The Insurance *perspective*

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Economic Commentary

The Fed continued to dominate market sentiment in Q3 with the anticipation of rate cuts growing as the Federal Funds rate has remained at levels not seen since the early 2000s for the past 14 months. Based on the expectations of cuts, the 10-year Treasury yield fell sharply over the quarter leading up to the September FOMC meeting, cratering from 4.40% at the start of the quarter to 3.62% on September 16th. As expected, the Fed started the cutting cycle in September as inflation data continued to trend lower towards the 2% target, as well as concerns over softening economic growth and rising unemployment. Despite the larger than expected 50-basis point cut, the 10-year reversed course, ending the quarter at 3.78%, up over 16 bps from September's low prior to the meeting. This rise in yields suggests that the market may have been overly optimistic to the degree of future cuts after language from Powell indicated that the "committee is in no hurry to cut rates quickly." Although volatility was present, equity markets remained resilient, continuing the rally through the 3rd quarter, with the S&P 500 ending the quarter at all-time highs. Despite signs of weakening in the labor markets, the economy as a whole continues to grow at a moderate pace, heavily supported by consumer spending and expectations of easier monetary policy.

<u>Domestic Fixed Income Market</u>

Fixed Income markets experienced significant shifts across short and intermediate-term bonds as rate cut expectations drove Treasury yields lower. The 2-year Treasury yield decreased by over 111 basis points from 4.76% to 3.64%, while the 10-year fell over 62 bps, ending the quarter at a 3.78%. Due to the drop in the 10-year, the Bloomberg US Aggregate Bond index (AGG), which serves as a benchmark for the intermediate term investment grade bond market, returned 5.2% during the quarter. This was the second-best quarterly return for the AGG index since 1995. During the quarter, the yield curve normalized as the 10-year Treasury offered a higher yield than the 2-year, marking the end of a prolonged inversion that lasted over two years. This shift reflects the greater sensitivity of shorter-term Treasuries to monetary policy changes compared to longer-dated securities. Meanwhile, corporate bond spreads, the additional yield investors demand for taking on credit risk, continued to tighten through the quarter after a sharp spike in early August. The shift towards higher-quality credit remained attractive as high-yield corporate bond spreads were trading below their five-year averages due to the strong current economic environment. Investment-grade bonds continue to be appealing as yields remain elevated and will perform better than lower rated securities if economic growth were to slow.

<u>Domestic Equity Market</u>

Equity markets boasted another strong quarter, with the S&P 500 returning 5.89%. This marks the seventh gain in the last eight quarters, positioning the index for its second consecutive annual return exceeding 20%, a feat not seen since the late 1990s. The market's performance is primarily driven by disinflationary trends, a resilient yet potentially slowing labor market, positive corporate earnings, and the anticipation of further rate cuts. However, the tech-heavy Nasdaq underperformed, posting a return of only 2.76% as Mega Cap Growth stock returns cooled. As interest rate cuts began during the quarter and are expected to continue, mid cap (S&P 400) and small cap (Russell 2000) stocks that more heavily rely on debt outperformed, returning 6.94% and 9.27%, respectively. Volatility in equities persist as we see shifts in monetary policy, mixed economic data, geopolitical tensions (particularly regarding U.S.-China trade relations) and the upcoming Presidential Election.

Federal Reserve

The Fed continued to navigate a delicate balance between inflation control and fostering economic growth during the quarter. In its September meeting, the FOMC lowered the Fed Funds rate by 50 basis points, signaling a more aggressive approach to rate cuts. This is only the fourth time in history a 50-bps cut has been implemented. This decision reflects moderating inflation and evidence that both the economy and labor markets have cooled. Fed Chair Jerome Powell stated, "Strength in the labor market can be maintained in a context of moderate growth and inflation moving sustainably down to 2%. The US economy is in a good place, and our decision today is designed to keep it there." While the World Interest Rate Probability (WIRP) is pricing in nearly three additional rate cuts through 2024 and four more in 2025—resulting in implied rates of approximately 4.10% and 2.90%, respectively—the FOMC's Summary of Economic Projections indicates median expectations for the Fed Funds rate at 4.40% for the end of 2024 and 3.40% for the end of 2025. This discrepancy between market expectations and the Fed's projections shows a potentially overly optimistic view of monetary easing. While lower interest rates will provide relief for cash strapped consumers and businesses, which will stimulate overall spending, unnecessary cuts may lead to a resurgence of inflation.

Summary

Q3 remained the "story of the Fed", as the highly anticipated start to the rate cutting cycle significantly influenced market dynamics. Treasury yields fell to yearly lows as spreads remain tight and investors flock to higher-quality bonds. Broad equity markets ended the quarter at all-time highs, reflective of strong consumer spending and the much-desired onset of easier monetary policy. The Fed's slightly altered stance on interest rates highlights the growing importance of keeping unemployment down as inflation cools. Many investors are cautious as historical trends show that achieving a soft-landing following a rapid tightening of monetary policy is rare. In contrast, others are more optimistic about the economy, bolstered by strong consumer spending, resilient labor markets, and now a more accommodative monetary policy. As more economic data is released, specifically regarding employment, a clearer direction of the economy will emerge. As equity markets continue to reach all time highs amid attractive rates on bonds, given the question marks ahead it remains prudent to revisit your asset allocations to ensure you are positioned appropriately for either the much anticipated "soft landing" scenario or a potential slowdown if labor markets continue to cool.

Statutory Reporting Updates

Andrea Frizzell
Senior Investment Accountant

Over the past several years the Insurance Industry has seen a shift in investment strategies. Insurance companies have begun to hold more complex assets and private investments. As insurance companies' holdings in complex assets have grown, the need to revise regulations that govern those investments has become apparent. With this shift in assets, the NAIC has taken on a multi-year initiative to update the framework of statutory reporting and RBC. At the center of this initiative is the need for transparency in insurance companies' investments.

This initiative has three main areas of focus. The first area of focus is the classification of investments. This has been discussed at length in the principals-based bond project. The new guidance from the bond project is effective January 1, 2025. A training course over the new regulations has been released by the NAIC. This course will be free for the remainder of 2024. If you are interested in this course you can find the registration information at https://web.cvent.com/event/920b55bf-8d48-4cab-9bad-b584b542931b/summary. In addition, you can find all the materials relating the principles-based bond project at https://content.naic.org/committees/e/statutory-accounting-principles-wg.

The second area of focus relates to assigning designations. This has generally centered on the use of rating agencies. The financial condition (E) Committee has adopted the process that extends NAIC staff discretion over agency rating-based designations. The NAIC has stressed that it does not endorse rating agencies or their ratings. The NAIC is a consumer of rating agency products. As a consumer, the goal is to move from a place of blind reliance on ratings to a place of informed reliance. Each rating agency has its own methods and standards. The SEC's office of credit ratings does not validate or endorse rating agencies methodologies or ratings which is prohibited by law. The NAIC is prohibited from regulating credit rating agencies and their methodologies. The intent of extending the NAIC oversight is only as a consumer of these ratings. The NAIC now has the ability to question a rating's validity. There is a group within the SVO that can do an analysis on a rating that is in question. This adoption sets up a process that allows for conversations between Insurers and the SVO about a rating being used.

In addition to extending NAIC oversight, a draft RFP to solicit proposals from 3rd party firms to develop a due diligence framework for overseeing the use of rating agencies was created. This is a multi-year initiative. It is expected that the NAIC will have to make changes to their data systems and internal resources to accommodate the process of overseeing ratings. As it stands, the process could be effective as early as January of 2026, but it may be pushed out to a later date.

The third area of focus is on capital differentiation for risk-based capital calculations. As part of a long-term effort to differentiate the treatment of structured assets, the RBC-IRE-WG initiated efforts with the Academy to develop a framework to differentiate capital for CLOs and structured assets more broadly. The academy previously explained its plans to map out and assess a comprehensive set of attributes that can differentiate the risks of ABS as part of assessing an appropriate C-1 charge for ABS. They plan to determine a set of easily identifiable attributes that explain most of the tail risk. If the set is small, they become candidates for comparable attributes for determining C-1. If the set is large and complex, modeling individual CLO's may be necessary. As the NAIC continues its initiative to refine investment guidelines in response to insurers' evolving investment strategies, we can expect that RBC and the rules that govern it will be reviewed and possible changes will be presented. To keep up with conversations surrounding RBC you can view the risk-based capital investment risk evaluation (E) working group at https://content.naic.org/committees/e/risk-based-capital-investment-risk-evaluation-wg

Interest Rate Spreads

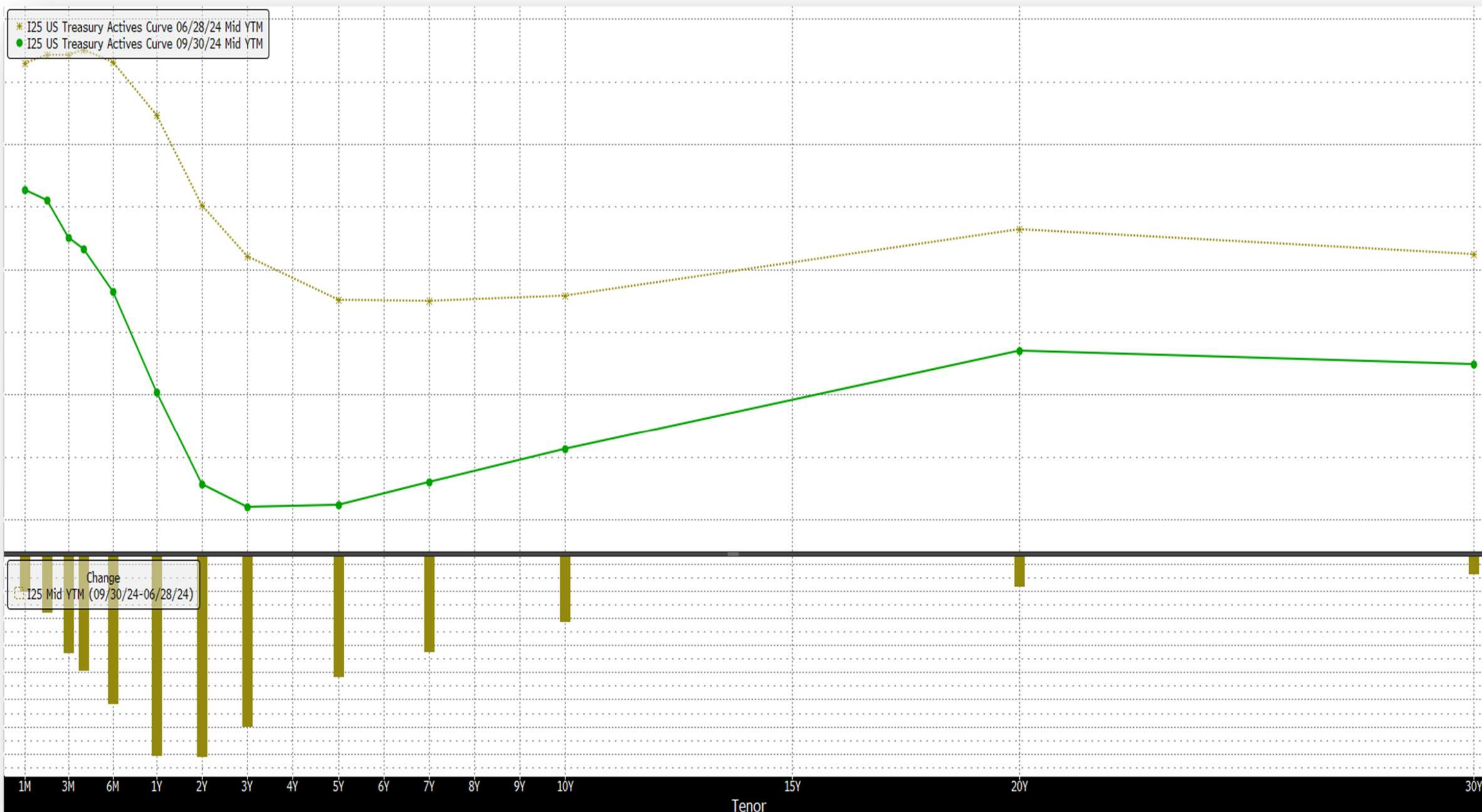
As of: 9/30/2024

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
1yr	3.98	4.2199	0.2399	4.3933	0.4133	4.7931	0.8131
2yr	3.66	3.89	0.23	4.0586	0.3986	4.4214	0.7614
3yr	3.58	3.8262	0.2462	3.9918	0.4118	4.3754	0.7954
5yr	3.58	3.9557	0.3757	4.1416	0.5616	4.5157	0.9357
7yr	3.67	4.1258	0.4558	4.348	0.678	4.7469	1.0769
10yr	3.81	4.3549	0.5449	4.6227	0.8127	5.0196	1.2096
20yr	4.19	4.8637	0.6737	5.1119	0.9219	5.4406	1.2506
30yr	4.14	4.8708	0.7308	5.0863	0.9463	5.4423	1.3023

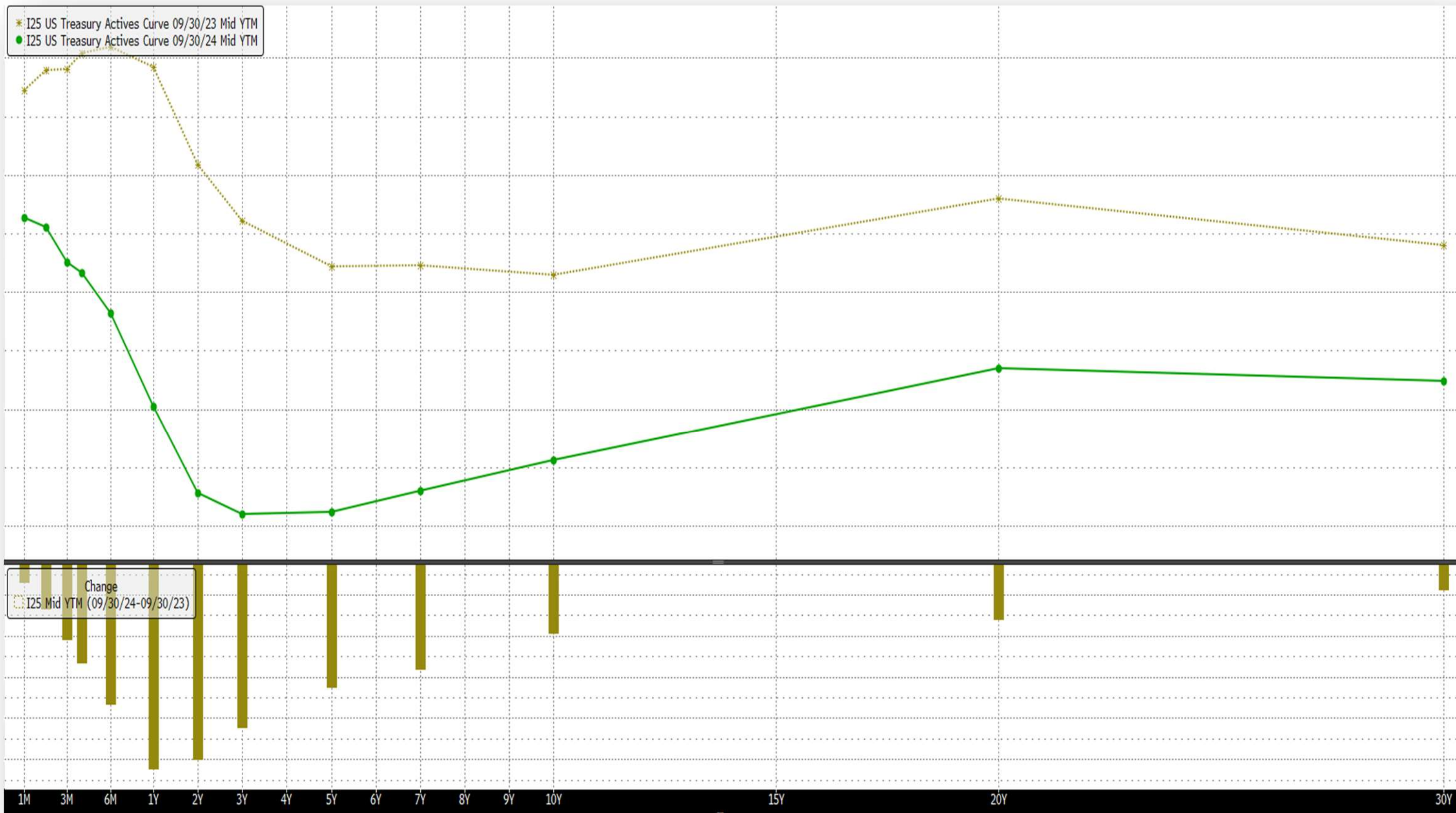
Disclosures: This material is for your use only and is based upon information which we consider reliable, but we do not represent that it is accurate or complete and should not be relied upon as such. Information was obtained from Blooomberg and represents the respective Bloomberg US Composite BVAL and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

10 Year A-Rated Corporate Spreads

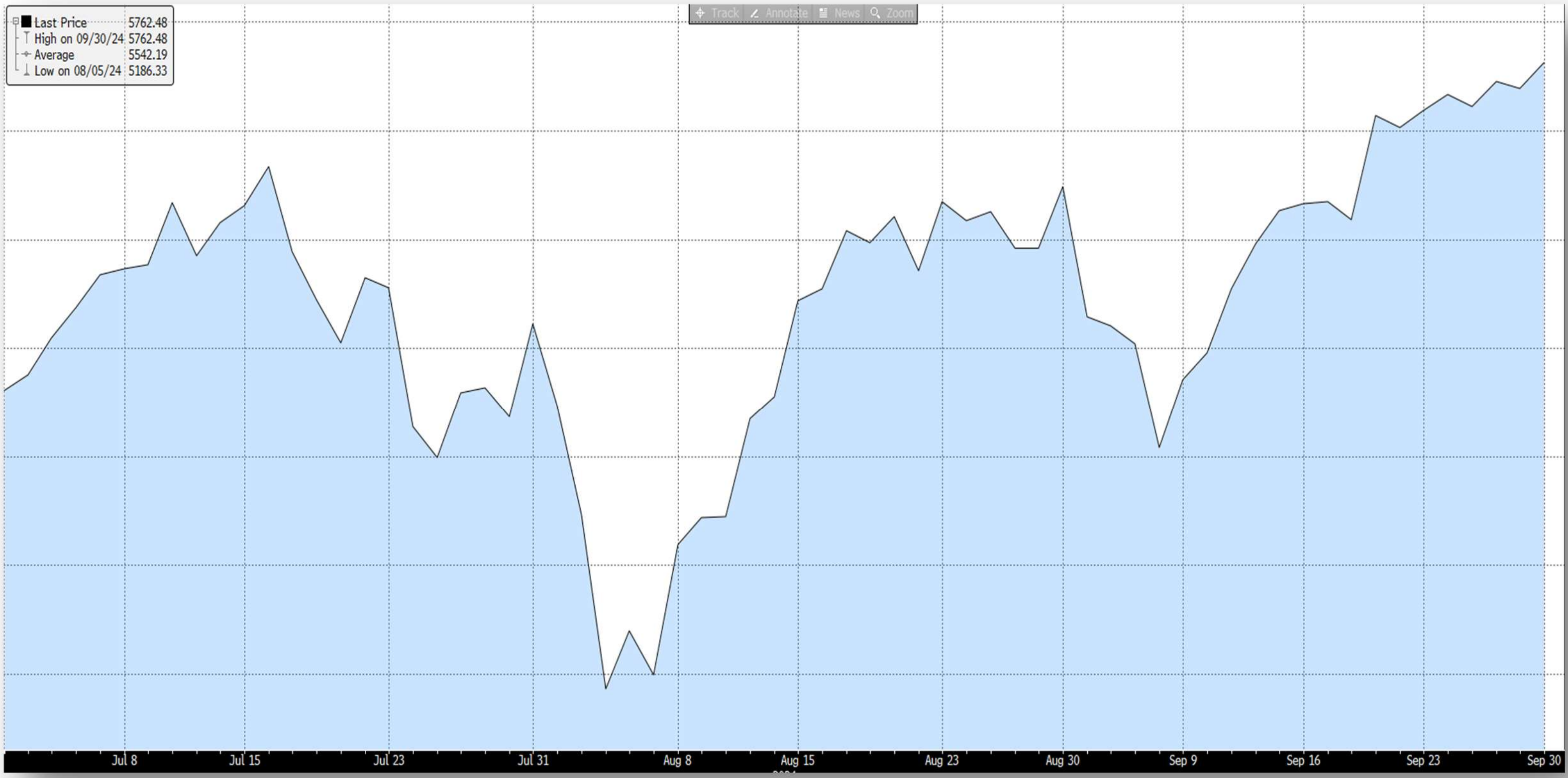
US Treasury Yield Curve 2nd Quarter



US Treasury Yield Curve YTD

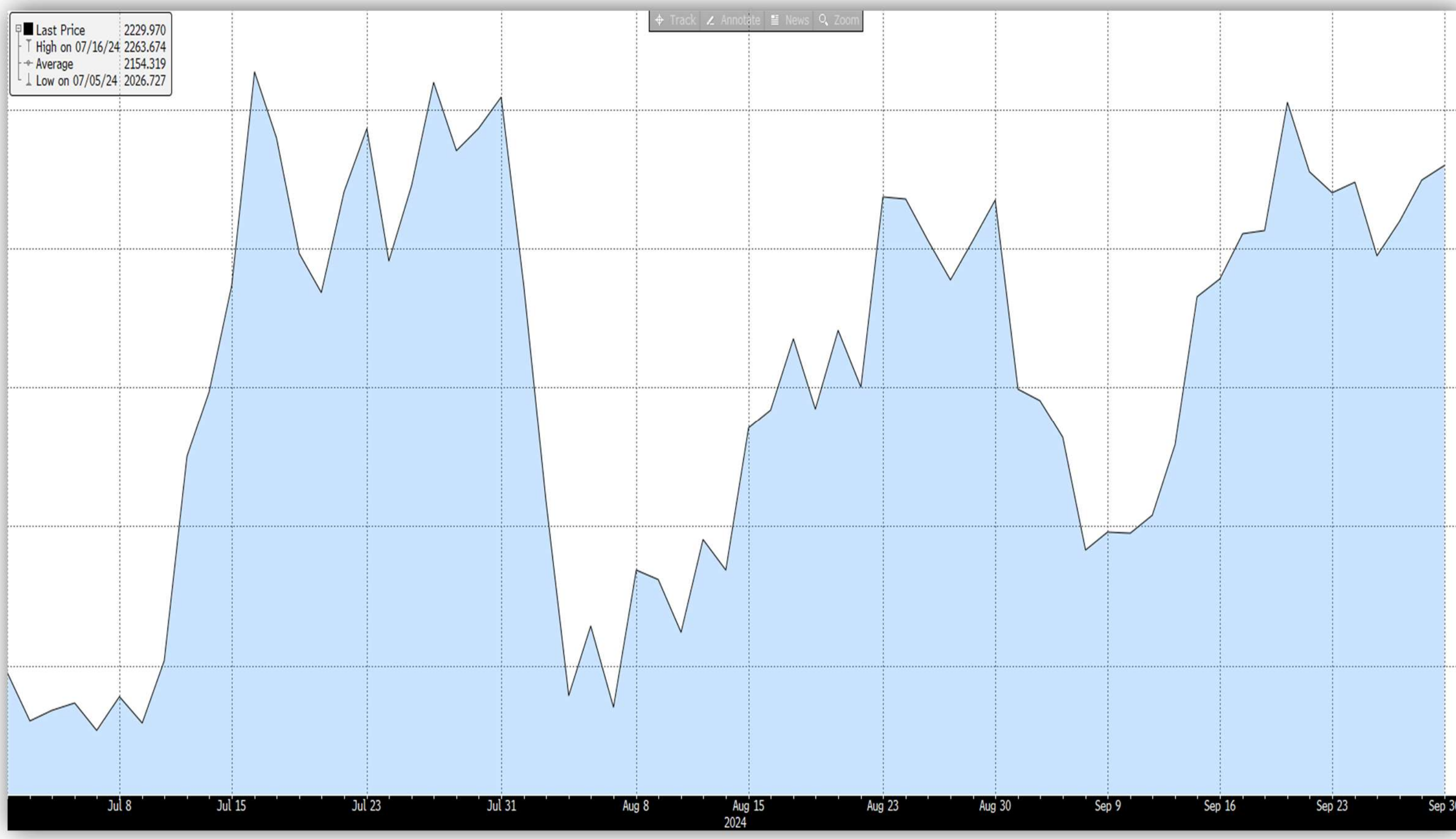


S&P 500 Index


Last Price 5762.48
High on 09/30/24 5762.48
Average 5542.19
Low on 08/05/24 5186.33
Track
Annotate
News
Zoom
Jul 8
Jul 15
Jul 23
Jul 31
Aug 8
Aug 15
Aug 23
Aug 30
Sep 9
Sep 16
Sep 23
Sep 30

Dow Jones Industrial Average

Russell 2000 Index



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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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