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Sixty second summary

After the crash: the ten-year challenge

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The collapse of global equity markets in the slipstream of the global financial crisis and Great Recession ended around the end of the first week in March 2009. We take a high-level look at a very unusual decade and whether it can give any pointers to the next one.

A new normal

Conventional wisdom was that recoveries from financial crises tend to be slow and protracted … and so it has proved. Output in the major developed economies troughed in the first half of 2009. Between then and the final quarter of 2018, growth has ranged from 1.4% p.a. in the Eurozone to 2.3% p.a. in the US; the UK is in the middle at 1.9% p.a. Except for Japan, the pace of post-crisis recovery has been well below the pre-crisis trend. Any hopes that output lost in the recession would be recovered have long gone – indeed, most commentators expect that the subdued pace of growth in the last 10 years may be a good guide to sustainable trends in the future.

What growth there has been was supported by an enormous level of monetary easing around the world since 2008. There were some fears that massive liquidity injections would be inevitably inflationary, but the outturn has confounded them. Here it is the old normal that applies – the major central banks still use 2% p.a. CPI inflation as a "target" (interpreting the word very flexibly). Aided by some old-fashioned sterling depreciation just before the recession and, more recently, after the EU referendum, UK CPI inflation has been just above target on average in the last 10 years. It has been a little below in the US, well below in the Eurozone and not much more than zero in Japan. And although wage growth has eventually started to show some signs of life in the US, UK and Eurozone, inflation pressures still seem well contained.

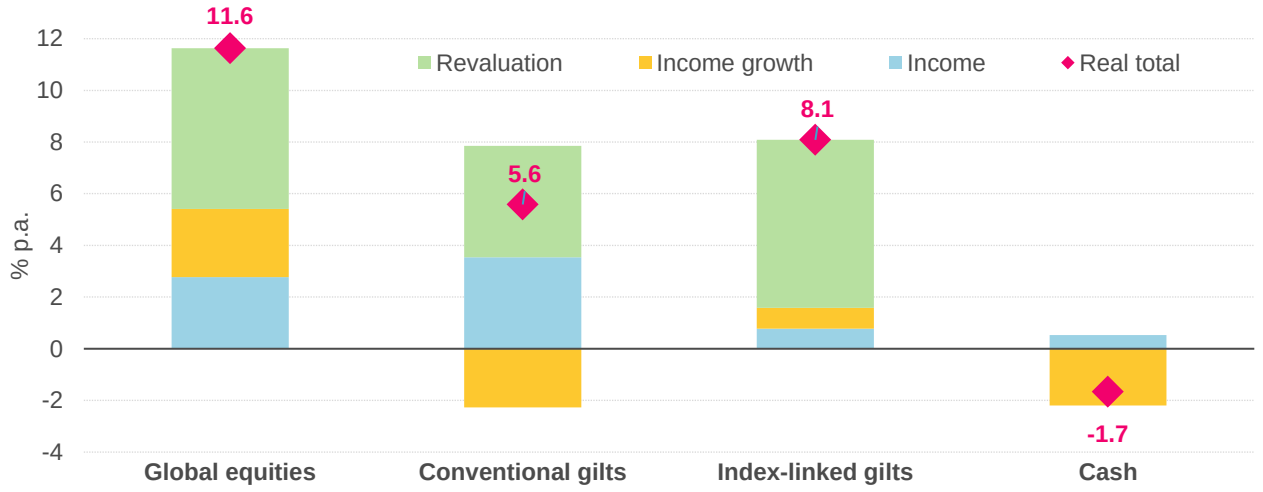
Lower for longer

For most of the last 10 years, investors have expected monetary policy to be tightened much sooner than it has been in practice. But the "lower for longer" mantra is now less often heard than it was. The first rise in US interest rates in the current cycle was over 3 years ago, and interest rate futures reflected a "higher and sooner" mentality in the final quarter of 2017 and for most of 2018. US bond yields hit post-crisis lows as early as mid-2012, although the latest sustained rise in yields started in mid-2016.

Over the last 10 years as a whole, the change in the 10-year US Treasury Bond yield has not been dramatic. It did fall from 3% p.a. in February 2009 to 1.5% p.a. in mid-2012; but it had climbed back above 3% p.a. as recently as October 2018, although it has fallen back a little subsequently. The fall in the equivalent real yield on inflation-linked bonds has been more significant – from 2% p.a. in February 2009 to 0.7% p.a. in February 2019 – although it is well above the 2012 low of -0.9% p.a.

In the Eurozone and the UK, against a background of more sluggish growth and little or no tightening of monetary policy, the middle of 2012 was merely a pause in a more sustained fall in bond yields and the rise since the middle of 2016 has been more modest. That has, of course, had significant implications for the financial position of many UK pension schemes.

Chart: Sterling returns relative to UK CPI, 28 February 2009 – 28 February 2019



Source: Datastream, Hymans Robertson. Feb 19 CPI and RPI inflation assumed unchanged from Jan 19

Profiting from adversity

If the economic background of the last decade has been unusual, the same is not obviously true of equity market returns. Sterling investors would have been pleased with a near 12% annual return in excess of CPI at any time in recent decades; any open or expanding pension schemes whose main concern is with sustaining real returns would have little cause for complaint. Analysing the return (see chart) provides more illumination.

- An income return of under 3% p.a. is unexceptional and, given current dividend yields around 2.6% p.a. on global indices, may be largely repeatable.
- Real income (earning per share) growth of under 3% p.a. is comfortably above the long-term pre-crisis trend, but fairly pedestrian compared to the best levels achieved in recent decades. It is nevertheless flattered by earnings that have moved from cyclically depressed to cyclically extended levels; sustainable growth in a new normal environment is likely to be lower.
- Just over half the return came from revaluation. We think current equity valuations are at worst a little expensive, but that means we would expect no sustained contribution from revaluation from here.

For many pension schemes, the benefit of strong equity returns in the last decade has been undermined to the extent that interest rate and inflation exposure have not been hedged. Returns relative to gilts and index-linked gilts (as a proxy for liability growth) have been much lower. Here, the outlook for the next decade may be more favourable.

- Yields on gilts are now much lower than they were 10 years ago and so future income returns will be commensurately lower.
- Negative real income growth on conventional gilts reflects inflation and may be little different if the Bank of England meets its inflation target on average. The income growth shown for index-linked gilts is the gap between RPI and CPI inflation and may be under a little pressure if renewed moves to reform RPI prove successful.
- The experience of the US suggests that a more normal economic background (even if it's a new normal) means higher bond yields (both nominal and inflation-linked). If hedging pressure has eased by 2029, assuming a zero revaluation return from gilts may overstate their return potential.

Of course, hedging over the next decade should be driven by risk management plans rather than a single market view. However, unless the new normal actually turns out to be a "new dismal", pension schemes may have a more benign environment in which to implement those plans.