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: Spring 2017

2017 Begins With Calm Despite Rising Interest Rates and Policy Risk

Since the Capital Markets Bureau's last *Capital Markets Update* was published in December, most financial markets have remained remarkably calm. The key drivers of the markets in recent months are familiar and interconnected: improving but slow global economic growth, heightened policy risk worldwide, and shifting yield curves. 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. The discussion centers on the evolving outlook for the U.S. economy and interest rates and their divergence from macroeconomic trends and policies in Europe and Japan. Additionally, it highlights heightened political and policy risks, especially in the developed world. These factors could have significant implications for asset prices and investment yields in 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 March. Year to date (YTD), U.S. dollar-based fixed-income total returns have been modestly positive, amid muted inflation expectations and stable, tight credit spreads. International fixed income returns have been mostly flat YTD in dollar terms, as the climb in global bond yields—which are still low by historical standards—has paused, and has largely been offset by modest weakening in the U.S. dollar. Thus far, 2017 has been favorable for high-yield debt, as credit risk concerns have largely abated; the credit woes of 2015–2016 did not venture much beyond the confines of the energy and commodity sectors, except for the retail sector. YTD U.S. equity returns also have been solid, fueled by optimism that the new presidential administration's anticipated tax reform and infrastructure spending initiatives will benefit U.S. companies. Some economists and monetary officials are concerned that there is a disconnect, however, between the various financial markets—where valuations have become quite lofty on optimistic expectations—and economic realities that are little changed while interest rates have risen.

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

Selected Bond Index Total Returns (%)			
Index	2015	2016	2017 YTD
BAML US (IG) Corp & Gov Index	0.30	2.92	1.01
BAML US HY Master II Index	(4.64)	17.49	2.71
BAML US Muni Index	3.55	0.44	1.39
BAML Global Government Index	1.32	3.82	(0.13)
BAML Global HY&EM Sov	(1.34)	15.60	3.02

Source: Bloomberg LP.

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

Selected Equity Index USD Total Returns (%)			
Index	2015	2016	2017 YTD
S&P 500 (US)	1.37	11.95	6.07
STOXX Europe 600	10.14	2.38	7.81
FTSE 100 (U.K.)	(1.37)	19.15	5.33
Nikkei 225 (Japan)	10.99	2.38	4.39
MSCI Emerging Markets	(14.61)	11.55	11.45

Source: Bloomberg LP.

The Fed Leads the Turn as Monetary Policies Diverge

As Table 3 shows, global economic growth appears stable but slow by historical standards, with most observers expecting the gradual recovery in worldwide activity to accelerate slightly through 2018. U.S. economic growth appears to be accelerating; after dipping to 1.6% in 2016, the International Monetary Fund (IMF) now forecasts a recovery in U.S. real gross domestic product (GDP) growth to 2.3% and 2.5% in 2017 and 2018, respectively. The Organization for Economic Cooperation and Development (OECD) has a similar outlook. Interestingly, the Federal Reserve Board (FRB) is less sanguine, projecting median real GDP growth of 2.1% this year and next, declining to a 1.8% long-run rate. Still, on March 15, 2017, the Federal Open Market Committee (FOMC) voted to raise its target for the benchmark federal funds rate to a 0.75% to 1% range, against the backdrop of a tightening labor market and inflation approaching the FOMC's 2% long-run objective. The FOMC members' median prediction—laid out in the so-called "dot plot"—calls for two more fed funds rate hikes of 25 basis points (bps) this year, to end 2017 with a range of 1.25% to 1.5%. Longer term, the FOMC expects gradual rate hikes to continue toward a 3% fed funds rate.

Table 3: Global Economic Growth Expectations: Muted but Improving

World Economic Outlook Projections (% change)					Change from 10/16 Projections	
	2015A	2016E	2017P	2018P	2017	2018
U.S.	2.6	1.6	2.3	2.5	0.1	0.4
Euro Area	2.0	1.7	1.6	1.6	0.1	0.0
UK	2.2	2.0	1.5	1.4	0.4	-0.3
Japan	1.2	0.9	0.8	0.5	0.2	0.0
Advanced Economies	2.1	1.6	1.9	2.0	0.1	0.2
Emerging Markets	4.1	4.1	4.5	4.8	-0.1	0.0
World	3.2	3.1	3.4	3.6	0.0	0.0

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

The Eurozone economy expanded 1.7% in 2016, which is 0.3 percentage points slower than in 2015, but in line with its average annual growth rate since 1995. GDP growth was flat or improved in the larger Eurozone countries, however, modestly exceeding consensus forecasts. As of March 9, the European Central Bank (ECB) is slightly more optimistic than it was in December, projecting real GDP growth of 1.8% this year, declining to 1.7% next year and 1.6% in 2019, with core inflation of 1.6% to 1.7%; the ECB Governing Council, therefore, says, "A very substantial degree of monetary accommodation is still needed."

United Kingdom (UK) GDP growth was also stronger than expected in 2016 at an estimated 2%, as the June 23 "Brexit" vote has not materially hurt economic activity thus far because the British pound's decline has supported exports, although household spending and fixed investments growth has slowed. With Article 50 just triggered on March 30 and the two-year European Union (EU) exit process formally begun, the true economic ramifications should

gradually manifest themselves. UK monetary policy has been stable and accommodative, as the Bank of England expects declining real incomes to weigh on consumer demand this year. IMF and OECD projections call for a decline in real GDP growth to about 1.5% this year and as low as 1% in 2018.

In Japan, GDP growth remains slow; from an estimated 0.9% rate in 2016, the median IMF forecast is 0.8% this year and just 0.5% for 2018. Monetary policy remains extremely easy, and the Bank of Japan has 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.

Emerging market economies remain mixed, although in aggregate, they grew at an estimated 4.1% in 2016. China's GDP growth continues to gradually decelerate due to the continued rebalancing of its economy from industry to services; the IMF projects growth of 6.5% and 6% this year and next, respectively. India's economy continues to perform well, growing an estimated 6.6% in 2016. Resource-based economies should benefit from recovering oil and commodity prices; Russia, Brazil and Nigeria are all expected to emerge from recession this year as a result.

Global Bond Yields Stabilize

In contrast to the FRB raising the overnight federal funds rate, long-term bond yields changed relatively little in the past four months; Chart 1 shows that the yields on key benchmark 10-year government bonds retreated slightly after reaching a near-term peak earlier this month. YTD as of March 31, the Bank of America Merrill Lynch Global Government Bond Index has returned 0.18% in U.S. dollar terms.

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

Chart 2 shows the yield differential, or spread, between 30-year and one-year government bonds. This serves as an indicator of the shape of government yield curves, which investors can use as a gauge of the growth and inflation outlook. A steepening yield curve implies that economic growth may accelerate and fuel inflation, while a flattening curve suggests slowdown. With U.S. short-term rates expected to rise from record lows and demand for attractive long-term yields driven significantly by central bank bond-buying, flattening yield curves dominated the bond markets last year. Yield curves began to steepen late in 2016, as the one-year to 30-

year spread in most major government markets widened significantly, 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 retraced a portion of the steepening that occurred late last year. With economic growth in the EU, the UK and Japan set to remain sluggish, and inflation expectations still shy of central banks' 2% objectives, bond investors expect easy monetary policy to continue for the time being, as are central bank bond purchase programs, thereby keeping a lid on long-term government bond yields.

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

Insurance Industry Impact

The majority of U.S. insurance industry investments are in bonds, with a book/adjusted carrying value (BACV) of $3.9 trillion based on year-end 2015 data. U.S. government debt accounted for only 6.4% 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.

Credit Risk Concerns Fade

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 gradually trended tighter over the past 12 months and, despite some recent retracement, remain near their 52-week lows. Concerns over long-term credit fundamentals seem to have abated, as rising default rates in energy and other resource-based credits in 2016 failed to spread to the broader market, although credit quality indicators are mixed and the retail sector is showing signs of weakness due to secular changes.

Corporate bond supply remains robust; YTD IG and HY issuance are up 8.3% and 144.1%, respectively, to $253.9 billion and $43.1 billion, as companies continue to take advantage of favorable market conditions. On the demand side, U.S. bond fund flows have been solidly positive, except for net outflows from HY funds in March. Investor demand for yield remains

high, and skepticism regarding the positive outlook for U.S. stocks based on President Donald Trump's administration policies also may be driving some investors into bonds.

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

Insurance Industry Impact

Year-end 2015 data show the U.S. insurance industry held $2.12 trillion in BACV of corporate bonds, or 54.2% of the industry's total bond investments. Only 5.7% of bond investments were designated NAIC 3 or lower (below-IG). Life insurers tend to have significantly more exposure to corporates (61% of year-end 2015 bond investments) than property/casualty (P/C) companies (34%), and they have a slightly larger exposure to below IG credits (6.1% versus only 4.6% for P/C). Because their exposures to HY credits are limited and skewed to the stronger end of the spectrum, unless adverse credit developments spill over into the broader corporate market, deterioration in HY credit quality should only affect insurers at the margin.

Policy Risk

Policy risk, which has been on the rise in much of the developed world in recent years, remains at the forefront of institutional investor concerns. Political trends in Europe and the U.S. often mirror each other, in particular the rise in popularity of anti-establishment candidates and causes.

U.S.

Most concerns center on President Trump's tax reform and trade plans, which could not only boost economic growth, but also could increase the U.S. budget deficit and national debt burden, increase inflation and lead to sharply higher interest rates. Thus far, optimism has prevailed, especially in the stock market; the S&P 500 Index has continued to trend higher, save for a slight pullback after reaching a record high of 2378.36 on March 1.

UK

UK Prime Minister Theresa May has triggered Article 50 of the Lisbon Treaty, which starts two years of formal negotiations concerning the UK's exit from the EU. This means the UK would leave the EU by the summer of 2019. Thus far, there has been little economic impact from Brexit. The long-term implications are far from clear; official forecasts vary in magnitude, but most expect a material slowdown in economic growth from 2017 to 2019; the Bank of England raised its 2017 GDP growth projection to 2% from 1.4% last November, but still sees growth slowing to 1.6% next year and 1.7% in 2019. At worst, Brexit could affect not only the British

economy, but also the political stability of the UK. Scottish First Minister Nicola Sturgeon has promised to move forward with a fresh independence referendum, given the desire of most Scots to remain within the EU. In Northern Ireland, Sinn Fein, which has been gaining popularity, has called for a referendum on reunification with the Republic of Ireland, although polls show a majority still prefer to remain part of the UK. Lastly, the EU also is claiming that the UK owes it up to €60 billion, while some UK officials claim the EU owes the UK money. The dispute could lengthen the Brexit negotiations.

The British pound fell 16% after the June 23 vote, hitting a three-year low in October of 1.10 against the euro. Since then, the pound has recovered a bit versus the euro and has been largely range-bound between 1.15 and 1.20; against the U.S. dollar, the pound has remained in a 1.20 to 1.25 range, near its low. A weaker pound helps UK exports and tourism, but raises the risk of importing inflation. Still, while raw materials, fuel and producer price inflation are accelerating, British consumers have yet to be significantly affected by higher prices.

Eurozone

Offsetting reduced concerns about potential monetary tightening in the EU are ongoing worries about political risk in Europe given the onset of the Brexit negotiation process, continuing negotiations with the EU over Greece's debt bailout (€6 billion maturing in July), the ongoing Italian banking crisis, and populist and nationalist political movements that could threaten the economic policy outlook. Although nationalist candidates were defeated in Austria last year and the Netherlands earlier in March, investors will be keenly watching the presidential election in France on April 23, followed by Germany's federal election in September and Italy's general election in May 2018. Although still an underdog, the chance that National Front candidate Marine Le Pen—a so-called Euroskeptic—could win the French presidential election has pushed French government bond spreads wider and could make sovereign bond yields more volatile in the months ahead.

Common Stocks: "Trump Effect" or Disconnect?

In U.S. dollar terms, most major stock markets gained in 2016, although Europe and Japan lagged. Virtually all global stock markets are also higher YTD in 2017, but Japanese stocks have lagged year to date, and UK equities have gained a bit less than U.S. and EU shares because Brexit concerns have weighed on UK-focused stocks, especially in the consumer sectors.

The U.S. stock market is performing well; the Standard & Poor's 500 index (S&P 500) remains near record levels and has returned 5.5% YTD. Within the index, there has been a disparity in returns by sector, as shown in Table 7, but most sectors are higher YTD. The strong performance of some sectors can be attributed at least partially to a "Trump effect," where likely beneficiaries of President Trump's proposed policies have surged. Financials have been rallying since November on President Trump's promise to reduce regulatory burdens by dismantling the federal Dodd-Frank Wall Street Reform and Consumer Protection Act, and also because of the steepening yield curve, although it now appears that both of those expectations may take longer to bear fruit than many anticipated. The industrials, energy and materials sectors, meanwhile, likely gained on expectations of increased infrastructure spending and looser environmental regulation.

Table 7: S&P 500 Index Sector Returns, 2015 and YTD through March 31, 2017

Groups (10)	2015	2016	2017 YTD
S&P 500 Index	1.4%	9.5%	5.5%
All Groups			
Info Tech	5.9%	12.0%	12.2%
Health Care	6.9%	-4.4%	8.1%
Consumer Discretionary	10.1%	4.3%	7.9%
Utilities	-4.8%	12.2%	5.6%
Consumer Staples	6.6%	2.6%	5.4%
Materials	-8.4%	14.1%	5.3%
Industrials	-2.6%	16.1%	4.0%
Real Estate	1.2%	0.0%	2.7%
Financials	-1.6%	20.1%	2.1%
Telecom Services	3.4%	17.8%	-5.1%
Energy	-21.1%	23.7%	-7.3%

In the OECD's March 2017 Interim Economic Outlook, the organization warned, "There are apparent disconnects between the positive assessment of economic prospects reflected in market valuations and forecasts for the real economy. Equity valuations have increased significantly further in many major markets over the past six months, despite the large rise in nominal interest rates and with long-term nominal and real GDP growth expectations based on consensus forecasts barely changed. Expectations for corporate earnings growth in the euro area and the United States have also not been revised up over this period." The OECD contrasted the markets' continued uptrend with ongoing low growth of consumption and investment, combined with slow productivity growth and income inequality. The Bank of England recently expressed similar concerns regarding UK stocks.

U.S. investors showed some signs of concern in early March, as the fledgling administration weathered a deepening investigation into the Trump campaign's ties to Russian officials, and it suffered its first significant legislative defeat—failing to garner sufficient votes in the House of Representatives to pass the American Health Care Act. This defeat could dent optimism that the Trump administration will be able to advance its tax reform and/or infrastructure plans, and it could undermine the rationale for the so-called "Trump" trade that has underpinned the U.S. stock market's advance since the 2016 election. The stock market reaction thus far has been limited to a modest pullback. Still, there could be a downside risk to U.S. equity prices if long-term interest rates rise and sufficient fiscal stimulus fails to materialize.

Insurance Industry Impact

Based on data as of Dec. 31, 2015, the U.S. insurance industry held common stock investments totaling $673 billion (11.6% of total cash and invested assets), of which $269 billion (5.2%) were unaffiliated common stock or mutual fund holdings, and $373 billion (6.4%) were affiliated holdings. P/C insurers' common stock exposure totaled $491 billion (28.3% of total invested assets), of which $251 billion (14.5%) was unaffiliated and $240 billion (13.9%) was affiliated, whereas life companies' exposure was only $148 billion (3.9%), of which only $30 billion (0.8%) was unaffiliated and the remaining $118 billion (3.1%) was affiliated. The robust stock market of recent years—in which the S&P 500 returned 12% or more, including dividends, in six of the eight years ended 2016—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.

March 31, 2017								
Major Insurer Share Prices			Change %			Prior		
		Close	Week	QTD	YTD	Week	Quarter	Year
Life	Aflac	$72.42	0.6	4.1	4.1	$71.99	$69.60	$69.60
	Ameriprise	129.68	3.5	16.9	16.9	125.26	110.94	110.94
	Genworth	4.12	4.8	8.1	8.1	3.93	3.81	3.81
	Lincoln	65.45	2.6	(1.2)	(1.2)	63.81	66.27	66.27
	MetLife	52.82	1.6	(2.0)	(2.0)	52.01	53.89	53.89
	Principal	63.11	1.5	9.1	9.1	62.17	57.86	57.86
	Prudential	106.68	1.2	2.5	2.5	105.44	104.06	104.06
	UNUM	46.89	2.4	6.7	6.7	45.79	43.93	43.93
PC	Axis Capital	67.03	0.5	2.7	2.7	66.72	65.27	65.27
	Allstate	81.49	0.6	9.9	9.9	80.99	74.12	74.12
	Arch Capital	94.77	1.7	9.8	9.8	93.21	86.29	86.29
	Cincinnati	72.27	0.5	(4.6)	(4.6)	71.88	75.75	75.75
	Chubb	136.25	0.1	3.1	3.1	136.06	132.12	132.12
	Everest Re	233.81	0.2	8.0	8.0	233.40	216.40	216.40
	Progressive	39.18	(0.9)	10.4	10.4	39.53	35.50	35.50
	Travelers	120.54	(0.2)	(1.5)	(1.5)	120.77	122.42	122.42
	WR Berkley	70.63	0.3	6.2	6.2	70.42	66.51	66.51
	XL	39.86	0.1	7.0	7.0	39.83	37.26	37.26
Other	AON	$118.69	1.0	6.4	6.4	$117.54	$111.53	$111.53
	AIG	62.43	2.5	(4.4)	(4.4)	60.88	65.31	65.31
	Assurant	95.67	0.6	3.0	3.0	95.06	92.86	92.86
	Fidelity National	38.94	1.0	14.7	14.7	38.55	33.96	33.96
	Hartford	48.07	1.6	0.9	0.9	47.33	47.65	47.65
	Marsh	73.89	(0.9)	9.3	9.3	74.57	67.59	67.59
Health	Aetna	$127.55	0.6	2.9	2.9	$126.77	$124.01	$124.01
	Cigna	146.49	0.5	9.8	9.8	145.82	133.39	133.39
	Humana	206.14	(0.5)	1.0	1.0	207.27	204.03	204.03
	United	164.01	(0.6)	2.5	2.5	165.00	160.04	160.04
Monoline	Assured	$37.11	0.7	(1.7)	(1.7)	$36.85	$37.77	$37.77
	MBIA	8.47	4.3	(20.8)	(20.8)	8.12	10.70	10.70
	MGIC	10.13	1.8	(0.6)	(0.6)	9.95	10.19	10.19
	Radian	17.96	1.2	(0.1)	(0.1)	17.74	17.98	17.98
	XL Capital	39.86	0.1	7.0	7.0	39.83	37.26	37.26

March 31, 2017 Major Market Variables	Close	Change % Week	Change % QTD	Change % YTD	Prior Week	Prior Quarter	Prior Year
Dow Jones Ind	20,663.22	0.3	4.6	4.6	20,596.72	19,762.60	19,762.60
S&P 500	2,362.72	0.8	5.5	5.5	2,343.98	2,238.83	2,238.83
S&P Financial	394.58	0.8	2.1	2.1	391.36	386.53	386.53
S&P Insurance	362.67	0.9	2.7	2.7	359.59	353.26	353.26
US Dollar $		**Change %**			**Prior**		
/ Euro	$1.07	(1.3)	1.3	1.3	$1.08	$1.05	$1.05
/ Crude Oil bbl	50.74	5.8	(5.7)	(5.7)	47.97	53.81	53.81
/ Gold oz	1,245.90	(0.2)	8.3	8.3	1,248.50	1,150.90	1,150.90
Treasury Ylds %	**%**	**Change bp**			**%**	**%**	**%**
1 Year	1.03	0.06	0.21	0.21	0.97	0.82	0.82
10 Year	2.39	(0.02)	(0.06)	(0.06)	2.41	2.45	2.45
30 Year	3.01	(0.00)	(0.05)	(0.05)	3.01	3.07	3.07
Corp Credit Spreads -bp		**Change %**			**Prior**		
CDX.IG	66.33	(1.0)	(1.9)	(1.9)	67.01	67.59	67.59

March 31, 2017
Major Insurer Bond Yields

	Company		Coupon	Maturity	Current	Weekly Change: Price Change	Yield	Spread over UST B.P.	Spread over UST Change	YTD Spread Change
Life	Ameriprise	AMP	3.700%	10/15/2024	$102.95	$0.04	3.25%	97	2	(7)
	Lincoln National	LNC	3.350%	3/9/2025	$99.04	$0.13	3.49%	118	1	7
	MassMutual	MASSMU	3.600%	4/9/2024	$103.51	$0.68	3.04%	81	(5)	(11)
	MetLife	MET	4.050%	3/1/2045	$96.76	($0.06)	4.25%	128	(0)	1
	New York Life	NYL	2.350%	7/14/2026	$93.80	$0.06	3.12%	75	1	0
	Pacific Life	PACLIF	5.125%	1/30/2043	$108.03	($0.20)	4.59%	167	1	(23)
	Principal	PFG	6.050%	10/15/2036	$122.12	$0.17	4.36%	161	0	(8)
	Prudential	PRU	4.600%	5/15/2044	$105.59	($0.67)	4.25%	131	4	(2)
	Allstate	ALL	4.500%	6/15/2043	$106.58	($0.46)	4.09%	118	5	(2)
	Berkshire Hathaway	BRK	4.300%	5/15/2043	$102.84	($0.94)	4.12%	121	7	11
	Travelers	TRV	4.600%	8/1/2043	$109.21	($0.16)	4.03%	108	1	3
	XL Group	XL	6.250%	5/15/2027	$117.72	$0.07	4.09%	157	1	(12)
Other	AON	AON	4.250%	12/12/2042	$90.35	($1.32)	4.92%	201	16	27
	AIG	AIG	6.820%	11/15/2037	$124.93	$0.09	4.89%	207	(1)	(3)
	Hartford	HIG	4.300%	4/15/2043	$97.23	$0.49	4.48%	156	(1)	(28)
	Nationwide	NATMUT	5.300%	11/18/2044	$109.65	($0.09)	4.67%	168	(0)	(31)
Health	Aetna	AET	6.750%	12/15/2037	$134.25	$0.47	4.25%	149	(1)	(14)
	CIGNA	CI	6.150%	11/15/2036	$121.07	$0.09	4.52%	177	0	(31)
	United Healthcare	UNH	4.750%	7/15/2045	$110.37	($0.23)	4.13%	115	2	2

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

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