The Insurance perspective

2020- Volume 16

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Economic Commentary

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"Unprecedented" may be the word that will best describe the year 2020 in the history books. From all-time equity highs to patient zero, which led to a global recession and 3-year equity lows, to a monster recovery that is again testing positive returns for 2020. No brain or algorithm could have predicted the idiosyncratic path that the economy has walked so far in 2020, and while the events that have unfolded may be unprecedented, maybe the framework in which they unfolded is all too familiar.

US Bond Market- The shorter end of the Treasury curve remained fairly flat throughout the second quarter while the 30-year Treasury exhibited some risk on behavior and rose 8.92 bps. Additionally, the US Treasury re-launched their 20-year bond program to help fund their growing deficit in a time where more funds are being used to stimulate the economy. However, the US Treasury was not the only one increasing their debt burden. Corporations issued record levels of investment grade bonds within the first half of 2020 in order to have adequate cash on hand for any unprecedented challenges that COVID-19 and additional shutdowns could bring. With consumers stuck inside and economic activity being halted, the National Bureau of Economic Research (NBER) stated that the US was in a recession during the 2nd quarter of 2020. The current recession continues to weigh on many industries and by June the number of large retailers filing for bankruptcy had surpassed the amount that filed in the first six months of 2008. Airlines, oil and gas companies and tourism related companies all still face pressure from the presence of COVID-19, as the demand for their services dried up overnight and restrictions on travel became commonplace. The companies that have survived in these spaces have done so by swift cost cutting, raising capital and hope of a swift reopening of the economy.

Although the events that led to this recession are unprecedented, the economy had been giving a familiar warning sign well before the recession. In the 2nd quarter of 2019, the yield curve inverted as it had done so before many previous recessions. Unfortunately, the inversion didn't tell us what industries to avoid, when the exact date of a recession will be, or that we will see oil futures trade in the negative dollar handle. Instead, the great track record of the yield curve inversion urges us to proceed with caution and allocate capital in a risk averse way. Just as the warning sign of the recession presents some familiarity amidst the randomness, so does the actions of the Fed and government to steer us out of a recession.

FOMC- The economy was provided loads of liquidity during the second quarter of 2020 to help stabilize falling asset prices and support the economy. This liquidity was provided through the Fed's open market operations ("unlimited quantitative easing"), stimulus checks to individuals, added unemployment benefits, and various relief programs to businesses. The Fed and US government providing these tools wasn't unprecedented as they also had a form of stimulus checks and quantitative easing during the "great recession", however, the size and speed of the stimulus in 2020 was vastly different. Quantitative easing during the financial crisis wasn't enacted until about a year after the recession had officially started, and in 2020 quantitative easing began about a month from the start of the major fall in asset prices before the recession was officially known. Additionally, during the whole quantitative easing program during the financial crisis, August 2008 to August 2014, the Fed's balance sheet increased roughly $3.5 trillion, and through the first few months of the 2020 quantitative easing program the Fed's balance sheet has increased by roughly $2.9 trillion to a total of $7 trillion with some analysts seeing the possibility of it reaching $10 trillion.

With the Fed prepared to do "whatever it takes" they made commitments to not only buy Treasuries and investment grade bonds, but to also buy non-investment grade bonds. However, their purchases of corporate bonds have been subject to scrutiny, and some have questioned the legality of the Fed being allowed to purchase corporate bonds based on interpretations of the Federal Reserve Act of 1913. Nonetheless, the actions from the Fed pressed credit spreads down and began the recovery of bond prices in even the most distressed sectors. The Fed has also indicated that rates will remain near zero until 2022, which in effect should continue to leave borrowing costs low for the foreseeable future. In times of uncertainty, the monetary tools and actions of the Fed have historically been a crutch for the economy to lean on until it can firmly stand on its own two feet again.

US Stock Market- The second quarter witnessed unemployment ramping up to levels not seen in decades, nearly every city in the nation in quarantine, large companies declaring bankruptcy and the number of new coronavirus cases increasing. Though some had predicted a rebound in the equity market, the majority underestimated the magnitude to which equity prices would recover. Common wisdom of the stock market would tell us that the equity rally should not have been as fierce as it was. Earnings multiples were trading at overvalued levels last seen during the "tech bubble" of the late 90's. Estimates showed global GDP declining around 5% in 2020. Multiple juggernaut fund managers also expressed their view that the market is "overvalued" and offered some of the worst risk to return relationships they have ever seen. Regardless of the common knowledge, however, the equity market has so far had an "unprecedented" rally with the S&P 500 increasing ~19.95% for its best quarter since 1998. The rally appeared to be fueled by positive reopening surprises and hope of a "V" shaped recovery.

Many economic estimates were either too pessimistic or not optimistic enough which assisted the real data in posting a positive economic surprise. When the actual data was revealed it proved that unemployment wasn't as bad as it could have been and that manufacturing, or the housing market, or retail recovered more than expected. To illustrate, on May 5th, 2020 when employment reports showed 20.2 million people lost their jobs in April compared to the 20.5 million expected, the S&P rose ~0.9% and on June 5th, 2020 it was reported that the unemployment rate in May was 13.3% compared to the estimated 19%, the positive surprise led to a ~2.6% rally in the S&P 500. While economic data is showing a rebound is in progress, it doesn't necessarily show the jolt of new life that would give equity markets the all clear signal that the market has recovered. However, the precedence we grasp towards is that the market is extremely forward looking. From each previous drop in equity prices, when the economy has seemed to be in a desolate place, the market has somehow managed to rise with the chance of a future recovery even if one doesn't seem logical yet.

Summary- Is the worst over for the COVID-19 induced recession? All we know for certain is that the next bull market will be unlike any of those that came before and will contain nuances that only exist within its bounds. The past will continue to be an imperfect guide for the future, but by understanding the broad scope of precedented events we have a template for future actions. While the number of COVID-19 cases begin a resurgence, bankruptcies increase and the number of people filing for unemployment remains high, the third quarter and rest of 2020 may still see the worst to come from this unprecedented event. However, former precedence elicits confidence of a few things, our ability to overcome the virus and the high likelihood of a market recovery. I expect that with the Fed continuing to support asset prices and provide liquidity, yields on shorter term treasuries will likely stay low throughout the third quarter. Yields on the ten-year and thirty-year treasury will see upward momentum as the resilience of the equity market elicits risk on behavior. Finally, with the low expectations on 2nd quarter performance, I anticipate the earnings reports that come in July to contain positive surprises on recovery efforts and that some guidance may be provided that will add fuel to the equity market rally.

Statutory Reporting Updates

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Due to the COVID pandemic, the NAIC had to cancel its 2020 Spring National Meeting. Instead, through a series of conference calls, the NAIC has made many changes to statutory accounting and reporting. One key item to note is the adoption of 2020-17BWG. This adoption adjusts the asset valuation presentation to include separate lines for each of the expanded bond designation categories. The Blanks Working Group and the SVO adopted 20 bond designations for the 2020 reporting that will flow into the RBC but will not include factors. An impact analysis will need to be done to confirm factors for the new expanded categories. For 2020 reporting, the current factors for designations 1-6 will remain in the RBC. This proposal applies the same expanded presentation to the AVR as it is used to populate the RBC formula.

The new designations are shown below. You can view agenda item 2020-17BWG in its entirety at https://content.naic.org/cmte_e_app_blanks_related_adopted_mods.htm

NAIC Designation	NAIC Designation Modifier	NAIC Designation Category
1	A	1A
	B	1B
	C	1C
	D	1D
	E	1E
	F	1F
	G	1G
2	A	2A
	B	2B
	C	2C
3	A	3A
	B	3B
	C	3C
4	A	4A
	B	4B
	C	4C
5	A	5A
	B	5B
	C	5C
6		6

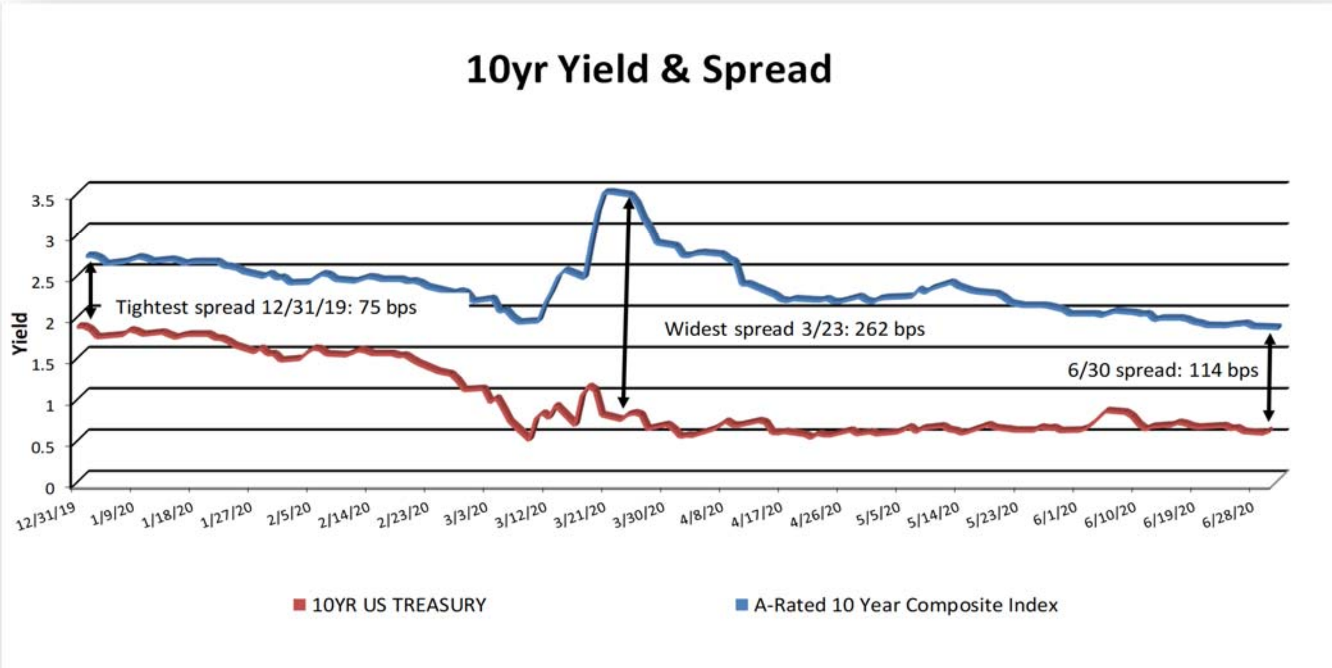
Another key change to note is INT20-05T. This is a temporary interpretation that will be reevaluated in August of 2020. If it is not extended, it will automatically expire on September 29, 2020. This item states that, due to the COVID pandemic, no evaluation on collectability would be needed for quarter one and quarter two financial statements for bank loans, mortgage loans, and investment products with underlying mortgage loans that were current as of December 31, 2019 and for which no other events (for example, bankruptcy) had occurred. This allows accrued investment income that is deemed collectible to be admitted even though it may be over 90 days past due in quarter 2 of 2020. If there has been a forbearance or other modification, carriers need to assess whether the investment income has been earned in accordance with the modified terms. This exception does not encompass mortgage loans in default. Mortgage loans in default shall continue to follow SSAP 34 guidance. For a more in-depth discussion on this temporary interpretation please refer to the below link.

The information for this Interpretation will be under the related documents tab. https://content.naic.org/cmte_e_app_sapwg.htm

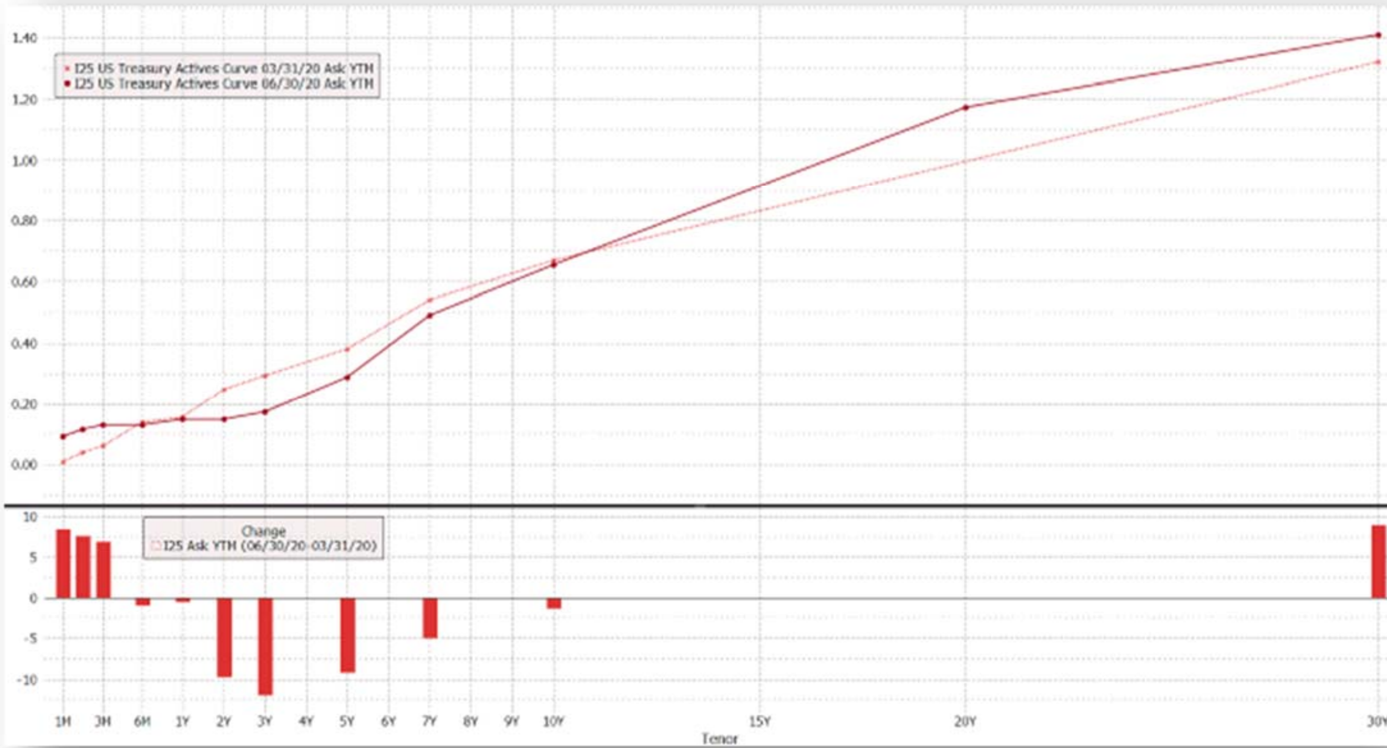
Interest Rate Spreads

As of: 6/30/2020

	Treasury	US Composite BVAL AA Curve		US Composite BVAL A Curve		US Composite BVAL BBB Curve		US Composite BVAL BB Curve	
Term	Yield	Yield	Spread	Yield	Spread	Yield	Spread	Yield	Spread
1yr	0.16	0.32	0.16	0.441	0.281	0.854	0.694	3.524	3.364
2yr	0.16	0.36	0.2	0.496	0.336	0.937	0.777	3.805	3.645
3yr	0.18	0.459	0.279	0.631	0.451	1.102	0.922	4.083	3.903
5yr	0.29	0.762	0.472	0.95	0.66	1.465	1.175	4.644	4.354
7yr	0.49	1.145	0.655	1.338	0.848	1.888	1.398	5.098	4.608
10yr	0.66	1.604	0.944	1.795	1.135	2.377	1.717	5.56	4.9
20yr	1.18	2.406	1.226	2.783	1.603	3.388	2.208	6.682	5.502
30yr	1.41	2.626	1.216	2.826	1.416	3.292	1.882	6.718	5.308


10yr Yield & Spread
Yield
3.5
3
2.5
2
1.5
1
0.5
0
Tightest spread 12/31/19: 75 bps
Widest spread 3/23: 262 bps
6/30 spread: 114 bps
12/31/19
1/9/20
1/18/20
1/27/20
2/5/20
2/14/20
2/23/20
3/3/20
3/12/20
3/21/20
3/30/20
4/8/20
4/17/20
4/26/20
5/5/20
5/14/20
5/23/20
6/1/20
6/10/20
6/19/20
6/28/20
10YR US TREASURY
A-Rated 10 Year Composite Index

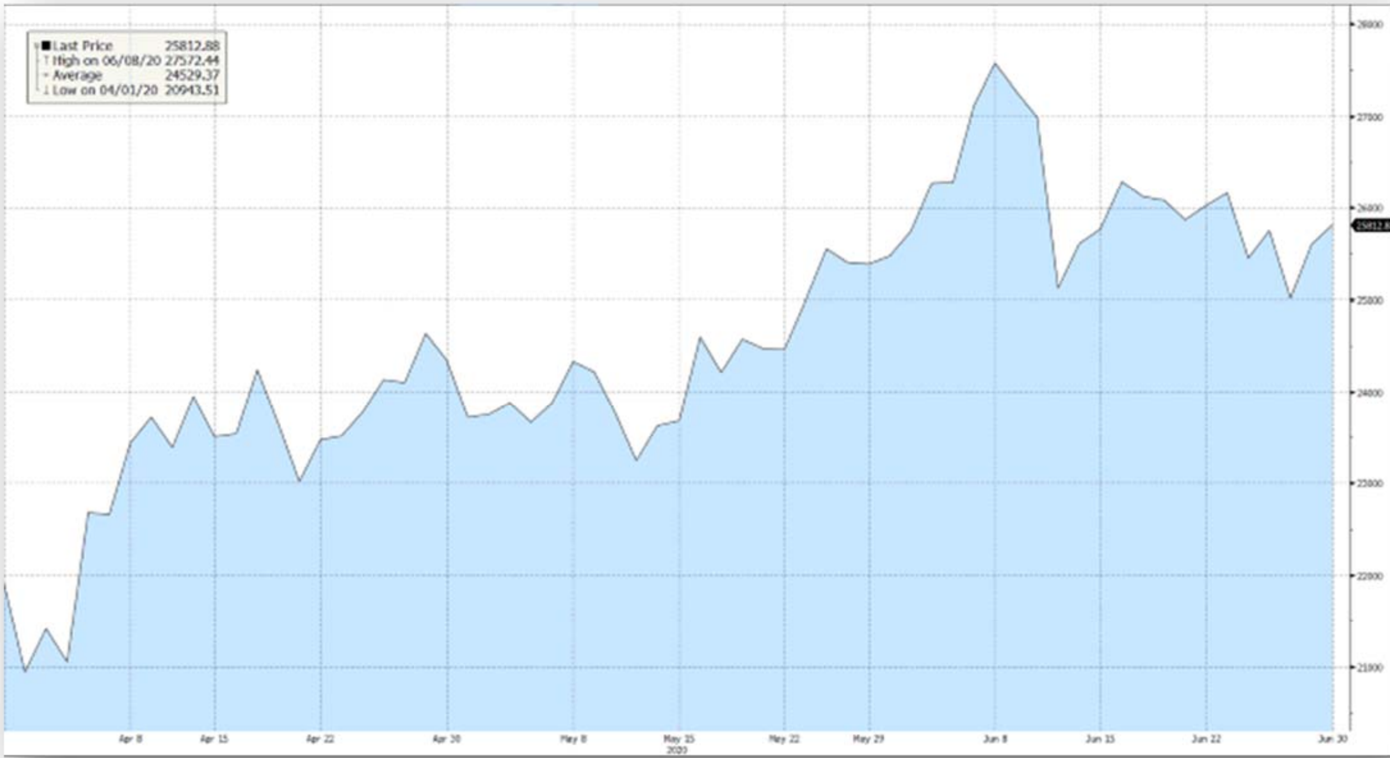
US Treasury Yield Curve



S&P 500 Index


Last Price 3100.29
High on 06/08/20 3232.39
Average 2926.26
Low on 04/01/20 2470.50
3300
3200
3100.29
3000
2900
2800
2700
2600
2500
Apr 8
Apr 15
Apr 22
Apr 30
May 8
May 15
2020
May 22
May 29
Jun 8
Jun 15
Jun 22
Jun 30

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

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