



Negative rates: implications for asset allocation

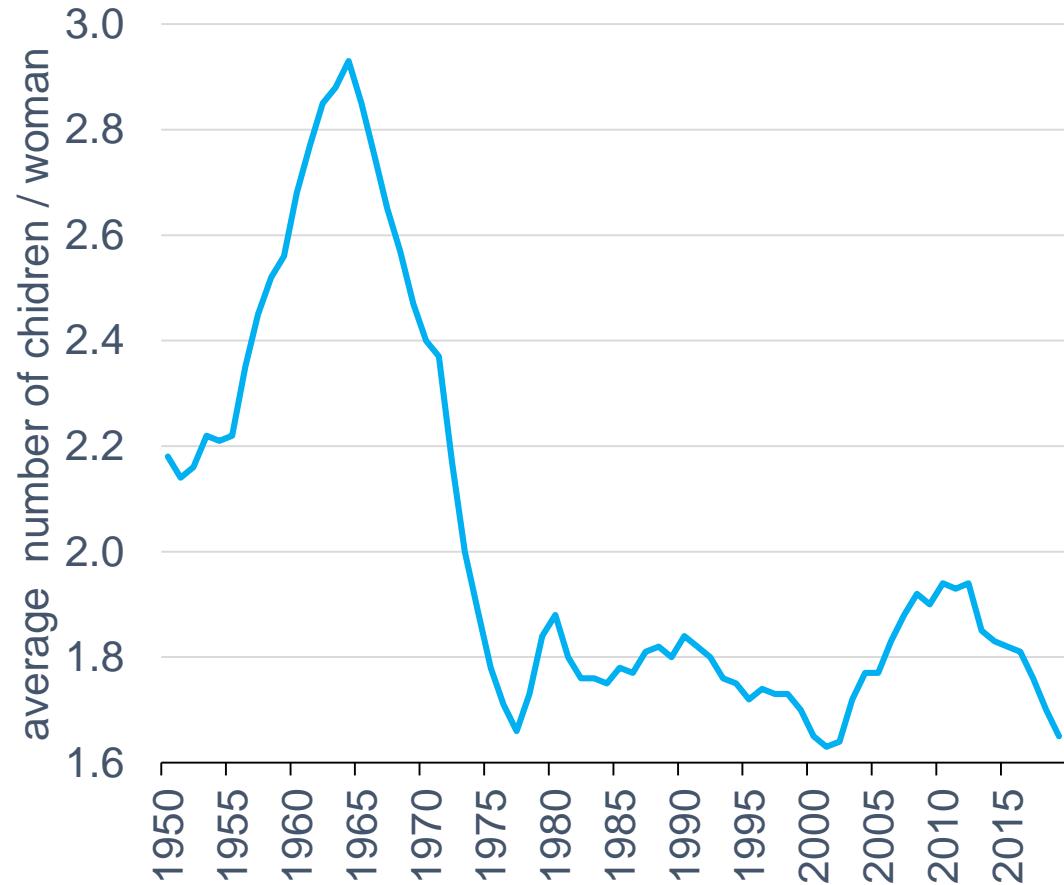
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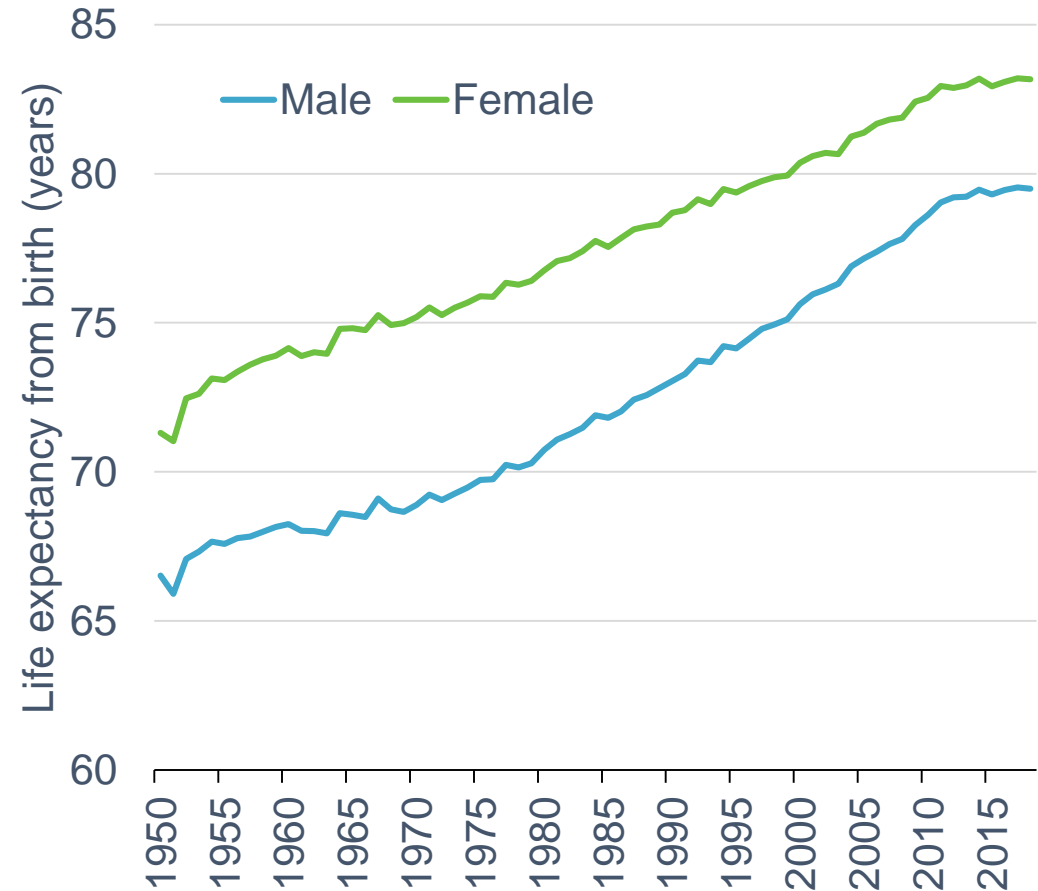
25 November 2020

Negative rates a symptom of more tectonic shifts

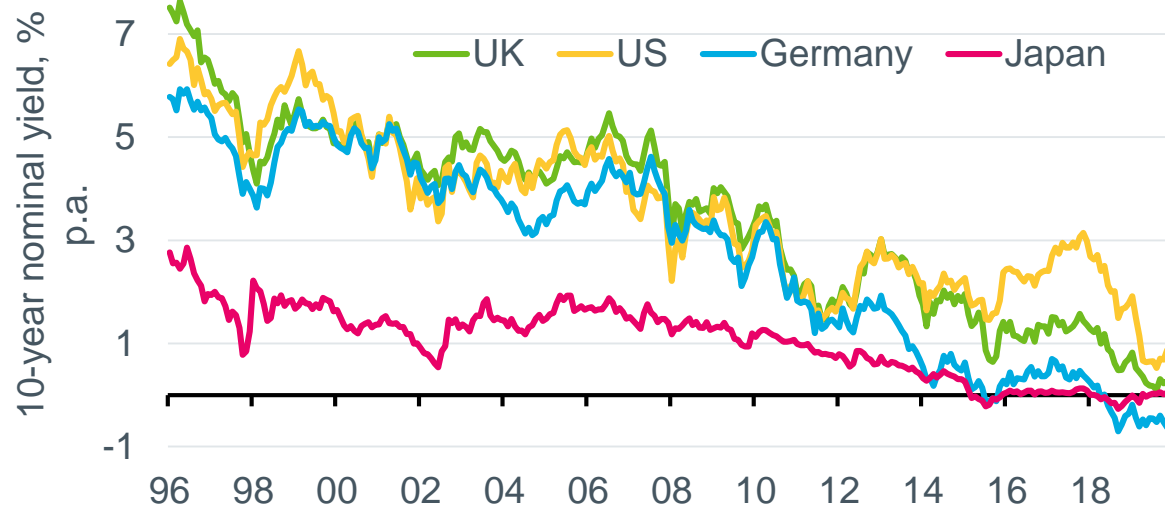
UK total fertility rate



UK life expectancy



Negative rates are nothing new...



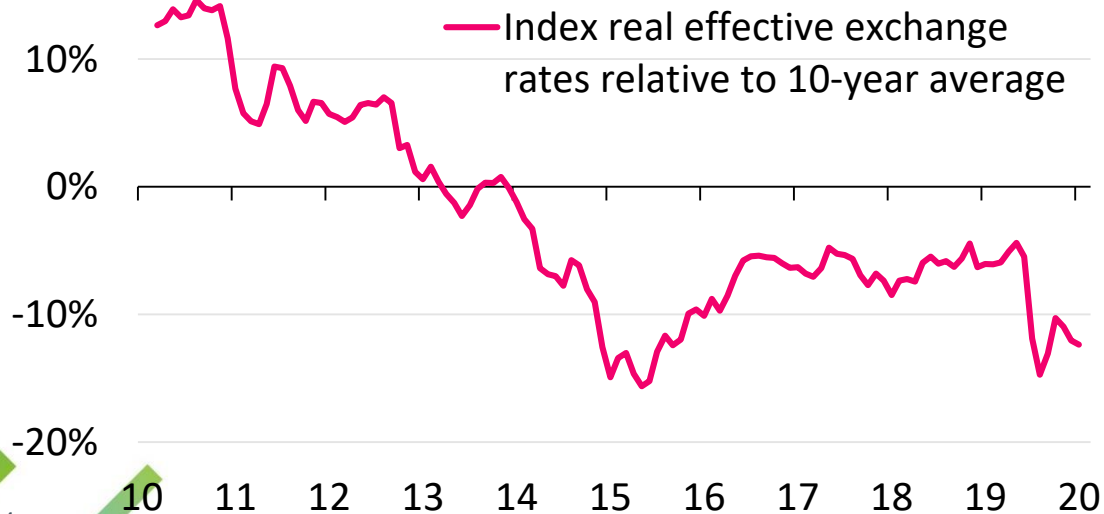
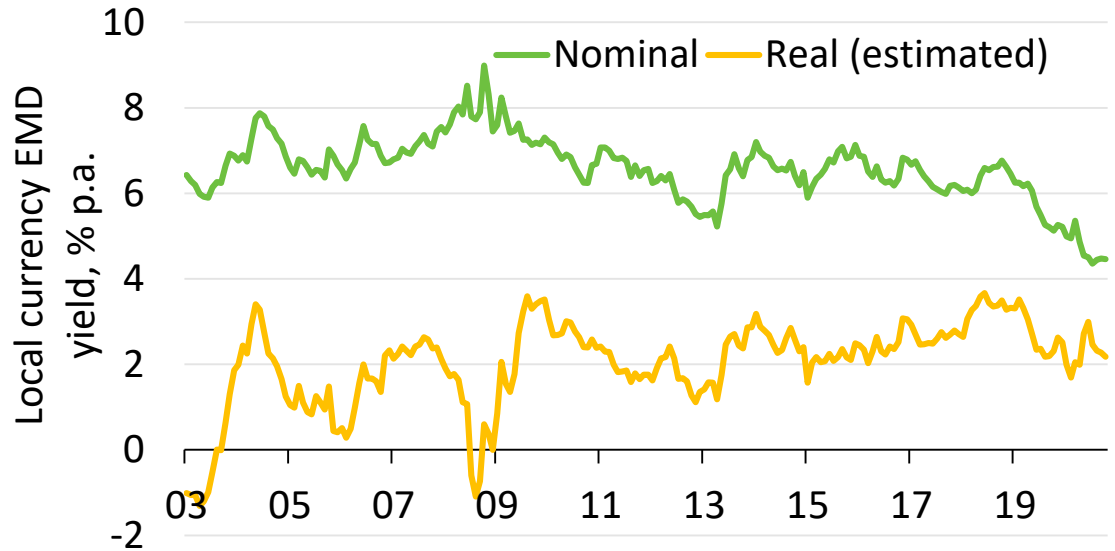
...but potentially new practical considerations for UK interest-rate hedging strategies

- Interest paid on cash collateral
- Floor on repurchase rate
- Floor on the floating leg of swaps

Negative rates introduce the prospect of liabilities exceeding nominal cashflows:

- Gilts-based discount rate appropriate? Credit spread margin over gilts?
- Long-term objective and regulatory environment are key

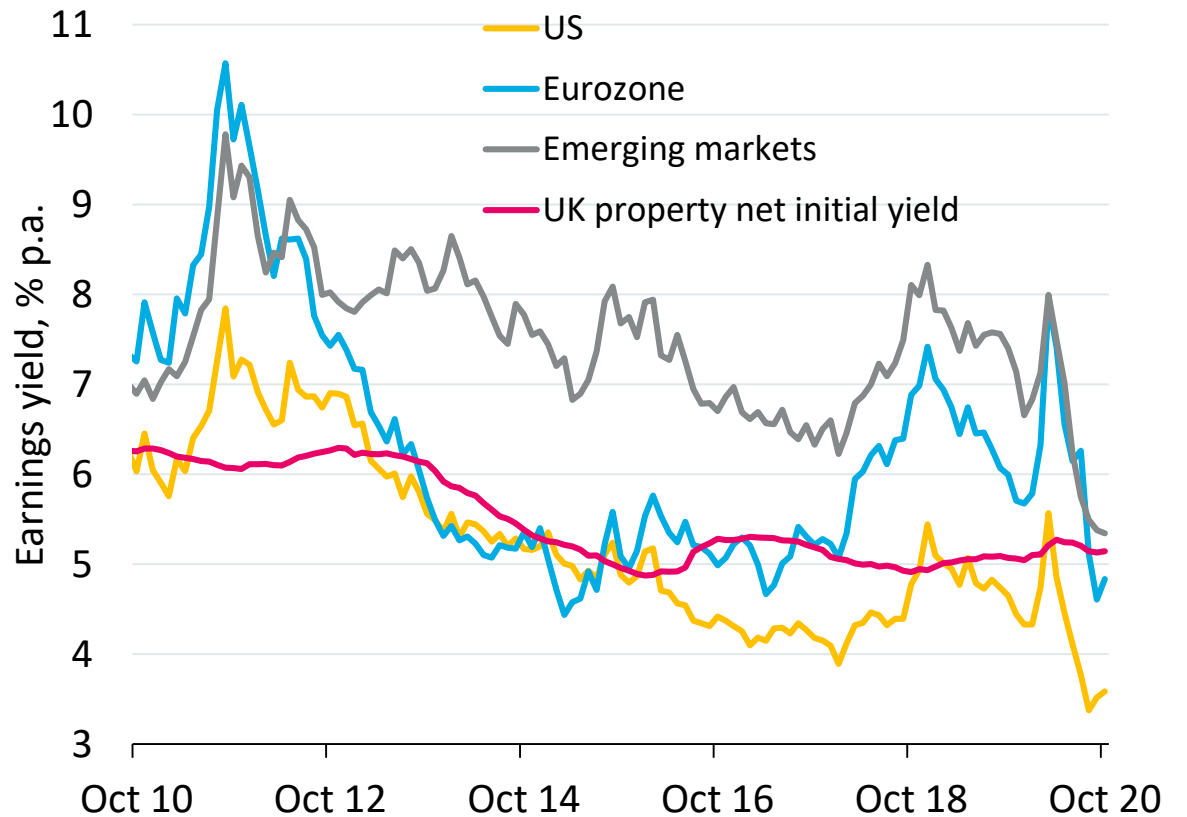
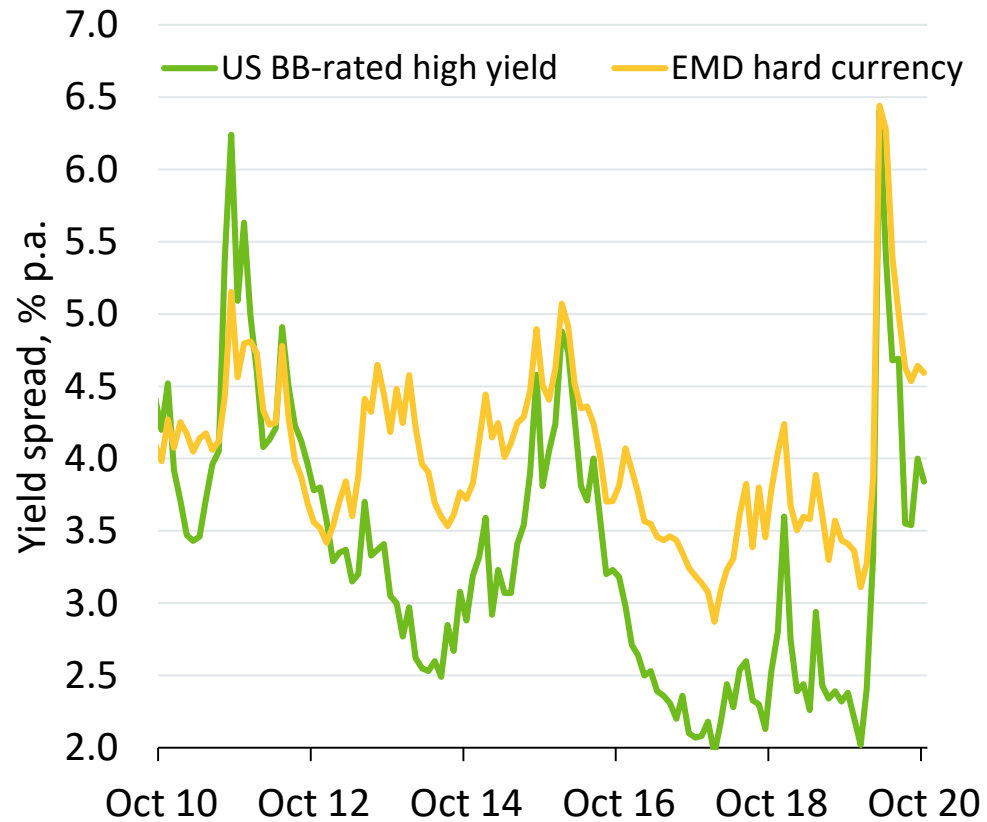
Very much a developed market phenomenon



Perhaps a catalyst to accelerate capital allocation to emerging markets

- Currency risks are lower and institutional frameworks more robust than in past
- Real yield differentials
- Depreciated currencies
- More favourable valuations
- Broad diversification or careful market selection is key

Negative rates are supportive for asset prices



Hedging considerations

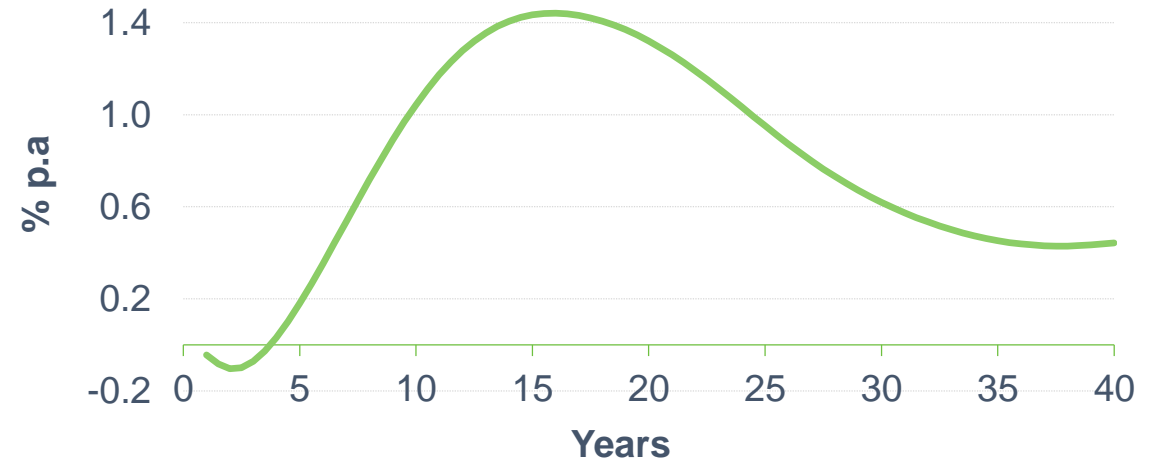
Potential upside from future gilt appreciation may reduce as gilt yields fall towards zero:

- Schemes in deficit and with risk budget may alter level of strategic hedging
- Still makes little sense to take unrewarded risk for well funded schemes

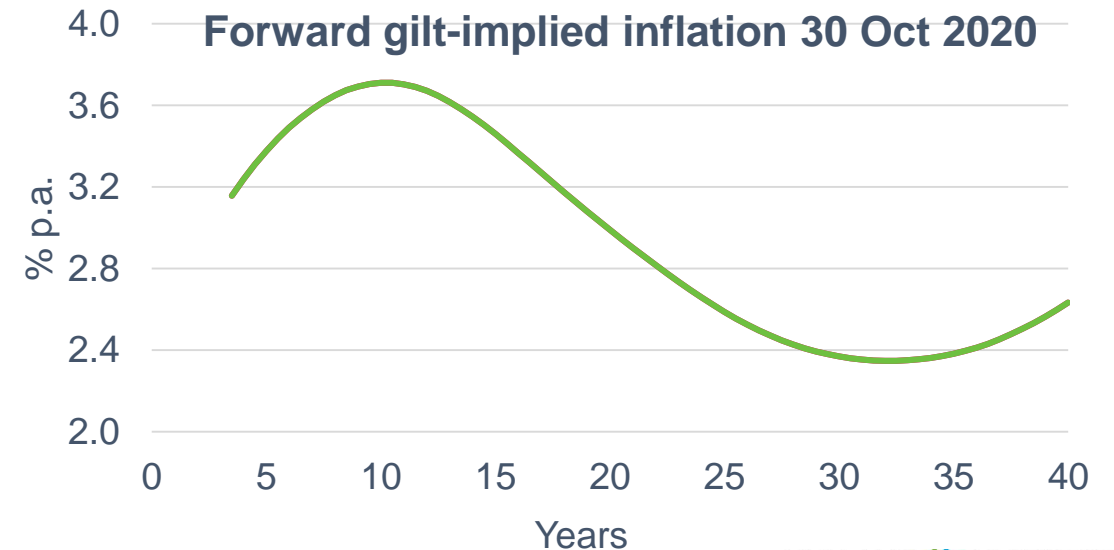
But this asymmetry may not apply to real yields:

- Already have materially negative real yields currently and in past periods
- At lower bound, further easing of financial conditions would be via reducing real rates i.e. letting inflation overshoot

Forward nominal yields 30 Oct 2020

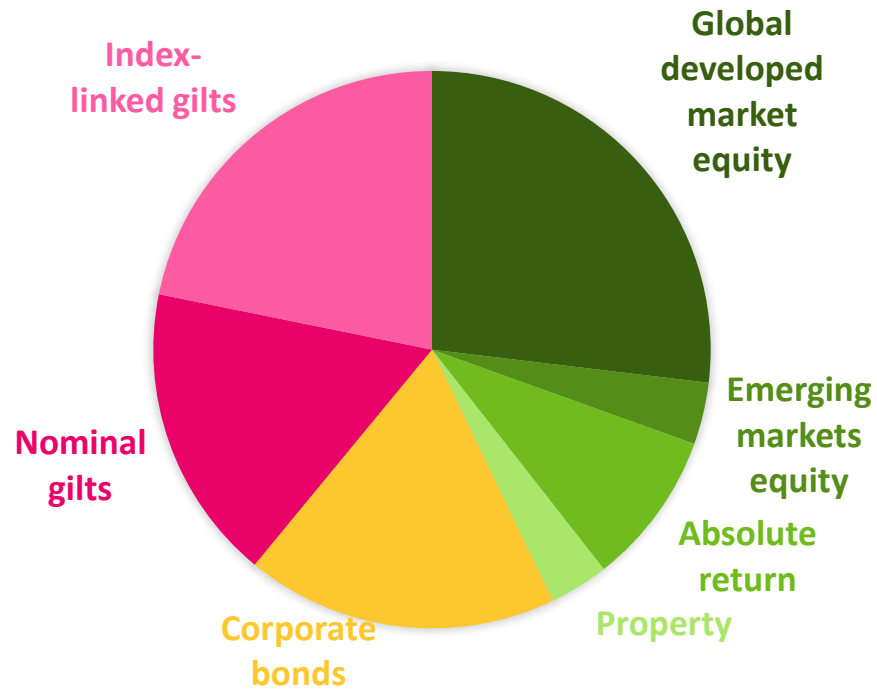


Forward gilt-implied inflation 30 Oct 2020

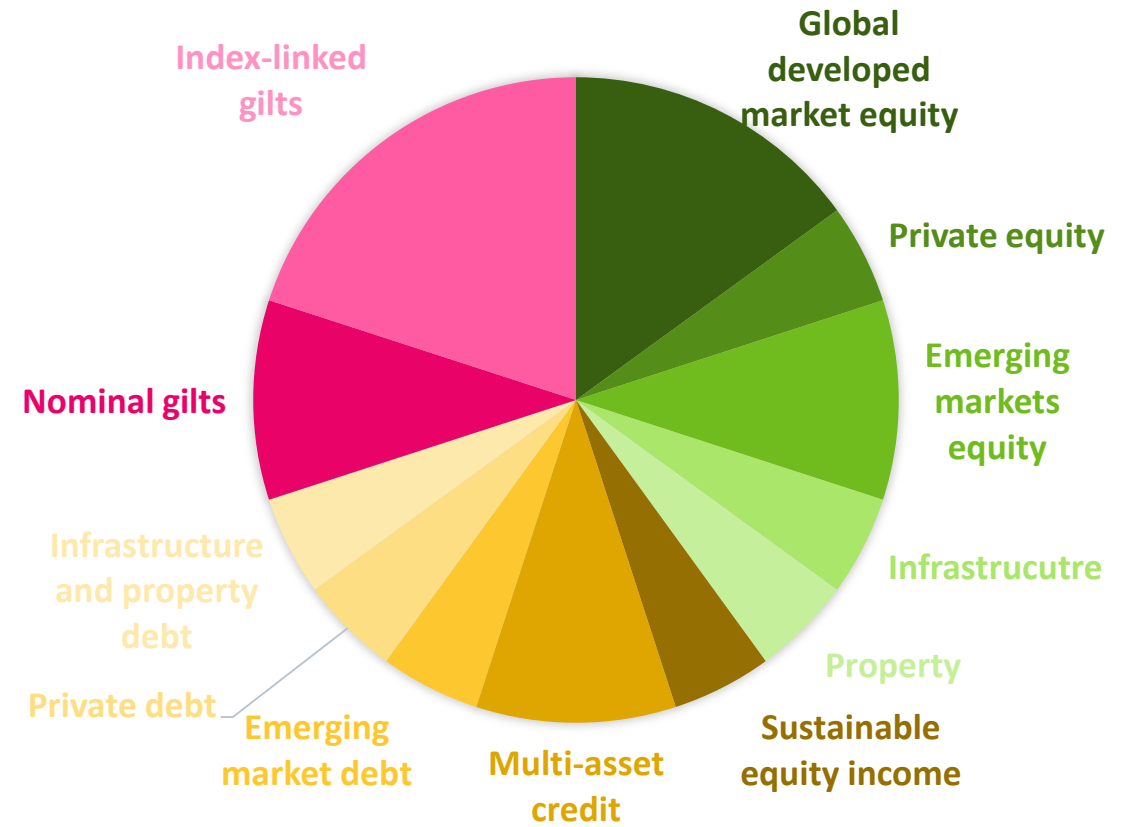


New portfolio for a new cycle

Typical corporate scheme allocation



Low for long allocation



Thank you

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Appendix



Relative value considerations

- Schemes that do not hedge their interest rate risk will need to bear in mind the implications for total returns
- For those that do, rigorous relative value analysis may highlight opportunities
- Compression of fixed-rate assets could potentially create attractive risk-adjusted opportunities elsewhere

