Focus on the macro

The rebound in equity and credit markets since the collapse of trade talks in early May reflects increasing optimism that the macroeconomic environment will remain positive for risk assets. In the coming months, three things likely need to happen to validate that confidence. First off, negotiation with China, the EU, and other trading partners needs to continue without further tariff escalation. Second, economic activity must remain relatively resilient in the face of recent headwinds. And third, the Fed must ratify market pricing and cut rates at the July or September FOMC meeting. Taken together, the combination of lower geopolitical risk, steady US growth, and continued Fed dovishness should be sufficient to drive valuations higher.

That the US and China have resumed trade negotiations after the G20 meeting is a clear positive. What remains to be seen is if both sides can reach a compromise. Significant hurdles to an agreement would seem to remain, specifically around the issues of intellectual property, technology transfer, government subsidies, and the rollback of existing tariffs. As such, the possibility remains that the US could announce further tariffs in the future on the $300 billion of Chinese goods that are currently not subject to duties.

The direct negative effects on the US economy to date from tariffs have been modest. First quarter growth came in at a surprisingly robust 3.1% and the second-quarter is tracking at 1.5-2%, which means that first-half GDP is set to exceed potential. Of course, it is likely that the increase in tariffs on the previous round of goods from 10% to 25% in May has yet to fully show up in the data, and it is possible that Chinese growth is still slowing down. That being said, there is evidence that Chinese companies are circumventing the new duties by rerouting exports through countries such as Vietnam and Mexico, and thus limiting the damage to both the US and China.

At some point, the economic costs from tariffs are likely to be nonlinear as further escalation will eventually weigh on business confidence, hiring intentions, and capital expenditures. What is more, the additional $300 billion of Chinese goods that the US was targeting ahead of the G20 are mainly consumer-oriented products on which tariffs would likely be passed through to US consumers—a crucial contributor to US growth this year. Although estimates from economist vary widely, the ultimate hit to US growth in the event tariffs were imposed on all remaining Chinese exports would likely be 0.5-0.75%. Such an outcome would not by itself lead to a US recession but would increase the economy’s vulnerability and weigh on what is already anemic corporate earnings growth.

Recent communication from the Fed suggests they are closely watching how the trade negotiations develop as they formulate monetary policy. At the June FOMC meeting, Fed officials noted that the argument for cutting rates has grown stronger with trade headwinds building and inflation remaining below target. These sentiments and a lack of pushback on the more
than three cuts priced into rates markets this year has left many investors and economists anticipating a preemptive cut to support the economy, similar to the so-called insurance cuts made in 1995 and 1998.

In light of June’s G20 trade truce between the US and China, the argument could be made that the Fed should hold off on cutting rates as the economy is not showing weakness commensurate with the experience of 1995, or a tightening in financial conditions as seen in 1998 when the Fed was navigating the Mexican peso’s devaluation and the LTCM/Russia defaults, respectively. Indeed, there is risk that cutting rates now leads to overexuberance and increases economic risks over the medium-to-longer term, as some might argue the 1998 cuts contributed to the dot-com bust in 2001-2002. Markets have dismissed the possibility that the Fed will leave rates unchanged over the summer, but Fed voting members would seem to be split judging by the “dot-plot”.

In the absence of further negative trade developments, the decision to cut in July or September will likely come down to the inflation data, upcoming employment reports, and the Fed’s willingness—or lack thereof—to surprise markets. As recently as the May FOMC meeting, Chair Powell described the dip in US core inflation measures as likely transitory. If this proves to be the case and employment remains robust after May’s softer than expected number, the Fed may regret its recent dovish turn. Still, after the string of communication errors in the fourth quarter of 2018, there is some confidence the Fed will deliver at least one 25 basis point cut and not repeat the mistakes of last year.

In recent weeks, some pundits have expressed concern about the apparent disconnect between the significant decline in rates this year and the elevated valuations of risky assets. Such moves harken back to when quantitative easing dominated markets and drove all asset prices higher. It is notable then that the European Central Bank appears to be laying the groundwork to restart asset purchases given the EU’s lackluster economic performance, and that Japan also seems ever-ready to ramp up purchases if needed. Yet it is difficult to imagine the Fed following suit in any economic scenario, other than a recession that would lead to a sizable correction in equities and credit.

It could be said that markets are pricing in a different sort of Goldilocks environment to the one of low inflation/above trend growth that characterized the last few years and allowed the Fed to hike at an unusually slow pace. The new Goldilocks environment assumes inflation stays below trend and that growth is just weak enough to encourage Fed cuts, but not so weak as to affect corporate earnings and risk recession. While this is a plausible scenario, market valuations are providing little compensation should it not come to pass. As such, there is reason for investors to be constructive on markets into the second half of the year, but not overly enthusiastic.

**Focus on fixed income**

It is difficult to argue that the most notable development in fixed income markets over the past few months is anything but the continued decline in interest rates in the US and globally. The US 10-year Treasury yield declined 50 basis points during the second-quarter to end at 2%, while 2-year yields declined even more as investors now expect the Fed to cut rates multiple times this year. Viewed from a global perspective, a now record amount of government debt trades at a negative yield, which should incentivize yield-starved foreign
investors to buy US fixed income debt. One bright spot is that the Treasury curve is now steeper across the curve and, to an extent, concerns about the curve inverting have diminished.

While lower risk-free yields have in the past been a headwind for credit spreads, the US credit markets appeared more preoccupied with trade developments and managed to recover much of the May selloff to end tighter on the quarter. The US Bloomberg Barclays Long Credit Index tightened by 10 basis points to end at a spread of 161 basis points—just 3 basis points shy of the mid-April lows—while the US Credit Index notched a more modest 3 basis point gain to end at a spread of 109 basis points. Echoing the move in Treasurys, the yield on the US High Yield Index dropped by 50 basis points and is now below the psychologically meaningful 6% level.

Securitized products underperformed their corporate comparables in the second quarter of the year. The MBS index widened 10 basis points over the period, as rate volatility and upwards spread pressure from the Fed balance sheet runoff affected the asset class. CMBS moved wider in May in sympathy with IG credit, but managed to tighten back to flat quarter-over-quarter during the month of June. Issuance in CMBS is relatively flat to slightly up year-over-year, and should provide a solid technical backdrop to prevent further steepening. The ABS index widened 2 basis points, led by front end underperformance in credit cards/autos as dealer balance sheet troubles affected market liquidity.

The market volatility experienced in the second-quarter proved to be beneficial for most of the credit portfolios LGIMA manages. As trade woes intensified throughout May, portfolio risk was initially reduced to express a more neutral opinion on credit, although the prospect of a trade truce at the G20 argued against selling risk more aggressively and we continued to adjust higher beta positions throughout the quarter. The rotation of some high-beta BBB credits into low-mid beta BBB and single A issuers was one way we modestly reduced exposure to the market. A slight reduction in exposure to select large capital structures across tobacco, autos, wirelines, and pipelines has allowed LGIMA to fund positions in sectors with less beta such as consumer cyclicals and utilities.

**Focus on client solutions**

For clients focused on pension risk management, the second quarter of 2019 proved to be volatile. In hindsight, a strategy focused on hedging interest rate and credit spread risk could have helped navigate the unpredictable market movements. LGIMA measures an average pension plan’s funding ratio assuming a typical liability profile (~12 year duration) and a 60% global equity/40% aggregate bond investment strategy. Through the month of April, the average plan’s funding ratio increased from 85.6% to 87.4%, primarily on the back of strong performance in the equity markets. In addition, Treasury rates reversed course after rallying much of March on the back of positive headlines surrounding the US/China trade rhetoric. Coupled with the positive equity performance, the higher liability discount rate led to positive gains in the plan’s funding ratio. May was characterized by falling equity markets and decreasing Treasury rates, both headwinds to a pension plan’s funding ratio. The escalating trade war and tariff threats from the US administration pushed long-end rates to pre-2016 election levels, causing liability values to rise.
In total, the average plan’s funding ratio fell 2.5% from 85.6% to 83.1% over the second quarter. The positive gains in global and US equity markets were offset by the increase in liability values due to a lower discount rate. LGIMA estimates an average plan with a 60/40 asset mix increased 3.6%, but due to liability discount rates dropping 40 basis points, liability values advanced 6.8%. The market dynamics that were observed over the second quarter highlight the benefits of derisking in order to “lock-in” funding ratio gains as well as the impact hedging additional interest rate risk can have on a plan’s financial health. Although long-term asset allocation decisions may be unique to each plan and agnostic to the near-term capital market risk, thoughtful interest rate, credit spread, and equity hedging can provide positive funding ratio outcomes in a variety of environments.

In light of recent swings in risk assets as well as the potential for idiosyncratic headlines, many plan sponsors continue to look for ways to mitigate risk within their plan. Conversations with our clients continue to focus on hedging interest rate and credit spread risk inherent in plan liabilities. Doing so can help reduce funded status volatility. As clients continue to move along their glidepath, completion management and other custom hedging strategies have increased in popularity across the industry. These outcome-oriented strategies, which tailor a plan’s fixed income portfolio to more effectively match the underlying liabilities, also help to support potential end-game objectives, such as pension risk transfer and self-sufficiency.

On the equity side, clients have taken their cue from volatility experienced in December and May to explore reducing equity risk in a variety of ways. One approach that is gaining traction is using overlays to implement a downside protection strategy while possibly selling some upside to reduce the overall cost. We have also seen wider interest in equity overlay investment strategies from clients wanting to replicate outright equity exposure or help equitize cash. Finding ways to efficiently reduce funded status volatility while respecting their derisking glidepath continues to be a core objective of many defined benefit pension plans.
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