For institutional clients only.

Viewpoints

2023

Welcome to our latest Viewpoints, a publication presenting candid discussions with industry experts on vital topics. Should you seek additional information on this issue's subject, feel free to contact us. We welcome feedback as we shape content for future issues.

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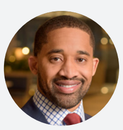
Featuring



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Rising Rates, Falling Banks and What it Means for Investors

The past few months have been marked by persistent inflation, a recent banking crisis and reverberations of the Fed's actions. Investors often find themselves swimming in a sea of competing data and information. Higher yields in fixed income make the asset class more attractive relative to recent history. At the same time, the very factors contributing to higher yields also give rise to an environment fraught with uncertainty. In our conversation with Anthony Woodside, CFA, FRM, Head of US Fixed Income Strategy at LGIM America, we gather some insights on the direction of the market and consider what strategies may be appropriate given this economic backdrop.

It is important to note that this conversation took place on April 6th, 2023, and the views expressed here are consistent with the market conditions at that time.

Anthony, thanks for taking the time to answer a few of my questions. With everything going on in the market today, we have an abundance of topics to choose from. Let's begin by reviewing the recent turmoil experienced in the banking sector. The markets appear to be calming somewhat, and attention is returning to the Fed and its battle against inflation. How will this bank crisis impact the Fed's hiking cycle?

Anthony: Chris, it's my pleasure. And you are correct that there are numerous timely topics in this environment. Let's dive right in. The markets have certainly calmed down a bit from peak angst in mid-March, but rates volatility remains elevated. At this juncture, the Fed seems intent on applying the separation principle to navigate the formidable challenges of price and financial stability. More specifically, the Fed believes that it can maintain its hawkish stance to bring inflation closer in line with its 2% target while using targeted solutions (e.g., the recently implemented Bank Term Funding Program) to restore confidence and resolve liquidity concerns in the banking sector. While we believe the bar for the Fed to reverse course is relatively high given sticky inflation dynamics, we note that quantitative tightening (QT) and the Fed's overnight Reverse Repo Facility (RRP) are amplifying deposit flight pressures within the banking system, particularly amongst smaller banks.

Why would QT and the Fed's RRP amplify deposit flight pressures?

Anthony: Firstly, QT reduces the asset side of the Fed's balance sheet (balance sheet runoff currently amounts to ~$95 billion worth of securities per month). To offset this decline, the liability side of the balance sheet must shrink in commensurate fashion. However, RRP usage has spiked as government money funds take advantage of the higher rate offered by this facility compared to alternatives such as T-bills. Consequently, the other major liability of the Fed,

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excess reserves, have experienced a steep decline, with the loss largely concentrated in smaller banks. In summary, the superior rate available via the RRP has accelerated deposit flight from the banking system as bank deposit rates have exhibited a very low beta during this Fed hiking cycle.

Speaking of inflation, everyone's favorite topic these days, when do you expect we'll see inflation get back down to the Fed's 2% target?

Anthony: While we do expect inflation to gradually slow over the coming quarters, we do not expect inflation to return to the Fed's 2% target this year or next. Our economists' view is a severe profit recession likely starting in the second half of the year which will allow the Fed to cut rates by the end of this year or early next year.

Many investors have noticed that the market's expectations for where rates will end this year are at odds with the Fed's own forecast. Is it reasonable for me to believe that the Fed has been consistent in stating that no cuts are expected this year? Given the recent volatility, market participants are projecting a few cuts by year-end. Why do you believe there is a disparity, and what is LGIM America's position?

Anthony: The Fed has been resolute in its commitment to "keeping rates higher for longer" to avoid repeating its mistake of prematurely declaring victory over inflation in the 1970s.

However, market participants largely interpreted the March FOMC meeting as dovish as the central bank altered its language from "ongoing increases" to "some additional policy firming may be appropriate."[1] While the language adjustment may be construed as dovish, we note that the distribution of Fed dots was modestly more hawkish than that seen in the December Summary of Economic Projections. The Fed's median dot remained at 5.1% for the end of 2023, and the expectation for the policy rate for the end of 2024 was actually revised higher from 4.1% to 4.3%. Conversely, market expectations for the policy rate for the end of this year plummeted from 5.3% at the end of February to ~4.1% currently.

We believe the discrepancy exists because investors' confidence in the Fed put has been partially restored after perpetual disappointment over the past few quarters. In recent months, market participants have finally accepted that a slowdown in growth and/or a healthy correction in asset prices were insufficient catalysts to bring about a Fed pivot. However, the threat of financial instability in the form of a banking crisis presents a more compelling argument to reverse course.

In terms of our view, as I mentioned before, we believe that a severe profit recession is likely in the coming quarters, which will pave the way for the Fed to cut rates by the end of 2023, into 2024.

With the global economy facing a potentially challenging period of slowing growth and still-elevated inflation, where can fixed income investors turn to prepare for continued uncertainty?

Anthony: Unlike last year, we believe the diversification property of risk-free assets have been meaningfully rebuilt given the substantial re-pricing over the last 15 months. Current valuations, as well as our view that the US economy is headed for a recession, have informed our defensive bias in corporate credit in favor of US Treasuries, as we anticipate better entry points to add risk in the coming quarters.

After a decade of accommodative policies and ultra-low interest rates, we finally have some attractive yields in fixed income. Are there any particular strategies that are interesting in the current environment?

Anthony: Absolutely. Over the last decade, higher-quality fixed income has often been dismissed as uninteresting in some corners due to yield scarcity. With the Fed engaged in the fastest hiking cycle in over 40 years, the asset class has returned to the spotlight as investors can finally earn attractive levels of income. Not only are all-in yields for spread sectors hovering around their highest levels in a decade, but risk-free asset valuations are also compelling on a 10-year lookback.

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> LGIM America

However, the synchronized withdrawal of monetary stimulus by global central banks has also given rise to a sharp increase in fixed income volatility. While there was essentially nowhere to hide in fixed income in 2022 due to inflated valuations, today's notably improved entry points provide investors with ample opportunities to build diversified and durable portfolios. Intermediate credit looks attractive in the current environment.

Intermediate credit strategies have been topical for a variety of reasons. Firstly, they can be a strong fit within an LDI framework, particularly given recent market dynamics. As rates have moved higher over the last 15 months, durations have fallen across the board. Liability durations which previously hovered around 12-14 years now sit around 10-12 years. Consequently, many plans are now allocating to shorter duration benchmarks to better align with the liability. The superior risk-adjusted return profile of intermediate credit benchmarks versus longer duration counterparts has also resonated with current clients.

In talking with current clients, are there any other strategies or approaches that have resonated particularly well?

Anthony: We have also seen an uptick in interest for higher alpha, total-return oriented solutions:

Absolute return/Enhanced cash solutions – The well-known mantra "cash is trash" is no longer appropriate given today's market backdrop. Markedly higher short-term yields have led to an uptick in interest in enhanced cash solutions/absolute return strategies, particularly for clients that wish to avoid taking on too much duration risk. Fixed income investors can benefit from dynamic solutions that exploit opportunities across investment grade and high yield credit, emerging markets and securitized sectors with the goal of generating positive total returns while minimizing interest rate sensitivity. Moreover, the deeply inverted yield curve in the US has served to bolster the appeal of shorter-duration strategies.

Multi-sector intermediate duration solutions – In the current era of elevated volatility, above-target inflation and shifting correlations, multi-sector strategies can serve as an attractive option for total return focused and ALM-driven investors alike. Similar in focus to enhanced cash solutions, intermediate duration multi-sector solutions benefit from an extensive toolkit where managers can dynamically rotate allocations across Treasuries, corporate credit (both investment grade and high-yield), emerging markets and securitized sectors based on relative value assessments, which can help in minimizing drawdowns over the course of a business cycle.

We're always available to discuss the macro environment and its implications for growth, monetary policy and fixed income strategy holistically. ■

About LGIM America

LGIM America (LGIMA) was founded in 2006 with the purpose of helping people achieve their long-term financial goals. We offer a range of strategies to help our institutional clients (corporations, healthcare agencies, non-profit, education, public plans and Taft-Hartley) manage their investment objectives, which can range from market-based alpha-oriented strategies to those that are designed to be more liability-centric, derivative overlays, or indexed solutions. Encouraging a diverse and inclusive environment coupled with a solutions-focused culture allows us to increase our breadth of knowledge and the likelihood of improved client outcomes and stronger financial performance. We have teams of experienced, innovative professionals committed to helping plan sponsors meet their pension promises, managing investment exposures efficiently to seek enhanced returns while mitigating risks, and working to generate returns while making a positive societal difference.

For further information about LGIM America, find us at www.lgima.com

1. Source: The Federal Reserve.

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