LGIM America

4Q 2020

Market Commentary

Focus on the macro

As cathartic as leaving 2020 behind feels, it may take the entirety of 2021 to assess the lasting economic cost of COVID-19. At 12%, the underemployment rate in the US is more than 5% above pre-pandemic levels and suggests the US economy remains a long way from being back to normal. Even so, optimism is high that a smooth vaccine rollout will further help to heal the job market as the service sector is fully able to reopen. How many of those lost jobs come back is the question at heart of the outlook. Indeed, the final cost of the virus will be determined by whether the output gap can be reduced sufficiently to return the economy to the pre-pandemic growth trend. As such, the coming year is likely to leave behind the epidemiological forecasts and will instead be defined by the post-pandemic behavior of the consumer and corporate sectors of the economy.

In the short-term, there is little disagreement about the trajectory of US growth. Following the increase in stay-at-home recommendations in many US states, most economists expect a weaker winter to be followed by a stronger summer as vaccines are deployed. Thankfully, the soft patch should not result in a double-dip into negative growth given the year-end passage of the $900 billion COVID-19 assistance bill.

The most recent round of COVID-19 relief does highlight the more interesting debate around how consumers will behave as COVID-19 restrictions are lifted. Leaving aside the partisan politics of direct stimulus checks, one of the many "unprecedented" elements to the COVID-19 recession is that discretionary income and the savings rate substantially increased throughout 2020 at an aggregate level. In contrast to the typical recession experience, the lost labor income due to COVID -19 was more than replaced by government transfer payments, and as a result, there is little precedent to inform what might happen next. Consumers that did not lose their jobs could decide to treat 2020 as a one-off opportunity to improve personal finances, or alternatively, they may spend the savings accumulated over the last nine months unleashing pent-up private demand. If consumers do the latter, the economy stands a much better chance of achieving a full recovery.

In an analogous way, corporate behavior is also crucial to the economic outlook this year. Typically, companies focus on balance sheet repair in the immediate aftermath of a recession, which tends to be good for credit investors. After a record year of issuance, corporate liquidity is at a decade high along with gross leverage. Many presume that the emergency cash raised in 2020 that still sits on corporate balance sheets will be used to repay debt as earnings rebound over the next year. Yet like consumers, corporates could prove to be less focused on deleveraging than expected, particularly companies in sectors that were less negatively impacted by the virus. In the scenario where consumption takes off, business investment might quickly follow given how low interest rates remain. Already there has been more M&A in the US than one would typically expect coming out of a recession, which suggests not all companies are viewing the post-pandemic period as a normal business cycle.

On the other hand, central banks seem to be viewing the recovery from the COVID-19 recession as relatively ordinary—in the sense that improvement from here will be gradual and not rapid—even as they continue to deploy extraordinary monetary policy tools. For instance, the Fed's central economic projections have a full rebound in growth taking until 2022, the unemployment rate only declining below 4% in 2023 and core PCE not meriting a rise in the policy rate until the end of 2023 or later. Surprisingly, the latest FOMC statement made no mention of the vaccine approvals improving the outlook. Meanwhile, risk markets appear to reflect a more optimistic scenario where the US reaches herd immunity by the middle of the year. Likewise, forward inflation markets are currently trading at the highest level since 2018 before the Fed made their "mid-cycle" correction. As difficult as it proved to generate inflation over the last ten years, rates investors nevertheless appear to believe that the Fed will eventually hit their target.

It follows then that one risk for markets in 2021 is that the growth rebound is stronger and generates more inflation than expected given the sizable fiscal and monetary stimulus deployed in 2020. While that sounds like a potential upside scenario at first, the danger is that the Fed could judge monetary policy to be too accommodative under such an outcome and accelerate the tapering of asset purchases to the detriment of markets that have very

little remaining risk premium. Of course, concerns that monetary policy could turn less supportive are not likely to grow until late in 2021, but the markets may move well ahead of the Fed. In the meantime, it would appear to be a race between the virus and the deployment of the vaccine. Yet over a medium-term horizon, if it turns out that the costs of COVID-19 are far lower than expected or that the costs have been shifted into the future through the issuance of debt, 2021 could prove to be less benign than anticipated and nothing like the typical year that follows a recession.

Focus on fixed income

After a remarkable November rally, the central question facing credit investors as 2021 gets underway is whether valuations reflect too much optimism. Like most risk assets, credit markets have managed to recover nearly the entirety of the March selloff. Remarkably, the US investment grade credit markets begin the year with spreads just two basis points wider to where they began 2020 with the US Credit index and the Long Credit index at 92 and 141 basis points, respectively. The allegation could be made that the recovery has gone too far, too fast. At current levels, investment grade credit spreads have only been lower about 5 percent of the time since the financial crisis of 2008. And yet, the possibility that spreads could go lower still is not out of the question given the abundance of central bank liquidity, the return to a record amount of negative yielding debt globally and the knowledge that the Fed is willing to provide direct support to credit markets. Frankly, the last year has been a glaring illustration of the power of liquidity over fundamentals.

Much like the credit markets, the US rates complex has a Goldilocks feel to it with the US 10-year below 1%, which is roughly 100 basis points lower than where it began 2020. While this is one market that has failed to retrace the pandemic moves, it is entirely the result of the drop in real rates (which are negative in the US by more than 100 basis points) while inflation breakevens are right around 2% (which leaves the nominal rate just below 1%). In some sense, the message seems to be that the Fed's ultra-accommodative monetary policy will succeed at increasing inflation slowly over time to reach the mandated target, but the upward pressure on inflation never becomes self-fulfilling such that the Fed can tighten policy and return real rates to positive territory.

One corner of fixed income that is still reflecting some of the disruptions of COVID-19 is the securitized markets. The ABS/CMBS new issue markets were shuttered from mid-March through June, then re-opened with several ABS auto transactions. Yet unlike in the investment-grade corporate market where issuance increased by 60% year on year, ABS issuance ended the year down 25% at $175 billion and CMBS issuance down 35% at $65 billion. Not surprisingly, certain CMBS sectors – such as central business district office and regional malls – face challenges as tenants right-size their footprints and rationalize their space needs. Other sectors, such as industrial and multifamily, have experienced increased demand as e-commerce and work-from-home capabilities offer more flexible living arrangements. The result is that the junior parts of the CMBS market remain more than 100 basis point wider than where they entered 2020, while the senior tranches have followed high-quality corporates to end tighter on the year.

From a portfolio perspective, it is not just valuations that present a challenge in 2021 but the degree of consensus among investors and strategists. Echoing the typical post-recession playbook, few market participants expect spreads to end the year wider as corporate fundamentals should improve. As such, it is widely expected that the sectors most sensitive to COVID-19 will continue to outperform and compress versus the insensitive sectors. Likewise, the view that rates will rise modestly by year-end to the benefit of long-end credit spreads is also common as is the view that dollar weakness will continue and support emerging market credit. While the consensus need not be wrong, the reward for positioning portfolios in this manner will be lower. Indeed, the credit portfolios managed at LGIM America are still overweight COVID-19 sensitive sectors such as aerospace, REITs and energy/midstream, but at the last strategy meeting the short-term outlook was moved to neutral as there is a strong argument to reduce directional beta until more attractive risk-reward opportunities arise.

Focus on client solutions

Investment professionals entered 2020 with recessionary fears due to political uncertainty, low growth expectations and risk markets hovering near all-time highs. Although 2020 validated investors worst fears, the catalyst for the dramatic downturn that occurred in the first half was something nobody could have predicted. COVID-19 introduced the world to phrases like “social distancing” and “stay-at-home orders” which led to a significant decline in economic activity across the globe. Institutional clients were forced to navigate one of the most volatile market environments in recent memory, and pension funds, in particular, faced a difficult period that saw a substantial drop in Treasury yields coupled with a falling equity market, two key ingredients for a deterioration in funded status. However, as the year progressed, Government intervention and the prospect for a vaccination campaign propelled a historic recovery in asset prices.

LGIM America estimates that an “average” plan (60% global equity / 40% US aggregate fixed income) started 2020 with a funding ratio of approximately 83%. Considering the 60/40 portfolio ended the year with a funding ratio just over 82%, it would seem markets were relatively stable and pension funds continued their journey unscathed. On the contrary, our estimates depict a rather volatile year for the average pension plan. In the first quarter alone, US equities dropped 20% and the 30-year US Treasury yield fell below 1% (compare to 2.4% at the beginning of the year). As a result, the average pension plan's funding ratio tumbled to 73% by the end of the first quarter. Fortunately, monetary and fiscal support quickly followed, boosting consumer confidence and driving risk markets higher. As the year drew to a close, equity markets

ended the year in positive territory, elevating funding ratios nearly back to where they began the year.

With COVID-19 still surging and countries reimposing lockdowns, heightened risks remain within the market. However, with risk assets sitting near all-time highs, it would seem markets are relatively accepting of near-term volatility so long as we continue to receive positive headlines related to the vaccine roll-out. Looking ahead to 2021, the focus will be on how quickly we can return to our normal lives and determine the lasting economic toll of the virus.

From a client perspective, we saw many take advantage of more attractive valuations and opportunistically rotate into return seeking assets in the first half of the year. Those with a set policy allocation also rotated back into equities to maintain target weights after the severe drawdown we experienced in March. At the height of the pandemic, some clients took the opportunity to synthetically rebalance their policy allocations to avoid excessive transaction costs. In addition, several clients are heeding lessons from earlier in the year and are taking a more strategic, thoughtful approach to managing equity risk through 2021 and beyond. We have seen an uptick in demand for downside protection strategies given the level of uncertainty and the divergence in narratives between the economic data and market valuations. Within the fixed income space, investors allocated to credit at very wide spread levels over Treasuries in the first quarter. With markets normalizing in the back half of the year, we have seen growing appetite for more tailored LDI strategies – including completion management and custom buy & maintain solutions with the goal of reducing this uncompensated rise in volatility and increase predictability for the plan sponsor. These highly customized solutions have also sparked interest related to other fixed income diversification options, including increased demand for yield enhancement opportunities.

Away from the COVID-19 induced volatility saga we experienced throughout 2020, ESG strategies have become an emerging trend. As a result, integrating ESG factors within the investment process has been an increasingly relevant topic for institutional clients. We've also seen growing demand across the public plan landscape for a range of risk management solutions, such as strategies to improve liquidity, reduce frictional costs of rebalancing and reduce tracking error versus policy benchmarks. Though institutional clients have varying objectives and challenges, 2020 forced many to re-examine their overall risk management strategies.

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