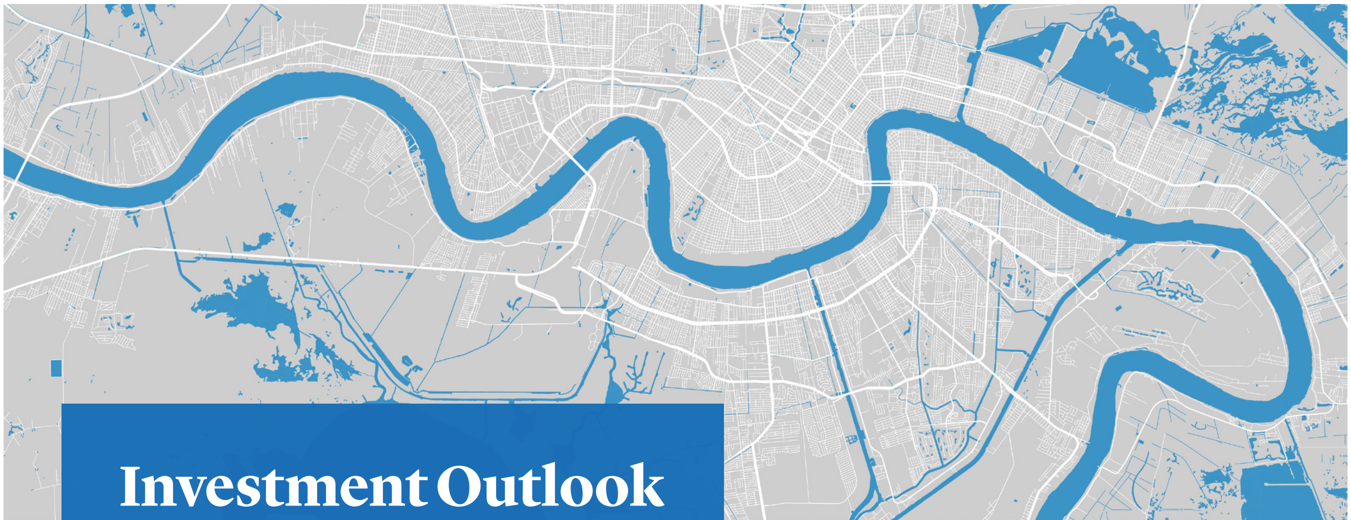
LGIM America



Investment Outlook

Navigating the Narratives

Q4 2024

Macro Environment

Jason Shoup
CIO, Co-head of Global Fixed Income

"Investors should be prepared for a more nuanced landscape—one where opportunities exist, but the margin for error has narrowed."

A blockbuster September employment report and recent GDP revisions have transformed the narrative surrounding the US economy. Many now question whether the Federal Reserve (Fed) moved too aggressively in September by cutting interest rates by 50 basis points, and whether a more gradual approach to normalizing monetary policy is warranted. Indeed, recent data present an economic landscape reminiscent of last year's: growth remains persistently above trend, job creation far exceeds what is necessary to maintain a stable unemployment rate and inflation is inching back towards target. Yet, the rapid shift from August's slowdown concerns to October's "Goldilocks" scenario invites caution. The volatility in economic outlooks underscores a cycle that is charting its own course, largely unconstrained by historical precedent.

The prospect of a soft landing has shifted from a remote possibility at the beginning of 2023 to the base-case scenario as we approach 2025. Less discussed, however, is how investors' expectations of this landing have evolved. Increasingly, there is a recognition that the "landing" may be more turbulent, as the economy reveals growing disparities. Stress among low-income households, lackluster private-sector hiring and a languishing manufacturing sector are counterbalanced by record household wealth, steady job creation in government and healthcare and a resilient services industry. The result is an economy that resembles a patchwork of winners and losers—making the soft landing more of an average between divergent realities.

In a global context, the American experience remains an outlier among developed markets. One obvious caveat to the strength of the US economy is that it has been achieved alongside a historically large budget deficit, expected to surpass 7% of GDP next year, regardless of the outcome of November's elections. Yet, a mix of innovation (AI, GLPs, EVs) and structural supports (immigration, rising defense spending, constrained housing supply) appear to be sustaining growth, even as monetary policy remains relatively tight. No other advanced economy seems quite as well positioned.

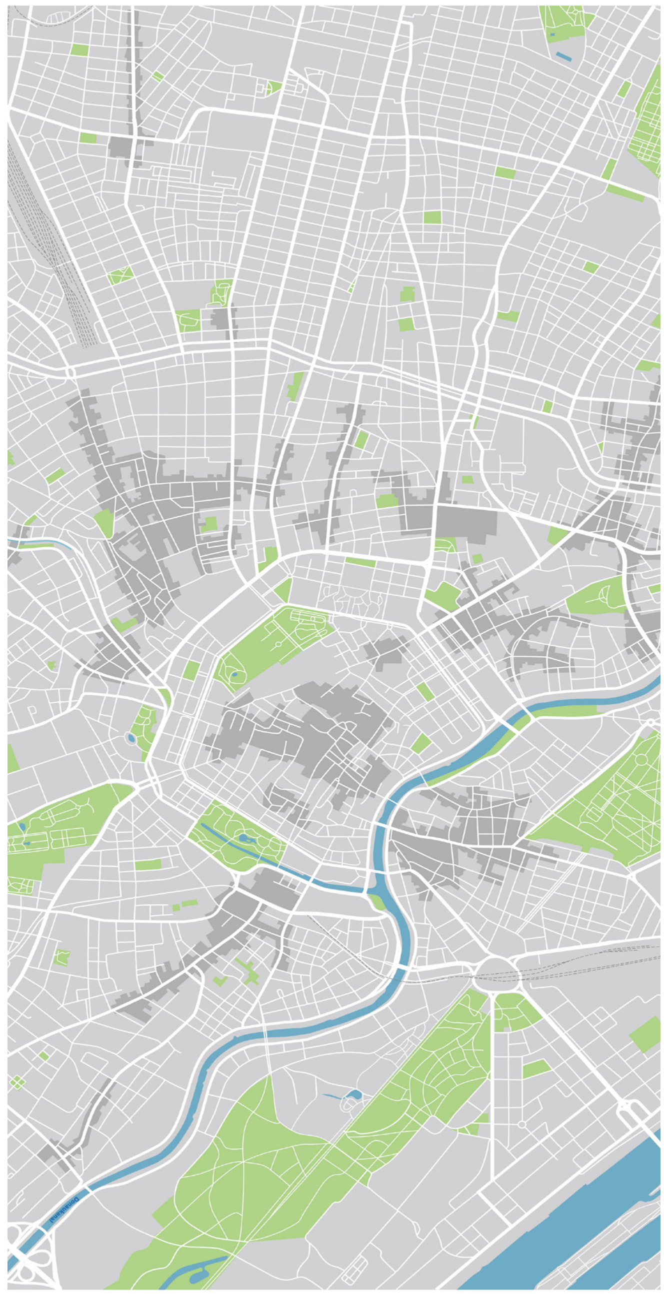
The natural question is whether this exceptional macroeconomic backdrop is sustainable. At a minimum, there is the risk that the US may already be slowing, despite the resilience suggested by recent data. The apparent weakening of the labor market at summer's end seemed significant enough to prompt the Fed's decision for a 50 basis point cut rather than a more gradual easing. While hindsight suggests the Fed's summer concerns may have been overstated, this stronger data needs confirmation through further reports before prudent investors can take comfort US exceptionalism is more than a mirage of post-pandemic statistical anomalies. Yet, many investors have already jumped to that conclusion, which may prove premature.

A second risk lies in the potential stalling of progress in reining in inflation. For some time, economists have debated how high the neutral rate in the US might be in this post-pandemic world of large deficits, structural tailwinds and heightened productivity. If the Fed eases policy too quickly in an economy capable of sustaining higher rates, a resurgence of inflation could follow. From this perspective, October's higher-than-expected inflation reading warrants attention, hinting that theoretical concerns could be on the verge of becoming tangible risks.

In some respects, the outlook for the year ahead is not dramatically different from that at the beginning of the year. The expectation remains for a gradual cooling of growth that culminates in a soft, if bumpier, landing. Yet, at times, economic data has pointed towards a sharper slowdown—or, as now, a backdrop too robust to justify much further Fed easing. A critical difference, however, is the starting point for asset valuations. Where 2024 began with room for yields to decline, equity multiples to expand and credit spreads to tighten under various economic scenarios, the current market landscape is far more finely tuned for perfection. This raises the bar for 2025, making it challenging to match 2024's performance, even under the most favorable conditions.

Credit markets appear most vulnerable to disappointment. Over the past year, demand from yield-hungry investors has compressed the typical spread-over-Treasury valuation metric to a 20-year low. As a result, it will be mathematically challenging to deliver positive returns beyond those of Treasuries, except in the most benign of soft landings or in a scenario where growth remains robust and the Fed still manages to cut rates. In other words, there is little margin for error within investment grade or high yield markets. Yet, few asset allocators are inclined to reduce exposure, as the prospect of high single-digit positive total returns remains enticing.

For all assets, the path forward is likely to be defined by the interplay between economic resilience and the pace of policy adjustments. Investors should be prepared for a more nuanced landscape—one where opportunities exist, but the margin for error has narrowed. In such a world, flexibility will be key to navigating the shifting narratives that continue to shape markets.



Pension Solutions Monitor[1]

Chris Wroblewski, CFA
Co-head of Solutions Strategy

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

Our analysis of market movements impacting US corporate defined benefit pension plans leads us to estimate that pension funding ratios increased slightly over the third quarter of 2024. Based on market movements, the average funding ratio is estimated to have increased from 109.9% to 110.0%.

Equity markets experienced strong performance over the quarter with both global equities[2] increasing 6.7% and the S&P 500 up 5.9%. Plan discount rates[3] were estimated to have decreased approximately 71 basis points over the quarter with the Treasury component decreasing 65 basis points and the credit component tightening 6 basis points. Plan assets with a traditional "50/50" asset allocation increased 7.3% while liabilities increased 7.2%. The solid asset performance and corresponding decrease in liability values resulted in a 0.1% increase to funding ratios over the third quarter of 2024.

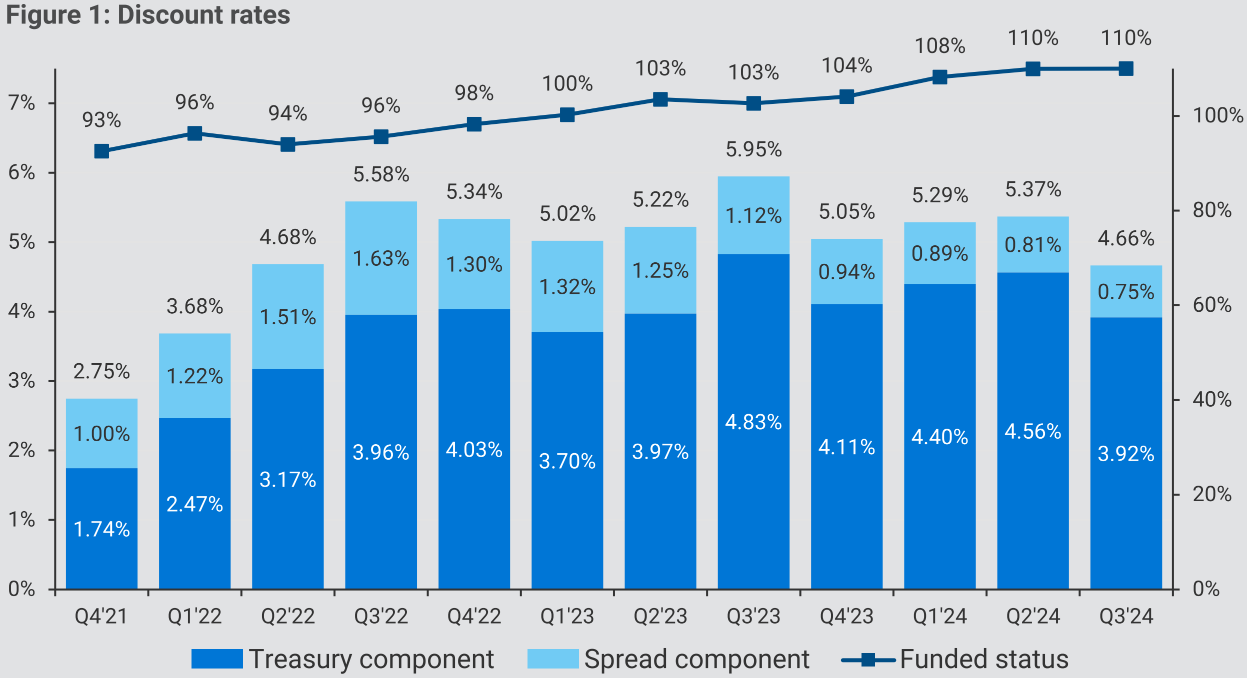
Average funding ratios reached recent highs in Q3 following another rally in equities mostly offset by a meaningful decrease in plan discount rates. As we enter Q4, investors continue to express interest for custom hedging strategies to lock in funded status gains. Additionally, plan sponsors are increasingly 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. For those looking to enhance plan liquidity amidst challenging private market fund lock-up periods, investors may look to custom credit portfolios to align interest and principal payments to short-term liabilities.

The Pension Solutions Monitor 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 increased due to lower discount rates.
- Funding ratio levels increased slightly with the rise in assets outpacing the rise in liabilities.

Figure 1: Discount rates



Sources: LGIM America, ICE indices and Bloomberg. Data as of September 30, 2024.

Fixed Income Markets

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

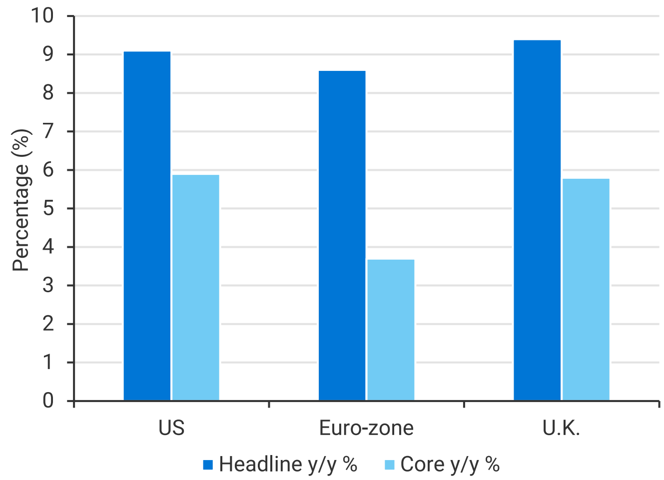
"We are inclined to stay fully invested in the near term, but we are prioritizing flexibility in portfolios in what is likely to be a volatile closing act of the year."

In most athletic endeavors there exists a generally accepted principle that the climb is more arduous than the descent. Indeed, a runner begrudgingly accepts the strain of scaling up a hill with the tacit understanding that relief awaits him on the way back down. Similarly, as we enter the final quarter of the year market participants appear galvanized by the prospect of friendlier terrain as developed market central banks begin a synchronized descent from peak rates to less restrictive settings. However, it is worth debating whether such exuberance has gone a step too far. On the one hand, the transition from hikes to cuts should provide an additional tailwind for risk sentiment as financial conditions become even more accommodative. Alternatively, fickle economic data and mounting event risks implore one to question whether greener pastures truly beckon on the "easier" side of the policy rate hill. We argue that the outlook for risk assets will be heavily dependent on the underlying motivation for ongoing easing. Specifically, will the cycle be driven by a pre-emptive response to goldilocks conditions, or will deeper cuts become a necessity due to US exceptionalism screeching to a halt?

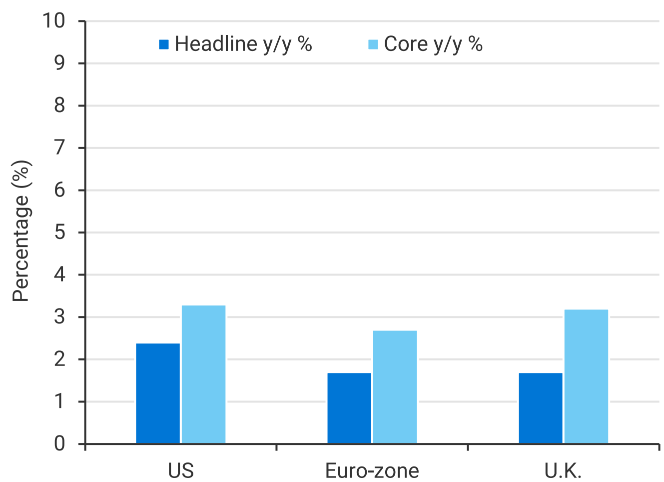
The magnitude of the Fed's pivot is evident in the dramatic repricing in the term structure of rates over the last quarter. In June, the median dot in the central bank's summary of economic projections pointed to only one 25 basis point cut in 2024. Fast forward to September, not only did the Fed eclipse this projection with a super-sized 50 basis point cut to kick off its cutting cycle, but its updated median dot now implies 100 basis points of cumulative easing this year. Chair Powell summarized this shift by stating that "the risk to achieving its employment and inflation goals are now roughly in balance."[4] However, we see an elevated risk of the dual mandate resembling more of a "jobs mandate" in the short-term as the Fed seeks to preserve a soft landing outcome given the material progress already made on inflation (Figure 2).

Figure 2: Inflation – then and now

June 30, 2024



September 30, 2024



Source: LGIM America and Bloomberg. Data as of September 30, 2024.

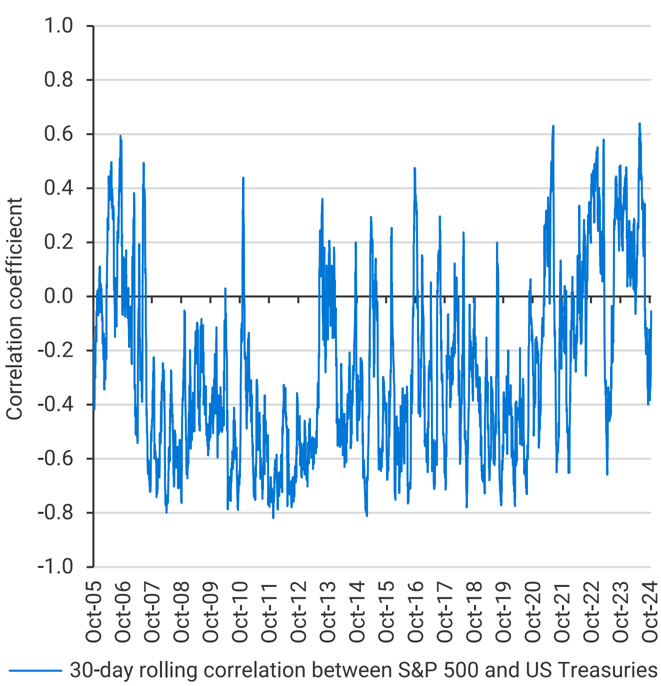
Treasuries rallied aggressively during the quarter, with 2-year yields falling 111 basis points, while 10- and 30-year yields declined by 62 and 44 basis points, respectively.[5] This bull steepening also led to the yield curve dis-inverting following a protracted period of shorter-dated maturities trading at higher yields than longer-dated paper.

Corporate credit also responded favorably to the prospect of less restrictive monetary policy. In investment grade, full market and long credit indices registered strong total returns of +5.71% and +8.10%, respectively.[5] Both benchmarks (Bloomberg US Credit and Long Credit) also generated positive excess returns, and the outperformance has continued in the early innings of the fourth quarter, with spreads currently sitting at the tightest levels of the year. High yield credit also posted robust performance in the third quarter, with risk premiums in the asset class similarly hovering around year-to-date tights.

In our last Investment Outlook, we argued that the peak in yields for this cycle was likely in the rearview mirror. This assertion looks even more probable today given policymakers' median expectation of 200 basis points of cumulative easing by the end of 2025. Consequently, we view the rates outlook as more broadly balanced from here. The bullish case for duration rests on a few key factors. First, with monetary easing finally underway, income focused investors will be tempted to come off the sidelines to lock in relatively attractive yields while they can, particularly as bonds tend to outperform cash during cutting cycles. An additional tailwind for rates is burgeoning evidence that Treasuries have regained the diversification properties that it was abruptly stripped of during the inflation surge. The renewed negative correlation with equities should increase the allure of risk-free assets as insurance against a growth shock (Figure 3).

Conversely, we acknowledge that rates have repriced significantly in a short space of time for only fledgling signs of slowing momentum. Specifically, the market has gone from pricing in a terminal rate of 4% for this cycle to below 3% in a matter of a few months. If one believes that the US economy will ultimately avoid a recession, it is difficult to argue that there is much upside from being constructive on duration at these levels. We retain our preference for the intermediate part of the curve as we expect steepening pressures to persist due to elevated deficits, particularly given our view that the odds of a sweep (by either party) in the US election are currently being underappreciated by the market.

Figure 3: Negative correlation between Treasuries and equities possibly restored



Source: Calculations based on Bloomberg US Treasury Index and S&P 500 Index. Data as of October 15, 2024.

In corporate credit, we have alternated between neutral to modestly overweight positioning for much of the year. While risk premiums remain very compressed, we believe it is a little premature to turn bearish on the asset class given solid fundamentals, strong technicals and the dovish turn by global central banks, including China. However, we acknowledge that forward looking excess returns have been underwhelming historically when spreads have been near current levels, and consequently, we advocate for increased portfolio diversification at this point of the cycle. Notably, pockets of securitized products seemingly still offer attractive relative value in our view, particularly top of the capital stack ABS, which benefit from excess spread and overcollateralization. Moreover, after three years of outflows, we believe hard currency emerging market debt looks compelling for a few reasons. First, emerging markets is an improving asset class, with upward ratings momentum and a positive growth differential versus developed economies that stands at the highest level since pre-COVID-19. Moreover, all-in yields remain attractive, and the Fed's cutting cycle is likely to provide additional support to the asset class.

At the inflection point of a journey, it is natural to reflect on how far we've come and the hard yards that remain. There are more than just glimmers of hope that inflation can return to target in 2025 after the disorderly price increases triggered by the pandemic. However, the mosaic of economic data paints a more nuanced, if unclear, picture of underlying growth momentum. Fiscal policy and immigration have served as positive catalysts in the past few years, but their impacts are likely to fade moving forward.

Meanwhile, signals from the consumer and the labor market have become somewhat garbled due to material, narrative-shifting revisions. Our base case remains that the US economy will achieve a soft landing, but we maintain that the odds of recession over the next twelve months are higher than a typical year. Rates and earnings are normalizing, while the geopolitical landscape is anything but. While the direction of travel in the monetary policy is clear, the ultimate terminal rate for the cycle and how fast we will get there remain open questions. As we head into the final quarter of 2024, we find ourselves investing against a relatively constructive macro backdrop complicated by questions that valuations leave little room to entertain. We are inclined to stay fully invested in the near term, but we are prioritizing flexibility in portfolios in what is likely to be a volatile closing act of the year.

Equity Markets

Dave Chapman, CFA
Head of Multi-asset

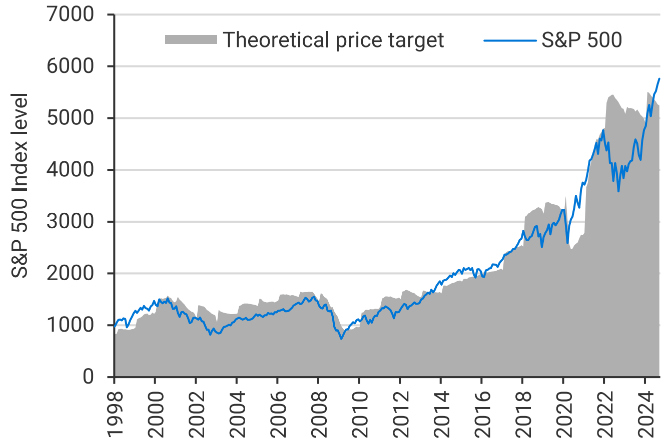
"In spite of volatility in longer-term macro narratives, we don't need to overthink the short-term."

We practice what we preach. Jason mentioned in the macro section that "flexibility will be key to navigating the shifting narratives." We recently brought our cross-asset risk view up to flat, but we are expressing this through a tactical overweight to equity and underweight to credit. Not only is this consistent with Jason's comment that credit markets are most vulnerable, but also the arguments for vulnerability in equity markets have weakened. Inflation is in a clear downtrend; growth is sufficiently strong; the Fed is accommodative. In spite of volatility in longer-term macro narratives, we don't need to overthink the short-term.

The two obvious rebuttals to a bullish equity view are valuations and geopolitics. Clearly, both present headwinds to equities, but we believe much of that risk is priced in. We previously expressed our concerns about long-term equity returns starting from current valuations. Interestingly, though, this quarter we came across a paper that highlights price expectations relative to recent historical valuations.[6] In this commentary, we will utilize that framework to highlight dynamics independent of, but certainly subject to, the macro forces ebbing and flowing to demonstrate why we hold the views we do across different horizons. On the geopolitical front, we believe that uncertainty priced into implied volatility outstrips all but the very worst-case scenarios of possible realized volatility around the election and beyond, and this creates an opportunity for investors regardless of outcome.

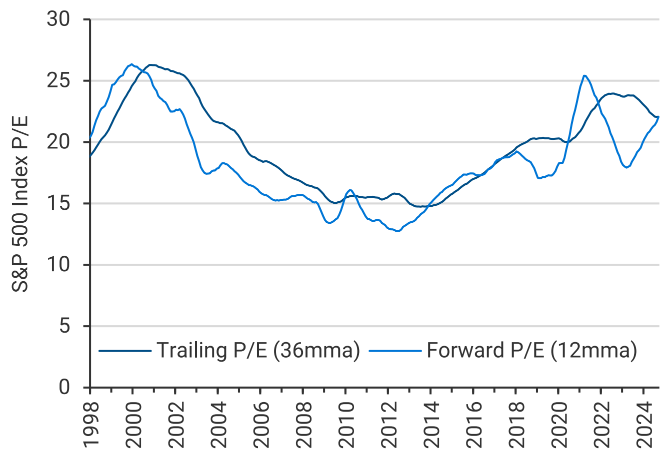
Valuations are stretched, but for every foreboding historical analog there are several nuances and caveats (e.g., Mag 7 contributions to index-level multiples). The paper we mentioned demonstrates that the vast majority of equity analyst stock price targets can be explained by earnings expectations and changes in a moving average of the trailing P/E. For an index like the S&P 500 where most of the names have broad analyst coverage, it may be fair to extrapolate this model to the index level. Figure 4 replicates the approach in the paper. We can see the index is trading above its theoretical price target, although that is not uncommon and the index is within about one standard deviation of what the model suggests.

Figure 4: Expected EPS versus Trailing P/E



Source: Ben-David, Itzhak and Chinco, Alexander, Expected EPS × Trailing P/E. Data as of September 01, 2024.

Figure 5: Trailing P/E versus Forward P/E



Source: Bloomberg and LGIM America. Data as of September 30, 2024.

Digging into the model components, Figure 5 shows divergent paths of the declining historical average in the model against rising optimism of forward-looking expectations. The trailing average currently includes several months of very modest valuations that will soon roll off, raising the theoretical price target in the coming months. At the same time, earnings expectations remain robust, with nearly 10% growth still expected as reported by FactSet.[7] So, while equities are hardly a bargain, even persistently high valuations allow for a yet higher ceiling while the favorable macro environment sets a more comfortable floor..

To evaluate more event-specific risk, we look to slightly more esoteric parts of the equity market. In options space, implied volatility is extremely elevated, trading at very rich premiums to realized volatility and pricing in significant movements around the election and beyond. Further, several counterparties are publishing custom equity baskets that focus on likely beneficiaries of each candidates' policies (i.e., a Harris basket and a Trump basket). Those baskets are trading in a highly correlated way with polls and prediction markets and in a strongly negatively correlated way with each other, as expected.

From this, we expect a significant amount of dispersion within broad equity indices with the election result. Higher dispersion drives realized volatility down. So, again, in all but a true crisis scenario, selling that volatility appears very attractive to us. Finally, high implied volatility premia can have reflexive properties with price levels. If our interpretation of implied volatility dynamics is correct, then we would ultimately expect that to be supportive of equity returns as well.

Equity Solutions: MSCI Rebalance Predictions

Dave Barron, CFA, CAIA
Head of US Equity Solutions

"Last quarter, we made 27 add and delete predictions for the MSCI World rebalance. Ultimately, we accurately predicted 25 of the 29 constituent changes."

Overview

Passive investing continues to grow at a fervent pace and for good reason. Index returns have been strong, and fees continue to come down; naturally, allocations have increased. But, despite the growth, benchmarks continue to be inefficient which can expose index investors to uncompensated risks.

We have designed and implemented a low active risk approach to capture outperformance created by these index micro inefficiencies. In our investment approach, we target a variety of opportunities, one being rebalance predictions, where we model widely followed methodologies to predict index additions and deletions. This predictive capability provides an opportunity for us to optimize portfolio adjustments before official index announcements, potentially enhancing returns.

To put our money where our mouth is, so to speak, we are publishing our list of MSCI predictions for the upcoming index rebalance. Here's how this works:

- On a quarterly basis, MSCI will re-establish its market cap weighted index series using a publicly available methodology, which means it can be independently modeled with reasonable certainty.
- We identify which companies we believe will be reclassified between the Standard (Large + Mid Cap) indices and Small Cap indices.
- MSCI selects one of ten days at the end of the month prior to the actual rebalance to crystalize sizing classifications.
- A public notification of the changes happens approximately two weeks before the rebalance, with the rebalance happening at the end of the month (February, May, August, November cycle).

Accurately predicting this information in advance is knowing what trillions of dollars are likely to do before they do it.

Last quarter's scorecard

We have implemented a scorecard to track the success of our predictions. Here's how it works:

- Correct prediction (i.e., True positive; 1 point) - We assign ourselves one point for every accurate add or delete prediction
- Incorrect prediction (i.e., False positive; -1 point) - One point is deducted for every prediction that is not ultimately added or deleted by MSCI
- No prediction (i.e., False negative; 0 points) - No points are assigned or deducted for an add or delete that was not originally predicted

The sum of the number of points assigned is then divided by the total possible number of points (i.e., the total number of adds and deletes implemented by MSCI) and then multiplied by 100 and rounded to create the Rebalance Accuracy Score.

Last quarter, we made 27 add and delete predictions for the MSCI World rebalance. Ultimately, we accurately predicted 25 of the 29 constituent changes. However, two of our original predictions were not included in the final reconstitution, and thus we deduct two points from our score. Further, while there were two more benchmark changes than we originally predicted, because we took no position in these names we assign zero points. In summary, our Rebalance Accuracy Score for the quarter was 79, indicating a strong level of accuracy.

Our latest predictions

Below are our predictions for the November 2024 MSCI rebalance. The key dates for this cycle are the following:

- 10 business day window: October 14 - October 25.
- Announcement: November 6.
- Implementation point: Close of Monday, November 25, but may be different for some markets (e.g., market holiday, exchange closures).

Figure 6: Our MSCI predictions for November 2024

Benchmark	Country	Name	Prediction
World ex USA	Australia	AMPOL LTD	Delete
World ex USA	Australia	DEXUS/AU	Delete
World ex USA	Australia	PILBARA MINERALS LTD	Delete
World ex USA	Austria	VOESTALPINE AG	Delete
World ex USA	Canada	BRP INC/CA- SUB VOTING	Delete
World ex USA	**Italy**	**BPER BANCA SPA**	**Add**
World ex USA	**Italy**	**UNIPOL GRUPPO SPA**	**Add**
World ex USA	**Japan**	**FUJIKURA LTD**	**Add**
World ex USA	Japan	NOMURA REAL ESTATE HOLDINGS	Delete
World ex USA	Japan	NIPPON PROLOGIS REIT INC	Delete
World ex USA	Japan	SUMCO CORP	Delete
World ex USA	Japan	IBIDEN CO LTD	Delete
World ex USA	Japan	ROHM CO LTD	Delete
World ex USA	Japan	HAMAMATSU PHOTONICS KK	Delete
World ex USA	Japan	MAZDA MOTOR CORP	Delete
World ex USA	Japan	KEISEI ELECTRIC RAILWAY CO	Delete
World ex USA	**New Zealand**	**INFRATIL LTD**	**Add**
World ex USA	New Zealand	SPARK NEW ZEALAND LTD	Delete
World ex USA	**Singapore**	**YANGZIJIANG SHIPBUILDING**	**Add**
World ex USA	**Spain**	**INTL CONSOLIDATED AIRLINE-DI**	**Add**
World ex USA	**Sweden**	**SPOTIFY TECHNOLOGY SA**	**Add**
World ex USA	Sweden	HUSQVARNA AB-B SHS	Delete
World ex USA	Sweden	VOLVO CAR AB-B	Delete
World ex USA	Switzerland	SWATCH GROUP AG/THE-REG	Delete
World ex USA	**United Kingdom**	**MARKS & SPENCER GROUP PLC**	**Add**
USA	**United States**	**CARVANA CO**	**Add**
USA	United States	BATH & BODY WORKS INC	Delete
USA	United States	CELSIUS HOLDINGS INC	Delete
USA	United States	CHORD ENERGY CORP	Delete
USA	United States	MOSAIC CO/THE	Delete
USA	United States	PARAMOUNT GLOBAL-CLASS B	Delete

Source: LGIM America. Data as of October 2024. For illustrative purposes only.

Invetsment Grade Private Credit

Dan Dreher
Solutions Strategist

"Investors should consider moving up the risk spectrum into investment grade private credit to capture the benefits of the asset class with more favorable exposure to leverage and certainty of cashflows."

Shifting benefits up the risk spectrum

Private credit has been one of the fastest-growing segments of the financial system over the past 15 years. The asset class, as commonly measured, totaled nearly $2 trillion by the end of 2023.[8] While it remains a small fraction of the broader fixed-income landscape, private financing solutions continue to perform well – and win, in many instances – against bank and public alternatives. 30 years ago, companies would work with banks to access financing – as those solutions became more commoditized, private credit stepped in to offer a unique partnership and bespoke financing solutions tailored to specific borrower needs. Borrowers' willingness to pay a premium to comparable publics for the speed and certainty of execution, unregistered status (particularly important for cross-border issuers), and customizable structures was promptly met by yield-hungry lenders.

Much of private credit's growth to date has been concentrated in direct lending – and as AUM has ballooned, it has captured a lot of headlines around excessive risk taking under the name of "private credit." Thus, many of the broad characteristics assigned to private credit are features of direct lending – sub-investment grade rating, floating rate obligations and most notably, illiquidity.

Investment grade (IG) private credit, an often overlooked $200 billion segment of the asset class, carries meaningfully different characteristics. While still benefiting from the issuer preferences of execution and customization, the space also offers stronger covenant packages compared to publics. These features drive a meaningful portion of the spread premium received relative to public credit equivalents, suggesting a "complexity" premium where investors are required to navigate several additional factors not present in public markets (Figure 7, 8 and 9).

Figure 7: IG Private Credit versus Private Credit

	Investment grade private credit	"Private credit"
Rating	Investment grade (BBB- to AAA)	Unrated
High-level distinction	Corporate, Infrastructure, Alternatives	Direct lending, Mezzanine, Special situations, Distressed debt
Coupon type	Fixed rate	Floating rate
Spread above publics	+50-300bps	+500-1,000bps
Market size	$100-200B	$1.50-1.70T
Liquidity	Strong demand from buy-side	Very limited
Premium sources	• Illiquidity • Structural (i.e. disintermediation) • New issuer • Tenor • Rating differential • Optionality • Size	• Illiquidity

Source: LGIM America. For illustrative purposes only.

In addition to execution and customization, privacy can also play a major role in the willingness to pay a private market premium. The incredibly well capitalized National Football League (NFL) is one of the largest borrowers in the investment grade market. The NFL's preference for borrowing from private markets is also influenced by their desire to maintain financial privacy. Unlike public markets, which require extensive disclosures and adherence to SEC regulations, private credit allows the NFL to keep its financial details confidential. This discretion is particularly valuable for the NFL and more than justifies a premium to public comparables.

If not standard agency ratings, what?

Aside from being fixed rate and meaningfully more liquid than sub-IG counterparts, IG private credit markets benefit from a mostly uniform ratings methodology akin to public markets. As many market participants are beginning to realize, the broader conversation around private credit has focused high-level distinctions such as direct lending rather than ratings distinctions in-line with public market convention. But this evolution makes sense – early users of the market were more levered companies who could not land favorable terms with their banking relationships.

However, most of the market has continued its evolution towards manager preferences as opposed to industry standards. To date, many managers focus more on their internal ratings or risk/reward trade-off assessments. They frequently try to take the public ratings out of the analysis and focus on a more flexible internal rating criteria and/or measure risk as leverage per unit of spread or return per unit of leverage.

Major opportunity in the IG segment

Historically, IG private credit has been a favored investment for US insurance companies seeking diversification through unlisted, high-quality debt assets. While this market segment has been outpaced by aforementioned categories, investors are starting to identify a massive opportunity in high-grade debt. This is timely, as diversification in high-quality assets has become increasingly important with public indices becoming more and more concentrated.

Currently, there is a tremendous appetite for capital – we talk about the “Global Industrial Renaissance”– data and compute, power for AI, energy transition – which suggests the real economy needs massive amounts of capital. Apollo views private credit as a $40 trillion market, a majority of which is investment grade. McKinsey ran a similar analysis and found “the addressable market for credit could be more than $30 trillion in the United States alone.”[8]

Some of biggest public capital market participants are looking for diversified financing, flexibility and high-quality partners who can bring speed and certainty such as Anheuser-Busch Inbev SA, Intel and Air France. These are investment grade, name brand firms with plentiful access to public markets yet turn to the private markets looking for differentiated solutions. Asset-backed financing (ABF) is also anticipated to play a crucial role in this growth, offering a diverse range of investment opportunities backed by tangible and financial assets such as residential mortgages, aircraft leases, auto-financing, fund finance and receivables.

Shifting private credit benefits up the risk spectrum

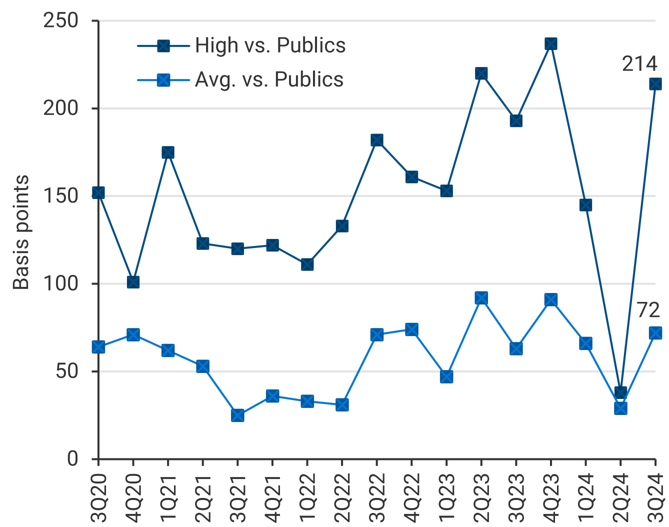
As Jason outlines in his macro section, we are looking at an economy resembling a patchwork of winners and loser – and given valuations, credit markets appear most vulnerable to disappointment. This comes at a time where asset allocators are seeking to meaningfully increase private credit exposure (over 40% of investors seeking to increase allocations in next 12 months).

Risks on the lower end of the market are beginning to materialize. Fundamentals are deteriorating in more levered portions of the credit markets and calls of “complacency” have begun to grow louder. And although defaults remain low, the recent Pluralsight saga has highlighted the risks of sub-IG floating rate debt issued during the Covid zero-rate environment. Further, there are other challenges unique to private markets such as evaporating fund-level liquidity.

The sub-IG world was built around loan-to-own and locked up capital affords very little ability to "get out" before asset maturity. This wasn't a problem until high rates upended some of the usual capital flows across credit.

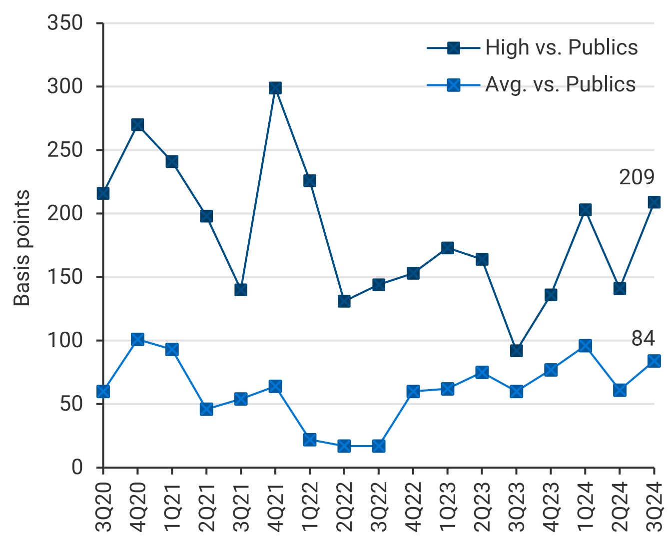
Investors should be prepared for a more nuanced landscape—one where opportunities exist, but the margin for error has narrowed. In such a world, flexibility will be key to navigating the shifting narratives that continue to shape markets. In the private credit context, investors may want to consider moving up the risk spectrum into investment grade private credit to capture the potential benefits of the asset class with more favorable exposure to leverage and certainty of cashflows.

Figure 8: NAIC-1 Spreads (A-AAA) versus public comparables



Source: LGIM America, Bank of America. Data as of April 30, 2024. For illustrative purposes only.

Figure 9: NAIC-2 Spreads (BBB) versus public comparables



Source: LGIM America, Bank of America. Data as of April 30, 2024. For illustrative purposes only.

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. 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.
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. The Federal Reserve.
5. Bloomberg.
6. Ben-David, Itzhak and Chinco, Alexander, Expected EPS × Trailing P/E (September 01, 2024). Fisher College of Business WP 2024-03-018 and Charles A. Dice WP 2024-18, Available at SSRN: https://ssrn.com/abstract=4946881 or http://dx.doi.org/10.2139/ssrn.4946881.
7. Factset. Data as of October 11, 2024. https://advantage.factset.com/hubfs/Website/Resources%20Section/Research%20Desk/Earnings%20Insight/EarningsInsight_101824.pdf.
8. McKinsey.

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