The Insurance perspective

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Economic Commentary


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As 2024 comes to an end, the year was highlighted by notably strong performance within equity markets alongside optimism of the Fed achieving a soft landing. Equity markets started 2024 after strong results in 2023, which continued through the year, driven by Federal Reserve interest rate cuts, a robust economy, and AI optimism. These factors contributed to the second consecutive year of 20%+ gains in the S&P 500, marking the largest 2-year increase since 1997-1998. Yields remained volatile, with the 10-year yield whipsawing over 109 basis points throughout the year. Most notably, all eyes were on the results of the presidential election and the Fed's policy projections heading into the new year, which dominated the moves seen in Q4.

Domestic Fixed Income Markets

We continue to see volatility in treasury market yields, as seen by the 10-year Treasury which started 2024 at 3.93% and proceeded to rise to 4.71% in April before retracing to a low of 3.62% in September. We've witnessed a shift to a more "normalized" yield curve as the Fed has effectively lowered the short end while macro expectations have drawn up the long end of the curve. Longer term yields have steadily climbed since the September Fed cuts, with the 10-year ending the year at 4.57%, wrapping up the year with a total increase of 64 basis points. Persistent inflation concerns accompanied by a resilient economy indicate the Fed may cut less aggressively than previous market expectations. Additionally, there is mounting concern over increased deficit spending under the helm of President-elect Donald Trump. The Fed's rate cutting journey began in the latter half of 2024 and is projected to continue with 1-2 cuts throughout 2025, which has brought the short-end of the curve lower, leading to a steepening of the curve. While yields longer than 2-years ended the year higher, the 3-month Treasury started 2024 at 5.36% and ended at 4.32%. For reference, the 30-year started the year at 4.07% and ended at 4.78%. While Treasury yields increased through the year, spreads (the additional yield credit securities earn over government securities of the same duration) continued to tighten, with the average additional yield of a 10-year A-rated corporate bond declining to just 74 basis points at year-end compared to the long-term average of 1.25%.

Domestic Equity Market

2024 was another spectacular year for equities with the S&P 500 returning 25%. The broad theme of the year was AI, tech, and The Magnificent 7. Given the S&P 500 is a market cap weighted index, the Magnificent 7, which returned over 67% for the year, contributed almost 14% of the index's 25% return. In other words, just seven stocks contributed to more than half of the S&P 500's return in 2024. As a result, the tech heavy NASDAQ returned 28.6% in 2024. These impressive gains led the market to experience the first consecutive 20%+ annual returns since the start of the millennium. During the final quarter of 2024, despite an initial rally following the Trump victory, the S&P 500 returned 2.4%, mid-caps (S&P 400) returned 0.32%, and small caps (Russell 2000) returned 0.33%. Small caps saw the most volatility, starting off strong with a 6% increase after the Republican sweep amid optimism over more favorable tax policy moving forward. These small cap returns were later erased at the end of the quarter as yields moved higher, adversely affecting smaller companies which feel the effects of higher interest rates more than their large and mid-cap constituents.

Federal Reserve

Inflation has been decreasing after the Fed's aggressive stance and the difficult task of maintaining elevated rates without triggering a recession. Rate cuts began with a 50 bp cut in September, followed by 25 bp cuts in October and December. After lowering interest rates by a total of 1% this year, the target Federal Funds Rate is 4.25% - 4.50% heading into 2025. The aforementioned cuts were no surprise to investors, however, in the December meeting, Fed chair Jerome Powell noted slowing the rate of cuts going forward to allow for more data on potentially sticky inflation and the policy effects of the next administration. We left this meeting with markets projecting 1-2 additional cuts in 2025, which gave a more hawkish impression than the market preferred. The upcoming administration's tariff policy has caused some FOMC members to worry about reigniting inflation if the suggested blanket tariffs transpire into more than threats for greater bargaining power. Overall, the Fed has tamed inflation thus far as it continues to trend towards the 2% target and proved that the economy can operate and grow despite higher rates.

Summary

As we enter 2025, several key factors warrant attention. Market valuations remain elevated, particularly among large-cap stocks, which will need to meet ambitious earnings expectations to justify current levels. The political transition brings uncertainty, especially regarding trade policy and its potential inflationary impact. While the Fed has successfully engineered progress toward a soft landing thus far, the possibility of re-emerging inflation could complicate the path forward. Given current spreads and uncertainty, higher quality securities remain attractive relative to the modest additional return for the increased risk of most lower rated securities. Historically speaking within equities, the third year of a bull market is met with challenges, with all 11 previous instances experiencing a pullback of at least 5% in the subsequent 12 months, and nearly half experiencing a decline of 10% which could present some buying opportunities in 2025. Regardless, attractive fixed income yields provide an alternative to the volatility equities carry should insurers look to reduce or rebalance asset allocations.

Statutory Reporting Updates

The NAIC is looking at changing the way CLOs are modeled, with a current start date of December 31st 2025. CLOs will be treated more similarly to how RMBS and CMBS are treated and will be included under the financial modeling guidance in SSAP No. 43R – Loan Backed and Structured Securities. This means that CLOs will be financially modeled to determine their NAIC designations and RBC charges. This modeling process aims to provide a more precise assessment of the risk associated with CLOs held by insurance companies. CLOs will now receive a single NAIC designation, as opposed to the previous 19 price point system, in order to reduce, or eliminate entirely the arbitrage where insurance companies may have benefitted from a lower overall risk charge by holding CLO tranches, rather than the underlying loans directly. This change was adopted to align the risk assessment more closely with the underlying collateral risk of the CLOs.

There are some exemptions and exceptions for CLOs that cannot be financially modeled but are still rated by a Credit Rating Provider (CRP), and those ineligible for modeling and that are not rated by a CRP. For those that cannot be financially modeled, but are rated by a CRP, they will follow the filing exempt procedures, where the NAIC designation is based on the second-lowest CRP rating. For CLOs not eligible for modeling and not rated by a CRP, insurers must file these with the SSG and must provide detailed documentation like identures, prospectuses, offering memorandums, etc. However, certain securities like Commercial Real Estate CLOs, re-securitizations, ABS, CDOs, and TruPS CDOs (Trust Preferred Securities) are excluded from this modeling requirement.

The primary reasons for the changes are to minimize RBC arbitrage, to ensure that the capital charge for holding CLOs reflects the actual risk of the underlying loan pool, and to provide regulators with more clear insight of the real risk profile of insurers' investments in structured securities.

These changes represent a significant shift in how insurance companies must report and manage their investments in CLOs, aiming for more accurate risk assessment and alignment with the true economic risk of these securities.

NAIC Guidance on Artificial Intelligence Systems

In December of 2023, the NAIC adopted the Model Bulletin on the use of Artificial Intelligence Systems by Insurers. Over the year following its adoption, the bulletin's guidance has led to its implementation in eighteen states and the District of Columbia, as well as four states that have created their own unique insurance industry specific regulation governing the use of artificial intelligence.

The NAIC Model Bulletin offers guidance for state insurance departments to formulate policies and procedures pertaining to AI usage by insurance companies. The primary objective of the bulletin is the development, implementation, and maintenance of a written document for the use of Artificial Intelligence Systems (Labeled an AIS program by the NAIC). The AIS may be added as a portion of an Enterprise Risk Management program, or a standalone document; however, it should accomplish the following goals.

- Mitigate risk that the use of AI systems will result in Adverse Consumer Outcomes
- Address governance, risk management controls, and internal audit functions
- Ensure AI-driven decisions comply with federal and state insurance regulations
- Reduce the risk of unfair discrimination or other regulatory violations by incorporating verification and testing methods for AI systems
- Include measures to promote transparency, enabling consumers to understand how AI systems impact decisions affecting them
- Establish oversight mechanisms for both in-house AI systems and those developed by third-party vendors

Overall, the NAIC's approach facilitates the growth of the insurance industry's use of artificial intelligence systems by grounding the bulletin's guidance in existing regulatory frameworks. Under this model, AI systems can be leveraged to enhance operations and decision-making, provided that insurers remain compliant with the rules and standards they are already required to follow. This balanced and open perspective on governance encourages innovation while maintaining accountability and consumer protections. Notably, this approach mirrors similar strategies in industries like banking, where AI usage is also guided by preexisting law rather than entirely new regulatory frameworks.

Looking ahead, it would be prudent to establish internal policies and procedures governing the use of artificial intelligence in order to remain up to date with current NAIC guidance as well as be prepared for the possibility of regulatory changes concerning the use of AI.

Interest Rate Spreads

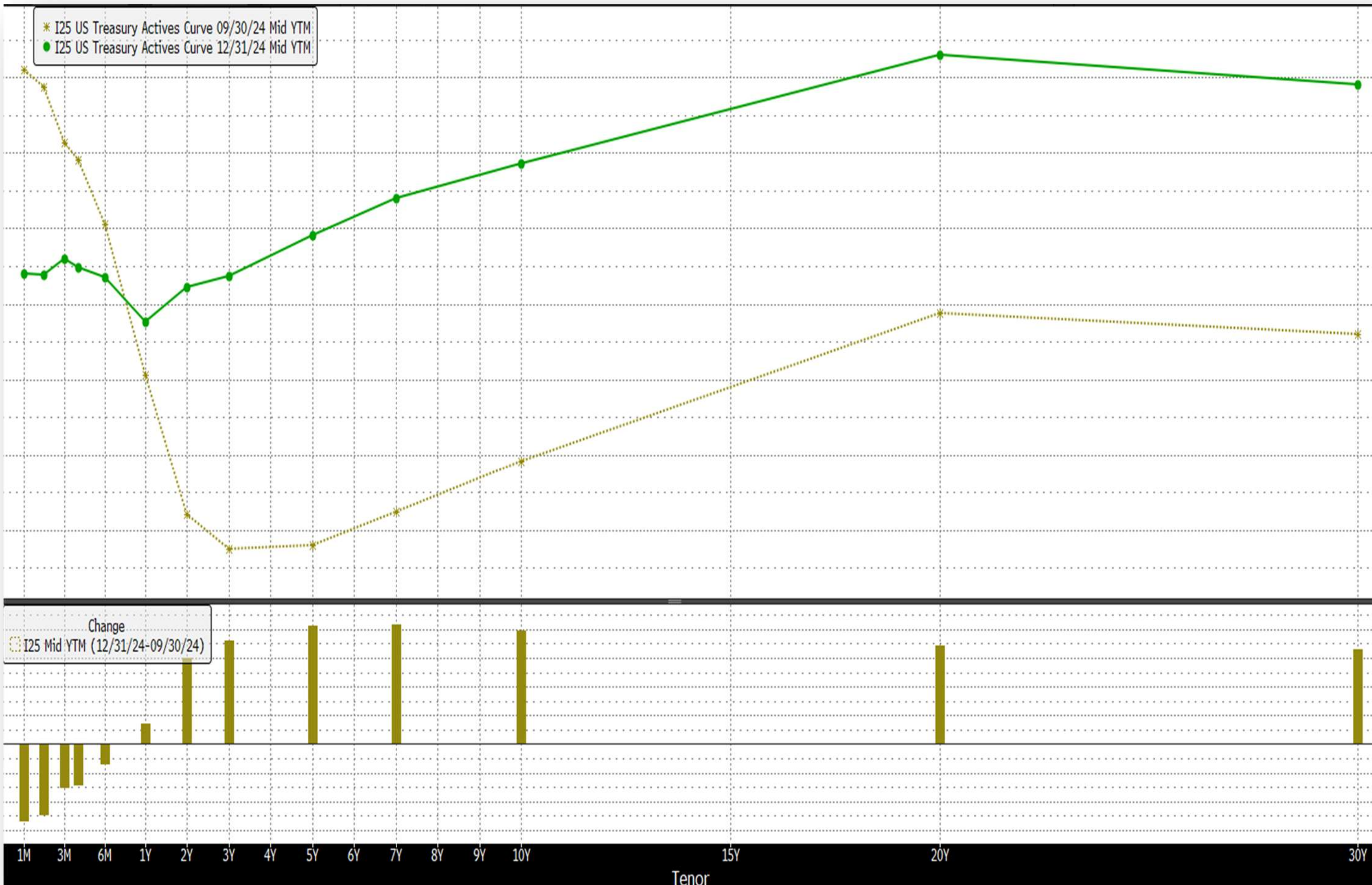
As of: 12/31/2024

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	4.16	4.4892	0.3292	4.6144	0.4544	4.8811	0.7211	5.7869	1.6269
2yr	4.25	4.404	0.154	4.5301	0.2801	4.815	0.565	5.7889	1.5389
3yr	4.27	4.4744	0.2044	4.6382	0.3682	4.9133	0.6433	5.9374	1.6674
5yr	4.38	4.6963	0.3163	4.8679	0.4879	5.1554	0.7754	6.3138	1.9338
7yr	4.48	4.8796	0.3996	5.086	0.606	5.3742	0.8942	6.5267	2.0467
10yr	4.58	5.0847	0.5047	5.308	0.728	5.6164	1.0364	6.7655	2.1855
20yr	4.86	5.5157	0.6557	5.7203	0.8603	6.0156	1.1556	7.1658	2.3058
30yr	4.78	5.5137	0.7337	5.6919	0.9119	5.9885	1.2085	7.0141	2.2341

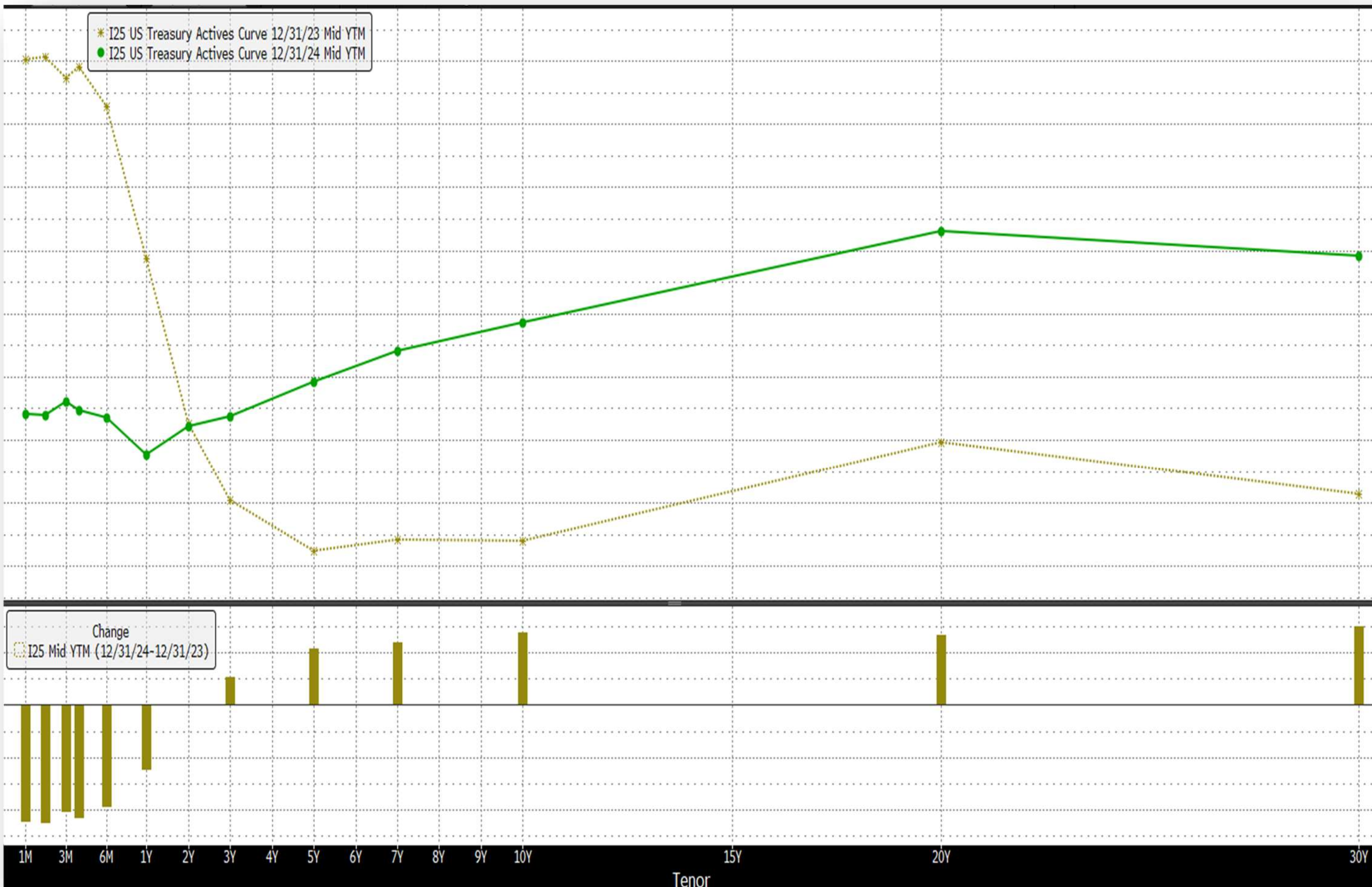
Disclosures: This material is for your use only and is based upon information which we consider reliable, but we do not represent that it is accurate or complete and should not be relied upon as such. Information was obtained from Blooomberg and represents the respective Bloomberg US Composite BVAL and 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 4th Quarter



US Treasury Yield Curve YTD

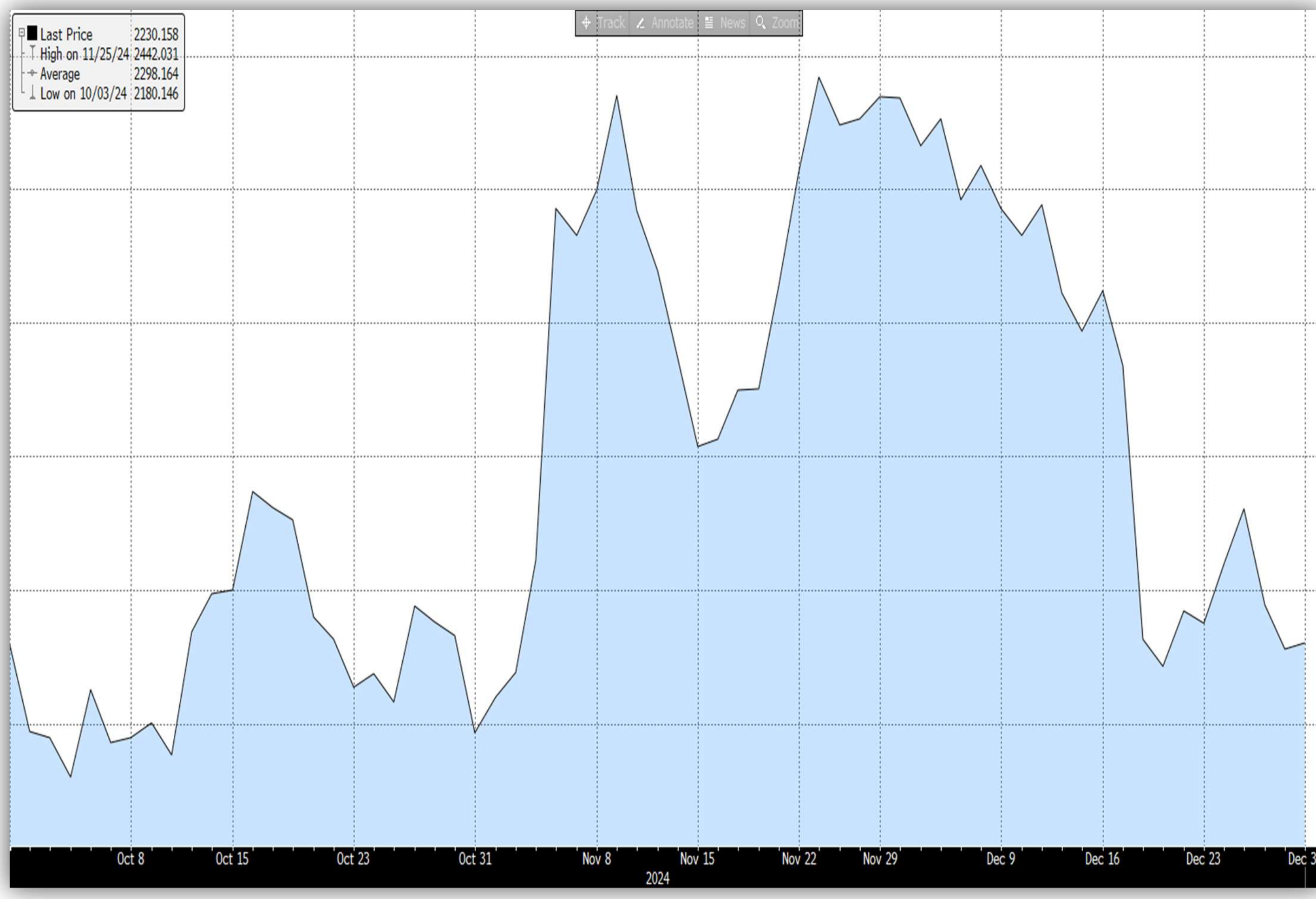


S&P 500 Index


Last Price 5881.63
High on 12/06/24 6090.27
Average 5904.82
Low on 10/07/24 5695.94
Track
Annotate
News
Zoom
Oct 8
Oct 15
Oct 23
Oct 31
Nov 8
Nov 15
Nov 22
Nov 29
Dec 9
Dec 16
Dec 23
Dec 31
2024

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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