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

Year-End 2020 Capital Markets Wrap-Up

December 2020

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Executive Summary

- An expanding U.S. economy came to an abrupt halt in the early spring of 2020 as the economic impact of the COVID-19 pandemic and its ensuing lockdowns and social distancing hurt the financial markets worldwide.
- The International Monetary Fund (IMF), among other forecasters, expects the U.S. economy to contract about 4% in 2020, compared to 2.2% growth in 2019.
- U.S. government bond yield dipped below 1%, due in part to investors' expectations of slowed economic growth.
- Credit spreads have recovered to pre-pandemic levels from their year-to-date (YTD) peak in late March as aggressive fiscal and monetary policies were implemented globally, and quarantines and lockdowns gradually lifted worldwide.
- Global stocks fell to their lowest levels of the year in late March as COVID-19 became a worldwide pandemic and have since fluctuated.
- While the price of oil dropped to negative $37 per barrel for the first time in history due to a lack of capacity to store existing oil inventory in April, it quickly rebounded to trade at normalized levels.

Economic Backdrop Amid COVID-19

When 2020 began, the U.S. was heading into its 11th year of expansion, having reached its longest period of growth on record in July 2019. Before the onset of COVID-19, the U.S. economy was expected to continue growing in 2020, with the U.S.- China trade dispute having reached partial resolution, a U.S.-Mexico-Canada agreement was established, and residential investment was on the rise. In fact, the White House Council of Economic Advisors (CEA) stated that there was "… reason to expect that the economy has further room to expand in 2020."

COVID-19 developed into a pandemic, with cases spreading and rising worldwide. As a result, lockdowns and quarantines carried on for longer. In the U.S. (at least), businesses began to shut down, and unemployment reached a high of 14.7% in April 2020—the highest unemployment rate since reaching almost 25% during the

Great Depression; it has since declined to 6.7% as of November. Upon the outbreak of COVID-19, markets worldwide descended rapidly as quarantines, lockdowns and social distancing had a negative impact on many sectors, particularly retail and lodging/leisure. As the possibility of a vaccine to be made widely available by mid-2021 sheds light at the end of a long, seemingly dark tunnel, some markets are picking up albeit at a sluggish pace. Many economists expect recovery to occur slowly.

Gross domestic product (GDP) for 2019 was 2.2% in the U.S. at year-end 2019, and the IMF's World Economic Outlook dated October 2020 forecasts U.S. GDP to decline by about 4% in 2020. (See Table 1). Globally, the IMF predicts a -4.4% contraction for 2020, with China the only country expected to achieve growth of 1.9%. According to the IMF, "... a recovery has taken root in the third quarter of 2020. The recovery is likely to be characterized by persistent social distancing until health risks are addressed – and countries may have to again tighten mitigation measures depending on the spread of the virus."[1]

Table 1: IMF's Global and Regional Growth Forecasts (% Change)

	Year over Year			
			Projections	
	2018	2019	2020	2021
World Output	**3.5**	**2.8**	**–4.4**	**5.2**
Advanced Economies	**2.2**	**1.7**	**–5.8**	**3.9**
United States	3.0	2.2	–4.3	3.1
Euro Area	1.8	1.3	–8.3	5.2
Germany	1.3	0.6	–6.0	4.2
France	1.8	1.5	–9.8	6.0
Italy	0.8	0.3	–10.6	5.2
Spain	2.4	2.0	–12.8	7.2
Japan	0.3	0.7	–5.3	2.3
United Kingdom	1.3	1.5	–9.8	5.9
Canada	2.0	1.7	–7.1	5.2
Other Advanced Economies[2]	2.7	1.7	–3.8	3.6

Source: IMF World Economic Outlook, October 2020.

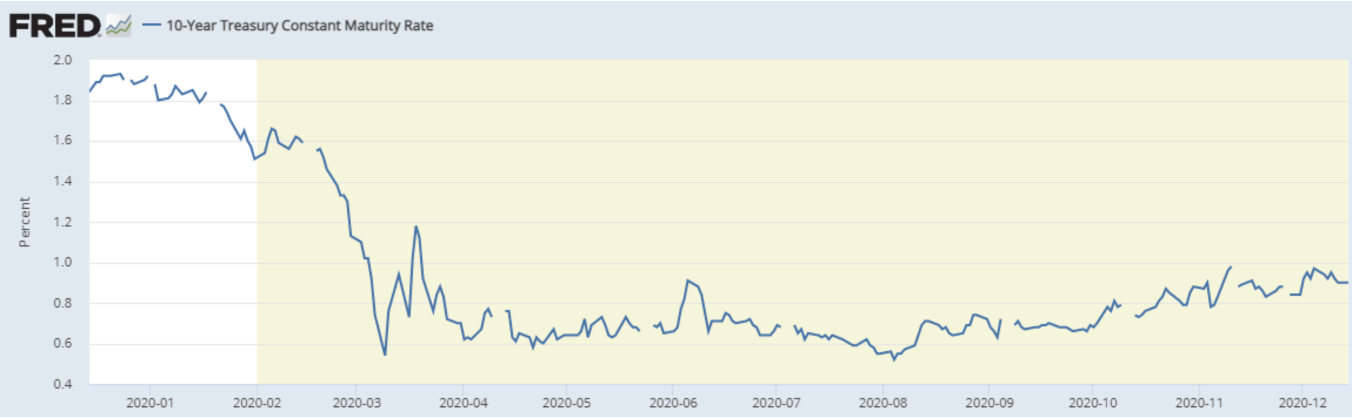
Government Bond Yields

As stated in a Hot Spot published by the NAIC Capital Markets Bureau in April 2020, most sovereign yields have declined, led by U.S. Treasuries. Along with gold, U.S. Treasuries are considered a safe haven by investors and are attractive during times of economic stress. The yield on the 10-year Treasury dropped to 0.5% on March 9, due in part to expectations of slowing economic growth because of the global impact of the fast-spreading virus combined with the already low interest rate environment.

As the year progressed, the 10-year Treasury yield fluctuated but remained below 1%. Yields on U.S. Treasuries have been on a slight increasing trend over the last few months as a new COVID-19-related financial package and funding bill to avoid a government shutdown has been in discussion, vaccinations are expected to be made widely available in the near future, and economic recovery is expected to continue into 2021 albeit at a slow pace. As of mid-December, the yield on the 10-year U.S. Treasury was 0.90%, compared to about 1.8% at the same time last year. (See Graph 1.) As of year-end 2019, U.S. insurers had exposure to about $283 billion in U.S. government bonds, including 10-year U.S. Treasuries, which was about 4% of total cash and invested assets.

[1] IMF World Economic Outlook: A Long and Difficult Ascent, October 2020, p. 8.

Graph 1: U.S. 10-Year Treasury Yields, Year-To-Date December 2020



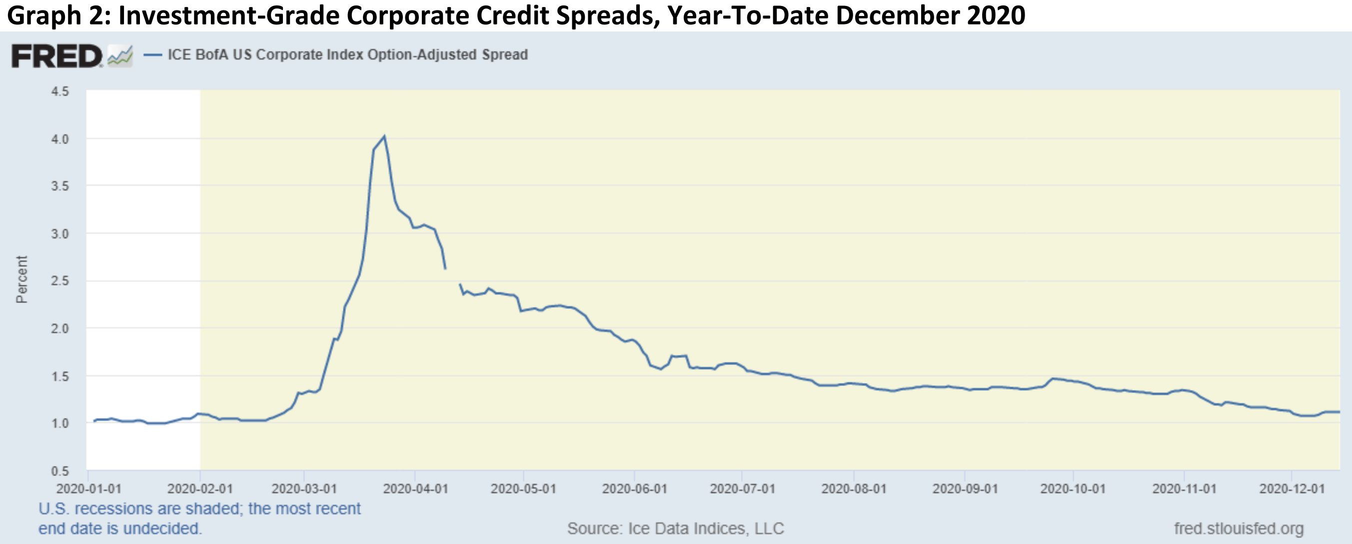
Source: Federal Reserve Bank of St. Louis, Board of Governors of the Federal Reserve System (U.S.). Shaded areas represent a recession.

Credit Spreads Recover to Near Pre-Pandemic Levels

Significant concerns about the COVID-19 pandemic and its effect on the global economy, together with a collapse in oil prices, resulted in a volatile and stressed market environment with corporate credit spreads widening dramatically in late March. As aggressive fiscal and monetary policies took effect globally and quarantines and lockdowns gradually lifted worldwide, credit markets began to recover.

Investment grade spreads reached 401 basis points (bps) on March 23, the highest level since the financial crisis when spreads exceeded 600 bps in November 2008. (See Graph 2.) They then recovered relatively quickly as the Federal Reserve stepped in with an asset purchase program that specifically targeted investment-grade issuers and fell to below 200 bps by late May. Investment-grade spreads are now almost back to pre-pandemic levels, closing at 111 bps on Dec. 14—and only 12 bps away from levels at the beginning of the year.

Graph 2: Investment-Grade Corporate Credit Spreads, Year-To-Date December 2020



Source: Federal Reserve Bank of St. Louis, Board of Governors of the Federal Reserve System (U.S.). Shaded areas represent a recession.

Like investment-grade, high-yield spreads also peaked on March 23 at almost 1,100 bps, the widest level since the almost 2,000 bps reached in November 2008 during the financial crisis. (See Graph 3.) While high-yield spreads took longer to recover than investment-grade spreads, they declined gradually from April through June and fell below 600 bps in July and then below 500 bps in November. High-yield spreads remain above pre-pandemic levels of approximately 350 bps and closed at 407 bps as of Dec. 14.

Graph 3: High-Yield Corporate Credit Spreads, Year-To-Date December 2020

Source: Federal Reserve Bank of St. Louis, Board of Governors of the Federal Reserve System (U.S.). Shaded areas represent a recession.

The recovery in corporate credit spreads appears to some extent to be disconnected from credit quality indicators like credit ratings and defaults. A record level of negative rating actions were taken by S&P Global Ratings (S&P) and Moody's Investor Service (Moody's) in 2020 as a result of credit deterioration experienced by many issuers amid the COVID-19 pandemic and the oil price shock. In addition, credit defaults have been rising given the stressed economic and credit environment. S&P's trailing 12-month speculative grade default rate in the U.S. increased to 6.3% at the end of the third quarter from 3.1% at the beginning of 2020. The disconnect is likely attributed to the aggressive fiscal and monetary policies in conjunction with strong demand for corporate bond investments in the current ultra-low interest rate environment—both of which are supporting the recovery in credit spreads.

The U.S. insurance industry's exposure to corporate bonds totaled $2.5 trillion, or 35% of total cash and invested assets, as of year-end 2019. The U.S. insurance industry's corporate bond portfolio is expected to be relatively insulated from the record level of negative rating actions, as it predominantly consists of higher credit quality companies that have greater financial flexibility to withstand the negative credit effects of this year's macroeconomic shocks. However, it may nonetheless be subject to some credit quality deterioration and ratings migration, as well as losses from credit defaults, as the credit impact resulting from the COVID-19 pandemic, and the oil price shock has been broad-based.

Equity Markets – Highs to Lows then Back Up Again

Global stocks plummeted to their lowest levels of the year in late March, as the virus emerged in countries outside of China at an increasing rate. (See Graph 4.) The Standard & Poor's (S&P) 500 dropped 30.75% on March 23 for a YTD low (as of Dec. 16), following a 29% increase in 2019; it was up 14.3% YTD as of Dec. 16. The STOXX Europe 600 dropped by about 5% YTD as of Dec. 9. In addition, in March, the Chicago Board Options Exchange

(CBOE) Volatility Index (VIX) closed at its highest level since December 2018, suggesting investors were anticipating more related market volatility, and it was up 71.3% YTD as of Dec. 16.

Graph 4: S&P 500 Year-To-Date December 2020, % Returns

Source: Wall Street Journal

In terms of S&P 500 sectors, there were four YTD (as of Dec. 16) that experienced negative returns: 1) real estate, -6%; 2) energy, -34%; 3) financials, -7%; and 4) utilities, -3%. Technology, health care, consumer discretionary and communications experienced positive YTD returns of 38%, 9.5%, 29.7% and 22%, respectively.

With regard to U.S. insurers' exposure to equities, total return in November 2020 was 8.7% compared to being down 3.2% in October 2020.[2] As of year-end 2019, U.S. insurers' exposure to common equity was $784 billion.

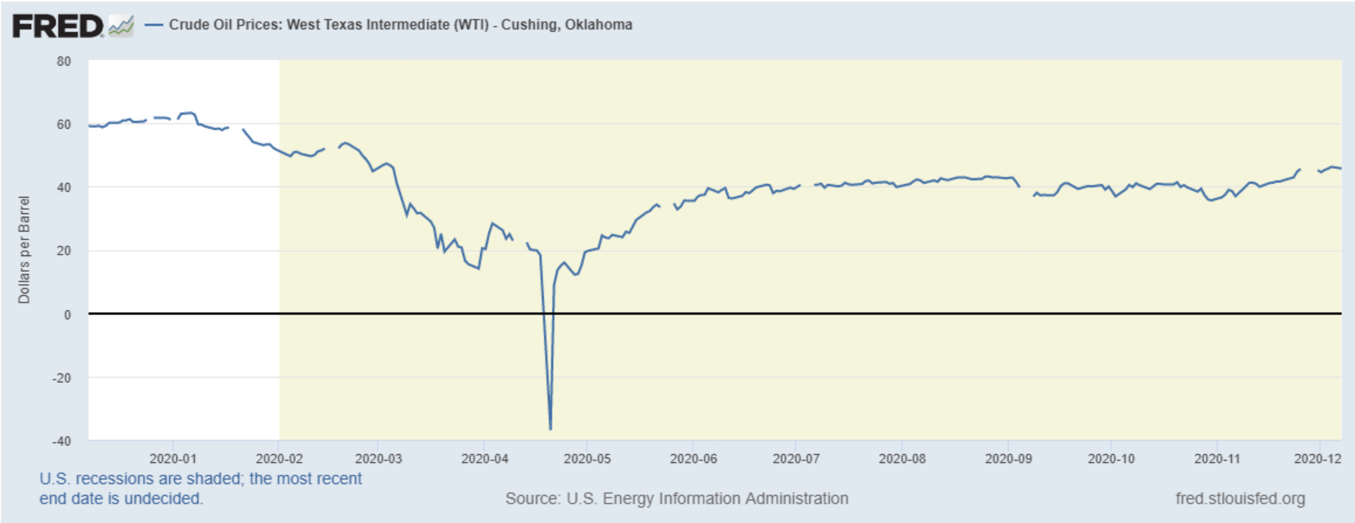
Oil Prices Briefly Drop Below Zero but Rebound from Historic Low

Oil prices were also significantly affected by the effects of the COVID-19 pandemic. The price of crude oil dipped to its lowest level in more than 20 years following a Saudi Arabia-Russia disagreement that resulted in a large oversupply and pressure on the demand side as the rapid spread of the coronavirus and unprecedented lockdowns in much of the U.S., Europe and Asia weakened the short-term global economic outlook and oil demand and consumption.

The price of West Texas Intermediate (WTI) crude oil began 2020 at approximately $60 per barrel and declined over the following four months to below $20 per barrel due to weaker demand and consumption. (See Graph 5.) On April 20, U.S. oil futures fell below zero for the first time in history due to a lack of capacity to store existing oil inventory. The price of oil dropped to negative $37 per barrel after closing at $18 per barrel the prior business day. It recovered the following business day to close in positive territory, and it gradually rose to more than $30 per barrel on May 18. Oil prices have rebounded from their lows largely because of massive supply cuts from the Organization of the Petroleum Exporting Countries (OPEC) and Russia, as well as the gradual reopening of global economies. As of Dec. 16, the price of WTI was $47 per barrel.

[2] For state insurance regulators only, U.S. insurer equities' monthly total returns may be accessed via StateNet.

Graph 5: Crude Oil Prices – West Texas Intermediate (WTI), 12 months through December 2020



Source: Federal Reserve Bank of St. Louis, Board of Governors of the Federal Reserve System (U.S.). Shaded areas represent a recession.

Oil and gas companies have been the most directly affected by depressed oil prices from a credit and default perspective. More than 65% of oil and gas companies rated by S&P Global Ratings have experienced a negative rating action in 2020 as of Dec. 8, with 45% experiencing a rating downgrade and 27% of experiencing a multi-notch downgrade. In addition, based on S&P data as of Nov.18, the oil and gas sector accounted for 29 of the 121 defaults in the U.S., or almost 25% of year-to-date defaults.

The U.S. insurance industry's exposure to oil and gas companies totaled $102 billion in bonds and $10 billion in common stock as of year-end 2019. The $112 billion in oil and gas related exposure represents less than 2% of the industry's cash and invested assets.

The Capital Markets Bureau will continue to monitor trends in the capital markets and report on any developments as deemed appropriate.

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