LGIMA's Pension Solutions' Monitor

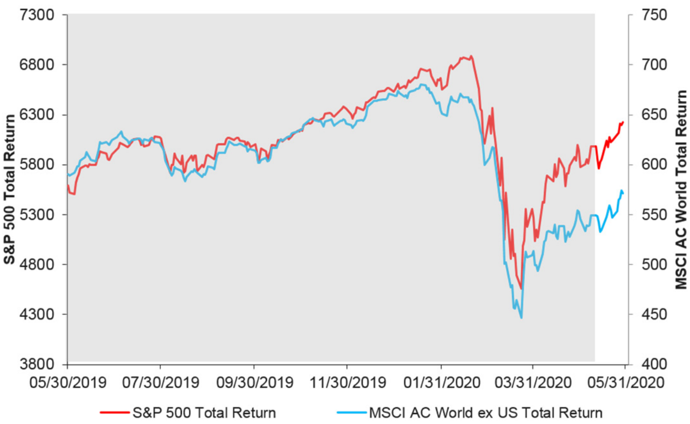
May 2020 Market Update

Overview

Pension funding ratios increased throughout the month of May, with changes primarily attributed to higher Treasury rates and an increase in global equities. We estimate that the average plan's funding ratio increased 1.8% to 75.2% throughout the month.

Global equities

"The economy is not the stock market!"



Source: Bloomberg/Barclays and LGIMA as of 05/31/20.

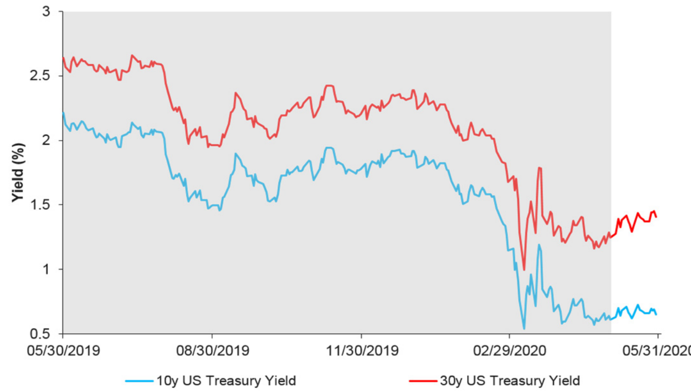
The strong equity market bounce back in April was followed by another strong month. As COVID-19 shutdown restrictions began to relax, investors focused on how quickly the market could get back to full capacity. This was fueled by early signs of success on the vaccine front and some positive news around falling global infection rates. The challenge, however, has been reconciling equity market pricing with weak economic data – consumer spending remains low, the U.S. unemployment rate reached ~15.0%, and PMI numbers showed decreased activity across both services and manufacturing.

U.S. stocks (4.8%) outperformed international stocks (4.4%), developed markets outperformed emerging, growth stocks outperformed value stocks, and small cap (6.5%) outperformed large cap (4.8%).[1] However, small caps are still trailing substantially year-to-date. Volatility continued to fall from extreme levels in both risk and safe haven assets but remains significantly elevated, notably in medium-term risk.

In the U.S., all S&P 500 sectors closed the month up at least 1% with tech (7.7%) leading the way, followed closely by materials (6.6%), industrials (6.3%), and consumer discretionary (6.0%).[1]

1 Source: Bloomberg/Barclays and LGIMA as of 05/31/20.

Interest rates



Source: Bloomberg/Barclays and LGIMA as of 05/31/20.

The front-end of the U.S. yield curve remains tethered near zero while the long-end stayed mostly range bound. The 30-year Treasury rate closed out April at 1.28, dipping down to 1.23 in May before rising to its local high of 1.48, and finally closing out the month at 1.41. Not surprisingly, the Treasury announced a record issuance of $96 billion for May, including the introduction of a new 20-year auction. They also stated that over the coming quarters, they plan on shifting issuance from bills to longer dated financing. Shortly after, Jan 2021 Fed Funds contracts started trading above 100 (getting as high as 100.04), implying negative rates, despite the Fed's instance that they are not considering negative rates.[1] In an address to Congress, Fed chair Powell stressed that rarely does the FOMC have a unanimous opinion, but they are united in all not wanting to see negative rates in the U.S.[2] Despite this continued emphasis, the 2-year Treasury rate traded at 10 basis points, the lowest ever yield on record for a 2-year Treasury.

While NFP came in at an eye popping 20.5 million job losses in April along with a 14.7% unemployment rate, these numbers were better than the consensus estimates of 22 million job losses and 16.0% unemployment. Retail sales were similarly abysmal, as expected, showing a 16.4% month-over-month decline. But initial jobless claims at 2.98 million last week was the sixth consecutive week of declines. Although continuing claims has been trending upwards, it does appear to be leveling off. The data the last week of May did show some improvement. U.S. consumer confidence rose slightly after having its largest drop in nearly 50 years in April. U.S. new homes sales also had a small (0.6%) month-over-month rebound and the Dallas Fed's manufacturing index rose as well.[1] Central banks globally continue to be supportive of recovery and the U.S. is continuing to discuss further stimulus packages. It remains to be seen if the cautious re-openings in some states will be successful in avoiding a second wave of coronavirus infections.

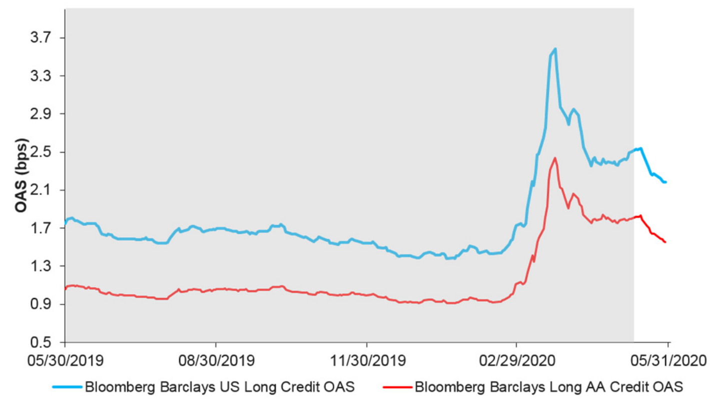
Credit

Risk assets rallied throughout May on the back of global economies reopening and responding economic data. The Bloomberg Barclays U.S. Long Credit index tightened 18 basis points, ending the month at 218 basis points. The Fed has continued to be accommodative, buying over $3 billion in corporate bond ETFs. U.S. economic data has shown improvement as the most recent U.S. job losses number declined by almost 4 million, indicating a strong rebound in hiring for areas that are reopening. The pace of fallen angels has also slowed substantially,

2 The Federal Reserve, 2020.

bringing us to $145 billion of non-financial downgrades to high yield on the year.

As earnings season drew to a close, reports have shown issuers have increased their leverage substantially. A Bank of America study estimates that for IG non-financial issuers ex. utilities, median gross leverage levels increased from 2.7x to 3.1x over the quarter. Gross debt is also estimated to have grown by ~5% YoY based on liquidity constraints due to COVID-19.[3]

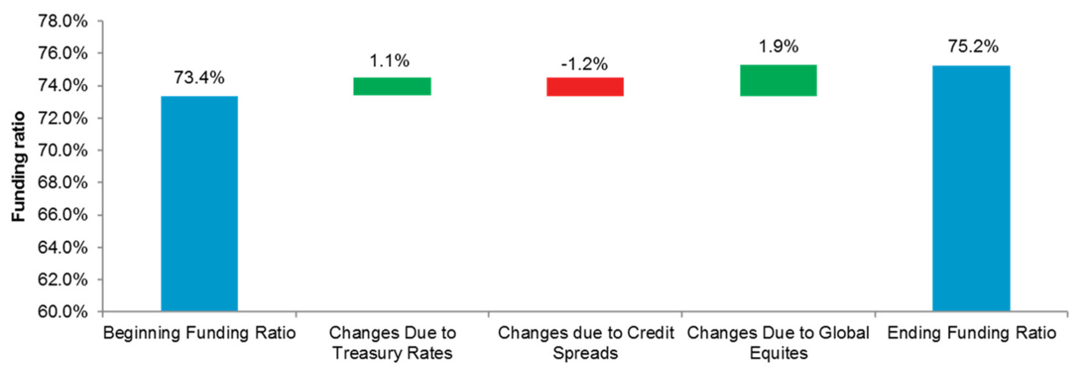


Source: Bloomberg/Barclays and LGIMA as of 05/31/20.

In line with the above metrics, the trend of record issuance has continued, as the month of May totaled ~$233 billion in supply. This puts us at around $980 billion on the year, 97% ahead of last year's pace. The Fed's buying of credit ETFs, strong inflows into U.S. IG bond funds, as well as robust foreign demand has resulted in positive supply/demand technical dynamics that has pushed the market tighter. We continue remain moderately optimistic; however, there are various factors, such as the widespread protests, the potential for an uptick in COVID-19 cases, as well as key data being released later this week, that we will continue to monitor throughout the month of June.[1]

Funding status monitor

LGIMA estimates that pension funding ratios increased ~1.8% throughout May, with changes primarily attributed to an increase in global equities. Our calculations indicate the discount rate's Treasury component increased by 9 basis points while the credit component tightened 10 basis points, resulting in a net decrease of 1 basis point.[4] Overall, liabilities for the average plan increased ~0.3%, while plan assets with a traditional "60/40" asset allocation increased by ~2.8%.[5]



Source: Bloomberg/Barclays and LGIMA as of 05/31/20.

3 Bank of America. Monthly HG Market Review - May '20: Reopening by Hans Mikkelsen and Yunyi Zhang.
4 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.
5 For the average plan, LGIMA assumes a 60% allocation to MSCI AC World and a 40% allocation to Bloomberg Barclays Aggregate.

Principles of LGIMA’s LDI philosophy

Understand Client’s Situation	Align Fixed Income to Plan Liability	Target Strategic Interest Rate Hedge	Size Credit Allocation

Objectives

Tailor **custom solutions** to each client given their objectives and constraints	**Aim to reduce funded status volatility** by increasing the capital efficiency of the asset portfolio	Help to reduce **uncompensated risks,** while providing liquidity to fund benefit payments	Give considerations to **growth asset** allocation and liability discount basis Key emphasis of **avoiding downgrades and defaults**