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Market Briefing

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Date: February 21, 2025

Subject: Market Recap for Year-End 2024 and Potential Impact on U.S. Insurance Company Investments

Introduction

2024 was in many respects a continuation of the market volatility that we have seen since 2020. With reasonable moderation in inflation data, the Federal Reserve Board (the "Fed") at the end of the year began to lower its target for the Fed Funds rate. The market had been anticipating that and shorter-term interest rates began declining earlier. On the other hand, as the prospect for a recession declined, longer term interest rates increased. This improved outlook also led market spreads to decline, approaching, or even going lower, than where they were at the beginning of 2022 and 2023. The last few weeks of 2024 saw a noticeable increase in volatility as the Presidential Election results led to uncertainty about future policies. Some of the policies suggest larger deficits and an increase in inflationary pressures. This Market Briefing reviews some of the key market metrics and discusses the likely impacts on U.S. insurance company investments and investment strategies. Additionally, this briefing may help U.S. insurance regulators prepare for and review market impacts to U.S. insurance company financial statements for 2024 as they become available in the next few months. *[The data for U.S. insurance company investments was all based on Financial Statement Data submitted to the NAIC and acquired via S&P Capital IQ, which is a unit of S&P Global. Market data was acquired via the Federal Reserve Bank of St. Louis.]*

U.S. Insurer Invested Assets

	Total Insurance Industry		Life Insurers		P&C Insurers		Health Insurers	
	2022Y	2023Y	2022Y	2023Y	2022Y	2023Y	2022Y	2023Y
	(as a percent of Unaffiliated Long Term Invested Assets)							
Total Bonds	75.57	74.85	78.85	78.11	66.66	66.26	83.21	83.16
Corporate (plus Loans)	44.01	43.02	51.50	50.30	26.55	26.82	33.20	32.39
Governments	13.46	12.89	8.98	8.66	23.70	21.98	21.83	22.28
Structured	17.59	18.43	17.90	18.66	15.88	16.97	26.85	27.61
Mortgages and Real Estate	11.49	11.81	15.85	16.47	1.86	1.91	0.29	0.34
Equities (Preferred and Common)	8.85	9.17	1.29	1.29	27.19	27.54	12.50	12.52
Investments Reported on Schedule BA	4.09	4.17	4.01	4.13	4.29	4.28	4.00	3.98
	(as a percent of Surplus)							
Equities			9.86	9.53	40.62	40.59	9.38	9.24
Schedule BA			30.67	30.56	6.40	6.31	3.00	2.93

Before diving into the specific market details, a quick review of U.S. insurance company investments is useful. Insurance industry investment portfolios consist primarily of fixed income investments, with about 75% of unaffiliated long-term assets in bonds and just under 12% in mortgage loans. The fair market value of investments with fixed coupons was significantly impacted by higher interest rates in 2022, resulting in fair values below carrying value. There was not much directional consistency in 2023, but longer-term interest rates increased in 2024, though not as much as in 2022. Investments with longer maturities, and likely longer duration, were impacted more. Investments in equities are also significant, though the exposure as a percent of assets is not that material for Life companies. The percentage of reported equity exposure increased slightly in 2023 which is not surprising given the 24.2% increase in the S&P 500 index in that year. Less transparent in terms of their equity market risk, are those investments reported on Schedule BA. These tend to lean heavily to equity-type risk, but also include some fixed income-like instruments. Investments in private equity funds which represent a sizeable percentage of those reported on Schedule BA face some of same trends in valuations as publicly traded equities, though changes in valuations may be recognized on a different timeline. However, data tracked by S&P Global indicated that

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distributions from private equity funds, which peaked in 2021, continued to be significantly lower in both 2023 and 2024.

	Total Insurance Industry		Life Insurers		P&C Insurers		Health Insurers	
	2022Y	2023Y	2022Y	2023Y	2022Y	2023Y	2022Y	2023Y
Bond Portfolio Maturity Score	12.72	12.32	14.43	14.03	8.43	8.30	8.23	8.00
1 or less	8.93%	11.00%	6.48%	7.99%	14.83%	17.90%	17.34%	19.92%
1 to 5	30.57%	31.43%	25.99%	27.52%	42.16%	40.53%	42.07%	42.25%
5 to 10	27.01%	24.79%	26.33%	23.97%	28.89%	27.03%	27.44%	24.45%
10 to 20	16.42%	16.73%	19.24%	19.78%	9.53%	9.71%	7.35%	7.68%
greater than 20	17.07%	16.06%	21.95%	20.74%	4.60%	4.83%	5.80%	5.69%
Greater than 10 year	33.49%	32.79%	41.20%	40.52%	14.13%	14.54%	13.15%	13.37%

A key consideration for bond portfolios is the duration, and therefore interest rate risk, of the holdings. Duration is not reported on the investment schedules, but expected maturity dates are. While different variables impact the actual duration of individual holdings, maturity can be a reasonable indicator of exposure to longer duration assets. The average maturity score for Life insurers had been increasing in recent years and was almost 14.5 years as of year-end 2022. This declined slightly in 2023 to 14.0 years. Property & Casualty ("P&C") insurers and Health insurers maintain considerably shorter portfolios, and they also shortened some in 2023.

	Total Insurance Industry		Life Insurers		P&C Insurers		Health Insurers	
	2022Y	2023Y	2022Y	2023Y	2022Y	2023Y	2022Y	2023Y
Bond Portfolio Credit Sore	1.44	1.42	1.51	1.48	1.30	1.28	1.32	1.29
NAIC 1	63.14%	64.91%	57.40%	59.09%	77.59%	78.65%	76.16%	77.98%
NAIC 2	31.78%	30.37%	37.20%	35.88%	17.97%	17.19%	18.76%	17.63%
NAIC 3	3.13%	2.81%	3.48%	3.14%	2.21%	1.97%	2.68%	2.32%
NAIC 4	1.51%	1.45%	1.40%	1.36%	1.74%	1.63%	2.12%	1.82%
NAIC 5	0.44%	0.46%	0.47%	0.47%	0.39%	0.48%	0.19%	0.18%
NAIC 6	0.00%	0.00%	0.06%	0.06%	0.09%	0.08%	0.11%	0.07%
Below Investment Grade	5.08%	4.71%	5.40%	5.02%	4.43%	4.16%	5.09%	4.39%

Based on the distribution of bond holdings across the broad categories of NAIC Designations, credit quality in the bond portfolios has remained relatively stable. Holdings of below investment grade bonds declined in 2022 and again in 2023. This was also the case for holdings of bonds in the triple-B category. Of potential interest, and perhaps deserving of special focus, would be those with a BBB-minus rating since those would be most at risk of downgrade in an economic downturn to below investment grade. For P&C and Health insurers, below investment grade bonds are held at the lower of cost or market. Life insurers can carry them at amortized cost as long as the bonds are not in default. In addition to changes in interest rates, another significant factor impacting the fair market value of bonds is the spread over risk free rates. The market based credit spread that can be expected varies depending on expectations of default. Declines in general market spreads noted above may have offset some of the increase in Treasury yields in 2024.

(000s)	Total Insurance Industry		Life Insurers		P&C Insurers		Health Insurers	
Derivatives	2022Y	2023Y	2022Y	2023Y	2022Y	2023Y	2022Y	2023Y
Carrying Value	17,604,782	23,902,918	17,662,887	23,586,572	(61,385)	300,457	3,280	15,889
Fair Value	7,307,005	18,957,643	7,350,632	18,825,170	(35,561)	125,775	(8,065)	6,698

Life insurance companies are significant participants in the derivatives markets. Activity tends to be concentrated in two areas. One is in interest rate hedging strategies. The second is in equity hedges against crediting rates for different annuity products. Historically only a small percent of the industry's hedge strategies are reported as Hedge Effective for Statutory Accounting purposes, and are carried at fair value if not deemed Hedge Effective under Statutory guidelines. Notwithstanding, since these are hedging strategies, there should have been an offsetting change in the hedged instrument. Both carrying value and fair value of derivatives declined in 2022 but recovered in 2023. The significant increase in interest rates in 2022 impacted both of those hedging strategies. Increased volatility may impact the effectiveness of hedging strategies. Many insurance companies reported realized and unrealized capital losses on their derivatives programs in 2022 and 2023.

Inflation

A continuing headline in 2024 was inflation, as indicated by year over year percentage changes in the Consumer Price Index ("CPI"). The CPI began increasing at the end of 2021, reaching levels in 2022 that had not been seen since the 1980s. Let's focus on two metrics – the Overall CPI and the Core CPI. The Core CPI excludes food and energy as those two contributors to CPI can be very volatile from month to month. The jump in both of the CPI metrics were driven initially by supply chain issues that were a holdover from the COVID-19 Pandemic in 2020.

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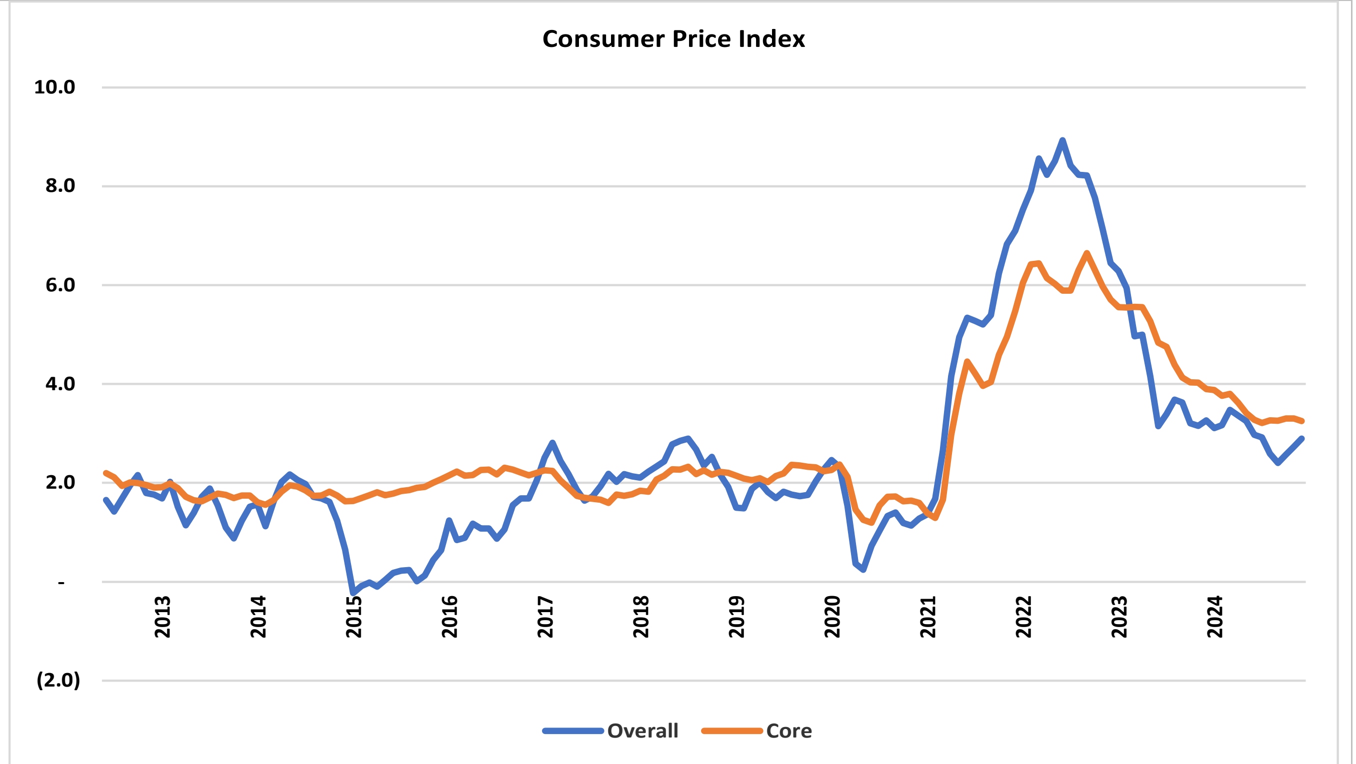
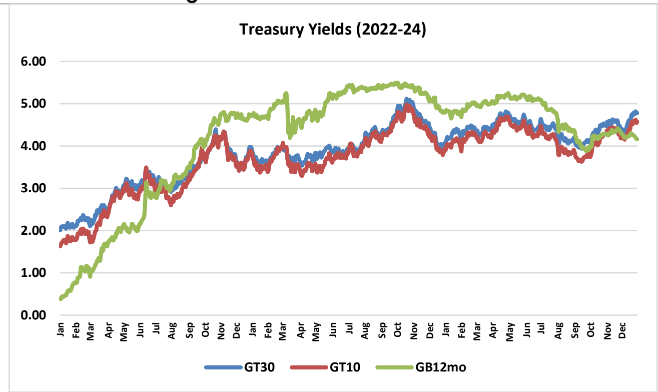
However, other factors contributed such as a spike in oil prices in 2021. Housing costs were also a significant component as population migrations overtook available supply. Overall CPI peaked in June of 2022 at 9.1%. Core CPI peaked a few months later, in September, at 6.6%. The Fed began taking aggressive action in early 2022, raising the target range for Fed Funds repeatedly. The pressure on borrowing rates led to moderation in both of the metrics. At its meeting in January 2024, the Fed decided to hold its target for the Fed Funds rate as it noted concerns about inflation re-igniting. Overall CPI came down to 2.9% and Core CPI to 3.2% by December 2024. This continues to exceed the Fed's stated target of 2.0% inflation. (*https://www.federalreserve.gov/economy-at-a-glance-inflation-pce*)



Interest Rates

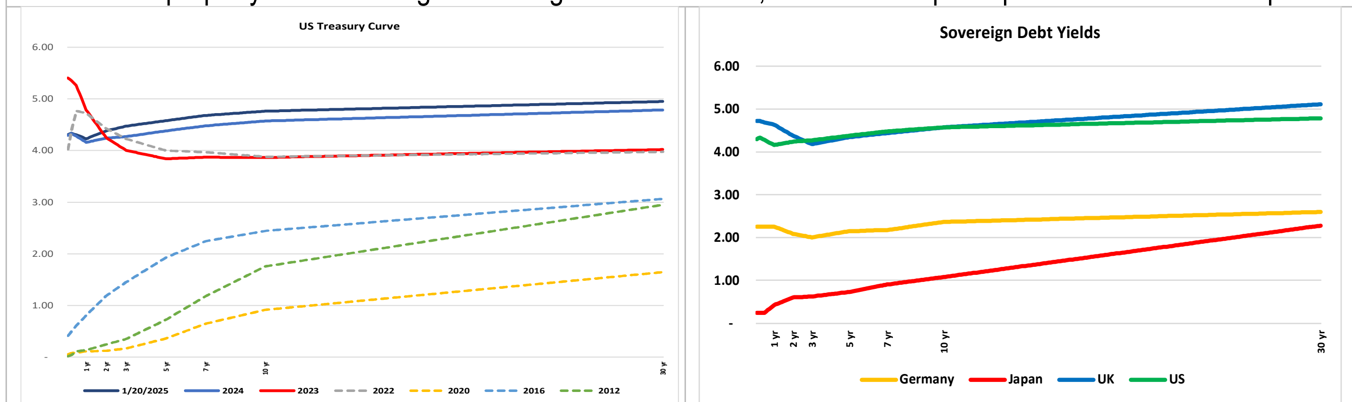
With moderation of inflation measures in 2023, market expectations in 2024 that the Fed would begin lowering interest rates began to build. While short-term interest rates declined, long-term interest rates began increasing. The Fed began lowering the Fed Funds in September 2024. By the end of December 2024, the 1-year Treasury had declined by 54 basis points from the beginning of the year and the 30-year Treasury yield had increased by 73 basis points. As a result, the Treasury yield curve, which had been inverted (with longer term yields lower than shorter term yields) for more than 18 months, once again reflected a positive slope, albeit still not to the degree of historical averages.



While the Fed increased the Fed Funds target aggressively in 2022 and into 2023, the market throughout that time contemplated the likelihood of a recession that longer term would push the Fed to lower interest rates quickly. The result was an inverted yield curve in which longer term Treasury yields were lower than those on shorter maturities. Inverted yield curves are not commonplace. In the last 40 years, the Treasury yield curve has been inverted less than ten times, and each time this generally was not by a significant amount and lasted only a few months. Using the differential between the 30-year and 10-year Treasuries to the 1-year Treasury as a measure, the Treasury yield curve first became inverted in July 2022. The steepest point of inversion was in June 2023 when the negative spread was by approximately 150 basis points. After that there was a relatively rapid flattening until the negative spread was only 50 basis points in October 2023. From October 2023 to July 2024, the degree of inversion was rangebound between 50 and 100 basis points, before continuing on course to be positively sloped by October 2024. As of year-end 2024, the 30-year Treasury yield was higher than the 1-year Treasury by 62 basis points (versus a negative 76 basis points at the end of 2023), and the differential between the 10 and 1 year was 42 basis points (versus a negative 91 basis points at the end of 2023).

Interest rates as represented by the Treasury yield curve continue to be high in comparison with where they were from 2008 until 2020. Significant portions of insurance companies' fixed income investments, especially for Life insurers, were made prior to 2020. With the increases in long-term interest rates in 2022 and again in 2024, the fair market value of those investments was negatively impacted. A comparison of the overall fair market value of Bond portfolios in comparison with carrying value likely will show that fair market values are materially lower than carrying value. What the actual impact is will vary from insurer to insurer and depend on the specific profile of the Bond portfolio. For longer dated holdings this may be by a substantial amount. This may significantly impact liquidity planning at many insurance companies. Most bond investments are carried at amortized cost on the assumption that they can be held until maturity. If that turns out not to be the case and the assets need to be sold, the sale could be at a significant realized loss which would then also impact Surplus. This is a dramatically different scenario than what was likely the case a few years ago.

Certain specific asset classes may also have been impacted in other ways. Residential Mortgage-Backed Securities ("RMBS") are susceptible to significant changes in cash flows based on prepayments of the underlying mortgage loans. As interest rates rise, prepayments may decline resulting in substantially less cash inflows in comparison with what investors are expecting. This would also impact the fair market value of RMBS as they become longer dated holdings that are valued off of the longer end of the yield curve. Additionally, Bank Loans are typically floating rate instruments. As shorter-term interest rates rose even more than longer term interest rates in 2022, the cost to those borrowers increased significantly. This would negatively impact the borrowers' cash flows and their creditworthiness. These conditions may also make it more difficult for Bank Loan borrowers to refinance at maturity. Most types of invested assets are valued by discounting expected cash flows. Higher interest rates mean higher discount rates. Commercial real estate properties are a good example. The present value of the projected cash flows on the property will be lower given the higher discount rate, which market participants refers to as a "cap rate".



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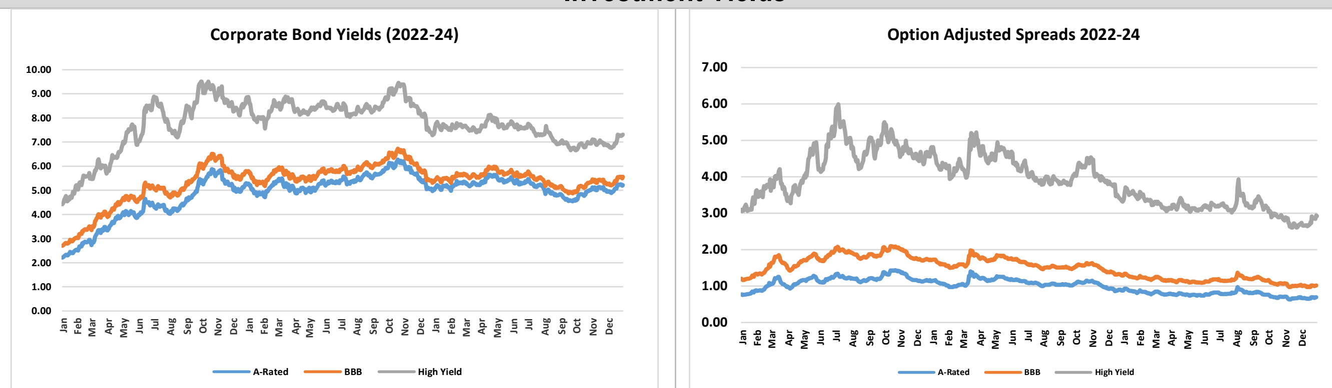
The changes in the shape of yield curve have the potential for creating significant anomalies in the fair market value of different instruments. One area for special focus is interest rate related derivatives used in hedging. Different interest rate hedging strategies may be impacted in different ways as the value of longer dated swaps will differ from shorter dated ones, and derivatives that use shorter duration risk to offset longer duration risk may be affected in unusual ways. There were significant changes in the fair market value of different interest rate hedging instruments in 2022 and 2023, resulting in both realized and unrealized capital losses. This may also impact determinations of hedge effectiveness both for economic and Statutory Accounting purposes. U.S. insurer holdings of bonds issued by non-U.S. entities are not that significant, but investments in those will be impacted differently and to different degrees. Different interest rate markets have also impacted foreign currency exchange rates. Any non-U.S. dollar investment that has not been hedged effectively will see material differences in valuations.

Investment Yields



In 2022, Corporate Bond yields rose both because of the rise in Treasury yields and a widening in credit spreads. This was the case across all credit qualities. By the end of 2022, yields on A-rated and BBB-rated Corporate Bonds were at 5.28% and 5.78%, respectively. Those stayed relatively stable throughout 2023 before declining through most of 2024. While longer-term Treasury yields were increasing, spreads were declining. By the end of 2024, A-rated bond indices yielded 5.22% and BBB-rated were at 5.55%. There was some volatility in credit spreads for those two benchmarks over the two years. However, variation from year-to-year was not significant. The trend line for high yield bonds was different, whether focusing on the overall yield or the credit spread. This is due to more significant shifting sentiments for the likelihood of default. In the summer of 2022, high yield credit spreads spiked to 600 basis points before moderating to around 450 basis points by the end of 2022. While there continued to be significant volatility in this measure through 2023, the trend was generally downwards and ended 2023 at 339 basis points. This continued through most of 2024. Notwithstanding an uptick in the fourth quarter, high yield credit spreads ended 2024 at 292 basis points. As was the case for other metrics, this reflects decreasing concerns about a recession and bond defaults. In 2022 and 2023, defaults were higher, but not as high as some had feared, and by the end of 2024 concerns had declined.

The general trends in credit spreads are also reflected in the differentials between credit qualities. The differential between A-rated and BBB-rated Bonds rose from 40 basis points to 75 basis points in July of 2022, by the end of 2023 was back to 40 basis points, and 33 basis points at the end of 2024. Not surprisingly, the differential between high yield and BBB-rated Bonds is considerably more volatile. While this differential reached its peak of 400 basis points back in July 2022, it was at 210 basis points at end of 2023 and down to 190 basis points by the end of 2024.

An additional comparison worth considering is the Emerging Markets Debt index. This consists of the debt instruments at the weaker end of investment grade and just below investment grade credit qualities. Option-Adjusted spreads also spiked in 2022, which is also reflected in the differential to U.S. Corporate Bond indices. These metrics have trended back to levels at the beginning of 2022 or better.

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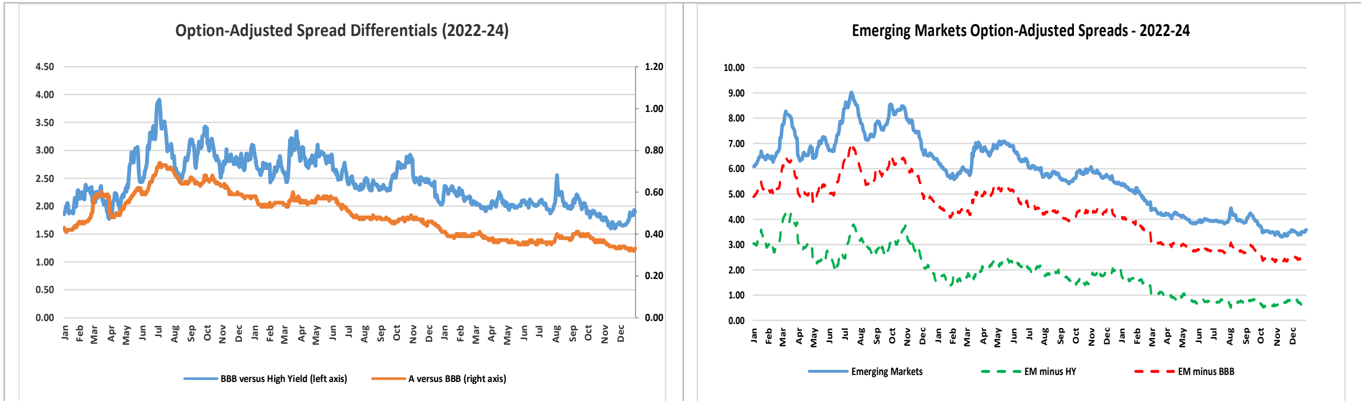
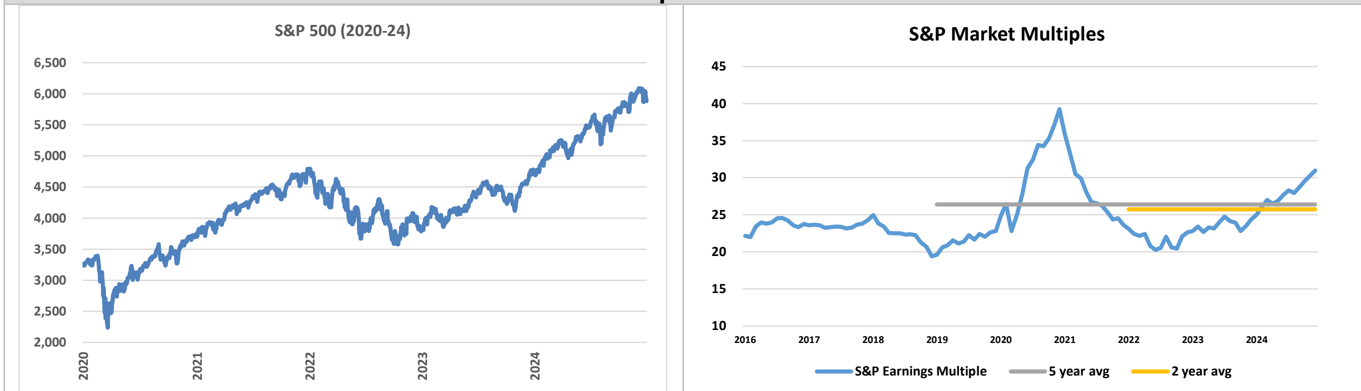


The last few weeks of 2024 and the beginning of 2025 has seen some increased uncertainty in the marketplace. It is too early to tell what the real impact of the new Administration will be, but market indicators are suggesting larger Federal deficits, concerns of higher inflation and, once again, the possibility of a recession. This is demonstrated in part by changes in interest rates and the shape of the Treasury yield curve, as well as directional uncertainty with the S&P 500.

Equities



While equity holdings are less significant as an asset class for U.S. insurance companies, fair market values are more volatile. Carrying values are also at fair market value, which therefore has a more immediate impact on an insurer's capital and surplus.

In 2022, the S&P 500 declined 19.4% and at one point was down 25% from year-end 2021. In 2023, the S&P 500 more than reversed the 2022 decline, closing the year up 24.2%. 2024 ended the year with the S&P 500 up significantly again, by 23.3%, notwithstanding some volatility during the year. The performance of equity markets can be typically tied to different measures including price-earnings multiples. In the graph on the right above, the market multiple for the S&P 500 trended upwards in 2024. Ending the year slightly above 30 times earnings, this is significantly above the two and five year average. If corporate earnings do not grow, there may be some concerns for a correction in valuations. Higher interest rates could also result in a revaluation downwards.

Valuations of private equity and private equity funds are generally expected to follow trends in public equity valuations though they may not track directly. However, one continuing concern in 2024 was private equity exits. This reflects private equity fund sales of their underlying holdings. This can happen through two main avenues – secondary buyouts and trade sales. A third avenue, through initial public offerings, has been noticeably dormant since 2021. S&P Global recently published data that it had acquired from Prequin.

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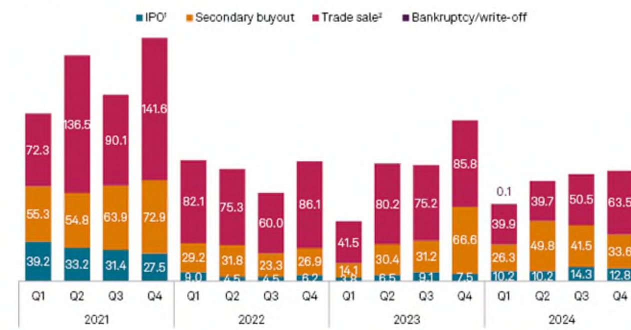

Data compiled Jan. 3, 2025.
[1] IPO = IPO and private placement/follow on.
[2] Trade sale = trade sale and sale to management.
Source: Preqin Pro.
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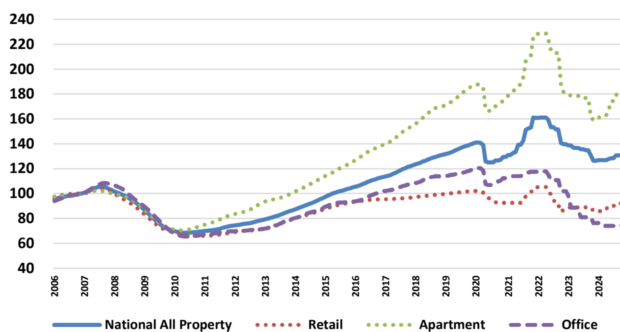
The quarterly data for 2024 was lower than the last three quarters of 2023. Private equity exits for three consecutive years have been significantly below the 2021 peak year, notwithstanding strong equity markets in 2023 and 2024. Distributions to fund partners can only occur when the fund managers can sell assets. As a result, some fund managers experienced difficulties in 2024 raising new funds. The inability to exit private equity holdings may also begin to raise questions about internal valuations of the underlying assets in the funds. This could further impact distributions as fund managers may decide to hold on to assets longer.

Commercial Real Estate Values



Source: Various including NCREIF and Green Street.

As U.S. insurance company investments in real estate related assets have increased over time, albeit mostly in the form of mortgage loans, commercial real estate valuations have become a more material consideration. 2022 and 2023 saw significant declines in index values. While 2024 experienced a modest recovery, this was not consistent across property types. National All Property measures improved 4.8% in 2024, compared to declines of 13.2% in 2022 and 9.5% in 2023.

The worst performing sector since 2020 was Office, which was down 1.1% in 2024 after declines of 13.3% in 2022 and 25.2% in 2023. The drag continued to Central Busines District properties. Based on trends in media reporting, there does seem to be some signs of stabilization punctuated by the occasional dire announcement of a greatly discounted sale. Apartments recovered from a 12.5% decline in 2023 with an indicated improvement of 13.5% in 2024. Retail improved 12.2%, though this is after an extended period of lackluster index valuations. The apparent stabilization of the Office sector and significant improvement in Apartment and Retail are encouraging. The potential for higher long term interest rates may not bode well however. Higher costs of borrowing will make refinancing of maturing loans more difficult. If the interest rates on maturing loans date back to the days of low interest rates, the properties may not be able to support higher coupons that may be required, and if high interest rates continue to impact valuations, the revised loan-to-values may not be acceptable to lenders.

What continues to be the case for Office properties is that valuations, which have always been somewhat idiosyncratic from property to property, have become even more so. Work-from-Home arrangements continue to pressure vacancy rates which ended 2024 still in the 15% range for Central Business Districts. There did appear to be some improvements in actual occupancy rates. The question is if the improvement does continue and if it arrives in time satisfy potential lenders that are needed to refinance existing mortgage loans. Lending from banks is still weaker than before the banking turmoil of 2023.

Closing Thoughts and a Few More Questions to Consider

Economic uncertainty, high inflation, and a sharp rise in interest rates came together in 2022 to negatively impact virtually every asset class and investment practice. This led to both realized and unrealized losses in 2022 and 2023. Improvements in economic data in 2024 and moderation in inflation since mid 2023 led the market to believe that the Fed achieved the seemingly elusive "soft landing" and fears of a recession dissipated.

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With higher interest rates, insurers have been able to invest in new bonds and mortgage loans with higher yields. However, existing holdings of bonds and mortgages loans saw their fair market values decline in 2022 which likely saw no significant improvement in 2023. Higher long-term interest rates in 2024 likely resulted in additional pressure on the fair market values of longer dated investments. Higher mortgage rates also continues to impact RMBS cash flows.

Uncertainty in the commercial real estate sector significantly decreased, with the possible exception of the Office sector. The fact the national index levels have stabilized for the Office sector is encouraging. But is this due to the lack of transactions? Watching what happens in the next 12 to 24 months for maturities of mortgage loans will be key.

The continued softness in private equity fund exits is a significant concern. With no real explanation for why exits remain low, how does this impact expectations of cash flows that may have been built into an insurer's Asset Adequacy Analysis and Cash Flow Testing?

2024 was a challenging year for investors, including insurance companies. Low interest rates from 2008 to 2019 meant extremely low investment yields, but that was also coupled with relative stability. The last few years (2020 to 2024) have seen greater uncertainty and more market volatility. While broad market trends in 2024 were generally positive, there was also more differentials across sectors.

A continuing theme and an important question for regulators to ask insurers is whether their risk monitoring and management have kept pace. This includes the level of investment expertise with insurer Boards of Directors who provide ultimate oversight. Market volatility has returned and does not show any immediate signs of going away. Perhaps more importantly is how that market volatility impacts liquidity planning. Many insurance companies stretched for yield during the low rate environment by shifting to less liquid assets, investments that were more complicated and bonds that were longer in duration. Does the insurer have a robust liquidity policy and is the liquidity stress testing adequate? Lower fair market values and extension of cash inflows from investments won't have a material negative impact on the insurer if it can continue to hold the investment. Key to this question is also the potential for volatility in cash flow demands from the liability side of the equation. Higher investment yields have also impacted policy surrender and lapse dynamics among Life products.

This document is intended to provide a general overview of the 2024 market conditions and thoughts on implications to the insurance industry. It is not intended to provide investment advice, nor is it intended to suggest specific risks or actions for any given insurance company. Actual impacts on investments and individual insurers will depend on a range of facts and circumstances and any such analysis is beyond the scope of this briefing.

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