ALLIANCEBERNSTEIN®

Insurance Relative Value

June 2023

LOOKING FOR THE NEXT SHOE TO DROP

The Macro Picture: Beware of False Peaks

The risks of a rapid economic unraveling from March's bank failures and of a US government default are in the rearview mirror, so markets enter the first summer month again tethered to conflicting economic data. Inflation is falling but still too high, though the path to target inflation feels more attainable, given restrictive financial conditions and tighter lending standards. Labor market data have been puzzling. The US economy added 339,000 jobs in May according to the non-farm payroll survey, but the unemployment rate ticked up to 3.7% and the household survey implied a loss of 310,000 jobs. Banking sector fears have eased, but deposit flows have neither deteriorated further nor improved. We expect net flows to continue declining as total commercial bank deposits revert to pre-pandemic long-term trends.

The resilient economy forced government bond markets to dramatically reprice the path of Fed rate cuts for the rest of 2023. Markets are pricing only a single 25 bp rate cut through December—in line with our expectations. Equity and credit markets are even further away from pricing in a recession—or even significant deterioration in economic conditions—while FOMC members continue pointing to a mild recession in late 2023. The Fed decided to raise rates in May, pushing the fed funds rate up to a range of 5% to 5.25%, keeping its options open and staying data-dependent. "Fed speak" has implied no rate hike in June, as the FOMC assesses the full impact of restrictive monetary policy and tighter lending conditions. As long as inflation is above target and the labor market is relatively healthy, policy should remain restrictive.

Developments on inflation, employment, central-bank policy and the banking sector will continue to drive markets. Investors' will likely refocus on inflation as the narrative of economic resilience takes hold. Europe and the UK are a few months behind the US in their inflation fight. Rising inflation may force the Bank of Japan to tighten. China's re-opening seems to have run its course, leaving a more inward-facing and slower growth outlook. Geopolitical risks remain, highlighted by US-China tensions.

Looking Ahead: Stay the Course

Neither the debt ceiling nor regional banking stress brought an immediate hard landing, highlighting the remarkably resilient US economy and narrowing the range of potential outcomes in 2023. We expect the economy to gradually return toward normal as inflation decelerates and growth slows. That path will likely be bumpy, exemplified by volatile markets, headlines, and economic data so far in 2023. Unless there's a systemic shock that depresses the growth and labor outlook, Fed policy will remain more restrictive. We think the Fed is likely at or near the peak of the rate-hike cycle, but policy rates will likely stay high for a while. Economic data and bank lending behavior will remain critical to assessing central bank policy. The path of rates is still unclear, and downgrades will likely increase, reinforcing the need to stay closer to home, tilt to defensive sectors and maintain underwriting discipline.

Where Do We See Value?

We continue to see value in higher-quality assets and certain agency MBS pockets. Risk-asset spreads have fallen given fewer negative headlines and the resolution of the US debt ceiling negotiations, but macro uncertainties persist. Generic US IG spreads have retraced more than 60% of their widening in late Q1, after several government-led bailouts on failed banks. Banking concerns have eased, compressing beta and flattening credit curves. We believe a downturn is inevitable but are less certain on the timing. Our base case is for a mild recession, so rising default risks should be manageable relative to historical experience. However, rating agencies could take precautionary actions and downgrade cuspy credits. Meanwhile, credit spreads have remained resilient so far and the credit curve has flattened, pointing to value in up-in-rating-quality assets.

In contrast, agency MBS have been under pressure due to unfavorable technical factors. The Fed and US banks are typically large buyers; without that activity and with rates more volatile, nominal and option-adjusted spreads have widened. Securities liquidation by recent failed banks is concentrated in agency MBS, further pressuring a fragile sector. Spreads reached local high points at the end of May and have since fallen, but we still see good relative value versus US. IG corporates for insurance portfolios that can take negative convexity risks. For insurers that want to limit negative convexity risks, certain pockets of agency MBS, such as CMOs and other structuring, and agency CMBS could offer value, too.

Here's where we see value:

- **US IG**: Financials continue to retrace their spread widening from early March; fundamentally, we prefer high quality in larger money-center banks, which no longer look attractive relative to non-financials. We find value in rotating out of consumer cyclicals and into utilities.
- **Emerging Markets**: EM corporates outperformed US IG last month; relationships with IG bonds now look fair. We're finding value in select intermediate BBB corporates and some high-quality (A or above) sovereign issuers for portfolio diversification.
- **Securitized Assets**:
  - ABS: A top pick, with on-the-run sectors offering an attractive spread advantage over US IG combined with positive fundamentals.
  - Agency MBS: Security selection remains key; spread pick-up versus US IG and non-agency MBS remains attractive.
  - CLOs: AA is the sweet spot; we prefer more stable managers with issuance-platform longevity and growth potential

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Public Fixed Income Universe

Asset Class	Rating/ Tranche	Spread						Yield			
		Current	**MoM Δ**	**Z-Score***	**Average***	**Max**	**Min**	**Current**	**MoM Δ**	**Z-Score**	**Average***
US Credit	AA	80	-3	0.47	68	251	33	4.49	0.23	1.69	2.89
	A	139	-10	1.12	102	309	58	5.08	0.16	1.75	3.22
	BBB	193	-7	0.93	153	409	93	5.62	0.19	1.77	3.73
	BB	257	-39	-0.03	259	719	155	6.41	0.05	1.65	4.55
	B	420	-25	0.06	413	936	272	8.04	0.19	1.57	6.09
EM Corps	AA	89	-2	0.30	81	180	44	4.58	0.24	1.40	3.13
	A	123	-15	0.25	116	238	68	4.92	0.11	1.59	3.36
	BBB	235	-14	0.64	199	469	126	6.04	0.12	1.77	4.19
EM Sovs	AA	23	-7	-1.27	66	279	14	3.92	0.19	1.20	2.86
	A	85	-4	0.21	76	289	-2	4.54	0.22	1.96	2.96
	BBB	150	-17	0.64	125	331	72	5.19	0.09	1.70	3.46
Taxable Munis	AAA	117	1	0.98	87	172	25	4.86	0.27	1.74	3.06
	AA	106	3	0.46	95	194	51	4.75	0.29	1.68	3.14
	A	150	1	0.80	128	217	87	5.19	0.27	1.82	3.47
Agency RMBS	MBS LCF	190	5	3.71	98	190	60	5.59	0.31	2.48	3.18
CMBS	AAA LCF	159	0	1.90	97	267	59	5.28	0.26	2.00	3.18
	AS	235	-10	2.09	131	332	76	6.04	0.16	2.17	3.51
	AA	360	-2	2.60	163	528	92	7.29	0.24	2.68	3.83
	SASB AAA	210	0	0.84	149	275	66	7.16	0.24	1.68	3.03
	SASB AA	310	-10	1.14	200	350	92	8.16	0.14	1.70	3.54
CLO	AAA	180	0	1.08	139	440	96	7.03	0.19	2.48	3.12
	AA	255	10	1.27	192	500	135	7.78	0.29	2.48	3.65
	A	305	-5	0.79	251	635	170	8.28	0.14	2.23	4.24
Non-Agency RMBS	CRT LCF	190	-14	0.23	172	350	70	6.96	0.10	1.67	2.99
	AAA	183	30	1.52	130	306	66	5.68	0.63	2.09	3.41
BMK ABS	AAA	140	20	1.65	75	306	16	5.90	0.79	2.35	2.30
	AA	170	20	1.15	110	506	39	6.20	0.79	2.32	2.63
	A	220	20	1.32	133	600	54	6.34	0.71	2.25	2.90
Non-BMK ABS	AAA	150	-25	0.54	120	250	33	5.64	0.26	1.16	3.16
	AA	225	-15	1.07	149	300	64	6.39	0.36	1.28	3.45
	A	300	-25	1.03	200	800	94	7.14	0.26	2.08	3.77

*Z-Scores and averages are based on 5-year averages. SASB: single asset, single borrower. LCF: last cash flow.
Source: Bloomberg Index Service Limited, JPMorgan Securities, Wells Fargo Securities, AB
As of June 2nd, 2023

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IMA-390509-2023-06-06, ICN2023928