INFLATION

The rise and fall of inflation

Clients should re-examine their management of inflation risk and seek to enhance efficiency of capital structures, say Guy Carpenter's Richard Hewitt (left) and Jay Dhru.

Over the past three years, economic inflation has consistently been one of the top concerns cited by re/insurers' CEOs and CFOs in a global cohort of 45 companies in their earnings calls with analysts and investors. The latent and lingering effects of the COVID-19 pandemic, disrupted supply chains, higher energy prices, constricted labour markets and uneven demand growth led to the spike in inflation that peaked in 2022.

Since the end of 2022 however, inflation has been on a steady declining trend, drawing nearer to many central banks' 2 percent headline targets.

Implications for reinsurance

Reinsurers have largely been able to mitigate the effects of higher inflation due to increased pricing, as the market responded to increased catastrophe frequency and high loss costs in multiple lines. This is resulting in more stable margins on current year insurance business.

> “Higher new money reinvestment rates have provided an additional tailwind.”

Since the Federal Reserve's primary monetary policy tool to combat inflation has been to raise interest rates, higher new money reinvestment rates have provided an additional tailwind for reinsurers' earnings. To put this into context, in 2022, the 10-year US Treasury yield more than doubled to ~3.6 percent, which it had not done since at least 1980, and at August 21, 2024 was ~3.8 percent.

KEY POINTS:

- More stable margins on current year business
- Price competition expected to intensify
- Inflation remains a pernicious tail risk

As inflation has recently cooled, nominal bond yields have remained relatively stable. The implication is that real bond yields—the difference between the nominal bond yield and headline inflation—have improved and, in some cases, turned positive in the past 12 months. This can be ascribed in part to financial markets wanting to see further evidence that a low rate of inflation is sustainable over the long term.

As most of reinsurers' investments are held in bonds, and reinsurers' investment leverage at the end of 2023 was approximately 3x, nominal and real yields are a significant driver of P&C earnings and value, according to the Guy Carpenter Reinsurance Composite (GCRC). We note that investment income's share of reinsurers' P&C earnings is forecast to be approximately 40 percent for 2024/25, also according to the GCRC.

As a result, lower inflation and rising real investment yields should be a boon for reinsurers' current year underwriting margins, and elevated nominal investment yields can be expected to remain a tailwind for their investment income. But conversely these factors can also be expected to intensify price competition.

More challenging for some, though, has been the adverse impact of inflation on prior year reserves, longer tail lines in particular. Favourable development of shorter tail lines, where it exists, can be a helpful offsetting factor to adverse development.

Nevertheless, this is not the time for complacency on inflation even after its falling back significantly in the past year toward 2 percent. Inflation remains a pernicious tail risk and there is potential for its outlook to remain above 2 percent. Therefore, we would advise clients to stress test for alternative long-term scenarios and consider contingencies, including retrospective reinsurance, where appropriate.

How Guy Carpenter can help

Shifts in the macroeconomic environment and market conditions demand a rigorous focus and response. Looking forward, our clients should re-examine their management of inflation risk and seek to enhance efficiency and flexibility of capital structure.

> “We would advise clients to stress test for alternative long-term scenarios.”

We can help our clients solve their complex issues through the effective use of reinsurance, including structured and capital-oriented solutions, particularly in the areas of capital, volatility, legacy and business transformation.

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