The Insurance perspective

2017 - Volume 5

PARKWAYADVISORS
6550 Directors Parkway Abilene, TX 79606 800.692.5123
www.parkwayadvisors.com/
Follow us on in

Economic Commentary

Chad B. Hoes, Chief Investment Officer

The second quarter involved many big headlines and events including: the US launching missiles at Syria after a gas attack; reporting that the offshore drilling impact from low oil prices was exaggerated which began tremendous volatility in the price of oil the last several months; and two scheduled FOMC meetings. Some of the major second quarter 2017 events are discussed below.

US Bond Market – The domestic bond market continued it's flattening of the yield curve in the second quarter. Specifically, Treasuries 3 years and shorter increased and Treasuries 5 years and longer decreased in yield over the second quarter, continuing the flattening trend from the first quarter. In the second quarter, the three-month Treasury increased 24 basis points to 1.01% which was the largest basis point movement on the Treasury yield curve. The 10-year Treasury ended the quarter at 2.30%, which is 8 basis points lower than the first quarter end and 14 basis points lower than year-end. The 30-year Treasury yield fell 18 basis points over the second quarter to end at 2.84%. The yields on longer Treasury bonds reached a low in mid-June, touching levels not seen since November of 2016. The general trend has been a decline in yields on longer bonds since March.

FOMC – The Federal Reserve met twice in the second quarter, once in early May and once in mid-June. The first scheduled meeting of the quarter left benchmark rates unchanged at 0.75% to 1%. Inflation targets are running near the Fed's goal, jobs gains are solid and household spending only rose modestly. The Fed repeated its expectations that the economy will warrant "gradual" rate hikes and maintained its balance sheet reinvestment strategy. The market priced in a June rate hike and, with no surprise, the Fed obliged. The labor market continued to strengthen, job gains moderated, spending picked up and economic activity rose moderately. Thus, the Fed believed a 25 basis point hike was appropriate in the Federal Funds rate, increasing the range to 1% - 1.25%. While the Fed is "monitoring inflation developments closely," the FOMC maintains its forecast for one more hike in 2017. Implied probabilities, as determined by the futures market, slates that potential hike for the last meeting of the year which occurs in December. Moreover, the Fed's current estimation for the longer-run median Fed Funds rate at 2.1% in 2018 and 2.9% by the end of 2019. This interpolates into one more rate hike in 2017, two in 2018 and three in 2019.

US Stock Market – The stock market continued its upward momentum in the second quarter after an initial pullback in early April. Despite another almost 2% dip in mid-May, major stock indices reached new all-time highs in mid-June. Although it closed off highs, the S&P 500 Index was up a respectable 3.09% over the second quarter, which culminates to 9.33% for the first half of the year. The Dow Jones Index closed up 3.95% for the quarter, which is also 9.33% for the first six months of 2017. The NASDAQ led the pack with a second quarter return of 4.2% and 14.76% year-to-date.

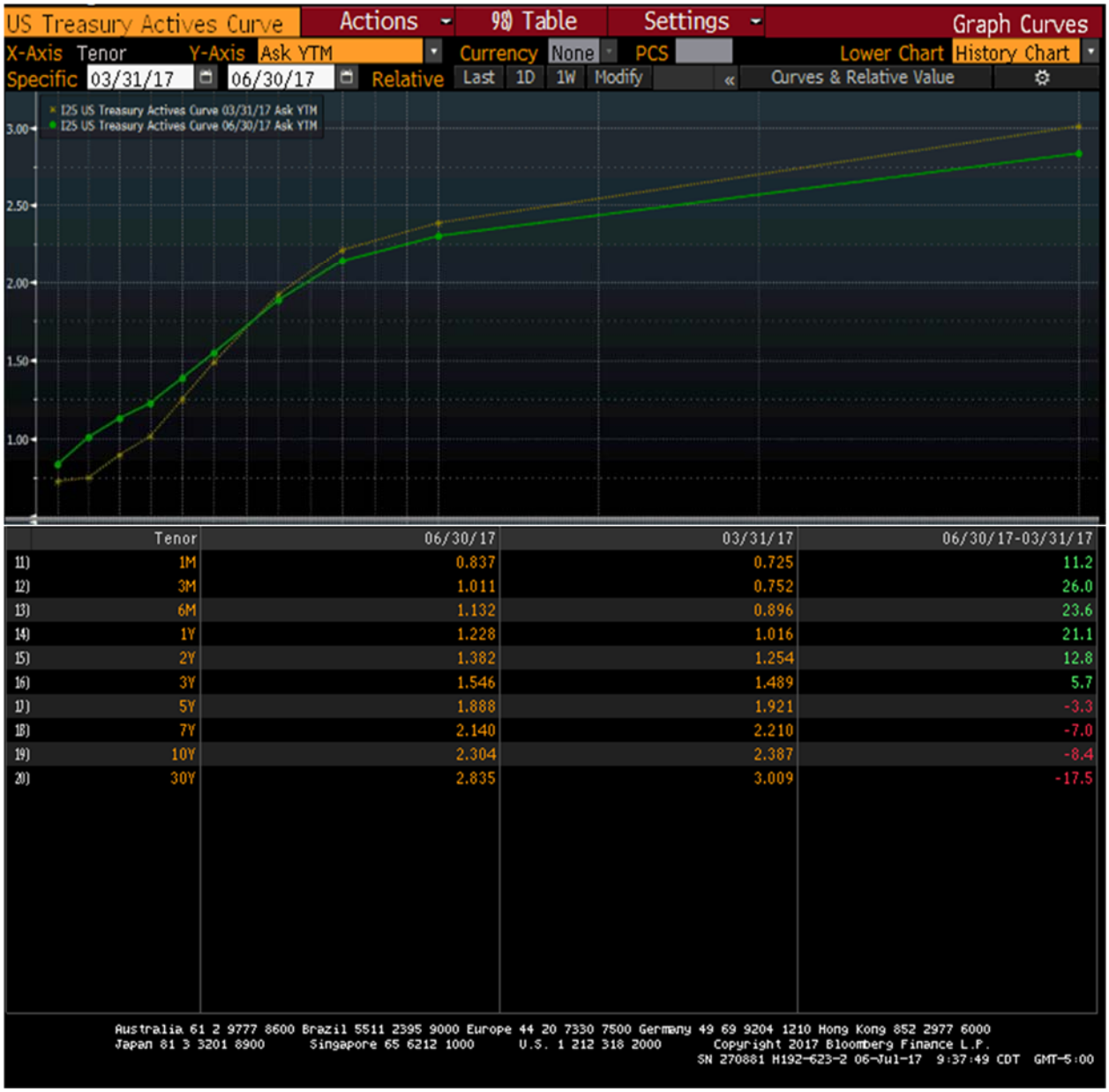
Summary – This year has generated a good deal of news and events and we are only half way through. I expect the flattening yield curve trend to continue throughout the second half of the year. In light of the first half of the year, I anticipate domestic stocks will be relatively flat to slightly positive the remainder of 2017. It is possible for one more rate hike to occur, but if it does it will materialize in December at the last scheduled FOMC meeting.

Interest Rate Spreads

As of: 6/30/2017

Term	Treasury Yield	US Composite BVAL AA Curve		US Composite BVAL A Curve		US Composite BVAL BBB Curve		US Composite BVAL BB Curve	
		Yield	Spread	Yield	Spread	Yield	Spread	Yield	Spread
1yr	1.24	1.444	0.204	1.612	0.372	1.855	0.615	2.503	1.263
2yr	1.38	1.704	0.324	1.883	0.503	2.15	0.77	3.001	1.621
3yr	1.55	1.938	0.388	2.128	0.578	2.424	0.874	3.434	1.884
5yr	1.89	2.342	0.452	2.514	0.624	2.889	0.999	4.134	2.244
7yr	2.14	2.7	0.56	2.861	0.721	3.307	1.167	4.73	2.59
10yr	2.31	3.096	0.786	3.23	0.92	3.739	1.429	5.336	3.026
20yr	2.61	3.726	1.116	3.964	1.354	4.491	1.881	6.48	3.87
30yr	2.84	3.877	1.037	3.94	1.1	4.412	1.572	6.488	3.648

US Treasury Yield Curve



	Tenor	06/30/17	03/31/17	06/30/17-03/31/17
11)	1M	0.837	0.725	11.2
12)	3M	1.011	0.752	26.0
13)	6M	1.132	0.896	23.6
14)	1Y	1.228	1.016	21.1
15)	2Y	1.382	1.254	12.8
16)	3Y	1.546	1.489	5.7
17)	5Y	1.888	1.921	-3.3
18)	7Y	2.140	2.210	-7.0
19)	10Y	2.304	2.387	-8.4
20)	30Y	2.835	3.009	-17.5

S&P 500 Index


GRAB
SPX Index
95) Compare
96) Actions
97) Edit
Line Chart
03/31/2017 - 06/30/2017
Last Price
USD
Mov Avgs
Key Events
1D 3D 1M 6M YTD 1Y 5Y Max Daily
Table
Chart Content
Last Price 2423.41
High on 06/19/17 2453.46
Average 2397.42
Low on 04/13/17 2328.95
2460
2440
2423.41
2420
2400
2380
2360
2340
2320
Apr 7
Apr 17
Apr 21
Apr 28
May 8
May 15
May 23
May 31
Jun 8
Jun 15
Jun 22
Jun 30
2017
Australia 61 2 9777 8600 Brazil 5511 2395 9000 Europe 44 20 7330 7500 Germany 49 69 9204 1210 Hong Kong 852 2977 6000
Japan 81 3 3201 8900 Singapore 65 6212 1000 U.S. 1 212 318 2000 Copyright 2017 Bloomberg Finance L.P.
SN 270881 H192-1392-3 11-Jul-17 14:33:40 CDT GMT-5:00

Dow Jones Industrial Average

Opportunities Shorter on the Curve

We have seen the Fed raise rates four times since December of 2015 and are currently slated for one additional rate hike in 2017. These hikes have brought the Fed Funds rate from a dismal .25% up to the current rate of 1.25%. This slow and steady path has been the result of the Fed's plan to tighten monetary policy in a way that doesn't send shockwaves through the market. Overall, the result has been what is known as a "flattening" of the yield curve. That essentially means that yields on the shorter end of the curve have increased at a faster rate than the long end. Specifically, we have seen the 1 year Treasury bond jump 75.3 basis points from December 1, 2015 to June 30, 2017 which marks a 158% increase in yield. While we have seen a substantial increase in yields on the short end, the long end tells a different story. The 30 year Treasury stood at 2.90% on December 1, 2015 and currently yields 2.83%, marking a 7 basis point decline.

What does this mean for an insurer? First and foremost, Parkway still believes that the two main risk reduction measures that should take priority for an insurance company remain:

1. Diversification of assets relative to surplus
2. Cash flows appropriate for products sold (Asset Liability Matching for life companies)

That being said, it's difficult if not impossible to determine the future of interest rates. Trying to time the market resulted in loss of net investment income for many who decided to park cash as rates continued their downward trajectory. However, for those that continued to invest at current rates, two predominate practices were used to maintain yield: dipping down in credit quality and buying longer on the curve. Both of these strategies carry pitfalls, namely mismatches where asset cash flows do not match anticipated outflows and/or additional securities ending up on watch lists due to credit concerns. However, now that we have seen rates increase shorter on the curve, we find opportunities to find value in years that may require additional attention from a cash flow perspective. *At this time, on average, you do not pick up additional yield for investing longer than 20 years in A rated US corporate bonds*. While you can always find outliers and value in individual names or sectors, the average yield for the aforementioned 20 year corporate bonds is essentially the same as 30 year bonds. We are still seeing a normalized yield curve up to 20 years, meaning you still get more yield for tying your money up longer, but on average there is no real benefit from a yield perspective to buy longer than 20 years out in this space. This trend continues outside of the A rated corporates and Parkway has been finding considerable relative value in the mid part of the curve. If you have potential shortfalls in asset cash flows compared to your expected outflows, the market is currently giving you an opportunity to invest in those years without substantial give up in yield. Once your portfolio has become fully "immunized" and asset cash flows are in excess of claims, the mid part of the curve offers attractive value relative to other parts of the curve. Shorter duration investments will also fair better in a rising rate environment with less volatility in market value.

If you have any questions or would like assistance putting together a cash flow picture, please feel free to reach out.

Disclosures

Parkway Advisors, L.P. is an investment advisor registered with the Securities and Exchange Commission offering investment management, consulting, and statutory reporting services. This material is for your use only and is based upon information obtained from various sources which we consider reliable, but has not been independently verified and thus we do not represent that it is accurate or complete and should not be relied upon as such. Graphical and tabular information was obtained from Bloomberg and represents the respective Bloomberg US Composite BVAL and Bloomberg Fair Value Composite Curves. Spreads are calculated off the Treasury yield for each term. The opinions expressed are our opinions only. Past performance is no guarantee of future performance and no guarantee is made by this document.

About this Publication

The Insurance Perspective is a quarterly publication prepared by the staff of Parkway Advisors, L.P. Each issue focuses on the U.S. economy and specific insurance industry issues and/or concepts. Our clients and prospective clients enjoy Parkway's dedication and unique focus on the insurance industry.

For More Information

We welcome your inquiry and can be reached by mail at Parkway Advisors, L.P., P.O. Box 5225, Abilene, Texas 79608 or by phone at (800) 692-5123 or by fax at (325) 795-8521. A copy of our Form ADV, Part II is available upon request.

For more information, please email info@parkwayadvisors.com or visit www.parkwayadvisors.com.