The Insurance *perspective*

2021- Volume 22

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Economic Commentary

Another year in the books! The focus throughout 2021 remained on the economic recovery from the pandemic, which entailed a focus on the Fed's every word. Topics that also received honorable mention during the year include the caution surrounding the emergence of new COVID-19 variants, inflation concerns, supply chain disruptions, a meme stock frenzy and skyrocketing cryptocurrency prices. Despite all the headwinds and uncertainty, 2021 shaped up to be a very good year for the domestic equity market, which was a surprise to many.

Domestic Fixed Income Markets

Treasury yields remained volatile across the quarter, continuing the trend that we've seen throughout the year. The curve also flattened, meaning short term rates increased while longer term yields fell during the quarter. The largest change came from the 2-year Treasury, which increased nearly 46 basis points, rising from .27% to .73%, an increase of over 270%, while the 30-year Treasury fell 14 basis points to finish the quarter at 1.90%. The increases shorter on the curve can be attributed to the market's expectation of the reduction in the Fed's bond buying program which has artificially kept rates low to help stimulate the economy and foster the recovery. The curve also was slightly inverted on the long end, with the 20-Year wrapping up the year at 1.93%. While only modestly higher than the 30-year, an inverted yield curve signals expectations of a potential slowdown.

Domestic Equity Market

Despite ongoing supply chain issues and the highest inflation reading in over 30 years, the equity market showed strong returns during the fourth quarter, with the S&P recording a 10.65% gain. This brings overall gains for the year to a very impressive 26.9%, the third-best yearly performance in the 21st century. Despite some volatility in September, the S&P trended upward for the majority of the year, recording over 70 all-time highs in 2021. Ongoing support from the Fed certainly helped drive returns, but support for the rally can be found in the improving labor conditions, where over 18.5 million jobs have been added since April of 2020, leading to a 52-year low number of people filing unemployment claims. Another noteworthy point, nearly 33% of the index's return for the year can be attributed to just 5 stocks, Apple, Microsoft, Nvidia, Tesla, and Google as the mega-cap names represent a large part of the index.

Federal Reserve

The most notable mention of the Fed comes from Powell's abandonment of the word "transitory", as inflation is no longer appearing to be as temporary as the word conveys. Inflation readings for October came in at 6.2%, followed by 6.8% in November, far above the Fed's 2% inflation target. As consumer spending accounts for over 2/3 of GDP, higher prices will certainly lead to issues as the consumer experiences sticker shock, thus working to bring inflation back into check has become a top priority for the Fed without detriment to the recovery. The Fed has added trillions of dollars to its balance sheet by purchasing Treasury/Agency securities to keep rates artificially low and provide liquidity for the market. The Fed had been purchasing $120 million worth of securities per month, and initially announced they would begin tapering (i.e., spending 15 million less per month) in November. In the December meeting, the Fed announced a more aggressive policy of tapering its asset purchase program by announcing they will pare down purchases by $30 billion per month, which means the bond buying program will wrap up by March of 2022, earlier than initially projected. This also gives the Fed the ability to raise interest rates earlier if necessary. Futures are now pricing in 3 rate hikes in 2022, which would bring the Fed Funds rate to somewhere in the range of ~.75%-1% compared to the current range of 0-.25%.

Summary

Stimulus from the Fed lends to low interest rates, which equity markets love, as evidenced by returns we've seen the past couple of years. As the Fed withdraws its stimulus, I anticipate rates to continue increasing and a potential decline in the equity market, especially in the richly valued tech names and non-profitable startups that rely on debt. Additionally, anytime the market rallies more than 20% in a year, it historically has fallen a median of 4.6% at some point within the first quarter of the following year, but still rallies for a median gain of 13% for the year, providing an opportunity for those willing to "buy the dip." However, historical averages do not always consider the current environment of highly leveraged companies following arguably the largest recovery rally in history. As such, a focus on quality names with strong financials is paramount at market tops amid more restrictive fiscal policies. As the case with 2021, we can expect monetary policy to be a main driver of returns, positive or negative, in 2022.

Industry Insight:
Prolonged Low Rates and the Grab for Yield

As interest rates remain suppressed, despite the recent uptick in inflation, insurers everywhere are hunting for yield. This is obviously no surprise to anyone, as every insurers income statement has taken a hit over the past decade and we are all searching for remedies. While keeping an open-mind and maintaining a willingness to explore higher yielding assets is prudent, not all "risk-assets" are equal, even those that appear to be of high quality. In this article, we will unpack the appropriateness of three main risk-assets that we are seeing and the inherent danger that they can possess.

Before I delve into the meat of this article, I first want to give a little background on some of the risk-assets that we are seeing in the market, many of which are being eagerly purchased by insurers, and why these assets currently exist in such abundance. 2020 was a record-breaking year for corporate bond issuance, as over $1.9 trillion was issued, which broke the previous annual record by more than $600 million. While the capital markets are an essential component of a healthy economy and allow business to flourish by their ability to raise money to fund projects, there are invariably unintended consequences as well. One of the most prominent issues with capital markets can be clearly seen during economic times like this, when interest rates are low for prolonged periods of time. These economic cycles allow unviable companies to continue to operate due to their utilization of leverage. This can be clearly seen in 2020, with the record-breaking bond issuance. As Torsten Slok stated in the Wall Street Journal, "one consequence of persistent low interest rates is that it keeps more unproductive firms alive, which ultimately lowers the long-run growth rate of the economy." In addition to Slok's assessment of slower economic growth, I believe that many of the underperforming corporations that are staying afloat via low interest rate borrowing, will have going-concern issues during the next recession. With this, the insurers that own bonds in these corporations will suffer the consequences.

The first risk-asset that is prevalent among insurers right now is lower-rated and singularly rated corporate bonds. While we have been seeing a steady increase in the allocation to NAIC 2 rated bonds for some time, and the NAIC has clearly taken notice, the increased exposure to bonds solely rated by one rating agency has been a more recent trend. Most prominently these bonds carry a strong NAIC rating by one of the lesser-known rating agencies, e.g., Egan Jones, DBRS, etc. Although there is nothing inherently wrong with these agencies, there is a fundamental moral hazard with rating providers, and this is exacerbated when there is only one rating applied to a security. As rating providers should come to their own conclusion on the correct risk of a particular issuer, there is a degree of comfort for an investor when multiple established rating agencies come to similar conclusions independently. Furthermore, the bonds that we have seen that fit in this category are generally micro or small financial institutions that serve a niche market, such a leveraged lending or sub-prime lending. These bonds could have a place in some insurers' portfolios, but we would strongly recommend taking smaller allocations than normal and be cognizant of the actual risk/rating as we feel the rating is often much higher than the assigned designation.

(Industry Insight cont'd)

The second risk-asset that we are seeing increased allocations to are structured products, including CMO, CLO, CDO, ABS, CMBS, etc. While this asset class can add needed diversification to a portfolio, there are two main risks that come with these investments. The first key risk is disintermediation risk with the insurer's liabilities. In most cases, the cash flows of structured products, especially those that are mortgage backed, will act in polarity to annuities. In a rising interest rate environment, the annuities will contract, while the structured assets that are backing these liabilities will extend. If the allocation to these assets is too high, it could create a situation that poses material risk to the solvency of the insurer. The second major risk with these products is the credit risk that they possess. For example, we recently saw a CDO with a WARF rating (weighted average risk factor) that indicated the underlying assets had an average credit quality of single B; however, the actual credit rating was BBB. That being said, these securities are highly complex and there is more to the overall rating than the WARF rating. These securities could see issues if the economy falls into recession. When analyzing these securities, it is important to look at the overall credit, the underlying securities, waterfall reports, the collateral structure, tranche, etc. If you are considering investing in these securities, considerable due diligence is needed due to the complexity of these assets.

The final asset that insurers are gravitating towards are direct mortgages, both residential and commercial. These securities can be additive to an insurer's balance sheet as they provide additional yield; however, they obviously come with added risk. One of the key risks of direct mortgages is liquidity risk. For an insurer, this is often a prudent risk to take assuming that the overall ALM position is immunized. However, if liquidity is a need for the insurer, these assets are likely imprudent. The other major risk that these assets possess is credit risk due to lax underwriting. While we have seen some insurers utilize direct lending that complement their core strengths well, we have also witnessed insurers be far too cavalier with their lending practices. Allocations in this asset class should be highly scrutinized by property location, the manager's experience, tenants' occupancy, etc. Furthermore, direct mortgages carry higher AVR and RBC reserves, which could create unintended consequences at year end. Lastly, it is important to understand potential delinquency rates and how they will affect the cash flows of these assets.

It is important to understand that it is sensible and often necessary for insurers to weigh the pros and cons of investing in higher yielding assets when the market's return is unpalatable. We have done the same thing for our clients and have added exposure to some of these asset classes. As we have increased allocations to the above-mentioned securities, we have taken a more conservative approach by taking smaller positions than normal and performing enhanced credit research. It is imperative to recognize that there are no "free lunches" when it comes to excess yield. At year end, NAIC 3 and NAIC 4 30-year bonds were yielding 4.83% and 5.41%, respectively. Regardless of credit rating, if a security is trading at these yields, the overall risk is roughly equivalent. If you are not comfortable investing in B rated bonds but are willing to purchase an A rated bond with a 5%+ yield, is it imperative to know that these inherent risks are the same, albeit they may be different risks, which is why enhanced scrutiny is so paramount. The most important item to consider when looking at these assets is how they fit your organization's risk appetite, ALM position, and diversification policy. Insurers should not blindly grab for yield as this will undoubtedly lead to negative ramifications over the long run. As you look to increase yield, set clear guidelines within your IPS, and do not waver from these policies.

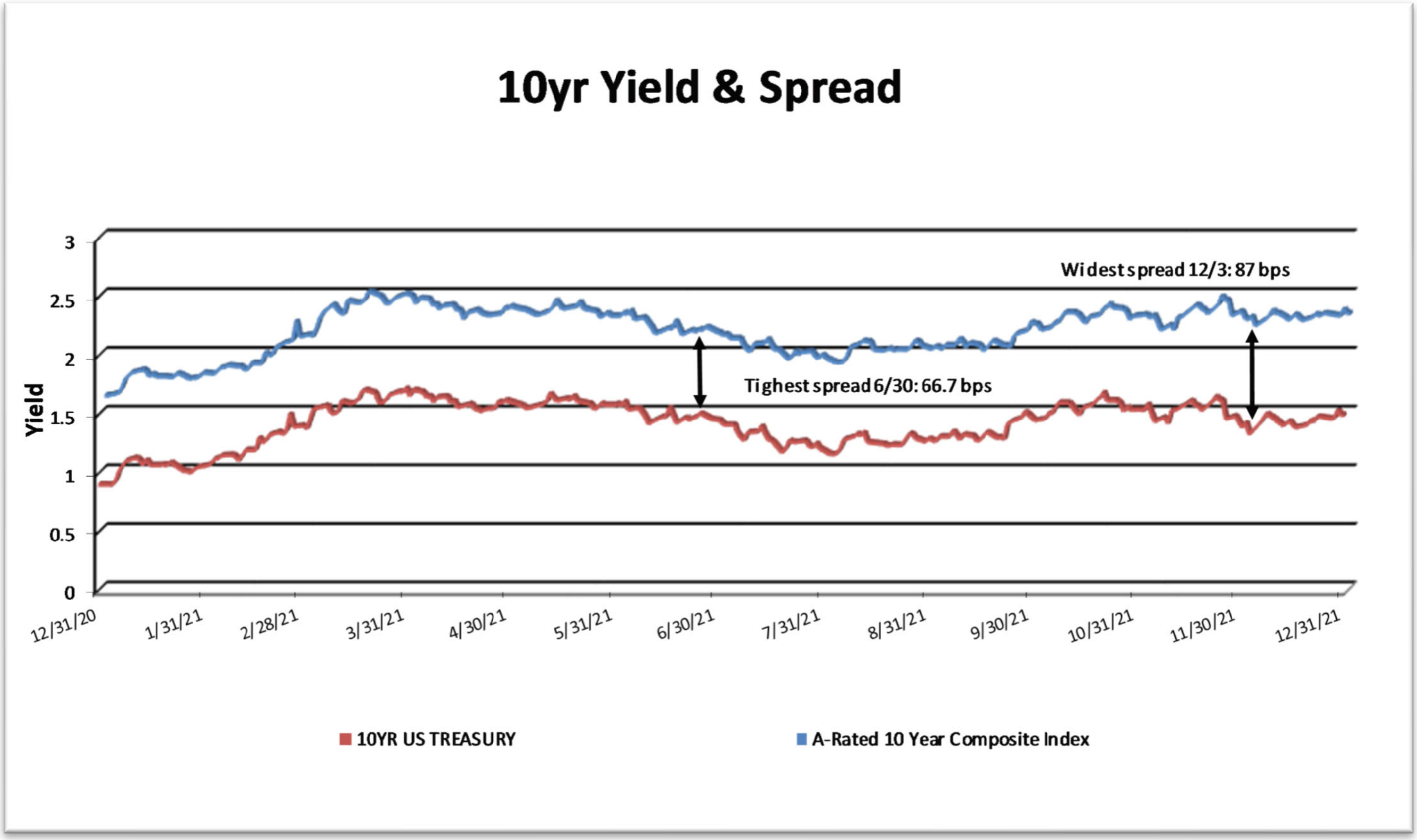
If you are looking to begin investing in risk-assets and want more information on how these securities may impact your organization, please feel free to reach out to us anytime for a conversation. We would be happy to help you navigate the pros and cons of these assets.

Interest Rate Spreads

As of: 12/31/2021

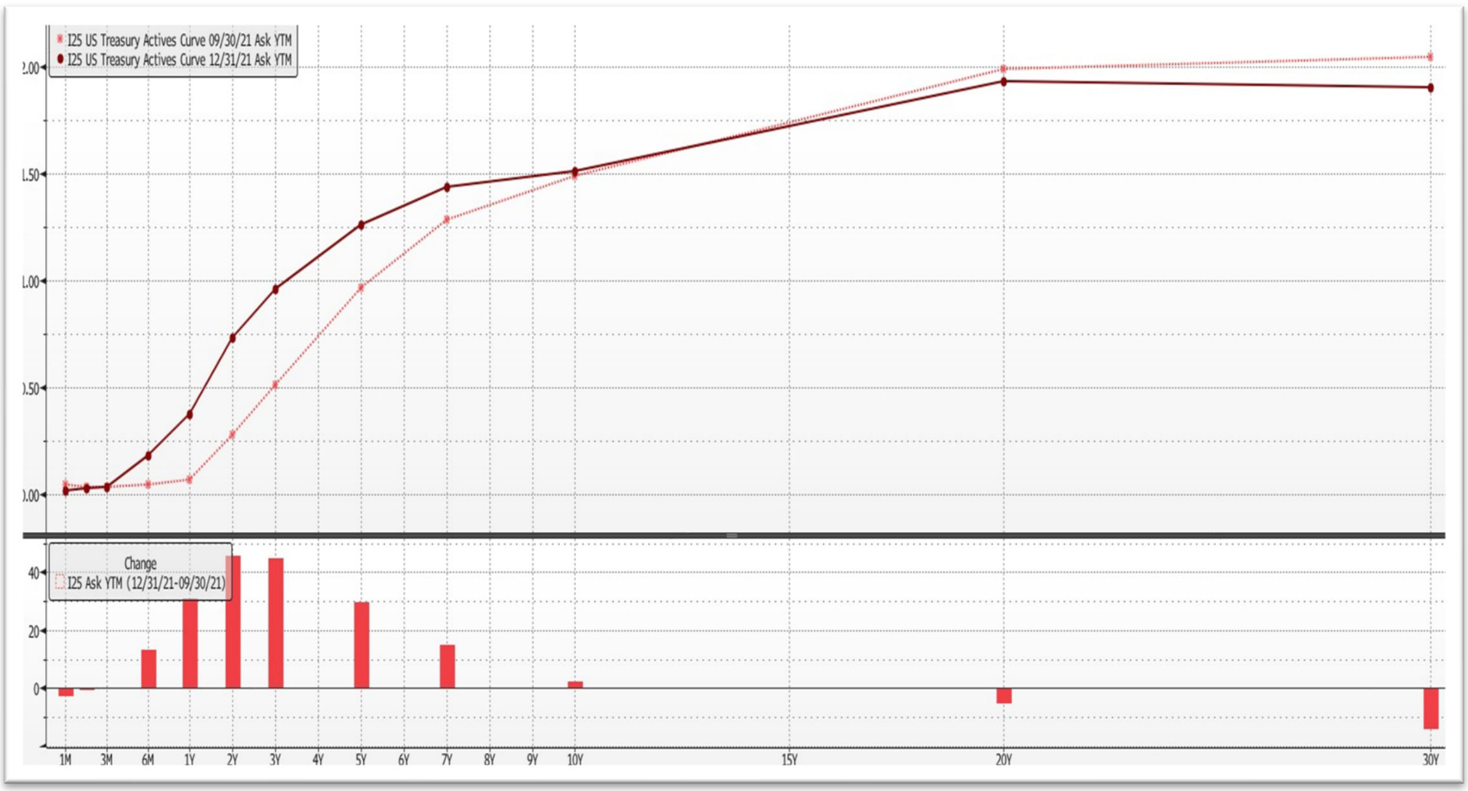
Term	Treasury Yield	US Composite BVAL AA Curve		US Composite BVAL A Curve		US Composite BVAL BBB Curve		US Composite BVAL BB Curve	
		Yield	Spread	Yield	Spread	Yield	Spread	Yield	Spread
1yr	0.39	0.4713	0.0813	0.5662	0.1762	0.8168	0.4268	1.8453	1.4553
2yr	0.73	0.8305	0.1005	0.8973	0.1673	1.1659	0.4359	2.1982	1.4682
3yr	0.97	1.1328	0.1628	1.233	0.263	1.5174	0.5474	2.6306	1.6606
5yr	1.26	1.5122	0.2522	1.6619	0.4019	1.9961	0.7361	3.3428	2.0828
7yr	1.44	1.8178	0.3778	1.9834	0.5434	2.3379	0.8979	3.7969	2.3569
10yr	1.52	2.1275	0.6075	2.3236	0.8036	2.7136	1.1936	4.1879	2.6679
20yr	1.94	2.7553	0.8153	2.9377	0.9977	3.3417	1.4017	4.7983	2.8583
30yr	1.9	2.8176	0.9176	2.9248	1.0248	3.2374	1.3374	4.6992	2.7992

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.

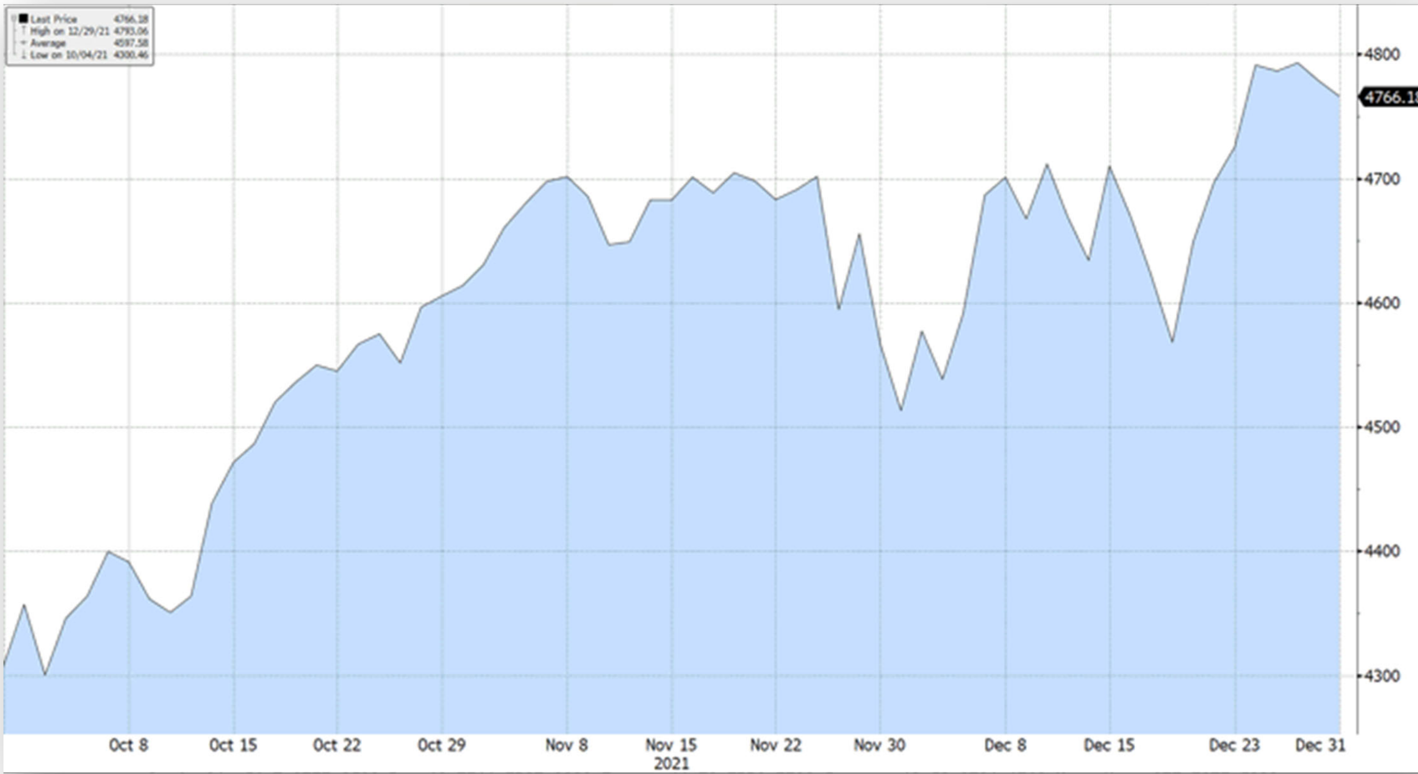


10yr Yield & Spread
Yield
3
2.5
2
1.5
1
0.5
0
Widest spread 12/3: 87 bps
Tighest spread 6/30: 66.7 bps
12/31/20
1/31/21
2/28/21
3/31/21
4/30/21
5/31/21
6/30/21
7/31/21
8/31/21
9/30/21
10/31/21
11/30/21
12/31/21
10YR US TREASURY
A-Rated 10 Year Composite Index

US Treasury Yield Curve

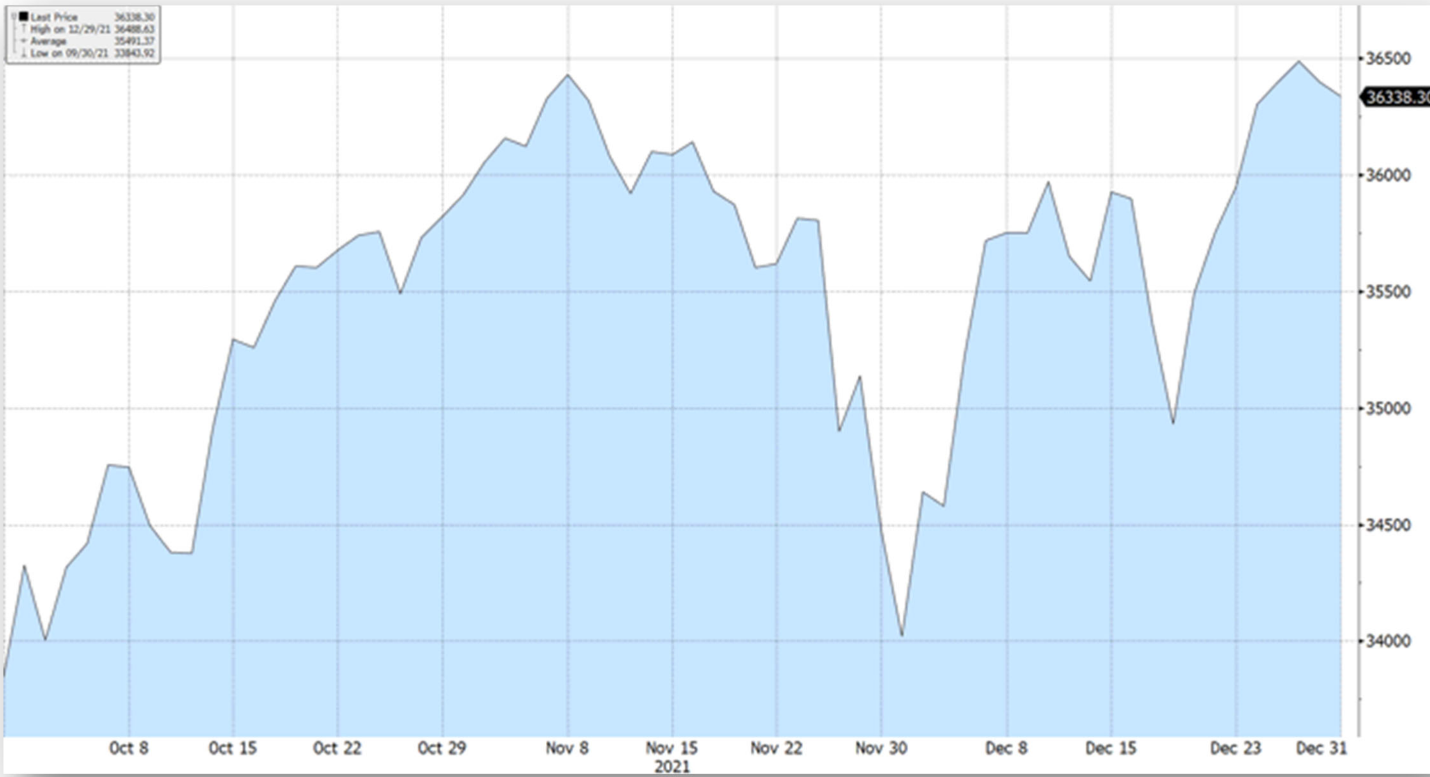


S&P 500 Index

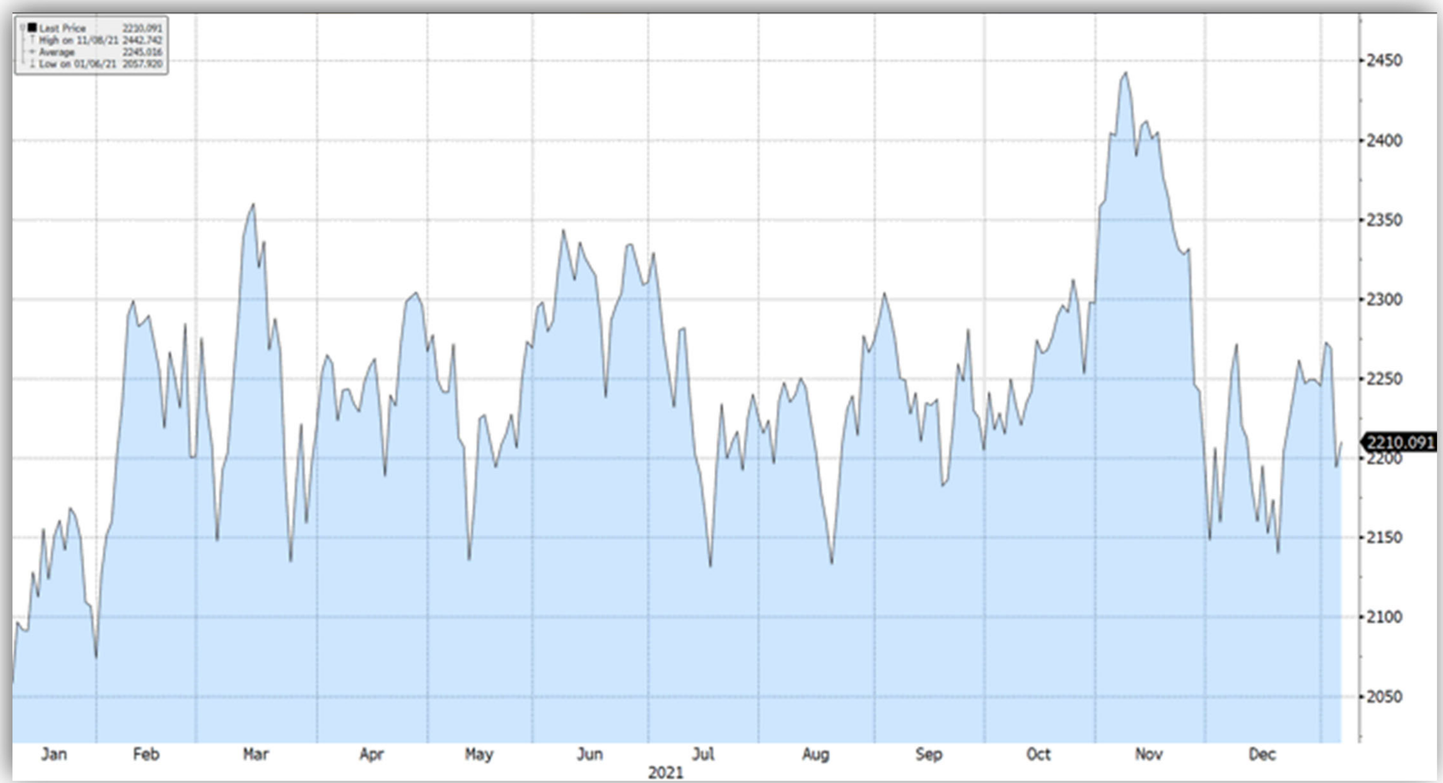


Last Price 4766.18
High on 12/29/21 4793.06
Average 4597.58
Low on 10/04/21 4300.46
4766.18
4800
4700
4600
4500
4400
4300
Oct 8
Oct 15
Oct 22
Oct 29
Nov 8
Nov 15
2021
Nov 22
Nov 30
Dec 8
Dec 15
Dec 23
Dec 31

Dow Jones Industrial Average



Russell 2000 Index



Disclosures

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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