# The Monthly Pension Review: March 2022

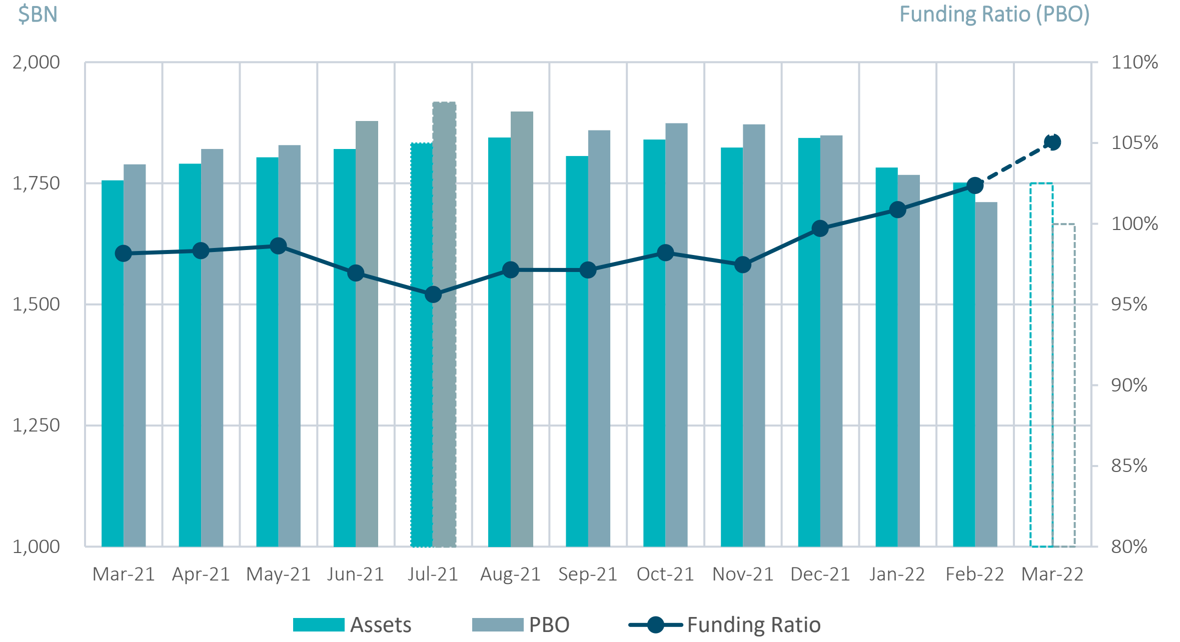
Positive equity performance and higher discount rates improved funded status by nearly 3%

## March Market Summary

- Funded status improved in March – Driven by higher discount rates and a rebound in equity markets, funded status increased by 2.7%. Assets stayed relatively flat returning -0.1% while liabilities fell by 2.8%. (1)
- U.S. equity markets rebounded after two straight months of negative returns – After a turbulent first half of March, the S&P 500 rallied in the final two weeks and finished the month up 3.6%. Remarkably, the index is only down roughly 5% year-to-date despite a drawdown of over 12.4% on March 14th.
- The yield on the Bloomberg Barclays Long Credit Index increased 26 basis points (bps) – Long credit spreads tightened 10 bps over the month while the underlying Treasury basis increased 36 bps.

| Market Watch | Dec-2020 | Dec-2021 | Feb-2022 | Mar-2022 |
|---|---|---|---|---|
| Funded Status | 90.3% | 99.7% | 102.4% | 105.1% |
| CITI Discount Rate (2) | 2.23% | 2.63% | 3.17% | 3.40% |
| Long Credit Yield (2) | 2.78% | 3.10% | 3.76% | 4.02% |
| US 30Y TSY Yield | 1.64% | 1.90% | 2.16% | 2.45% |
| S&P 500 | 3,756 | 4,766 | 4,374 | 4,530 |

**Milliman Pension Funding Index (March Estimate)**

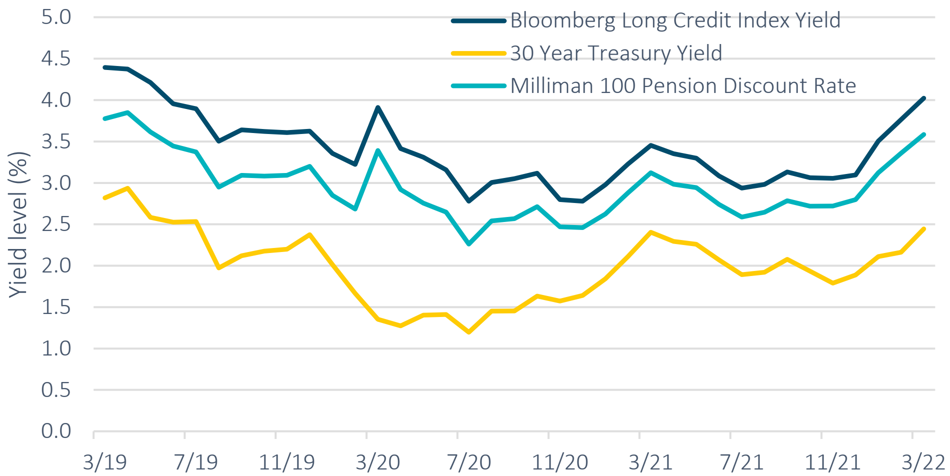



## SPOTLIGHT: All Eyes on the Curve!

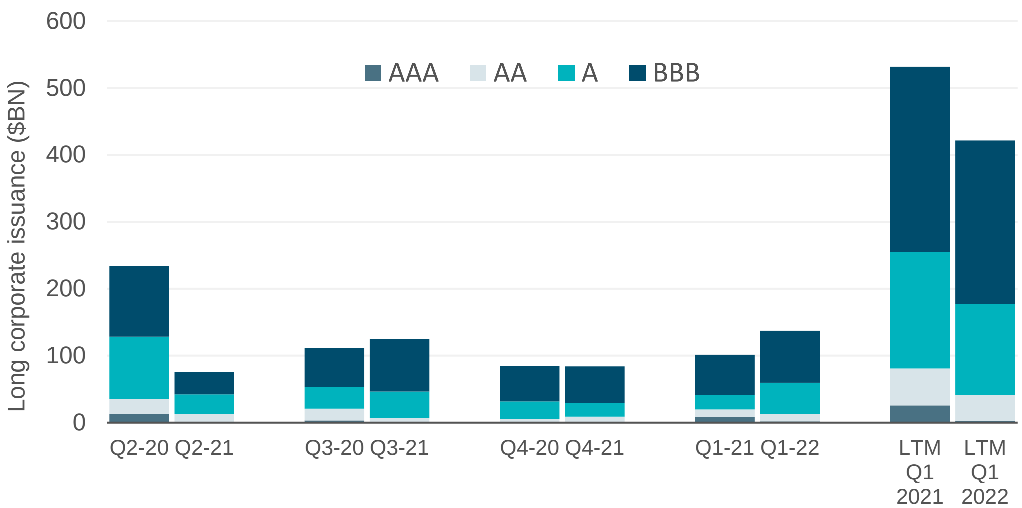
- Risk appetites rebounded in March as markets digested the implications of the Fed beginning their hiking cycle, as well as the continued Russian invasion of Ukraine. Strong equity markets and higher discount rates resulted in an estimated 3% funding improvement for the top 100 U.S. corporate DB plans
- The beginning of the hiking cycle
  - As expected, the Fed hiked interest rates by 25 bps in March. The surprise came in the form of the dot plots, which projected seven rate hikes in 2022
  - As the month progressed, some market participants also voiced much more hawkish expectations for the Fed; Bank of America predicted two rate hikes of 50 bps
  - The uncertainty also drove volatility in the interest rate markets with the 10-year rate spiking from 1.7% to 2.5% during the month
  - Furthermore, we also saw the yield curve invert briefly, with the curve being almost completely flat from 5 years onwards
  - Mortgage rates spiked from 4.1% to 4.9%, casting a potential shadow over the economy
- For corporate DB plans, higher funded status over the last quarter likely means a move to higher fixed income allocations as plans de-risk along their glidepaths
  - While traditional hedging assets such as public corporate bonds and U.S. Treasuries should remain a staple in a plans LDI framework, alternative sources of credit such as investment grade private credit, securitized credit and real estate debt can be a good complement to hedging portfolios
    - These asset classes share some of the same risk factors inherent in liability discount rates while also providing diversified credit exposure in hedging portfolios
  - Over the last quarter, we have observed that private credit markets have been more resilient than their public counterparts, as the magnitude of spread widening in public markets has been more pronounced.
  - Plan sponsors that had diversified their hedging portfolios should have felt the benefit this month as alternatives such as private credit helped buffer some of the losses in public markets.

(1) Funded Status for the current month is estimated and subject to change as final numbers are released. Data from reference Bloomberg Indices.
(2) The Long Credit yield corresponds to the Bloomberg Long Credit Index. The Citi Discount Rate corresponds to the FTSE short pension liability index.
(3) Reference sector data is from Bloomberg indices.

**Wider credit spreads and higher Treasury rates pushed the Long Credit index yield above 4%**




**Q1 saw heavy supply of long end corporate issuance led by BBB rated companies**




### Market Observations: Risk on or off?

- It was a turbulent quarter for Long Credit spreads as the index OAS widened from 130bps to 182bps by mid March before snapping back to 153bps by quarter-end.
- Strong demand from large Asian insurers helped drive the rally over the last two weeks of the quarter. With specific yield targets and ratings-based buying, A rated corporates offering 4% yields were an attractive target to the insurers.

### SLC Management View:

- Overall, our view of US corporates is positive, with most issuers having strong fundamentals despite the Russian invasion related spread widening.
- Liquidity in the market remains strong, and corporate America's balance sheet remains solid.
- One area of attention are the banks/financials, which lagged in Q1 due to large issuances which the market had to digest. We viewed this as a buying opportunity and moved to an overweight position.

### Implications for Plan Sponsors:

- Although fixed income markets experienced severe drawdowns this quarter, wider long end credit spreads and higher interest rate levels reduced pension liabilities and likely improved funded status for most plans.
- As funded status improves and fixed income allocations increase, sponsors should consider diversifying their fixed income portfolios. Asset classes like investment grade private credit can provide additional yield and reduce issuer concentration in long duration fixed income portfolios.



Source: Bloomberg, Milliman. A full list of data sources and indices can be found in the back of this presentation

## Market Observations: As vs BBBs

- While corporate credit spreads widened across the risk spectrum, the gap between A and BBB spreads stayed relatively tight compared to prior risk off environments.
- One potential reason for this market anomaly is the increased leverage among A-rated issuers over the last several years. As a result, the credit profile of the two different rating segments have become more similar.

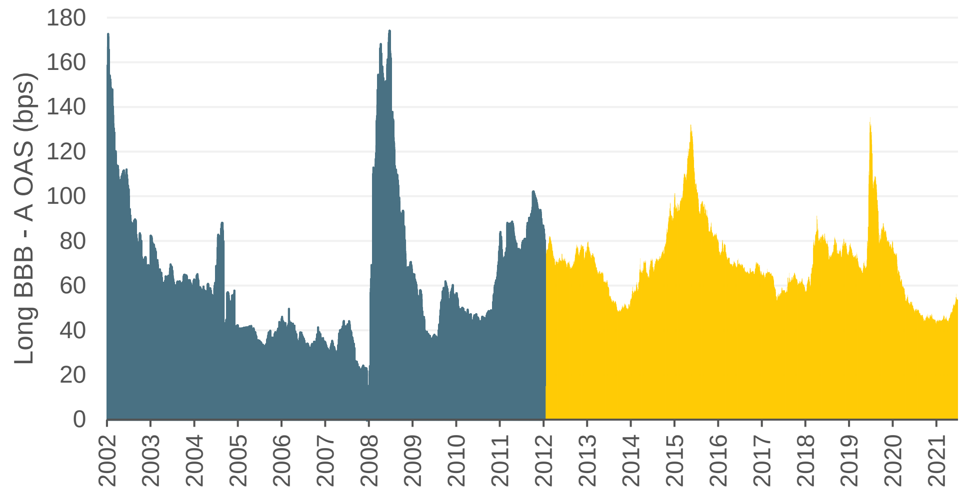
## SLC Management's view:

- Going into Q1 2022, our typical long credit portfolio had a roughly 8% underweight to BBBs due to deteriorating market conditions. This positioning did not provide as much of a cushion as we expected due to many BBB and A-rated corporate issuers trading in tandem during the credit selloff.
- As the quarter progressed, we participated in a number of attractive new issue BBB-rated deals to reduce the underweight position. In the current environment we broadly believe owning BBB corporate credits is more favorable compared to A-rated names, due to the higher risk of downward ratings migration from A-rated issuers.

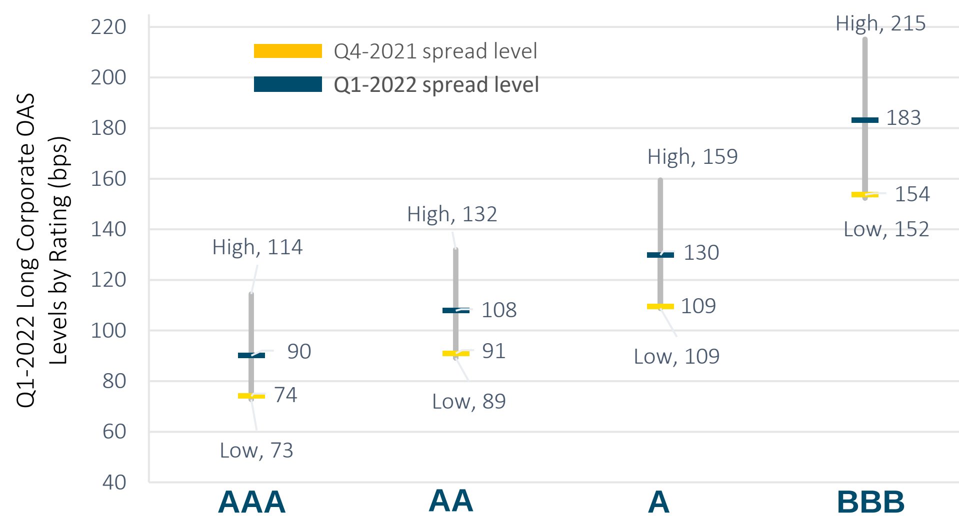
## Implications for Plan Sponsors:

- Generally speaking, plan sponsors taking a higher-quality bias in their long credit portfolios may not have gotten the outperformance they were hoping for relative to managers who had higher allocations to BBB-rated securities.
- The shifting dynamics of the credit markets emphasize the need for active management to tactically allocate across the ratings spectrum

**Despite credit widening, the difference between Long BBB & A credit spreads remain tight relative to historical selloffs**




**Inflation concerns coupled with the war in Ukraine pushed credit spreads off their cyclical tights in Q1**






Source: Bloomberg. A full list of data sources and indices can be found in the back of this presentation

**Market Observations: Energy & Inflation**

- We have seen energy companies experience significant gains following the Russian invasion of Ukraine and the resulting spike in energy prices.
- For non-energy companies, the full impact of inflation will not be known until Q1 earnings are released. The big questions are to what extent higher prices have hurt demand and whether companies have been able to pass the rising costs onto consumers and maintain margins.
- As Covid related supply constraints start to ease, we may see this help offset energy price driven inflation, however the interplay of these two factors may be hard to predict given the current global environment.

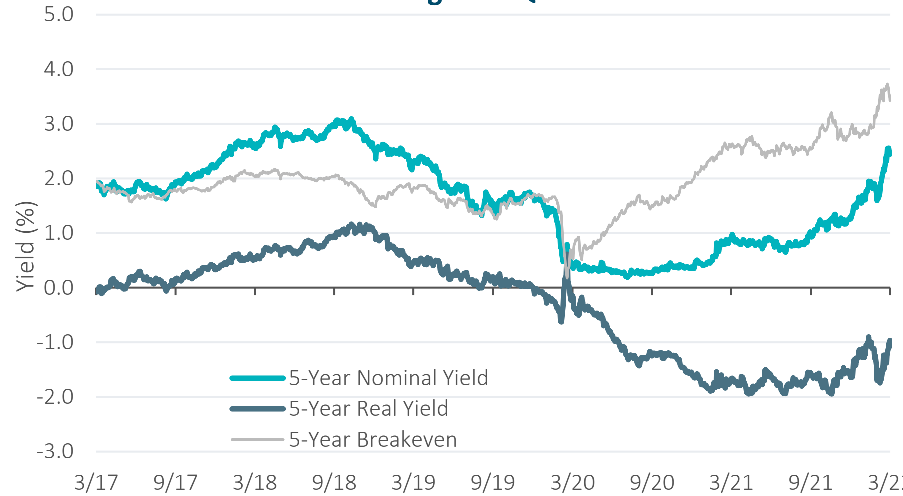
**SLC Management's view:**

- Our base case is that there will be a slight impact from higher energy prices on corporate profits, with most of the increased costs being passed on to consumers.
- After beginning the quarter underweight to energy, we increased our long credit exposure to a ~2.3% overweight position by mid-March.
- As the sector outperformed, we began trimming back our overweight position and rotating into wider trading sectors of the market such as banks and REITS.

**Implications for Plan Sponsors:**

- Despite multi-decade high US CPI prints, inflation is not generally a major concern for most US corporate DB plans as defined benefit calculations do not typically account for cost of living adjustments (COLA) and many are frozen to future accruals reducing the impact of higher salaries.

**The 5-year breakeven rate reached multi-decade highs in Q1**




Price of Oil




Source: Bloomberg. A full list of data sources and indices can be found in the back of this presentation

# Disclosure – Market Charts

**Market Chart Indices:**

- Treasury Curve sources: US Generic Govt 1 Mth, US Generic Govt 3 Mth, US Generic Govt 6 Mth, US Generic Govt 12 Mth, US Generic Govt 2 Yr, US Generic Govt 3 Yr, US Generic Govt 5 Yr, US Generic Govt 7 Yr, US Generic Govt 10 Yr, US Generic Govt 20 Yr, US Generic Govt 30 Yr
- Credit Curve sources: Bloomberg US Corporate 1-3 yr, Bloomberg US Corporate 3-5 yr, Bloomberg US Corporate 5-7 yr, Bloomberg US Corporate 7-10 yr Bloomberg US Corp 10-15 yr, Bloomberg US Corp 15-20 yr, Bloomberg US Corp 20-25 yr, Bloomberg US CORP 25+ yr
- Credit Rating sources: Bloomberg Aaa Corporate Index, Bloomberg Aa Corporate Index, Bloomberg A Corporate Index, Bloomberg BBB Corporate Index
- Inflation sources: St. Louis Fed
- AA pension discount rate sources: FTSE Pension Discount Curve
- Average funded status source: Milliman
- Long end issuance source: Bloomberg
- CLO source: J.P. Morgan CLO A Post-Crisis, J.P. Morgan CLO AAA Post-Crisis
- MBS source: Bloomberg MBS 30 Year: 2.5 Coupon, Bloomberg MBS 30 Year: 4 Coupon, Bloomberg US MBS Index
- Non-Agency CMBS & High Yield source: Bloomberg Non-Agency Investment Grade CMBS: Bbb Index, Bloomberg US Corporate High Yield Index
- CMBS & ABS source: Bloomberg CMBS Invest Grade Aaa Index, Bloomberg ABS Auto Index, Bloomberg ABS Credit Card Index