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Q3 2023

Active Insights: Walking the line

LGIM

Walk the line

Colin Reedie
Head of Active Strategies

As policymakers attempt to thread the needle, we continue to favour a combination of high-quality credits and risk-free duration. We believe the latter not only offers potentially attractive returns in the event of a recession, but could also serve as an effective cushion against market volatility.

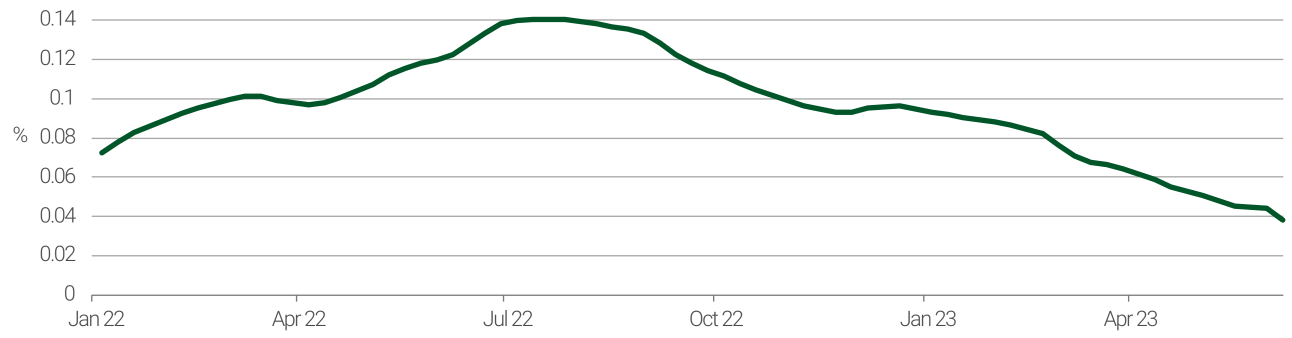
It's been well over a year since global central banks began hiking interest rates in response to the post-pandemic bout of inflation.

With monetary policy biting, we've seen both stress in the banking sector and a significant tightening of financial conditions on both sides of the Atlantic. Borrowing has fallen significantly as interest rates have risen, as we can see in the charts opposite.

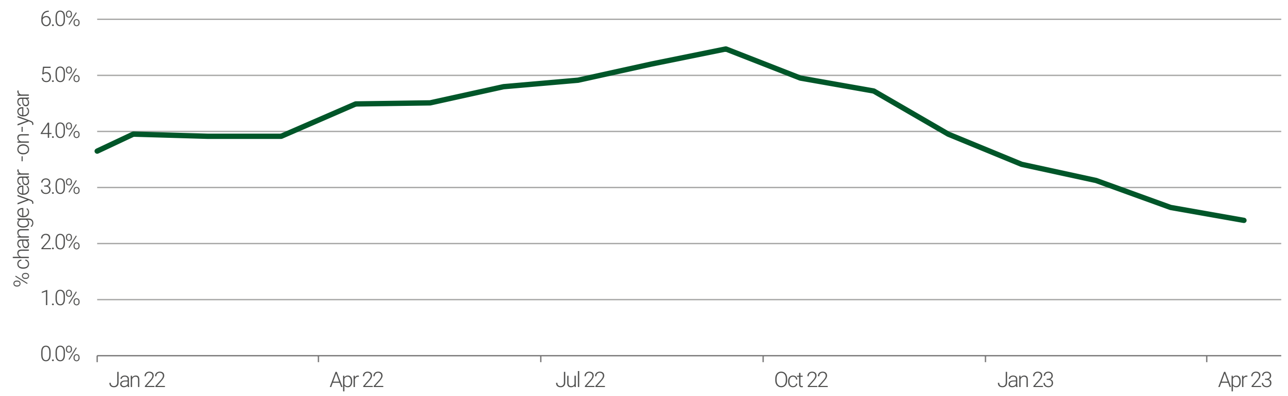
As the screw tightens, we see potential opportunities for fixed income to rally.

Although we like the combination of credit risk and duration risk, we're taking a more cautious stance on credit risk in isolation.

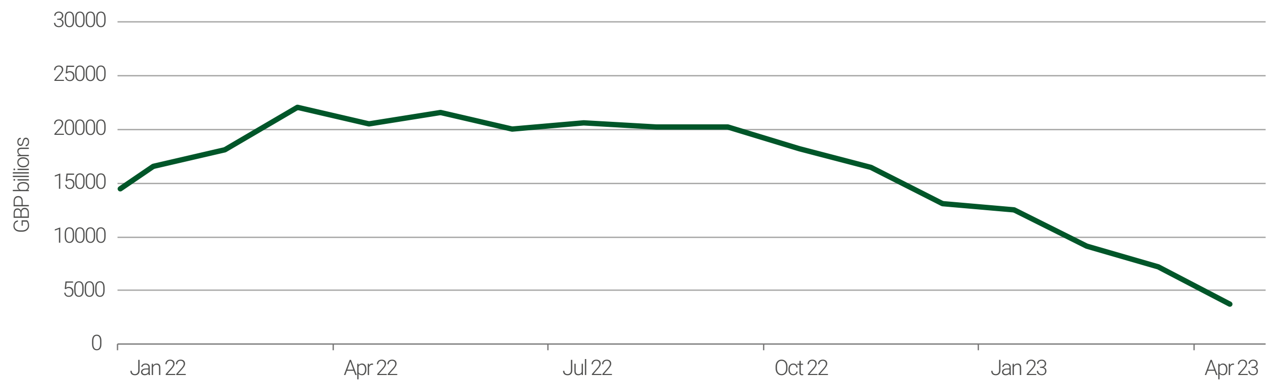
Stock of outstanding loans at US banks 3m/3m, annualised (adjusted for SVB bankruptcy)



Credit to private sector in euro area, % year-on-year



Net lending to individuals, UK £bns (3m sum)



Source: LGIM, Bloomberg as at 22 June 2023

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Where could the opportunities lie?

In short, we prefer fixed income markets. As we see in the chart below, the negative correlation between risky and risk-free assets has recently returned, and we think this is set to continue as long as recession risks remain high.

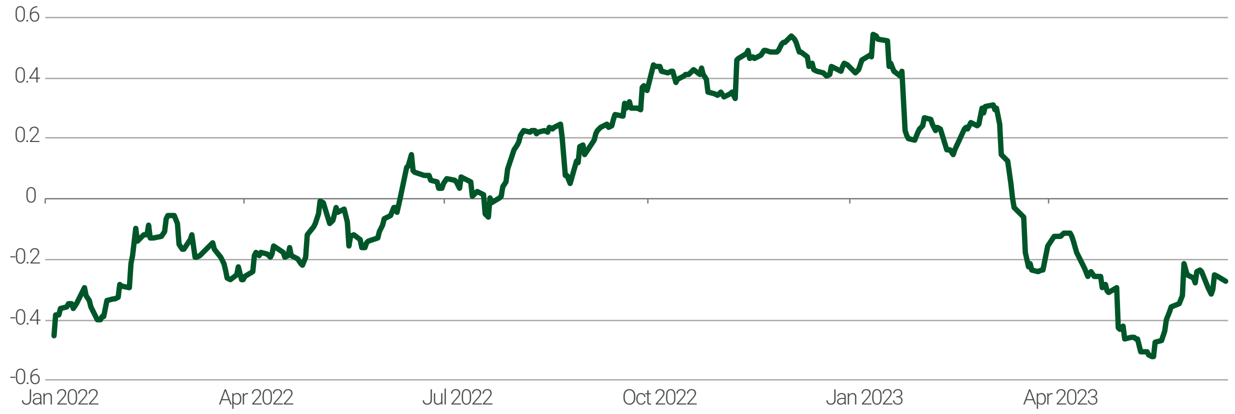
Although we like the combination of credit risk and duration risk, we're taking a more cautious stance on credit risk in isolation, and we maintain our negative stance on long-term global credit risk.

The current pricing of credit risk isn't telling us much in isolation; credit spreads remain near the middle of their historic ranges, as we can see below.

Our cautious view is instead derived from a view on the fundamentals. We believe that monetary policymakers are increasingly reacting to backward-looking data points like inflation and wage data, and that a focus on this type of data is bad for economic stability.

The problem is that it's hard not to instinctively keep reaching for the cold tap when you're in a scalding hot shower – or indeed an overheating economy.

Correlation between S&P 500 and US 7 Year Treasury returns



Source: LGIM, Bloomberg as at 22 June 2023

Long-term spread percentile analysis

Source: LGIM, Bloomberg as at 22 June 2023

Key risks: Past performance is not a guide to the future. The value of any investment and any income taken from it is not guaranteed and can go down as well as up, and investors may get back less than the originally invested. Assumptions, opinions and estimates are provided for illustrative purposes only. There is no guarantee that any forecasts made will come to pass.

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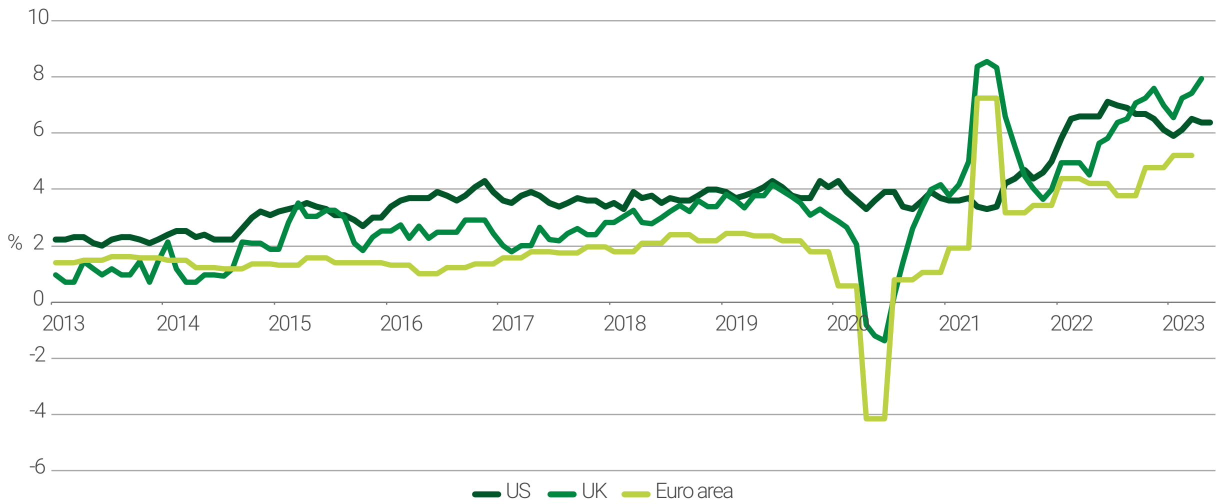
The Bank of England's Monetary Policy Committee has found itself backed into a corner, forced to respond to persistently high inflation with the only tool at its disposal. The higher they drag rates, the longer and deeper any resulting recession is likely to be, but circumstances have forced the Bank to ignore its prior warnings of weaker growth and keep upping rates.

Central bankers love to say that "monetary policy operates with long and variable lags", but they're acting as if turning the cold tap on should have an instant impact on the temperature of the water. When policymakers are acting like this, we remain particularly concerned about the shower suddenly turning cold.

We can't know for sure what will happen, but we do know that the combination of recession and higher rates is likely to put downward pressure on corporate earnings, in turn pushing credit risk up.

Wage growth



Source: Macrobond as at 22 June 2023

Walking a narrow path

We acknowledge that the path to positive returns from credit is narrow, and must navigated thoughtfully. As corporates and consumers alike reckon with the growing cost of debt servicing, it is inevitable that chips will start falling.

The turmoil we saw in the global banking sector and, closer to home, the troubles at *Thames Water together serve as stern reminders that high levels of scrutiny are more important in our credit research process than ever.

We believe that it is likely that most companies will survive the next cycle – but some won't.

And we still don't know how cold the water will get.

*For illustrative purposes only. The above information does not constitute a recommendation to buy or sell any security.

Banking stress: What did we learn?


Dan Haut
Senior Research Analyst


Dan Lustig
Senior Credit Analyst


Matthew Rees
Head of Global Bond Strategies

The early months of 2023 were characterised by turbulence in the banking sector on both sides of the Atlantic; here we break down what the fallout could be for the rest of the year.

With three of the four largest-ever bank failures in the US occurring in first quarter of 2023, attention has returned to risks in the American banking sector. All three banks succumbed to the classic bank killer: a lack of liquidity.

SVB faced unprecedented deposit outflows after crystalising unrealised losses on its available-for-sale bonds and failing to raise equity. This led to pressure on other names with similar positions and homogenous deposit bases. While the acute phase of liquidity stress for US regional banks appears to have passed, focus remains on the sector as it faces likely earnings pressure driven by higher funding and regulatory costs.

With asset-liability mismanagement flagged as a key factor in these failures, liquidity will be a focus of a forthcoming package of regulations, with banks and regulators alike surprised by the speed of deposit outflows in the digital age.

Bank run like the wind

A key liquidity ratio for banks is the Liquidity Coverage Ratio (LCR), which measures liquidity to stressed outflows over a 30-day period. When major deposit outflows occur in 30 hours, retaining 30 days of liquidity becomes less important. We expect regulators to focus on shorter-term liquidity and to require banks to hold more than they are currently obligated to.

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We believe capital requirements will also increase. The largest banks were already seeing higher capital requirements from both global systemically important bank surcharges and stress testing, while many regionals had reached their long-term targets. We expect regional banks will have to increase their capital ratios and issue bail-in-able debt to grow their total loss absorbing capacity.

Holding more liquidity and capital will reduce American banks' lending capacities and require them to pay more to keep deposits. At the same time, issuing more regulatory-required debt will increase the cost of funding. This combination will, in our view, lead to lower bank profitability and a reassessment of banking relationships as banks try to optimise their businesses to the appropriate scale.

Source: LGIM Views as at 30 June 2023. Assumptions, opinions and estimates are provided for illustrative purposes only. There is no guarantee that any forecasts made will come to pass.

A postmortem of failed banks

The failed banks shared common characteristics, primarily catering to similar clients or industries while building up concentrations of uninsured deposits. The swift and effective response of regulators through the implementation of the Bank Term Funding Program played a crucial role in stabilising the situation. This programme enabled banks to pledge securities to the US Federal Reserve (Fed) at par rather than market value, thereby accessing liquidity based on the value of high-quality assets that were below par thanks to lower interest rates.

The banks that failed had also experienced substantial growth in their balance sheets during the pandemic, driven by favourable borrowing rates. This growth, however, concealed underlying vulnerabilities that would be exposed as the sector faced mounting pressure from Fed rate hikes.

The repercussions of these bank failures extend beyond individual institutions. The era of low borrowing costs appears to have come to an end, prompting a re-evaluation of lending practices. As monetary conditions tighten, banks will face increased pressure to reassess their risk management strategies and reconsider their business models' reliance on historically low rates. This will likely lead to more restrictive lending practices.

One possible consequence will be the displacement of lending activities from traditional banking institutions to more opaque, less regulated non-bank markets. Even a partial and gradual shift away from traditional banking intermediation will create new challenges for regulators.

European exceptionalism

The turmoil we saw in the US reverberated across the Atlantic. Credit Suisse was the most prominent casualty. However, in our view this case is an outlier within the European banking landscape. Credit Suisse's unique deposit base, characterised by its volatility, coupled with its loss-making performance, set it apart. However, we believe the convergence of digital banking and social media has amplified the potential for bank runs to occur swiftly as much in Europe as in the US.

Unlike their American counterparts, however, we believe European banks stand to benefit from rising interest rates, enjoying record profitability while avoiding the significant unrealised losses we saw on US banks' balance sheets. However, we believe the prospect of ongoing rate increases also implies a reduced likelihood of bank consolidation and an elevated risk of recession.

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So far, European banks have exhibited robust asset quality, maintaining provision levels below the norm, and displaying limited signs of economic slowdown. However, European banks' Chief Risk Officers are adopting a more cautious stance, as evidenced by the European Central Bank's bank lending survey. Additionally, our economists anticipate recession, which will impact banks' bad debt provisions and profitability.

Among European banks' balance sheet components, Commercial Real Estate (CRE) is a potential weak link. The adverse effects of rising interest rates, potential recessionary pressures, and the risk of contagion from the US pose challenges for banks heavily involved in US CRE financing markets.

Overall, however, European banks have solid fundamentals, including strong earnings as a primary defence against losses, robust capital positions and significant macro overlays that can withstand potential losses arising from a recession. Meanwhile, in our view, the exposure of European banks to US CRE is generally manageable, with only a select few institutions having notable exposures. We expect macro to be the primary driver of sentiment for the rest of 2023.

The investment perspective

Over the year to date senior bank spreads in the USD index have performed in line with non-financials,[1] which might appear odd given the sector has experienced such a dramatic crisis. However, this index is mainly made up of large, globally systemic banks that have benefited from a flight to quality. We still see senior USD financial spreads as expensive, given the underperformance we would anticipate from bank spreads in a recessionary environment.

In Europe, financial spreads have underperformed non-financials,[2] which have been supported by the ECB's corporate bond-buying scheme (although it is due to end over the summer). Combined with what we see as the better fundamental positioning of some European banks, this leads us to believe there may be better opportunities in European financials compared to their American counterparts.

1. Source: LGIM, Bloomberg as at June 22 2023
2. Source: LGIM, Bloomberg as at June 22 2023

Source: LGIM Views as at 30 June 2023. Assumptions, opinions and estimates are provided for illustrative purposes only. There is no guarantee that any forecasts made will come to pass.

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Earnings season: Canary in the coal mine?

Robert White
Fund Manager

Ewan Bowerbank
Equity Analyst

Early 2023 saw an earnings season defined by mixed messages and surprise beats of low expectations. What can we make of this confusing picture?

The first quarter's reporting season is often seen as an opportunity for companies to set out their views for the year ahead. While there was certainly plenty of noise from some corporates, most notably negative news from US regional banks and positive from artificial intelligence (AI) facilitators, other companies generally had little of note to share.

What has been most surprising about this subdued season was that it came when an above-average number of companies were beating market expectations of their own earnings.

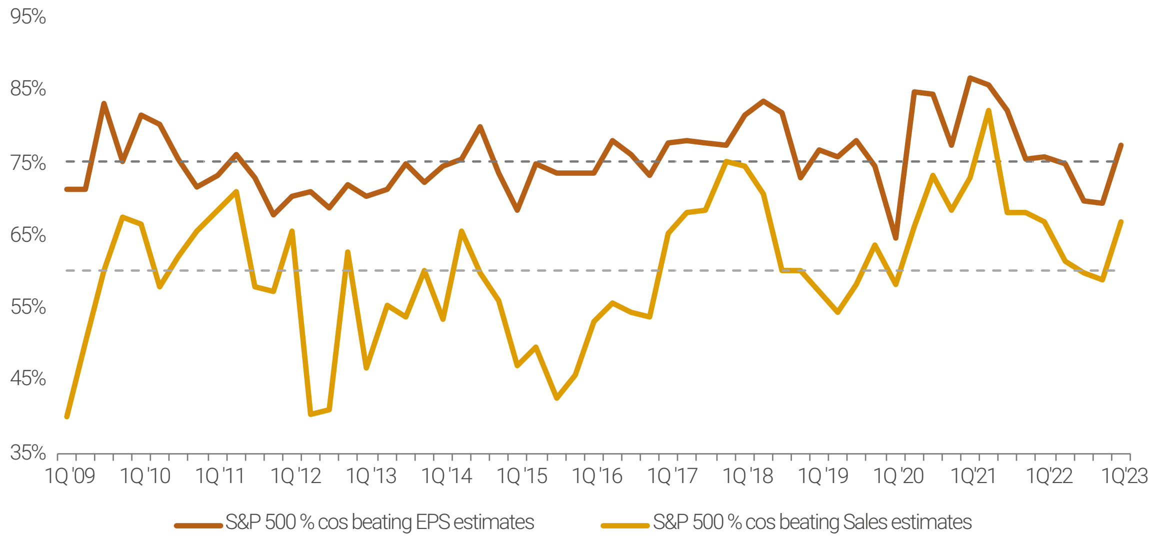
We think this lack of excitement reflects revenues that have surprised on strong pricing. However, this dynamic is now moving into the rear-view mirror as management teams focus on the macro uncertainty ahead.

Correspondingly, the market appeared to discount these longer-term concerns. Stock price reactions to beats were subdued, outperforming by smaller margins than we might have expected. Meanwhile, companies that missed estimates were penalised to a greater extent than we've seen historically.

It is also important to note the low hurdle rate we saw as we entered this reporting season. Specifically, consensus 2023 EPS for the S&P 500 had fallen 13% since June 2022 in the lead up to first quarter reporting.[3]

In other words, results beat very low expectations.

S&P 500 companies beating quarterly EPS and sales estimates



Source: Bloomberg Finance L.P., J.P. Morgan as at 22 June 2023; dotted lines denote median EPS and sales beats

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Thematic impacts

There was one theme that garnered the most interest: AI.

The emergence of ChatGPT has moved AI rapidly up the acceptance curve, with businesses and consumers alike scrambling to understand its implications. Much like the internet, we expect AI to be another tech tidal wave, both disrupting existing and establishing new industries and value chains.

However, it's not immediately clear who will benefit the most from AI. This has meant analysis of potential second-order effects has tended to focus on which established business models faced risk, rather than which ones may benefit. For example, *Chegg, the online educational platform that assists students with coursework, saw its stock price plummet 48% after its management team stated that student interest in ChatGPT is believed to be impacting the company's new customer growth rate.[4]

Outside of short-term earnings, we saw continued growth in both companies' reported capex spend (Q1 23, 12% YoY)[5] and planned spending for the year ahead. COVID-19 and growing geopolitical risk have highlighted the fragility of global supply chains; companies have responded by diversifying the locations of manufacturing hubs.

This drive to invest in greater security in supply coincides with a growing focus on sustainability, alongside a parallel drive to improve and upgrade the efficiency standards of new and existing facilities. We expect capital investment programmes to remain elevated, supported by these structural trends and near-term government incentives through the USA's Inflation Reduction Act and its global counterparts.

While this earnings season was characterised by a high proportion of beats versus expectations, early indicators of demand weakness are starting to creep in. For example, on earnings calls packaging companies DS Smith and Stora Enso* both reported lighter volumes across North America and Europe. Similarly, UPS* reported a sharp slowdown in activity through decreasing freight volumes in the final month of the quarter, which subsequently continued into April.[6]

3. Source: Bloomberg as at 16 June 2023
4. Source: Bloomberg as at 16 June 2023
5. Source: BofA Securities as at 16 June 2023
6. Source: https://www.reuters.com/business/ups-profit-falls-lower-e-commerce-demand-2023-04-25/

*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.

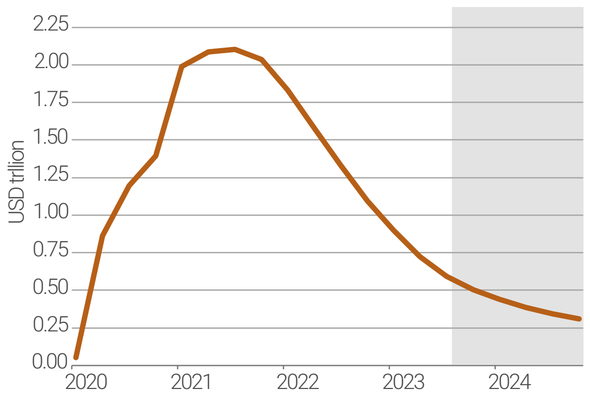
Gathering clouds

We see companies' reluctance to extrapolate a better-than-expected first quarter earnings print into upgraded full-year guidance as evidence that things could get tougher from here.

China's reopening following the abatement of the pandemic and the global stimulus it was expected to bring disappointed many analysts. The government's very prolonged and severe anti-Covid measures appear to have caused a hangover that policymakers are struggling to shift.

The US appears to be reaching the end of consumers' excess savings, as we can see below. This raises questions over how resilient demand will be, having been hitherto sustained by pandemic-era savings despite significant and sustained price rises.

US cumulative excess savings



Source: Macrobond 30 June 2023

The government's very prolonged and severe anti-Covid measures appears to have caused a hangover that policymakers are struggling to shift.

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Although monetary policy transmission mechanisms appear to have slowed, when they do kick in the ongoing pressure on disposable incomes is likely to continue impacting consumer sentiment, particularly in the lower income bracket. This was evidenced by discount retailer Dollar General*, where the management team highlighted the challenging macro environment for its core customer amid falling sales volumes.[7] Given the lower starting point of accumulated savings, the spending behaviour of Dollar General's customer base is a useful leading indicator as to how wealthier socioeconomic groups will behave as their own excess savings may deplete over the course of this year.

For now, consumers' hesitation in discretionary spending categories appears to be centred on goods, as demand for experiential services still remains strong – in certain sectors, the post-COVID revenge spend from pent-up demand is certainly still in play. We've seen this most in the resilient results from the leisure, hospitality and travel-related businesses, particularly airlines. Again, this speaks to the behavioural disparity between income groups, which in turn brings into question the persistence of this trend.

Weak – but how weak?

In summary, first quarter earnings were weak - but not as weak as expected. They managed to clear a low hurdle, but as macro uncertainty persists, few companies took this as an opportunity to raise guidance beyond current levels. Investors similarly responded with a muted response to what was technically good news.

Traditional early indicators are starting to indicate tension in the market but there are still remaining pockets of structural and cyclical resilience. Canary in the coal mine or tempest in a tea pot? Tune in next quarter…

7. Source: https://www.retail-insight-network.com/news/dollar-general-outlook-core-customers-spending/

Source: LGIM Views as at 30 June 2023. Assumptions, opinions and estimates are provided for illustrative purposes only. There is no guarantee that any forecasts made will come to pass.

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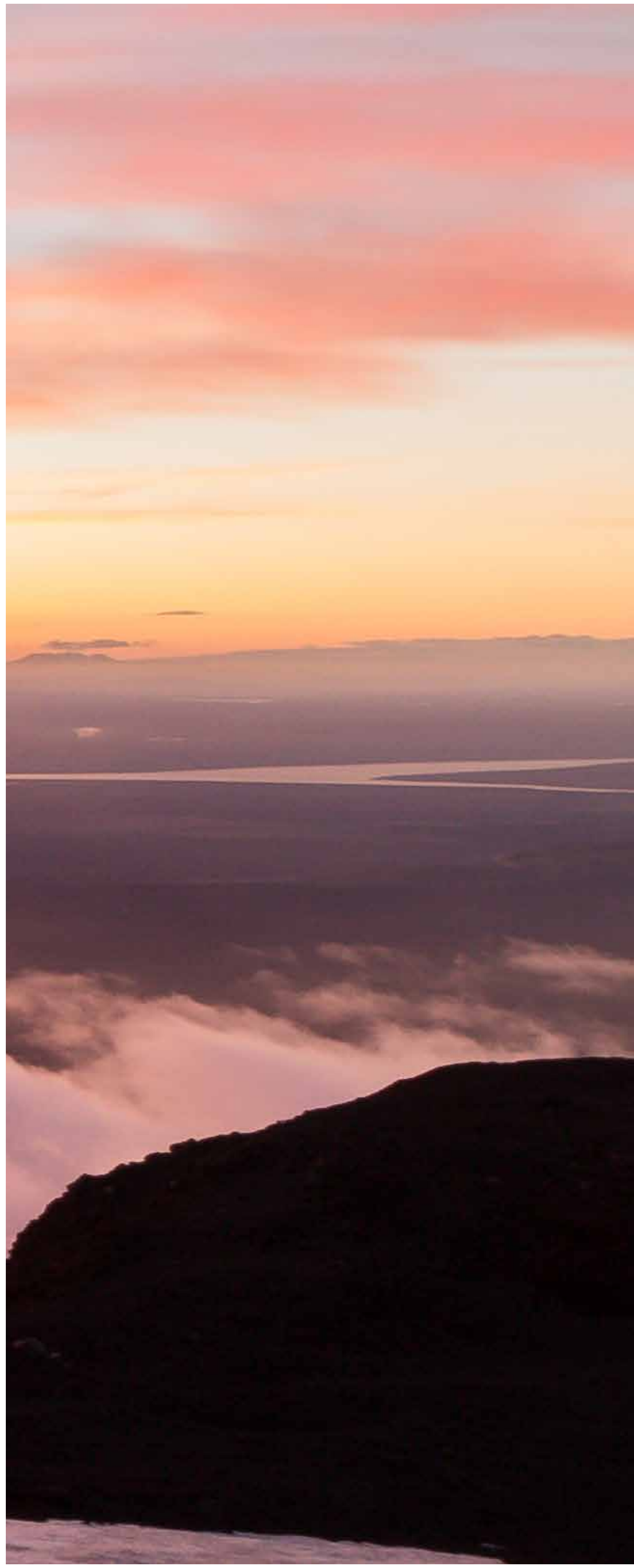

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Active Strategies and Destination@ Risk

Justine Schafer
Climate Economist

Everything you need to know about the tool LGIM's active portfolio managers use to embed climate concerns into their strategies

LGIM's Destination@Risk tool allows the robust measurement of the climate risk embedded in investors' portfolios and their climate alignment.

Our Active Strategies team uses it to set fund objectives around temperature alignment, understand macro trends and transition opportunities, evaluate climate risk concentrations in portfolios, and engage with companies on their climate positioning.

The LGIM Destination@Risk toolkit translates climate scenarios called 'destinations' into company, sector and portfolio-level implications.

It allows us to answer the questions we believe investors should be asking:

01 What do different climate outcomes mean for the economy?

02 What risks does climate change expose my portfolio to?

03 What climate outcome is my portfolio aligned with?

04 How far away from Net Zero 2050 are my financed emissions

The toolkit consists of four modules:

Module	Inputs	Outputs
Destination	Carbon budgets, technology costs, service demand projections	Energy mix, oil prices, carbon prices, economic output, emissions pathways
Climate Risk	Carbon prices, energy demand, emissions pathways	Risk to GDP, inflation and asset values (listed corporate and sovereign bonds and equities)
Temperature Alignment	Energy mix, sectoral emissions pathways, economic output	Company and country temperature alignment scores
Gap Risk to Net Zero	Temperature alignment scores, sectoral emissions pathways	Distance to net-zero outcome for countries and companies

Destination@Risk currently models four energy pathways to 2050:

Inaction
Approximate global warming by 2100: 3 – 4°C

Global failure to act on climate change means emissions continue to grow at historical rates

Below 2°C
Approximate global warming by 2100: <2°C

Immediate, ambitious policy and investment action to address climate change limits global warming to below 2°C, but warming most likely exceeds 1.5°C.

Net-zero 1.5°C
Approximate global warming by 2100: 1.5°C

Immediate, highly ambitious action to address climate change leads to a reduction in CO2 emissions to net-zero around 2050.

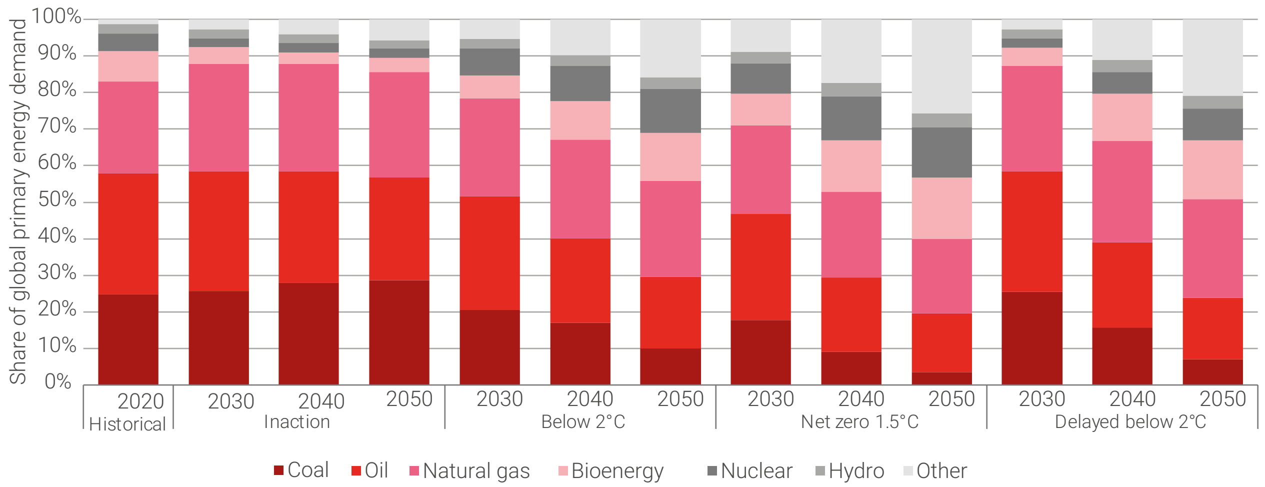
Delayed below 2°C
Approximate global warming by 2100: <2°C

Policy and investment action to limit warming to well below 2°C is delayed to 2030, resulting in much more disruptive change. Warming will most likely exceed 1.5°C.

Destinations
Scenario analysis helps us understand the implications of possible climate pathways, including the key features of a transition to a net-zero economy.

At LGIM, we develop our own bottom-up scenarios, called 'Destinations', of how the energy system may evolve over the next 30 years. In trying to model plausible well-below 2°C futures, we aim to capture technology change across the entire energy system and make difficult trade-offs between minimising short-term policy impact and limiting long-term physical climate change.

Example output: Global primary energy mix



*2020 data is estimated, not actual
Source: LGIM Destination@Risk

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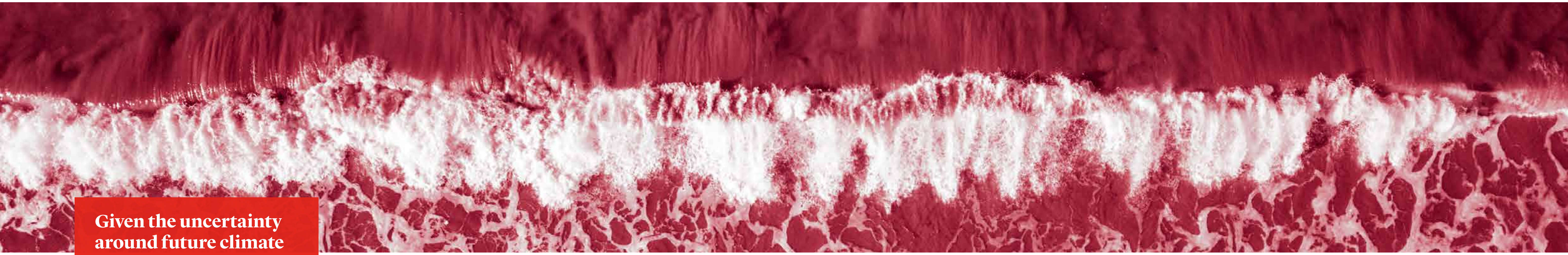


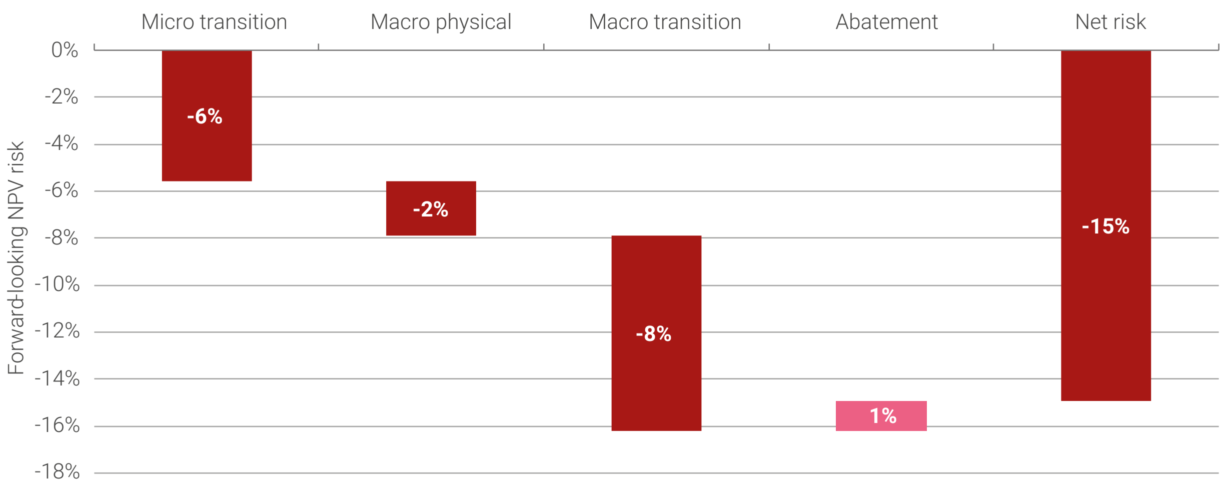
Given the uncertainty around future climate outcomes, it is unlikely that climate risk is properly priced into markets today.

Climate risk

LGIM's climate risk metric allows investors to evaluate the physical and transition risks from climate change for their portfolios, across climate scenarios. Risks are based on forward-looking valuations of individual companies across the capital structure, recognising the stock-specific nature of climate risk. Given the uncertainty around future climate outcomes, it is unlikely that climate risk is properly priced into markets today.

The climate risk metric offers a view on the extent of this mispricing across various climate scenarios. While the default configuration of the model is to run on 'Destination' outputs, the model can also take in external scenarios to assess climate risk. Beyond security-level impacts, we also assess macroeconomic climate risks, including risks to GDP and inflation at a country level.

Example output: Company NPV risk composition in 'Delayed below 2°C' scenario



Source: LGIM Destination@Risk. For illustrative purposes only.

Temperature Alignment

Temperature Alignment provides a tool for measuring and managing the impact of investments on climate change.

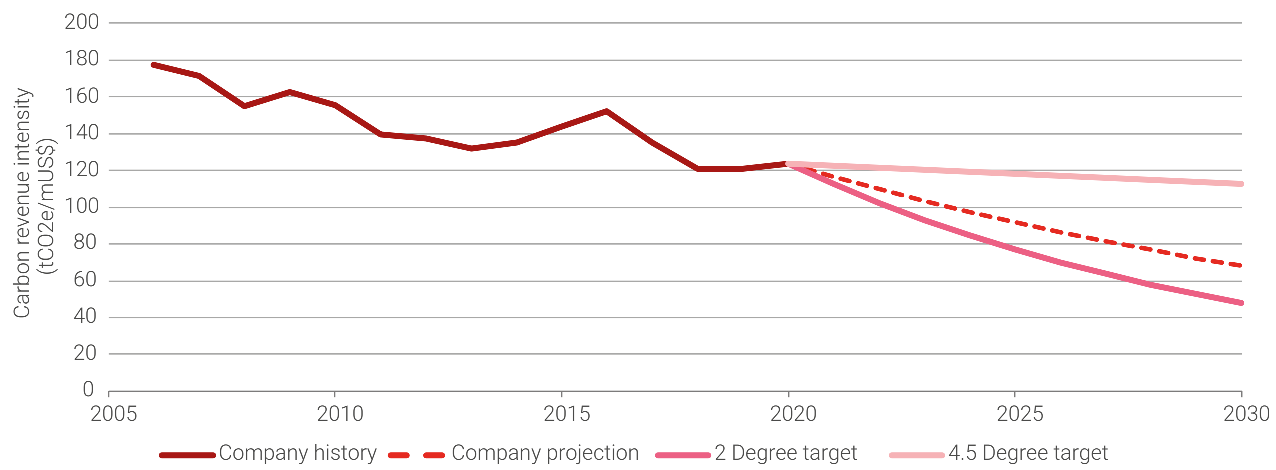
The metric asks of companies: what climate outcome are your actions compatible with? The approach reflects the direct connection between companies' carbon emissions and global warming. It allows investors to measure their impact on climate change through their investments and evaluate performance against science-based global climate targets, such as 'well below 2°C' and 'net-zero 2050'. In the below example, the company is aligned with 2.8°C.

Gap Risk to Net-Zero

LGIM's Gap Risk to Net-Zero assesses the divergence of companies' future pathways from what is required to reach net zero greenhouse gas (GHG) emissions by 2050.

Taking outputs from our temperature alignment module as an input, it calculates how much further assets would need to decarbonise to reach a net-zero 2050 target. We believe this is one way for creating roadmaps of how the distance to net-zero alignment can be reduced over time. We believe this is especially relevant given many investors' commitments to align their investments to a net-zero 2050 outcome.

Example output: Company temperature alignment



Source: LGIM Destination@Risk. For illustrative purposes only.

LGIM Destination@Risk enables us to partner with our clients to meet their decarbonisation objectives, building Paris-aligned solutions and providing climate reporting.
Please contact your LGIM representative for further information.

Contact us

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

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Key risks

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. LGIM Destination@Risk is constructed to follow the recommendations of the TCFD and provides scenario analysis to explore a range of possible future climate pathways and their potential impacts, rather than predictions or probabilities. Our scenarios focus on the energy system as this is the source of the majority of anthropogenic GHG emissions. Our scenario, risk and temperature alignment models all rely on external data which could include approximations, errors and assumptions. Assumptions, opinions and estimates are provided for illustrative purposes only. There is no guarantee that any forecasts made will come to pass.