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Briefing note

Deflation and a low-yield environment

The latest published inflation statistics show that inflation has now fallen below zero over the twelve months to March 2015 (as measured by CPI) and RPI falling to 0.9%. Recent falls in oil, energy and food prices have driven these falls and fears remain that we may yet see inflation fall further in the coming months.

> Could we be seeing the start of a period of sustained price falls? Not according to Mark Carney, governor of the Bank of England

Recent falls in oil, energy and food prices have driven these falls and fears remain that we may yet see inflation fall further in the coming months. As a result of the expansive monetary policies introduced by the European Central Bank, which have led to a stronger pound, goods and services priced in Euros will also be a source of deflationary pressure.

So could we be seeing the start of a period of sustained price falls? Not according to Mark Carney, Governor of the Bank of England. The theory goes that as falls in energy prices work their way through these effects will drop out of the annual rate and inflation will rebound, boosted by greater global demand off the back of cheaper prices and easing measures taken by various central banks. Indeed, official forecasts project a return to the Monetary Policy Committee's CPI inflation target of 2% within two years.

What is deflation?

Deflation (or negative inflation) is a decrease in the general price level of goods and services. Economic theory suggests that deflation is bad because it increases the real value of debt, and can lead to a deflationary spiral - where decreases in prices lead to lower production, wages and deferred consumption, ultimately causing a vicious circle of ever decreasing prices.

In deflationary conditions pension schemes will see the value of their benefit payments increase in real terms, since pensions in payment cannot be reduced against a backdrop of falling inflation. Couple this with low nominal asset returns and scheme sponsors may face demands from trustees for additional financial support.

The consensus view remains that the UK is not heading for a period of sustained deflation, albeit it may be seen in the mid-part of 2015. However, some economists are predicting a sustained period of low inflation, dubbed 'lowflation' – and that could be troubling in itself.

But surely low inflation is good news for pension scheme sponsors as benefits will increase more slowly?

On the face of it, yes, low inflation will be 'good news' for sponsors. However, the fall in inflation expectations has been accompanied by a reduction in growth expectations and gilt yields. All things being equal, low inflation has delayed the expected date of the first interest rate increases both in the UK and Europe and that has implications for government bond yields.

With nominal gilt yields at historic lows and real yields well below zero, pension schemes face a number of problems. Firstly, for schemes carrying out triennial valuations, liabilities are typically measured relative to gilt yields and falling yields will lead to increased deficits and consequently increased contribution requirements for scheme sponsors.

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Secondly, the cost of de-risking a pension scheme, perhaps by looking to offload some or all of the pension scheme risk to an insurance company, can be expected to increase. Low borrowing costs available to many companies present an opportunity to obtain finance which can be used to remove pension scheme risk from the balance sheet, but the cost of de-risking can be a prohibitive factor. And with real yields at their current levels greater hedging via the scheme's asset strategy will come with a sizeable price tag.

What can sponsors do?

Sponsors can influence a scheme's investment strategy. Tactical asset allocation switches can be made to 'lock in' gains from outperforming asset classes. And sponsors with strong covenants may be able to afford to deliberately reduce the level of matching in order to benefit from relative price movements between different asset classes.

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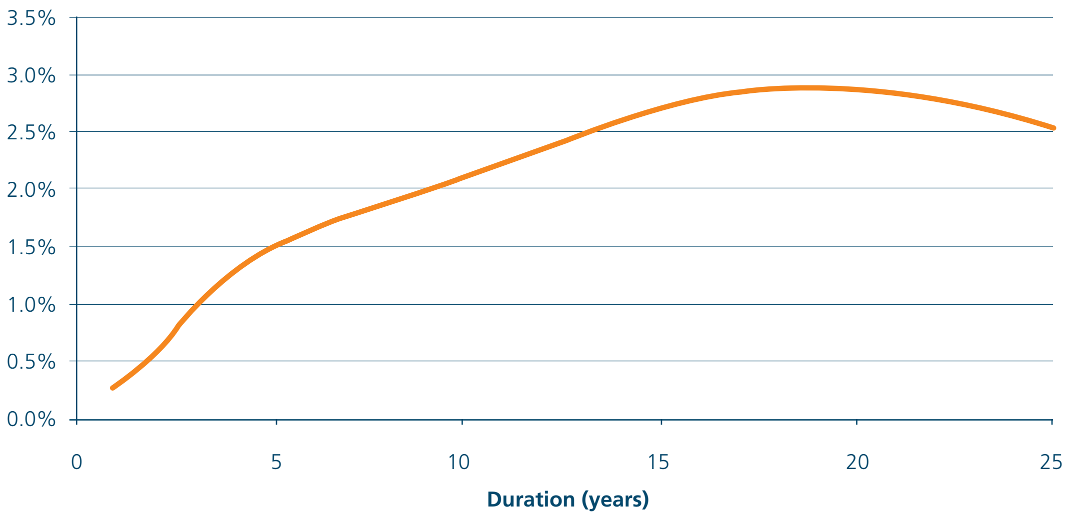
Finally, for trustees and sponsors entering negotiations over funding measures and contribution requirements, both parties may look to The Pensions Regulator's latest code of practice on scheme funding and the flexibilities contained within it. In particular, sponsors may look to agree 'dynamic' recovery plans where contributions decrease as gilt yields rise.

Riding the storm

For all the talk of low yields and deflation, the outlook for the future looks reasonable. The graph below shows forward rates for gilt yields which demonstrate an expectation that yields will ultimately return to higher levels (albeit lower than those seen in previous interest rate cycles).

Bank of England Nominal Gilt Forward Curve (annual)



Source: Bloomberg and Bank of England calculations

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Bond yields remain volatile however and the falls seen in the last year may have resulted in an increase in liabilities of over 20% for some schemes compared to the position twelve months ago. Sponsors should therefore consider the appropriateness of significant increases in hedging or the use of relatively short recovery plans during a period where liability measurement has been quite volatile.

We are in the middle of an unprecedented period of quantitative easing, a process which no developed economy has yet successfully unwound. Sponsors of pension funds should consider the impact of a range of potential outcomes for the current wave of monetary policy and ensure that funding and investment decisions are being made appropriately.

Concluding remarks

Inflation will, as it often is, continue to remain a talking point. Some commentators may even look to draw parallels with Japan's 'lost decade'. But the message from the Bank of England is clear – deflation, if we even experience it at all, is not here to stay.

Nevertheless, gilts are returning historically low yields, if held to maturity at current rates, and inflation expectations for the foreseeable future show a period of significantly low price rises. Sponsors need to be aware of this environment and take this into account when entering into funding negotiations. Importantly sponsors need to remember that most pension schemes have an extremely long-term horizon, and short-term factors should eventually dissipate.

Please contact your Barnett Waddingham consultant if you would like to discuss any of the above topics in more detail. Alternatively contact us via the following:

simon.taylor@barnett-waddingham.co.uk
020 7776 2200
www.barnett-waddingham.co.uk
