LGIMA's Q3 2018 Market Commentary

Focus on the macro

After a disappointing start to the year, capital markets finally appear to be responding to the recent acceleration in the rate of US growth. In what was a decidedly risk-on third-quarter: high-grade credit spreads retraced much of their first-half widening; US equities posted the strongest three-month return in five years; and the yield on 10-year Treasuries rose to a seven-year high. More than anything, the rebound in risk sentiment is particularly impressive in light of elevated political and emerging market risk. Can the momentum be sustained through year-end and into 2019?

It would seem that the continued resilience of markets is likely to be determined largely by the sustainability of US growth. In that respect, the second-quarter's 4.2% GDP report—while remarkable nine years into an expansion—may be of less importance to the outlook for risk assets than the revisions released alongside it. The large upward adjustment to the savings rate, for instance, suggests households are not as overstretched and vulnerable to a pullback as previously thought. Similarly, estimates of the neutral real rate keep climbing higher, implying the Fed has more room to hike before short-term rates enter territory restrictive to growth.

Said differently, the performance of the economy is yet to validate either the Keynesians or the supply-siders. On the one hand, the higher consumption and business investment numbers suggest tax reform is responsible for a significant portion of the growth acceleration this year, which likely means growth will revert back to trend near the middle of 2019. On the other hand, there is little indication that fiscal stimulus delivered at a time of full employment is overheating the labor market. With average hourly earnings increasing 2.8% year-on-year, the Phillips curve still looks depressed relative to past cycles and broader measures of inflation appear well anchored. What is more, the improvement in productivity and looser bank lending conditions could lift trend growth and prolong the expansion into 2020.

From the perspective of the Fed, the performance of the economy in conjunction with the third-quarter bounce back in markets makes it increasingly difficult to deviate from the once-per-quarter pace of hikes. An interesting question is whether the Fed might nevertheless need to end quantitative tightening earlier than expected and perhaps compensate by hiking rates more quickly. There are two issues that the Fed will need to discuss with respect to its balance sheet: (1) the slow pace of mortgage debt run-off relative to Treasuries, and (2) indications that an elevated level of reserves will be required to ensure a well-functioning overnight rates market. For a process that has been described as exciting as watching paint dry, balance sheet runoff looks as if it will be an added source of uncertainty for markets in the months ahead.

Just the same, the improvement in the US economy has not been matched by a decrease in geopolitical risk. If anything, capital markets have performed well as the risks to the economy from trade tariffs, emerging markets, and Italian populists have grown. Relative to just a few months ago, it now looks more probable that the US will impose tariffs of 25% on nearly all Chinese imports in 2019 just as evidence of a broad based slowdown in the Chinese economy is becoming more apparent. And in Italy, a high-stakes budget confrontation looks all but unavoidable between the country's populist government and the EU.

It is in this respect that the performance of the US relative to the rest of the world raises the most questions going forward. With European and Asian debt and equity markets lagging their US counterparts and seemingly pricing-in a higher

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degree of macro-economic uncertainty, the prospect of convergence over a longer-term horizon is a cause for worry. Likewise, while the US is a relatively closed economy, it is nevertheless a risk that US growth is dragged lower by weakness elsewhere with the dollar the most likely transmission mechanism. Of course, convergence need not be negative for the US if the rest of the world were to gradually catch up. But at the very least, it would not be a surprise if the outperformance of US markets were to slow in the months and year ahead.

Focus on fixed income

For as weak as the investment-grade credit market has felt at times during 2018, after rallying in the third quarter, the US credit and the US long credit indices are within 1 basis point of the levels which they were trading heading into the fourth quarter of 2017. Such performance leaves the US credit markets well ahead of their non-dollar equivalents, which generally widened in conjunction with the US earlier this year but have failed to participate in the recovery. A lower pace of issuance and higher Treasury yields seem to be the obvious drivers of US credit's outperformance. With foreign exchange hedging costs continuing to rise, higher rates are necessary to maintain foreign demand for credit.

Not surprisingly, the lower-beta securitized product sectors significantly underperformed credit during the quarter given the risk on environment. Agency mortgages were flat during the quarter while AAA ABS and CMBS both reversed their respective second quarter widening by tightening 10 basis points. In light of the steady upward movement in front-end interest rates, there was significant demand for higher yielding shorter-dated cash flows during the third quarter in non-agency securitized markets.

For credit portfolios, the relatively sizable rally in credit spreads over the past three months has been more differentiated than might have been expected. For a start, the premium for owning illiquid versus liquid bonds appears to be increasing after years of steady compression. Somewhat logically, investors appear to be more sensitive to the risk of owning bonds that cannot be easily sold as the credit cycle ages. Similarly, sector dispersion has grown relative to a year ago even though the overall spread of the credit indices is unchanged. Deleveraging sectors such as telecom, technology, and energy are being rewarded while the consumer, manufacturing, and quasi-sovereign sectors are underperforming. In LGIMA portfolios, we remain overweight liquid bonds, and in recent months have decreased exposure to non-US domiciled names.

Focus on client solutions

The third quarter displayed further increases in funding ratios for US corporate defined benefit pension plans. The uptick in Q3 for pension funding ratios can be generally attributed to the strong performance of global equities, as they increased 4.4% over the previous three months. Overall, plan assets with a traditional "60/40" asset allocation increased 2.6%, resulting in the average funding ratio amounting to 91.5%, up 1.8% from Q2 2018. LGIMA also anticipates further funding ratio gains from tax reform driven plan sponsor contributions, which will be disclosed in company filings (and subsequently reflected in this report) in the coming months.

We continue to see an uptick in demand for more customized strategies to help hedge interest rate risk and lock in funding ratio gains. Completion management and multi-asset hedging strategies remain in high demand. More customized credit strategies have also continued to be popular this year as plans de-risking objectives have evolved further.

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