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Q4 2023

Active Insights: Higher ... and for how much longer?

LGIM

Higher … and for how much longer?

Colin Reedie
Head of Active Strategies

While a recession has been delayed this year, that's not to say it won't happen in 2024.

For much of 2023, resilience has been something of a watchword in financial markets. Equities have taken comfort from the fact that economic activity and tighter labour markets, particularly in the US, have kept macroeconomic conditions buoyant. Credit spreads have also shown surprising resilience. The yield curve, on the other hand, has been inverted since July 2022 (10-year bonds have been yielding less than two-year bonds), at odds with the dominant market narrative of a soft landing, and definitely at odds with the views of the no landing camp.

The hawks have started to circle

September's Federal Open Market Committee reiterated what had already been set in motion at the annual symposium of central bankers at Jackson Hole in late August. Namely, that the strength of the US economy would likely trigger the need to keep interest rates high. Real rates started to rise. Financial markets, which had initially worked on the premise that the effects of monetary tightening would quickly work their way through to the real economy, culminating in a rate peak, followed by a fall in interest rates, became concerned that their original assessment was incorrect. Indeed, investors have now pushed out the timing for rate cuts from the US Federal Reserve (Fed), with the first reduction not fully priced in until the second half of 2024.

Living with higher interest rates

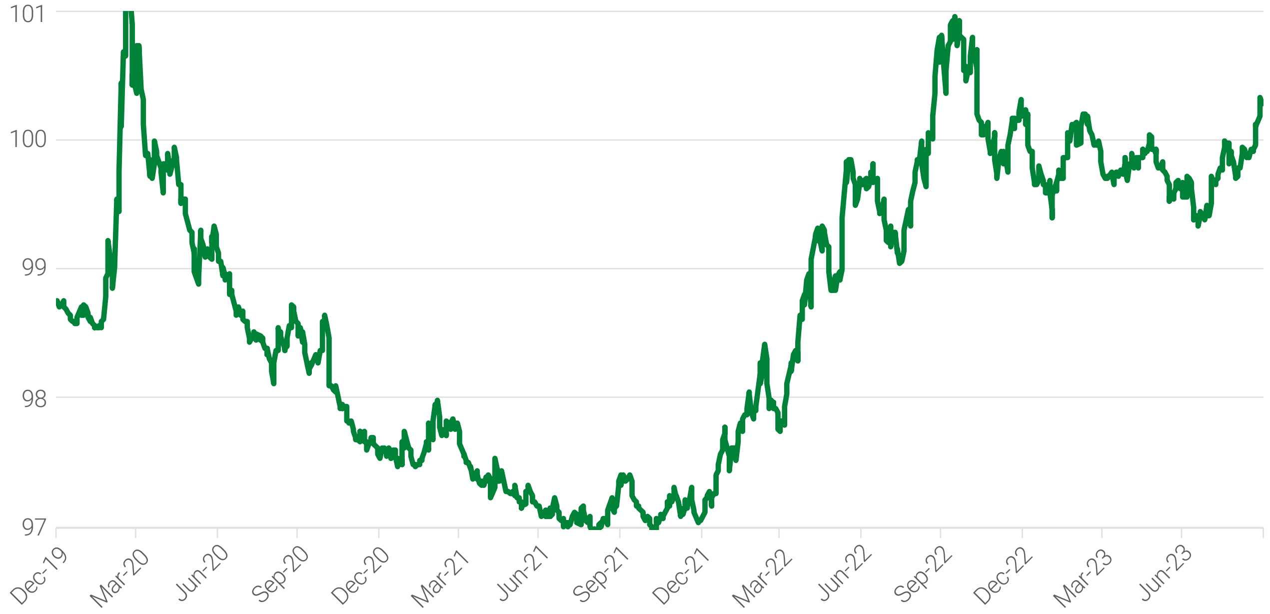
As a result, investors are becoming more convinced that the Western world may have to live with higher interest rates, and for longer than previously thought. How comfortable the economy is with the current level of interest rates is debatable.

As a house, we're interested in the question: "What will investors be more concerned about going forward – is it high inflation, or low growth?" While there is evidence to suggest that headline inflation appears to be slowing, we haven't seen enough disinflationary momentum in wages and enough slack developing in the labour market to be confident that inflation is "yesterday's problem." The risk is that inflation continues to be embedded in the system even when the economy starts to slow down.

We also continue to probe the widely held belief that any recession will be shallow. Won't the lagged effect of cumulative tightening mean higher refinancing rates, a pick-up in default rates and depleted household savings ratios, thus making a hard landing more likely?

Already we are seeing some deterioration in corporate fundamentals in the US and Europe, while leverage is starting to pick up.

Financial conditions tightening again



Source: GS, Bloomberg as at 29 September 2023. **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.**

Too many unknowns

For now, we are not seeing any meaningful pick-up in default rates, and in the high-yield space, we believe, we are unlikely to see that until 2025 or 2026. We also believe strong technical demand continues to underpin the high-yield market.

It's possible that rate stability, coupled with a goldilocks labour market, may mean that we see robust credit demand as we head into the seasonally stronger fourth quarter of 2023. But at this stage, too many unknowns, coupled with heightened geopolitical tensions in the Middle East and elsewhere, make us cautious in our approach.

Investor implications

In terms of investment-grade corporates, while the ratio of upgrades to downgrades still shows a greater percentage of upgrades in the US and Europe, that differential has reduced in the past quarter. Many issuers will start refinancing their fixed-maturity debt in 2024 and 2025, and they will have to absorb higher coupon payments. When we look at the level of credit spreads, we don't believe that we are sufficiently compensated to take overweight positions in investment-grade credit risk.

As a house, we remain defensive in our outlook for risk assets, given our belief that there will be a recession in the latter stages of 2024. Within that cautious outlook, we remain positive on fixed income. Our conviction will grow, and we will meaningfully increase our appetite for duration, if we see widespread evidence that investors believe the economy can live with higher for longer interest rates.

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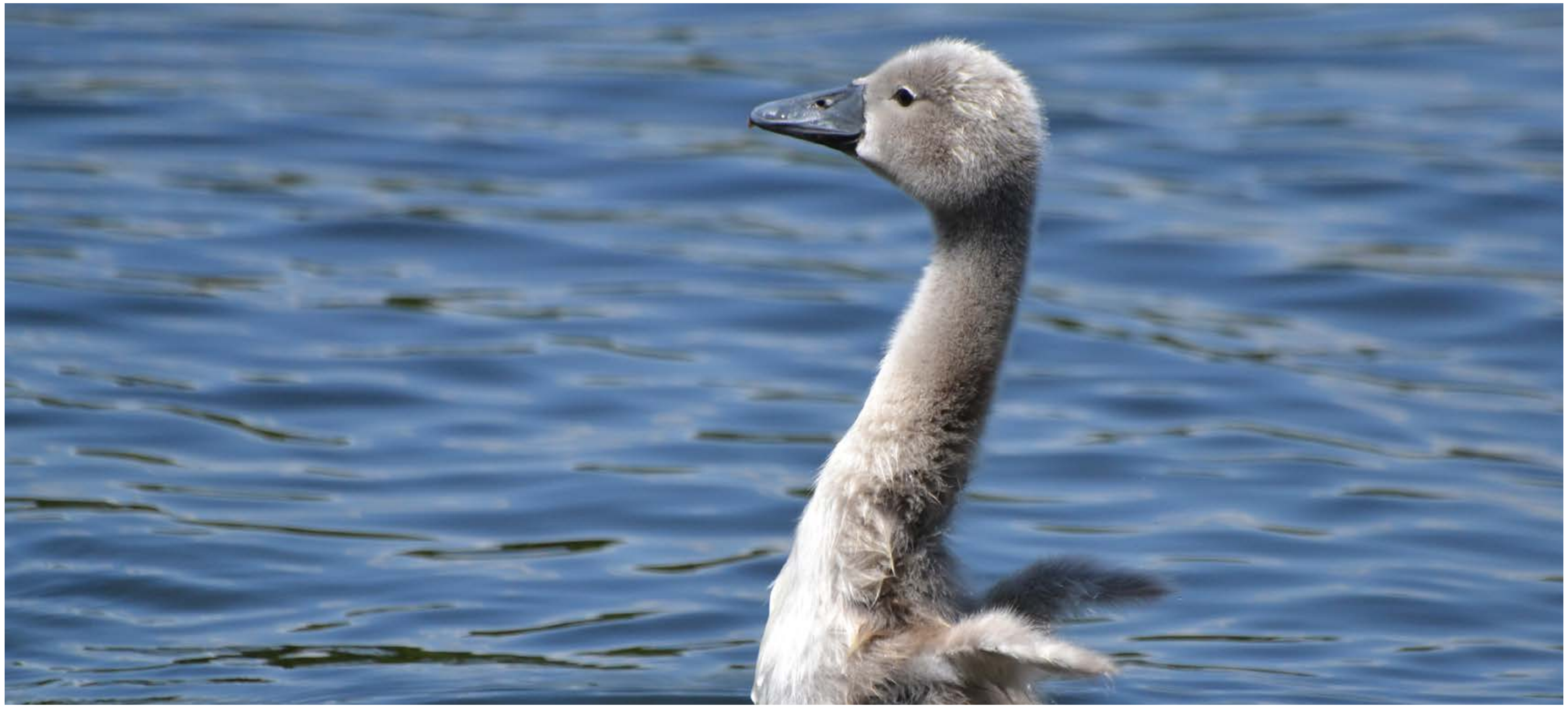

High yield: the ugly duckling of the fixed-income universe?

John Ryan
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Global High Yield

Most of us are familiar with Hans Christian Andersen's classic fairy tale about an unloved, unwanted duckling who grows up only to find he has become a beautiful swan.

No investor would suggest that this small part of the fixed income universe should be on a par with investment-grade swans (high-yield bonds make up just 2%[1] of the universe currently). But, as Andersen himself tried to subtly point out, even ugly ducklings should be given a better reception in life.

And yet high-yield bonds are typically disliked by investors, in our view. Potential default fears, which inevitably gather momentum at the later stages of the economic cycle, are one reason. The permanent association of being inextricably linked with the label of 'junk bonds,' or triple C rated debt, another.

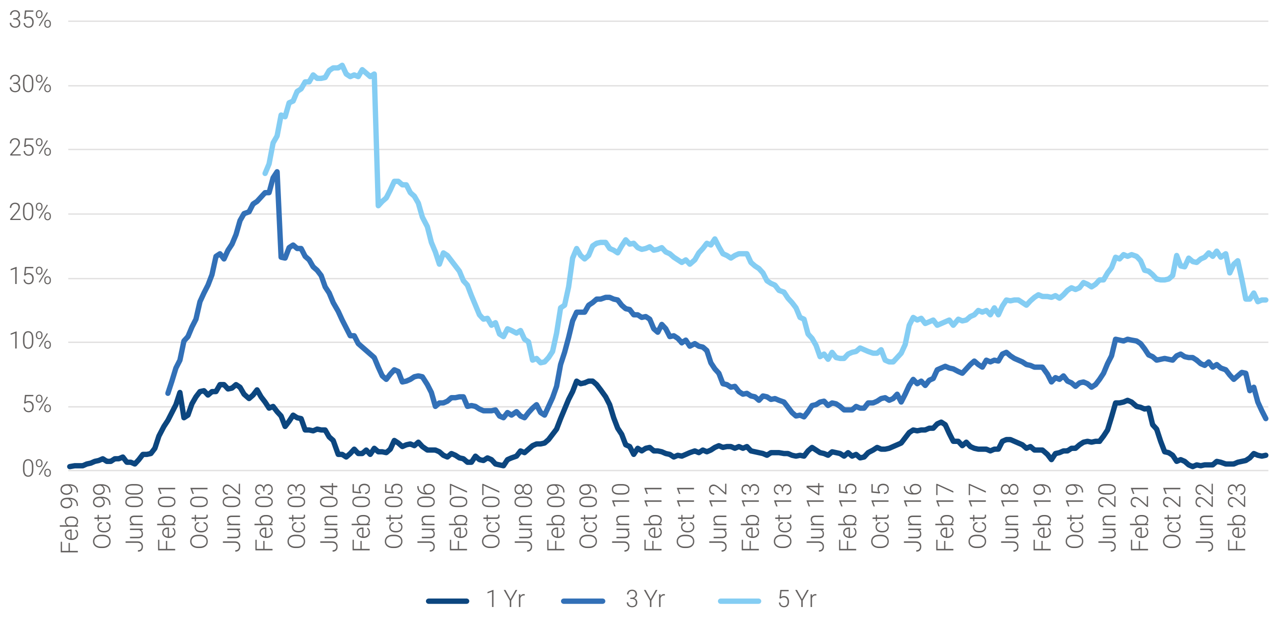
1. Source: ICE-BAML (via Bloomberg) as at 28 September.

Income high-flyers

Undisputedly though, high-yield bonds have long been a source of income for investors, often competing, in the publicly listed arena at least, with both dividend equity income on the one hand, and rental income from property on the other. While all investments can change in value on a mark-to-market basis, equity and property prices don't always revert to fair value. Bonds, however, have a deadline by which they have to repay at par ... unless of course investors are forced to take a haircut in the event of a default.

For now, default rates for BB and B rated high-yield bonds remain low (see chart on opposite page). Admittedly, this has been a particularly benign global economic cycle, characterised by an era of unprecedentedly low interest rates. But, as the chart below shows, US longer-term defaults are only just normalising, with the one-year rate still low compared to historic standards. Any rise in defaults is invariably concentrated in the triple C part of the market – an area we studiously avoid.

High yield issuer default rate



Source: Bloomberg as at 01 September 2023. **Assumptions, opinions and estimates are provided for illustrative purposes only. There is no guarantee that any forecasts made will come to pass.**

Migrating to Europe

Europe is an economic region characterised by relatively low growth (compared to emerging markets and the Americas). But it enjoys relative political and economic stability. We believe this is a potentially favourable environment for high-yield bonds: the stability keeps defaults contained, while low (but still positive) growth is enough to keep fundamental credit metrics improving.

For investors mindful of defaults, we believe Europe is still top of the pecking order in terms of quality. Two-thirds of the index we follow[2] is BB rated, with the remaining third single B. BB default rates average around 1% annually, against a current yield, in euros, of 8%[3]. Furthermore, we believe there is sufficient protection here from the triple C end of the credit spectrum.

The debate between the merits of public versus private credit has been hotly contested for several years. The latter has soared in popularity – private debt currently sits at US$1.5 trillion[4]. But asset allocations into leveraged loans, direct lending and private credit have taken demand away from the European high-yield space in recent years. We believe this has served to keep the pricing of European high-yield bonds low in relative terms, which represents an attractive entry point, in our view.

> **“Are current yields in the high-yield universe compensating investors sufficiently?”**

Investor implications:

The big question for investors right now is how will high yield perform in a higher-for-longer rates environment? As high-yield bonds are a fixed coupon investment and, in aggregate, don't reach their maturity walls for another three years or so, cash interest costs would take a long time to rise for our universe of issuers under this scenario. The price outcome would be magnified for higher-duration government and investment-grade bonds, in our view, but the greater yield drawn from high-yield bonds, we believe, protects the prices more from a higher rates environment.

2. Source: ICE BofA BB-B Global High Yield Non-Financial 2% Constrained Total Return Index (Hedged to GBP).
3. Source: Bloomberg as at 23 October 2023.
4. Source: Bloomberg as at September 2023.

Navigating the storm – emerging market debt

Raza Agha
Head of EM Credit Strategy

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Emerging market (EM) credit has had a difficult two years. For most equity and bond investors, 2022 proved to be the perfect storm, with the war in Ukraine exacerbating inflationary pressures and the US Federal Reserve (Fed) embarking on policy normalisation.

While price pressures are receding in 2023, stronger-than-anticipated US economic data and concerns about sticky inflation have led to continued pressure on central bank rates.

Consequently, while EM sovereign and corporate spreads are tighter year-to-date[5], negative US Treasury returns have weighed on the performance of the asset class, triggering outflows from dollar-denominated emerging market hard currency funds.

Indeed, 15 out of the last 21 months have seen negative Treasury returns, including an unprecedented five-consecutive-month streak over May to September 2023[6], while 19 out of the last 21 months have seen outflows from EM hard currency funds[7]. As we head into 2024, will the tide finally turn for the asset class?

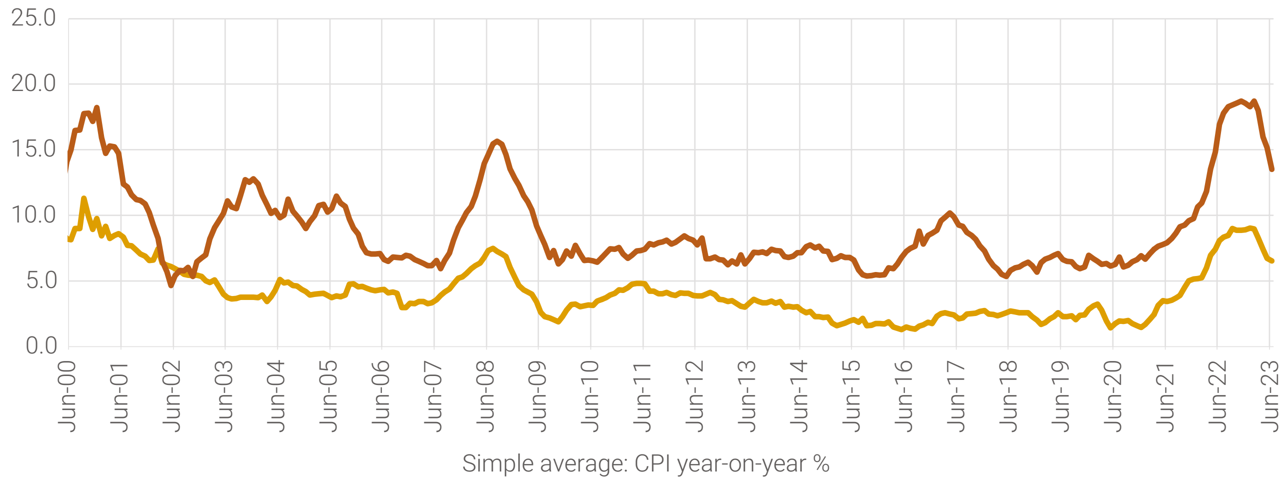
A resilient macroeconomic context

The latest forecasts from the International Monetary Fund suggest the global economy will continue to grow this year and next. That, in part, is a reflection of two factors: resilient growth in emerging markets, which is expected to increase by 4.0% this year and 4.1% in 2024[8], and the fact that emerging markets remain global growth drivers, reflecting their rising importance in the world economy.

With the slowdown in advanced economies, these forecasts imply that growth differentials between emerging markets and developed markets will rise to 2.5% this year and 2.7% in 2024 - their highest level in a decade[9].

5. Source: Bloomberg as at September 2023.
6. Source: Bloomberg as at September 2023.
7. Source: JP Morgan as at 30 September 2023.
8. Source: IMF as at June 2023.
9. Source: IMF as at June 2023. Assumptions, opinions and estimates are provided for illustrative purposes only. There is no guarantee that any forecasts made will come to pass.

Headline price pressures: Single B* vs IG credits**



*Single B average inflation

**IG average inflation

*Average for Egypt, Tunisia, Nigeria, Ghana, Kenya, Angola, Mozambique, Sri Lanka, Pakistan, Mongolia, Armenia, Costa Rica, El salvador, Jamaica and Honduras

**Average for Romania, India, Malaysia, South Korea, Poland, Israel, China, Peru, Mexico, Panama, Hungary, Chile, and Indonesia

Source: Bloomberg as at 30 June 2023. **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.**

The resilience of emerging markets is not just apparent in growth indicators, but also in the external sector. EM foreign exchange reserves remain at healthy levels, 2.5x higher than total external debt amortisation due over the next 12 months, or approximately 13 months of imports, despite many countries being shut out of the global capital markets[10].

Yields – riding the crest of a wave?

Given the above context, we believe the yield argument remains compelling for EM credit. The hard currency sovereign index is currently yielding 9.0%[11], while the corporate index stands at 7.9%[12]. At the time of writing, yields had only ever been this high at around the time of the global financial crisis. Meanwhile, in EM investment-grade debt, while spreads are tight compared to historic levels, we have seen continued demand, given the yield pickup over developed markets. Furthermore, although EM issuance has picked up this year, it has been front-loaded, while net supply will still be the second lowest since 2015[13].

10. Source: Bloomberg as at September 2023.
11. Source: JPM EMBI GD Index as at end September 2023.
12. Source: JPM CEMBI BD Index as at end September 2023.
13. Source: JPM, Bloomberg Finance L.P. as at end of September 2023.

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What could blow markets off course?

Having thought we were near the peak of the interest-rate cycle, investors have been contemplating the 'higher for longer' narrative since Jay Powell's hawkish comments at September's FOMC meeting. Given stronger-than-expected US economic resilience, the Fed has continued to remain data dependent, and any future economic surprises may lead to further volatility in interest rates, in our view. Our base case remains that the Fed has almost finished hiking and, coupled with the anticipated downturn in US growth dynamics, we believe that will eventually imply a rally in the prices of US Treasuries.

Tied to timing the turn in US rates, the risk remains EM outflows, which have persisted throughout the year, although at a slower pace than in 2022. Our view is that EM spreads could come under pressure if selling continues, although EM hard currency funds have historically never seen two consecutive years of outflows [14].

Investor implications

Despite the pressure from rising interest rates, EM credit has delivered positive returns this year[15]. The supportive macroeconomic conditions that have prevailed in 2023, we believe, are expected to continue into 2024. Given our view that we are nearing the peak in US interest rates, we believe the opportunity to lock in yields (and hence income) at these levels is rare.

> **"Furthermore, the strong prevailing technical factors we are currently experiencing – issuance remaining low, with supportive cashflows and investor cash balances high – add weight to our conviction."**

14. Source: JPM, Bloomberg Finance L.P. as at 23 August 2023.
15. Source: Bloomberg as at 29 September in total return terms for EM hard currency credit.

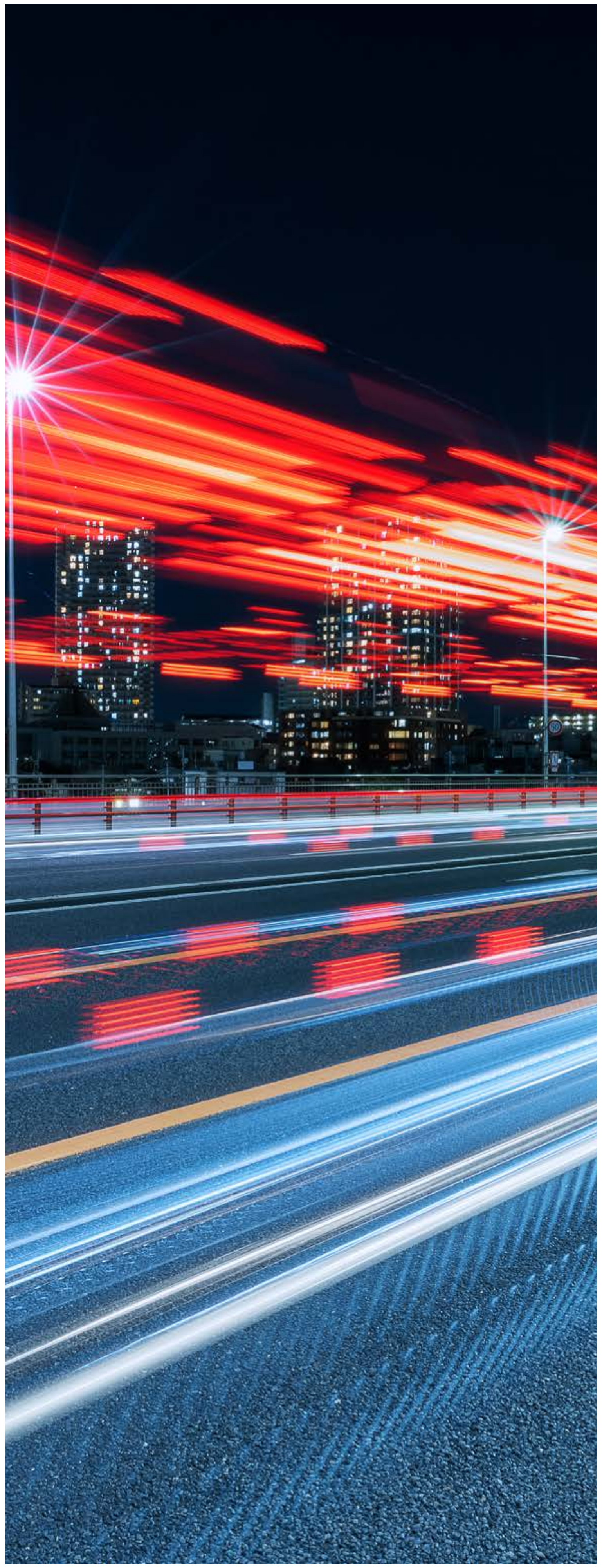
China's electric dreams - a nightmare for European automakers?

James Odemuyiwa
Senior Credit Analyst

How are European car manufacturers combatting the growing competition from Chinese automakers in global markets? And what are the potential implications for holders of automotive credit?

For motorists everywhere, undergoing the annual MOT can be a nerve-racking experience. At issue are the potential costs involved, the time needed to carry out any repairs or, in extreme cases, the risk that the vehicle will fail its test completely.

In their own way, European car manufacturers, particularly in Germany, are facing an altogether different type of MOT in China, the world's largest automotive market.



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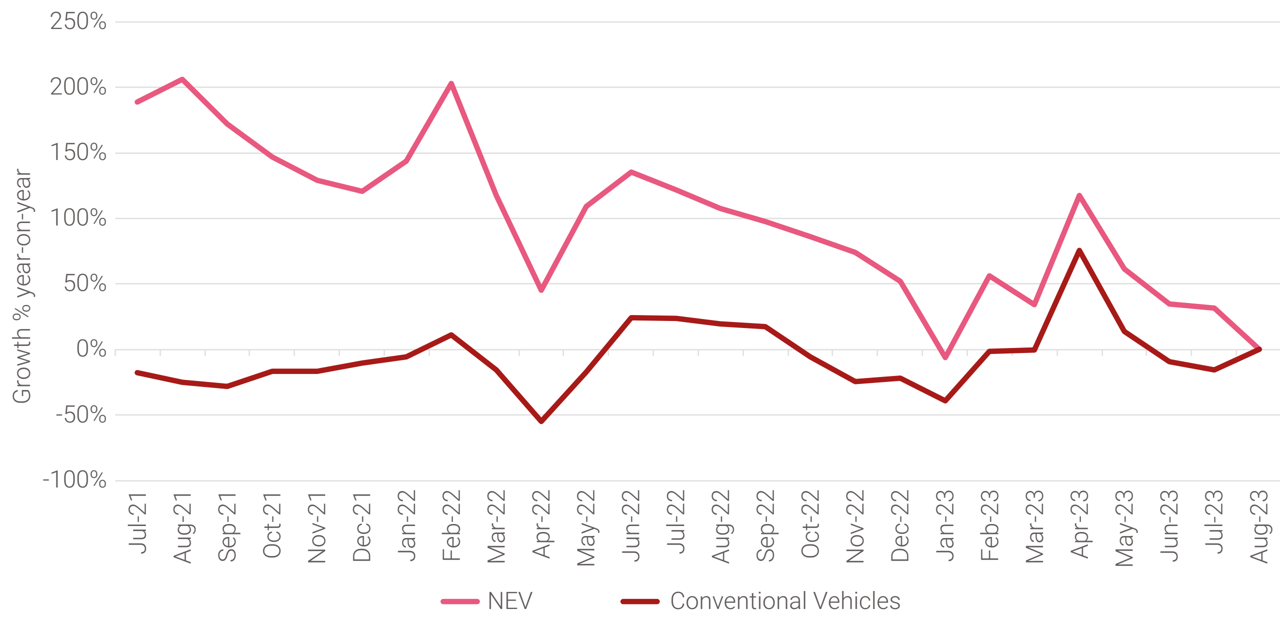
This 'test' is characterised by three key elements:

- **M** A 'melting' ICE (internal combustion engine) segment
- **O** Overcapacity in the industry
- **T** Fierce technological change

Melting ICE: China leads the world in the transition to EVs. August sales of new electric vehicles (NEVs*) accounted for 37%[16] of the country's new passenger vehicle sales, the highest share among any major vehicle market. While year-to-date NEV sales growth stands at 39%[17], this is in stark contrast to conventional vehicles, which are down by around 4% over the same period[18]. With the Chinese government determined to channel future growth into the NEV segment, we believe this dynamic is unlikely to change anytime soon, posing a potential challenge to Western automakers, which have typically enjoyed a healthy market share within this segment.

China auto wholesale growth year-on-year



Source: Bloomberg data as at 31 Aug 23.
*References to NEVs include Battery Electric Vehicles, Plug-in Hybrid Electric Vehicles and Fuel Cell Electric Vehicles.

16. Source: Bloomberg NEF as at September 2023.
17. Source: Bloomberg NEF as at September 2023.
18. Source: Bloomberg NEF as at September 2023.

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Overcapacity: China's strategic focus on growing the home EV market has encouraged a plethora of new entrants, all attempting to gain market share, with sales struggling to keep pace with capacity expansion. As Mary Barra, CEO of General Motors*, recently stated: "China has 100 vehicle brands vying for sales and a 50% capacity utilisation rate."

This overcapacity has inevitably led to discounting and a full-blown price war, despite efforts from the Chinese industry body, CAAM[19]. Western automakers, which for so long have enjoyed above-average margins in China, are now having to decide whether to cut prices to preserve competitiveness or hold firm to maintain their profitability.

Technology: European car manufacturers also face the challenge of pivoting to more 'software defined' vehicles. Volkswagen*, the biggest Western OEM in China by market share, has had to recalibrate its platform strategy due to software-related platform delays. This has led to VW striking deals this summer with Chinese companies, SAIC* and Xpeng Motors*, to utilise their platforms and co-develop vehicles. Time will tell whether these moves are sufficient to arrest a slide in market share.

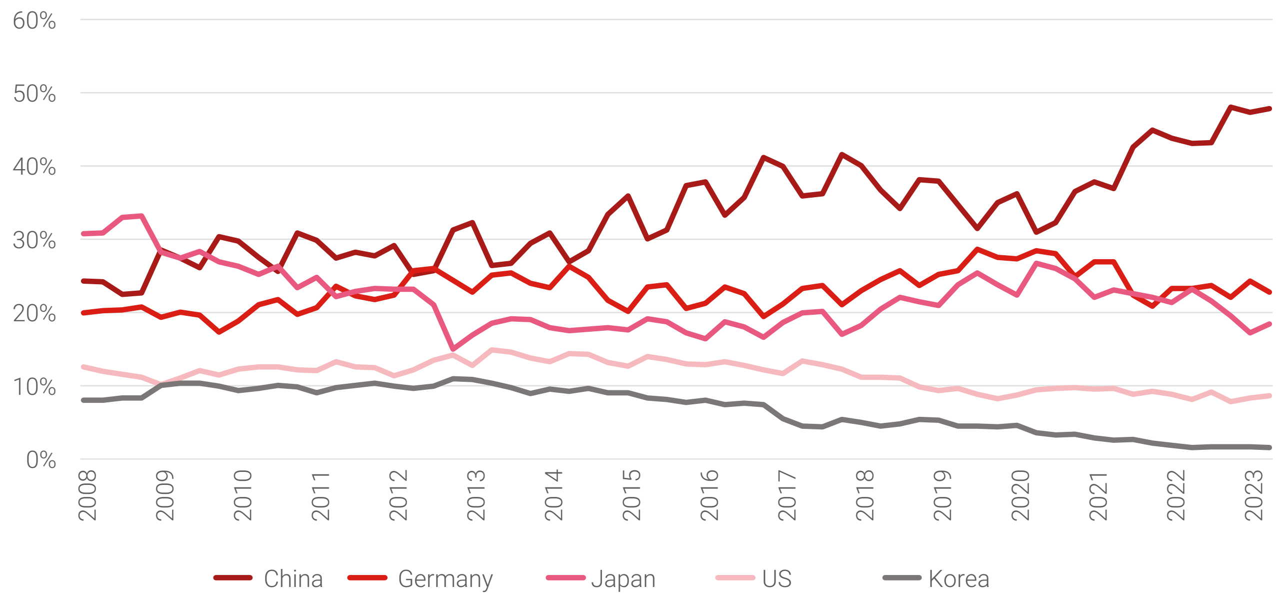
Western carmakers: Failing their MOTs?

Our view is that some European players may be at risk of failing their respective MOTs in China, with the market share of Chinese brands in the country up from around 30% in recent years to over 50% as of July 2023[20].

With capacity utilisation still below ideal levels, China's attention is also increasingly turning overseas, as Chinese brands look to export more to alleviate overcapacity concerns. The European Commission (EC) estimates that 8%[21] of European EV sales now originate from China, with this share expected to increase to 15% by 2025[22]. As a result, the EC has recently launched an investigation into Chinese subsidies for electric vehicles, with the potential for higher tariffs on imports. Such a move could allow vehicles produced in Europe to become more competitive in the face of Chinese imports, but it risks retaliatory action against European automakers in what, for now, remains a lucrative Chinese market.

19. Source: https://www.reuters.com/business/autos-transportation/chinas-auto-group-retracts-pledge-avoid-abnormal-pricing-2023-07-08/
20. Source: Bloomberg as at August 2023.
21. Source: https://www.euractiv.com/section/economy-jobs/news/how-will-the-eus-investigation-into-chinese-electric-vehicle-subsidies-work/
22. Source: Ibid.

China - market share of passenger vehicle slaes by brand origin



Source: Bloomberg, China Automotive Technology and Research Centre as at June 2023.

Investor implications: Rapid developments in the EV segment are changing the dynamics of automotive production in China. At the same time, Western automakers are facing an increasingly challenging environment here, in what has traditionally been their most profitable region. In the short term, these automakers continue to reap the benefits of pent-up demand in the aftermath of the pandemic and related supply chain issues.

However, in the long run, we believe action is needed today to ensure that both product offerings and cost bases remain competitive. In our view, a failure to successfully address these issues poses downside risk to profit and, over time, potentially to credit ratings.

***For illustrative purposes only. Reference to this and any other security is on a historical basis and does not mean that the security is currently held or will be held within an LGIM portfolio. Such references do not constitute a recommendation to buy or sell any security.**

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Key risks

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