# The Insurance *perspective*

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# *Economic Commentary*

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We continue to see strong economic recovery after the pandemic as the American consumer happily spends the additional savings they have accrued through the past year. The second quarter of 2021 was further fueled by another round of government stimulus checks and empowered by the confidence of the COVID-19 vaccines, with close to 70% of Americans having received at least one dose. The pent-up demand coupled with supply chain disruptions and the strongest GDP growth in decades has led to inflation concerns, with Consumer Price Index levels rising 5% for the year as of May, over double the 2% "target" rate pursued by the Fed.

**US Bond Market-** As inflation concerns drove yields higher throughout the first quarter, a lot of the anxieties were abated as the reality of the situation becomes more known. While it is true that prices have increased for the majority of goods and services, notably in lumber which had increased over 67% from March to May alone (and nearly 550% from March 2020 to May 2021) and in vehicles which due to semiconductor shortages have seen prices increase over 30% for the year, the consensus and narrative from the Fed continues to relay these pressures are "transitory," a word used often by Powell. From his point of view, these increases were primarily the result of supply chain issues caused by reduced production on the supply side at a time when unforeseen increased consumption occurred on the demand side. We have seen this prediction begin to come to fruition, as the exogenous shocks caused by the pandemic are worked out, with lumber already falling nearly 60% from its May high. As the expectations of hyperinflation have subsided, we have also seen bond yields fall, especially on the long end of the curve. After starting the quarter at 1.74%, the 10-year Treasury ended the quarter at 1.47%, with the 20 and 30-year also falling 29.3 and 32.5 basis points, respectively. Inflation is generally fixed income's "kryptonite" as many bonds make a fixed interest payment, which becomes worth less in inflationary periods leading to a decline in purchasing power.

**US Stock Market-** Strength continues to build in the labor market. Wage growth was higher than expected (most notably in low wage industries where unemployment benefits compete with wages), business hiring plans were high and savings accounts have grown. Company earnings in the first half of the year were some of the best ever recorded. Pair lower rates, a strong consumer that accounts for nearly 2/3 of GDP who increased spending over 11.4% in the first quarter and (fingers-crossed) the pandemic fully in the rear-view, you should get strong GDP numbers. The formula must have been right, because the U.S. economy grew at a solid 6.4% during the first quarter, setting the stage for one of the strongest years in over 7 decades. Projections for the 2nd quarter range from 8-12% due to much anticipated summer travel and spending. This obviously translated to strong equity performance, with the S&P 500 returning over 8.5% during the second quarter. Although a strong return, more noteworthy performance comes from the Nasdaq, with a return of 11.2% in Q2 alone.

**FOMC-** The Fed had adjusted some of their language to allow some flexibility to accommodate a stimulative posture despite inflation concerns by saying they will allow inflation to run above the 2% target and instead look at it as a long term "average" target. This allows them the ability to continue providing sufficient support to ensure the economy keeps moving upward and onward. However, it is imperative inflation does in fact remain transitory. If these supply chain disruptions are not all resolved like lumber, as is the case with oil as it approaches its 5-year high, the economic recovery can be muted as everyday items can become prohibitively expensive for most people and quell the consumer spending that drives the American machine. It is also just as imperative they do not raise rates too soon, which could solve the inflation issues but potentially drive the still recovering economy back into a recession. Or potentially worse, this could introduce an event witnessed back in the 70's, stagflation, which incorporates high inflation and sluggish economic growth. Although we have seen substantial GDP growth and earnings soar, the reality is that some sectors are still in the recovery phase, with the leisure and hospitality sector only back to ~85% of its workforce compared to February 2020. The Fed anticipated leaving rates low until 2024 but have updated their expectations to begin increases during 2023, which still gives plenty of time and flexibility to continue monitoring and adjusting expectations as the recovery continues to unfold.

**Summary-** We have continued to live in the bliss of the recovery phase with over a year of incredible performance from the stock market, which was not always rooted in fundamentals or reality, but on the expectation that things would go back to normal, fueled by an arguably unnecessary amount of government intervention. It should not be surprising that the economy is showing signs of running hot, whether that is from these so-called supply chain issues, or the fact trillions of dollars were pumped into the financial system. Regardless, inflation will continue to be the fixation of monetary policy, which then in turn affects capital market expectations that drive both the fixed income and equity markets. While opinions vary and expectations change, we do anticipate rates to remain low and the ugly inflation monster to become less of a concern moving forward. The strong consumer and summer spending should continue to drive equity performance in consumer cyclical and energy names, absent potential volatility from the new Delta variant or some other "unprecedented" event (another word I know we are all tired of hearing about).

# Industry Insight: Beyond Total Return


Measuring performance for an insurance company is a tricky item that does not have a singular answer. As the majority of assets owned by insurers are carried at amortized cost, the quintessential total return benchmark is not applicable. Furthermore, every insurer is unique and has different financials, goals, solvency requirements, and most importantly they sell vastly different products. To simply compare book yields from one insurer to the next would also not be appropriate. A life insurer with stable long-tailed liabilities may have a book yield in excess of 5%; however, this type of strategy would be woefully imprudent for a health insurer that has shorter liability cash flows or even a life insurer that sells interest sensitive annuities. Therefore, every company must have unique performance objectives built around their needs. Some insurers should have an immediate performance objective to increase their RBC ratio; others want to improve book yield as compared to their peers. For this reason, every organization should build the appropriate performance objectives that matter to stakeholders. We will address some items to consider when building your own performance targets.

A key factor in the success of an insurer is the performance of the investment portfolio; unfortunately, the valuation tools used to measure insurance performance are often inappropriate. As a society we are conditioned to view investment success by comparing the total return of our portfolio to that of a benchmark index of similar securities. This approach is extremely appropriate for most investment portfolios. Consider for example the equity portion of your personal IRA or 401-k account. If the total return on the portfolio over time exceeds that of the S&P 500 Index you are probably excited about your portfolio. The appropriate asset allocation of your retirement account is based upon the risk that is appropriate considering your personal needs and objectives. The expected time until retirement is normally the greatest factor in assessing the appropriate portfolio risk that can be assumed. The objective is essentially to generate the largest pile of money possible considering the risk profile appropriate for your needs.

When insurance assets are managed to optimize total return there are several unintended consequences that often adversely impact the insurer. Furthermore, decisions that a prudent investor would make in order to optimize total return may actually reduce surplus or the net investment income of an insurer. A key to understanding these potential issues is centered on the ultimate objective of the insurer. An insurance company is entrusted with funds that represent future payments to members or policy holders. This simple concept is the basis for statutory accounting principles and the majority of regulations developed by the NAIC or various state departments.

A large component of total return is the unrealized position of a portfolio at any given time. However, insurance companies carry the majority of assets at amortized cost. The basis for cost accounting is that fixed income investments are to be held to maturity in a manner where the cash flows are sufficient to provide for the future expected claims of the insurer. This reduces the concern related to decreasing market prices and places the focus on net investment income. This focus is appropriate and actually reduces risk. Securities purchased should support the future cash flows of the representative product and provide sufficient book yield (spread) to support product growth rates and operations. This is true regardless of the direction of interest rates. Insurance investing should not focus on speculation or "bets" on interest rates, but work to ensure that surplus and net investment income are appropriate in any economic environment.

Additionally, there are circumstances where a focus on total return would dictate the sale of a security in order to realize a gain and reinvest in another security with a better appreciation profile. If an insurer files an Interest Maintenance Reserve (IMR), then the gain on a disposal would not be realized initially, but amortized into income over the remaining life of the security that was sold. When a gain is considered, reinvestment would typically occur at a lower current yield; therefore reducing the overall book yield of the portfolio and negatively impacting net investment income. If taxes come in to play, the impact to income is amplified by the tax rate.

Another tool that is often used in an attempt to generate positive return versus an index is shifting between asset classes or qualities. This reduces diversification and has significant impacts to risk based capital in addition to creating volatility in the AVR. This in turn can place downward pressure on surplus in addition to the trading impacts to IMR. More importantly, if the amount invested in any single security is large in relation to surplus, the risk to the insurer is enhanced. This would not be the case for other types of investors as diversification is considered based upon total assets.

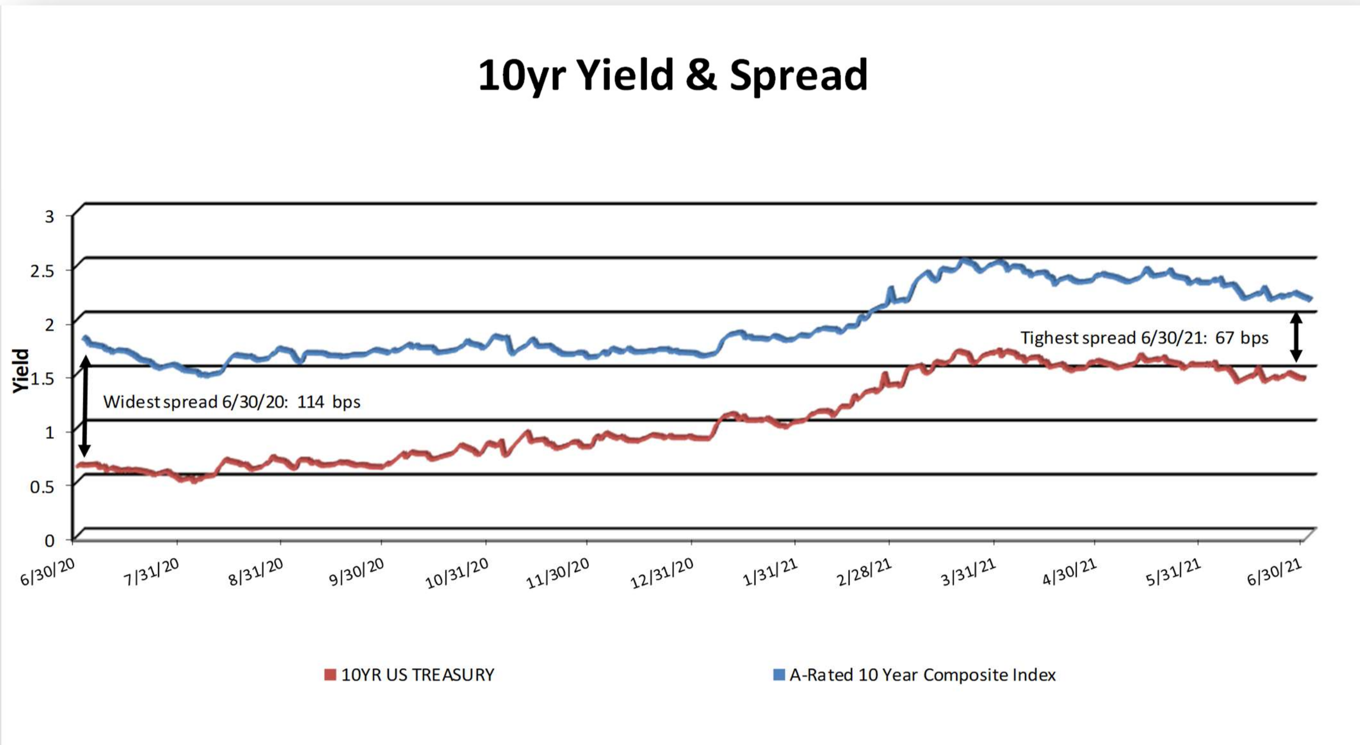
One final total return concept that is impracticable to apply to insurance investing is the typical strategy of a total return benchmark. As an insurance company your products, members, marketplace, liabilities, statutory reports, surplus and history are unique. Appropriate investing must consider the liabilities and surplus; therefore, every insurance portfolio should be unique. This makes the common benchmarks that are applied to all portfolios meaningless even when total return is the objective. Each benchmark would need to be custom designed, which reduces the ease of market understanding. Regardless, a total return benchmark could never quantify the specifics of investing to match liabilities, enhance surplus or better position IMR/AVR. Better benchmarks for insurers are: ALM objectives, book yield comparison to competition, surplus enhancements or anything that more efficiently ties performance to the true needs of the insurer.

## Interest Rate Spreads

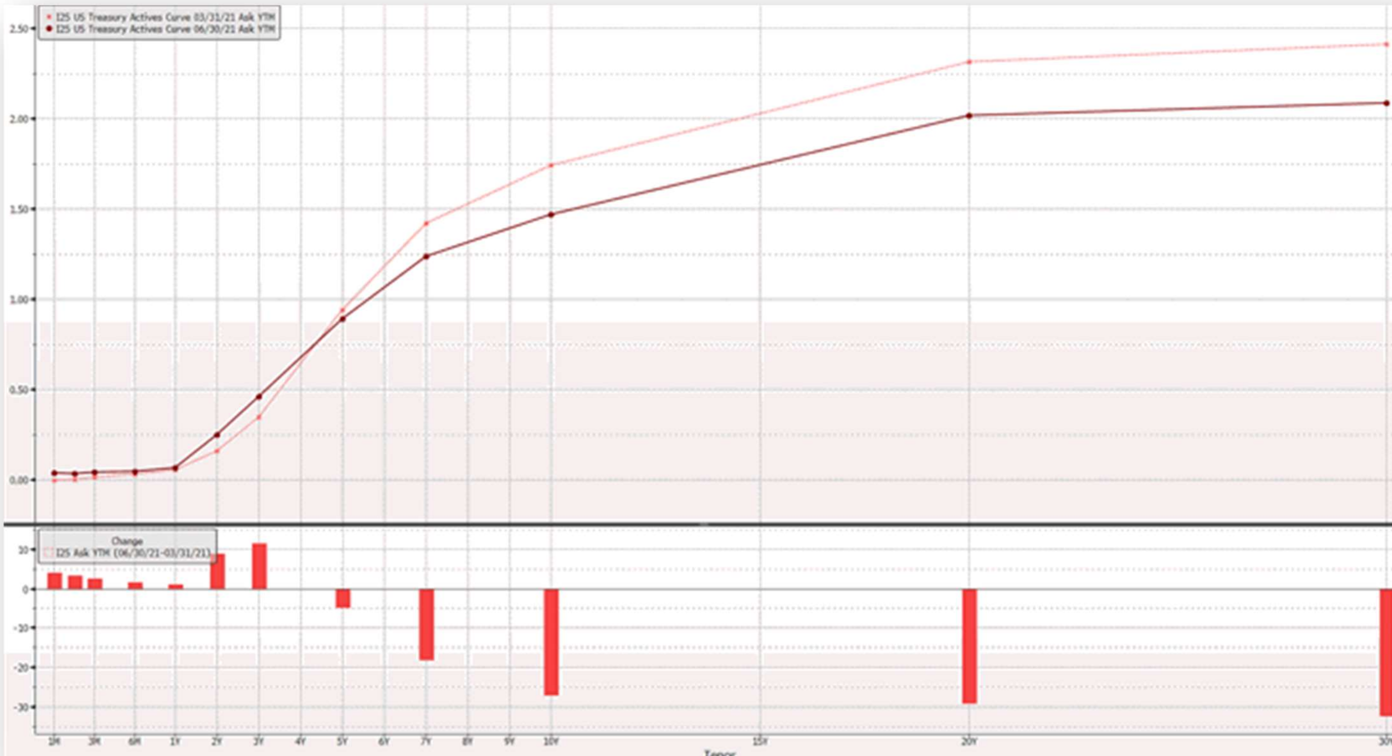
As of: 6/30/2021

| 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 | 0.07 | 0.233 | 0.163 | 0.266 | 0.196 | 0.472 | 0.402 | 1.368 | 1.298 |
| 2yr | 0.25 | 0.326 | 0.076 | 0.389 | 0.139 | 0.622 | 0.372 | 1.733 | 1.483 |
| 3yr | 0.46 | 0.548 | 0.088 | 0.63 | 0.17 | 0.873 | 0.413 | 2.162 | 1.702 |
| 5yr | 0.87 | 1.085 | 0.215 | 1.198 | 0.328 | 1.475 | 0.605 | 3.013 | 2.143 |
| 7yr | 1.21 | 1.522 | 0.312 | 1.663 | 0.453 | 1.983 | 0.773 | 3.643 | 2.433 |
| 10yr | 1.45 | 1.961 | 0.511 | 2.137 | 0.687 | 2.504 | 1.054 | 4.182 | 2.732 |
| 20yr | 2 | 2.673 | 0.673 | 2.86 | 0.86 | 3.282 | 1.282 | 4.896 | 2.896 |
| 30yr | 2.06 | 2.838 | 0.778 | 2.924 | 0.864 | 3.257 | 1.197 | 4.752 | 2.692 |

Disclosures: This material is for your use only and is based upon information which we consider reliable, but we do not represent that it is accurate or complete and should not be relied upon as such. Information was obtained from Blooomberg and represents the respective Bloomberg US Composite BVAL and Bloomberg Fair Value Composite Curves. Spreads are calculated off the Treasury yield for each term.


10yr Yield & Spread
Yield
3
2.5
2
1.5
1
0.5
0
Widest spread 6/30/20: 114 bps
Tighest spread 6/30/21: 67 bps
6/30/20
7/31/20
8/31/20
9/30/20
10/31/20
11/30/20
12/31/20
1/31/21
2/28/21
3/31/21
4/30/21
5/31/21
6/30/21
10YR US TREASURY
A-Rated 10 Year Composite Index

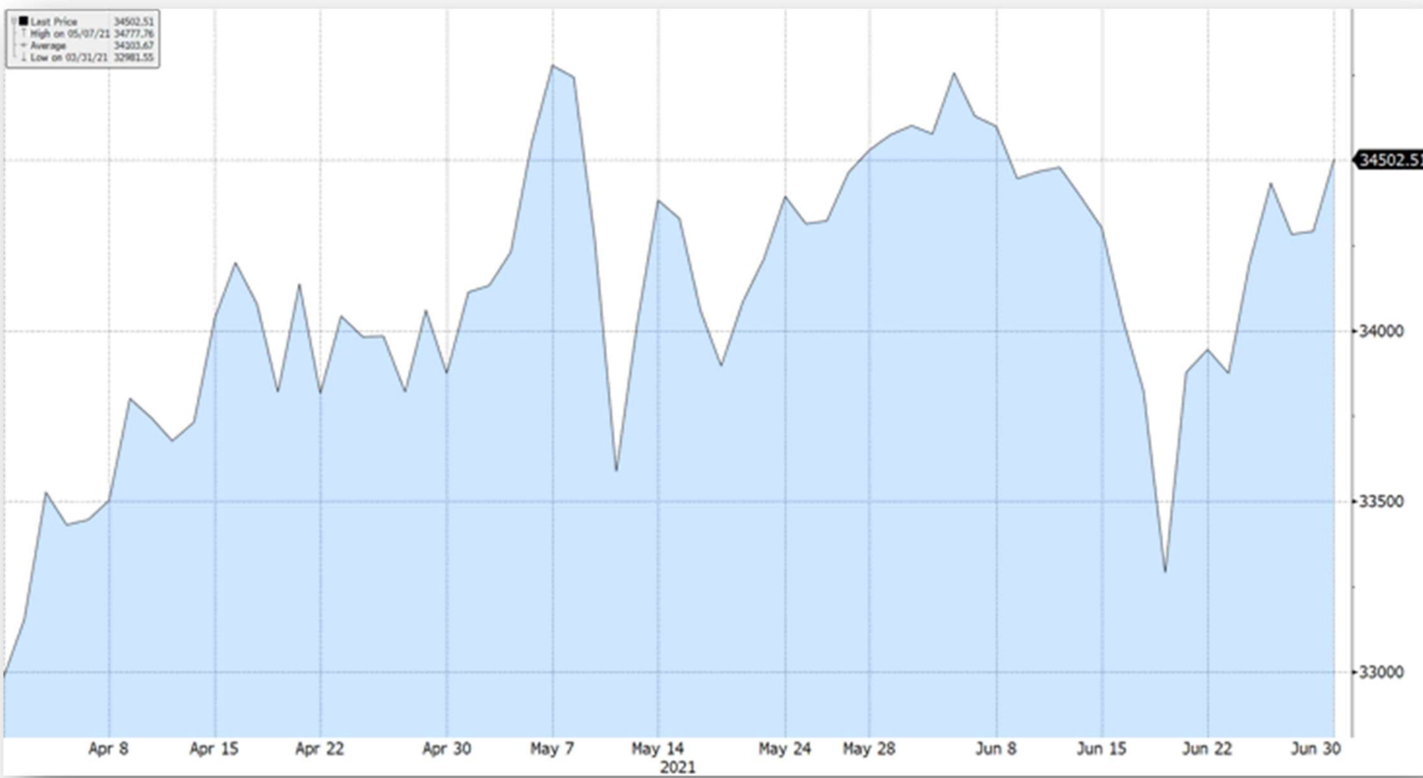
# US Treasury Yield Curve



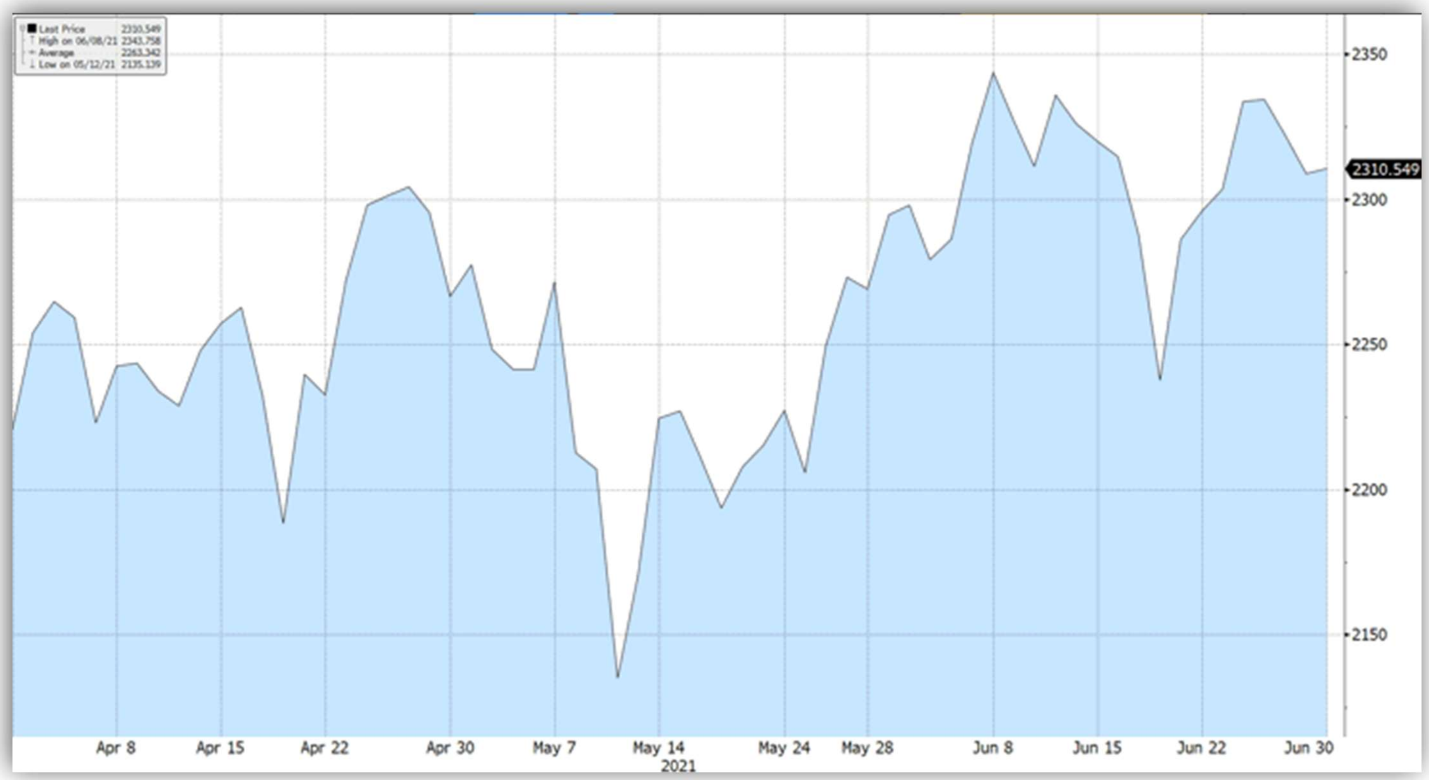
# S&P 500 Index

Last Price 4297.50
High on 06/30/21 4297.50
Average 3741.63
Low on 07/13/20 3155.22
4297.50
4200
4000
3800
3600
3400
3200
Jul
Aug
Sep
Oct
Nov
Dec
Jan
Feb
Mar
Apr
May
Jun
2020
2021

# Dow Jones Industrial Average



# Russell 2000 Index



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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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