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SLC Management

# 2023

# Global investment outlook

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# A letter from Steve Peacher

2022 was a challenging year for investors and asset managers alike. Global economies struggled against high inflation, which brought with it concerns over interest rates and slowing growth, adding to ongoing geopolitical and global security worries worldwide. I find that it's times like these that make perspective and insight even more valuable, allowing us to digest the news of the day in context, focus in on areas of uncertainty and position our strategies for the market conditions ahead.

That's why I'm pleased to present SLC Management's investment outlook for 2023. I hope the macroeconomic discussions that follow can help set the stage for the year ahead. This outlook includes the diverse viewpoints of our investment teams and solutions providers, with analyses of public and private fixed income, real estate, infrastructure, insurance asset management and retirement plans. Our investment outlook is a chance to hear from all our investment professionals across SLC Management, BentallGreenOak, InfraRed and Crescent Capital as they look toward a year of opportunities.

It's important to note that 2023 may be as uncertain as the year preceding it. Issues of geopolitical security, such as the war in Ukraine, could potentially further escalate in the coming months, which would affect financial markets on top of the significant human impact. Central banks around the world have enacted severe interest rate increases to fight inflation, and we may see the fuller effects of these policies manifest this year. This could include a moderate recession, considerable disparities in economic performance across different markets and inflation coming off its highs – yet remaining a significant source of concern.

But difficult periods often bring with them opportunities. In fixed income markets, it's no secret that 2022 was not a good year for bonds. However, the difficulties of the past year may have created an environment for a strong rebound. Yields hitting historic highs in 2022 might be welcome news to bond investors used to seeing low-returning core investments. And despite fixed income markets being affected by overarching macroeconomic issues, many of the fundamentals underpinning bond markets have remained relatively strong.

While the cost of debt has increased, the resultant repricing of many investment assets may bode well for disciplined investors. It's also important for all of us to focus on longer-term themes as well, such as global sustainability and responsible investment, which will continue to be supported by policy initiatives and geopolitical realities, such as global energy security.

The year ahead will not be without its risks, from central banks responding to data surprises, to liquidity concerns in some asset classes, to possible economic contractions more serious than forecast. This underscores the importance of perspective and insight, which can help us see beyond near-term worries and focus on the historical resilience of financial markets.

We look forward to continuing to provide you with our broad range of asset management expertise and compelling solutions for the months and years ahead. And, as always, we're committed to being your investment partner throughout all market conditions.

Sincerely,

**Steve Peacher, President, SLC Management**

# Macroeconomic outlook

**Dec Mullarkey**
Managing Director, Investment Strategy and Asset Allocation, SLC Management

## Central banks expected to remain vigilant on policy, but fixed income poised for a comeback

### Growth will be scarce

As supply shocks fade and central banks raise rates, inflation across most developed economies is expected to drop toward 3% later in 2023 *(Source: Bloomberg, 2022)*. However, global growth will be subpar and divergent as higher rates mute activity and varying local and geopolitical challenges take a toll. For instance, China and the eurozone are working through a tougher set of challenges than those percolating in North America.

China's growth continues to be vulnerable to rolling COVID lockdowns as the country renews its efforts to vaccinate more of its elderly. Its clampdown on property developers was disruptive, and authorities are now switching to a more targeted approach. China hopes to revitalize activity and restore consumer confidence.

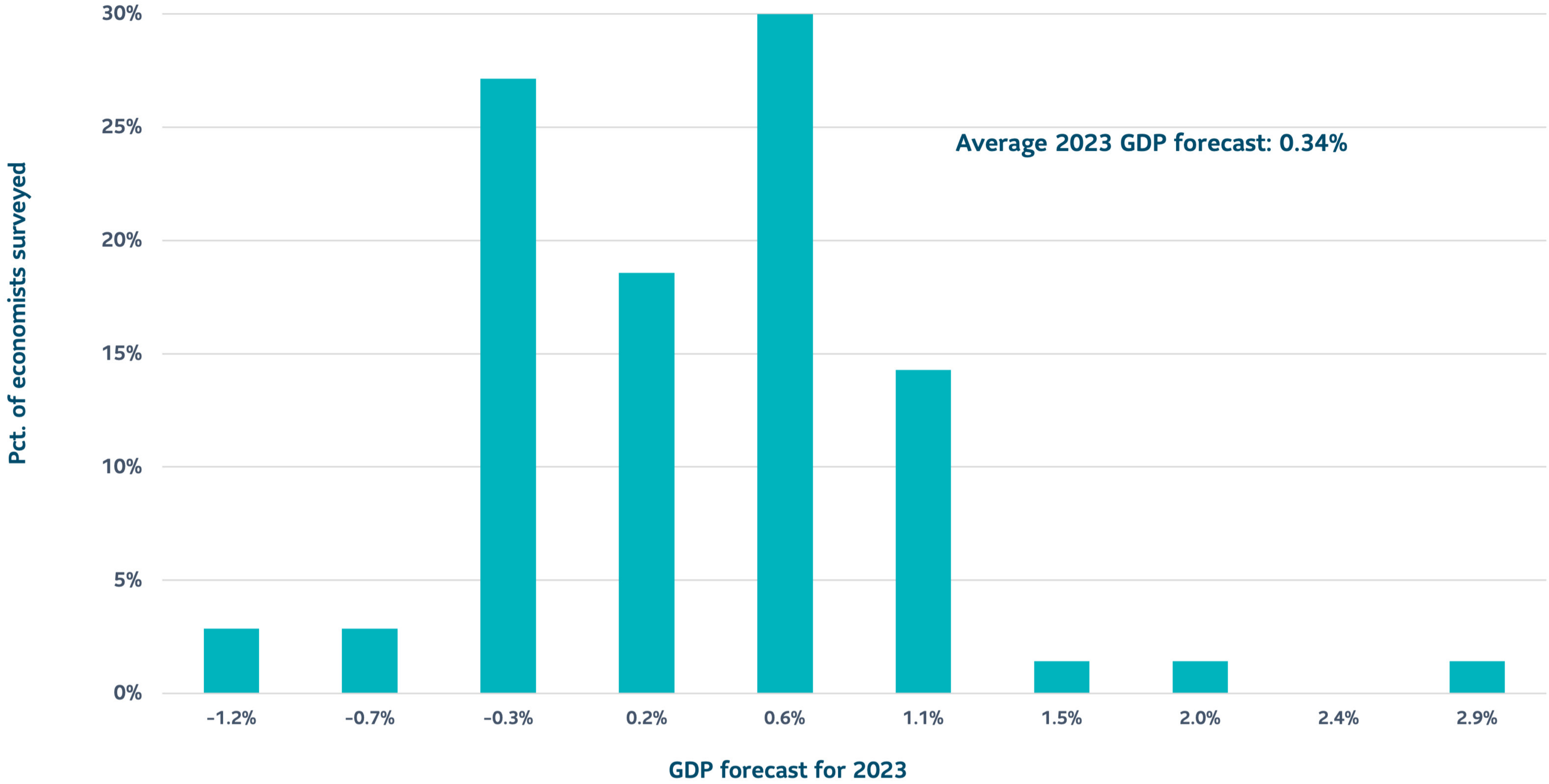
The eurozone still needs to navigate the effects of energy supply dislocation and escalating prices. While the region skillfully built up gas storage for this winter, Europe will soon need to restock for next season. The region is likely to hit a recession this year as high energy bills weigh on consumer demand. Meanwhile, Canada and the U.S. are expected to post modest growth.

Across developed economies, the range of GDP forecasts are some of the widest in decades. That level of uncertainty ranges from recession to modest growth for many.

Forecasters that are calling for a downturn expect six months of stalled growth – not devastating but still a setback. Fortunately, many economies are operating from a strong starting point, with solid household and corporate balance sheets. That should create some resiliency and soften the blow from any slowdown.

Emerging economies are, on average, expected to outpace developed economies, powered by China and India.

### Economists' U.S. 2023 GDP forecasts vary widely




Source: Bloomberg, 2022. Range of forecasts based on Bloomberg surveys of economists.

## Central banks remain vigilant

Inflation is finally coming off its highs as major central banks ramp up rates. But no central bank thinks its job is done, and we expect they will keep conditions tight until inflation lands closer to target.

The U.S. Federal Reserve is expected to pause in May and assess how well policy tightening is downshifting the economy. However, while markets expect the Fed to cut rates later this year, the Fed is hinting it is unlikely to pull back that quickly.

The challenge for any central bank in calibrating its economy is that its tools are not precise. In the U.S., rate increases have impacted housing immediately and commercial banks are also getting tightfisted on who they lend to. But in other parts of the economy, it takes time for higher rates to slow activity.

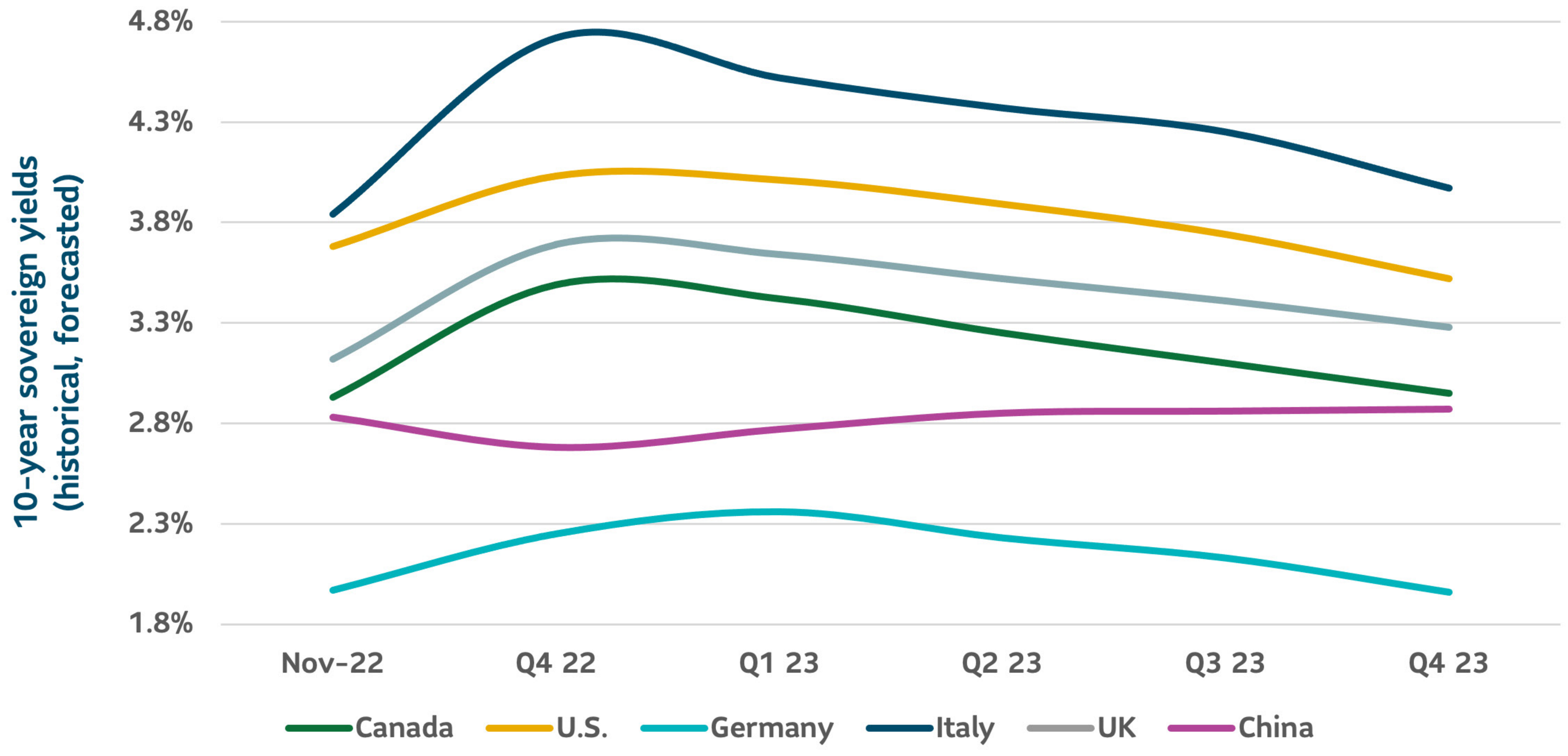
A risk the Fed wants to avoid is prematurely cutting rates and inadvertently igniting a second round of inflation. This would seriously undermine the central bank's credibility. That happened in the 1970s and the Fed doesn't want a rerun of that misstep. Therefore, expect the Fed to keep rates higher for longer than the market expects.

## Fixed income makes a comeback

As inflation cools and central banks pause, markets will start to focus less on policy risk and more on growth prospects. The U.S. dollar should start to weaken as rate differentials between the U.S. and other countries start to level off.

Interest in fixed income is starting to revive as yields hit multi-year highs. We expect U.S. corporate credit defaults to be close to long-term averages. Healthy balance sheets and manageable levels of maturities and refinancings over the next several years provide a solid backdrop for corporate bonds.

### Sovereign yields at multi-year highs




Source: Bloomberg, 2022. Sovereign yields for 2023 based on forecasts.

# Fixed income: investment grade

**Randall Malcolm**
Senior Managing Director, Portfolio Manager,
Public Fixed Income, SLC Fixed Income

## Bank of Canada changes its policy tone, with investor sentiment reflecting optimism on inflation

### Focus to shift to growth

While 2022 was focused on high inflation and Bank of Canada (BoC) rate hikes, the spotlight in 2023 will be on growth. After hiking its overnight rate by 400 basis points in 2022 to fight inflation, the BoC is moving from "how much to raise" interest rates to "whether to raise," with policy becoming more data dependent. The good news is that inflation has probably peaked and is expected to continue decelerating, but the bad news is that it is expected to remain above the BoC's 1%–3% target range until at least the second half of 2023, as wages seem poised to rise even as commodity prices finally ebb. Policy usually eases leading into, or during, a recession. This time, however, given the persistency of elevated inflation the BoC needs to stay the course with higher overnight rates to ensure it honors its inflation mandate.

### What are the markets telling us?

Canadian bond yields rose in 2022 and the yield curve inverted significantly. The inversion of the 2–10-year Canada yield curve is the largest inversion in over 30 years, as the BoC has been actively raising its overnight rate with hopes of moderating inflation. With the longer 10–30-year term of the Canada yield curve sitting just below 3%, investors seem very confident that inflation will be relatively contained over the longer term. Inflation-linked real return Canada bonds also imply that inflation will be contained over both the short, medium and longer terms, with breakeven inflation rates in the 1.8%–2.2% range.

As 2022 comes to a close, credit spreads in many major markets have changed course to move tighter, but Canada has been a notable exception to this trend. Credit spreads in Canada lagged as other markets widened early in 2022, with U.K. and European credit spreads leading the way. Even after a mild rally, Canadian credit spreads remain at levels similar to those seen during the sovereign crisis earlier in the previous decade. To avoid taking a double dose of higher interest rates and wider credit spreads, many corporate bond issuers were more inclined to use shorter term funding sources rather than issue bonds during 2022. This in turn increased the proportion of bank funding that was done in the corporate bond market, pressuring bank bond credit spreads significantly while at the same time depleting the supply of longer-term corporate bond new issues. As issuers adjust to the new normal in interest rates and credit spreads, we should see more diverse corporate new issue supply in Canada in 2023. However, more competitive global funders will likely prefer more attractive U.S.-dollar funding levels.

Shorter-term corporate bonds have the benefit of both wide credit spreads and high underlying Canada yields. The inflation breakeven levels on shorter-term Canada real return bonds imply a market sentiment that believes inflation will return to the BoC's 2% target very quickly, which seems very optimistic – perhaps a little overly so in our view.

Source: Bloomberg, 2022.

# Fixed income: below investment grade

**John Fekete**
Managing Director and Head of Capital Markets, Crescent Capital Group

## Credit fundamentals remain strong following a rough 2022; current market environment attractive for high yield

### Below-IG yields set to rise

Investors ended 2022 buffeted by inflation headwinds and facing losses approaching double-digits across most fixed income asset classes. Credit fundamentals were quite strong in 2022, however, despite increased macro volatility. Most borrowers are expected to exhibit moderate revenue and cash flow growth in 2023. Interest coverage ratios have likely peaked as benchmark rates (and floating coupons) begin to increase from historically low levels. High yield bond and bank loan coupons are likely to rise to multi-year highs in early 2023, potentially resulting in elevated refinancing risk for vulnerable, CCC-rated borrowers. The U.S. labor market remains tight, and U.S. bond yields will likely remain elevated until the labor market cools. The U.S. Federal Reserve is expected to slow down the pace of rate hikes as 2022 comes to a close.

### Attractive entry points in below-IG securities

The distress ratio in high yield bond and bank loan markets has risen to mid-single digits, suggesting higher defaults in 2023 from a very low starting point (1%–2% in 2022). Pressure on borrowers has increased due to a combination of higher interest rates and a potential recession. Many borrowers have ample liquidity and would benefit from additional private equity sponsor support, if needed. A multi-year wave of debt refinancing activity has concluded, limiting near-term debt maturities before 2025. Distressed debt is mostly concentrated in defensive sectors like healthcare and technology. The lack of more cyclical sector distress may result in a subdued default cycle. Loan recoveries have been elevated, tracking at 61%, the second highest annual level since 2014. Current spread levels compensate for a 2023 default rate of approximately 4%–5%, indicating that a doubling of default activity is already priced into the market.

Bank loans and high yield bonds are yielding high-single digits and the average price as a percentage of par value is in the high 80s (double-B bonds) to low 90s (secured bank loans). The current market opportunity for entering the asset class is among the best we have seen in recent years.

We expect investors to increase their allocation to credit as the Fed pivots away from rate hikes in 2023. Positive fund flows into fixed income should also be helped by U.S. pension funds de-risking. The median funded status for U.S. defined benefit (DB) pension funds has grown to 113% in 2022, a level not seen since 2000. DB pension plans are now increasingly motivated to de-risk by reducing equities in favor of fixed income.

Sources: Morningstar, Inc., Bank of America, Milliman, 2022.

# Private credit: investment grade

**Elaad Keren**
Senior Managing Director, Portfolio Manager and Head of Mid-Market Private Debt, SLC Fixed Income

**Andrew Kleeman**
Senior Managing Director, Head of Corporate Private Placements, SLC Fixed Income

**Gary Greaves**
Managing Director, Private Fixed Income, SLC Fixed Income

## Improving volumes could bring new IG private credit opportunities, though macro risks remain

### Mixed reviews on the past year

When the books close on 2022's investment grade private credit market, we expect issuance will be the second-best year on record, just short of 2021's volume. Sounds like a solid year, right? The answer to that is both yes and no.

The IG private credit market, like most markets, was volatile and investors' perspectives varied by quarter, month or, sometimes, even the day. The first half of 2022 was robust. March was especially strong as issuers rushed to market to take advantage of historically low rates as the U.S. Federal Reserve and other central banks started to tighten. The second half of 2022 was weaker as rising rates caused issuers to reassess their needs or the timing for capital. September was particularly soft. Volume did pick up in October and November, but it was not as strong as in the prior year.

### The IG private credit market in 2023: cautiously optimistic

We expect volatility to continue in the new year, similar to 2022. Deal sources report that the Q1 2023 pipeline is building, in part driven by the issuers that paused financings in 2022 but that are expected to come back to the market in 2023. A hallmark of IG private credit is that the market is open when other markets are not. We saw issuers come to the private credit market in 2022 because they could not execute in the public markets – this was particularly evident in asset-backed securities and with European issuers. We expect this trend to continue as we begin 2023, and this will present IG private credit investors with unique opportunities.

We believe that financial sector issuance will continue to anchor volume, although with slower growth than in the last two years. As financial sector issuance continues to expand to include smaller issuers and weaker credits, this will create more opportunities, but will require strict underwriting as well. We think deal activity in infrastructure and alternative and renewable energy will be a timely investment theme. Deal sourcing will continue to be important as the trend in IG private credit has been toward more bespoke and narrowly distributed deals with smaller lending groups, favoring investors that have good capacity, sector expertise and strong origination capabilities.

### Considerations for clients and consultants

It's important for investors in private credit to maintain a long-term perspective. This could be especially important in 2023 with ongoing volatility, the threat of an economic slowdown or even a possible recession. Strong underwriting and solid structures have historically underpinned the attractiveness of IG private credit and rewarded investors throughout economic cycles. Despite volatility in 2022, we were always actively investing, and we believe continuing to do so in 2023 should result in compelling opportunities for clients even in challenging markets.

# Private credit: below investment grade


**Chris Wright**
Managing Director & Head of Private Markets, Crescent Capital Group

**Chris Wang**
Managing Director, Crescent Credit Solutions, Crescent Capital Group


## Volatile conditions in fixed income markets could spell advantages for private credit investors

### Secular shift to private credit accelerates

Public fixed income markets have continued to experience significant pricing pressure and volatility with banks remaining preoccupied with offloading their hung deals. This has provided private credit the opportunity to directly finance transactions overlooked by public capital markets and to purchase deeply discounted loans and bonds that banks have been trying to sell. This backdrop has accelerated the long-term secular shift toward private credit. Over 80% of sponsored middle-market new issuance today is directly placed, compared to 25% just eight years ago (source: Refinitiv, 2022). This trend will continue into the foreseeable future as private credit provides certainty of execution for private equity sponsors, and sponsors increasingly appreciate the benefits of having relationship lenders in their capital structures.

### Designed to maintain resiliency through cycles

By design, private credit is positioned to remain resilient through recessionary environments. Private credit has the benefit of being senior within a borrower's capital structure and having directly negotiated credit agreements that offer tighter terms, which can be seen as providing superior covenant protections. Private credit managers' investment horizons are long: they hold on to their privately originated loans and can remain more insulated from public market price fluctuations. Furthermore, they often have hands-on monitoring and portfolio management capabilities that tend to be more partnership-oriented in supporting borrowers through periods of business dislocation.

### Rising rates in private credit a twofold story

Increases in interest rates present a double-edged sword. During rising-rate environments, private credit directly benefits from an increasing base rate given its focus on floating-rate debt securities. Conversely, higher rates could have a burdensome effect on borrowers. Barring any interest rate hedges in place, an increase in interest costs will result in lower free cash flow and subsequently lower interest coverage and fixed charge coverage ratios. Lenders will need to closely monitor their existing portfolio companies and new transactions will need to be structured with lower, more prudent levels of leverage.

### Lenders gain advantage amid shifts in spreads, prices and terms

The balance of power between lenders and borrowers has markedly shifted in favor of lenders. Today's period of volatility and dislocation has introduced higher spreads and larger original issue discounts, which accrue on top of the higher base rate, resulting in compelling absolute returns for the asset class. Private credit investors have witnessed lower leverage and improving call protection, allowing investors to benefit from these potentially higher yields in more conservative structures for longer periods of time. Credit agreement documentation terms have tightened and focused on further restricting borrowers' abilities to take on new debt or pay dividends, which results in more cash available to service debt.

Although private credit is not immune to geopolitical risks, rising rates or other macroeconomic headwinds, it is equipped to withstand such pressures while it seeks to consistently deliver higher absolute and risk-adjusted returns than broader fixed income markets.

# Real estate

**Phil Stone**
Principal, Head of Canada Research, BentallGreenOak

**Michael Andrews**
Managing Partner, Portfolio Manager, BentallGreenOak

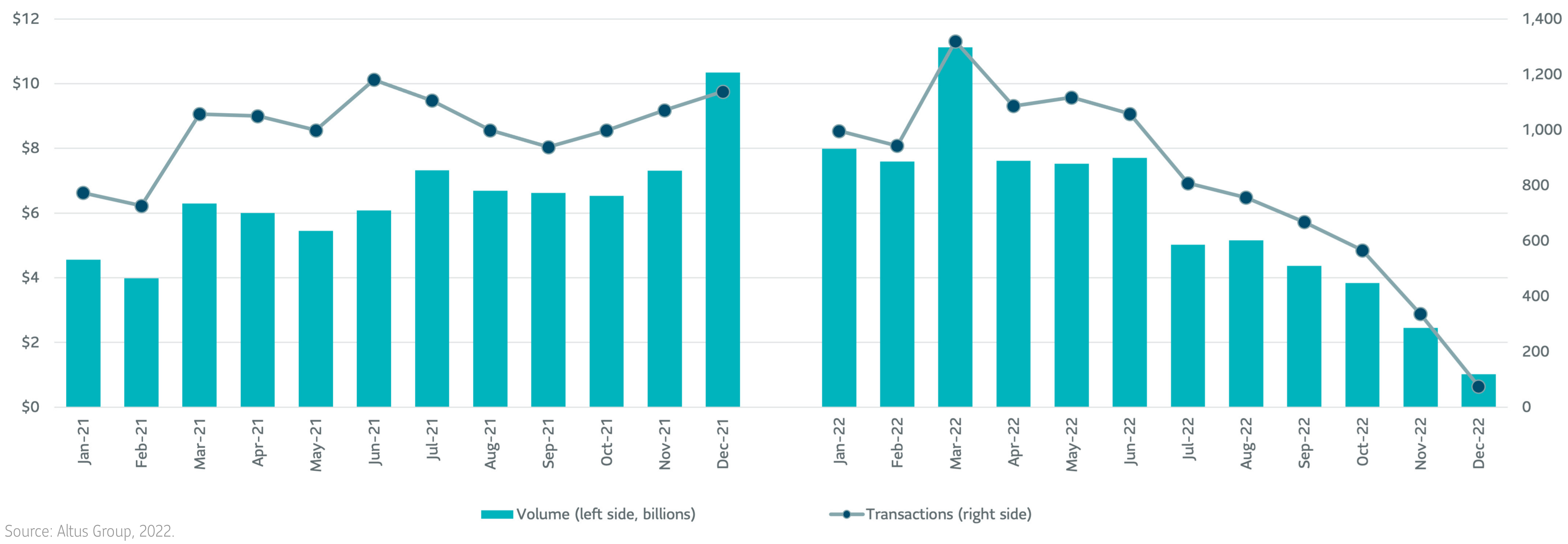
## High cost of funds and economic uncertainty prevail, but there are opportunities at all points of the cycle

### Cautious and selective

As market participants digested the higher cost of capital, Canadian commercial real estate transaction activity came to a halt in the second half of 2022. Inflation, rising interest rates and recession fears all weighed on investor confidence. Commercial real estate, like all risk assets, is going through a new period of price discovery to adjust to this new interest rate reality. Bid–ask spreads remain wide, and the number of bidders on each market transaction has significantly decreased. Investors are being very selective in their debt and equity capital deployment. The denominator effect of falling stock and bond values on portfolios has resulted in over-allocations to real estate, hampering lower-leveraged institutional investors' ability to deploy capital. Meanwhile, expected returns for leveraged buyers have fallen sharply, as debt is no longer accretive in many cases in which mortgage rates are higher than net operating income yields.

Broader interest rate-driven repricing is likely in 2023, as credit conditions tighten, and the economy weakens. In general, the Canadian commercial real estate market is well capitalized, but more motivated sellers are likely to emerge in order to shore up balance sheet liquidity. While significant market distress is not expected, more notable price corrections in structurally challenged areas such as "commodity" office and discretionary retail may occur, with more modest repricing happening in multi-family, industrial and food-anchored retail, in which operating fundamentals are strong and the outlook for rent growth is more positive.

### Canadian commercial real estate activity ground to a halt in 2022




Source: Altus Group, 2022.

## Recession risks cloud the outlook to varying degrees across sectors

Financial markets are largely pricing in a moderate but noticeable recession in 2023, which would almost certainly result in a slowing of real estate demand. Fortunately, real estate operating fundamentals are in good shape as the economy enters a period of slower growth. Uncertainty about value is most pronounced in the office sector, which is currently facing the most cyclical and structural headwinds – layoffs in the tech sector, a new era of hybrid work and low physical occupancy. However, there is a clear occupier flight away from "commodity" office space, with the benefits accruing to best-in-class office buildings that deliver "placemaking" enhancements to communities and occupiers' sustainability goals. A consumer-led recession in Canada would have a negative impact on discretionary consumer spending, which has already begun to slow. Malls will continue to bear the brunt of it, having endured the most of any sector during the pandemic.

Conversely, we continue to see strong fundamentals and investor demand for food-anchored retail strip centres, multi-family rental apartments and logistics real estate, including cold storage facilities. Spending on essentials is expected to remain strong despite stretched household budgets. Strong immigration and the high cost of homeownership have boosted multi-family tenant demand. Low vacancy rates and strong rent growth should continue to drive industrial performance. We remain optimistic about the long-term demand drivers in these sectors, which are complemented by supply constraints that limit new development.

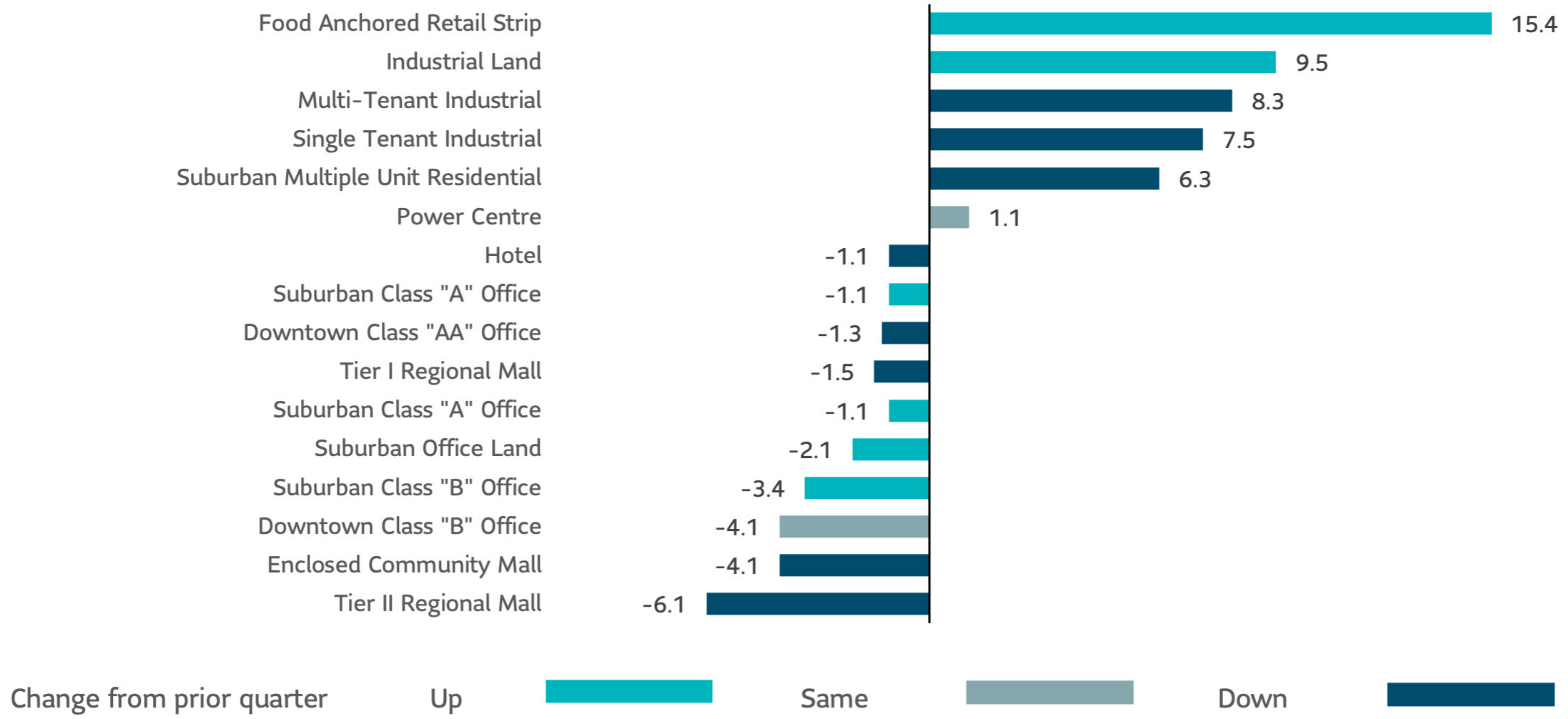
With markets re-pricing assets in 2023, we believe opportunities for equity capital may generate compelling value-add returns. Canadian real estate investment continues to offer investors a powerful source of diversification and growth potential.

## Higher interest rates provide compelling returns for lenders

From a lender's perspective, borrowers have adjusted and continue shaping their respective strategies around commercial mortgage interest rates not seen since the Great Recession. While limited transaction activity has reduced demand for acquisition financing, there remains a significant outstanding mortgage market resulting in a pipeline of ongoing maturities that need to be renewed or refinanced at maturity. Availability of capital remains healthy overall, although there is a clear bifurcation between industrial, muti-residential and grocery-anchored retail versus office and non-grocery-anchored retail, for which availability of capital is much more constrained. Credit quality is holding up, with few signs of deterioration in high quality core mortgages. However, we continue to monitor the refinancing risk.

Maximum loan amounts remain constrained by minimum debt service coverage ratios, resulting in lower loan-to-value ratios. We continue to see the current market as a near-term opportunity to lend on generally conservative terms while locking in higher interest rates, resulting in compelling risk-adjusted returns.

### Momentum ratio indicates bifurcated investor sentiment by property type




Source: Altus Group, as of Sept. 30, 2022. Momentum ratio reflects percentage of plurality of surveyed investors more likely to buy rather than sell (positive value) or plurality of investors more likely to sell rather than buy (negative value).

Sources: Altus Group, Cornell University's Baker Program in Real Estate/Hodes Weill & Associates 2022 Allocations Monitor, CBRE Econometric Advisors.

# Infrastructure

**Richard Crawford**
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**Edward Hunt**
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**Jack Paris**
Partner, Head of Americas, InfraRed

## Macroeconomic and policy factors expected to continue to drive infrastructure investment appetite in 2023

### Inflation's impact on infrastructure

We expect that the prevalent themes of 2022, from the macroeconomic pressures of inflation and interest rates to the ever-increasing focus on sustainability, will continue to generate investor demand for infrastructure in 2023.

In the broader financial markets, higher interest rates in response to multi-decade high inflation will likely continue to impact the cost of capital. Infrastructure investments can play a key role as a hedge in such inflationary conditions, based on the following characteristics:

- The value of infrastructure assets historically correlates to inflation
- Cash flow from revenue-producing infrastructure (e.g., electricity generation, utilities) also correlates positively to inflation, with many underlying contracts explicitly inflation-linked
- Power-generating and power-storage infrastructure is well positioned in an environment of global energy shortages and pricing volatility, a major driver of inflation in 2023

That stated, inflation also poses some risk to infrastructure investments, such as increases in the costs of construction, maintenance, labor and other critical inputs.

### Risks of rising debt costs

The sharp interest rate increases implemented by many central banks to fight inflation have increased the cost of debt on a global scale. This poses a challenge in infrastructure financing, particularly for organizations requiring high leverage and those without long-term hedging in place. As debt becomes more expensive, many assets will undergo repricing, which is a risk to valuations but also represents an opportunity for investors to secure attractive entry points.

We remain cognizant of debt and leverage risk in an inflationary environment, and as such maintain our conservative positioning in both our long-term income-driven strategies and our exit-driven investments. We favor investments that are exhibiting low levels of leverage and long-term debt and hedge structures, and that will likely be less affected by high interest rates. In the income-focused market specifically, we favor investments with fixed financings. We believe assets with higher-quality characteristics will be more resilient to repricing pressures.

An additional risk stems from the repricing of traditional equities and fixed income. This could generate a so-called "denominator effect" negatively impacting infrastructure allocation. Any writedowns of equities and fixed income and subsequent decreases in overall portfolio value would require investors with strict allocation policies, such as those in the institutional market, to decrease exposure to alternatives (including infrastructure) to comply with their mandates.

### Infrastructure's role in global sustainability

While the current inflation and interest rate challenges are temporary by nature, the ongoing movement toward greater global sustainability remains a secular theme that will continue to drive markets in the long term. Infrastructure investment, particularly the green infrastructure essential to many sustainability initiatives, is poised to benefit against this backdrop.

A recent combination of policy imperatives and macroeconomic and geopolitical realities are creating increased urgency around global sustainability. Europe, for instance, faces mounting concerns over its energy supply, exacerbated by the supply chain risks of Russian gas given the war in Ukraine. We expect global energy security concerns and public subsidies to further drive green infrastructure development from renewables to hydrogen at scale.

The clean energy transition remains a major investment theme for us heading into 2023, including sub-themes such as clean energy generation, advancements in energy storage and the further development of electricity transmission and distribution infrastructure. We are also seeing thematic opportunities in digitalization – such as in mobile towers and fiber networks – and in the upgrading, decommissioning or otherwise repurposing of aging infrastructure assets.

# Insurance asset management

**Ashwin Gopwani**
Managing Director, Head of Retirement Solutions, SLC Management

**Nitin Chhabra**
Managing Director, Head of Insurance Client Relationships and Solutions, SLC Management

## After a trying year in fixed income, insurers look to capitalize on higher yields

### Tough 2022 could mean higher investment income in the future

The resolve of central banks to increase rates to painfully restrictive levels in an attempt to tame inflation has led to the worst total return performance year ever recorded by the bond market and has pushed insurance fixed income unrealized loss positions deep into the red.

For an industry that has dealt with years of anemic levels of investment income, this is actually welcome news as the bond market selloff has resulted in all-in market yields increasing roughly three-times since the beginning of the year. As older, lower-yielding bonds mature and get reinvested at today's higher yields, the amount of investment income generated by portfolios over the foreseeable future will increase meaningfully. The companies poised to benefit the most are, in order, those who are 1) able to hold existing bonds until maturity instead of being forced to sell at losses to cover operational cash needs; 2) in a position to reinvest cash flows to take advantage of today's higher yields; and (3) able and willing to proactively harvest losses – perhaps to offset gains in other asset classes – and reinvest into current bond markets.

Source: Bloomberg, 2022

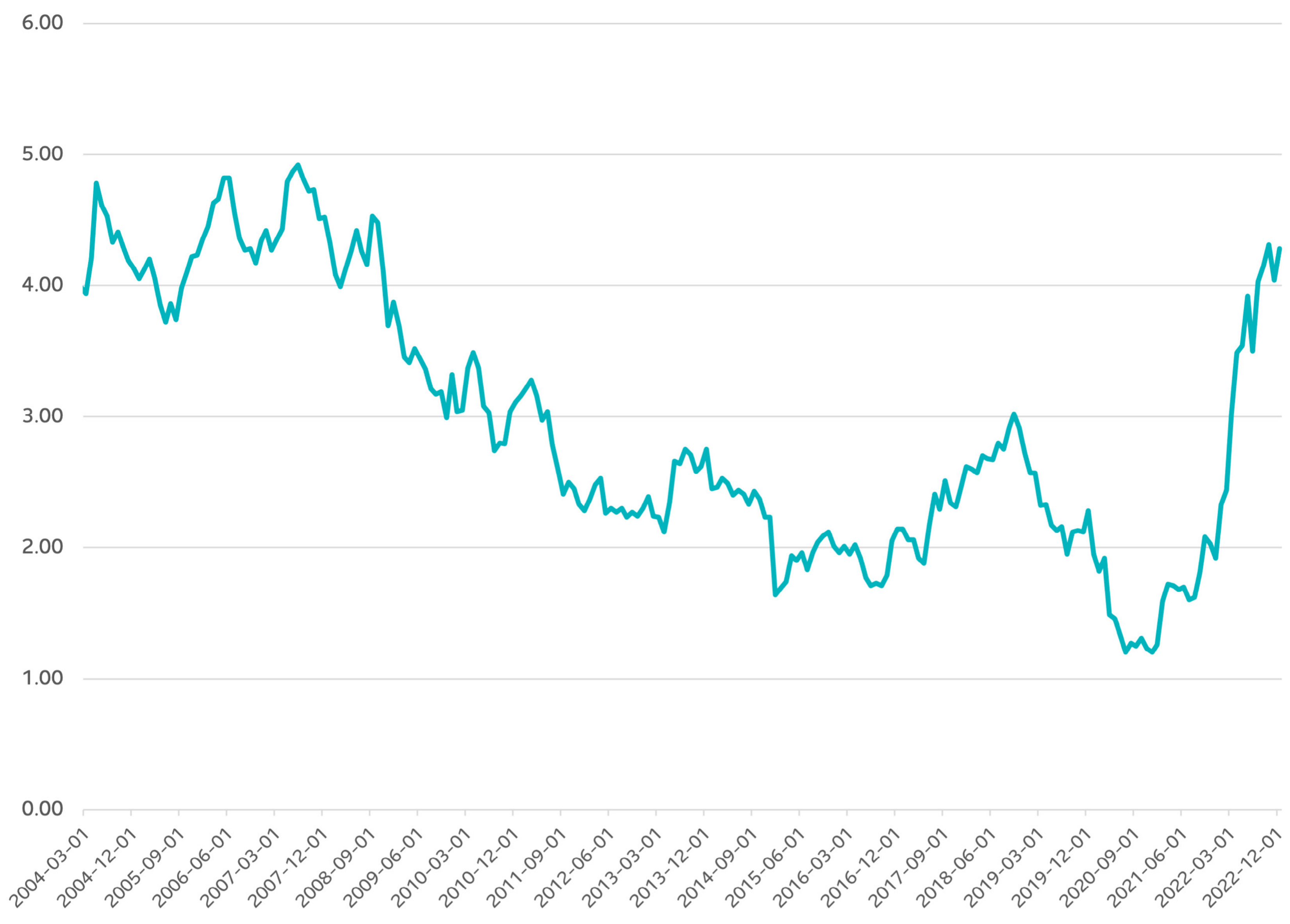
### Taking advantage of improved core yields

As investors, it's important to have a lens that includes both risk free rates and credit spreads, and how the two balance with each other. We expect both to continue to move higher in the near future. However, we believe they will soon start diverging and moving in opposite directions as recessionary risks escalate, at which point spreads will likely continue to move higher while risk free rates will fall as rate cut expectations increase. Given how difficult it is to time the peak of all-in yields, our general strategy in this market is to gradually leg into more spread risk with a goal of achieving more normal-state risk allocations shortly after major central banks achieve their terminal rates. A laddered maturity structure will allow us to accomplish this in a measured way.

### Alternatives in focus for client conversations

Prior to the recent spike in rates, alternative asset classes were generating increased interest from insurance company investors in their search for yield, given what traditional fixed income was compensating investors for. While yields in core fixed income are now much more attractive, alternative asset classes continue to offer additional spread and superior expected returns, and insurance companies are getting increasingly more comfortable with the perceived risk and complexity associated with these investments. An important part of this evolution is utilizing strategic asset allocation analysis to better understand the impact on expected overall risk/return from adding alternatives to a portfolio, including their diversification benefits and downside protection features that help during recessionary periods. Based on conversations with clients and prospects, we believe we are in the early innings in the trend toward increasing allocations to alternative asset classes.

### All-in IG yields the highest since the Great Financial Crisis




Source: FTSE Canada Universe Index.

# Retirement plan solutions

**Ashwin Gopwani**

Managing Director, Head of Retirement Solutions, SLC Management

## Funded statuses improve in past year; plan de-risking impacting fixed income, private credit markets

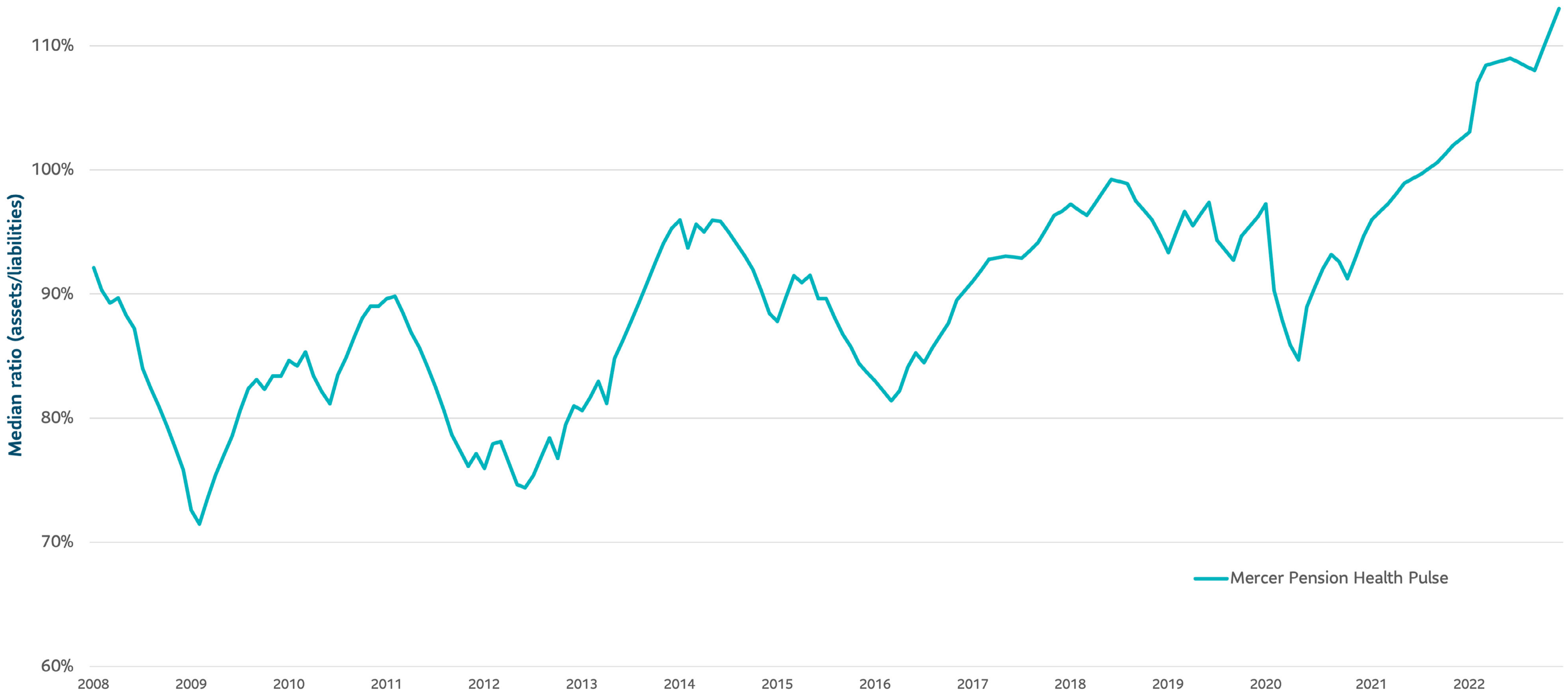
### Defined benefit plans resilient amid a stormy 2022

As we wrapped up the past year, defined benefit (DB) plans for the most part had weathered a volatile period. While almost every asset class had seen negative returns, plan funded statuses have largely improved. The biggest driver of improvement has been the rise in interest rates, which more than offset losses experienced in plans' equity portfolios. With annuity proxy rates approximately 195 basis points higher than at the start of 2022, combined with interest rate underhedges that most plans maintain, the average DB plan funded status was approximately 113%, 10% higher than at the start of the past year.

Funded status improvements typically drive de-risking activity from plan sponsors, and 2022 was no different. We have seen many plan sponsors either increase their allocation to liability-hedging fixed income or lengthen the duration of existing portfolios. Alongside this de-risking activity, funding relief in recent years relating to contribution requirements has removed some of the pain points experienced by plan sponsors in maintaining a DB plan, and has led some to a higher rate of self-insurance and hibernation. This involves using techniques similar to those used by insurance companies, such as hedging unrewarded risks (e.g., interest rate risk), and incorporating an allocation to illiquid private debt and real assets to build a buffer against adverse longevity and potential credit defaults.

The Government of Canada's announcement to cease issuance of real return bonds (RRBs) took many by surprise, and is likely to adversely impact plan sponsors that provide inflation-linked benefits to plan members. In the final weeks of 2022, we experienced challenges making changes to existing portfolios, though small allocation trades were possible. We will continue to monitor developments in this market in 2023, and are actively exploring alternatives that can be adopted should the RRB market freeze.

### DB plan funded statuses improve in 2022




Source: Mercer, 2022. The Mercer Pension Health Pulse tracks the median ratio of solvency assets to solvency liabilities of the pension plans in the Mercer pension database, a database of the financial, demographic and other information of the pension plans of Mercer clients in Canada.

Sources: Mercer, Bloomberg, 2022.

## Plan sponsors diversifying liability-hedging, return-seeking portfolios

As plan sponsors direct more contributions toward fixed income, plans face two increasing risks: that portfolio yields fail to keep up with liability growth and that concentrated credit positions expose plan assets to default risks not faced by plan liabilities. As a result of these risks, we increasingly saw plan sponsors either research options or take action to grow and diversify their exposure to credit. The main asset class to benefit from these actions was investment grade U.S. corporate bonds hedged back to Canadian dollars and interest rates, investments that provide similar credit quality to traditional corporate bonds but with access to sectors not found in the Canadian corporate market and the potential for higher yield due to a positive U.S./Canada 30-year swap spread.

For plan sponsors that have exhausted their opportunities in the investment grade fixed income market, we've seen increased interest in below investment grade alternatives such as high yield bonds and bank loans, either as standalone sleeves or as part of a broader multi-asset credit solution, as well as in real estate and infrastructure. For plan sponsors unaccustomed to investing away from traditional asset classes, we recommend considering small incremental changes, which can still lead to improvements in a plan's risk/reward outcomes.

## What does 2023 have in store?

How each pension plan will fare over 2023 will depend heavily on its positioning moving into the new year. While equity allocations in pension plans generally appear to have fallen due to de-risking activity, this allocation continues to be a source of potential volatility. While an equity rebound could further buoy funded statuses, continued turmoil coupled with low GDP expectations for 2023 could add unwanted volatility for plan sponsors. To help sustain current funded status levels, plan sponsors should make sure they don't have any more equity risk than needed.

A plan's remaining exposure to interest rate risk should be similarly considered. In general, when funded statuses and interest rates are high, and the future path for interest rates seems uncertain, decreasing a plan's interest rate exposure can make a lot of sense for plan sponsors. Conversely, if a plan sponsor does nothing and interest rates fall, we could see funded statuses revert to lower levels.

Sources: Mercer, Bloomberg, 2022.

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