1Q 2021

Market Commentary

Focus on the macro

It is a bit of a historical oddity that one of the slowest economic recoveries after a recession looks as if it will almost surely be followed by one of the fastest. Indeed, the COVID-19 recession-and-recovery looks nothing like the financial crisis of a more than a decade ago. And yet, in both cases there seems to be a propensity to misestimate the speed of the recovery, albeit in different directions. After the financial crisis, economists at the Fed and elsewhere were continually disappointed as the output gap took much longer to close with inflation remaining depressed. Ultimately, the first-rate hike came much later than originally anticipated, subsequent hikes came at a glacial pace, and the Fed had to stop hiking far sooner than expected at the end of 2018. These days markets seem rightly concerned that the risks are in the opposite direction: the economy could recover even more rapidly than expected, generate more inflation, and leave the Fed well-behind the curve.

Aided by aggressive fiscal and monetary policy, there is little doubt that as the US economy fully reopens in the coming months that all the lost output suffered during the COVID-19 pandemic will be recovered and then some. After the passage of the $1.9 trillion American Recovery Plan earlier this year, it now looks likely that GDP will end 2021 well-above the pre-pandemic path and continue to exceed the trend rate of growth over the next few years. But even these optimistic base-case forecasts may prove too conservative should the labor market snap back more quickly than anticipated and consumers choose to spend the sizable amount of excess savings accumulated over the last year. In such a scenario, it is conceivable that US growth exceeds 10% in the second quarter, approaches 8% on a full-year basis and the unemployment rate falls below 4%.

As Chair Powell has articulated numerous times this year, the Fed is formulating monetary policy based on the experiences of the last decade. Despite the US delivering an unprecedented amount of fiscal stimulus that has only ever been surpassed in times of war, the view embedded in the Fed's current economic outlook is that as growth accelerates and the economy returns to full employment, inflation will nevertheless remain subdued much like it did in the years leading up to the pandemic. The Fed seems intent on applying the lessons learned over the last 10 years to the current recovery. However, it is likely far too soon to know whether these are the right policy prescriptions coming out of a pandemic.

It may be that the well-documented forces of secular disinflation such as demographics, globalization and technology will yet dominate the inflationary upswing that is likely to arise from the coming period of stimulus-fueled "hot" economic growth. If that is the case, then the Fed's ultra-easy stance on inflation should be rewarded with one of the best labor markets in generations. Yet in pursuing such an outcome against the backdrop of unprecedented growth in money supply and deficit spending, the risk is that the output gap rapidly turns positive and inflation moves persistently higher. Confronted with that scenario, the Fed would likely find itself behind the curve and needing to raise the level of unemployment to cool the economy, which has rarely been achieved without precipitating recession.

Few will dispute that in the coming months the US economy will produce some truly eye-popping numbers as reopening takes hold and the latest round of economic stimulus starts to circulate. What is more, year-over-year comparisons are going to make for some very noisy prints such that it will be difficult to get a direct handle on inflation for some time. As such, it is likely the employment data will take on added importance. However, the real emphasis should be on the speed of the labor market recovery. As desirable as a rapid recovery in pandemic job losses would be, a faster than expected progress could indicate that monetary policy is too loose and the Fed's timetable for tapering and the first-rate hike is inconsistent. To date, the recovery has been exceedingly quick and consistently ahead of estimates. If the economy continues to rapidly heal, the Fed needs to be careful that it avoids making unpleasant history in allowing one of the longest expansions to be followed by one of the shortest.

Focus on fixed income

It is not surprising that risk markets have been watching interest rates closely this year. With equities and investment-grade credit spreads having retraced the entirety of the pandemic selloff, interest rates entered 2021 looking like a conspicuous outlier. As such, the 80 basis point move higher in US 10-year yields during the first quarter should not have come as much of a surprise, at least in retrospect. Regardless of monetary policy, the combination of vaccine rollout success and large-scale fiscal stimulus was always going to put upward pressure on yields. That being said, the rise in yields will be closely watched going forward as 10-year breakevens at 2.36% are near the Fed's target while real rates imply the first hike would come in early 2023 with subsequent hikes following at a pace of three per year. From the perspective of Chair Powell and others on the FOMC, current rates pricing is just about consistent with Fed guidance, but if rates continue to rise it would suggest that investors believe that monetary policy will need to become more restrictive.

The sharp rise in government yields during the first quarter has led to investment-grade credit funds experiencing one of the worst starts to a year on record in total return terms. The US market credit index lost 4.45% over the first three months of 2021 while Long Credit is down 8.4%. As bad as those numbers may seem, it is something of a surprise that they were not even worse. After a powerful late-March rally, credit spreads managed to end the quarter tighter with the US market credit index at 86 basis points (-6 basis points YTD) and Long Credit at 126 basis points (-15 basis points YTD). As such, excess returns ended the quarter in positive territory despite the rate volatility and surge in issuance.

Compression was a popular theme throughout the first quarter as higher spread issuers have outperformed. While this is evident when looking at BBB-rated issuers within investment grade markets, it is even more prominent within high yield. High yield spreads are more than 40 basis points tighter this year with CCC-rated credit more than 80 basis points tighter. In both the investment grade and high yield markets, the energy sector has been a major contributor to the spread tightening on the back of the sharp move higher in oil prices during the quarter.

One aspect of credit markets that has been challenging to navigate over the last three months is liquidity—not in regard to wide bid-offer spreads per se, but more in terms of the outperformance of sectors that are difficult to source and trade even in the best of times. Sectors such as hospitals, taxable municipals and universities, where deal sizes are smaller and secondary market liquidity nearly nonexistent, have tightened meaningfully in 2021 and created a drag on performance of some LGIM America funds. Another illiquid segment of the market that has done well is off-the-run BBB-rated 20-year bonds. These bonds tend to be higher-dollar price and trade with a meaningful discount to on-the-runs. However, as rates have moved higher and 20-year government bonds have increased in liquidity, high-dollar 20-year corporate bond spreads have tightened.

It is often the case that illiquid portions of the credit market move tighter toward the end of prolonged rallies, and as such, the performance of credit in the first quarter of 2021 may suggest there is little remaining cushion in credit markets to absorb future volatility. Indeed, in light of valuations and the challenges confronting the Fed going forward, LGIM America credit portfolios have moved to a modest underweight albeit with larger idiosyncratic positions. With M&A accelerating and businesses still navigating the aftermath of the pandemic, dispersion relative to the outright level of spreads remains elevated. That suggests that the environment is still one where credit picking skills can be rewarded even as "generic" risk increasingly trades at an unappetizing spread level.

Focus on client solutions

Relative to this time last year, market sentiment at the end of the first quarter looks markedly different. The onset of 2020 was surrounded by recessionary fears, market turmoil and an overarching theme of uncertainty. Dissimilarly, the first quarter of 2021 saw strong gains across risk markets, fueled by a rapidly increasing vaccination campaign and exuberance in the prospect of a re-opening of the economy. Furthermore, an additional stimulus package centered on infrastructure developments was recently proposed, the Federal Reserve continues to keep interest rates at the lower bound, and over 3 million vaccines are being distributed per day. In other words, there is a case for a strong growth period ahead.

Pension funds in particular have found themselves in a highly advantageous scenario, experiencing rising interest rates coupled with strong equity returns. Rising Treasury yields have led to lower liability values, while plan assets have been propelled higher with strong equity market returns. LGIM America estimates that an "average" plan (60% global equity / 40% US aggregate fixed income) started 2021 with a funding ratio of approximately 82%. In the first quarter, we saw US equities rise by over 6% and the 30-year US Treasury yield increase ~77 basis points to 2.41%. Credit spreads have grinded tighter, but fixed income performance has been a negative mark on the year for fund assets. Given the dramatic rise in Treasury yields affecting total returns, US Investment Grade credit has seen one of the largest quarterly losses on record, declining ~4.5%. Irrespective of the credit losses, the average pension plan's funding ratio rose to almost 91% at the end of March due to falling liability values and higher equity markets.

From a client perspective, the run up in asset prices and stretched valuations have led many to focus on risk management activities. Plans continue to explore liability driven investment strategies in an effort to lock in recent funded status gains. They also recognize that with the current low rate environment, opportunities for yield enhancement are becoming increasingly attractive. We have seen an uptick in demand for derivative overlay strategies, specifically focusing on downside protection and equity replication as plans aim to improve capital efficiencies and protect against any adverse market corrections. Within the fixed income space, there has been a growing appetite for more tailored LDI strategies as plans become better funded – including completion management and custom credit solutions. The objective of these investment strategies is to reduce uncompensated risks and increase predictability for plan sponsors. These highly customized solutions have also sparked interest related to other fixed income diversification approaches, including strategies targeting a higher level of alpha.

ESG strategies have continued to become increasingly popular across asset classes. As a result, integrating ESG factors within the investment process has been a very relevant and timely 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. Given the demand in this space, the intersection of ESG objectives and strategic asset allocation decisions also seems to be an emerging trend for consultants and clients we engage with. The scope of this engagement will likely evolve considerably this year as further education and discussion on ESG objectives takes shape with institutional and retail investors. How this intersects with investment strategy more broadly continues to become a more important area of focus.

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