

# LGIMA's Q3 2019 Market Commentary



## Focus on the macro

Far more than usual, politics now look set to play a prominent role in defining the direction of markets over the coming months. At the top of the list of potentially market-moving political events are the ongoing US-China trade war, Brexit, and next year's presidential election. As unpredictable as each is likely to be over the coming months, the real challenge for investors is that political risk is being reflected unevenly in markets. While interest rates are sharply lower than where they were at mid-year, credit and equity investors still appear surprisingly sanguine with valuations only modestly below July levels. The key question would seem to be when, if at all, risk markets might take notice of the disconnect, particularly with widely-followed measures of political uncertainty at six-year highs.

The ability of risk markets to ignore such an uncertain political backdrop is likely in part attributable to the resiliency of the US economy to the slump in global manufacturing activity this year. Two-thirds of the world's manufacturing surveys are in contractionary territory with the US survey at a 10-year low. Yet, risk markets continue to derive confidence from the fact that there is little evidence of any spillover to the services side of the economy or consumer confidence. In fact, US consumers appear to be in remarkably good shape to weather the trade war with average hourly earnings rising, interest rates near the lows of the year, and savings rates elevated. As such, the base case envisions US growth stabilizing at a trend rate of 1.5-2% while global growth continues to be under pressure from weak trade.

For credit and equity markets, an obvious risk is that the resiliency of the US economy fades in the coming months

as the China-US trade war defies an easy resolution and continues to result in tit-for-tat escalation. As it is, the fourth round of tariffs—set to come into force before year end—are likely to test the US economy to a greater degree than the previous three rounds. As the Chinese goods to be targeted are mainly consumer-oriented ones that were previously excluded from tariffs, there is greater risk that confidence dips and consumers retrench. Even now, there are growing concerns that consumer confidence is showing signs of deterioration—admittedly from sky-high levels.

Companies are just as susceptible, if not more so, to a political shock from trade, Brexit, or the rise of a less business-friendly candidate for president. One way that political risk is manifesting itself currently is via the dollar, which continues to appreciate as an offset to the increase in tariffs and related outperformance of the US economy. If dollar strength continues, it is likely to result in a large drag on earnings going forward at a time when earnings growth is already on the cusp of turning negative. Likewise, for companies in the managed care, pharma, technology, energy, and banking sectors (40% of the credit market), the presidential elections and impeachment proceedings are a major concern should the election odds of a more progressive candidate increase.

The critical question is how companies react to mounting political headwinds. At what point does corporate America cut capex and lay off workers? At the moment, businesses do not yet seem to be in belt-tightening mode. Capex spending this year has been weak, but in line with the deceleration in earnings growth. Meanwhile, there is little sign of imminent layoffs. Many companies will likely

think twice before preemptively reducing their workforce as the cost to replace labor in a tight market is high. As a result, the risk is that companies wait to become more defensive but then do so quickly as political uncertainty accumulates. It is this potential for a self-fulfilling loss of confidence that makes the outlook so difficult to assess when political risk is elevated.

To their credit, the Fed has shown a willingness to ease monetary policy in order to sustain the expansion in light of the policy risks facing the economy. How much more support they can provide is up for debate. After the Fed's two 25 basis point "insurance cuts" over the summer, it would seem that there is limited scope for a further reduction in policy rates before investors conclude the Fed is embarking on a prolonged easing cycle that is indicative of a much weaker growth trajectory. As such, it is unlikely that further cuts provide much support to markets. Ironically, it may be the response to the recent turmoil in repo markets that ends up supporting markets more directly. The Fed could conclude it needs to once again expand the balance sheet to ensure adequate excess reserves within the financial system. Such a move would look a lot like quantitative easing, albeit with a lower monthly purchase amount.

Ultimately, it is very difficult for central banks to set monetary policy appropriately when the outlook is dominated by downside political risks. A recent op-ed by Bill Dudley, the former President of the New York Fed, suggested the Fed should more explicitly incorporate the potential for political decisions to interfere with achieving the Fed's dual mandate and tactically refuse to support such policies. Leaving aside the topic of whether such a course of action would threaten the Fed's independence, it is likely that equity and credit valuations would not be as elevated as they are right now had the Fed refrained from cutting rates earlier this year as Dudley might have recommended. In that sort of scenario investors might be unhappy with lower asset prices, but the silver lining would be a far less binary and more symmetric outlook than the one markets currently face.

## Focus on fixed income

Risk free rates continue to be the focal point for fixed income investors as the 52 basis point decline in 10-year Treasury yields to 1.5% over the course of August seemed to catch many by surprise. Rates did rebound somewhat in September as the 10-year closed the third quarter at a yield of 1.68%, but in some respects, the September move just underlines how volatile government markets have become, with the intra-day range on the 10-year exceeding 10 basis points during 19 of the last 45 days.

In contrast, credit volatility has been conspicuously subdued. In fact, the OAS of the Bloomberg Barclays Credit Index finished the quarter exactly where it began it at 115 basis points, while Long Credit was 6 basis points wider. While the sharp drop in rates did not translate into much weakness in the credit markets, it did precipitate a surge in opportunistic debt issuance by companies. In the first holiday-shortened week of September over \$75 billion in investment grade bonds were issued as many A-rated companies rushed to print 30-year deals with coupons below 3%. High yield companies issued \$31 billion of bonds in September—the largest month of issuance in the last two years.

Much like credit, securitized products displayed a measure of resilience to the rates volatility. MBS spreads matched the low volatility profile of corporates, as spreads widened in early-August before tightening to finish the quarter close to unchanged. CMBS spreads widened roughly 10 basis points over the period on AAA LCF & AA bonds. Fundamentally, performance continues to be good with industrial and multifamily property types exhibiting strong demand with retail a laggard in light of store closure headlines. ABS spreads tightened for the majority of the period, as demand for higher quality, shorter duration securities drove buying of the asset class.

One theme that LGIMA continues to express in credit portfolios is a bias for domestically exposed companies given the continued outperformance of the US

economy relative to the rest of the world. One way in which LGIMA has expressed this strategy is through an overweight to US bank, telecom, and pipeline companies paired with an underweight to sovereigns and quasi-sovereigns. While the strategy has generated outperformance this year, it is not without risk, particularly if US outperformance is called into question. Indeed, surprisingly good performance from the sovereign and quasi-sovereign sectors in the third-quarter turned into a headwind for portfolios. It will be especially important as we head into year end, to manage portfolio beta as liquidity conditions are likely to exacerbate volatility.

### Focus on client solutions

Defined benefit pension plan funded statuses have experienced an increase in volatility consistent with the broader market movements over the third quarter. While the average plan's funded status steadily increased over the first three quarters of 2018, we've experienced the opposite effect this year. Tax reform played a role in the improvement of funded statuses last year as corporate treasury teams took advantage of making additional contributions to their pension plans in order to benefit from the old corporate tax rate before a lower one became effective. 2019 has seen a dramatic drop in interest rate yields, which has been the most impactful market dynamic across equities, credit and treasuries on funded status. LGIMA measures an average pension plan's funding ratio assuming a typical liability profile (~12-year duration) and a 60% global equity/40% aggregate bond investment strategy. Over the course of this year, the average pension plan's funded ratio decreased from 84.4% to 79.2%, hitting a three-year low.

Breaking down the third quarter, LGIMA estimates the average funding ratio declined from 83.1% to 79.2% over the quarter based on market movements. Equity markets were range bound, with Global Equities increasing 0.10% and the S&P 500 improving 1.70%. Plan discount rates were estimated to have decreased

33 basis points, as Treasury rates fell 39 basis points on average and credit spreads widened six basis points. These changes resulted in a 5.96% increase in plan liabilities. Overall, plan assets with a traditional "60/40" asset allocation rose 1.00%, resulting in a 3.9% decrease in funding ratios over the third quarter of 2019.

The most significant monthly change during the quarter occurred in August when President Trump escalated the trade war, which led to an increase in global recession concerns and a collapse in interest rates. The 10-year Treasury yield fell 52 basis points and negatively impacted the average funded status by -6.2%. Furthermore, a weaker equity market contributed to additional funded status deterioration, however, the widening of credit spreads partially offset the decline. Heightened market volatility combined with a substantial interest rates move led to an overall average funded status of 76.9%. Plans that adopted a well-designed LDI program were likely better protected; as a result, those plans experienced fewer drawdowns in funded status over the period. Adopting a more tailored fixed income allocation through a Completion framework can help protect funded status drawdowns and complement a plan's de-risking glidepath.

While overall market volatility has been top of mind for pension plans this quarter, clients continue to seek custom strategies to align their fixed income more closely to the liability in order to mitigate funded status volatility. Furthermore, there is increased demand for custom credit strategies as plans approach their end-game state. Activity in the pension risk transfer market has increased across the defined benefit space, culminating in \$9.5 billion of buyout sales in the first half of 2019. Lastly, given the current market environment of record low interest rates combined with US equity markets approaching all-time highs, demand for multi-asset solutions has increased as clients think more holistically on how to manage the risk of their investment strategy. LGIMA has seen a growing interest in

equity protection solutions and various approaches to glidepath monetization. As slowing global growth and recession concerns increase, designing the investment strategy through a risk management framework for defined benefit corporate pension plans will only become more important in order to mitigate funded status volatility.

## Contributors



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