LGIM America

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# Market Commentary

## Focus on the macro

After a period of rapid recovery over the summer, it now appears as if the pace of the economic rebound in the US will moderate in the months ahead without another round of fiscal stimulus to support consumption. To some extent, the weaker near-term outlook is already incorporated into asset prices with equity and credit markets trading below the highs reached in the middle of the third quarter. Yet with risk markets near-or-above beginning of the year levels, there seems to be plenty of scope for valuations to correct further if economic headwinds grow stronger. However, the question of whether the coming growth downshift will do even more damage is likely to depend on the outcome of the upcoming elections and how COVID-19 spreads during winter.

It is difficult to understate the role that fiscal stimulus has played in supporting the recovery over the last six months. Despite the unemployment rate reaching 14.7% in April, disposable income is sharply up this year due to the generosity of the Paycheck Protection Program and the emergency unemployment assistance. Said differently, even though many Americans have lost their jobs due to the pandemic, those lost wages and salaries have been exceeded by government transfer payments. As such, households have experienced far fewer bankruptcies and evictions than is typical during a recession.

Without the exceptional level of government intervention seen during the summer, there is no doubt that US growth will not be as strong in the fourth quarter as it would have been had another fiscal stimulus deal been agreed. Under the assumption of a $1-2 trillion fiscal package, most economists were forecasting an annualized rate of growth in the fourth quarter in the 5-8% range. It now looks likely that the pace of growth might slow to below 3% into year-end. More importantly, uncertainty will almost surely increase as near-term growth will now become more dependent on the path of the virus, the ability to continue to reopen the economy, and whether consumers draw down their savings to keep spending steady.

As uncertain as the next three-to-six months appears, it is easy to lose sight of how the economic outlook has improved since mid-summer. Indeed, the business of economic forecasting is returning to a world of more normally-distributed outcomes with risks in both directions. In the months immediately following the lockdowns, investors had to evaluate economic scenarios that ran the spectrum from a severe great-depression-like recession to a rapid reopening with growth recovering to the pre-virus trend before year-end. In this respect, the last three months have brought a dramatic decrease in economic uncertainty even as political headlines have taken center stage.

A lot of the credit for the overall reduction in uncertainty is due to the experience with COVID-19 in the sunbelt states over the summer. After infections began to spike in late June, the subsequent ability of states like Florida, Texas and Arizona to control the outbreak without resorting to full-scale lockdowns removed many of the most severe downside risks heading into the winter months and helped to establish the degree to which economies can reopen. To be sure, a key factor in the relative success of the sunbelt states was the dramatic improvements in treating those infected by the virus, as well as the fact that the infections were primarily among younger people. As such, the sunbelt experience goes a long way to explaining the relatively muted financial market reaction to Europe's second wave of outbreaks.

The real encouraging news during the last few months is the progress being made to develop a vaccine against COVID-19. Past precedent suggests that with so many vaccines in phase three trials, it is statistically likely that multiple vaccines will be available and ready for distribution in 2021. Less discussed in the media are the ongoing improvements in testing for COVID-19. In recent days, the US has exceeded more than one million daily tests and the number should continue to increase as these tests come down in price, become easier to administer and provide results more quickly. In fact, there is a high likelihood of a pregnancy-style COVID-19 test being available in the first quarter of 2021, which should accelerate a return to a more normal environment even if the vaccines currently in development disappoint or take longer to distribute than expected.

Over a six-month horizon, the most positive scenario for financial markets is one where an effective vaccine is found, and lawmakers revisit the need for a sizable fiscal

stimulus package after the November elections. If either party were to win the House, Senate and Presidency, there is a high likelihood this would come to pass. In the event of a clean sweep by the Democrats, the stimulus package would likely be considerably larger, all else equal, but financial markets would need to contend with the prospect of higher corporate and individual tax rates. On the other hand, a divided result could lead to further partisan gridlock. Of course, with so much focus on the possibility of a contested election, it could be that an orderly transition may be just as important for markets as who ends up winning.

Finally, a word on monetary policy. The Fed deserves as much credit for the summer recovery as lawmakers do, but its tools seem increasingly limited to backstopping financial markets rather than providing additional stimulus to the economy. The recently-formalized pivot to a framework that targets inflation at an average of 2% is an acknowledgment that the Fed believes they hiked rates too soon during the last cycle and will not make the same mistake again. Yet financial markets have already incorporated the likelihood of a prolonged period with policy rates at zero, and unless the Fed is willing to further increase the quantity of their asset purchases and go beyond restoring market function, there seems to be little more that can be done. In recent weeks, the Fed has all but ceased purchasing corporate bonds.

As such, it is not surprising that the near-term outlook for markets is so sensitive to what's going on in the halls of Washington DC. For those who subscribe to the "Don't fight the Fed" mantra, it is worth considering that nearly every member of the FOMC has testified to or spoken about the need for lawmakers to provide further fiscal stimulus in the last month. When every member of the Fed thinks the economic outlook is out of their hands, it is difficult to disagree.

## Focus on fixed income

If there is one topic that has gripped fixed income markets over the past few months, it is the outlook for supply. After record-setting issuance in the months immediately following COVID-19's emergence in the US, the credit markets entered the third quarter expecting a return to more normal supply patterns. Yet the typically slow month of August surprised to the upside as companies rushed to refinance debt at record low yields and continued to do so into September. To be fair, the spread on the US Investment Grade Index still finished the quarter 14 basis points lower at 128 basis points. However, there is no doubt that spread product would have performed even better had issuance been more restrained as the index hit 118 basis points in early August before supply started to weigh on the market. For its part, the Long Credit Index finished the quarter at 188 basis points, 14 basis points tighter as well, but 15 basis points off the early August tights.

In the rates market, there is equal concern around supply, but mostly directed at 2021. A big question is what might happen if the Democrats were to sweep the election. Under a Biden presidency there is the possibility of a much larger fiscal stimulus package and initiatives like green infrastructure that likely would result in a larger budget deficit, at least initially. Rates markets appear to be paying attention, although it is tempting to argue otherwise with 10-year Treasury yields only 3 basis points higher in the third-quarter and volatility at record lows. However, looking at the changes since the early-August lows tells a different story. Since then, the 10-year and 30-year Treasury yields are 17 and 26 basis points higher, respectively.

The focus is also on supply in the securitized markets. ABS issuance in September set the monthly record for the year at $26.5 billion and brings total year-to-date issuance to $139 billion. October and November are traditionally busy issuance months, but like the corporate bond markets, may see lower activity due to the upcoming elections. Even with the record month of issuance in September, 3-year prime AAA auto and credit card paper trade in the high-teens/low-twenties in basis points. Investors have kept a close watch on modifications in the auto space as extension (payment holiday) was the most common option granted. After peaking at 6% in April for prime auto, modification rates were 0.9% in July and 0.7% in August (pre-pandemic average was 0.5%). Absent another shock, we anticipate servicers to continue pulling back on COVID-19 related relief programs.

Non-agency CMBS ended the quarter with 15 new issues totaling almost $10 billion. As in the ABS space, we anticipate a slowdown in issuance in the fourth quarter given the uncertainties surrounding the presidential election. Senior 10-year AAA last cashflow spreads are currently slightly inside 100 basis points with some variability for shelf name and collateral composition. Hotel and retail collateral continue to be the two property sectors most negatively impacted by the pandemic. Forbearance agreements have been executed on roughly $13 billion of loans (~2% of the Fitch rated CMBS universe) with the most common agreements including the reallocation of existing reserves to pay debt service, payment forbearance with a payback period over 3 to 12 months, and maturity date extensions for loans with near term maturities. LGIMA continues to favor properties that are located in high-barrier-to-entry markets with little-to-no available vacant land and that are sponsored by well-capitalized, institutional entities.

Not surprisingly, how fixed income markets might finish the year is now an increasingly discussed subject as both elections and winter months loom, when COVID-19 could be more difficult to contain. Yet in the absence of these catalysts, there is a strong argument that credit spreadscould be biased toward modest tightening. Typically supply slows into November and December given the holiday breaks, and this year it is possible that October also surprises to the downside with issuers reluctant to bring deals ahead of the election. If issuance does in fact downshift, the combination of lighter supply and dealers holding less inventory ahead of year-end could result in an end-of-year squeeze, as observed in the past. If that were to be the case, many of the higher-spread virus-sensitive credits could be the beneficiaries as investors search for

beta. Much like last quarter, the LGIMA credit portfolios remain modestly-barbelled with overweights to sectors like telecom and banks which are less sensitive to COVID-19, as well as overweight specific issuers with aviation, retail, or oil price exposure that should benefit significantly as supply concerns recede.

## Focus on client solutions

Throughout the third quarter, we have observed funding ratio levels for plans with a traditional asset allocation to have increased, primarily as a result of stronger global equity performance. Although we have recently experienced positive asset performance, volatile times like this continue to illustrate the importance of understanding each risk that can impact pension plan funded status, such as interest rate, credit spread and equity risk. Further aligning the plan's fixed income allocation with the plan's liability profile through a completion framework can help clients better control uncompensated volatility. Plans are also in a prime position to consider the benefits of equity protection, as costless structures are attractive at current market values.

LGIMA estimates the average funding ratio increased from 75.3% to 77.9% over the quarter based on market movements. Positive asset portfolio returns (composed of a 60/40 mix of global equities and US Aggregate bonds) outperformed the rise in liability values, resulting in increased funding ratios. Equity markets saw a strong rally over the quarter, as Global Equities increased over 8% and the S&P 500 rose nearly 9%. Plan discount rates were estimated to have fallen by 6 basis points in total. Treasury rates remained stable, rising 3 basis points on average, while A-AAA credit spreads tightened 9 basis points over the quarter. Overall, plan assets with a traditional "60/40" asset allocation increased 5.2%, resulting in a 2.6% gain in funding ratios over the third quarter of 2020.

Throughout the quarter, we have seen elevated interest in reducing funding ratio volatility and protecting sizable asset gains. Stronger equity performance has helped plans begin to reassess the credit and interest rate components of their liability hedging assets. As a result, plans have displayed increased interest in a wide range of LDI strategies, such as allocating to long duration fixed income, implementing completion strategies, as well as structuring end-game solutions. Even in a low interest rate environment, clients are looking to better understand how they can design a more effective LDI strategy that continues to meet their evolving objectives.

As we approach the US Presidential election, clients are looking for ways to reduce broad market exposure, specifically to equities. While some clients have asked about overlays and absolute-return strategies, a majority of inquiries have expressed a desire to implement option-based downside protection. While absolute levels of equity volatility have fallen dramatically from their peak in March, they still remain very high. Put spread collars are the weapon of choice for many plans – and with heightened volatility, these structures become even more attractive. Plans can implement meaningful protection to the downside while maintaining ~30% more upside than a "normal" market.

Liquidity management has continued to be a primary topic of interest. We have been discussing a number of approaches that our clients might utilize to help improve their liquidity framework, particularly in light of the market volatility experienced this year. For example, by pairing allocations with synthetic exposures, plans can create a bucket of high-quality, liquid assets to ensure cashflow obligations are met without reducing the expected return of the portfolio.

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