The Insurance *perspective*

2023- Volume 27

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Economic Commentary

After double digit declines across the majority of asset classes in 2022, the start of 2023 was initially marked with optimism. The biggest contributor of this confidence was the market's perception of the Fed nearing an end of its aggressive hiking cycle, a constant theme throughout 2022, amid falling inflation numbers and resolutions within the supply chain and inventory woes. However, another staple of 2022 remained constant, volatility, emerging from concerns over the stability of the banking system. A new theme is a divergence in signals across asset classes, with equities pointing to a more favorable outcome economically, while the fixed income market points to more potential pain on the horizon.

Domestic Fixed Income Markets

The yield curve continued its inversion trend during the first quarter with Treasury yields inside 1-year increasing, while longer duration yields fell amid recession concerns. This marks the fourth quarter of inverted yields and steepest inversion since the early 1980's, with the 10-year earning 1.07% less than the 2-year Treasury at its peak during the quarter. However, a "flight to quality" occurred after systemic issues within the banking sector emerged, leading to substantial demand for Treasuries, driving prices up and yields down. Most notably, after hitting a high of 5.05% on March 8, the 2-year Treasury fell to 3.76% by March 24. At one point during the freefall, it recorded the steepest three-day decline since the stock market crash of 1987. Other notable moves include the 1-month Treasury, which rose 43 basis points to finish the quarter at 4.40%, while the 3-, 5-, and 7-year Treasuries all fell 43 basis points, finishing the quarter at 3.79%, 3.57%, and 3.53% respectively. Credit spreads, which represent the additional yield corporate or municipal bonds earn above a Treasury, widened throughout the quarter as fixed income investors sought quality, a common theme when uncertainty is on the horizon and a "risk off" mentality becomes prominent.

Domestic Equity Market

The broad market started the year solid as it looked towards the potential end of the Fed hiking cycle with strong labor markets and subsequently a strong consumer. While issues within the financial sector rocked headlines, fortunately the Fed's implied backstop to support consumers deposits at failing banks helped quell a larger systemic "run on the banks" which could have had a substantial negative impact on the broader equity markets. Subsequently, the S&P 500 increased 7.48% during the first quarter after being down 18.33% in 2022. The Nasdaq, which is comprised of more interest rate sensitive growth stocks was up 17.05% after losing 32.93% in 2022. However, the Russell 2000, which represents smaller domestic companies that are more sensitive to economic cycles only increased 2.73%. Additionally, after leading 2022 returns amid the highest inflation in over 40 years, the energy sector was the worst performing sector as oil prices dipped to their lowest level since 2021 amid concerns over a pending economic slowdown. Interestingly enough, copper, which is a common manufacturing input thus an economic gauge, ended the quarter up 9%, further supporting the "mixed signal" narrative.

Federal Reserve

After the equivalent of seventeen 25 basis point hikes in 2022, the Fed only hiked rates twice during the first quarter during its February and March meetings, bringing the Federal Funds rate to the 4.75-5% range. Expectations for future hikes remain extremely volatile, with the Fed finding itself in a difficult predicament. On one hand, if they do not continue to raise rates or employ restrictive monetary policy, there could be a resurgence of inflation, which already appeared stickier than expected in the February economic data. However, broader economic impacts of the aggressive hiking cycle have appeared, namely cracks in the banking system and slowing growth within the labor markets. Employers only added 236,000 jobs in March compared to 326,000 in February. Additional unnecessary hikes could lead to a "hard landing," an outcome equally as unpalatable as lingering inflation. At the end of the quarter, futures were pricing just a 57% chance of one additional hike in 2023, with upwards of two cuts occurring in the second half of the year. However, Powell has indicated that he does not foresee any cuts occurring this year, further complicating the outlook and setting up scenarios for further volatility.

Summary

With inflation no longer continuing its upward trend, many have viewed fixed income as the more attractive asset class as yields remain at levels not seen in decades. The U.S. is likely in a late-cycle expansion phase, which typically means a recession is next on the horizon. Additionally, as fixed income generally performs well within a recession phase, this helps explain the recent shift to longer term Treasuries despite shorter term yields offering a higher yield. However, it is hard to justify the case of a deep prolonged recession at a 3.5% unemployment rate with employers hiring above the long-term monthly average, even despite the recent slowdown. With employment still running strong, this will further complicate the inflation hurdle as companies are forced to hire at higher wages to attract and retain talent. As long as this occurs, prices will most likely remain elevated supporting the Fed's narrative of "no cuts" in 2023. That being the case, the forward-looking equity market may have gotten ahead of itself and subject to a "come to Jesus" moment when the Fed does not cut. While we do anticipate a longer-term trend of falling yields and increasing equity prices, there remains a heightened probability of high volatility.

Industry Insight

What is going on with Regional Banks?

Bank failures caused a large stress on the financial sector last month exposing issues within regional banking. These banking issues in the U.S. began with the collapse of Silicon Valley Bank (SIVB), which was closed by regulators as depositors pulled tens of billions of dollars from the bank.

Following the collapse, investors posed the question, “is this a banking crisis or is the market operating on sentiment?” Contagion became an added risk as customers began to rush to withdraw large amounts of their deposits across other local regional banks in favor of larger institutions.

What happened?

US Regulators stepped into the headquarters of SVIB on the morning of March 10th where they closed the bank due to a large “run on money.” Two days later, a smaller Signature Bank was also closed by regulators. Shortly thereafter, Swiss regulators brokered the sale of European bank, Credit Suisse, to UBS.

Another regional bank, First Republic Bank, began to get hit hard during the collapse of its peers with the stock declining 61.8% on March 13th. JPMorgan amongst others stepped in and deposited $30 billion as a capital injection to assist in preventing the failure.

Why did this happen?

Although different in makeup, Silicon Valley Bank and Signature Bank failed for the same reasons. These banks experienced risk management issues with traditional assets. Over the course of the previous several years, the bank positioned assets in long-term bonds to seek the highest yield offered at the time. Due to the inverse relationship between bond values and yields, the Fed raising rates drove values down creating large unrealized losses. Whenever customers began the run on money, the bank was forced to sell these bonds to create the liquidity needed to provide the customers with their funds, realizing large losses.

Credit Suisse, one of Switzerland’s leading financial institutions, was among a group of 30 banks known as globally systematically important, and a full collapse might have devastated the global financial

(Industry Insight cont'd)

system. Credit Suisse had been plagued with issues over the previous several years, initially stemming from the collapse of the US family investment fund Archegos Capital, and more recently by consumer withdrawals following SIVB and Signature's collapse. Many of these concerns were cleared following the purchase of Credit Suisse by UBS which boosts liquidity ratios to a healthy level.

Is this a repeat of 2008?

Banking failures cause investors to reminisce on the 2008 financial crisis. While banks have failed and the market is currently experiencing a crisis, these failures have occurred for different reasons. For the US to undergo a 2008 type banking crisis, banks would have to experience a sharp deterioration in collateral values. Unlike the early 2000s, US banks have a limited exposure to sub-prime mortgages, household debt levels remain low, and capital ratios for systemically important banks are well above regulatory minimums. Additionally, banks are more liquid currently than in 2008.

Vastly different than 2008 and traditional banking, SIVB assets were very heavily weighted in bonds rather than in loans as seen in traditional banking. Additionally, SIVB's customer base was very undiversified being made up primarily of venture capitalists and startup tech companies.

Although different from 2008, smaller regional banks still face risks. The key source of vulnerability is not their investment decisions, but their lending portfolio. Regional banks account for 67% of all commercial real estate loans, a sector which potentially faces headwinds amid low office occupancy rates in regions such as New York and California, and a high interest rate environment.

What will the market see going forward?

There is no doubt that the pressure on regional banks has created ripples in the US Economy that will take some time to smooth out. These include changes to depository activity within banks and investment firms, the banking industry's appetite for lending and the Fed's approach of tightened monetary policy.

Deposit activity has shifted following the bank collapses, leaving customers and investors concerned over their deposits' safety. The industry has seen customers withdrawing deposits to store under the mattress, spreading their deposits across various banks and accounts to structure for insurance purposes, or even moving their deposits into money market fund accounts in the market. During March alone, depositors pulled just over $300 billion from domestic banks, according to seasonally adjusted Federal Reserve data. At the same time, JPMorgan estimates that money market mutual funds saw about $360 billion in inflows from investors.

This ongoing deposit flight has created a problem for banks that have to maintain capital ratios. In the current case, the situation has seen banks dip into reserves to cover their capital requirements, sell long-duration bonds at losses like SIVB and Signature, and maintain their liquidity by all means necessary.

(Industry Insight cont'd)

With the reduced liquidity available and tightened capital ratios, banks have been forced to tighten their lending efforts for various reasons; including the clear decreased availability of funds and to maintain adequate capital ratios. These recent runs on money were not the beginning of the tightened lending market however. As the Fed Funds rate has risen over the previous year, the internal loan rates of banks have risen, causing tightened capital ratios, resulting in banks holding their funds to lend to their top customers.

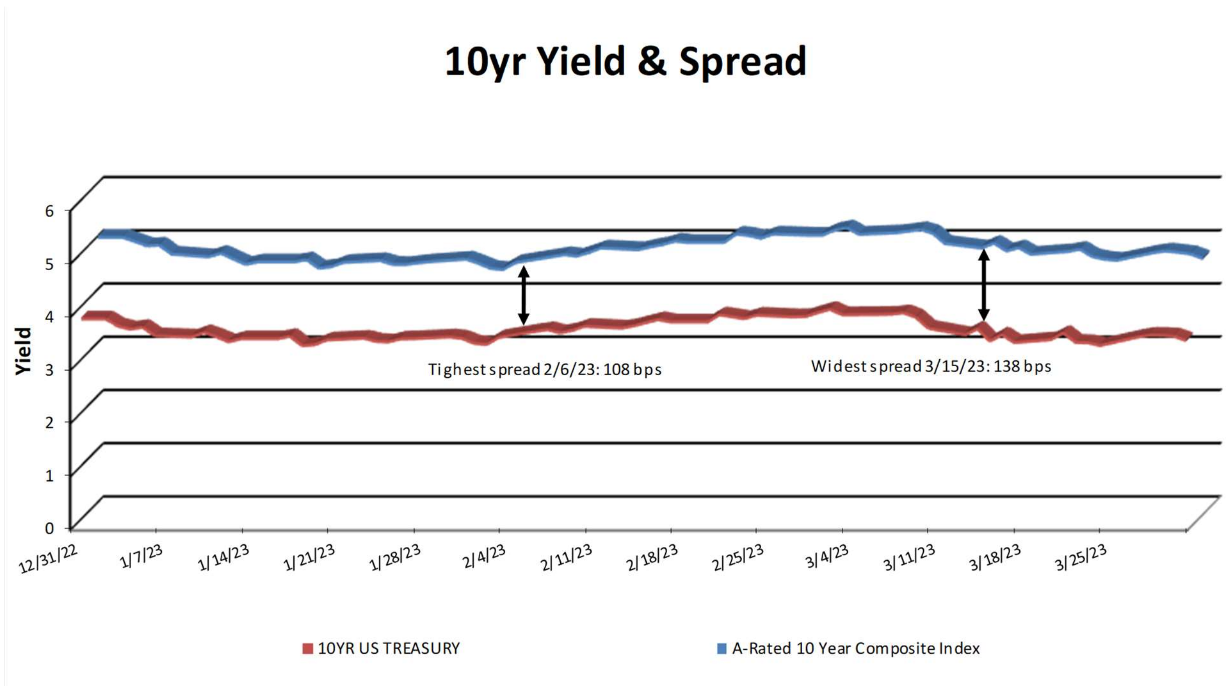
When considering these effects to banks and their customers, the market also realizes this pressure. As a result, some state that these banking challenges effectively priced in the equivalent of two to six interest rate hikes (50-150 bps), changing the way the Fed should view further tightening monetary policy to combat inflation. The Fed was tasked with a hard decision during the March meeting – to continue to raise rates aggressively as inflation remains high or to slow down hikes due to these mentioned banking issues. Many were concerned that if the Fed did not raise rates, that would reflect a high level of concern with the banking industry, further contributing to contagion. As a result, the Fed slowed rate hikes by only raising the Fed funds rate 25 bps in March.

Interest Rate Spreads

As of: 3/31/2023

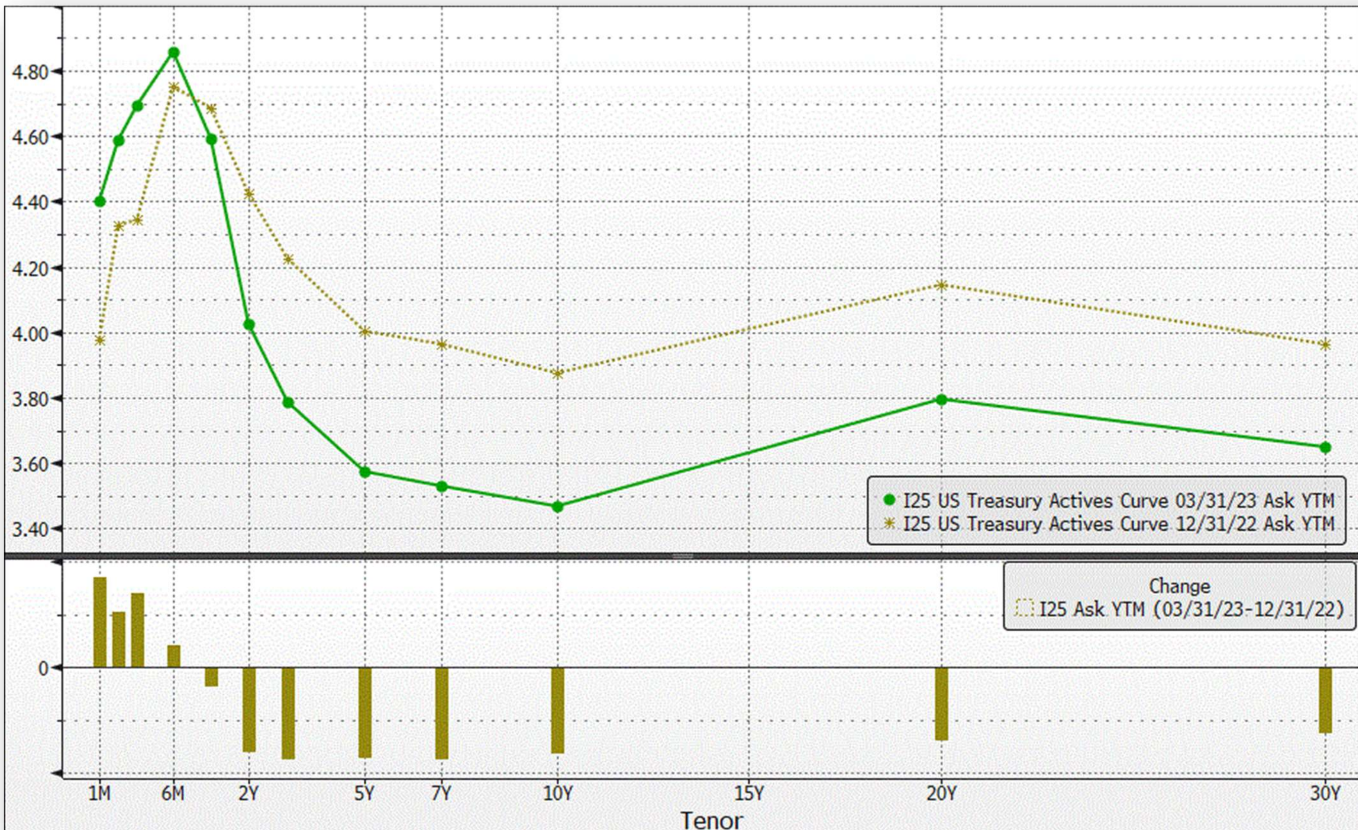
Term	Treasury Yield	US Composite BVAL AA Curve Yield	Spread	US Composite BVAL A Curve Yield	Spread	US Composite BVAL BBB Curve Yield	Spread	US Composite BVAL BB Curve Yield	Spread
1yr	4.64	4.6031	-0.0369	4.8641	0.2241	5.3423	0.7023	6.0384	1.3984
2yr	4.06	4.3776	0.3176	4.641	0.581	5.1663	1.1063	6.2492	2.1892
3yr	3.81	4.2186	0.4086	4.4858	0.6758	5.0608	1.2508	6.2879	2.4779
5yr	3.6	4.1267	0.5267	4.4301	0.8301	5.0356	1.4356	6.4455	2.8455
7yr	3.55	4.1616	0.6116	4.5167	0.9667	5.1246	1.5746	6.6054	3.0554
10yr	3.48	4.2745	0.7945	4.6931	1.2131	5.2859	1.8059	6.8377	3.3577
20yr	3.81	4.7381	0.9281	5.1111	1.3011	5.6002	1.7902	7.2574	3.4474
30yr	3.67	4.7546	1.0846	5.0015	1.3315	5.4597	1.7897	7.0164	3.3464

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.

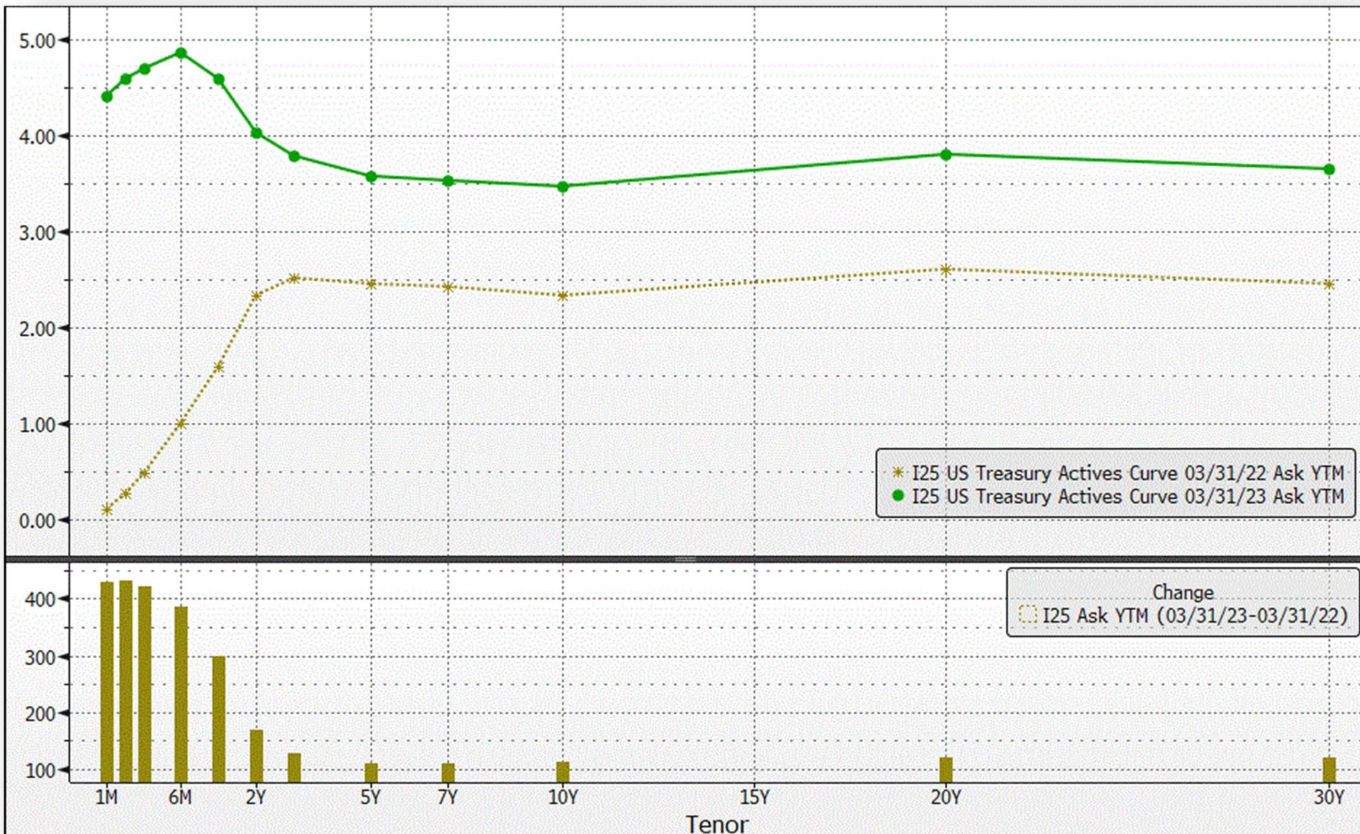


10yr Yield & Spread
Yield
6
5
4
3
2
1
0
12/31/22
1/7/23
1/14/23
1/21/23
1/28/23
2/4/23
2/11/23
2/18/23
2/25/23
3/4/23
3/11/23
3/18/23
3/25/23
Tighest spread 2/6/23: 108 bps
Widest spread 3/15/23: 138 bps
10YR US TREASURY
A-Rated 10 Year Composite Index

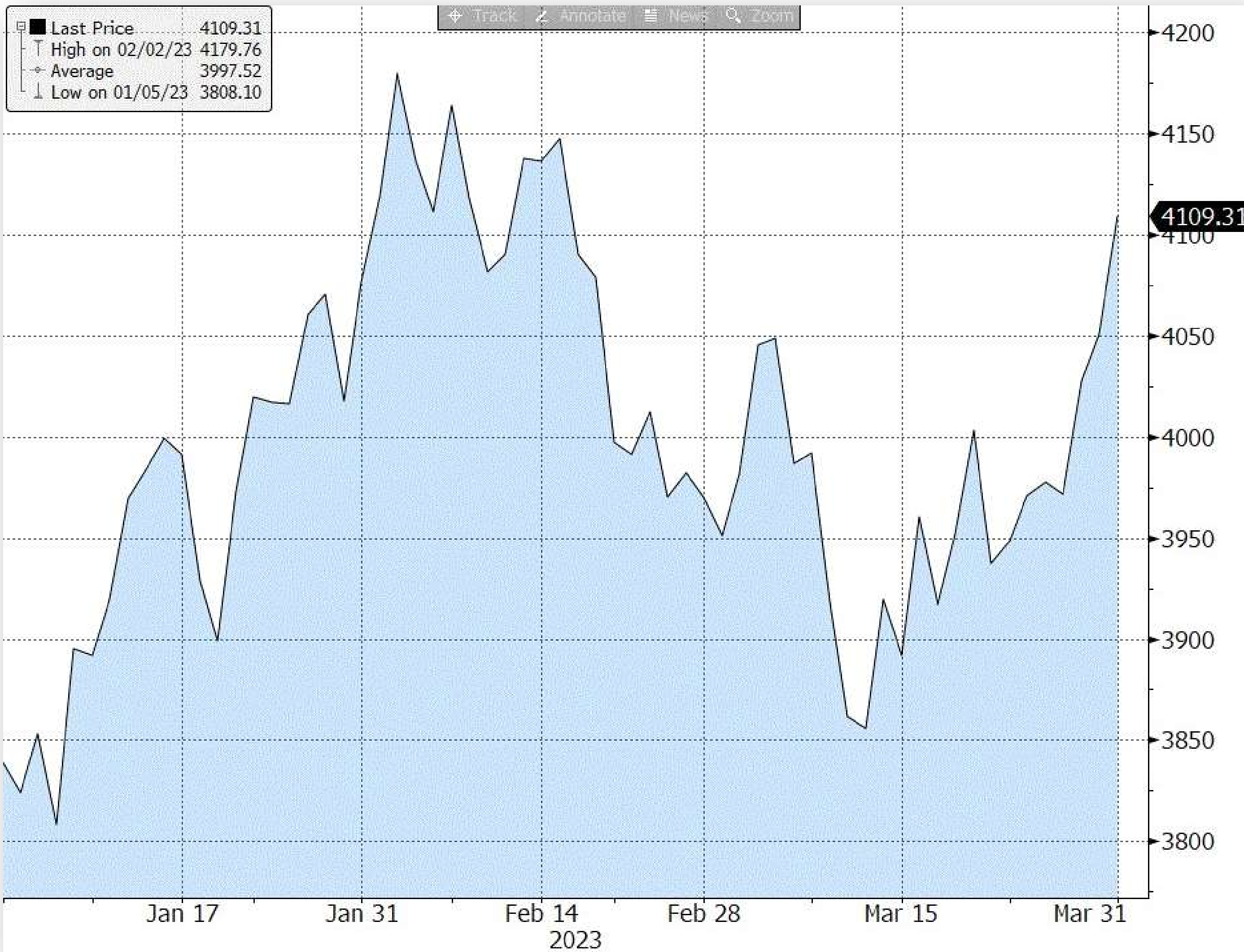
US Treasury Yield Curve 1st Quarter



US Treasury Yield Curve YTD



S&P 500 Index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High on 02/02/23 4179.76
Average 3997.52
Low on 01/05/23 3808.10
Track Annotate News Zoom
4200
4150
4109.31
4100
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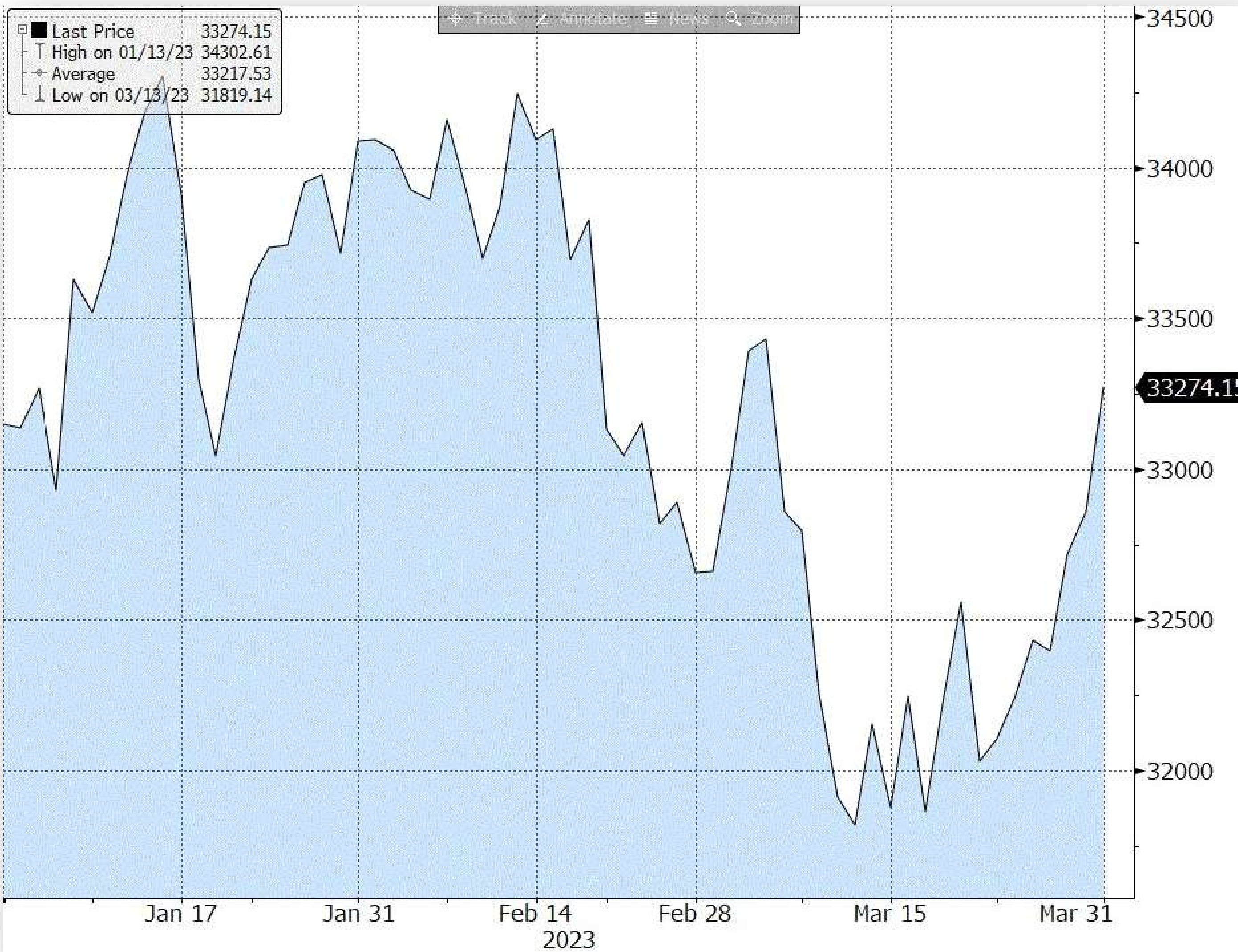
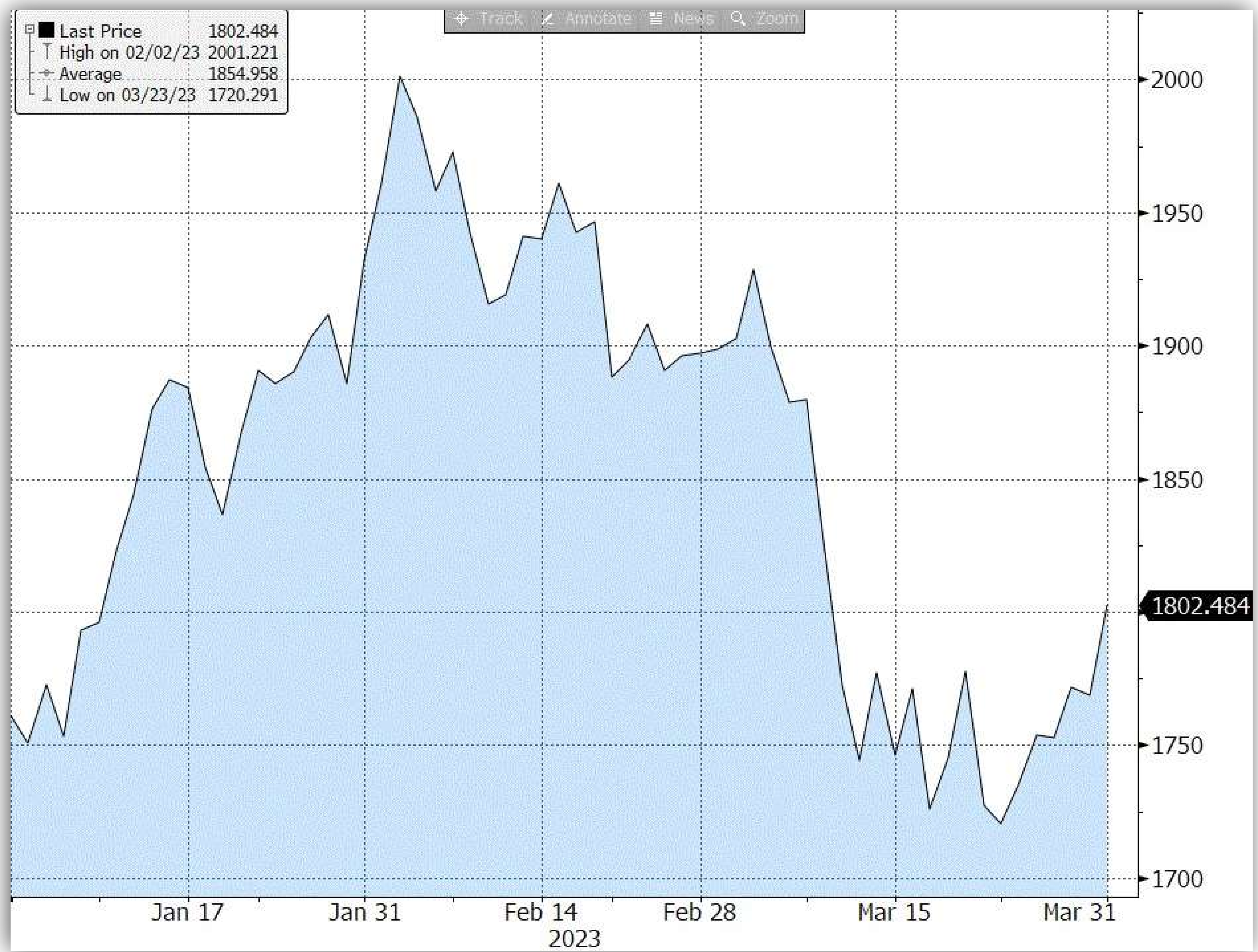
3900
3850
3800
Jan 17
Jan 31
Feb 14
Feb 28
Mar 15
Mar 31
2023

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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