U.S. Insurance

Fundamental or head-fake?: lower interest rates and last week's P&C sell-off

Industry Overview

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Equity
United States
Insurance

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Sell-off in P&C names unlikely fundamental

On November 2 and 3, the S&P 500 was up 3% with banks up 6% as investors contemplated the prospect of the Federal Reserve lowering short-term interest rates. P&C insurance underwriters were down across the board with the most significant decline coming from the "offshore"/reinsurance peers down 6%. We believe this sell-off was mostly positioning-related, based a combination of funding capital being allocated toward previously underperforming other financials and perhaps preparing for the year-end tax loss harvesting of marrying winners with money-losing investments to offset those losses.

Positive EPS revisions continue

The insurance stocks have enjoyed positive EPS revisions since mid-2022 (and earlier) when the Federal Reserve first raised the Fed Funds rate above 2% to short circuit the deleterious impact of inflation. Through the 3Q23 reporting season just past, EPS revisions continued to remain positive among the P&C insurance subgroups. Most notably, the positive EPS revisions were greatest in the "offshore"/reinsurance, which also experienced the most significant correction against the backdrop of last week's rally.

Overall P/E valuations appear largely unchanged

While P&C insurance stocks have appreciated and outperformed over the past 15 months (or longer), this has been largely a function of rising earnings estimates as opposed to P/E multiple expansion. As such, the valuations are not more stretched than they were before the Fed began aggressively raising interest rates. In most cases, the P/E valuations seem modestly lower than they were 15 months ago on both an absolute and relative basis.

Interest income should continue to compound higher

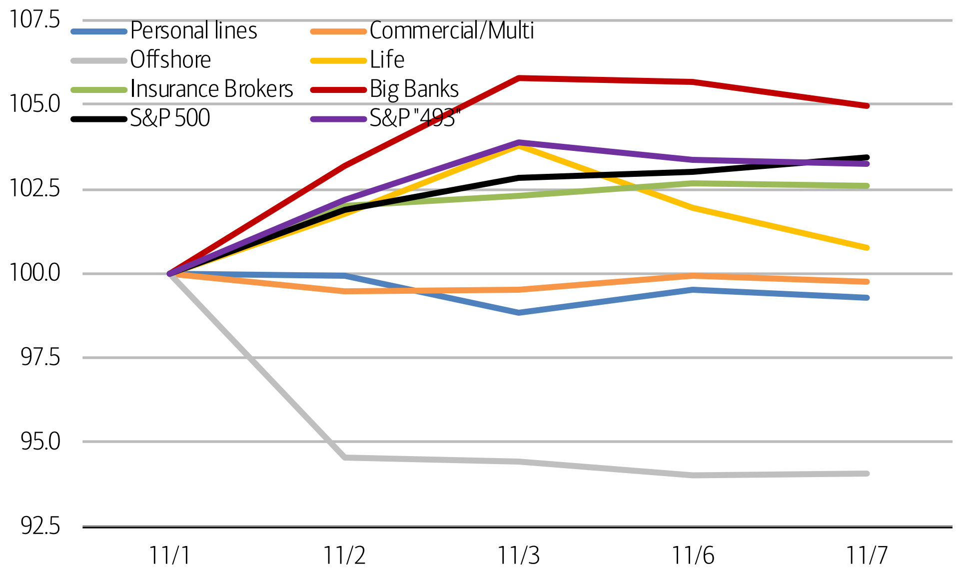
There are a number of P&C underwriters in our coverage universe who are still earning a materially lower yield than what could be earned with new money in "near risk-free" U.S. Treasuries with similar term structures. Even in a modestly lower interest rate environment, these companies would likely continue see escalating investment returns. This is most evident for Arch Capital and Progressive, but is also largely the case for AXIS, Everest, RenaissanceRe and W.R. Berkley. Were the Federal Reserve to materially lower short-term yields, the earnings impact might most quickly appear among insurance brokers who have been making an atypically high return on the fiduciary assets they hold for about a month, which are currently enjoying around a 5% yield.

Timestamp: 07 November 2023 04:51PM EST

Over the past four trading sessions, the S&P 500 is up 3.3%, principally driven by a two-day rally on November 2nd and 3rd, responding to comments from the Federal Reserve that were interpreted to suggest the current period of high short-term interest rates may be coming to an end and that rate cuts could become a possibility in the not-too-distant future. 10-year Treasury yields, which had been ranging at a 15-year high between 4.8% and 4.9% in the back half of November, have fallen 19bps over the past four trading sessions from 4.77% to 4.58%. The prospect for the currently inverted yield curve to moderate and eventually steepen was greeted warmly by financial services stocks with the S&P 500 Financials (the XLF ETF) up 3.4% and the Bank Index (the BKX) up 6.6% over the past four trading sessions. However, amidst this newfound enthusiasm for financials, P&C insurance underwriters have notably underperformed with multi-line/commercial carriers down very slightly over those same four trading sessions, personal lines carriers flattish and offshore insurers notably exposed to reinsurance markets down 5% (!). It is worth enquiring whether the trading action of the past four days contains anything fundamental to the outlook for these names.

Exhibit 1: Performance of the broad market and financials subgroups over the past four trading sessions

Over the past four trading days, the broad market has seen a sharp bid with banks notably advancing while insurance stocks have underperformed.



Source: Bloomberg

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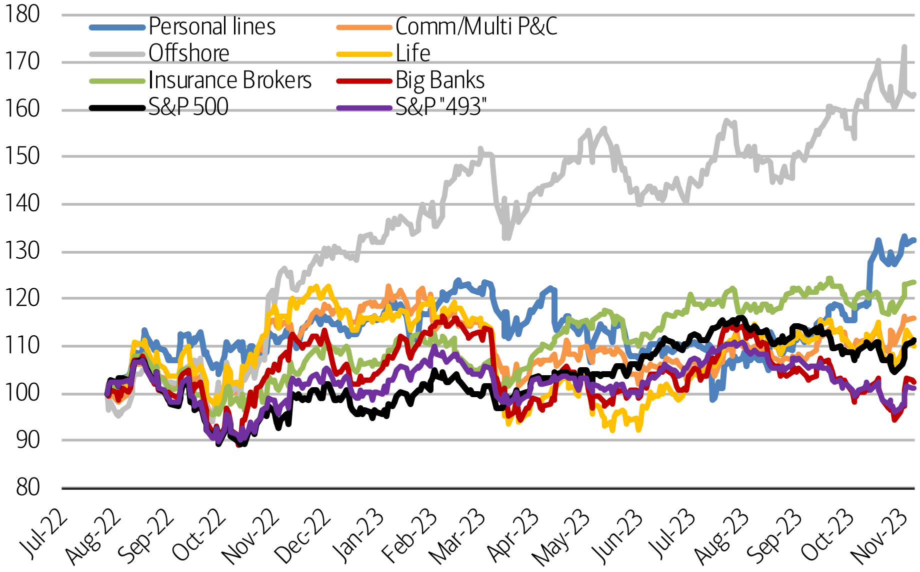
It is first worthwhile to point out nothing happens in a vacuum. Since July 27, 2002 (the day before the Fed Funds rate exceeded the rule-of-thumb 2% goal for targeted annual inflation) through November 1, 2023, insurance has generally outperformed the markets and financials broadly. Over that 15-month timeframe, the S&P 500 was up 7%; however, much of its performance could be explained by the performance of seven very large technology companies we have referred to as the “Magnificent 7” (Apple, Alphabet, Amazon, Meta, Microsoft, NVIDIA and Tesla). Excluding their contribution, the S&P “493” was down 2% during this same timeframe. S&P 500 Financials were up just 1% during the 15-month stretch, dragged down by banks (including the failures of First Republic, Silicon Valley Bank and Silvergate) with the BKX Bank index down 28% over that time.

Exhibit 2: Performance of the broad market and financials subgroups since Fed Funds rate exceeded 2%

The recent financials subgroup performance has seemed to reverse performance trends that have been playing out over the prior 15 months.



Source: Bloomberg

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Over those 15 months, however, insurers have largely outperformed. Personal lines insurers (a market-capitalization-weighted index of Allstate and Progressive) were up 33%. Commercial/multi-line insurers (a market-capitalization-weighted index of Chubb, Hartford, Travelers and W.R. Berkley) were up 16%. Insurance brokers (a market-capitalization-weighted index of A.J. Gallagher, Aon, Brown & Brown, MarshMac and WTW) were up 21%. Life insurers (a market-capitalization-weighted index of Aflac, Globe Life, Lincoln, MetLife, Principal and Prudential) were up 9%; however this was significantly a function of the outperformance of Aflac, excluding which, the group's performance was otherwise flat. Most notable was the "offshore" group (a market-capitalization-weighted index of Arch, AXIS, Everest and RenaissanceRe), a collection of companies domiciled in Bermuda with notable exposure to reinsurance markets. This group was up 73% over those 15 months, with on particularly boost stemming from Arch Capital being added to the S&P 500 on November 1, 2022.

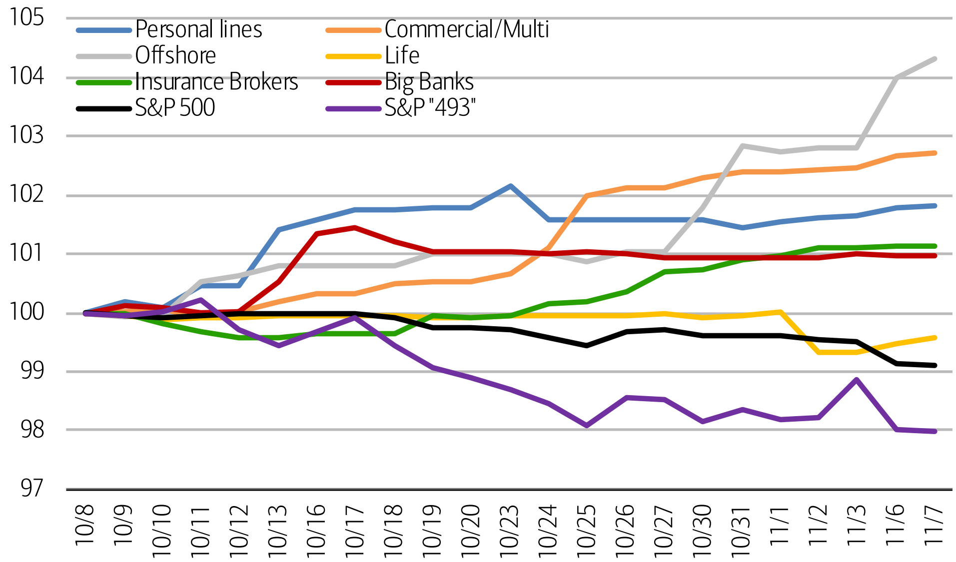
Broadly speaking, we would suggest that the November 2nd and 3rd market action including a sell-off in insurance companies contained a number of related features:

- A migration of money into banks stocks, which would presumably benefit from a yield curve with low short-term yields and higher longer-term yields.
- A rotation out of one balance sheet-intensive financials sector—P&C insurance underwriters—into another—banks.
- A selling of market "winners" to fund the purchase of erstwhile market "losers." This may be occurring in concert with year-end tax efficiency strategies to marry capital gains with losses.

The winningest financials subsector in terms of stock performance has arguably been the "offshore"/reinsurance market, so it may not be so surprising that this group has been most negatively impacted by the reversal of trading positions over the past week. Additionally, RenaissanceRe reported 3Q23 earnings on November 1st after the market closed. The market reaction may have been one of disappointment as the company seemed to miss on revenues (though it probably is worth also mentioning that consensus 2024 EPS forecasts for RenaissanceRe have increased by 3.3% since reporting 3Q23 results).

Exhibit 3: Consensus 2024 EPS revisions during the 3Q23 earnings season

Despite underperformance over the past few days, consensus EPS revisions for the insurance subgroups have been generally positive during the 3Q23 earnings results season.



Source: Bloomberg

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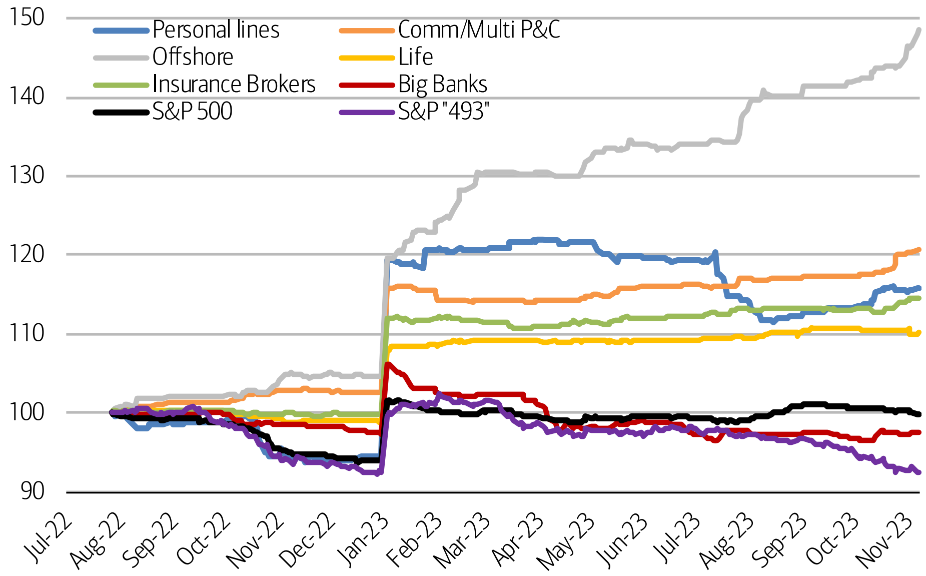
This brings us to one of the essential contradictions in the recent market action that suggests to us it is not fundamental in nature: consensus EPS revisions do not suggest any disappointment in 3Q23 P&C underwriting results. The opposite is true, positive P&C earnings revisions in concert with the 3Q23 earnings results argue for increasing optimism. Across the 3Q23 reporting season, the “offshore” group say 4.3% upwards earnings revisions in the 2024 EPS forecasts. The commercial/multi-line P&C growth saw 2.7% positive earnings revisions. Personal lines enjoyed 1.8% upwards EPS revisions. Insurance brokers’ EPS were revised upwards by 1.1%. While big banks saw their EPS revisions upward revised by 1% in aggregate, 3Q23 results were a mixed bag, with upward revisions and Wells Fargo and mega-cap J.P Morgan offsetting negative revisions for some other banks. Life stocks saw their EPS forecasts modestly downward revised, and the S&P 500 (and more particularly the S&P “493”) saw EPS revisions downward in the range of 1-2%.

This echoes EPS revision trends consistent with the past 15 months: “offshore” group up materially. “Onshore” P&C underwriters (both personal and commercial) followed by brokers all with positive EPS revisions, albeit less significant than the “offshore” group. And then more middling trends for banks and the broad market.

Exhibit 4: Consensus year-ahead EPS revisions since the Fed Funds rate began to exceed 2%

The positive EPS revisions during 3Q23 results for the insurance subgroups tend to echo what have been the trends relative to the market broadly and banks over the past 15 months.



Source: Bloomber

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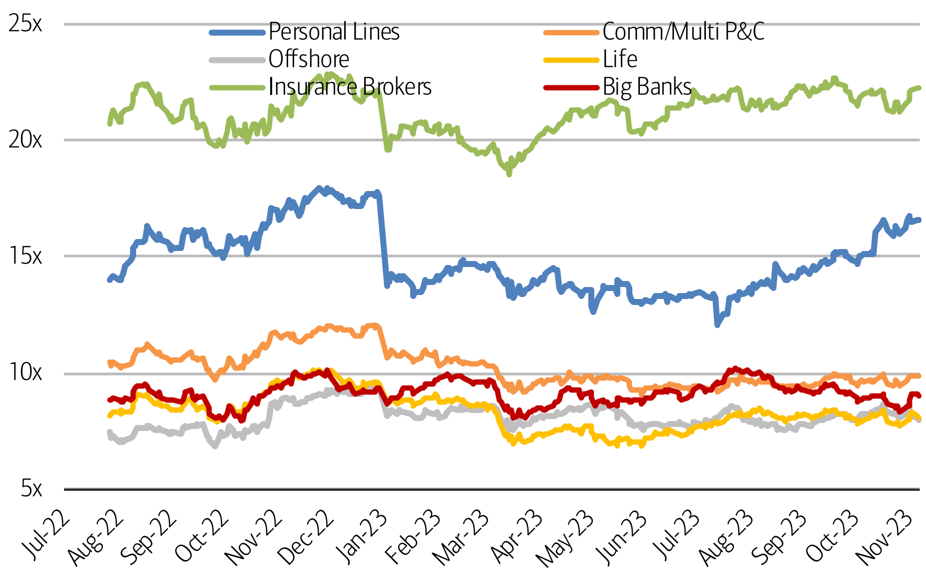
Further, it is worth noting that the valuations for any of these subgroups haven't materially changed. It is hard to argue that insurance companies have gotten materially more expensive or that bank stocks have gotten materially cheaper. The P/E multiples on consensus year-ahead earnings are not so much changed over the past 15 months.

Exhibit 5: Consensus year-ahead P/E multiples for insurance subgroups and banks

It does not seem abundantly clear that, despite outperformance, insurance stock valuations are notably more expensive than they were 15 months ago.



Source: Bloomberg

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It might be more appropriate to look at these stocks as a P/E multiple relative to the S&P "493" (adjusting out the skew provided by the "Magnificent 7"). Commercial/multi-line P&C names are currently trading at 9.9x 2024 EPS or at about 61% of the multiple of the S&P "493" (which currently trade at about 16.2x 2024 consensus earnings). In late July 2022, those same numbers were 10.5x consensus 2023 EPS and 69% of the

S&P "493" P/E multiple. The mildly contracting valuations hold true for all members of this peer group (Chubb, Hartford, Travelers and W.R. Berkley). Similarly, the offshore names are currently trading at 8.1x 2024 EPS or at about 50% of the multiple of the S&P "493." In late July 2022, those same numbers were 7.4x consensus 2023 EPS and 49% of the S&P "493" P/E multiple. However, AXIS, Everest and RenaissanceRe have all suffered multiple contraction. This has been notably offset by multiple expansion from Arch Capital. The P/E multiple for the personal lines companies (Progressive and Allstate, though leaning more into Progressive's valuation, given its notably higher market cap) has been more volatile over the past 15 months, peaking at a 13% premium to the S&P "493" stocks in early October 2022 but also trading at a 27% discount on July 13, 2022. It currently stands at about 103% of the S&P "493." The big banks valuations are largely unchanged, currently 9.0x year-ahead earnings (56% of the S&P "493"), which is essentially where they were in July.

It is our view that there is nothing inherently fundamental in the performance of the stocks over the past four trading days. We would see these sell-offs as opportunities to acquire the stocks at discounts to where they trading a week earlier. There are some who might argue that lower interest rates will be a headwind for insurers who have been beating consensus results in part due to investment income above expectations. This has also been contributing to the positive EPS revisions. To this argument, we would make two observations.

- Currently, the fuel for this rally is the anticipation of lower interest rates; however, at this point they are still merely a theory. Further, the Fed could lower short-term rates while longer-term interest rates remain in the 4-5% range. This would be wonderful for commercial lending economics (benefitting banks), but it would not necessarily impact insurers in any negative way.

- Even if interest rates were to decline in the 3-to-10 year term structure, a number of company's we cover and recommend are still earning so far below their new money yields, that a 50-100bps decline in the new money yield would not slow the growth of their investment income.

The P&C peer group tends to cultivate investment portfolios, depending on the company with fixed income maturity average durations in the sub-3-year up to about a 5-year range. We recently published a short note entitled, "U.S. Insurance: All investment portfolios are not created equal: Arch and Progressive shine in 3Q23" on October 31 that is worth revisiting. Arch and Progressive are not alone in having constructed an investment portfolio that will continue to increase its yield in an outsized way for a while (others include AXIS, Everest Re, RenaissanceRe and W.R. Berkley), but we will stick with these two as they are the clearest examples.

Right now, these companies have approximately 3-year average durations on their fixed income portfolios. 3-Year Treasury yields currently trade at about 4.6-4.7% yields. Presumably, if one were willing to take some modest credit risk, it would be possible to find bonds that fit that duration profile with 5-6% yields. In the event that interest rates were to spontaneously phase shift down 100bps, those same bonds would likely yield just 4-5%. A few thoughts:

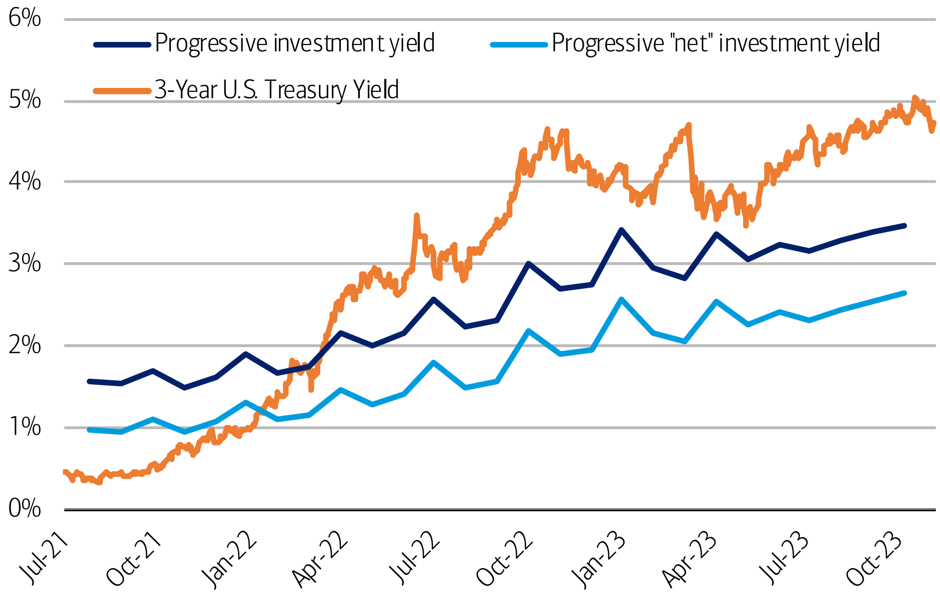
- A 4-5% investment yield is still materially above where these companies' portfolios are yielding today.

- We have been conservative in our forecasts for Arch's and Progressive's investment yield potential will terminal investment yield projected in the 4.0-4.5% range in 2025. Even in a 4-5% investing environment, we believe there could be risk that our forecasts for investment income might be too low.

- These companies do not need to remain at sub-3-year investment portfolio durations. If the economics make sense to pivot to a longer-term structure, these companies can make that pivot.

It may be useful to visualize the gap between current investment yield and the current market opportunity for investing.

Exhibit 6: Progressive investment portfolio yield vs. 3-Year U.S. Treasuries
Despite material growth in Progressive's investment income, its portfolio yield still represents a wide gap between current yield and what the "near risk-free" return of U.S. Treasury securities provide with the same term structure.



Source: Company filings and Bloomberg

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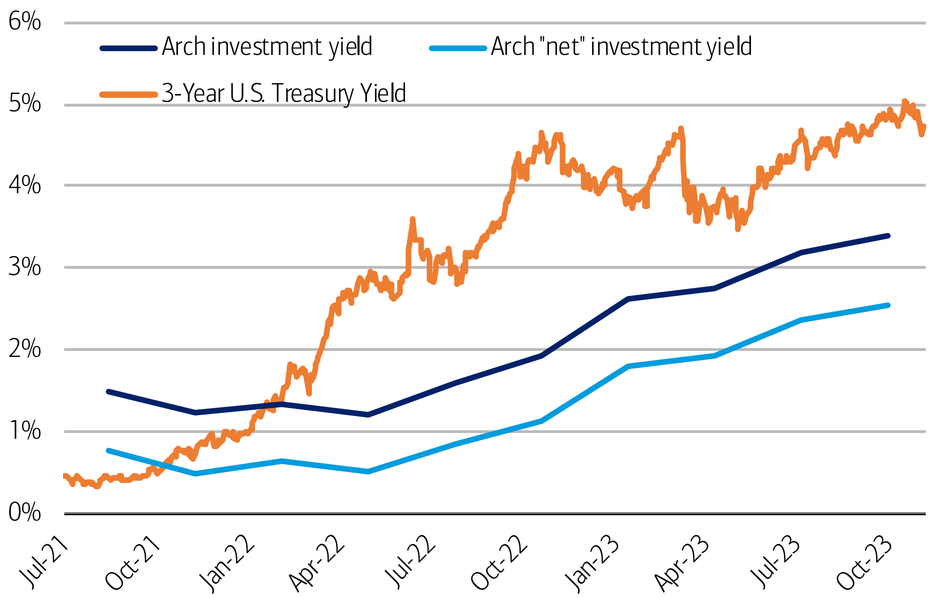
Exhibit 7: Arch Capital investment portfolio yield vs. 3-Year U.S. Treasuries
Despite material growth in Arch's investment income, its portfolio yield still represents a wide gap between current yield and what the "near risk-free" return of U.S. Treasury securities provide with the same term structure.



Source: Company filings and Bloomberg

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Likely the greatest risk on lower investment income comes among insurance brokers, which are currently earning once-in-a-generation yields on short-term fiduciary income, These companies hold the money for premiums and claims between carriers and customers for a month, which is currently yielding 5% and essentially all of those earnings fall to the bottom line. Lately, this fiduciary income has been providing margin support for operating income, which otherwise might be contracting without it.

Stocks mentioned

Prices and ratings for stocks mentioned in this report

BofA Ticker	Bloomberg ticker	Company name	Price	Rating
ACGL	ACGL US	Arch Capital	US$ 85.41	B-1-9
AXS	AXS US	Axis Capital	US$ 54.91	B-1-7
EG	EG US	Everest Group LTD	US$ 383.99	B-1-7
PGR	PGR US	Progressive Corp	US$ 158.61	B-1-7
RNR	RNR US	RenaissanceRe	US$ 207.36	B-1-7
WRB	WRB US	W.R. Berkley	US$ 68.30	B-1-7

Price objective basis & risk

Arch Capital (ACGL)

Our price objective is $94 is based on 110% of the large-cap P&C peer year-ahead P/E multiple (10.1x) on our 2024 EPS forecast. While there is no impact from a Bermudian income tax in 2024, we are also reducing the multiple by the impact we expect such a tax to have in 2025. This is a premium to the historical trading range (90% of the peer group P/E) given Arch's above-average growth, margin outlook and tactical capital management strategy.

Downside risks are depression-like scenarios leading to a collapse in homeownership rates, however, Arch does have $3 billion of collateralized reinsurance protection, partly mitigating this material risk. While Arch had been generally under-exposed to natural catastrophe losses in recent years, the company has been recently increasing its exposure to such events as the price of underwriting that risk has been increasing.

Axis Capital (AXS)

Our price objective of $70 represents a 25% discount to the P/E multiple of the U.S. P&C insurance peer group (10.4x). This steeper-than-peer discount we believe to warranted in a period of management and strategy transition. Still, despite the sizable discount there is still material upside to our price. We believe the company's investment portfolio is particularly well-positioned for the inverted yield curve environment. Additionally, we believe fears of a 4Q23 reserve charge may be weighing on the stock, and we might expect a re-rating as we get past 2023 numbers.

Upside risks are an acquisition of AXIS at a premium valuation, lower-than-expected catastrophe losses, and favorable prior-year reserve development.
Downside risks are higher-than-expected catastrophe losses, reserve charges, and further elevation in casualty loss cost trends. The reserve charge risk is likely the greatest focus of skeptical investors today.

Everest Group LTD (EG)

Our price objective of $484 is based on 80% of the year-ahead multiple for large cap property and casualty (P&C) peers (10x). The 20% discount is based on a reversion to the relative multiple where RE has traded in the past, which we also find likely/appropriate given the greater earnings volatility associated with the reinsurance subsector. While there is no impact from a Bermudian income tax in 2024, we are also reducing the multiple by the impact we expect such a tax to have in 2025.

Downside risks are pressure from lower interest rates causing a decline in earnings power and potentially leading the company to miss our EPS expectations, volatility associated with catastrophes also creates the risk of missing or exceeding our EPS outlook, and lawmakers enacting what the industry sees as a retrospective change in coverage to insurance contracts, enfranchising virus-triggered business interruption.

Progressive (PGR)
Our $199 price objective is based on the current S&P 500 P/E multiple for 2025 of 16.1x on our 2025E EPS forecast. Due to quickly accelerating EPS ahead of the market growth rate, as seen in 2016-2019, we believe Progressive shares should trade at a premium to market as its earnings accelerate. However, given a multiple valuation two years out, we only assume parity due to the necessarily decreased certainty in an out-year forecast.

Downside risks to our PO are 1) presented by the pressure from lower interest rates, causing a decline in earnings power and potentially leading the company to miss our EPS expectations, 2) the volatility associated with catastrophes, which also creates the risk of missing and exceeding our EPS outlook, 3) the impact of material pricing changes by major competitors, 4) the long-term impact of emergent technologies, such as ride-sharing applications and autonomously driven automobiles.

RenaissanceRe (RNR)
Our $287 PO is based on 80% of the large cap P&C year-ahead P/E multiple (10.4x) on our 2024E EPS forecast. While there is no impact from a Bermudian income tax in 2024, we are also reducing the multiple by the impact we expect such a tax to have in 2025. We believe that RenaissanceRe, because it is uniquely constrained to reinsurance markets, may be disadvantaged from a valuation standpoint. Once it traded at a premium, but currently reinsurance is viewed as a derivative market with less upside in an improving market for P&C underwriting margins.

Downside risk is presented by the pressure from lower interest rates causing a decline in earnings power and potentially leading the company to miss our EPS expectations. The volatility associated with catastrophes also creates the risk of missing or exceeding our EPS outlook.

W.R. Berkley (WRB)
Considering our 2024E EPS estimate, we arrive at a price objective of $85, valued at 140% of the large-cap P&C peers' P/E multiple of 10x. Berkley has traditionally enjoyed a sizable premium to peer multiple valuation likely due to its long-term compounding of equity in excess of other best-in-class peers. As the premium valuation has dissipated to be being arguably negligible, this gives investors an opportunity to own a premium franchise at no premium. We would expect the stock can re-rate upward from here. That said, book value growth has been material dependent on realized investment gains during an equity bull market, which could persist as long as the bull market lasts, but also presents a risk, should those conditions change.

Upside risk comes from recent price gains manifesting themselves as widening underwriting margins in excess of our expectations. Downside risk presented by the pressure from lower interest rates causing a decline in earnings power and potentially leading the company to miss our EPS expectations. The volatility associated with catastrophes also created the risk of missing and exceeding our EPS outlook. Additionally, the state of Berkley's loss reserves, be they deficient or redundant, creates a bi-direction risk for the stock.

Analyst Certification

I, Joshua Shanker, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or view expressed in this research report.

US - Insurance Coverage Cluster

Investment rating	Company	BofA Ticker	Bloomberg symbol	Analyst
BUY				
	Aflac	AFL	AFL US	Joshua Shanker
	Allstate Corp.	ALL	ALL US	Joshua Shanker
	American International Group	AIG	AIG US	Joshua Shanker
	Arch Capital	ACGL	ACGL US	Joshua Shanker
	Assurant	AIZ	AIZ US	Grace Carter, CFA
	Axis Capital	AXS	AXS US	Joshua Shanker
	BRP Group, Inc.	BRP	BRP US	Joshua Shanker
	Cincinnati Financial Corporation	CINF	CINF US	Grace Carter, CFA
	Corebridge Financial	CRBG	CRBG US	Joshua Shanker
	Everest Group LTD	EG	EG US	Joshua Shanker
	Intact Financial	YIFC	IFC CN	Grace Carter, CFA
	Intact Financial	IFCZF	IFCZF US	Grace Carter, CFA
	MetLife	MET	MET US	Joshua Shanker
	Progressive	PGR	PGR US	Joshua Shanker
	RenaissanceRe	RNR	RNR US	Joshua Shanker
	The Hartford	HIG	HIG US	Joshua Shanker
	Voya	VOYA	VOYA US	Joshua Shanker
	W.R. Berkley	WRB	WRB US	Joshua Shanker
NEUTRAL				
	Aon	AON	AON US	Joshua Shanker
	CNA Financial	CNA	CNA US	Joshua Shanker
	Lincoln National	LNC	LNC US	Joshua Shanker
	Marsh McLennan	MMC	MMC US	Joshua Shanker
	Principal Financial Group	PFG	PFG US	Joshua Shanker
	Prudential Financial	PRU	PRU US	Joshua Shanker
	The Hanover	THG	THG US	Grace Carter, CFA
	Trupanion	TRUP	TRUP US	Joshua Shanker
	Unum	UNM	UNM US	Joshua Shanker
UNDERPERFORM				
	Arthur J. Gallagher & Co.	AJG	AJG US	Joshua Shanker
	Chubb Ltd	CB	CB US	Joshua Shanker
	Goosehead Insurance Inc.	GSHD	GSHD US	Joshua Shanker
	Selective	SIGI	SIGI US	Grace Carter, CFA
	Travelers Cos	TRV	TRV US	Joshua Shanker
	Willis Towers Watson	WTW	WTW US	Joshua Shanker

Disclosures

Important Disclosures

Equity Investment Rating Distribution: Financial Services Group (as of 30 Sep 2023)

Coverage Universe	Count	Percent	Inv. Banking Relationships [R1]	Count	Percent
Buy	156	53.24%	Buy	94	60.26%
Hold	79	26.96%	Hold	52	65.82%
Sell	58	19.80%	Sell	32	55.17%

Equity Investment Rating Distribution: Global Group (as of 30 Sep 2023)

Coverage Universe	Count	Percent	Inv. Banking Relationships [R1]	Count	Percent
Buy	1869	53.48%	Buy	1046	55.97%
Hold	828	23.69%	Hold	461	55.68%
Sell	798	22.83%	Sell	370	46.37%

[R1] Issuers that were investment banking clients of BofA Securities or one of its affiliates within the past 12 months. For purposes of this Investment Rating Distribution, the coverage universe includes only stocks. A stock rated Neutral is included as a Hold, and a stock rated Underperform is included as a Sell.

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Investment rating	Total return expectation (within 12-month period of date of initial rating)	Ratings dispersion guidelines for coverage cluster[R2]
Buy	≥ 10%	≤ 70%
Neutral	≥ 0%	≤ 30%
Underperform	N/A	≥ 20%

[R2]Ratings dispersions may vary from time to time where BofA Global Research believes it better reflects the investment prospects of stocks in a Coverage Cluster.

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