LGIMA's Pension Solutions' Monitor

July 2018 Market Update

Overview

Pension funding ratios increased through July, as strong equity returns offset a slight decrease in the discount rate. We estimate that the average plan's funding ratio increased 0.8% during the month of July.

Equities

July saw impressive recovery across equity markets, with all but a handful of bourses posting strong gains. Among regions, the US and Europe led the way, finishing the month up over 3%. In the US, strong corporate earnings packaged with more positive economic data overshadowed any developments on both the trade front and the headline-grabbing price action in Facebook and Twitter. Halfway through the earnings season, the majority of S&P 500 companies thus far have beat analysts' earnings estimates, while consumer spending and employment data provide additional evidence of strong economic fundamentals beyond the Q2 GDP growth print, itself the highest rate since 2014.

While plenty of uncertainty remains, trade tensions have softened as China reasserted that it is reactive rather than proactive in its approach to any "trade war", affording some element of control to The White House, while negotiations with the European Union appear to have turned more cooperative. Brexit concerns remain without any definitive direction on the UK's future relationship with the EU, and respective price action has trended sideways.

Interest rates

US long end rates started the month by hitting local lows with the 30-year Treasury trading at 2.92%, its lowest level since late January. Mounting global concerns over trade wars helped fuel the move lower in rates, with late June statements from both Bank of England's Carney and Bank of Canada's Poloz acknowledging trade turbulence risks are increasing. These concerns only intensified as the US unveiled plans to impose tariffs on an additional $200 billion in Chinese imports, following the initial announcement of tariffs on $34 billion. The Chinese government quickly announced plans to take "firm and forceful measures" against these proposed charges. The 5s30s yield curve flattened to 20 basis points, its lowest level in over ten years, partially fueled by long end STRIP buying from the pension community taking advantage of tax breaks ahead of the September deadline.

The Treasury curve bear steepened in the second half of the month, with the 30-year Treasury rate closing out July at 3.08 and the 5s30s steepness at 23 basis points. As the BOJ cut their long end buybacks, several stories were released stating that the BOJ is considering changing their yield curve control policy to a more "flexible stance", which many interpreted as a sign the BOJ would allow rates to move higher. This would reduce Japanese buying in US Treasuries and contributed to the bear steepening. Additional factors in the move were the PBoC weakening the CNY fixing by the largest one day amount in two years and unexpected tweets from the President questioning the Fed's decision to continue hiking rates.

Credit

Nearly to the day of 2Q-end of 2018, the summer credit rally began. US Long Duration credit and US Credit tightened 18 and 13 basis points in July, respectively. This has been the longest and sharpest rally of 2018, and is due to a confluence of events that continue to persist. First, the pace of new issuance has slowed in July, as the market is currently 9% behind 2017's total supply number, year-over-year. Furthermore, it seems as if M&A-related supply—a major swing factor—is likely to be lower in the months ahead as well. Second, dealer inventories are at multi-year lows, which generally exacerbates credit spread tightening. Third, demand for credit has picked up as foreign investors have returned to the market along with increased inflows into IG bond funds/ETFs in July. Fourth, half-way through earnings season, year-over-year earnings growth is solid and currently running at 21.6%, similar to the 21.5% year-over-year growth from 1Q. Lastly, at least for now, macro and trade-related risks have faded somewhat and the equity market appears on the path to new record highs. Meanwhile, a 2Q GDP print of 4.1% suggest recession risk is low. That being said, it remains to be seen how long this rally will continue as global central banks continue to tighten and at some point in 2019 the US fiscal stimulus is likely to fade.

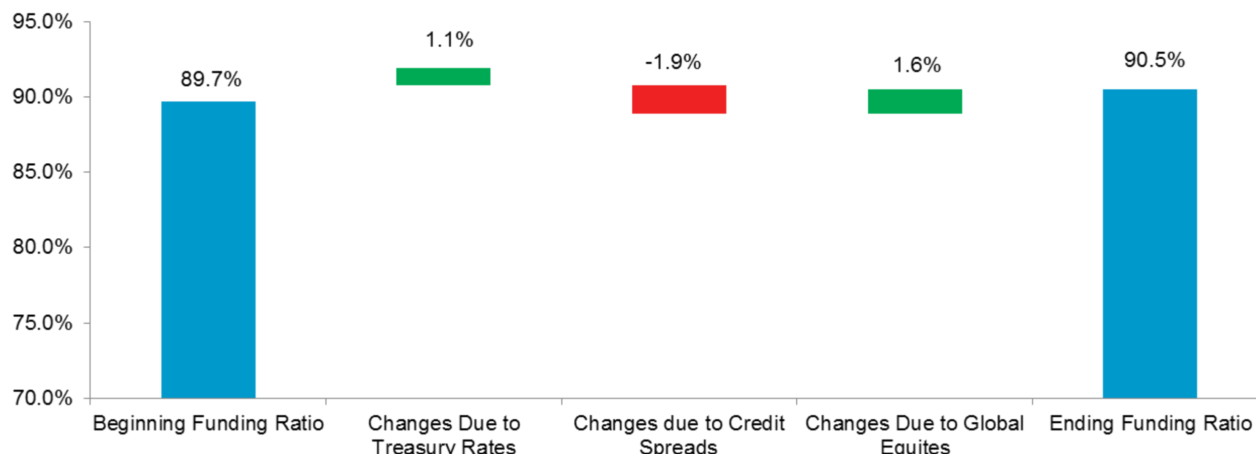
Funding status monitor

Contact LGIMA

Follow us on LinkedIn

http://www.lgima.com/

LGIMA estimates that pension funding ratios increased 0.8% over the month of July, with gains driven primarily by a strong month in the global equity markets offsetting a slight decrease in the discount rate. LGIMA estimates the Treasury component increased by 11bps while the credit component decreased by 15bps, resulting in the discount rate[1] falling 4bps. Overall, liabilities for the average plan were up 0.9%, while plan assets with a traditional "60/40" asset allocation[2] increased by 1.8%.



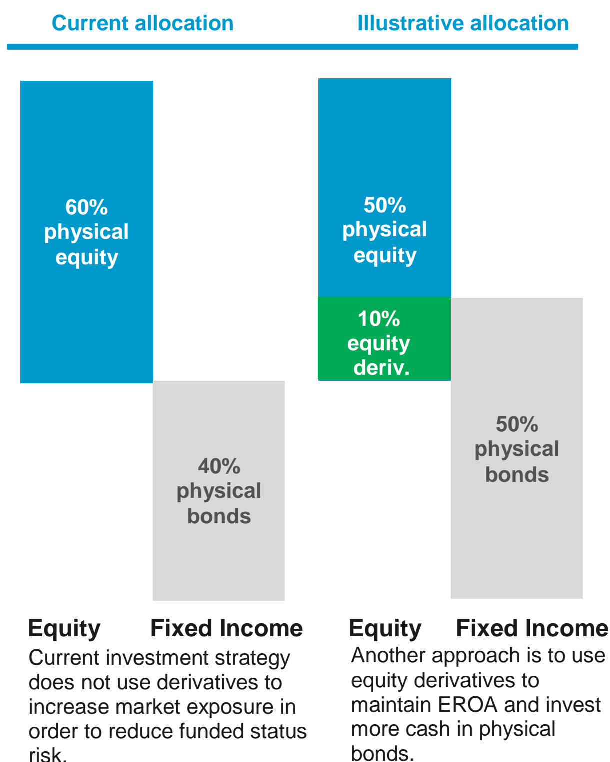
[1]Discount rates based on a blend of the Bank of America Merrill Lynch Average US Pension Plan AAA-A and Bank of America Merrill Lynch Mature US Pension Plan AAA-A discount curves

[2]For the average plan, LGIMA assumes a 60% allocation to MSCI AC World and a 40% allocation to Bloomberg Barclays Aggregate

Pension market highlights

Considerations for equity replacement

- As funding ratios continue to grind higher, plans may give equity replacement strategies further consideration to meet their investment objectives
- One implementation approach is to consider selling physical equity allocations and replace exposure with attractive equity derivatives
    - Sell 10% of physical equities
    - Invest 10% in more high quality fixed income
    - Can hedge more interest rate risk up to the Plan's objectives
    - Tailor new equity exposure relative to 10% delta-one notional value
- We can tailor a custom equity derivative mandate to take advantage of strategic objectives and active management opportunities
    - Strategic: Willing to give up some equity upside for larger amounts of equity protection
    - Active: Manage relative value derivative positions to defray some of the strategic costs



Disclosure: Views and opinions expressed herein are as of July 2018 and may change based on market and other conditions. The material contained here is confidential and intended for the person to whom it has been delivered and may not be reproduced or distributed. The material is for informational purposes only and is not intended as a solicitation to buy or sell any securities or other financial instrument or to provide any investment advice or service. Legal & General Investment Management America, Inc. does not guarantee the timeliness, sequence, accuracy or completeness of information included. Past performance should not be taken as an indication or guarantee of future performance and no representation, express or implied is made regarding future performance.