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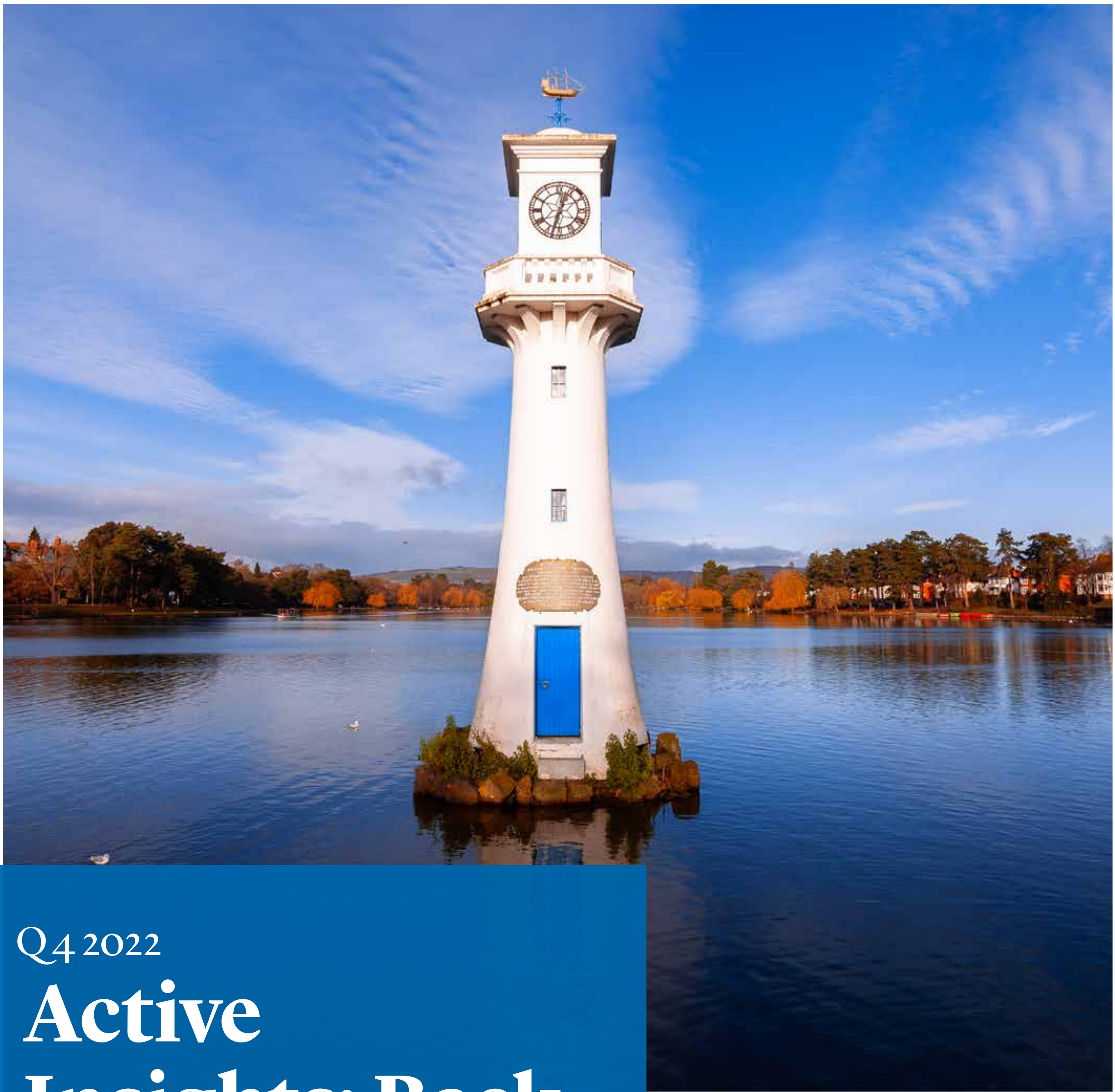


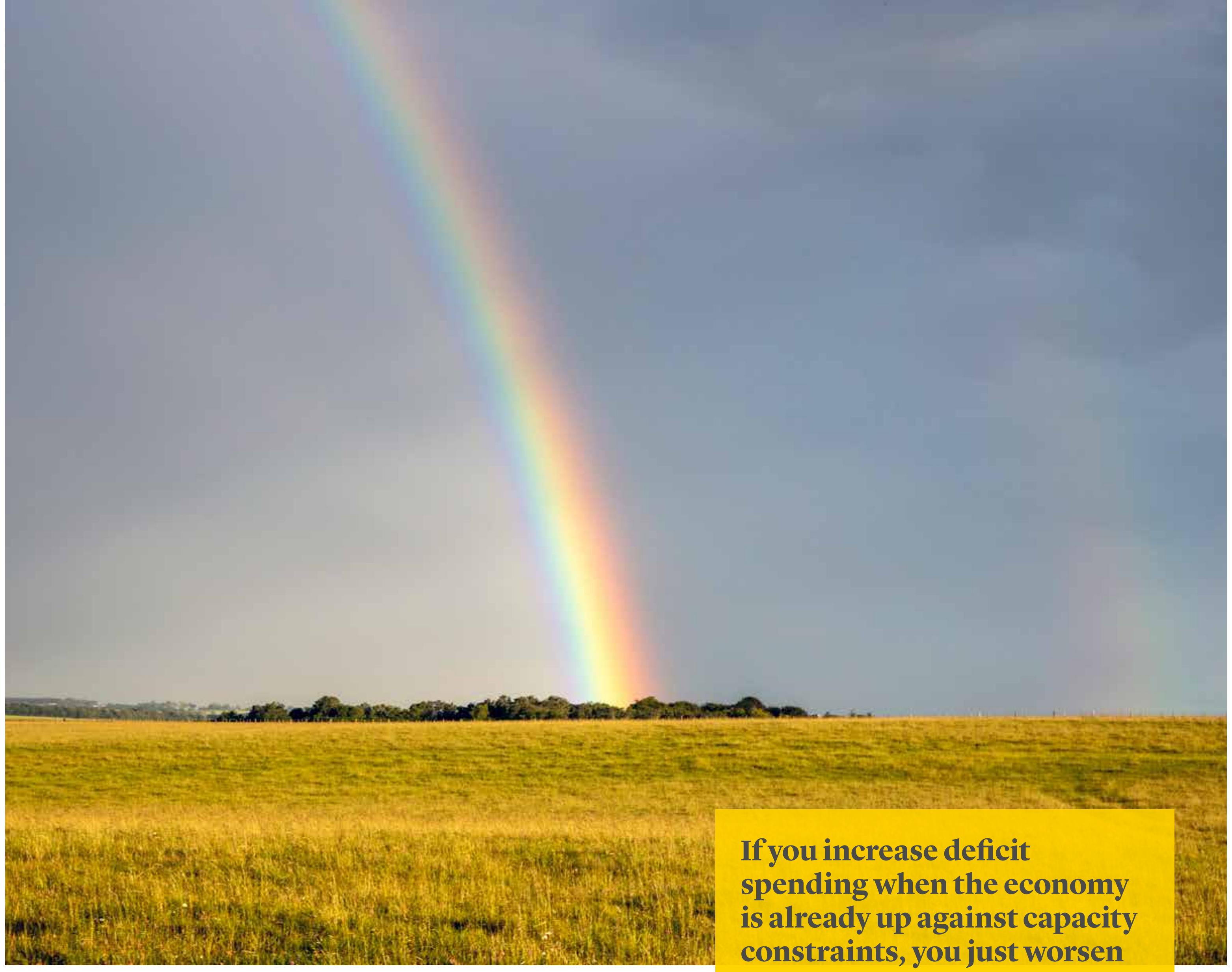
Q4 2022

Active Insights: Back to the Future?

LGIM

After a challenging year, is it all doom and gloom?

Colin Reedie
Head of Active Strategies



The end of 2022 presents a forbidding picture to investors and policymakers alike. How much of what we are seeing is new, and what continuities are there that could create opportunities?

Over the last couple of years, we have highlighted a range of dynamics within fixed income markets that could prove challenging for investors. There is little doubt a change in the political and intellectual backdrop occurred during the COVID-19 pandemic – one where fiscal policy took over from monetary policy as the principal tool for stimulating economic growth.

The UK government has learned the painful lesson that ill-advised and badly timed fiscal expansion will not be tolerated by financial markets. If you increase deficit spending when the economy is already up against capacity constraints, you just worsen the inflation problem. We still think fiscal policy will remain the dominant tool for growth, but we expect markets will only accept it if used in response to weak demand – as it should be – and not as an open-ended tool for every policy fantasy.

The blow-up in the UK bond market also highlights an important point. Following years of very low interest rates and low market volatility, the use of leverage to enhance financial returns has become much more widespread. If central banks are forced to continue to raise interest rates, we have little doubt that the huge amounts of leverage deployed in the financial system will create further blow-ups.

Looking longer term, if you deconstruct the forces that sat behind a near 40-year bull market for fixed income assets, you could be forgiven for expecting a return to the old world.

If you increase deficit spending when the economy is already up against capacity constraints, you just worsen the inflation problem.

We don't think it will be as straightforward as simply returning to where we were. The next cycle can still take us to a place where unhelpful correlations remain prevalent, but these should stop the moment recession risk becomes greater than the risk of inflation.

Aside from the early 1950s – when the US Federal Reserve ended its yield curve control policy – there is significant evidence to suggest bonds routinely rally in a recession, as we can see in the table opposite.

Overall, we believe that yields have risen to levels where the total return from duration looks attractive.

The impact of interest rate easing (%) in post-war recessions*

Federal Reserve

Recession start date	Recession end date	Change in 1y yields (%)	Change in 10y yields (%)
Aug-57	Apr-58	-2.50%	-1.00%
Apr-60	Feb-61	-2.50%	-1.00%
Dec-69	Nov-70	-4.50%	-1.75%
Nov-73	Mar-75	-3.25%	-0.75%
Jan-80	Jul-80	-5.00%	-1.25%
Jul-81	Nov-82	-7.25%	-3.75
Jul-90	Mar-91	-4.50%	-1.75%
Mar-01	Nov-01	-5.50%	-2.50%
Dec-07	Jun-09	-4.75%	-2.50%
Average		-4.50%	-1.75%

Bank of England

Recession start date	Recession end date	Change in 1y yields (%)	Change in 10y yields (%)
Feb-79	Apr-82	-2.50%	-1.00%
Jan-84	Mar-84	-2.50%	-1.00%
Apr-88	Feb-92	-4.50%	-1.75%
Apr-08	Jun-09	-3.25%	-0.75%
Average		-4.50%	-1.75%

European Central Bank/Bundesbank

Recession start date	Recession end date	Change in 1y yields (%)	Change in 10y yields (%)
Jul-74	Mar-75	-5.50%	-3.00%
Jan-80	Sep-82	-3.00%	-0.25%
Jan-92	Sep-92	-3.25%	-2.25%
Jan-08	Jun-09	-4.25%	-1.75%
Jul-11	Mar-13	-1.50%	-2.25%
Average		-3.50%	-2.00%

* Difference between the maximum yield in the 12 months leading up to the business cycle peak and the minimum yield during the downturn and subsequent 12 months. Cycle dates are taken from NBER (USA), CEPR (EMU) and NIESR (UK)

Source: Bank of England, Bundesbank, Federal Reserve, Shiller & McCulloch (1987), LGIM as at 15 November 2022

Elsewhere in this quarter's Active Insights, you'll find analysis of some of the other key dynamics that will shape the new investment environment.

China has been the 21st century's undoubted economic success story, but challenges to its meteoric growth are increasing at precisely the time that political risks are mounting. Our Global Emerging Market Economist Erik Lueth looks at Xi Jinping's in-tray as he begins an unprecedented third term as the 'great helmsman' of the Chinese Communist Party.

Another of the main investment narratives of the years since 2008 has been the explosive growth in illiquid securities. With one eye on recent events, our Global Head of High Yield Martin Reeves makes the case for liquid credit in today's environment.

Finally, without progress on sustainability and net-zero any discussion of the future becomes academic. Investment specialists Amelie Chowna and Karlson Lau close out this outlook by breaking down LGIM's approach to integrating net-zero into our portfolios.

China has been the 21st century's undoubted economic success story, but challenges to its meteoric growth are increasing at precisely the time that political risks are mounting.

The six factors behind secular stagnation

Six forces shaped the context for the 40-year bull market for fixed income assets.

Four have only intensified as long-term deflationary forces, as you can see below

Where do we see their trajectories?

01 Debt ↑

02 Demographics ↑

03 Inequality ↑

04 Digitalisation ↑↑

05 Globalisation ↓

06 Oligopolisation ↔

China: hitting the wall?

Erik Lueth
Global Emerging Market Economist

This year Xi Jinping ends the modern convention of Chinese presidents serving two terms. He does this at an inflection point, with a range of challenges from a tottering property sector to zero-COVID threatening China's breakneck growth. Where could the world's second-biggest economy be headed?

October saw China's 20th Communist Party Congress. Even-numbered congresses usually mark a power transition, except that this time President Xi secured an unprecedented third term and prepared the ground for – in theory – his life-long leadership of the most populous country in the world.

Many observers have expressed reservations about the declining number of checks and balances on Xi's power. As well the amendments to the constitution mentioned above, Xi also secured the removal of all members of the Politburo Standing Committee not affiliated with his faction of the Party, including current Prime Minister Li Qiang and the key pro-market reformer Wang Yang.

We expect China to abandon its zero-COVID strategy and commit the government's balance sheet to ensure the completion of pre-sold homes.

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It's too early to know for sure what future course this new leadership team has in store for the People's Republic. We'll know more after next March's meeting of China's legislature, when we'll find out who is replacing economic tsar Liu He, banking regulator Guo Shuqing and central bank governor Yi Gang.

This churn in personnel is taking place against a challenging economic backdrop.

China's zero-COVID policy is exerting a high economic toll amid the emergence of ever more infectious virus variants. In addition, the property sector remains depressed and could be entering a dangerous new phase. People are balking at buying houses off-plan – the predominant practice in China – as fears grow that cash-strapped developers will never deliver. This leads to a vicious cycle by further depriving developers of badly needed funds.

The government has cut interest rates and boosted infrastructure spending, but unless the crisis of confidence in the property sector is addressed decisively, a recovery remains elusive. We forecast 2.5% growth this year, a far cry from the 5.5% official growth target.

Looking to 2023

Next year promises to be much better, but risks remain.

We expect China to abandon its zero-COVID strategy and commit the government's balance sheet to ensure the completion of pre-sold homes. Our best guess for the lifting of COVID restrictions is Q2 2023.

By that time the power transition will be complete (with the National People's Congress session in March rubberstamping the decisions taken in October), winter will have passed, and the medical preconditions for re-opening should be in place. Specifically, vaccination rates of the elderly should have improved materially from the current 67% and therapeutics should be available in sufficient quantities to contain the number of deaths to the 88,000 associated with a typical flu season.

Under this baseline we expect growth to accelerate markedly in H2 2023 and reach 5.5% for the whole year. Risks to this forecast include zero-COVID remaining in place for longer, re-opening leading to mass panic, or the leadership dragging its feet on the property sector.

Sustaining the growth miracle

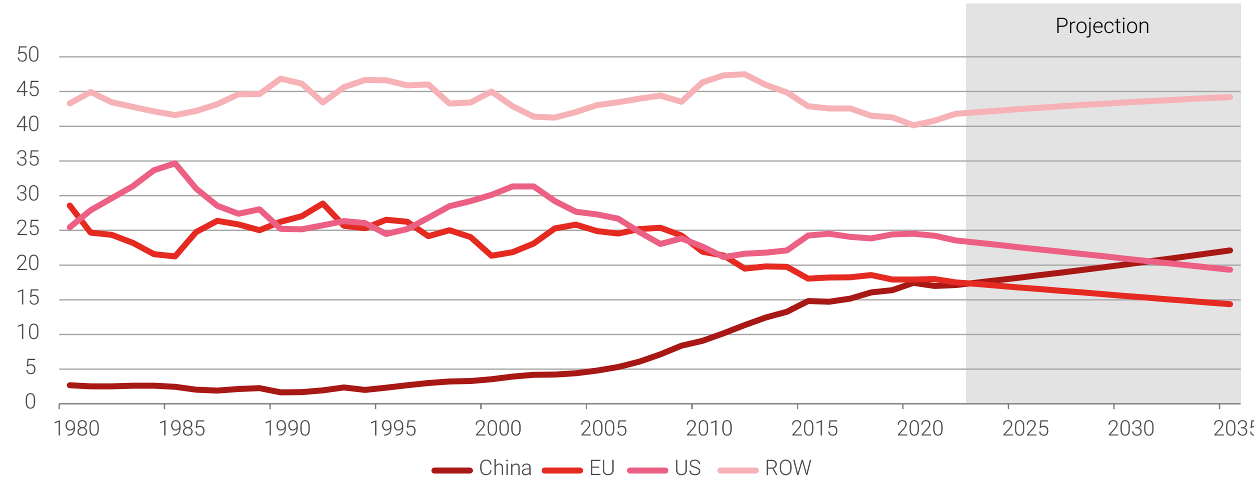
What is the longer-term outlook for China?

The official growth target is to double per capita GDP between 2020 and 2035. This would require 4.5% annual average growth over the next 13 years. China's GDP is already bigger than the European Union's; on this trajectory, China would overtake the US early in the next decade to become the world's largest economy and account for a third of global growth. China's per capita GDP would still trail advanced economies amounting to 30% and 40% of the US and German level, respectively.

How realistic are these growth targets?

Judging from the experience of China's Asian peers, it can be done. In past decades Japan, Taiwan and Korea pursued similar development strategies to China and grew well above 4.5% at similar levels of development and continued to do so for the ensuing 15 years. These countries were strategic allies of the US and their export-driven growth strategies caused less backlash that those of China.

Share in world output



Source: IMF and LGIM calculations as at 15 November 2022. Assumptions, opinions and estimates are provided for illustrative purposes only. There is no guarantee that any forecasts made will come to pass.

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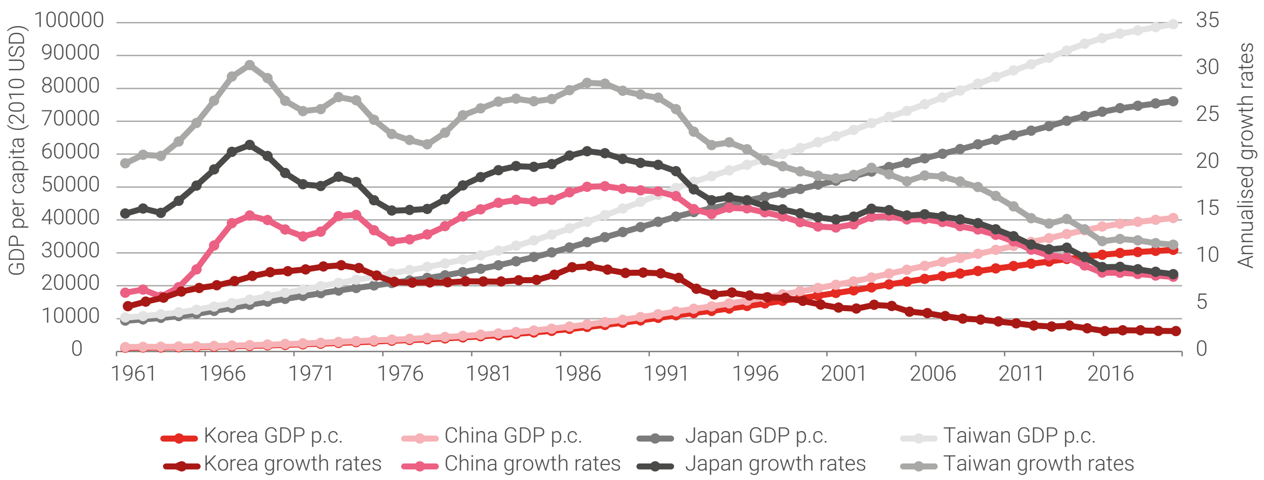
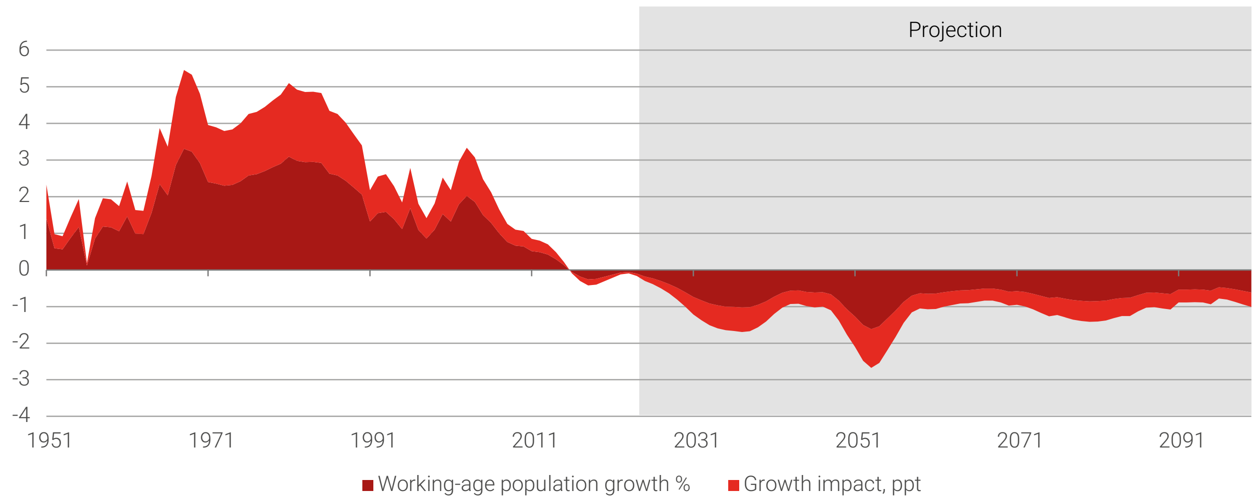
China: Growth prospects



Source: World Bank and LGIM calculations as at 15 November 2022.

China: Working-age population



Source: UN population projections and LGIM calculations as at 15 November 2022. Assumptions, opinions and estimates are provided for illustrative purposes only. There is no guarantee that any forecasts made will come to pass.

The vast scale of China's market means its growth has had and will have a substantially greater impact, but its huge market is also an asset and bargaining chip that continues to give it access to direct investment, know-how and technology.

China gets old

Demographics are often mentioned as a strong headwind to Chinese growth. Indeed, the working age population is shrinking which currently subtracts 0.1 percentage points from annual growth. By 2035, this headwind will have increased to 0.6 percentage points, a rather small difference.

Against this, we can still expect significant, productivity-enhancing migration from agriculture to industry – according to UN projections, some 150 million people. To put this in perspective, 64% of China's population today lives in cities; this is where Japan was in 1960.

However, risks to our broadly favourable long-term outlook are on the rise. An increasing antagonism between China and the West could deprive China of cutting-edge technologies and foreign direct investment. This is unlikely to halt China's advance but could slow it down.

Nowhere is this antagonism more apparent than over Taiwan. As China is moving further away from Western political thought and towards a more muscular foreign policy, the US seems to be slowly moving away from its One China policy – the bedrock of Sino-US relations since 1972. This trajectory is a worrying one, and we believe military conflict between now and 2035 is increasingly harder to rule out.

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The challenges of balancing 'alternative credit' and liquidity

Martin Reeves
Head of Global
High Yield

What are the issues around liquidity when investing for the long term?

Since the global financial crisis, more leveraged credit has been created than ever before. Is this an unintended consequence of the global move to manage, mitigate and reduce risk across capital markets?

For those of us working in 2008, one of the main challenges the market faced was managing illiquid securities. Cut to 2022, and these are exactly the profiles of securities that now dominate the world of leveraged credit.

In a mature financial system, the availability of a wide-ranging set of borrowing solutions is a positive. From a systemic perspective, the disintermediation of banks and the reduction of financing costs are positives if we seek a growing economy.

However, history shows that asset classes that enjoy periods of rapid growth will sooner or later come to be tested. Some of the many problems of 2008 emerged from the rapid rise of an alphabet soup of structured products that were highly rated, but where the underlying fundamental cashflows were opaque. It has proven to be a mistake to assume liquidity is correlated to higher credit quality.

Bonds vs loans

The challenge of loans and direct lending is the ease – or otherwise – of buying and selling those claims.

In UCITs terms, the lack of certain settlement dates and uncertainty of an available market make them hard to include in publicly quoted pooled funds.

Meanwhile, the high yield bond market has been overtaken by leveraged loans, and in the last decade a material amount of direct lending has emerged.

There is limited data on direct lending markets, but some estimates have concluded that in the US it is already approaching the size of the domestic high yield bond market. One of the drivers of growth of the loan market has been the increase in single B rated issuance, previously the purview of high yield bonds. This has led to fewer companies using bonds. At the same time, the credit quality of high yield bonds has risen with more BB issuance, and the quality of loans has deteriorated with more single B issuance.

However, we should bear in mind that direct lending could be to a listed company with a credit rating. The lenders would also carry out credit risk assessments to arrive at an internal rating if an external rating is not available.

Given the lack of liquidity one can argue that private lenders need to do much more due diligence and stress testing given they are generally locked in until redemption or a bitter end.

No doubt loans and direct lending have a place in most diversified portfolios. The challenge is to hold a quantity sufficient to take advantage of low price volatility, while still balancing the lack of readily available liquidity.

What happens when the music stops?

As we have mentioned, history shows that some will be caught out by the missing liquidity. This is not always due to problems with the fundamentals of the credit but might be caused by issues elsewhere in multi-asset portfolios, for example if there is a drawdown or redemption.

Normally, when a strategy suffers a drawdown and the more liquid securities are sold first, this increases the proportion of illiquid securities beyond what was intended. Some illiquid alternatives can withstand quite a lot of strain and credit testing, but this does not mean they can be sold to raise cash.

The question is whether this creates systemic risk. The disintermediation of banks as a result of the growth in alternative credit should be appealing. The challenge that we anticipate is when impairment rises for loans and direct lending when there is a coincidental rise in the demand for liquidity.

High yield bonds have been proven to survive crises and default cycles. CLOs (Collateralised Loan Obligations) and leveraged loans got through 2009 owing to strong fundamentals going in; indeed, this worked well for clients who were not forced sellers. All three parts of the leveraged credit world – i.e rated bonds, loans and private credit – are likely to experience similar default rates, but only one of these will be able to provide daily liquidity.

In illiquid markets, investors must understand that they are locking away their capital for a period so liquidity planning is critical, and that's where liquid credit comes in. Loans and direct lending of this size have also not been tested by a major financial crisis, whereas liquid credit has more of a track record.

The casualties along the way serve as a reminder to investors when they look back that illiquid securities have their place in a portfolio, but during periods of stress they will not provide the same liquidity as high yield bonds.

If recent years have taught us anything, it's that even at times when liquidity may be perceived to be ample and the way ahead smooth, sudden events can have unpredictable consequences. Indeed in a highly leveraged system, possibly built upon steady state rates regimes, events thought 'unlikely' can seem to occur more often and their unforeseen ramifications lead inevitably to demand for liquidity at the worst possible time. Value at risk (VAR) is not much use for 'illiquid' credit, as Lehman Brothers discovered.

These liquidity events can be manageable in a diverse pool of credit strategies, but likely require a prudent risk modelling of exposure to alternative credit within that pool.

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Reaching for net-zero within Active Strategies

Amelie Chowna
Fixed Income Investment Specialist

Karlson Lau
Active Equities Investment Specialist

LGIM is committed to achieving net-zero greenhouse gas emissions by 2050 across all assets under management. Here's how the Active Strategies team is working toward this goal.

This year has been characterised by geopolitical and market upheaval. It has also demonstrated the importance of energy to the global economy. We believe the most effective way to achieve energy security over the long term, and avoid a climate catastrophe, is by achieving net-zero emissions.

In December 2020 LGIM was a founding signatory to the Net Zero Asset Managers Initiative, which is committed to supporting the goal of net-zero greenhouse-gas emissions by 2050 or sooner and to supporting investing aligned with net-zero.

To this end, we have set concrete targets; our ESG strategies are increasingly incorporating net-zero considerations; we continue to engage investee companies – with consequences, should they fail to act; and we are investing in 'green' opportunities.

We also incorporate net-zero considerations into some of our strategies alongside broader ESG components, such as LGIM's Active ESG View, UN SDG assessment, Climate Impact Pledge and more.

We believe the most effective way to achieve energy security over the long term, and avoid a climate catastrophe, is by achieving net-zero emissions.

Climate metrics for credit

Managing a credit portfolio with a dual target of financial performance and net-zero objectives requires a thoughtful optimisation exercise between yield- and climate-related considerations.

Our net-zero portfolios are aimed at achieving relative and measurable decarbonisation, while also investing in issuers on the pathway to net-zero by 2050. LGIM's net-zero framework is applied to these portfolios, with an emphasis on the reduction of emissions versus the reference benchmark and an improvement in temperature alignment over time.

Our targets capture past and future improvements in climate-related metrics. This means active managers can look for alpha opportunities in sectors with high carbon-emission intensity, rather than excluding them entirely. As these sectors will continue to require capital to transition towards net zero, we believe issuers transitioning adequately should eventually benefit from a lower risk premium. This is because market participants are likely to start repricing climate-related risks and model their impact on credit ratings.

We also establish targets for our net-zero portfolios at the outset – and make them more stringent over time – as well as engaging with laggards and closely monitoring progress by issuers.

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Integrating net-zero in our active equity portfolios

A broad sweep of companies is critical to the energy transition – not just those with solid climate credentials.

We recognise that climate laggards will also need to achieve net-zero emissions or risk becoming stranded assets. Within our active equity climate transition strategy, we utilise our LGIM Destination@Risk framework to identify and invest in those laggards, where we see potential to help them advance the energy transition and reach net-zero goals.

Indeed, we can unlock value to effect real-world outcomes, in our view, by engaging and partnering with such companies, drawing on the combined expertise of LGIM's Investment Stewardship and Investments teams. We believe we can use our size and scale to support the transition to a low-carbon economy, even within sectors like energy and materials that are typically excluded from many active, climate-aligned strategies.

How does LGIM apply exclusions?

In a sentence: we seek to engage, rather than simply exclude.

The net-zero challenge is broader than merely excluding high-emitting sectors, as all companies generate some emissions – either directly through their operations (Scope 1 and 2) or through their value chain (Scope 3). Some high emitters, such as mining companies, will have an important role in developing and investing in solutions. Unilaterally divesting holdings is, therefore, not guaranteed to lead to the decarbonisation of the real economy and indeed could impede necessary investment in climate solutions.

Our exclusions relating to new thermal coal and new oil sands target some of the highest-carbon sectors of the global economy, which are structurally misaligned to the direction of travel, and to which cleaner, cheaper alternatives are increasingly available. These exclusions are also designed pragmatically, so as not immediately and substantially to reduce diversification – and increase turnover and costs – for some of the existing portfolios that are committing to net zero.

Over the next decade, issuers that are not making substantial progress in reducing their own emissions – regardless of their sector – are likely to find themselves at risk of exclusion from the growing share of LGIM assets managed in line with net zero. Where relevant, we may also seek to apply further sanctions – for example, under our Climate Impact Pledge, or more stringent temperature alignment requirements.

Looking forward

The momentum behind the net-zero transition is unmistakeable: the percentage of companies setting ambitious decarbonisation targets has almost doubled in a year. Even where companies do not yet have net-zero aligned transition plans in place, practices are improving. The number of companies sanctioned for not meeting our minimum expectations has decreased by over 35% since 2021: in 2021, we sanctioned 130 companies for failing to meet minimum standards, in 2022 that number has decreased to 80.

We believe the most significant question for most diversified investors is not whether a portfolio is net-zero today, but how to devise strategies that effect long-term change in the market.

We are further evolving our product range aligned with net-zero and will continue to monitor and review our funds in light of the progress made in the real economy. At the same time, we will increase our engagement with companies and governments to help accelerate this progress.

While asset managers have made material progress in setting climate targets and innovating to meet client needs, we recognise that there is much further to go. That's why at LGIM, in addition to the steps outlined above, we continue to collaborate with policymakers and other stakeholders with the aim of making a net-zero future not just possible, but probable.

We believe the most significant question for most diversified investors is not whether a portfolio is net-zero today, but how to devise strategies that effect long-term change in the market.

Contact us

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

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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.

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