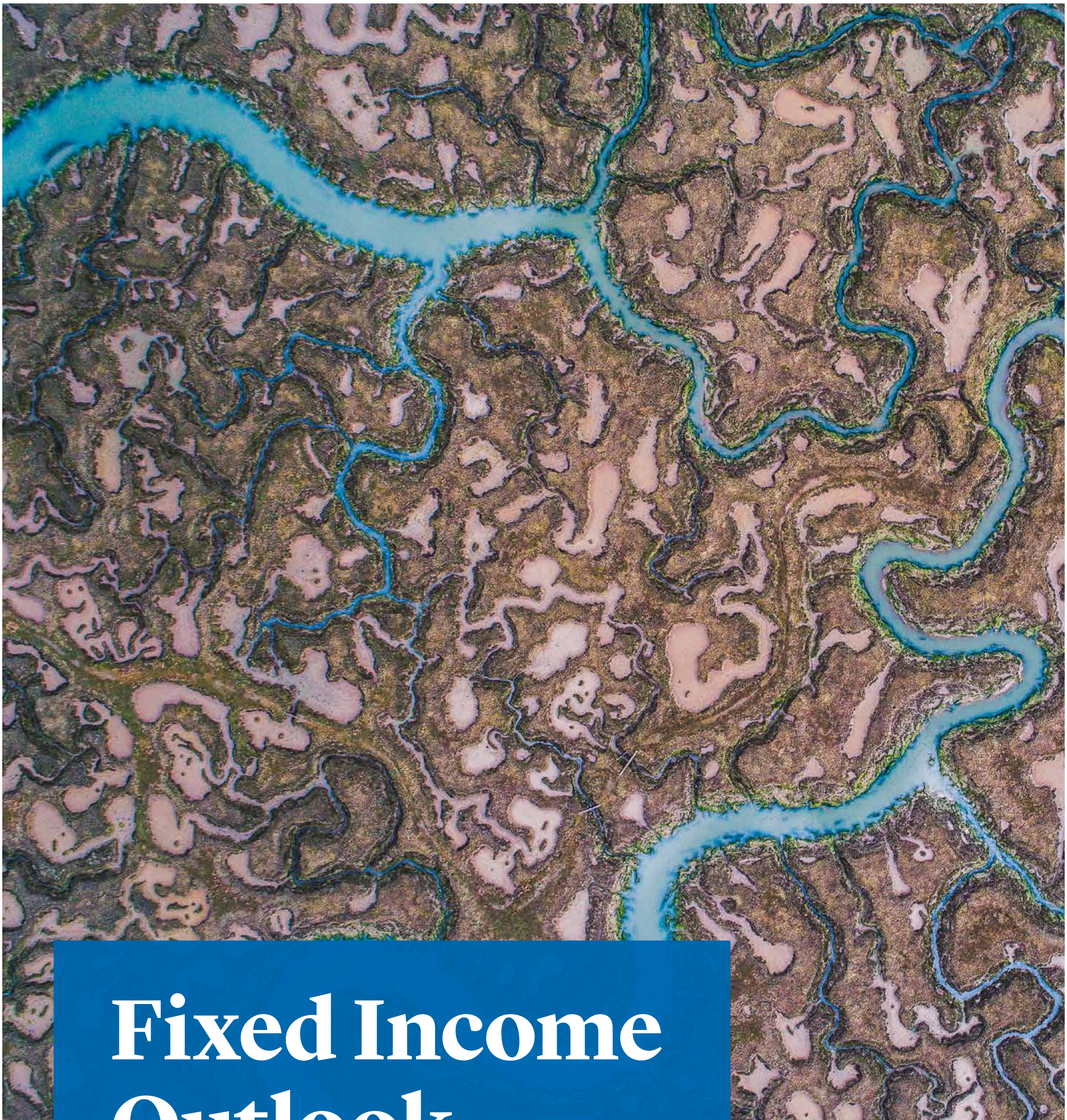


Fixed Income Outlook

Q3 2020

Legal & General
INVESTMENT MANAGEMENT

Q3 Outlook: Taking stock

Colin Reedie
Co-Head of Global Fixed Income

When we became more constructive on credit during March's COVID-19 'crash', we highlighted three key concerns that we thought would affect markets for the foreseeable future:

- Companies with unsustainable capital structures
- Virus 'echoes' and the risk of a second wave
- Sovereign rating risks, given the enormous fiscal policy response

Following the second quarter's sharp recovery in risk assets and economic growth, all three feel as valid today as they did in the midst of that tumultuous period.

Unsustainable capital structures

With markets rallying so strongly, companies have been quick to exploit the demand from credit investors through record new issue volumes, with most now finding themselves in a strong liquidity position. This necessary and prudent response to plug sizeable cash holes in balance sheets has come alongside substantial increases in leverage. The market eagerly awaits the latest company earnings to better gauge both the scale of the deleveraging now required, and whether the sharp recovery in economic activity is translating as swiftly to a recovery in company profits. It is worth reminding ourselves that while the fiscal response has been enormous, it was largely designed to protect household income, not corporate income.

Figure 1: Global credit: option adjusted spreads (bps)

Source: Barclays, 07 July 2020. Past performance is not a guide to the future.

Our Economics Team forecast that more than half of the lost output due to the crisis will be recovered by the end of the third quarter (under their three-scenario analysis), but that still leaves the global economy far from normal. Even in the more optimistic scenario, it would still take at least another year to get back to the pre-virus trend. It seems likely that there will be some permanent scarring and some sectors will have to settle for a less upward-sloping trajectory. The key difference between an economy and a company operating well below previous capacity is that profits are highly geared to even marginal shortfalls in revenues. In addition, a 'social distancing' recession is completely different from anything we have seen before – it will affect companies other than just the usual cyclical suspects. We expect greater dispersion between the winners and losers and ultimately, higher corporate concentration. Our Credit Research team have extended their 'Fallen Angel' rating analysis to take a more granular look at sectors and they will be keen observers of the upcoming earnings season from that leverage perspective.

Virus echoes

The Coronavirus has forced all market participants well out of their comfort zone, explaining the severity and speed of the moves in March. Through most of the second quarter, our biggest short-term focus was the US attempting to reopen their economy prematurely; the recent sharp increase in infection rates raises the risk of a more traumatic outcome in the US. We are probably reliant on positive news in the development of a vaccine from here to help markets side-step growth implications from further quarantines or more severe lockdowns. Any vaccine 'disappointment' that extends recovery timeframes would be a set-back.

The fiscal day of reckoning

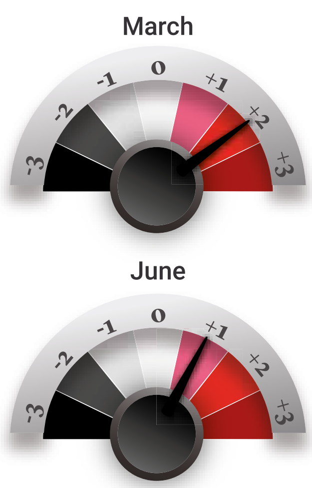
Looking further down the road, a key question is whether policymakers address exploding budget deficits, or whether they continue to run their economies full throttle with both fiscal and quantitative easing taps in full flow. These decisions could have significant implications for interest rates, yield curves and inflation expectations. So far, nobody has suggested a replay of 2010, when governments arguably pivoted too quickly towards austerity.

We remain of the opinion that all of this is playing out in, and further contributing to, a geopolitical recession. For us, the 'Trade War' was always the opening salvo in a longer period of strained US-Sino relations. This has already had significant economic consequences, but left unchecked, this global 'decoupling' could extend from diplomatic channels to the board room. If geopolitical risks continue to escalate, companies are likely to move to further secure supply chains. Assuming China wants to maintain a trade relationship with the West, how do they secure their position in the global manufacturing and supply chain? We have learnt to live with an increasingly erratic US in this context. As we head into the more volatile stage of the US election cycle, it is difficult to see these tensions decreasing when the incumbent President's only winning hand is to go after China.

Beyond the first step

Extraordinary policy measures have done a good job of insulating both markets and, to a lesser extent, economies from the government-mandated economic shutdowns required to deal with the immediate impact of the virus. We remain broadly constructive on credit as a result, despite the improvement in valuations. Nevertheless, we suspect there will be greater uncertainty ahead. Further out, there will be some harder choices on how to 'allocate' the accumulated costs of the policy response to the virus. In a sense, the first step was the easiest – no cost was too great and governments' incentive to spend has not been questioned. Subsequent decisions are likely to be harder.

LGIM's global fixed income views



Source: LGIM. Views current as at July 2020.

Forward-looking statements are, by their nature, subject to significant risks and uncertainties and are based on internal forecasts and assumptions and should not be relied upon.

The strongest link

Tim Drayson
Head of Economics

Jason Shoup
Head of Global Credit Strategy

Ben Bennett
Head of Investment Strategy and Research

We shine a light on the connection between our macroeconomic views and our fixed income portfolio construction.

What are the economic scenarios that LGIM is currently working with?

Tim: Growth has surprised positively in recent weeks, aided by huge transfers from governments, and has been consistent with our Scenario 1. However, there is still only a 50% chance that we remain on this path. This requires either the recent virus outbreaks to be brought under control or a successful management of the virus case loads. It could involve a combination of mask-wearing and 'track and trace', while infections tilted towards younger people could result in fewer hospitalisations alongside better treatment once in hospital. With activity well below normal, further fiscal support will be needed as social distancing is likely to continue through the rest of this year. To return to the pre-virus trend by the end of 2021 as envisaged by Scenario 1 would require a widespread and successful vaccine to become available by next spring.

In our Scenario 2, which is almost as likely as Scenario 1, we envisage more significant long-term economic scarring. Scenario 2 assumes that the virus spreads through the summer and into the autumn, leading to a partial re-imposition of restrictions. Even with the extension of government support programmes, many firms would file for bankruptcy and make permanent redundancies. A vaccine may arrive later in 2021, but by this stage the damage would have been done and the world would have lost 2-3 years of output, only returning to the level of pre-crisis output in 2022.

Our Scenario 3 is the bleakest, but is also the one to which we attach a low probability. Here, a full-blown second wave would develop, prompting a widespread lockdown and double-dip recession. With no vaccine and a lack of herd immunity, social distancing would persist through all of 2021. High unemployment and a deflationary backdrop would risk becoming catalysts for deeper social and political upheaval.

It is possible we would move between some of these scenarios. One plausible path is a deterioration in the virus dynamics, which would move the world economy away from its current Scenario 1 trajectory towards Scenario 2. But if this were met first with a robust policy response and then followed by a successful vaccine, 2021 could see a return towards Scenario 1.

Probabilities of our global economic impact scenarios

50%
Probability

Scenario 1: Strong, partial rebound

- Virus managed without major additional restrictions
- Social distancing continues 2H20
- Vaccine spring 2021 and return to normal by end 2021

45%
Probability

Scenario 2: Some recovery, some scarring

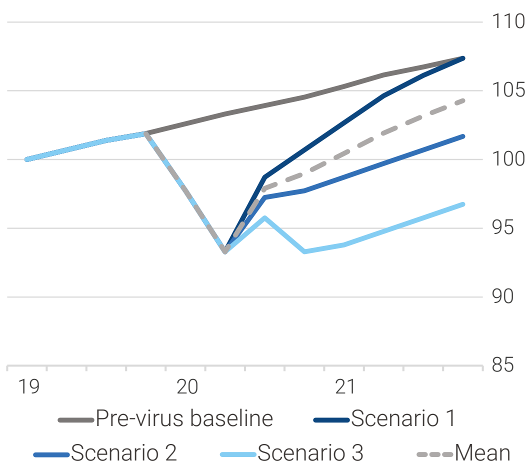
- Virus numbers increase, renewed restrictions
- More bankruptcies and permanent redundancies
- The world loses 2-3 years of output growth

5%
Probability

Scenario 3: Persistent slump

- Second wave, lockdown and double dip recession
- No vaccine, no herd immunity
- Deflation and social unrest

Level of GDP scenarios



Source: LGIM, as at 19 May 2020. Assumptions, opinions and estimates are provided for illustrative purposes only. There is no guarantee that any forecasts made will come to pass.

What impact would each of these scenarios have on global bond markets?

Ben: At the height of the crisis back in March, the future economic trajectory didn't matter much – it was all about a liquidity crisis as everyone rushed to hoard cash. Since then, governments and central banks have intervened on a massive scale, explicitly supporting bond markets through purchase programmes. Looking ahead, this support should remain in place for a while yet. Indeed, economic disappointment would probably lead to even more intervention. However, we would expect credit quality to deteriorate under our second and third scenarios. So while government bond yields are likely to remain lower for longer, good credit analysis should still be rewarded, particularly in our downside economic scenarios.

What signs are you looking at from the broader economy that might indicate which scenario we find ourselves in?

Tim: We have witnessed historic swings in output over the last few weeks; the GDP figures for the second quarter will not fully reflect the dramatic plunge in output as economies went into lockdown and the subsequent rebound as restrictions were lifted in May and June. Even more timely indicators such as the PMIs are not particularly useful because it is unclear whether they currently reflect the change in activity which is clearly higher, or the level which remains far below normal. Instead, economists are turning to a new range of high frequency indicators. These include mobility trackers from Apple* and Google*, credit card spending, electricity output, mortgage applications, restaurant, cinema and hotel bookings and air passenger miles. Growth in the US had been tracking above Scenario 1, but with the virus spreading again, many of these high frequency indicators have flattened off in July. The virus dynamics will continue to be crucial: understanding the relationship between inflection, hospitalisation and mortality rates will determine whether governments may be forced to renew restrictions, and should help to assess the impact on businesses and household behaviour.

In global fixed income portfolios, how are you balancing strong macro forces with bottom-up factors?

Jason: In every recession, credit quality worsens as earnings drop and companies rush to issue debt to improve their liquidity position. The challenge for investors is to determine which companies will be in a healthy enough position to service and repay their increased debt burdens, and which are never likely to recover to pre-virus profitability. After the rapid initial recovery in credit markets, investors are now distinguishing between companies based on their sensitivity to the pace and completeness of reopening. An uncertain economic outlook makes it important to maintain core positions in global fixed income portfolios where there is limited downgrade and default risk in the event the virus results in substantial economic scarring. However, it is equally important to take intelligent risk in reopening-sensitive companies where investors are being generously compensated. The opportunity to buy high-quality credits at historically cheap valuations is gone and credit work is now more important than ever. Indeed, even in the most benign of recovery scenarios, the world economy will not look the same as it did before the virus. As such, we believe identifying the winners and losers is of utmost importance to generating returns.

*For illustrative purposes only. Reference to a particular security is on a historical 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.

Investment grade credit outlook

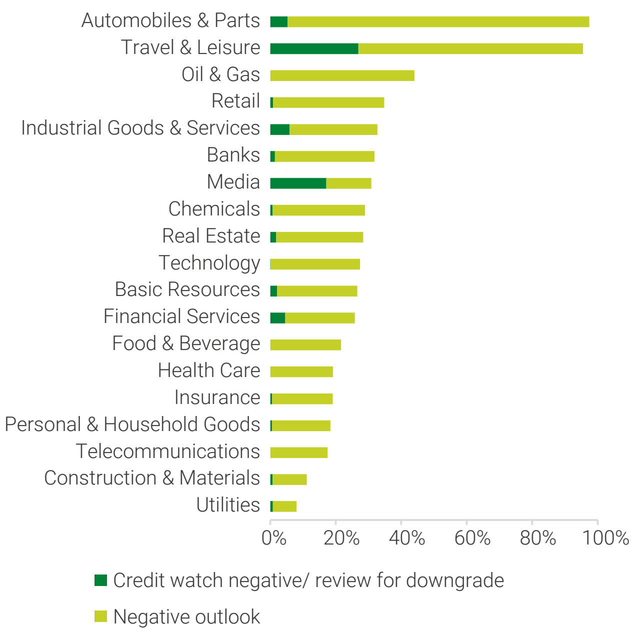
Madeleine King
Co-Head of Global Investment Grade Research

Several months have passed since the start of the pandemic and the investment grade market has had time to adjust to the seismic deterioration in credit quality. After a wave of rating downgrades, including a record volume of fallen angels, the pace of rating actions has slowed. Credit market volatility has fallen and we expect a period of relative calm in the third quarter.

Central banks across the world stepped in to support investment grade companies very early on in this crisis, which in turn opened up primary markets and provided ample liquidity to even the more challenged credits. This has bought companies time to assess and try to repair the damage. For the most part, we think that management teams have done the right thing by slashing dividends, cutting costs and in some cases raising equity.

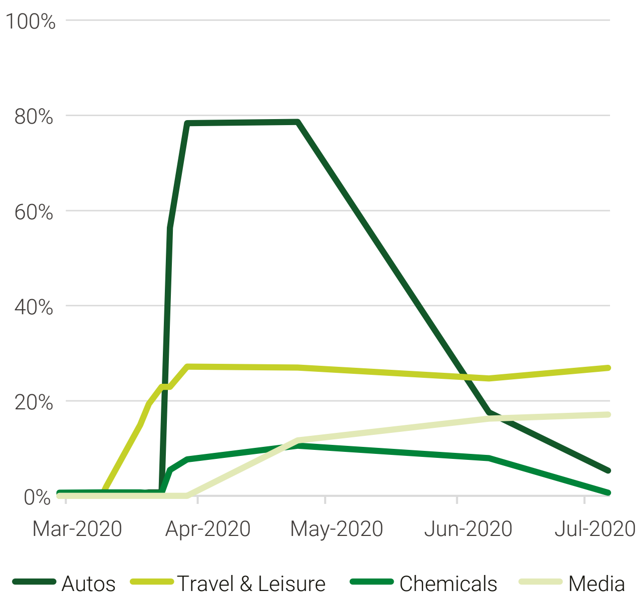
After the initial aggressive wave of downgrades we think the rating agencies are now taking a more benign approach, mostly thanks to this ocean of liquidity. This means that any company that has made it this far without a rating action is likely to stay where it is for the time being. The agencies still assign a negative outlook to around a quarter of the credit market, but the volume of bonds on review for downgrade has fallen substantially since the peak in April, suggesting that most ratings will take longer than three months to migrate lower.

Rating outlook by sector



Source: LGIM, ratings agencies, July 2020.
There is no guarantee that any forecast made will come to pass.

Percentage of bonds on credit watch negative

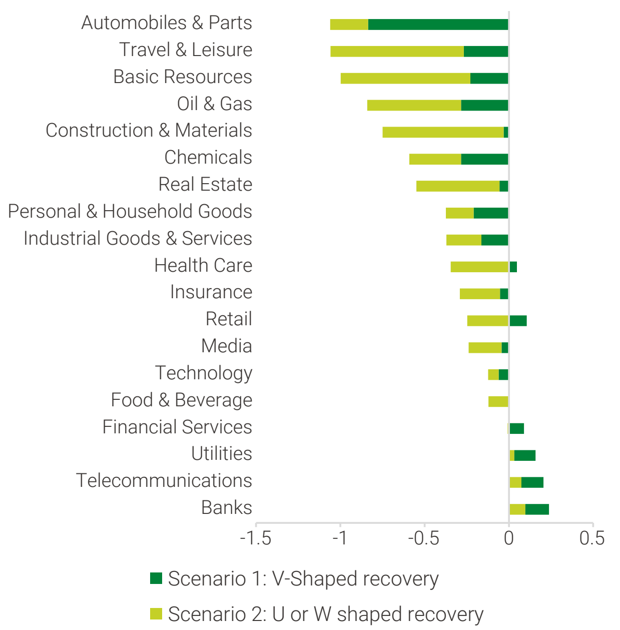


Source: LGIM, ratings agencies, July 2020.

However, we are not yet out of the woods. We think that the downgrades aren't over, even under a best case V-shaped recovery. And it's very possible that the current period of stability could be relatively short-lived. If we experience a widespread second wave of infections and lockdowns, or the elusive V-shape recovery turns into a disappointing 'U' or 'W', we could see many more rating actions in late 2020 and early 2021. We think the market has largely priced in the initial repercussions of COVID-19, but at this point we believe that potential second and third order impacts – including a potential prolonged economic downturn – are not reflected in spreads. We therefore think this period of likely stability could present a good opportunity to insulate portfolios against these risks.

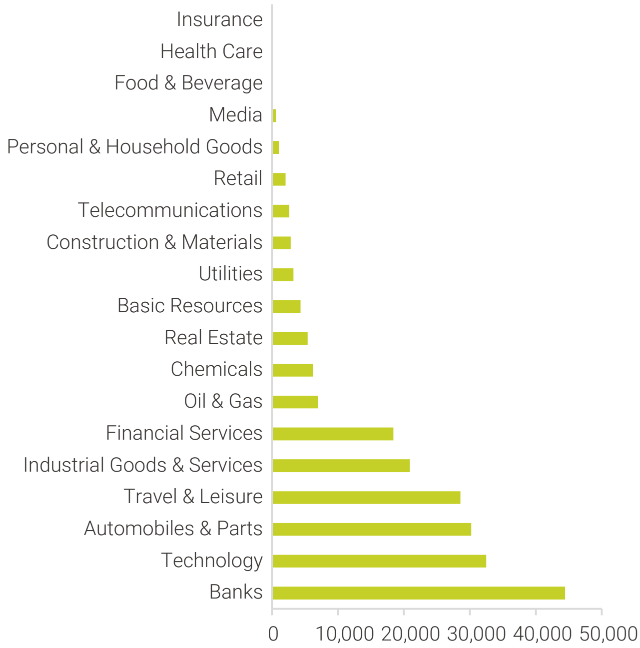
The challenge for credit markets, in our view, is that the subsequent rounds of downgrades will be quite different to the first. During the first phase of this crisis, the hardest hit companies saw their revenues collapse as lockdowns across the world either eroded demand or shut down production. With second-quarter earnings season now underway, we are starting to see the damage this has inflicted on balance sheets. It's not pretty so far, but it is also no surprise to the market. The rating agencies and markets reacted quickly to these impacts due to their severity, and therefore spreads largely price in these risks already. Autos is one such sector, where after months of underweight positioning we recently started adding risk due to attractive valuations.

More to come: expected downgrades by sector



Source: LGIM, ratings agencies, 2020.
There is no guarantee that any forecast made will come to pass.

Fallen angels by sector ($ bn)



Source: LGIM, ratings agencies, 2020.
There is no guarantee that any forecast made will come to pass.

The next stage of downgrades is likely to encompass a wider range of companies. Those hit hard by lockdown, but where a strong balance sheet has so far provided rating protection, will look vulnerable as cratering EBITDA erodes the leverage denominator. If consumer demand and corporate investment fails to rebound then a whole host of traditional cyclicals are at risk. The media sector is a good example, where so far uncertainties around the advertising climate have yet to claim any downgrades.

Longer term we also need to consider the implications of potential sovereign downgrades. This means that even the 'safe haven' sectors – telecoms, utilities and banks – should be on our radar.

Overall, although we expect this quarter to be much calmer than the last, these remain challenging market conditions for credit investors, especially now that spreads have recovered substantially from the wides of March. The good news for investors is that this crisis and its implications are now more widely understood than they were a few months ago, which means that many of the land-mines have been exposed already. Although we see pockets of mispriced risk, we still see potential value in investment grade credit as an asset class, at least for now.

Emerging market credit: analysis and outlook

Uday Patnaik
Head of Emerging Market Debt

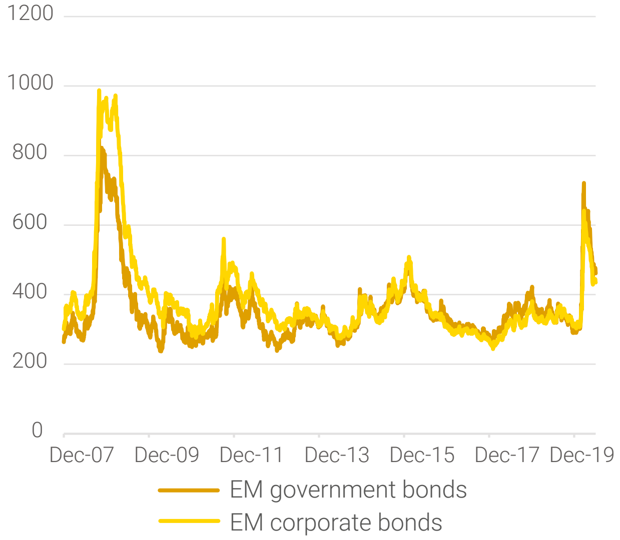
We take a closer look at the impact of recent market movements on emerging market credit.

A sharp shock

The COVID-19 shock hit emerging market bonds across sovereigns, corporates, ratings, regions and duration. Corporate and sovereign spreads widened almost continuously from late February to mid-March, as shown in Figure 1, representing one of the fastest and largest such moves ever recorded. Sovereign bonds, high yield and shorter duration issues were hardest hit.

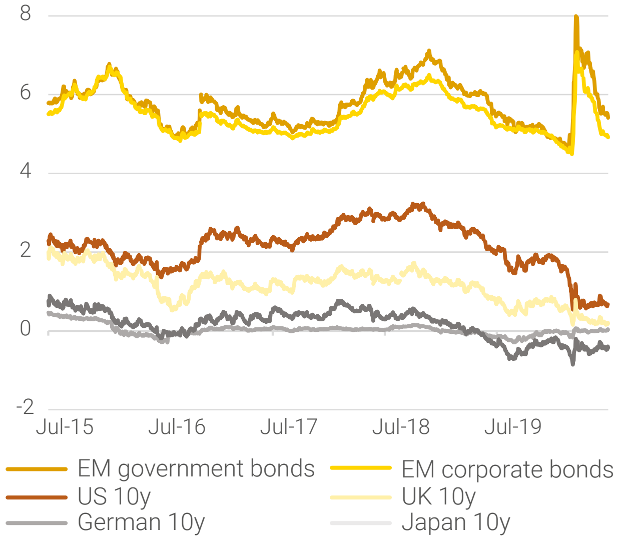
The market recovery from late March has been supported by improving inflows and better risk sentiment, helping emerging market credit spreads retrace 60% of the widening experienced in February and March. The yield on the emerging market benchmark (investment grade) sovereign index is currently 5.3%, while the emerging market corporate index (investment grade) is at 4.8%, at the time of writing. This compares favourably with developed-market counterparts: both the US and UK corresponding index yields are below 1%, while those in Japan and Europe are even lower.

Figure 1: Emerging market spreads (bps)



Source: Bloomberg, JP Morgan & LGIM. 02 July 2020.
Past performance is not a guide to the future.

Figure 2: Emerging vs developed market yields (%)



Source: Bloomberg & LGIM. 02 July 2020.
Past performance is not a guide to the future.

What lies ahead?

Amid quantitative easing by central banks in developed countries, we anticipate strong flows into emerging markets, as experienced in the wake of the global financial crisis. Each crisis is different, but post-crisis growth rebounds over the past 30 years have been stronger in emerging markets. A faster recovery is also likely to be supported by a better starting point for emerging markets: not only are their borrowing requirements lower than developed markets, but going into the crisis they also had lower debt levels. Most had debt levels below 60% of GDP with small primary balances, ranging from 2-3% of GDP deficits to 2-4% of GDP surpluses, according to the most recent data available from the IMF.

As markets recovered, investment-grade emerging market issuers quickly regained market access and in the last few weeks we have also seen single B issuers such as Egypt, Belarus and Jordan return to markets in encouraging sizes. Year-to-date issuance as at the end of June was over \$140bn, versus full year estimates of roughly \$170bn, according to JP Morgan. IMF support for emerging markets has helped sentiment, and multilaterals such as the World Bank and African Development Bank have also stepped in. Meanwhile, the G20's debt service suspension initiative (DSSI) has provided the weakest countries with time-bound relief.

Risks and reasons to be hopeful

The key near-term risk is a resurgence of COVID-19 as economies reopen. However, certain things make us hopeful. First, barring outliers, second waves of the virus may be 'pocketed' rather than broad-based, leading to the use of localised 'smart lockdowns', rather than nationwide measures, which should entail lower social costs in terms of lost employment and earnings. Secondly, while the initial COVID-19 pandemic was unanticipated, risks of a second wave have been well-flagged. In our view, emerging markets should therefore be better prepared for a second wave than they were for the first; if the initial outbreak hit developed countries harder than emerging markets, there is some reason to expect this could also be the case in the event of a second surge.

In balancing the opportunities and challenges, while we are constructive on emerging markets, we remain cognisant of the market movements since the extremes of March, which may increase the prospects for short-term profit-taking. Come September and once COVID-19 begins to fade in earnest, the potential for gyrations spinning out from the US elections, the evolving US-China relationship and the outlook for commodity prices are likely, in our view, to return to the foreground.

Responsible investing: the social side

Jonathan Lawrence
ESG Analyst, Fixed Income

A closer look at the social impact of corporations and industries, and why we believe it should be high up on investors' agendas.

Responsible investing often focuses on climate change, green energy or governance issues. But the Coronavirus has brought social risks to the fore.
The economic damage of the virus has rippled through society. It has also turned a spotlight on health and safety risks, from considering both customers (what is Disney doing to protect its theme park visitors?) and employees (are the supermarkets providing adequate personal protective equipment for their staff?)

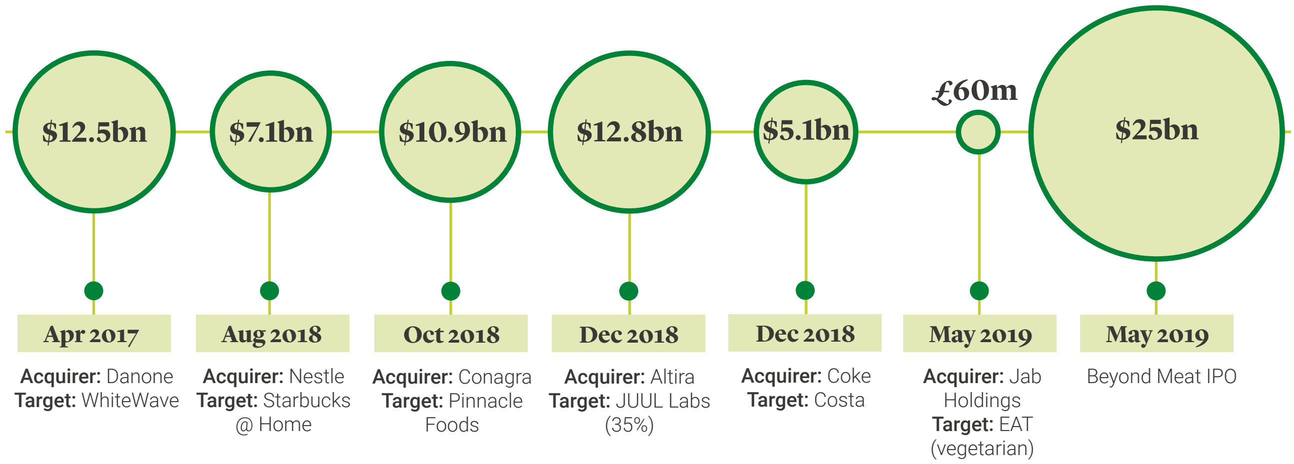
However, the social aspect of responsible investing goes much further, incorporating the quality, safety and social impact of core products and services, and the management of key stakeholders including workers, customers and local communities. One reason we believe social factors have tended to get less focus than environmental and governance issues is because they have been the hardest risk for investors to quantify. But the case studies below illustrate how these social factors are as important for credit investors as other responsible investment considerations, in our view.

Eat your greens: the food and beverage sector

From vegan sausage rolls to non-dairy ice-cream, food and beverage companies are increasingly adapting their product offering and business models to shift towards the growing market for healthier lifestyles. For many, this has resulted in targeted merger and acquisition (M&A) activity as larger conglomerates have gobbled up smaller challenger brands that are thriving in the healthier segment of the market.

Figure 1 overleaf shows some of the most significant M&A activity in this area over recent years. For example, as part of its strategy to create a positive impact on health and the planet, Danone acquired Whitewave in 2016 for $12.5bn, which was a market leader in some of the fastest growing health focus categories such as plant-based and organic produce.

Figure 1: Recent M&A activity has been healthy



Source: LGIM, July 2020. 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. Case studies are shown for illustrative purposes only. The securities information does not constitute a recommendation to buy or sell any security.

For credit investors, identifying (and avoiding) companies in need of M&A to give their brand portfolios a 'healthy lifestyle makeover' is key to preserving value, while the new bond deals issued to fund these investments may provide attractive investment opportunities.

A modern tragedy: the US opioids scandal

In 2019, the repercussions of the opioids crisis in the US were felt across the pharmaceutical industry. A number of companies are facing litigation over their alleged role in the crisis and many of the exposed issuers – from branded manufacturers to distributors – have pursued settlements which were financially material. In September 2019, Purdue, the manufacturer of OxyContin, filed for bankruptcy as part of a $10bn agreement to settle opioid related lawsuits. In October, a majority of states reached a tentative settlement agreement with distributors for more than $19bn, and over the last 9 months, various manufacturers have individually settled for several billion apiece. However, not all states have approved of the distributor settlement and multiple cities and counties have pursued their own litigation outside the state cases, so the ultimate financial impact from the opioid crisis has yet to be determined.

As the healthcare and pharmaceutical industry races to find treatments and a vaccine for COVID-19, the opioids crisis illustrates the diversity of social issues facing this sector; the tragic social cost is clear, and the financial consequences for the companies involved also demonstrate the importance of considering such implications and the role of companies in crises such as these from an investment perspective.

I spy: cyber security in telecommunications

Political tensions between China and the West have led to heightened cyber security concerns relating to Huawei, leaving the European telecommunications industry potentially vulnerable to the frosty relationship between Washington and Beijing. The Chinese equipment manufacturer now looks likely to fully or partially miss out on contracts to build 5G telecom networks across Europe, making its Scandinavian rivals unlikely beneficiaries of COVID-19 and its political fallout.

As Colin highlighted at the start of this document, one of our fears stemming from the virus is that tensions with China could continue to grow. If this is the case, there could be far reaching repercussions for the telecom sector. Mobile operators may be required to replace their Huawei 4G equipment throughout Europe, at a cost of multiple billions per country. The sector has warned that eradicating Huawei in the UK could result in mobile blackouts, and credit investors are increasingly nervous that a supposed COVID-19 safe haven sector could face a sudden multi-billion debt funded cash call.

Almost every aspect of both daily life and investment has been and will continue to be affected by COVID-19, and responsible investment considerations are no exception. And not all the consequences are negative: the drop in pollution levels from drastic reductions in travel has been one noticeable shining light in a period of gloom. On the governance side, the abrupt end of market cycles often coincides with the discovery of corporate impropriety and failings at a high level. But we mustn't forget the social side of investment: despite these factors being by their very nature harder to quantify, we believe they are likely to be of greater importance than ever for investors in a post-COVID-19 world.

Contact us

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Important information

Key risks

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