LGIMA’s Pension Solutions’ Monitor

November 2017 Market Update

Overview

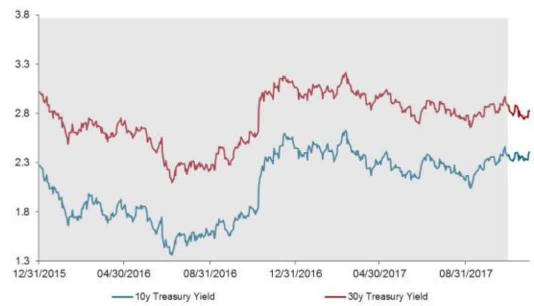
November saw pension funding ratios increase over the month, primarily driven by gains in the equity market and minimal changes in the discount rate. There was limited movement in both interest rates and credit spreads month to month. We estimate that the average plan’s funding ratio increased 0.7% during the month of November.

Equities

Stocks continued their run in November, with strength driven by a month-end rally in the U.S. Although international equities were up 0.8%, the shares primarily benefited local investors' gains in local currency terms as the dollar declined. The S&P 500 continued to surge and returned 3.2%, rotating from technology to consumer and telecom sectors on holiday spending season optimism. Equity volatility hovered near record lows, though began to show signs of investor concern amid uncertainty surrounding U.S. tax reform. Sentiment was buoyed by sustained high consumer confidence. International equities were led by Asia and emerging markets while Latin American weakness continues. The increase in equities had a positive impact on pension funding ratios over the month.

Interest Rates

Jerome Powell’s appointment, coupled with apprehension that the new GOP tax cut plan would face resistance in the Senate, led to a rally in treasuries in the beginning of the month. The rally halted and treasuries began to sell off throughout the month as the tax plan began to gain more traction and equities continued to rally. The market has priced in a ~96% likelihood that the Fed will raise rates in their December meeting.

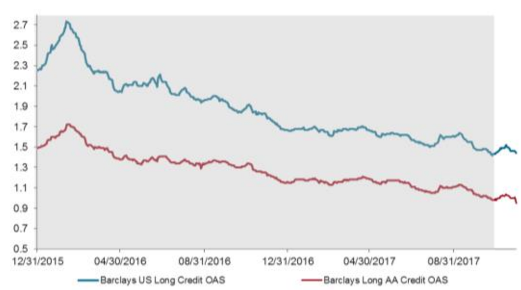


Both 10-year and 30-year rates traded in a tight, 9 basis points range in November. The low realized rate vol has been reflected in implied swaption volatility with the 3mo10y vol dropping 6.5 abpv to 56.9 and 3mo30y falling more modestly by 2.1 abpv to 57.86.

Over the month, the Treasury curve flattened substantially as the 10s30s spread contracted by 8.5 basis points to 41.7 basis points, the 10-year rate rose 3 basis points to 2.41 basis points, and the 30-year rate fell 5 basis points to 2.83. The moves in rates have had a negative impact on pension funding ratios over the month.

Credit

After a shaky beginning to November, the most notable influence in credit markets over the month has been the progress on tax reform.



The Barclays US Long Credit OAS remained unchanged month-to-month while the AA Long Credit OAS tightened 4 basis points primarily due downgrade mathematics. GE’s AA rating was lowered to A by two ratings agencies during the month. GE’s bonds were over 30 basis points higher than the AA Index and accounted for over 11% of the index. When they are no longer included in the weighted average, the OAS falls 4 basis points.

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

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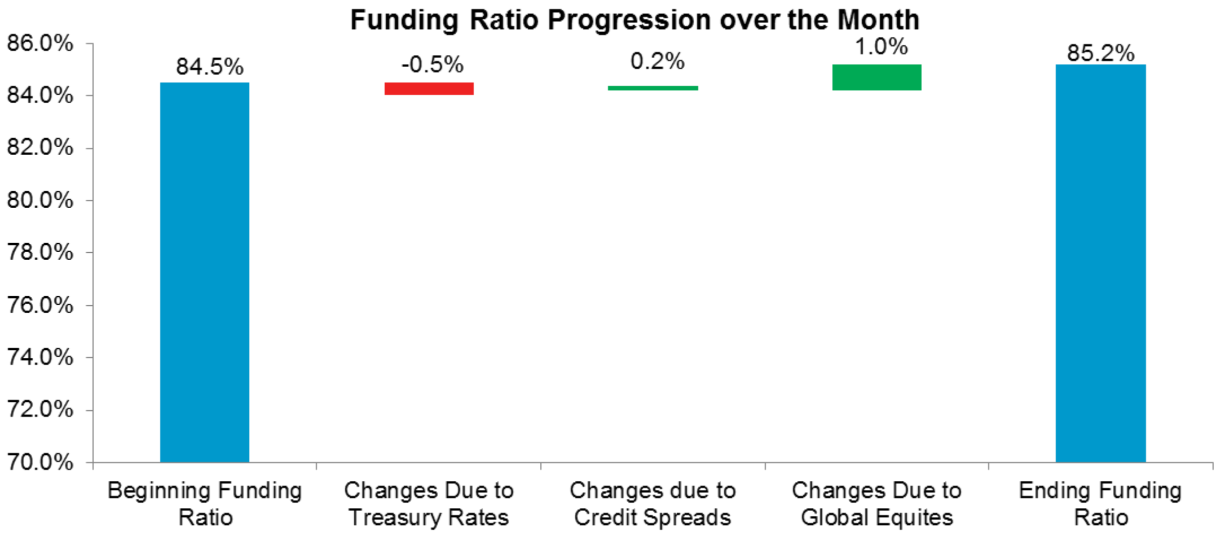
Funding Status Monitor

LGIMA estimates that pension funding ratios increased 0.7% over the month of November, driven primarily by gains in the equity market. LGIMA estimates Treasury rates decreased by 1 basis point while credit spreads widened 2 basis points, resulting in the discount rate[1] rising 1 basis point. Overall, liabilities for the average plan were up 0.3%, while plan assets with a traditional "60/40" asset allocation[2] increased by 1.14%.



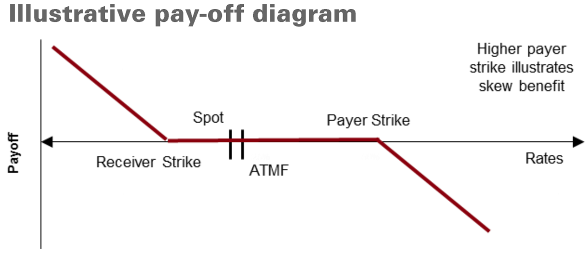
1: Discount rates based on a blend of the Bank of America Merrill Lynch Average US Pension Plan AAA-A and Bank of America Merrill Lynch Mature US Pension Plan AAA-A discount curves
2: For the average plan, LGIMA assumes a 60% allocation to MSCI AC World and a 40% allocation to Barclays Aggregate.

Strategies to benefit from recent market moves

Swaption Collar

- Implied interest rate volatility continues to move lower, however corporate defined benefit plans can take advantage of the current skew environment
- Plans can take advantage of the skew by selling high strike payer swaptions and utilize premium to purchase low strike receiver swaptions
- Should rates rise from current levels, plans will be legged into higher interest rate exposure and will be protected should rates fall from current levels

Illustrative pay-off diagram



80/90% Put Spread

- This strategy simultaneously buys a 90% put and sells an 80% put in the 6-month maturity, giving plans downside protection at a reduced cost
- In this strategy, the plan's maximum cost would be 80 basis points to potentially earn 10% if markets fall up to 20%

Illustrative pay-off diagram