The Insurance perspective

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PARKWAYADVISORS

6550 Directors Parkway Abilene, TX 79606 800.692.5123

www.parkwayadvisors.com/

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Economic Commentary

Trevor R. Rupe,
Portfolio Manager

The first quarter was one for the record books. After a decade long bull run with some of the best returns in history coupled with both elevated valuations and emotions, the market was at risk for a selloff. However, the trigger that set off the historic decline wasn't a trade war, disaccord over monetary policy, or even the various recession indicators flashing concern ahead. Instead it was a virus originating in the now infamous Wuhan China that would wreak havoc across the markets, derail long standing plans and change almost every aspect of life as we knew it.

US Bond Market – If investing in fixed income has taught you anything, it should be that you shouldn't bet on what you think rates will do. After decades of falling rates, with the 10-year hitting a historic low back in July 2016 of 1.35%, the bottom was "in" and rates were now finally moving upwards. This was true for the next couple of years before rates starting falling again through most of 2019. The 10 year began 2020 at 1.88% before extreme volatility led investors to pile into the US Treasury "safe haven," driving the 10 year yield all the way to an intraday low of .33% on March 9, marking over a 100-basis point reduction from its previous all-time low. Demand for Treasuries became so great, issues with maturities inside 6 months were trading at negative yields. Liquidity became sparse and trading sporadic, with bids on bonds coming at very weak levels and offers being pulled as the market struggled to digest information from the Fed, virus updates, with many of its constituents working remotely on laptops from home. Given the extreme concern and volatility, spreads momentarily widened to over 400 basis points on investment grade corporate bonds, allowing those brave enough to stomach putting money to work at some of the best yields seen in years, although intervention from the Fed caused this to be a short-lived opportunity.

FOMC – Amid weak economic data, the Fed had previously cut rates 3 times in 2019, leaving the Fed Funds rate at 1.75% heading into 2020. Given the substantial risks to the economy from the virus, the Fed made two emergency cuts during March bringing the rate to zero, a move open to criticism as they have now used the majority of their ammunition to combat further issues down the road. Additionally, the Fed has introduced various short-term lending programs, but most notably began purchasing securities in the open market in an effort to inject liquidity into the financial system, a program known as Quantitative Easing, which was first implemented back in 2008. Beginning in 2018, the Fed began reducing their balance sheet by forgoing reinvestment of securities that were maturing, bringing the balance sheet down to $3.75 trillion in the final quarter of 2019. The balance sheet now stands at a record $5.25 trillion, which translates to around 25% of the U.S. economic output before the coronavirus. Despite the dramatic increase in the balance sheet, an ever-increasing U.S. deficit fueled by stimulus programs, the Fed had indicated they will continue to do whatever is necessary to ensure liquidity remains in the system and rates will stay low to encourage economic development.

US Stock Market – Outside of the coronavirus, the other topic demanding headline attention was how terrible the stock market faired during all these impacts. So terrible, it recorded the worst first quarter in history, with the S&P wrapping up the quarter right at a 20% loss. Additionally, this was the fastest 30% drop in history, with the S&P 500 only needing 22 trading days to fall deep into bear market territory, at one-point trading almost 34% off its February high. Industries hit the hardest include airlines, cruise lines and any company with a retail focus. Additionally, the energy sector has seen substantial pain. While demand for oil fell from the virus, an ill-timed disagreement between Saudi Arabia and Russia led to each country ramping up production effectively flooding the market with oil in an attempt to gain market share. This led to a nearly 70% decline in the price of oil, pressuring companies still struggling from the 2016 oil rout. Oil concluded the quarter at $20.10, posting the worst quarter on record and lowest price in almost 20 years.

Summary – The consumer has been the saving grace to the economy over the past year. The longer the consumer remains out of the picture, the higher the likelihood the virus leads to a full-blown recession. At this point, the Fed has intervened and provided necessary liquidity, a stimulus package has been approved providing government support, yet only time will tell how long the virus will continue to impact the economy. While some of the extreme volatility has subsided over the past couple of weeks and equities have recovered from their lows, I anticipate further volatility until the major question marks surrounding the virus have been answered, namely "When will this end?" A longer than anticipated recovery will lead to additional pain with equities retesting lows, declining Treasury yields and increasing spreads in corporate bonds as risk increases for companies struggling to make money absent the consumer. If we see the number of new cases start to decline and commerce resume with consumers eager to spend their stimulus checks soon, I do anticipate a strong recovery. Albeit that is until the next uncertain risk emerges: the 2020 election.

COVID-19: Market Effects of Coronavirus

We are indeed in a time of turbulence in the market and unchartered territory for our nation. We recommend keeping a close eye on the impacts to your portfolio. In an effort to get you started on measuring the impacts, we have put together a list of what we characterize as the larger threats to the market, particularly within corporate bonds. This provides details on the corporate sectors most adversely affected by the coronavirus, broken into tiers according to their overall severity. Please note this is not meant to be a list of sectors where all companies will default or file for bankruptcy, but our view of the most adversely impacted sectors as a result of these tumultuous times.

The largest level of impacts, which we will label “Tier 1,” are the industries that have been directly affected by the recent shocks to the largest degree and that maintain a high level of risk of longer lasting effects. Next are the “Tier 2” impacts, which consists of industries that will face near term obstacles due to the recent market tremors and policies, but should return to normal fairly quickly as volatility subsides. Finally, “Tier 3” sectors are those that could become affected if the current impacts take a substantial amount of time to be resolved.

Within Tier 1, we include the following segments: airlines, aerospace, gaming, lodging & leisure, energy, oil & gas. With travel being limited/banned across the US, the airlines will see a sudden sharp decline in demand. This will lead to airlines slowing new purchases and further adding stress to aircraft suppliers (such as Boeing & Airbus). Gaming, lodging and leisure companies, locations that thrive off high foot traffic and tourism (such as casinos, cruise lines, vacation resorts, restaurants, etc.), are directly impacted by social distancing efforts and will see impacts to profit in the short term. Moreover, some shelter in place efforts have been instituted in cities and counties, mandating certain companies in these segments to be closed. However, when things clear up these industries should be able to make strong comebacks. A substantial decline in oil occurred, marking a 70% decline in per barrel price, as a result of decreased demand along with an OPEC price war. Upstream oil & gas companies are at risk due to the even lower profitability expectations, which will lead to a scale back of projects and damage oilfield service providers’ revenues as projects are cut. Pipeline transportation companies are at less risk to price volatility compared to exploration and production but are still included within Tier 1 due to industry-wide impacts.

Tier 2 segments include retail, automotive, car rental and metals/mining/chemical companies. The quarantine will have mixed effects on retail. While initial demand may surge at pharmacies and grocery stores, increased quarantine measures may limit demand and online delivery options may be more fully utilized. Additionally, leisure shopping will likely see a drop in performance as people social distance and cut out non-essential interaction. The automotive industry is already facing lower demand and could continue to see demand slow due to quarantine impacts. Inventories are likely to accumulate with fewer buyers and increases in unemployment could affect financing for vehicle purchases. Additionally, slow demand will result in less revenue for parts makers. Industrial vehicles could see changes either way, as more online deliveries could keep stable growth; however, if supply chains become affected, less capacity may run through the industrial vehicles reducing demand. With travel and tourism stopped for the time being, car rental locations, especially those based out of airports, will see a dramatic decline in demand. Petrochemical companies will be directly affected by lower oil prices and declines in manufacturing activity will lead to less demand of chemicals. Some commodity prices have begun to trend lower which will lower revenues for mining companies.

The longer the virus lasts, the higher the likelihood of entering a recession. As such, every industry will be adversely affected but ones that stand out in our Tier 3 impacts include companies in the technology, real estate services, banking and manufacturing segments. International supply chains within the technology sector may slow as countries face the pandemic together and international demand for products decreases. Recession fears could slow the purchase of homes and a healthy workforce may be difficult to assemble and make it more costly to complete projects. However, with mortgage rates moving lower, there is still potential for demand to remain stable. The main impacts in the banking sector will come from lower interest rates that will decrease top-line revenues. Quarantine impacts could cause companies to release employees or reduce hours and lead to more non-performing loans if these individuals do not receive some form of assistance. However, most banks hold diverse positions across industries to limit the impact of credit issues from any one sector. The manufacturing industry has already faced operational struggles as competition is high and companies are pushed to find ways to lower prices and remain competitive. However, if overall GDP falls and demand for products takes a hit, manufacturing firms could see hits to their bottom line.

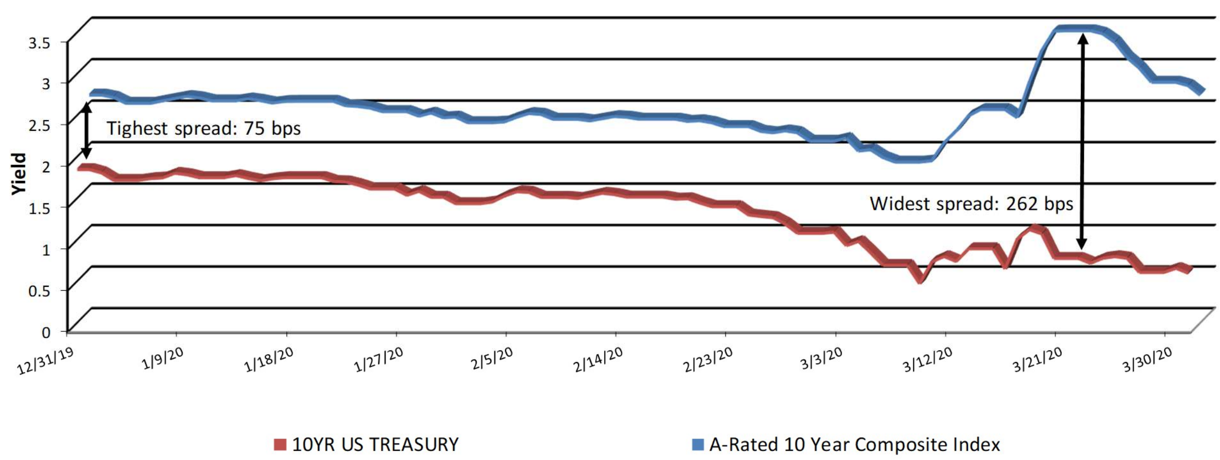
These are the segments within the corporate landscape that pose some level of concern. We believe a recession is impending and the severity of the resultant impacts will depend upon the duration and effect of the coronavirus. These tiers were developed by Parkway to aid in proactively isolating threats, ranked by the largest potential market impacts and respective severity. We recommend closely monitoring the market and your portfolio in particular to remain abreast of developments and potential threats. If you have any questions as to the specific impacts to your portfolio and would like Parkway's assistance, please let us know.

Interest Rate Spreads

As of: 3/31/2020

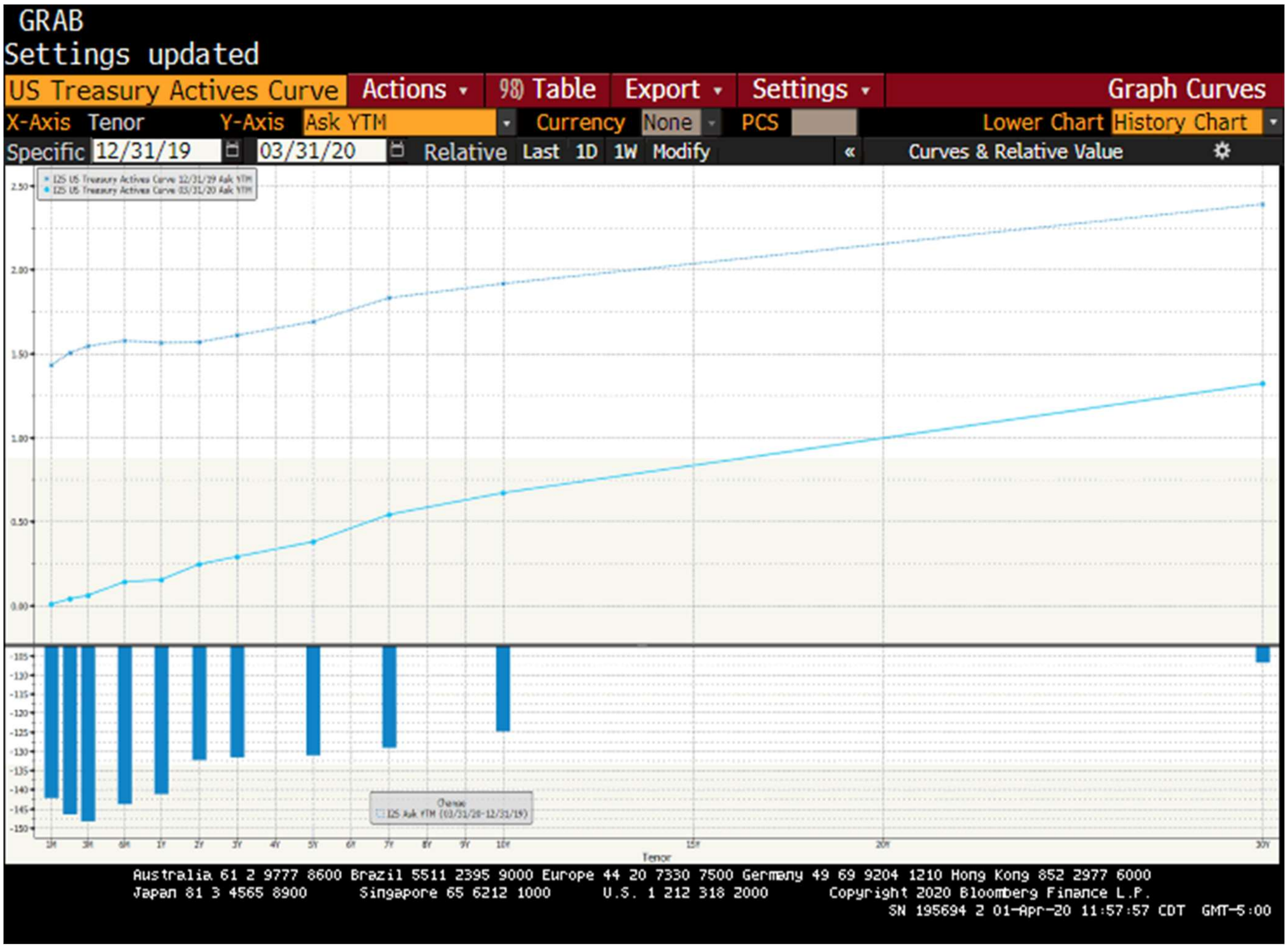
Term	Treasury Yield	US Composite BVAL AA Curve Yield	US Composite BVAL AA Curve Spread	US Composite BVAL A Curve Yield	US Composite BVAL A Curve Spread	US Composite BVAL BBB Curve Yield	US Composite BVAL BBB Curve Spread	US Composite BVAL BB Curve Yield	US Composite BVAL BB Curve Spread
1yr	0.17	1.553	1.383	1.982	1.812	2.587	2.417	6.148	5.978
2yr	0.23	1.453	1.223	1.941	1.711	2.678	2.448	6.121	5.891
3yr	0.29	1.472	1.182	1.999	1.709	2.783	2.493	6.075	5.785
5yr	0.37	1.66	1.29	2.186	1.816	3.019	2.649	6.087	5.717
7yr	0.55	1.882	1.332	2.421	1.871	3.247	2.697	6.169	5.619
10yr	0.7	2.171	1.471	2.668	1.968	3.512	2.812	6.294	5.594
20yr	1.15	2.794	1.644	3.284	2.134	4.082	2.932	6.659	5.509
30yr	1.35	2.866	1.516	3.282	1.932	3.994	2.644	6.657	5.307

10yr Yield & Spread



Average 10yr Treasury: 1.38 Average 10yr A-rated: 2.50
12/31 Spread: 75.07 bps 3/31 Spread: 199.83 bps
Average Spread: 111.8 bps

US Treasury Yield Curve



*Graphs obtained from Bloomberg Professional Service

S&P 500 Index


GRAB
SPX Index
95) Compare
96) Actions
97) Edit
Line Chart
12/31/2019 - 03/31/2020
Last Px
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Dow Jones Industrial Average

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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

We welcome your inquiry and can be reached by mail at Parkway Advisors, L.P., P.O. Box 5225, Abilene, Texas 79608 or by phone at (800) 692-5123 or by fax at (325) 795-8521. A copy of our Form ADV, Part II is available upon request.

For more information, please email info@parkwayadvisors.com or visit www.parkwayadvisors.com