NEAM VANTAGE POINT

Quick Takes

JANUARY 2017

TIMELY TOPICS FOR INSURANCE EXECUTIVES

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NEAM New England Asset Management

Returns and Yields 2017

A Review of NEAM's 2016 Estimated & Projected Total Returns for 2017

A bit of rate relief in the second half of 2016, but total returns fade post-election.

BACKGROUND

As our regular readers know, NEAM utilizes its proprietary return projection methodology to establish an annual forecast for fixed income returns within the U.S. P&C insurance industry. As part of this process, we also create a distribution of possible outcomes which is used to estimate the probability of a negative total return. While 2016 exhibited roller coaster-like characteristics, our estimates proved reasonably accurate. Our estimated return for 2016 was 1.59% with a standard error of 1.84%. Using Bloomberg Barclays index returns as proxies (and assuming a split of 2/3 taxable and one third tax exempt), ***we estimate that P&C investment grade fixed income returns for 2016 were approximately 1.86%. If one includes the industry average allocation to high yield (HY) securities of roughly 6% of fixed income holdings, the estimated return increases to approximately 2.70%***. While we ended the year roughly where we thought we would, we certainly didn't predict a low of 1.36% on 10 year U.S. Treasuries (UST) or a Trump presidency. Nonetheless, our underlying assumptions – namely that rates would exhibit modest upward drift from their starting point of 2.27% on 10 year UST and that corporate spreads (and those in other sectors) would remain relatively well behaved – proved to be correct.

Table 1. 2016 Indicative Yield and Spreads

U.S. Treasury Yields		
Maturity	1/1/16	12/31/16
2-Year	1.05%	1.19%
10-Year	2.27%	2.44%

U.S. Corporate 10-Year Spreads		
Sector	1/1/16	12/31/16
Industrial A	121 bps	90 bps
Industrial BBB	262 bps	160 bps

Source: Bloomberg, BofA ML Index Data

The U.S. Presidential election and all of its implications have set the tone since the second week in November, causing interest rates to rise, and equities (particularly U.S.- centric small and mid-caps) to rise alongside. These are logical movements given the proposed agenda, but we expect that the buoyant feeling that has enveloped the capital markets will give way to caution and additional volatility as we enter the New Year.

INVESTMENT ENVIRONMENT FOR 2017

2017 will prove to be a year filled with surprises. Of course, we could say that every year and be correct, so let us be more specific. Donald Trump's unlikely victory, in and of itself, should create volatility. The policy agenda includes tax reform, possible trade renegotiation, repeal and

replacement of the ACA, and rolling back at least some of the regulations which have proliferated over the last decade. In this regard, the backdrop should be more business friendly. Meanwhile, the Federal Reserve should be able to continue "normalizing" interest rates, particularly if fiscal stimulus makes its way through the legislature. We believe the move to fiscal stimulus will be a global phenomenon as monetary stimulus has done what it can to spur growth.

Importantly, the reaction function of the Fed should start to change as we get through the first term of Trump's presidency. Janet Yellen's term concludes in 2018 and others will rotate off the committee as well. In addition, there are two open positions which will be filled by the new administration. As new appointments are made, the Fed will almost certainly have a different philosophy regarding the role of the Fed and of monetary policy. While this is not directly related to 2017's return outcomes, it's important to note that the uber-dovish, try-anything approach may no longer be in vogue.

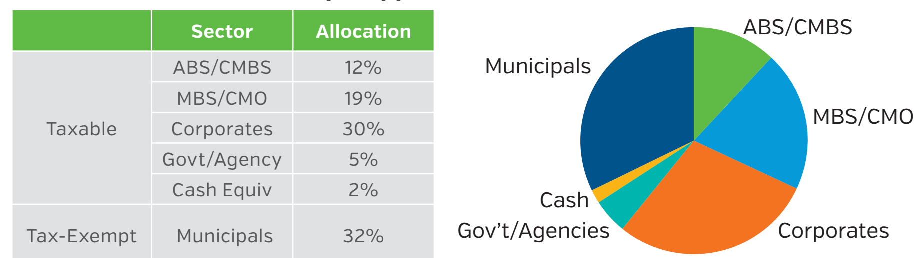
With regard to interest rates themselves, we still believe the macro factors which have put a governor on growth (debt, demographics, etc.) are still very much at play. Using an intermediate to longer term horizon though, we believe the reaction in the bond market since November 8th is logical and justified. Our call is for interest rates to slowly drift higher over the next few years, as exceptionally accommodative monetary policy gives way to fiscal stimulus to provide a much needed lift for nominal GDP growth. The U.S. Dollar, which raced to 15 year highs post the election has paused (and we believe it should) as somewhat higher rates and a stronger dollar will (at least temporarily) create some drag in economic activity and corporate profits.

2017 PROJECTED RETURNS

We base our return projection on a portfolio of securities which closely resembles the aggregate P&C fixed income universe. We calculate total returns on the aggregate portfolio assuming numerous and varied interest rate and spread changes. These returns are then probability weighted based on our firm's capital market views. In this way, our assessment of capital market expectations influences the expected level of returns and the distribution of those returns.

The characteristics of our "aggregate" P&C fixed income portfolio are represented below in Exhibit 1. Using this proxy portfolio and our expected return methodology, we've calculated total returns across a range of rate and spread scenarios. Those returns are summarized in Exhibit 2 below.

Exhibit 1. 2017 P&C Industry – Approximate Fixed Income Sector Allocation*



	Sector	Allocation
Taxable	ABS/CMBS	12%
	MBS/CMO	19%
	Corporates	30%
	Govt/Agency	5%
	Cash Equiv	2%
Tax-Exempt	Municipals	32%

** Taxable/tax exempt allocations are representative of P&C industry. Sector characteristics and investment grade sector allocations may differ slightly.*

Source: NEAM

Each cell represents the estimated total return for the corresponding combination of rate and spread changes. For example, if interest rates, curve shape and credit spreads remain completely unchanged, we estimate a total return for the industry of approximately 2.83%. Instead, if interest rates rise by 50 basis points and spreads remain stable, our estimate drops to 1.01%. It should be noted that our model differentiates between fixed income asset

classes with regard to spread widening. That is, an “extreme” spread widening is different for investment grade corporate bonds than it is for high yield or structured securities. Thus, we incorporate historical volatilities of each asset class when calibrating the impact of spread changes.

Exhibit 2. Projected Returns Across Various Rate and Spread Scenarios

Projected 1-Year Horizon Return (%) – Market Value Basis										
			Interest Rate Shift							
			Lower Rates			NC	Higher Rates			
			-200	-100	-50	0	+50	+100	+200
Spread Change	Wider	Extreme	(1.00)	(3.30)	(4.80)	(6.43)	(8.15)	(9.84)	(13.14)
		Moderate	3.09	0.68	(0.88)	(2.58)	(4.30)	(6.00)	(9.30)
		Benign	6.49	4.00	2.41	0.66	(1.12)	(2.89)	(6.34)
	NC	No Change	8.82	6.26	4.64	2.83	1.01	(0.81)	(4.36)
	Tighter	Benign	9.65	7.04	5.40	3.58	1.73	(0.11)	(3.70)
		Moderate	10.38	7.78	6.13	4.31	2.46	0.61	(3.03)

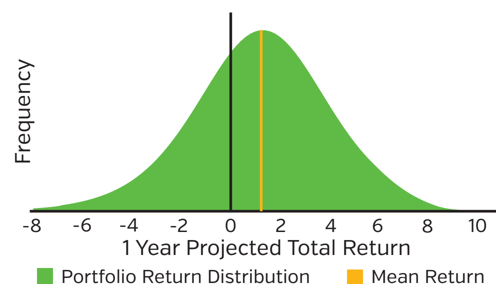
Source: NEAM

The next step in our projection process is for our investment team to ascribe a probability to each of the outcomes above. Those estimates are based on our assessment of the global economic environment, U.S. economic growth, relative valuation across fixed income sectors and the impact of anticipated pro-growth U.S. policies. Given the current level of rates, we’ve ascribed relatively low probabilities to outcomes which feature materially lower interest rates. Higher probabilities are ascribed to outcomes with modestly higher rates and stable spreads, reflecting our base case forecast.

Utilizing statistical techniques, we create a distribution of returns which is used to assess and quantify portfolio risk and return. ***Combining the returns above with our ascribed probabilities, we derive a mean projected return of approximately 1.18% with a standard deviation of 2.74% (see Exhibit 3 below).***

Exhibit 3. 2017 P&C Industry - One Year Projected Fixed Income Return Distribution and Risk Measures

	P&C Universe Proxy
Mean Expected Return	1.18%
Standard Deviation of Return	2.74%
Probability of Negative Return	31.0%
Yield	2.60%
Effective Duration	4.85



Source: NEAM

CONCLUSIONS AND IMPLICATIONS

Our forecasts for 2015 and 2016 have proven relatively accurate.[1] We’d be the first to admit though, that the volatility in spreads in January and February of 2016 and the spike in rates post the U.S. election wasn’t exactly the path we’d anticipated. As we begin the new year, it does appear the headwinds for fixed income assets will continue. The pro-growth agenda of the new Administration will likely continue to put upward pressure on rates, provided that the sharp tongued rhetoric on trade barriers remains more bark than bite. We believe that on balance, the pro-growth stance should trump the trade banter (pardon the pun). With spreads as narrow as they are though, the prospects for negative total returns are the highest they’ve been in a while. Our base case interest rate forecast for 2017 incorporates some relief from the

current low yield levels, primarily in the form of somewhat higher interest rates. Short-term Treasury rates have moved higher and should continue to drift upward as the Fed slowly normalizes monetary policy. We expect the long end of the curve to continue to be held in check by modest levels of global inflation and economic growth, as well as an unsettled Europe heading further into 2017. Accommodative central bank policy should continue to provide a relatively benign environment for risk assets and the introduction of fiscal measures will likely extend the expansion for some time longer. We would not have said this at the beginning of November. In general, we believe fixed income returns for the industry in 2017 will be lower than in 2016, with income returns being largely consumed by price declines caused by upward drift in rates.

KEY TAKEAWAYS:

- NEAM estimates that investment grade fixed income returns for the P&C industry in 2016 were 1.8%, generally consistent with our prior year forecast.
- Given the exceptional performance of HY bonds and assuming the industry allocation to below investment grade fixed income, we estimate total fixed income returns for the P&C industry in 2016 of approximately 2.70%
- We believe that rates will continue to slowly drift higher over the next few years, albeit with increased volatility as the Fed continues on the path of normalizing rates.
- Fiscal stimulus of a reasonable magnitude should extend the current (7 ½ year old) expansion. We would not have predicted this at the beginning of November.
- Our estimated 2017 investment grade fixed income return for the U.S. P&C Industry of ~ 1.18% is lower than last year with appreciably more volatility. Additionally, we believe the probability of a negative total return has increased to approximately 1 in 3 (from 1 in 5).

ENDNOTE

[1] Please note that past performance is not indicative of future results.

Expectations for 2017 are based on our capital market assumptions and are subject to change.

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NEAM's portfolio management tools utilize deterministic scenario analysis to provide an estimated range of total returns based on certain assumptions. These assumptions include the assignment of probabilities to each possible interest rate and spread outcome. We assume a 12 month investment horizon and incorporate historical return distributions for each asset class contained in the analysis. 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. Clients will experience different results from any projected returns shown. There is a potential for loss, as well as gain that is not reflected in the projected information portrayed. The projected performance results shown do not represent the results of actual trading using client assets but were achieved by means of the prospective application of certain assumptions. Results shown are not a guarantee of performance returns. Please carefully review the additional information presented by NEAM.