LGIMA's Pension Solutions' Monitor

January 2018 Market Update

Overview

January saw pension funding ratios increase over the month, primarily driven by gains in the equity market and an increase in the discount rate. We estimate that the average plan's funding ratio increased 4.4% during the month of January.

Equities

The global rally in equities accelerated in January to ongoing record highs. The S&P 500 Total Return Index closed the month +5.7% and the MSCI AC World ex US Total Return Index closed +5.6%. US stock valuations continued to benefit from corporate tax reform, and the Trump administration's efforts to move the fiscal agenda towards a target of $1.5t in infrastructure investments. Macroeconomic factors contributed to strong returns: higher but moderate inflation tempering fears of excessive central bank hawkishness, synchronized global growth, rising commodity prices, high consumer confidence, and a rest in the news cycle from geopolitical tensions. International equities benefited from similar developments, as global macroeconomic factors offered a number of "buy" signals, somewhat mirroring the US. The rally was headlined by strong performance out of Asia (+8.0%) and Latin America (+13.2%). The US Dollar's decline of more than 3%, however, raised investor questions as to the relative pace and nature of quantitative tightening across the major central banks. Tough talk on trade seems to have moderated, and consensus still expects sizable room for rates to rise before affecting economic slowdown.

The equity market had a positive impact on pension funding ratios over the month.

Interest Rates

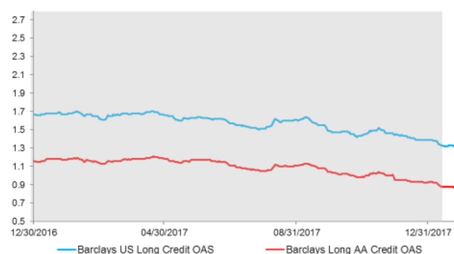
Rates have moved higher over the past month, with the 30-year Treasury rate rising to its current level of ~2.95 after closing at a 3 month low of 2.69 in mid-December. Despite the move higher in rates, the yield curve has continued to flatten, with 10s30s trading at 25 basis points, the lowest level since October 2008. The curve flattening has been influenced by pensions and insurance companies heavy flows into the long-end of the curve, likely related to firms committing to pension contributions in order to capture the tax deductions before the new policy is fully enacted.

Globally, central banks, with the exception of the ECB, are exhibiting a continued appetite for higher rates, taking strong employment data and slowly accelerating inflation as positive signals. The US Fed's regime change has gone smoothly, with Janet Yellen's last meeting resulting in no change to current Fed Funds Rate. As new Fed chairman Jerome Powell takes the baton, all eyes are on the March meeting, with a 99% probability of a rate hike currently priced into the market.

The rates market had a positive impact on pension funding ratios over the month.

Credit

As earnings season gets underway, the focus is on how companies plan to react to tax reform and not actual fourth-quarter results. While many investors expect the additional after-tax free cash flow to go to shareholders, early indications suggest some portion of the IG universe is likely to take the opportunity to deleverage, or at a minimum, issue less debt than they might have otherwise. Thus far, we've seen debt pay-down remain a top priority, especially for companies that have just repatriated their overseas cash. From a capital allocation perspective, it seems companies have not changed capital deployment plans, while others are focused on increased investments in capex and M&A opportunities.



The earnings headlines thus far emphasizing deleveraging have only reinforced the emerging concern that supply could be significantly lower in 2018. According to the investment banks, issuance was roughly 30% lower than last January's total, despite still being the second highest ever for the month of January. The US long credit index tightened 11 basis points in January, and we continue to watch the market grind tighter with higher rates, healthy demand, and strong earnings.

Overall, credit spreads had a negative impact on pension funding ratios over the month.

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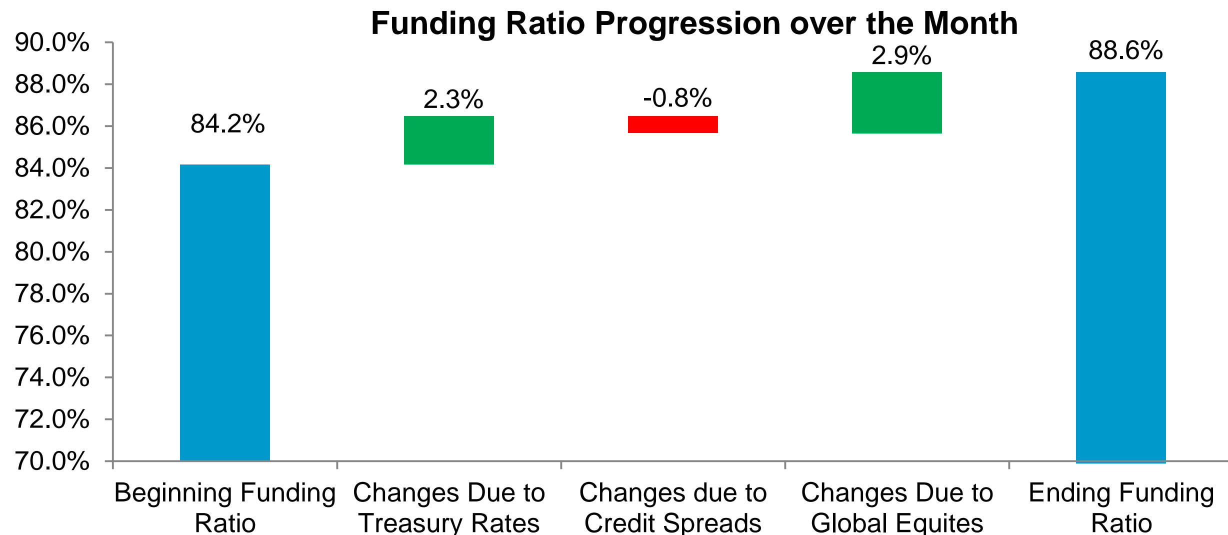
Funding Status Monitor

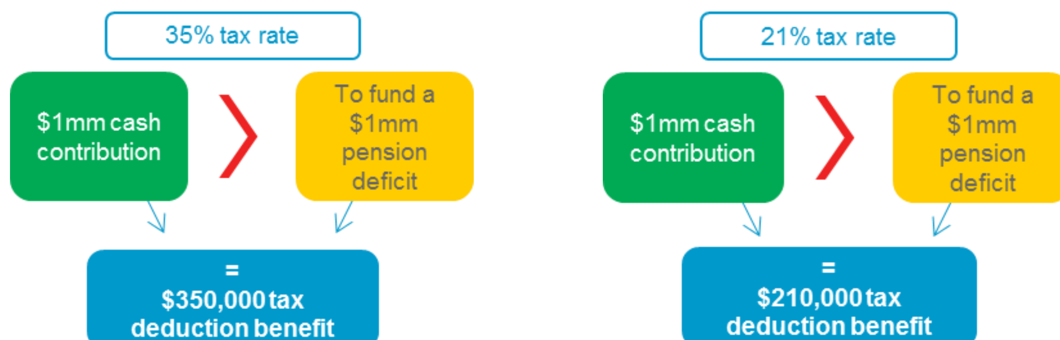
LGIMA estimates that pension funding ratios increased 4.4% over the month of January, driven primarily by strong equity returns and an increase in the discount rate. LGIMA estimates Treasury rates increased by 23 basis points while credit spreads tightened 5 basis points, resulting in the discount rate[1] rising 18 basis points. Overall, liabilities for the average plan were down 2.19%, while plan assets with a traditional "60/40" asset allocation[2] increased by 2.94%.



1: Discount rates based on a blend of the Bank of America Merrill Lynch Average US Pension Plan AAA-A and Bank of America Merrill Lynch Mature US Pension Plan AAA-A discount curves
2: For the average plan, LGIMA assumes a 60% allocation to MSCI AC World and a 40% allocation to Barclays Aggregate.

Pension market update

- The recent US tax reform legislation has lowered the corporate tax rate from 35% to 21%.
- With these lower tax rates taking effect in 2018, LGIMA believes plan sponsors will take advantage of the opportunity to improve their funding deficit, while deductions for cash contributions are worth more.
    - For example, a company with a $1 million pension deficit and a 35% tax rate could effectively fund the plan with $650,000, while that same company in a 21% tax environment would need $790,000 to close the funding gap.
    - Cash contributions made **prior to September 15, 2018** can be deducted for the 2017 plan year.
- Another potential theme to develop in 2018 is plan sponsors raising debt to fund pension deficits.
    - This can ultimately reduce risk by eliminating the need to pay rising PBGC premiums.



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