Citizens Market Update

December 5, 2022

- Inflation rose in October about in line with estimates, sending a sign that price increases at least might be stabilizing. The CPI rose 0.3% in October on a seasonally adjusted basis and 6% on an annual basis. The monthly increase was the same as September, while the annual gain was a step down from the 6.3% pace. The index for all items less food and energy rose 0.2% in October and was up 5% from a year ago, after rising 0.6% in September. Another positive sign is manufacturing activity posted its lowest reading in two and a half years for November – the ISM Manufacturing Index registered a reading of 49, was 1.2% below October and the lowest since May 2020. However, 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 labor force participation rate is at 62.1% and has shown little net change since early this year, and is still 1.3% below its pre-COVID level of 63.4% in February 2020
- The student loan forgiveness plan battle is still going on as it plans to forgive up to $20,000 in student loans for individuals making less than $125,000 is expected to translate into a 5% of additional spending, or $1,000 per individual, which will add further 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 six times by a total of 3.75% to the current target rate of 3.75% - 4.00%. The market expectation is for another 50 basis points rate hike at the FOMC December meeting and another 25 bps in January 2023 for a terminal rate to be close to 4.75% to 5%
- 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 year. Since the beginning of this year, the 1-year UST has increased from 0.40% to 4.72%, the 2-year UST has increased from 0.78% to 4.33%, the 5-year UST has increased from 1.37% to 3.74% and the 10-year UST has increased from 1.63% to 3.57%.
- 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 inverted yield curve is reflecting that with both the spread between 2 and 10 year UST and 3 months to 10 year UST at approximately -67 basis points.

- 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. The market now reflects all of the expected rate increases and we expect 3+ UST rates starts to come down as the Fed gets to terminal rats and 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
    - Base effect as higher prices becomes part of the base prices so the rate of change will slow down
- The increase in interest rates is 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 of approximately $794 million 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 remaining portion after Ian's claims of our maturing securities as well as additional premiums at higher rates
- Internationally, weather disasters caused an estimated economic loss of $260 billion in 2022, surpassing the 10-year average of $207 billion. Insured losses in 2022 are estimated at $115 billion, again higher than the 10-year average of $81 billion. Hurricane Ian caused approximately $40 billion to $60 billion in insured damages, second only to Hurricane Katrina in 2005
- Global macro factors are continuing to stress the risk transfer markets on top of insured losses, including mark-to-market losses in fixed income portfolios from rising interest rates, which is expected to lead to rate increases nationally of approximately 20% in 2023 and in Florida the rate increases are projected to be 40%-60%