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CIO autumn update:

Endurance test

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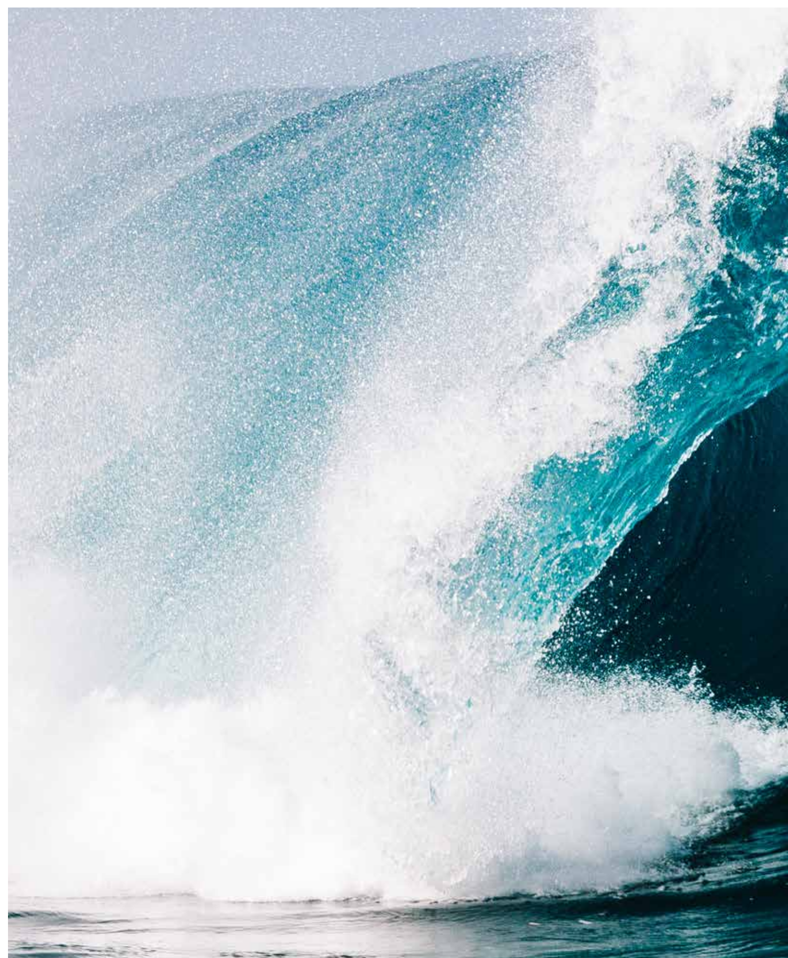


Foreword:

The more things stay the same...

Change may be the only constant over the coming months. We believe investors will need to be dynamic in striking a balance between managing risks and seizing opportunities.

Since we published our last outlook, many of the dynamics we observed have persisted – not least the recovery in asset prices and acceleration of long-term investment trends.

But given the nature of these persistent dynamics, in this case we have to invert an old aphorism: the more things stay the same, the more change we should expect. Looking ahead towards 2021, this gives us cause for both optimism and caution.

We now have a clearer sense of the collapse in global output caused by lockdowns and the initial speed of the recovery. This has led our economists to present a new central scenario for the world economy, involving continued but much slower growth over the next six months, followed by a renewed pick-up after vaccines become widespread next year.

And yet the picture remains unsettling, with new cases of COVID-19 still in the hundreds of thousands worldwide, the advent of mini-lockdowns and the fact that despite heartening progress, a vaccine is still not a done deal.

At the same time, the remarkable rebound in risk assets from their nadir in March means the remaining upside is likely to be limited, at least in the near term, even as policymakers pump out more and more stimulus.

In this autumn update, we offer views from our Global Fixed Income, Active Equity and Asset Allocation teams on the likely trajectory of markets. Key points they cover include:

- The long-term risks facing a credit market buoyed by stimulus
- How strong companies are growing stronger, even when stung by the virus
- Why markets and the real economy appear disconnected

Many investors, of course, are gripped by the US presidential race, which is heating up in its final months.

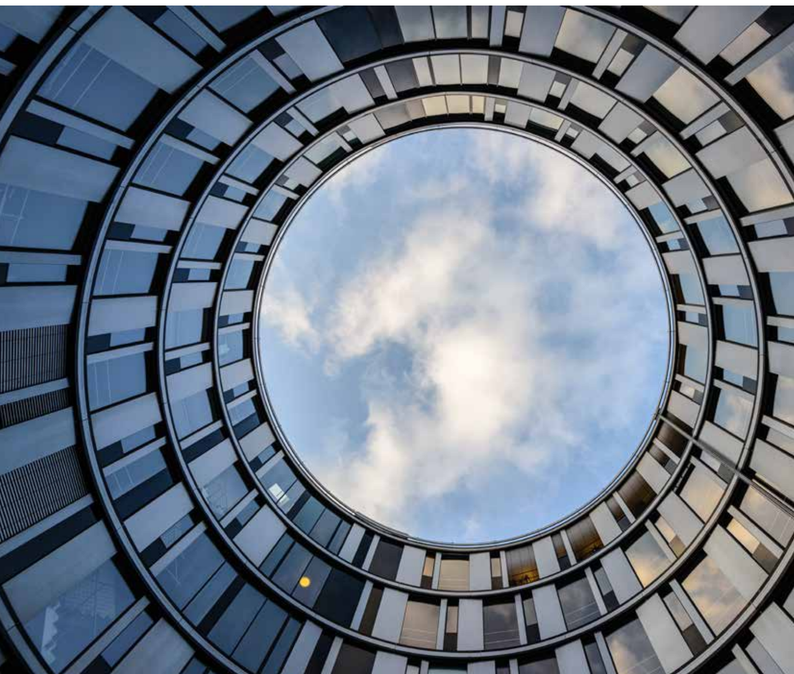
We are covering this subject in detail elsewhere, but suffice it to say that the election is but one of the previously dormant geopolitical risks that may spark fresh bouts of volatility. Others worth mentioning are US-China tensions and the latest round of Brexit talks.

So on our journey to 2021, we will clearly need to traverse many more obstacles that require caution, making it something of an endurance test for investors. But some of the risks we face are, in fact, also catalysing opportunities.

Nowhere is this more evident than in the realm of responsible investing. The multiple challenges besetting the world – from the pandemic, to climate change, to ingrained racism – have prompted ever more investors to agree that inaction is simply not an option.

For us, they have only hardened our resolve to take further decisive action to deliver positive change, through the stewardship of our clients' assets and the capital-allocation decisions we make on their behalf. We look forward to sharing more detail on these initiatives in the months ahead.

Sonja Laud
Chief Investment Officer



Credit:

Beyond the first step

Stimulus measures keep us broadly constructive, even as we position for economic scarring from the pandemic to be revealed.

During the depths of the COVID-19 'crash' in March, we took the relatively straightforward decision to become more constructive on credit in the face of widespread panic, even as we held concerns over capital structures, virus developments and sovereign ratings.

Today, after a phenomenal compression in spreads, our call on the market is far less straightforward – and we still harbour those concerns.

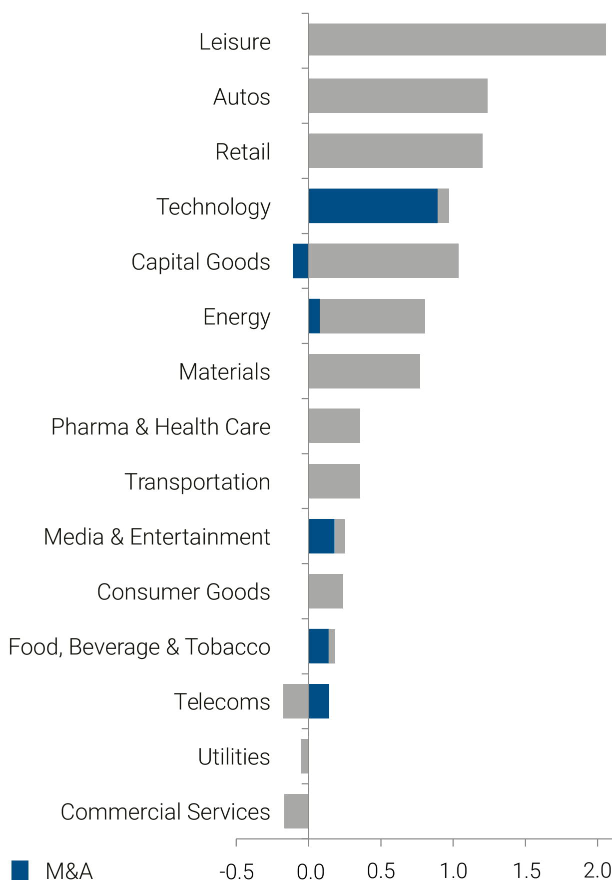
Capital structures

With markets rallying so strongly, companies have been quick to exploit the demand from investors through record new issue volumes. But this prudent action to plug sizeable cash holes in balance sheets has come alongside substantial increases in leverage.

The second-quarter earnings season indicates that at an aggregate level, the latter trend will continue for some time, as greater borrowing has been accompanied by a drop in EBITDA, which has the mechanical effect of driving leverage yet higher. Indeed, leverage may only peak towards the very end of this year, or more likely next year in our view.

It is also worth reminding ourselves that while the fiscal response has been enormous, it was largely designed to protect household income, not corporate income.

Levering up: Year-on-year change in net debt to EBITDA



Source: LGIM, Bloomberg, as at 30 June, 2020. Leverage figures are for issuers in the iBoxx IG EUR and GBP Corporate Indices, where available. Past performance is not a guide to the future. The value of an investment and any income taken from it is not guaranteed and can go down as well as up, you may not get back the amount you originally invested.

Virus echoes and fiscal reckoning

Reversals of the virus spread in some US 'hotspot' states are encouraging. But we continue to worry about the risk of a second wave, with markets reliant on positive vaccine developments to side-step concerns over fresh outbreaks and any fresh setbacks to growth.

At the same time, a key question is whether policymakers will address exploding budget deficits – and the attendant risks to sovereign ratings – or whether they will continue to run their economies with both fiscal and quantitative easing taps in full flow. So far, nobody has suggested a replay of 2010, when governments arguably pivoted too quickly towards austerity.

Credit quality

Extraordinary policy measures have done a good job of insulating both markets and, to a lesser extent, economies from the government-mandated economic shutdowns. As a result, we remain broadly constructive on credit, even though spreads are now trading near or at post-pandemic lows.

The remainder of the year is dominated by largely binary events – vaccine development news and the US Presidential election. Both have the capacity to move markets significantly. Given central bank support for credit markets, this may be of more concern to riskier asset classes than investment grade credit. Against this backdrop, we prefer to improve the underlying credit quality of portfolios and further diversify as we approach the turn of the year as we believe the economic scarring from the lockdown will start to be revealed from here on.

Colin Reedie
Co-Head of Global Fixed Income

Equities:

Trials of strength

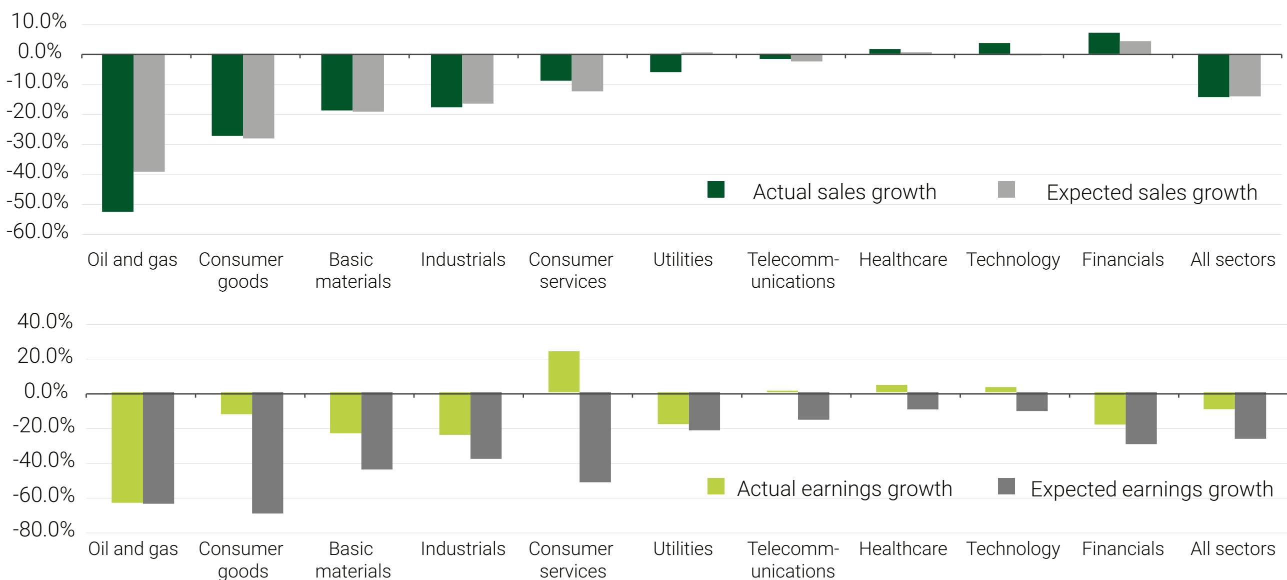
Strong companies are growing stronger versus their competitors, even when adversely affected by the virus.

This past earnings season has told us far more than its predecessor, which largely covered a pre-pandemic period. The second quarter captured the worst of the COVID-19 crisis – and, crucially, pointed towards trends that may continue to play out for some time.

The headline corporate results were understandably bad: year-on-year revenue growth slumped 14.4%[1] for companies in the MSCI World index during the period, which was a terrible performance even compared to any previous downturn that we have experienced. That said, after stripping out the oil and gas sector, these dire revenue numbers actually beat market estimates. This positive surprise was due to successful expectations-management and a slightly stronger-than-anticipated economic recovery.

More surprisingly, earnings comfortably beat market expectations, helped by effective cost control by companies, stemming from drastic cuts to variable costs and support from government programmes, such as the UK furlough scheme. A number of favourable dynamics also benefited certain sectors, such as financials, where investment banks benefited from a spike in trading and issuance revenues amid the market turmoil.

Q2 results were weak, but beat expectations



Note: Aggregate year-on-year growth for companies in the MSCI World index for quarters ending between 16/5/2020 and 15/8 2020. Source: Bloomberg, MSCI, LGIM. Past performance is not a guide to the future. The value of an investment and any income taken from it is not guaranteed and can go down as well as up, you may not get back the amount you originally invested.

There was a divergence in performance, with those sectors most directly exposed to lockdowns and social distancing, like consumer goods, and more cyclical sectors, such as industrials, suffering the most in terms of earnings and sales. By contrast, those better-placed to thrive in these conditions, in particular healthcare and technology, outperformed.

Drilling down to individual companies, another broad trend is evident: strong companies are growing stronger versus their competitors, even when impacted by the virus.

A tale of two hotels

The performance of two large budget hotel chains in the UK is illustrative of this theme. Whitbread plc*, owner of Premier Inn, entered the crisis with net debt 2.5 times higher than its EBITDA; it was forced to close all of its hotels during the lockdown but successfully raised fresh equity capital, and is now well-placed to flourish post crisis, in our view. Private equity-owned Travelodge*, by contrast, with more than seven times its EBITDA in net debt before the crisis, struggled to raise new capital and had to stop paying rent to its landlords; it now faces the prospect of losing many of its hotels, with future performance likely to be compromised.

So we know today a lot more about what may happen to the 'winners' and 'losers' if COVID-19 stays with us. At the same time, we expect the strong to keep growing stronger, regardless of virus developments.

Still, it is becoming increasingly challenging for investors to focus solely on the more robust sectors and companies, given the astonishing degree to which valuation differentials have widened. We now need to decide whether to back stocks that appear pricey, but are doing well, or look at companies where valuations are lower, albeit with good reason.

Nigel Masding
Senior Fund Manager,
Active Equities

1 Source: Bloomberg, as at 7 September 2020

*For illustrative purposes only. Reference to a particular security is on a historic basis and does not mean that the security is currently held or will be held within an LGIM portfolio. The above information does not constitute a recommendation to buy or sell any security.

Asset allocation:

Anatomy of a rally

The disconnect between financial markets and the real economy is a matter of perception.

It is perceived wisdom that if you wish to understand the present and future, studying the past is a good place to start. This is particularly relevant today for investors, as we calibrate our expectations for asset class returns into year end and beyond.

Indeed, we are currently confronted by a market that appears to have lost touch with reality, with risk assets registering strong gains since they troughed in March – even as the world has experienced a pandemic and recession.

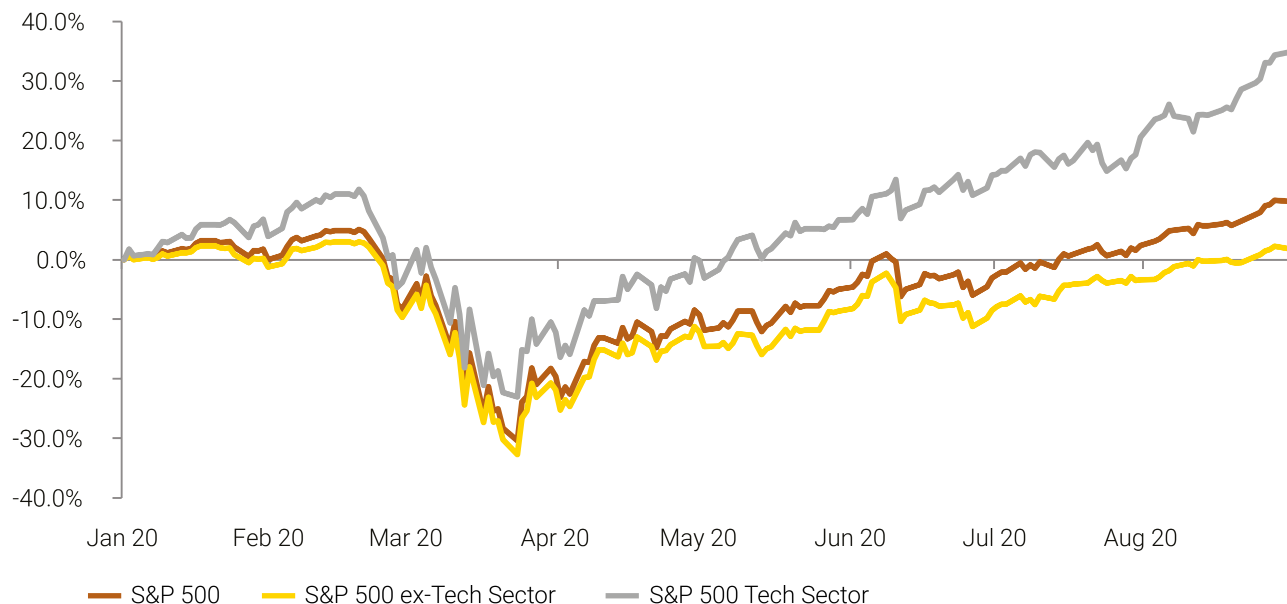
We believe, however, that there are three reasons for the apparent divergence between markets and the real economy, which offer clues to the near- and medium-term outlook.

1. Central banks and governments have embarked on aggressive programmes of monetary and fiscal stimulus, pushing interest rates even further down. All else equal, lower yields are good for risk assets through the discounting of future earnings.

2. Markets are a forward-looking mechanism. They constitute the collective view of market participants on the future state of the world, which is what drives asset prices, rather than the current state. Therefore, it is the expectation of a better economy that has driven markets higher. We believe markets look forward about three to 12 months. Given this window, the question around the discovery of a vaccine for COVID-19 comes into play. Focusing on this allows investors to imagine a world in a somewhat normal state by then.

3. The outperformance of mega-cap technology stocks has distorted the market picture as well. The Nasdaq has outperformed the S&P 500 index year to date, for instance, while the S&P 500 ex-Technology is barely in positive territory in 2020 (see chart). This could end up in a technology bubble, but we don't believe we are there yet. Our bubble monitor is elevated but not yet in the stratosphere. We therefore remain overweight technology.

US equity performance – with and without tech



Index return over period	S&P 500	S&P 500 ex-Tech sector	S&P 500 Tech Sector
1 year	21.9%	11.7%	55.9%
2 year	25.5%	13.5%	63.7%
3 year	50.2%	31.3%	114.6%
4 year	74.6%	48.6%	177.5%
5 year	96.5%	66.3%	223.9%

Source: LGIM, Bloomberg, as at 31 August 2020. Past performance is not a guide to the future. The value of an investment and any income taken from it is not guaranteed and can go down as well as up, you may not get back the amount you originally invested.

The combination of these factors should give some comfort that the disconnect between financial markets and the real economy is actually a matter of perception.

Overall, we have a neutral risk position, but have been reducing exposure to assets that may have gone too far, too quickly, such as US investment grade credit and inflation in Europe and the UK. Complementing this, we hold positions in some higher-yielding government bond markets such as Australia, South Korea, and longer-dated US Treasuries.

The probability of a vaccine by mid-2021 is around 80%, in our view, leaving ample room for disappointment. And investors may be too optimistic on other virus dynamics, earnings, the economy and politics. Even as we get to grips with the past, the future is still likely to surprise us.

Emiel van den Heiligenberg
Head of Asset Allocation

Q&A

Sonja Laud, CIO; Madeleine King, Co-Head of Global Investment Grade Research; and John Roe, Head of Multi-Asset Funds, discuss key issues raised in our autumn update.

How is the pandemic accelerating long-term investment themes?

Sonja: For some years now at LGIM we've discussed the long-term themes that are shaping the investment landscape – from technology, to energy, to demographics and politics. By fundamentally changing the way we live, work and play, COVID-19 has intensified the trends that lie beneath these themes.

Take technology. The switch to remote working, undertaken on a massive scale amid lockdowns, has sped up the theme of global digitisation – with tech companies the obvious beneficiaries.

Another example is the energy transition: the demand shock from the pandemic has heaped yet more pressure on oil and gas companies, whose business models were already challenged, at the same time as prompting a huge decline in global carbon emissions. Of course, we wish that drop had taken place under different circumstances.

In short: we have witnessed years of change in a matter of months.

Have bond yields reached their floor?

John: In some markets, maybe: 10-year Bund yields touched -0.85% in March[2], but then it became clear the European Central Bank (ECB) sees limited value in further rate cuts, so that level will be tough to hit again.

What's more important than whether we've reached floors is that we're definitely closer to them in many cases than at the end of 2019; for example, in the US and UK. And when we're closer to the floor, the return potential is lower. So as at the end of August, 10-year US Treasuries had delivered strong year-to-date returns of 11%, while equivalent Bunds had generated 3%.[3] The context is that US Treasury yields started 2020 at a much higher level, so were able to fall further.

Drawing all this together, we need to accept that the protection value of government bonds has fallen significantly, in our view.

If bond yields will struggle to fall much further, how do multi-asset portfolios now hedge their risky assets?

John: Within the Asset Allocation team, one option open to us is to target rates markets which still offer more potential for yields to fall, such as long-end US Treasuries and maybe smaller markets like Australia (also at the long end) and South Korea.

We can also increase the use of currencies for risk mitigation, just as heads of governments (e.g. Donald Trump) and central banks (e.g. the ECB) are more focused on foreign exchange when most rates are close to zero already and so they have fewer tools to stimulate the economy. We see sterling as a 'risk on' currency, while the US dollar and the yen may be the best candidates for 'risk off' behaviour in extreme market conditions.

Elsewhere, we can look for thematic risks and target them more directly – say, climate change – and new asset classes to increase diversification. In addition, we just accept the limited return potential (term premium) and risk mitigation from government bonds, so seek out other premiums with ideally limited mark-to-market risk.

Turning to corporate bonds, what level of credit rating downgrades have we seen and what do we expect going forward?

Madeleine: We obviously saw a huge volume of 'fallen angels' earlier this year, when downgrades during the heat of the crisis pushed a record amount of bonds out of investment grade. Although, to be fair, we expected a large number of fallen angels this year even before the onset of coronavirus.

It feels a lot calmer now – only a few months ago, it seemed as though every company we covered was on negative watch. That's not the case anymore. A quarter of our investible universe currently has a negative outlook from one of the three major ratings agencies, which does suggest that there are more downgrades to come. But we think the pace will be much slower from here.

Are there any other reasons for credit investors to be cheerful – or at least, less anxious?

Madeleine: Well, it's hard to overstate the importance of fiscal and monetary support. And while we do harbour a number of near- and longer-term concerns, I think investors can take heart from the fact that where we did see surprises in earnings season, they were mostly positive. Cash balances are also high, given the record bond issuance we've seen; this is not a liquidity crisis.

Because corporates have enough cash, this buys them time. So even the worst performing – those that remain in partial shutdown and offer no line of sight as to when revenues will recover – still have adequate liquidity to keep them going for some time.

In terms of portfolio construction, how do we view corporate bonds versus equities?

John: Importantly, these asset classes offer different risk premiums. Yes, they can behave similarly in extreme conditions (like March of this year) but in combination we believe they can generally help us to achieve positive returns in a greater range of outcomes.

Right now, investment-grade spreads have contracted a long way, with each region close to the median of the past 15 years now, while 80-85% of the widening seen in 2020 already retraced. So going forward, we expect the return potential from credit to be more normal.

We believe equities offer a more symmetric return potential. Yes, US equities have generated a strong year-to-date performance, but returns have still been negative for the euro area and very negative for the UK. There are also sectors that still offer plenty of upside in positive vaccine outcomes, in our view.

Stepping back from pure investment returns, have COVID-19 and the other challenges facing the world changed the way LGIM sees its role as a responsible investor?

Sonja: I think it's fair to say that across the industry, there has been a greater emphasis on the 'S' in ESG integration – whether in regard to healthcare, diversity or simply treating employees fairly in extremely difficult circumstances.

We've long focused on these areas. They are captured in our quantitative ESG scores and Active ESG view, which also incorporates qualitative measures, and in the work carried out by our Global Research & Engagement Platform. This all helps determine how we engage with the companies in which we invest, and allocate capital on behalf of our clients.

What this period has done, though, is give us a renewed sense of mission – by reinforcing our message that investors can no longer justify inaction by saying, "This is all someone else's problem – we are solely motivated by shareholder returns."

Through responsible investing, we must evaluate the externalities and wider context – by this I mean the impact of our actions on people and the environment.

2 Source: Bloomberg, as at 28 August
3 Source: Bloomberg, as at 28 August

Contact us

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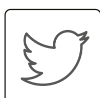

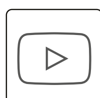

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