The Insurance *perspective*

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Economic Commentary

Following a stellar first half of the year in equity markets, Q3 took a bit of a breather to reassess the current economic conditions and outlook moving forward. While broad equity markets pulled back, rates in the fixed income markets continued to climb across the curve. As uncertainty of economic conditions mounts, all eyes remain on the Fed and what their next steps are as they continue to combat inflation while striving for a "soft landing" outcome.

Domestic Fixed Income Market

The yield curve hit its deepest inversion since 1981 in early July, with the 2-year Treasury yielding 109.5 basis points more than the 10-year. However, longer duration yields are potentially becoming more attractive as expectations of the end of the hiking cycle nears, followed by subsequent cuts, which are bring priced in futures markets to occur in the second half of 2024. We also have begun to witness initial indications of the shift in the credit cycle as downgrades outpace upgrades and defaults increase. Throughout the quarter, we noted an impressive 75 basis point move from July 3 at 3.86% to the quarter high, September 27 at 4.61% on the 10-year Treasury. Another notable move came after positive June CPI numbers, causing the 2-year to fall 29 basis points in just two days before rallying back to end the quarter at 5.03%. While we have seen large step-ups in yields, spreads are held in check due to the decline of issuance as the effects of the restrictive monetary policy are being felt. While the rally in rates has exerted pressure on previously purchased fixed income positions, the current market remains attractive for putting new money to work being at the highest yields seen in 16 years.

Domestic Equity Market

Equity markets showed a strong first half of 2023, heavily led by information technology, communication services, and consumer discretionary sectors. July continued the upward trend of gains across the market, before an additional Fed rate hike caused by an unfavorable uptick in CPI numbers brought the bulls back to bay. Along with continuing "sticky inflation", durable labor markets and stronger than expected GDP support the notion of restrictive monetary policy remaining for longer. Equities objected to the idea of "higher for longer" and as investors have capitalized on favorable cash rates, we have seen a pullback in equity markets through August and September of Q3. As a result of the decline in August and September, the S&P 500 and Nasdaq posted quarterly returns of -3.27% and -2.86%. The Russell 2000, which is commonly considered a better economic indicator due to its focus on smaller companies that primarily do business within the US, returned -5.14% over the quarter. Overall, nine of the eleven sectors finished the quarter negative, with real estate and utilities being the worst performing.

Federal Reserve

Following one of the most aggressive credit tightening cycles in US history throughout 2022, the Fed has continued its increasingly restrictive policy but at a slower rate thus far in 2023. While being cautious of over restrictive policy that could potentially send the US into a deeper recession, the Fed continues to work towards taming balky inflation. Treading carefully, the Fed opted to make an additional 25 basis point hike in July but chose to hold rates where they were during the September meeting. The .25% hike in July brought the Fed Funds Rate to 5.25%-5.50%. Following months of declining inflation, CPI increased from 3.0% to 3.2% in July, then to 3.7% in August. Although CPI did increase, the main contributor was a more than 10% recent surge in gas prices. The futures market is predicting that Fed Funds rate will remain at the current level through 2023 and halfway into 2024 with the first cut expected in July 2024. The Fed looks to continue the fight against inflation while preventing a "hard landing" scenario. Healthy labor markets and strong consumer spending have largely contributed to the economic resilience up to this point, but with credit card balances crossing over a trillion dollars for the first time in history and student loan payments resuming, the average consumer may be getting closer to being "tapped out."

Summary

As the futures market is under the impression that rate hikes are over, the question remains of the duration of these higher rates. How long will labor markets, and a potentially weakening consumer, be able to hold up the economy until the reprieve of lower rates occurs? Will inflation continue to trend higher as indicated by the last two months? What are the Fed's next moves? Now that investors have viable options outside of equities with meaningful returns on cash and fixed income, will we see additional rotation across asset classes? These are some of the questions that will drive additional volatility throughout the coming quarters.

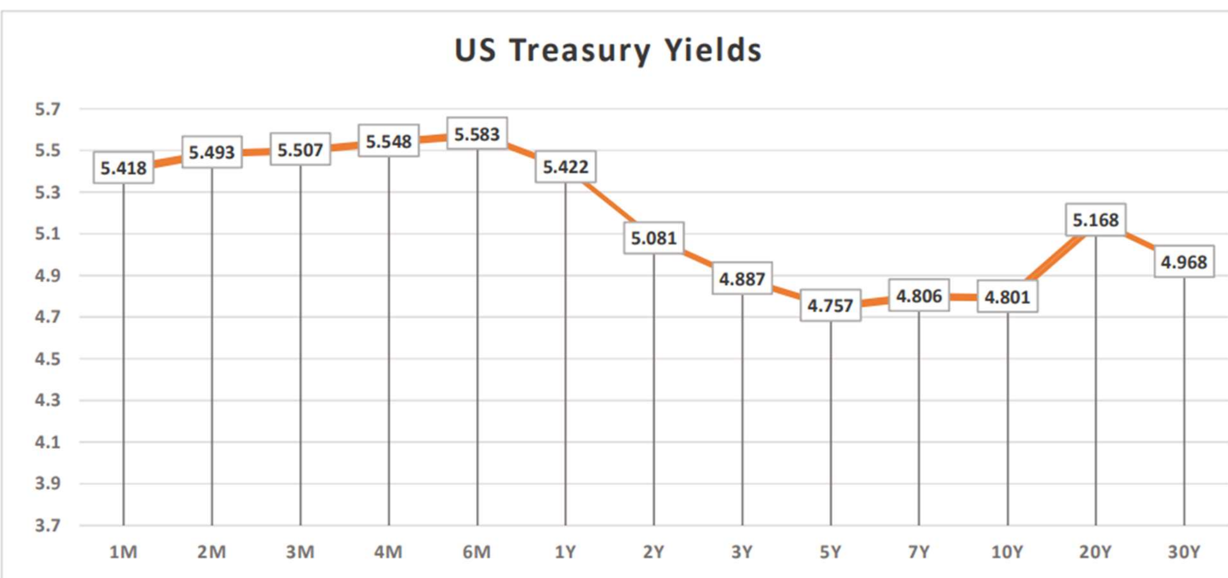
Industry Insight

The insurance industry is no stranger to the ebb and flow of economic cycles. In a particularly challenging environment, such as when the yield curve inverts, insurance companies face critical decisions regarding their investment strategies. In this article, we will explore the debate within the insurance industry: whether to opt for short-term or long-term investments during an inverted yield curve. Emphasizing the idea that while short-term investments can yield higher returns, long-term investments offer the attractive prospect of locking in higher interest rates, serving as a protective buffer in case interest rates take a dip.

Understanding the Inverted Yield Curve

Before diving into the short-term vs. long-term investment discussion, let's establish a common understanding of what an inverted yield curve is and why it matters.

A yield curve is a graphical representation of interest rates on debt for a range of maturities. Conventionally, long-term bonds have higher yields compared to their short-term counterparts, reflecting the expectation of higher returns over time. However, when an inverted yield curve occurs, the script flips. This phenomenon is characterized by short-term interest rates being higher than long-term interest rates, indicating potential economic concerns. Below is a representation of the inverted yield curve taken on 10/09/2023.



Short-Term Investments: Chasing Immediate Returns

In a world with an inverted yield curve, short-term investments often stand out for their appeal. They offer several distinct advantages, including higher yields to lock in short term gains, flexibility in shifting market conditions, and reduced interest rate risk. However, it's important to note that short-term investments come with their unique set of challenges such as reinvestment risk. In a falling interest rates environment, insurers face the challenge of reinvesting maturing short-term assets at lower rates, which can erode the overall returns on their portfolios. This is a significant concern when interest rates are already low.

Long-Term Investments: The Safety Net of Higher Interest Rates

Conversely, long-term investments offer a different strategy for insurance companies during an inverted yield curve. These investments bring their own set of advantages, such as locking in higher rates, stability in cash flows, and reduced reinvestment risk. By investing in long-term bonds, insurance companies can secure higher, stable, interest rates for an extended period. This approach functions as a safeguard against the further decline in interest rates. Challenges to long-term investment in an inverted yield curve include lower rates than investing in the short term as well as reduced liquidity, limiting flexibility in changing market conditions.

The Balance: A Blend of Short and Long-Term Investments

In reality, the choice between short-term and long-term investments is not a strict binary. A well-balanced investment strategy for insurance companies often involves a combination of both. By doing so, insurers can leverage the unique strengths of each approach while mitigating the associated risks.

In an inverted yield curve environment, insurance companies can choose to allocate a portion of their investment portfolio to short-term assets to capture immediate yields and maintain flexibility. Simultaneously, they can strategically invest in long-term bonds to lock in higher rates and provide a safety net in case interest rates fall further.

Covering Liabilities: Providing for Policy Holders

The most important aspect of an insurance company's portfolio is whether or not assets are rolling in to cover the liabilities of the company. If investing in purely short-term bonds, it may be a challenge to support the long-term liabilities of the organization. Likewise, unless the portfolio is well laddered, it may be difficult for purely long-term liabilities to properly align with the projected liabilities. In order to properly provide for these liabilities and pick up short-term gains, adopting a balanced approach is likely most prudent. What is of utmost concern is ensuring that the portfolio, and any purchases, do not create undue risk to the organization. It is imperative to balance achieving the highest current yield with a long term focusing on asset liability management.

Conclusion: Safeguarding the Future

When the yield curve inverts, insurance companies must make strategic decisions about their investments. The choice between short-term and long-term investments is a crucial one that can significantly impact the financial stability and long-term prospects of an insurer. While the allure of higher short-term yields may be tempting, a wise approach for insurance companies is to consider the long-term horizon. Locking in higher interest rates through long-term investments can serve as a failsafe, providing stability and predictability in a volatile economic landscape. The decision between short-term and long-term investments should be guided by a holistic strategy that considers the unique advantages and drawbacks of each approach. By blending these strategies, insurance companies can navigate the challenges posed by an inverted yield curve and safeguard their financial future.

Negative IMR: A Temporary Solution

There is good news for some life insurance companies with negative IMR. As we discussed at the end of 2022, the rise in interest rates was creating a strain on insurers and creating losses on almost all sales of fixed income. The American Council of Life Insurers brought this to light in October 2022, and pointed out that insurers were effectively experiencing double losses. First, they were taking losses on securities that were sold in the effort to keep up with interest rates. They were again suffering losses in the non-admittance of their IMR that had gone negative. When IMR is positive, it is a liability, but it was not allowed to be admitted on the Annual Statement when below zero. A perception of decreased financial stability was quite possible without the admittance of net negative IMR, a "contra-liability".

The good news is that the NAIC adopted limited-time guidance on negative IMR. There are some rules. The first is that an insurer can only admit 10% of their capital and surplus of negative IMR. Within this guidance are rules regarding general and separate accounts, and adjustments for goodwill, EDP equipment, software, and net deferred taxes. There are further details on the NAIC website, and state commissioners' offices should have more guidance. Another rule is that the reporting entity should have an RBC greater than 300%, which should be affirmed on all quarterly and annual statements. This is to ensure that insurers are in good financial standing while taking losses and not taking advantage of those losses while not reflecting the true financial health of the company.

While reporting the negative IMR, if permitted from the NAIC's guidance, in a general account, the net negative IMR should be reported as an aggregate write-in to miscellaneous other-than-invested assets (line 25) on the asset page. Anything over the 10% threshold should be non-admitted. If the negative IMR is in a separate account, and the total negative IMR still does not meet the 10%, the reporting entity can report the negative IMR as an asset in the separate accounts.

Reporting entities shall include a note disclosure stating the following:

-Fixed income investments generating IMR losses comply with the reporting entity's documented investment or liability management policies.

-IMR losses for fixed income related derivatives are all in accordance with prudent and documented risk management procedures, in accordance with a reporting entity's derivative use plan and reflect symmetry with historical treatment in which unrealized derivative gains were reversed to IMR and amortized in lieu of being recognized as realized gains upon derivative termination.

-Any deviation from the first disclosure was either because of a temporary and transitory timing issue or related to a specific event, such as reinsurance transaction, that mechanically made the cause of IMR losses not reflective of reinvestment activities.

-Asset sales that were generating admitted negative IMR were not compelled by liquidity pressures (e.g., to fund significant cash outflows including, but not limited to excess withdrawals and collateral calls).

This change was adopted on August 13th, and the provisions will be in effect as a short-term solution until EOY 2025. It will automatically be nullified on January 1st, 2026.

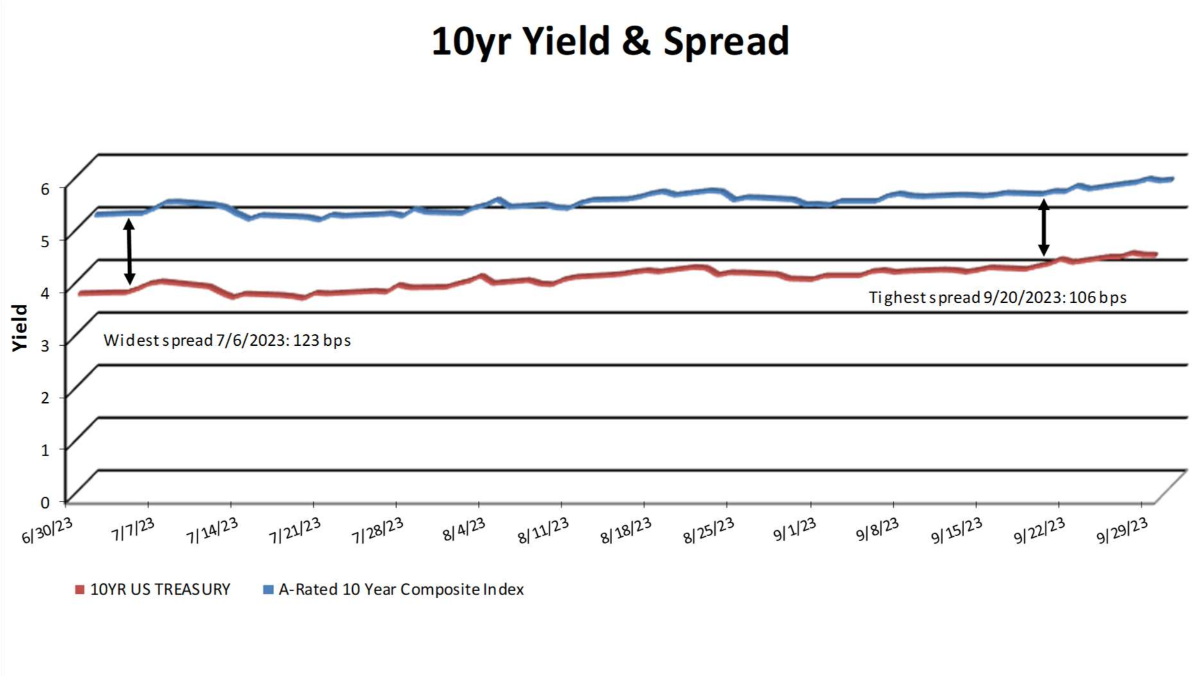
Overall, this new guidance is good news. Insurance companies can continue to reflect their financial health, and not have to show losses twice.

Interest Rate Spreads

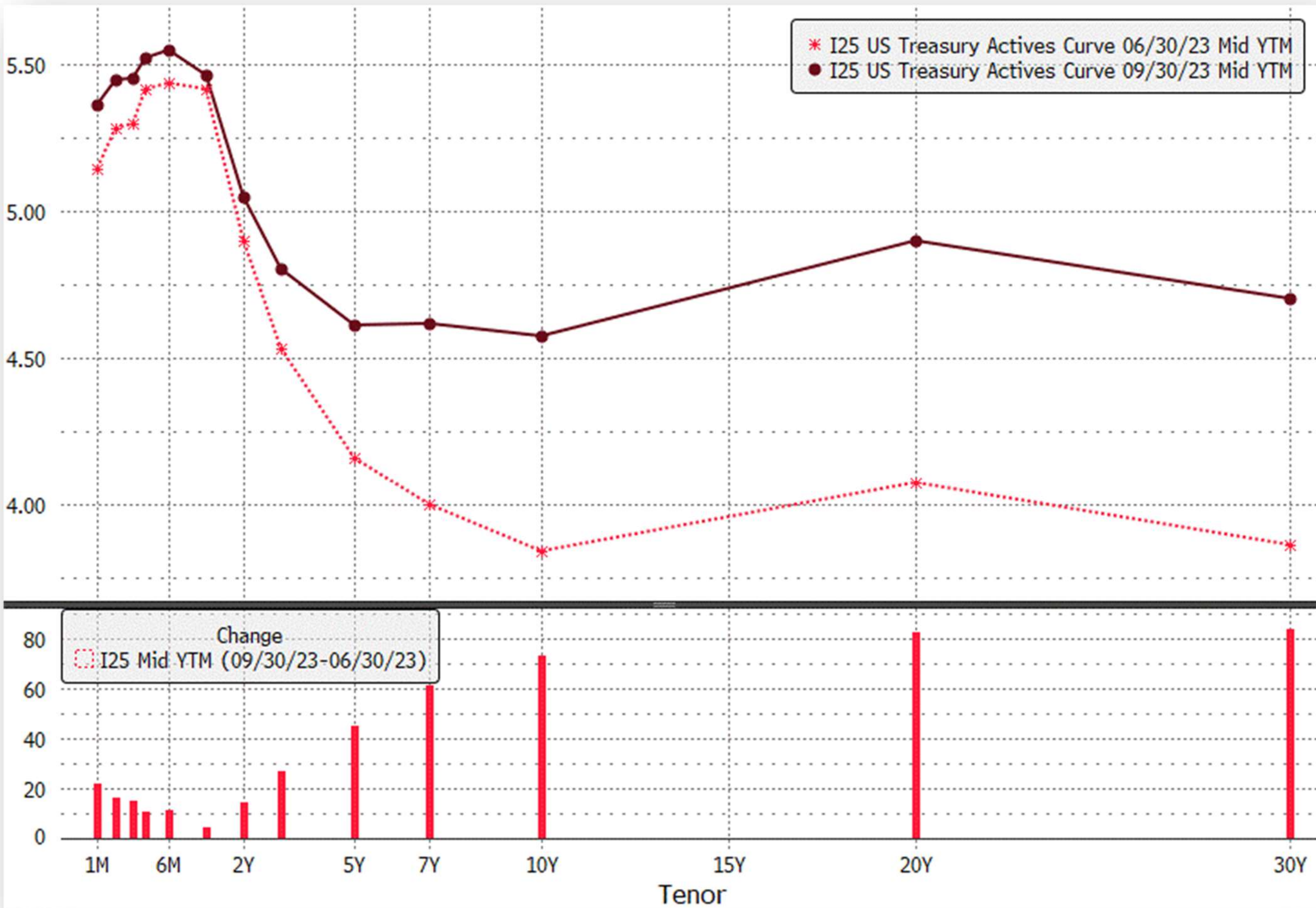
As of: 9/30/2023

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	5.46	5.6124	0.1524	5.7715	0.3115	6.1598	0.6998	7.1655	1.7055
2yr	5.03	5.3551	0.3251	5.5356	0.5056	5.9894	0.9594	7.1526	2.1226
3yr	4.8	5.1893	0.3893	5.4395	0.6395	5.9535	1.1535	7.1656	2.3656
5yr	4.6	5.113	0.513	5.3839	0.7839	5.9325	1.3325	7.2934	2.6934
7yr	4.61	5.1793	0.5693	5.5018	0.8918	6.0784	1.4684	7.4995	2.8895
10yr	4.59	5.3237	0.7337	5.6928	1.1028	6.2408	1.6508	7.7496	3.1596
20yr	4.92	5.657	0.737	6.0061	1.0861	6.4896	1.5696	8.0598	3.1398
30yr	4.73	5.6362	0.9062	5.8492	1.1192	6.2864	1.5564	7.8138	3.0838

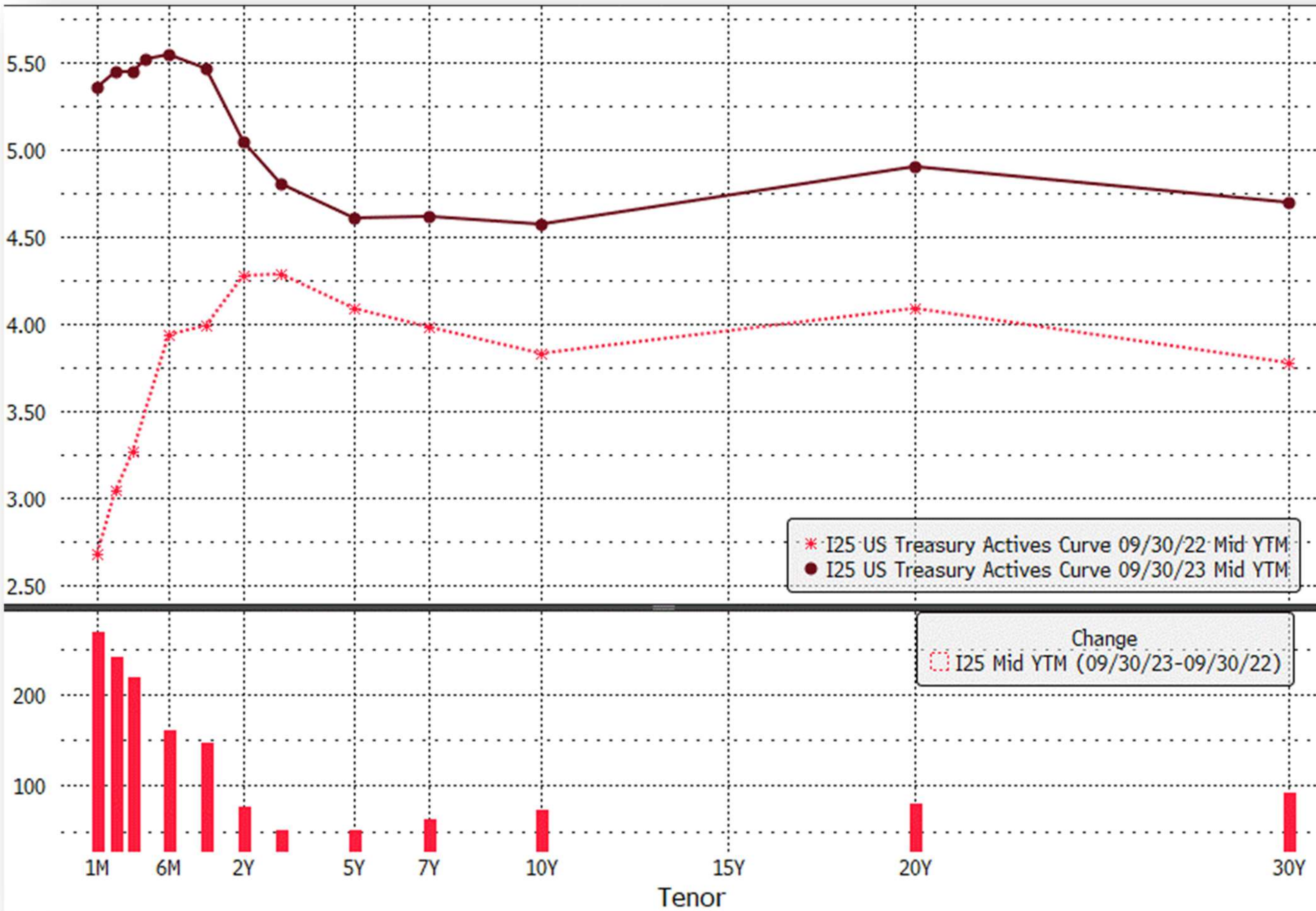
Disclosures: This material is for your use only and is based upon information which we consider reliable, but we do not represent that it is accurate or complete and should not be relied upon as such. Information was obtained from Blooomberg and represents the respective Bloomberg US Composite BVAL and 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
Widest spread 7/6/2023: 123 bps
Tighest spread 9/20/2023: 106 bps
6/30/23
7/7/23
7/14/23
7/21/23
7/28/23
8/4/23
8/11/23
8/18/23
8/25/23
9/1/23
9/8/23
9/15/23
9/22/23
9/29/23
10YR US TREASURY
A-Rated 10 Year Composite Index

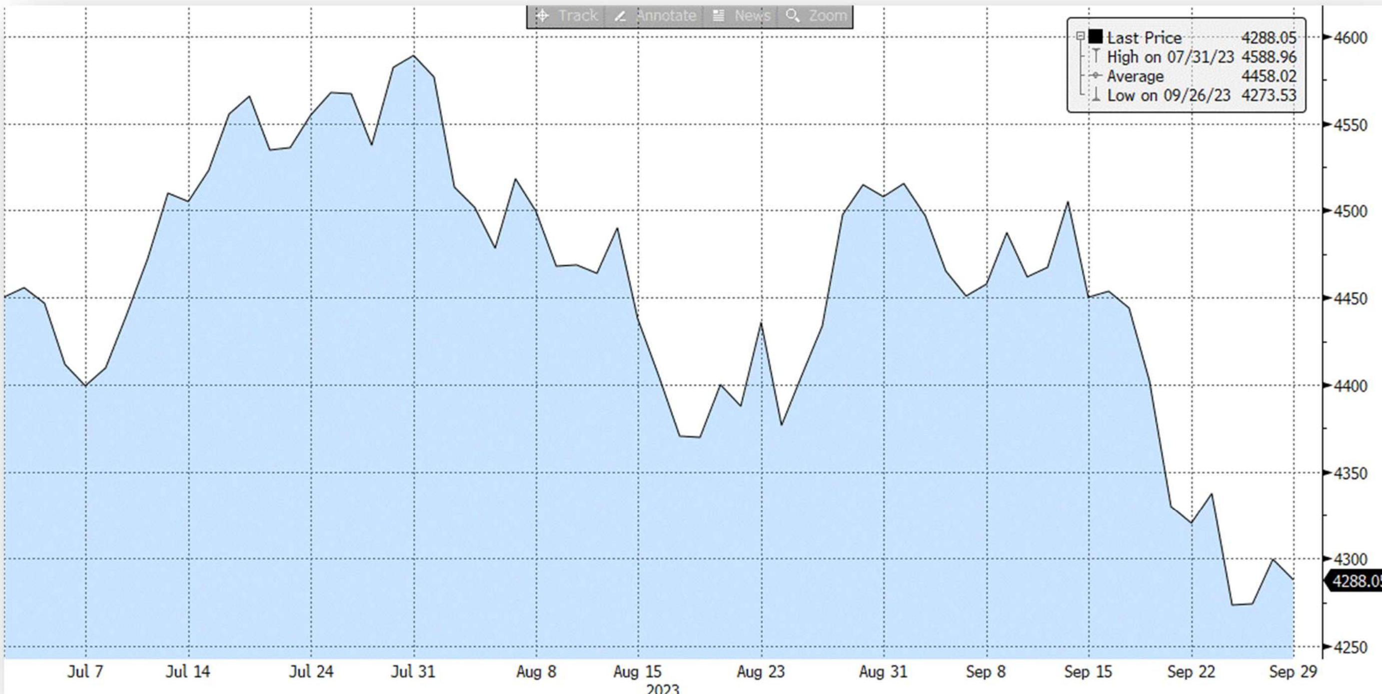
US Treasury Yield Curve 3rd Quarter



US Treasury Yield Curve YTD



S&P 500 Index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Annotate
News
Zoom
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Average 4458.02
Low on 09/26/23 4273.53
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4288.05
4250
Jul 7
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Aug 31
Sep 8
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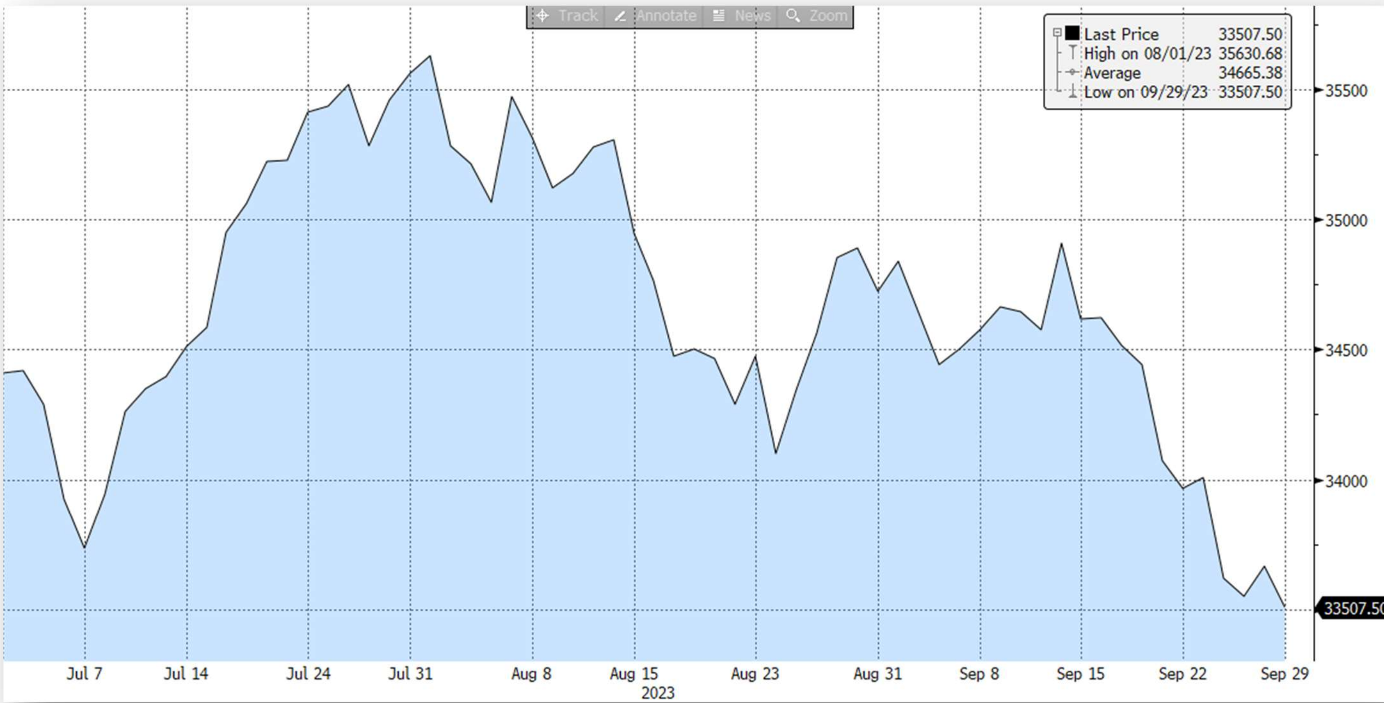
Sep 22
Sep 29
2023

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

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