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What's in Store for US Insurance Investors in 2023?

US insurance investors enter 2023 facing a less-than-stellar macro environment as well as looming regulatory change. There are opportunities, but it will take selectivity and flexibility to capitalize on them.

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Insurers' risk controls and investment skills faced stiff tests in 2022, as both inflation and interest rates skyrocketed and nearly every asset class endured a sharp selloff. With traditional diversification approaches failing, investors had nowhere to hide. Insurers had been hoping for higher interest rates for quite a while, since a low-rate environment squeezes margins and makes legacy blocks of business unprofitable. As they enter a new world of lower asset valuations and much higher rates due to seismic changes in the market landscape, what should insurance investors be thinking about in 2023?

Here are a few key themes to bear in mind for 2023:

- Economic growth is likely to slow, with inflation staying elevated but under control. Credit fundamentals will be challenged, but stabilizing interest rates should boost margins and earnings while somewhat reducing credit-migration risk.
- Reshuffled valuations have reshaped opportunities across public and private markets—but it's critical to manage duration exposure, be selective and flexible across credit and securitized assets, and balance private exposure against liquidity needs.
- The US National Association of Insurance Commissioners (NAIC) is examining areas like expanded modeling, reining in ratings from nationally recognized statistical ratings organizations, and driving toward a principles-based bond definition. These developments could alter the allocation calculus.

Slowing Growth in 2023...and a Monetary Policy Plateau

Insurers, like all investors, will face a softer economic environment in 2023, with growth continuing to slow (*Display 1*). Our base-case forecast is for a fairly mild recession across larger economies, with growth near zero in the US and slightly negative in the UK and euro area. But we don't see much evidence of economic or financial imbalances that could lead to a worse outcome, nor evidence of asset-price bubbles in systemically important economic sectors—though these can be hard to spot ahead of time.

Display 1: AB Key Forecasts

	Real GDP (%)		Inflation (%)		Rolicy Rate (%)		10-Yr. Bond Yield (%)		FX Rates vs. USD	
	2022F	2023F	2022F	2023F	2022F	2023F	2022F	2023F	2022F	2023F
US	1.60	0.50	5.50	3.50	4.38	4.38	4.00	3.75	—	—
China	2.80	5.10	2.00	2.30	2.00	2.00	2.95	3.10	7.00	6.80
Euro Area	2.90	−0.60	9.50	3.70	2.00	2.50	2.25	1.50	1.05	1.05
UK	3.20	−0.80	10.00	6.00	3.50	3.50	4.00	3.50	1.20	1.20
Japan	2.00	2.00	2.40	2.50	0.00	0.25	0.45	0.75	130	120
EM ex China/Russia	4.00	2.70	12.70	10.80	9.70	9.10	7.80	7.10	—	—
EM: Asia	4.60	3.80	5.30	4.10	4.20	4.70	5.60	5.30	—	—
EM: LATAM	2.60	1.30	17.80	16.90	21.10	18.80	10.70	9.30	—	—
EM: EEMEA	−1.10	−0.20	24.20	15.50	8.10	7.10	6.10	5.70	—	—

Current forecasts do not guarantee future results.
As of December 31, 2022 | **Source:** AB

Monetary policy is now restrictive in most of the world's economies, but we think the peak of this cycle is in sight, with rates likely to reach a plateau relatively soon. One reason for that policy plateau is inflation—it will likely stay high for the next few months, but there's good reason to think it has peaked and will begin coming down.

Japan, in contrast, will likely tighten policy to rein in inflation, but less so than in Western economies, so its downturn may not be as severe. China is off cycle, too, and we think its economic reopening will bolster growth. Many emerging market (EM) economies may be in better shape than the broader developed economies, given that they tightened monetary policy earlier and more aggressively.

A Reshaped Opportunity Set Calls for a Selective Approach and Disciplined Risk Taking

With global growth slowing, central banks fighting inflation with rate hikes and fundamentals weakening, we think it makes sense for insurers to emphasize higher quality, diversification across and within sectors, and setting aside portions of risk budgets to allocate opportunistically in dislocations. As downgrade and default risk rise, it's critical to be selective and disciplined with risk-taking.

Our assessment of the current patterns of relative opportunities highlights a few considerations for insurance investors.

Rate uncertainty suggests keeping duration closer to home.

Duration was a big driver of negative returns across the investment-grade universe last year as interest rates rose; lower-duration assets outperformed higher-duration assets. We don't expect rates to rise as much in 2023, but central banks are still battling inflation, which makes more near-term rate hikes likely.

We expect rates to plateau in the second half of the year. However, the uncertain timing and magnitude suggest that insurers should stay close to home in their duration positioning, minimizing mismatches at both the overall portfolio and key-rate-duration levels. This approach should be more straightforward for portfolios with a natural liability duration target than for those measured against a benchmark.

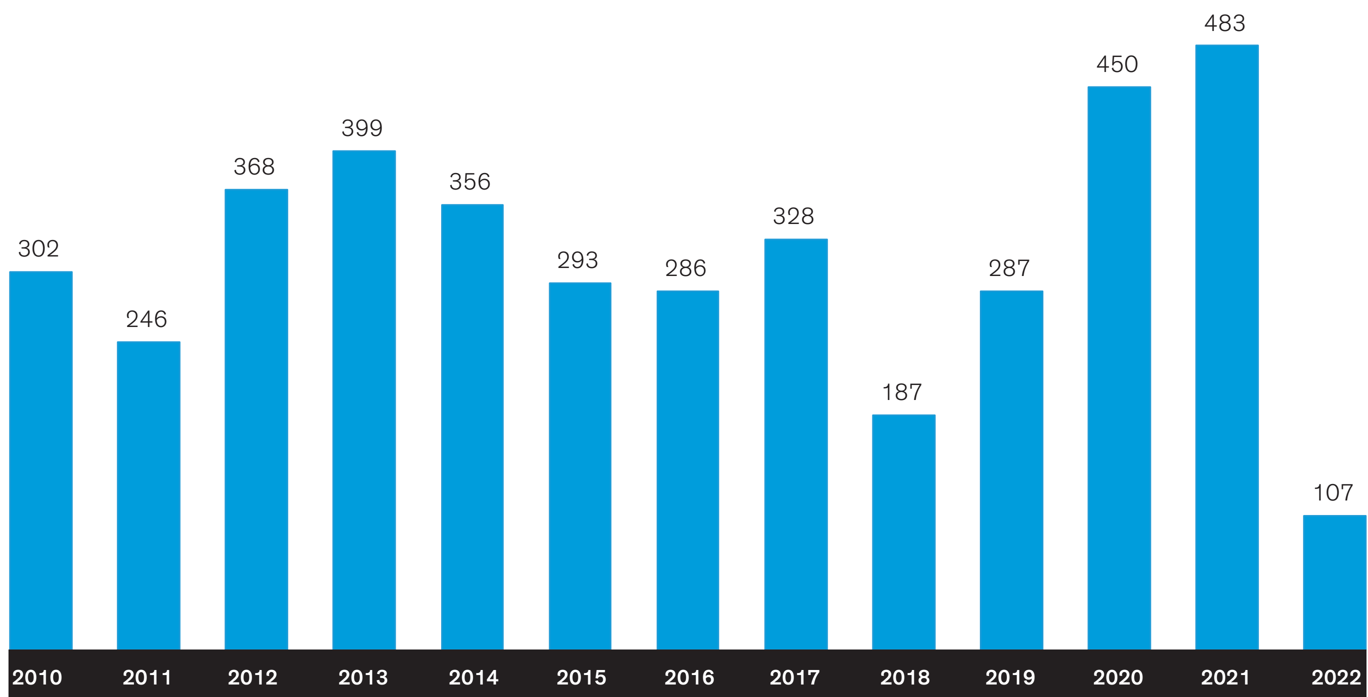
As attention turns to growth worries, stay diversified and selective in credit.

Corporate credit spreads declined in the fourth quarter of 2022 as signs of easing inflation pressures emerged. Investment-grade spreads fell back to their historical averages and high-yield spreads declined to well below average. Spread dispersion is down across quality cohorts, but still prevalent in the intermediate part of the yield curve and among BBB-rated bonds. We see potential for further spread dispersion and rising spreads across the capital structure, with high-yield spreads likely to experience a bigger increase.

We expect investors' focus to turn from inflation pressures to recession concerns, with key risks in corporate-credit portfolios shifting from duration positioning to credit exposure. Investment-grade fundamentals are entering a weak-growth period on strong footing, but high-yield defaults could double from roughly 1.75% in 2022 to 3%–5% this year. Investment-grade issuance should slow and high-yield issuance will likely be muted, as in 2022 (*Display 2*), or up moderately.

Display 2: High Yield Issuance in 2022 was the Lowest in Over a Decade

US High Yield Issuance by Calendar Year ($Billion)

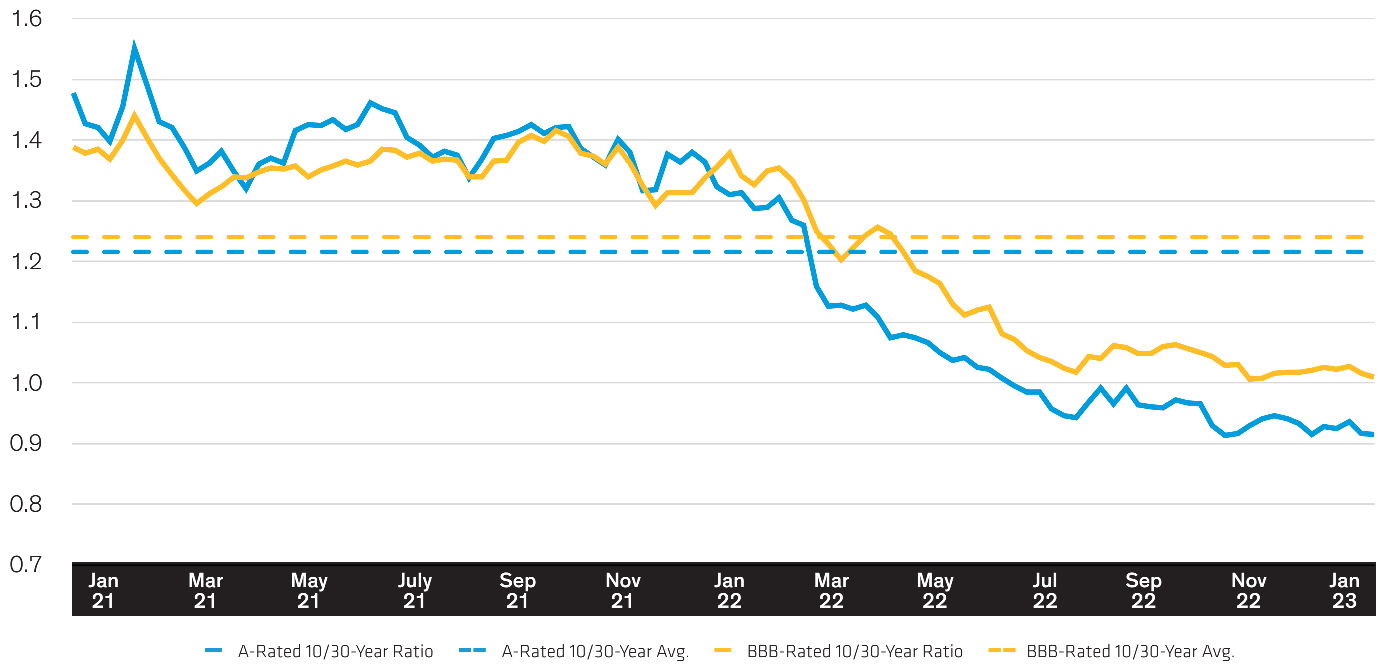


Historical and current analyses do not guarantee future results.
As of December 31, 2022 | **Source:** J.P. Morgan

Given the market backdrop, selectivity is key in insurance credit portfolios, with a bias to increase quality and further diversify allocations to combat negative ratings migration. Credit curves are relatively flat (*Display 3, on page 4*), so we prefer the intermediate part of the curve in order to maximize carry and roll.

Display 3: A and BBB Credit Curves Are Flat, Pointing to Higher Value at 10-Year Segment

Spread Ratios of US 10-Year and 30-Year Investment-Grade Corporate Bonds



Historical performance does not guarantee future results.
Current spread and yield levels are based on generic market levels. Average based on 5-year time horizon.
As of January 13, 2022 | **Source:** Bloomberg

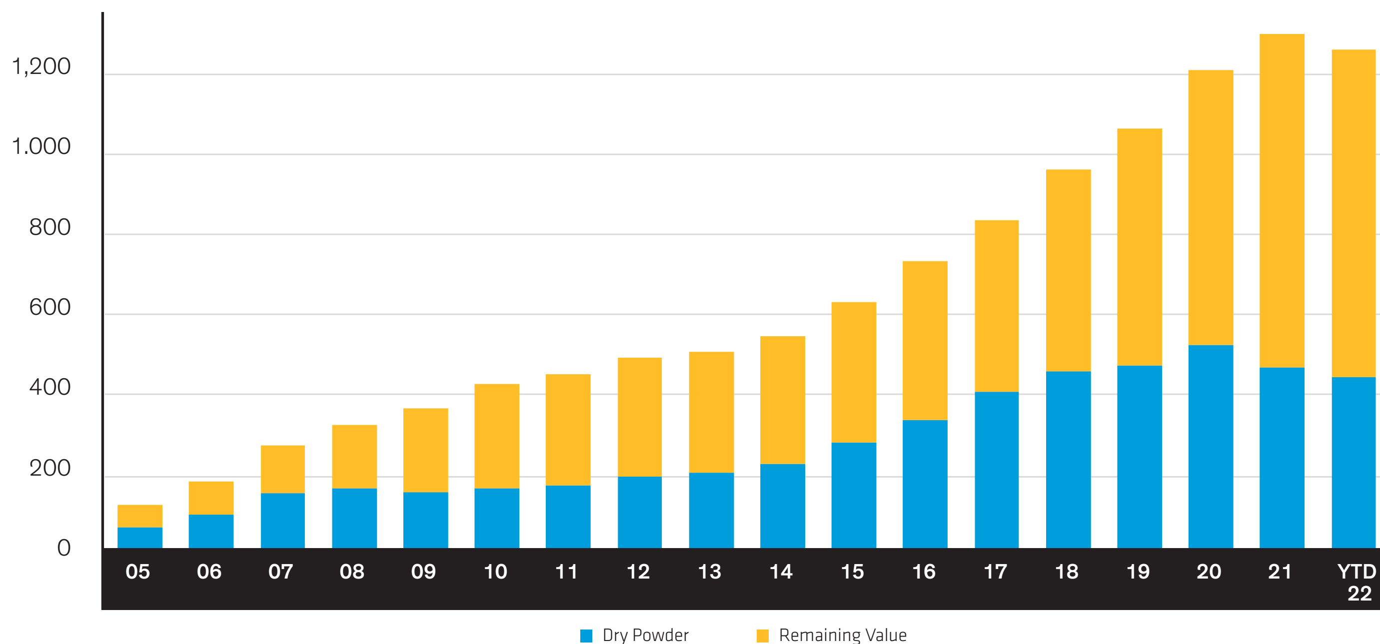
We also think it makes sense to rotate out of lower-spread BBB-rated issuers with less-flexible business models into A-rated issuers, a move that only requires a marginal sacrifice in spread. It's prudent to be selective in BBB issuers and higher-quality high-yield issuers that have sold off but can survive the turbulence ahead. And investors should keep the majority of their risk capacity ready to step into solid businesses when dislocations emerge.

Balance private-market allocations with liquidity needs.

Globally, private debt assets under management have grown meaningfully in recent years, topping $1.3 trillion (*Display 4, on page 5*). That growth was partially fueled by institutional investors' surging allocations—with insurers being no exception. Private placements will remain an important allocation for insurers, providing diversification and relative value. While it took some time for private-credit spreads to catch up to public-credit spread widening in 2022, they eventually did—a relationship we'll continue to monitor.

Display 4: Private Debt Assets Have Been Growing Significantly in Recent Years

Global Assets Under Management ($Billion)



Past performance does not guarantee future results

Includes direct lending, distressed debt, credit special situations, mezzanine financing, bridge financing, real estate debt, infrastructure debt, venture debt and general debt.

As of June 30, 2022 | **Source:** Pitchbook

Given the higher stakes of liquidity today, insurers should weigh private allocations against their specific liquidity needs—needs that may have changed in the wake of the pandemic and sharply rising rates. Current yields in public markets might also prompt insurers to reassess illiquidity premiums available in private markets. Requiring robust covenant packages remains critical for managing downside risk; we've yet to see a broad shift to covenant-lite deals. From a positioning standpoint, the focus should remain on quality, and we see good value among shorter maturities—strong demand for long-term bonds has made them relatively less attractive.

Keep the macro picture and downgrade risk top of mind in emerging markets.

The spread relationship between emerging-market (EM) debt and US investment-grade debt will be a big input into insurers' allocations in 2023. EM debt was resilient in a volatile second half of last year, reducing its relative attractiveness. An early supply influx has pushed EM spreads up in 2023, but we think spreads will stay relatively tight versus US investment-grade bonds going forward.

Investors should monitor potential downward ratings migration this year. Defaults in 2022 were driven by specific events, such as the war in Ukraine and turmoil within China's property sector. In 2023, different dynamics are likely to prevail. A growth slowdown could undermine commodity prices, adding pressure to EM with more potential downgrades and defaults—though dynamics in commodity supply might counterbalance these cyclical demand forces.

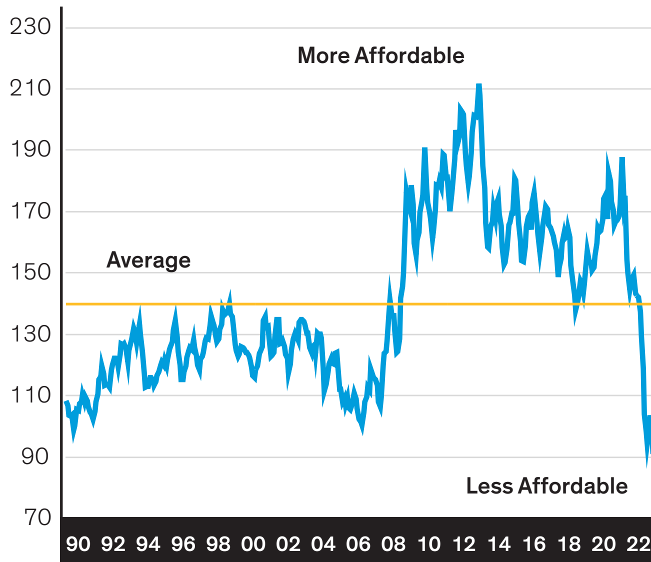
Investor demand and supply should be more balanced than last year, which saw only $220 billion in issuance. We expect 2023 issuance to top $300 billion, providing room for investors to add exposure. As with developed-market credit, being diversified and selective will be vital in the coming year. From a regional perspective, Latin American issuers seem relatively attractive, but positions should be monitored closely and diversified when possible.

Waning demand for securitized assets presents opportunity.

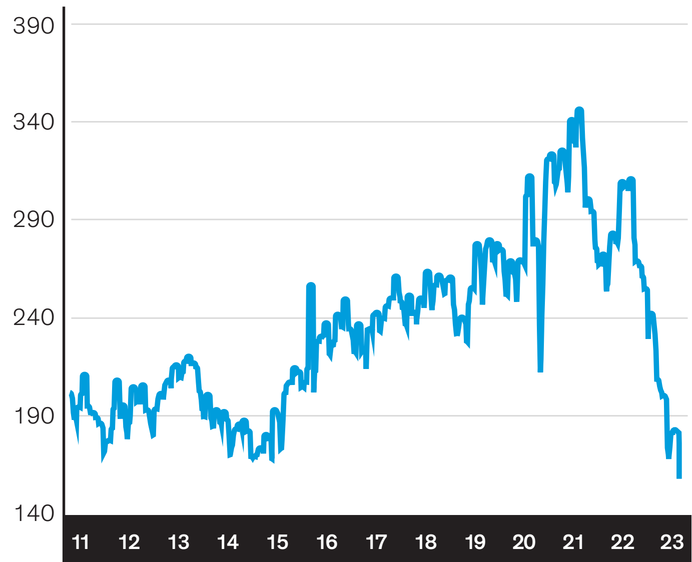
We expect securitized assets to face more headwinds in 2023 from negative headlines, weaker fundamentals and receding demand (*Display 5, on page 6*). The resulting wider yield spreads in certain asset classes would present opportunities. Securitized issuance should decline in the first half before picking back up, with agency and non-agency residential mortgage-backed securities (RMBS) falling back the most as the housing market slows. Supply in asset-backed securities (ABS) should fall from its recent heights back to pre-pandemic levels, and collateralized loan obligation (CLO) issuance will likely decline.

Display 5: Waning Demand Could Push Spreads Wider in Securitized Assets

Home Affordability Is Extremely Challenged...
Homebuyer Affordability Fixed Mortgage Index
(Year-over-Year, Seasonally Adjusted)



...Leading To A Decline in Home Purchases
MBS Purchase Index



Historical analysis does not guarantee future results
Left display as of October 31, 2022; Right display as of January 6, 2023
Source: National Association of Realtors, Freddie Mac, J.P. Morgan, MBA and AB

Wider ABS spreads, combined with structural protection and fundamentals in line with expectations, continue to make ABS the most attractive securitized segment, in our view. We favor transactions with robust structures and well-understood collateral, especially those with long track records, such as auto loans. In the non-prime space, we favor large, frequent issuers with higher FICOs and a track record of underwriting loans through multiple cycles.

CLO loan fundamentals are showing signs of weakness, and with Fed rate hikes possibly winding down, we wouldn't be surprised if investors reallocate into comparable fixed-rate instruments. For insurers, regulatory risk is top of mind; interest in BBB and lower-rated CLOs could wane as uncertainty mounts over the NAIC's risk-based capital (RBC) treatment. We're cautious on CLOs, especially those lower in the capital structure. A rated and higher securities offer attractive spreads in exchange for accepting uncertainty around all-in-yields, given that CLOs are floating rate.

Conduit CMBS delinquency rates and specially serviced rates have been steady. With a limited conduit maturity schedule in 2023 and early 2024, we expect default rates to be low versus the historical average. We remain generally cautious on commercial real estate (CRE) valuations, though investors can no longer ignore single-asset, single-borrower CMBS and CRE CLOs, given their large market share. We think AAA-rated CRE CLOs offer an attractive spread advantage versus comparably rated CMBS products, though valuations are closer to fair versus broadly syndicated loan CLOs.

Residential credit will likely face greater headwinds from falling home prices, especially if mortgage rates remain higher—we prefer AAA-rated nonqualified mortgages. Vintage matters for credit risk-transfer securities (CRTs), given that they're strongly linked to the National Home Price Appreciation (HPA) Index. Older vintages remain fundamentally strong because the HPA has bolstered loan-to-value profiles. Newer deals, such as those issued in 2022, don't have the benefit of home-price appreciation over time, yet only one investment-grade government-sponsored enterprise CRT failed to receive an NAIC designation of 2 or higher, even though stress cases included larger home-price declines.

Pending NAIC Proposals Could Alter Allocations and Demand

We're closely monitoring pending changes in insurance regulation and accounting treatment that could affect insurance asset allocations and incremental demand in some asset classes. Chief among the developments we're following are pending NAIC updates on CLO risk assessment, bond definitions and the use and regulatory treatment of feeder-fund vehicles.

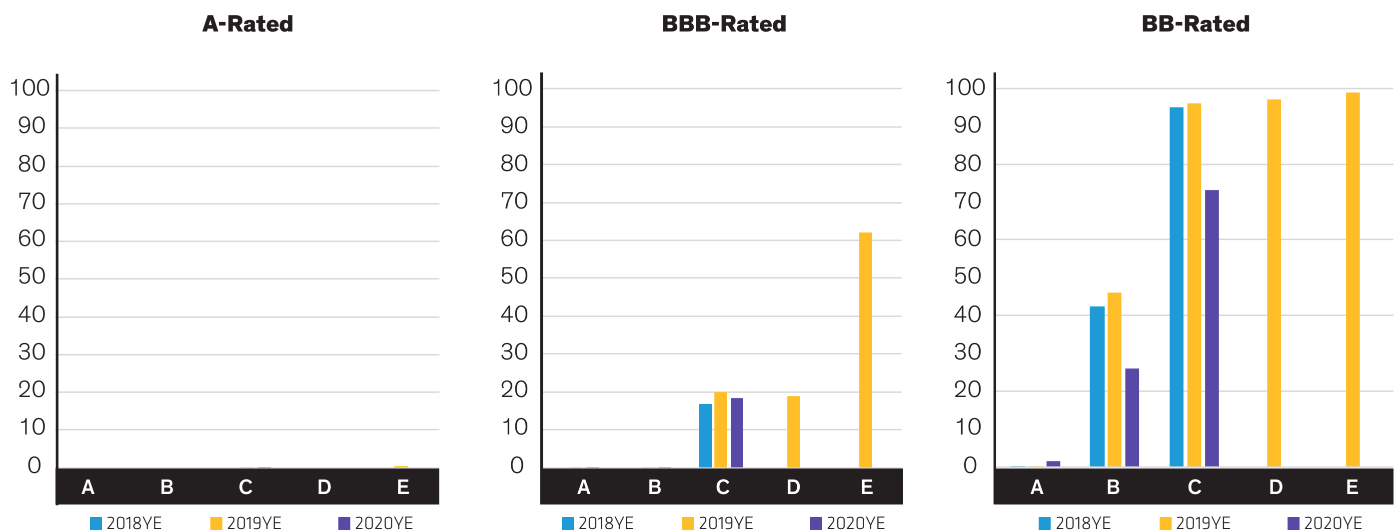
Change in CLO risk assessment could redefine capital requirements.

The NAIC's Structured Securities Group (SSG) and Securities Valuation Office (SVO) have recommended that the capital required for holding all tranches of a structured security should be consistent with the capital required when holding all of the underlying collateral. Some sell-side research has suggested that this recommendation could push up RBC charges uniformly across classes rated BBB or lower.

There's a potential ratings upgrade to AA-rated and single A-rated tranches, with BBB and BB-rated tranches subject to potential downgrade, and equity holdings facing steeply increased charges. The NAIC conducted a stress-testing exercise (*Display 6*) that reinforced this view: CLOs could suffer losses at the BBB and BB tranches in severe stress environments, while A tranches face only minimal impacts.

Display 6: Tranches Impacted Differently by NAIC CLO Stress Testing

Percent of Principal Write-down on CLO Tranches under Five Scenarios



Scenarios

A. Historical (Most Likely Base Case)
B. Lower Recovery
C. Default + 1 Standard Deviation & Lower Recovery
D. 2008 Recession
E. Severe Recession

Current analysis does not guarantee future results.
As of October 31, 2022 | **Source:** NAIC and AB

Revised bond definitions could trigger equity treatment on some securities.

The NAIC intends to establish principles-based guidance for determining whether or not a security should be categorized as a bond. The intent is to address the increasing financial innovation by providing regulators and other financial statement users with more transparency regarding the risks in an insurer's investment portfolio.

CMBS, RMBS and CLOs were spelled out as ABS that are "financial-asset-backed," so the NAIC's bond definition seems based on whether a security has a "substantive credit enhancement." Those without one would be treated as equity. Overcollateralization and subordination are taken into account but appear to fall short of the "substantive" hurdle. We think a one-size-fits-all definition of credit enhancement could create unintended consequences. For example, prime auto ABS have meaningfully less subordination than subprime auto, giving them a distinct risk profile.

The definition of "non-financial asset-backed instruments" seems to target mainly the private ABS universe and some esoteric ABS as well as, in our view, credit tenant loans. To be classified as bonds rather than equities, securities must satisfy a "meaningful cash flow" test. If less than 50% of the contractual principal and interest rely on refinancing or selling the underlying collateral assets, a security satisfies the test. If more than 50% of the cash flows rely on refinancing or selling underlying collateral, a security could still satisfy the meaningful test, but a full analysis is required to provide proof. We think this test could lead to questions on the accounting treatment of instruments such as CMBS and corporate bonds, which rely on refinancing at maturity.

New proposal could end feeder funds' advantageous capital treatment.

In 2022, the NAIC's SVO recommended the creation of a new asset category—Structured Equity and Fund—for feeder funds and the notes or equity interests they issue, excluding these investments from filing-exemption eligibility and making the SVO solely responsible for analyzing and rating all such investment structures. The regulator's rationale is that feeder funds may enable some insurers to:

- Circumvent regulatory guidance
- Obtain NAIC designations derived from credit rating providers' (CRP) ratings through the filing-exempt process—which wouldn't otherwise be permitted
- Engage in RBC arbitrage and/or get around state investment limits
- Obscure the true nature of the underlying investments and their risks

Unless the NAIC carves out a grandfathering provision to this proposal, existing feeder funds could lose their advantageous capital treatment. This could boost operational and monetary expenses for insurers and fund sponsors compelled to have the NAIC re-examine and re-rate existing feeder fund structures.

Certain notes issued by a feeder fund may no longer be able to rely on CRP ratings to determine NAIC RBC charges, and they could face higher capital charges, which might undermine demand.

It may take time for the new guidance to become official, and regulatory uncertainty could hamper the creation of feeder-fund structures. In our view, insurers that invest in or are considering feeder fund-rated notes should examine whether those investments would be covered under the proposal. If they would be, it's important to assess whether the incremental returns they provide compensate for both regulatory uncertainty and what could be a much-higher capital burden.

INVESTMENT RISKS TO CONSIDER

The value of an investment can go down as well as up and investors may not get back the full amount they invested. Capital is at risk. Past performance does not guarantee future results.

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