

CIO spring update:

Heating up





Foreword:

Winning the peace

It is our responsibility as stewards of our clients’ capital to seize the opportunities, and manage the risks, presented by a post-pandemic future.



Sonja Laud
Chief Investment Officer

Ever since the outbreak of the pandemic, the world economy has essentially been on a war-footing, involving the deployment of previously unthinkable amounts of fiscal and monetary stimulus. Now, as COVID-19 begins to retreat – albeit with some notable exceptions – it is time to win the peace.

The global response to coronavirus has brought about lasting changes to the way we live, work and play, accelerating trends that would otherwise have unfolded over the course of years in a matter of months, with momentous implications for investors. The increasing dominance of the tech sector, driven by remote working and e-commerce, is a striking example of this phenomenon.

It is our responsibility as stewards of our clients’ capital to seize the opportunities and manage the risks presented by a post-pandemic future, identifying the companies and asset classes we believe will emerge as relative winners.

We also need to tackle the critical environmental, social and governance (ESG) challenges highlighted by COVID-19 – from access to healthcare, to income inequality, to the risk of a climate catastrophe. Indeed, we believe that due to the financial materiality of ESG factors, both objectives are inextricably linked: only through responsible investing can we generate long-term returns for our clients.

In this document, investment teams from across LGIM examine these themes in greater detail. Our conclusions include the following key points:

- Climate risk means some companies are increasingly likely to struggle to access capital
- Reports of the ‘death of the office’ have been greatly exaggerated
- Risk assets are likely to grind higher, albeit with a fair amount of volatility

Other issues addressed are the battle faced by the Biden administration in delivering on its vast investment plans; the likely shift in investor attention towards inflation risk and stimulus withdrawal; and how pension schemes could become more resilient ahead of the next market shock.

Energy and urgency

The overall theme of this spring update is “heating up”, in a not-so-subtle reference to both the global economy and our planet.

In the run-up to COP26, the climate change conference later this year in which LGIM is participating, some governments are making admirable commitments to cut emissions. But given the extraordinary fiscal action taken during the past 12 months, the budgetary headroom to support these measures – whose cost will run into the trillions – is meagre at best.

Tough regulation and a truly global approach can do some of the work. But much of the heavy-lifting will ultimately need to be carried out by the private sector, in our view, with the same energy and sense of urgency with which it handled COVID-19.

This is where the asset management industry can play a crucial role, by expediting the transition to a low-carbon economy through the capital we invest and manage on behalf of our clients. At LGIM, our purpose is to create a better future through responsible investing. Averting the looming climate crisis is central to this mission.

Economics:

Spotlight on policy in a post-pandemic economy

As the recovery strengthens and broadens, investor attention is likely to shift towards inflation risks and the timing of stimulus withdrawal.

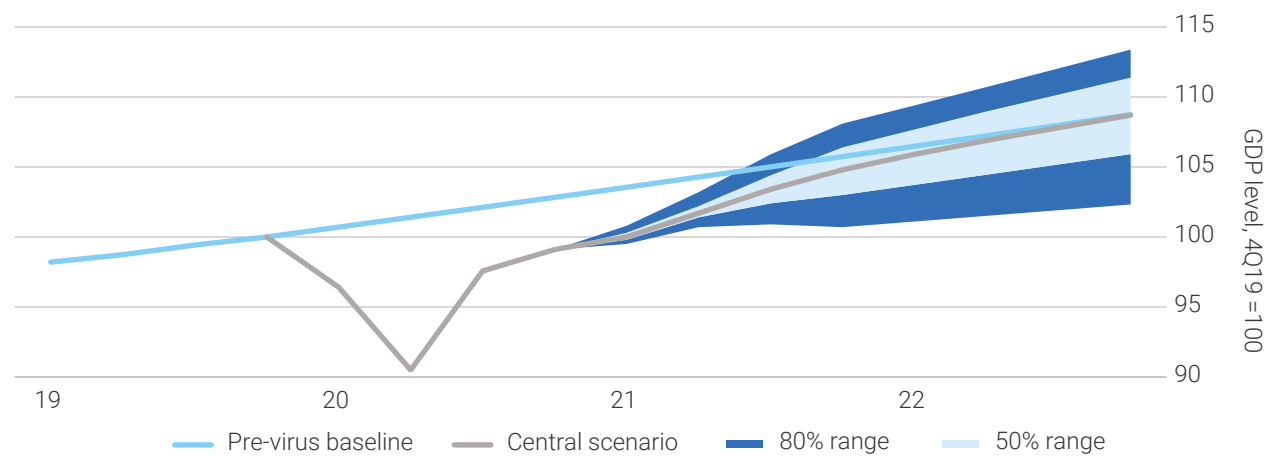
Despite some renewed restrictions in response to various virus waves in recent months, economies have proven far more adaptable than in the initial phase of the pandemic, with most economic activity able to continue with the exception of high-contact services. Now the rebound that we hoped for in our [Winter 2020 outlook](#) is materialising.

Led by the US, growth is expected to broaden as the vaccine rollout gathers pace across the globe and stimulus remains plentiful. The strong efficacy and safety findings from earlier trials have now been replicated across large proportions of adult populations in countries such as Israel and the UK. Manufacturing production of vaccines is now ramping up, which should ensure a more plentiful supply is available for countries across the world.

Europe – which had been slow initially – is expected to catch up on vaccinating over the next few months. China has fully recovered from the pandemic and, with some policy restraint on credit growth, is expected to grow around its potential. Other emerging markets in general are further behind, but should also obtain increasing access to vaccines later in the year.

It is increasingly likely that forced change due to the disruption and policy support are offsetting the economic scarring from the pandemic. So overall, we expect global growth to return to its pre-pandemic path by the end of next year, though this masks some regional variation. Downside risks remain around mutant strains, which could evade existing vaccines, but our central expectation is that if necessary, new vaccines will be developed and deployed in time to prevent a return to lockdown.

Level of global GDP



Source: LGIM, as at 28 April, 2021. There is no guarantee that any forecasts made will come to pass.



Spending splurge

Many countries, in particular the US, have accumulated [excess savings](#) over the last year; this is the main upside risk to the forecast, should global consumers decide to make up for lost time as restrictions ease.

We expect very rapid US employment growth over the next few months, which should help recover virtually all the jobs lost due to the pandemic by the end of the year. Furthermore, as Jason discusses in more detail, there is potential for Congress to pass a large infrastructure and social spending bill in the region of \$4 trillion later in the year. This spending is likely to be spread out over time, with some revenue-raising on corporates and high earners, which will only partially cover the cost for the first several years.

The net effect is more stimulus spending at a time when the US economy will likely have fully recovered from the pandemic. So investor attention could shift to the dangers of overheating.

Inflation threat

It's clear from recent data that US inflation is in the [process of accelerating](#), for three reasons:

1. Purely due to a base effect – prices fell sharply in the first lockdown and so inflation will rise relative to a year ago

2. As the economy reopens, some prices which have remained depressed over the last year are set to normalise; airfare and hotel prices are clear examples
3. Commodity prices have risen and there have been a number of supply chain disruptions including to shipping and semiconductors

The US Federal Reserve (Fed) has already warned investors to expect a temporary overshoot of its 2% inflation target. We tend to agree that price pressure will likely ease later in the year, but any reprieve could be relatively short-lived.

We expect the Fed to begin tapering towards the end of the year, given the outlook for growth and wages, but it might also have to reassess the timing of lift off for short-term interest rates. Fortunately, the market is already anticipating a somewhat earlier start to rate hikes, but any sudden shift in Fed thinking has the potential to be disruptive for markets addicted to tremendous policy support.



Tim Drayson
Head of Economics



Multi asset:
Challenging assumptions in asset allocation

While a lot of good news has certainly been priced in, we expect markets to grind higher – albeit with a fair amount of volatility along the way.

“If everyone is thinking alike, then somebody isn't thinking” – this axiom from George S. Patton, the legendary US general, is relevant to many professions. It is particularly so for asset allocators at times like this, when a consensus view on the market outlook is cementing.

Take fixed income, for example. Having worried about COVID-19 for 12 months, institutional investors now say they are most concerned about inflation and a bond market tantrum. That's because the macroeconomic landscape is shaping up as expected, with the vaccine- and stimulus-driven recovery gathering pace, as Tim details in his section.

And yet, in our view, the size of the [short base in US Treasuries](#) is now such that the reflationary narrative needs to be constantly buttressed by new information to keep yields moving higher. As a result, we are neutral on duration.

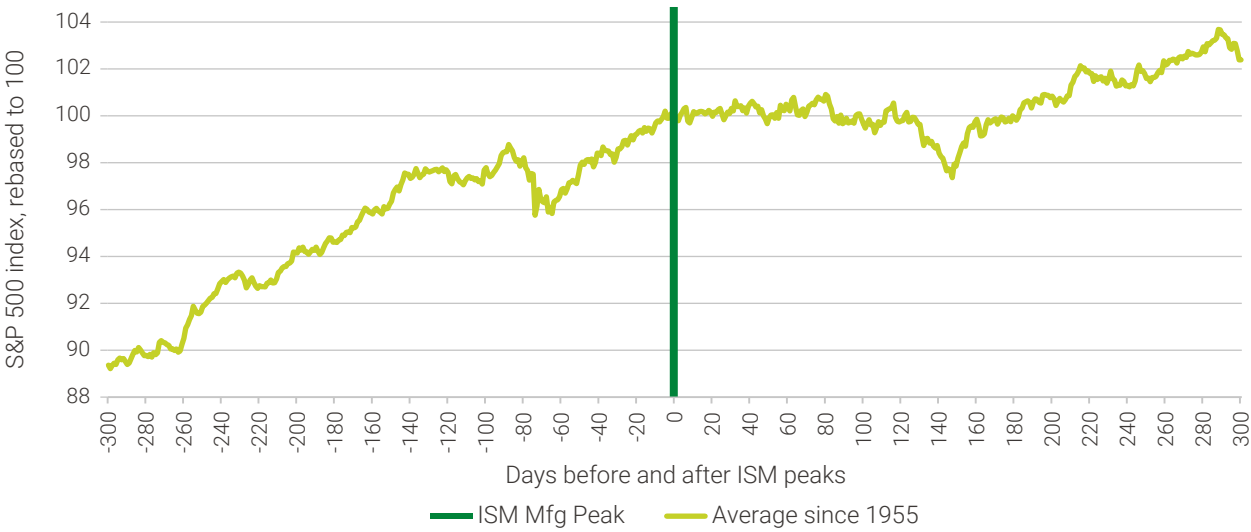
Equities versus economic indicators

At the same time, we anticipate a counter-narrative developing with regard to purchasing managers' indices (PMIs). Many of these forward-looking economic indicators are at multi-decade highs, so it will probably not be long before our inboxes fill up with bearish missives on what their near-inevitable decline means.

Our answer: there are plenty of things to worry about, but PMIs declining from a post-recession peak is not one of them. Indeed, as the chart shows, equities have – after a pause – tended to do well after PMIs peak, as this is typically a sign of the economic cycle maturing, rather than of imminent recession.

That said, within equities, we believe a turn in PMIs would be problematic for cyclical, which are more sensitive than the broader market to momentum in these indicators. A decline in PMIs – coupled with a record-breaking rally – would not bode well for such stocks over the coming six months, in our view, even if it may be premature to position for this at this stage.

Average S&P 500 returns around US ISM manufacturing index peaks



Source: Bloomberg as at 23 April, 2021. Data range: 1955-2011. The value of an investment and any income taken from it is not guaranteed and can go down as well as up, you may not get back the amount you originally invested.

Grinding higher

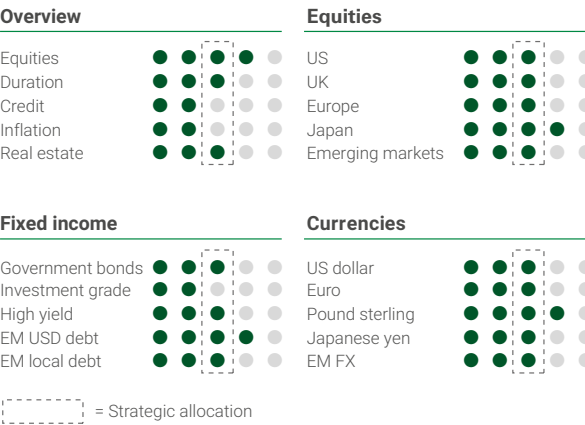
So how are we positioning overall? While a lot of good news has certainly been priced in, we expect markets to grind higher – albeit with a fair amount of volatility along the way.

The first three months of the year witnessed record inflows into equity funds, as the consensus remains very bullish. The optimism we all feel now that kids are back in school and pubs are open translates into investor exuberance as well. Then there is the vast amount of liquidity provided by governments and central banks, a wall of money, that continues to support markets.

We believe sentiment will act as a speed limit for equity markets in an overall upward trajectory – it's hard to see investors becoming even more bullish than they are currently. So we remain long risk assets, on the view that most investors are positioned to buy any meaningful market dip and will probably shrug off potential headwinds like US tax hikes.

We struggle to see how this attitude could change over the coming months, to make investors become sellers of dips, bar a black swan event like the pandemic or a geopolitical conflagration.

Asset class views



This schematic summarises the combined medium-term and tactical views of LGIM's Asset Allocation team as of May 2021.

The midpoint of each row is consistent with a purely strategic allocation to the asset/currency in question. The strength of conviction in our medium-term and tactical views is reflected in the size of the deviation from that mid-point.



Emiel van den Heiligenberg
Head of Asset Allocation

Solutions:

Resilience is an underestimated asset

Action now could help pension schemes to increase their resilience to the next market shock.

Resilience is defined as the capacity to recover quickly from extreme stress. The impact of the pandemic has made all investors focus on this quality and how well companies are prepared and positioned to withstand such events. We have also been considering the wider lessons for pension schemes as to what can be done to improve their resilience in the coming years.

More mature schemes can be more susceptible to the impact of market dislocations. Funding levels can start to decline quickly once a deficit appears, due to the high levels of cash payments out. Repairing the deficit is harder as the scheme starts to run out of time and has fewer assets.

Sterling investment grade credit spreads have been in the upper half of their range for only 8% of the time since the start of 2008, and in the lowest quadrant for three quarters of the time (bps)



Source: LGIM analysis, as at 31 March, 2021. The value of an investment and any income taken from it is not guaranteed and can go down as well as up, you may not get back the amount you originally invested.



Building resilience with a lockdown portfolio

We have seen a marked increase in interest from our clients over the last 12 months in cashflow driven investment, or CDI, as a lockdown investment approach, with a focus on three key objectives:

1. Cash management to pay pensions

Cash demands change over time – projected liabilities are an estimate, not a certainty – so CDI assets must be flexible and able to generate cash when it is needed, without having to sell the assets that are aimed at closing the deficit.

Sources of cash include sponsor contributions, dividend payments, interest and redemption proceeds of cashflow instruments, or generating cash from the liability-driven (LDI) portfolio.

2. Cashflow investment to generate returns

Corporate bonds or ‘secure income’ assets that generate cashflows are an attractive lockdown investment, in our view. They tend to generate a return above government bonds that can be used to close the deficit, and they repay their redemption amount at a known time and value (absent any default) which increases the certainty of returns compared with equities and can be used to pay pensions.

So, a popular approach from clients that have a significant allocation to government bonds is to convert a portion of them to higher-yielding credit investments on a buy-and-maintain basis, potentially with cashflows aligned with the expected liability payments.

We expect to see significant flows into credit over the coming years. Sterling investment grade credit spreads (the return over government bonds) are currently relatively compressed but the direction of travel for pension schemes is clear.

3. Hedging interest rate and inflation risk

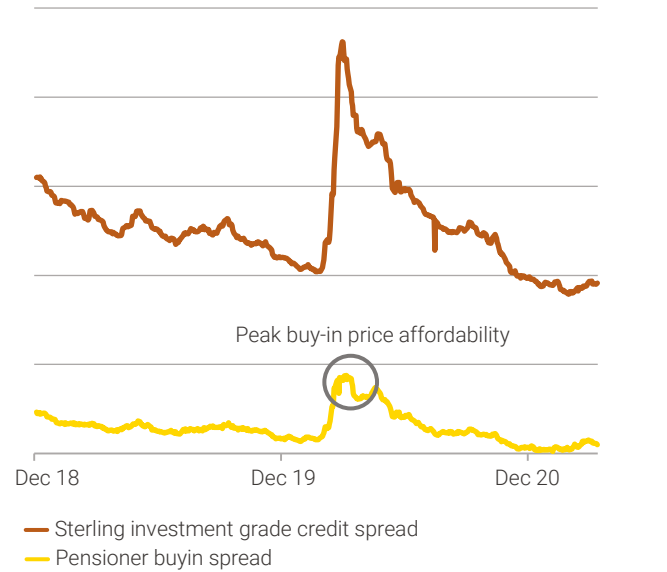
CDI is often implemented as an extension to an existing LDI portfolio, which needs to dovetail with increased activity around cash management and cashflow investment to maintain a target hedge ratio to interest rates and inflation.

A new beginning

The ultimate expression of CDI is a buyout with an insurance company, under which the responsibility for paying members’ benefits passes to the insurer. As insurance companies adopt a CDI approach for their investments, it’s no surprise that buy-in pricing is correlated to changes in credit spreads. Pension schemes that have prepared well for buyout can be ready to capture attractive pricing when the next market shock comes along.

In our experience, trustees and sponsors can find it helpful to engage with insurers before formally approaching the market. Within the L&G Group, we work closely with our colleagues in the pension risk transfer team to provide our clients with an insurer’s perspective on what they may wish to consider before approaching the market.

Pensioner buy-ins have been priced more cheaply than gilts over the last three years, with pricing being particularly attractive when credit spreads spiked during Q2 2020



Source: Legal & General Retirement, as at 31 March, 2021. Illustrative pricing for a pensioner buy-in with a scheme duration of 12 years, individual pricing will vary based on scheme specific parameters. The value of an investment and any income taken from it is not guaranteed and can go down as well as up, you may not get back the amount you originally invested.

A scheme’s resilience will come from careful preparation and a focus on its target endgame. We believe CDI can be a useful and straightforward way to address this in anticipation of further challenges.



Mathew Webb
Head of Insurance Solutions & Strategy

Responsible investing:
The growing climate threat to companies

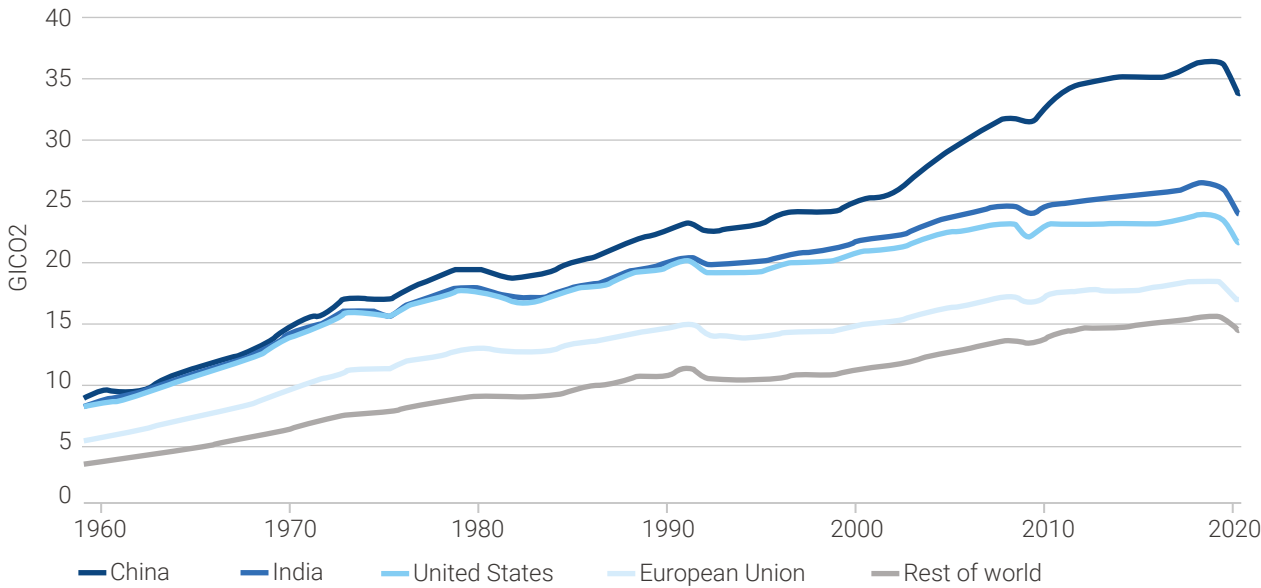
Expect businesses heading in an environmentally and socially unacceptable direction of travel to find it harder and harder to access capital.



Of the more than 3,000 companies we track worldwide, only a small fraction appear to be decarbonising at a sufficiently brisk rate to be aligned to a rise in global temperatures of no higher than 1.5 degrees – an outcome necessary if we are to avoid a climate catastrophe.

As a result, the climate-related threats faced by these companies are mounting as policymakers take increasingly dramatic steps to avert this danger, such as net zero targets backed up by aggressive regulation. To what extent are these risks currently being priced in by markets?

Carbon emissions from fossil fuels slipped during the pandemic



Annual CO2 emissions from fossil fuels and industry by major country and rest of world from 1959-2020, in billions of tonnes of CO2 per year (GtCO2). Note that 2020 numbers are preliminary estimates. Source: Global Carbon Project, Highcharts, [Carbon Brief](#) as at December 2020.

According to our Destination@Risk model – which enables us to assess physical and transitional risks within portfolios, across a variety of climate scenarios – markets are not factoring in anything close to all the risks involved. This is particularly evident from our bottom-up analysis. For example, one aluminium company with a coal-fired electricity generation base and another that uses hydro power may exhibit some difference in valuation, but nowhere near the extent that would be implied if investors were discounting an outcome aligned to the Paris climate accord.

This should not come as a huge surprise, given that the world itself is not currently on track for a 1.5 degree scenario, in our view. That’s because we need to see a reduction in emissions similar to that which took place in 2020 every year for the next 10-15 years to build some confidence that we are on track for such an outcome.

But the threat to these companies is larger than just a question of fundamental risk.

Buyer strike

We are seeing ever-greater numbers of investors, who are attuned to these risks, seeking to deploy their capital within strategies that are aimed at meeting the Paris goals.

Companies, therefore, face a growing danger not just that they start to witness climate risk per se discounted into their share prices or credit spreads, in our view, but that they suffer a progressively disadvantaged cost of capital; that those heading in an environmentally and socially unacceptable direction of travel find it harder and harder to access capital.

We expect such companies to incur higher costs as they become less favoured, with fewer buyers for their shares and bonds, leading to a gradual but probably inexorable difference in valuations and performance with those that are aligned to the Paris goals.

Given the nature of their businesses, the scale of this effect might turn out to be just as big – or even bigger – than what would happen to these companies if the market were really to price in a 1.5 degree-type climate outcome.



Nick Stansbury
Head of Climate Solutions



Real estate:

The future of the office: a view from the UK

While the spread of returns across the sector is likely to widen, we believe reports of the ‘death of the office’ have been greatly exaggerated.

There has never been so much scrutiny of offices. Workers have been working remotely for over 12 months in a ‘great experiment’ that, in the short term, has succeeded in maintaining operations. The longer-term implications for productivity are being hotly debated.

This has led to profound questions about offices. For investors, this means pressure to predict returns and reconsider portfolios. This debate is being played out globally, to various extents, informed by evidence from market activity and surveys. In the UK, the volume of occupier-released space has been exacerbated by subdued leasing. We expect some short-term pressure on rents overall regardless of the medium-term future.

Employee surveys were broadly consistent for 12 months, suggesting the majority would prefer to work from home two-to-three days a week. Employer surveys corresponded: most planned to reduce floorspace. Recently we have seen this soften – fewer companies appear to be intending to cut space,¹ while more employees are expressing a desire to return to the office.² But it is too early to declare a switch.

The impacts will not be binary; taking a starting point of two-to-three days a week and translating it into a 40-60% drop in space requirement is too simplistic. For one reason, to achieve commensurate releases of space, occupiers would need to force their workforce to spread their office time through the week. This is a requirement for those motivated to cut space, but less desirable for those prioritising collaboration.

1. Major employers scrap plans to cut back on offices – KPMG, Reuters, <https://www.reuters.com/article/uk-economy-ceos-idUSKBN2BF00B>
2. Workers eyeing return to the office after lockdown, The Times, <https://www.thetimes.co.uk/article/workers-eyeing-return-to-the-office-after-lockdown-kz2g08z0j>

Winning cities

We expect utilisation – employees in on a given day – to settle 10-20% lower than the pre-pandemic average of about 60%. This should be substantially offset by medium-term jobs growth and changes to office configuration – more space per head and more collaboration space. Equally, we expect the flow of new supply to be held back by less construction activity and conversion into other uses.

The spread of returns across the office sector is likely to widen. We expect much more pressure on weaker quality space in fringe locations and more resilient performance for well-specified assets that create vibrant and healthy workspaces.

Specifically, we expect occupiers and employees to focus much more closely on indoor environmental quality and wider ESG credentials, such as energy performance. We expect winning cities to continue to capture demand and do not expect ‘hub-and-spoke’, or a plethora of suburban coworking, to be a significant long-term factor displacing central locations.

The great experiment of the last 12 months will be overshadowed by the hybrid working experiment of the next 12. This time next year, we will be better placed to judge the implications for the UK office sector. There is no doubt that its role will continue to evolve but, in our view, reports of the ‘death of the office’ have been greatly exaggerated.

We expect **utilisation** (employees in on a given day) to settle

10-20%

lower than the **pre-pandemic average** of about **60%**



Bill Page
Head of Real Estate Markets Research



Credit:

US largesse and Biden’s battle over words

The new president might need to redefine ‘infrastructure’ and ‘bipartisan’ to push through fresh fiscal stimulus, which could have far-reaching implications for investors.

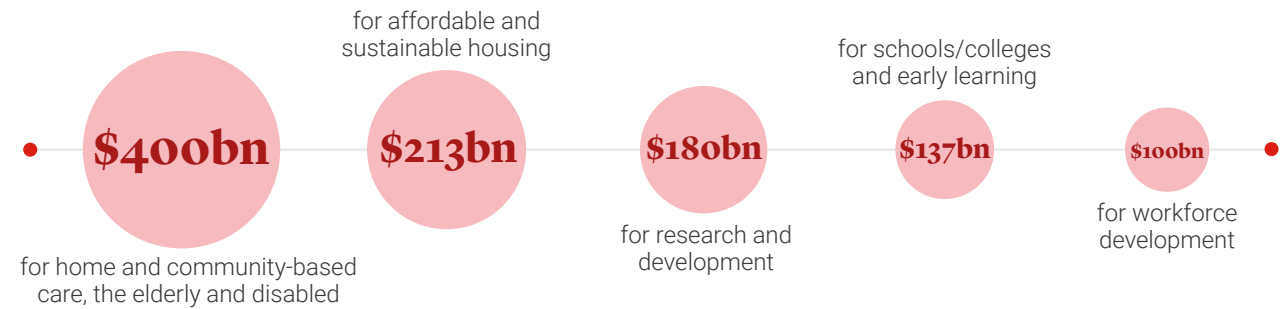
Hopes that Joe Biden would usher in a more bipartisan spirit of cooperation have so far yet to materialise, after the \$1.9 trillion American Rescue Plan passed Congress via the budget reconciliation process without any Republican support.

But the prospect of a sizable infrastructure deal should – in theory – provide more opportunity to find common ground, as it tends to be popular among Republicans and Democrats (and everyone can point to a pothole or freeway that needs fixing). And yet, negotiations already look to be faltering.

For a start, what constitutes ‘infrastructure’ investment is the subject of serious debate, as the Biden administration argues that human capital should be included alongside hard infrastructure. Hence, the US president’s team has proposed both The American Jobs Plan and The American Family Plan.

The former, which comes with a \$2.2 trillion price tag over the next 10 years, is what would more traditionally be considered infrastructure. But even here, a nonpartisan might argue that nearly 50% of the plan is not infrastructure (see infographic).

'It's good, but is it infrastructure?'



Source: Washington Post, White House as at 31 March, 2021.

Predictably, Congressional Republicans have coalesced around the idea that any infrastructure plan should contain only brick-and-mortar projects, adding up to less than \$1 trillion. This counteroffer has been roundly rejected by Democrats, which does not bode well.

Finally, the Biden administration might simply seek to redefine the word ‘bipartisan’ along with infrastructure. In recent press conferences, it has claimed that bipartisanship can be achieved if some Republican voters are supportive of the legislation, even if Republican lawmakers are not.

Sector implications

If infrastructure spending cannot be agreed in a bipartisan way, expect to see it funded through a budget-neutral reconciliation process, under which any expenditure plans will need to be paired with ‘payfors’ – revenue-raising measures. These would likely have the most impact on risk markets, such as credit and equities.

The largest proposed payfor are (1) raising the corporate tax rate from 21% to 28%; and (2) tightening global tax rules around intangible income (GILTI).

As it stands, moderate Democrats in the Senate appear to be opposed to raising the corporate tax rate to 28% but might compromise at 25%. If that were to be the case, the Biden tax hikes on corporations would only end up being a partial reversal of the Trump tax cuts. Still, it’s worth noting that the latter allowed for many companies with predominantly domestic revenues to increase their cash flow.

For the telecom sector, and AT&T* and Verizon* in particular, the improved cash flow helped to deleverage balance sheets in 2018-2019. As such, the tax hikes will likely have a negative, albeit limited, impact on such businesses. Meanwhile, the focus on GILTI is new and likely to be more important for technology and pharmaceutical companies.

From a more macro perspective, much of the debate about infrastructure centres around the appropriateness of even more fiscal stimulus when the US economy is showing signs of rapid recovery. Even major proponents of infrastructure investments, such as Larry Summers, wonder aloud about whether the US has run out of fiscal space.

As many of the projects contemplated in the 10-year infrastructure plan are not immediately shovel-ready, it would probably not add to near-term growth. However, in 2022 and beyond, the Biden infrastructure plan could easily increase US GDP by about 1% per year, a nontrivial uplift.

While that sounds all well and good, as Tim notes, macro investors remain concerned that infrastructure spending may prove excessive and lead to a positive output gap, inflation and ultimately hasten the Fed’s hiking cycle.



Jason Shoup
Head of Global Credit Strategy,
LGIMA

*For illustrative purposes only. Reference to a particular security is on a historical basis and does not mean that the security is currently held or will be held within an LGIM portfolio. The above information does not constitute a recommendation to buy or sell any security.

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