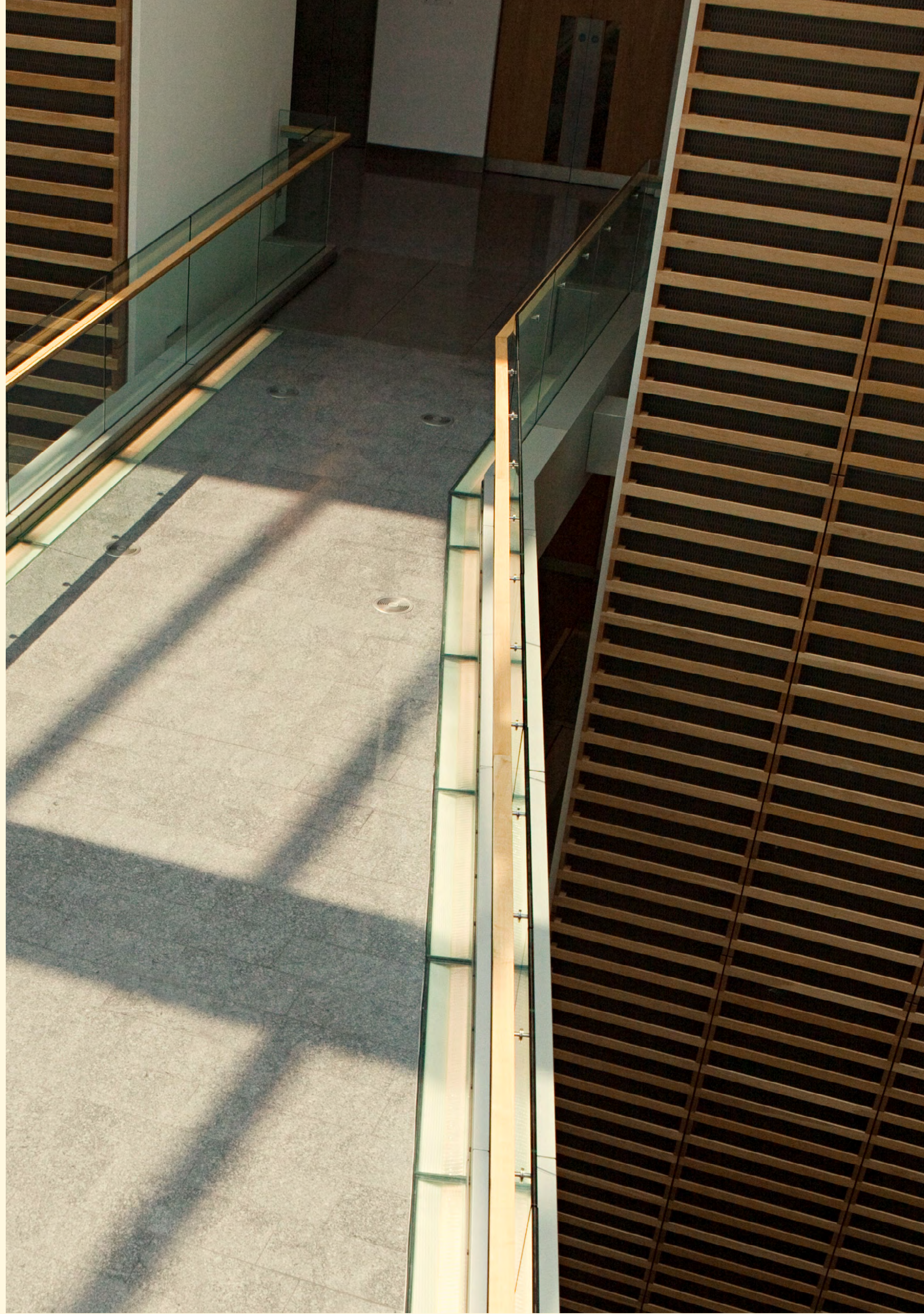
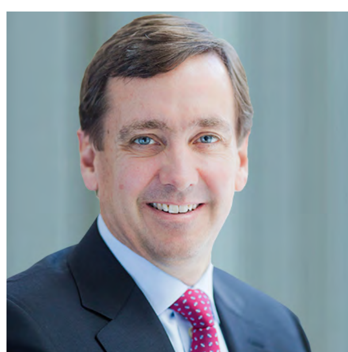
2023 Mid-year

Global Investment Outlook





A letter from Steve Peacher

The term "cautious optimism" is an oft-overheard phrase in asset management during times of change, and there's little doubt in my view that it best encapsulates the market environment at the midway point of 2023. Following a challenging 2022, for fixed income investing as well as for other asset classes, we have experienced a healthy rebound in financial markets so far this year. But many of the sources of concern that underpinned 2022's difficulties – from macroeconomic and policy issues to geopolitical matters – remain in place, and in some cases merit greater attention as we head into the last half of the year and beyond.

So amid constructive markets, with both opportunities and risks well represented, where do investors go from here? In many ways that's the central question we tackle in SLC Management's 2023 Mid-Year Global Investment Outlook. While we have witnessed strength across multiple asset classes year to date, there has been considerable variation in performance during the semi-annual period, and similarly varied outlooks for the months ahead. I invite you to review the diverse perspectives of our investment and solutions teams as they discuss public and private fixed income, real estate, infrastructure, pension plans and insurance asset management. Our twice-yearly outlook is a rare one-stop window into the insights of the investment professionals across SLC Management, as well as of our affiliate asset managers BentallGreenOak, InfraRed and Crescent Capital.

Conditions at the beginning of this year presented considerable opportunities for fixed income investors to pick up yield, and a similarly fertile investment environment is expected to continue to some extent going forward. At the same time, investors searching for additional sources of yield are increasingly looking at non-traditional investments, ranging from real estate, infrastructure and high yield to investment grade and below investment grade private credit.

However, as investors we should also remain mindful of the risk factors that have persisted throughout 2023. The monetary policies that had previously set out to moderate inflation have increasingly had their impact felt this year. The prospect of a recession looms for major economies – including the United States and Canada – even as everyday consumers feel the sting from higher prices. And overall global uncertainty remains, from the ongoing war in Ukraine and its human impact to concerns over global energy security, sustainability and/or a triggering event (e.g., another bank failure, economic data surprise or political impasse) that could spark additional volatility.

Regardless of these uncertainties, at SLC Management we remain committed to seeking out compelling opportunities and providing steadfast solutions for our investors. I hope you benefit from the diverse views of our investment experts as we head into the remainder of 2023 and into the next year.

Regards,

Steve Peacher,
President, SLC Management

Macroeconomic outlook

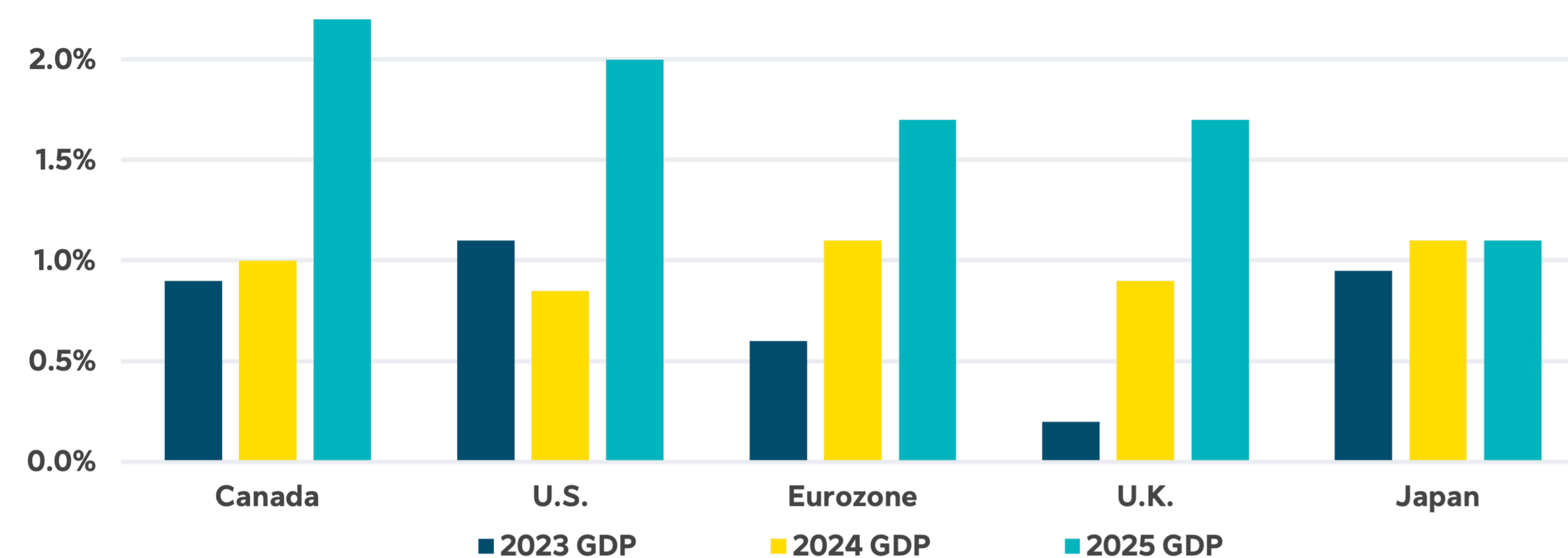
Dec Mullarkey
Managing Director, Investment Strategy and Asset Allocation, SLC Management

Growth expected to be subpar, but strength in employment welcomed by central bankers

GDP projections modest for major economies

At the mid-year point of 2023, central banks remain vigilant and are keeping rates high while inflation lingers well above target. As activity cools, most advanced economies are posting subpar GDP growth. **The U.S. and Canada both expect roughly 1% growth this year**, half their normal target, according to Bloomberg's survey of economists in June.

GDP outlook for major economies



Source: Bloomberg monthly survey, June 2023.

Meanwhile, **the eurozone is expected to deliver 0.6% growth**. This is also well below a normal range, but is an improvement over earlier estimates as Europe has exceeded expectations in managing its energy disruptions.

Meanwhile China's post-COVID economic recovery continues at a tepid pace. After swiftly abandoning its restrictive lockdown policies in January, the world braced for the second largest economy to reset with a bang. But a surge in consumer spending has not emerged and Chinese households appear to remain cautious. Nevertheless, **rate cuts and potential stimulus are expected to guide China to its 5% growth target this year**.

The biggest surprise so far this year is how resilient labor markets have been. Across most regions there are more job openings than applicants. The U.S. is a good example. COVID slowed immigration and drove a surge of early retirements. That shrunk the U.S. labor force and intensified competition for talent. This has made companies reluctant to lay off workers, even as wages rise and growth cools.

Fortunately, the labor demand and supply mismatches are starting to rebalance. While early retirees have not returned to the work force, immigration has picked up, allowing the labor pool to expand and to help abate some of the demand pressure.

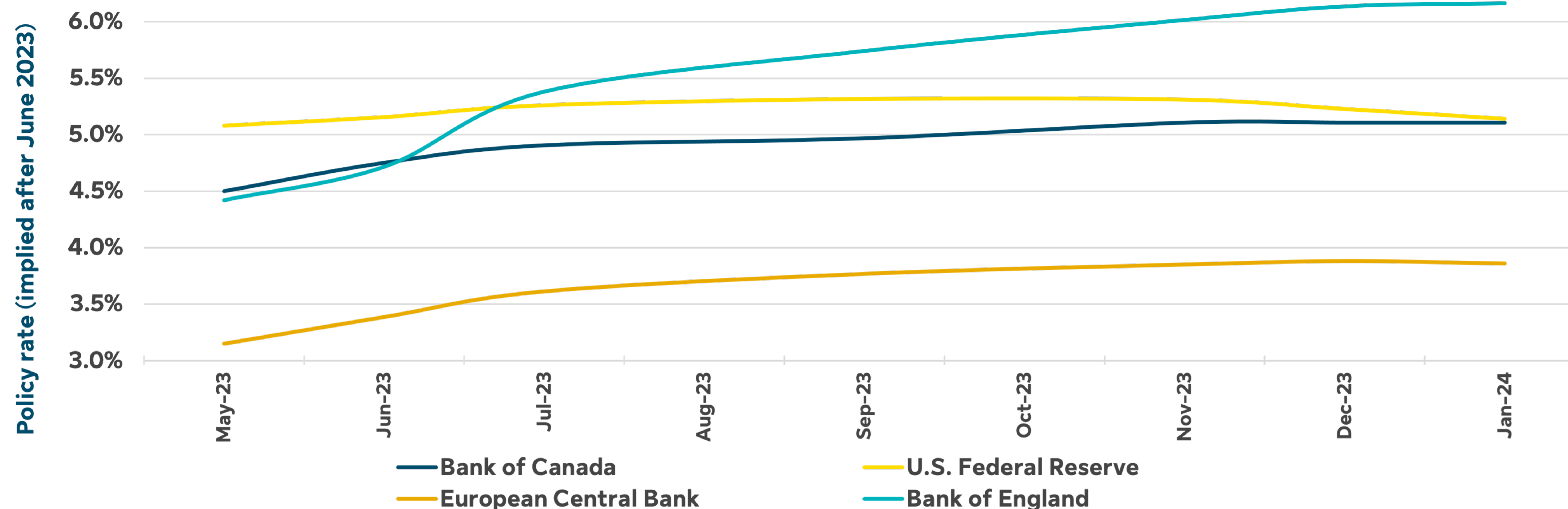
Inflation slowly decreasing

The big challenge for most central banks, and the U.S. Federal Reserve in particular, is to cool activity and inflation without igniting a severe recession. While core inflation has been stubborn it is slowly coming down.

Trimmed U.S. core inflation measures from the Federal Reserve Banks of Cleveland and Dallas, which normalize for outliers, show deceleration across a wide range of goods and services. Improvements in supply chains have helped, as has some cooling in the labor market. Rent costs, which represent a large weight in the inflation index, are down significantly on renewal rates which will pull the average down as in-force leases renew.

Core inflation is expected to hit 3.6% by the end of this year and 2.3% by the end of 2024, bringing it close to the Fed's target of 2%.

Expected central bank rate paths



Source: Bloomberg, implied rates based on futures and swap pricing, as of June 2023.

Central banks close to peak rates

After a busy year of rate increases, the Fed hit pause. But don't assume the central bank is done. The Fed and other major policymakers may find themselves in an advanced endgame as they calibrate how much more tightening is needed. Central bank rate setting works with a difficult-to-forecast lag, which is forcing central banks to become more reflective and data dependent on what remains to be done.

The Fed appears to think it needs to increase rates another 50 basis points this year, while markets think 25 basis points is enough. But both appear to agree that there will be no rate cuts this year, something the market had been slow to accept.

The biggest insight at the mid-year point from Fed Chair Jerome Powell was his praise for the growth benefits of a tight labor market, rather than its assumed corrosive effects. That's in line with recent research from Ben Bernanke and Olivier Blanchard, two titans of monetary thought leadership, showing the tight labor market accounted for only a minority of excess inflation as of early 2023.

However, Bernanke and Blanchard warn that if the demand for and supply of labor are not brought into balance, this could keep inflation above target. One encouraging nugget from their modeling is that an easy way to engineer that could be to reduce the number of job openings below available workers. If that works, then a surge in layoffs could be avoided in getting the economy back to normal. That gives some credence to the Fed's forecast of a soft landing.

Source: Bloomberg, 2023.

Fixed income: investment grade

Rich Familetti
CIO U.S. Total Return Fixed Income

Policy signals continue to be a focus amid promising opportunities in IG bonds, structured credit

Short term favors risk, but longer term eyes on inflation, financials

By the mid-year point of 2023, we saw two distinct perspectives emerging in investment grade (IG) U.S. fixed income: from a short-term basis and from an intermediate- to longer-term time horizon. In the shorter term, for the balance of 2023 we expect to see some continuation of the "risk-on" environment that characterized the halfway point of the year. The VIX benchmark of equity volatility, which historically correlates to credit spreads as well, had been dropping by June. This suggests a higher tolerance of risk in both equity and fixed income markets, with credit spreads tightening as a result.

Beyond this short-term outlook, the picture becomes less clear in the intermediate term and beyond, with several critical factors coming into play. Inflation continues to be a focus, with much attention paid to the U.S. Federal Reserve's 2% inflation target. Another way of characterizing the Fed's position is by the yield on 10-year Treasury notes, with the central bank aiming for a flat to slightly positive real yield on the notes, of roughly 2%–3%. We expect to see further Fed policy tightening should inflation persist above the 4% level.

There remains some risk that the Fed's policies may not filter down into the real economy as quickly or as visibly as the market expects. This could trigger some spread volatility, though we would note that setting interest rates is the main policy tool the Fed has, and that the central bank has less influence on some of the other, more intractable, factors underlying high inflation. These include ongoing supply chain issues, below-optimal productivity levels and a general market sentiment that, to us, still appears calibrated to the zero-inflation environment of the past.

Turning to fundamentals, outside of the financials sector we're constructive on the strong liquidity levels we're seeing at the mid-year point, along with leverage levels that are slightly elevated but still reasonable and pressured corporate margins that are still holding up well, in our view. Some uncertainty remains in the banking space, with the risk that the lending problems affecting certain U.S. and European names earlier in 2023 could return and spark spread volatility in IG fixed income as well as in other asset classes. However, we would classify this risk as a moderate one. Overall, we do not view any one sector in IG fixed income as currently being a significantly disproportionate source of volatility than another, but we are monitoring the banking sector closely for any signs of a re-emergence of liquidity risks or a deterioration in asset quality.

IG issuance set for continued comeback

With respect to issuance, while 2023 began strongly for IG corporates, the regional U.S. and European banking failures led to a temporary slowdown in March and April. As of the end of May, issuance was down approximately 7% year to date compared to the same period from last year, despite strong activity resuming in that month when the bank crises were out of the news. Heading into the second half of 2023, we expect issuance to be supported by announced deals that have not hit the market yet, as well as an uptick in activity from banks – especially regional names re-entering the field following the early-2023 crises.

In **structured credit**, we see promising opportunities despite some weak market sentiment that we believe has been overly discounted in the sector as a whole. For example, in the commercial mortgage-backed security (CMBS) space, the challenges facing the office sub-sector (with weak occupancy rates persisting in the time of post-COVID hybrid work) have ignored the stronger fundamentals in other property types, such as retail, industrial, hospitality and multi-family, in our view. This has helped create what we see as wide valuation disparities, and at this point in 2023 we are seeing opportunities in CMBS that we have not seen in nearly 20 years. In the structured credit sector as a whole, we see potential investment ideas further strengthened by strong liquidity levels, the benefits of underlying structural protections and the much-improved underwriting standards of the post-Global Financial Crisis era.

Sources: Bloomberg, U.S. Bureau of Labor Statistics, 2023.

Fixed income: below investment grade

John Fekete
Managing Director and Head of Capital Markets, Crescent Capital Group

Market and macroeconomic signals sending mixed messages on the elusive recession

Economic resilience casts doubt on expected contractions

Everyone seems to be bearish these days. Just about every economist is betting higher interest rates will cool the economy, resulting in a spike in corporate defaults and wider credit spreads. More than a year and 500 basis points into the U.S. Federal Reserve's rate-hiking program, an investor might reasonably expect to see a potential recession looming.

However, economic activity has been positive and resilient, and signs of a recession remain elusive. Employers have been hiring aggressively. Equity markets have rebounded, with the S&P 500 Index up more than 11% by June and the NASDAQ up more than 25%. Consumers are spending freely on services such as travel and restaurants, even in spite of rising prices, while the housing market has stabilized given a shortage of homes for sale.

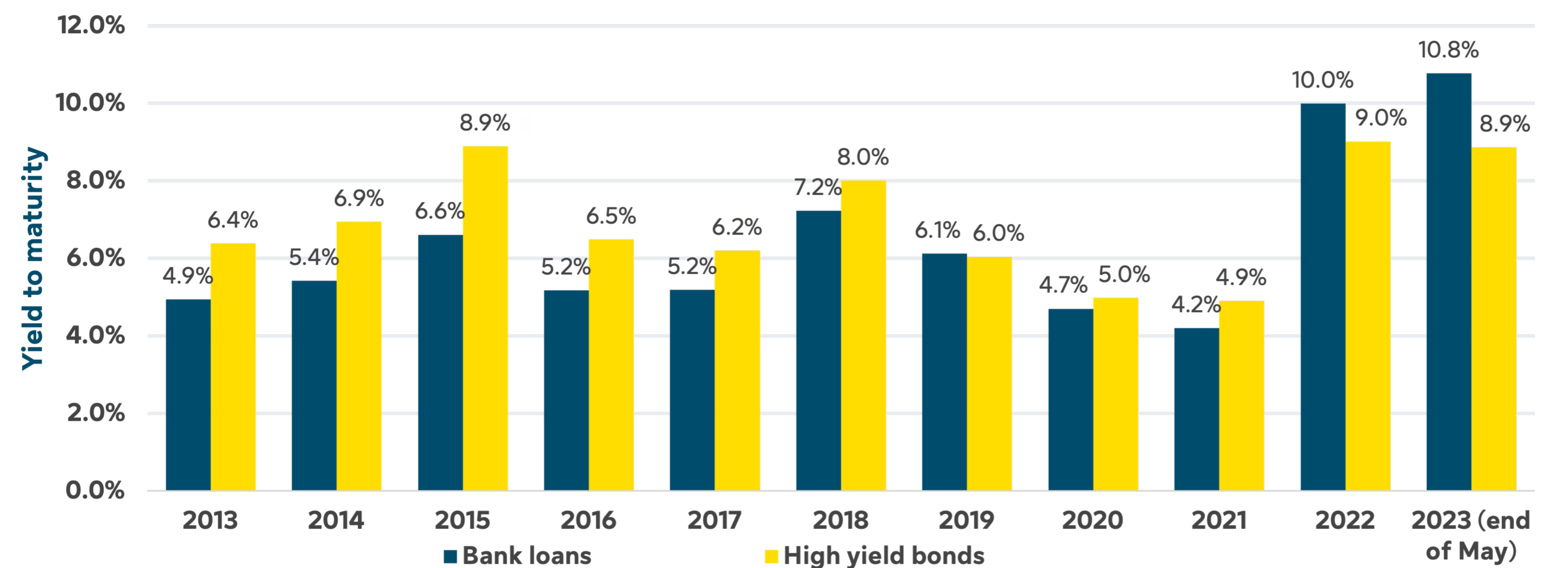
The pessimistic positioning on the scale that we see today can often be a contrarian indicator. When bullish or bearish sentiment reaches an extreme level, sooner or later the market moves in the opposite direction. Could economists have underestimated the lagged effect low interest rates, $5 trillion of pandemic stimulus spending and a 40%-plus drop in oil prices from recent peaks are having on consumer consumption? We think it's a possibility.

Another sign of strength can be seen in the May employment data. The headline number – a payroll gain of 339,000 – vastly exceeded estimates, and sectors with the strongest gains were some of the hardest hit by the pandemic, including leisure, health care and hospitality. In fact, the current U.S. unemployment rate is only approximately 10 basis points higher than when the Fed first started hiking rates last year. This suggests the labor market will likely remain strong for months to come as the labor force participation rate has yet to return to pre-pandemic levels.

The outlook for high yield

It could take several quarters before the labor market cools and the economy shows signs of slowing. Meanwhile, yields on U.S. high yield bonds and bank loans are at or close to their highest levels in a decade and are providing equity-like returns, with high-yield bonds returning close to 9% at the mid-year point and syndicated bank loans returning more than 10% (as represented by the ICE BAML US HY Index and Morningstar SP LSTA Loan Index, respectively). Income will once again be the primary driver of returns given the high carry offered by these asset classes, with yields sitting in the 90th percentile rank of the post-GFC period, according to Goldman Sachs.

Yields on HY, bank loans at or close to their highest in a decade

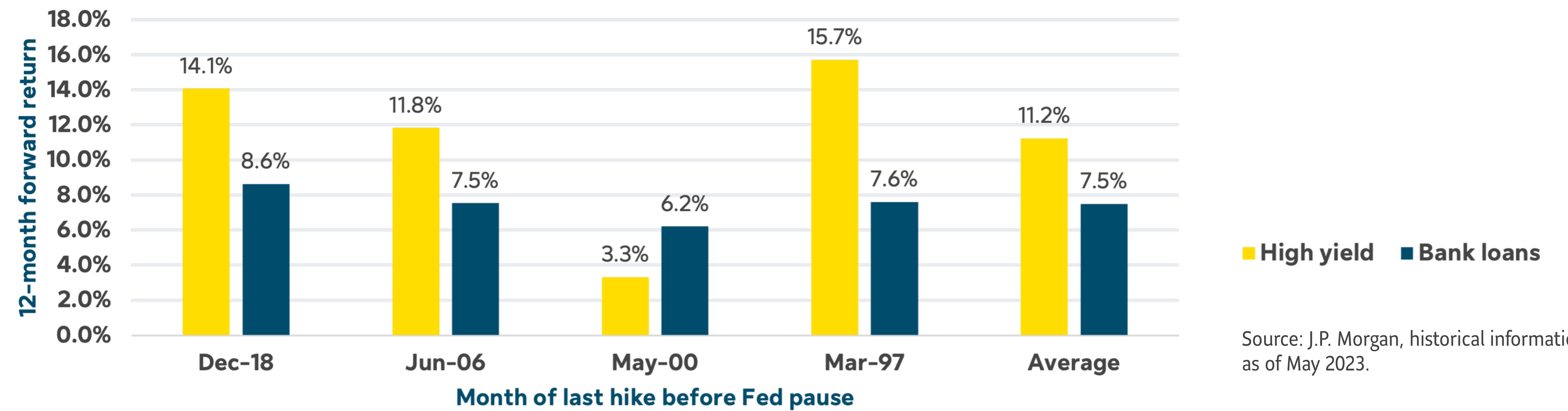


Source: Bloomberg, 2023. Bank loans represented by Morningstar SP LSTA Loan Index, high yield bonds represented by ICE BAML US HY Index.

Despite all of the bearishness, the highest performing segment of the credit market this year has counterintuitively been the lowest quality tier. CCC-rated bonds and loans have outperformed the BB-rated cohort by a factor of nearly two times year to date. In our view, this makes the market opportunity for entering BB-rated bond and bank loan cohorts more attractive than it has been in recent years.

We are often asked what to expect if the Fed pauses and holds interest rates steady. J.P. Morgan examined the performance of high yield bonds and bank loans following a Fed pause. Over the past 30 years, there have been five instances of Fed policy transitioning to a pause, which notably lasted an average of 10 months until the onset of the first rate cut. Historically, high yield bonds and bank loans performed well following a pause with an average 12-month forward total return of +11.2% for high yield and +7.5% for bank loans.

High yield and bank loan performances following pause in Fed rate hikes



Source: J.P. Morgan, historical information as of May 2023.

We see two key factors as contributing to this solid performance over time. First, the historical fundamentals following a policy pause remained favorable and not weak enough to elicit a rate cut. And secondly, rates had been a tailwind for performance, with five-year U.S. Treasury yields declining an average 101 basis points over the next year. The current backdrop has caused credit markets to re-price, creating potential opportunity throughout the rest of the year should an expected recession remain elusive.

Key takeaways for mid-2023

- Credit market bearishness has been pervasive despite resilient economic data.
- Fixed income yields are at their highest level in over a decade.
- The highest quality segments of the credit market have lagged, providing investors with a potentially attractive entry point.
- High yield bonds and bank loans have historically performed well following Fed pauses.

Source: Bloomberg, JP Morgan, Goldman Sachs, 2023.

Private credit: investment grade

Andrew Kleeman
Senior Managing Director, Head of Corporate Private Placements

Elaad Keren
Senior Managing Director, Portfolio Manager and Head of Mid-Market Private Debt

Gary Greaves
Managing Director, Private Fixed Income

Market resilient in first half of 2023

Large deals anchor volumes

Reported volume for the investment grade (IG) private credit market through the first half of 2023 was solid but less than the first half of 2022, driven by lower financial sector issuance that was partially offset by robust issuance in other sectors. The current year started out strongly, with some deals that were postponed from 2022 due to market volatility.

Some of the notable market highlights from H1 2023 include:

- The IG private credit market's capacity to execute large and complex deals anchored total volume as the market completed more issuances of $1 billion or greater in the first half of 2023 than were completed in all of 2022.
- The IG private credit market was "open for business" throughout the Silicon Valley Bank crisis and the general concerns over smaller banks. At the height of the crisis, the public market was closed and private market pricing required discovery, but that quickly returned to normal.
- Market pricing has largely been rational, in our view, and deal allocations have been good. Underpinning the favorable market tone is decreased competition: the industry has seen less activity by some investors in private credit, reportedly due to slower insurance product sales or overall portfolio strategy.
- Maturities shorter than 10 years as a percentage of total issuance has increased materially since interest rates started to rise. Issuers are seeking to borrow shorter due to expectations that rates may come down in the next few years while investors are seeking longer duration.
- Infrastructure deals in H1 2023 have been stronger than we have seen in recent years, with rational pricing and attractive structures.

Resilience and opportunities for rest of 2023

Looking back at our outlook from January, we were "cautiously optimistic" at that time about the upcoming year. We maintain that outlook mid-year, as **we believe that the market has been resilient and that these investment themes we highlighted at the beginning of 2023 should remain intact**:

- We expect financial sector issuance to continue to anchor volume, although not growing as rapidly as in the last two years. Growth in the sector continues to expand to include smaller issuers and weaker credits. We believe this will create more opportunities, but will also require strict underwriting.
- Deal activity in infrastructure and renewable energy should remain robust.
- Real estate and REIT issuance could struggle as higher interest rates and lower valuations make transactions in private real estate difficult to execute. While real estate activity has been muted, we still see compelling opportunities in structured deals such as credit tenant leases.
- There should also be attractive opportunities in private asset-backed securities and cross-border deals.
- The IG private credit market could benefit from volatility, as this market is a reliable source of execution when other markets falter.
- Investors that have strong deal origination should benefit as the trend in IG private credit has been for more bespoke and narrowly distributed deals with smaller lending groups.

Considerations for clients and consultants

As at mid-year 2023, we continue to stay the course. It's important for investors in private credit to maintain a long-term investment horizon throughout the credit cycle as the IG private credit market benefits from strong underwriting and robust structural protections. Historically, volatility has often yielded attractive investment opportunities.

Sources: Private Placement Monitor, 2023.

Private credit: below investment grade

Chris Wright
Managing Director & Head of Private Markets, Crescent Capital Group

Chris Wang
Managing Director, Crescent Credit Solutions, Crescent Capital Group

The asset class offers sought-after solutions for both investors and borrowers

Why private credit today

Turmoil in the banking sector, rising interest rates, recession fears and geopolitical events have accelerated the secular shift toward private credit as banks and traditional lenders retreat from the credit markets. We expect this shift to continue as banking regulations increase and balance sheet flexibility decreases for the entire banking sector. But what is driving interest in private credit today extends beyond dislocation in the banking system – **we believe private credit offers a much sought-after solution for both investor and borrower needs**.

Why investors are choosing private credit

In our view, private credit can offer a potentially compelling combination of features to investors:

- **Attractive yields with high current income**
- **Better lender protections in more conservative capital structures**
- **Lower mark-to-market volatility**
- **Resiliency throughout economic cycles**

Higher base rates and wider spreads currently allow private credit investors to reap potential double-digit yields and high current income on senior secured debt, an increase of 400–500 basis points or more over the same time last year. This is due to both private credit's focus on floating-rate debt securities and private credit's ability to capture higher spreads and higher original issue discounts from today's market volatility.

Private credit managers also have the opportunity to conduct disciplined, bottom-up credit underwriting, to put in place conservative capital structures and to directly negotiate stronger lender protections in credit agreements.

Furthermore, as private credit managers tend to be buy-and-hold investors with long investment horizons, marks are typically more insulated from public market price fluctuations and exhibit lower historical volatility.

Lastly, investors who are worried about an impending hard economic landing may choose private credit due to its resiliency through cycles. Private credit can benefit from being senior within a borrower's capital structure, having directly negotiated credit agreements with tighter terms and superior covenant protections, and having access to hands-on monitoring and proactive portfolio management capabilities.

Why borrowers are choosing private credit

Borrowers and private equity sponsors are increasingly turning to private credit as they value the certainty of execution and ease of use that relationship lenders provide. A private credit financing solution can mean no market flex, no marketing meetings, no unknown outcomes and, most importantly, the ability to choose who exactly is in your capital structure.

In periods of market dislocation, borrowers are also choosing private credit due to a lack of bona fide alternatives. When the syndicated financing markets are shut, private credit remains open for business with its committed capital base.

One key difference today is that private credit can rival the syndicated markets in size and scale in a way that had been recently unfathomable, offering a financing solution to a much broader range of businesses through all types of market conditions.

Current market trends and opportunities

This market is seeing the balance of power continuing to shift in favor of lenders with more attractive structures, pricing and documentation.

Valuation expectations between buyers and sellers have remained apart for much of 2023 thus far, driving a decline in overall merger-and-acquisition volumes. That stated, private equity "dry powder" is at record levels and an increasing number of private companies are looking for an exit, often to private equity. As these valuation expectations converge and buyers and sellers acclimate to the new market environment, M&A volume is expected to pick up. Finally, private credit isn't just providing capital for buyouts: demand has grown for private credit in non-buyout financings such as incremental financings and refinancings.

In summary, we believe the growing acceptance of private credit as a bulwark in any investor's portfolio is accelerating in tandem with the momentum it is gaining as a preferred financing solution for borrowers.

Sources: Bloomberg, Private Placement Monitor, 2023.

Real estate

Ryan Severino
Chief Economist,
Head of U.S. Research, BGO

Select equity and debt opportunities emerge amid continued commercial real estate challenges

Banking crisis draws attention to CRE

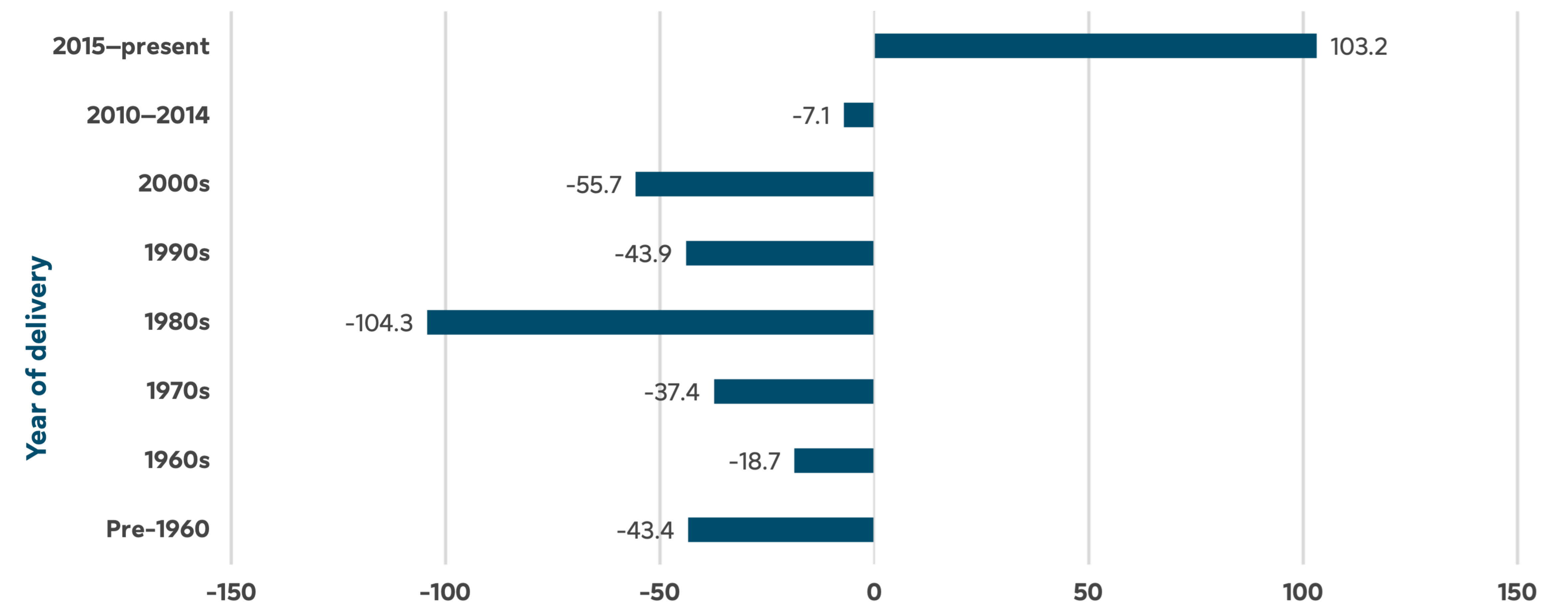
Heading into 2023, the U.S. commercial real estate (CRE) market was facing well-known challenges. Coming under pressure from the U.S. Federal Reserve's aggressive rate hikes, valuations declined, cap rates increased and price discovery failed, causing transaction volume to collapse. Then in 2023, just when it seemed like the situation had possibly turned a corner – with inflation slowing and most of the market's anticipated interest rate increases already in the books – the situation became even more challenging. Rapid rate hikes led to the failure of certain mismanaged banks, which served to further tighten credit standards and dampen demand for loans. That occurred broadly, but it helped to focus attention on potential troubles in the CRE market, especially the commercial mortgage market. **That caused the role of CRE to shift slightly, from being purely subject to economic circumstances to possibly playing an active role in slowing the economy.** CRE has not played such a prominent role in macroeconomic weakening since the savings and loan crisis of the of the late 1980s and early 1990s.

Office sector remains the outlier

Consequently, many observers are calling CRE potentially the next shoe to drop in a deteriorating environment. But that characterization still seems somewhat misguided, in our view. Most of that narrative stems from the office market and the challenges it faces as return-to-office initiatives appear to have stalled. But we believe that concern belies more widespread strength in the market. While the overall office sector faces challenges due to factors like the increased prevalence of working from home, office properties represent only 21% of the NFI-ODCE index of the National Council of Real Estate Investment Fiduciaries (NCREIF).

It is also important put some of the office sector's challenges into a meaningful context. The office market is experiencing a flight to quality, with demand for high-end space remaining firm, outperforming the rest of the office market. But in practice that really means a flight to newness, in our view, with properties constructed since 2015 capturing all the positive net absorption since the onset of the pandemic. Beyond office, CRE space-market fundamentals are generally holding up well with some signs of moderation, which mostly stems from supply growth in favored sectors such as industrial and multifamily. But we believe that remains a short-term disruption, not a long-term structural problem. Overall asking rents are holding firm though concessions for office leases remain elevated.

Net absorption of office sector since pandemic (mm square feet)



Source: Jones Lang LaSalle (JLL), as of May 31, 2023.

Disruption starting to create more opportunities

On the equity side of the market, more bidders and increasingly deliberate due diligence are returning to the market, but asset write-downs are occurring slowly. This is keeping the bid–ask spread wide and limiting transaction activity. Distress is starting to bring more assets to market, albeit gradually. As more valuation write-downs occur, it should create the potential for more distressed selling and better price discovery. And distress in some assets could force sales of better-performing assets by investors that need liquidity. Debt capital remains available for equity investment, but cost remains an impediment to many investors.

On the debt side, distress is already creating more opportunities. Banks are beginning to sell performing loans at a discount to reduce their commercial mortgage exposure, which is above mandated targets for some institutions. Additionally, traditional balance sheet lenders, such as life insurance companies, are still willing to lend under the right circumstances. But some have limited capacity because mortgages are not paying off as quickly in a high-interest-rate environment, leaving their balance sheets relatively full. This effective pullback by traditional lender groups continues to create opportunities for non-bank lenders such as debt funds to either purchase loans at a discount or fill a void and provide capital for recapitalizations and for purchases.

Sources: National Council of Real Estate Investment Fiduciaries (NCREIF), Jones Lang LaSalle (JLL), 2023.

Infrastructure

Richard Crawford
Partner, Head of Energy Income Funds, InfraRed

Edward Hunt
Partner, Head of Core Income Funds, InfraRed

Stephane Kofman
Partner, Head of Capital Gain Funds, InfraRed

Jack Paris
CEO, Head of Americas, InfraRed

Opportunities, risks in the asset class amid sticky inflation and sustainability initiatives

A tighter focus on recurring themes driving infrastructure

Looking toward the second half of 2023, we view the dominant themes affecting infrastructure investing as being largely a continuation with those identified in our previous outlook (elevated interest rates and inflation, sustainability and demand drivers). However, national policy initiatives and market responses to developments so far this year have shifted the landscape somewhat, affecting both the opportunity set in infrastructure as well as potential risks going forward.

Investing for tomorrow's economic development

By 2024, the world will need an estimated **$94 trillion** in global infrastructure investment to meet growth goals (G20 Global Infrastructure Outlook 2023).

For example, the issue of interest rates has, in our view, moved even more to the forefront in mid-2023, especially with respect to the potential implications of high rates for the valuations of other investment types, such as infrastructure and other real assets. The high-rate environment may be a longer-term reality, as evidenced by some key benchmark bond yields remaining elevated even as short-term market disruptions pass. At the halfway point of 2023, for instance, gilt yields indicated that they would be entrenched in the 4%-plus range for some time, as they increased to those levels during the U.S. debt ceiling debates but continued to linger there even after political leaders reached an agreement.

Inflation readings in certain economies have suggested the upward price pressures have become stickier and more deeply rooted than previously anticipated. Such developments could underpin the case for a higher-for-longer interest rate environment, which would in turn pose a potential challenge to real assets and other investments should the cost of capital remain high.

However, the differentiated nature of infrastructure investing might paint a different picture for the asset class. We expect the effects of central bank policies intended to moderate inflation to increasingly filter into the economy, and the likelihood of a recession has increased as well. Infrastructure investments have historically held up well in recessionary conditions, as demand for long-term infrastructure assets tends to be inelastic and many such investments have defensive characteristics, such as pricing protection through underlying contracts.

The expanding infrastructure market opportunity

By 2035, an average of **$3.7 trillion** per year in infrastructure investment worldwide will be required to keep pace with growth (McKinsey & Company, 2023).

Shorter- and longer-term growth catalysts from sustainability

We expect sustainability issues to also drive infrastructure investment. A combination of geopolitical developments and longer-term secular themes should support sustainability initiatives and related green infrastructure. On top of its immense human cost, the war in Ukraine has continued to increase concerns about energy security and, consequently, the urgency toward renewable energy development. On the legislative front, 2022's U.S. Inflation Reduction Act (IRA), which directed $400 billion in federal funding to clean energy, should continue to drive green infrastructure demand as this funding works its way through the economy. Such legislation has incentivized other economies, such as in Europe and Canada, to similarly invest further in clean energy.

Investments needed for sustainability goals

Until 2030, an estimated **$2.6 trillion** annually in global sustainable infrastructure investment will be needed to meet UN Sustainable Development Goals and 2050 net-zero emissions (World Bank, 2023).

Immediate-term geopolitical affairs aside, the longer-term global move toward sustainability will continue to act as a catalyst for infrastructure, in our view. Investment themes we are paying particularly close attention to include electrified vehicle infrastructure – such as charging facilities – as well as digitalization and the circular economy.

Sources: Bloomberg, McKinsey Group, World Bank, G20 Global Infrastructure Outlook, 2023.

Insurance asset management

Peter Cramer
Senior Managing Director, Head of Insurance Portfolio Management & Trading

Nitin Chhabra
Managing Director, Head of Insurance Client Relationships and Solutions

Thomas Klem
Managing Director, Head of Institutional Client Experience

Louis Pelosi
Managing Director, Client Solutions

Higher yields creating opportunities for insurers across the fixed income market

Window of opportunity in fixed income

Relative to last year, expected returns have risen across the universe of asset classes that insurance companies invest in, with the most notable increases coming in fixed income. The higher yields driving the improved forecast are likely here for the duration of 2023, creating a window of potential opportunity to invest across the fixed income spectrum, including:

1. Traditional core fixed income, to lock in high quality attractive yields in the face of a likely recession
2. Lower-traffic areas of the investment grade (IG) public bond market, such as structured securities, which can offer additional spread if you have the expertise and resources to monitor underlying loan collateral
3. Alternative credit, which comes with enhanced yield and diversification potential, in exchange for less liquidity and greater complexity

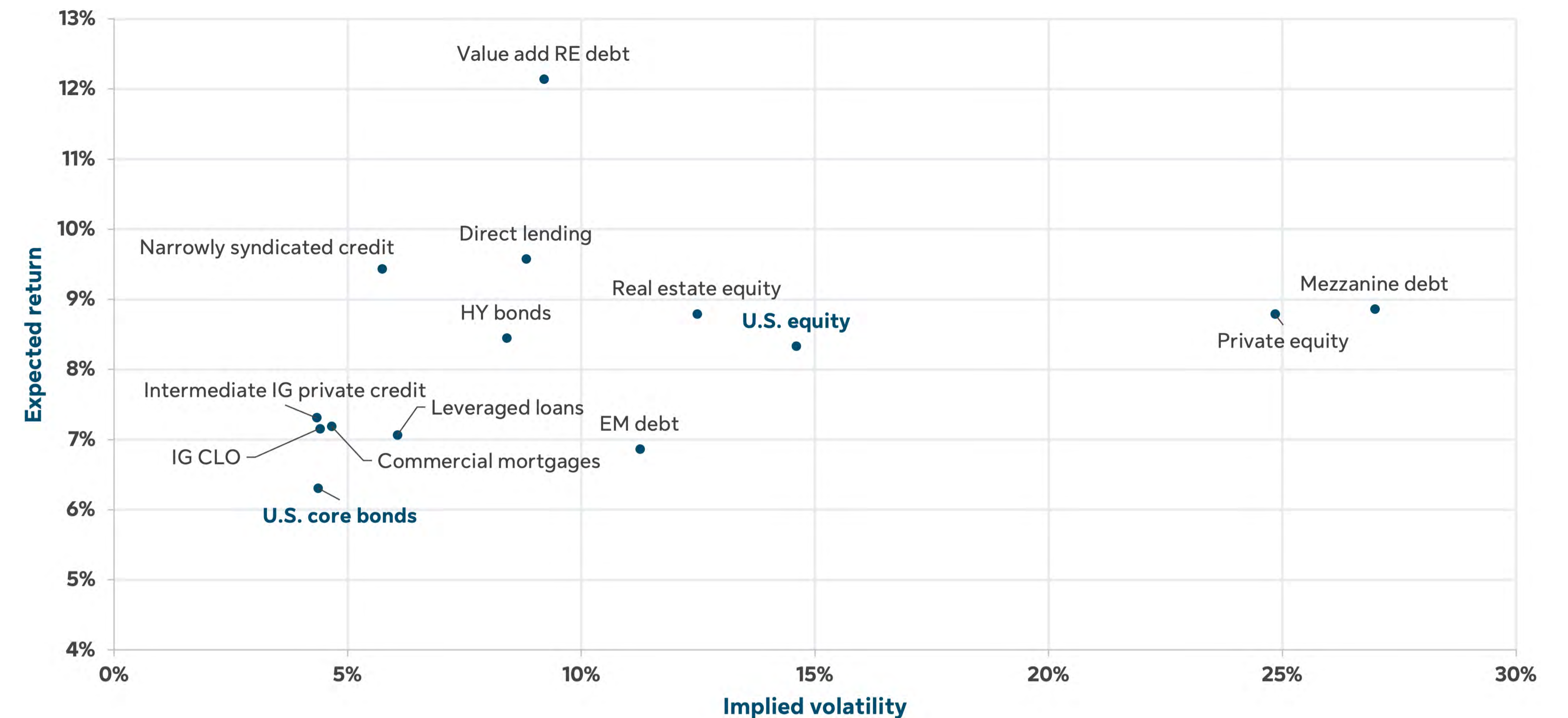
Insurance asset allocation shifting toward bonds

Given the increase in yields, it's no surprise that we're witnessing a shift in insurer asset allocations out of equities and into fixed income, as the move in valuations has driven a divergence in relative value. To illustrate this divergence, we look at the Bloomberg Intermediate Aggregate Index, which exhibited a yield of 2.8% in March 2022. Our expected return at the time for core fixed income, as represented by this broad benchmark, over the next 3–5 years had been 3.3%, annualized.[1]

At the time of this writing, the yield on the index was approximately 4.7%, and our forward expected return increased to 6.3% using the same methodology. Compare that to equities, in which our forward return forecast has barely budged (7.9% last year compared to 8.3% today, using the S&P 500 Index as a proxy benchmark). To put that change into a portfolio context, last year an allocation of 80% core fixed income and 20% equities (using the two previously mentioned benchmarks as proxies) would have resulted in an expected return of 4.2%, annualized, over that illustrative 3–5 year period. Today, expectations of that same asset mix would be 6.7%.

On a risk-adjusted basis, the change in relative value is even more striking. The following exhibit illustrates the historical volatility in core fixed income (as represented by U.S. bonds) at 4.4%, a fraction of the 14.6% historical volatility on equities.

Mid-term risk/return profile of asset classes used by insurers



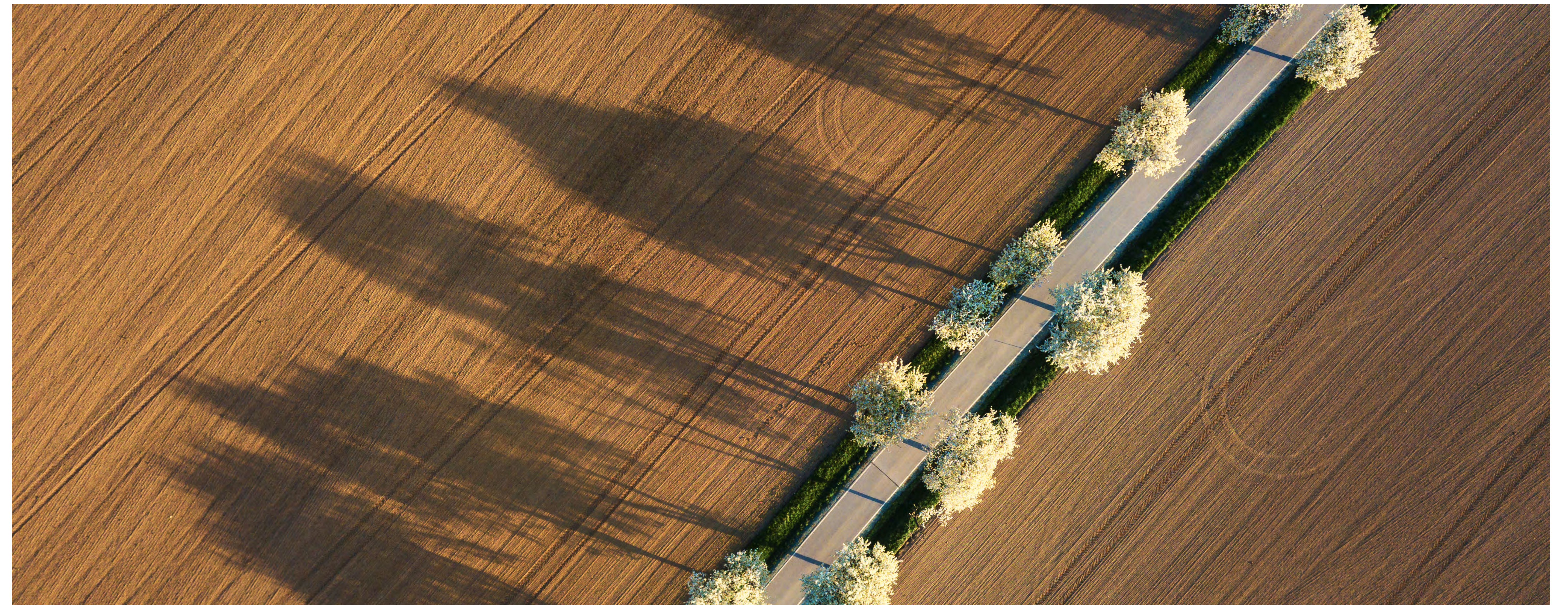
Source: Bloomberg and SLC Management, as of March 31, 2023. Expected returns based on SLC Management's analysis of the current risk free rate as of the end of Q1 2023 versus spreads characteristic of asset class benchmarks over a 3–5-year economic cycle. Proxy benchmarks used: Bloomberg US Aggregate (U.S. core bonds), JP Morgan CLO Index-Blend (IG collateralized loan obligations [CLO]), Morningstar LSTA US Leveraged Loan Index (leveraged loans), Bloomberg US Corporate High Yield Index (high yield [HY] bonds), NCREIF Property Index (real estate equity), S&P 500 Index (U.S. equity), Bloomberg EM USD Aggregate Index (emerging markets [EM] debt), S&P Listed Private Equity Index (private equity), LPX Mezzanine Index (mezzanine debt) and SLC Management internal data (intermediate investment grade [IG] private credit, narrowly syndicated credit, direct lending, commercial mortgages, value add real estate [RE] debt). Implied volatility measured by the annualized historical standard deviation of the asset class since the inception date of its corresponding benchmark. Please refer to benchmark disclosures at the end of this document.

Alternative credit continues to see increased interest

Looking further out into the risk–return spectrum into alternative credit, we're seeing a similar trend, with below IG public and private credit and real estate debt being the primary beneficiaries. While initiating an allocation to these asset classes can increase the portfolio's overall yield and, oftentimes, expected return, what's less obvious is the resulting potential improvement to portfolio diversification and reduction in overall portfolio volatility, which can be displayed by strategic asset allocation (SAA) analysis. That said, it's important to understand that this type of analysis focuses on maximizing economic value, but insurers may have different portfolio objectives such as generating more investment income, increasing surplus or optimizing capital adjusted returns. Therefore, SAA should be viewed as just one input into a process that aligns asset allocation changes with a company's goals and risk tolerance.

Considering stakeholder objectives when making portfolio decisions

With compelling opportunities available today for insurance investors of varying risk appetites, it's important to maintain an understanding of who an insurer's primary stakeholders are – be it shareholders for a publicly traded stock insurer or policyholders for a mutual insurer. **Aligning portfolio decisions with stakeholder objectives while keeping an eye on emerging regulatory changes is an important part of the insurance asset allocation process today.**



Source: Bloomberg, SLC Management, 2023.

[1] Return expectations based on an analysis of the current risk free rate as of the end of Q1 2022 versus spreads characteristic of the core fixed income benchmark, or the benchmark of another asset class, over a 3–5-year economic cycle.

Retirement plan solutions

Tim Boomer
Senior Managing Director, Head of Client Solutions, SLC Management

Ashwin Gopwani
Managing Director, Head of Retirement Solutions, SLC Management

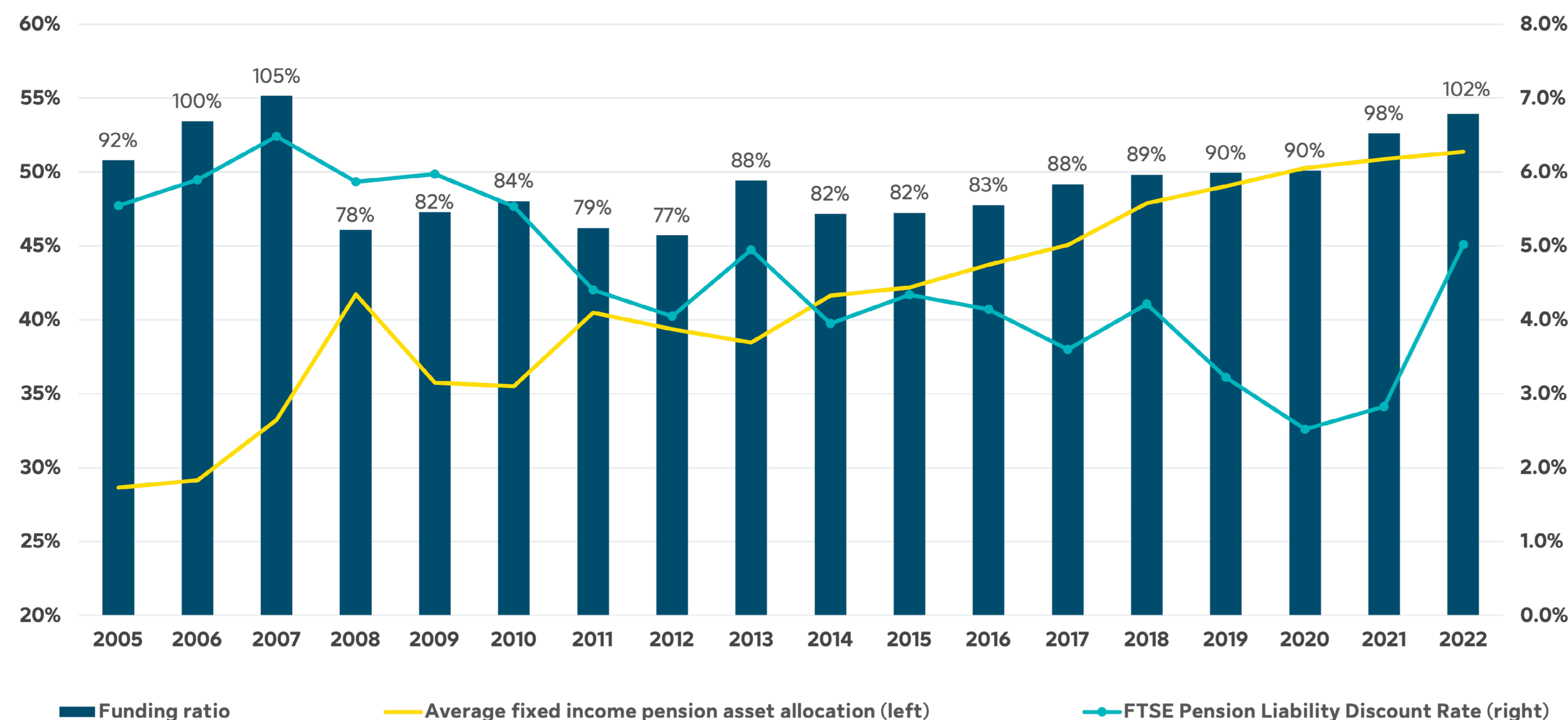
Plan sponsors move to lock in higher rates; diversification key as fixed income allocations begin to grow

As interest rates have stabilized, plan sponsors move to lock in attractive yields

So far, 2023 has provided a semblance of stability in rate markets compared to the turbulence of 2022. Many plan sponsors had experienced increases in funded statuses in 2022 off the back of rate gains, but remained hesitant to act due to fears of further rate moves. **Now that further significant rate rises appear less likely, we have seen plan sponsors come off the sidelines and look to lock in those funded status gains.**

At the mid-year point of 2023, AA accounting discount rates are over 215 basis points higher than at 2021 year end (source: FTSE Pension Liability Index, Society of Actuaries Retirement Section Council). Consequently, we believe this is an opportune time for plan sponsors to take risk off the table, as most plan sponsors are still underhedged with respect to interest rate exposure, in our view. The currently attractive yield environment (as well as the uncertainty around how long it might persist), when combined with volatile return expectations for equity markets, means that many defined benefit (DB) plan sponsors are choosing to reallocate to fixed income instruments that increase their interest rate hedge and can better protect their funded status gains from last year.

Recently higher discount rates suggest opportune time to reduce plan risk



Source: Milliman, 2022. Average based on Milliman's analysis of the financial disclosures of the 100 U.S. public companies sponsoring the largest DB pension plans. The FTSE Pension Liability Rate is a measure of the discount rates of the accounting liabilities of pension and retiree medical plans, based on the FTSE Penson Discount Curve, which is a set of yields from a hypothetical pension plan cash flow.

Impact of higher yields, regulatory changes on plan sponsors

Persistently attractive yields throughout the year, as well as uncertainty in more high-risk asset classes, have led many plan sponsors to revisit their fixed income allocations. Many DB plans are on a pre-designed glidepath that drives a shift toward fixed income as the funded status of their plan improves. For less liability-focused investors like public pension plans, we have seen a similar dynamic as **many plan sponsors are now more likely to hit their expected return targets while utilizing fixed income across the duration spectrum**. The yield on short duration corporate credit reached as high as 5.75% in the first six months of the year (source: Bloomberg U.S. 1–3 Year Corporate Index). This suggests the potential utility of these assets to be building blocks in obtaining typical plan return targets of 7% (source: Milliman 2022 Public Pension Funding Study). More broadly, fixed income and real assets are becoming particularly promising as these plans continue to mature, and many plans have become cash flow negative, increasing the importance of asset classes that provide investment income in the form of stable cash flows.

For Taft-Hartley plans, the impact of the Special Financial Assistance (SFA) program of the American Rescue Plan Act has been significant in driving changes in asset mixes. Plans have benefited from these funds available, and this has helped to secure the retirement futures of the plans' participants. However, the available funds come with restrictions that at least two thirds of any granted assets must be in fixed income securities (as well as rules around which instruments qualify). This has led many Taft-Hartley plans to expand their manager lineup as they build out fixed income portfolios and utilize managers who can help them meet their cash flow requirements while staying within the provisions of the SFA program.

Diversification a focus for investors amid new fixed income allocations

The key topic in 2023 among fixed income investors has been diversification within fixed income. With increased flows into the asset class, we have seen investors increasingly look at how they can add complementary investment styles or alternative fixed income strategies to their existing lineups. Within public investment grade (IG) fixed income, this has led to an additional focus on how managers within a multi-manager lineup are additive to one another over the long term, as well as how they perform during periods of significant market volatility. Plan sponsors are using metrics, like improvements in information ratio (IR) as a measure of the potential benefits of a multi-manager approach.

Outside of traditional credit, one of the main asset classes to benefit from these actions was IG private credit, which can provide a similar credit quality and a higher yield when compared to traditional corporate bonds. IG private credit can give plan sponsors access to additional issuers and sectors not found in the publicly traded corporate market, plus a higher yield due to the additional underwriting required and as compensation for lower liquidity. This trend has been particularly visible in the DB market, where IG private credit is typically used within a liability hedging portfolio and within the defined contribution (DC) market, in which the additional spread available in intermediate duration IG private credit can be a boost to a traditional core fixed income allocation.

For plan sponsors that have exhausted their opportunities in the IG fixed income market, we've seen increased interest in below-IG alternatives such as high yield bonds and bank loans, either as standalone sleeves or as part of a broader multi-asset credit solution, as well as increased interest in real estate and infrastructure. For plan sponsors unaccustomed to investing away from traditional asset classes, small incremental changes might be a viable option, as these can still lead to significant improvements in a plan's risk/reward outcomes.

What does the rest of 2023 have in store?

It's hard to predict what will happen as we move toward the end of the year. The consensus appears to be that we will see limited rate rises through the next six months. With this in mind, we see the trend toward fixed income to continue full steam ahead as plan sponsors look to de-risk their plans while conditions remain favorable. The adoption of alternative fixed income assets in both the DB and DC markets still feels like it is in its early stages. We anticipate significant growth for these alternative strategies as more plan sponsors become comfortable with private assets and look to potentially benefit from their attractive risk and return characteristics.

Sources: Bloomberg, Milliman, Society of Actuaries, 2023.

Disclosure

This document is intended for institutional investors only. It is not for retail use or distribution to individual investors. The information in this document is not intended to provide specific financial, tax, investment, insurance, legal or accounting advice and should not be relied upon and does not constitute a specific offer to buy and/or sell securities, insurance or investment services. Investors should consult with their professional advisors before acting upon any information contained in this document.

Sun Life Capital Management (Canada) Inc. is a Canadian registered portfolio manager, investment fund manager, exempt market dealer and, in Ontario, a commodity trading manager. Sun Life Capital Management (U.S.) LLC is registered with the U.S. Securities and Exchange Commission as an investment adviser and is also a Commodity Trading Advisor and Commodity Pool Operator registered with the Commodity Futures Trading Commission under the Commodity Exchange Act and Members of the National Futures Association. In the U.S., securities are offered by Sun Life Institutional Distributors (U.S.) LLC, an SEC registered broker-dealer and a member of the Financial Industry Regulatory Authority ("FINRA").

BentallGreenOak, InfraRed Capital Partners (InfraRed), Crescent Capital Group (Crescent) and Advisors Asset Management are also part of SLC Management.

BentallGreenOak is a global real estate investment management advisor and a provider of real estate services. In the U.S., real estate mandates are offered by BentallGreenOak (U.S.) Limited Partnership, who is registered with the SEC as an investment adviser, or Sun Life Institutional Distributors (U.S.) LLC, an SEC registered broker-dealer and a member of the Financial Industry Regulatory Authority ("FINRA"). In Canada, real estate mandates are offered by BentallGreenOak (Canada) Limited Partnership, BGO Capital (Canada) Inc. or Sun Life Capital Management (Canada) Inc. BGO Capital (Canada) Inc. is a Canadian registered portfolio manager and exempt market dealer and is registered as an investment fund manager in British Columbia, Ontario and Quebec.

InfraRed Capital Partners is an international investment manager focused on infrastructure. Operating worldwide, InfraRed manages equity capital in multiple private and listed funds, primarily for institutional investors across the globe. InfraRed Capital Partners Ltd. is authorized and regulated in the UK by the Financial Conduct Authority.

Crescent Capital Group is a global alternative credit investment asset manager registered with the U.S. Securities and Exchange Commission as an investment adviser. Crescent provides private credit financing (including senior, unitranche and junior debt) to middle-market companies in the U.S. and Europe, and invests in high-yield bonds and broadly syndicated loans.

AAM is an independent U.S. retail distribution firm that provides a range of solutions and products to financial advisors at wirehouses, registered investment advisors and independent broker-dealers.

The information provided is intended for informational purposes only and represents the views and opinion of the author(s), which may differ from those of other investment teams at SLC Management and its affiliates. The material does not consider the suitability or needs of any person or entity, and is not a recommendation in any asset class or strategy. Diversification and asset allocation do not protect against loss nor guarantee returns. Any financial indices referenced as benchmarks are provided for illustrative purposes only. The use of benchmarks has limitations because portfolio holdings and characteristics will differ from those of the benchmark(s), and such differences may be material. You cannot make a direct investment in an index. All referenced indexes are shown for illustrative purposes only. Factors affecting portfolio performance that do not affect benchmark performance may include portfolio rebalancing, the timing of cash flows, credit quality, diversification, and differences in volatility. In addition, financial indices do not reflect the impact of fees, applicable taxes or trading costs which reduce returns. No representation is being made that any investor will or is likely to achieve profits or losses in any asset class described or based on any benchmark. Past performance is not necessarily indicative of future results.

The information provided may present materials or statements which reflect expectations or forecasts of future events. Such forward-looking statements are speculative in nature and may be subject to risks, uncertainties and assumptions and actual results which could differ significantly from the statements. As such, do not place undue reliance upon such forward-looking statements. Any hypothetical data provided is for illustrative purposes only and does not represent actual client portfolios. Efforts have been made to ensure that the information contained in this report is obtained from sources believed to be reliable and accurate at the time of publication. However, SLC Management does not guarantee its accuracy or completeness. All, opinions, commentary and information is subject to change and SLC Management accepts no responsibility for any losses arising from any use of or reliance on the information provided herein. SLC Management does not provide tax, legal or investment advice and the information within does not consider the reader's investment objectives or needs. Investors should consult a professional based on their unique situation. All opinions and commentary are subject to change without notice and are provided in good faith without legal responsibility.

Unless otherwise stated, all figures and estimates provided have been sourced internally and are as of June 30, 2023.

All data are subject to change.

No part of this material may, without SLC Management's prior written consent, be (i) copied, photocopied or duplicated in any form, by any means, or (ii) distributed to any person that is not an employee, officer, director, or authorized agent of the recipient.

© 2023, SLC Management

SLC-20230712-2997525