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Q4 2024

Active Fixed Income Outlook: America decides

LGIM

The world holds its breath

Colin Reedie
Head of Active Strategies

Global central banks have begun cutting rates – but the chief market determinant is sure to be (another) generationally consequential US election.

At the time of writing, markets are enjoying a powerful mix of US monetary policy easing and now Chinese policy stimulus. Their reaction to these crucial events is helping us build a picture of the potential shape of the next economic cycle.

As the US Federal Reserve (Fed) finally switches its focus from inflation to employment, markets have been quick to price in a bout of aggressive policy easing.

The case for owning duration now is that it offers good insurance value as long as the 'disinflation' story remains intact. If investors find it hard to get concerned about the risks of resumed high inflation, the correlation between risk-free and risky assets should be negative (in other words, helpful). As a result, we have continued to run unconstrained fixed income funds long on duration and long in credit.

We don't believe there's any mean reversion in nominal yields – just because they went down doesn't mean they'll go up, and vice versa. We aren't buying into the narrative that they'll magically go back up just because they've gone down a lot.

We also don't buy into the idea that the pace of cuts that's been priced in cannot be delivered in reality. In fact, we're not focusing much on the pace of cuts at all. We're much more interested in the level rates will be at when the cuts stop – where will the neutral point turn out to be? And until rates markets start pricing below the range of plausible estimates from 'sensible' economists, we continue to think there's room to rally.

At the same time, a deteriorating geopolitical backdrop can provide further support for rates (and by extension, fixed income). So too can any further signs that the US economy is seeing uncertainty in the outcome of the Presidential election impacting growth. Delayed decision-making from companies could lead to reduced capital formation, even if the consumer remains robust. Increased risk aversion among investors could also become a factor.

At the start of the year, many highlighted the number and significance of the elections we would see this year. Some two thirds of the world's population will have gone to the polls by the end of 2024. To us, the most striking observation is that austerity has not been on the ballot in any of them.

If we see further evidence that fiscal policy will remain policymakers' primary economic growth stimulant in the next cycle, then the landscape will look very different to what many market participants have experienced before.

The latest cost estimates for Kamala Harris's policies come to around $1.8 trillion added to the 10-year deficit. Donald Trump's will add $5.8 trillion. When could markets say enough is enough? Either way, it all helps paint a picture of a shorter, more volatile cycle than we have seen since the late 1980s. We think there is a plausible path to rising interest rates far earlier than currently expected.

Overall, the possibilities that exist within fixed income markets in an environment like this are fascinating. As ever, our mantra is that we cannot predict – only prepare.

The LGIM credit scorecard

▲ Upgraded ▼ Downgraded ▬ Unchanged

Strategy	Score (This month / Last month)	-3	-2	-1	N	+1	+2	+3
UK credit	N, Unchanged	-3	-2	-1	**N**	+1	+2	+3
US credit	N, Unchanged	-3	-2	-1	**N**	+1	+2	+3
Global credit	N, Unchanged	-3	-2	-1	**N**	+1	+2	+3

Source: LGIM as at 14 October 2024 - can be subject to change at any point.
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European credit: Staying cautious

Marc Rovers
Head of European Credit

Lan Wu
European Credit Portfolio Manager

After market jitters in late summer, we are positioning cautiously in the absence of hard data indicating central banks have achieved a 'soft landing'.

The past: what just happened?

Developed market government bond yield curves fell lower and steepened significantly in the third quarter of 2024 as they priced in a faster pace of interest rate cuts now the easing cycle has begun. European investment grade credit spreads remained broadly unchanged, though there were short-lived periods of significant volatility around the European Parliamentary and French elections, US labour market data prints, and the unwinding of Japanese currency-related trades.

Since October 2022, credit spreads have been greatly supported by the volume and consistency of inflows into the asset class, which appear to have accelerated recently despite the fall in yields. This could be down to investors hurrying to lock in yields at their current levels in anticipation of them falling further.

This has also been supportive against the backdrop of the historically largest-ever volume of new bond issuance by this point in the year[1], and the ECB (European Central Bank) not reinvesting the proceeds from the maturities of bonds it holds. In June, the ECB cautiously began its rate-cutting cycle as backward-looking inflation and inflation expectations data suggested sufficient progress was being made.

The US Federal Reserve has only recently followed on; strong growth in the US had suggested there was no rush to cut and the fear remains that inflation could reaccelerate if they act too soon.

The present: key themes

The conversation in fixed income has long been around whether central banks around the world can bring down inflation without triggering recessions. Markets are currently highly sensitive to data that might suggest labour markets or growth are weakening. Consequently, Euro credit spreads have moved off the tights of the summer and are in our view attractive in comparison to sterling and US dollar spreads. At the time of writing, they're sitting around the 46th percentile – although we still don't feel they have priced in the risk of a recession sufficiently[2].

To reflect our cautious view, our portfolios are positioned with a skew towards higher quality, in terms of ratings and parts of the capital structure, and we are using little of our flexibility to reach for portfolio risks outside of the investment universe defined by our benchmark indices. The BBB:A spread differential has recently compressed significantly[3], so the forgone spread from being underweight BBBs versus As is less than it would otherwise have been.

Real estate issuers have performed well as the path of financing costs has improved with expectations of interest rate cuts and banks have seen their spreads compress versus non-financials, so we have been reducing our exposure to issuers in both sectors. As a result, we have more liquidity in the portfolios to allow room to opportunistically buy should a significant sell-off materialise. Other existing themes remain in place, such as our overweight to utilities, underweight to automobile companies, and focus on bottom-up issuer selection.

1. Source: Bloomberg as at 24 September 2024
2. Source: Bloomberg as at 24 September 2024
3. Source: Bloomberg as at 24 September 2024

What could go wrong?

There is a lot of uncertainty at present: inflation is steadily coming down, but if central banks have cut interest rates too early or if geopolitical events cause oil prices to rise, inflation could reaccelerate. Growth appears to be holding up and labour markets haven't cracked, but that could still happen. The outlook for the US economy may be affected by the result of the election in November, and it remains to be seen if asset class flows will be affected by changes to investors' asset allocations as yields trend downwards. To echo the comments from last quarter: these are things to prepare for rather than predict...

Outlook

We expect market nerves to continue through the fourth quarter and that 'no news will be good news' if data releases continue to not provide any deviation from survey expectations. Corporate strength largely hinges on the health of the global economy, so we'll be looking for clues on broader economic performance in third quarter earnings. We prefer less cyclical sectors and ensure we own credits we are comfortable with based on their fundamentals as we wait to see if the 'soft landing' is achieved – or if we need to brace for a 'hard landing'.

The LGIM credit scorecard

▲ Upgraded ▼ Downgraded Unchanged

Strategy	Score						
	This month	Last month					
European credit	-3	-2	**-1**	N	+1	+2	+3

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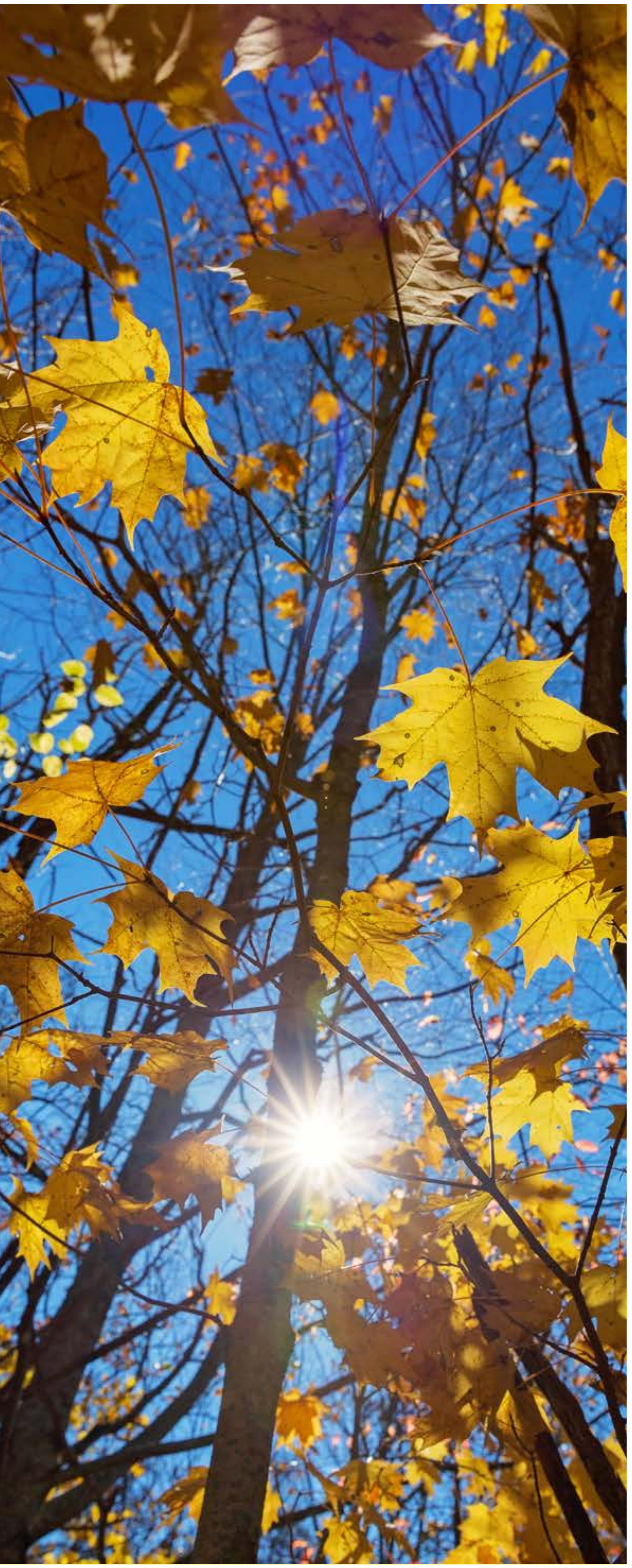

Global high yield: Will the good times last?

Martin Reeves
Head of Global High Yield

Sophia Hunt
Fixed Income Product Specialist

Falling fears of recession and rate cuts have made for a good period for high yield – but will they continue?

The past: what just happened?

Despite fears of recession abating, investors were caught somewhat off guard by the dovish pivot from the US Federal Reserve (Fed). The statement from Fed Chair Jay Powell reinforced his intention to halt aggressive rate tightening, given firm evidence that inflation was on a declining trend, and despite tight labour markets. High yield markets were weaker toward the end of last year, although November and December saw two strong return months, helped by a return to a more risk-on environment.

The US economy continued to surprise with growth, though the third quarter was dominated by market expectations of the Fed starting to cut rates and debate on what speed. In this environment, high yield markets have continued to perform strongly with strong returns over the summer months.

The present: moving away from recession fears

The strategy continues to target a higher income than the comparative benchmark, expressed through an overweight position in higher spread global names. Our view remains that spreads adequately compensate for the degree of credit risk undertaken (see outlook).

From a regional perspective, we have started to reduce exposure in Europe, rotating back into the US, with emerging markets constituting our largest overweight position. From a sector perspective, our focus on the 'core' part of the economy remains, with an overweight exposure to the consumer, services and industrial sectors. Conversely, we have underweight positions in the global automotive, utilities and shipping sectors.

Outlook

As we move into a rate cutting cycle, we believe this will be supportive for the consumer and the economy – both for the US and globally.

Earnings for companies have been going well and we think they are unlikely to fall as much as expected. In this environment we expect the default rate by issuer to continue to remain low. There shall doubtless be a focus on the US presidential election in the near term, where the result could have important implications for fiscal policy, inflation and bond yields. Though with clarity after a number of elections globally and interest rates being cut around the world, we think there will be a pickup in M&A, creating potential income opportunities for the high yield investor.

The LGIM credit scorecard

▲ Upgraded ▼ Downgraded ▬ Unchanged

Strategy	Score (This month / Last month)						
Global high yield	-3	-2	-1	N	+1	**+2** (this month; last month: +2, unchanged)	+3

Source: LGIM as at 14 October 2024 - can be subject to change at any point.
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Emerging market debt: Geopolitical risks but strong fundamentals

Raza Agha
Head of EM Sovereign Strategy

Viraj Nadgir
Fixed Income Investment Specialist

It's been a stellar year for EMD and the resilience of the asset class has been demonstrated by its weathering successive crises. There are risks in unpredictable events, and the global macro direction is key.

The past: what just happened?

The early August selloff due to the Bank of Japan's rate hike and weaker-than-expected US jobs data turned out to be short-lived as macro data released the same week supported a 'soft landing' scenario in the US. Coupled with the ongoing narrative of the US rate-cutting cycle, this has continued to drive positive returns in emerging market debt (EMD).

While the high yield (HY) segment within EMD has been the outperformer in the year to date, more recently, the above has helped investment grade (IG) returns outpace HY across both sovereigns and corporates.

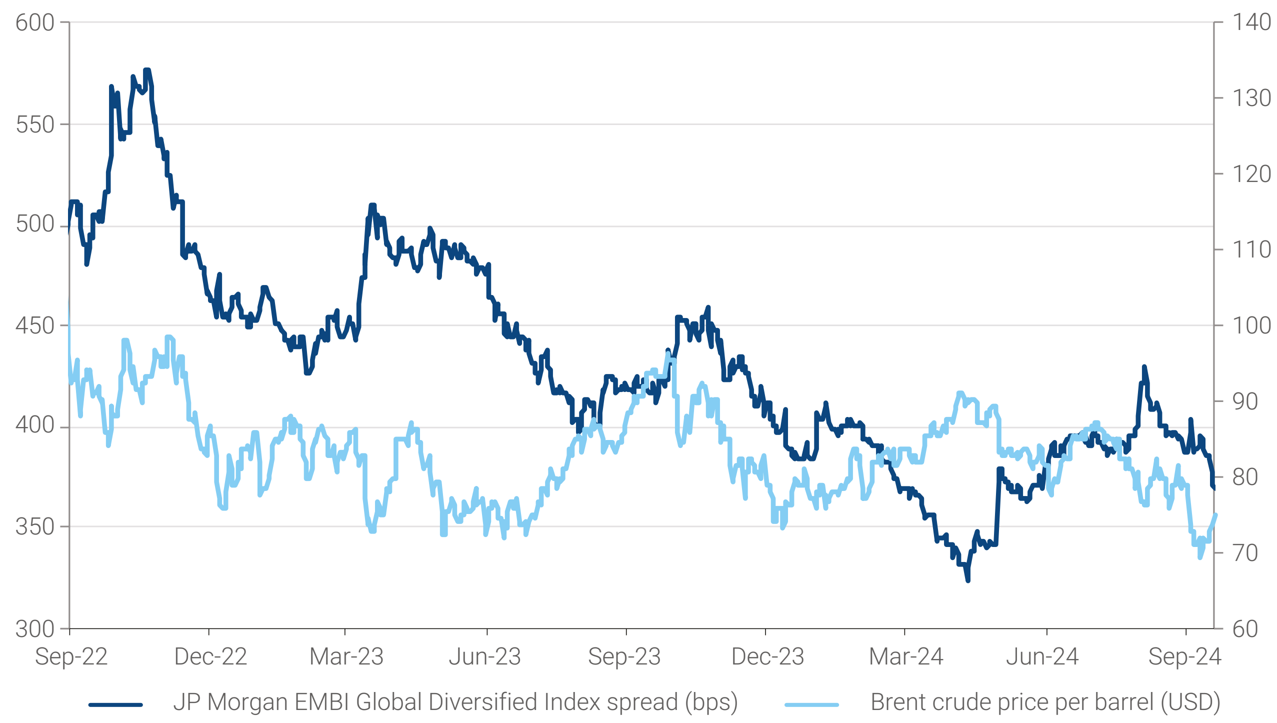
The present: value creation?

Sovereign spreads are relatively unchanged over the year[4], even if we include the impact of Venezuela in the index. This largely reflects spreads in the IG space, at the time of writing c.10bps wider than their post-financial crisis tights[5]. Meanwhile, not only did high yield have more value to begin with, but with it having lagged spread compression recently, this has created value in selected sovereigns. This may represent a good opportunity to add some high-yielding names that provide attractive carry to the portfolio, particularly where we assess default risks to be muted.

However, issuance has also been strong. The sovereign primary market was busy in September, with issuance concentrated in the IG space. This looks set to continue in the near term, as issuers are likely to want to borrow before US elections and as high yield issuers catch up. This could keep high yield from performing, which could see value returning in sovereigns for selected credits.

Oil prices have dropped to around $70 a barrel, close to the lows seen in late 2021 and driven by concerns about the growth outlook in major economies, notably the US and China. This has led to oil exporters – both in the IG and HY space – lagging the broader rally we have seen in EM credit. Looking ahead, a potential floor in oil prices imposed by OPEC could open attractive opportunities in credits we assess as having the ability to withstand lower oil prices.

Emerging market spreads vs oil price



Source: Bloomberg as at 18 September 2024
Past performance is not a guide to the future.

In corporates, the expected negative net financing for 2024, stable corporate fundamentals and declining default rates has continued to support spread compression. A theme this year has been increased issuance in EM banks' subordinated debt. In the year to date we have seen a supply of $25.7bn USD, as compared to $9.8bn in 2023 and $9.6bn in 2022[6]. We believe the asset class offers attractive risk/reward profiles and provides significant yield premium in our portfolios – without the worry of default risk. That said, we do note that the US Federal Reserve (Fed) cutting cycle could lead to further issuance in this space.

4. Source: Bloomberg as at 18 September 2024
5. Source: Bloomberg as at 18 September 2024
6. Source: Bank of America as at 30 September 2024

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What could go wrong?

With relatively strong growth dynamics, comfortable external sector positions, rating upgrades outpacing downgrades and improving market access, we believe any near-term risks for emerging markets are largely exogenous. Global macroeconomic factors are key, in particular in the United States. As the Fed begins its rate-cutting cycle, if the market interprets any larger-than-expected cuts as a sign of a weaker-than-anticipated economy, this could lead to a wider sell off in risk assets.

In addition, November's US election – which remains too close to call – adds another layer of uncertainty around the outlook for the US dollar and rates. Although we expect the Fed cutting cycle and a renewed focus on growth differentials between emerging markets and developed economies to aid inflows, the evolution of US rates and the dollar are key considerations.

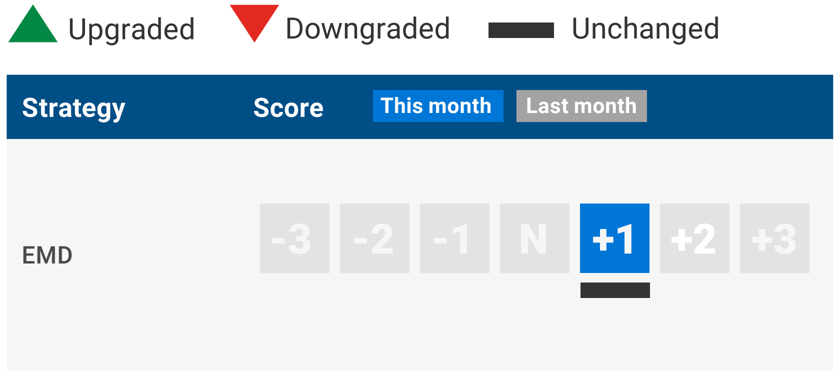
Finally, looking at muted market reactions, investors appear complacent around geopolitical risks. This contrasts with the situation on the ground in both major ongoing conflicts. The Russia-Ukraine war has taken a new turn with the latter's incursion into Russian territory and reports that the West may consider allowing Ukraine the use of long-distance weapons to hit targets inside Russia. This could in turn lead to a new level of Russian belligerence.

In the Middle East, recent developments have led to renewed fears of the conflict expanding yet further. Needless to say, both conflicts warrant close monitoring, all the more so as valuations in the region do not compensate for negative scenarios.

Outlook

We believe the baseline scenario for the outlook in EM is constructive. Idiosyncratic risks within EM are muted, with credit fundamentals improving, as reflected in rating upgrades outpacing downgrades. EMs are proving resilient on the back of institutional reforms, stronger balance sheets and with the experience of having been through a range of crises these past few years, including Covid-19 and an aggressive Fed tightening cycle unprecedented in over two decades. Overall, as long as the US economy does not slip into recession, we believe the fall in US rates will only add to the already stellar year-to-date EM returns.

The LGIM credit scorecard



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Research and Active Engagement: Investing in a world in turmoil

Madeleine King
Head of Research and Active Engagement

There are a number of potential global flashpoints that, should the worst happen, would impact our portfolios. We are conducting detailed modelling exercises to prepare.

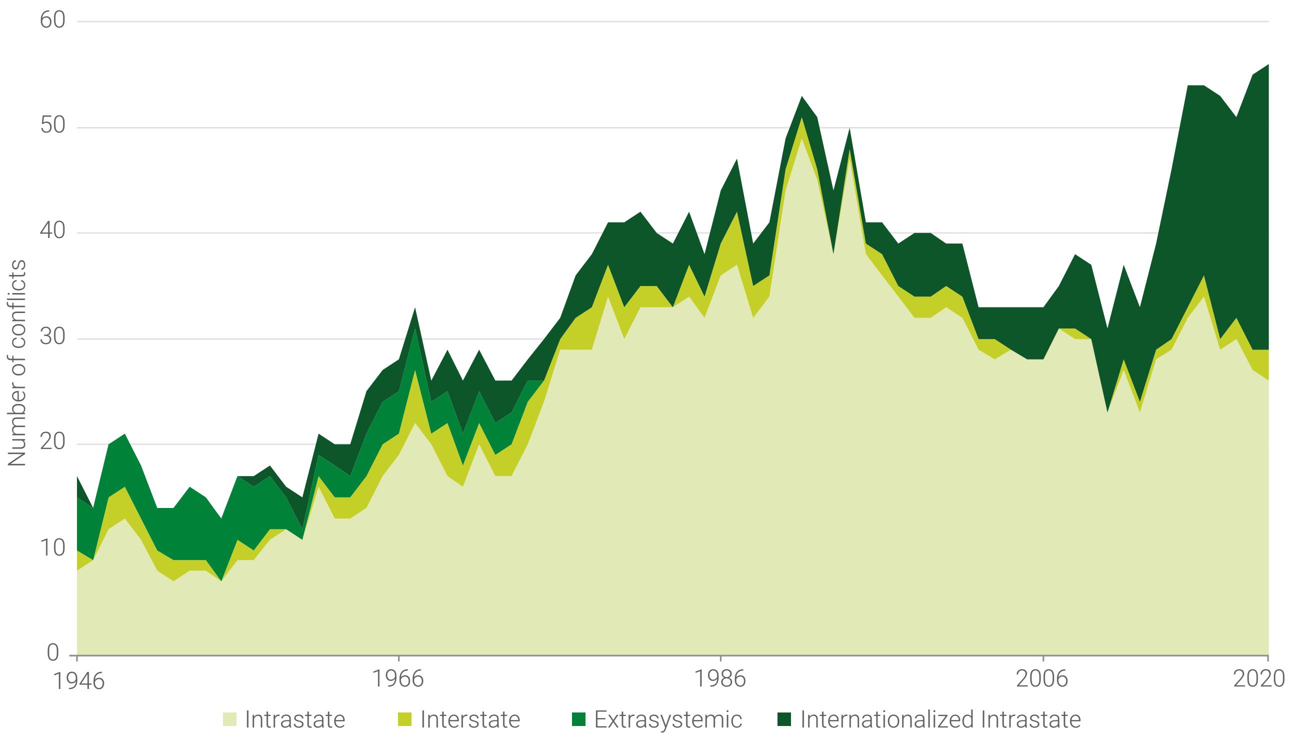
In November, the US will go to the polls in what is likely to be a tightly contested election. Whatever the outcome, the implications will reach far beyond the nation's borders given the US's key role in global conflict management at a time when the world is the most conflicted it has been since World War II[1].

Financial markets are bad at pricing geopolitical risk, especially in relation to conflict.

1. Source: According to the Global Peace Index, there are currently 56 conflicts in the world, the highest level since World War II. Conflicts have become more international with 92 countries involved in conflicts outside their borders, the most since the GPI's inception. "The rising number of minor conflicts increases the likelihood of more major conflicts in the future".

Global Peace Index 2024, Institute for Economics & Peace; GPI-2024-web.pdf (visionofhumanity.org)

Number of conflicts by type, 1946–2020



Source: UCDP/PRIO Armed Conflict Dataset

Investors tend to underestimate the probability of conflict, in part because most of us based in developed world are fortunate enough to have grown up in unusually peaceful times on our home soil. In addition, as financial analysts we are accustomed to evaluating potential actions and outcomes based on an economic rationale. This is inherently different to the drivers of the various government decisions that may lead to armed conflict – the considerations when deciding to invade a neighbouring country are not the same as those driving a company to pursue a takeover bid or to invest in a high-risk project.

Acknowledging our biases as investors is hugely important in making the right decisions for our portfolios.

Instinct tells us that war isn't good for anyone and that the status quo is the highest probability outcome, but we need to be prepared for the possibility that we are wrong.

When we prepare for future volatility, we find it useful to stress test our portfolios for a wide range of possible future events, even if we consider these to have a relatively low probability of occurring.

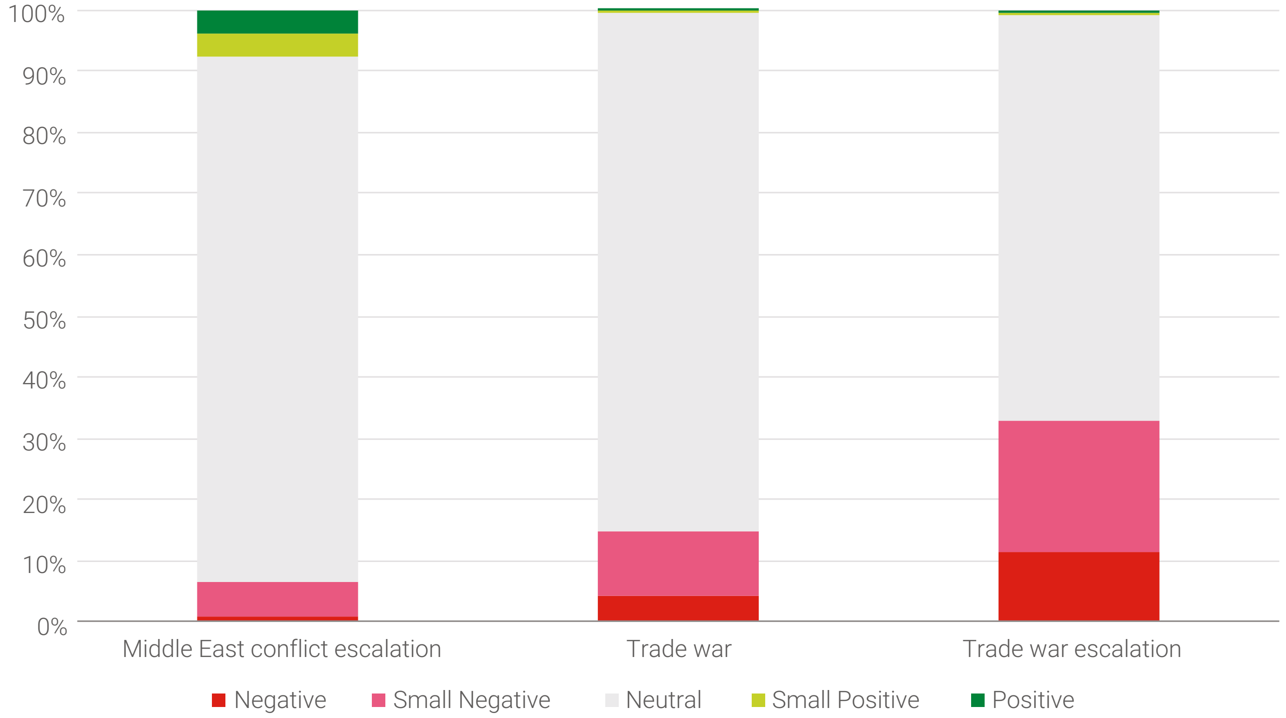
In our latest stress test exercise, we considered three geopolitical scenarios:

- An escalation of tensions in the Middle East, leading to a direct conflict between Israel and Iran, but without drawing in the broader region
- A trade war between China and the US involving a broad-based imposition of tariffs
- A Taiwan-related incident that leads to a breakdown of relations between China and the West

We began by considering the direct financial impacts of these possible events on the companies in our investable universe – the expected lost revenues and higher costs.

In our view, a Taiwan-related conflict is the most impactful in terms of the economic cost to the companies that we invest in, with supply chain disruptions affecting a broad spectrum of companies across the world. We have assumed a major disruption in semiconductor supply in particular, given Taiwan's critical position in the industry.

Scenario stress test (all corporates)



Source: LGIM as at 14 October 2024

From a financial perspective, the second order effects of these scenarios are much more significant for our portfolios. In our opinion, any one of these geopolitical events could lead to a global recession, and could have major repercussions for long-term trade patterns and investment.

As investors, it is increasingly important that we factor in geopolitical risk into our portfolios. As mentioned elsewhere in this document, we believe in preparation - not prediction.

Contact us

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

Key risks

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