Press Release

Thursday, 11 June 2020

LGIM: Investors should look beyond the pandemic for signs of economic recovery

Legal and General Investment Management (LGIM) has today published a Summer 2020 CIO Outlook, in which Sonja Laud, together with investment and economic specialists from across the business, provide their look ahead at the economic recovery roadmap. This includes the impact on asset allocation decisions, the fate of credit, equities, real estate and what the unprecedented circumstances mean for client solutions. This Outlook addresses some of the biggest questions for investors raised by COVID-19, including:

- What shape will the economic recovery take?
- Which asset classes are likely to benefit?
- Is the bull market in bonds finally over and will defaults wipe out returns for credit investors?
- Which equity factors held up during the market turmoil?

Given the huge uncertainty over the path of COVID-19, we think about the economic outlook in terms of probabilities around scenarios. The scenario we attach the highest probability involves a lacklustre rebound for the global economy, with some ‘scarring’, meaning business failures and high unemployment, alongside lower investment and productivity. The second most likely and more optimistic scenario is where we see the global economy make a strong but partial recovery, with a return to ‘normal’ by the end of 2021.

Many economies are clearly heading for record-breaking, double-digit drops in GDP in the second quarter, but we also know that lockdowns helped bring the infection under control, so some are now gradually reopening. This means growth will probably be strong in the third quarter as we venture out of our homes; it will look like a ‘V’ at first in most scenarios. But the level of activity is likely to be far from normal, probably recapturing only about 50% of the drop.

As most governments will be relatively cautious, we believe we should end up somewhere between Scenarios 1 and 2 by year end. With a vaccine, there is a path to return to ‘normal’ by the end of 2021 but unemployment is likely to remain elevated and will only begin to approach full employment in 2022. Without a vaccine, we are stuck with social distancing, which will exacerbate the scarring in our most likely scenario. The socioeconomic consequences of long-term unemployment, and the skill degradation this causes, are a concern for us all.

Sonja Laud, Chief Investment Officer (CIO), at LGIM commented:
“Considering asset allocation, a balance-sheet recession would typically be associated with a trend towards less corporate leverage and lower pay-outs. Longer-term solvency issues for companies have not been solved. Put simply: not all business models will be viable in the future. This should be positive for credit, assuming the wave of defaults and downgrades is fairly priced.”

Equities

In equities, we consider that we are entering an environment in which technology will be seen as a strategic industry and where its growth, pricing power, cashflows, automation and limited supply-chain complexity will come at a premium. As a result, we see opportunities for investors to pick companies that are likely to emerge from the pandemic as winners, while avoiding those whose business models will turn out to be obsolete.

Credit

For credit investors it is easy to picture a bleak outlook. Volumes of ‘fallen angels’ – bonds that have lost their investment grade (IG) status – have already hit new heights in 2020 and, even in a best-case scenario of a V-shaped economic recovery, we expect this to double. With such enormous changes underway, it is natural to wonder what this will mean for default rates in IG credit. It is safe to say that they will increase substantially. Based on our default analysis, investors could afford to ignore

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conventional wisdom and use this period as an entry point to IG credit – but only if they plan to go away for quite some time. It is unlikely to be a quiet summer.

To avoid a disruptive default cycle, governments have decided to increase their debt in order to support struggling businesses and people. Such a dramatic increase in fiscal spending could push borrowing costs higher, but the bull market in bonds is not necessarily over. If interest rates were to rise, debt that still exists outside the government's balance sheet that could go bad, requiring further support. Indeed, we may have made this dependency worse as some companies, regardless of their mistakes, increasingly rely on government bail outs.

Pensions and Multi-Asset
From an investment perspective, no longer being able to count on falling interest rates and inflation through the cycle would have interesting implications. The ability to dynamically hedge such risk within pension funds becomes more interesting. And multi-asset portfolios may have to rethink their correlations and stress scenarios. In general, there could be more opportunities for actively managing rates, inflation and currency risk. The investment world could be changing significantly.

Emerging Markets
Investors could have been forgiven for presuming that emerging markets (EM) would be hit particularly hard by the sudden combination of a pandemic and a global economic shutdown, given their relatively less advanced healthcare systems and the dependence of many on exports to developed markets.

We have a higher conviction on EM credit than on currencies. Although local-currency valuations are at an all-time low according to our real effective exchange rate model, the prospect of quantitative easing in emerging markets makes the upside less certain. There is also a significantly higher yield available from hard-currency emerging-market debt at the moment, with that part of the universe paying around 6.5% compared with less than 5% for local-currency bonds.

Real Estate
Real estate has been one of the areas most visibly affected by the pandemic and measures deployed to limit its spread. As we tackle today's challenges, it is possible to identify the factors that should underpin the long-term performance of the asset class. There are some positive stories in the market and the Build to Rent residential property is demonstrating the resilient return profile expected. Although new letting enquiries have fallen and some tenants are exercising break clauses, we see this as being short term. Occupancy and rent collection remain very high; and we would expect performance relative to other sectors to be robust.

ESG
Indeed, one of the common themes is that we believe the pandemic has intensified a number of long-term trends already underway, from global digitisation to the rise of populism, many of which we have been discussing for some time will still be central. For those themes with ESG implications, we believe responsible investing can capture the opportunities, mitigate the risks and strengthen long-term returns for our clients. That's because by using our investments to help make our society and environment more resilient to future crises, we are ultimately building more resilient portfolios for our clients.

For more detail, please see LGIM's CIO Summer Outlook for 2020, **here**.

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Key Risk Warnings

One Coleman Street, London EC2R 5AA

Reference to a particular security is on a historic 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.

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.

Notes to editors

Legal & General Investment Management

Legal & General Investment Management is one of Europe's largest asset managers and a major global investor, with total assets under management of £1.2trillion (€1.4 trillion; $1.5 trillion, CHF1.5 trillion)[1]. We work with a wide range of global clients, including pension schemes, sovereign wealth funds, fund distributors and retail investors.

Throughout the past 40 years we have built our business through understanding what matters most to our clients and transforming this insight into valuable, accessible investment products and solutions. We provide investment expertise across the full spectrum of asset classes including fixed income, equities, commercial property and cash. Our capabilities range from index-tracking and active strategies to liquidity management and liability-based risk management solutions.

[1]LGIM internal data as at 31 December 2019. These figures include assets managed by LGIMA, an SEC Registered Investment Advisor. Data includes derivative positions.

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