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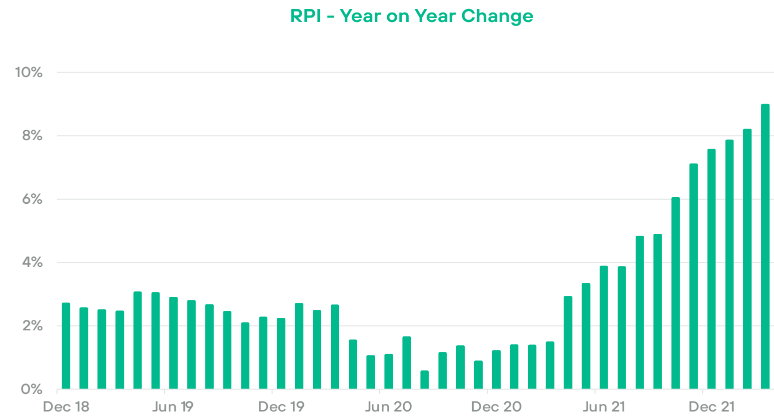
Vision Cast

Inflation barks at last but will it bite?

The high levels of current inflation have been caused by a series of shocks. These have restricted the supply of some goods and dramatically increased production costs of others. This, in itself, has not been a major problem for DB pension schemes, many of whom have inflation hedging strategies in place.



Source: Office for National Statistics

What happens next is the issue. The economy could transition to an era of high interest rates coupled with stagflation, caused by one of two factors:

a) contagion - the current supply-side inflationary environment spreads to wage growth and demand pull inflation

b) policy error - central banks pouring cold water in the wrong places at the wrong time causing economic growth to stall

In both of these scenarios we would expect return seeking assets such as equities to perform badly and credit to reprice as the yield curve rises at all durations. Ahead of this, trustees should act to protect their positions, and capitalise on current gains. The actions required depend on the scheme's current investments and overall Integrated Risk Management strategy so should be taken in the context of your own scheme's specific circumstances.

Actions for pension scheme trustees

Recalculate the inflation sensitivity and rebalance the LDI holdings

Your exposure to inflation risk is dynamic due to the caps and floors of benefit increases. As inflation has risen, many schemes' inflation sensitivity will have fallen. You may well need to adjust your LDI holdings to reflect the decreased sensitivity to further changes in inflation.

Check there is sufficient liquidity

As interest rates have risen, leveraged LDI funds have eroded schemes' available liquid assets and supporting collateral. You need to ensure that there remains sufficient liquidity and collateral for your scheme's needs.

For any schemes that are under-hedged, consider increasing your hedges

You can use the gains from the gilt sell off to lock down risk. As interest rates have risen, schemes with lower hedge ratios will have seen funding levels improve materially. Assess the opportunity to lock in these gains.

Have liquidity for investment opportunities, particularly if you have a return seeking strategy

A change in economic landscape typically leads to repricing of different asset types. Investors who are fleet of foot can reorganise their strategy to refresh and improve their portfolios.

As always, speak to your Isio consultant to discuss this further.

Watch this quick 2 minute video of our CIO Barry Jones as he gives his views on inflation

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