LGIMA’s Q1 2020 Market Commentary

Focus on the macro

After a dreadful month spent watching COVID-19 spread worldwide, there are still more questions than answers when it comes to the impact on the global economy, financial markets and society in general. The good news is that policymakers have been quick to respond compared to past experiences. The U.S. Congress managed to pass a bipartisan fiscal package that exceeds $2 trillion in the short space of a few weeks while the Federal Reserve re-introduced nearly all their crisis-era programs from 2008 and expanded the asset purchase program to include investment-grade corporate bonds for the first time. Yet there is no modern-day precedent for what a recovery from a pandemic of the current magnitude looks like. Time will tell if efforts to contain the virus are successful, but until then there remains a wide range of plausible economic outcomes over the next few months.

A lot of attention among economists is now focused on the timing and “shape” of the recovery. With uncertainty so high, one can envision a recovery in the second half of 2020 that might resemble a “V”, “U”, “W”, or even an “L” in a worst-case scenario. However, one thing is becoming clear: the economic contraction will be deep and will exceed the global financial crisis. Consider that roughly 10 million Americans have filed unemployment claims so far and there is ample evidence to suggest that number is understated and will continue to grow in the coming weeks. Given that the U.S. workforce is approximately 157 million, that means the real-time unemployment rate of the U.S. economy is already at about 10%, which is where it peaked in the fourth quarter of 2009. Likewise, the drop in second-quarter U.S. GDP with so many parts of the economy shut down could be anywhere from 25-40% on an annualized basis; in the fourth-quarter of 2008, GDP contracted just over 8%.

In some sense, the depth of the contraction may not matter much if the recession’s duration is short and the bounce back in economic activity quick. Certainly, the benefits provided in the stimulus bill incentivize many workers to file jobless claims, but if those workers rapidly regain their same jobs as the economy reopens then the unemployment rate may fall nearly as quickly as it is rising right now. For such a “V” shaped scenario to transpire then efforts to contain the spread of the virus need to prove successful so that stay-at-home measures can be eased heading into the summer and businesses can reopen. Furthermore, the economic impact of seasonal outbreaks—if there are any—must be mitigated by a combination of testing and treatment in the absence of a vaccine. Finally, the fiscal stimulus being rolled out by the U.S. and other countries needs to be sufficient to cover a high percentage of worker income lost during the shutdown phase and provide stimulus during the recovery. Nevertheless, this best-case scenario would still likely translate into global growth contracting 3% or so in 2020 before rebounding in 2021.

Alternatively, failure to contain the spread of the virus or to provide adequate bridge support to individuals and businesses during the shutdown could result in an economic outcome that resembles The Great Depression. While China and other Asian countries would seem to offer a

template that suggests economies can return to normal after new virus cases dissipate, there are also reports of resurgent outbreaks which could precipitate another round of quarantines. As such, the crucial question underlying the outlook is whether economic activity will continually be disrupted by the virus throughout 2020 and if fiscal stimulus can stay the course. In an environment where businesses are unable to reopen swiftly, the unemployment rate will remain high and it is difficult to imagine that global growth returns to normal until the end of 2021. The worst-case outcome would be if policymakers balk at adding to already massive deficits and bankruptcies undermine confidence.

After years of central banks providing extraordinary support to the global economy, it is evident the burden is now on fiscal stimulus to limit the damage from COVID-19. Frankly, it is difficult to see how the Federal Reserve—for one—could do significantly more than it has announced. For sure, the Fed could expand their purchases to an even broader range of securities if they felt it necessary, but in making their quantitative easing program unlimited the Fed is essentially monetizing the debt issued to fund the fiscal stimulus legislation—a truly groundbreaking development. Likewise, the Fed is showing a remarkable commitment to addressing liquidity challenges by expanding the dollar swap lines with the other major central banks and setting up programs to purchase investment grade corporate bonds in primary and secondary markets. There is still plenty of solvency risk to confront as the shutdown persists, but the Fed programs ensure there will be ample liquidity for foreign banks and high-quality companies.

Not surprisingly, there has been an improvement in dollar funding conditions, Treasury market liquidity, and corporate bond markets as a result of the intervention by the Fed. Yet there is scope for more normalization. Libor remains unusually elevated at levels above 100 basis points while the Fed funds rate is set near zero; off-the-run Treasury bonds still trade with punitive bid-offer; and until very recently short-dated investment grade bonds traded at wider spreads than longer-dated bonds. Still, financial conditions are much better than they were in mid-March and there is no better example than the investment-grade primary markets. Over the course of March, investment grade corporates were able to issue more than $260 billion in debt, as many companies raised funds to term out commercial paper facilities and bolster liquidity. As such, March set the record for the heaviest month of issuance ever.

One criticism of the Federal Reserve's response to the COVID-19 crisis is that the programs being rolled out create winners and losers. For instance, the Fed is willing to support investment-grade corporates but not high-yield and leveraged-loan issuers. Similarly, the Fed is backstopping the commercial paper market and buying agency MBS but not CMBS or CLOs. Rightly or wrongly, the Fed programs would seem to increase dispersion within fixed income markets. In the credit markets, these dynamics highlight the valuation risks that can arise due to downgrades. Currently, the consensus is for $200-250 billion of investment-grade bonds to fall to high yield, of which nearly $150 billion has already occurred. Yet in a scenario where economies struggle to return to work this summer and oil prices remain below $30 for the next year, there is scope for an additional $350-400 billion of fallen angels.

From an investment perspective, the most straightforward trade right now is to buy what the Fed is buying that still looks "cheap". At a spread of 260 basis points, the U.S. Investment Grade Credit Index has only been wider during the financial crisis when banks were at risk of failing and the Fed was just beginning to craft the extraordinary policy response that would come to define the following 10 years. While the COVID-19 crisis entails a more severe economic recession than in

2008 and it is uncertain whether economic activity quickly will bounce back, the speed of the policymaker response and the Fed's willingness to buy corporate bonds should put a ceiling on how wide credit spreads can go. The more difficult decision is whether to buy high yield or equities at current valuations. In the past, quantitative easing has been broadly supportive of all risk asset classes, but until the outlook for the virus becomes clearer it is likely investors remain reticent to move down the risk spectrum.

Focus on fixed income

If there is one feature to the COVID-19 crisis that is truly unprecedented, it is the speed with which economic activity ground to a halt, markets sold off, and policymakers responded. In credit markets, the pace of spread widening up until the Fed's announcement that it would buy corporate bonds was simply ferocious as it took less than two weeks for credit spreads to widen out to levels consistent with a recession, which is roughly 6-10 times faster than any other observed sell-off. The U.S. Investment Grade Index entered the year within spitting distance of the post-crisis tights at 90 basis points, widened to a peak of 341 basis points mid-March, and closed the quarter more than 75 basis points off the wides at 265 basis points.

While the abruptness of the market sell-off certainly reflects the unique nature of a global pandemic, it is likely that some of the market moves were exacerbated by the unwinding of certain strategies. Risk-parity strategies have not fared well throughout the volatility with equities declining and Treasury yields sometimes rising in a very uncorrelated way. It is likely that many of the funds following these strategies were forced to delever during March and as a result exacerbated the volatility in equity and fixed income markets before the Fed stepped in to intervene. At this point, it would seem that the bulk of the selling pressure in government rates is passed and yields now more truly reflect underlying economic sentiment. At a yield of 0.7%, the U.S. 10-year has declined 122 basis points this year as it crossed 1% for the first time in history.

Structured products were spared the original speed of the corporate sell-off, outperforming in the first two weeks of March before illiquidity in the market moved spreads into a brief moment of crisis level. A combination of re-allocation, redemption flows and margin calls drove forced sellers in prime assets. This had a ripple affect across the entire structured complex, with AAA CMBS LCF widening to over the +300a, and AAA 2-year prime auto and AAA credit cards moving even more into the +400a. The announcement of TALF 2.0 – a GFC era program to support AAA issuance of consumer ABS – as well as support in the broader investment grade universe helped provide a backstop to some of these asset classes. Spreads in in prime ABS and AAA CMBS have corrected to >100 basis points and >200 basis points respectively. Bifurcation in the market still exists, with distressed levels remaining in AAA single asset/single borrower CMBS, CLOs, and down the stack ABS. The Structured Finance Association (SFA) has proposed a list of recommended changes to the TALF program, including the purchase of non-AAA securities, the purchase of secondary market securities and the purchase of assets such as RMBS, private label CMBS and esoteric ABS that were not involved in the original 2008 program. While market sentiment around some or all of the recommendations being implemented is positive, we remain cautious in the Fed rescuing the entire sector at the moment. We continue to favor up in quality, short, prime ABS, and look for selective opportunities to add short AAA, high quality single asset/single borrower CMBS at attractive levels when possible.

In the credit markets, the case for buying investment grade credit looks strong with the Fed now an active participant. At LGIMA, we continue to add risk in-line with our recently-upgraded short-

and long-term outlook scores (+1 on our -3 to +3 scale). The purchases being made are almost exclusively via the primary market as highly-rated companies in defensive industries have been bringing bond deals with concessions of 20-40 basis points. In recent weeks, LGIMA has added A-rated exposure in the cable, utilities, technology, food & beverage, financials and transportation sectors. On the opposite side, LGIMA continues to actively reduce exposure to credits that are not expected to fare well in a prolonged economic downturn, particularly with WTI oil at $20. These issuers primarily consist of BBB-rated credits across energy, autos, aerospace and life insurance.

Focus on client solutions

Clients faced an unprecedented market climate during the first quarter of 2020, as volatility spiked on the back of a diverse news cycle. As the year began, equity prices exhibited strong performance, credit spreads were extremely tight and rates were trending downwards. In January, tensions between the U.S. and Iran increased significantly, the U.K. finally Brexited and trade tensions between the U.S. and China were relatively elevated. February was engulfed in technological disasters in the political realm, while COVID-19 began to spread throughout China, causing their economy to essentially shut down. March saw an oil price war and the global spread of COVID-19 causing many countries to take extreme measures to fight the spread of the virus.

The benefits of hedging interest rate and credit spread risk were extremely valuable during this period, as interest rates fell 109 basis points and spreads widened 116 basis points. The overall impact on liability values was negligible, as the spread widening essentially counteracted the decrease in interest rates; both of which inherently alter plan discount rates. However, from a risk basis, significant volatility was experienced due to the decoupling movement in interest rates and credit spreads. The asset side also experienced elevated volatility, especially for plans with a sizeable allocation to equities. Our estimate of funding ratios for the average pension plan (60% global equities/40% aggregate fixed income) was ~73.5% at the end of March. This is ~9.7% lower than our estimates for the beginning of 2020.

While market dynamics throughout 2019 offered strong incentives for sponsors to contribute or continue to de-risk their pension plans, the first quarter of 2020 has highlighted the importance of risk management in the context of designing a pension plan's investment strategy. Although long-term asset allocation decisions are unique to each plan, thoughtful interest rate, credit spread and equity hedging can provide positive funding ratio outcomes in a variety of environments.

On the heels of this elevated market volatility, we are seeing clients continue to look for ways to mitigate risk within their plan. Separating the decision to hedge interest rate exposure and credit spread exposure can lead to better funded status outcomes, and this quarter has demonstrated the importance of doing so. Hedging more interest rate risk through a completion framework, as well as avoiding defaults and downgrades through active credit management, are examples of attractive management strategies in such volatile markets. In fact, this can be seen when you compare the sample plan performance above with a more deliberately hedged plan. For example, a plan that had a 40% fixed income allocation with a higher duration (13% Long Credit, 27% STRIPs 15+) would have had a decrease in funded status of 5.2% compared to 9.7% over the quarter.

On the equity side, clients have continued to look for ways to reduce equity risk. Downside protection strategies, employing overlays and tactical option strategies have helped clients mitigate both short and medium-term tail risks during these unprecedented times. Full plan completion management has also become incrementally popular, as plans look to keep their

strategic asset allocation in line on a total exposure, volatility, or factor basis. Specifically, synthetic rebalancing can provide opportunities during times of high volatility. Recent market movements resulted in many plans being underweight their desired equity exposure. Where appropriate, we have used equity total return swaps that were priced at attractive levels to rebalance a plan's asset allocation, avoiding the high transaction costs of selling physical assets. Cost savings achieved were in the range of 25 basis points to 125 basis points of the exposure transacted, compared to rebalancing using physical assets.

Lastly, liquidity management has increasingly become a topic of discussion for many clients, as March illustrated elevated liquidity constraints in the fixed income market. At one point, actively traded investment grade bonds – which traded at a bid-ask spread of 8 basis points to start the year – were trading at spreads three times that level (assuming there was a buyer for the position). The assessment of thoughtful rebalancing via the use of total return swaps or other forms of synthetic exposure, can help mitigate liquidity constraints as they arise during times of market turmoil.

Contributors

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