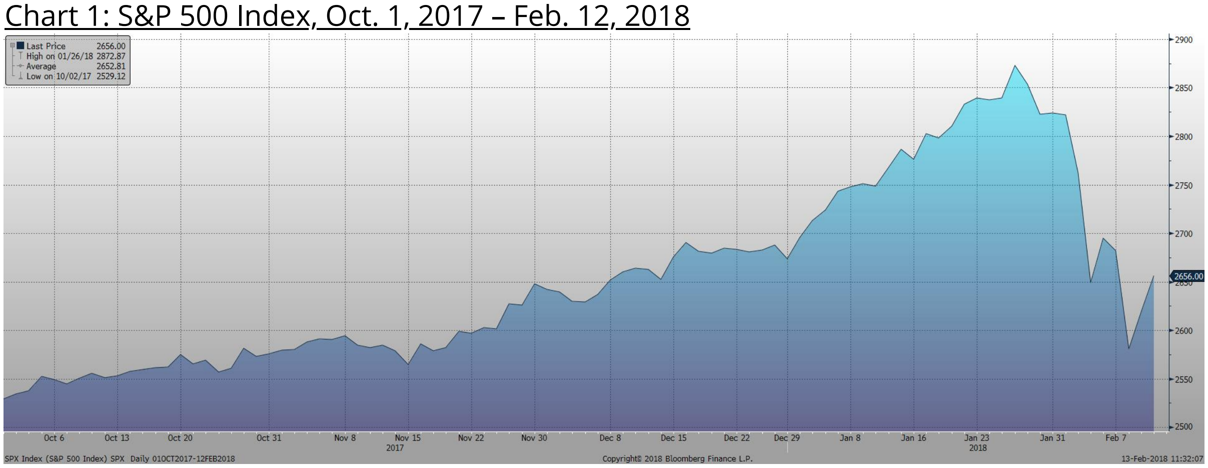
Market Update: Volatility Returns to the Capital Markets in 2018 (02/13/2018)

Following approximately two years of relative stability, volatility has returned to the capital markets. The U.S. equity markets, as measured by the Standard & Poor's (S&P) 500 Index (S&P 500), reached a 52-week high of 2,873 on Jan. 26, 2018, and ended the month up 5.6% from the year-end 2017 close. (See Chart 1.) On Feb. 2, however, economic data that included strong wage growth and lower-than-expected unemployment sparked market fears of a greater likelihood of increased inflation and, therefore, a faster pace for interest rate increases by the Federal Reserve (Fed), which drove the S&P 500 down 2.2% for the day—despite Fed comments a few days prior that it expected "economic conditions [would] evolve in a manner that [would] warrant further gradual increases." Volatility in the equity markets remained throughout the following week, with significant declines of as much as 4% on two separate trading days; rebounds followed the declines, but with increases in the range of 1% to 2%. In addition, intraday volatility was high, with indices moving from positive to negative territory throughout the day. The S&P 500 closed on Feb. 12 at 2,656, down 0.7% year-to-date (YTD), and down 7.6% from the 52-week high on Jan. 26. The U.S. equity market has rebounded since Feb. 8 when the S&P 500 was down 10.2% from its peak—which was a "correction," or a decline of 10% or more from a recent peak. Other global equity markets have followed the trend of the U.S. markets, with the Nikkei 225 Index (Nikkei) down 6.1% and the FTSE down 6.6% on a YTD basis. In addition, the Chicago Board Options Exchange (CBOE) Volatility Index (VIX), which represents a measure of implied volatility of the S&P 500 stock index option prices, had increased to its highest level since the 2016 presidential election last week, and it remains at two-year highs.

Chart 1: S&P 500 Index, Oct. 1, 2017 – Feb. 12, 2018



Since year-end 2017, government bond yields have been on a steady upward trajectory across the globe as economic conditions improve, and central banks are expected to begin paring back their quantitative easing efforts. The 10-year U.S. Treasury yield closed on Feb. 12 at 2.86%, the highest level in four years. (See Chart

2.) The German 10-year government bond yield reached 0.75% (the highest since December 2015), and the United Kingdom (UK) 10-year yield government bond yield reached its highest level since the Brexit vote at 1.60%. The U.S. yield curve is beginning to steepen, with the differential between the 12-month note and the 30-year Treasury at 122 basis points (bps), compared to 100 bps at year-end 2017.

Chart 2: U.S. 10-Year Treasury Yield, Oct. 1, 2017 – Feb. 12, 2018

As of Dec. 31, 2016, the U.S. insurance industry held common stock investments and corporate bond investments totaling $727 billion (or 11.8% of total cash and invested assets)—including affiliated holdings—and $2.2 trillion (or 36.2% of total cash and invested assets), respectively. Property/casualty (P/C) insurers' exposure to common stock was $528 billion (or 29% of total cash and invested assets), while life companies' exposure was $158 billion (or 4% of total cash and invested assets). However, because insurers' aggregate exposure to common stock is relatively modest compared to other assets, such as bonds, the expected impact of a significant stock market sell-off on their capital and surplus is limited. Nonetheless, the common stock exposure of individual insurance companies relative to total capital and surplus, in particular for P/C insurers, can vary greatly and should be monitored closely.

A rise in bond yields results in lower bond prices and would also have a negative impact on the market value of bonds in investment portfolios. Longer-dated bonds, in particular, have greater interest rate sensitivity (or duration), resulting in a greater impact on market value; for example, a 100 bps rise in interest rates would result in a price decline of approximately 15 or more points for a long duration bond. However, because insurance companies report the majority of their bond investments on an amortized cost basis, fluctuations in the market value of bonds do not have a significant impact on their reported value. On the flip side, higher yields should benefit book yields on new investments for the insurance industry, which generally tends to invest in longer duration bonds, somewhat easing the pressure of "reaching for yield" and investing in typically higher risk asset classes. A steeper yield curve will also benefit insurers as they execute their investment strategies.

With the return of heightened volatility to the markets, the Capital Markets Bureau expects fluctuations within the global equity and bond markets to continue. In addition, increasing bond yields and market volatility could not only impact insurer investments in stocks and bonds but also the value of insurers' commercial real estate and private equity and hedge fund investments. As such, we will closely monitor trends and developments that have the potential to impact insurer investment portfolios and provide updates as deemed necessary.