The Road Ahead: 2025 North America Insurance Outlook

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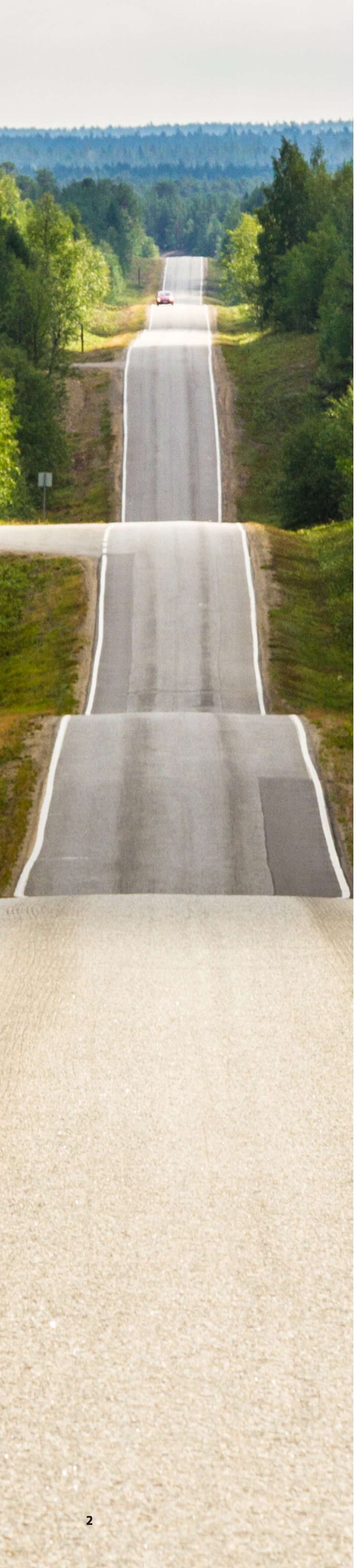
As we get ready to close the books on 2024, the US economy continues to expand, though the labor market has weakened, painting a picture of a coming deceleration in growth. With both growth and inflation likely to continue slowing, the door is wide open for the Federal Reserve to continue rate cuts, which should forestall a more negative economic outcome. Still, the path of interest rates isn't certain and some inflation risks remain. A policy regime change from new US leadership creates uncertainty, and continued geopolitical tension bears monitoring.

North America insurance market growth remains fragmented. Life insurance in force has extended its decade-long flat trend, while annuity sales have continued outpacing other life products. Growth has been driven mainly by record fixed annuity sales: annual sales have nearly tripled since 2021 as higher rates have made these products more attractive to policyholders. Variable annuity sales have rebounded to 25% growth year to date, driven by record sales in registered index-linked annuities, up 39%.[1]

Annuities tend to have much shorter contract durations than traditional life and long-term-care products, creating a home for shorter-duration assets with attractive yields and breaking the mold of insurers investing solely in long-duration assets. It can also be argued that insurers could be a better asset liability management fit than banks in providing longer-term financing. Life insurers with spread-lending capabilities continue to optimize their funding sources, such as Federal Home Loan Bank (insurers' usage has topped $160 billion) and funding agreement–backed notes (issuance is up over 50% year over year).

In an even more fragmented property and casualty market, more-frequent catastrophes have increased claims, creating a liquidity need for certain insurers. Some others have benefited from rising property values, which have led to high insured value, higher premiums and higher investment needs. We're seeing a shift in investment strategy from capital gains to a more balanced approach between income (book yield) and total return while also balancing equity gains with fixed-income losses. The use of reinsurance strategies continues.

1 Source for all sales figures: LIMRA, Preliminary US Retail Individual Life Insurance Sales Summary Report, third quarter 2024.



Reinsurance volumes have picked up in 2024 after a quieter 2023, with Bermuda remaining the preferred offshore choice. The reinsurance market bears watching: heavier healthcare use and medical cost inflation could prompt more transactions, perhaps spurred by the recent announcement of a Manulife-Long Term Care transaction. Reinsurance sidecar launches and new fundraising is up as asset managers, insurers and other interested parties seek more ways to tap into the value in the insurance sector.

We expect these trends to continue, influencing insurance investment strategy. As we prepare to head into 2025, we see the following key themes emerging:

- Maintain duration positioning close to target and be nimble on fixed vs. floating-rate exposure
- Emphasize quality and diversification as the credit environment softens
- Express relative value views through marginal changes to allocations and liquidity raises
- Favorable supply from bank pullback and demand technical from strong annuity sales would provide plenty of access to private-market potential…but diversify across existing and new opportunities
- Maintain focus on portfolio liquidity and cash management

Maintain Duration Positioning vs. Target; Be Thoughtful on Fixed vs. Floating Rate

Most central banks have started rate cuts with inflation very near targets—the Federal Reserve kicked things off with a 50 basis point (bp) cut in September. We reiterate our view that insurers should stay closer to home with overall duration positioning while being thoughtful with exposures along the yield curve and minimizing duration mismatches with liabilities where possible.

While the Fed may continue to cut, we see a risk of inflation reaccelerating as this happens, especially in light of policy changes and geopolitical conflicts that could push energy prices up. Also, we don't necessarily expect long-term rates to move in tandem with falling short-term rates, so the curve could eventually steepen—making reinvestment risk an important consideration. In our view, insurance investors need to be discerning about which sectors provide enough risk compensation—an assessment that could vary depending on whether investors are yield-focused or spread-focused.

Emphasize Quality and Diversification as the Credit Environment Softens

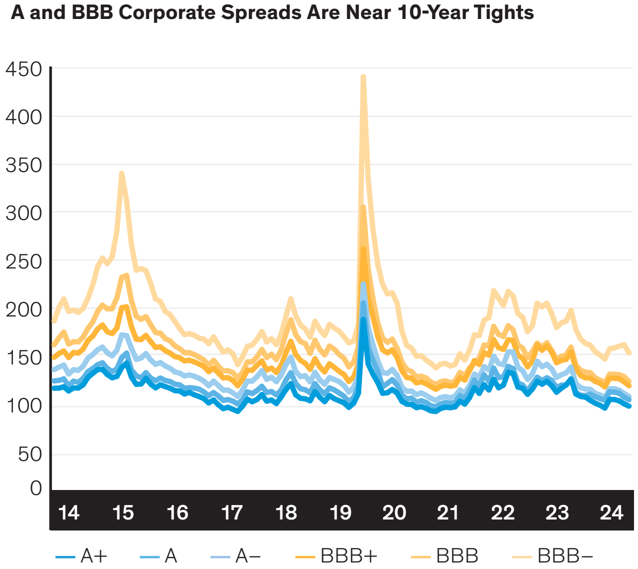
While we don't expect a global downturn, higher rates for a sustained period and a slowly rising unemployment rate could eventually weigh on credit fundamentals. Rating agencies could take precautionary action if default risk rises, and any downgrades would impact regulatory capital budgets.

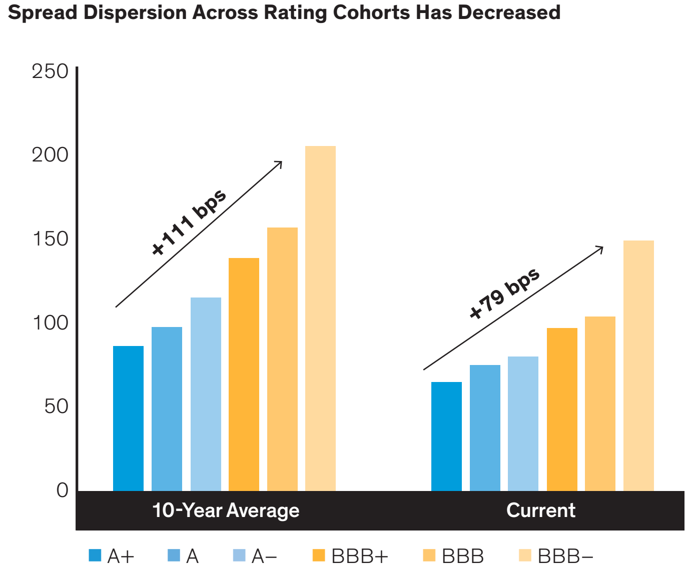
As we see it, this makes it more important to allocate with diversification and quality in mind. Avoiding negative ratings migration will require being selective when investing new flows, using fundamental tools to anticipate potential weak areas and focusing on watch-list screens.

Within investment-grade credit, we still favor staying positioned higher in quality, because spreads are tight across the board and the credit curve between A and BBB is flatter than average (*Display 1, page 3*). Investors should continue to screen for attractive new issues while staying aware of cyclical concerns in a slowing economic growth environment.

DISPLAY 1: BE DEFENSIVE IN A AND BBB CORPORATES GIVEN THE LACK OF QUALITY DISPERSION

Historical and Current Credit Spread by Rating (Basis Points [bps])





Current analysis does not guarantee future results.

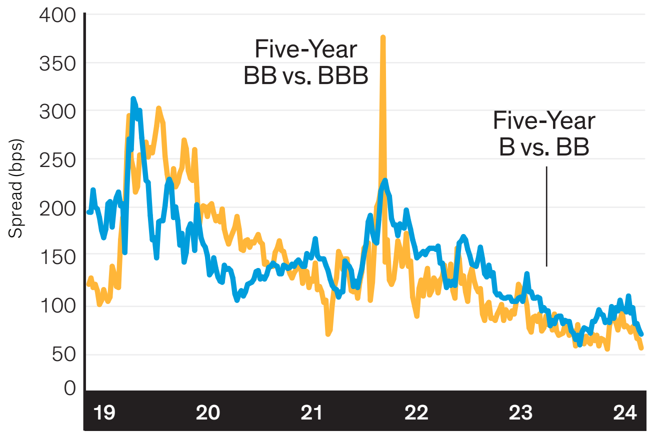
Spreads represent ratings cohorts of the Bloomberg US Corporate Investment Grade Index.

As of October 31, 2024 | **Source:** Bloomberg and AllianceBernstein (AB)

When it comes to insurance portfolios, we remain very cautious on high-yield allocations (*Display 2, page 4*). Spreads in some asset classes are near their tightest in the post-GFC era (Display 1), so the current environment seems to offer a good opportunity to clean up portfolios and reduce risk. We remain very selective within high-yield: credit spreads between B and BB and between BB and BBB issuers look historically tight and have continued to tighten recently.

DISPLAY 2: BE CAUTIOUS WITHIN HIGH-YIELD CORPORATE ALLOCATIONS

Compressed Credit Spread Relationships in Lower Ratings
Intra-Rating Spreads (bps)



Lack of Compensation for Added Capital Requirements
Capital Charge Across North American Regulatory Regimes (%)

Capital Regime	BBB–	BB+	BB	BB–
NAIC Risk-Based Capital: Life Insurance (Pretax)	2.17	3.15	4.53	6.02
NAIC Risk-Based Capital: Property & Casualty	2.50	5.50	6.00	6.60
BMA Bermuda Solvency Capital Requirement	3.00	8.00	8.00	8.00

Past performance and current analysis do not guarantee future results.
Bloomberg US Corporate Investment Grade Index and Bloomberg US High Yield 2% Issuer Capped Index; BMA: Bermuda Monetary Authority; NAIC: National Association of Insurance Commissioners
As of September 30, 2024 | **Source:** Bloomberg, NAIC, BMA and AB

In emerging market (EM) debt, we're monitoring risks of fewer early Fed rate cuts as well as to the dollar and oil prices, which could temper easing cycles in Asia, Mexico and South Africa. For the rest of Latin America and EMEA, domestic factors matter more. There's also the potential escalation of the Middle East conflict. On a risk/reward basis, we think higher-quality EM debt segments are more attractive.

Express Relative Value Views Through Marginal Changes to Allocations and Liquidity Raises

Outside of credit, early adopters that added to securitized assets exposure when spreads were wide have benefited from attractive returns. Spreads have declined, but we're still seeing pockets of relative value opportunity in certain areas.

In 2024, the asset-backed security (ABS) space has benefited from a stronger US economy and strong job market. We saw value in three areas: (1) using short-term AAA ABS to enhance cash yields over the fed funds rate; (2) on-the-run ABS with long histories that look attractive versus A and BBB corporates; and (3) investment-grade nonbenchmark ABS, including private ABS, which offer an attractive spread versus high-yield credit and better treatment under US risk-based capital (RBC) regulations.

The larger subsectors within public ABS are mainly tied to the overall health of US consumers. With rising unemployment rates and spreads compressing versus public corporate bonds, we think a more measured pace in investing in ABS is warranted.

Technical conditions continue to turn in the housing market: demand for new homes remains subdued, with affordability still a challenge despite existing home inventory rising. Economic stress and/or weakness in labor markets as conditions cool could pose a risk to fundamentals. Non-agency residential mortgage-backed securities (RMBS) seem attractive versus US investment-grade credit but neutral versus agency mortgage-backed securities (MBS). We expect agency MBS to perform well as growth slows and/or volatility subsides with decelerating inflation. We see incremental opportunity in production-current coupons.

In the collateralized loan obligation (CLO) market, strong supply has been met with strong demand, keeping spreads range bound. We still believe that AAA and AA CLOs are loss-remote and a good opportunity at current valuations. Manager selection is key, with an emphasis on stable loan platforms that have demonstrated longevity and growth potential. Highly rated middle market (aka private) CLOs could also offer additional spread pickup over broadly syndicated loan CLOs.

In commercial mortgage-backed securities (CMBS), we're seeing more workout solutions that are bringing more clarity to the ultimate performance of collateral. Declines in interest rates could support commercial real estate valuations, but secular changes in how people live and work persist. We think it makes sense to position defensively, focusing on senior tranches in new vintages. In our view, any further spread compression on subordinate tranches or further flattening of the credit curve would be opportunities to reduce tail risks in CMBS exposure.

Access Private Market Potential…but Diversify Across Existing and New Opportunities

Private allocations, in our view, are still an important allocation for many insurance investors. Several nascent segments gaining traction, and more clarity on the path of rates, could support capital formation and transaction activity across private markets. Continuing bank disintermediation—particularly in consumer lending—should spark new opportunities to diversify exposure within private credit. The focus should be on illiquidity premiums, given the higher yields today in public assets.

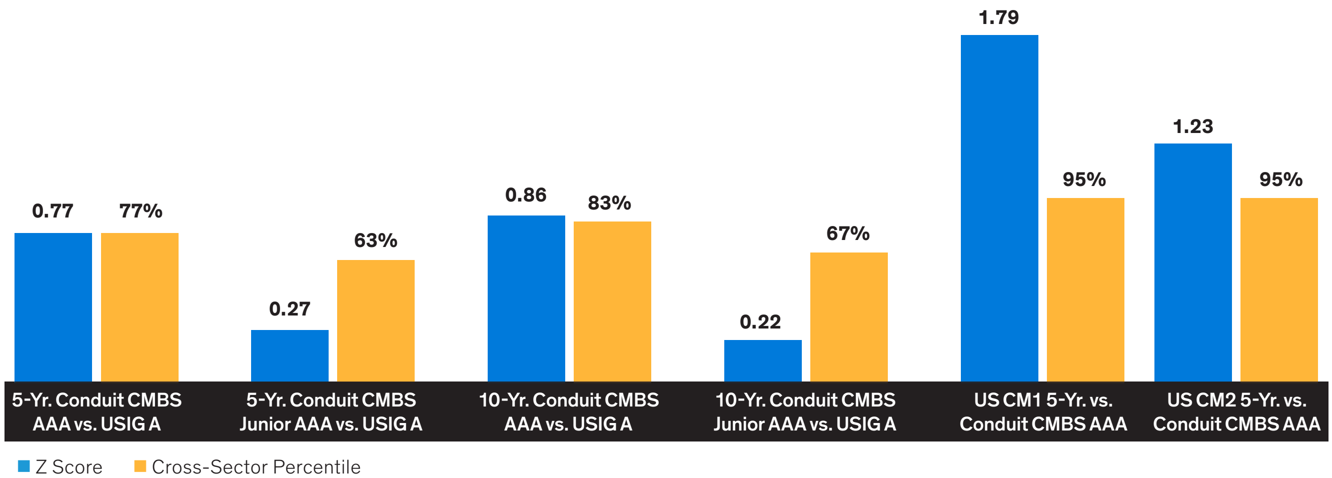
Across commercial real estate markets, we've seen improved liquidity and higher transaction activity.

Lower rates and tightening spreads should lead to lower capitalization rates, which could help cash-flow-generating assets' valuations versus the market trough. Interest-coverage ratios on floating-rate loans could benefit from falling rates, while fixed-rate borrowers would likely opt for shorter-term financing in hopes they can refinance into lower rates in the future.

Investors are still wary about commercial real estate risks, resulting in US CM1 loan spreads (the highest commercial mortgage loan quality designation from US insurance regulators) standing at historically wide levels versus AAA conduit CMBS. Meanwhile, lower volatility in interest rates and greater transparency in commercial real estate pricing has caused CMBS spreads to compress versus US investment-grade credit. While CMBS spreads remain wide (*Display 3, page 6*), they're not as wide as they were at this time last year.

DISPLAY 3: DIVERGENT COMMERCIAL REAL ESTATE FUNDAMENTALS IMPACT RELATIVE VALUE

Spreads by Sector Relationship



Past performance, historical analysis and current estimates do not guarantee future results.

Z score is a statistical measurement indicating the number of standard deviations the current relative spread level is from its average in our seven-year sample size. The cross-sector relationship percentile measures an asset's current spread advantage versus a particular sector. For example, a cross-sector percentile of 90 indicates the 90th percentile versus the five-year historical range. A higher percentile indicates stronger relative value against the comparison sector.
CMBS: commercial mortgage-backed security; USIG: US investment-grade.
As of November 17, 2024 | **Source:** Bloomberg and AB

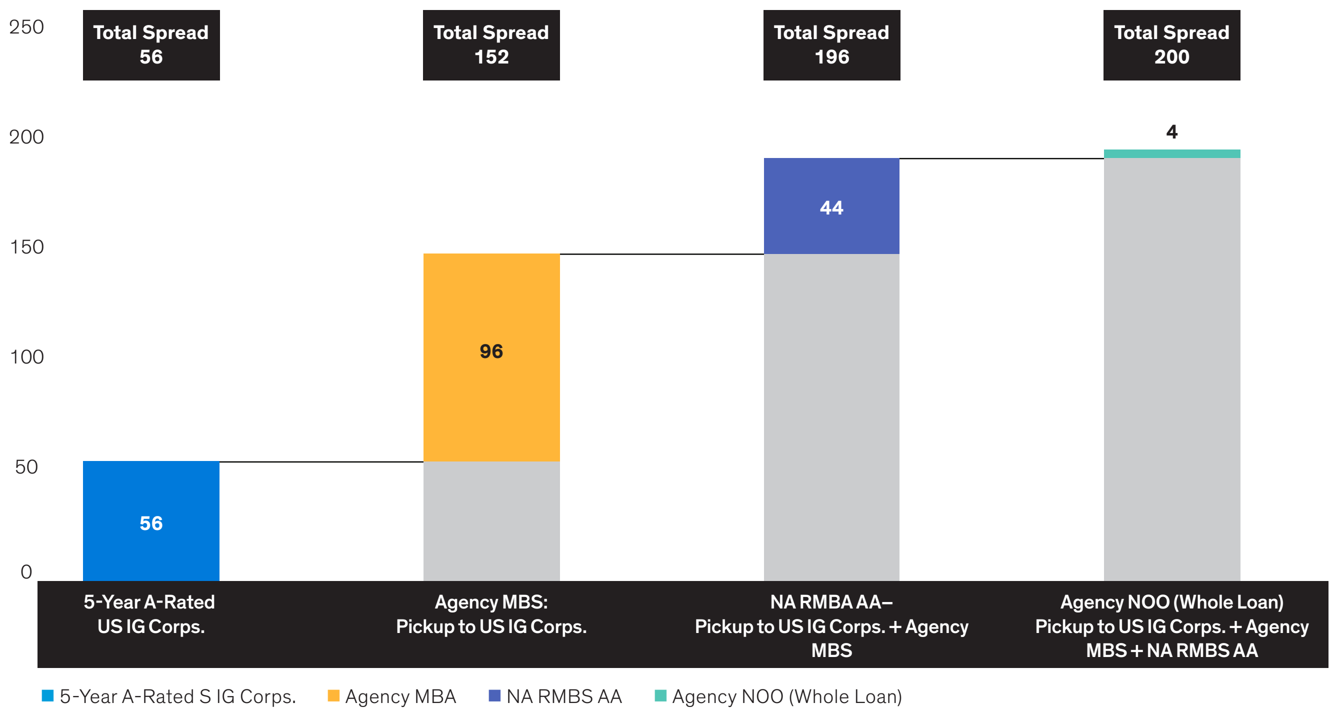
One segment we think is underrepresented in insurers' private-market allocations, especially given its higher-quality, often investment-grade, nature, is the private ABS market. This multitrillion-dollar addressable market consists of senior secured loans to originators and other nonbank lenders. It features diverse collateral types in transportation, hard assets and the consumer arena, with typical yields of 7%–8%.

As we mentioned earlier, we maintain a positive view across residential credit. Valuations within non-agency RMBS and agency MBS look attractive versus US investment-grade credit (*Display 4, page 7*). Residential mortgage whole loans, typically a smaller allocation for insurance investors, are another area of interest. They enable investors to efficiently deploy regulatory-capital budgets into prime-quality performing assets, with yields in a 6.0%–7.5% range in size. For insurers with Federal Home Loan Bank (FHLB) programs in place or potentially in place, we think residential whole loans can be a valuable source of eligible collateral for most lending programs.

Net asset value lending is another fast-growing asset class emerging as a suitable investment-grade option. These loans, secured against diversified and divisible portfolios of private equity holdings, offer meaningful illiquidity premiums with yields at SOFR +450–650 bps and loan-to-value ratios in the 5%–25% range—an opportunity we think is compelling for insurers who can provide liquidity.

DISPLAY 4: RESIDENTIAL CREDIT SECTORS OFFER SPREADS OVER US CORPORATES

Spreads by Sector Relationship (bps)



Past performance, historical analysis and current estimates do not guarantee future results.

IG: investment-grade; NOO: non-owner occupied

As of September 30, 2023 | **Source:** Bloomberg, J.P. Morgan, Morgan Stanley and AB

Maintain Focus on Portfolio Liquidity and Cash Management

Liquidity, always a critical dimension for insurance investors, should be at the top of insurers' checklists when determining the overall scale of private-market allocations. Given that we're entering a volatile environment in which fundamentals could soften, it's arguably even more important. To unlock the liquidity of private assets, we think insurers should seek out creative solutions with partners such as FHLB, Farmer Mac, FABN and other institutions.

Continued interest-rate volatility mandates a focus on potential liquidity needs in insurers' portfolios. High-quality, short-term ABS may serve as a nice complement to traditional money market products such as time deposits, commercial paper and short-term investment funds.

Investors should continue to analyze portfolio holdings to identify potential sale candidates for when liquidity needs arise. Having the right toolkit for making these decisions rapidly is critical. Candidates should be chosen based on their tradability and, where possible, to decrease overall risk or improve diversification. When assessing liquidity, we think it makes sense to consider the percentage of their overall portfolios that should be positioned in securities that enable a nimble response to emerging liquidity needs.

As we see it, these key themes should guide insurance investing efforts as the calendar turns to 2025. The start of the year will also be notable as the effective date for the National Association of Insurance Commissioners' (NAIC's) principles-based bond-classification guidance. It shifts responsibility to insurers in assessing whether a security qualifies to be reported as a bond. In 2025 and beyond, sound decisions will require a full and timely understanding of a security's investment and accounting implications. We think a comprehensive framework is invaluable in this effort. Other regulatory updates could affect insurers' asset-allocation and capital-management decisions. For example, we believe the NAIC will soon release more information on its collateralized loan obligation (CLO) project. Based on current available information, we believe that our base case still holds: higher-rated CLOs should benefit from lower RBC charges while lower-rated CLOs could see meaningful higher RBC charges.

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