Insights
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What the Fed's Recent Commentary Means for Defined Benefit Plans

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TK's Corner
Market Thoughts from Thomas Kennelly

On August 27, Fed Chair Jerome Powell gave his much-anticipated comments at the economic policy symposium in *Jackson Hole, Wyoming*. Powell's comments did not reveal anything new in terms of policy decisions since the July Federal Open Market Committee meeting (see our *Weekly Economic Perspectives* from August 30), but Powell did point out that he supported tapering before year-end in line with statements from several regional Fed presidents prior to the event. Powell made a concerted effort, however, to dissociate "tapering" from "tightening," a distinction the market embraced and viewed as dovish. Spreads tightened, breakevens and real yields rallied, and equity markets strengthened after his comments. **Still, his speech solidified our house view that Fed tapering is likely to begin later in 2021 and will serve as another step toward a 2022 rate hike** — despite Powell's efforts to disconnect tapering and tightening, and despite a rise in COVID-19 variant concerns, a surprisingly weak August jobs report, and an unexpected fall in consumer confidence in August.

The new dot plot released with the FOMC September 21–22 meeting also supports a 2022 rate hike. More members are estimating that rates will rise next year by more than a quarter point, versus the June projections, according to the September 22 dot plot (Figure 1).

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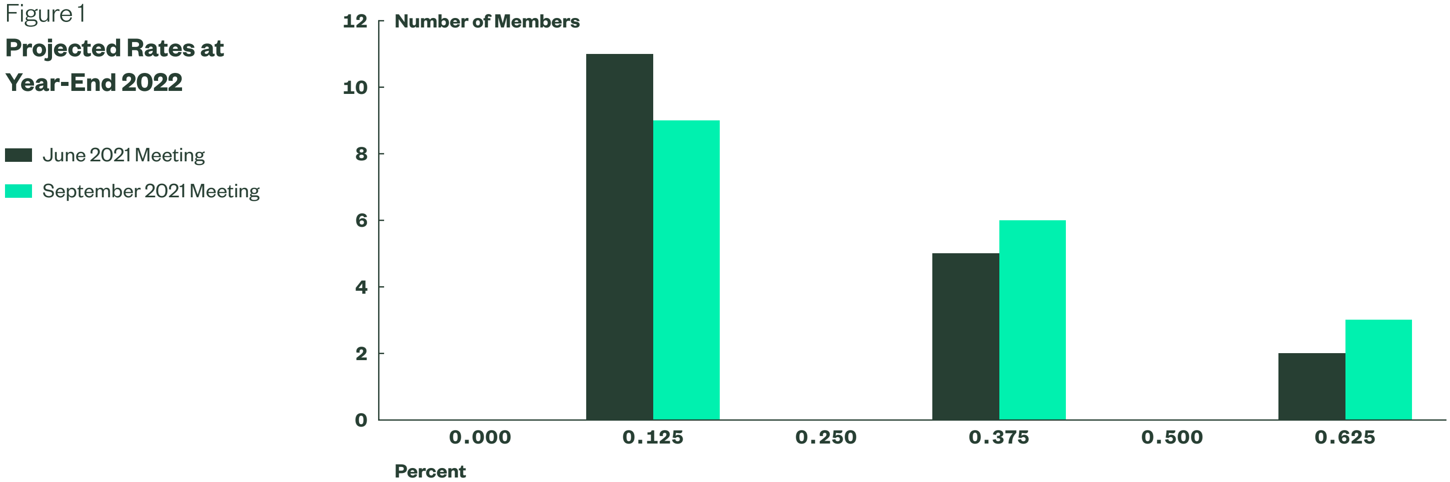
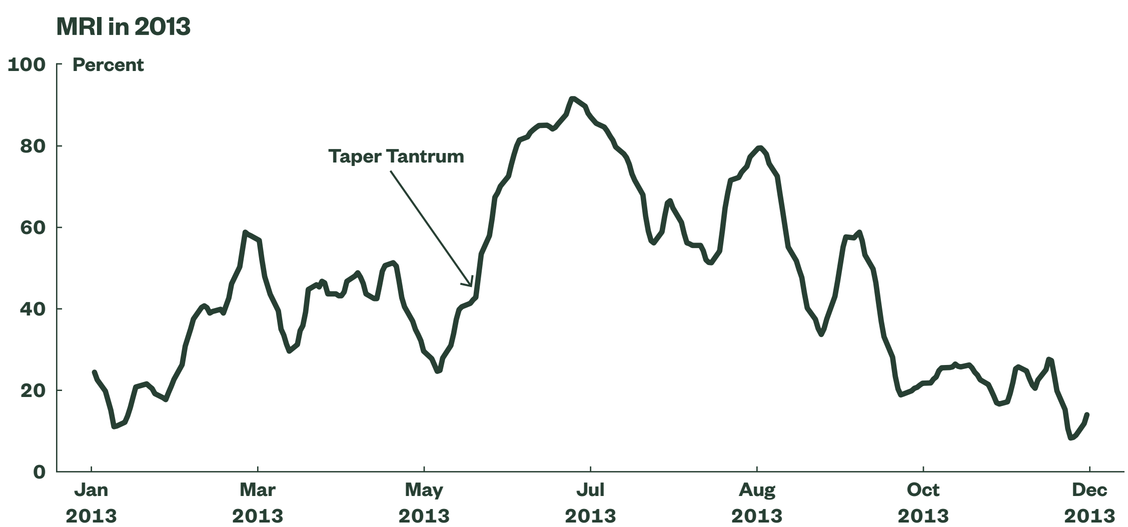
Figure 1
Projected Rates at Year-End 2022



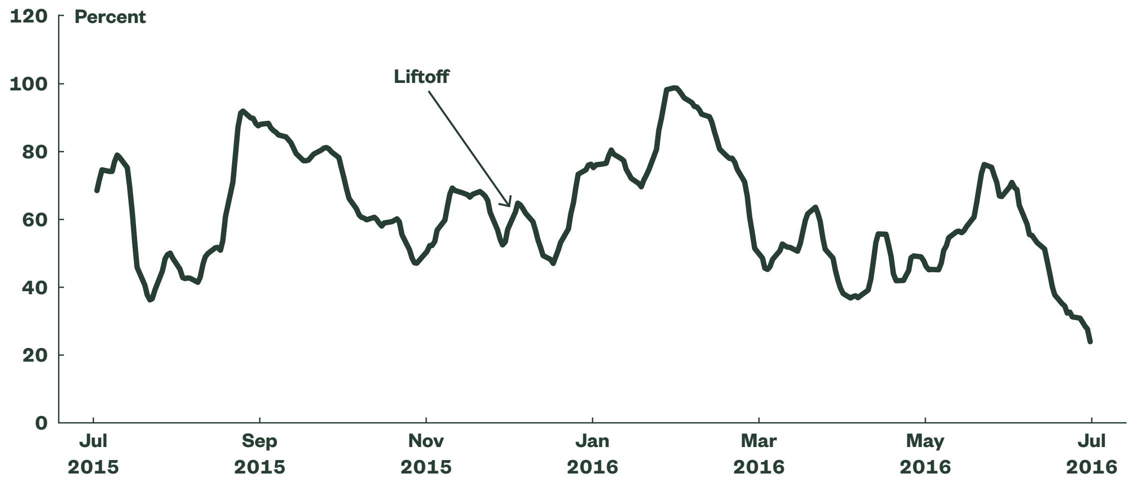
Source: US Federal Reserve, as of September 22, 2021.

What does the expected monetary policy trajectory mean for defined benefit (DB) plans? Much of the answer lies in the way growth assets will react to future Fed announcements. The Fed is trying to mitigate a severe reaction, as it continues to offer cautious rhetoric and to reference "uncertainty" to keep markets from banking on any specific action. At Jackson Hole, the Fed was successful at this, as evidenced by our Market Regime Indicator (MRI)[1] data. The MRI charts in Figure 2 show that after the 2013 taper tantrum, the MRI went up sharply, while in 2015 when the Fed began raising rates, the MRI move was unremarkable because market expectations were already set for hiking. Similarly, at Jackson Hole, the MRI move was muted because Powell simply reiterated a view that was already in place — a view reflected in the increased inflation expectations we have seen throughout the year.

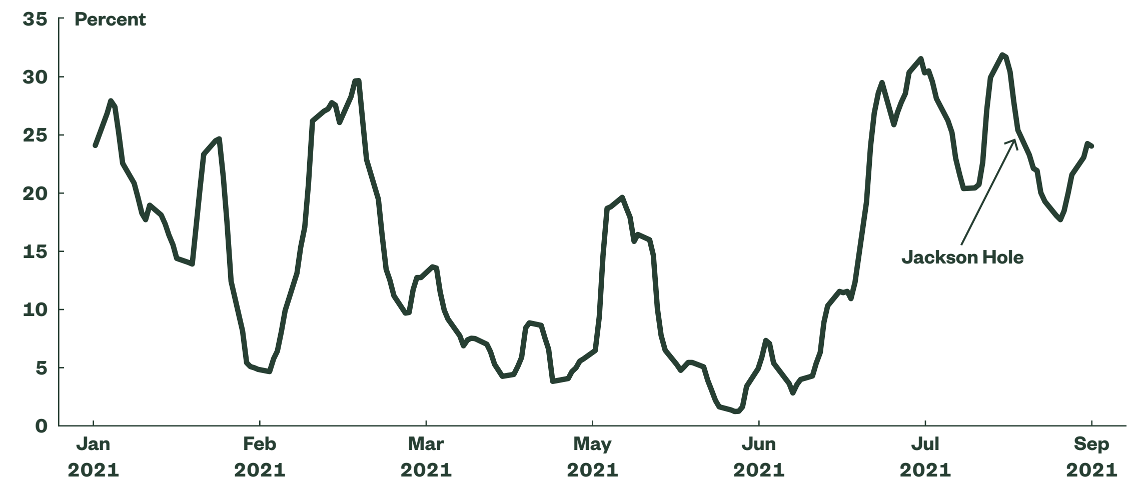
Figure 2
Risk Indicators Moved Modestly in Response to Jackson Hole



MRI in 2015/2016



MRI in 2021



Source: State Street Global Advisors ISG, as of September 15, 2021. The data displayed is not indicative of the past or future performance of any SSGA product. All data shown above does not represent the results of actual trading, and in fact, actual results could differ substantially, and there is the potential for loss as well as profit. The Market Regime Indicator (MRI) is a quantitative framework that attempts to identify the current market risk environment based on forward-looking market indicators. We believe the factors used, equity implied volatility, currency pairs implied volatility and bond spreads, are good indicators of the current risk environment as they are responsive to real-time market impacts and in theory should include all current and forward views of those markets. These factors are combined to create a single measure and used to identify one of five risk regimes: Euphoria, Low Risk, Normal, High Risk, and Crisis. A slight calculation change was made as of 28 June 2019.

If the Fed sticks to its playbook of telegraphing its plans in simple and repetitive terms, market expectations can be managed and growth assets will continue to benefit from the ongoing economic recovery. We also note that other emerging and developed markets have already started to back off of their ultra-loose policies, so the US is not “leading the way” in reducing accommodation. This all implies that the Fed’s path can coincide with continued improvement in funded status, as rates can increase while equity markets can continue to thrive. However, strong demand from liability-driven investing (LDI) could curb a significant rise in long-end rates, and we can point to other risks that DB plans should consider.

Funded Status Review

Based on Representative DB Portfolios Using Different Equity/ Fixed Income Asset Allocations

	Benchmark Proxy	YTD Return (%)
Plan Liabilities	BBG Long AA US Credit	-0.70
Plan Fixed Income Assets	BBG Long US Gov/Credit	-2.00
Plan Equity Assets	MSCI ACWI	14.69

Source: Bloomberg Barclays, MSCI, as of September 17, 2021.

Funded Status as of 12/31/2020 (%)	09/17/2021: Estimated Funded Status based on Equity/Bond Mix (%)				
	70/30	60/40	50/50	40/60	30/70
80	88.40	87.10	85.80	84.40	83.10
90	99.40	97.90	96.40	94.90	93.40
100	110.40	108.70	107.00	105.40	103.70

Source: Bloomberg Barclays, State Street Global Advisors. Calculations based on asset returns from benchmark proxy equity and fixed income assets, including the BBG Barclays Long U.S. Gov/Credit Index and the MSCI ACWI Index.

Funded status continues to show improvement year-to-date, but looking just at recent months, funded status has been essentially treading water. Equities have surged to record levels in 2021, but September has pared those gains. The S&P 500 and Russell 2000 Indexes are currently in the red for September, and volatility has crept up again. The VIX Volatility Index in mid-August was at 15.45, while in mid-September it peaked at 28.79. In addition, the drop in Treasury yields and tighter credit spreads have lowered liability discount rates enough to offset gains in return-seeking assets. Nonetheless, we continue to see clients who have moved to over-funded positions in 2021 pursue additional de-risking, particularly via partial annuitizations and, in some cases, full plan termination.

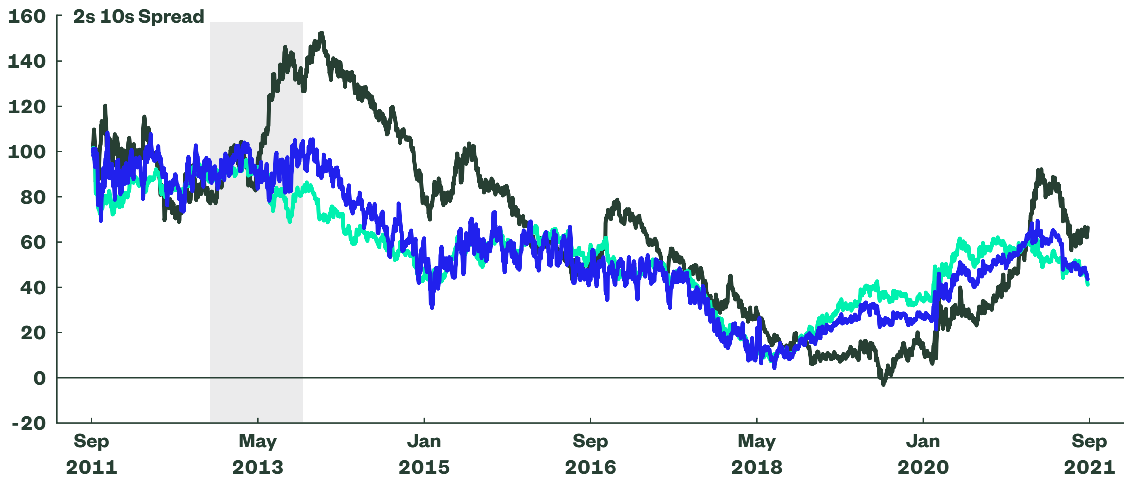
Strategic Perspectives: Monetary Policy

Thoughts on the Curve: Tightening Versus Tapering

Money market liquidity has been a significant focus, with the reverse repo facility quickly swallowing the ballooning Treasury supply from the United States' accommodative monetary policies, resulting in a $1 trillion lift in money market assets under management since February 2000.[2] Cash market investors are celebrating a potential lift from the zero bound in rates that could result from Fed hikes — though this will take time given the excess liquidity in this market. Looking at short-end bonds, rate hikes tend to impact the short end more than the long end, implying curve flattening once tightening starts. For example, the 2s10s flattened significantly when the Fed increased rates from March 2017 through the end of 2018. The 2s10s then steepened significantly after the Fed began decreasing rates in the fall of 2019.

In the meantime, before rate hikes begin and tapering is the Fed's only lever, the impact on the curve could vary depending on the maturity range in question. During the 2013 taper tantrum, the 2s10s curve steepened sharply, as the 10-year range reacted most aggressively to then Chair Ben Bernanke's *May 2013 announcement* (Figure 3). The 5s30s and 10s30s curves *flattened*. This time around, we expect that the short end will be hard-pressed to move higher when tapering begins, as rates remain very low and investors are still piled into the short end to avoid any negative impacts of duration. This implies that the 2s10s could again steepen in response to tapering. The behavior of the 10s30s is less clear, but we note that the 2s10s has steepened year-to-date, while the 10s30s and 5s30s curves have flattened slightly given some concern that the Fed is questioning its flexible average inflation targeting (FAIT) framework. For longer bonds, the strong bid from pension plans that are de-risking will most likely continue if the equity markets strengthen alongside tapering. This, alongside subdued expectations of the terminal rate, is also supportive of flattening further out the curve and potentially lower discount rates and higher liabilities.

Figure 3
The 2s10s Curve Reacted Most to the 2013 Taper Tantrum



Source: Barclays, as of September 17, 2021. Based on US Government bond yields. Spread data indexed to 100.

Places to Hide?

For DB plans seeking to maintain the funding status gains made over the past year, it is worth considering pockets of the market that can help mitigate any unfavorable impacts of Fed actions.

First, with the Fed's continued efforts to pacify markets, credit spreads remain tight and plan sponsors, their advisors, and fixed income managers are mindful of the valuation risk in corporate bonds. The credit curve (which measures average spreads across different maturity buckets) trends flatter and the disparity between higher quality (A or better) and the BBB cohorts remains compressed. However, the fundamental and technical backdrop remains strong, with ratings upgrades continuing to come through and corporate earnings outperforming. Also, the bid for investment-grade credit from foreign investors and LDI remains strong. For investors seeking to be more defensive, and at the same time take advantage of the lower-quality credit rally, we note that high-quality corporates (A-rated and higher) are still relatively attractive, as the spread compression between ratings categories means that less upside may be had from going down in quality (see *Why High-Quality Corporates Still Make Sense for Defined Benefit Plans*).

Second, we have seen growth return to favor in the summer, following the large move higher in value stocks earlier in the year. Specifically, the Russell 3000 Growth Index outperformed the Russell 3000 Value, with returns of 13.9% and 1.7% respectively, during the period of June-August. (However, YTD, as of Sept 17, the Russell 3000 Growth Index is only up 23 bps relative to the Value.) While the market reaction to rising rates through the middle of the year hurt tech stocks due to the implied longer duration of their valuations, we think there is more to it because this thesis doesn't necessarily hold over longer periods. Instead of focusing on value versus growth, it may be more prudent to focus on the overall quality of each stock — including cash flow generation, balance sheet strength, business model resilience, or other fundamentals. As we face uncertainty with rates and a potential for equity-implied volatility to rise,[3] a focus on fundamentals and quality may improve investment outcomes.

Interestingly, amid today's low rate environment, mortgages are one of the few fixed income asset classes that has maintained its spread. For example, since the start of 2019, investment-grade (IG) corporate spreads have tightened more than 75 basis points,[4] while agency mortgage-backed securities (MBS) spreads are flat.[5] Overall mortgage spreads remain low on an absolute basis, and they have not participated in the spread tightening in the IG space partly due to the interest rate volatility and to moving from higher to lower rates this year, given the well-known convexity of this asset class. The Fed's discussions of tapering have been a headwind to mortgage spreads, as the Fed is currently buying roughly $40 billion per month of agency MBS alongside $80 billion of Treasury bonds. (From March 2020 through June 2021, the Federal Reserve increased its agency MBS holdings from $1.4 trillion to $2.3 trillion.) Given these trends, mortgage spreads have widened off their lows in the past several months.

We have been engaged in conversations with our pension clients interested in the role of mortgage-backed securities within the fixed income LDI portfolio. While not typically associated with an LDI program given their shorter duration and negative convexity, MBS presents an opportunity for sponsors to add to a mortgage allocation and for active managers to diversify their investment-grade credit portfolio, while retaining a level of quality and liquidity given the aforementioned credit market dynamics.

Risks Related to Fed Actions

We point to several risks for defined benefit plans that are related to the Fed's recent monetary policy announcements:

1. **The Fed's caution could be prompting markets to underestimate the post-COVID recovery** Currently, several pieces of economic data point to a stronger recovery than what is implied by the Fed. GDP remains above trend, a hefty level of cash is sitting on the sidelines for both corporates and individuals, and the US PMI survey remains solid; therefore, economic performance could turn out better than the Fed expects and liftoff timing could be brought forward — negatively surprising markets.

2. **Ten-year yields have peaked at only 1.75 percent, well below the secular neutral rate level** Rates have increased this year, but the peak of 1.75 percent in March was not as high as we would have expected. Since that time, rates have plummeted roughly 45 bps, which is consistent with a bond market that may be pricing in a cyclical slowdown after pricing in very optimistic forward GDP growth. However, the 1.75 percent high point implies that structural factors could mean that yields remain somewhat capped as demand for duration from pensions and insurers, as well as demographic factors, may dampen a significant rise in discount rates that could boost funded status in the near term.

3. **The delta variant, inflation, and lofty equity valuations still loom** Many of the risks we discussed in previous commentaries (see *The Five Biggest Challenges Defined Benefit Plans Face in 2021 — and How to Address Them*) could mean headwinds for risk assets as the Fed tapers. In particular, the Fed has moved into a flexible framework that allows for an overshoot of its 2 percent inflation target. Even though inflation has already begun to play out, investors broadly, along with less well funded pension plans with a growth-oriented bias, remain exposed to further Consumer Price Index increases. On the upside, Figure 2 shows that the MRI level is still low on an absolute basis — well below the 2013 and 2015/2016 ranges by comparison, which bodes well for growth assets. For the time being.

Overall, the macroeconomic backdrop is still very favorable. For example, there are 10.9 million job openings in the US, against 8.4 million unemployed. The economy looks strong despite the COVID Delta variant. In general, this is a favorable sign for growth assets.

Conclusion

We continue to navigate markets that are at a critical inflection point, as many of our point-counterpoint observations above reflect markets in the midst of a potential inflationary regime shift. More broadly, we are moving past peak US economic growth (reflation trade), and into a more mature part of the cycle. Therefore, continued focus on Fed statements and their potential impact on volatility as exhibited by rates market, yield curve, and implied volatility in risk-seeking growth assets is warranted. Growth assets often exhibit a more severe reaction to unexpected hawkish Fed announcements, though the Fed has so far telegraphed its views well. We offer some potential asset classes that may be worth considering as concern around Fed action is likely to continue during this normalization process. As DB plans seek to maintain the funding status improvements made during the COVID-19 pandemic recovery, we also point out that plan sponsors are not out of the woods, and it is important to monitor key risks related to Fed policy in the near term.

Endnotes

1 State Street Global Advisors' Market Regime Indicator is a tool used for risk budgeting that puts a range of forward-looking indicators into a percentile; typically, a lower MRI is more favorable for equities.

2 Bloomberg Finance, L.P., Investment Company Institute.

3 The VIX is at 24.36 as of September 21, 2021, versus 16.11 at the start of September, per Yahoo Finance.

4 Barclays, as of September 17, 2021. Based on the Bloomberg Barclays U.S. Long IG Corporate Index, OAS.

5 Barclays, as of September 17, 2021. Based on the Bloomberg Barclays U.S. MBS: Agency Fixed Rate MBS Index, OAS.

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* Pensions & Investments Research Center, as of December 31, 2020.
† This figure is presented as of June 30, 2021 and includes approximately $63.59 billion of assets with respect to SPDR products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Global Advisors are affiliated.

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