Compound Interest.

PIC's Quarterly Update

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Introduction.

If 2023 was defined by heightened geopolitical tensions, 2024 promises even more of the same. In this edition of *Compound Interest* we take a look at how geopolitics affects the markets, government borrowing costs and a potential return of Quantitative Easing (QE), wider investment in the economy, and what we might expect in the year ahead.

This year there is rare confluence of geopolitically significant elections as countries accounting for two fifths of global GDP go to the polls. These include elections in Taiwan, India, Russia, Austria, the US, likely the UK, Indonesia, South Africa, Portugal, Romania, state elections in Germany, as well as elections for the European Parliament (EP) and the appointment of a new European Commission.

Incoming governments face fiscal challenges as they inherit growing debt piles and higher borrowing costs. They also have to contend with the growing geostrategic difficulties for the West: Russia/Ukraine; Israel/Hamas; the threats from Iran and North Korea; and the challenge from China. How will incoming governments engage with the challenges to the rule-based international order, and the emergence of multipolarity? Will the US continue to focus on jobs at home at the expense of security abroad?

Setting the scene in this issue is a guest article by Sir David Lidington, Chair of the Royal United Services Institute (RUSI). In our other essays, Hartej Singh, PIC's Head of Public Credit, explains how geopolitics affects the markets and the thinking of long-term investors.

With the new UK government inheriting ever growing debt liabilities what is the likely trajectory of sovereign debt yields, especially gilts, and will the Bank of England reverse back into QE? And how will higher borrowing costs affect public credit issuance?

Dr Vladan Martinovic, Senior Debt Origination Manager, explains why ports have a significant part to play in geopolitical considerations, and hence why they can be an interesting investment for long-term investors.

Mitul Magudia, Co-Chief Origination Officer, provides an insight into how geopolitical considerations are discussed by trustee boards, what they might mean for funding positions, and the impact on the pension risk transfer market in 2024.

Finally, Jeremy Apfel, Managing Director, Corporate Affairs, looks at the lessons that an incoming UK government, with limited fiscal headroom to manoeuvre, can learn from the 2010 government's attempts to woo international investors to invest in UK infrastructure and underpin economic growth. Whoever the incoming UK government is, it will need to focus on less glamorous policy work to drive investment, address the housing crisis, bridge the skills gap, and create social value across the country.

I hope you enjoy this issue, and please get in touch if you have any opinions you'd like to share, or suggestions for the next issue of *Compound Interest* in April.

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 of £44.9 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.

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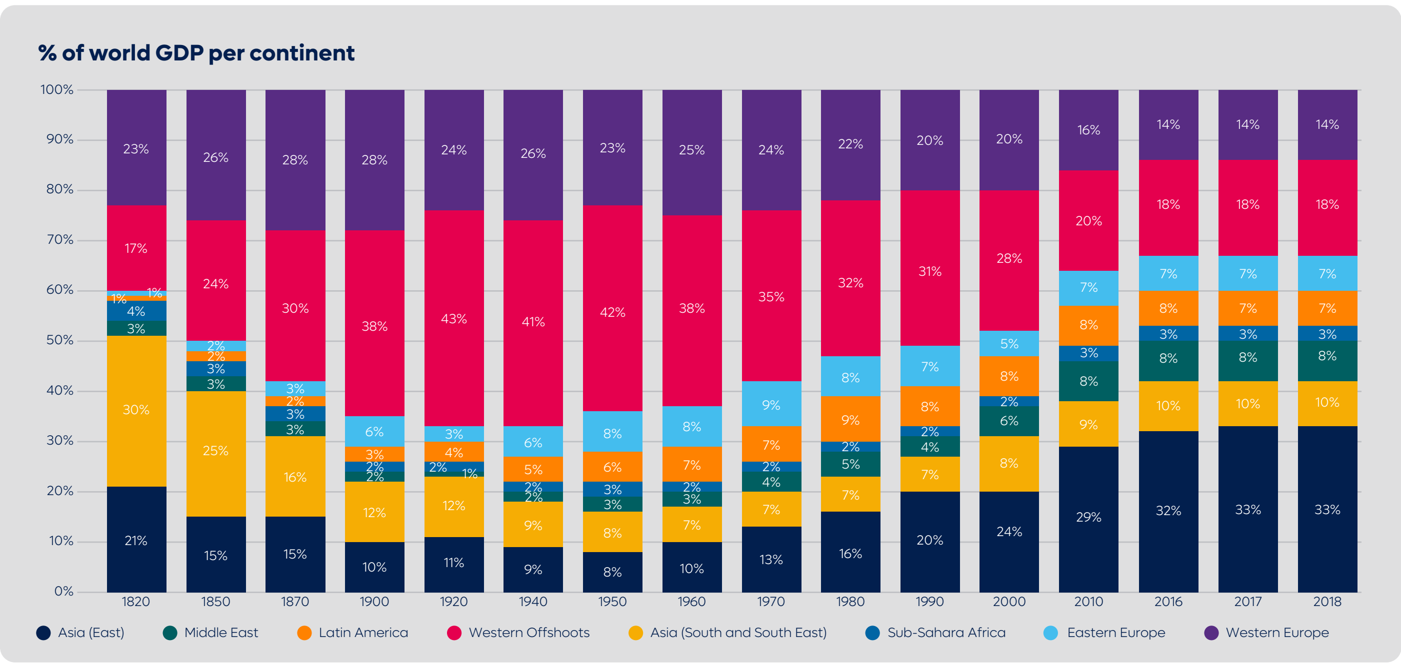
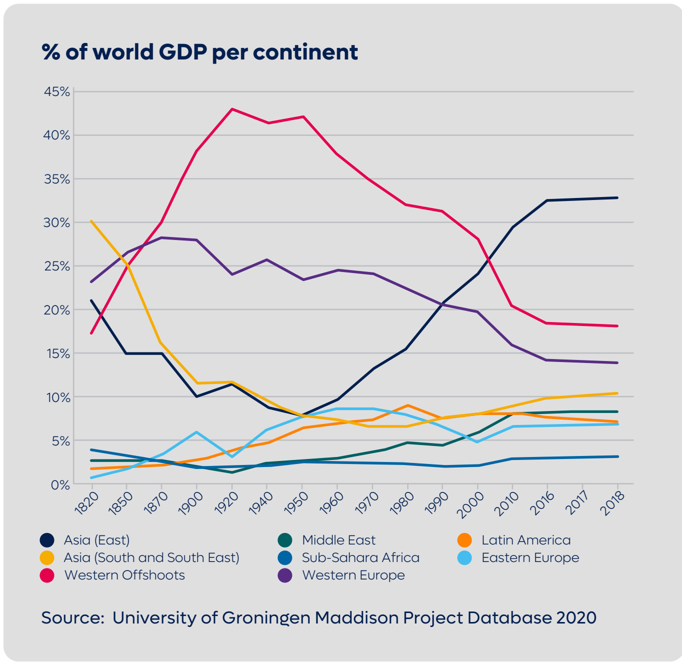
Key charts at a glance.

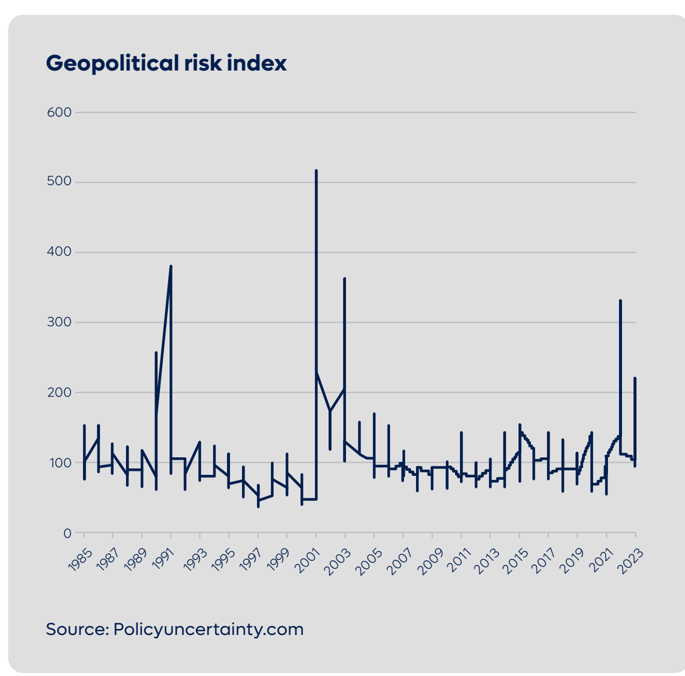
Key data in this issue



As the charts above and below left show, the global shift of global economic influence has trended Eastwards over the last century, although the last five years have remained surprisingly constant.



Source: University of Groningen Maddison Project Database 2020



Source: Policyuncertainty.com

Whilst it is hard to be objective about geopolitical risk, on the Geopolitical risk index (above right) we look at which measures of stories in newspapers have some reference to geopolitical risk.

Read on for an overview of the geopolitical risks in 2024, by Sir David Lidington, Chair of RUSI

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Geopolitical risks in 2024.

Sir David Lidington, Senior Counsel, H/Advisors Cicero
and Chair of the Royal United Services Institute (RUSI)

How markets should be thinking about 2024.

The world faces more serious geopolitical risks in 2024 than at any time since the Cold War, possibly since 1945. The consequences will be felt across the global economy and at the ballot box. With the post-war system of international institutions frayed, the risk of misjudgements tipping rival powers into confrontation, even war, is real.

Financial markets face enormous challenges as countries accounting for two fifths of global GDP go to the polls, while rising international tensions risk spiralling into regional and possibly even global conflicts. Political and market volatility will feed each other. Supply chain fragmentation and sanctions will make it harder for central banks to reduce inflation. That in turn will have electoral consequences.

If forecasts are to be believed, many countries will endure another year of inflation and sluggish growth. Economists fear the Japanification of Europe, whereby institutional investors fly to safety in bond markets as interest rates remain high, eschewing investment opportunities that could support governments' strategies to grow their economies through better investment allocation.

The Dollar's position as the world's global reserve currency is unlikely to be dislodged, especially at a time of geopolitical uncertainty. But an increasingly multipolar world will see the Dollar's position come under threat over the longer term.

Would the return of Trump derail Western unity?

Relationships between the United States and both China and Russia are characterised by tension and mistrust. Autocrats in Moscow, Beijing, and Tehran, facing domestic discontent, may be tempted to rely even further on playing the nationalist card and risking foreign adventures.

The US presidential election in November is likely, on current polls, to be very close. If President Trump wins, it might be expected that he would take office surrounded not by experienced people from business and the military such as Rex Tillerson and General McMaster, as was the case in his first administration, but by true 'Make America Great Again' believers.

He might be expected, if elected, to pursue trade and investment policies even more protectionist than President Biden's, as well as trying to strong-arm US allies into aligning with a strategy designed to isolate China commercially. Trump's commitment to NATO and the defence of Europe cannot be taken for granted. He has said that he would end the Ukraine war within 24 hours of coming to office. What might hold Trump back is either a Democratic-controlled Senate, or the argument that a Russian win in Ukraine would embolden China's aggression towards Taiwan.

China's leader, Xi Jinping, who is already beset by economic problems, is expected to double down on efforts to make China less dependent on the West and may even resort to brinkmanship on Taiwan, such as a blockade, to rally nationalist support within China.

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Other electoral tests will prove crucial in 2024

The European Parliament elections in June and the choice of a new Commission (requiring agreement by the EP and member-states) over the summer and autumn mean that Brussels will look inwards during 2024. This is also likely to be the case in the UK with its own looming election. Any attempt to reset UK/EU relations will therefore wait until 2025. The success of the populist right in the Dutch elections will stoke fears of a nationalist surge in the EP elections. European governments will seek to reduce immigration.

Weaker German leadership in Europe, due to tensions between Germany's coalition parties and the constitutional court's decision to strike down Berlin's extra-budgetary spending programmes will make it harder still in 2024 for the EU to agree on member-state deficits, migration, or programmes to finance net zero. Nor will the EU agree a credible action plan to match its renewed commitment to enlargement.

European leaders fret that a new US administration might severely dilute or even abandon its 80-year old commitment to European security but cannot summon up the political will to reduce their dependence on American taxpayers for their defence.

Barring a new Russian revolution, Putin will be re-elected President in March – having decided in advance how big his majority should be.

Middle Eastern tensions could spill over

In the Middle East there is no easy end to the war in Gaza and the risks of further turmoil in the region are increasing.

Moderate Arab countries are acutely worried about their streets' response to Israeli action. If the surge of violence in the West Bank worsens, it will put huge pressure on the Hashemite regime in Jordan, where about 70% of the population is Palestinian.

So far the US has deterred Iran from getting involved. But with both Iran and Israel led by hard-line nationalists under massive domestic political pressure, the risk is real of a miscalculation or misjudgement leading to a wider war that would engulf Lebanon in the conflict and put Gulf oil and gas supplies at risk. Just fears of such a conflict could cause energy prices to surge.

A volatile year for markets

For business, geopolitical risks (including to energy and critical raw materials) include interruption of supplies and volatile prices. Political uncertainty will make it harder for companies to make confident decisions about future investment.

A turnover in governments could also lead to an overhaul of economic policy – in both directions. New Argentine President Javier Milei is determined to radically change course – abolishing the central bank and dollarizing the economy. The response in the bond markets will be a test case for how populist politicians could disrupt the global economy.

Increasing divisions between the West and large emerging powers such as China, but also India, could disrupt markets and put a premium on borrowing costs. We face a turbulent and unpredictable year.

- Ongoing geopolitical risk & upcoming elections create uncertain landscape in 2024.

Read on to understand the view from the Public Credit Desk by Hartej Singh, Head of Public Credit at PIC

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The view from the capital markets: the return of Quantitative Easing?

By Hartej Singh, Head of Public Credit

2023 was anticipated to be a weaker year for economic growth, but it surprised many by performing better than expected. Coming into 2023, the *Wall Street Journal* economist survey predicted a median US recession probability of 65%.

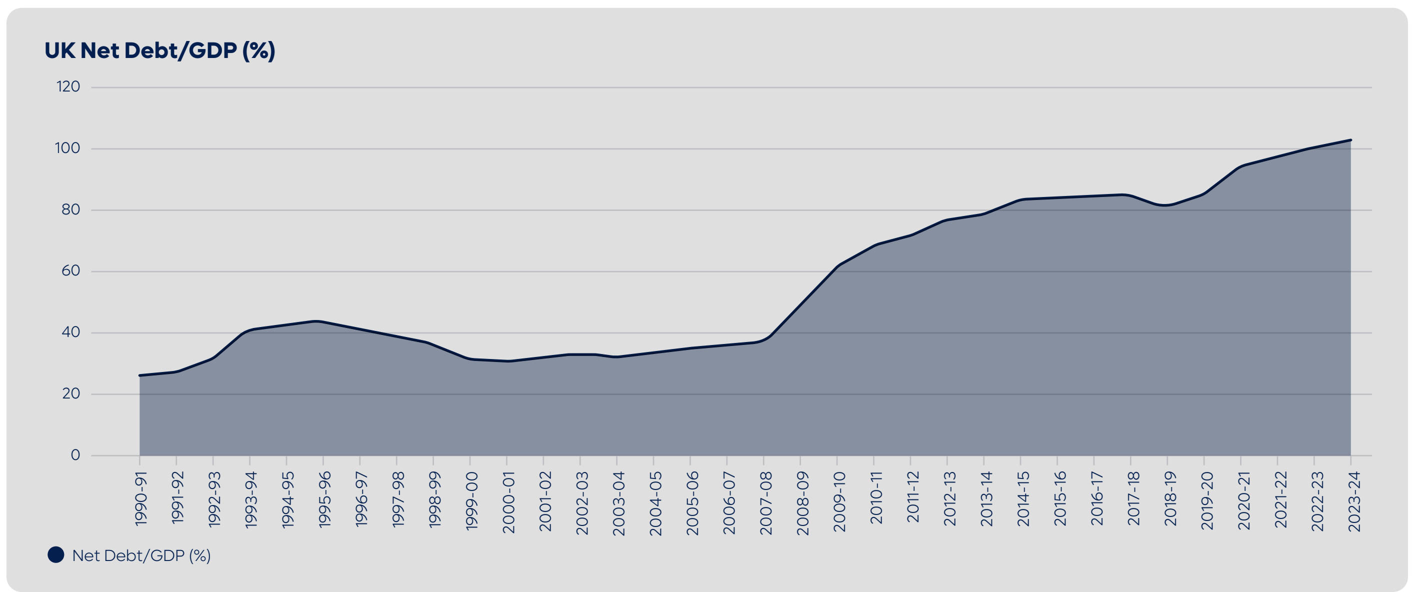
Instead of credit spreads widening (indicating an increased risk of corporate bankruptcies) as you would have expected with a looming recession, they tightened due to stronger economic activity and a lower likelihood of corporate defaults.

By the end of the year the majority of the world's stock exchanges were up, particularly in the technology sector, because companies also made more profit, despite high inflation. Economic activity continued with less drag than expected from higher interest rates and inflation measures reduced to more normalised levels, albeit still at a level higher than the last decade. However, higher interest rates typically take 18 months to be felt in the wider economy, and 2023 might therefore have been the calm before the storm.

Part of the stronger economic activity we have seen has been funded by additional government spending. The UK has the highest UK Net Debt to GDP ratio since WWII when it topped over 200%, and the highest tax burden for more than 70 years. Whilst sovereign debt sustainability is not generally talked about, although the outgoing head of the Debt Management Office is now on the record warning about this, we expect a mixture of higher interest rates, an ageing population, and little room for more tax increases, to mean this number will continue to rise.

To stabilise the debt to GDP ratio, whoever is in government will need all, or a combination of controlled higher inflation, low gilt yields, (even) higher tax revenues and less government spending.

One prospect not currently being discussed is that, if and when inflation is under control, we might see a reversal of Quantitative Tightening and more Quantitative Easing and other extraordinary monetary policy measures to bring down borrowing rates and help the UK finance its large debt load.



As Sir David Lidington pointed out in the first article on page 3, we are likely to see elections in not only the UK, but also large population centres like US, India, Mexico, Bangladesh, Indonesia and Pakistan. This not only has both national effects but also international effects and the relationships between countries is becoming more important.

Geopolitical risk feels like it is rising. To qualify that statement, I think a good working definition is an increase in hostile interactions between countries.

This is not just in terms of open conflicts as Russia/Ukraine and in the Middle East, but also in terms of significant changes in trading partnerships and supply chains for economies. This will likely be more of a problem for long-term investors than is currently recognised.

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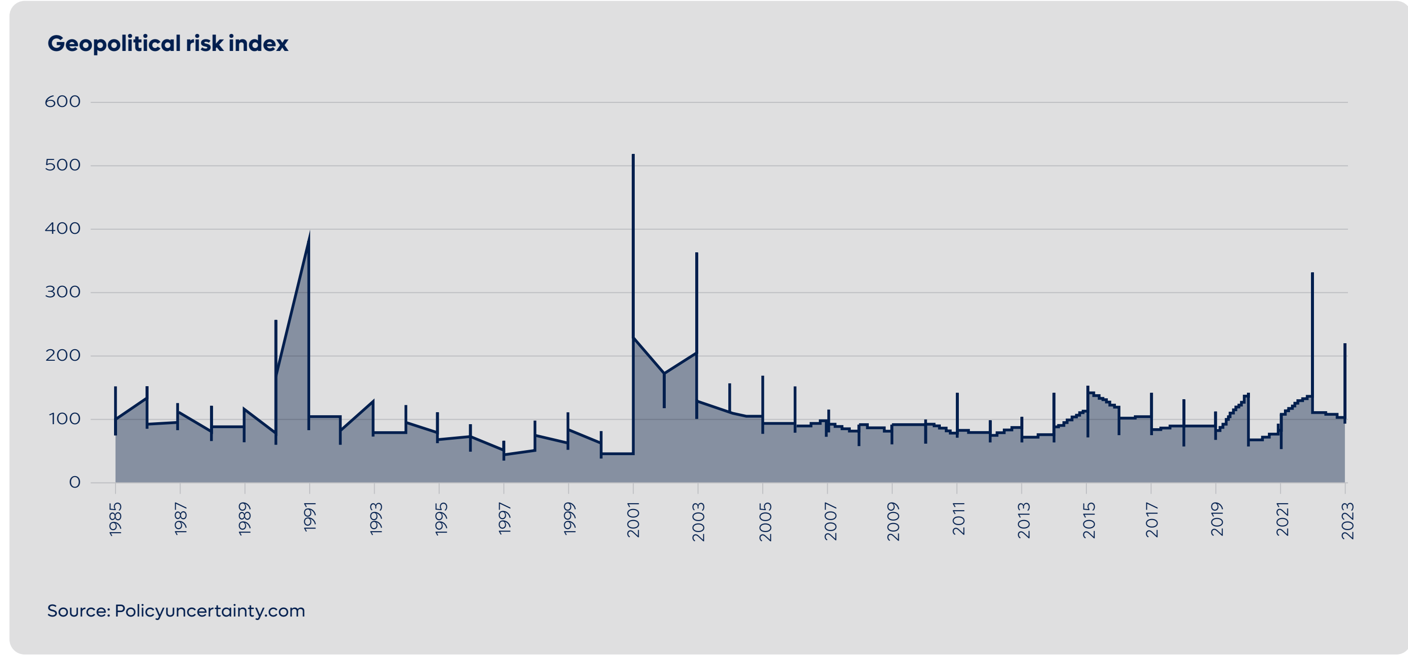

Geopolitical risk index

Source: Policyuncertainty.com

Whilst it is tough to be objective about geopolitical risk, there is an index we look at which measures which proportion of stories in newspapers have some reference to geopolitical risk. That, at least, tells us if geopolitical risks are being talked about, so a proxy of sentiment.

Geopolitical events like 9/11, the Iraq and Afghanistan war, the Russia and Ukraine war, and the Gaza conflict, are front and centre for a period, but then very quickly both the world and the markets start to discount the impacts. Soon they are relegated from the front pages. The problem is when they drift on with no discernible outcome.

In my experience, the markets would prefer a 'bad' certainty which they can price, than general uncertainty which they can't, or at least they tend to behave that way. From our perspective, taking a gamble on geopolitical events, or anything else, is not an investment strategy that sits well with our purpose, of paying the pensions of our policyholders.

But underlying the big shocks, are the longer-term, less reported impacts of geopolitics, which we also need to consider. Let's take Germany as an example. Germany has been impacted by two large geopolitical changes. Russia's invasion of Ukraine led to Western nations sanctioning Russia. This impacted Germany's material energy dependence on cheap Russian natural gas supplies.

Additionally, Germany has also built a large part of its economy on exports to China. Whilst there are many contributors to China's lower than trend growth, the US/China tariffs and technological sanctions mean that Germany is directly impacted by the US/China face-off. These impacts mean that capital markets, technology sharing, and resource supply might decouple, leading to supply chains being refocussed amongst allied nations, rather than truly global trade. This is likely to have economic ramifications as a less-than-orderly – or perhaps openly-disorderly in the event of a further escalation. The pace at which companies retreat from China may pick up pace.

Geopolitical risk is taking up more and more of my time as I seek to manage our portfolio, and is probably at its highest level in my 20+ years in the markets. Companies that have large resource, manufacturing or sales exposure to countries that could be at the centre of hostilities are running very real geopolitical risk – this might in the future impact credit profiles and change our decision on a new or existing investment.

What happens next?

- QE may be closer than anyone expects in order to bring down interest rates.
- PIC will monitor the underlying trading relationships and supply chains rather than focus on the headlines to account for geopolitical risk.

Read on to understand the view from our Origination team by Mitul Magudia, Co-Chief Origination Officer at PIC

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Whilst not immune from the effects of global macro-economics many DB schemes are well funded and ready to de-risk.

By Mitul Magudia, Co-Chief Origination Officer

Ongoing conflicts have influenced the geopolitical landscape in 2023 and with no immediate signs of resolution, are likely to do so again in 2024, as governments and policymakers worldwide respond to persistent risks, against a backdrop of elections across the globe.

At the same time fiscal and monetary policy is constrained by excessive borrowing, higher interest rates, and high tax burdens.

These are all issues that trustees of defined benefits (DB) pension schemes will have to consider as they manage their assets and liabilities. However, the threat isn't over yet as a shift towards nationalism by major countries could have lasting effects on global inflation expectations, pressuring central banks to maintain higher interest rates. Whatever the circumstance, a scenario with prolonged higher rates could significantly impact pension schemes.

The bulk annuity market had a record year in 2023 despite the geopolitical and economic headwinds. It witnessed increased activity, driven by higher gilt yields allowing schemes to capitalise on improved funding levels, making buyouts an attractive option for trustees seeking to secure member benefits amid uncertainty.

What we have seen is that even in periods of heightened economic volatility, well-prepared schemes, particularly those already in discussions with insurers, can leverage market movements in stressed scenarios to secure insurance at optimal affordability.

This process has been helped because over the past decade trustees in large part have been continually reengineering their schemes' profiles as they progress their de-risking journey. The PPF's Purple Book has DB schemes in aggregate surplus to buyout for the first time ever, meaning many now even closer to buyout, leading to consultant projections of an extremely busy market in 2024.

Finally, buying out a defined benefit scheme can provide corporate sponsors with the flexibility to respond swiftly should they need, to the demanding geopolitical situation. We expect more deals to be based on this rational.

From a trustee perspective in 2023, the central bank focus on curbing inflation and bringing stability, will have been welcome as it creates more certainty in matching assets and liabilities.

What happens next?

- Well prepared schemes can leverage market movements in stressed environments.
- Buy-ins provide corporates additional flexibility to respond to geopolitically uncertainty.

Read on to understand the view from the Private Debt Markets team by Dr Vladan Martinovic, Senior Debt Origination Manager at PIC

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Enhancing port infrastructure in order to respond to the changing global geopolitical landscape is essential for the UK's economic stability.

By Dr Vladan Martinovic, Senior Debt Origination Manager

Infrastructure assets have been a core part of our purposeful investment strategy for more than a decade given the stability of long-term cashflows they produce, as well as the social value they create.

The majority of these investments are of importance to the local economy (and in aggregate to the national economy). However, in 2023, we made an investment of international significance, deploying £100 million of funding in three major UK Port Groups – Associated British Ports, Peel Ports and Forth Ports – covering port sites from Southampton, Liverpool and all the way to Dundee.

The diversity of cargo transited, their varied customer base, long-term customer contracts, and ability to adapt their product offering makes the UK ports sector resilient through business cycles, making them an attractive asset for a buy-to-hold investor like PIC, with pensions to pay stretching out decades into the future.

The funds we have provided will help them develop their basic infrastructure, making them – and by extension UK trade and exporters – more resilient and adaptable to the ever-changing global trade dynamic. Recent examples of the importance of this exceptional adaptability are acting as the critical link in the wind farm supply chain, as well as during Covid, when they successfully managed a significant increase in cargo traffic.

Enhancing port infrastructure to be able to act quickly and efficiently to the changing global geopolitical landscape will provide stability for the country. Whether it is a change in supply chain profiles as mentioned in Hartej's article, or further energy price pressures due to escalation of the war in the Middle East highlighted by Sir David Lidington, ports will remain a key asset that the government and wider UK economy will rely on.

When it comes to supporting net-zero ambitions, UK ports are already underway with a number of exciting projects that PIC, along with other financial institutions are investing in:

- In 2022, **ABP** announced the first large-scale green hydrogen import facility in the UK. The facility will be located at the Port of Immingham and will be used to import green ammonia which will be used to produce green hydrogen to help decarbonise hard-to-abate sectors such as transport and industry.
- **Peel Ports** is developing a new maritime logistics hub that will take an estimated 14,700 lorry journeys off roads across the UK and continental Europe annually.
- **Forth Ports** are leading the charge on Scottish Green Freeports, with a proposal that will generate up to 50,000 new jobs and act as a catalyst for new green technologies and renewable energy manufacturing which will make a significant contribution to the re-industrialisation of Scotland.

We remain committed to this sector, and look forward to supporting it through 2024 and beyond. Whilst we are primarily focused on UK ports, we believe opportunities exist in other major trade hubs in Europe and Asia, which are exposed to global trade dynamics rather than local environments.

Source: Port of Immingham, courtesy of ABP

Ports are strategically important assets for the UK:

- they handle c.95% of international trade
- they are a critical component in addressing geopolitical pressures, such as energy security, by providing storage and handling of a range of fuels
- they are leaders in enabling government's net-zero ambitions

What happens next?

- We remain committed to the port infrastructure sector, and look forward to supporting it through 2024 and beyond.

Read on to understand the challenges facing the next incoming government by Jeremy Apfel, Managing Director, Corporate Affairs at PIC

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Stimulating the infrastructure investment that underpins economic growth in the era of increasingly constrained government spending.

By Jeremy Apfel, Managing Director, Corporate Affairs

Whoever wins the upcoming UK general election will face a very difficult set of financial circumstances, perhaps best encapsulated by the famous 2010 note from the (then outgoing) Chief Secretary to the Treasury to his successor, "Dear Chief Secretary, I'm afraid to tell you there's no money left."

In short, with the national debt standing at 98% of GDP[1], more than £100 billion being spent on servicing this debt annually, little room to issue more according to the Debt Management Office[2], and the highest tax burden "as a percentage of national income, than at any time since the 1940s"[3], whoever forms the next Government is going to be severely fiscally constrained.

With such clarity of circumstance it is no surprise that politicians across the political divide are shaping their thinking about how to stimulate the infrastructure investment that underpins economic growth in the era of increasingly constrained government spending which will define the next Parliament.

In that regard, recent history can be instructive. In fact it could be argued that today's politicians face a not dissimilar set of choices to the those faced by the coalition after the surprise outcome of the 2010 election. So the questions about economic growth that are now being kicked around echo the thinking then – how to make the UK a more attractive investment destination for overseas investors, how to bring forward significant national infrastructure projects to kickstart economic growth, and (that hardy perennial) how to solve the housing crisis.

The good news is that the history of how those decisions played out is there if politicians want to learn from it. First, the political effort expended in attracting overseas investors has been largely irrelevant to the investment that we have received – if the geopolitical environment is favourable and the investment opportunity is attractive to highly mobile international and domestic investors alike, they will invest. On the flip side, changing geopolitical dynamics and national security concerns have totally undermined the political efforts to woo overseas investors, most notably (but not exclusively) the Chinese, who turned out to be significant geopolitical rivals, rather than partners in a new golden age.

The other bit of good news is that there is an abundance of capital looking to be invested in the UK. For example, domestic life insurance companies like Pension Insurance Corporation and our peers are expected, if there are sufficient projects available, to invest around £200 billion in UK infrastructure and built environment projects over the next decade to back policyholder pensions, creating significant social value. Which means that the more important question for politicians is, what are we seeking to attract investors to invest in? At the moment, there simply aren't enough projects to meet investor demand.

Whilst prestigious national infrastructure projects are clearly important in context, they are notoriously difficult to bring forward and are risky to invest in because they are prone to delay, overspend, and even cancellation. So the main political focus should be on helping local and regional government bring forward the projects that will regenerate our towns and cities, provide high quality jobs, bridge the skills gap, and drive regional GDP growth, whilst achieving key policy goals, such as the provision of good quality, climate friendly housing.

This means that from a national perspective politicians should focus on less glamorous, but nevertheless crucial-to-solve, issues like the quality and quantity of planning officers in local government planning teams; the interplay between the plethora of regulators and arm's length bodies and what this means for growth and prosperity; how to encourage genuine public-private partnerships with local government; how to raise governance standards within local government, including the production of investment data, long-term plans and so on; and understanding how the convening power of central government can help and enable local authorities to bring forward investable opportunities with the sufficient scale to make them attractive investments for long-term, institutional investors.

Not only would these types of reforms move us away from the mistakes made after 2010 by opening up a new wave of investment across the UK, they would also help insulate the economy from a geopolitical environment which is much more volatile than it was then, and which could potentially see a realignment of investment, economic activity and supply chains within politically aligned blocs.

Hindsight is a wonderful thing, but the lessons of 2010 can help provide a path through the fiscal constraints that the next government will face. These constraints will leave little room for error as the next government seeks to encourage the right sort of infrastructure investment to deliver economic growth.

[1] https://commonslibrary.parliament.uk/research-briefings/sn02812/
[2] UK debt chief warns excessive borrowing risks investor backlash https://www.ft.com/content/fb8974e4-355e-4276-be1f-7edb73273f75
[3] https://ifs.org.uk/articles/will-be-biggest-tax-raising-parliament-record

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Further information.

Jeremy Apfel
Managing Director, Corporate Affairs, PIC

apfel@pensioncorporation.com

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.

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PENSION INSURANCE CORPORATION PLC
14 Cornhill, London EC3V 3ND
pensioncorporation.com

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