What goes up must come down and what’s gone down may go up – eventually

Last month I wrote it was likely that the Federal Reserve would increase policy rates at its September meeting and that the MPC would probably not be too far behind. Once again however we have learnt that there is no such thing as a certainty in financial markets with risky assets enduring one of their worst months since the financial crisis of 2008. It is not yet clear how recent developments are likely to impact the upcoming policy decision as US data has remained reasonably strong however it will not make the upcoming meeting any easier.

The Chinese equity market rose rapidly, without fundamental reason and mostly on the back of naive retail investors using borrowed money. A correction was inevitable. Such things are features of developing markets and should not prompt panic. However there is equally always a reason why the bubble bursts and it is hard to avoid the conclusion that on this occasion it was concerns about the real level of activity taking place in the Chinese economy.

So why does this matter for UK and US interest rate decisions? The Chinese economy has been providing much of the world’s growth over the last decade and as it slowly moves towards a consumer driven society it is expected to provide a sizeable market for developed world goods and services and as such generate growth in the US and Europe. If the Chinese economy slows and Chinese consumers feel less wealthy then this will have an impact on developed markets as well. In the wake of the falls in China developed market equities also fell and this is liable to have a negative influence on both wealth and confidence.

What can we learn from this? The chart below shows that markets have been consistently wrong about the timing of interest rate moves since the start of the financial crisis in 2008.
Trustees have also tended to be over optimistic about the level of long term rates and as such have postponed increasing hedging levels. Anyone who had made investment decisions based around the likelihood of rising interest rates (both policy rates and longer term yields) over the last few months will have lost money with markets once again proving you can take nothing for granted. However the difference will have been in the scale of losses incurred. A typical fund manager, confident in their predictions, would typically size their trades to out or underperform by 0.01% for every 0.01% increase or decrease in yields. As such a fund manager who in June was confident rates would rise would have underperformed their benchmark by 0.25% as at the end of August as yields have fallen about 0.25%. By contrast a pension scheme that was 20% hedged would have lost 4.0% relative to their liabilities assuming growth assets were unchanged.

Having a low hedge results in changes in UK interest rates having a disproportionate impact on a scheme’s funding ratio. In an uncertain world, where markets can surprise us all, where interest rates can go down as well as up increasing your hedge so that the scale of the risks is in line with other asset classes is the best way to protect against funding ratio volatility. The sponsor should also be fully aware of these risks and engaged in how to manage this risk, much like any other business risk.

Robert Scammell
Portfolio manager
M: +44 (0) 758 533 2844
T: +44 (0) 207 002 1424
robert.scammell@kempen.co.uk

Nicholas Clapp
Client director
M: +44 (0) 758 555 4438
T: +44 (0) 207 002 1431
nicholas.clapp@kempen.co.uk

Kempen
60 Cannon Street
London EC4N 6NP
United Kingdom

If you have any feedback or questions please contact your usual Client Director, Robert Scammell or Nicholas Clapp.