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Quarterly insurance update

Q1 2024

Summary

Welcome to the Quarter 1 2024 investment update designed for insurers and produced by Royal London Asset Management. Economic attention over the quarter was primarily on inflation. At the start of the quarter investors had focused on the persistence of large price increases and central bank messaging on rates being held higher for longer. Yet, as headline inflation fell, sentiment swung dramatically towards the end of the quarter, pushing markets to price in interest rate cuts in 2024.

In addition, reviews of the regulatory frameworks within both Europe and the UK have continued to progress.

In the UK, the Prudential Regulation Authority (PRA) published a consultation paper on funded reinsurance and their expectations as to how the associated risks should be managed. Additionally, the PRA published a Solvency II (SII) year-end review and gave a speech on the mutual insurance industry. In wider Europe, insurers were left disappointed by the lack of clarity around how the European Commission will achieve it's targeted 25% reduction in reporting. However, the industry responded positively to the reported amendments to the SII directive, easing capital rules for insurers which releases capital for additional investment.

Within this quarterly update, we cover developments in the two main areas most prevalent to the asset side of insurers' balance sheets - investment markets and regulations. In addition, we highlight investment themes we believe are pertinent to many insurers at the present time.

Market update:

- Global government bond yields started the quarter continuing the rising trend that started in mid-2020. This reflected market views that rising inflation would necessitate even higher interest rates and the mantra of higher for longer. Yet, with inflation starting to come down, expectations of rate cuts in 2024 contributed to significant falls in bond yields.
- The final couple months of 2023 saw very strong returns thanks to a reversal in yields combined with tighter spreads. November ended up being the best month in 38 years for investment grade bonds, while it was simply the best month since last summer for the high yield market.
- Equities saw a significant turnaround over the quarter, rebounding sharply from their October lows as investor sentiment recovered. This was thanks to softer growth and inflation data, that reduced fears of higher for longer rates and raised hopes of early and deep rate cuts in 2024.

Regulatory update:

The regulatory environment for insurers continued to develop. Over the quarter:

Europe

- Insurance Europe reiterated its support in relation to the European Commission's (EC) commitment to reducing the EU reporting burden by 25%. However, at the same time, it expressed its disappointment as nothing concrete was proposed that outlined or indicated how the 25% reduction target would be met.
- Insurance Europe welcomed the EU's provisional agreement on amendments to the Solvency II directive. The new reforms will ease capital rules for insurers which has the potential to free up tens of billions of euros for investing in green technology and infrastructure to boost growth.
- The European Insurance and Occupational Pensions Authority (EIOPA) published results of a Europe-wide comparative study on non-life underwriting risk in internal models. The study evaluated the differences between different insurers' internal models to understand whether, and to what extent, the models capture and quantify similar risks in a consistent manner.

UK

- The PRA gave a speech at the Association of Financial Mutuals annual conference. The speech focused on the importance of insurance mutuals, as well as the opportunities and challenges facing the mutual sector in the context of the evolving regulatory landscape and volatile economic conditions.
- The PRA published a consultation paper which outlined its expectations for UK life insurers which utilise funded reinsurance, be that to transfer part, or all, of the risks from a portfolio of annuities to third parties.
- The PRA published a statement relating to the Solvency II reforms to be implemented for the 2023 year-end in advance of the PRA's final decisions on its recent Solvency II reform proposals.
- The PRA published a statement outlining their intention to run a dynamic general insurance stress test in 2025; this test incorporates a sequential set of adverse events over a short period of time.

We explore these areas in more detail, also highlighting what these could mean for insurers going forwards.

Insurance investment themes:

We set out investment ideas and themes for insurers that we believe are well placed and relevant relative to the future economic and regulatory environment. For this quarter's publication we include:

- **Asset class themes in 2024 for insurers:** 2023, following the difficulties of poor asset class returns for the vast majority of assets in 2022, was another challenging year. Although inflation rates are still much higher than most central banks targets, the question remains around if, and how quickly, banks will look to press inflation down further. However, the environment that has emerged does present potential opportunities both within, and between, the different asset classes and we explore these further.

Overview

Economic attention over Q4 2023 was primarily on inflation. At the start of the quarter investors focused on the persistence of large price increases and central bank messaging on rates being held higher for longer. Yet, as headline inflation fell, sentiment swung dramatically towards the end of the quarter, pushing markets to price in interest rate cuts in 2024. The Federal Reserve (Fed), European Central Bank (ECB) and Bank of England (BoE) all left rates unchanged over the quarter, maintaining official rates at multi-year highs. The Fed has now held rates unchanged at its last three meetings. There has however been a significant shift in messaging, with the US central bank now indicating that it expects to cut rates by 0.75% in 2024. The ECB has similarly kept rates steady at its two most recent meetings, but central bankers in the eurozone said that no rate cuts have yet been discussed.

In tune with the other major central banks, and potentially marking the high point in the UK interest rate cycle, the Bank of England left interest rates unchanged over the period.

The Monetary Policy Committee continued to be split – at the December meeting three of the nine members were still voting for a rate hike. UK inflation has fallen significantly, with the annual inflation rate falling to 3.9% in November. This is the lowest rate of increase in over two years. However, this remains well above the BoE 2% target, with core and wage inflation significantly higher than the headline rate.

Over the fourth quarter, the ECB kept rates on hold. Going into the December meeting, various ECB speakers had already broached the topic of rate cuts, effectively opening the door for cuts in the second half of 2024 while pushing back on the chance of a near term cut. President Lagarde said that they did not discuss rate cuts in December and that "between hike and cut there is a whole plateau – a whole beach – of hold." Euro area CPI fell to only 2.4% year-on-year in November from 5.2% in August. Core CPI fell sharply over the same period too to 3.6%. The euro area economy (GDP) shrank by 0.1% quarter-on-quarter in the third quarter after recording only 0.1% GDP growth in both the first quarter and the second quarter.

The Fed kept rates on hold at 5.25-5.50% over the quarter against a still resilient labour market backdrop, but with inflation continuing to cool. As of their December meeting, the median forecast of participants had 75bp of rate cuts in it for 2024 with a further 100bp of cuts pencilled in for 2025. Over the quarter, CPI inflation fell from 3.7% year-on-year in August, to 3.1% in November. That is still above June 2023 levels, but core continued a more consistent drift lower over the period. The core PCE measure of inflation fell over the quarter and month-on-month was only 0.1% in November. Third quarter GDP recorded a strong 4.9% quarter-on-quarter annualised growth. More timely economic activity indicators were mixed over the fourth quarter. The House of Representatives passed a spending package that pushed the effective next government spending deal/shutdown deadline into early 2024.

Market update

	Yield (%)*		**Total 3 month return***	
	29 September 2023	29 December 2023		
Euro Treasuries†	3.55	2.67	7.53% (GBP)	7.19% (EUR)
UK Gilts†	4.66	3.89	8.11% (GBP)	
US Treasuries†	4.85	4.08	5.43% (GBP)	5.12% (EUR)

	Spread (bps)*		**Total 3 month return***	
	29 September 2023	29 December 2023		
Global IG Corporates†	134	115	7.25% (GBP)	6.95% (EUR)
Euro IG Corporates†	145	131	5.48% (EUR)	
UK IG Corporates†	143	121	7.34% (GBP)	
Emerging Market Debt†	430	383	10.16% (GBP)	9.86% (EUR)
Global High Yield†	373	318	6.47% (GBP)	6.16% (EUR)

	Price index*		**Total 3 month return***	
	29 September 2023	29 December 2023		
Global Equities†	17446.48	18610.88	6.67% (GBP)	6.79% (EUR)
Euro Equities†	4174.66	4521.44	8.31% (EUR)	
UK Equities†	4127.24	4232.01	3.23% (GBP)	
Emerging Market Equities†	605.7	625.53	3.27% (GBP)	3.38% (EUR)

	Index*	
	29 September 2023	29 December 2023
Volatility†	17.52	12.45

*Source: Bloomberg, IHS Markit.

†See appendix for details on index used and returns quoted.

Past performance is not a guide to future performance. The value of investments and any income from may go down as well as up and is not guaranteed. Investors may not get back the amount invested.

Government bonds

Global government bond yields started the quarter continuing the rising trend that started in mid-2020. This reflected market views that rising inflation would necessitate even higher interest rates and the mantra of higher for longer. Yet, with inflation starting to come down, expectations of rate cuts in 2024 contributed to significant falls in bond yields in November and December. The fall in yields was such that yields across all maturities ended the quarter lower than they started but closed 2023 at roughly the same levels as they started.

In the US, 10-year treasury yields fell from 4.57% to 3.88%, falling back from 15-year highs to reverse virtually all of the rise seen in the prior quarter. German 10-year bunds similarly saw material falls in the fourth quarter, falling from 2.84% to 2.01%. UK government bonds produced strong returns due to falling yields, delivering an 8.1% return (FTSE Actuaries) over the fourth quarter with the benchmark 10-year gilt yield falling from 4.44% to 3.54%.

Credit

The final couple months of 2023 saw very strong returns with a stunning magnitude of reversal in yields - with yields falling combined with substantially tighter spreads. November ended up being the best month in 38 years for investment grade bonds, while it was simply the best month since last summer for the high yield market. Investment grade bonds did well relative to high yield due to the higher duration of these assets which was beneficial in a falling yield environment.

Global corporate bond markets saw a strong rally into year-end but this could limit performance from spreads in 2024. December continued in a similar vein to November with spreads and rates continuing their declines leading to another month of healthy returns — allowing 2023 to report double digit returns.

Over the fourth quarter, the ICE BofAML US Corporate Index returned 7.91%, while in the euro zone and UK, the ICE BofAML Euro Corporate & Pfandbrief Index and iBoxx Sterling Non-Gilt indices returned 5.49% and 7.35% respectively.

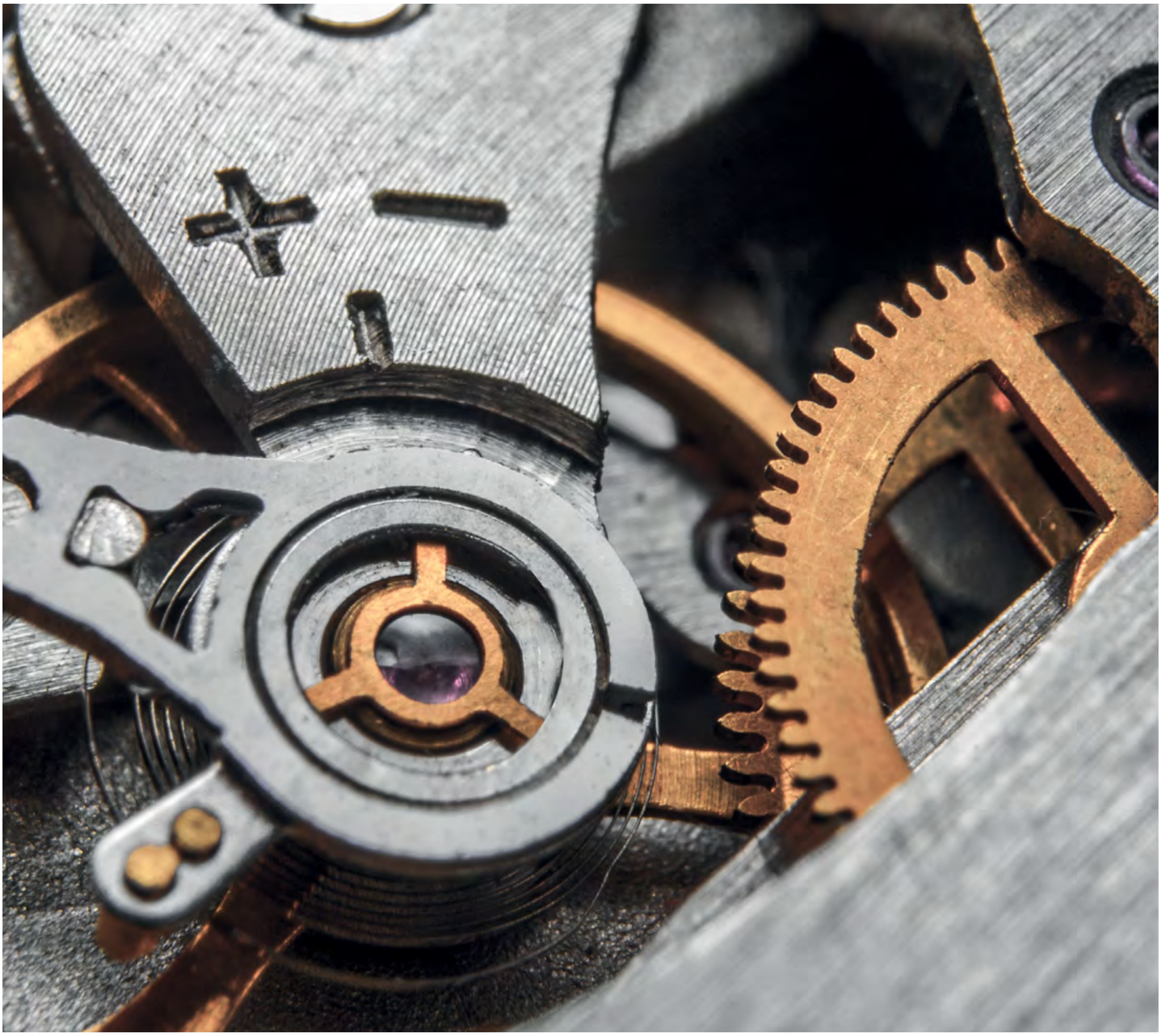
Equities

Equities saw a significant turnaround over the quarter, rebounding sharply from their October lows as investor sentiment recovered. This was thanks to softer growth and inflation data, that reduced fears of higher for longer rates and raised hopes of early and deep rate cuts in 2024.

For the fourth quarter, the MSCI World and MSCI All Countries World Index (ACWI – which also includes 26 emerging markets) produced positive returns in US dollar terms. Looking at national MSCI indices, the strongest market was Sweden, while the weakest was China. In terms of style, the MSCI World Growth Index produced stronger returns than the MSCI World Value Index.

The change in backdrop meant that the fourth quarter has been one of the strongest for global equity markets for a long time. The best performing sectors in the quarter were information technology, real estate and industrials.

The tech sector continues to benefit from the excitement around artificial intelligence (AI) and real estate is a sector that stands to benefit from falling interest rates. Industrials experienced a tailwind from a resilient macro backdrop combined with government stimulus towards infrastructure spending. The only sector that was negative in the quarter was energy, reflecting the weaker tone in the oil market.



Regulatory updates

1. Insurers disappointed in EU plan to deliver 25% reporting reduction

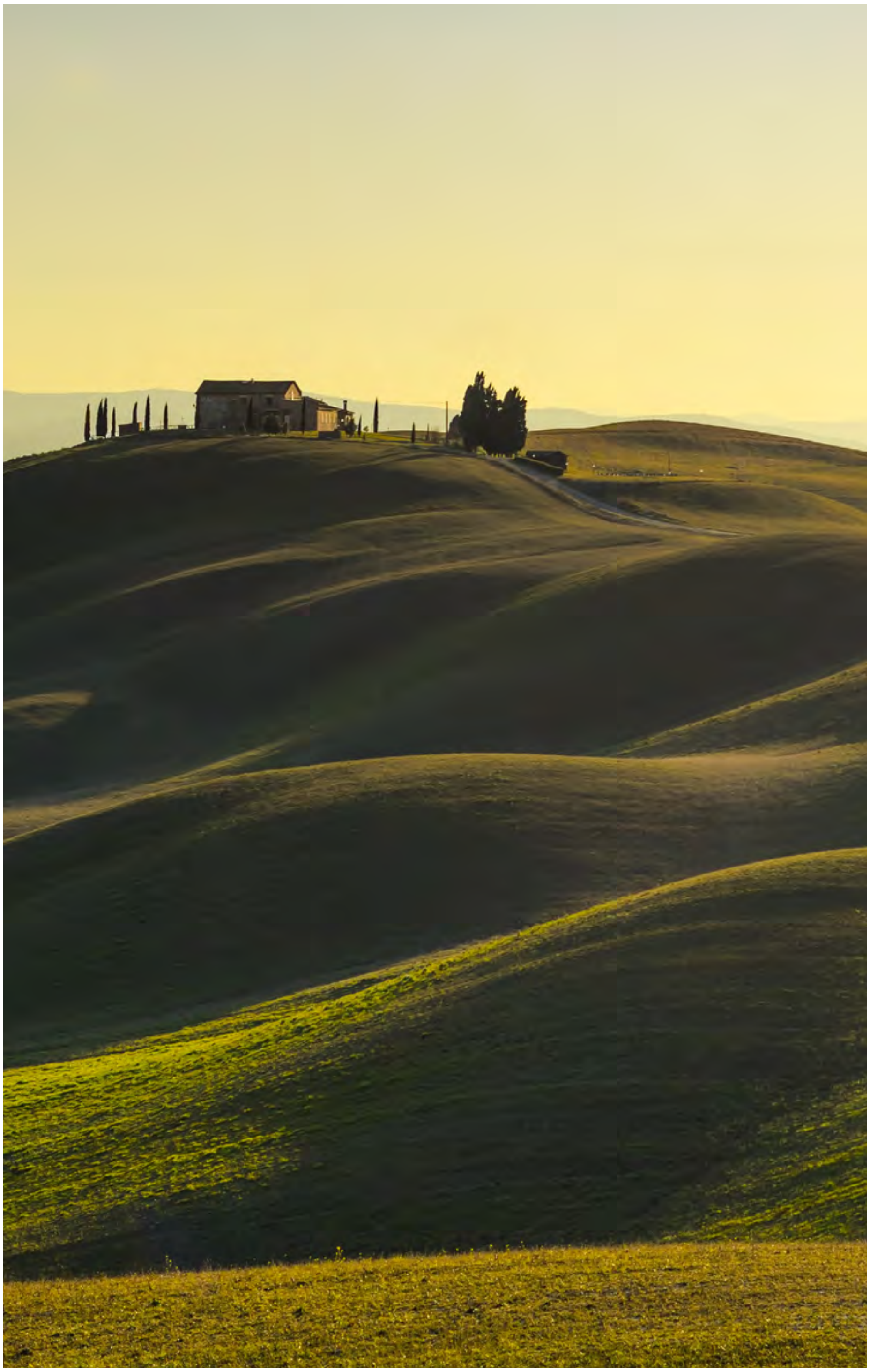
On 1st December 2023, Insurance Europe reiterated its support in relation to the European Commission's (EC) commitment to reducing the EU reporting burden by 25%. However, at the same time, it expressed its disappointment as nothing concrete was proposed that outlined or indicated how the 25% reduction target would be met.

In its response, Insurance Europe urged the EC to recognise that this burden is created not only by too many reporting requirements, but also by duplications and overlaps between different pieces of legislation, lack of sufficient time to implement the requirements, and a lack of clarity and the timely provision of Q&As. As such, Insurance Europe strongly recommends the EC to use this current initiative not only to seek ways to simplify and reduce the existing reporting burden, but also to embed the following principles into all current, ongoing and future regulatory initiatives:

- Avoid unnecessary new reporting requirements whilst removing reporting overlaps and duplications;
- Embed proportionality into the requirements whilst allowing flexibility and avoiding being over-prescriptive;
- Where requested by the industry, provide the necessary clarity and Q&As quickly, ensuring sufficient time is given for implementation;
- Conduct thorough consumer-testing to gauge the view of the insurance market; and
- Ensure a proper and swift correction process for errors identified in Implementing Technical Standards.

What does it mean for insurers?

More clarity on how exactly the EC plans on reducing the reporting burden will help insurers better plan and redirect resources, previously consumed by reporting requirements, and allow them to focus on more pressing priorities. This will be a significant boost to the European insurance industry and will allow it to regain some of its competitiveness relative to international markets.



2. EU's provisional agreement on amendments to the Solvency II directive

On 14th December 2023, Insurance Europe welcomed the EU's provisional agreement on amendments to the Solvency II directive (the initial review began in February 2019). The new reforms will ease capital rules for insurers which has the potential to free up tens of billions of euros for investing in green technology and infrastructure to boost growth.

Insurance Europe highlighted the reforms, which address some of the existing measurement flaws in Solvency II, will result in more appropriate capital requirements and lower volatility. The bulk of capital at EU insurers is being freed up by cutting the risk margin, which in the past has meant insurers have had to hold billions of euros in excess capital above the minimum reserves.

Insurance Europe's Deputy Director-General, Olav Jones, said, "These changes can reduce unnecessary regulatory barriers to offering the long-term products, guarantees and investments customers want and need. They can help the industry to remain key long-term investors who act as a stabilising force during periods of market volatility".

Nevertheless, pointing to the next 'Level 2' stage of technical discussions that will start in 2024, Olav Jones added that, "The devil is in the detail and in order to realise the potential benefits, the political ambition agreed must be reflected in the technical details which will follow."

The provisional agreements will be finalised and presented to member states' representatives and the European Parliament for approval. The Council and the Parliament will have to formally adopt the texts if approved.

What does this mean for insurers?

The reformed rules on Solvency II will undoubtedly boost the role of the insurance sector in providing long-term sources of investments to European businesses. Furthermore, it will ensure insurers play a significant role in contributing to Europe's post pandemic recovery and leading the way in financing the green and digital transitions.

3. Non-life underwriting risk in internal models study results

On 4th January 2024, EIOPA published results of a Europe-wide comparative study on non-life underwriting risk in internal models. An important element for monitoring the ongoing appropriateness of internal models covering non-life underwriting risk, the study was the second of its kind and is designed to ensure the stability and solvency of non-life insurance undertakings, protecting policyholders, and maintaining the overall health of the insurance market.

The study analysed the internal models for the non-life underwriting of 75 European insurers belonging to 31 insurance groups, recognising that non-life underwriting risk contributes significantly to the solvency capital requirements (SCR) and is of material importance for the majority of internal model undertakings. The aim of the study was to evaluate the differences between different insurers' internal models to understand whether, and to what extent, the models capture and quantify similar risks in a consistent manner and how this can, and may, change over time.

In brief:

1 **Deployment of capital:** Insurers with similar economic profit and loss distributions (and profit levels) showed notable differences in their capital levels and how they deployed this capital (a capital intensity measure was used, defined as SCR divided by different forms of exposure). The study examined the dispersion for each individual insurer and respective peer groups as well as its variation over time, in order to identify potential root causes. Capital intensities did not increase or decrease over time suggesting that the capital allocation of insurers has been stable.

2 **Differences in risk measurement:** Different risk measures can have a significant impact on the observed capital intensities and these differences were linked to the treatment of expected profits. Many insurers with lower capital intensity were relying on uncertain future profit estimates in the calculation of their premium risk leading to unfair advantages. Additional analysis is being conducted by the European supervisors to explore this further.

3 **Standard formula comparison:** Insurers using internal models showed significant variation and generally lower capital intensities compared to standard formula calculations.

4 **Inflation:** Most insurers model inflation based on past trends and, despite its impact upon paid claims and claims reserves, weren't appropriately prepared for long-lasting moderate inflation vs. temporary spikes.

It was recommended that insurers monitor their inflation risk closely and potentially increase capital to allow for increased uncertainty around the path of inflation looking ahead. The more detailed package is expected to be unveiled by the EC later in the year.

What does this mean for insurers?

Non-life underwriting risk plays both a significant and important role when insurers calculate their SCRs. The study allows EIOPA to gauge the different approaches adopted across the European insurance sector. Whether or not insurers utilise internal models or not, the analysis is worth reviewing as it will provide an insight into what peers are doing and enable insurers to compare against their own approaches and models.

1. The Feeling is Mutual – PRA Speech

On the 2nd October 2023, Shoib Khan, Director of Insurance Supervision at the Prudential Regulation Authority (PRA) gave a speech at the Association of Financial Mutuals (AFM) annual conference. The speech focused on the importance of insurance mutuals in the context of the broader structure of the insurance sector and their alignment to the PRA's objectives of safety, soundness, and policyholder protection. Additionally, the speech identified the opportunities and challenges facing the mutual sector in the context of the evolving regulatory landscape and volatile economic conditions.

The speech gave recognition to the challenging economic conditions and inflationary pressures that insurers are facing, and the impact on claims costs, credit and concentration risks and the challenge of adding value from investment assets in this environment. These are of particular concern to the PRA given their priorities in overseeing and ensuring: financial resilience, effective risk management frameworks and preparing for ease of exit in case of insolvency.

Many insurers will benefit from the UK Solvency II (SUK) reforms which aim to increase proportionality, reduce complexity for smaller insurers, many of which are mutuals, as well as facilitate entry and competition for new insurers.

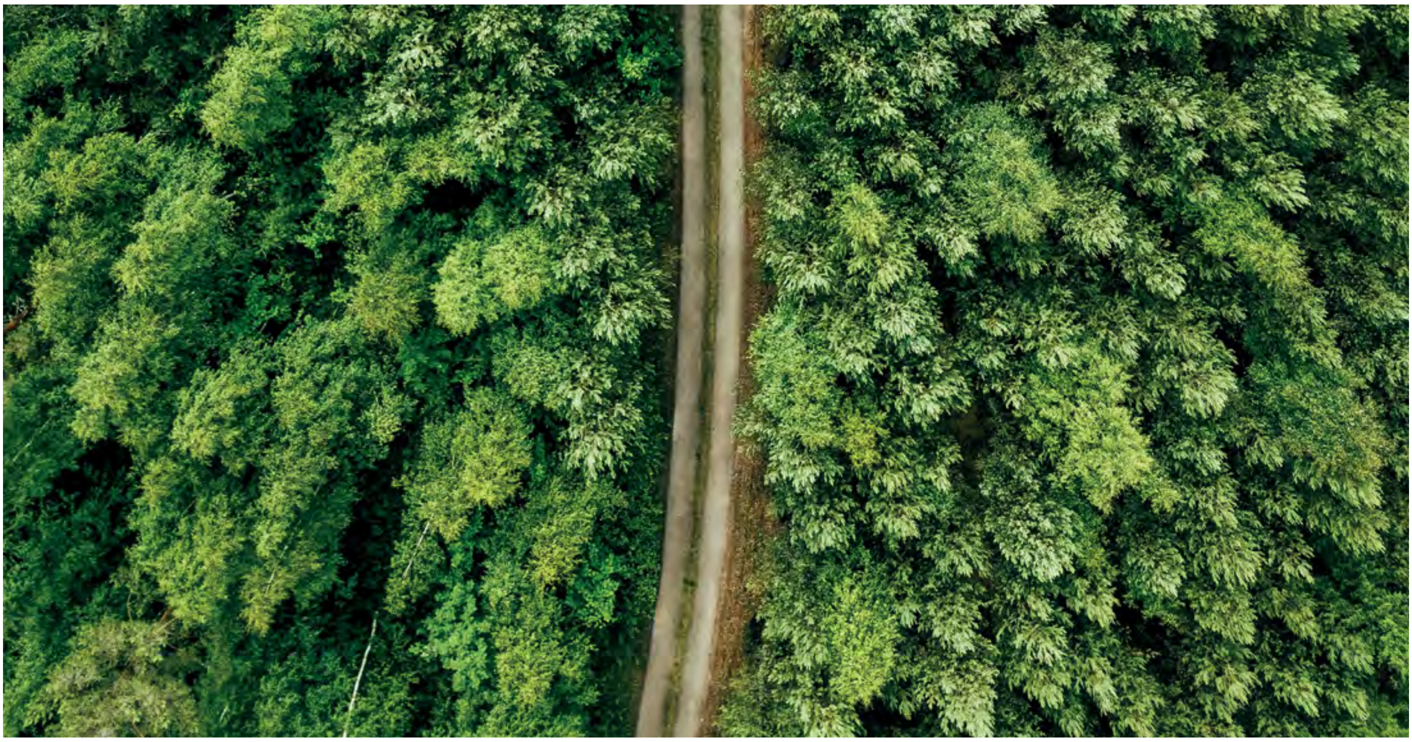
Of particular note, the reforms will not only reduce the risk margin but also improve investment flexibility for insurers which is hoped to incentivise long-term productive investments across additional asset classes.

The PRA recognises that mutuals play an important role in contributing to their objective of competitiveness and growth, particularly where mutuals provide a crucial role in under-served markets, providing important financial inclusion. Beyond this, the PRA encouraged mutuals to continue to collaborate with one another on common operational challenges, such as cyber risk, outsourcing and third-party risk, and to share best practices and threat intelligence.

What does it mean for insurers?

The overhaul of the existing regulatory regime into SUK will have a wide-reaching impact across the insurance industry, not only to mutual insurers who were the focus of this speech. Overall, the proposed reforms are expected to result in a less cumbersome regime by streamlining existing processes, regulation and reporting. Where mutuals, and other smaller sized insurers, will disproportionality benefit is the focus of streamlining to enhance proportionality. Whilst there will be operational costs associated with the implementation of this new regulatory regime, it is expected that there will be significant savings in the medium to long term.

The main body of the SUK reforms that will have the most impact on the investments of insurers are the revisions to Matching Adjustment, Risk Margin and the increased investment flexibility which is hoped to incentivise investing productively. Following these reforms being finalised, insurers may want to review the strategic asset allocation of their investments and ascertain if there are any efficiency gains to be had.



2. PRA Consultation Paper – Funded Reinsurance

On 16 November 2023, the PRA published a consultation paper which outlined its expectations for UK life insurers which utilise funded reinsurance, be that to transfer part, or all, of the risks from a portfolio of annuities to third parties.

Whilst recognising the efficiencies that funded reinsurance can offer, the PRA is concerned by the specific risks that can occur at a systemic level, namely:

1. Excessive exposure to correlated and credit-focused counterparties;
2. Deterioration in the quality and nature of the underlying capital; as well as
3. Underestimation of the counterparty risk and the recapture scenarios.

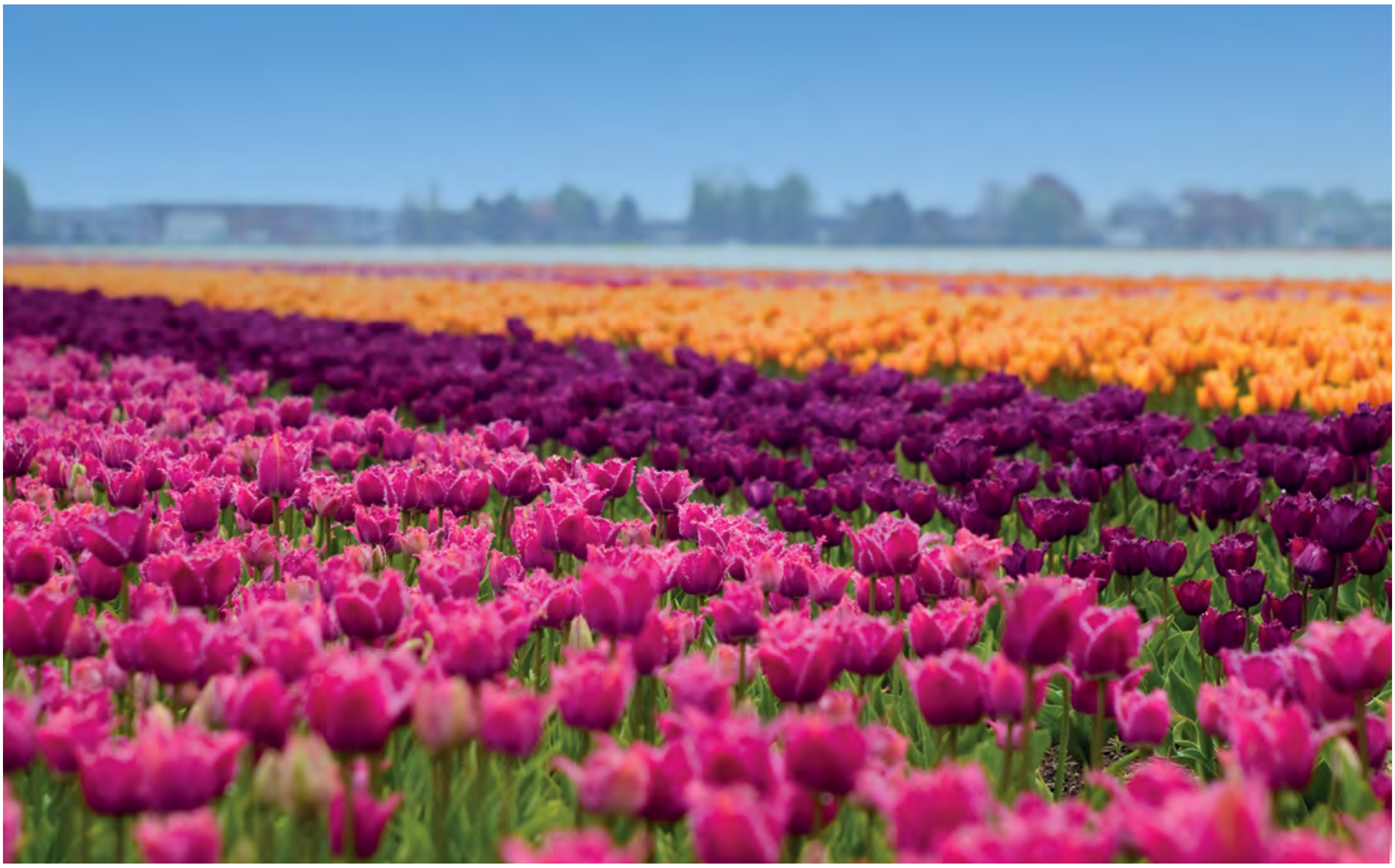
The PRA proposes to address these risks through:

- Ensuring appropriate risk management frameworks remain in place (i.e. setting internal limits for counterparty exposures, having clear collateral policies, and formulating and documenting recapture plans).
- Implementing a quantitative risk assessments processes. This will include an approved internal contractual risk appetite statement and a framework to consider basis and collateral mismatch risks.
- Appropriately accounting for and quantifying the counterparty credit risk. The PRA expects firms to comprehensively capture all relevant risks and features for internal models to accurately calculate the counterparty SCR for funded reinsurance including:
  - The probability of default;
  - The loss given default and downgrade;
  - The collateral used together with any associated haircuts; and
  - The risks and process surrounding recapture within matching adjustment portfolios in the event that the counterparty were to default.

The PRA has set the 16th February 2024 as the deadline for insurers to submit responses to this consultation paper. Changes resulting from this consultation paper would be implemented in Q2 2024.

What does it mean for insurers?

The PRA have been signposting their concern over funded reinsurance for some time and such a consultation paper is unsurprising. For some insurers such proposed changes will be consistent with existing practises but for others, this will carry greater operational burden and cost, making the funded life reinsurance business more expensive.



3. PRA Solvency II Review

The PRA published a statement relating to the Solvency II reforms to be implemented for the 2023 year-end in advance of the PRA's final decisions on its recent Solvency II reform proposals. The statement set out:

- Changes to regulatory reporting requirements:

The changes include the immediate removal of the Regular Supervisory Report (RSR), and the deletion of some Quantitative Reporting Templates (QRTs).

- Recalculation of TMTP and changes to the FRR

The PRA will consider removing the financial resource requirement (FRR) test for firms that were required to limit the Transitional Measure of Technical Provisions (TMTP) in their last recalculation before 31 December 2023, and will no longer expect firms to carry out the FRR test when recalculating the TMTP. Additionally, the PRA invites firms to apply for permission to recalculate the TMTP as of the end of 2023, reflecting the reforms to the risk margin by the government.

- Calculating risk margin for PPOs

The PRA also provided guidance on how firms should interpret the government reforms to the risk margin as it pertains to Periodical Payment Orders (PPOs).

The PRA identifies that PPOs are eligible for the 0.9 risk tapering factor, as they are treated as life insurance obligations within the existing regime. Recognising that there is an existing pipeline of potential claims, the PRA does not object to firms adopting a probabilistic approach in the risk margin calculation, where the 0.9 risk tapering factor is applied to potential PPO obligations on a probabilistic basis.

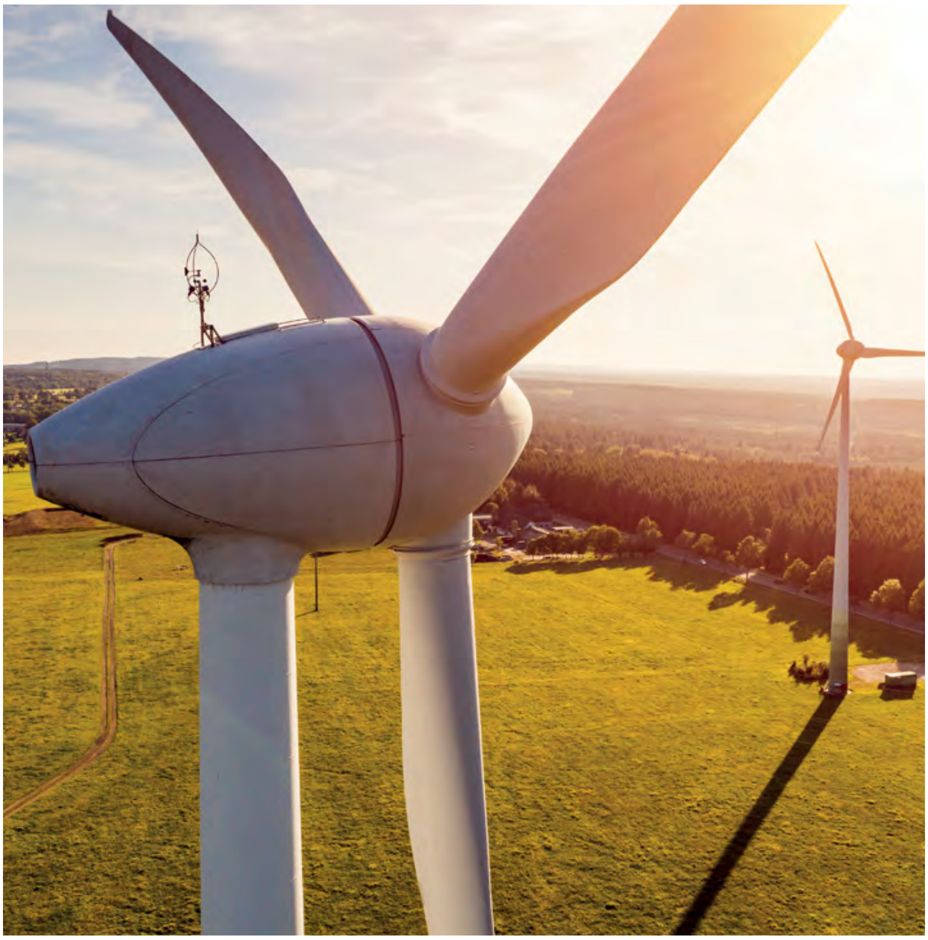
What does it mean for insurers?

The reforms and changes outlined above aim to reduce the reporting burden on insurers, as well as the duplication and complexity of reporting, and align the SII regime with the UK insurance market, as the RSR, and some QRTs, are not considered to be as useful, or relevant, for the PRA's supervision. Furthermore, the changes to the TMTP and the risk margin aim to make the UK regime more suitable for the long-term nature of the UK insurance market, and to avoid excessive volatility and procyclicality in the solvency position of insurers. This package of reforms will create a regulatory environment that is less burdensome, more proportional, and permit greater investment flexibility. Although there will be some upfront operational costs born out of the transition phase, it is expected that most insurers will benefit in the long-term.

4. PRA statement on the dynamic general insurance stress

On 3 October 2023 the PRA published a statement outlining their intention to run a dynamic general insurance stress test in 2025; this test incorporates a sequential set of adverse events over a short period of time, which is a departure from previous dynamic stresses. Such a stress analysis will allow the PRA to assess the industry's solvency and liquidity resilience to a specific adverse scenario as well as testing the effectiveness of insurers' risk management and management actions following an adverse scenario.

The results of the exercise will be disclosed at an aggregate industry level and better prepare firms against adverse scenarios.



Insurance investment themes

Asset class themes in 2024 for insurers

Looking back

2023 was a year of both challenges and opportunities for institutional investors.

Whilst the world economy was much more resilient than anyone expected, the year saw persistent economic uncertainties with higher-than-target inflation, continued hikes in interest rates and the prospect of recessions looming with every step. In such circumstances it was no surprise to find insurers reassess their investment strategies, with a heightened focus on diversification and resilience.

As we came into 2023 the consensus was for a recession, caused by higher interest rates and energy costs, which would negatively impact equities but would benefit bonds, which had performed poorly in 2022. All of this turned out to be incorrect. There was no recession and as a result bond yields have continued to rise (falling in value) whilst equities have performed generally well.

We are expecting an economic slowdown in 2024. That may be a mild recession, or just flat-lining growth. The economy more widely has also been resilient to this point, but we think that most investors expect the monetary policy tightening of the past two years to start to show up more in the real economy.

Whilst much of 2023 will have a knock-on effect for 2024, the ever-changing environment does potentially present opportunities for the nimbler investors. We summarise below the high-level outlook across different asset classes and what may lie ahead in 2024.

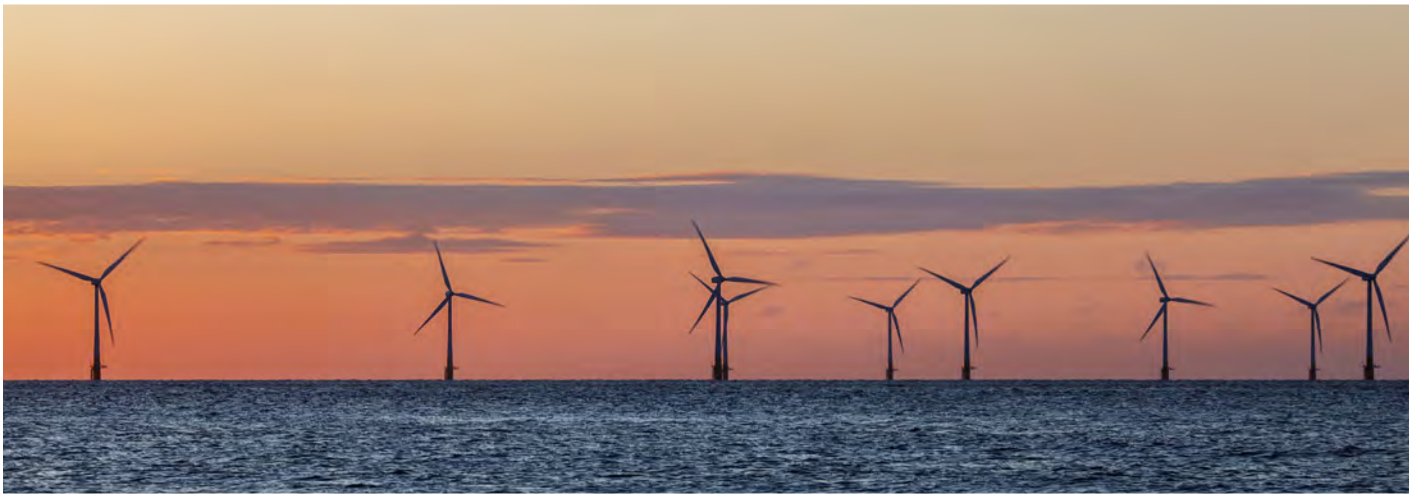
Global equities

Outside of unit-linked assets, equity allocations for most insurers remain a relatively low proportion of overall assets. However, when considering the impact on risk, return and capital requirements, the asset class punches above its weight and it remains a key component of driving excess risk adjusted returns for many insurers. In support of this view, insurers who held equities in 2023 found themselves in a much stronger position compared to 2022.

After more than a decade of global interest rates, and bond yields, at or near long-term lows, the post-pandemic landscape has been characterised by a period of higher than target inflation. Exacerbated by the Ukraine-Russia war, the initial ‘transient’ inflation expectations proved overly optimistic and has consequently caused major central banks to increase interest rates rapidly and substantially.

Whilst some of the impacts of these changes have already been reflected in economic activity and financial markets, as we enter 2024 it is likely that the most meaningful impacts of higher rates and bond yields on consumers, businesses and the financial system are still to emerge. How these impacts unfold, and, indeed, how central banks react to them, will be a key driver of market and intra-market volatility and activity in 2024.

Of key interest will be technology stocks and, in particular, the ‘Magnificent seven’ being made up of Alphabet (previously Google), Amazon, Apple, Meta (previously Facebook), Microsoft, Nvidia and Tesla. These seven describe the mega-cap technology growth stocks, some of the most valuable companies in the entire stock market, that are all largely focused on technology growth trends such as artificial intelligence. These seven stocks alone were a key contributor to stock market robust returns across 2023 and, to some, their lofty valuations, based on forward earnings multiples and price-to-sales ratios, are cause for concern and reminiscent of the run-up to the dot-com crash.



Multi asset

On the back of numerous 2023 surprises there are three main questions to ask as we move into 2024, the first being where the business cycle is headed and whether it's likely that we have entered a period of 'Spikeflation'. Our third and final question relates to investment strategy. What sort of approach does a highly uncertain economic outlook with the risk of further inflation shocks argue for?

This section looks at these questions in more depth and, as ever, the key for investors looking to take advantage of these uncertainties is to remain as flexible as possible.

Where is the business cycle headed?

Our multi asset team use an Investment Clock as part of their tactical asset allocation process to relate the current stage of the business cycle to asset allocation, telling the 'time' using indicators for both growth and inflation. At the year end the indicators were mixed, with the reading on our diagram close to the crosshairs. Whilst global growth was holding up quite well, business confidence had been declining. The surge in inflation has mostly reversed, but further progress is dependent on commodity price trends and the evolution of labour market slack. Over 2024, our base case sees economies continuing to weaken as consumers and businesses gradually refinance their debt at higher rates. Rising unemployment eventually bears down on wage inflation and bond yields drop. Stock and credit markets soften in the face of earnings downgrades and corporate defaults.

This is a move into Investment Clock Reflation, with central banks beginning to cut interest rates. It sounds convincing enough, but the same was said a year ago, before developments led us to take a more positive short-term view. So where are the risks to this base case? We might move back into equity friendly Recovery if the US can deliver a soft landing. With inflation coming back under control, it's plausible the Fed cuts rates before the full pain has been felt, turning what today looks like a looming wall of refinancing into a garden hedge the economy can simply step over.

We suspect the same trick won't work as easily in the UK and Europe with wage inflation sticky and earnings prospects less rosy. If a US soft landing means the dollar stays strong, we could see another year of strong equity market performance in Japan though, with exporters benefiting from a weaker yen. Downside scenarios come back to inflation and the lagged impact of interest rate rises. If core inflation stays high, or a deteriorating geopolitical situation leads to another surge in commodity prices, central banks could end up hiking rates still further, drawing obvious parallels with the stock and bond weakness of 2022. The sort of interest rates hikes we have seen over the last two years have almost always ended in recession after what monetarist economist Milton Friedman first called "long and variable lags".

Will inflation spike again?

Our second big question is longer term. Was the inflation surge of 2021-2 a one-off, related to excessive Covid stimulus left too long in a supply constrained world economy, or is it a taste of things to come? In our view, we think it's likely that we have entered a new era of what we are calling 'Spikeflation'. This is a regime characterised by periodic upward shifts in prices on the back of structural drivers including the transition to net zero – which means reduced investment in fossil fuels, offset by a surge in the demand for

metals that support renewable energy infrastructure – heightened geopolitical risk, demographics and deglobalisation all against the backdrop of high debt levels which create the temptation to debase the value of money.

A period of spiky inflation would be very consistent with the historical record. Inflationary eras around the two World Wars and in the 1970s did not see high, stable inflation. They saw a series of individual price level shocks which in aggregate resulted in a twofold to more than fourfold rise in the cost of living. The measured annual rate of inflation over these periods fluctuated wildly, from close to zero to more than 20%.

What does this mean for multi asset investing?

So, what does all this mean for insurers investment strategy. What sort of approach does a highly uncertain economic outlook with the risk of further inflation shocks argue for? For us it means being as flexible as possible. We believe insurers should consider diversifying broadly, moving beyond stocks and bonds to include inflation hedging assets like commodities or commercial property in their portfolios. They should also consider adopting a more active tactical approach to asset allocation suited to a period with more frequent recessions, as central banks repeatedly step in to bring inflation back under control. And they should look for strategies that can help them to manage downside risk.

The low inflation world from the 1980s onwards saw extremely long business cycles. We may be back to the five-year average that prevailed historically. More frequent recessions mean more frequent bear markets in equities. This matters especially to those drawing their retirement income from an investment portfolio. People are living longer but market cycles are getting shorter. Sequencing risk is a growing issue for advisers to consider as more people use income drawdown - with market drawdowns potentially hurting future income potential. This was a factor in 2023, with many people forced to take large withdrawals after suffering large investment losses.

With higher interest rates making annuities more attractive, decumulation investors will have to up their game. There are no straightforward solutions for how insurers should react to the materially different environment now being faced. Inflation hedging will be even more important with a now higher level and increased variability in inflation, including using more non-traditional assets such as commodities to achieve this. In addition, being more nimble with asset allocation decisions is likely to provide benefits in managing downside risk, being more dynamic around asset valuations and recognising increased path-dependency in investment markets at the current time.

Investment grade credit

Whilst 2023 saw many challenges, the collapse of Credit Suisse had a clear impact across the financial market, with the complete wipe-out of AT1 bond holders, while equity holders achieved some modest recovery. Effectively, this stopped any new AT1 issuance but credit markets have since remained resilient as this pause came to an end.

Looking ahead, there is some potential for sterling credit markets, as for the first time in a decade we feel that the headline yield is attractive and sustainable. This is further supported by underlying factors, including the fact that interest rates appear to have peaked and inflation is falling. For investors with significant fixed income exposures such as most insurers, that is a decent starting point for any year.

High yield

At the start of 2023, the market was forecasting a higher default rate than the trend that ultimately played out. Looking ahead, we see defaults sitting around 3% to 5%, with our most pessimistic case seeing 7%. Even if defaults were to go beyond 5% and creep towards 7%, this wouldn't be cause for concern; fundamentals of the high yield market wouldn't change.

With this in mind, we believe 2024 should play out similarly to 2023: maturity wall concerns being overplayed; companies holding high liquidity; private debt markets eating the bottom cohort of public markets; public markets remaining open with solid issuance levels.

Critically, as long as public markets stay open, any maturity wall concerns will be swept away and, as long as private markets continue to reduce the CCC rated issuance of public markets, which not only improves the quality of names in which we choose to invest but also reduces the weakest parts of public markets, defaults should stay low.

Whilst the downward trending economic cycle is not much to fret about for the high yield market, the 'higher-for-longer' environment could lead to a shift in the make-up of yields – which is currently about half spread and half underlying government bond yield. Even in this higher-for-longer world, we still see the default cycle being extended into 2025, leading us to believe spreads will fall in a range of 340 to 450 for next year. So, if defaults and spreads are in a relatively benign state, the key for us then becomes income production, also known as carry.

As rate cuts from the Fed, and most other major central banks, are already priced in to markets as well as corporate valuations, the biggest danger to the high yield market is the higher for longer stance; corporate valuations are tied to interest rate expectations and any change in rates will have a knock-on impact on valuations, which will then impact credit markets by reducing the margin of safety in terms of equity cushions and, ultimately, would cause higher spreads.

While we are comfortable with what we feel is a benign economic environment, we do accept there is increased idiosyncratic risk compared to 12 months ago. There is uncertainty around the Middle East and the upcoming US elections, while rising government deficits also offer a technical risk that is flying under the radar.

For a high-yield strategy, there is a preference for liquid capital structures, staying away from smaller capital structures, and a preference for larger names which have established routes to capital. With the main uncertainty in 2024 coming from interest rates (timing and pace of any reductions), we are more focussed towards shorter duration bonds where the cushion provided by carry/income is even more pronounced in this yield environment.

Government bonds and cash

Government bonds were very much under the spotlight in 2023 with increasing interest rates and yields resulting in material falls in market values for not just insurers, but all investors. Looking ahead, the possibility of this volatility continuing remains as higher than target inflation, for longer, remains. While there are likely no more hikes on the agenda, what will cause problems is the increasing 'higher-for-longer' interest rate narrative that has emerged. We will be looking closely as to whether banks will wait for a recession before starting to cut or if they will feel the recent trend of no growth is good enough to start cutting.

With five-year gilt yields significantly lower than current base rates, there is no firmer sign that markets see rate cuts coming in the next few years – it is just about deciphering when, and how quickly, they come. If this predicted recession is a deep one, then yields will fall more than expected, but an intriguing issue to keep an eye on is the increased amount of gilt supply coming our way, which could exacerbate these falls. In a recession, investors seek out quality, which typically means we see buyers in the front-end of the curve, and with rate cuts typically being front-end led, we expect to see curves steepen which favours holding shorter maturities.

For many insurers focusing on asset-liability management through government bonds, the management of duration and curve risk will remain key, given the prospects for continuing increased volatility in market values and yields. For insurers who are able to have more of a return focus for at least part of their government bond portfolio, and as this market volatility continues, we feel it has never been more important to manage these bonds actively.

Looking ahead into 2024, we see volatility persisting which will be caused by investors looking to re-risk, moving assets back out of cash and into other vehicles in an attempt to maintain the current yields being offered. There is also a series of macro factors to consider: geopolitics in the Middle East, elections in the US, a continued heightened focus on monthly economic indicators, and increased supply. While it is hard to be certain about an end point for gilt yields by the end of 2024, we do expect those macro factors and uncertainty around them to lead to some swings in yields which in turn provides opportunities to tactically trade around these events.

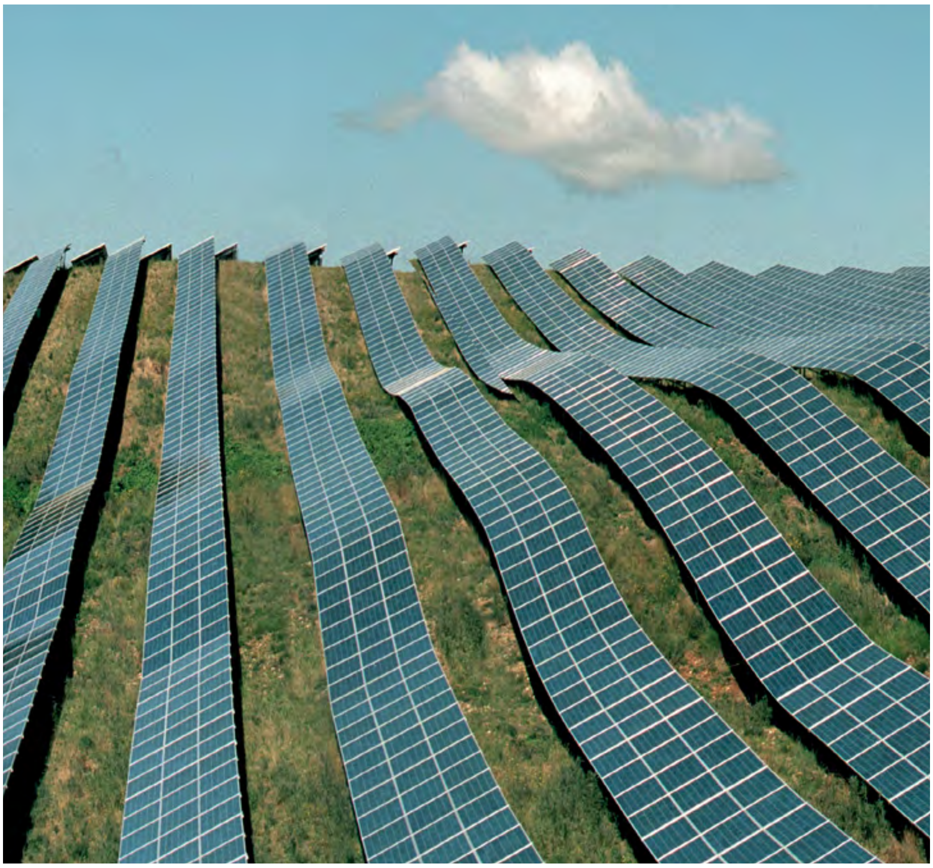
Commercial property

The real estate market has also not been immune to the challenges played out in 2023 such as rising interest rates, which real estate markets are more sensitive to. Other factors have also presented themselves however, which are more nuanced to the property market, such as the drive to Net Zero. Investors are placing as much emphasis on impact and sustainability as financial returns in their investment decisions, and for insurers there is the potential for pressure from wider stakeholders too.

The capital value cycle is finely poised as we head into 2024. While there are plenty of areas where we would exercise caution, such as secondary stock in the office and industrials sectors, we are still in the early stages of seeing huge growth in new sectors that we feel could generate attractive long-term returns and help create solutions to some of the long-term issues facing us today. For insurers who have the ability to invest in less liquid assets, we believe that property remains an attractive asset class from both economic and sustainability perspectives, subject to this being implemented in an appropriate manner in the right sectors and markets.

2024 – ongoing uncertainty but pockets of opportunity

2023, following the difficulties of poor asset class returns for the vast majority of assets in 2022, was another challenging year. Although inflation rates are still much higher than most central banks targets, the question remains around if, and how quickly, banks will look to press inflation down further. For insurers and long-term investors, a critical area is the extent to which rates stay at these higher levels rather than falling back, particularly if inflation remains stickier than expected. However, the environment that has emerged does present opportunities at both the overall asset class level as well as sectors and areas within these assets. If you would like to know more about how Royal London Asset Management can potentially help position your portfolio to take advantage of these uncertainties, please get in touch with your usual contact and we'd be happy to help.



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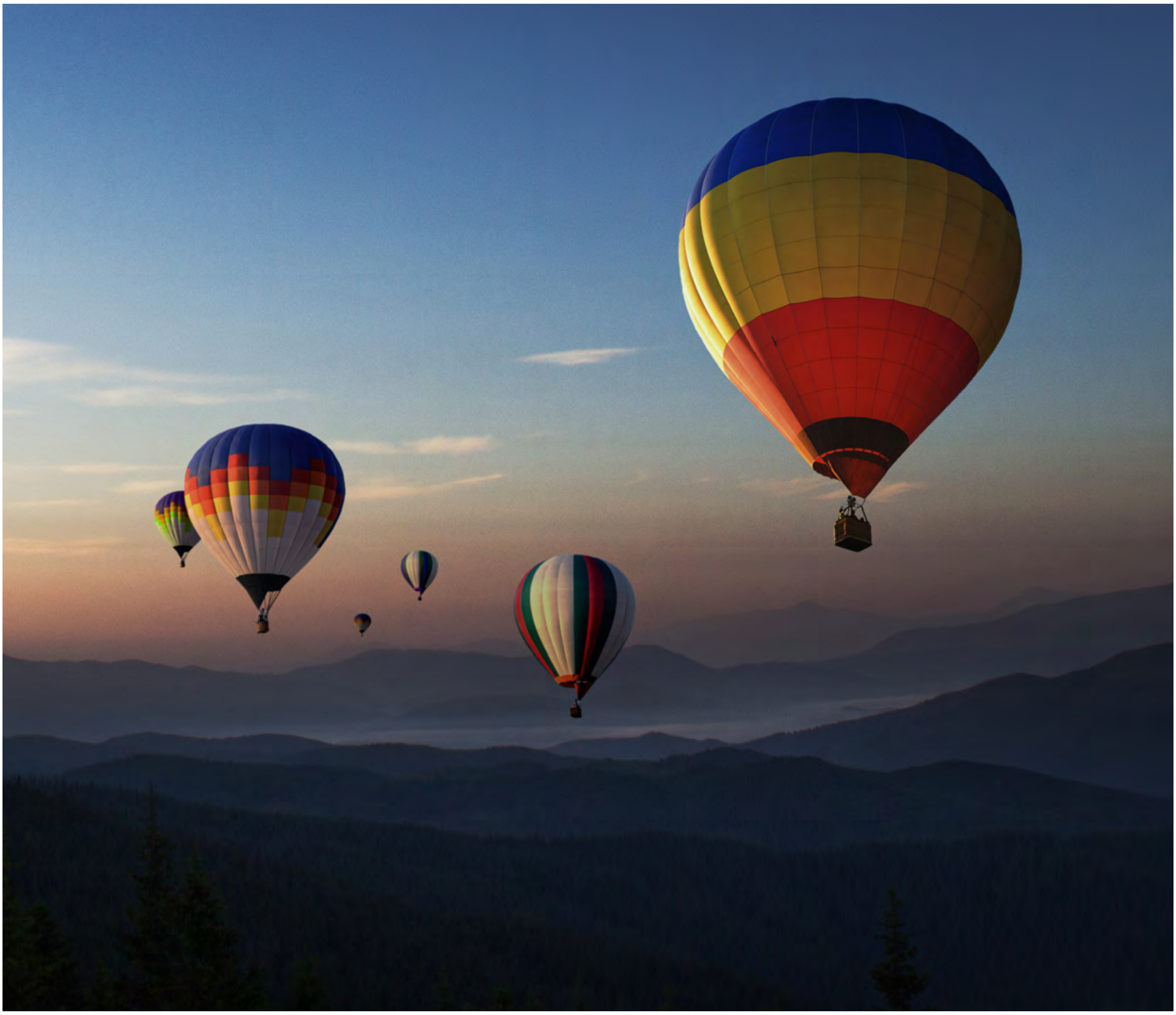


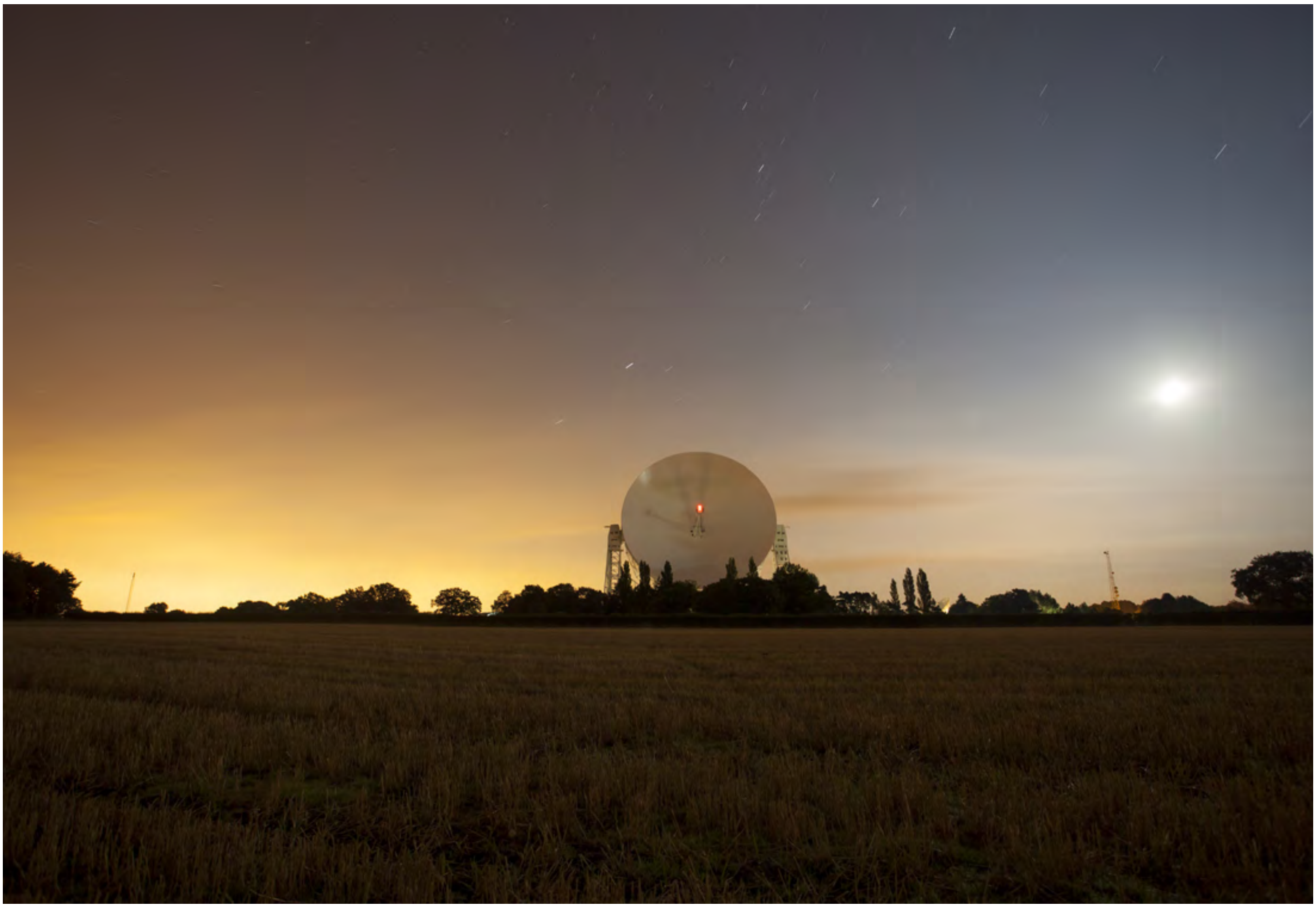
Appendix

Fixed income	Index used	Returns quoted
Euro Treasuries	Bloomberg Barclays Euro Treasury Index	EUR Hedged
US Treasuries	Bloomberg Barclays US Treasury Index	EUR Hedged
Euro IG Corporates	ICE BofA Euro Corporate & Pfandbrief Index	EUR Unhedged
Global IG Corporates	Bloomberg Barclays Global Aggregate Corporate Index	EUR Hedged
EMD	JPM GBI-EM Global Diversified Index	EUR Hedged
Global High Yield	ICE BofA BB-B Global Non-Financial High Yield Constrained Index	EUR Hedged

Equities	Index used	Returns quoted
Euro Equities	Euro Stoxx 50 Index	EUR unhedged
Global Equities	MSCI World Net Total Return GBP Index	EUR unhedged
EM Equities	MSCI Emerging Markets Net Total Return GBP Index	EUR unhedged

Volatility	Index used
Volatility	Cboe Volatility Index (VIX)

Source: Bloomberg, HIS Markit



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