

The
Insurance
perspective

2018 - Volume 8



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Economic Commentary



The first quarter of 2018 brought something that most of the market forgot about: volatility. From 1,600 point swings on the DOW to the 10YR Treasury climbing to nearly 3%, this quarter reminded everyone that the market doesn't only skip along in a slow steady march upward, but also demands some respect and attention to allocations and risk tolerances. The market made up for its quiet spell and record run without a 3% pullback within the first quarter, setting a new tone in the market compared to what we've seen the past several years. We've seen various changes across many different market segments, discussed below.

US Bond Market – Quarter over quarter we've continued to comment on the flattening of the yield curve. The first quarter of 2018 continued this trend, however to a lesser degree than we saw previously. Instead of seeing shorter term yields rise while longer rates decline, we saw rates increase across the curve. While the largest percentage increase continues to remain on the short end in response to monetary policy changes at the Fed, speculation of inflation concerns led to a selloff in the overall bond market causing a substantial rally in yields throughout most of the quarter. However, volatility in the equity market amid global trade concerns led to a traditional "flight to quality" that drove back bond prices higher and subsequent yields lower heading into the end of the quarter. To put some numbers down to help paint this picture, the 10YR yield began the year at a 2.46%, rising to a high of 2.95% at the end of February before reverting back to 2.74% to wrap up the quarter.

FOMC – The first quarter of 2018 marked the first appearance of new Federal Reserve Chairman, Jerome Powell. Powell, a former private-equity executive who has sat on the Federal Reserve's Board of Governors since 2011 has made it known he will be guided more by the performance of the economy as opposed to the theories and/or models that his predecessors had leaned on before him. The March 21 meeting brought an expected rate hike, bringing the Fed Funds rate to 1.50-1.75%. Powell indicated the Fed had initially planned a total of three hikes throughout 2018, but may entertain the idea of a fourth in the event economic data points to inflation concerns as the economy continues to improve. The market however is still currently pricing in two additional hikes throughout the year.

US Equity Market – The equity market continued to make headlines throughout the quarter. From concluding a record run to the largest intraday point decline in history, there has been plenty of newsworthy material. Fueled by the approval of the Republican tax plan that cut corporate taxes, equities started 2018 in a fury, returning almost 7.5% on the S&P 500 by late January. To help put this in perspective, this run up in the first month had already met various analyst's return forecast for the entire year. This type of exuberance in the market obviously cannot be justified indefinitely, especially given the

rich valuations seen in the equity markets after a nearly decade long bull market. The inflation concerns that spooked the bond market and caused higher yields leads to not only higher borrowing costs for corporations which reduces profitability, but also gives investors other asset classes to consider after years of historically low yields on fixed income. This inevitably led to a pullback in the equity market, which the market hadn't seen since November 2016, falling just over 10% from the highs on the S&P 500. A subsequent rally followed the drop, advancing just over 7.5% and bringing the broad based index back into positive territory for the year. Heading into quarter end, increased concerns surrounding competition in the global economy has since eroded returns for the year and has tested new lows.

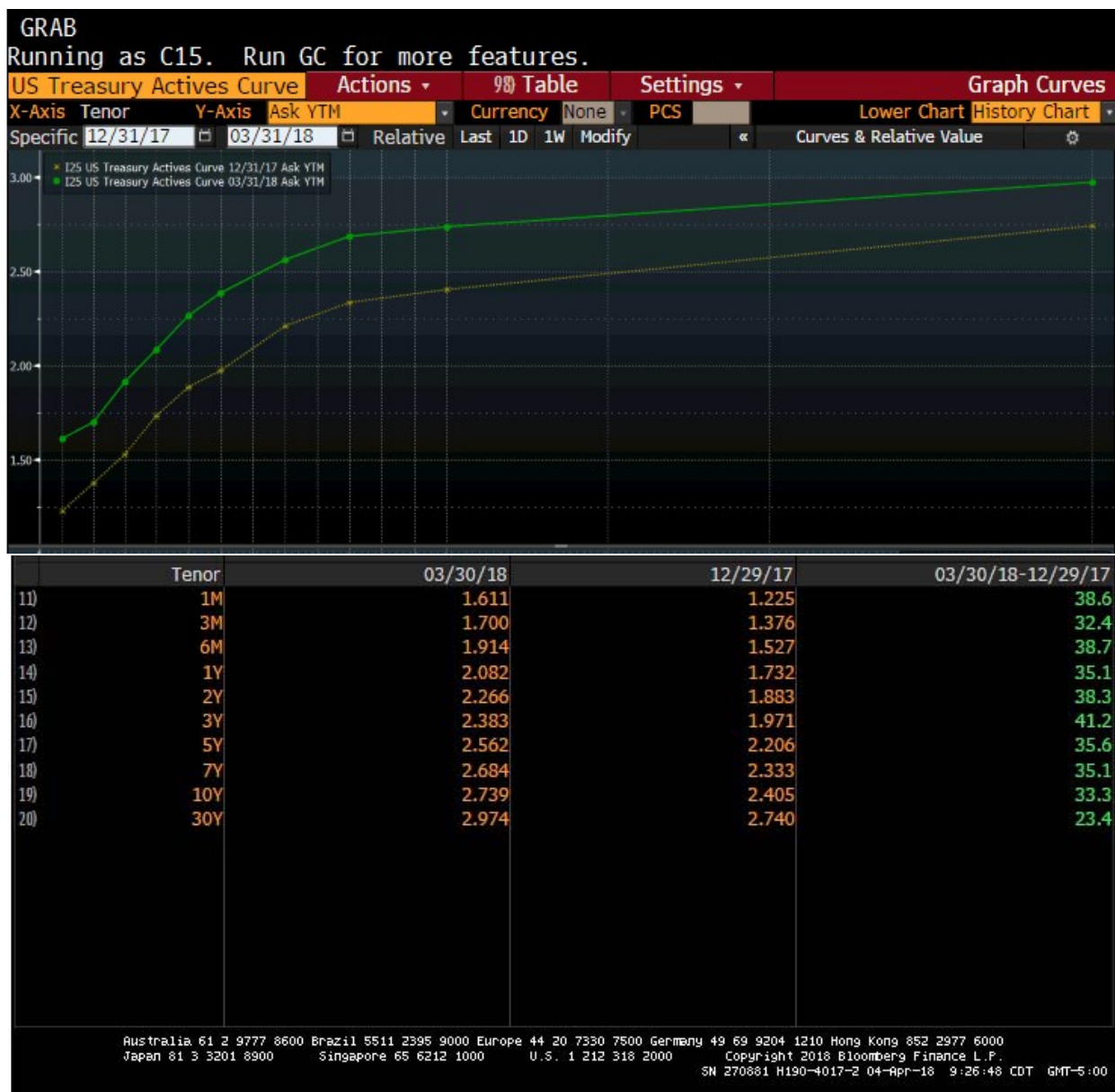
Summary – To some, volatility brings fear. To others, it brings opportunity. You might have heard the saying “a rising tide lifts all boats” which is definitely true as investment selection is less important when whatever you buy yields positive returns. However complacency doesn't bode well when the tide turns and your investment process is tested. We anticipate volatility to continue throughout 2018, but overall positive returns for the year in the equity market given the improving economy amid positive earnings growth. We also anticipate several more rate hikes which will continue to lend to the ongoing flattening of the yield curve.

Interest Rate Spreads

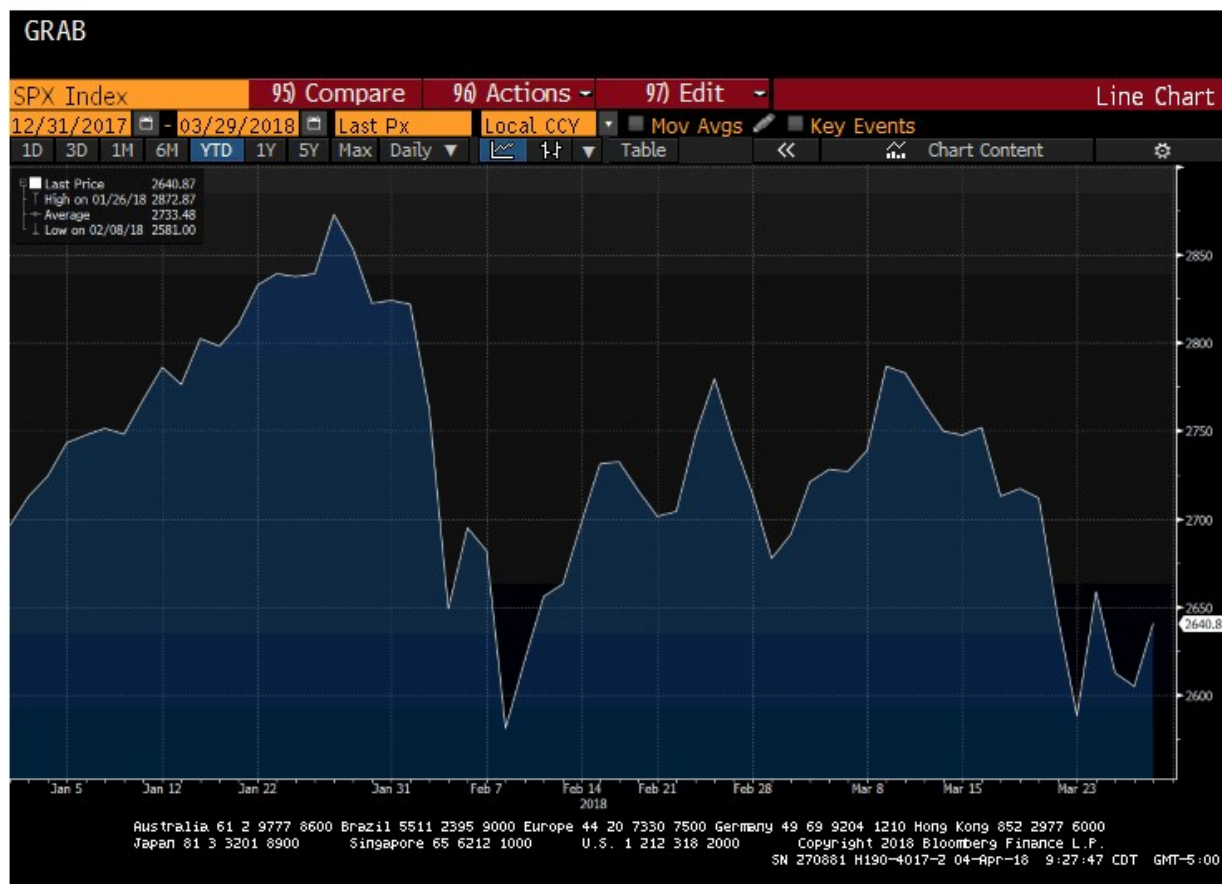
As of: 3/29/2018

Term	Treasury	US Composite BVAL AA Curve		US Composite BVAL A Curve		US Composite BVAL BBB Curve		US Composite BVAL BB Curve	
	Yield	Yield	Spread	Yield	Spread	Yield	Spread	Yield	Spread
1yr	2.09	2.432	0.342	2.604	0.514	2.851	0.761	3.834	1.744
2yr	2.27	2.659	0.389	2.822	0.552	3.092	0.822	4.224	1.954
3yr	2.39	2.822	0.432	2.993	0.603	3.285	0.895	4.565	2.175
5yr	2.56	3.077	0.517	3.221	0.661	3.586	1.026	5.112	2.552
7yr	2.68	3.313	0.633	3.436	0.756	3.879	1.199	5.602	2.922
10yr	2.74	3.58	0.84	3.68	0.94	4.19	1.45	6.098	3.358
20yr	2.85	3.882	1.032	4.092	1.242	4.616	1.766	6.944	4.094
30yr	2.97	3.974	1.004	4.081	1.111	4.558	1.588	6.655	3.685

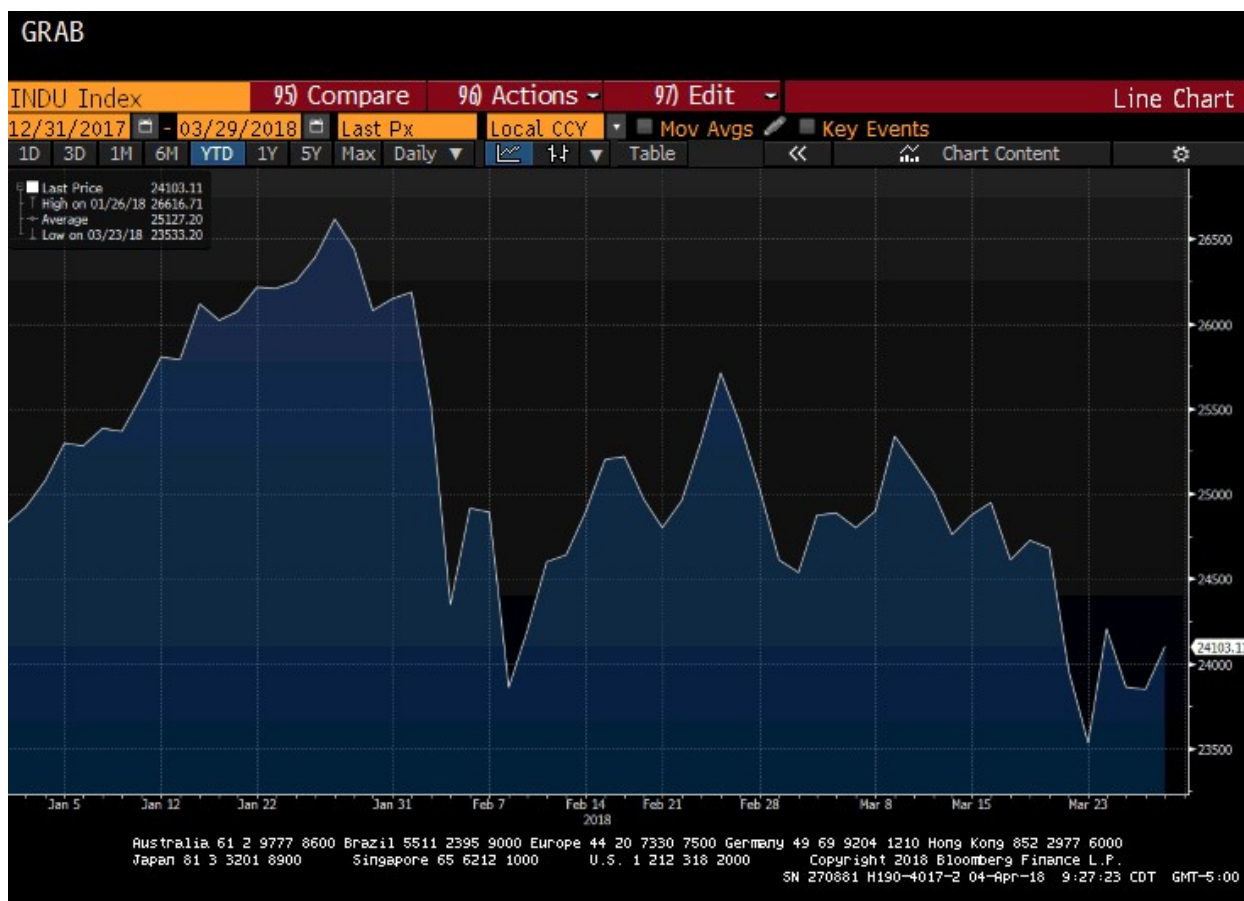
US Treasury Yield Curve



S&P 500 Index



Dow Jones Industrial Average



2017 Tax Law Review



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In December 2017 Congress passed the *Tax Cuts and Jobs Act*, drastically changing the landscape of corporate taxation. Arguably one of the best changes that came from the tax overhaul was the drop of the corporate tax rate from 35% to 21%. While the bill had a multitude of other sweeping changes, there were quite a few that were specifically for insurance companies. With that said, we are going to focus on one provision that has made tax-free municipal bonds more attractive to life insurance companies.

First, let's unpack the changes to the tax law that created this possibility. In the past, life insurance companies would have to go through complex calculations to determine what amount of income from tax-free bonds was taxable. The downside to this process was the amount of time it took to calculate and having to wait until the end of the tax year to truly know what the taxable income amounts were. The 2017 tax law changed all that by making 30% of the earnings from these bonds taxable. The new rate can be seen as a catalyst for the 7.7% (\$13.8 B) growth in municipal bond holdings by

life insurance companies between 2017 and 2016 (Illustration 1).

A primary advantage of this change is the effect it has on after-tax income received from interest payments. For example, a tax-free bond with a 2.5% coupon has the same after-tax income as a taxable bond with a 2.97% coupon, assuming both are purchased at par (Illustration 2). As you can see this calculation is simpler, potentially giving life insurance companies more confidence in purchasing tax-free bonds.

Keep in mind the change discussed above is only one of many changes that will affect the insurance industry. Other provisions in the bill that impact life insurance companies is the repeal of the small life insurance company reduction, along with setting the tax-deductible reserves at 92.81% of actuarial reserves. While we've spent most of our time on the tax law's impact on the life insurance companies, there are also quite a few that impact property and casualty companies, too.

Illustration 1

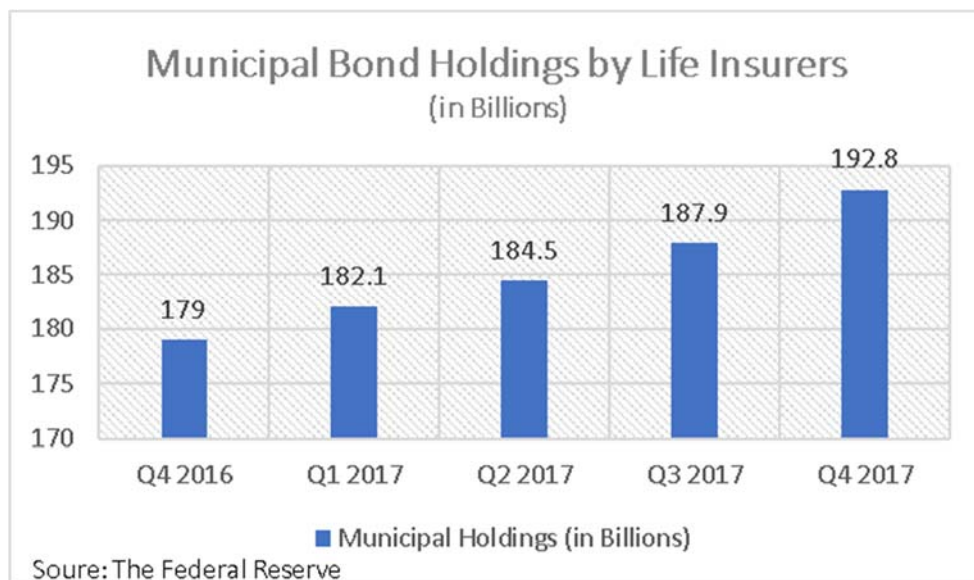


Illustration 2

	<u>Non-Taxable</u>	<u>Taxable</u>
Par	500,000	500,000
Coupon	2.50%	2.97%
Annual Income	12,500.00	14,825.95
% of Income Taxable	30%	100%
Taxable Income	3,750.00	14,825.95
Tax Expense	787.50	3,113.45
Year 1 After Tax Income	11,712.50	11,712.50

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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

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