LGIMA's Pension Solutions' Monitor

May 2018 Market Update

Overview

May saw pension funding ratios experience a slight decrease driven by a fall in Treasury rates, partially offset by widening in credit spreads. We estimate that the average plan's funding ratio decreased 0.3% during the month of May.

Equities

Stock markets were mixed over the month of May, with divergence between the US vs. ex-US markets leaving the ACWI essentially flat. While US markets posted strong gains on bullish sentiment and robust economic fundamentals, international markets were generally down across the board. European stocks kept up with US markets through the first three weeks of the month before sharply selling off on political turmoil in Italy, namely the likelihood and extent of Euro skepticism of a populist coalition in Europe's third largest economy and the world's third largest debtor, and the potential for ensuing contagion. Emerging markets were the biggest losers, both on systematic factors such as a seemingly negative shift in risk appetite and trade war concerns and idiosyncratic risks in specific Latam and EMEA markets (with Turkey and Argentina battling crises). Other data points in the US, such as the sharp outperformance of growth over value, small cap over large cap, and sectors such as tech over telecom, suggest that risk sentiment is clearly much firmer in the US than in the rest of the world.

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

Interest rates

From April month-end to May month-end, Treasury yields fell by about 10 basis points across the curve. But mid-month rates hit new cycle highs, with the 30-year rate touching 3.26 for the first time since late 2014. This sell off was fueled by selling in Asia, some above consensus manufacturing prints, and retail sales figures showing that spending data is rebounding from a sluggish Q1. Additionally, in the Fed statement following the May meeting, language was added about inflation being "symmetric" around their 2% target, which many interpreted as a sign that the Fed would let inflation run above target and not let it alter their proposed hiking path. The selloff in rates quickly reversed, however, heading into the Memorial Day weekend. Political uncertainty in Italy surrounding questions about the formation of a government and timing of elections led to a flight to quality rally in Treasuries as periphery spreads gapped wider. The 30-year US yield traded down to 2.95 before the initial panic settled and ended the month at 3.03.

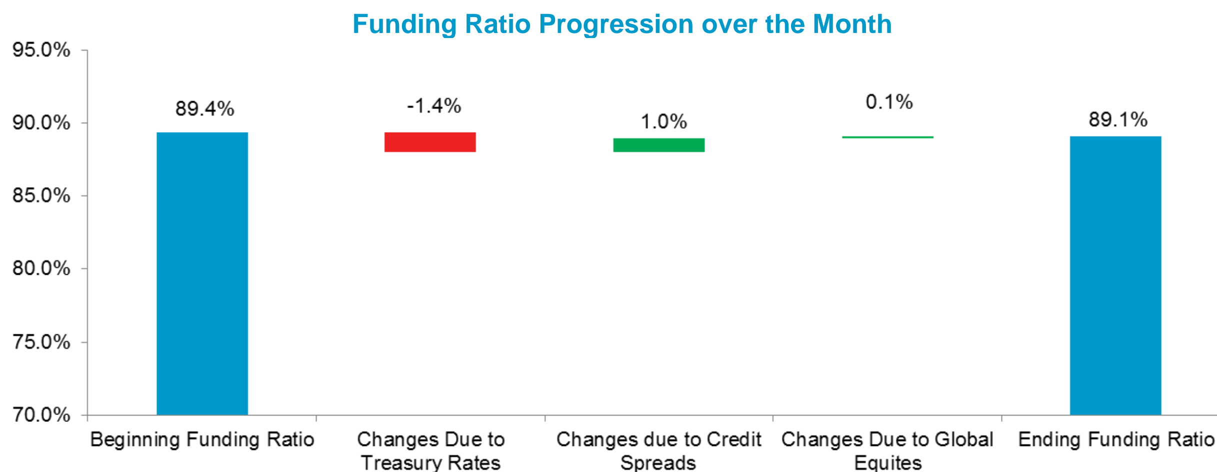
Credit

US Long duration credit continued to leak 11 basis points wider in May, ending the month at year-to-date wides of 164 basis points. The new issue market brought $112 billion in supply, in line of the $100-120 billion expected for the month. While June tends to historically be a lower average issuance month, some of the larger M&A deals are expected to come to market and will likely bring additional supply. Given the oscillating demand in IG credit on any given week this month, the incremental supply may potentially further weigh on spreads.

The recent volatility stemming from geopolitical events such as Italy and trade tariffs has been relatively contained in US IG credit, although bank credit spreads have underperformed. The question is whether any of these issues would have mattered last year, when central bank-supplied liquidity was still ample. There's a strong suspicion that much of the volatility we are currently experiencing would have been suppressed, and that the current bout of EM risk aversion and Eurozone stress would have been easily dismissed against a backdrop of rock solid technicals. If the weakness in credit markets is really just an illustration of less central bank accommodation, then this month's performance may be a warning of more repricing to come as quantitative tightening really gets going in the second half of 2018.

Funding status monitor

LGIMA estimates that pension funding ratios decreased 0.3% over the month of May due to a slight decrease in the discount rate and weak equity returns. LGIMA estimates the Treasury component decreased by 11 basis points while the credit component increased by 8 basis points, resulting in the discount rate[1] falling 3bps. Overall, liabilities for the average plan were up 0.8%, while plan assets with a traditional "60/40" asset allocation[2] increased by 0.4%.



[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

Themes	Why?
Customized liability strategies continue to have strong demand (liability benchmarking and completion management).	• The recent performance of equities and rise in Treasury yields have made entry points into more customized LDI strategies more attractive
Custom credit strategies are a growing area of interest by clients focused on the end-game objective, self-sufficiency or pension risk transfers.	• Focus on high quality, diversified credit portfolios with lower turnover, reduced costs and a better match to the plan liability • Monetize decisions already made within a glidepath
Derivative overlays have been a growing component of plans' investment strategies to help shape funded status outcomes.	• Dynamic protection strategies • Synthetic equity strategies: TRS, risk reversals, put-write strategies
Synthetic risk premia (alternative beta) strategies have also been a topic of interest to help replicate hedge fund exposure and/or for factor completion.	• Institutional investors increasingly looking to alternative allocations for diversification rather than "alpha" • Synthetic risk premia strategies offer similar exposures with greater transparency, lower fees, and increased liquidity

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