

LGIMA's Multi-asset Market Update

October 2019



Equity market

Returns were rather forgettable across most markets over the past month, especially when measured point-to-point – most markets registered moves of about 0.25 standard deviations or less. However, depicting those results objectively and through the cheerful L&G color scheme belies the true experience. Instead, those four bright colors are more analogous to the leftover party favors from a child's birthday, outwardly portraying happiness and a reasonably well-managed event while the hosts are left to hide in a quiet space, reflect on the utter chaos, noise, messiness, and tears shed, and probably imbibe a bit.

Normalized Asset Returns Last 30 Days



Source: Bloomberg

In the period since our last publication, equity factors such as value and momentum had multiple standard-deviation events and reversals, while Treasury yields had a 40 basis point round-trip. The onslaught of up-and-down headlines regarding trade progress and economic developments continued to drive much of the volatility. Both trade developments and economic releases have generally resolved favorably for now, and equity markets are back near all-time highs. **Nevertheless, we have just initiated a tactical underweight to global equity.** Our odds of recession in the next 12 months are ticking higher, recent market dynamics are stressing our internal turbulence indicators, we expect continued volatility around political developments, worry that we may be at peak optimism for trade, and it seems that much of the support that the Fed can provide to equity markets is priced in.

These developments are on top of valuations that we have long highlighted as rather elevated, and – in certain segments of the market – dizzyingly untethered from reality. For instance, we included a skeptical comment about WeWork in our August issue, just as its IPO was announced. In a matter of weeks, that company has gone from a potential \$40B+ valuation to near bankruptcy. A recent article in The Atlantic detailed the debacle and noted that The We Company's precarious financials are not particularly unique:

If you wake up on a Casper mattress, hail a Lyft to get to your desk at WeWork, use DoorDash to order lunch to the office, hail another Lyft home, and have Uber Eats bring you dinner, you have spent your entire day interacting with companies that will collectively lose nearly \$13 billion this year. Most have never announced, and may never achieve, a profit.

- "WeWork and the Great Unicorn Delusion", September 20, 2019.

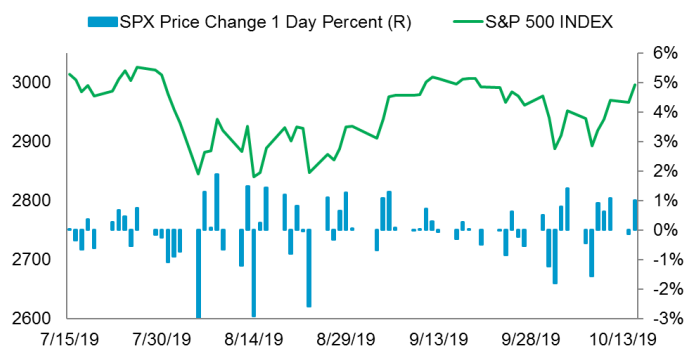
All of these factors together create substantial vulnerability for equity markets. We recognize, however, that reducing equity may be difficult for many clients; there are several factors still potentially supportive of further gains, institutions are simultaneously faced with meeting total return, payout, or funded status objectives in a low-rate, low-return environment, and clients could be beholden to other idiosyncratic internal policies and/or constraints. Nevertheless, there can be relatively attractive and/or lower risk alternatives to gain equity exposure that could suit many institutional portfolios.

Long-term investors have patient capital. Patient capital doesn't have to be private capital, and private capital isn't necessarily productive capital. For investors with allocation targets to private or public markets, we have identified strategies to make your patient capital more productive. For private market allocations, liquid private equity alternatives can enable a plan to remain more nimble and less cash-constrained in advance of any potential stress – times when illiquid exposures can be especially problematic – and to be more selective about future private fund commitments. For public market exposures, institutions with physical allocations to equities can lock in excess return above their equity benchmark index, if they have the flexibility to utilize derivatives and deploy that capital to pockets of the Treasury market that are experiencing persistent supply-demand imbalances.

In an era of constrained bank balance sheets and increasing demand for leverage, long-term institutions with access to cash or cash securities can utilize the value of patient capital to shape outcomes or enhance returns. We are happy to discuss these approaches in more detail with any interested client, and of course previously mentioned equity hedging approaches can still be achievable and effective for reducing risk consistent with our short equity view.

Equity volatility

As managers review this year's stock market returns, they will observe dramatically varying results for the S&P 500, depending on the assigned observation window. On the one hand, the index is up 19.5% year-to-date after recovering from a brutal fourth quarter in 2018. On the other hand, the index is up only 4.3% since January 26, 2018 after a remarkable 2017. Most recently, the market is down 0.6% over the last three months as it hovers near all-time highs. We want to take stock of this recent period's volatility conditions.



Source: Bloomberg

In the first half of September, VIX futures' term structure flattened, but did not invert. Longer-dated maturities' implied volatility expanded, and the front months were relatively capped given elevated, but not panicked, daily volatility. More recently, the equity market recovery was marked by a "spot up, vol up" dynamic, where the equity market advance occurred with larger daily movements. The strong recovery in spot encouraged traders to shed short-dated volatility exposure, substantially marking down related prices, while the sustained realized volatility helped maintain a stronger bid for longer-dated volatility pricing. For outright tactical hedges, we would rather own the recently-depressed short-dated maturities. Because longer-dated maturities remain elevated, we continue to see value in structuring long-short packages that allow investors to fit exposure to their overall risk budget. That said, although longer-dated implied volatility is elevated, investors implementing overlays should remain aware that it isn't simply the absolute cost of the structure that influences the attractiveness of an overlay decision, but also the reference strike and stock market entry levels.

Rates market

Long-end rates had an average daily move of nearly 5 basis points over the past month, but stayed range bound relative to the tumultuous previous two months. The 30-year Treasury rate closed at 2.24 after September's FOMC meeting, rallied to 2.11 at the end of last month, and hit 2.02 on October 4, but has since sold off to its current level of 2.23. Weak data – domestically and abroad – drove rates lower, but progress in US trade negotiations and Brexit helped push them back up, although the path to get there was a bit rocky.

Post FOMC, President Trump indicated that he wanted a “complete deal” with China, which may have contributed to the visiting Chinese officials’ early departure and cancelled portion of their visit to the western states, causing rates to rally. The rally continued through the last week of September, as consumer confidence and Richmond Fed manufacturing numbers disappointed, and Democrats began mounting a case for impeachment of President Trump based on his dealings with the Ukraine. With Fed repo facilities oversubscribed, General Collateral rates began to creep up, leading the NY Fed to increase their daily repo lines up to \$100bln from the previous \$75bln levels.

Rates continued to rally as October got off to a rough start. After a selloff overnight during the Tokyo session as the JGB auction tailed, rates quickly reversed course as ISM manufacturing printed 47.8, its lowest level since June 2019, perhaps indicating that the US economy might not be able to escape the effects of a global manufacturing slump. Data disappointment continued as ISM non-manufacturing and UK/EU PMI numbers came in lower than consensus. The NFP report for September was mixed at best. Job growth continued at a steady pace and unemployment came in at 3.5%, 0.2% lower than anticipated. However, average hourly earnings failed to show any growth, dragging the year-over-year growth down to 2.9%.

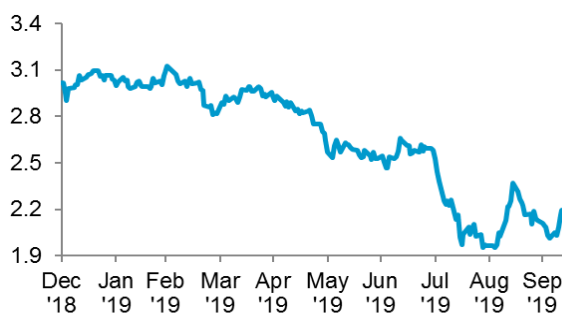
Sentiment quickly turned positive last week as a steady stream of trade-related updates were released. The China Foreign Ministry publicly stated they were open to a partial trade deal ahead of the US-China talks in Washington, and agreed to more agricultural purchases. Chinese VP Liu announced he was extending his stay in the US to continue trade talks ahead of both sides indicating that a tentative trade truce would be reached as a partial trade agreement began to come to fruition. Across the pond, we saw what seemed like the first positive news around Brexit all year. UK PM Johnson and Ireland PM Varadkar announced they see a pathway to a potential deal. In Europe, the ECB MPC letter was leaked by a “whistleblower” that indicated there may be more dissent internally than previously expected around the EU’s seemingly open-ended quantitative easing (QE) reboot. This potential for slowing QE operations coupled with the positive trade news helped push the US long end rate 20 basis points higher in only four trading days.

US Rate Environment

Index	10/15/2019	One-month ago	Three-months ago	One-year ago
Fed Funds Rate	2.00	2.25	2.50	2.25
2y	1.62	1.80	1.83	2.85
5y	1.60	1.75	1.84	3.01
10y	1.77	1.90	2.09	3.16
30y	2.23	2.37	2.61	3.33

Source: Bloomberg

30yr Treasury Rate



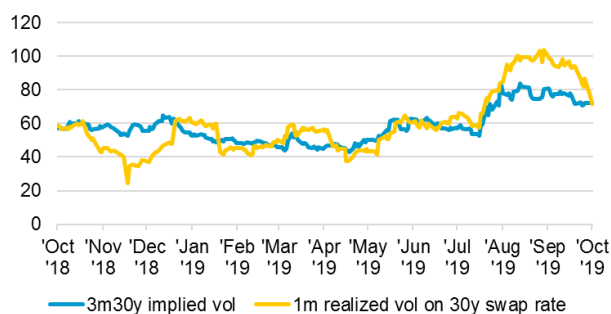
Source: Bloomberg

The next FOMC meeting is only two weeks away and the market is currently pricing in a 70% chance of another 25 basis point cut. But considering the resiliency of job growth and the dissent from two voting members at last month's cut, further cuts from here are far from certain. Despite the progress seen during last week's trade negotiations, the markets will remain on edge as a random tweet could torpedo any potential resolutions. The risk for a global recession remains high which can always lead to unforeseen contagion in the US.

Rates volatility

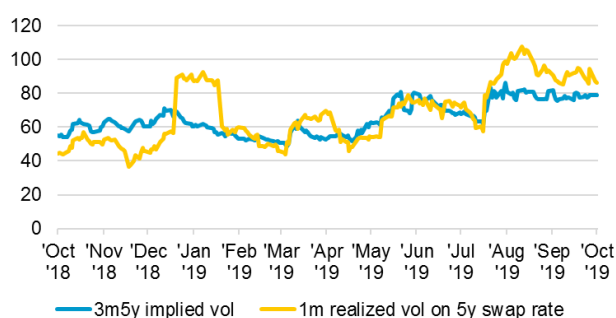
Rates staying relatively range-bound and realized movements drifting back to more normal (although still elevated) levels, have led short-dated volatility to drift lower, while longer-dated volatility is up 1-3abpv from buying of forward volatility structures. Short-dated volatility still experienced intraday spikes, particularly on days with large rallies, but these moves tend to reverse fairly quickly. When rates gapped lower on the weak ISM print OTC volatility in the upper left, we bid up 2-5abpv but ended the day lower than the previous close. Interestingly, during these moves, volatility in the green Eurodollar strip remained unchanged. Trailing 1-month realized volatility on the 30-year rate has fallen sharply from its peak of 103abpv to 72abpv currently. Shorter tails have remained more volatile, with the realized volatility on the 5-year rate still hovering at 86abpv, down from its local high of 109abpv. This dynamic has led to the shorter-dated volatility on short tails to remain relatively unchanged, while short-dated volatility on 30-year tails is down 1-9abpv. Longer-dated volatility has caught a bid as it looks cheap relative to shorter dated volatility, but the concern going forward is that as we remain in this low rate regime, Formosa bonds will continue to get called, leading to an uptick in issuance and flooding the street with a supply of long-dated volatility. In skew, high strike payers have been richening, but low strike receivers still trade with a higher implied volatility. The pain trade for end users continues to be rates moving lower.

3m30y Implied Volatility and 1m Realized Volatility on 30y Swap Rate



Source: Citi

3m5y Implied Volatility and 1m Realized Volatility on 5y Swap Rate



Source: Citi

Current Implied Volatility Levels and Change Over 1 Month

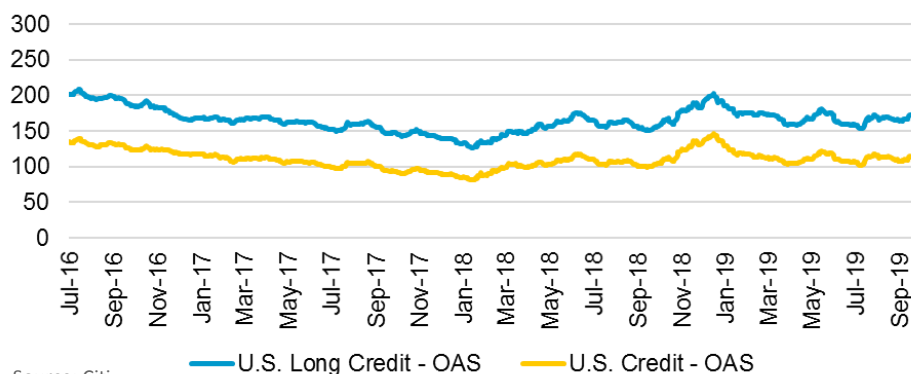
P/TAIL	1Y	CHANGE	2Y	CHANGE	5Y	CHANGE	10Y	CHANGE	30Y	CHANGE
1M	71.7	↓ -0.7	80.9	↓ -1.8	82.4	↓ -9.6	79.7	↓ -9.9	74.1	↓ -16.5
3M	72.3	↓ -1.8	77.7	↓ -2	79.1	→ -3	76.5	→ -3.5	72.4	→ -8.6
6M	70.8	→ 0	73.9	↓ -0.4	75.3	↑ 0	73.3	↑ -0.5	70.1	↑ -3
1Y	69.1	→ 0.8	69.7	→ 0.5	71.6	↑ 1.1	70.2	↑ 0.9	66.6	↑ -1
2Y	68.1	↓ -1.4	68	↓ -1.4	68.5	↑ 1.8	68	↑ 1.8	63.3	↑ -0.3
3Y	68.1	↑ 2.4	67.8	↑ 1.5	67.8	↑ 1.9	67.1	↑ 2	61.7	↑ 1.3
4Y	67.5	↑ 2.9	67.4	↑ 1.8	67.3	↑ 2.1	66.3	↑ 2.1	60.6	↑ 1.9
5Y	67.9	↑ 3.3	67.1	↑ 2.2	66.9	↑ 2.3	65.7	↑ 2.3	59.7	↑ 2.2
7Y	66.3	↑ 2.2	65.8	↑ 2.6	65.6	↑ 2.7	64.2	↑ 2.9	57.8	↑ 2
10Y	64.8	↑ 2.8	64.2	↑ 3.1	63.9	↑ 3	62.1	↑ 3.1	55.4	↑ 2.2

Source: Citi

Credit market

Over the previous month, the U.S. Credit market traded relatively range-bound, as the Long Credit index tightened 3 basis points. As earnings season approaches, bottom-up consensus anticipates further margin compression for public U.S. IG issuers. Estimates for US IG issuers expect revenues to increase 3.3%, and earnings (excluding buybacks) are projected to decline around 4.7%. Given that actual results tend to beat expectations, adding the average earnings surprise of 4.0% implies an earnings growth that is close to flat.

US Credit Spreads



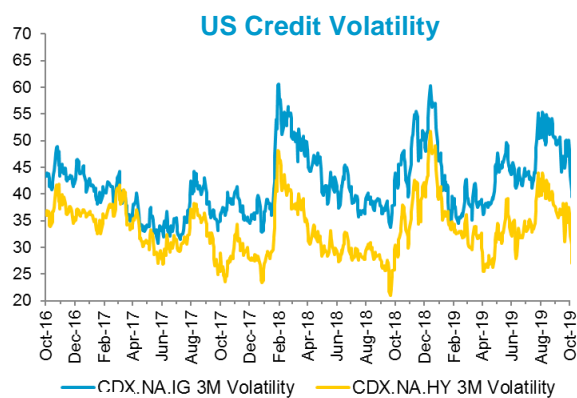
Source: Citi

Last month, primary issuance was higher than expected, as supply amounted to \$140bln in aggregate – the third highest amount of monthly volume on record. In the face of abundant supply, US IG Credit Spreads still managed to tighten as demand is robust for US corporate bonds. September’s issuance bolsters the year-to-date figure to \$890bln, around 8% behind last year’s pace. With approximately \$15tln of negative yielding global debt, LGIMA continues to anticipate a heightened demand for IG Credit from both US and foreign buyers. October is expected to offer \$70 - \$90bln over the month, relatively in line with the October 2018 issuance figure.

The market is also pricing in a 25 basis point cut for the FOMC’s October meeting, as refreshed data points have illustrated relatively weaker US manufacturing data. The potential for a hard Brexit, negative economic data in the Eurozone, and heightened sanctions in Iran could impact global growth moving forward. That said, overall geopolitical tail risks seem to have recently softened. Political developments in the UK suppress the probability of a hard Brexit in October, and the news of a potential US - China mini-deal could help ease immediate concerns of a near-term recession. Under the pretense that these two events have already been priced into the market, improvement in either situation could act as a tailwind for US IG Credit performance.

Credit volatility

Over the past month, the on-the-run IG CDX index traded in at 12 basis point range. The last two weeks of September experienced a 12 basis point widening in the index, while the first half of October has reversed 6 basis points off of the local wises as market volatility has eased. However, since the beginning of the year, IG CDX is trading at the lower end of the range. Investment grade and high yield option volatility declined in October, partially due to the indices rolling. As the IG index widened, volatility dropped in comparison.



Source: Citi

Irrespective of the roll, credit derivative indices have remained moderately range-bound and credit option investors have taken the opportunity to sell longer-dated volatility to benefit from subdued realized volatility. Index carry has been a significant driver of CDX index returns over the past few months as CDX indices have traded in a narrow range. Selling outright options allows investors to enhance index carry while trading the ranges. From a volume perspective, September appeared quiet for market participants, while October saw an increase in hedging and short volatility strategies.

Contributors



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