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INSIGHTS SUMMARY

Market Headwinds Offer Opportunity Tailwinds

T. Rowe Price representatives recently discussed the challenging current macroeconomic environment and where investment opportunities exist for insurance company investors.

October 19, 2022

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Economic Outlook—Current Investor Concerns

- **Growth**—Gross domestic product (GDP) forecasts keep going down, while consumer price index (CPI) forecasts keep going up. Growth predictions have been accurate, while inflation predictions have not.
  - Forward-looking Purchasing Managers' Index (PMI) indicators in China have been improving
  - European and U.S. indicators continue to head south
  - Manufacturing and servicing PMIs are still pointing down but have not yet reached crisis level
  - **TRP Outlook:** We are forecasting that PMIs continue to remain weak
    - We feel the likelihood of a recession in Europe is 100% and in the U.S. is greater than 50%

Consensus Forecasts—Lower Growth, Higher Inflation

As of September 30, 2022

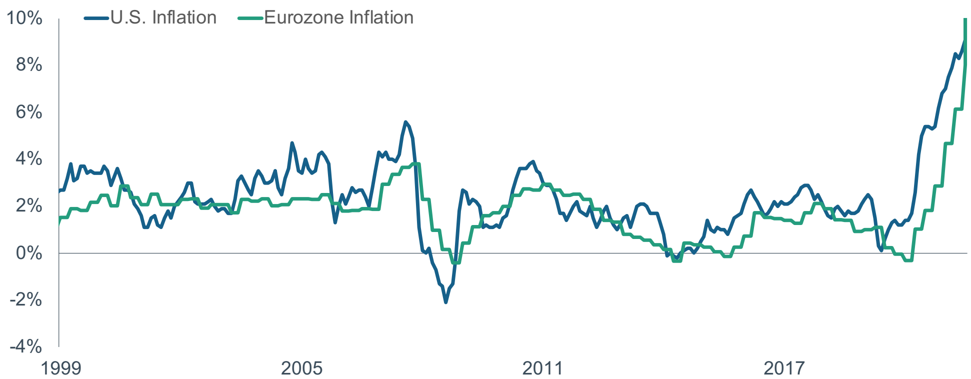
Percent (%)	GDP 22	GDP 23	CPI 22	CPI 23
U.S.	1.6% ▼	0.7% ▼	8.0%	3.8% ▲
China	3.3 ▼	5.0 ▼	2.3 ▼	2.3
Eurozone	3.0 ▲	0.2 ▼	8.2 ▲	5.1 ▲
Japan	1.6 ▲	1.5 ▼	2.2 ▲	1.4 ▲
World	3.7 ▲	3.8 ▲	3.3 ▲	3.3 ▲
EM	5.1 ▲	5.1 ▲	4.1 ▲	4.1 ▲

CPI is consumer price index. Inflation, average consumer prices.
Sources: Bloomberg Finance L.P., Morgan Stanley.

> The macro outlook is not for the faint of heart, but that environment creates incredible opportunity.
>
> *— Andy McCormick*
> *Head of Fixed Income and CIO*

Inflation—A Global Challenge

As of September 30, 2022

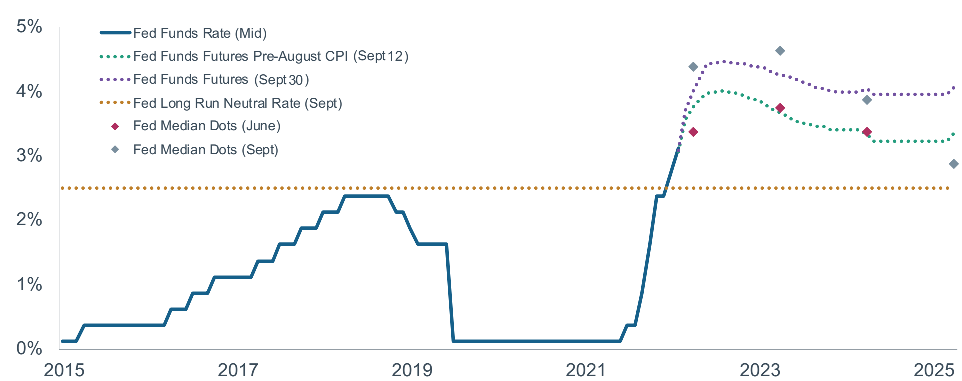


Source: Bloomberg Finance L.P.

- **Inflation**—It is a rough story. Looking at the components of inflation:
  - Gas prices have risen significantly, while home prices have been soft and used car prices have come down
  - Core goods, especially food prices, remain hot (partly due to the food/fertilizer supply chain from Ukraine)
  - Energy costs are easier to deal with than food prices
  - In the services sector, rents remain stubbornly high
  - **TRP Outlook:** We feel inflation will slowly and grudgingly come down

U.S. Interest Rates—Rising Terminal Rate

As of September 30, 2022

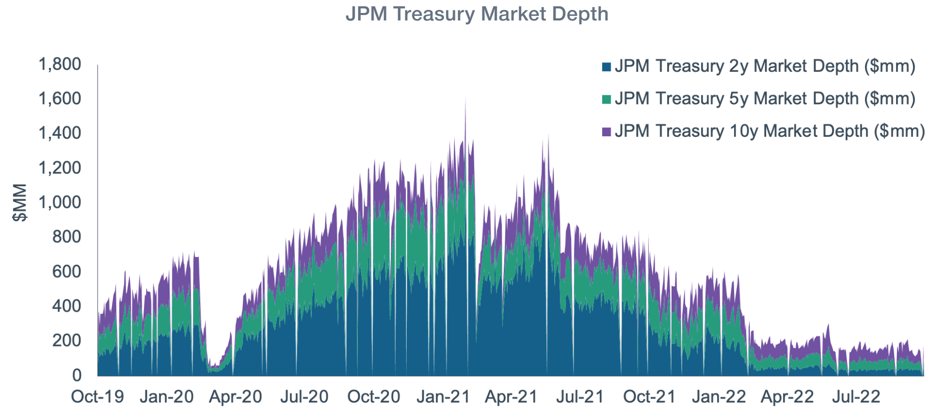


Source: Bloomberg Finance L.P.

- **Interest Rates**—The trick is to identify the terminal rate of fed funds
  - The market continues to build in additional rate hikes as inflation prints continue to come in higher than expected
  - The terminal rate is the only thing driving rates higher and continues to be the problem
    - Every time the terminal rate ratchets higher, the probability of a recession goes up with it (represents an inverted curve)
  - A yield curve inversion of 50 basis points represents hedging against recession
    - A 50 basis points yield curve inversion doesn't scare the Fed, while a 100 basis points inversion would
  - **TRP Outlook:** Until the end game of rising rates is seen, investors will remain skittish

Liquidity at Levels Comparable to March 2020

As of October 12, 2022



Source: J.P. Morgan Chase.
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- **Liquidity**—The systematic issues are possibly more terrifying than that of inflation and might require regulatory or legislative action to remedy
  - There have been recent bouts of illiquidity in the Treasury markets, which is not normal or healthy behavior and is akin to emerging markets rather than developed markets
  - The structural problem of the markets goes back to the Volker Rule, which came into effect in 2015
    - The Volker Rule curtailed dealers' ability to warehouse and use balance sheet assets in trading
    - But this change in market structure was never tested as the Fed and others poured monies into the system. As a result, liquidity wasn't an issue
    - Dealers have been using their balance sheets for passive exchange-traded fund trading because it's profitable and done at an agreed-upon price at the end of the day
    - Today, this change in market structure is being tested by tighter monetary policy and the increased use of derivatives, which preserves cash on balance sheets
      - However, if you can use balance sheet assets when a counterparty needs to raise cash, those providers of liquidity can source opportunities
  - **TRP Outlook:** These market dynamics are not changing anytime soon, so the trick is to get on the right side of this illiquidity dynamic
- Do public credits still offer the liquidity they have traditionally?
  - The illiquidity premium has risen in public credits versus a decline in private credits
  - Some are worried while others are not: Where can I get paid for illiquidity?
  - Public market liquidity is worse than it used to be and can now be viewed as moment to moment and asset to asset specific
    - We need to better understand what environments work well for some assets and not for others
    - History may not be a guide moving forward

As active managers, we look forward to volatility in markets

- For 10 years, with volatility suppressed by central bank polices, prices barely changed due to tight spreads and low yields. This was a historical aberration.
- Uncertainty around future economic data and rates is exactly what is needed as it creates opportunities
- Volatile markets will reactivate the muscle memory needed to take advantage of dislocations

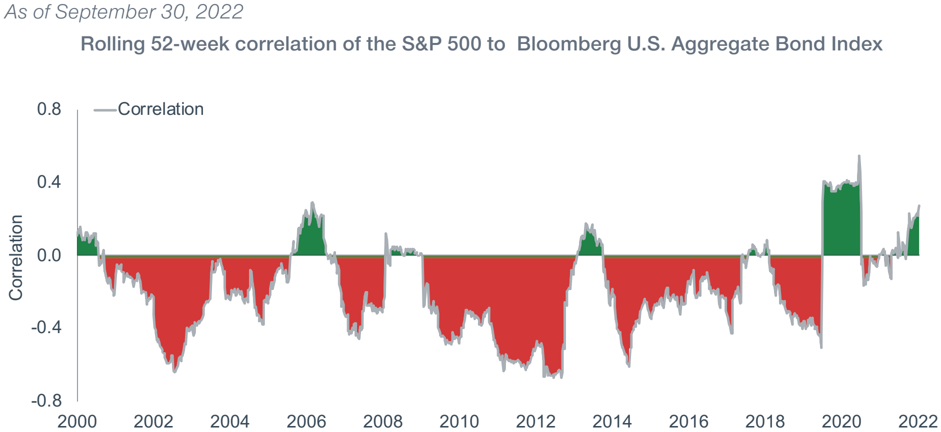
- As an example, the recent gilt situation in the UK brings back the market dynamic of what investors can sell versus what they want to sell, leading to some interesting entry points
- Some short-term opportunities are not always due to fundamental reasons but, rather, painful market disruptions

Is this the end of the 60/40 portfolio?

- For years, money pouring into the systems (i.e., central banks) masked problems and inflated asset prices
  - As money has been pulled out of the financial ecosystem, asset prices have gone down
  - This is an adjustment, not a permanent change
  - Many asset allocators would have said that the 60/40 portfolio was ending during the post-global financial crisis environment
    - The view was right, the journey was wrong...subtly
    - Economic growth was driven by liquidity versus inflation. This environment became perceived as "normal" when it really wasn't.
    - We were starting to see normalization of fed funds before the pandemic, but never saw it play out
    - Is the Fed now going to pivot from being worried about inflation to being worried about growth?
- It shouldn't be surprising that correlations break down during a stagflation environment due to unknowns, like a pandemic
  - We expect equity and fixed income correlations to revert back to negative
- Investors are being more thoughtful in hedging—diversifying their diversifiers beyond Treasuries
  - Portfolio construction: Don't just think of high-quality bonds, think of other diversifiers

What's Your Hedge?

As of September 30, 2022

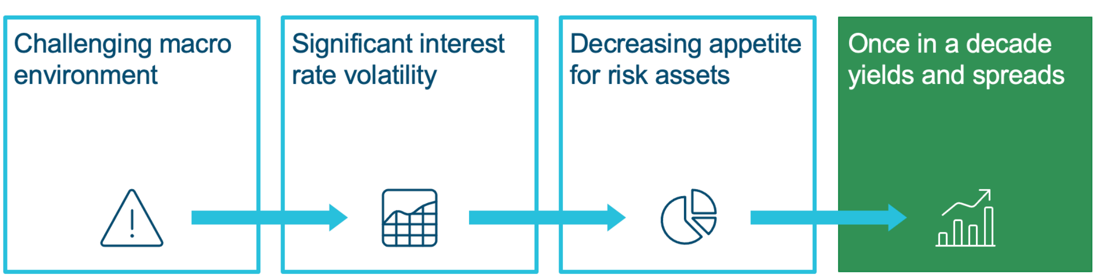


Source: Bloomberg Index Services Limited. Please see the Additional Disclosures page for more information about this Bloomberg information.

Looking Ahead to Investment Opportunities

- High Yield
  - Today's high yield market is different from the high yield market of old
    - More than half of today's high yield universe is composed of BB rated companies
      - Many companies are larger and, more substantial
    - Credits are very barbelled, offering opportunities at good value
    - The market refinanced itself, so there are limited maturities for the next two years, trending in higher quality

        - High yield is also attractive in emerging markets
            - Many emerging high yield companies have healthy balance sheets and attractive valuations
                - There is less debt accumulation, and underlying fundamentals look healthy
            - In many emerging market countries, GDP is running ahead of inflation as many countries raised rates quicker than developed countries
- Emerging Markets, Ex-China
    - Chile, Colombia, Indonesia, Philippines, India, Qatar, and Saudi Arabia look attractive and are beneficiaries of healthy balance sheets
    - They are at the shorter end of the yield curve with positive exposure to inflation (i.e., utility companies with inflation escalators, agriculture)
    - BB/BBB market segments contain considerable runway
        - We expect that low-single-digit/low-double-digit yield carry will convert into high-teens/low-twenties carry over the next few years
- The Securitized Markets
    - MBS
        - Relative cheapness and valuations are not about credit quality
        - Many municipalities are in better shape and are awash in cash, either from pandemic monies or from tax revenues, or both
    - CLOs
        - Allocation to private credit in a form that is regulatory and capital friendly
            - Top of capital structure with a little leverage
            - Clips a consistent coupon and has been a strong performer
        - For investments with a perceived remote loss potential, we believe that they have the potential for high returns
- Diversifying Into Private Credit?
    - Earlier this year, the debate was on whether the illiquidity premium to lock up capital was worthwhile
    - The denominator effect is constraining interest in privates as investors are now over-allocated
    - However, the pricing of privates in the last six months has made it more attractive, on a select basis
- General Asset Allocation
    - The risk of unexpected inflation is worse-than-expected inflation
    - One benefit to a flat yield curve is to pick up similar yield by moving shorter and not thinking about LDI hedging
    - Consider high-quality bonds and leveraged loans
    - Consider short-term Treasury inflation protected securities (TIPS) over longer-term TIPS



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