

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

The exhibits below are updated 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. Consensus forecasts are derived from Blue Chip Economic Indicators and Moody's economy.com.

Employment Growth

Employment growth in the United States is accelerating with 3 million jobs having been created in the last year. This is the strongest growth seen in the last 15 years. In February, total nonfarm employment increased by close to 300,000 jobs, and the unemployment rate declined to 5.5%, down 1.2 percentage points from the year-ago rate. Energy-related jobs declined due to falling oil prices, but that was more than offset by increases in services, construction, healthcare, and transportation and warehousing. Over the past four months, employment has grown by more than 1 million jobs. Moody's does not expect this pace to be sustainable, but still expects private employment growth to tick up to 2.6% this year and next from 2.3% in 2014. This is an increase from an average annual 2% employment growth from 2011 to 2013 and a decline in 2010 when the country was just emerging from the Great Recession.

Increases in employment will likely lead to increases in exposure-based premium and create upward pressure on claim frequency and exposure.

Employment: Forecast is for Growth in the Private Sector

Growth Rate:
Private Employment



Source: US Bureau of Labor Statistics, Moody's Analytics

Wage Growth

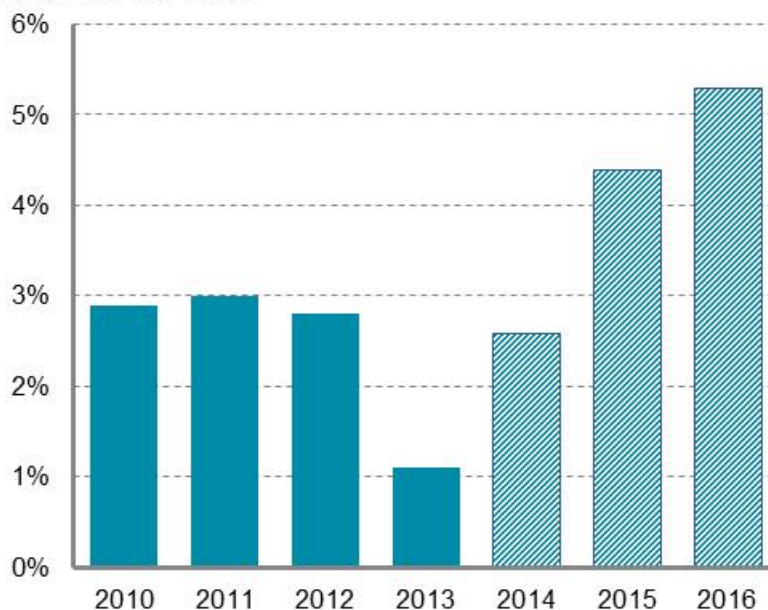
A key driver of indemnity severity is the average weekly wage. Average weekly wage growth lagged in 2013, increasing by only 1.1%. Wage growth rebounded somewhat in 2014. Wages are expected to have increased by 2.6% during 2014, which is still below the average annual 2.9% rate of growth from 2010 to 2012. Lagging growth in wages may be due, in part, to continued slack in labor markets indicated by the high unemployment rate (until just recently), plus large numbers of discouraged workers.

There may also be other factors at play. Moody's thinks that wage growth is still about half a percentage point below what would be expected given labor market slack. Possible reasons for this gap are lower inflation due to the decline in oil prices and businesses having become accustomed to not paying their workers more.

But now that employment growth is starting to increase, stronger wage growth can be expected for both 2015 and 2016. The potential for rising wages suggests that there will be upward pressure on indemnity severity. Private-sector payrolls should also grow due to the combined impacts of higher employment and increases in the average weekly wage.

Wages: Expected To Rebound Strongly From the Low Increases in 2013

Growth Rate:
Average Weekly Wage



Source: US Bureau of Labor Statistics, Moody's Analytics, NCCI

Medical Inflation

Medical price inflation is a major driver of changes in medical severity. Rising medical care inflation suggests that we can expect increased pressure on medical costs per claim. In addition, increased use of costly advanced medical treatment options may also add upward pressure to severity.

However, medical care inflation has been muted for the last two years, increasing by only 2.5% in 2013 and 2.4% in 2014. This is considerably below the average annual medical inflation of 3.4% experienced from 2010 to 2012. Moody's forecast is for medical care inflation to accelerate somewhat this year and next—2.9% in 2015 and 3.4% in 2016—but still to remain below 4%.

Rising medical care inflation will put upward pressure on medical costs. Medical inflation will continue to outpace general inflation in the economy in the foreseeable future. Moody's forecast for general inflation is 0.7% this year and 2.5% next year.

Medical Care Inflation: Expected to Remain Below 4%

Growth Rate:
Medical CPI, Urban Consumers



Source: US Bureau of Labor Statistics, Moody's Analytics

Interest Rates

The current low-interest-rate environment continues to restrain investment income in the property/casualty (P/C) industry.

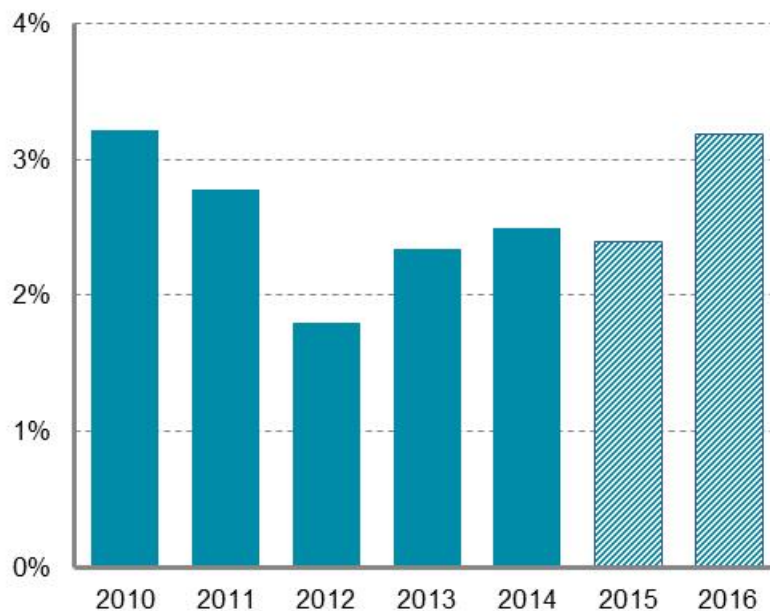
Since December 2008, the Federal Open Market Committee (the Fed) has maintained the target range for the federal funds rate at 0%–0.25%. In her monetary policy report delivered in February 2015, Federal Reserve Chair Janet Yellen said that there has been improvement in labor markets, but that the Fed recognizes there is still room for more. However, the Fed may soon be raising the target rate. The Blue Chip consensus forecast expects the Fed's first rate hike to come in June or September of this year.

Blue Chip Economic Indicators' consensus expects the 10-year Treasury note yield to remain fairly steady at 2.4% in 2015 and then to increase to 3.2% in 2016.

The P/C industry's investment performance and profitability should be positively affected as long-term interest rates begin to rise.

Interest Rates: Moderate Expectations Through Next Year

Interest Rate:
10-Year Constant Maturity Securities



Source: Federal Reserve Board, Blue Chip Economic Indicators

Drilling Down: Macroeconomic Outlook

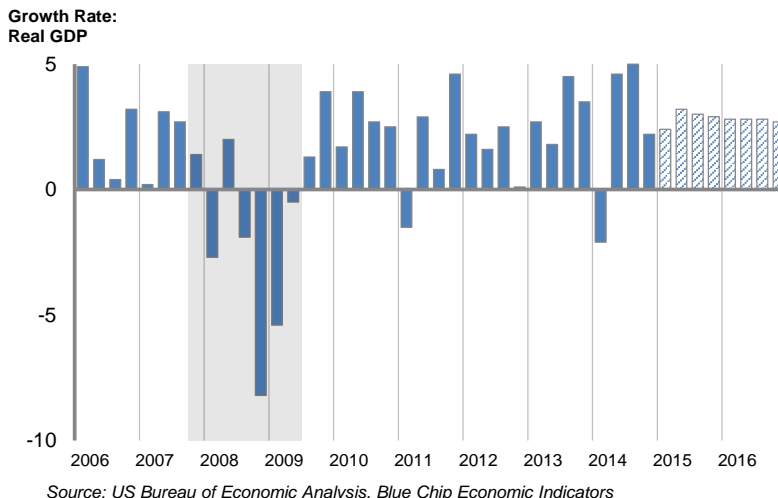
The following charts focus on macroeconomic conditions and their ramifications for the P/C industry. Macroeconomic factors affect the workers compensation line. This section presents separate charts and commentary, focusing on real GDP growth, interest rates, the dollar exchange rate and net exports, oil prices, the housing market, and unemployment.

1. Real Gross Domestic Product (GDP)

Since the recession formally ended in 2009, real GDP has experienced weak growth of only 1.6% to 2.5% per year. This has been the weakest postwar expansion, creating a challenging environment for the workers compensation industry.

While the unemployment rate has fallen in recent months, there is still a large number of workers who are only marginally attached to the labor market, including discouraged workers who are not actively seeking employment (see the unemployment rate discussion below). The Blue Chip consensus forecast is that real GDP will increase by 3.1% in 2015 and 2.9% in 2016. This will help reabsorb those marginally attached workers. However, the consensus forecast includes downward revisions for the current quarter due to severe winter weather and labor management disputes that slowed trade through West Coast ports. Moody's notes that lower gasoline prices were also expected to boost real GDP during the first quarter, but that has not happened.

GDP Is Forecast to Grow Moderately

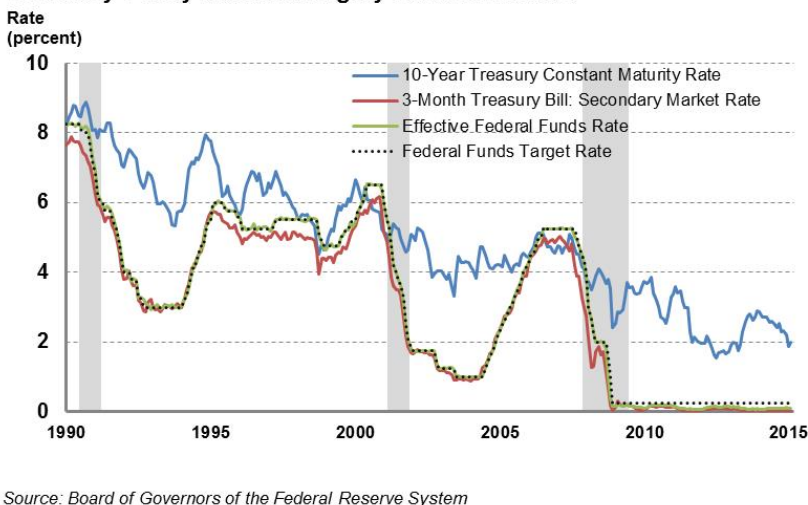


2. Interest Rates

As the Great Recession took hold, the federal funds target rate (overnight bank lending rate) dropped from 5.25% in August 2007 to a mere 0% to 0.25% range by December 2008. The rate has remained unchanged since then.

Long-term interest rates have been declining since December 2013. Moody's views lower interest rates as a moderate plus to the economy, being responsible for about 150,000 jobs and a slight boost to real GDP. However, the P/C industry's investment performance will be adversely affected as long as interest rates remain at such low levels. The Blue Chip consensus forecast expects the Fed to begin raising the target range for the federal funds rate later this year, and expects longer term interest rates to start to increase by 2016.

Monetary Policy Remains Highly Accommodative



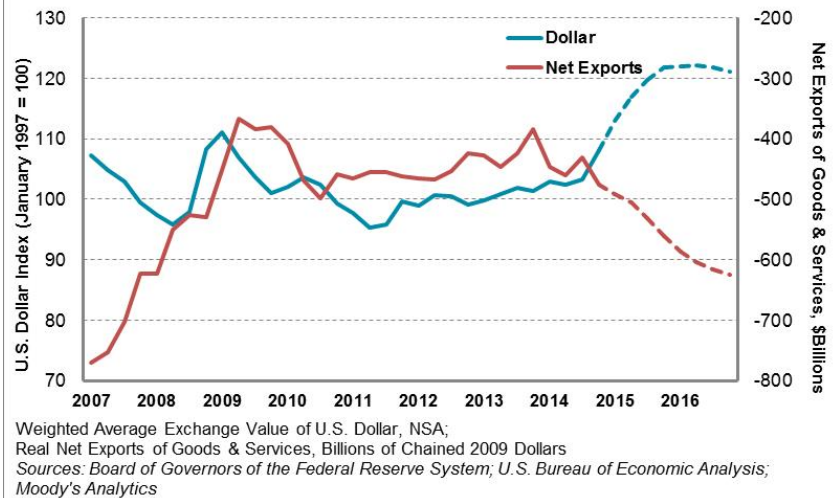
3. Dollar Exchange Rate and Net Exports

The dollar has continued to appreciate during the first quarter, causing an increase in the trade deficit and weaker profit margins for exporters. A stronger dollar will offset some of the benefits of lower oil prices and lower interest rates discussed elsewhere in this report. A relatively wide trade deficit reduced Fourth Quarter 2014 GDP by 1.15 percentage points, and Moody's expects the decline in net exports to continue to constrain GDP growth for the first six months of this year. In the last year, the dollar has risen an average of 20% against other major currencies and is up 27% against the euro. As of March, it is currently at an 11-and-a-half year high. Moody's expects the dollar to appreciate another 12.5% this year, which could reduce real GDP growth by almost half a percentage point.

The dollar's appreciation depresses exports, which is causing US companies to lose competitiveness. Sectors particularly impacted include technology companies in the West and industrial machinery manufacturers in the Midwest.

A weak export market is a downside risk for the recovery in workers compensation business because of the unfavorable impact on employment growth, particularly in the manufacturing sector. Manufacturing is a big source of workers compensation premium, since the sector makes up 9% of payroll but 17% of premium. Moody's expects net exports to continue to decline through 2016.

Net Exports Are Down Due to the Rising Dollar

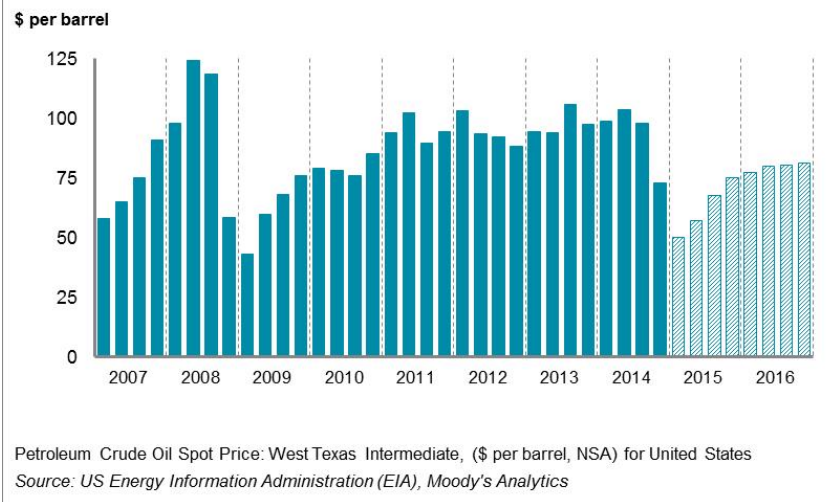


4. Oil Prices

Oil lost more than half its value since the second half of 2014 before stabilizing in February. Currently, US crude is at \$47 to \$53 per barrel compared to \$107 last June. The number of working rigs has declined, along with prices for oil and natural gas, down by 40% since the October 2014 peak.

This is a significant negative for energy-dependent states. Overall, Moody's expects energy-related industries to lose 100,000 jobs in the next year, with half of those job losses in Texas. Already, new unemployment claims are up by more than 25% from a year ago in Louisiana, North Dakota, and Oklahoma due to layoffs at drillers and oil field service firms. In Texas, unemployment claims are up 15%. Several metro areas in both Texas and North Dakota are at high risk of recession. As a result, growth in the Texas economy is expected to be below the US average for the first time since 2003.

Crude Oil Spot Price: Lower Prices for Economic Inputs



Oil-producing states are also expected to suffer from reduced severance taxes. States with high shares of total tax revenue from severance taxes on oil, natural gas, and mining activities include Alaska (75%), North Dakota (50%), and New Mexico (15%). Other states that may feel a pinch with tax shares near 10% are Oklahoma, Louisiana, Texas, Montana, and West Virginia.

Overall, the drop in oil prices should be a net positive for jobs and growth, as the loss of energy-related jobs should be more than offset by increases in other industries. Moody's expects that their forecasted oil prices, around \$63 per barrel this year, will boost real GDP growth by half a percentage point and employment by 680,000 jobs. However, this positive

impact will be lagged if households elect to increase savings due to lower oil prices. In fact, the lagged effect on employment growth, as lower oil prices are channeled in increased savings, may be longer than anticipated. Oil prices have been in decline for the past six months, but an increase in consumer spending has yet to happen.

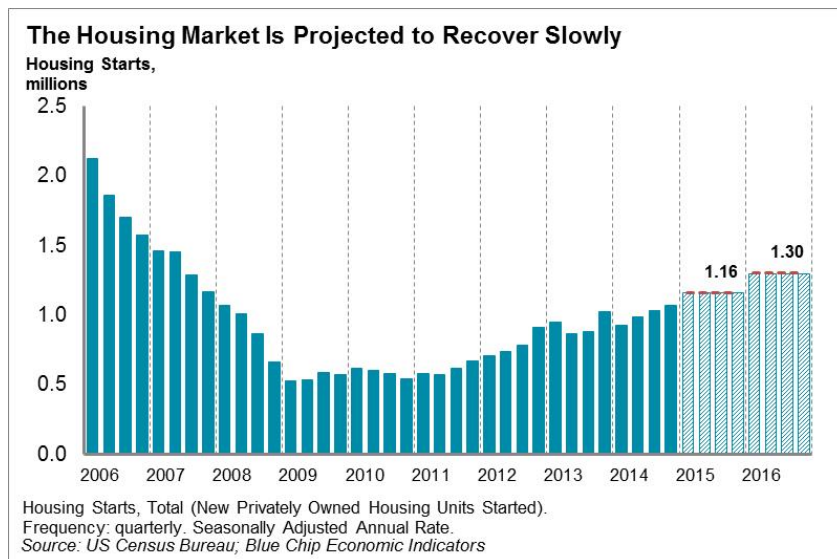
Lower oil prices also mean lower producer prices. In particular, chemicals and plastics manufacturers are benefiting from lower energy prices. Many of these are located in the Midwest and Southeast. The Southeast is also expected to benefit since the region has lower household incomes that will gain from lower gas prices. If oil stays low, then consumers will eventually spend their extra disposable income from lower fuel prices rather than pay down debt, especially since average household balance sheets are already in the best shape they have been since the beginning of the Great Recession.

NCCI's 2013 frequency study looked at the oil and gas industry in detail. From 2007 to 2011, payroll for the oil and gas industry increased 16%, while total countrywide payroll declined nearly 2%. The increase was attributed to the rise of hydraulic fracturing and the resulting boom in oil and natural gas drilling. Claim frequency was higher for those segments of the oil and gas industry associated with hydraulic fracturing. Additional information can be found in the NCCI Research Brief "Workers Compensation Claim Frequency—2013 Update" and in the forthcoming report "Workers Compensation and the Oil and Gas Industry" on ncci.com.

5. Housing Market

Housing starts have doubled from the 2009 lows during the recession. Just over 1 million homes were built last year. That number is expected to continue to increase as economic recovery continues. The Blue Chip consensus forecast expects housing starts to increase both this year and next with more than 1.16 million starts this year and 1.30 million starts in 2016. The Moody's forecast is somewhat more optimistic with 1.4 million starts this year and close to 2 million starts in 2016.

The effect of changes in the housing market on employment can be seen not only in the construction sector, but also in supporting industries associated with building and buying houses. According to Moody's, every single-family housing start creates more than three jobs, while every multifamily housing start creates more than one job in a year. Therefore, its forecast for an average increase in housing starts of 700,000 over the next two years could generate an increase of 1.4 million jobs, assuming half are single family and half are multifamily.



The March release of the Housing Market Index (HMI) of builder confidence for single-family homes declined 2 points to 53. The decline was due to lot and labor shortages as well as to tight underwriting standards. Expectations are for the HMI to improve due to job growth, low mortgage rates, and pent-up demand.

6. Unemployment

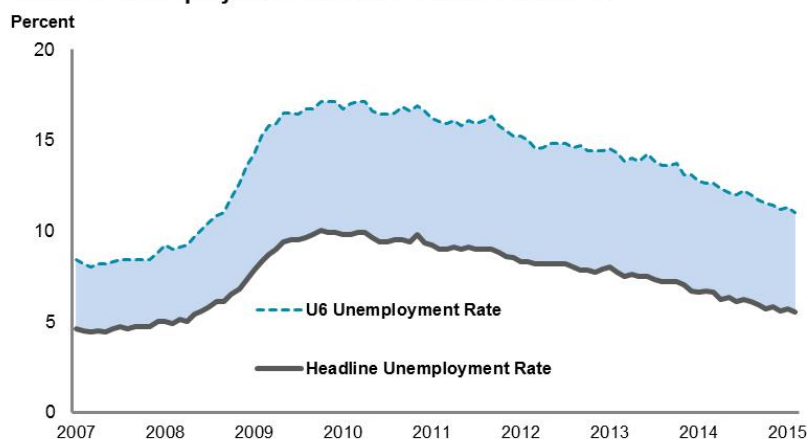
Labor market conditions are the most important single driver of workers compensation premium growth as well as claim counts. The latest reading (in February) of the unemployment rate showed that it has moved lower to 5.5%. This is down considerably from the peak of around 10% immediately following the end of the Great Recession.

This is encouraging, but it is important to note that the unemployment rate would double to 11.0% if we add shadow unemployment of 5.5% (the U6—Bureau of Labor Statistics rate of total unemployed in the graph). These are people who are marginally attached to the labor market. People are considered to be marginally attached if they are without a job and are interested in working, but have not actively looked for work in the past month. Many of these are so-called discouraged workers. Low wage growth since the onset of the Great Recession also underscores the observation that the labor market remains weak despite the decline in the headline unemployment rate to 5.5%.

Moody's expects employment growth to remain close to the current pace of 3 million per year. At that pace, the economy would return to its historical "full employment" rate of unemployment by the middle of next year.

As employment levels increase and the labor market tightens, then wage growth can also be expected to accelerate, causing workers compensation premium to increase.

The U.S. Unemployment Rate Continues to Decline



Sources: U.S. Bureau of Labor Statistics

Summary

Employment is growing at its strongest pace since 2000 and is expected to post stronger, although still moderate, annual gains this year and next. This should help to alleviate slack in the labor market, which, in turn, will accelerate wage growth. Falling oil prices and lower long-term interest rates are a net plus to the economy. However, some sectors and states benefit from the lower oil prices while others are hurt. The strong dollar is a negative for US exporters, though it benefits consumers of imported products. The combined impact of all of these forces will vary by region as well as by economic sector.

NCCI will release preliminary 2014 workers compensation industry results at the 2015 **Annual Issues Symposium**, which will be held in May. We hope to see you there!