

Looking forward

The outlook for pension fund investments is still shrouded in uncertainty. Six experts give their forward-looking views for capital markets

The asset manager

Simona Parvani,
global investment
strategist at HSBC
Global Asset
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Last year saw the beginnings of recovery in most major economies and with it a strong rebound in risk assets. Now, at the beginning of 2010, although the economic backdrop is positive, risks are still skewed to the downside, as there are considerable headwinds to face.

Equity valuations are no longer at the compelling levels we saw a year ago. Although current multiples are not particularly demanding, they offer less of a cushion against negative surprises.

However, despite our moderately cautious stance, we still see tactical opportunities. For example, within emerging markets, Latin America is trading at a discount to Asia, and yet has the potential for positive macro surprises. Globally, we favour defensive sectors, because they appear to be

undervalued relative to cyclical sectors.

We think the outlook for government bonds is neutral. Supply remains a concern, as governments are issuing record amounts of bonds and yet are looking to end their quantitative easing strategies. However, recent weakness means that bonds are no longer overvalued, which mitigates downside risk. Elsewhere, we believe the outlook for corporate bonds is still positive, despite their strong recovery. Credit spreads remain attractive in a historical context, new supply is fairly modest, and given the low yields on cash and government bonds, investors will be looking elsewhere for yield.

The recovery in UK commercial property has picked up pace. Many pooled property funds have experienced significant net inflows from investors seeking higher-yielding assets. We expect capital performance to be strong in the short term, despite weak occupier markets and falling rental values. There is an increasing risk that strong demand for investment property drives prices up too quickly during 2010, rendering the market unattractively priced once again. ■

The actuary



Hamish Wilson,
senior partner at
Hamish Wilson

The outlook for the UK is difficult because it depends on how the government manages the economy, the fiscal stimulus and how quickly they aim to reduce their borrowing requirement. That is going to be absolutely fundamental. If it is too quick, you could actually stifle recovery. On the other hand, if it is too slow you might have inflation being another problem.

I would be somewhat nervous of the bond market, particularly fixed interest bonds, because if inflation were to reappear it would seriously erode their value. But the market is made up by supply and demand. There is a very real possibility that as

defined benefit pension funds close and benefits crystallise there is a natural march towards bonds. Therefore that nervousness about inflation might be counteracted by the march towards bonds, and so you might find the bond market being pretty level.

I have to declare that I am an eternal optimist. I do believe that equities and all forms of growth have to deliver a better return than bonds and more secure investments. What the last ten years have taught us is that the economy is made up of more than just corporates, it's made up of commodities, private equity, hedge funds and things like infrastructure.

I am naturally bullish about growth assets. My view of the future is pretty optimistic but coloured by a concern about inflation. Therefore, I would be more return-seeking asset orientated but nervous about bonds. ■

The IFA

Tom McPhail,
head of pensions
research at
Hargreaves
Lansdown



After a very poor period up to March 2009, followed by the mother of all recoveries, global equity markets have paused for reflection amidst continuing uncertainty over the strength and pace of recovery. It is important to bear in mind that global equity markets can go through relatively long periods of sideways or downward movement, followed by periods of strong growth.

In the short-term, after such a strong recovery last year and with the UK economy facing a huge debt mountain, strong growth is unlikely. However it is still possible for equity investing to outperform property, bonds and cash in the UK, with equity income funds being the order of the day. It would take a brave investor to make big asset allocation decisions right now and for regular savers the benefit of pound cost averaging is hugely important.

Looking to the longer-term, the demographics and developing economy of India presents a compelling story and reason to buildup an exposure to the market (looking to a 20-year horizon). Again, for regular investing, I see China as a must-have over the longer-term.

For those closer to retirement the tough decision is whether to cash out completely now, ditching even gilts and bonds and sticking with cash, or to try to squeeze a couple more percent of growth before switching to decumulation. I don't imagine that we will see major movement until after the election. However, if it were my pension fund I would probably prefer to sacrifice growth in favour of the low yield on cash, rather than risk getting caught out. ■

The consultant

Robert Brown,
chairman of the
global investment
committee at
Towers Watson



We consider that economic and market uncertainty remains elevated and the range of possible outcomes remains higher than in a normal cyclical recovery. Given this, we have developed a number of scenarios for the capital markets over the next three to five years.

Our current central scenario states that indebted developed economies will undergo a period of de-leveraging and anaemic growth, whilst emerging markets such as China and India will continue their secular growth story. However, given the elevated economic uncertainty and risk in policy actions, there is currently significant uncertainty around our views and thus we prefer a diversified approach to asset allocation. This is also reflected in our capital market expectations where many assets are closer to fair value than they have been for some time.

In particular, we believe that on a ten-year view, global equities will generate returns close to the middle of their historic range (around 3% in excess of risk-free assets with a range of 2-4%). This view incorporates significant near term volatility.

With regard to emerging market equities, our views are more positive. Indeed, we think the long-term secular growth in these economies warrants serious consideration from investors.

We believe investment grade credit is moderately attractive with much lower volatility than equities. With regard to alternative forms of credit, we view high yield debt as less attractive than investment grade and are neutral on leveraged loans and securitised debt.

Our views on property are mixed: UK yields are attractive, but we have some concerns regarding the underlying fundamentals. ■

The solvency manager

Hemmo Hemmes,
asset allocation
specialist at
Cardano



The most likely scenario for the next few years is the ‘new normal’, as coined by Bill Gross – that is, lower economic growth than seen in the past 20 years. The performance of equities is therefore likely to disappoint investors.

In the short-term – as long as liquidity continues to flow and positive economic data continues to emerge – there is potential upside for risky assets. But over the medium-term the big question will be whether consumers can take over from fiscal stimuli to fuel economic growth. The level of consumer indebtedness suggests they will not be in a position to do so.

Two other scenarios – high inflation and a double dip recession – are possible, but less likely. The uncertainty that arises from opposing inflationary and deflationary forces will cause investor appetite for risky assets to be reduced and more volatile.

For the above reasons, good

long-short fund managers who can take advantage of volatility should outperform traditional long only managers.

Emerging market equities have a stronger outlook than developed markets over the medium term, but again we favour nimble long-short investors over long only managers.

In the short-term, inflation may cause government bond yields to rise, but over the medium-term the inflationary pressures are likely to come under control with yields coming back close to where they are today.

There is relatively positive outlook for corporate bonds for 2010 (albeit far less positive than 2009). Yields on both investment grade and high yield corporate bonds are still fairly close to levels seen historically during previous recessions. But the big question is over the cost of defaults, meaning the latter look more attractive than high yield.

As with equities, long-short only managers will be best placed to perform.

Despite last year’s market rally, UK commercial property may benefit from some momentum in 2010, but is likely to see lower returns over the medium term. ■

The hedge fund investor

Andrew Weir,
senior analyst at
Stenham



The currently benign growth, inflation and interest rate environment is likely to be a tailwind for global equity and corporate credit markets over the near term. Although we believe corporate earnings will plateau (as top line growth is subdued and cost cutting programmes instituted in late-2008 run their course), capital expenditure and dividend levels should pick up as companies make use of healthy cash positions built up over the last 12 months.

Equity and corporate credit markets should also be supported by M&A activity and a recovery in corporate spending, and cash investors sitting on the sidelines will be tempted to buy into market dips as long as yields on cash remain close to zero.

Political posturing, ‘exit plan’ anxiety (that is, concerns over, or actual reversal of, stimulus and quantitative easing, or interest rate hike concerns), or a low growth scare could lead to episodes of

volatility during the year and, if global economic growth proves unsustainable, a turn downward in equity and credit markets later in the year. The ‘wall of refinancing’ that looms for leveraged loans originated in the US from 2006 to 2008, and so maturing between 2012 and 2014, may present a major obstacle for credit and equity markets over the longer term.

Sovereign debt markets could show volatility over the year as a result of concerns over funding problems in countries with high debt to GDP levels, especially in the eurozone where currency devaluation is not available as a tool for member nations to boost growth (for example, Greece and Italy), as well as in countries where quantitative easing has kept yields on government securities artificially low (for example, US, UK and Japan).

Commodity prices, particularly base metals, should remain supported by government infrastructure initiatives, mainly in China.

Commodities and emerging market equities will however remain vulnerable to any signs of Chinese restraint or general risk aversion outflows in times of volatility. ■

Expert view

Inflation or deflation?

The market fears inflation, should you? asks Hugh Ferrand

Financial markets have become nervous about inflation again. Some see a risk of it rising sharply, especially in those countries which have embraced quantitative easing (QE) policies. We think that such views are misguided and that inflation around the world will remain subdued with a threat of deflation.

Those who cite QE policies as posing a risk of higher inflation fail to understand the mechanism of money and credit creation and the transmission from this to inflation. QE policies involve central banks buying securities in the financial markets: in the UK, those securities have been mainly government bonds; in the US, mortgage and other asset-backed bonds. In return for those purchases, the selling banks’ accounts at the central bank are credited. That increases their reserves at the central bank, the main part of the ‘monetary base’. It is no coincidence that in the UK, the increase in banks’ reserves at the Bank of England matches, almost identically, the value of securities bought by it.

A long-defunct textbook model of money creation sees these extra reserves providing the base from which banks are able to make more loans, which in turn will create more deposits, boosting both sides of banks’ balance sheets. In

practice, however, that series of events looks like falling at the first hurdle, just as it did in Japan during its period of QE from 2001 to 2005.

The reason is that after the boom in global credit in the five years up to 2007, many households, companies and financial institutions are too highly leveraged. Their emphasis is now on repaying debt. In the decades that followed previous booms in asset prices, fuelled by money and credit creation, that is precisely what happened. With little appetite to borrow, the most that QE can be expected to do is stave off an even more marked downturn in the economy.

We get very much the same message if we look at ‘real world’ indicators: the output gap is large; unemployment rates are high and not yet falling convincingly; companies have little pricing power; labour is not in a strong position to demand higher wages; and governments, after their brief spurt of fiscal largesse, are set on raising taxes and cutting spending. Add to that the persistence of structural long term deflationary forces – the greater integration in the world economy of low cost producers, the decline in the role of organised labour and the overcapacity in many industries – and there is indeed a risk of deflation.

We do need to be aware that the problems in US, UK and eurozone banking systems are not replicated in emerging economies. In China, banks have remained willing to lend and the central bank has quickly moved to tighten credit even though inflation has only just turned positive.

The importance of keeping inflation under control is just as keenly recognised in other emerging economies. Brazil experienced hyperinflation as recently as the early 1990s and such memories mean the central bank, fortified by independence from government and the requirement to meet an inflation target, is vigilant to any signs of inflation.

On balance, in developed economies weak credit and money growth is likely to persist, meaning that inflationary pressures are set to remain subdued, with a risk of deflation.

