The Insurance *perspective*

2018- Volume 10

PARKWAY ADVISORS

6550 Directors Parkway Abilene, TX 79606 800.692.5123

www.parkwayadvisors.com/

Follow us on in

Economic Commentary

Chad B. Hoes,
Chief Investment Officer

As we turn our attention to the final quarter of 2018, let us not forget the excitement of the year thus far: trade tariffs, Fed rate hikes, new levels on the 10-year Treasury unseen in seven years, new all-time highs in the domestic equity market. These items have given journalists and economists a plethora of conversational fodder. Let's take a further look into some of the primary market moving elements.

US Bond Market – The Fed's rate hikes continue to push up the short end of the Treasury yield curve, perpetuating its flattening trend. Although Treasury yields have seen some fluctuations, the general trajectory for the first nine months of this year has been an upward trend. The short-end of the curve gained the most in the quarter while the long-end increased the least. A popular gauge for the shape of the Treasury yield curve is the spread differential between the 2- and 10-year Treasury bonds. In August this spread fell below 20 basis points, its lowest level in over ten years. This is another indicator to show the flattening of the yield curve we have been harping on for so many quarters. For some specific data points, the three-month US Treasury ended the quarter at 2.19%, 28 basis points higher than it began. The 10-year US Treasury gained 19 basis points to conclude at 3.05%. I anticipate this year's trend will continue throughout the fourth quarter, revealing an even flatter domestic yield curve at the conclusion of 2018.

FOMC – Two scheduled rate decision meetings occurred during the third quarter. As widely expected and "baked into" the market, the Fed raised rates one quarter of a percent at the September meeting. The Fed updated their economic projections and signaled confidence for a longer period of above-trend economic growth. Economists project a continued gradual pace of tightening over the next several quarters. While the Fed has indicated a fourth rate hike in 2018, the market has been reluctant to price another increase in the short-term borrowing rate throughout most of this year. However, implied probabilities based upon the futures market for a December hike continue to improve and appear to be indicating a fourth rate hike to be "in the money." It is likely the Fed will pause to see how trade tensions, the midterm elections and economic growth pan out before the mid-December meeting. I anticipate one more increase at the last meeting of the year, concluding 2018 with a Fed Funds range of 2.25-2.50.

US Stock Market – The domestic equity market continued its longest bull run in the third quarter, closing September only marginally off all-time highs. The third quarter was an incredible quarter for domestic equity returns with the S&P 500 Index up 7.7% and the NASDAQ gaining 7.4% for the quarter. The Dow Jones Industrial Average led the pack with a 9.63% increase for the quarter, marking an increase of 17.49% for the year. While investor confidence is high and economic growth looks solid, the continued testing of new highs without a pullback likely won't last forever. All things considered, I wouldn't be surprised to see some sort of correction before year-end.

Summary – While some fear a potential recession and others inflation concerns, the Fed seems to be unwavering in their commitment to react appropriately to market conditions. Also, the market seems to be gung ho despite trade tensions and any potentially unsettled news from the Oval Office's agenda on that front. All things considered, I anticipate the spread differential between 2- and 10-year Treasury yields will continue to fall and the domestic equity market will achieve new all-time high records at some point in the fourth quarter.

Risk Within Investment Grade Bonds

Trevor R. Rupe,
Portfolio Manager

While the extended low interest rate environment squeezed margins for all financial institutions including insurance companies, it gave companies the opportunity to borrow at historic lows. This provided financing for various corporate endeavors including acquisitions or share repurchase plans, which has helped fuel the extended rally we've seen in the equity markets over the past 10 years. This has come at the expense of higher leverage ratios, which can be measured by looking at a company's net debt divided by their earnings. Leverage ratios have more than doubled since 2011 and have reached levels not seen since the early 2000's. This increase in debt has led to lower ratings, witnessed by the current allocation of investment grade corporate bonds in the BBB range. Currently 45% of investment grade corporate bonds have ratings below the "A" threshold and with a current face value of about 3 trillion, it's about the size of the entire corporate bond market at the turn of the millennium. To help put this into perspective, that allocation is 50% higher compared to the level seen in the financial crisis when bonds in the BBB range accounted for just 30% of investment grade bonds.

What does this all mean? As a whole, the general bond market has moved into "lower quality." Another way of looking at it is that it is now easier to find yourselves with higher allocations to lower rated bonds, such as NAIC 2, than what you historically may have held. While there are plenty of solid NAIC 2 bonds without lingering credit concerns, it's important to understand the risk this rating segment entails. While default rates for BBB rated bonds are still low, there is a higher likelihood they will be downgraded to non-investment grade. This is important as lower rated securities require a higher reserve held against them (for life companies via AVR), which in turn directly reduces your surplus in addition to negative impacts to RBC. In addition, spreads (the excess yield on a specific security compared to a treasury) tend to increase at a higher degree on lower rated bonds during volatility compared to NAIC 1 rated securities. As bond prices are inversely related to spreads/yields, this means lower rated securities will fall in price faster than their higher rated counterparts which can exponentiate losses in any event a disposal is needed. In the first half of 2018, we've seen spreads widen on BBB bonds by 29 basis points, compared to 20 on A rated corporates with no change on AAA rated securities.

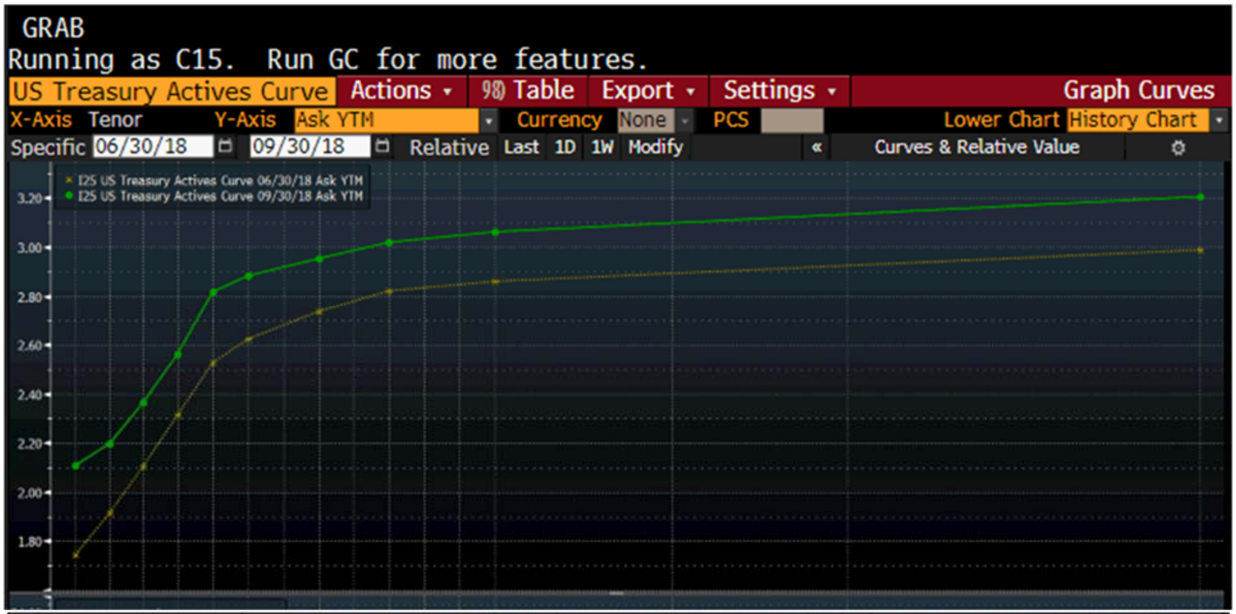
As we find ourselves in a rising interest rate environment with companies carrying higher levels of debt, it's important to stay diligent and closely monitor individual holdings. As debt matures and companies are now faced with higher interest costs to "roll their debt" out longer, it's possible to see additional credit rating downgrades. While things currently still look good economically, it's important to structure a portfolio that can weather various cycles and unforeseen circumstances, and to work with an asset manager who understands risk reduction measures for insurance companies to protect and benefit policy holders.

Interest Rate Spreads

As of: 9/28/2018

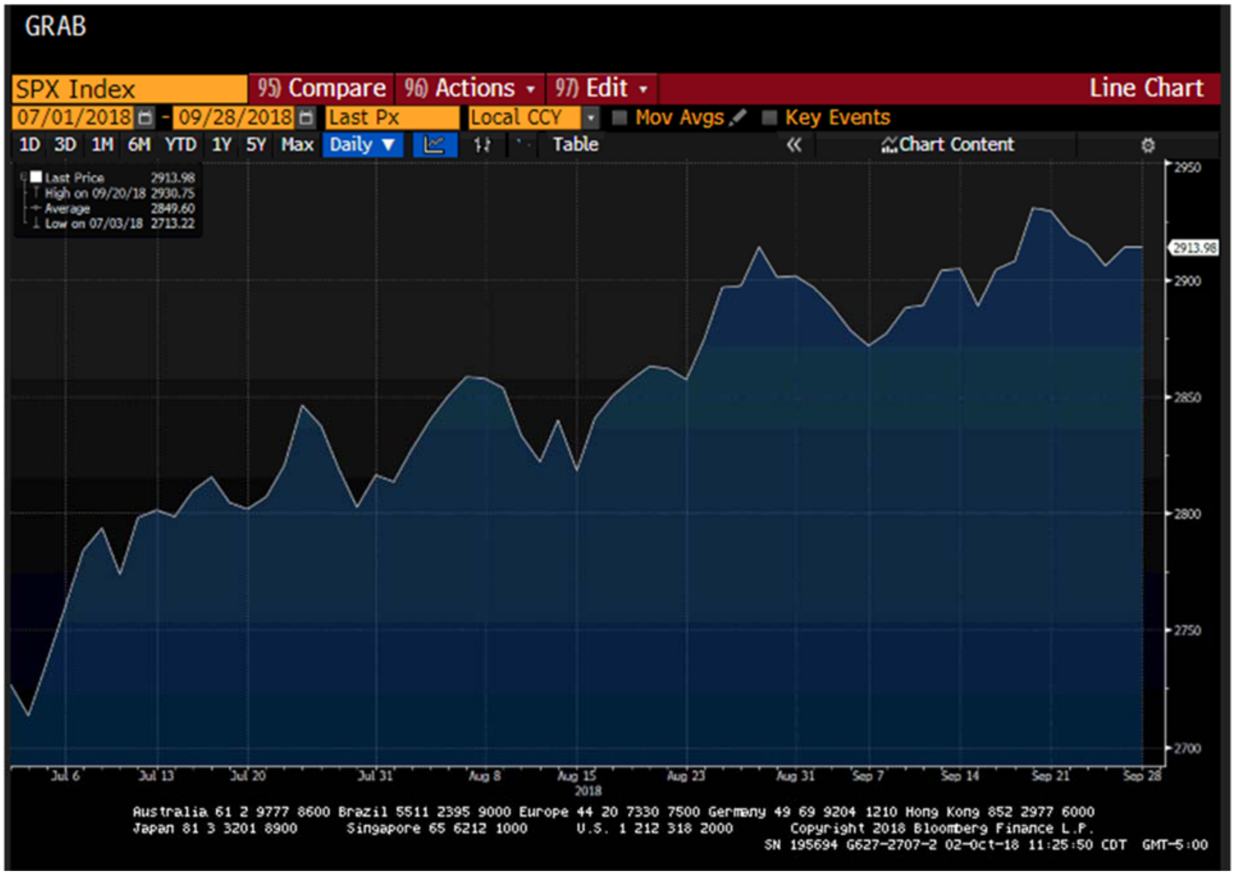
Term	Treasury Yield	US Composite BVAL AA Curve Yield	US Composite BVAL AA Curve Spread	US Composite BVAL A Curve Yield	US Composite BVAL A Curve Spread	US Composite BVAL BBB Curve Yield	US Composite BVAL BBB Curve Spread	US Composite BVAL BB Curve Yield	US Composite BVAL BB Curve Spread
1yr	2.59	2.687	0.097	2.854	0.264	3.086	0.496	3.96	1.37
2yr	2.81	2.999	0.189	3.164	0.354	3.44	0.63	4.45	1.64
3yr	2.88	3.147	0.267	3.341	0.461	3.671	0.791	4.798	1.918
5yr	2.94	3.367	0.427	3.541	0.601	3.963	1.023	5.317	2.377
7yr	3.01	3.554	0.544	3.734	0.724	4.238	1.228	5.744	2.734
10yr	3.05	3.77	0.72	3.981	0.931	4.525	1.475	6.162	3.112
20yr	3.13	4.092	0.962	4.402	1.272	4.943	1.813	6.768	3.638
30yr	3.19	4.177	0.987	4.321	1.131	4.842	1.652	6.669	3.479

US Treasury Yield Curve



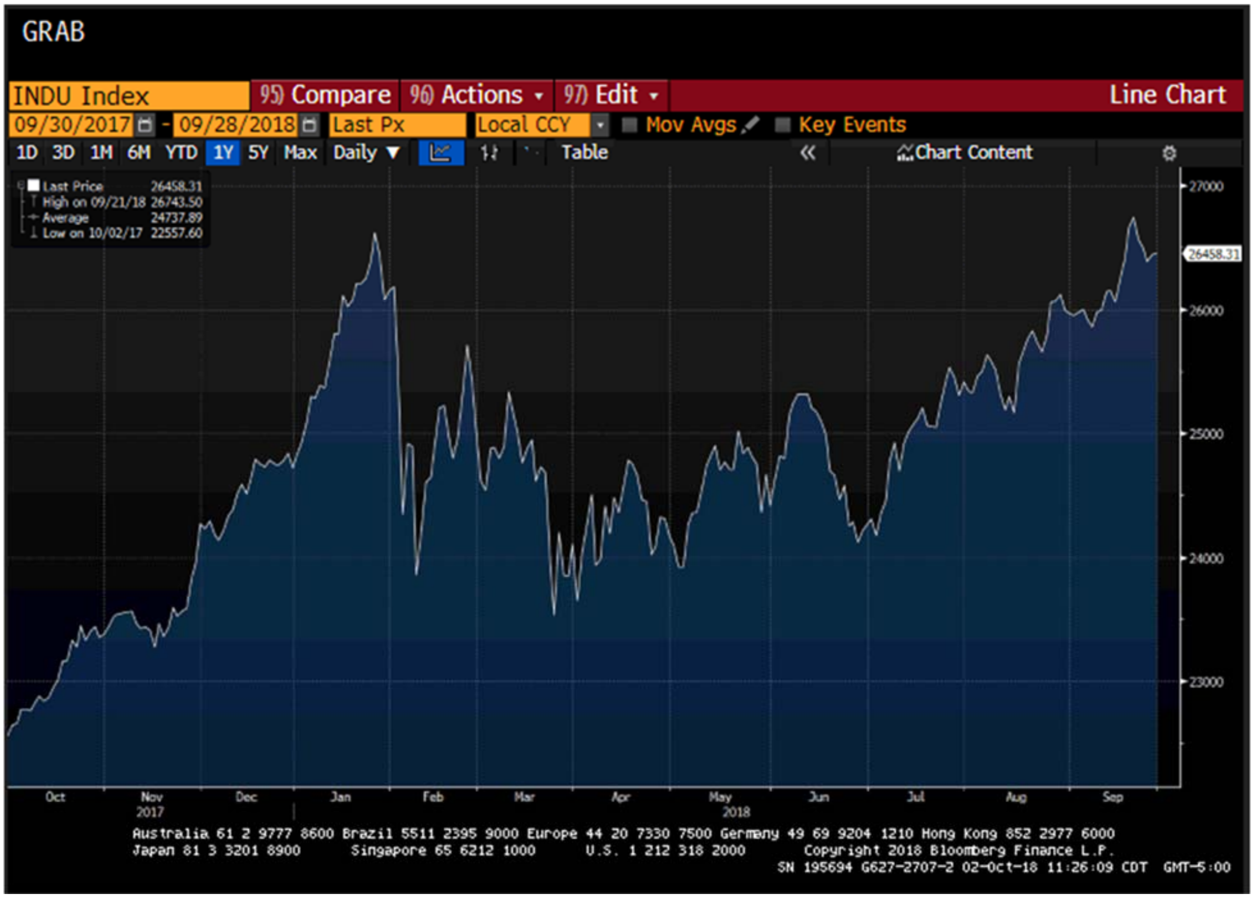
	Tenor	09/28/18	06/29/18	09/28/18-06/29/18
11)	1M	2.107	1.743	36.3
12)	3M	2.196	1.912	28.4
13)	6M	2.364	2.105	25.9
14)	1Y	2.563	2.312	25.1
15)	2Y	2.819	2.528	29.1
16)	3Y	2.883	2.622	26.1
17)	5Y	2.953	2.738	21.5
18)	7Y	3.020	2.822	19.8
19)	10Y	3.061	2.860	20.1
20)	30Y	3.206	2.989	21.7

S&P 500 Index



GRAB
SPX Index
95) Compare
96) Actions
97) Edit
Line Chart
07/01/2018 - 09/28/2018
Last Px
Local CCY
Mov Avgs
Key Events
1D 3D 1M 6M YTD 1Y 5Y Max Daily
Table
Chart Content
Last Price 2913.98
High on 09/20/18 2930.75
Average 2849.60
Low on 07/03/18 2713.22
2950
2913.98
2900
2850
2800
2750
2700
Jul 6 Jul 13 Jul 20 Jul 31 Aug 8 Aug 15 Aug 23 Aug 31 Sep 7 Sep 14 Sep 21 Sep 28
2018
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 2018 Bloomberg Finance L.P.
SN 195694 G627-2707-2 02-Oct-18 11:25:50 CDT GMT-5:00

Dow Jones Industrial Average



SSAP 43R Update


Regi McCabe-Gossett, Senior Insurance Accountant

The NAIC has issued new guidance surrounding the handling of Other-Than-Temporary-Impairments (OTTI) within IMR and AVR for Loan-Backed and Structured Securities within SSAP 43R. An entity should assess if an other-than-temporary-impairment exists if the fair value of a security is less than the amortized cost; which can be done a couple different ways. First, if the entity intends to the sell the security, an OTTI shall be considered to have occurred. Here, the term "intends" means the firm has already decided to sell the security in question. However, if the entity does not intend to sell the security, then they shall assess their intent and ability to retain the investment for a period of time to recover the amortized cost basis. If the entity decides not to do this then an OTTI can be determined to have occurred. However, please keep in mind the decision to recognize another-than-temporary-impairment is up to the judgement of the entity.

For companies required to maintain an IMR and AVR, bonds with recognized OTTI losses will now be recorded in either IMR or AVR and no longer split. However, for loan-backed and structured securities additional guidance has been developed. Below are summaries of how to handle transactions for loan-backed and structured securities.

-Unrealized Gains and Losses - Record all unrealized gains and losses that are non-interest related to AVR. As gains become realized see below for treatment between IMR and AVR.
-Other-Than-Temporary Impairment – If the firm has decided to sell a security with an OTTI or has decided not to retain it to recover the amortized cost, the non-interest related losses go to AVR. The interest related OTTI losses will go to IMR.
-Security Sold at a Loss without Prior OTTI – The firm will split the realized loss between IMR and AVR as appropriate, similar to how non-structured security is handled.
-Security Sold at a Loss With Prior OTTI – The firm will split the current realized loss into AVR and IMR in accordance with the analysis performed at the date of sale. However, the firm will not adjust the previous allocations to AVR and IMR that resulted from previous recognition of an OTTI.
-Security Sold at a Gain With Prior OTTI – The firm will split the gain between AVR and IMR based on interest and non-interest factors. However, the bifurcation between AVR and IMR that occurs on the date of sale may be different than the allocation that occurred at the time of the previous OTTI. The firm should not adjust the prior IMR and AVR allocations that resulted from previous recognition of an OTTI.
-Security Sold at Gain Without Prior OTTI – The firm shall bifurcate the gain into AVR and IMR portions depending on the interest and non-interest factors.

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