The Insurance perspective

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Economic Commentary

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Ready, Set, Rally! The second quarter of 2019 was a mix of emotions driven by panic of economic conditions and excitement from Chairman Powell's comments. In April, the equity market hit all-time highs before the bears showed up in May to evoke fear and cause a rush to treasuries. Despite global concerns around tariffs & growth, the market reached all-time highs in June. The quarter contained multiple about-faces in market sentiment.

US Stock Market-

Record highs were set in April due to companies reporting above average earnings for the quarter. Equities then fell in May due to escalating trade war tensions with China and reports that all talks of a trade deal with China had ceased. Additional fears in May included a bearish triple top technical pattern developing in the S&P 500 chart and the threat of tariffs being placed on Mexico, which would have disrupted global supply chains. The dip stopped in June with the FOMC apparently "saving the day" by announcing that it would no longer be "patient" to move on a rate cut, but would "closely monitor" economic conditions to decide on when to cut interest rates. The FOMC has not yet promised a rate cut, however, the equity market is strongly expecting a 25-basis-point cut at the July FOMC meeting. A rate cut would imply that the economy is headed in an overall worse direction than last year when rate hikes were on the table. Rate cuts have been notoriously deployed before major pull backs in the market, as they are usually reactive measures to try and patch an already slowing economy. If the FOMC cuts rates in July, we will likely see the S&P 500 reach new highs once again due to market optimism and cheaper financing. This new high could be followed by a slight correction if China trade issues and indications of a slowing economy are still present. Besides the comments from the FOMC, another rationale for the rebound in equity in June could be as simple as a rebalancing act in asset allocation. As yields declined across the curve in May, portfolios would have seen a rise in value of their fixed income holdings coupled with a decline in their equity holdings. The rebalance would have sent an influx of cash back into the equity market after May, creating the rebound in June.

FOMC-

This year has been a total about-face for the FOMC as Chairman Powell and his group have reversed from expecting 4 rate hikes at the beginning of the year to a possible rate cut in July. His lack of use of the word "patient" in the June meeting was viewed as the saving grace by the equity market, as it appears that the hope of a rate cut spurred the rebound in June. Based on the interest rates predicted by the futures, options, and OIS markets, the market has predicted a 100% chance of a rate cut in July with an approximate 20% chance of as much as a 50-bps cut. As President Trump and the futures market try to push the FOMC to cut rates based on fear of slowing economic growth and a below target inflation rate, it appears that Chairman Powell and the Committee will avoid outside pressure and look solely at economic data to make their decisions. Though some economic data appeared bleak, rates were left untouched in June off reports of strong May retail sales and a slight increase in factory output in May. Chairman Powell's rate decisions in July will need to take into account the slowing home sales, slowing job growth, tariffs that are impacting long established supply chains and trade networks, increasing geopolitical issues and the effects of allowing more easily accessible debt to corporations that are already highly levered. As Chairman Powell becomes the easy scapegoat for all economic issues, it is important to remember that a rate cut is not always the secret formula to fix the economy and a rate hike is not the root cause of a slowing economy.

US Bond Market-

Cleverly coined in our last volume, the "Nike Swoosh" of the yield curve is continuing and getting swooshier? More swoosh like? However you describe it, the yields derived from the 1-year to 30-year treasury continue to fall with the 1 to 6 month treasury yields higher than the 1 to 10 year treasury yields. This is partly due to the fear and sell off of equity in May. This selloff caused a rush of cash into the bond market driving demand and prices higher, and consequently pushing yields lower. The dip in yield that occurred in May caused the 1-year treasury to invert over the 10-year treasury. Though the 10-year treasury was able to regain its position over the 1-year treasury (not by increasing but by falling at a slower pace than the 1-year) the general inversion of the yield curve has persisted for a full quarter which has traditionally been used as an indicator for a recession. An increased concern in this low yield environment is that investors have been more willing to place money into riskier assets for the sake of yield, however, the compensation for this risk is continuing to decline. With interest rates closer to zero and some institutional investors (mainly pension funds & endowments) required to generate a specified minimum yield, investors have employed heavy risk-taking behavior to compensate for falling yield. To put this into perspective, the 10-year treasury dropped by 16.63% (40-bps) in the quarter. The run to high-yield/high-risk assets of some firms coupled with the already highly leveraged nature of corporations creates amplified hazards for investing in this bond market.

Summary-

As July approaches, all eyes will be on Chairman Powell and his team to see what actions they implement. However, it seems like this meeting in July may be a double-edged sword. If they choose not to cut rates due to a stable/positive outlook on the economy, the market could throw a childlike tantrum selling off equities and scurrying into the bond market. If they cut rates due to a negative outlook, we could see the equity market inflate from unmerited positivity on the state of the economy and an extension of easier credit in a market that is already highly leveraged. In the latter scenario if the indicators that warranted the rate cut do not improve, there could be a harsh backlash when everything slows. Though the future of the economy can seem ominous at times with many indicators flashing red and foreboding headlines surfacing every week, we at Parkway are implementing proactive measures to protect each customized portfolio while still delivering valuable yields and safety for our clients. To learn more about how Parkway can help guide you through the complexities of insurance investing in every economic environment, visit: https://www.parkwayadvisors.com/.

Insurance Specific Investment Policy Statements

The Investment Policy Statement, also known as an IPS or more simply an investment plan, is arguably one of the most important documents as it dictates the strategy deployed by the investment manager. A strong investment plan outlines the risk and return objectives of the portfolio along with constraints and unique circumstances to be considered in the investment process. When it comes to creating an investment plan, what is appropriate for an insurer is vastly different than other financial institutions given the majority of assets are backing liabilities generated by products sold. This means most of the assets are essentially property of the policy holder. Although investment plans can vary substantially given the size and complexity of the specific investment portfolio, we will discuss a couple objectives that are important for all insurance companies.

Specific topics that should be considered in the investment plan relate to risk mitigation strategies within the portfolio. Specifically, for life companies, an Asset Liability Matching (ALM) strategy directs the investment manager to structure the portfolio around the projected liabilities of the company. An appropriate ALM strategy can reduce interest rate risk in various interest rate scenarios. For a P&C insurer, care should be given to creating a well-defined ladder that generates consistent income through interest and principal which can provide for claims as they occur. With any type of insurer, if the securities purchased are long the assets (their maturities are longer than the duration of liabilities) the insurance company can realize losses caused by rising interest rates if assets have to be sold prematurely to cover claims. On the contrary, in a falling rate environment, insurance companies whose invested assets are short their liabilities will experience book yield and subsequent net investment income decline as assets mature and are reinvested at lower rates while the higher yielding liabilities remain on the books. The IPS should outline the strategy that the investment manager uses to align investments to the products sold.

Another risk reduction tool that should be included relates to diversification. Under modern portfolio theory, a diversified portfolio can be created with as little as 20 securities, which limits exposure to a single name to 5% of assets. As mentioned previously, the majority of investments are backing policy holder claims and are therefore not truly "assets" of the insurance company. Thus, we believe an appropriate investment plan should reference diversification requirements as a percentage of surplus, which generally substantially reduces the amount invested in any single name and subsequently reduces the impact a credit concern can have to the portfolio. Limits on exposure should also take into account the rating or credit quality of the investment. Lower quality investments should have a smaller allocation allowed on a per name basis compared to higher rated securities. Inadequate diversification within a portfolio can have immediate detrimental effects to surplus. Not only should the plan limit exposure to specific companies, but it should also take into consideration limits on sectors and industries as a whole while also including a limit on the total allocation to lower rated securities.

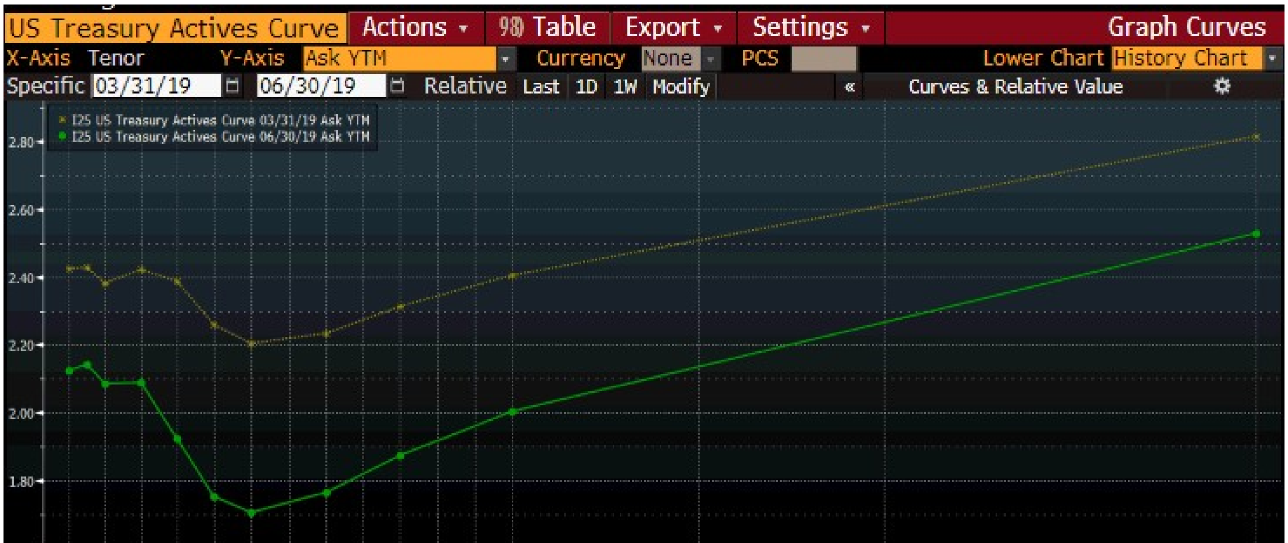
Additional considerations for an insurance company's IPS should include an Other Than Temporary Impairment Policy (OTTI) which proactively outlines the treatment of credit concerns should they ever occur. It is also prudent to reference the appropriate applicable NAIC and state laws or regulation. Finally, the plan should be reviewed for updates and approved annually by the board and/or the investment committee.

Interest Rate Spreads

As of: 6/28/2019

Term	Treasury Yield	US Composite BVAL AA Curve Yield	US Composite BVAL AA Curve Spread	US Composite BVAL A Curve Yield	US Composite BVAL A Curve Spread	US Composite BVAL BBB Curve Yield	US Composite BVAL BBB Curve Spread	US Composite BVAL BB Curve Yield	US Composite BVAL BB Curve Spread
1yr	1.92	2.151	0.231	2.291	0.371	2.536	0.616	3.331	1.411
2yr	1.75	2.091	0.341	2.261	0.511	2.552	0.802	3.668	1.918
3yr	1.71	2.089	0.379	2.262	0.552	2.585	0.875	3.879	2.169
5yr	1.76	2.231	0.471	2.42	0.66	2.818	1.058	4.336	2.576
7yr	1.87	2.426	0.556	2.639	0.769	3.122	1.252	4.788	2.918
10yr	2	2.678	0.678	2.929	0.929	3.479	1.479	5.222	3.222
20yr	2.31	3.351	1.041	3.662	1.352	4.326	2.016	6.068	3.758
30yr	2.52	3.468	0.948	3.639	1.119	4.2	1.68	6.184	3.664

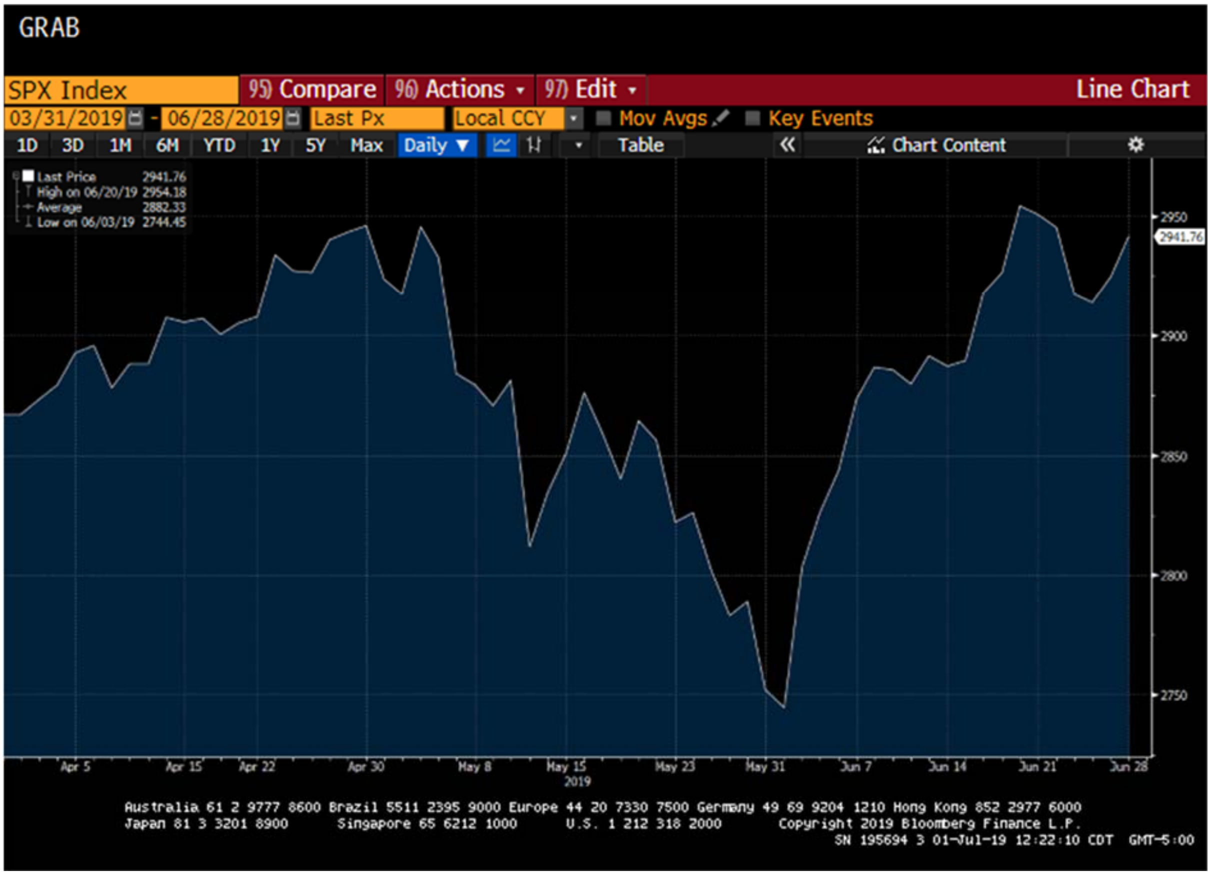
US Treasury Yield Curve



	Tenor	06/28/19	03/29/19	06/28/19-03/29/19
11)	1M	2.126	2.424	-29.8
12)	2M	2.142	2.429	-28.7
13)	3M	2.087	2.381	-29.4
14)	6M	2.090	2.422	-33.3
15)	1Y	1.925	2.387	-46.2
16)	2Y	1.755	2.260	-50.5
17)	3Y	1.706	2.205	-49.8
18)	5Y	1.766	2.233	-46.7
19)	7Y	1.875	2.313	-43.8
20)	10Y	2.005	2.405	-40.0
21)	30Y	2.529	2.814	-28.5

*Graphs obtained from Bloomberg Professional Service

S&P 500 Index


GRAB
SPX Index
95) Compare
96) Actions
97) Edit
Line Chart
03/31/2019 - 06/28/2019
Last Px
Local CCY
Mov Avgs
Key Events
1D 3D 1M 6M YTD 1Y 5Y Max Daily
Table
Chart Content
Last Price 2941.76
High on 06/20/19 2954.18
Average 2882.33
Low on 06/03/19 2744.45
2950
2941.76
2900
2850
2800
2750
Apr 5 Apr 15 Apr 22 Apr 30 May 8 May 15 May 23 May 31 Jun 7 Jun 14 Jun 21 Jun 28
2019
Australia 61 2 9777 8600 Brazil 5511 2395 9000 Europe 44 20 7330 7500 Germany 49 69 9204 1210 Hong Kong 852 2977 6000
Japan 81 3 3201 8900 Singapore 65 6212 1000 U.S. 1 212 318 2000 Copyright 2019 Bloomberg Finance L.P.
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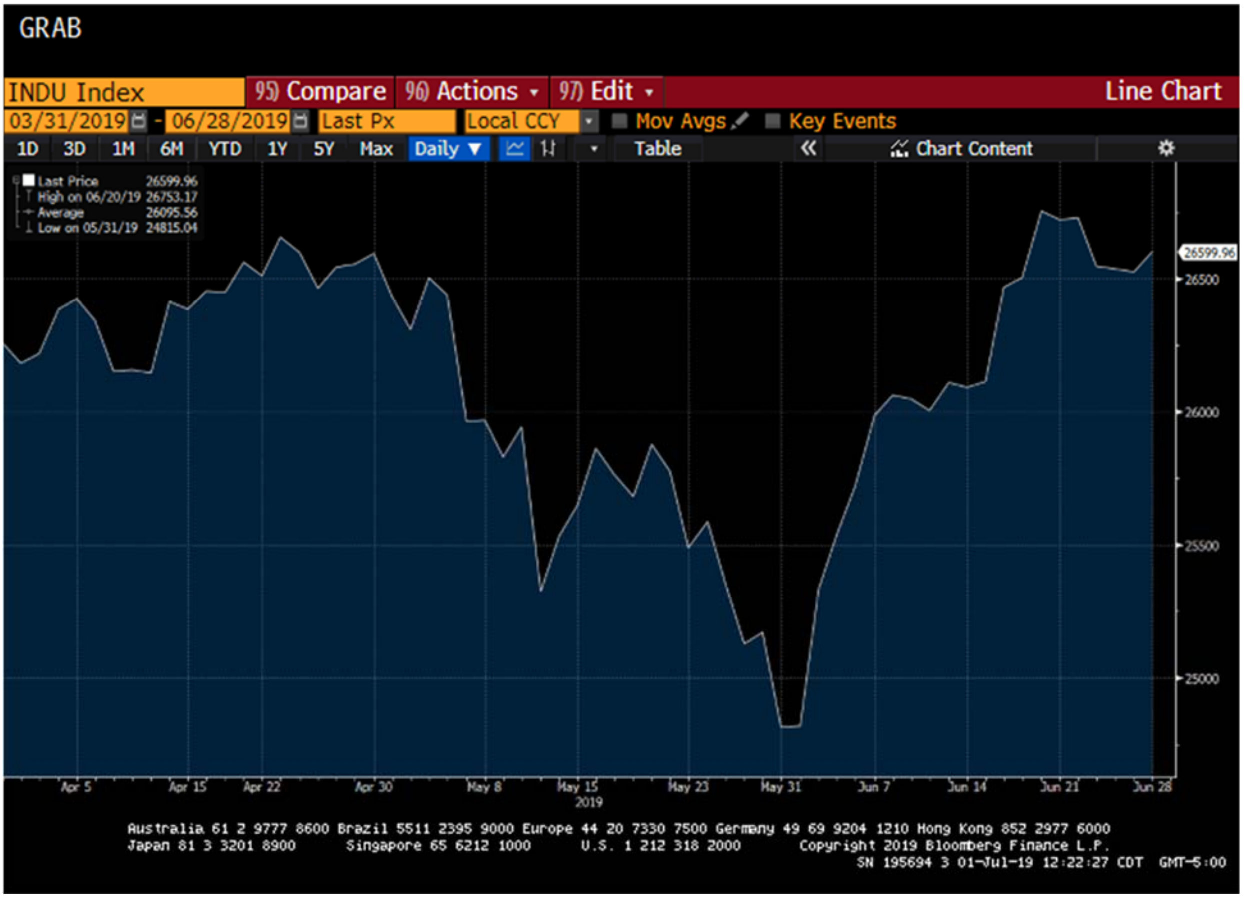
Dow Jones Industrial Average



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About this Publication

The Insurance Perspective is a quarterly publication prepared by the staff of Parkway Advisors, L.P. Each issue focuses on the U.S. economy and specific insurance industry issues and/or concepts. Our clients and prospective clients enjoy Parkway's dedication and unique focus on the insurance industry.

For More Information

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