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Mid-Year 2022 Capital Markets Update

June 2022

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The economic recovery the U.S experienced in 2021 reversed in 2022, resulting in a slowdown and recessionary concerns due to continued high inflation rates, the impact of the Russia-Ukraine war, and supply chain disruptions.

The International Monetary Fund (IMF), among other forecasters, expects the U.S economy to grow by about 3.7% in 2022, a downward revision from its initial expectations in January, after experiencing 5.7% growth in 2021.

Inflation has trended higher for longer and reached a four-decade high of 8.6% in June.

The Federal Reserve raised



As the global economy continues to be affected by the Russia-Ukraine war, ongoing supply chain disruptions, and high inflation, investors are concerned about the impact of rising rates on an already fragile economy. As a result, the financial markets have been volatile, evidenced by stock markets falling into bear market territory i.e., down 20% from a recent high and government bond yields surpassing previous highs. In addition, on June 16, U.S. mortgage rates reached their highest level in 13 years, at 5.78% for a 30-year fixed mortgage average rate; this was also the largest weekly mortgage rate increase since 1987. Note that U.S. mortgage rates are closely tied to the U.S. 10-year Treasury yield.

In the U.S., inflation, as measured by the Consumer Price Index (CPI), has been elevated since mid-2021, setting new record highs almost every month (see Graph 1). As of May 2022, U.S. inflation reached another new four-decade high of 8.6% due in part to continued low interest rates and monetary policy measures to address the COVID
The main contributors to the price increase in May were shelter, gasoline, and food. Inflation has remained high longer than many economists anticipated, increasing much faster than the 2% annual gains that the Federal Reserve generally aims for. The combination of slowing economic growth with rising prices has, in turn, increased the risk of stagflation; i.e., when growth stalls but inflation raises prices.

compounding the

damage from the COVID-19 pandemic, the Russian invasion of Ukraine has magnified the slowdown in the global economy, which is entering what could become a protracted period of feeble growth and elevated inflation [t]his raises the risk of stagflation. While the World Bank expects global inflation to moderate next year, it believes the inflation rate will remain above inflation targets in many economies. If high inflation persists, policy adjustments that are viewed as more aggressive than anticipated, or unanticipated altogether, are a significant risk to the health of global financial markets. of global financial contents and the slowdown in the global financial markets.

According to the Federal Reserve, sticky, or core, CPI is viewed as a gauge for expectations about future inflation. For example, if the price of a sticky good or service rises, then inflation is expected to increase, and the reverse is true if the price of a sticky good or service decreases. After two consecutive years of sticky CPI exceeding headline CPI (in 2019 and 2020), it was trending below headline CPI throughout 2021, and as of May 2022, sticky CPI was about 5%

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High-yield (HY) spreads are typically more volatile than IG spreads, particularly in times of markets stress when investors generally shy away from risky assets. They began 2022 near 300 bps, significantly below the pre-pandemic levels of approximately 350 bps, but

declined by 19% YTD through April 2022 compared to last year, with the majority, or 90%, issued by IG companies. The HY market is facing greater challenges, with YTD issuance down approximately 70%, as investor cautiousness has led to a risk-averse sentiment.

The U.S i



Source: Federal Reserve Bank of St. Louis, Board of Governors of the Federal Reserve System (U.S).

While significant demand destruction resulting from the COVID-19 pandemic weakened the financial performance and credit quality of the energy sector in prior years, oil and gas companies are now benefiting from higher oil prices.

totaled \$89 billion in bonds and \$13 billion in common stock as of year-end 2021. The \$102 billion in oil and gas-related exposure is a decline from \$111 billion in exposure as of year-end 2020 and represents

The Capital Markets Bureau will continue to monitor trends in the capital markets and report on any developments as deemed appropriate.

Questions and comments are always welcome. Please contact the Capital Markets Bureau at CapitalMarkets@naic.org.

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