# The Insurance perspective

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# Economic Commentary


The Federal Reserve's pause in rate hikes was a welcomed change in the second quarter after an aggressive tightening cycle that began in 2022. Throughout the quarter, market volatility calmed as fears over contagion and weakness in the regional banking market eased. Equity was the clear winner this quarter due to a tech-driven rally finishing off a very strong first half of the year. Investors have faced more pain in the fixed income markets as rates continue to rise across the curve, coming to accept that higher rates may be here to stay for longer than initially expected.

**Domestic Fixed Income Market**

As we entered the second quarter, market volatility remained elevated related to fears over systemic troubles in the regional banking sector and their balance sheets. The flight to quality that occurred as investors sought safe havens with a risk off mentality drove treasury rates down with the expectation the Federal Reserve would be forced to end tightening monetary policy sooner than previously thought. As the second quarter progressed, fears regarding issues within the regional banking sector began to ease with the expectation the Federal Reserve still has additional flexibility to maintain rates in restrictive territory for longer. This coupled with evidence of sticky inflation that will take longer to slow down to the long-term Fed target of 2% led rates to rise across the curve. More rate-sensitive tenors were the most heavily impacted, with the 2-year rising 87 basis points to finish the quarter at 4.90% near first quarter highs. The less rate-sensitive 10-year rose 37 basis points to finish the quarter at 3.84%, up from a quarterly low of 3.36%. While rising rates can cause pain in fixed income portfolios, bond yields available in the current market present compelling alternatives to equity. Fixed income investors have an opportunity to lock in relatively attractive yields versus the historically low rates we have seen over the last decade.

**Domestic Equity Market**

Equity markets continued their rally in the second quarter, feeding off the momentum that was built in the first quarter. In stark contrast to 2022 growth stocks once again were favored over value, with the tech-heavy Nasdaq finishing its best first half in over forty years with a return of 32.32% through two quarters. The Nasdaq and S&P 500 finished with quarterly returns of 13.05% and 8.74% respectively. With the strong performance through the first half of 2023 investors would be prudent to revisit historical performances following yield curve inversions. Equity markets typically experience increased volatility post-inversion, with positive performance that peaks on average 17 months later. The 2Y/10Y spread inverted in April of 2022, 15 months ago, with elevated volatility in markets. The strong recovery over the first half of 2023 may be just the opportunity investors need to take some gains off the table and reallocate into other compelling asset classes.

**Federal Reserve**

The long-awaited pause to the Federal Reserve's rate hikes finally came in June. This has ended a streak of rate hikes that occurred at the previous 10 Fed meetings, leaving the Fed Funds Rate at the 5-5.25% range. While they opted to pause rate hikes at the June meeting, the Fed has cautioned investors to view the meeting as a "skip" versus an end to their hikes. The Fed continues to find itself in a difficult situation, with evidence of sticky inflation. CPI has fallen to 4.0% year-over-year from a peak of 9.1%, a strong improvement driven mainly by falling oil and gas prices. Core inflation, which excludes food and energy, has run 5.3% over the last year, trending lower but at a slower pace. A resilient labor force combined with consumer spending boosted from savings accumulated during the pandemic have tolerated higher rates up to this point. On one hand additional hikes risk a "hard landing," an outcome that would inflict pain on consumers equally as undesirable as elevated inflation. Conversely failure by the Federal Reserve to rein in inflation will place more pressure on a consumer base that has been depleting savings and adding additional debt at these higher rates.

**Summary**

In the face of restrictive monetary policy, we continue to see a resilient domestic economy, supported by a strong labor market. Employment growth remains strong, with low unemployment and wages largely keeping pace with inflation. Mixed performance across asset classes with equity markets feeding off tech-driven momentum and building upon the strong first quarter returns. Meanwhile fixed income investors experienced additional pain as rates rose across the curve, however this presents opportunities for repositioning and reinvesting at attractive yields. First quarter fears over contagion in the regional banking system have calmed, yet investors remain on high alert for recession risks and instabilities within the market as the Federal Reserve maintains restrictive monetary policy to rein in inflation.

# Industry Insight

## Pressures on Commercial Real Estate


Over the past several months, the commercial real estate (CRE) sector has become a focal point of uncertainty for businesses and investors alike. The industry faces an array of challenges influenced by tightening credit conditions, shifting market dynamics, and lingering effects from the global pandemic. While most talk of commercial real estate remains bleak, some feel the “turbulent conditions” are being overemphasized and that we will see some reprieve as overall market conditions become more favorable.

In response to mounting inflationary pressures, the Federal Reserve raised the Fed Funds Rate more than five percentage points since early 2022. These tightening conditions have been a significant stressor to the CRE sector. It has become increasingly challenging for investors and developers trying to secure a loan or access capital for projects due to these conditions. With nearly $1.5 trillion in commercial mortgages coming due over the next three years, companies will be forced to refinance at interest rate highs not seen since 2007, sell the property, or default.

The retail CRE sector has particularly struggled to adapt and keep up with the e-commerce boom that was amplified during the pandemic. The shift away from traditional brick-and-mortar retail stores in the United States has affected companies such as Macy's, Kohl's, GameStop, Nordstrom, and others. Among Commercial Mortgage-Backed Securities (CMBS) debt, retail properties make up the highest volume of maturities in 2023 at 42%. The surge in e-commerce, coupled with 16-year high interest rates, has led to the retail sector having the highest delinquency rates of all CRE sectors. Additionally, the resumption of student loan payments in October (estimated at $6 to $10 billion in monthly payments) is expected to impact consumer spending, further affecting the retail business.

While significant market shifts weigh on the retail sector, office properties are experiencing the least favorable conditions in CRE. The expedited adoption of remote work and hybrid work models due to the COVID-19 pandemic continues to stress the sector. As remote work became the “new norm” during the pandemic, companies have struggled with bringing workers back to the office. Remote work offers increased flexibility for a more favorable work-life balance, eliminates commuting, and reduces costs such as dining out for lunch and workplace attire. Companies are recognizing that the transition back to the office may be a gradual and evolving process. Office space occupancy varies geographically, with the

*(Industry Insight cont'd)*

average occupancy of the top 10 metropolitan areas ending the quarter at just under 50%. San Jose (39.1%) and Philadelphia (40.6%) lag behind, while Austin (59.4%) and Houston (61.2%) rank among the highest in occupancy levels.

Despite prevailing uncertainty and lack of optimism surrounding commercial real estate, there are several encouraging aspects worth mentioning. Occupancy rates in office CRE spaces continue to climb and reach new post-pandemic highs. Inflation, although stickier than anticipated, has slowed as the Fed continues to tighten credit conditions to slow the economy. However, as inflation continues to cool, rate cuts could follow which would noticeably benefit the sector. Finally, many CRE mortgages set to mature over the next few years have extension options built into their loan agreements. These options allow businesses to prolong their payback period and avoid refinancing risks. While these options do not resolve the issues, they provide companies with additional time to adjust to current and future market conditions.

# The Bond Project


There has been a significant amount of purchases of Asset Backed Securities by insurance companies in the last several years. After the recession of 2008 and 2009, the industry saw a long period of rates and yields falling. In an effort to increase yields, the trend of buying structured securities increased. A popular security type in the industry was the asset backed security. These provided cashflows and higher yields.

An issue that has arisen from this is that ABSs can be substantially different than traditional bonds. The cash flows are different, and the collateral is different. This raises the question if they should be included on the Schedule D Part 1 for an insurance company's Annual Statement. After several meetings and calls over the last year, the answer seems to be no. If not Part 1, where do these belong? The solution is to break Schedule D Part 1 into 2 parts, creating a new Schedule, which will be D Part 1-2, for asset backed securities. Schedule D Part 1-1 will be for more traditional bonds.

Before diving further into what this means, there should not be reason to panic. The breakdown of determining where a specific security goes will be fairly straight forward. This will also not take effect until 2025, so we will have time to prepare for the overhaul.

Here are a few aspects of this change. The 2 sections will be one of these types of security, Issuer Credit Obligation or Asset-Backed Security. A bond represents a security structure representing a creditor relationship with a fixed payment schedule. Once the creditor relationship is established, qualifying structures are either issuer obligations or asset-backed securities. With an issuer obligation, the repayment of the instrument is supported by the general creditworthiness of an operating entity or entities. Asset-Backed Securities are issued by entities that have a primary purpose of raising debt capital backed by collateral that provides the cashflow to service the debt. (This language and definition come from the NAIC.)

There will also be new NAIC Group Codes with the change to the Schedule D.

Here is a sample list of what would be reported on Part 1-1.

| | |
|---|---|
| U.S. Government Obligations | 0019999999 |
| Other U.S. Government Securities | 0029999999 |
| Non-U.S. Sovereign Jurisdiction Securities | 0039999999 |
| Municipal Bonds – General Obligations | 0049999999 |
| Municipal Bonds – Special Revenue | 0059999999 |
| Project Finance Bonds Issued by Operating Entities (Unaffiliated) | 0069999999 |
| Project Finance Bonds Issued by Operating Entities (Affiliated) | 0079999999 |
| Corporate Bonds (Unaffiliated) | 0089999999 |
| Corporate Bonds (Affiliated) | 0099999999 |
| Mandatory Convertible Bonds (Unaffiliated) | 0109999999 |
| Mandatory Convertible Bonds (Affiliated) | 0119999999 |
| Single Entity Backed Obligations (Unaffiliated) | 0129999999 |
| Single Entity Backed Obligations (Affiliated) | 0139999999 |
| SVO-Identified Bond Exchange Traded Funds – Fair Value | 0149999999 |
| SVO-Identified Bond Exchange Traded Funds – Systematic Value | 0159999999 |
| Bonds Issued from SEC-Registered Business Development Corps, Closed End Funds & REITS (Unaffiliated) | 0169999999 |
| Bonds Issued from SEC-Registered Business Development Corps, Closed End Funds & REITS (Affiliated) | 0179999999 |
| Bank Loans – Issued (Unaffiliated) | 0189999999 |
| Bank Loans – Issued (Affiliated) | 0199999999 |
| Bank Loans – Acquired (Unaffiliated) | 0209999999 |
| Bank Loans – Acquired (Affiliated) | 0219999999 |
| Mortgages Loans that Qualify as SVO-Identified Credit Tenant Loans (Unaffiliated) | 0229999999 |
| Mortgages Loans that Qualify as SVO-Identified Credit Tenant Loans (Affiliated) | 0239999999 |
| Certificates of Deposit | 0249999999 |
| Other Issuer Credit Obligations (Unaffiliated) | 0259999999 |
| Other Issuer Credit Obligations (Affiliated) | 0269999999 |
| Total – Issuer Credit Obligations (Unaffiliated) | 0489999999 |
| Total – Issuer Credit Obligations (Affiliated) | 0499999999 |
| Total – Total Issuer Credit Obligations | 0509999999 |

This is what would be reported on Part 1-2.

| | |
|---|---|
| Financial Asset-Backed Securities – Self-Liquidating | |
| Agency Residential Mortgage-Backed Securities - Guaranteed | 1019999999 |
| Agency Commercial Mortgage-Backed Securities - Guaranteed | 1029999999 |
| Agency Residential Mortgage-Backed Securities – Not Guaranteed | 1039999999 |
| Agency Commercial Mortgage-Backed Securities – Not Guaranteed | 1049999999 |
| Non-Agency Residential Mortgage-Backed Securities (Unaffiliated) | 1059999999 |
| Non-Agency Residential Mortgage-Backed Securities (Affiliated) | 1069999999 |
| Non-Agency Commercial Mortgage-Backed Securities (Unaffiliated) | 1079999999 |
| Non-Agency Commercial Mortgage-Backed Securities (Affiliated) | 1089999999 |
| Non-Agency – CLOs/CBOs/CDOs (Unaffiliated) | 1099999999 |
| Non-Agency – CLOs/CBOs/CDOs (Affiliated) | 1109999999 |
| Other Financial Asset-Backed Securities – Self-Liquidating (Unaffiliated) | 1119999999 |
| Other Financial Asset-Backed Securities – Self-Liquidating (Affiliated) | 1129999999 |
| Subtotals – Financial Asset-Backed Securities – Self-Liquidating | 1209999999 |
| Financial Asset-Backed Securities – Not Self-Liquidating | |
| Equity Backed Securities (Unaffiliated) | 1319999999 |
| Equity Backed Securities (Affiliated) | 1329999999 |
| Other Financial Asset-Backed Securities – Not Self-Liquidating (Unaffiliated) | 1339999999 |
| Other Financial Asset-Backed Securities – Not Self-Liquidating (Affiliated) | 1349999999 |
| Subtotals – Financial Asset-Backed Securities – Not Self-Liquidating | 1409999999 |
| Non-Financial Asset-Backed Securities – Practical Expedient | |
| Lease-Backed Securities – Practical Expedient (Unaffiliated) | 1519999999 |
| Lease-Backed Securities – Practical Expedient (Affiliated) | 1529999999 |
| Other Non-Financial Asset-Backed Securities – Practical Expedient (Unaffiliated) | 1539999999 |
| Other Non-Financial Asset-Backed Securities – Practical Expedient (Affiliated) | 1549999999 |
| Subtotals - Non-Financial Asset-Backed Securities – Practical Expedient | 1609999999 |
| Non-Financial Asset-Backed Securities – Full Analysis | |
| Lease-Backed Securities – Full Analysis (Unaffiliated) | 1719999999 |
| Lease-Backed Securities – Full Analysis (Affiliated) | 1729999999 |
| Other Non-Financial Asset-Backed Securities – Full Analysis (Unaffiliated) | 1739999999 |
| Other Non-Financial Asset-Backed Securities – Full Analysis (Affiliated) | 1749999999 |
| Subtotals - Non-Financial Asset-Backed Securities – Full Analysis | 1809999999 |
| Total – Asset-Backed Securities (Unaffiliated) | 1889999999 |
| Total – Asset-Backed Securities (Affiliated) | 1899999999 |
| Total – Asset-Backed Securities | 1909999999 |
| Total – Long-Term Bonds (Issuer Credit Obligations and Asset-Backed Securities) | 2009999999 |

From these images, we can see that there will be a significant change to the schedules, for example, the Municipal Section is only two groups, and not three as it currently reports. There is also a new breakdown for any asset backed securities.

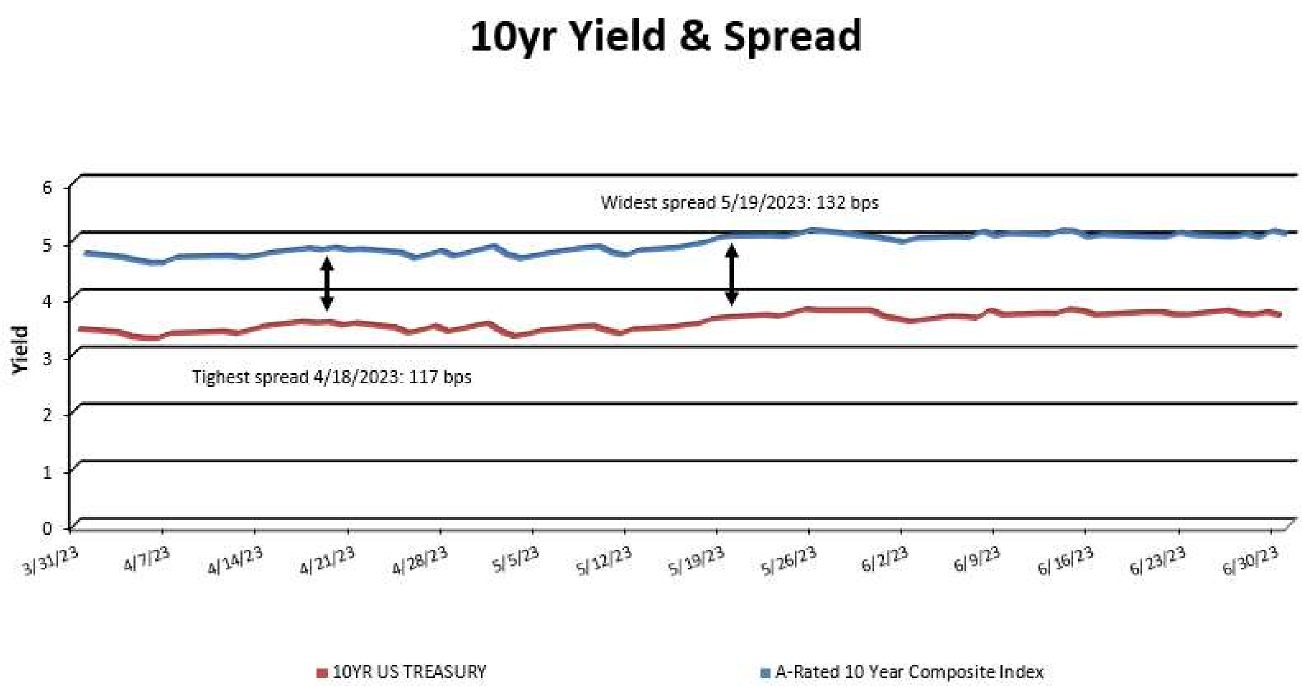
This is only a brief overview of the changes and more details will be coming soon. I will mention again, we don't have to panic, the NAIC is providing details and giving us all some time to sort through all of it. We are watching this closely as it is one of the biggest changes in a long time.

## Interest Rate Spreads

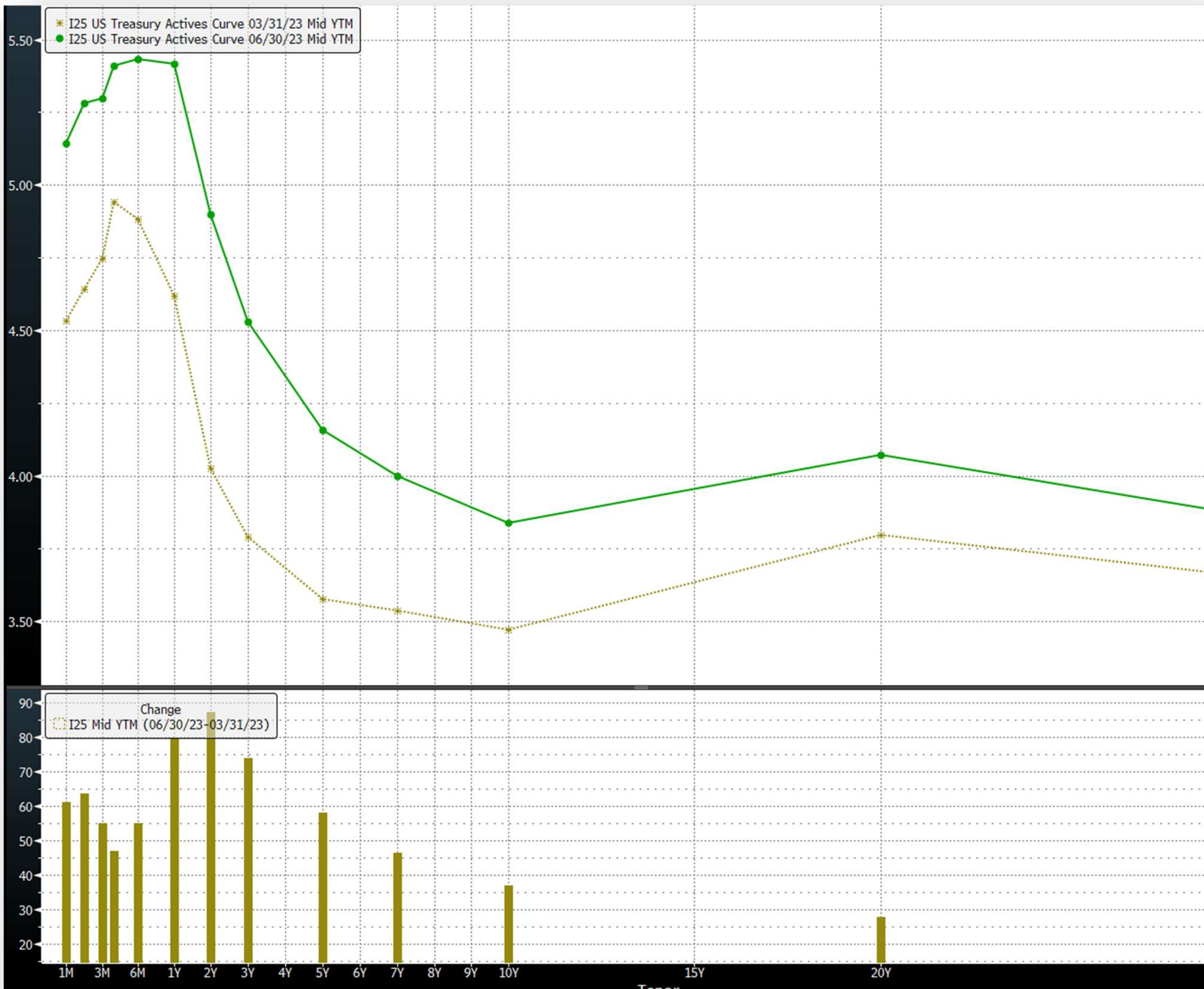
As of: 6/30/2023

| | Treasury | US Composite BVAL AA Curve | | US Composite BVAL A Curve | | US Composite BVAL BBB Curve | | US Composite BVAL BB Curve | |
|---|---|---|---|---|---|---|---|---|---|
| Term | Yield | Yield | Spread | Yield | Spread | Yield | Spread | Yield | Spread |
| 1yr | 5.4 | 5.3354 | -0.0646 | 5.5137 | 0.1137 | 5.7867 | 0.3867 | 6.4998 | 1.0998 |
| 2yr | 4.87 | 5.0386 | 0.1686 | 5.2224 | 0.3524 | 5.9353 | 1.0653 | 6.5199 | 1.6499 |
| 3yr | 4.49 | 4.7957 | 0.3057 | 5.0488 | 0.5588 | 5.9057 | 1.4157 | 6.516 | 2.026 |
| 5yr | 4.13 | 4.5833 | 0.4533 | 4.8561 | 0.7261 | 5.7406 | 1.6106 | 6.6355 | 2.5055 |
| 7yr | 3.97 | 4.5453 | 0.5753 | 4.8815 | 0.9115 | 5.5577 | 1.5877 | 6.8589 | 2.8889 |
| 10yr | 3.81 | 4.598 | 0.788 | 5.0222 | 1.2122 | 5.534 | 1.724 | 7.1683 | 3.3583 |
| 20yr | 4.06 | 4.9459 | 0.8859 | 5.2782 | 1.2182 | 5.6678 | 1.6078 | 7.5982 | 3.5382 |
| 30yr | 3.85 | 4.8869 | 1.0369 | 5.1299 | 1.2799 | 5.6152 | 1.7652 | 7.2992 | 3.4492 |

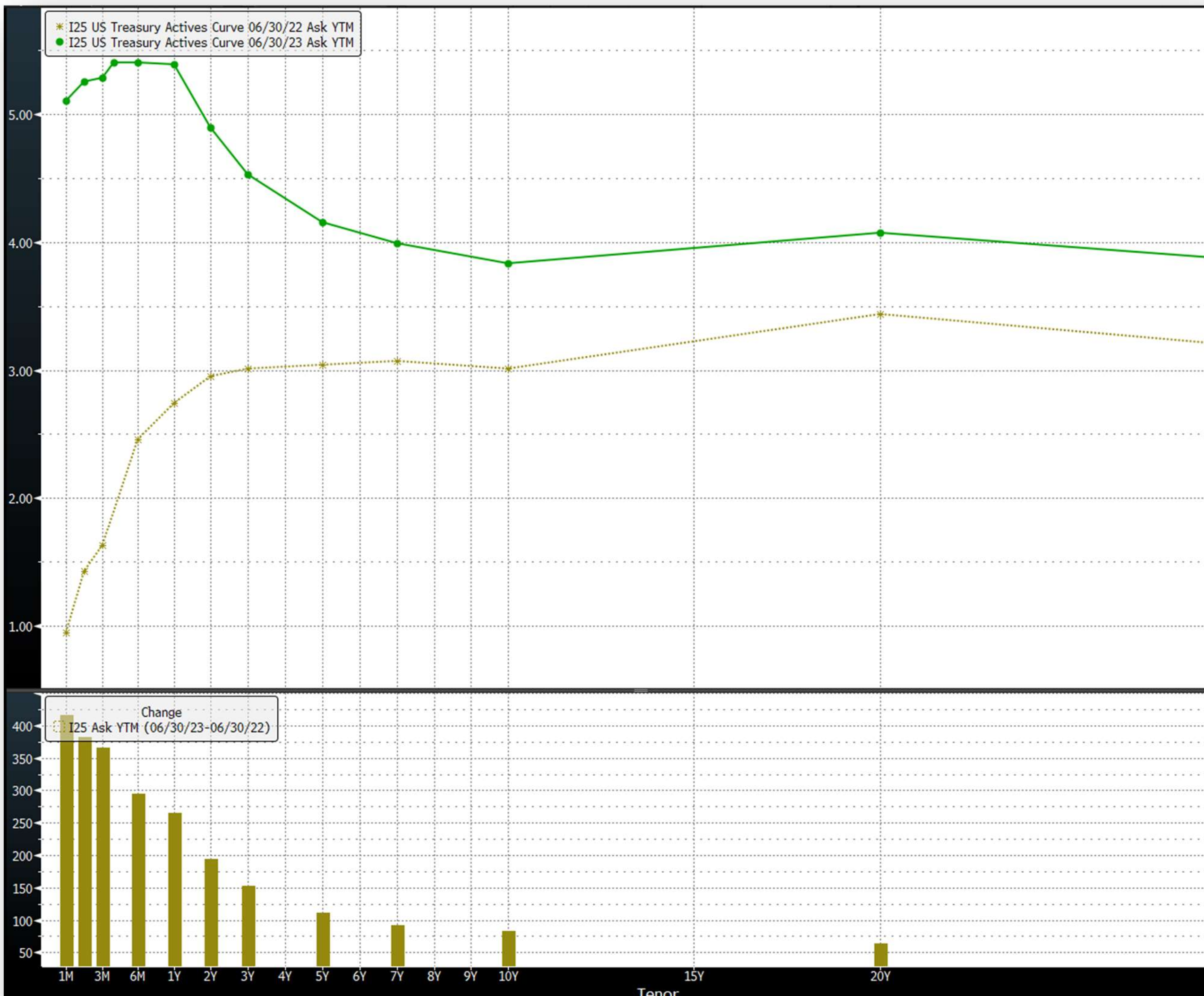
Disclosures: This material is for your use only and is based upon information which we consider reliable, but we do not represent that it is accurate or complete and should not be relied upon as such. Information was obtained from Blooomberg and represents the respective Bloomberg US Composite BVAL and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


10yr Yield & Spread
Widest spread 5/19/2023: 132 bps
Tighest spread 4/18/2023: 117 bps
Yield
6
5
4
3
2
1
0
3/31/23
4/7/23
4/14/23
4/21/23
4/28/23
5/5/23
5/12/23
5/19/23
5/26/23
6/2/23
6/9/23
6/16/23
6/23/23
6/30/23
10YR US TREASURY
A-Rated 10 Year Composite Index

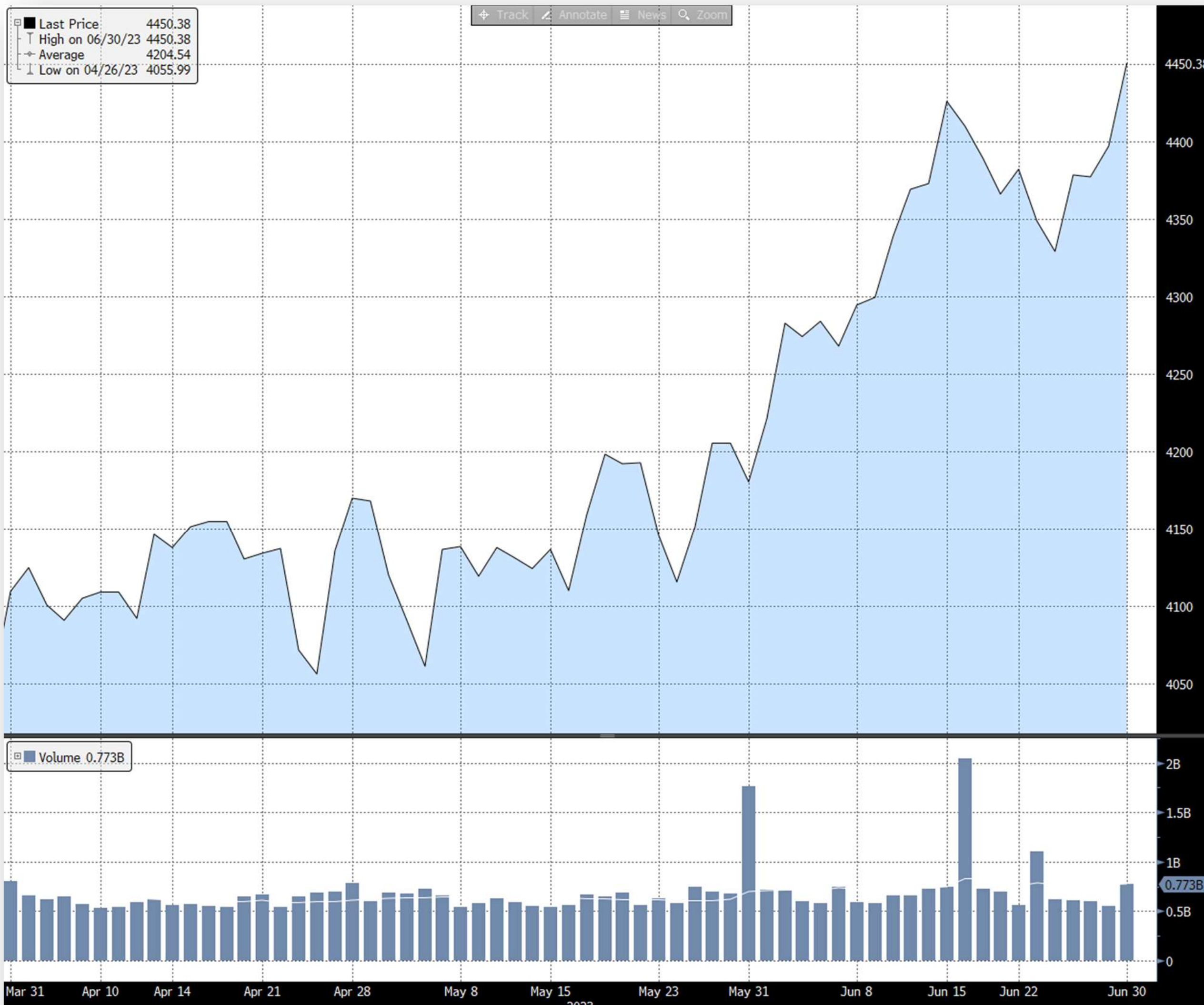
# US Treasury Yield Curve 2nd Quarter



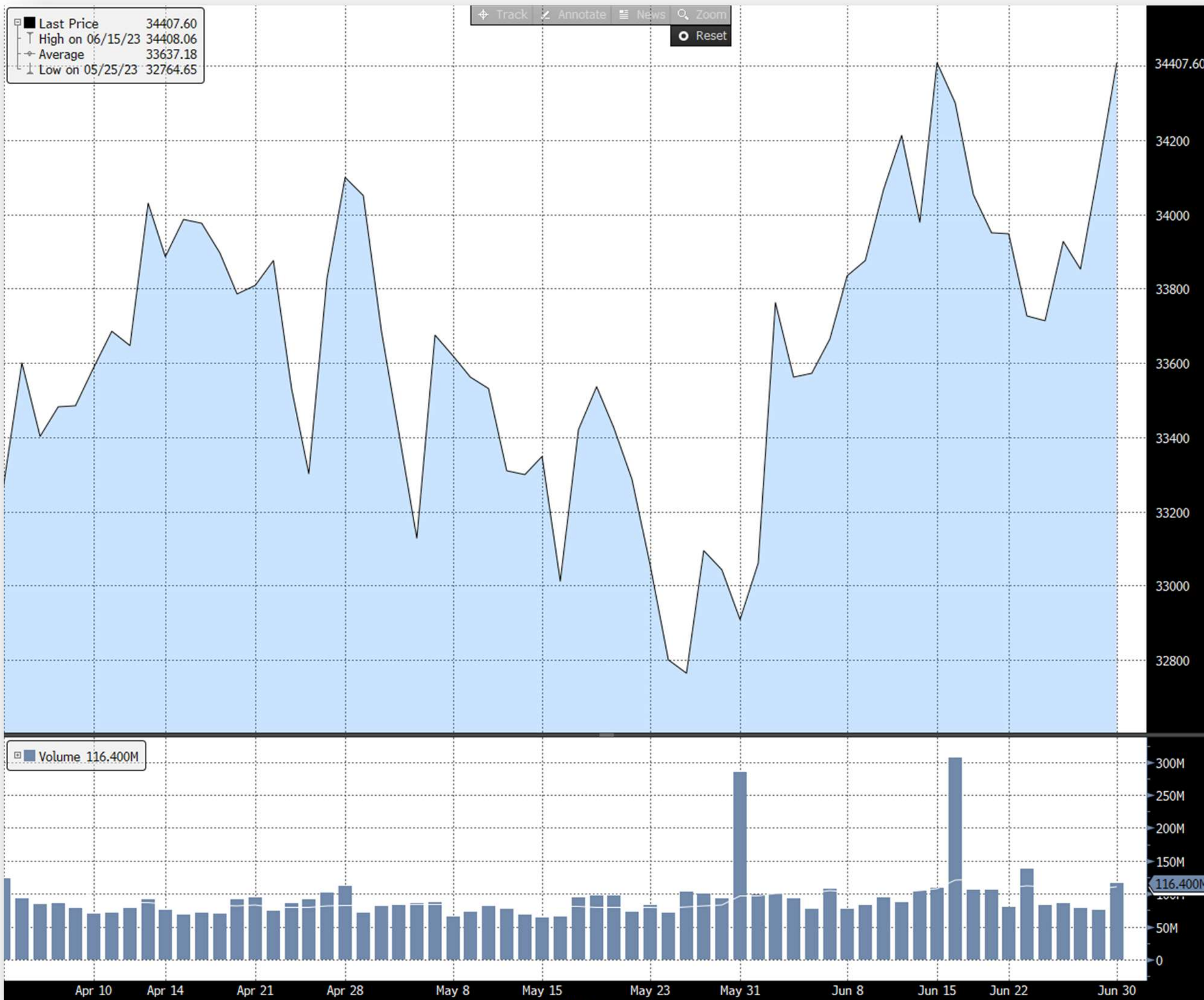
# US Treasury Yield Curve YTD



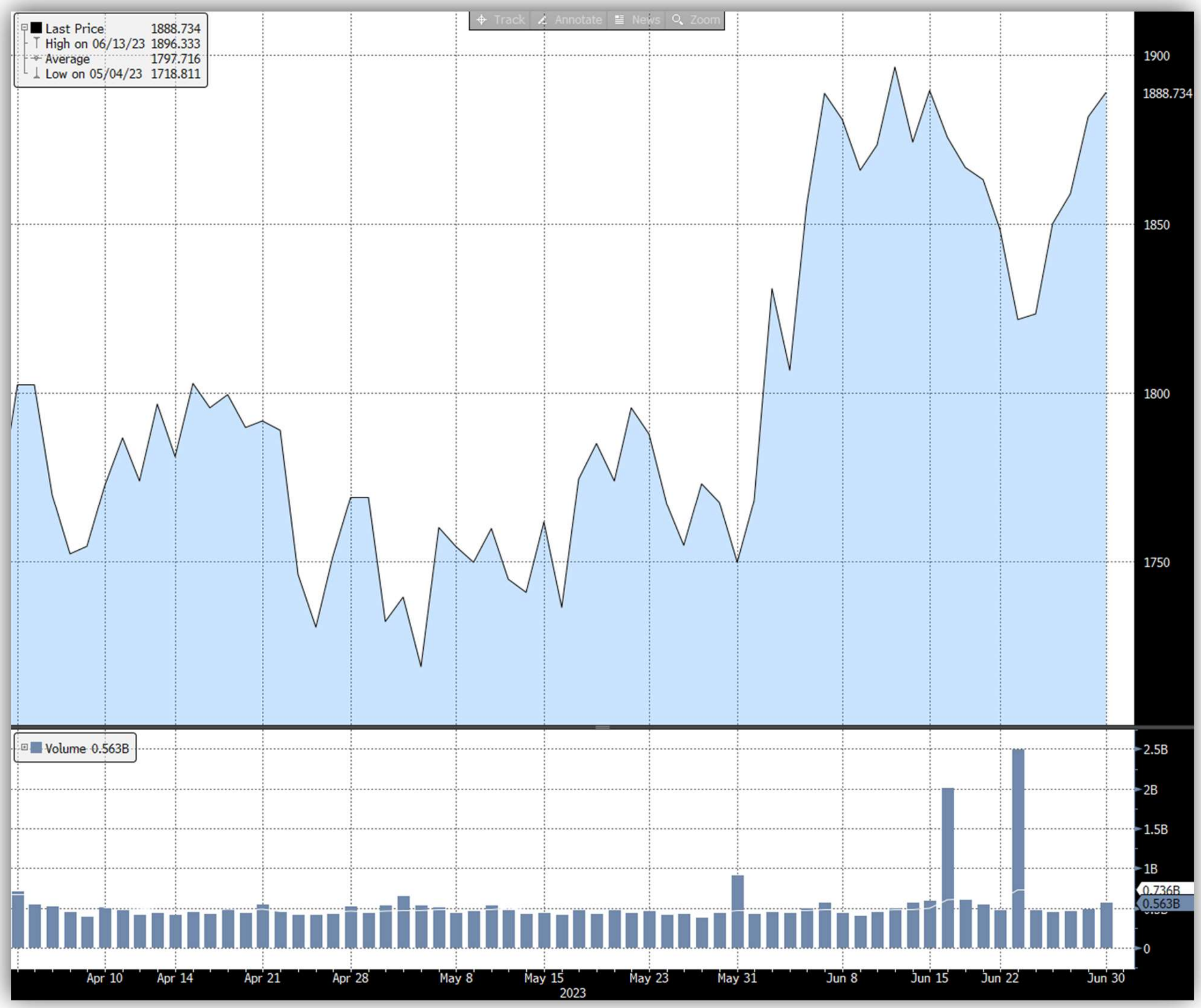
# S&P 500 Index


Last Price 4450.38
High on 06/30/23 4450.38
Average 4204.54
Low on 04/26/23 4055.99
Volume 0.773B
4450.38
4400
4350
4300
4250
4200
4150
4100
4050
2B
1.5B
1B
0.773B
0.5B
0
Mar 31
Apr 10
Apr 14
Apr 21
Apr 28
May 8
May 15
May 23
May 31
Jun 8
Jun 15
Jun 22
Jun 30
2023

# 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*

We welcome your inquiry and can be reached by mail at Parkway Advisors, L.P., P.O. Box 5225, Abilene, Texas 79608 or by phone at (800) 692-5123 or by fax at (325) 795-8521. A copy of our Form ADV, Part II is available upon request.

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