For European institutional investors and consultants

Financial markets update
How can pension funds react?

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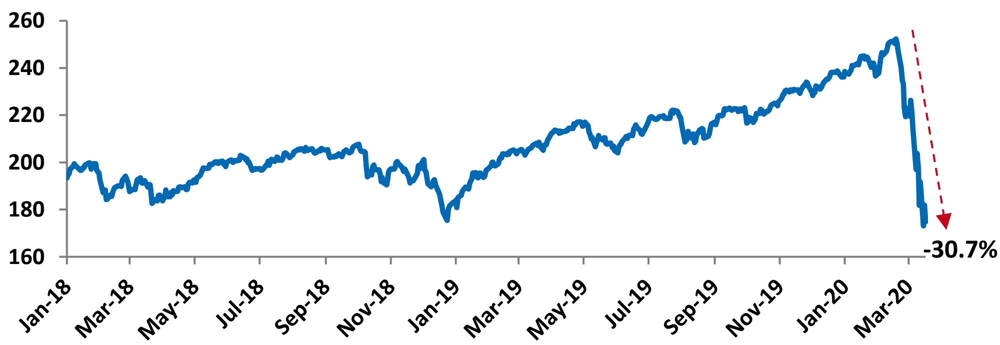
The outbreak of COVID-19 across the world has sent markets into shock. Pension funds have suffered sharp reductions in their funding positions as equity and risk asset values have dropped and interest rates have fallen. This article provides an update on where financial markets now stand and considers the options for pension funds seeking to react to the effects. In general we maintain a cautious stance in the short term. At the same time, investors with a long term investment horizon have the opportunity to consider the benefits of maintaining strategic plans and rebalancing back into risk assets where lower prices have improved the longer term expected returns compared to safer bond alternatives.

Introduction

What began in Hubei province in China has now spread throughout the world and authorities are having to take measures which are unheard of in most people’s lifetimes. In many countries, schools are closed, travel across borders is restricted or prohibited, events are cancelled and, wherever possible, workers are being required to work from home.

Financial markets were slow to react when the initial outbreak emerged in Wuhan in January. This was perhaps due to past experience with less transmissible coronaviruses such as SARS and MERS. However since it has become clear that this coronavirus is more transmissible and is unlikely to be contained, markets have been swift to fall, pricing in severe disruption to the world economy. Governments and central banks have reacted, although, at present, this seems to be having limited effect on markets. The uncertainty regarding the virus and the disruption it will cause is their focus and fiscal and monetary relief is unlikely to solve that in the shorter term.

Figure 1: Development of the MSCI ACWI in Euro terms



Source: Bloomberg, Aegon Asset Management. Updated to 18 March 2020.

Monetary and fiscal policy reaction

The ECB has left interest rates where they are – the main refinancing rate was already at zero – but announced further asset purchases and bank lending on better terms, designed to particularly help small and medium-sized businesses. On 19 March, as the crisis has deepened, a further bond purchasing program was announced of €750 billion. This program was designed to combat the credit contraction and fears on the sustainability of the euro zone.

The Fed made an emergency 1% reduction in overnight interest rates and also announced $700 billion of asset purchasing, amongst other measures. The Bank of England cut rates by 0.5% and then a further 0.15%. They too, along with the Bank of Japan, announced further asset purchases.

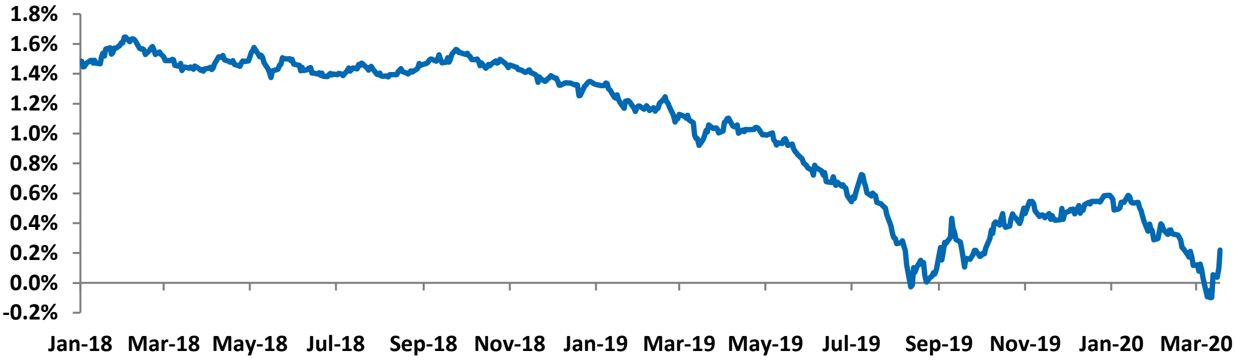
In addition to central bank stimulus, many governments have announced measures to support their local economies. Central bank policy can only do so much for small and medium-sized enterprises who will feel the greatest immediate impact. Governments are also considering cash handouts to individuals to soften the effects of the coronavirus. This includes in the US where such a policy proposal would be unheard of in normal circumstances.

Market reaction

Equity markets have fallen over a cliff edge, as can be seen from Figure 1. The drawdown exceeded 30% as at 18 March with no signs yet of support. The US dominates the world market but all regions have experienced significant falls.

Oil prices have also fallen (now at around $25 per barrel versus more than $60 before this crisis) on the back of lower demand and more supply due to disagreement between Saudi Arabia and Russia about production strategy. This seems unlikely to recover quickly given the large fall in demand due to further lockdowns in many economies.

Figure 2: 20 year Euribor swap rate

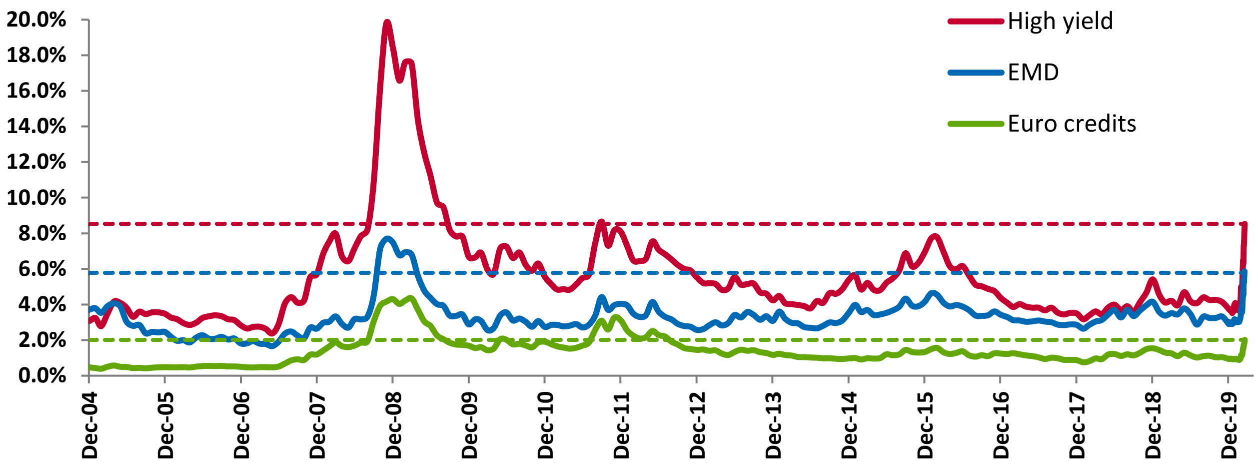


Source: Bloomberg, Aegon Asset Management. Updated to 18 March 2020.

Bond markets initially saw lowered yields, as investors sought safe havens and central banks lowered rates where possible. As can be seen from Figure 2, long term euro swap rates once again turned negative. This dynamic changed after the actions from the latest ECB meeting disappointed markets, who were expecting more. Following that, we have also seen a rise in yields on the back of higher expected government bond supply. Governments are going to need to borrow significantly to pay for the fiscal measures which have been promised or are expected.

As seen from Figure 3, credit spreads have widened significantly as well. Most companies will see lower profits based on the dramatic fall in demand for services and products, accompanied by reduced production capacity in many cases. Market liquidity for corporate bonds has also worsened significantly and investors can expect to pay several multiples of normal transaction costs to exit positions. This adds to the uncertainty and will potentially deepen further shocks.

Figure 3: Development of credit spreads



Source: Bloomberg, Aegon Asset Management. Dashed lines are levels at 18 March 2020.

How can pension funds react?

There is still great uncertainty about how this pandemic will further unfold. We know however that in the short term the virus will cause great economic disruption as countries seek to limit its spread to relieve pressure on the healthcare system. We therefore expect financial markets to stay volatile for the coming period.

Potential short term actions

Given the stress in markets, there are limited options available for clients that want to position themselves cautiously. At this moment it is difficult to trade several asset classes. For example, we see that the bid-ask spreads for corporate bonds, both investment grade and high yield, have risen dramatically due to the lack of liquidity. This means that selling riskier assets in this market environment is very costly. The same holds for buying protection using derivatives, as market-implied volatility has jumped. Government bonds and equities do still have reasonable liquidity. Another downside of lowering the exposure to risky assets is that the pension fund will no longer profit from a potential turnaround in markets.

Many pension funds will operate a strategic asset allocation (SAA) with accompanying tolerance ranges. There will also often be a rebalancing policy should an asset allocation fall outside its tolerance range. These tolerance ranges offer pension funds some discretion, allowing them to reduce their risky asset allocations to be closer to the lower end of their tolerance ranges, where they can sell assets. Where pension funds have the ability to intentionally position outside the tolerance ranges at short notice, or to suspend or amend the rebalancing policy, this gives them more leeway to position defensively.

Longer term planning

In the longer term, our base case scenario is that the impact of the coronavirus will dissipate as a result of the actions of authorities and better understanding of the virus. Potential treatments are already in testing and considerable effort is being made to find a vaccine. It may also be that a herd immunity can develop over time as more people recover from the virus, although there is still scientific uncertainty about whether recovered patients are then immune and for how long. As with seasonal influenza, it may be that the virus mutates quickly and so regular vaccinations will be required. This process of reaching a stable position where restrictions can be eased without healthcare systems being overwhelmed could take a few months, during which much economic activity will be on hold.

There are however much worse scenarios, for example a very prolonged period of lockdowns while waiting for a vaccination or treatment. At some point the economic costs of these lockdowns will be too great compared to their benefit. We therefore expect restrictions will have to be lifted partially within a few months. Some countries in the Far East, including China itself, have demonstrated that it is possible to successfully restrict the spread of the virus but they were better prepared and can potentially impose greater restrictions on their populations than in Europe and the US. Many of the restrictions put in place there have now been eased although they continue to widely monitor and test for the virus.

When more clarity does emerge, financial markets and the economy will gradually return to normality. Given the amount of central bank and fiscal stimulus, there is also the potential for markets to show a rebound. Institutional investors may consider how they plan to reallocate when the crisis period begins to subside. Input assumptions for ALM studies will have changed significantly and are likely to lead towards very different outcomes. Higher weights to riskier asset classes such as equities, high yield and emerging market debt are likely to offer improved projected outcomes. Hence, we expect that when markets show signs of stabilization, institutional investors will begin to increase their positions in these asset classes.

Conclusions

The impact of COVID-19 has been and will be dramatic on both personal lives and financial markets. The impact is clearly severe and the actual consequences are very difficult to predict at present. The focus for markets currently remains the battle with the virus and the effect this is having on the world economy. In the short term we maintain a cautious stance, despite the large-scale central bank and government support.

The sharpness of the falls and the impact on the economy means investors will be presented with a very different economic outlook once markets show signs of stabilization. Assets that were previously looking very expensive from a historical perspective may then have very different potential returns. We may however be a long time away from seeing this greater certainty and stabilization.

Aegon Asset Management is focusing its work and studies on the impact of the coronavirus and the accompanying challenges and options for our clients.

Aegon Asset Management

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