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Capital at risk.**

CIO 2024 outlook:

Skirting risks, harvesting yields

Foreword

What next?

As inflation and growth dynamics vie with political risk for investor attention next year, we anticipate fresh volatility – and opportunity – in this higher-rate environment.

Political risk will also need to be priced, and re-priced, as about half of humanity goes to the polls.

This has been yet another extraordinary year for investors – from the concentration of gains in a handful of stocks, to the rapid and synchronous rate hikes in developed economies, to the whiplash in bond markets. To assess the outlook for 2024, we clearly need to consider a large range of scenarios.

And yet we believe that almost regardless of how growth and inflation dynamics play out, investors should expect fresh volatility. As throughout 2023, outsized moves are likely, as market participants continue to recalibrate their expectations of monetary policy in light of new economic data.

Political risk will also need to be priced, and re-priced, with more than two fifths of humanity going to the polls. The US, EU and India are scheduled to hold elections; the UK may well follow suit. Taiwan's presidential election – in which the country's relationship with China will likely feature prominently – is set to take place in January.

In this outlook, teams from across LGIM assess the investment implications of this backdrop, while ever mindful of the need to be humble in their conclusions.

Key takeaways include:

- Our base-case economics view suggests the US Federal Reserve (Fed) may cut rates more aggressively than the market expects
- We favour duration and take a selective approach to corporate debt, in light of tail risks and after the current bout of investor optimism
- Yield levels, technical factors and economic resilience may support emerging market debt
- 2024 could be the year of a multi-asset revival
- Higher rates may buttress private credit returns, but debt servicing could become an issue

We also outline why we believe credit can play an important role as defined benefit pension schemes focus on their endgame, whether their target is buyout, low-risk self-sufficiency or surplus generation through run-off. And we examine how geopolitics informs our thinking about long-term themes, such as cyber security, clean water and 'friend-shoring'.

December 2023 | CIO 2024 outlook

Ongoing conflicts

Geopolitics is indeed very much top of mind. The invasion by Russia of Ukraine last year highlighted how the decades-old, US-led world order is fragmenting. The new, tragic conflict between Israel and Hamas further highlights the perilous nature of an increasingly multipolar world.

Investors also need to consider US-China tensions and rising political populism. We are all also still living in the shadow of COVID-19, which wrought so much pain alongside so much change.

It is safe to say that these themes will feature prominently in the elections next year. But it's also clear that this geopolitical turbulence means the world will struggle to rise to some of the challenges it faces, not least climate change.

Our outlook has been published during the COP28 climate summit, which presents another chance to tackle this generation-defining problem.

We fear that without global collaboration on a scale we have never seen before, this and future such opportunities will be missed. World leaders need look beyond short-term interests and focus on the long-term action urgently needed. The same is true of companies critical to the energy transition.

At LGIM, we are clear on our role: to create a better future through responsible investing. This involves recognising both the risks and opportunities posed by this fast-changing investment landscape, understanding their structural drivers, and seeking to address them on behalf of our clients.

Sonja Laud
Chief Investment Officer

Economics

Pain delayed, not averted

Unsustainable US fiscal support and a favourable reversal of supply shocks have led to increased investor optimism around a soft landing.

Over the past year the euro area and the UK have stagnated, while Chinese growth has disappointed. Yet the US economy has been remarkably resilient to the sharp rise in interest rates. Can the positive news from the world's largest economy continue?

Four surprises have led to stronger-than-expected US growth:

1. Fiscal policy has been far more supportive than anticipated. The underlying budget deficit has blown out by almost four percentage points over the past year, and while the multiplier on some of this is extremely low, it can still account for a significant share of recent growth.

2. The Fed's new emergency lending facility averted a potential regional banking crisis in the spring.

3. Excess savings accumulated during the pandemic were revised significantly higher, which helps explain continued consumer momentum.

4. Manufacturing construction has boomed as semiconductor production in particular has been re-shored.

These supports have masked the impact of the huge rise in bond yields, which has led to tighter lending standards and a sharp slowing in overall credit growth. It is also possible the lags on monetary policy are longer this cycle, because households and businesses locked in low rates during the pandemic, while interest receipts on elevated cash assets increased more immediately.

Headwinds are building

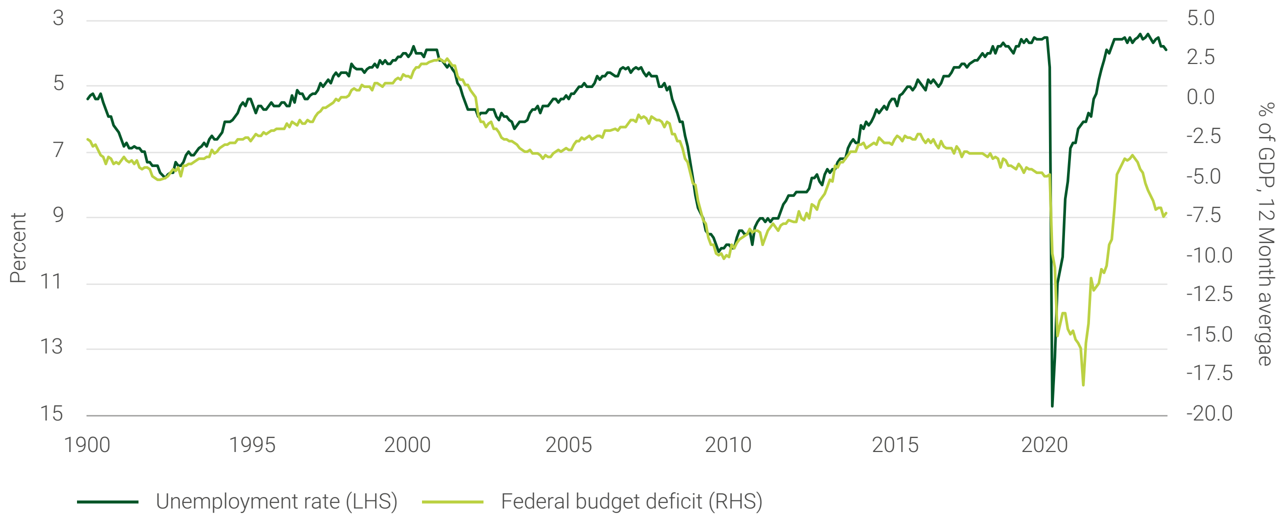
Fiscal policy is set to turn more restrictive. Democrats will be keen to continue spending in an election year, but House Republicans are proposing cuts. The compromise is likely to be a near freeze in the level of spending. State and local governments will have to curb spending after their recent splurge, as revenue disappointment has begun to place a strain on their finances.

The consumer environment is deteriorating because of reduced transfer payments, rising student loan repayments, slower job and wage growth, restricted credit availability, rising delinquencies, and pressure to raise the extremely low saving rate.

This seems to be reflected in weak consumer confidence, even if actual spending has only slowed gradually so far.

A slowing US, alongside tight credit conditions, could tip Europe over the edge

US federal budget deficit (adj for student loans)



Source: Macrobond, as at 21 November.

Inflation should ease further

The reversal of supply shocks has driven a significant reduction in goods-price inflation, but for the next few months services inflation is likely to remain sticky and prevent inflation from returning to target.

However, if the recession we expect to begin in the first half of 2024 materialises, this should increase unemployment and squeeze out the wage and services inflation pressure. Ultimately, this should allow the Fed to cut rates more aggressively than the markets expect.

The alternative scenario is a benign labour market rebalancing so inflation returns to target and yields fall, which avoids tipping the economy into recession. We see this as more likely than the economy failing to land at all in 2024. For the latter to occur we'd look for signs of an aggressive take-up of the open-ended tax credits in the Inflation Reduction Act.

When the US sneezes, the rest of the world catches a cold

Europe is already on the verge of recession. A slowing US, alongside tight credit conditions, could tip the region over the edge. Fiscal policy is constrained, and with core inflation still well above target consistent levels, scope for monetary support is limited. The prospect for rate cuts will increase if the recession intensifies next year.

China is also struggling from structural problems in housing, a reluctance to ease monetary policy given potential pressure on the exchange rate, and a loss of confidence amid a more hostile international environment, leading to pronounced weakness in foreign direct investment.

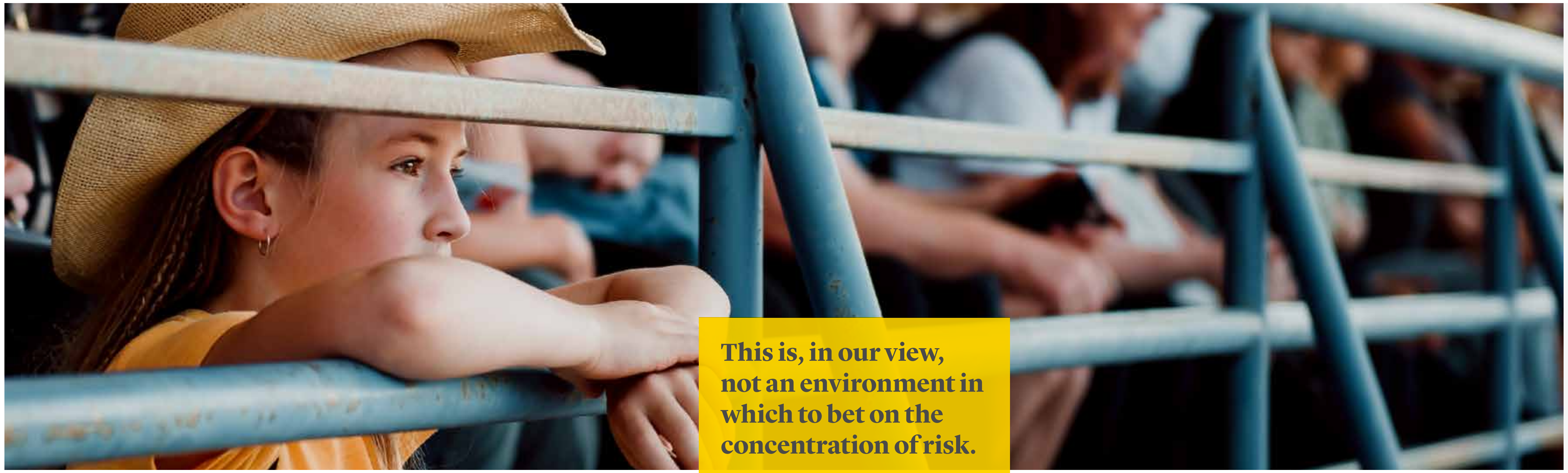
The engines of global growth in 2024 among the larger economies appear limited to only India and Japan (for more on the former, read Uday and Raza's piece).

Tim Drayson
Head of Economics

Asset Allocation

The comeback kid

It has been a tough couple of years for diversified portfolios. But we think 2024 could be the year of a multi-asset revival.



This is, in our view, not an environment in which to bet on the concentration of risk.

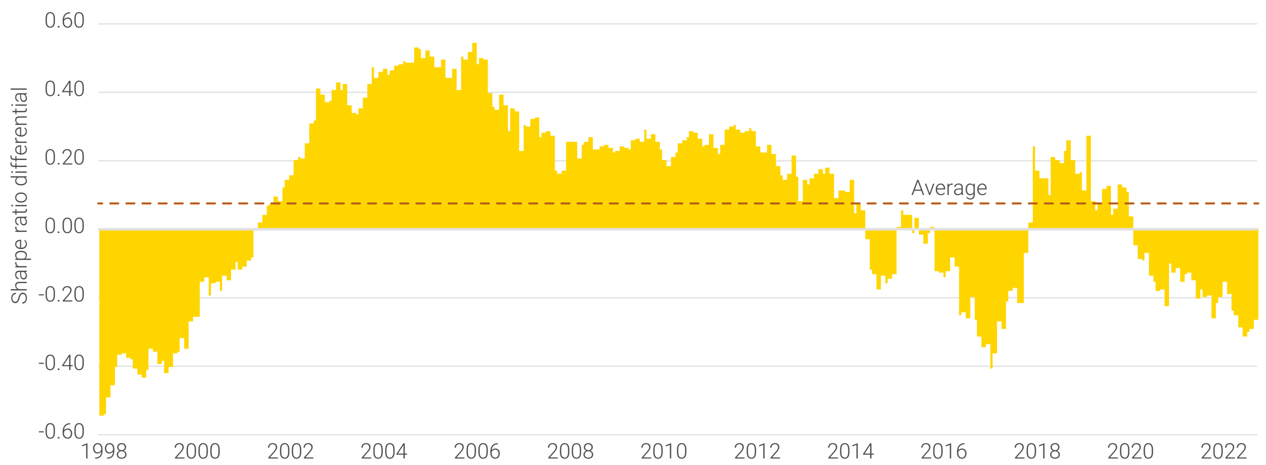
History is littered with stories of individuals who were written off as finished before rising to previously unimagined levels of greatness, from Eleanor of Aquitaine to Winston Churchill. In recent years, markets have been so challenging for multi-asset strategies that some investors are tempted to judge the entire approach to be similarly finished.

The chart below shows the Sharpe ratio (five-year excess returns divided by risk) of a diversified portfolio minus that of a global equity portfolio. The difference between the two has been negative since 2020, right after the COVID-19 crisis – meaning equities, concentrated in the US, did better than a well-diversified, multi-asset portfolio.

Why have concentrated equity portfolios outperformed more diversified multi-asset portfolios recently? There are two main reasons:*

- Big stocks have been very beautiful: Lots of the performance of equities has been in the mega cap stocks in the US. Diversification in the asset class has not paid off.
- The cycle keeps going: Equities did very well as society left lockdowns behind. Meanwhile, bonds and other 'defensive' assets did not. Though this isn't abnormal late in the cycle, the extent of the performance differential is. The exceptionalism lies in bond returns as yields rose massively from very low levels, and the usual late-cycle risks did not materialise (we will never quite know how close we came with the US regional banks crisis).

Difference in risk-adjusted returns of diversified strategy vs equities



Source: LGIM calculations as at 30 September 2023.

*** It should be noted that diversification is no guarantee against a loss in a declining market.**

Will this outperformance of equities over diversified strategies continue in 2024? We don't think so.

First, as Tim highlights in his economic outlook, cyclical pains are being delayed, not postponed indefinitely. On the contrary, we believe a recession in 2024 is likely. Secondly, real yields are now back above zero, providing a valuation anchor on how far nominal yields can rise, especially when central banks are mostly done raising rates and inflation is on a downward trajectory.

We expect lower yields in 2024, so look for bonds to outperform cash. But even if we see a sideways move, healthy bonds yields should provide a positive return.

There is an alternative

The yields available on other asset classes have started to become interesting as well. We think the absolute yields on credit – including alternative credit – are becoming appealing from a starting yield perspective as they provide a nice cushion against further yield increases or spread widening.

As Sonja notes, we live in a challenging, multipolar world that is characterised by the rising risk of conflict. Tensions between China and the West continue to intensify, and the polarisation of politics continues, with the possible return of an 'America first' Trump presidency.

This is, in our view, not an environment in which to bet on the concentration of risk. One might be lucky and avoid a crisis but if not, performance could be terrible. Instead, we believe it's a matter of spreading risk over multiple regions and multiple return drivers. Over a longer horizon, we believe diversification should outperform more concentrated portfolios on a risk-adjusted basis. The historical average of the difference in Sharpe ratios is in favour of diversification, according to our calculations.

If we are right on the recession call, that adjustment of returns might be abrupt and quite meaningful, providing a remarkable return to the spotlight for diversified strategies.

Emiel van den Heiligenberg
Head of Asset Allocation

Active Strategies

Santa Claus is comin' to town – for now

Goldilocks, it seems, is alive and well

Despite economic resilience in 2023, our watchwords are 'caution' and 'selectivity' in 2024.

Consensus views aren't always all they are cracked up to be.

As fixed income investors know only too well, 2023 was meant to be the year of the bond. The logic went something like this: tighter monetary conditions in 2022 would induce a recession, leading to a subsequent taming in inflation and a fall in interest rates.

Furthermore, after a 30-year period of palpably low fixed-income yields, starting yields for the beginning of 2023 were looking perkier, making entry points relatively more attractive for bond holders, with the promise – finally – of some income without having to take excessive amounts of risk.

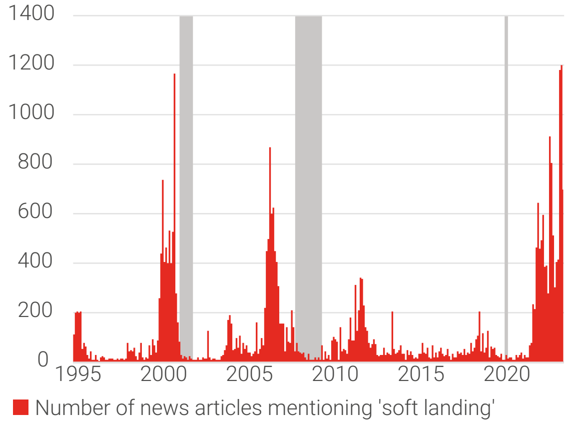
That was the theory. The reality, as we know, has been somewhat different. Inflation proved stickier than first thought, while a recession in the US, courtesy of a buoyant labour market, was impressively averted. So, as market commentators find themselves in the unenviable position of penning yet another outlook, how is the macroeconomic background shaping up as we enter 2024?

Some short-term comfort…

At the time of writing, the combination of technical and fundamental factors has served to fuel a rally in both bonds and equities. Positive flow dynamics are expected to continue into the quieter holiday period, making us reluctant to be on the wrong side of the rally.

Fuelling that rally is the belief (once again) that we have reached 'peak interest rates' and that inflation will soon be yesterday's problem.' Goldilocks, it seems, is alive and well. But just as the little girl had to contend with her own kind of bears, market watchers will be aware that the rosy soft-landing narrative is being baked into financial markets, leaving little room for pessimism.

Soft-landing narratives often precede recessions



Source: LGIM, Bloomberg, as at 11 October 2023.
Assumptions, opinions and estimates are provided for illustrative purposes only. There is no guarantee that any forecasts made will come to pass.

Moreover, falls in yields and tighter credit spreads on a 'peak rates' narrative are likely to be self-defeating as lower yields and looser credit conditions make central bank hawkishness more likely. If we've learnt anything in in 2023, it's surely to beware the 'consensus' narrative.

… but little long-term joy

Positioning ourselves against the consensus, just for the sake of it, isn't a clever thing to do. But when all minds think alike, it's important to hold fast to the things that may break the consensus. For example:

- We believe the inflation problem has not been solved and has plenty of potential to re-introduce volatility into markets. Core inflation rates have stalled over the last few months. We don't think we're many data points away from widespread concern that inflation is stuck at levels that are too high to be compatible with stable inflation expectations.
- As we head into 2024, we expect fundamental corporate strength to be increasingly challenged by weaker earnings growth and we've already seen this starting to come through in Europe and in the US. Additionally, we find current analyst expectations of robust earnings growth difficult to square with (consensus) declining nominal GDP growth.

2024: the year of the election

An important feature of 2024 will be the fact that in the next 12 to 18 months, two fifths of the world's population – and roughly the same proportion of the world's GDP – will go to the polls.[1] That's not traditionally the time for politicians to turn Scrooge-like. So, in terms of macroeconomic framework, a combination of fiscal policy to fuel growth, coupled with monetary policy to act as a brake, seems a distinct possibility.

In the long run, however, this fiscal largesse means that economies will struggle to cope with real interest rates that are in excess of real growth. Of course, in the short run, interest rates that stay high because growth is higher than expected (and as long as they're just staying high and not jumping higher), might not seem too bad. That said, the period leading up to any election, US or otherwise, typically produces higher volatility as investors cope with uncertainty.

The last word

So, how does all the above shape our thinking? We believe there are grounds for short-term optimism. Real wage growth and cooling, not frozen, labour markets make the slowdown in developed market growth more palatable.

Over the longer term, though, we cannot help but adopt a more cautious stance. Elections, heightened geopolitical tensions and deteriorating corporate fundamentals make us wary. Our watchwords for 2024 should be 'caution' and 'selectivity'. In this regard, we have increased exposure via non-cyclical, higher-rated credits and senior bank exposure.

Colin Reedie
Head of Active Strategies

1. According to Bloomberg economics, voters in countries representing 41% of the world's population and 42% of its gross domestic product have a chance to elect new leaders next year.

ETFs

The geopolitical ripple effect

We examine how geopolitics informs our thinking about long-term themes, focusing on cyber security, clean water and friend-shoring.

Geopolitics has always shaped the course of human history. As Sonja explains, today's geopolitical landscape looks increasingly fractured, with ideological rifts giving rise to a multipolar world.

As investors concerned with themes that have the potential to change the world in previously unimaginable ways, we are cognisant of the impact of geopolitics on the three broad areas we see driving transformative change: technology, demographics, and energy and resources.

An example we've covered previously on these pages is the increased focus on cybersecurity in the wake of Russia's invasion of Ukraine. As well as the looming threat of full-blown cyberwar, state-sponsored cyberattacks may increase the danger posed by non-state actors by creating an environment in which identifying cyber-attackers is harder than ever.

Just as energy security became a priority for Europe as Russian gas lines were shut down last year, water security is rising up the agenda

The river in the desert

Elsewhere, geopolitics is lending fresh urgency to challenges that have been created by long-term changes in the climate and demographics.

Although water covers approximately 70% of planet Earth, only around 3% of that is fresh water that can be processed into potable water.[2] Climate change is exacerbating water scarcity by causing droughts in some areas and floods in others.[3] Global population growth is further stretching supplies, with the UN forecasting a rise from 7.9 billion people today to 9.7 billion by 2050.[4]

This challenge is particularly pronounced in dry countries that have experienced rapid population growth, such as Sudan and Egypt, both of which rely heavily on the Nile River for irrigation and drinking water.

2. Source: https://education.nationalgeographic.org/resource/resource-library-hydrosphere
3. Source: https://www.worldwildlife.org/threats/water-scarcity
4. Source: UN, 2019

The strategic importance of the Nile means geopolitics further complicates the situation. In 2011, Ethiopia began construction of the Grand Ethiopian Renaissance Dam (GERD), which when completed will have a capacity of around 5,000 megawatts, more than doubling the country's total capacity.[5] In a country where half of the population is currently without access to mains power,[6] the dam has transformative economic potential – but its development has stoked tensions with downstream countries.

Just as energy security became a priority for Europe as Russian gas lines were shut down last year, water security is rising up the agenda. Egypt, for instance, has an US$8 billion long-term plan to reverse its annual water deficit of about seven billion cubic meters.[7]

Across the Middle East, Africa and parts of Asia, desalination holds the promise to address water scarcity, with the market forecast to see compound annual growth of 8.8% between 2011 and 2027.[8]

The chart shows how the cost of desalination has fallen over the long term. This has been driven by technological advances, larger plants translating into greater economies of scale, and project development choices such as colocation of desalination plants with power plants.[9]

Opportunities closer to home

Another way in which geopolitics is leaving its mark in financial markets is via the phenomenon of 'friend-shoring', as mentioned by Tim, meaning the re-allocation of trade towards countries that are perceived to be friendly to the US.

The friend-shoring effect is already somewhat evident in global goods trade, and to a greater extent in flows of foreign direct investment (FDI) between countries, according to research from LGIM's economics team. They note an [IMF study] found the top 20% of geopolitically aligned countries accounted for 37% of global FDI flows in 2010 – but more than 50% in 2021.

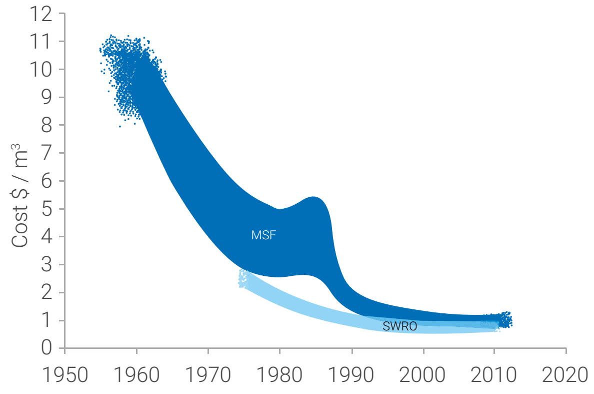
In the US, the Inflation Reduction Act and the CHIPS and Science Act have potential to galvanise investment in strategically important industries. In Europe, the Net Zero Industry Act aims to achieve the same thing.

The impact of policy support is already evident in FDI into the semiconductor sector, where FDI flows towards the US and Europe doubled between 2020 and 2022.[10]

Our approach

The linkages between geopolitics and technology, demographics, and energy and resources are dynamic and idiosyncratic. In the context of a multipolar world, we will continue to focus on potentially overlooked areas of risk, as well as those areas where geopolitical pressures reinforce existing long-term structural shifts.

The falling cost of desalination



MSF = multistage flash distillation SWRO = saltwater reverse osmosis.
Source: World Bank whitepaper The Role of Desalination in an Increasingly Water-Scarce World, 2019, p10

Aanand Venkatramanan
Head of ETFs, EMEA

5. Source: https://www.africanews.com/2022/08/11/ethiopia-starts-power-generation-from-second-turbine-at-mega-dam/
6. Source: https://iea.blob.core.windows.net/assets/220b2862-33a6-47bd-81e9-00e586f4d384/AfricaEnergyOutlook2022.pdf
7. Source: https://smartwatermagazine.com/news/smart-water-magazine/egypt-plans-build-21-desalination-plants-worth-3-billion-boost-water
8. Source: https://www.globenewswire.com/en/news-release/2022/05/10/2439389/28124/en/Global-Desalination-Market-2022-to-2027-Industry-Trends Growth-Insight-Impact-of-COVID-19-and-Opportunity-Company-Analysis.html
9. Source: https://documents1.worldbank.org/curated/en/476041552622967264/pdf/135312-WP-PUBLIC-14-3-2019-12-3-35-W.pdf
10. Source: https://www.imf.org/en/Publications/WEO/Issues/2023/04/11/world-economic-outlook-april-2023 (see page 95, figure 4.4)

Emerging Market Debt

Time to shine?

Given a resilient macroeconomic picture and supportive technicals, we believe the outlook for emerging market debt (EMD) is positive.

It has been a challenging two years in emerging market (EM) credit, during which sharp increases in developed market yields have led to outflows from EM bond funds – and nearly three years of negative or low returns.

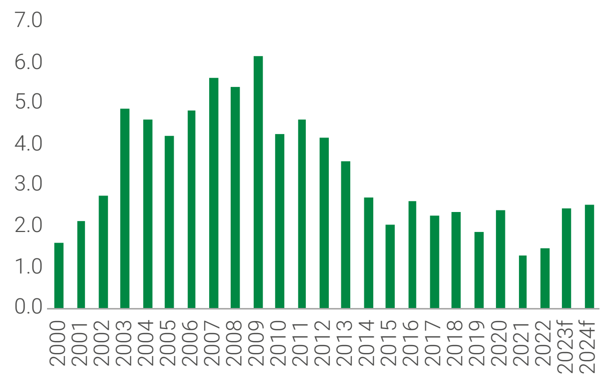
Falling bond prices, though, have meant the higher EM yields on offer have found few precedents in recent history. The hard-currency, sovereign benchmark index[11] yields 8.5%, implying 70 basis points (bps) of monthly carry, while outflows have also meant investor positioning is cleaner.

Higher borrowing costs have resulted in many emerging markets shifting their focus to multilateral agencies, meaning new issuance from sovereigns over 2021, 2022 and 2023 year-to-date has remained lower – even compared to 2020 levels. Looking ahead, 2024 cashflows returned to investors, in the form of amortisation and coupon payments, are forecast to see a 30% plus increase.[12]

Support from yields, technicals and macro

According to the International Monetary Fund (IMF), and despite sharp monetary tightening over the last two years, headline EM real GDP growth is forecast to come in at 4% this year and expected to stay at this level for 2024. This implies that growth differentials, relative to their developed market peers, will rise to 2.5% – increasing for the third consecutive year to the highest level since 2016.

EM-DM growth differentials (%)



Source: IMF, World Economic Outlook, October 2023; LGIM
Assumptions, opinions and estimates are provided for illustrative purposes only. There is no guarantee that any forecasts made will come to pass.

Meanwhile, government debt in EM is forecast rise to 69% of GDP – about 2% higher than last year – but significantly lower than the 113% of GDP pencilled in for advanced economies.[13] This increase is, in fact, driven by just a few large economies, making the country-by-country picture considerably better than suggested by headline data.

The strength of emerging markets is also apparent in external sector dynamics. Trade surpluses are running at about $550 billion, some $100 billion lower than the peak, but still close to their highest levels. This, coupled with the rebound in tourism, implies that EM current account surpluses will persist this year and next at about 0.5% of GDP, according to the IMF. That's better than pre-COVID levels, which typically saw modest deficits.

In addition, emerging markets have enjoyed strong support from multilateral institutions, such as the IMF and the World Bank. This not only provides cheap financing, making up for closed capital markets, but also acts as an anchor for policy reforms.

11. Source: JP Morgan EMBI GD Index, October 2023.
12. Source: JP Morgan, October 2023.
13. Source: IMF, World Economic Outlook databases, October 2023

Support from multilateral institutions not only provides cheap financing, but also acts as an anchor for policy reforms

Importantly, these dynamics have also meant that EM FX reserves remain healthy at $10.3 trillion, almost $500 billion higher than pre Covid (end 2019) levels, and equal to nearly 3x the level of external debt amortization due in 2024.[14]

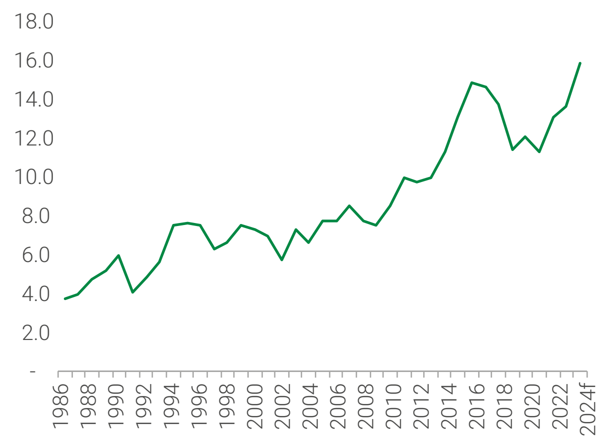
India – a key driver of emerging market growth

A key driver of the growth resilience in emerging markets has been India, where real GDP has expanded in recent years at the fastest pace among large economies. These growth dynamics are underpinned by a vibrant economy, driven by a resilient private sector and a government focused on reforms and addressing the infrastructure deficit.

India heads to elections next year, where the incumbent Bharatiya Janata Party is likely to secure another term. The question is the extent of the majority the party will likely win in parliament – as that will determine the pace and scale of reforms.

The government's track record on the latter has not only aided growth but has also led to India's forthcoming inclusion in the JPM GBI-EM Global Diversified Index, and potentially other indices. When this happens, we expect capital inflows to rise, helping to lower domestic borrowing costs for the government and private sector, further boosting growth dynamics.

India's contribution to global growth (%)



Note: Chart shows the three-year moving average.
Source: Macrobond, based on IMF data; LGIM as at November 2023.
Assumptions, opinions and estimates are provided for illustrative purposes only. There is no guarantee that any forecasts made will come to pass.


Uday Patnaik
Head of Emerging Market Debt


Raza Agha
Head of Emerging Market Credit Strategy

14. Source: Bloomberg, as at 13 November, 2023

Real Assets

Brave new world

Higher rates may be supportive of debt returns, but debt servicing could become an issue.

Our central case remains a recession for the US, Europe and UK in the first half of 2024, as Tim Drayson outlines. What does this mean for real assets?

Weaker GDP growth is likely to lead to lower demand for cyclical businesses and the more economically sensitive areas of real estate and infrastructure, such as offices and transportation, in our view. Conversely, residential property, utilities and social infrastructure are relatively uncorrelated to the economic cycle.

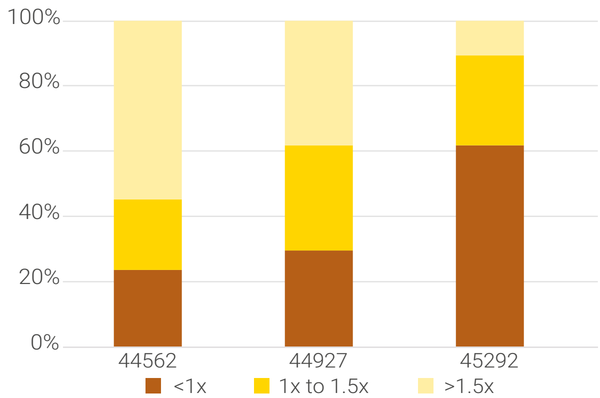
The flipside of higher rates is attractive debt returns. With interest rates at their highest levels for more than a decade, public credit yields are currently trading around the 80-90th percentile versus their 20-year histories; we can see a similar pattern in private credit. In real estate and infrastructure, debt yields are higher than valuation-based asset yields in several markets.

We think the lower-rated segment of the private credit market (B rated or below) will come under increasing debt servicing pressure. Recent research by Moody's showed that, assuming a federal funds rate of 5.25%-5.50%, the proportion of North American B3-rated issuers where EBITDA no longer covers interest cost would jump from 29% at the end of 2022 to 62% at the end of 2023.[15]

A further year of weak earnings growth and continued high funding costs is likely to push coverage ratios down further; pressure on credit metrics is likely to ripple up the sub-investment grade end of the rating scale.

As such, we expect rising defaults, restructurings and writedowns (although not a GFC-style crisis). From a debt investor's perspective, we continue to believe that the tactical opportunity lies in the investment grade and resilient BB space, where returns are driven by interest rates more than as compensation for credit risk.

B3 rated issuers interest coverage breakdown



Source: Moody's as at July 2023. January 2024 is based on Moody's projection. **Assumptions, opinions and estimates are provided for illustrative purposes only. There is no guarantee that any forecasts made will come to pass.**

15. Source: Moody's, July 2023

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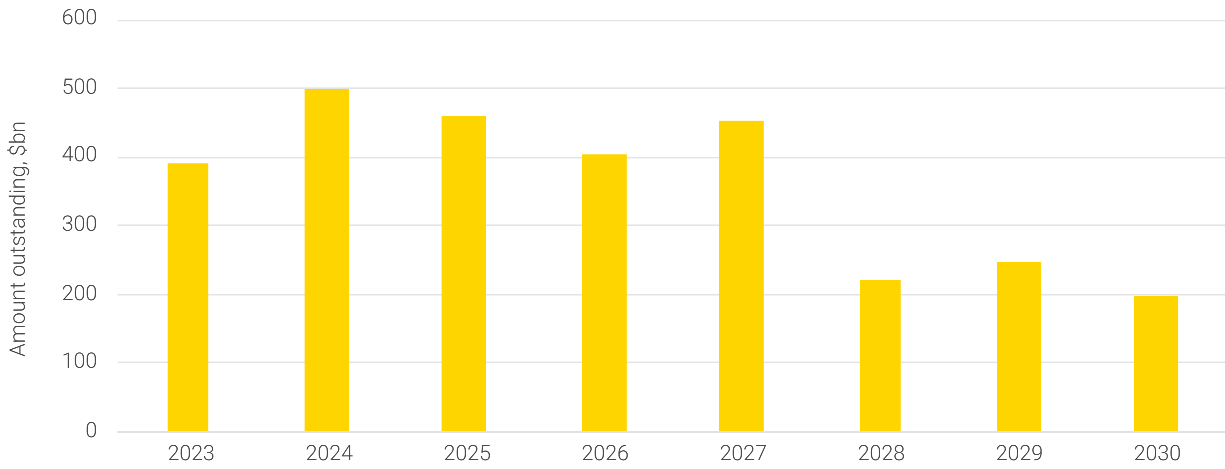
US CRE debt maturing between 2023 and 2030



Source: MSCI as at October 2023

Capital structures created in a very different interest rate environment could be challenged by refinancing schedules. This is particularly the case in commercial real estate, where lending is typically shorter-term than most corporate or infrastructure lending.

There is an estimated $1.4 trillion of commercial mortgages maturing in the US during 2024-26.[16] Even for assets where cashflows have remained stable or grown, the material increase in rates since many of these loans were originated means that many loans cannot be refinanced on terms acceptable to lenders without injections of fresh equity. We believe this is likely to drive asset disposals from borrowers without access to equity, as well as demand for preferred equity to bridge. Either avenue could open opportunities for long-term investors with flexible capital.

These opportunities will need to be assessed with a robust approach to underwriting long-term free cash flows. A number of areas of real estate, with offices the most prominent example, are experiencing both changing occupier requirements and high future capital expenditure liabilities, including those associated with energy efficiency.

Conversely, residential and industrial assets are seeing more consistent demand with less risk on future capital liabilities. Those investing fresh equity, or originating new loans, need asset profiles and business plans that support long-term investment performance.

Rob Martin
Global Head of Investment Strategy & Research, LGIM Real Assets

16. Source: MSCI as at 27 October 2023

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Solutions:

DB schemes: Is credit the answer?

Whether the target is buyout, low-risk self-sufficiency or surplus generation through run-off, we believe credit has an important role to play as schemes focus on their endgame.

In an audience poll at LGIM's client conference in October, 22% of defined benefit (DB) clients said they had a well-funded buyout surplus, with a further 45% saying they had reached full funding or soon would.[17] Given the significantly improved funding levels, we've observed schemes changing their investment strategy and we expect this focus on their endgame to persist in 2024.

DB scheme action points:

- **Capture interest rate market opportunities**
- **Consider appropriate credit exposure**
- **Prepare portfolios for endgame**, whether run-off strategy or buyout

Case study March 2023: British Steel Pension Scheme, working in partnership with LGIM, achieved a £7.5 billion full scheme in the UK to have fully insured all its members benefits.[18]

Peak rates?

In our 2023 CIO outlook, Sonja noted the lack of clarity around peak inflation and peak rates. A year on, yields were back above the peak we saw in the September 2022 gilt market dislocation. We believe the peak of interest rates and the end of the rate-hiking cycle could now be here, as potentially evidenced by the November reversal in rates, with yields falling around 40 basis points in the run-up to the Autumn Statement.[19]

Perhaps unsurprisingly, we have seen hedge ratios of mandates managed by LGIM rise throughout 2023 as schemes take advantage of the higher level of interest rates and opt to 'lock in' their funding level gains. This trend has accelerated recently, with schemes wanting to avoid missing this potentially attractive opportunity, and we believe this may continue in early 2024.

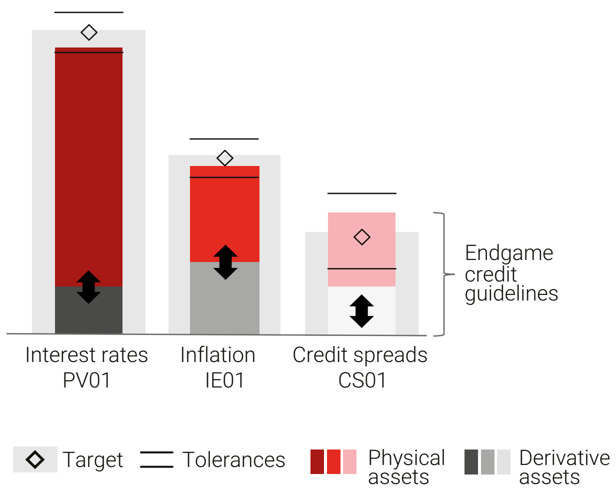
Government bond yields

Source: Bloomberg as at 23 November, 2023

A new metric: the credit spread hedge ratio

The industry has historically considered investing in credit as appropriate for self-sufficiency-focused schemes. Additionally, well-funded schemes usually have a high hedge ratio when focusing on buyout-liability basis, but often lack credit exposure compared to an insurer's cashflow-matched strategy. The Purple Book shows that the average corporate bond allocation for pension schemes was 22% as of 31 March 2022, which is much lower than the expected insurer allocation of around 50% of total interest rate exposure, depending on scheme duration and changing market conditions.

Integrating credit into holistic portfolio management



Source: LGIM

Consequently, many schemes have been increasing their credit exposure to focus on their endgame and this may well develop further through 2024. In doing so they may monitor and even add mandate objectives to target an additional 'de-risking metric' – their credit spread hedge ratio – by investing in physical credit and/or utilising leveraged credit e.g. index credit derivative swaps transacted quickly with typically low transaction costs.

Preparing portfolios for run-off or buyout

Given LGIM's long history managing self-sufficient insurance mandates, it's no surprise we're now also managing pension scheme mandates with specific run-off targets; e.g. returns of liabilities plus a spread using traditional credit, alongside private credit, emerging market debt and high yield.

Similarly, as schemes approach buyout, we've been using our experience managing and transitioning assets to insurance companies to help identify which assets can be transferred in-specie and what restructuring opportunities exist on a scheme's balance sheet to seek to improve the buyout price. Examples range from simple changes such as maturity of instruments within LDI mandates and Solvency II Matching Adjustment eligibility criteria for credit mandates, to innovative solutions to manage illiquid holdings.

As such, over 2024 we expect more schemes to prepare their portfolios for their bespoke endgame.


Will Riley
Head of Solutions


Anne-Marie Morris
Head of DB Solutions Strategy

17. Also illustrated by Pension Protection Fund data and the Pensions Regulator's latest Annual Funding Statement
18. Case study shown for illustrative purposes only. The above information does not constitute a recommendation to buy or sell any security.
19. 30 year nominal yield fall between 31 October 2023 and 22 November 2023

Contact us

For further information about LGIM, please visit lgim.com or contact your usual LGIM representative

Key risks

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.

Assumptions, opinions and estimates are provided for illustrative purposes only. There is no guarantee that any forecasts made will come to pass. It should be noted that diversification is no guarantee against a loss in a declining market.

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