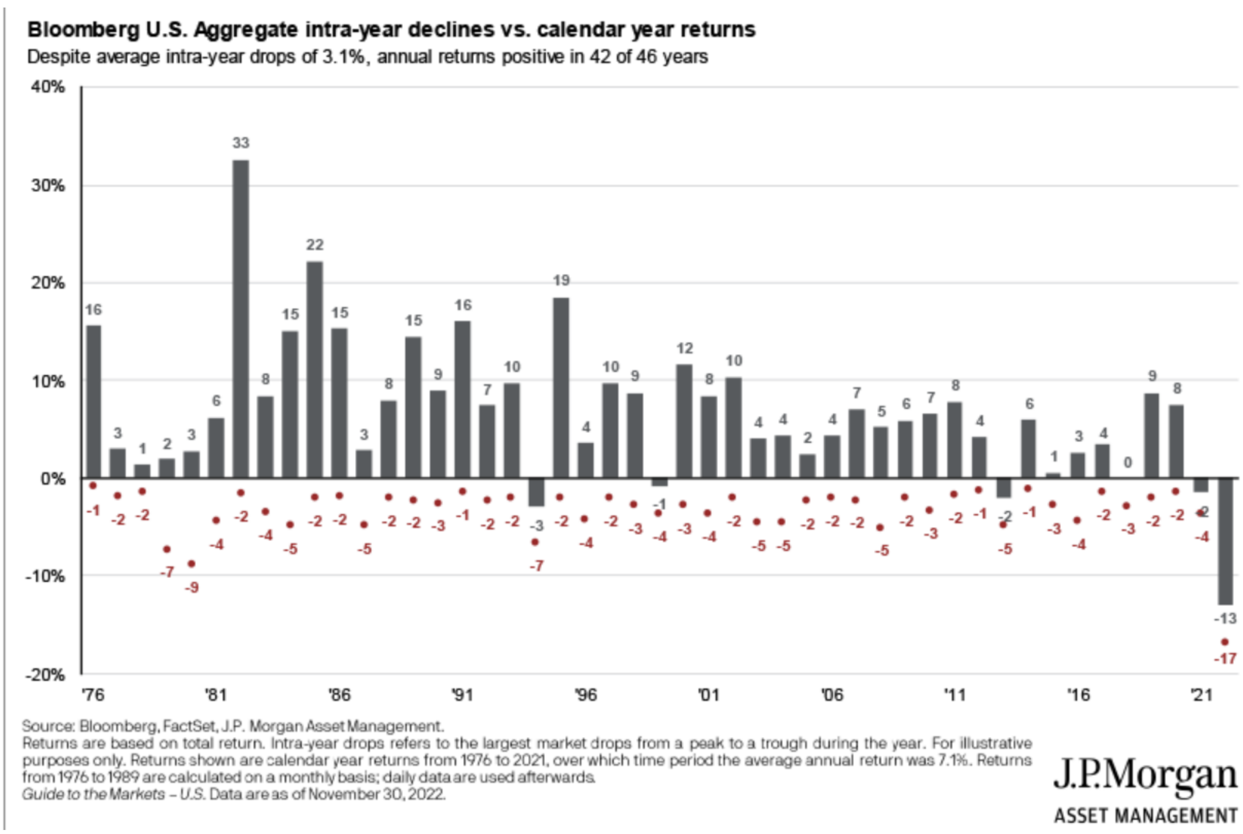
Some thoughts on the unusual year of 2022

12/12/22
Carl E Terzer, Principal and Chief Insurance Strategist
CapVisor Associates LLC

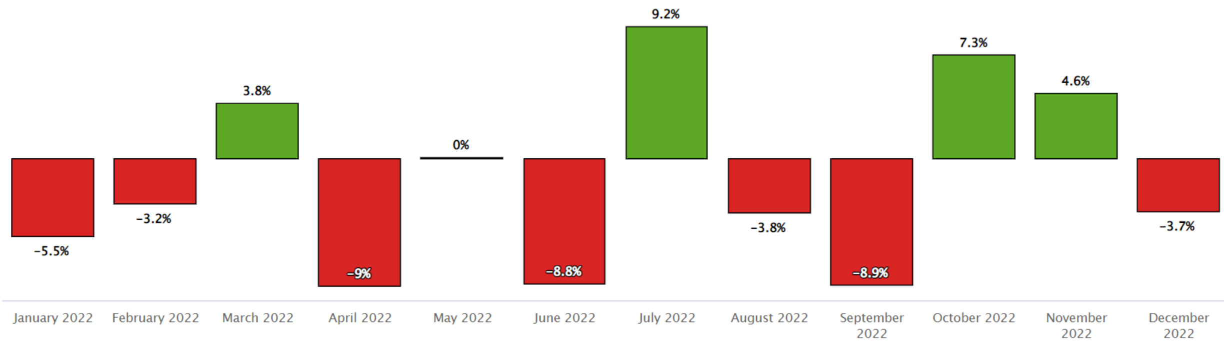
This year, stock and bond markets have been brutal - - why is this happening and what does it mean for Captive Insurance Company portfolios?

In the majority of market cycles, when stocks fall, bonds either hold their value or rise. In investment terminology, they are usually slightly "inversely correlated" and therefore, typically provide a diversification benefit when combined in a captive's investment program.

This year, we have experienced negative bond returns at levels unprecedented in recent history. Since 1976, we have seen the Bloomberg Aggregate, the commonly-used benchmark index representing the US investment grade bond universe, produce negative annualized returns only 5 times, including this year. The chart below shows that even negative intra-year returns (in red) have been nowhere near the losses experienced in 2022.



Equity markets have been on a roller coaster but unfortunately mainly headed downward. The chart below shows monthly returns for the S&P 500 for 2022 through December 9th. The year-to-date return is -16.17%.



Source: StatMuse

This year was truly an anomalous year in which both stocks and bonds produced significantly negative returns. This has only happened 3 times since 1927[1]. 2022 will go down in the record books and one of the worse since records have been kept.

WHY? We have recently come out of the longest bull market in the history of the U.S. stock market, as well as an unprecedented 14 years of near-zero interest rates. We have had an "easy money" monetary policy, coupled with a fiscal policy that flushed the economy with additional liquidity during the Covid pandemic. Then for good measure, throw in a bit of current geopolitical turmoil: a war, supply chain kinks exacerbated by the pandemic and the start of a deglobalization cycle. The result: conditions that have combined to produce the worse inflation since the early 1980s. We believe that it is these "market distortions", many of which have been baked in the last decade, that are primarily why markets are not currently behaving as they would under normal economic and other socio-political influences.

While there are many contributors, the crux of the problem is inflation. At 40-year highs, the Fed[2] is in process of steep interest rate increases in an effort to slow inflation. Figuring out the level of interest rate hikes that will bring it within a reasonable range is the tricky part. Inflation itself will help drain excess dollars/liquidity from the marketplace. High rates should depress demand also bringing inflation down. These influences will likely take some more time, as there is typically a "lag" during which time behaviors are adapting to the new prices and cost of capital. That's the tricky part for the Fed.

Economists are uncertain of where rates may top out since inflation appears to be more stubborn that anticipated. Notwithstanding the fact that the underlying US economy is still in pretty good shape, forecasters are presently factoring in a 65% probability for a recession in 2023. They expect that the Fed is likely to oversteer, and their past track record is not reassuring. Fortunately, most think that the severity and duration of a recession would be mild and short although at this point, that outcome remains far from certain. The Fed is committed to raising rates until inflation is under "control", meaning making tangible progress toward the Fed's 2% target rate. At that point, we will expect to see rate hikes cease and even perhaps witness rate declines if the economy risks a deep recession, or if unemployment becomes too elevated or if risks of stagflation increase. Bonds will be expected to make adjustments almost in lockstep with the Fed's actions. Equity markets may take longer to normalize as the stock market reacts more so to things like future earnings growth, socio-political global events, employment, sentiment/momentum, etc.

Final Thoughts

While the last several quarterly investment performance reports are disappointing to view, please keep in mind that all insurers must rely on their sound long-term strategy and an optimized "strategic" asset allocation. Presently, all insurers are in the same or very similar unfortunate situation. Under the more normalized market conditions that lie ahead, this will provide the expected diversification benefits and improve risk-adjusted returns for captive portfolios. In fact, most if not all, of the bond market's value "losses" are unrealized and will likely be recouped as the bonds move through time to mature at face value. As the markets continue their adjustment from the easy money policies that have distorted many natural market forces since 2008, we will hopefully see more normal and predictable market forces take over. We expect that by the second or third quarter 2023, there will signs of such normalization. For insurers, it is important to "stay the course" through these volatile periods as they need to be disciplined, long-term investors. Once asset classes experience the inevitable "reversion to mean", asset classes in captive portfolios should regain historical relationships, returns and correlations.

In the meantime, and looking at the bright side, current conditions present some tactical opportunities: that is, before the beginning of the new economic cycle or interest rate regime. New incoming premiums can be put to work at bond yield levels that have not been seen in a decade! Stock prices have substantially moderated from their record highs, with many strong companies being oversold, presenting seasoned stock pickers with potentially fantastic opportunities over the next several quarters!

Here's to a happier New Year for investing! Cheers!

---

1 source: https://pages.stern.nyu.edu/~adamodar/New_Home_Page/datafile/histretSP.html

2 Federal Open Market Committee (AKA the Fed)