INSIGHT INVESTMENT THOUGHTS FOR 2024

FOR INSURANCE COMPANIES

DECEMBER 2023

BNY MELLON | INVESTMENT MANAGEMENT

EXECUTIVE SUMMARY

INVESTMENT

- Global rates – higher rates should mean higher long-term returns: In our view, the neutral rate, or level of real interest rates at which central bank policy is neither stimulating nor restricting economic growth, has shifted upwards. This raises the range in which central banks will be conducting monetary policy in the years ahead, with two key consequences:

  – The potential for monetary easing in 2024 is limited, as policy is not currently as restrictive as many believe, leaving central banks only able to edge interest rates downwards.

  – Tightening monetary policy sufficiently for it to truly tame inflation over the longer term is going to be difficult, as the impact on broader asset prices may become politically intolerable.

  Bond yields have risen to reflect this new reality, and we believe higher yields create a positively skewed, asymmetric return profile for fixed income investment. If we are wrong, and the neutral rate has not changed, yields could decline sharply as inflation is brought under control – potentially generating significant gains for fixed-income investors.

- Global inflation – sustainably returning to target is likely to be tricky: Inflation moderated in 2023, driven by the powerful statistical impact of base effects as food and energy price spikes following the Russian invasion of Ukraine dropped out of the year-on-year data. We believe 2024 should bring greater clarity on where the underlying rate of inflation is likely to settle – and at this stage, it appears likely to be above 2%. This is likely to create a dilemma for central banks as unemployment drifts upwards and calls for easier policy grow. Some may prove far more willing to adapt their policy frameworks to this new reality than investors currently believe, effectively allowing inflation to run at higher levels than in the past.

- Investment grade credit – careful analysis is critical to maximize the yield opportunity: The yields available in investment grade credit have risen to levels comparable to those of the decade before the global financial crisis. In our view, this represents an opportunity to lock in attractive levels of income, but to really maximize returns we believe careful credit analysis will be key. There is the potential for significant divergence in corporate bond performance in the year ahead in an environment of slow growth and rising funding costs.

- Municipal bonds – naturally complements US credit: For those investors seeking to take advantage of the yields available in corporate credit, we believe taxable municipal bonds are an asset class that are an overlooked opportunity that is systematically mispriced. Taxable munis offer similar yields to US corporates but have several advantages; many of these public corporations are virtual monopolies that deliver services with inelastic demand to the public, meaning the asset class has previously been more resilient to periods of sub-trend growth and has historically experienced extremely low default rates.

- High yield credit – the new growth asset: For the first time in many years high yield is living up to its name, with high yield offering very high levels of income at a time when defaults are expected to remain contained. In the US high yield market, yields are now so high that they offer returns in excess of average long-term rolling 12-month returns on the S&P 500 Index. As long as defaults remain low as we expect, this offers an opportunity to contractually lock in returns normally associated with equity market investment in an asset class which has historically experienced significantly lower drawdown risk.

- Structured credit – maximizing income in a risk averse way: For investors that don't want to migrate up the risk spectrum, the floating rate structure of most structured credit issues allows investors to take advantage of higher interest rates in very short maturities without the duration risk implicit in fixed-rate bonds. Perhaps the most important feature of all, however, is the powerful payment waterfall structures built into the asset class that make them fundamentally defensive. This makes the senior tranches of structured credit issuers well placed to withstand a period of economic weakness that may result from the policies implemented by central banks to slow growth and reduce inflationary pressures.

- Currency – navigating a less certain environment for the dollar: The global economy is slowing, but the US economy is still expected to grow at a more rapid pace than other developed markets. This, combined with higher interest rates, makes it difficult to bet against the US dollar. However, after a bull run that's lasted more than a decade, the US dollar sits close to historical highs, and an unsustainable fiscal position has created a vulnerability. This sets the scene for a choppy backdrop against which we feel a tactical approach is the best option.

GLOBAL RATES

HIGHER RATES SHOULD MEAN HIGHER LONG-TERM RETURNS

Five reasons we believe the neutral rate has shifted higher

In our view, the neutral rate, or level of real interest rates at which central bank policy is neither stimulating or restricting economic growth, has moved upwards and will remain higher in the years ahead. We believe this is being driven by five key factors:

- **Deglobalization:** After being one of the most important sources of disinflation for decades, globalization is in the process of reversing, putting upward pressure on inflation and the neutral rate.
- **Demographics:** As growth in working-age populations slows, a shortage of labor can result in higher wages and investment. We believe this will be more important than the impact of slower trend growth, pushing the neutral rate upwards.
- **Inflation volatility raises risk premia:** If inflation is volatile, markets can demand higher risk-premia for low-risk assets such as government bonds to ensure that they generate positive real returns. This pushes the neutral rate upwards.
- **Climate investment:** Many countries have committed to decarbonize their economies over the next 30 years to hit the 'net zero' emissions target by 2050. We believe a higher neutral rate will be needed to attract sufficient capital for this investment.
- **Productivity and artificial intelligence:** Productivity has materially slowed over recent decades, but some believe that artificial intelligence could result in a new productivity boom. Although we are skeptical about the benefits and cautious on the timescales, it is likely to have at least a marginal impact, putting upward pressure on the neutral rate.

A higher neutral rate means higher policy ranges

If the neutral rate has shifted upwards as we believe, then central banks are going to be maintaining interest rates within a higher range than we have seen since the global financial crisis. Although central banks may edge rates downwards in 2024, we believe the potential for monetary easing is limited, as a higher neutral rate means policy is not currently as restrictive as many believe. Over the longer term, if economies experience a cyclical upswing, central banks are likely to find it difficult to raise interest rates to levels sufficiently restrictive to truly tame inflation as the impact on broader asset prices becomes politically intolerable.

> Central banks are going to be maintaining interest rates within a higher range than we have seen since the global financial crisis.

Higher rates potentially create an asymmetric payoff profile for fixed income investors

Bond yields have risen substantially over recent years (see Figure 1). In our view, this has created a positively skewed, asymmetric return profile for fixed income investment which we outline below by considering three different scenarios for future yields:

- **Yields continue to trend higher:** Even after such a significant recent rise in yields, there is a risk that yields continue to drift higher if inflation remains sticky. However, the high level of income available in fixed income assets acts as a buffer against losses; for example, a US fixed income portfolio could absorb an additional 100bp of yield rises before incurring losses over a one-year time horizon (see Figure 2).
- **Yields remain in a new range around current levels:** If we are correct, then both policy rates and bond yields are likely to remain in a new higher range in the years to come. Some central bank policy easing may exert downward pressure on the yield curve, but we do not expect a return to the low yields we have experienced over recent years. In this scenario fixed income investors could expect to generate attractive, income-driven returns in the years ahead, which compound over longer time horizons.
- **The neutral rate hasn't changed – and the low-yield era returns:** If we are wrong, the neutral rate hasn't risen, and current policy proves sufficiently restrictive to bring inflation back to target more quickly than forecasters anticipate, yields are likely to decline sharply. In this scenario, a combination of income and capital gains has the potential to generate solid returns.

We demonstrate the types of returns that we would expect to occur for an investment in the Bloomberg US Aggregate Index across these various scenarios in Figure 2.

Figure 1: Nominal US bond yields have risen sharply[1]

Figure 2: Yields would need to rise meaningfully to incur losses[2]

Change in yields over 12mths	Return
Yields unchanged	5.65%
Yields rise	
+50bp	2.7%
+100bp	-0.3%
Yields fall	
-50bp	8.6%
-100bp	11.6%
To average from 2021: 3.21%	20.2%

For insurers that currently have a duration gap between assets and liabilities, now might be an opportune time to increase the allocation to fixed income assets, given risk-reward tradeoffs in debt and equity have compressed.

[1] Source: Bloomberg US Aggregate Index. Data as of October 31, 2023. **Past performance is not indicative of future results.**
[2] Source: Insight. Data as of October 31, 2023. Any projections or forecasts contained herein are based upon certain assumptions considered reasonable. Projections are speculative in nature and some or all of the assumptions underlying the projections may not materialise or vary significantly from the actual results. Accordingly, the projections are only an estimate.

GLOBAL INFLATION

STRUCTURALLY HIGHER INFLATION AHEAD

The disinflationary impact of base effects has ended

The rate of inflation has trended downwards across major economies at varying speeds in 2023 (see Figure 3). This downtrend has been driven by the powerful statistical impact of adverse base effects as the surge in food and energy prices that followed the Russian invasion of Ukraine have dropped out of the year-on-year data. More recently, the prices of both food and energy appear to be nearing a low (see Figure 4), suggesting that the disinflationary impact of base effects is nearing its end. We believe 2024 should bring greater clarity on where the underlying rate of inflation is likely to settle – and at this stage, it appears likely to be above central bank targets.

Figure 3: Inflation has broadly trended downwards[3]

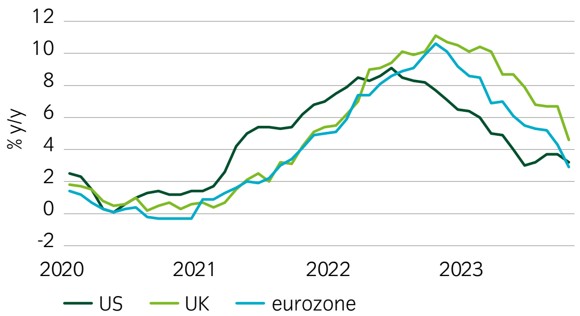
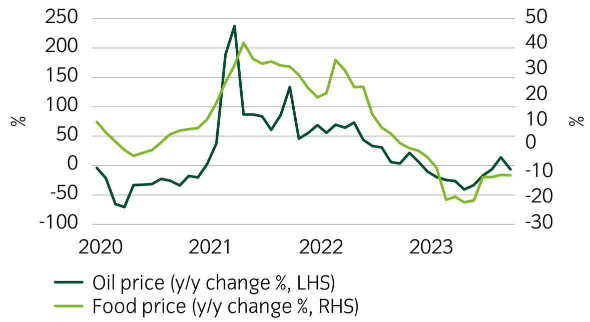


Figure 4: Food and energy prices have stopped falling[4]



Central banks may be forced to adapt to a higher inflation baseline

If inflation were to prove structurally higher in the years ahead, sufficiently tightening policy to bring inflation back to target on a sustained basis is likely to exert considerable stress on those economic players that increased leverage during the era of low rates. Not least of these are the governments of major economies, which now find themselves forced to divert ever-increasing proportions of tax revenues to cover interest costs. In the US, the Congressional Budget Office is predicting that US debt/GDP will rise to 185% of GDP by 2052 (see Figure 5), requiring interest payments of 7.2% of GDP[5].

But why do we need to keep inflation at 2%? In early 1990, the Central Bank of New Zealand announced that it would target a rate of inflation of between 2.5% to 4.5% in 1991, dropping to 0% to 2% in 1992[6] – the concept of inflation targeting was born. The Bank of Canada followed with its own version of the policy in 1991, then the UK in 1992, after it was forced to exit the European Exchange Rate Mechanism. This relatively simple concept of targeting a low and steady rate of inflation followed decades of unsuccessful policy regimes in the form of the gold standard, monetary targets and fixed exchange rates, and proved highly successful in anchoring inflation expectations. The US Federal Reserve eventually adopted the policy under the chairmanship of Ben Bernanke in 2012.

[3, 4] Source: Insight and Bloomberg. Data as of October 31, 2023. Inflation forecasts are for Consumer Price Inflation.
[5] Source: https://www.cbo.gov/publication/58340
[6] Source: https://www.federalreserve.gov/pubs/ifdp/1994/473/ifdp473.pdf

A 2% inflation target is not guaranteed

Ultimately, however, 2% was always an arbitrary number, and never meant to be rigidly set in stone. The Central Bank of New Zealand moved its target over time and currently targets a 0% to 3% range. The Fed has also softened its position, moving to a flexible average inflation target in 2020 and may prove far more willing to continue to adapt its framework than investors currently believe. For politicians, a slightly higher rate of nominal growth has advantages as debts would be slowly inflated away over time relative to GDP, with Italy being a good recent example of this (see Figure 6).

Figure 5: US debt/GDP is forecast to keep rising[7]

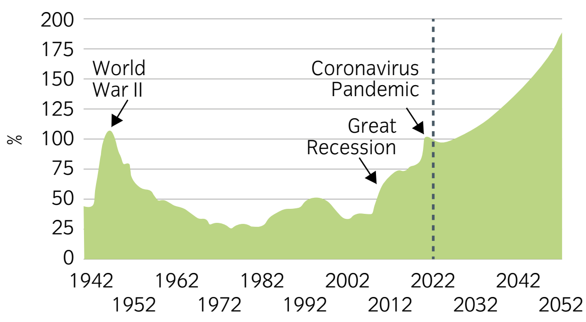
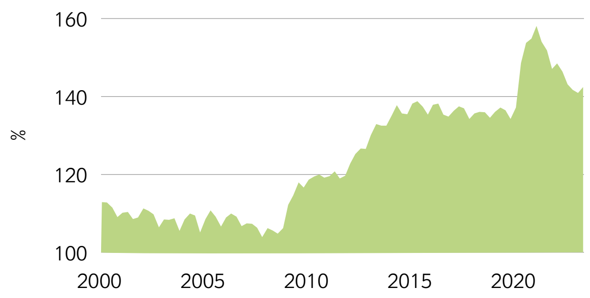


Figure 6: Italian debt/GDP has declined sharply from its peak[8]



> 2% was always an arbitrary number, and never meant to be rigidly set in stone.

If inflation is likely to settle at a higher level, insurers may need to review their investment strategies to better manage their liability risks.

[7] Source: https://www.cbo.gov/publication/58340
[8] Source: Macrobond. Data as of October 31, 2023.

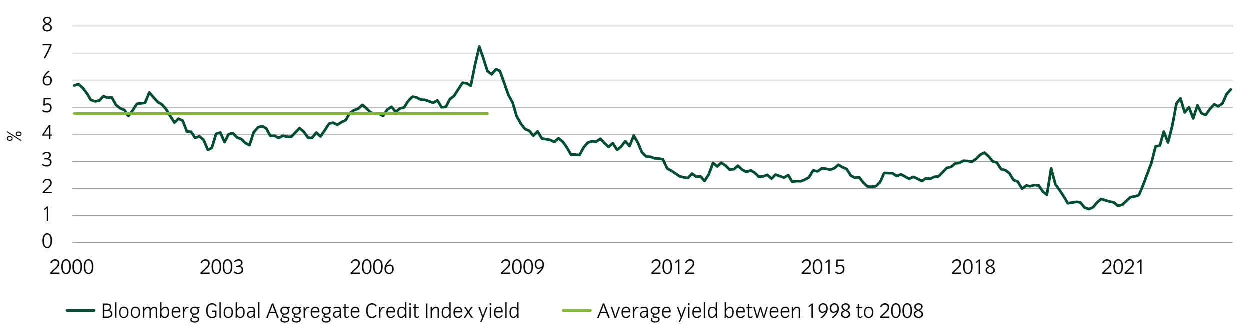
INVESTMENT
GRADE CREDIT

YIELD IS BACK – BUT CAREFUL ANALYSIS COULD HELP MAXIMIZE RETURNS

Absolute yields are back to pre-financial crisis averages

Driven by a combination of higher government bond yields and wider spreads, investment grade credit offers yields comparable to those available in the decade running up to the global financial crisis (see Figure 7). In our view, this represents an opportunity to lock in attractive levels of income, but to really maximize returns we believe careful credit analysis will be key. There is the potential for significant divergence in corporate bond performance in the year ahead in an environment of slow growth and rising funding costs.

Figure 7: Yields in investment grade credit are back above pre-global financial crisis averages[9]



Corporate resilience is going to vary, making company analysis critical

Although many corporate issuers extended their debt maturity profiles to lock in funding costs, there is still a gradual impact over time as bonds mature and need to be refinanced. HSBC[10] has analyzed three scenarios and their potential impact on US households and corporates:

1. the Fed maintains rates at 5.5% until the end of 2025;
2. US rates follow the path outlined in the June 2023 Federal Open Market Committee (FOMC) dot plot, which showed the median forecast of Federal Open Market Committee members was for rates to peak at 5.6% before declining to 3.4% in 2025; and
3. a hard landing scenario where the FOMC slashes rates to 2.375% in 2024.

In the first two scenarios, interest payments for both corporates and households rise from their 2021 low by up to 2% of GDP during a period where forecasts for growth have declined to sub-trend levels across developed markets (see Figure 8) and profit margins are likely to be under pressure.

[9] Source: Insight and Bloomberg. Data as of October 31, 2023. **Past performance is not indicative of future results.**
[10] Source: HSBC: Debt puzzle, published August 29, 2023.

In a hard landing scenario, interest costs would decline as rates fell, but this would be more than offset by the deterioration in the operating environment. This tricky range of outlooks comes at a time when credit ratings have become increasingly concentrated in the BBB/Baa rating category (see Figure 9). This creates the potential for significant divergence between individual corporates even within the same sector – an environment where careful company analysis and security selection is likely to prove indispensable for investors seeking to maximize the opportunities that higher yields should bring.

Figure 8: Growth forecasts have trended downwards[11]

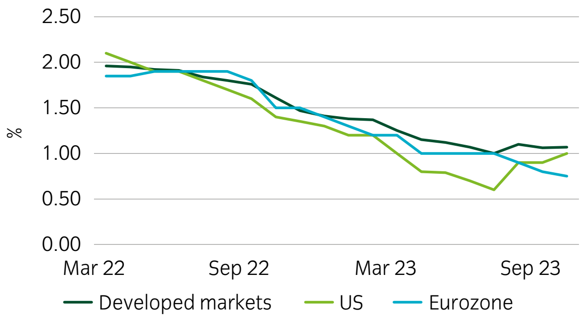
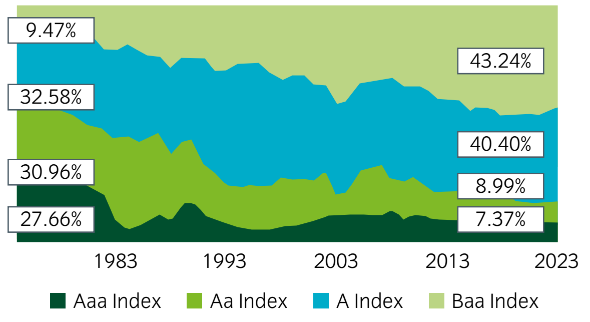


Figure 9: Credit ratings have migrated towards BBB/Baa[12]



> This creates the potential for significant divergence between individual corporates even within the same sector – an environment where careful company analysis and security selection is likely to prove indispensable.

Insurers can take advantage of the higher all-in yields now available in public IG corporate bonds to enhance returns and increase liquidity relative to private IG.

[11] Source: Bloomberg consensus forecasts. Data as of October 31, 2023.
[12] Source: Barclays: US Investment Grade Corporate Update. Published October 2023.

MUNICIPAL BONDS

TIME TO ADD MUNIS TO THE CREDIT MIX

Municipal governments are awash with cash and more resilient to a slow growth environment

In our view, taxable US municipal bonds are an asset class that naturally complement an allocation to US credit, with several attributes that could prove especially advantageous in the current environment.

In aggregate, taxable muni bonds have a higher credit rating relative to US investment grade corporates. The Bloomberg Municipal Bond Index has an average credit rating of Aa2/Aa3 versus an average rating of A3/Baa1 for the Bloomberg US Corporate Investment Grade Index[13]. A key attribute of most munis is a direct link to the revenue streams of underlying infrastructure assets, or the backing of the tax revenue streams of individual states. This makes the credit rating of munis more resilient to changes in credit conditions.

This can be clearly demonstrated when looking at the Moody's Credit Compass score, which aims to capture trends in credit conditions. Slower growth and more difficult financing conditions have seen the backdrop for corporate credit shift to more neutral territory, but credit conditions for munis remain strong (see Figure 10). Most US states set their 2024 financial year budgets very conservatively, with many building in forecasts of a mild recession over the year and committing to only very limited spending increases. With the economic backdrop proving more resilient than expected and given the replenishment of reserves over the last few years (see Figure 11), states should be very well positioned over the years ahead.

Figure 10: Munis are more resilient to current conditions[14]

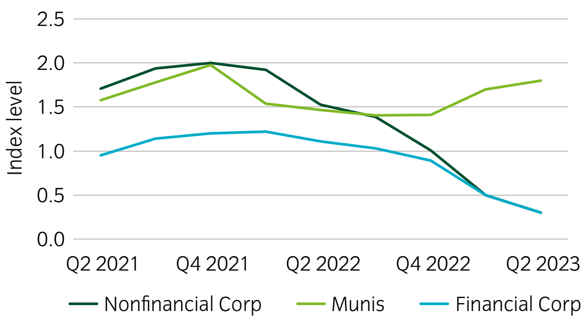
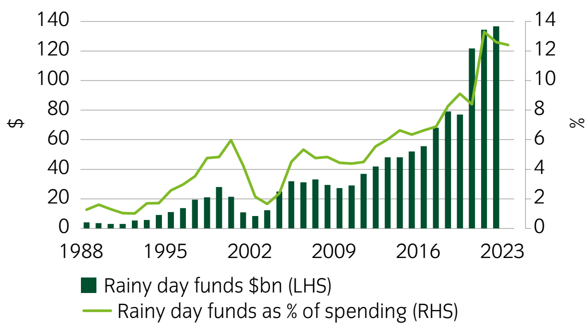


Figure 11: Municipal reserves have surged post-pandemic[15]



> Most US states set their 2024 financial year budgets very conservatively, with many building in forecasts of a mild recession over the year and committing to only very limited spending increases.

[13] Source: Barclays. Data as of October 31, 2023.
[14] Moody's credit conditions compass. Ranges: From -2 to -1 (stressed), -1 to 0 (weak), 0 to +1 (neutral), +1 to +2 (strong).
[15] Source: Urban Institute, BAML; National Association of State Budget Officers (NASBO) Fiscal Survey of States, January 2023.

Default rates and volatility have historically been lower, despite broadly similar credit spreads

From 1970 to 2021, investment grade muni bonds experienced a cumulative default rate of only 0.09% versus 2.17% of IG global corporates within 10 years of issuance. In addition, munis have displayed a lower default rate for any given credit rating (see Figure 12). The ability of muni issuers to honor their debts to bondholders reflects the fact that many of these public corporations are virtual monopolies that deliver services with inelastic demand to the public. Despite these attributes, taxable munis generally trade at a comparable spread (relative to US Treasuries) as to investment grade corporate bonds (see Figure 13) with a similar credit rating, but with historically lower volatility. The 360-day volatility of the spread of the US Bloomberg Taxable Muni Investment Grade Index is 21.7%, significantly lower than the 360-day volatility of the Bloomberg US Corporate Agg at 30.4%[16].

Figure 12: Historical default rates have been far lower for munis over a 50-year period[17]

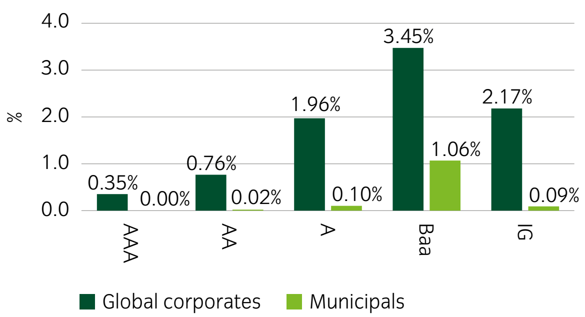
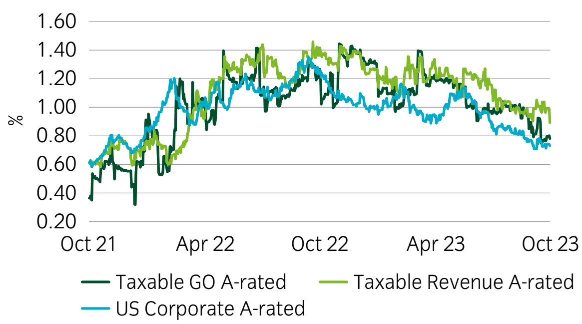


Figure 13: Taxable muni spreads have been correlated with broader credit markets, but with less volatility[18]



> Many of these public corporations are virtual monopolies that deliver services with inelastic demand to the public.

Municipal bonds, both taxable and tax- exempt, can provide diversification from core credit assets as well as the potential for enhanced risk-adjusted returns.

[16] Source: Bloomberg. Data as of August 15, 2023.
[17] Source: Moody's cumulative default rates by rating category, 1970-2021.
[18] Source: Insight and Bloomberg. Data as of October 31, 2023.

HIGH YIELD

THE NEW GROWTH ASSET

High yield now offers income above long-term historical equity returns

As yields in fixed income markets have broadly adjusted upwards, the yields available in high yield credit have reached levels not seen for decades. The yield of the Bloomberg US High Yield Index ended October at close to 9.5% (see Figure 14), well in excess of the 8.3% average 12-month rolling return of the S&P 500 Index over recent decades (see Figure 15). This means that it is now possible to contractually secure returns above the 6% to 8% ranges normally used for long-term annual equity returns.

Figure 14: Yields have moved sharply higher[19]

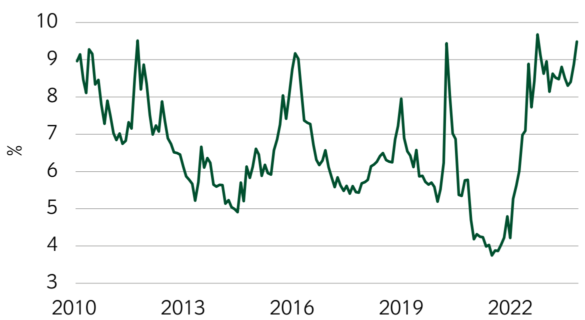
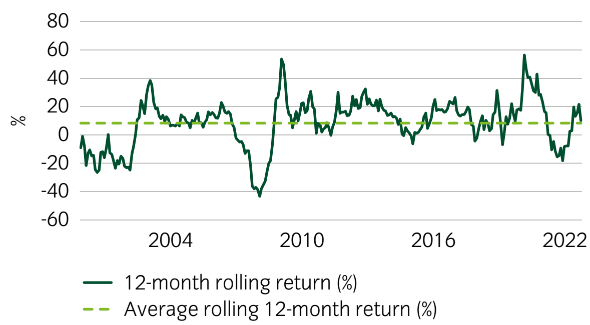


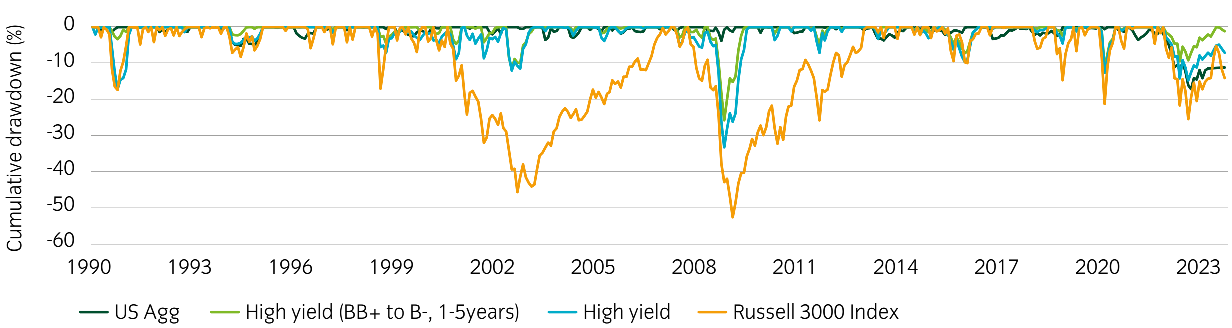
Figure 15: The S&P 500 Index rolling 12-month returns[20]



LOWER DRAWDOWN RISK AND LOWER VOLATILITY

Historically, drawdowns in high yield have tended to be far smaller than in equities (Figure 16). This is partly because high yield bonds are senior to equity in the capital structure and generally have defined maturity structures, resulting in the 'pull-to-par' effect: a maturing bond not in default will return its principal at maturity. Equities have no such guarantee, which can result in valuations remaining depressed for extended periods. High yield has also been far less volatile, with a 9% annualized standard deviation, versus equities at 16%[21].

Figure 16: High yield has historically recovered faster from drawdowns[22]



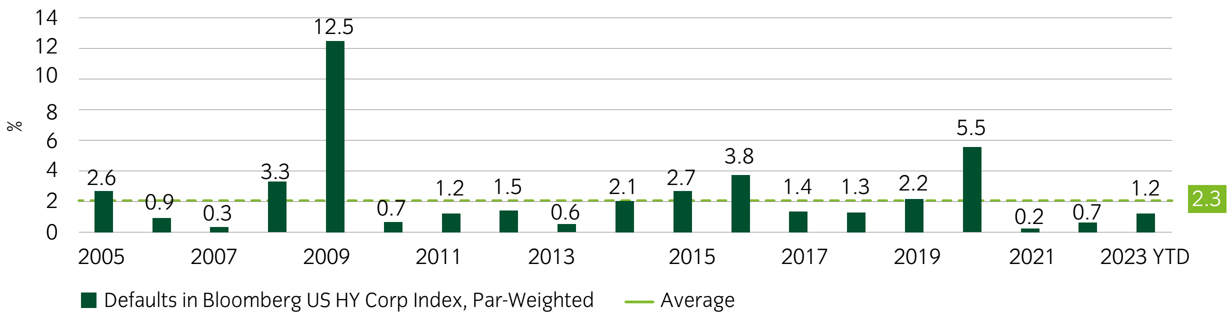
[19] Source: Insight and Bloomberg. Bloomberg US High Yield Index. Data as of October 31, 2023.
[20] Source: Insight and Bloomberg. Data as of October 31, 2023. **Past performance is not indicative of future results.**
[21, 22] Source: Russell 3000 index, Bloomberg US Corporate High Yield Index. Data between 1990 and October 2023.
Past performance is not indicative of future results.

Default rates have been much lower than commonly perceived

Defaults are the main risk for high yield investors, as they threaten permanent losses of capital. However, consensus default predictions consistently exceed realized defaults in high yield indices. Ratings agency default expectations are typically in the range of 3% to 5% pa. But broad high yield index defaults since 2004 have averaged c.2.3% pa on a par-weighted[23] basis (see Figure 17). This is because Moody's and S&P default metrics cover all speculative grade investments for which they provide ratings, but these universes include far more issues than are included in most indices, and so these agencies' default metrics are unrepresentative of most institutional high yield portfolios.

Despite the high level of yields available, we do not see signs of stress in global high yield markets, but we do see strong interest coverage, historically low leverage and other sources of financing competing to refinance high yield companies. This leads us to believe that default rates will rise only gradually from historically low levels, with the level of yields available in the asset class offering compelling value.

Figure 17: High yield defaults in broad high yield indices have been contained[24]



> Despite the high level of yields available, we do not see signs of stress in global high yield markets, but we do see strong interest coverage, historically low leverage and other sources of financing competing to refinance high yield companies.

Insurers seeking higher yields can consider selective exposure to US HY favoring double-B and B-rated bonds over loans.

[23] We believe calculating defaults in par ($100) terms provides the most conservative metric, as bonds may already trade at deep discounts when they default.
[24] Source: Bloomberg, Insight calculations, October 2023.

STRUCTURED CREDIT

HIGH INCOME WITH THE POWERFUL DEFENSE OF PAYMENT WATERFALLS

High cash rates and wide spreads combine to offer an attractive high income

For those investors who do not want to migrate up the risk spectrum, we believe structured credit offers a way to generate attractive levels of income in a defensive way. The floating rate structure of most structured credit issues allows investors to take advantage of higher interest rates in very short maturities without the duration risk implicit in fixed rate bonds. Yields have moved upwards along with short-term rates (see Figure18). Spreads have also widened, even relative to corporate bonds (see Figure 19), which provides the potential for capital appreciation if the risk environment becomes more positive in future.

Figure 18: Yields have moved sharply higher along with short-term interest rates[25]

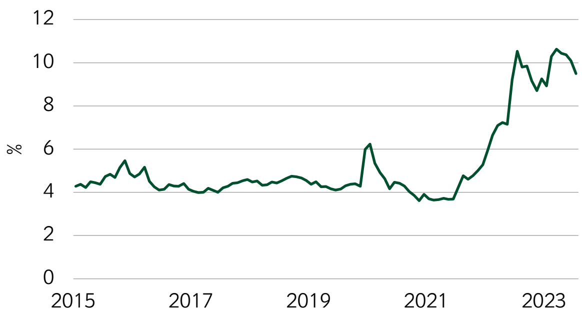
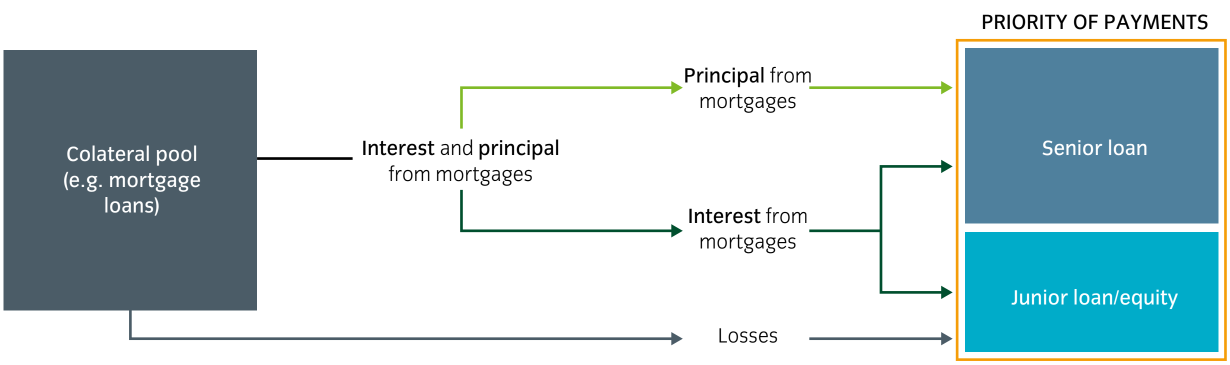


Figure 19: Wide spreads offer the potential for capital appreciation in a positive risk environment[26]

The powerful waterfall structures built into the asset class make it fundamentally defensive.

Within a structured credit structure, there are different classes of bonds issued with different credit ratings. As Figure 20 illustrates, the principal and interest payments from the underlying loan pools are distributed to holders of the highest-rated bonds (senior bondholders) first. Only once these senior bondholders have been paid in full are proceeds distributed to the holders of lower rated bonds (mezzanine or junior).

Figure 20: Higher rated tranches are first in line to receive cashflows[27]



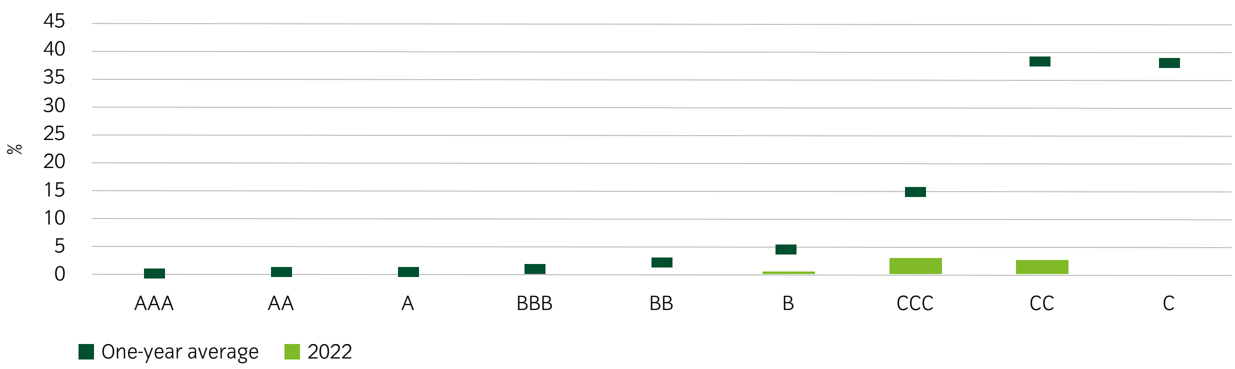
[25] Source: Insight and Bloomberg. Data as of October 31, 2023. **Past performance is not indicative of future results.**
[26] Source: S&P Insight and Bloomberg. Data as of October 31, 2023.
[27] Source: Insight, for illustrative purposes only.

This cascading pattern continues all the way down the capital structure and is known as a 'waterfall' structure. Effectively, the bonds higher up the capital structure have a higher credit quality than the underlying loan pool in aggregate because they will generally still be repaid even if a portion of the underlying loans default. We call this process 'credit enhancement'. However, those at the bottom of capital structure would suffer losses immediately should loans in the pool begin to go bad, hence they are called 'loss absorbing'. This makes the senior tranches of structured credit issuers well placed to withstand a period of economic weakness that may result from the policies implemented by central banks to slow growth and reduce inflationary pressures.

An additional comfort is also the security implicit within the debt – with bond holders holding a claim against the assets on which the debt is secured. Underwriting standards have improved over the years, especially in Europe, and in our view, this leaves the asset class in a strong position to weather even a meaningful downturn.

These factors are the reason that defaults in higher-rated securities are extremely rare (see Figure 21) – the last default in a US asset-backed security that was investment grade rated was in 2010[28]. In our view, this makes the asset class a natural fit for those investors that seek to generate high income with limited drawdown/default risk.

Figure 21: Default rates remain largely confined to the speculative grade level[29]



This makes the senior tranches of structured credit issuers well placed to withstand a period of economic weakness that may result from the policies implemented by central banks to slow growth and reduce inflationary pressures.

From a relative value perspective, structured products screens attractive from both yield and quality metrics and also provides portfolio diversity.

[28, 29] Source: S&P Global Ratings, "2022 Annual Global Structured Finance Default Study and Rating Transitions", March 2023.

CURRENCY

STAY TACTICAL IN 2024

Hard to bet against the dollar

Monetary policy is clearly working, and consensus forecasts for global growth are slowly declining (see Figure 22). Against that backdrop it may be natural to think that the central bank that had tightened the most, and where inflation was moderating most rapidly, would be the first to start the easing cycle. The long-term fixed nature of US mortgages has complicated this picture considerably, with US consumers significantly less interest rate sensitive than those in other major economies. Although global growth is expected to expand only slowly over the next few years, US growth is still expected to meaningfully outpace other developed markets, especially those in Europe (see Figure 23).

Figure 22: Forecasts for global growth in 2024 keep declining[30]

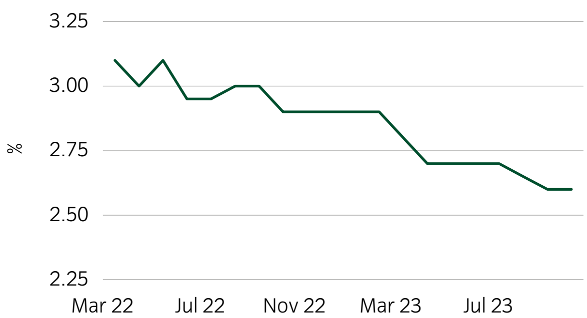
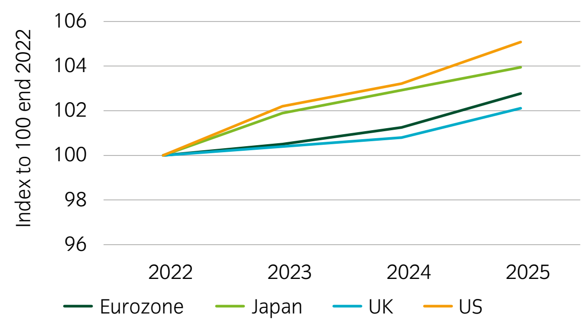


Figure 23: Growth forecasts suggests the US economy will outpace other developed markets[31]



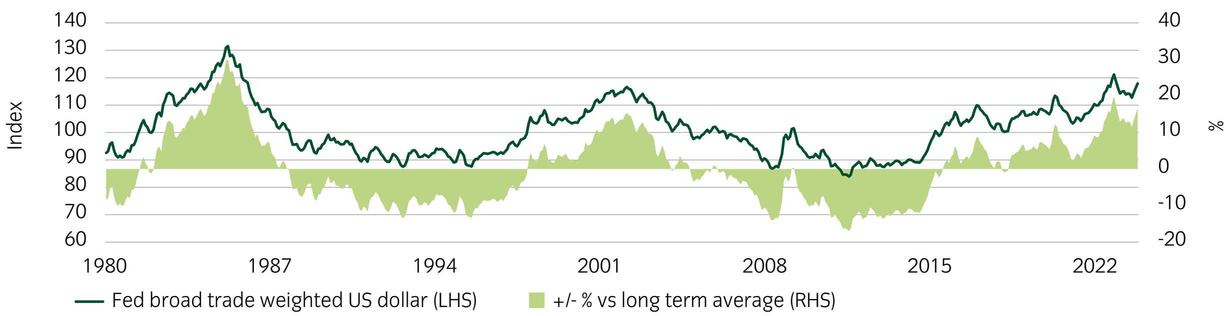
> Although global growth is expected to expand only slowly over the next few years, US growth is still expected to meaningfully outpace other developed markets.

[30, 31] Source: Insight and Bloomberg. Data as of October 31, 2023. Figure 23 shows forecasts for cumulative growth in major economies rebased to 100 at end 2022.

Tricky technicals favor a tactical approach to currency markets in 2024

More rapid growth projections, combined with higher interest rates, make it difficult to bet against the US dollar. However, it's also difficult to ignore the gathering storm clouds. After a bull run that's lasted more than a decade, the US dollar sits close to a historical high on a trade weighted basis (see Figure 24), a valuation from which meaningful further gains should be more difficult. An unsustainable fiscal position creates vulnerabilities, with a fiscal deficit running in excess of 8% of GDP. Central banks in China and Japan have started to push back against the dollar's strength – clearly indicating that further weakness in their currencies would be unwelcome. These headwinds set the scene for a potentially choppy outlook, in which aggressive positions based on macroeconomic fundamentals may be particularly risky. We favor a tactical approach in this environment – acknowledging the powerful dynamics that are underpinning US dollar strength, but conscious of the underlying fragilities that could create sharp pullbacks from extreme valuations.

Figure 24: The US dollar remains very overvalued by historical standards[32]



> These headwinds set the scene for a potentially choppy outlook, in which aggressive positions based on macroeconomic fundamentals may be particularly risky.

Insurers will typically be hedging their assets to the currency of their liabilities, taking minimal currency risk in order to mitigate capital requirements. From time to time there may be the opportunity to target specific currency exposures to add value.

[32] Source: Insight and Bloomberg. Data as of October 31, 2023.

FIND OUT MORE

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