

Inflation

How insurance companies can adjust
their investment portfolios in an
inflationary environment

Asset Management

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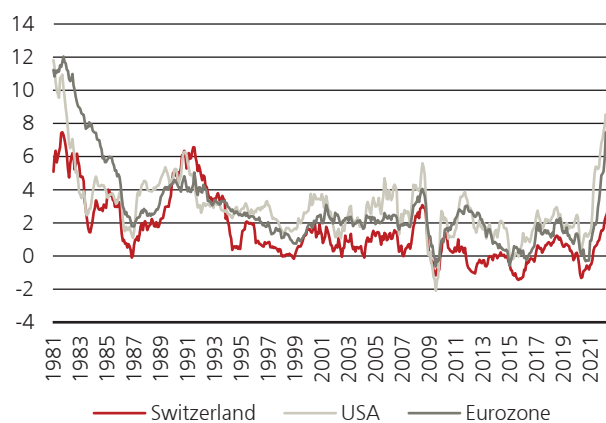
By end of 2021, the Swiss insurance market was composed of around 200 life and non-life insurance companies. The biggest part of total assets (approx. CHF 550bn) for this industry sector are allocated to fixed income securities, so these firms are highly exposed to inflation and yield dynamics (FINMA, 2022). Since existing, fixed income investors are negatively affected during high inflation regimes and the persistence of price pressures is currently a dominant topic in the

industry. Inflation fears became reality during 2022. Unprecedented fiscal and monetary stimulus helped facilitate the economic recovery from the global financial crisis (GFC) and more recent from the initial COVID shock. However, these policies also led to unintended consequences in the form of excess aggregate demand during a period of still constrained and fragile supply chains. Moreover, the war in the Ukraine and other macroeconomic uncertainties continue to disrupt supply chains and exert upwards pressure on consumer prices.

In the beginning of 2022 consumer prices climbed at their fastest pace in decades. With inflation hitting multi-decade highs, major central banks have become increasingly hawkish, and are rapidly raising policy rates while shrinking their balance sheets. This is on one hand leading to negative fixed income returns through rising yields and on the other hand leaving investment managers with the challenge to find alternatives and hedges to navigate this high inflation.

It remains to be seen whether the fast pace of rate hikes will only have a temporary negative effect on credit and equity markets or if financial markets are confronted with a prolonged period of weak economic growth or even a more severe economic downturn. Whether inflation is here to stay or has already reached its peak is widely discussed. This paper picks up on some of the current developments with regards to inflation and investment management. Figure 1 is showing the consumer price index (CPI) for the European Economic Area, United States and Switzerland. This statistical measure includes food and energy prices. These two consumer price contributions are often volatile, which can distort the data to a certain extent. Nevertheless, such magnitude and longevity of price pressures has not been seen since the 1980s, therefore it is safe to say that consumer price inflation has made a forceful comeback.

Figure 1: CPI yoy (in %)



Source: UBS Asset Management, Macrobond

Simplified, inflation can be caused by too much money chasing too few goods (or services). We have seen that this impact is particularly potent through fiscal channels, compared to central banks' balance sheet expansions in the wake of the 2007-08 global financial crisis. In recent years, governments across the developed world engaged in fiscal stimuli by directly handing citizens money. At the same time supplies were limited by lockdowns, factory closures, long shipping delays, and people losing their job during the pandemic or unable to work due to illness. This shortage of supply resulted in higher inflation levels. Since government executives in all major countries now show little effort to tighten fiscal policy through higher taxes or reduced government spending, the job of bringing inflation down is largely borne by central banks. Since inflation is too high and no longer appears transitory, central banks have adopted tighter policy stances, as shown in Table 1.

Table 1: Inflation and Policy Rate changes (in %)

Jurisdiction	Inflation		Policy Rate	
	Jan-22	Oct-22	Jan-22	Dec-22
UK	5.50	11.10	0.25	3.50
US	7.50	7.70	0.00-0.25	4.25-4.50
Euro Area	5.10	10.00	0.00	2.50
Canada	5.10	6.90	0.25	4.25
Sweden	3.90	10.90	0.00	2.50
New Zealand	5.90	7.70	0.75	4.25
Norway	3.20	7.50	0.50	2.75
Australia	3.50	6.90	0.10	3.10
Switzerland	1.60	3.00	-0.75	1.00
Japan	0.50	3.70	-0.10	-0.10

Source: World Economic Forum, Global Rates November 2022

Possible Inflation Scenarios

Temporary: Current inflation is temporary and reverts to recent historical levels (~2%) as consumer demand for services compared to goods rebalances and supply chain disruptions settle during 2023-2024.

Higher levels: Inflation settles at a higher level of 3-4% as a combination of longer-term inflation drivers (fiscal outlays, demographics, deglobalization, among others) and ongoing supply disruptions keep inflation elevated. Inflation expectations shift higher forcing central banks to keep hiking rates.

Stagflation: A continuation or worsening of a sluggish macroeconomic backdrop or even negative real economic growth in combination with elevated inflation levels. Would largely be driven by supply side factors including energy scarcity.

Decline: Inflation falls to 0-1% as supply chain disruptions are resolved faster than expected and a steep aggregate supply curve exerts deflationary pressures at even modest declines in demand.

Trends in Global Insurance Market

Growth

The non-life and life insurance market is seeing flat growth in real terms for 2022. However, in nominal terms total global premiums are rising to more than USD 7 trillion for the first time ever.

Profitability

In the non-life business inflation means higher claims cost and these erode profitability. The life business on the other hand is expected to follow 2021's trend of moderate improvement in 2022 and 2023.

Short to medium-term

Darkening global economic outlook, claims severity to rise in non-life business, mark-to-market losses.

Medium to long-term

Paradigm shift towards higher yields, structurally higher risk awareness, market hardening.

Source: Swiss Re Institute

Implications on Insurer Portfolios

If we look at property and casualty insurers, the claim costs are increasing with higher inflation. That is because policies are priced today but claims against those policies can be different and increase in the future. As already mentioned, the investment portfolios of insurers are mostly comprised of fixed income securities. As interest rates rise due to inflation, bond prices will fall, and so would the market value of the insurers' investment portfolio. However, investors may now obtain a good level of income from holding bonds purchased while inflation is high. Nevertheless, this impact is dwarfed short- to medium-term due to the price loss. Life insurers on the other hand, tend to be less impacted by inflation on the liability side since many of their products have fixed policy pay-out amounts.

Stagflation Scenario

The probably most threatening scenario for investors is stagflation where economic growth is weak or negative, and inflation continues to run at elevated levels.

Active managers can actively tilt the portfolio towards sectors and factors that have historically performed well during inflationary scenarios – including during weak growth periods. To illustrate this fact, we looked at the average annualized sector performance during different growth and inflation regimes since the 1970s. For example, energy stocks and to a lesser degree real estate have done extremely well during rising inflation periods irrespective of economic growth. On the other hand, e.g., consumer discretionary underperformed during those higher inflation periods – in line with what we have seen during 2022. This makes intuitive sense as inflation can be seen as an additional added cost on the consumer which decreases real disposable income and in turn confidence and spending.

Figure 2: Performance of US market sectors in different inflationary environments (in %)

Sector	Higher growth and inflation	Higher growth, lower inflation	Lower growth, higher inflation	Lower growth and inflation
US Market	15.2	18.8	6.5	11.0
Energy	5.9	-4.5	8.8	-9.7
Financials	1.1	5.0	-1.2	-2.7
Healthcare	-3.9	-0.5	3.9	5.2
Tech	2.2	2.7	-2.4	-3.0
Utilities	-2.8	-4.7	7.0	-0.8
Cons Discr	-3.2	4.1	-2.7	2.7
Cons Staples	-8.1	0.8	6.3	3.5
Industrials	4.0	1.2	0.3	-2.4
Telco	-5.2	-5.9	1.2	4.8
Real Estate	7.6	4.0	2.3	-3.2

Source: Refinitiv datastream US data from 1974-2022

Potential in different Asset Classes

To underpin the importance of the subject for insurer's portfolios, different asset class returns have been assessed with regards to their correlation with the changes of the consumer price index. In Figure 3 the results of the correlation analysis of US CPI and predominantly the US market can be seen. It becomes visible that aggregate bonds are negatively correlated with rising consumer prices. With a high exposure to traditional fixed income, insurance companies could consider allocating assets to other asset- or sub-asset classes. It is worth to mention here that shorter duration fixed income normally outperforms longer duration fixed income as valuations are less impacted by higher rates and investors have a shorter time horizon to reinvest at more favourable entry points. So, insurance companies could also investigate reducing duration on their existing fixed income portfolios to also decrease their risk to rising inflation as an initial step. Also on the bond side, in the observed timeline high yield bonds have been proven to be less affected by rising inflation than aggregate bonds. They are not immune though, and BB rated bonds in particular show the highest sensitivity to interest rate changes of the non-investment-grade universe.

Shift to Alternatives

Alternatives like real estate, collateralized loan obligations (CLO), commodities and both private-credit and private equity have shown a positive correlation with the CPI. This means that in regimes with rising inflation these asset classes need to be analysed more closely as they could constitute an attractive addition to a traditional insurance portfolio.

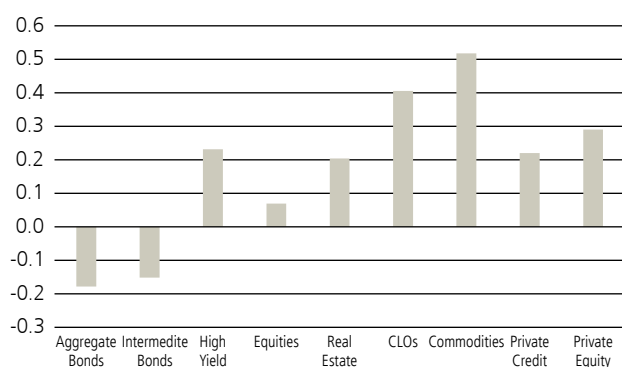
Real Estate in high Inflation environment

Real Estate offers generally stable income returns with relatively modest risk in portfolios due to its combination of subdued volatility and low correlations of returns with traditional asset classes. However, the challenging times we are in pose threats to all asset classes and require some words of caution regarding real estate. Limited evidence from the US, dating back to the latest period of stagflation in the 1970s, shows that real estate outperformed equities and bonds, though performed below expectations compared to times of better economic growth (Figure 4). To mitigate risks linked to inflation, broad diversification across countries is the most prudent strategy. However, the US real estate market is in better condition than during the global financial crisis (2007+). In Europe, the relationship between inflation and strong real estate returns has historically been tenuous. Nevertheless, subsectors like logistics located in strategic distribution hubs where demand potential still exceed construction activity, and European rental housing are still offering robust growth and positive outlooks in this challenging environment.

Collateralized Loan Obligations

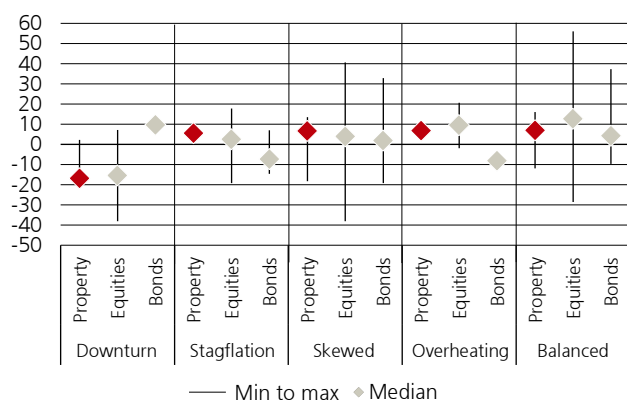
Floating rate debt, such as leveraged loans, is considered below investment grade but investors can also access floating rate debt in the investment grade space through allocations to floating rate corporate notes and securitized debt tied to secured overnight financing rate (SOFR). This presents an option for investors who require an investment grade minimum rating.

Figure 3: Correlation of different US asset classes to the US Consumer Price Index (CPI)



Source: UBS Asset Management, US CPI Index, BarCap US Agg Bond TR, Bloomberg Intermediate US Agg. Bond Index, Bloomberg US High Yield TR, S&P 500 TR and US TRET Index Mar.1991-Dec.2021, Credit Suisse Leveraged Loan Index and Thomson Reuters/CoreCommodity CRB Index TR Mar.1992-Dec.2021, IVPNCT Private Credit Index and S&P Listed Private Equity Index Dec.2013-Dec. 2021. **Past performance is not a reliable indicator of future performance.**

Figure 4: US real total returns by asset class
(% YoY, Q4 1978 - Q1 2022)



Source: UBS Asset Management. Equities = S&P 500; government bonds = ICE Bank of America Merrill Lynch 7-10 Year US Treasury Index; average defined as within one standard deviation of mean; inflation = 3.5% average and 2.7% standard deviation; annual GDP growth = 2.6% average and 2.3% standard deviation. Source: Thomson Refinitiv Datastream; NCREIF; UBS Asset Management, Real Estate & Private Markets (REPM), May 2022

Commodities

Some commodity exposure is likely beneficial in most portfolios as this asset class (as well as commodity-linked investments like energy, materials, or mining stocks) provide attractive diversification benefits. First, they provide a partial hedge against unexpected supply driven inflation shocks which remain increasingly likely in today's world of limited spare capacity and geopolitical uncertainties.

Although commodities may benefit in some inflationary scenarios, the corresponding central bank tightening is expected to have a negative impact on global economic growth and in turn on commodity demand. So, commodities are only an inflation hedge to a certain extent. Nevertheless, if inflation is stickier than what the market expects, they offer to be a potential asset class for excess returns in high inflationary environments.

Private Credit & Equity

Inflation can be a double-edged sword to private credit, creating both headwinds and tailwinds across the corporate, real estate and consumer segments. A large portion of private credit strategies are floating rate, and therefore they generally provide some protection to investors against inflation. As a result, many strategies will benefit from rising interest income and the underlying deals should ultimately generate higher yields. This exposure should serve as a complement to a traditional fixed rate bond allocation.

For private equity, inflation can be a manageable challenge. Private equity structures are allowing companies to be managed with a longer-term view than public companies. Nevertheless, inflation can have a bigger impact on certain sectors or regions and thus, investments should be well diversified in terms of geography, investment stage, company size and industry.

Conclusion

As elaborated in this paper, Insurers have a wide range of options to mitigate the challenges posed by elevated or rising inflation. This may be on the business, reserving, or asset-liability management (ALM) side – on the latter investment management is of utmost importance. For that the asset allocation strategy needs to be reassessed and continuously observed. On sub asset class level, it can be worth over- and underweighting certain sectors like energy which has performed positively in high inflation and economic growth as well as low economic growth environments in the past. Or underweighting consumer staples or telecommunication when the investment manager has the conviction that inflation levels will be high in the future, but the economic growth will be high as well.

On asset class level the shift to alternatives is as well a way to tackle high inflation. For that a tactical position in CLO's or Commodities can have a mitigating effect on the negative impact on traditional asset classes of high inflation. The asset classes real estate and private credit/equity have also shown robust growth in inflationary environments in the past and can thus, also be a way to mitigate the negative effects of high inflation on the investment portfolio. Certainly, the allocation needs to be in line with convictions and the long-term investment strategy. Nevertheless, investment managers need to overthink their long-term investment strategy when a paradigm shift is happening.

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