The Insurance perspective

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Economic Commentary

With the first half of 2024 in the books, Q2 data reflected both optimistic and concerning signals for investors. Within the quarter, the Fed held rates constant for the seventh time in a row, signaling fewer rate cuts in 2024 than previously estimated. May's Inflation report poised positive results with prices increasing 3.3% year over year, which is closer, but not yet at the Fed's 2% target. Following this news, the Equity markets regained some footing previously lost from the high April inflation report. Overall, equities continue to rally during the quarter, furthering the upward trend that began in Q4 of 2023. In the fixed income markets, bond prices recovered slightly in the second quarter, boosted by falling inflation and a firmer, more confident outlook for rate cuts. As prices moved upward, yields fell slightly, representing the inverse relationship between yields and prices.

Domestic Fixed Income Market

Investors trudged through another quarter of volatility in the bond markets with the 10-year treasury ending the quarter almost 30 basis points lower than its peak in the quarter, yet up 9 bps overall to finish the quarter at 4.40%. The Treasury curve remains inverted with higher yields offered on the front end, with the 1–3-month Treasuries yielding ~5.2% compared to the 2-year Treasury at 4.6%. This inversion is a display that market expectations point to lower yields in the future. Spreads on a composite of 10-year single A-rated corporate bonds, the excess yield picked up over a 10-year benchmark Treasury bond, stayed relatively unchanged, falling 1 bps from the start of the quarter to .88%. This spread between Treasury bonds and corporate bonds is the compensation paid to the investor for the perceived higher credit risk of the corporate issuer. Although this spread is tighter than historical averages, overall corporate yields still remain elevated which creates an environment that is attractive for fixed income investments. Historically, during periods marked by heightened economic policy uncertainty, higher quality bonds tend to outperform equities and exhibit lower volatility. Since 1986, when the U.S. Economic Policy Uncertainty Index was more than one standard deviation above its mean, returns for U.S. Treasury securities and investment-grade corporate bonds (Baa3/BBB- and up) were, on average, more than 10 basis points greater than equities, which typically experienced negative returns. This outperformance of higher quality fixed income may indicate a preference among investors for more predictable returns in times when a clear view of future policies is elusive.

Domestic Equity Market

Equity markets finished Q2 on a positive note, despite the volatility within the quarter. Following March's higher than expected inflation data released in April, equity markets fell approximately 4.50% due to investors' concerns that the Fed's rate cut trajectory would be pushed out further, or even a potential hike at their next meeting. This fear was short lived, with equities rebounding the following week and increasing approximately 10% from this low. The S&P 500 wrapped up the quarter with a gain of 4.13%, along with a 7.60% return for the tech heavy

NASDAQ. The “Magnificent Seven” continue to drive the majority of gains in the S&P 500, rising over 16% in Q2, fueling optimism for investors. Coupled with the strength of the “Magnificent Seven,” the S&P 500 continues its rise from October ‘23 lows, up 32%, with Nvidia shares accounting for 34% of the S&P 500's ascent. Small cap stocks underperformed with a slight loss of 2.54% return for the quarter, however they remain up over 20% from their October 2023 lows. As a result, the bifurcation between large cap companies with better access to capital and an ability to pass along higher costs to customers, and small cap companies that are struggling with higher interest expense, persists.

Federal Reserve

The Fed remains dedicated in holding interest rates steady to combat high inflation and bringing it back to their 2% target, despite earlier expectations that rate cuts would occur earlier in 2024. The expectation for at least one rate cut in 2024 remains high, especially when considering historical trends. Since 1980, the Fed has hiked or cut rates in every election year except 2012, when rates were at zero and the economy was still healing from the financial crisis. Otherwise, the Fed cut rates in five election years and hiked in five election years. The main driver for these rate movements, US core inflation, continues to cool from highs of 9.1% in June of 2022 to 3.3% in May of 2024. Although this figure has moved significantly lower, the decline is flattening, remaining around the 3% mark since December of 2023. Following the May Fed meeting, Chairman Powell stated that the Fed would not be prepared to cut rates for at least a few months, if not longer. He added, however, that it's unlikely the Fed would resume hiking rates even if inflation takes longer to tame absent a notable acceleration in consumer prices. The progress so far continues to mute the fears of a recession in 2024 as the Fed has so far proven capable of a soft landing. This comment was received well by investors and led to lower rates and higher equity prices.

Summary

With the second half of the year remaining, investors certainly have plenty to look forward to. Recession probabilities continue to decrease, down from 35% to 30% in Q2, year-over-year inflation continues to decline, the Fed continues to point toward the possibility of rate cuts in 2024, and the potential opportunities mentioned created by the Presidential Election in November. The economic landscape continues to evolve, presenting both challenges and opportunities. By staying informed and adaptable, investors can position themselves advantageously in the market

CLOs and Modeling by the NAIC

Jamin Phillips
Investment Accountant

In 2021, the NAIC proposed modeling CMBS and RMBS by providing their own ratings and corresponding RBC charges. These securities were broken into 2 groups, Legacy securities and Non-Legacy securities. The separation was determined by the issue date, before or after December 31, 2012. Any Non-Legacy security was rated by its intrinsic price.

The Structured Securities Group Task Force was assigned with a similar implementation of Modeling CLOs (Collateralized Loan Obligations). The NAIC's plan announced complete transparency. That would involve insurers with modeling software, relevant Trustee reports, and other modeling agencies; and should be able to tie out to numbers from the NAIC. Their methodological approach would be similar to Moody's approach with discounting, Intrinsic Pricing, and Designation Categories similar to the process for modeling RMBS and CMBS. The implementation was exposed for comment in late 2022. Their goal was to implement the modeling by year-end 2023 at the earliest, and by year-end 2024 in the most likely scenario. The VOS Task Force recently changed the implementation to year end 2025. There are several reasons for the delay, but for now, it seems like a prudent decision.

CLOs accounted for 60% of all leverage loans in 2022 and the historical performance has been good. Senior tranches have performed extremely well, including during periods of financial stress, specifically the dotcom bubble of 2000, the Global Financial Crisis of 2008, and more recently the COVID-19 pandemic in 2020.

There has been a trend in recent years of insurance companies searching for additional yield. With that search comes the issuance and investments of bonds rated by only one CRP. Many of these bonds and investments are often rated by a lesser-known agency, specifically Egan Jones and DBRS. This has become a trend with CLOs. We at Parkway have committed to performing due diligence when researching single rated investments.

CLOs, or detail collateralized loan obligations, are single securities backed by a pool of loans ranked below investment grade. The average loan is rated a single B, but they are first lien loans. Typically, there are 150-250 loans in a security, and they are structured in tranches, like CMOs. The higher tranches are paid first, and the lower tranches (residual and equity) are paid last. The risk and return are correlated with the tranches. Most of the loans are backed by quality collateral. In theory, if a company invests in all of the tranches of the CLO, it holds the same risks as buying all of the loans. The risks with CLOs include credit risk and prepayment risk.

The S&P began rating CLOs in the mid-1990s and has rated over 18,000 securities. These ratings have included the three periods of stress mentioned earlier, the dotcom bubble, Global Financial Crisis, and the COVID pandemic. Of these 18,000, only 60 CLOs have defaulted, 40 of which were prior to 2009. Since 2009, no Middle Market CLOs under the S&P coverage have defaulted.

(CLOs and Modeling cont'd)

CLOs can be broken into 2 types, Middle Market and Broadly Syndicated Loans. MM CLOs are directly negotiated by long-term lenders, or small group lenders who perform due diligence. They are structured to allow the lender to take early preventive action to avoid default. The lenders remain directly engaged with the borrowers for loan terms. BSL CLOs are typically negotiated by banks using documents similar to the standardized loan documentation forms of the Loan Syndication and Trading Association. The banks broadly offer BSLs to a wide variety of investors who have limited time, usually only a few days. There are a large number of investors, hence the term "broadly syndicated."

The most recent conversation with the NAIC and industry involves the RBC charges on the residual tranches of Asset Backed Securities. The RBCIE Working Group proposed a 45% charge. Multiple organizations countered with a 30% charge on certain residuals, mainly on Middle Market CLOs. Some of the groups are the Alternative Credit Council, Americans for Tax Reform, the American Academy of Actuaries, the Global Atlantic Financial Group, The Guardian Life Insurance Company, and others. Most of these groups referred to the Oliver Wyman Study. The premise of the study is that Middle Market CLOs performed better than Broadly Syndicated Loan CLOs.

These groups argued that applying a 45% charge could affect not only the insurance companies that hold them but would also raise borrowing costs for the 200,000 Middle Market companies and 61 million jobs they provide. According to them, this could be disastrous for the U.S. economy. Middle Market companies are defined as organizations with annual revenue between $10MM and $1B. The National Center from the Middle Market stated that 90% of these companies have been in business for approximately 40 years and the 2023 topline revenue grew by 12.4%. Access to capital has been more difficult the last several years, and the assumption that millions of American families and hundreds of thousands of stable businesses would default on loans does not correspond with the data. We should also note that these families and businesses are policyholders and important to the insurance base. The NAIC should commit to a broad, yet precise evaluation of CLOs.

Earlier this month, the NAIC adopted a 45% capital charge to ABS residuals, which will be an interim solution. I will also point out that residual tranches should be reported on Schedule BA. In conclusion, the VOS Task Force has delayed modeling CLOs until year-end 2025. Whatever the modeling looks like and in the meantime, Parkway Advisors will continue to commit to performing our due diligence and recommend insurance companies to do so as well.

New Overtime Exemption Rules

The United States Department of Labor (DOL) released new overtime exemption rules effective July 1, 2024. The new rule increases the minimum salary amount required in order for certain employees to be considered exempt from overtime pay requirements under the Fair Labor Standards Act (FLSA). The rule allows an exemption from both minimum wage and overtime pay for executive, administrative, professional, outside sales, and certain computer employees. To qualify for an exemption, employees have to meet certain tests based on their job duties and be paid on a salary basis. The final rule did not make any changes to the job duties tests to determine overtime exemptions.

The new rule raises the minimum salary level for employees to be considered exempt from the overtime pay requirements from $684 per week ($35,568 annually) to:

- $844 per week ($43,888 annually) beginning July 1, 2024 and
- $1,128 per week ($58,656 annually) beginning January 1, 2025.

It also raises the minimum salary level for highly compensated employees who are exempt from the overtime pay requirements because of their compensation amount without considering the duties they perform from $107,432 annually to:

- $132,964 beginning July 1, 2024 and
- $151,164 beginning January 1, 2025

The final rule also provides for planned adjustments to the minimum salary levels on July 1, 2027 and every 3 years thereafter.

The final rule is already being challenged in the courts. On June 28, 2024, a Texas federal judge issued a preliminary injunction specifically for Texas state employees that delays the rule's implementation. In the *State of Texas v. U.S. Department of Labor,* the Court said, "since the EAP Exemption requires that the exemption status turn on duties – not salary – and the 2024 Rule's changes make salary predominate over duties for millions of employees, the changes exceed the authority delegated by Congress to define and delimit the relevant terms." The injunction only applies to the state employees of Texas, but the outcome of the case may set a precedent for other challenges to the Rule. *Flint Ave., LLC v. U.S. Department of Labor* is another case before a Texas federal court. Flint Ave., LLC is a software company that is seeking a nationwide injunction against the Rule and is arguing that the DOL exceeded its statutory authority by adjusting the salary level test. Currently there are several other legal challenges to the Rule, including requests for nationwide injunctive relief. However, for the time being, the Rule is in effect for all employers except for the State of Texas.

Interest Rate Spreads

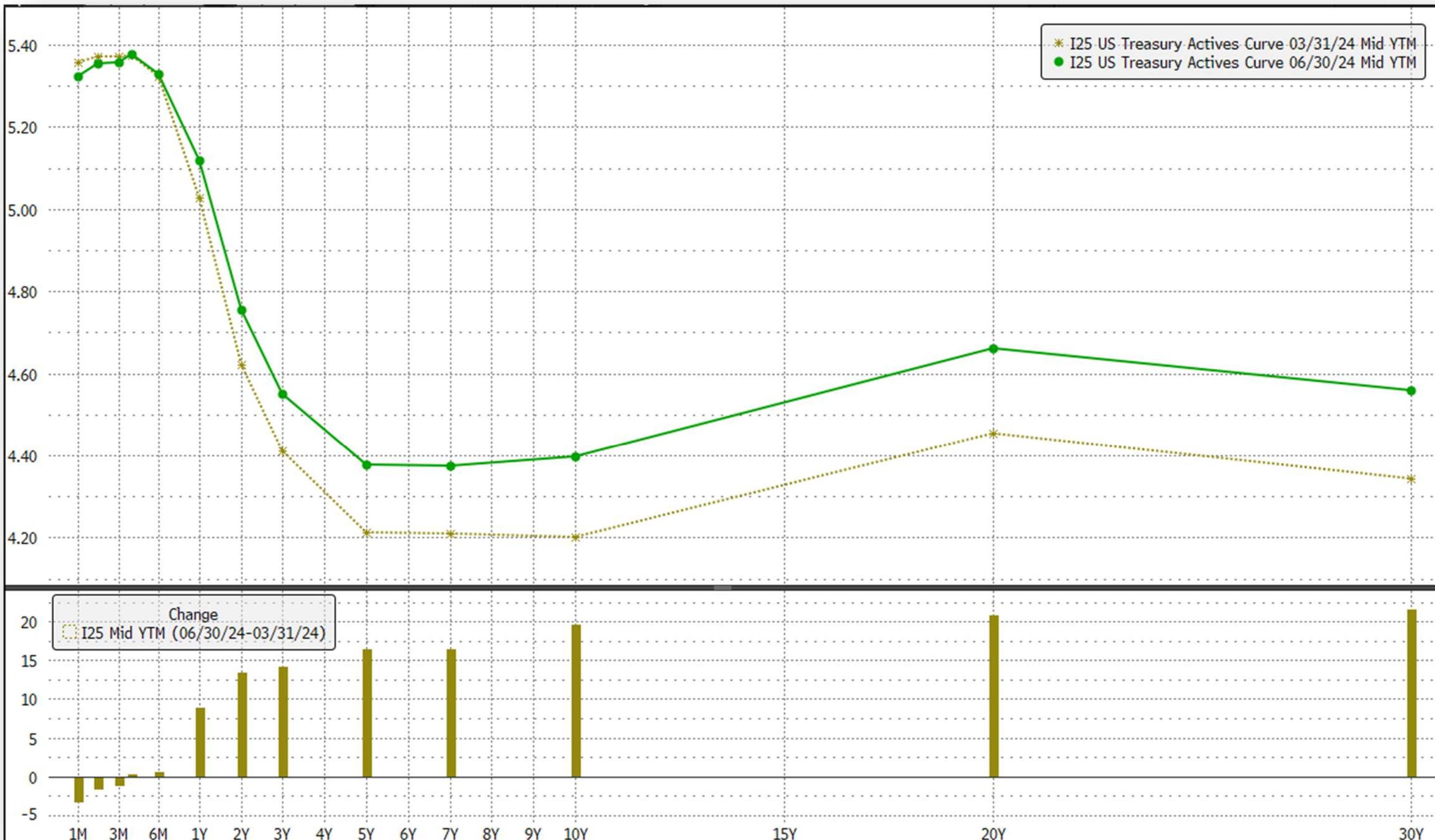
As of: 6/30/2024

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	5.09	5.2945	0.2045	5.4216	0.3316	5.7436	0.6536	6.0881	0.9981
2yr	4.71	5.0024	0.2924	5.1334	0.4234	5.4509	0.7409	6.0235	1.3135
3yr	4.52	4.8607	0.3407	5.0137	0.4937	5.3681	0.8481	6.0488	1.5288
5yr	4.33	4.8032	0.4732	4.9658	0.6358	5.3278	0.9978	6.289	1.959
7yr	4.33	4.8446	0.5146	5.0701	0.7401	5.4621	1.1321	6.4594	2.1294
10yr	4.36	5.0132	0.6532	5.2795	0.9195	5.664	1.304	6.645	2.285
20yr	4.61	5.3472	0.7372	5.6234	1.0134	5.9478	1.3378	6.9331	2.3231
30yr	4.51	5.3289	0.8189	5.5763	1.0663	5.8956	1.3856	6.7788	2.2688

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.

10 Year A-Rated Corporate Spreads

US Treasury Yield Curve 2nd Quarter

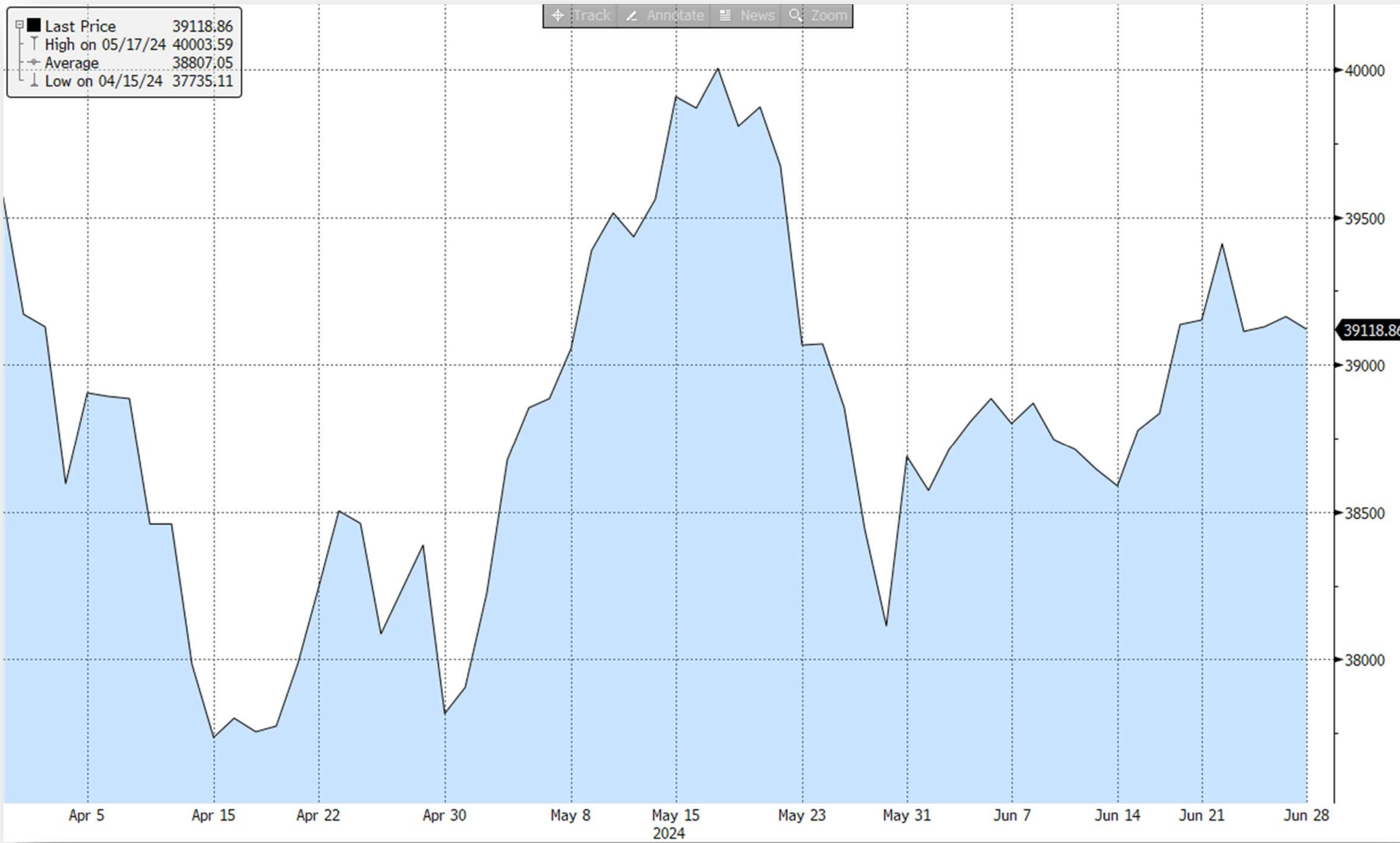


US Treasury Yield Curve YTD

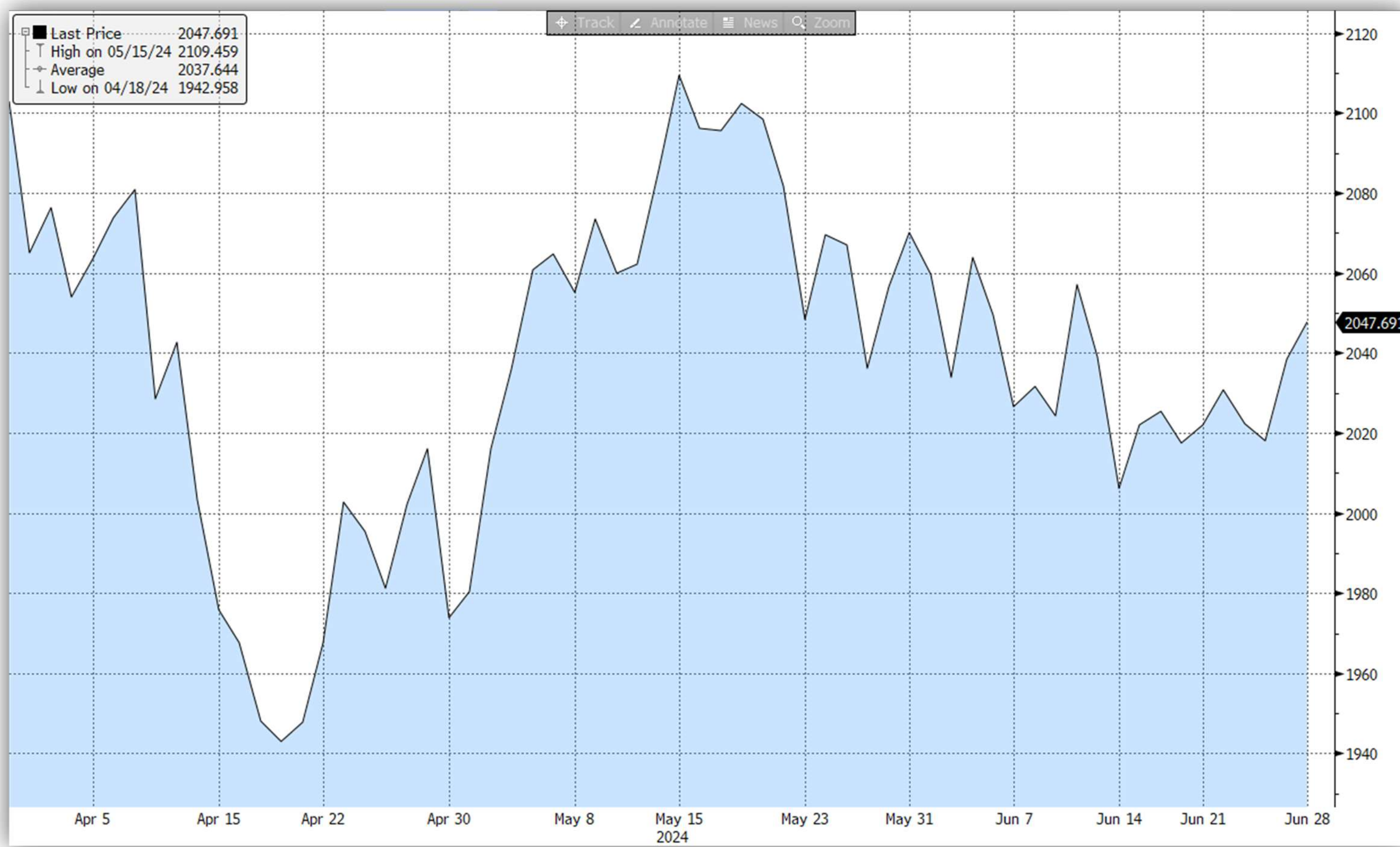
S&P 500 Index


Last Price 5460.48
High on 06/18/24 5487.03
Average 5246.63
Low on 04/19/24 4967.23
Track
Annotate
News
Zoom
5500
5460.48
5400
5300
5200
5100
5000
Apr 5
Apr 15
Apr 22
Apr 30
May 8
May 15
2024
May 23
May 31
Jun 7
Jun 14
Jun 21
Jun 28

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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