Investment Institute Macroeconomics

Insurance investment outlook 2023: Adapting to the higher-for-longer paradigm

1 December 2022

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Key points

- With inflation at multi-decade highs central banks have swiftly tightened monetary policy to restore price stability
- Credit and equity markets have seen material adjustments while liquidity has deteriorated across asset classes
- Difficult financial conditions point to recessions in 2023 with potential for further volatility and market downturns
- Higher rates and risk premia offer an opportunity to rebuild book yields, but volatility disturbs asset liability matching and can hurt capital ratios
- Insurers need to be agile in the way they manage their balance sheet and capture investment opportunities.

A shift is underway

For more than a decade financial markets enjoyed benign economic conditions: Muted inflation, central bank interventionism, abundant liquidity and low interest rates. The ‘lower for longer’ and ‘hunt for yield’ narratives prevailed and insurers adjusted their asset allocation and investment strategies accordingly, in order to keep matching their liabilities, mitigate the dilution of book yields and preserve operating earnings.

A major trend has been active participation in the rapidly-developing private markets to harvest an illiquidity premium, including lower-quality private credit investments. In the core assets space insurers have also gone down the credit spectrum in their search for yield and lengthened asset duration through longer-dated high-quality bonds. Low market volatility also permitted greater use of interest rate derivatives[1] to hedge duration and convexity gaps at a reasonable cost.[2]

COVID-19 presented a massive exogenous shock to the global economy. It quickly revived market volatility which hurt investment portfolios. Supply-side disruptions and a significant rebound in consumer demand conspired to produce supply bottlenecks and an inflation rate not seen for decades. But a common view in 2021 was for a gradual absorption of the pandemic shock and for a normalisation of global supply chains, allowing for sustained growth, a slowdown in inflation and a digestible pace of monetary policy normalisation.

[1] A derivative is an arrangement or product, the value of which derives from, and is dependent on the value of, an underlying asset.

[2] The convexity gap measures the relationship between bond yields and prices.

The inflation spike was deemed temporary by many but the Ukraine crisis, together with lingering supply chain disruptions and tight labour markets, pushed prices even higher. The conflict led to steeper energy and food costs and more persistent inflation which had been turning more broad-based as high input costs were passed to consumers and labour markets remain tight.

With inflation at multi-decade highs and its future path clouded by uncertainty, developed market central banks accelerated the pace of policy normalisation in a bid to restore price stability. Interest rates have increased at an unprecented and uneven pace across markets while risk premia have widened across the board. Global growth has been slowing and a consensus is building that the ongoing tightening of financial conditions, in combination with deteriorating real income and profit margins, point to recessions in 2023, with natural gas shortages adding to the risk in Europe.

Central banks are strongly committed to delivering on their price stability mandates and acknowledge the possibility of a hard landing. US Federal Reserve Chair Jerome Powell indicated in November that the peak rate was likely to be higher than previously expected and the Fed would not cut prematurely. As labour market resilience and inflation persistence lead to the Fed delivering more restrictive policy, Powell acknowledged the path to a soft landing had "narrowed".

In its latest Global Financial Stability Report the International Monetary Fund (IMF) warned "the global economic outlook has deteriorated materially" and "global financial stability risks have increased" with "the balance of risks… significantly skewed to the downside".[3] The IMF added that "financial vulnerabilities are elevated in the sovereign and nonbank financial institution sectors, while market liquidity has deteriorated across some key asset classes" and that "there is a risk… that a rapid, disorderly repricing of risk in coming months could interact with, and be amplified by, preexisting vulnerabilities and poor market liquidity".

Calling the peak

The unexpected decline in US inflation in October could support the idea that inflation has peaked and most of the monetary tightening is behind us. But there is still a high degree of uncertaintly over inflation's future path and over rates and about whether the landing will be soft or hard. Multiple drivers, both cyclical and structural, such as inflationary pressures related to energy transition and changes in the nature of globalisation suggest rates will remain higher for longer – and volatile. Risks are skewed to the downside and asset prices could adjust further, while liquidity is likely to suffer.

However, higher interest rates and wider risk premia mean better opportunities for insurers to rebuild book yields and boost investment returns. At the same time they can potentially preserve the quality and lower beta profile of their credit allocation, especially as current entry points had not been seen for many years and as the next (stable or easing) phases in the monetary cycle could support fixed income markets. But there is a major paradigm shift underway with a new combination of risks that insurers will have to closely manage – and to which they must be ready to adapt.

Inflation will reach a peak sooner or later, tempered by central bank policies, recessionary pressures and potentially relaxed supply chain disruptions. But expectations are for inflation to stay high for some time yet – fuelled by structural shifts such as the energy transition and supply chain restructuring. Inflation is centre stage and it can hurt property and casualty and health insurance companies particularly, as it can impact both assets and liabilities and ultimately the profitability and solvency of insurers. In a report published in September, Fitch Ratings warned that sustained inflation and rising rates could deteriorate the insurance sector's outlook, with non-life insurers carrying a high proportion of long-tail business being the most affected.[4] As outlined in last year's insurance investment outlook, inflation risk should be factored into the asset and liability management framework and can call for potential adjustments of strategic and/or tactical asset allocations.

More dynamic asset liability management required

Soaring inflation and uncertainty on its future path has translated into volatile interest rates which now trade at levels not seen for years. Rising interest rates can have a positive impact on insurers' capital position, notably for life insurers with long-dated liabilities and a negative duration gap as the value of technical provision decreases relatively more than the assets, while reinvestments can be made at higher yields.

Conversely, non-life insurers who tend to have a positive duration gap can be squeezed by a combination of increasing claims and interest rates. Uncertainty is still high and we expect interest rates to remain higher and volatile for longer. Duration and convexity gaps, and therefore capital ratios, can be highly sensitive to interest curve movements, requiring insurers to strengthen their asset liability management and hedging

[3] Global Financial Stability Report: Navigating the High-Inflation Environment, IMF, October 2022

[4] European Insurance Sector Outlooks at Risk from Inflation, Rising Rates, Fitch Ratings, September 2022

strategies.[5] The entry into force of the new IFRS 17 standards in 2023 will reinforce the need to closely manage discounting effects on both sides of the balance sheet.[6] In an environment where liquidity has become scarcer in bond markets and where rising rates have led to massive pockets of unrealised losses in fixed income portfolios, derivatives-based strategies can prove useful to manage asset portfolios and duration gaps.

Interest rate derivatives are a valuable asset liability management tool but require financial engineering and execution expertise. They also require a robust liquidity and collateral management framework.

Liquidity is a valuable asset but at what price?

Global economic uncertainty and cautious investor behaviour have significantly increased market volatility and deteriorated market liquidity conditions across asset classes. The recent stress faced by UK pension funds has put liquidity risk back on the stage. In its latest Global Financial Stability Report the IMF provides evidences of much lower market depth and warns "deteriorating market liquidity conditions may pose risks to financial stability" and "as central banks proceed with balance sheet normalisation and investors continue to reprice risk, market liquidity conditions may deteriorate further".[7]

Most insurers have long-term liabilities with stable liquidity needs but they should consider two dimensions of liquidity risk. First, they should make sure they maintain a sufficient level of cash and high quality assets available to fullfill commitments vis-à-vis policyholders and counterparties to derivatives agreements. Second, they should assess the impact of increased scarcity of liquidity in bond markets on their ability to manage portfolios and to deploy investment plans which optimise risk-adjusted investment returns and liability matching.

In aggregate, European insurers have a relatively small exposure to derivatives but the use of interest rate swaps[8] has significantly increased over recent years and this could continue amid a growing need to strengthen asset and liability matching in a context where liquidity has become tighter in fixed income markets.

The European Insurance and Occupational Pensions Authority (EIOPA) is closely monitoring liquidity risk as margining requirements, which apply to new trades concluded after the applicable phasing in deadlines, will progressively become the norm. In its latest risk dashboard EIOPA qualifies the level of liquidity risk as "medium" and reports a relatively stable median liquidity ratio of 47% – as of end-June 2022.[9] But the range is wide across insurers and in its latest Financial Stability Report,[10] EIOPA shows evidence that short-term volatility could potentially increase the pressure on the liquidity position of insurers stemming from margin calls.[11]

Another indicator that we think life insurers should closely monitor is lapse rate (a measure of life policy redemption). EIOPA reports in its risk dashboard that the distribution of lapse rates in life business shifted upwards, with a median at 3.4% at end-2021 (+0.4% versus the previous quarter). It stresses that a recession impacting real disposal income, combined with a strong increase in yields, could increase lapse risk further.

Exhibit 1: US Treasury Bid-Ask Spread and Market Liquidity Index (Basis points)

Sources: Bloomberg; JPMorgan; IMF. Note: The market liquidity index is the average of Bloomberg US Government Securities Liquidity index and the JP Morgan US Treasury total root mean square error (RMSE) index. IMF Global Financial Stability Report – October 2022

The above has multiple implications for insurers, starting with a potential questioning of their strategic asset allocation. They have been monetising their liquidity for years through growing allocations to private markets but tightening financial conditions (including quantitative tightening) should reduce liquidity further and normalise liquidity premiums across public markets, while insurers might see their liquidity needs grow.

A strategic allocation to private assets is certainly justified but the price of liquidity should be reassessed in this new market environment. We think insurers should also develop a robust liquidity and collateral management framework which would

[5] Asset liability management seeks to manage the use of assets and cash flows to reduce the risk of loss from failing to pay liabilities on time.
[6] IFRS refers to International Financial Reporting Standards. IFRS 17 relates specifically to insurance contracts.
[7] Global Financial Stability Report: Navigating the High-Inflation Environment, IMF, October 2022
[8] An agreement where one stream of future interest payments is exchanged for another based on a specified principal amount.
[9] Risk Dashboard, EIOPA, October 2022
[10] Financial Stability Report, EIOPA, June 2022
[11] A margin call is a request for additional funds from a financial counterparty where assets held as collateral for a debt fall in value.

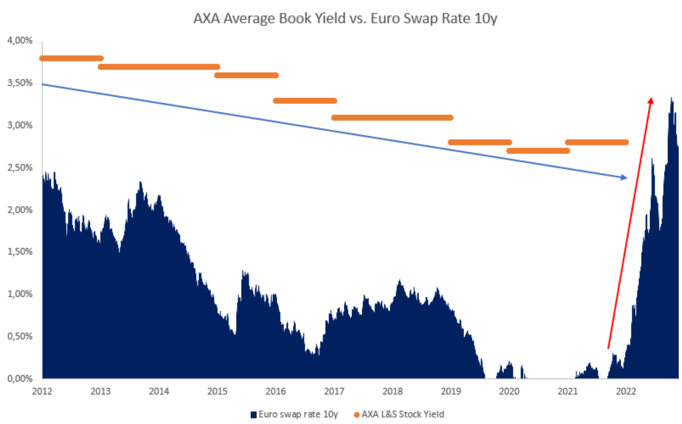
allow them to optimise cash buffers and pockets of eligible collateral, generate the required liquidity without being forced sellers and minimise opportunity costs related to margin calls or client redemptions.

Flexibility and agility can make a difference

The other side of liquidity risk pertains to insurers' ability to manage fixed income portfolios and deploy investment plans which optimise risk-adjusted investment returns and liability matching. With investment-grade corporate bond yields at levels not seen for years, insurers have a huge opportunity to rebuild book yields, but with liquidity conditions deteriorating they should be very selective and make sure they can buy and hold as it may prove challenging to exit a position in case of stress. They should be more agile to ensure they can deploy their credit investment plans in a timely manner while maintaining the quality of their exposure and consider their liability profile, especially as higher funding costs could reduce the supply of long-dated corporate bonds.

An efficient partial use of interest rate derivatives for liability matching is one way to gain agility as credit investments can be more agnostic of the liability profile and insurers can exploit a broader set of opportunities, including in the short duration space where credit risk and capital adjusted returns may be higher. Insurers have a strong home bias and diversifying further away from their domestic market could potentially provide more leeway. There are hedging techniques which allow for a proper treatment of foreign currency-denominated investments under capital regimes and accounting standards.

Exhibit 2: Average book yield on AXA Life & Savings portfolios versus 10-year euro swap rate (%)



Source: AXA Group final year results presentations from 2012 to 2021

Another way to improve the ability to invest or reallocate significant volumes in credit markets in a timely manner is portfolio trading. This is not new but has evolved over recent years, supported by the growth of fixed income exchange traded funds (ETFs) and the digitalisation of the process. Referring to the lapse risk, and as illustrated in Exhibit 2, a key challenge is to see the yield on existing portfolios lagging the current market rates, deteriorating competitiveness further vis-à-vis new saving products and exacerbating the liquidity risk. Rebuilding book yields will be key and clearly calls for the willingness and ability to respond quickly to market conditions.

Catch the train and rebuild book yields

Profit margins have already been hit by the challenging macroeconomic environment and higher input and funding costs. Corporate credit spreads have significantly widened over the last months amid reduced risk appetite, higher volatility and tighter liquidity. While earnings forecasts have already been revised downwards, sustained inflation combined with further monetary tightening and recessionary headwinds should continue to put pressure on the corporate sector. Rating migrations and bankruptcies have already increased compared to last year and major rating agencies report a stormy credit outlook for the months ahead with further credit fundamentals deterioration, downgrades and defaults.

This augurs further market volatility and potential further asset prices adjustments. But once we get to a position where inflation and interest rates peak and where monetary policy is expected to enter into a new – stable or easing – phase, the risk return in credit markets will improve, especially as current yields and spreads are at combined levels not seen since the global financial crisis. We believe insurers could take this opportunity to rebuild book yields in their matching portfolios by accelerating and increasing their investment-grade credit investments as issuers with sound fundamentals and robust business models also trade at historically high levels of spread and yield.

In the current environment credit selectivity and credit risk diversification are paramount. We think insurers could consider focusing on quality investment-grade issuers with sound fundamentals and build more resilience in their matching portfolio by diversifying away from their domestic market. In its latest Financial Stability Report EIOPA reports that European insurers have increased their allocation to lower quality bonds and continue to have a strong home bias in their corporate bonds portfolio.[12] All regions, sectors and issuers will not react the same way to the economic headwinds and expanding the investment universe not only has the potential to reduce systemic risk but may also broaden the scope of issuers with

[12] Financial Stability Report, EIOPA, June 2022

sound credit and environmental, social and governance (ESG) fundamentals while increasing the ability to deploy capital in a timely manner. Selecting best-in-class companies across markets can also potentially enhance risk-adjusted book yields while reducing a portfolio's carbon footprint as the set of sustainable opportunities becomes wider. Higher diversification should also reduce the impairment risk under the new Expected Credit Loss model under IFRS 9.[13]

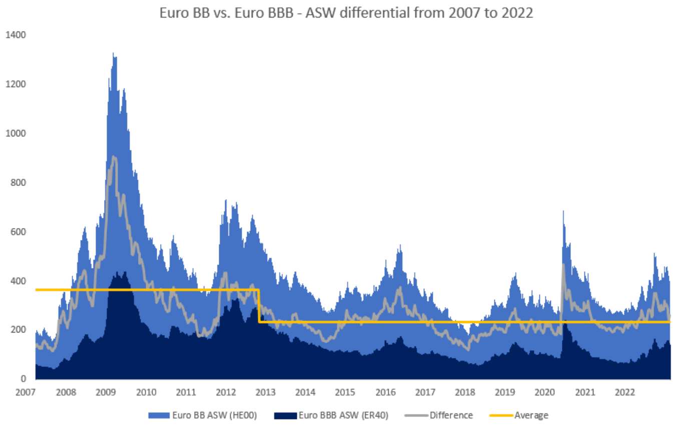
The risk is to let it go and it may be tempting at some point to front-load investment-grade credit investments to extract maximum value and boost investment returns. This can be achieved through well-designed credit derivatives or repo-based investment strategies allowing to manage the exposure to credit beta more dynamically and to catch opportunities in a timely manner.[14] This approach may require making concessions to other parameters and notably, a temporary increase of the capital charge related to spread risk and of the volatility in the financial statement, but the extracted value can then be recycled to boost investment income and operating earnings.

Stepping into riskier asset classes

In its Global Financial Stability Report the IMF warned the combination of high inflation, lower revenues and tighter financial conditions would further worsen leverage metrics and increase the volume of debt-at-risk "resulting in losses at bank and non-bank financial institutions with significant exposures to highly indebted non-financial firms, a development that could amplify the shock". The IMF reports the results of a sensitivity analysis showing that small and mid-sized companies as well as issuers in the emerging market space would be the most vulnerable to a combined shock to revenues, inputs and funding costs.

In our view, there is still too much uncertainty to re-enter the high-yield, emerging market debt and equity markets as recessionary headwinds should materialise into further downgrades, defaults and asset price adjustments. Current spread-implied default rates are below forecasts for high-yield markets and, as illustrated by Exhibit 3, the current asset swap spread differential between euro-denominated BB-rated debt and euro BBBs is still very close to the average observed since former European Central Bank President Mario Draghi's "whatever it takes" pledge in July 2012 and well below the average observed in the era before quantitative easing.[15] But as we reach the peak in inflation and interest rates and turn into the next phase of the monetary policy, high-yield and emerging market debt are likely to become increasingly attractive and could represent a real investment opportunity.

Exhibit 3: Asset swap differential between Euro BBs and Euro BBBs from 2007 to 2022



Source: Bloomberg – AXA IM – asset swap spreads on HE00 (BB) and ER40 (BBB) Bloomberg indices from December 2006 to November 2022.

We think insurers should definitely monitor signals of an inflection point and get ready to push the button. One way to mitigate the risk of being too much ahead of a future compression in spreads and yields could be to select more defensive strategies. Short-duration bond strategies in high-yield and emerging debt markets may allow for a reduction in volatility and drawdown risk while capturing potentially significant excess investment income.

Short-duration credit strategies may also exhibit a better liquidity profile. Insurers can also progressively broaden the universe of their core portfolio to take advantage of the compression on high-quality BB-rated bonds, buying high quality companies at a discount, and subsequently benefiting from a significant spread tightening. BBs are usually underrepresented in standard high yield strategies, leaving some room for investors seeking to exploit these opportunities.

Insurers' allocation to emerging market debt remains marginal while it represents a growing source of diversification and incremental return. It is also in the developing world that the climate transition is at stake with a massive financing gap that absolutely has to be filled, as urged once again at COP27 in Egypt. But here the financial industry is being active in

[13] IFRS 9 specifies how an entity should classify and measure financial assets as well as hedge accounting and impairment requirements.
[14] Repo is short for repurchase agreement and generally refers to overnight lending. 'Beta' refers to market returns.
[15] 'Spread' refers to the difference between the bid and the ask price of a single security. It can also refer to the difference in price between securities.

partnering with public institutions and state-backed agencies to develop blended climate-finance solutions.

We expect this trend to develop further, including with innovative investment strategies embedding financial guarantee agreements. Such guarantees offer an absorption of first credit losses in a predefined bond portfolio, which may be able to significantly reduce volatility and drawdown risks and can exhibit a relatively interesting return on capital under Solvency II.[16] These innovative investment solutions should enable institutional investors, and thus insurance companies, to grow their allocation to emerging fixed income markets and potentially catch sustainable investment opportunities in a risk-controlled manner.

A year of execution

In our previous insurance investment outlook one key point was that 2022 would be a transition year from a regulatory perspective. We believe 2023 will be a year of execution with IFRS 9 and IFRS 17 standards effective from January. Not only will these standards have an impact on how assets and liabilities are classified and measured, with direct implications on the net income's composition and volatility but they may also require adapting the way assets portfolios are organised and structured. These standards are generally more economic and market consistent and insurers will have to navigate unprecedented macroeconomic and market conditions while factoring in how investment decisions would translate in financial statements.

[16] Solvency II is the European Union's insurance regulatory regime for all member states

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