Peel L&P is developing over the next decade, with 100 affordable homes and new transportation infrastructure on the wider Wirral Waters site.

Such investments, which have a lasting impact on current and future generations, are socially beneficial but, as the table below shows, in the short term there are current headwinds to driving social value further and faster. For example, labour costs rose 6% on average in 2022, a trend which is still gathering pace. At the same time construction orders fell in Q1 by 12.4% which was below the five year quarterly average. It's no surprise that over 4,000 construction company insolvencies have been recorded in the last 12 months – which is the highest since the 2008 financial crisis.

Construction Inflation Update

Labour Wages

- Construction pay increased 6% in 2022
- Low number of vacancies due to falling number of new jobs
- Government have agreed to interim measures to ease visa applications for specialist trades

Market Outlook

- New Construction orders fell 12.4% in Q1 2023 – below the 5 year quarterly average
- Over 4,000 construction insolvencies in 2022 (highest since financial crisis)
- Contractors less open to single stage tendering due to unstable market

Material

- Re-opening of Chinese real estate market will add to demand for industrial metals (copper & aluminium) and commodities
- Energy prices lower than anticipated but still higher than 1 year ago
- Material inflation likely to impact MEP packages more than others

Source: Gardiner & Theobald; Mace

The re-opening of the Chinese economy, post-Covid restrictions will add heightened demand for industrial metals, such as copper and aluminium, further squeezing costs for UK construction.

Warehousing and transportation networks are also seeing sharp rises in operating costs in 2023 with little immediate relief on the horizon, as inflation remains stubbornly high, there is a need for material and labour costs to be sourced as locally as possible to become as time and energy efficient as possible.

Combine that with consumers becoming more concerned about the energy efficiency of their homes, as well as a strong legislative focus on emission reduction within Europe, and there is growing motivation for social value and sustainability to be increasingly important priority looking forward.

Case Study

On the Miller's Quay site 41% of the costs of construction have been placed with businesses located within a 50 mile radius of Wirral Waters, helping to reducing energy consumption, particularly for fossil fuels, and cutting the distance goods and contractors need to travel.

Fifteen local contractors are delivering services such as culvert removal, structural steel works, block work, fire protection, screeding, floor finishing, tiling, decoration, and roofing.

Over the four years of construction the average monthly spend on local labour is in excess of £1 million per month.

Scheme Summary	
Deal Type	• Regeneration Lease - Forward fund construction and then leased to Wirral Borough Council post completion for 50 years
Location	• Wirral - Located adjacent to the Wirral docks
Asset Description	• The wider Wirral Waters scheme is one of the largest urban regeneration projects in the country • 6 blocks of 8 and 13 storey height • 500 residential apartments with 100 affordable tenure & 560m^2 amenity pavilion of the residents
Development Partners	• Contractor: Grahams Construction Ltd • Developer: Peel L&P
Total PIC Commitment	• £130 million
Progress Update	
Site Progress	Topping out ceremony held in June 2023. Façade progressing on all blocks
Build Progress Status	

Start April 2022
Complete January 2025

What happens next?

- House building is going to be a battleground at the next general election.
- Insurers like PIC can play a leading role in delivering the funds needed to build the UK's social infrastructure.
- Different asset classes of housing have different funding requirements with equal amounts of urgency required to satisfy the demands of an aging population, social housing tenants and young professionals seeking reasonably priced accommodation.

Do you have a question for our experts?

We'd be delighted to hear from you. Whether you have a specific query raised in this issue of *Compound Interest*, or whether you've a question you'd like us to answer in the next issue.

Please email any questions or observations to **apfel@pensioncorporation.com**

Further information.

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