CIO Investment Outlook

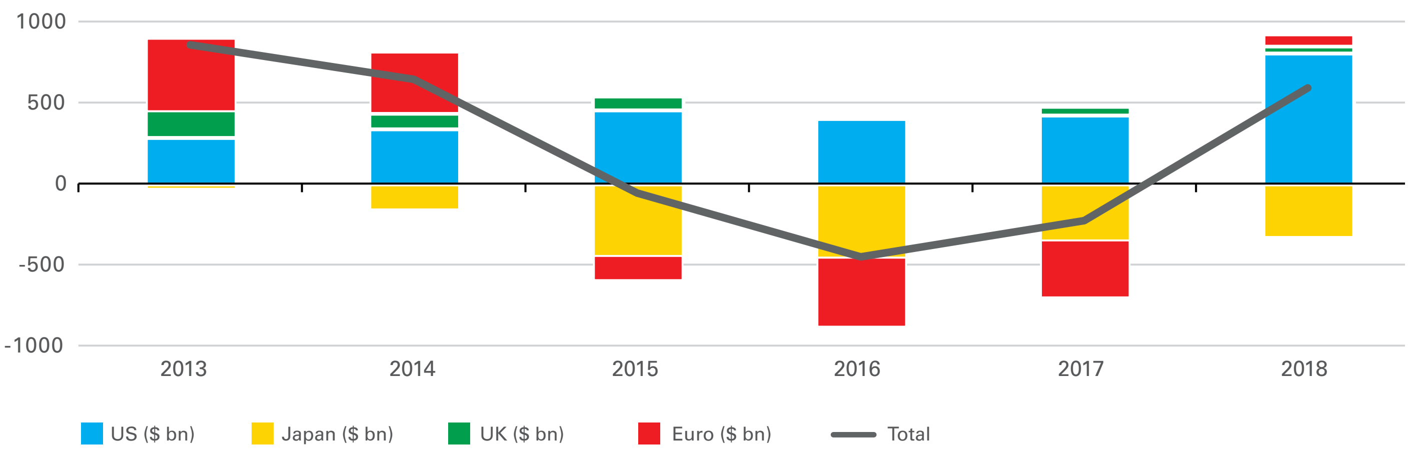
Expect the bumpy journey to continue

Investors have been buffeted by a large number of negative headlines in 2018. We remain of the view that tightening global liquidity conditions are likely to exacerbate market volatility.

Anton Eser became Chief Investment Officer of LGIM in 2017. Prior to this, Anton was Co-Head of Global Fixed Income leading the London based Fixed Income team and managing LGIM's flagship global credit portfolios.

As we highlighted in our year ahead outlook, Figure 1 is the key chart for the year, describing how investors like us would switch from having $300bn of fresh quantitative easing-funded (QE) capital to deploy in 2017 to having to find $700bn to absorb the net government bond issuance in 2018. As well as this one trillion dollar liquidity shift, we also highlighted risks posed by stretched market valuations.

Figure 1: Net of redemptions and QE, government bond supply is soaring in 2018



Source: Morgan Stanley, LGIM estimates

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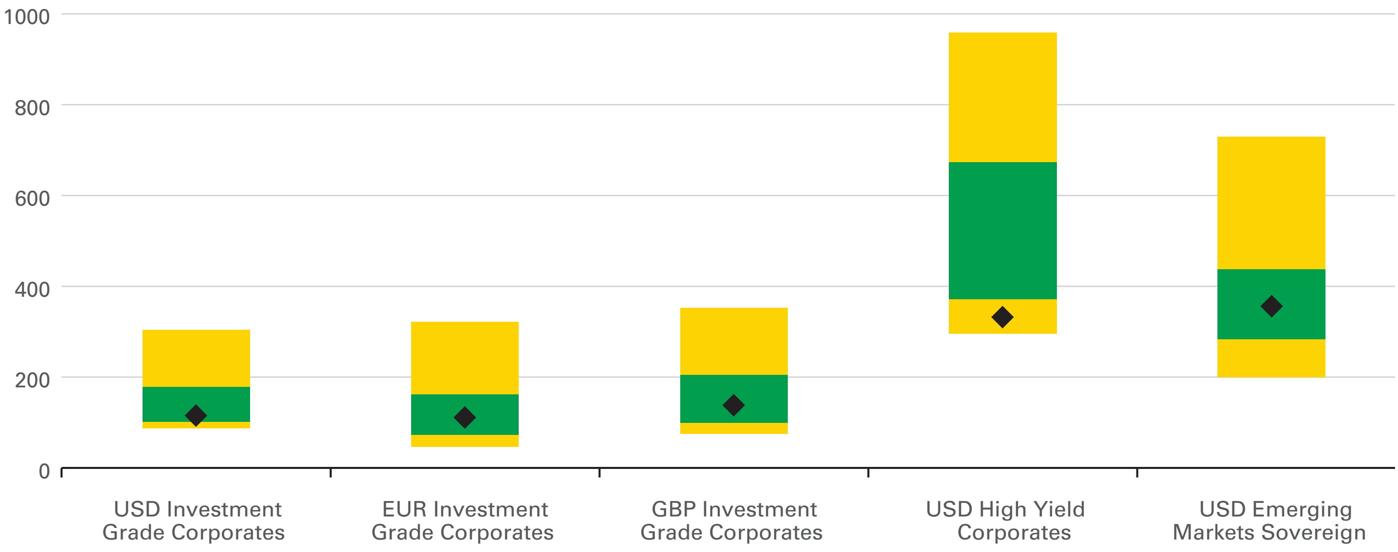
Figure 2: Credit spreads (bps) versus history (current diamond versus both 5%-95% and inter-quartile range)



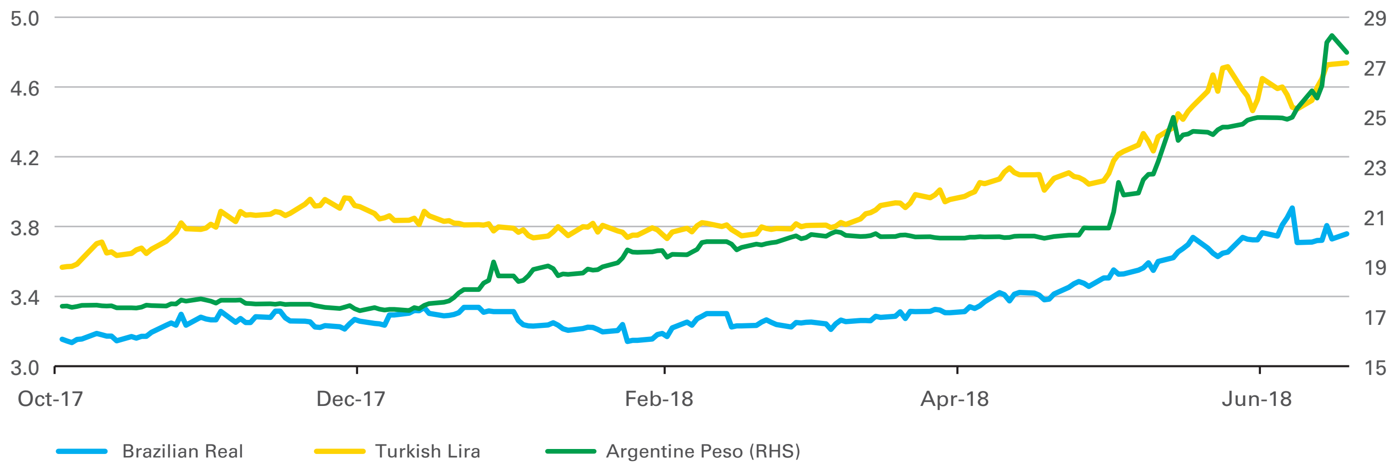
Source: LGIM, Bloomberg Barclays indices as at 18 June, 2018

As we head into the second half of 2018, valuations have corrected to some degree, but as Figures 2 and 3 suggest, they are still some way from appearing cheap, in our view. More importantly, liquidity tightening is set to accelerate in the coming months as the US Federal Reserve (Fed) shrinks its balance sheet and the European Central Bank's (ECB) bond purchases come to an end.

Figure 3: US P/E ratio remains elevated

Source: Robert J. Shiller, using a comparable data set to the S&P 500, as at 1 June, 2018

Figure 4: Emerging market currencies under pressure



Source: Bloomberg L.P., all currencies versus the US dollar as at 18 June, 2018

Given this backdrop, we think there are five key topics to focus on in the coming months. Our investment process is to assign cross-asset class groups to analyse these themes and form views as to how to capture the opportunities they present, which are then expressed efficiently across our portfolios.

LIQUIDITY CONDITIONS

The most important of these themes is global liquidity conditions. The removal of monetary policy support is felt particularly keenly in the international dollar funding market, where cheap leverage has been used to buy higher-yielding assets. We have already seen stress build in a few emerging markets (EMs) such as Argentina, Turkey and Brazil (Figure 4). The impact of weaker local currencies and tighter monetary and fiscal policy to combat market moves will likely have negative economic implications for the countries affected, but our main concern is how far dollar liquidity tightening spreads – and whether any large banks or asset managers are overexposed. We will be looking for signs of funding stress, likely associated with dollar strength and higher interest rates.

Importantly, we don't think the Fed will be prepared to reverse its tightening trajectory at the first sign of market weakness. As we wrote recently, the US domestic economy is less sensitive to monetary tightening than in the past thanks to a shift away from shorter-dated funding. In addition, the US economy has been boosted by tax cuts, and corporate profitability is very strong. Therefore, recent complaints of tightening liquidity conditions are likely to fall on deaf central banker ears for now.

INFLATION

Our second topic, inflation, plays an important role, too. We are fully paid up members of the lower-for-longer club, given the structural global weight of excess debt and deteriorating demographics. But there is every chance of a cyclical burst of inflation in the coming months driven by tightening labour markets, higher oil prices or even the rise of populist policies resulting in significant fiscal loosening.

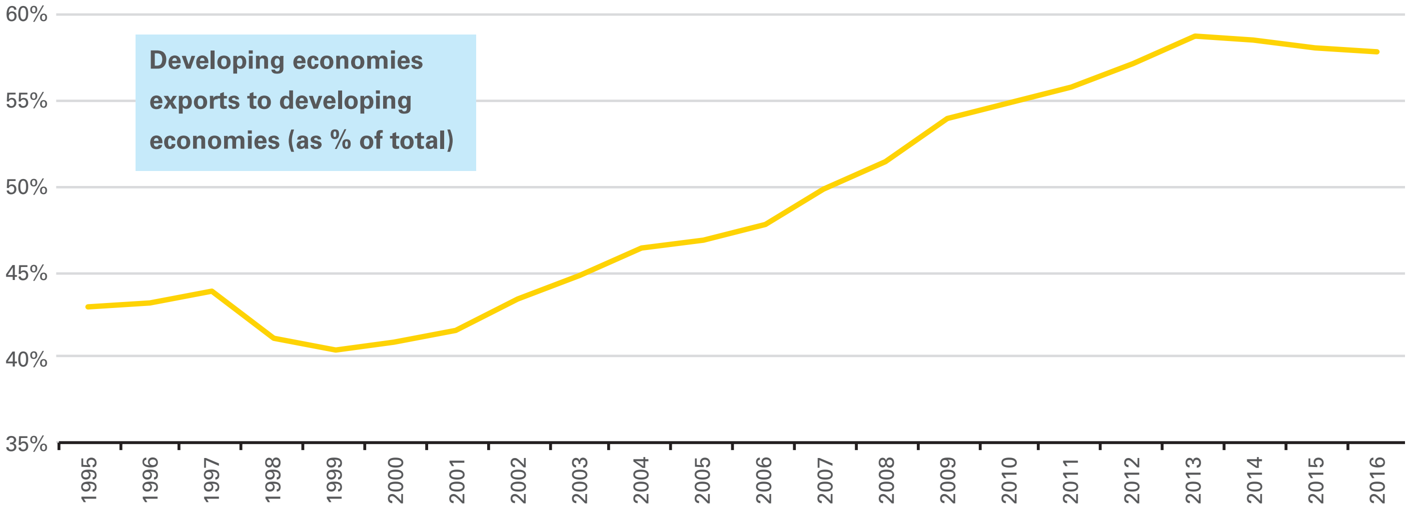
Such an unanticipated inflation spike would have the potential to accelerate monetary tightening across developed markets, and constrain central banks even when faced with market volatility.

CHINA

While Argentina, Turkey and Brazil are large economies in their own right, the most systemically important emerging market is, of course, China. Tighter dollar funding conditions also affect the world's second largest economy, not least if a rising dollar encourages capital outflows like those we saw at the end of 2015. But domestic authorities also appear to be tightening liquidity conditions to try and slow the rampant growth of debt.

China has been the creator of much of the world's debt in recent years and, therefore, can heavily influence global asset prices, funding conditions, trade etc. The key question is whether Chinese authorities will press ahead with deleveraging, or will they relent once the negative implications become visible?

Figure 5: EM relies more on EM



Source: UNCTAD

TRADE

If emerging market growth slows, then trade is very likely to suffer given the increasing importance of EM-EM trade flow (Figure 5). But there is also political tension surrounding trade, instigated by US President Donald Trump. Our focus is on signs of slowing global trade as a leading indicator for broader economic activity. Again, this is likely to be an emerging markets story to begin with, and we have already seen some indications of moderating growth after an acceleration at the end of 2017. Ultimately, we wouldn't be surprised if Trump relents once he has extracted a few headline concessions, but the damage done in the meantime could be significant.

CORPORATE FUNDAMENTALS

Our final group focuses on corporate fundamentals. As stated earlier, economic growth remains robust and **earnings have been strong**.

The US tax cuts passed earlier this year boosted profits, but even after stripping out their impact, the underlying numbers were also robust. For example, S&P 500 earnings were 23.5% higher in Q1 2018 versus the same period last year, with 7.5% being due to the tax boost, according to data from Credit Suisse. There is also decent earnings momentum across Europe (around 8% growth) and Japan (12%). A key question going forward is whether companies take the opportunity to invest in productivity enhancements and increase wages. Capital expenditure has accelerated, with the S&P 500 showing 20% growth in Q1, much of this driven by technology and energy companies. If this trend broadens, then 2018 could emerge from monetary tightening relatively unscathed. On the other hand, more share buybacks and mega mergers/acquisitions could lead to higher leverage and greater vulnerability to an eventual economic slowdown.

We look for opportunities across productivity-enhancing themes such as artificial intelligence, robotics and healthcare. But we are careful to avoid the disrupted industries such as brick-and-mortar retailers and wireline telecoms. Importantly, we think today's backdrop of tightening liquidity will accelerate disruption, both negatively and positively. This is when long-term themes play out.

FUTURE WORLD BLOG

All of our groups studying long-term themes (energy, demographics, technology and politics) as well as the teams looking at the five near-term topics described above regularly discuss their research in our recently launched **Future World blog**. We'll be posting our very latest ideas and conclusions, and we hope you will find this an engaging and useful resource in the likely volatile markets ahead.

BOTTOM LINE: VOLATILITY REMAINS ON THE RISE

In sum, we see no reason to stray far from our original 2018 outlook: volatility is increasing and markets are being whipsawed by numerous negative headlines. As a result, we suspect investor sentiment will gradually deteriorate throughout the year. Importantly, we expect higher market volatility to weigh on business and investor confidence, influencing the timing of the next economic downturn.