Let's do the time warp again

Despite the warning lights flashing red, the recession still hasn't arrived. But that doesn't mean we're out of the woods – this all feels eerily familiar.

Emiel van den Heiligenberg
Head of Asset Allocation

Our outlook remains that this cycle will end in recession and risk assets will underperform going forward. We've been wrong on the timing, however, and now expect the US recession to land in the first half of 2024.

This is a frustrating position to be in, but the thing we are focused on is whether we can remain confident in the end game: that a slowdown will ultimately unfold into a recession. We believe we're right to go against the crowd.

Rose tint my world

Although global equity markets are now around 5% off their peak[1], we don't think this move is about the market sharing our US recession fears. Instead, we think this has been driven by a rise in real rates and widespread belief that China will go through a long period of low growth and elevated credit risk

Indeed, US growth estimates for the third quarter have been moving higher on the back of benign inflation prints in June and July and signs of a gradual loosening of the labour market. Combined with robust growth earlier in the year from higher fiscal and infrastructure spending, excitement is building about the health of the US economy, yet we think some of the positive news on growth and inflation is temporary.

1. Source: Bloomberg as at 22 September 2023.

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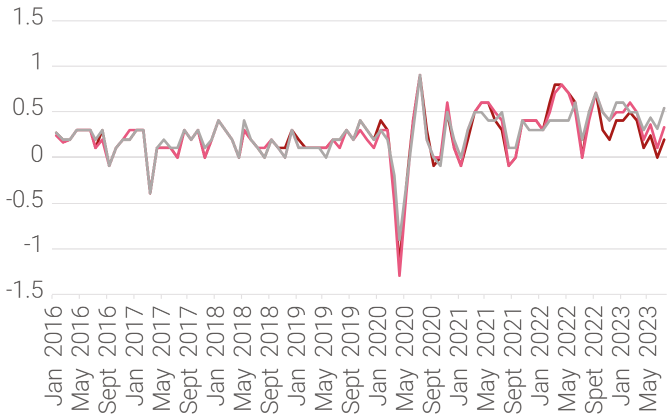
Quite a bit of the inflation improvement has been erratic, making it difficult to discern a solid trend.

Wage growth, meanwhile, remains too high for inflation to be consistent with central bank policy, and if we get wage growth without inflation you get a margin squeeze.

US core services inflation



— United States, services less energy services and rent

— United States, services less energy services and rent and health insurance

— United States, services less energy services and rent and health insurance and airfares

Source: Macrobond, data covers to 1 July 2023

The Sword of Damocles

The biggest driver of our recession view is the lagged impact from tighter monetary policy. Ongoing Federal Reserve (Fed) quantitative tightening should influence bank lending behaviour as pressure on their deposit base builds.

Given that we've been wrong on our recession call for several quarters now, what would it take for us to abandon the view?

1. Wages falling while unemployment remains low: not much news in recent weeks on this front
2. The trend in bankruptcies/ delinquencies reversing: we still see a weakening trend
3. Bank lending picking up: again, we still see a weakening trend
4. Europe improving: European PMIs have been very weak in recent weeks
5. House price transactions increasing and prices not falling: limited evidence so far

We've seen this horror show before

History also gives us some comfort in our contrarian call, showing that the ship can sometimes sail on while the hull fills with water.

There are parallels with the year 2000, when the Fed felt comfortable holding rates in restrictive territory through the summer and autumn, only to be surprised by the extent to which the economy slowed. This triggered an emergency rate cut in January 2001. But with inflation more of a constraint today, we believe it will take greater economic weakness for the Fed to suddenly reverse course.

2007 and early 2008 also provide a salutary reminder that it's wrong to believe nothing bad will happen just because nothing bad has happened yet.

> **"There are parallels with the year 2000, when the Fed felt comfortable holding rates in restrictive territory through the summer and autumn, only to be surprised by the extent to which the economy slowed."**

The S&P rallied 20% in 2006 and 2007, peaking just eight weeks before the global financial crisis started. Real GDP in the second half of 2007 increased at an annual rate of 2.5%. In January 2008, the Fed did not forecast a recession. The collapse of a pair of Bear Stearns hedge funds with heavy exposure to assets such as the now infamous collateralised debt obligations (CDOs) went unnoticed by many as a signal of the crisis to come.

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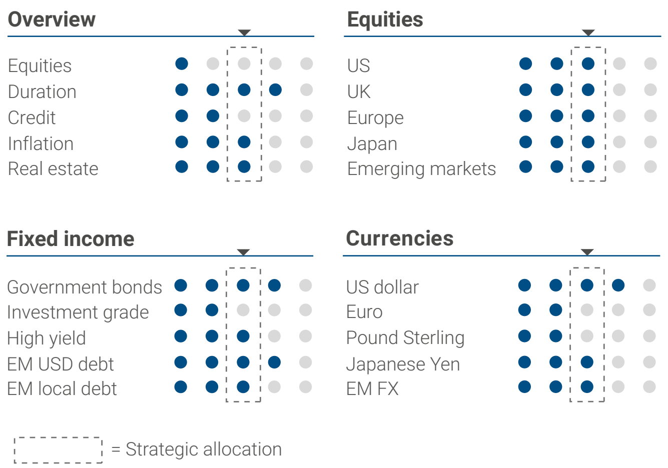
How we're positioned

We expect risk assets to underperform over the medium term, and therefore have a negative outlook for equities. We prefer defensive equity sectors over cyclicals and have a positive view on infrastructure.

In line with our pessimistic outlook for economic growth, we are positive on government bonds, particularly UK gilts. We believe exposure to sovereign bonds could be beneficial should significant signs of economic weakness emerge. We also favour US inflation-linked bonds and consider current real yields to be unsustainable over the medium term.

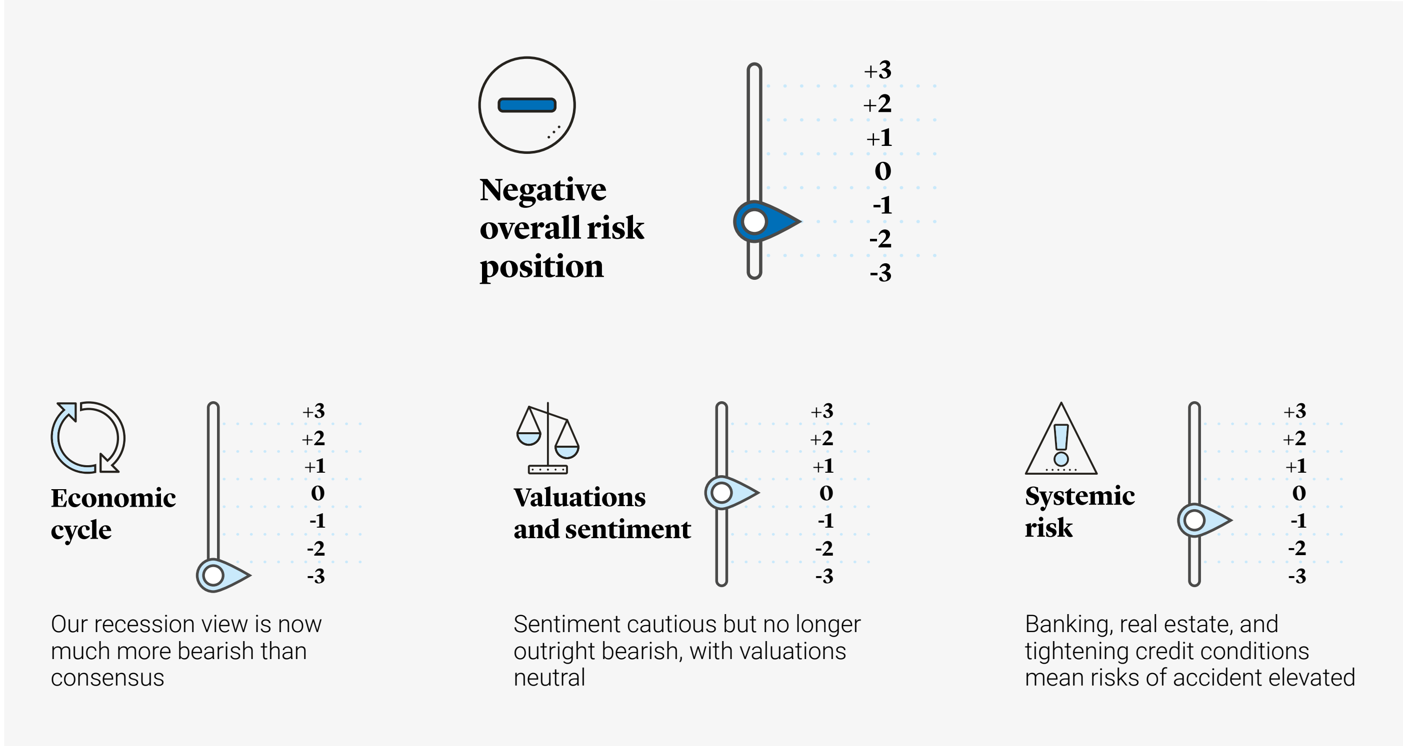
We are underweight corporate credit and have a modest negative view on sterling.

Our key asset class views



This schematic summarises the combined medium-term and tactical views of LGIM's Asset Allocation team as of 15 September 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 15 September 2023. **Assumptions, opinions and estimates are provided for illustrative purposes only. There is no guarantee that any forecasts made will come to pass.**

The case against American exceptionalism

Martin Dietz
Head of Diversified Strategies

US equity markets have performed very strongly over the past decade. As multi-asset investors, we believe in diversification[2] not just across asset classes, but also geographically: we want to avoid country and regional concentrations in our portfolios.

In many client meetings, I am asked if this approach still holds given the recent performance of US equities, and what to do going forward. Is the US market 'special', and can it continue to outperform?

This leads us to a bigger question: how should we think about regional risks in an investment portfolio?

The risk lens

Risk depends on the investor's reference point or benchmark. An equity investor with a global equity index may find it natural to hold two-thirds of their investments in the US market.

As a multi-asset investor without such a benchmark and a greater focus on target returns, market cap is just one reference point among many for us. As we want to balance political and economic region-specific risks, we favour a more balanced global exposure.

Can the US continue to outperform?

The outperformance of US equities has been spectacular over recent years. Clearly, the strong US economic performance was a key driver, but advocates of US equities would also emphasise the country's robust institutions and favourable sector split.

However, to my mind there are good structural reasons to believe that this exceptional performance can't continue:

1. US outperformance is a relatively recent feature. While North American markets have been the top performer in eight out of the past 12 years (2011 to 2022), they only topped the regional equity market ranking twice in the 20 years before that (1991 to 2010)[3]

2. Dividend growth and earnings growth only explain part of US returns. The strong outperformance is largely a result of US equities getting more expensive, and valuation gains can only ever be a temporary driver of returns.[4] Higher valuations for US equities would suggest lower trend market growth going forward, as equities will struggle to exceed ever-increasing expectations

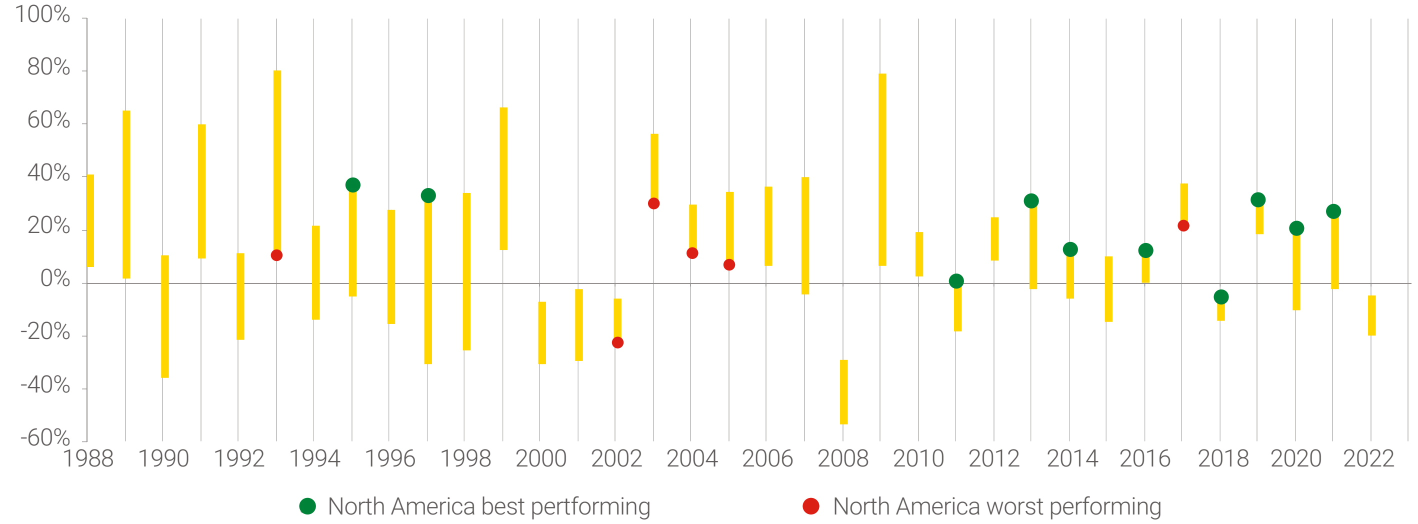
3. Markets are, for the most part, efficient. Long-term analysis[5] shows that there tends to be an initial period when disruptive industry or country news is priced in. Thereafter, we believe investors shouldn't expect to be rewarded for owning such favourable exposure

The fight against recency bias

As is often the case when making investment decisions, it is hard not to be influenced by recent performance. However, the case for diversification[2] – across asset classes and also across regions – remains strong in my mind. It is backed by financial theory and decades of historic data.

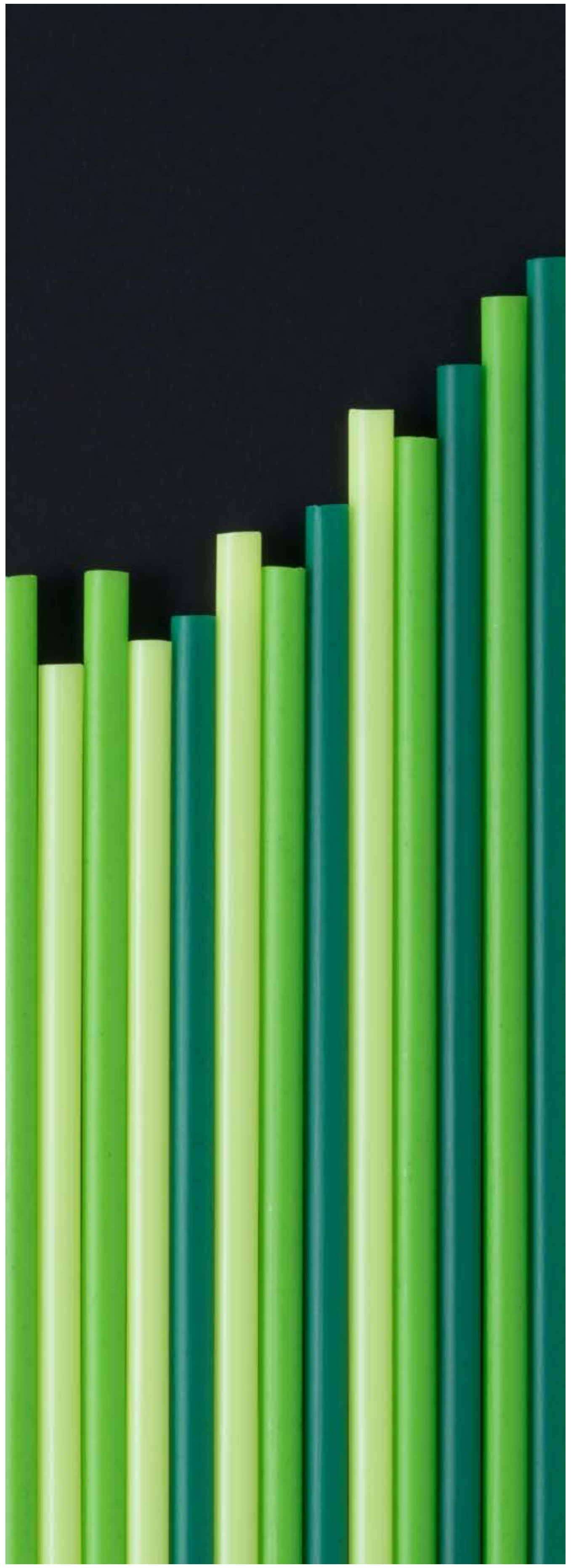
> **"It's important for us as investors to fight recency bias."**

Does the US always outperform?



Source: Bloomberg analysing annual returns between 1987 and 2022. **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 amount originally invested.**

2. **It should be noted that diversification is no guarantee against a loss in a declining market.**
3. Source: Bloomberg's analysis of annual returns between 1987 and 2022.
4. See the analysis of regional equity returns in LGIM Blog – Return of the 'cult of equities'?
5. See, for example, the Credit Suisse Global Investment Returns Yearbook 2015.



Correlation is not causation, nor constant

Bruce White
Head of Dynamic Strategies

Fiona Wu
Portfolio Construction Associate

From the early 1990s until 2021, the correlation between equity and bond returns had generally been negative.

That changed last year. 2022 delivered negative performance for all asset classes except cash and commodities. Why the change, and is this the new normal?

Over the long term, the correlation between bonds and equities varies considerably in both magnitude and direction. Simple explanations, such as the level of inflation, don't account for the variation.

Instead, we need to think about the types of shocks driving the economy and markets. Aggregate demand shocks tend to drive cashflow expectations and discount rates in the same direction. Positive demand shocks push up earnings forecasts and expectations for short-term interest rates. This means that generally, bond and equity prices tend to be inversely correlated in response to such shocks.

In contrast, aggregate supply shocks tend to drive inflation up and output down. For a nominal bond, higher inflation would reduce the value of its cashflows, likely resulting also in a fall in bond prices. Higher costs associated with inflation feed through to businesses and corporates, which typically lead to lower equity prices in this environment too.

The observed correlation between equities and bonds will be determined by which type of shock dominates. Our Economist team's roadmap points to the growing risks of a recession (demand shock) and a gradual abatement of supply issues, suggesting that equity/bond correlations could move to be negative – a potential silver lining for multi-asset portfolios.

Average beta to North America of EAFE and emerging markets (in US dollars)

EAFE = Europe, Australasia, and the Far East. Source: Bloomberg as at 31 August 2023. **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 amount originally invested.**

Fixed income implications

The high valuation of global fixed income since the beginning of this millennium may have been partly due to its value as a portfolio diversifier. Research from the Federal Reserve suggests the negative equity/bond correlation could have reduced the bond risk premium on US treasuries by several hundred basis points.

Changes in that correlation make it riskier for investors to hold bonds in their portfolio, so we can conclude that investors must be compensated by a higher bond risk premium.

A return to a negative correlation would therefore be likely to drive down yields again.

A new era?

For a multi-asset portfolio, a positive stock/bond correlation means an increase in the risk profile of the portfolio. If the risk tolerance of the investor remains the same, a reduction in the equity allocation may be required to maintain a constant level of risk.

We believe investors should calibrate their risk-taking considering a range of possible outcomes, not simply what has just occurred. This is why the question of whether we are in a temporary period of high equity/bond correlation or a structural 'new era' is important.

On balance, we lean to the former, but acknowledge some more structural inflationary factors that could mean we won't fully return to the golden age of equity/bond correlation.

However, it is important to note that the diversification[6] between equities and bonds is just one of the factors that is important in a global portfolio. The relationship between equities and other assets changes all the time.

If we compare the pre-pandemic and post-pandemic periods, bonds now offer less offset to equity risk, but regional equity co-behaviour has become less pronounced over time. That is demonstrated in the chart, showing a progressive decline in the average beta of EAFE and emerging markets to North America (all in US dollar terms).

This is driven in part by the greater weight to China within EM indices and China's economic and market dynamics de-coupling from the US in many respects. This benefits funds where the equities are regionally diversified to a greater extent than those where equities are dominated by North America.

In addition, the US dollar, a sizeable part of many of our funds' foreign currency exposure, has become more widely appreciated as a 'risk-off' currency. That supports our approach to considering foreign currency typically beneficial in portfolio construction. A resilient, diversified portfolio doesn't rely on one single component working.

In summary, there is no simple conclusion. The equity/bond correlation has changed in a way that is consistent with markets being dominated by concerns about aggregate supply shocks. Although that has weakened a valuable source of diversification, others have grown in importance relative to the pre-pandemic period.

6. **It should be noted that diversification is no guarantee against a loss in a declining market.**

The changing nature of commodities

Patrick Greene
Strategist

Justine Schafer
Climate Economist

To successfully decarbonise the economy, we need to change the commodities we consume. Fossil fuel consumption will need to fall, but new opportunities will also emerge. What does this mean for commodity allocations?

Winners and losers of the energy transition

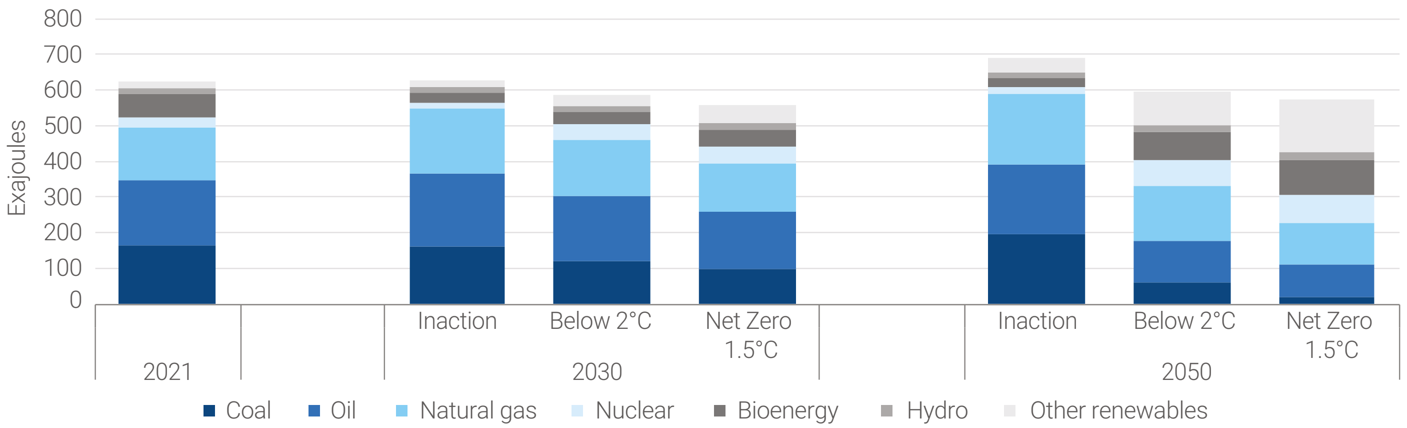
The future of the energy transition is uncertain, but if we are to succeed there are some clear messages from the scenario analysis. In our Net Zero 1.5°C scenario, total fossil fuel demand falls by more than half by 2050.

Coal is hardest hit, with demand reductions of over 85% by 2050 due to its rapid phase-out from power generation. Over the same period, oil demand halves due to full electrification of the passenger vehicle market and partial shifts to alternative fuels in heavier transport. By comparison, gas is least impacted, but demand still falls by nearly a quarter to 2050.

In our view, there are plenty of commodities with potential to benefit as well. Copper is a key commodity for the electrification of the economy. Lithium and nickel have the potential to benefit from growth in battery sales – though the winning battery technology is far from settled.

Annual solar and wind additions would have to triple and double, respectively, compared with 2021 in our Net Zero 1.5°C scenario. Wind turbines need a lot of steel and zinc. Silicon is used in both solar photovoltaic (PV) cells and electric vehicle battery anodes. Increased biofuel usage could support agricultural commodities through direct demand or competing land use.

Total primary energy demand



Source: IEA World Energy Outlook (2021 figure), LGIM Destination@Risk (2030 and 2050 scenario figures).
Assumptions, opinions and estimates are provided for illustrative purposes only. There is no guarantee that any forecasts made will come to pass.

What does this mean for returns?

As if knowing the future of demand weren't challenging enough, we believe investors also need to think about supply to determine commodity returns. If supply adjusts ahead of demand, then prices may rise even as demand falls (and vice versa). For investors gaining commodity exposure through derivatives, the shape of the commodity curve is also likely to influence returns, in our view. So, we cannot extrapolate straight from lower demand to lower returns.

It is also worth acknowledging the role of commodities in portfolios. We discussed this at the beginning of last year, highlighting the diversification[7] benefit and the potential inflation hedging properties – we also discussed why inflation hedging can't be assumed to work every time. The inflation hedging quality is in large part due to oil and natural gas, key sources of inflationary shocks.

> **"Even as we try to transition away, higher oil or natural gas prices still matter for inflation."**

Where does that leave us?

In the Asset Allocation team we have an equity allocation to a variety of decarbonisation themes. We believe, using equities can help as some of the commodities that benefit from the transition aren't in commodity indices or are difficult to trade.

The themes we have include battery chemical producers and miners of key metals for batteries. There are also renewable energy producers. You may not consider renewable energy providers as relevant to commodities, but they are the alternative to natural gas and (as electric vehicles grow in popularity) oil.

This approach – maintaining commodities as a diversifying tool in our asset allocation framework, while adding exposure to themes that we believe are set to benefit from the transition – is our way of positioning for evolving commodity demand.

7. **It should be noted that diversification is no guarantee against a loss in a declining market.**

Contact us

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

LGIM talks

The LGIM blog

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.

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