LGIMA's Q1 2018 Market Commentary

Focus on the macro

If the first three months of the year prove to be any indication, markets in 2018 are unlikely to resemble 2017 all that much. The most dramatic departure from last year seems to be to the technical backdrop, in which quantitative easing contributed to excess demand for US fixed income and unusually low equity volatility. Yet, that is by no means the only difference; fundamental trends look like they may improve somewhat due to tax reform this year, while politics are becoming a larger headwind to markets. Ironically, this year may end up the exact reverse of last year - weaker demand for risk assets including fixed income, heightened political risk, but better economic growth and corporate results.

For investors grown accustomed to operating with a central bank backstop, the rapid increase in equity volatility during the first quarter is a sign that the transition back to fundamentally-driven markets has begun. Likewise, what is happening in the fixed income markets also appears strongly connected to the ever diminishing role of central banks. As the supply of US government bonds has accelerated, higher real rates have been required to attract foreign demand for Treasuries. Meanwhile, credit spreads are widening despite this year's 15% reduction in corporate bond issuance.

To some degree, the change to risk appetite was an inevitable outcome of current Fed policy that is once again making cash competitive as an asset class. Yet, just the same, it is clear that the law of unintended consequences is at work, particularly as it relates to tax reform, fiscal stimulus, and ongoing balance sheet normalization. Few Fed officials likely would have anticipated the speed of 3 month LIBOR's rise or the widening in 1-3 year corporate bond spreads during the quarter. Last year, buoyant markets contributed to loose financial conditions, but as the Fed continues to hike rates into territory restrictive for economic growth, the risk increases that markets will get ahead of the Fed and dent economic growth.

Just as importantly, the widening in measures such as LIBOR-OIS are a reminder of how stress in short-term funding markets remains a risk nine years after the credit crisis. While most of the pre-crisis "carry" trades are gone, many foreign investors buy longer-dated US fixed income funded with 3 month rolling FX contracts. The steady rise in the cost of these derivatives is a major reason why demand for US fixed income market has deteriorated.

In contrast to the technical challenges, economic growth and corporate fundamentals look less likely to develop into near-term headwinds for markets largely thanks to fiscal stimulus. Despite a softening in recent economic data, US GDP should enjoy an uplift of 0.5-0.75% as a result of the tax bill and expanded federal budget. Likewise, the lower effective tax rate will provide an earnings cushion for the next year before analyst attention returns to organic performance.

For credit investors in particular, tax reform is proving to be more beneficial than first anticipated as a non-negligible number of companies are choosing to repay debt, increase capital expenditures, or make larger pension contributions rather than simply pass the tax savings along to shareholders. Indeed, much of the telecom sector's underperformance in 2017 has reversed on the back of the sector's post-tax reform commitment to accelerate deleveraging plans.

If there is a negative development to the fundamental picture this year, it is the increase in aggressive M&A activity after the lull of the last two years. The consolidation going on between managed care providers, pharmacy benefit managers, and pharmacy operators is just one

example of an emerging trend toward deals with greater integration risk and away from transactions predicated on cost synergies.

Finally, US political risk seems to have veered off course from last year as well. After succeeding with tax reform, the administration is now transitioning to issues—like trade—that can be addressed through executive action, but tend to be less market friendly. As a result, markets are likely to see far less upside from political developments this year, and far greater downside in the event of a full blown trade war.

What is important about the past three months for investors is not just that last year's script has been flipped so completely, but that uncertainty is on the rise, and likely to continue. As such, weaker technicals and increased political risk likely argue for more nimble and defensive portfolios - or in trader lingo, it's no longer "buy the dip", but "sell the rip".

Focus on fixed income

As selloffs go, it is tempting to dismiss the 13 basis point pullback in the Bloomberg Barclays US Credit Index during the first quarter as a relatively modest correction, particularly given the Index began the year at a post-crisis low of just 89 basis points. But while the current level of the Index may remain on the tight side, 1Q18 nevertheless registers as the worst quarterly performance for the last two-and-a-half years, and seems to represent a transition to a more volatile regime. That being said, the Long Credit Index marginally outperformed, widening less than 10 basis points, as pension flows continue to provide incremental stability to long spreads.

For their part, securitized sectors were not immune to the sell-off in credit during the quarter, but outperformed given their higher quality collateral. Agency mortgage spreads widened 4 basis points as continued expectations of higher near term interest rates continue to pressure the market. Elsewhere, investment grade CMBS widened 5 basis points and AAA ABS widened 12 basis points, as robust issuance in both sectors weighed on spreads.

In contrast, US 10-year Treasuries have traded in a remarkably tight range just below 3% after January's 40 basis point move higher. More than anything, the surprise in the US rates markets has been the stubborn resistance to the sort of flight-to-quality rallies that typically accompany an increase in equity volatility.

For credit portfolios, the combination of weak technicals, benign corporate fundamentals, and increased M&A risk favors targeted overweights among higher-beta credits, and vigilance when it comes to exiting tighter trading credits with asymmetrically skewed risk-reward. Tactically, we have gravitated to a more conservatively positioned portfolio with a higher than typical Treasury position. With new issue concessions growing and relative value trading opportunities more numerous, maintaining a less than fully invested portfolio creates flexibility to capitalize on an improved environment for alpha creation.

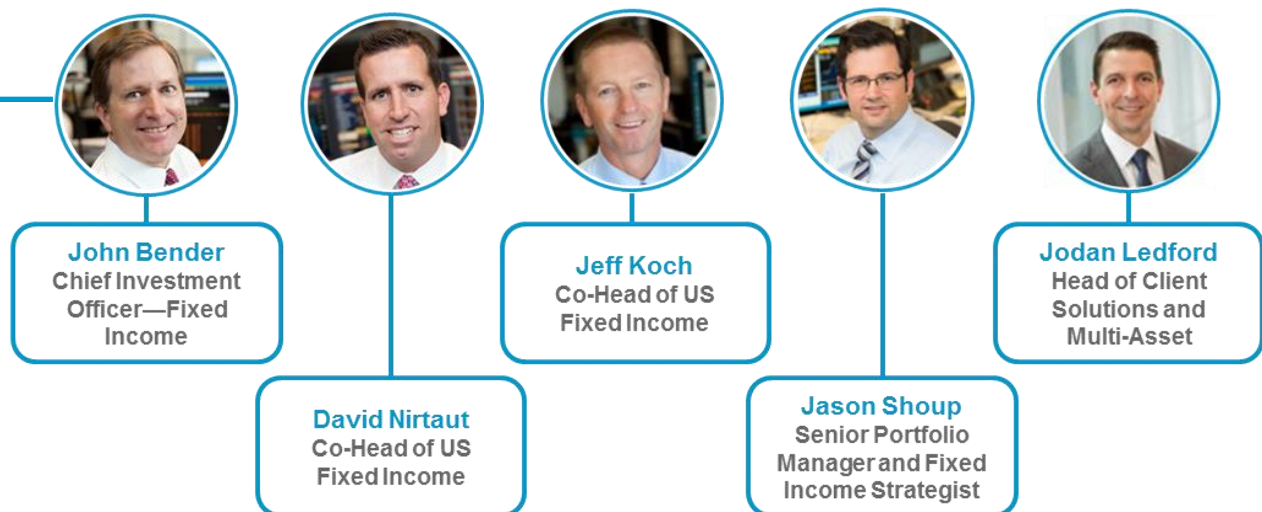
Focus on client solutions

US corporate defined benefit pension plans saw pension funding ratios rise over the first quarter of 2018. Pension funding ratios increased over the quarter primarily due to the significant increase in plan discount rates. Global equity markets decreased by 1.75% and the S&P 500 decreased 2.11%. However, this was offset by plan discount rates rising 44 basis points, as Treasury rates increased by 30 basis points and credit spreads widened by 14 basis points. Overall, liabilities for the average plan fell 5.07%, while plan assets with a traditional "60/40" asset allocation only decreased 1.55%, resulting in a 3.1% increase in funding ratios over the first quarter of 2018.

Q1 2018 brought on an uptick in demand for more customized strategies to help hedge interest rate risk and lock in funding ratio gains after benefitting from an increase in discount rates. We are also seeing many clients make contributions to their plans and/or exit their liability obligations through lump sums and pension risk transfers to insurance companies, given the tax reform and PBGC premium backdrop. A key objective is to manage these

changing investment exposures and transitions efficiently. Liability benchmarking, completion management, and option-based hedging strategies remain in high demand. Additionally, there has been 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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