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Chin Up... Things Don't Look So Bad

Good riddance to 2022 – we all took a beating

It was simply a devastating year for investors and to some extent shocking after so many years of relatively calm and more predictable markets. After 14 years of low or zero interest rates accompanied by fiscal policies that also injected liquidity into the economy, major investment markets were inflated in some fashion. We've addressed the market distortions over the last few years on more than one occasion. These distortions manifested in US stocks that broke their record for the longest bull market in history, in roaring bond issuance, in overheated real estate, and in digital coinage and Reddit-reader speculative investing. All of this encouraged by the backdrop of an economy that hummed along and an inflation rate at or below the Fed's 2% target accompanied by full employment levels. What could go wrong? Most investment professionals knew that there would be a payday. The easy money policies were the primary cause of the resultant 40-year high inflation rate, although the catalyst can be

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Q4 Economic and Market Review: Mixed Signals

- The Federal Reserve is expected to announce 25 bps hikes at the February 1st and March 22nd meetings before pausing to assess the impact of 475 bps of hikes over the past 12 months.
- Many traditionally accurate recession metrics indicate that a U.S. recession is likely in 2023. As the same time, the employment picture remains surprisingly robust and the impact of a China re-opening which could boost economic activity is unclear.
- All insurance composites underperformed their benchmarks during the quarter, but outperformed for the year. We expect continued volatility in 2023 and continue to reduce portfolio risk as appropriate.

2022 was Difficult for Bonds and Equities

2022 was a challenging year that most investors will be happy to forget. As the year came to an end, most forecasters expect the economy to soften significantly and even fall into recession during 2023. This level of pessimism is unusual, reflecting continuing distortions caused by the Covid echo.

The labor market is the prime example. While traditionally a lagging indicator, it is unusual to have a labor short during an economic slowdown. There are currently more than 10 million job openings (per JOLTS) versus six million job seekers and the labor force participation rate continues to decline, partially due to baby boomers retiring.

For several quarters, we have highlighted the risks associated with a rotation of inflation from goods to services. Goods, largely produced outside of the United States and more subject to supply side shocks, have seen inflation moderate. Services inflation, inclusive of shelter, has likely peaked but remains stubbornly high. Labor costs represent the largest expense for most service businesses and the labor shortage suggests they will be difficult to contain. This leaves the Fed in a difficult position; if wage pressures don't dissipate, the Fed's only recourse will be to lower demand. Putting it all together, we expect inflation to continue falling but expect it will remain well above the Fed's 2% target.

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Q4 Economic and Market Review: Mixed Signals

John Saf, CFA, Vice President, Co-Portfolio Manager Calamos Investments - John Saf contributes 25 years of investment industry experience. Prior to joining Calamos in 2017, he served as a managing director and portfolio manager at Oppenheimer Investment Management (2006-2017). In this role, he was responsible for nearly $1 billion in assets, including insurance portfolios. In addition to being a CFA charterholder and Certified Public Accountant (inactive), John is a Fellow in the Life Management Institute.

We expect the Fed will take overnight rates to 5.0%-5.5% before pausing. At the same time, the Fed will continue to shrink its bloated balance sheet as officials assess the impact of prior policy moves. The Fed has been clear that it expects to maintain rates at these levels for most of 2023. The market disagrees and is pricing in significant cuts (AKA “pivoting”) beginning in the third quarter – see FOMC Dot Plot below.

In this environment, we would expect the economy to muddle through, better than feared. This may put upward pressure on rates as the market begins to reflect a “higher for longer” environment that the Fed has been openly discussing. We would expect the Treasury curve to become steeper (less inverted) in that scenario.

Credit markets enter 2023 in a strong fundamental position. Through the COVID era, management teams wisely locked in fixed rate funding at historically cheap levels. For high yield issuers, where most credit problems show first, leverage is at multi-year lows and interest coverage at multi-year highs. Refinancing needs are modest until 2025 at the earliest. While default rates remain well behaved, we do expect them to slowly return to long-term averages.

Starting point matters. Higher yields provide more return cushion against unexpected changes in yields. While coupon-like returns are unusual, we expect investment grade markets to deliver mid-to-high single digit returns in 2023 as a better than feared economy, stubbornly sticky inflation, and a higher-for-longer Fed work their way through the market.

The market believes lower inflation and a stalling economy will prompt the Fed to pivot and cut rates in the second half of 2023 as indicated by the green dashed line charting Fed Funds Futures. This is contrary to

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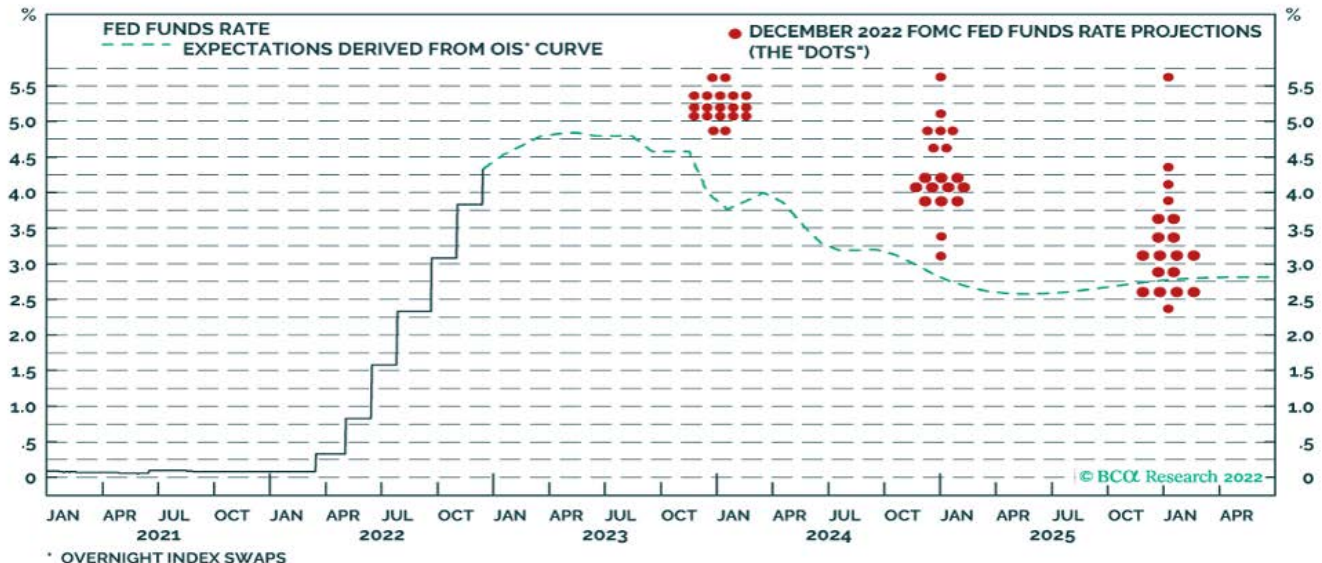
FOMC Dot Plot as of 12/20/22 (Courtesy of BCA Analytics)



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Source: Morningstar (10/17/22)

Q4 Economic and Market Review: Mixed Signals

the Fed's red "dot-plot" guidance. It is also difficult to reconcile how the economy can by bad enough for the Fed to quickly pivot and cut rates without corporate earnings suffering. Unless the market expects the corporate earnings dip to be transitory, equity prices and credit spreads should react poorly, but it is hard to quantify the impact on trade and inflation from China's re-opening.

Short Treasury Rates Continue Higher

Treasury rates under 3 years moved higher in anticipation of additional Fed Funds hikes, but 3 to 10yr were mostly unchanged at year-end, causing the curve to invert by almost 50 bps.

Intermediate Credit option-adjusted spreads (OAS) tightened 23 bps during the quarter with A-rated corporates tightening from 117 bps to 98 bps and BBB-rated corporate OAS tightened from 168

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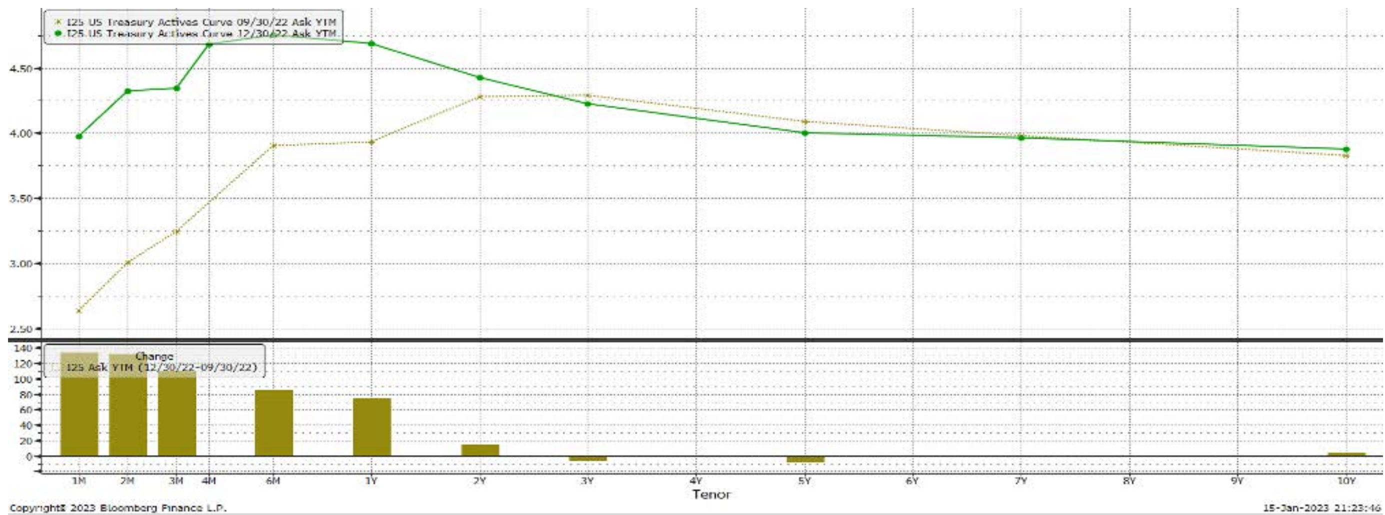
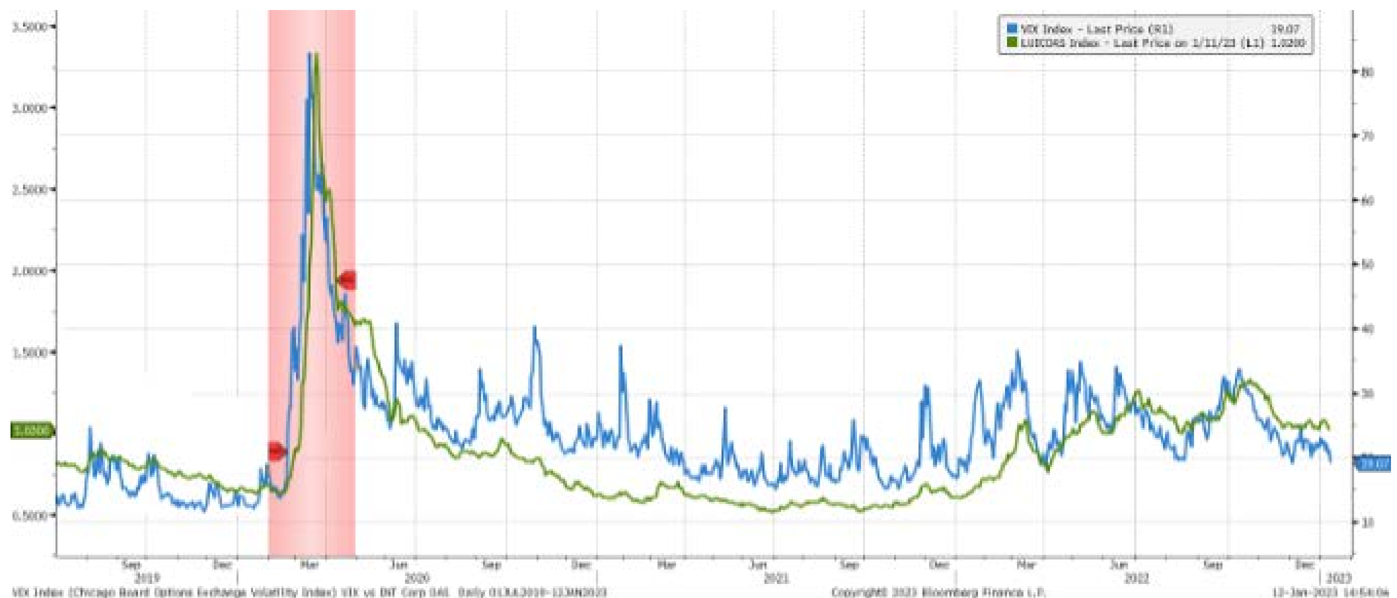
TREASURY YIELD CURVE MOVEMENT DURING 4Q22 AND YEAR-TO-DATE



VIX (BLUE) & INTERMEDIATE MATURITY INVESTMENT GRADE OAS (GREEN)



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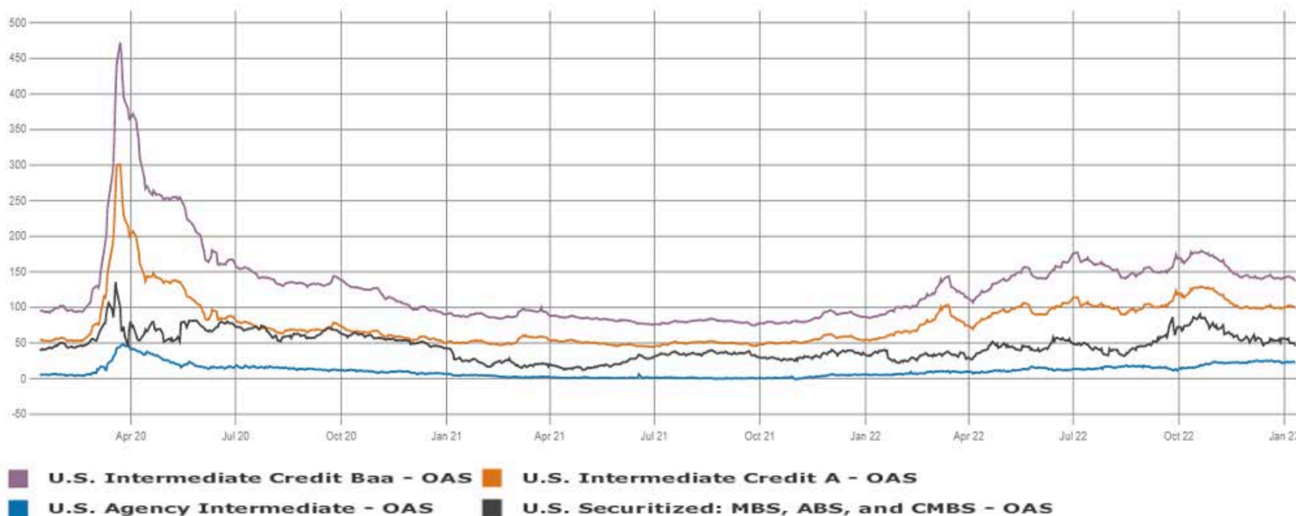
Q4 Economic and Market Review: Mixed Signals

OPTION-ADJUSTED SPREADS (OAS) FOR INTERMEDIATE INDEX COMPONENTS



Past performance is no guarantee of future results. Source: Barclays Live - Chart.

bps to 140 bps.

4Q22 Sector and Index Performance

Intermediate Corporate, Securitized and Agency index nominal spreads were 29, 12 and 5 bps tighter during the quarter, producing modest outperformance over duration-matched treasuries. This contrast with full year performance, treasuries were the best performing sector followed by Agency, Corporate and Securitized which underperformed by 27 bps, 84 bps and 214 bps respectively. The yield-to-worst of the Bloomberg Intermediate U.S. Aggregate Index decreased from 4.69% to 4.63% during the quarter, but finished 3.11% higher for the year.

Investment Strategy – Higher Yields Likely in 2023

Our long-term strategy is to overweight credit by favoring issuers we are confident can survive cycle downturns and mature as scheduled. We continue to surveil all holdings and remain comfortable that yields are attractive for the risks taken. We expect credit impairments and defaults to be lower this cycle, but investment grade spread product yields are biased to go higher. The treasury curve will likely continue to invert through 1Q23, but credit curves should stay positively sloped reflecting wider credit spreads in longer maturities until the severity of the recession is known with more certainty. If credit spreads remain under pressure, credit will underperform treasuries over the short-term, but compare more favorably over longer time frames due to the yield advantage.

> “This leaves the Fed in a difficult position; if wage pressures don’t dissipate, the Fed’s only recourse will be to lower demand. Putting it all together, we expect inflation to continue falling but expect it will remain well above the Fed's 2% target.”

Markets are volatile and credit conditions can change. We proactively trade to improve portfolios which may include selling corporate securities to buy longer maturity treasuries or very high quality taxable municipal bonds. We continue to underweight securitized products due to their negative convexity. ☐

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Chin Up... Things Don't Look So Bad

debated. The Fed's tough medicine that followed consisted of the steepest rise in interest rates in US history; arguably setting off the 2022 market distortion to offset their prior one.

Seasoned institutional investors expect cyclical economic and market volatility, particularly in stocks. Last year's -18.11% return by the S&P 500 index defined a cyclical change from bull to bear and was the worst market downturn, by far, since 2008! In fact, only 7 years since 1927 saw negative returns as great. Most P&C insurance clients have about 15-25% exposure to equities and normally such downturns are partially offset by strong bond returns. Holding both stocks and bonds is the simplest form of diversification as these asset classes historically possess low-inverse correlation to one another. Such a diversification benefit helps to smooth out overall investment returns through choppy markets; an important feature for insurers who rely on their portfolio to support their claims paying ability and capital growth.

What made 2022 so special, in a bad way, was a market distortion: that of a simultaneous bear markets for equities and bonds. Investment-grade (IG) bonds, as measured by the Bloomberg US Aggregate Index (AGG) returned -13.01% for the year. This was a particularly anomalous outcome since bond volatility is historically mild compared to stocks, with negative years averaging about -3.5%. This low expected volatility rate is a primary reason that IG bond portfolios constitute the ballast of an insurers' claims paying ability. Accordingly, insurers as an institutional investor group, were particularly hurt since it was the worse year in US history for bonds[1], and by a lot!

Many insurers use asset liability matching (ALM) in their bond portfolios. Aligning an insurer's portfolio with their liability durations is an important risk management tool as it reduces interest rate risk by correlating asset and liability value movements across the balance sheet. Some mid-longer tail P&C writers have the bulk of their bond portfolios in a duration range similar to that of the Bloomberg US Aggregate (AGG) index, a representation of the US investment-grade bond market. Many insurers, given their mix of lines of business, have a slightly shorter duration which is better approximated by using the Bloomberg Intermediate Aggregate or the Intermediate Government/ Credit Bond Index. As you can see from the chart below, there was absolutely nowhere to hide for the calendar year as all major bond indices suffered significantly negative returns.

Another observation, one that should concern insurers, is that bond returns have failed to keep pace with inflation over the last 10 year period. Therefore, those insurers that relied on an 80%/20% mix of bonds and stocks saw the bulk of their portfolio lose "real" value.

Generating "real" investment returns, net of the inflation rate, is a must for insurance companies long term survival since liabilities inflate at the inflation rate, if not faster for certain lines. Therefore, as soon as

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Bloomberg US Indices	1 Mo.	QTD	YTD	1 Yr.	3 Yr.	5 Yr.	10 Yr.
1-3 Year US Government/Credit	0.19	0.89	(3.69)	(3.69)	(0.32)	0.92	0.88
Intermediate US Government/Credit	(0.18)	1.54	(8.23)	(8.24)	(1.26)	0.73	1.12
Long US Government/Credit	(1.38)	2.61	(27.09)	(27.10)	(6.20)	(1.21)	1.57
US Government: 1-3 Year	0.18	0.73	(3.81)	(3.81)	(0.46)	0.74	0.66
US Government: Intermediate	(0.24)	1.01	(7.73)	(7.73)	(1.38)	0.46	0.69
US Government: Long	(1.69)	(0.59)	(29.19)	(29.21)	(7.39)	(2.19)	0.61
US Treasury	(0.52)	0.72	(12.46)	(12.47)	(2.62)	(0.10)	0.58
US Treasury: Long	(1.70)	(0.59)	(29.26)	(29.27)	(7.40)	(2.20)	0.60
Global Real U.S. TIPS	(1.02)	2.04	(11.85)	(11.85)	1.21	2.11	1.12
US Agency	(0.05)	0.70	(7.87)	(7.88)	(1.39)	0.58	0.95
Investment Grade CMBS	0.04	0.95	(10.94)	(10.95)	(1.70)	0.76	1.61
Asset-Backed Securities	0.66	0.81	(4.30)	(4.30)	(0.11)	1.18	1.23
US Corporate Sector: Industrial	(0.67)	3.85	(16.79)	(16.80)	(3.22)	0.34	1.82
US Corporate Sector: Utility	(0.22)	3.80	(18.55)	(18.56)	(3.67)	(0.32)	1.78
US Corporate Sector: Financial Institutions	(0.10)	3.23	(13.06)	(13.07)	(2.03)	0.85	2.23
Aaa Credit	(0.39)	1.22	(10.08)	0.00	0.00	0.00	0.00
Aa Credit	(0.66)	2.33	(16.10)	(16.11)	(3.31)	(0.11)	1.31
A Credit	(0.40)	3.27	(15.15)	(15.16)	(2.87)	0.22	1.76
Baa Credit	(0.42)	4.18	(15.94)	(15.95)	(2.88)	0.70	2.17

Source: PIMCO as of 12/31/22

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Chin Up... Things Don't Look So Bad

feasible, it would be prudent for insurers to review and possibly modify their asset allocation. Many may want to consider a more sophisticated asset allocation by modeling several asset classes that could incrementally provide additional diversification benefits to their current allocation.

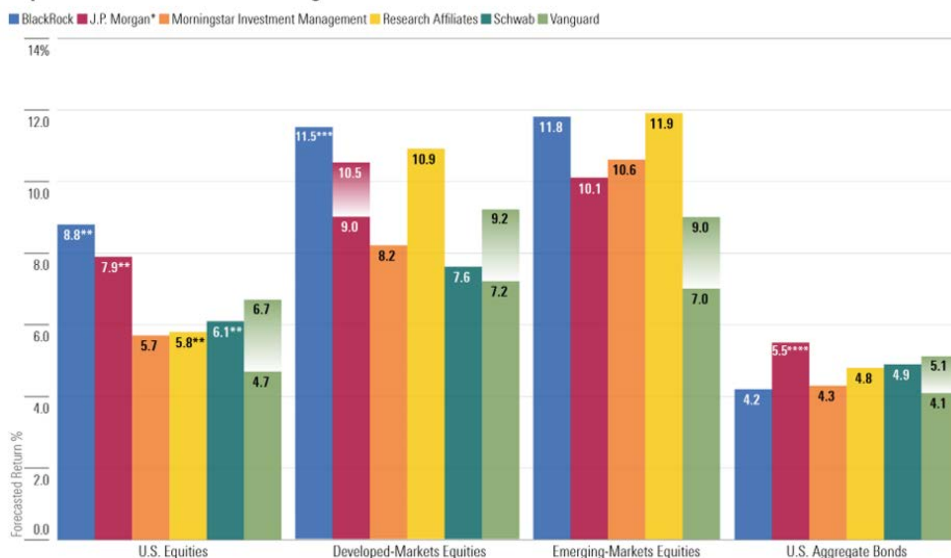
To evaluate allocation options, insurers should consider a proven analytic process, preferably one designed in a manner that accommodates its nuanced investment requirements due to claims payout patterns as well as accounting and regulatory considerations.

Furthermore, allocation considerations should be made with a long-term investment horizon, typically referred to as a "strategic" asset allocation. Major Wall Street firms provide much of the research and required data inputs to optimize a set of allocations for consideration by an investment committee or insurance company's Board of Directors. Typical data points required for a Strategic Asset Class (SAA) optimization include asset class expected returns, volatilities, and correlations. Some long-term asset class return forecasts are provided in the chart below.

Over the next few quarters, interest rates are expected to rise a bit more before falling and stocks will most likely continue to be volatile while we await more directional clues for the US and global economy before a new bull cycle can begin. These cyclical changes in both the stock and bond market requires every insurer to review both tactical and strategic aspects of their investment program (short and long investment horizon, respectively). Considerations should include not only asset allocation changes but also are the best managers in place, or available, to execute strategies in new asset classes or adapt their tactical portfolio positioning to existing allocations.

Beaten down markets: A good entry point for several asset classes Once interest rates have peaked, the new cycle downward is expected to stop well before the near-zero rates of the recent past. In fact, bond investors that are putting new money to work are currently experiencing the highest yields in over ten years. Regarding stocks, the 15+% annualized equity return in 4 of the last 6 years is not expected to repeat itself anytime soon. In fact, the US stock market's historical 10% annualized return is substantially higher than most forecast stock returns for the next 10 years. However, the good news for insurers is that bonds will generate returns that should exceed inflation, a positive 'real' return, and look significantly stronger than what we have seen in recent years. Note that the forecasted gap in returns between US stocks and US bonds is significantly compressed relative to recent years. Furthermore, non-US developed and emerging markets look better positioned than the US stock market. This represents a major change from the past 10 years. Forecasted returns for other asset classes such high yield, direct lending, leveraged loans, convertibles and REITS are all likely to play a larger role in asset allocations. Alternative investments (ATLs), some of which are designed specifically with insurers in mind and have "A" credit ratings, have also begun to take on an important role, in small allocations in an issuer's surplus portfolio. With ALTs, insurers with strong balance sheets can trade liquidity for significantly higher potential returns and low correlations, providing diversification to the public market securities.

The bottom line is that last year's market setbacks may be this year's market opportunities. These new market conditions will need different strategies than were utilized in the past. Insurers need to make the necessary adjustments to enhance the probabilities for success and optimize their investment results.



Source: Morningstar

1 Analysis by Edward McQuarrie, professor emeritus at Santa Clara University

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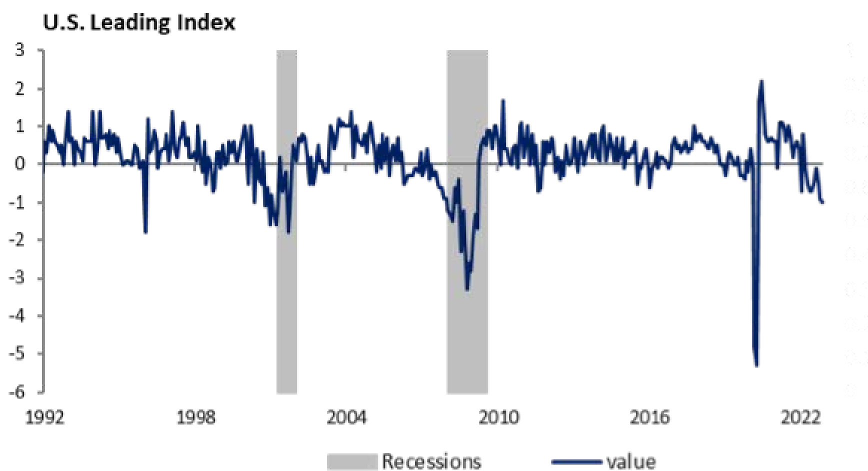
A New Year, A New Problem

Greg Hahn: Prior to forming Winthrop Capital Management, Greg was the Chief Investment Officer and Senior Portfolio Manager for Oppenheimer Asset Management and its subsidiary, Oppenheimer Investment Management. Greg also served as the Chief Investment Officer and Senior Portfolio Manager with Conseco Capital Management (40|86 Advisors). Greg was President and Trustee of the 40|86 Series Trust and the 40|86 Strategic Income Fund. Also, Greg had responsibility for the $1.2 billion real estate and private equity portfolio.

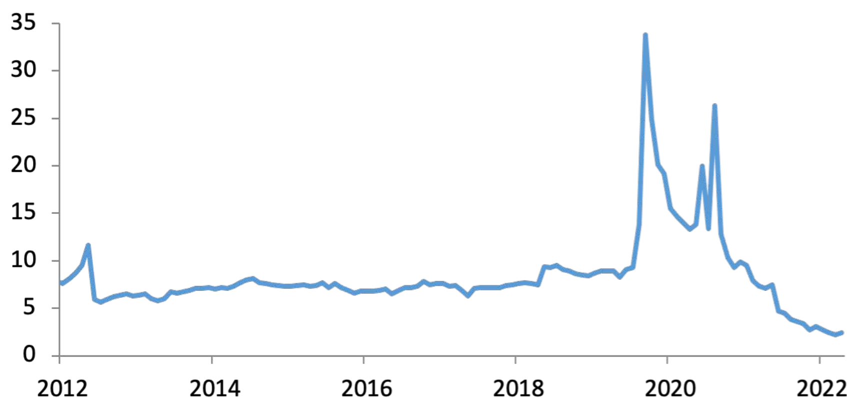
On the surface, the US economy looks fairly strong. Third quarter Gross Domestic Product (GDP) increased 3.2% according to the BEA and consumer confidence increased sharply in December according to the Conference Board. In addition, the employment market remains extremely tight as employers added 4.5 million jobs in 2022, the second-best year of job creation after 2021, and the unemployment rate is running at 3.5% in December. The manufacturing sector also is showing strength with supply chains no longer a barrier, and a mild winter thus far, easing pressure on energy demand.

However, when we look beneath the surface, the picture turns more gloomy. There are a series of compounding factors that are accumulating to cloud our forecast for the coming year. First, we know that historically employment is a lagging indicator that typically peaks at the inflection point of economic activity. With increased pressure on corporate profit margins, we expect to see some deterioration in employment in 2023.



Source: Federal Reserve Bank of Philadelphia

The inversion in the yield curve is often mocked for predicting 13 of the last 10 recessions; however, we are choosing to give it credence leading into 2023. We believe the current inversion of the yield curve is a leading indicator of a pending recession. Whether measured by the 3-month, 1-year, or 2-year US Treasury rate, the yield curve has inverted, which has an over 80% success rate of implicating an eminent recession. Further, the monthly Conference Board US Leading Indicator Index has declined for 9 months in a row. On average the index declines by only 3 months in a row prior to the US economy slipping into recession.



Source: US Bureau of Economic Analysis

Finally, US personal savings rate, which has averaged over 6% the past 15 years, has slipped to 2.4%. The US savings rate received a boost over the past two years as a result of government support during the pandemic, and the last time the savings rate was this low was just prior to the 2007-2008 financial crisis.

Tighter monetary policy will also

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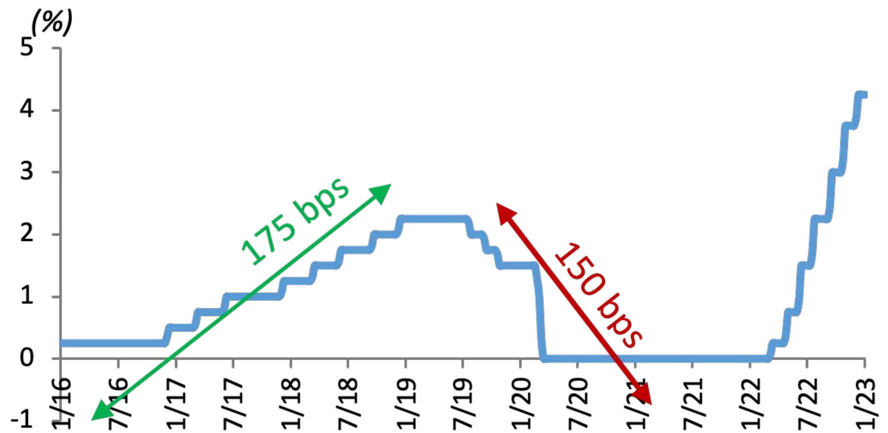
A New Year, A New Problem

combine to slow economic growth in 2023. The Federal Reserve's monetary policy was the singular story driving capital markets in 2022. Labelling it "transitory", the Fed was slow to recognize the growing rate of inflation in 2021 resulting from sustained low interest rates, the rapid growth in money supply, and supply chain disruptions. However, in 2022 the highest rate of inflation in the US since the 1970s was met with an aggressive shift in monetary policy. The Fed increased the short term interest rate seven times through the year from a level near zero to a target yield of 4.50%, the highest level for the overnight borrowing rate in 15 years.

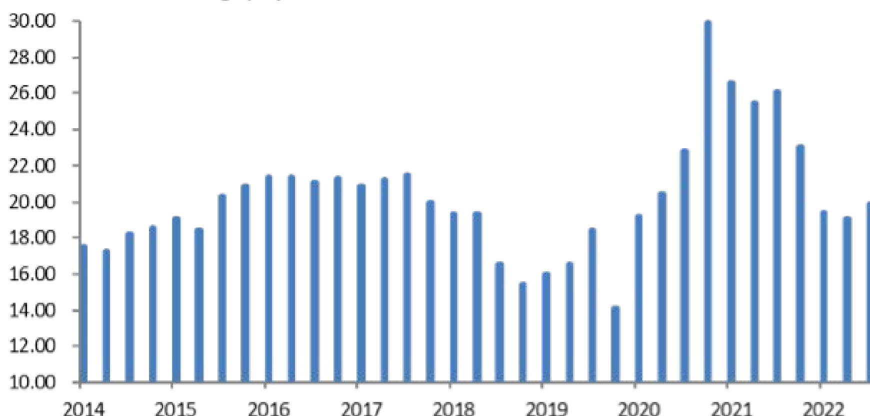


Source: Federal Reserve

The Fed has indicated a continued diligent aggressive push to higher short term interest rates. We expect their estimated terminal rate is 5.1%, while the capital markets are implying that after reaching 4.75% the Fed will begin reducing rates. We would be careful with this premise and expect the Fed to pause and hold rates steady for a sustained period. The time old testament of *don't fight the Fed* was challenged over and over in 2022 as investors tried to front run the Fed and bet against the potential Fed shift in policy only to be wrong.

While we expect inflation will likely decelerate below 4% quickly, it will also take aggressive policy to reach 2% inflation target once again. This will likely lead the Fed to, at a minimum, maintain the current range of Fed funds rates for longer. An extended period of tighter monetary policy will likely cause a further credit contraction and lower global liquidity.

We believe this will lead to a dramatic slowdown in economic growth which is not fully priced into the capital markets. The current Fed policy has one objective, demand destruction. The bond market seems to understand that this is occurring. Slower long term economic growth will result in lower long term interest rates. Equity markets are misreading the decline in long term interest rates as a sign that the Fed is likely to pivot. The reality is that equity valuations have only returned to a historically normal levels. We believe interest rates will continue to decline out the yield curve. As a result, we like current bond valuations, but until we see a full reset of valuation in stocks to make them relatively cheap, returns will be challenging in equities. ☐



Source: Standard & Poor's

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Carl Terzer Named Highly Commended - Captive International Cayman Awards

From Captive International: The 2022 Captive International Cayman Awards are our tribute to the stars and unsung heroes of the captive insurance industry on Cayman. It is their efforts and achievements that keep Cayman at the forefront of the captive insurance world.

Over the past few months, Captive International readers have cast hundreds of votes in support of service providers they believe are at the top of their game.

Every year, each category of awards becomes more competitive than before. Given the highly contested nature of the categories, in most cases we have named two additional highly commended companies or individuals that were runners-up.

CapVisor's Carl Terzer is recognized as highly commended in the best asset manager category.

Upcoming Events

1. The CICA International Conference will be held in Rancho Mirage, CA from March 5-7. Carl Terzer and Travis Terzer will both be attending. We hope you stop by booth #212 to visit with the CapVisor team.

2. Carl Terzer is attending the Risk Management RIMS Conference in Atlanta, GA from April 30- May 3. We look forward to seeing you there!

3. The North Carolina Captive Insurance Association Conference (NCCIA) is in Asheville, NC from May 7-10. Carl Terzer and Travis Terzer will both be in attendance. Carl is speaking in the session, "From Pandemic to Inflation to Recession: Uncertain Economic Times Impacting Captive Investments" on Wednesday at 10:00 a.m.

Carl E. Terzer, Principal & Editor in Chief
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