howden

UKRAINE CRISIS
A MACRO VIEW

Introduction

The war in Ukraine is first and foremost a human tragedy, brought about by an act of aggression on a sovereign country. Our thoughts are with all those affected. The return of conventional warfare to Europe is a huge shock that brings considerable global consequences, from geopolitical realignments to financial shocks. The risk of escalation is ever present and a period of macroeconomic instability is assured.

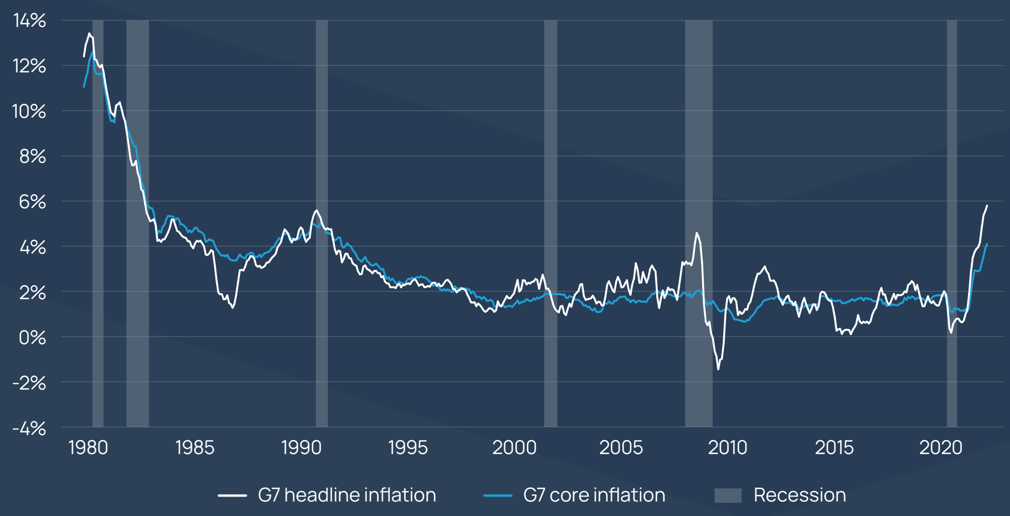
Whilst the economics are of course secondary to the devastating human toll, this report examines the macro reverberations and how they are likely to impact the (re)insurance market. The Ukraine crisis presents a myriad of risks to the sector – direct underwriting losses, rapidly rising prices, slower economic growth, financial market volatility and the potential for asset shocks – that are not altogether different to what occurred during COVID-19 and the financial crisis. But with direct investment and underwriting exposures limited overall, and with second order effects in financial markets currently manageable, the (re)insurance market is strongly positioned to support clients through this period of uncertainty.

Pre-existing macro pressures

The fallout from the crisis in Ukraine is best defined by the VUCA acronym – volatile, uncertain, complex and ambiguous. The world now looks very different: heightened geopolitical risks, renewed security threats, soaring energy costs (amidst scrutiny about Europe's energy dependency on Russia), higher inflation, additional supply chain disruption, tapered economic growth, monetary policy impacts, financial markets volatility…the list goes on.

Even before the start of the conflict, some equity markets were in correction territory due to the threat posed by rapidly rising inflation and tighter monetary policy. Figure 1 shows that by the end of January 2022, headline and core consumer price inflation across G7 nations stood at levels not seen since the early 1980s and 1990s. Decades have passed since inflation fell from these levels without some sort of recessionary impact. CPI is now certain to climb to higher levels in the near term, and the possibility of 'stagflation' – a period of inflation accompanied by or preceding slowing economic growth – has reared its head in the world's major economies for the first time in 40 years.

Figure 1: Consumer price inflation year-on-year change for G7 countries – 1980 to Jan 2022 (Source: Howden, OECD)



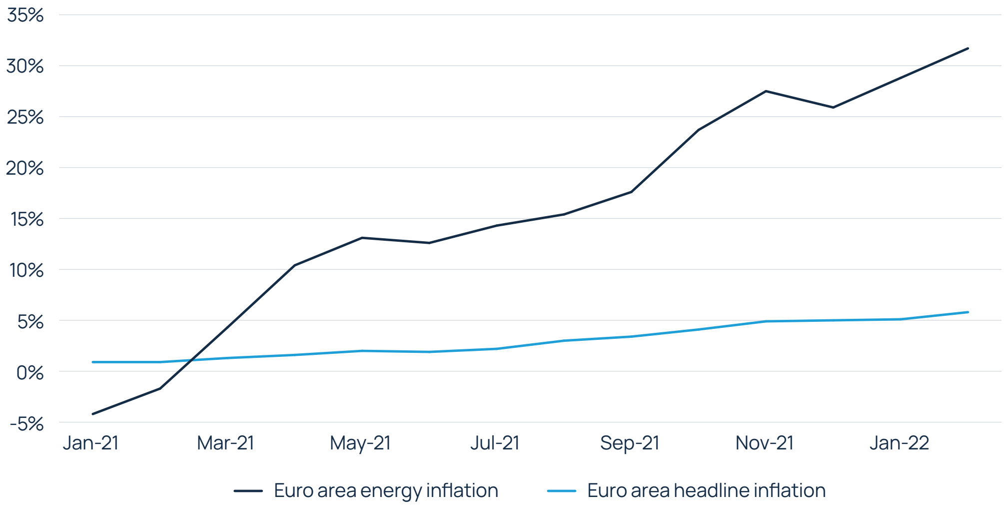
The predominant drivers of pre-war inflation were three-fold:

1. High energy prices (originally expected to relent this year)
2. Supply constraints and supply chain disruption (likewise expected to moderate)
3. Tight labour markets and rising wages (expected to persist through 2022)

1. Energy prices

The decoupling of headline and core inflation from early 2021 reflects the outsized impact of rising energy costs (more on this shortly). Figure 2 shows the degree of energy price rises in the Euro area since the start of 2021 relative to overall CPI.

Figure 2: Euro area energy costs and headline inflation – Jan 2021 to Feb 2022
(Source: Howden, Eurostat)



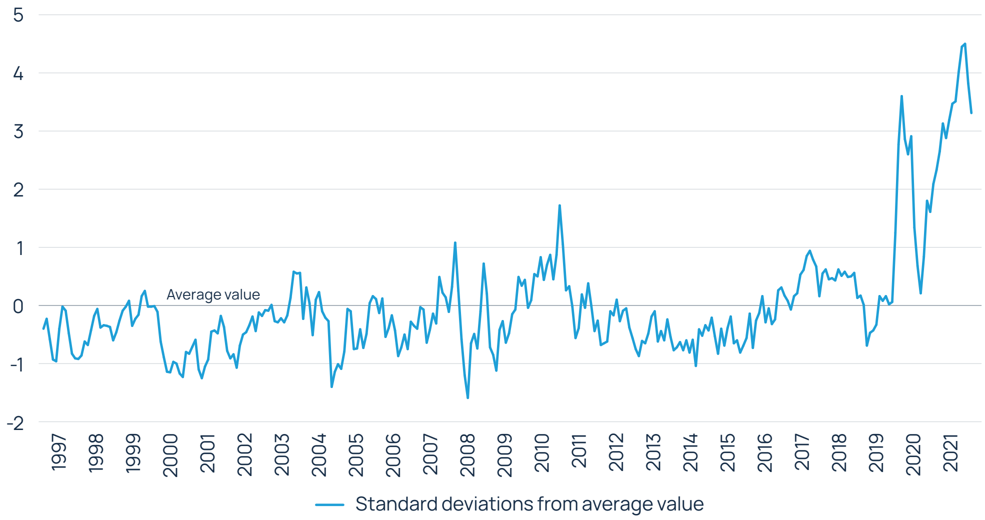
One of the few economic certainties to emerge this early from the war is higher for longer energy costs. This will inevitably exacerbate headline inflation and slow economic growth. With Europe's reliance / vulnerability to Russia's energy supply brought into sharp focus, the transition to other energy sources will see inflation remain above target for some time come.

2. Supply shock

A pandemic-induced supply shock (at a scale not seen in decades), combined with booming consumer demand for manufactured goods, has added to the inflation problem. Indicators of supply-side constraints, as demonstrated by the supply chain pressure index in Figure 3, underscore the magnitude of disruption and shortages worldwide. Factory closures, disrupted logistic networks and longer delivery times have stretched 'just in time' (JIT) production models to breaking point.

Whilst supply pressures were initially expected to ease this year, they remain at historically high levels and the Ukraine war is likely to see the situation deteriorate. There is already evidence of this. Within just a week of the conflict, several manufacturers were forced to shut European plants or curtail production in the region because of a lack of parts from Ukraine. Increased geopolitical volatility (regionally and globally) will see businesses recalibrate their supply chains and JIT strategies, which is likely to mean more local supply, earlier orders and more inventory being held.

Figure 3: Global Supply Chain Pressure Index – 1997 to Feb 2022[1] (Source: Federal Reserve Bank of New York)

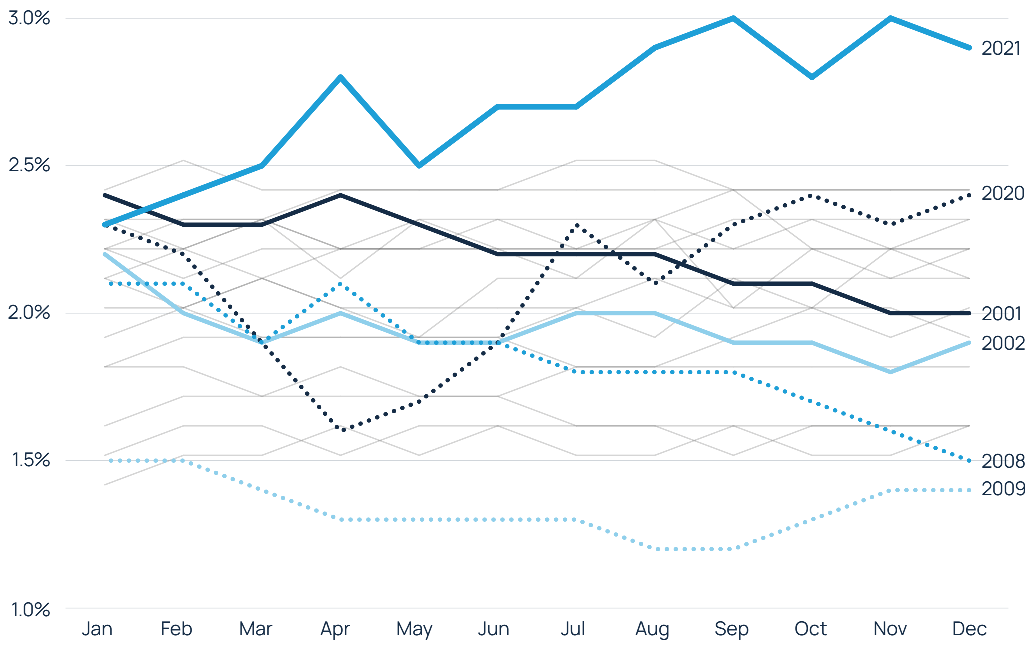


[1] Gianluca Benigno, Julian di Giovanni, Jan J. J. Groen, and Adam I. Noble, "Global Supply Chain Pressure Index: March 2022 Update" Federal Reserve Bank of New York Liberty Street Economics, March 3, 2022, https://libertystreeteconomics.newyorkfed.org/2022/03/global-supply-chain-pressure-index-march-2022-update/.

3. Labour market

The labour market in certain countries (e.g. the United States and United Kingdom) has undergone a post-pandemic reset amidst a wave of worker movement (aka 'The Great Resignation') and building wage inflation. Figure 4 shows historically high levels of worker movement in the United States last year, as the unemployment rate fell close to pre-COVID levels and rising pay settlements heightened concerns about a wage price spiral.

Figure 4: 'The Great Resignation' of 2021 vs previous 20-year trend (Source: Howden, BLS)



Expectations in early 2022 were for aggressive monetary policy tightening in an effort to cool a 'hot' labour market and prevent price pressures spreading into less acutely affected areas of the economy, such as wage settlements and services. In what was already a challenging trade-off for policymakers in weighing up rapidly rising inflation and a tight labour market on the one hand and a delicate recovery on the other, the conflict in Ukraine has made the task all the more difficult.

Post-invasion escalation

Russia's invasion into Ukraine has amplified these pre-existing pressures and added new risks. The relatively modest size of both Russia's and Ukraine's economies notwithstanding (Russia and Ukraine make up less than 2% of global GDP), secondary impacts from financial market disruption, higher energy and other commodity prices and rising inflation expectations pose significant threats to global economic growth.

Russia's role as a significant global energy supplier is well known, but it is also a major producer of other commodities (e.g. palladium). Both Russia and Ukraine are big food producers (the latter is the world's fifth-largest exporter of wheat). Events are moving quickly, with tough sanctions imposed by the West on Russia amidst moves to ban or curb Russian oil and gas imports. Attendant pressure on global energy and food supplies is sending prices spiralling. Financial markets have fluctuated wildly (in Europe especially) amidst fears of an economic shock. Asset prices, commodity costs and their attendant effects on interest rates, inflation and balance sheets could become more significant to insurance carriers in the near-term than increased claims.

1. Equity markets

Figure 5 shows equity markets' movements over the last two years. Post-COVID gains have been all but wiped out for several indices, initially from the correction that took place pre-crisis as markets adjusted to the reality of higher inflation and interest rates, and latterly because of market volatility following the invasion and concerns that a protracted conflict will bring higher prices and weaker economic growth.

A more near-term view is presented by Figure 6 on page 8, which shows losses to the indices in 2022. Russia's MOEX is the standout faller, losing close to 50% of its value since the turn of the year. It remains closed. European stocks have underperformed relative to other markets since the invasion amidst fears of stagflation.

Figure 5: Performance of major equity market indices – 2020 to 2022 YTD
(Source: Howden, Bloomberg)

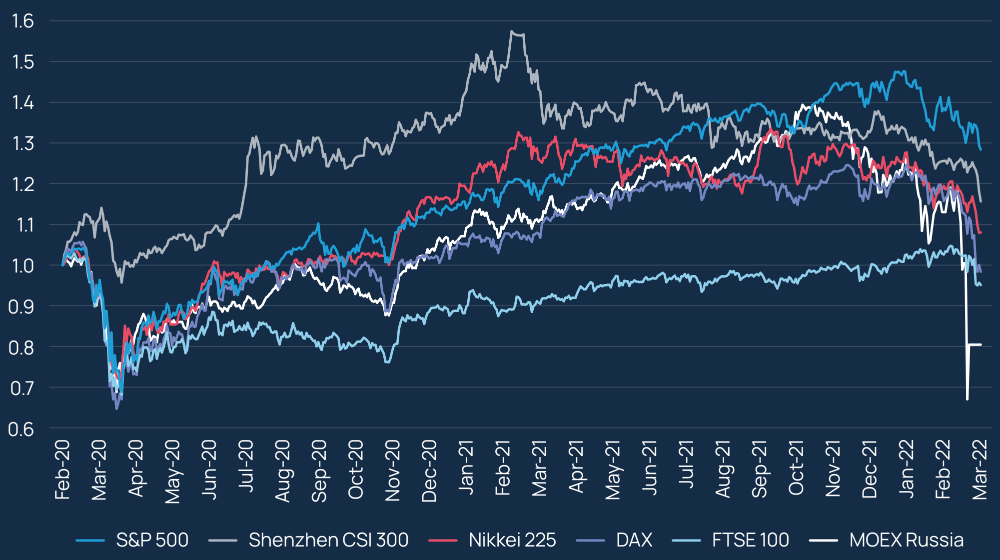
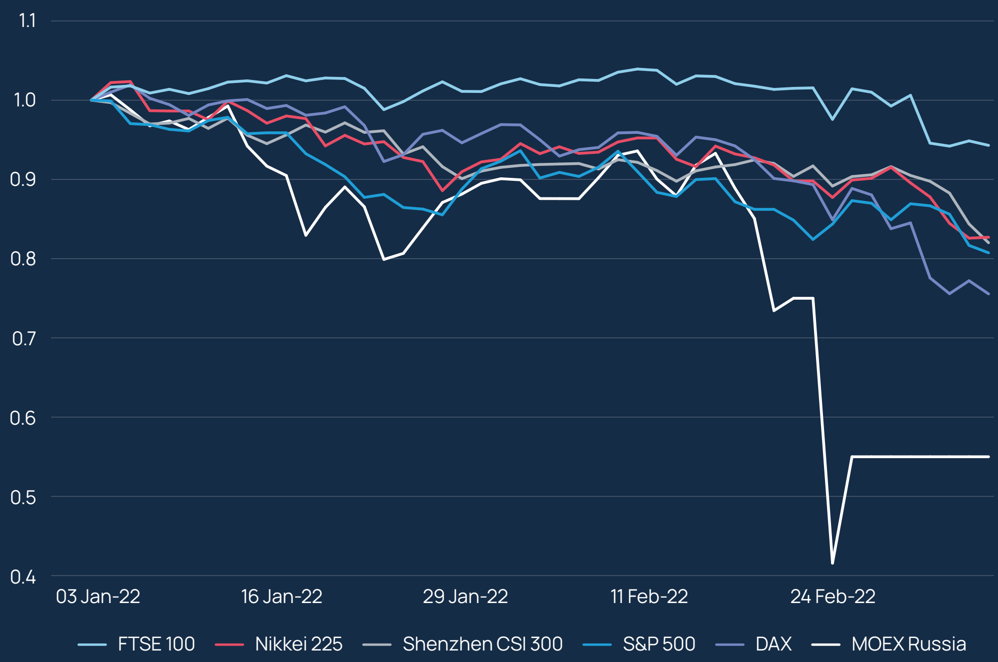


Figure 6: Performance of major equity market indices in 2022 (Source: Howden, Bloomberg)

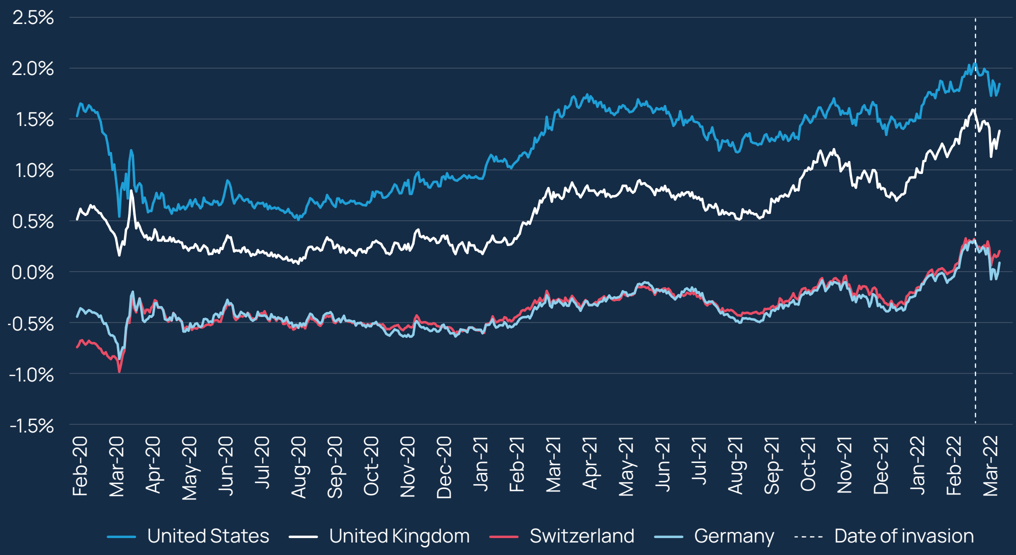


The potential for serious flashpoints, as demonstrated by shelling near the Zaporizhzhya nuclear plant last week, along with surging commodity prices and higher supply-driven inflation more generally, means equity markets are likely to remain highly volatile for some time to come.

2. Bond market

There have also been meaningful impacts in the bond market, with investors following the playbook of previous geopolitical crises by reining in exposures to riskier assets and seeking refuge in 'safe havens' like high-quality government bonds. This flight to quality has reversed the pre-invasion trend for such sovereigns by pushing yields down significantly (Germany briefly slipped back into negative territory immediately after the invasion – see Figure 7) just as central banks are looking to tighten monetary policy to combat inflation.

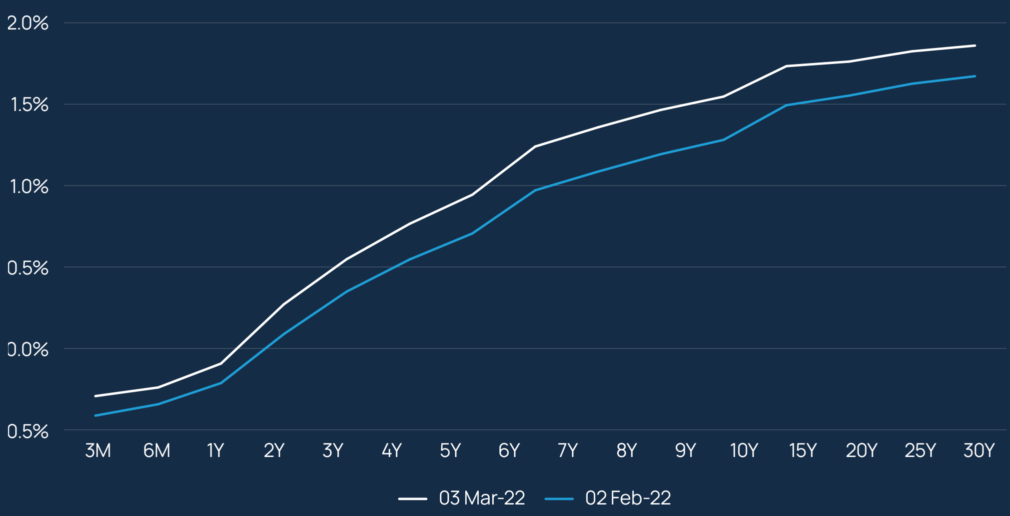
Figure 7: 10-year government bond yields – 2020 to 2022 YTD (Source: Howden, Bloomberg)



As the largest class of investors in high-grade fixed income securities, (re)insurers are particularly exposed to sharp movements in interest rates. Under such circumstances, asset values are more susceptible to sudden changes, stressing balance sheets and creating potential short-term liquidity issues.

The flight to quality and expected slowdown in monetary tightening are, at the current moment, net positives for the sector's balance sheet. Falling corporate bond prices, occurring in tandem with wildly fluctuating equity markets, provide some adverse offsets, although borrowing costs, even in Europe, have so far remained relatively modest (see Figure 8). Any further yield spike and / or destabilisation of the global financial system (e.g. energy supply disruption to Europe) could nevertheless pose significant risks for the (re)insurance sector.

Figure 8: European investment grade corporate yields – pre-invasion vs post-invasion (Source: Howden, Bloomberg)

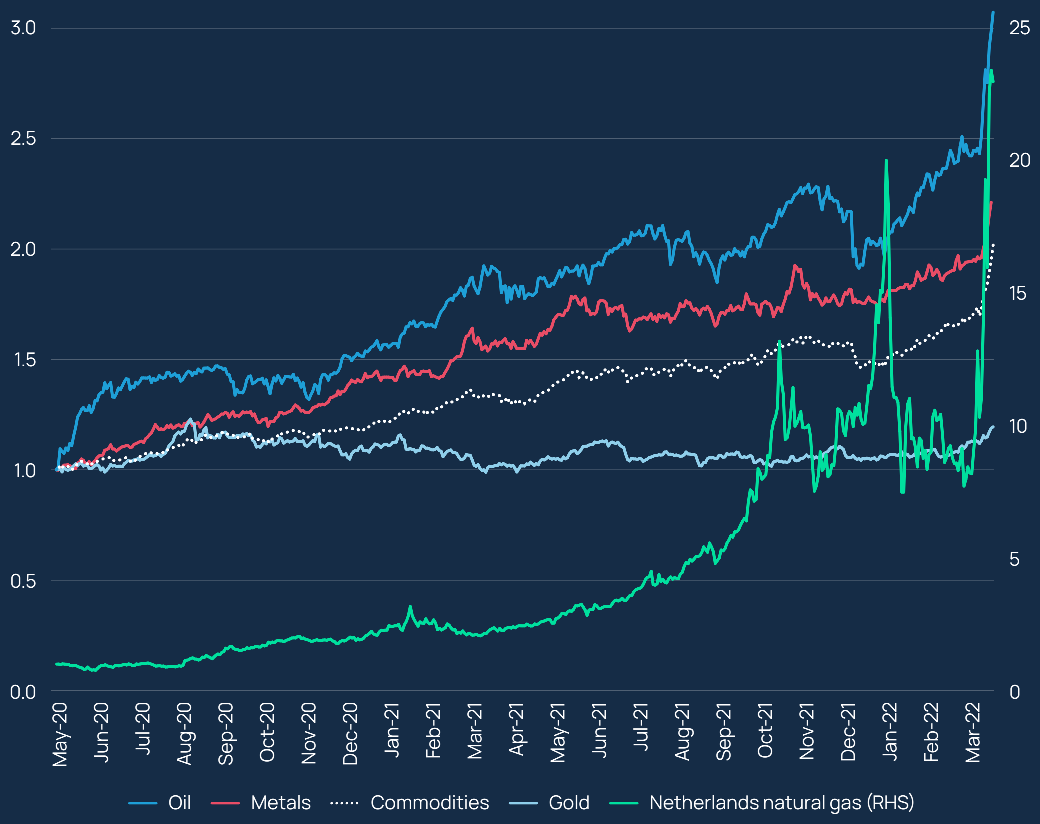


3. Commodity prices

The other big macro impact from the crisis is fast-rising commodity prices. Figure 9 shows how prices for both energy and non-energy commodities, already at elevated levels due to the 'great reopening' of economies following peak-COVID shutdowns, have spiked further since the start of the crisis. The price of oil has nearly doubled since December last year.

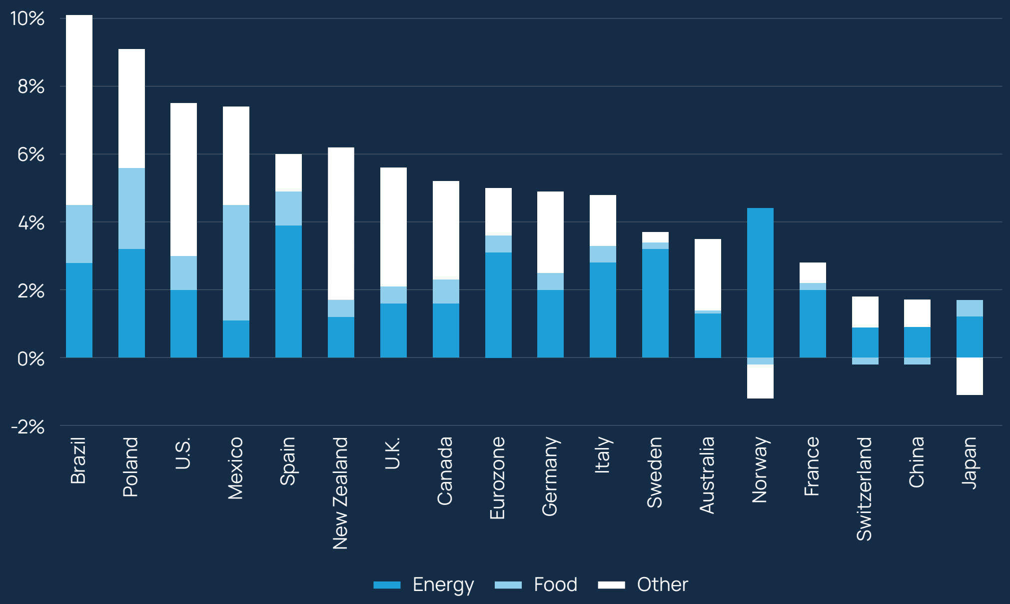
Even more strikingly, natural gas in Europe (shown by a separate axis in Figure 9 to avoid distorting the original scale) has surpassed the previous record high recorded in late 2021.

Figure 9: Energy and non-energy commodity index – May 2020 to 2022 YTD
(Source: Howden, Bloomberg)



This will fuel energy inflation and potentially slow economic growth. Rising energy prices pre-crisis were already the dominant driver of headline inflation in several countries, Europe especially where energy currently accounts for bulk of CPI (see Figure 10). The post-invasion spikes for gas and oil will exacerbate this trend and increase the risk of pressures extending to other areas of the economy (e.g. higher cost of producing and shipping goods).

Figure 10: Breakdown of latest CPI by category and country (Source: HSBC, Bloomberg)



CPI vs loss costs

Higher energy prices and knock-on effects to supply chains are negative developments for (re)insurers already confronting accelerating claims costs in certain lines of business. Risks of entrenched inflation and a wage price spiral have undoubtedly increased as a result of the war, which only adds to uncertainty about forward loss trends.

But, as outlined in Howden's *Times Are A-Changin'* report, there are some mitigating factors. Whilst mostly short-tail lines such as property and motor will feel the compounded effect of rising commodity prices and add significantly to loss severity, liability lines are more exposed to wage, medical and legal costs – areas that currently lag overall CPI in certain territories.

Equally important, reserve buffers for the sector are strong and likely to have been shored up further by conservative loss picks through the pandemic, not to mention largely favourable loss experience in long-tail lines and (compounded) rate increases.

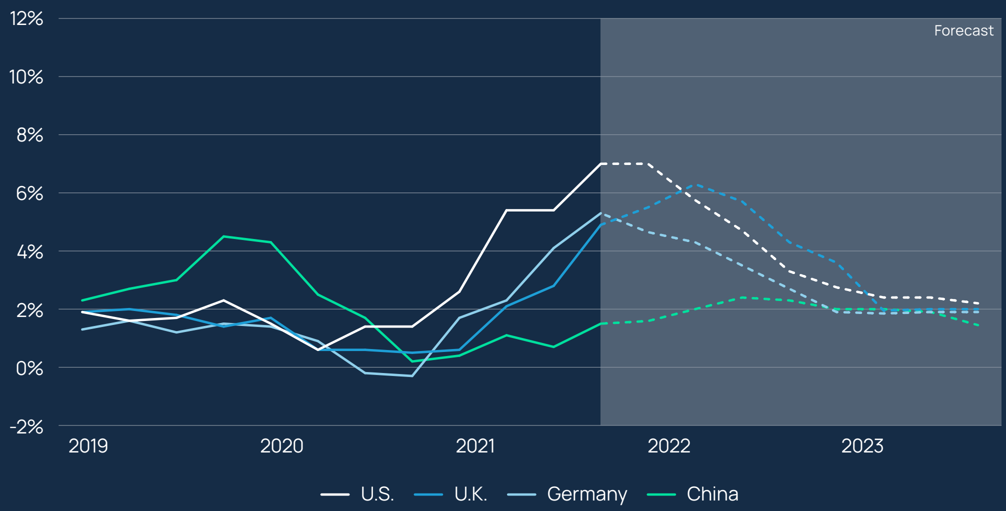
4. Inflation expectations

Figure 11 provides some context to the rapid rise in inflation over the last 12 months. Price pressures are particularly acute in the United States, Europe and Latin America, whilst CPI rises have been more contained in Asia (e.g. China up by 0.9% only).

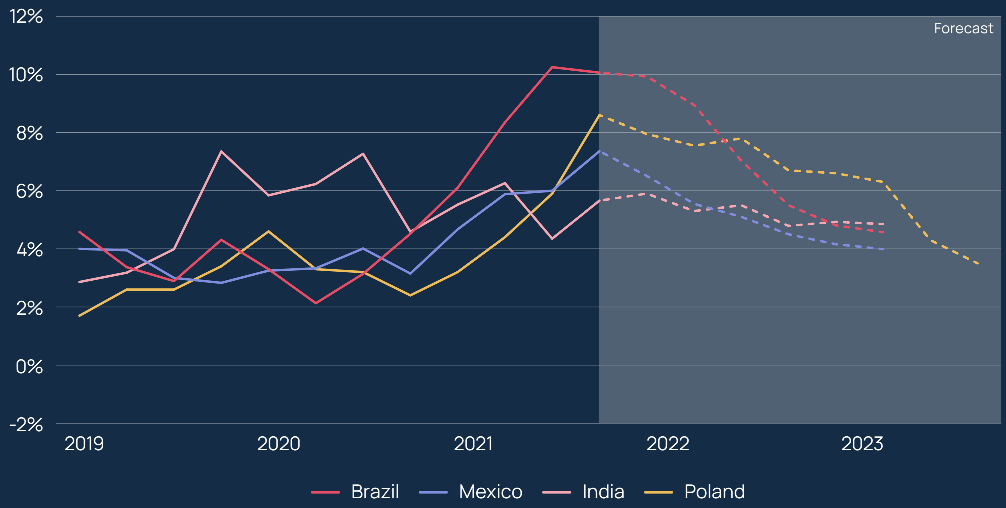
Inflation in the United States is currently 7.5%, the highest level in 40 years. Consensus forecasts shown in Figure 11 were taken before the Ukraine crisis, and are therefore likely to significantly understate the likely trajectory of inflation this year. Indeed, economists now expect CPI to rise significantly from here, with figures as high as 10% predicted for the United States and United Kingdom in the near term.

Figure 11: Inflation (recorded and pre-invasion projections) by quarter for select countries (Source: Howden, Bloomberg)

Advanced economies

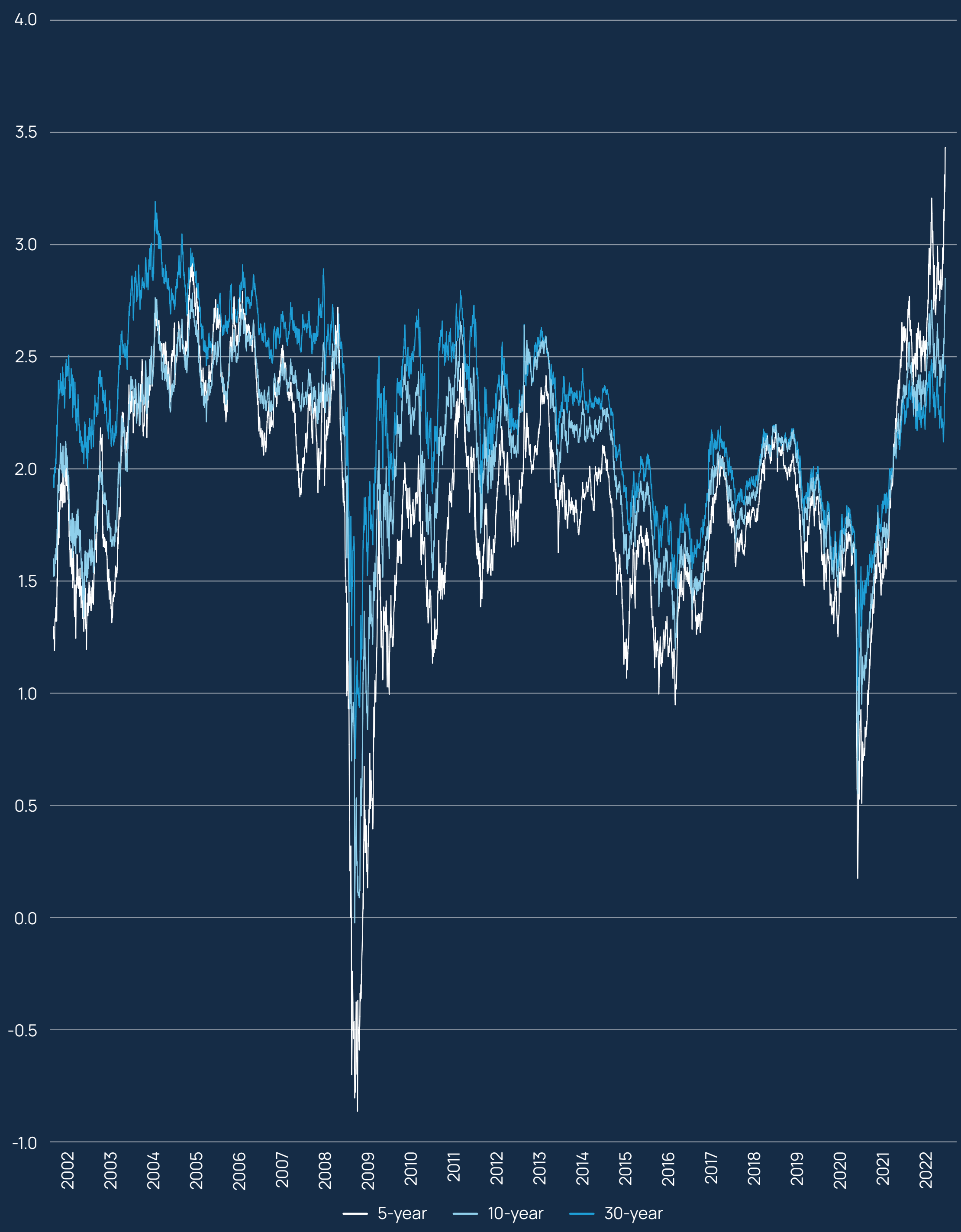


Emerging economies



Bond market-based measures of forward inflation, already on a steep upward curve through 2021, have been propelled even higher by the Ukraine crisis. U.S. breakeven rates, the difference between the yield of an inflation-linked bond and the yield of a traditional Treasury security of the same duration, have risen across all shown maturities, with the 5-year rate rising to a record high prior to publication (see Figure 12).

Figure 12: U.S. breakeven rates for 5-year, 10-year and 30-year inflation-linked Treasury securities – 2002 to 2022 YTD (Source: Howden, Bloomberg)



(Re)Insurance implications

The (re)insurance market is strongly positioned to navigate the economic fallout from the war in Ukraine. Whilst the crisis is tragically unique to any others in recent memory, it presents a myriad of risks – direct underwriting losses, rapidly rising prices, slower economic growth, financial market volatility and the potential for asset shocks – that are not altogether different to what occurred during COVID-19 and the financial crisis.

Despite the considerable economic turmoil both events brought, the (re)insurance market emerged relatively unscathed in both cases. All of the factors are in place for a similar outcome during this crisis, with some potential for claims uncertainty over sanctions compliance, albeit on a far smaller scale than what transpired with COVID.

1. Direct exposures

Direct underwriting and investment exposures to the crisis are limited and currently look manageable. Even for global P&C carriers with operations in Russia, S&P Global estimates local asset and insurance liability exposures at less than 2% of total adjusted capital.[2] Reinsurers have even lower exposure at less than 1% of assets and liabilities, according to S&P.

Claims, whilst meaningful, are likely to be limited primarily to the speciality market. Lines of business most exposed are likely to include political violence, political risk, cyber, aviation (war), marine / cargo (war), energy and trade credit, most of which are heavily concentrated in the Lloyd's market. War exclusions may not always apply in these niche areas, and there is potential for significant losses for specific business lines depending on how events play out. Sanctions are an additional complication in the claims settlements process, but carriers have experience in dealing with other sanctioned countries, albeit not on this scale.

Cyber is of course an area of concern for the market, given Russia's well known activity in this space and the risk for systemic attacks. Any such attack would likely test the sector's effort to address silent cyber risk, which is again under close scrutiny following a recent, high profile court case that ruled against insurers over a large claim (on an all-risks property policy) from the NotPetya attack in 2017.

2. High inflation / interest rates

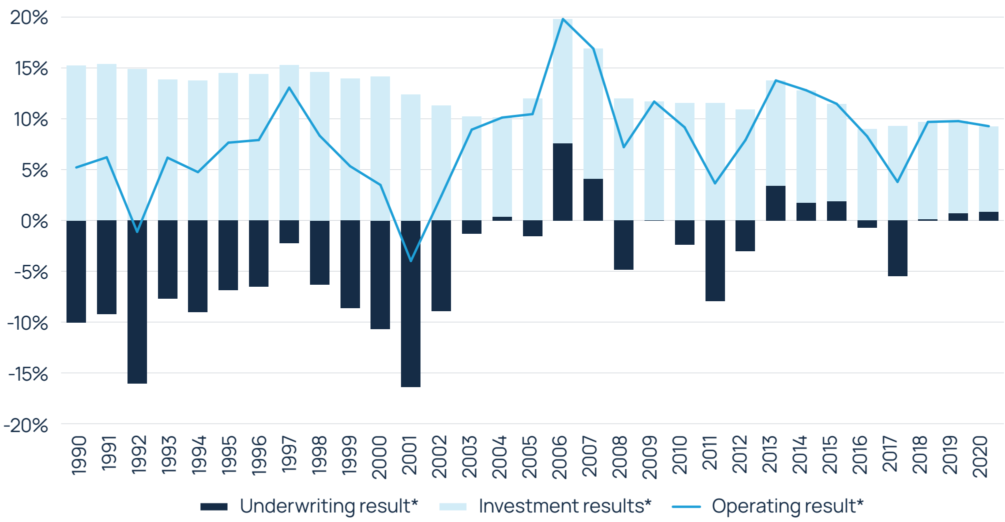
CPI is not always directly correlated to claims inflation, especially for long-tail lines where medical and legal costs and wage inflation are more important. But with headline inflation rates set to surge on the back of higher energy prices, rising costs could add to loss severity and erode margins in already impacted areas of the market (e.g. property and motor).

The insurance market has nevertheless traditionally performed better during times of high inflation, driven by higher pricing and investment yields. Whilst expectations for the scale and pace of monetary tightening this year have moderated due to the prospect of slower economic growth stemming from the war, inflation will reach multi-decade highs.

Yields on high-grade fixed income securities are likely to increase into 2023, boosting (re)insurers investment returns, which have been (and continue to be) by far the biggest contributor to sector performance over the last 30 years (see Figure 13). This will be important if claims increase over the medium term.

[2] S&P Global Bulletin: *Credit Quality Of Insurers Is Weathering The Geopolitical Storm*, 4 March 2022.

Figure 13: Operating performance of U.S. P&C sector split by underwriting and investment results (Source: Howden, A.M. Best)

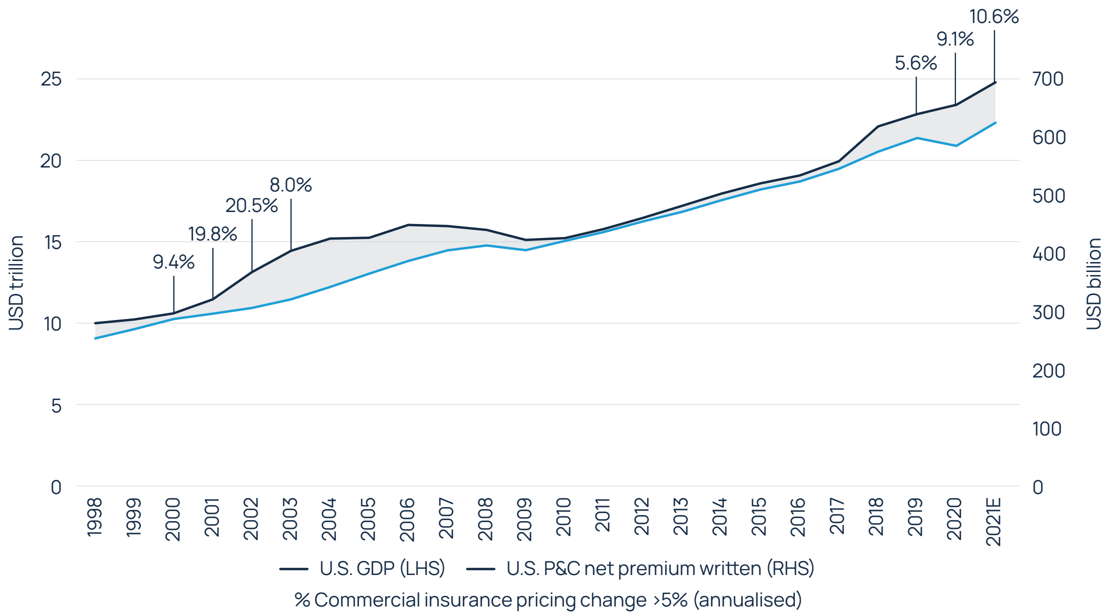


* All results are a percentage of net earned premium

3. Slower economic growth

Despite the highly instable macroeconomic backdrop, the sector looks set to continue to benefit from above-trend premium growth. Cyclical and structural factors, including significant rate increases and increased risk aversion in an uncertain risk landscape, have propelled P&C premium growth ahead of GDP growth in recent years (see Figure 14). Notwithstanding the loss of premium income at local or individual line of business level due to sanctions, this trend is likely to be sustained this year, even if economic growth is pared back.

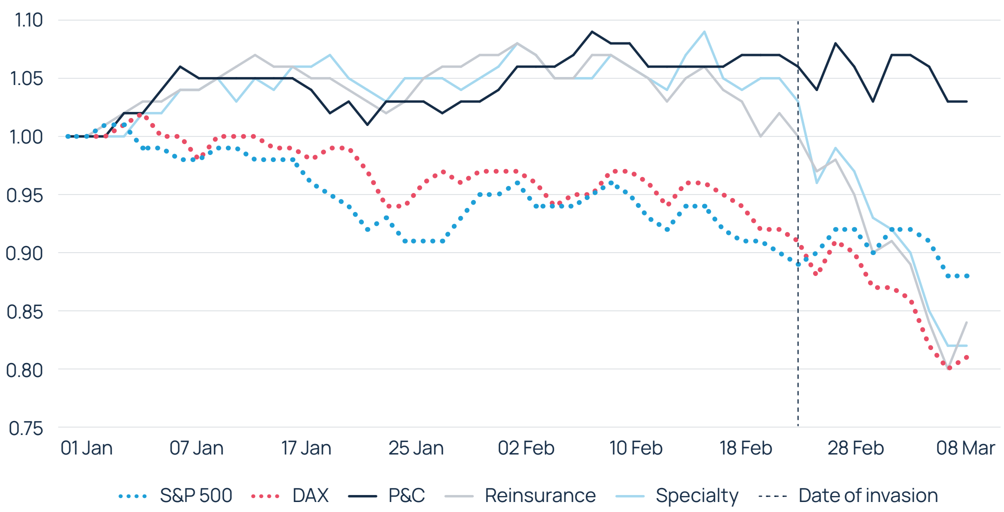
Figure 14: U.S. GDP vs P&C insurance premiums – 1998 to 2021 (Source: Howden, U.S. Bureau of Economic Analysis, S&P Global Intelligence, CIAB)



4. Outperformance

All of which has culminated in a strong, relative performance for (re)insurance since the start of the year. Figure 15 shows how different (re)insurance subsectors – primary P&C, reinsurance and specialty – have fared leading up to and during the Ukraine crisis relative to the S&P 500 and the DAX.

Figure 15: Performance of (re)insurance subsectors vs S&P 500 in 2022 (Source: NOVA)



The mixed performance post-invasion is testament to the characteristics and impacts of each subsector. Whereas the P&C composite, which is U.S. heavy, significantly outperformed the S&P 500, in line with the sector's defensive qualities, the specialty and reinsurance composites, which are more European in makeup, are more likely to be directly exposed to the underwriting and asset fallout from the crisis.

Here to help

Howden is closely monitoring developments in Ukraine and stands ready to support clients through this highly fluid and challenging period. (Re)insurance sector capitalisation is currently strong but this crisis brings considerable macro and financial market risks.

Howden exists to support clients during times of adversity, so please get in touch with any questions you may have.

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