Investment White Paper

Life after Covid: the LDI view

Released by Generali Insurance Asset Management S.p.A. Società di gestione del risparmio

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Report completed on 10 July 2020.

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Summary – Life after Covid: the LDI view

THE ECONOMY: SUDDEN STOP, PERMANENT SCARS

- The economic and social costs of the Global Covid Crisis (GCC) will dwarf those of the Great Financial Crisis (GFC). Forget the V-shaped recovery; prepare for a "**swoosh**". The key risk is "W".
- Longer term, deglobalisation, tighter regulation & state intervention will weigh on **potential growth**.
- Despite unabated money printing, inflation will be **dormant** over the foreseeable future. The longer-term call is less certain, but digitalization and automation should offset the effects of deglobalisation.
- **Asset prices** will benefit, e.g. bonds and real estate. Even elevated equity risk premia may still be compatible with structurally higher price/earnings ratios.

NEW BEHAVIOURS

- We screen behaviours through 4 dimensions (DARE): Digitalisation, Activism, Repression and ESG.
- Four trends: 1/ *Less* **globalisation**. 2/ *More* financial **repression**, e.g. QE for longer; and higher taxes for the rich & Corporates? 3/ *More* **interventionism**. 4/ *Lower* **financial returns** in the future.
- Investors will chase asset, geographic & factor **diversification**, **Alpha**, new **Growth** (MedTech, CleanTech, data protection, FinTech...), and **real assets** (long-term inflation uncertainty). Stretched valuation and liquidity mismatches demand a greater focus on **liquidity and risk management**.
- AM: Sustainability becomes more **Social**; Real Asset & Credit **expertise** matters more; **Protection** needs suit insurers; hybrid **human & digital** service prevails but big players win **digitalisation** race.

COVID AN ACCELERATOR OF EUROPEAN INTEGRATION?

- We see **€ sovereign ratings** mostly on hold in 2020; longer-term challenge is daunting, but ECB backstop & temporary risk-sharing imply a shallower downturn in sovereign ratings than post GFC.
- The ECB stands ready to break **more taboos** (e.g. capital key buying) if baseline scenario of post-lockdown recovery does not materialize. The **future is fiscal**, but requires the **ECB backstop**.
- We see the (upcoming) Recovery Fund as a **baby step towards a common fiscal policy**; a powerful and permanent joint response is far-distant. ECB support is invaluable but growth-enhancing reforms and measured consolidation will be key to put debt-ratios on a downward path.

CORPORATE RATING MIGRATION & DEFAULTS: THIS TIME IS DIFFERENT

- We expect the **peak in corporate defaults at 6%** in this GCC cycle, lower than GFC (c.10%). But record leverage and weak growth will imply **higher defaults for longer and lower recovery rates**.
- **Credit rating migration** is underway; downgrades from A to BBB will outweigh record volumes of Fallen Angels. Circa 55% of the BBB- names are on negative outlook or CWN… the **HY index is about to get much bigger**, with Banks, Autos and Industrials dominating Fallen Angel volumes.
- Rating migration, spread moves, ALM/currency mismatches etc. are costly under **SII**. Careful management has helped GIAM keep default and migration risk well below market averages.

INSURANCE SECTOR: THE DAY AFTER

- **Covid hurts Life** more than P&C. Risk aversion penalizes unit-linked products; guarantees (in demand) will have to be wrapped in an innovative way to be sustainable for insurers.
- **Fall in SII** ratios implies greater focus on capital saving. Regulators will gradually tighten stance on IR mismatch & transitional measure. **Shareholders to be penalized** at the expense of Policyholders.
- **Opportunities**: Social policies (and ESG), green & digital revolution, M&A, run-off specialisation, new Protection (Accessible healthcare, mix annuity/medical care, Insurtech, Fraud & Cyber risk etc.).
- **LDI trends**: 'Lower for longer' rates and dividends reinforce the appeal of Credit, Private Markets & Distressed. More hedging, despite the costs. Preference for 'low volatility' and 'quality' factors, lower duration gap, and less capital-intensive products.

01

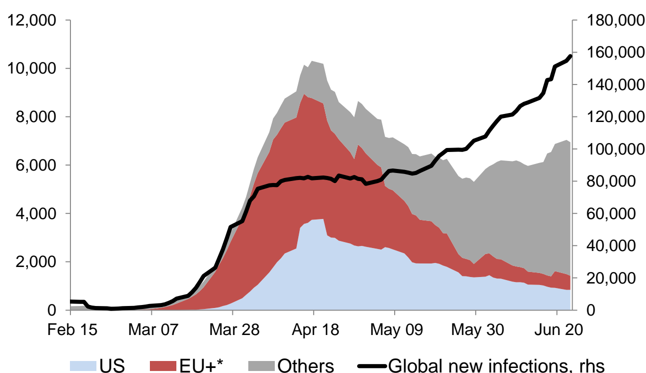
Sudden stop, permanent scars

The fast spreading of the new Coronavirus disease (Covid-19) has become the biggest global challenge in decades, with more than 10 million (recorded) infections and a death toll exceeding 500k by mid-2020. Transmission by asymptomatic people is still debated, but may be a factor facilitating unconscious spreading, and making containment difficult.

The persistence of the contagion is striking. The pandemic likely started in the autumn 2019, and was still vivid by mid-2020, especially in the US and EM countries. Arguably, the dynamic picture of official recording is distorted as reporting and testing respectively improved and increased through the crisis. We argue that [reported deaths may be a more reliable indicator], if a lagging one. This number has been rising, too, but less dynamically. The biggest risk would be a second wave of infections in the autumn. Better behavioural and medical preparation (including potentially new medicine) would make the onset of a second wave less acute, but would still require restrictions and local shutdowns.

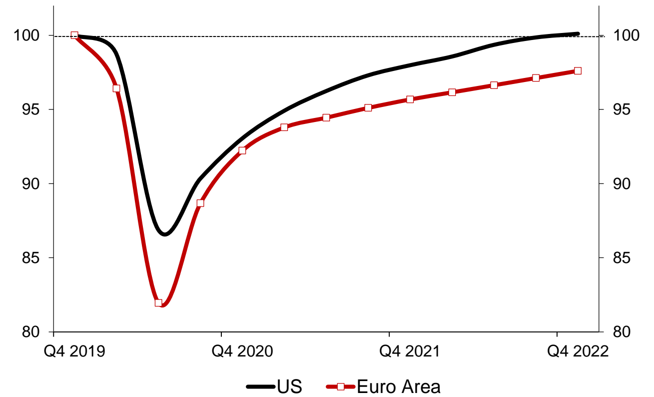
As we go to press by mid-2020, the drastic responses by governments have already incurred immense economic and social costs, dwarfing those of the Great Financial Crisis (GFC). Many advanced economies will see activity in Q2 15% or more below pre-crisis levels. Meanwhile, many governments have started to ease restrictions. Yet hopes that the collapse in activity would be followed by a V-shaped recovery, with GDP quickly returning to the pre-crisis level, seem headed for disappointment. More realistically, we will likely see a 'swoosh' way out of the crisis (see chart). The initial rebound will be strong, but in a moderately optimistic scenario it will take many quarters before the sharp losses in activity can be fully recouped.

Confirmed new Covid-19 deaths and infections



EU+ as EU, UK, Norway, Switzerland; 5-day averages; Source: Refinitiv Datastream. GIAM

A 'swoosh' recovery



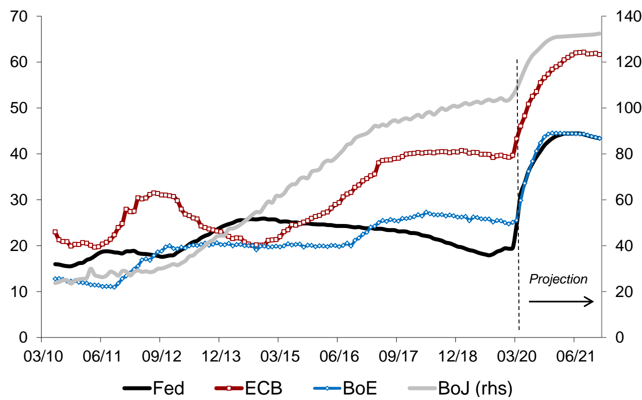
Real GDP Q4 2019 = 100; Source: Eurostat and Bureau of Economic Analysis until Q1 2020, GIAM forecasts as of June 20th 2020

First, many sectors will remain hampered. Tourism, hospitality and mass events will re-main disrupted as social distancing will be maintained until an effective vaccine is rolled out or a treatment is available.

Second, local resurgence of the virus may be the norm rather than the exception. This has become evident from places such as Singapore, South Korea and China, which had been praised for their effective handling of the crisis in its early stages. Social distancing and masks will help to slow the spreading while new tools (incl. tracing apps) may help to identify local clusters more quickly. But colder weather and social gathering in closed rooms in the autumn still carry the risk of a larger second wave of infections. With the virus spreading fast in the US and many EMs, the risk of reimporting cases is also high for countries that have done a better job taming the pandemic.

Third, necessary structural shifts may be delayed. Policy makers have done a great deal to avoid a sharp rise in bankruptcies via huge liquidity injections and guarantees. Yet **policy support is temporary**, and the persistence of the virus keeps many businesses – especially in services – undermined for longer. Airlines, hotels and event locations will see capacities curtailed for much longer.

Central bank balance sheets ballooning



in % of GDP; Source: Refinitiv Datastream, GIAM projections

A sluggish recovery of demand

Fourth and more importantly, overall demand will remain severely harmed for an extended period. Impaired balance sheets, the risk of renewed lockdowns and persistent uncertainties about the economic outlook will lead firms to **postpone or cancel investment projects**. Similarly, consumers will increase **precautionary saving** amid soaring unemployment and health risks. Apart from persistently harmed demand for spare-time services (which consumers may find much less enjoyable than before), durable goods demand may suffer for longer, with people refraining from more costly expenses. Exports will remain in the doldrums amid weak trade and higher risks of supply chain disruptions.

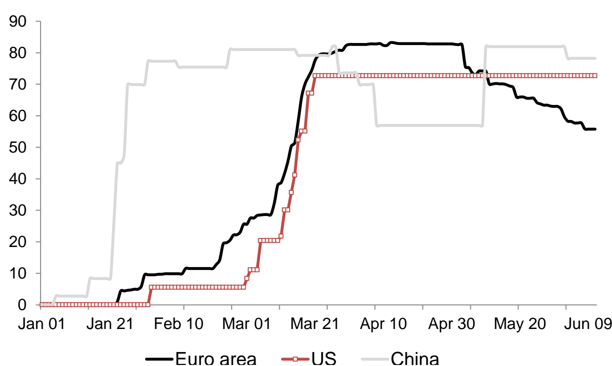
Fortunately, stronger government support, including furlough schemes, as well as higher research and infrastructure expenses are helping. Announced global discretionary fiscal measures already amount to a massive 6% of GDP, a large and highly welcome boost that seems set to be extended. And major central banks have committed to open-ended asset purchases, including corporate bonds. Yet amid the severe slump and persistent uncertainties, 'animal spirits' among consumers and businesses are unlikely to return fast.

The summer illusion of a V-shape. Since late May, the economic recovery has tentatively started in many advanced economies. Re-opening and pent-up demand will ensure a strong catch-up over summer 2020. Yet this bounce will likely fizzle out in the autumn. Pre-crisis levels of activity will unlikely be recouped before 2022 in the US and even later in the euro area. And in an adverse case of broadly resurgent infections, a W-shaped economic fallout (with a second dip in activity, possibly by end-2021) would imply that late 2019 levels of output would not be retrieved for years.

Lower potential growth. Even if pre-crisis GDP levels are reached faster than expected, expect permanent scars to growth potential, determined by labour supply, capital investment and productivity. Many workers may be discouraged by rising unemployment and shifts in required skills and leave the workforce. Some estimates reckon that 40% of US job losses may be permanent. Persistently lower investment and hampered productivity could be particularly harmful to welfare. Impaired corporate balance sheets and uncertainties about the duration of the pandemic may burden investment for longer and limit growth in production capacities.

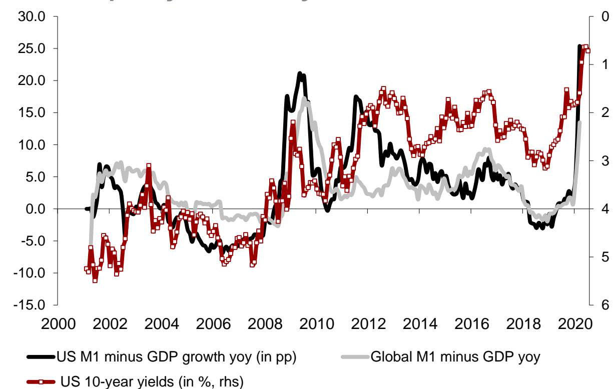
Similarly, productivity gains from trade and international supply chains seen over the past decades may come to a halt or even reverse if populist responses to the crisis promote nationalism and mercantilism. Tighter regulation and state intervention is likely to weigh on output per worker too. A reversal from lean production to larger inventories will make production more robust to supply

Lockdown index



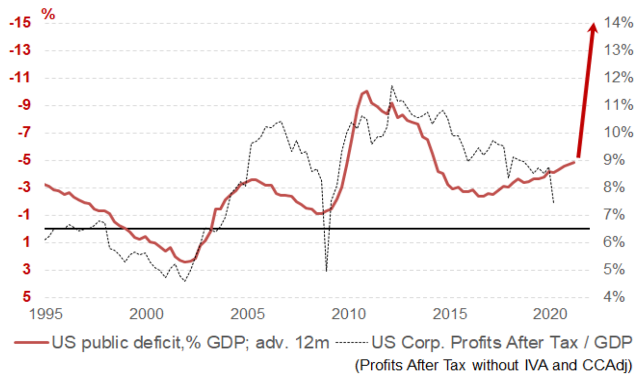
Univ. Of Oxford stringency index, EA: GDP-weighted avg. of 11 largest economies (98% of GDP). Source: https://covidtracker.bsg.ox.ac.uk/, GIAM

Excess liquidity and bond yields



Source: Refinitiv Datastream, GIAM calculations

US public deficit and corporate profits



Source: US Treasury, BEA, Bloomberg, GIAM

disruptions (a shift from "just in time" to "just in case"), but weigh on productivity. This crisis my lack the extreme financial imbalances of the 2008/09 GFC (which tend to be repaired only over a longer period), but the adverse economic fallout may still be visible over a full decade.

Inflation only a distant threat

The hit to demand caused by Covid-19 is sending inflation lower, with the fall in oil prices amplifying the move. As supply recovers quicker than demand, excess capacity will keep inflation depressed this year and next. Further out, concerns are growing that ballooning central bank balance sheets may herald a rebound in inflation, tacitly welcomed by highly indebted governments. De-globalisation, the rising bargaining power of workers and increased industrial concentration may favour structurally higher prices.

That said, demand seems set to recover only sluggishly from the deep crisis. This will keep the output gap wide for longer and demand for cash and excess reserves at central banks high, thus not exerting upside pressures on inflation. Furthermore, the Japanese experience shows that depressed inflation expectations are extremely hard to undo. Fiscal consolidation will be delayed for as long as possible, but cannot be ignored forever – especially not by highly indebted Southern European countries and many EMs. The experience from the pandemic will accelerate digitalisation and automation, which tend to be disinflationary, too. Thus it will likely take years rather than quarters before central banks may need to start worrying about higher inflation. The Japanese central bank has been waiting for almost three decades indeed.

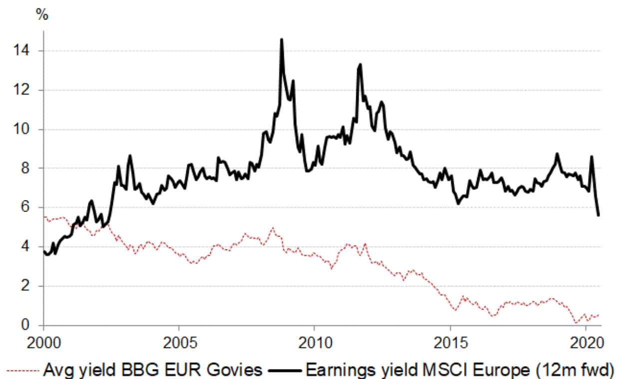
Asset prices inflation more likely

A marked acceleration of consumer price inflation thus remains a remote threat. It is more likely that asset prices will absorb a significant part of the persistent monetary policy support. This seems most evident for fixed income (both sovereigns and credit), as yields tend to fall on excess growth in global liquidity (see chart), usually compounded by low rates and quantitative easing (QE). Also residential real estate prices will remain underpinned by monetary accommodation – though the impact may greatly differ between countries, as they also heavily depend on cyclical variables like unemployment.

Equity prices have already rebounded sharply from the March troughs (with the S&P almost flat year-to-date). They will be more vulnerable to temporary setbacks as markets become aware of the looming shallow pace of recovery. Yet **earnings will likely recover more swiftly than overall activity** as large fiscal support in the past has been supportive to profitability (top-left chart). While multiples (e.g. P/Es, price/book values) seem elevated, **central banks' commitment to QE and very low rates for much longer will keep demand for riskier assets intact**. Many investors – especially liability-driven ones – can simply not afford to sit on negatively yielding cash forever.

But apart from the search for yield, financial repression is also amending views on valuation. Earnings multiples may look elevated compared to the past. But investors will be mindful that multiples are just the inverse of earning yields – which still render a decent risk premium amid the secular trend of low yields (bottom chart).

EUR equity earnings yield vs bond yield



Source: Bloomberg, MSCI, GIAM

02

New behaviours

First, a confession: we do not have a crystal ball. Who knows exactly what the long-term implications of the Global Covid Crisis (GCC) will be? For sure, this has been a crisis of historic proportions, leading to unprecedented lockdowns and the largest peace-time shock on the economy since the Great Depression. Will this cause a permanent shift in government, corporate and consumer behaviour? That remains to be seen. Making long-term forecasts in the heat of the moment is particularly difficult, as emotions distort the perception of the post-crisis environment. An example of misguided forecasting lies in the belief that crises will lead us to collectively prepare better for 'next time'. Yet the human nature has led to repeated failures to prepare, because of the herd instinct, optimism bias (and wishful thinking), exponential myopia and mistakes from governments (careless or wrongly allocating resources under constraints).

After the GFC. Looking back, with a cool head, at the Great Financial Crisis (GFC), what tectonic changes have we seen? The choice is disputable but we would highlight four:

1. Tighter **bank regulation**, a direct fallout from the pre-GFC surge in bank leverage and mortgage malpractices.
2. A significant rise in US **household savings**, from about 4% of disposable income to 8%.
3. Pressure for a better implementation of **Corporate Governance** standards (remuneration, risk management, ineffective board oversight, shareholder rights etc.).
4. A rise in **populism**, with the likes of Trump, Salvini, the Brexiteers etc. taking advantage of rising inequality – exacerbated by the severe recession – as well as immigration crises and population ageing.

Can we confidently outline similar structural changes of behaviour following Covid? We dare giving it a try. Rather than going through the three categories of agents (x-axis of the table), the section below analyses behaviours across the four vertical dimensions of our DARE table:

1. **Digitalisation**, or the broader technological disruption (automation, robotisation etc.), amplified by the GCC.
2. **Activism**: use of direct action to achieve a political or social result. First and foremost, *interventionism*.
3. **Repression**, or the financial policies that will inevitably follow such economic seism.
4. **ESG**, the hot factor in Asset Management (and Liability Driven Investment) that Covid has just made bigger.

We doubt that all potential changes listed in our DARE table will materialise. Below we emphasise the most likely ones, with a lens focused on the Asset Management industry and financial markets.

New Behaviours? We DARE making predictions

DARE	Consumers	Corporations	Governments
Digitalisation	Changing the way we **work**, consume, entertain & learn Less going out? Not so sure, but **home entertainment** wins anyway (video, streaming etc.) End of cash? More **digital payments** **Wages pressured down** (automation, unemployment...)	**Automation & robotisation** good for productivity More **digital services, e-commerce** **Critical size** becomes more important: concentration European **champions.** Good for margins? Asset Management needs **digital/human mix**	**Infrastructure** spending to enable tech revolution Protect **data privacy,** as tech makes world safer but less private (Europe leads). Protect **cyber security** Tech war drives **geopolitical and military** power (Europe lags)
Activism	Demands for a strong **safety net** **Inequality** a larger focus and political driving force Deglobalisation should have a limited impact on **consumer choice and prices** (Automation an offsetting force)	**Regionalisation & diversification** of production chains But balance sheet impairment **complicates re-shoring** Negative for **productivity** US/China Tech War: **Tech Wall** causes divide & operational difficulties	**Interventionism,** e.g. security & self-sufficiency Populism increases pressure towards **deglobalation** Forced march towards more **European integration?** **Immigration** an even bigger problem if EM convergence slows & climate deteriorates
Repression	Lower yields, larger deficits = **more household savings** Savings: lower returns & deglobalisation (winners/losers) call for geographical, sector and style **diversification** Inflation uncertainty: increase weight of **real assets**	**Less corporate debt**, better liquidity management Higher **corp. taxes;** bad for profits? **Tech sector** a target (too much power, not enough taxes) **Lower expected returns** hurts AM (cut cost)	**More debt,** hard to reverse; **more taxes** on rich & corp. **CB balance sheets** to durably bloated (monetisation) **Reduced potential growth** (misallocation of capital) **Disinflation** or Inflation? 12-18m clear. Beyond, less so
ESG	Demand for a stronger **safety net** (gvt, insurance) Less public transport, flights & sharing; **more cars?** More **electric cars** More focus on **health** (improved viral resilience) Make **residential buildings** more eco-friendly	More **tech** and **health** services **Smaller offices?** Probably, but city centers still a buoyant area of exchange **Social component** of ESG gains weight (salary dist., corp. Tax, profit sharing etc.)	Stronger **safety nets** require transparency of "critical" sectors; insurance companies can help provide 'security' Pressure on corporate to **share profits** with employees Deficits: **less resources for climate?** Less aid for EM energy transition?

Source: GIAM

The Digital Disruption

The Covid crisis has been an accelerator of the already fast digital transformation. Covid has amplified shifts in both the consumer behaviour and business operations.

The **consumer experience** is increasingly digital, be it for shopping, learning, 'socialising', entertainment, personal finance or health. The lockdowns have only made that shift more extreme. While changes in the consumer journey, for both goods and services, are undisputable, we would argue against extrapolating them with too much zeal. We do read about technology leading to the death of the office and a reversal of the urbanisation trends with a degree of scepticism. **City centres will remain vibrant**, in our opinion, as they offer opportunities and an appeal hard to resist for humans (social animals).

Yet technology will continue to filter through all aspects of our personal and professional life, in a way that often improves efficiency and safety, at the cost of making it less private. Demand for the **protection of privacy** (as well as cybersecurity) will grow, and this is one of the very few areas where Europe is at the forefront of the digital revolution. Another potential drawback from technology will be the heightened **pressure on jobs and wages.** Half of the jobs in the OECD are seen as either directly exposed to automation or facing significant changes over 10-20 years. A massive **training challenge** arises.

Jobs bring us to the business side of the equation. The Covid crisis, and the related lockdowns, have profoundly impacted the way we work. Working From Home (WFH) has led to a surge in video streaming for meetings, conferences, webinars etc. While the office will likely remain an area of creative exchanges and innovation, we suspect that it will become smaller – which **should impact the Office Real Estate sector**. The Home Improvement sector should benefit.

Technology will also facilitate **reshoring**, as automation, AI and robotisation may enhance productivity and offset the rise in the wage costs. Reshoring however will be easier said than done, as it will require capex, in an environment of impaired balance sheets. Digitalisation will remain a **key differentiator for retailers**; again, related capex will confer an advantage to companies with a critical size. The crisis may contribute to the rise of national, or European, **champions**.

Governments will remain key actors of the digital revolution. First, digital innovation is closely intertwined with **military intelligence and dominance** – an area where Europe is lagging dramatically, if not irremediably. Second, states will provide the **infrastructure** investments that broaden the access to the digital economy. Third, governments will want to **control** the rising power of the tech giants, given their growing impact on social and political developments (including elections), the privacy threats and their insufficient contribution to the **public good** (cross-border tax issues).

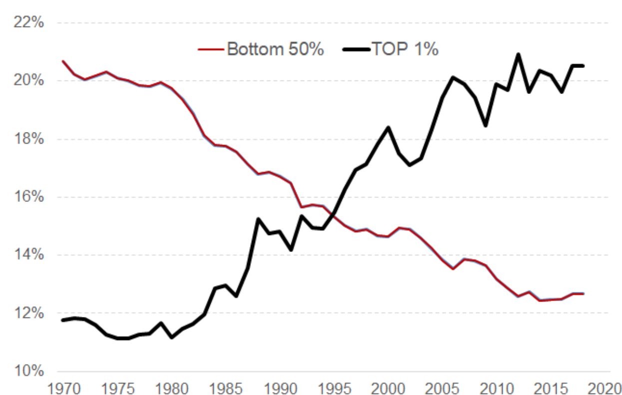
To be clear, the GCC has only reinforced those (already irresistible) trends. The impact on finance will continue to be profound. ***Large*** **Asset Managers will be in a better position** to invest in digitalisation, though for such sensitive matters (e.g. personal finance) we expect the **human touch** and local presence to remain important. On the portfolio side, screening technological progress will require an increasingly broad focus, as innovations are seen in many areas (medical, clean energy, data protection and privacy, fintech etc.): the sourcing of the equity **Growth factor will likely become more diversified geographically, less US-centric**.

Activism (and Interventionism)

Activism is the use of direct action to achieve a political or social result. It is often linked to private initiatives trying to influence government policy, but we broaden the scope to government action aimed at changing the social fabric.

Inequality became a hotter topic following the Great

USA, share of pre-tax national income



Source: University of California Berkeley, https://taxjusticenow.org

Financial Crisis, for at least two reasons: 1/ The surge in unemployment aggravated the situation of those at the bottom of the income scale. 2/ Forceful central bank action was seen as supporting Wall Street over Main Street. Bank losses were mutualised, while gains had been privatised.

Likewise, the **Covid crisis has disproportionately hit the 'have-nots'**, as low income areas have suffered higher death rates, while many low-salary employees lost their jobs or were asked to operate in conditions that were not always safe (key workers). So inequality is sure to remain a key driver of the political debate. Central banks are printing money like never before, which will also fan the Wall Street vs Main Street debate. So far the populists in power, not least Trump and his large corporate tax cut, have often been very pro-business. But that may not always be the case. Because the mere **threat of a left-wing populist wave** is getting tangible, the 'haves' may be self-interested in defusing the inequality crisis. This could be a driver of social changes (higher corporate taxes, more progressive income tax or wealth tax, distribution of salaries and profits etc.). We are not holding our breath, but expect the **Social factor in ESG to grow**. While we do expect profits to recover faster than GDP in the coming quarters, eventually a more balanced distribution of the added value in the economy should contribute to a **lower pace of earnings growth** (US compensation per hour has grown much slower than productivity over the past 40 years).

Inequality is also an important driver of **deglobalisation**, as populists build trade barriers and put pressure on corporations to repatriate production, in order to shore up manufacturing activity. The GCC will increase support for de-globalisation, slowly reversing a trend that has defined the past 40 years (and even more so the past 20, since China joined the WTO). The child poster of this turn will be the US-China decoupling. We recently published an in-depth '[Core Matters]' report on the topic, so will not expand further here, if only to reiterate that inefficiencies (waste of comparative advantages and economies of scale) will **reduce potential growth** – and asset return. Countries with higher participation in the global value chain – EU and EMs – should be more impacted. That said, the **regionalisation of the supply chains** may also benefit selected areas, e.g. the **CEE region may win** from a lower reliance on off-shoring in China.

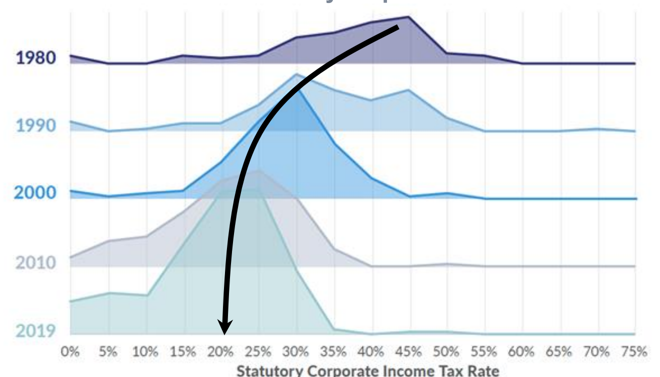
Last but not least, **interventionism**: expect some payback from the gigantic state intervention, spending and guarantees during the crisis. Governments will get more involved in the economy, to better control the rescued corporates (executive pay, dividend policy etc.) and satisfy the call to reinforce the safety net, health security and self-sufficiency. The Chinese model cannot be replicated in the West, but to mobilise energies and align actions at short notice, a push towards centralisation may appeal. Again, **interventionism will do no good to potential growth**.

Financial Repression

The roots of the GFC and the GCC are radically different. The 2008-09 crisis was preceded by a large rise in both **household and financial (bank) leverage**. It was fairly obvious and easy for governments to address the popular frustration (Occupy Wall Street) and tighten the screw on bank regulation (capital requirement, leverage ratio, stress tests etc.), once the economy was back on its feet. In contrast, the GCC was preceded by a large rise in both **corporate and government debt globally**. What will policy makers do? They will attach strings to the rescued corporations (interventionism), and will focus on ensuring cheap funding conditions. So expect financial repression to reach a whole new level. To contain the depth of the recession, governments have chosen to turn a blind eye on debt levels; now, the only way (assuming a reluctance to quickly tighten fiscal policy) to keep debt sustainable will be to **keep yields low**. For sure, **central banks** are giving a hand, by keeping policy rates low (or negative), threatening to launch Yield Curve Control (YCC) and buying loads of bonds. **Financial regulation** will continue to channel savings towards government bonds notwithstanding the collateral damage on the economy.

If that is not enough, government may eventually need to cut spending (not easy, given the demands for a tighter

Global distribution of statutory corporate tax rate



Note: The number of countries included varies by decade as some historic corporate tax rates were not available.
Source: Statutory corporate income tax rates were compiled from various sources.

Source: Tax Foundation

safety net) **or raise taxes.** That may not be necessary, Olivier Blanchard argues: “Put bluntly, **public debt may have no fiscal cost**.” In other words, a surge in public debt may not require future tax hikes or spending cuts. That may be true if central banks keep **rates lower and balance sheet bigger for longer**. The Modern Monetary Theory (MMT) stipulates that an expansionary fiscal policy should be financed by money creation (which, in our opinion, ignores the fact that such policy may eventually scare investors off, particularly if and when inflation shows its ugly face). The blurring of the limit between fiscal and monetary is a strong form of financial repression. **An alternative would be to raise taxes**, particularly on high income, wealth and corporates. The chart above shows that corporate taxes have declined sharply over the past 40 years, with the modal rate falling from 40+% to about 20%. Again we are not holding our breath: a reversal will require international cooperation, in sharp contrast to the past race to the bottom. One sector will be under scrutiny: many tech giants enjoy very low effective tax rates. The OECD has come with proposals to address the cross-border issue; yet again, international cooperation is proving hard to build.

➔ Whatever the form of repression, one clear implication emerges: **financial returns will be lower**. Forget the 14% annual return from the S&P over the past decade; rather expect mid-single digit returns. In Fixed Income, the Global Aggregate currently yields (to worst) 1.0%, and this is a good predictor of future returns. Investors will thus look deeper into **asset, geographic and factor diversification** to enhance risk-adjusted returns. **Alpha** will become more important in a world of lower beta returns. Expect **real assets** to turn ever more popular, not just for their superior returns, but also their appeal in an environment of long-term inflation uncertainty. Rising credit risk (leverage) and the hunt for yield will also make **expertise in Credit** more valuable. Finally, bloated CB balance sheets will imply stretched valuation and a further rise in the liquidity mismatch, making **liquidity and risk management ever more important**.

ESG: ‘S’ has just got bigger

ESG (Environmental, Social and Governance) investing did not need Covid. Flows of funds prove that the rise of ESG preceded the crisis. The environmental roots of the pandemics are not obvious either (some will dispute that). Still, Covid does have many ramifications with ESG:

- The GCC has magnified the vulnerabilities of our tight global network. Such disaster should lead to a repricing of event risk, e.g. climate; **tail risks have become fatter,** and make ESG ever more relevant to corporate governance, public and investment policies.

- Covid will likely **increase the weight of the Social** factor (inclusive capitalism: effective corporate tax rate, salary pyramid, profit sharing, employees’ health, safety and well-being, labour practices etc.). Post-GFC the focus moved to Governance; over the past few years, the Environment has by far got most of the attention. Now Social has a chance to get a touch bigger.

- **Climate, however, will still be the elephant in the room**. The WEF’s Global Risk Report, which admittedly predates the Covid crisis, easily put it at the top of its ranking. Covid may support deglobalisation and as such contribute to **lowering carbon emissions**. But impaired balance sheets, not least on the public sector side, will also reduce fiscal capacities, e.g. **budgets to support the energy transition in EM economies will diminish**.

- Policy makers may compensate by adding pressure on the private sector. Already the planned **European Recovery Fund** will favour businesses that embrace climate change. Interventionism, as well as a heightened governmental focus on energy transition, will impact corporate practises, at least in Europe.

- This is a good start, but governments may be pressured to enforce a greater corporate focus on society at large. Corporate choices in favour of the ‘**common good**’ may imply higher costs and lower profitability. Executive and shareholders are more likely to make those choices if they face proper incentives, positive and/or negatives. Investor preference will be one, and it will grow on further evidence that ‘sustainable’ companies offer better risk-adjusted returns. Regulators will also have a major role, including in the financial system. **Europe is well positioned in this field of climate regulation,** with financial institutions soon to be stress-tested on climate change-related financial risks. This ESRB report reminds that “more than 15% of insurers’ overall corporate bonds and equity investments are likely to be in the automotive, coal, oil and gas, and power-generating sectors. This corresponds to almost 7% of their total investments. An additional 3% is likely to be other significant climate-relevant sectors, namely aviation, cement, shipping and steel production.”

More globally, as for taxes, progress on climate, will require a strong **international cooperation** to protect the level playing field. On that front, we fear that the Covid crisis, if anything, has fanned international tensions and protectionism.

03

Covid-19: an accelerator of European integration?

"Europe will be forged in crises, and will be the sum of the solutions adopted for those crises". Jean Monnet's quote sounds strikingly relevant today, given the huge task governments are facing. The responses by EU policy makers have been quick, compared to the slow half-hearted steps taken after the 2008 and 2011 crises. Moreover, policy makers have realized the pandemic's threat to the stability of the EU and especially the single currency area (EMU).

Strong increase in public debt

A joint and coordinated fiscal response is currently even more warranted than during the Great Financial Crisis (GFC). Most advanced economies entered the Global Covid Crisis (GCC) with elevated levels of public debt, amounting to around or above 100% of GDP in seven of the 19 EMU members in 2019. Cushioning the Covid-19 fallout and restarting the economy will dramatically deteriorate public finances. The European Commission (EC) predicts that in 2020 the euro area's overall debt-to-GDP ratio will increase by an unprecedented 17pp, to nearly 103%, and may climb above 160% in more heavily indebted countries. Even assuming a relatively quick rebound in growth and that the economy is strong enough to allow the governments to rein in the fiscal loosening already next year, the euro area debt-to-GDP would come down by just 4 pp (to 99%) in 2021.

How to restore public finances without choking off growth will be the crucial question in the post-Covid world. Euro area economies are quite heterogeneous, with widely different levels of debt and significantly divergent long-term growth prospects, financial conditions and government bond yields. In 2019 the average (inflation-adjusted) real rate varied between -1.1% for the Netherlands and +1.6% for Italy. If rates remain low, some countries do not even need to run a primary (i.e. excluding interest payments) surplus to stabilize debt ratios. For others, even a small increase in rates will require very strong offsetting fiscal efforts. Financial markets will closely monitor these differences in the sustainability of public debt.

Primary surplus as % of GDP needed to stabilize debt

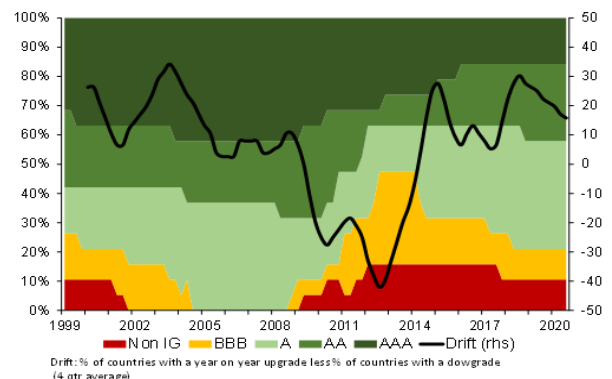
	Debt as % of GDP	Potential Growth	With real interest rates at…	
			1%	2%
Germany	76	1.1	-0.1	0.7
France	117	1.1	-0.1	1.0
Italy	159	0.4	0.9	2.5
Spain	116	1.0	0.0	1.2
Netherlands	62	1.0	0.0	0.6
Belgium	114	1.3	-0.3	0.8
Portugal	132	1.2	-0.3	1.0

Debt: European Commission's 2020 Forecast
Potential growth: 2019-2030 European Commission's Forecast
Source: European Commission, data as of June 20th 2020

Rating agencies: wait and see

Debt sustainability is a key ingredient to sovereign ratings, which in turn shape the decisions of heavily bond-exposed liability-driven investors. One of the legacies of the 2008 and 2011 crises was a sizeable negative rating drift in the euro area, as the increase in debt was exacerbated by worries about an effective backstop (only gradually created via the EFSF and the subsequent ESM). Afterwards, ratings improved markedly as the return of growth helped to heal government balances.

Euro area: Sovereign rating evolution
Average of S&P, Moody's and Fitch



Source: GIAM from Rating Agencies' data as of June 20th 2020

Since March 2020, the main rating agencies have adjusted their assessment to the post-Covid outlook. Those, like Fitch, focused on the risks to solvency from large debt burdens and alleged lack of political commitment to fiscal discipline, have cut ratings and revised the outlook of a few DM countries (and many EM). Others (Standard and Poor's, Moody's) have stressed the unprecedented, one-off, shock that Covid represents, and cited strong offsetting factors such as large private wealth, sound external balances and the backstop provided by the ECB. They will postpone a full assessment until macro and fiscal data provide more clarity. Such leniency should not be taken for granted. What will matter, especially for countries like Italy and Portugal, whose ratings are not far from the High Yield threshold, is the further course of economic policy.

A first reckoning looms for late September, when the draft budgets for 2021 are sent to the EC. Agencies will look at the mix of growth-enhancing measures, incl. public sector reforms, lighter regulation and higher infrastructure spending, and ambition for fiscal consolidation. This will be challenging for governments based on heterogeneous coalitions, including parties openly hostile to central pieces of EU recommendations. Nevertheless, thanks to strong ECB support and further steps towards European integration (below), we see a good chance that rating agencies will keep European sovereign ratings mostly on hold this year. Longer term, heavily indebted countries will have to show credible commitments to policies that are both fiscally sound and supportive to growth. Rating downgrades should prove much shallower than over past decade.

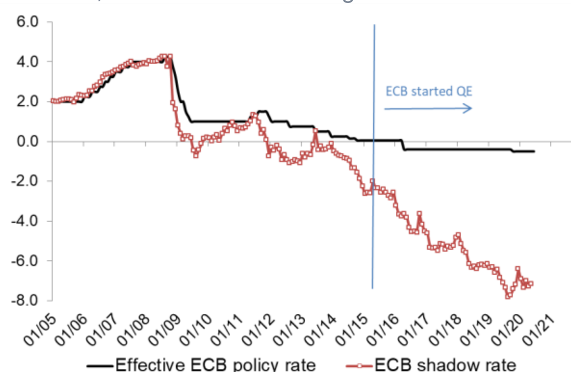
ECB: breaking taboos

The ECB's role differs from other major central banks in that it has to cope with an incomplete monetary union and the lack of a pan-EMU fiscal entity. In the post-Covid world the ECB will face unprecedented challenges. Will it be able to master them within the current policy framework?

Over the past decade the ECB had already strongly increased its degree of policy accommodation, to a scale hard to imagine at the outset of the monetary union 20 years ago. It adopted negative interest rates, provided large-scale cheap liquidity schemes (e.g. TLTROs), softened collateral rules, embarked on quantitative easing (QE), including the purchases of corporate paper. More taboos may need to be broken, though, as monetary policy reaches its limits. The deposit rate of -

ECB policy rate including QE

%, effective ECB policy rate: repo rate if >0, depo rate otherwise; Shadow rate according to Wu & Xia methodology



Source: Datastream as of June 20th 2020

0.5% is close to the estimated 'reversal rate' (-1%), below which adverse effects from further cuts may prevail. After five years of QE the ECB has accumulated about € 3trn of assets and will hold more than 25% of outstanding euro area government debt by end 2020. The ECB's 'shadow rate', a measure which condenses conventional and unconventional policy measures into a policy rate, fell from a pre-GFC level of 3.8% to -7.1% in H1 2020.

Concerns that the ECB overstretches its mandate have resulted in lawsuits. The German Constitutional Court recently ruled that the Public Sector Purchase Program (PSPP) required a proportionality check, openly contradicting the European Court of Justice (ECJ). As the ECB has now moved into new unchartered waters, most prominently by launching the Pandemic Emergency Purchase Program (PEPP), courts may see more cases against the ECB. And yet, given the need to explore new routes of monetary easing, it seems quite likely to us that the **ECB may question more of its current limits for fresh action**, if needed.

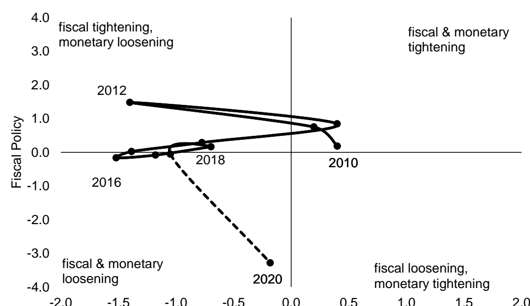
- First, and most importantly, amid new circumstances, it may well argue that several self-imposed restrictions are no longer warranted. For instance, the ability to extend QE further is constrained by the need to buy government bonds according to their respective shares in the ECB's capital ('capital key'), a rule the ECB imposed on itself to soothe critics about state financing. Yet with the availability of papers from fiscally sounder countries drying up faster, this may force QE to a halt if flexibility to deviate from the capital key purchases is not enhanced.

- Second, the ECB has always been creative in extending, adapting, inventing and applying new policy tools. The ECB could broaden the **universe of assets** by purchasing Fallen Angels (high yield bonds) or debt securities of financials. It could also extend QE to **new asset classes**, such as equities (through stock indices) or real estate (REITS). Following the Bank of Japan, it could move towards **Yield Curve Control**, targeting longer-dated yields, though this may be compounded by questions about 'fair' spread levels for lower-rated issuers. The extreme would be **helicopter money**. By giving money directly to households and firms the ECB could in principle – leaving aside considerable operational hurdles – bypass the financial sector as a tool for policy transmission.

These considerations are less exotic then they look. While we do not expect that another taboo will need to be broken for digesting the Covid-19 recession, aftershocks may change that view. The legacy of the crisis will keep inflation low for a long time and extra efforts will be needed to bring it up. The crucial question is whether monetary policy is the appropriate policy mean. With the shadow rate that low there is increasing evidence that additional monetary policy easing exerts unwanted side-effects (e.g. real estate bubbles) but is hardly stimulating activity and lifting inflation. In a world characterized by uncertainty about another pandemic, persistently high geopolitical and trade tensions and a fall in potential growth, monetary policy alone will not be able to do the trick. Instead, fiscal policy will need to take the lead. The best the ECB can do is to offer a funding backstop, allowing governments to expand spending in downturns while keeping rates low.

Euro area policy stance

pp; fiscal stance: change in the structural balance, monetary stance: change in the shadow interest rate



Source: GIAM Calculation on Datastream data as of June 20th 2020

Baby steps towards fiscal union

The reduced effectiveness of extra monetary stimulus is a key reason for a stronger common fiscal policy. It is also much needed because some highly indebted countries will struggle to provide a sufficiently large fiscal impulse. **Covid-19 acts as a catalyst for EU fiscal action**. Before the virus, the EC had already pushed for a common fiscal effort to lift growth through productivity-enhancing public investment and to make the European economy greener and more digital. The EC now gauges the investment gap due to the crisis for 2020/21 at more than € 1.5 trillion.

The recently announced € 750bn Recovery Fund is an unprecedented step towards a common fiscal policy. The proposal targets to support those regions and sectors most damaged by Covid-19 and/or burdened by high unemployment. Money shall be spent for investments and reforms, in line with EU priorities. The Recovery Fund would furthermore set a precedent by allowing the EU to take on sizeable amounts of debt. That said, as we go to press (early July 2020) EU leaders have still to agree on the details of the plan. Requests by Southern European countries for grants conflict with resistance by "frugal" Northern countries against unconditional support. We expect a deal, but see this as a one-off and exceptional effort.

The proposed Recovery Fund would alleviate the debt burden of troubled economies. But do not expect miracles. The EC estimates that by 2024 the Fund may help to lower the debt-to-GDP ratio in these countries on average by 5 pp compared to the base case. Even this relatively modest relief hinges on a swift and full implementation of the plan.

➔ Coping with high debt ratios will thus continue to remain mostly national challenges for the coming decade. Especially highly indebted countries will need to **implement growth enhancing policies and improve their public finances**, as the pan-European measures provide some leeway. Yet the very strong support from the ECB's bond purchases and the political signal by EU leaders to agree on stronger fiscal integration may help a great deal in soothing investor concerns about high debt ratios, while also deepening the ties within the EU – validating Monet's constructive view on the role of crises for the European project.

04

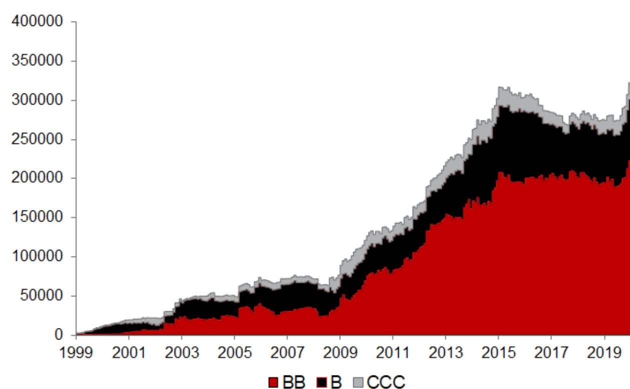
Corporate rating migration & defaults: this time is different

The intensity of the Global Covid Crisis (GCC) differs considerably from the Great Financial Crisis (GFC) as it combines both supply and demand-side shocks to the credit universe, which has seen stress spread quickly across sectors and geographies. In contrast, the GFC was rooted in the US housing and financial sector and only later spilled over globally to other sectors and countries. In this section, we outline why we expect the GCC peak default cycle to be lower than the GFC, but the defaults to stay elevated over a longer period. For perspective, it is worth noting that the European credit market today is very different from that of 2008, given the following:

The Euro HY credit market is much larger today, and better rated, than in 2008. The European HY market totalled around EUR50+bn in 2008 and was largely dominated by B-rated bonds. It has grown rapidly since 2010 to currently EUR370bn, comprising of 70% of BB rated (notional amount), compared to 56% during the GFC. Given that the current HY market has grown mostly via **fallen angels, where most bonds are without covenants**, the default protection & recoveries will be lower, reducing creditor protection.

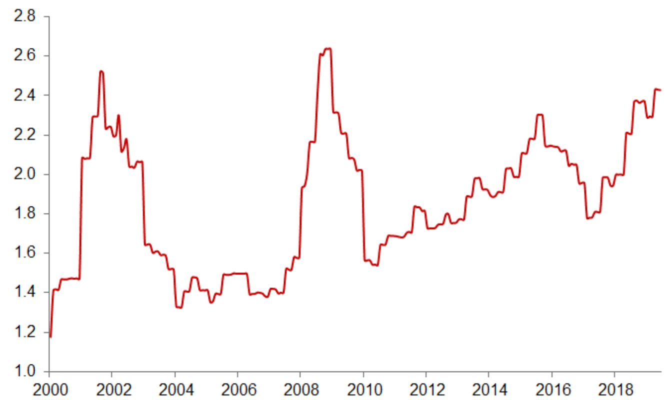
Investor base, bigger and more mature: The EUR HY investor base has matured considerably away from mainly bank books and hedge funds in 2008 to currently being dominated by traditional institutional investors. The number of dedicated EUR HY institutional real money investors has increased significantly from 2008 to 2020, making this market deeper. However, the generally low levels of yields (making credit carry more attractive), has attracted macro/multi-asset funds, which often use a top-down approach, with a lower focus on credit selection. Hence some of these investors will be ill-equipped to deal with problem credits, should the credit cycle turn sharply.

Size of EUR HY market, Eur Bn



Source: Bloomberg, GIAM as of June 18th, 2020

Non-Financial Large European Corporate leverage



Net debt to EBITDA Source: Markit, Bloomberg, GIAM

Market has become complex and less liquid: in Europe, sharp spread compression since the GFC has led non-dedicated accounts to take on more credit risk as macro-plays using indices. At the same time, the growing number of corporates tapping the market has increased the "complexity risk". The number of issuers in the EUR iBoxx indices has grown from 314 in 2010 to 617 in 2020 in Investment Grade, and from 80 to 204 in High Yield.

Mixed technicals: Further, a significant reduction in the single name traded CDS market in Europe has provided fewer hedging options to investors. A combination of fewer market makers, lower dealer inventories and fewer hedging tools has limited the capacity of market players to distribute risk efficiently. No surprise that air pockets are quick to develop through crises (e.g. March 2020).

Stronger European banking sector today compared to 2008: A combination of stringent regulatory oversight, frequent capital adequacy stress tests, NPA recognition, forced capital injections/restructurings of weak banks, pre-emptive liquidity measures have made the banking system

generally healthier. During difficult times, this has kept the credit flowing to the corporate world – even more so recently with the support of government guarantees. Although we have seen a change in rating outlooks, material rating downgrades are yet to materialize in Financials. Should the crisis drags on, we may see ratings pressure build, however. In contrast, the non-financial sector has been relatively hit harder by Covid, as some sectors saw their activity collapse (Airlines, Hospitality and Transport amongst others). Also years of near-zero yield encouraged corporates to take on more debt, in some cases to repurchase stock, pay extraordinary dividends etc. Leverage has built further through the strong wave of issuance seen since the start of the GCC (corporates craving for liquidity).

Sovereigns could add to future ratings pressure: Covid-19 costs will have added significantly to debt burdens faced by peripheral countries, leading to concerns about potential sovereign downgrades over time. Positively, recent EU measures or plans to support funding programs across sovereigns, banks and corporates have reduced market stress. However, the sharp increase in government debt to GDP ratios, coupled with structurally lowered growth prospects, could weigh on sovereign ratings, which could translate into the corporate sector over the next 12-24 months.

European default rates should remain significantly below 2009

Historically there was a strong correlation between diffusion indices like IFO or PMIs and default rates. A simple correlation between European default rates and the IFO index suggests an upcoming 12m trailing default rates for European Corporates of 10% (see side chart). Historically credit spreads had strong predictive potential of likely defaults as they led the default cycle by 8/9 months. However, given that the ECB has been aggressively buying corporate bonds since 2016, this signal has become less reliable, as the reduction in liquidity risk has made potential default rates lower.

Besides the severity of the crisis, its duration is also key. In the absence of a second Covid-19 wave, the extreme shock to the world GDP should prove more transitional than that of the GFC, hence **peak defaults will be lower**. However, **default rates could remain elevated for longer**, given prospects of lower growth and structurally higher sovereign and corporate debt. **Loss severity could be higher** due to an increase in cov-lite structures among lower rated issuers (found in CLO structures).

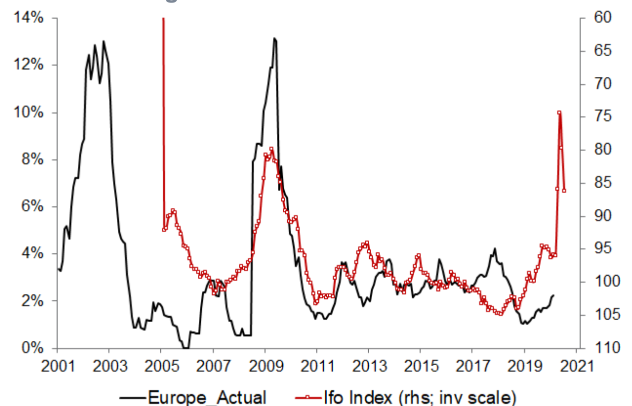
➔ To conclude, we believe that the **12m trailing defaults for the European corporates sector will most likely be less severe at 5-6%** (the European default rate in 2020 as of June is 2.8%) versus a 3% average and a 10% peak in 2008. The large, quick and comprehensive support packages provided both on the fiscal and monetary side across Europe will largely contribute to keeping the peak well below that of the GFC. We also expect the **Euro 5Y cumulative default rate to increase to around 15%, well below the 20% of 2013** in the aftermath of the GFC and the Euro sovereign crisis. Indeed, we now have five major central banks purchasing credit, while billions have been thrown in the developed world in guaranteed loans and unemployment schemes.

However, we remain **concerned about the length of this cycle, and the severity of losses.** Cov-lite structures allow companies to postpone defaults, giving them more time to burn cash, leading to lower recoveries. At current levels, average European high yield spreads are discounting a default rate of c.5% for 12m, which leaves very little premium for the liquidity and migration risk. We are also mindful of potential spillover effects, as defaults on HY bonds and, more importantly, SME loans, will translate into higher NPLs ratios for the banking sector. For the smallest banks of the periphery this could add to an already elevated burden. Hence from a default angle this crisis appears less severe than the GFC, but the new cycle will not start on a clean sheet as the excesses of the current cycle will not have been cleared.

Biggest threat to IG: rating migration

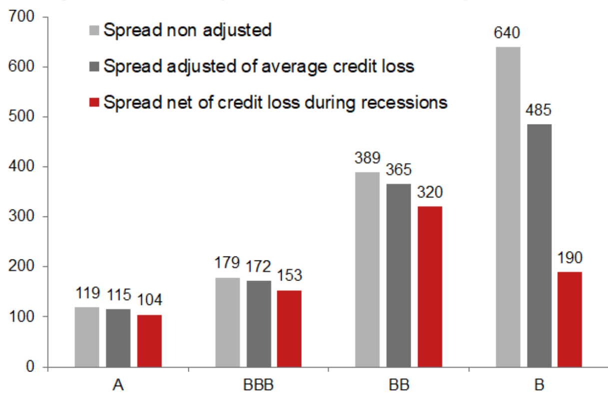
Peak default rates will be lower but could extend for longer. This has implications for the ratings migration risk, which is key for the solvency of European insurers.

HY 12m trailing default rates vs IFO index



Source: Moody's, GIAM

€ Corporate bond spread in excess of expected losses



Adjustments based on 12m defaults rates. Hyp. 30% recovery rate. Source: S&P Europe Corp. Default & Rating Transitions Study, GIAM own calculations

Consider the following:

- Under Solvency II, **the capital charge of an insurer's portfolio sharply increases as the debt ratings in its portfolio migrate lower**, particularly from BBB to High Yield (see chart). Under the standard model, the additional capital charge for rating change for instance from BBB to BB is increasing by ~80%. Here it is also important to note that besides rating migration, capital charges are also driven by spread movements, ALM/currency mismatches, whether an issuer is a financial/non-financial etc. Hence Solvency II is making Insurance companies' investment process more pro-cyclical as they are incentivized to sell credit during market sell-offs.

- **Expect more fallen angels:** The size of the BBB segment (at €1.2tn notional) has more than doubled since 2010 to reach 50.3% of the iBoxx EUR IG index, and more than half of the BBB- market (currently €228bn) is on Credit Watch Negative (CWN) or Negative Outlook. Assuming that 50% of these BBB- issuers on CWN/Negative Outlook are downgraded (c. €60bn), the size of the HY index could increase by c.30% compared to Jan 2020; the question is whether the current HY investor base will be able to absorb it.

- **Downgrade pain has started**: Within the EUR iBoxx index (as of July 9th 2020), we note that c. €47bn of debt was downgraded from A to BBB, €44bn from BBB to high yield, and €108bn within HY by at least one notch. In terms of sectors, **Financials, Autos, Materials and Industrials** are likely to represent c80% of possible Fallen Angels risk in Europe. Indeed rating agencies have been active downgrading the most cyclical and exposed sector, while taking many more rating actions in HY than in IG. Should a second large Covid-19 wave be avoided, overall IG and the most defensive sector should stay safe from a downgrade perspective. The **main threat to corporate ratings in our base case scenario would be the downgrade of peripheral countries**, as it would immediately imply downgrades for most financials and to a lesser extent for non-financials, especially those with strong with government ties.

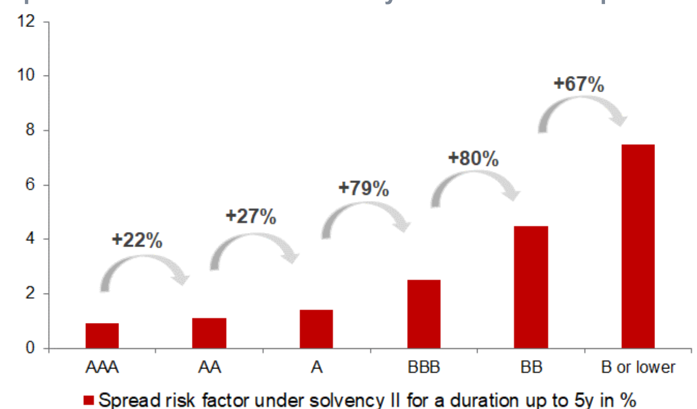
➔ Hence we recommend a **rather defensive positioning preferring IG and selective BBs to overall HY, and favouring defensive** sectors (Utilities Telcos) to most cyclical or impacted ones (Hospitality, Commercial Real Estate, Autos Basic materials, Oil & Gas). Nonetheless, spreads usually widen ahead of the downgrade, before tightening again when entering the HY benchmarks. Purchasing fallen angels selectively when they are still IG is often offering good risk/reward.

Managing credit migration actively

With GIAM, we monitor credit risk closely and proactively. We analyse an issuer's recent historical performance, meet management teams to understand their challenges and their plans to mitigate such risks and factor this to adopt a forward-looking approach on assessing migration risk our credit portfolio. Our team of 15 strong sector analysts work closely with our macro team and our PM team to constantly review risk-reward on a forward-looking basis, factoring in base and downside scenarios. We are quick to cut back on risk which we deem unacceptably high, and look to add opportunistically where the risk-reward trade-off is positive.

➔ **This strong focus on issuer and security selection has allowed us to avoid defaults and keep our credit rating migration risk well below market averages** (details and numbers available on request).

Spread risk factor under Solvency II for a duration up to 5Y



Source: Bloomberg, MSCI, GIAM

05

Insurance sector: the day after

The Global Covid Crisis, both in its public health and economic dimensions, has come largely unexpected, after selected warnings failed to foster proper preparation. The most immediate reference is the 2008-09 Great Financial Crisis (GFC), though it differs in both nature and depth. First of all a negative impact on the real economy: from top to bottom, the drawdown in quarterly GDP should be about three times that of 2009. Second, a sharp increase in financial volatility, characterized by large declines in world equity markets, a widening of corporate spreads and a fall of core bond yields. A perfect storm for insurance balance sheets, though powerful policy intervention has greatly mitigated those moves.

A multi-faced shock for insurers

Global insurers and reinsurers have suffered directly and indirectly from the coronavirus outbreak:

– **Directly** through a potential spike in claims (limited): the still relatively low death rate, the exclusion of pandemics from business interruption policies, event cancellation and contingency protection should limit direct impacts, both in Life and P&C. So should the exclusion of new viruses from critical illness policies.

However, there is **mounting political pressure on insurers** to take care of these critical issues, trying to mitigate the negative effects for policyholders. While it is difficult to quantify the impact at this stage, credible estimates suggest that globally the insurance industry could face a record bill of **$100+bn** this year due to claims related to the coronavirus pandemic.

– **Indirectly**: through risk asset valuation, low interest rates, and the adverse impact on business volumes (new production) from the recession. Adding losses investment portfolio, the bill for insurers could reach **$200bn,** far in excess of historical events such as Hurricane Katrina in 2005 and the 9/11 terrorist attacks. Let us offer more details about the indirect effects:

○ **Business volumes**:

Life insurance: **households risk aversion** will **increase, penalizing asset management businesses** in general and **unit-linked policies** in particular.

Policyholders will demand more guarantees, which will have to be wrapped in an innovative way to be sustainable for insurers. **Multi-lines products** (**hybrids**) for example, may meet the needs of clients both in terms of **capital protection** and **higher returns** when equity market volatility has normalized.

P&C: the **impact** of the pandemic crisis on Non-Life insurance will be **less severe**. Many insurers have already guaranteed the **suspension of motor policies** or **discounts** on renewal to their clients due to the reduced road usage of most drivers. This will lead to **a decrease in motor premiums collections**. As far as the Non-Motor segment is concerned, the health emergency will favour **health** insurance, expected to increase, albeit at a slow pace. **Property** line of business will be negatively affected by the decrease in investments in machinery and construction as well as by bankruptcies of small and medium-sized enterprises. Likewise for **Credit and surety** lines (bankruptcies and breakdowns in the supply chains).

Indeed, the overall expected drop in sales is about 1% for the European insurance equity sector - better than the whole market which should experience a decrease of about 9% in 2020 (see table). A rebound in 2021 and 2022 should take place.

○ **Profitability**:

The Life segment will be affected by impairments, as well surrenders triggered by income loss (liquidity needs) and the increase in risk aversion (unit-linked). This could

Earnings and Sales revisions

Index	YTD Earnings Revision			YoY Earnings Growth		
	2020	2021	2022	2020	2021	2022
MSCI EUROPE	-36%	-22%	-17%	-28%	32%	17%
MSCI EUROPE INSURANCE	-18%	-7%	-7%	-10%	20%	8%
MSCI WORLD INSURANCE ($)	-19%	-8%	-3%	-11%	22%	8%

Last update: June 17, 2020

Index	YTD Sales Revision			YoY Sales Growth		
	2020	2021	2022	2020	2021	2022
MSCI EUROPE	-13%	-10%	-9%	-9%	7%	3%
MSCI EUROPE INSURANCE	1%	2%	8%	-1%	4%	3%
MSCI WORLD INSURANCE ($)	-2%	-1%	13%	-2%	4%	5%

Last update: June 17, 2020

Source: Thomson Reuters, GIAM

represent a major concern in particular for **Traditional Life business**.

In P&C we see a milder impact (as was also the case during the 2008-09 financial crisis), as the loss ratio improves in motor as well as fire and other damages (corporate), thanks to lower accident frequency.

The largest hit to profitability comes from **impairment losses** on the companies' assets, to be recognized in the profit & loss account if there has been a significant or prolonged decline in the fair value of the investment below its purchase price.

➔ The **overall expected drop in earnings is about 10% for the European insurance equity sector**, better than the whole market (seen at -28% in 2020).

- **Liquidity**:

With financial markets suddenly more volatile than they have been for more than ten years, the pressure on companies' liquidity is high due to:

- higher margins on derivative markets;
- surrendering on unit linked products, when a portion of assets is illiquid.

Moreover, the insurance industry, like other businesses, is experiencing:

- a decline in the new business;
- late/suspension payments from policyholders;
- in contrast, insurers meet their commitments on time, offering support and liquidity to agents and clients.

In case of an intensification of the global recession an increase in surrendering life policies (segregated funds) might occur. These trends may result in a compression of companies' liquidity and/or forced selling of securities in a less liquid market.

- **Asset market / Solvency**:

Insurers tend to have common and concentrated exposures to sovereign, corporate and financial bonds as well as listed equities. Short-term volatility and falls in values affect insurers' investment equities, though for some contracts the loss is shared with policyholders.

Lower yields are generally negative for insurers' **fixed income** investments. Sustained lower yields are particularly problematic as they crystalize reinvestment risks, enhancing also the **duration mismatch**. The hunt for yields has also led many insurers to take more **credit risk,** although this has largely remained in the Investment Grade (IG) space. Rising defaults on corporate will be a drag for those active in the High Yield space while rating migration will be an issue for all (see previous section on Credit).

The outlook remains challenging; low interest rates, higher risks from lower grade credit and higher equity volatility will force insurers to review their overall financial management strategy to maintain an appropriate **capital (S2) and liquidity buffer** (also via lower dividend payments). Overall we expect an effort to protect capital positions, partly via de-risking and a reduction of the duration gap. Leveraging on a **strong internal credit research will be key,** to limit losses from downgrades (rating transition costly in capital) and rising defaults. This applies as much for the illiquid book as for the traded book, and has specific implications for the Matching Adjustment portfolio. Expect regulators to toughen up on interest rate mismatch and transitional measures: even if changes will be gradual, Shareholders will be penalized at the expense of Policyholders.

Notwithstanding:

- the current market stress that had a material impact on solvency coverage ratios: EU life insurers experienced a fall on average of about 25pp in their Solvency Ratio; this would have been closer to -50pp without applying the Volatility Adjustment;

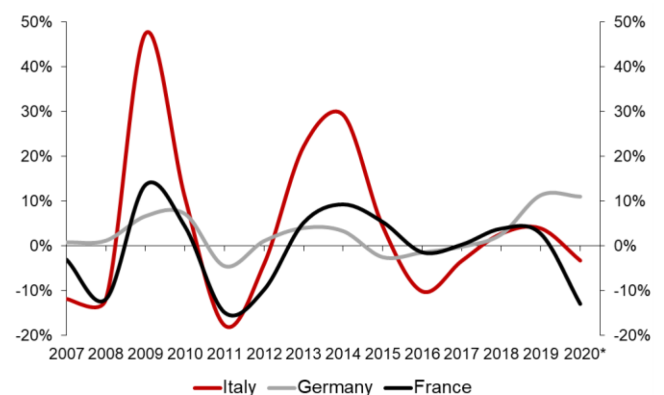
- the repricing of illiquid investments that has yet to be reflected as a result of the (potentially) changed market environment (assuming a fall in illiquid assets' value similar to the one experienced during the GFC, life insurers' Solvency ratio could further worsen by 10 to 20%);

the annual solvency capital generation should remain relatively strong. A drop of about 25pp in solvency ratios was observed across Europe in Q1 but a rebound of about 10pp is expected in Q2, driven by narrower credit spreads and a rebound in equity prices and earnings.

Business opportunities and risks

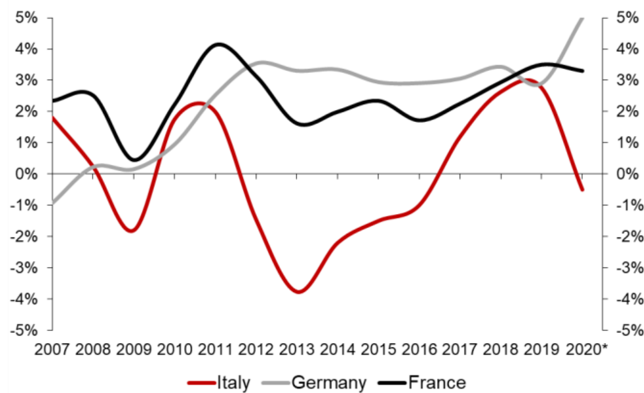
The post-Covid world will require financial institutions to pursue new challenges and business paradigms driven by

Life Insurance Premiums dynamic for main EU countries



Source: GIAM Research **Q1 YoY data*

P&C Insurance Premiums trend for main EU countries



Source: GIAM Research **Q1 YoY data*

changes in individual/corporate behaviours and needs. Clients are likely to seek more protection, which may increase the social role of insurers (including ESG goals). This creates both challenges and opportunities:

– Insurers will be asked to support the **(EU) recovery plan** integrating the green transition and digital transformation, while meeting their financing obligations and fiduciary duty. As long-term investors, insurers should be inclined to finance such investment plans, provided that regulation do not penalize them. Tax incentives for final investors facing a given degree of illiquidity to their policies may prove effective, together with an acceptable capital absorption rule.

– **M&A opportunities** will arise in light of the drop in market capitalizations. The target should be to seek higher growth/margin businesses and build digital and *Insurtech* capabilities.

– We see primary insurers willing to **consolidate** and **carve out run-off portfolios to specialized players**.

– **Making healthcare more available and accessible**: the pandemic might persuade more people to reconsider their needs, leading to a rise in sales of health insurance, critical illness and life coverage, even in countries where the public health system provides universal coverage.

– **Offering better protection for the elderly** in a low yield environment, by **mixing life insurance and annuity products with long-term medical care**, where the full death benefit (for beneficiaries) or the cash value is available when the healthcare insured capital is not fully used.

– **Boosting Innovation** (product/service/distribution network): as the social purpose grows, product innovation will become more important. Specifically, insurers will be under pressure to **re-design products** to make them more applicable and adaptable to emerging risks such as pandemics and threats related to **climate change** and **protection needs**. One challenge in Life will be to increase **transparency**, so that clients better understand their investments and more easily follow performance. This will be most needed if insurers want to sell capital-light products, while clients' traditional reluctance for Unit linked increases after a market downturn. Innovation will also be pursued in the field of **claim handling** and **remote interactions**, including **electronic documentation** handling and, more proactively, **telemedicine**.

– On the **Asset Management side,** the pandemic may provide tactical asset buying opportunities (asset dislocation, in the fixed income and the alternative space, EM equities and High Yield in the longer run), though this will be constrained by capital costs. Expect a broader move towards sustainable investing. ESG criteria have increasingly informed investment strategies and decision-making, and **positive flows into ESG funds are an accelerator of change**. The Covid-19 crisis will only reinforce that trend. Communicating and demonstrating the industry's social purpose will feature heavily in due diligence of acquisition targets and investment decisions.

– **Digital as mainstream**: digital technologies and **cybersecurity** are key to guarantee protection to asset, productive activities and people (privacy and savings). Insurers will need to accelerate the digitisation efforts, replacing processes that currently rely on face-to-face interactions. **RoboAdvisors** will be conceived as an 'omni-channel' digitalization tool for the investments value chain, not just an investment engine.

– **Sustainability** will require a strengthening of governance systems to support responsible businesses and contribute to a fairer society.

On the other hand, adapting to the new environment will bring exposure to new risks and associated costs:

– **Fraud & Cyber risk**: the risk of fraudulent claims over a range of insurance lines increases when economic conditions deteriorate, particularly when unemployment increases. The Covid-19 pandemic has revealed the weakness of the financial services industry in detecting frauds, including cyber frauds. In the UK for instance, the **National Crime Agency** (NCA) expects to see an increase in **authorised push payment** (APP) **fraud**: in 2019, a total of £456 million was lost to APP fraud, split between personal (£317 million) and business (£139 million) accounts. The risk of internal fraud will potentially increase due to **remote working** and associated reduced oversight and challenge.

– **Reputational risk**: public trust in insurers and supervisory authorities is **critically important** to mitigate any impact on the insurance industry. The increasing pressure on the industry by governments and industry

lobby groups to honour the "social contract" could undermine the reputation of the sector (as happened for banks in the 2008-09 financial crisis).

– **Capitalization risk**: some insurers may see **liquidity constraints**, if product cancellations and surrenders increase significantly, while new business and renewals decline in the face of deteriorating economic conditions. As a result, cash management - including intra-group - would likely be key in order to minimize new debt and capital injections.

New LDI Behaviours and Trends

During the past few years, the main challenges related to investment management decisions for insurance companies were **protecting their income**, sourcing **decent yields** on the bond market and optimizing their bond portfolio allocation in term of "**capital intensity**". The compression of spread premiums however pushed companies to look at long-term illiquid investment or to invest in High Yield bonds, which also have a higher spread capital charge.

The macroeconomic scenario which has started to unravel, following the major Covid-19 shock and measures enacted by policymakers to support the economy, will, if anything, amplify the magnitude and prolong the duration of such trends. "Lower rates for longer", in the presence of financial guarantees to be met, will require insurance companies to continue using these two leverages to reach their income targets: **lower creditworthiness and lower liquidity**. However, compared to the pre-Covid period, assets dislocation in the fixed income space as well as new opportunities in private markets (e.g. distressed assets) may create more compelling opportunities for investors equipped with sound risk management practices.

On the equity side, disregarding any consideration on market valuation, one observation has to be added for liability-driven investors that used to rely also on equity to reach their income targets. In the short term, political pressure and **regulators' intervention on dividend policies** in certain key industries have to be factored in.

Excluding extremely conservative allocation choices that would significantly endanger the profitability of the business, it is safe to assume that, ceteris paribus, in the post-Covid world many insurers will have to face a higher level of risk for a prolonged period. To avoid its undesired consequences on capital positions and P&L, we foresee that a larger proportion of insurers will recur to **volatility control and drawdown protection mechanisms** on their funds, though they will need to accept increased costs of hedging in a world characterized by a higher level of implied volatilities.

A different approach to reduce the risk of negative tail events and reduce the overall volatility of the portfolio would be to unlock the diversification potential that factor investing can provide, especially through specifically designed strategies such has **low-volatility and quality factors**. Those concepts are already well known among insurers, but for many are still not an integral part of the investment framework.

Inevitably, the effects of market dynamics and investment management decisions will end up on the tables of **capital and product management** departments. Increased allocations to High Yield or illiquid segments of the market, rating migrations and a more volatile environment will put pressure on insurance companies to strictly control their interest rate capital charge and direct new inflows towards less capital-intensive products. We already saw an aggressive shift towards unit linked contracts, especially in several European countries, like France, where the allocation was historically very low due to policyholder preferences.

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