For institutional clients only.

Investment Outlook
The Catch-22 Economy

Q3 2023

Macro Environment

Jason Shoup
Chief Investment Officer

"Unfortunately, what companies see as a navigable, albeit slow, route back to 2% inflation is proving to be a catch-22 situation from the perspective of the Fed."

Corporate America remains at the center of the debate on whether the US economy can avoid recession. In recent months, there has been a growing hope that the artificial intelligence (AI) boom could unleash a productivity miracle, turbocharging US growth for the next decade. Equity markets are up sizably since the beginning of the year. Yet the breadth of the rally has been narrow, with only ten AI-exposed companies accounting for almost all the gains. The performance of the S&P 500 Equal Weight Index has been far more restrained and reflects greater investor caution. So does the fact that corporate credit spreads are roughly unchanged over the same timeframe. Nonetheless, what is truly remarkable is how well these companies continue to perform fundamentally, despite increasingly tight monetary policy.

Some commentators have suggested that companies are taking advantage of inflation to raise prices in an exploitative manner, labeling the practice as "greedflation." A less nefarious explanation is that it is easier for prices to rise more quickly than wages when demand exceeds supply, leading to margin expansion. However, history suggests that the opposite is also true: when prices stagnate or fall, wages tend to be less flexible. Indeed, it is this reverse dynamic that poses the key risk going forward.

So far, corporate America has mostly avoided the payback for the margin expansion enjoyed after the pandemic, even as inflation has declined from its peak in the fourth quarter of

2022. The reason is that the pace of disinflation has been slow, allowing companies to minimize the squeeze on margins, particularly while revenues are still rising. Core Personal Consumption Expenditures (PCE) has decreased from its peak of 5.4% on a year-over-year basis to 4.6% as of the latest reading in June but remains well above the Fed's median forecast of 3.6% for 2023.[1] With only modest contraction in margins, analysts are starting to revise their earnings expectations higher for the upcoming quarters.

One consequence of inflation's slower decline is that companies have not been forced to shed labor nearly as quickly as anticipated. Until the June labor report (released in July), non-farm payrolls had exceeded economists' expectations for fifteen consecutive months, and the unemployment rate remains near 50-year lows. A stronger labor market has supported consumer demand, thereby maintaining pressure on wage inflation and preventing prices from falling rapidly. This virtuous feedback loop has been the foundation of the economy in the first half of 2023, giving rise to hopes of a soft landing.

Unfortunately, what companies see as a navigable, albeit slow, route back to 2% inflation is proving to be a catch-22 situation from the perspective of the Fed. Inflation is unlikely to decline rapidly until the labor market significantly loosens, but layoffs are unlikely to accelerate significantly until inflation declines quickly, causing a more acute squeeze on margins. Thus far, there has only been a modest decline in job vacancies and a slight uptick in weekly continuing claims.

Recent Fed commentary suggests that it is unlikely for the Fed to remain on pause and allow the economy to coast back into equilibrium without further intervention. At times, the Fed pursues a monetary policy that incorporates a risk-management approach. It may be that the accumulated tightening delivered to the economy will be sufficient to reduce inflation back to target. However, the risk lies in the fact that with the labor market so tight, a slower pace back to equilibrium could allow inflation to become entrenched, requiring an even tighter monetary policy response to dislodge it. Waiting too long could result in the categories currently driving disinflation—goods, energy, housing—even experiencing a resurgence.

Needless to say, the first half of 2023 has given the impression that the economy remains on the pathway to a soft landing, with a recession being avoidable. Throughout this year, all eyes have been on the macro environment, but it has been the ability of companies to successfully manage disinflation that appears to be responsible for the economy's resilience. However, companies are perhaps doing too well for the Fed's liking. Inflation is not declining swiftly enough, and the resilience of the labor market is creating upside risks for inflation going forward, risks that the Fed cannot ignore. We can thank corporate America for avoiding recession thus far. However, staying on the pathway to a soft-landing, while not impossible, still appears improbable.

Pension Solutions Monitor[2]

Chris Wroblewski, CFA
Co-head of Solutions Strategy

"US pension funding ratios increased over the second quarter of 2023."

Our analysis of market movements impacting US corporate defined benefit pension plan leads us to estimate that pension funding ratios increased over the second quarter of 2023. Based on market movements, the average funding ratio is estimated to have increased from 100.3% to 103.5%.

Equity markets experienced strong performance over the quarter with Global Equities[3] and the S&P 500 increasing 6.4% and 8.7%, respectively. Plan discount rates[4] were estimated to have increased roughly 20 basis points over the quarter with the Treasury component increasing 27 basis points and the credit component tightening 7 basis points. Plan assets with a traditional "50/50" asset allocation increased 2.5%. The strong asset performance combined with the decrease in liability values resulted in a 3.2% increase in funding ratios over the second quarter of 2023.

The modest increase in plan discount rates over the second quarter has primarily been driven by rising Treasury yields. This has caused liability values to decrease. In addition, strong asset performance in equity markets resulted in higher funding ratios for the average plan. We continue to see heightened demand for custom hedging strategies as a tool to lock in funded status gains. Plan sponsors continue to explore short and intermediate duration strategies to better align with falling liability durations. We've also seen many plans elect to transition from a blunt hedging approach to a more refined, completion management approach in hopes of reducing the potential tracking error due to interest rate risk.

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:

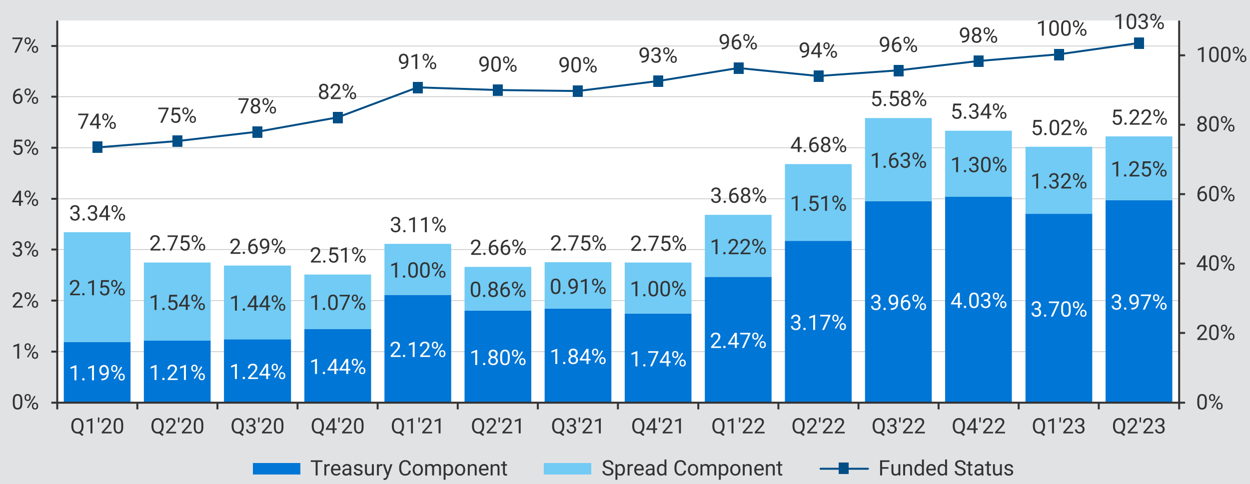
- Equity markets outperformed with global equities up roughly 6.4%.
- Plan liabilities decreased due to higher discount rates.
- Funding ratio levels increased due to strong asset performance over the quarter.

Funded status risk - Q2 2023

Equities	↑
Interest rates	↑
Credit spreads	↓

Sources: LGIM America, ICE indices and Bloomberg. Data as of June 30, 2023.

Figure 1 – Discount rates



Sources: LGIM America, ICE indices and Bloomberg. Data as of June 30, 2023.

Fixed Income Markets

Anthony Woodside, CFA, FRM
Head of US Fixed Income Strategy

“Investors find themselves confronted by familiar indicators, but questioning the reliability of their signals.”

"Past performance is no guarantee of future results." This disclaimer is a mainstay within investment parlance. However, the inclination to rely on history to inform a view of what’s to come is also central to the human experience. For example, after digesting a few chapters of a book or watching the opening scenes of a movie, we often feel convinced that we know how the plot will unfold. Indeed, the brain tends to latch on to familiar triggers to build the case that “we’ve seen this story before.”

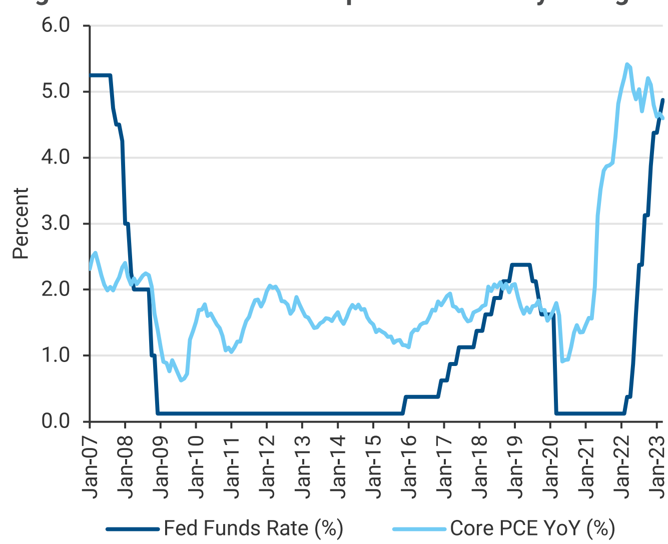
Coming into 2023, economists and investors alike recognized landmarks that left them uncharacteristically united on the direction of travel. Specifically, the consensus predicted that the US economy was poised to fall into recession, and 2023 would be the year of significant high-quality fixed income returns as the Fed reversed course on monetary policy. However, with the first half of the year complete, market participants now find themselves scrambling for the GPS, as the post-pandemic recovery has made a mockery of past associations and left investors in uncharted territory.

The Fed continued to prove its commitment to keeping rates higher for longer in the second quarter of 2023. The central bank’s policy rate ended June at 5.25%, matching the highest level since pre-financial crisis. Moreover, the Fed’s latest dot plot suggests that two additional 25 basis points hikes are likely this year. In rates, yields continued to climb across the curve, providing a strong headwind to widespread belief in the ‘year of the bond’ narrative. 2-year yields rose 87 basis points, while 10- and 30-year yields increased by roughly 37 and 21 basis points, respectively.[1]

Furthermore, the yield curve moved further into negative territory with the spread between 10-year and 2-year maturities declining to -106 basis points.[1] Despite continued Fed hawkishness, corporate credit remained resilient. While total returns for investment grade were negative due to the sharp increase in yields, excess returns were positive as market and long credit spreads tightened 15 and 11 basis points, respectively. In contrast, high yield credit posted positive excess and total returns with spreads tightening roughly 60 basis points over the quarter and finishing below the psychologically important 400 basis points threshold.[1]

As any sports enthusiast knows, games are not decided by the scoreboard at halftime. Nonetheless, the consensus view certainly finds itself in a difficult position after two quarters of play. Economic data has surprised to the upside (Figure 2), forcing economists to push out their recession forecasts. The labor market remains firm with strong payroll growth and elevated wage gains. This constructive employment backdrop has combined with residual fiscal tailwinds to support consumption and overall consumer confidence. Moreover, the housing market is showing signs of bottoming much earlier than expected, increasing speculation that the economy is headed for a “no-landing.”

Figure 2 – US Economic Surprise Index at 1-year highs

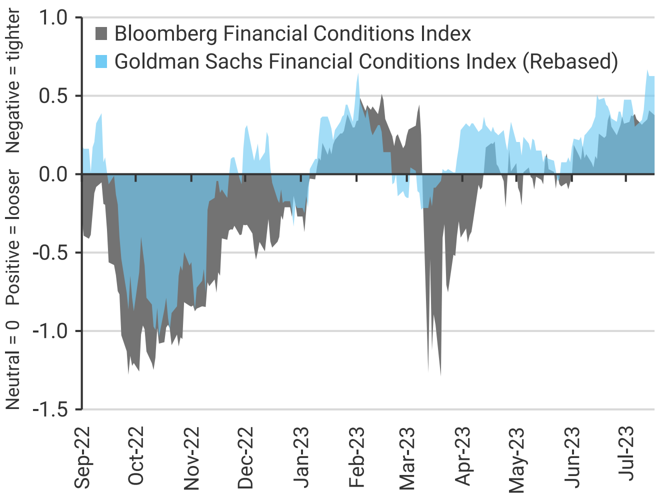


Source: Bloomberg. Data as of June 30, 2023.

As we push forward into the second half of the year, investors find themselves confronted by familiar indicators, but questioning the reliability of their signals. The deeply inverted yield curve and soft economic data have been flashing red since last year, but hard economic data continues to offer an emphatic rebuttal. In terms of valuations, the resilience of corporate credit can largely be attributed to the surprisingly robust economic activity. Additionally, attractive all-in yields across both investment grade and high yield, lower than expected new issuance supply and a growing optimism around artificial intelligence have also contributed to the supportive backdrop. Investors appear to be fatigued by the recession narrative and more willing to position for spreads to grind tighter over the summer months.

However, we identify clear threats looming ahead that will likely provide a stern test for risky asset valuations. First, despite ongoing rate hikes, financial conditions loosened last quarter due to increased usage of the bank term funding program and the US Treasury running down its cash balance at the Fed (due to the debt ceiling impasse), resulting in a net addition of liquidity into the system (Figure 3). In our view, the impact of restrictive monetary policy will be more severe in the upcoming six months, especially with the Treasury ramping up bill issuance to rebuild its general account. Second, credit card and auto loan delinquencies are rising at an alarming rate, particularly amongst younger age cohorts. Finally, developed market central banks appear to view generating mild recessions as a lesser evil than re-accelerating inflation and thus the odds of a policy error being made are increasing.

Figure 3 – Financial conditions loosened in Q2 despite rate hikes



Source: Bloomberg. Data as of July 17, 2023.

In investment grade credit, we continued to increase our holdings in defensive sectors such as pharmaceuticals, taking advantage of attractive concessions in the primary market during the quarter. We are also constructive on utilities as the sector has lagged due to elevated issuance in the first half of the year, which we expect to moderate over the next six months. In rates, we believe the long end of the yield curve looks attractive as pension funds continue to de-risk portfolios and lock-in funded status gains.

While the lesson in the adage, "history doesn't repeat itself, but it often rhymes" is often pertinent in forecasting outcomes, the post-pandemic recovery demands a heightened level of humility. The unprecedented nature of the crisis, coupled with the extensive policy response, complicates the search for a fitting historical comparison. Going forward, we will be closely monitoring the disconnect between soft and hard economic data as it should go a long way in providing a definitive resolution on whether the recession is merely delayed or ultimately denied.

Equity Markets

Dave Chapman, CFA
Head of Portfolio Solutions

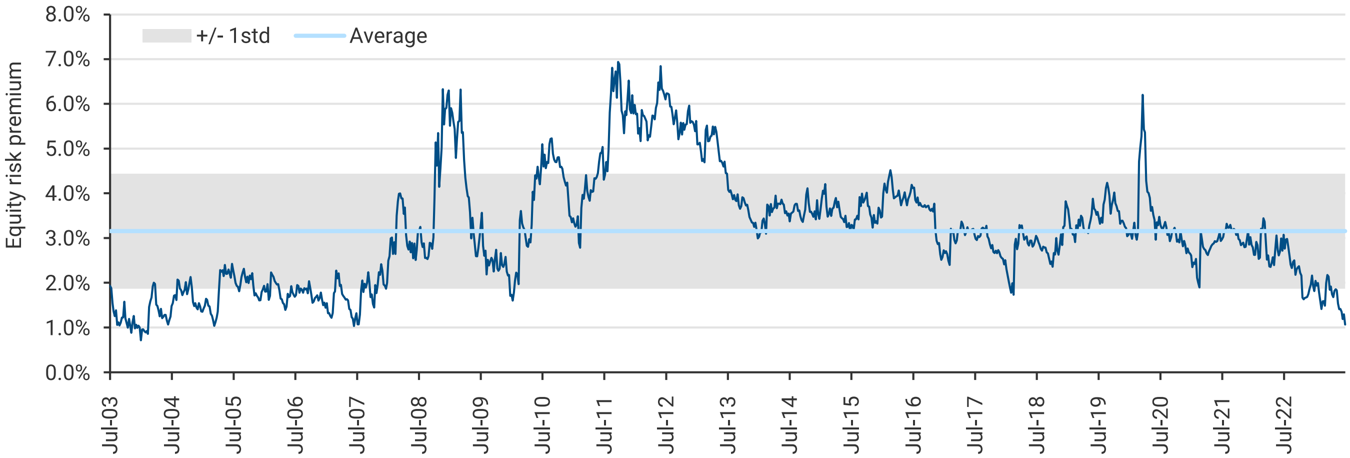
"The combination of environment and outlook lends very strong conviction to our view that put spread collars may be as compelling now as they ever have been on a prospective basis."

This year's reluctant rally has been driven by surprising economic resilience, another technological renaissance (AI), as Jason mentioned, and bearish equity positioning finally relenting. On one hand, it perplexes and frustrates investors like us who have maintained a cautious view…to the extent that we have quietly wondered whether we are the frog slowly being boiled. On the other hand, the outlook for any of the factors that supported this year's strong returns is even more bleak. It is increasingly difficult for the economy to continue delivering positive surprises, whether due to slowing momentum or adverse base effects. The initial AI ebullience has given way to pragmatism. And increasingly bullish positioning masks the narrow breadth of the rally and becomes an increasingly contrarian indicator.

So, while the water in which we swim is getting warmer, our framework for evaluating markets gives us no reason to change course, particularly at this point in the cycle. To illustrate this, we have focused on the outlook for valuations and the scenario implications for different types of investors this quarter. Our conclusion remains that equity put spread collars are an effective risk management tool in this environment—a view we have expressed adamantly over the last quarter and one that is increasingly reinforced by clients taking action.

Every detail of market performance this year comes with nuance, and our generally reliable guidepost of valuations is no different. Using current S&P 500 levels for reference, the crux is that a forward P/E greater than about 20x (where we stand currently) is often the precipice for poor returns going forward—often, but not always. So, we have seen commentators justify current valuations by comparing them

Figure 4 – S&P 500 equity premium



Source: Bloomberg and LGIM America. Data as of June 30, 2023.

to the level of interest rates or by suggesting that overall market valuation is dominated by the high multiples on the few largest stocks (which is justified by their higher AI-driven growth expectations) while the rest of the market is fairly, if not favorably, priced.

Giving these points their due, we construct a measure of the equity risk premium (ERP) to provide historical and practical context. The current ERP of just over 1% is, coincidentally, at the 1st percentile over the last 20 years and worse than -1.6σ below average (Figure 4).[5]

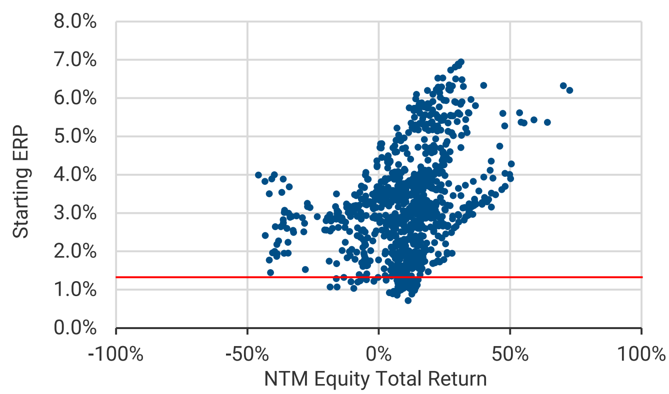
So, while comparable data is limited (Figure 5), it is still obvious that prospective equity returns have constrained upside, are more volatile and have a more negative skew compared to unconditional returns (Figure 6).[5]

Meanwhile, despite relatively placid and rising markets over the quarter, equity implied volatility levels have also remained strong. Notably, a put spread collar is a net seller of this rich volatility. It also exchanges capped upside (in a market that likely limits the right tail anyway) for a favorable range of protection against equity drawdowns (which are more likely on a conditional basis). For example, current pricing for a put spread collar with 1-year to maturity retains 13% in upside and still protects against losses from -5% to -20%.[6]

Finally, what may be even more compelling than the complementary asymmetry of current valuations and option pricing are the implications of our stretched equity risk premium (ERP) measure. For the measure to normalize, one or a combination of the following must happen: earnings must grow much more than expected, equity markets must fall, or rates must fall. Significant earnings growth over the short-term in the midst of a tightening cycle seems improbable. Falling equity markets are bad for total return and liability-aware investors alike. Falling rates may materially alter the funded status and contribution outlook for corporate pensions, which have otherwise put themselves in a strong position for their participants. For total return investors, falling rates may support fixed income returns, but if rates decline due to a negative growth shock, those gains may not offset equity losses.

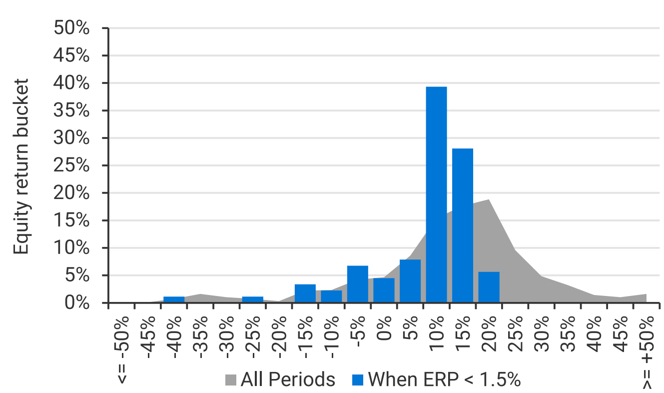
The combination of environment and outlook lends very strong conviction to our view that put spread collars may be as compelling now as they ever have been on a prospective basis.

Figure 5 – NTM equity total return



Source: Bloomberg and LGIM America. Data as of June 30, 2023.

Figure 6 – Forward equity return distributions



Source: Bloomberg and LGIM America. Data as of June 30, 2023.

1. Source: Bloomberg
2. 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. 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.
3. “Global equities” referred to here is represented by the MSCI AC World Total Gross Index.
4. 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.
5. Source: Bloomberg and LGIM America. Data as of June 30, 2023.
6. Source: Bloomberg and LGIM America. Data as of July 12, 2023.

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