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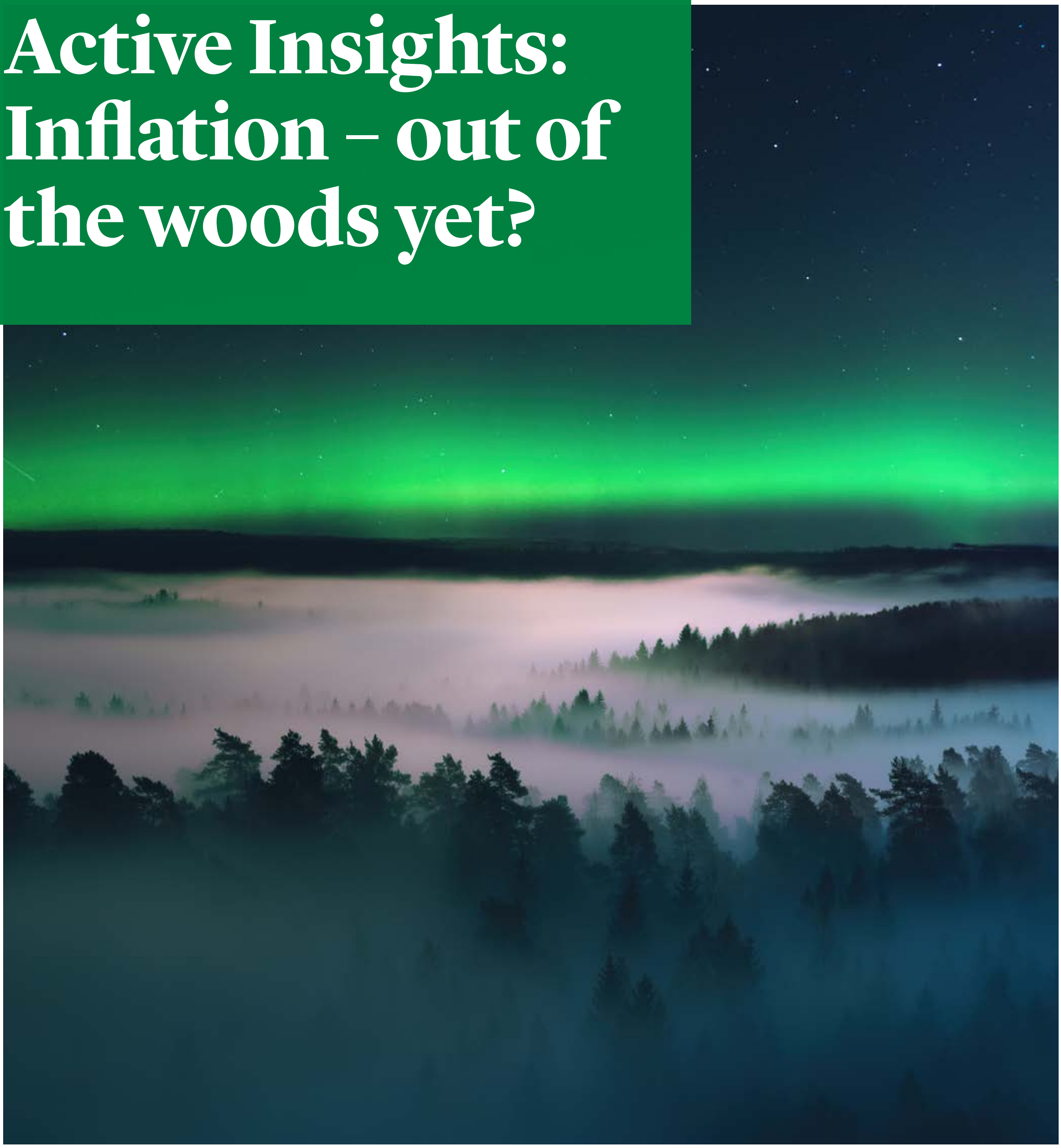
Q1 2024

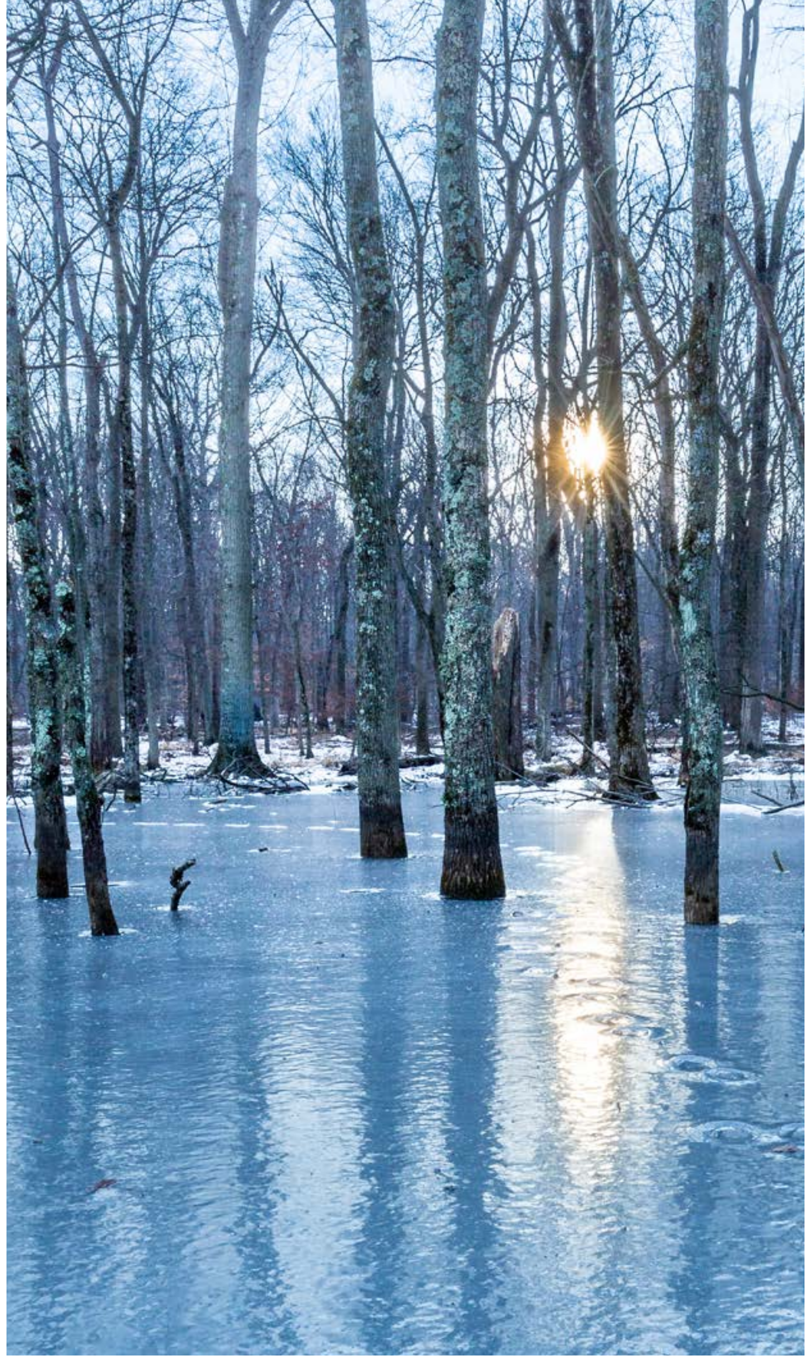
Active Insights: Inflation – out of the woods yet?



LGIM

Inflation – out of the woods yet?

Colin Reedie
Head of Active Strategies



Having fleetingly believed that inflation was yesterday's problem, should fixed-income investors be worried that it may be stickier than first thought?

If there's one thing us fixed-income investors don't like, it's inflation. And yet predicting the rate of inflation is probably the hardest thing to attempt. That's particularly frustrating when the last time inflation was so volatile was during the late 1970s, in the aftermath of the oil-price shock. Whether we like it or not, inflation is still one of the most powerful factors driving financial markets, and bond markets in particular. So, as we start 2024, the key question must surely be: Have we seen the back of higher inflation, or will it rear its ugly head again as we move further into the new year?

The Fed pivot

Investors interpreted December's pivot from the US Federal Reserve (Fed) as a clear signal that the inflation problem had been contained. Initial reaction to the pivot was euphoric. Inflation numbers were on a downward trend, triggering the belief that interest-rate cuts would be orderly, and that a harsh recession would be avoided. But are investors putting too much faith in the Fed? As we start the new year, we're seeing stronger-than-expected data points, most notably in the form of US job numbers. And already we're witnessing supply disruptions in the area around the Red Sea due to the conflict in the Middle East, with potential inflationary implications. In short, the more we see the market acting as if inflation were yesterday's problem, the less comfortable we are, as a team, in holding large amounts of duration.

Growth or no growth?

The other key question for us is whether the US economy will slow this year – with or without a recession. From recent economic surveys we know that global manufacturing is in the doldrums, whereas the service sector, particularly in Western economies, is buoyant. This may be a function of late-cycle indicators. As long as we have these, manifested largely through tight labour markets, economic models will continue to flag the risk of recession. However, we believe the probability of an impending recession, certainly in the first half of 2024, now looks less likely.

Figure 1: Has extended fiscal support kept the US economy afloat?

Source: LGIM, Macrobond as at 8 January 2024. **Assumptions, opinions and estimates are provided for illustrative purposes only. There is no guarantee that any forecasts made will come to pass. 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.**

No reason for volatility to abate

Another area of complexity for the bond investor has been having to get used to volatile trading conditions. Already we've experienced two consecutive years of extreme fluctuations in bond prices. On this front, it's important to distinguish between good and bad volatility. The latter centres largely around systemic risk when something goes wrong. But what we believe we are seeing now is good volatility, leading to potential opportunities for active managers.

A potential source of volatility comes from the fact that 2024 is a year dominated by elections – India, the UK and the US, to name but a few, all go to the polls this year. The period leading up to any election typically produces higher volatility as investors are forced to navigate through uncertainty.

Implications for investors

The rally witnessed in the last two months of 2023 has inevitably eroded some of the gains investors might have reasonably expected to materialise in 2024. While the soft-landing narrative is positive for risk assets, recent profit-taking aside, we believe that it is now mostly priced into financial markets. That said, we believe the income component in fixed income still looks appealing relative to historic levels. This income may be boosted by investing in corporate credit, which is how we are strategically positioned. On the flip side, we believe the outlook for capital appreciation may be more uncertain over the coming months, given the extent of the rally in the latter months of 2023.

Diversification: The name of the game

Matthew Rees
Head of Global Bond Strategies

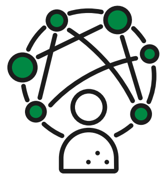
Has the positive correlation between bonds and equities over the last two years further strengthened the call for portfolio diversification?

With the benefit of hindsight, 2023 ended as it began, with many investors being wrong-footed. At the beginning of the year, we anticipated a recession that never came. At the end of 2023, fears over sticky inflation seemed to disappear into the ether as inflation numbers fell further, and faster, than anyone had dared imagine. The US Federal Reserve (Fed) pivoted, analysts rearranged their dots regarding the Fed funds rate, and for much of the year, investors once again witnessed something they had dreaded in 2022 – the return of a positive correlation between bonds and equities.

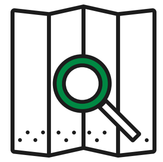
Widening the net

It's becoming increasingly evident that a traditional 60/40 portfolio structure is waning in popularity and that diversification needs to be found by looking at other sources. Increasingly, we believe investors are typically turning to absolute return bond strategies as a means of extracting uncorrelated returns. Absolute return strategies have no benchmark and aim to produce positive returns in all market environments with their managers' skills.

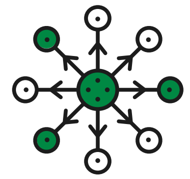
We believe the main differentiators of our absolute return strategy are:



The ability to 'outsource' global high yield and emerging market debt to our experts in the team

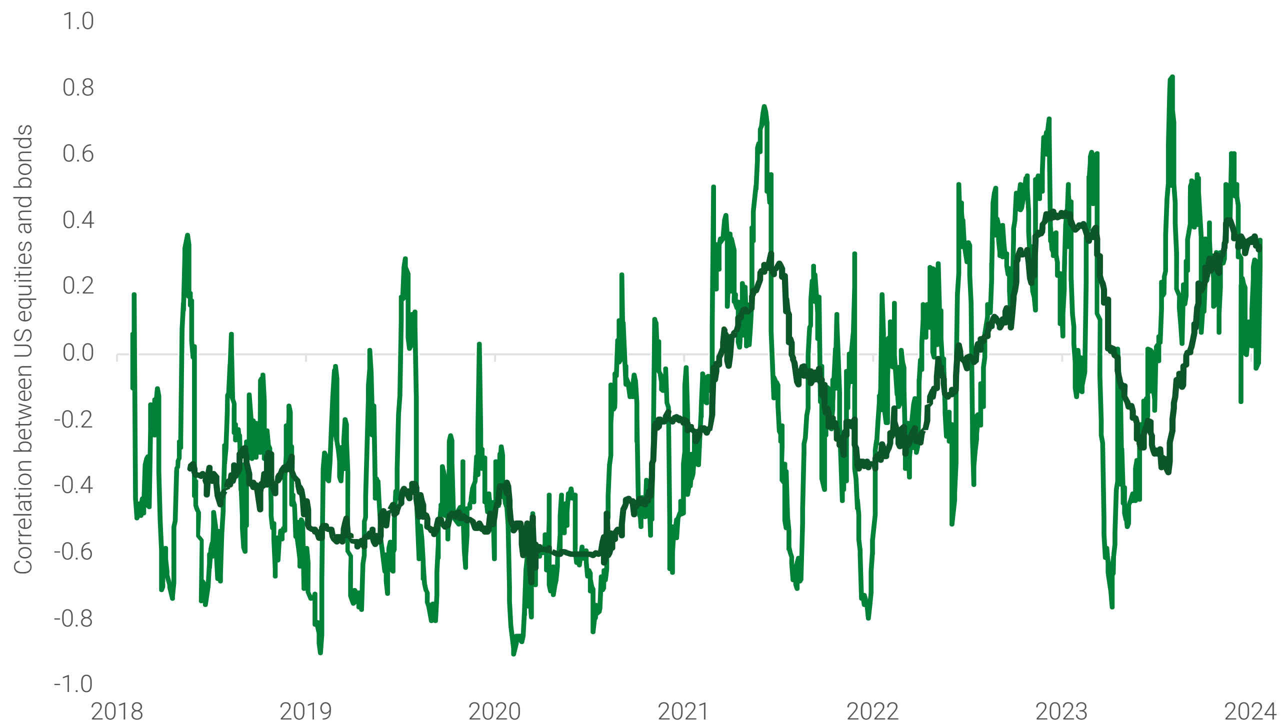


A lack of concentration in any one geographic region



The realisation that the bond universe is too diverse and too complex for a single manager to run

Figure 2: Government bonds have been a 'reliably unreliable' equity hedge since 2021



Source: LGIM, Bloomberg, as at 8 January 2024. Equities represented by S&P 500 total return index, bonds represented by US 10-year Treasury total return index. **Assumptions, opinions and estimates are provided for illustrative purposes only. There is no guarantee that any forecasts made will come to pass. It should be noted that diversification is no guarantee against a loss in a declining market.**

A strategic bond strategy invests in a range of fixed-income securities, including government bonds, corporate debt and high-yield bonds. At LGIM, we adjust interest-rate, or duration risk, aiming to accommodate changes in all macroeconomic conditions. We are also able to take advantage of a wide range of geographic exposures. Strategic bond funds do not focus on any one area of the market.

An absolute return bond strategy aims to deliver an absolute profit for its investors, regardless of the direction of the market. Our main aim over the last three years has been to guard against losses when interest rates rise, and when bonds have been producing negative returns.

Where do we go from here? Recession in the Eurozone?

At the time of writing, investors continue to believe in a soft-landing narrative, certainly in the US. The taming of inflation, without incurring a sharp drop in growth, would indeed be an optimal outcome for market participants. This is already reflected in US credit spreads, though, where strong inflows into fixed income have also contributed to the rally that started in the fourth quarter of 2023. But in Europe, and Germany in particular, we are already witnessing recessionary conditions. Although European spreads are wider than in the US, reflecting the weaker economic conditions, we don't believe that the possibility of a sharp European recession is sufficiently reflected in spreads. If these were to meaningfully reprice, due to a resurgence in recessionary expectations, then we are reasonably confident that government bond yields would go down, thus potentially offsetting losses from credit.

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Implications for investors

If this scenario were to materialise, we would argue that there is still value in holding corporate bonds rather than cash. The reduction in government bond yields would produce positive returns from duration, while also reducing the rates of return on cash. If a meaningful widening of credit spreads does indeed occur, we would focus our efforts on the riskier parts of fixed-income markets, such as global high yield and emerging market debt, which tend, in our view, to reprice more quickly than developed market investment-grade corporates.

"The reduction in government bond yields would produce positive returns from duration, while also reducing the rates of return on cash."

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Securitised products explained

Alec Duchatellier
Head of Securitised Research, LGIM America

Priya Joshi
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With roots dating back to the 1970s, securitised products have evolved to such an extent that they have now become the second-largest sector in the US fixed-income market[1].

What are securitised products?

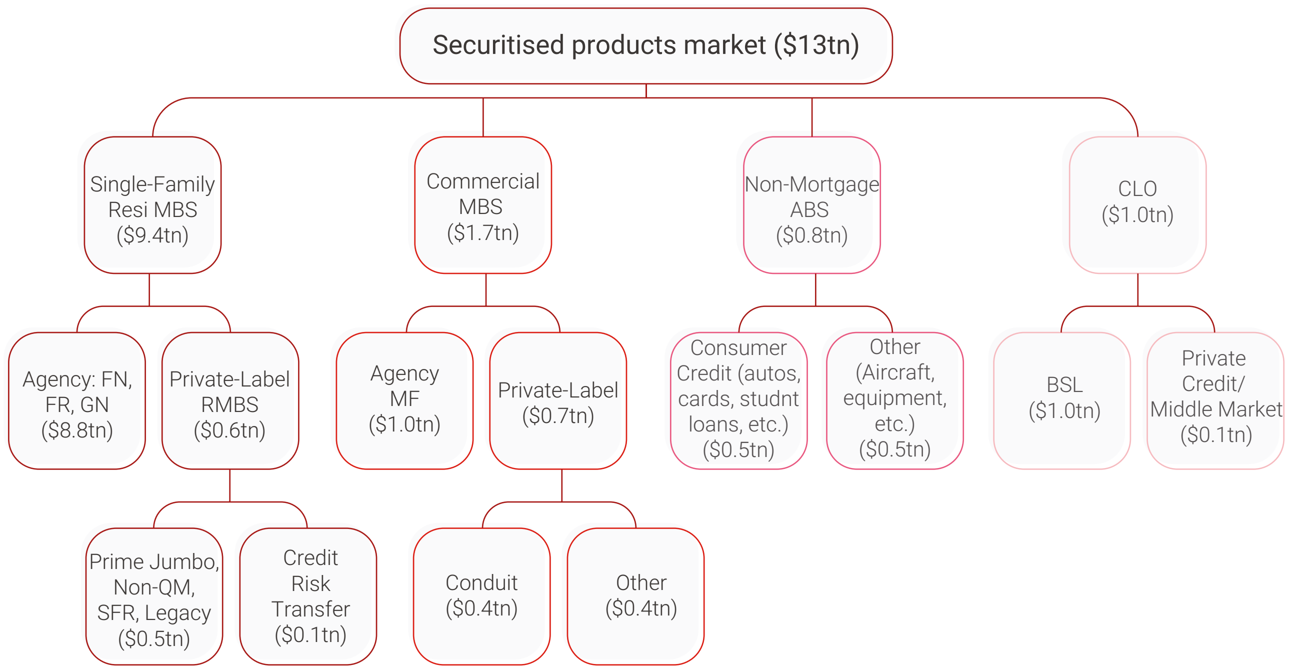
Securitised products are bonds backed by the cashflows from a dedicated pool of financial assets (for example, loans, leases and lines of credit). This is the key differentiating factor versus corporate debentures and sovereigns, which are general obligations of the sponsoring entity. Securitisation allows for both the financing of assets and the transfer of risk from lender to investor. Securitised bonds typically appeal to domestic banks, asset managers, insurance companies, hedge funds and overseas investors. See page 14 for investor implications of these products.

A large market

The market is large, diverse and mature, with a wide variety of income-producing assets being securitised. The combined outstanding balance of the overall securitised market, which stands at around US$13 trillion[2], second only to the US Treasury market, can be segmented into mortgage-backed and non-mortgage-backed securities. Mortgage-backed securities account for around 85% of the market[3] and include sectors such as agency single-family, non-agency single family and commercial real estate. In terms of annual issuance, mortgage-backed securities accounted for 75% of new issuance up to the third quarter of 2023[4], while asset-backed securities (ABSs) and collateralised loan obligations (CLOs) comprised the remainder.
Figure 3 gives a sense of the types of collateral that back securitised bonds.

1. Source: BofA as at 30 September 2023.
2. Source: BofA as at 30 September 2023.
3. Source: BofA as at 30 September 2023.
4. Source: BofA as at 30 September 2023.

Figure 3: Securitised products market taxonomy



Source: LGIM America as at 30 September 2023. **It should be noted that diversification is no guarantee against a loss in a declining market.**

Secured versus unsecured debt – potential investor benefits

We believe some of the potential benefits of securitised debt for investors may include:

Bankruptcy remoteness from the deal sponsor

Securitised bonds are created by transferring financeable assets to a special purpose vehicle (SPV) on a 'true sale' basis. To qualify as a true sale, the sponsor must surrender control of the assets, thereby isolating the respective trust from any potential bankruptcy risk of the sponsor. The trust then issues debt against the pool of assets, which is purchased by investors. If the sponsor of the SPV becomes insolvent, bankruptcy protection does not extend to any assets owned by the trust.

Diversification

Underlying collateral pools typically contain hundreds, or thousands, of assets that are diversified in many ways including by credit profile and geography. Diversification tends to lower aggregate default rates and result in more predictable periodic and cumulative losses.

Credit protection

Securitised deals are typically structured with multiple classes spanning a wide range of credit ratings. Bonds at the top of the capital stack benefit from subordination, reducing the risk of principal loss. Moreover, the deals often include other diversified forms of credit enhancement, including overcollateralisation, reserve accounts and excess spread.

Range of weighted average lives

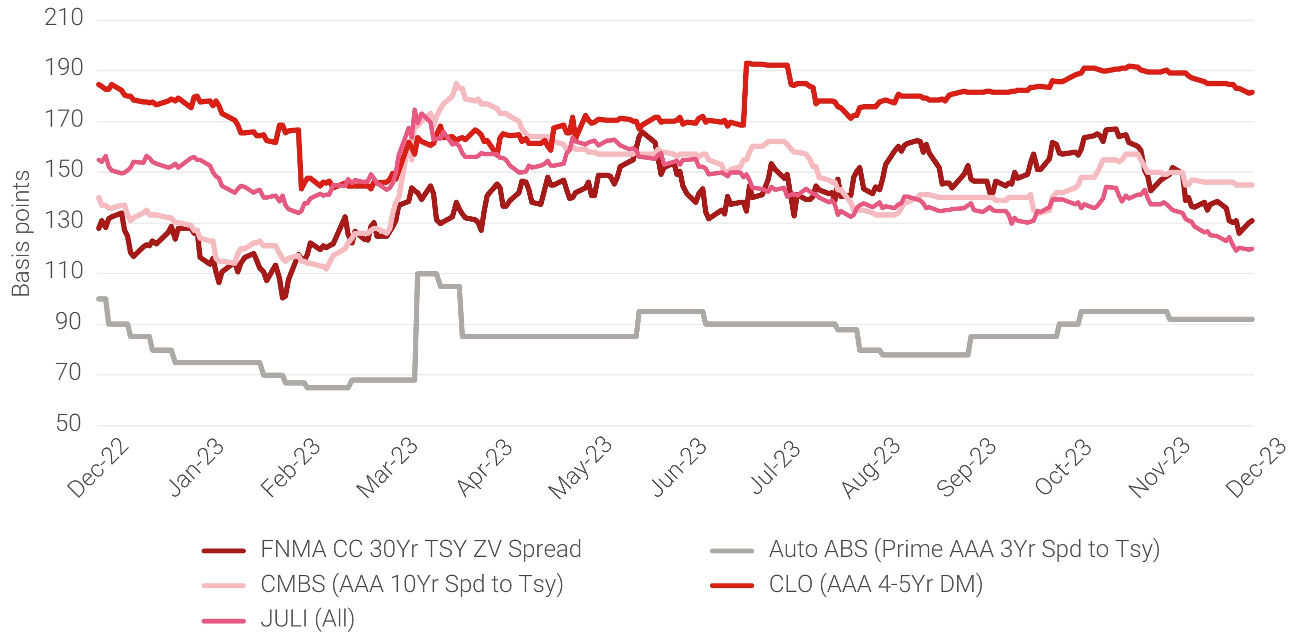
The deal structures distribute the underlying collateral cashflows to create bonds with a variety of weighted average lives (WALs) to fit investors' needs. WALs range from a few months to more than 10 years in some cases.

Spread pickups relative to competing sectors

The sector frequently offers a spread pickup versus competing unsecured debt (see Figure 4.). On the next page we highlight generic sector spreads relative to investment-grade corporate spreads. Duration, liquidity, underlying credit characteristics and convexity are inputs that we believe could be considered as requirements for spread compensation.

> **"Duration, liquidity, underlying credit characteristics and convexity are inputs that we believe could be considered as requirements for spread compensation."**

Figure 4: Spreads on selected securitised products sectors



Sources: JP Morgan and LGIM America as at 6 December 2023. **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, and investors may get back less than the amount originally invested.**

Implications for investors

Securitised products can be much more complex than corporate debentures in terms of deal structures. Certain sectors of the market, notably single-family residential MBS, are characterised by volatile and path-dependent cashflows. Market participants rely on complex models to project interest-rate paths, cashflows and bond analytics.

There can also be a trade-off in terms of liquidity in the more esoteric corners of the securitised bond market. But, for investors willing to put in the effort to acquaint themselves with this asset class, we believe the sector can offer an attractive risk/reward profile and a potential diversification opportunity.

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Look for the signs

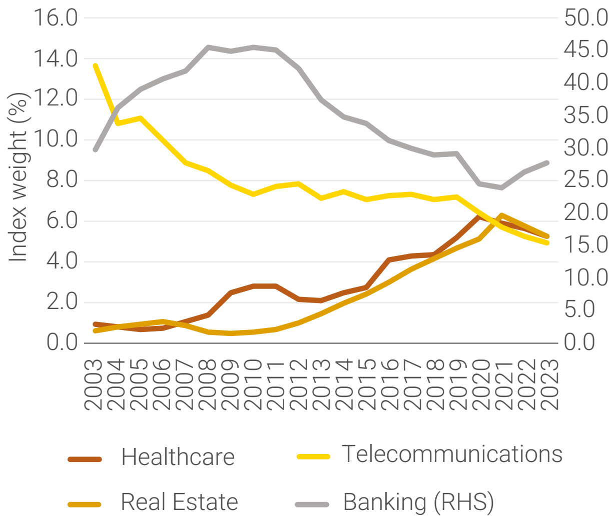
Marc Rovers
Head of Euro Credit

Connor Olvany
Portfolio Manager

A significant increase in debt issuance, and therefore the growth of a particular sector, can often be a warning sign of problems to come in the corporate bond market, in our view.

Since the European corporate bond market was established in the early 2000s, there have been several evolutions of index composition at the sector level. Sector-specific growth stories, and subsequent crises, have led to large fluctuations in the composition of the index. For example, investors saw a large amount of debt from telecommunications companies after the 3G licence spending spree in the early 2000s. They also saw the rapid growth of the banking sector ahead of the global financial crisis (GFC). From 2019 to 2021, there was an explosion of real estate issuance, which we flagged as a potential concern in a blog some time ago. The sector has come under pressure in the higher interest-rate environment of the last two years. Currently, bank bond issuance is on the rise, while long-term debt in the healthcare sector has also risen.

Figure 5: Evolution of euro credit sector weights

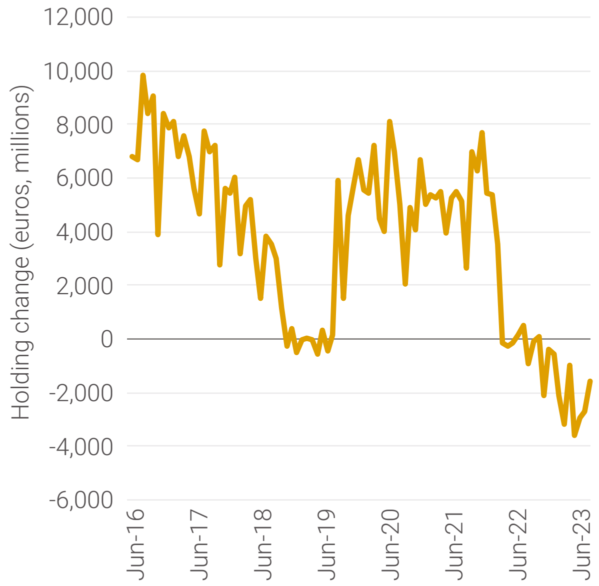


Source: Bloomberg, BofA as at 31 December 2023. **The value of an investment and any income taken from it is not guaranteed and can go down as well as up, and investors may get back less than the amount originally invested.**

The ECB – a dominant force in European corporate credit

When looking at the European corporate credit market, investors are unable to ignore the close links with European Central Bank (ECB) policies.
Since 2016, the ECB has been a dominant force in the market, purchasing hundreds of billions of euros worth of bonds under the Corporate Sector Purchase Programme (CSPP), as part of its quantitative easing policy.

Figure 6: Monthly change in ECB CSPP Holdings



Source: Bloomberg, BofA as at 31 December 2023. **The value of an 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.**

Despite one of the quickest rate-hiking cycles in history, whereby the central bank raised the benchmark interest rate by 4% within 18 months, taking the key refinancing rate to 4.5%, risk assets have held up remarkably well. Since the start of 2023, the spread of European investment-grade bonds over German government debt has tightened by around 30 basis points (bps)[5]. This is despite European growth looking challenging, with economic indicators suggesting the possibility of a recession and the ECB not expected to offer further support.

We believe the attractiveness of overall yields at levels over 4%, or even 4.5%, partly explains the strong demand for euro credit in 2023; at least until the end of the year, when the rally in rates pushed all-in yields below the 4% level[6]. When we look at spreads in a historic context, they still look attractive, in our view. That said, when set against our more negative economic outlook, we remain cautious. We believe a fair amount of positive news on the inflation side appears to be discounted, with markets currently pricing in a drop of over 1% in ECB policy rates before the end of the third quarter of 2024. In addition, there is the question as to what extent the lack of buying by the ECB will continue to be counterbalanced by inflows into the asset class.

Implications for investors

As a result, we remain defensively positioned, with a substantial underweight position in lower-rated issuers, and with a preference for less cyclical, more defensive companies. Banks continue to offer good relative value, in our view, while the inherent cyclicality is somewhat countered by stronger balance sheets. However, the mini banking crisis in March 2023 illustrated, once again, that the performances of issuers in the sector are highly correlated, and we continue to limit our overall exposure for that reason. Furthermore, the banking sector continues to grow as net supply continues to be above the index weight.

Identifying longer-term investment themes, sector deep-dives and bottom-up selection will continue to be core elements of our investment process over the next 12 months. We said 2023 would be challenging. We expect 2024 to be no less so, and we continue to prepare ourselves for any form of landing – soft or otherwise.

5. Source: Bloomberg as at 31 December 2023.
6. Source: Bloomberg as at 31 December 2023.

Contact us

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

Key risks

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. It should be noted that diversification is no guarantee against a loss in a declining market.

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