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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.

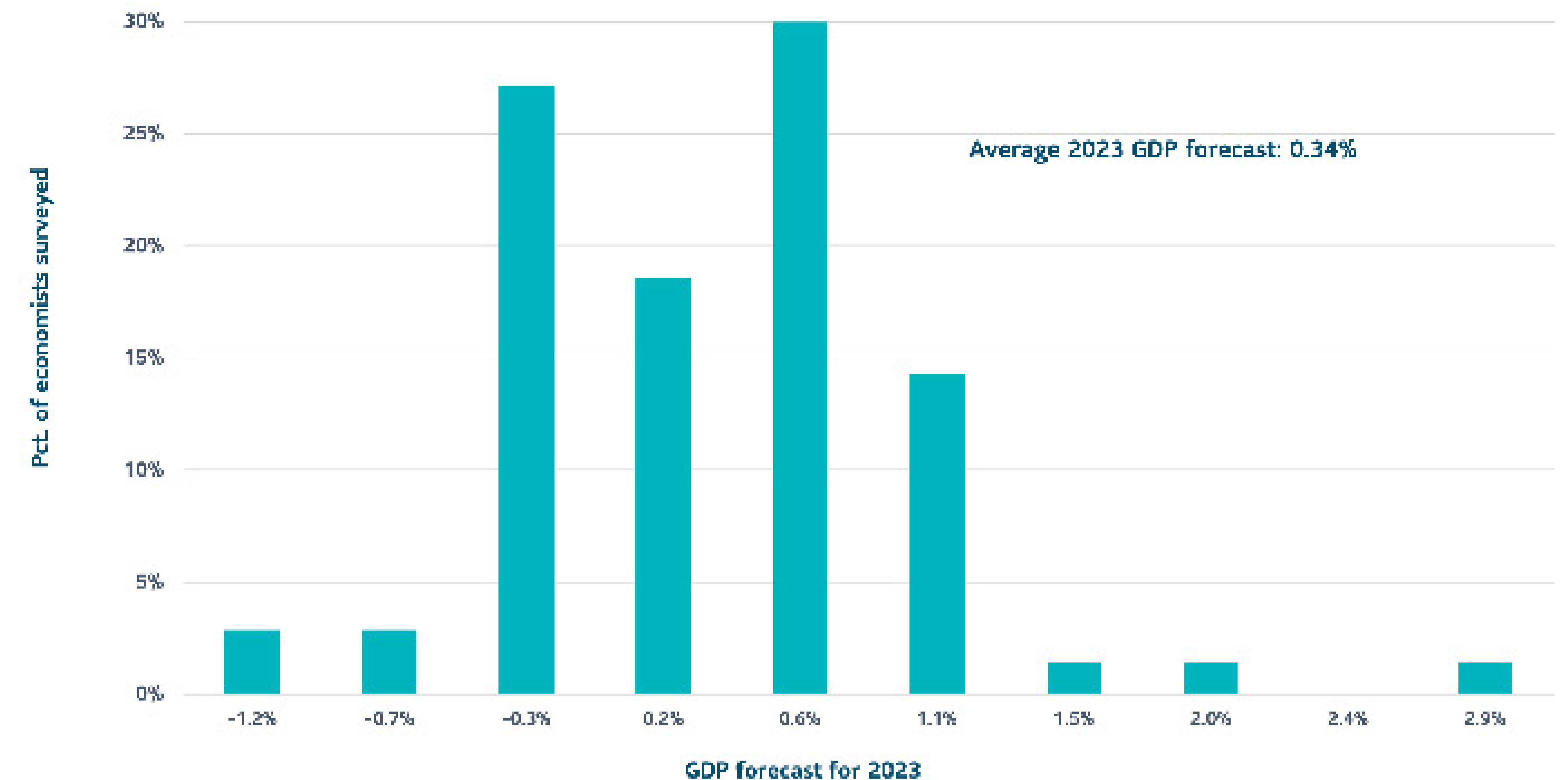
The eurozone still needs to navigate the effects of energy supply dislocation and escalating prices. While the region skillfully built up gas storage for this winter, Europe will soon need to restock for next season. The region is likely to hit a recession this year as high energy bills weigh on consumer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

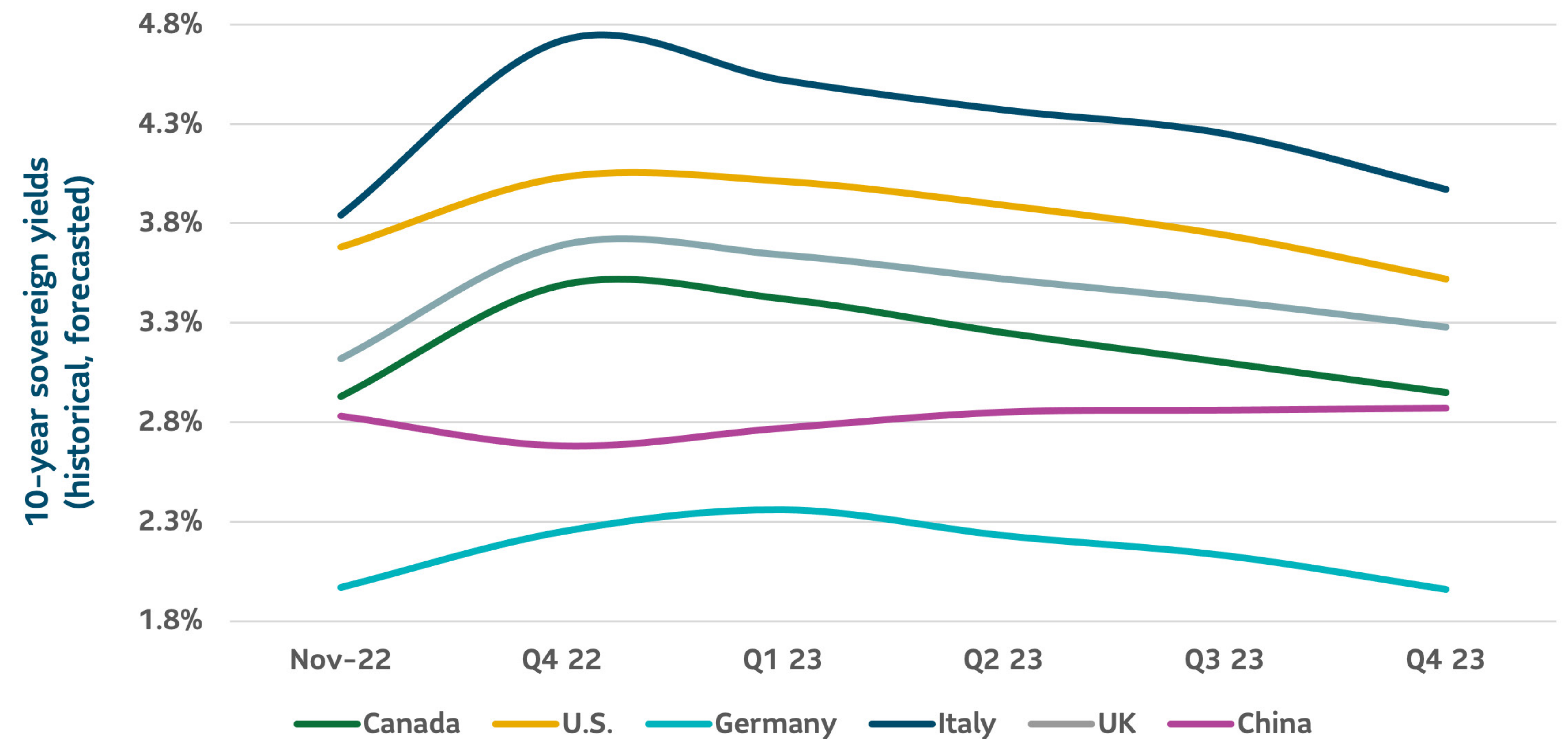
A risk the Fed wants to avoid is prematurely cutting rates and inadvertently igniting a second round of inflation. This would seriously undermine the central bank's credibility. That happened in the 1970s and the Fed doesn't want a rerun of that misstep. Therefore, expect the Fed to keep rates higher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

Richard Familetti

CIO U.S. Total Return Fixed Income, SLC Fixed Income

Compelling fundamentals and yields point to opportunities, but risks remain

Inflation remains prevalent, but signs of moderation ahead

Policy responses to persistently high U.S. inflation was a dominant economic theme throughout 2022, a very challenging year in core fixed income with sharp declines in investment grade credit, among other asset classes. Inflation is expected to continue to be the focus of attention in 2023. While the U.S. Consumer Price Index continued to report high levels in the past year, including a 9.1% year-on-year jump in June 2022 that reflected inflation levels not seen since 1981, viewing U.S. inflation in a broader context might reflect a more sanguine view of the macro and policy environment.

Regionally, for example, while U.S. inflation in 2022 remained fairly high in absolute terms, the country tended to occupy the middle of the pack compared to other economies globally. Other major world economies, such as the United Kingdom and eurozone, continue to face inflation pressures equivalent or greater than those faced by the U.S. Moreover, numerous indicators suggest that the hawkish positioning of the U.S. Federal Reserve could have its intended effect of bringing inflation back to normalized levels. For example, reports from the U.S. Bureau of Economic Analysis, Haver Analytics and other sources attribute a greater proportion of today's inflation to demand drivers, as compared to other historic periods of high inflation (such as the early 1970s). This is significant, as interest-rate hikes and other central bank policy tools are generally able to moderate demand better than other factors that sometimes drive inflation.

Encouraging fundamentals in credit markets despite recession risk

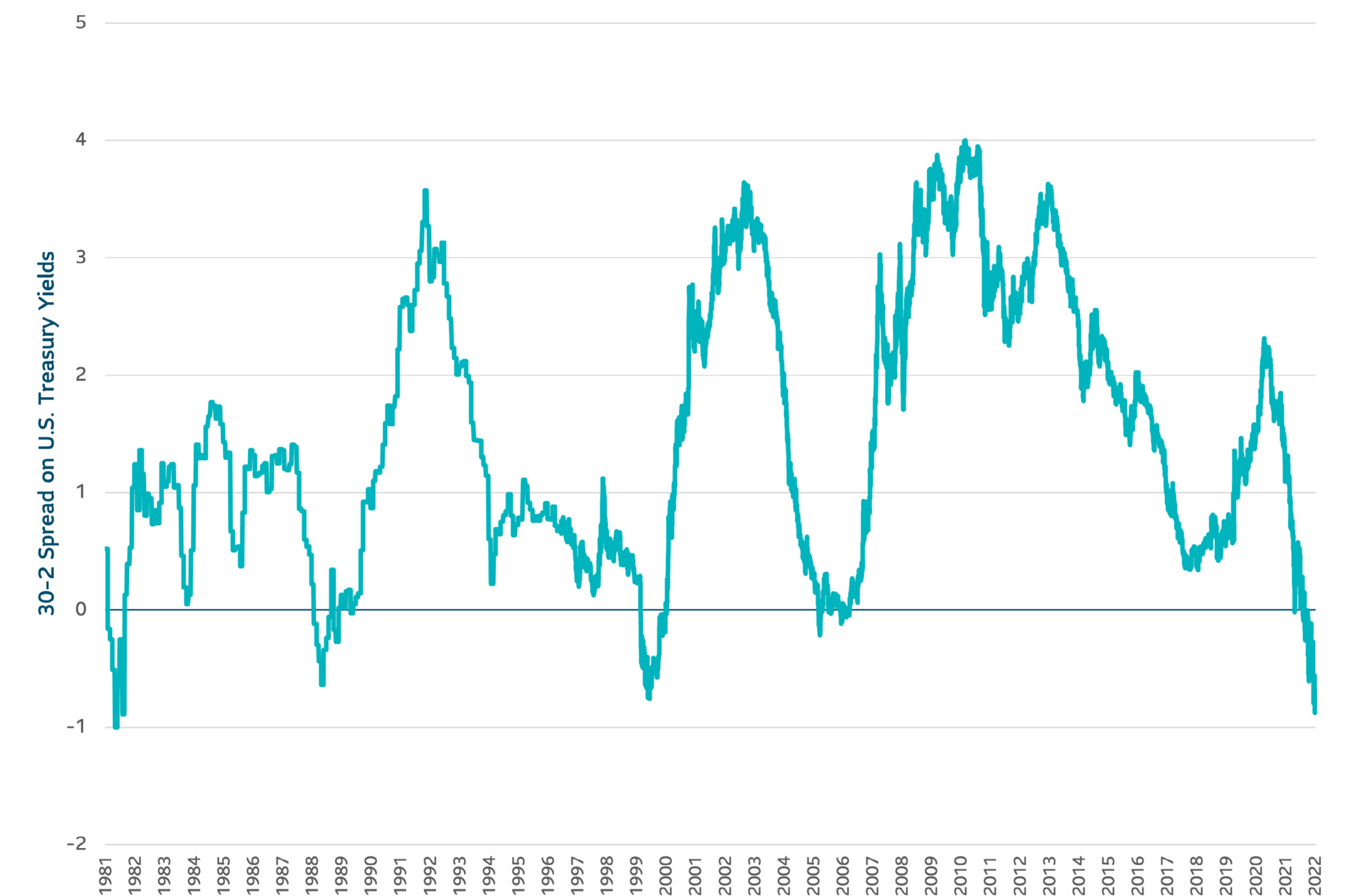
As of the end of 2022, spreads in IG credit appeared to price in expectations of a near-term but moderate recession. For example, spreads in both AAA and BBB corporates in 2022 hit low levels that have historically presaged incoming economic contractions. Along the yield curve, the inversion of spreads between 30- and 2-year Treasury yields also reflect expectations of a recession.

A notable rise in leverage among IG corporate issuers remains another risk factor for 2023. However, we note that much of this risk could be offset by other solid fundamentals, such as corporate profit margins remaining strong on a longer-term basis despite some softening in 2022. Furthermore, interest rate coverage among IG corporate issuers rebounded substantially since the 2020 depths of the pandemic, and now exhibit historically strong levels. With major fixed income yields approaching 10-year highs by the end of 2022, the IG fixed income space is poised to offer investors considerable value in the new year and beyond.

Opportunities in select securitized debt

Focusing on the securitized sector in particular, many of the overarching themes from the broader fixed income space carry over into this market as well. Some securitized subsectors have already priced in a moderate recession and have been offering high yields akin to the Great Financial Crisis. For example, in the commercial mortgage-backed securities market, the non-agency BBB space is exhibiting all-in yields that are at 10-year highs – save for a very brief COVID-driven spike in 2020. We believe the subordinate IG tranches of the CMBS, asset-backed securities and collateralized loan obligations markets can offer investors material spread and income benefits. Meanwhile, agency mortgage-backed securities have extended and have experienced negative convexity from the Fed's rate increases and other tightening measures.

30–2-year Treasury yield spread suggests pre-recession conditions



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

Andrew Kleeman

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

Elaad Keren

Senior Managing Director, Portfolio Manager and Head of Mid-Market Private Debt, 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

Paul Briggs
Managing Director, Head of
U.S. Research, BentallGreenOak

Abbe Franchot Borok
Managing Director, Head of
U.S. Debt, BentallGreenOak

Recession fears and liquidity risks lead yield expectations higher as the Fed hikes interest rates, but property fundamentals remain solid

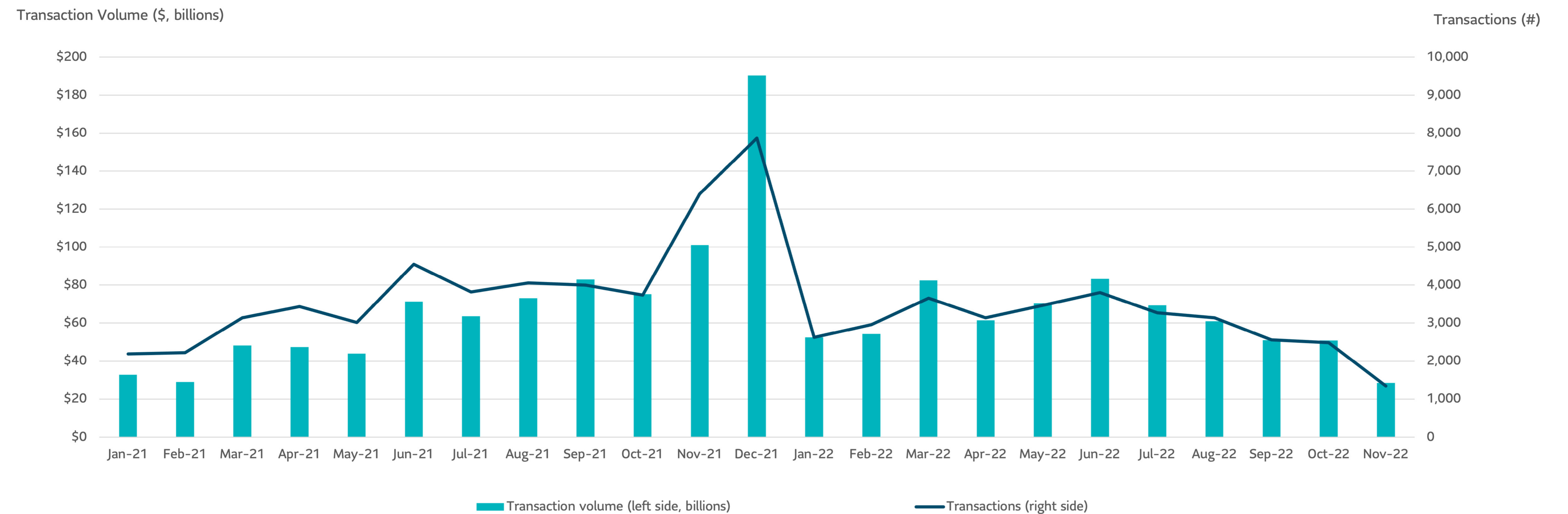
Rising interest rates and uncertainty slow activity

With the U.S. Federal Reserve aggressively hiking interest rates in response to persistently high inflation, commercial property investors are facing tighter lending conditions[1] and debt costs that exceed investment yields. While long-term interest rate expectations remain relatively low, current capital market conditions have increased the bid–ask spread between buyers and sellers, dramatically slowing investment activity. The dip in market activity is unlikely to subside until investors have more clarity on the economy and monetary policy.

The lower number of transactions that are closing reflect a broad range of repricing in the market, making it difficult to determine the precise level of value impact. Recent sale prices represent a complex interplay of asset, location and tenant quality, as well as lease structure. While some owners are facing pressure to sell, there are still buyers with capital to deploy that are willing to be aggressive on assets that meet their requirements.

Just as other asset classes have seen values drop in 2022, commercial property values are likely to see more widespread declines in 2023. The asset class's historical stability, strong current fundamentals and substantial diversification and inflation hedging characteristics should limit the deterioration as investors continue to place value on the performance enhancing benefits of the asset class.

U.S. transaction volume down 72% year over year



Source: MSCI, (all property types), as of November 2022.

Stark differences in performance across sectors will persist

Within commercial real estate, the different property sectors face varying supply and demand conditions and longer-term secular drivers. Retail and office properties face headwinds in the near term as the potential for layoffs and weaker consumer spending rises. Capital flows into the retail sector have been buoyed recently by relatively higher yields, limited new supply and shoppers returning to stores. But this recent success masks longer-term challenges driven by rising levels of online shopping, excess retail space in the U.S. and expectations for significant capital expenditures for repositioning existing centers. Office values face the greatest downside risk in the near term as economic uncertainty and sluggish return-to-office trends threaten demand. Longer-term, we see a future for well-located office properties that effectively meet the needs of tenants in the market. Thoughtful and proactive asset selection and asset management will be critical to successful office investment.

Multifamily and industrial properties have been the beneficiaries of strong demand tailwinds over the past several years. Insufficient homebuilding over the past decade resulted in dramatic escalations in home prices and forced many households to rent. Even with recent modest declines in home prices, principal and interest payments have surged along with rising interest rates. Rental occupancy rates are healthy[2] and should hold up comparatively well if a mild recession takes hold. Industrial vacancy rates are historically low[3] on the heels of a surge in demand from ecommerce users during the pandemic. Onshoring of manufacturing activity and the continued shift to more online shopping represent long-term demand tailwinds for the sector. Certain multifamily and industrial markets may face a period of oversupply in the short-run, but these risks can be mitigated through location and asset selection.

Liquidity and refinancing challenges in 2023 will create opportunities for both equity and debt strategies

Investors with capital to deploy in 2023 will see higher quality opportunities than were otherwise available over the past two years. All-cash buyers will be in the pole position on asset sales, getting their pick of assets as sellers favor these buyers in a less certain financing environment. Lenders and more opportunistic equity strategies that allow for high-yield debt investments will also see their share of opportunities. Traditional bank lenders have tightened their standards and will tighten them further if a recession takes hold and default rates rise. Debt funds should expect to see higher-yielding opportunities and less competition from traditional lending sources. There should be an uptick in distressed borrowers, and investors willing to assume the risk of entering the capital stack in these circumstances will have the potential for significant upside as capital flows and interest rates normalize.

Nearly $600 billion of senior commercial real estate debt will mature in 2023–24.[4] Many of these borrowers will be refinancing at dramatically higher interest rates, creating the potential for distress. The commercial mortgage-backed securities space is showing no signs of distress to date[5]; of the major property types only office had a higher delinquency rate than a year ago. We expect to continue to see a paucity of new CMBS issuance until markets receive more clarity.

Past cycles have demonstrated that investors with capital and conviction can strike some of their best deals in periods of uncertainty and reduced liquidity. The next year will not be without its challenges, but BGO expects to see opportunities to make compelling acquisitions and loans on behalf of our clients.

[1] Federal Reserve Senior Loan Officer Survey, Q4 2022.
[2] RealPage, Q3 2022.
[3] CoStar Group, Inc., Q3 2022.
[4] Newmark Capital Markets Report, Q2 2022.
[5] Moody's CMBS Delinquency Tracker, November 2022.

Infrastructure

Richard Crawford
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Edward Hunt
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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.

InfraRed Capital Partners

Insurance asset management

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Senior Managing Director, Head of Insurance Portfolio Management & Trading, SLC Fixed Income

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

Louis Pelosi
Managing Director, Client 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 the U.S. Federal Reserve to increase rates to painfully restrictive levels to tame inflation resulted in the worst annual total return performance in 2022 ever recorded by bond markets. This pushed insurance fixed income unrealized loss positions deep into the red.

However, for an industry that has dealt with years of anemic levels of investment income, this might be welcome news. The bond market selloff resulted in all-in market yields increasing by roughly three-times since the beginning of 2022. As older, lower-yielding bonds mature and get reinvested at higher yields, the amount of investment income generated by portfolios over the foreseeable future will increase. The companies best poised to benefit 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 needs; 2) in a position to reinvest cash flows to take advantage of 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.

Taking advantage of improved core yields

As investors, we believe it's important to have a lens that includes both Treasury yields and credit spreads, and also how the two balance each other. Near term, we expect both to continue to move higher. However, we believe they will soon start diverging and move in opposite directions as recessionary risks escalate, at which point spreads will likely continue to widen while Treasury rates fall as rate cut expectations increase. Given how difficult it is to time the peak of all-in yields, our general strategy is to gradually leg into more spread risk to achieve more normal-state risk allocations when the Fed achieves its terminal rate. A laddered maturity structure will allow us to accomplish this in a measured way.

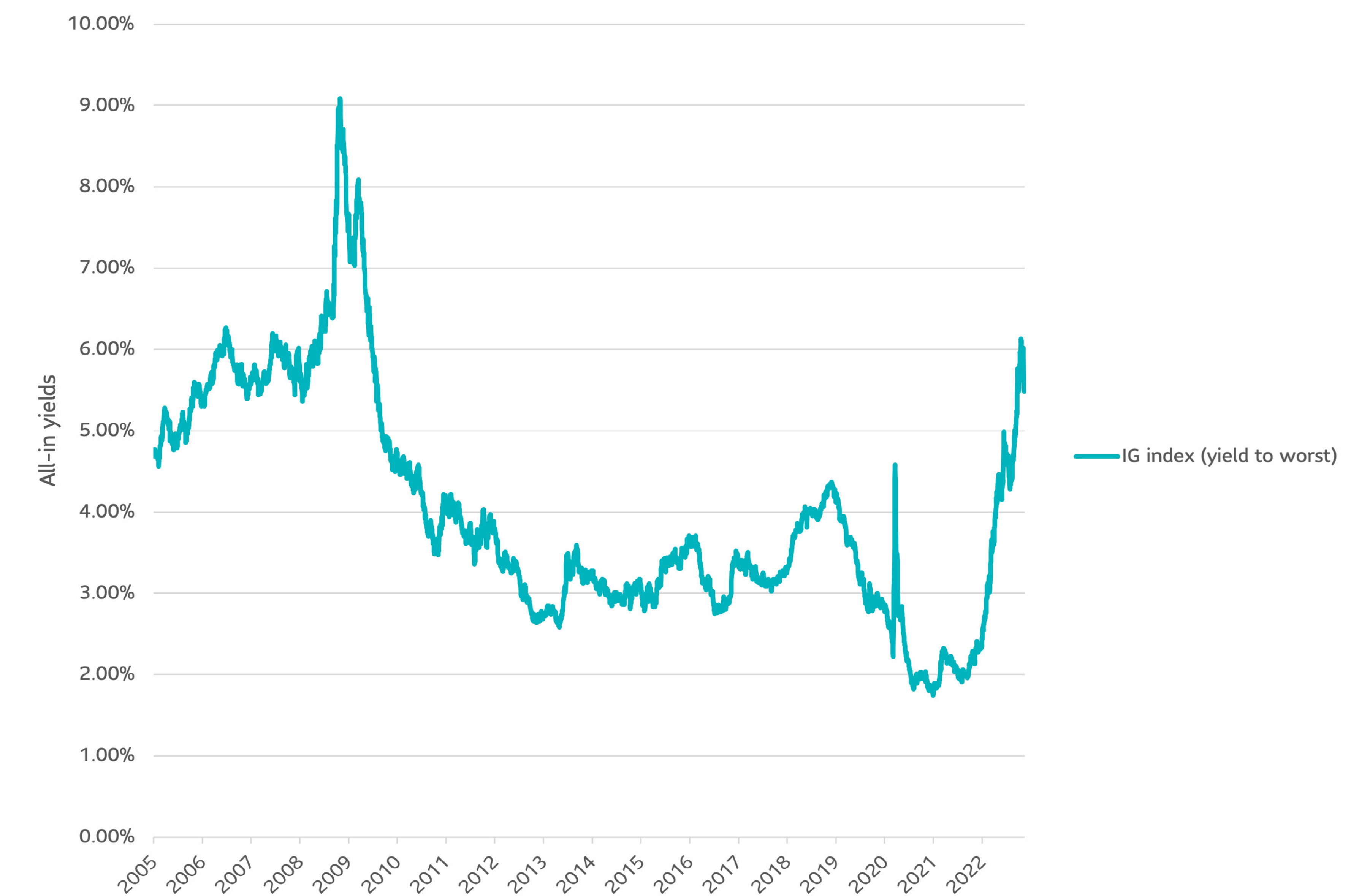
Source: Bloomberg, 2022

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. Insurance companies are also increasingly 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. Based on conversations with clients, we believe we are in the early innings of a trend toward increasing allocations to alternative asset classes.

However, product innovation has resulted in complex vehicles that qualify for the same favorable ratings and risk charges as simpler bonds, despite potentially holding greater risk. As a result, regulators such as the National Association of Insurance Commissioners are planning on making changes to capital charges, reporting requirements and definitions to improve transparency and better align investments with their underlying risk. We will continue to monitor these developments in 2023.

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



Source: Bloomberg: Bloomberg US Agg Credit Yield To Worst index (LUCRYW).

Retirement plan solutions

Tim Boomer
Senior Managing Director, Head of Client Solutions, SLC Management

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

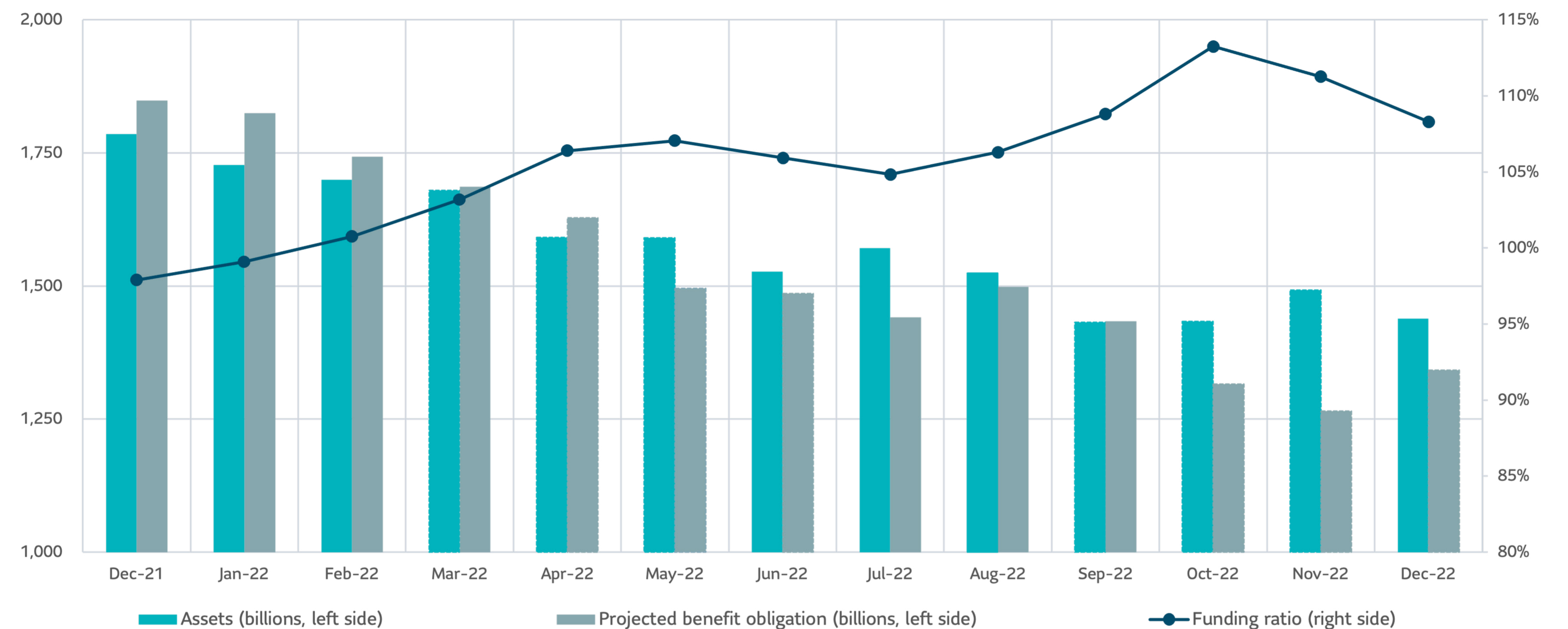
Defined benefit plans resilient amid a stormy 2022

As we wrapped up the past year, defined benefit 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 this improvement has been the precipitous rise in interest rates, which more than offset the losses experienced in plans' equity portfolios. With accounting discount rates 230 basis points higher than at the start of 2022, combined with the interest rate under-hedge that most plans maintain, the average DB plan funded status at the end of 2022 was approximately 108%, which is approximately 10% higher than at the start of the past year *(Source: Milliman, 2022).*

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 their existing portfolios. These changes resulted from either hitting glidepath triggers or discussions with plan sponsors' investment managers and consultants about taking risk off the table. Considering ongoing concerns related to future interest rate volatility, including the possibility of future rate cuts, these changes appear to be quite timely.

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 credit default experience.

DB plan funded statuses improve in 2022



Source: Milliman Pension Funding Index, December 2022 based on estimate.

Plan sponsors diversifying liability-hedging, return-seeking portfolios

As plan sponsors direct more contributions toward fixed income, plans face two increasing risks – the risk that their portfolio yields fail to keep up with liability growth, and the risk that concentrated credit positions expose plan assets to default risks not faced by plan liabilities. As a result of both of these risks, we increasingly saw plan sponsors either research options or take action to both grow and diversify their exposure to credit. The main asset class to benefit from these actions was investment grade private credit, which provides a similar credit quality and a higher yield when compared to traditional corporate bonds while giving plan sponsors access to additional sectors not found in the publicly traded corporate market, plus the potential for a higher yield due to an illiquidity premium.

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 significant 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.

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