

Fixed Income Update

Q2 2021





Introduction

Getting nervous



Colin Reddie
Head of Active Strategies

In fixed income markets, it's usually when things begin to 'feel' better that you run into maximum optimism. But wouldn't it be ironic if the long-awaited reopening of economies and societies turned out to be a difficult period for markets? We have been debating for a while now whether 2021 would be a 'sell in May and go away...' year.

We are increasingly of the opinion that risky assets will face stiffer headwinds over the next 3-6 months, and that cyclicity is no longer attractively priced. At most, there could be a significant consolidation, and at least a decent correction. The economic cycle itself remains intact, but the problems are bullish sentiment, full valuations and a lack of upside policy surprises, all of which encourage us to be more cautious from here on. This is a **tactical call** and as such, comes with the usual 'health warning': it is usually easier to identify the troughs in markets than the peaks.

Hindsight is a wonderful thing: it's easy to see that pretty much everything was aligned to be bullish on cyclicity in May last year. Sentiment was depressed, valuations were reasonable (especially for cyclical parts of the market), macro surprises were poised to move higher and there was plenty of stimulus (both monetary and, crucially, fiscal) still to come. Fast forward a year and the balance of evidence has shifted in the opposite direction.

Focusing on policy and the macro outlook, strong global growth for 2021 is now an overwhelming consensus. We completely agree, although risks remain, as explored by James Carrick later in this outlook. The question mark is policy. With the new US administration's fiscal package now agreed, policy is probably now 'as good as it gets'. If anything, as growth rebounds strongly throughout the middle of 2021, it is more likely that policy surprises (at the margin) will be negative. We've consistently highlighted that this monetary versus fiscal policy debate is the most important one, and it feels like we're getting close to the 'fish or cut bait' decision.

When?

As for catalysts and timing, from a tactical point of view, we believe headwinds are likely to strengthen for risky assets over the next 3-6 months. Whether this is just an equity issue and to what extent it will affect high-quality credit is still up for debate. As we have observed over the last 15 months, the pandemic has acted as an accelerant for almost everything it has touched. Cycle models, currently very friendly to credit, should not be viewed as immune to the risks of an economic cycle that could play out very quickly. So far, the Fed has done a good job of diffusing some of the extreme yield valuations in the US Treasury market without negative consequences for other asset classes.

Financial conditions remain 'easy', even as the inflation debate continues to rage. However, we are fast approaching a two-month period when we expect to see back-to-back inflation-related data (US Core Personal Consumption Expenditure price index) of around 2.6%. But we expect that it may be the FOMC (Federal Open Markets Committee) meeting in June where things could become more difficult. Holding their dovish line seems a lot harder following those inflation readings, especially against the backdrop of a very strong US economy. Any shift to a more hawkish tone, combined with a possible announcement about 'tapering' quantitative easing from January 2022, would signal a flip in those cycle models that attempt to

predict when we are moving into that more dangerous mid-late phase. A fast-moving, mid-cycle period would be far less supportive for credit (especially investment grade). We are, therefore, getting a bit nervous.

In this edition, we introduce our Active Strategies team, comprising cross-asset research at LGIM. Jose Almonte shares some recent work from our Global Research and Engagement Group, and we showcase some highlights from our recent online conference for advisers and wealth managers.



James Carrick
Global Economist, Asset Allocation

A rocky path to recovery?

As the UK begins to lift lockdown restrictions, many of us will be tentatively looking forward to summer months closely resembling normality. Although the government has been at pains to guard against over-optimism regarding the timetable for reopening entertainment and leisure and for relaxing social distancing rules, companies are understandably pushing for a return as fast as possible to ‘business as usual’.

The bright side...

The UK is in a better position than many other countries, having given first vaccination shots to 70% of the population versus 48% in the US and 40% in the EU as at 21 May 2021.

This is important because severe outcomes from the virus are heavily skewed. The oldest 25% of the population account for 95% of COVID-19 deaths and two-thirds of hospital and ICU visits, as [discussed in December](#). Rapid vaccination of priority groups and a harsh lockdown have seen UK deaths plummet by 95% and hospitalisations fall by 90% since their January peak.

Another positive factor is the weather. Just as we worried about the winter impact on respiratory viruses, we should be sanguine about the spring. Academic research suggests the reproductive growth rate (R) for flu can [swing by 30% due to seasonality](#).



However, it's unclear how much of this is [biological](#) (due to viruses being better able to bypass our immune systems) or [sociological](#) (due to less time spent indoors where the virus is easier to catch). Following the loosening of restrictions, we will be watching new data carefully.

...And the dark side

On the downside, we must consider virus mutations. There are two key mutations that have occurred around the world. First, the N501Y mutation (which is already dominant in the UK) is estimated to make the virus more transmissible because it can attack us more easily.

Second, the E484K mutation has proven to be harder for our immune systems and vaccines to fight, particularly the AstraZeneca vaccine which is the most widespread jab used in the UK. [Several strains have both mutations](#) – South Africa, Brazil, and recently the UK. [A variant first identified in India is also becoming more prominent](#).

Both of these mutations undermine the ‘herd immunity’ benefits from vaccination. For N501Y, a given level of social activity is associated with a 50% higher reproductive growth rate. For E484K, a vaccinated individual may still be vulnerable to infection. Thankfully, vaccines seem effective at preventing serious outcomes (hospitalisation and death) from this mutation.

Moreover, it is also possible (though not yet proven) that vaccinated individuals who catch the virus could be [less infectious than normal if they have a lower viral load](#).

The sunlit uplands?

Taken together, these competing dynamics suggest the UK should maintain its cautious approach to reopening. Europe seems to have underestimated the threat from the N501Y mutation (aka “UK” variant). It didn’t lock down as harshly as the UK, even though the mutant strain was set to rise exponentially. This, alongside slower vaccine roll-out, means European hospitals remain under intense pressure and social restrictions are being reimposed. But in a couple of months, Europe should have finished vaccinating its most vulnerable members and should be able to relax restrictions again.

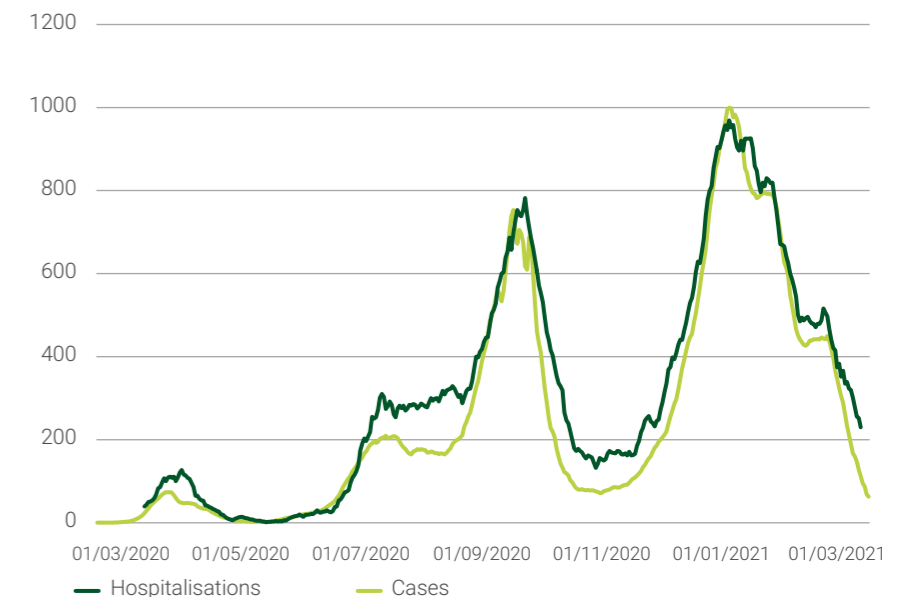
As economies reopen, we expect to see a divergence between mild and severe cases: infections should rise, but hospitalisations move sideways. There is a danger that some countries or states reopen too

rapidly, particularly given (and maybe encouraging) mutant strains. US hospital flows have already started to move sideways, having only fallen 70% from their peak. But as time passes, more of the vulnerable members of society will be vaccinated and given ‘booster’ shots against mutations.

Israeli data remain tremendously encouraging, with new cases and hospitalisations continuing to fall despite a significant reopening of its economy. This suggests herd immunity can be achieved, rather than just protecting the vulnerable.

We will continue to monitor developments around the world and integrate these dynamics into our views on current and future trends and patterns that will be important for investors.

Israel cases vs hospitalisations: one-week change



Source: LGIM, March 2021

Active strategies outlook

A summary from our recent conference for wealth managers and financial advisers.



At LGIM, our Active Strategies team combines cross-asset research and expertise to share knowledge, ideas and insights which feed into our portfolio management decisions. By pooling our expertise from our broad capability set, we can close the gap between “top-down” and “bottom-up” analysis, while integrating ESG (environmental, social and governance) factors directly into our portfolio management. We maintain a twin focus on alpha generation and achieving sustainable returns, aligning with our overall purpose of creating a better future through responsible investment.

By bringing together our experts from across credit, equity and investment stewardship, we aim to identify more holistically the risks that threaten the sustainability of returns.

We apply our beliefs across both sides of companies’ capital structure to build meaningful dialogue and more effectively allocate capital for long-term outcomes. From next quarter, we will also include our equity and investment stewardship insights in this quarterly outlook, while continuing to share our latest thinking on fixed income.

At our recent conference for wealth managers and financial advisers, members of our Active Strategies team shared their views about the economic outlook, along with specific insights into what they are seeing in terms of changes, risks and opportunities in their asset classes. We provide a summary of their key views on fixed income below.

Active strategies summary



Our **conviction-led philosophy helps us aim** to consistently deliver alpha, in combination with our ESG focus, targeting sustainable returns and better long-term outcomes



Our **unified research and engagement** structure helps us identify potential risks that threaten the sustainability of returns



Our **collaborative research culture** is powered by the expertise of our experienced leadership team, portfolio managers and career analysts

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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Changes in quality, changes in risk

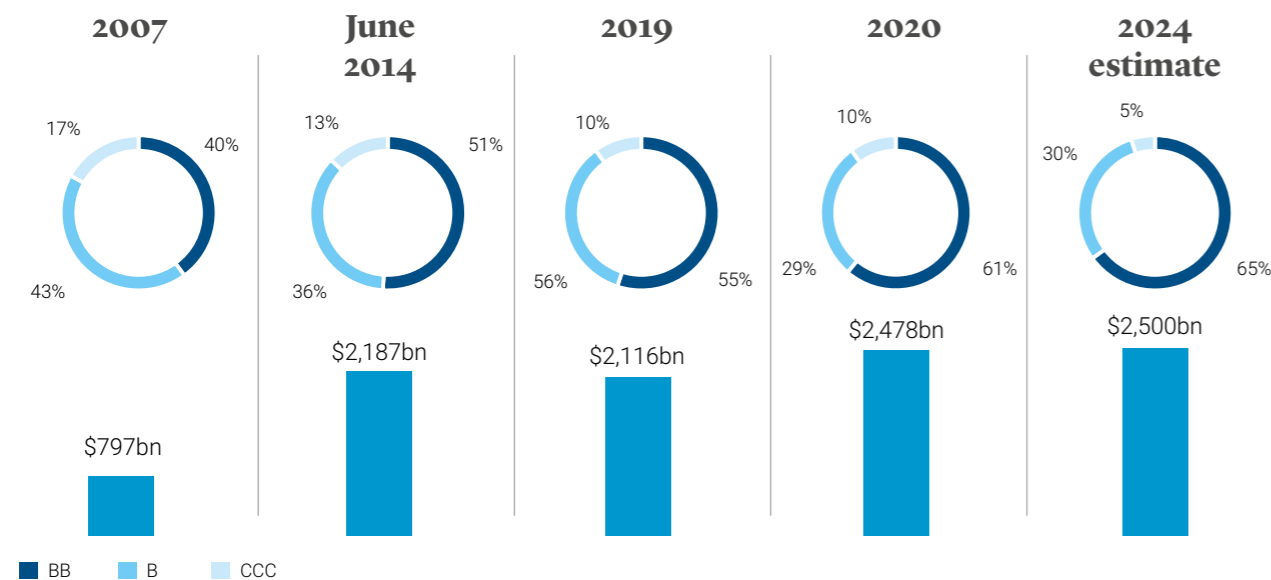
“CCC-rated bonds are becoming an increasingly smaller part of the world. Each time you go through a crisis, they reduce. Today, we actually have a situation where single Bs are falling in their index weight too, if not their absolute number. The high-yield world is becoming much higher quality, much more based on BBs. I think that is because people can take fewer losses than they could before. Why is that? Because yields are lower, the potential returns on offer are lower, so mistakes are penalised more.”



Who is steering the policy ship?

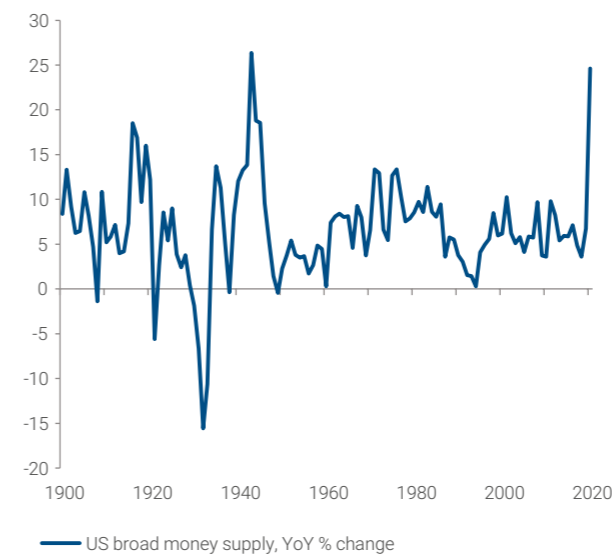
“For a while now, the key question for us has been whether policymakers are prepared to continue to run their economies hot, even in the face of the likely peak of COVID-19 infections, vaccination rollouts globally, and a potentially very swift recovery in growth in the second half of this year. When we talk about the bonding of monetary and fiscal policy, you just need to look at who is steering the ship. We have a very dovish former Fed chair now running the US Treasury in Janet Yellen, we have an ex-politician running the ECB, and we have the ex-head of the ECB now in charge of Italy. This is a very different backdrop from the one that sat behind the 35-year bull market in fixed income.”

Figure 1: change in ratings and growth of high yield universe



Source: Bank of America Merrill Lynch. Based on Global High Yield Index (HW00). Values are as at 31 December for each year and June for 2014. There is no guarantee that any forecasts made will come to pass. 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.

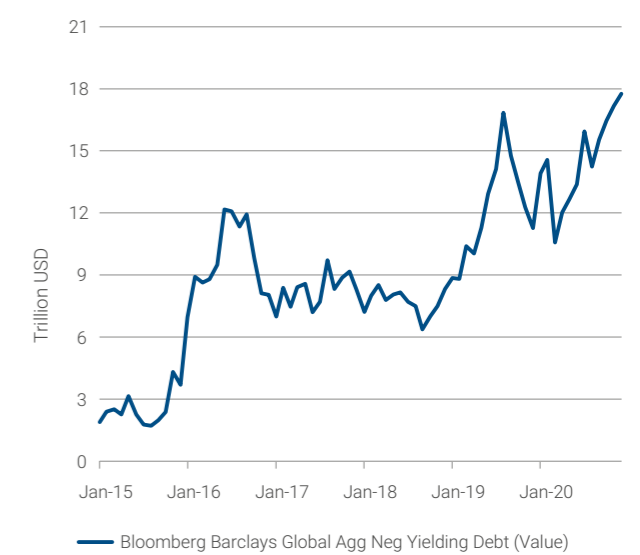
Figure 2: US broad money supply has increased to post-WWII levels



Source: Federal Reserve Bank of St Louis; data to 31 December 2020

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Figure 3: Negative yielding debt is climbing



Source: Bloomberg; data to 31 December 2020.

Jose Almonte

Senior Research Analyst, LGIMA IG Research

Global Research and Engagement case study:

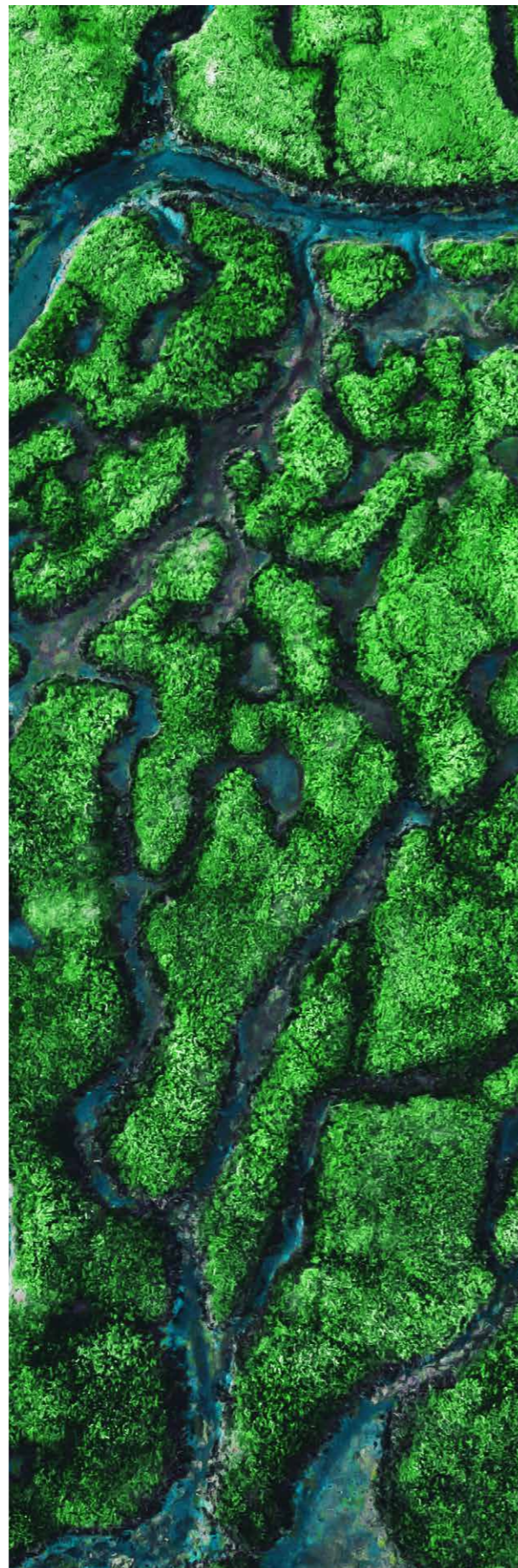
Chemicals and credit risks in the US

As part of our Active Strategies structure, our Global Research and Engagement Groups combine top-down and bottom-up analysis to identify global themes which are likely to have a significant impact upon the assets in which we invest. This global combination of cross-asset, sector-specific and ESG analysis allows our fund managers to make better-informed investment decisions across all parts of the capital structure.

In this case study, we provide an example of our cross-asset research on the potential investment risks posed by the PFAS group of chemicals (per- and polyfluoroalkyl substances). It has raised important points to consider across our actively managed portfolios, and highlighted areas of potential concern for the future.

What are PFAS chemicals?

Per- and polyfluoroalkyl substances (PFAS) are a group of man-made chemicals which have been manufactured and used in a variety of industries around the globe, including in the United States since the 1930s, when they were discovered by 3M*. The main properties of these chemicals are that they are very robust and do not break down after exposure to the elements, with the ability to repel and resist grease and water; they can therefore be used in a broad number of commercial and industrial applications including Teflon cookware, Scotchgard carpets and firefighting foam.



*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.

But the strength of the chemical compound that serves to make PFAS useful is also proving to be its greatest liability. Its durability means that it is persistent and bio-accumulative with a very long half-life and is consequently present in the environment and in humans. There is evidence that exposure can lead to adverse human health effects.

It is estimated that PFAS is so widespread that roughly 98% of the US population have measurable accumulations of it in their blood. Most of the exposure is attributable to the food we ingest, as we cook it in Teflon pans, and also to drinking water. Studies have shown that the ground water near military bases has high levels of PFAS given the military's historical use of firefighting foams with the chemical.

What is the risk for companies?

There is a lot we do not know about the effects of PFAS on the human body, but scientists have noted that there is evidence that exposure over time could be detrimental to health. Studies have shown it to have caused infertility and developmental issues with various organs in laboratory animals. Other evidence points to its impact on the immune system, cancer and thyroid issues.

To date, despite the concerns, PFAS and the related compounds are not deemed a hazardous substance by the EPA (Environmental Protection Agency), with the agency only establishing a health advisory in 2016 related to drinking water with the threshold set at 70 parts per trillion. As an advisory, it is non-enforceable and does not establish a definitive cut-off between 'safe' and 'unsafe' concentrations.

The manufacturers of PFAS, like 3M, and those that use the substance, such as DuPont*, are concerned about the health issues raised and the potential for costly litigation and settlements addressing environmental, health monitoring and bodily injury compensation.

One of the larger environmental issues so far has involved 3M, which paid \$850 million to settle with the state of Minnesota resolving a natural resource damage lawsuit. DuPont settled a case in 2004 that provided for the cost of medical monitoring of several PFAS-linked medical ailments for a population of roughly 80,000 people, at a cost of \$235 million. In that same case, DuPont settled with 3,500 people who clearly established that they were sick with an illness linked to PFAS for \$671 million.

Given the number of sites with PFAS contamination greater than the advised 70 parts per trillion located in very large population centres, the industry has good reason to be concerned. Estimates for clean-up,

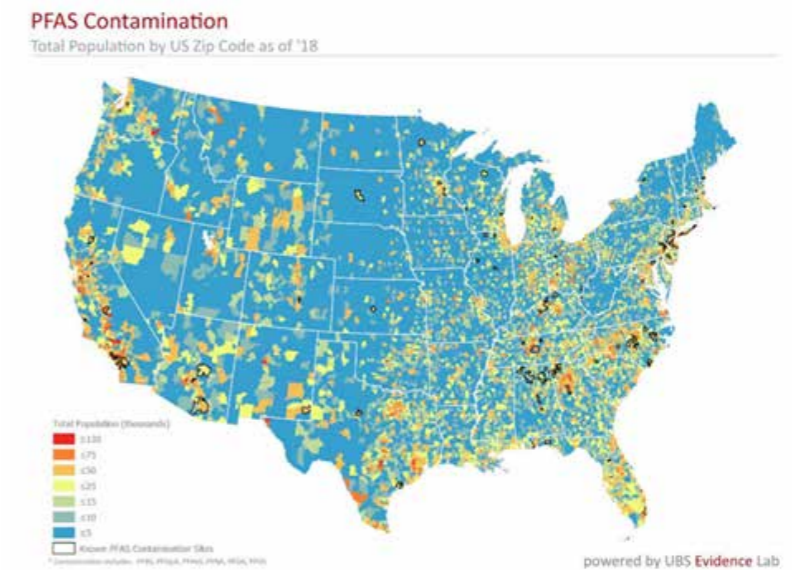
remediation, and medical monitoring continue to climb, with current estimates around \$10billion in damages.

A slow burner?

While the credit impact related to PFAS exposure appears manageable at present, we expect the Biden administration to deem the compound a hazardous substance, and to legislate accordingly. The current patchwork of state regulations for such chemicals creates a significant degree of uncertainty; consequently, there is a level of support for designating the compound as a hazardous substance with one clear and cohesive Federal position.

From an investment perspective, we will be monitoring this issue closely, both in terms of the responses of companies to potential legislation and their preparedness to adapt to it, and in terms of judging whether the risks we see on the horizon are reflected in the prices and yields of the assets that we are considering for investment.

PFAS contamination



Source: Tracking PFAS Contamination with UBS Evidence Lab Data© UBS 2020. All rights reserved. Reproduced with permission.

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