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2019 LDI Outlook

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Telephone calls may be recorded.

Key risk

The value of investments and any income derived from them can go down as well as up as a result of market or currency movements and investors may not get back the original amount invested.

Our outlook for 2019 focuses on the global geopolitical risks that could arise during the year and what they may mean for pension scheme funding levels and liabilities. We will also explore the key market developments defined benefit (DB) pension schemes are likely to grapple with in the next 12 months.

Economic and political outlook

2018 did not meet the high growth expectations set out in many market outlooks last year. There were various reasons for this:

- The rise in protectionist trade policies threatened to slow global growth
- Tension began to surface in Italy as the new coalition began to contradict and ignore European fiscal rules.
- Central banks cut their asset purchase programs as the global economy shifted form what many perceived to be 'mid-cycle' to 'late-cycle' in a bid to begin the process of monetary policy normalisation.

2018 saw equity market falls across the board, albeit with most declines occurring in the fourth quarter. The FTSE 100 price index was down 13% for the year, whilst the S&P 500 fell a more moderate 6%. This means that markets have given up some of the strong gains we have seen over the last three to four years. Whilst we start 2019 weaker than we started 2018, 3-year returns remain in strong positive territory almost across the board. Long-term sterling rates were volatile during 2018 with no obvious direction and although rates fell sharply in December, 20-year gilt yields ended the year pretty much where they started.

20 year gilt yield (%)

Source: Bloomberg, 03-Dec-2018.

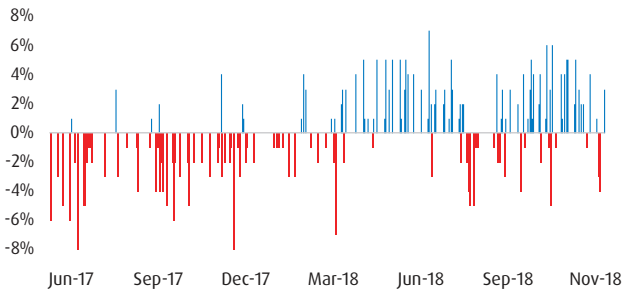
United Kingdom

It's difficult to look beyond Brexit as the key driver of financial markets in the UK. Despite Theresa May's recent 'victory' in the Conservative Party's no confidence vote, a cloud of uncertainty sits prominently over the UK's political and economic future. We believe that there are four potential outcomes, so have outlined them below, and assessed the probable impact on UK rates and inflation.

Disorderly Brexit – the UK leaves the EU without signing any new trade deals. This results in disruption at borders and a financial market sell-off. The Bank of England (BoE) presented a worst-case scenario of the economy shrinking by 8%, house prices falling by 30%, unemployment spiking, inflation and interest rates spiking. Sterling would also depreciate aggressively. In this scenario the BoE may, after a period that allowed markets to settle, choose to cut rates to support the economy. 10-year UK gilt yields would be expected to rise as there would certainly be downwards price pressure. Downward price pressure is likely to be the result of overseas investors selling UK government bonds as they look to move their assets to alternative safe havens. There could be a fall in longer-term UK gilt yields as domestic investors allocate more to UK gilts as they seek domestic safe havens. We could also see a fall in sterling, which could lead to inflation in the UK.

General election – Labour push for a general election in the hope of claiming power from the Conservatives. This remains unlikely given the only way a general election can now be triggered is if a two-thirds majority of MPs vote for one. If Labour did come to power then it's uncertain what it would mean for Brexit. The chart below shows current poling for the next UK general election. A Conservative or Labour government would be unlikely to change the BoE's policy directly, however the uncertainty surrounding the UK would probably cause gilt yields to rise as asset owners sell holdings.

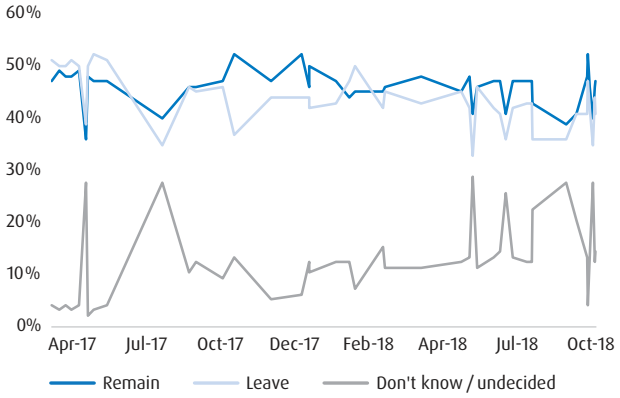
Conservative (Blue) v Labour (Red) majority



Source: BMO Global Asset Management, 38 separate pollsters. Accessed 12-Dec-2018.

Second referendum – Outcome backed by Lib Dems, SNP, Greens and some Conservatives. Labour leadership has remained relatively quiet on this option. Questions remain over what should be asked and if there is enough time to trigger a referendum. If the referendum vote was to remain in the EU, this would support the BoE's interest rate hiking policy. If the vote was to leave, then the UK would have certainly passed the final opportunity to call it all off. In this instance, markets may react violently as all hopes of remaining will have gone. However, before it gets to the second referendum the UK does have the legal option to cancel Brexit in its entirety, before 29 March 2019. However, 'cancelling' Brexit without a second referendum might be viewed as going against the will of the people, so it could prove a damaging political resolution.

If there was another referendum on Britain's membership of the EU, how would you vote?



Source: whatukthinks.org. Accessed 12-Dec-2018.

Theresa May gets her deal through the commons – Conservative MPs, under pressure of a general election which Labour might win, and on the back of a failed no-confidence vote, back the bill, and it is voted through. This is likely to be supportive of monetary tightening In the UK as the BoE would be comfortable to hike. Sterling could well rally from currently depressed levels, exerting downward pressure on inflation.

From an LDI hedging instrument perspective, no matter the outcome, it's very likely that we will see volatility in gilt and swap yields. While the two markets are very similar, an LDI strategy that is able to capitalise on a divergence in the relative value of gilt and swap rates makes sense. Indeed, the run up to the vote has already triggered considerable opportunity for dynamic switching as gilts have cheapened relative to swaps, particularly at the 30-year point.

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Europe

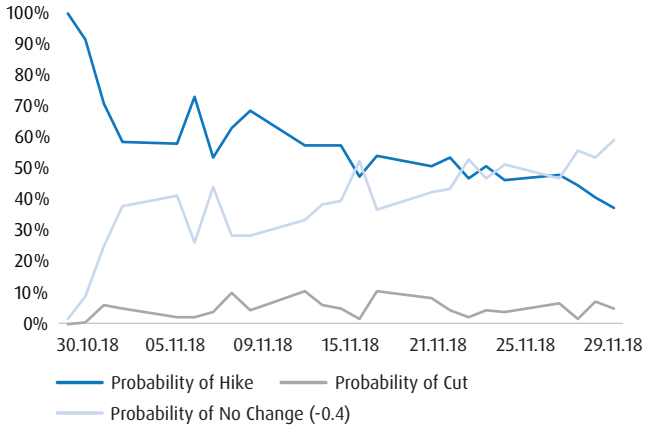
Politics and economics will dominate the headlines in 2019. One of the biggest European questions for the year will be whether the European Central Bank (ECB) will begin the process of normalising interest rates. Investors want to know if 2019 will be the year where we see the first rate-hike since Mario Draghi took over as President of the ECB. At the time of writing, there is a disconnect between what is reported in the press and bank economist opinion. Press consensus seems to be that we should expect a hike in 2019, whereas the experts in markets are less sure.

Those that believe the normalisation (rate hiking) process will begin in 2019 expect a hike in the third or fourth quarter of the year. The reasoning for this outcome is three-fold:

1) The ECB is ready to stop its asset purchase programme which has already bought c.€2.5 trillion European government bonds.
2) Growth in the block appears to be on track while inflation is ticking up towards the target of 2%.
3) The US Federal Reserve has already launched its tightening cycle and it is suspected that many central banks will follow suit.

However, those that don't believe in a rate hike this year argue the numbers don't quite stack up. The chart below shows how bank economist probabilities of a rate in Q3/Q4 2019 has changed since the start of November 2018.

Probability of interest rates changing in Q3/Q4 2019



Source: Bloomberg, 12-Dec-2018.

While September 2018 staff projections for core CPI suggest inflation will accelerate from 1.1% to 1.8%, the reality is that growth in Europe (and globally) is likely to slow. Low inflation expectations have been a pretty constant feature of the investment landscape for the last few years (around 1%).

Moreover, 2019 is an election year at the ECB. Three members of the Executive Board (the group that decide if it is appropriate to hike rates or not) will have to be replaced:

1) Peter Praet (May 2019) (also serves as Chief Economist)
2) Mario Draghi (October 2019) (President of the ECB)
3) Benoît Cœuré (December 2019)

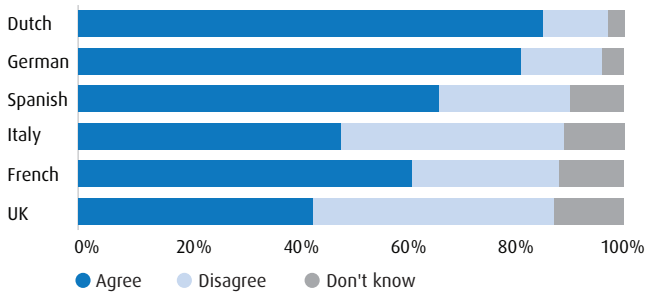
As outgoing President, Mario Draghi will decide if he wants to initiate the hiking cycle to signal the beginning of normalisation. Leaving it to his successor introduces a level of risk as investors may require convincing if the President has new or innovative ideas. However, Draghi may also choose to wait and let the new Executive board members make their own decision.

Away from the ECB, the Italian problem (while taken off the boil) continues to simmer. In Q3 2018 the Italian government submitted its draft budget proposals to the EU. The EU rejected the proposal as it increased the Italian budget deficit. In response, the Italian government initially refused to adjust the budget, which would bring it within EU rules, but have since agreed to make the changes required.

It is likely that 'bending-the-knee' and submitting to the EU's requirements has enhanced the discord between the EU's political and economic objectives and Italian independence. This is particularly significant as there may be government elections this year. European parliamentary elections held in May 2019 are likely to be a good barometer for outcomes as populist, anti-European parties are expected to poll well.

In the event of an Italian election it is possible that some political parties will include in their election campaigns a promise of delivering a referendum on Italian membership of the EU – already dubbed '*Italexi*'. While widely discussed, an Italian exit is considered an extreme outcome and those fighting in the election may not wish to select such a divisive issue as a centrepiece for their election campaign. It's worth being aware that the Italians are not overly infatuated with the EU, so a referendum would certainly be an unpredictable event.

Our country could better face the future inside the EU?



Source: Eurobarometer, Mar-2018 data, NatWest Markets.

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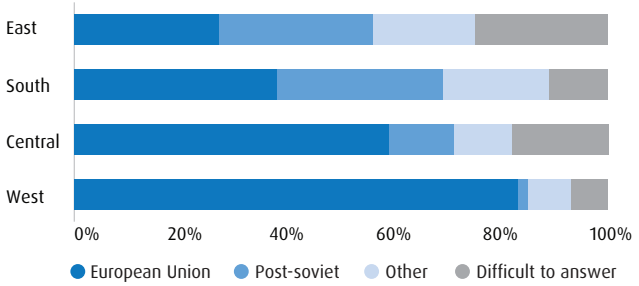
In addition to the potential for a disruptive general election, there is risk of a sell-off in Italian government debt. Depending on the rating system used, Italy is only one or two notches above a 'junk' credit rating. S&P have already adjusted the Italian outlook to negative and it is entirely possible that both Fitch and Moody's follow. If credit ratings were to dip just one notch (Moody's) there could be considerable downward price pressure on Italian bonds as investment managers are mandated to only hold investment grade credit in government bond portfolios.

In the European periphery, Ukrainian/Russian tensions continue to build as the naval incident in the Kerch Straight pushed the Ukrainian government to implementing martial law across the Ukrainian/Russia border regions. 2019 is likely to be a particularly volatile year as elections will decide the direction of the country. It is known that the east of Ukraine feels a stronger allegiance to Russia and the post-soviet countries, whereas the west feels more strongly that the west and NATO would be best placed to further enhance their nation's economic prospects.

With who should Ukraine enter into a trade deal?



Source: IRI, May-2017.

In the presidential race, the current front runner is Yulia Tymoshenko. She is known as former Prime Minister and driving force behind the 2004 'Orange Revolution', a movement which sought to eliminate corruption in the electoral system.

Further escalation of this conflict might have an impact closer to home. Ukraine is one of the world's largest crop producers, as shown below.

Probability of Recession

	Million tonnes	Position in the world
Corn	39	6
Wheat	27	7
Sunflower	11	1
Sugar beet	11	7
Barley	10	7
Soya	4	8
Rapeseed	2.2	9

Source: UN FAOSTAT, worldatlas.com (2015/2016 data).

If there was disruption to the Ukrainian agricultural production process, it would contribution to rising prices in the basket of good used to measure RPI and CPI, causing an increase in inflation. This, in turn, would increase the value of inflation linked pension scheme liabilities. Additionally, further inflammation of the situation by Russia is likely to lead to international sanctions. Sanctions on Russia would likely limit their ability to export oil. The decrease in global supply resulting from sanctions would push up prices further, adding to the inflation risk.

United States and China

Economically, the United States performed very well in 2018 and while we expect growth in 2019, we do expect it to taper a little. We expect tapering because US GDP growth in 2018 was heavily aided by the Trump administration's work to reduce the regulatory burden on American businesses.

One of the key US themes for 2019 is inflation driven by wage growth. NatWest Markets published their expectations of around 4%+ for the year. However, as they point out, this may not necessarily feed through as strongly into the overall inflation picture as the 4% may well be largely offset by improvements in productivity (reduced regulatory burden on American business has encouraged spending). If inflation remains relatively stable and within the c.2% target, and there are no more supply side policy boost policies from the White House, then there is no reason to expect the US Federal Open Market Committee to engage in any significant tightening, as this would put growth at risk.

Everything above assumes that the status quo is maintained. Trade wars between China and the United States could change the picture. President Trump has already threatened to increase tariffs in early 2019, although these plans appear to have been put on ice following talks with China. However, it is unknown if the Chinese and the Americans will be able to come to a mutual agreement that satisfies both countries. If heightened tariffs were to be imposed, then they would have a significant impact on the cost of goods for American and Chinese consumers, meaning an uptick in global inflation.

Some market commentators also point out that the US yield curve is very close to being indicative of recession. When long-term rates are below short-term rates – (for the last 60 years), a recession has followed.

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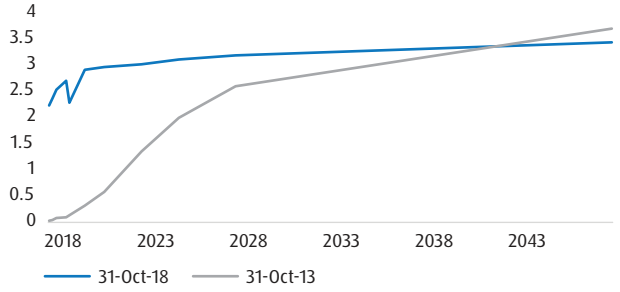
US Treasury yield curve



Source: Bloomberg 12-Dec-2018.

That said, longer-dated US government bonds have been subject to federal asset purchase programmes which will have had an impact on longer dated yields.

Issues remain in the Chinese economy as the corporate and personal debt mountain grows. In Q3 2018, local corporate borrowers (mostly privately owned) defaulted on a record $6.6bn of loans while 58 businesses accepted government bailouts (Bloomberg). A key reason for these defaults is that the Chinese government made a commitment to try and control the 'shadow banking' industry. While this makes sources of funding more transparent, it does mean availability of cash for corporates is reduced, and those companies that are unable to access state banks may continue to struggle to remain solvent.

In summary, it doesn't matter where you are, it's likely that politics and economics will walk hand in hand throughout 2019. The events described above are likely to introduce volatility, and therefore drive change in scheme funding ratios and liability values. What remains unclear, is the potential size of market reactions to these changes, it seems that markets are pricing the middle ground, which is the only impossible outcome. In this case, it makes sense that your hedge is high enough to ensure your funding level is secured and your LDI solution is able to exploit any changes in relative value between gilts and swaps.

Development in investment solutions

We think there we will be two key investment themes in 2019, both of which certainly began to make headway in 2018:

1) A continuation of 'end-game' discussions for DB schemes that are on their way to 100% funded.
2) How Environmental, Social and Governance (ESG) factors should be integrated into pension scheme investment decision making.

We have already published a lengthy white paper and thought pieces describing our optimum 'end-game' solution. In this outlook we will discuss the integration of ESG factors in client portfolios.

Integration of 'ESG' issues in investment solutions

In 2018, the policies of pension schemes surrounding ESG considerations were thrust into the spotlight. New regulations published by the Department for Work and Pensions (DWP) will require schemes with more than 100 members to state their policy on taking account of 'financially material' considerations. Those considerations make specific reference to ESG factors such as climate change. As a result, we expect there to be a considerable focus on the integration and reporting of ESG practices in investment solutions.

ESG can and should be imbedded in the day to day management of investment portfolios in two key areas. The first is through **integration with the investment process** whereby ESG factors are formally built into the research process to support investment decision making. This will often seek to score or quantify the current ESG credentials of a company as well as identify whether these are on an improving or deteriorating trend. Such an approach helps not only to identify robust well managed companies, but also to avoid investments where significant ESG related risks exist.

The second is through **direct engagement** with companies and through the exercise of voting rights. This work helps to improve both the financial prospects of the companies we invest in (or lend to), as well as helping to minimise downside risk. Engagement work is often prioritised towards companies with higher ESG risk scores and targets specific themes identified by our ESG specialists.

For schemes wishing to go one step further there are then a **wide range of specialist ESG investment strategies available.** These will often apply an initial screen to the investable universe based on factors such as ethical criteria, ESG standards and sustainability themes. They may then apply a positive investment selection process which targets assets with superior ESG characteristics.

ESG scoring and engagement are imbedded in our corporate bond investment process and so where clients combine LDI and traditional credit (e.g. our Credit Matching LDI strategy) they can take comfort from the fact that ESG issues are already taken fully into account. We also offer a green bond strategy which can sit alongside an LDI mandate for those clients looking for something more specialist. Where clients wish to combine synthetic equity exposure with LDI this equity exposure can incorporate ESG factors in a number of ways. Firstly, passive exposure can be created to a range of ESG indices using total return swaps. The index can be selected to reflect a broad range of ESG criteria or a more targeted set of criteria, as required. For clients who prefer active equity management we are able to replicate our Responsible Global Equity strategy via a total return swap.

Continued

BMO Global Asset Management is a market leader in Responsible Investment with over 30 years' experience. We believe that prudent management of ESG issues has a positive impact on the creation of long-term investor value. In recognition of this, our team of 13 responsible investment specialists were delighted to receive Investment Week's 'Best ESG Research Team' award in 2018, alongside multiple awards in 2016 and 2017.

Summary

If you would like to understand how we can improve your LDI solution, help implement your end-game journey or deepen your understanding of ESG factors and their implications, please do not hesitate to get in contact with us.

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LDI Manager of the Year 2018

Risk Management Provider of the Year 2018, 2017 and 2015

UK LDI Manager of the Year 2018 and 2017

LDI Provider of the Year 2017, 2016, 2015, 2014, 2013 and 2012

UK LDI Manager of the Year 2016

LDI Manager of the Year 2013, 2012 and 2011

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