Year-End 2023 Capital Markets Update

December 2023

Analysts: Jennifer Johnson and Michele Wong

Executive Summary

- The global economy was resilient in 2023, as inflationary pressures eased amid higher interest rates.
- The Federal Reserve (Fed) raised the federal funds rate 11 consecutive times between March 2022 and July 2023, resulting in a total rate increase of 525 basis points (bps) but signaled the end of its rate-hiking cycle in December.
- Inflation continues to ease since reaching a four-decade high in June 2022, but it has not yet reached the Fed's 2% target.
- The 10-year U.S. government bond yield reached a 16-year high of 5% in late October 2023 due to a deepening selloff in the U.S. bond market, but it has since settled at approximately 4% as of mid-December following the Fed's projections of three interest rate cuts in 2024.
- The inverted Treasury yield curve (which commenced in July 2022) has narrowed, implying that investors expect the Fed to ease in the near future and are more optimistic about future economic prospects.
- Economic resilience, investor optimism, and market expectations that the Fed is at the peak of its monetary tightening cycle have driven the credit spreads tightening trend in 2023.
- Global stocks have rebounded from negative returns in 2022; in the U.S., the Standard & Poor's 500 index (S&P 500) achieved a year-to-date return of 22.6% through mid-December, and the Dow Jones Industrial Average closed at a record high.
- The price of oil has declined well below a multi-year high of around $120 per barrel in June 2022 to approximately $69 per barrel by mid-December.

A Continuation of Rising Interest Rates in a Relatively Strong Economy

Rising interest rates throughout most of 2022 and into 2023 contributed to lower inflation as intended, but as of November 2023, U.S. inflation was at 3.1%, which is still higher than the Federal Reserve's

(Fed's) 2% target. Despite higher interest rates, economic growth has increased faster than predicted. As such, economists have reduced their expectations of a recession occurring within the next 12 months to 48% as of October, down from a previous forecast of 63%. Unemployment, which was 3.7% in November 2023, is lower than expected and demonstrates a stable and strong labor market. However, geopolitical turmoil continues, not only with Russia and Ukraine and tensions between the U.S. and China, but also more recently with Israel and Gaza. These global tensions have resulted in some pressures on global economic growth and financial market stability.

According to the International Monetary Fund (IMF) World Economic Outlook (WEO) dated October 2023, global growth is expected to decrease to 3.3% in 2023 from 3.5% in 2022 (refer to Table 1) as it is recovering slowly from the economic impact of the COVID-19 pandemic as well as geopolitical events. While a slow recovery instead of a stalled recovery shows the global economy's resilience, it is nowhere near achieving pre-pandemic trends. However, in the U.S., gross domestic product (GDP) for 2023 is expected to remain consistent with the 2.1% growth rate experienced in 2022, compared to a decline of 3.1% in 2020. For the Euro area, GDP growth is expected to decrease to 0.7% in 2023, down from 3.3% in 2022. Among major economies, growth in the Euro area has been weaker due to greater exposure to the Russia-Ukraine war and adverse terms-of-trade shock, according to the IMF WEO, as well as a sharp increase in imported energy prices. Across all regions, due to rising interest rates, a withdrawal of fiscal support, tighter lending standards, and geopolitical uncertainty, investments have not been able to achieve pre-pandemic trends, according to the IMF WEO.

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 July 2023 WEO *Update*[1]		Difference from April 2023 WEO[1]	
	2022	2023	2024	2023	2024	2023	2024
World Output	**3.5**	**3.0**	**2.9**	**0.0**	**–0.1**	**0.2**	**–0.1**
Advanced Economies	**2.6**	**1.5**	**1.4**	**0.0**	**0.0**	**0.2**	**0.0**
United States	2.1	2.1	1.5	0.3	0.5	0.5	0.4
Euro Area	3.3	0.7	1.2	–0.2	–0.3	–0.1	–0.2
Germany	1.8	–0.5	0.9	–0.2	–0.4	–0.4	–0.2
France	2.5	1.0	1.3	0.2	0.0	0.3	0.0
Italy[2]	3.7	0.7	0.7	–0.4	–0.2	0.0	–0.1
Spain	5.8	2.5	1.7	0.0	–0.3	1.0	–0.3
Japan	1.0	2.0	1.0	0.6	0.0	0.7	0.0
United Kingdom[2]	4.1	0.5	0.6	0.1	–0.4	0.8	–0.4
Canada	3.4	1.3	1.6	–0.4	0.2	–0.2	0.1
Other Advanced Economies[3]	2.6	1.8	2.2	–0.2	–0.1	0.0	0.0

[1]Difference based on rounded figures for the current, July 2023 WEO *Update*, and April 2023 WEO forecasts.
[2]See the country-specific notes for Italy and the United Kingdom in the "Country Notes" section of the Statistical Appendix.
[3]Excludes the Group of Seven (Canada, France, Germany, Italy, Japan, United Kingdom, United States) and euro area countries.

Source: IMF WEO, October 2023

To tame inflation, central banks have been tightening monetary policy and raising interest rates. The Fed raised the federal funds rate 11 consecutive times between March 2022 and July 2023, resulting in a total rate increase of 525 basis points (bps). The Fed has voted to hold the federal funds rate steady since

September, and at its December meeting, it forecasted three rate cuts in 2024 as inflation has declined faster than expected. The benchmark federal funds rate is currently in a range between 5.25% and 5.5%—the highest level since January 2001. While the rate hikes initially led to fears of a potential recession and volatility across all asset classes, including equities, U.S. Treasuries, and bonds, the U.S. economy has been resilient and market volatility subsided in late 2023.

U.S. Treasury Yields Rise, and the Yield Curve Inversion Narrows

U.S. Treasuries are considered a safe haven by investors, and they are attractive during times of economic stress. However, bond yields have been rising, and prices have fallen significantly following the Fed's successive and aggressive federal funds rate hikes. The 10-year U.S. Treasury began 2023 at about 3.8% and climbed steadily (refer to Graph 1) as the markets priced in expected Fed rate hikes with high inflation persisting. By late October, the 10-year U.S. Treasury reached a 16-year high of 5% due to a deepening selloff in the U.S. bond market. However, it reversed course in November on investor expectations that the Fed's rate-hiking cycle was over following cooling inflation data and early signs of a weakening labor market. The yield on the 10-year U.S. Treasury settled at approximately 4% as of mid-December.

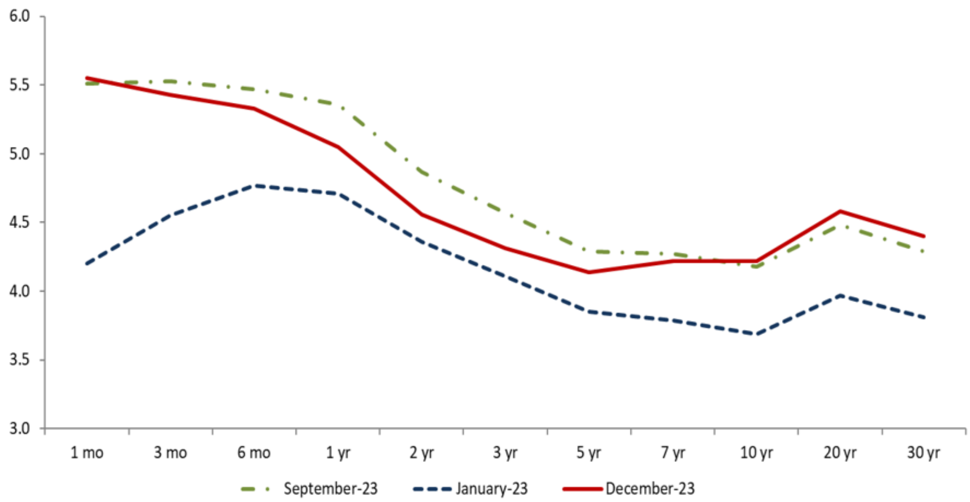
Rising rates benefit insurers' investment returns over time, with higher interest rates creating opportunities for higher yields on new investments and a positive for spread-based businesses. Higher interest rates will also lessen the need to reach for yield and take on incremental risk. On the other hand, the value of existing investments will fall as yields rise, but losses will generally be unrealized in a buy-and-hold portfolio and only be realized when, and if, investments are sold.

Graph 1: U.S. 10-Year Treasury Yields, 2022–Mid-December 2023

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

Further, investors earn less interest on long-term investments when the yield curve is inverted. In mid-December, the spread between the two-year and 10-year U.S. Treasuries was -53 bps, a small improvement from -61 bps in early January 2023. The shape of the Treasury yield curve generally provides insight into the market's expectations for interest rates and economic activity. A negative spread indicates the likelihood of an economic downturn and a pessimistic view about future economic activity. Note that the yield curve spread has been negative since July 2022, and as the Fed has been increasing rates, particularly since July 2023, the yield curve spread has been narrowing. When an inverted yield curve returns to "normal" (i.e., long-term rates are higher than short-term rates), it means that investors are becoming more optimistic about future economic prospects.

Graph 2: U.S. Treasury Yield Curve, January 2023 – December 2023



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

The consumer price index (CPI) rose 3.1% for the 12 months ending in November, down by half from 6.4% in January and a significant drop from a 9.1% peak in June 2022. The core CPI, which excludes energy and food prices, rose 4% in November from a year ago, easing from a 5.6% gain in January.

U.S. mortgage rates are closely tied to the U.S. 10-year Treasury yield and have reached record highs. The 30-year fixed U.S. mortgage rate is over 7% as of December 2023, which is more than double what it was in October 2021. In addition, home prices reached a new record high in September 2023, according to the Standard & Poor's (S&P) CoreLogic Case-Shiller National Home Price Index, while home sales fell to a 13-year low in October, according to the National Association of Realtors (NAR).

U.S. insurers' exposure to U.S. government bonds across various maturities totaled $322.8 billion at year-end 2022, up from $316.3 billion at year-end 2021. In both years, government bond exposure was approximately 6% of total cash and invested assets.

Credit Spreads Reflect Optimism, But Challenges Remain

After widening in 2022 amid persistent inflationary pressures, rising interest rates, and the prospect of lower economic growth, corporate bond spreads have tightened in 2023. Economic resilience supporting investor optimism and market expectations that the Fed is at or near the peak of its monetary tightening cycle have driven the tightening trend.

Investment grade spreads began the year at 138 bps and trended lower through February. (Refer to Graph 3.) However, the failure of several U.S. regional banks and the related banking sector stress led to a spike in March. Spreads reached a high of 164 bps but recovered relatively quickly following indications that a widespread contagion would not materialize. They then continued to tighten over the course of the year and closed mid-December at 108 bps—30 bps lower than the beginning of the year and the lowest level since February 2022. During the month of November alone, investment grade spreads fell 21 bps as investors became more confident that the Fed was done raising rates following cooling inflation data and signs of a weakening labor market.

Graph 3: Investment Grade Corporate Credit Spreads, January 2023–Mid-December 2023

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

High-yield spreads followed a similar trend to investment grade spreads. They began 2023 at 481 bps and rallied over the first two months. But bank sector stress and related market volatility drove spreads wider, and they spiked to 522 bps in late March—the widest level since October 2022. (Refer to Graph 4). They then began their recovery over the second half of 2023, with a brief pause in October when the 10-year U.S. Treasury yield reached a multi-year high. Spreads closed on Dec. 13 at 379 bps, or 102 bps lower than the beginning of the year.

Graph 4: High-Yield Corporate Credit Spreads, January 2023–Mid-December 2023

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

Note that with the material recoveries in spreads in 2023, current investment grade and high-yield corporate credit spreads are nearing pre-pandemic levels.

Higher interest rates have led to an increase in borrowing costs. More expensive financing could pose significant challenges for some companies, particularly those with higher debt and weaker cash flows, when they need to refinance maturing debt. In addition, credit defaults have been climbing from their lows amid the higher interest rate environment. The actual U.S. speculative grade corporate default rate rose to 4.1% as of September 2023 from less than 2% at the beginning of the year and in 2022. Under its base case scenario, S&P Global Ratings expects the U.S. trailing 12-month speculative-grade corporate default rate to reach 5% by September 2024.[1]

The U.S. insurance industry's exposure to corporate bonds totaled about $2.85 trillion, or 35% of total cash and invested assets, as of year-end 2022. High-yield bonds, or those with reported NAIC 3 designations and below, decreased to 5.3% of total bond exposure in 2022 from 6% in 2021. Investment grade bonds, or those with reported NAIC 1 or NAIC 2 designations, accounted for 94.7% of total bonds, a marginal increase from 94% at year-end 2021. High-yield bond exposure remains slightly above the pre-pandemic level of 5.1% at year-end 2019.

Equity Markets Rebound

For the most part, throughout 2023, equity markets rebounded following significant declines in 2022. Current economic resilience is attributed in part to strong consumer spending along with a low unemployment rate. The year-to-date (YTD) return on the S&P 500 was 22.6% as of mid-December, compared to an 18.1% decline for the full year 2022, and the Dow Jones Industrial Average closed at a

[1] S&P Global Ratings, *Default, Transition, and Recovery: Higher Rates for Even Longer Could Push the U.S. Speculative-Grade Corporate Default Rate to 5% by September 2024*, Nov. 16, 2023

record high. In addition, the Stoxx Europe 600 Index and Japanese Nikkei 225 Index have returned 11.2% and 26.2%, respectively, YTD through mid-December (refer to Graph 5). The NAIC Capital Markets Bureau performed a monthly analysis on U.S. insurers' unaffiliated publicly traded common stock exposure at year-end 2022 (which totaled $485.7 billion book/adjusted carrying value), and YTD as of November 2023, it experienced a weighted average increase of 15.7%. U.S. insurers that have increased their exposure to equities in recent years (particularly property/casualty [P/C] companies that have a higher relative equities exposure compared to other industry types) or insurers whose equity exposure is a significant percentage of total capital and surplus were likely negatively impacted in 2022 but should now be experiencing a much-needed recovery.

Graph 5: U.S. Equity Market Indices Performance, YTD Mid-December 2023, % Returns

Source: The Wall Street Journal

For the S&P 500 sectors, four of the 11 experienced negative returns YTD as of mid-December, including consumer staples, healthcare, energy, and utilities. The largest contraction was in utilities and energy at about 7% each. The negative performance of utilities, as well as energy, was due partly to a drop in oil and gas prices from 2021 to 2022, along with general economic recessionary fears. Consumer staples have been negatively affected by overly large grocery price increases since 2021. The largest three sector returns YTD occurred in the information technology (IT) (55.3 %), communication services (48.7%), and consumer discretionary (38.8%) sectors. The communication services sector includes entertainment, social media, and wireless and streaming companies, among others. The significant YTD return is likely due to an increase in pricing for these services, while the large YTD return among the IT sector—which includes artificial intelligence (AI) and cloud computing— is due partly to increased usage from the hybrid work environment.

Oil Prices Fall from Record Highs in 2022

After reaching a multi-year high of $120 per barrel in June 2022 due in part to the Russia-Ukraine crisis, West Texas Intermediate (WTI) crude oil prices have declined materially to below $100 per barrel. (Refer to Graph 6). As of mid-December, WTI crude oil was trading at approximately $69 per barrel. Energy companies have experienced a 7% decline YTD according to the S&P 500 Index as of mid-December due partly to the drop in oil prices since 2021. The U.S. insurance industry's exposure to oil and gas companies at year-end 2022 is estimated to be about $141 billion in bonds and $57 billion in common stock, and it represented about 2% of the industry's cash and invested assets.

Graph 6: Crude Oil Prices – West Texas Intermediate, 2022–Mid-December 2023

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

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 NAIC Capital Markets Bureau at [CapitalMarkets@naic.org.](mailto:CapitalMarkets@naic.org)