LGIMA's Pension Solutions' Monitor

August 2018 Market Update

Overview

Pension funding ratios were roughly unchanged through the month of August as a drop in Treasury rates were mostly offset by widening credit spreads and a positive month for global equity returns. We estimate that the average plan's funding ratio remained at 90.5% during the month of August.

Equities

While trading desks may have experienced a slight summer lull, August delivered headlines that we expect will have a sustained impact. Over the month, most equity indices sold off, while US equities continued a strong rally on the year, thanks to strong GDP growth numbers and business sentiment. Additionally, solid consumption data, benign inflation prints, and impressive employment numbers have led investors to expect no surprises from the Fed.

In Europe, GDP growth was revised upward, but core inflation remains low, likely prompting the ECB to hold off on any rate hikes. Investors are also beginning to question the strength of the Italian economy, as slow growth combined with political uncertainty sparked a sell-off in both equity and bond markets. Brexit continues to dominate UK headlines, with investors expecting little action from the Bank of England until the outcome is more certain. Headlines such as additional US tariffs on Chinese exports and tumultuous times in Turkey had a fairly significant contagion impact on emerging markets, with most related indices down on the month.

Interest rates

August saw a reversal of the selloff in rates that we saw in July as concerns mounted over the risk of contagion as financial conditions in Turkey deteriorated. The Lira had declined by as much as 20% intraday on August 10 as periphery spreads in Europe widened. Long end rates continued to rally on the release of Powell's Jackson Hole speech on August 24 as the 30-year Treasury rate hit an intra-month low of 2.96. Rates have recovered somewhat since then, with the 30-year closing out the month at 3.02. Although the speech didn't reveal any particularly new information, Powell emphasized the Fed plans to continue with gradual rate hikes even if inflation is not materially higher than the stated 2% target. This pushed the 2s30s steepness to a new cycle low of 34 basis points – 7 basis points flatter than the 41 basis points seen at July month end. This flattening reversed late in the day on light volumes at month end going into the long Labor Day weekend. The 2s30s curve closed out August at 39 basis points.

Credit

With many senior traders and portfolio managers on vacation during the month, August was predictably sluggish from the perspective of corporate bond issuance and spread volatility. That being said, the Bloomberg Barclays Long and Market Credit indices widened 9 and 5 basis points, respectively. And August did produce $80 billion in new supply—up from July—as expectations for a September surge continued to grow. In the first week after Labor Day alone, issuance is anticipated to be in the $40-60 billion range likely anchored by a $15-20 billion M&A funding deal. Not surprisingly, dealer inventories remained light throughout August as they position to absorb some of the paper syndicate desks will bring to market. How much bank balance sheets buy will be dependent upon how robust investor demand is as well as at what price new deals clear. While bond market technicals look to be in flux, US economic data remains robust and US GDP is still on track for 3 - 4% growth in 3Q18. Investors will be watching for the monthly non-farm payrolls number on September 7 for a further gauge of the momentum in the US labor markets. We expect the Fed to hike again in September as they continue to hike at a once-a-quarter pace into 2019. After the investment grade bond market digests the abundance of issuance in September, the near-term direction of credit spreads should be easier to assess.

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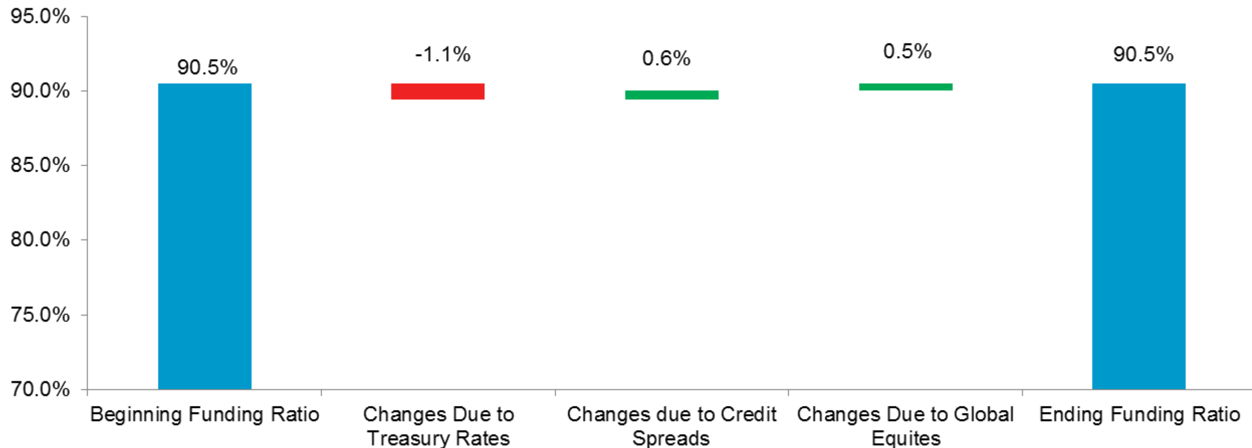
Funding status monitor

LGIMA estimates that pension funding ratios were roughly unchanged through August, with gains driven primarily by positive global equity returns and a modest widening in credit spreads offsetting a slight decrease in the discount rate. LGIMA estimates the Treasury component decreased by ~9 basis points while the credit component increased by 6 basis points, resulting in the discount rate[1] falling 3 basis points. Overall, liabilities for the average plan increased ~0.8%, while plan assets with a traditional "60/40" asset allocation[2] also increased by ~0.8%.

Funding Ratio Progression over the Month



[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

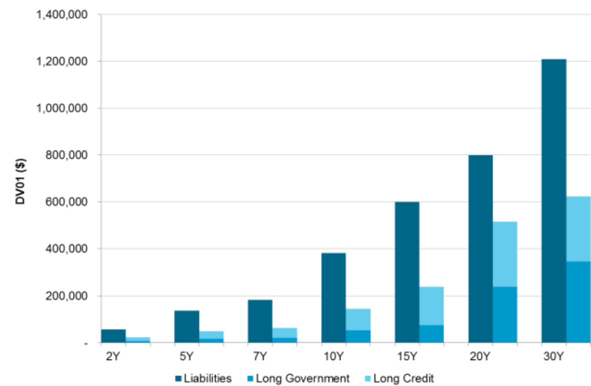
[2]For the average plan, LGIMA assumes a 60% allocation to MSCI AC World and a 40% allocation to Bloomberg Barclays Aggregate

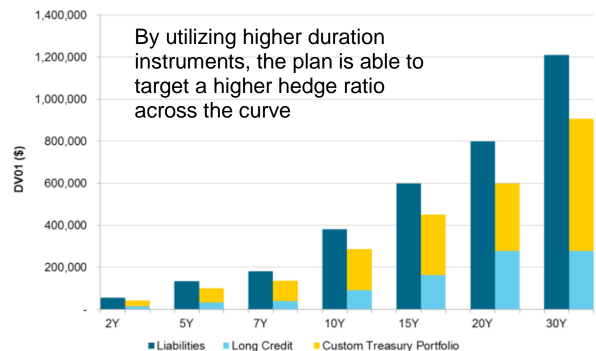
Pension market highlights

Considerations for customized hedging strategies

Customized liability hedging strategies continue to garner strong demand in the form of liability benchmarking and completion management

- Illustrated in the graphs to the right is an example of the sensitivity of the total liability value along with the fixed income components to changes in interest rates at different points across the curve
- The example scenario represents a 90% funded plan with a 50% allocation to fixed income
  - The top scenario allocates the fixed income portfolio to Long Gov't / Credit to target a ~50% interest rate hedge ratio at the total level
  - The bottom scenario allocates the government component to a custom Treasury portfolio to further improve the capital efficiency and increase the interest rate hedge ratio to ~75%
- LGIMA understands developing the appropriate solution for a plan depends on a multitude of factors, but incremental customization can offer several benefits
  - Achieve higher hedge ratios by improving the plan's capital efficiency
  - Mitigate unintentional curve exposure
  - Align the plan's fixed income portfolio more closely with the liability





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