The Insurance *perspective*

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Economic Commentary


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It's hard to believe the final quarter of the year has begun. Many concerns exist in the market including inflation, the US debt-ceiling debacle (yet again), concerns over China, continuing COVID caution, and sustained supply chain issues. Although the domestic equity market was down during September because of these concerns, the market remains near all-time highs. Treasury bonds remain volatile, whipsawing yields and prices for fixed income investors.

Domestic Fixed Income Market

While US Treasury yields across the curve ended the third quarter not far from where they began, yields were volatile intra-quarter. The 10-year Treasury, for instance, began Q3 at 1.468% and ended at 1.487%, a slight increase of only 1.9 basis points. However, the low within the quarter was 1.17% in early August and the high was 1.54% near the end of September, a range of 37 basis points. This same trend extended across various points of the Treasury yield curve, resulting in volatility throughout the period. Inflation is still a concern and remains on the radar of the Fed and bondholders alike. The personal consumption expenditures (PCE) price gauge rose 4.3% for the one-year ended August, which is the largest annual increase in thirty years. This has some worried that price increases will last longer than expected and will affect consumer spending. The concern for fixed income investors is that lasting inflation results in increasing yields, which reduces the value of previously purchased fixed income instruments and decreases the purchasing power of income dollars spinning off the investment.

Domestic Equity Market

Supply chain issues continue to persist. The average lead time for production materials increased in September to 92 days, which is a record high from data going back to 1987. Additionally, supplies used for maintenance, repairs, and operations increased to a new record of 45 days, according to a factory activity report from the Institute for Supply Management (ISM). This resulted in stocks mixed during the third quarter, with the S&P 500 Index squeaking out a small 0.58% return and the Dow Industrial Average falling 1.46% for the quarter. The NASDAQ was also down a negligible 0.22% for the third quarter and the Russell 2000 Index, a small cap index, was down 4.36%. There were several sub 5% pullbacks in the major indices during the quarter, but in general the market remains relatively high and maintains attractive positive returns year-to-date. While the economic recovery appears to persist and the market continues to enjoy low borrowing costs and cheap financing, this can't last forever. The domestic equity market is closely watching when and how quickly the Fed transitions away from these easy money policies.

Federal Reserve

Fed Chair Powell continues to reiterate the belief that the disruptions in the supply chain that have caused inflation increases around the world are transitory. At the September FOMC meeting, the Fed indicated tapering is coming, as was widely expected. As far as timeline, the Fed is unsurprisingly vague using "soon" as their schedule, leaving room for adjustments in the timing in order to monitor economic conditions. I anticipate more taper news at the November meeting, with tapering to begin as soon as December and the Fed to conclude asset purchases around June. There has also been a shift in the Fed's dot plot, moving up the median initial rate hike to 2022 from 2023. This hawkish sentiment suggests the Fed is more concerned about price stability than inflation, which has ticked up meaningfully as discussed above. The market will continue to hang on Powell's every word, dissecting and searching for any underlying meaning and implications.

Summary

The US economy continues to experience easy monetary policy, a strong labor market, supply chain disruptions, and strong consumer demand. We recommend watching inflation closely and keeping a close eye on the market's reaction to the Fed's taper timing. A small correction could be likely given slowing growth, less accommodative monetary policy, and issues stemming from China that lead to global volatility.

Industry Insight: Is it time to realize gains?

This will be no surprise to anyone, but interest rates remain near historic lows. Consequently, portfolios continue to maintain material unrealized gains. As there are enhanced pressures for yields to increase moving forward, I have frequently been asked: "Should we be realizing gains?" While this is a worthwhile question to be asking, the inherent rhetorical question that parallels this is, what to do with the gains? I will unpack these questions in our 3rd quarter article and provide you some guidance on making this decision.

Before I dive into the details of the topic, it is imperative to unpack IMR (life companies only) as it is paramount into making a prudent sell decision. Like many statutory requirements, the Interest Maintenance Reserve was designed to focus the insurance investor on the ultimate objective, the policy holder. IMR encourages an investment strategy that is more "buy and hold" by design. In simple terms, IMR reduces the temptation to take gains on the portfolio by requiring that any realized gains are not accounted for in the year they are realized, but slowly amortized into income over the remaining life of the security that was sold. For example, if a bond with ten years remaining to maturity is sold for a $100,000 realized gain, the gain will be slowly brought into income over the next ten years.

As there are numerous economic signs pointing to higher interest rates in the future, most notably inflation pressures, it may be time to look at capturing unrealized gains. However, these decisions should never be made in a vacuum. At surface level, the securities with the largest gains will also be those with the highest book yield. Considering this, as you sell a security, the insurer will pay tax on the gains and then reinvest the remaining proceeds at a materially lower yield. Assuming you ran a financial analysis on these transactions, and the sale still makes sense with the tax liability and give-up in book yield, then this transaction makes economic sense. While this is true from an economic perspective, the sale may have increased the insurer's ALM risk/ bond ladder discrepancy, reduced RBC, and hindered the annual cash flow testing. For this reason, it is necessary to review any potential sales from a holistic perspective and not merely in a vacuum.

I would never recommend realizing gains for this reason only; however, if enhancing IMR (by realizing gains) can occur while achieving other objectives it may be very beneficial. With liquidity high and gains in the portfolio, this is a good time to reduce risk and possibly enhance future returns by realigning any portfolio cash flow mismatches with the liabilities. For example, if the portfolio is generating future cash flows in a certain year that are far more than the expected liabilities, it might be appropriate to sell some bonds maturing in that year. Another opportunity for potential sales is on those bonds that have current credit issues, or those that your investment advisor has noted as having increased risk of future downgrade when the next economic slowdown occurs. While non-investment grade bonds will never be trading based solely upon the state of interest rates, as the underlying credit will take precedence, the overall value of these securities will be trading higher than if rates were to increase. For this reason, it would be prudent to sell "watchlist" items in coordination with bonds that are being sold merely because of their overall gain.

(Industry Insight cont'd)

In my mind, this question is the elephant in the room, and the question that is intrinsically tied to realizing gains. As has been stated, any sale will result in reinvestment below that of the initial bond. While reinvesting the proceeds may seem like the only option, I have witnessed insurers realizing gains, and merely accumulating cash and cash equivalents. Obviously holding these magnifies the net investment income loss. This is a strategy that I am, with few exceptions, adamantly opposed to. Realizing gains and hoarding cash is no different than betting on the direction of interest rates, and policyholder dollars should not be used as bets. We have seen many highly acclaimed economists predict higher interest rates over the past decade, and all of them have been wrong. I comment on this only to provide guidance to the fact that no one can accurately time the market.

As I do not believe that most insurers want to realize gains and hoard cash, there are several ways to capture gains and reallocate prudently. Reinvesting the proceeds in a year where the liabilities are more than the asset cash flows, thus reducing ALM risk, would be of tremendous net benefit. Of course, this cannot be decided in a vacuum either. If multiple objectives are accomplished, then it might make sense. These are objectives to consider: overall diversification, ALM, enhancing IMR, maintaining or improving current book yield, increasing credit quality, or reducing overall risk.

Another option to consider when looking to reallocate sales is to invest in "risk assets" or marked-to-market securities. While any investments in these asset classes should have increased diversification and a comprehensive understanding of the inherent risk, this allocation could boost the overall portfolio return. For companies that have equity toleration, and are not currently at the max threshold, selling bonds to realize gains and reinvesting in equities is a viable solution. Similarly, increasing diversification to other risk assets may be a sensible strategy, such as structured products, acquiring other entities, real estate, etc. These sales and allocations should strictly be isolated to a small percentage of surplus dollars to avoid jeopardizing any policyholders' funds.

The last option for using realized gains would be to enhance the insurer outside of the investment portfolio. If you are currently weighing the decision of purchasing a new admin system, adding on to your home office, increasing marketing presence, entering a new state, etc., realizing gains for these purposes may be highly beneficial as it will facilitate the long-term vision of your company while harnessing gains.

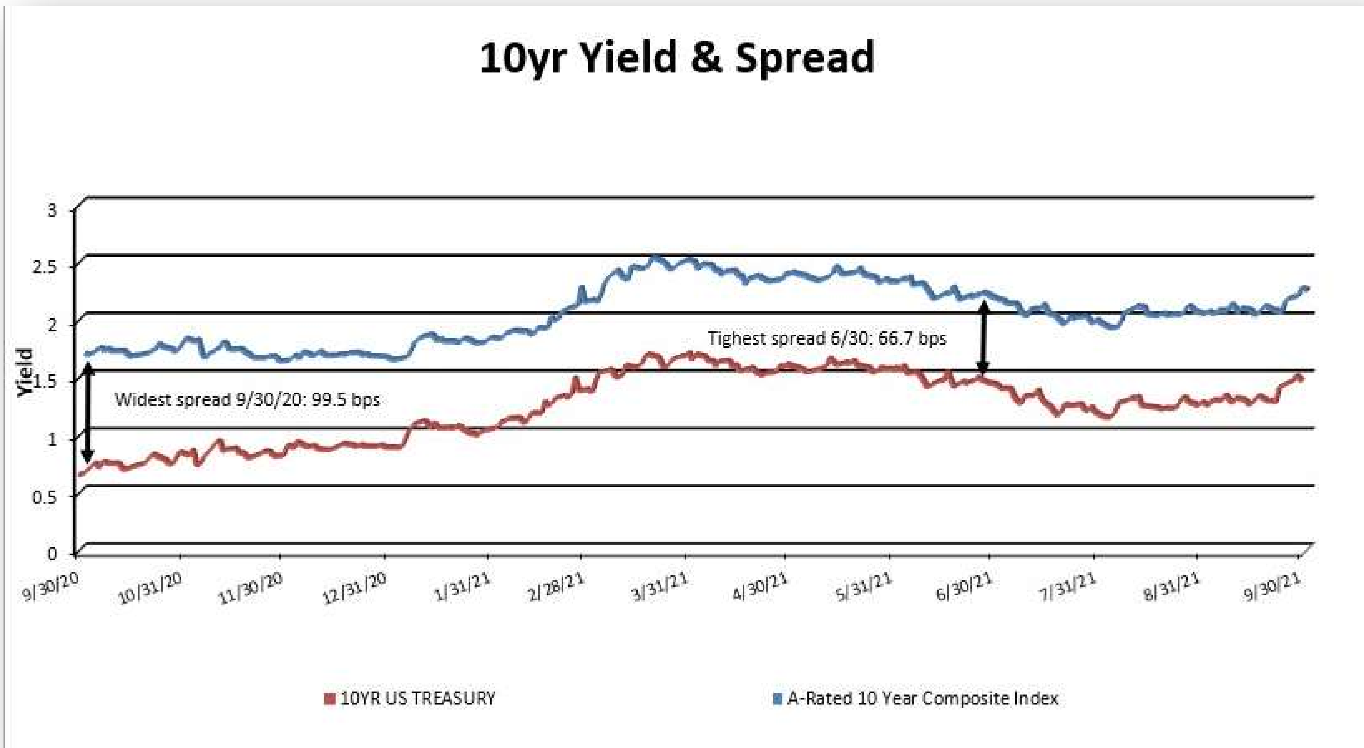
In closing, there is no short answer, or even right answer, to whether gains should be realized when rates are low, and potentially increasing. However, there are certainly situations in which realizing gains can be highly additive to both the bottom line as well the future growth of your insurer. The key is to not use policyholder funds to make bets and to make any decision with a holistic understanding of how the transaction will affect the bottom-line. Not everything is as good as it may appear at surface level due to IMR, taxes, and subpar reinvestment yields.

Interest Rate Spreads

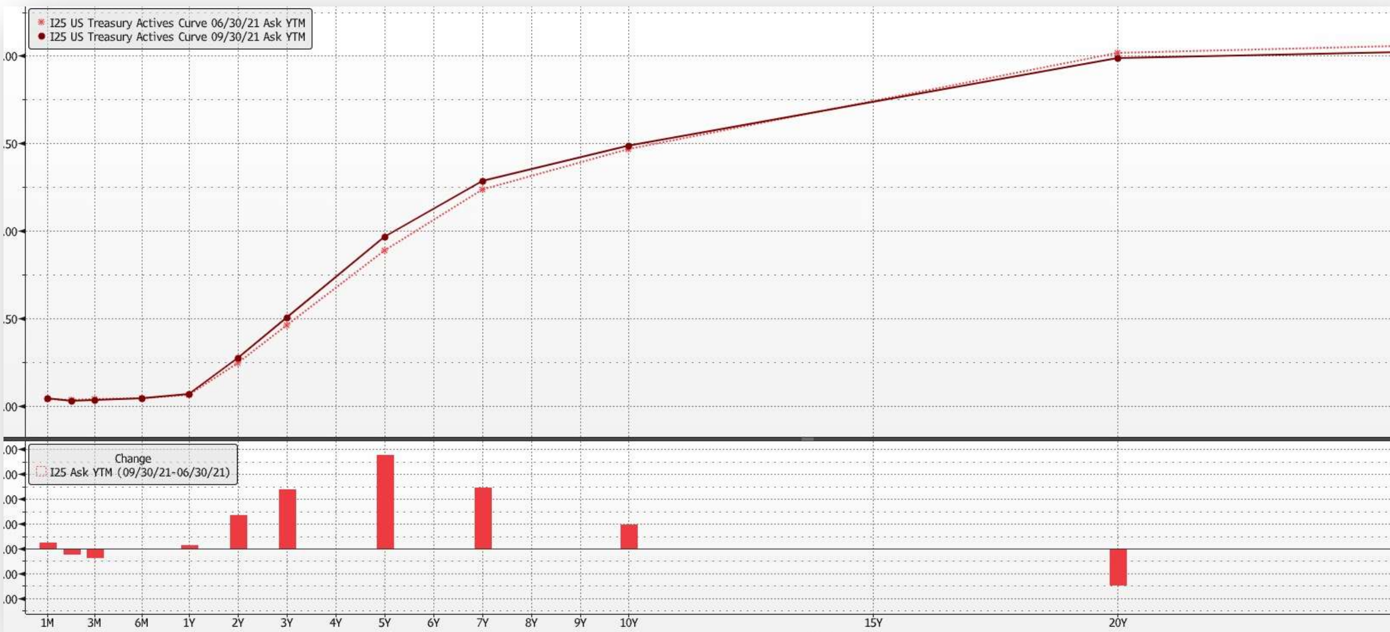
As of: 9/30/2021

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	0.09	0.2125	0.1225	0.2519	0.1619	0.4558	0.3658	1.5616	1.4716
2yr	0.28	0.3732	0.0932	0.4366	0.1566	0.68	0.4	1.9284	1.6484
3yr	0.53	0.6836	0.1536	0.7594	0.2294	1.012	0.482	2.3585	1.8285
5yr	0.98	1.206	0.226	1.3252	0.3452	1.6234	0.6434	3.167	2.187
7yr	1.32	1.6168	0.2968	1.7697	0.4497	2.0945	0.7745	3.709	2.389
10yr	1.52	2.0416	0.5216	2.2314	0.7114	2.5848	1.0648	4.1758	2.6558
20yr	2.02	2.7407	0.7207	2.9244	0.9044	3.3298	1.3098	4.8187	2.7987
30yr	2.08	2.874	0.794	2.9754	0.8954	3.2742	1.1942	4.7109	2.6309

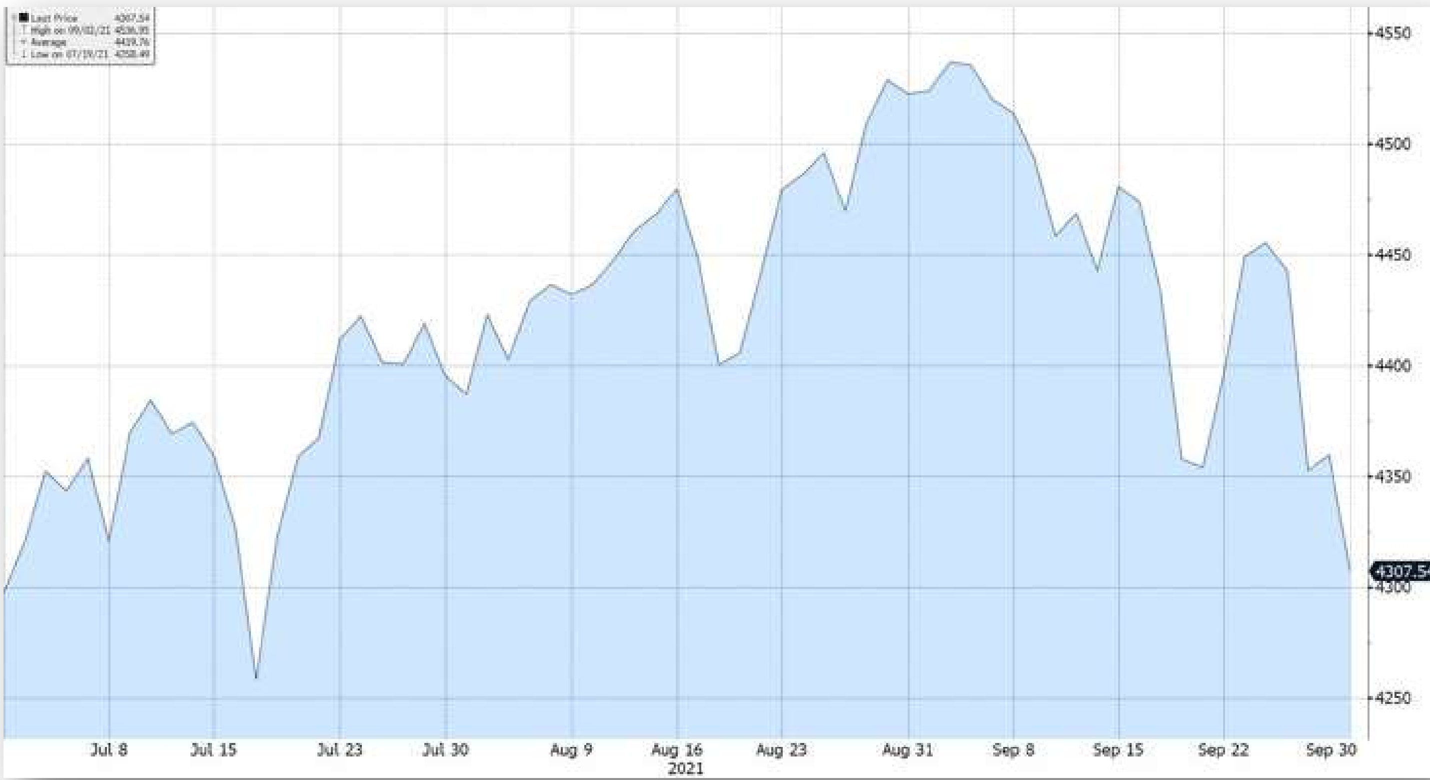
Disclosures: This material is for your use only and is based upon information which we consider reliable, but we do not represent that it is accurate or complete and should not be relied upon as such. Information was obtained from Blooomberg and represents the respective Bloomberg US Composite BVAL and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


10yr Yield & Spread
3
2.5
2
1.5
1
0.5
0
Yield
Widest spread 9/30/20: 99.5 bps
Tighest spread 6/30: 66.7 bps
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
7/31/21
8/31/21
9/30/21
10YR US TREASURY
A-Rated 10 Year Composite Index

US Treasury Yield Curve



S&P 500 Index


4550
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4400
4350
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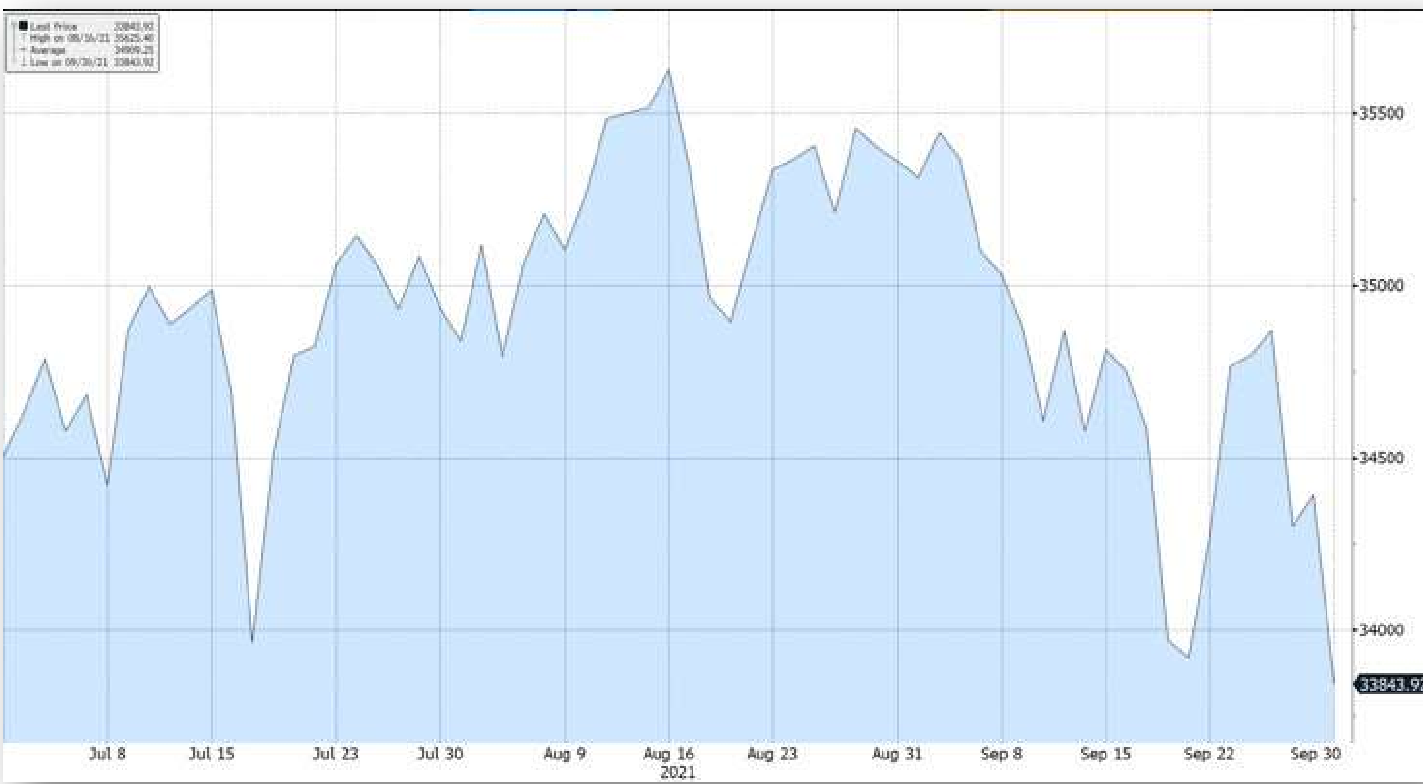
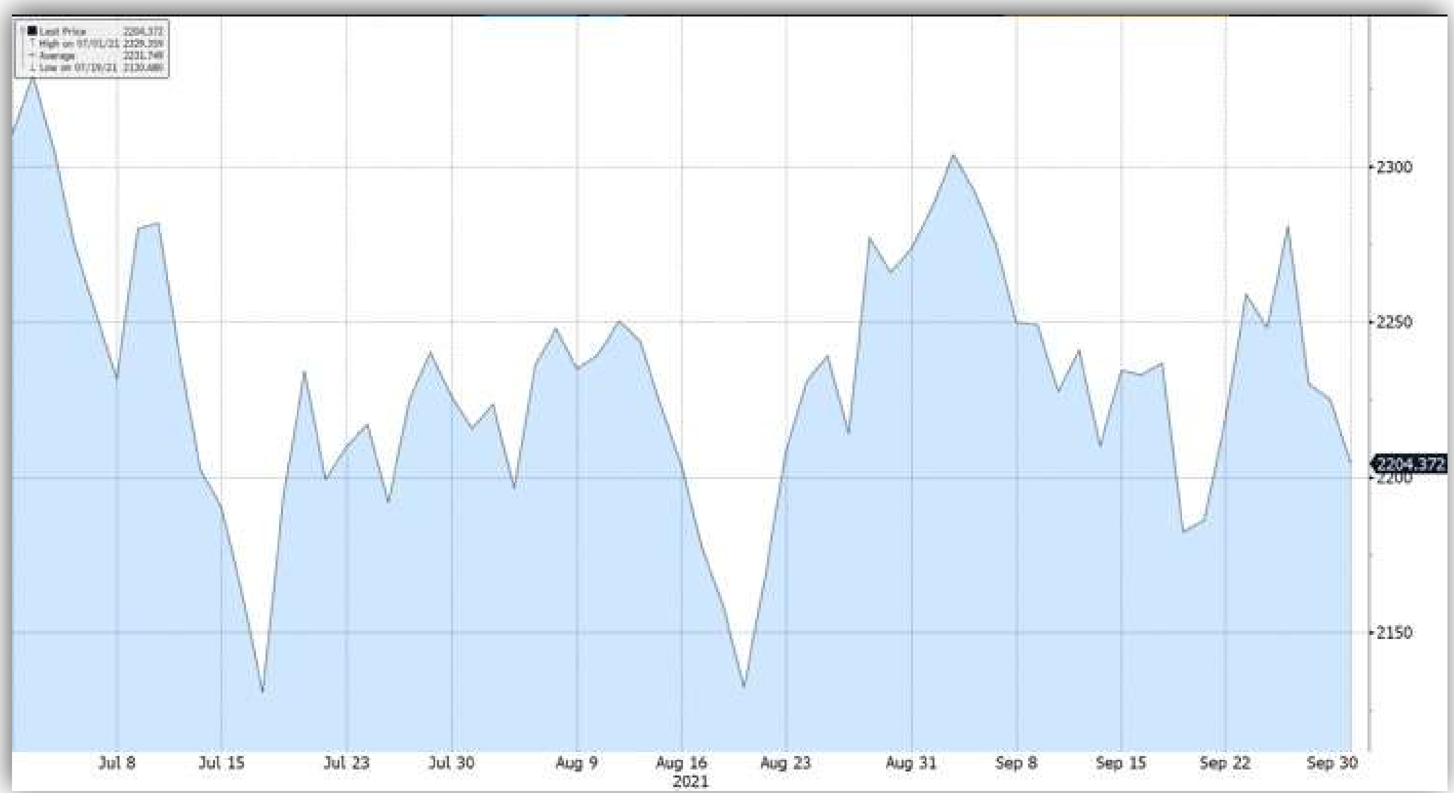
4300
4250
Jul 8
Jul 15
Jul 23
Jul 30
Aug 9
Aug 16
2021
Aug 23
Aug 31
Sep 8
Sep 15
Sep 22
Sep 30

Dow Jones Industrial Average



Russell 2000 Index



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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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