Gauging the Economy

March 2012

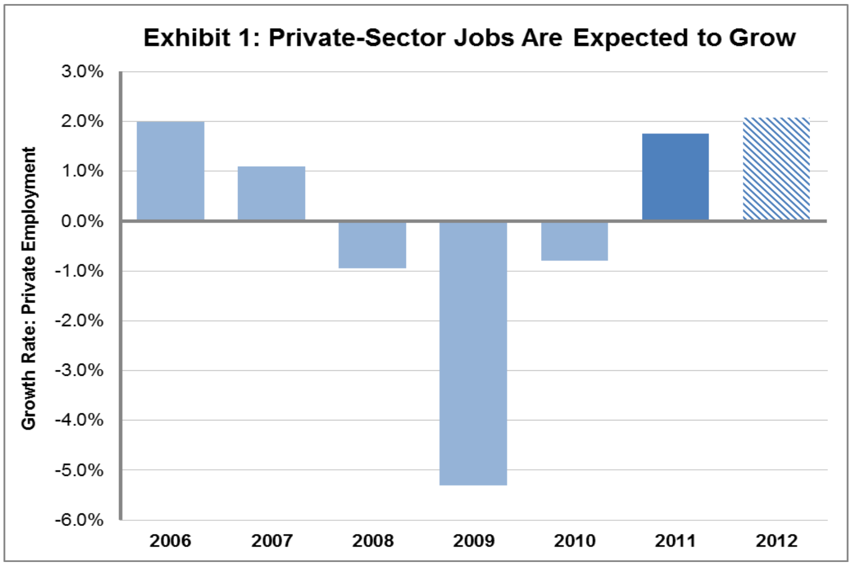
Gauging Current Conditions:
The Economic Outlook and Its Impact on Workers Compensation

The exhibits below are updated quarterly to reflect the current economic outlook for factors that typically impact workers compensation. Each exhibit also provides some context for the outlook, relative to the historical data.

Employment Growth

Recent increases in employment growth suggest that the recovery is gaining some traction. Barring any slowdown due to rising oil prices and weaker economic growth in the rest of the world, higher job growth will likely put upward pressure on claim frequency and exposure.

The economy added a better-than-expected 233,000 private-sector jobs in February. Job increases were relatively widespread across most sectors. The unemployment rate remained unchanged at 8.3%, as increased employment growth was tempered by a rise in labor force participation. However, a major cautionary note for the current optimism is warranted as rising fuel prices may put a crimp in consumer demand and hiring going forward.



Wage Growth

One of the key factors in determining indemnity severity is the change in average weekly wages. The projected recovery in the labor market suggests that pressure on severity due to wage inflation will increase as benefits are also linked to wages.

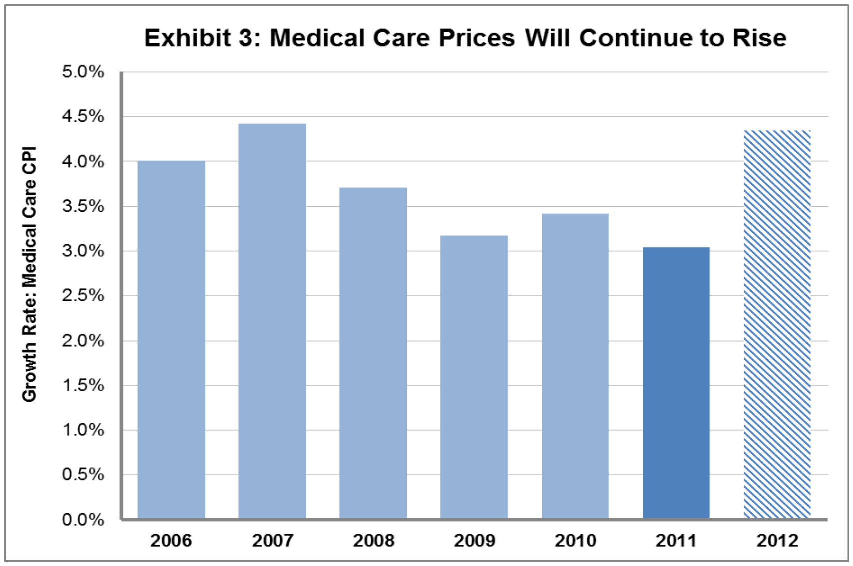
According to the latest estimates from Moody's Analytics, average weekly wages (AWW) are projected to grow by 3.4% in 2011 and 4.6% in 2012. The acceleration in wage increases, however, should not be a major concern for the workers compensation line. Premiums are also directly tied to wages, which would be expected to at least partially offset any adverse effect on severity.

Analysis and charts prepared March 2012.

Medical Inflation

Medical price inflation is a major driver of changes in medical severity. Accelerating medical care inflation suggests increased pressure on medical cost per claim. At the same time, increased use of costly medical treatment options will add further upward pressure to severity.

According to Moody's Analytics, general inflationary pressure is expected to ease in 2012, but medical inflation is expected to remain strong and will adversely influence medical costs. Medical price inflation will continue to outpace general inflation in the economy in the foreseeable future.

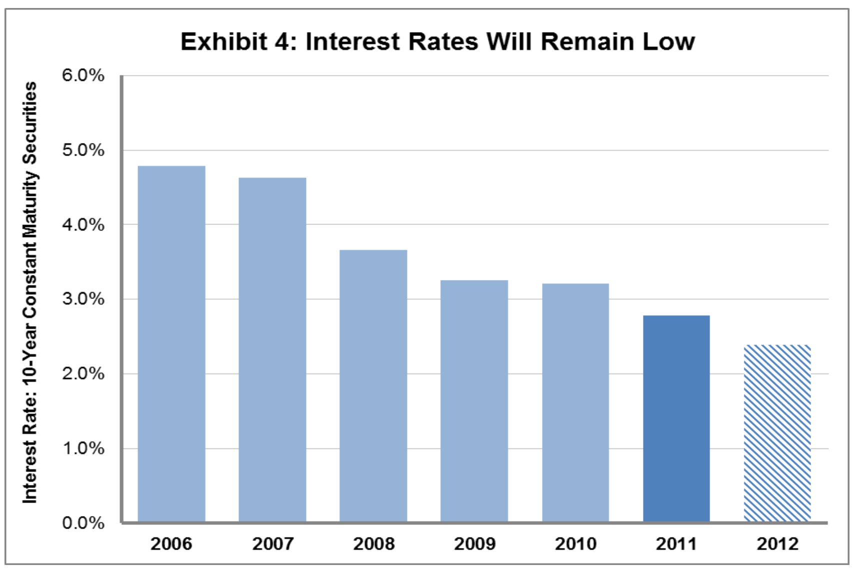


Interest Rates

The current low interest rate environment will keep downward pressure on investment income for the property/casualty (P/C) industry.

The Federal Open Market Committee (FOMC) met in January and decided to maintain a highly accommodative stance for monetary policy. In particular, FOMC decided to keep the target range for the federal funds rate at 0–0.25%. This target range has been in effect since December 2008.

Moody's Analytics expects the 10-year Treasury constant maturity security rate (annual average) to decline in 2012. The P/C industry's investment performance and profitability will be negatively affected as a result of continued downward pressure on long-term interest rates.



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Behind the Gauges:

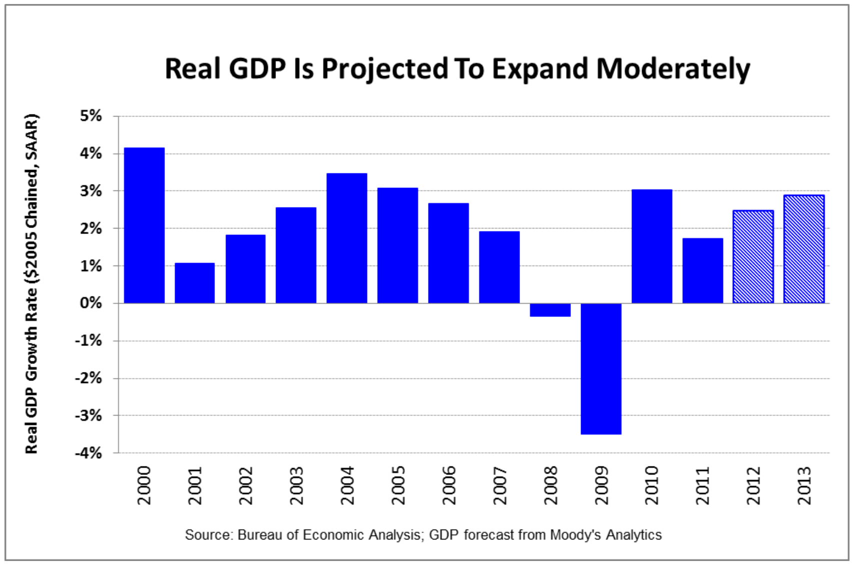
Macroeconomic Outlook

The following charts focus on macroeconomic conditions and their ramifications for the P/C industry. Macroeconomic factors affect the workers compensation line. This section presents separate charts and commentary focusing on real GDP growth, industrial production and capacity utilization, disposable income and personal consumption expenditures, US exports and dollar exchange rate, the housing market, and corporate profitability.

1. Real Gross Domestic Product (GDP)

A weak economic recovery from such a deep recession has presented a very challenging environment for the workers compensation line over the past couple of years. In fact, the current recovery has been the weakest postwar expansion on record on almost all accounts.

A healthy economy should grow by at least 3% annually to heal the labor market and bring unemployment to a more normal level. The economy is projected to grow at a relatively moderate pace over the next couple of years. The recovery in workers compensation is directly tied to the recovery in the labor markets and indirectly to the broader economy and the financial markets.

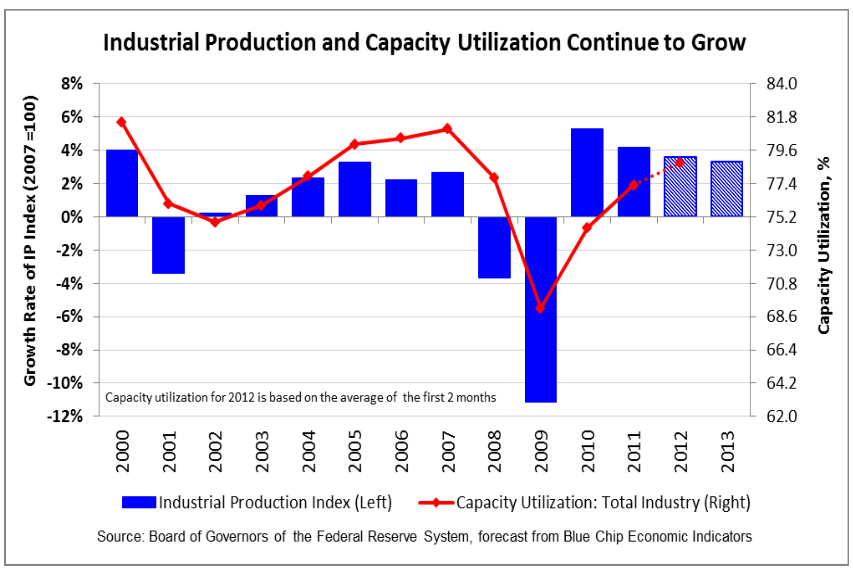


2. Industrial Production and Capacity Utilization

Continued improvement in industrial production (IP) and capacity utilization will be crucial for increased demand for workers compensation insurance.

IP measures changes in output for the industrial sector, which includes the manufacturing, mining, and utilities industries. There is a very close relationship between changes in industrial output and GDP growth.

Capacity utilization measures the amount of slack in the economy as indicated by the ratio of actual-to-potential output. Generally, a higher utilization rate is indicative of a healthier economy. But a very high utilization rate can also indicate an imminent threat of inflation. The current utilization rate suggests that general inflationary pressures are still well contained, except for pressure from rising gasoline prices.



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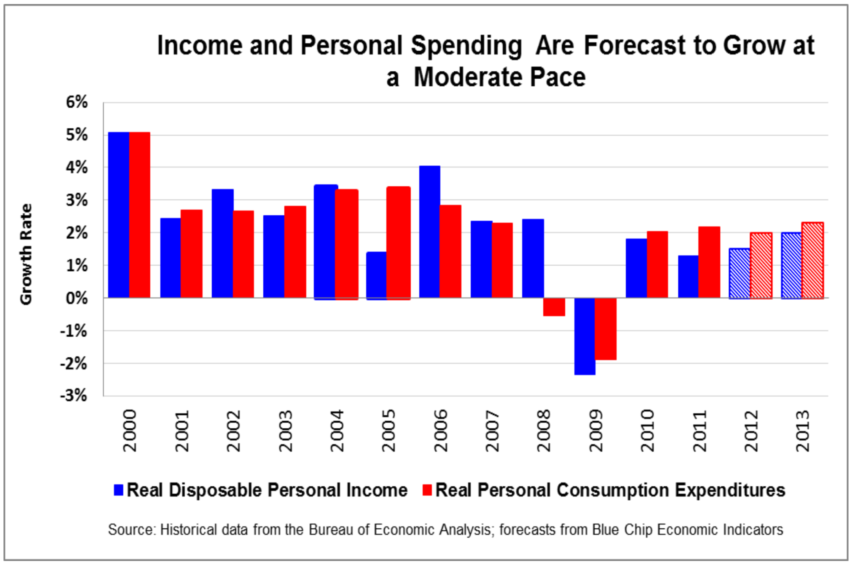
3. Disposable Income and Personal Consumption Spending

Disposable personal income is one of the major indicators of expected consumer demand, which drives two-thirds of general economic activity. Hence, growth in disposable personal income and personal consumption spending are crucial for increased demand for workers compensation insurance.

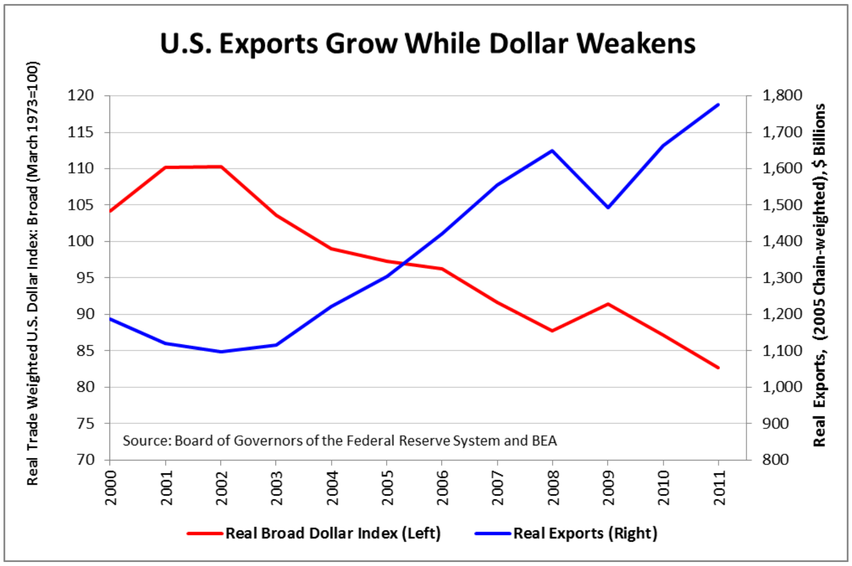
The consensus forecast calls for moderate growth in both real disposable personal income and real personal consumption expenditures. The forecast is highly dependent on what Congress may do at the end of this year when Bush-era tax cuts are set to expire. At this point, one of the key downside risks to this forecast is the threat of higher fuel prices. If gasoline prices continue to rise, they will filter through to broader inflation and affect every other sector of the economy.



4. US Exports and Dollar Exchange Rate

The export sector has been one of the few bright spots over the last few years. In terms of real exports, the US economy has fully recovered to its prerecession high. It is not surprising that the US dollar strengthened at the height of the international debt crisis and was one of the contributing factors to a sharp fall in exports during that time. In general, a competitively weaker currency makes a country's exports more attractive to foreign buyers and vice versa.

A healthy export sector is considered important for the recovery in workers compensation business because of its favorable impact on the labor market and, particularly, the manufacturing sector. One of the main downside risks to the export sector comes from slow growth abroad or an unexpected rise in the dollar exchange rate.



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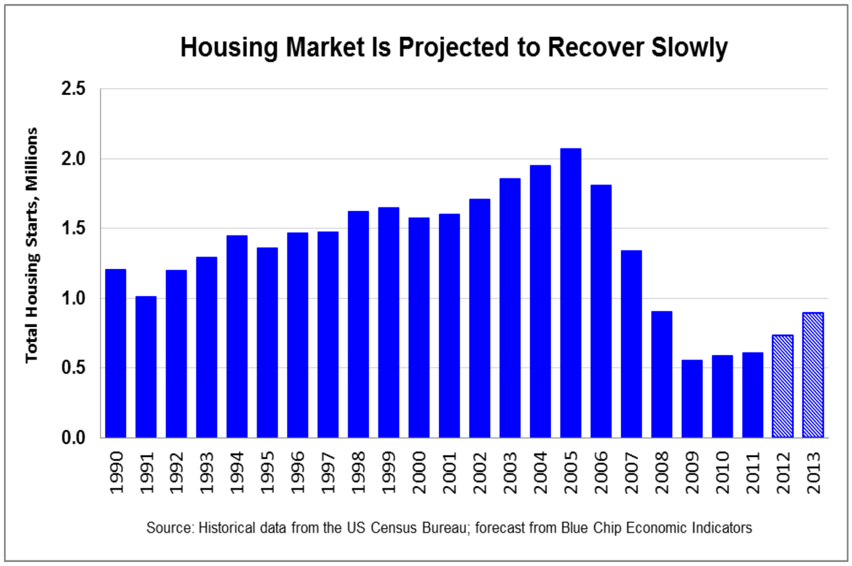
5. Housing Market

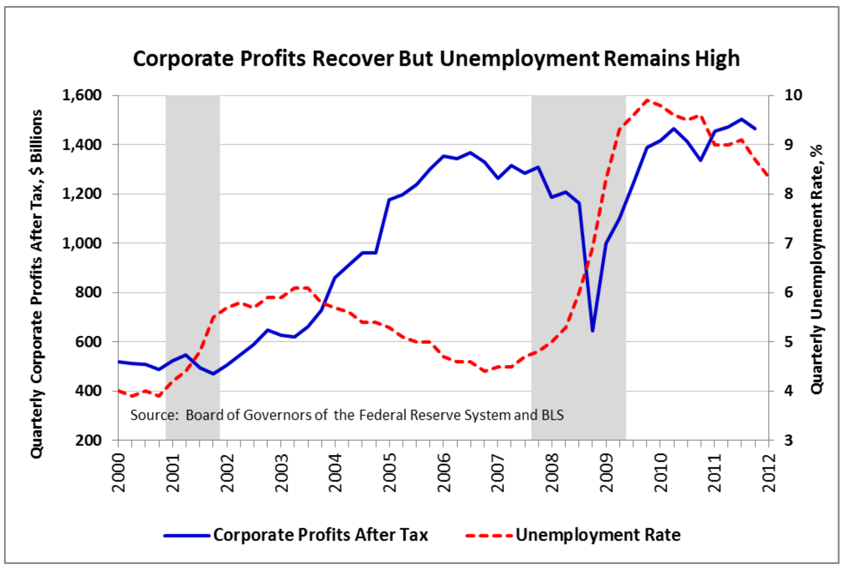
The limited recovery in workers compensation can be directly tied to pronounced weakness in the housing market. The effect on employment is not only seen in the construction sector but also in supporting industries associated with building and buying houses.



It will take years before the housing market returns to a more normal level. The current consensus forecast shows surprising double-digit growth in housing starts for the next two years. But those increases are coming from a very low base and the numbers will still remain below the 1990 level. Depressed home prices, a glut of home inventory on the market, and a backlog of mortgages yet to enter the foreclosure process will continue to weigh on the housing recovery.

6. Corporate Profitability

Healthy corporate profits are a key to a growing economy because these profits are reinvested back into the business. Businesses spending and hiring more workers helps increase demand for workers compensation coverage.



In the past, strong corporate profits led to hiring more workers; however, this has not happened during the current recovery. Some of the cost-cutting measures taken during the recession have been the driving force behind productivity and profitability gains. It appears that companies, having learned to do more with less, were able to bring production back up to prerecession levels without hiring significantly more workers.

Sales and profitability of US corporations benefited from strong demand from emerging markets. Going forward, deceleration in profit growth will likely result from rising fuel prices, increasing wage pressures, and slowing of emerging economies. In fact, some of that effect can already be seen in the recently released 4th Quarter 2011 data.

Analysis and charts prepared March 2012.

Summary

Premium—Recent gains in employment growth, along with the forecast of improving labor market conditions, suggest that workers compensation exposure-based premium growth will improve in the coming years.

Frequency—Results for 2010 (preliminary results were first presented at NCCI's 2011 ***Annual Issues Symposium***) indicate that lost-time claim frequency (relative to premium) increased for the first time in 13 years. This rise in frequency can be partly explained by the fact that there has been a shift to high-frequency office and clerical jobs relative to construction and manufacturing jobs. However, the more recent Bureau of Labor Statistics measure of workplace injury rates (the incidence rates for cases with days away from work, which, in the past, has closely tracked lost-time frequency) remained unchanged for 2010. Manufacturing was the sole private-sector industry to experience a small increase (2.3%) in the incidence rate in 2010—rising from 4.3 cases per 100 full-time workers in 2009 to 4.4 cases in 2010. It remains to be seen if modest increases in frequency will continue or if the long-term downward pressure on frequency will outweigh the short-term cyclical phenomenon.

Indemnity Severity—Two key factors in determining indemnity severity are changes in average weekly wages (AWW) and changes in duration. There is some evidence that duration is countercyclical—it increases during economic downturn, likely due to limited availability of return-to-work opportunities. The anticipated improvement in labor market should ease the upward pressure of duration on severity. On the other hand, the projected recovery in the labor market suggests that pressure on severity due to wage inflation will increase as benefits are also linked to wages. However, projected increases in AWW will be due, in part, to an increase in the average number of hours worked per week. All else being the same, this will likely cause the numerator of severity to go up because indemnity benefits are directly linked to an injured worker's AWW. But exposure, as measured by the numbers of hours worked, will also go up. This means that the number of claims will also rise. Thus, any anticipated increase in the denominator (number of claims) would offset some of the increased pressure on severity from the rise in AWW.

Medical Severity—Medical price inflation is a major driver of changes in medical severity. Accelerating medical care inflation suggests increased pressure on medical cost per claim. At the same time, increased use of costly medical treatment options will add further upward pressure to the severity.

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