NEAM VANTAGE POINT

Quick Takes

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TIMELY TOPICS FOR INSURANCE EXECUTIVES

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Anticipating a Post Pandemic World

What structural elements of the economy has the pandemic changed and how will this impact the investment environment that insurance companies will confront in 2021?

As we enter 2021, there appears to be light at the end of the tunnel. Multiple vaccines have been shown to be highly effective at preventing infection from the COVID-19 virus and various governmental authorities around the world have approved their use and commenced inoculation programs. While the spread of the virus persists at an alarming pace and the death toll from the pandemic continues to rise, there is cause for optimism. Stock markets have rallied strongly on the heels of the vaccine news as investors have begun to anticipate a post pandemic world. At this point, it appears appropriate to consider the "end" and look toward a future with a marginalized COVID-19 virus or at least with the virus in a manageable state.

As we move through the year, we will begin to look past the worst of the pandemic and there will be significant pent up demand for services (vacations, live events, eating out, etc.) and plenty of stimulus in the pipeline (low mortgage rates, borrowing costs, fiscal stimulus). This will create powerful cyclical momentum for growth once we are "closer to normal." However, the pandemic has also produced changes to structural elements of the economy that will have an enduring impact as well. What are these significant changes and what will they mean for the investment environment that insurance companies will confront in 2021?

LARGE BUDGET DEFICITS AND RISING DEBT LEVELS

Governments across the developed world have utterly abandoned the notion of austerity in favor of experimenting with higher and higher levels of fiscal support. Driven by ultra-low interest rates and the need to provide relief to households and businesses in the face of restrictions and prohibitions put in place to curtail the spread of the virus, developed world governments have dramatically increased their level of fiscal spending and pushed budget deficits to historic levels. Additionally, there is bipartisan support for the current level of deficit spending and little or no discussion of balancing budgets or even returning to pre-pandemic deficit levels. This has exploded the level of government debt both in absolute terms and relative to the size of economy.

For more information on this topic, contact the author:

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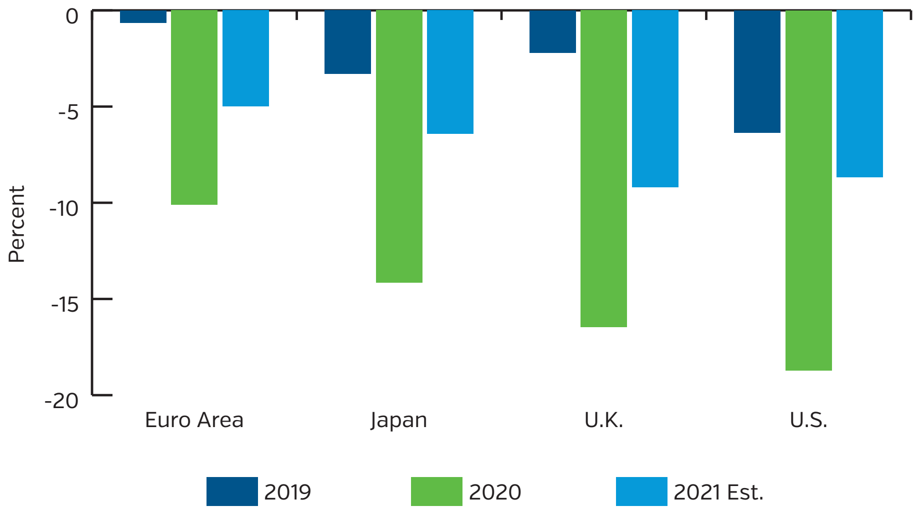
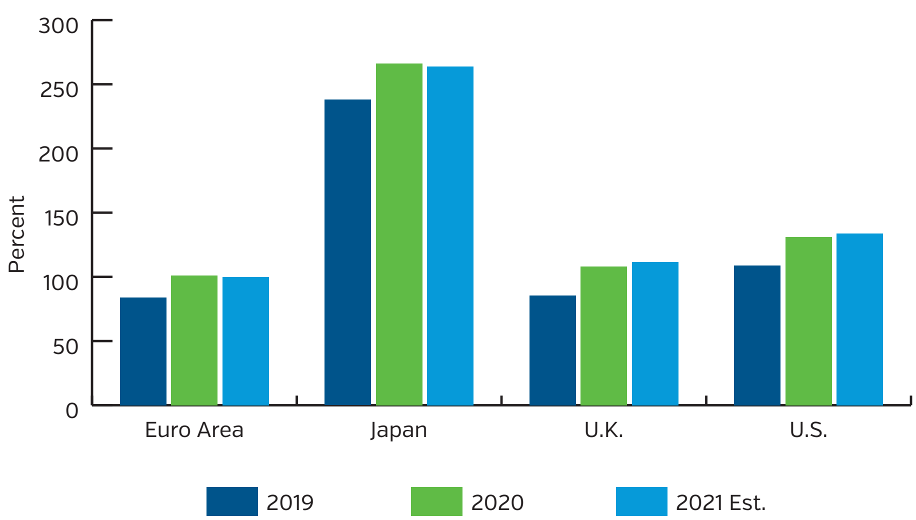
Chart 1. Government Fiscal Balance as a % of GDP



Source: IMF, Haver Analytics

Part of the political calculation for sustaining deficits and debt levels is the low level of interest rates. To date, the issuance of government debt has not translated into higher borrowing costs. It's quite the opposite - borrowing costs are rock bottom across the developed world. So, while the U.S. will see the highest level of government debt relative to GDP since World War II, interest expense as a percent of GDP could hit a multi decade low in 2021. The pandemic has caused a shift in thinking regarding the level of fiscal support for economies. And given the lack of fiscal penalty, an enduring element of the pandemic will be that governments are likely to continue to experiment with larger fiscal deficits and higher levels of government debt.

Chart 2. Gross Government Debt as a % of GDP

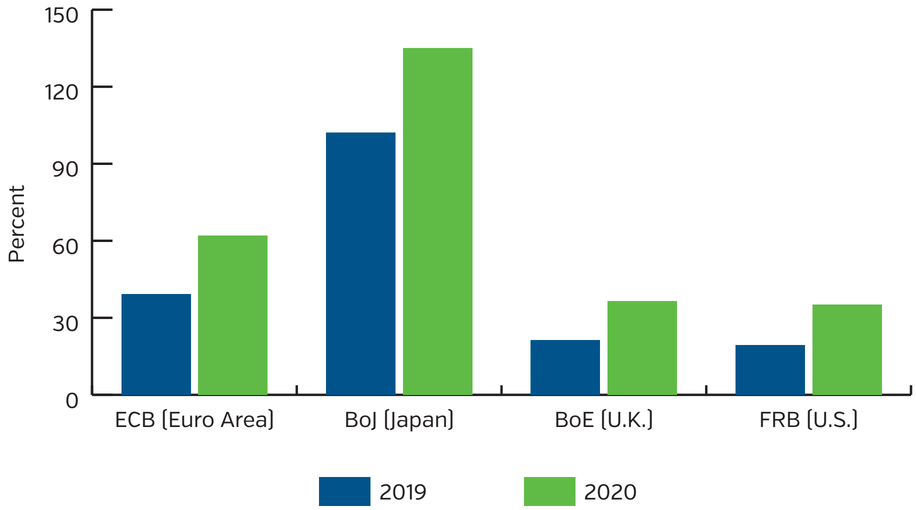


Source: IMF, Haver Analytics

ACCOMMODATIVE CENTRAL BANKS

One of the defining characteristics of pandemic responses from government authorities has been the coordination between fiscal and monetary policy, which has proven to be a powerful combination. It has allowed governments to spend freely while having an uneconomic buyer for their debt which has limited the impact on borrowing costs for governments and businesses. The major central banks have signaled their willingness and intent to extend their accommodative policies for the foreseeable future. This means that central banks in the developed world will be standing at the ready to purchase assets, regardless of price. To frame the potential influence on markets of the central banks, consider their size relative to global equity markets. At present, the assets owned on the balance sheets of the ECB, Fed, BOJ and BOE average approximately 78% of the market capitalization of their collective equity markets! Going forward, significant involvement from these uneconomic market participants should keep interest rates low, spreads tight and markets fully valued.

Chart 3. Central Bank Balance Sheets as a % of GDP

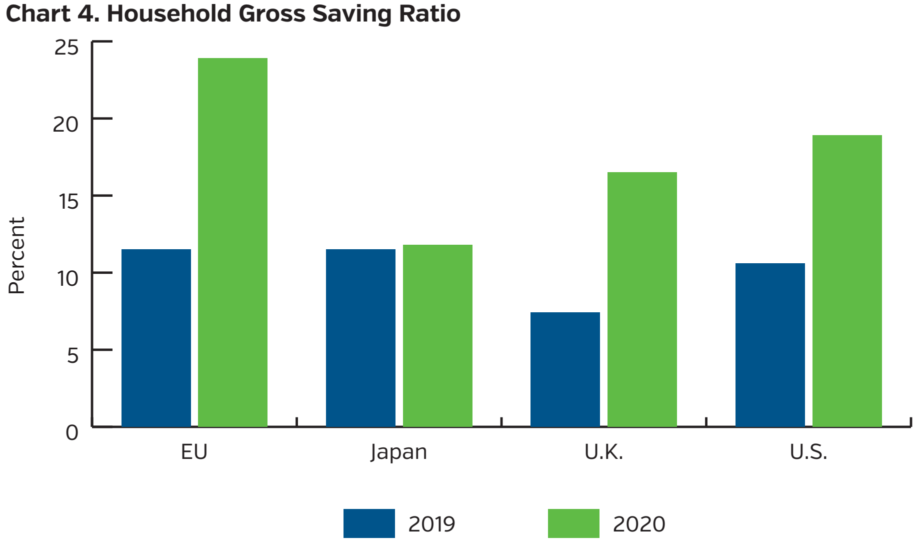


Source: Haver Analytics, Bloomberg

HISTORICALLY HIGH SAVINGS RATES

The events of the past year have unsettled many households and consumers. We are now aware of the threat from airborne pathogens and this new risk with large potential severity has had a significant bearing on the mindset of the consumer. Savings rates across the developed world have skyrocketed as a result. In the near-term, this level of savings represents a potential short-term source of pent up demand and, indeed, savings rates are likely to decline in the short run. But the likelihood is that savings rates will remain elevated relative to pre-pandemic levels which will restrain demand and add to the global glut of savings.

Chart 4. Household Gross Saving Ratio



Source: Statistical Office of the European Communities,Cabinet Office of Japan, UK Office for National Statistics, Bureau of Economic Analysis, Haver Analytics

IMPACT ON THE INVESTMENT ENVIRONMENT

Insurance companies have been confronted with an investment environment characterized by low yields, compressed credit spreads and elevated market multiples for some time. Unfortunately, the changes induced by the pandemic will only serve to reinforce, if not exacerbate, these challenging conditions for the time being. The combination of ultra-loose monetary policy and a global glut of savings will prolong the depressed interest rate environment across the yield curve. In addition, quantitative easing programs will continue to encourage risk taking in capital markets contributing to tight spread conditions and elevated price earnings multiples. Over time, this set of circumstances will raise the risk of moral hazard in markets and the potential for misallocation of capital. In general, insurance companies are likely to be confronted by lower reinvestment yields and a balance of risks that are skewed to the downside in 2021.

KEY TAKEAWAYS

- The post COVID economy will see strong cyclical momentum from pent up demand and fiscal stimulus.
- The pandemic has also induced changes in attitudes towards fiscal deficits, government debt levels, the role of central banks in markets and consumer savings.
- The net impact of these influences will likely reinforce the market conditions of low yields, reduced risk premiums and elevated market multiples.
- Insurance companies should refresh their asset allocation to reflect this risk return environment within their enterprise risk framework.
- For the coming year, insurance company investment portfolios should emphasize the prudent use of risk assets, a relentless focus on risk adjusted yield and proactive risk management.

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