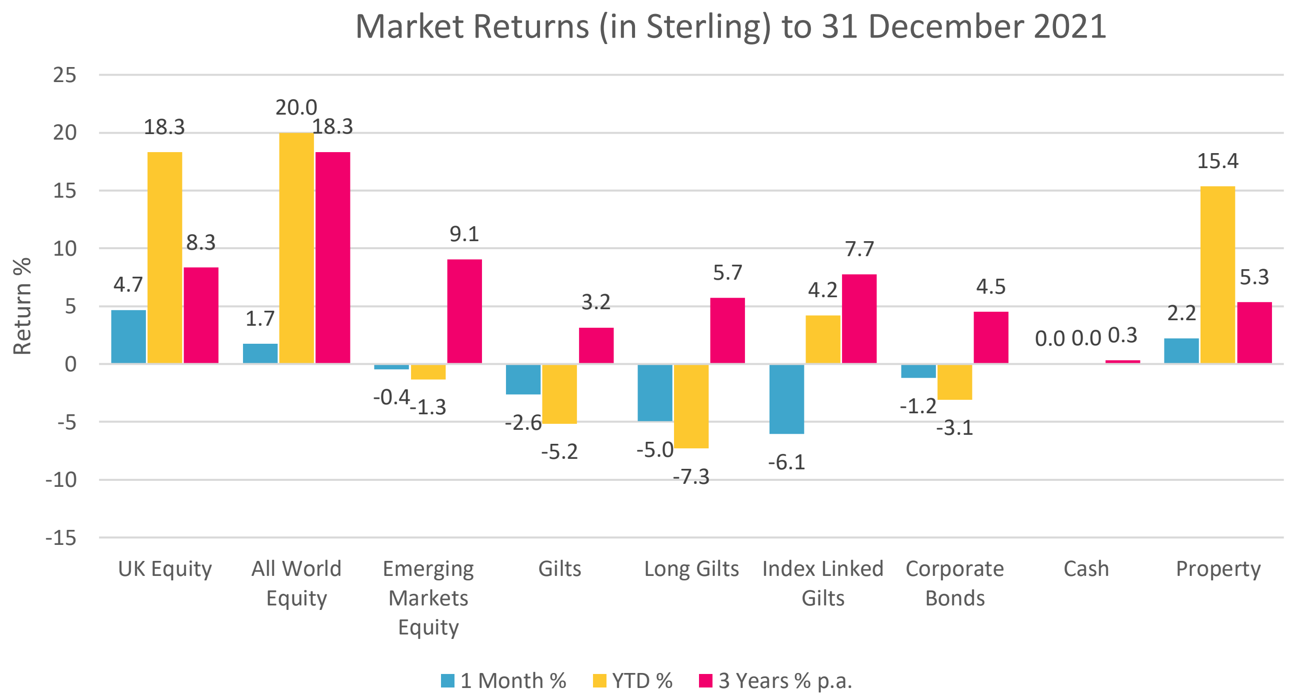
Investment Markets and PSPS Funds Update – December 2021

Introduction

This paper is addressed to the Trustee of the Prudential Staff Pension Scheme (“Scheme”) DC Section and providers 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



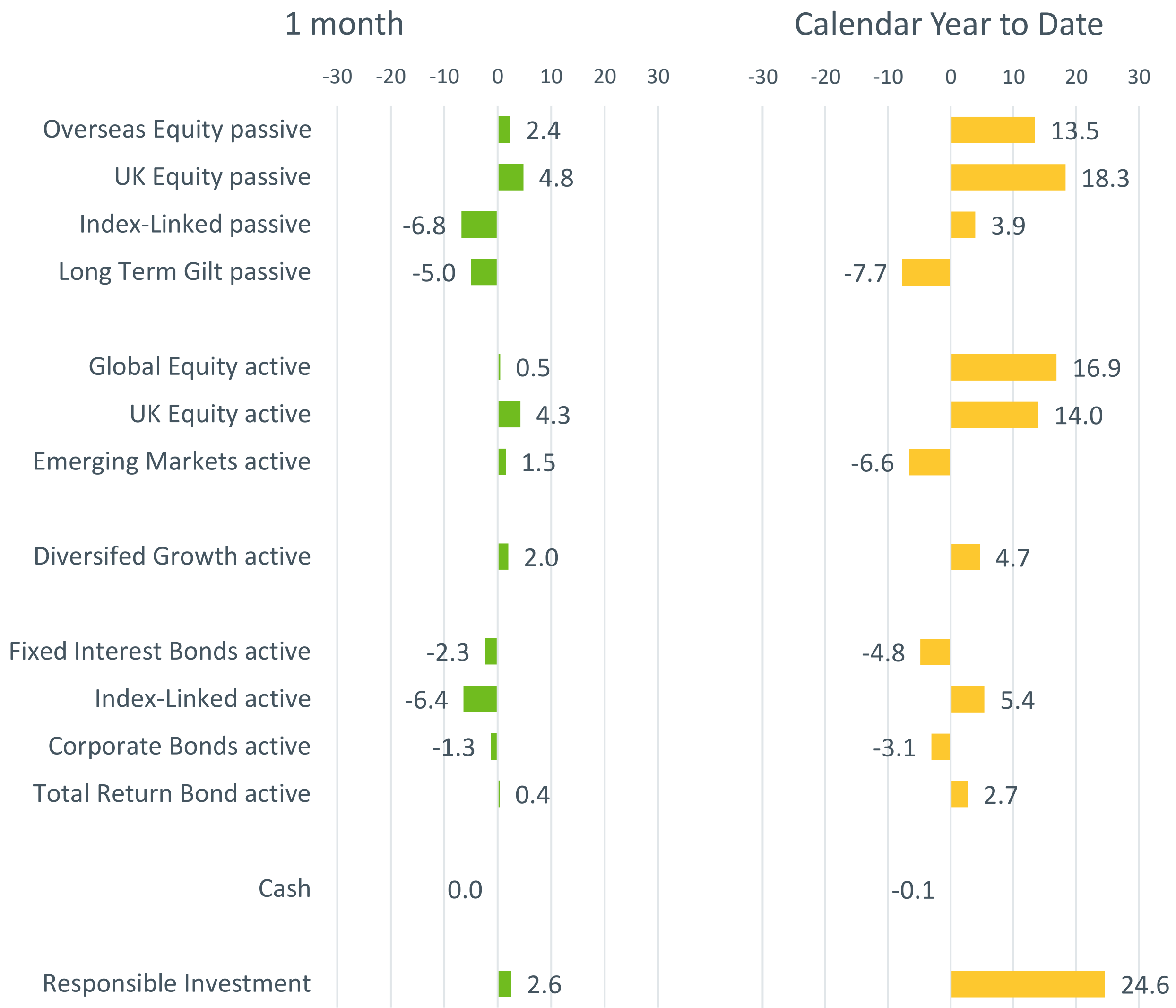
Note: Property one month in arrears   Source: Datastream

December’s highlights

- The current global wave of COVID infections is seeing near-term growth forecasts revised lower but for now it seems Omicron will delay rather than derail the global recovery.
- Flash PMI data show an easing in service sector momentum, but manufacturing remains resilient and composite indices remain at a level consistent with month-on-month expansion.
- Continued inflationary pressures have seen major central banks adopt less accommodative monetary policy stances in acceptance that these pressures are more persistent than first thought.
- Short-term sovereign bond yields subsequently rose as markets priced in a faster pace of near-term interest rate rises.
- Global equities bounced back from November’s Omicron induced volatility and credit spreads tightened as investors focussed on strong earnings growth and early indications the Omicron variant may be less virulent.

Estimated Performance of PSPS Funds

The chart below shows the **estimated** performance (net of annual fees) of the PSPS funds for December and for the calendar 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?

- The equity and diversified growth funds produced the strongest returns over December whilst bond funds in general fell back.
- The UK equity funds were strongest followed by the Responsible Investment equity fund.
- Index linked gilts and long conventional gilts were the weakest performers over December.
- The Diversified Growth Fund produced a positive return of 2.0%.
- For the calendar year 2021, equity returns have been very strong with the Responsible Investment Equity Fund leading the way with a return close to 25%. Emerging markets have been the weakest equity performer.
- Index linked gilts have been positive over the year, but conventional gilts and corporate bonds have lagged.

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 has been cut to very low levels in the wake of the pandemic as one of the economic stimulus measures taken and is currently at 0.25% p.a. (having been 0.1% until 16 December 2021). Therefore, the return from the Cash fund (net of fees) is marginally below 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

- Strong earnings growth drove global equity markets higher in Q4, despite increased volatility as economic concerns regarding the Omicron COVID variant and less accommodative central bank policy came to the fore. UK and US government bond yield curves flattened as short-term yields moved higher to price in a faster pace of interest rate rises while longer-term yields were kept in check as investors weighed the impact of policy normalisation on both growth and inflation. Spread tightening in December mostly reversed November's move wider to leave credit spreads largely in-line with end-September levels.

- Even if, as data from South Africa and the UK suggest, Omicron is associated with lower hospitalisations, healthcare systems could still be overwhelmed given greater transmissibility. Against this backdrop, global GDP growth forecasts have edged lower in recent months, reflecting a modest reimposition of some activity restrictions, an increase in voluntary social distancing and some resulting supply chain disruption. This is expected to weigh on growth in Q4 2021 and Q1 2022, but we still anticipate above-trend growth in 2022. The impact of Omicron is likely to be more manageable than previous waves due to higher levels of immunity and as consumers and businesses have increasingly adopted online shopping and remote working.

- The recent fall in December's Flash services purchasing managers' indices in the US, UK and eurozone support the idea that Omicron has caused a loss of positive momentum in services activity, particularly in consumer-facing sectors. However, global manufacturing sentiment is relatively resilient, with output increasing despite ongoing supply constraints and rising input prices. Across regions there were signs that the strain on supply chains is showing some signs of easing, though the overall rate of price increases remains near record-highs, and disruption from Omicron could add to supply-chain issues.

- UK headline CPI inflation increased to 5.1% year-on-year in November whilst the equivalent US and eurozone measures rose to 6.8% and 4.9%, respectively. Petrol and second-hand car prices have contributed strongly, but there are upwards contributions to inflation across almost all goods and services, implying broad price pressures across economies. Supply and demand imbalances, which are seeing producer prices rising at around 10% year-on-year in the US and UK, are likely to place ongoing upwards pressure on consumer prices, before moderating gradually in H2 2022 and in to 2023.

- As realised and forecast inflation continued to move higher and labour markets tightened rapidly, particularly in the US and UK where unemployment has fallen to 4.1%, central banks have adopted less accommodative stances. While the Federal Open Markets Committee (FOMC) left rates unchanged, they announced plans to accelerate the tapering of asset purchases, with the median FOMC member forecasting three rate hikes next year. Despite the prospect of near-term economic disruption due to Omicron, the Bank of England raised rates to 0.25% p.a., citing more persistent inflation pressures.

- US and UK government bond yield curves flattened significantly in Q4 as short-term yields rose to reflect expectations of higher interest rates whilst longer-term yields weighed the expected longer-term impact of policy normalisation on growth and inflation. The UK 10-year gilt yield fell slightly, to 1.0% p.a., whilst the equivalent US treasury yield nudged up to 1.5% p.a. – longer-term yields in both markets fell much more.
- UK 10-year implied inflation, as measured by the difference between conventional and inflation-linked bonds of the same maturity, ended the quarter a little higher, at 3.9% p.a., as near-term implied inflation rose, whilst longer-term implied inflation fell. US 10-year implied inflation rose 0.2% p.a. to 2.6% p.a. over the quarter.
- Global investment-grade spreads increased by 0.1% p.a. to 1.0% p.a. Global speculative-grade spreads, having tightened 0.6% p.a. in December, ended the quarter exactly in-line with end-September levels at 3.7% p.a. While US speculative-grade spreads fell 0.1% p.a. to 3.1% p.a., European speculative-grade spreads moved 0.3% p.a. wider, to 3.3% p.a. Falls in longer-term sovereign bond yields leant a little support to global investment-grade credit total returns whilst rises in shorter-term bond yields posed a headwind to shorter-duration global speculative-grade markets.
- Local currency emerging market debt, as measured by the GBI-EM Global Diversified Traded Index, returned -2.5% in dollar terms as yields rose 0.4% p.a. and index currencies, in aggregate, weakened against the dollar. Hard currency debt, as measured by the EMBI Global Diversified Index, returned -0.4% in dollar terms as spreads widened 0.1% p.a.
- Despite falling 2.2% (in local currency terms) in November over Omicron variant concerns, global equities produced a total return of 7.0% in Q4, propelled higher by strong earnings and the prospect of further growth in 2022. All sectors delivered positive returns except telecoms. Outside of telecoms, the main underperformers were energy and financials: the former negatively impacted by the impact of Omicron on potential demand and the latter was perhaps weighed on by the impact flattening yield curves have on net interest margins. Bolstered by strong earnings releases and, latterly, by the prospect of further lockdowns spurring demand for tech, the technology sector is the notable outperforming sector quarter-to-date.
- Given the large exposure to the tech sector, US equities remain the sole outperforming region over the quarter-to-date. Japan, which reintroduced strict border restrictions shortly after the Omicron variant was made public, is at the bottom of the regional performance rankings over the quarter. Asian and emerging markets continued their underperformance versus developed markets as concerns over Chinese growth, the spread of Omicron and less accommodative developed market central bank policy weighed on the region.
- Trade-weighted sterling rose 1.7% as investors re-calibrated the timing of rate rises. The US dollar rose 0.6% in trade-weighted terms, perhaps reflecting both safe haven appeal and slightly more hawkish messaging from the Federal Reserve. The JP Morgan Emerging Market currency index eased 4.8% against the dollar as developed market central bank stances turned less accommodative. Gold rose 3.5% over the quarter as long-term real Treasury yields fell, and inflation rose.
- A 10.6% rise in the UK Monthly Property capital value index over the 12 months to end-November is attributable to the buoyant industrials sector. Industrial capital values have risen 26.7% over the last 12 months, the strongest annual return to date. Retail capital values have been rising since May, resulting in growth of 4.3% over 12 months. There has been a flattening of the declines experienced in the office sector with very marginal growth in the latest monthly data, though over the 12-month period values have fallen by 0.7%. Total return on the index, including income, was 16.5% in the 12 months to end-November.

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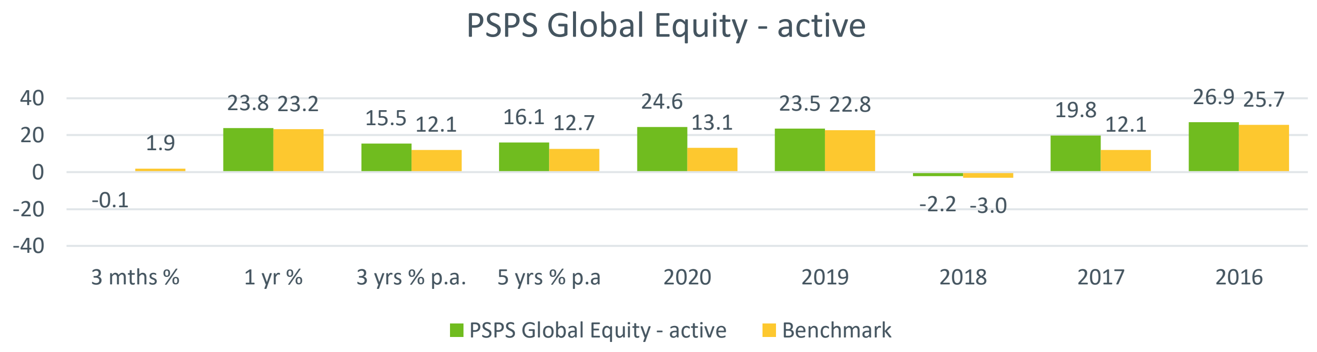
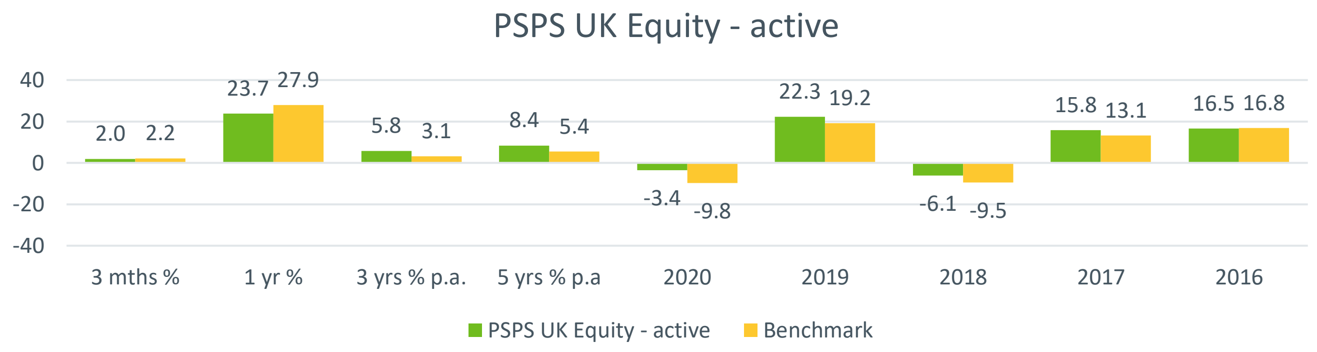
December 2021

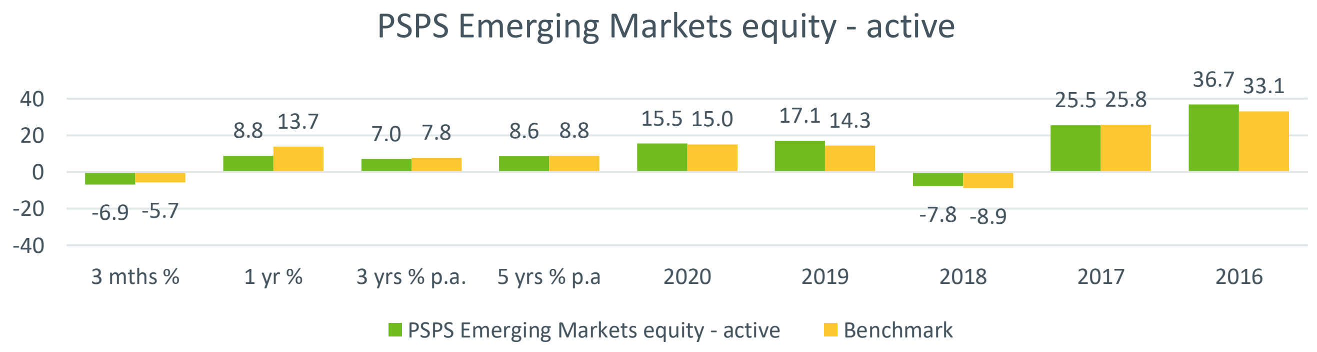
For and on behalf of Hymans Robertson LLP

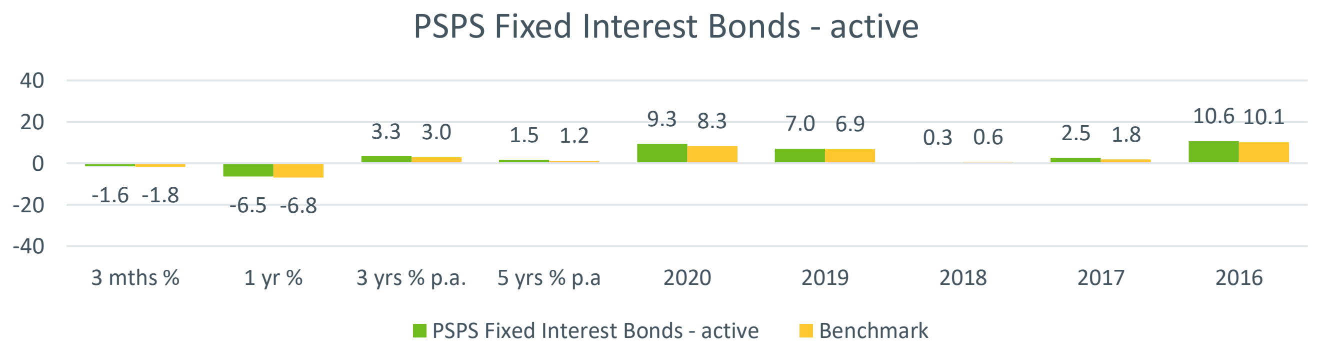
Appendix – Performance of PSPS Funds (to 30/09/21)

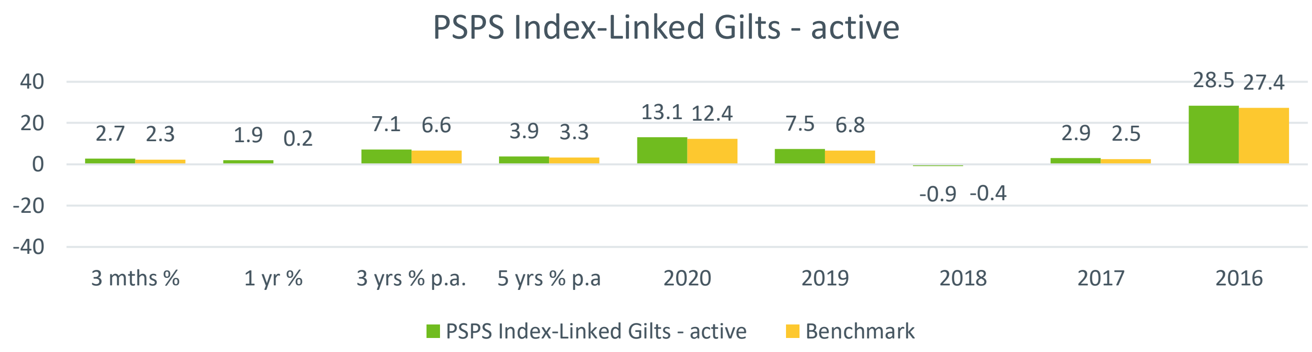
The charts below summarise the performance (gross) of the PSPS funds and their benchmarks showing historic calendar years and the current calendar year to latest available quarter end date (updated quarterly). **Official performance data from fund provider shown below is to end September 2021.**

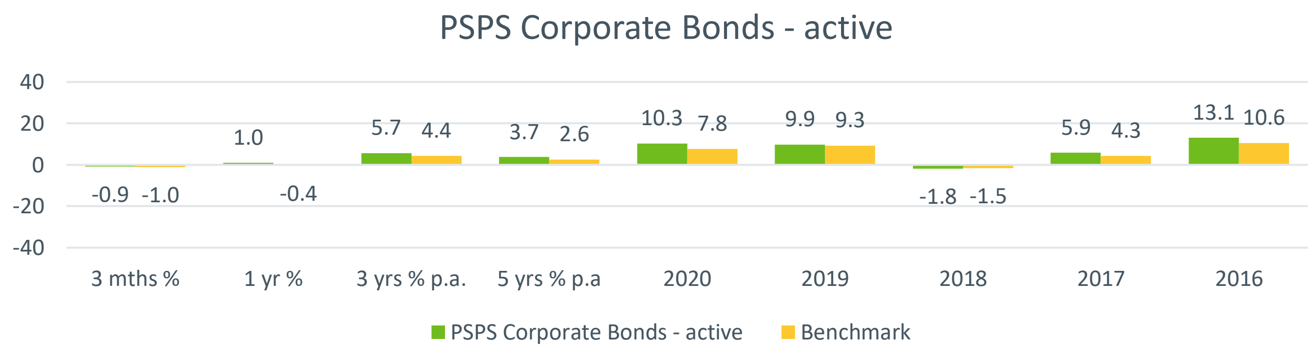


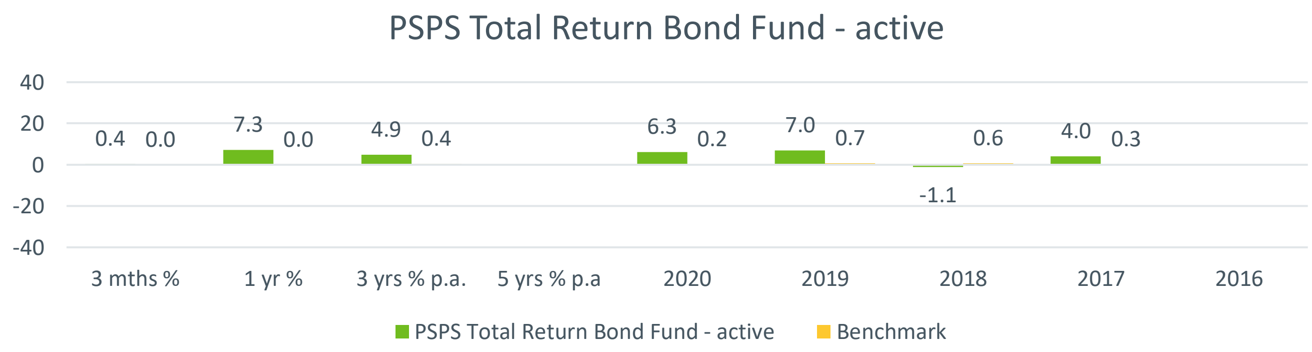




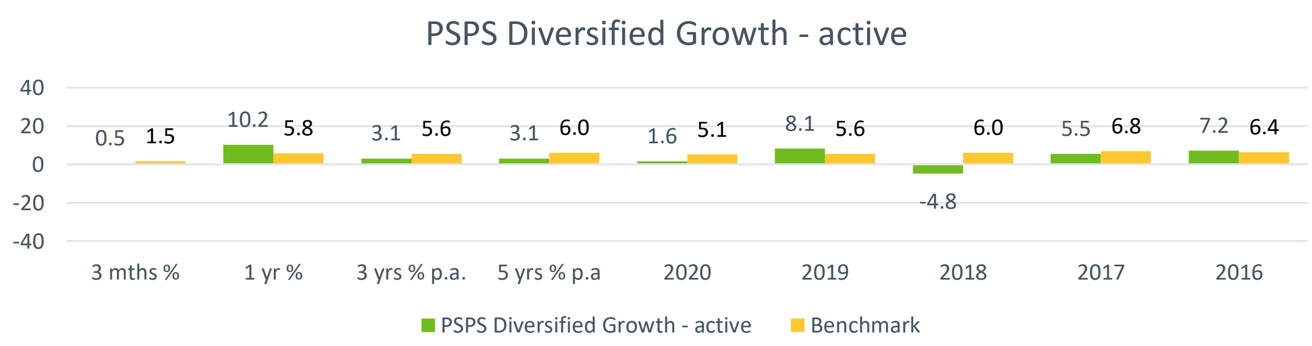


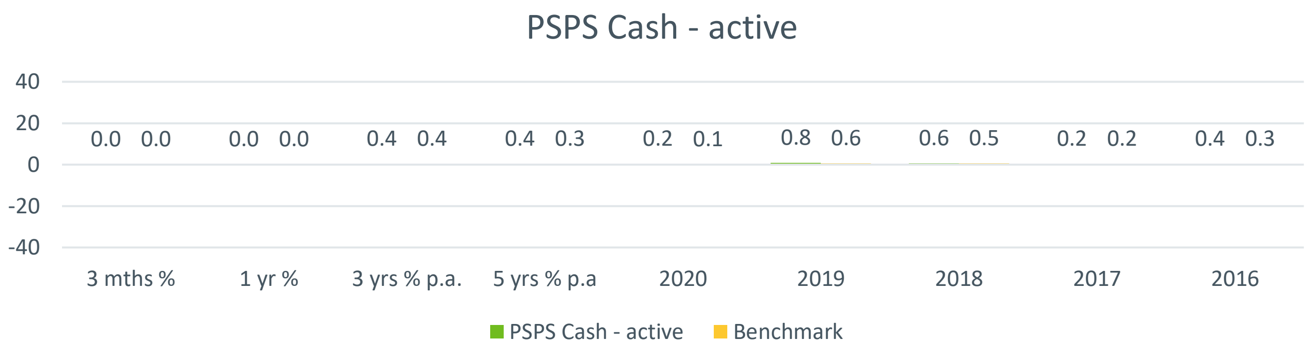


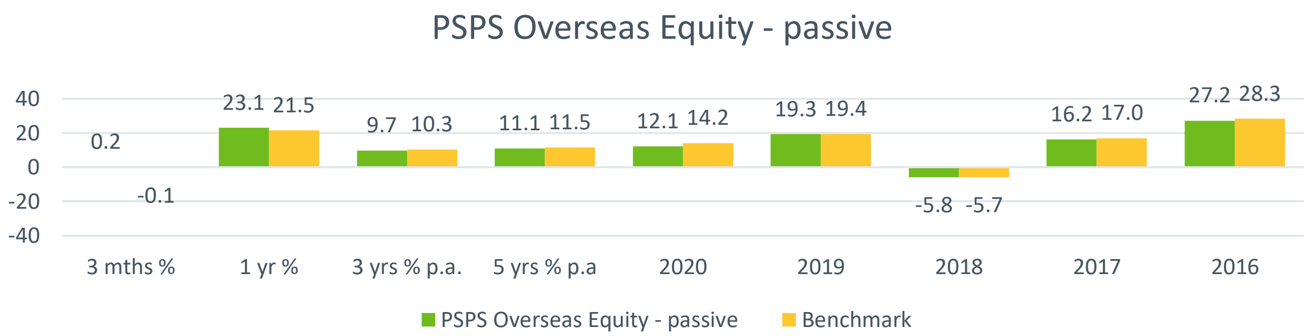


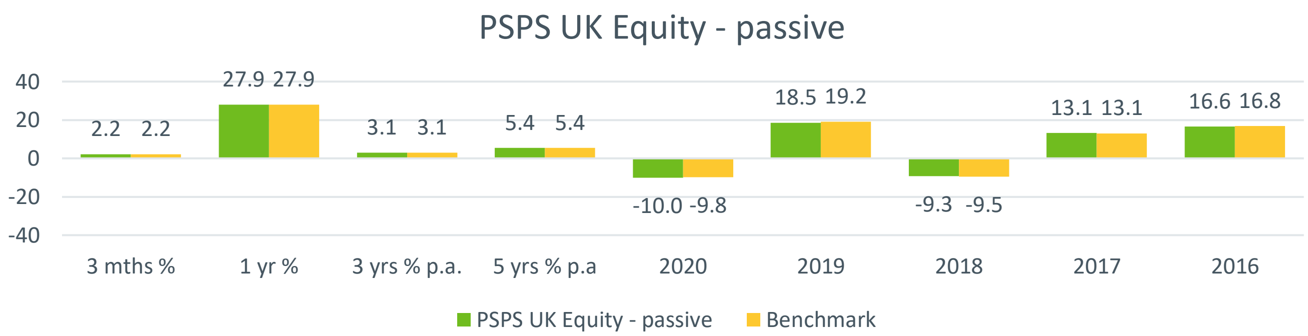


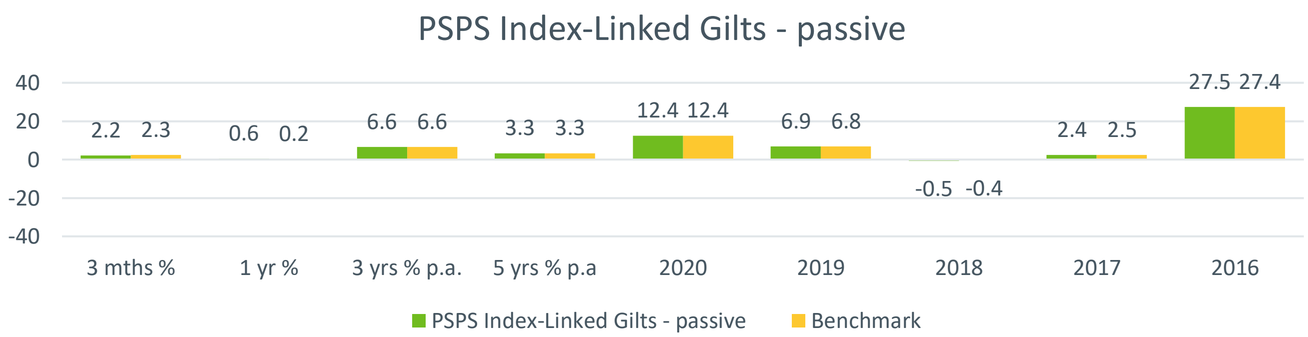
PSPS Total Return Bond Fund launched 8th July 2016

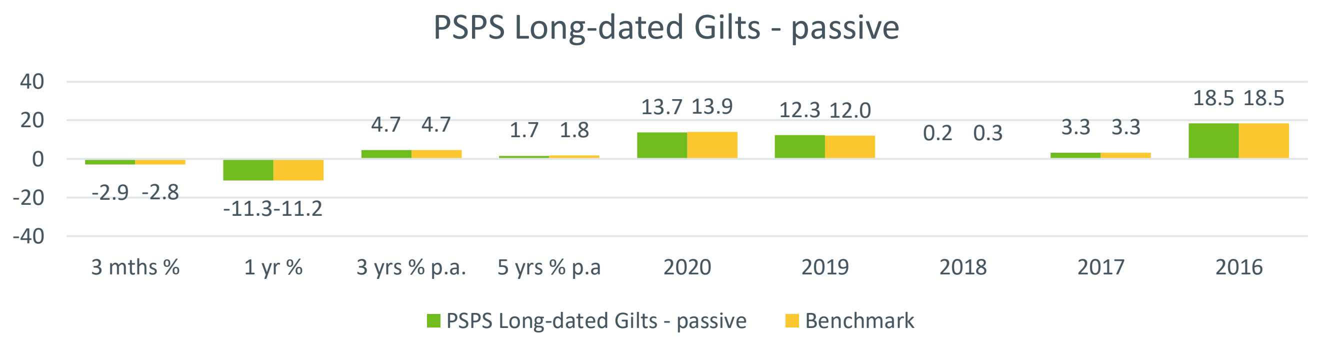


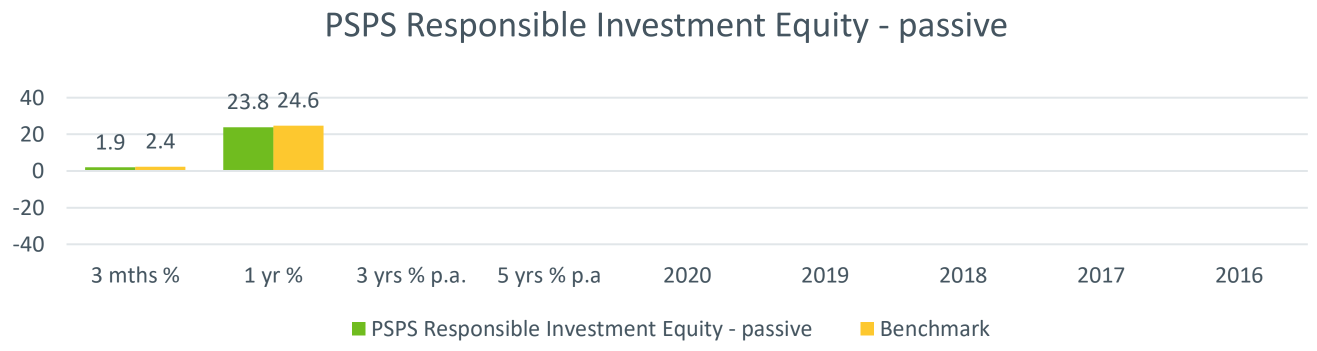

PSPS Cash - active
40
20
0
-20
-40
0.0 0.0
0.0 0.0
0.4 0.4
0.4 0.3
0.2 0.1
0.8 0.6
0.6 0.5
0.2 0.2
0.4 0.3
3 mths %
1 yr %
3 yrs % p.a.
5 yrs % p.a
2020
2019
2018
2017
2016
PSPS Cash - active
Benchmark


PSPS Overseas Equity - passive
40
20
0
-20
-40
0.2 -0.1
23.1 21.5
9.7 10.3
11.1 11.5
12.1 14.2
19.3 19.4
-5.8 -5.7
16.2 17.0
27.2 28.3
3 mths %
1 yr %
3 yrs % p.a.
5 yrs % p.a
2020
2019
2018
2017
2016
PSPS Overseas Equity - passive
Benchmark


PSPS UK Equity - passive
40
20
0
-20
-40
2.2 2.2
27.9 27.9
3.1 3.1
5.4 5.4
-10.0 -9.8
18.5 19.2
-9.3 -9.5
13.1 13.1
16.6 16.8
3 mths %
1 yr %
3 yrs % p.a.
5 yrs % p.a
2020
2019
2018
2017
2016
PSPS UK Equity - passive
Benchmark


PSPS Index-Linked Gilts - passive
40
20
0
-20
-40
2.2 2.3
0.6 0.2
6.6 6.6
3.3 3.3
12.4 12.4
6.9 6.8
-0.5 -0.4
2.4 2.5
27.5 27.4
3 mths %
1 yr %
3 yrs % p.a.
5 yrs % p.a
2020
2019
2018
2017
2016
PSPS Index-Linked Gilts - passive
Benchmark





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