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Third Quarter 2021

Multi-asset views for insurers

Asset class	View
Reserve assets	
Investment-grade credit	Moderately bearish
Securitized assets	Neutral
US government	Neutral
Europe government	Bearish
Japan government	Neutral
Surplus assets	
High yield	Moderately bearish
Bank loans	Moderately bullish
Emerging market debt	Moderately bullish
US equities	Neutral
Europe equities	Bullish
Japan equities	Neutral
Emerging market equities	Moderately bullish
Commodities	Moderately bullish

As of June 2021 | Views expressed have a 6 – 12 month horizon and are those of the authors and Wellington Management's Investment Strategy Team. Views are as of the date indicated, are based on available information, and are subject to change without notice. The authors' process has been updated to incorporate a wider set of inputs from the Investment Strategy Team; changes in views will be included again starting next quarter. Individual portfolio management teams may hold different views and may make different investment decisions for different clients. This material is not intended to constitute investment advice or an offer to sell, or the solicitation of an offer to purchase shares or other securities | Source: Wellington Management

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MULTI-ASSET VIEWS FOR INSURERS

The rising tide of inflation: Risks and opportunities for insurers

KEY POINTS

- COVID vaccination progress and ample policy support make us confident in taking a more pro-risk stance, but persistent inflation concerns curb our enthusiasm somewhat.
- Interest rates could keep rising, especially in Europe, where we see the sharpest acceleration in vaccination rates and economies reopening — an outcome that insurers welcome after years of low reinvestment rates.
- Within equities, we prefer Europe, where we expect improvement in domestic economies, and emerging markets, which should benefit the most from a reflating global economy.
- Recent inflationary pressures are likely to persist, which may benefit many global commodities but could potentially pose a headwind for some other asset classes going forward.
- Downside risks include a spike in interest rates, more COVID-related lockdowns, or policy mistakes. Upside risks include a lift in inflation-capping productivity or broader and more sustainable reopenings than expected.

THERE IS A GROWING SENSE THAT THE WORLD IS "GETTING BACK TO NORMAL," AND WHAT A RELIEF IT IS! WE SEE MORE PEOPLE VENTURING OUT, DINING AT RESTAURANTS, STAYING AT HOTELS, RETURNING TO THEIR NON-HOME OFFICES, AND MORE. Unfortunately, many countries are still dealing with more contagious and virulent mutations of COVID-19 and lower vaccination rates. But in aggregate, the global economy is recovering with the aid of accommodative fiscal and monetary policy, supporting the strong performance of risk assets and the continued rotation from growth to value.

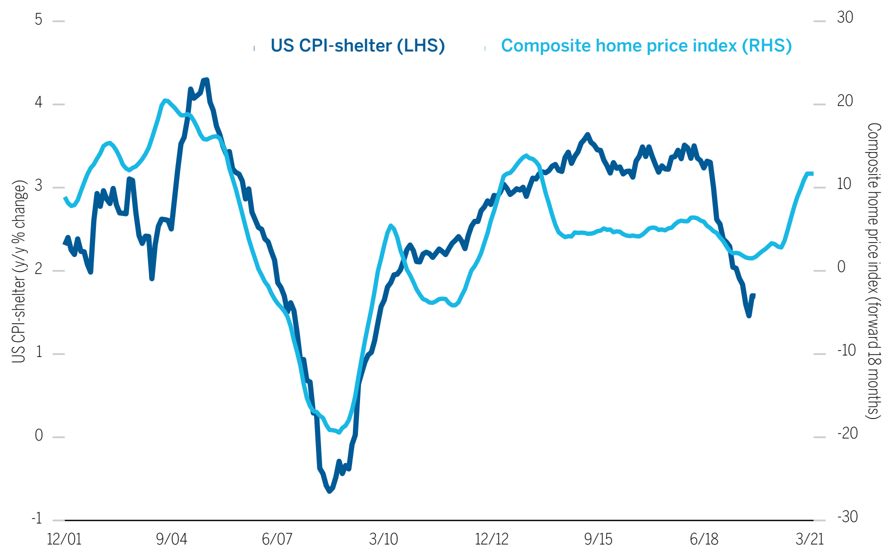
Inflation is the bogeyman now. US inflation leapt 5% in May from a year earlier, well above the Federal Reserve (Fed) forecast for 2021. "Transitory versus persistent" was the central debate at the June Federal Open Market Committee meeting, with recognition of the upside risks to inflation accelerating the Fed's tightening path from zero rate hikes in 2023 to two anticipated hikes in 2023. Even though the market has priced in earlier hikes, the Fed's base case is that temporary factors and base effects are still distorting inflation prints. We see an elevated risk that supply/demand imbalances in labor and commodity prices may become more persistent. In housing, for example, structural drivers are contributing to higher prices and could feed into rents 12 – 18 months from now (FIGURE 1).

> **Rising inflation supports our value-oriented tilts toward non-US equity markets, smaller caps, and cyclical sectors such as financials, consumer discretionary, materials, and industrials.**

Figure 1

Persistent inflation could show up in rents

US CPI-shelter and composite home price index



US CPI-shelter: US CPI Urban Consumers Shelter SA; Composite home price index: S&P Corelogic Case-Shiller 10-City Composite Home Price NSA Index | Chart data: December 2001 – April 2021

Against this backdrop, we continue to maintain a pro-risk stance, but it is tempered by a worse growth/inflation trade-off. Within equities, we are bullish on Europe, which we believe is on the cusp of an economic acceleration, and moderately bullish on emerging markets (EM), given their leverage to an improving global cycle and strong commodity prices, as well as continued US dollar weakness. We remain moderately bearish on government bonds, especially in Europe, where negative rates are particularly vulnerable to an improving cycle. Credit spreads are generally rich, but we find some value in bank loans, as well as EM sovereign and local debt.

Rising inflation supports our value-oriented tilts toward non-US equity markets, smaller caps, and cyclical sectors such as financials, consumer discretionary, materials, and industrials. Within commodities, we favor energy and industrial metals, which have historically been more sensitive to rising inflation than equities and can potentially help hedge against a rise in interest rates.

Of course, insurers face business implications from higher-than-anticipated inflation, above and beyond their investments. On the underwriting side of the house, if loss reserves on the balance sheet did not consider materially higher inflation when the claim was incurred, or when the product was originally priced for sale, the reserve could prove too low to cover the claims payment itself when due. This will be a critical story to follow in the coming months.

EM debt spreads have lagged the spread tightening in other sectors. We think the outlook for EM will begin to brighten as these countries receive vaccines and benefit from global growth and stimulus.

Finding value in fixed income

The Fed's more hawkish stance is likely to keep US long-term interest rates range-bound over our 6 – 12 month time horizon. We expect the Fed and the European Central Bank (ECB) to remain accommodative and to very cautiously begin their "tapering" processes sometime around year-end 2021 or early 2022. Still, we think inflation will likely increase more than central banks are forecasting. This could pressure global rates higher. Europe's negative rate structure seems particularly vulnerable in the face of its accelerating nominal growth.

We think credit valuations are rich, with most spreads well inside of median levels since inception of the indexes (**Figure 2**). That said, default rates continue to decline and demand technicals remain strong, driven by demand from Europe and Asia, as well as from US pension funds seeking long-duration assets to lock in their improved funded status.

Within credit, we prefer short-duration sectors, such as bank loans and certain areas of the securitized market. We continue to view securitized assets as a way to express a positive view on residential housing, but remain cautious on commercial property, such as malls and offices, where the outlook is more uncertain. Low mortgage rates, declining unemployment, and millennials' growing demand for housing continue to be potential tailwinds for sectors such as workforce housing and credit-risk transfer. Insurers continue to capitalize on this part of the bond market, as securitizations have grown as a percentage of US insurers' fixed income as of year-end 2020 (**Figure 3**).

EM debt spreads have lagged the spread tightening in other sectors. We think the outlook for EM will begin to brighten as these countries receive vaccines and benefit from global growth and stimulus. While EM central banks are actually hiking rates to tamp down inflation, we expect currency gains to contribute to local-debt performance.

Figure 2

Most credit spreads are rich

Option-adjusted spreads, 21 June 2021 (bps)

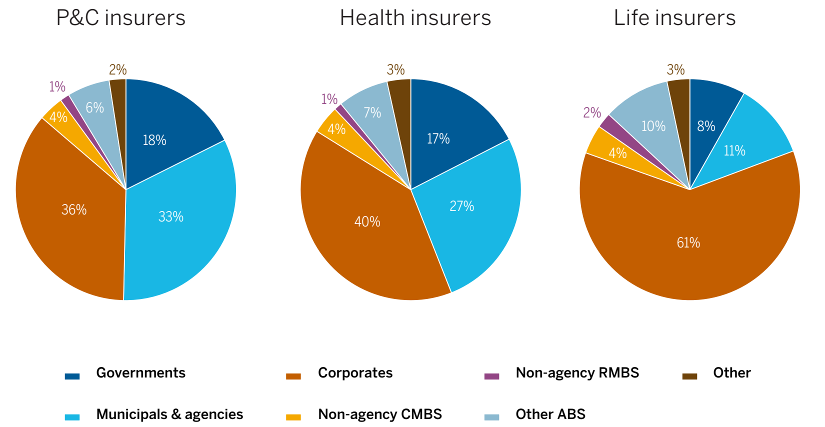
	Current	Percentile since inception (%)	Median	Low	Inception date
US corporates	82	19	112	51	30 June 1989
US high yield	281	6	441	233	31 January 1994
EM debt	351	39	386	149	31 December 1994
US CMBS	54	0	104	13	30 June 1999

PAST RESULTS ARE NOT NECESSARILY INDICATIVE OF FUTURE RESULTS AND AN INVESTMENT CAN LOSE VALUE. | Sources: Bloomberg, Wellington Management

Within credit, we prefer short-duration sectors, such as bank loans and certain areas of the securitized market.

FIGURE 3

US insurance industry: Bond sector allocations as of year-end 2020



Sources: Statutory financials, S&P Global Market Intelligence. Chart data as of 31 December 2020. "Other" includes affiliated, bank loans, bond funds rated by SVO, and hybrids.

Equities: More room to run

Among equity regions, we favor Europe, where we expect the sharpest increase in vaccinations (after a sluggish start) and economic growth, and where we find valuations relatively attractive. Leading economic indicators suggest the consumer sector may soon be booming, joining an already strong manufacturing sector.

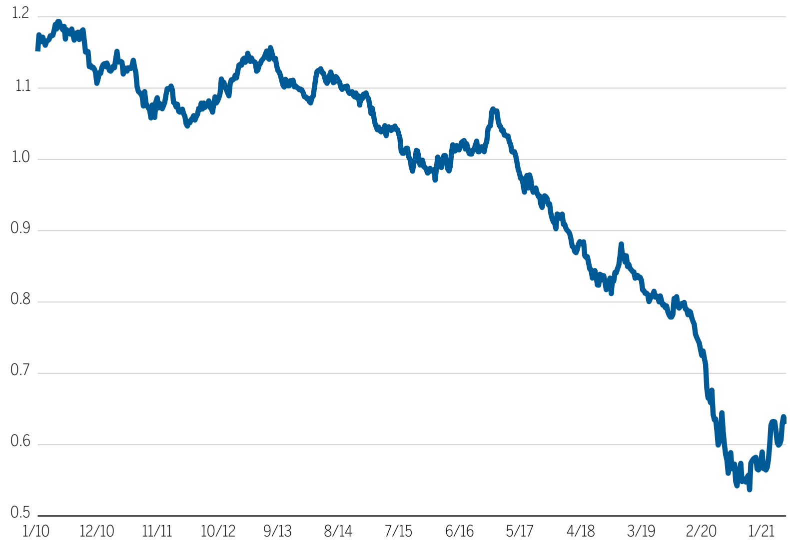
While we are moderately bullish on EM equities broadly, we see pockets of value and, as always, believe EM country, sector, and issuer differentiation will be key. In Asia, we are hopeful that the Chinese credit impulse will hold up and think net commodity exporters throughout the EM complex could benefit from higher commodity prices and better terms of trade.

We are neutral on US and Japanese equities. While we are quite optimistic about the US economy, its equity indices tend to be dominated by growth-heavy, interest-rate sensitive, and expensive stocks. We are also mindful of a potential increase in corporate tax rates, which could hamper earnings. We prefer value-oriented equities in the US, as well as smaller caps, which are typically more sensitive to changes in economic growth and less sensitive to rising rates. Similar to Europe and EM, Japan stands to benefit from a stronger global cycle. However, we are less optimistic about any domestic catalyst pushing Japanese equities upward and prefer Europe and EM.

Across factors and styles, we generally prefer value-oriented companies that can do well in a higher growth and interest-rate environment. While value has generally outperformed growth since September 2020, it still has a wide gap to close after lagging dramatically over the past decade (**FIGURE 4**).

We continue to see higher commodity prices as one source of inflation, given broad supply/demand imbalances across energy, metals, and agriculture.

Figure 4
Value has ample room to outperform
Value/growth, Russell 1000 indices



Source: Bloomberg | Chart data: 2 January 2010 – 28 May 2021

Commodities: Cyclical and structural factors underpinning performance

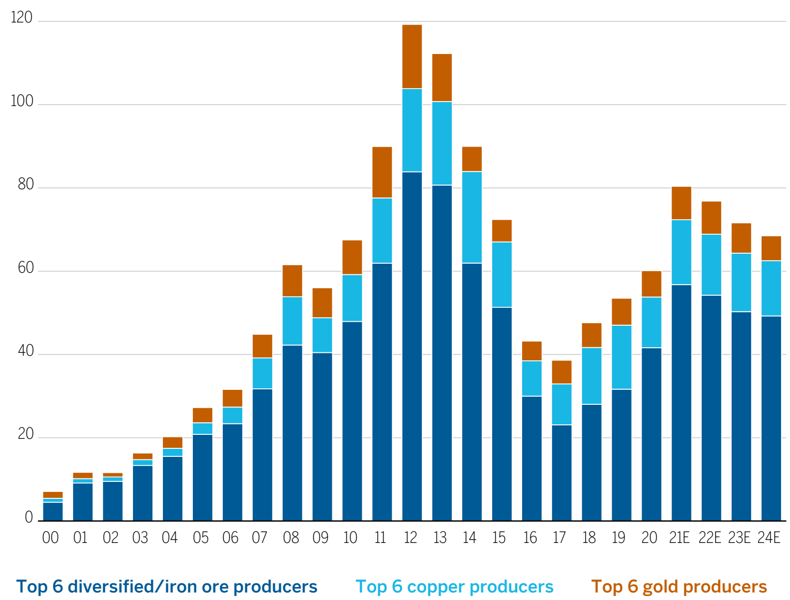
We continue to see higher commodity prices as one source of inflation, given broad supply/demand imbalances across energy, metals, and agriculture. As discussed last quarter, there are also structural changes that appear to be making commodity prices more inelastic. First, capital expenditures have been on a downtrend for the past decade, after a period of overspending and underdelivering on long-term projects (**Figure 5**). Second, amid the transition to a lower-carbon world, areas like metals and agriculture are facing higher costs and potentially lower supply due to climate-related goals.

We think central banks will be extremely careful in how they communicate, but bumps could occur along the way, as markets may be sensitive to any perceived change in policy support.

Figure 5

Commodities: Lack of capex may inhibit production

Capex by the top 6 iron ore, copper, and gold producers (USD billions)



Source: Bloomberg | Actual results may differ, perhaps significantly, from estimates | Chart data: actual: 2000 – 2020; estimated: 2021 – 2024

Risks

We think the inflation debate will be the market's primary focus in the coming months. A policy mistake in which the Fed allows inflation expectations to rise and then has to play "catch up" could be negative for risk assets. However, as noted, we expect the Fed and ECB to announce their tapering plans in the fall. We think central banks will be extremely careful in how they communicate, but bumps could occur along the way, as markets may be sensitive to any perceived change in policy support. The tapering theme and the prospect of less fiscal support in the second half of this year may cap total returns in risk assets and are the main reasons we are only moderately bullish on developed market equities.

Another risk is the potential for COVID variants to spread further and disrupt the global recovery. We are also monitoring the global cycle impact of tightening financial conditions in China.

On the upside, global markets may be underestimating the Fed's commitment to its new average-inflation-targeting policy. A scenario could unfold in which interest rates remain anchored at low levels for longer than anticipated and risk assets ramp considerably higher.

Finally, governments are spending on traditional and technological infrastructure after many years of underinvestment. Targeted investments could boost productivity and cap inflation because higher revenues can absorb increased wages without the need for higher prices.

About the authors

Tim Antonelli identifies, shares, and acts on major business trends affecting global insurers and their investments across asset classes. He interacts regularly with a range of insurance industry regulatory bodies, rating agencies, and trade organizations worldwide.

Daniel Cook analyzes and interprets markets and translates this work into investment insights. He researches investment ideas for portfolio managers and consults with clients on tactical and strategic asset allocation.

Investment implications

Count on high-quality bond allocations for stability — While our views tilt toward an economic recovery, we think it is still prudent to maintain an allocation to high-quality bonds in case of a sharp equity sell-off. We think municipal bonds play a strategic role for taxable investors, especially given the trend toward greater federal spending. US investors could also consider expanding their investment-grade fixed income universe abroad to seek value.

Get more selective in credit — Most spreads are rich, but we don't see a catalyst for them widening much from here. We see the best risk/reward potential in sectors like bank loans, CLOs, and residential-housing-oriented structured credit. We think EM sovereign and local debt also offer better upside potential from a spread and currency perspective.

Stick with value — We remain in the recovery phase of the cycle, and the risk of inflation and higher rates points to potential outperformance in value-oriented exposures such as non-US equities, smaller-cap stocks, and cyclical sectors like financials, materials, and industrials. We think there are attractive opportunities in select energy companies that have strong plans for navigating the transition to a lower-carbon economy. This remains an area ripe for ESG integration in an insurer's investment policy statement.

Pursue inflation protection with commodities — Inflation may reach higher levels or be more persistent than many asset allocators expect. While value-oriented equities may provide some protection, commodities (excluding precious metals) have historically been the most inflation-sensitive asset class. However, due to punitive capital treatment (both regulatory and rating agency-based), insurers may instead opt for the combination of equities and real estate assets. Direct real estate and mortgage loan investments have been popular target investments over the past five years.

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