LGIM America

4Q 2021

Market Commentary

Focus on the macro

The increase in volatility since Thanksgiving ends a nearly nine-month stretch of relative calm for markets. One factor that is surely responsible for the recent swings in asset prices is the highly transmissible and vaccine-resistant COVID-19 Omicron variant. However, the Federal Reserve's decision in December to accelerate the pace of tapering and acknowledge that inflation may be more persistent is undoubtedly a second important factor. Underlying both drivers of volatility is the lingering question as to how much the pandemic and subsequent fiscal response have permanently changed society and the economy. As the two-year anniversary of COVID-19 approaches in the US, we believe 2022 will be the year when investors can begin to answer that question in earnest.

Looking at the markets, it appears that fixed income investors have a tendency to believe that things will eventually return to the way they were. With core inflation ending the year at 5% and GDP also averaging roughly 5% over the second half of 2021, it is difficult to justify 10-year Treasury yields in the 1.5-1.75% range unless both inflation and growth decline back to trend soon.[1] The Fed may have retired the word "transitory," but rates markets are priced as if inflation will fall back to the Fed's target by the end of 2023. Granted, the fact that inflation needs to decline to meet target represents a major shift in the Fed's reaction function relative to the months following the first COVID-19 surge when investors assumed that inflation would slowly rise to meet the Fed's target in the years to come.

In many respects, the "inconsistency" of low Treasury yields at a time when growth and inflation are well-above trend reflects the Fed's credibility in the eyes of investors. Consistent with Fed guidance, the rates market has looked through the spike in goods inflation during 2021. While bottlenecks have persisted for longer than initially expected, we believe that inventories will eventually catch up as demand moderates leading to reduced inflation for automobiles, microchips and other goods that have been subject to acute price pressure. Nonetheless, investors remain confident that Fed hikes will quickly bring inflation under control, despite the fact that inflation concerns have shifted to the shelter and services components against a backdrop of rising home prices and tight labor markets.

How the economy responds to Fed rate hikes should provide a sense of the pandemic's legacy. As is often the case, investors appear to be anchored to using the last hiking cycle as a guide to how the coming hiking cycle will play out. For their part, the Fed began hiking at the end of 2015 and eventually raised the policy rate to 2.25% at a slow pace of one to three hikes per year.[2] However, despite the unprecedently gradual nature of the last hiking cycle, markets struggled in the fourth quarter of 2018 as credit spreads widened and equities sold off due to the perception that monetary policy tightening had gone too far. Ultimately, worried that tighter financial conditions would disrupt economic growth, the Fed acquiesced, reversed course, and cut rates to 1.5% in 2019.[2]

Given the previous rate hiking experience, markets would now seem to be assuming that the Fed's terminal rate will be nearer to 1.5% than their long-term projection of 2.5% published in the December dot plot. This is evident in the low level of 10-year nominal yields, and—more importantly—how flat the yield curve has become at such low levels. In our view, the market not only believes inflation will decline back to target but also that rate hikes will have an even greater impact on the economy than the Fed believes. Said differently, markets are priced as if the pandemic will have little lasting impact: deflationary forces will reassert themselves in the coming years, and, as in the previous cycle, we expect the Fed will find it unnecessary or unable to hike aggressively.

One risk to such a benign outlook is the possibility that, as a result of the pandemic, the economy has fundamentally changed in ways which make inflation more self-sustaining and growth more resilient to rate hikes. There are plenty of reasons to think this may be the case: consumer balance sheets appear to be in exceedingly good shape, wages and hours-worked are rapidly moving higher for those at the bottom end of the wage spectrum and fiscal stimulus has been far more prevalent in this recovery (even if the failure to extend the Child Tax Credit and pass the social spending plan at year-end represent important near-term headwinds).

In addition, corporate profitability has been much stronger than expected. Robust consumer demand has allowed companies to both pass along higher input costs with relatively ease and swiftly repair balance sheets damaged by the pandemic. Meanwhile, incentives to increase capital expenditure have grown substantially due to the lack of labor availability, supply chain disruptions and environmental commitments. With funding rates so low, M&A has increased and should remain elevated as an inorganic alternative to capex.

In potentially important ways, the economy of 2022 looks very different than that of 2019. As a result, the possibility that both growth and inflation remain well-above their pre-pandemic trend throughout 2022 and beyond should not be discounted. If that were to be the case, the Fed's job would become considerably more complicated as the need to hike at a faster pace and to a higher terminal rate would grow. While it is difficult to predict how risk markets might react to such an environment, it seems unlikely that volatility would remain as subdued as it was for much of last year. As such, the year ahead is likely to require a higher emphasis on security selection as investors evaluate which investments offer sufficient premium to compensate for a more volatile world.

Focus on fixed income

It is difficult to judge the impact of the decision to accelerate the pace of tapering by the Fed as it came squarely during the surge in Omicron cases. Yet, there is no doubt it contributed to the increase in interest rate volatility during the fourth quarter, which was the highest since the beginning of the pandemic. That being said, 10-year nominal yields ended the quarter exactly where they began at 1.52%.[1] Indeed, the more meaningful move was the 45 basis point rise in 2-year yields as the market began to price the possibility of multiple Fed rate hikes in 2022.[1] As of January 10, 2022, the market-implied probability of a March hike is 81%, up from 7% at the beginning of the fourth quarter.[1] If the first few days of 2022 are anything to go by, rate volatility is likely to remain elevated this year. With 10-year real rates still hovering around -0.75%, there would seem to be scope for a move higher in the months to come.[1]

Not surprisingly, credit market volatility was sharply higher in the fourth quarter along with rates. After trading within a narrow range from April through the last week of November, investment-grade credit spreads wiped out all of the spread tightening experienced during the year before recovering marginally by year end. While the Omicron variant and the hawkish Fed pivot clearly weighed on credit markets, the desire by US banks to reduce balance sheet into year-end also played a key role in reducing liquidity and widening bid-offer. The high yield market was more volatile yet better performing during the quarter. The spread on the Bloomberg US High Yield Index ended the quarter 7 basis point tighter after having been almost 50 basis points wider at the beginning of December. In contrast, the spread of the Bloomberg US Investment Grade Credit Index finished the fourth quarter 7 basis points wider at 87 basis points after briefly touching 95 basis points. Similarly, the Bloomberg Long Credit Index closed the quarter 7 basis points wider at 130 basis points having reached a high of 138 basis points in early December.

For much of 2021, full valuations were a barrier to adding credit risk across portfolios. However, the combination of volatile markets and a rush of year-end issuance provided a short window to add risk at more attractive levels. More than $63 billion of investment-grade corporate debt was issued in December, well above the $23 billion average over the last four years. Many investors, such as LGIM America, used the atypically large December issuance as an opportunity to reinvest the proceeds from recent tenders—the largest of which was General Electric's tender of $25 billion in bonds.[1] Yet, with credit spreads briefly widening back to beginning of the year levels, there was a strong case to go beyond reinvestment and decrease the credit underweight in portfolios. As such, the credit portfolios managed by LGIM America ended the fourth quarter less underweight credit than they began it, but they are still positioned to take advantage of the higher volatility environment expected in 2022.

Focus on client solutions

Investment professionals and the broader population leave 2021 behind with the same key question that was top of mind in the closing months of 2020. How quickly can we return to our normal lives and what will be the lasting impact of COVID-19? During the Spring and Summer of 2021, it seemed like we were on pace to answer the first part of that question favorably. However, the highly transmissible Omicron variant has disrupted our plans for a return to normalcy while re-introducing a level of volatility to markets that was largely absent for a good portion of the year. Couple the increase in positive COVID-19 cases with additional uncertainty related to the Fed's hawkish pivot and stuttering plans to pass additional fiscal stimulus, market volatility may become a more prevalent story in 2022. As a result, we have seen an uptick in demand for more tailored investment strategies across a variety of channels as a way to position portfolios for the new environment.

LGIM America estimates that an "average" plan (60% global equity / 40% US aggregate fixed income) began 2021 with a funding ratio of approximately 82%.[3] Funding ratios for the average plan closed out 2021 at the high watermark for the year at just shy of 93%. The main contributor to the increase was the strong performance of equity markets. Global equities climbed approximately 20%, while the S&P 500 rose almost 30% during 2021.[2] Pension plan sponsors also likely benefited from an increase in plan discount rates. We estimate discount rates rose close to 45 basis points over the year helping to lower liability valuations.[3] As funding ratios improve, we have experienced a heightened demand for custom fixed income strategies as a way to dampen funded status volatility and increase predictability for plan sponsors.

From a client perspective, two emerging themes have contributed to the growing appetite in more tailored LDI solutions. The first is the improvement in pension plan's funding levels. As funding ratios improve, many of our clients have hit de-risking triggers that has resulted in 1) additional capital moving to fixed income and 2) the decision to hedge more interest rate risk. The second factor is the recent spike in volatility within the Treasury market, as noted earlier in this newsletter. We have seen this to cause many to examine a custom LDI strategy that can insulate the plan's funded status to severe swings in market movements.

Along a similar vein, custom credit solutions have also gained traction recently for our client base. As plan's funding levels improve, many are considering or preparing for possible end-game scenarios, whether that be a pension risk transfer or constructing a self-sufficiency portfolio. Another theme through 2021 was a search for yield and diversification to client's current fixed income allocations. We saw an increase in demand for intermediate credit as well as a wider interest in private placements and how this asset class can complement a client's custom LDI strategy.

Additionally, many clients are heeding lessons learned from previous years and are taking a more strategic, thoughtful approach to managing equity risk. We have seen more interest in downside protection strategies given where markets currently sit and the level of uncertainty that exists today. Some have gone one step further and adopted collar strategies as a way to more efficiently shape funded status outcomes or offset the cost of protection strategies.

Lastly, this wouldn't be a true 2021 investment letter without at least mentioning ESG. ESG considerations and how these factors are integrated within the investment process has been an increasingly relevant topic for institutional clients. Across the investment landscape, we've seen a number of ESG-focused and more specifically, climate-focused strategies emerge. How these strategies are embraced from the investment community will be a key theme of 2022.

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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.

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