The Insurance perspective

2019- Volume 11

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Economic Commentary

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The year-end volatility in the markets carried over boisterously into the first quarter of 2019. Despite starting the year with a government shutdown, we witnessed a drastic bounce back in domestic equities in addition to yields on US Treasuries plunging near quarter-end.

FOMC – After the December rate hike by the Fed was not received well in the market (viewed as aggressive and hawkish), Chairman Powell revised expectations for rate hikes in 2019 down from four to two. After the first two meetings of 2019, the Fed left rates unchanged and again revised expectations for rate hikes, now to zero. That's right, the Fed is now not planning for any rate hikes this calendar year. Moreover, Powell said interest rates could be on hold for "some time" while inflation remains stable and global risks weigh on the economic outlook. Essentially, Powell and the Fed will remain patient and take a "wait and see" approach. Upon the very dovish news, stocks declined after reaching their high of the year and the 10-year Treasury fell ten basis points. Regarding the unwinding of their balance sheet, the Fed will start slowing beginning in May, reducing from $30 billion to $15 billion and cease balance sheet reductions altogether by October. Subsequently, MBS roll off will be put into Treasuries with a maturity structure that will "roughly match" current composition. As of the time of this writing, current implied probabilities actually predict a cut in the Fed Funds rate within twelve months. For now, the rate will remain constant in the 2.25-2.50% range.

US Bond Market – The first two months of the quarter were fairly uneventful with the short end of the curve trading fairly flat and the 10-year Treasury remaining consistently in the 2.6% to 2.8% range. After the Fed released their revised expectations late in the quarter, the entire curve shifted down. The three-month Treasury fell 11 basis points, the 10-year Treasury fell 16 bps and the long-end fell over 22 bps in less than two weeks. This created even more of an inverted yield curve, with the 1-month, 3-month, 6-month and 1-year Treasury yielding more than the 2-year, 3-year, 5-year and 7-year Treasuries. The plunge in yields was further fueled due to hedging in the swaps market as well as MBS managers' actions to offset convexity changes on mortgages. Bottom line, the market didn't like the Fed's hawkishness in the fourth quarter nor did it like the Fed's dovishness late in the third quarter. I attribute this to a finicky and emotionally driven market.

US Stock Market – A market correction that began in early October led the markets nearly 20% lower by late December; however, from this low the domestic equity market rallied over 20% through late March. Moreover, the majority of the correction was recovered in the rally. All things considered it was a very nice quarter for returns in the domestic equity market, especially after unattractive fourth quarter returns. The S&P 500 Index was up 13.65% and the Dow Jones Industrial Average gained 11.81% for the quarter. The NASDAQ gain led the pack with a 16.81% increase for the quarter. Although the last three months have trended much higher fairly quickly, investor confidence has been high and economic growth fairly solid so there aren't many reasons for a significant pullback at this point. However, some economists believe there is a heightened probability of a recession in the months to come which could result in a declining domestic equity market.

Summary –Fears of a potential recession have slowly increased although the market doesn't seem to mind much. We will continue watching the Fed and wait on pins and needles for a China trade deal. While the Treasury yield curve has flattened from a short-end to long-end perspective, the mid part of the curve also shifted down to a large degree within the quarter, which has created more of a "Nike swoosh" shape. I don't expect this shape to remain in place over the coming months but instead the spread differential between 2- and 10-year Treasury yields to compress.

California's Largest Utility Files for Bankruptcy

You probably saw the same headline that rocked the investment world for several months and was a topic that many insurance companies had plenty of well-warranted questions about. I wanted to walk through a little about what led to such an event and look at the situation from what we consider to be more of a political move instead of the company's going concern.

It all began with a couple little fires across the past several years, namely the Tubbs and Camp Fire, which quickly turned into massive structure incinerating blazes that claimed approximately 190,000 acres of land, 25,000 structures and unfortunately the irreplaceable lives of 107 people. Having been found the culprit of upwards of 17 additional fires in 2017, the obvious scapegoat to initially blame was Pacific Gas and Electric (PCG). Estimates of the liability across these two major fires came to over $30 billion and is where the story also gets a little more interesting. California can be considered "unique" in a lot of ways, and their regulatory framework surrounding utility companies is no different. Under the state's "reverse indemnification" rules, a utility company can be held liable for damages caused by its equipment, even if the utility company acted prudently and no proof of negligence is found. As you know, the bill was footed to PCG, with insurance companies lining up claims in hand, looking for reprieve from this situation. PCG, already burdened by the state's demands of more "green energy" solutions, had seen deterioration in its profit margin by the higher costs of such contracts with their customers already paying some of the highest utility rates in the nation. Under this current framework, the company could be looking at this situation repeatedly in the future with every fire caused by any of its equipment, which covers over 70,000 square miles of rugged terrain and forests that is in place to serve its 16,000,000 customers, even if caused by an "act of God" such as an earthquake or landside.

So, despite an enterprise value of over $53 billion, various attempts of private interest groups, including hedge funds, to provide liquidity for the liabilities and even the discovery that private electrical equipment started the Tubbs fire clearing PCG of a significant portion of the anticipated liabilities, PCG still proceeded with its Chapter 11 bankruptcy also known as a reorganization. News since the filing has been positive for the utility with the state seemingly understanding the utility shouldn't bear the entire burden on its own, with a recently released state report claiming that any real solution to the cost allocation "shares the burden broadly among stakeholders," which would include ratepayers, investors, insurance companies and local governments. The report also highlights potential changes to the reverse indemnification framework and adopting a more "fault based standard."

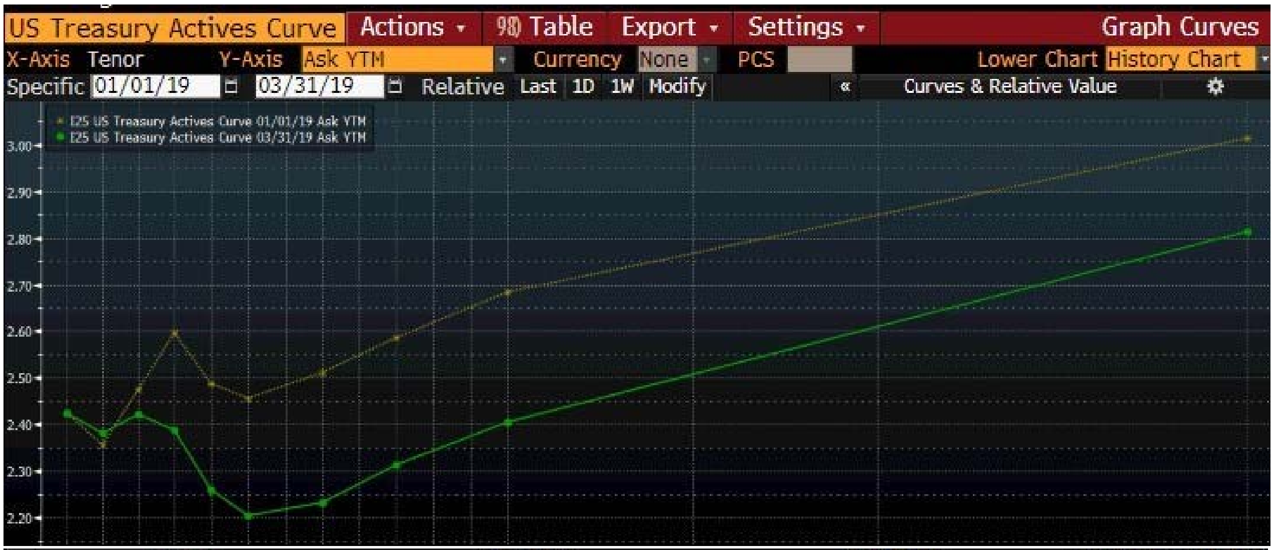
While a bankruptcy is no laughing matter, I think looking at things from this angle helps ease a little of the concern regarding the defaulted security and I think the market agrees with this viewpoint. The most widely traded issue, PCG 6.05 03/01/2034 that traded down in the mid $70's during the week of the announcement in January, has since traded back over par, which is generally unheard of for an NAIC 6 security. This gives bondholders the ability to sell and remove the concern off the books without substantial impacts. Those with higher risk tolerances can continue to hold, given various widely held opinions of a full recovery for bondholders.

Interest Rate Spreads

As of: 3/29/2019

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	2.4	2.551	0.151	2.649	0.249	2.931	0.531	3.689	1.289
2yr	2.27	2.532	0.262	2.673	0.403	3.02	0.75	4.146	1.876
3yr	2.21	2.531	0.321	2.69	0.48	3.081	0.871	4.425	2.215
5yr	2.23	2.674	0.444	2.857	0.627	3.338	1.108	4.891	2.661
7yr	2.31	2.875	0.565	3.089	0.779	3.66	1.35	5.33	3.02
10yr	2.41	3.128	0.718	3.387	0.977	4.004	1.594	5.755	3.345
20yr	2.63	3.709	1.079	4.025	1.395	4.724	2.094	6.547	3.917
30yr	2.81	3.78	0.97	3.957	1.147	4.599	1.789	6.661	3.851

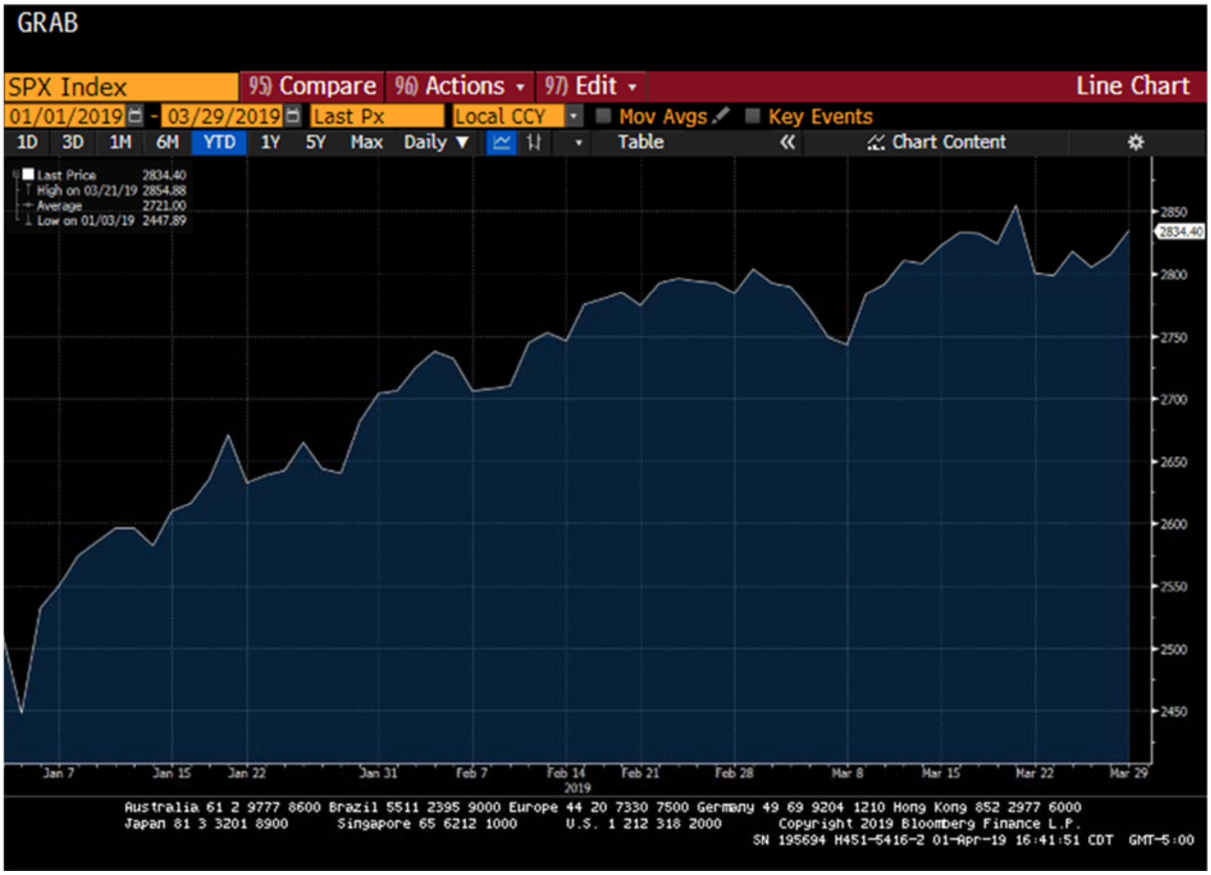
US Treasury Yield Curve



	Tenor	03/29/19	01/01/19	03/29/19-01/01/19
11)	1M	2.424	2.425	-0.1
12)	3M	2.381	2.355	2.6
13)	6M	2.422	2.475	-5.3
14)	1Y	2.387	2.596	-20.9
15)	2Y	2.260	2.488	-22.8
16)	3Y	2.205	2.456	-25.2
17)	5Y	2.233	2.511	-27.8
18)	7Y	2.313	2.586	-27.2
19)	10Y	2.405	2.684	-27.9
20)	30Y	2.814	3.015	-20.0

*Graphs obtained from Bloomberg Professional Service

S&P 500 Index


GRAB
SPX Index
95) Compare
96) Actions
97) Edit
Line Chart
01/01/2019 - 03/29/2019
Last Px
Local CCY
Mov Avgs
Key Events
1D 3D 1M 6M YTD 1Y 5Y Max Daily
Table
Chart Content
Last Price 2834.40
High on 03/21/19 2854.88
Average 2721.00
Low on 01/03/19 2447.89
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2834.40
2800
2750
2700
2650
2600
2550
2500
2450
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Jan 15
Jan 22
Jan 31
Feb 7
Feb 14
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Feb 21
Feb 28
Mar 8
Mar 15
Mar 22
Mar 29
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 2019 Bloomberg Finance L.P.
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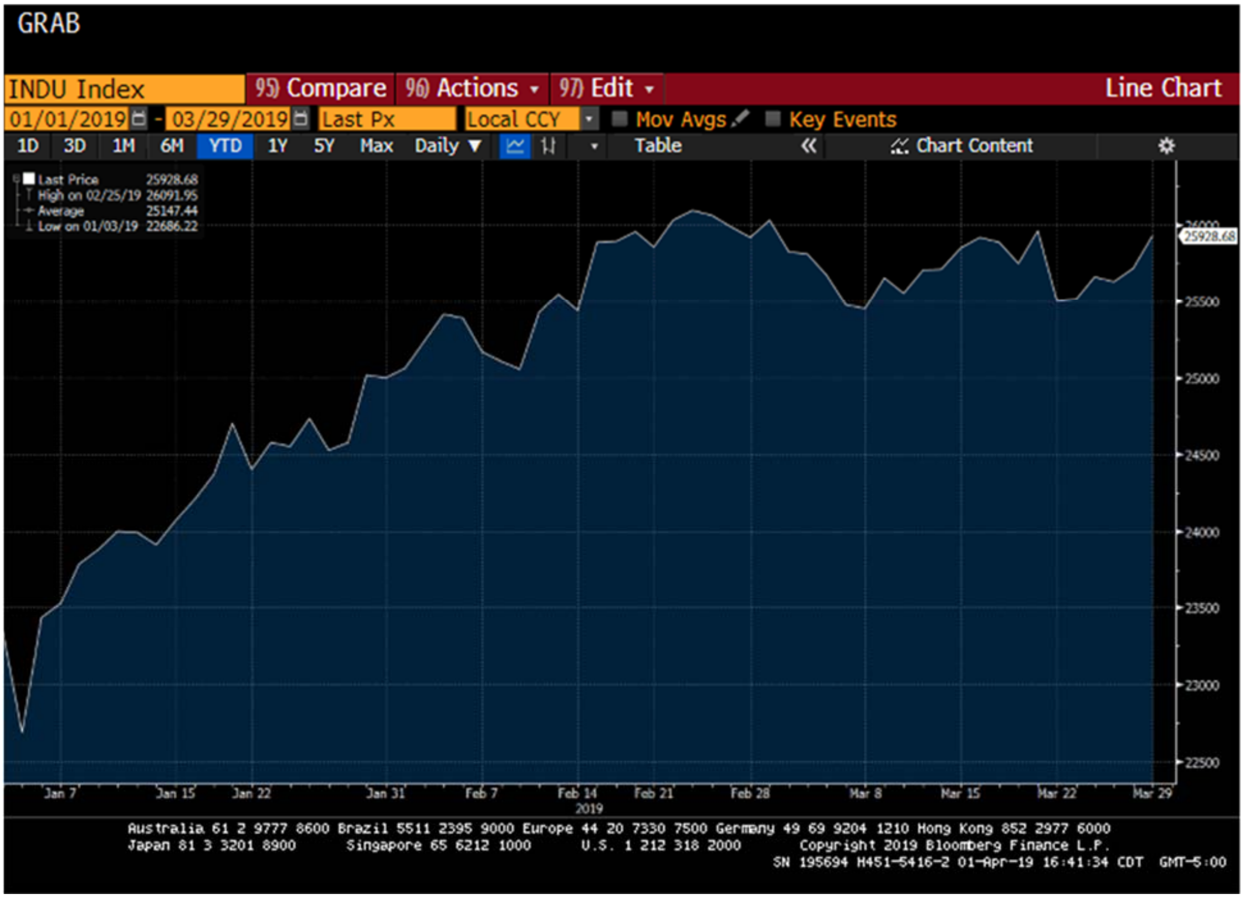
Dow Jones Industrial Average



NAIC SSAP 48R and 26R Update

Regi McCabe-Gossett, Senior Insurance Accountant

The following items are being discussed by the NAIC's Statutory Accounting Principles Working Group (SAPWG) for 2019. While these items may not be implemented until later in the year it's important to be aware of how they may impact your institution.

There have been questions surrounding the proper treatment of multiple lots of the same loan-backed security. Agenda item 2018-03 has been developed to help clarify the accounting and treatment for these securities that fall under *SSAP No. 48R – Loan-backed and Structured Securities* (LBSS). Many of the questions surround whether securities acquired at different purchase prices can report NAIC designations under a "weighted average" method under the "financial modeling" or "modified filing exempt" process.

Due to requirement of using the scientific method of amortization, the purchase date, along with the purchase price, are inherent parts of this method. This is will typically result in different amortization values for different lots of the same CUSIP. Therefore, different lots can result in a different NAIC designation for the same CUSIP. Also, keeping with the current method for calculating AVR and IMR, reporting entities are required to keep track of the different lots separately, which means reporting the different designations. However, as the calculations of RBC for these securities is an automatic pull from investment schedules, there is no mechanism that allows for reporting entities to change the NAIC designation for RBC purposes. So, if one lot of the same CUSIP is an NAIC 1, while the other lot is an NAIC 3, the entity can't show that on their RBC. Instead, the weighted average assuming equal division, NAIC 2, is used to determine RBC for the entire investment.

On April 6th, the NAIC staff and SAPWG recommended that a reporting entity should either 1) report the entire investment in a single reporting line at the lowest NAIC designation that would apply to a lot or 2) report the investment separately by purchase lot in the investment schedule. However, not to take power away from states, if a commissioner opposes the separate reporting by lot, then the reporting entity would default to reporting the entire investment at the lowest NAIC designation. Further discussion, along with final modification of SSAP 48R, will likely occur later in 2019.

Another agenda item for 2019 has to do with prepayment penalties. As you may already know in 2017 SSAP 26R was updated with guidance on how to treat prepayment penalties, which went into effect in 2018. This changed how investment income from bonds liquidated prior to their scheduled maturity is reported. The new formulas were:

- Realized gain/(loss) = Difference between Par and BACV
- Investment income = Consideration less Par

The issue brought to the SAPWG committee was that when consideration is less than par, the allocation to investment income for the prepayment penalty misrepresents that there has been a large realized gain and a large realized loss. Under the new guidance recommended by the SAPWG, prepayment penalties for securities where the call price is less than par would be calculated as stated below:

- Realized gain/(loss): Fair Value less Book
- Investment income: Consideration less Book

This treatment is consistent with how the reporting would have occurred if the bond had been amortized under the yield-to-worst concept. For a visual on how this impacts the financial reporting please see Exhibit 1 below.

Please keep in mind these are proposed modifications to SSAP 26R and SSAP 48R and have not yet been approved and/or implemented by the NAIC. Parkway Advisors will continue to monitor the discussion and write a follow up to this article when updates occur.

EXHIBIT 1: Current and proposed treatment of bonds where Call Price Less Than Par

Current Treatment	
Par	100
BACV (Book)	25
Consideration	26

Gain (Par - Book)	75
Income (Consideration - Par)	-74
Net Financial Impact	1

Proposed Treatment	
Par	100
BACV (Book)	25
Consideration	26
Fair Value (FV)	25

Gain (FV - Book)	0
Income (Consideration - Book)	1
Net Financial Impact	1

* Information from tables comes from SAPWG exposure draft 2018-32

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