Mid-Year 2022 Capital Markets Update

June 2022
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Executive Summary

- The economic recovery the U.S. experienced in 2021 reversed in 2022, resulting in a slowdown and recessionary concerns due to continued high inflation rates, the impact of the Russia-Ukraine war, and supply chain disruptions.
- The International Monetary Fund (IMF), among other forecasters, expects the U.S. economy to grow by about 3.7% in 2022, a downward revision from its initial expectations in January, after experiencing 5.7% growth in 2021.
- Inflation has trended higher for longer and reached a four-decade high of 8.6% in June.
- The Federal Reserve raised rates by 50 basis points (bps) in May, followed by another 75 bp increase in June to balance an inflation rate reduction and avoid a recession.
- The 10-year U.S. government bond yield reached a high of 3.5% in mid-June, its highest level since 2011, due to inflation fears.
- The Treasury yield curve has shifted higher and flattened following the Federal Reserve's aggressive rate hikes as investor concerns of a recession arise.
- Credit spreads are widening amid concerns of pressures on profitability and credit quality stemming from rising interest rates and persistent inflation.
- Global stocks have declined drastically; in the U.S., the Standard & Poor's 500 index (S&P 500) entered bear market territory in June for the first time since 2020 and has posted negative returns year-to-date (YTD) in mid-June.
- The price of oil continued to climb into 2022 and reached an eight-year high of $123 per barrel in March due to the Russia-Ukraine war; demand for oil has also increased while the global supply market has tightened.

Lower Global Growth Expectations

In 2021, the global economy was recovering from the impact of COVID-19 for the most part, albeit slowly. However, progress was halted due in part to Russia's invasion of Ukraine and the sanctions that followed. In addition, according to the IMF World Economic Outlook (WEO) dated April 2022, a reprise of lockdowns in China due to a resurgence of COVID-19 cases resulted in continued supply chain disruptions.

Gross domestic product (GDP) was 5.7% in the U.S. at year-end 2021, and the IMF WEO forecasts U.S. GDP to grow 3.7% in 2022 (see Table 1), down 30 bps from its earlier prediction in January 2022. Globally, GDP growth was 6.1% in 2021, and the IMF forecasts growth to decrease to 3.6% in 2022, down 80 bps from its projection in January 2022.

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

Overview of the *World Economic Outlook* Projections
(Percent change, unless noted otherwise)

		Projections		Difference from January 2022 WEO *Update*[1]	
	2021	2022	2023	2022	2023
World Output	**6.1**	**3.6**	**3.6**	**–0.8**	**–0.2**
Advanced Economies	**5.2**	**3.3**	**2.4**	**–0.6**	**–0.2**
United States	5.7	3.7	2.3	–0.3	–0.3
Euro Area	5.3	2.8	2.3	–1.1	–0.2
Germany	2.8	2.1	2.7	–1.7	0.2
France	7.0	2.9	1.4	–0.6	–0.4
Italy	6.6	2.3	1.7	–1.5	–0.5
Spain	5.1	4.8	3.3	–1.0	–0.5
Japan	1.6	2.4	2.3	–0.9	0.5
United Kingdom	7.4	3.7	1.2	–1.0	–1.1
Canada	4.6	3.9	2.8	–0.2	0.0
Other Advanced Economies[2]	5.0	3.1	3.0	–0.5	0.1

Source: IMF WEO, April 2022.

Central banks have begun to wind down stimulus (e.g., the Federal Reserve bank raised the federal funds rate by 50 bps to a range of 0.75% to 1.0% in May and followed that with another 75 bp increase on June 15—i.e., the largest rate increase since 1994—to a target range of 1.5% to 1.75%. The Federal Reserve continues to anticipate increasing the federal funds rate range a few more times this year. While another 75 bp rate increase is a possibility this year, it is not expected to be common for all future rate hikes. Keeping at this pace would be the most aggressive rate-increasing trend since the 1980s, all to return inflation to its 2% target. In addition, the Federal Reserve has announced plans to reduce the $9 trillion asset portfolio, whereby almost $50 billion in U.S. Treasuries and mortgage bonds will roll off as they mature between June and August 2022, and $95 billion in U.S. Treasuries and mortgage bonds will roll off each month after that. The Federal Reserve is challenged with avoiding a recession while taking appropriate measures to calm inflation.

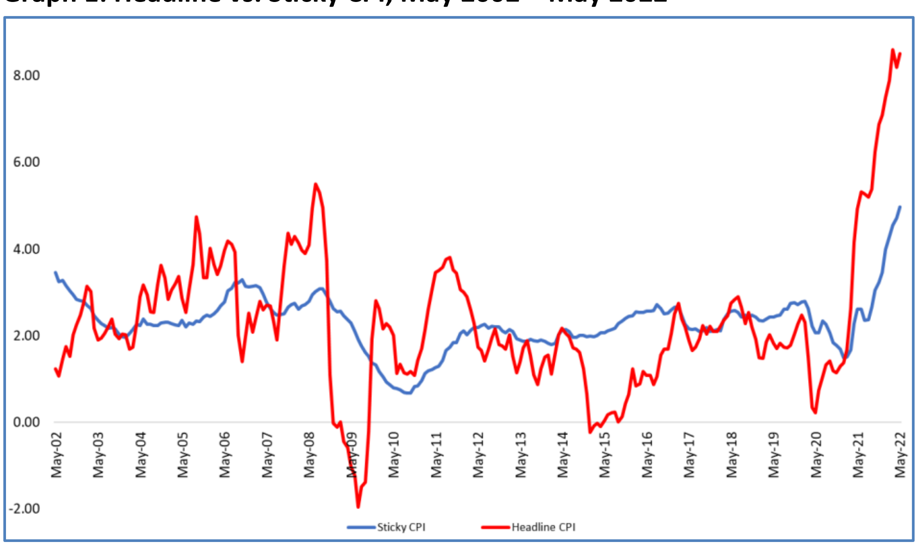
As the global economy continues to be affected by the Russia-Ukraine war, ongoing supply chain disruptions, and high inflation, investors are concerned about the impact of rising rates on an already fragile economy. As a result, the financial markets have been volatile, evidenced by stock markets falling into bear market territory—i.e., down 20% from a recent high—and government bond yields surpassing previous highs. In addition, on June 16, U.S. mortgage rates reached their highest level in 13 years, at 5.78% for a 30-year fixed mortgage average rate; this was also the largest weekly mortgage rate increase since 1987. Note that U.S. mortgage rates are closely tied to the U.S. 10-year Treasury yield.

Is Stagflation a Possibility?

In the U.S., inflation, as measured by the Consumer Price Index (CPI), has been elevated since mid-2021, setting new record highs almost every month (see Graph 1). As of May 2022, U.S. inflation reached another new four-decade high of 8.6% due in part to continued low interest rates and monetary policy measures to address the COVID-19 pandemic's economic impact. The main contributors to the price increase in May were shelter, gasoline, and food. Inflation has remained high longer than many economists anticipated, increasing much faster than the 2% annual gains that the Federal Reserve generally aims for. The combination of slowing economic growth with rising prices has, in turn, increased the risk of stagflation; i.e., when growth stalls but inflation raises prices.

According to the World Bank's Global Economic Prospects report published in June, "compounding the damage from the COVID-19 pandemic, the Russian invasion of Ukraine has magnified the slowdown in the global economy, which is entering what could become a protracted period of feeble growth and elevated inflation… [t]his raises the risk of stagflation." While the World Bank expects global inflation to moderate next year, it believes the inflation rate will remain above inflation targets in many economies. 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.

Graph 1: Headline vs. Sticky CPI, May 2002 – May 2022



Source: Federal Reserve Bank of St. Louis.

According to the Federal Reserve, sticky, or core, CPI is viewed as a gauge for expectations about future inflation. 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. After two consecutive years of sticky CPI exceeding headline CPI (in 2019 and 2020), it was trending below headline CPI throughout 2021, and as of May 2022, sticky CPI was about 5%.

Government Bond Yields Close At Highest Level Since 2011

U.S. Treasuries are considered a safe haven by investors, and they are attractive during times of economic stress. However, bond yields have risen, and prices have fallen significantly following successive federal fund rate hikes by the Federal Reserve.

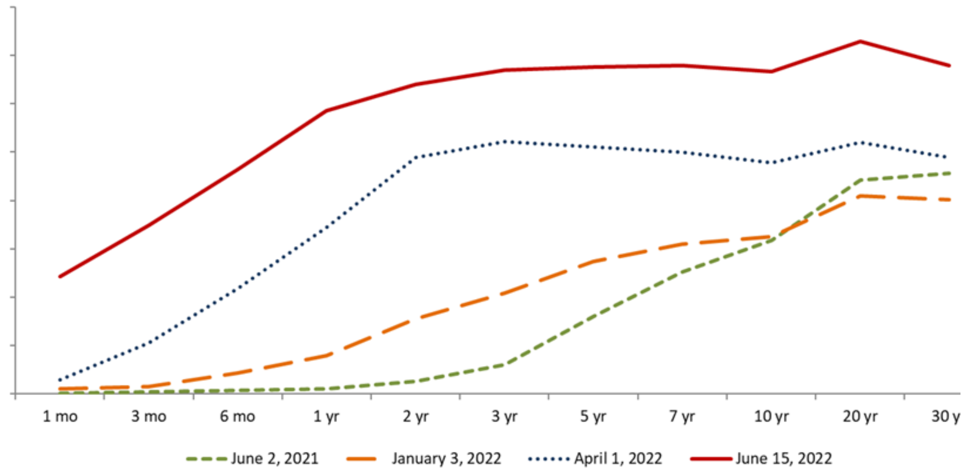
The 10-year U.S. Treasury began 2022 at about 1.6% and has fluctuated, but it reached 2% in late March and has been upward trending since (see Graph 2). On June 14, the 10-year U.S. Treasury yield closed at its highest level since April 2011, at 3.5%, due in part to inflation fears. In addition, the two-year U.S. Treasury yield, at 3.36%, increased 0.641 percentage points over the past seven trading sessions leading up to June 13, marking the biggest seven-day yield gain since 2001. However, treasuries rallied thereafter due to recession concerns with the 10-year and two-year yields settling at approximately 3.1% and below 3%, respectively.

Graph 2: U.S. 10-Year Treasury Yields, 2017 – June 2022

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

The shape of the Treasury yield curve generally provides insight into the market's expectations for interest rates, as well as economic activity. As of June, the yield curve has shifted higher and flattened compared to the beginning of the year and the last year. The Federal Reserve's recent aggressive actions have resulted in the higher Treasury rates and a flattening of the yield curve, as many investors believe higher rates will push the U.S. economy into a recession. The yield curve also inverted briefly in mid-June, which market participants view as a recession signal.

Graph 3: U.S. Treasury Yield Curve, June 2021 – June 2022



Source: U.S. Department of the Treasury (Treasury Department).

As of year-end 2021, U.S. insurers had exposure to about $316.3 billion in U.S. government bonds across various maturities, or about 6% of total cash and invested assets. This was an increase from $280.6 billion at year-end 2020, but it was unchanged as a percentage of total cash and invested assets.

Credit Spreads Widen Amid Market and Economic Uncertainty

The dynamics of the credit market have also shifted following geopolitical uncertainty, persistent inflationary pressures, tightening monetary policies, and lingering COVID-19 concerns. These factors are pressuring credit quality, and corporate credit spreads are generally wider in 2022 compared to 2021 as a result.

Investment grade (IG) spreads began the year under 100 bps and gradually rose over the first two months as investors were concerned about the impact of heightened inflation on credit (see Graph 4). Following the Russian invasion of Ukraine, IG spreads climbed to 152 bps in mid-March but recovered to 115 bps by early April. However, with the U.S. equity markets in turmoil and near bear market levels during May, IG spreads gapped out again to 155 bps on May 20—the widest level since June 2020 when the world was in the midst of the pandemic. Following a brief recovery, IG spreads revisited the widest levels of the year as the equity markets entered bear market territory in June.

Graph 4: IG Corporate Credit Spreads, June 2021 – June 2022

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

High-yield (HY) spreads are typically more volatile than IG spreads, particularly in times of markets' stress when investors generally shy away from risky assets. They began 2022 near 300 bps, significantly below the pre-pandemic levels of approximately 350 bps, but gradually approached that level over the next few weeks amid inflationary pressures (see Graph 5). After reaching 421 bps in March following the onset of the Russia-Ukraine war, HY spreads recovered to 327 bps in early April. However, they spiked again to almost 500 bps on May 24 with equity market weakness. There was then a brief recovery before HY spreads climbed back to over 500 bps in June as equities continued to sell off into a bear market, closing at 517 bps on June 16, the widest level in almost two years.

Graph 5: HY Corporate Credit Spreads, June 2021 – June 2022

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

While issuers have benefited from favorable lending conditions like abundant market access and liquidity, financing conditions are tightening in 2022 as higher interest rates and yields are making it more expensive to raise capital. According to S&P Global Ratings data, global bond issuance volumes declined by 19% YTD through April 2022 compared to last year, with the majority, or 90%, issued by IG companies. The HY market is facing greater challenges, with YTD issuance down approximately 70%, as investor cautiousness has led to a risk-averse sentiment.

The U.S. insurance industry's exposure to corporate bonds totaled $2.8 trillion, or 35% of total cash and invested assets, as of year-end 2021. The credit environment in 2021 was largely positive, with fewer downgrades than the record numbers in 2020. As such, the credit quality of U.S. insurance companies' bond portfolios stabilized in 2021. HY bonds, or those with reported NAIC 3 Designations and below, decreased marginally to 6% of total bond exposure in 2021 from 6.1% in 2020. IG bonds, or those with reported NAIC 1 or NAIC 2 Designations, accounted for 94% of total bonds, relatively unchanged from 93.9% at year-end 2020.

Equity Markets – With a Dip into Bear Market Territory, Volatility Continues

The S&P 500 entered bear market territory on June 13—the first time since 2020—due mostly to fears that inflation could trigger the Federal Reserve to implement aggressive rate increases because of continued high inflation. Globally, stock markets have been experiencing volatility due to continued high inflation, the Russia-Ukraine war, supply chain issues, and anticipating larger than usual interest rate hikes. Some equity indices have not achieved positive returns thus far this year, after experiencing double digit growth in 2021.

The S&P 500 YTD return through mid-June was down 20% (see Graph 6), after having experienced a 26.6% return in 2021. For the one-year ending mid-June, the S&P 500 contracted by about 12%. The STOXX Europe 600 index (STOXX 600) was down by about 15% YTD in mid-June; in comparison, in 2021, it returned about 16.7% as Omicron rates declined and fears over the spread of the COVID-19 variant subsided. For the one-year ending mid-June 2022, the STOXX 600 contracted by about 10%. In addition, measuring equity market volatility, the Chicago Board Options Exchange (CBOE) Volatility Index (VIX) reached 92.62% YTD through June 16. This suggests that a high value of uncertainty is being priced into the equity markets, in particular the S&P 500.

Graph 6: S&P 500 YTD June 2022, % Returns

Source: The Wall Street Journal.

In terms of S&P 500 sectors, all but one of the 11 experienced negative returns YTD as of June 14; energy achieved a YTD return of 50.62%. The largest three sector contractions were consumer discretionary (-33.41%), communication services (-31.54%), and technology (-28.07%).

Regarding U.S. insurers' exposure to common stock, total return YTD through May 2022 was -10.85%[1] compared to -13.85% for the S&P 500 over the same time period. As of year-end 2021, U.S. insurers' exposure to common stock was $1.1 trillion.

Oil Prices Surge to Record Levels

Oil prices have reached new highs following the Russian invasion of Ukraine in February as Russia was one of the largest oil and gas exporters in the world. In the first quarter of 2022, oil prices exceeded $100 per barrel for the first time since 2014 and have continued to rise. Prices are expected to remain at elevated levels given continued geopolitical uncertainty, demand trending upward, and a lack of near-term supply growth.

The price of West Texas Intermediate (WTI) crude oil began 2022 at approximately $77 per barrel and surged to $123 per barrel in early March amid the Russia-Ukraine war (see Graph 7). The price of WTI remained at elevated levels into mid-June, at eight-year highs of almost $120 per barrel. However, oil prices have since fallen to below $110 per barrel amid concerns that central bank efforts to fight inflation will slow economic growth and hurt demand for oil and fuel.

[1] For state insurance regulators only, U.S. insurer equities' monthly total returns may be accessed via StateNet.

Graph 7: Crude Oil Prices – WTI, 2014 – June 2022

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

While significant demand destruction resulting from the COVID-19 pandemic weakened the financial performance and credit quality of the energy sector in prior years, oil and gas companies are now benefiting from higher oil prices. The U.S. insurance industry's exposure to oil and gas companies totaled $89 billion in bonds and $13 billion in common stock as of year-end 2021. The $102 billion in oil and gas-related exposure is a decline from $111 billion in exposure as of year-end 2020 and 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.