Citizens Market Update

July 12, 2022

- As we all are seeing in prices that inflation has increased significantly over the last six months and is expected to continue until the end of 2022 even though the employment picture is still stable.
- The inflation initially started because of demand surge in goods with global supply constraints due to COVID lockdowns, significant fiscal stimulus measures, in the total amount of $5.7 trillion or approximately 24% of GDP resulting in unprecedented demand surge.
- Since February 2022, inflation has gotten worse with Russia's invasion of Ukraine, which has significantly increased energy, food, and commodity prices and now inflation has shifted from goods to services as labor shortage continues and demand surge has moved from goods to services.
- To manage inflation, so far, in 2022 the Fed has increased its fed funds target rate three times by a total of 1.50% to the current target rate of 1.50% - 1.75%. This includes the most recent 0.75% increase on June 15th or the largest rate hike since 1994.
- The Fed has also communicated that it plans to raise rates expeditiously to control inflation. We expect the Fed to increase rates by an additional 125 basis points over the next three meetings before taking a pause in December or to 2.75% to 3.00% by the end of 2022.
- We also expect inflation to come down by the first quarter of 2023 year and therefore the interest rate may not increase at the current projected rate, however, continuation of energy crises and additional COVID lockdowns in China may further exacerbate the supply chain problems and may lead to continued inflation next year.
- Global markets are in similar position as Global Central Banks followed the Fed's monetary policy and US fiscal policy during the COVID lockdown and now the world is trying to play catch up to manage inflation – again, part of this inflation is due to the unanticipated Russian invasion of Ukraine which has worsen the inflation and economic outlook.
- Interest rates have responded to Feds rate increases and has significantly increased over the last six months. Over the last year, 1 year UST has increased from 7 bps to 2.96%, 2 year has increased from 20 bps to 3.10%, 5 year UST has increased from 80 bps to 3.12% and 10 year has increased from 1.30% to 3.8% .
- The result of higher interest rates and lower equity prices will lead to higher unemployment and to economic slowdown or may even lead to mild recession over the next 12 months – not just technical recession but economic recession. Yield curve is flat and even has marginal inversion as the spread between 2 and 10 year UST is -2.5 bps.

- However, at the same time we believe the pendulum on the interest rates has swung too far and as always the market has over reacted and over corrected. We expect UST rates to come down as the economy slows down for some of the following reasons:
  - As almost all of the Fiscal stimuli in the total amount of $5.7 trillion are spent and is mostly already reflected in economic growth numbers
  - Economy is going to slow down with the increase in interest rates and with equity market declines
  - Housing sector is slowing as mortgage rates have increased
  - Global Macro conditions will improve as the world adjusts to Geopolitical crisis
  - Large increase in energy prices and its effect on demand
  - Savings rate is down and that should reduce consumer demand and of course the increase in prices due to inflation
  - We have already seen this in our 1st quarter GDP numbers or growth rate of -1.4% and expect 2022 GDP growth to be close to zero or even negative
  - Base effect as higher prices becomes part of the base prices so the rate of change will slow down
- This has also impacted our investment portfolio as interest rates have significantly increased and that has resulted in negative Mark to Market (MTM) value in our portfolio but MTM negative values are non-economic and non-cash as these negative values pull to par as they mature.
- However, our income return is stable and rising interest rates are economically beneficial as they lead to higher interest income and we will get the benefit of increasing rates by investing our maturing securities as well as additional premiums at higher rates. We have approximately $2 billion maturing over the next 12 months and an additional $880 million maturing between 12-24 months.

Risk Transfer Markets

- Reinsurance markets are in flux and have significantly reduced capacity and also increased prices. So far this year, the risk transfer rates are approximately 10% to 15% higher globally and 30% to 40%v higher in Florida.
- Some of the factors for this increase globally are similar to what we are talking about from Global macro perspectives as the world is in semi-permanent volatile stage and looking for further direction with multiple unknown variable from inflation to global monetary policy tightening . Just in summary, some of the major factors of risk transfer markets dislocation are:
  - 5 years of Global insured losses have totaled over $500 billion

  - The continuation of Covid crises and associated business interruption losses
  - Russia’s invasion of Ukraine and associated aviation and other significant losses
  - Significant mark to market losses in Reinsurers investment portfolio as a result of higher interest rates and lower equity prices resulting in MTM unrealized losses and that has reduced the available capacity to write risk
  - Trapped capital from prior events especially from recent hurricane events and large number of Covid related claims
- And of course we all know Florida market has its own problems stemming from litigation, continued adverse loss development, and credit quality concerns of primary insurers as some insurers have gone into receivership.
- While the legislation passed in the special session is a step in the right direction, however, the long-term result remains to be seen and more importantly depends on the amount of losses this season.