Quarterly strategy – Increasing duration above 6 years

Executive summary

The second half of 2023 should see the onset of one of the most telegraphed recessions in history. Our central case remains that the recession will be mild as both the consumer and corporate sectors have relatively strong balance sheets. There is bifurcation between those consumers with excess savings and those struggling due to cuts in real wages. Similarly, we expect greater dispersion in the outcomes for businesses as 14 years of ultra loose monetary policy has come to an end.

It is likely that the US Federal Reserve has reached peak interest rates for this cycle, with a high hurdle for the data to beat to persuade the Fed to start hiking rates again. Given the Fed's dependence on data, investors will be watching the data releases even more closely than usual, with the potential for markets to over react to economic surprises. The market is already pricing in US rate cuts later this year, even though there are some aspects of the data, particularly core inflation and employment, where we haven't seen a significant impact from the high interest rates yet. There is now a strong central case that the European Central Bank (ECB) will raise rates by two more 25bps increments to reach a terminal rate of 3.75%; similarly to the Fed, it would take a big shift in economic data to deter it from this path.

In recent data releases, we have seen a modest deterioration in economic data, and we expect this to continue as the year progresses and we start to see more of an impact from interest rate hikes, so we have increased the duration of our strategic bond strategies. Presently we have 6.25 years exposure (US 2.25 years, UK 2 years, Europe 1.5 years and New Zealand 0.5 years) in strategic portfolios and we would look to add another 0.25 years soon if some of the flight-to-quality premium due to the US regional bank difficulties comes back out of bond prices.

Credit spreads, the additional yield above the comparative sovereign bonds, have tightened since their recent zenith in October 2022. Credit spreads, as well as the total yield available in corporate bonds, are attractive for long-term investors but we do expect market volatility to create buying opportunities later in 2023.

We currently have exposure to investment grade and high yield bonds of 50% and 20% respectively in our strategic portfolios, levels that we deem to be neutral. The aforementioned volatility, caused by the impending recession, US debt ceiling drama, or an unknown unknown, is viewed as a time when we would look to increase our aggregate credit exposure. At the individual issuer level, we have recently been participating in high quality BB-rated high yield new issues which are offering very attractive coupons i.e. yields, as we observe the 're-couponing' of the high yield market.

Macroeconomics

After a real global growth rate of 2.9% in 2022, forecasts are for a deceleration to 2.4% in 2023 (using JP Morgan economists' forecasts; the Bloomberg median is 2.5%). The fall in nominal growth rates is forecast to be more pronounced, from approximately 10.0% in 2022 to 6.0% in 2023, with the global inflation rate falling to 3.6% by the end of 2023. The geographic mix within these growth figures has significantly shifted, with developed economies seeing growth rates halve and emerging markets' economic growth accelerating – driven by China's reopening.

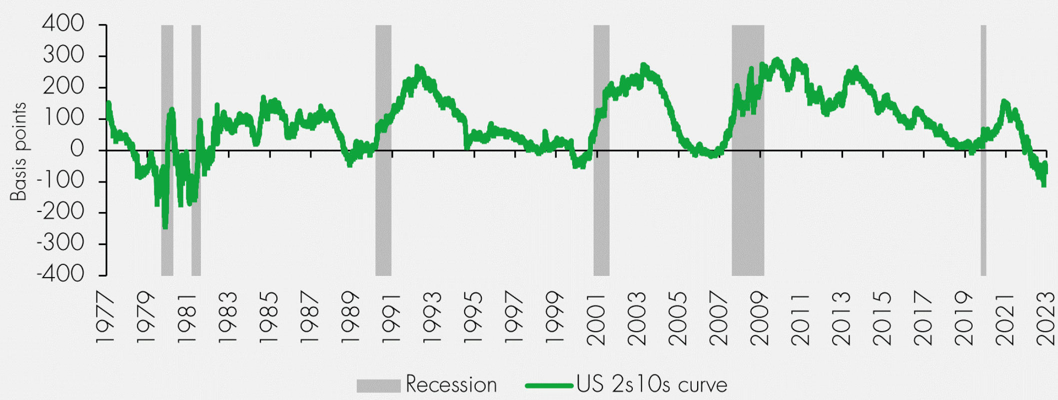
We expect China to grow over 6% this year before slipping back to nearer 5% thereafter. On a longer-term basis, China's rapidly ageing population will constrain economic capacity and its marginal impact on global growth will be less than we saw last decade. Adding about 1% to global growth in 2023 makes the Chinese economy supportive, but unfortunately not a game changer. A beneficial corollary of China's reopening has been a further easing in supply chains, which should add a disinflationary impulse to goods prices.

Europe managed to avoid a recession over the winter as warm weather and reduced usage helped to avoid the downside scenario of energy rationing. Gas storage levels are way above their usual seasonal levels, and the gas price has fallen dramatically. Although there is nothing to concern us for the next six months, much greater energy infrastructure investment is needed throughout large parts of Europe in order for capacity not to be constrained during an extremely cold winter.

In the US, risks over raising the US borrowing cap loom, with an "X date" (when the limit becomes binding) that, according to Treasury Secretary Yellen, could come as soon as 1st June. Assuming the US scrapes through to mid-June, corporate tax receipts on the 15th and more extraordinary measures that can start at the end of June mean a late July/early August X date is the most likely scenario. Given the politics involved, there is now at least a 50/50 chance that we actually hit the X date, but a miniscule probability of the US actually defaulting as debt payments can still be made (even without Biden invoking the 14th Amendment). There will be prioritisation of debt payments over other spending, but various other outlays including federal workers' wages as well as some Medicaid payments will be suspended. The backlash that this causes should be enough to bring Democrats and Republicans to the negotiating table; we think a resolution will ultimately be reached, as does the market. Our central case is that some fiscal tightening, relative to existing budgetary plans, is the price paid in order for the debt ceiling to be raised.

Yield curve inversion is a good predictor of recessions, albeit with a lag. The chart below shows the difference in yields between 2-year and 10-year US Treasuries, the shaded areas highlighting previous recessionary periods. The inversion (short-dated yields greater than longer-dated ones) that started in earnest last July is signalling that the market is currently anticipating a recession. As economic forecasts have reduced for the second half of 2023, the gap between the yield curve signal and the consensus macroeconomic outlook has diminished.

US 2s10s curves and recessions



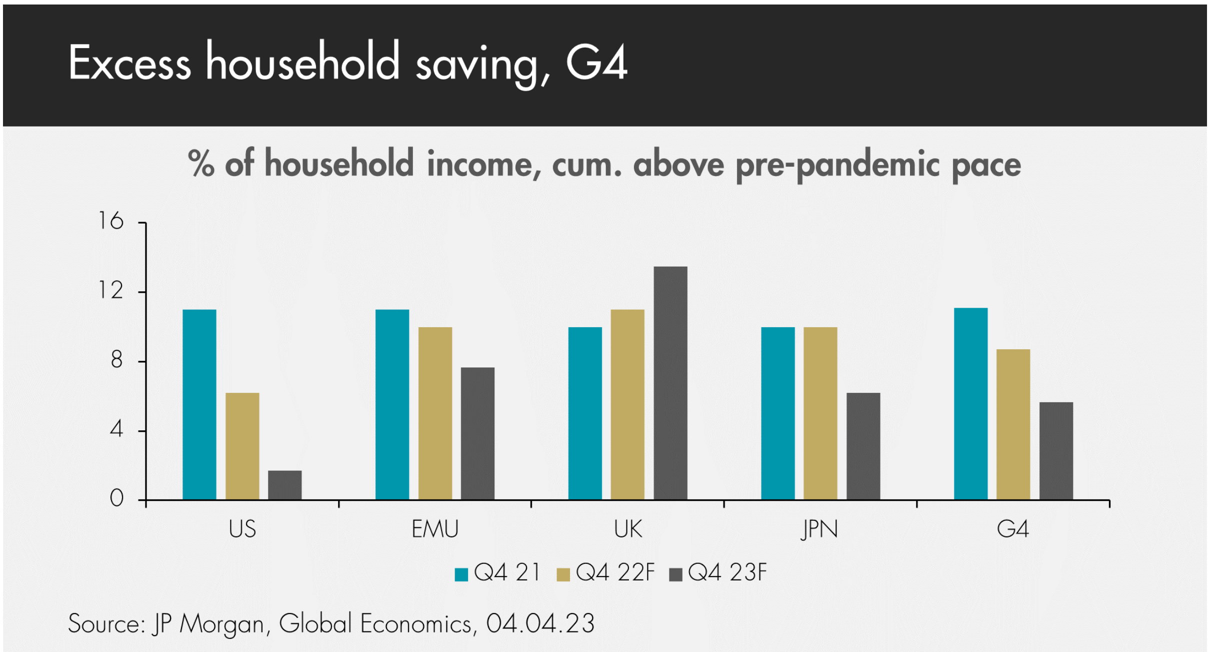
Source: Bloomberg, NBER, Liontrust. '2s10s' series: US 10 year treasury yield minus the US 2 year treasury yield. 01.01.77 to 28.04.23

We examine our three key economic drivers of consumption, employment, and inflation to give further context to this.

<u>Consumption:</u> Consumption remains the bedrock of developed economies, particularly in the US where it represents approximately two thirds of GDP. At the aggregate level, the consumer balance sheet remains strong

- it was government debt that expanded during lockdown periods. The level of excess savings in the aftermath of the pandemic had been a source of comfort for us in terms of the consumer. However, with persistent inflation and increased consumption as we have come out of the pandemic, we can see that the level of household savings have depleted significantly in the US and this trend is likely to continue for the remainder of the year.

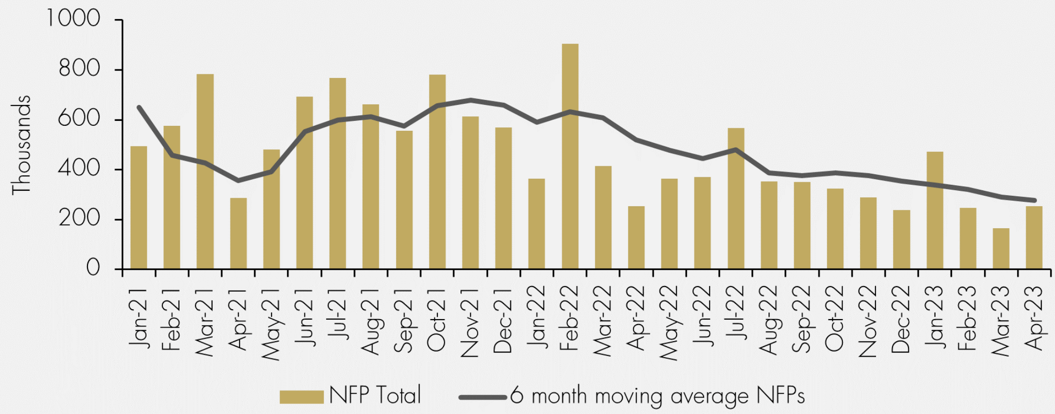
For those in the lower socioeconomic demographic groupings there has been a big hit to real income as the highest inflationary rates have been seen in necessities rather than luxuries. These socioeconomic groups have been supporting spending with borrowing, reflected in increased use of consumer credit, which is far from ideal when entering an economic slowdown.



US consumption had slowed to a 1.0% rate in Q4, but accelerated to unsustainable 3.7% growth in Q1 as warmer than usual weather in January and February caused a spending spike. The consumer is still looking to rebuild spending power as cuts in real wages, and wallet spend share substitution effects, have impacted living standards; wage inflation is covered below. The biggest spending driver for most consumers remains their income; as unemployment picks up later in the year, this will take its toll on consumption. Finally, with much higher mortgage rates and a moribund housing market, we anticipate far less mortgage refinancing activity along with the associated equity withdrawal and consumption boost that this has frequently historically given.

Employment: We would characterise the labour market as still being hot but down from having been red hot until near the end of 2022. Employment is still strong, but the data is indicating that the aforementioned heat in the job market is starting to show signs of cooling. We are seeing a gradual decline in nonfarm payrolls (see chart below), with the erratic monthly noise in the monthly figures sometimes masking the clear trend downwards shown by the six-month average.

Non-farm payrolls, month-on-month change



Source: BLS, Bloomberg, Liontrust, 28.04.23

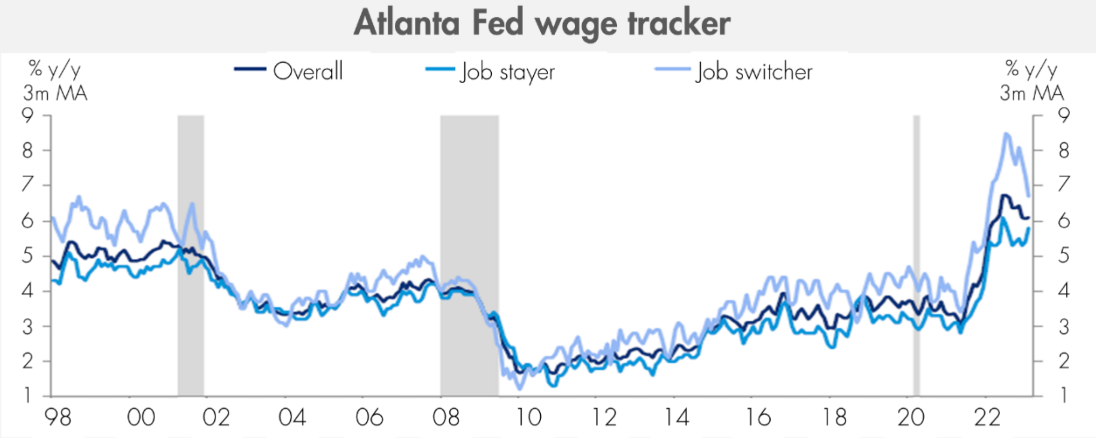
The number of job openings per unemployed person is starting to reduce now (see chart below), indicating the central bank actions are now modestly appearing to address the supply/demand imbalance in the labour market. This is through both the numerator, with job openings falling below 10 million, and the denominator of those in unemployment. The latter is boosted constructively when labour force participation increases – at 62.6% there has been a huge improvement from the 60.1% Covid lockdown nadir, but participation remains below the approximately 63% level seen prior to Covid. This takes the number of job openings per unemployed person to 1.64, representing excess demand but below the peak of over 2. We remain cognisant that unemployment is a lagging indicator and only tends to increase towards the latter stages of an economic cycle. Once employment conditions start to meaningfully deteriorate, they tend to do so rapidly.

Job openings/Unemployed

Source: BLS, Bloomberg, Liontrust, 28.04.23

Another sign of the slight easing in labour market pressures manifests itself within wage inflation data. The chart below shows that the wage increase you'd expect to get when switching jobs is still higher than if you stayed with your job, but the gap between staying or changing jobs has decreased. This reduces the incentive to leave your job, which feeds through to both lower job openings and the ability to negotiate higher wages.

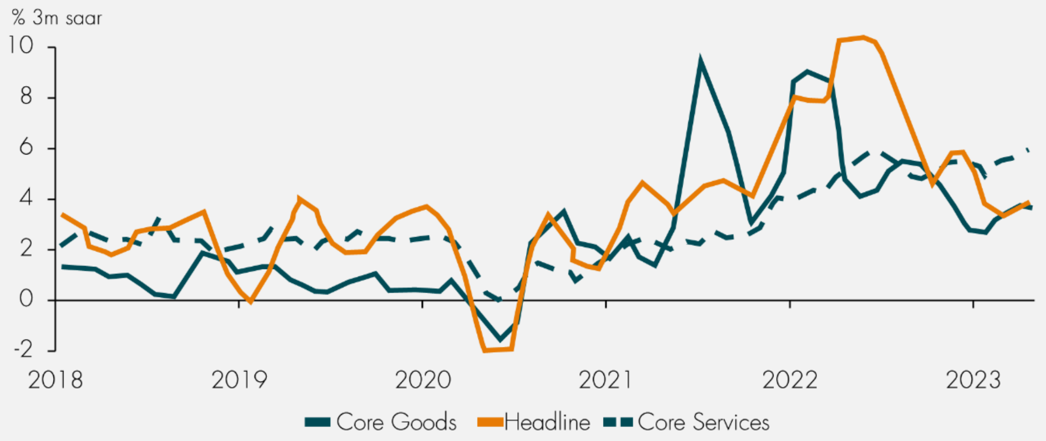
Job switchers continue to have faster wage growth but gap to stayers is closing



Source: Atlanta Fed, Haver Analytics, Deutsche Bank Research March Jobs Report, April 2023

Inflation: We like to break inflation down into components to help us identify what is driving the figures. Firstly, there is goods price inflation; then services inflation, which itself splits into shelter and other. Before examining these for the US, we wanted to show the global picture. The chart below shows that headline inflation is coming down, along with core goods. Core services is looking stubborn and continuing to move up.

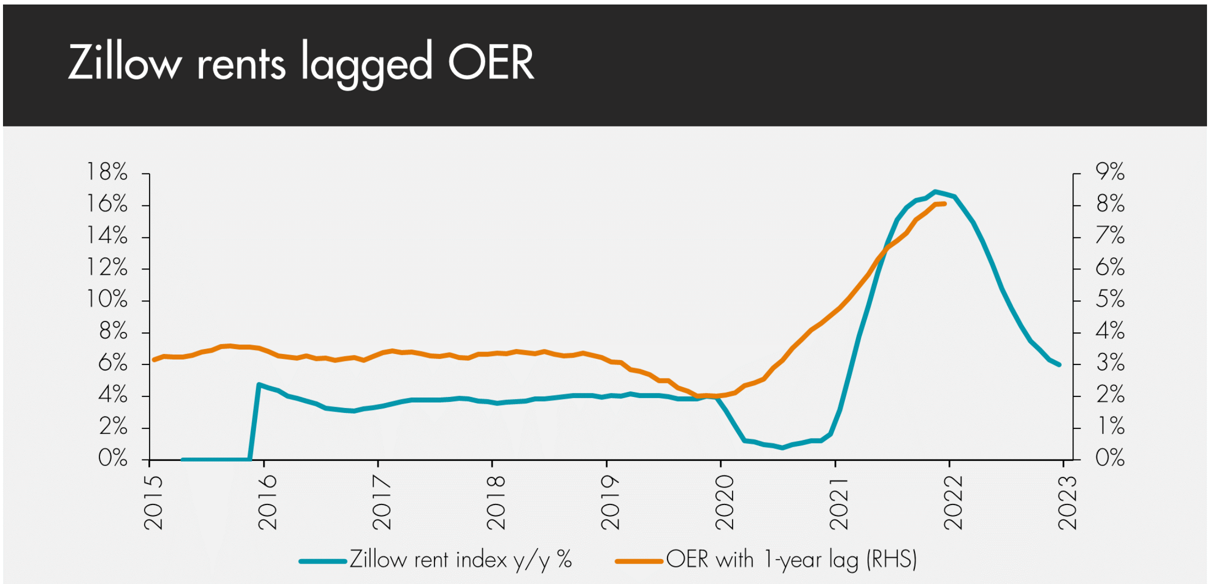
Global CPI



Source: JP Morgan, Global Inflation Monitor, March 2023. Excludes Turkey and Argentina

Focusing on the US, core goods prices are having a temporary fillip higher in the first half of 2023. We expect disinflation to resume later this year, driven by lower input costs, reduced corporate margins and the easing in supply chains. Headline goods prices will fall more as lower energy and agricultural prices continue to feed through to the figures.

Within services there is shelter inflation, which mainly consists of rents and owners' equivalent rents (OER); this category represents about a third of overall consumer price inflation (CPI) and 40% of core CPI. Due to the methodology behind the way that OERs are calculated, there is a big lag between falls in housing market activity and a lower inflation contribution. Higher interest rates have led to increased mortgage rates in the US at the usual 30-year pricing point. This in turn has fed through to a fall in housing market activity as over 15 million households have been priced out due to being unable to afford a mortgage. A better real time indicator of rents is provided by the Zillow series. In the chart below we show Zillow rents and the Bureau of Labor Statistics' OER measure lagged by a year.



Source: BLS, Zillow, Bloomberg, Liontrust, 28.04.23

Although the magnitude of the numbers is not identical, the direction, with lags, is clear. OERs have recently started stepping down on a monthly rate from the 0.7-0.8% inflationary area down to around 0.5%. As 2023 progresses they should fall further, and the annual figures will start to reduce too.

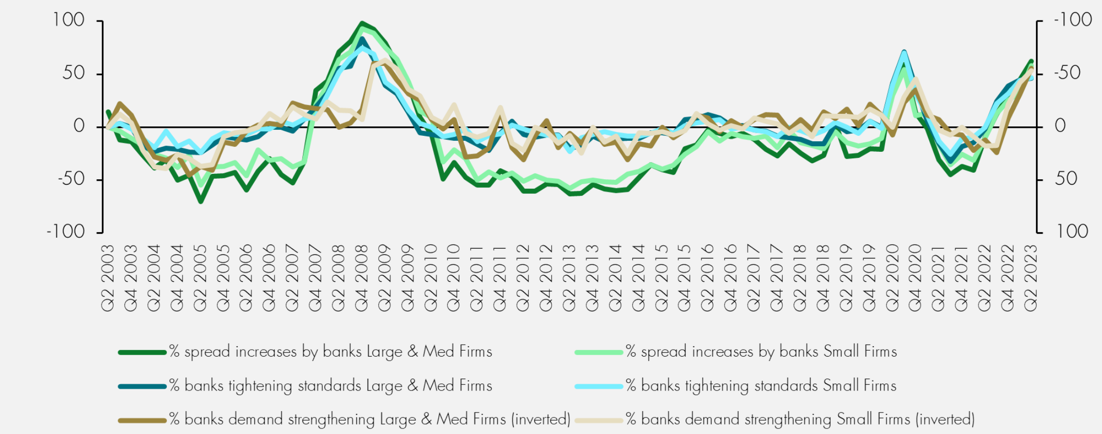
This leaves inflation in other services as the remaining factor that the Fed needs to tame. It is the part of the economy and CPI basket that is most correlated to nominal wage inflation. This is exactly why the Fed deemed it necessary to tighten monetary policy so much – a recession will be created to rectify the imbalance in the labour market. Only when wage inflation then falls further, down to the 3.5-4.0% area which the Fed deems consistent with its 2% overall inflation target, will the Fed feel able to declare it has tamed inflation.

Central Bank policy:
The rapid rate hiking cycle in the US is starting to have an impact on inflation and we believe the Fed is mostly likely to pause on the rate hikes as suggested by the statement issued in conjunction with May's 25bps rate hike. Potential for future rate hikes will be data dependent, with a high hurdle for the Fed to increase rates further. We do not believe the conditions are in place yet for the Fed to be cutting rates, despite markets pricing the beginning of an easing cycle starting in the autumn. The ECB, on the other hand, has increased rates by 25bps and from Christine Lagarde's comments we are likely to see two more rate hikes before a pause in the eurozone.

Relative to any neutral interest rate (referred to as r*) monetary policy is now undoubtedly tight. Added to this, we are seeing money supply shrinking year-over-year after the huge expansion in the monetary base during the Covid crisis. Monetary policy infamously works with long and variable lags; the failure of some US regional banks was due to their own errors managing the duration of their balance sheet assets, but it is the hiking cycle that brought this to the fore.

The main transmission mechanism from the banking mini crisis to the real economy is via tighter credit conditions. Examining Fed statements prior to the banking travails and those afterwards suggests that the impact is to knock 50 basis points off terminal rates. The recent quarterly Senior Loan Officers (SLO) survey is shown in the chart below, with the data from April labelled as Q2 2023. Please note that we have inverted the “demand strengthening” measures on the graph to make everything point in the same direction, namely up means tighter credit conditions.

Fed SLO survey C&I



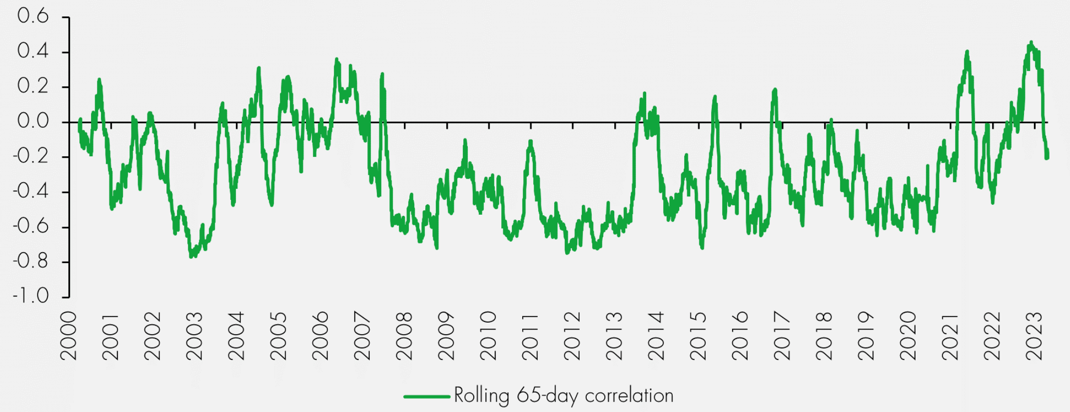
Source: US Federal Reserve, Bloomberg, Liontrust, 28.04.23

The most important two lines are the percentage of banks tightening standards.. The percentage of banks tightening lending standards for large and medium firms (dark blue line) rose from 44.8% in January’s survey to 46.0% in April; the respective numbers for tightening lending standards for small firms (light blue line) were 43.8% in January and 46.7% in the April survey. As can be seen from the chart, the tightening in lending standards post the recent banking mini crisis is a marginal increase, with the big jump having already occurred in the previous quarter. We are not quite at the Covid peak level and way off the financial crisis zenith, but the tightening seen does point towards an impending recessionary period.

Bond market conditions

With the markets’ collective thoughts turning from the inflationary problems of 2022 to the impending economic slowdown later in 2023, we have seen one relationship pleasingly reassert itself. Namely, the correlation between high quality sovereign bond returns and those on riskier assets has become negative again.

Rolling 3 months (daily returns) correlation of S&P 500 and US Treasury returns

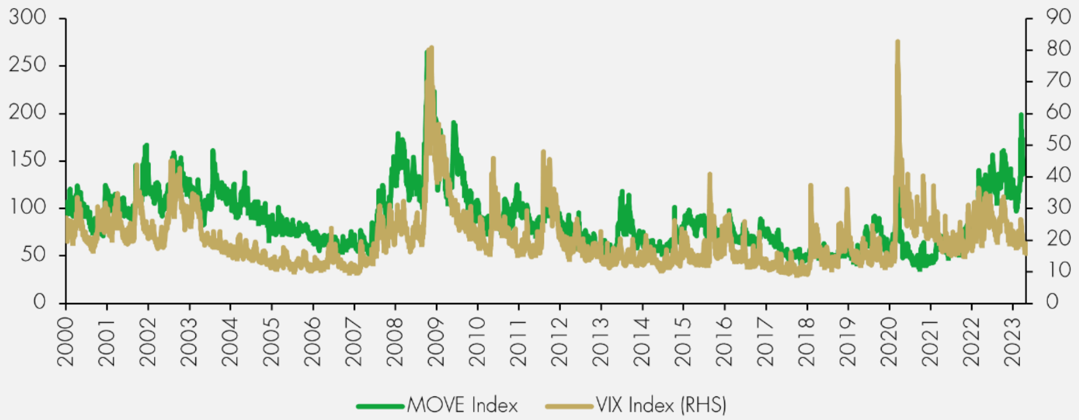


Source: Bloomberg, Liontrust, 28.04.23

The chart above shows the rolling 3-month correlation of daily US Treasury and S&P 500 returns. The fall from last year's anomalous positive correlation back into negative territory can clearly be seen.

One other observation we have made is that bond market volatility has been much higher than equity volatility. This is shown on the chart below with the MOVE index representing bond volatility and VIX for equity volatility. Prima facie, this points towards greater dislocations having occurred in bond market pricing, which we view as a buying opportunity for duration exposure.

MOVE and VIX

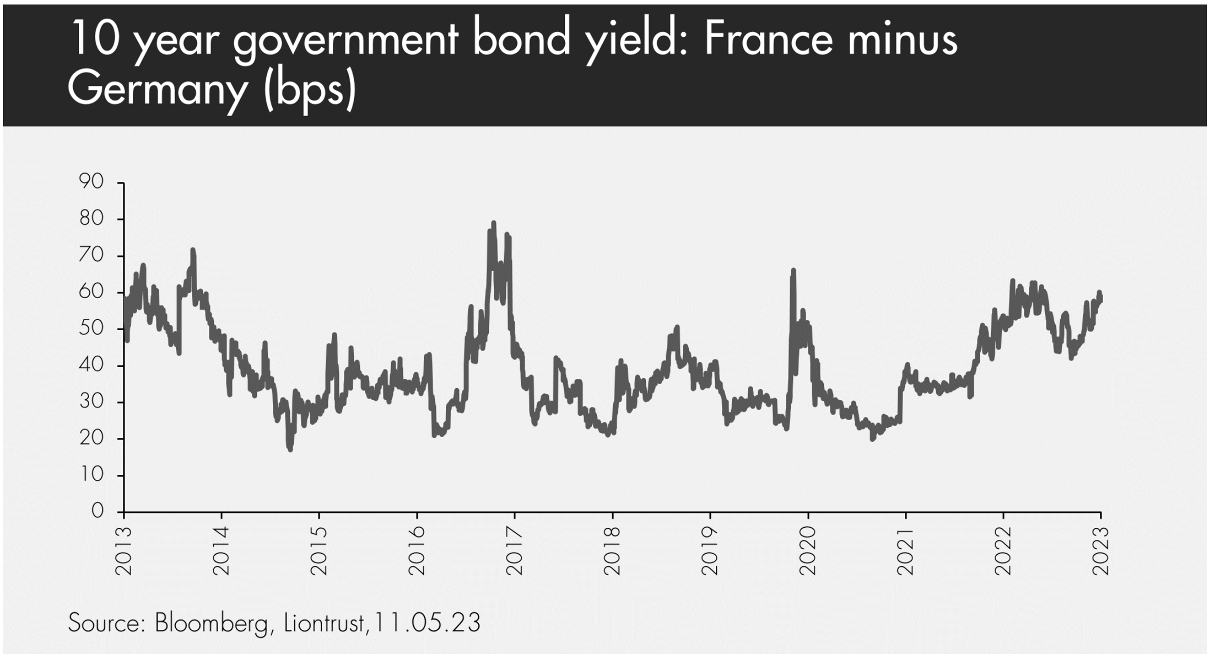


Source: Bloomberg, Liontrust, 28.04.23

Rates Positioning

The duration of the strategic bond strategies is mandated to be between 0-9 years, where 4.5 years is a neutral position. Post our strategy meeting, we have increased duration from 5.5 years to 6.25 years and would add another 0.25 years on any reduction in the bond markets' flight-to-quality premium.

Geographically, the duration exposure is split between the US 2.25 years, UK 2 years, Europe 1.5 years and New Zealand 0.5 years. Within Europe, our marginal addition has been into France, which is looking cheap relative to Germany. In the chart below you can see that the France minus Germany differential in government bond yields is nearly at the wides of the covid period and in 2017 prior to that.



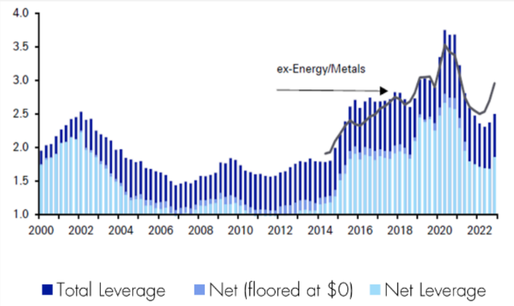
Regarding yield curve positioning, we have a strong preference for the 5-year to 10-year maturity area. We expect yield curves to steepen later in the year as we approach the time when central banks start their easing cycles. In this environment, longer dated bonds normally lag compared to shorter-dated tenors. The net duration exposure of the strategies in the over 15-year maturity bucket is zero.

Spread product

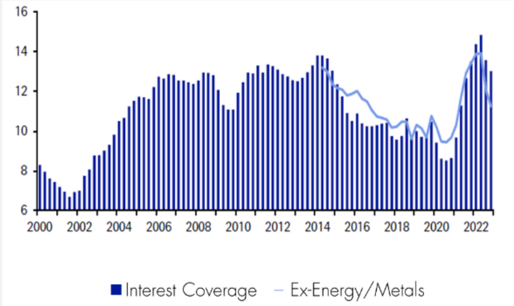
Corporate fundamentals remain strong with the levels of net leverage of corporates are similar to pre-pandemic levels. Companies have learnt how important it is to preserve liquidity, cash on hand and access to bank facilities, to remain prudent in the face of a challenging environment. Although interest costs will go up as debt refinancing works its way through over the next few years, we are starting from the point of healthy interest cover ratios, shown in the charts below.

Spread product: Investment Grade

US IG Total and Net Leverage



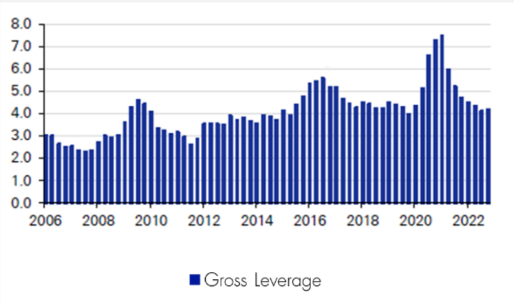
US IG Interest Coverage



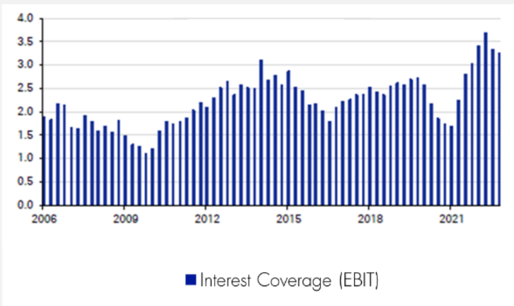
Source: Deutsche Bank, Global Credit Chart Book, March 2023

Spread product: High Yield

US HY Total and Net Leverage



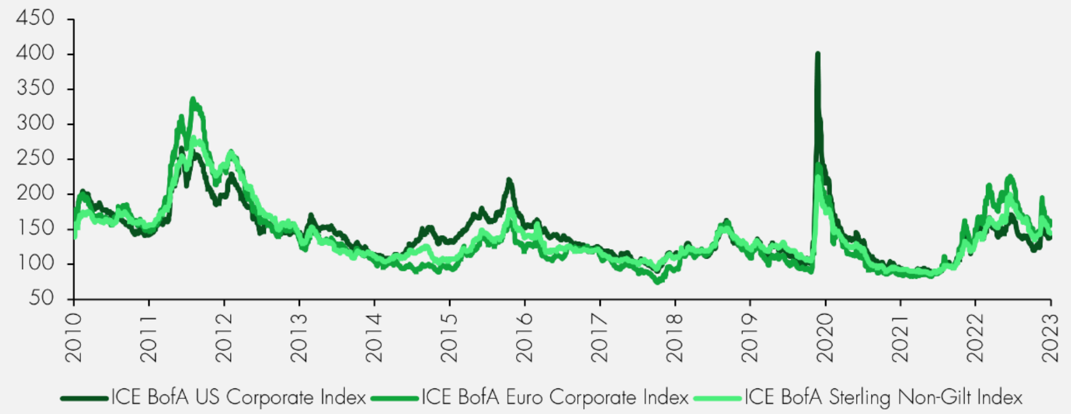
US HY Interest Coverage



Source: Deutsche Bank, Global Credit Chart Book, March 2023

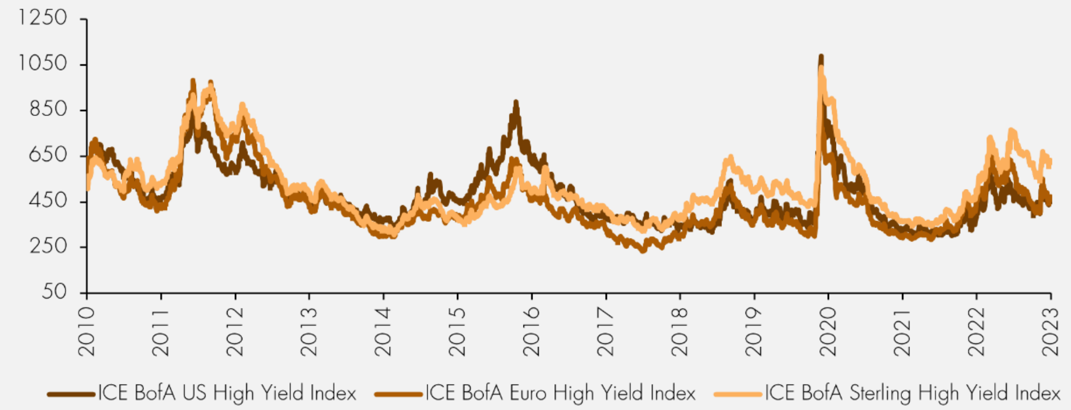
Moving on to valuations, below we have graphs showing how investment grade and high yield credit spreads have evolved in the period since the global financial crisis. Credit spreads have contracted since their most recent peak in October 2022. Whilst they do offer good long-term value, and a decent liquidity premium above the credit spread required to compensate for default risk, we would require a higher cushion for recessionary risk so are currently neutrally positioned in credit. We deem neutral to be a 50% weighting in investment grade and 20% allocation to high yield bonds.

Investment Grade Index credit spreads (bps)



Source: ICE BofA, Liontrust, 28.04.23

High Yield Index credit spreads (bps)



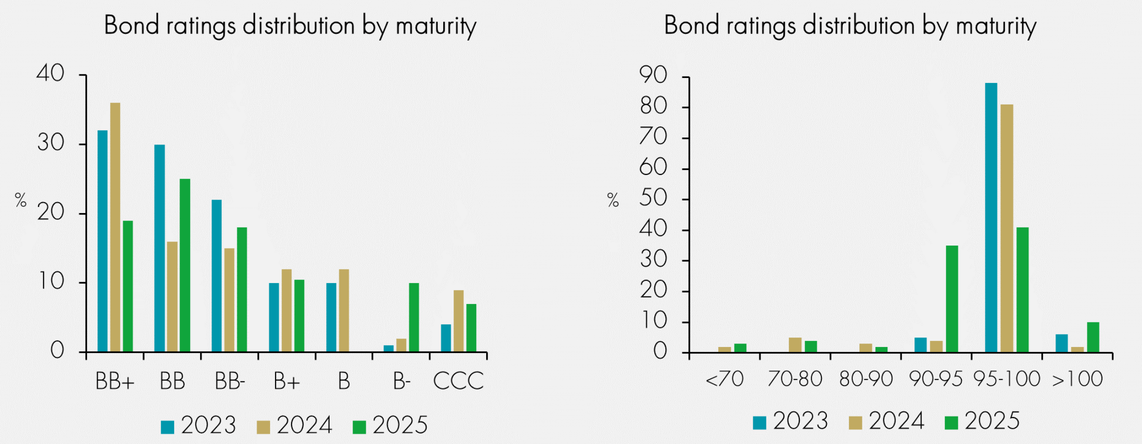
Source: ICE BofA, Liontrust, 28.04.23

A market implication of increased yields is a gradual re-couponing of debt as issuers refinance their liabilities. As old low-coupon debt gradually matures over the coming years, companies will have to pay a much higher coupon, commensurate with today's market yield levels, to attract capital. The downside to this is a deterioration in interest coverage ratios and free cash flow for the companies, which is another reason why we avoid those issuers with the most fragile balance sheets.

The upside is that bond investors receive a significant boost to the running yield from the higher coupons and that lifts future expected returns from the asset class. Overall, the refinancing wave and tighter credit conditions should see more re-couponing for good companies and a prolonged slightly higher default rate caused by those issuers whose business model and/or balance sheet cannot withstand a period of higher interest rates. This will lead to greater dispersion within credit, an environment that naturally suits our style of preferring higher quality companies operating in less cyclical sectors of the economy.

We have recently seen an increase in activity in the high yield new issue market. Borrowers, predominantly BB-rated ones, are coming to the market and successfully placing bonds. Deals have been oversubscribed and have offered attractive coupons. The charts below show you the ratings distribution of bonds that are nearing their maturity date. One can see the skew to the better quality part of the market. Furthermore, although most bonds are trading below par, they are at a high enough level to suggest the market would be receptive to a refinancing of bonds at the right yield.

Breakdown of maturity pipeline across ratings, sectors and cash prices



Source: ICE, Bloomberg, Morgan Stanley Research, March 2023

For a comprehensive list of common financial words and terms, see our glossary at:
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