LGIMA's Q2 2018 Market Commentary

Focus on the macro

Robust economic growth in the US has yet to translate into capital market performance in 2018. If anything, the opposite has been the case—equity multiples are lower, credit spreads are wider, and interest rates are higher since the beginning of the year. Needless to say, it's not just the economy contributing to the malaise. In recent months, there has been no shortage of headwinds buffeting markets, from ongoing trade negotiations to renewed political tension in Europe. Moreover, a growing weight of evidence suggests that Fed policy is exaggerating downside volatility after suppressing it in past years.

Arguably, even the supportiveness of the growth backdrop is not as obvious as it first appears. High frequency data points to a pace of economic expansion near 4% during the second quarter, but increasingly the US looks like the lone bright spot on the global stage. European growth has moderated from the relatively rapid pace of late 2017, while credit creation in China has slowed to such a degree that the People's Bank of China has recently needed to inject liquidity into the banking system. In short, global growth looks far less synchronized today than it did at the beginning of the year.

The outperformance of the US is proving particularly problematic for an expanding list of emerging market countries. The combination of a stronger dollar, higher oil prices, and Fed hikes is putting pressure on countries dependent on external financing. As capital flows reverse and currencies weaken, the risk of 'stagflation' is growing in Emerging Markets, and thus, the prospect of more disjointed global growth going forward. And that is before the effects of ongoing trade negotiations are taken into account.

While the political aspects may be more important than the economics, escalating trade tensions likely pose the biggest risk to global growth in the near term. The tit-for-tat tariffs announced so far by the US and its trading partners are unlikely to have a material impact on growth, provided some sort of détente can be reached. Unfortunately, negotiations seem to have stalled on multiple fronts, with the US midterms and Mexican Presidential elections at least partly to blame. That being said, the possibility that tariffs end up lower over a longer horizon should not be discounted, even as the near-term path to such an outcome is less obvious.

Likewise, as intractable as the situation may appear, past precedent suggests that the potential for a resolution to Europe's resurgent political crisis should not be underestimated. Still, the newly elected populist government in Italy and growing dissatisfaction within EU rules regarding asylum seekers look likely to continue to test market patience in the coming quarters, particularly without a commitment from the European Central Bank (ECB) to "do whatever it takes." Indeed, the forthcoming end to ECB asset purchases is quite clearly weighing on the government debt of Southern Europe.

Amidst such a challenging global macroeconomic backdrop, it is perhaps surprising then to see a resurgence of M&A among US companies. Dealmaking was already off to a record-setting start this year, even before the Department of Justice lost the case to block AT&T's acquisition of Time Warner Inc. Afterward, a further acceleration seems inevitable. The Comcast-Disney bidding war for Fox's non-news assets is illustrative of an atmosphere where companies are newly emboldened and more than willing to sacrifice their balance sheet—and in many cases equity market cap—in pursuit of a strategic target. The fact that earnings growth has surprised to the upside this year is of little mitigating comfort.

For the Fed, corporate frothiness this year is an unwelcome development from a financial stability perspective, but the struggles of capital markets this year suit the objectives of a central bank looking to gradually tighten policy. The fact remains that the Fed has hiked five times since the beginning of 2017, yet financial conditions are still significantly easier than 18 months ago. Part of the problem is that the yield curve continues to flatten as the Fed raises rates, which thereby diminishes each hike's economic impact on the real economy. Consequently, if the long end of the yield curve remains uncooperative, then credit spreads, equities, and the dollar will need to continue to do the tightening instead.

Focus on fixed income

Fixed income markets continued to underperform in the second quarter, as poor technicals and strong economic data contributed to an environment of wider investment grade credit spreads and upward pressure on risk-free yields. While 10-year Treasuries were only 10 basis points higher over the period versus 40 basis points in the first quarter, the 13 basis points of widening in the spread of the Bloomberg Barclays Credit Index would normally be associated with a rally in rates. Instead, it appears that Fed's once-a-quarter pace of rate hikes have substantially weakened demand for fixed income at a time when supply is growing due to an expanded deficit, an increase in debt-financed M&A, and less central bank buying.

The outperformance of high yield in the current environment is further evidence that the technicals are in the driver's seat. Despite investment grade spreads being 26 basis points wider year-to-date, the OAS of the Bank of America High Yield Index is just 8 basis points wider. While there are a variety of contributing factors, the short duration nature of high yield (duration of just four years) combined with the fact that supply is down roughly 20% this year (versus roughly flat in investment grade) seem to be the most obvious reasons for the outperformance. Even within investment grade credit, longer maturity bonds are underperforming with the Bloomberg Barclays Long Duration Credit Index 36 basis points wider this year—10 basis points more than the full market credit index.

Not surprisingly then, securitized products significantly outperformed credit during the quarter due to the high quality short duration nature of the asset class. Agency mortgage and AAA ABS tightened one basis point while commercial mortgage-backed securities widened three basis points. Agency MBS and AAA ABS continue to garner support as a safe haven in risk off markets.

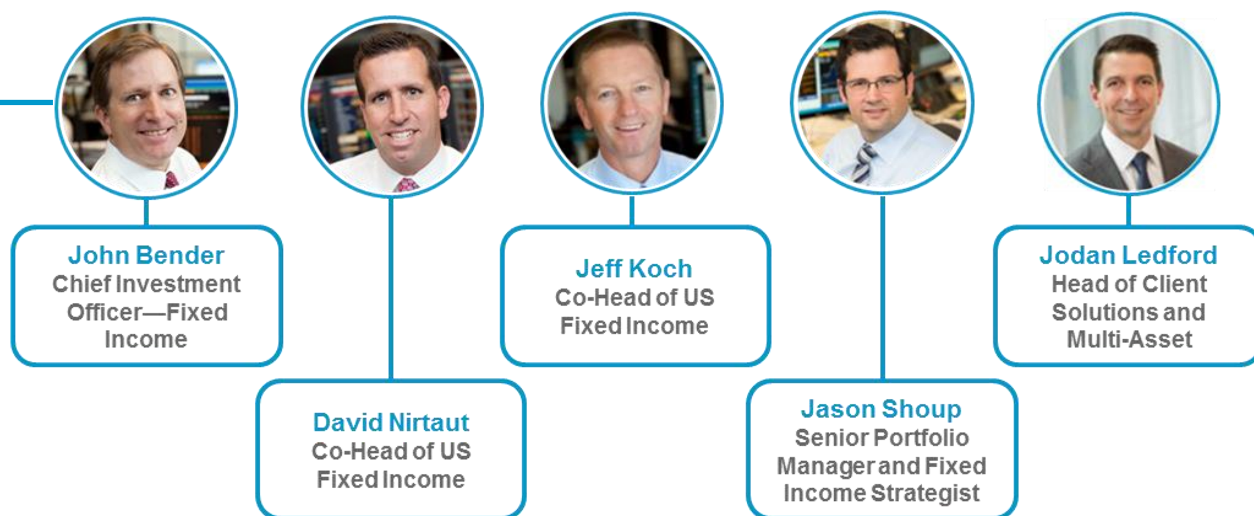
For credit portfolios, the steady underperformance of credit does not alone justify a more constructive stance. While credit spreads are back to early 2017 levels, credit on an absolute basis is still much closer to the post-crisis tights than the wides. As such, we remain cautiously positioned with an above average allocation to Treasuries, and are likely to remain conservatively positioned until the supply-demand technicals improve. In general, we continue to favor financials over non-financials given the acceleration in M&A activity this year; however, we have reduced the overweight on the bank sector modestly given the underperformance of the sector so far in 2018.

Focus on client solutions

US corporate defined benefit pension plans saw pension funding ratios rise over the second quarter of 2018. Pension funding ratios increased over the quarter primarily due to the increase in plan discount rates along with positive equity performance. Global equity markets increased by 0.79% and the S&P 500 increased 3.43%. Plan discount rates increased by 24 basis points, as Treasury rates increased 4 basis points and credit spreads widened 20 basis points. Overall, liabilities for the average plan fell 2.17%, while plan assets with a traditional "60/40" asset allocation increased 0.41%, resulting in a 2.3% increase in funding ratios over the second quarter of 2018.

We continue to see an uptick in demand for more customized strategies in Q2 2018. The trend of clients making contributions to their plans and/or exploring pension risk transfers to insurance companies has continued from Q1. Completion management and option-based strategies remain in high demand, as clients continue to move assets into fixed income and synthetically replicate equity exposure. Additionally, we have also seen an increase in the demand for custom credit strategies, particularly from plans focusing on a pension risk transfer or self-sufficiency strategies.

Contributors



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