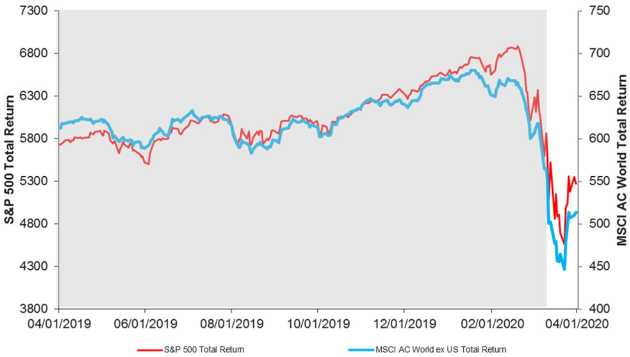
LGIMA's Pension Solutions' Monitor

March 2020 Market Update

Overview

Pension funding ratios decreased throughout the month of March, with changes primarily attributed to poor equity performance and widening credit spreads. We estimate that the average plan's funding ratio decreased 0.9% to 73.5% throughout the month.

Global equities



Source: Bloomberg/Barclays and LGIMA as of 03/31/20.

Over the past month, COVID-19 has become the primary focus for investors in all markets and asset classes. Equity markets experienced the heavy initial shock followed by "peak panic," as implied volatility measures hit essentially the highest prints ever recorded, and realized volatility reached levels not seen since the Great Depression. The unprecedented level of uncertainty about the course of direction of the disease and its impact on the economy meant that markets across the board became extremely illiquid, with bid-ask spreads blowing out, and many essentially ground to a halt. As the month progressed and the range of probable outcomes was somewhat better understood – and with perhaps at least some relief from dramatic central bank interventions – volatility reversed and liquidity started to return to the markets, although both still remain at highly distressed levels.

While no index was spared substantial losses, U.S. large cap stocks outperformed international stocks, falling 12.4% versus 14.1%. U.S. small cap stocks significantly underperformed both, posting a -21.7% return. Economic data and commentary was grave across the board, with initial jobless claims soaring to by far their highest weekly number ever recorded and dramatic predictions of much worse to come. The severity of economic data will perhaps have a less dramatic impact on the markets than some predict. For example, an extreme unemployment rate tells us that the government stimulus benefits are generous while a massive GDP contraction tells us people stayed at home and reduced the spread of the virus. Except for virus data, the most important driver could be data reassuring the markets that businesses are getting the government support they need to avoid bankruptcy during the lockdown period.

The top performing sectors in the U.S. included healthcare (-3.6%), consumer staples (-4.9%), and technology (-9.3%). Energy stocks (-29.4%) experienced the largest hit due to the perfect storm of crashing demand because of the virus and increasing oil supply from the Saudi-Russia price war. Financials (-22.3%) and industrials (-17.7%) also experienced heavy losses. Naturally, equities had a very negative impact on pension funding ratios.

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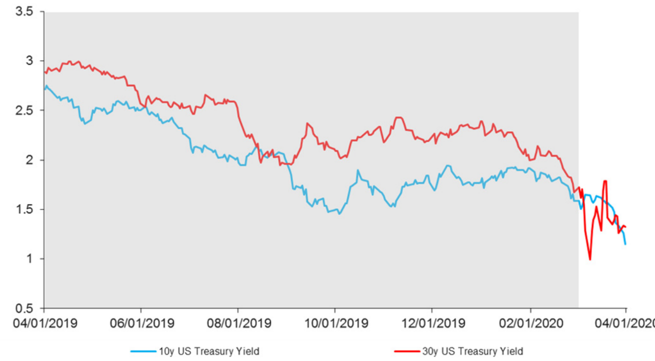
Interest rates



Source: Bloomberg/Barclays and LGIMA as of 03/31/20.

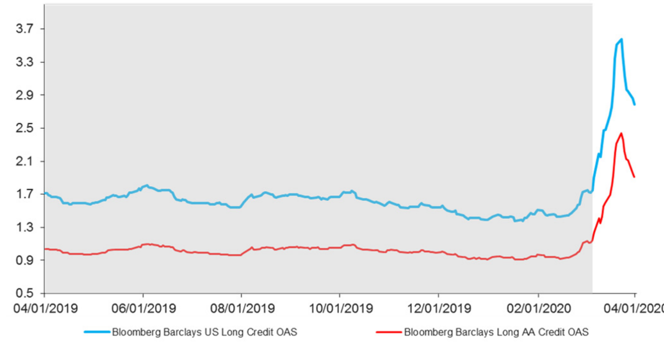
Long-end rates experienced one of the most volatile months on record in March as the 30 year Treasury rate went from 1.68 at the end of February all the way down to 70 basis points, back up to 1.78, and then closed out March at 1.29. Other than the last day of the month, the 30-year bond traded in double digit range on a daily basis, averaging a 25 basis point difference between the high and low print of the day. The 5s30s Treasury curve went from 74 at the end of February down to 51 in less than two weeks before rocketing up to 109 over the next two weeks before closing out the month at 94. The wildly swinging market movements felt eerily reminiscent of the financial crisis in 2008. The other point of comparison is that the 37 basis point rally on March 20 was the largest one day long bond close-to-close move since October 19, 1987, otherwise known as Black Monday. Comparisons to the Great Financial Crisis and Black Monday basically sums up the market sentiment at this point.

As the Coronavirus spread in the U.S. and abroad, governments and central banks took drastic actions to keep the economy going and prevent the further spreading of the disease. It is still way too early to tell how many people will be infected and how much impact this will have on growth, which led to a violent risk off move. Fears had already pushed the U.S. 30-year Treasury rate to 1.68 to close out February. On March 3 the Fed announced an emergency 50 basis point cut - the first non-meeting rate change since the financial crisis.

A strong employment report at the end of the week was no match for the failed OPEC+ meeting negotiations that helped push crude oil prices plummeting 30% after the weekend. In the overnight trading session, the 30-year treasury traded just below 70 basis points, which was a new all-time low, before selling off in the N.Y. session to end the day at a more respectable 99.5 basis points. The Fed moved up their March meeting to the weekend and on Sunday, March 15 they cut rates back to zero and announced a $700 billion Treasury and MBS purchase program.

Later in the week, Congress began discussing a $1-2 trillion stimulus package and the President declared a national emergency, pushing the long end rate up to 1.78. This was probably less due to calm hitting the market and more a result of an expectation of an incredible increase in long end issuance in the near future. Over the last week and a half of the month, the Fed, and every other major central bank, have used virtually every tool in their arsenal to help calm the markets. The Fed has tried to destigmatize and expand the use of the discount window and essentially announced “QE infinity” by expanding their purchase program with no limit in size, but rather stating it will be “in amounts needed to support smooth market functioning.” They have also announced and implemented a veritable alphabet soup of acronym facilities to help improve liquidity and depth in treasury bonds, corporate bonds and regional bank lending: CPFF, FIMA repo lines, TLAC and TALF revisions, PMCCF and SMCCF. Liquidity and bid/offer in the Treasury market has improved somewhat from the worst days in the middle of the month when some off-the-run bonds would go bidless for hours at a time, but it’s still a far cry from what most would consider normal.

Credit



Source: Bloomberg/Barclays and LGIMA as of 03/31/20.

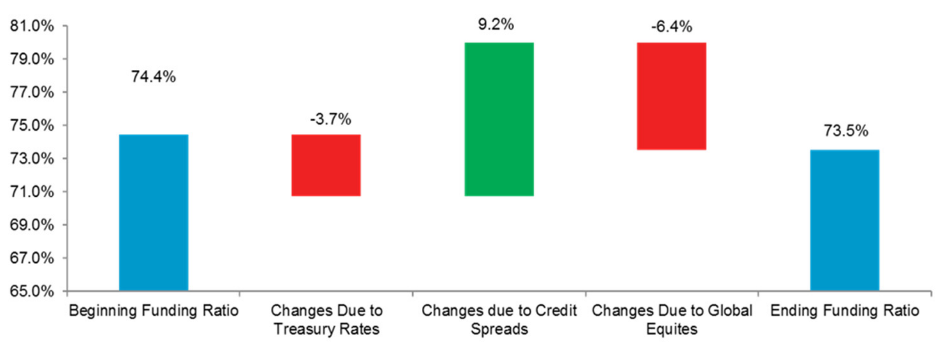
Over the past month, we have seen an unprecedented global policy response in efforts to mitigate the economic impact of COVID-19. The $2 trillion U.S. fiscal package has been signed into law, with 8% of GDP stimulus, as well as loan guarantees. The Fed has cut rates to 0% and is deploying its unlimited QE program very aggressively alongside several liquidity facilities, providing support to the corporate bond market. Although fixed income liquidity was initially very challenged and spreads rapidly gapped out throughout the first half of the month, the assistance from the Fed has led to a relief rally, retracing ~40% of March's credit spread widening and improved market conditions. The Bloomberg Barclays Long Credit Index widened out 185 basis points to 358 basis points over the span of three weeks prior to recovering at the end of March, ending the month at 227 basis points.

The severity of the corporate earnings outlook is uncertain, as the breadth and depth related to the damage of COVID-19 and the oil price war is relatively unclear. Companies continue to revise their outlook, with some corporates withdrawing earnings guidance for 2020 altogether. Downgrades from rating agencies are expected to be significant, as there have been $135 billion of fallen angels in March alone. Estimated fallen angels for 2020 range $200-250 billion.

U.S. IG new issuance reached a new monthly record of $255 billion in March, marking 1Q20 supply at $470 billion - the fastest ever start to a year and 46% ahead of 2019's pace. Robust primary issuance, challenging liquidity conditions, extreme market volatility, and record outflows all led to the significant credit spread widening in March. Liquidity conditions saw improvement after the Fed's announcement of liquidity facilities supporting the corporate bond market.

Funding status monitor

LGIMA estimates that pension funding ratios decreased 0.9% throughout March, with changes primarily attributed to the decline in global equity performance. Our calculations indicate the discount rate's Treasury component fell by 35 basis points while the credit component widened 87 basis points, resulting in a net increase of 52 basis points.[1] Overall, liabilities for the average plan decreased ~7.2%, while plan assets with a traditional "60/40" asset allocation decreased by ~8.3%.[2]



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.

LGIMA's completion management process

Align fixed income to liabilities

Credit versus Treasury

Manage credit actively

Risk manage using Treasuries

Align fixed income to liabilities

- Help to reduce uncompensated risk
- Increase portfolio's capital efficiency
- Reduce funded status volatility

Credit versus Treasury

- Design holistic solution
- Size credit allocation with considerations given to the credit quality of the liability discounting basis and return seeking asset composition

Manage credit actively

- Use full investment grade credit to generate alpha
- Avoid defaults and downgrades to complement a plan's de-risking objectives

Risk manage using Treasuries

- Minimize interest rate risk
- Provide liquidity to pay benefit payments