M&G

PRUDENTIAL

Staff Pension Scheme

Defined Contribution Section

Market commentary from the DC Section Investment Consultant

March 2022

Your journey

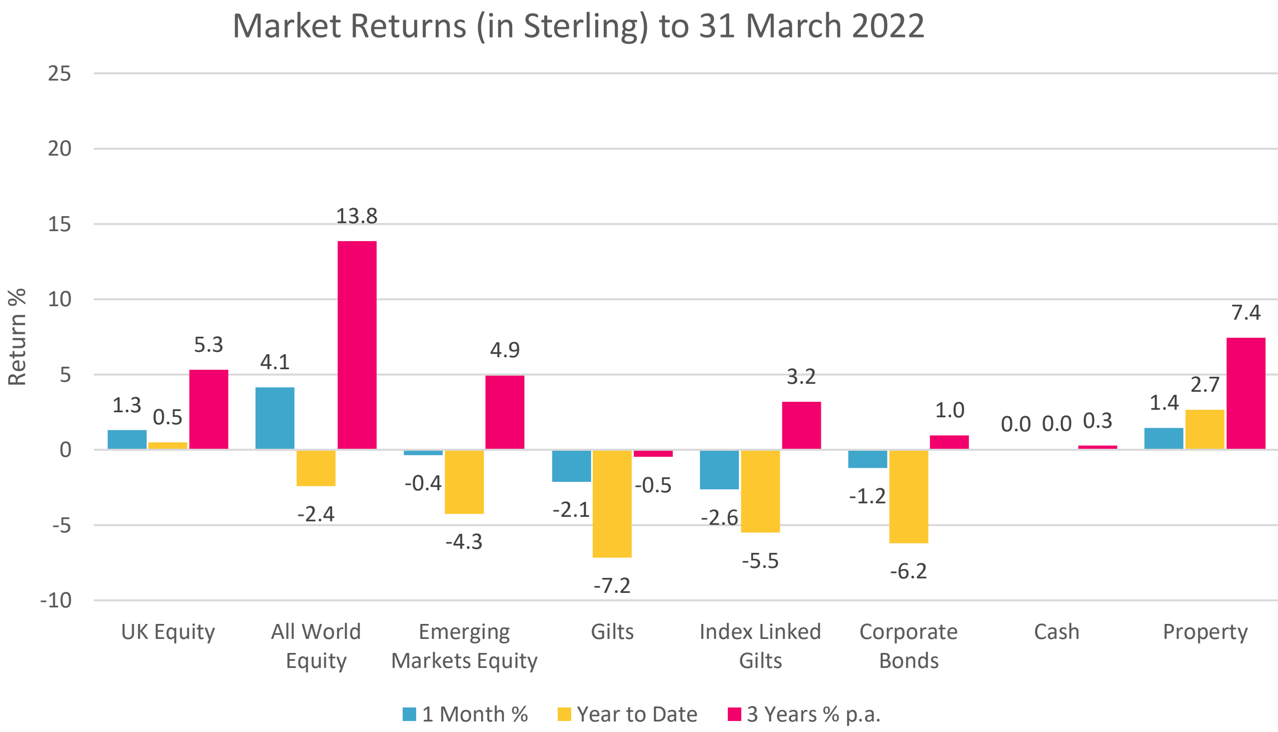
Investment Markets and PSPS Funds Update – March 2022

Introduction

This paper is addressed to the Trustee of the Prudential Staff Pension Scheme ("Scheme") DC Section and provides a regular update on the performance of PSPS funds and investment markets.

This paper should not be released or otherwise disclosed to a third party except as required by law or with our prior written consent, in which case it should be released in its entirety. This paper may be shared with DC Section members of the Scheme on a non-reliance basis. We accept no liability to any third party unless we have expressly accepted such liability in writing.

Performance of Investment markets



Note: Property one month in arrears   Source: Datastream

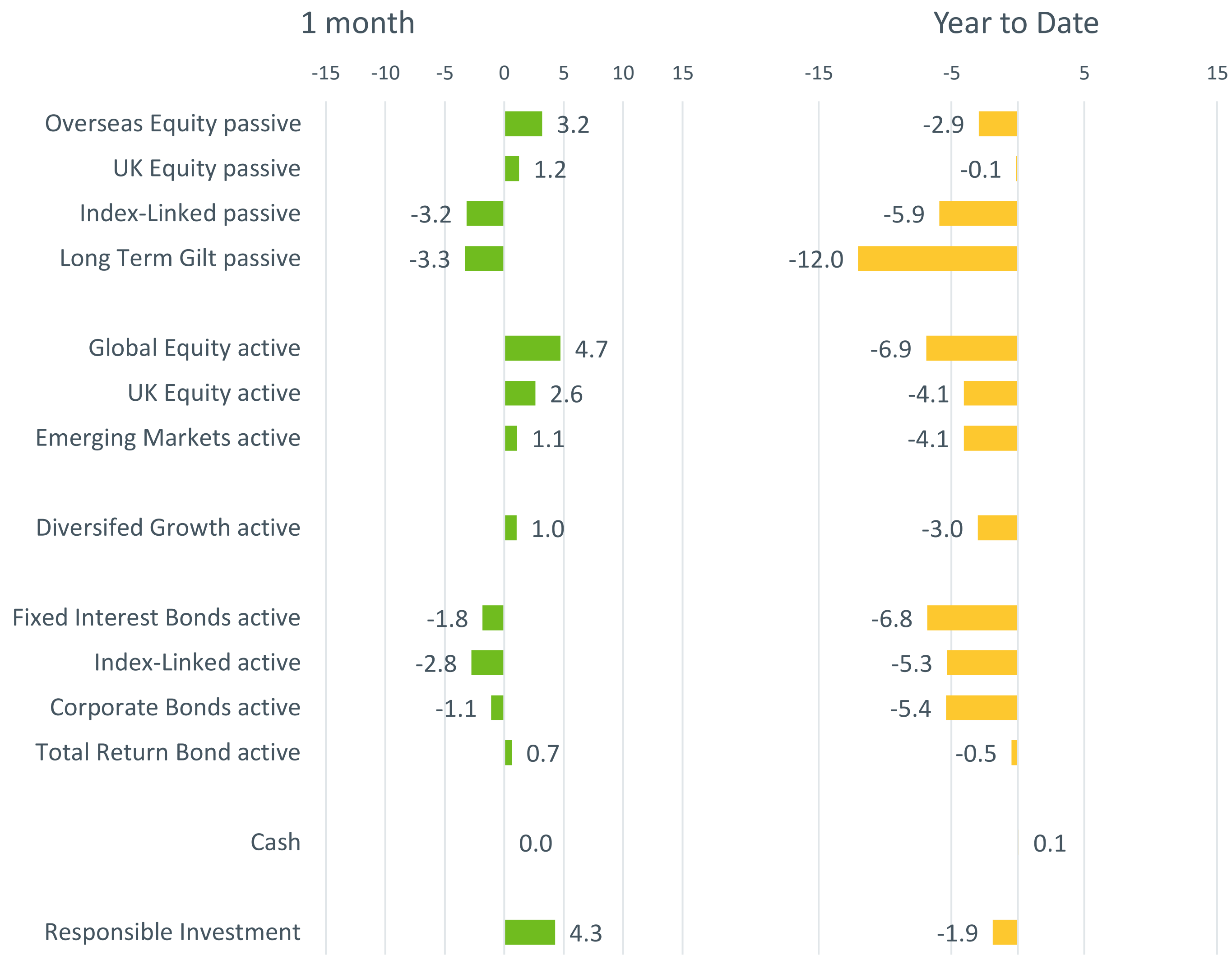
March highlights

- Global growth forecasts were revised down in March, while inflation forecasts reached new highs, reflecting the expected stagflationary impact of the commodity price shock emanating from the Russia-Ukraine conflict.
- Composite PMIs moderated in March, but generally remain at a level consistent with month-on-month expansion: services were more resilient than manufacturing and European and North American surveys were stronger than Asian counterparts.
- Both headline and core inflation continued to rise, and surprise to the upside, in February and are expected to rise further.
- Sovereign bond yields extended year-to-date upwards moves in March as central banks adopted increasingly hawkish stances in response to worsening inflation pressures, despite a less upbeat growth outlook.

- Equity markets recovered most of their losses from the initial Russia-Ukraine sell-off, rising 3%, while credit spreads fell back from levels touched in mid-March, reversing at least some of the widening seen year-to-date, and ending the month lower.

Estimated Performance of PSPS Funds

The chart above shows the **estimated** performance (net of annual fees) of the PSPS funds for March and for the year to date. Please note that these are estimates of fund performance and not official performance figures from the fund provider. Longer term historical performance can also be found in the appendix.



What is the impact on DC Section members?

- Equity fund returns were positive over the month, the strongest funds being the Global Equity, Overseas Equity and Responsible Investment funds.
- However, gilt and corporate bond funds produced negative returns in the main. The Total Return Credit Fund continued to post positive returns.
- Year to date returns do remain negative reflecting the concerns of rising inflation and interest rates and the geopolitical uncertainties with the Russian invasion of Ukraine. However, this shorter-term performance should be put in the context of the strong longer-term returns (as shown in the appendix).

Note on PSPS Cash Fund

The PSPS Cash Fund – active is a fund that is used in the lifestyle strategies (in the last few years prior to retirement age) and available as a self-select fund. It invests in cash and short dated instruments. Returns on cash funds are generally close to the Bank of England base rate. The base rate was cut to very low levels in the wake of the pandemic as one of the economic stimulus measures taken and is currently at 0.75% p.a. (having been 0.1% until 16 December 2021, rising to 0.25% and then again rising on 3 February 2022 and 17 March 2022 to 0.5% and then 0.75%). Therefore, the return from the Cash fund (net of fees) is close to zero.

Note on Currency

For the PSPS funds which invest in non UK assets, the funds bear currency risk (i.e. the effect of changes in the value of currencies and in particular the change in value of the currency in which the assets are invested relative to sterling). Therefore, the return from these funds is driven both by the change in valuation of the assets themselves and the translation of that value from the local currency to sterling.

Market commentary

- Sovereign bond yields rose significantly as inflation pressures, exacerbated by Russia-Ukraine conflict, led to expectations of a faster pace of interest-rate rises. Equity prices fell and credit spreads widened, as rising input and living costs, alongside less accommodative central bank messaging, weighed on the outlook. Commodity prices surged to extreme levels and faster expected monetary tightening in the US contributed to a rally in the dollar, whilst safe-haven appeal drove gold prices higher.

- Russia and Ukraine represent a small share of global GDP and trade but produce a disproportionate share of key global commodity exports. Physical disruptions and sanctions have triggered broad commodity price rises which, alongside existing inflationary pressures, are increasing input costs and weighing on consumer’s real incomes. Existing supply chain issues will be compounded by the conflict and China’s zero-COVID policy, which has led to new large-scale lockdowns. As a result, consensus forecasts for global growth have been revised downwards and CPI forecasts have reached new highs.

- However, global growth forecasts still point to a relatively robust pace of growth over 2022 and 2023, by post-global financial crisis standards. While PMIs eased in March, surveys indicate month-on-month expansion in the services and manufacturing sectors. Service sector data rebounded strongly in February as COVID-19 restrictions were eased and showed ongoing resilience in March, despite headwinds from higher energy prices. The global manufacturing PMI slipped to an 18-month low in March as multiple headwinds weighed on activity. However, the indices still point to month-on-month expansion, albeit at a slower pace, with Europe and, in particular, North America relative bright spots but Asian activity looking more subdued. While the surveys highlight ongoing labour market strength, input cost and selling price inflation continue to gather pace.

- Inflation continued to rise, and surprise to the upside, in February: UK, US and eurozone headline CPI inflation increased to 6.2%, 7.9% and 5.9% year-on-year, respectively. This is partly attributable to soaring energy costs, but more concerning to policymakers, core inflation, which excludes volatile energy and food costs, is also running at 30-year highs. Inflation is expected to peak at higher levels in the near-term and fall back more slowly than previously expected: consensus forecasts UK CPI inflation will average 6.7% year-on-year in 2022 before moderating to 3.6% in 2023.

- The inflation backdrop has seen central banks turn gradually more hawkish this year, despite the potential downside risks to growth from higher commodity prices. After a first hike in December, the Bank of England (BoE) raised rates twice in Q1, to 0.75% p.a. As expected, the US Federal Reserve (Fed) raised rates by 0.25% p.a. in March, with the median voting member now expecting 7 rate rises in 2022 and 4 in 2023. The European Central Bank confirmed its asset purchases will end this year, leaving the door open to an interest rate rise, while the Fed noted it plans to reduce the size of its balance sheet.

- Sovereign bond yields rose significantly to reflect increased rate rise expectations. UK 10-year gilt yields rose 0.7% p.a., to 1.6% p.a., while equivalent US and German equivalent both rose 0.8% p.a., to 2.4% p.a. and 0.6% p.a., respectively.
- UK 10-year implied inflation, as measured by the difference between conventional and inflation-linked bonds of the same maturity, rose 0.5% p.a., to 4.4% p.a., as real yields rose to a lesser extent then their nominal counterparts. US 10-year implied inflation rose 0.2% p.a., to 2.8% p.a., despite a 0.6% p.a. rise in 10-year real treasury yields.
- Global investment-grade credit spreads rose 0.3% p.a., while US and European speculative-grade spreads increased 0.3% p.a. and 0.7% p.a., respectively. Larger increases in European spreads perhaps allude to the greater exposure of European corporates and consumers to higher energy prices.
- Local currency emerging market debt, as measured by the GBI-EM Global Diversified Traded Index, returned -6.5% as yields rose from 5.7% p.a. to 6.2% p.a. Hard currency debt, as measured by the EMBI Global Diversified Index, returned -10.0% as underlying treasury yields rose, and spreads increased 0.3% p.a. Russian debt, which comprised 7.2% and 3.3% of the local and hard currency indices, respectively, at the start of the year was excluded from the indices at the end of March.
- Expectations for faster monetary tightening in the US saw the trade-weighted dollar increase 1.1%. The yen fell 6% in trade-weighted-terms, to a 6-year low, as the Bank of Japan bucked the global trend for tighter monetary policy. Despite plummeting in the wake of the introduction of sanctions, the Russian rouble has rebounded in value against the US dollar due to Moscow’s stringent capital controls and large interest-rate rises.
- Global equities largely recovered from the initial Russia-Ukraine sell-off, rising 2.6% in local currency terms in March, but still ended the quarter down 4.6%. Concerns about central bank tightening, slowing earnings momentum, and the geopolitical situation have all contributed to falls this year. Value stocks notably outperformed growth stocks as rising yields weighed most heavily on the valuations of stocks with earnings growth further in the future, such as those in the technology sector. The consumer discretionary sector also underperformed as markets considered the impact of inflation on real consumer incomes. Surging oil and gas prices sees the energy sector lead the year-to-date performance rankings by far.
- Europe has fallen to the bottom of the performance rankings since the invasion as markets price in a larger economic impact on continental Europe. Emerging markets fell further in March, increasing their underperformance year-to-date, as new COVID-19 lockdowns and broader geopolitical concerns weighed on Chinese markets. Above-average exposure to energy, metals, and miners, sees the UK lead the regional rankings and make it the only major region to deliver a positive return in 2022.
- A 15.9% rise in the MSCI UK IPD capital value index over the 12 months to the end of February is largely attributable to a 34.6% rise in industrial capital values. However, retail capital values have also been increasing since May 2021, rising 9.6% over the same period, while offices saw a marginally positive capital return. Return on the all-property index, including income, was 21.8% in the 12 months to end-February. Monthly rental growth has been positive since March and continues to strengthen, rising 3.1% over 12 months to end-Feb, albeit it with wide disparity across sectors: nominal industrial rents have risen almost 10% while retail rental growth remains negative and office rents are only slightly higher over 12 months.

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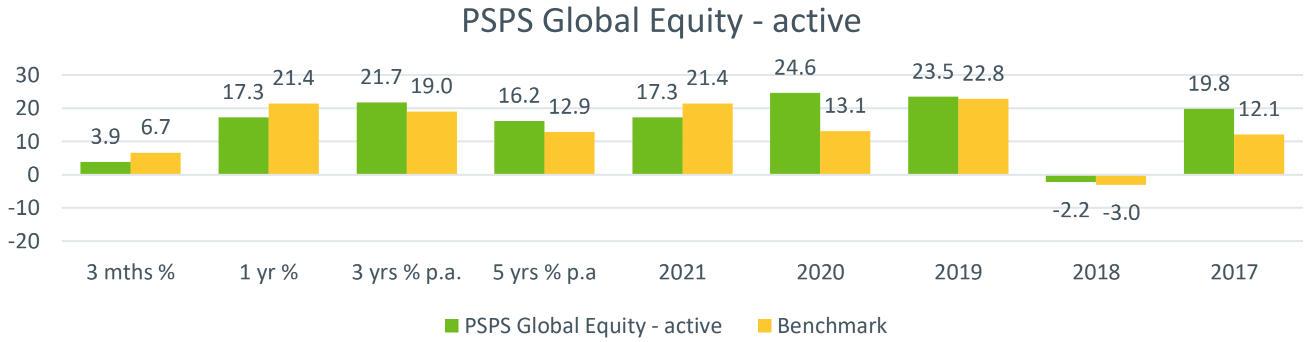
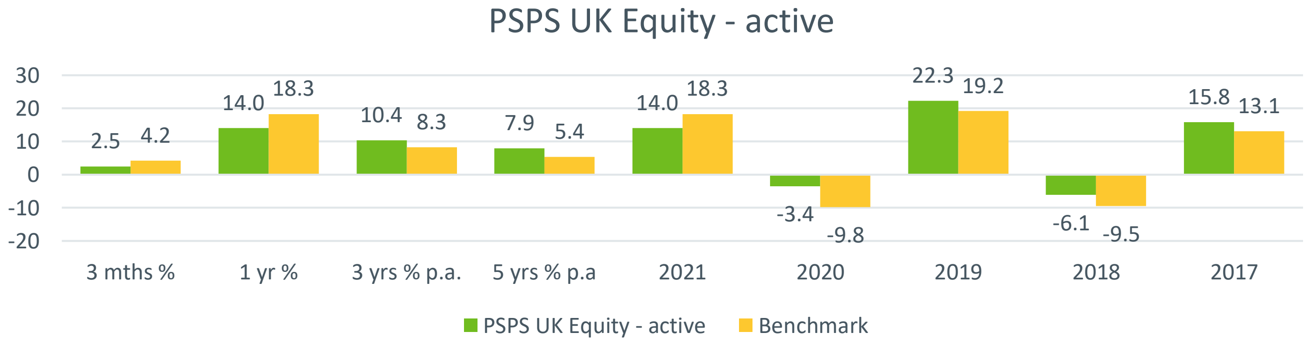
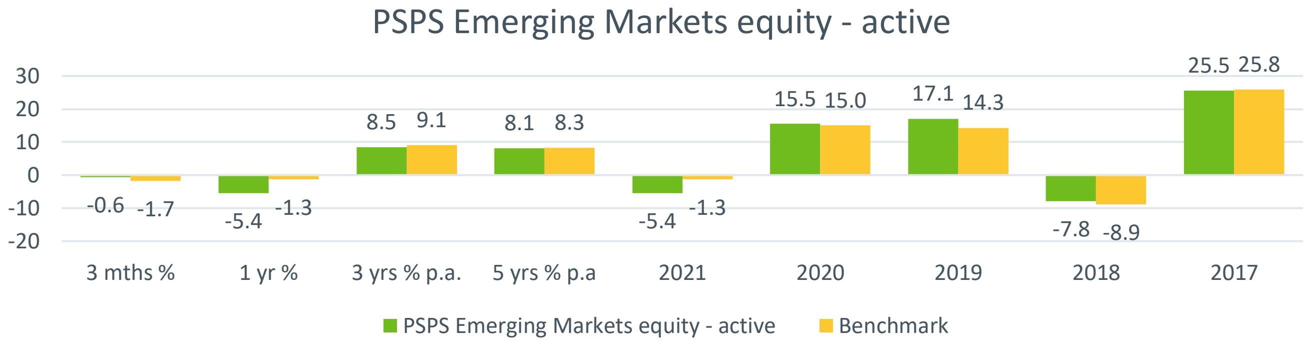
For and on behalf of Hymans Robertson LLP

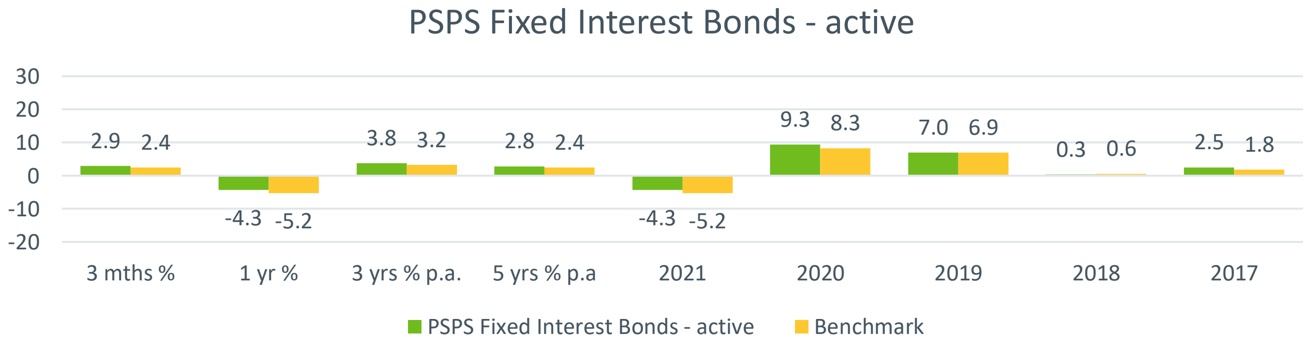
Appendix – Performance of PSPS Funds (to 31/12/21)

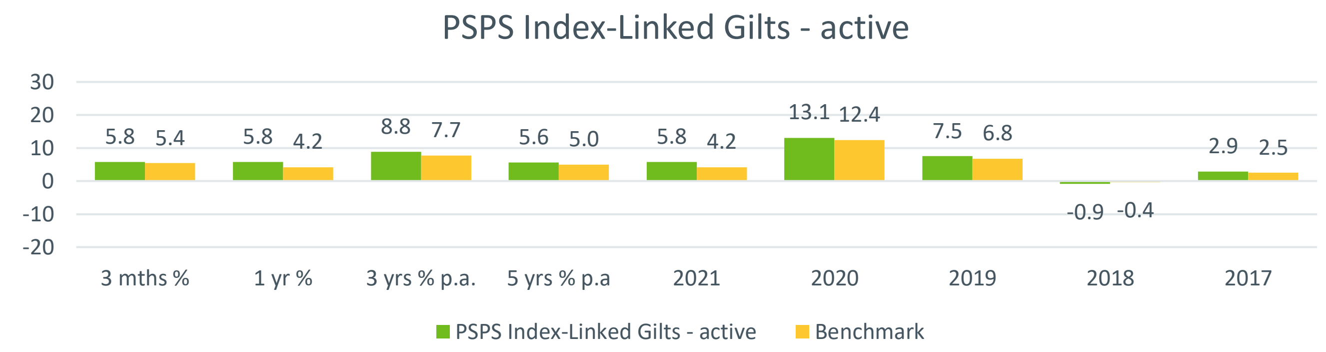
The charts below summarise the performance (gross) of the PSPS funds and their benchmarks showing historic calendar years and the current calendar year to latest available quarter end date (updated quarterly). **Official performance data from fund provider shown below is to end December 2021.**

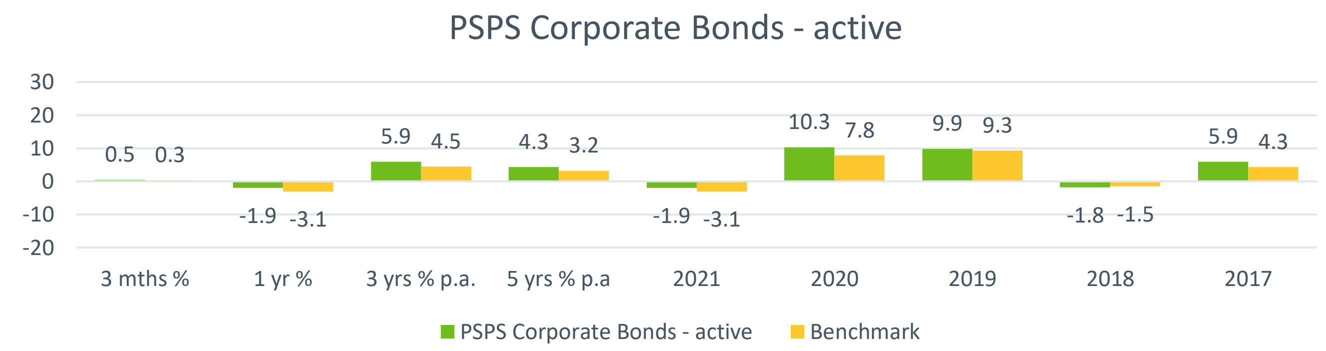


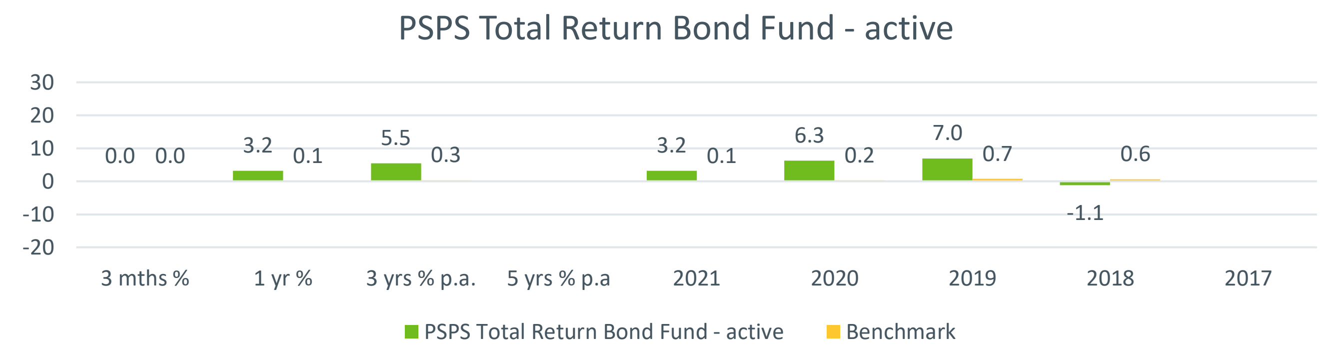




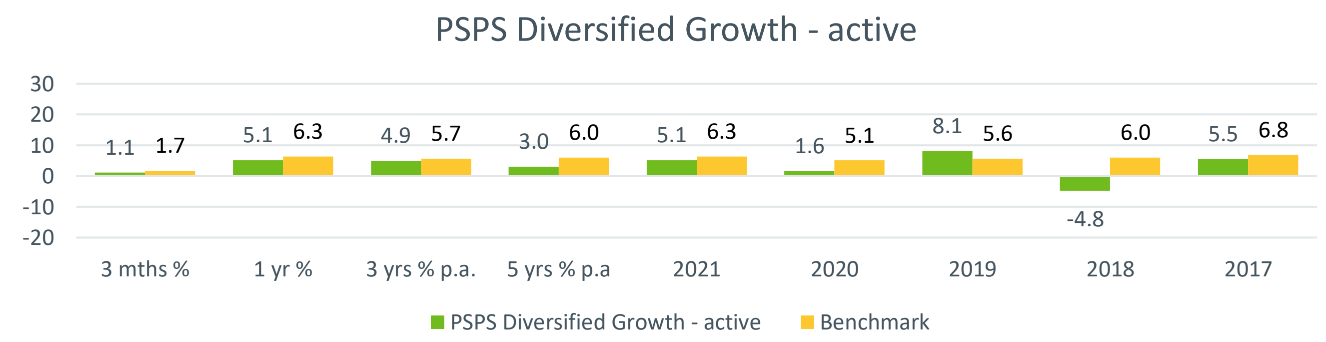


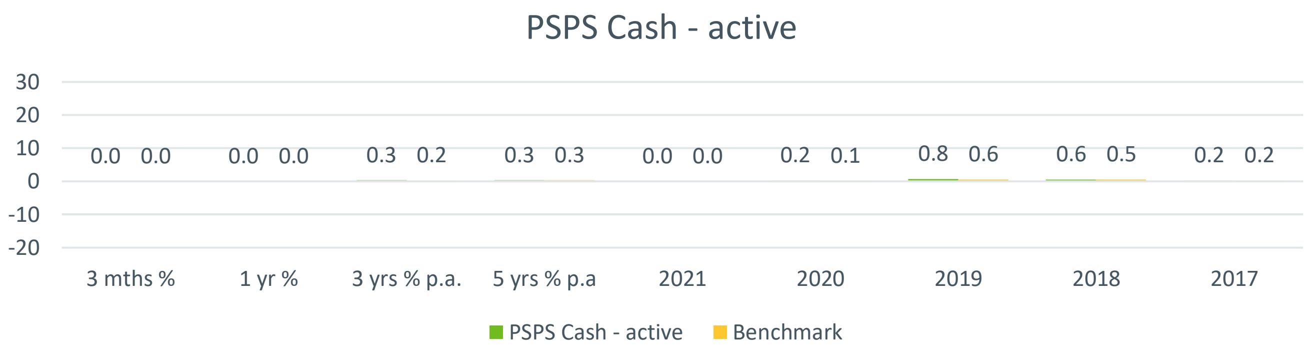


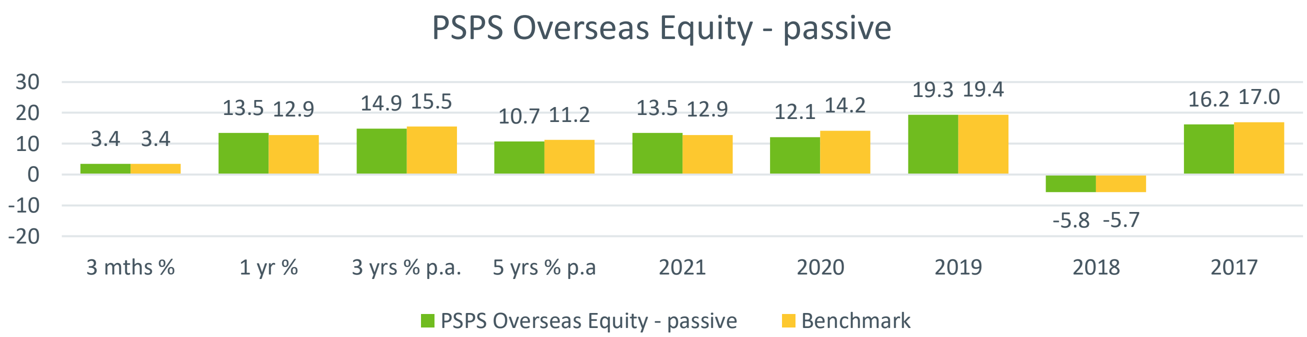


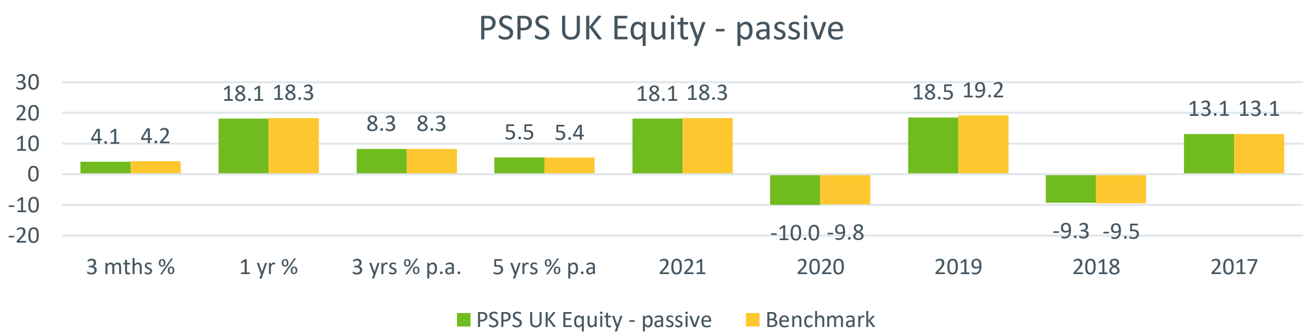


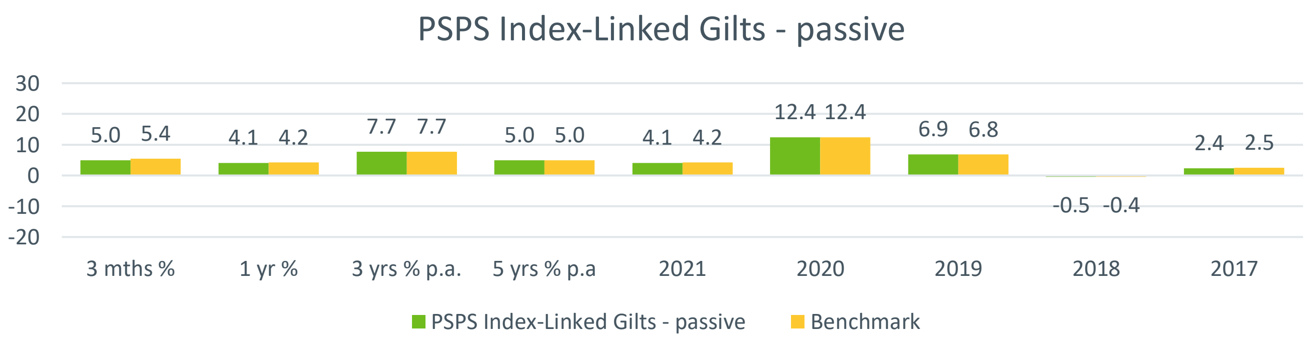
PSPS Total Return Bond Fund launched 8th July 2016



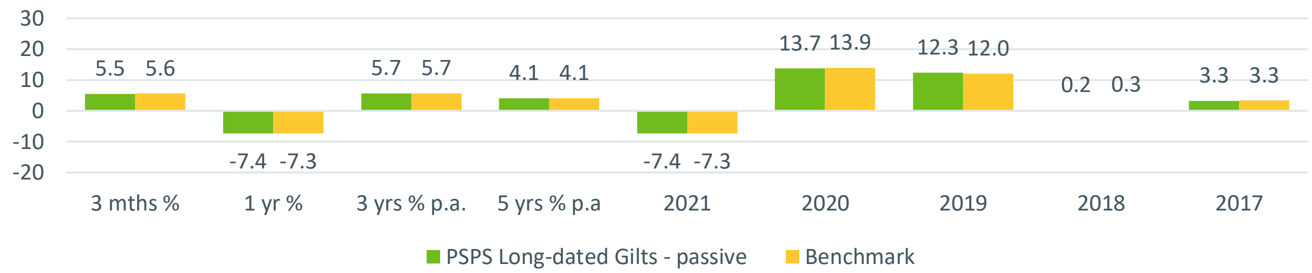

PSPS Cash - active
30
20
10
0
-10
-20
0.0 0.0
0.0 0.0
0.3 0.2
0.3 0.3
0.0 0.0
0.2 0.1
0.8 0.6
0.6 0.5
0.2 0.2
3 mths %
1 yr %
3 yrs % p.a.
5 yrs % p.a
2021
2020
2019
2018
2017
PSPS Cash - active
Benchmark


PSPS Overseas Equity - passive
30
20
10
0
-10
-20
3.4 3.4
13.5 12.9
14.9 15.5
10.7 11.2
13.5 12.9
12.1 14.2
19.3 19.4
-5.8 -5.7
16.2 17.0
3 mths %
1 yr %
3 yrs % p.a.
5 yrs % p.a
2021
2020
2019
2018
2017
PSPS Overseas Equity - passive
Benchmark


PSPS UK Equity - passive
30
20
10
0
-10
-20
4.1 4.2
18.1 18.3
8.3 8.3
5.5 5.4
18.1 18.3
-10.0 -9.8
18.5 19.2
-9.3 -9.5
13.1 13.1
3 mths %
1 yr %
3 yrs % p.a.
5 yrs % p.a
2021
2020
2019
2018
2017
PSPS UK Equity - passive
Benchmark


PSPS Index-Linked Gilts - passive
30
20
10
0
-10
-20
5.0 5.4
4.1 4.2
7.7 7.7
5.0 5.0
4.1 4.2
12.4 12.4
6.9 6.8
-0.5 -0.4
2.4 2.5
3 mths %
1 yr %
3 yrs % p.a.
5 yrs % p.a
2021
2020
2019
2018
2017
PSPS Index-Linked Gilts - passive
Benchmark

PSPS Long-dated Gilts - passive



PSPS Responsible Investment Equity - passive

PSPS Responsible Investment Equity - passive Fund launched 10th January 2020