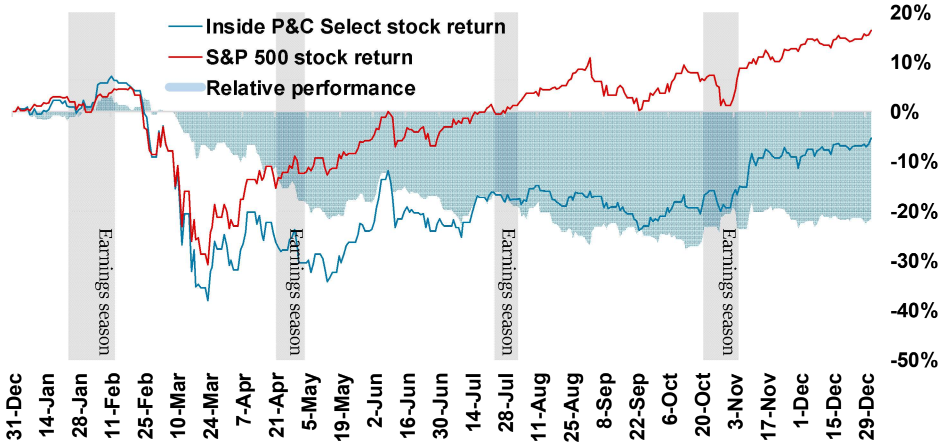
Stock market report
12 January 2021

2020 stocks review and themes on the 2021 agenda



The year 2020 for the stock market ended much like it began with the S&P 500 rallying to new highs and analysts telegraphing a bullish outlook. Following the 16% rally in 2020, market strategists expect another "green" year for the S&P 500 in 2021 with optimistic targets implying up to a 15% upside.

This is a truly remarkable outcome given that in the course of 2020 the world has undergone a global pandemic, a steep recession and countless record-breaking capital market events. This litany of records includes the fastest stock market drop, all-time low 10-year yields, the highest "fear index" since 2008, record outflow from junk bond funds and negative prices on oil futures to name but a few.

While the stock market spent the last four months of the year extending gains into the record high territory, P&C stocks struggled to recover losses and closed the year with the status of an "unloved" sector with 80% of the industry stocks still trading below their 2019 year-end level. The Inside P&C Select Composite (our select of 34 US listed P&C firms) was down 5.3% for the year.

The sector's underperformance was warranted by several factors including low interest rates, high cat activity, recession-related growth headwinds and cooler market sentiment on mature stocks.

Beneath the surface, individual industries and firms were able to pull off a positive year largely on the back of the pandemic-related benefits, including frequency benefits (personal carriers) and expense savings (brokers).

Now, with the broader 2021 story focusing on the "reopening" of economies the key question for P&C stocks will be the pace and extent of the return to normality. While there is a consensus that 2021 will become the recovery year for economies, there is still a significant divergence in how experts portray the post-pandemic world.

What exactly the world will look like after the shock – in-between the two extremes of the pre-pandemic normality and a secular shift in the behavior of all economic agents – will have profound implications for the relative valuations in the P&C sector.

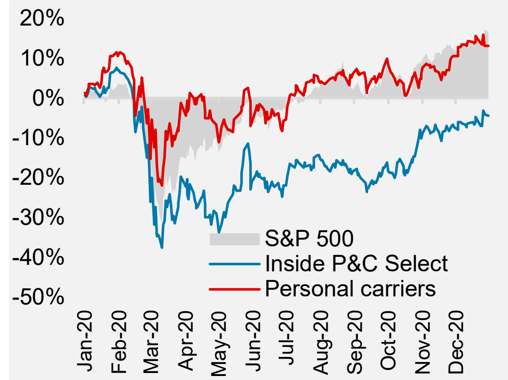
In the commercial space, with frequency benefits manifesting themselves more broadly, the question is which companies will be the first to detect the business lines with secular shifts in loss trends and win share before it becomes apparent to everyone else.

Inside P&C Research

Dan Lukpanov, CFA
Research Analyst
E: dan.lukpanov@insidepandc.com
T: (212) 224 3326

Composite	YTD px chg.	P/B
Large comm.	1.2%	0.9x
Regional	2.4%	1.4x
Specialty	0.5%	1.6x
Personal	(2.3)%	1.9x
Bermuda	0.6%	1.1x
Florida	2.5%	0.9x
Brokers	(4.0)%	-
IPC Select	0.3%	1.2x
S&P 500 Fin.	5.1%	-
S&P 500	1.2%	-

1YR Price Peformance



A clear bull case for commercials stocks broadly in 2021 is to prove their ability to extract enough rate in excess of trend to compensate for lower new money yields and to maintain their long-term double-digit ROE targets.

Furthermore, even as the sustained market hardening remains a consensus view, the year will likely provide clues on how much further carriers can push the current market firming cycle in an environment where rate in excess of trend and frequency benefits are manifesting more broadly.

Also, with interest rates seemingly past the inflection point now, whether the rates continue to mean revert or swing back to their long-term downtrend will have important repercussions for the industry and for the financial sector more broadly. With the Fed pointing to continued monetary accommodation and asset managers sending notes of caution about unsustainably low yields, the market views on the future path of the rates remain highly binary.

In the personal lines space, with the frequency benefits are likely to be competed away in the near term, as the industry turns its focus back to omni-channel competition (e.g. Allstate's recent strategic pivot).

Importantly, the disruption potential within personal lines will be a thematic issue, as markets continue to price for substantial market share gains by the recently floated InsurTechs, with more IPOs likely to come.

In summary, attempts to predict the future are always akin solving an "underdetermined system of equations". While 2021 is unlikely to give answers to most of these questions, it is likely to add more equations than the unknowns, providing more clues to the future of industry stock performance.

More details below.

The year of peripeties

The year 2020 was one of the most memorable in the history of the capital markets. It started with the markets turning highly complacent in January about the Fed's dovish rhetoric, despite the strong economic fundamentals and the temporary resolution of the US-China trade war.

Even as coronavirus was showing early signs of emerging as a real global threat in early January, these factors drove the stock market to new highs and corporate credit spreads narrowed to near all-time lows.

However, as soon as late February the pandemic turned the capital markets binge into a massacre, which was associated with countless record breaking events, including the fastest stock market drop, the all-time low 10-year yield, the highest "fear index" since 2008, record outflow from junk bond funds and negative prices on oil futures.

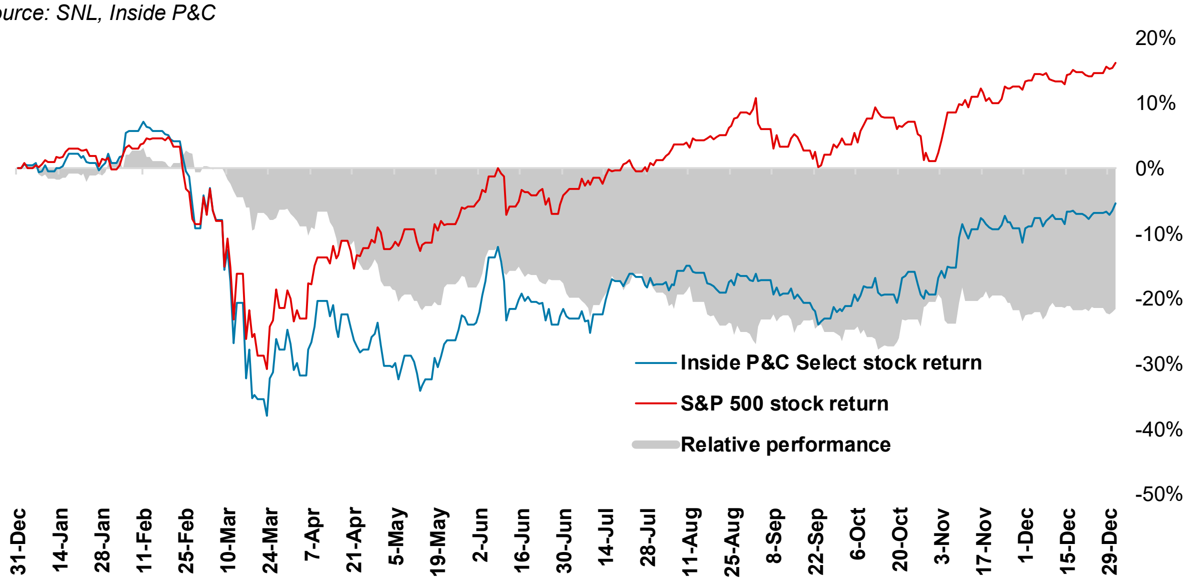
What happened next was no less historic. The unprecedented stimulus programs from the central banks and governments of the world's largest economies fueled inflation of most asset values, quickly turning the V-shaped curve into the most common chart pattern for publicly traded assets.

The resulting market rally has proven highly resilient. Through the second half of the year, the market continued trending up at a remarkable pace, largely disregarding the negative headlines from the economic, pandemic and political fronts.

Despite the deepest economic downturn in history and the associated struggles that no one imagined were possible at the beginning of the year, the S&P 500 ended the year up by 16.3%, far surpassing the 5% forecast telegraphed by the strategists at the end of 2019.

Exhibit: 2020 performance. Inside P&C Select vs S&P 500

Source: SNL, Inside P&C



For P&C stocks, of course, the macro environment was by far the most important driver of the valuations in the year. However, following the selloff in the spring, the sector struggled to follow the market's push to new highs in the second half, as investors preferred to overweight growth stocks over traditional industries. For the year 2020, among 39 carrier and broker stocks in our coverage, only 12 ended the year in the "green" territory.

Exhibit: P&C stocks ranked by 2020 performance

Source: SNL, Inside P&C

	Company	Trough vs year-start	Annual gain/loss
1	Watford	-54%	38%
2	Progressive	-8%	37%
3	AJ Gallagher	-28%	30%
4	Brown & Brown	-20%	20%
5	RLI	-24%	16%
6	HCI	-27%	15%
7	Mercury	-30%	7%
8	Marsh & McLennan	-31%	5%
9	Willis Towers Watson	-27%	4%
10	Selective	-37%	3%
11	Travelers	-40%	2%
12	Aon	-30%	1%
13	Kemper	-28%	-1%
14	Chubb	-39%	-1%
15	Allstate	-35%	-2%
16	Horace Mann	-28%	-4%
17	WR Berkley	-37%	-4%
18	Donegal	-22%	-5%
19	Third Point	-43%	-10%
20	Markel	-35%	-10%
20	CNA	-42%	-13%
21	Hanover	-39%	-14%
22	Axis	-44%	-15%
23	RenRe	-39%	-15%
24	Everest Re	-42%	-15%
25	Arch	-48%	-16%
26	Cincinnati	-54%	-17%
27	Hartford	-57%	-19%
28	AFG	-57%	-20%
29	Heritage	-32%	-24%
30	Alleghany	-43%	-24%
31	AIG	-63%	-26%
32	Greenlight	-48%	-28%
33	Argo	-60%	-34%
34	United Fire	-56%	-43%
35	State Auto	-61%	-43%
36	Universal	-60%	-46%
37	United Ins	-65%	-55%
38	FedNat	-70%	-64%

The top quartile in the performance league was dominated by the public brokers, personal carriers and the stocks with high growth profile (RLI, HCI) or a company-specific corporate event (Watford sale). Commercial carriers are generally settled in the middle of the ranking. Finally, the bottom half of the league is populated by the Floridians, reinsurers and life exposed carriers.

These patterns in the performance divergence were justified by several macro and industry specific trends that prevailed during the year. We highlight some of them below:

- Low yield favored the stocks with low interest rate sensitivity. Brokers were the biggest beneficiaries of the low rates. In contrast, the low rate environment disadvantaged most carriers due to their reliance on net investment income. As a rule of thumb, short tail lines have the lowest exposure to interest rates, followed by long tail lines with a higher exposure and life insurance carriers with the highest degree of reliance.
- The “remote” economy reduced the frequency of claims largely due to less driving, which produced a substantial margin benefit for personal carriers. In the commercial space, after sporadic signs of lower claims activity in Q2, the frequency benefits started manifesting more broadly in Q3.
- Relatedly, the remote economy allowed firms to extract expense savings from lower travelling. The effect was most pronounced at client-facing businesses, i.e. brokers.
- Another year of above-average cat activity pressured the stocks with significant catastrophe risk, particularly those with Southeast US exposure.

Macroeconomy and the industry’s future

From a macro perspective, with the broader 2021 story focusing on the “reopening” of the economies, the key question for P&C stocks will be the pace and extent of the return to normality. The “remote” economy has been a key to investor desires to overweight growth and tech stocks over value and defensive names in 2020, which led to the underperformance of traditional sectors including P&C carriers.

While it's clear the world will never be same again, where exactly it lands between pre-pandemic normality and a complete shift in the behaviors of all economic agents will have profound implications for the relative valuations in the sector.

Similarly, the level of interest rates during and post the recovery period will be an important driver of the valuations. While the recent upward momentum in interest rates seems encouraging for the financial stocks, the Fed rhetoric to date suggests it remains committed to maintain its highly accommodative monetary stance for several years ahead, with further expansion of stimulatory actions also being considered. This may mean there is sustained pressure on the interest rates, which may hurt long-term ROEs of P&C carriers, other things being equal - particularly the firms with life insurance exposure.

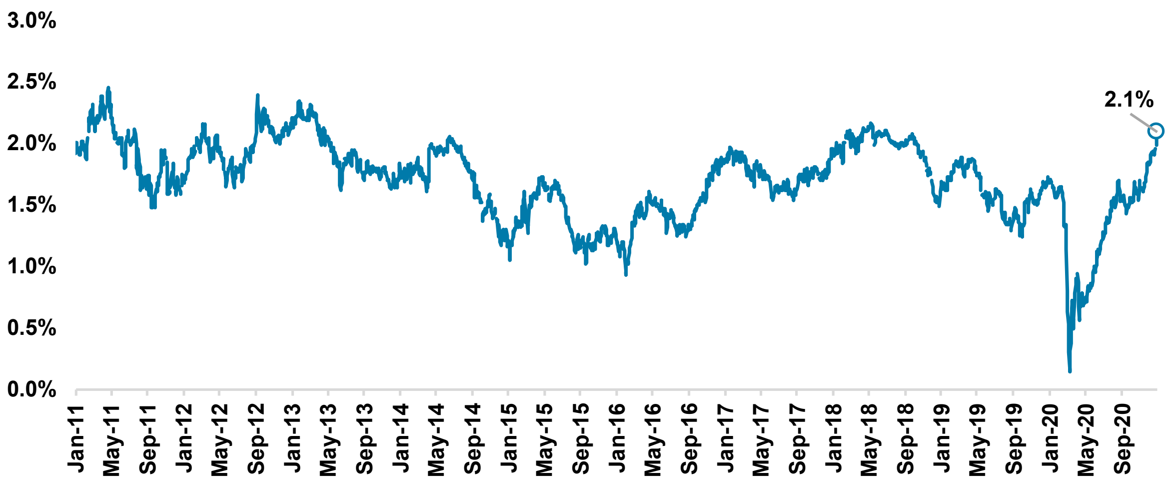
Finally, although it seems not to be much of an issue now, inflation is one of the biggest risks to the current bull market and P&C stocks in particular, which are typically cherished during deflationary periods. Inflation risk has historically been the highest when the government and central banks acted like there is no such risk.

With the accommodative monetary policy projected to remain for years to come and the growing sense of sustained fiscal support, the risk of overheating the economy during the recovery phase seems tangible. The Fed's so-called symmetric inflation targeting, which means the central bank will allow the inflation to overshoot the 2% target, provides further support for such risk.

Note, inflation expectations have been accelerating heading into 2021. The 5-year breakeven inflation rate – a widely used proxy for inflation expectations – is currently hovering right below the 6.5-year high.

Exhibit: 5-year breakeven inflation rate

Source: Federal Reserve Bank of St. Louis



Industry trends under the spotlight

Despite the fact that macro events were by far the strongest force driving P&C equity moves, the sector was distinguished by several important industry-specific drivers.

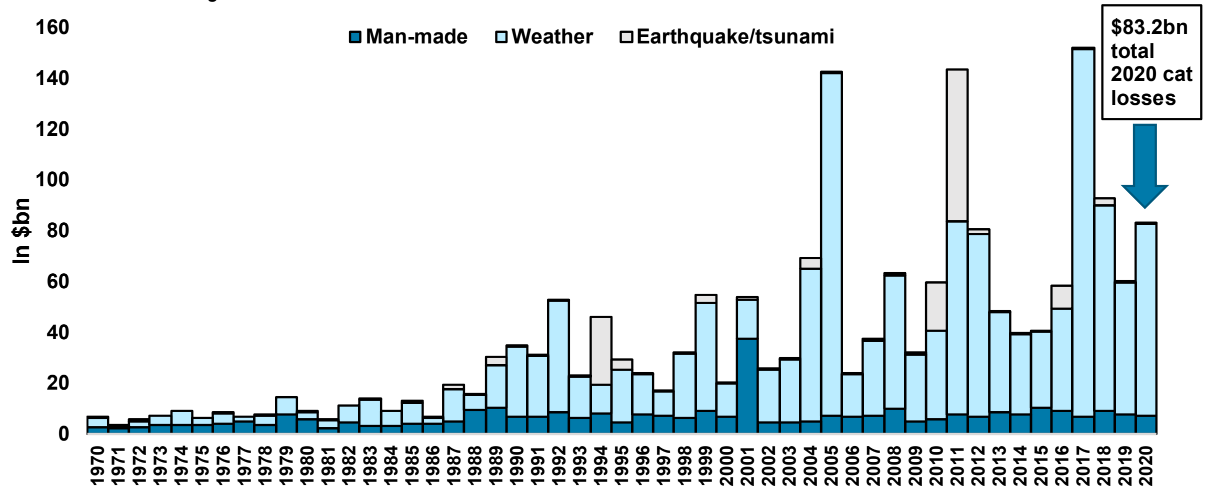
The year was the fifth biggest on record for catastrophe losses after adjusting for inflation. The industry suffered over $80bn of catastrophe losses globally of which $75bn came from weather-related events, according to the data from Swiss Re.

Covid losses added to the cat exposure although the losses were substantially less than initially feared. As of year-end, the real-time global Covid losses totaled up to $30bn. Although the highest exposure to the pandemic losses was registered at the European carriers, including Munich Re (over $4bn), Swiss Re ($3bn), Axa ($1.8bn) and Allianz ($1.5bn), there are insurers at the other side of the Atlantic that too reported losses of close to a billion or more, including Chubb ($1.4bn), AIG ($0.9bn) and Berkshire Hathaway ($0.9bn).

Exhibit: Annual historical data for global catastrophe losses

Note: data for 2019 and earlier are in inflation-adjusted for 2019 prices

Source: Swiss Re Sigma



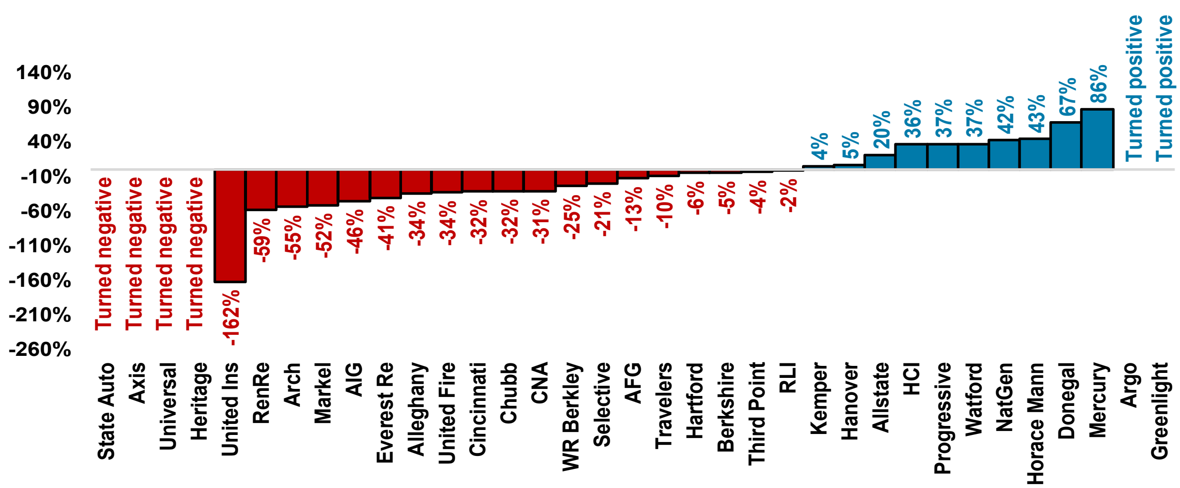
Within the commercial space, most carriers continued to report social inflation headwinds. Furthermore, the recession made a material impact on topline growth as lower economic activity pressured new business flow, although retention generally remained resilient as businesses mostly remained solvent.

However, there were offsetting factors that helped carriers cut the losses or even excel (e.g. Progressive) in this grim macro environment. Rates in the commercial space continued to pick up during the year at an accelerating pace as low interest rates and the pandemic-induced losses added fuel to the pre-existing trends. Also, in Q3 frequency benefits started to manifest at commercial carriers more evidently and broadly, something that personal carriers had significantly benefited from since the pandemic began in March.

The combination of the macro and industry factors listed above had a net negative impact on the earnings of most commercial carriers and reinsurers. Conversely, the personal lines profits mostly benefited from these trends. Two-thirds of carriers in our coverage are set to report negative EPS changes for the full year 2020.

Exhibit: 2020 EPS growth consensus estimate by individual firms

Source: FactSet



Going forward, one of the central questions for commercial carriers will be whether they can extract enough rate in excess of trend to compensate for lower new money yields and maintain long-term ROE targets. This is something that many carriers shared optimism about during Q3 earnings, most notably Travelers and Chubb.

Also, with frequency benefits manifesting more broadly in commercial space, the question is whether the trends become secular in certain areas. If yes it will be important to see which companies will be superior at detecting the lines with the secular shifts and will win the business by lowering premiums first.

Furthermore, one of the key questions will be how much further carriers can push the current hardening cycle in the environment when frequency benefits are becoming more broadly recognized along with rate in excess of trend, and interest rates seemingly past the inflection point and trending up.

For personal carriers, as we have been citing in our monthly reports on auto frequency trends, our view is that any long-standing benefits will eventually be competed away in the near term – something already visible with recent CPI disclosures pointing to negative premium inflation and high competition.

Hence, for the space the attention will likely revert to the pre-pandemic trends, including omni-channel competition (e.g. Allstate's recent strategic pivot).

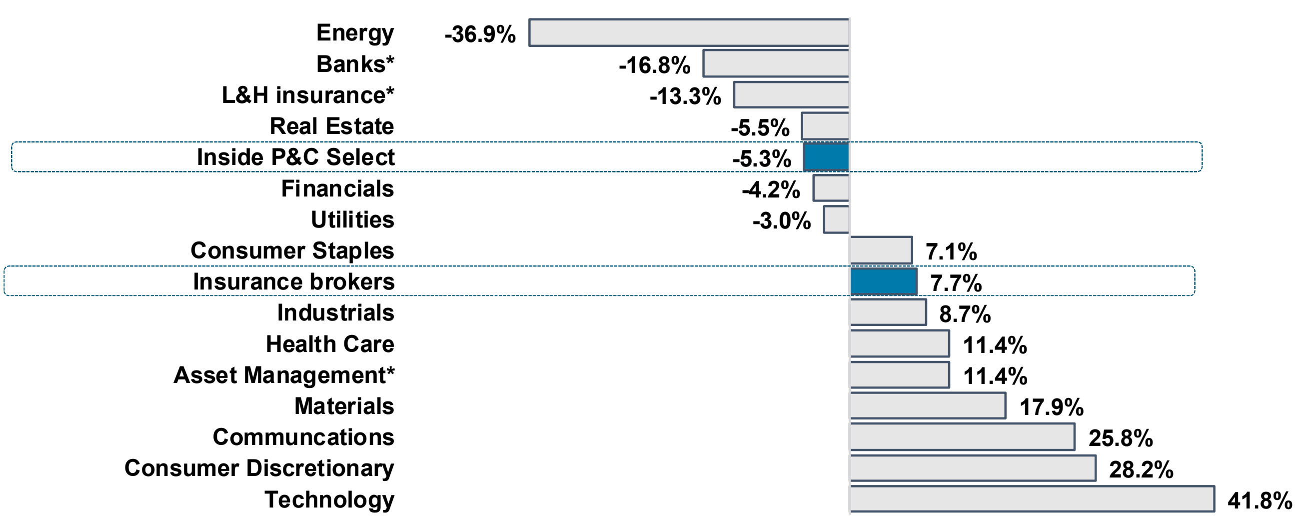
Also, the highly topical and controversial theme will remain the disruption threats, as markets continue to price for substantial market share gains by the recently floated InsurTechs.

P&C lagged all sectors outside energy and real estate

The P&C sector (proxied by Inside P&C Select) underperformed all S&P 500 sectors outside energy and real estate. The sector's underperformance was the result of, among other things, dampened sentiment in interest-sensitive financial stocks, lower attractiveness relative to "remote" economy stocks, and lower DCF benefit from the lower equity premiums as growth stocks with delayed cash flow expectations enjoyed higher terminal value increases.

Exhibit: Inside P&C Select vs S&P 500 sectors' performance in November

Source: FactSet, SNL, Inside P&C



**Selected sub-sectors within S&P 500 financials*

Chart Appendix: Peer group performance charts

Personal lines

Exhibit: YTD stock performance for personal carriers (December performance highlighted)
Source: SNL, Inside P&C

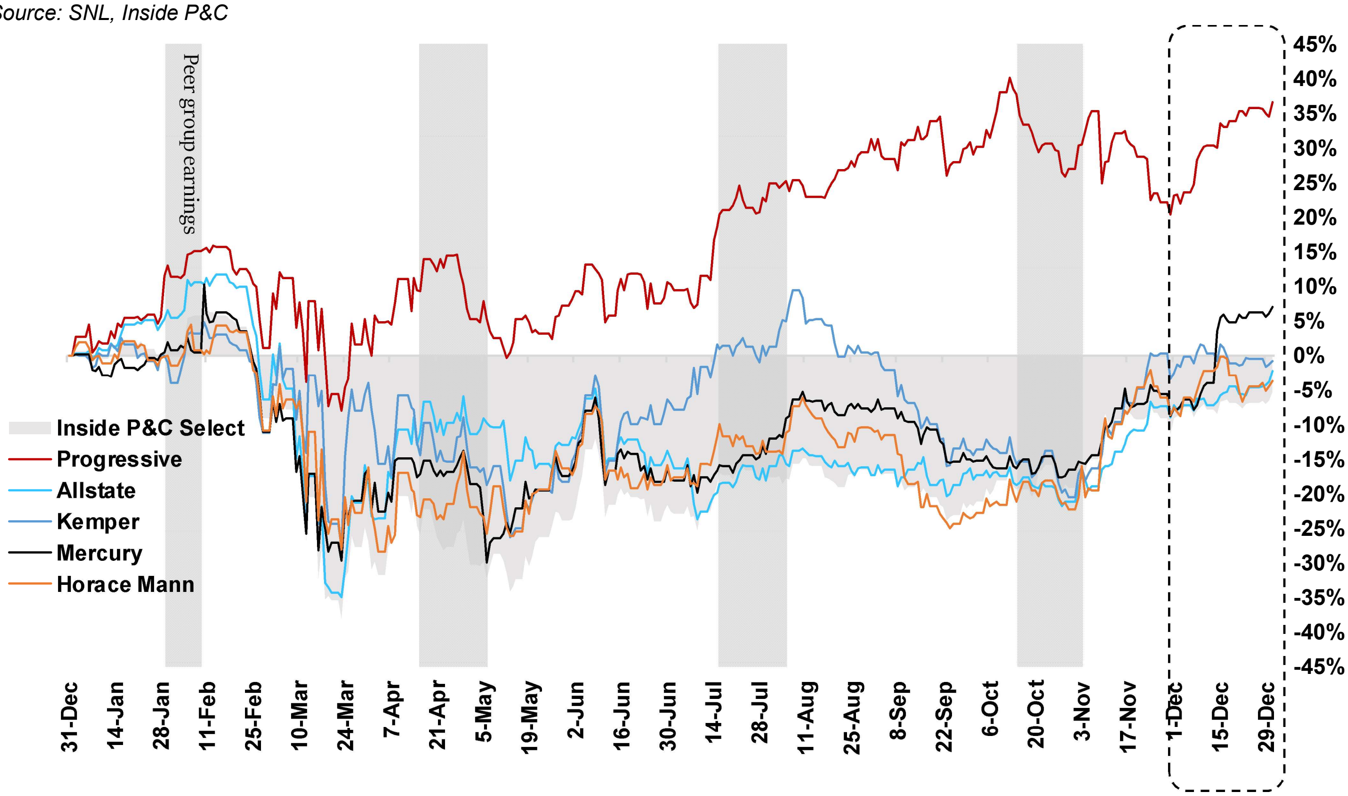
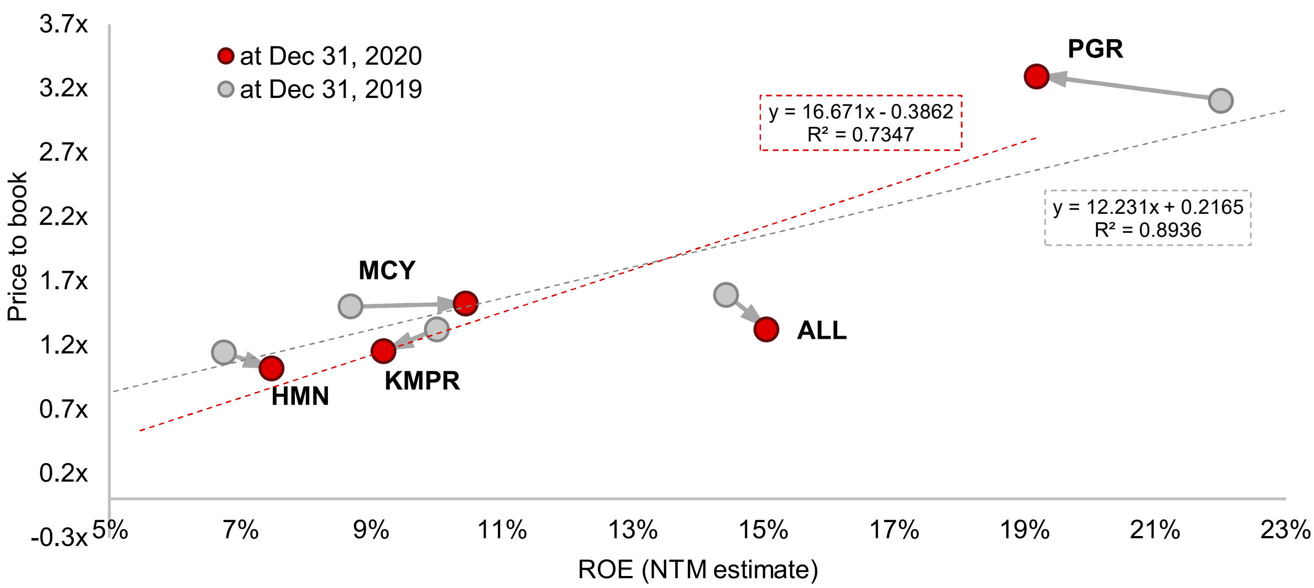


Exhibit: Price-to-book vs NTM ROE. YoY changes
Source: FactSet, SNL, Inside P&C



Large commercials

Exhibit: YTD stock performance for large commercial carriers (December performance highlighted)
Source: SNL, Inside P&C

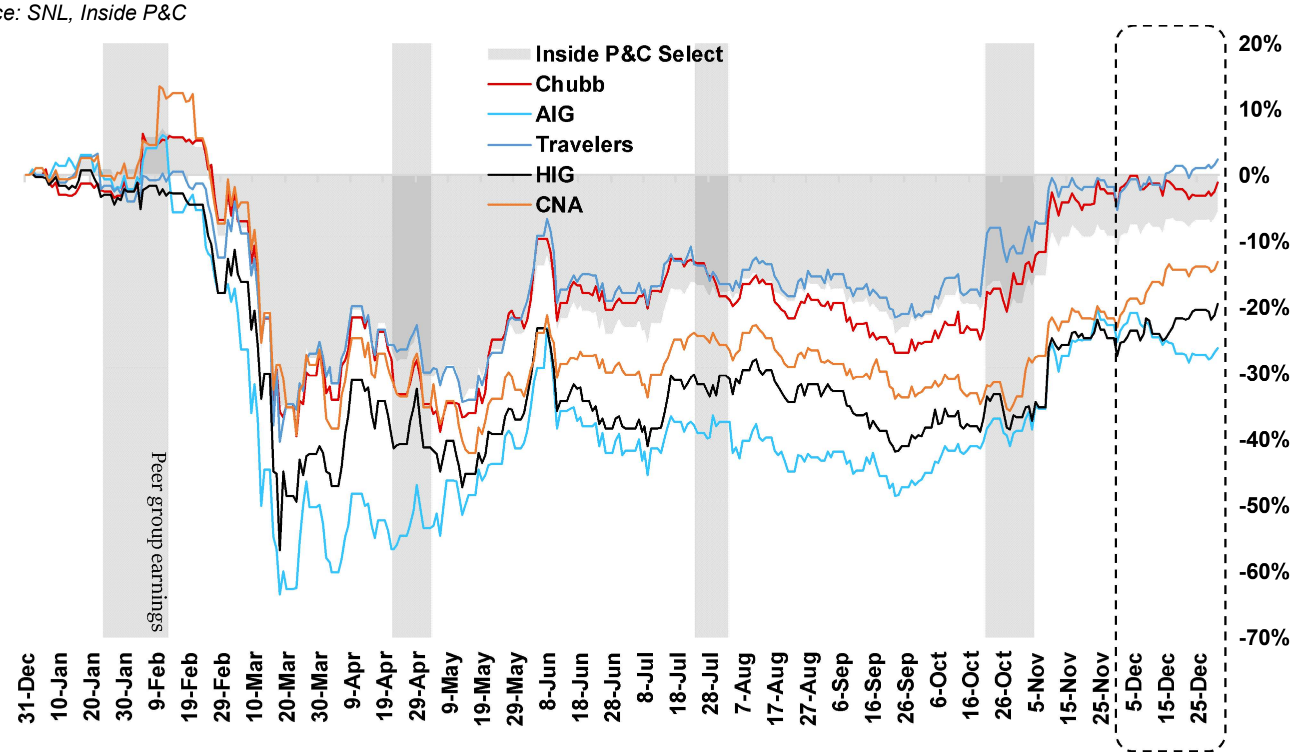
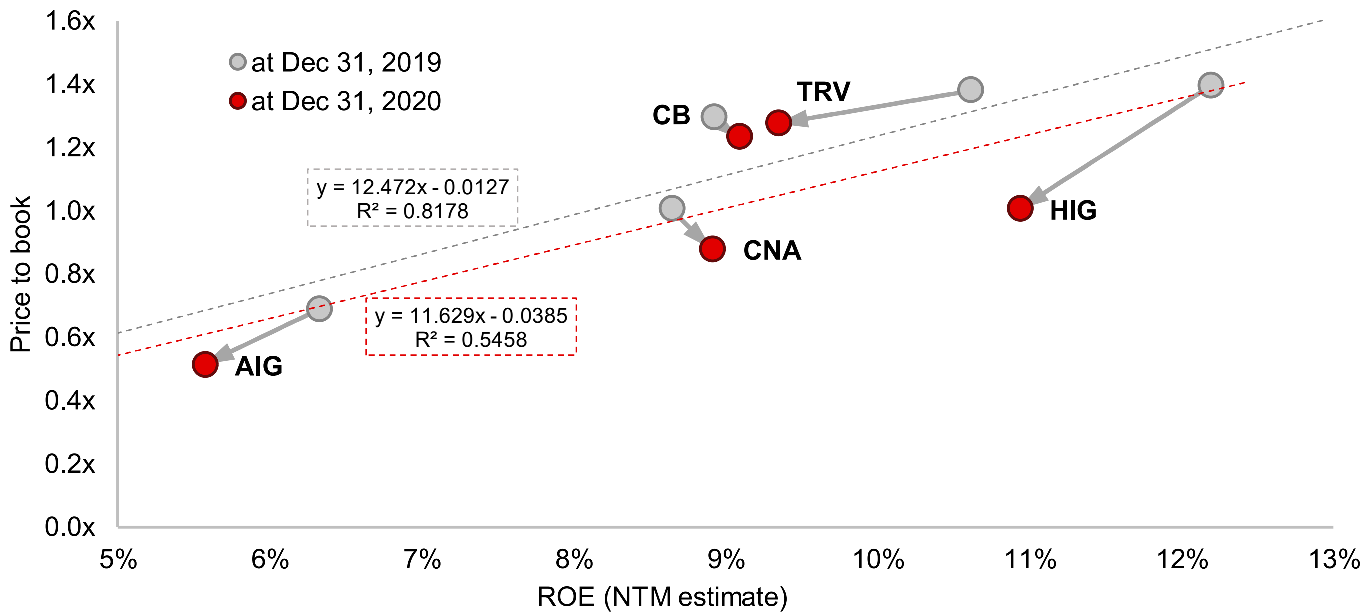


Exhibit: Price-to-book vs NTM ROE. YoY changes
Source: FactSet, SNL, Inside P&C



Bermuda

Exhibit: YTD stock performance for Bermuda carriers (December performance highlighted)
Source: SNL, Inside P&C

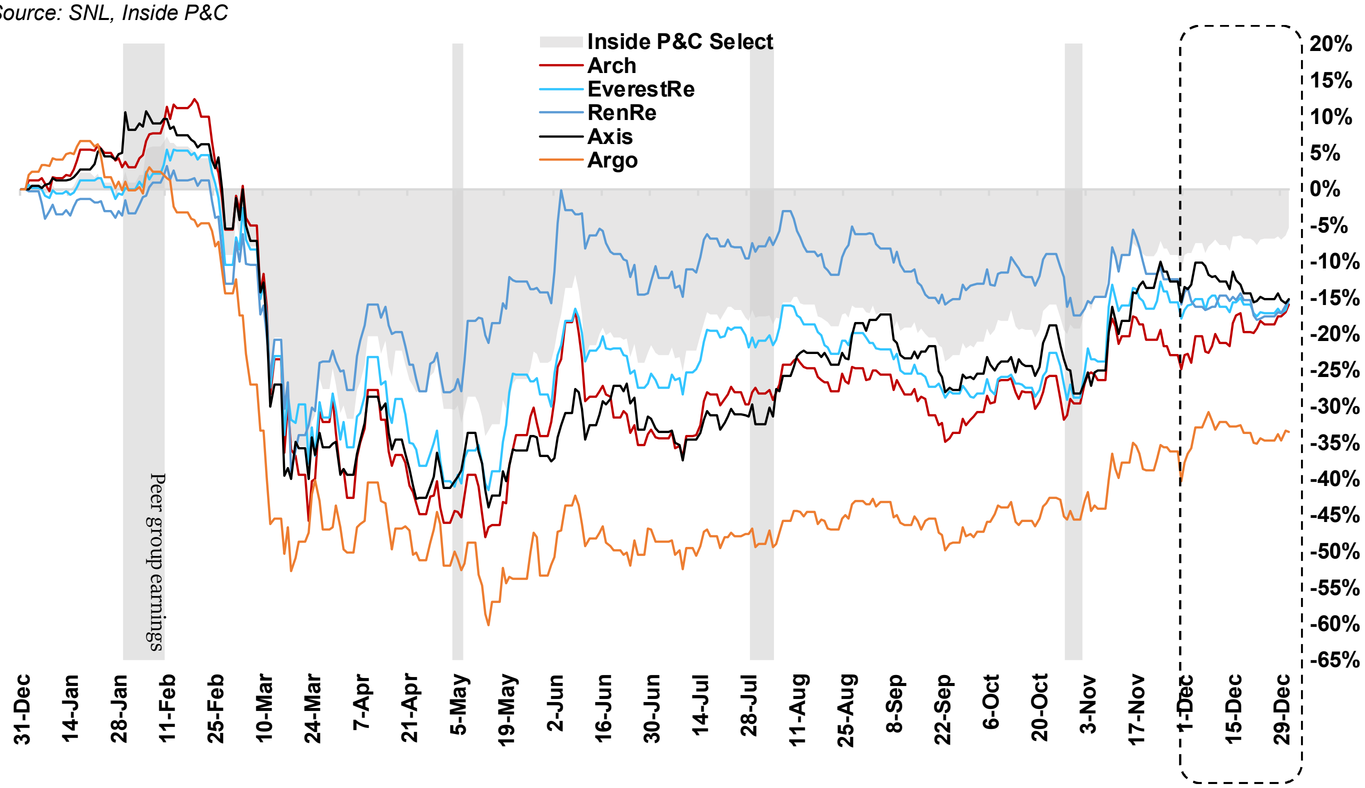
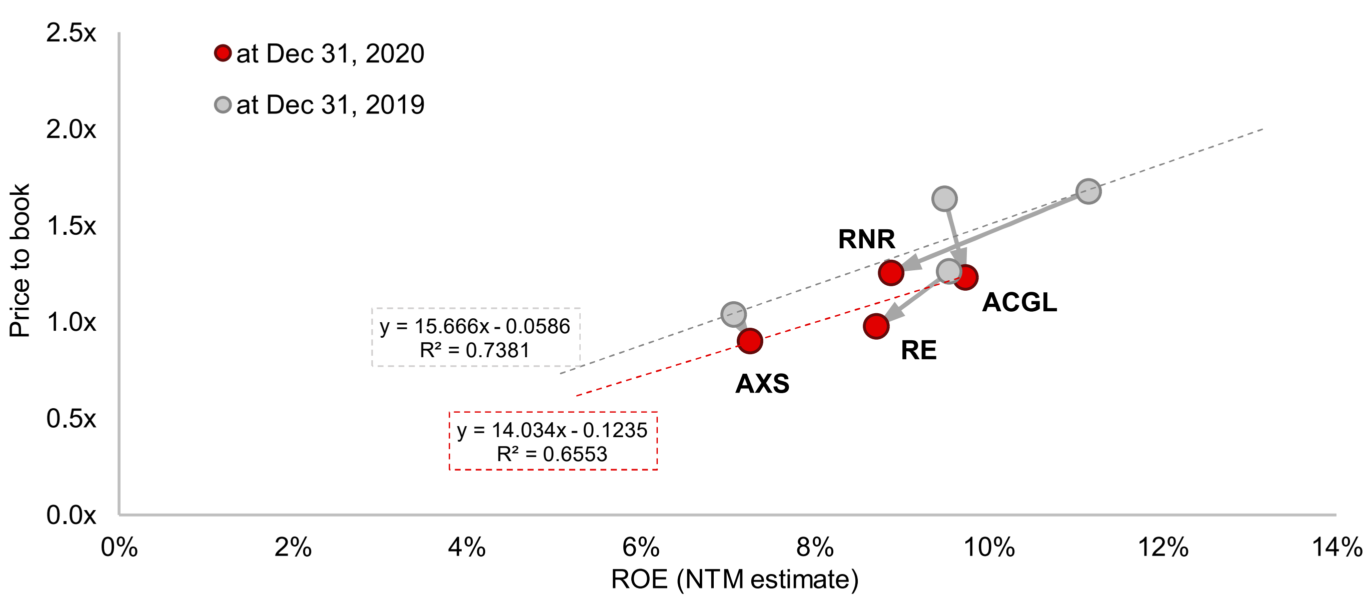


Exhibit: Price-to-book vs NTM ROE. YoY changes
Source: FactSet, SNL, Inside P&C



Regionals

Exhibit: YTD stock performance for regional carriers (December performance highlighted)
Source: SNL, Inside P&C

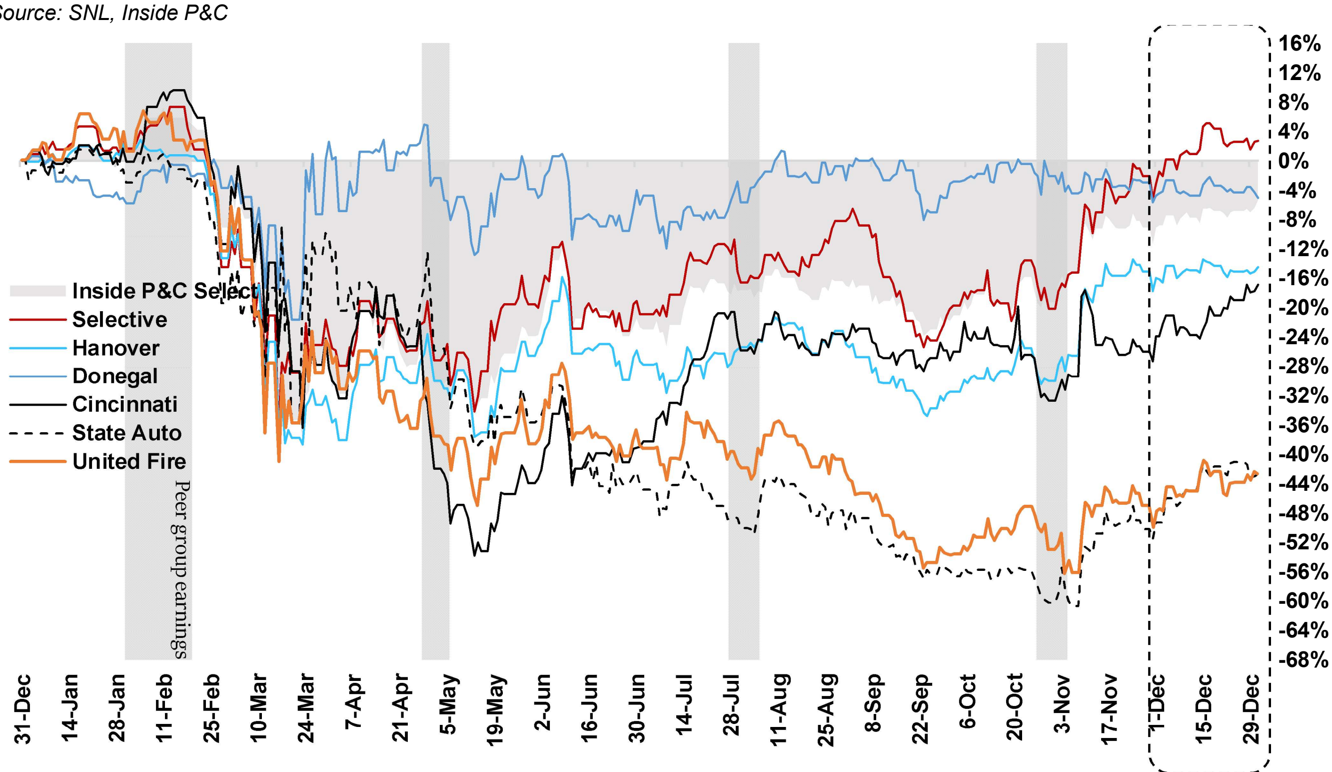
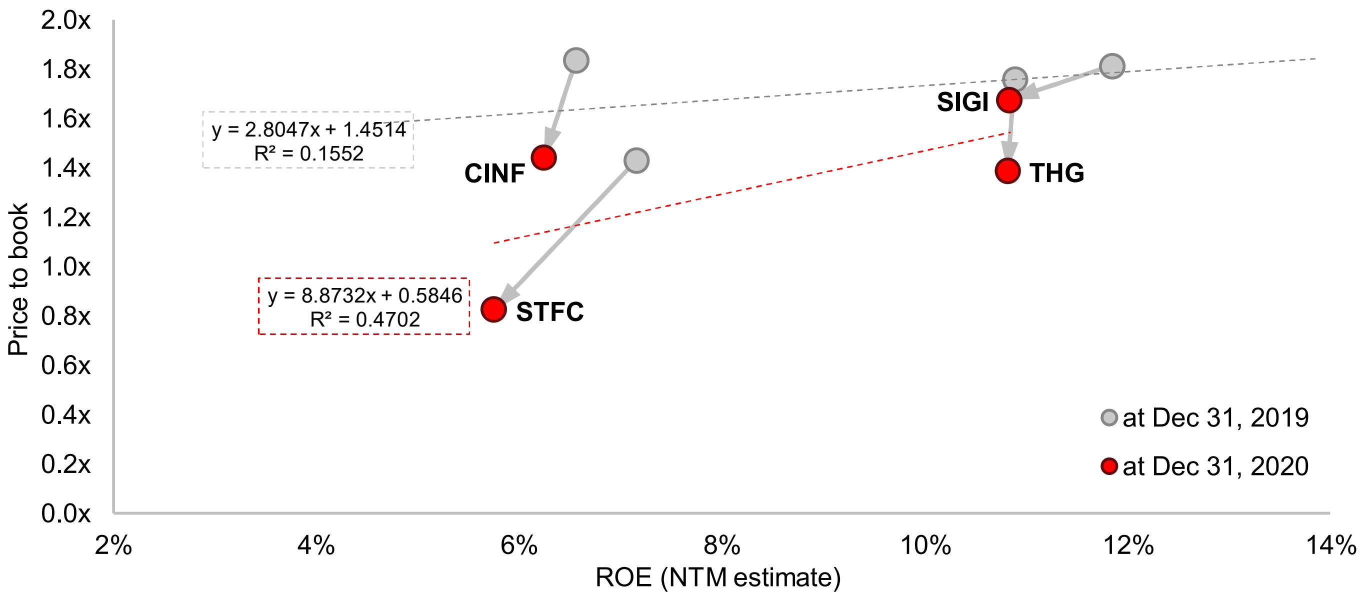


Exhibit: Price-to-book vs NTM ROE (selected carriers). YoY changes
Source: FactSet, SNL, Inside P&C
Note: Small number of estimates (lower than three) may have been used to calculate ROE (NTM estimate) for individual firms in the peer group
Source: FactSet, Inside P&C



Florida

Exhibit: YTD stock performance for Florida carriers (December performance highlighted)

Source: SNL, Inside P&C

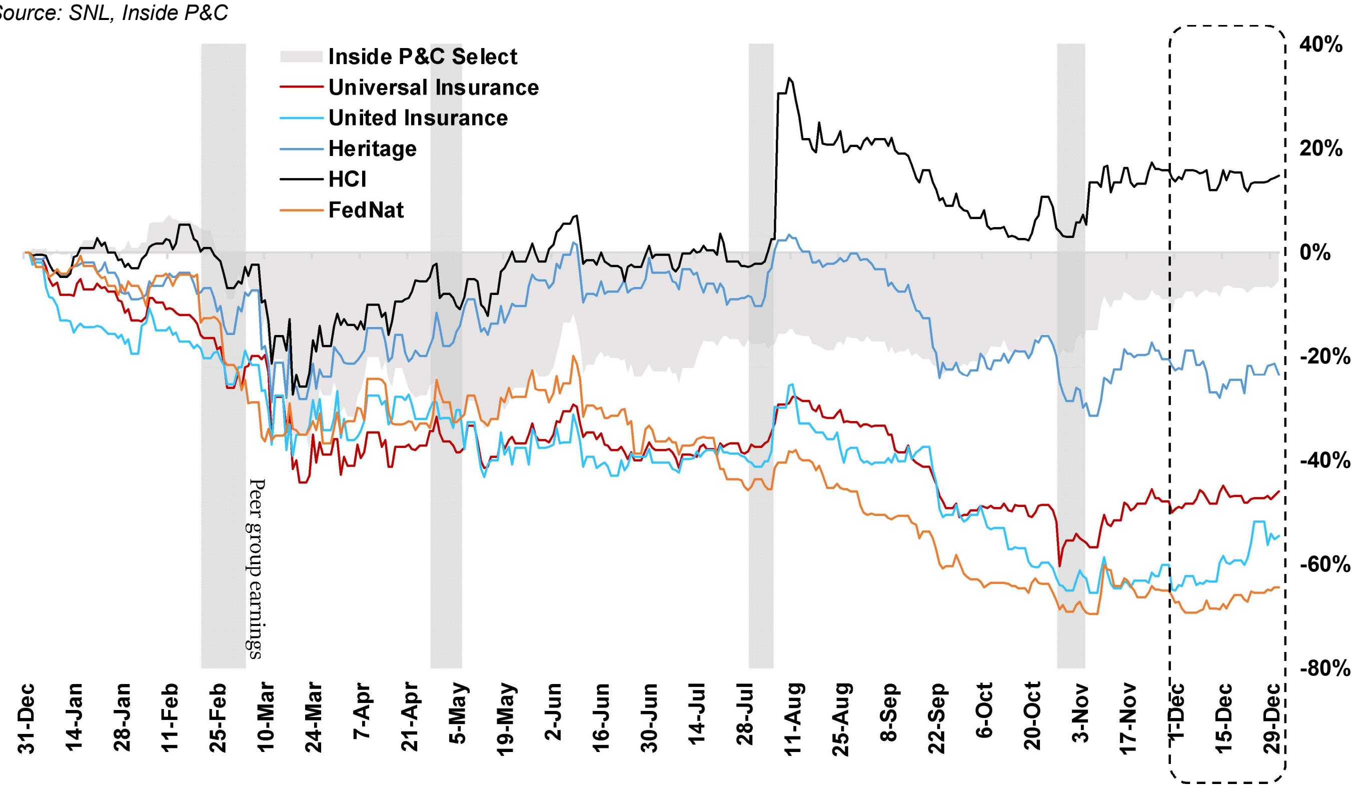
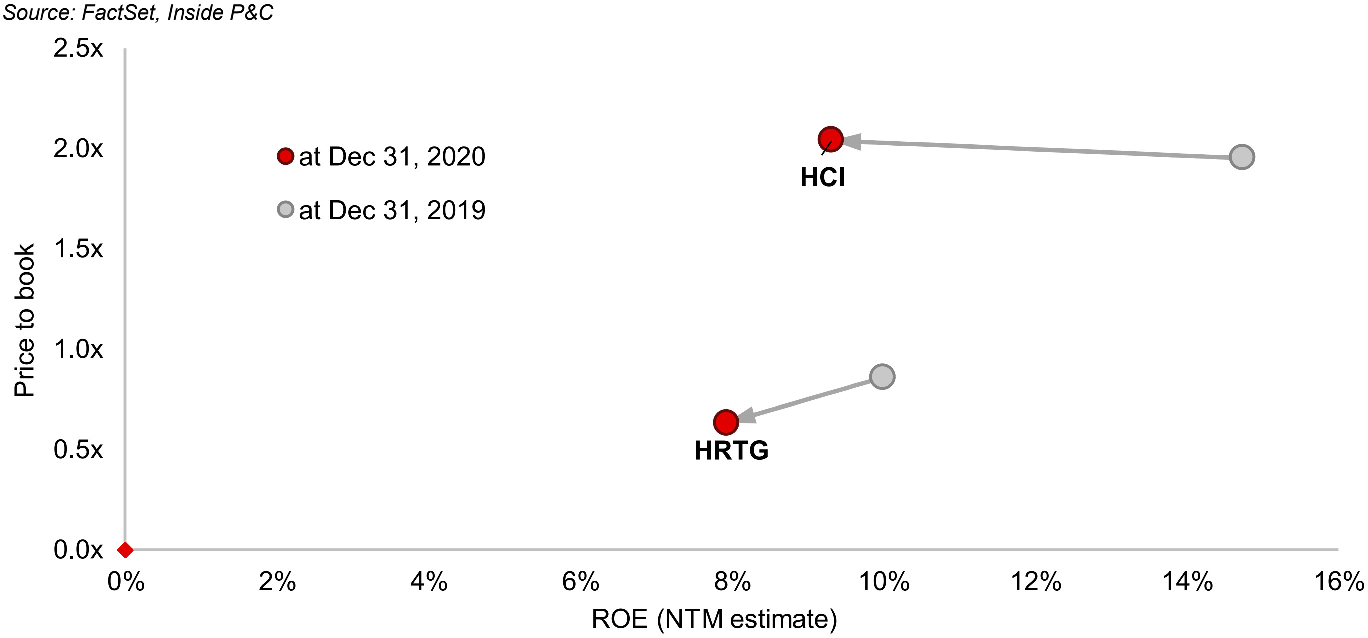


Exhibit: Price-to-book vs NTM ROE (selected carriers). YoY changes

Source: FactSet, SNL, Inside P&C

Note: Small number of estimates (lower than three) may have been used to calculate ROE (NTM estimate) for individual firms in the peer group

Source: FactSet, Inside P&C



Specialty

Exhibit: YTD stock performance for specialty carriers (December performance highlighted)
Source: SNL, Inside P&C

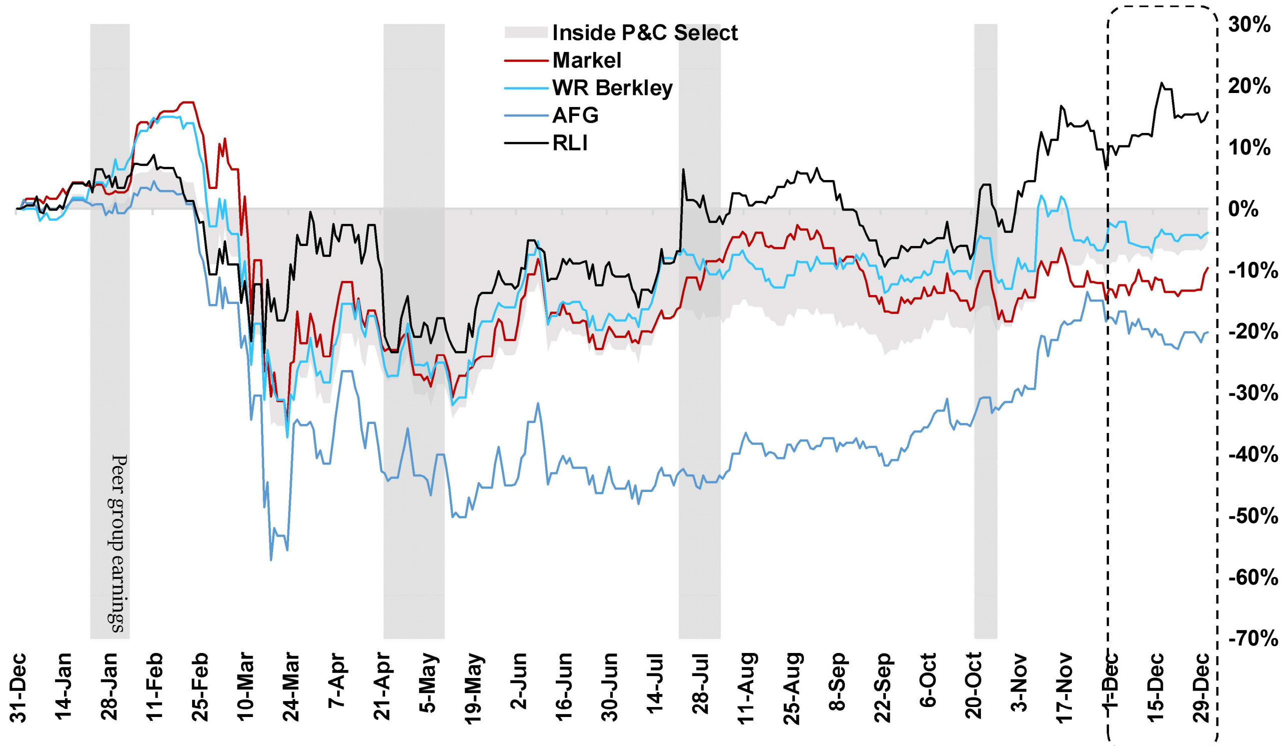
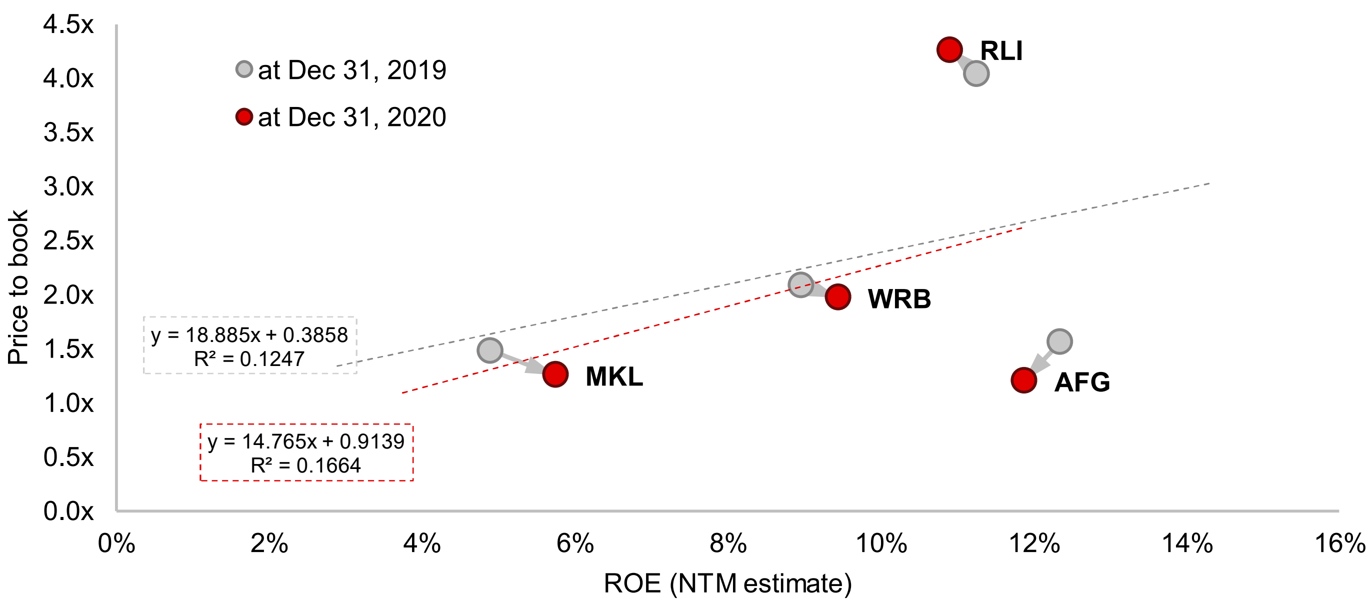


Exhibit: Price-to-book vs NTM ROE. YoY changes
Source: FactSet, SNL, Inside P&C



Inside P&C

Insurance brokers

Exhibit: YTD stock performance for insurance brokers (December performance highlighted)
Source: SNL, Inside P&C

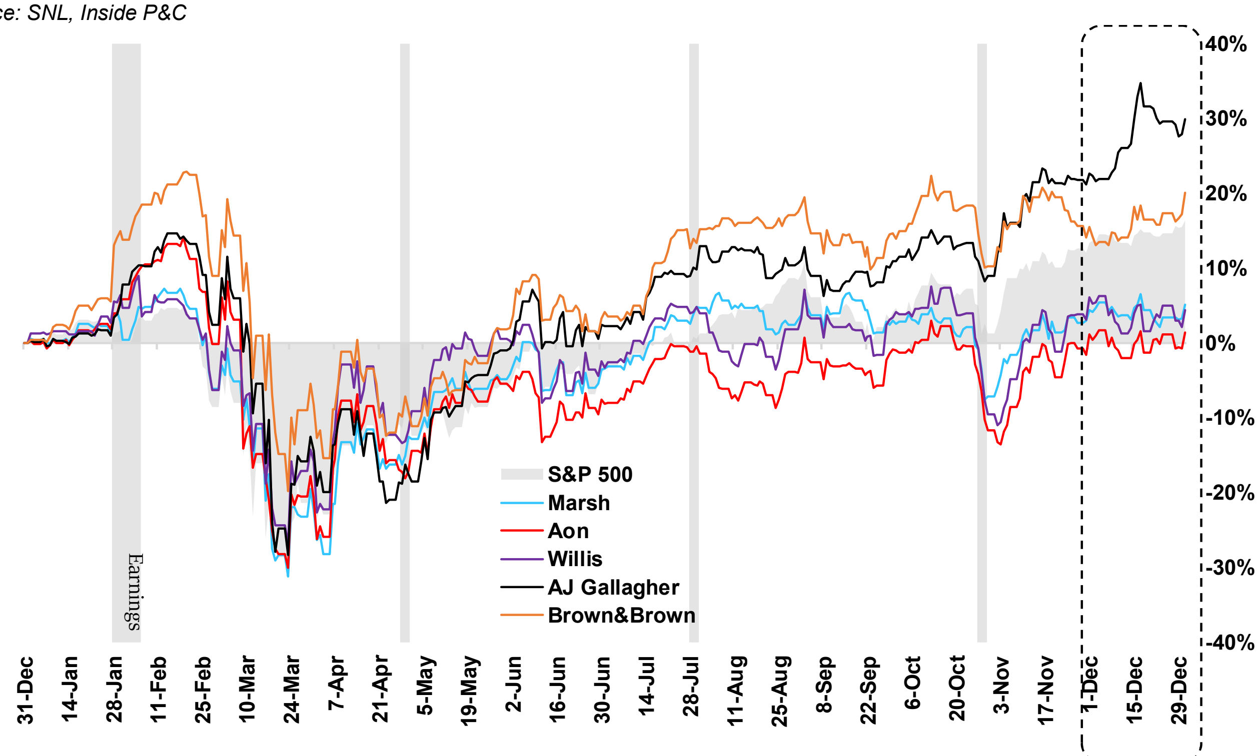
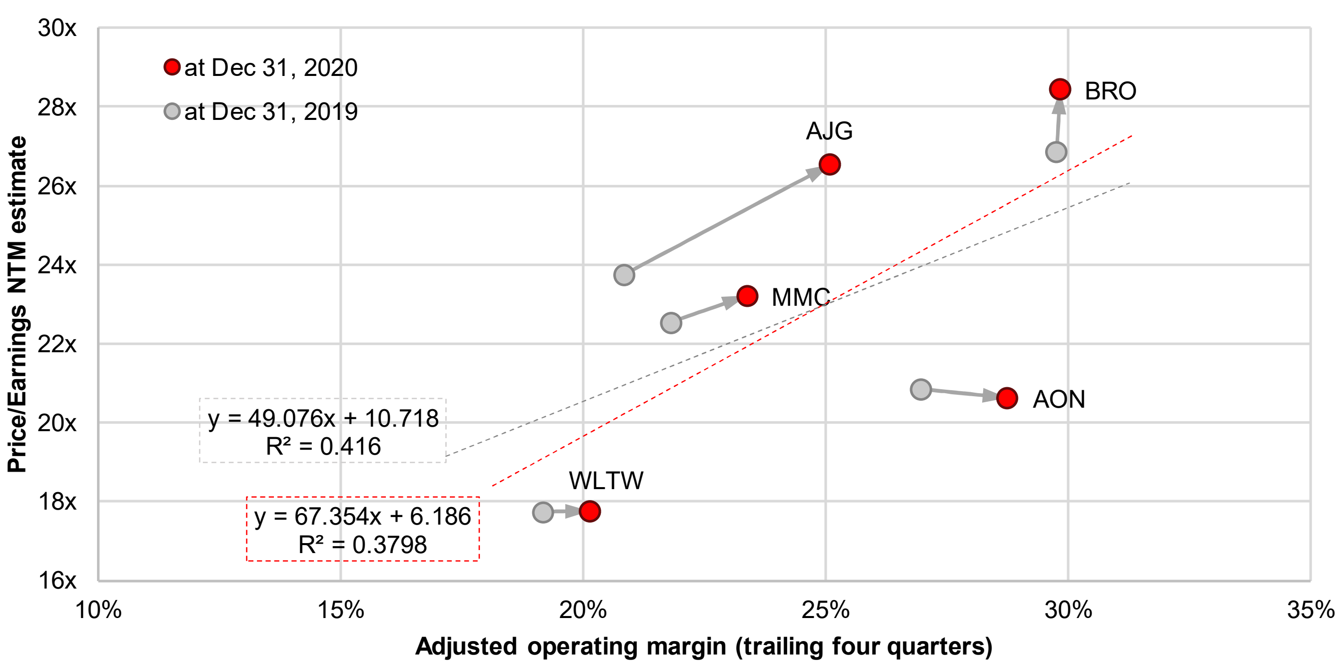


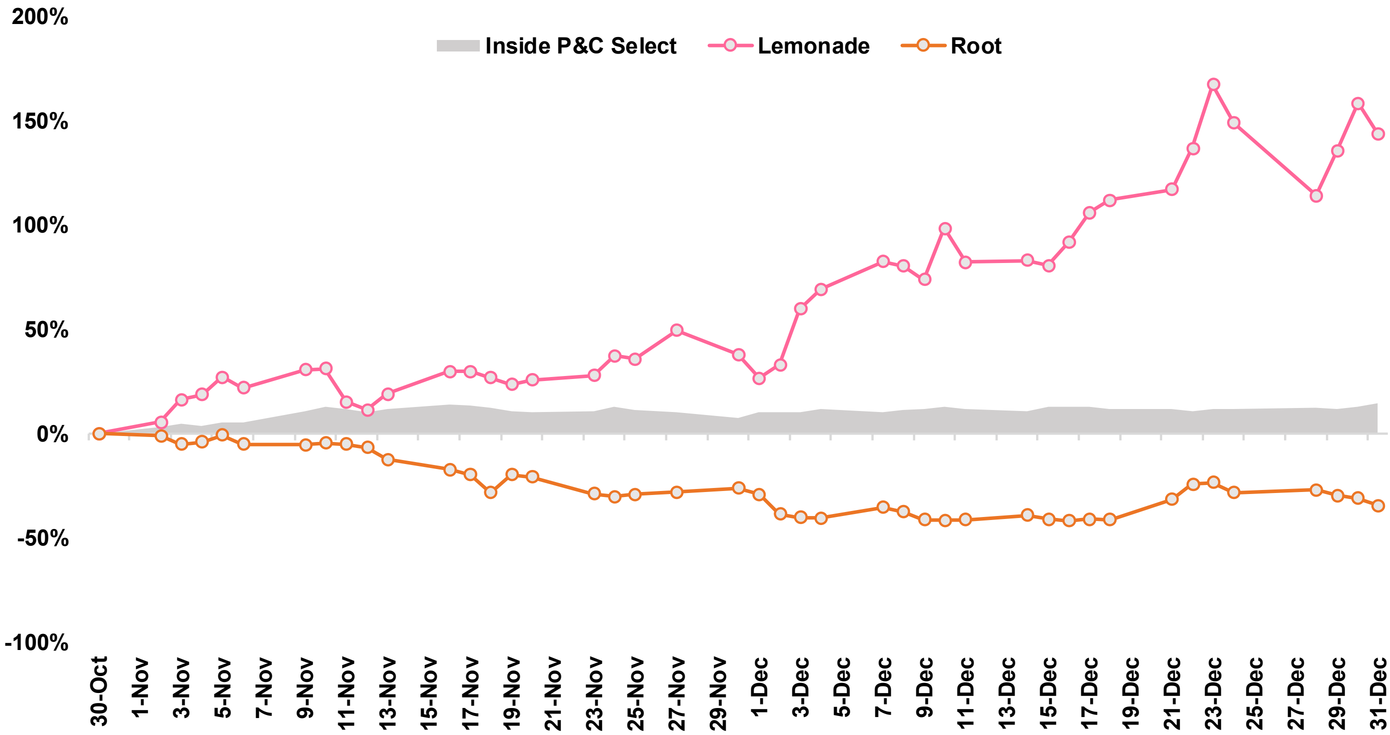
Exhibit: Forward P/E versus operating margins for insurance brokers. YoY changes
Source: FactSet, Company reports, Inside P&C



Insurtechs

Exhibit: Insurtech performance since the end of October

Source: SNL, Inside P&C



This research report was written by Insider Publishing's Research team which includes Gavin Davis, Gianluca Casapietra, and Dan Lukpanov.

The content of this report includes opinions based on publicly disclosed financials and management commentary.