LGIM America

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Market Commentary

Focus on the macro

The rapidity of this economic cycle continues to be its defining characteristic. Many of the milestones that often take three-to-four years to achieve have been reached in half the time – a full recovery of lost growth, a return to full employment, a rebound in corporate earnings and the deleveraging of balance sheets. There is no doubt the combination of loose fiscal and easy monetary policy is responsible in part for the speed of the rebound, but as is now becoming clear, a byproduct is persistent inflation. As a result, the hiking cycle that has just begun appears to be moving at a much faster pace than is typical. While hindsight is twenty-twenty, the evidence is growing with each quarter that the pandemic policy response was miscalibrated to the upside. Of course, the final say on the matter will be whether the Fed can engineer a soft-landing for what appears to be an overheating economy.

One ominous sign for the Fed is the shape of the yield curve and how quickly it has flattened in this cycle. Chair Powell has so far dismissed the inversion of the 2-year/10-year Treasury spread, preferring to focus on the steepness between the 2-year yield and the Fed funds rate. Despite the Fed's preference, it is difficult to find a recession predictor as accurate as the 10-year/2-year Treasury spread; over the last 65+ years, it has inverted roughly 1-2 years ahead of the previous ten recessions, sending only two false signals.

On the other hand, the Fed's preferred front end yield curve indicator appears to indicate little risk of a near-term recession, with the 2-year Fed funds spread as steep as it has ever been. Unfortunately, the steepness of the front end provides little comfort, as the Fed is now expected to deliver an additional 200-225 basis points of hikes over the remainder of the year—some of which will likely be in 50 basis point increments. What is steep today could be very flat by year end. Put differently, the Fed has never been as far behind in raising rates as it is now in the eyes of bond investors, and this should not be a reason to be sanguine.

The dramatic shift in the Fed's reaction function since the beginning of the year is almost entirely the result of inflation. Since abandoning the transitory terminology at the Fed's December meeting, the inflation outlook has only become more troublesome with growing evidence that the fiscal largesse during the pandemic has resulted in excess demand which has exacerbated supply chain shortages. Indeed, even before the tragic invasion of Ukraine, supply chain issues were proving more persistent than anticipated. However, as the war in Ukraine enters a more protracted phase leading to long--term sanctions on Russia, it is likely to worsen the inflation situation further through the impairment of European supply chains as well as higher food and energy costs. While food and energy tend to be excluded from the most closely monitored core measures of inflation, the rise in both is having a clear negative impact on consumer sentiment and could increase the risk that inflation expectations among consumers become de-anchored to the upside.

Meanwhile, the components of inflation which are generally thought to be inherently more persistent and less volatile are now also rising at an undesirable rate. Despite the 165 basis point rise in US mortgage rates this year, home prices are still moving higher, dragging rents along with them. Prices for services are also rising briskly as companies have been successful at passing along higher input and wage costs. A reasonable forecast is that both shelter and core services inflation rise by roughly 5% over the next year. Given their weight in the calculation, measures of overall core inflation could easily exceed 3% a year from now, even after accounting for a long overdue moderation in core goods inflation.

Surprisingly, markets appear to be relatively at ease with the prospect of inflation remaining well above the Fed's target a year from now. The Fed's most recent dot plot released at the March meeting indicates that most FOMC members envision raising the policy rate above the long run terminal rate to return inflation to target. For the time being, markets appear to believe that the Fed can gradually reduce inflation without triggering a recession. Indeed, the relative outperformance of growth-sensitive sectors in equities, subdued expectations for rating downgrades and defaults in credit markets, and an inverted 10-year/2-year Treasury curve all make sense if the Fed can engineer a soft-landing.

However, there are numerous reasons to doubt the soft-landing narrative, including the Fed's own track record of failing to achieve one. In normal times, monetary policy is a blunt instrument that can be difficult to calibrate, particularly because it operates with variable lags on the economy. With the Fed so far behind the curve, it is both unclear how fast the Fed should be hiking and how far. Already, a few of the hawkish FOMC members have argued for a 3% policy rate by year end. But if the post-pandemic economy proves more resilient to rate hikes than expected, even 3% may prove insufficient to bring inflation back to target. If this is the case, it would argue for higher long end yields while also raising the risk of a recession. In some sense, this is the classic late cycle debate about how far the Fed can hike before growth suffers. The difference this time is the Fed has only recently begun to raise rates, and investors may need to consider shifting to a more defensive late-cycle playbook.

Focus on fixed income

Following the Fed's December pivot, most investors expected interest rate volatility to remain elevated in 2022, but even so, the first quarter still managed to overdeliver relative to expectations. While the Omicron-BA2 variant is partially responsible for the subdued level at which long end rates entered the year, the 80 basis point move higher in the 10-year nominal yield during the first quarter has taken it to levels not seen since before the pandemic. The more significant move, similar to the fourth quarter of last year, was the 155 basis point rise in the 2-year yield, as investors have moved from pricing in one 25 basis point hike per quarter to a pace that implies a hike at every remaining meeting, with one or two meetings delivering a 50 basis point rise. Consequently, the 10-year/2-year Treasury spread inverted during the quarter for the first time since mid-2019. More astonishingly, the forward curve implies that the magnitude of the inversion could increase to 50 basis points by year end, a level last seen prior to the dot-com bust and during Chair Volcker's term in the early 80s.

The prospect of tighter monetary policy continues to weigh on demand for credit. Much of the weakness can be attributed to outflows from total return investors. Year to date, US investment grade credit has seen nearly $30 billion in mutual fund outflows, on pace for $120 billion this year. In contrast, last year there was $270 billion of inflows into credit funds, indicating a potential decrease of nearly $400 billion in demand year-on-year. Meanwhile, the first quarter produced $450 billion in supply, a 5% increase over the first quarter of 2021. Credit spreads widened during the quarter, which was unsurprising given the challenging technical backdrop. The spread of the Bloomberg US Investment Grade Credit Index finished the first quarter 21 basis points wider at 108 basis points while the US Long Credit Index was 25 basis points wider to end at 155 basis points. At current levels, both indices now trade near their respective 50th percentiles on a 5-year basis. For its part, the Bloomberg US High Yield Index ended the quarter 52 basis points wider at a spread-to-worst of 325 basis points.

Whether right or wrong at this point in the conflict, the impact of the Ukrainian war on markets has been relatively short-lived. In the rates market, the invasion's impact is best observed through the lens of 10-year real-rates, which declined from -42 basis points ahead of the invasion, to a quarter low of -107 basis points in March, before retracing back to -42 basis points by quarter-end. In credit markets, investment grade spreads widened 30 basis points over the same period before retracing all the war-related widening. Meanwhile high yield credit spreads widened 50 basis points following the invasion but have since tightened 90 basis points, leaving them 40 basis points tighter than their pre-war levels (albeit still 52 basis points wider on the year).

One intriguing dynamic is that, even as credit spreads have widened, risk has remained compressed across the ratings spectrum, with very little decompression evident between high yield and investment grade debt or within investment grade between BBB-rated and A-rated debt. Typically, credit spread widening and decompression go hand in hand as wider spreads usually coincide with increased recession risk and growing concerns around downgrades and defaults. But for the moment, credit investors appear to be discounting the prospect of a hard landing and have instead repriced credit spreads wider in a more parallel fashion. Consequently, for the first time in this cycle, there appears to be more relative value in higher rated debt than in lower rated. As a result, LGIM America's credit portfolios have steadily reduced their underweight to A-rated debt at the expense of BBB-rated debt while remaining cautiously positioned. If markets either lose confidence in the Fed's ability to engineer a soft landing or once again become concerned about the war in Ukraine, making portfolios less barbelled should help drive outperformance.

Focus on client solutions

We have entered 2022 quite differently to 2021, as the Fed starts a potentially aggressive hiking cycle, grappling with persistent inflation as investors absorb the ongoing invasion of Ukraine and its impact on international policy. Markets continue to focus on the Fed and its ability to address inflation concerns without tightening financial conditions to the point where economic growth languishes. While credit spreads have retraced to pre-war levels, expectations of short-term volatility persist given uncertainty around the ongoing invasion, hawkish tilt in monetary policy and inflation concerns.

Market dynamics have also impacted pension plan's funding ratios over Q1 2022. LGIM America estimates that an "average" plans' (60% global equity / 40% US aggregate fixed income) funding ratio rose from 92.6%% to 96.3% over Q1 2022.[3] While equity markets declined over the quarter with Global Equities and the S&P 500 falling 5.3% and 4.6%, respectively, rising discount rates weighed on liability values helping to push funding ratios higher.[1] The main contributor to the increase was the dramatic rise in Treasury yields. We estimate plan discount rates increased roughly 94 basis points over the quarter, with only 22 basis points of the increase coming from the credit component. As plan funding ratios improve and sponsors continue along their de-risking journey, we have experienced an increase in demand for custom Liability Driven Investment (LDI) solutions focused on protecting funding status against interest rate volatility as the Fed starts their rate hiking cycle.

Clients who have now experienced the volatility in the Treasury markets can see the importance of separating interest rate and credit spread risk to aid in the design and implementation of a more appropriate LDI strategy. We have seen an interest in using completion management solutions to more effectively manage these risks through volatile market environments. Within the fixed income space, underperformance in Treasury and US credit markets has helped plans to be conscious about reducing uncompensated risk and potentially looking at custom strategies beyond standard market-based benchmarks.

ESG investing has been a major headline during the first quarter of the year, with the invasion of Ukraine prompting many public plans to divest of Russian assets. ESG integration and strong communication within the investment process continue to be relevant for institutional clients managing ongoing volatility and geopolitical risks. The scope of engagements and interest will likely continue to evolve as clients explore other measurable ESG factors in their investment strategies.

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1. Source: Bloomberg
2. Source: Federal Reserve
3. For illustrative purposes only. LGIMA prepares the Pension Fiscal Fitness Monitor data assuming a typical liability profile using an approximate duration of 12 yrs and a traditional 60/40 portfolio of 60% MSCI AC World total Gross Index/40% Bloomberg US Aggregate Index, incorporating data sourced from LGIMA, ICE, MSCI and Bloomberg. These results are based on simulated or hypothetical assumptions that have certain inherent limitations. Unlike the results in an actual performance record, these results do not represent actual trading. Because these trades have not actually been executed, these results may have under- or over-compensated for the impact, if any, of certain market factors, such as lack of liquidity. Simulated or hypothetical trading programs in general are also subject to the fact that they are designed with the benefit of hindsight. No representation is being made that any account will or is likely to achieve profits or losses similar to these being shown.

Unless otherwise noted, index performance and related index statistics has been sourced from Bloomberg.

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