NEAM VANTAGE POINT

Quick Takes

JANUARY 2025

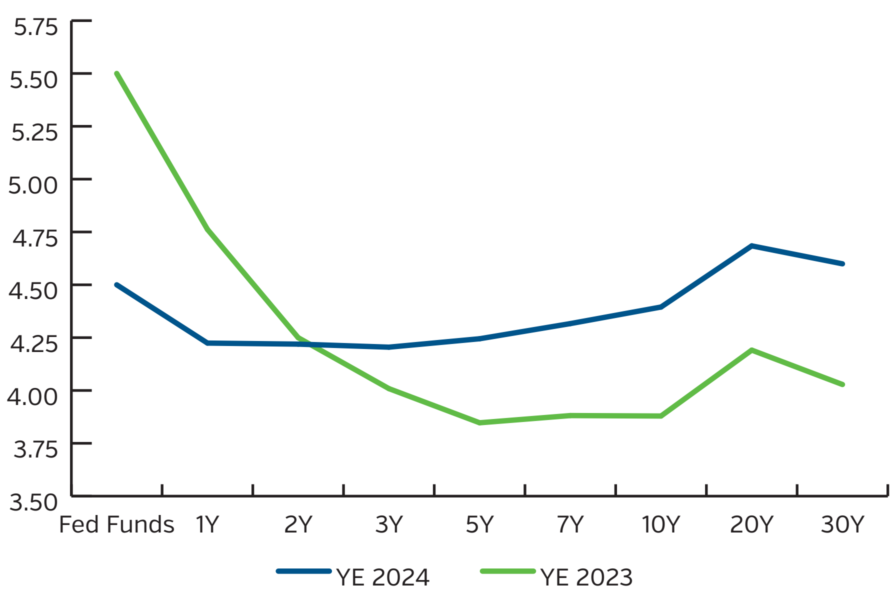
TIMELY TOPICS FOR INSURANCE EXECUTIVES

2024 Fixed Income Yields and Returns...and Beyond

HEALTHY APPETITE FOR RISK IN 2024

Risk appetite across the U.S. capital markets was strong in 2024. The U.S. economy was supported by low unemployment, resilient consumer spending, and optimism over the promise of large language models and AI. The Federal Reserve moved to a monetary easing stance, reducing both its policy rate and balance sheet. The final kick came from the sweeping election result, setting off expectations for a growth tailwind from easing regulations and tax cuts. Fixed income markets underwent their own transition. Treasury yields fluctuated over the period but ended the year both steeper and higher as shown in the chart below. Credit spreads narrowed significantly, leaving most sectors on the rich side of historical valuations.

Chart 1. Treasury Curve (Year-End 2023 vs. 2024)



Source: Federal Reserve, Bloomberg

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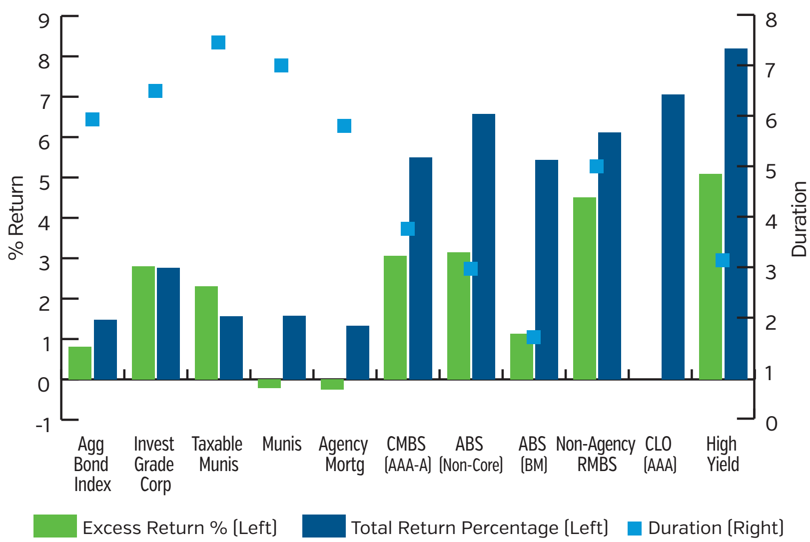
The shift in the treasury curve, together with valuations that richened over the year, resulted in positive, though variable, total returns across sectors. Key observations are as follows:

- The yield curve moved from an inverted position (measured as the difference between the 10-year and 2-year treasury yield) of -40 basis points to +33 basis points as short-end rates fell and longer-end rates rose.
- Short duration tended to outperform longer duration (see chart below). AAA-rated CLOs (Collateralized Loan Obligations floating to 3-month SOFR) outperformed all high-quality sectors, with a total return of nearly 7%.
- Lower-rated and down in credit securities outperformed their highly rated, up in credit peers. This outperformance was on display in both BBBs vs. single-A corporates, and high yield vs. investment grade sectors.
- Investment grade structured sectors strongly outperformed the corporate and municipal sectors on both a total return and excess return basis.

Chart 2. 2024 Fixed Income Sector Total and Excess Returns

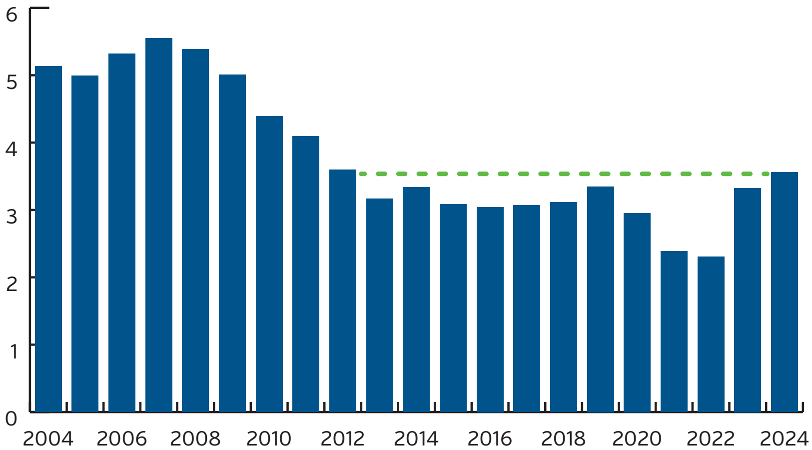


Source: ICE BofA, JPMorgan, Citi

INCOME RETURN ON THE RISE

Insurance companies value the income component of fixed income securities to support operating needs, cash flow stability, and reinvestment growth potential. For 2024, that story improved as the secular trend of income growth continued its upward trajectory. The chart below shows that the *income component* of the ICE BofA Aggregate Bond Index rose to the highest level since 2012. This is good news for investors that took advantage of attractive all-in yields during the year to lock in durable yields, a strategy NEAM has been recommending throughout the year.

Chart 3. ICE BofA Aggregate Bond Index Income Return



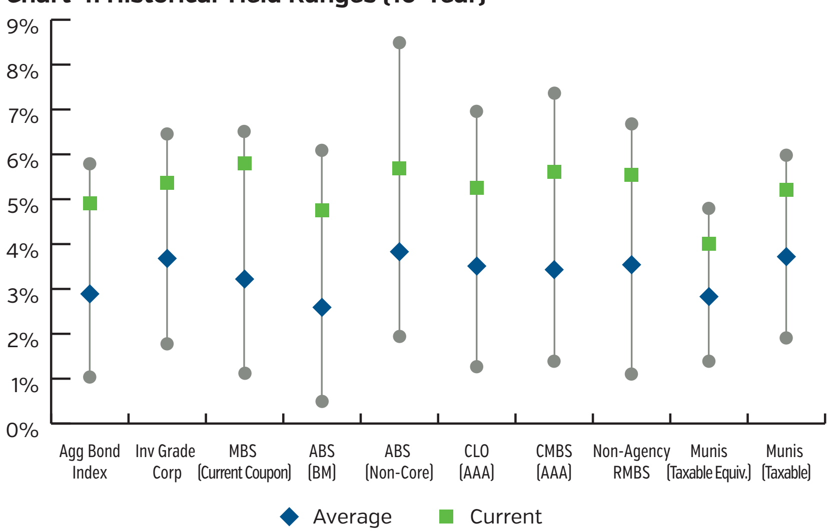
Source: ICE BofA, Bloomberg

LOOKING TO THE YEAR AHEAD

The U.S. economy entered 2025 with positive momentum and stable fundamentals based on a fully employed labor force, healthy corporate and household balance sheets, and the absence of excess leverage in the system. At the same time, and as we start the year, we are getting a taste of the headline driven interest rate volatility arising from high impact economic data (payrolls and inflation) and policy proposals from the incoming administration. With this backdrop in mind, a neutral duration positioning seems prudent.

An added risk on the horizon for fixed income investors concerns the very tight level of credit spreads compared with long term historical levels. Within a mean reversion framework, that would suggest that spreads could be vulnerable to widening in the future. That said, market yields sit at very attractive levels, particularly within non-benchmark structured securities (ABS, CLOs and Non-Agency RMBS), as shown in the chart below.

Chart 4. Historical Yield Ranges (10-Year)

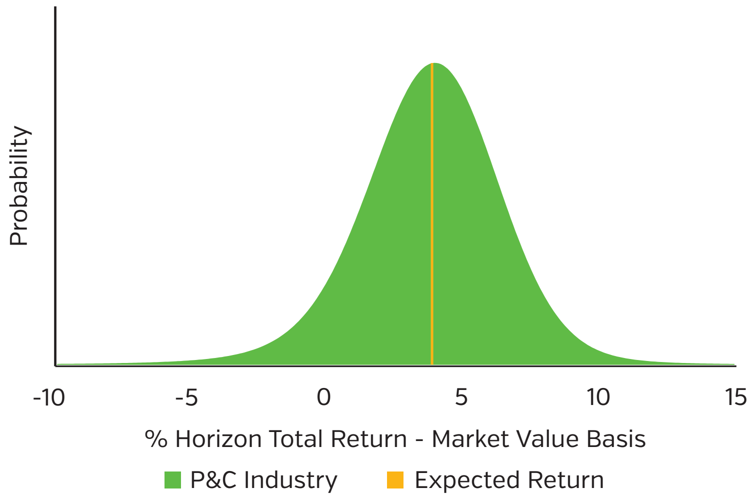


Source: ICE BofA, JPMorgan, Citi

NEAM's assumptions and views are captured in our projected total return methodology which, when applied to the fixed income portfolio of the P&C industry, results in a projected total return of 4.3% for 2025. Income will once again do the heavy lifting in 2025, in our estimation. Income is expected to contribute +4.7% to total return, with a -0.4% offset from price return.

Chart 5. Projected 1 Year Horizon Return Distribution: P&C Industry

1 Year Forecast (11/30/2024)	
Expected Return	**4.29**
Income	**4.68**
Price	**-0.40**
Volatility	2.38
Prob. Negative Ret.	5%
Skewness	-0.34
99.5 VaR (% Mkt Val)	-6.55
99.5 T-VaR (% Mkt Val)	-14.95



Horizon returns are not bounded by the return numbers shown on the x-axis. There is a probability associated with a potential 100% loss scenario
Source: NEAM

KEY TAKEAWAYS

- The U.S. economy continues to show positive momentum supported by low unemployment, robust overall consumer spending, and optimistic business sentiment on the expectation of deregulation and expanded tax cuts.
- The bear steepening in the yield curve generally benefitted shorter duration sectors while spread tightening was most pronounced in lower rated securities. Structured sectors outperformed across the board.
- Total returns in 2024 enjoyed a higher contribution from income which were offset by negative price returns, a trend that is expected to continue.
- Credit spreads sit at tight levels across most fixed income sectors. However, all-in yields have returned to the higher end of yield ranges over the past decade.
- Heightened interest rate and spread volatility are expected in 2025. Along with incoming economic data, executive actions and initiatives from the new administration will be closely watched for their impact on Fed policy, economic growth, sector performance, and the trajectory of inflation.

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The 2025 Projected P&C Fixed Income Return chart is based on an estimated aggregate P&C fixed income universe. Returns for this universe are forecasted under numerous interest rate and spread environments and then probability weighted based on our firm's capital market views (i.e. historical returns, growth outlook, central bank policy, fiscal considerations) to create a hypothetical distribution of returns. These projected returns do not take into consideration the effect of taxes, changing risk profiles, operating cash flows or future investment decisions. Projected returns do not represent actual accounts or actual trades and may not reflect the effect of material economic and market factors. No representations or warranties are made as to the reasonableness of the assumptions made in these projections. Actual results will vary from any projected returns shown.