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Insight INVESTMENT

OCTOBER 2020

US PENSION MARKET

A statistical and qualitative review of Q3 2020 and investment outlook

With the economic carnage of the first half of the year moving into the rear-view mirror, investors spent the third quarter grappling with the question of defining the 'new normal'. Key economic data releases showed activity gradually recovering, but this was in the context of a record 31.7% annualized Q2 contraction. Cautious optimism generally prevailed, although technology stocks were pushed to record highs on perceptions that they would be the key beneficiaries of the crisis. This led to a rebound in equity markets, but an uneven one, with the market values of many traditional companies barely recovering at all.

As we look for certainties in this uncertain period, one thing we are confident about is that the Federal Reserve is going to do everything it can to support the recovery, with its new policy framework giving it significant flexibility to do so. As Humphrey Bogart said in the final line of Casablanca, "I think this is the beginning of a beautiful friendship". In this new environment, US interest rates are likely to be held at historically low levels for years to come, and we believe this will be critical for the outlook of various asset markets and pension plan hedging strategies.

- The Federal Reserve have shifted to a new policy framework – flexible average inflation targeting. This gives the central bank greater flexibility to keep interest rates at historical lows for a long time. We re-examine our outlook in light of this shift to a 'new normal'.

- We believe that the funded status of many pension funds will have improved over the quarter, as gains in risk assets more than counterbalanced a decline in discount rates and consequent rise in the present value of liabilities.

- In our solutions section we ask the question – to hedge or not to hedge? Has the Fed changed the game?

- In pension news, new rules on ESG investment could increase pressure on plan fiduciaries to ensure that decisions are made purely for financial considerations. We highlight how our approach to investing responsibly, in particular using ESG as a risk management tool, helps our clients with their financial goals.

- Issuance in investment grade credit markets has surged in 2020, and in Q3, cumulative year-to-date issuance exceeded the previous 2017 annual record. We have become more cautious as spreads have tightened but acknowledge that a desperate search for yield is likely to continue to drive flows into credit markets.

- Significant uncertainties remain. The US Presidential election is likely to be a major focus of markets in Q4 – with a divergence in tax policies between the two parties, and major implications for issues such as future trade policy. In Europe, the risks are growing that the transition period between the UK and EU ends with no deal, and relations appear to be growing increasingly strained.

> I think this is the beginning of a beautiful friendship.
>
> HUMPHREY BOGART IN CASABLANCA, 1942

A NEW FED FRAMEWORK LIKELY TO HOLD RATES AT HISTORICAL LOWS

On 21 August 2020, following an extensive review, Federal Reserve (Fed) Chairman Jerome Powell announced that the central bank would shift to a new policy framework[1]: flexible average inflation targeting. This will see the Fed continue to target inflation at 2%, but over longer periods. In future, if inflation persistently fails to meet the 2% target, it will be allowed to run moderately above target such that inflation averages 2% over time. By making this change, the Federal Open Markets Committee (FOMC) hopes to anchor longer-term inflation expectations at the 2% rate.

Another critical change was on employment, with the Committee now focusing on the extent of any shortfall in employment from its maximum level and noting that the maximum level of employment is "not directly measurable and changes over time". This implies that maximizing employment and sustaining it at elevated levels will become a more important factor in future policy decisions.

Since the Fed's 2% inflation target was introduced by Ben Bernanke in 2012, inflation, as measured by the Personal Consumption Expenditure Price Index, has persistently failed to meet that target over time. A considerable gap has grown between the recorded level of prices and the level had inflation met the 2% target (see Figure 1). This has led to criticism that pre-emptive tightening of monetary policy to dampen perceived inflationary pressures (that have then failed to materialize in actual price rises) has simply damaged economic growth unnecessarily.

Figure 1: US inflation has consistently undershot target[2]

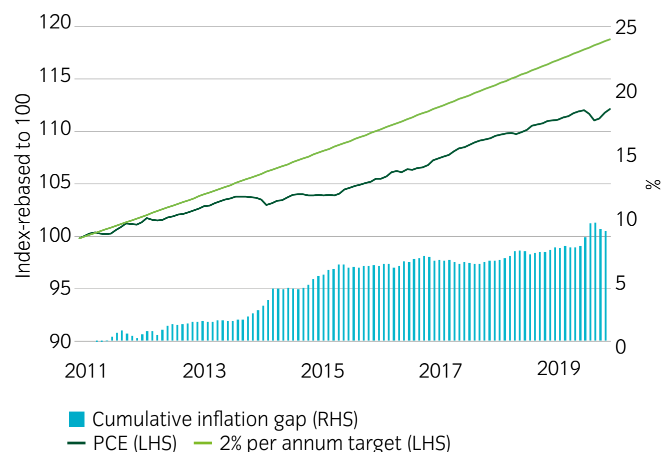
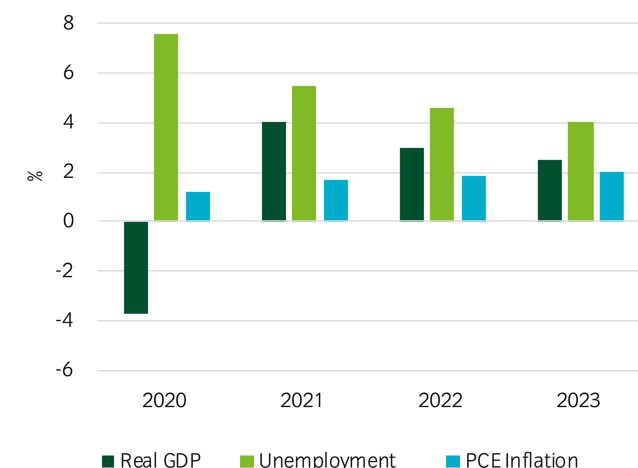


Figure 2: The Fed's new forecasts[3]



The clear message from this change in policy framework is that investors should expect monetary policy to remain at highly stimulative levels for an extended period. Minutes from the September FOMC meeting show that the committee members don't expect inflation to reach 2% until 2023, suggesting that year would be the very earliest they would be starting a new tightening cycle.

Even if inflation were to move above this level earlier than expected, there is no guarantee that it would be met with higher interest rates. Given the extent of the undershoot in recent years and the level of unemployment, it could be argued that the Fed would now accept quite an extended period of above-target inflation if it materialized before meaningfully seeking to constrain growth. Of course, recent experience would suggest that getting inflation to meaningfully accelerate may not be that easy.

For many pension plans, this new environment of ultra-low yields, and policies designed to generate higher inflation could take some getting used to. We discuss our outlook for this 'new normal' later in this document.

[1] https://www.federalreserve.gov/monetarypolicy/review-of-monetary-policy-strategy-tools-and-communications-statement-on-longer-run-goals-monetary-policy-strategy.htm [2] Source: Insight and Bloomberg. Data as at 31 August 2020. [3] Source: Federal Reserve. Economic projections of Federal Reserve Board members and Federal Reserve Bank presidents, under their individual assumptions of projected appropriate monetary policy. September 2020.

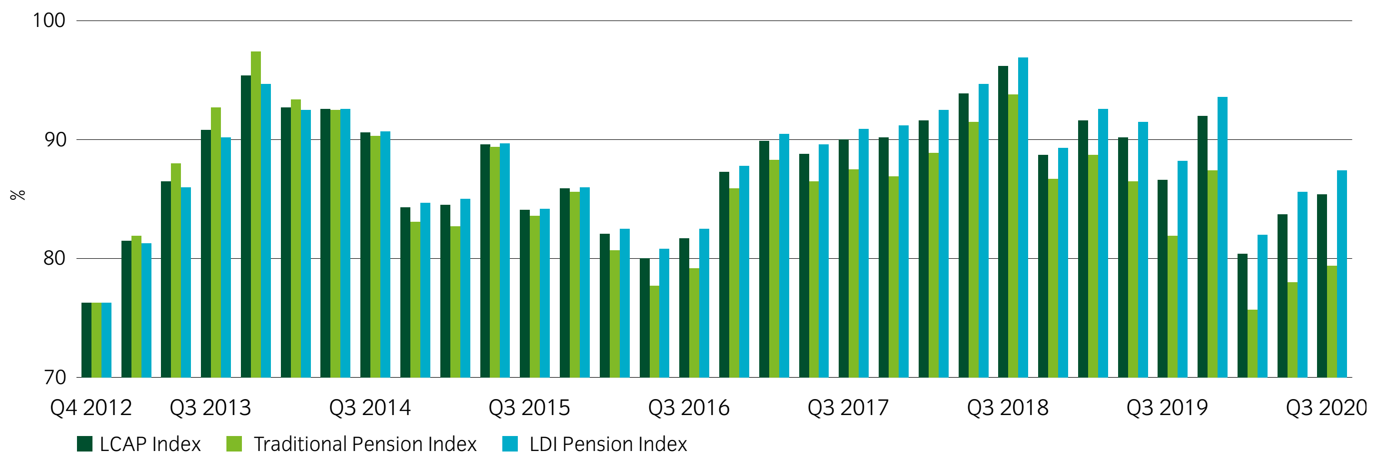
PENSION TRENDS

PENSION FUNDED STATUS UPDATE

Pension plan funded status, as measured by Insight's model pension indices, improved during Q3. Although discount rates declined, increasing pension liabilities, growth assets recorded very strong returns[4].

Insight maintains three model pension indices. Each index aims to reflect the changing funded status ratio for pension plans following different approaches to hedging the same liability profile. The indices illustrate the effect of hedging with core fixed income versus long duration, holding constant a significant allocation to growth assets. All three funding indices saw improvements in funded status in Q3. Rates rose by 3bp over the quarter but spreads tightened by 9bp, resulting in a 6bp fall in discount rates. The LDI and LCAP indices, which contain long duration fixed income, saw the largest improvements in funded status, at 1.8% and 1.7% respectively, while the Traditional index saw its funded status improve by 1.4%.

Figure 3: Plan funding ratios[4]



[4] Source: Insight and Bloomberg. Data as of June 30, 2020. Note: Beginning in 2014, we introduced three indices to provide insight into the impact of rate and market movements on three types of pension plan investors. Large Company Aggregate Pension (LCAP) Index: The "average" corporate pension plan index we have developed which represents an asset weighted average of allocations held by S&P 500 companies' plans. Traditional Pension Index: The index reflecting those pensions that have not yet adopted LDI. LDI Pension Index: The index reflecting those who have adopted LDI in the fixed income portion of their portfolio. Assumptions behind the Insight indices include 14-year typical pension liability duration, 45% equity allocation, an aggregate 5% liability impact of updated mortality assumptions effective Q4 2014 and no external cashflows. WHERE MODEL OR SIMULATED RESULTS ARE PRESENTED, THEY HAVE MANY INHERENT LIMITATIONS. CLIENTS' ACTUAL RESULTS MAY BE MATERIALLY DIFFERENT THAN THE RESULTS PRESENTED. UNLIKE AN ACTUAL PERFORMANCE RECORD, MODEL RESULTS DO NOT REPRESENT ACTUAL TRADING AND MAY NOT REFLECT THE IMPACT THAT MATERIAL ECONOMIC AND MARKET FACTORS MIGHT HAVE HAD ON INSIGHT'S DECISION-MAKING IF ACTUAL CLIENT FUNDS WERE BEING MANAGED. ALSO, SINCE SUCH TRADES HAVE NOT BEEN EXECUTED, THE RESULTS MAY HAVE UNDER OR OVER-COMPENSATED FOR THE IMPACT, IN ANY, OF CERTAIN MARKET FACTORS, SUCH AS LACK OF LIQUIDITY. SIMULATED TRADING PROGRAMS IN GENERAL ARE ALSO SUBJECT TO THE FACT THAT THEY ARE DESIGNED WITH THE BENEFIT OF HINDSIGHT. MODEL RESULTS ARE ACHIEVED THROUGH THE RETROACTIVE APPLICATION OF A MODEL. MODEL RESULTS SHOWN DO NOT REFLECT MANAGEMENT FEES, TRANSACTION COSTS AND OTHER EXPENSES THAT WOULD REDUCE RETURNS. THIS IS A HYPOTHETICAL MODEL. THE QUOTED BENCHMARKS DO NOT REFLECT DEDUCTIONS FOR FEES, EXPENSES OR TAXES. THE BENCHMARKS ARE UNMANAGED AND DO NOT REFLECT ACTUAL TRADING. THERE COULD BE MATERIAL FACTORS RELEVANT TO ANY SUCH COMPARISON SUCH AS DIFFERENCES IN THE VOLATILITY, AND REGULATORY AND LEGAL RESTRICTIONS BETWEEN THE INDEXES SHOWN AND THE STRATEGY. INVESTORS CANNOT INVEST DIRECTLY IN ANY INDEX.

PENSION NEWS

- **US Corporate Pension Plans in August have the largest monthly funding gain in 17 years**[5]

  Data from Milliman on the funded status of the largest 100 corporate defined benefit pension plans showed a $93bn improvement in August, the largest increase since 2003. The move was driven by a $83bn decrease in liabilities as the benchmark corporate interest rate rose from 2.26% to 2.54%. This caused the funded status to rise from 81.1% to 85.1%, although funded status remains 4.7% below where it started the year.

- **Proposed new rules could limit some ESG investment strategies**[6]

  The Labor Department (DOL) has proposed an amendment to the "Investment duties" regulation under the Employee Retirement Income Security Act of 1974 (ERISA).

  Investments: Plan fiduciaries will be required to select investments and investment courses of action based solely on financial considerations relevant to the risk-adjusted economic value of a particular investment or investment course of action. Fiduciaries would violate ERISA if they accept reduced expected returns or greater risks to secure social, environmental, or other policy goals.

  Proxy votes: Plan fiduciaries are to be prevented from voting for corporate policies unless they can identify an economic benefit from doing so. The department stated that some fiduciaries "may be acting in ways that unwittingly allow plan assets to be used to support or pursue proxy proposals for environmental, social or public policy agendas that have no connection to increasing the value of investments."

- **Global Peer Financing Association (GPFA) formed**[7]

  In July 2020, the California Public Employees' Retirement System (CalPERS), Healthcare of Ontario Pension Plan (HOOPP), Ohio Public Employees Retirement System (OPERS), and the State of Wisconsin Investment Board (SWIB) joined together to form the GPFA. The goal of this association is to increase and encourage peer-to-peer trading in the security lending and repo markets in order to supplement traditional bank counterparties. In September, a further announcement was made, welcoming Australian Super, The California State Teachers Retirement System (CalSTRS) and Thrivent Financial to the group.

- **Treasury Department denies request to reduce plan benefits**[8]

  The American Federation of Musicians and Employers' Pension Fund, which is reported as having liabilities of $3bn versus assets of $1.2bn, has seen its application to reduce plan benefits denied. The Treasury Department have reviewed the application and determined that mortality assumptions used are "not reasonable", and significantly overestimates the rate at which plan participants and beneficiaries will die. As such, the proposal "does not satisfy the statutory requirement that it be reasonably estimated to avoid insolvency."

RESPONSIBLE HORIZONS 2020[9]

Our 2020 Responsible Horizons report explains how our approach to investing responsibly helps our clients with their financial goals, including our engagement on several issues related to the long-term sustainability of financial markets.

With many agreeing that ESG risks can materially affect financial performance, understanding and engaging on these risks in our research activities is an essential part of establishing an accurate fair value for any investment.

In this report we:

- Outline the six principles that guide us as we seek to help our clients achieve their objectives
- Offer examples from our own experiences of the difference a responsible investment approach can make
- Analyze the impact bond market and show how some investors put their impact objectives into practice. We analyzed 126 impact bonds in 2019, of which only 33 fully satisfied our expectations

[5] https://us.milliman.com/en/insight/pension-funding-index-september-2020
[6] https://www.federalregister.gov/documents/2020/06/30/2020-13705/financial-factors-in-selecting-plan-investments
[7] https://globalpeerfinancingassociation.org/
[8] https://pmcdeadline2.files.wordpress.com/2020/08/afm_notification_letter-wm.pdf
[9] https://www.insightinvestment.com/united-states/nav/responsible-investment/

Insight plays an active role in partnership with our clients to influence long-term outcomes

SOLUTIONS:
WHERE NEXT FOR LDI – HAS THE HEDGING GAME CHANGED?

THE LOW RATES DILEMMA

Bonds play a crucial role for pension plans: they provide a source of total return, diversification against return-seeking assets, a hedge against liability risks and regular contractual cashflows and liquidity to protect against forced-selling to meet cash outflow obligations.

However, with interest rates at historic lows, many pension plan sponsors are facing a dilemma. Should they maintain or increase their hedge ratio to protect the funded status against a further fall in rates and to counter the increased liability sensitivity to rate changes, or should they decrease their hedge to benefit from higher rates in the future?

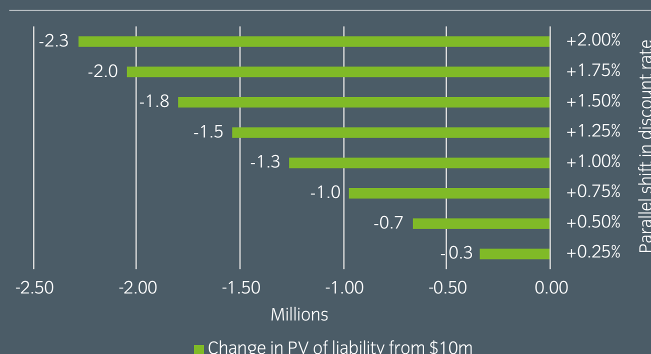
If rates fall further, as experienced in Europe and Japan, plans that are not fully hedged to rates would see their funded status deteriorate. Also, with falling rates over the last five years, the sensitivity of a pension plan's liabilities to rates has gone up. We indicate this in Figure 4 for a hypothetical plan, which shows how the sensitivity to a 0.01% change in rates would have increased by 46%.

Figure 4: Interest rate risks have risen as rates have fallen[10]

At the same time – other investors are wondering if it is time to reduce their hedges, in case rates have reached the bottom and are set to rise from here.

DB plans that were not fully hedged would stand to gain as liability values would be expected to fall faster than bond values, improving the plan's funded status (Figure 5).

Figure 5: We believe an unhedged $10m pension plans could gain from a rise in rates[11]



Such investors would then increase hedge ratios after rates rose and the cost of hedging was cheaper – allowing the plan to then crystallize those funded status gains. A higher funded status would translate into lower cash needs to fund minimum requirements and PBGC variable rate premiums. By the same token of course, these costs can end up rising if rates instead fall.

In our experience, how a plan will choose to proceed will depend on whether they are more of a 'total return' investor or more of a 'strategic risk management' investor. Each types of investor tends to have distinct objectives from the other (Figure 6).

Figure 6: The objectives of different investor types will influence the strategy adopted

	Total Return investor	Strategic Risk Management Investor
Return objective	Maximize long-term risk-adjusted returns Tolerate short-term volatility	Reduce asset / liability return mismatch Hedge liability interest rate risk
Diversification objective	Long bonds for 'ballast' through down markets and Treasuries as 'safe havens'	Reduce funded status volatility
Hedging objective	Low hedge ratio – seek to benefit from interest rate risk	High hedge ratio – seek to meet liabilities and mitigate need for contributions
Liquidity generation	As needed, selling more liquid holdings (eg Treasuries and equities)	Through standalone cashflow driven investing solution

[10] Insight, hypothetical plan with starting duration of 12 years and discount rate in line with the Bank of America-Merrill Lynch AA curve +15bp. Assumes fixed cash flows. [11] Insight, hypothetical plan with $10m in present value liabilities. Illustrative of average 2.5% initial discount rate and illustrative 14-year duration liabilities. Where model or simulated results are presented, they have many inherent limitations. model information does not represent actual trading and may not reflect the impact that material economic and market factors might have had on insight's decision-making.

AVOID THE TRAPS

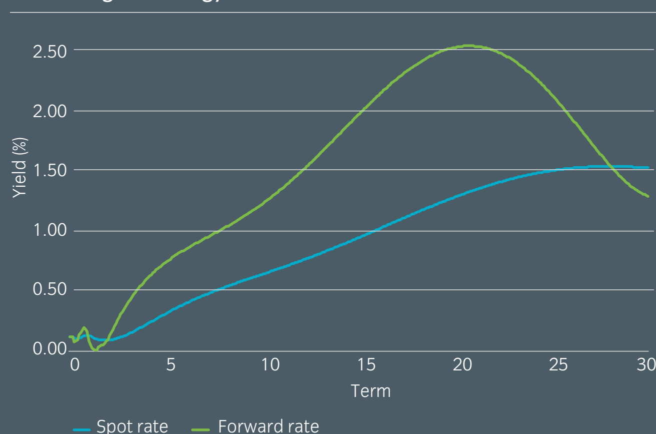
Investors seriously considering reducing their interest rate hedge need to be careful to avoid two traps.

1 Watch interest rate forwards

It has become the default for rates to consistently surprise to the downside – reflected by spot rates regularly undershooting forward rates. This has consistently punished unhedged positions.

The current term structure also indicates there will be a higher hurdle for a rise in rates to surprise the market to the upside. As spot rates will need to rise relative to implied forwards, the current hurdle is above 2% at maturities above 15 years (Figure 7).

Figure 7: Spot rates need to rise relative to implied forwards for an unhedged strategy to benefit[12]



2 Convexity – more to lose than to gain?

Downside rate risks are amplified by convexity. At low yield levels, interest rate sensitivity is higher for a fall in rates than it is for an equivalent rise in rates (Figure 8).

Figure 8: Convexity can amplify the downside impact of rates relative to the upside (based on a hyperthetical plan)[13]

This means that there is potentially more to lose than to gain from an unhedged position.

It is, of course, also not impossible that rates continue trending lower – as evidenced by the fact yields are generally between ~50bp to ~150bps below US Treasuries in other advanced economies.

WHERE NEXT FOR LDI INVESTORS?

Tactically reducing a hedge ratio at today's lower rate levels may be a viable strategy for certain plans, provided the sponsor can tolerate the downside risks. If not, adaptive or asymmetric hedging strategies that seek to protect downside risk while maintaining upside exposure may be worth considering.

However, for other investors, particularly those in the 'strategic risk management' camp, it may be important to keep sight of the fact that rates typically represent the largest single risk exposure for DB plans – and yet funded status volatility offers no measurable risk premium (like equity or credit investments do).

We argue that it is an uncompensated risk and therefore believe plan sponsors need to carefully consider their next move – working closely with strategic advisors to quantify and understand the range of outcomes. As ever, different investors may require very different solutions.

[12] Insight, Bloomberg, September 30, 2020. [13] Insight, hypothetical plan with $10m in present value liabilities. Illustrative of average 2.5% initial discount rate and illustrative 14-year duration liabilities. Where model or simulated results are presented, they have many inherent limitations. model information does not represent actual trading and may not reflect the impact that material economic and market factors might have had on insight's decision-making

ECONOMICS AND MARKETS

KEY MARKET MOVEMENTS: Q3 2020

Treasury yields drifted marginally higher over the quarter, but the short end of the curve remained well anchored. The US Federal Open Market Committee's 'dot plot', which signals members individual forecasts, suggested that inflation would not reach 2% until 2023. If correct, the Fed are likely to maintain monetary policy at highly accomodative levels for a considerable period.

Corporate credit spreads tightened, with BBB-rated issuers and high yield credit outperforming.

US equity markets experienced a strong, but volatile, quarter, with technology stocks rallying to record highs before giving back some of these gains at the end of the quarter.

The US dollar broadly depreciated over the quarter.

Figure 9: Q3 2020 Fixed Income/Equity Index Returns (%) and Volatility Index Levels[10]

Index	Q3 2020 total return	YTD 2020 total return	Q3 2020 excess return	YTD 2020 excess return
Barclays Treasury	0.17	8.90	–	–
Barclays Intermediate Treasury	0.19	6.02	–	–
Barclays Long Treasury	0.12	21.35	–	–
Barclays Corporate	1.54	6.64	1.36	-2.27
Barclays Intermediate Corporate	1.33	5.61	1.13	-0.41
Barclays Long Corporate	1.91	8.36	1.79	-12.98
BofA Merrill Lynch High Yield	4.71	-0.30	4.53	-9.20
S&P 500 Index	8.93	5.57	–	–
MSCI Emerging Markets Equity Index	9.56	-1.16	–	–
VIX[11]	26	–	–	–
MOVE[11]	36	–	–	–

ECONOMICS: A DEEP CONTRACTION IN GLOBAL GDP

Economists started to get a better sense of the impact of coronavirus on different economies in Q3 and this led to some significant changes in forecasts. Notably, although global growth is now expected to experience a deeper contraction in 2020, forecasts for US growth have been raised as the US economy is now expected to ouperform its developed market peers. Inflation forecasts were raised for both 2020 and 2021, but in developed markets inflation is expected to remain below 2% through 2021.

Figure 10: Consensus GDP and CPI expectations[12]

Real GDP	Consensus*			Change over Q3	
	2019	2020F	2021F	2020F	2021F
United States	2.3	-4.4	3.8	1.2	-0.4
Euro area	1.2	-8.1	5.5	0.0	0.0
Japan	0.9	-5.7	2.5	-0.8	0.0
China	6.1	2.1	8.0	0.3	0.0
Developed markets	1.7	-5.8	4.2	0.3	-0.1
Emerging markets	4.2	-1.0	4.7	-0.7	-0.2
Global	**3.0**	**-3.9**	**5.2**	**-0.2**	**0.1**

CPI	Consensus*			Change over Q3	
	2019	2020F	2021F	2020F	2021F
United States	1.8	1.1	1.9	0.3	0.2
Euro area	1.2	0.4	1.0	-0.1	-0.1
Japan	0.5	0.0	0.2	0.1	0.0
China	2.9	2.8	2.2	0.0	0.1
Developed markets	1.7	1.0	1.6	0.2	0.1
Emerging markets	3.9	3.6	3.7	-0.2	0.2
Global	**3.0**	**2.3**	**2.6**	**0.3**	**0.2**

F=Forecast. *Bloomberg consensus forecast.

[10] Source: Barclays and Bloomberg. Data as of September 30, 2020. [11] VIX and MOVE are actual value at month end.
[12] Source: Insight and Bloomberg. Data as of September 30, 2020.

DERIVATIVES

CFTC provides additional relief for LIBOR transition

The US Commodity Futures Trading Commission (CFTC) has announced[13] that they have issued revised no-action letters which provide additional relief to swap dealers and market participants that are transitioning away from swaps that reference LIBOR. This is designed to help smooth the transition, particularly for older, legacy swap contracts by "removing regulatory obstacles to the adoption of potential protocols updating robust fallback procedures in the event that an IBOR ceases or becomes non-representative".

TREASURY MARKETS

The curve steepens marginally as sentiment improves

The Treasury yield curve shifted marginally higher and steeper over the quarter as shorter maturities remained anchored by Fed policy, but longer-maturity yields drifted higher after making strong gains in the previous quarter. The 2-year maturity Treasury yield declined by 2bp, the 10-year maturity Treasury yield rose by 3bp and the 30-year maturity Treasury yield rose by 6bp.

Unprecedented levels of issuance raise concerns

At its August presentation, the US Treasury Borrowing Advisory Committee estimated that Q3 2020 tax receipts were down by $351bn (-13%) versus Q3 2019 as a result of a change in tax deadlines to July 15. **Total outlays rose by $1,648bn (+49%) versus Q3 2019 as a result of payments related to COVID-19 relief efforts.**

The estimate of 2020 Q4 borrowing was increased by $270bn from the May meeting. 2021 Q1 borrowing is forecast at $1,216bn. The Treasury has increased its cash holdings to $800bn and will maintain this level for some time given the uncertain needs for funding.

It was noted that T-Bill demand remained robust and that the new 20-year issuance had been well received despite its larger than expected initial size. The Committee recommended increases in future issuance sizes across all maturities but suggested that larger increases be undertaken in maturities out to 10 years.

Figure 11: Treasury yield curve change

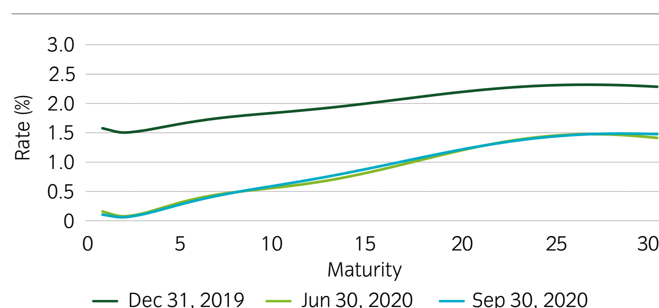


Figure 12: US Treasury net marketable borrowing[14]

Market ($bn)	2018 FY	2019 FY	Q1 to Q3 2020	Yr/Yr change
Bills issuance	438	137	2703	2,736
Floating rate issuance	26	55	38	0
2-5yr Treasury issuance	210	403	323	103
5-10yr Treasury issuance	139	206	229	135
Over 10yr Treasury issuance	176	191	214	63
5-10yr TIPS	32	33	46	10
Over 10yr TIPS	19	20	8	2
Buybacks	0	0	0	0
Total	**1,040**	**1,045**	**3,560**	**3,048**

"The Committee recommended increases in future issuance sizes across all maturities but suggested that larger increases be undertaken in maturities out to 10 years."

[13] https://www.cftc.gov/PressRoom/PressReleases/8228-20
[14] Source: Insight and US Treasury. Data as of August 31, 2020. Yr/Yr change is August 31, 2020 versus August 31, 2019.

Investment grade issuance smashes previous records

Cumulative investment grade credit gross issuance reached $1,835bn at the end of Q3, breaking above the previous annual high of $1,468bn set in 2017 (see Figure 13). Issuance started to climb in March as the coronavirus crisis led corporate treasurers to build liquidity buffers in anticipation of an uncertain future. The Federal Reserve then reacted to the crisis with an unprecedented series of measures designed to support corporate liquidity, including the purchase of corporate debt funds. With credit spreads contracting and nominal yields at historical lows, issuance continued to run at elevated levels through Q2 and into Q3, broadening from investment grade to the high yield market.

For pension plans, looking for instruments than can match long-term liabilities, one additional benefit from these market conditions has been that corporates have extended their maturity profiles – the average maturity of the Bloomberg Barclays US Corporate Index has risen by over 1.5 years since late 2018 (see Figure 14). Although we have viewed 2020 as an opportunity for careful investment, it has been with careful consideration of companies' liquidity positions, financial flexibility and looking for names that may be more insulated from wider economic events. At longer maturities, investment grade spreads have returned to long-term average levels (see Figure 15), which in our view reinforces the need for caution at this stage.

Figure 13: Gross investment grade issuance smashes previous annual highs[15]

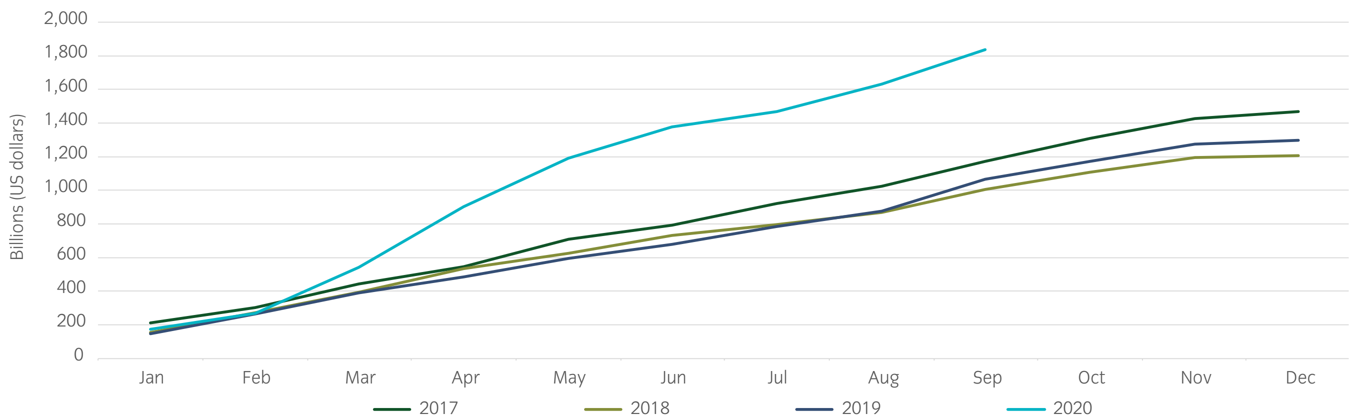
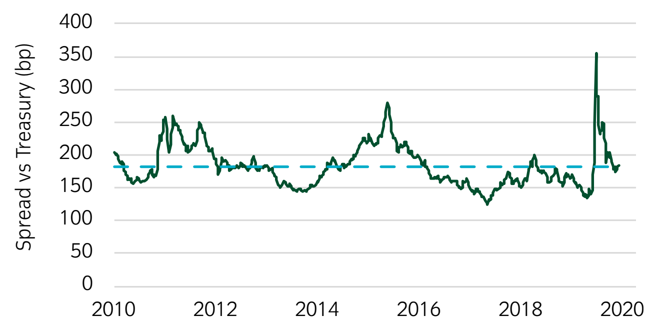


Figure 14: Issuance is being used to extend maturities[16]

Figure 15: Long maturity corporate spreads return to 10-year average levels[16]



[15] Source: Barclays. Data as of September 30, 2020.
[16] Source: Insight and Bloomberg Barclays. Data as of September 30, 2020.

Issuance breakdown

Investment grade and high yield issuance continued to grow strongly in Q3, with gross investment grade issuance in the first nine months of the year exceeding the previous annual record set in 2017.

Figure 16: New U.S. bond issuance in $billions[17]

Market	2018 total	2019 total	Q1 to Q3 2020	Yr/Yr change (%)
US Investment Grade	1,208	1,297	1,835	63.0%
US High Yield	171	263	324	84.1%

In US high yield credit, Barclays estimate that in Q3 there were no issues upgraded to investment grade, with $18.2bn of debt downgraded into the high yield bracket. New issues added $121.1bn, offset by $80.2bn in debt that was called or falling below 12 months to maturity and $8bn in defaulted debt. Demand for high yield was a small positive, with Lipper estimating that high yield mutual funds and exchange-traded funds had inflows of $3.1bn, taking inflows in the first nine months of 2020 to $34.3bn.

Credit Market Performance

Credit spreads tightened in Q3, with aggregate US corporate spreads ending the quarter 14bp tighter than where they began. The intermediate area of the credit curve outperformed marginally, tightening by 16bp. BBB-rated issues generally outperformed given more positive sentiment in credit markets.

Figure 17: Average spread (bps) of Corporate Bonds[17]

Barclays Index	09/30/19	06/30/20	09/30/20	Change Q3	Weight (%)
Corporate	115	150	136	-14	100.0%
Intermediate	88	119	103	-16	64.9%
Long	166	202	188	-14	35.1%
– Long AAA	91	111	100	-11	
– Long AA	103	139	131	-8	
– Long A	124	156	147	-9	
– Long BBB	205	249	231	-18	

STRUCTURED CREDIT: THERE'S VALUE IN COMPLEXITY

When managing liquidity pools structured credit is one potential asset that can be used, and we have created a Structured Credit Primer[18] to help investors understand these securities.

The structured credit, or asset-backed securities (ABS), market is a credit market in which the coupons and principal payments are backed by collateral. The investments typically derive their coupons and principal payments directly from underlying pools of loans. Examples of these loans can include mortgages or corporate loans which are often secured against hard assets like real estate in the event of default. The key difference between structured credit and more mainstream corporate bonds is that the latter are typically unsecured (particularly in the investment grade market) and also offer comparatively little in the way of structural protection.

Traditionally, in our view, investors expect that in order to achieve higher returns they must be comfortable with taking more risk. This assumption has been a cornerstone of portfolio theory since the original mean-variance models of the 1950s. However, structured credit may turn this assumption on its head. We have seen that ABS markets offer higher credit spreads than comparable corporate bonds with lower credit ratings. We strongly believe the main reason structured credit can frequently offer higher credit spreads for higher credit ratings is due to complexity. It is a lot more onerous for a manager to invest in structured credit, which means there are fewer eligible buyers. Lower eligible demand leads to higher credit spreads.

[17] Source: Insight and Bloomberg Barclays. Data as of September 30, 2020.
[18] https://www.insightinvestment.com/globalassets/documents/us-redesign-documents/perspectives/us-a-structured-credit-primer.pdf

MARKET OUTLOOK

RECALIBRATING TO THE NEW NORMAL

After an unprecedented fiscal stimulus and financial support program, policy makers are arguably pursuing financial suppression, financing large fiscal deficits with monetary expansion. As part of this policy bond purchase programs are likely to be used to cap any upside in longer-maturity government bond yields and to reduce Treasury volatility – this can already be seen in the MOVE Index[19], which measures US Treasury volatility and has fallen to multi year lows.

At the same time, the short end of the yield curve is likely to be anchored by the Federal Reserve who can use the increased flexibility granted to them from their new policy framework to keep monetary policy at historically easy levels for a considerable period. Indeed, although comments from the Federal Open Markets Committee suggest that interest rates will be kept at current levels, or lower, until at least 2023, we believe that it is quite possible that the first interest rate hike may not come until 2024 or beyond. A similar outlook appears true for Europe, where the European Central Bank now forecast inflation rising to just 1.3% in 2022, still well below target.

As investors recalibrate their medium and long-term outlooks, so they are re-examining previous assessments of value. A re-steepening of yield curves in recent months, for example, has led us to take a more neutral position on duration, despite long-term yields at historically low levels. In a world searching for yield, investment grade credit spreads have snapped back to their long-run averages – but there are still substantial uncertainties ahead. Careful analysis, methodical stock selection and searching for pockets of value in segments of the fixed income market are the best way to extract value in this new environment.

Figure 18: Treasury volatility falls to historical lows[20]

[19] The MOVE Index is a measure of U.S. interest rate volatility that tracks the movement in U.S. Treasury yield volatility implied by current prices of one-month over-the-counter options on 2-year, 5-year, 10-year and 30-year Treasuries.
[20] Source: Insight Investment and Bloomberg. Data as of September 30, 2020.

MARKET OUTLOOKS

Investment grade credit: With spreads in investment grade credit markets returning to longer-term average levels the outlook has become more difficult from a valuation perspective. However, the need for income is real and continues to drive demand. For many investors a basket of higher quality investment grade corporate credit, where liquidity is abundant, and where management teams have used market conditions to bolster their balance sheets such that they can survive a long period of adversity, is one of very few available options to potentially generate sufficient income within acceptable risk parameters. However, significant uncertainties remain, and this makes us believe the prospect of a further meaningful rally in spreads is limited. Given this, a focus on shorter duration issues seems a sensible way to generate incremental yield while limiting exposure to any future volatility. We continue to advocate a large degree of caution in terms of security and sector selection, focusing on high-quality issuers in defensive sectors. Elevated issuance volumes also increase the potential for opportunities to become available in primary markets.

High yield credit: The high yield market has benefited from investors insatiable demand for yield as it has become apparent that interest rates are likely to remain low for a prolonged period. Spreads have continued to tighten, and with nominal yields so low we have become more cautious as a result. In our view, the need for intensive credit work has never been so apparent. Business models need to not only demonstrate that they will survive the current downturn, but also need to have the ability to withstand a secondary lockdown. Certain segments of the economy are being disproportionately impacted, and we expect defaults to rise as a result, but focused on those companies that are most exposed. As ever, there is a need to focus on cashflow, and ensuring that companies have sufficient resources and liquidity even in a scenario where there is only a gradual recovery through 2021. The regular dialogue that we have established with management teams over time becomes critical during periods such as this, and we remain vigilant on cashflow forecasts, debt profiles, revolving credit facilities and underlying business operations.

Emerging markets: As we search for value amongst fixed income markets, we have shifted to become more tactically positive on emerging markets generally. Emerging market credit, largely denominated in US dollars, has lagged developed market credit, leading to us to become more positive on a relative basis both in investment grade and high yield, with a preference for corporate over sovereign issuance. In local rates we are selectively positive, looking for central banks that are still playing catch-up to their developed market counterparts and have the potential to ease rates further. We would avoid the longer end of yield curves however, as we worry about deteriorating fiscal outlooks and the still unproven use of quantitative easing in emerging market economies. We also remain cautious on emerging market currencies for now but would look for signs from major currency markets, particularly in regard to the US dollar, as a catalyst to begin to build larger exposures.

Structured credit: We continue to focus on higher-quality assets with greater liquidity as the credit enhancements within these structures are substantial, which should mitigate the impact of any underlying loan defaults. We are not overly concerned about defaults in the short term, as the low level of interest rates and extensive government measures introduced to support households and corporates is likely to limit the economic pain. In the longer term, a material and sustained increase in unemployment and reduction in earnings is necessary for consumer delinquencies to rise, which would likely require the recession to be significantly longer than we currently expect. In contrast to corporate credit markets, supply has not materially increased, with issuers largely stepping back from markets until broader volatility subsided. As stability has returned, the pipeline of future issuance is starting to pick up, which could lead to some opportunities in primary markets later in the year. The strong technical backdrop through the coronavirus crisis has reinforced our view of the asset class as fundamentally defensive in nature.

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We continue to advocate a large degree of caution in terms of security and sector selection, focusing on high-quality issuers in defensive sectors

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KEY MARKET RISKS

THE ELECTION RESULT IS DIFFICULT TO ESTIMATE

On November 3, the US is holding elections for the Presidency, 35 Senate seats, the entire House of Representatives, and numerous elections at state and local level. Our current expectation is that the Democrats are highly likely to retain control of the House of Representatives but would need to win the popular vote by at least 8% to take control of the Senate. If President Trump wins a second term, he will thus likely face a divided congress.

We would expect a second term Trump Presidency to maintain a loose fiscal stance, with a focus on infrastructure spending as the most likely policy able to garner sufficient bipartisan support. Trade policy is an area we would expect to remain as a major focus given the significant powers the President has on this issue, and a re-escalation of the China trade war or a pivot towards Europe seem likely, especially if Europe continues to push forward with digital taxes.

If the Democrats win the Presidency, Joe Biden has proposed around $4.5 trillion in new spending plans, partly funded by a $3.8 trillion increase in taxation. Whether an incoming President Biden can actually implement any of these plans will depend on whether the Democrats can take control of the Senate, or at least reduce the Republican majority to a marginal one. If the Republicans retain sufficient control, we believe that contractionary policies will find an easier path than expansionary ones, potentially a negative for growth in the years following the election.

Critically, it is a distinct possibility that the Senate majority will not be known for months after the election, which could prolong the uncertainty. The Democrats need to win three seats to take the Senate to a 50-50 seat tie, allowing the Vice President to break tied votes. One of these three seats is likely to be Georgia, where if no candidate wins at least 50.001% of the vote, a runoff is held on January 5.

For markets, the election result could be significant given the divergence in tax plans between parties. The Democrats plan to raise the corporate tax rate from 21% to 28%, and to double the tax on income derived from global intangibles to 21% from 10.5%. A new bank liabilities tax is also proposed for banks with more than $50bn in assets to raise $300bn. The outlook for corporate profits could thus vary significantly dependent on who wins, and whether they win by a sufficient margin to implement their plans in full. It is difficult to estimate how much of this is priced into markets at this stage.

BREXIT RETURNS AS A POTENTIAL FLASHPOINT IN EUROPE

The UK withdrew from the European Union (EU) on January 31, 2020 and entered a transition period, during which the two sides were supposed to agree their future relationship. The transition period ends on December 31, 2020. With the relationship between the two sides increasingly strained, it now appears that the range of potential scenarios for this future relationship have narrowed. Of the four main scenarios we had as possible, a bare-bones deal or no deal are now the two that appear most likely. We have never anticipated a smooth path to a deal; both sides need to be able to claim a victory when any final compromise is agreed, but it now appears that a comprehensive free trade agreement is out of reach. This leaves a bare-bones free trade agreement at best. Forecasting the short-run economic impact of no-deal is tricky given few precedents and the uncertain parameters of the scenario, but there is a risk of market dislocations in Europe which could potentially have global consequences.

EDUCATIONAL: NEOFISCALISM

The neoliberal policy paradigm of smaller-government involvement in the economy is under threat. Longer-term trends were already moving in this direction, but emergency policies implemented to deal with the COVID-19 crisis have created a potential tipping point. A new paradigm of big government could have begun, which we are calling Neofiscalism. If we are correct, then Neofiscalism could last for decades just as neoliberalism and Keynesian fiscalism did.

Five ways we think Neofiscalism could impact markets:

1. Yields are likely to remain low by historical standards
2. Inflation could trigger spikes in bond yields if it causes quantitative easing to be tapered
3. For sovereigns without full control over the currency they issue in, government effectiveness could be key
4. Identifying governments able to maximize trend growth is likely to become important for equity markets
5. Corporates with state support could have an advantage during funding droughts

FURTHER READING

For more detail on this subject, please see our paper: Global Macro Research: Neofiscalism

FIND OUT MORE

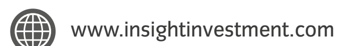
Insight Investment
200 Park Avenue, 7th Floor
New York, NY 10166
212-527-1800

Client Relationship Management
institutionalna@insightinvestment.com

Consultant Relationship Management
consultantsna@insightinvestment.com

@InsightInvestUS

company/insight-investment-north-america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