The end (of the cycle) is nigh

One way or another this economic cycle will end, and the arguments for a hard landing just keep stacking up.

Emiel van den Heiligenberg
Head of Asset Allocation

Our first-quarter outlook was bearish. A lot has happened since then, but our underlying cautiousness has not changed.

Central bank hiking cycles often collide with a moment of financial crisis as unexpected leverage gets exposed. Policymakers showed their hand and underwrote some of the systemic risk from the banking sector. Though this has been quite painful for specific stocks and credits, it has for now prevented a breakdown of trust in the financial system. We think policymakers have the willingness and ability to act in a major market crisis.

Our take on the banking crisis in both the US and Europe is that the longer-term damage is done. Bank risk managers will be more cautious because deposits have become flightier, their cost of capital will rise and they just had a VAR shock.

This makes a US soft landing less likely and our base case of a US recession in the second half of the year quite a bit more likely. And even if a crisis is avoided, the already-difficult goal of achieving an inflation-busting soft landing has become more difficult.

First banks, then commercial real estate?

Attention is now turning to stress in commercial real estate lending, with concerns it could be the next domino to fall.

The factors at play are well known: tighter financial conditions and reduced lending from banks, combined with structural headwinds such as a low occupancy rate for offices after COVID (central London occupancy rates are around 50%[1]) or more online shopping damaging the prospects for high street real estate.

This is a gigantic market with plenty of connectivity with the financial system and significant leverage, so it's something to watch carefully.

1. Source: https://www.globalcapital.com/article/2bdpsx1d13w5b27xz435s/people-and-markets/leader/brace-brace-for-the-great-office-crash and https://return.remitconsulting.com/resource-centre/34-news-release-latest-data-shows-uk-office-occupancy-reaching-new-pandemic-highs

Debt deadlock raises the pressure

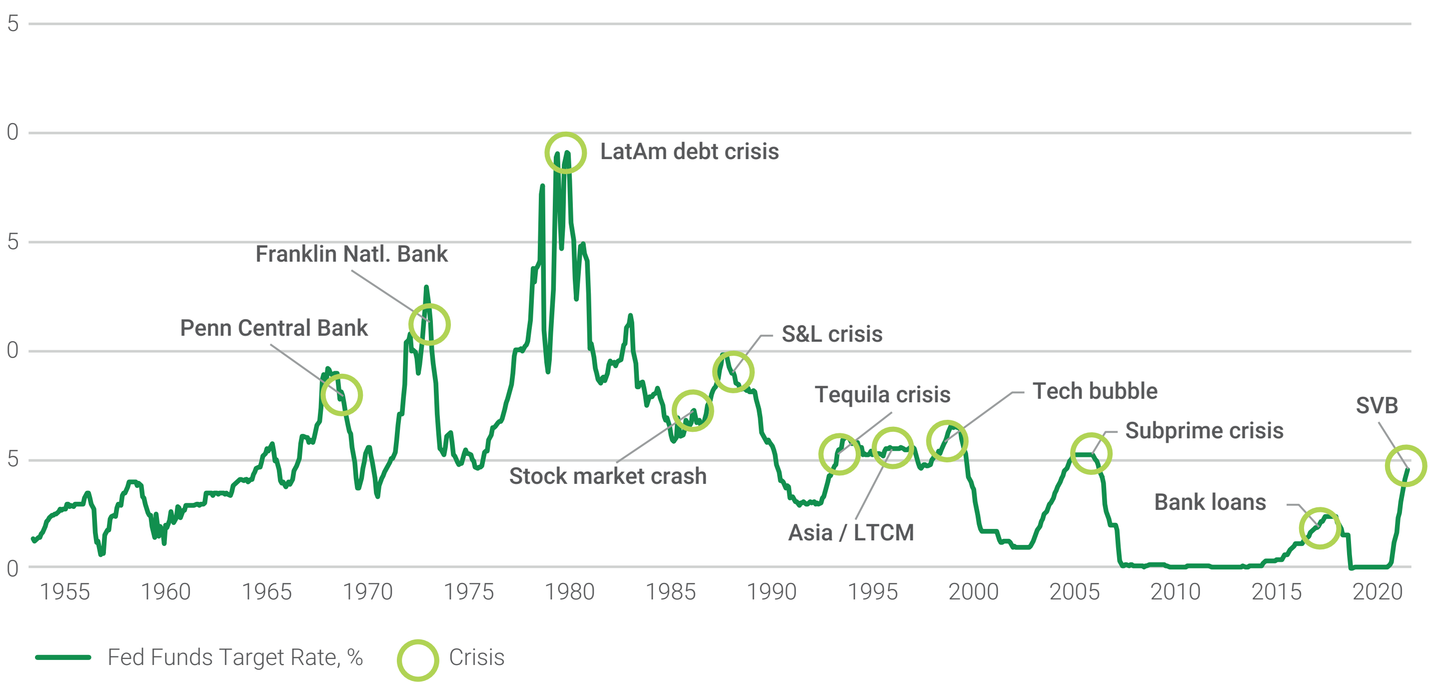
On top of this is the US debt ceiling risk, which is likely to go right to the brink as politicians often need a market scare before they are willing to compromise.

The base case is that the standoff will be resolved at the last minute, but the real-world impact could still be meaningful: more uncertainty, erosion of trust in government and less investment. Tim Drayson, our head of economics, explores this subject in detail later in this outlook.

When there's a hard landing, equities fall as earnings correct significantly. It may take longer than usual to discern how the cycle will end, but the cycle will end with either a hard or soft landing. We think the probability of the latter is getting lower and lower.

The rate cuts priced for later this year seem too aggressive, in our view. A rate cut is possible, but only because the economy slumps into recession. Equities are complacent to believe the US Federal Reserve (Fed) will come to the rescue without the pain of an economic recession and a huge hit (more than 20%) to profits.

US rates and crises



LGIM analysis, US Federal Reserve. As at 27 March 2023.

A question of timing

We must acknowledge that timing the recession precisely was always going to be difficult. Recessions are often marked by discontinuity in the data, meaning events happen suddenly (like a sudden banking crisis). Given the negative carry of being short risk our strategy aims to be patient, measured and price sensitive in terms of risk taking from the short side, so we can stretch out the sell-by-date of this strategy.

Should the current crisis drift over, we expect that as an immediate effect the market would take out some of the risk aversion. However, as noted the longer-term effect of the crisis would be a tightening of the willingness of banks to lend. If the crisis itself lasts longer, and bank stocks remain quite weak even after central bank support, one should also expect more negative confidence effects to filter through to the economic fundamentals.

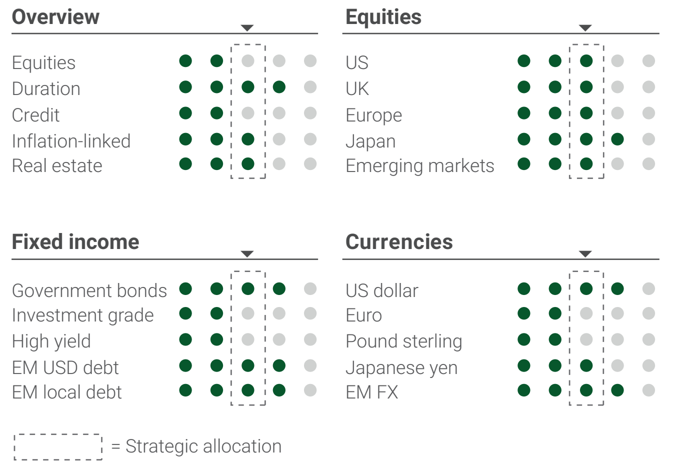
The negative feedback loop

At this stage we believe a systemic risk event can be avoided (famous last words) as central banks have the ability and willingness to act. However, we can't deny that credit concerns have spiralled, opening a left-tail risk that we struggle to calibrate. For now, this had not yet really had much equity market impact. We believe there is a tipping point where the systemic risk can become the all-dominating driver, the current narrative breaks, equities broadly fall, potentially a lot. We must be closer to that tipping point even if we don't know where exactly it is as the feedback loop between weakness in the banking sector and weakness in the broader economy is in motion.

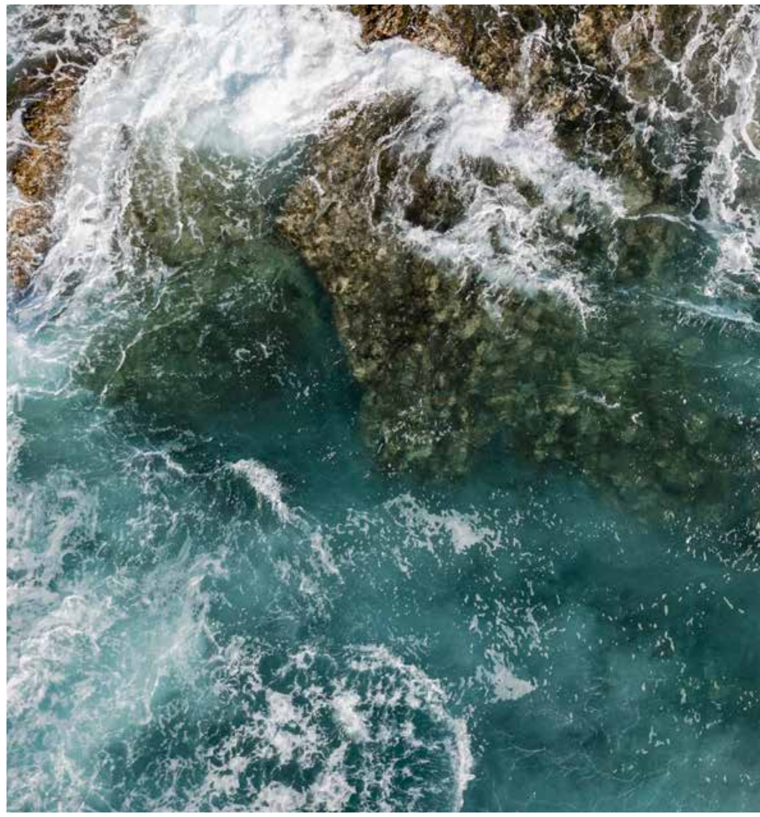
We believe this will continue to drag on economic growth and supports our base case economic forecast – that most developed economies are likely to enter recession before the end of this year.

To quote Sergeant Phil Esterhaus in the hit 80s TV show from my youth Hill Street Blues, "let's be careful out there".

Our key asset class views

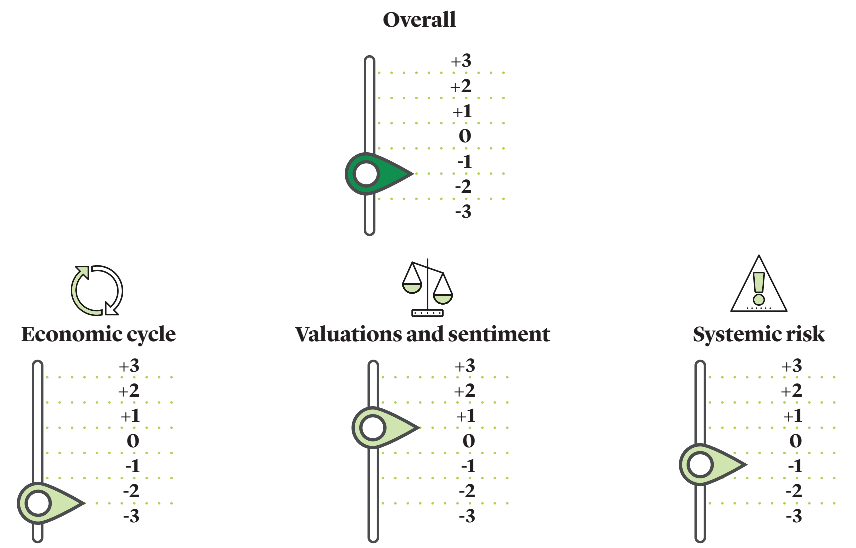


This schematic summarises the combined medium-term and tactical views of LGIM's Asset Allocation team as of 24 March 2023. Asset allocation is subject to change. The midpoint of each row is consistent with a purely strategic allocation to the asset/currency in question. The strength of conviction in 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

We have moved to a negative overall risk position as markets have strengthened, despite building recession risks.



Baseline recession view with a clearer path to weakness via tighter lending standards

Sentiment cautious but not extremely bearish, with valuations overall neutral

Stresses in the banking system with potential spill over into commercial real estate

Source: LGIM. Views current as at 24 March 2023. **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 inclined to keep rates restrictive to stamp out inflation
- Tightening lending conditions set to stall credit flow and the economy

Valuations and sentiment

- Sentiment indicators show caution but not extreme bearishness
- Relative valuations are no longer the natural bullish support for equities
- Absolute valuations have improved moderately

Systemic risk

- Banking stress remains firmly in investors focus
- Real estate may suffer from tighter lending conditions and structural headwinds
- Systemic risk has not yet triggered a reaction, but can be asymmetric

The US debt ceiling could be the final straw

Bank stress nudged the US closer to the brink of recession, and a failure to break the debt deadlock could provide a definitive shove.

Tim Drayson
Head of Economics

The US is approaching the recession we have been expecting. Further banking stress or a failure to raise the debt ceiling in a timely manner would almost guarantee this outcome, but even with successful resolutions, the US is very late cycle.

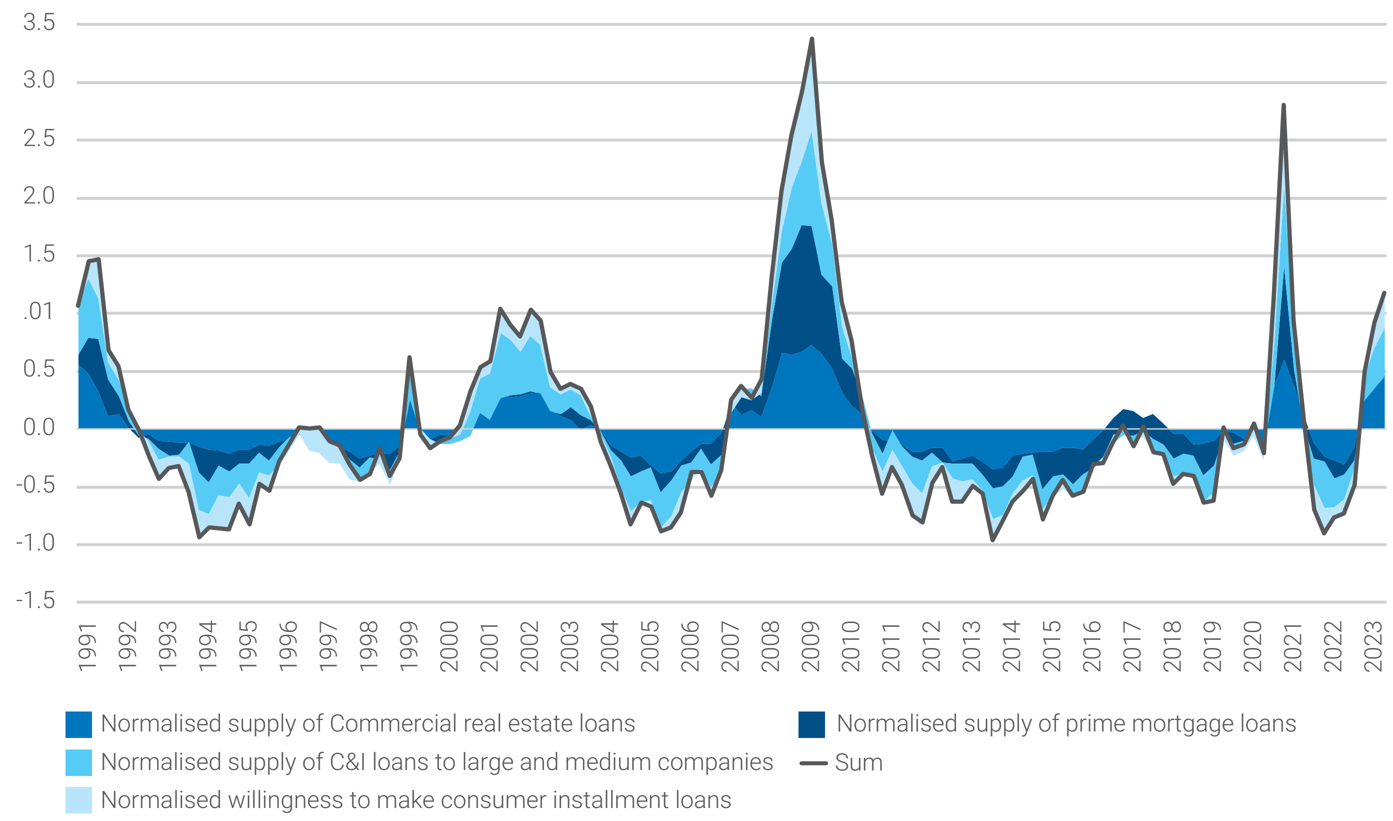
For the first two months of this year, the US proved remarkably resilient to rate hikes, especially in relation to the still incredibly strong labour market. Consensus was becoming more optimistic about growth, and markets were wondering how high the Fed would need to raise rates before something broke. We now know the answer.

Bailouts and backstops

While it's still early days, the Fed's new lending facility appears to have prevented further bank failures, alongside forward guidance that depositors would be protected, even though a universal deposit guarantee requires action from a heavily divided Congress. But there is still likely to be a real-economy effect.

Silicon Valley Bank (SVB) was the 16th largest bank in the US. All the banks smaller than this account for around a third of US bank assets and lending, according to our estimates. These banks should anticipate increased capital and regulatory costs at the same time as some deposit outflows to larger banks. This will likely lead to a tightening in lending standards beyond what we have already seen.

US SLO survey lending standards



Source: Macrobond as at 16 February 2023.

Fed dilemma

The Fed is now walking a tightrope between financial stability and inflation.

Services inflation is proving persistent. In previous episodes of market stress, the Fed was not constrained by the overheating pressures seen today. A premature pivot away from its focus on tackling inflation could undermine its credibility.

But even if the immediate panic subsides, tighter lending standards should mean the Fed no longer needs to reach as high a peak.

Debt ceiling – a potentially bigger crisis

Amid all the banking stress, the debt ceiling is creeping up on investors. Absent Congressional action, the US will default on its obligations later this year. This is known as the X date.

We are concerned the date could be brought forward from the Washington consensus for August. Revenues appear to already be disappointing and April tax collections will be crucial.

While the pressure of a timeline is necessary to focus the mind of Congress, an earlier X date increases the chance the political process fails to take the multiple steps necessary to raise the debt ceiling.

If the debt ceiling is breached, principal and interest payments will likely continue to be made on time. But the Treasury will have to make daily decisions about which other government payments to make. Rating agencies may consider spending failure a technical default. We believe this contraction in government spending could take 5-10% off GDP (on an annual basis) – and make the recession much deeper.

The Congressional Budget Office's latest projections show a dire long-term budget outlook, with interest expenses set to surge. An eventual deal will likely require some austerity. While not good for an economy already likely slipping into recession, this is vastly preferable to no deal.

It seems likely that market volatility is here to stay – for the time being at least.

Friend-shoring: are India and Mexico the new China?

There's plenty of anecdotal evidence that friend-shoring is on the rise, but macro evidence is harder to come by.

Erik Lueth
Global Emerging Market Economist

Rising tensions between China and the West could lead to a shift in production and supply chains over the medium term. Globally, the most important consequence would be higher prices. From a country perspective, the most likely beneficiaries from this friend-shoring would be Mexico and India – the former owing to its manufacturing prowess and proximity to the US, and the latter due to its scale.

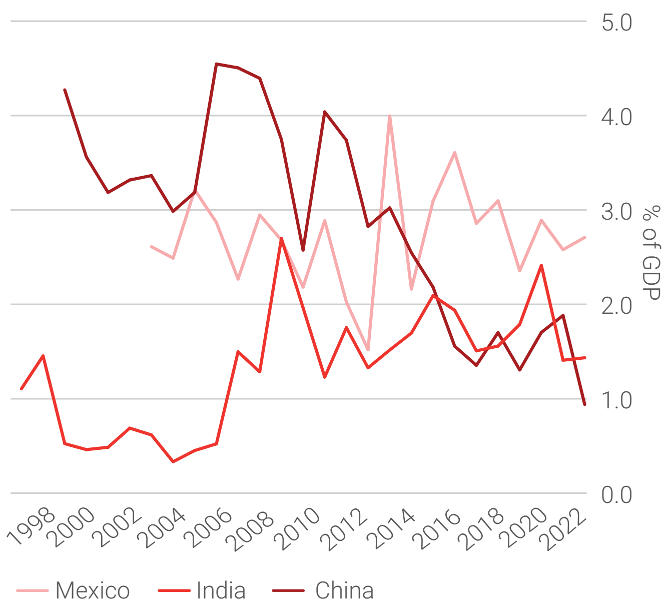
Indeed, anecdotal evidence of friend-shoring abounds. For example, Apple* plans to shift 25% of its iPhone production to India by 2025, a marked increase from the current 6%[1]. Similarly, Mexico just announced that Tesla* plans to build a mega factory in the north worth more than $5 billion[2].

Macro evidence on friend-shoring remains mixed so far. We observe no pickup of foreign direct investment into India or Mexico through 2022. Neither has their share in total emerging markets (EM) foreign direct investment risen.

Sources:
1. https://www.reuters.com/technology/apple-targeting-raise-india-production-share-25-minister-2023-01-23/
2. https://www.reuters.com/business/autos-transportation/mexican-president-says-tesla-will-build-major-plant-northern-city-2023-02-28/

***For illustrative purposes only. Reference to a particular security is on a historic basis and does not mean that the security is currently held or will be held within an LGIM portfolio. The above information does not constitute a recommendation to buy or sell any security.**

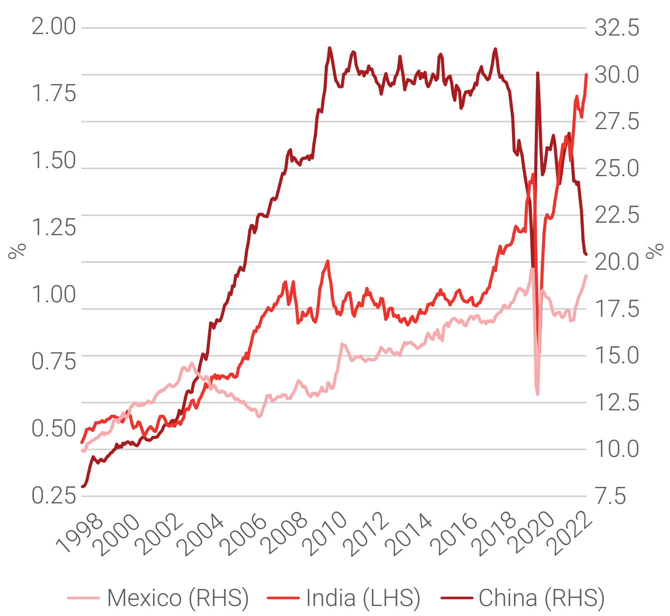
Inward FDI



Source: Macrobond. Data through January 2023 as of 16 March 2023.

However, India's and Mexico's share in US manufacturing imports has risen notably, admittedly from very low levels in India and not above the pre-COVID level in Mexico, but risen nonetheless. This contrasts with a collapse in China's share by 10 percentage points since 2018, pointing to friend-shoring.

Share in US manufacturing imports

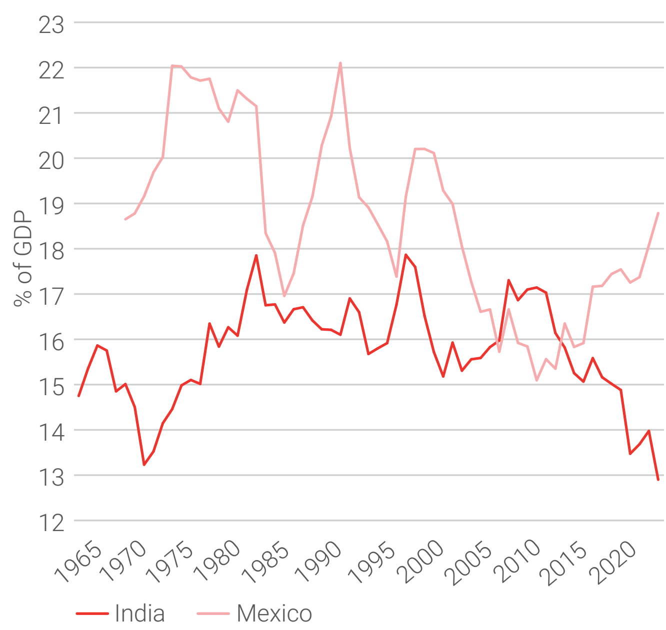


Source: Macrobond. Data through January 2023 as of 16 March 2023

A shift of global production from China to countries more aligned with the US should also buoy the latter's manufacturing sectors. On this metric, Mexico and India diverge starkly.

Mexico's manufacturing share contracted by 5 percentage points in the decade following China's 2001 WTO accession but has mostly recovered since. By contrast, India's manufacturing share has been falling since 2005 with no signs of a turnaround.

Manufacturing share



Source: Macrobond. As at 16 March 2023.

Investing around the friend-shoring theme is not straightforward. Relying on anecdotes runs the risk of chasing a fad with little in the way of fundamental underpinnings. On the other hand, by the time friend-shoring shows up in macro data, markets may have largely priced it in.

Mexico is a case in point. One year back, there was scant macro evidence that Mexico was benefitting from the US-China rift. Manufacturing exports to the US were lacklustre and output still below pre-COVID levels. One year on, Mexican stocks and currency have outperformed most EM peers.

We see strategic competition between the US and China as a long-term trend and as such acknowledge friend-shoring as a medium-term investment theme. However, it is only one of many factors that we consider in our investment decisions. In Mexico, valuations are not attractive currently, in our view. In India, we are long the currency as the potential of larger foreign direct investment aligns with a robust external position – moderate deficit, large reserves and attractive carry.

Commodities: What happened to the inflation hedge?

After outrunning inflation in 2021 and early 2022, commodity returns have turned negative as inflation stayed high.

Patrick Greene
Strategist

Commodities can provide inflation hedging in two sets of circumstances:

- A price shock in commodities themselves – when energy prices increase, inflation increases and owning commodities is a direct hedge against this kind of inflation
- Strong economic growth leads to strong demand growth and higher commodity prices

2021 and 2022 saw a mix of these two shocks, leading to high inflation and rising commodity prices, culminating in a large price shock when Russia invaded Ukraine.

Russia was sanctioned by governments across the globe and commodity prices rose as investors speculated this would make it hard to buy Russian or Ukrainian commodities, including wheat, natural gas and oil. The peak was in June 2022.

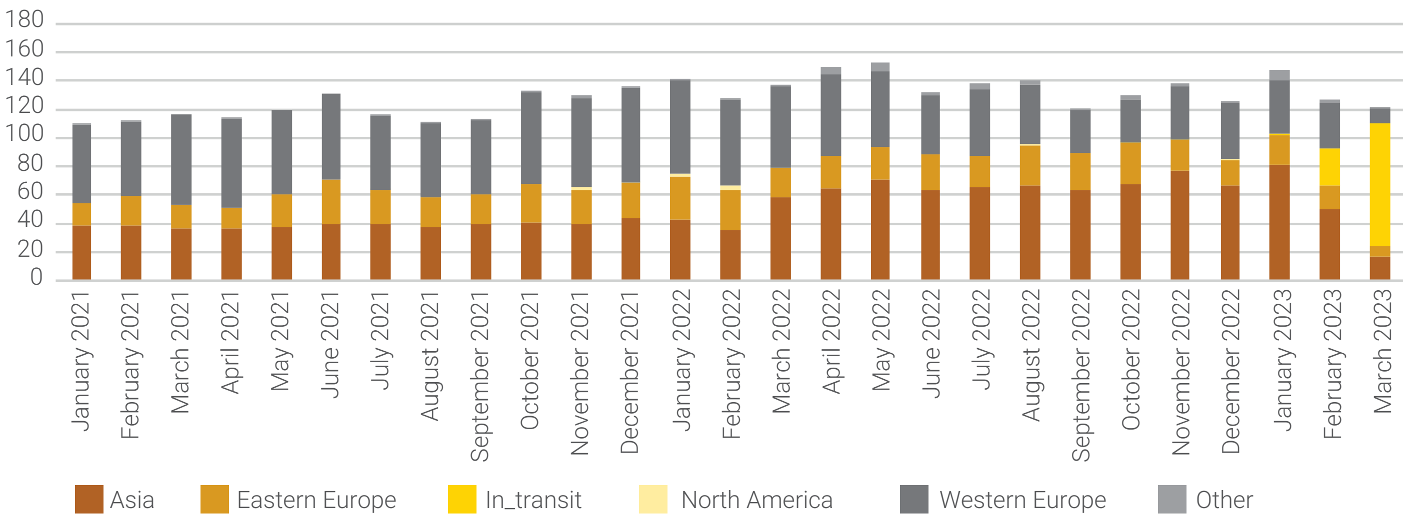
Why commodity prices fell

Since June 2022 there are three main causes of falling prices:

- Russia was much better at exporting commodities to new places than expected, and a spell of good weather eased the natural gas problem
- China lockdowns and property problems
- Recession fears in Europe and the US

The chart below shows how Russia redirected its seaborne exports of oil from Europe to Asia, where there are fewer sanctions. The price of oil had already incorporated the risk of a fall in supply and so oil prices fell as Russian oil kept flowing.

Russian seaborne crude oil exports by destination



Source: Bloomberg as at 1 March 2023. Vessel tracking data, tracking oil vessels port locations. March data is based on data so far. In transit represents oil where the final destination is not yet known, due to it still being at sea.

Something similar happened to grain prices, with both Ukraine and Russia playing a big role in global agriculture exports.

Natural gas is harder to move around the world, but a mild winter allowed Europe to make it through with healthy supplies going into next year, contrary to fears last autumn.

The lockdowns in China have ended and the economy is now reopening, but that was not the case for much of last year. China is a large consumer of commodities, particularly industrial metals. And property is the biggest metal-consuming sector, so lockdowns and a property crisis meant lower industrial metal prices.

The high global energy prices led to concerns consumers would cut spending and cause a recession. In the end there was no recession last year, but that is partially due to the response of energy consumers that cut back: US gasoline consumption fell compared with 2021 and European firms and households used less natural gas. And recession fears have caused prices to fall again in recent weeks.

What's the future for the asset class?

We still view commodities as a useful part of the toolkit to hedge inflation, but they are not a panacea. In our tactical positioning we are neutral commodities.

China has re-opened its economy and its property market is improving. Sentiment surrounding the Chinese reopening had become excessive earlier in the year given the reopening is likely to favour services but that is fading. However, the risk of a US recession is high, in our view, and a decline in demand in the world's largest economy is likely to act as an offset to stronger Chinese growth.

After surging, industrial metal prices fell in Q2 2022 as Chinese growth outlook weakened, indexed to 100

Source: Bloomberg as at 23 March 2023

Contact us

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

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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.

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