

CIO Investment Outlook

Brace for a credit squeeze

Unfortunately for markets, our bearish outlook for 2018 came to pass. For 2019, the key question is how tightening financial conditions will impact heavily indebted borrowers – and whether this raises the risk of recession.



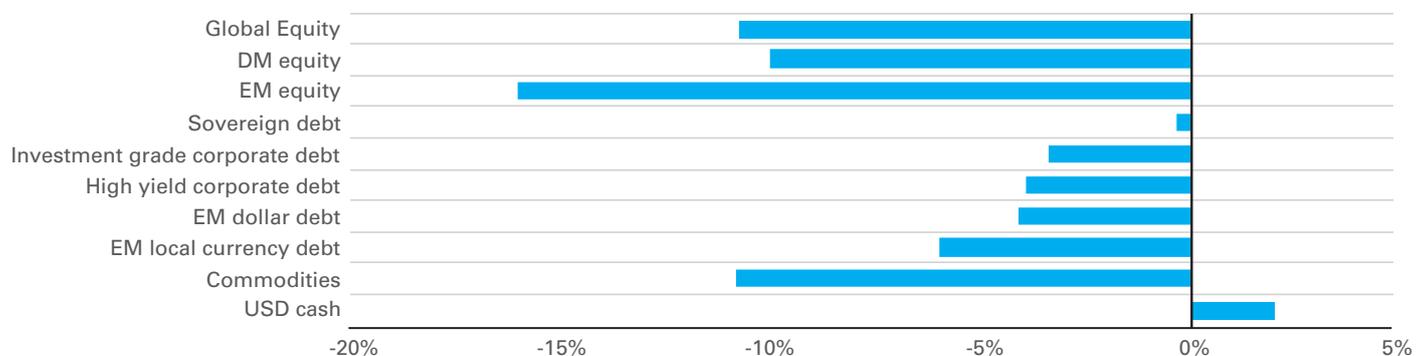
Anton Eser is the Chief Investment Officer of LGIM, responsible for the firm’s investment management activity. Prior to this, Anton was Co-Head of Global Fixed Income, managing LGIM’s flagship global credit portfolios.

This time last year, I wrote about quantitative tightening, and how the liquidity tide going out would likely reveal structural problems associated with excess debt, deteriorating demographics and poor productivity – ultimately weighing on markets.

The first casualties were emerging markets, which suffered from a stronger dollar and higher bond yields. In second place were European borrowers, highly sensitive

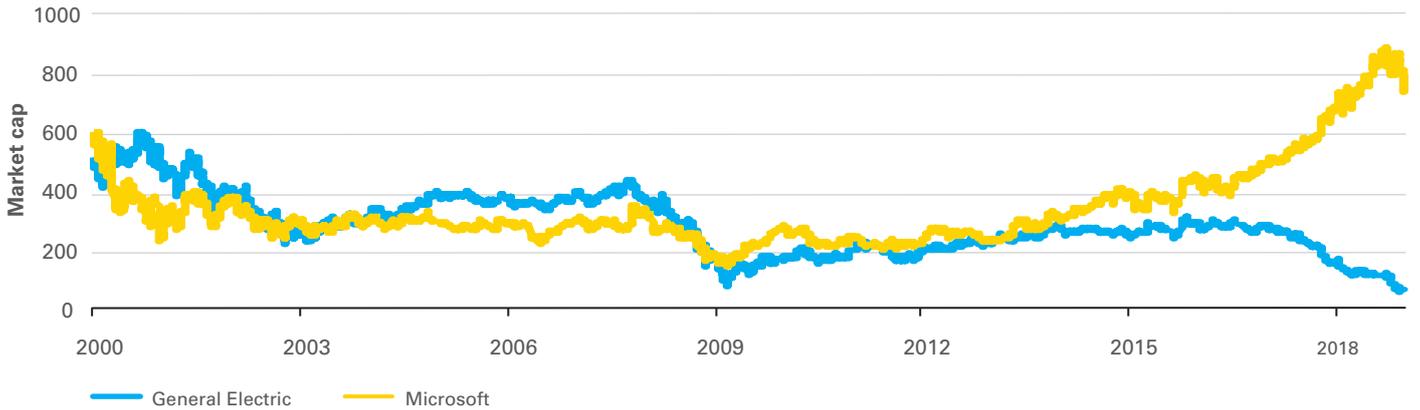
to the European Central Bank (ECB) slowing its asset purchases – weakening growth and political fragility is not a good mix to face without massive central bank support. US domestic assets had a good first half of the year, boosted by US President Donald Trump’s tax cuts, with the S&P 500 near the highs and US credit spreads close to the tights of the year as recently as October. But this relative strength dramatically evaporated in the final weeks of 2018.

Figure 1: Total returns in 2018



Source: Bloomberg L.P., Barclays, MSCI, JP Morgan, Deutsche Bank

Figure 2: Equity markets have differentiated between traditional companies and technological innovators (USD bn)



Source: Bloomberg L.P., as at 2 January 2019

WHERE IS THE NEXT VULNERABILITY?

Over the longer term, technological developments should partially offset the economic drag from excess debt and weak demographic trends. In the shorter term, however, we believe large corporate borrowers left behind by such technology shifts are particularly vulnerable to ongoing quantitative tightening.

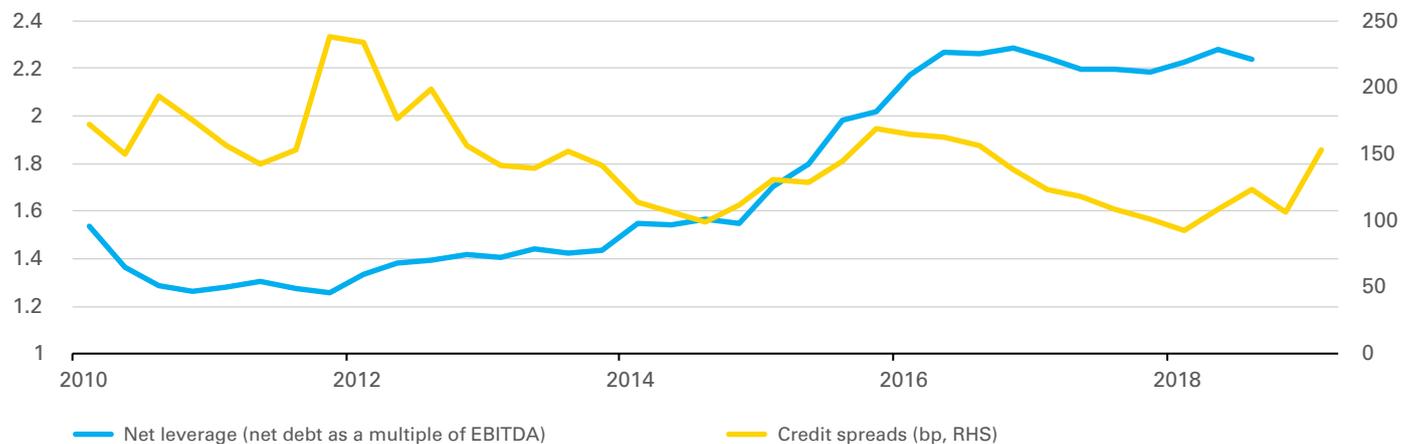
Such corporates have generally had a successful last few years, using cheap leverage to reduce borrowing costs, buy back shares and maintain profitability. But they now face tougher financing conditions, weakening economic growth and tightening liquidity. There have also been some very large mergers and acquisitions over the past few years; the sheer scale of some corporate balance sheets may become a concern in this environment.

This is when business models are tested and credit rating agencies become impatient.

Equity markets have already witnessed large moves between traditional companies and technological innovators – a stark demonstration being the relative performance of General Electric versus Microsoft (Figure 2). There are many other examples across sectors such as autos, media companies and retailers.

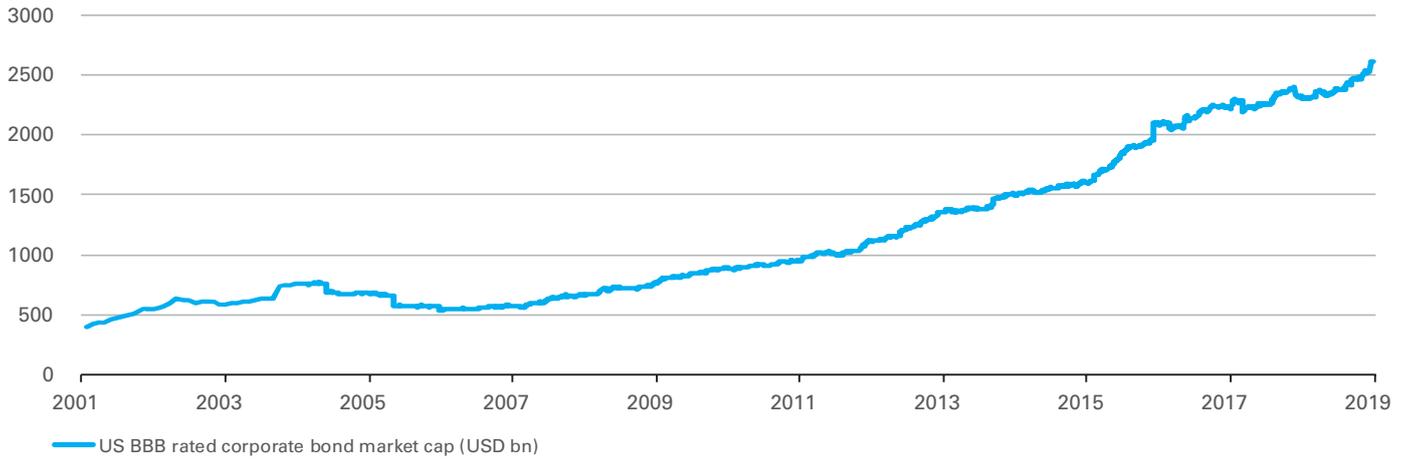
Up until now, credit markets have been less discriminating. Figure 3 plots the average leverage of US investment grade corporates against credit spreads – demonstrating that credit markets have largely ignored weakening profiles. But I’d expect this to change, should economic activity slow under the grip of monetary tightening, resulting in downward pressure on credit ratings.

Figure 3: US investment grade corporate spreads have yet to react to higher leverage



Source: Bloomberg L.P., Barclays, JP Morgan as at 31 December 2018

Figure 4: The BBB rated bond market has grown rapidly



Source: Bloomberg L.P., Barclays, as at 31 December 2018

What will happen to this debt, if and when it is downgraded? As figure 4 shows, the growth of the BBB rated bond market has been significant in recent years. In the last recession, the peak annual downgrade rate of BBB debt into sub-investment grade was about 8%. Such a wave of downgrades could prove challenging for investors to absorb, representing around 16% of the current high yield universe. In addition, many of these issuers are traditional companies that employ a lot of people, resulting in a self-fulfilling negative economic impact.

The high yield universe itself will also be sensitive to slowing economic growth. But while the high yield bond market's size has been pretty stable, the leveraged loan market has ballooned in the last three years and become less credit worthy, in our view. A slowing US economy, rising cost of finance and pricing mostly around par means

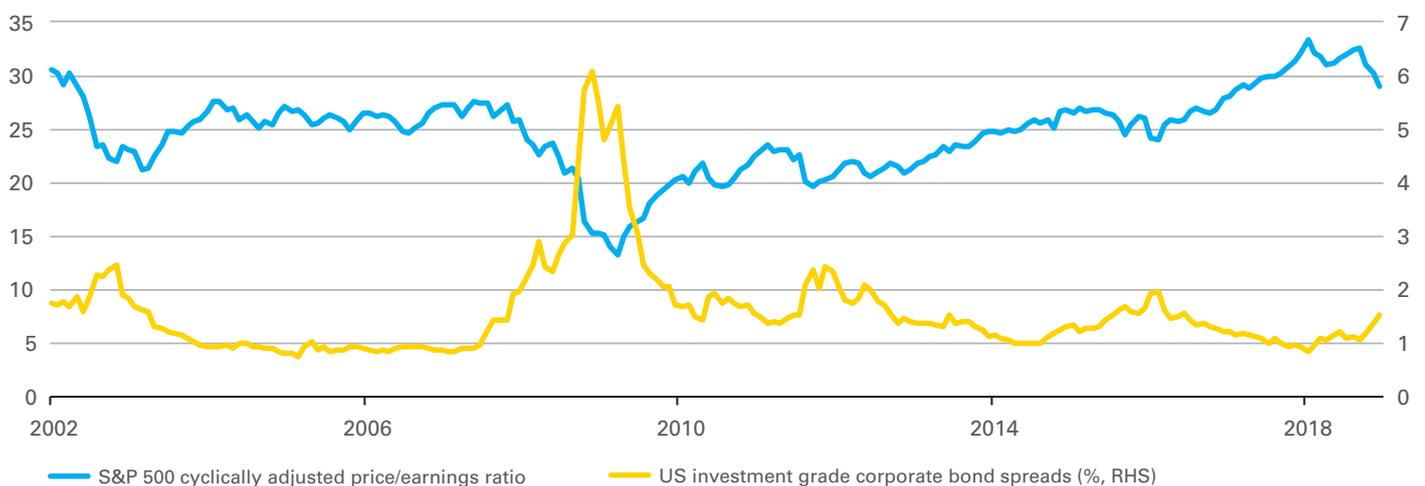
this asset class, which has already started to sputter, could suffer as liquidity is withdrawn.

In sum, I expect the next downturn to be more like the corporate-led stress of 2001-2, with a focus on credit quality, than the banking crisis of 2007-8, which centred on excess exposure to leveraged products on financial institutions' balance sheets.

ARE VALUATIONS CHEAP ENOUGH?

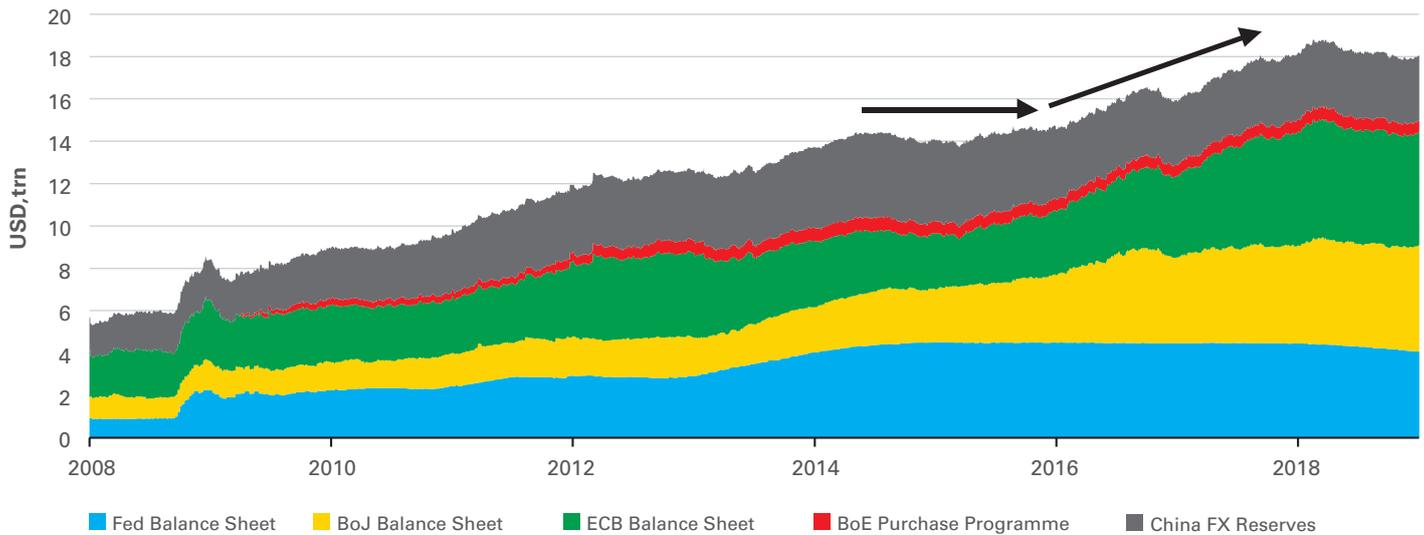
A positive outcome for markets in 2019 would be that liquidity conditions do not deteriorate further and an economic downturn is postponed. Credit and equity valuations have already cheapened somewhat (Figure 5) and therefore a stabilization of the macroeconomic backdrop could prompt a decent recovery.

Figure 5: Valuations have corrected a little



Source: Bloomberg L.P., Robert Shiller, as at 31 December 2018

Figure 6: Markets rebounded in 2016 after central banks reopened the liquidity taps



Source: Bloomberg L.P., as at 2 January 2019

This narrative could well play out for periods of the year, resulting in tradable rallies, but the combination of central bank tightening and global structural problems means that any such relief should prove temporary.

I'd therefore be wary of 'catching a falling knife'. Investors' unencumbered liquidity has already declined in recent months, and is likely to deteriorate further alongside quantitative tightening. To misquote Rudyard Kipling: If you can maintain liquidity as all around you are losing theirs, then there may be opportunities to pick up good assets at potentially very attractive valuations. But in order to exploit any such opportunities, investors would probably need to start preparing their portfolios now.

WHAT COULD GOVERNMENT AND CENTRAL BANK SUPPORT LOOK LIKE?

The last time that monetary policy tightening resulted in a growth scare, back at the beginning of 2016, markets were saved by global central banks turning the liquidity taps back on (Figure 6).

The problem today, as we discussed in a [recent article](#), is that central banks are now more constrained. Japanese banks are suffering from negative interest rates, and the Bank of Japan already owns more than 40% of Japanese government bonds, with a balance sheet the size of the country's GDP. The ECB has just stopped buying government bonds, restricted by self-imposed limits, and China appears to be very keen on reducing rampant non-bank leverage. However, we would imagine that stimulus in China would be forthcoming and effective if significant negative economic risks materialise.

We are therefore left with the US Federal Reserve (Fed). Reducing the number of planned interest rate hikes in 2019 would help, by lowering borrowing costs and weakening the dollar. But Fed policy makers' most effective action would probably be to reverse their balance sheet shrinkage.

Figure 7: US wage pressure continues to build (% YoY)



Source: Macrobond, as at 1 January 2019

The key constraint here is wage pressure (Figure 7). I suspect they would be unlikely to engage in another round of quantitative easing with such a tight labour market. But that suggests the need for rising unemployment, often associated with a recession. In other words, things would probably need to get worse before the Fed steps back in.

TAIL RISKS

There has been a cacophony of noise surrounding a number of geopolitical stories in 2018 – from European populism to global trade wars. Even if the underlying market driver continues to be tightening liquidity conditions, rather than these idiosyncratic headlines, they remain a focus for many investors. As a result, positive developments could catalyse periods of relative calm, but this would again encourage central bankers to keep their tightening policies in place.

We are more concerned with the downside risk. Further geopolitical upheaval has the potential to cause significant price dislocations, with investors and market makers pulling back all at once. This could be the time to deploy portfolio liquidity to pick up potential bargains.

MARKET IMPLICATIONS

Interest rates are likely to remain very low in Europe, Japan and the UK thanks to lacklustre economic growth. While the Fed will initially want to keep hiking interest rates, weakening growth prospects should keep a cap on longer-term yields, leading to more curve flattening. As growth concerns build, we expect the US Treasury curve to bull-steepen eventually.

Given liquidity tightening and mounting downside growth risks, a cautious approach to **equity** exposure makes sense, in our view, reducing risk on rallies.

Credit is also likely to remain under pressure in general, but there should be opportunities to invest in viable entities at distressed levels.

The outlook remains structurally **dollar**-bullish as liquidity conditions tighten. In the context of a cautious credit outlook, this is generally more positive for dollar-denominated **emerging market** debt versus local currency paper.

There are obvious downside risks for sterling and growth-sensitive **UK assets**, but valuations are more aligned to this observation than 12 months ago.

Commodities would likely be impacted by economic growth disappointments, but a new stimulus programme from China would clearly be very positive.

WHAT DOES THIS ALL MEAN FOR INVESTORS?

Against this backdrop, we are focused on managing risk to achieve long-term financial goals. We seek to enable defined benefit pension schemes to reduce inflation and interest rate risk, while managing allocations to growth assets. And of course 'growth' assets can range from pure equity exposure, to buy and maintain credit, to multi-asset target return strategies.

And we provide a number of similar solutions to defined contribution (DC) pension schemes, with a focus on multi-asset strategies.

Market volatility should matter less for investors in the 'accumulation' phase ahead of retirement, be they retail or DC scheme members. But we do offer solutions that are aimed at managing market risk at the same time as providing an income, for investors closer to retirement, and in line with their appetite for risk.

Meanwhile, we continue to integrate environmental, social and governance factors into our investment processes, as we believe that by doing so we can help to mitigate a wide range of risks for investors other than those posed by the macroeconomic outlook.

Important Notice

Legal & General Investment Management Limited (Company Number: 02091894) is registered in England and Wales and has its registered office at One Coleman Street, London, EC2R 5AA ("LGIM").

LGIM is authorised and regulated by the Financial Conduct Authority.

This document is designed for our corporate clients and for the use of professional advisers and agents of Legal & General. The views expressed within this document are those of Legal & General Investment Management, who may or may not have acted upon them. The information contained in this brochure is not intended to be, nor should be construed as investment advice nor deemed suitable to meet the needs of the investor. Nothing contained herein constitutes investment, legal, tax or other advice nor is it to be solely relied on in making an investment or other decision. This document, and any information it contains, has been produced for use by professional investors and their advisors only. It should not be distributed without the permission of Legal & General Investment Management Limited. This document may not be used for the purposes of an offer or solicitation to anyone in any jurisdiction in which such offer or solicitation is not authorised or to any person to whom it is unlawful to make such offer or solicitation.

M1855