Citizens Market Update

September 20, 2022

- Inflation continues to remain elevated albeit decreasing from its highs in June 2022 mainly due to a decrease in energy prices. Excluding volatile food and energy categories, core inflation increased by 0.6% from July to August, higher than many economists had expected and a sign of inflation's persistence. Inflation is expected to continue to remain elevated until the early to mid-2023
- Unemployment remains very low at 3.7% but the labor force participation rate has not yet returned to pre-pandemic levels
- The student loan forgiveness plan to forgive up to $20,000 in student loans for individuals making less than $125,000 is expected to translate to 5% of additional spending, or $1,000 per individual, which will add to inflation, but not to the same magnitude as prior stimulus measures, which added approximately 1.5% or 25% to the current core inflation
- To manage inflation, so far, in 2022 the Fed has increased its fed funds target rate four times by a total of 2.25% to the current target rate of 2.25% - 2.50%. The market expectation is for another 0.75% rate hike at the FOMC September meeting. After that hike, the U.S. central bank is expected to increase rates by an additional 50 basis point by the end of 2022
- 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 – however, part of this inflation is due to the unanticipated Russian invasion of Ukraine which has worsened the inflation and economic outlook.
- Interest rates have responded to Feds rate increases and has significantly increased over the last six months. Since the beginning of this year, the 1-year UST has increased from 0.40% to 3.96%, the 2-year UST has increased from 0.78% to 3.85%, the 5-year UST has increased from 1.37% to 3.62% and the 10-year UST has increased from 1.63% to 3.45%.
- The result of higher interest rates and lower equity prices will lead to higher unemployment and to economic slowdown and most likely will lead to recession over the next 12 months – not just technical recession but economic recession. The yield curve is inverted with the spread between 2 and 10 year UST at -40 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, as seen by the ~0.25% increase in a single day last week due to the difference in CPI from market expectation to the reported rate by only 0.3%. 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 to levels not seen since 2007
- Global Macro conditions will improve as the world adjusts to Geopolitical crisis
- Savings rate is down and that should reduce consumer demand and of course the increase in prices due to inflation
- The US economy shrank at a slightly slower rate than estimated during the second quarter with a reduction of 0.6% at an annualized rate
- 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 $2.3 billion maturing over the next 12 months and an additional $1.8 billion 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% higher in Florida.
- Some of the factors for this increase globally are similar to what we are talking about from Global macro perspectives as everyone is anticipating further headwinds due to multiple unknown variables from Russian invasion, to inflation, and 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 significant 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 number of 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
- The challenges in the Florida market include the greater frequency of secondary perils (severe thunderstorms, hail), rising reinsurance costs and escalating litigation
- A report published by A.M. Best illustrates the magnitude of reinsurer losses related to Florida specialists despite no significant storms
    - Premium assumed by U.S. reinsurers has grown roughly 66% the last three years, and the loss ratio has still increased without significant hurricane losses over that time, further suggesting that current prices are not adequate to cover the claims inflation and fraud
    - Losses have increased fourfold over the last three years even without significant hurricane activity. Losses paid topped $1 billion in 2021 – ten times more than in 2012