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Investment Outlook

New Frontiers: How 2024's US Election Redefines Boundaries

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Macro Environment

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"Unfortunately, politics is likely to conspire against such an economically favorable backdrop persisting beyond November's election."

US elections do matter, but the reality is that rarely are they as meaningful for markets as investors expect. That's because the real changes tend to be correlated with sweep scenarios. At the risk of flying in the face of decades of collective wisdom, this year has the potential to be very different. Sweep scenarios in both directions are likely being underappreciated, and presidential executive actions may matter more to the economy and Fed policy than ever. The leading candidates' starkly diverging views on tariffs and immigration are likely to mark a pivotal moment for the economy in 2025 and beyond.

On a basic level, this year's election rematch appears to be about which Presidential candidate can avoid losing the least number of votes relative to their 2020 tally. Both parties need a strong turnout from their core base as swing voters are likely to be disengaged. But this backdrop may increase the likelihood of "winner take all" outcomes, particularly given the notable decrease in split ticket voting over the past decade. As a consequence, Democrats have an underappreciated opportunity to maintain control of the chamber should Biden be re-elected, even though Republicans have a more favorable map in the Senate. Likewise, contingent on Trump winning the election, the probability of Republicans winning the House and Senate is much higher. Taken together, the likelihood of a sweep scenario—by either party—may be over 50% with Republicans having nearly double the odds as Democrats.

For the economy, sweeps are especially important as they allow the controlling party to pass fiscal legislation unilaterally through the filibuster-proof budget reconciliation process. This is key for Republicans and Trump, as parts of the TCJA—aka the Trump tax cuts—are set to expire in 2025. The Republican sweep is the only scenario where extending the TCJA is likely. Discretionary spending is likely to increase in either sweep scenario via growth in either defense (Republicans) or non-defense (Democrats) spending. Under a Democratic sweep, Biden is likely to pursue tax increases while letting the TCJA expire. More importantly, the Child Tax Credit policy could return as an offsetting fiscal impulse concentrated on consumers.

While typically not considered a fiscal policy issue, tariffs are a wildcard under a Trump presidency. Unlike other fiscal policies, presidents have near unilateral discretion to enforce tariffs. Trump has mentioned a 10% "across-the-board" tariff in interviews, a 60% tariff on imports from China, a 100% tariff on Chinese automobiles made in Mexico and reciprocal tariffs on all imports. While it is unclear how many of these tariffs are realistic, it is safe to assume Trump will increase tariffs substantially relative to the counterfactual status quo that Biden would likely enact. While presidents have authority to impose tariffs, only Congress can decide how to spend the proceeds. Without a sweep most of the funds likely would go towards deficit reduction, while under a sweep scenario additional tax cuts targeted at the middle class and small business could be on the table.

Tariffs are also consequential to the pace of disinflation. Goods disinflation has been crucial to core-PCE returning towards target but appears to be nearing a bottom while service inflation has been much stickier. Should the US impose tariffs precisely as the rest of the world (i.e., China) begins a potential growth recovery in 2025, rising goods prices could spark fears of a reacceleration in inflation, posing a difficult question to an Federal Open Market Committee (FOMC) that appears poised to embark on a rate cutting cycle later this year.

According to recent polls from Gallop and the Wall Street Journal, immigration is quickly becoming the primary policy concern of voters, with 1 in 5 voters declaring it a single issue policy for their vote in November. 72% of swing state voters believe immigration and border policies under Biden are going the wrong way.[1] Similar to Tariffs, presidents have singular influence over border enforcement policies surrounding unauthorized immigration. Biden's relaxed control over the border has caused an exponential increase in immigration during his tenure, following a net decrease in foreign born immigration under Trump.

For economists, immigration is quickly coming to be recognized as the answer to the question of how the US can be generating so many jobs without further tightening to the labor market and upward wage pressure. The Congressional Budget Office (CBO) recently updated their estimates for net immigration in 2023 up from 1 million to 3.3 million.[2] The updated number implies population growth of 0.9%, nearly double the census estimate used by the Department of Labor for their employment statistics. Not only does this explain the divergence between strong payrolls and a rising unemployment rate, but it also explains why the labor market is not tightening to the degree economists have expected – the elevated payrolls are a result of the labor pool expanding rapidly.

Notably, Biden's executive actions to overhaul the asylum process in 2022 have allowed unauthorized immigrants to receive work permits, allowing widespread legal employment in more industries while being counted in official employment statistics. Specifically, the influx of immigrants has been supplying construction and the service industry with the labor they critically need. This has contributed to stabilizing wage levels within these sectors and has had a ripple effect throughout the economy.

Had immigration remained a net drag on the labor pool as it was under Trump previously, it is possible–and perhaps even likely–that wage pressures would have continued to rise, keeping core-PCE elevated while risking the de-anchoring of long-term inflation expectations. The Fed's November pivot may never have arrived, and the prospect of further hikes in 2024 could have been on the table as opposed to cuts. While it is difficult to know for certain, the US economy may have failed to avoid recession last year without such a large supply side labor shock. What happens to immigration policy going forward under a potential Trump presidency is therefore of economic significance. Furthermore, there is a tail risk that Biden reverses his border policies ahead of the election to appease voters.

As is always the case, pinpointing the precise moment when elections start to matter to markets is a challenge. While it would be unusual to see evidence more than six months in advance, the recent rise in long-maturity US Treasuries could be an early indication of election-related fiscal risk. Regardless, it is likely that markets will start to trade the election in the coming months. Last year's mix of surprisingly robust growth and disinflation look to be at least partially attributable to fiscal stimulus and the surge in immigration. Unfortunately, politics is likely to conspire against such an economically favorable backdrop persisting beyond November's election. Exactly what changes will depend on who wins. Markets should take note.

Pension Solutions Monitor[3]

Chris Wroblewski, CFA
Co-head of Solutions Strategy

"US pension funding ratios increased over the first quarter of 2024."

Our analysis of market movements impacting US corporate defined benefit pension plans leads us to estimate that pension funding ratios increased over the first quarter of 2024. Based on market movements, the average funding ratio is estimated to have increased from 104.1% to 108.2%.

Equity markets experienced strong performance over the quarter with both Global Equities[4] increasing 8.3% and the S&P 500 increasing 10.6%. Plan discount rates[5] were estimated to have increased approximately 24 basis points over the quarter with the Treasury component increasing 29 basis points and the credit component tightening 5 basis points. Plan assets with a traditional "50/50" asset allocation increased 2.9% while liabilities decreased 1.1%. The strong asset performance and decrease in liability values resulted in a 4.1% increase to funding ratios over the first quarter of 2024.

Average funding ratios reached recent highs in Q1 following a strong rally in equities and a further increase in plan discount rates. Specifically, global market equities and the S&P 500 saw increases of 8.3% and 10.6%, respectively, contributing to the rise in funding ratios. As we enter Q2, investors continue to express interest in custom hedging strategies to lock in funded status gains. With an uncertain outlook on the direction of interest rates, many plans are adopting custom completion strategies to improve their governance framework and reduce funded status volatility. Additionally, plan sponsors are increasingly looking for ways to diversify their fixed income portfolio as allocations to the asset class grow. Among strategies discussed are intermediate credit, investment grade private placements and shorter duration fixed income mandates.

The Pension Solutions Monitor now assumes a typical liability profile using an approximate duration of 12 years and a 50% MSCI AC World Total Gross Index / 50% Bloomberg US Long Government/Credit Index investment strategy. Our analysis incorporates data from LGIM America research, ICE indices and Bloomberg.

Pension funded status market summary:

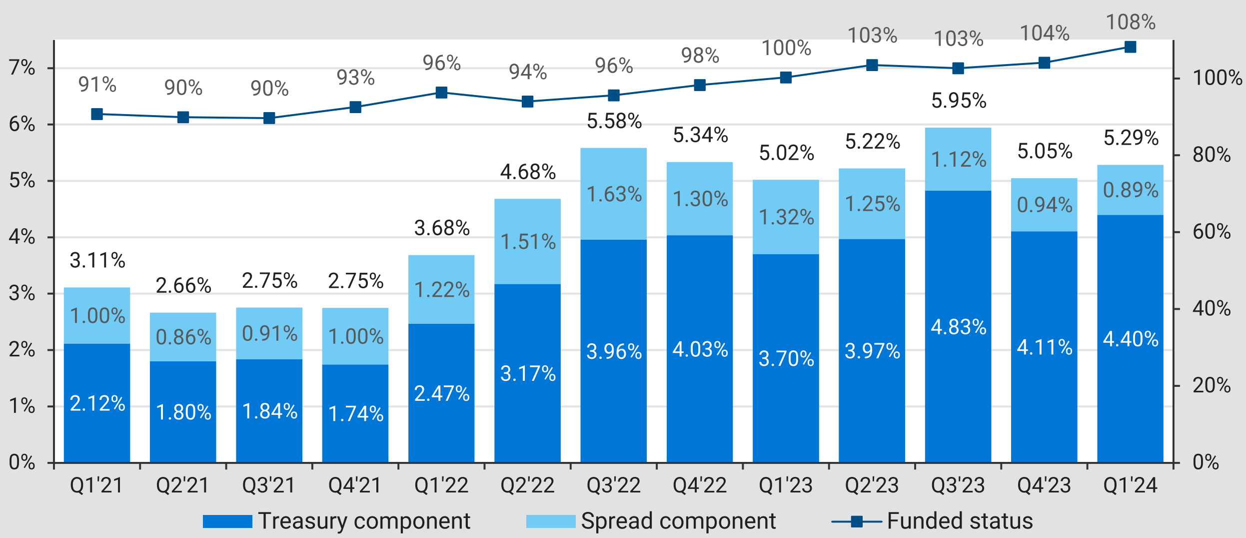
- Equity markets delivered strong performance with Global Equities and the S&P 500 up throughout the quarter.
- Plan liabilities decreased due to higher discount rates.
- Funding ratio levels increased with the rise in assets and drop in liabilities.

Funded status risk - Q1 2024

Equities	↑
Interest rates	↑
Credit spreads	↓

Sources: LGIM America, ICE indices and Bloomberg. Data as of March 28, 2024.

Figure 1: Discount rates



Sources: LGIM America, ICE indices and Bloomberg. Data as of March 28, 2024.

Fixed Income Markets

Anthony Woodside, CFA, FRM
Head of Multi-Sector Fixed Income & Investment Strategy

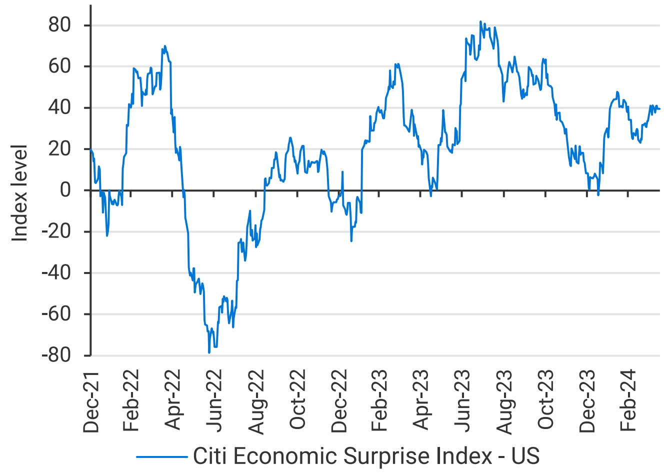
"Given robust growth and a Fed that appears biased to ease, we remain fully invested in credit in the short-term."

"What goes up must come down." While this principle is certainly instructive for everyday life, it reveals very little about how long an object can remain airborne before succumbing to gravity's irrepressible force. Despite dire prognostications and ostensibly deflating monetary policy, the US economy continues to resist overtures to initiate a sustained descent (Figure 2). The footprints from 2023 remain etched in our memory banks, commemorating the year of the most telegraphed recession…that never happened.

Coming into 2024, hard landing advocates had largely retreated, as data consistent with "immaculate disinflation" spurred optimism that a soft landing was the most probable outcome for the US economy. However, with the first quarter of the year now in the rear-view mirror, investors are forced to reconsider whether consensus went far enough in upgrading its outlook. Indeed, robust momentum and mounting evidence of a potential reacceleration of inflation suggest that the economy is meaningfully less interest rate sensitive than previously thought. If the second quarter brings more of the same, market participants would be wise to modify their playbooks as the ramifications for policy response and asset valuations would likely be considerable.

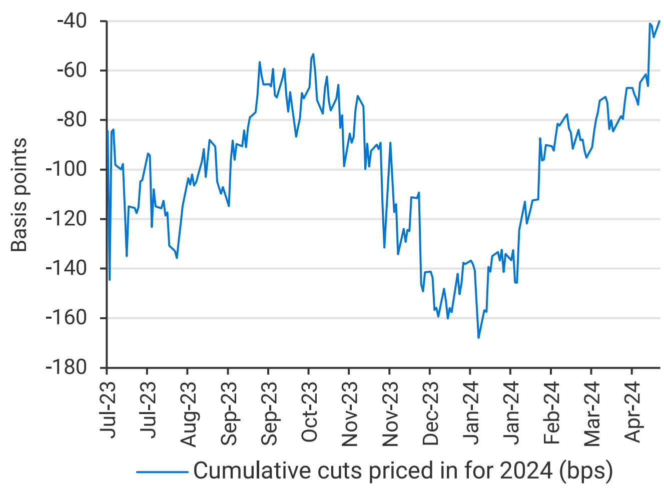
The first quarter of the year extended the run of the "perfect setup" for bonds failing to live up to its billing. With the Fed signaling that a pivot was imminent at its December policy meeting, market expectations for cumulative easing in 2024 initially surged to nearly 170 basis points, significantly outpacing the 75 basis points of cuts implied by the central bank's median dot (Figure 3). However, with the economic activity displaying little sign of moderating and the Consumer Price Index (CPI) report exceeding expectations for three months in a row, rate cut expectations have been pared back dramatically, with investors now pricing in less cumulative easing than the Fed's forecast.

Figure 2: No landing expectations fueled by resilient economic data



Source: LGIM America and Bloomberg. Data as of April 12, 2024.

Figure 3: The market has gone from pricing in almost seven cuts to less than two



Source: LGIM America and Bloomberg. Data as of April 12, 2024.

Unsurprisingly, the aftershocks of the hawkish repricing in rate cut expectations reverberated across the yield curve. Overall, 2-year yields increased by 37 basis points, while 10- and 30-year yields increased by 32 basis points each over the quarter.[6]

In corporate credit, the tussle between yield-sensitive buyers and spread-focused investors remained largely one-sided. Despite upward pressure on risk-free rates and increased uncertainty around the timing and magnitude of a Fed pivot, credit markets remained stubbornly resilient. While total returns were negative in investment grade credit due to the move higher in rates (US credit -0.41%, US Long Credit -1.65%), excess returns were positive as spreads tightened 9 and 7 basis points, respectively, inching closer to historical tights.[6] This outperformance is particularly noteworthy given the record pace of supply in the first quarter, substantially fueled by a pickup in M&A activity. High yield credit also posted another strong quarter, registering positive total and excess returns as investors continue to clamor for the high levels of income offered by the asset class set against a relatively benign default outlook.

In terms of positioning, we moved from neutral investment grade credit to modestly overweight over the course of the quarter. While the technical backdrop became less supportive due to record supply, spread widening in the middle of the quarter was relatively short-lived as yield-sensitive buyers ramped up demand. In long credit specifically, we believe that more than half of full-year M&A related issuance has already been met, and thus we expect supply to be less of a headwind going forward. Meanwhile, the demand outlook is likely to remain robust in the coming months.

Heading into the second quarter, we continue to see scope to add value through exploiting relative value opportunities. With credit spreads hovering around the tights of the year, there has been a glaring lack of participation from many higher quality A-rated issuers in the rally. Many BBB-rated issuers are now near (and even through) the tights of the year while some higher quality issuers remain nearly ten basis points off January levels. We attribute most of this disparity in performance to the fact that supply from A-rated issuers has significantly outpaced issuance from the BBB cohort. We advocate rotating out of select, outperforming BBB issuers in favor of A-rated laggards. This rotation can also find support from a strengthening of the reacceleration narrative as yield focused investors would no longer need to dip as far down the quality spectrum to hit their targets in a "higher for longer regime."

In rates, last quarter we expressed our view that the risk of a reacceleration was being underpriced through a tactical underweight in duration in the long end of the curve. We believe that we are approaching an attractive entry point to initiate yield curve steepeners, with the view that this strategy offers potential upside in both bearish (neutral rate revised higher and term premium gets rebuilt) and bullish (slowing inflation and/or a deterioration in economic momentum) backdrops for rates markets.

With the fog surrounding the post-COVID economy gradually dissipating, market participants have uncovered latent factors that continue to play an instrumental role in generating above-trend growth. The deficit remains abnormally elevated at this point of the business cycle, while positive supply side forces, specifically outsized immigration, have been underappreciated until recently. Additionally, while the Fed is engaged in quantitative tightening, the Fed's balance sheet is still large from a historical perspective. Against this backdrop, the view that the US economy will avoid a hard landing appears intact in the short-term, but it is difficult to dismiss the notion that a no landing outcome has emerged as a compelling alternative to the soft landing consensus.

Looking ahead, investors remain confronted with the familiar conundrum of elevated macro uncertainty and compressed risk premiums. Understanding the reaction function of policymakers will be critical in coming quarters. In our view, the Fed wants to cut rates to preserve a soft landing, but the data has simply failed to cooperate over the last few months. On the positive side, higher nominal growth is supportive for earnings, which in turn can validate elevated valuations for risk assets. Furthermore, we believe the Fed would likely need to see more definitive signs of reacceleration for hikes to be back on the table.

On the other hand, the longer monetary policy remains restrictive, the greater the pressure will be on more vulnerable cohorts in the financial ecosystem. Lower income consumers continue to show cracks in the form of rising credit card and auto delinquencies. Additionally, the fallout in regional banks and commercial real estate looks far from resolved. While neither of these risks appear systemic in isolation, there is a case to be made that the longer they are allowed to fester without relief from monetary policy, the greater their potential to upset the apple cart later this year or early next year. For high-grade credit investors, it is also important to note that negative total returns have historically precipitated outflows from the asset class, and thus a continued rise in rates may eventually be met with waning demand. Lastly, escalating geopolitical tensions and a higher-than-expected chance of a sweep outcome in the US election (as referenced in the macro section) are also potential landmines for valuations that appear to be priced for near perfection.

Given robust growth and a Fed that appears biased to ease, we remain fully invested in credit in the short-term. However, we caution that investors should monitor economic data particularly closely in the coming months as the medium-term trajectory of the US economy, and by extension, the monetary policy outlook, hangs in the balance.

Equity Markets

Dave Chapman, CFA
Head of Multi-asset

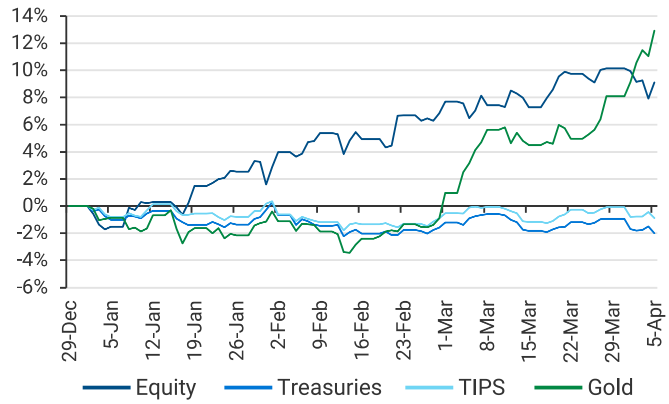
> **"One of the most interesting developments of the first quarter has been the sudden ebullience in commodity markets."**

Caitlin Clark, UConn men's basketball and US equities round out the list of things that have been both entertaining and unstoppable for the past few months. The S&P 500 is up another 9% in the first quarter and nearly +28% since the low last October.[6] To us, the most surprising aspect of the current leg of the rally is that it has come in the face of rising rates—both real rates and break-even inflation—which is a very different dynamic than the initial portion of the run-up. We interpret the price action as confirmation of both the relative strength of the US economy and of the reacceleration of growth and inflation.

In the context of better-than-expected growth, the resilience of equity markets is less surprising. However, valuations remain persistently stretched. Over the last few quarters, we've demonstrated that medium- to long-term returns from starting conditions similar to today's are very unappealing, if not outright negative. This is perhaps a case for reducing exposure to equity. We have also been adamant about the favorability of hedging equity exposure through very vanilla put spread collars, which benefit from the most favorable combination of market and implied volatility dynamics in available data history. This quarter, we'll focus on another alternative for managing risk by adding exposures that have favorable return and diversification characteristics that we believe are also a prudent allocation in the current environment.

One of the most interesting developments of the first quarter has been the sudden ebullience in commodity markets. The performance of gold, copper and cocoa attracted a modicum of interest, and a collective eyebrow was raised when Brent crude hit $90 a barrel. Our impression is that, for now, this interest is fleeting and much of the related commentary is somewhat dismissive of the implications. We strongly disagree based on the breadth of commodity sector performance, the relative performance of real rates versus nominals and the parallels of the current macro environment to the inflationary waves of the 1970s.

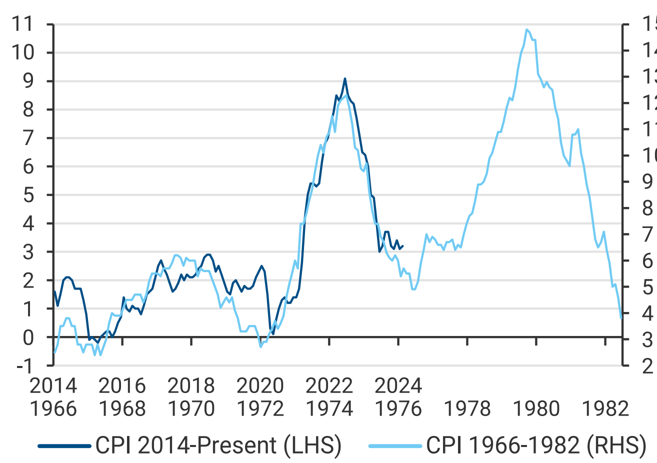
Figure 4: Year-to-date returns (equity, Treasuries, TIPS and gold)



Source: Bloomberg and LGIM America calculations.
Data as of April 5, 2024.

The major commodity sectors (Agriculture, Energy, Industrial Metals and Precious Metals) typically have slightly different sensitivities to macro variables. We see the sudden price rises across all four sectors occurring in coincidence with a reevaluation of the consensus macro outlook as evidence for the reacceleration of inflation. This is not unlike the pattern witnessed in the late-70s, and all the events and developments expected over the course of this year that Jason elaborated on may make it difficult to restrain further price increases.

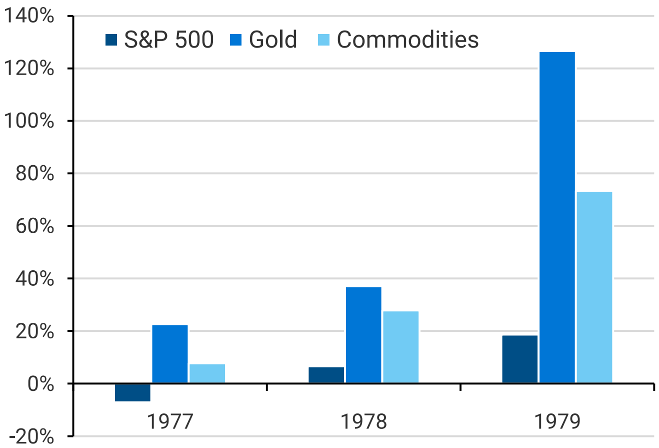
Figure 5: Consumer Price Index (CPI) year-over-year



Source: Bloomberg and LGIM America calculations.
Data as of March 31, 2024.

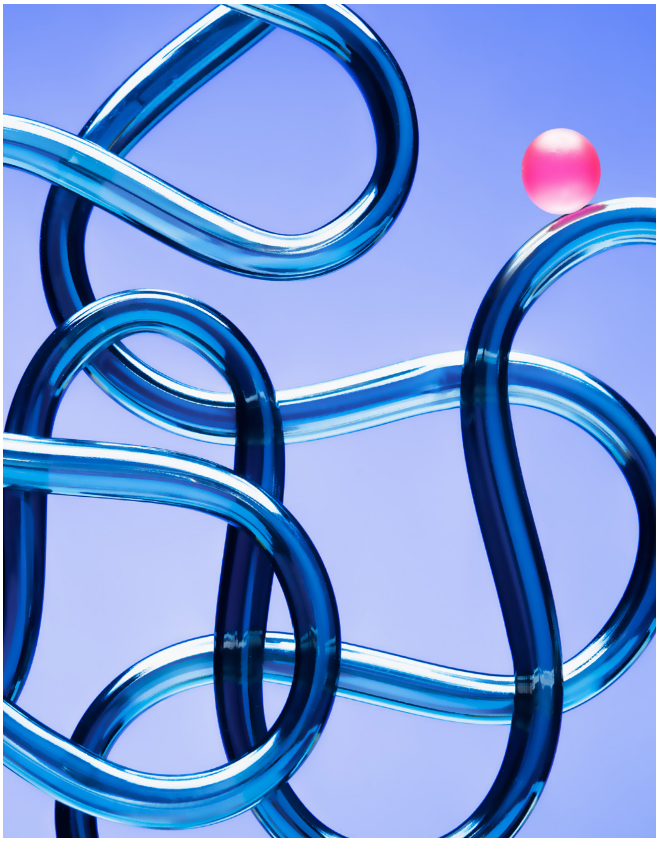
Interestingly, during the second wave of inflation from 1977-1979, equity performance held up fairly well (in contrast to the initial wave of 1973-1974 which was also more similar to our experience in 2022). Critically, though, the forward P/E of the S&P 500 during the '70s second wave was in the high single digits compared to 21.5 now.[6]

Figure 6: Annual returns (S&P 500, gold and commodities)



Source: Bloomberg and LGIM America calculations.
Data as of March 31, 2024.

LGIM America offers a strategy that delivers capital efficient exposure to TIPS, broad commodity markets and an explicit allocation to gold. It is a simple and effective way to add exposures that may diversify the economic and valuation headwinds faced by equities. We are available to partner with our clients on rebalancing, hedging and diversification solutions. Please reach out to your LGIM America representative if we can be of any help with your risk management challenges.



Private Credit

Dan Dreher
Solutions Strategist

"On top of the traditional private illiquidity premium, IG private credit offers premiums for understanding more complex deal structures, newer issuers and relative size versus public markets."

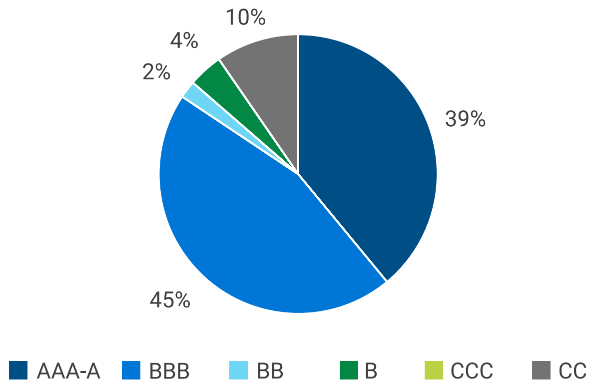
Over the past decade, private credit, particularly direct lending, has generated higher returns than most other comparable asset classes. Lenders have been yield-hungry while borrowers have been willing to pay a premium for the speed and certainty of execution, agility, customization and looser terms that private lenders offer. Direct lending amounts to roughly $800 billion, or about one half, of the total private credit market. Thus, many of the broad characteristics assigned to private credit are features of direct lending—a sub-investment grade rating, a high floating rate coupon, and, most notably, illiquid.

Given lenders typically hold these loans until maturity or a refinancing event, the absence of a liquid secondary market for many private credit instruments is not surprising. However, investment grade (IG) private credit, an often-overlooked segment of the asset class, offers a somewhat unique experience. Historically, IG private credit has been a favored investment for US insurance companies seeking diversification through unlisted, high-quality debt assets. On top of the traditional private illiquidity premium, IG private credit offers premiums for understanding more complex deal structures, newer issuers and relative size versus public markets. These premiums, historically averaging between a 50-100 basis point spread to public equivalents, have seen a recent increase as more borrowers turn to the IG private credit market in response to stricter bank lending conditions following the banking crisis in the spring of 2023.

With a significantly expanded opportunity set within private credit more generally, the "liquidity" consideration of the liquidity premium has left some investors weighing the risks of accessing a premium while potentially locking up capital.

While the investment grade segment of private credit may not be as liquid as public markets, IG private credit dominates the secondary market landscape. One primary dealer is shown below with IG at 84% of volume from 2018-2023.

Figure 7: IG private credit volume by rating



Source: Seaport – Private Place Reg D breakdown covers 2018-2023 with $6 billon+ traded over period.

So, why is this?

The perception of illiquidity is driven by the extreme demand from long-term buy and hold investors that dominate the IG private credit market. Most limitations on liquidity stem from bondholders lacking an interest in selling—stated simply, it is easy to sell but very difficult to buy.

We estimate that the secondary private credit market trades approximately $3 billion per year. It is relatively concentrated in a few of independent brokers with round lots of $10-50 million seeing the lowest transaction costs. Given the relatively opaque nature of private markets, familiarity with the markets themselves often drive liquidity. However, the number of holders, credit quality, trajectory, sector, covenants, jurisdiction, currency, relative position size, etc. also contribute to each deal on a case-by-case basis.

As a result, a vast majority of all trades are initiated by sellers making a portfolio adjustment. For example, some of today's insurance companies are actively rotating out of coal exposure.

The investment grade advantage

Inclusive of standard illiquidity premia across markets, additional trading costs can range from 3-20 basis points on a spread basis and include compensation paid to a broker (seller only) and additional premia as determined by the buyer. Trades can be executed quickly within a matter of days while others may need to be worked by the broker for 30 to 60 days.

Given the potential for an extended execution period, any hyperactive private portfolios will likely be suboptimal. But given the upfront premium at purchase, alpha via trading activity becomes much less important.

Thus, liquidity concerns are most prominent in periods of distress—which is true of any asset class. Even for credits at risk of downgrade, IG names carry an advantage. While liquidity can certainly become constrained for credits appearing to be at risk of falling below IG, at times, liquidity can actually improve for distressed IG credits as certain workout funds value the control covenants can provide.

Looking ahead

The investable universe of private markets is rapidly growing and evolving. Our team has identified several observable megatrends that are in our view already reshaping private markets, creating both risks and opportunities. In private credit, we anticipate meaningful increases in digital infrastructure, alternatives and transmission utilities. As primary markets evolve, one can expect secondary markets to expand alongside.

1. WSJ Survey, GBAO Document. Data as of February 21, 2024.
2. Congressional Budget Office - Demographic Projections. November 15, 2023.
3. For illustrative purposes only. LGIM America prepares the Pension Solutions Monitor data assuming a typical liability profile using an approximate duration of 12 years and a 50% MSCI AC World Total Gross Index / 50% Bloomberg US Long Government/Credit Index investment strategy, incorporating data sourced from LGIM America, ICE, MSCI and Bloomberg. Prior to January 2023 the funded ratio of a typical US corporate defined benefit plan was calculated using an approximate duration of 12 years and a 60% MSCI AC World Total Gross Index/ 40% Bloomberg US Aggregate Index ("60/40") investment allocation strategy incorporating data from LGIM America research, ICE indices and Bloomberg. The change to a "50/50" asset allocation reflects our understanding that most US corporate defined benefit plans have extended the duration of their fixed income as funded status has improved for the broader market. Furthermore, we believe that the duration of a typical plan's fixed income portfolio is better represented by the Bloomberg US Long Government/Credit Index compared to the Bloomberg USAggregate Index. These results are based on simulated or hypothetical assumptions that have certain inherent limitations. Unlike the results in an actual performance record, these results do not represent actual trading. Because these trades have not actually been executed, these results may have under- or over-compensated for the impact, if any, of certain market factors, such as lack of liquidity. Simulated or hypothetical trading programs in general are also subject to the fact that they are designed with the benefit of hindsight. No representation is being made that any account will or is likely to achieve profits or losses similar to these being shown.
4. "Global equities" referred to here is represented by the MSCI AC World Total Gross Index.
5. Discount rates based on a blend of the Intercontinental Exchange Mature US Pension Plan AAA-A and Intercontinental Exchange Retired US Pension Plan AAA-A discount curves.
6. Bloomberg.

Disclosures

LGIM America