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Q2 outlook: Tackling inflation and recession risk

We're still bullish on equities on a medium-term view, but have removed some risk in portfolios. As the cyclical risk will likely increase in the coming 12 months, with our recession indicators flashing more warning signals, we now favour selling into strength.

Emiel van den Heiligenberg
Head of Asset Allocation

As we enter the second quarter, investors face dangers to the global economy and markets stemming from two related issues: rising inflation and the war in Ukraine. The attendant challenges require a thoughtful and determined approach by asset allocators.

Over the coming pages, we examine this investment environment in depth, with a focus on inflation, and outline the steps we are taking to meet our clients' objectives over the long term.

Unintended consequences

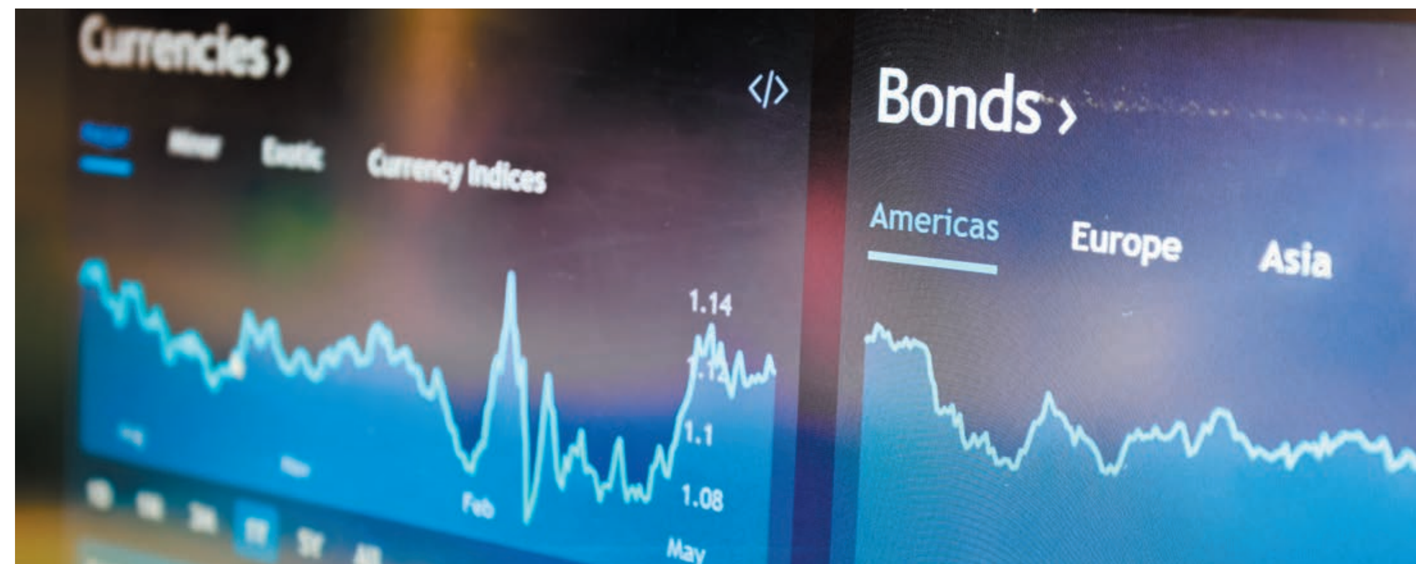
Russia's invasion of Ukraine and the massive rally in energy prices raise the risk of recession, which looks more likely in the euro area and UK than the US. (For more on the situation in Europe, see Hetal's section below.)

A possible escalation of hostilities, together with further sanctions on energy products, would heighten the risk of a recession, on which we believe the market narrative will increasingly focus.

While Russia's share of global GDP is negligible, its importance to global commodity markets is anything but – both in terms of flows and trade finance links – meaning the potential impact of the conflict on global markets remains significant. What's more, the spike in volatility and position squeezes could have a number of unintended consequences, such as margin calls triggering the default of a commodity trader or even a bank.

We have downgraded our view on the global economy, as our economists are starting to warn of the increasing probability of a recession occurring in the coming 12 to 18 months. But we have increased our score for market valuations, to reflect the relative improvement of equities over bond valuations. And our measure of systemic risk has also improved, somewhat counterintuitively, given that it appears to be properly priced into indicators such as European equities and the VIX index.

LGIM



Bond market signals

Fixed income assets have also seen their share of drama of late, raising a number of questions for investors. During March, US Treasury yields pushed higher in reflection of inflation pressures, the tight labour market and recognition that the Federal Reserve's reaction function is more hawkish than previously anticipated.

At the same time, the US bond market also seems to be signalling economic weakness on the horizon, with the yield curve flirting with inversion – a leading indicator of recessions. And yet stock markets appear relatively insensitive to this phenomenon.

Our analysis suggests that while the curve inverting is a warning flag for equities, it is not a sell signal. Equities have on average continued rising for another 11 months after such a moment. This could also be a particularly painful period to miss: the last year of cycles has tended to deliver returns of around 15%, LGIM analysis indicates.

With regard to bonds themselves, the sections below by Chris Jeffery and Chris Teschmacher sketch out how we're tackling the themes shaping fixed income markets.

A long-term view

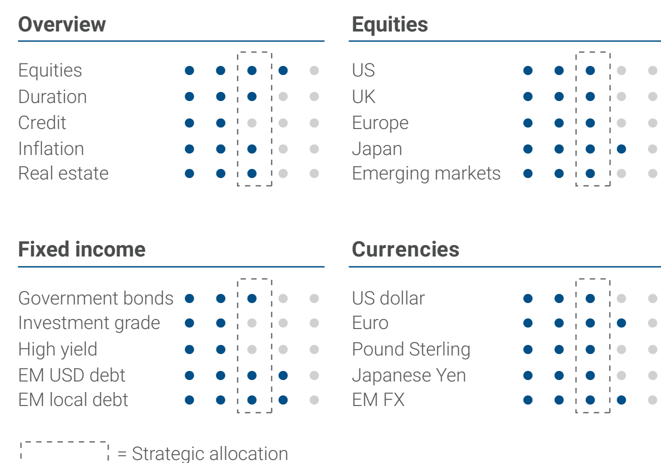
Drawing all of this together, we are still bullish on equities on a medium-term view, but have removed some risk in portfolios. As the cyclical risk will likely increase in the coming 12 months, with our recession indicators flashing more warning signals, we now plan to focus on selling rallies instead of buying dips.

The Asset Allocation team also remains focused on managing risk for our clients over multiple time horizons – not least the near term, given the fast-moving developments in Ukraine and their outsized impact on global markets.

But we are also weighing the possible longer-term consequences of this terrible conflict, which has caused a vast humanitarian crisis. These range from the fragmentation of commodity markets, to a greater focus on ESG risk for governments and the erosion of the US dollar's status as the dominant reserve currency.

Our key asset class views

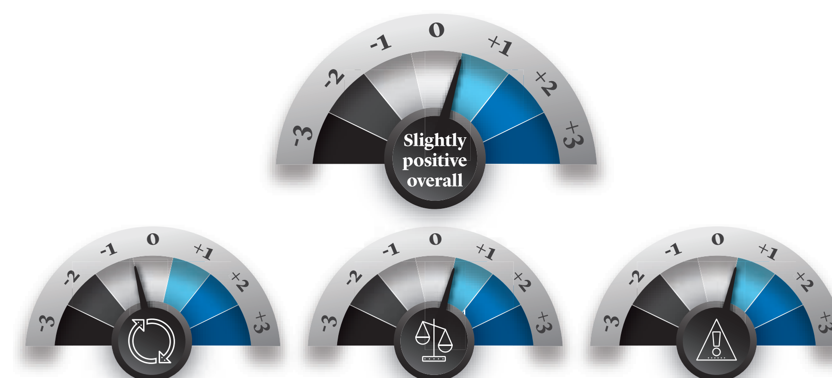
We prefer to take risks in equities over credit.



= Strategic allocation

This schematic summarises the combined medium-term and tactical views of LGIM's Asset Allocation team as of 31 March 2022. Asset allocation is subject to change. 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. **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.**

Summary of LGIM's asset allocation core view



Economic cycle

Risk of recession has increased with the energy crisis, particularly in Europe

Valuations

Relative valuations attractive and absolute valuations fair

Systemic risk

A significant amount of negative news has now been priced into markets

Source: LGIM. Views current as at 31 March 2022. **Forward-looking statements are, by their nature, subject to significant risks and uncertainties and are based on internal forecasts and assumptions and should not be relied upon.**

Economic cycle

- Economy was already into late cycle before Ukraine conflict
- Monetary policy is tightening but nowhere near restrictive
- Energy price spike raises the risk of recession, especially in Europe

Valuations

- Relative valuations remain a positive factor
- Absolute valuations of equities moved to fair from expensive
- Credit spreads have moved towards non-recessionary wides

Systemic risk

- High uncertainty on the path forward in Ukraine
- Common goal of western nations tightens resolve and eases prior tensions
- Significant negative news priced in, offering a potential risk premium

Chris Teschmacher
Fund Manager

Scenario planning and embracing uncertainty

Inflation is a major concern for asset allocators. Lacking the proverbial crystal ball, we must embrace uncertainty and make pragmatic decisions to deal with all scenarios.

It's easy to get stuck in a narrative that we are in a period of high and prolonged inflation – particularly since Russia's invasion of Ukraine, which has lifted commodity prices at the same time as lowering economic growth. But predicting inflation is notoriously difficult. When it comes to portfolio construction, we see a risk in fixating on questions of how high it will go, how long it will last and how broad it will be.

While it is, of course, our role to make forecasts about the future path of inflation, we prefer to think in terms of scenarios and likelihoods, each with different outcomes that our clients' portfolios might encounter. We must, therefore, prepare for different possible outcomes, not predict which ones we will follow.

We believe investors should not lose sight of their overall return objectives and investment horizon, while taking a balanced approach by keeping an eye on other risks. We should analyse inflation, not obsess over it.

Real diversification

As a result, our approach is more structural in nature and focused on creating and managing truly diversified portfolios, which take inflation risks into account and can perform in today's high-inflation scenario – but also in other scenarios that could unfold. In doing so, we are guided by the following four considerations.

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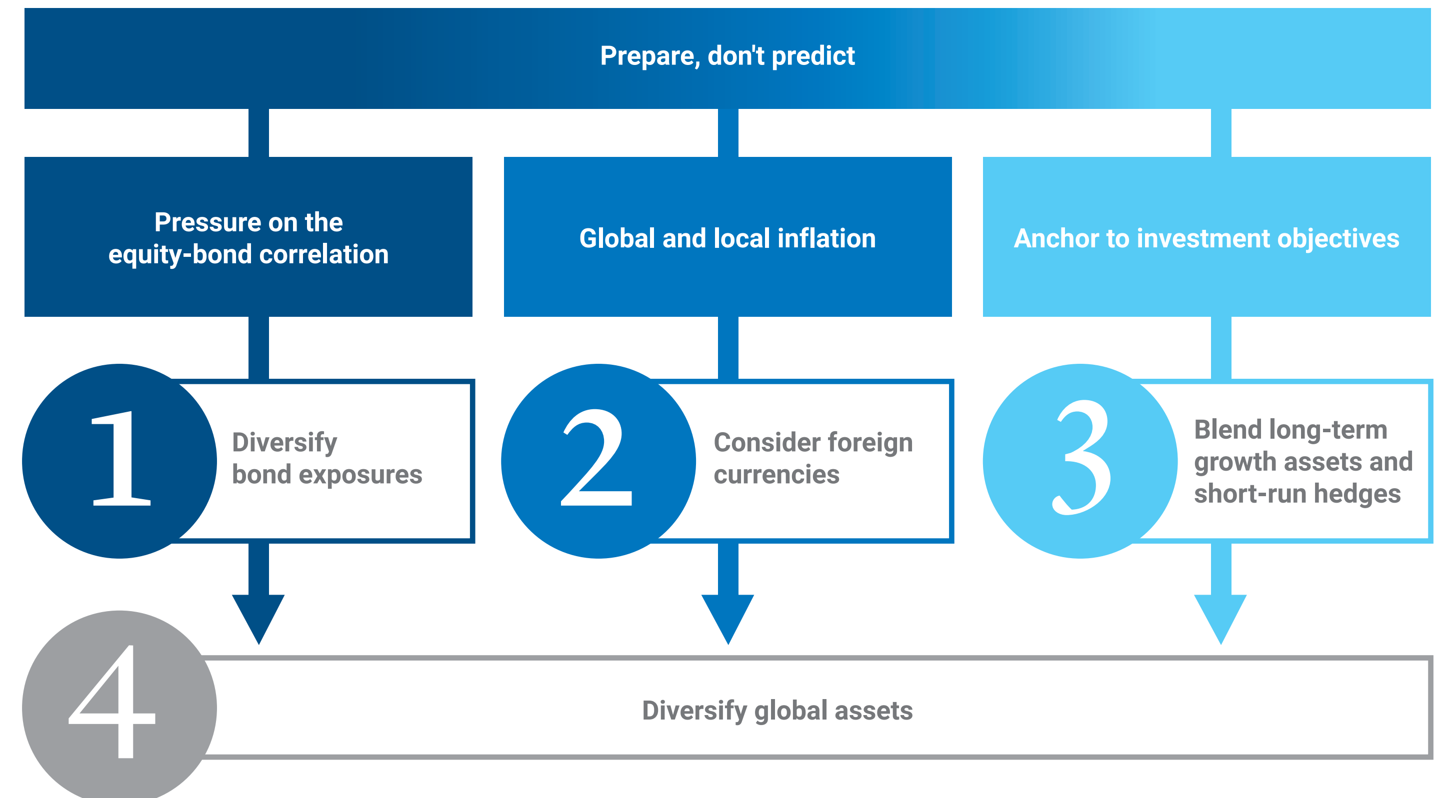
First, central banks believe they can control inflation by tightening policy. In turn, this puts pressure on normal equity-bond correlations, reducing portfolio diversification benefits. Combined with the prospect of rising rates, this challenges the role of sovereign bonds in our portfolios. But we prefer to diversify rather than remove bond holdings, as Chris Jeffery explains below.

Second, the global inflation picture is at risk of becoming more fragmented, given the disproportionate impact of the energy crisis on Europe, and the varying responses of central banks in the past 6-12 months. So we believe strategic, diversified foreign currency holdings make sense. This is particularly the case for sterling-based investors, given the UK's long history of high inflation – and the burden that places on the currency.

Third, it's of critical importance to keep investment horizons in mind. Commodities and inflation-linked bonds may be most sensitive to short-term inflation spikes, but they offer a poor store of value in the long run, in our view. We believe equities and listed alternatives, such as infrastructure, are more likely to enjoy positive real returns in the long term.

Taken together, these points generate a fourth and final consideration: the ability of global diversification, across a range of asset classes, to expose investors to different inflation dynamics around the world and thus help dampen overall volatility.

Four steps we've taken to navigate inflation



Source: LGIM, as at 9 March 2022. **It should be noted that diversification is no guarantee against a loss in a declining market.**

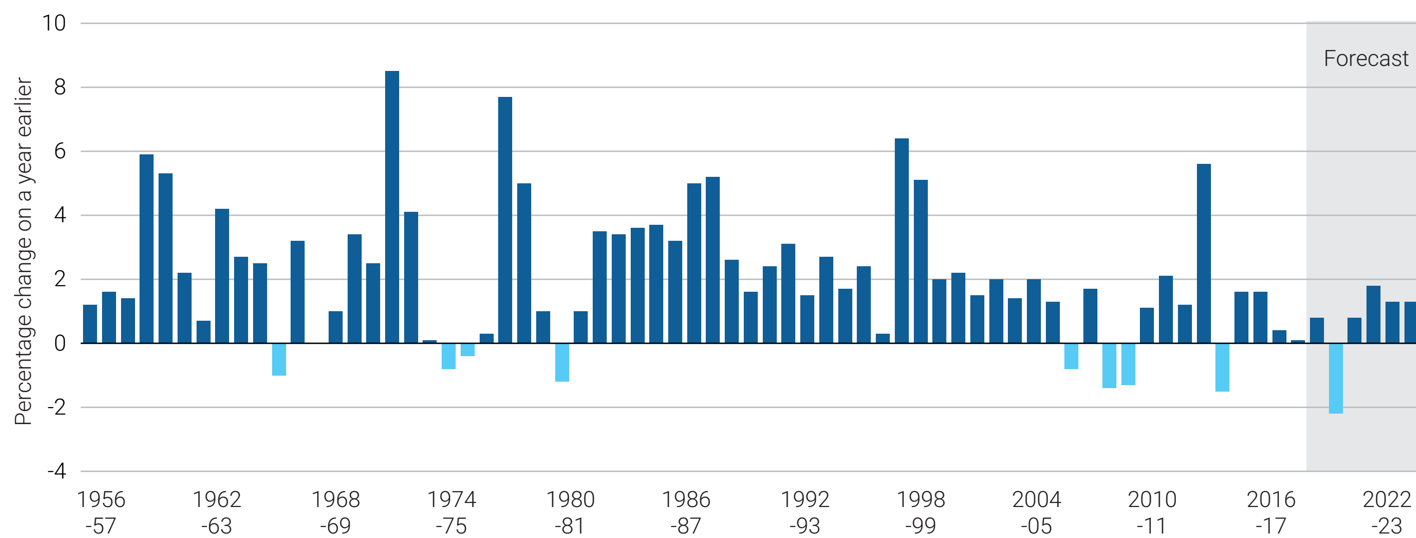
Hetal Mehta
Senior European Economist

Europe's fiscal response to inflation

Europe is today facing the biggest cost-of-living squeeze in at least a generation. The rapid rise in inflation began as a supply-chain hangover from the pandemic; Russia's invasion of Ukraine put further pressure on energy prices that were already rising fast.

In the UK, many remember the 1970s as a time when inflation stopped being a number on an economist's notebook and became a defining feature of everyday life. Yet the UK's Office for Budgetary Responsibility estimates real incomes will fall by over 2% in 2022/23 – a bigger decline than anything seen in the 1970s.

UK real disposable incomes face dramatic decline



Source: ONS, OBR. **Forward-looking statements are, by their nature, subject to significant risks and uncertainties and are based on internal forecasts and assumptions and should not be relied upon.**

In response, governments across Europe are scrambling to alleviate the pain. But having recently redefined the word 'largesse' as a result of the pandemic, how much more will they be willing to spend? And might today's inflationary environment lead to longer-term reforms?

Opening the medicine cabinet

Across the region, individual countries are taking steps to soften the blow of higher prices. In the UK, the total support amounts to 0.8% of GDP so far, although other fiscal changes mean the net support to the economy is smaller.

With inflation not expected to peak until the autumn, however, we believe more support is likely. This could include highly visible measures such as a reduction in fuel duty, or a lower VAT rate. Cash handouts of the type seen in the US during the pandemic are another possibility, as are government loans. Germany, meanwhile, has taken the step of increasing defence spending, reversing a long-term underspend.

Compared with the exceptional measures introduced in response the pandemic, the total value of these measures is tiny. This is perhaps not surprising, as many governments will be concerned about their higher debt levels as a result of COVID-19 spending. With the European Central Bank seemingly on course to raise rates later this year, servicing these debts will become more onerous.

Given this dilemma, a joint EU fund could help take the pressure off individual countries, especially if it helped to reduce funding costs in the same way that the NextGenerationEU recovery package did.

Inflation: a chronic condition

History suggests times of crisis can accelerate reform in Europe. However, large-scale EU support packages take a long time to agree, given the varying stances and objectives of the countries within the region.

Government measures can limit the pain caused by higher prices. But, as we are seeing in the UK, there is a limit to what they can do – ultimately these measures won't be able to fully insulate consumers.

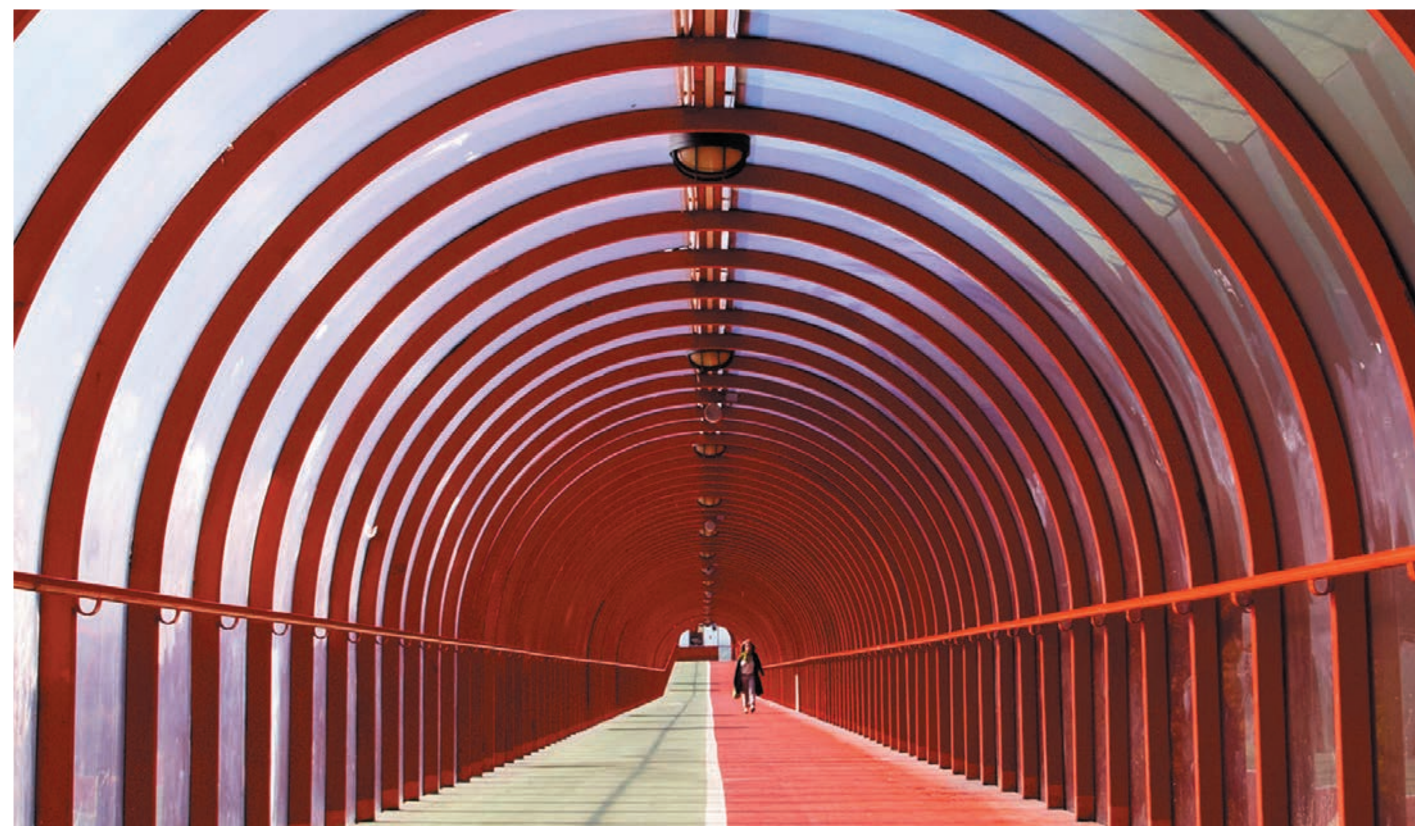
Christopher Jeffery
Head of Rates & Inflation Strategy

Five thoughts on bonds and central bankers in a supply shock

Central banks are grappling with whether to raise interest rates in response to a commodity supply shock – and are often reaching different conclusions. And just as we haven't seen a 'one size fits all' policy response, we shouldn't expect a uniform reaction from the bond market.

What does this mean for fixed income investors? We see five important conclusions:

(1) Global diversification of nominal assets is likely to be appropriate. The performance differential between the US Treasury market and the Chinese government bond market since the start of last year makes this case well. The former has seen yields rise around 120bps as US inflation spiralled to 8%; the latter has seen rates fall steadily as Chinese inflation has dropped below 1%.[1]



1. Source: Bloomberg as at 24 March.

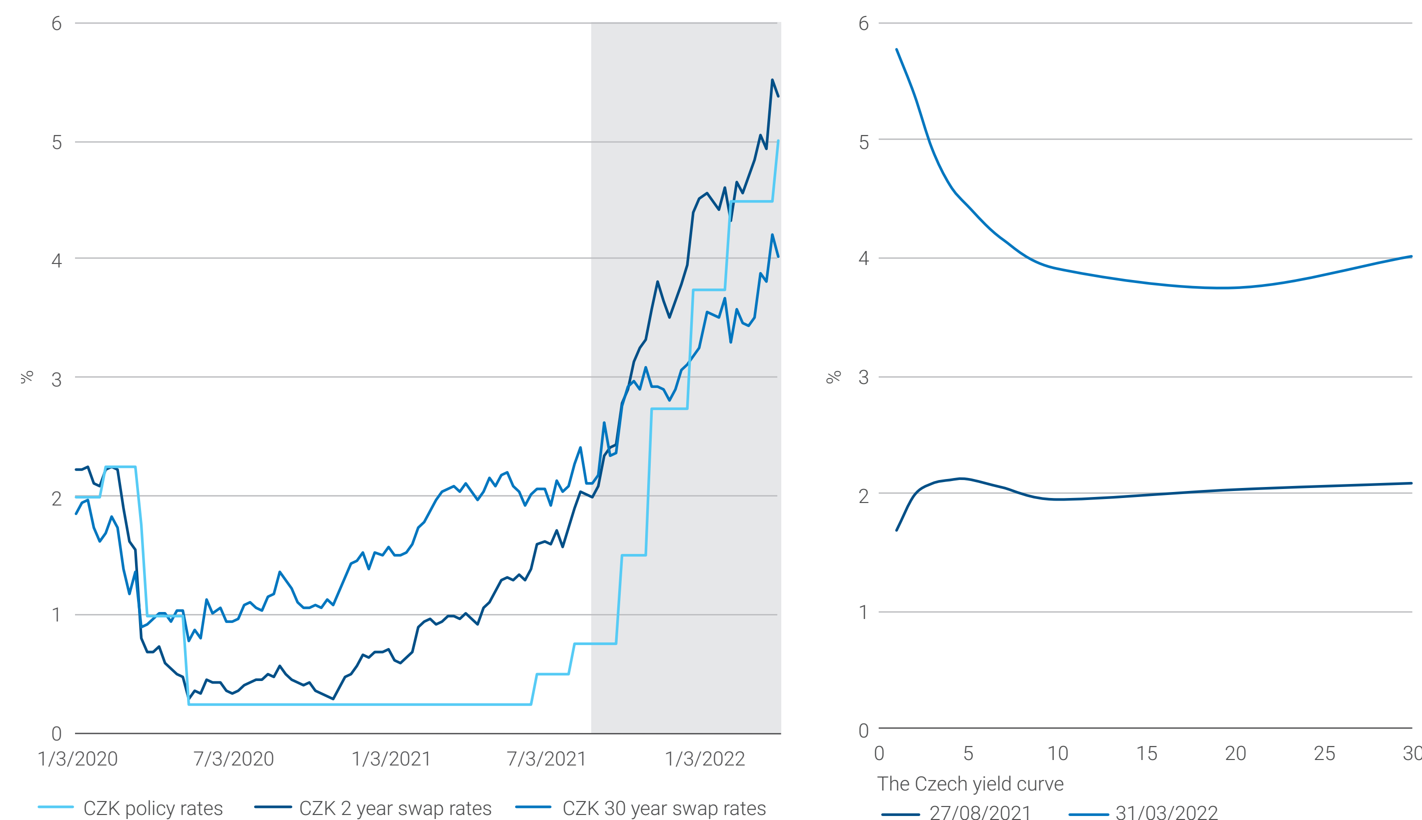
(2) We believe investing in bond markets (and currencies) with high inflation-adjusted yields to start with is likely to be rewarded over time. In this cycle, emerging market economies have largely got ahead of the problem and started adjusting interest rates early in 2021. Excluding Russia – a big caveat, we recognise – local currency-denominated emerging market debt has delivered positive returns for sterling investors this year, despite an aggressive sell-off in developed-market fixed income assets.

(3) Central banks that are aggressive in response to supply shocks are likely to see their yield curves flatten and, eventually, invert. That doesn't mean long-dated yields won't rise. It just means that our playbook should be for the long end to rise less than the front end. The response of the Czech bond market to aggressive monetary tightening in the past 12 months is the poster child here. The US and UK markets are just following that well-trodden path.

(4) Bond investors need to get accustomed to higher volatility when the market is repricing the inflation outlook. When the consensus is positioned one way (in this case, for higher yields) you tend to get large price swings when investors all lurch to one side of the market boat. High inflation doesn't mean that bonds offer 'return-free risk', but it does mean that volatility will be higher than it would be otherwise.

(5) And finally, we don't believe in throwing out the bond baby with the inflation bathwater. Treasury yields have fallen during 17 out of the last 18 US recessions.[2] Recession-inducing shocks are invariably negative for risk assets. Assets that typically do well in the face of a sudden downturn in growth are hard to find, and we shouldn't lose sight of this important role played by the bond market.

Czech rates signal a path for other curves



Source:Bloomberg, as at 25 March, 2022. **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.**

2. Source: Bloomberg as at 24 March.

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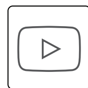

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