JANUARY 2021

US PENSION MARKET

A statistical and qualitative review of Q4 2020 and investment outlook

Hope returned to markets in Q4, with announcements from several major pharmaceutical companies that effective vaccines for the coronavirus were available for widespread distribution. Against this backdrop the S&P 500 Index rose to all-time highs, driven by a rotation from tech to value.

Although this is undoubtedly good news, the economic damage from the coronavirus remains significant and, for investors, this likely means a structural change for interest rate markets that could last for years to come. We believe the Federal Reserve (Fed) will take a very cautious approach to monetary policy in the coming cycle, and its new policy framework provides it the flexibility to do so. When we look at the outlook for interest rates, some lyrics from The Who spring to mind – "I can see for miles and miles and miles and miles….". Rates are not expected to rise for a very long time.

If yields are to remain in a new lower range for a considerable period, then investors may need to make their assets work harder, and we believe this should underpin the demand for credit.

- We outline the 10 key issues that we believe defined 2020
- A new administration means changes ahead; we outline seven issues we believe are important to investors
- When we review 2020, it is apparent that the year could have been disastrous for many pension plans if the Fed had not taken such unprecedented action. In what was effectively a real-world stress test, the benefits of liability-driven investment (LDI) and liquidity strategies were notable
- In pension news, we discuss the Department of Labor's 'final rule' on financial factors in selecting plan investments which removed references to environmental, social and governance (ESG) factors
- We discuss the potential for segment rate 'corridors' to widen in 2021 – this could lead to an up to 5% increase in plan liabilities in 2021, purely for technical reasons
- In our solutions section, we examine the three key considerations for LDI in 2021
- In credit, we look at how credit ratings within the S&P 500 Index have evolved over time, and why we believe some investors need to reconsider the way they think about BBB credit

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I can see for miles and miles and miles and miles and miles…

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THE WHO, 1967

REVIEWING 2020
TEN KEY ISSUES THAT DEFINED THE YEAR

1. **The coronavirus shock caused an economic slump:** In late 2019, a new strand of coronavirus, later named COVID-19, was reported to the World Health Organization (WHO) in the Chinese city of Wuhan. The first death from the virus was recorded on 11 January and a few days later the WHO confirmed a case had been identified in Thailand. Within a few months the virus had spread around the world, with government-imposed lockdowns and travel restrictions causing global economic activity to slump.

2. **Treasury yields plunged as the Fed aggressively eased:** The US Federal Reserve cut its target rate by 150bp in Q1 and restarted its quantitative easing program on a vast scale. Treasury yields plunged, with the US 30-year Treasury briefly moving to a yield below 1%.

3. **The Fed's mandate changed:** On August 21, 2020, following an extensive review, Fed Chairman Jerome Powell announced that the central bank would shift to a new policy framework[2]: flexible average inflation targeting. This will see the Fed continue to target inflation at 2%, but over longer periods. The implication of this change is that monetary policy is likely to remain at highly stimulative levels for a considerable period of time.

4. **Corporate credit issuance surged:** Corporate 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. With credit spreads contracting and nominal yields at historical lows, issuance continued to run at elevated levels through the rest of the year, broadening from investment grade to the high yield market. By year-end there was a record $2.5 trillion of gross new issuance[3].

5. **Equities reached new highs:** After initially plunging, equity markets bounced upwards. This was initially driven by a narrow rally in technology names seen as likely to benefit from an acceleration in the trend towards online shopping and working from home. News of a vaccine then saw a broader rally, driving the S&P 500 Index to new highs.

6. **Funded status deteriorated:** Pension plans experienced a rollercoaster year, but funded status ended the year lower than when the year started. The average funded status of all three of our pension indices declined over the year. We outline this in more detail on page 4.

7. **LDI strategies worked:** We observed that pension plans with higher allocations to LDI experienced significantly lower volatility, and funded status declined only marginally throughout the crisis period[4]. The crisis highlighted the risk that interest rates and yields do not have an apparent floor, as proven in Europe, and those plan fiduciaries that hedged their liabilities benefited accordingly.

8. **The need for liquidity strategies was highlighted:** Until the Fed stepped into markets, the freeze in Treasury and credit markets was acute, and it became difficult to trade for an extended period. The market experienced a material increase in bid/offer spreads, leading to large price differentials even within bonds of similar credit quality and risk. As maturing plans increasingly enter the 'decumulation' stage and become cashflow negative, so the need for carefully thought-out liquidity strategies is becoming more important – and this was highlighted by events in 2020.

9. **A new President means new policies:** A Biden Presidency is likely to be significantly different to that of President Trump, and the election was thus a key event for 2020. We expect the priority to be normalizing relations with the EU, and to focus on climate change, but to keep pressure on China.

10. **Impact bond issuance continued to boom across the world[5]:** In 2020 the volume of outstanding impact bond issuance breached $1 trillion and the market continues to grow robustly. The asset class broadened beyond green bonds, with new types of bonds covering issues from gender equality to marine ecology. This trend is increasingly likely to impact corporate behavior and the ability of corporates to fund in some markets, so it is important to monitor even for those that do not focus on these issues.

[2] https://www.federalreserve.gov/monetarypolicy/review-of-monetary-policy-strategy-tools-and-communications-statement-on-longer-rungoals-monetary-policy-strategy.htm [3] source: Barclays, data as of December 31, 2020. [4] based on observations of Insight clients over 20202. [5] An impact bond is a bond where the proceeds of issuance are used for a defined purpose deemed to be beneficial to society. Green bonds are a type of impact bond focusing on environmental issues such as carbon reduction or the mitigation of the impact of climate change.

THE IMPLICATIONS OF A NEW ADMINISTRATION

- **A shift towards domestic policy:** Whereas President Trump's economic policy in large part focused on remaking the US's international trade agreements, we expect the Biden administration to prioritize domestic economic matters over trade. This is an agenda that Janet Yellen, in her new role as Treasury Secretary, is well suited to facilitate given her expertise on labor markets and monetary matters.
- **A return to a strong dollar policy:** Yellen is likely to return to a stated preference for a strong and stable dollar, a long-standing policy that the Trump administration deviated from, but the increased competitiveness of US exports that comes from a weaker currency may be very welcome in the short term. There will be much lower risk of unilateral tariffs and other surprise trade actions, which may reduce volatility in currency markets.
- **Stimulus likely to be up to $1 trillion:** Yellen will likely lobby hard for one more stimulus package to support the economy as the vaccine is widely rolled out. But, with Senate Republicans likely to adopt a much more hawkish fiscal position, we expect a package to be capped at between $500 billion to $1 trillion. Most of the incremental funds are likely to be tied to state and local aid, stimulus checks, schools, and enhanced unemployment. There is broad appetite for infrastructure spending – $1.5 trillion over a 10-year period may be achievable with some focus on green infrastructure.
- **Tax hikes are likely to be moderate:** Given budget reconciliation rules, there will likely need to be tax hikes to finance spending items on infrastructure and a public option for health care insurance. We would expect around one third to one half of the Trump tax cuts to be reversed – $500 to $750 billion, and corporate taxes likely to rise to 25% to 28%.
- **Technology regulation is likely to grow:** One area of bipartisan consensus is the need for additional regulation on social media and technology firms, but both sides are likely to struggle to find meaningful measures that appeal to the other side. Although this may mean regulation grows only gradually – it seems clear that it will grow. Drug-pricing rules are another issue where compromise seems possible.
- **Unilateral powers may be the only way to push a green agenda:** There are areas where the Constitution grants the president unilateral powers – and these could be used to implement the Democrats' green agenda. A ban on new fracking on federal lands (which is over one third of US shale oil production), or a ban on new land leases could both impact shale oil production over time, as would a halt on new permits. Oil producers have built up a considerable backlog of unused drilling permits however, so it is unlikely that any of these measures would meaningfully impact production before 2023.
- **Jerome Powell likely to remain:** Federal Reserve Chairman Jerome Powell seems highly likely to be nominated for a second term given his broad popularity.
- **Immigration reform possible:** There is scope for some modest immigration reform, likely resulting in a net increase in skilled immigration.
- **From confrontation to co-operation with the EU:** On foreign policy, re-building relations with the European Union is likely to be a priority. This will see the US take a different tone on trade, re-engage on climate policy and seeking reform of multilateral institutions such as the WTO and WHO. A joint European/US front versus China is a possibility, looking to increase pressure on areas of joint concern such as industrial subsidies, intellectual property theft and forced technology transfers.

Figure 1: Key policy areas over the coming years[6]

Issue	Likely policy
COVID Relief	$500 billion to $1 trilliion in H1
Personal Taxes	An increase in taxes on top-earners, starting in 2022
Corporate Taxes	An increase to between 25% to 28%, starting in 2022
Infrastructure	Potential for $1.5 trillion over 10 years
Filibuster reform	Highly unlikely
Health Care	Potential for moderate reform of pharmaceutical pricing and an insurance public option
Immigration	Potential for a partial amnesty and modest legal immigration reforms
Tech Regulation	Potential for moderate increase in regulation and antitrust law restrictions
Federal Reserve	Powell second term likely. Quarles to be replaced by a hawk on bank regulation as Vice-Chair of Supervision

[6] Source: Insight, December 2020.

PENSION TRENDS

PENSION FUNDED STATUS UPDATE

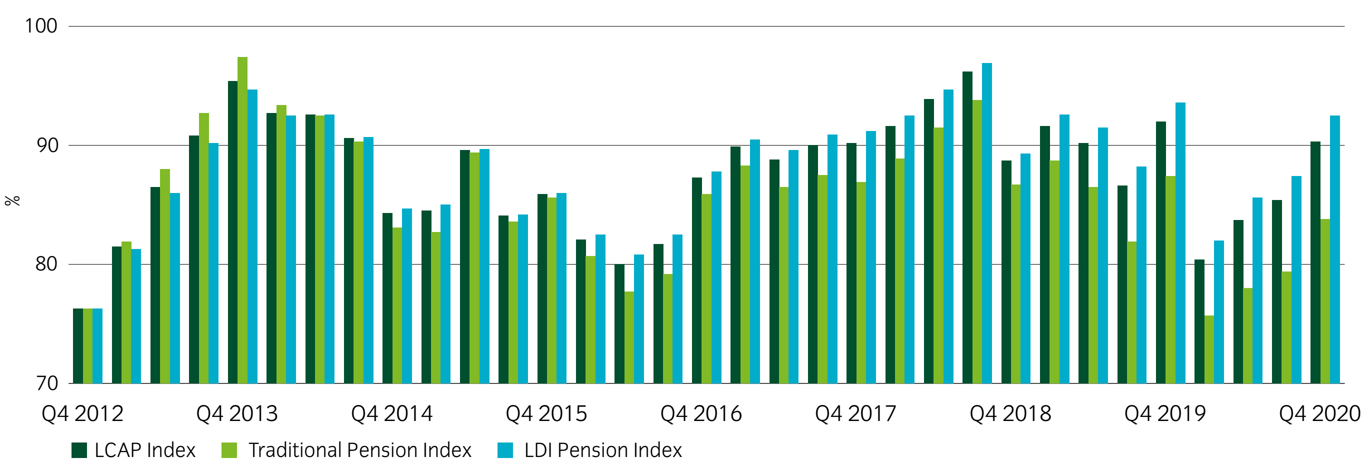
Pension plan funded status, as measured by Insight's model pension indices, improved significantly during Q4. Although discount rates declined, increasing the present value of pension liabilities, growth assets recorded very strong returns [7].

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 solid improvements in funded status in Q4. Rates rose by 19bp over the quarter but spreads tightened by 30bp, resulting in a 11bp fall in discount rates.

The LDI and LCAP indices, which contain long duration fixed income, saw the largest improvements in funded status, at 5.1% and 4.9% respectively, while the Traditional index saw its funded status improve by 4.4%.

Over 2020 as a whole, all three indices ended the year with funded status below end 2019 levels, although having made a substantial recovery from the worst point. Rates fell by 80bp over the year and spreads widened by 6bp, resulting in a 74bp fall in discount rates. Strong equity returns were insufficient to counterbalance the increase in liabilities.

Figure 2: Plan funding ratios improved over the quarter, but remained below end 2019 levels[7]



[7] Source: Insight and Bloomberg. Data as of December 31, 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.

- **ESG: Department of Labor (DOL) softens final wording**

  On October 30, the DOL released its 'Final Rule' on financial factors in selecting plan investments[8], which outlines provisions applicable to pension plans covered by the Employee Retirement Income Security Act (ERISA). This confirmed that fiduciaries must evaluate investments and investment courses of action, purely based on pecuniary factors (which they define as factors that the responsible fiduciary prudently determines are expected to have a material effect on risk and/or return of an investment based on appropriate investment horizons consistent with the plan's investment objectives and the funding policy). It also bars fiduciaries from sacrificing investment returns or taking additional investment risk to promote non-pecuniary goals.

  The final text, however, did not include any specific reference to ESG, which was seen as the DOL acknowledging that ESG factors are not necessarily nonpecuniary.

  The final rule becomes effective 60 days following its publication in the Federal Register, with plans having until April 30, 2022 to make the necessary changes to comply.

- **US tightens restrictions on Chinese investment**

  Executive Order 13959 – Addressing the Threat from Securities Investments that Finance Communist Chinese Military Companies (CCMC)[9], prohibits any US citizen from transacting in the securities of CCMC entities, or their subsidiaries, from January 11, 2021. Any securities that are already held must be divested by November 11, 2021. This includes ownership within exchange-traded funds (ETFs) and index funds.

  A number of index providers, including MSCI, have announced that they will remove the prohibited Chinese securities from major indices, although they will maintain versions of these indices that continue to include them.

[8] https://www.dol.gov/agencies/ebsa/about-ebsa/our-activities/resource-center/fact-sheets/final-rule-on-financial-factors-in-selecting-plan-investments [9] https://www.federalregister.gov/documents/2020/11/17/2020-25459/addressing-the-threat-from-securities-investments-that-finance-communist-chinese-military-companies

THE EFFECTIVE INTEREST RATE CORRIDOR IS SET TO WIDEN

Pension plans could be about to see their funding liabilities rise by 5.5% in 2021 for purely technical reasons as segment rate 'corridors' are set to widen, reducing the lower bound for funding interest rates.

A brief history of the discount rate 'corridor'

In 2012, Congress passed the 'Moving Ahead for Progress in the 21st Century Act' (MAP-21) to raise tax revenues for highway and transit programs, including a policy to reduce corporations' minimum required pension contributions[10] (as they are tax-deductible).

This was done by allowing plans to base their discount rates within a corridor around a 25-year average market rate – the segment rate[11]. If a segment rate has a 25-year average rate of (say) 2.0%, the current segment rate would be subject to a +/- 10% corridor (i.e. 1.8% to 2.2%) for discounting purposes. Naturally – current segment rates are often well below their corridor's lower bound, meaning plans use higher discount rates than if a corridor was not permitted, lowering Funding Target liabilities and reducing minimum required contributions.

The corridor will finally widen in 2021

MAP-21's funding relief was intended to be somewhat temporary. Each year, the corridor was intended to widen by 5% until reaching a 30% limit in 2016.

However, two subsequent pieces of legislation[12] maintained the 10% corridor through 2020. Now, the +/- 10% corridor is finally set to phase-out by 5% each year until it reaches +/-30% in 2024.

How much will discount rates fall?

In 2021, although projected segment rates[11] will still be lower than the 15% floors, as the floors will also be lower, the segment rate used for discounting purposes (after applying the floors) could still fall (Figure 3).

Figure 3: Widening corridor means falling segment rates[13]

	Actual 2020 rate (with -10% corridor applied)	Actual 2021 rate (with -10% corridor applied)	Actual 2021 rate (with -15% corridor applied)
PPA Effective Rate	5.46%	5.33%	5.04%
Target Liability	1,000,000,000	1,016,858,036	1,054,807,448
Increase over 2020	n/a	+1.7%	+5.5%
Increase due to corridor	n/a	n/a	+3.7%

The costs of higher target liabilities

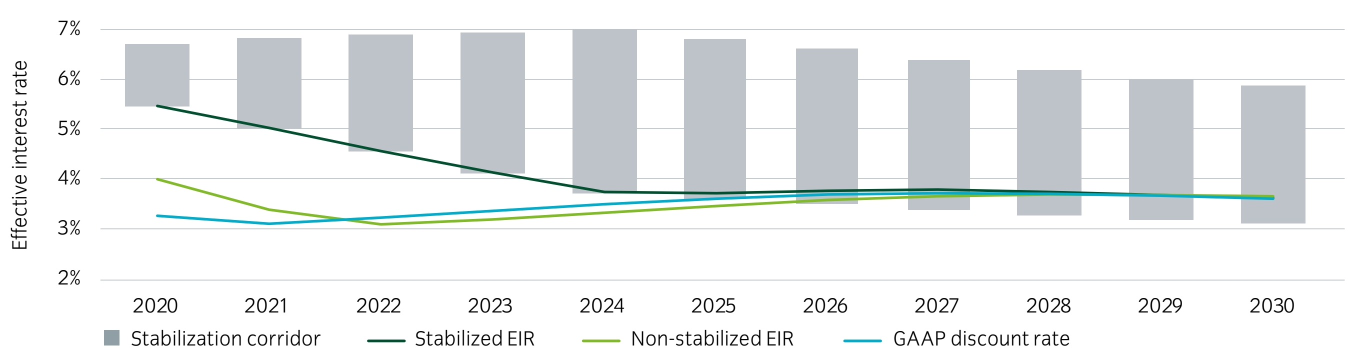
MAP-21 reduced minimum required contributions (MRC) and now the widening of the corridor is expected to negatively impact a plan's AFTAP, Carryover/Prefunding balances (if applicable) and cash contributions (if required). We estimate the impact of 5% wider corridors could increase an underfunded plan's shortfall amortization base established in 2021 approximately threefold.

This process is set to repeat for the next four years

This process will continue until 2024. So, unless rates rise or there is another regulatory change (as had been proposed under a prior draft of the latest COVID-relief bill), funding liabilities are projected to continue rising.

Using implied forwards as a guide – we estimate the floor will be in effect until 2026 to 2027 – implies that MAP-21 will still ultimately deliver funding relief for some time yet.

Figure 4: Funding relief is set to decline between 2021 and 2024[14]



[10] For qualified defined benefits. [11] Segment rates are a 24-month rolling average rates across one of three segments of the yield curve (the first segment is 0-5 years, the second is 5-15 years and the third is 20 years and above) [12] The Highway and Transportation Funding Act of 2014 (HATFA), kept the 10% corridor for 5-years (until 2017), and the Bipartisan Budget Act of 2015 (BBA) further maintained it to 2020. [13] Based on rolling 24-month averages. [14] Source: Insight, as of December 31, 2020. Discount rates published by the IRS <https://www.irs.gov/retirement-plans/interest-rates-tables> through November 30, 2020 and follow forward curve thereafter. Plan liability profile has duration of 12 years at January 1, 2020

SOLUTIONS:
2020 COULD HAVE BEEN A LOT WORSE

THREE KEY CONSIDERATIONS FOR LDI STRATEGIES IN 2021

In many ways, 2020 could be seen as a health warning for pension plan risk-management strategies. In a tumultuous year, many plans will have seen their funded status plunge before recovering. If the Fed had not intervened in markets to the degree in which it did, it can be argued that things could have turned out significantly worse. Refreshing strategies while deficits are still 'solvable' may ensure that deficit reduction is achievable as an investment objective, without risking that target returns increase to unattainable levels.

1 Low yields – a lower hedge ratio may be riskier than thought

Based on the Milliman Top 100 Pension Plan Funding Index, November 2020, the average pension plan started 2020 with an 'under-hedged' liability interest rate position. We believe many were waiting for rates to rise, with the goal of improving their funded status[15]. However, this investment position did not work out. Although rates started the year around record lows, the average projected discount rate fell yet again by ~50bp over the year, increasing the average value of liabilities by ~6%[16].

Looking forward, it is not impossible that rates will fall even further. While implementing a higher hedge ratio might seem counterintuitive at first in a world in which yields have never been lower, by stabilizing the funding gap, a plan can invest their way out of a deficit position.

When looking at the experience of Europe and Japan – long duration corporate bond rates (the equivalent US GAAP discount rates) are close to 2% lower than here in the US. If US rates fell to that degree, the average plan liabilities could increase by another 20% to 30%, or more, and make the need for unplanned contributions more likely.

2 Searching for yield is ever-more challenging

The low-yield environment is also a challenge for the asset side of pension balance sheets. Many investors are reaching down the capital structure and assuming higher credit risks to generate higher expected returns. We are concerned that the potential for higher returns may not be realized. This is because we view the economic shutdowns in 2020 as a tipping-point for the global economy, likely to lead to an increase in the future rate of defaults.

For shorter maturity holdings, we believe that one alternative way to potentially generate higher returns and to diversify from corporate bonds is via structured credit. By optimizing a portfolio to be more capital efficient, matching cash inflows from coupons and principal repayments with expected liabilities, it reduces the risk of forced sales. This can allow a plan to invest a proportion of its assets into areas such as structured finance, where complexity or illiquidity premia can potentially provide access to higher yields without the need to reduce credit quality.

3 The approach to diversification will need to evolve

Many pension plans have historically used high quality credit to provide strategy diversification and to act as a hedge against equity tail-risk exposure. But something seemed to change in 2020 as equities and fixed income sold off together during episodes of market volatility.

This is causing us to pose the question: "What if we can no longer rely on bond markets to act as ballast when equities decline?" This is not something pension plans can afford to get wrong as the implications could materially influence investment outcomes.

Therefore, it may be better to look at controlling downside volatility and the risk of large, sudden asset drawdowns in a much more direct way – with 'tail-risk' strategies designed to be there when diversification is not. These strategies do not come free but can be now be implemented using a much more dynamic and intelligent process to reduce long-term program costs.

[15] Higher interest rates help because the present value of liabilities fall if rates rise, all else equal, and vice versa if rates decline. [16] Results would vary from plan to plan. We have taken the average figures from Milliman Top 100 Pension Plan Funding Index, November 2020.

ECONOMICS AND MARKETS

KEY MARKET MOVEMENTS: Q4 2020

Treasury yields moved higher over the quarter, but the short end of the curve remained well anchored. The US Federal Open Market Committee stated that they would continue to purchase Treasuries until the economy made 'substantial progress'.

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

US equity markets experienced a very strong quarter, with a broad based rally as risk sentiment improved on hopes that the roll out of vaccines would allow growth to rebound in 2021.

The US dollar broadly depreciated over the quarter.

Figure 5: Q4 2020 Fixed Income/Equity Index Returns (%) and Volatility Index Levels[17]

Index	Q4 2020 total return	YTD 2020 total return	Q4 2020 excess return	YTD 2020 excess return
Barclays Treasury	-0.83	8.00	–	–
Barclays Intermediate Treasury	-0.23	5.78	–	–
Barclays Long Treasury	-3.00	17.70	–	–
Barclays Corporate	3.05	9.89	3.88	1.89
Barclays Intermediate Corporate	1.76	7.47	1.99	1.70
Barclays Long Corporate	5.14	13.94	8.15	-3.76
BofA Merrill Lynch High Yield	6.48	6.17	7.31	-1.84
S&P 500 Index	12.15	18.40	–	–
MSCI Emerging Markets Equity Index	19.70	18.31	–	–
VIX[18]	23	–	–	–
MOVE[18]	49	–	–	–

ECONOMICS: A SIGNIFICANT REBOUND IN US GROWTH FORECASTS

With economic data proving more resilient than expected, growth forecasts were moved upwards in most regions. In the US, the potential for an economic stimulus package saw forecasts raised for growth in 2021, even with the expectation of a smaller than expected contraction in 2020. Global growth forecasts are lagging regional forecasts but are likely to be revised upwards over time. Inflation forecasts were broadly unchanged for both 2020 and 2021, and in major economies inflation is expected to be below 2% through the period.

Figure 6: Consensus GDP and CPI expectations[19]

Real GDP	Consensus*			Change over Q4	
	2019	2020F	2021F	2020F	2021F
United States	2.3	-3.5	3.9	0.9	0.1
Euro area	1.2	-7.4	4.6	0.6	-0.9
Japan	0.9	-5.3	2.7	0.4	0.2
China	6.1	2.0	8.2	-0.1	0.2
Developed markets	1.7	-5.2	4.0	0.6	-0.2
Emerging markets	4.2	-0.7	5.1	-0.1	0.0
Global	**3.0**	**-3.8**	**5.2**	**0.1**	**0.0**

CPI	Consensus*			Change over Q4	
	2019	2020F	2021F	2020F	2021F
United States	1.8	1.2	2.0	0.1	0.1
Euro area	1.2	0.3	0.9	-0.1	-0.1
Japan	0.5	0.0	0.1	0.0	-0.1
China	2.9	2.6	1.6	-0.2	-0.6
Developed markets	1.7	1.0	1.6	0.0	0.0
Emerging markets	3.9	3.4	3.4	-0.1	-0.2
Global	**3.0**	**2.2**	**2.7**	**-0.1**	**0.1**

F=Forecast. *Bloomberg consensus forecast.

[17] Source: Barclays and Bloomberg. Data as of December 31, 2020. [18] VIX and MOVE are actual value at month end.
[19] Source: Insight and Bloomberg. Data as of December 31, 2020.

DERIVATIVES

LIBOR update

In December 2020, ICE Benchmark Administration (IBA) Limited, the administrator of LIBOR, launched a consultation on the potential cessation of LIBOR[20]. IBA plans to cease the publication of non-US dollar LIBOR rates on December 31, 2021, and US dollar LIBOR on June 30, 2023. This would potentially mean that US dollar LIBOR exists for a longer period than other rates to allow legacy contracts to mature. New issuance would be limited after 2021, however, due to supervisory guidance from the Federal Reserve Board of Governors, the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency[21].

TREASURY MARKETS

The yield curve steepened as sentiment improved

The Treasury yield curve steepened over the quarter as shorter maturities remained anchored by Fed policy, but longer-maturity yields moved higher as markets took a more optimistic tone. The 2-year maturity Treasury yield was unchanged at 9bp, the 10-year maturity Treasury yield rose by 26bp and the 30-year maturity Treasury yield rose by 19bp.

Unprecedented borrowing – primarily in Bills so far

At its November presentation, the US Treasury Borrowing Advisory Committee estimated that Q4 tax receipts were down by $42bn (-1%) versus the same quarter in 2019. **Total outlays increased by $2,105bn (+47%) on the same basis, impacted by payments related to COVID-19 relief efforts**.

The estimate of FY2020 borrowing was $4,014bn, an increase of $2,969bn over FY2019. Q1 FY2021 borrowing is forecast at $617bn and Q2 FY2021 is forecast at $1,127bn.

The Treasury has increased its cash holdings to $800bn and will maintain this level for some time given the uncertain needs for funding.

Issuance has been primarily in the Bills market, but the Treasury has guided that issuance will be shifted to longer-dated tenors over time.

Figure 7: Treasury yield curve change[22]

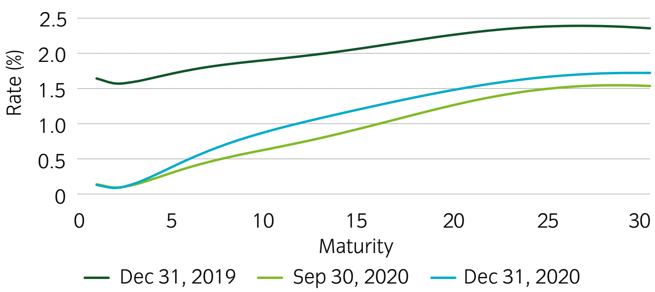
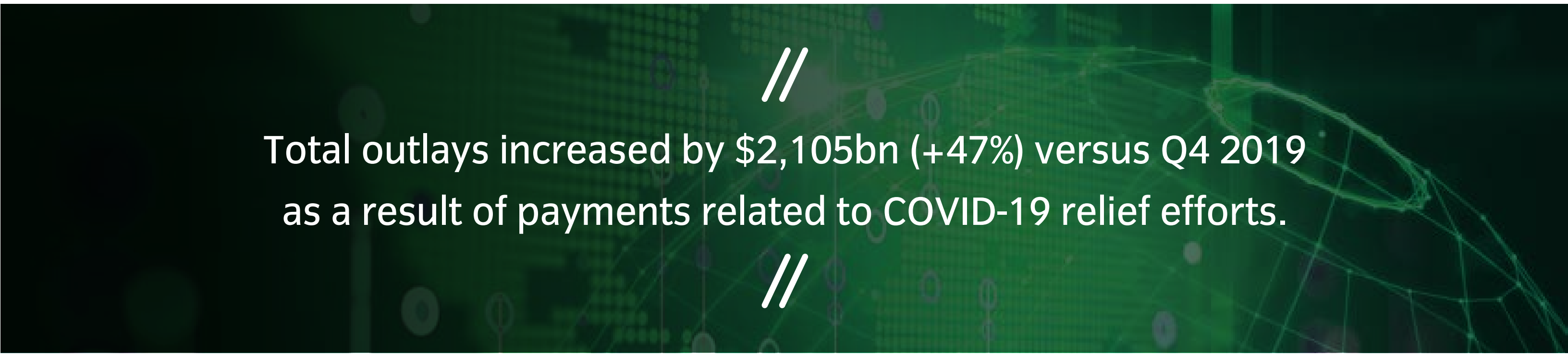


Figure 8: US Treasury net marketable borrowing[23]

Market ($bn)	2018 FY	2019 FY	2020 FY	Yr/Yr change
Bills issuance	438	137	2,652	2,515
Floating rate issuance	26	55	54	-1
2-5yr Treasury issuance	210	403	477	74
5-10yr Treasury issuance	139	206	425	219
Over 10yr Treasury issuance	176	191	354	163
5-10yr TIPS	32	33	37	4
Over 10yr TIPS	19	20	16	-5
Buybacks	0	0	0	0
Total	**1,040**	**1,045**	**4,014**	**2,969**



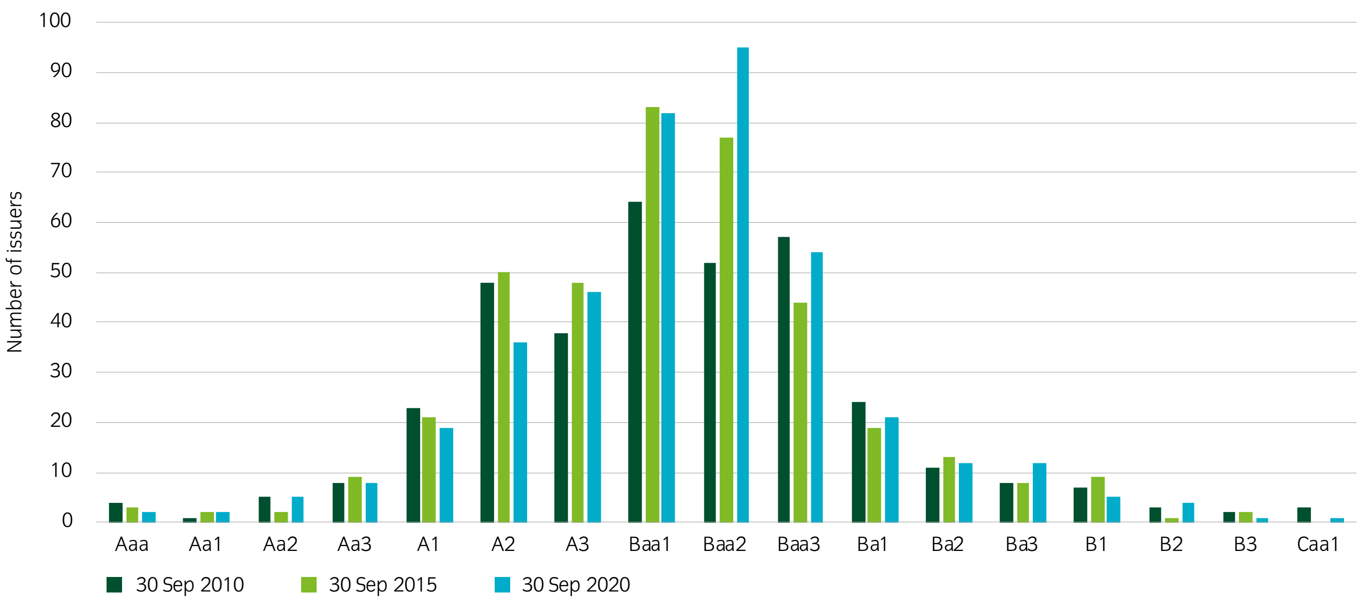
[20] https://www.theice.com/publicdocs/ICE_LIBOR_Consultation_on_Potential_Cessation.pdf [21] https://www.federalreserve.gov/newsevents/pressreleases/bcreg20201130b.htm [22] Source: Bloomberg, data as of December 31, 2020. [23] Source: Insight and US Treasury. Data as of November 30, 2020. Yr/Yr change is November 30, 2020 versus November 30, 2019.

A different way to think about BBB credit

If yields are to remain in a new lower range for a considerable period of time, then assets need to be made to work harder. One way to do this is to look at carefully selected credit holdings – and most investment grade credit indices are now dominated by issuance in the BBB rating category. Should investors be concerned about this lower rated category of corporate bonds? We don't believe so.

In fact, we believe that many pension plans are already quite happily purchasing these issues – as equities. When we break down the companies in the S&P 500 Index that issue debt, there has been a steady shift over time towards issuers in the BBB category (see Figure 9). A trend of increased dividend payments, stock buybacks and M&A activity has persisted for over a decade against a backdrop of low interest rates and strong demand for corporate credit, and this has led to a general deterioration in corporate credit ratings.

Figure 9: The S&P 500 Index is probably lower rated than you think[24]



Of course, that doesn't mean that caution can be thrown to the wind in such a challenging economic environment. Security selection is key, and we would always advocate a rigorous approach to credit analysis. It is also important to consider that some sectors appear more insulated from the economic crisis than others. For example, stable businesses such as utilities or cable companies may be better placed for now, while more cyclical companies could become more interesting once a recovery is on firmer footing.

Fed's corporate purchase facilities to close for now

Secretary of the Treasury Steven Mnuchin has announced that he will not renew the Fed's $750bn corporate credit purchase facilities that expired at the end of 2020. The Fed was granted Congressional approval to purchase corporate credit in March 2020 as part of the $2 trillion CARES ACT with $454bn allocated to the Treasury Department to support such programs. These corporate credit facilities were primarily able to support investment grade credit, but also had the ability to purchase credits that were downgraded to below investment grade.

We do not believe this decision will have a material impact on the economic or market outlook. To date, the programs have only been used up to 10% – with the Fed's purchases dwindling to less than $30m a day – compared to the central bank's Treasury and mortgage-backed securities purchases of over $5bn per day. If there was seen to be an impact, perhaps via sentiment as markets appeared to consider the underutilization as potential 'dry powder', then we believe that Janet Yellen – Biden's reported nominee for Treasury Secretary – would likely be very quick to reverse this move.

[24] Source: Insight and Bloomberg. Data as of 30 September 2020.

Issuance breakdown

Investment grade and high yield issuance continued to grow strongly in Q4, contrary to some concerns that issuance levels would decline at the end of such a strong year. Gross investment grade issuance reached $2.1 trillion in 2020, a new annual record.

Figure 10: New U.S. bond issuance in $billions[25]

Market	2018 total	2019 total	2020 total	Yr/Yr change (%)
US Investment Grade	1,208	1,297	2,102	+62.1%
US High Yield	171	263	418	+59.0%

Figure 11: High Yield issuance breakdown in $billions[26]

	2020	Q4
New issuance	418	94
Downgraded to high yield	201	23
Called or falling below 12mths	256	79
Upgraded to investment grade	25	11
Defaults	57	5

In US high yield credit, Barclays estimates there was $117bn of new issuance and fallen angels in Q4, offset by $95bn of issues either called, dropping below 12mths to maturity, upgraded to investment grade, or defaulting. Demand was strong, with Lipper estimating that high yield mutual funds and exchange-traded funds had inflows of $9.2bn, taking inflows over 2020 to $43.5bn.

Credit Market Performance

Credit spreads tightened in Q4, with aggregate US corporate spreads ending the quarter 40bp tighter than where they began. The long end of the credit curve outperformed, tightening by 48bp. BBB-rated issues outperformed significantly, tightening by 59bp given generally positive sentiment and the strong rally in equity markets.

Figure 12: Average spread (bp) of Corporate Bonds[27]

Barclays Index	12/31/19	09/30/20	12/31/20	Change Q4	Weight (%)
Corporate	93	136	96	-40	100.0%
Intermediate	70	103	68	-35	64.6%
Long	136	188	140	-48	35.4%
– Long AAA	70	100	73	-27	
– Long AA	84	131	97	-34	
– Long A	98	147	109	-38	
– Long BBB	171	231	172	-59	

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Gross investment grade credit issuance reached $2.1 trillion in 2020, a new annual record.

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[25] Source: Barclays. Data as of December 31, 2020. [26] Source: Barclays. Data as of December 31, 2020.
[27] Source: Insight and Bloomberg Barclays. Data as of December 31, 2020.

MARKET
OUTLOOK

A NEW ADMINISTRATION MEANS NEW WINNERS AND LOSERS

After a volatile start to the year, credit markets were broadly supported by both fiscal and monetary easing, and spreads tightened through the second half of 2020. The Goldman Sachs US Financial Conditions Index, which measures key financial variables to judge how stimulative conditions are for growth, dropped to all-time lows (see Figure 13). Although we believe this backdrop is likely to generally underpin both investment grade and high yield credit markets for some time, a new administration means new policies. Some sectors should benefit, but others are likely to lose out.

A Democrat Senate essentially puts a partial reversal of the 'Trump tax cuts' on-the-table. However, a full reversal is unlikely, which could be good news for a number of sectors, including telecommunications, banking and technology, which were expected to lose out from future tax reform. For the banking sector, higher capital requirements could benefit credit investors by strengthening credit worthiness at the expense of equity holders.

With climate change expected to be a key policy focus for the new administration we would expect tougher rules for utilities, and greater efficiency requirements for the auto sector. Oil and gas will likely be resilient, at least in the short term, as efforts to curtail new fracking activity is likely to take until at least 2023 to make an impact.

There are some areas where the Democrats and Republicans have common ground, especially in social media, technology and pharmaceuticals. Although substantial disagreement remains, limiting the potential for compromise, we would still expect regulation to gradually increase over time. A public option for health insurance is likely to be a headwind for that sector.

More generally, a watering down of stimulus and infrastructure plans by a hostile Senate is likely to constrain consumption and corporate revenues, and a de-escalation in trade tensions could benefit large importers at the expense of domestic producers.

We summarize these expected winners and losers in Figure 14 below.

Figure 13: US financial conditions are highly stimulative[28]

Figure 14: Likely winners and losers

	Winners	Losers
Less than feared tax hikes	Telecoms Banking Tech	
Public health insurance option		Pharmaceuticals Hospitals Health insurers
Potential infrastructure public spend	Construction	
Pivot to climate policy	Clean energy	Oil and gas
Re-regulation		Utilities Oil and gas Banking
Less hawkish foreign policy	Tech Durable goods importers	Firms competing with Chinese imports

[28] Source: Bloomberg, Goldman Sachs. Data as of December 31, 2020.

MARKET OUTLOOKS

Investment grade credit: Although we remain fundamentally constructive on investment grade credit, we have become more cautious from a valuation perspective as spreads have tightened back towards pre-pandemic levels. We believe sentiment should be underpinned through the first half of 2021 as vaccines are rolled out and economic activity recovers. The technical backdrop should also be supportive, with developed market interest rates unlikely to rise for years to come, leaving investors searching for ways to add incremental yield. Corporate issuance is also likely to be more subdued in 2021, following elevated levels of issuance in 2020. Corporates have used the proceeds of issuance to strengthen their balance sheets given the economic uncertainty but they should become less defensive as the outlook becomes clearer. We continue to advocate a large degree of caution in terms of security and sector selection, focusing on issuers in more defensive sectors that we still believe offer some potential for spread compression.

High yield credit: The high yield market has benefited from investors insatiable demand for yield, and nominal yields have declined to historical lows. However, the rally has lagged that seen in investment grade credit, leading to a widening in relative spreads. For investors this created a dilemma – there is value to be extracted, but low nominal yields mean little buffer to protect against defaults. As economic activity recovers, and with corporates able to fund at historically low interest rates, default risk should become more quantifiable, allowing the value argument to come to the fore. We believe this should see more investors willing to allocate to high yield in the coming quarters, making us cautiously constructive on the asset class. However, the need for intensive credit work remains, as the economic recovery is likely to be uneven, and the long-term impact of the coronavirus on some sectors remains highly uncertain. Companies need to have a business model that can survive in a post coronavirus world, with sufficient resources and liquidity to implement it. The regular dialogue 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.

Emerging markets: The improving economic outlook should create a more positive backdrop for emerging markets in 2021. We believe emerging market credit, largely denominated in US dollars, is an area that stands out as especially attractive. Spreads remain wide relative to developed market corporates, especially in high yield, and we believe this presents an opportunity to purchase sovereign high yield issues where spreads are attractive in both a historical and global relative value context. We also favor high yield in corporate debt given strong fundamentals, low default rates, supportive technicals, and expected cyclical growth recovery which we expect to cause further spread compression versus investment grade issues. In local rates we are selectively positive, looking for central banks that are still playing catchup to their developed market counterparts and have the potential to ease rates further. We are also tactically positive on emerging market currencies but are somewhat cautious given the already extended decline in the US dollar – we would look to add to positions on any meaningful US dollar strength.

Structured credit: Structured credit markets have lagged the rally in investment grade credit, and we believe this has opened a relative value opportunity for investors with the flexibility to invest in the asset class. We continue to view structured credit as 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. The technical backdrop was supportive through 2020, with issuers stepping back from markets as spreads widened, and this constrained supply over the year. We would expect a similar backdrop in 2021, with issuers to utilizing cheap central bank funding where possible.

> Corporate issuance is also likely to be more subdued in 2021, following a record year for US dollar issuance in 2020.

KEY MARKET RISKS

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, particularly for BBB rated issuers. 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, particularly for higher rated credits.

Valuations have already priced too much good news

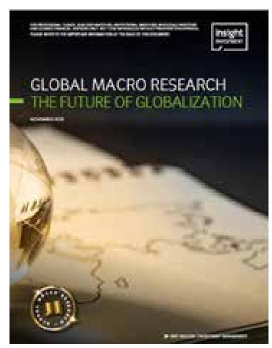
After an extensive rally in the second half of 2020, investment grade credit spreads have returned to levels similar to those seen before the crisis began. There is a risk that the current rally has priced in too much good news and that despite future demand is softer than currently expected, leading to a retracement of recent gains.

EDUCATIONAL: THE FUTURE OF GLOBALIZATION

From 1990 to 2008, manufacturing supply chains rapidly moved out of the developed world, causing a surge in trade volumes and foreign direct investment flows. The main beneficiary of this shift was China, which gained significant market share in many manufacturing markets. With the power struggle between the US and China intensifying, and the coronavirus crisis highlighting the risks of global supply chains, we examine the future of globalization.

- The rapid growth in China's share of global exports has come to a halt
- Overreliance on Chinese supply is now seen as a risk to global supply chains
- Diversifying away from China will not be easy, but China may lose out on new investment
- There will be winners and losers from a shift away from China. We believe:
  – South Korea, Malaysia and Poland are best positioned to benefit from manufacturing competitiveness
  – Indonesia and India are best positioned to benefit from labor competitiveness
  – We believe governments will carry a higher fiscal burden, consumers will face higher prices and corporate profit margins will be squeezed

FURTHER READING



For more detail on this subject, please see our paper: The Future of Globalization[29].

[29] https://www.insightinvestment.com/globalassets/documents/us-redesign-documents/perspectives/us-global-macro-the-future-of-globalization.pdf

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