PANDEMIC BRIEFING

Pandemic Briefing - Asset Impacts

DATE: 24 June 2020

PREPARED BY: COVID-19 Working Group – Life Insurance

Objective and scope

The purpose of this note is to identify various considerations relating to the impact of COVID-19 on the assets and investment side of the balance sheet, for life insurers.

Whilst this note is aimed at life insurers and actuaries advising life insurers, the considerations discussed herein are general in nature and may also be applicable for actuaries advising in other industry sectors such as general insurance, wealth management or superannuation.

The impact of the pandemic continues to evolve globally with no end expected in the near term. The implications for asset values and expected returns will no doubt change over time, in some cases very rapidly, as further knowledge and information emerges about the pandemic and its impact on societies and economies.

This note provides a general overview of various key factors and considerations likely to impact asset values and expected returns. However, it is not designed to provide a detailed review of implications for each asset class and the considerations discussed within this note are not intended to be exhaustive.

The commentary and considerations within this document are primarily from an Australian perspective. Although some international observations are made, detailed consideration of international perspectives has not been undertaken.

General observations

Disruption to investment markets resulting from COVID-19 has been significant including sharp falls in equity markets and other asset prices, pronounced increases in market volatility and credit spreads. The economic impacts of COVID-19 also have broader implications on asset and commodity markets, with resulting market dislocation and short-term disruptions, for example near term WTI oil futures were observed to go negative in April.

The current levels of heightened volatility and short-term impacts may have implications for economic assumptions, capital calculations and investment strategies of life insurers. Relevant considerations may include:

- Review and potential revision of economic assumptions – long term vs short term.
- Rebasing of asset values (in particular, for illiquid assets.)
- Volatility of capital position due to volatility in economic benchmarks and assumptions.
- Allowance in capital and target surplus for economic shocks.
- Identification of issues arising from economic shocks (e.g. countercyclical considerations for credit spreads, default risk, counterparty exposures, asset valuations, risk of sovereign downgrade and resulting flow-on impacts.)
- Implications for participating portfolios and products with investment guarantees or other asymmetric risks.

Actuaries should consider the appropriateness of economic assumptions based on current market conditions, implications for liquidity and volatility, including for example reviewing the linkages between assumption setting and relevant market benchmarks.

Investment strategies and management of investment guarantees, or bonus declarations may need review. Companies may also consider it prudent to increase the emphasis and frequency of scenario modelling and stress testing due to the heightened market volatility across all asset classes.

Equity markets

All major equity markets across the world fell sharply from late February through most of March, followed by a retracing of over half of those losses through April and May as governments around the world implemented various social distancing measures coupled with economic stimulus packages.

As at 12 June 2020, the ASX 200 was down 13% YTD, while the FTSE 100 was down 20% YTD and the S&P 500 down 7% YTD. Although almost all sectors of the equity markets are down significantly, a deeper look into specific sectors illustrates that the sectors that have been hardest hit are:

- energy;
- financials;
- listed property;
- industrials; and
- consumer discretionary.

Conversely, the sectors that have generally been less significantly impacted are:

- healthcare;
- consumer staples
- utilities; and
- technology.

In considering the rebasing (or marking to market) of asset values, companies should review current market values of their listed equity portfolios. However, they should also have regard to a range of other factors, including:

- Liquidity of their respective holdings and the ability to realise current prices.
- Potential downward pressure on stock prices in the event of a need to divest large quantities of equity assets.
- Increased market volatility under the current environment, resulting from heightened uncertainty, rapid changes in information and effects of algorithmic / high-speed trading.

Where companies have unlisted equities within their portfolios, they should have regard to the sectors that those investments are in, and carefully consider the potential implications of the pandemic at the sector level or if appropriate, at the individual asset level. While price movements in listed comparable stocks may provide a guide to the magnitude and relativity of impacts, the liquidity implications for unlisted equities can be expected to be more severe.

In considering the expected returns from equity assets, companies should distinguish between short-term and long-term expectations. Australia has thus far fared well relative to other major economies, in terms of both containment of the spread of the pandemic as well as market impacts. Almost all brokers and asset managers are reassessing their equity market forecasts for the year, with numerous brokers expecting a continuation of the gradual recovery in the ASX 200 over the remainder of 2020.

Factors that companies should have regard to in setting asset return assumptions for equity portfolios, include:

- Portfolio composition and sector concentrations.
- Susceptibility of their portfolio investments to the social and economic impacts of the pandemic, both in the short and long term.
- Potential for their portfolio investments to capitalise on the economic recovery as it emerges.
- Recapitalisation requirements and likelihood of capital raisings and within their portfolios.
- Potential for sustained economic downturn and likelihood of portfolio investments facing insolvency/administration.

Debt and credit markets

Central banks globally have instituted bond purchase programs as part of broad-based monetary policy stimulus packages to address financial markets dysfunction resulting from the impacts of the pandemic.

As financial markets reacted to the spread of COVID-19 in late February and early March, government bond markets became somewhat dislocated. Investors initially moved away from more risky assets into government bonds causing further tightening in yields. However, the heightened volatility and sharp price falls in other asset classes resulted in investors seeking to realise liquid assets such as government bonds, causing a spike in yields before further bond purchase programmes saw yields stabilise.

In the US, corporate bond spreads widened materially, particularly for high yield borrowers, before the Fed's bond purchasing program was extended to recently downgraded speculative-grade corporate debt. The combination of low interest rates and monetary stimulus packages together with investors' search for yield has resulted in unprecedented levels of bond issuance in the US debt markets.

In Australia, corporate bond spreads widened in March before staging a gradual recovery through April and into May. Liquidity support mechanisms and term funding support has facilitated increased cash within the system further supporting strong primary market bond issuance from both corporate and financial borrowers.

However, credit market volatility remains elevated and markets continue to react sharply to new developments, both positive and negative.

In considering the rebasing of asset values for debt portfolios, companies should have regard to a range of factors in the current circumstances, including:

- Current market observed pricing of portfolio assets (where available.)
- Liquidity of their respective holdings and ability to realise current observed pricing.
- Elevated levels of volatility and price/volume sensitivity across debt markets.
- Differences between listed debt markets and OTC markets in terms of liquidity and bid/offer spreads.

When considering expected debt portfolio returns, companies should again distinguish between short and long-term expectations. Factors that may impact return expectations include:

- Current market yields for short and long-term securities across government bond markets, swap markets and credit markets.
- Credit quality of constituents and sector concentrations within the portfolio.
- Ongoing availability of central bank support.
- The potential to withstand sustained economic downturn within the portfolio constituents.
- The ability / propensity for portfolio constituents to recapitalise resulting in corresponding credit improvement.

Real estate

Following the various extensive pandemic containment and social distancing measures implemented by governments around the world, real estate markets have been severely impacted with the listed real estate markets falling sharply across all real-estate sub-sectors. The real estate sectors that have suffered the largest falls in valuations are:

- retail and shopping centres;
- diversifieds;
- residential and student accommodation; and
- offices and development.

Real estate sectors that have suffered less severely are:

- industrial;
- self-storage; and
- healthcare.

In the US and UK, many commercial tenants have indicated they will be seeking rent waivers or deferrals and some major commercial landlords have already agreed to defer or waive rents.

In Australia, indications are that 25-30% of retail stores within major shopping malls have been closed during recent months. Although staged re-openings are a positive sign for increased foot traffic, retail sales are expected to remain subdued for some time resulting in lower rental collections and potentially rental resets for many commercial landlords.

In rebasing asset values for listed property and real estate assets, companies should have regard to:

- Current market observed pricing of portfolio assets.
- Available market liquidity and ability to realise current pricing.
- Any sub-sector concentrations within portfolio holdings and implications for those sub-sectors.
- Elevated levels of market volatility with respect to portfolio holdings.

For unlisted property assets, companies may consider increasing the frequency of independent valuation assessments, potentially including intra-period assessments and / or independent determination of impacts of the pandemic on any significant unlisted property assets within their portfolio.

To undertake a thorough assessment of potential returns for real estate investments, companies should again distinguish between short and long-term expectations. Factors which should be considered in determining expected returns for real estate assets, include:

- Any sub-sector concentrations within portfolio holdings and implications for those sub-sectors.
- Rental waivers or deferrals and expected recovery of missed / delayed payments.
- Possible impact on demand for office spaces and surrounding retail and shopping centres if office workers shift to working from home on a more permanent basis.
- Ability of portfolio constituents to withstand sustained downturn and / or capitalise on post pandemic property market recovery.
- Likelihood of recapitalisation requirements or potential for administration in respect of any listed property holdings.

Commodities

The economic impacts of global suspension of activity through the pandemic has dramatically impacted commodity markets resulting in unprecedented volatility and uncertainty in the markets.

Oil prices fell sharply to historic lows in April as mitigation efforts globally ground almost all travel to a halt. As demand for oil dried up, suppliers in the US had to resort to renting storage facilities to store the excess oil supply resulting in the May WTI futures contract briefly turning negative during April, meaning that suppliers would have to pay customers to take the oil. Although this has since stabilised, prices remain depressed and volatile given the uncertainty in the economic outlook.

Energy prices in general are expected to be substantially lower during the remainder of the year due to reduced industrial activity. Similarly, lower levels of demand for industrial metals are expected to weigh on prices.

Conversely, the gold price has risen significantly YTD as investors have sought the defensive qualities of precious metals during the financial market turbulence.

Companies with direct or indirect commodity exposures should carefully consider:

- Differential impacts of the global response to the pandemic on different commodities.
- The impact of heightened volatility on their economic modelling assumptions.
- Any concentrations in commodity exposures and the potential outlook for both short and long-term prices.

Foreign exchange

Foreign exchange markets have also seen unprecedented volatility during this period as market uncertainty saw a rally in the USD with most major currencies depreciating against USD. By mid March, the AUD had fallen more than 18% to a close at a low of 57 US cents. However, the AUD has since recovered almost all of its decline and as at 12 June 2020, is broadly flat YTD against the USD.

Whilst the general dysfunction across the foreign exchange markets has subsided with greater stability in trading amongst major currency pairs, volatility remains elevated.

Companies with unhedged currency exposures should carefully consider the appropriateness of their FX assumptions, both in the short and long-term. Given the elevated volatility, companies may consider more extensive sensitivity analysis and stress testing with respect to their FX assumptions and currency exposures.

Inflation

Although headline inflation in Australia increased slightly in the March 2020 quarter, near term inflation is expected to be lower due to the impacts of the pandemic, caused by expected drop in consumer demand for goods and services.

Containment measures implemented across the world has supressed global demand for oil which in turn has put downward pressure on fuel prices. The Australian Government's initiatives to support households may also impact inflation in the near term.

Consequently, market economists have generally lowered their inflation expectation forecasts. According to the RBA's May 2020 Statement of Monetary Policy, the CPI forecast for the year to June 2022 is currently at 1.5%, considerably below the RBA's medium-term inflation target of 2-3%.

Implied inflation based on market trading levels of Government Index Linked Bonds is even lower, for example, as at 12 June 2020 the Australian Government 2027 maturity index linked bond was trading at a breakeven implied inflation of approximately 0.80%. This dislocation between market implied inflation and the RBA forecasts reinforces the view that market expectations are for a sustained period of low inflation over coming years.

Given the current expectations of relatively low CPI over the near to medium term, companies should have regard to various factors in setting inflation assumptions, including:

- Distinguishing between short and long-term inflation assumptions.
- The type of costs being forecast and whether the RBA inflation target, RBA near or medium-term CPI forecasts or some other inflation forecast is most appropriate.
- Dislocation between implied market expectations and the RBA CPI forecasts.
- Potential dislocation between wage inflation and inflation in other costs.