For institutional clients only.

LGIM America

Investment Outlook
A Double-edged Sword

Q3 2022

Macro environment

Jason Shoup
Deputy Head of US Fixed Income

"Strange as it may seem, the longer the economic expansion, the more difficult the Fed's job may become."

According to numerous surveys, most investors now anticipate a US recession before the end of 2023. But it is not just the professional investment community that is concerned; a recession is now a topic of conversation at the dinner table. Consumer and business confidence is falling precipitously to levels that have typically preceded economic contractions. While downbeat attitudes abound, it is paramount to observe how consumers and businesses actually behave rather than what they say.

There is no doubt that the equity market correction, ongoing supply chain issues and inflationary pressures have eroded business confidence. However, it may come as a surprise that US companies have shown no signs of defensiveness, continuing to draw down liquidity buffers established at the start of the pandemic to fund share buybacks and dividends. Away from the energy sector, capex spending remains resilient, while M&A activity has been far more robust than one might expect, especially given higher interest rates and a less receptive regulatory framework. Lower equity valuations appear to be both enticing and discouraging potential buyers.

Compare the situation in the US to that of Europe, where the prospect of recession is far more imminent due to the Ukraine-induced energy shock. Indeed, European companies are conserving cash to a much greater extent and now have more cash on their balance sheets than at the end of 2020. Meanwhile, corporate liquidity in the US has nearly returned to pre-pandemic levels.

Importantly, the drop in business confidence has yet to be reflected in lower labor demand in the US or Europe. While European labor markets are far more rigid than the US, the extreme tightness of labor markets appears to be contributing to an unusual level of reluctance to shed labor even in regions where growth appears to be most at risk. US companies are not even reducing their advertised job openings, which remain near peak levels.

The US economy's skew toward consumption makes it mathematically difficult to produce a recession without a retrenchment by the consumer. While measures of consumer confidence have fallen significantly this year as inflation hits home, individuals have continued to spend as both hours worked and earnings have increased. Excess savings amassed at the start of the pandemic have provided an additional buffer against high inflation. Certainly, there is growing evidence that more product substitution is occurring among consumers with the least amount of savings, but consumption at a macroeconomic level tends to be driven disproportionately by the more affluent.

For the Fed, the fact that economic activity has remained resilient despite a drop in business and consumer confidence is a double-edged sword. To curb inflation and achieve a soft landing, an extended period of below-trend but not negative growth is likely required. Eventually, ever tighter financial conditions will restrain economic growth. However, hopes for a relatively quick slowdown appear to be fading at a time when balance sheets remain relatively strong. Companies and consumers may be expressing concerns about the future, but they have not yet altered their behaviors in a way that is consistent with the Fed's desire for demand destruction in order to control inflation.

Strange as it may seem, the longer the economic expansion continues, the more difficult the Fed's job may become. Even if US growth hovers near trend for the remainder of the year, as we expect, it will increase the likelihood that the Fed will need to raise rates well into restrictive territory (perhaps above 4 percent), increasing the likelihood of a much harder landing sometime next year.

Pension Solutions Monitor[1]

Chris Wroblewski, CFA
Solutions Strategist

"US pension funding ratios decreased over the second quarter of 2022."

Our analysis of market movements impacting US corporate defined benefit pension plan leads us to estimate that pension funding ratios decreased over the second quarter of 2022, with the average funding ratio decreasing from 96.3 percent to 94.0 percent during this timeframe.

Equity markets saw a decline over the quarter with global equities[2] and the S&P 500 falling 15.5 percent and 16.1 percent, respectively. Plan discount rates[3] were estimated to have increased roughly 100 basis points over the quarter with the Treasury component rising 71 basis points and the credit component widening 29 basis points. Plan assets with a traditional "60/40" asset allocation decreased 11.3 percent. The impact of higher discount rates weighed heavily on liability values, but asset performance declined further over the quarter, resulting in a 2.4 percent decrease in funding ratios over the second quarter of 2022.

The second quarter saw continued market volatility; most notably, the significant increase in Treasury yields and the sustained drop in equities. Liabilities have fallen due to higher discount rates; however, asset values fell further, contributing to a decrease in funding ratios. Volatility experienced in the Treasury market shows the importance of decoupling risks that can impact pension plan funded status, such as interest rate and credit spread risk. We've seen heightened demand for custom hedging strategies to lock in earlier funded status gains or to better manage interest rate risk. Separately, cash balance plans have entered new territory with the dramatic rise in Treasury yields, especially those with floors. There may be unique considerations to weigh when a plan's interest crediting rate fluctuates with a Treasury yield, like the 30-year, for example.

For this analysis, we assume a typical liability profile using an approximate duration of 12 years and 60 percent MSCI AC World Total Gross Index/40 percent Bloomberg Barclays US Aggregate Index ("60/40") investment strategy, and incorporate data from LGIM America research, ICE indices and Bloomberg.

Pension funded status market summary:

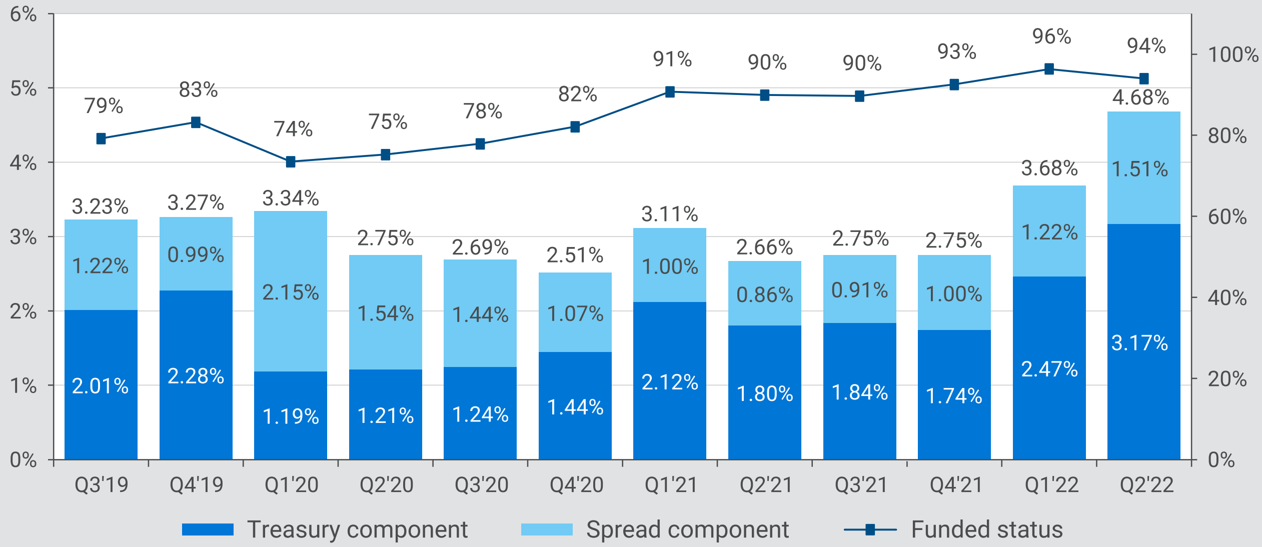
- Equity markets performed poorly with global equities down roughly 15.5 percent.
- Plan liabilities decreased due to higher discount rates.
- Funding ratio levels decreased as poor asset performance overwhelmed the decline in liabilities.

Funded status risk - Q2 2022

Equities	↓
Interest rates	↑
Credit spreads	↑

Sources: LGIM America, ICE indices and Bloomberg. Data as of June 30, 2022.

Figure 1 – Discount rates



Sources: LGIM America, ICE indices and Bloomberg. Data as of June 30, 2022.

Fixed Income

Anthony Woodside, CFA, FRM
Senior Solutions Strategist

"We argue that it is premature to get outright constructive on credit as global central banks continue their sprint towards neutral, and in some cases, restrictive policy rates at the expense of growth."

As we accelerate into the second half of the year, a cursory glance through the rear-view mirror informs us that the only constant over the last six months was, ironically, change. Indeed, the volatile backdrop has been challenging as market participants have been forced to constantly adjust their outlooks to account for an outbreak of war, disorderly moves in commodity markets and belligerent central banks. However, when sifting through the dismal returns across the investment landscape, one does not need a magnifying glass to detect inflation's fingerprints littered across the crime scene.

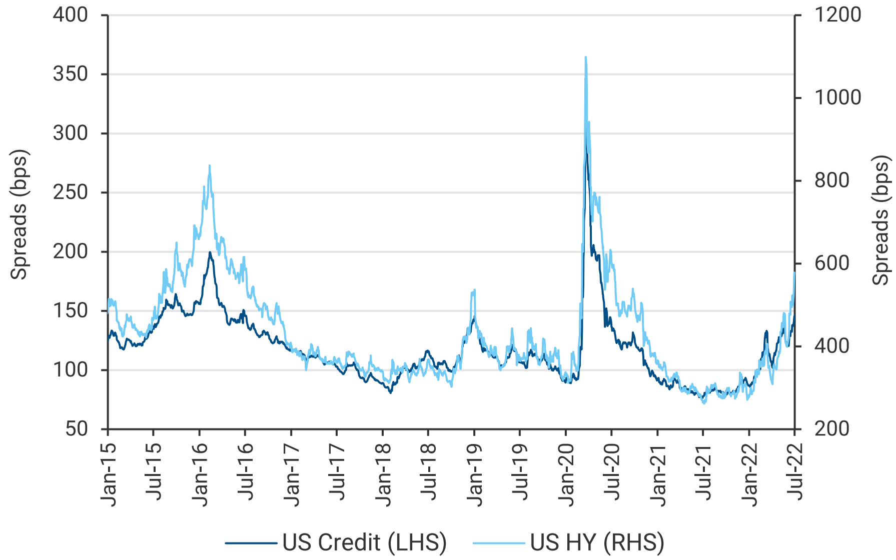
For the past twelve months, we have argued that global central banks were courting danger in maintaining emergency policy settings for a patient that was firmly on the road to recovery. With price pressures running above target across the globe, policymakers have embarked upon a synchronized withdrawal of monetary stimulus this year, ostensibly embroiled in a competition of who can hike rates at the fastest pace. However, while poor performance in fixed income in the first quarter can largely be attributed to the market revising rate hike expectations higher, as the macro section notes, the recent sell-off has been heavily influenced by burgeoning concerns that the economy will cave under the pressure of tighter policy.

Looking ahead, against a highly uncertain backdrop we identify a few key themes. First, valuations have improved substantially in 2022 (see Figures 2 & 3). In Treasuries, yields in the front-end of the curve have increased by over 200 basis points year-to-date, while intermediate and long-end maturities have seen rates rise by well over 100 basis points.[4] In corporate credit, some sectors are discounting a meaningful probability of recession. Notably, high yield spreads have eclipsed 500 basis points, which historically has led to attractive excess returns over the medium-term.[4] Meanwhile, US investment grade spreads are trading wide to long-term medians, albeit well inside recessionary levels. Given this context, we are inching closer to levels where we would shift from underweight to neutral in investment grade credit. We continue to emphasize sectors and issuers with resilient earnings and cash flow, and we favor management teams that are committed to maintaining solid balance sheet fundamentals amidst a challenging outlook.

In terms of solutions trends, many clients with glidepaths in place have capitalized on the sell-off in fixed income by increasing allocations to fixed income and locking in funded-status gains. Current bond market valuations can serve as an attractive entry point for de-risking activity, particularly if market expectations for rate cuts in 2023 prove correct. For institutional clients interested in picking up additional yield, we have seen an uptick in interest for incorporating investment grade private placements within an LDI solution to capture illiquidity premiums while benefiting from enhanced diversification and structural protections.

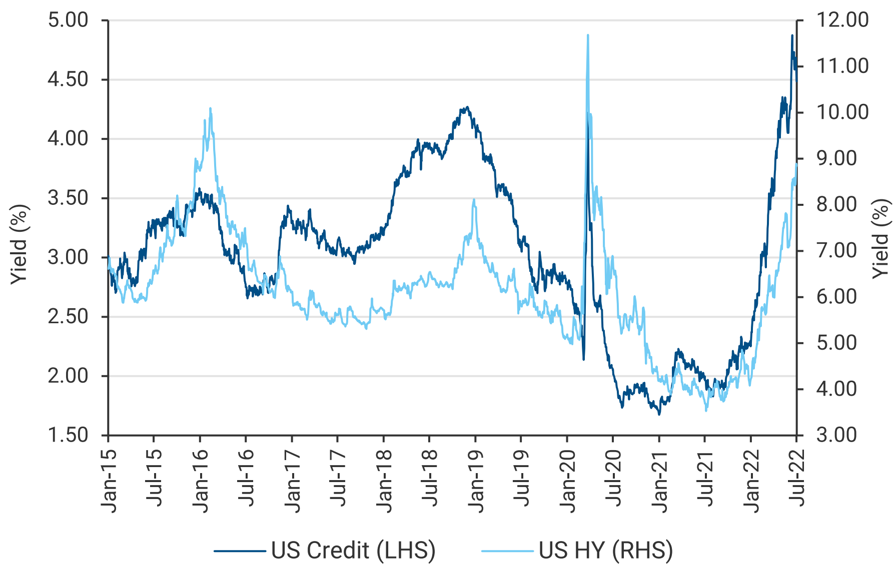
For years investors have unflinchingly subscribed to the investment axiom "Don't fight the Fed" and reaped the rewards. We believe the time has come to optimize portfolios in light of a Fed that seems intent on fighting you. Consequently, we argue that it is premature to get outright constructive on credit as global central banks continue their sprint towards neutral, and in some cases, restrictive, policy rates at the expense of growth.

Figure 2 – Investment Grade and High Yield spreads



Source: Bloomberg. Data as of June 30, 2022.

Figure 3 – All-in yields for Investment Grade and High Yield



Source: Bloomberg. Data as of June 30, 2022.

Equity Markets

Dave Chapman, CFA
Head of Multi-Asset and LDI

"Without a higher risk of a severe recession, we view current markets as already quite bearish, and, accordingly, have reduced short positions in some risk markets and taken a very tactical long position in US equity."

I filled my gas tank a few weeks ago while running errands with my family, and after watching the pump readout tick by dizzyingly, my oldest child exclaimed, "your gas cost how much!?" Inflation has pervaded the consciousness of middle schoolers, and now, as Jason previously mentioned, recession is now a dinner table conversation topic. This unpleasant family debacle is the reality television that investors and policymakers are binge watching.

Previously, we posed that the current equity drawdown is being driven by inflation directly through the impact of inflation on equity discount rates. Price declines have naturally led to multiple compression, but now our economists are also calling for a sharp decline in earnings. Applying a constant multiple to sharply lower earnings implies that there is more downside ahead, but this ignores trickier questions about further multiple compression, how much of an earnings decline there will be and, of course, timing.

Current valuations sit right around their modern average. However, multiples tend to compress even more in equity drawdowns, particularly in recessionary environments. Based on historical data analyzed from the S&P 500, multiple compression could result in an additional -10 percent to -30 percent drawdown in equity markets. Using the same historical analogues, earnings fell by 10-15 percent on average from peak to trough. However, prices tend to rebound before earnings as markets anticipate a recovery, and Goldman Sachs data shows that roughly half of the earnings decline occurs before the market bottom.[4] Taken together, these imply a further hypothetical drawdown of -15 percent to -40 percent, or approximately -30 to -50 percent from the highs, in line with experiences during the tech bubble burst and global financial crisis.

However, a market drawdown of that magnitude is more consistent with a severe recession, and our view is that a severe recession is only likely if we also experience a credit shock (i.e., a banking shock like the global financial crisis or some other factor that materially impedes consumer demand). We do not see a necessary catalyst for such an event in the near-term.

In the event of such catalyst, however, we do not anticipate a significant impulse from the options market. Equity implied volatilities remain quite elevated, yet orderly. We have not seen the violent spikes in shorter-dated volatility that would be expected in a significant correction, but rather elevated volatilities have persisted across the term structure. The endurance of these conditions has been frequently, albeit anecdotally, attributed to ongoing demand for equity protection (investors establishing new positions and those already with positions continuing to roll them out and down). This may limit the panic and additional selling that options markets can sometimes incite, and, in fact, any eventual recovery in equity markets could be well supported by the steady unwinding of long volatility positions.

Without a higher risk of a severe recession, we view current markets as already quite bearish (i.e., futures positioning, sentiment indicators, implied volatilities), and, accordingly, have reduced short positions in some risk markets and taken a very tactical long position in US equity. For clients who previously implemented equity protection strategies utilizing collars, that is being expressed by buying back the short call positions that have mostly decayed.

Rates Market

Matt Cohen
LDI Portfolio Manager

"Global central banks have entered a new regime of action centered on aggressively containing runaway inflation."

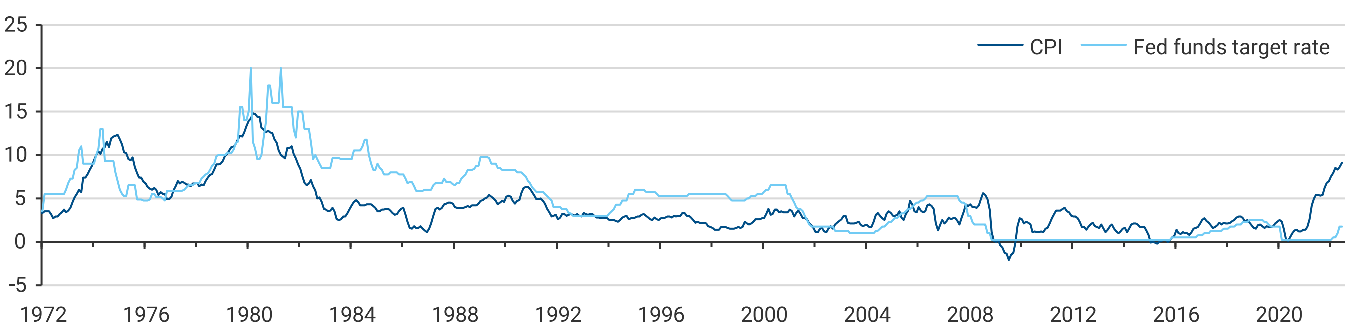
Persistent inflation and central bank actions have pushed yields to new post-COVID highs, and curves have flattened. On June 1st, the Bank of Canada raised interest rates by 50 basis points.[4] While this came as no surprise, they did state that they were prepared to act "more forcefully" if required to bring inflation under control. This would serve as a foreshadowing of what was to come for the rest of the month, as global central banks have entered a new regime of action centered on aggressively containing runaway inflation, in stark contrast to their efforts over the previous 15 years to bolster the economy and foster employment. The European Central Bank (ECB) followed suit, laying out a road map that included a 25 basis point hike in July, followed by a 50 basis point hike at the September meeting.

Then it was the US's turn. The US Consumer Price Index (CPI) surprised to the upside (8.6 percent year-over-year headline vs 8.3 percent estimated) and reached a new four decade high.[4] The front end of the US rates curve surged 25 basis points higher to 3.06 percent, its highest level since 2008.[4] Prior to this data point, it appeared that inflation may have peaked and was slowly declining, leading to competing narratives of "persistent inflation" versus "impending recession," which had helped keep rates somewhat range bound. With inflation continuing to rise, concerns over reining in inflation have prevailed. Almost as concerning, the University of Michigan Index of Consumer Sentiment plummeted to 50, signaling growing concerns among consumers.[4] Rates continued selling off into the June Federal Open Market Committee meeting, with the 2-year Treasury reaching 3.45 intraday.[4] The market had fully expected a 75 basis point hike by the time of the June meeting, and that is exactly what was delivered, which was the largest hike since 1994. The Fed accelerated the pace of hikes forecasted in their dot plot while lowering their terminal rate.

As of July 13, the US CPI once again surprised to the upside, coming in at 9.1 percent year-over-year, compared to the consensus estimate of 8.8 percent.[4] Headline inflation numbers have been steadily rising since September and each print continues to be the highest in over 40 years. The rates market has now fully priced in another 75 basis point hike at the July meeting, with a 50 percent chance of a 100 basis point hike. If the Fed raises rates by 100 basis points, which the Bank of Canada did in a surprise move in an effort to "front-load the path to higher interest rates," it will be the largest hike since 1984. The Fed has stated it is willing to accept some economic downturn in order to keep inflation at bay, but many forecast a recession looming on the horizon, possibly as soon as this year.

Futures contracts are pricing in Fed Funds to peak at 3.5 percent in the first half of 2023 before the Fed starts cutting rates lower, but CPI expectations will still be above 3.5 percent, indicating that this may be the first time the Fed does not raise their benchmark rate over the prevailing rate of inflation. The important questions are: Will the hikes be enough to keep inflation from rising further? Will these hikes send the economy spiraling into a deeper recession? Can the Fed engineer a soft landing –threading the needle between controlling inflation and avoiding a huge economic downturn? With rates currently sitting around 30 basis points below the post-COVID highs from June and no sign of inflation abating, we remain bearish on rates and expect them to move higher from these levels. We are expressing this view through short duration positions in the front end of the US Treasury curve, which we expect to the worst performer and the yield curve to flatten.

Figure 4 – Headline CPI year-over-year growth compared to Fed Funds target rate



Source: Bloomberg. Data as of July 13, 2022.

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 traditional 60/40 portfolio of 60% MSCI AC World Total Gross Index/40% Bloomberg US Aggregate Index, incorporating data sourced from LGIM America, ICE, MSCI and Bloomberg. 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. Source: Bloomberg

Disclosures

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