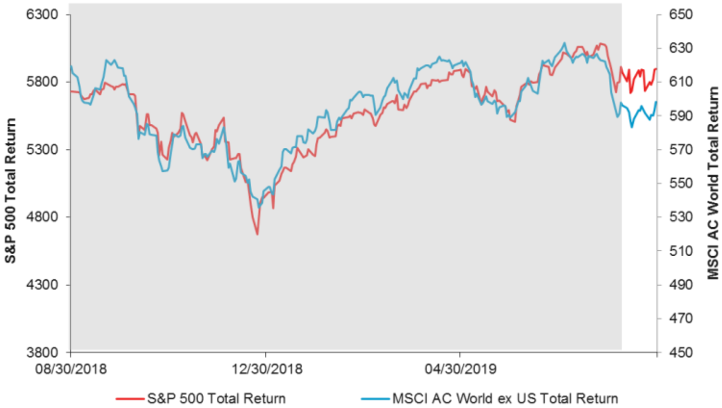
LGIMA's Pension Solutions' Monitor

August 2019 Market Update

Overview

Pension funding ratios decreased throughout the month of August, primarily driven by a selloff in global equities and a sharp decline in US Treasury rates. We estimate that the average plan's funding ratio fell 5.4% to 76.9% through August.

Global equities



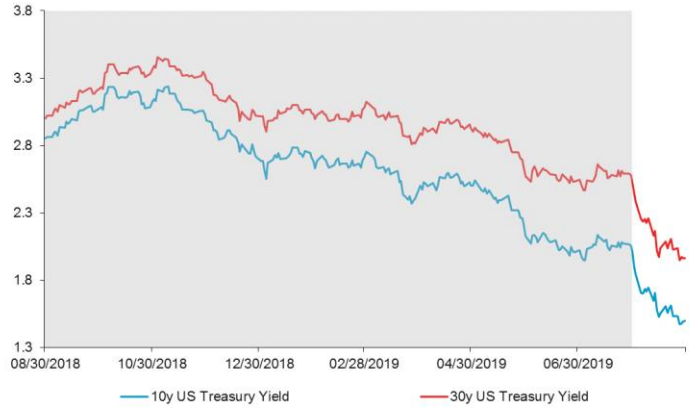
Source: Bloomberg/Barclays and LGIMA as of 8/31/19.

A volatile August was sparked by another tweet from President Trump informing the public of an additional 10% of tariffs on remaining Chinese goods. The ensuing communications resulted in increased tariffs against the US and a future commitment by the President to increase tariffs another 5%. While the trade war narrative remains unpredictable, it paints a similar picture to the myriad risks that investors faced through the month as global equity indices suffered losses across the board. Due to the trade war and broadly negative economic commentary, the US saw a decline in both PMI data and consumer confidence reports. The eurozone economy continued to slow down, as Germany approaches a recession, British Parliament struggles to avoid a no-deal Brexit risk, and Italy wrestles with snap elections. Chinese data, specifically retail sales, also fell. These negative headlines have central banks, most notably the ECB, PBoC, and the US Fed, engaging in rate cuts and debating further stimulus to offset global growth and trade concerns. With several risks on the table, it is still important to note that some broad selling of equities may be as simple as investors taking profits – many equity indices are up over 10% year-to-date.

Interest rates

Long end rates in the US rallied nearly 60 basis points in August, the largest rally since the 2011 US debt-ceiling crisis. As has been the theme of the year, these moves continued to be driven by central bank actions, trade war escalations, and increasing fears of recessions looming in the near future, both in the US and abroad. The rally started the day after the Fed cut rates by 25 basis points at their July 31 meeting when President Trump tweeted that he was imposing an additional 10% tariffs on 300bn of Chinese goods as retribution for a lack of progress in their recent trade negotiations. The President has been arguing that the Fed had raised rates too high too fast for the past few months, so it did raise some suspicions that the timing of this announcement was to try to push the Fed to act with more urgency going forward. The following week, China weakened their currency against the dollar in a move that led Treasury Secretary Mnuchin to officially declare China to be a currency manipulator.

The next leg down in rates occurred in the wake of the shocking upset of Argentinian President Macri by Alberto Fernández in their primary, by a landslide margin of 48% to 32%. In the close after the election, the 30-year treasury rate closed at 2.13, down 40 basis points from the July close in only 10 trading days. Rates rallied further on weak data out of Europe and worries that Germany was entering a technical recession. Headlines sparked further volatility in the rates markets for the rest of the month. The Fed's Bullard also gave an interview where he discussed the possibility of negative rates in the US and said it was an alternative strategy the Fed was discussing. The ECB's Olli Rehn stated that the ECB was ready to take "substantial and sufficient" action at their September meeting, noting that "it's often better to overshoot than undershoot." The markets took this as an incredibly dovish signal and global rates rallied as the US 30-year treasury rate dipped below 2%. Rates traded sideways from there and the 30-year rate closed out the month at 1.96. The next FOMC meeting is on September 18 and the market is already pricing in a 100% chance of a Fed cut.



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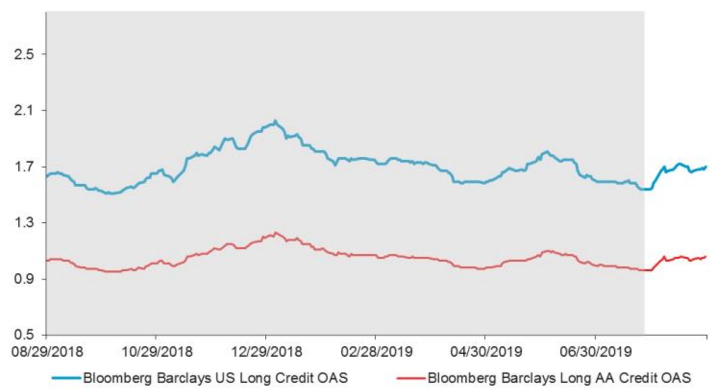
Credit

Throughout the month of August, the US credit market sold off as the Long Credit index widened 15 basis points to 170. The US/China trade war escalation fueled global growth concerns and fears of increased risk of recession. The volatile market led to an increasing illiquid environment as credit investors largely remained on the sidelines throughout the month. Geopolitical sentiment has remained volatile, as the G7 Summit seemed to yield positive news related to the US and China trade negotiations, yet no material progress was made and further tariffs are still expected to be implemented during the holiday season. The deadline for Brexit is also rapidly approaching, as LGIM currently estimates a 45% chance of a hard Brexit under new leadership. The trend of dovish monetary policy for most Central Banks has continued, as the Fed cut rates 25bps at the end of July to mitigate the aforementioned issues related to geopolitical uncertainty and slowing global growth. Furthermore, the Fed is expected to "act as appropriate" to keep the expansion moving forward. As for supply/demand technicals, M&A volume remained relatively consistent to expectations, growing to ~$189mm throughout August. US fund and ETF flows remained stable as well. Total investment grade corporate issuance for the month amounted to $73bn, in line with the $65-$75bn expected. Compared to this time last year, issuance is down ~7% YTD. September is seasonally the busiest month of the year for investment grade issuance and ~$130bn is expected to hit the market.



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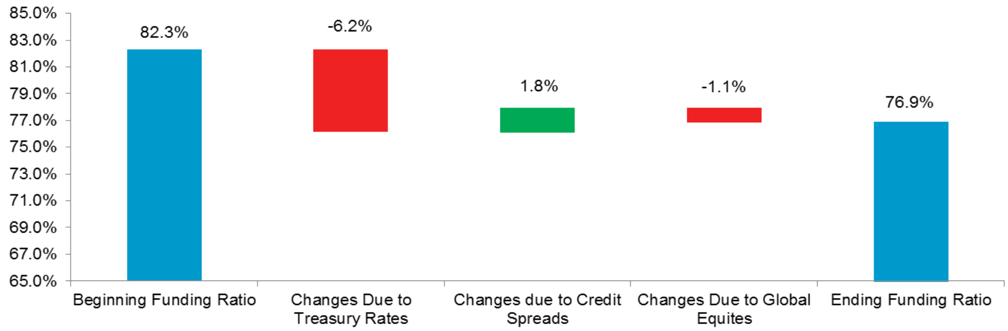
Funding status monitor

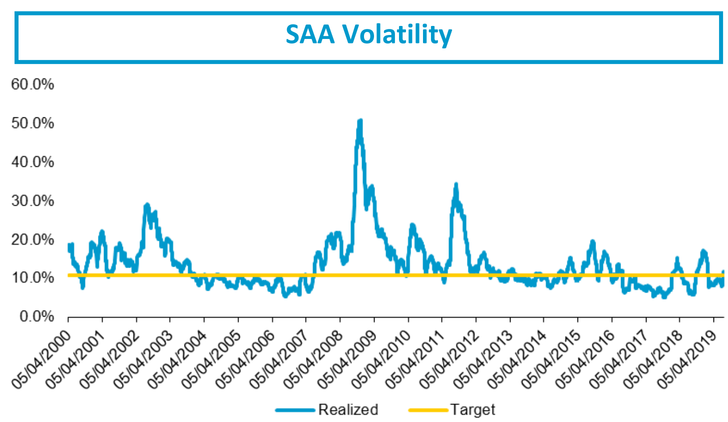
LGIMA estimates that pension funding ratios decreased throughout August, with losses driven primarily by diminished US Treasury yields and global equity performance. LGIMA estimates the discount rate's Treasury component decreased by 55 basis points while the credit component widened 13 basis points, resulting in a net decrease of 42 basis points[1]. Overall, liabilities for the average plan increased 6.67%, while plan assets with a traditional "60/40" asset allocation[2] decreased by ~0.36%.



1: Discount rates based on a blend of the Intercontinental Exchange US Pension Plan AAA-A and Intercontinental Exchange 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.

Volatility-based rebalancing

- Investors spend significant time, effort, and money on determining the optimal strategic asset allocation (SAA)
- While sponsors are certainly focused on expected return, a significant driver of allocation decisions is based upon expected volatility
- However, plans often realize a much different level of volatility than originally expected



- Market volatility can be risk managed and controlled to a specific target with the use of an overlay