The Conning Commentary

Strategic Issues for Insurance Industry Executives

DECEMBER 2022

VOLUME 32, NO. #12

A foundation ready for growth in 2023

As 2023 begins, we find that individual and business consumers are facing a higher-risk world. The economy has been battered by inflation and the efforts to tame it. Volatile equity markets have reduced individual retirement and investment accounts along with company valuations. At the same time, employment has remained strong, contributing to the war for talent, even as the threat of recession looms ahead.

Beyond the economic picture, the rise of cyber-crime, natural catastrophes, and concerns about outliving retirement savings have made consumers more aware of the need to find protection.

Given this backdrop, it may seem that any insurance industry outlook for 2023 would be gloomy. Yet, as we look at the macro-environment, we see a foundation for strong growth in the property-casualty, life-annuity, and health insurance sectors.

In this look-ahead *Commentary*, we identify the key pieces of that foundation and why we think they indicate strong growth in 2023. We also give an overview of our 2023 forecast for all three insurance sectors. Next month, we will take a close look at each sector and what growth might look like for each of the major statutory product lines.

It's (almost) about the economy

As we head into 2023, the possibility of a recession looms over the economy. A decline in real estate prices, an inverted yield curve, high inflation, and high-profile layoffs have all helped to increase this possibility. Despite this, however, our baseline is for economic growth, albeit slower than previously forecast. If a recession were to occur, it would likely be short and shallow.

The outlook for GDP (gross domestic product) growth and continued strong levels of employment are positive for premium growth in both the property-casualty and life-annuity sectors. Inflation is increasing expenses, but also is enabling property-casualty insurers to take rate. Higher interest rates are, finally, bringing some relief to life-annuity insurers, which have struggled to find yield during a prolonged low interest rate environment.

GDP outlook supporting P&C exposure growth

The growth in real GDP is a key part of the foundation for property-casualty exposure growth leading to higher premiums. Looking at 2023, we anticipate real GDP growth that is modest, at best.

Supporting that view is the Federal Reserve Bank of Philadelphia's 2022 fourth-quarter Survey of Professional Forecasters. Their estimate for annual GDP growth is 0.7%, down from the previous quarter's survey of 1.3%.[1] Much of this growth is expected in the second half of the year.

There is some worry for a potential downturn in real GDP in the first half of 2023. For the first two quarters of 2023, the Philadelphia Federal Reserve Bank Survey of Professional Forecasters predicts an almost 50% chance of a contraction, decreasing for the second two quarters of the year.[1]

As we head into 2023, we look at the most recent GDP report from October 2022. Real GDP increased on a quarter-by-quarter basis at 2.6%, or 1.8% on an annual basis, in the third quarter of 2022, driven in part by increases in exports, consumer spending, and federal and state government spending.[2]

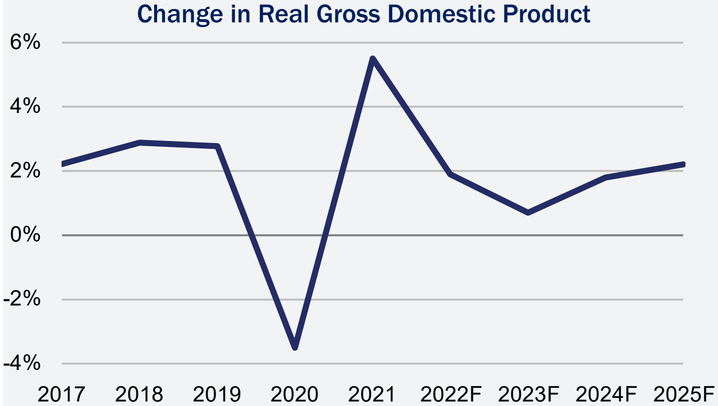
Strong employment positive for premium growth

Looking next at the employment market, we expect to see a slower increase in payrolls as we head into 2023. Strong employment supports continued premium growth in all group benefits. In addition, employment enables individuals to purchase insurance and retirement products.

The Federal Reserve Bank of Philadelphia's fourth-quarter 2022 Survey of Professional Forecasters lowered its 2023 monthly payrolls projection from 167,600 per month in the third-quarter projections to 143,600.[1]

While still positive, we project that the unemployment rate will increase slightly as the number of individuals looking for work

Change in Real Gross Domestic Product



Prepared by Conning, Inc. Source: Bureau of Economic Analysis, U.S. Department of Commerce (2022); forecast source: Federal Reserve Bank of Philadelphia Survey of Professional Forecasters (fourth-quarter 2022) increases. This was seen in the October 2022 jobs report. The unemployment rate increased from 3.5% in September to 3.7% in October as the number of individuals looking for work increased, despite payrolls increasing 261,000 for the month. Looking at 2023, the Philadelphia Federal Reserve's fourth-quarter 2022 Survey of Professional Forecasters projects an unemployment rate of 4.2% in 2023, up slightly from the prior quarter's forecast of 3.9%.[1]

Wage increases also continue to be a positive factor within the labor market. Per the Bureau of Labor Statistics, total private average hourly earnings continue to increase, beginning the year at $31.56 in January and increasing to $32.58 in October, a 3.2% increase year-to-date. Since January 2021, average hourly earnings have increased 8.9% through October 2022.[3] Should the economy remain strong, we would anticipate that wages will continue to increase. Supporting that outlook is that several groups have already projected potential wage increases in 2023 of 4% or higher.[4,5]

Inflation giveth and taketh

Inflation hit a 40-year high during 2022. While elevated inflation is expected to persist well into 2023, the outlook for price increases should ease over the coming year.

For the property-casualty sector, stubbornly high inflation created an array of issues, affecting underwriting results, pricing, reserving, and investment management. One of the starkest effects during 2022 was the impact on claim severity due to increased input costs. For example, in its third-quarter 2022 10Q, Allstate reported property damage incurred claim severity for auto losses up by approximately 27% year-over-year.[6]

While inflation has a negative impact on claims, it also supports property-casualty insurers' rate increases to cover those higher claims. The ability to increase rates in the face of inflation should contribute to premium growth in 2023.

Going into 2023, there is some support for the notion that inflation peaked in 2022 and is on an improving trend. The all-items consumer price index increased 7.7% for the twelve months ending October. This was better than expectations and was the smallest twelve-month increase since the period ending January 2022.[7]

An important factor driving inflation was the unprecedented growth in the money supply since the beginning of Covid-19, but money supply growth (as measured by M2) slowed during 2022 to more traditional levels and at a level more likely to achieve the Federal Reserve's 2% inflation target.

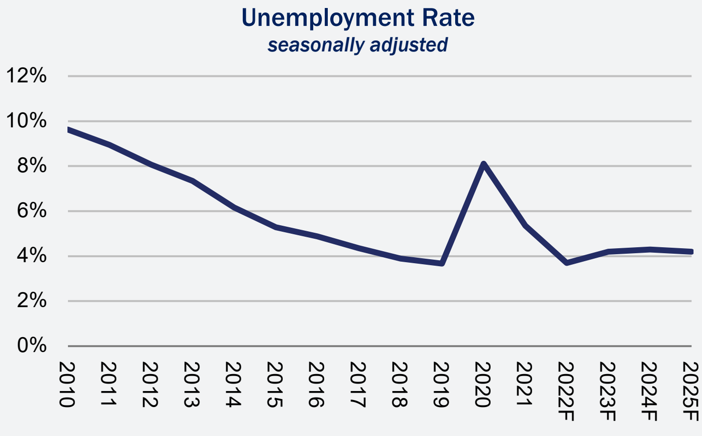
Fed interest rate hiking along with slowed growth in the money supply are expected to slow inflation in 2023. The Federal Reserve Bank of Philadelphia's fourth-quarter 2022 Survey of Professional Forecasters projects core CPI to slow to 3.5% growth by year-end 2023.[1] This is up from the outlook a quarter earlier, but a significant improvement from conditions over the past two years. This will ease some of the upward pricing pressure in the property-casualty sector and ease expense pressure across the industry.

Interest rates bring relief to life insurers

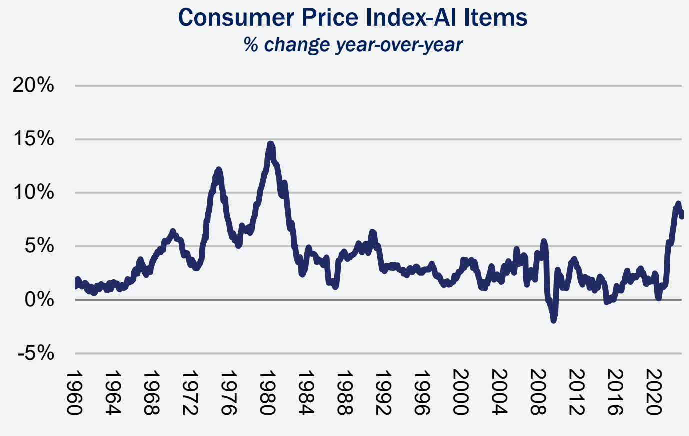
While inflation contributes to the growth in property-casualty claims and premium increase, Federal Reserve responses to inflation are having a positive effect on life-annuity insurers. In 2022, the ten-year Treasury rate rose higher than has been seen in years. On November 7, 2022, the ten-year rate reached 4.22%, in contrast to 1.63% on January 3, 2022. This relatively rapid rise in rates has been driven by the Federal Open Market Committee's six rate increases during 2022 in response to the high inflation rates observed during the year.

Looking at 2023, we expect to see continued rate hikes by the Federal Reserve, albeit not at the same pace or level as in 2022. Evidence for that was seen in the November 30 speech Chairman Jerome Powell gave to the Brookings Institution's Hutchins Center on Fiscal and Monetary Policy. In that speech, he stated that the time for moderating the pace of rate increases may come as soon as the December meeting.[8]

These increased interest rates are relieving pressure on spread margins. For example, American Equity Life reported in its third-quarter 2022 financial supplement that its investment spread for the nine months ending September 30, 2022, was

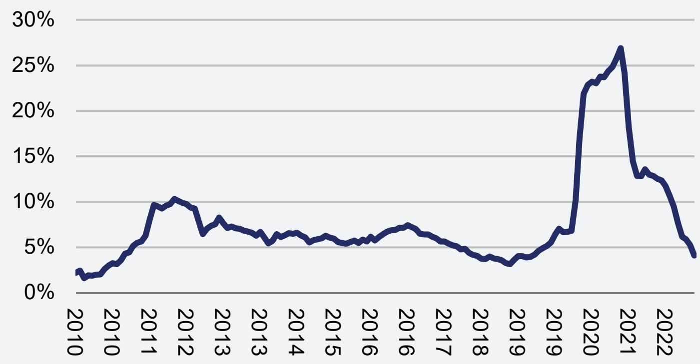


Prepared by Conning, Inc. Source: Bureau of Labor Statistics, U.S. Department of Labor (2022); forecast source: Federal Reserve Bank of Philadelphia Survey of Professional Forecasters, fourth-quarter 2022



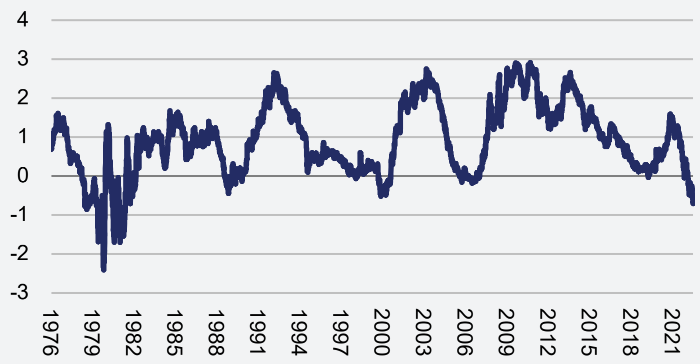
Prepared by Conning, Inc. Source: Bureau of Labor Statistics, U.S. Department of Labor (2022)

M2 Money Supply
% change year-over-year



Prepared by Conning, Inc. Source: Board of Governors of the Federal Reserve System (2022)

U.S. 10-year Treasury Yield minus 2-year Treasury Yield
in percentage points



Prepared by Conning, Inc. Source: U.S. Treasury Department (2022)

2.64%, compared to 2.16% for the same period in 2021. Its return on average assets increased from 3.71% to 4.33% as well.[9]

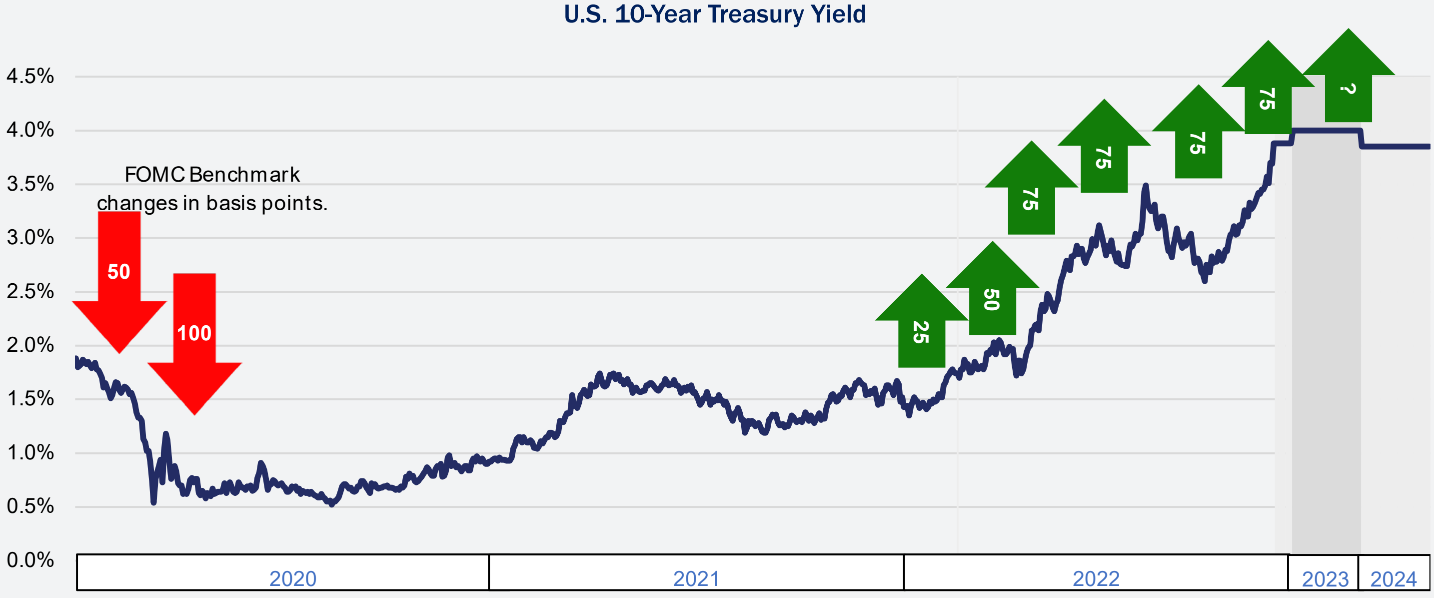
As a result, life-annuity insurers are likely to see higher net investment income in 2023. Higher spread margins also allow insurers to increase crediting rates on universal life and fixed annuities. Those increased crediting rates are likely turning into higher premiums. At Conning, we estimated that, based on third-quarter 2022 statutory premium, as reported by S&P Global Market Intelligence LLC, individual annuity direct premium increased 13% on a year-to-date basis compared to the same period in 2021.

Rising interest rates mean that higher-yielding bonds are available for purchase. However, this only incrementally affects the overall portfolio rates for insurers. The new rates are averaged into the portfolio yields already being earned. While Conning forecasts increasing portfolio yields for the life industry, we do not project portfolio rates to rise as fast as the ten-year rate due to the averaging effects.

One concern about the increase in interest rates is the signal of the yield curve inversion, which has been very persistent and deep. This can be measured in multiple ways, but a standard measure is the ten-year rate minus the two-year rate. This yield curve inversion indicates another danger to the bond portfolio: increased credit losses. Insurer credit losses during the Covid-19 economic turmoil of 2020 were historically low and mostly took the form of downgrades more than defaults.

While interest rates may rise, credit risk may also increase in 2023. Insurers may be balancing the two by de-risking their portfolios. Many insurers have sought to improve their yield through shifting to lower-rated BBB bonds and by taking on a riskier profile in their asset portfolios overall. The higher

U.S. 10-Year Treasury Yield



FOMC = Federal Open Market Committee of the Federal Reserve

Prepared by Conning, Inc. Source: U.S. Department of the Treasury (2022), Federal Reserve Bank of Philadelphia, Survey of Professional Forecasters (fourth-quarter 2022) interest rate environment may give them a chance to shift back into safer higher-rated Treasuries and cash to reduce the credit risk exposure even while increasing their portfolio yield.

Equity markets hindering growth?

The S&P 500's recovery from the Covid-19 lows proved short-lived. The recovery ran from March 2020 through December 2021. Over that period, the index climbed past pre-pandemic levels. However, the S&P 500 cratered more than 20% between January 1, 2022, and November 22, 2022. Accompanying that decrease was significant volatility. Looking ahead to 2023, equity markets may well continue to decline and remain volatile.

While the S&P 500 decreased almost 20%, the insurance industry fared much better. Conning's Personal Lines Index was up 17%. Our Commercial Lines Index was only 2% lower than the start of the year, and our Life Index was 4% lower.

The health of the equity market is one economic area that may hinder premium growth in 2023. Publicly traded companies are likely to remain under shareholder pressure to increase returns. In the past, this has led to balance sheet restructurings to reduce capital and an increased emphasis on share buybacks and dividends. From a growth perspective, however, those actions reduce the capital available to invest in new products, markets, or technologies. We would expect that pattern to continue in 2023.

In 2023, continued market volatility may also have an impact on the ability of companies to raise capital through IPOs or new stock issuance. At the same time, while public stock represents a small percentage of life-annuity insurer portfolios, the same is not true for property-casualty insurers.

Our analysis of property-casualty investments at the end of 2021, the latest data available, found the sector had 10% of its assets in equities, excluding Berkshire Hathaway and State Farm. A decrease in equity markets, therefore, has a ripple effect on realized and unrealized gains. The property-casualty sector has benefited from those gains as the markets rose; in 2023, those insurers may be on the flip side.

For the life-annuity sector, market decreases can have a double impact. One impact is on revenue. The reduction in Separate Account fees can be significant for insurers with large blocks of variable annuity business. The second impact, then, is on an increase in expenses. The cost of hedging the risks from the embedded guarantees inside annuities increases when markets are volatile. We would expect both impacts during 2023 if markets continue their 2022 pattern.

The recessionary wildcard

From our baseline economic forecast, Conning expects there to be overall positive support for continued premium growth. Some of those factors will affect expenses and, in the case of equity markets, potentially reduce revenue and capital. Of course, this assumes the economy dodges a deep or prolonged recession. However, should the economy see a significant contraction, then our outlook for growth would be challenged. As we head into 2023, we will continue to monitor these economic inputs and the effect on the insurance industry's growth.

It's not just the economy

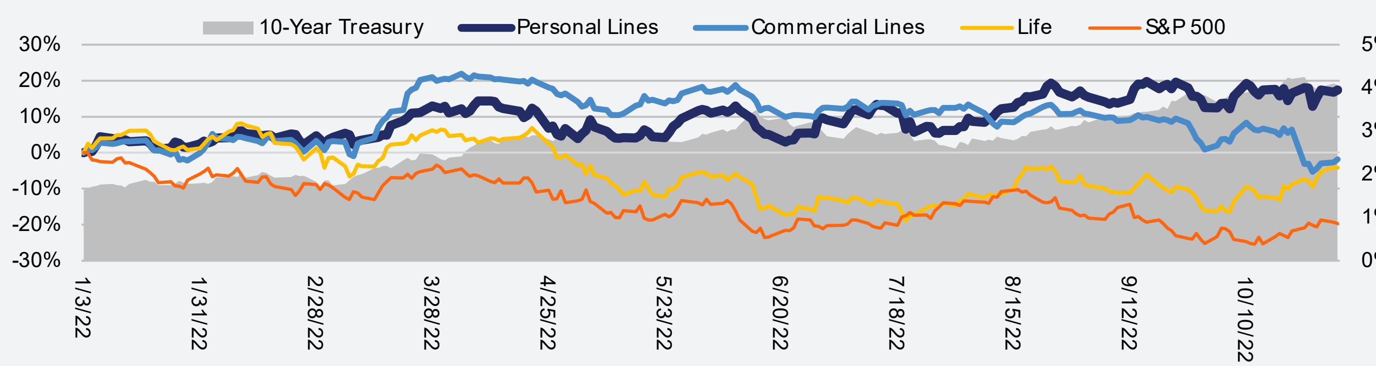
While the economy forms a key part of our 2023 forecast, it is not the only part. From a demand perspective, we see customers still needing significant coverage to close their protection gaps. Those gaps remain in 2023, and a hardening reinsurance market helps create new markets. At the same time, the ability of the insurance industry to realize growth opportunities depends on continued modernization of technology. That modernization is supported by an InsurTech sector undergoing a shift in 2023.

Insurance gaps creating demand, but at a cost

Individuals and businesses will be buying new insurance and renewing existing coverage in 2023 for the same reason they always have: the need for financial protection. The gap between their available resources and the potential financial losses is significant for both life-annuity and property-casualty customers.

The nature of catastrophe exposure is changing. Population increases in areas subject to drought, flooding, sea rise, and hurricanes, along with urban density and economic growth in general, have caused insured values to increase due to the accumulation of people and property in zones most affected by climate change. Frequency and severity will generate in-

Insurance Stock Indices Compared to S&P 500 January 3, 2022, to November 1, 2022



Prepared by Conning, Inc. Source: ©2022 S&P Global Market Intelligence LLC, U.S. Department of the Treasury (2022) creased losses.[10] While some insured losses will be retained by the insurer, a substantial percentage of these insured losses will be reinsured.[10]

According to NOAA (the National Oceanic and Atmospheric Administration), in 2022 (as of October 11), the United States had experienced 15 weather/climate disaster events where losses exceeded $1 billion.[11] Overall, these events resulted in the deaths of 342 people and had significant economic impacts on the areas affected. In total, NOAA reported that the total economic loss was $29 billion from those 15 events.[11] That amount does not include the losses from Hurricane Ian. For the insurance industry, a significant portion of these economic losses turn into insured losses.

As businesses and individuals seek protection from these financial losses, new risks continue to emerge that create growth opportunities. The need for protection from cyber-crimes is a recent example. With everyday life increasingly dependent on access to data and the Internet, this has been a growth area in terms of product design and premium. In 2023, we expect cyber-insurance premiums will continue to grow.

The challenge to meeting this consumer demand in 2023 will be the availability of capital and reinsurance to support the coverage. The current hardening of the reinsurance market challenges an insurer's ability to meet demand. If insurers struggle to obtain coverage from reinsurers, the end users—insureds—will ultimately see premium rates increase or reduced coverage. At the same time, this hardening of the market has created coverage gaps where forward-looking insurers can fill voids and capitalize on growth opportunities with their unique risk transfer skills and expertise. We expect to see the continued development of insurers looking to develop solutions to fill those gaps in 2023.

Falloff in InsurTech funding shifting sector focus

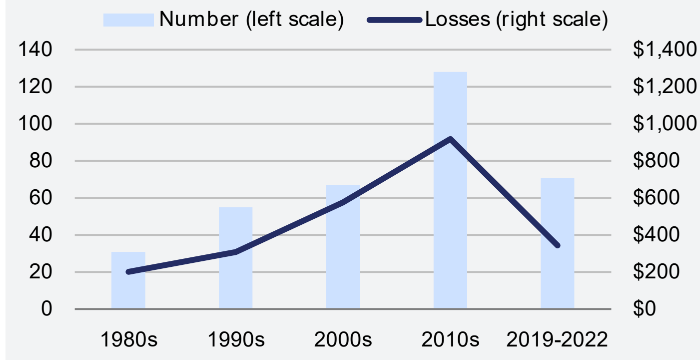
In 2023, we anticipate that insurers will continue investing in technology that will support the growth in premium and customers. Doing so will require partnering with InsurTechs. Fortunately for insurers, we see the InsurTech sector undergoing a shift to a more sustainable approach to business.

After the frenzy of investments in 2021, the market for InsurTech investments has significantly cooled down in 2022. The recent stock market downturn has exacerbated the downward slide of publicly traded InsurTech companies. Looking at 2023, the InsurTech sector is now entering a period of consolidation with significantly lower valuations driven by a more limited funding environment than even a year ago.

Conning's InsurTech Index (an index of 22 publicly traded InsurTech companies) demonstrates the precipitous slide in market capitalization of these companies.

This signals a new era for 2023, where InsurTechs with weak balance sheets and earnings profiles will struggle to raise capital. Increasingly, InsurTechs will be forced to demonstrate the long-term sustainability of their business models to attract new investments. Most InsurTech companies will need to adopt austerity measures and cut costs to achieve profitability and avoid raising capital at drastically lower valuations.

U.S Natural Catastrophe $1 billion-plus events
$ in billions



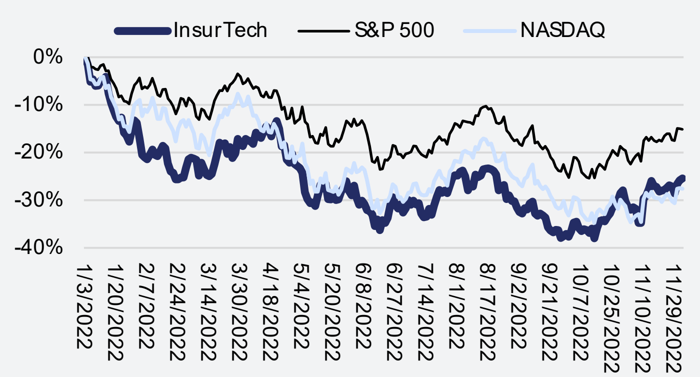
Prepared by Conning, Inc. Source: NOAA National Centers for Environmental Information (NCEI) U.S. Billion-Dollar Weather and Climate Disasters (2022) https://www.ncei.noaa.gov/access/billions/, DOI: 10.25921/stkw-7w73

Not all is gloom and doom in 2023. While InsurTechs recently suffered as investors sought more profitable opportunities, we believe the sector is here to stay. Lower valuations and a decrease in available funding could prove to be the ideal mix for some investment firms looking for InsurTech acquisitions at bargain prices. We expect to see PE (private equity) firms more active in this sector and more deals like the Lemonade and Metromile deal in 2023 as companies with strong cash reserves look for InsurTech acquisitions at bargain prices.

The stratospheric valuations of 2021 proved to be unsustainable, and the current levels of valuations are becoming the new norm. Looking ahead to 2023, InsurTech companies will delve deep into streamlining expenses and lower their cost of operations to survive during the current economic downturn. Those that are unable to quickly adapt to a lower cost of operating environment may need to raise additional capital at significantly depressed valuations. The current market dynamics will create a strong momentum for consolidation, which will lead to more mergers and acquisitions in 2023 and beyond. All of this will create an interesting future for InsurTechs.

For insurers, the shift away from high-flying "disruptors" to more sustainable InsurTech partnerships focused on helping

Conning's InsurTech Insurance Stock Index
Indexed to 1/3/2022



Prepared by Conning, Inc. Source: ©2022 S&P Global Market Intelligence LLC insurers and distributors solve problems is a positive. Our analysis of expenses reported in statutory filings has found that both property-casualty and life-annuity insurers have been investing in technology at almost three times the growth in liabilities.

A foundation set for growth

While the performance of each product and sector has its unique set of drivers, they are building on a macro-environment foundation discussed here. As in 2022, however, there are a few wildcards that could affect growth positively and negatively. We would be remiss if we did not point out the ongoing rise in global unrest. How that plays out has ramifications for the insurance industry and all of society.

Closer to home, the midterm election brought gridlock back to Congress. That said, states and federal regulators may seek workarounds to that gridlock. Those workarounds could certainly change the business climate and regulatory environment for insurers.

While investments in technology are leading to real efficiencies for insurers, they are also changing the nature of the insurance workforce. In 2023, an insurer's ability to attract, develop, and retain highly skilled technical staff is crucial to winning the competitive battle. As a result, the industry's success in the war for talent could be a determining factor in who wins or loses in achieving growth.

So, looking out at 2023 from mid-December, we forecast continued premium growth across the life-annuity and property-casualty sectors. Both sectors are forecast to enjoy positive net operating results and net income. Next month's *Commentary* will take a close look at the performance of each sector and their major product lines.

Footnotes

1. Federal Reserve Bank of Philadelphia, "Fourth Quarter 2022 Survey of Professional Forecasters," November 14, 2022, https://www.philadelphiafed.org/surveys-and-data/real-time-data-research/spf-q4-2022

2. Bureau of Economic Analysis, U.S. Department of Commerce (2022), "Gross Domestic Product, Third Quarter 2022 (Advance Estimate)" news release, October 27, 2022

3. Bureau of Labor Statistics, U.S. Department of Labor, https://www.bls.gov/news.release/empsit.nr0.htm

4. Copyright 2022 SHRM (Society for Human Resource Management), "Average US Pay Increase Projected to Hit 4.6% in 2023," November 29, 2022, https://www.shrm.org/resourcesandtools/hr-topics/compensation/pages/us-pay-increase-forecast-for-2023.aspx

5. Copyright 2022 The Conference Board, Inc., "2023 Salary Increase Budgets Projected to Be the Highest Since 2001," September 20, 2022, https://www.conference-board.org/blog/labor-markets/2023-US-Salary-Increase-Budgets

6. U.S. Securities and Exchange Commission (2022), Form 10-Q for the quarterly period ended September 30, 2022, The Allstate Corporation, https://www.allstateinvestors.com/static-files/22d8ce91-6b1a-45fa-92ac-784599569b68

7. Bureau of Labor Statistics, U.S. Department of Labor (2022), "Consumer Price Index Summary – October 2022" news release, November 10, 2022, https://www.bls.gov/news.release/cpi.nr0.htm

8. The Board of Governors of the Federal Reserve System, speech by Chair Jerome H. Powell, "Inflation and the Labor Market," November 30, 2022, https://www.federalreserve.gov/newsevents/speech/powell20221130a.htm

9. American Equity Investment Life Holding Company Financial Supplement, September 30, 2022, https://ir.american-equity.com/static-files/84248f20-743f-46b2-a13a-afe15ca3a4af

10. Copyright 2000-2022 International Risk Management Institute, Inc., (IRMI), "Expert Commentary: Climate Change and Reinsurance," by Larry Schiffer, June 2022, https://www.irmi.com/articles/expert-commentary/climate-change-and-reinsurance

11. NOAA National Centers for Environmental Information (NCEI) U.S. Billion-Dollar Weather and Climate Disasters (2022), access December 7, 2022, https://www.ncei.noaa.gov/access/billions/, DOI: 10.25921/stkw-7w73

Index to 2022 Conning Commentary articles

Conning's New and Upcoming Releases

InsurTech: Artificial Intelligence Focus Series

Next in our series of InsurTech focus series reports, Conning examines artificial intelligence across both property-casualty and life-annuity sectors. Building on our previous installment, "The Pressure to Innovation Through RPA," Conning explores how artificial intelligence is quickly becoming an essential business capability for insurers. The focus series report starts by defining AI and analyzes forces motivating AI adoption. Next, the report discusses how insurers quantify their return on significant AI investments. The study concludes with our outlook for this technology, including how insurers can build a winning strategy, the impact of AI, and impacts with respect to ESG. Case studies highlighting InsurTech startups and insurer use cases are featured throughout the report. Coming soon

U.S. Insurance Industry Outlook

Conning's annual presentation of the year ahead for the insurance industry examines property-casualty, life-annuity, and health sectors. This year's outlook finds significant growth opportunities, with increasing demand for insurance and risk transfer products as well as increasing input costs and expectations for future claims costs—all translating into higher premiums in just about every insurance sector. The 2023 report also reviews the numerous uncertainties and new risks insurers face heading into the new year. Our view is the opportunities for insurers to grow and enhance their relevance far exceed the challenges they face. Coming soon

Global Insurance M&A in 2022

This study, Conning's 33nd annual in-depth analysis of global insurance M&A (mergers & acquisitions), reviews insurance M&A transactions announced in 2021. The analysis covers acquisitions of insurers in one volume and distributors and insurance service providers in a second. Coming soon

ANNUAL—Personal Lines State Environmental

Conning's Personal Lines State Environment Annual provides a detailed look at the premium growth and profitability outlook in each of the states. The review focuses on the unique characteristics of each state that cause its outlook to diverge from Conning's national forecast. Historical performance, legislative and regulatory changes, as well as economic and demographic trends are reviewed, with an eye on the key drivers of state premium growth and profitability. Coming soon

Life Settlements—Growing Through Turbulence

The economy emerged in 2021 with an outlook for renewed growth. However, consumer concerns about Covid-19 lingered. Those concerns led to a decrease in the amount and number of life settlements in 2021. During 2022, global unrest and Covid-19 have created an economic environment of high inflation. In response, central banks are raising interest rates, possibly leading to a recession. Given this economic turbulence, what is the outlook for continued life settlement growth? Released October 2022

2022 Managing General Agent & Program Market Annual: Strategic Study

MGAs (managing general agents) are increasingly at the forefront of product, technology, and business model innovation in commercial and personal lines insurance. They account for a growing share of product distribution in these markets. This will be the ninth year that Conning has analyzed the uses of MGA distribution using industry-filed data from insurers. We will explore in-depth the talent and technology that a modern MGA needs to start and succeed and look at the diverse universe of Lloyd's U.S. coverholders, the MGAs backed by the world's largest insurance market. In common with previous studies, we will also present the results of our annual MGA survey, offering a granular view of how the market is evolving. Released July 2022

Embedded Insurance Focus Series

Embedding insurance in the products and services of noninsurance companies is both an old practice and potentially the most disruptive trend in property-casualty insurance today, presenting threats and opportunities to insurers, reinsurers, brokers, MGAs, and InsurTechs. Our study will analyze the technology advances that have transformed perceptions of embedded insurance and the economics—including, crucially, the behavioral economics—that have generated such high investor excitement. How far might this revolution extend, and who will win and who will lose in the process? Coming soon

Asset Manager Re/Insurers: The Ongoing Quest for More Assets: Focus Series

The U.S. annuity industry continues to undergo significant restructuring as asset managers and private equity firms acquire or establish liability platforms. However, as more platforms emerge, the competition for annuity liabilities is increasing. Conning continues its ongoing analysis of the restructuring that is changing the U.S. annuity landscape by considering where these platforms may turn next in their search for new liabilities. Could life insurance and non-U.S. liabilities be next? Released April 2022

CONNING®

©2022 by Conning, Inc.
ISSN 1067-7364
THE CONNING COMMENTARY
is published monthly by
Conning
One Financial Plaza
Hartford, CT 06103
Phone: (860) 299-2000
Subscription rate: $295 per year
Reprints available.
Visit us at
www.conning.com/insurance-research

Guy Yeakley, Editor
Scott Hawkins, Managing Editor