LGIMA’s 2018 Recap
Market Commentary

Focus on the macro
The most important question facing investors this year is whether the recent weakness in markets portends slower economic activity to come. While valuations and volatility were under pressure for much of last year, the tightening of financial conditions during the fourth-quarter of 2018 has significantly increased economic uncertainty. Yet it is unclear if markets are leading the economy or simply experiencing a temporary loss of confidence brought about by concerns related to weaker growth, uncertain geopolitics, and tighter central bank policy. At the moment, the latter seems more likely and there is a high likelihood that the current expansion will become the longest uninterrupted period of growth in US history later this year. Still, the message from the fourth-quarter is that continued growth should no longer be considered a foregone conclusion; there is plenty to worry about.

The Fed—for one—seems nonplussed by the weakness in markets given the US economy’s lack of obvious vulnerabilities. But such confidence from the Fed and a willingness to continue hiking despite the selloff is itself troubling to markets. Over the last four months, Chair Powell’s remarks and the FOMC minutes have added to the uncertainty around the precise level of the terminal rate, the appropriate size of the balance sheet, the pace of rate hikes in 2019, and the Fed’s reaction function. Increasingly, market participants complain that Fed communication is unclear and inconsistent from month to month. Suffice it to say that, after hiking interest rates four times in 2018, the market is no longer confident that the Fed is sensitive enough to global developments and will succeed in soft-landing the economy, particularly given the central bank’s poor track record of doing so in the past.

As much as Fed policy remains a challenge, the bigger issue is that further normalization of central bank policy looks set to occur against a backdrop of slowing global growth, in contrast to last year. In the US, most economists believe that the majority of the boost from the tax cut will fade by the second half of 2019 and result in a return to trend growth of around 2%. Moreover, there is increasing concern that corporate profit growth is likely to stagnate as demand slows and wages steadily rise against a backdrop of already high corporate leverage levels.

Meanwhile, rest-of-world growth looks poised to decelerate as well and continue to decouple from the US. The dip in Chinese growth is proving to be of a larger magnitude and of a longer duration than expected, as the authorities there seem reluctant to resort to the type of imbalance-creating credit stimulus previously employed. Arguably, the European growth picture looks even worse, with the ECB ending quantitative easing even with growth and inflation remain stubbornly below target. If anything, it looks likely that the headwinds facing the eurozone economy—intractable Brexit negotiations, expansionary Italian budgets, French labor strikes, and the shift to higher auto emissions standards—may spill over into 2019 with the ECB able to provide only limited monetary policy support.

While growth will almost assuredly weaken this year, few expect a global or US recession in 2019, and as such, there appears to be a disconnect with financial markets. Typically, the sharp widening in credit spreads and precipitous drop in equity and oil prices experienced during the fourth quarter would be associated with a meaningful growth drag of 1-2%, according to academic and private sector models. Incorporating such a shock into the US outlook would leave growth well below trend and within 1% of contraction, a forecast that is at odds with the vast majority of economists as well as the Fed.

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Most economists argue that the US economy should be relatively resilient given the health of the consumer. With employment growth at levels well above what is necessary to keep the unemployment rate falling, there is considerable room for the pace of hiring to slow before it would likely trouble consumption or lead to a damaging fall in confidence. Likewise, lower oil prices and rising wages should provide additional support to real incomes. So even though CEO concern is growing and the outlook for business investment is worsening, the expectation is that the consumer remains well-insulated. Furthermore, interest-rate sensitive sectors of the economy such as housing and autos that are showing signs of weakness are relatively small contributors to growth.

After the fourth-quarter selloff then, it appears as if risk and reward are better balanced as both credit and equity markets seem to be priced for a more negative economic backdrop than is likely to materialize. If economic growth holds up in the face of tighter financial conditions and the Fed can correct the communication errors of last year, there is likely room for markets to recover a portion of their losses. Yet given the deterioration in liquidity conditions—exacerbated at year-end, to be sure—and rising single-name idiosyncratic risk—as exemplified by General Electric—volatility may remain elevated in 2019 and keep valuations from making a full recovery.

Focus on fixed income
The shape of the yield curve has played a major role and will likely continue to influence how fixed income markets trade in 2019. Not surprisingly, the flattening of the 2s10s curve from 54 basis points at the beginning of the year to 15 basis points at year-end captured significant attention given the curve’s success at predicting recession. However, a flatter curve has more practical implications for fixed income markets. For one, it makes it difficult for longer-end rates to stage a substantial rally as the front-end acts as an obstacle. Indeed, despite the substantial weakness in equity and credit markets, 10-year rates only rallied 50 basis points in the fourth-quarter to end the year at 2.69% (still 23 basis points higher on the year).

The flatter yield curve also played a part in the disappointing performance of the credit indexes in 2018, which finished at the lows of the year after spreads gapped wider during the fourth quarter. At an OAS of 143 basis points, the Bloomberg Barclays US Credit Index widened 53 basis points throughout 2018 to produce a -2.11% excess return relative to Treasuries, while the US Long Credit Index widened 61 basis points leading to an excess return of 6.76%. Given the flattening of the yield curve, the underperformance of longer-duration credit is not all that surprising as credit curves tend to steepen when the Treasury curve flattens, all else equal.

Securitized products also underperformed in sympathy with the widening in credit, albeit they still managed to outperform comparable IG securities into year end. US Agency MBS Index widened 12.47 basis points on the year despite a lack of credit risk, mostly due to upwards spread pressure from the Federal Reserve continuing to runoff their balance sheet. The US CMBS Index widened 22.54 basis points, while the US ABS widened 18.48 basis points. Due to the shorter duration & weighted average life of CMBS/ABS products, they were less affected by the steepening of broader credit curves caused from the flattening of rates curves.

In stark contrast to 2017, the past year proved to be one of higher volatility and growing dispersion. For asset managers, this should be an environment conducive to generating alpha. However, the deterioration in liquidity conditions makes it more difficult to maneuver portfolios to take advantage of opportunities. As such, high investment conviction is more important than ever. In the credit portfolios, we began to add risk as valuations cheapened in the fourth quarter as we have confidence that the economy will avoid recession given the strong consumer and the Fed’s ability to slow tightening against a backdrop of well-behaved inflation. We continue to focus on sectors and companies that we believe can reduce leverage in more challenging macro environments.
Focus on client solutions

2018 provided a case study on the importance of mitigating risk for clients focused on pension risk management. Entering 2018, the pension market outlook was strong—the economy and equity markets both appeared quite healthy, tax reform offered a strong incentive for sponsors to contribute to the pension plan, and many clients had reached a ten-year high in funding level.

LGIMA estimates that an “average” plan, one defined as employing 60% global equity/40% US aggregate fixed income allocation, started 2018 with a funding ratio of ~84%. By the end of the third quarter, the average funding ratio increased to ~92%. This was driven primarily by strong equity markets as well as a steady rise in the liability discount rate, which lowered the present value of plan liabilities. In the fourth quarter, we entered a period of equity drawdowns, with global and US equities both falling by over 12%, paired with largely unchanged liability discount rates. This reversed any previous gains, closing out the year with an estimated funding ratio of ~84%.

Over the year, many sponsors not only contributed to the pension plan, but they also de-risked the plan further. As funding levels improved, many plans hit funding level triggers which drove a common decision to sell equities and buy more fixed income. De-risking activities into more fixed income was also supported by front loading additional pension contributions to take advantage of tax reform before the September 15 deadline. These activities dramatically helped many clients lock in funding ratio gains before the fourth quarter.

On the heels of these outcomes, clients continue to look for ways to reduce risk within their plan. While equity risk was most pronounced in 2018, plan sponsors remain focused on mitigating interest rate and credit spread risk. These activities include a focus on more customized LDI strategies such as liability benchmarking, completion management, and other custom fixed income and derivative strategies to help reduce funding ratio volatility. Very well-funded clients that are focused more on their end-game outcome have extended the level of customization to their corporate bond allocation by implementing custom buy and maintain credit strategies aimed at meeting client specific objectives such as avoiding defaults and downgrades, cashflow matching to plan liabilities, preparing for a pension risk transfer or self-sufficiency and reducing transaction costs. Conversations around diversifying clients’ credit allocations have also increased with an emerging focus on private credit and other yield enhancing fixed income strategies.

On the equity side, clients have expressed a desire to reduce equity risk in a variety of ways. One approach is through traditional hedging, using overlays and tactical option strategies to mitigate either short/medium term risk or rolling tail-risk strategies. Full plan completion management has become increasingly popular, as clients look to keep their Strategic Asset Allocation in-line on a total exposure, volatility, or factor basis. Lastly, we’ve seen heightened interest in risk premia strategies to replace a portion of a plan’s equity exposure.
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