LGIM America

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Market Commentary

Focus on the macro

As Q4 gets underway, investors can be forgiven for feelings of déjà vu. With rates rising, commodities rallying and the dollar strengthening, the reopening theme is starting to take center stage once again, much like it did six months ago before the Delta variant's spread. Yet despite the apparent similarities between then and now, the macro economic outlook has shifted in a direction that may prove trickier for risk assets to navigate. In the last few months, a clearer picture is emerging of a more cautious consumer, undergoing a rethink of work-life balance, and expecting the post-pandemic period of higher inflation to persist for years to come. The economic implications of such a shift are only beginning to be understood.

From an economic perspective, one of the bigger surprises this year has been the limited rebound in services consumption. After a period of well-above trend goods consumption, the hope was that pent-up demand for services would drive growth in the second-half of the year. Yet consumption of services has failed to exceed 2019 levels by and large, and the recovery of certain sectors of the economy has been further hindered by the Delta variant. Beyond the impact of the virus, two factors seem to be holding the service economy back.

The first factor is that consumers are still saving at a rate much higher than before the pandemic. Consumers have accumulated more than 2.5 trillion in "excess" savings since the beginning of the pandemic and continue to add to the stockpile. Most economists expect this behavior to change and the US consumer to return to their spending ways, going so far as to draw down a portion of the "excess" savings. Were the consumer to do so, it could be very supportive of growth in the years to come. On the other hand, if the more cautious behavior were to become entrenched, as it appears may be happening, then it is difficult to imagine that service spending much exceeds pre-pandemic levels in the near-term.

A second behavioral factor also seems to be playing a part in the lackluster services rebound. In the sectors of the service economy where demand is robust, difficulty finding labor is constraining the supply of those services. Even as enhanced unemployment benefits expire across the country, there appears to be widespread reluctance to return to pre-pandemic work patterns. It may be that the Delta variant and childcare practicalities are holding back the return of workers as the Fed postulates, but as time goes on, it looks like some workers have left the workforce. The result is that wages are moving higher and making services more expensive even as the unemployment rate appears elevated relative to 2019 levels.

Just as important, consumers appear to be recalibrating their views on inflation too. After years of decline, measures of long-term inflation expectations among consumers have risen back to levels last seen before the financial crisis. No doubt, the wage growth dynamics are partly responsible for this move. However, the rapid reopening of the economy has also resulted in bottlenecks that have proven far more persistent than expected. Decades of "just-in-time" supply chain optimization has resulted in system-wide fragility and the very real possibility that bottlenecks will be a recurring problem for years to come.

From the perspective of the Fed, the economy likely looks very different today than might have been expected just six months ago. The Fed continues to believe that supply chain woes will ultimately be resolved, and thus much of today's goods inflation will prove transitory. However, as the bottlenecks drag on, the risk is now that inflation begins to fade only for new sources of inflation to take over. Empirical evidence suggests that the rise in house prices will likely lead to a broad-based increase in rental inflation within the next year, while companies seem intent on passing along higher wages to consumers. Indeed, in the most recent Fed economic forecasts made in September core PCE in 2022 is now expected to hit 2.3% up from 1.9%.[1]

It almost goes without saying that there is less room for maneuvering monetary policy in a world where inflation is persistently above target. Recent communication from the Fed hints at this point. The Fed had been looking for the labor market to make "substantial progress" before

beginning to taper asset purchases but had until the September FOMC meeting failed to clarify the exact threshold that needed to be met. Yet with inflation running well-above the Fed's target and Fed economic forecasts expecting core PCE to remain above 2% in 2022, the decision to start tapering in November now seems all but a foregone conclusion.[1] What is more, the Fed appears intent on concluding asset purchases by the middle of 2022 to create optionality to hike rates next year.

Compared to last spring, the mix of growth and inflation would seem to have gotten less favorable over the course of the summer. For risk assets, the question is whether the outlook has deteriorated enough to matter. Even now growth remains well above the pre-pandemic potential rate and should remain so throughout the next year. Meanwhile, the Fed and other central banks remain accommodative even if they plan to do less going forward. Earnings continue to exceed expectations and few US companies seem at risk of stress. Stagflation may be an emerging worry, but it is not yet the base case.

Nevertheless, risk premiums have been supported by an extremely favorable macroeconomic backdrop that looks to be coming to an end as the pandemic's long-term effect on the consumer becomes more apparent. At the very least, the period of ultra-low volatility experienced during the summer looks set to give way to greater choppiness ahead. For some asset classes, like investment grade credit, there does not appear to be enough cushion to absorb a potential increase in volatility, which should argue for spread widening ahead.

Focus on fixed income

One of the more perplexing elements of US rates at current valuations is just how negative real rates remain even as nominal rates have resumed moving higher. While evidence suggests that the neutral rate of interest for the US economy has moved lower over the last decade, most estimates put it closer to zero-to-modestly-positive. The fact that the 10-year real rate in the US still trades nearer to -1% than 0%, looks to be the product of ongoing asset purchases and the current dynamics around inflation.[2] In any case, real rates deserve as much scrutiny in the coming months as nominal rates, as higher real rates are often negatively correlated with the performance of risk assets and have in past periods of tapering risen quite sharply. Indeed, in some respects the real rate move is already underway. While the 10-year real rate is basically unchanged over the entirety of Q3 (with nominals higher by 10 basis points), focus on the quarterly period masks a relatively large move from -1.2% to -0.9% that occurred starting in August.[2] If rates are to continue their march higher into year-end, it is likely that real rates make a disproportionate contribution.

For credit, the relationship with interest rates can be complicated. The Bloomberg US Credit Index entered July with an option adjusted spread of 77 basis points, a post financial crisis low, and finished the quarter at 80 basis points.[2] Yet, rates clearly weighed on credit spreads in the middle of the quarter as the 10-year Treasury yield fell below 1.2% during peak worries about the impact from the Delta variant.[2] As those concerns faded, credit spreads were able to narrow again as interest rates rose. But the respite has been short-lived; as interest rates have continued to climb, credit and equities have struggled in late September and into October. The result is that US credit markets now trade right in the middle of a relatively tight range established over the last six months, with option adjusted spreads for the Bloomberg US Credit Index at 80 basis points (6m range 77-86bps), Bloomberg Long Credit Index at 123 basis points (6m range 118-128bps) and Bloomberg High Yield at 293 basis points (6m range 262-314bps).[2]

As the complexity around interest rate sensitivity illustrates, the bar to owning investment grade credit at current valuations is moving higher, particularly as the Fed and other central banks scale back accommodation into 2022. That said, one tailwind that has kept investment grade spreads from widening more aggressively is supply. Much of the heavy supply seen in September was to fund tenders for outstanding debt, meaning that supply net of redemptions and maturities is much lower than the gross supply figures would suggest. Indeed, tenders have been a valuable source of alpha over the past few months as companies have been willing to pay up to take out high coupon debt. Even in an environment where spreads are compressed, the recent uptick in tender activity is another example of the value of active credit selection.

Focus on client solutions

As we enter Q4, investors are faced with navigating an increasingly complex macroeconomic landscape. Valuations in risky assets remains challenging, while the outlook is complicated by ongoing uncertainty surrounding the Delta variant, intensifying supply bottlenecks, escalating inflation concerns and an evolving policy backdrop. In terms of market price action, investment grade credit has remained resilient with spreads hovering near historical lows. While equities managed to eke out modestly positive returns for Q3 overall (S&P 500 +0.58%), the asset class came under pressure in September with the S&P 500 down -4.7% last month.[2] From an economic perspective, momentum has noticeably slowed in the 2nd half of the year, prompting Wall Street economists and the Federal Reserve to revise their 2021 growth forecasts lower. Nevertheless, growth is expected to remain above its

pre-pandemic trend for the next 12 months, and consensus forecasts for growth in 2022 have recently risen on the expectation that consumption in services will eventually pick up steam. On the policy front, we appear to be approaching an inflection point with the Fed on the verge of tapering and Congress struggling to get the infrastructure bill and President Biden's social spending plan over the line.

During Q2, the typical pension plan's funding ratio modestly declined. Our estimates for Q3 paint a similar picture, as LGIM America estimates funding ratios declined from 89.9% to 89.7%. Plan liability discount rates increased roughly 9 basis points, resulting in slightly lower liability present values.[2] Credit spreads widened 5 basis points over the quarter, while treasury rates increased 4 basis points, respectively.[2]

From a client perspective, interest in liability driven investment strategies remains firm despite the modest deterioration in funded status in Q3 as clients look to lock in funded status gains prior to year-end. Tailored investment strategies, such as completion management and custom credit solutions, continue to gain traction. Amidst the uptick in de-risking activity, there is a growing interest from clients and consultants to look at ways to expand the fixed income toolkit in search for higher yield and diversification to current fixed income allocations. One avenue of interest has been an increase in search activity for intermediate credit mandates.

We continue to see demand from institutional investors for derivative overlay strategies as part of their risk management objectives. This has centered around institutional investors seeking either downside protection strategies or efficient ways to manage asset allocation decisions. LDI clients who have adopted a more custom LDI program are increasingly engaging with us on the benefits of consolidating derivative programs. Benefits, such as reducing collateral requirements, as well as avoiding unnecessary trading in different overlay programs across managers are some of the main catalysts.

Lastly, ESG considerations within the investment process continues to be an important focus for institutional clients. Understanding managers approach to integrating ESG objectives within the investment process continues to be a strong focus of engagement.

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1. Source: Federal Reserve
2. Source: Bloomberg

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