Focus on the macro
There is little argument that January’s FOMC meeting proved pivotal in restoring investor confidence after the market selloff in 4Q18. In slowing the pace of rate hikes and telegraphing an earlier end to quantitative tightening, the Fed eased investor concerns that increasingly tighter monetary policy would bring an end to the current expansion. Yet, why exactly the Fed flip-flopped at the January meeting is still a subject of active debate, and the answer would appear to have some bearing on how markets are priced today and where they might go over the remainder of the year. Even as equities and credit have almost fully retraced to early-October levels, government yields seem to be sending a more cautious signal—rates are much lower over the past six months and portions of the US yield curve are inverted.

One worry is that the Fed’s pivot is an indication that officials are concerned about slower growth, foreign developments, or that short-term rates may have already been raised too much. At the March FOMC meeting, committee members uniformly downgraded their forecasts to signal no further hikes in 2019, and concurrently announced that the balance sheet wind-down would finish in September. Given the recovery in financial conditions this year, the decidedly dovish message could be construed as the Fed providing upfront support to markets for tough times ahead.

At the corporate level, investors are already braced for relatively weak 1Q19 results. After companies lowered guidance at the beginning of the year, earnings estimates for the S&P500 are close to flat—around 0%—for the next three quarters. For sure, much of the deceleration in earnings growth is attributable to the diminishing tailwind of the 2017 tax cut, oil prices no longer rising, and headwinds in the FANG stocks, rather than broad-based weakness. Nevertheless, a growth rate near zero is a significant departure from last year’s rate of +20%. If global growth were to weaken further, this year’s anemic earnings growth could easily turn into an earnings recession.

From the perspective of the Fed, the uncertain outlook for growth away from the US is likely one of the biggest reasons to proactively maintain a dovish policy stance. So far US growth has proved resilient to capital markets volatility as the consumer looks well-supported by low unemployment and rising wages. Yet Chinese and European growth data have disappointed over the past few quarters.

In China, the authorities seem committed to supporting the economy through further credit expansion even if it means a reordering of priorities to emphasize growth at the expense of financial stability. That being said, growth is only now showing nascent signs of bottoming and the possibility that the recovery is shallower than anticipated is a real risk, especially if US-China trade talks were to unexpectedly falter.

A more L- versus V-shaped recovery in China would likely prove problematic for Europe given that EU growth is expected to be just 1% this year. Indeed, the persistently weak manufacturing numbers in France and Germany hint at an underappreciated sensitivity to China.

In light of these risks, the argument that the Fed’s dovish pivot is in response to poor corporate earnings and weaker foreign growth is difficult to dismiss. It could be the case that the Fed is worried about a repeat of what happened in late-2015/early-2016, whereby weak Chinese growth caused a collapse in commodity prices that was further exacerbated by the Fed’s desire to hike rates. If that were true, then the Fed’s flip-flop may be a bearish signal for markets.
A more benign explanation is that Fed’s first-quarter dovishness is really an inflation story and not a harbinger of headwinds to come. While traditionally economies with little spare capacity tend to produce inflation, the experience since the financial crisis has differed—diminishing labor slack has only produced modest wage growth, which has yet to lead to upward pressure on the prices of goods and services. In embracing a patient stance, the Fed may be of the view that there is scope for an extended period of macro-economic equilibrium with inflation well contained and the policy rate near neutral.

To that end, talk of “average inflation targeting” by various Fed officials would seem to be a way to incorporate recent inflation dynamics into the central banks’ reaction function. By advocating that inflation should be allowed to modestly exceed 2% in order to make up for undershoots during future recessions, the Fed appears to be providing the intellectual rationale—albeit after the fact—for a pause to the current rate hiking cycle. While such a policy is yet to be formally endorsed by the FOMC, it could explain why so many committee members were willing to lower their “dots” at the March meeting.

Whatever the rationale for the pause, achieving a soft-landing would seem to be the ultimate objective for the Fed, and on that basis the probability of success is likely higher this cycle given the lack of upward pressure on inflation. In the coming months, it should become clear whether the Fed’s first-quarter about-face was the result of an abundance of caution or an evolution to the current monetary policy framework. Meanwhile, it would seem that the bar to a hike—or a cut for that matter—has increased and risk assets are clearly enjoying the reprieve, at least for the time being.

**Focus on fixed income**
As quickly as spreads widened in the latter months of 2018, the 1Q19 rebound in credit was equally rapid with the OAS of the Bloomberg Barclays Credit Index 30 basis points tighter year-to-date to end March at 113 basis points. Yet the rally this year has not simply been a reversal of last year’s weakness as there has been a clear up-in-quality bias with higher-rated bonds performing as well as lower-rated.

Within investment grade markets, the result is that many A-rated bonds have fully retraced the widening experienced in 4Q18 while triple-Bs are still wider over the past two quarters. As such, it would seem that lower-quality bonds will need to participate more fully going forward if credit spreads are to continue to tighten from here.

For credit, the decline in nominal rates over the past six months has been a headwind preventing an even more powerful rally. At an end-of-quarter yield of 2.4%, the 10-year UST is roughly 80 basis points lower than where it was at the beginning of 4Q18 as both real yields and inflation breakevens dropped. The continued inversion of the yield curve is also a concern, particularly the 3m10y section, which Fed research recently noted was the best predictor of a recession. Minimal inflation pressures and negative foreign yields likely explain the inversion in the curve, but the shape of the curve will likely continue to be a focus for investors.

After outperforming credit into the end of year widening, securitized products have lagged the broad IG rally to start the year. US Agency MBS moderately tightened over the quarter, reflecting continued upward spread pressure due to increased supply as the Fed continues to shrink their balance sheet. The US CMBS Index tightened 19 basis points, with value still being seen in AAA Last Cash Flow (LCF) in the 7-10-year duration bucket. The ABS Index rallied roughly 15 basis points, led by outperformances in higher quality, shorter-term assets such as credit cards and prime auto securities. The continued inability of the front end of the rates curve to steepen makes shorter-term spread assets look cheap in this environment.

In credit portfolios, the importance of credit selection is beginning to become apparent once again. Even as volatility—much like in 2017—continues to grind lower, earnings results have taken on renewed importance. This is particularly true when it comes to large-cap triple-Bs—a segment of the market that’s lagged the 1Q19 rally the most. While it is likely that triple-B valuations normalize versus higher
quality credit at some point, in LGIMA portfolios we are taking a selective approach to positioning within the sector and recently decreased holdings of BBB healthcare on earnings concerns. Meanwhile, banks and pipelines remain core overweights in the portfolios, although in recent months we have trimmed the exposure to a number of outperforming positions.

Focus on client solutions
For clients focused on pension risk management, 2018—as well as the first quarter of 2019—provided a template to illustrate the benefits of hedging interest rate and credit spread risk. Through the first three quarters of 2018, many pension plans experienced a significant increase in their funding ratio due to strong market dynamics. An average pension plan (60% equities / 40% aggregate fixed income) had a funding ratio of ~84% entering 2018. By the end of the third quarter, the average funding ratio jumped to ~92%.

However, after significant equity market volatility in the fourth quarter, funding ratios fell back down to 84.4%. Entering 2019, the pension market outlook was uncertain, but equities recovered most of what was lost over the fourth quarter, posting year-to-date returns of over 12-13% across US and global indices. Unfortunately for pensions, funding ratios are also impacted by a corporate discount rate. Falling rates and tighter credit spreads drove an average pension plan’s liabilities to increase ~7.0%, offsetting most of the positive asset performance, resulting in a funding ratio gain of only ~1.2% over the first quarter of 2019.

While market dynamics throughout 2018 highlighted the benefits of derisking in order to “lock-in” funding ratio gains, the first quarter of 2019 highlights the importance of asset liability management—what if the equity market in the fourth quarter of 2018 was combined with the performance of fixed income market in the first quarter of 2019? 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.

On the heels of recent market volatility, we are seeing clients continue to look for ways to mitigate risk within their plan. Plan sponsors remain focused on decreasing interest rate and credit spread risk, especially given the volatility noted in the above sections. For interest rate risk, customized LDI strategies such as liability benchmarking, completion management, and other custom option based strategies (Treasury futures, options or swaptions) remain best-practice. In the credit markets, we have had a number of clients implement custom cash flow matching credit strategies aimed at avoiding defaults and downgrades and reducing transaction costs.

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 plans 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 as plans search for equity-like returns without correlation to the broader market.
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