London & Capital is an SEC-registered investment management firm headquartered in London. Our Institutional team work exclusively with insurers and have been working with Captives for more than 15 years. Our team of insurance experts work with Captives to create, execute, and report on investment strategies designed for their business.

We recognise that many Captives have long-term, conservative investment guidelines in place or leave cash on deposit locally. However, in a rising inflation and interest rate environment, many Captive boards are actively reviewing their investment options. As an aide to those discussions, we have provided below our insights into the current market and risk/return environment. We would be happy to provide further and more detailed analysis or advice on request, please see our contact details at the end of this update.

MACROECONOMIC & MARKET SUMMARY

Financial markets digested higher inflation readings and lower US GDP growth estimates over Q4 2021, with the bond markets feeling the brunt of the rotation as shorter dated bond yields ended the quarter c.+0.5% higher. The longer dated US-10 year yield finished Q4 roughly where it started as long-term inflation expectations remained firmly anchored, though trading was volatile throughout.

This yield curve 'flattening' was a reaction to the Federal Reserve's plan to tighten monetary policy, as the central bank announced the beginning of the end of its bond purchase programme and prepared for rate hikes. Markets are also now pricing in four to five interest rate hikes during 2022, although London & Capital believes three to four hikes are more realistic at this point.

RISKS FOR 2022

- Structurally higher inflation. Inflationary pressures have initially been generated by supply, rather than demand, as COVID created a dislocation of global supply chains. However, 'onshoring' of supply chains and high wage demands could create stickier inflation.
- Central Banks becoming less predictable and effective. The reliability of Central Bankers' words and actions remain critical. If markets begin to lose confidence in their ability to balance inflation and growth prospects, we could see much more volatility across markets.
- Exuberant risk markets. Equity valuations are now in the top 1% of valuations seen in the last 100 years and mergers and acquisition (M&A) activity has surged - topping $1 trillion in each of the past three quarters.

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RETURNS & EXPECTATIONS

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For Fixed Income investors, a combination of higher inflation expectations and the monetary tightening from global Central Banks dragged on all sectors of the US bond market as government bond yields rose sharply. Going into 2022, we expect corporate bonds to continue to outperform government bonds as corporates continue to benefit from the global recovery.

FIXED INCOME BENCHMARK PERFORMANCE & L&C EXPECTATIONS

	Q4 2021	2021	3 year expected returns (avg. annualised returns)	3 year expected volatility (avg. annualised volatility)
US Gov't (1-5 yrs)*	-0.7%	-1.2%	1.5%	2.8%
US Gov't (1-3 yrs)**	-0.6%	-0.6%	1.4%	1.3%
US Corporate Bonds (1-5 yrs)***	-0.7%	-0.5%	2.3%	3.6%

Source: Bloomberg and London & Capital
* Bloomberg US Gov't Bond 1-5 Year Index **Bloomberg US Gov't Bond 1-3 Year Index *** Bloomberg US Corporate 1-5 Year Index

EQUITIES

US equities were buoyant, even in the face of a normalising growth outlook, supported by a decent earnings season. Late November saw a sharp drop in stocks on the back of fears over the economic impact of the new Covid-19 variant, Omicron, but markets quickly regained lost ground in December as concerns over the severity of the variant faded. Looking into 2022, the equity backdrop will likely be quite different from 2021. After a rapid recovery in share prices, global stocks have moved into the mid-cycle stage. We are expecting economic tailwinds to become weaker as monetary and fiscal stimulus fades and we see less liquidity in the system.

EQUITY BENCHMARK PERFORMANCE & L&C EXPECTATIONS

	Q4 2021	2021	3 year expected returns (avg. annualised returns)	3 year expected volatility (avg. annualised volatility)
World Equities*	7.0%	21.1%	7.8%	17.0%
US Equities**	10.7%	28.7%	8.1%	16.5%

Source: Bloomberg and London & Capital
*MSCI AC World Index **S&P 500 Index

INSURANCE INVESTORS ASSET ALLOCATION

US insurers' allocation to Fixed Income makes up the vast majority of most insurers' investment portfolios. However, allocations to Equities and Alternatives (shown in 'Other' below) have increased in the past two years as Fixed Income yields have fallen.

US INSURERS ASSET ALLOCATION

	PEER GROUP*
Government Bonds	20%
Corporate Bonds	48%
Equity	22%
Cash	7%
Other**	3%

Source: London & Capital
* Peer group is based on a selection of P&C insurers underwriting business in the US.
** Includes property, collateralized securities, hedge funds and alternative assets.