

The Monthly Pension Review: October 2022

Higher discount rates and a risk-on environment increased funded status by 5% in October



October Market Summary

- A rally in equity markets and rise in discount rates boosted funded status by over 5% – Assets returned 2.3% while liabilities fell by 2.5%.⁽¹⁾
- Equity markets rebounded in October – After two straight months of negative performance, the S&P 500 Index rallied by 8.0% in October. Year to date, the index is now down 18.8%.
- The yield on the Bloomberg Barclays Long Credit Index increased by 22 basis points (bps) – Credit spreads rallied 12 bps in sympathy with broader risk assets while the underlying Treasury basis increased by 34 bps. The Long Credit index yield now sits at 6.1%, its highest level since February 2010.

Market Watch ⁽²⁾	Dec-20	Dec-21	Sep-22	Oct-22
Funded Status	90.3%	97.9%	109.2%	114.7%
FTSE Discount Rate	2.23%	2.63%	5.14%	5.41%
Long Credit Yield	2.78%	3.10%	5.89%	6.12%
US 30Y TSY Yield	1.64%	1.90%	3.78%	4.16%
S&P 500	3,756	4,766	3,586	3,872

SPOTLIGHT: U.K. PENSION FALLOUT

Unpacking what happened

- A series of tax cuts rolled out by the U.K. government amid 10% inflation and full employment sent shockwaves through U.K. capital markets.
- The controversial economic policy caused a precipitous rise in U.K. government bond yields with the 30-year gilt skyrocketing 140 bps in just four trading days.
- For U.K. pension plans that utilize derivatives to achieve interest rate exposure, this required an unprecedented amount of liquidity to meet daily variation margin to settle their contracts.
- After all cash was exhausted, many plans turned to other liquid assets, which meant selling existing U.K. gilt holdings, creating further selling pressure that exacerbated an already spiraling market.
- The silver lining out of all of this is that the impact on U.K. funded status has been relatively muted as the rate shock had an offsetting effect on liabilities.

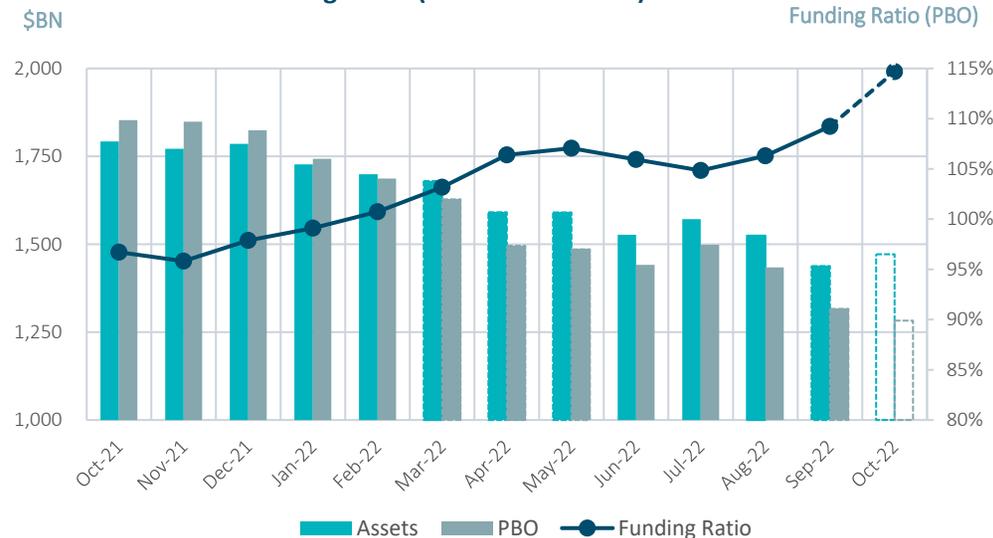
Impact on the U.S. market

- The initial frenzy in U.K. government bond yields was generally contained to the U.K. market; however, subsequent forced liquidations did impact the U.S. bond market as U.K. plans turned to U.S. long corporate bonds as a source of liquidity.
- Overall, this caused an estimated 10–15 bps of spread widening but had minimal impact on overall funding of U.S. plan sponsors.

The importance of a liquidity plan

- While the U.S. market was well insulated from this situation, it highlights the need for a strong liquidity plan in place for those that utilize derivatives in their liability-driven investment program.
- We recommend using a framework that 1) clearly identifies risk factors in both the overlay and physical asset portfolios; 2) understands the correlation between these risk factors, particularly in stress scenarios; and 3) performs historical stress testing/reverse stress testing to ensure ample liquidity is available in a broad range of stress scenarios.

Milliman Pension Funding Index (October estimate)



U.K. 30-year gilt yield



(1) Funded status for the current month is estimated and subject to change as final numbers are released. Data from reference Bloomberg Indices. Funded status is in reference to the top 100 U.S. corporate pension plans sourced from Milliman.
 (2) Funded status source: Milliman. FTSE Discount Rate source: FTSE. Long Credit Yield source: Bloomberg. U.S. 30Y TSY yield source: Bloomberg. S&P 500 source: Bloomberg. U.K. 30-Y gilt yield source: Bloomberg.

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Market Chart Indices:

- Long Corporate Spreads sources: Bloomberg Long Corporate Index
- AA pension discount rate sources: FTSE Pension Discount Curve
- Average funded status source: Milliman
- Long end issuance source: Bloomberg
- Moody's Baa spread source: Moody's
- MOVE source: Bloomberg
- Monthly issuance source: SIFMA
- Top sector downgrade table source: Bank of American Global Research, Bloomberg
- Rolling 5-year monthly correlations and YTD index returns for S&P 500 and U.S. Aggregate source: Bloomberg

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(2) The Long Credit yield corresponds to the Bloomberg Long Credit Index.