The Euromoney UK Conference 2016

What Next for Investors and Borrowers?

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Speaker E-Book

The Sterling bond market has seen increased activity in recent weeks, with a surge in issuance from both financial and corporate borrowers attracted to tightening Sterling bond spreads following the Bank of England's announcement of new stimulus measures at the beginning of the month.

Against this increasingly competitive backdrop, The Euromoney UK Conference will examine how Britain's decision to leave the EU has affected Sterling markets, the funding environment for the UK Government and other British issuers and its impact on the UK's economy as a whole. An expert line-up of speakers will also tackle the practical implications of Britain's exit from the EU, as well as discussing how best to navigate the volatility and uncertainty triggered by the referendum result.

Ahead of the upcoming event, Euromoney Conferences interviewed some of our key investor speakers on the outlook for the sterling bond market in the coming months. We asked interviewees for their perspectives on how British pension reforms are affecting the Sterling market and for their views on how the referendum result will affect UK economy in the medium term, as well as on the importance of secondary market liquidity.

Interviewees include:

Mike Amey
PIMCO

Jadd Chamié
Nippon Life Global Investors

Lloyd Harris
Old Mutual Global Investors

Paul Hodges
The pH Report

Interviews

Q: British pension reforms are fundamentally changing the behaviour of a vast investor group. What do you think are the most significant implications for the sterling bond market?

Mike Amey, Head of Sterling Portfolios, PIMCO: There are a number of ways in which pension reforms could affect the sterling bond market, not least the increased flexibility that individuals have with regard to their pension savings. As yet there has been little influence on the sterling bond market, suggesting that giving individuals flexibility may in time actually enhance market liquidity. Ironically some of the legislation that hasn't changed has created more volatility than legislation that has, for example around studies concerning the use of CPI for pension indexation.

Jadd Chamie, Director, Fixed Income Investment Manager, Nippon Life Global Investors Europe: While not an expert in that field, I believe the pension reforms will reduce the overall duration of the sterling bond market. Investors will also have to look for more liquid assets given the greater flexibility for cash withdrawals.

Lloyd Harris, Portfolio Manager and Lead Financials Analyst, Old Mutual Global Investors: Pension reforms undoubtedly have the potential to change the shape of the sterling bond market over time with less of a natural home for long-dated credit, particularly lower-rated long-dated credit. The impact is more benign for higher-rated corporate bonds. However, the effect has not been nearly as pronounced as once thought because of much lower gilt yields this year which has pushed up defined benefit pension deficits and hence has net/net increased the bid for long-dated credit. This has been further exacerbated by the Bank of England's corporate bond purchase programme.

Paul Hodges, Chairman, The pH Report: Probably the most significant issue is the way these reforms are now taking place at the same time as the Bank of England is launching a new QE programme. Already the Pension Protection Fund has warned that only 925 of the DB schemes in its universe are in surplus, with 5020 in deficit, and that the funding ratio has fallen to 77.4%. This deficit will have real world consequences as either employers will have to increase their contributions, or pensioners will not get their promised pensions. Both outcomes will have negative consequences for the UK economy, as they will either reduce company profitability or reduce pensioner's future spending power. One also cannot ignore the potential for political fall-out if pension funds fail to meet their commitments to pensioners – the BHS developments are the proverbial 'canary in the coalmine' in this respect. The problem is that the BoE seems to feel it is necessary to be seen to be doing something in response to Brexit – but by creating further artificial demand for gilts in the short-term, it is creating major economic and political risks for the medium and longer term.

Q: After the referendum many of the inputs to economic forecasts changed, such as interest rates, foreign exchange rates, investor confidence, etc – what do you think is the net impact of these on the British economy in the medium term?

Mike Amey: We have lowered our twelve month GDP forecast by 1 to 1.5% as a result of Brexit, whilst also raising our expectations for CPI which we now see at 2.5% by mid-2017. Longer term, we believe the impact will be more muted, in large part as we expect the exit negotiations to be a multi-year process.

Jadd Chamie: This is a very difficult question to answer and will largely depend on the results of the UK's negotiations with the EU. As around 50% of UK exports go to the EU, access to the single market will be key in determining the net impact of Brexit on the British economy. We also have to monitor UK's potential new trade agreements with other countries like Canada, Australia and India. Another aspect to consider is how immigration will be affected by the vote to leave the EU. Immigration plays an important role in stimulating the economy, meaning a significant decline in net arrivals could derail any post Brexit recovery. In our view, consumer spending should not be severally impacted by the referendum result, except if large companies start relocating outside the UK and launch large restructuring plans. On a more positive note, the declining value of sterling will create investment opportunities to foreign investors, notably in infrastructure and real estate, in the medium term. Finally, the recent BoE rate cut and QE, coupled with a potential fiscal stimulus, should prevent the UK economy from slipping into recession over the next few quarters.

Lloyd Harris: Low interest rates are not a long-run positive for the economy. They provide a short-term fix but in the longer-term lead to an avoidance of the necessary creative destruction that is required to ensure capital is allocated in an efficient manner. This is obviously not only a UK phenomenon. The lower FX rate is undoubtedly a positive for the country. Every country in the western world wants a lower exchange rate to stimulate exports and avoid importing deflation. The UK has a lower, albeit not drastically lower level of sterling which will be supportive for growth over the medium-term and could well be the saving grace of Brexit.

Investor confidence has taken a hit, but it appears to be a manageable hit at this stage. That said, it is early days and investor confidence could well take a further hit when the UK begins negotiations. It is unclear when this will happen though and for now investors and some companies have shown a willingness to take the opportunity to invest at a cheaper level than they would have otherwise, primarily because of the benefits of the lower exchange rate.

Paul Hodges: The key issue is the uncertainty caused by the lack of clarity over the meaning of the phrase 'Brexit means Brexit'. Some interpret it as meaning that everything will stay more or less the same, once a 'cooling-off period' has taken place. Others are at the opposite end of the spectrum - they assume the UK will abrogate all EU relationships, and instead embark on the process of applying for WTO membership. As we all know, markets hate uncertainty – and they clearly now have years of this ahead, as the Brexit debates intensify and start to impact real world issues. One key question is around the future attitude of foreign investors to UK gilt purchases. Foreign investors currently own 27% of the market according to DMO data, and one has to wonder about the impact of the Brexit process on their enthusiasm to maintain this level of support. What would be their attitude, for example, to a scenario where the Bank's renewed activism in terms of monetary policy leads to a combination of (a) continued weakness in the value of sterling and (b) interest rates remaining at zero percent, or even going negative? Would some foreign investors then decide it was time to exit their UK holdings, given the fundamental unattractiveness of this value proposition for them?

This scenario also highlights today's worrying level of complacency about the UK's future status in the world, post-Brexit. China's ambassador to the UK has already raised public questions over the threat to 'mutual trust' from any decision to cancel Hinckley Point. And they are probably not alone in wondering how things might play out more generally over the next few years. We all need to recognise that the UK is now in uncharted waters, which abound with dangerous shoals.

In these circumstances, it would seem prudent to dust off the scenario planning handbooks from the more turbulent 1960 - 1970s. In recent years, we have all tended to assume any outcome will inevitably be based

around a ‘comfortable middle’. Today, however, a prudent investor needs to investigate scenarios that are potentially very uncomfortable, if they want to survive and prosper in today’s new normal world. For example, can one really rule out a scenario where a large number of foreign investors decided to exit the gilt market? Or that this development, in turn, could then lead to pressure for a return to capital controls? These were in place for 40 years until 1979. It seems dangerous to us to ignore a potential risk of this magnitude, even if the current probability seems low, simply because it is outside the personal experience of most of today’s investors.

Q: How much importance do you give to secondary market liquidity when you invest in an asset class? And do you expect it to get worse, better or stay the same in the medium term?

Mike Amey: Secondary market liquidity is one of many key considerations we look at when deciding on buying or selling a security in our portfolios. Since the financial crisis, secondary market liquidity has indeed declined as one of the side effects of new regulations in the banking industry. When we look at investing in any security, we will always incorporate liquidity as part of the credit evaluation process, to ensure that we are getting adequately compensated for that security. We do not anticipate any significant change in secondary market liquidity over the medium term – neither an improvement nor a deterioration.

Jadd Chamie: The sterling bond market has historically been less liquid than the US dollar market and the euro markets as it is less deep and is characterised by long-term buy and hold investors (pension funds and insures). With the recent £10bn corporate purchase programme launched by the BoE, we expect the liquidity to get even worse over the next couple of years. Liquidity is very important for dynamic bond investors, who are trying to beat a benchmark; less so for buy and hold investors; although periodic portfolio rebalancing necessary for any type of investor requires some level of liquidity.

Lloyd Harris: A huge amount of importance. As a corporate bond investor, you have to be aware that liquidity can ebb and flow and whilst it is possible to receive a liquidity premium in certain corporate credits, especially in sterling, this has to be balanced by those bonds which are much more liquid. Because sterling is a smaller market than EURs and USDs the liquidity considerations are much more pronounced, especially in investment grade credit.

Paul Hodges: Liquidity is very important for anyone investing in today’s markets, given their increasing volatility. It is already being undermined by high-frequency trading, which can exit the market in milliseconds and with no notice. We worry that investors have come to rely on central banks to provide a back-stop whenever markets start to wobble, and we wonder what might happen if this confidence were to prove unfounded at some point in the future.

To hear more from these speakers and on these topics join us on Thursday 22 September, in London at The Euromoney UK Conference.

For more information and to register to attend, please visit our website: www.euromoneyconferences.com/sterling

Speaker biographies

MIKE AMEY, HEAD OF STERLING PORTFOLIOS, PIMCO

Mike Amey is a managing director and portfolio manager at PIMCO in the London office. He is responsible for sterling portfolios, the European insurance (ex Germany) and the European LDI (liability-driven investing) portfolio management groups. Before joining PIMCO in 2003, he was head of U.K. fixed income at Rothschild Asset Management and after their merger, at Insight Investment. Mr Amey is also a member of the UK Society of Investment Professionals.

JADD CHAMIÉ, FIXED INCOME INVESTMENT MANAGER, NIPPON LIFE GLOBAL INVESTORS

Jadd Chamié is a fixed income investment manager at Nippon Life Global Investors. He has been co-managing several corporate bond funds since 2011, focusing on the EUR and GBP markets. He is responsible for investment grade non-financial bonds, as well as corporate hybrid instruments. Before joining Nippon Life, he spent four years at Gordian Knot as a senior credit research analyst working with the team investing in European and American issuers. He has been a CFA charterholder since 2012.

LLOYD HARRIS, PORTFOLIO MANAGER AND LEAD FINANCIALS ANALYST, OLD MUTUAL GLOBAL INVESTORS

Lloyd Harris joined OMGI in January 2012 as a senior credit analyst focusing on the financial sector, before being appointed lead manager of the Old Mutual Corporate Bond Fund in 2015. Before joining OMGI, Lloyd was at Cutwater Asset Management from 2007 to 2011, initially as an asset-backed CP/MTN trader, then as a European financials credit analyst. Before this, Lloyd worked in structured capital markets at Deutsche Bank from 2002 to 2007.

PAUL HODGES, CHAIRMAN, *THE pH REPORT*

Paul Hodges is chairman of IeC and publisher of *The pH Report*, whose clients include many of the world's major companies and investors. IeC's analysis highlights the influence of demographics and ageing populations on the economy, consumer demand and investment. Previously, Paul was an executive director of a major global business for ICI, where he worked from 1978 until 1995. He serves as a global expert for the World Economic Forum, and is a Freeman of the City of London.

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