For institutional clients only.

Investment Outlook

There Is No Alternative?

Q1 2025

Macro Environment

Jason Shoup
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“The outlook for US risk assets in 2025 is as much about having a view on whether TINA persists as it is understanding the underlying US economic fundamentals.”

An economically challenging year for much of the world has seen the notion of "There Is No Alternative" (TINA) to the US gain significant traction. Investors have flocked to US assets not only because of attractive fundamentals but because global alternatives appear unappealing. But as with all narratives, it's worth unpacking to see what's driving the current consensus and what could change over the course of 2025.

The fundamental argument for overweighting US growth seems to be well supported at a high level. Investors expect the economy to grow at 2% or more this year, supported by consumer spending and increased business investment, especially in areas like artificial intelligence. Inflation appears to be heading slowly back towards the Fed's 2% target, aided by the lagged impacts of housing. The labor market – despite some softening – still looks solid. Last year's slight increase in labor market slack suggests there could be room for the job market to absorb changes without major disruptions or rising wage pressures. Finally, the consensus view remains that the Fed will deliver cuts in 2025 and into 2026, even if the cuts don't materialize as quickly as risk assets would prefer.

The potential for disruptive policy changes is not alarming investors either. There is no serious concern that Trump will interfere with the Fed's ability to manage monetary policy. Net immigration is expected to remain positive, with deportation rates viewed as unlikely to spike due to legal and practical constraints. While tariffs remain a point of tension, they are expected to be manageable; broad global tariffs seem unlikely and even increases on China or other trading partners are expected to remain targeted and utilized largely as a negotiation tactic. Finally, Congress is not expected to tackle the growing deficit aggressively. Tax cuts from previous years are sure to be extended, and despite efforts from Elon Musk and Vivek Ramaswamy, there exists little appetite in Congress for significant spending cuts in areas like defense or social programs. A widely held assumption is that the stock market and inflation dynamics will constrain the Trump administration from doing anything too dramatic.

Put simply, investors seem to believe the US will maintain its pro-business momentum, with deregulation and tax policies helping to support corporate earnings and economic activity, while all the potential negative policies to growth and inflation will be moderated significantly.

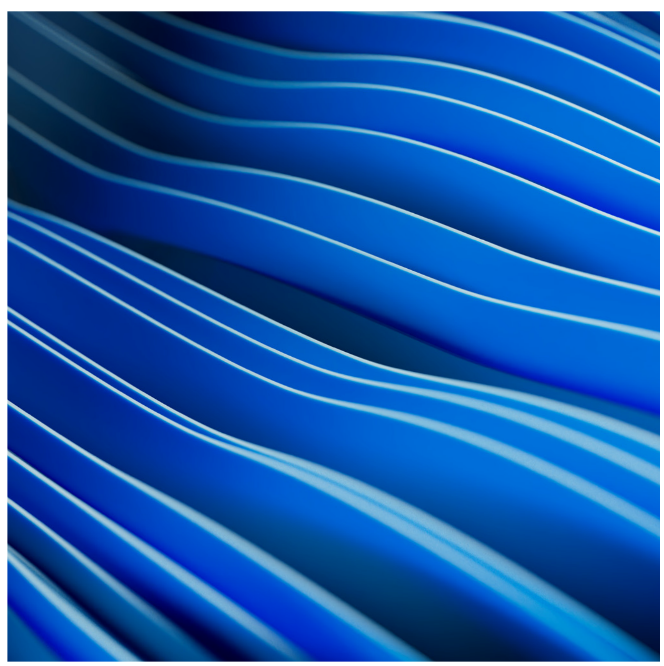
The other reason for the TINA effect is that the rest of the world doesn't offer compelling options. China continues to face demographic challenges and economic headwinds which draw parallels to Japan's stagnation. Repeated stimulus efforts seem to be yielding diminishing returns. Japan offers stability but limited growth prospects. Europe remains weighed down by Germany's economic struggles and political uncertainty in key countries such as France. As always, emerging markets face a mix of idiosyncratic risks and external pressures. Emerging markets may appear a reasonable diversifier relative to the US if not for the fact that US strength against a backdrop of global weakness has driven the dollar back to multi-year highs, thereby exporting tighter US monetary policy back to emerging market countries.

Hence, US valuations aren't just rich because the fundamentals are healthy, they are also inflated by the scarcity of alternatives and the resulting TINA effect. When investors believe there is no better place to go, they become willing to pay up. But this creates a precarious situation: the more investors crowd into a single trade, the more fragile it becomes, and the larger the downside may become if sentiment changes. As such, investors should be viewing US markets through as wide a lens as possible. The outlook for US risk assets in 2025 is as much about having a view on whether TINA persists as it is understanding the underlying US economic fundamentals.

So, what could change the narrative? No narrative lasts forever, and TINA is no exception.

- Something breaks globally: The combination of a strong US dollar, persistently elevated real yields and a less accommodative Fed than previously expected could create stress in Asia, Europe or emerging markets. If the stress becomes severe enough, the ensuing risk-off sentiment could spill back into US markets.
- A recovery in China or Europe: A stronger than expected recovery in either region could draw capital away from the US as alternative prospects improve. Should Chinese structural reforms succeed or Europe find a way to reignite growth, investors may look to rebalance their US-heavy allocations.
- US growth slows: If the US economy falters with growth dipping below trend or corporate earnings stagnating, the TINA narrative would likely start to wane. Opinions and commentary, such as this letter asking if US valuations have gotten ahead of reality, could quickly manifest into investors taking chips off the table.
- Market disruption from Trump policy surprises: Policies that initially seem manageable could quickly escalate or have unintended consequences. As any good negotiator knows, all threats must be credible. Thus, enlisting tariffs as a negotiation tactic necessitates his willingness to enforce them. With no re-election pressure there is a potential that President Trump focuses on legacy rather than maintaining short-term market stability. Trump may be more willing to emphasize his vision of prioritizing American interests on trade and immigration than investors currently believe.

The US undoubtedly remains the dominant force in global markets, and for good reason. The economy is strong, and attractive alternatives – for now – seem few. Yet no narrative lasts forever, and it's especially important to question the narrative when a single thesis dominates. TINA has served investors well in recent years, but preparing for shifting landscapes is what separates reactive decision-making from thoughtful long-term strategy.



Pension Solutions Monitor[1]

Chris Wroblewski, CFA
Co-head of Solutions Strategy

“US pension funding ratios increased over the fourth quarter of 2024.”

Our analysis of market movements impacting US corporate defined benefit pension plans leads us to estimate that pension funding ratios increased over the fourth quarter of 2024. Based on market movements, the average funding ratio is estimated to have increased from 110.0% to 111.1%.

Equity markets experienced mixed performance over the quarter with global equities[2] decreasing 0.9% and the S&P 500 increasing 2.4%. Plan discount rates[3] were estimated to have increased approximately 61 basis points over the quarter with the Treasury component increasing 68 basis points and the credit component tightening 7 basis points. Plan assets with a traditional “50/50” asset allocation decreased 4.2% while liabilities decreased 5.2%. The mixed asset performance and decrease in liability values resulted in a 1.1% increase to funding ratios over the fourth quarter of 2024.

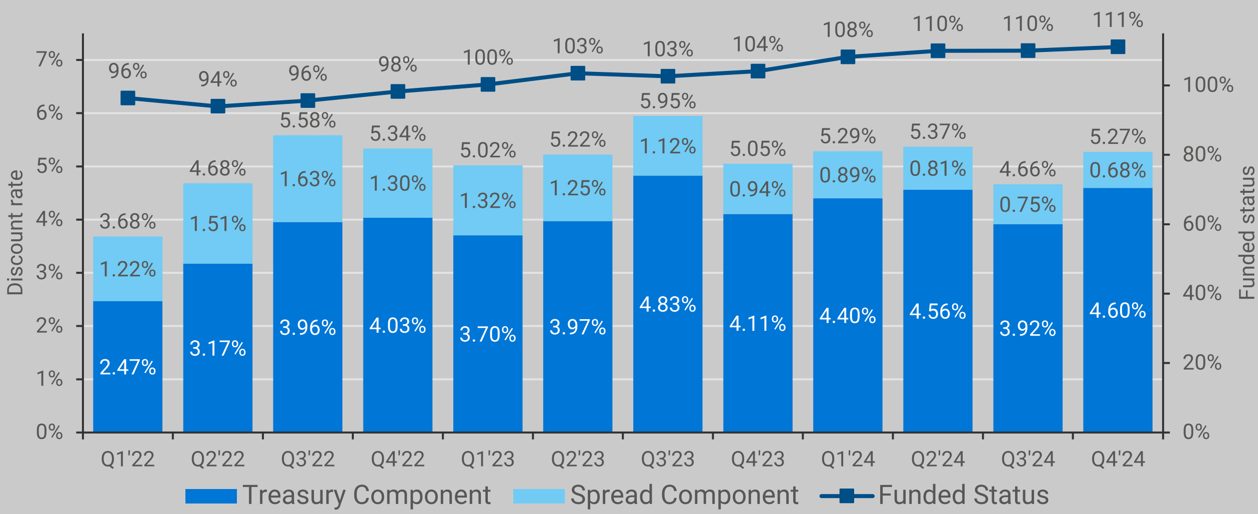
Looking back over 2024, the average plan’s funding ratio has improved on the back of strong equity performance and a modest rise in interest rates. For plans operating in a surplus position, we’ve seen greater demand for custom hedging strategies and an increased focus on ways to diversify their fixed income portfolio. Historically, the initial wave of LDI allocations centered on longer duration market-based benchmarks. The next phase of the LDI evolution includes strategies such as intermediate credit, investment grade private placements and shorter duration fixed income mandates. These fixed income strategies offer diversification benefits, the potential for enhanced yield, and ultimately, the chance for improved funded status outcomes. As we enter 2025, we anticipate a continued emphasis on customization to target plan’s unique objectives. For those with a primary focus of funded status preservation, custom credit portfolios that are managed in an annuity-aware framework and built benchmark agnostic could be a suitable approach.

The Pension Solutions Monitor assumes a typical liability profile using an approximate duration of 12 years and a 50% MSCI AC World Total Gross Index / 50% Bloomberg US Long Government/Credit Index investment strategy. Our analysis incorporates data from LGIM America research, ICE indices and Bloomberg.

Pension funded status market summary:

- Equity markets delivered mixed performance with global equities down and the S&P 500 up over the quarter.
- Plan liabilities decreased due to higher discount rates.
- Funding ratio levels increased primarily due to the fall in liabilities outpacing the drop in assets.

Figure 1: Discount rates



Sources: LGIM America, ICE indices and Bloomberg. Data as of December 31, 2024.

Fixed Income Markets

Anthony Woodside, CFA, FRM
Head of Multi-Sector Fixed Income & Investment Strategy

While the bond market sell-off in the fourth quarter created an attractive entry point for fixed income investors from a total return perspective, the path to generating attractive excess returns will certainly be more arduous from here."

Our perception of what is probable is naturally influenced by historical observations. This bias is certainly prevalent in financial markets where deviations from what feels familiar are often viewed as extremes in a discipline that frequently finds refuge in mean reversion. On the heels of yet another year of US exceptionalism, market participants find themselves confronted by glaring anomalies whose resolutions will likely have a material impact on market performance in 2025. The unusual price action during this easing cycle provides one such example. The Fed finally cut rates this past September, after repeatedly defying expectations for a dovish pivot. However, despite kicking off its descent with a 50 basis point cut, the much promoted "year of the bond" has been undermined by an atypical surge in yields. Additionally, risk premiums in credit continue to compress, much to the chagrin of sell side strategists that argued that spreads could not remain in this zip code for an extended period. While the cliché "you can't know where you're going unless you know where you've been" has merit, it might be time for fixed income investors to consider if we are on the precipice of a structural break from recent history.

Persistent volatility in the economic narrative was a defining characteristic of 2024, and the fourth quarter was no exception. Robust economic data, along with the Republican's decisive victory in the election, transformed concerns about a hard landing–after the weak payrolls release in August–to optimism around a reacceleration. The Fed contributed to this macro whiplash with an abrupt hawkish pivot in December after committing to a more dovish posture just three months earlier. While the central bank opted to cut rates by 25 basis points in line with expectations, the updated dot plot points to only 50 basis points of cumulative easing in 2025, compared to 100 basis points in September. Recent rhetoric from policymakers suggest that the Fed will remain on hold for a while to evaluate incoming data and the impact of policy from the new administration. The rates market repriced aggressively on the back of this less accommodative tilt, with yields rising 60 to 80 basis points across the curve in the fourth quarter.

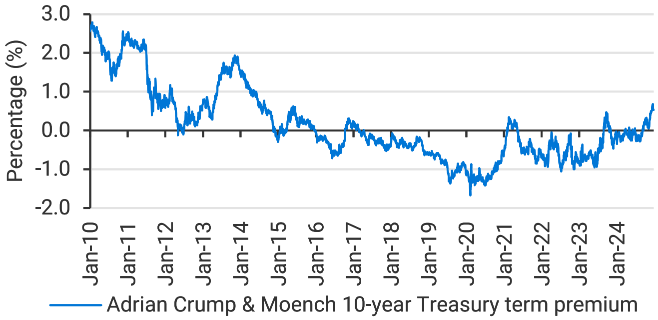
Amidst the tantrum in Treasuries, corporate credit has remained resilient. While total returns for investment grade were negative in the fourth quarter (Bloomberg US Credit and Bloomberg US Long Credit indices were down over 3% and 6%, respectively) owing to the increase in Treasury yields, excess returns were positive as spreads for both indices tightened roughly 7 basis points apiece. High yield credit fared even better, eking out positive total returns–aided by its shorter duration profile–and solid excess returns as spreads tightened over 12 basis points last quarter.[4]

Over the past few years, policy rate expectations have dominated the discussion on the direction of yields. However, with the market pricing in the Fed to stand pat for the next 6 months, other drivers may take precedence in the near term. One potential candidate is the neutral rate, which has come under increased scrutiny as economic momentum appears to be unperturbed by the higher rate regime. The FOMC has gradually lifted its estimate of the theoretical level that neither stimulates nor restricts growth (most recently to 3%), but market participants and the Fed's own internal models suggest that further upward revisions may be needed.

While the Republican sweep has led to an uptick in sentiment, it has also increased inflation expectations and policy uncertainty, and dampened hope that the fiscal deficit will be prioritized. Consequently, the normalization of the yield curve has accelerated in recent weeks, with term premium hitting more than a decade high (Figure 2). While our view aligns more with market pricing than the Fed in terms of where the neutral rate likely resides, we view the risk/reward of an overweight position in the front-end of the curve as attractive with roughly one cut priced in for 2025 and a terminal rate for the cycle approaching 4%.

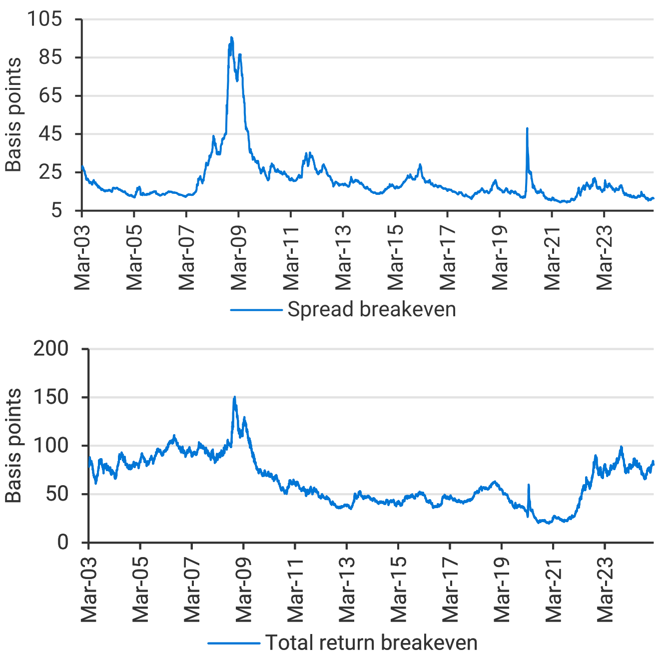
With spreads in corporate credit hovering around historical tights, it is worth asking how much upside remains in the asset class. The answer, unsurprisingly, is more nuanced than a time series chart would lead one to believe. For the last few years, the tussle between yield and spread investors has been relatively one-sided. Flows into investment grade and high yield credit have remained robust, as asset allocators have prioritized elevated all-in yields over paltry risk premiums. Indeed, while spread breakevens are hovering near historical lows in investment grade, total return breakevens are near post-GFC highs (Figure 3).

Figure 2: The extra yield that investors demand to own 10-year US treasuries is at the highest level in over 10 years



Source: Bloomberg. Data as of January 21, 2025.

Figure 3: Spread breakevens near historical lows, total return breakevens near post-GFC highs



Source: Bloomberg. Data as of January 21, 2025.

Despite elevated supply, the technical backdrop should remain broadly supportive for corporate credit in the near-term. First, the funded status for corporate pension plans increased yet again in 2024, and de-risking flows appear poised to accelerate given frothy equity valuations and elevated macro uncertainty. Second, the increased prevalence of portfolio trading has continued to reduce transaction costs, serving as another catalyst for spreads to remain tight. Finally, as we have pointed out in previous updates, there remains a significant amount of dry power sitting in money market funds that can be potentially deployed into fixed income should increasing optimism translate into greater risk appetite.

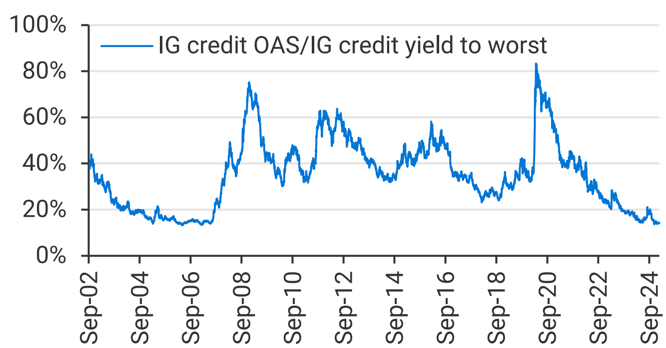
Yet, the risks to the credit outlook are far from inconsequential at current valuations. As the macro section highlights, the market appears to be pricing in the growth-friendly aspects of Trump's agenda–deregulation and tax cuts, while downplaying the potential headwinds–tariffs, mass deportation and D.O.G.E. Moreover, we believe that spreads can gap wider should the market take rate cuts off the table and/or Fed hawkishness leads to rate hikes being priced in. Corporate fundamentals may also come under modest pressure this year as M&A activity accelerates fueled by deregulation and improved business sentiment.

In terms of portfolio positioning, we entered the year modestly overweight credit risk in our intermediate and full market credit strategies, and neutral in our long duration credit strategies. In our multisector offerings, we remain constructive on US securitized credit given its attractive ratings-adjusted spread.

When surveying the investment landscape for 2025, it is tempting to assess the terrain primarily through the lens of historical benchmarks. However, we caution that there is budding evidence that this cycle may represent a break from the past. Specifically, the secular stagnation narrative that dominated much of the post-GFC period is looking increasingly out of step with the current macro environment. President Trump is inheriting a strong economy with an underleveraged private sector, fertile conditions for animal spirits to be awakened from slumber. Consequently, it might be time for market participants to purge themselves of the view that the elevated yield environment is temporary and rewrite their playbooks for a new normal.

Moreover, while a cursory glance through the rearview mirror makes the case for an underweight to credit at current valuations, solid growth, benign credit fundamentals and positive technicals suggest that risk premiums can remain modest for an extended period. Nonetheless, with investment grade credit spreads as a percentage of all-in yields near historical lows, rates duration will play a meaningfully larger role in forward looking total returns (Figure 4). While the bond market sell-off in the fourth quarter created an attractive entry point for fixed income investors from a total return perspective, the path to generating attractive excess returns will certainly be more arduous from here.

Figure 4: As a ratio of all-in yields, IG credit spreads are near a record low



Source: Bloomberg. Data as of January 21, 2025.

Equity Markets

Dave Chapman, CFA
Head of Multi-asset

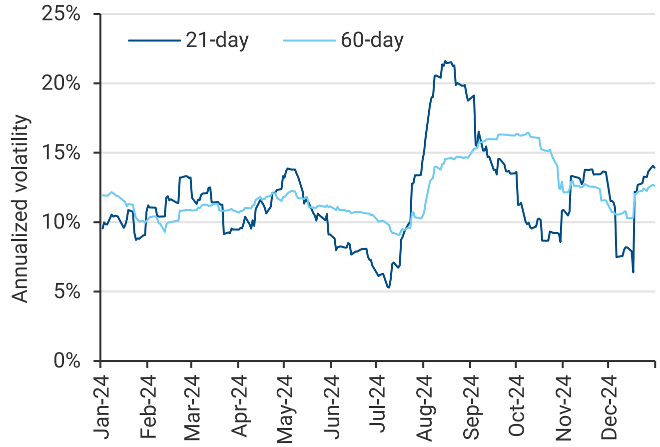
“Investors who remain resolute about this year’s goals may also consider additional tools beyond reliance on traditional stock-bond diversification, though.”

A new year ushers in goal setting. But, like many of us, the S&P 500 also quit its nascent gains for the year by January 10— also known as Quitter’s Day. The recent volatility and shallow sell-off seem to be a response to growth data that was so good it’s bad, causing a sharp rise in longer-dated rates, particularly real yields. Our view is that the rates move is overdone; we have maintained both our long equity and long duration views for the time being. However, there are some uncomfortable echoes of 2022, and multi-asset investors are wise to heed potential signals from the recent co-behavior of stock and bonds.

When we last wrote in October 2024, we were very sanguine about election-related volatility, particularly for what was priced into options markets. That view largely played out—as Figure 5 illustrates—with even very short-term measures of realized volatility declining below longer run historical averages. A simple delta-hedged volatility carry strategy had an excess return of over 2% from the end of the third quarter of 2024 through the election results. Optimism abounded and Trump’s potential policies were given a goldilocks treatment by markets, as described in the beginning macro environment section.

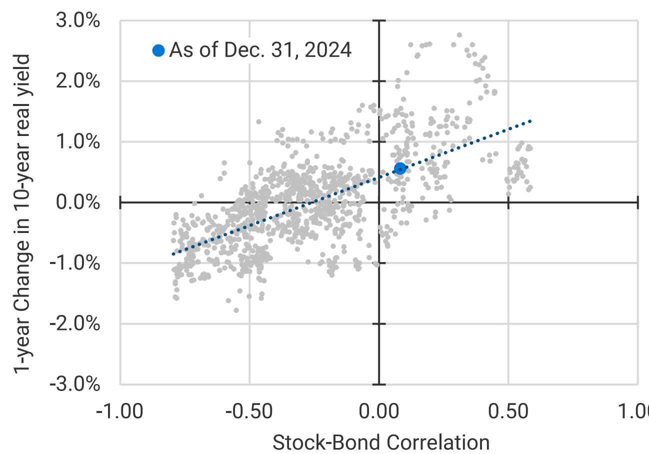
However, in late December, the Fed delivered a 25 basis points cut as expected but surprised the market with a more hawkish outlook, which was subsequently corroborated by a strong ISM survey (and subcomponents) and non-farm payrolls. Rates rose in response, and equities subsequently struggled across a couple dimensions. First, very high valuations can be sustained in the short-term but do leave markets more vulnerable to shocks. Current valuations are strongly supported by out-year earnings of high growth technology

Figure 5: Annualized volatility of the S&P 500



Source: Bloomberg and LGIM America. Data as of December 31, 2024.

Figure 6: Real rates change and correlation of S&P 500 with US Treasuries



Source: Bloomberg and LGIM America. Data as of December 31, 2024.

firms, and the sharp rise in long-term real yields forces the market to discount its lofty expectations a bit. Second, the market may be reassessing how much policy room Trump will actually have while maintaining a business environment that is both pro-growth and disinflationary.

This is the crux for multi-asset investors because we are near an inflection point for diversification. Figure 6 highlights the relationship between changes in real rates and the correlation of the S&P 500 with US Treasuries. While not a perfect fit, it does suggest that the current environment is kryptonite to the superpower of diversification.

Our view is reasonably constructive, however. As mentioned, we see recent moves as an overshoot, evidenced by the associated steepening and with real rates above levels consistent with trend growth. We expect yields to converge to the neutral rate long-term, an obvious positive for bonds, and we are optimistic that it would also be supportive of equities (with those long-term yields biting less) as long as growth remains solid. This does imply, though, that equity index levels rest on a three-legged stool of (1) sufficient growth to justify high valuations, (2) policy optimism and (3) a balanced interest rate environment. We are wary of taking away any one leg.

Investors who remain resolute about this year's goals—beating your spending rule, achieving your EROA, meeting a funded status objective—may also consider additional tools beyond reliance on traditional stock-bond diversification, though. The multiple-driven expansion of the previous two successive years constrains further upside, making the relative value of equity collars more appealing. Average allocations to real assets like commodities, real estate and infrastructure are quite low, yet these assets typically perform better in a stubbornly high inflation environment. Lastly, while it is a more fundamental shift, utilizing a framework like a Total Portfolio Approach can be an effective way to identify fundamental risk drivers of a portfolio and stay focused on long-term goals.[6] We all know that consistency is key, and any portfolio can be objective-driven.

Equity Solutions: MSCI Rebalance Predictions

Dave Barron, CFA, CAIA
Head of US Equity Solutions

"Last quarter, there were 10 adds and 21 deletes named in the MSCI World rebalance. Of the 31 total constituent changes, we accurately predicted 29 of them."

Last quarter's scorecard

The start of a new year is a natural time to reflect on the recent past; however, for passive equity investors, reflection comes more frequently than once every twelve months. Much is the same for us, as we evaluate our index add and delete predictions against the MSCI World once a quarter. As a benefit of this more frequent schedule, we can provide to you a more detailed track record of our prediction performance, supporting what we believe is a continued source of outperformance for passive investors.

In the fourth quarter, there were 10 adds and 21 deletes named in the MSCI World rebalance. Of the 31 total constituent changes, we accurately predicted 29 of them. And, after accounting for two incorrect predictions, our Rebalance Accuracy Score for the fourth quarter of 2024 was 87, which bested our third quarter accuracy score of 79. A highly accurate prediction exercise, like this one, can be used to achieve outperformance in a low active risk framework, delivering a better outcome to investors.

Our latest predictions

Figure 7 highlights our predictions for the first quarter of 2025 MSCI rebalance. The key dates for this cycle are the following:

- 10 business day window: January 17 - January 31.
- Announcement: February 11.
- Implementation point: Close of Friday, February 28, but may be different for some markets (e.g., market holiday, exchange closures).

Figure 7: Our MSCI predictions for Q1 2025

Benchmark	Country	Name	Prediction
World ex USA	Australia	ENDEAVOUR GROUP LTD/AUSTRALI	Delete
World ex USA	Australia	MIRVAC GROUP	Delete
World ex USA	Australia	MINERAL RESOURCES LTD	Delete
World ex USA	Australia	RAMSAY HEALTH CARE LTD	Delete
World ex USA	Australia	SEEK LTD	Delete
World ex USA	Belgium	ELIA GROUP SA/NV	Delete
World ex USA	Belgium	WAREHOUSES DE PAUW SCA	Delete
World ex USA	Canada	CELESTICA INC	Add
World ex USA	Canada	CAN APARTMENT PROP REAL ESTA	Delete
World ex USA	Canada	MEG ENERGY CORP	Delete
World ex USA	Canada	PARKLAND CORP	Delete
World ex USA	Germany	CARL ZEISS MEDITEC AG - BR	Delete
World ex USA	Germany	BECHTLE AG	Delete
World ex USA	Japan	MCDONALD'S HOLDINGS CO JAPAN	Delete
World ex USA	Japan	MITSUI CHEMICALS INC	Delete
World ex USA	Japan	TOTO LTD	Delete
World ex USA	Japan	SHIZUOKA FINANCIAL GROUP INC	Delete
World ex USA	Japan	HITACHI CONSTRUCTION MACHINE	Delete
World ex USA	Japan	BROTHER INDUSTRIES LTD	Delete
World ex USA	Japan	KOKUSAI ELECTRIC CORP	Delete
World ex USA	Japan	JAPAN REAL ESTATE INVESTMENT	Delete
World ex USA	Japan	TOKYO ELECTRIC POWER COMPANY	Delete
World ex USA	Japan	TOKYO METRO CO LTD	Add
World ex USA	New Zealand	CONTACT ENERGY LTD	Add
World ex USA	New Zealand	MERCURY NZ LTD	Delete
World ex USA	Sweden	GETINGE AB-B SHS	Delete
World ex USA	Sweden	VOLVO AB-A SHS	Delete
World ex USA	Switzerland	ADECCO GROUP AG-REG	Delete
World ex USA	Switzerland	BACHEM HOLDING AG	Delete
World ex USA	Switzerland	CLARIANT AG-REG	Delete
World ex USA	United Kingdom	BERKELEY GROUP HOLDINGS/THE	Delete
World ex USA	United Kingdom	ENDEAVOUR MINING PLC	Delete
World ex USA	United Kingdom	PERSIMMON PLC	Delete
USA	United States	UNITED AIRLINES HOLDINGS INC	Add
USA	United States	INTERACTIVE BROKERS GRO-CL A	Add
USA	United States	NATERA INC	Add
USA	United States	REDDIT INC-CL A	Add
USA	United States	AES CORP	Delete
USA	United States	APA CORP	Delete
USA	United States	CELANESE CORP	Delete
USA	United States	CHARLES RIVER LABORATORIES	Delete
USA	United States	HF SINCLAIR CORP	Delete
USA	United States	ENPHASE ENERGY INC	Delete
USA	United States	FORTUNE BRANDS INNOVATIONS I	Delete
USA	United States	HUNTINGTON INGALLS INDUSTRIE	Delete
USA	United States	KNIGHT-SWIFT TRANSPORTATION	Delete
USA	United States	LAMB WESTON HOLDINGS INC	Delete
USA	United States	MARKETAXESS HOLDINGS INC	Delete
USA	United States	MOSAIC CO/THE	Delete
USA	United States	MATCH GROUP INC	Delete
USA	United States	QORVO INC	Delete
USA	United States	TELEFLEX INC	Delete
USA	United States	TORO CO	Delete

Source: LGIM America. Data as of January 2025. For illustrative purposes only.

Methodology

We have designed and implemented a low active risk approach to capture outperformance created by index micro inefficiencies. In our investment approach, we target a variety of opportunities, one being rebalance predictions, where we model widely followed methodologies to predict index additions and deletions. This predictive capability provides an opportunity for us to optimize portfolio adjustments before official index announcements, potentially enhancing returns. Here's how it works for an MSCI rebalance:

- On a quarterly basis, MSCI will re-establish its market cap weighted index series using a publicly available methodology, which means it can be independently modeled with reasonable certainty.
- We identify which companies we believe will be reclassified between the Standard (Large + Mid Cap) indices and Small Cap indices.
- MSCI selects one of ten days at the end of the month prior to the actual rebalance to crystalize sizing classifications.
- A public notification of the changes happens approximately two weeks before the rebalance, with the rebalance happening at the end of the month (February, May, August, November cycle).

After the rebalance period ends, we evaluate our predictions based on the following method:

- Correct prediction (i.e., True positive; 1 point) - We assign ourselves one point for every accurate add or delete prediction.
- Incorrect prediction (i.e., False positive; -1 point) - One point is deducted for every prediction that is not ultimately added or deleted by MSCI.
- No prediction (i.e., False negative; 0 points) - No points are assigned or deducted for an add or delete that was not originally predicted.
- We add up the total number of points and divide it by the total number of adds and deletes implemented by MSCI to determine the Rebalance Accuracy Score. While we do not expect to achieve perfect accuracy, our aim is to maximize correct predictions and minimize mistakes.

Accurately predicting this information in advance is knowing what trillions of dollars are likely to do before they do it.

Invetsment Grade Private Credit

Dan Dreher
Solutions Strategist

"As pension plans continue to adapt, incorporating IG private credit may offer a compelling opportunity for enhanced returns, greater diversification, and robust structural protections."

Liability-Driven Investment (LDI) strategies have evolved from simply extending portfolio durations to creating custom fixed income portfolios for precise interest rate hedging. This has been highly effective, contributing to improved funding ratios as equities have risen alongside interest rates; our previously mentioned Pension Solutions Monitor estimates that the average funding ratio is now 111% (Figure 1), rising 15% in just the last 3 years. Looking at the 100 largest plans, 2024 saw an improvement of $68 billion—a stark contrast to the $31 billion funded status loss experienced during 2023.[1]

The strength we've seen in funded ratios has led to an increase in the average portfolio's fixed income allocations as plans de-risk their asset base. According to a 2023 Cerulli report, Corporate Defined Benefit Plans' Fixed Income assets sit at roughly 45%, up from 40% in 2015. Further, a striking 99% of surveyed plans stated they are "very" or "somewhat likely" to de-risk their plan over the next two years.[6]

JP Morgan has also observed a recent trend towards de-risking. One indicator of this shift is the increased demand for US Treasury STRIPS, which pension funds use to manage duration exposure. In December, P-STRIPS outstanding rose by $6.3 billion, the largest increase since July, with demand concentrated at the long end of the curve, indicating a positive momentum towards more fixed income in pension portfolios.[7] Further research from JP Morgan suggests that now may be an opportune time to invest in fixed income. Historical data shows that negative total return years in investment grade bonds are rare, with only eight such years in the past 40. Additionally, the relationship between starting yields and returns is reasonably strong, with a regression analysis predicting a positive total return for the current year.

To adapt to these changing needs, plans must explore new approaches to constructing their fixed income portfolios. Clients looking to diversify their investments should consider investment grade (IG) private credit, which offers higher quality and fixed duration compared to more notable "private credit" segments of the market (direct lending, etc.). Not only can broad diversification reduce the volatility of the portfolio but incorporating IG private credit can potentially result in enhanced returns, diversified issuer exposure, structural protections and better-than-expected liquidity (additional information on the liquidity advantages of IG private credit can be found in our blog).

Growing opportunity in IG private credit

Private Credit offers unique advantages that complement broader Fixed Income portfolios. Market participants have identified the private market as a $40 trillion market, with a majority being investment grade.

This growth is driven by a tremendous appetite for capital, particularly in the context of the global industrial renaissance, which includes data and compute, power for AI, and energy transition—sectors that require massive amounts of capital for the real economy. Additionally, some of the biggest capital market participants, such as Anheuser-Busch InBev, Intel and Air France, are seeking diversified financing, flexibility, and high-quality partners who can provide speed and certainty in ways not previously seen. These investment grade firms, despite having ample access to public markets, are looking for differentiated solutions to meet their unique needs–which they are willing to pay for.

Enhanced returns

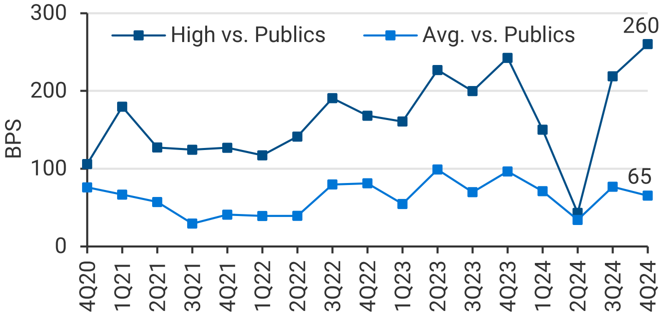
This expansion of the credit universe carries with it a meaningful premium relative to public credit. The IG opportunity set has the potential to offer up to 150+ basis points of spread premium on average versus comparably rated public securities. Furthermore, covenants have the potential to provide additional return over life of the deal via covenant-driven lifecycle payments. (See Figure 8)

Greater diversification

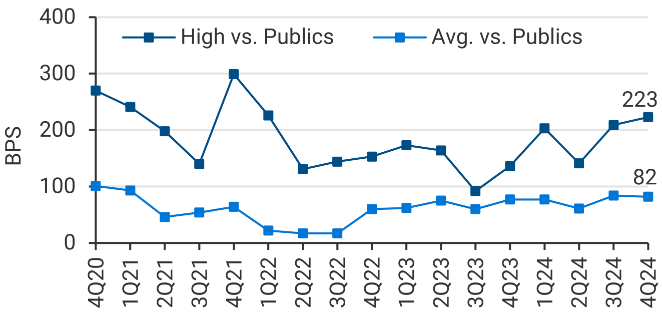
Private Credit offers greater diversification within fixed income allocations, beyond its returns and favorable risk characteristics. By investing in sectors like infrastructure, private credit helps balance otherwise imbalanced credit allocations, as public credit tends to have much higher concentration than private markets. Additionally, many issuers in the private credit market do not issue in the public market, providing investors with access to unique issuer exposures. This results in minimal public overlap in terms of issuer, sector, geography and maturity further enhancing diversification. (See Figure 9)

Figure 8: Spreads to public comparables

A- or better credit premium (NAIC-1)



BBB credit premium (NAIC-2)



Source: BAML – public index references ICE BAML corporate indices (blend of C0A1/2/3 to align with NAIC-1 & C0A4 aligned with NAIC-2). Data as of December 31, 2024. NAIC refers to the National Association of Insurance Commissioners.

Structural protections

Covenant packages can result in lower credit losses over the life cycle of assets by providing downside and event risk protection through more robust covenants than those typically found in the public market. These packages allow for early intervention with deteriorating credits, helping to mitigate potential losses. The market is heavily skewed towards senior secured issuances, which further enhances security. Additionally, the reliance of issuers on the market drives good behavior, ensuring that they adhere to the agreed-upon terms and conditions.

Figure 9: Diversification in IG private credit

Corporate	Infrastructure
• Traditional corporates • Healthcare systems • Asset managers • Energy & Utilities • REITs	• Transportation • Social • Energy & Utilities • Comms & Tech • Renewables
Alternatives	**Real Estate debt**

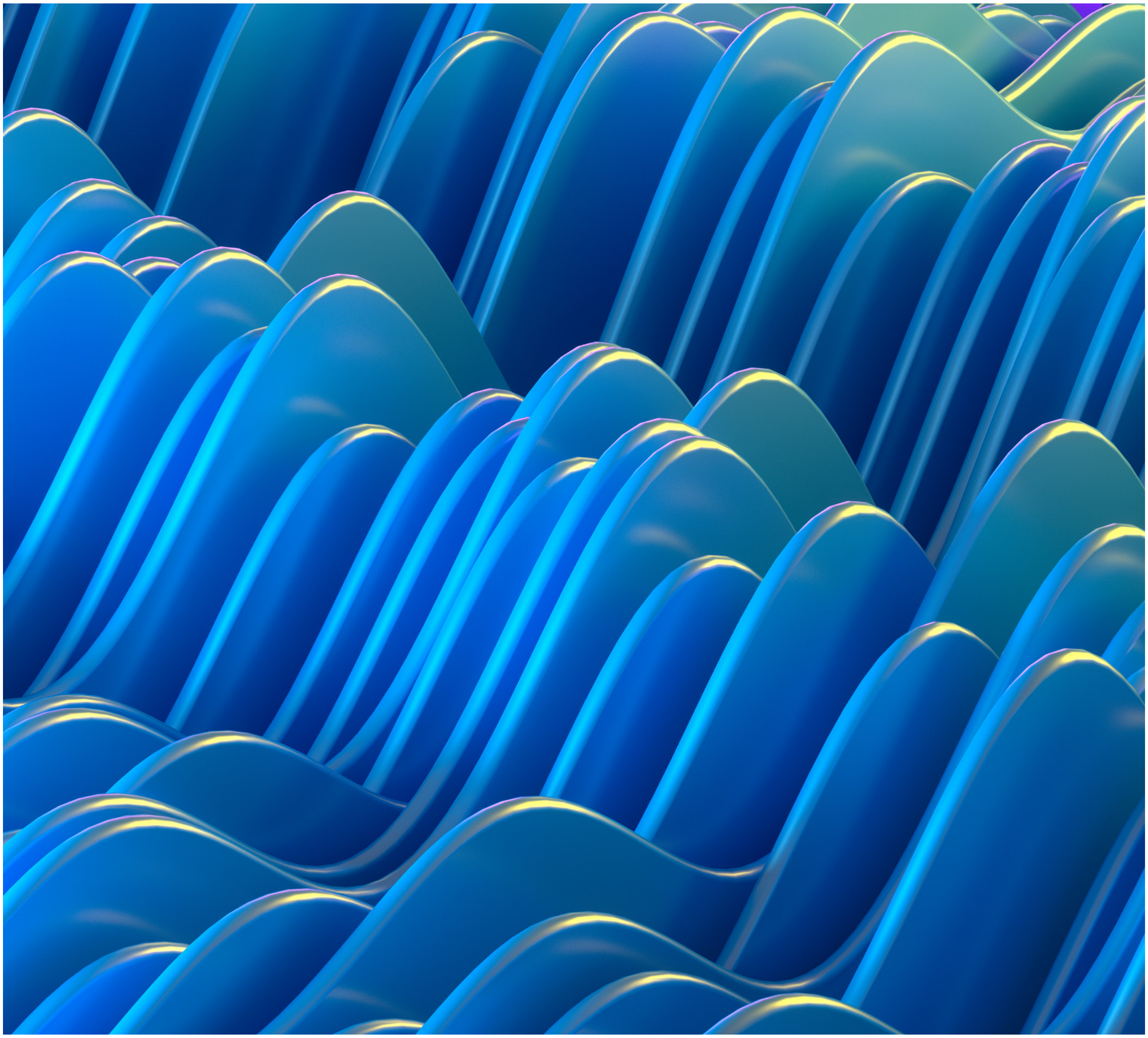
• Structured RE [Credit Tenant Leases, Ground Lease Financings]
• Fund Finance [Cap Calls, Closed-End Funds, BDCs, NAV Loans, CFOs]
• Esoteric ABS
• Contract Monetization
• Credit Linked Notes
• Supply Chain / Receivables Financing
	• Multifamily
	• Industrial
	• Office
	• Retail
	• Alternative CRE
	  ◦ Build-to-rent
	  ◦ Single-family rental
	  ◦ Storage
	  ◦ Flex industrial
	  ◦ Student housing

Source: LGIM America. For illustrative purposes only.

Diversification - Even within the IG Private Credit Universe

Even within the world of IG private credit, you can achieve diversified returns. Our correlation against competitors demonstrates that our investment approach is distinct and uncorrelated with peers.

The evolving landscape of LDI strategies and the momentum towards de-risking have significantly improved pension funding ratios and portfolio stability. As pension plans continue to adapt, incorporating IG private credit may offer a compelling opportunity for enhanced returns, greater diversification and robust structural protections. This strategic shift not only aligns with the current market dynamics but also ensures the potential for long-term financial health and resilience for pension portfolios.



1. For illustrative purposes only. LGIM America prepares the Pension Solutions Monitor data assuming a typical liability profile using an approximate duration of 12 years and a 50% MSCI AC World Total Gross Index / 50% Bloomberg US Long Government/Credit Index investment strategy, incorporating data sourced from LGIM America, ICE, MSCI and Bloomberg. Prior to January 2023 the funded ratio of a typical US corporate defined benefit plan was calculated using an approximate duration of 12 years and a 60% MSCI AC World Total Gross Index/ 40% Bloomberg US Aggregate Index ("60/40") investment allocation strategy incorporating data from LGIM America research, ICE indices and Bloomberg. The change to a "50/50" asset allocation reflects our understanding that most US corporate defined benefit plans have extended the duration of their fixed income as funded status has improved for the broader market. Furthermore, we believe that the duration of a typical plan's fixed income portfolio is better represented by the Bloomberg US Long Government/Credit Index compared to the Bloomberg USAggregate Index. These results are based on simulated or hypothetical assumptions that have certain inherent limitations. Unlike the results in an actual performance record, these results do not represent actual trading. Because these trades have not actually been executed, these results may have under- or over-compensated for the impact, if any, of certain market factors, such as lack of liquidity. Simulated or hypothetical trading programs in general are also subject to the fact that they are designed with the benefit of hindsight. No representation is being made that any account will or is likely to achieve profits or losses similar to these being shown.
2. "Global equities" referred to here is represented by the MSCI AC World Total Gross Index.
3. Discount rates based on a blend of the Intercontinental Exchange Mature US Pension Plan AAA-A and Intercontinental Exchange Retired US Pension Plan AAA-A discount curves.
4. Bloomberg.
5. -Pensions & Investments; https://www.pionline.com/pension-funds/large-institutional-investors-embrace-total-portfolio-approach-new-and-innovative-way.
6. Cerulli Report on North American Institutional Markets. Data as of December 31, 2023.
7. JPM NA Credit Research: Daily Credit Strategy

Disclosures

LGIM America