US PENSION MARKET

A statistical and qualitative review of Q3 2021 and investment outlook

At the annual Jackson Hole Economic Policy Symposium, Federal Reserve Chair Jerome Powell noted that, in his view, the “substantial further progress” test had been met for inflation, and “clear progress” had been made towards the goal of maximum employment. The Federal Open Markets Committee (FOMC) had previously indicated that “substantial further progress” would be necessary on the Federal Reserve’s dual mandate on price stability and employment. This was followed by a statement following the FOMC’s September meeting that “moderation in the pace of asset purchases may soon be warranted.”

The FOMC now faces a tricky balancing act. Members clearly want to signal a more hawkish tone, and to reduce the excess liquidity that has flooded the system. However, with Treasury supply expected to remain elevated for years to come, any reduction in Treasury purchases will require markets to absorb a greater proportion of supply. Periodic bouts of volatility could accompany any variations in market demand and require a rapid tempering of policy tone.

At Insight, although we acknowledge the ‘taper talk’ and speculation of early interest rates rises, we believe there is unlikely to be any dramatic reversion to historical norms. The level of debt in most economies will make it extremely difficult for central banks to escape the era of low yields that they have created. As Morpheus said to Neo in the Matrix, “there is a difference between knowing the path and walking the path”.

- Elevated levels of inflation give the more hawkish members of the FOMC a greater voice for now, but we don’t believe this will last, with the eventual ‘lift-off’ likely to be slow
- In pension news, we note some of the pension-related proposals within the Reconciliation bill, and highlight the Department of Labor’s FAQ on lifetime income rules
- In credit, we look at the outlook for credit spreads and examine two historical scenarios: In 2004, spreads were low but trended sideways for a significant period, whereas in 2007 spreads widened dramatically from compressed levels
- In our market outlook, we highlight the potential peak in delta variant cases, and examine why we believe the market risks from a withdrawal of quantitative easing are small
- Key risks include stickier than expected inflation, forcing a more disruptive response from the Fed, and pressure on corporates to increase leverage in the low-yield environment, leading to credit downgrades and greater financial risk
- In our educational section we highlight our latest Global Macro Research paper – Desynchronizing recoveries, where we assess the differentiated pace of economic recovery as the world emerges from pandemic-induced recession

1 https://www.federalreserve.gov/newsevents/speech/powell20210827a.htm

There is a difference between knowing the path and walking the path

With the FOMC shifting towards a more hawkish position, we look at some of the factors that could sway the policy tone in the months ahead.

Elevated levels of inflation support the hawks for now
With inflation breaching 5% and GDP returning to its pre-pandemic trend more quickly than expected, it is unsurprising that some members of the FOMC feel the need to take a hawkish tone. However, inflation has so far been dominated by ‘volatile’ rather than ‘sticky’ categories, underpinning our view that inflation will struggle to remain at such an elevated level. Some of the more volatile price items have already started to normalize. Used car prices for example, a significant driver of inflation in recent months, declined by 1.5% month on month in August, while hotel prices declined by 3.3%. Owners’ equivalent rent, which makes up over 20% of the inflation basket, has failed to gain any meaningful momentum through this period.

If inflation does moderate as we expect in 2022, it would remove pressure from FOMC members. Mitigating this somewhat, however, substantial further progress is likely in the labor market, with unemployment down towards 4% to 4.5% by year-end. This is likely to prove sufficient to meet the Fed’s threshold to start tapering its bond purchase program.

Delta variant adds to the doves’ argument but cases appear to be peaking
The resurgence of cases in the form of the more contagious delta variant has strengthened the argument of the doves, as it exacerbates the downside risks to the recovery. Although the vaccine rollout has dramatically reduced the probability of renewed large-scale restrictions, the rises in cases has slowed the pace of economic growth in the third quarter, and negatively impacted consumer confidence. As a result, economic activity has gone from consistently and substantially outperforming expectations, to significantly undershooting them (see Figure 2). Ultimately, uncertainty regarding the pace of recovery makes it less compelling to tighten policy. This argument is likely to lose traction if cases peak and the recovery regains momentum.

Figure 1: The key drivers of the recent acceleration in inflation have already started to moderate

If inflation does moderate as we expect in 2022, it would remove pressure from FOMC members. Mitigating this somewhat, however, substantial further progress is likely in the labor market, with unemployment down towards 4% to 4.5% by year-end. This is likely to prove sufficient to meet the Fed’s threshold to start tapering its bond purchase program.

Delta variant adds to the doves’ argument but cases appear to be peaking
The resurgence of cases in the form of the more contagious delta variant has strengthened the argument of the doves, as it exacerbates the downside risks to the recovery. Although the vaccine rollout has dramatically reduced the probability of renewed large-scale restrictions, the rises in cases has slowed the pace of economic growth in the third quarter, and negatively impacted consumer confidence. As a result, economic activity has gone from consistently and substantially outperforming expectations, to significantly undershooting them (see Figure 2). Ultimately, uncertainty regarding the pace of recovery makes it less compelling to tighten policy. This argument is likely to lose traction if cases peak and the recovery regains momentum.

Figure 2: Economic data continues to be strong, but is no longer outperforming expectations

There is no rush to tighten but longer yields could drift upwards
These counteracting forces of elevated levels of inflation and economic softness related to the delta variant are likely to slowly unwind in the months ahead. Despite the discord between hawkish regional Presidents and the rest of the committee, we do not think the FOMC will rush to meaningfully tighten policy against this backdrop. We expect the Fed to announce its plan to ‘taper’ its asset purchases in November this year and to then implement this policy over 2022, with the first rate-hike to potentially follow in 2023. Although Fed policy should help to anchor longer Treasury yields, the recent rally has taken them towards the lower end of their recent trading range. This leaves us more cautious on a valuation basis, and we anticipate an upward bias to yields into the end of the year.

2 Source: Insight and Bloomberg, data as of September 30, 2021 3 Source: Insight and Bloomberg, data as of September 30, 2021
PENSION TRENDS

PENSION FUNDED STATUS UPDATE

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.

The Large Company Aggregate Pension (LCAP) Index aims to represent an asset weighted average of allocations held by S&P 500 companies’ plans. The Traditional Pension Index aims to index reflect those plans that have not yet adopted LDI. The LDI Pension Index aims to reflect those plans that have adopted LDI in the fixed income portion of their portfolio.

Rates rose by 3bp over the quarter and spreads widened by 1bp, resulting in a 4bp rise in discount rates. Growth assets increased by 0.6%.

All three of our pension indices saw their funded status improve by 0.3% over Q3, with all three having a roughly 10% improvement year to date. The Traditional index, which has a zero weight in long duration fixed income, saw its funded status increase to 93.8%, while the LDI and LCAP indices, which contain long duration fixed income, saw improvements in funded status to 102.3% and 100.2% respectively.

Figure 3: Plan funded status continued to improve over the quarter

4 Source: Insight and Bloomberg. Data as of September 30, 2021. 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.
New York state pension plan reviews investments on climate concerns
The third largest public US pension plan has announced that it will review its 42 holdings in shale oil and gas companies to determine if they are preparing for the transition to a low-carbon economy. After this review is complete they will shift to focus on oil and gas pipeline and processing investments.

Aon-Willis Towers Watson merger plan ended on US regulatory impasse
The US Department of Justice filed a civil antitrust lawsuit to block the merger of Aon and Willis Towers Watson on concerns that the combined group would pose a threat to competition and result in increased costs. Plans to divest segments of the two businesses were not sufficient to address US concerns, and the deal was called off after an expedited resolution to the US litigation proved impossible.

Department of Labor issue FAQ on lifetime income rules
In September 2020, the Labor Department issued an interim final rule (IFR) laying out how plan sponsors should convert member plan assets into an estimated monthly income after the members retirement. After soliciting public comments on the IFR, there were a number of requests for clarification on the effective date of the IFR and the way that statements should be delivered. In July 2021 an FAQ was published providing clarification on a number of key issues.

Reconciliation bill contains various pension related proposals
• Requirement for businesses that have been operating for more than two years and with more than five employees to automatically enroll their works in a pension plan, with a tax credit to offset administrative costs.
• SAVERS credit is to be expanded and made refundable so that it would become possible for those who don’t pay federal tax to qualify for the benefit.
• A contribution limit could be introduced for high earners with pension account balances in excess of $10m.

Special assistance for multiemployer plans
The Pension Benefit Guaranty Corporation (PBGC) announced an interim final rule setting forth the requirements for special financial assistance applications and related restrictions and conditions under the American Rescue Plan Act of 2021. Lunched in July, the deadline for comments was August 11, with all comments to be posted on the PBGC website (www.pbgc.gov). The rule also identifies which plans will be given priority to file applications before March 11, 2023. Insight provided a response to the PBGC as part of this process.

KEY MARKET MOVEMENTS: Q3 2021

Treasury yields out to 12 years in maturity rose over the quarter, but the yields of maturities beyond 12 years declined, leading to a flatter yield curve.

Corporate credit spreads marginally widened, with long-maturity BBB-rated issuers outperforming given the still positive economic outlook.

US equity markets edged higher, with a decline into quarter end eroding earlier gains. Solid earnings growth was counterbalanced by concerns about a peak in growth and potential for tighter monetary policy.

The US dollar, as measured by the dollar index, appreciated over the quarter.

Figure 4: Q3 2021 Fixed Income/Equity Index Returns (%) and Volatility Index Levels

<table>
<thead>
<tr>
<th>Index</th>
<th>Q3 2021 total return</th>
<th>YTD 2021 total return</th>
<th>Q3 2021 excess return</th>
<th>YTD 2021 excess return</th>
</tr>
</thead>
<tbody>
<tr>
<td>Barclays Treasury</td>
<td>0.09</td>
<td>-2.50</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Barclays Intermediate Treasury</td>
<td>-0.01</td>
<td>-1.15</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Barclays Long Treasury</td>
<td>0.47</td>
<td>-7.49</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Barclays Corporate</td>
<td>0.00</td>
<td>-1.27</td>
<td>-0.09</td>
<td>1.23</td>
</tr>
<tr>
<td>Barclays Intermediate Corporate</td>
<td>0.08</td>
<td>-0.44</td>
<td>0.08</td>
<td>0.71</td>
</tr>
<tr>
<td>Barclays Long Corporate</td>
<td>-0.12</td>
<td>-2.56</td>
<td>-0.59</td>
<td>4.93</td>
</tr>
<tr>
<td>BoFA Merrill Lynch High Yield</td>
<td>0.94</td>
<td>4.67</td>
<td>0.85</td>
<td>7.17</td>
</tr>
<tr>
<td>S&amp;P 500 Index</td>
<td>0.58</td>
<td>15.92</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>MSCI Emerging Markets Equity Index</td>
<td>-8.09</td>
<td>-1.25</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>VIX</td>
<td>23</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>MOVE</td>
<td>61</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
</tbody>
</table>

Source: Barclays and Bloomberg. Data as of September 30, 2021. VIX and MOVE are actual value at month end.

ECONOMICS: DIVERGING ECONOMIC OUTLOOKS

Forecasts for global growth softened slightly in Q3 as the delta variant negatively impacted activity in the US and Asia, although forecasts increased for growth in the eurozone and emerging markets as a whole. In the US, sectors such as hospitality and leisure have frozen employment plans, at least in the short term, causing the consensus forecast for US growth to drop to 5.9%, 0.7% lower than at the end of Q2.

Notably, inflation forecasts continued to move higher, again driven by the US. Higher commodity prices, bottlenecks in key sectors and a global semiconductor shortage have combined to boost inflation in 2021. In line with our view, inflation is then expected to moderate in 2022 but to remain above central bank targets in the UK and the US.

Figure 5: Consensus GDP and CPI expectations

<table>
<thead>
<tr>
<th>Real GDP</th>
<th>Consensus*</th>
<th>Change over Q3</th>
<th>CPI</th>
<th>Consensus*</th>
<th>Change over Q3</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2020</td>
<td>2021*</td>
<td>2022*</td>
<td>2020</td>
<td>2021*</td>
</tr>
<tr>
<td>United States</td>
<td>-3.5</td>
<td>5.9</td>
<td>4.2</td>
<td>1.3</td>
<td>4.3</td>
</tr>
<tr>
<td>Euro area</td>
<td>-6.8</td>
<td>5.0</td>
<td>4.3</td>
<td>0.3</td>
<td>2.2</td>
</tr>
<tr>
<td>Japan</td>
<td>-4.8</td>
<td>2.4</td>
<td>2.5</td>
<td>0.0</td>
<td>-0.2</td>
</tr>
<tr>
<td>China</td>
<td>2.3</td>
<td>8.4</td>
<td>5.5</td>
<td>2.5</td>
<td>1.2</td>
</tr>
<tr>
<td>Developed markets</td>
<td>-4.8</td>
<td>5.2</td>
<td>4.0</td>
<td>1.0</td>
<td>3.1</td>
</tr>
<tr>
<td>Emerging markets</td>
<td>-0.6</td>
<td>6.5</td>
<td>5.2</td>
<td>3.2</td>
<td>3.4</td>
</tr>
<tr>
<td>Global</td>
<td>-3.7</td>
<td>5.9</td>
<td>4.5</td>
<td>2.2</td>
<td>3.5</td>
</tr>
</tbody>
</table>

LIBOR tough legacy contract fix passed
The Adjustable Interest Rate (LIBOR) Act of 2021\(^\text{12}\) will allow contracts that reference LIBOR but don’t have adequate fallback provisions to be moved to reference the Secured Overnight Financing Rate (SOFR) once LIBOR ceases to be published, without the need to change the contract.

TREASURY MARKETS
The yield curve flattened with longer maturities outperforming
The Treasury yield curve flattened over the quarter. In shorter maturities yields rose, reflecting speculation around early rate hikes, but yields in longer maturities declined on concerns around a peak in growth. The 2-year maturity Treasury yield rose by 2bp, the 10-year maturity Treasury yield rose by 3bp and the 30-year maturity Treasury yield declined by 5bp.

Tax receipts surge as the economy recovers
At its August 2021 presentation, the US Treasury Borrowing Advisory Committee estimated that tax receipts in the first three quarters of the financial year were up by $796bn (+35%) year over year. Total outlays increased by $290bn (+6%) over the same period.

It was noted that the Treasury had completed its internal review of a SOFR-indexed FRN and will now consider whether such an instrument is necessary to meet borrowing needs.

The Bipartisan Budget Act of 2019 suspended the debt limit through July 31, 2021, with the Treasury required to use extraordinary temporary measures for financing beyond that date. It was noted that there was “considerable uncertainty” as to how long the use of these extraordinary measures would last.

The debt ceiling could weigh on market nerves
The Senate has passed a bill which will raise the debt ceiling by $480bn, pushing out the date at which the Treasury could theoretically be forced to default from mid-October to December 3. However, with the use of “extraordinary measures,” the true deadline is likely not until late January or February. Although this averts the problem in the short term, it merely pushes it out by a few months. Democrats could amend the budget resolution and raise the debt ceiling in a party-line vote, but this would take time and is controversial. As the implications are severe, we believe that politicians will ultimately agree to raise the debt ceiling on a sustained basis, but it appears that we could see further periods of brinksmanship, potentially fraying nerves in the months ahead.

Assessing the outlook for credit spreads
With credit spreads close to historical lows, some investors are cautious, looking for spreads to widen. We look at history to try and judge whether we are closer to a scenario that resembles 2004 (where spreads remained compressed for a prolonged period) or 2007 (where spreads widened dramatically).

Figure 8: Will spreads trend more like 2004’s tightening or 2007’s widening?15

1. The policy environment
The Fed’s QE programs (which began in 2008) have changed credit market dynamics, essentially reducing the purchasable supply of financial assets and in doing so creating upward pricing pressure across all asset classes. Since the pandemic, these purchases have accelerated, creating a ‘wall of money’ supporting bond markets. Since 2020, the Fed has expanded its bond holdings by $4.1 trillion, over $1 trillion more than the net volume of bonds created in the Bloomberg US Aggregate Index over the same period (Figure 9).

Figure 9: The Fed’s ‘wall of money’ has outpaced growth in bond issuance16

2. The corporate environment
At the height of the pandemic, corporates rushed to raise liquidity and term out debt. This, alongside other factors such as fiscal stimulus, helped contain corporate bankruptcies in 2020 and had generally left corporate issuers cash rich relative to history.

3. The economic environment
As the US economy reopens, it is progressing into what appears to be a 2004-style ‘mid cycle’ phase of the expansion rather than the late-cycle 2007. GDP growth is currently being driven by the consumer, a result of pent up savings and demand. We expect growth to continue into 2022 driven increasingly by public and private sector investment, a result of fiscal stimulus and rising corporate R&D. We also believe we still have some way to go before we reach the ‘late’ cycle. Several areas of the economy still need to recover, such as retail inventories, exports and employment.

Fundamentals suggest we may be closer to 2004 than 2007
When accounting for the current economic cycle, monetary policy and corporate fundamentals, it appears that we are closer to 2004 than 2007, meaning spreads potentially have more room to run. Against this backdrop we believe investors need to retain a core allocation to investment grade credit to take advantage of the higher income available. However, we also believe that investors need to take into account the variable impact of the pandemic between sectors. Housing, autos and related sectors such as durable goods have outperformed their pre-crisis trend levels, a product of the large ‘echo boomer’ contingent of the millennial generation taking the opportunity to buy houses in the suburbs. Although demographics and a recent history of depressed housing construction may mean continued support to the market, investors may wish to begin exercising caution within these sectors, paying close attention to security selection.

From a technical perspective, as pension liabilities shorten (with corporate DB plans increasingly closed to new members), pension investments are likely to shift towards slightly lower-duration assets, supporting the intermediate section of the corporate bond curve. This trend may also support other lower duration fixed income sectors, such as high yield credit and structured credit.

15 Source: Bloomberg. 16 Source: Federal Reserve, Barclays, August 31, 2021.
Issuance breakdown
After a record year for issuance in 2020, gross US investment grade issuance moderated in the first nine months of 2021, but remained at historically elevated levels as corporates locked in low funding rates. Issuance in US high yield has also been strong, running ahead of the same period in 2020 as non-traditional investors have looked to high yield issuance as a way to enhance income in the low yield environment.

Figure 10: New US bond issuance in $billions

<table>
<thead>
<tr>
<th>Market</th>
<th>2019 total</th>
<th>2020 total</th>
<th>2021 YTD</th>
<th>Yr/Yr change (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>US Investment Grade</td>
<td>1,297</td>
<td>2,102</td>
<td>1,355</td>
<td>-21.5%</td>
</tr>
<tr>
<td>US High Yield</td>
<td>263</td>
<td>418</td>
<td>393</td>
<td>24.1%</td>
</tr>
</tbody>
</table>

Figure 11: High yield issuance breakdown in $billions

<table>
<thead>
<tr>
<th>Market</th>
<th>2020</th>
<th>Q3</th>
<th>YTD</th>
</tr>
</thead>
<tbody>
<tr>
<td>New issuance</td>
<td>418</td>
<td>109</td>
<td>385</td>
</tr>
<tr>
<td>Downgraded to high yield</td>
<td>201</td>
<td>8</td>
<td>10</td>
</tr>
<tr>
<td>Called or falling below 12mths</td>
<td>256</td>
<td>91</td>
<td>271</td>
</tr>
<tr>
<td>Upgraded to investment grade</td>
<td>25</td>
<td>14</td>
<td>35</td>
</tr>
<tr>
<td>Defaults</td>
<td>57</td>
<td>1</td>
<td>2</td>
</tr>
</tbody>
</table>

Credit market performance
Credit spreads widened in Q3, with aggregate US corporate spreads ending the quarter 4bp wider than where they began. The intermediate part of the credit curve outperformed, widening by 2bp. At the long-end, BBB-rated issues marginally outperformed, widening by 5bp.

Figure 12: Average spread (bp) of corporate bonds

<table>
<thead>
<tr>
<th>Barclays Index</th>
<th>09/30/20</th>
<th>06/30/21</th>
<th>09/30/21</th>
<th>Change Q3 2021</th>
<th>Weight (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Corporate</td>
<td>136</td>
<td>80</td>
<td>84</td>
<td>4</td>
<td>100.0%</td>
</tr>
<tr>
<td>Intermediate</td>
<td>103</td>
<td>58</td>
<td>60</td>
<td>2</td>
<td>61.9%</td>
</tr>
<tr>
<td>Long</td>
<td>188</td>
<td>117</td>
<td>122</td>
<td>5</td>
<td>38.1%</td>
</tr>
<tr>
<td>– Long AAA</td>
<td>100</td>
<td>60</td>
<td>66</td>
<td>7</td>
<td></td>
</tr>
<tr>
<td>– Long AA</td>
<td>131</td>
<td>79</td>
<td>84</td>
<td>5</td>
<td></td>
</tr>
<tr>
<td>– Long A</td>
<td>147</td>
<td>91</td>
<td>97</td>
<td>6</td>
<td></td>
</tr>
<tr>
<td>– Long BBB</td>
<td>231</td>
<td>141</td>
<td>146</td>
<td>5</td>
<td></td>
</tr>
</tbody>
</table>

MARKET OUTLOOK

A DELTA PEAK COULD PROVIDE RELIEF FOR SOME SECTORS INTO YEAR END
Although the high level of vaccinations has kept the level of hospitalizations and death rates from the delta variant well below previous highs, the surge in cases has impacted confidence and negatively impacted third quarter growth. Hiring in the leisure and hospitality sector came to an abrupt halt, with restaurant hiring going into reverse as businesses reacted to the rapid rise in cases.

A number of states also reintroduced mandatory mask wearing. If the delta wave has peaked and case numbers start to decline, then it could be positive news for growth into the end of 2021 and for those sectors that are best positioned to benefit from further reopening.

Figure 13: The delta wave appears to be peaking

17, 18 Source: Barclays research. Data as of September 30, 2021.
20 Source: Insight and Bloomberg, as of September 30, 2021.
The unprecedented pace of the Federal Reserve’s balance sheet growth has sparked concerns this policy could create significant inflation or that tapering could spark significant, sustained market volatility. Given the mechanisms of the Fed’s asset purchase programs, we don’t believe this is very likely.

The Fed conducts QE by buying Treasuries and MBS from its 24 primary dealers and depositing newly created cash in their Federal Reserve Account. While money is longer literally “printed,” these funds are new money, in the form of accounting entry on the Federal Reserve’s ledger. This is why the Fed’s asset growth is coupled by growth in its liabilities, namely cash held at the central bank, by banks, the Treasury Department, or money market funds (in the form of reverse repurchase agreements). As you can see in the chart below, the Fed’s asset growth has largely been offset by increased cash holdings at the Fed. As such, of the $4.27 trillion of cash created since the end of 2019, just $600 billion has exited the Fed.

In essence, the majority of the QE program is an accounting exercise where a liability of the Federal Government (Treasury bonds) is exchanged for a liability of the Federal Reserve (reserves). Because of this, only a fraction of the Fed’s QE is cash that actually hits the real economy or financial markets. So, it is unlikely to be the primary driver of either inflation or market appreciation, which is why over time, we do not expect a tapering of purchases to cause undue market volatility. To the extent policy has contributed to elevated inflation, it has likely been fiscal policy (i.e. stimulus checks) not monetary policy that is the primary culprit.

Theoretically, if inflation were to stay appreciably higher, the Fed may want to reduce the size of its balance sheet. Given it has several hundred billion in 2022, 2023, and 2024 maturities, it could do so by simply not reinvesting principal and still reduce its balance sheet materially. If it chose to also sell maturities to shrink its balance sheet even faster, it could theoretically erode its capital. This does not in and of itself hinder the Fed’s ability to operate, rather it means that the Fed permanently increased the money supply. QE is a temporary increase in the money supply because the Fed can retire the cash when its Treasury or MBS bond matures. If however the Fed buys a Treasury at $100 and sells it at $97, $3 of money has been permanently created.

In practice, the primary implication of a negative equity position would be that the transfers to the Treasury Department, which totalled $88 billion last year, would stop until the Fed has rebuilt its capital position. Therefore, the largest consequence would be a larger federal deficit, though Fed transfers generally accounts for less than 3% to 4% of federal revenue.

The Fed’s QE program has proven to be an important part of its policy toolkit, helping to alleviate liquidity challenges, and signal its intent to maintain accommodative policy for a prolonged period of time. By purchasing Treasuries that would otherwise have to be purchased by the private sector, QE likely reduces long-term yields, so if the Fed were to reduce its balance sheet that would likely increase yields. This is one reason we do not expect balance sheet reduction for several years. QE also impacts markets by signalling the Fed’s intent.

This was particularly true in March 2020 when the Fed announced it would buy corporate bonds. This simple announcement put a floor beneath the market, sparking a rally, which meant the Fed did not actually need to buy much paper to improve financing conditions. Knowing the Fed is prepared to step in during severe sell-offs is still benefitting US credit and may be contributing to its resilience during periods of volatility. While no policy is without risk, we believe the risks of the Fed’s QE policy over the past 18 months to financial stability are relatively modest.

---

**MARKET OUTLOOKS**

**Investment grade credit**: Although we acknowledge the positive technical backdrop for investment grade credit, we remain cautious from a valuation perspective, as spreads have tightened to levels that appear expensive in a historical context. Counterbalancing these valuation concerns are the size of the US fiscal stimulus package and successful rollout of vaccinations, which should reduce the need for future lockdown measures to control the virus. We believe monetary policy should remain anchored for now, with central banks unlikely to raise interest rates and risk derailing the recovery in the near term until output gaps are fully closed. This backdrop should sustain demand for credit as investors seek ways to add incremental yield. Many corporates have used the low level of interest rates to lock in funding, reducing financing risk in the years ahead. We continue to advocate a large degree of caution in terms of security and sector selection and are searching for opportunities in sectors that are best positioned to benefit from the ongoing recovery. With cases of the delta variant appearing to be peaking we are also searching for opportunities where a lockdown risk premium is still available in spreads.

**High yield credit**: The high yield market continues to be supported by a very strong technical backdrop. Demand is benefiting from the low yield environment, which is likely to persist for a considerable period yet, with non-traditional high yield investors moving into primarily BB-rated credit to enhance their income. Although we have some concerns about the level of nominal yields, which leave little buffer to protect against defaults, actual default rates have continued to decline, and the low number of distressed bonds suggests there is little reason to believe this trend will change for now. Supply has increased in the US and is notably above the levels seen over the same period in 2020, with European supply also starting to pickup. The need for intensive credit work remains, with companies needing robust business models and to have sufficient resources and liquidity to deal with differentiated economic recoveries across countries and regions, especially as a lot of companies are starting to see rising input and labor costs. The regular dialog that we have established with management teams over time is critical when making such assessments, and we remain vigilant on cashflow forecasts, debt profiles, revolving credit facilities and underlying business operations. We continue to be cautious on CCC rated credits but have been selectively looking for opportunities in the subordinated debt of stronger credits.

**Emerging markets**: We continue to have a constructive outlook for emerging markets and believe attractive valuations and the ongoing economic recovery should insulate the asset class from a gradual removal of US monetary stimulus. We have become somewhat more cautious on Asia given financial difficulties faced by Chinese property group Evergrande, as there is a risk that it could reduce confidence in other Chinese issuers. The region has also been more heavily impacted by the spread of the Delta variant, with measures to control the virus slowing consumption. We continue to believe that emerging market credit, largely denominated in US dollars, should benefit from the search for yield, but we have become more neutral on investment grade credit as valuations have tightened. We remain broadly positive on both corporate and sovereign high yield issuers. In local rates, we have a neutral outlook but targeting pockets of value where positive real yields are available. We remain cautiously positive emerging market currencies, favoring those where positive carry and appealing valuations combine.

**Structured credit**: A robust economic recovery, led by the US, has led to a positive backdrop for structured credit markets, especially those focused on consumer debt. US consumers have continued to de-leverage, leading to low levels of delinquencies and accelerated payment rates for sectors such as autos. A strong labor market and the extension of federal student loan forbearance until January 2022 has provided additional support for consumers. Strong gains in house prices across several markets including the US and UK have supported mortgage backed securities. We continue to believe this is an attractive environment for new issues and anticipate that we will be an active participant over the rest of the year. In our view structured credit is an attractive asset class for long-term investors, with complexity resulting in a structural spread premium to corporate debt, despite arguably stronger credit fundamentals. The credit enhancements within higher rated tranches are substantial, mitigating against the impact of underlying loan defaults.

**Municipal bonds**: The backdrop for municipal bonds continues to be positive, supported by the strong economic recovery and the focus on federal infrastructure as a way to sustain economic momentum. This should allow states and local governments to reduce deferred spending on capital projects, bolstering their balance sheets, while increased federal aid could reduce deficits. Issuance has been elevated so far in 2021, and taxable muni issuance remains a notable proportion of supply at around 25%. Those states most impacted by the delta variant underperformed in the third quarter, potentially presenting an opportunity if the delta wave is peaking, although there will also be some fiscal drag due to the impact on growth.
Inflation proves stickier than anticipated, forcing a more disruptive response from the Fed

Although we believe that inflation will prove to be transitory, there is a risk that it proves more sustained. For example, the New York Fed’s Underlying Inflation Gauge (UIG), which is designed to capture sustained inflationary pressures, ignoring transitory factors, has risen to the highest level since the series began in 1995. Historically, this has been a good indication that inflationary pressures will broaden. If this proves to be the case, it could trigger a more rapid tightening of monetary policy than we expect, with potentially disruptive consequences for financial markets.

Pressure to increase leverage leads to credit downgrades

With yields at historically low levels there could be growing pressure on some corporates to increase leverage. Corporate leverage has already increased over recent years as a result of M&A activity and share buybacks, but a desire to maintain investment grade status has constrained this to a degree. In an environment where abundant demand makes corporate treasurers and investors believe that credit ratings are no longer so important, it could lead to a further rise in leverage and corresponding downward shift in credit ratings.

Valuations have already priced too much good news

After an extensive rally as markets priced in the more optimistic outlook, investment grade credit spreads have returned to pre-crisis levels similar to those seen before the crisis began. There is a risk that the rally has left credit markets pricing in too much good news and that future demand is softer than currently expected, leading to a widening of credit spreads.

EDUCATIONAL: DESYNCHRONIZING RECOVERIES

As COVID-19 spread across the world, countries quickly moved into lockdown, triggering a synchronized global recession. The rollout of vaccination programs and varying impact of the pandemic across countries and regions means that not all economies are recovering at the same pace. Some may never return to their pre-pandemic trend.

Against this backdrop, market pricing of future interest rates appears to have dislocated from the underlying fundamental outlook in some economies. This is an environment that can present opportunities for investors able to analyze these desynchronizing recoveries.

- Access to vaccinations has been uneven, with large developed markets at an advantage
- Most governments embarked on fiscal easing, but the size and duration of the stimulus varies, potentially creating considerable fiscal divergence between countries
- The depth of recession has also been differentiated, with some countries needing to recover significantly more lost GDP
- We analyze interest rate pricing across markets to gauge those out of synch with fundamentals

FURTHER READING

For more detail on this subject, please see our paper: Desynchronizing recoveries.22

IMPORTANT DISCLOSURES
This document has been prepared by Insight North America LLC (INA), a registered investment adviser under the Investment Advisers Act of 1940 and regulated by the US Securities and Exchange Commission. INA is part of “Insight” or “Insight Investment”, the corporate brand for certain asset management companies operated by Insight Investment Management Limited including, among others, Insight Investment Management (Global) Limited, Insight Investment International Limited and Insight Investment Management (Europe) Limited (IIIMEL).

Opinions expressed herein are current opinions of Insight, and are subject to change without notice. Insight assumes no responsibility to update such information or to notify a client of any changes. Any outlooks, forecasts or portfolio weightings presented herein are as of the date appearing on this material only and are also subject to change without notice. Insight disclaims any responsibility to update such views. No forecasts can be guaranteed.

Nothing in this document is intended to constitute an offer or solicitation to sell or a solicitation of an offer to buy any product or service (nor shall any product or service be offered or sold to any person) in any jurisdiction in which either (a) INA is not licensed to conduct business, and/or (b) an offer, solicitation, purchase or sale would be unavailable or unlawful.

This document should not be duplicated, amended, or forwarded to a third party without consent from INA. This is a marketing document intended for institutional investors only and should not be made available to or relied upon by retail investors. This material is provided for general information only and should not be construed as investment advice or a recommendation. You should consult with your adviser to determine whether any particular investment strategy is appropriate.

Assets under management (AUM) represented by the value of the client’s assets or liabilities Insight is asked to manage. These will primarily be the mark-to-market value of securities managed on behalf of clients, including collateral if applicable. Where a client mandate requires Insight to manage some or all of a client’s liabilities (e.g. LDI strategies), AUM will be equal to the value of the client specific liability benchmark and/or the notional value of other risk exposure through the use of derivatives. Regulatory assets under management without exposures can be provided upon request. Unless otherwise specified, the performance shown herein is that of Insight Investment (for Global Investment Performance Standards (GIPS), the “firm”) and not specifically of Insight North America. A copy of the GIPS composite disclosure page is available upon request.

Past performance is not a guide to future performance, which will vary. The value of investments and any income from them will fluctuate and is not guaranteed (this may partly be due to exchange rate changes). Future returns are not guaranteed and a loss of principal may occur.

Targeted returns intend to demonstrate that the strategy is managed in such a manner as to seek to achieve the target return over a normal market cycle based on what Insight has observed in the market, generally, over the course of an investment cycle. In no circumstances should the targeted returns be regarded as a representation, warranty or prediction that the specific deal will reflect any particular performance or that it will achieve or is likely to achieve any particular result or that investors will be able to avoid losses, including total losses of their investment.

The information shown is derived from a representative account deemed to appropriately represent the management styles herein. Each investor’s portfolio is individually managed and may vary from the information shown. The mention of a specific security is not a recommendation to buy or sell such security. The specific securities identified are not representative of all the securities purchased, sold or recommended for advisory clients. It should not be assumed that an investment in the securities identified will be profitable. Actual holdings will vary for each client and there is no guarantee that a particular client’s account will hold any or all of the securities listed.