NAIC National Association of Insurance Commissioners & The Center for Insurance Policy and Research

# Capital Markets Special Report

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: Fall 2017

Since the Capital Markets Bureau's last *Capital Markets Update* was published in early August, most financial markets have remained relatively stable, with U.S. stocks regularly reaching new highs and government bond yields on the rise. The key drivers of the markets in recent months continue to be familiar and interconnected: improving but slow global economic growth and political 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, with year-end valuations and investment yields for the remainder of 2017 and into 2018. Table 1 and Table 2 show total returns (price change plus dividend or coupon income) for representative fixed-income and equity benchmark indices through mid-November. Year to date (YTD), U.S. dollar-based fixed-income total returns have been positive. The U.S. inflation rate reached 2% for the 12 months ended October 2017 (down slightly from 2.2% in September), and credit spreads continued to remain stable, given a benign credit environment. Global bond yields are still low by historical standards, and some are still negative, but less so than a year ago. YTD equity returns have been strong in the U.S. and abroad; any declines have been short-lived.

As markets have generally been strong and volatility low, investors appear to be focused on relatively strong economic data worldwide, including higher U.S. corporate earnings and a steadily expanding U.S. economy. There has been the occasional pull-back in stocks (and, in turn, an increase in government bond investments as safe havens) when there has been uncertainty regarding the potential impacts of proposed tax changes in the U.S., as well as renegotiation of the North American Free Trade Agreement (and possible withdrawal of the U.S. from this agreement), however transitory.

**Table 1: Selected Bond Index USD Total Returns (%), through Nov. 16, 2017**

| Index | 2015 | 2016 | 2017 YTD |
|---|---|---|---|
| BAML US (IG) Corp & Gov Index | 0.30 | 2.92 | 3.61 |
| BAML US HY Master II Index | (4.64) | 17.49 | 7.46 |
| BAML US Muni Index | 3.55 | 0.44 | 4.83 |
| BAML Global Government Index | 1.32 | 3.82 | 0.99 |
| BAML Global HY&EM Sov | (1.34) | 15.60 | 8.14 |

Source: Bloomberg LP.

**Table 2: Selected Equity Index USD Total Returns (%), through Nov. 16, 2017**

| Selected Equity Index USD Total Returns (%) | | | |
|---|---|---|---|
| Index | 2015 | 2016 | 2017 YTD |
| S&P 500 (US) | 1.37 | 11.95 | 15.39 |
| STOXX Europe 600 | 10.14 | 2.38 | 6.57 |
| FTSE 100 (U.K.) | (1.37) | 19.15 | 3.46 |
| Nikkei 225 (Japan) | 10.99 | 2.38 | 16.93 |
| MSCI Emerging Markets | (14.61) | 11.55 | 28.85 |

Source: Bloomberg LP.

**Global Growth Expectations**

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 3.7% in 2018 (from 3% in 2016), which is a slight improvement from its previous forecast in June, as investment, employment and trade are expanding. According to the OECD's Interim Economic Outlook dated Sept. 20, 2017, "Short-term momentum is no guarantee of medium-term sustainable growth." The OECD also cited that "the recovery of business investment and trade remains weaker than needed to sustain healthy productivity growth." In addition, the International Monetary Fund's (IMF) quarterly update (October 2017) to its World Economic Outlook cited a slightly higher forecast than the OECD for 2017 global growth rates, projecting 3.6%, but the same forecast as the OECD (3.7%) for 2018. The IMF continues to expect global growth to be driven by strong activity in the U.S., Canada, euro area and Japan.

As shown in Table 3, U.S. economic growth appears to be continuing with its acceleration, after dipping to 1.5% in 2016. As of the most recent report in October 2017, the IMF forecasts a recovery in U.S. real gross domestic product (GDP) growth to 2.2% in 2017 and 2.3% in 2018, compared to 2.1% for both 2017 and 2018 as forecasted in July. The OECD maintained its outlook for growth in the U.S. at 2.1% in 2017 (up from 1.8% in June), but it expects 2.3% growth in 2018. The higher forecasts reflect "stronger consumer spending and business development."

In November 2017, the Federal Open Market Committee (FOMC) voted to maintain its target for the benchmark federal funds rate in the 1% to 1.25% range, having raised it to that level in June. According to the official Federal Reserve Board (Fed) statement, "The stance of monetary policy remains accommodative, thereby supporting some further strengthening in labor market conditions and a sustained return to two percent inflation." In addition, following the November FOMC meeting, the Fed stated that since July, "the labor market has continued to strengthen and that economic activity has been rising modestly so far this year." In addition, in early November, Jerome Powell was announced as President Donald Trump's choice as the successor Fed chair replacing Janet Yellen (for when her term expires in February 2018). His views about monetary policy have been consistent with the current consensus, as he has supported reversing the post-financial crisis stimulus given a strengthening U.S. economy; therefore, market expectation is for continuity in current policies. While the Fed expects inflation to rise over the coming years, a rate increase may occur in the December 2017 FOMC meeting, and additional rate increases could follow in 2018. Additionally, at the Sept. 20 meeting, the FOMC indicated it would begin gradually reducing its $4.5 trillion holdings of U.S. Treasury and mortgage securities as the quantitative easing program is no longer needed given confidence in the momentum of U.S. economic recovery.

**Table 3: Global Economic Growth Expectations**

| World Economic Outlook Projections (% change) | | | | | Change from 7/2017 Projections | |
|---|---|---|---|---|---|---|
| | 2015A | 2016A | 2017P | 2018P | 2017 | 2018 |
| U.S. | 2.6 | 1.5 | 2.2 | 2.3 | 0.1 | 0.2 |
| Euro Area | 2.0 | 1.8 | 2.1 | 1.9 | 0.2 | 0.2 |
| UK | 2.2 | 1.8 | 1.7 | 1.5 | 0.0 | 0.0 |
| Japan | 1.1 | 1.0 | 1.5 | 0.7 | 0.2 | 0.1 |
| Advanced Economies | 2.1 | 1.7 | 2.2 | 2.0 | 0.2 | 0.1 |
| Emerging Markets | 4.3 | 4.3 | 4.6 | 4.9 | 0.0 | 0.1 |
| World | 3.4 | 3.2 | 3.6 | 3.7 | 0.1 | 0.1 |

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

Also as shown in Table 3, the Eurozone economy expanded 1.8% in 2016, which is 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 September 2017. Unlike the IMF and OECD, the ECB projects a 2.2% real GDP growth rate for the euro area, which would be a post-crisis peak. The euro area economy is stronger than it has been since the financial crisis, and it experienced stronger than expected growth in the first half of 2017. According to OECD research, unemployment in the euro area dropped to 9.1% in July 2017, the lowest level since 2009. A September ECB policy meeting left euro area monetary policies unchanged. The net monthly bond purchases of €60 billion are to continue until the end of December 2017, and they will thereafter be reduced to €30 billion beginning in January 2018 until the end of September 2018, or beyond, if deemed necessary. ECB President Mario Draghi explained that monetary policy stimulus is still needed for inflation rates to reach levels that are close to 2%.

The median IMF forecast for growth in Japan is 1.5% for this year (as of October 2017), up from 1.7% in April. (See Table 3.) However, the IMF forecasts growth in 2018 at only 0.7%. 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 September 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, and it believes economic recovery will occur without additional stimulus.

As their respective economies improve, the major central banks will begin to scale back economic stimulus programs, including reducing monthly asset purchases and eventually the balance sheets themselves. Although the Fed in particular has stated that its balance sheet reduction will be a gradual process, the sale of the longer-term assets will place undue pressure on market prices given the scale of the stimulus programs. The decline in market value prices will have a negative impact on existing insurance company investment portfolios, yet at the same time, will improve investment yield opportunities at the longer-end of the market.

**Global Bond Yields Continue to Stabilize**

From the beginning of 2017 through November, long-term bond yields among major developed countries 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 Nov. 16, the Bank of America Merrill Lynch Global Government Bond Index has returned 0.99% in U.S. dollar terms.

**Chart 1: 10-Year Government Yields, Major Advanced Economies (12 Months Ending Nov. 16, 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. Signs of economic improvement are beginning to gradually materialize across the globe. Growth in euro GDP has been rising for several quarters. In the U.S., economic activity has been improving and the labor market continues to strengthen, despite hurricane-related disruptions. Although inflation measures are still below its 2% target, the Fed has tightened monetary policy (i.e., raised interest rates) in 2017 and is expected to continue doing so in 2018. As previously noted, it is also discussing the reduction of its $4.5 trillion balance sheet, which is expected to push long-term yields up. With current low coupons, the duration of longer-dated bonds—8.5 for 10-year U.S. Treasuries and 18.7 for 30-year U.S. Treasuries—would result in substantial declines in the fair value of fixed income instruments if yields were to increase dramatically. For example, a 100 bps increase in yields would result in an approximate $15 - $18 decline in the fair values of long-dated bonds, depending on the coupon.

**Chart 2: Government Yield Curves: Flattening No More (One- to 30-Year Yield Spreads, 12 Months Ending Nov. 16, 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; residential mortgage-back securities [RMBS], commercial mortgage-backed securities [CMBS] and asset-backed securities [ABS]; and commercial mortgages) and indirectly influence the value of most other asset classes (including real estate and equities). For commercial real estate (CRE), valuations benefit from utilizing low interest rates for discounting cash flows. As rates increase, however, CRE will lose value, and, secondarily, loan-to-value (LTV) will be negatively impacted. Shifting short- and long-term interest rates also can affect residential mortgage rates, which can have a secondary impact on home sales activity and refinancing. This could dramatically slow mortgage prepayments, reducing cash inflows from those assets and extending their duration.

**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 Nov. 16, 2017.

In the U.S., corporate bond supply remains robust; YTD corporate debt issuance was $1.3 trillion as of Sept. 30, 2017 (compared to a total $1.5 trillion in all of 2016), and it was a 2.3% increase from the same time last year according to Securities Industry and Financial Markets Association (SIFMA) data. IG and HY issuance were $1.1 trillion and $216 billion, respectively, as companies continue to take advantage of favorable market conditions. HY issuance as of Sept. 30, 2017, represented a 14.7% increase from the same time last year, while IG new issuance was consistent. According to Dealogic data, European non-financial corporate bond issuance is expected to exceed the €345 billion record-issuance that occurred in 2016.

Corporate bonds have benefited from a relatively benign credit environment with low default rates; however, the retail sector is showing some weakness. S&P Global Fixed Income Research expects the U.S. corporate default rate to decrease to 2.7% by September 2018 from 3.1% in September 2017 and 5% in September 2016. The expected decline in default rates is due, in part, to commodity prices stabilizing in 2017.

**Chart 3: CDS Index Spreads, 12 Months Ending Nov. 16, 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. However, if credit spreads were to widen, corporate bond prices would decline, and the ability of HY credits to refinance would become more challenging.

**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 pending tax reform legislation, health care reform, trade plans and global political uncertainty (particular to tensions with North Korea). So far, however, optimism in the investment markets continues to generally prevail, especially in the stock market; the S&P 500 has continued to trend higher, reaching its latest all-time high in early November. Strong consumer spending and a strengthening labor market have supported the market's strength.

**UK**

The United Kingdom (UK) continues to work 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. Thus far, however, no progress has been made in determining the final payment the UK will have to make upon exiting the EU, which has delayed substantive discussions on other issues, such as the rights of workers crossing borders post-Brexit.

**Eurozone**

While the European Union (EU) is "in the midst of a solid economic expansion" with GDP rising for 18 straight quarters according to ECB President Draghi, ongoing concerns about political risk in Europe include Italian elections in early 2018 and the recent unrest in the Catalonia region of Spain, as well as the aforementioned Brexit negotiation process. In addition, Germany, Europe's largest economy, is currently facing a political crisis as recent talks to form a ruling coalition have failed, raising concern about ongoing economic stability and growth.

**China**

The IMF, as of October, projects a 6.8% real GDP growth rate for China in 2017. This represents a 0.2% increase from its April forecast; it also anticipates a growth rate of 6.5% in 2018, as well as an average annual growth rate of 6.3% from 2018 through 2020. The upward revisions reflect continued strong infrastructure spending and a rebound in the real estate sector in the first half of 2017.

**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 26 and has approached record lows. The U.S. stock market in particular is performing well; the S&P 500 has returned 17.5% YTD (Nov.16), reaching a record close on Nov. 8. In Asia, stock prices have risen due to rallies in tech giants.

**Chart 4: Global Equities, 12 Months Ending Nov. 16, 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.

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

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