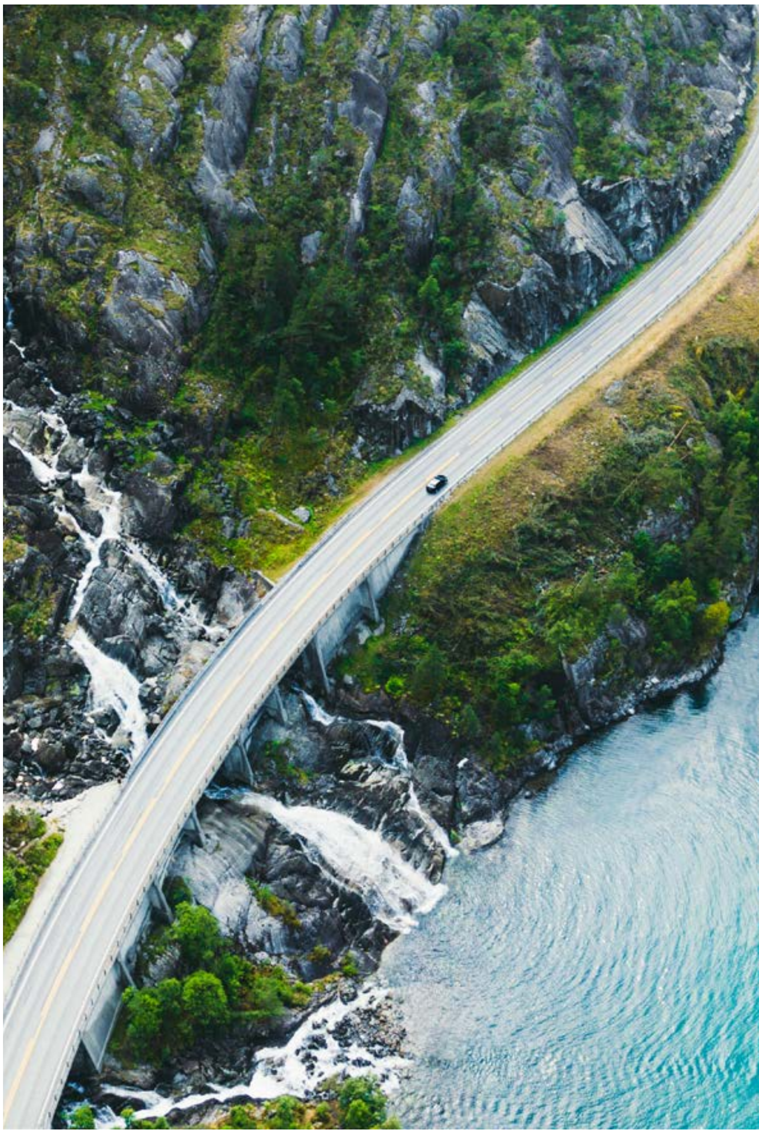


Beware the unstable table

After a period of extreme investor pessimism, comparable to the deeply depressed mood of the 2008 financial crisis, we believe investors are now becoming more optimistic.

Emiel van den Heiligenberg
Head of Asset Allocation

One of our favourite sentiment indicators, the American Association of Individual Investors' bull/bear survey, recently reaching the highest reading of the last 18 months.

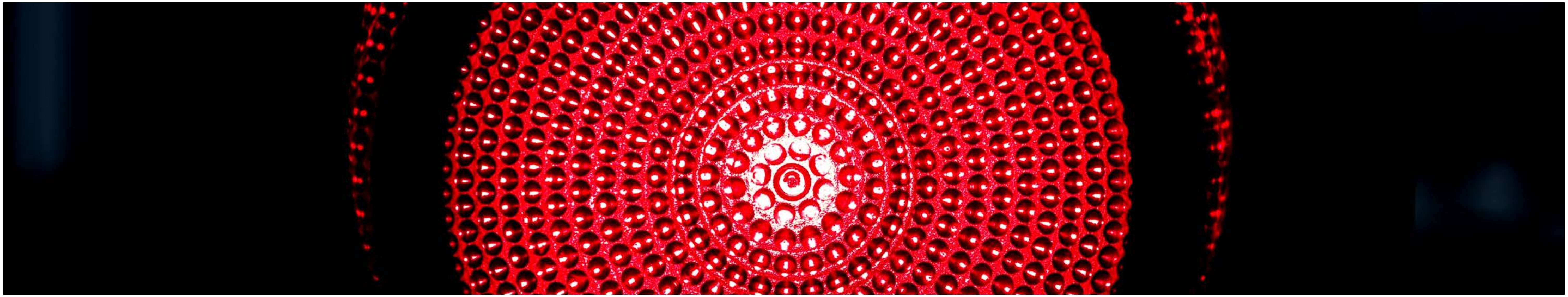
Enjoy it while it lasts

Sadly, we still think a downturn is still needed to bring global inflation back under control. US core inflation is now off its peak, but it's easing at a slower pace than the Federal Reserve (Fed) had been expecting. June's CPI print in the US was not high enough to convince the Fed to shock markets with a hike, but if activity doesn't turn down over the next few weeks and core services prices remain firm, the central bank could raise rates again in July. The current hiatus appears to be based on the Fed's desire for additional time to monitor policy lags and regional bank stress.

On the subject of US banks, the crisis has ebbed since March, but the dangers haven't gone away. Possible real estate contagion, our own proprietary bank stress indicator and tightening credit indicators suggest the risks of an accident remain elevated.

As anticipated, the debt ceiling proved a big fuss over nothing in the end. But watch out for a dramatic rebuild in the US Treasury General Account over the coming weeks and months. Basically, the US Treasury ran down its cash during the debt deadlock and will now have to rebuild. This matters for investors because the speed of this process could drain liquidity in financial markets – and we know US banks are already starved for cash.

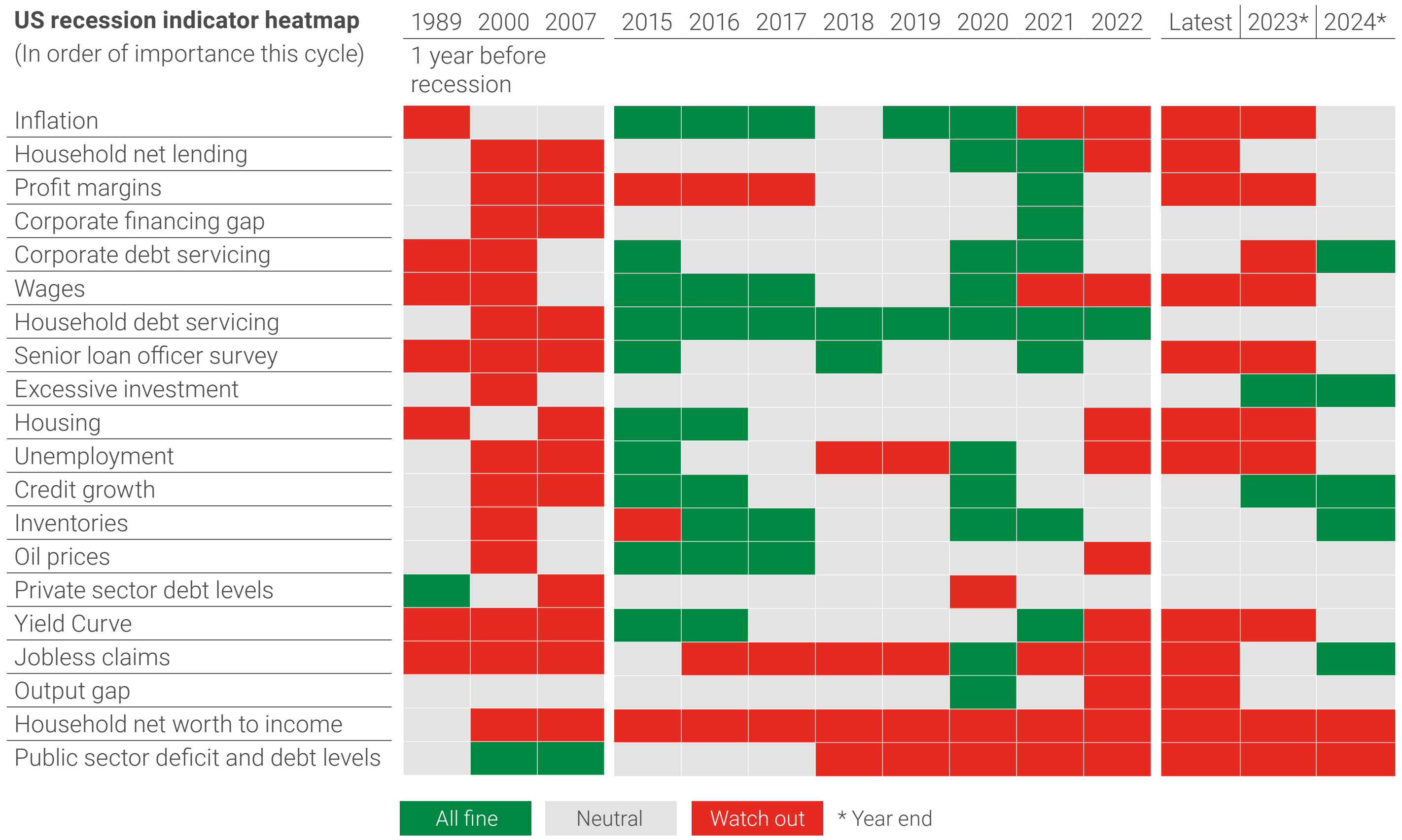
Q3 2023 | Outlook: beware the unstable table



The indicators are flashing red

Our high-conviction, base-case view remains that a US recession is likely this year. Indeed, there was very little change in the second quarter in our recession indicators, which continue to flash red.

US remains on track for recession this year



Source: LGIM, Macrobond, as at 10 May 2023. **Assumptions, opinions and estimates are provided for illustrative purposes only. There is no guarantee that any forecasts made will come to pass.**

The ongoing strength of the labour market is not a source of comfort in this framework as it indicates overheating and future weaker growth.

We see the positive data for now as postponing the recession, rather than significantly increasing the probability of a soft landing.

There is one important caveat: the nature of the pandemic shock makes this cycle difficult to predict. Inflation is particularly hard to forecast; if it did fall durably back to target levels, we believe this would provide an opportunity to central banks to pivot in a more dovish direction. This is something we carefully monitor, but for now inflation is coming down slower than we initially expected, and we expect it will remain well above central bank's target levels.

> **"Earnings revisions have turned positive in the US and Europe. However, we see a risk that earnings per share for end-2024 will be significantly below consensus."**

The earnings squeeze

Given our recession call, we are more bearish on the earnings outlook. We note that even if inflation comes down, sticky wage inflation should push margins and earnings lower. While consensus seems to have moved to a 0-5% earnings growth outlook for the coming quarters, we believe a recession will create significant negative earnings growth.

So far, the earnings bulls have been vindicated. Earnings revisions have turned positive in the US and Europe. However, we see a risk that earnings per share for end-2024 will be significantly below consensus.

Earnings have a good link with nominal growth through operational leverage, which works against you when nominal growth turns negative (earnings will turn more negative).

The bigger issue, in our mind, is profit margins, with both the profit share of GDP and profit margin being very elevated. Margins will likely come under pressure now that real wage growth has turned positive.

Q3 2023 | Outlook: beware the unstable table

How we're positioned

Against this backdrop, we remain bearish on equities and credit, and more positive on long duration (for our take on gilts, see Josefine's article below) and short inflation. Within equities, we like defensives and tech but dislike cyclicals.

Sentiment towards China is very bearish, following disappointing data and the limited stimulus options on the table. With everyone reducing exposure this could create tactical opportunities, but we note that the country's property market overhang poses downside risk to our growth forecast – read on for Erik's thoughts on this subject.

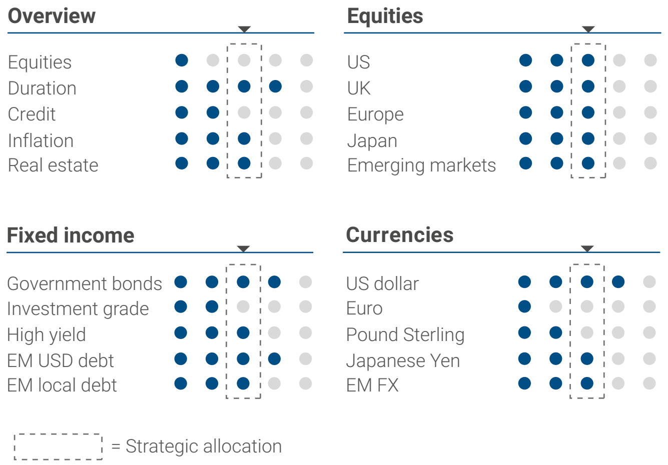
Markets have been drifting higher on better-than-expected data and investors capitulating on their shorts. But it's important to note that the rally in the US equity market is very narrow.

In his article below on the shortcomings of the growth versus value narrative, Andrzej explores this theme further, showing how narrow, sector-specific leadership largely explains the apparently superior performance of growth.

Yet investors have a very positive take on this narrow base of market gains, based on optimism around technology diffusion, specifically artificial intelligence (AI). While we believe AI will likely lead to some great efficiencies that could help to fight inflation, it's unlikely to prevent the deep earnings recession we forecast for this year. That's because it takes longer for new technology to be embedded in regular business models.

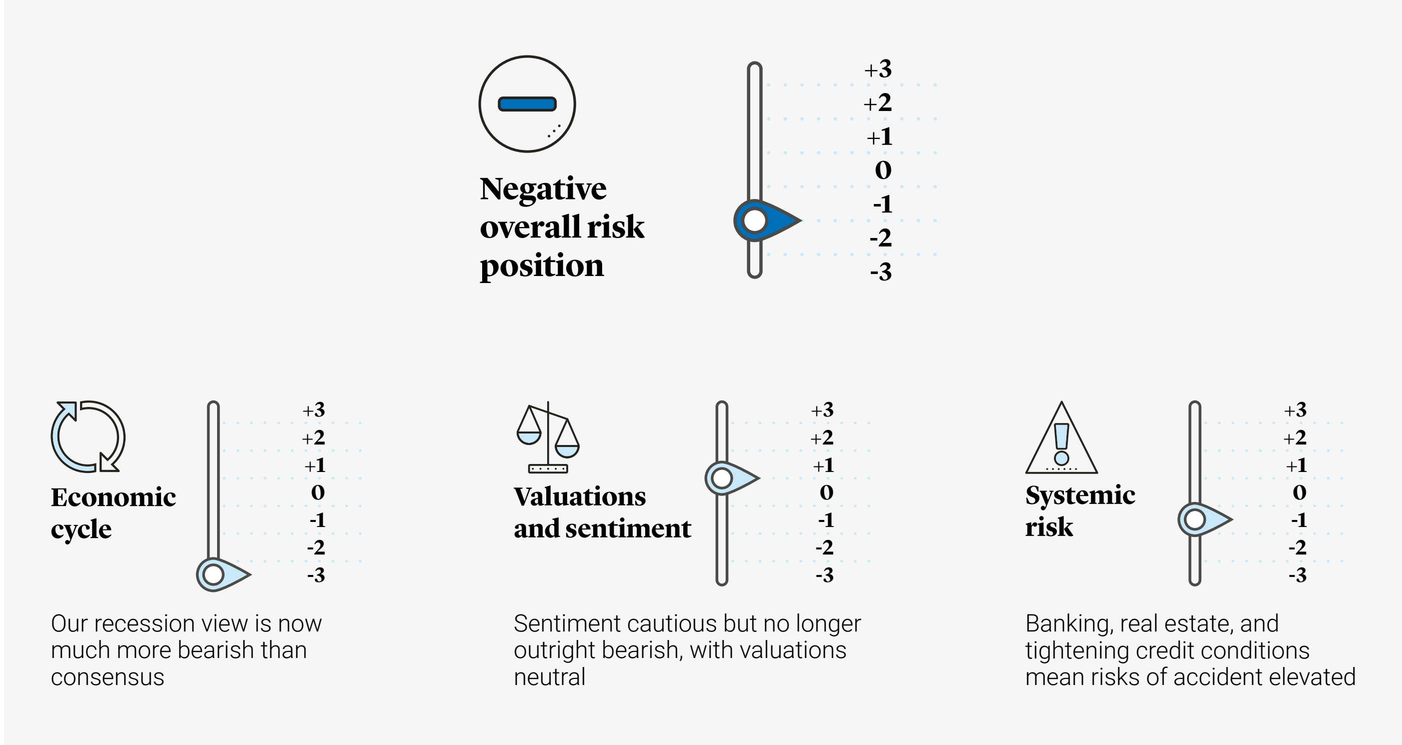
However, we will continue to carefully monitor the impact of AI on non-tech earnings.

Our key asset class views



This schematic summarises the combined medium-term and tactical views of LGIM's Asset Allocation team as of 30 June 2023. 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.**

Our core asset allocation view



Source: LGIM. Views current 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.**

Strap yourself in for another gilt trip

Jose ine Urban
Senior Portfolio Manager
Asset Allocation

Gilt yields have spiked again in response to unexpectedly strong inflation and labour market numbers. But is the inflation story in the UK fundamentally different from that in Europe and the US?

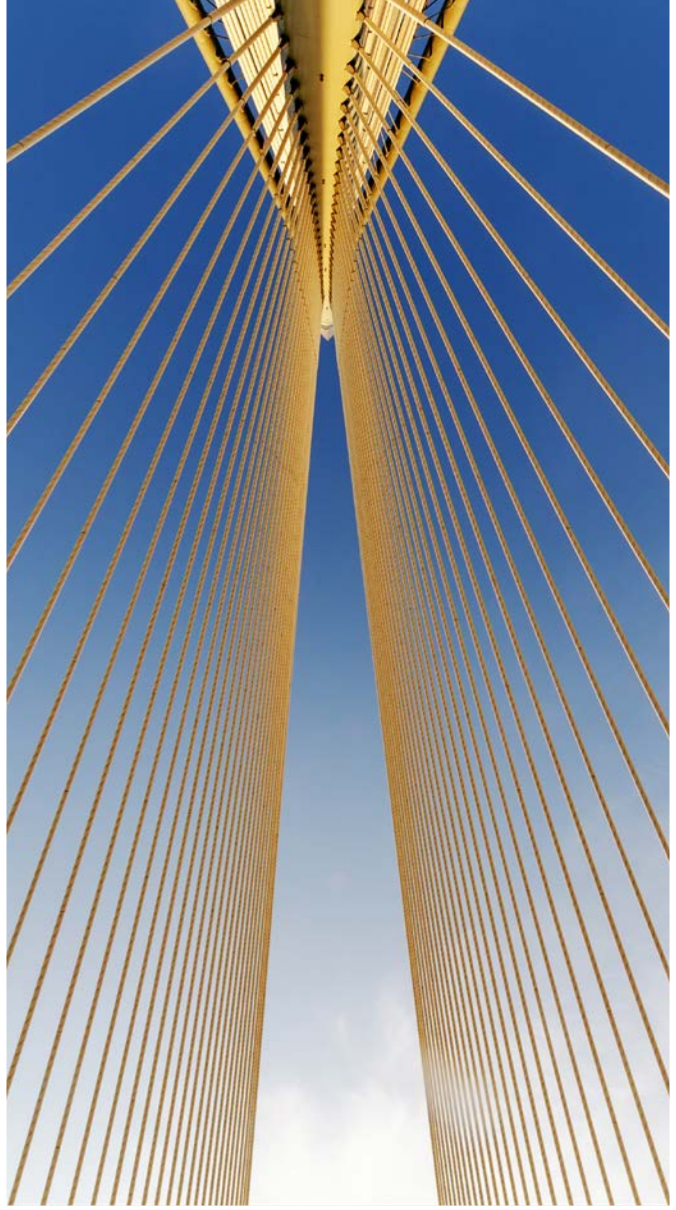
After the turbulence seen following last autumn's controversial and ultimately short-lived 'mini-budget' proposals, the gilt market is once again making headlines.

Rather than unfunded tax cuts, the catalyst for the move higher in gilt yields this time has been the stronger-than-expected inflation and labour market data in the UK.

Past the mini-budget peak: two-year gilt yields

Source: Refinitiv, as of 26 June 2023.

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.



We have seen significant upside surprises in inflation for a few months in a row now, and even though headline inflation has come down from the peak of 11.1% in October to 8.7%,[1] it is still way above the Bank of England's inflation target of 2%.

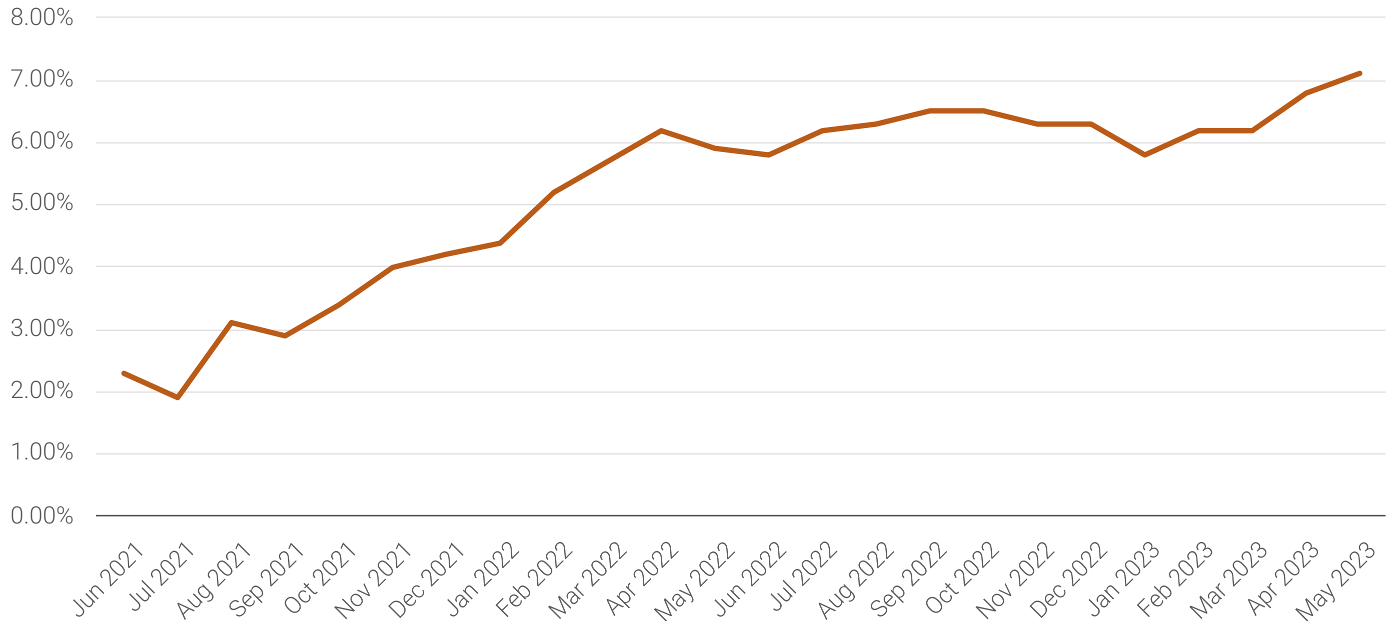
The super-sticky inflation problem

More importantly, it is not just that the headline inflation numbers have been stronger than expected, it is the underlying strength of inflation that is worrying market participants and policymakers, with core inflation stickier than expected and no signs of it having peaked yet.

> "In the US, core CPI peaked in September last year. Over six months later and we are still waiting for the peak in the UK."

1. Source: Office for National Statistics estimate for 12 months to April 2023.

Still no peak in sight: UK core CPI % change year-on-year



Source: Refinitiv, as of 26 June 2023.

The recent data show that the labour market is still tight, and wages are continuing to run uncomfortably hot. These numbers make the job difficult for the Bank of England and given its data dependence (as the Monetary Policy Committee put it, "If there were to be evidence of more persistent pressures, then further tightening in monetary policy would be required") the market's laser focus on inflation and labour market data makes sense and explains the recent re-pricing.

The market is now pricing in a terminal rate of close to 6.3% (i.e. around 130 basis points more hikes).[2] If those hikes were to materialise, we would expect this to lead to a recession based on the monetary policy tightening alone.

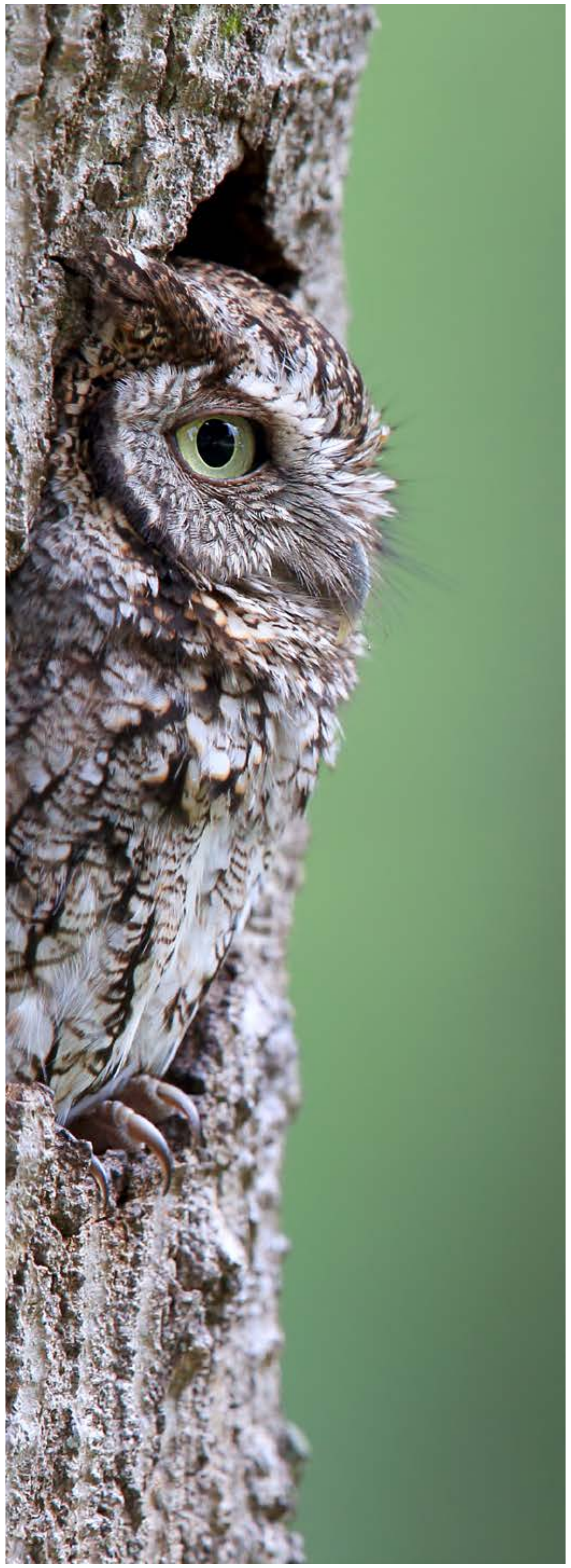
Our gilt positioning

We don't think the UK is facing an inflation problem that is fundamentally different from that seen in other countries. In our opinion, it's a story of an unusual lag rather than anything more fundamental. The reaction in gilt markets, with yields surging higher, is therefore overblown, in our view.

That has led us to take an overweight stance in UK gilts versus other government bonds (German bunds and US Treasuries) in our portfolios. In general, we are looking to increase interest rate exposure in countries where central banks are less patient and show more signs of making decisions based on lagging data (inflation and labour market data).

We think that in these countries there is a greater risk of overtightening of policy rates, and therefore more scope for rates to rally once the data turns.

2. Overnight index swap pricing. Source: Bloomberg as at 04 July 2023.



Value versus growth: more than meets the eye

Andrzej Pioch
Fund Manager
Asset Allocation

Few investment topics are subject to more debate than the relative merits of the value and growth factors. Anyone who joined the ride in recent years has experienced quite a rollercoaster, with 2021's headlines declaring the return of value now replaced with those hailing the rise of growth. So where do we go from here?

When things get increasingly complex, mental shortcuts or rules of thumb become very tempting. They bring us comfort by making sense of the muddy world around us.

One of those that rose in popularity last year was the assertion that growth stocks are inherently more sensitive to interest rates, given the longer-term nature of cash flows underpinning their valuations.

Here's where it gets complicated

However, our analysis has shown that this relationship is modest at best, with certain factors forcing the dynamic in the other direction. For example, if higher inflation driven by rising wages is a concern that sends bond yields higher, a tech stock (a poster child of growth) may benefit from having the least labour-intensive business model.

Another idea we hear today is that we are in the middle of the growth environment, with the MSCI World Growth index up 20% year to date and the MSCI World Value down nearly 2%.[3]

Yet a closer examination reveals significant regional divergence. The gap in the UK is closer to 9%, with value still outperforming growth until mid-March. Europe is closer to 7%, Japan 6% and the rest of Asia-Pacific closer to 4%. Emerging markets march to their own drum, with value ahead of growth by more than 2%.[4]

3. Source: Bloomberg data, net total return to the end of May 2023 in US dollar terms
4. Source: Bloomberg data, net total return to the end of May 2023 in US dollar terms

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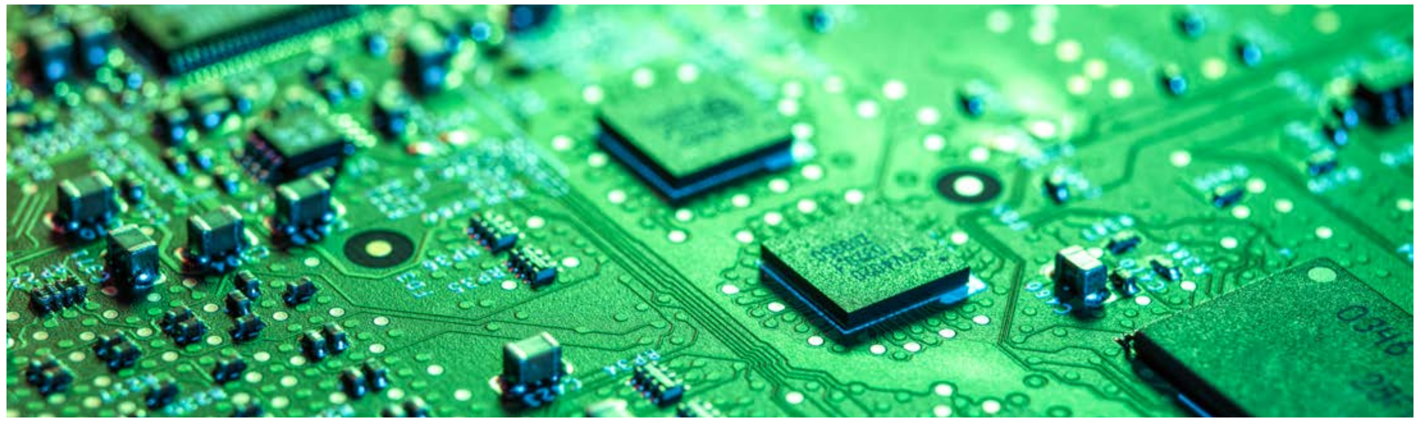


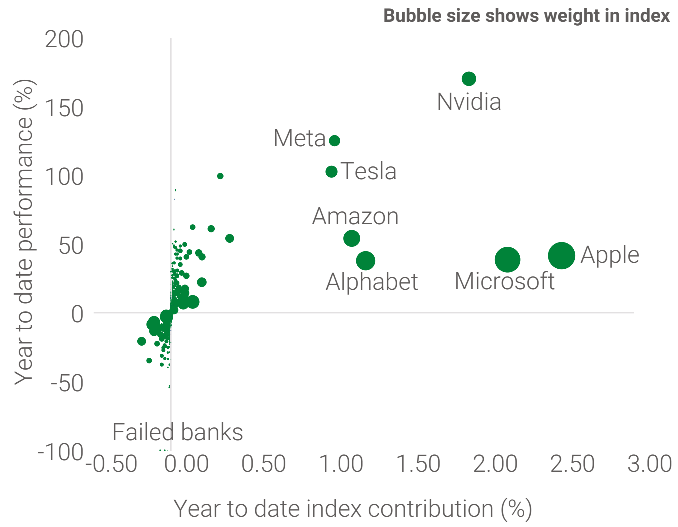
The sector vector

That makes the United States the big outlier in the value/growth dynamic this year. Why is it different and how much does this have to do with equity factors, such as value and growth? Our performance attribution reveals that two-thirds of the growth outperformance can be traced back to differences in sector allocation. Here, the sector effect is largely down to the overweight in information technology at the expense of financials and energy.

In other words, a growth strategy implemented on a sector-neutral basis would shrink the outperformance by a factor of three. The same happens if one excludes the effect of different allocations to 'MATANA'[5]* stocks. These six stocks alone explain 64% of the year-to-date performance gap between value and growth.

The 'growth environment' so widely discussed today may actually be a 'US tech environment' or, more precisely, a 'MATANA environment' – much more driven by stock-specific risks rather than broad equity factor risks. This, in turn, should have implications for how sustainable that environment might be going forward, given how narrow the recent rally in US equities has been, in our view.

S&P 500: individual stock performance and contribution to index return



Source: Bloomberg, LGIM, as at 12 June 2023.

> **"As tempting as they are in an ever-changing world, beware of shortcuts as they may sometimes lead one astray."**

5. Microsoft, Alphabet, Nvidia, Amazon, Tesla and Apple

***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.**

Q3 2023 | Outlook: beware the unstable table

China's housing overhang casts a long shadow

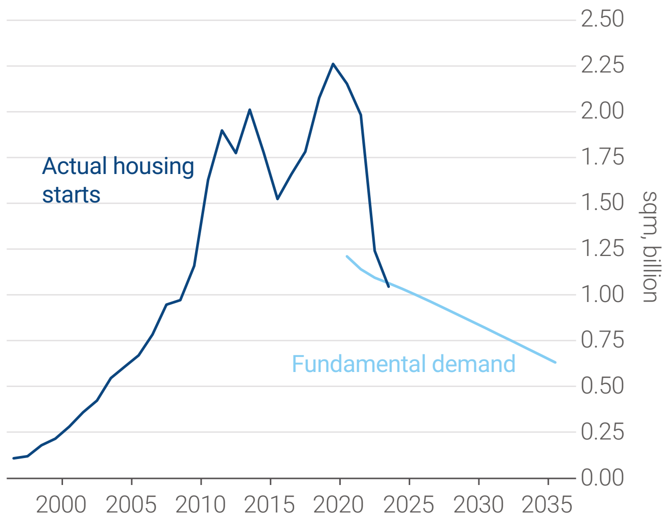
Erik Lueth
Global Emerging Market Economist
Asset Allocation

We believe speculation in China's housing market jeopardises GDP growth expectations, and could break the historic link between Chinese stimulus and global asset prices.

Our base case is for Chinese GDP to grow 5.5% this year, despite weaker-than-expected activity recently. This assumes some policy easing and is based on moderate annualised growth of 4% over the remainder of 2023. However, the property sector poses a downside risk to this outlook.

To assess how much more property activity needs to correct or whether it has already undershot, we estimate how much new housing or living space is needed per year. This is determined by annual rural-to-urban migration (as the new arrivals need to live somewhere), living space per capita, and the rate at which the existing housing stock depreciates.

Chinese housing starts versus fundamental demand



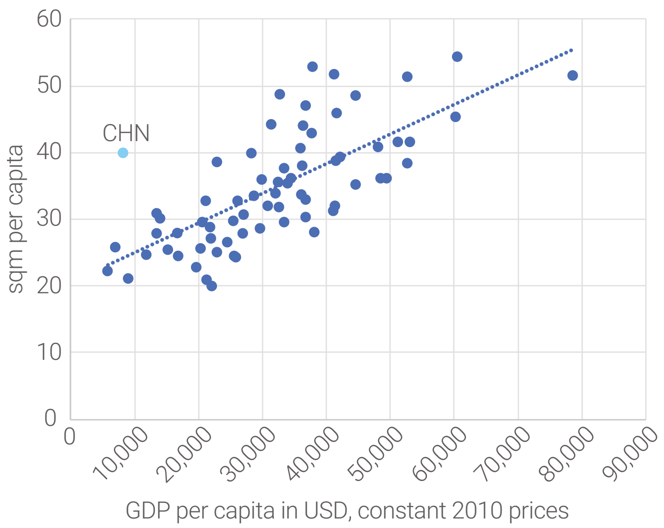
Source: Macrobond and LGIM calculations, as of June 19.
Assumptions, opinions and estimates are provided for illustrative purposes only. There is no guarantee that any forecasts made will come to pass.

It turns out that China needs to add about 1 billion square metres (sqm) of new urban living space per year (rural construction is negligible), at least for the next few years. Actual housing starts have fallen to about these levels, suggesting that there is not much upside to construction activity.

Hoarding houses

If anything, risks are to the downside as a closer look at the housing stock reveals. Subtracting cumulative housing sales from cumulative housing starts suggests that housing stocks are at normal levels of about two years of sales. It is the housing owned by Chinese households that looks excessive excessive, in our view.

Living space by level of development

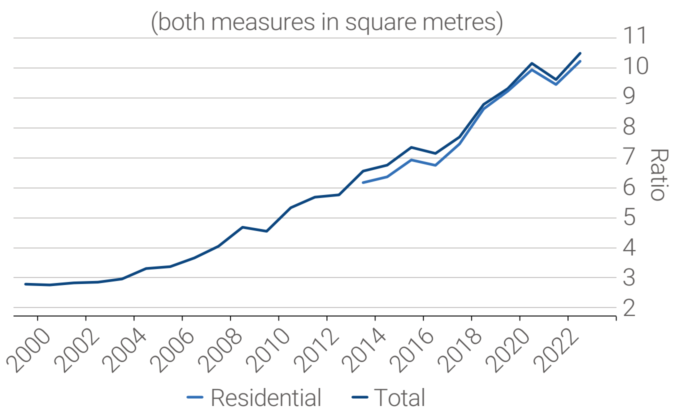


Source: Rogoff and Yang (2022) A tale of tier 3 cities; https://entranze.enerdata.net, IEA (2004) 30 Years of Energy Use in IEA Countries, World Bank, and LGIM calculations. As of June 2023.

Living space per capita is around 40sqm in China – almost double what is normal at China's level of development. If the excess stock were to come back onto the market it would take 13 years to clear, according to our estimates.

In addition, excesses are evident in housing currently under construction, which is 10 times the housing completed each year. Since it takes three years to complete a housing project, this ratio really should be three (where it was during 2000-2005). Since developers are pre-paid for construction, incentives are strong to take on ever more projects, particularly if other funding sources are being squeezed. This housing overhang would take another 3.5 years to clear, we believe.

China: ongoing construction over completed construction



Source: Macrobond, as of June 2023.

Of course, it is not clear whether this housing overhang, mostly the result of speculative buying, will ever come back onto the market and, if so, over what period. But it definitely poses a downside risk to future construction activity.

What does this mean for commodities?

That subdued outlook for construction activity has a couple of implications. Most important for the rest of the world, the link between Chinese stimulus and global asset prices has historically flowed through commodity prices and commodity-exposed sectors. That link is likely to be significantly weaker than has been true historically, and may even be broken with housing under structural pressure.

For Chinese assets, we think the combination of excessively bearish sentiment and stimulus expectations can drive a temporary rebound in performance at the current juncture, but that should not be mistaken for expectations of a sustained recovery.

Contact us

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

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. Past performance is not a guide to the future. 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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