For professional clients only. Not to be distributed to retail clients. Capital at risk.

Q2 outlook:

The quest for resilience in a fragile world

LGIM

Q2 2022 | Active Strategies outlook

Foreword

Russia's invasion of Ukraine, and central bank back-peddling in the face of surging inflation, create significant uncertainties for investors. But that does not mean the market outlook must be gloomy.

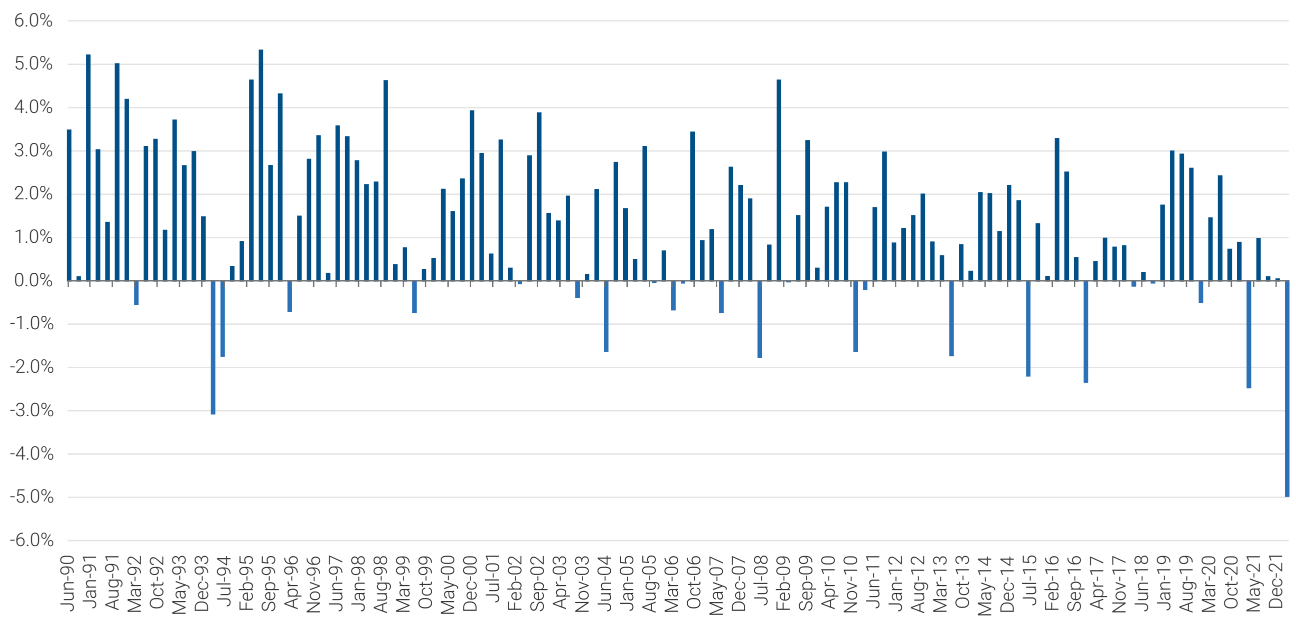
> **Global 'shocks' are adding urgency to the need for investors to favour resiliency over efficiency.**

Colin Reedie
Head of Active Strategies

Just as the 2008 crisis exposed the fragility of the financial system, the pandemic revealed that of the non-financial system – and now the war in Ukraine has highlighted geopolitical vulnerabilities.

The latter conflict, together with the reluctant acknowledgement from central banks they are woefully behind the interest-rate curve, has stoked the worst quarterly drawdown in bond indices in over 30 years.

Figure 1: Fixed income investors endure a tough Q1



Source: Bloomberg as at 31 March 2022. Bloomberg Global-Aggregate Total Return Index USD (60% Govt, 40% Credit). **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.**

Scrambling central banks

Given that the threat of inflation has been with us for some time now, investors had been relatively relaxed that the issue would prove 'transitory' in nature. This was the reason why 10-year US Treasury yields could finish 2021 at only 1.5%, while core CPI rose to 5.5%.

But fixed-income markets have been forced to wake up to this inconsistency this year. The Russia-Ukraine conflict has further added to the inflationary impulse through the weaponisation of energy prices, especially European gas.

The central bank scramble to restore credibility has been another significant source of volatility. The forward interest-rate market is currently priced for eight to nine further hikes by end this year from the US Federal Reserve (Fed), implying two or three 50bps moves; five to six more hikes from the Bank of England; and two hikes from the European Central Bank.

This dramatic repricing has been most felt in the shorter maturity areas of yield curves, as two-year yields have moved to a level higher than their 10-year equivalents. And the brief inversion of the two-year/ten-year yield curve is seen as a long-trusted indicator that recession is now on the horizon – and investors will be looking to position for it.

The case for optimism

But we're not so sure. If the hostilities in Ukraine can be de-escalated, we believe there is still strong underlying demand in a post-pandemic world. (For insights on the impact of the conflict on emerging markets, see the section below by Uday and Raza.)

We have to acknowledge the concern around the pace of central bank rate increases now factored into valuations. If fixed-income investors, in particular, simply cannot get comfortable with the path to higher rates, then we will likely witness a more significant tightening of financial conditions via the credit channel. This could threaten further economic expansion.

However, if markets can see a 'demonstration' over the coming months that economies can actually cope with higher rates, the cycle could be extended. In the US, for example, 10-year yields are still well below levels seen in 2018, while the economy is in much better shape today than it was back then.

Part of what could draw out the cycle is the high likelihood of inflation relief at some stage in the next 12-18 months. A potentially significant slowdown would give the Fed some leeway to temper the pace of rate increases. Not to stop the hikes – and certainly not to reverse them – but pause a little to assess the impact of what they have already done.

In addition, decelerating inflation would be a big support for consumers, assuming ongoing solid nominal wage growth. Household labour income growth over the four quarters to December was about 9%, but only some 3% after inflation. The nominal growth rate will almost certainly slow, but if inflation slows at least as fast, real aggregate labour income will be maintained at robust levels. (See Jennifer and Ilana's piece on the next page for more on the overall state of the consumer.)

> **"Part of what could draw out the cycle is the high likelihood of inflation relief at some stage in the next 12-18 months."**

Big questions

If markets can find relative calm under this scenario, existing behaviours will probably reassert themselves. An area we are watching closely is corporate investment intentions, as discussed by Nitin below. Company management teams have a once-in-a-decade opportunity to raise prices and invest while growth is higher than interest rates. Given challenges with labour costs, should companies embark on capex that alleviates cost pressures – as appears to be underway – this could be very positive for equity valuations.

As we have consistently highlighted, the pandemic has accelerated many existing trends. The current war will further amplify some, while introducing others. We expect to see more onshoring, more diversification of supply, higher inventories and the balkanisation of certain sensitive industries.

Big questions remain, though. Following the sanctioning of the Russian central bank, what are the implications for central bank reserves? And how might environmental, social and governance factors, and the mega-trend of responsible investing, be redefined in this environment?

Our upcoming Spring CIO update will be dedicated to the longer-term implications of the Russia-Ukraine war, the first conflict in the new multi-polar world we have entered. The world is not what it was.

If markets can find relative calm under this scenario, existing behaviours will probably reassert themselves.

LGIM's Credit Scorecard

(-3 to +3 range and previous scores in parentheses if different)

	-3	-2	-1	0	+1	+2	+3
Short-term scores		US (-1)		Europe Global UK (-1)	EM		
Long-term scores			US	Europe (-1) UK (-1)	HY (+2) Global (-1)	HY (+2)	

Source: LGIM, as at March 2022; can be subject to change at any point. No HY short-term provided. **The value of any investment and any income taken from it is not guaranteed and can go down as well as up, and investors may get back less than the amount originally invested.**

Q2 2022 | Active Strategies outlook

The state of the consumer

As consumers, companies and economies adjust to post-pandemic life, our consumer-sector Global Research and Engagement Group gathered to analyse the [key trends that will shape 2022 and beyond].

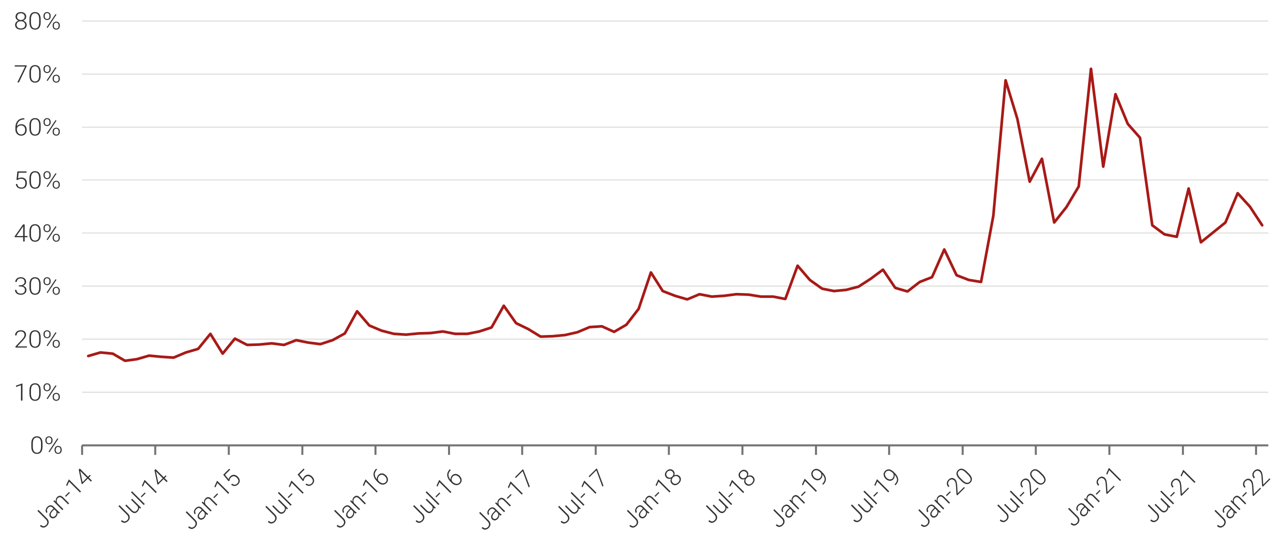
Jennifer Wong
Equity Investment Analyst,
Active Strategies

Ilana Elbim
Senior Credit Analyst,
Active Strategies

Colleagues across our Active Strategies and Investment Stewardship teams in London and Chicago contributed to this research.

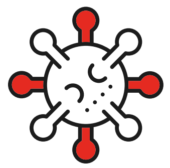
COVID-19 has meaningfully disrupted numerous consumer trends. Online adoption accelerated during the pandemic; although the pace has moderated somewhat as economies reopen, many industries are settling at a higher online penetration rate than we might have had otherwise at this point in time.

UK online penetration of non-food categories



Source: BRC data via JP Morgan, as at January 2022.

The UK grocery sector is a good example, with online penetration now almost double the pre-pandemic level[1]. Looking ahead, we expect online retail penetration to continue ticking upwards, and prefer retailers with scale and a strong multi-channel presence that can make sustainable profit out of their online operations.



On the other hand, we expect the pre-pandemic trend of consumers shifting their spending towards services versus goods to return, as society reopens and consumers seek out experiences missed during the pandemic. We expect discretionary consumer travel spending to continue recovering in 2022, and to reach 2019 levels by 2023-24.

1. Source: ONS

Beyond disruptions caused by Covid, we expect inflation to have a meaningful impact on competitive dynamics. Private-label products, which lost market share in the US during the pandemic across most consumer categories, may regain share as inflationary pressure hits consumer wallets.

In the UK grocery sector, we expect the 'big 4' not to repeat the mistakes of 2008-09, and refrain from fully passing cost inflation on to consumers, given the threat of hard discounters. Thus, we believe grocers will see some margin deterioration, and favour larger retailers that have greater scale and pricing power versus suppliers.

Lower-income consumers will be hardest hit by the sharp rise in the cost of living, and we prefer discounters that will likely be beneficiaries of downtrading. We also continue to be positive on select luxury brands that have strong pricing power, are exposed to higher-income consumers less impacted by inflation and have been less impacted by supply-chain tightness.

Looking longer term, we continue to monitor the spending habits of younger consumers. Survey data[2] suggest Millennials and Gen Z (who will account for 70% of global consumer expenditure by 2040) are looking to substitute away from unhealthy foods, alcohol and environmentally intensive foods such as meat.

Importantly, the data also indicate there's a willingness to pay higher prices for more sustainable products: in most cases up to 10% more. This cohort is also driving growth in digital fashion, which is being sold across social games and as non-fungible tokens.

2. Source: Credit Suisse Research

Where's the beef?

Lastly, we remain focused on working with consumer goods companies to reduce their supply-chain risk. We believe two commitments signed at COP26 last year (Glasgow Leaders' Declaration on Forest and Land Use, and the COP26 Commitment on Eliminating Agricultural Commodity-Driven Deforestation from Investment Portfolios) will further ratchet up expectations around how consumer goods companies manage and perform due diligence on their supply chains.

This may ultimately even impact the calculus for those commodities in product portfolios with the most significant land-use impact, such as beef.

Q2 2022 | Active Strategies outlook

Emerging-market credit amid the Ukraine conflict

Emerging-market (EM) credit was hit hard by Russia's invasion of Ukraine.

Uday Patnaik
Head of Emerging Market Debt, Active Strategies

Raza Agha
Head of Emerging Market Credit Strategy, Active Strategies

From the start of the conflict on February 24 to March 8, EM Sovereign and corporate spreads widened by approximately 100bps. Barring the initial impact of the pandemic, spread levels are the widest since the global financial crisis (see chart).

Looking at the dynamics of the widening, at an overall level, it was led by high-yield credits. Within the latter, sovereigns widened by about 170bps[3] from the start of the invasion. Investment-grade credits also widened, but by a relatively smaller ~65bps.

Regionally, credits in close geographic proximity to the crisis weakened the most (countries like Azerbaijan, Kazakhstan and Uzbekistan), despite relatively decent economic fundamentals. Similarly, countries like Egypt and Pakistan – which are heavily dependent on food and /or energy imports – saw sharp falls in bond prices.

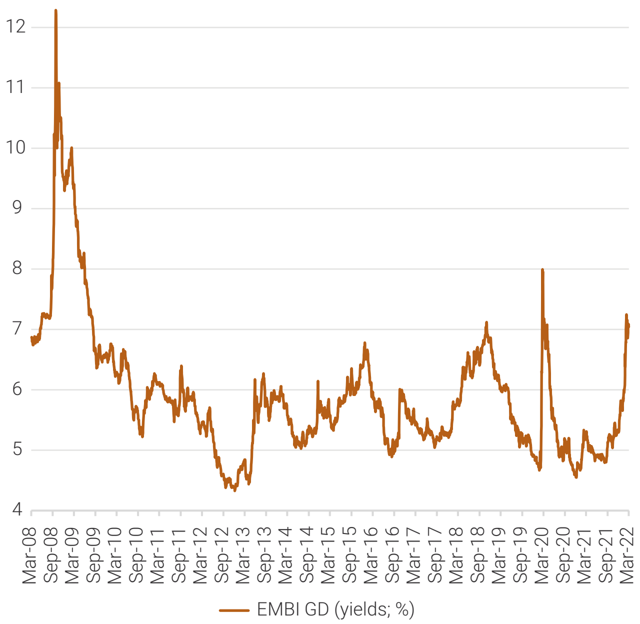
Underperformers included countries where the reform story and fundamentals were weak, either due to large financing needs (reflecting big budget and current account deficits) or high debt levels. That includes the countries of **El Salvador, Ghana, Sri Lanka and Pakistan**.

The relative **outperformers** included commodity producers like the Gulf Cooperation Council countries **(including Qatar, Saudi Arabia and UAE), South Africa, and Brazil** where exports would benefit from higher commodity prices.

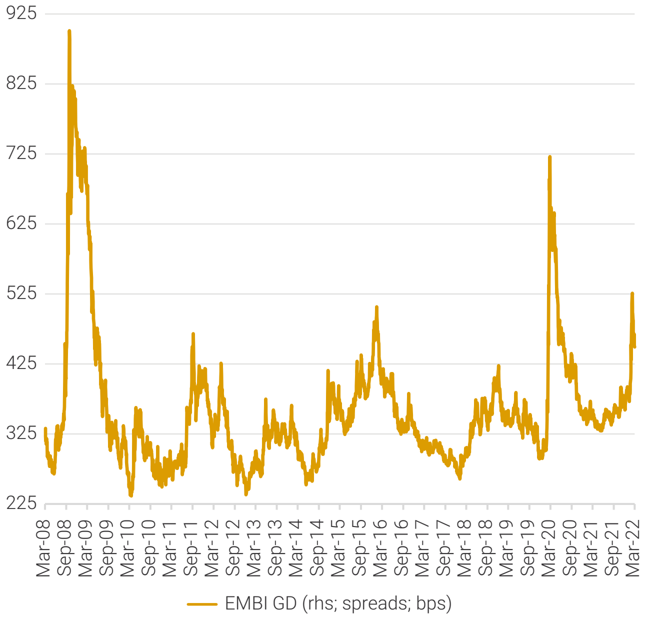
3. Source: Unless otherwise stated, all information is sourced from Bloomberg as at 29 March, 2022.

What all this widening of spreads meant is that the yield on our emerging-market sovereign benchmark rose to over 7%, meaning nearly 60bps of monthly carry alone. Much of the long end in the high-yield space rose above 9% – in those tenors at least – meaning market access was restricted. Indeed, issuance remains muted since the conflict began.

EM sovereign benchmark yields



EM sovereign benchmark spreads



Source: JPMorgan, Bloomberg, as at 28 March, 2022 (J.P. Morgan EMBI Global Diversified Index). **The value of any investment and any income taken from it is not guaranteed and can go down as well as up, and investors may get back less than the amount originally invested.**

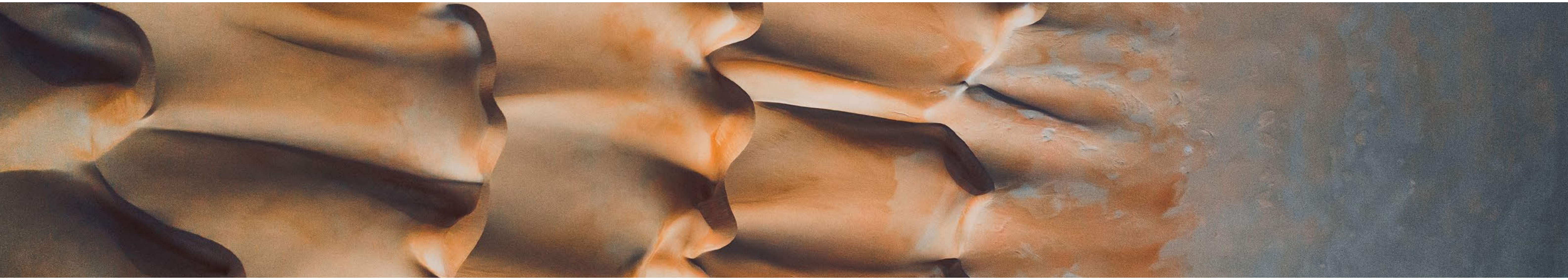
Diversity amid contagion

While contagion from the crisis has been widespread, we have several diverse themes running in our portfolios. We like bonds from countries and corporates which benefit from higher commodity prices (Angola, Gabon, Oman and Bahrain, for example).

We also have a positive view of countries which have reform momentum, or have reform anchors in place like the IMF or a reform-minded government (e.g. India, Ivory Coast, Oman). These commodity producers and reformers also benefit from stable and improving ratings. Indeed, some of the countries we have exposure to have actually been upgraded in recent months (such as Angola, Gabon, Ivory Coast).

In addition, we view curves and/or bonds that have potential for buybacks favourably as this supports technicals and helps lower their beta to the market (Angola, Mongolia, Gabon, Kenya). Then there are credits which are defensive in nature, with relatively lower betas to market moves, due to supportive technicals like a small-traded float, participation of local investors, and/or tightly held bonds (Mongolia, Jordan).

Finally, we are comfortable with names where valuations are attractive and where we are not overly concerned about fundamentals given decent external liquidity buffers, lower debt burdens, favourable growth dynamics and/or a proven ability to weather exogenous shocks (e.g. Nigeria, Egypt). This portfolio diversification and credit selection has supported performance in EMD funds since markets turned on March 8.



Q2 2022 | Active Strategies outlook

Capex and the challenge of rising labour costs

The corporate world is casting around for ways to combat the pressure of rising inflation. Could capital spending be the solution?

Nitin Anandkar
Equity Fund Manager,
Active Strategies

For many decades, the response to rising costs has been to move production to regions with a lower cost base, largely to developing countries with vast labour pools. However, labour shortages and wage inflation are today hitting various sectors and geographies globally. Besides, geopolitical concerns make it unlikely that the corporate sector will want to concentrate production further in certain geographies.

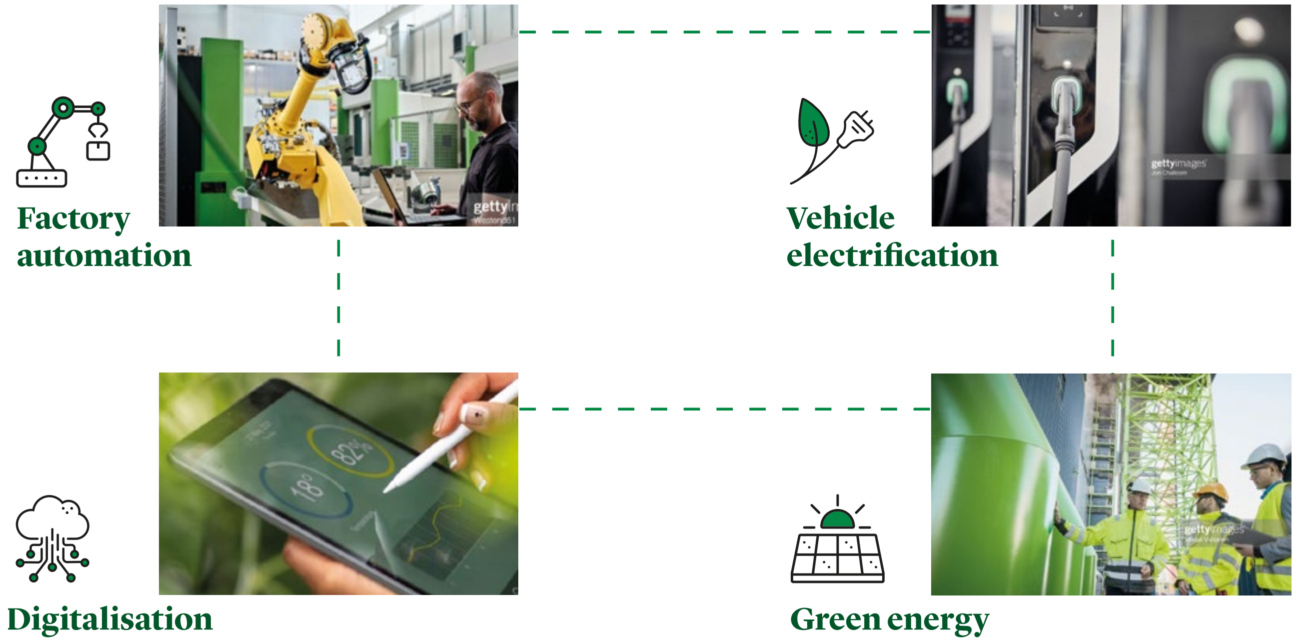
Automation investments vs people

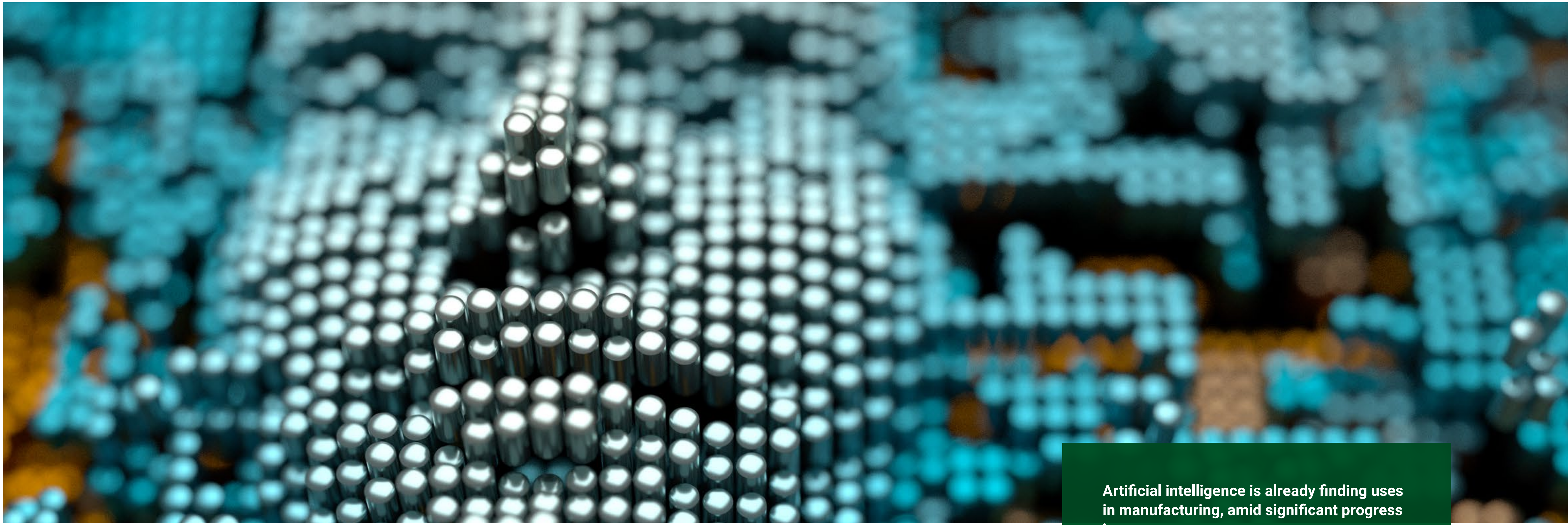
Capital spending does indeed offer one possible solution to this issue. While the potential for automation to enhance productivity has long been acknowledged, shortages of labour and consequent wage inflation have created additional incentives.

A number of complementary factors support the idea that increasing capital spending will be the corporate sector's response to wage inflation.

The installed fleet of fixed capital equipment has aged in the past decade, especially post the global financial crisis. Capex-to-depreciation trends show signs of a recent rise; these have been backed up by surging orders reported by providers of capital equipment.

The industrial world is also currently in the midst of several structural growth trends that complement the need to replace ageing equipment.





The new industrial revolution

Telecom operators around the world have recently started rolling out 5G networks; this has the potential to spur an innovation and investment cycle in the Industrial Internet of Things.

Artificial intelligence is already finding uses in manufacturing, and this comes alongside significant progress in industrial machine vision, robot guiding and equipment with embedded industrial software. All these systems could help tackle the problem of rising labour costs. 5G network rollouts could prove the tipping point in adoption of these industrial technologies, potentially paving the way for innovative industrial businesses over the next couple of decades.

After a long period of economic growth being dominated by consumption trends, we appear to be on the cusp of industrial investment taking on the growth mantle. While there are clear economic cycles at play that could make the road bumpy, the need to offset labour-cost inflation, coupled with structural megatrends, suggests we are in the early stages of a sustained capital spending cycle.

Artificial intelligence is already finding uses in manufacturing, amid significant progress in:

- **Industrial machine vision**
- **Robot guiding**
- **Equipment with embedded industrial software**

Contact us

For further information about LGIM, please visit lgim.com or contact your usual LGIM representative

---

Key risks

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.

Important information

Legal & General Investment Management Limited ("LGIM"), a company incorporated in England & Wales (Registered No. 2091894). Registered office: One Coleman Street, London EC2R 5AA. Authorised and regulated by the Financial Conduct Authority. Ultimate holding company - Legal & General Group plc.

The term “LGIM” or “we” in this document refers to Legal & General Investment Management (Holdings) Limited and its subsidiaries. Legal & General Investment Management Asia Limited (“LGIM Asia Ltd”) is a subsidiary of Legal & General Investment Management (Holdings) Limited.

The information contained herein reflects the views of LGIM and its subsidiaries and sources it believes are reliable as of the date of this publication. LGIM and its subsidiaries makes no representations or warranties concerning the accuracy of any data.

The contents of this document may not be reproduced or further distributed to any person or entity, whether in whole or in part, for any purpose. There is no guarantee that any projection, forecast or opinion in this material will be realized. The views expressed herein may change at any time after the date of this publication. This document is for informational purposes only and does not constitute investment advice. LGIM and its subsidiaries do not provide tax, legal or accounting advice. It does not take an investor’s personal investment objectives or financial situation into account; investors should discuss their individual circumstances with appropriate professionals before making any decisions. This information should not be construed as sales or marketing material or an offer or solicitation for the purchase or sale of any financial instrument, product or service sponsored by LGIM and its subsidiaries. LGIM accepts no responsibility for the content of any website to which a hypertext link from this document exists. The links are provided 'as is' with no warranty, express or implied.This document is issued in Hong Kong by LGIM Asia Ltd, a licensed entity regulated by the Hong Kong Securities and Futures Commission (“SFC”) to conduct Type 1 (Dealing in Securities), Type 2 (Dealing in Futures Contracts) and Type 9 (Asset Management) regulated activities in Hong Kong.

This document has not been reviewed by the SFC.Legal & General Investment Management Asia Limited, Unit 5111-12, Level 51, The Center, 99 Queen’s Road Central, Central, Hong Kong. www.lgim.com

D003418_ASIA