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Viewpoint

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The Risks of 2023 – And a Path Forward

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Welcome to 2023, a year featuring an exhaustive list of threats to markets and investors. What's an insurer to do?

Insurance companies are facing significant portfolio allocation challenges at a time when many others are scrambling to do the same thing: find alternatives to offset risk. There are tried-and-true methods as well as new ideas, but what still works and what needs to be revisited?

Conning offers our views on the major challenges for insurance portfolios, the risks they pose, and how insurers might address them.

The Challenges

(IR) Interest rate risk – (CR) Credit Risk
(EQ) Equity Risk – (L) Liquidity strain

U.S. Policy	Risks
The U.S. Federal Reserve's (the Fed) inflation fighting seriously jolted fixed income markets, driving rates to 5% from near zero. New money rates have crested above portfolio book yields for many companies but unrealized losses limit rebalancing opportunities and crush total returns. Broader economic effects could crimp earnings of corporate bond and stock issuers, straining liquidity and raising asset risk.	***IR, CR, EQ, L***
The recent banking crisis was eased in the near term by prompt actions from the Fed, the Federal Deposit Insurance Corporation and a consortium of large banks, but lending may still be disrupted for commercial real estate and smaller businesses.	***IR, CR, L***
The dysfunctional Congressional debt-ceiling battle threatens market stability and growth, now made worse by the bank bail-out spending, a crisis in turn caused by the Fed's interest rate policy.	***IR***
The 2024 election campaign season will soon dominate the news cycle, with many candidates proposing policies to attract attention and address problems. Both interest rate and equity markets will react to calls for expansionary fiscal policy, making the Fed's job harder and spooking markets with fears of aggressive tax changes.	***TBD***

Geopolitical	Risks
Reversing several decades of pro-growth trends, we now have global stresses such as superpower conflicts, de-globalization and constricted supply chains, the rise of privacy and content moderation offsetting benefits of expanding broadband, a steady migration away from shareholder value management, and stubborn inflation.	***CR, EQ, L***
Erratic U.S. policy-driven volatility in global energy markets was brought to a head by April's OPEC+ crude oil supply cuts.	***CR, EQ***
Tragic news continues to emanate from the Russia-Ukraine front and tensions are rising between NATO and Russia and its allies.	***IR, EQ***

Managing Exposure to Risks

We have closed out a very challenging period for debt and equity markets resulting from tightening monetary policy across the globe, geopolitical conflict, and China's zero-Covid policy lasting far longer than expected. In 2022, we saw the worst equity market performance since 2008; in the bond market, it was the first double-digit decline (-13%, according to Barclay's U.S. Aggregate Bond Index) since 1931's -15%. Entering 2023, the question was how significant a downturn might the economy experience and what, if any of it, is priced into valuations.

As expected, earnings and equity markets have seen fits and starts in 2023 and this will likely continue until the Fed's tightening cycle ends. The U.S. dollar will likely ease a bit but continue to be strong against economies still under stress, especially in the U.K. and continental Europe.

- In this environment, high-grade USD bonds in the short to middle part of the yield curve should provide a good opportunity for income and stability. If we have a short, mild recession, look for an earnings recovery in consumer sectors in the second half of next year, with opportunities in USD equities and longer-dated bonds.

- The aforementioned risks and March's spike in volatility suggest that insurers should exercise duration-neutral strategies through prudent asset-liability management (ALM). Further, as we progress through the current central bank tightening cycle, a laddered exposure across the curve should allow the most flexibility to be opportunistic.

- Though the temptation to shed risk is strong following 2022's horrible capital market performance, the repricing of many assets across the investible universe provides opportunities for fundamentally strong issuers in spread sectors. With the increase in volatility has come spread widening. While risks remain in the banking sector and in the broader economy, these wider spreads present possible opportunities to find value at sector and sub-sector levels.

- Amid concern about shrinking corporate profits, consensus forecasts for 2023 still project near 5% annualized earnings growth. Downward revisions are possible though, even likely, as a potential recession looms and the Fed's rate increases, which always work with a lag, come home to roost. Recessions are bad for earnings, making both stock multiples and tight credit spreads hard to maintain. But they also provide opportunities for fundamental investors emphasizing selection over rotation.

As always, navigating the investment environment requires the ability to be flexible and to adapt to constantly changing conditions. It starts with the economy, which drives corporate earnings, which in turn support market valuations. What hasn't changed is the value of a prudent ALM discipline and solid fundamental credit research.

Richard L. Sega, FSA, MAAA, is a Managing Director and Global Chief Investment Strategist. He plays an integral role in the formulation of the firm's economic and market views. Previously he served as Conning's Chief Investment Officer, and was responsible for credit research, investment management and trading. Prior to joining Conning in 2000, Mr. Sega was President and Chief Executive Officer of Charter Oak Capital Management, Inc. He earned a degree in mathematics from Fordham University and an MA in statistics from Columbia University. Mr. Sega is a member of the CFA Institute.

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About Conning

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