Shifting Focus: 2024 Insurance Investment Outlook

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As US insurance investors turn their eyes toward 2024, they'll make their decisions against a macroeconomic backdrop in transition.

The Federal Reserve responded forcefully to surging inflation during 2023, but worries of a hard economic landing have mostly faded. Consumers' strong balance sheets have been a key factor, supported by a robust labor market and savings accumulated during the COVID-19 pandemic. Given that inflation has already fallen significantly, we expect benefits to consumers to decline.

The focus now turns from how high rates can go to how long they'll stay up—a more significant economic aspect. We believe they'll stay elevated for several quarters, with higher energy prices keeping inflation up and rising longer-term interest rates slowing growth. A potential stagflation shock against this backdrop would be unwelcome. And while we don't expect the upcoming US election cycle to disrupt the economy, we're keeping an eye on developments.

With this environment in mind, how should insurers think about navigating markets as the calendar turns to 2024? From our perspective, their efforts should be organized along these key themes:

- Maintain portfolio duration positioning and balance risks
- Emphasize quality and diversification as the credit environment softens
- Rely on relative value tools to navigate a complex environment
- Balance allocations to private market opportunities with liquidity considerations

Let's take a closer look at each of these themes, with an eye toward presenting actionable opportunities for insurance investors.

Maintain Duration Positioning; Balance Across Risk Types

Rates have climbed to their highest levels since before the global financial crisis, and central banks are sending guidance that they'll stay higher for longer. Inflation is decelerating, but it's less clear that it will fall back to central bank targets. So even if the economy continues to slow, we expect to see a sustained period of higher policy rates (*Display 1*). We're maintaining the view we've had throughout 2023: insurers should stay closer to home when it comes to overall duration positioning, gradually locking in higher yields by swapping out longer, floating-rate issues and minimizing duration mismatches with liabilities where possible.

We also think insurers should be looking closely at reinvestment risk in light of their approach. For example, insurers with a five-year investment horizon that are more spread-focused investors might benefit from leaning into short-term asset-backed securities (ABS) (*Display 2, page 3*) instead of five-year investment-grade corporates, because the spread they receive compensates them enough for taking on investments with a shorter maturity than their investment horizon.

However, for insurers who are more yield-focused, that same scenario at current yield levels results in a cushion of just under 100 basis points (bps). In our minds, that isn't enough risk compensation, given the potentially volatile environment for interest rates going forward.

Of the four main types of asset credit risks for insurers—corporate credit, commercial real estate, direct consumer credit and residential real estate—most insurers have larger allocations to the first two categories, with over 50% to corporate credit and over 20% to commercial real estate risk. Because we think economic growth may slow in 2024, it seems prudent to build a portfolio that's better diversified across asset types, sectors and issuers in order to avoid concentrations (*Display 3, page 4*).

Emphasize Quality and Diversification as the Credit Environment Softens

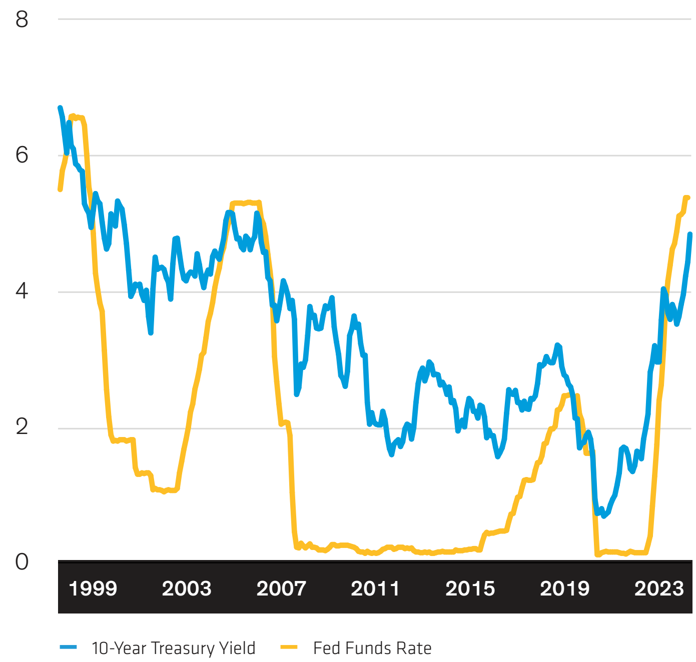
While we don't expect a global downturn, sustained higher rates could weigh on fundamentals. The next few years will see a steady wall of climbing maturities for most US dollar–denominated credit markets (*Display 4, page 5*), with US investment-grade credit alone accounting for over $2 trillion in scheduled maturities from 2024 to 2026, followed by $918 billion in emerging market (EM) corporates and almost $700 billion in US high-yield and leveraged loans.

We think this situation will generally be manageable. However, higher rates mean higher financing costs, and firms unable to pass those costs to end consumers may see their debt-service burdens grow as they refinance debt. For insurers, this situation makes credit migration a greater-than-normal consideration, because downgrades would impact regulatory capital. The ratio of upgrades to downgrades is still favorable in most public credit sectors (*Display 5, page 6*), but we expect rising corporate downgrades to outpace upgrades as slowing economic growth flows through to balance sheets.

In fact, we've already seen deterioration start in some corporate sectors. Notable EM downgrades in PEMEX and China's real estate sector drove more downgrades than upgrades in the third quarter, while Middle East tensions weigh on the outlook for future upgrades. In US investment grade, the third-quarter ratio was 2.3×, down from 6.5× in the second quarter.

DISPLAY 1: STAY CLOSE TO HOME WHILE RATES ARE ELEVATED

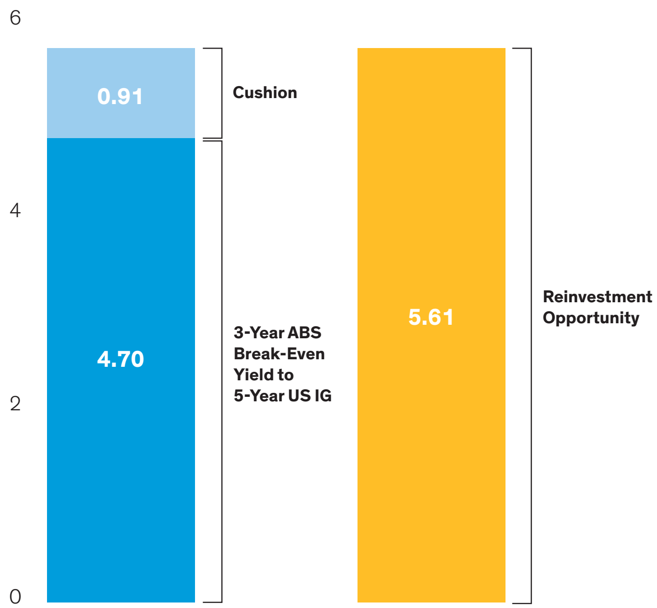
Percent



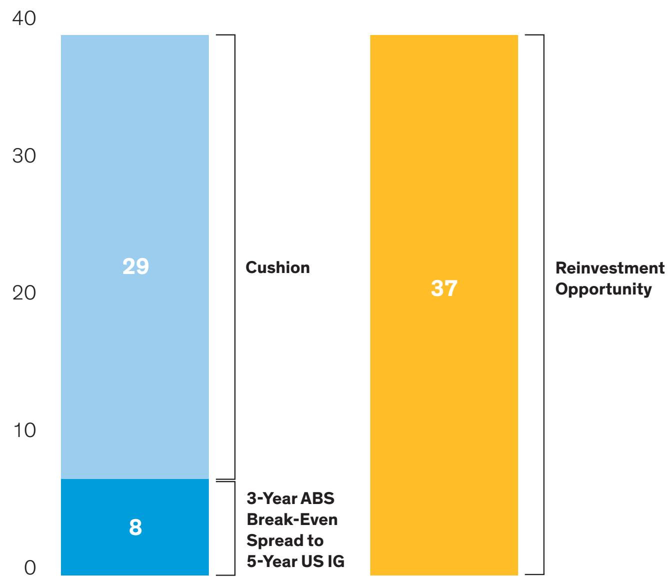
Current analysis and forecasts do not guarantee future results.
Through September 30, 2023
Source: Bloomberg, US Federal Reserve and AllianceBernstein (AB)

DISPLAY 2: FOR SPREAD-FOCUSED INSURERS, SHORT ABS OFFER RELATIVE VALUE

ABS* Break-Even Yields Provide Little Cushion for Reinvestment Risk
Percent



ABS Break-Even Spreads Provide Material Cushion for Reinvestment Risk
Basis Points



Current analysis does not guarantee future results.
Reinvestment opportunity reflected as current 1-3 Year IG BBB yield
ABS: asset-backed securities; IG: investment-grade
*****Single-A and above
As of October 13, 2023 | **Source:** Bloomberg and AB

However, sector and rating-tranche dynamics matter in this segment: certain sectors, such as automotive, consumer and banks, actually saw upgrades. And while we expect more downgrade pressure, the risk of fallen angels—bonds downgraded from investment-grade to high-yield—may not be as prevalent as previous cycles. That's because bonds rated BBB- make up 10.7% of the index, a seven-year low; the overall BBB portion of the index is at a five-year low.

That said, we still believe it's critical to allocate with diversification and quality in mind. Insurers should be selective when investing new flows, use fundamental analysis to anticipate potential weak areas, and prudently screen and monitor watch lists. Because of credit-migration risk in the medium term, we generally prefer taking convexity and consumer risk over corporate risk, although some segments of corporate debt markets could benefit insurers.

Find Relative Value to Maneuver in a Complex Landscape

Strong relative-value processes are key for insurers to navigate the current environment. We think it makes sense to use new money flows, liquidity raises and other rotation opportunities to diversify portfolios and pursue opportunities across the public fixed-income spectrum—to the extent strategic asset-allocation permits.

In the following sections, we zero in on specific segments of the bond market, reviewing the risks and opportunities for insurers.

Stay well-diversified in investment-grade credit. Within US investment-grade credit, elevated yields remain attractive for insurers looking to address income needs, with the inverted yield curve creating dispersion between short and long maturities. In macroeconomic scenarios that are either too strong or too soft, we see potential for further spread widening and dispersion. US investment-grade corporates have started to weaken, which could hurt the upgrade/downgrade ratio, though they entered this part of the cycle from a strong starting point.

Issuance has been strong throughout 2023, with almost $1 trillion issued through the third quarter. We think it makes sense to be selective, and that investors' macro narratives are shifting away from inflation pressure and the risk of a hard landing to one of lengthy periods of slow growth and high rates. It's a good idea to pursue BBB issuers with positive credit stories while rotating out of those with less-flexible business models into A-rated issuers with only a marginal reduction in yield spread. However, staying diversified across those allocations will be key.

Yield spreads on banks are wider than for nonfinancials, driven by lower-tier regional banks that in our view should be generally avoided. Higher-quality banks, in contrast, have seen spreads come back in line with financials, making us indifferent between the two. With the yield curve inverted, we generally see more value in the short and intermediate parts of the yield curve than the longer end, given the desire to maximize carry. However, insurers with long-term liabilities will always have some demand for longer-term bonds, so we think staying up in quality and concentrating on sectors like big tech makes sense.

DISPLAY 3: AVOID CONCENTRATIONS ACROSS DIFFERENT ASSET CREDIT RISKS

Four Primary Credit Risks in Insurance Portfolios

Corporate Credit

- US Investment-Grade and High-Yield Corporates
- Leveraged Loans
- Collateralized Loan Obligations
- Private Corporate Lending
- Emerging-Market Corporates

Direct Consumer Credit

- Public Asset-Backed Securities
- Specialty Finance/Private Asset-Backed Lending

Larger ← **Typical Size of Allocation** → **Smaller**

Commercial Real Estate

- Conduit Commercial Mortgage-Backed Securities
- SASB Commercial Mortgage-Backed Securities
- Commercial Mortgage Loans
- Commercial Real Estate Collateralized Loan Obligations

Residential Real Estate

- Non-Agency Residential Mortgage-Backed Securities
- Residential Mortgage Whole Loans
- Credit Risk–Transfer Securities

For illustrative purposes only.

Caution on high yield, given weakening fundamentals. High-yield bonds are generally experiencing a similar story to their investment-grade counterparts. The inverted yield curve is having a similar effect on high yield, and we're seeing short and intermediate parts of the curve widen in line with US investment grade while longer-duration components have compressed.

We're starting to see fundamentals deteriorate (*Display 6, page 7*), with net leverage ticking up as interest-coverage ratios and EBITDA margins shrink. Defaults are rising; we expect US default levels in the 4%–5% range, above their historical 3% average. However, high-yield fundamentals start from a strong position—interest coverage is still above 3× and lending standards are tightening. Most sectors seem to be in the downturn phase of the credit cycle; those still in expansion will likely shift to a downturn over the next year or so.

A lack of supply combined with the pushing out of a maturity wall has supported technical conditions. A total of $137 billion has been issued over the first nine months of 2023, above 2022 levels but significantly below the $219 billion 10-year average. With a number of rising stars upgraded to investment grade, the index's outstanding debt has shrunk by $48 billion. These positive technical trends should offset fundamental headwinds on the horizon to some extent.

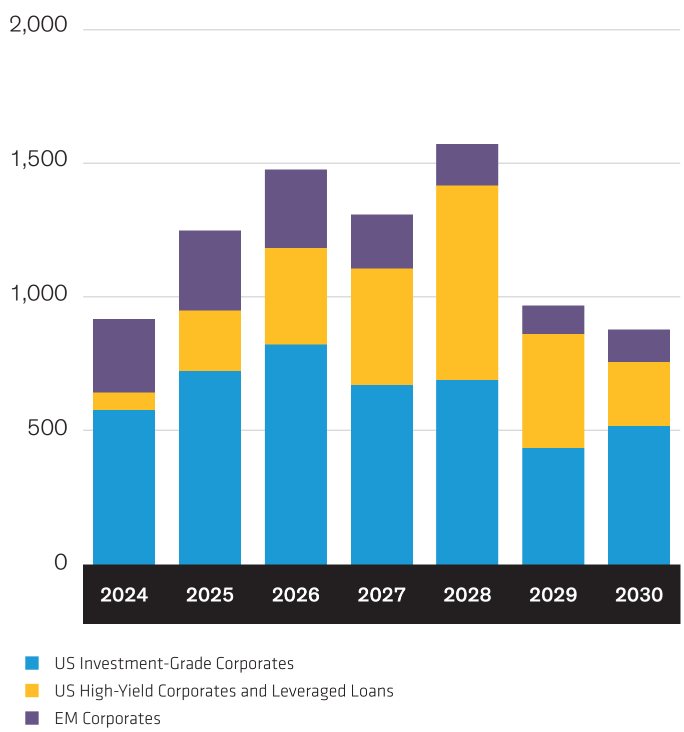
Looking forward, we remain very cautious on high-yield allocations for insurance portfolios. Our preference for quality and generally benign high-yield spreads, which haven't widened this year, point to more relative value elsewhere in public fixed income, despite historically high overall yields. That said, we'll continue to monitor BB/BBB valuations for select opportunities.

Avoid concentration risks in EM allocations. EM spreads have been resilient despite a recent uptick in geopolitical risk—mainly due to a strong positive technical picture. In contrast to the first half of the year, when spreads rose due to a supply influx, sovereign spreads have declined in the second half on stronger demand. Supply, strong to start the year, has waned and will likely stay low versus prior years, as a relatively stronger dollar is leading more issuers to prefer local debt financing. Net financing should be negative for the second consecutive year.

Most EM central banks have begun loosening monetary policy, and most EM corporate sectors are in the recovery and expansion phases, though commodity-linked sectors could move into a downturn. Default forecasts are in the 4% range, partly driven by Latin American issuers with links to distressed sovereigns, such as Brazil and Argentina. In terms of defaults and ratings migration, EM corporates have historically been similar to developed-market corporates (*Display 7, page 8*). However, in a softening credit environment, we'd expect downgrades to continue in most US-dollar debt markets. We'll be monitoring a slew of key 2024 elections across the EM landscape for potential market disruption.

DISPLAY 4: MATURITY WALL IS RISING THROUGH 2026, BUT VARIES BY ASSET CLASS

Scheduled Maturities Across USD Credit Sectors Through 2030 (USD Billions)



Maturities past 2030 are not shown.
As of September 30, 2023 | **Source:** Barclays, Bloomberg, J.P. Morgan and AB

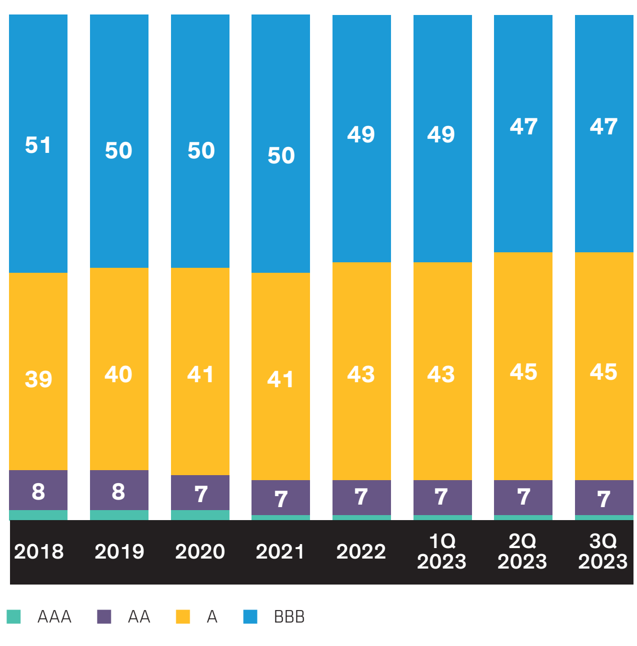
EM credit risk will be top of mind for insurance portfolios. China's reopening could be bumpier than expected, so we favor other regions such as Latin America, and we advocate against concentrated exposures within allocations. Looking forward, we'll watch for EM corporate spreads to rise relative to US investment grade, though we haven't seen this yet; it may be delayed, given their resiliency.

Pursue increased pockets of opportunity in securitized assets. Securitized markets have become more fragmented in the last few years, with new asset types capturing share in the commercial mortgage-backed securities (CMBS) market while nonqualified mortgages and other nonjumbo collateral gain share in the residential mortgage-backed securities (RMBS) market.

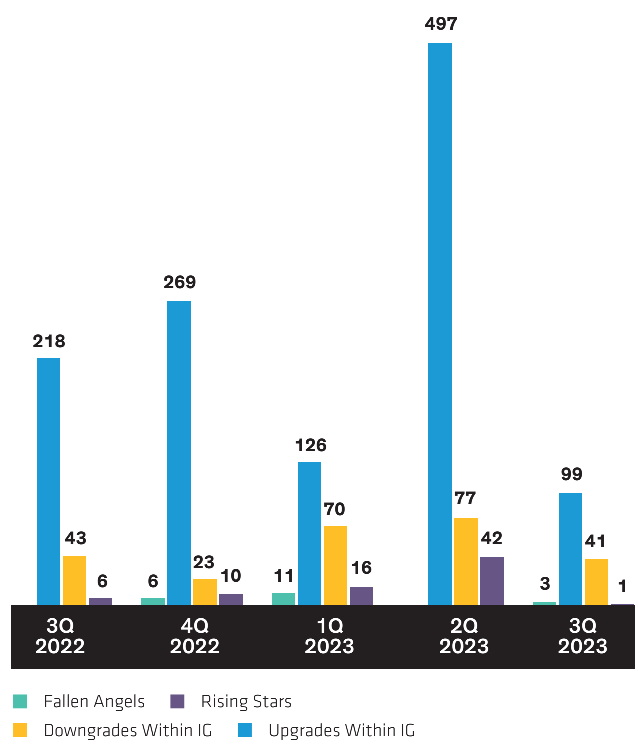
Consumer-related delinquencies have increased, indicating that higher default rates could be on the horizon. In contrast, the collateral performance of RMBS has held up, though implied property prices have fallen as a result of higher interest rates, indicating that losses could rise if loans originated at the peak of a housing market default. CMBS loan delinquencies remain low historically, but we expect that to change—especially for loans with floating-rate funding costs. Softening fundamentals should keep spreads on the wide side.

DISPLAY 5: FUNDAMENTALS COULD WEIGH ON UPGRADE/DOWNGRADE RATIOS

Market Value Share of US Investment-Grade Ratings
Percent



US Investment-Grade Ratings Migration
USD Billions



Past performance, historical analysis and current estimates do not guarantee future results.
IG: investment grade
As of September 30, 2023 | **Source:** Bloomberg, J.P. Morgan, Morgan Stanley and AB

Most estimates predict declining gross issuance across major securitized sectors. Lighter supply could limit the magnitude of spread widening in higher-rated securities, but the ability to source becomes an issue. As high mortgage rates remove options to refinance, homeowners are exploring new ways to tap home equity, such as second-lien and home equity lines of credit. We expect more activity in those sectors ahead.

ABS remains one of the most attractive opportunities, given attractive yield spreads and structural protection. Investor interest and issuance have been strong, especially in prime auto loans and digital infrastructure. ABS is the only securitized sector with higher year-over-year issuance, though this is in part from consumer credit turning over quickly and the shorter-term nature and lower extension risk of ABS financing vehicles. There's less dispersion, and we prefer solid structures with well-understood collateral, especially those with long track records, such as auto ABS.

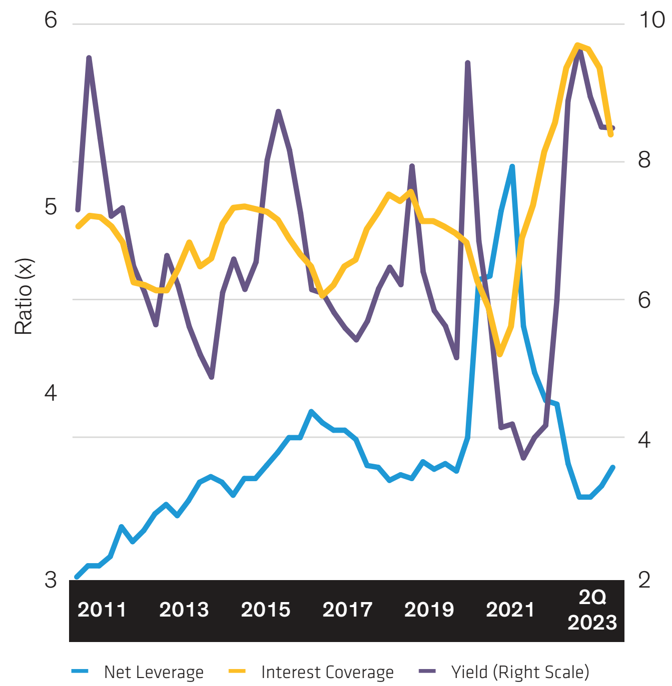
Lower-FICO borrowers are driving nonprime auto delinquencies; we favor larger, more frequent issuers in the nonprime space, focusing on higher FICO scores and tight underwriting standards. While there's value across the capital structure, we think it makes sense to focus on higher-quality and select subordinate tranches with more upgrade potential, given built-in structural deleveraging. Historically, A and BBB-rated auto ABS have exhibited between three and five times as many rating upgrades as similarly rated IG corporates (*Display 8, page 9*). Elsewhere, we think quality nonbenchmark opportunities offer diversification.

Dislocations in agency mortgage-backed securities (MBS) present an opportunity for insurers that can trade credit risk for convexity risk; we expect yield spreads to remain wider than historical norms as net demand wanes. We think the sector remains attractive, offering high risk-adjusted carry, attractive risk-adjusted returns in a time of market stress, and the ability to outperform corporates when spreads widen. As growth slows and volatility eventually subsides with decelerating inflation, we expect agency MBS to perform well.

Government National Mortgage Association issues seem more attractive than conventional mortgages, given better capital treatment and wider spreads from a lack of demand from banks and non-US investors. We think collateralized mortgage obligations offer more protection than pass-throughs for insurers seeking to reduce prepayment volatility, and we see value in production coupons trading near par, which should have minimal book-yield impacts in rate shocks.

DISPLAY 6: HIGH-YIELD FUNDAMENTALS SHOW SIGNS OF WEAKENING

High-Yield Fundamentals and Yield



Historical and current analyses do not guarantee future results.
Net leverage is debt/EBITDA. Interest coverage is EBITDA/interest. Yield represented by Bloomberg US High Yield Corporate Index. Historical data provided as weighted average from 2Q:11 to 2Q:23.
Through June 30, 2023 | **Source:** Bloomberg, J.P. Morgan and AB

The strong US housing market has surprised investors. Home prices are up, existing inventory is very low, new-home supply is down, and current homeowners—many locked into low-rate mortgages—are unwilling to sell (*Display 9, page 10*). In residential credit, we think AAA and AA-rated jumbo 2.0 issues are an attractive way for insurers to gain housing-credit exposure while staying up in quality. Credit risk–transfer (CRT) securities are another attractive option; their spreads and the potential upside of faster prepayment speeds could help offset a weaker credit profile.

In the commercial market, CMBS issuance has been very low at $31 billion, down almost 66% from the prior year. Despite its emergence in the sector, commercial real estate (CRE) collateralized loan obligation issuance was down 84% year over year, with conduit issuance down 30%. Coupons on maturing issues and new originations have diverged, which could spur more extensions and modifications. A lack of loan originations is concentrating new conduit deals, resulting in record low loans-per-deal figures.

Office utilization rates are near their highest since the COVID-19 pandemic, but are still under 50%. We're still cautious on CRE valuations and selective in conduit and SASB transactions, seeking high-quality, diversified exposure. Given potential headwinds in commercial real estate, we think insurers should keep a close eye on their aggregate exposure across commercial mortgage loans (CMLs), CMBS and real estate investment trusts.

DISPLAY 7: EM CORPORATE RATING MIGRATION IS IN LINE WITH DEVELOPED-MARKET (DM) CORPORATES

One-Year Rating Transition		
% of Cohort Downgrade from…	EM	DM
…AA to A	7.60%	7.70%
…A to BBB	4.50%	5.00%
…BBB to BB	4.40%	3.50%
…BB to B	4.70%	6.60%
Two-Year Rating Transition		
% of Cohort Downgrade from…	EM	DM
…AA to A	14.40%	13.90%
…A to BBB	8.20%	8.80%
…BBB to BB	7.50%	5.70%
…BB to B	7.00%	9.80%

Historical analysis does not guarantee future results.
EM rating study covering rating changes from 1997 to 2019
As of November 24, 2020 | **Source:** S&P and AB

In the direct lending space, the CRE market is still in the buyer-discovery phase, given that higher rates have pushed cap rates up. CRE transaction activity has slowed, and while CML maturities are manageable in the near term and lenders have been willing to extend maturities, extension risk has risen, which investors should consider. If the refinancing environment doesn't improve, larger loans on trophy assets could have more extension risk than smaller loans.

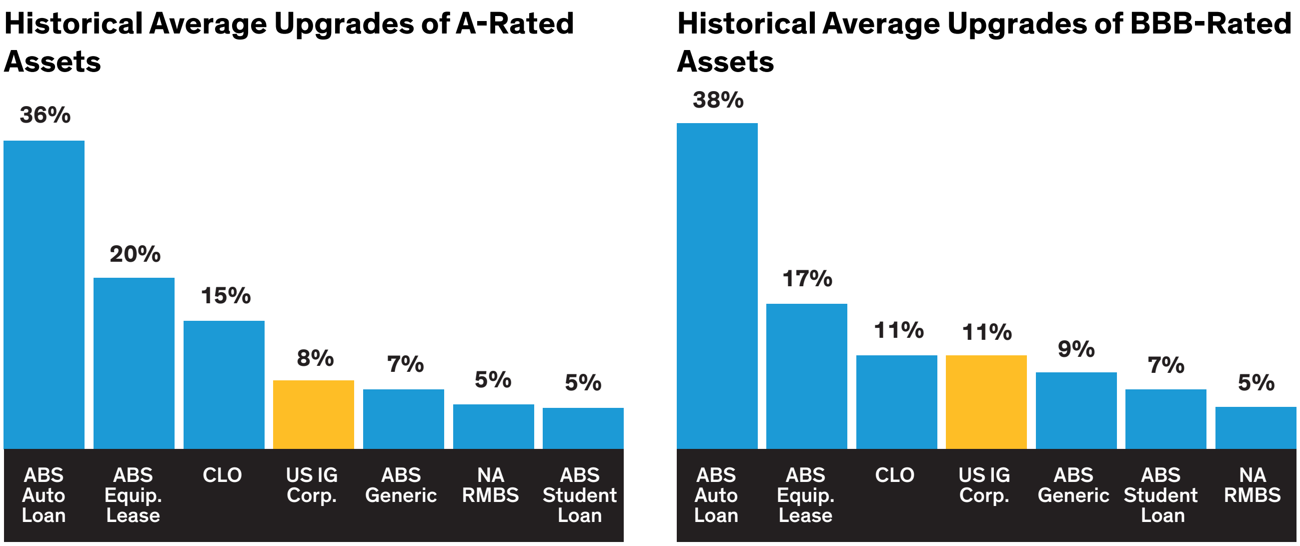
Across asset classes in insurers' portfolios, we think a watchful eye on portfolio liquidity is warranted, especially with more rate volatility possible. Leveraging short-term, high-quality ABS—most of them with attractive yields—could be a good complement to traditional money-market products such as time deposits, commercial paper and other liquidity funds. It's important to prepare for potential liquidity needs, which includes analyzing portfolio holdings to identify potential sale candidates, emphasizing tradeability and the potential to help reduce overall portfolio risk or improve diversification.

Balance Private Allocations with Liquidity Considerations

Liquidity is also an important input when determining private-market allocations. We do expect private allocations to continue, especially as several nascent segments gain traction, but insurers should reexamine these allocations regularly to ensure they're getting the most from them. This includes reassessing—and possibly demanding higher—illiquidity premiums, for several reasons:

- Public securities now offer much higher yields and somewhat higher spreads.
- Insurers' liquidity needs might have shifted in the wake of the pandemic and the 2022 interest-rate surge, making liquidity worth more than it had been.
- The credit environment has shifted from benign to stormy, so a preference to stay closer to home might reduce incremental allocations to private assets, which tend to have a shorter performance history throughout the credit cycle.

DISPLAY 8: CLOs AND SOME ABS SECTORS UPGRADED MORE OFTEN THAN US IG



Historical analysis does not guarantee future results.
Period of analysis: 1983–2021. Upgrades include all upgrades.
Source: Moody's and AB

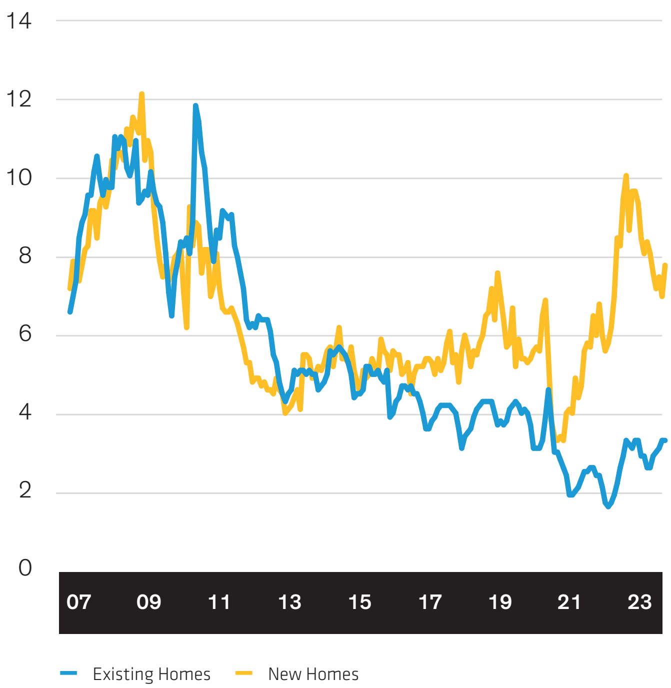
Private markets will continue to be an important allocation for insurers, but the current environment demands higher returns, better deal documents and stronger covenant packages. Strengthening our case for remaining selective, insurers have a broad array of private assets to choose from, as the banking pullback that started after the global financial crisis has intensified with the recent banking disruptions.

In addition to investing in familiar high-quality assets such as commercial mortgages and private placements, insurers are positioned as natural liquidity providers to an increasingly diverse market. Once considered to have higher capital costs and be more opportunistic, the private market has evolved into a lower cost-of-capital market with attractive investment-grade-quality opportunities.

Specialty finance, or private ABS, is one of those areas, with a $5 trillion addressable market consisting of senior secured loans to originators and other nonbank lenders. An array of collateral types in transportation, hard assets and the consumer space, such as installment loans, credit cards and auto loans, has created a diverse market with typical yields of 7%–8%. We think this segment is underrepresented in insurers' private allocations, especially given its higher-quality, often investment-grade, nature.

DISPLAY 9: LOW HOUSING INVENTORY AND LOCKED-IN BORROWERS SUPPORT RMBS

Inventory of Existing and New Homes
Months of Supply



Borrowers Not Locked In*
Percent

Historical analysis does not guarantee future results.
*Percentage of borrowers not locked in is represented by the Morgan Stanley Truly Refinanceable Index.
Left display through August 31, 2023; right display through September 28, 2023
Source: Morgan Stanley, National Association of Realtors and AB

Residential mortgage whole loans are another example. Despite a decade of growth in insurance portfolios, exposure to this segment still constitutes only a sliver of total mortgage exposures. These loans enable investors to efficiently deploy regulatory capital budgets into prime-quality performing assets with yields around a 6.5%–8.0% range. For insurers with Federal Home Loan Bank programs in place or potentially in place, residential whole loans can be a valuable source of eligible collateral for most lending programs.

Finally, net asset value lending is another intriguing and fast-growing asset class that's emerging as a suitable investment-grade option for insurers. These loans, secured against diversified portfolios of private-equity holdings, offer meaningful illiquidity premiums and loan-to-value ratios in the 5%–25% range, an opportunity we think is compelling for insurers that can provide liquidity.

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