



The NAIC Capital Markets Bureau monitors developments in the capital markets globally and analyzes their potential impact on the investment portfolios of U.S. insurance companies. Previously published [NAIC Capital Markets Bureau Special Reports](#) are available via its webpage and the NAIC archives (for reports published prior to 2016).

Year-End 2021 Capital Markets Wrap-Up

December 2021

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Executive Summary

- The U.S. economy has made a solid recovery as COVID-19 vaccinations were made increasingly available, social distancing began to ease, and businesses gradually reopened.
- The International Monetary Fund (IMF), among other forecasters, expects the U.S. economy to grow by about 6% in 2021, after contracting about 3.4% in 2020.
- Inflation reached a 39-year high of 6.8% in November following a strong rebound from the COVID-19-induced recession.
- The 'stronger for longer' inflation rates prompted the Federal Reserve to accelerate the tapering of its asset purchases and to suggest the likelihood of three rate hikes in 2022.
- The 10-year U.S. government bond yield has generally ranged between 1.3% and 1.7% in 2021, increasing from less than 1% in 2020, due in part to fiscal stimulus aiding in economic recovery.
- Credit spreads have been muted in 2021 given robust global economic growth, favorable funding conditions, and overall solid corporate performance despite higher costs and supply disruptions.
- Global stocks have achieved relatively high returns; in the U.S., the Standard & Poor's (S&P) 500 posted seven record closing highs in November alone.
- The price of oil reached a seven-year high of \$85 per barrel in 2021 as demand for oil normalized while the global supply market tightened.

A Pandemic-Affected Economy Begins to Recover

As COVID-19 vaccines were made widely available in 2021 and quarantines and social distancing began to ease, markets continued to recover. However, cross-border supply-chain issues have arisen, resulting in higher input costs and prices. Inflation concerns are also prominent, as a strong rebound from the COVID-19 induced recession resulted in inflation persisting for longer than originally anticipated. Geopolitically, tensions remain with China and, separately, with Russia. In the U.S., the labor market is



improving, with the unemployment rate declining to 4.2% in November 2021, compared to 6.7% in November 2020.

Gross domestic product (GDP) was -3.4% in the U.S. at year-end 2020, and the IMF's World Economic Outlook dated October 2021 forecasts U.S. GDP to increase by about 6% in 2021 and 5.2% in 2022 (see Table 1). Globally, the IMF predicts 5.9% GDP growth in 2021 and 4.9% in 2022, while there was a -4.4% contraction for 2020. According to the IMF, "[m]ultilateral efforts to speed up global vaccine access, provide liquidity and debt relief to constrained economies, and mitigate and adapt to climate change remain essential."¹

Table 1: The IMF's Global and Regional Growth Forecasts (% Change)

	2020	Projections	
		2021	2022
World Output	-3.1	5.9	4.9
Advanced Economies	-4.5	5.2	4.5
United States	-3.4	6.0	5.2
Euro Area	-6.3	5.0	4.3
Germany	-4.6	3.1	4.6
France	-8.0	6.3	3.9
Italy	-8.9	5.8	4.2
Spain	-10.8	5.7	6.4
Japan	-4.6	2.4	3.2
United Kingdom	-9.8	6.8	5.0
Canada	-5.3	5.7	4.9
Other Advanced Economies ²	-1.9	4.6	3.7

Source: IMF World Economic Outlook, October 2021.

Inflation: Transitory or Here for Longer?

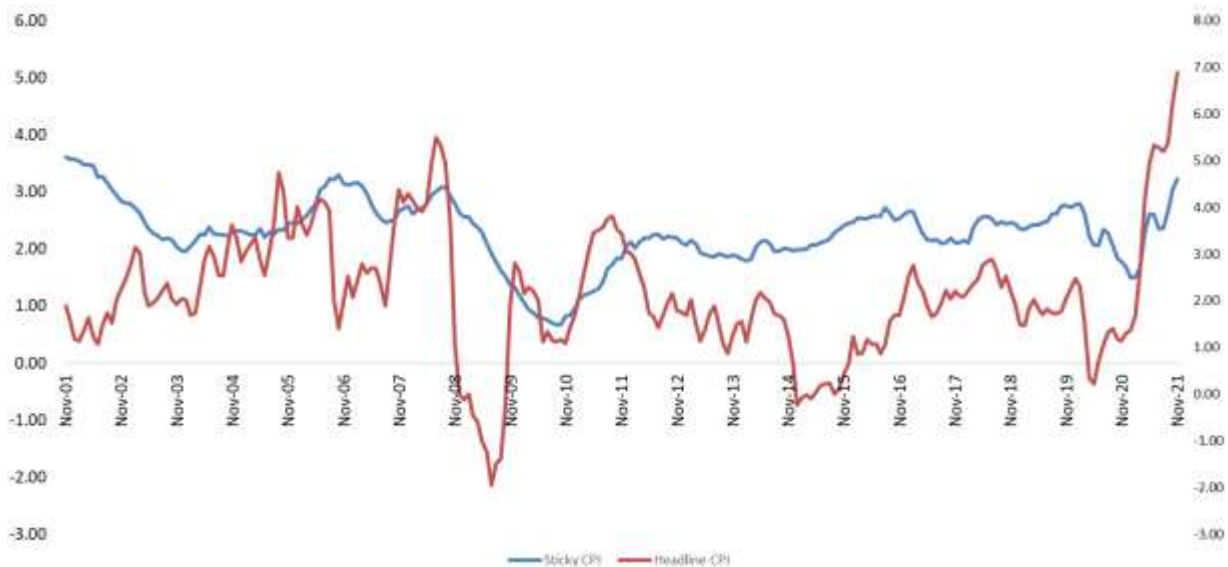
Inflation is measured as the percentage change in the price of a basket of goods and services from the prior year. In early 2021, market participants expected a modest and temporary rise in inflation as global economies began to rebound from when prices were depressed because of the impact of COVID-19. However, price pressures have been stronger and have persisted for longer than originally anticipated, not only in the U.S., but in other major economies as well.

In the U.S., inflation began the year at 1.4% in January—as measured by the Consumer Price Index, or headline CPI (see Graph 1). As the economy re-opened, inflation rose quickly in the following months, and reached a 39-year high in November at 6.8%, due in part to strong consumer demand (particularly for automobiles, furniture, and appliances) outpacing supply constraints, along with a shortage of available workers in the workforce and higher commodity prices. The inflation rate has increased faster than the 2% annual gains that the Federal Reserve generally aims for, and it has not moderated as



expected by economists. Many factors have caused inflation to rise, including an increase in service-industry prices, rising rents after weak 2020 prices, and a sharp increase in food and fuel prices, to name a few.

Graph 1: Headline vs. Sticky CPI, Nov. 2001- Nov. 2021



Source: Federal Reserve Bank of St. Louis

According to the Federal Reserve, sticky, or core, CPI is “calculated from a subset of goods and services included in the CPI that change price relatively infrequently” and excludes food and energy. Thus, the term ‘sticky’ or ‘core’. For this reason, sticky CPI is considered to be a gauge for expectations about future inflation. So, for example, if the price of a sticky good or service rises, then inflation is expected to increase, and the reverse is true if the price of a sticky good or service decreases. Sticky CPI exceeded headline CPI for all of 2019 and 2020, but it is now trending below as inflation accelerated in 2021. As of early November, the sticky CPI was almost 4%.

On Dec. 15, the Federal Reserve announced that it would keep short-term interest rates near zero, but it is prepared to raise them at least three times in 2022 to stave off high inflation until labor market conditions are consistent with maximum employment. In addition, quantitative easing, in the form of monthly purchase of U.S. Treasury and mortgage-backed securities, will be tapered to \$60 billion per month from \$90 billion beginning in January 2022; the bond-buying program is expected to end by March 2022.

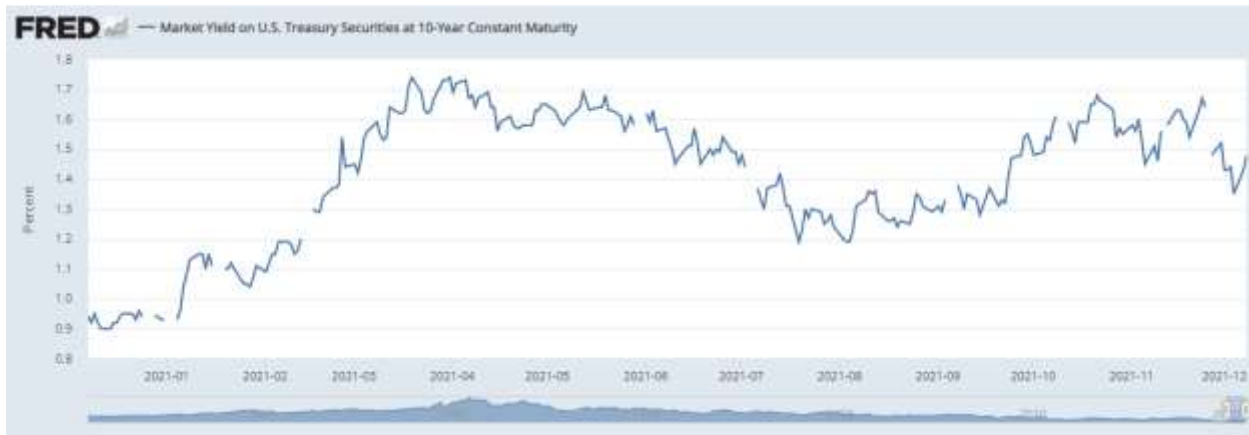
If high inflation persists, policy adjustments that are viewed as more aggressive than anticipated, or unanticipated altogether, are a significant risk to the health of global financial markets.

Government Bond Yields



U.S. Treasuries are considered a safe haven by investors, and they are attractive during times of economic stress. At the end of March 2021, the 10-year U.S. Treasury yield reached a high of 1.75% year-to-date (YTD) as investors bet that a reopening of the U.S. economy would bring strong growth and inflation. As the year progressed, the 10-year Treasury yield fluctuated but remained within a 1.3% to on- 1.7% range. Economic recovery continued in 2021 but with a “weakened momentum,” according to the IMF. As of early December 2021, the yield on the 10-year Treasury was 1.5%, compared to 0.9% at the same time last year (see Graph 2). As of year-end 2020, U.S. insurers had exposure to about \$280.6 billion in U.S. government bonds, including 10-year U.S. Treasuries, which was about 6% of total cash and invested assets, a decrease from \$283 billion at year-end 2019, which was about 4% of total cash and invested assets.

Graph 2: U.S. 10-Year Treasury Yields, YTD December 2021



Source: Federal Reserve Bank of St. Louis, Board of Governors of the Federal Reserve System (U.S.).

Credit Spreads Muted in 2021 Despite New Variants

The credit environment in 2021 has been largely positive with fewer downgrades and lower default rates than 2020. The credit market has benefitted from robust economic growth, favorable funding conditions, and overall solid corporate performance—offset by risks such as the ongoing COVID-19 pandemic, new variants, and persistently high inflation resulting in market volatility and uncertainty. Lockdowns and quarantines, while more focused and less extreme, continue to negatively affect many market sectors; travel, leisure, cruises, and fitness sectors are still under stress, according to S&P Global Ratings (S&P).

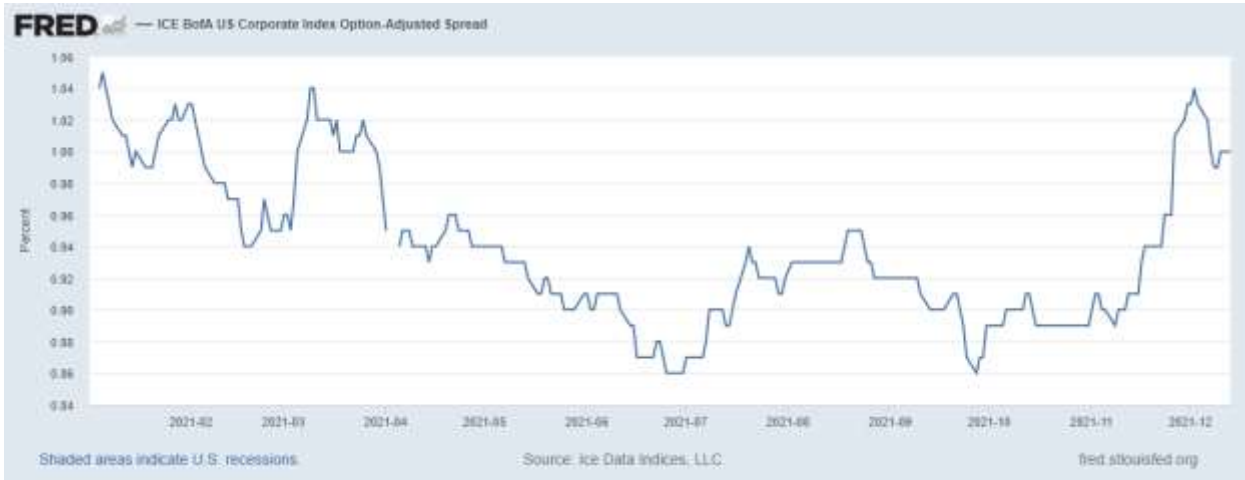
Following the volatility in 2020, corporate bond spreads have been muted in 2021 given the favorable credit conditions. In addition, companies have generally been able to manage supply disruptions and higher costs well.

Investment grade spreads have traded at around 100 basis points (bps) or below for most of the year (see Graph 3). They began the year at 104 bps and dipped down to 86 bps by the end of June as



economic activity continued to accelerate in the first half of the year. Then, renewed coronavirus uncertainties related to the Delta variant and inflation concerns led to spreads bouncing between 86 bps and 95 bps over the next several months. The most recent Omicron variant and the resulting market reaction and volatility resulted in spreads widening from the mid-90s just before the Thanksgiving holiday to 104 bps in just one week. Spreads have since recovered modestly to close at 100 bps as of Dec. 13, yet near the widest levels of the year.

Graph 3: Investment-Grade Corporate Credit Spreads, YTD December 2021



Source: Federal Reserve Bank of St. Louis, Board of Governors of the Federal Reserve System (U.S.).

High-yield spreads were somewhat more volatile than investment-grade spreads in 2021 but were tighter overall with high-yield issuers continuing to benefit from abundant market liquidity and access. Spreads began the year at just under 400 bps and dropped to about 300 bps in July, the lowest level since before the financial crisis (see Graph 4). In the second half of the year, spreads widened as investors repriced growth and inflation assumptions and new COVID-19 variants worried market participants. Spreads widened from about 300 bps to 340 bps in August following the Delta surge; then, with the news of the Omicron variant, spreads widened by 50 bps in just one week to end November at 367 bps. High-yield spreads rebounded to begin December, closing at 333 bps on Dec. 13, below the pre-pandemic levels of approximately 350 bps.

**Graph 4: High-Yield Corporate Credit Spreads, YTD December 2021**

Source: Federal Reserve Bank of St. Louis, Board of Governors of the Federal Reserve System (U.S.).

Favorable credit conditions are reflected in current low default rates. According to S&P, the trailing 12-month speculative grade default rate in the U.S. decreased to 2.4% at the end of Q3 2021 compared to 6.7% in December 2020. This recent peak in the default rate was not as severe as other default cycles, where the default rate reached approximately 12% in 1991 and 2009, and about 11% in 2002. In its base case scenario, S&P expects corporate defaults to remain low into next year with the default rate in September 2022 projected at 2.5% as credit metrics stabilize and favorable lending conditions continue. Risks to the projected default rate and the corporate outlook in 2022 include persistent high inflation, heightened input costs and supply disruptions leading to profit margin pressures, potentially rising financing costs, and additional coronavirus variants adding another layer of uncertainty to the economic and credit recovery.

The U.S. insurance industry's exposure to corporate bonds totaled \$2.6 trillion, or 35% of total cash and invested assets, as of year-end 2020. The U.S. insurance industry's corporate bond portfolio predominantly consists of higher credit quality companies that have greater financial flexibility to withstand the negative credit effects of macroeconomic shocks. Credit quality deterioration was nevertheless evident in the year-end 2020 bond portfolio given the broad-based economic and credit impact of the COVID-19 pandemic. Investment-grade bonds, or those with reported NAIC 1 or NAIC 2 designations, accounted for 93.9% of total bonds, declining from 94.9% at year-end 2019.

Equity Markets – Record High Valuations

Global stocks steadily increased as the economy began a slow recovery due in part to COVID-19 vaccination availability and the reopening of businesses and leisure travel. COVID-19 is no longer the biggest “street fear,” according to S&P,² but it could have a large impact on equity markets if the

² S&P Global, *U.S. Equities Market Attributes*, Nov. 2021.



Omicron or next variant is worse than expected. However, the bigger influence is inflation, which continues to be affected by supply and worker shortages, as well as high consumer demand.

The S&P 500 YTD return through mid-December 2021 was 24.3%, having been on a relatively steady incline for most of the year (see Graph 5). In comparison, total return for the S&P 500 in 2020 was 18.4%. The STOXX Europe 600 returns also steadily increased during 2021 and had a YTD return of 18.7% through mid-December, after reaching a high of about 22% a month prior. In addition, the Chicago Board Options Exchange (CBOE) Volatility Index (VIX) experienced a spike of 54% on Nov. 26, one of the five largest single-day volatility moves in the last three decades. However, the VIX was down 4.79% YTD as of Dec. 15, due partly to the Federal Reserve’s approval of a faster wind-down of its bond-buying program and an anticipated move to raise interest rates three times in 2022 to stave off inflation. Economic data shows that in November, consumer prices increased at the fastest annual rate since 1982.

Graph 5: S&P 500 YTD December 2021, % Returns



Source: Wall Street Journal.

In terms of S&P 500 sectors, all 11 experienced positive returns YTD as of Dec. 14. The largest three sector returns were energy (+46.8%), real estate (+36.4%), and technology (+32.5%). In comparison, for the same time period last year, four sectors experienced negative returns: real estate (-6%), energy (-34%), financials (-7%), and utilities (-3%).

With regard to U.S. insurers’ exposure to common stock, total return YTD through November 2021 was 20.45%³ compared to 23.41% for the S&P 500 over the same time period. As of year-end 2020, U.S. insurers’ exposure to common stock was \$993 billion.

³ For state insurance regulators only, U.S. insurer equities’ monthly total returns may be accessed via StateNet.

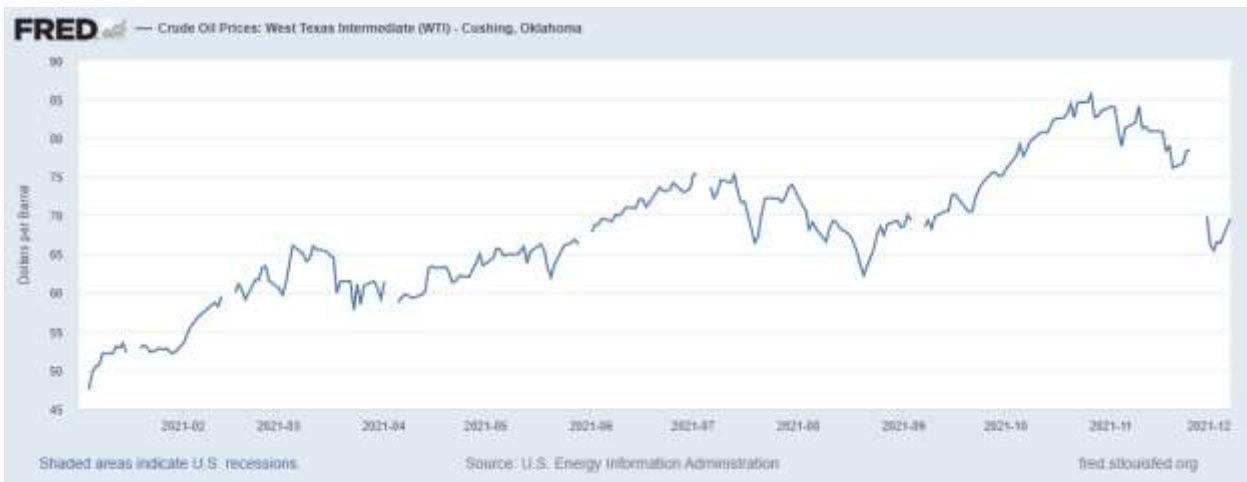


Oil Prices Rebound as the Economy Recovers

After dipping to its lowest level in more than 20 years in 2020 due to the impact of COVID-19 on the global economic outlook and oil demand and consumption, oil prices rebounded amid the continued normalization of global economies. The return of goods transportation and air travel also supported prices.

The price of West Texas Intermediate (WTI) crude oil began 2021 at approximately \$48 per barrel, just below the pre-pandemic range of \$50 – \$60 per barrel. Prices continued to increase throughout the year as demand for oil normalized, while the global supply market remained tight (see Graph 6). Oil output has slowed due to cutbacks from producing nations during the pandemic and pressure on governments to transition to cleaner energy. The price of WTI reached a seven-year high of \$85 per barrel at the end of October and then declined to \$70 per barrel as of Dec. 6.

Graph 6: Crude Oil Prices – WTI, 12 Months Through December 2021



Source: Federal Reserve Bank of St. Louis, Board of Governors of the Federal Reserve System (U.S.).

Oil and gas companies have been the most directly affected by depressed oil prices from a credit and default perspective. However, current price levels should support some credit quality stabilization and/or improvement.

The U.S. insurance industry’s exposure to oil and gas companies totaled \$105 billion in bonds and \$6 billion in common stock as of year-end 2020. The \$111 billion in oil and gas related exposure represents less than 2% of the industry’s cash and invested assets.

The Capital Markets Bureau will continue to monitor trends in the capital markets and report on any developments as deemed appropriate.



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

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