

Q3 2022

Active Strategies Outlook: All change, please





A changing of the guard?



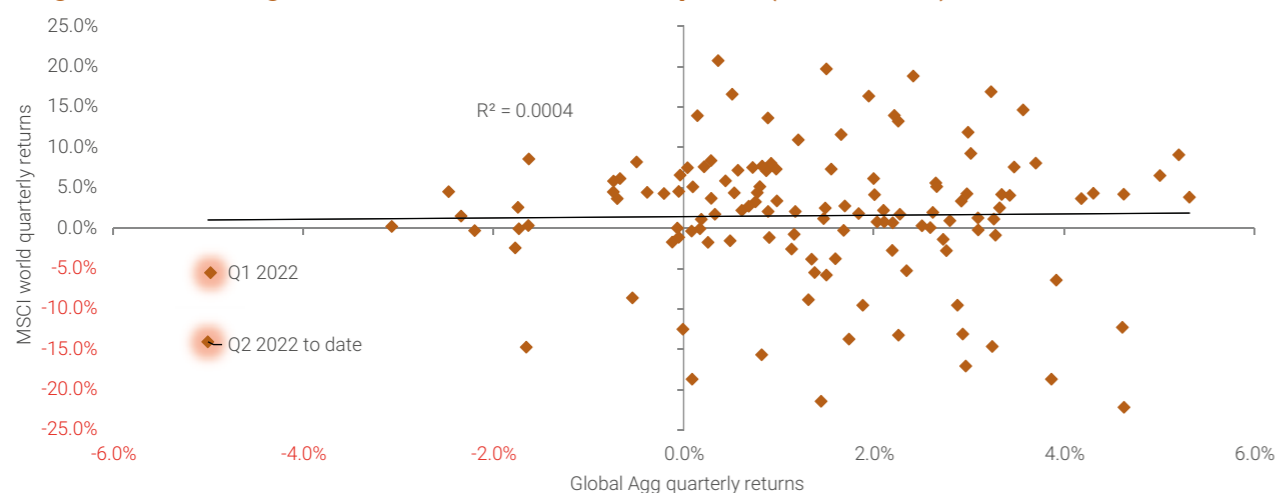
Colin Reddie
Head of Active Strategies

If the market regime is changing, it may be time to pick your battles

A consistent feature of financial markets for the last 30 years has been the mutually beneficial relationship between equities and bonds. When the former has gone through difficulties, the latter has helped soften the blow by delivering an offsetting positive total return.

The chart below starkly illustrates how powerful this relationship has been since the late 1980s. The lack of observations in the bottom left quadrant of the chart (<5%) sets today's markets in a historical context. The most recent quarterly total

Long-term return regression between bonds and equities (1989 to date)

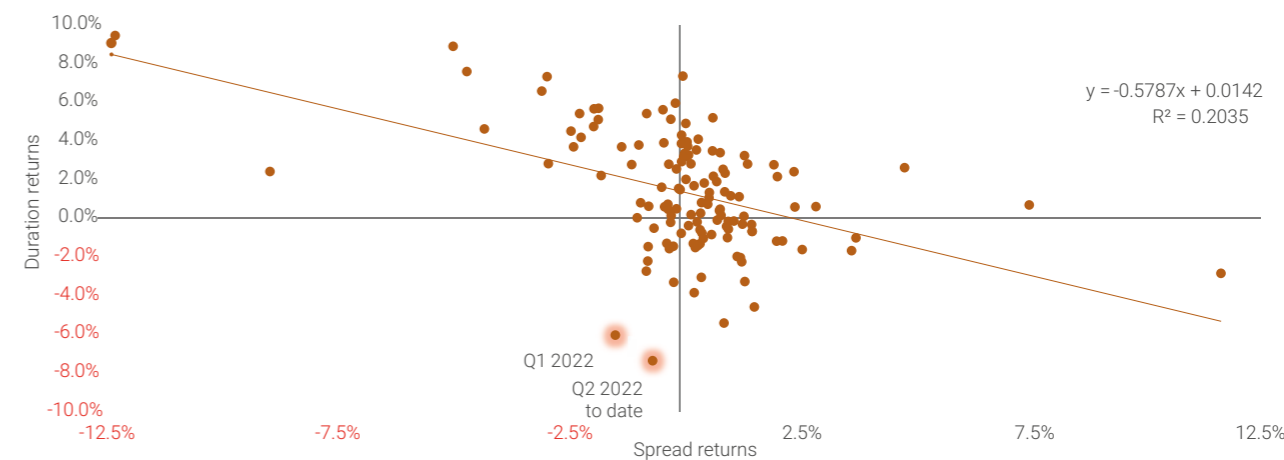


Source: Global aggregate bond index, Bloomberg/Barclays. Equity index, MSCI World. Data as at 21 June 2022.

return observation of -16.7% and -5.7% means a '60/40' equity/bond fund has lost 12.3% in less than three months and takes the year-to-date outcome to -16.9% using these indices.¹

This is where market 'regimes' can change. Over the last 12 months, we have witnessed changing dynamics between risky and risk-free assets in fixed income funds. We regularly run competitor analysis, and we see that funds which have continued to run higher interest rate risk alongside higher credit risk have significantly underperformed as interest rate risk, which traditionally offsets credit risk, has instead moved in the same direction.

US credit duration vs spread returns (quarterly since 1990)



Source: Bloomberg/Barclays, as at 21 June 2022.

1. Data as at 21 June 2022.

*LGM's full cross-asset class research platform, incorporating both fundamental and ESG risk factors.

Will risk-free assets continue to act as risk-additive assets to portfolios, or will they return to being great insurance?

In this edition of the Active Strategies Quarterly Outlook, Alex Mack digs into this dynamic in more detail and highlights how much we will learn in the next downturn and how it will shape investor behaviours in the next cycle.

What does all this mean for corporate fundamentals? My Chicago-based colleagues Jason Shoup and Jason Becker discuss the outlook for the credit quality of companies.

Finally, we recently tasked our Consumer Global Research & Engagement Group (GREG)* with a deep dive on the cost-of-living crisis. With inflation at levels most have never seen before, which companies will be the winners and losers, as consumers are forced to change consumption and purchasing behaviours? Ilana Elbim summarises the research group's findings.

Regime change: What's at stake in the next recession

A range of factors are coming together to radically alter investors' base assumptions about their operating environment. Where can we find clues about the new market paradigm?



Alex Mack
Fund Manager, Active
Fixed Income



Over the last few years, we've seen changes in the global economy that make it possible that excess rather than deficient demand will be the norm in the coming decade.

In economics, as in life, there are some simple truths that we can usually fall back on. For example, an increase in demand for any given quantity of a good will cause its price to go up.

Over the last 30 years, low levels of demand have led to low inflation, low interest rates and low volatility in financial markets – conditions that have persisted for so long that very few of today's investors know anything different.

What's changed?

Over the last few years, we've seen changes in the global economy that make it possible that excess rather than deficient demand will be the norm in the coming decade.

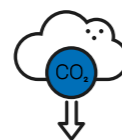
Three key drivers are:



Deficits: during the COVID-19 pandemic, governments learnt that they can shore up demand by giving money away and guaranteeing people's jobs. It will be politically difficult to resist calls to do so in response to any future negative economic shock.



Deglobalisation: with geopolitical tension likely to remain high for the foreseeable future, governments will be increasingly incentivised to push for more goods to be produced domestically or in friendly nations. This leads to a less flexible global economy that is less able to adapt to changes in demand – meaning price rises are more likely than supply increases.

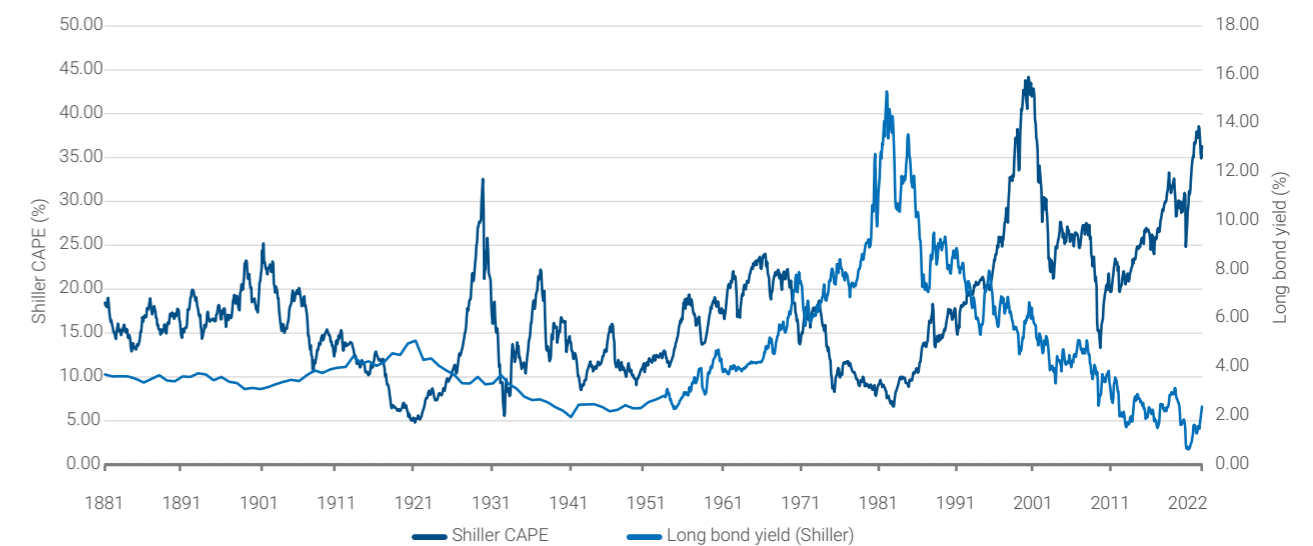


Decarbonisation: the move to a more sustainable economy will involve a large amount of investment and transition to potentially less efficient energy sources. Moves to prevent the exporting of emissions – say through carbon border taxes – could accelerate deglobalisation.

Why does this matter for markets?

1. A world where high inflation trumps low growth as a concern for investors is not a world where we would expect the correlation between risky and risk-free assets to remain negative. The 'offsetting' negative correlation we have seen for the last 20 years is far from a law of nature – there are periods when equity valuations and bond yields seem to move together, and periods when they very clearly don't, as we can see from the chart below:

Shiller PE and bond yields



Source: <http://www.econ.yale.edu/~shiller/data.htm> as at 4 April 2022.

2. We anticipate the return of income to fixed income. We expect interest rate curves to move higher as central banks raise rates to control inflation, and steeper as investors demand greater premiums for holding longer-dated bonds.

Indeed, estimates of the compensation investors have received for buying longer-dated over shorter-dated bonds have been falling consistently since the mid-1980s, as you can see in the top chart below.

3. Central banks will likely be unable to dampen market volatility as they prioritise managing inflation. Investors in turn may have to learn to cope with an environment without the support of quantitative easing (QE) including its underpinning of asset prices and volatility curbing function.

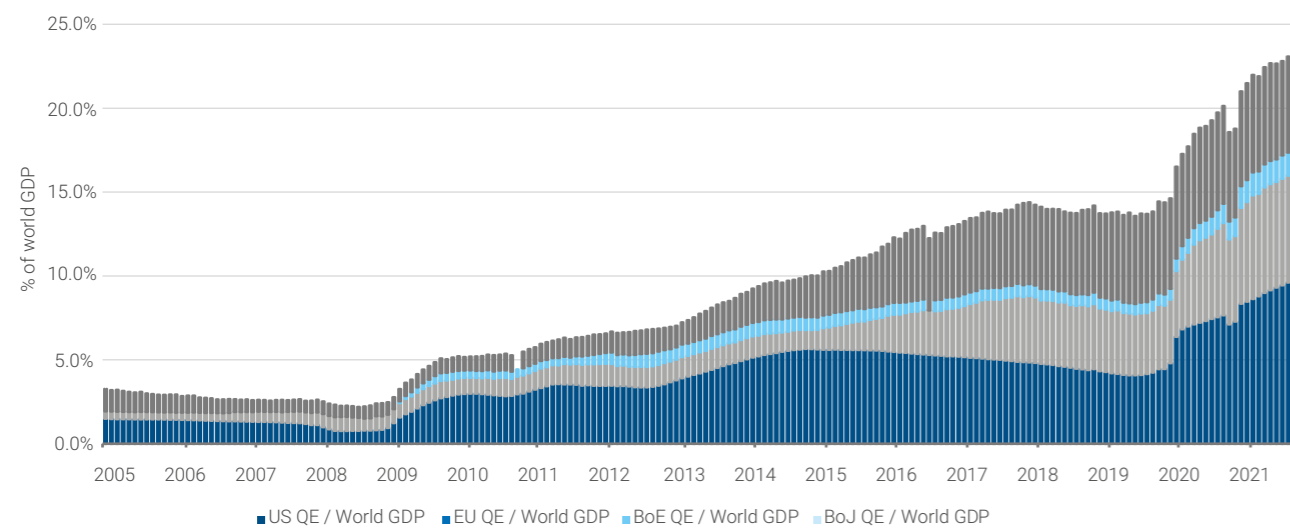
As the bottom chart below shows us, by the end of 2021 QE had reached unprecedented levels; we believe even a gradual unwinding is going to have enormous consequences for markets.

Adrian, Crump and Moench (ACM) term premium estimate



Source: Bloomberg, as at 22 June 2022.

Quantitative easing as share of world GDP



Source: Bloomberg, as at 22 June 2022.



The next recession: what we'll learn

There is a growing consensus that much of the developed world faces a recession at some time in 2023. If this comes to pass, investors will soon have a full business cycle's worth of data, making it much easier to develop coherent theories to project forward.

We'll also know if the fiscal support measures of the COVID-19 pandemic era were a one-off, whether post-pandemic shifts in the labour market are now structural, and whether commodity prices can still fall in a recession at a time when environmental concerns have stymied investment in new output.

If we look closely, we might just be seeing the contours of a whole new investment paradigm emerging.





Corporate fundamentals: Are they recession-proof?

Despite recessionary fears, today's investors don't appear as worried about corporate balance sheets as their historical counterparts. Are they right?



Jason Shoup
Head of Global Credit Strategy



Jason Becker
Quantitative Credit Strategist

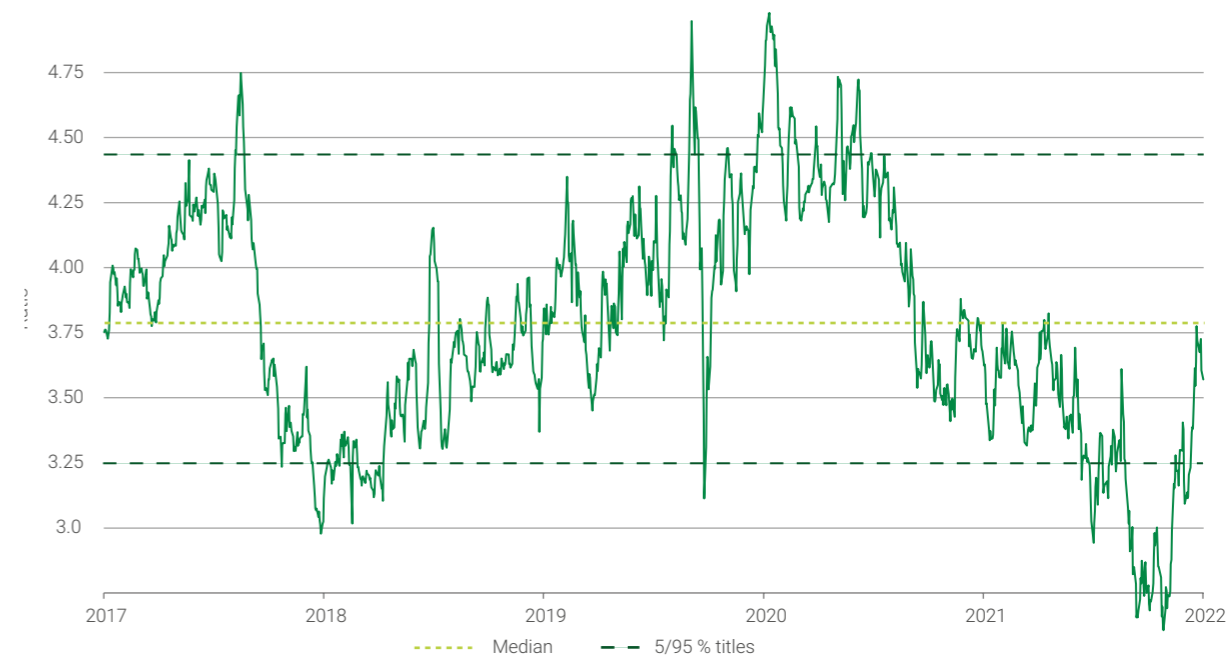
Despite rising yields, widening credit spreads, and growing concerns about a recession in Europe and the US, some investors appear to be taking a constructive view on traditionally riskier corporates.

This is evident when we examine how lower-rated credit has been trading relative to higher-rated credit, which can be seen in the high yield: investment grade (HY: IG) credit spread ratio.

Credit risk where it's due

Historically, when fears of recession hit credit markets, as we experienced earlier this year, default and downgrade risks have often tended to be more heavily factored into credit spread levels. Put another way, if credit spreads compensate investors for liquidity risk, credit risk and supply risk, the credit risk premium tends to dominate during these recessionary periods. As we have seen, most recently during the COVID-19 pandemic and illustrated in the chart above and opposite, investors are

HY: IG spread ratio



Source: LGIM America, Bloomberg, as of 27 June 2022.

beginning to heavily factor credit quality into determining fair value, causing the HY:IG ratios to rise towards the higher end of their ranges. Over the past few periods which saw recession fears (2008, 2016, 2020) the HY:IG ratio hit peaks that nearly coincided with maximum spread levels.

Recently, in investment grade, BBB rated credits have been trading at historically tight levels relative to their A rated counterparts. In high yield, CCC rated credits have been historically compressed versus BB and B rated issuers. Across asset classes, high yield has been trading at levels which are historically tight, when compared with investment grade.

Very recently, decompression has moved the HY:IG ratio into the 33rd percentile over the last five years, as shown in the green line on the chart above. However, given that outright credit spread levels are near the 90th percentile for that same period, one might expect the ratio to be much higher, and high yield credit to have further underperformed investment grade credit year-to-date.

As we have seen, most recently during the COVID-19 pandemic, investors are beginning to heavily factor credit quality into determining fair value, causing the HY:IG ratios to rise towards the higher end of their ranges.

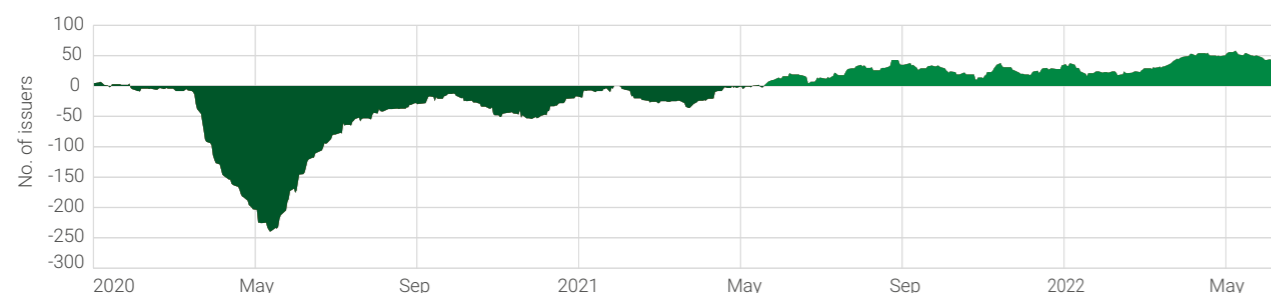
Maxing out on metrics

So, why are investors relatively relaxed?

One explanation could be the dramatic improvement in credit metrics since mid-2020. Gross leverage in investment grade corporates has reverted to pre-Covid levels after spiking at the start of the pandemic. In the high yield space, leverage has declined to its lowest level in a decade. Meanwhile, cash levels remain unusually elevated, with corporates still flush with the precautionary liquidity they acquired early in the pandemic. However, more than half of this cash has already been spent, mostly on share buybacks and M&A.

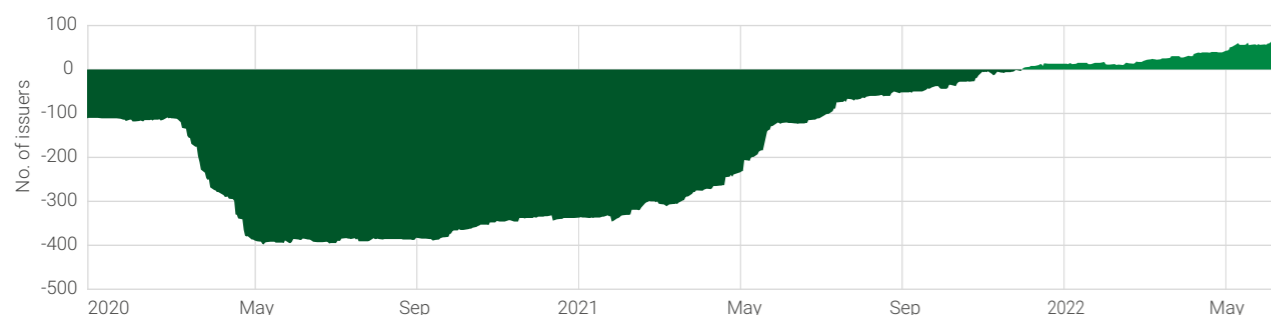
Meanwhile, the low-rate environment of the pandemic era meant companies were able to term out their debt with low-coupon payments. Rating agencies took note, upgrading more IG corporates than they downgraded over every two-month period since May 2021, as we can see the charts below:

Two-month rolling net upgrades in US IG



Source: LGIM America, Bloomberg as at 27 June 2022.

Net upgrade bias in rating agency US IG outlooks



Source: LGIM America, Citi, Bloomberg as at 27 June 2022.

Forward-looking rating outlooks only became more positive over the same period.

Taken in the round, this accumulation of factors has led some in the market to posit that balance sheets may be relatively strong as we head into the current hiking cycle, despite a possible recession to come.

Removing investors' rose-tinted specs

However, such a benign view on credit fundamentals could prove far too rosy.

While investment grade leverage has indeed reverted to pre-Covid levels, leverage ahead of the pandemic was already at an all-time high, barring recessions. Prior to the pandemic, concerns were mounting around the growing size of the BBB market and how high corporate leverage could result in elevated downgrade risks. It is difficult to argue those same risks do not exist today.

Meanwhile, issuers have been able to pursue buybacks and M&A without much pushback from bondholders because these activities have not been funded with new debt. But as cash buffers recede, the corporate bond market may find itself once again the source of funds to support equity valuations.

At the same time, even if inflation is brought under control, input costs and wage inflation could remain sticky, leading to lower profits and contractions in margins – with the Federal Reserve unlikely to come to the rescue this time.

While many market participants believe corporate balance sheets are well positioned for a potential recession, it is difficult to find in history find a single example where even a 'mild' recession resulted in meaningfully fewer corporate defaults or ratings downgrades. And yet it could be possible this potential overconfidence resolves the paradox of why markets do not yet seem to be fully pricing in a recession, while so many investors believe that one is highly likely in the next 18 months.

Gross leverage in investment grade corporates has reverted to pre-Covid levels after spiking at the start of the pandemic.



Cost of living: Are consumers tightening their belts?

With inflation biting, LGIM's consumer sector Global Research and Engagement Group conducted a deep dive analysis to understand its implications for essential and discretionary spending



Ilana Elbim
Senior Credit Analyst,
Active Strategies

Three words have been on everyone's lips for the past few months: 'cost of living'.

More recently, and worryingly, a new word has been added: 'crisis'.

Inflation has taken hold across large swathes of the world. Companies in the consumer sector must find the right balance between passing on higher input costs through prices without impacting volumes too much or absorbing them and having to report lower profit margins.

Not all firms are created equal

In this environment, some consumer companies should be better placed than others: those whose strong innovation and premiumisation capabilities allow them to justify higher prices, and those exposed to inelastic products such as coffee or pet care.



At the other end of the supply chain, food retailers do not want to repeat the mistakes they made during the financial crisis and are reluctant to pass on price increases to consumers who are already suffering from the higher cost of living. While they intend to protect consumers' buying power, cost-cutting initiatives are unlikely to sufficiently offset increasing inflation pressures. Scale and strong supplier relationships will be key if food retailers are to outperform in the short to medium term. They will also need to offer a large range of private label products alongside diverse store formats and in-store services if they are to meet consumers' evolving needs and buying behaviour.

It is very likely that the inflationary environment will impact discretionary spending, but it is difficult to predict when and how consumers will shift their expenditure.

Winter is coming

The airline, leisure and lodging sub-sectors are currently benefiting from pent-up demand and consumers' strong desire to travel after more than two years of restrictions. As a result, we expect a strong summer for 2022 – close to 2019 levels – but as the year draws on, winter represents a significant unknown. While credit metrics are set to improve, they should remain higher than historical levels, and most companies are still likely to benefit from strong liquidity buffers built over the past couple of years.

Pandemic savings should support spending on clothes and other non-food products in the short term, but the medium term is uncertain. Consumers' appetite for borrowing is low, and we anticipate that many will rather buy less, or not at all, than trade down to value retailers.

As a result, low-priority categories like beauty or footwear, which enjoyed a greater 'share of wallet' during the lockdowns of 2020-21, are likely to feel the most pressure.

Low-income cohorts are likely to feel the greatest burden from the cost-of-living squeeze due to their lower pandemic savings and greater exposure to rising food and fuel costs. Low-value retailers are likely to be more impacted than their high-margin luxury counterparts.

Colleagues across Active Strategies in London and Chicago contributed to this outlook.

Contact us

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