Insurance Multi-Asset Outlook

Come on in, the water's fine! Ready for a surplus summer

Key points:

- Global fundamentals look favorable from a growth, inflation, and monetary policy standpoint, and I think they support leaning into surplus assets, even with lofty valuations and political uncertainty. Whether inflation settles lower remains an open question, but central banks are in cutting mode.
- Insurers running a shorter asset duration versus their liability may find it is a good time to add duration given signs of moderating growth and inflation, the Fed's tilt toward policy easing, and market alignment with fewer cuts than in the second quarter.
- I think it may be wise to plan for interest-rate normalization by locking in current all-in yields, but I expect moderate spread tightening from here.
- I maintain a moderately overweight view on global equities and would turn more positive on signs equity market gains are broadening out beyond the mega caps. Earnings growth should broaden across regions.
- The alternatives picture is mixed, with leveraged buyout private equity and down-in-quality private credit showing signs of weakness, but potential opportunities in venture capital and commodities, and oil in particular.
- Downside risks to my views include a resurgence of inflation, US or European political turmoil, and a broader conflict in the Middle East. Upside risks include a resumption of disinflation that drives more aggressive rate cutting, stronger-than-expected earnings outside of mega-cap tech, and a resolution to the war in Gaza.

Multi-asset views

Asset class	View	Change from previous quarter
Reserve fixed income	Moderately OW	▲
Surplus fixed income	Neutral	–
Global equities	Moderately OW	–
Commodities	Moderately OW	▲

Within asset classes

Asset class	View	Change from previous quarter
Reserve fixed income		
US government	Neutral	▲
Europe government	Neutral	▼
Japan government	Neutral	–
Global IG credit	Neutral	▼
Securitized assets	Moderately OW	▲
• Non-agency RMBS	Moderately OW	–
• Non-agency CMBS	Moderately UW	–
• CLO	Overweight	–
• ABS	Moderately OW	–
Taxable municipals	Moderately OW	–
Tax-exempt municipals	Neutral	–

Asset class	View	Change from previous quarter
Surplus fixed income		
High yield	Neutral	–
EMD	Moderately UW	▼
Bank loans	Neutral	▲
Convertibles	Moderately OW	–
Global equities		
US	Neutral	▼
Europe	Neutral	–
Japan	Neutral	▼
China	Neutral	▲
Emerg mkts ex China	Neutral	▲

Scale

- Large overweight (OW)
- Overweight
- Moderately overweight (OW)
- Neutral
- Moderately underweight (UW)
- Underweight
- Large underweight (UW)

Key themes in alternative assets

Buyout private equity	Performance headwinds likely to continue
Private credit	Lower-quality issuers showing signs of stress
Artificial intelligence	Potentially large opportunity in private assets

Source: Wellington Management | As of 30 June 2024 | Views expressed have a 6 – 12 month horizon and are those of the author and the Investment Strategy & Solutions Group. Views are as of the date indicated, are based on available information, and are subject to change without notice. Individual portfolio management teams may hold different views and may make different investment decisions for different clients. This material is not intended to constitute investment advice or an offer to sell, or the solicitation of an offer to purchase shares or other securities

We knew 2024 would be marked by a seemingly unprecedented number of global elections, with 64 countries and the European Union (EU) all facing potential changes, representing more than half of the world population. And as of July 1, more than one billion people had already voted, per *Time*. With the increase in political uncertainty can come a corresponding bout of market volatility, in particular within surplus assets. That being said, political noise has been largely offset by supportive economic fundamentals. It's a fool's errand to predict election outcomes, so I continue to anchor my outlook to a view that the fundamental backdrop of decent growth, moderating inflation, and credible monetary policy has staying power and is bullish for surplus assets despite high valuations. I recognize that growth is slowing and there is a bit more slack in the labor market. And while services inflation remains sticky, and specifically shelter in the US, the path forward is pointing downward. These factors leave the Federal Reserve in a position to ease eventually, which should be supportive of bond and equity markets alike. All this lines up for what may be a promising summer break for insurance CIOs (or a winter break for those in the southern hemisphere!).

Drilling down into some specifics, the success of France's right wing in the EU elections and President Macron's announcement of a snap election spooked bond markets last month. Populist-driven spending proposals by the National Rally party on top of a French budget deficit of 5.5% of GDP drove the spread between French and German 10-year bond yields to its widest level since early 2017, when French fiscal concerns also arose. However, I don't see this growing into a systemic issue for a couple of reasons. First, I don't see an EU breakup as a risk, although its fiscal rules and institutional setup face challenges. Second, as we saw in the UK in 2022, Greece in 2015, and France in 2017, markets can impose discipline on politicians when fiscal policies are deemed profligate. Even if a crisis were to ensue, the European Central Bank (ECB) would likely be a buyer of last resort at some level of risk premia spike. I'll be watching for politically induced market disruptions elsewhere too, but I don't think they'll be sustained enough to influence my 12-month view. Ultimately, a divided US Congress could curb spending, while the UK election was largely a non-event for markets and may even yield a better outlook. Bottom line, it's too early to be shifting positioning in anticipation of any political outcome.

Reserve fixed income continues to be the sweet spot for insurers, and not to sound like a broken record, but I think locking in all-in yields at these levels should be a focal point for the second half of 2024. I've been cautioning clients to avoid recency bias and think about a world in which interest rates normalize; in my view, it calls for seeking out every incremental basis point of yield, being proactive now, and reaping the benefits later.

From a duration perspective, slowing growth, declining inflation, and eventual central bank easing may provide an opportunity to add duration across insurers' reserve-backing fixed income, or to tighten the gap toward the liability profile for those running at a short posture.

Turning to surplus assets, the income in high-yield bonds continues to be impressive, but the potential for spread tightening remains limited. However, I continue to see future upside in equities broadly, given the positive fundamental backdrop. Finally, for insurers who have commodities in their opportunity set, I have a moderately overweight view on oil given OPEC's desire to keep the market tight and oil futures' positive carry.

Reserve fixed income: Regional divergence is the name of the game

Disparate factors popped up over the second quarter to drive moves in government bonds in developed markets. In the US and Germany, central bank easing is on the horizon and bond yields have rallied. Both of those government bond markets got a boost from their safe-haven status relative to France, where the spread to Germany rose in response to the political shift to the far right. Other "weak links" in southern Europe also saw spreads rise. In Japan, yields moved higher as the Bank of Japan's (BOJ's) measured policy appeared out of sync with rising inflation and a weak yen.

For insurers who have been questioning when to extend duration, my view is that central bank easing will be the primary driver of rates over the next 12 months, and that may provide an entry point to tighten up duration gaps and add some duration. In the US, I've seen more evidence that growth is softening (albeit from strong levels), including in manufacturing, consumption, and employment, and that inflation is decelerating. I think this is paving the path for the Fed to cut rates at least once this year following the ECB's first rate cut in June. I also think the BOJ will remain patient given the recent negative GDP print and I would note that the high carry makes shorting Japan duration expensive.

The big question is on term premia and the extent to which France's deficit concerns could ensnare a wider set of countries with similar issues. The US could face its own debt problems, of course, given that both presidential candidates share a predilection to spend beyond their means. However, the US dollar's reserve status is likely to tip flows toward US Treasuries in a eurozone crisis scenario. My view is that the environment is ripe for disruption but that markets will force politicians away from extreme policies. Either way, I expect higher rate volatility to persist and think investors need to be quite tactical to capture opportunities.

Within investment-grade credit, I think income-focused insurers should still embrace the all-in yields, while those who skew toward total return will need to be aware of a more carry-focused environment versus potential spread tightening from here. Against the backdrop of solid economic growth, receding inflation, impending interest-rate cuts, declining default rates, and all-in yields twice as high as they were in 2021, credit looks attractive. Tight credit spreads give me pause, but with strong demand for bonds and weak supply, I believe credit is an attractive place to generate income with limited potential for spread widening.

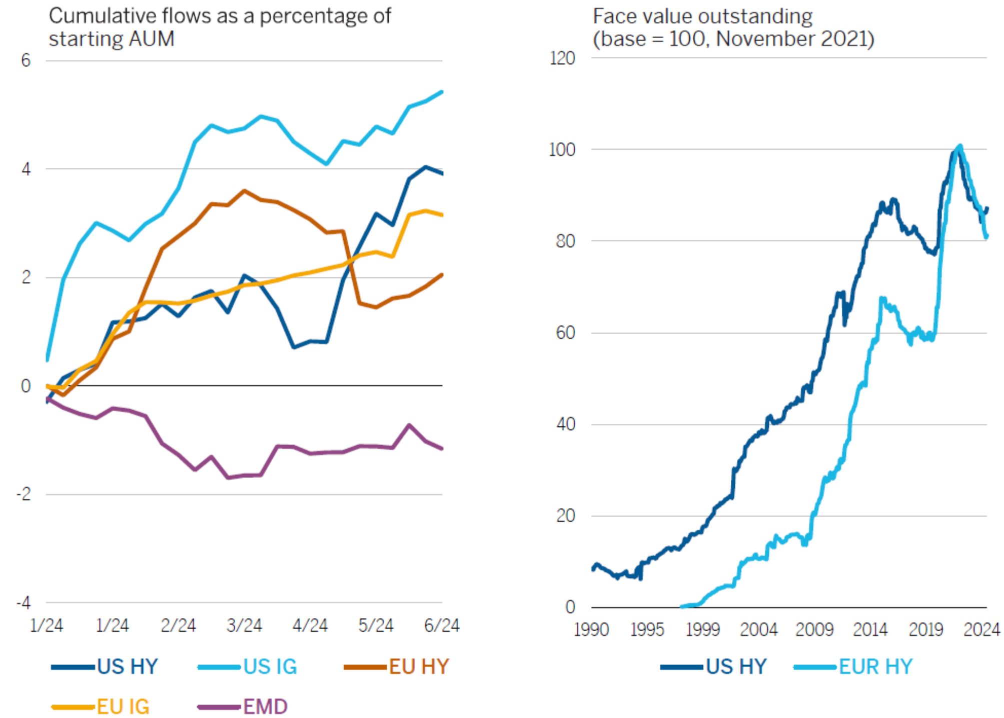
I think securitized assets across the CLO, ABS, and non-agency RMBS space remain attractive even at rich valuations, but I am cautious about CMBS given potential pain from office properties in the future.

Surplus fixed income: Hope on the horizon

While I acknowledge moderate stress in issuers at the lower end of the quality spectrum, indicating that the "higher for longer" rate regime is creating headwinds for some companies, the rate cuts already arriving in some regions and imminent in others should provide relief to some of the riskiest names. In turn, this should take a bite out of the left-tail risk spreads, which haven't compensated insurers for months.

In addition, technicals continue to be supportive of price levels, as the supply and demand dynamics remain favorable. Demand for corporate bonds has been very strong, as investors seek to lock in attractive yields ahead of a rate-cutting cycle. But the size of the high-yield market (the supply of bonds available to and held by investors) has been shrinking as many companies graduate back to investment grade after being downgraded in recent years. Strong company balance sheets, robust refinancing year to date, and a limited M&A pipeline suggest supply may continue to be overwhelmed by demand going forward (**Figure 1**).

Figure 1
Expecting positive supply/demand technicals in high yield to continue



Source: EPFR | Left chart data: 3 January 2024 – 19 June 2024 | Right chart data: 1 March 1993 – 1 June 2024

One of my key themes for insurers in 2024 is the ability to seek diversification and think tactically, and for those that can invest across regions, I have a slight preference for European high yield. On valuation, Europe is where there is still a bit of a premium left and the potential for some tightening in spreads. I am also turning more constructive on the European macro outlook, where momentum is improving and the ECB has already delivered a rate cut. I continue to monitor political developments in France (20% of the European high-yield market), which have caused spread widening in recent weeks, but I see these as an opportunity to add risk. In emerging markets, growth remains weak while many lower-rated idiosyncratic stories have played out, sometimes resulting in their spreads over-tightening relative to their fundamentals. Flows also remain lackluster.

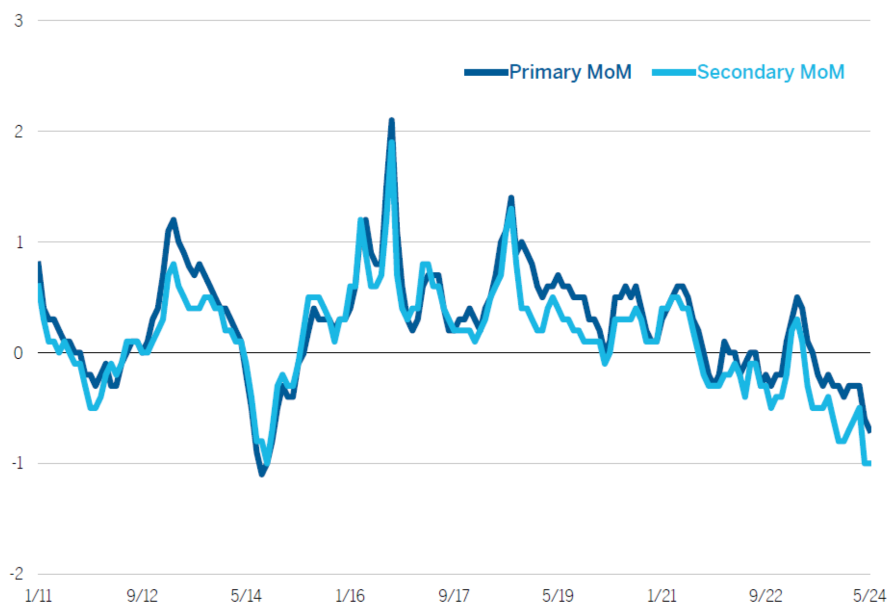
Equities: Room to run, but broad exposure is preferred

I remain cautiously optimistic about global equities, with a moderately overweight view. While economic growth momentum has slowed in the US, global activity continues to improve and the rates outlook is more realistic. Meanwhile, global earnings revisions continue to inflect positively and I expect earnings growth, rather than valuation expansion, to drive returns over the next 12 months. I'm also expecting earnings growth to be more broad-based than it has been recently in the narrow market driven by mega-cap tech stocks. On the negative side, the resumption of mega-cap outperformance and the narrowing market advance in the latter half of the second quarter is a source of concern. The recent softness in growth data in the US and the flare-up in eurozone political risk have probably compounded market concentration dynamics. If I begin to see the equity rally broadening out, or if valuations cheapen due to political or macro shocks, I'd turn even more positive on global equities.

While I don't have a regional preference within equities, I have reduced my view on Japan to neutral. I had moved to an overweight view on the country in November 2022, based on strong evidence of a macro regime shift and improvements in corporate governance. The push for better corporate governance, returns to activism, and rising margins have been helpful, and my view is that Japanese equities can continue to re-rate over the medium term and reduce the margin/ROE gap versus other markets. However, I am less bullish on macro conditions in the short term. My outlook on inflation and rates is above consensus and I believe the BOJ is behind the curve on policy settings and risks losing credibility. While the BOJ has (seemingly) intervened as yen depreciation has intensified, this has provided only temporary support and more monetary policy action will likely be needed to stabilize the currency. All of this raises the potential for higher macro volatility or uncertainty in the short term, which means the overall risk/reward skew is less positive than a few months ago. The caveat to this view is that Japanese equities' relative performance has become less tied to moves in the yen as companies have increasingly diversified their production abroad through subsidiaries.

In addition, I have raised my view on China and emerging markets broadly to neutral, thanks in part to the beginning of a rate-cutting cycle, albeit one that is likely to be shallow. I am also less willing to maintain an underweight view on China given cheap valuations, which recently drove a sharp rally. At the same time, structural headwinds and the lack of policy traction (**Figure 2**) keep me on the sidelines and reluctant to engage positively.

Figure 2
No clear signs of China property bottoming
China house price growth (%)

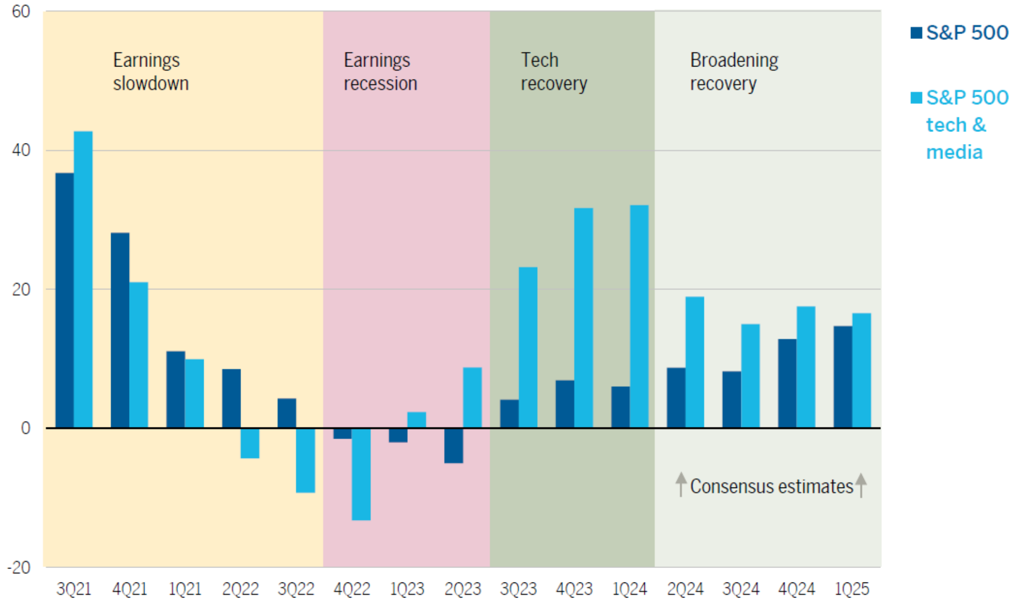


Sources: Refinitiv, National Bureau of Statistics China (NBS), Wellington Management | NBS 70 city house price indices. | Primary: Includes major metropolitan areas with most developed economies, highest urbanization. Secondary: Smaller, typically more regional cities that have been rapidly growing.

I had been more positive on Europe given evidence of improvement in earnings and market breadth, but the resumption of political uncertainty has made me cautious, and, as such, I maintain a neutral regional view. Valuations are still compressed relative to global equities, and the valuation discount is even more pronounced in the UK, where underperformance has been driven by weakness in both relative earnings and sentiment.

In the US, I believe earnings will broaden out, with large-cap tech likely to normalize as other sectors catch up (**Figure 3**) — with little or no expected valuation expansion. This should spell relief for insurance equity investors who tend to favor higher-dividend value-style strategies. I have turned neutral here as well.

Figure 3
Earnings growth is broadening in the US equity market
% EPS growth year-on-year



Sources: Wellington Management, Bloomberg | As of 20 June 2024 | Data represents year-on-year change in EPS ($/share) for S&P 500 Index and the technology and media industries within S&P 500 Index | Data after 1Q24 is consensus estimates.

Within sectors, I favor an overweight view on financials, utilities, and consumer discretionary, and an underweight view on materials, staples, and communications. I still have a neutral view on information technology.

Commodities: A stronger view fueled by oil

I have moved from a neutral view on commodities to a moderately overweight view, driven by an upgrade to oil. Oil looks fairly valued, with prices in the mid US$80s. However, I think a positive roll yield, which reflects the lower cost of longer-dated futures, warrants a more constructive stance.

Geopolitical risk in the Middle East should limit downside to the oil price, and with supportive growth dynamics globally and a tight supply, the price is likely to remain range-bound at current levels. As a result, carry should primarily drive returns this year, with some potential for capital gains if demand is stronger than expected or OPEC+ pricing power comes back into play.

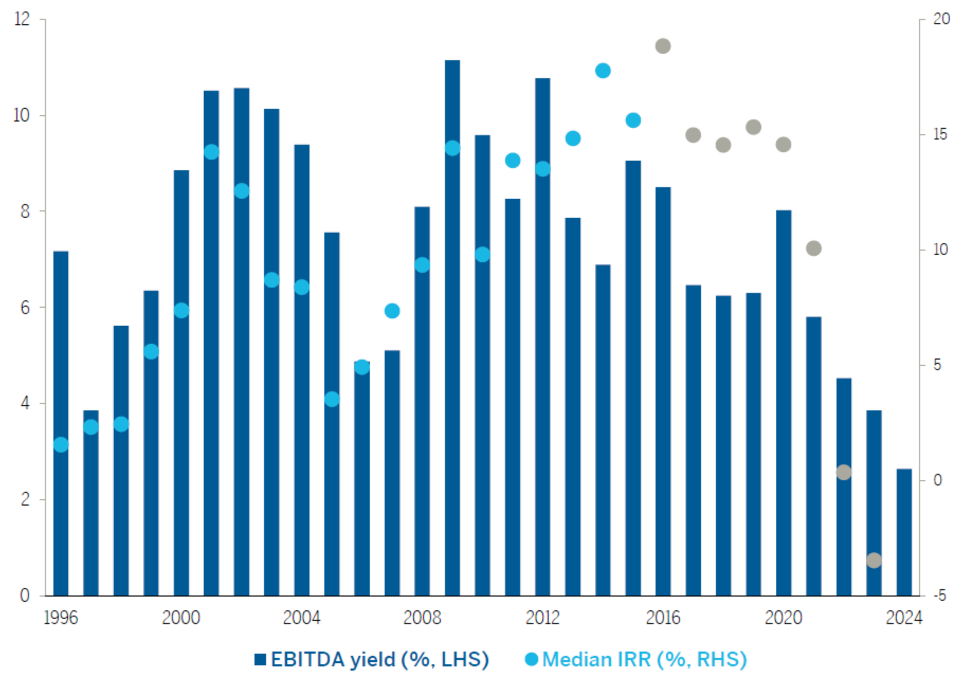
While gold has been a strong performer in recent periods, I see limited price appreciation moving forward. Investors and central banks have been building gold allocations this year after weak sentiment in 2023, but with heightened geopolitical risks largely priced in, I think a lot of the positive case has already played out.

An eye on alternatives

A bad time for buyouts?

Insurance companies are no strangers to investing in the leveraged buyout (LBO) space, with the majority of their private equity allocations invested in LBOs, but with the macro/rates backdrop we find ourselves in, the return picture may remain challenged for the foreseeable future. As the name of the asset class suggests, the business model utilizes debt/leverage to finance transactions. When rates are high, it makes an LBO fund manager's ability to generate returns or service existing debt particularly difficult. On top of high rates, poor exit multiples have meant a corresponding increase in the use of continuation funds as managers wait for improved pricing, locking up the capital of insurers. It is a reasonable assumption that in the current macro environment, LBO firms will wait for better pricing before exiting to another sponsor, and, as such, multiples won't drift much lower. Per PitchBook, multiple expansion made up over 40% of the growth in the enterprise value of realized investments from 2010 to 2019, a significant portion of the total return. The combination of higher interest rates and less attractive EBITDA multiples (**Figure 4**) may mean insurers need to be more selective before committing to future funds.

Figure 4
Investors may need to be more selective in the buyout market
EBITDA yield versus median IRR minus 10-year Treasury

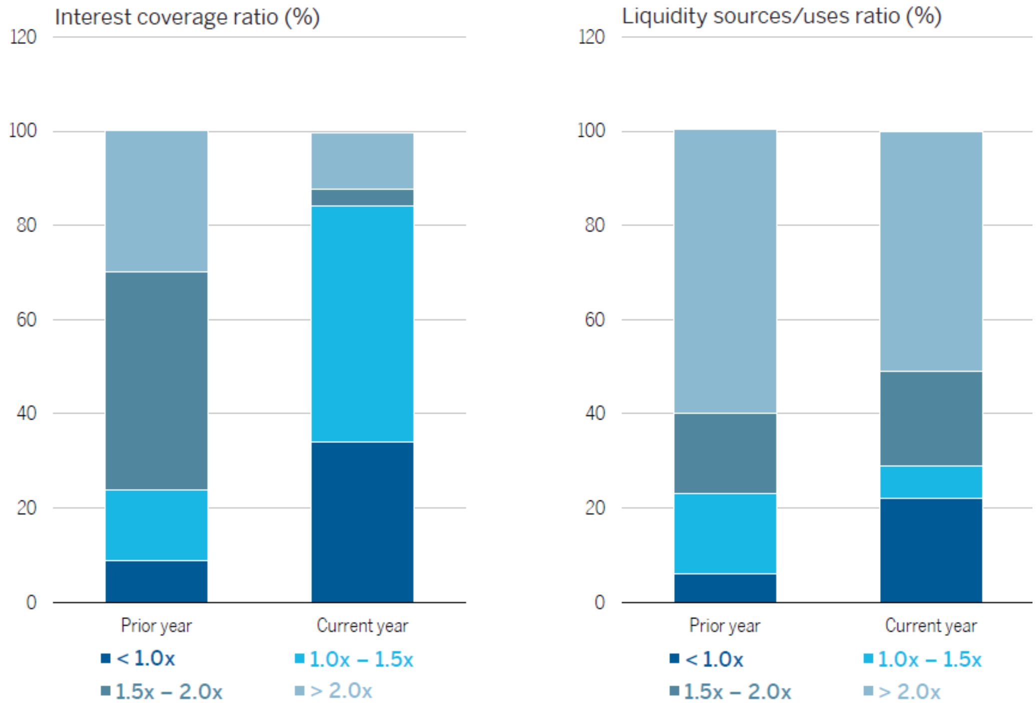


Source: PitchBook. | Data is for the US. Returns as of 30 September 2023. EBITDA and Treasury data as of 31 March 2024. EBITDA yield is the inverse of EV/EBITDA transaction multiples. Gray dots reflect vintages that have the majority of their returns unrealized. For illustrative purposes only. **PAST RESULTS ARE NO GUARANTEE OF FUTURE RESULTS.**

Don't reach for yield in private credit

I've expressed my view about favoring higher credit quality across all of fixed income (both public and private) in recent quarterly outlooks, and there are early signs in the private credit universe that this may become even more important moving forward. Morningstar DBRS has indicated that nearly 10% of rated issuers of private debt are now operating under covenant waivers or amendments. Looking at the cohort of those issuers who have sought out covenant relief, the degradation in credit quality metrics jumps off the page (**Figure 5**). So far in 2024, 34% of borrowers who have looked to adjust terms have had interest coverage ratios below 1.0x, up from 9% last year. Liquidity ratios have also compressed, with 22% less than 1.0x, up from 5.6% last year.

Figure 5
Credit metrics for private credit borrowers requesting relief



Source: Morningstar DBRS. | Based on Morningstar estimates and company documents. Charts show the distributions of interest coverage ratios and the ratio of liquidity sources/users for the group of rated private credit companies that have requested covenant relief.

It is important to note that this story is largely a down-in-quality phenomenon, with 54% of the group CCC rated and below. The bottom line is that the benign default and credit stress environment that has defined the majority of the life of the private credit boom may become increasingly challenged, so I think it may be a time to lean into fundamental credit research and skew toward quality over quantity (yield).

AI: It's not just a Magnificent 7 play

The exceptional growth in the market cap of the front-line players in the AI space has been a dominant market theme over the last year and a half and, quite frankly, shows no signs of slowing down. Going forward, a critical piece of the puzzle will be the essential role that venture-backed tech can play in the rapid expansion of the AI story, and I encourage insurers to consider using private assets to seek out disruptors in this structural theme. The continued demand for graphics processing units, coupled with strategic initiatives from the US government to "onshore" their production, has fostered not only an increase in public equity valuations, but also private equity deal flow. Preqin reports that AI-related venture deals made up nearly 25% of year-to-date VC deals through 14 June 2024, a gain of 10% since 2018.[1] Yet as of June 13, 48% of all US VC investments were in the software or internet sectors. Given how much of public equity beta has been driven by AI/tech names recently, it could benefit insurers to diversify their exposure to market volatility by combining VC tech/growth investments with the large publicly traded players. This could allow for alpha capture, while reducing market volatility due to differences in valuation and pricing methodologies.

Risks

Downside risks to my views include a reacceleration or spike in core inflation, leading central banks to push back against aggressive rate-cut expectations or even to resume hiking. In addition, my expectation of more broad-based gains in equities could be undermined by sharp upward momentum in one or more mega-cap stocks. Finally, geopolitical issues will bear watching, including the potential for election-year turmoil in the US and Europe and a broader conflict in the Middle East.

Upside risks to my views include a scenario where growth is more widespread globally and disinflation resumes, allowing central banks — and particularly the Fed — to cut rates faster than currently priced in by markets. We could also see a second-quarter earnings surprise on the upside, with a better earnings impulse outside of mega-cap tech stocks, and/or positive rotation in the market and better breadth than I expect. Additional upside risks include a resolution to the Middle East conflict and a balanced coalition emerging from the French election.

Investment implications

It may be time to add duration and continue pursuing yield — Most central banks have pivoted to rate-cutting mode, so there is scope for lower yields across regions. The all-in yields across fixed income remain compelling, and I think insurers should look to the investment-grade part of the market, and securitized assets in particular, to lock in yields before interest-rate normalization. A return to less lofty yields may not be too far away!

Global equities seem to be becoming more compelling — Growth and inflation are moderating from strong levels and central banks will eventually cut rates. Insurers should consider keeping a risk-on tilt despite expensive valuations and political noise, as I expect positive fundamentals to support earnings.

Anticipate broadening in the equity rally — I no longer have a regional equity bias and think gains could accrue to developed and emerging markets. I also see the earnings trajectory improving for areas outside of the mega-cap tech stocks, which could benefit some that have lagged, including value and small cap. Among sectors, I favor financials, utilities, and consumer discretionary over materials, staples, and communications, and I have a neutral view on information technology.

Alternatives — Both leveraged buyout private equity and down-in-quality private credit are exhibiting some signs of weakness, so I believe insurers should be thoughtful before making future commitments heading into the back half of 2024 and into 2025. Consider diversifying exposure to “growthy” tech names in the public market by taking some gains and targeting VC funds that may be primed to capitalize on the emergence of AI deals in the private market. I think this is a theme with significant alpha potential.

Benign expectations could be disrupted — While I believe my risk-on tilt is supported by fundamentals, I am wary of volatility stemming from politics in Europe and the US, in particular. Depending on developments, I am biased toward using cheaper valuations as an opportunity to add risk in equities given the positive earnings backdrop and more reliable mean reversion in credit spreads. As long-term investors, insurers should be attentive to market dislocations and may want to consider adding positions to build surplus over time.

[1]Source: Preqin’s State of the Market: H2 2024, July 2024.