NORTHERN TRUST
ASSET MANAGEMENT

FIVE-YEAR MARKET OUTLOOK: IMPLICATIONS FOR INSURANCE COMPANIES

For investors overseeing insurance general account assets, the next five years may be unusually critical for meeting portfolio objectives, given this rapidly changing market environment and your unique asset allocation needs. Our forward-looking, historically aware approach to developing long-term return forecasts across asset classes can aid insurance companies in tackling strategic portfolio construction decisions.

Inflation Recalibration and **Not So Negative** are the two key strategic themes impacting insurance companies over the next five years.

Relative to other institutional investors, insurance companies must conform to regulatory risk-based capital standards and thus rely heavily on investment grade fixed income to fund their operations. With the ultra-low interest rate environment finally in the rearview mirror insurance investors are finding rewarding yields via Investment Grade bonds for the first time in years. That said, traditional fixed income investing may still not offer insurers enough yield potential to overcome the headwinds of rising inflation.

Our five-year return forecasts for fixed income remain low, with diversified fixed income portfolios likely to produce low single-digit returns over the next five years (3–4% annually; see Exhibit 1).

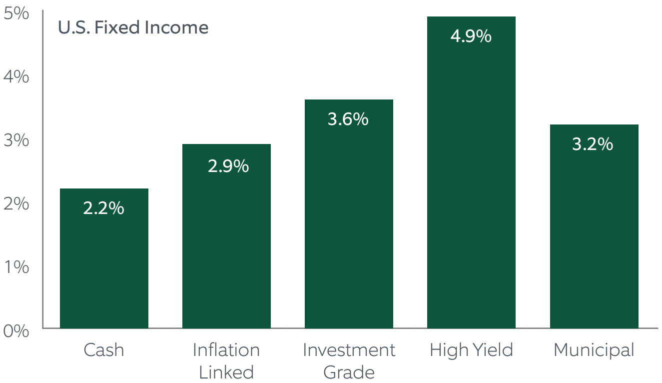
Credit spreads may stay near long-run averages as stable-to-solid fundamentals face modest drag from slow economic growth. Rising inflation will likely put some pressure on profit margins, but high yield's improved quality mix and benign maturity schedule should keep the default rate at or even modestly below long-run averages — providing an attractive return expectation relative to investment grade fixed income.

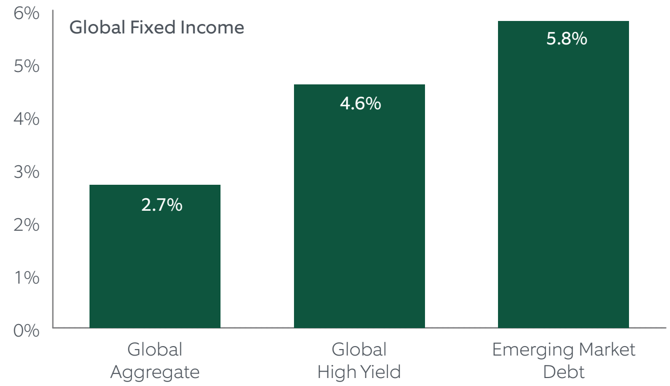
We see **Inflation Recalibration** and **Not So Negative** as the two key strategic themes affecting insurance companies' ability to balance their risk and return and to meet their liabilities over the next five years.

EXHIBIT 1: U.S. AND GLOBAL FIVE-YEAR FIXED INCOME FORECASTS

Single-digit returns are expected in U.S. and global fixed income.

Five-Year Forecast





Source: Northern Trust. Pre-tax strategic, growth and income accredited investor portfolio model. All figures in percentage terms. Forward-looking statements could differ from actual results. For illustrative purposes only. Capital Market Assumptions (CMA) model expected returns do not show actual performance.

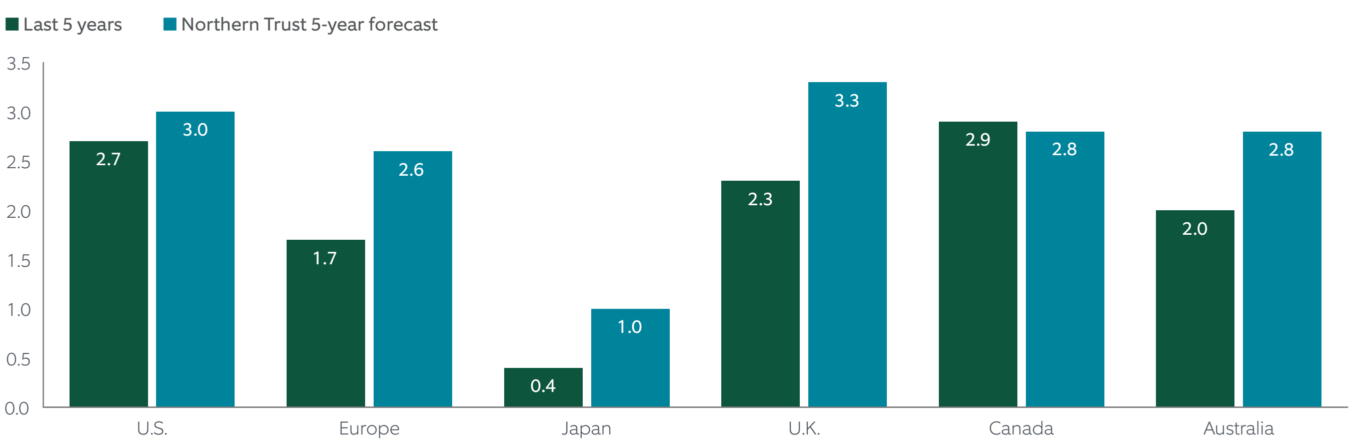
INFLATION RECALIBRATION

Post-pandemic global supply chain complications and worker shortages left a bigger mark than expected on inflation. Still, many investors and policymakers believed inflation was "transitory" and would eventually revert to normal levels. This all changed with the war in Ukraine, which triggered soaring food and energy prices. The inflation genie escaped the bottle, and putting the genie back will take some time. However, we believe the worst has passed, and we expect inflation to moderate gradually.

EXHIBIT 2: THE END OF AN ERA

The Stuckflation regime is over, replaced by a period of recalibration back toward target levels.

Annualized Inflation (%)



Source: Northern Trust Asset Management, Bloomberg. Data from 3/31/2017 to 3/31/2022. All regions use headline Consumer Price Index as the inflation metric..

Considerations for Insurance Companies

Inflation affects both insurers' general account portfolio management and their underwriting results. Life insurance general accounts are the most sensitive to interest rate risk; however, they are far less affected by inflation on the underwriting side than their property and casualty (P&C) and health insurance counterparts. The opposite is true for P&C and health insurers; their inflation concerns stem from the increased cost of potential claims, and their portfolios typically have less exposure to interest rate risk.

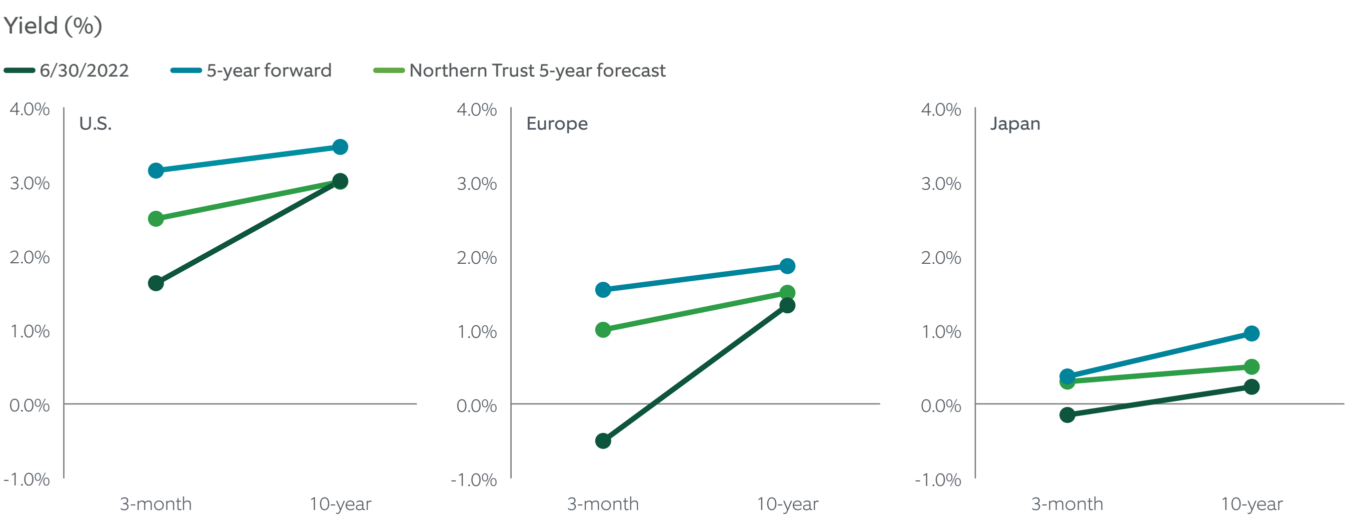
Therefore, we see the private markets playing a much wider role in insurance portfolios as insurers search for new ways to achieve their objectives. According to Cerulli, 56% of insurers have already increased their allocations to private credit in the past six months, while 83% of life insurers have increased their holdings of infrastructure and real estate debt, which are common strategies for hedging against inflation.[1] This ongoing shift in asset classes will likely require enhanced focus on the risk budgeting of the overall portfolio.

NOT SO NEGATIVE

The post-Global Financial Crisis (GFC) era of ultra-accommodative policy has come to a close as central banks have sharply pivoted to tightening in the wake of higher inflation. Nearly all central banks have exited zero/negative interest rate policy — with the Bank of Japan the lone holdout. However, we expect yield curves to remain relatively flat compared to history, with short-end rates moving higher and long-end rates capping out for the most part (see Exhibit 3). The percentage of negative-yielding debt has dropped from over 25% in 2020 to 3% more recently. Even though expected cash returns still imply slightly negative rates on a real (after-inflation) basis, the departure from negative rates should help economic functioning.

EXHIBIT 3: LOWER FOR NO LONGER (BUT NOT HIGH EITHER)

We believe short-end rates will move higher, but long-end rates have mostly capped out.



Source: Northern Trust Asset Management, Bloomberg, as of 6/30/2022. German yields, often cited as the euro area benchmark, are used as a proxy for Europe.

[1] Cerulli, North American Institutional Markets 2021.

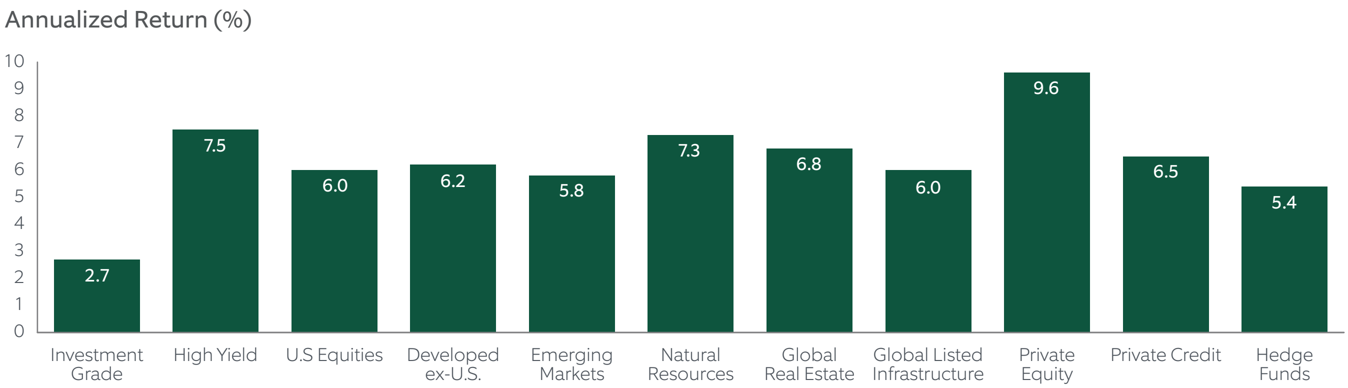
Considerations for Insurance Companies

According to Cerulli's recent survey, insurers are most concerned with changes in interest rates, which follow changes in inflation.[2] The low-rate, low-yield environment requires insurers to reassess how they deploy risk in their portfolios in order to match liabilities. This presents a larger challenge for life insurers compared to P&C and health due to the nature of the guarantees nested into their products.

Relative to life insurers, P&C and health portfolios have shorter durations, which means they are less affected by interest rate risk since they typically turn to equities as a source for incremental return. However, equities face headwinds from a lower valuation ceiling and some margin compression, leaving investors with a more volatile and historically lower-return environment (see exhibit 4).

EXHIBIT 4: LOW-RETURN EQUITIES MAY NOT COVER LIABILITIES

Equities face headwinds from a lower valuation ceiling and some margin compression.



Northern Trust Asset Management, Bloomberg. Annualized return data in local currency from 6/30/2017 to 6/30/2022. Index performance returns do not reflect any management fees, transaction costs or expenses. It is not possible to invest directly in any index. Past performance is not indicative of future results.

To overcome this challenge, we anticipate that insurers will continue to favor private investments such as private equity and private credit for diversification and higher returns. Private investments potentially provide attractive premiums relative to public markets. However, the wide return dispersion among strategies means that manager selection is paramount.

FINAL THOUGHTS

Insurance investors are no strangers to the steep regulations that often limit the risk they can take in their general accounts. Unlike other institutional investors, they can't simply increase risk in turbulent markets. To generate yield over the next five years, insurers will need to get creative and complex with their investments — likely venturing beyond their traditional areas of investment expertise. Asset managers with a strong understanding of the unique needs of insurance companies—and expertise across the full range of public and private asset classes—can serve as strong strategic partners as insurers navigate this challenging environment.

[2]Cerulli, North American Institutional Markets 2021.

ABOUT NORTHERN TRUST ASSET MANAGEMENT

Northern Trust Asset Management is a global investment manager that helps investors navigate changing market environments, so they can confidently realize their long-term objectives.

Entrusted with $999.1 billion of assets,[3] we understand that investing ultimately serves a greater purpose and believe investors should be compensated for the risks they take — in all market environments and any investment strategy. That's why we combine robust capital markets research, expert portfolio construction and comprehensive risk management to craft innovative and efficient solutions that deliver targeted investment outcomes.

As engaged contributors to our communities, we consider it a great privilege to serve our investors and our communities with integrity, respect, and transparency.

Explore Our Full Five-Year Outlook

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- Gain valuable insights from our investment experts
- Get exclusive access to our full research paper
- Explore our detailed return/risk and correlation matrix

[3]As of September 30, 2022.

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CMA model expected returns are based on IPC forecasted returns and reflect Northern Trust's Investment Policy Committee's (IPC) forward-looking annual capital market assumptions. The Capital Market Assumptions Working Group (CMAWG), a subset of IPC members, publishes its assumptions as a white paper report. Forecasted returns are annual returns (geometric basis). Five year forecasts are developed annually; most recent forecasts released 8/10/2022. The model cannot account for the impact that economic, market and other factors may have on the implementation and ongoing management of an actual investment strategy. Model outcomes do not reflect actual trading, liquidity constraints, fees, expenses, taxes and other factors that could impact future returns. The model assumptions are passive only. References to expected returns are not promises or even estimates of actual returns an investor may achieve. The assumption, views, techniques and estimates set out are provided for illustrative purposes only. Forecasts of financial market trends that are based on current market conditions constitute CMAWG judgment and are subject to change without notice. "Expected"
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