For professional clients only.
Not to be distributed to retail clients.

Q4 outlook: pushing through bottlenecks

We are marginally more cautious as the Chinese economy becomes unsettled and supply-chain issues persist, but retain our belief that we are in the middle of the cycle, not approaching the end.

Emiel van den Heiligenberg
Head of Asset Allocation

After cruising along for months, the S&P 500 saw a correction in September. Several narratives are intruding on what had been a sanguine outlook for global equities and a post-pandemic recovery, which clearly will determine how we position ourselves into year-end.

Firstly, there is China, where the woes at the giant developer Evergrande* stirred concerns about further defaults in the property sector and a knock-on effect on consumer confidence and local credit conditions. Another use of the government's "policy bazooka" to counter this may not be imminent. As Erik Lueth writes later in this piece, this dovetails with the concerns that began earlier in the year about the nation's regulatory crackdown, which is affecting industries from fintech to education.

Secondly, there are supply-chain and capacity issues gathering pace around the world, with cargo stacking up at major ports, some well-known companies reporting factory closures due to coronavirus outbreaks, and energy shortages driving price spikes in China and Europe. This spells a longer period of elevated inflation.

We favour buying this dip. We believe that China's issues and the adjustment of the growth and inflation mix in the developed world are priced in. Though it's impossible to tell whether we have corrected enough or not, we believe that some of the tail risks have receded recently: The US debt ceiling debate is done until December and the low probability of a disastrous default has decreased even further. We also think that the global risks of corona are ebbing, with vaccination levels increasing, some countries going for booster shots, no signs of important new variants in the past few months, vaccines holding up as defence against hospitalisations, and the Merck antiviral pill emerging as a potential game-changer -- especially for countries with a low vaccination rate.

Another tail risk that is receding comes in the European political sphere. As Lars Kreckel writes, the German election result suggests that centrist parties have been strengthened by the pandemic, and a similar tendency may be seen in France's vote next year.

*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.

LGIM

Winter is coming

Over the next few months, the inflation outlook is set to be dominated by what happens on commodity markets. US and European natural gas futures are up 35% and 90% respectively over September.[1] Another "polar vortex" driving up demand for heating over the winter could send prices spinning further into the stratosphere.

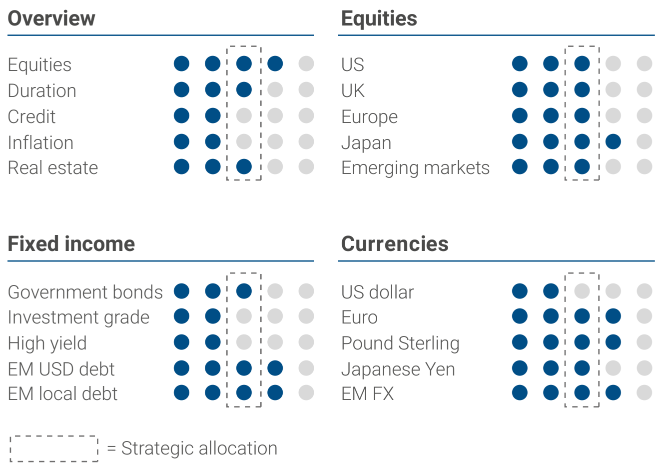
Some of our analysis, like asset performance, would suggest we are in the late cycle – except that most of the recession indicators on our heatmap are not flashing.

Moreover, we note that sentiment on equities is already quite cautious. If one is anticipating a big selloff, that's not normal. The biggest risk is inflation.

Federal Reserve (Fed) Chairman Jerome Powell has highlighted his belief that though these effects have been longer-lasting than anticipated, they will abate, and the ECB has warned about overreacting to a ``transitory'' situation. There are dissenting views: the Czech central bank delivered a shock 75 basis point policy rate increase, citing an overheating labour market.

As long as supply chain issues are temporary, rather than structural, and caused by strong demand rather than weak demand, we believe equities will be able to push through these bottleneck effects.

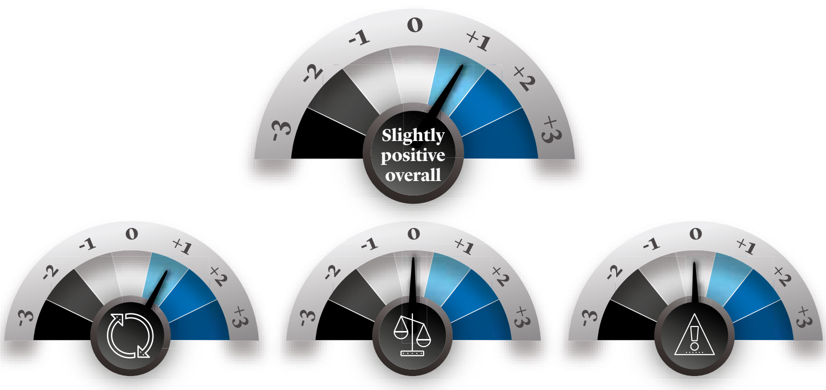
Our key asset class views



This schematic summarises the combined medium-term and tactical views of LGIM's Asset Allocation team as of 11 October 2021. 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.

1. Source: Bloomberg.

Summary of LGIM's asset allocation core view



Economic cycle

Above trend growth backed by broadly accommodative policy

Valuations

Overall neutral but relative valuations backdrop has improved slightly

Systemic risk

Political and financial system resilient through COVID-19, but new risks are emerging

Source: LGIM. Views current as at 11 October 2021. 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.

Economic cycle

- Significant slack in aggregate, with some bottlenecks
- Unemployment to continue falling into year end
- Policy support remains significant, despite upcoming taper

Valuations

- Marginal improvement in more relevant relative valuations
- Absolute valuations of equities remain above average
- Credit spreads below average and less attractive

Systemic risk

- Impressive institutional resilience in the last year
- Troubled relationship between US and China
- Concerns around house prices, Chinese high yield, politics

Lars Kreckel
Global Equity Strategist

Political risks in Europe: keeping calm and carrying on in the centre

Europe is emerging from the pandemic with a much more stable political environment than it had after the financial crisis.

Those two traumas are clearly not directly comparable, but nevertheless one of the contributing factors to stability this time has likely been the much more aggressive use of fiscal policy, rather than reliance on monetary policy alone. Furlough schemes and other support measures have helped protect voters from extreme financial outcomes. This, in turn, has likely helped quell the appetite for political change, limiting the appeal of populist parties on both sides of the political spectrum.

This dynamic played out in the German election, where it seems voters chose change and the status quo at the same time. The CDU may have lost, but Germans have given a mandate to a broad coalition of centrist parties, even if the precise make-up of the next government remains unclear. The main losers of the election were the fringes on both sides. AfD, on the right, and Die Linke, on the left, both lost support compared with the last election.

French connection

But the true test for whether the political calm in Europe persists will be next year's French election. Predictions this far out must be taken with a pinch of salt, given the many twists and turns five years ago. So far, however, incumbent President Emmanuel Macron appears to be in pole position, with his approval ratings at reasonably healthy levels. The populist fringe's failure to appeal can perhaps also be seen in Marine Le Pen's National Rally party, which has deliberately shifted towards the centre. This strategy could result in losing some support on the far right to new challengers; any resulting vote splits on the right could also end up strengthening the centre.

Another development to watch will be whether there is another wave of refugee flows from Afghanistan or elsewhere. This likely won't become a potential issue until after the winter, but the last time it did, around 2015, it was a contributing factor to the rise of populist parties.

From a market perspective, there are two potential implications from the political outlook. Firstly, the political risk premium in Europe may stay lower than it was over the past cycle. This trend is not firmly established, and will be tested in future elections. But if it holds, then the risk of fringe parties gaining power – and pursuing unpredictable policy outcomes such as EMU break-up – could be lower for now.

Secondly, the lesson political leaders will likely learn from this experience is that fiscal policy works, or at the very least, that spending is a winning strategy at the ballot box. The consequences of this may be that come the next downturn or crisis, the threshold to use fiscal policy to soften the blow for voters will be far lower than it was in the past.

Erik Lueth
Global Emerging Market Economist

China's regulatory crackdown: a new Cultural Revolution?

This year, China's leadership launched a regulatory crackdown that affected a wide range of sectors, including fintech, property, internet firms, education, and gaming. The list is likely to expand in the months to come, with the beauty industry rumoured to be next.

The campaign has led to a marked underperformance by the Chinese stock market, with the tech index down about 35% down year to date,[2] as at the time of writing. Investors caught unaware have called China uninvestable, and some commentators have drawn comparisons to Mao Zedong's Cultural Revolution.

The crackdown has been painful for equity investors and will certainly weigh on short-term growth. There are also instances of overreach that will raise eyebrows abroad, such as the ban of 'effeminate men' from TV.

But, all in all, the regulatory campaign fits into the nation's broader development strategy, and could put long-term growth on a firmer footing, in our view. The thread that runs through the initiatives is to make growth more sustainable: less prone to financial crisis, more equitable, geared towards innovation.

Take financial soundness. The business model of fintech companies had been to identify credit-worthy borrowers, rather than provide the loans, which was left to the banks. Perhaps inspired by the lessons of the US subprime crisis – the danger posed by credit originators without skin in the game – regulators demanded that fintech companies maintain 30% of their loans on their balance sheet, which requires more capital and limits growth. Overstretched property developers pose similar threats to financial stability, which explains the imposition of leverage caps.

Bringing innovation home

We have talked elsewhere about the mechanisms that propel inequality in fast-developing economies. The crackdown on private tutoring and the effort to rein in runaway property prices are attempts to counter these centrifugal forces. Similarly, the clampdown on internet giants aims to level the playing field between corporations and consumers – similar to antitrust actions that are underway in Europe and South Korea.

The more assertive stance of the US and Europe has highlighted the need for home-grown innovation in China. And that innovation is seen to emanate primarily from the manufacturing sector, as opposed to the services, consumer, internet or property industries. For China, reining in excesses within those latter sectors not only serves financial and social stability, but also channels resources to where they are most productive.

So what is the bottom line? China is not about to abolish the private sector or markets – the original sin of the Soviet Union. Rather, it will likely continue to use markets and the private sector to achieve broader social goals. Its regulatory reset is certain to affect short-term growth, but by furthering financial stability and by softening the sharper edges of inequality, we believe it should put long-term growth on a sounder footing.

Chinese asset markets remain quite interesting. We are fairly bullish Chinese government bonds as we believe they provide diversification, a reasonable yield and a central bank that is loosening monetary policy. Given the recent selloff, Chinese equities are starting to get more interesting, in our view, but we want to be patient until we see more forceful policy support.

2. Source: Bloomberg

John Roe
Head of Multi-Asset Funds

How 2022 could reveal a new macro world

Extreme shocks and the huge stimulus that tends to follow them can change longer-term macro dynamics once the event itself has cleared.

For example, after the Global Financial Crisis (GFC), we saw structural deflationary forces and a growth drag from austerity for many years. So, what might the post-pandemic period look like, and why?

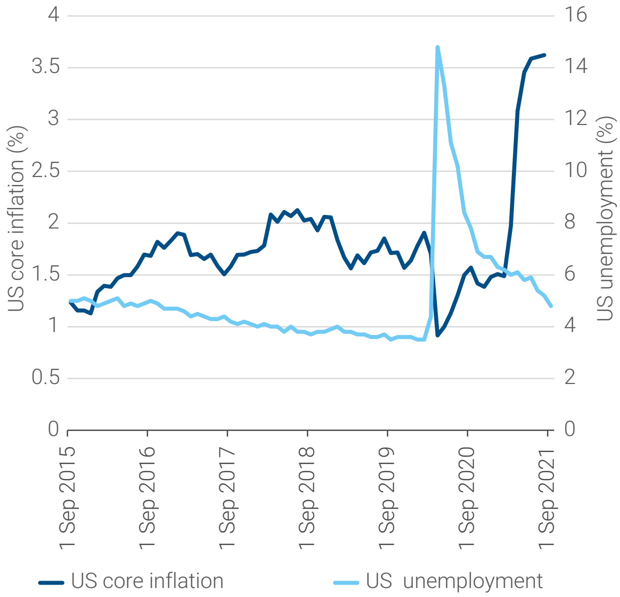
After the GFC, most of the stimulus was monetary. But since COVID-19 emerged, we have seen unprecedented levels of fiscal support from developed nations' governments, and US consumers have built cumulative excess savings of about 11% of GDP, according to LGIM calculations. In Europe, that figure is less, at 6%, but the Recovery and Resilience Facility is on the way, which according to European Commission figuress to about 5% of GDP. There are also the ongoing infrastructure and spending discussions in the US, with a potential net fiscal stimulus of 1% of GDP per year over the next few years.

The infrastructure plans in both regions will span several years, offering structural support for the economy for the next three to five years at least. Looking back at similar spending in the US from 2009, two-thirds was spent more than 18 months after the stimulus deal was agreed.[3]

Inflation conundrum

Against this supportive backdrop, in 2022 we will probably get a much clearer picture of the labour market. It may be that people want to work less – whether that's through earlier retirement or shorter working weeks. There have also been shifts in demand that have left certain skills in short supply. In addition, demand for labour may be boosted due to the ongoing decoupling of parts of the Chinese and US economies. In early 2020, US unemployment had shrunk to just 3.5%, with limited signs of sustained wage inflation, but this time there seems to be a lot more wage pressure despite unemployment at 4.8% with a potential net fiscal stimulus of 1% of GDP per year over the next few years, according to LGIM calculations. We'll see in 2022 how much of this is transitory and due to ongoing pandemic disruptions -- or if we're entering a new status quo.

US unemployment and core inflation



Source: Bloomberg, 30 September 2021.

Of course, there are also strong arguments that COVID-19 could result in deflation, not inflation, over the medium term. There has been the faster adoption of technology – a deflationary force. The last 18 months have shown how effective remote working can be, opening much more potential for intra-country and inter-country outsourcing and decentralisation. Jobs that many firms thought could only be done from major cities could now be done from a remote forest (indeed, I worked from one throughout the summer.)

On the fiscal side, we've also seen a few countries start to tighten, like the UK. In the US, some more conservative Democrat politicians, notably Joe Manchin and Kyrsten Sinema, are sceptical about the extent of their colleagues' spending plans.

The bottom line is that it is hard to take a strong view on the directionality of the changes, and the uncertainty is abnormally high as the impacts from the pandemic shock and its responses play out. We could be heading for a stagflationary outcome, where inflation is structurally higher and central banks are forced to raise rates and slow growth to combat price increases; or, alternatively, we could be heading for an acceleration of pre-pandemic trends, with further deflationary pressures building and fewer tools left to fight it – in Europe, in particular.

As ever, within the Asset Allocation team, rather than seeking to predict any one outcome, we will prepare for a range in line with our economists' guidance and the prevailing market environment, as we aim to meet our clients' objectives.

3. American Recovery and Reinvestment Act (Feb 2009), https://fas.org/sgp/crs/misc/R46343.pdf

Contact us

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

Key risks

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. Views expressed by LGIM as at October 2021

Legal & General Investment Management Asia Limited, Unit 5111-12, Level 51, The Center, 99 Queen's Road Central, Central, Hong Kong. www.lgim.com

D002160_ASIA