The Insurance perspective

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Economic Commentary

Volatility and uncertainty defined the first quarter of 2022, two words that markets scorn. Investors are facing concerns including Russia's invasion of Ukraine, continued inflationary pressures, the rate hiking cycle, and the Fed's plan to reduce their balance sheet. Inflation data shows that CPI rose 7.9% year-over-year, the highest inflation since January of 1982. The Fed's continual tightening of monetary policy to combat elevated inflation will have a significant impact on the economic outlay of the rest of 2022.

Federal Reserve

The Federal Reserve kicked off its hiking cycle with a quarter-point increase to the Fed Funds Rate in March, the first-rate hike since 2018, and signaled hikes at all six remaining meetings this year. On the Fed's dot plot, officials' median projections were for the target rate to end 2022 at 1.875% and rise to 2.75% in 2023. Additionally, minutes of the Fed's March meeting revealed that officials "generally agreed" to shrink the size of its nearly $9 trillion balance sheet by up to $95 billion per month, beginning as soon as their May 4th meeting. The Fed's quantitative tightening has driven Treasuries to their worst quarter in decades, down 5.58% YTD, as investors prepare for a series of aggressive rate hikes throughout the rest of the year. Powell repeatedly stated the committee was committed to curbing high inflation and stressing the goal of a soft landing for the economy. The FOMC, which until recently was insistent that high inflation was transitory, now sees inflation running above the target rate with 2.7% inflation at the end of 2023 and 2.3% at the end of 2024.

Domestic Fixed Income Market

Throughout the quarter, yields on US Treasuries stepped up aggressively, with the 2-year and 10-year yields rising 160 and 83 basis points, respectively. The dramatic selloff has led to steep drop-offs in market values of fixed-income securities, posing significant challenges for total return investors. Hold to maturity investors, such as insurers, are realizing higher yields on new purchases, and increasing cashflows to support their products. Notably, the 5-year/30-year yield curve spread inverted on March 28th, the first instance of this since 2006. The 2-year/10-year followed close behind on April 1st, inverting for the first time since 2019. Recessions have historically been preceded by inversions in the yield curve, although not all yield curve inversions have led to a recession. Past recessions have followed inversions by an average of 19 months, further fueling the Fed's need to be methodical in their monetary policy.

Domestic Equity Market

Quarter ending data does not fully depict the pullback equity markets experienced intra-quarter. The S&P 500 and NASDAQ Q1 returns were -4.9% and -9.1% respectively, while their quarter lows were over -12% and -19%.

The second half rebound was driven by an increase in buying pressure from both retail and institutional investors. Volatility saw growth stocks suffer worse than value as investors preferred safe assets this quarter. Corporate earnings had a strong recovery in 2021 and returned to pre-pandemic levels. We have yet to get a full picture of first quarter earnings as rising input costs and supply chain issues put increasing pressure on corporate bottom lines. So far though companies have successfully passed higher cost of materials and labor on to the end-consumer. In the past, equity markets have fared well in the short-term post inversion in the yield curve. Of the last four times the 2-year/10-year spreads inverted, the S&P 500 continued to trend upwards, peaking an average of 17 months later and returning an additional 28.8%.

Summary

All eyes will be on the Fed as they hike rates and reduce their balance sheet moving forward. The question remains of how close to their target inflation they will be able to get as they attempt to tighten the economy without sending it into a spiral. We will continue watching the Fed to see if the market has correctly priced in a more aggressive hiking cycle, along with the actions they take to reduce their balance sheet. In the meantime, the recent selloff has provided attractive yields ready to be capitalized on.

The Ongoing Saga of RMBS/CMBS Ratings

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Senior Investment Accountant

Since the financial crisis of 2007 the NAIC's Structured Securities Group and the NAIC's Valuation of Securities Task Force have been working on ways to assign ratings and apportion an appropriate amount to RBC and AVR (for life insurance companies). The breakpoint approach for RMBS and CMBS securities was first introduced in 2009. This methodology was applied to RMBS and CMBS securities and involved calculating a final intrinsic price, (defined as the weighted average of discounted principal losses, expressed as a percentage, reflecting the credit risk of the security), and the midpoint between two adjoining AVR RBC (pre-tax) charges. This made it so that different insurers could own the same CUSIP at different book prices and carry it at different NAIC designations because it considered the actual dollars at risk an insurer had. At the time this methodology was used, the economy provided opportunities for insurers to buy many of these products at a discount, so the risk of these securities was minimal. As the economy recovered, the trading price of RMBS and CMBS securities began to increase to near or above PAR and interest rates continued to fall. This prompted the NAIC to introduce a "No Loss" exception to the models. A "No Loss" security could be designated an NAIC 1 if it had a "zero loss" in any of the modeled scenarios presented and would be rated AAA to A under filing exempt rules, regardless of the security's book value.

When the world entered the Pandemic though, our economy saw another shift, and with that shift flaws in the developed methodology became apparent. In the early spring of 2020 interest rates fell dramatically and COVID 19 caused worldwide uncertainty. With these low interest rates many highly rated, conservative, and upper tranche CMBS and RMBS securities began trading at premiums. Under these circumstances, a security would take longer to get to the breakeven point as a "zero loss" security. Now that these securities did not qualify for zero loss treatment, they were subject to book adjusted carrying value price breakpoints, and securities purchased at a premium under this low interest rate economy had higher book values. Unintended consequences came to the forefront of conversations in working groups as anomalies arose in the breakpoint calculations due to the premiums being paid for high quality securities. Many securities with otherwise strong credit were being reported as NAIC 2, 3, and 4 simply because they were owned at a premium and not because of their credit risk. To address this, the NAIC began to divide RMBS and CMBS products into two groups, Legacy, and Non-legacy securities. The Legacy securities would be those that closed prior to January 1, 2013. These securities would continue to use the structured securities grid based on breakpoints as seen in prior years. However, Non-legacy securities (those that closed after January 1, 2013) would now need to be filed with the structured securities working group to receive a single designation on a CUSIP level provided by the NAIC. The hope was that moving away from the financial modeling price breakpoints process for Non-legacy securities would avoid market disruptions and provide a better assessment of credit risk.

The transition from price breakpoints reporting for RMBS and CMBS Non-legacy structured products to the single designation/designation category methodology had been discussed for quite some time, and most insurers were aware that the methodology would be changing. However, the NAIC's precise method of calculating the new ratings, as well as the new files showing the NAIC provided ratings were not available until after the 2021 year-end. At that time some insurers were a bit taken aback by the single designation/designation category assigned for certain RMBS CMBS products. For example, some CMBS securities that were rated a BBB- by ratings agencies and were purchased at a discounted price had been rated a NAIC 1 or 2 due to the price break point method in prior years. However, under the new single designation methodology, these ratings fell to NAIC 4 or 5 for 2021, even though the ratings provided by rating agencies still showed these investments as investment grade in multiple cases and the securities were paying monthly principal and interest payments. Thus, holding these securities increased an insurer's AVR and negatively impacted their RBC based on the new rating from the NAIC being lower, even though many of these products had no fundamental change in the securities themselves between the 2020 rating and the 2021 rating. Are we now seeing the other side of the coin with the dilemma of RMBS/CMBS ratings methodology? The goal in changing the rating methodology was to avoid market disruptions on securities simply because of the price at which the security was purchased. But will the transition in ratings methodology have a negative lasting impact on the demand for certain RMBS CMBS products, particularly those lower tranche CMBS bonds? Some examples of securities that had ratings fall to non-investment grade are listed below:

		NAIC Designation as of	**Single Rating as of**			**CRP Equivalent**
CUSIP	**Description**	**11/30/2021**	**12/31/21**	**Fitch**	**Kroll Rating**	**FE Rating**
17326FAL1	CGCMT 2017-C4 D3 10/12/2050	1.B FM	4.B	BBB	BBB+	2.B FE
065403AJ6	BANK 2019-BN17 D 3 4/15/2052	1.B FM	4.B	BBB	BBB+	2.B FE
95001XAL0	WFCM 2019-C50 E 3 5/15/2052	2.C FM	5.B	BBB-	BBB-	2.C FE

The shift in rating methodologies has many insurers looking for guidance on structured securities product ratings going forward. In an effort to be fully transparent, the NAIC has two primary sources for modeling methodologies and current reporting matters that may provide insight, the NAIC's Structured Securities Group webpage and the Valuation of Securities (E) Task Force (naic.org). The structured securities group webpage is where the methodologies, macroeconomic scenarios, proforma mid-year results release, and any material changes including relevant policy implementation are being communicated. Insurance companies are encouraged to check this site for any updates to existing policies as well as methodology analytics. The valuation of securities task force page will show public meeting schedules and current issues/materials being discussed by the regulators. Insurance companies are encouraged to check the task force meeting agendas and meeting minutes to keep abreast of any changes to current regulation.

While the long-term impacts of the new guidelines are yet to be seen, it is safe to say that the shift in methodology can, and has, taken a toll on some insurance companies. This could result in a decrease in demand not based on the risk of the product itself but based instead on a shift in policy. The NAIC's core function is to protect consumers and stabilize markets. As the long-term impact of the policy change sets in and the impact on the market is assessed, it will be important to monitor the NAIC website for any updates to current guidelines.

Interest Rate Spreads

As of: 3/31/2022

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	1.63	1.7467	0.1167	1.9035	0.2735	2.2706	0.6406	3.4923	1.8623
2yr	2.28	2.4173	0.1373	2.5151	0.2351	2.9034	0.6234	3.9419	1.6619
3yr	2.45	2.6258	0.1758	2.8251	0.3751	3.2428	0.7928	4.3516	1.9016
5yr	2.42	2.8439	0.4239	3.069	0.649	3.518	1.098	4.8673	2.4473
7yr	2.4	2.9958	0.5958	3.2165	0.8165	3.6885	1.2885	5.1695	2.7695
10yr	2.32	3.165	0.845	3.4031	1.0831	3.9025	1.5825	5.4447	3.1247
20yr	2.59	3.6121	1.0221	3.8245	1.2345	4.323	1.733	5.8837	3.2937
30yr	2.44	3.584	1.144	3.7043	1.2643	4.1126	1.6726	5.7698	3.3298

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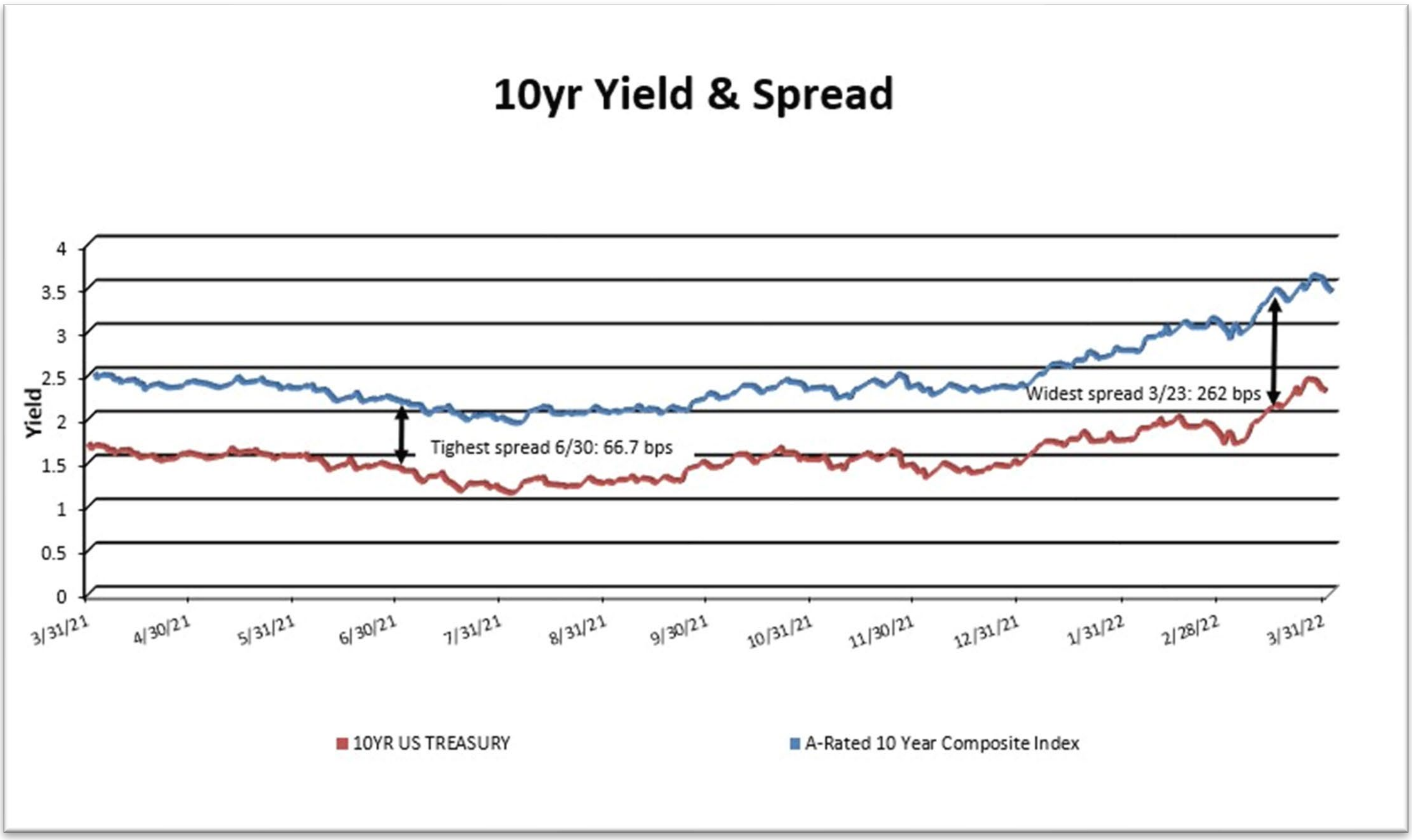
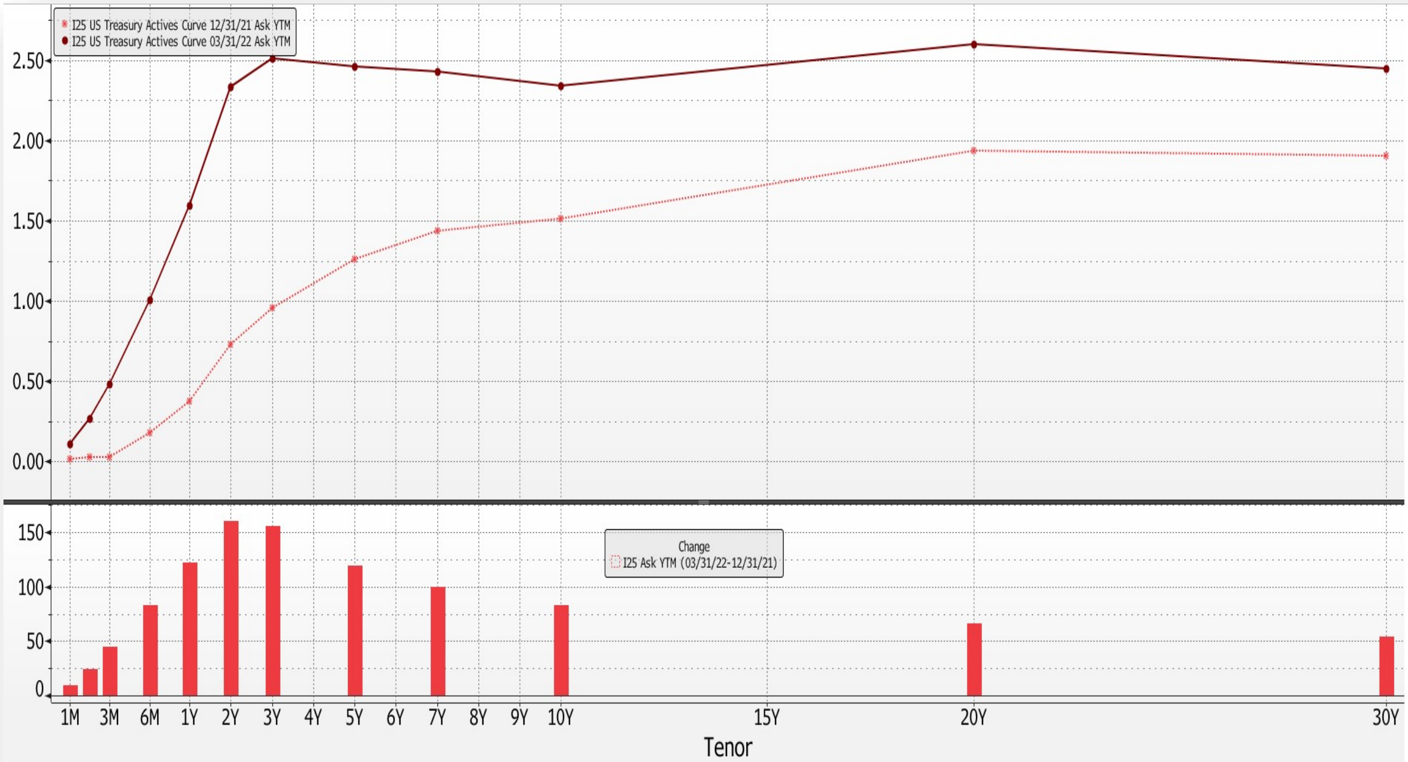
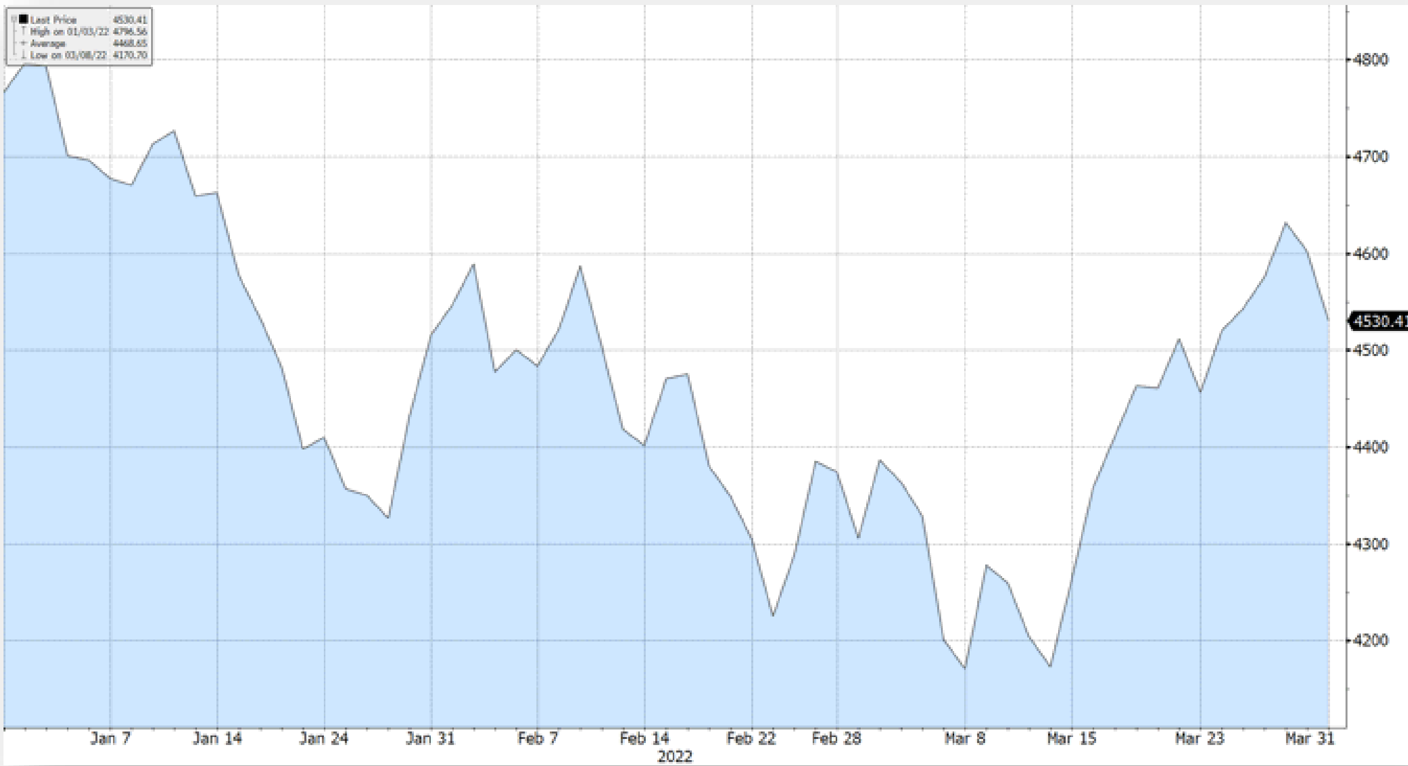


10yr Yield & Spread
Yield
4
3.5
3
2.5
2
1.5
1
0.5
0
3/31/21
4/30/21
5/31/21
6/30/21
7/31/21
8/31/21
9/30/21
10/31/21
11/30/21
12/31/21
1/31/22
2/28/22
3/31/22
Tighest spread 6/30: 66.7 bps
Widest spread 3/23: 262 bps
10YR US TREASURY
A-Rated 10 Year Composite Index

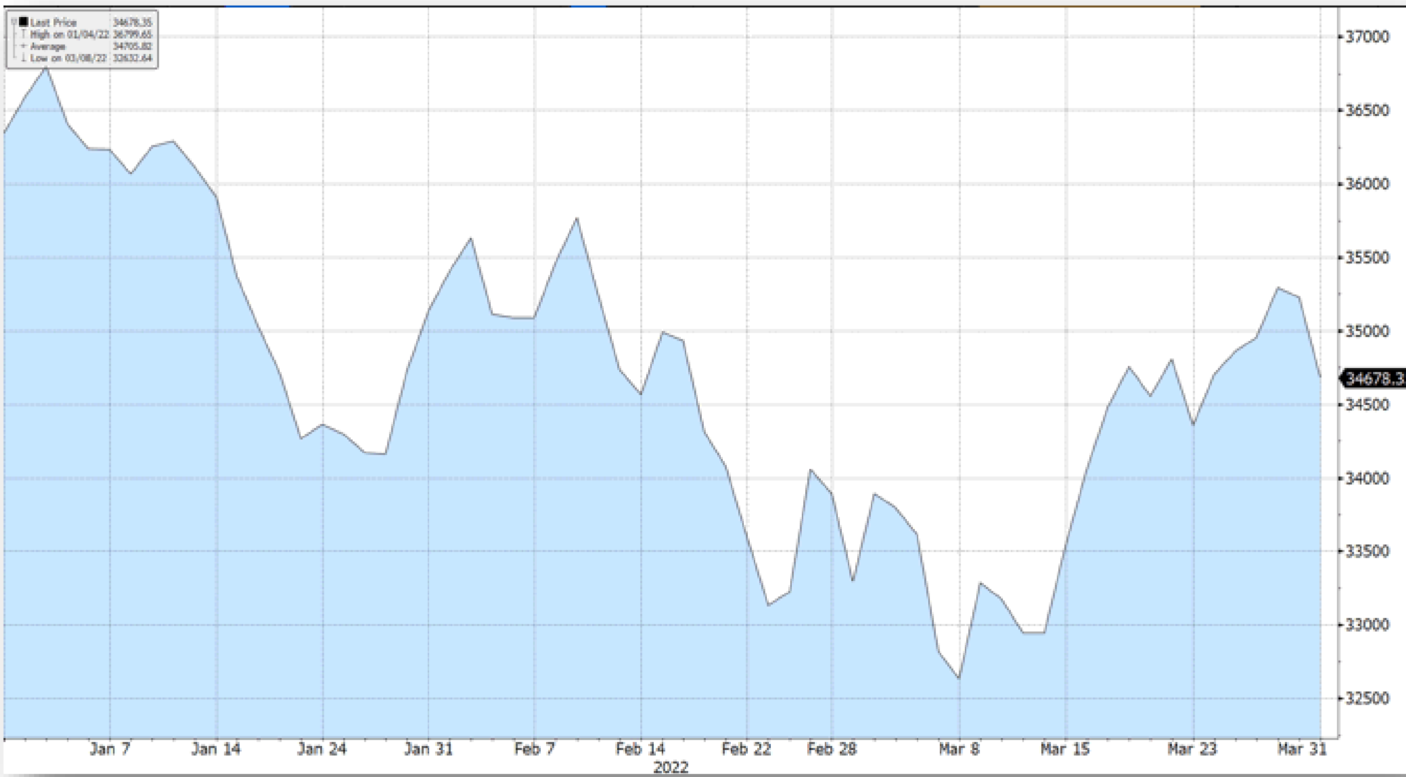
US Treasury Yield Curve



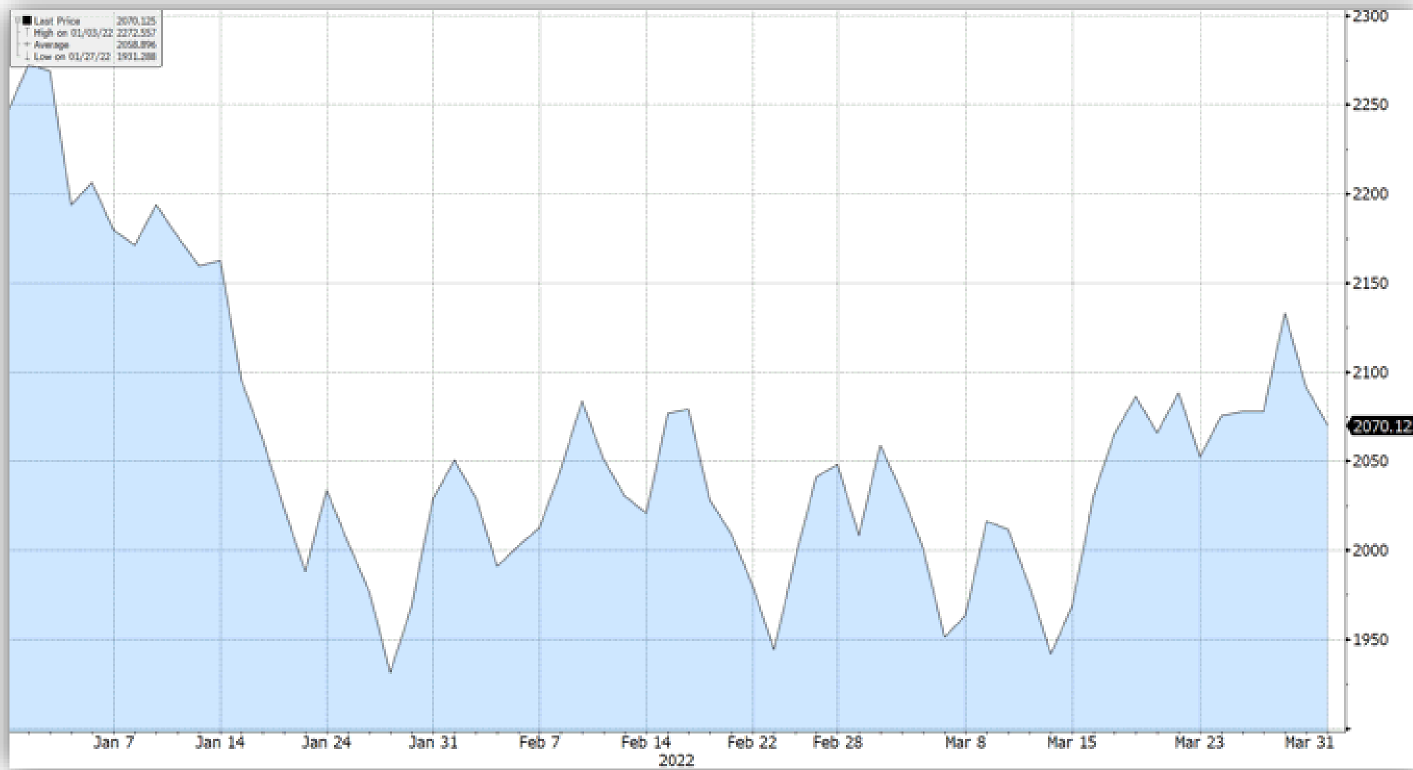
S&P 500 Index


4800
4700
4600
4530.41
4500
4400
4300
4200
Jan 7
Jan 14
Jan 24
Jan 31
Feb 7
Feb 14
2022
Feb 22
Feb 28
Mar 8
Mar 15
Mar 23
Mar 31

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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