

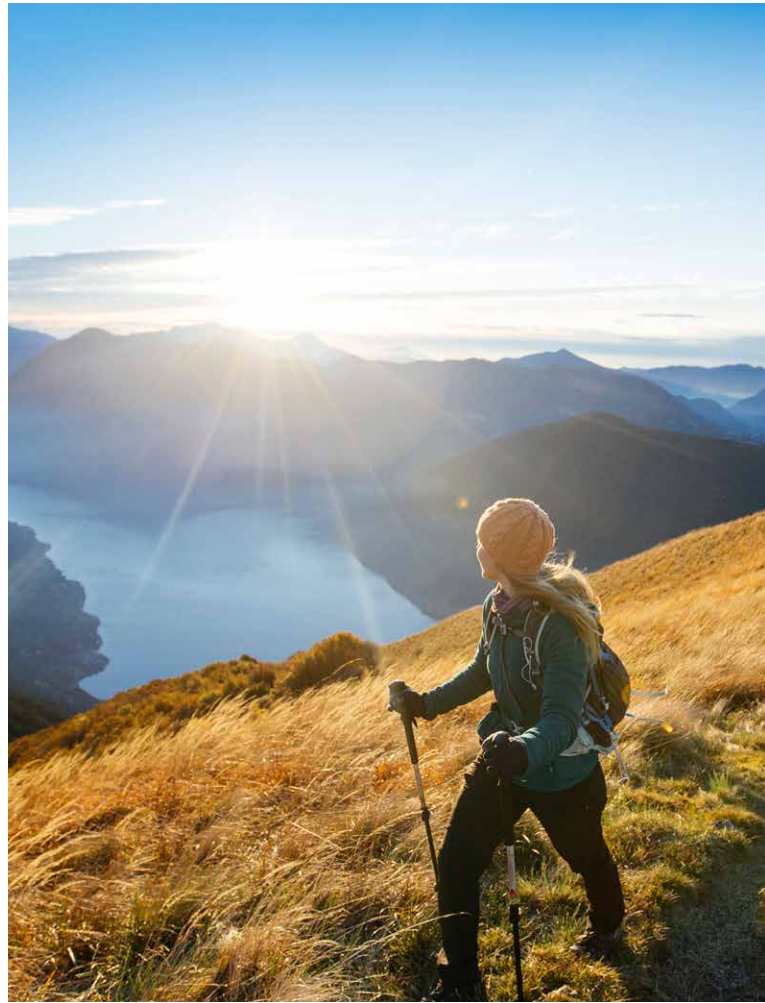
Q2 Outlook: Staying the course

With record amounts of stimulus still gushing through global markets, and the economic cycle at a relatively early stage, we remain positive on risk assets.



Emiel van den Heiligenberg

Emiel joined LGIM in August 2013 as Head of Asset Allocation, with responsibility for asset allocation, strategy and multi-asset macro research.



Risk assets have notched up strong and even spectacular returns from their pandemic lows, prompting the question: how much upside remains? While a lot of good news has certainly been priced in, we expect markets to grind higher – albeit with quite a bit of volatility along the way.

We believe most investors, like us, are positioned to buy meaningful market dips. We struggle to see how the short-term narrative would make investors become sellers, bar a geopolitical incident or a new black swan like the pandemic.

In our view, further market upside faces a headwind of bullish investor sentiment and positioning, which is already long. But with record amounts of stimulus still gushing through global markets, and the economic cycle at a relatively early stage, we see a significant tailwind as well.

Follow the money

The short-term outlook is one of economies opening up and normalising. Policymakers, meanwhile, will likely continue to be very supportive in the absence of pressure from rising inflation expectations. And even if this cycle plays out more quickly than the last, we believe it would be premature to expect equities to price end-of-cycle dynamics now. Such a scenario is too distant and too uncertain, in our view, with recession risk low.

At the same time, there has been a surge in US broad money supply, the magnitude of which has not been seen since the Second World War. Half of the increase has flowed into household accounts, while cash as a share of financial assets for non-financial corporates is at its highest level since 1969.

Markets are still figuring out what all the monetary and fiscal stimulus means for the world economy. We believe that a significant amount of this cash will be spent, boosting growth and possibly inflation (as Tim explains below). Of equal importance is our expectation that a significant amount of the cash on consumers' balance sheets will be invested in financial markets.

Equity markets may look expensive in absolute terms. However, we believe the equity risk premium – especially outside the US – remains acceptable on a relative basis.

We also see meagre long-run return potential in bonds, which makes long-term expected equity returns, albeit lower than normal, still quite attractive, in our view. In addition, we expect corporate profitability to improve, thanks to operational leverage and short-term increases in productivity.

Real yield moves

Investors are understandably growing concerned about the rise in yields and recent choppiness of equities. Yet we believe equity markets would be able to digest a move higher in yields, if it reflected the anticipation of faster inflation and stronger growth (a possible catalyst for which could be the weakening of the US Senate's filibuster).

There is also little empirical evidence that rising real yields are particularly bad news for equities, especially at their still very low levels; rising real yields have mostly been associated with higher stock markets.

In the event policymakers become fearful about the impact of all the stimulus they have unleashed, not least with regard to inflation, we would be ready to shift our positive stance. For now, though, within our portfolios we favour exposure to equities to play the current phase over investment grade credit, where we believe tight spreads pose an asymmetric risk to investors.¹

1. 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.

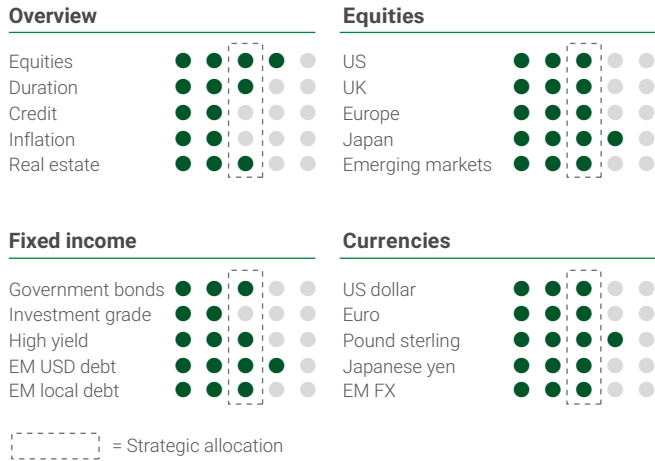
US money supply surges



Source: LGIM, St Louis Fed, Bloomberg as at 31 December 2020.

Our core macro views

Key asset class views:

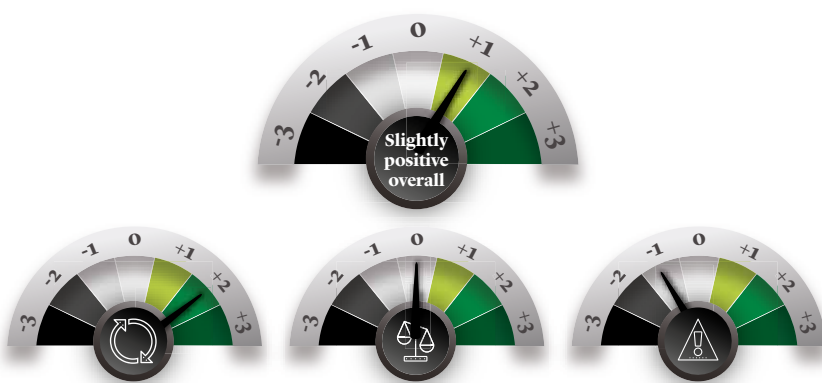


This schematic summarises the combined medium-term and tactical views of LGIM’s Asset Allocation team as of April 2021.

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.



Summary of LGIM’s asset allocation core view



Economic cycle

Coming out of recession is the most positive phase

Valuations

Relative valuations now less attractive

Systemic risk

Concerns around both political and credit risk

Economic cycle

- Coming out of recession is the most positive phase of cycle
- Vaccines rollout competing with rising case loads
- Monetary policy exceptionally easy and fiscal policy support stabilises the short-term outlook

Valuations

- Absolute equity valuations are high but not stretched
- Credit spreads now below average and less attractive
- But relative valuations remain positive and more relevant

Systemic risk

- Troubled relationship between US and China
- But Europe’s core more unified and Brexit deal done
- Global debt burden becomes worrying if inflation re-emerges

Source: LGIM. Views current as at April 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.



Tim Drayson
Head of Economics

How much stimulus is too much?

The US is embarking on a giant economic experiment to test capacity limits, involving both monetary and fiscal policy.

The Federal Reserve's (Fed) new framework means there is a commitment to wait for inflation to sustainably breach 2% before raising rates, rather than tightening pre-emptively if demand is strong given the usual lags in monetary policy.

This shift coincides with Democrats concluding that they did not go big enough after the global financial crisis. As a result, the latest \$1.9 trillion in fiscal stimulus is front-loaded, with over \$400 billion in direct payments to households reaching accounts before Easter. This comes after a \$900 billion bill was signed at the end of December 2020.

Meanwhile, discussions have already begun on the next round of stimulus to boost infrastructure spending. The numbers here are potentially even larger, but would be spread out over a number of years.

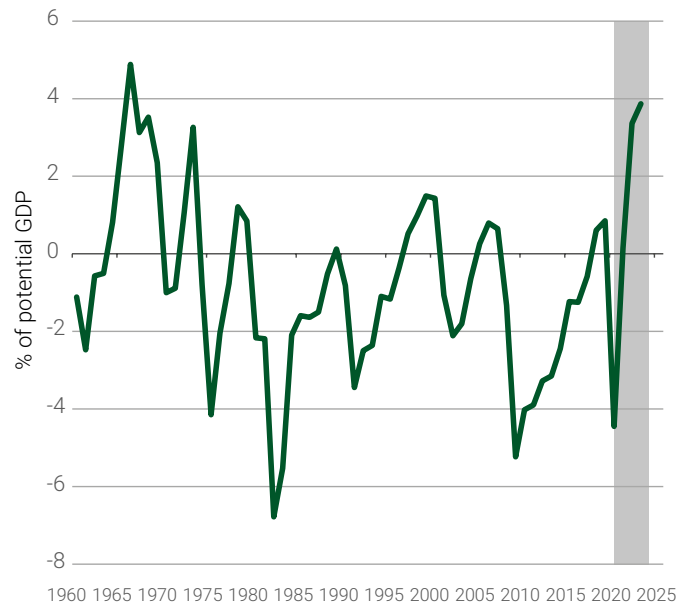
By the end of the first quarter households have accumulated more than \$2 trillion (or 10% of GDP) of excess saving. But now there are increasing opportunities to spend as the COVID-19 vaccine rollout is proceeding rapidly and the economy is starting to reopen. Even with 6% growth expected in 2021, most economists assume this cash stock is largely saved. So there are some significant upside risks to growth if the virus can be successfully contained and the economy fully reopens.

Echoes of the 1960s

What does this mean for inflation? The Fed's Chair, Jay Powell, has already warned about an imminent increase due to base effects from last year and some prices normalising (like airfares and hotels) as the economy reopens. Recent supply chain disruptions and commodity price increases, coupled with pent-up demand, could add to this upward pressure.

However, the Fed is likely right that this initial increase will prove transitory. Base effects start to move in the other direction later in the year and the supply tensions should ease. Even with a rapid jobs rebound, it will likely take a few quarters to return to full employment and so any wage pressures are unlikely to emerge until 2022. But at this point some of the slower-moving elements in the inflation basket, such as rent and education costs, could also be starting to move higher.

CBO output gap and LGIM forecast



Source: Macrobond, CBO and LGIM estimates as at 26 March 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.

There is a scenario where US growth is so strong, it drives the output gap to its most positive since the 1960s.

However, that does not mean a repeat of this era will follow. The Fed is now much more attuned to inflation expectations and could be forced to begin raising rates earlier than it has signalled to keep them well anchored. While this has the potential to be disruptive for markets, the recent rise in bond yields suggests this shift is already beginning to be anticipated.



Erik Lueth
Global Emerging Market Economist

The powerful cross-currents facing commodity prices

This year will likely see growth fireworks: according to the International Monetary Fund, only on three occasions in the past 40 years has world economic output grown at a similar rate to the pace we expect in 2021. Does this mean global commodity prices can continue to climb?

The growth outlook is undoubtedly supportive; indeed, the manufacturing PMI of advanced economies can explain more than 40% of the price variation in industrial commodities.

However, China poses a powerful headwind to the bullish commodity story. Not only has Chinese growth already returned to pre-virus levels, but credit conditions are likely to tighten markedly this year. After a COVID-19 induced jump in already-high debt levels, the country's leadership wants to keep its debt-to-GDP ratio stable in 2021. This implies a slowdown in credit growth from 13% to 11%, our analysis suggests.

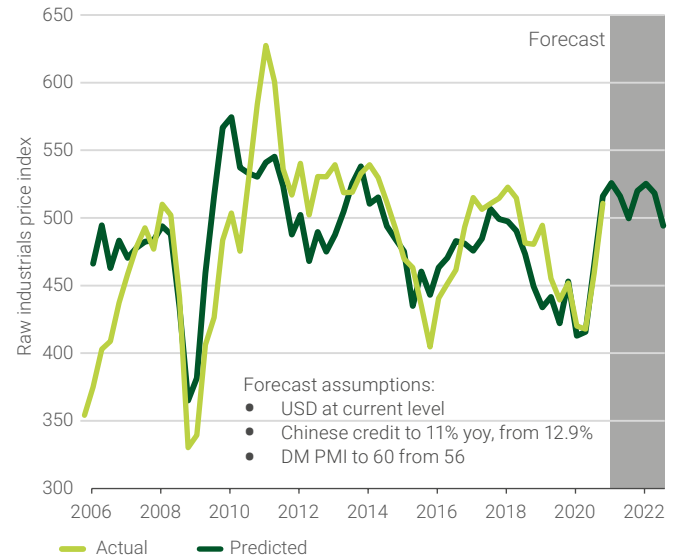
Historically, Chinese credit conditions have been a strong driver of industrial commodity prices. This is because most of the credit ends up in heavy industry and construction, areas in which China is a big player. For example, the country accounts for half of global steel consumption and more than half of global copper consumption.

Modelling commodities

To determine which of the above cross-currents will prevail, we have built a commodity model. In addition to the advanced economy PMI and Chinese credit impulse, this includes the US Dollar Index. Since commodities are denominated in US dollars, a weaker greenback makes them more affordable for non-US players, boosts global demand and leads to higher commodity prices.

What does our model indicate? For starters, commodity prices are exactly where they should be given historical correlations with activity, dollar and Chinese stimulus.

Commodity model



Source: Bloomberg, Macrobond and LGIM calculations as at 18 March, 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. 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.

Second, despite China's massive clout in global commodity markets, our model suggests that the advanced economy cycle matters more than the country's credit impulse for commodity prices.

This is also true for the 2020 commodity price appreciation. The price of industrial commodities rose 25% between Q1 and Q4. We estimate that 50% of this increase was due to the recovery in advanced economies, with 30% due to China's credit impulse and 20% on account of a weaker dollar.

What do we expect over the rest of this year? The model suggests that industrial commodity prices will probably remain around current prices throughout 2021 as the global recovery and Chinese tightening offset each other. This assumes a stable dollar, tighter Chinese credit and an advanced economy PMI of 60. The latter currently stands at 56.4 and has never hit 60 in its 23-year history.

To sum up, the world's economic recovery matters more than Chinese credit for global commodity prices. But as most of that recovery appears to have been priced in, the appeal of investing in commodities has dimmed significantly, in our view.



Willem Klijnstra
Strategist

Sterling: A return to ‘normality’

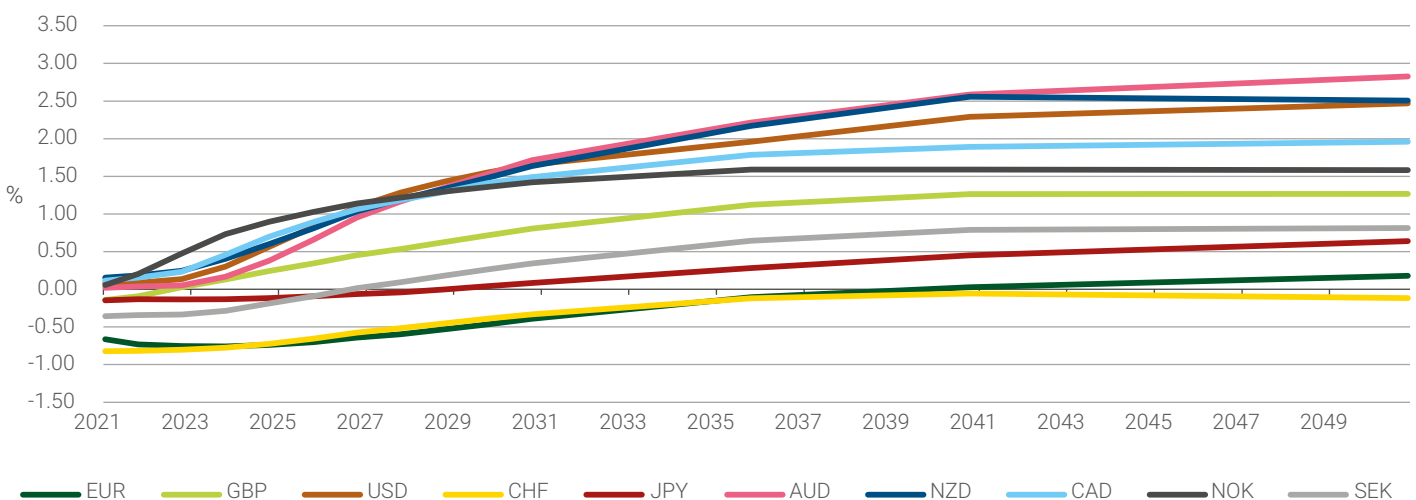
The pound has undergone quite a reversal thus far in 2021: from being the whipping-boy of G-10 currencies in recent years, it has become one of the stronger performers among its rivals. What explains this shift – and how durable is it likely to be?

Following the Brexit referendum, many investors were wary of sterling, amid concerns over the potential damage from the vote and uncertainty over the future UK-EU relationship. The global economic upheaval wrought by COVID-19 intensified that wariness, given the pound’s traditional status as more of a ‘risk-on’ currency.

Much of that wariness has dissipated since the end of the transition period on 31 December 2020, and in light of the UK’s relatively speedy rollout of vaccines. With investor positioning much cleaner and volatility more muted, sterling is trading much more like its G-10 rivals. (Since 2016, the pound occasionally behaved more like an emerging market currency, leading some to dub it the ‘British peso’).

A reassessment of the Bank of England’s outlook of late has been particularly supportive, with investors pricing out the possibility of negative interest rates. The market narrative is now focused on when the central bank will need to tighten policy, should faster growth lead to higher inflation.

UK 10-year yields: in the middle of the pack



Source: Bloomberg, as at 26 March 2021. 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.

Referendum fatigue

Looking ahead, we anticipate further strength in the pound, a view we favour expressing versus the euro given the close ties between the UK and euro-area economies.

Our conviction stems from the belief that any further normalisation on the rates front should be positive for sterling, especially if this takes the UK further away from its perennially low-yielding counterparts among other developed markets – not least within Europe’s currency bloc.

In addition, we see the pound’s valuation as appealing on a simple real effective exchange-rate basis, a composite measure that weights bilateral real exchange rates against each of the UK’s major trading partners by their shares in its total trade. Of course, the euro area’s halting response to COVID-19 is also a factor.

One potential market catalyst we are monitoring is the Scottish parliamentary election, on 6 May, whose results could raise the chances of a second independence referendum. Such an outcome could dent the growing enthusiasm for the pound among global investors, for whom the Brexit vote is still a relatively fresh memory and who are continuing to pay for protection against further volatility in the currency, according to options markets.

In line with our motto of ‘prepare, don’t predict’, we will adjust our stance as the situation unfolds.

Contact us

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



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