New Inflation Rate High of 7.5% Could Affect Real Return on Investments

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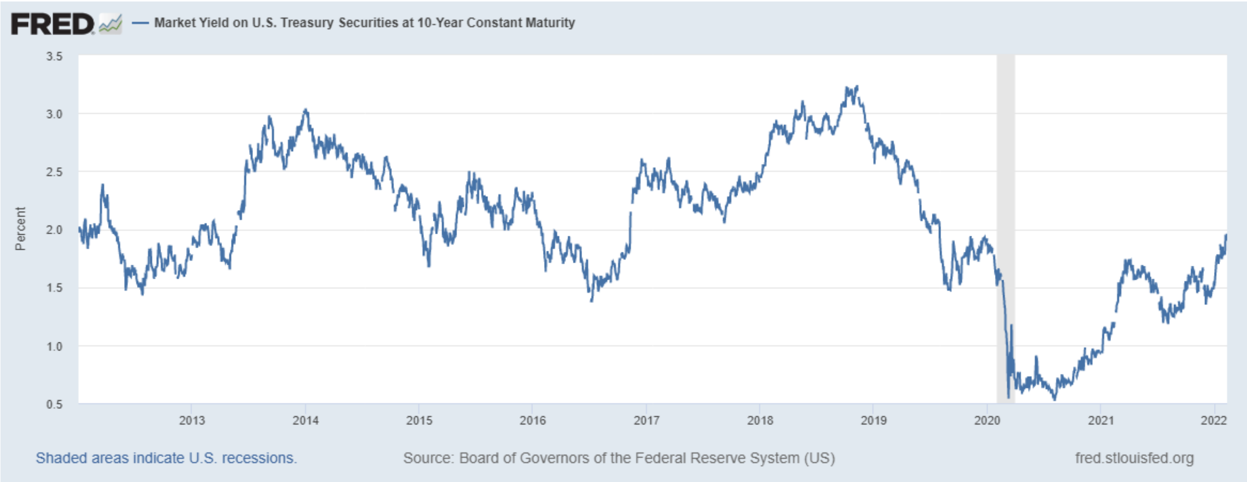
With inflation reaching a new 40-year high of 7.5% in January, real returns on investments are at risk of losing value if the return on the investments does not outpace the inflation rate. The inflation rate has reached its highest level since February 1982 due to strong consumer demand and pandemic-related supply chain constraints limiting supply. In particular, prices for used cars are said to be driving overall inflation, increasing 40.5% in January from a year earlier; food prices have increased 7%, representing the sharpest rise since 1981; and restaurant prices have also increased the most since the early 1980s. In addition, oil supply issues have caused crude oil prices to increase sharply, reaching $91/barrel (West Texas Intermediate Crude) as of Feb. 11. As a result, gas prices remain elevated.

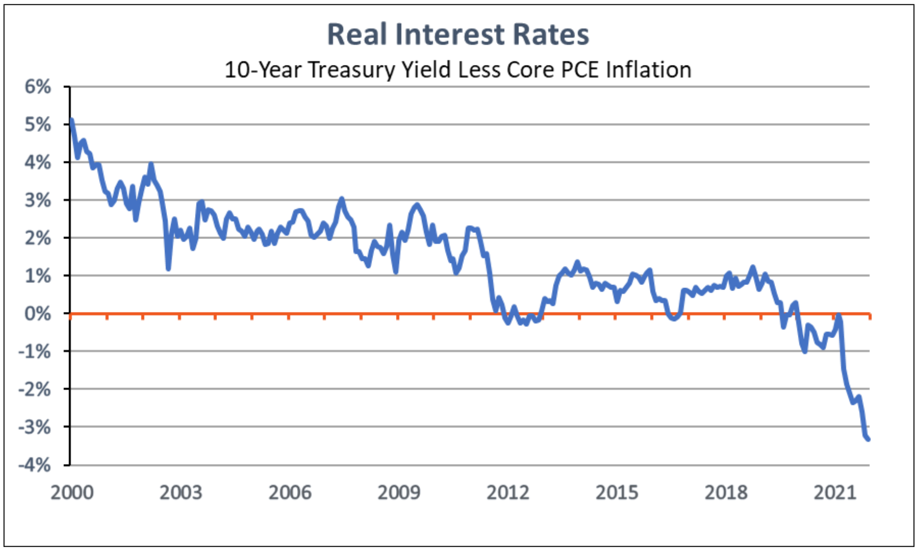
Financial market reactions include a drop in stocks and an increase in bond yields. The Standard & Poor's 500 index (S&P 500) has been volatile in 2022, declining approximately 8% on a year-to-date basis as of Feb. 11. The yield on the 10-year U.S. Treasury has been rising in 2022, reflecting expectations that the Federal Reserve will begin to raise interest rates soon, perhaps more aggressively than originally expected. The 10-year yield began 2022 at 1.63% and closed at 2.03% on Feb. 10, exceeding 2% for the first time since 2019.

Graph 1: U.S. 10-Year Treasury Yield, Jan. 1, 2012–Feb. 9, 2022



While inflation had been relatively tame until recent months, real interest rates in the U.S. briefly dipped below zero in 2012 and 2016, but they have been consistently negative since 2020. Inflation was not a significant factor in 2020, but nominal interest rates were historically low, or below 1%, as the Federal Reserve adopted an accommodative policy to encourage economic activity during the COVID-19 pandemic. The spike in inflation is playing a bigger role in the recent sharp decline in real interest rates in late 2021 and 2022. Real interest rates are nominal interest rates less the inflation rate. Chart 1 shows the yield of the U.S. 10-year Treasury less inflation as measured by the Core Personal Consumption Expenditures (PCE) Index, which excludes food and energy categories because they tend to be volatile. Real interest rates in the U.S. dipped to -3.3% as of December 2021.

Chart 1: Real Interest Rates in the U.S., June 2000–December 2021

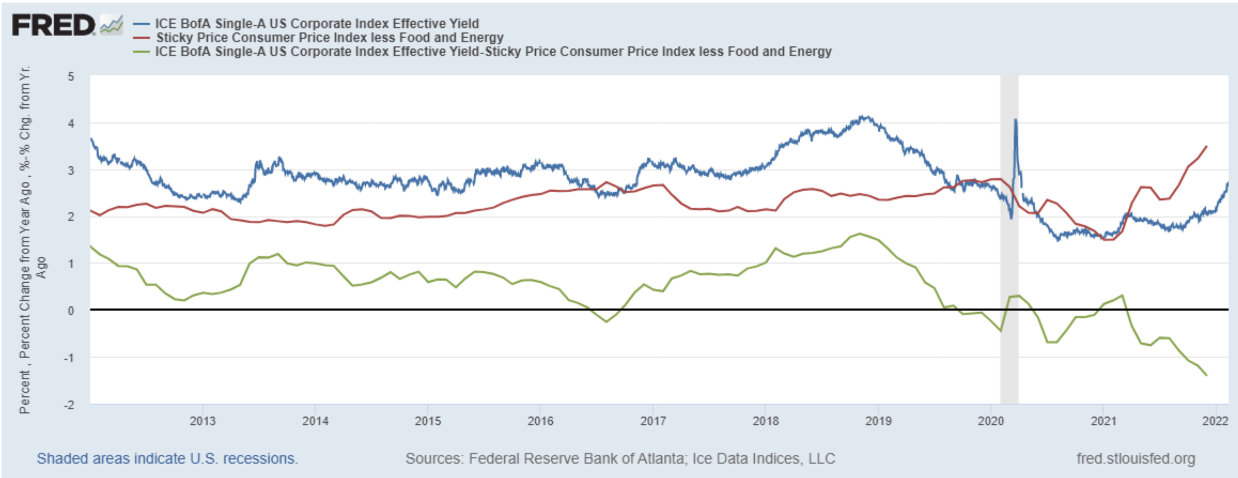


Source: www.fred.stlouisfed.org , Bureau of Economic Analysis

While U.S. insurance companies have adapted to investing in a world of low interest rates, they are now also facing the challenge of investing in a high inflationary environment whereby yields may not be providing adequate returns on investment on an inflation-adjusted basis. Using a similar approach to estimating real interest rates in Chart 1, we estimate how corporate bond yields are holding up against high inflation.

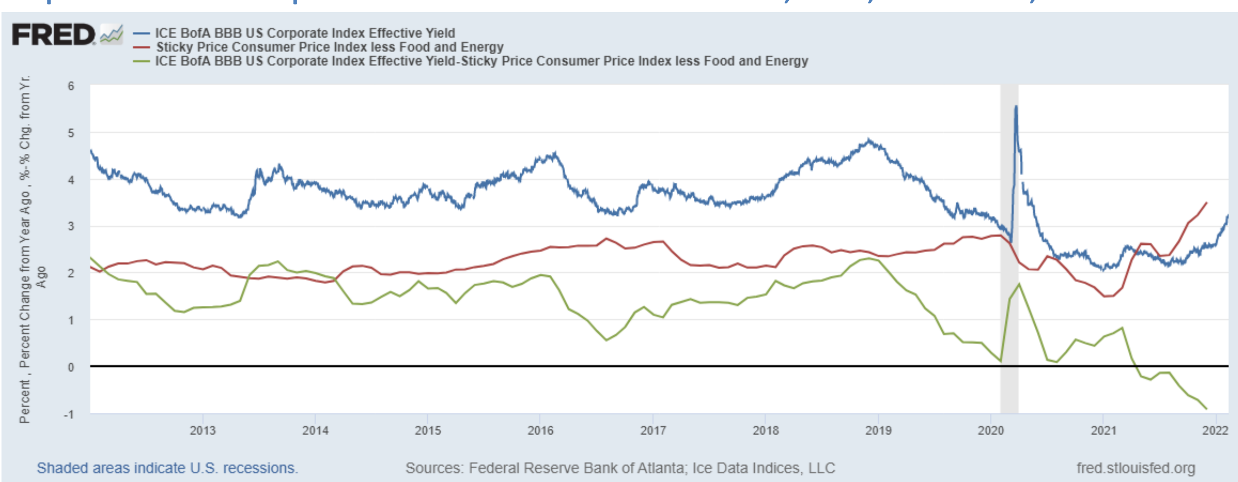
Using the St. Louis Federal Reserve Economic Data (FRED), Graph 2 shows the effective yield on A-rated corporate bonds (blue line) versus the Sticky Price Consumer Price Index (or Core CPI, excluding food and energy) as a measure of inflation (red line). The difference between the two measures (green line) can be viewed as a simplistic proxy for a “real yield” or an inflation-adjusted bond yield. Note that the proxy for the real yield of A-rated corporate bonds temporarily dipped below zero in 2020, but now it appears to be consistently negative given the rise in inflation—reaching a low of -1.4% in December 2021.

Graph 2: A-Rated Corporate Bond Effective Yield and Core CPI, Jan. 1, 2012–Feb. 9, 2022



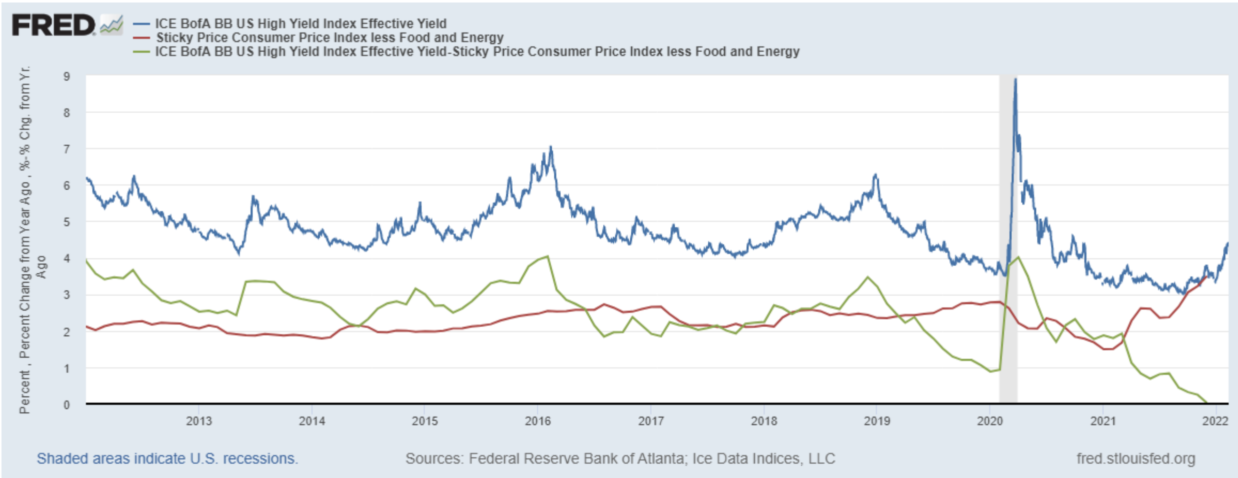
Graph 3 shows similar data for BBB-rated corporate bonds. With BBB yields generally higher than A yields, the difference between the two measures has been negative for a shorter period of time. Real yields did not turn negative until May 2021, and they dipped to almost -1% in December 2021.

Graph 3: BBB-Rated Corporate Bond Effective Yield and Core CPI, Jan. 1, 2012–Feb. 9, 2022



And finally, Graph 4 shows the data for BB-rated corporate bonds. While BB-rated bond yields dipped to record lows in mid-2021, inflation was not a significant factor at the time. Yields have recovered from the lows, but with inflation rising, inflation-adjusted yields for BB-rated bonds have declined and are dangerously close to zero.

Graph 4: BB-Rated Corporate Bond Effective Yield and Core CPI, Jan. 1, 2012–Feb. 9, 2022



In addition to the continued low interest rate environment, inflation has become another challenge to insurers in the current investment climate. Even lower credit quality corporate bonds, like BB-rated bonds, are facing negative yields on an inflation-adjusted basis. Assuming high inflation levels persist, real bond yields are at continued risk of being relatively low or even negative depending on the credit quality rating. Expected and upcoming interest rate hikes might alleviate some of this strain, both in terms of easing inflationary pressures and boosting corporate bond yields overall.

The NAIC Capital Markets Bureau will continue to monitor market events pertaining to this topic and report as deemed appropriate.

Questions and comments are always welcome. Please contact the Capital Markets Bureau at CapitalMarkets@naic.org.