It's darkest before dawn

We remain neutral on risk overall as we brace for the months ahead, given that the odds of recession are rising, geopolitical tensions are flaring and market liquidity is ebbing.

Emiel van den Heiligenberg
Head of Asset Allocation

Reflecting on the last quarter, in which risk assets enjoyed a bear-market rally that deflated swiftly, a saying by Warren Buffett springs to mind: "Only when the tide goes out do you discover who has been swimming naked."

Monetary stimulus is being withdrawn, at pace, from the global economy. And as in most rate-hiking cycles, cracks are emerging in financial stability and market functioning – which have the potential to trigger significant volatility. This means the coming months will likely prove perilous for investors, but should also present potential opportunities.

Over the following pages, we look at the near-term market backdrop and also offer answers to important longer-term questions, including:

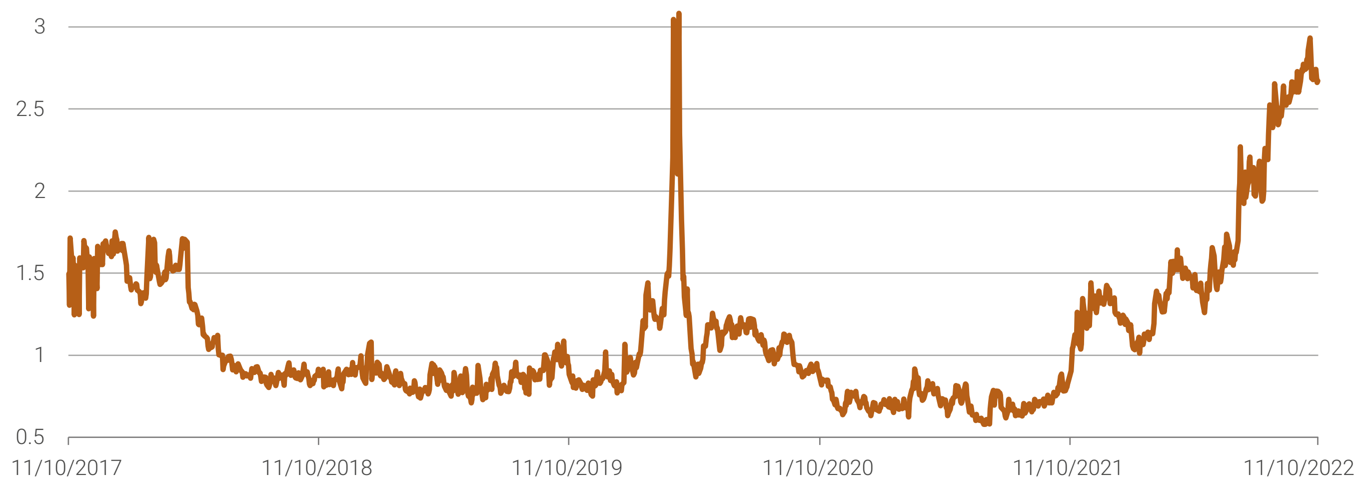
- Which countries are most vulnerable to rising rates?
- Is a torrid 2022 undermining the case for multi-asset investing?
- What could the US midterm elections mean for markets?

Vicious circles

During market crises, volatility rises, Valuation at Risk-based models order traders to reduce risk and investors typically focus on capital preservation rather than expected returns. As a result, liquidity in the overall market tends to dry up. This can create a vicious circle in which illiquidity creates risk aversion, which creates more illiquidity, and so on – as has occurred in the UK government bond market recently.

The chart on the next page suggests that illiquidity is currently approaching levels last seen at the onset of COVID-19. Back then, central banks led by the US Federal Reserve (Fed) were pumping liquidity into markets to support the global economy. This time, they are removing it in a bid to curb rampant inflation.

Illiquidity spikes to COVID-19 levels



US govt securities liquidity index. Source: Bloomberg, as at 7 October, 2022

As a general rule, we believe investors should stop panicking when policymakers intervene to support markets. However, because our monetary guardians are now constrained due to their fight against inflation, they look less likely to pivot on market weakness alone.

But as we have seen in the UK, the Bank of England was willing to step up to prevent further dislocations in gilts. So investors can take comfort that, while the bar to action is high, central bankers still seem ready to act in the event of severe market stress.

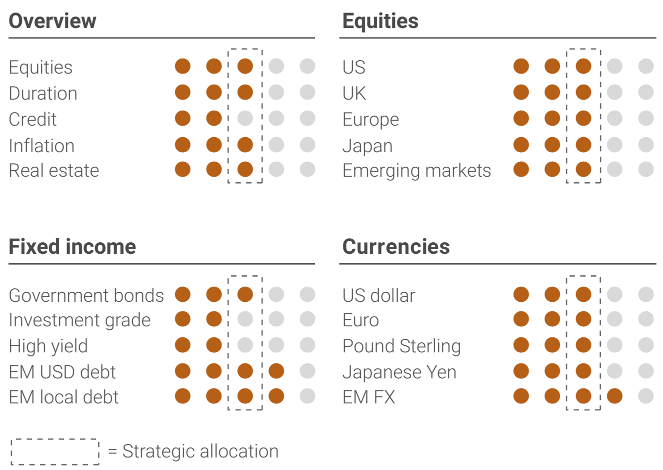
Other worries

More broadly, much pessimism already appears to be priced in to markets, which are anticipating a significant amount of rate hikes. This also offers investors some ground for hope, as 'peak pessimism' often signals a market trough.

But the overall investment environment remains far from favourable: there is much to worry about beyond declining liquidity. De-risking by pension funds is resulting in the selling of growth assets. At the same time, the odds of a global recession are rising. Earnings expectations remain too lofty, in our view. And geopolitical risks, already high, continue to rise.

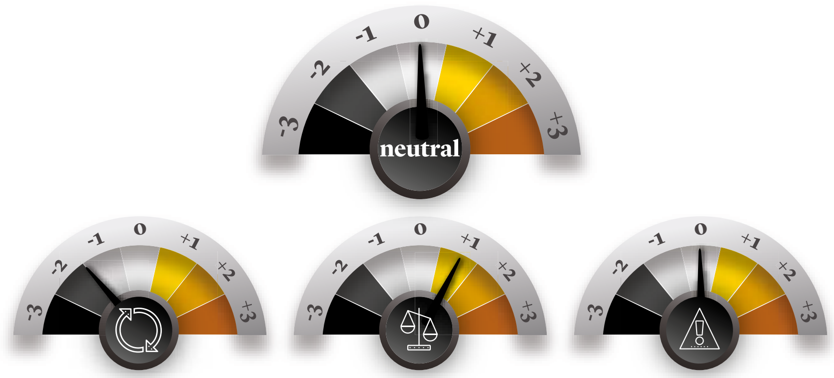
As a result, we remain short credit and commodities, and neutral on equities and risk overall as we brace for the months ahead. Still, the excessive pessimism in markets keeps us from an underweight in risky assets: it may indeed be darkest before dawn.

Our key asset class views



This schematic summarises the combined medium-term and tactical views of LGIM's Asset Allocation team as of 30 September 2022. Asset allocation is subject to change. The midpoint of each row is consistent with a purely strategic allocation to the asset/currency in question. The strength of conviction in our medium-term and tactical views is reflected in the size of the deviation from that mid-point. **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.**

Our core asset allocation view



Economic cycle
Baseline recession view for 2023. Central banks willing to move rates to be restrictive

Valuations & Sentiment
Relative valuations remain attractive and sentiment is still weak

Systemic risk
Unwind in the existential & systemic fears. Credit conditions deteriorating

Source: LGIM, as at 3 October 2022. **Assumptions, opinions and estimates are provided for illustrative purposes only. There is no guarantee that any forecasts made will come to pass.**

Economic cycle

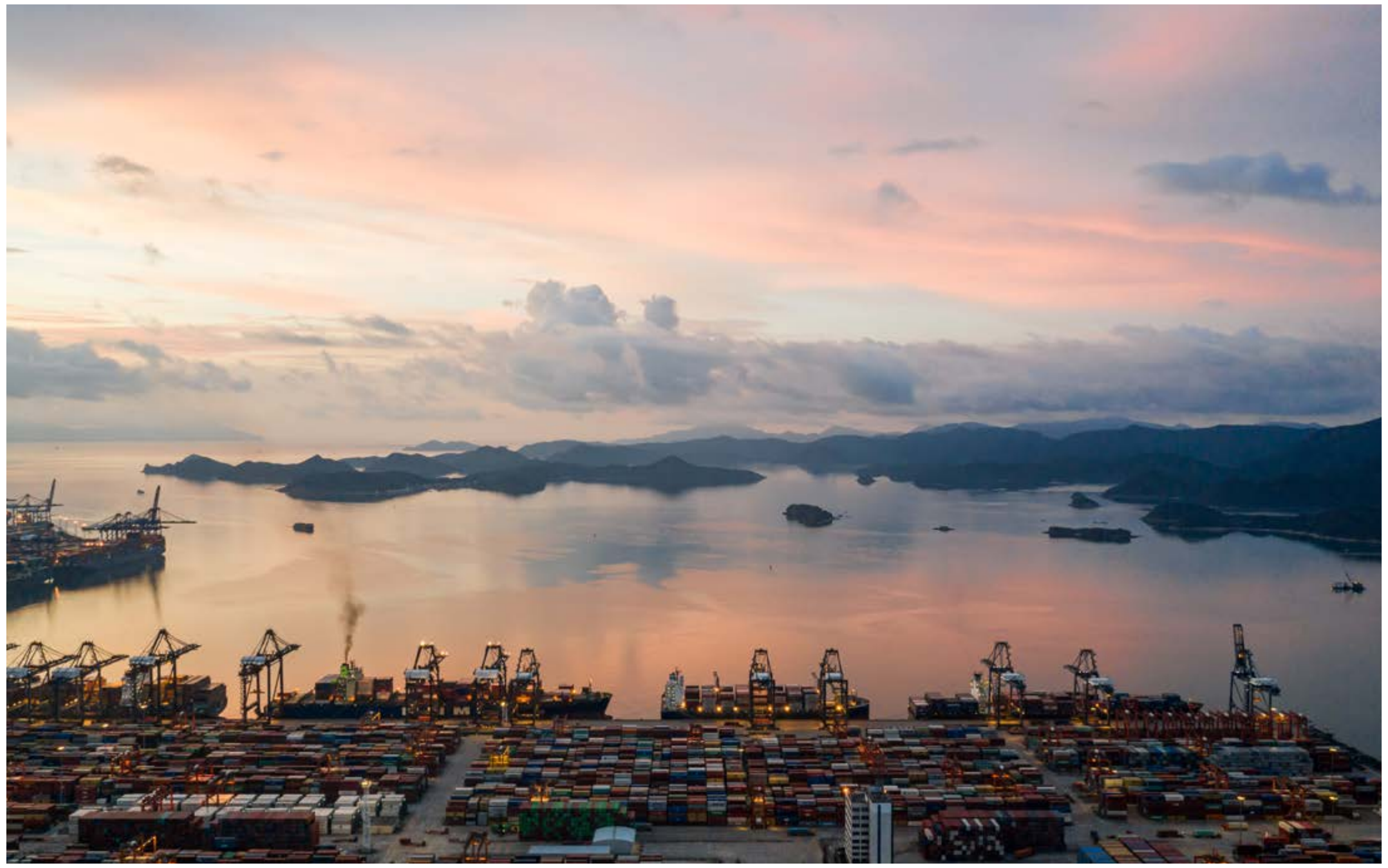
- US is likely to be very late cycle and on the cusp of recession
- Central banks committed to moving rates into restrictive territory
- Fiscal support is coming, but adding to pressure on monetary policy

Valuations & Sentiment

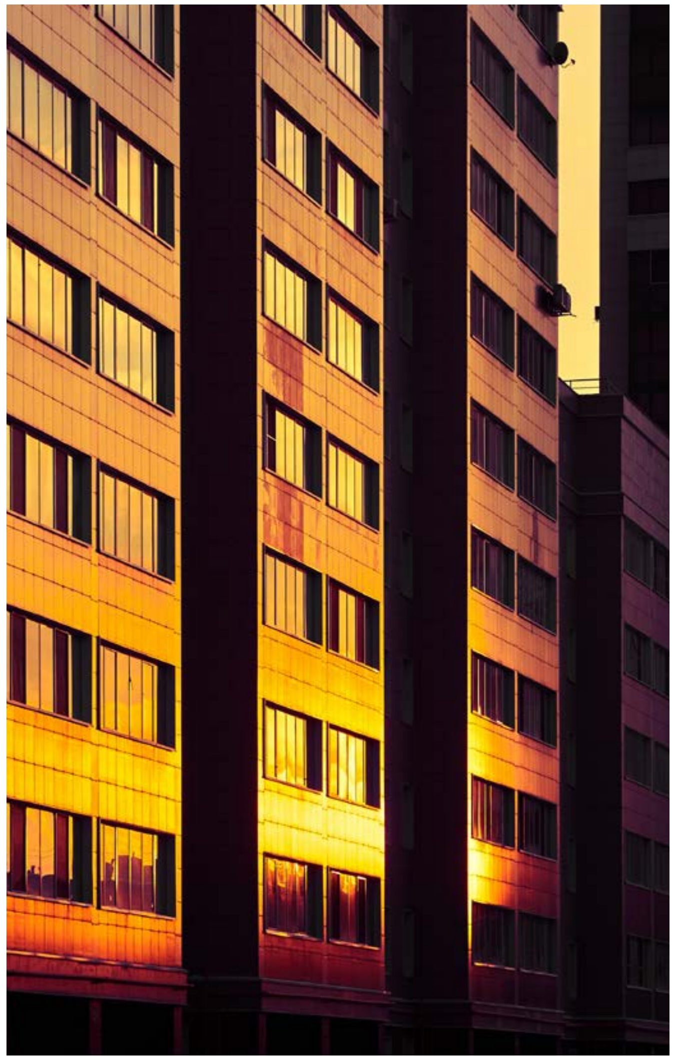
- Sentiment indicators have moved well into bearish territory
- Relative valuations volatile, but attractive compared to longer-term averages
- Absolute valuations have declined again with the recent price correction

Systemic risk

- The Ukraine war grinds on, but the market's focus has moved to inflation
- Unwind in the existential/systemic fears from the start of the conflict
- Credit conditions and housing market more vulnerable with higher rates



Hetal Mehta,
Senior European Economist

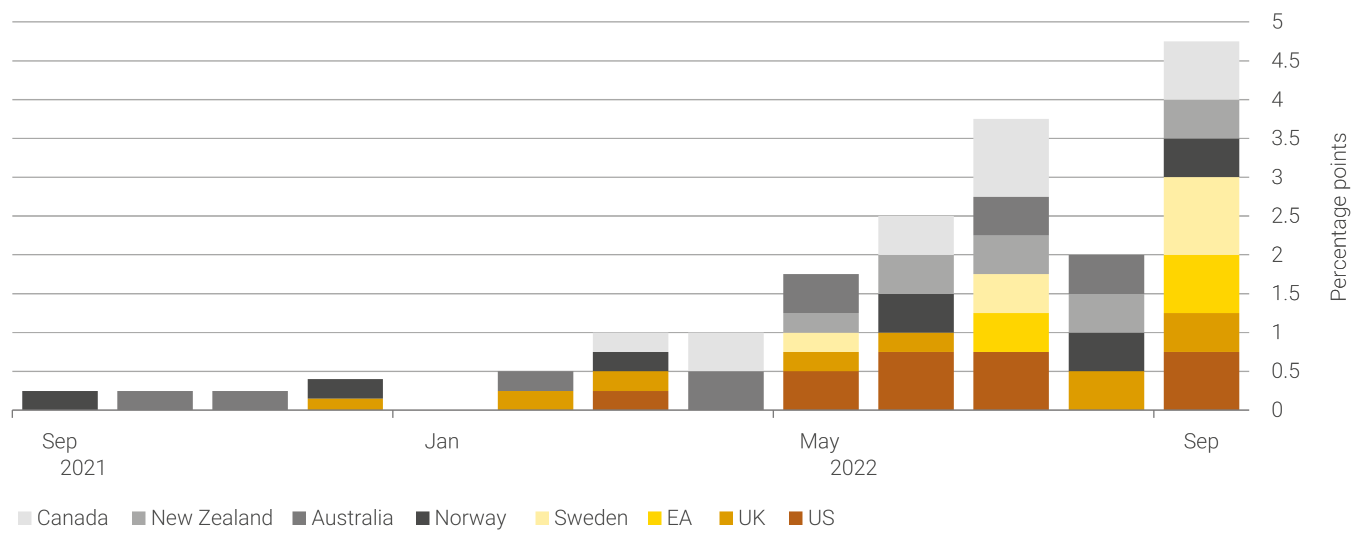


Which housing markets are most vulnerable to rising rates?

Central banks have scrambled to contain the well-documented rise in global inflation, yanking interest rates higher in a short period of time. Across much of the developed world, the pace of hikes has been unprecedented, with some – such as Canada and Sweden – opting for 100bps in one go. Upward moves of this size have not been seen in decades.

But consumer price inflation isn't the only thread that many countries share: a sharp rise in house prices also became very widespread. This was partly driven by policy stimulus unleashed during the pandemic that kept interest rates low, as well as pent-up demand during the lockdown phase and a preference shift towards larger living spaces as more people spent time at home.

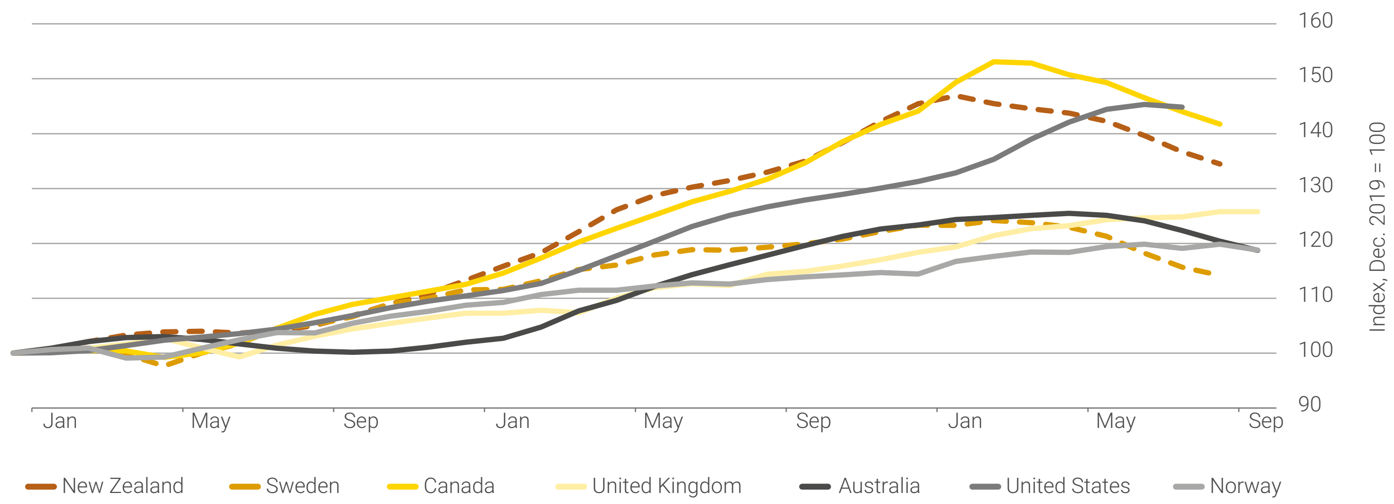
Developed market policy rates surge



Source: Macrobond, as at 1 October, 2022

Q4 2022 | It's darkest before dawn

Nominal house prices turn lower



Source: Macrobond, as at 1 September, 2022

Now interest rates are rising rapidly, we are starting to see a reversal in several housing markets. With plenty of evidence that housing cycles can be a threat to financial and macroeconomic stability, it's worth a closer look.

Some countries are more exposed to changes in interest rates than others. To assess the extent to which they differ in this regard, we have compiled a housing vulnerability index, based on a range of indicators. These include price metrics, relative debt serving burdens, residential investment and mortgage market structure, among others.

As illustrated on the right, for a given interest-rate shock, Canada, Australia, Norway and Sweden appear to be some of the developed markets most exposed to higher rates. The US and UK are in the middle of the pack, while Japan and the major euro-area countries look the least vulnerable.

However, the magnitude of interest rate increases will also vary by country, so this needs to be overlayed, too. Moreover, real incomes also play a significant role. For example, the squeeze on real incomes in the UK is more severe than that in the US; as such, the housing market in the former is likely to experience a larger downturn than that of the latter, in our view.

We do not think the price declines witnessed thus far are enough to prompt an imminent about-turn in rates – indeed, many central banks have clearly signalled their desire for both housing markets and inflation to cool significantly. But we believe the more vulnerable countries are likely to see an earlier end to the rate-hiking cycle, as spillovers from their housing markets exacerbate economic downturns and the accompanying disinflationary forces.

Country rankings

	Housing vulnerability index
Canada	73
Australia	68
Norway	66
Sweden	60
United States	52
New Zealand	49
United Kingdom	44
Japan	39
Germany	36
Spain	33
France	27
Italy	14

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

Patrick Greene,
Strategist

2022 versus multi-asset investing

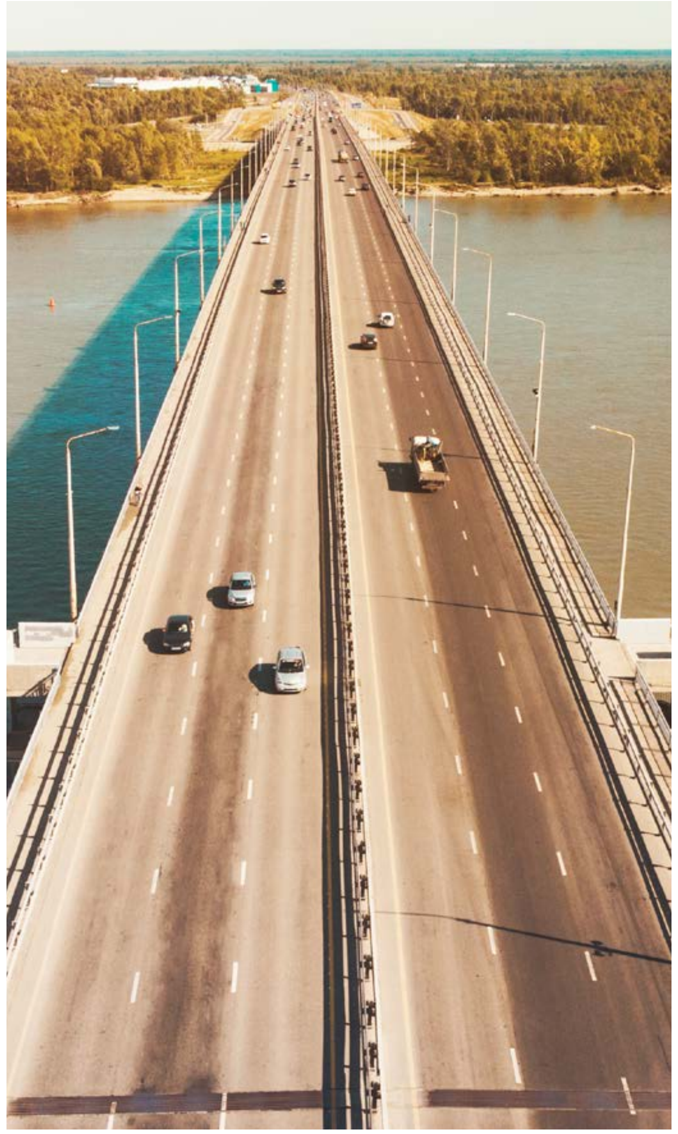
There have been few places for investors to invest profitably in 2022. Global equities have slumped; government bonds have dropped by nearly as much. The joint decline has led to talk of the demise of multi-asset investing. We disagree.

At LGIM, we remain firm believers in the value of diversification. But we don't entrust all our diversification to bonds. Going beyond the simple 60/40 approach, our multi-asset portfolios feature allocations to alternatives – such as real estate, infrastructure and even more niche asset classes, like forestry. We also diversify currency exposure: our portfolios hold a range of developed and emerging market currencies. Even in strategies targeting low risk, awareness that bond-equity correlations can be positive has meant we avoid large exposures to interest rates.

While that approach has not prevented our funds from experiencing losses, it has kept performance in ranges we would expect relative to equity drawdowns – despite the decline in government debt.

Yet diversification, which of course is no guarantee against loss, is not just about drawdown risk. Owning a diverse range of assets can also safeguard investors against losing out on long-term trends. A well-diversified portfolio should not be reliant on any one region or sector; it should also be able to avoid worst-case scenarios spawned by concentrated allocations to regions or sectors.

1. Source: Bloomberg



The case for keeping bonds

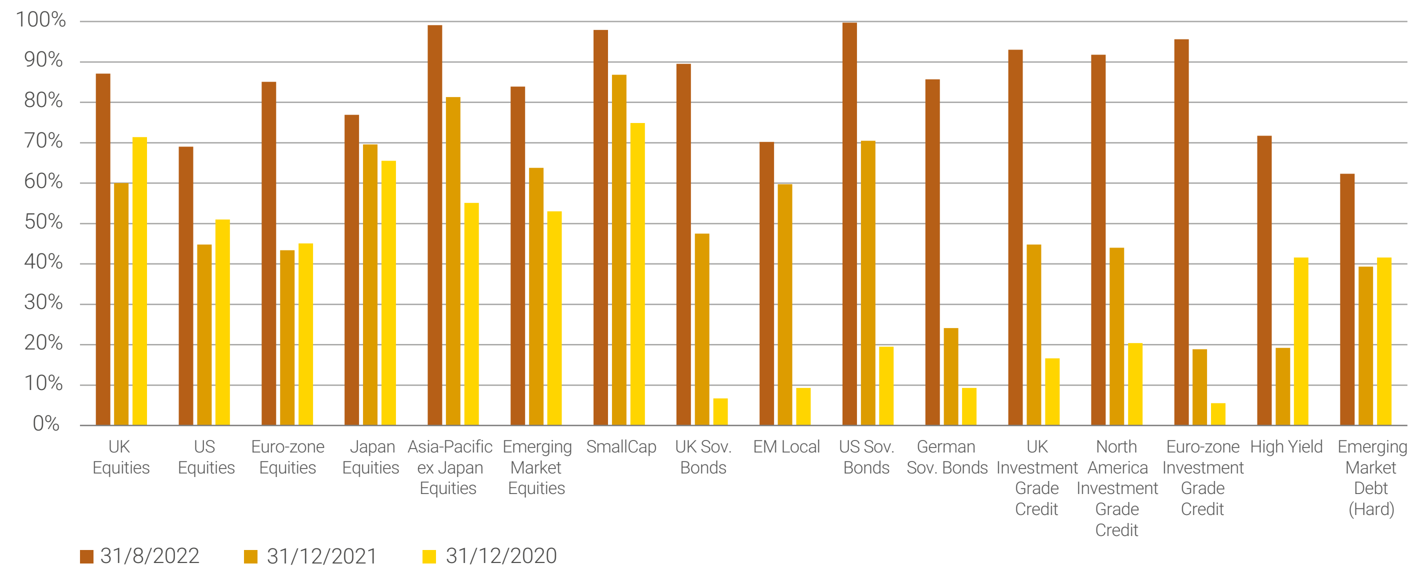
Just as using only bonds to diversify is not the answer, shunning them altogether is a mistake, in our view. Even with higher inflation, the role of fixed income in a recession has not changed.

"We don't believe in throwing out the bond baby with the inflation bathwater," as Chris Jeffrey, our Head of Rates & Inflation Strategy, says. Indeed, US Treasury yields have fallen during 17 out of the past 18 US recessions.[1]

What's more – the recent lurch upwards in yields means the longer-term outlook for bonds is improving.

We have always known (and modelled) that equities and bonds could both fall together, as they have done this year, even if they usually don't. This does not mean that they will always repeat this behaviour from now on.

Risk premia spike vs history



The percentile rank of risk premia relative to expected, long-term levels. Source: LGIM calculations, as at 31 August, 2022. **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**

Expected returns

Challenging years for portfolios can often improve longer-term prospects. One of several ways we think about expected returns is through the prism of risk premia, or the reward investors receive for investing in a risky asset, rather than cash.

Risk premia can be earned over medium or long-term horizons. Unfortunately, while we cannot know them in advance, we can make estimates. These are imperfect – but on average, when we see higher estimated risk premia, we would expect to see higher returns in the future. To understand the investment outlook, we compare current estimates of risk premia against our long-term expectations, as detailed in the chart above.

Looking at this year, rising bond yields and lower equity prices have increased risk premia across a range of assets. While this certainly does not promise higher returns, it does point towards a potentially good starting point for multi-asset portfolios.

So what?

"One swallow does not a summer make," goes the old adage. We believe the inverse is true for multi-asset investing: One tough year does not a tested strategy break.

Indeed, despite a challenging time for both bonds and equities, we believe the multi-asset approach is as valuable as ever – especially when there's a broader focus on diversification, for the reasons detailed above, and given the likelihood of stronger future returns, as indicated by risk premia.

Aristide Goualin,
Investment Specialist

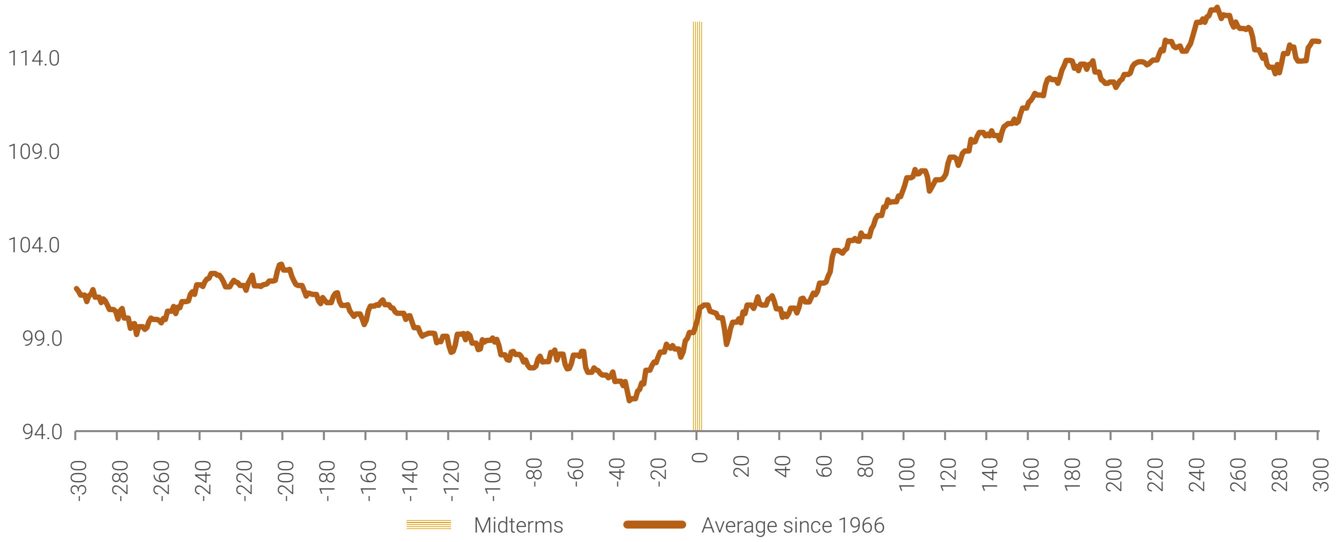
US midterms, markets and risk management

With geopolitical developments having dominated investor attention for much of 2022, focus will shift next month to midterm elections in the US.

The vote on 8 November will decide which party controls the Senate and the House of Representatives, which the Democratic Party currently holds by a narrow margin.

Since taking over Congress in 2020, the Biden administration has experienced some difficulty getting legislation passed. History suggests that when a sitting president loses control of both chambers, they are usually hamstrung in implementing their agenda.

Average S&P 500 Index returns around US midterms



Source: LGIM, Bloomberg as at 28 September 2022. **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.**

2. Source: Bloomberg

Q4 2022 | It's darkest before dawn

What are the bookies saying?

Betting odds as at the time of writing suggest the Democrats are likely to retain control of the Senate, with the Republican party taking the House.

But in the last three midterm elections, Republicans have tended to improve their position by around three to four points between Labour Day (the first Monday in September) and the election. Additionally, since 1954, the party in control of the White House has managed to gain seats in the house in a midterm election on only one occasion, 2002.

What does this mean for equities?

Historically, stock markets have welcomed midterms: the S&P 500 Index has, on average, surged into the vote and in the months following.

However, stubborn inflation and a looming recession are key factors this year. And the two post-war elections during which inflation was accelerating – 1974 and 1978 – were the two where the S&P 500 failed to rally.[2]

The only outcome that we believe could see any meaningful legislation passed would be a 'clean sweep' by the Democrats. Under this scenario, we would expect the party to expand its social spending, such as the Child Tax Credit, which is set to expire in December 2025. We could also see the Biden administration raise taxes on the wealthy and large corporations, to which equities would likely react unfavourably.

Markets have typically tended to favour gridlock in Congress, as this limits the chance of dramatic policy shifts. Still, with the US heading for recession, a Democratic party majority in Congress could actually be seen as a positive, given the potential need for fiscal action to buttress the economy.

Volatile markets

What is certain is that the midterms are likely to add volatility to an already-fragile market environment. Against this backdrop, we remain focused on managing risk to achieve our clients' long-term objectives.

Indeed, our approach to all such risk events is summarised by the motto: "Prepare, don't predict." This means we undertake rigorous scenario planning, rather than seek to forecast imponderable outcomes.

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. Past performance is not a guide to the future. Assumptions, opinions and estimates are provided for illustrative purposes only. There is no guarantee that any forecasts made will come to pass.