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LGIM America

Investment Outlook

Collectively Forecasted, Never Arrived

Q1 2024

Macro Environment

Jason Shoup
Chief Investment Officer

“For their part, economists seemingly could be accused of oversteering after last year's collective forecasting miss.”

For drivers that hit a patch of ice there are two common pitfalls, paralysis and oversteering. The same dangers confront investors after seemingly avoiding last year's "most forecasted" recession. For their part, economists seemingly could be accused of oversteering after last year's collective forecasting miss. Whereas a year ago two-thirds of economists expected a recession in 2023, now the majority expect a soft landing with GDP of roughly 1% and core PCE ending the year at 2.5%. Even if suspicions remain that the US economy is more vulnerable than it appears, it is just too challenging to stick with a recession call against the fourth-quarter backdrop of moderating inflation and resilient labor markets. More than anything, the important point is to recognize that a behavioral aspect is at play as 2024 gets underway. At this point, it is difficult to find anyone not expecting a soft landing, which may make markets more vulnerable than typical should the consensus prove wrong.

If 2024 does bring a surprise, the question is what direction it will be.

The outperformance of the US economy in the second half of last year highlights the possibility that growth could remain more resilient than anticipated. With wage growth moderating more slowly than inflation, real incomes appear set to grow at a rate that could support healthy consumption throughout the year. Excess savings may be nearing depletion, but household balance sheets remain in good shape relative to history. Moreover, the considerable loosening in financial conditions during the fourth quarter should provide some uplift to growth in the immediate quarters ahead. There are even nascent signs of animal spirits returning as M&A is starting to pick up – which is not what one would expect if a surge in layoffs was imminent.

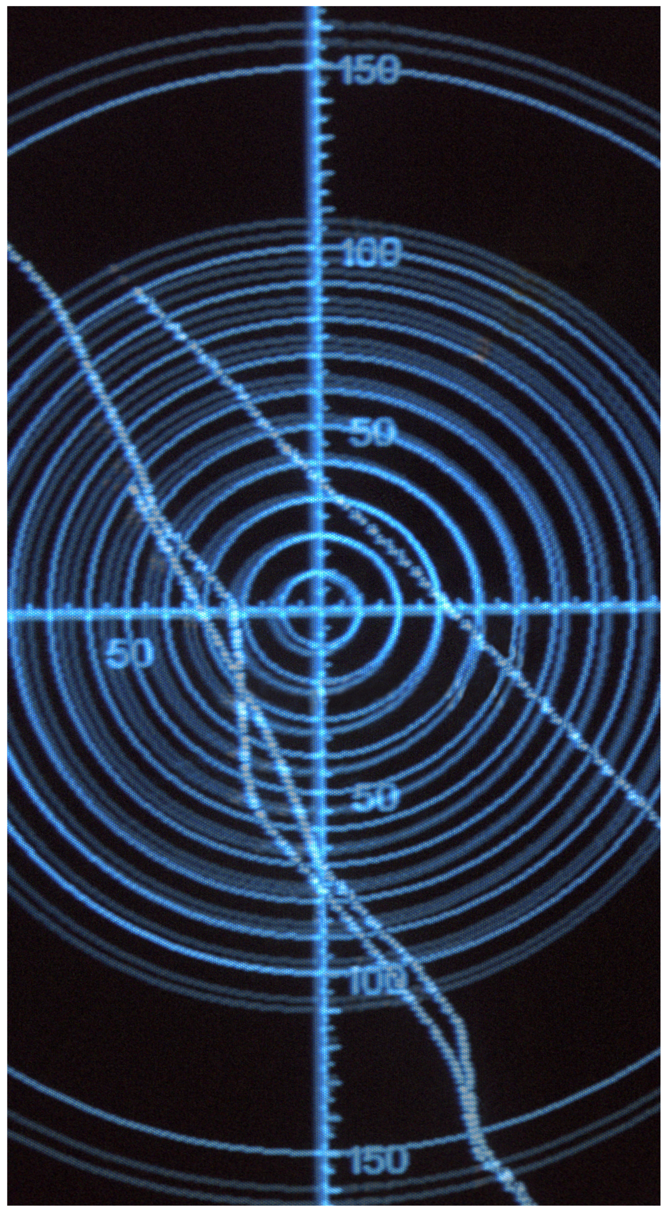
How markets respond to higher than anticipated growth will depend on what inflation does alongside it. As much of a relief as it was to see both headline and core inflation move lower in 2023, underlying core service inflation appears far more entrenched, and it could be that disinflation in core goods prices is nearly finished. If core measures of inflation were to remain sticky at 3%, it is unlikely that the Fed will cut rates anything near what is priced into markets. The pricing out of 3-4 cuts may not prove much of a problem for overall risk appetite in a higher growth environment, but it would likely cause considerable pain if the Fed were forced to go further and consider additional hikes.

The real upside surprise for risk assets would be if growth came in above trend while core inflation continued its move back to target, permitting the Fed to deliver multiple cuts. For this to occur the problematic category of core services inflation would likely need to reflect the continued rebalancing of the labor market while core goods prices would need to resume falling as producer prices weaken and new weaknesses appear in large one-off categories such as used cars.

The greater temptation is to believe that 2024 at long last brings a recession after so many forecasters switched to expecting a soft landing – a sort of economic irony scenario. A key reason the US avoided recession last year was the considerable uptick in government spending, which has resulted in the strongest government job growth of the last two decades. But unless the government continues the fiscal largesse, there will likely be some overhang in 2024. Moreover, there is evidence that the labor market is not as healthy as the headline payrolls figures suggest. Temporary hiring is falling ominously, the household survey is not painting as rosy a picture, and some 20% of all jobs created in 2023 have subsequently been revised away. Even if this only amounts to a modest weakening of the labor market, investors may struggle to look through the first negative payroll print given current valuations.

From a liquidity perspective, there are also reasons for concern as the year begins. Last year's banking crisis avoided becoming a significant drag on the economy because of the Fed's swift action to introduce the Bank Term Funding Program (BTFP). As importantly, ongoing quantitative tightening (QT) has come almost exclusively at the expense of Reverse Repo Facility (RRP) usage, which means that bank reserves have been steady as the Fed balance sheet shrinks. Unfortunately, the positive backdrop is unlikely to last. As RRP balances dwindle, QT would once again put pressure on banks, and the prospect has members of the Fed openly discussing next steps. Meanwhile, banks continue to report an increase in defaults and delinquencies among consumers, which is beginning to look like more than just normalization back to pre-COVID levels. While household balance sheets may be healthy in aggregate, there seems to be growing evidence of weakness at lower incomes.

In some respects, not much has changed with the US economic outlook besides the year. Yes, inflation has declined, which should give the Fed far more flexibility going forward. But growth seems vulnerable to a downside surprise far more than in a typical year, and strangely at the same time, the US economy continues to defy expectations to produce above trend growth and may continue to do so. The takeaway is that this is not a macro environment where investors should have much confidence in any "base case" scenario unfolding, including the soft landing. Like driving on ice, the trick to surviving 2024 may be not overcommitting in one direction. Staying flexible at the beginning of the year should allow for more insightful decisions down the road.



Pension Solutions Monitor[1]

Chris Wroblewski, CFA
Co-head of Solutions Strategy

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

Our analysis of market movements impacting US corporate defined benefit pension plans leads us to estimate that pension funding ratios increased over the fourth quarter of 2023. Based on market movements, the average funding ratio is estimated to have increased from 102.6% to 104.1%.

Equity markets experienced strong performance over the quarter with both Global Equities[2] and the S&P 500 increasing 11.2% and 11.7%, respectively. Plan discount rates[3] were estimated to have decreased approximately 90 basis points over the quarter with the Treasury component decreasing 72 basis points and the credit component tightening 18 basis points. Plan assets with a traditional "50/50" asset allocation increased 12.2%. The strong asset performance outpaced the increase in liability values and resulted in a 1.4% increase in funding ratios over the fourth quarter of 2023.

Average funding ratios reached new peaks in Q4 following a strong rally in equities. As we enter 2024, investors are expressing a need for custom hedging strategies. These strategies will help maintain their funded status surpluses amidst expected rate cuts and market volatility. Plan sponsors should approach this market with caution and diligence. We expect duration to be a key risk factor for plan performance in the upcoming quarters.

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:

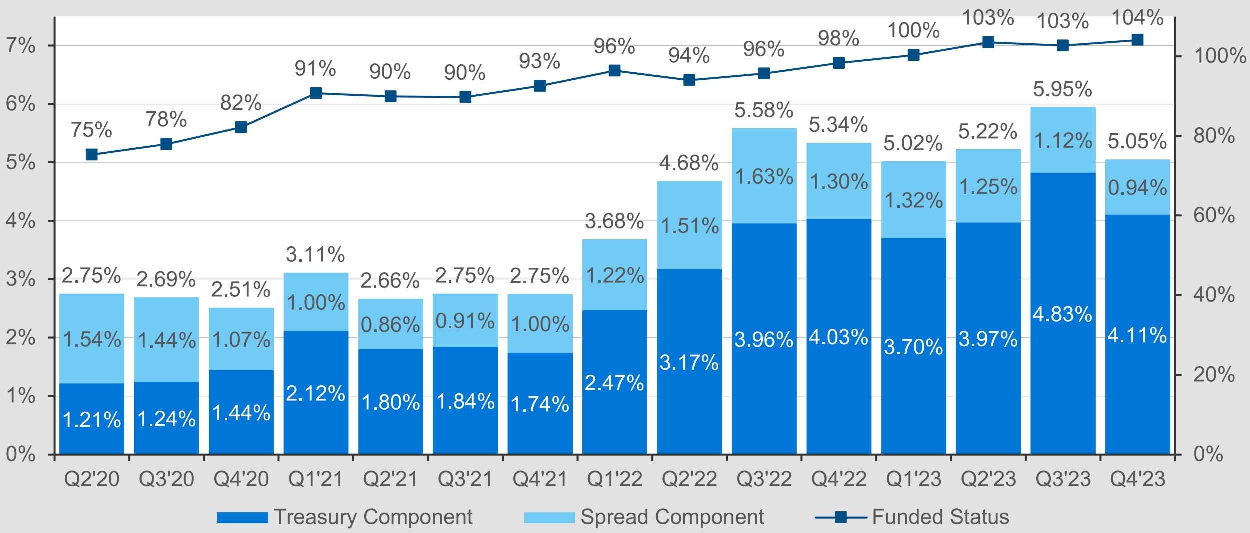
- Equity markets delivered strong performance with Global Equities and the S&P 500 up over the quarter.
- Plan liabilities increased due to lower discount rates.
- Funding ratio levels increased as the rise in assets outpaced the rise in liabilities.

Funded status risk - Q4 2023

Equities	↑
Interest rates	↓
Credit spreads	↓

Sources: LGIM America, ICE indices and Bloomberg. Data as of December 29, 2023.

Figure 1 – Discount rates



Sources: LGIM America, ICE indices and Bloomberg. Data as of December 29, 2023.

Fixed Income Markets

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

"Although we maintain that a soft landing is still not a forgone conclusion, we concede that the odds associated with the left tail of the distribution have decreased."

Improbable is not impossible. While we are often guilty of using these words interchangeably, 2023 provided a stark reminder of how much distance can lie between related, but distinct, concepts. With policymakers confronted by spiraling inflation, market participants (including ourselves) were mostly skeptical of the Fed's ability to perfectly calibrate policy to reduce inflation without cratering growth. Indeed, the annals of history are littered with central banks that failed to deftly steer the economy amidst the turbulence of hawkish monetary policy. However, after witnessing the Fed hike rates by 525 basis points over an 18-month span, investors are now faced with the reality that yesteryear's improbable is not only possible, but it might even be…probable.

The US economy has remained resilient, while immaculate disinflation appears to be more than just a theoretical construct. Although we maintain that a soft landing is still not a forgone conclusion, we concede that the odds associated with the left tail of the distribution have decreased. At the same time, we caution that a less negative view of the economic outlook should not be construed as a green light to add market beta, as most asset classes are already priced for a goldilocks outcome.

While the Fed kept its policy rate steady at 5.5% in the fourth quarter, the end of its hiking cycle was all but confirmed at its December policy meeting. The updated dot plot saw the median policy rate estimate for the end of 2024 decline to 4.6% (from 5.1% in September), implying 75 basis points of cuts this year.[4]

Rate volatility remained elevated last quarter, with bond vigilantes having the upper hand early before succumbing to the doves in the last two months of the year. Overall, 2-year yields fell 79 basis points, while 10- and 30-year yields declined by 69 and 67 basis points respectively, largely fueled by ongoing disinflation and the Fed's dovish pivot last month.[4]

The sharp repricing in rates buoyed risk assets, and corporate credit was no exception. Total returns were strongly positive for investment grade credit (market credit +8.15%, long credit +13.7%), while excess returns were also positive as market credit and long credit spreads tightened 19 and 17 basis points respectively. Similarly, high yield credit also posted positive total (+7.16%) and excess returns (spreads tightened by 72 basis points) as the prospect of imminent rate cuts bolstered risk appetite.[5]

The turn of the calendar closed a chapter on a year of unfulfilled expectations. Not only did the most telegraphed recession fail to materialize in 2023, but the "year of the bond" looked like a misnomer until a strong fourth quarter justified some of the hype. However, with inflation cooling, the Fed signaling imminent rate cuts, and yields near the highest levels in a decade, there appears to be ample opportunities for investors to earn attractive levels of income in their fixed income allocations should economic momentum slow.

In investment grade credit, the technicals remain supportive amidst strong demand from defined benefit plans, insurance companies and other yield sensitive buyers. Supply dynamics, particularly in the long-end of the curve, have added to the positive backdrop as corporate treasurers remain reluctant to lock in higher-coupons over the long-term. With credit spreads at the tighter end of the historical range, a natural question to ask is how long will yield obsession persist before investors start demanding additional risk premium for the credit risk they are taking? We prefer to start the year neutral high-grade credit as we see elevated risk of continued strong inflows into the asset class in advance of the Fed cutting rates and considering the record $6 trillion in cash currently residing in money market funds.

In rates, we believe the fair value range for the 10-year treasury yield is 3.75%-4.50%, and we would look to take advantage of opportunities at either extreme. Unlike the positive supply/demand backdrop in credit, the technical backdrop in treasuries is more challenging with a large, yield insensitive buyer in the Fed stepping back from the market, while supply has ramped up to fund burgeoning deficits. Moreover, pricing in the front-end of the curve looks vulnerable in the short-term as the market is pricing in over 50% chance of the rate cutting cycle beginning in March, and roughly 160 basis points of easing in 2024 overall, more than double the easing implied by the Fed dots.

As the post-pandemic recovery continues to evolve, a more balanced view of the economic outlook looks increasingly appealing. This business cycle was borne out of an exceptional chain of events, and therefore it should come as little surprise that its inherited features are similarly unique. Notably, the monetary policy transmission mechanism has been slowed by the prevalence of fixed rate mortgages locked in at low rates, but rising consumer debt service ratios confirm that higher rates are starting to bite. Furthermore, excess savings are higher than originally thought, but the distribution of those savings is heavily concentrated in higher income cohorts, while excess liquidity for lower income households looks to be nearing exhaustion. Unsurprisingly, credit card and auto loan delinquencies remain on an upward trajectory.

We see similar dispersion amongst corporates as interest coverage ratios are near all-time highs for the largest US companies but significantly weaker for their smaller counterparts. Perhaps the primary takeaway from last year is the importance of stress testing the consensus, and the general accord on a soft landing deserves similar scrutiny. The goldilocks outcome rests on two key assumptions. First, the economy will cool in an orderly fashion and swerve the non-linearities that transform a mild slowdown into a full-fledged recession. Second, inflation will gradually move closer to the 2% target over the course of 2024 and avoid a second wave despite sticky price pressures in core services. Against this delicate backdrop, we argue that investors will be better served prioritizing the micro over the macro for the medium term. Given where starting valuations are, security selection and sector rotation will be pivotal, with success over the next few quarters likely being defined by avoiding idiosyncratic mistakes as opposed to generating outsized gains from directional calls.

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Equity Markets

Dave Chapman, CFA
Head of Portfolio Solutions

"To us, the most straightforward way to attack this is with a standard put-spread collar."

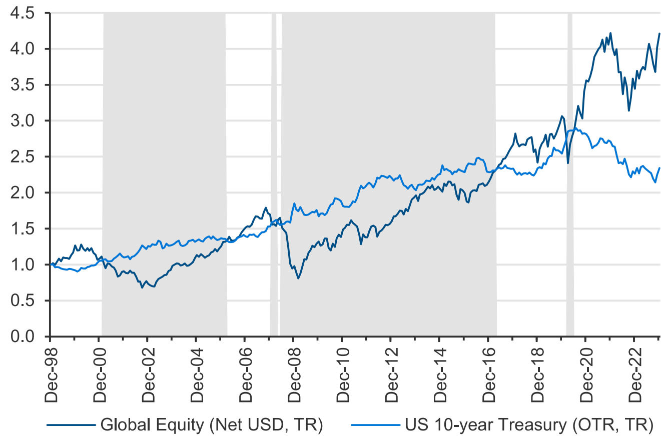
Our stance on equities echoes the points Anthony makes on credit markets. We have shifted our view from fairly bearish to merely cautious as the historically improbable soft landing becomes more likely. However, that puts us—and many other investors—in the uncomfortable position of navigating a more favorable macro backdrop with very challenging valuations.

Interestingly, our client conversations this quarter have been neatly divided between chasing upside due to the improved macro fundamentals and questioning the wisdom of owning any equity at all given the relatively attractive all-in yields on offer elsewhere. We find this dichotomy very provocative, particularly after fielding questions about "why bother holding fixed income?" just last quarter. So, in this publication, we provide some interesting historical context, and reiterate our very high conviction on utilizing options to help shape equity outcomes.

"Stocks for the Long Run" was published by Jeremy Siegel in 1994. That mindset has been, and seemingly remains, pervasive among institutional and individual investors alike. The challenges are, of course, defining what the long run is and—even if that can be enumerated—beginning that period with a favorable entry point. Figure 2 shows the total cumulative returns of global equities (MSCI ACWI Index) and owning the on-the-run US 10-year Treasury. The shaded areas represent periods where fixed income returns exceeded equity returns. While it is fair to say that the annual returns of equities may have bested fixed income within some of those periods, it is still illustrative of how demanding a large equity drawdown is on a portfolio.

Our data history begins shortly after Siegel's publication, and for more than half of the months we observed, an investor would have been better off holding only 10-year Treasuries. Our window includes the two most prominent bear markets in modern history, and we still find it remarkable how long it takes equities to catch up to fixed income once the rebounds begin. Mitigating the large drawdowns would be a tremendous success, particularly for investors with liquidity demands on their portfolio, as we have previously illustrated.

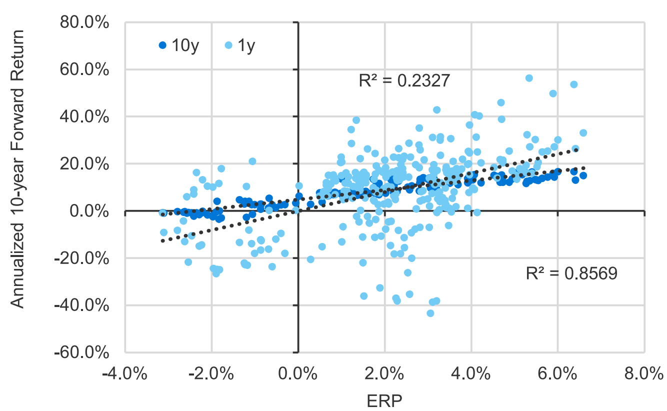
Figure 2 – Cumulative returns of global equities vs. US 10-year Treasury



Source: Bloomberg and LGIM America calculations.
Data as of December 31, 2023.

We believe this data transcends casual observation into coherent narrative through valuations, especially in the context of investor expectations. Updating work on valuation as a predictor of returns, which we first discussed in our 2021 commentary, we find that the starting P/E multiple of equities is highly predictive of forward returns at reasonably long horizons. The P/E can be simply transformed into a measure of the equity risk premium (ERP) by subtracting the 10-year Treasury yield from the earnings yield (E/P).

Figure 3 – Forward returns by starting ERP

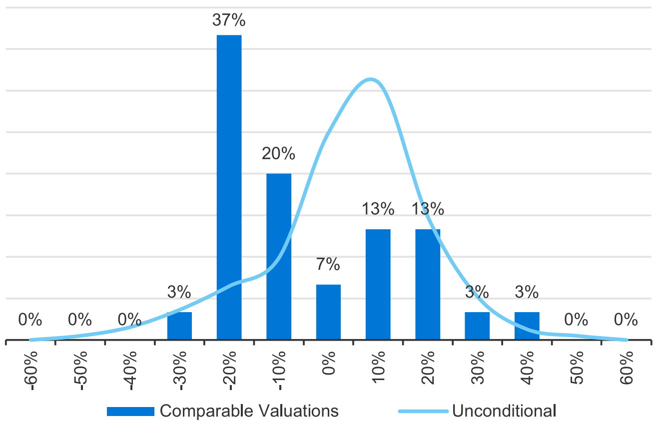


Source: Bloomberg and LGIM America calculations.
Data as of December 31, 2023.

Today's S&P 500 P/E is nearly 23x, resulting in an ERP close to zero.[5] Even for a long-term investor, the current entry point bodes poorly for future success. This set-up was similar prior to the 2001 and 2008 bear markets, and Figure 2 illustrates the subsequent damage. However, as each of these peaks approached, high valuations became even more stretched, contributing to the evidence that valuations may be poor predictors of short-term returns. This is illustrated in the

Figure 4, which shows the distribution of all 1-year forward returns and the distribution of forward returns starting from valuations comparable to today's (i.e., P/E of 22-24x). Certainly, healthy returns may still be had, but the propensity for a significant, near-term drawdown is much higher.

Figure 4 – Year-ahead returns



Source: Bloomberg and LGIM America calculations.
Data as of December 31, 2023.

To us, the simplest and most straightforward way to attack this is with a relatively vanilla put-spread collar. We have been strongly advocating these structures for the past year, as the favorability of option market dynamics matches the challenge of the current market set-up in ways that have rarely been found historically. While we are sympathetic to the desire to maximize upside, we are more circumspect about the need. A put-spread collar retains more upside than any unconditional expectations revealed by investors' capital market assumptions, while protecting against the types of drawdowns that are more likely in environments similar to today. Constraining the range of possible outcomes to a much more favorable distribution will ultimately benefit investors more than taking a chance on additional returns beyond what are otherwise deemed necessary.

Real Assets

Lushan Sun
Private Credit Research Manager,
LGIM Real Assets

Ed Wood, CFA
Head of Private Credit Investment,
LGIM America

"We expect 2024 to be another busy year as tight bank lending conditions are expected to remain in place for a while."

2023 was a good year for private credit, driven by high yields, economic strength and borrowers' desire to reduce reliance on bank lending. Despite increased investor optimism around a soft landing, we believe there are still too many uncertainties and prefer a more risk-focused approach. We view the risk-adjusted returns in investment grade and crossover private credit as attractive, and so is duration. In terms of sector exposures, we lean towards needs-based assets, borrowers with resilient business models and/or long-term structural shifts, which we believe are better able to cope with macroeconomic and/or geopolitical volatility.

Corporate debt

The corporate debt market enjoyed a busy 2023, helped by borrowers looking to diversify their funding sources after the banking crisis in March. Borrowers appeared to have realized that debt costs are unlikely to fall soon, so they've decided to get on with their refinance and investment plans, with a focus on shorter maturities (15 years or less).

The US market has been less diversified than the European market and has been dominated by utilities and infrastructure – sectors better able to pass on the higher debt costs to the consumer.

A busy pipeline led to a bifurcation in investor demand. High-quality borrowers were regularly oversubscribed, but weaker borrowers needed to offer additional incentives to get traction, for example longer maturities, higher premia, or additional ESG KPIs.

We expect 2024 to be another busy year as tight bank lending conditions are expected to remain in place for a while. This could generate potential opportunities for private credit investors, and we think issuer diversification should improve in the US once we draw nearer to rate cuts. Given our cautious outlook, we favor counter-cyclical sectors with strong cash flow generation.

Real estate debt

Real estate debt faced many challenges in 2023: higher interest rates, property re-pricing and the regional banking crisis. Together, these drove a significant flight to safety by lenders. The availability of finance has held up in residential, logistics and certain alternative sectors. Retail and offices are struggling (except for very high-quality assets), as are properties with poor sustainability credentials.

2024 marks the point when loans taken out in 2019 – the valuation peak for most sectors – will reach the end of the typical five-year maturity. Refinancing these loans could be more challenging than earlier vintages due to lower equity buffers. We may see more lenders enforcing or encouraging sales in 2024 which could accelerate price discovery and help the market bottom out.

Despite the challenging backdrop, our opinion is that the current environment offers potential opportunities for investors to provide financing on attractive terms. Yields are high, loan-to-value is lower (to support interest coverage) and there is less bank competition. That said, macroeconomic uncertainties demand a careful assessment of cashflow risk and ESG-related capex needs.

We favor sectors supported by demand-supply mismatch and long-term structural trends, such as residential, student accommodation, industrials and data centers.

Infrastructure debt

Relative to other sectors, infrastructure debt activity was more subdued for much of 2023. Infrastructure equity pricing has been slow to adjust to the higher rate environment which makes the economics of project financing more difficult.

Lower pipeline volume means that investor demand remained strong, with some deals over-subscribed by multiple times. The transportation, energy and digital sectors dominated issuance. Public-private partnership activity in the US and Canada has increased, with recent deals including toll roads, education, healthcare and rail.

We expect infrastructure debt to perform well in 2024, with high pricing power offering valuable downside protection. Activity increased in the last four months of 2023, as sponsors learned to live with a higher for longer environment, and we expect it to recover further once the prospect of rate cuts becomes more evident.

Pricing has become in our view more attractive, but tighter overall than other private credit asset classes as asset fundamentals remained resilient. We are seeing relatively higher premia in crossover-rated assets, where competition is less given limited bank participation.

1. 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.
2. "Global equities" referred to here is represented by the MSCI AC World Total Gross Index.
3. 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.
4. Federal Reserve Summary of Economic Projections, December 2023.
5. Bloomberg

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