The Insurance perspective

2022- Volume 25

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Economic Commentary

Much like the word "unprecedented" dominated our headlines a couple years ago, "volatility" is the current buzz word that depicts our market environment. The Fed's rate hikes and inflation concerns have driven bond yields higher, causing market values to fall. Equity investors are concerned over a potential recession as well as tightening monetary policy. While much is happening in the market, it's difficult to find someone who is enjoying this cycle except for income-focused investors who are enjoying the higher yield on new purchases.

Federal Reserve -The Federal Reserve met twice during the third quarter, hiking the fed funds rates by 75 basis points at each meeting. Jay Powell's Fed has proven to be very hawkish this year, fighting hard to overcome record high inflation levels. As of the September meeting, the dot plot shows the median participant expects the fed funds rate to be 4.4% at year-end. But where does it end? The market seems to have uncertainty about where the fed funds rate needs to be, which results in a sell off every time Powell speaks or the Fed hikes rates and warns of additional hikes to come. The current expectations are for a 75-basis point hike at the November meeting and another 50-basis point hike in December, which equates to a range of 4.25-4.50. Powell was very clear at his last address, stating the Fed is prepared to take rates into more restrictive territory. The primary takeaway from recent Fed meetings is how unified the committee is on the need for aggressive monetary policy as evidenced by their upward terminal rate adjustment.

Bonds - US Treasury yields continued their momentous increase, with the largest moves continuing to be on the short end of the curve. The three-month Treasury increased 162 basis points in the quarter, culminating a total increase of 322 basis points since the start of the year where it began at 0.03%. The yield curve continues to see inversion among various points. The traditionally watched measure of 2s to 10s inverted again in early July where it resided for the remainder of the third quarter. This means the 2-year Treasury offered a higher yield than the 10-year Treasury. Inversion of the yield curve has historically been a recession indicator and has proven to be quite reliable.

Equity - Fear has continued to lead the domestic equity market as sentiment remains negative and domestic stocks continue to fall. The vast increase in bond yields this year has created a difficult environment for stocks. After increasing over 17% from mid-June to mid-August, the S&P 500 Index fell almost 17% through the end of the third quarter, ending at the lowest point of the year. The Index has now remained under its 200-day moving average for one of the longest stretches since 2008. This resulted in domestic equity posting its worst performance since the financial crisis as selling pressure has taking over. The S&P 500 Index fell 4.89% in the third quarter, which marks a total decline of 23.88% year to date. While the NASDAQ fell only 3.9% during the third quarter, tech stocks have racked up almost 32% in losses this year. With the Fed's actions and inflation running hot, we expect general selling pressure to remain until the market has appropriately priced in expectations. Many economists are projecting a recession and some an elevated level of severity along with it, which creates additional downward pressure on the general market.

Summary - We will see if the aggressive monetary policy can help tame inflation, keeping an eye on any negative implications on unemployment. Recession is looming, if you don't consider the US to already be in a recession. Even the global economy is struggling, with the pound weakening to record levels near the end of the quarter. Inflation, the Fed's response, and the weakening economy will continue to keep our attention as we watch the impacts play out in both fixed income and equity. We do believe inflation has peaked but will likely remain elevated in coming months. We expect continued volatility as we wait for our country to admit we are in a recession.

Industry Insight
Are All Credit Ratings Equal?

At the end of last year, prior to the increase in interest rates, I wrote an article outlining several of the ways in which we saw insurers grasping for yield. While many of the tactics we have witnessed are prudent investments, including strategies that we have implemented on behalf of our clients, I want to extrapolate on one of the key risks that we are seeing and what the long-term effects of this strategy could be.

I have included a brief excerpt from the previous article which outlines one of the areas in which insurers are taking added risk and which will be the basis for our expanded analysis.

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. These bonds often carry an investment-grade 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 cap financial institutions that serve a niche market, such as 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.

As noted, there is nothing inherently wrong about securities that only maintain a rating by one agency; however, it is imperative to dig a little deeper and be cognizant of the long-term rating transitions. As we are most frequently seeing securities that are merely rated by Egan Jones, our analysis will focus upon their ratings and that of S&P.

In 2021, Egan Jones submitted their "2021 Form NRSRO Annual Certification." Within this report, they outline rating transitions and historic default rates by classification from 12/31/2010-12/31/2020. At the beginning of 2011, Egan Jones rated 830 corporate issuers, with ratings ranging from AAA-C. In aggregate, the largest number of their ratings carried an A-, BBB+, and BBB. When looking at these ratings over the stated 10-year period, the initial securities rated A-, BBB+, and BBB generally had a declining transition. At the end of the period, 12/31/2020, the A- bucket experienced a 1.2% default rate and 23.9% of the securities had deteriorated to non-investment grade. Similarly, those that had an initial rating of BBB+ and BBB had default rates of 0% and 1.2%. Furthermore, 20.2% of the initial BBB+ securities and 41.5% of the BBB securities fell to non-investment grade status by 12/31/2020.

	Egan Jones Rating Transitions																
	12/31/20 Rating																
12/31/2010 Rating	A-	BBB+	BBB	BBB-	BB+	BB	BB-	B+	B	B-	CCC+	CCC	CCC-	CC	C	Defaulted	Withdrawn
A-	10.70%	11.90%	11.90%	13.10%	7.10%	2.40%		3.60%	1.20%	4.80%	3.60%		1.20%			1.20%	26.10%
BBB+	4.80%	8.70%	17.30%	18.30%	5.80%	3.80%	2.90%	1.00%	1.90%	3.80%				1.00%		0.00%	29.70%
BBB	4.90%	13.40%	7.30%	9.80%	11.00%	9.80%	8.50%	3.70%	4.90%	2.40%			1.20%			1.20%	20.70%

It is imperative to note that the experienced defaults were minimal during this 10-year period; however, the rating transitions were supremely negative. While it is not uncommon for there to be rating transitions over a decade, it is rather surprising to see this level of negative movement, especially in the BBB ratings, in which 41.5% of the securities became non-investment grade. What compounds these effects is that these adverse trends occurred in direct correlation with the longest period of economic expansion in US history. This means that despite the greatest economy recorded, a large number of securities that initially maintained investment grade status fell to high-yield credit.

As disseminated by S&P Global, the average 10-year corporate transition rates from 1981-2021, have a starkly different outcome than that of Egan Jones. On average, during this 40-year period, bonds that carried an A rating (A+, A, A-), 4.11% became non-investment grade over a 10-year period, while 1.85% experienced a default. When analyzing the BBB rated securities (BBB+, BBB, BBB-), 9.63% drifted to non-investment grade status, while 4.46% realized a default, which is higher than that of Egan Jones. However, while each of these transition studies, published by the respective firms, are over a 10-year period, they cover differing years. As noted, Egan Jones transitions were from 2010-2020, while S&P's study was from 1981-2021. This is important to recognize because S&P's date range includes several economic recessions, including the Great Recession, while Egan Jones range only includes the best decade of economic growth in US history.

	Average 10-Year S&P Rating Transitions (1981-2021)						
	10-Year Transition						
Initial Rating	A	BBB	BB	B	CCC/C	Defaulted	NR
A (NAIC 1)	38.49%	17.44%	2.86%	1.07%	0.18%	1.85%	33.13%
BBB (NAIC 2)	11.16%	36.57%	6.91%	2.54%	0.18%	4.46%	37.46%

Now that we have outlined the data, it is important to remember that past performance does necessarily correlate to the future. Given that, it is possible that each of these rating agencies have gotten better at predicting future financial performance and have aptly applied a more correct rating, specifically that of Egan Jones. However, our concern with the propensity of insurers to over-allocate to certain asset classes/rating agencies, is in our belief that the sustained period of low-interest rates has created many "zombie companies." Zombie companies, as often described by David Trainer, CEO of investment firm New Constructs, are companies that have over-levered themselves given the low interest rate environment and have considerable headwinds in maintaining their going concern. This is one of the downfalls of prolonged low rates, it allows unviable companies to stay afloat via the use of leverage. If interest rates continue to rise, or even stay at these levels, many of the firms that have gorged on leverage over the past decade will have issues repaying their debt, as they will be unable to simply refinance.

As we noted, Parkway has invested in several securities that are singularly rated by Egan Jones, without the commensurate rating of a more established rating agency like Moody's/S&P/Fitch. However, as is often the case, moderation is paramount. As we have seen, Egan Jones does have a higher propensity for rating transitions than that of S&P, which could erode balance sheets with higher AVR, or future defaults. That does not necessarily mean that insurers should completely avoid buying securities rated by Egan Jones, as these assets generally have yielded more than the wider bond market, but it is in an insurers best-interest to enact more stringent diversification on these securities. As we believe that these securities have elevated risk, some of this risk is unsystematic, thus it can be diversified to reduce the threat. When looking to purchase these assets, our recommendation would be to set maximum allocations as well as purchase smaller pieces than what is typically bought. Finally, while it is imperative to always execute sound due diligence when purchasing a security, the need is even more paramount when looking to invest in securities that are singularly rated.

NAIC Updates

Changes for 2022 Year End & What's on the Horizon for 2023

With year-end right around the corner, there are a few changes relating to investment reporting to be aware of. One of those changes arose during the principles-based definition of bonds project. As part of the discussions on this project it was identified that some entities were reporting residual tranches on Schedule D while other entities were reporting these residual tranches on Schedule BA. A residual tranche is similar to a Z tranche in that these tranches receive what is left over after satisfying all other claims against the underlying cash flow. However, unlike a Z tranche the residual serves only as the equity in the CMO. The residual has no stated face value or interest rate, but you receive any cashflows that remain after the cash flow obligations to other tranches are paid. For year-end 2022, any residual tranche investments will need to be reported on Schedule BA to ensure consistent reporting moving forward.

Another change for 2022 reporting is the modeling of Legacy securities. For year-end any Legacy MBS (issued prior to 1/1/2013) will still be modeled, however, with the expansion of the NAIC Ratings modifier list there is a need to increase the breakpoints for each NAIC ratings modifier. There will be 19 breakpoints in the modeling file for each filing type (AVR and Non AVR) for securities that are not zero loss securities. Securities issued since 2012 will still have a single rating.

A final point of interest for year-end reporting 2022 is related party reporting. Originally this wasn't going to change until 2023, but one change has now been slipped in for year-end 2022. This change was in response to recent discussions on reporting and disclosures requirements for investments with related parties. A new electronic only column will be added for year end and each security within a portfolio will need to have a number assigned to it (1-6 as outlined below). Most securities will be "No related party exposure", which is a 6 in the new electronic column, but if the portfolio has an investment that is with a related party, you need to decide how that exposure needs to be reported. The options for this are below:

1. Direct credit exposure
2. 50% or more exposure
3. Less than 50% Exposure
4. In-substance exposure
5. Exposure not 1-4 above
6. No related party exposure

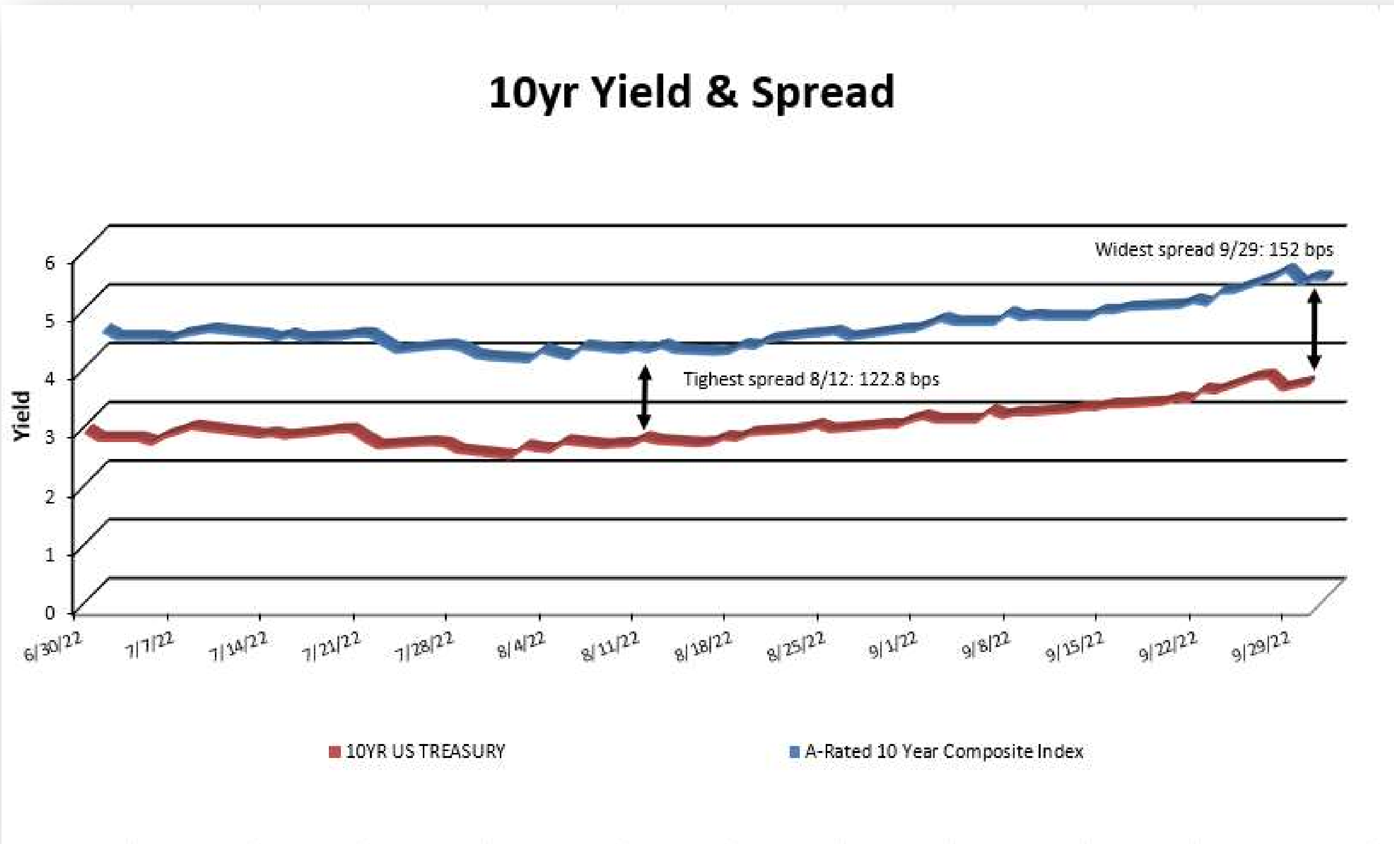
Something to keep your eyes on in 2023 is the discussions around the rating process of CLO's. At the June 9th meeting, the VOS (E) task force exposed a memo calling for an internal modeling of CLO's as well as extended designation categories 6.A, 6.B and 6.C. Responses to this memo have been summarized as cautious. NAIC staff's responses to these concerns can be found at 2022-004.02 CLO Response SMN 2022 vF.pdf (naic.org). Just as with the discussions around the ratings of RMBS/CMBS, there is sure to be at length discussions in the coming year and opportunities for industry's input as the framework of this potential change in ratings methodology of CLOs is hashed out. Some of the responses were supportive with caveats, but most of the other responses indicated concern about the proposal and the implications of it. The concerns from Industry were around the timeline and opportunity for comments, policy arguments about the importance of CLOs to the U.S. Financial markets and the historical performance of CLOs, transparency, and methodology. For any future updates on the risk assessment and rating process of CLO's please see the NAIC website at NAIC - Supporting Insurance, Regulators, & Public Interest.

Interest Rate Spreads

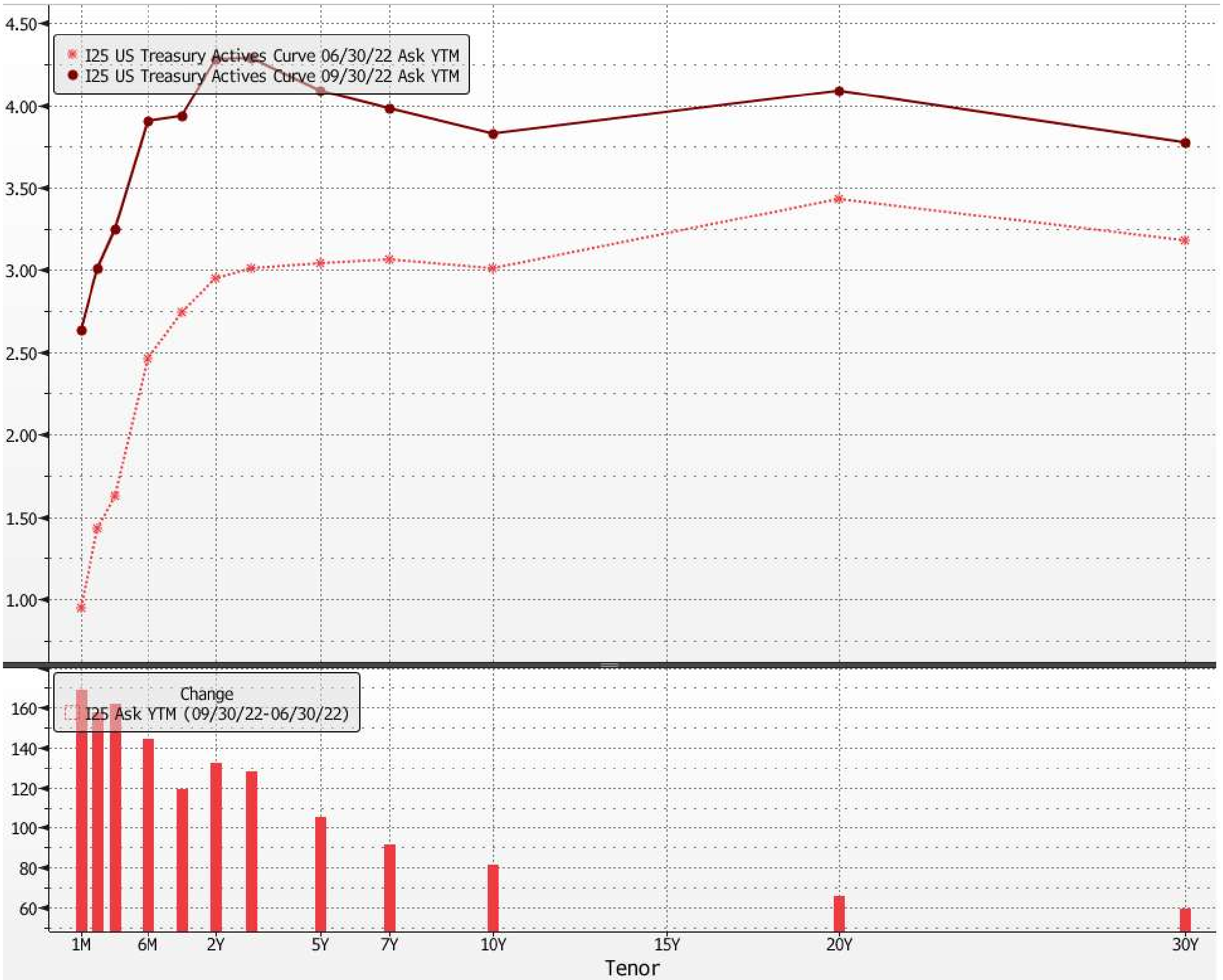
As of: 9/30/2022

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	4.05	4.3477	0.2977	4.5001	0.4501	4.9676	0.9176	6.3887	2.3387
2yr	4.22	4.5067	0.2867	4.7457	0.5257	5.3062	1.0862	6.8952	2.6752
3yr	4.25	4.5765	0.3265	4.8541	0.6041	5.4517	1.2017	7.1973	2.9473
5yr	4.06	4.6925	0.6325	5.0057	0.9457	5.6755	1.6155	7.5267	3.4667
7yr	3.97	4.7892	0.8192	5.129	1.159	5.86	1.89	7.7219	3.7519
10yr	3.83	4.9308	1.1008	5.3024	1.4724	6.0424	2.2124	7.881	4.051
20yr	4.08	5.2421	1.1621	5.6136	1.5336	6.2387	2.1587	8.0884	4.0084
30yr	3.79	5.208	1.418	5.3926	1.6026	5.9176	2.1276	7.7757	3.9857

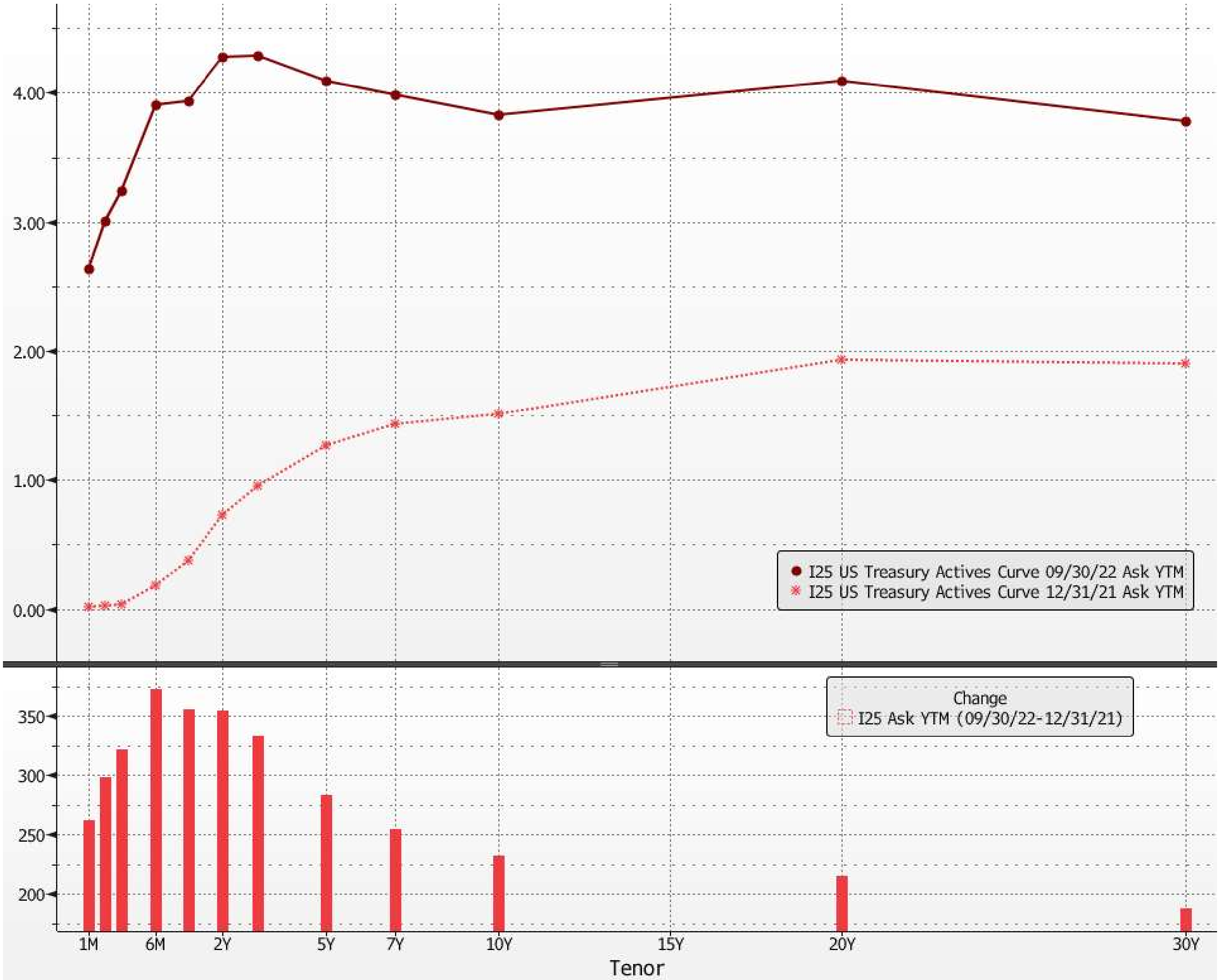
Disclosures: This material is for your use only and is based upon information which we consider reliable, but we do not represent that it is accurate or complete and should not be relied upon as such. Information was obtained from Blooomberg and represents the respective Bloomberg US Composite BVAL and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


10yr Yield & Spread
Widest spread 9/29: 152 bps
Tighest spread 8/12: 122.8 bps
Yield
0
1
2
3
4
5
6
6/30/22
7/7/22
7/14/22
7/21/22
7/28/22
8/4/22
8/11/22
8/18/22
8/25/22
9/1/22
9/8/22
9/15/22
9/22/22
9/29/22
10YR US TREASURY
A-Rated 10 Year Composite Index

US Treasury Yield Curve 3rd Quarter



US Treasury Yield Curve YTD



S&P 500 Index

Last Price 3585.62
High on 08/16/22 4305.20
Average 3977.35
Low on 09/30/22 3585.62
4300
4200
4100
4000
3900
3800
3700
3585.62
Jul 15
Jul 29
Aug 15
Aug 31
Sep 15
Sep 30
2022

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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