# LGIMA's Pension Solutions' Monitor

February 2020 Market Update

## Overview

Pension funding ratios decreased throughout the month of February, with changes primarily attributed to declining treasury yields and poor equity performance. We estimate that the average plan's funding ratio decreased 5.3% to 74.4% throughout the month.

## Global equities

The Coronavirus became the primary focus for equity markets in February. Over the course of the month, it seemed that interest rates and commodities immediately reflected Coronavirus risk while equities played catch up. Initially, equity markets dismissed concerns over the outbreak as U.S. Q4 earnings season surprised to the upside and business surveys improved from January. But while recent hard macro data indicates that the U.S. economy remains healthy, the spread to a growing number of countries has dramatically increased the probability of it crossing the threshold from epidemic to pandemic in the coming weeks. Because of this realization, U.S. and global equity indices fell over 8% on the month.


Source: Bloomberg/Barclays and LGIMA as of 02/29/20.

The good news is that within China, the government seems to have been successful in containing the virus (assuming reported numbers are accurate). From an economic perspective, the ultimate damage to China will depend on how quickly the country can get back to work. Currently, it seems that Chinese economic activity is at 50-80% of normal. However, data released in February showed a larger decline than markets had expected, with GDP falling at an annualized rate of 6.3%. Japan has also experienced heavy exposure to the virus, leading experts to predict falling inbound tourism and trade in Q1, greatly increasing risks for an already fragile Japanese economy.

The eurozone opened February off with positive momentum from January, where it saw positive survey results in the face of multiple drags, including the trade war, Brexit uncertainty and an emissions scandal. The improvement was also notably reflected in German manufacturing in January. However, the February flash PMI results quickly showed a negative impact from the virus. Moving west, both consumer and business sentiment improved in the U.K. through February. However, experts predict the U.K. to have a similar experience to the rest of the eurozone.

## Interest rates

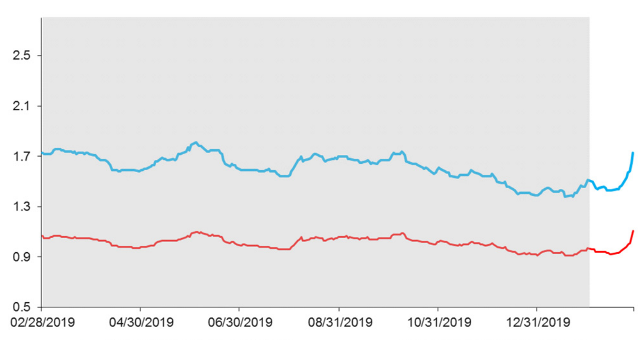

Source: Bloomberg/Barclays and LGIMA as of 02/29/20.

The Coronavirus outbreak continued to dominate the rates narrative in February, as fears of a full blown pandemic further slowed domestic and global growth. This environment led the U.S. yield curve to bull steepen violently over the month. The front-end led rates on the way down. The 2-year treasury yield rallied from 1.31 to 0.91 in February as the market began pricing in more aggressive rate cuts for the Fed in 2020 (which came to fruition on March 3, when the Fed announced an emergency 50 basis point cut). The long end rate closed out January at 2%. Rates sold off at the start of the month as the PBOC injected liquidity into the market via reverse repos and more attractive lending terms to local banks. This was in an effort to offset the economic drag of the Coronavirus outbreak and subsequent factory closures.

Despite a strong jobs report (including strong wage growth), new cases of the Coronavirus in Japan led to the temporary suspension of many manufacturing plants. In the Fed's semi-annual Monetary Policy Report to Congress, Chair Powell acknowledge the uncertainty around the virus outbreak and that it would not be known for some time what the economic impact would be. Weak retail sales numbers coupled with a continuing climb in newly confirmed Coronavirus cases helped long-end rates rally back below 2%. More confirmed infections in China and South Korea emphasized the uncertainty around incubation and containment, and preliminary export data from Korea showed it was down nearly 10% in the first three weeks of February. A new case in California of unknown origin spooked the market going into month end, as the 30-year rate closed out the month at a new all-time low of 1.68.

Governments and corporations – both domestic and international – have been taking aggressive steps in an effort to contain the outbreak: limiting travel, cancelling flights, closing schools, closing plants, cancelling festivals and parades, etc. Testing for the Coronavirus infection is still expensive and time consuming. New cases pop up in new countries seemingly every day, so it's difficult at this point to know the full extent of how far the disease has spread. The longer the uncertainty and the bold efforts to curb the spread persist, the larger the drag on global growth is likely to be. The next Fed meeting is in mid-March and the market is already pricing in more than one cut.

## Credit




Source: Bloomberg/Barclays and LGIMA as of 02/29/20.

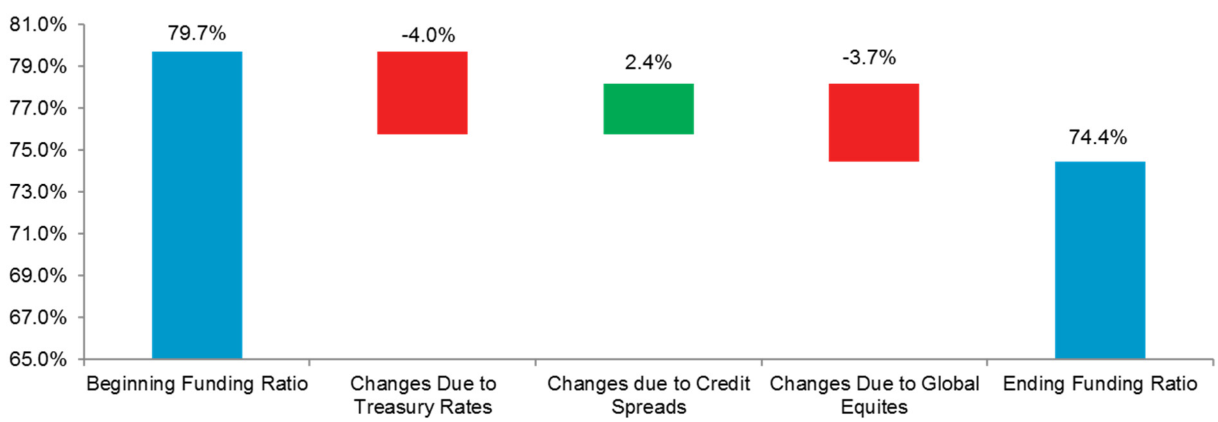
The news cycle throughout February was consumed by the development and spread of the Coronavirus. The public response to the virus has effectively resulted in supply-chain disruptions, weak retail sales, and the potential for a decrease in consumer sentiment. U.S. Manufacturing surprised to the downside with a reading of 50.1, just narrowly escaping contraction territory. Meanwhile, the March 2nd Caixin manufacturing PMI reading came in at 35.7, around 14 lower than January's reading.

As a result, various asset classes across the globe have experienced high volatility. The U.S. Fed conducted an emergency 50 basis point cut 2 weeks before the March FOMC meeting to help mitigate some of this unanticipated risk. The market has also priced an additional 2-3 cuts throughout 2020. Global Central Banks have openly communicated their willingness to support financial markets, pledging to "stand ready to take appropriate and targeted measures." Our base case now incorporates a significant near-term hit to activity, where U.S. GDP could experience 0% growth in 1H20, followed by extensive dovish monetary policy. Assuming the virus is ultimately contained, we anticipate a sizable economic rebound in the summer months, as normalization of activity will be supercharged by excessively loose monetary policy.

In terms of technicals, the global uncertainty has resulted in a "flight to quality", as issuers remained on the sideline for the last week of February. Typically, this supply-demand dynamic is supportive of credit spreads. However, the risk-off sentiment caused the Long Credit benchmark to widen 22 basis points to 173. Currently, supply has continued to outpace 2019's issuance while demand remains elevated as investors have built up cash that needs to be put to work. Given the record low in funding costs, the estimated issuance for March is expected to range from $100-200 billion. Our overall short-term outlook is slightly negative, with a more neutral stance in the long-run.

## Funding status monitor

LGIMA estimates that pension funding ratios decreased 5.3% throughout February, with changes primarily attributed to lower treasury yields and the decline in global equity performance. Our calculations indicate the discount rate's Treasury component fell by 36 basis points while the credit component widened 19 basis points, resulting in a net decrease of 16 basis points. [1] Overall, liabilities for the average plan increased ~2.7%, while plan assets with a traditional "60/40" asset allocation[2] decreased by ~4.1%.




1 Discount rates based on a blend of the Intercontinental Exchange U.S. Pension Plan AAA-A and Intercontinental Exchange Mature U.S. 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.

# Potential benefits of completion management

| Themes | | Comments |
| --- | --- | --- |
| Hedges liabilities | ✓ | Asset exposure completes to the Plan’s interest rate hedge ratio |
| Capital efficiency | ✓ | Allocation allows for the plan to hedge a greater amount of risk with fewer dollars allocated |
| Incorporates external manager exposures | ✓ | Completion management incorporates benchmark exposures so as not to offset any active decisions of the external manager |
| Customized to liability | ✓ | Completion portfolio is designed to match the key rate duration profile of the liability |
| Allows for derivative positions | ✓ | Completion management offers the flexibility to use derivatives to provide a more precise hedge. Exposure can be dialed up or down to meet the Plan’s hedging objectives |
| Transfers accountability of duration/curve risks to manager | ✓ | Completion portfolio reduces uncompensated risks such as curve exposure mismatch and hedge ratio drift |
| Evolves with liability | ✓ | Completion portfolio is designed to match the liability characteristics as time passes |