LGIMA's Pension Solutions' Monitor

February 2018 Market Update

Overview

February saw pension funding ratios experience a modest increase driven by an increase in the discount rate offset by negative equity returns. We estimate that the average plan's funding ratio increased 0.2% during the month of February.

Equities

The broad equity market experienced a heavy correction in early February, with many ascribing it, at least initially, to technical drivers within systematic short volatility strategies. From February 2 to February 9, the S&P 500 fell ~12%, only to retrace to finish the month down ~3.7%. Global equities finished down ~4.7%, with almost every major index finishing in the red.

Economic data remains robust, positioning and sentiment are generally supportive, and Q4 earnings were very strong. On the other hand, the most recent CPI print was higher than expected, wage growth surprised to the upside, and fiscal stimulus measures are increasingly perceived as badly-timed. Inflation fears are focusing the conversation on rising rates, the pace and timing of Fed rate hikes, and the repercussions for risk markets both directly, through deleveraging and de-risking in portfolio positioning, and indirectly, through potential deterioration of economic and, subsequently, corporate fundamentals.

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

Interest rates

Interest rates continued selling off for the second straight month, with the 5-year Treasury rate moving from 2.51 to 2.64. On the long end, the 30-year Treasury rate rose 19 basis points to end the month at 3.12. A strong ISM print on the first of the month helped move long-end rates 8 basis points higher, and the sell-off continued the next day as the January employment report showed wage growth surprising to the upside. The sell-off paused due to the short volatility driven equity sell-off on February 5, but resumed later that week, bolstered by the passage of the Senate budget resolution that included additional spending.

Long-end rates reached an intraday high of 3.23 on February 21 (the highest since July 2015) on the back of a hawkish interpretation of the Fed minutes from the January meeting. Jerome Powell will take the lead at his first Fed meeting in mid-March, and is expected to echo optimism in US economic growth going forward.

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

Credit

The credit markets leaked wider over the past couple weeks from an uptick in supply, inconsistent demand from foreign investors, and in anticipation of the ~$40 billion CVS deal to fund the acquisition of Aetna. Furthermore, slightly hawkish statements from Powell contributed to the pullback. While fundamentals remain strong, it remains to be seen if the soft tone will persist.

We have seen increased demand for long-end credit from liability-driven investors, as well as recent curve flattening due to weaker front-end demand. Regardless of exact identity of the front-end seller(s), it is clear that spreads have needed to move wider to find a new clearing level. At the same time, the move higher in yields is starting to translate into negative total returns and changing demand for intermediate credit in the process. So while demand for long-dated credit has increased with 30-year Treasuries above 3%, at every other part of the curve the technicals look a lot less solid.

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

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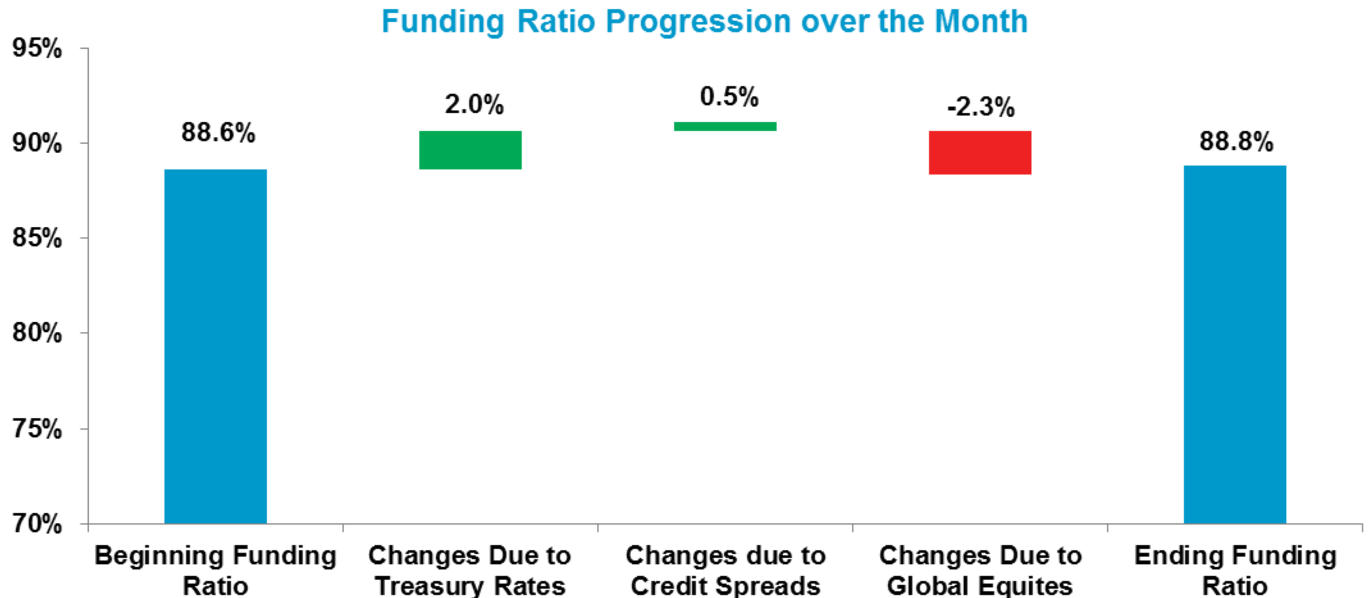
Funding status monitor

LGIMA estimates that pension funding ratios increased 0.2% over the month of February, driven by an increase in the discount rate largely offset by negative equity returns. LGIMA estimates Treasury rates increased by 19 basis points while credit spreads widened 6 basis points, resulting in the discount rate[1] rising 25 basis points. Overall, liabilities for the average plan were down 3.1%, while plan assets with a traditional "60/40" asset allocation[2] decreased by 2.9%.



[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 Bloomberg Barclays Aggregate

Pension market update

Pension plan contributions

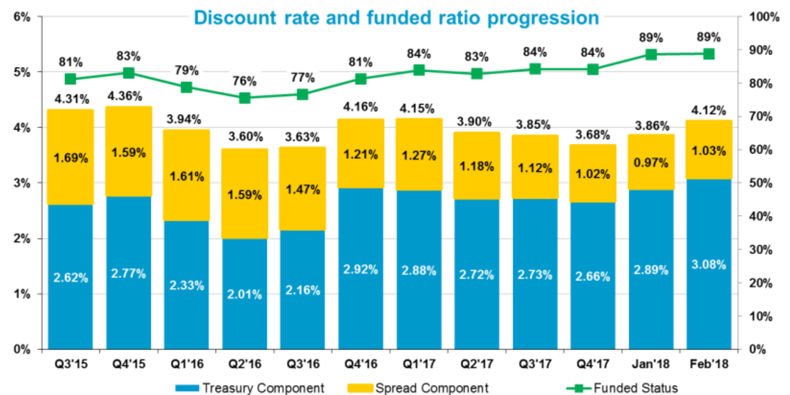
The US pension market has experienced increased activity in the past few months, triggering many companies to increase contributions.

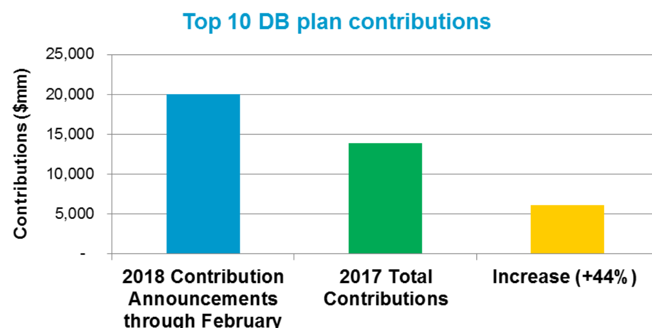
- **US tax reform legislation** has lowered the corporate tax rate from 35% to 21%, making deductions for cash contributions today worth more.
- Due to **increasing PBGC premiums**, companies can reduce risk by funding deficit.
- Another developing theme in 2018 is plan sponsors **raising debt to fund pension deficits.**

Impact

We expect a significant amount of contributions to fixed income, as plans will likely de-risk further due to:

- Improved funded ratios
- Increased interest rates
- Strong equity returns





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