The **NAIC's Capital Markets Bureau** monitors developments in the capital markets globally and analyzes their potential impact on the investment portfolios of US insurance companies. A list of archived Capital Markets Bureau Special Reports is available via the **index**

Capital Markets Update: Summer 2017

Since the Capital Markets Bureau's last *Capital Markets Update* was published in early April, most financial markets have remained relatively stable, with U.S. stocks reaching an all-time high mid-July and government bond yields declining. The key drivers of the markets in recent months continue to be familiar and interconnected: improving but slow global economic growth and policy risk worldwide. In that context, this *Capital Markets Special Report* provides an update on the recent performance and current state of the investment markets that are most relevant for the U.S. insurance industry. These factors could have significant implications for asset prices and investment yields for the remainder of 2017 and beyond.

Table 1 and Table 2 show total returns (price change plus dividend or coupon income) for representative fixed-income and equity benchmark indices through the end of July. Year to date (YTD), U.S. dollar-based fixed-income total returns have been positive. In the current economic environment, the inflation rate has remained below the 2% target (in the U.S.) at 1.6% for the 12 months ended June 2017, and credit spreads have remained stable, given a benign credit environment. International fixed income returns, in dollar terms, have been increasing YTD. Global bond yields continue to fluctuate and are still low by historical standards. In recent news, about 33 U.S. states reported lower than projected revenues in 2017, which could negatively affect municipal bonds. Total return on municipal bonds was about 4.1% YTD through July 31, 2017, as measured by the Bank of America Merrill Lynch (BAML) Municipal Bond Index. YTD U.S. equity returns also have been strong, with the Standard & Poor's 500 Index (S&P 500) and the Dow Jones Industrial Average both closing at record highs in July due in part to investor anticipation of low interest rates for the foreseeable future.

Table 1: Selected Bond Index USD Total Returns (%), through July 31, 2017

Index	2015	2016	2017 YTD
S&P 500 (US)	1.37	11.95	10.33
STOXX Europe 600	10.14	2.38	5.19
FTSE 100 (U.K.)	(1.37)	19.15	4.04
Nikkei 225 (Japan)	10.99	2.38	4.55
MSCI Emerging Markets	(14.61)	11.55	23.65

Source: Bloomberg LP.

Table 2: Selected Equity Index USD Total Returns (%), through July 31, 2017

Index	2015	2016	2017 YTD
S&P 500 (US)	1.37	11.95	10.33
STOXX Europe 600	10.14	2.38	5.19
FTSE 100 (U.K.)	(1.37)	19.15	4.04
Nikkei 225 (Japan)	10.99	2.38	4.55
MSCI Emerging Markets	(14.61)	11.55	23.65

Source: Bloomberg LP.

Global Growth Expectations

As Table 3 shows, global economic growth continues to be stable but slow by historical standards, with a slight, gradual recovery expected to accelerate worldwide through 2018. The Organization for Economic Co-operation and Development (OECD) expects the global economy to grow 3.5% in 2017 and 3.6% in 2018 because of increasing confidence along with an increase in investment and trade (from low levels). Notwithstanding, the OECD's chief economist believes "more progress needs to be made in order to ensure sustainable growth forecasts." In addition, the International Monetary Fund's (IMF) quarterly update (July 2017) to its World Economic Outlook cited the same forecast as the OECD for global growth rates, indicating more reliance on China, Japan, the Eurozone and Canada as drivers of global growth, and less so on the U.S. and United Kingdom (UK).

U.S. economic growth appears to be continuing with its acceleration, after dipping to 1.6% in 2016. As of the most recent report in July 2017, the IMF forecasts a recovery in U.S. real gross domestic product (GDP) growth to 2.1% in 2017 and 2018, though this was lower than the 2.3% for 2017 and 2.5% for 2018 it had forecasted as recently as April. Consistent with the IMF, the OECD lowered its outlook for growth in the U.S. to 2.1% in 2017 (down from 2.4% in March), but it expects 2.4% growth in 2018 (which is also lower than the 2.8% it had previously forecasted in March). The lower forecasts reflect delays in President Donald Trump's plans to accomplish planned tax cuts and infrastructure spending.

After the Federal Open Market Committee (FOMC) voted in March 2017 to raise its target for the benchmark federal funds rate to a 0.75% to 1% range, it was increased once again in June to a 1.0% to 1.25% range. While the Federal Reserve Bank (Fed) expects inflation to rise over the coming years, Fed Chairwoman Janet Yellen recently stated she expects to "tighten monetary policy at a slow but steady clip," and likely another rate increase will not occur unless inflation increases. As of mid-July, investors believe there is a 48% probability of a rate increase by the end of this year, according to the Fed funds futures tracked by CME Group. Additionally, in a July 26 meeting, the FOMC indicated it may begin reducing its more than $4 trillion holdings of U.S. Treasury and mortgage securities "relatively soon" (possibly September), but it kept the benchmark fed funds rate unchanged.

Table 3: Global Economic Growth Expectations

World Economic Outlook Projections (% change)					Change from 4/2017 Projections	
	2015A	2016E	2017P	2018P	2017	2018
U.S.	2.6	1.6	2.1	2.1	-0.2	-0.4
Euro Area	2.0	1.8	1.9	1.7	0.2	0.1
UK	2.2	1.8	1.7	1.5	-0.3	0.0
Japan	1.1	1.0	1.3	0.6	0.1	0.0
Advanced Economies	2.1	1.7	2.0	1.9	0.0	-0.1
Emerging Markets	4.3	4.3	4.6	4.8	0.1	0.0
World	3.4	3.2	3.5	3.6	0.0	0.0

Source: International Monetary Fund *World Economic Outlook*, updated July 2017.

The Eurozone economy expanded 1.7% in 2016, which is 0.3 percentage point slower than in 2015, but in line with its average annual growth rate since 1995. Growth in the euro area is expected to continue, according to European Central Bank (ECB) research dated June 2017. The euro area economy is stronger than it's been since the financial crisis, and it experienced strong growth in the first quarter of 2017. A July 20 ECB policy meeting left euro area monetary policies unchanged; ECB President Mario Draghi explained that more information is needed about the area's economic outlook before additional decisions can be made regarding rate increases and tapering the bond-buying program (which is not expected to occur before January 2018).

In Japan, GDP growth is picking up from an estimated 0.9% rate in 2016, as the median IMF forecast is 1.3% for this year (as of July 2017), up from 0.8% in January. The IMF forecast for growth in 2018 is only 0.6% (up from 0.5% in January). Monetary policy remains easy, and the Bank of Japan remains committed to expanding the monetary base, keeping the 10-year Japanese Government Bond yield around 0% until inflation exceeds and remains above the 2% target. In a July policy meeting, the Bank of Japan left its monetary policy unchanged, including asset purchases, as it does not expect to achieve the targeted 2% inflation rate until fiscal 2019.

Global Bond Yields Continue to Stabilize

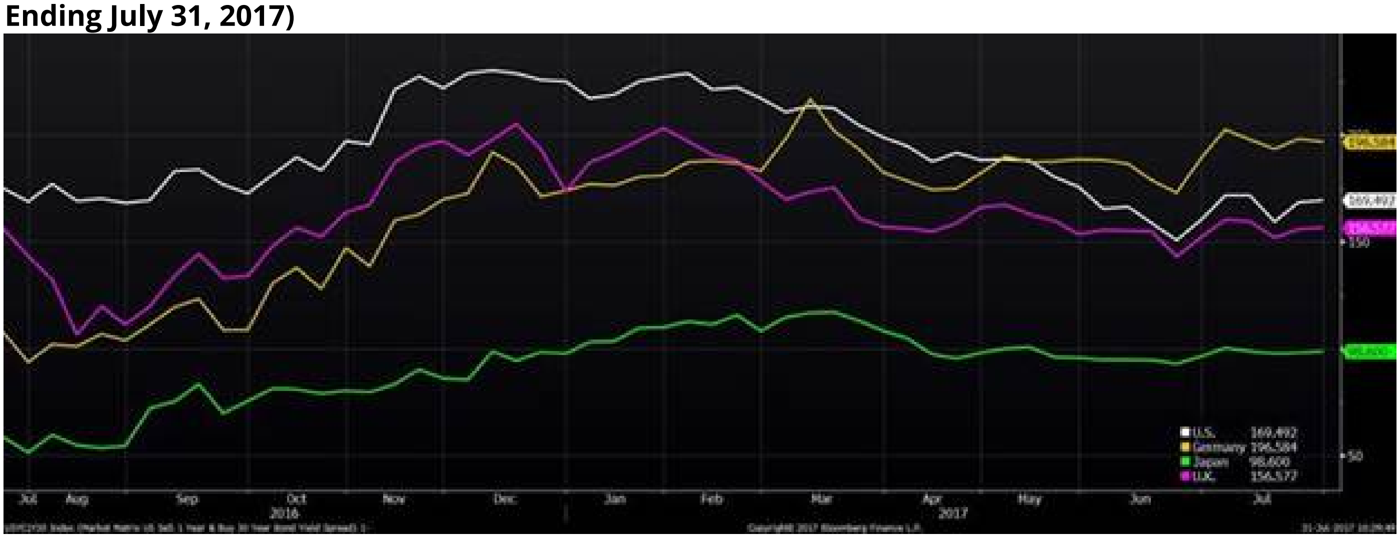
So far in the first half of 2017, long-term bond yields changed relatively little, hovering around 2.3% for the U.S. 10-year Treasury. Chart 1 shows that yields on key benchmark 10-year government bonds have been relatively stable since the beginning of the year. YTD as of July 31, the Bank of America Merrill Lynch Global Government Bond Index has returned 0.41% in U.S. dollar terms.

Chart 1: 10-Year Government Yields, Major Advanced Economies (12 Months Ending July 31, 2017)

Source: Bloomberg L.P.

Chart 2 shows the yield differential, or spread, between 30-year and one-year government bonds. Yield curves began to steepen late in 2016, reflecting worries that central bank bond-buying programs would wind down, increased fiscal spending would lead to more long-term debt supply, and global inflation would pick up. Thus far in 2017, however, the major government yield curves have flattened. With economic growth in the U.S., UK and Japan remaining sluggish and inflation expectations shy of central banks' 2% objectives, bond investors expect easy monetary policy, and central bank bond purchase programs to continue for the time being, thereby keeping long-term government bond yields at lower levels.

Chart 2: Government Yield Curves: Flattening No More (One- to 30-Year Yield Spreads, 12 Months Ending July 31, 2017)



Source: Bloomberg L.P.

Insurance Industry Impact

The majority of U.S. insurance industry investments are in bonds, with a book/adjusted carrying value (BACV) of $4 trillion based on year-end 2016 data. U.S. government debt accounted for about 7% of total bond investments, but movements in government yield curves directly affect the market value of nearly all fixed-coupon instruments (including investment grade [IG] and high-yield [HY] corporates, mortgage- and asset-backed securities [ABS], and commercial mortgages) and indirectly influence the value of most other asset classes (including real estate and equities). Shifting short- and long-term interest rates also can affect residential mortgage rates, which can have a secondary impact on home sales activity and mortgage prepayments.

Corporate Credit Spreads

Chart 3 shows the change in credit spreads over the past 12 months for U.S. IG and HY corporate bonds, European IG corporates, and emerging markets, as represented by their respective benchmark credit default swap (CDS) indices. As the chart shows, credit spreads have continued to tighten over the past 12 months ended July 31, 2017.

In the U.S., corporate bond supply remains robust; YTD corporate debt issuance was $868 billion as of June 30, 2017 (compared to a total $1.5 trillion in all of 2016), and it was a 3.8% increase from the same time last year according to Securities Industry and Financial Markets Association (SIFMA) data. IG and HY issuance were $714 billion and $154 billion, respectively, as companies continue to take advantage of favorable market conditions. HY issuance as of June 30, 2017, represented a 26.5% increase from the same time last year, while IG new issuance was consistent. According to Société Générale, first-half 2017 supply of European corporate bonds was €183 billion, representing a 10% increase from 2016. Corporate bonds have benefited from central banks' support, as well as the benign credit environment.

Chart 3: CDS Index Spreads, 12 Months Ending July 31, 2017

Source: Bloomberg L.P.

Insurance Industry Impact

Year-end 2016 reported data showed the U.S. insurance industry held $2.2 trillion in BACV of corporate bonds, or about 54% of the industry's total bond investments (relatively consistent with year-end 2015 data). About 5.9% of overall bond investments were designated NAIC 3 or lower (below-IG). Life insurers tend to have significantly more exposure to corporates (43% of year-end 2016 bond investments) than property/casualty (P/C) companies (15%) and other insurance company types, and they have a slightly larger exposure to below IG credits. Because their exposures to HY credits are limited and skewed to the stronger end of the spectrum, unless adverse credit developments seep into the broader corporate market, deterioration in HY credit quality should only affect insurers at the margin.

Government Policy Volatility

U.S.

Unpredictability of government policy continues to be at the forefront of institutional investor concerns. In the U.S., most concerns center on the delay in President Trump's tax cuts, health care reform and trade plans, which have resulted in U.S. real GDP forecasts being revised downward for this year and next. So far, however, optimism continues to generally prevail, especially in the stock market; the S&P 500 has continued to trend higher, reaching an all-time high late-July, after achieving a previous record high on March 1.

UK

The UK is working through its formal Brexit negotiations, with a departure expected for March 2019. A "rule maker" option, whereby the UK would "take back control of our borders, our money and our laws," as described by Prime Minister Theresa May, would leave the UK vulnerable to new barriers to trade, but it would give the UK more control, whereas a "rule taker" option would minimize economic disruption.

Eurozone

While the EU is "finally experiencing a robust recovery," according to ECB President Draghi, ongoing concerns about political risk in Europe include German elections occurring in September, as well as the aforementioned Brexit negotiation process. Meanwhile, Greece returned to the international bond markets for the first time in three years. Greece issued €4 billion in bonds due in 2019. Greece's current bailout program ends in July 2018, after which it must rely on the capital markets for funding (or require another bailout to remain solvent).

China

The IMF, as of June, projects 6.7% real GDP growth rate for China in 2017. This represents a 0.1% increase from its April forecast; it also anticipates a growth rate of 6.4% in 2018, as well as an average annual growth rate of 6.4% from 2018 through 2020.

Common Stocks

Most major stock markets have been rising so far in 2017, as shown in Chart 4. The Chicago Board Options Exchange (CBOE) Volatility Index (VIX), which measures expected stock volatility, dropped to its lowest level since 1993 on July 14 and has approached record lows. The U.S. stock market in particular is performing well; the S&P 500 has returned 10.3% YTD (July 31), reaching a record close on July 26. In Asia, stock prices have risen due to rallies in tech giants.

Chart 4: Global Equities, 12 Months Ending July 31, 2017

Source: Bloomberg L.P.

Insurance Industry Impact

Based on reported data as of Dec. 31, 2016, the U.S. insurance industry held common stock investments totaling $727 billion (11.8% of total cash and invested assets), of which $329.5 billion (5.3%) were unaffiliated common stock or mutual fund holdings, and $397.5 billion (6.4%) were affiliated holdings. P/C insurers' common stock exposure totaled $528 billion (of which about 47% was unaffiliated) and life companies' common stock exposure totaled $158 billion (about 17% of which was unaffiliated). The robust stock market of recent years has been a benefit, particularly for P/C insurers, which has helped alleviate some of the pressure to generate investment income from fixed-income holdings in the low-interest-rate environment.

The NAIC Capital Markets Bureau will continue to monitor volatility and other capital market developments and their impact on the insurance industry, and publish additional research as deemed appropriate. The likely recurrence of episodes of heightened volatility also highlights the need to remain attentive to changing market valuations, even for assets that insurers generally carry at some version of amortized cost.

July 28, 2017 Major Insurer Share Prices			Change %			Prior		
		Close	Week	QTD	YTD	Week	Quarter	Year
Life	Aflac	$79.38	2.3	2.2	14.1	$77.57	$77.68	$69.60
	Ameriprise	144.45	5.9	13.5	30.2	136.34	127.29	110.94
	Genworth	3.39	(3.1)	(10.1)	(11.0)	3.50	3.77	3.81
	Lincoln	72.81	2.9	7.7	9.9	70.73	67.58	66.27
	MetLife	55.25	1.1	0.6	2.5	54.65	54.94	53.89
	Principal	67.37	1.4	5.2	16.4	66.42	64.07	57.86
	Prudential	113.20	1.3	4.7	8.8	111.74	108.14	104.06
	UNUM	49.80	4.2	6.8	13.4	47.80	46.63	43.93
PC	Axis Capital	63.88	(1.7)	(1.2)	(2.1)	65.00	64.66	65.27
	Allstate	90.50	1.5	2.3	22.1	89.16	88.44	74.12
	Arch Capital	95.91	(2.6)	2.8	11.1	98.50	93.29	86.29
	Cincinnati	75.81	1.9	4.6	0.1	74.42	72.45	75.75
	Chubb	145.35	(1.1)	(0.0)	10.0	147.00	145.38	132.12
	Everest Re	259.86	(3.8)	2.1	20.1	270.12	254.59	216.40
	Progressive	47.22	1.9	7.1	33.0	46.36	44.09	35.50
	Travelers	127.21	1.6	0.5	3.9	125.15	126.53	122.42
	WR Berkley	68.96	(2.3)	(0.3)	3.7	70.58	69.17	66.51
	XL	43.40	(6.5)	(0.9)	16.5	46.41	43.80	37.26
Other	AON	$138.67	(0.3)	4.3	24.3	$139.14	$132.95	$111.53
	AIG	65.27	1.7	4.4	(0.1)	64.20	62.52	65.31
	Assurant	105.47	0.1	1.7	13.6	105.41	103.69	92.86
	Fidelity National	48.36	1.7	7.9	42.4	47.57	44.83	33.96
	Hartford	54.82	1.9	4.3	15.0	53.79	52.57	47.65
	Marsh	78.68	(1.7)	0.9	16.4	80.01	77.96	67.59
Health	Aetna	$155.29	(0.7)	2.3	25.2	$156.31	$151.83	$124.01
	Cigna	173.97	(0.1)	3.9	30.4	174.23	167.39	133.39
	Humana	233.08	(1.2)	(3.1)	14.2	235.92	240.62	204.03
	United	191.15	(0.3)	3.1	19.4	191.78	185.42	160.04
Monoline	Assured	$44.67	(0.9)	7.0	18.3	$45.09	$41.74	$37.77
	MBIA	10.21	(2.1)	8.3	(4.6)	10.43	9.43	10.70
	MGIC	11.45	(3.9)	2.2	12.4	11.91	11.20	10.19
	Radian	17.28	(1.5)	5.7	(3.9)	17.54	16.35	17.98
	XL Capital	43.40	(6.5)	(0.9)	16.5	46.41	43.80	37.26

July 28, 2017 Major Market Variables	Close	Change % Week	Change % QTD	Change % YTD	Prior Week	Prior Quarter	Prior Year
Dow Jones Ind	21,830.31	1.2	2.3	10.5	21,580.07	21,349.63	19,762.60
S&P 500	2,472.10	(0.0)	2.0	10.4	2,472.54	2,423.41	2,238.83
S&P Financial	413.61	0.5	1.0	7.0	411.73	409.59	386.53
S&P Insurance	392.15	0.7	2.8	11.0	389.44	381.48	353.26
US Dollar $		Change %			Prior		
/ Euro	$1.18	0.8	2.9	11.8	$1.17	$1.14	$1.05
/ Crude Oil bbl	49.74	8.9	7.6	(7.6)	45.69	46.22	53.81
/ Gold oz	1,268.40	1.1	2.1	10.2	1,254.50	1,241.80	1,150.90
Treasury Ylds %	%	Change bp			%	%	%
1 Year	1.22	0.01	(0.02)	0.40	1.21	1.23	0.82
10 Year	2.29	0.05	(0.01)	(0.16)	2.24	2.30	2.45
30 Year	2.90	0.09	0.06	(0.17)	2.81	2.83	3.07
Corp Credit Spreads -bp		Change %			Prior		
CDX.IG	57.65	1.3	(4.7)	(14.7)	56.90	60.52	67.59

July 28, 2017 Major Insurer Bond Yields	Company		Coupon	Maturity	Weekly Change Price Current	Weekly Change Price Change	Weekly Change Yield	Spread over UST B.P.	Spread over UST Change	YTD Spread Change
Life	Ameriprise	AMP	3.700%	10/15/2024	$104.81	($0.54)	2.95%	82	6	(21)
	Lincoln National	LNC	3.350%	3/9/2025	$100.89	($0.20)	3.22%	105	2	(6)
	MassMutual	MASSMU	3.600%	4/9/2024	$104.72	($0.42)	2.82%	68	(3)	(25)
	MetLife	MET	4.050%	3/1/2045	$101.48	($1.20)	3.96%	111	(1)	(16)
	New York Life	NYL	2.350%	7/14/2026	$96.13	($0.38)	2.84%	59	(1)	(15)
	Pacific Life	PACLIF	5.125%	1/30/2043	$112.57	($0.95)	4.31%	152	(3)	(38)
	Principal	PFG	6.050%	10/15/2036	$126.58	($1.23)	4.05%	142	1	(27)
	Prudential	PRU	4.600%	5/15/2044	$110.39	($1.03)	3.97%	115	(3)	(18)
	Allstate	ALL	4.500%	6/15/2043	$109.69	($1.52)	3.90%	110	(0)	(10)
	Berkshire Hathaway	BRK	4.300%	5/15/2043	$107.83	($1.05)	3.82%	103	(2)	(8)
	Travelers	TRV	4.600%	8/1/2043	$111.87	($1.17)	3.87%	107	(1)	2
	XL Group	XL	6.250%	5/15/2027	$121.14	$1.02	3.66%	133	(16)	(36)
Other	AON	AON	4.250%	12/12/2042	$98.71	($0.35)	4.33%	152	(5)	(22)
	AIG	AIG	6.820%	11/15/2037	$130.55	($1.49)	4.51%	186	3	(24)
	Hartford	HIG	4.300%	4/15/2043	$101.68	($1.51)	4.19%	138	(1)	(47)
	Nationwide	NATMUT	5.300%	11/18/2044	$114.57	($1.12)	4.38%	153	(3)	(47)
Health	Aetna	AET	6.750%	12/15/2037	$140.06	($1.13)	3.88%	125	(0)	(38)
	CIGNA	CI	6.150%	11/15/2036	$127.97	($0.45)	4.05%	143	(5)	(65)
	United Healthcare	UNH	4.750%	7/15/2045	$115.86	($1.41)	3.82%	97	(1)	(16)

Questions and comments are always welcome. Please contact the Capital Markets Bureau at **CapitalMarkets@naic.org**.