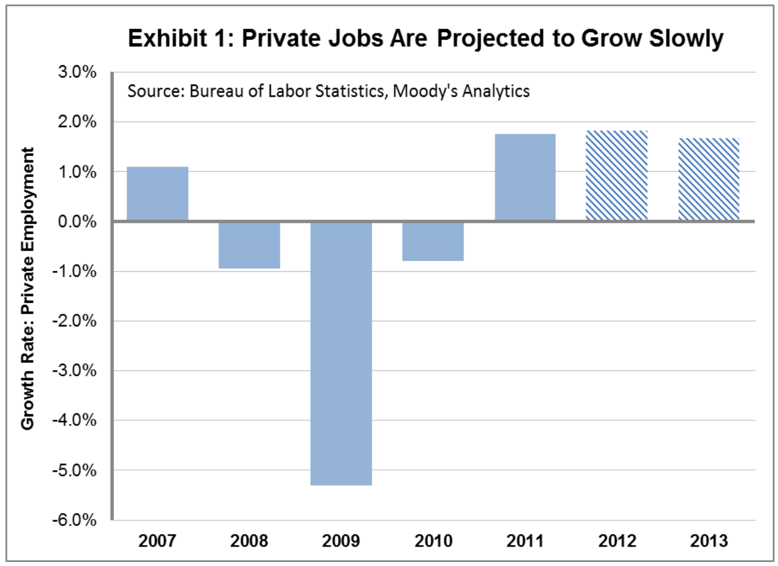
Gauging Current Conditions:

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

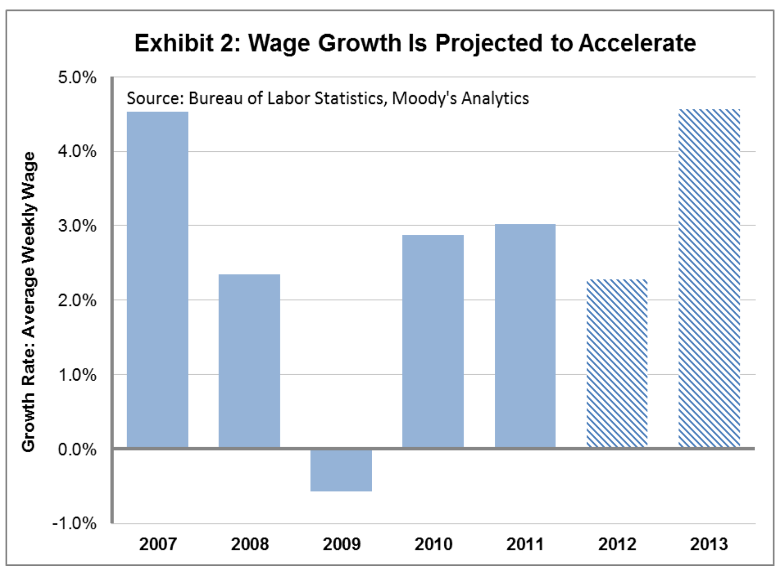
After a promising start early in the year, the US economy posted a third consecutive month of weak job growth in June. A sign of faltering momentum, the recent weakness in the labor market does not bode well for exposure-based premium growth. On the other hand, weaker job growth should limit upward pressure on claim frequency and exposure.



Moody's Analytics expects private-sector jobs to grow even at a slower pace next year. The economy added a less-than-expected 84,000 private-sector jobs in June while the unemployment rate remained unchanged at 8.2%. Both of these job numbers were generally in line with other economic data that suggested a slowdown across major economies worldwide. However, the manufacturing sector gain of 11,000 workers seems at odds with other economic indicators, especially the Institute of Supply Management (ISM) index of manufacturing, which dropped below 50 (indicating contraction) for the first time since July 2009. It appears that the economy will continue to send mixed signals, adding to the uncertainty of its future course.

Wage Growth

Changes in average weekly wages (AWW) are a key factor in determining indemnity severity. While stronger wage growth is expected next year, the pressure on indemnity will be less than that suggested by the rise in AWW. This is because part of the increase in AWW will be due to an increase in the number of hours worked per week, which could be expected to increase the number of claims—the denominator in the severity calculation.



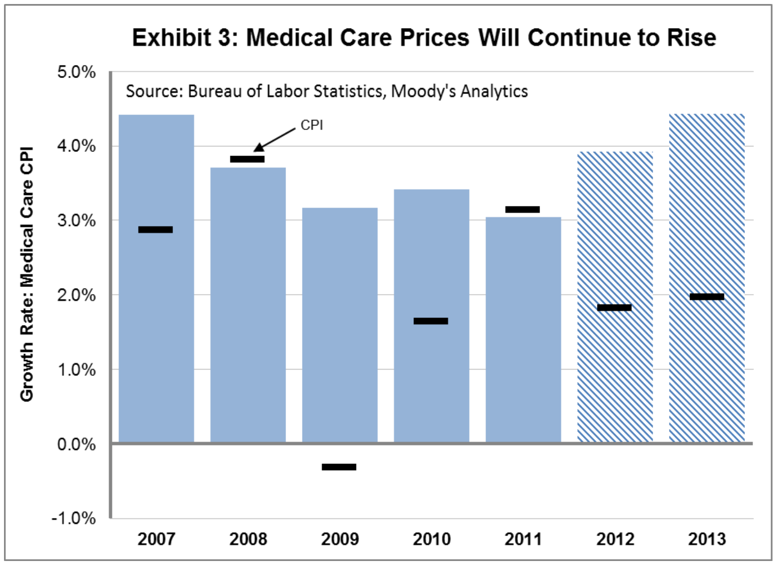
According to the latest estimates from *Moody's Analytics*, AWW is projected to grow by 2.3% in 2012 and 4.6% in 2013. The acceleration in wage increases, however, should not be a major concern for the workers compensation line. Premiums are also directly tied to wages, which would be expected to at least partially offset any adverse effect on severity.

Analysis and charts prepared July 2012.

Medical Inflation

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

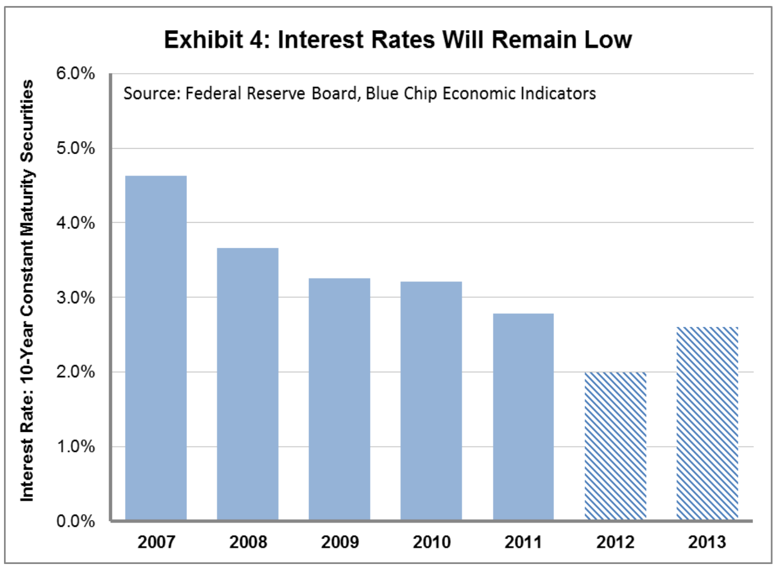
According to *Moody's Analytics*, general inflationary pressure is expected to ease by year's end and will remain below 2% for 2013. But medical inflation is expected to remain strong and will adversely affect medical costs. Medical price inflation will continue to outstrip general inflation in the economy 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 June and decided to maintain a highly accommodative monetary policy. In particular, the FOMC decided to keep the target range for the federal funds rate at 0–0.25% and expects this low level to hold at least through 2014. This target range has been in effect since December 2008.



Blue Chip Economic Indicators' consensus expects the 10-year Treasury constant maturity security rate (annual average) to decline to 2.0% in 2012 and then increase to 2.6% in 2013, which is in line with the growth prospects of the overall economy next year. These low rates are expected to remain far below the historical average in the foreseeable future. The P/C industry's investment performance and profitability will be negatively affected as a result of continued downward influence on long-term interest rates.

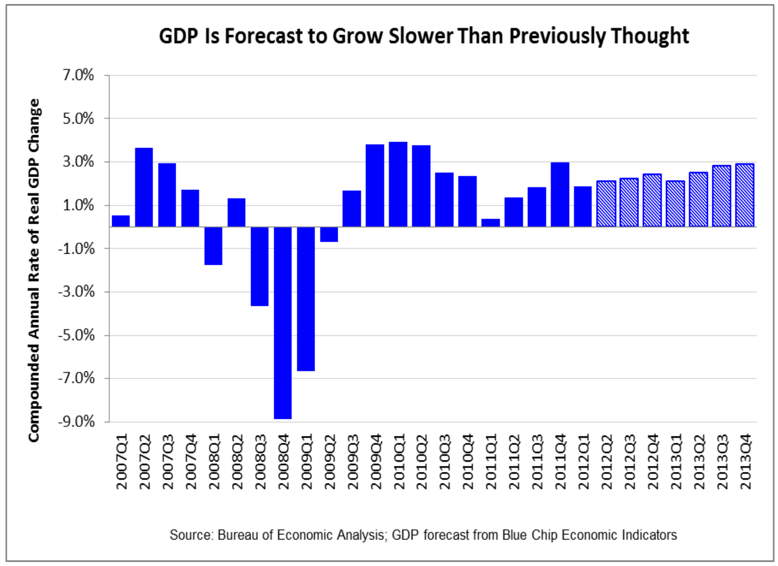
Analysis and charts prepared July 2012.

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, interest rates, the housing market, and unemployment.

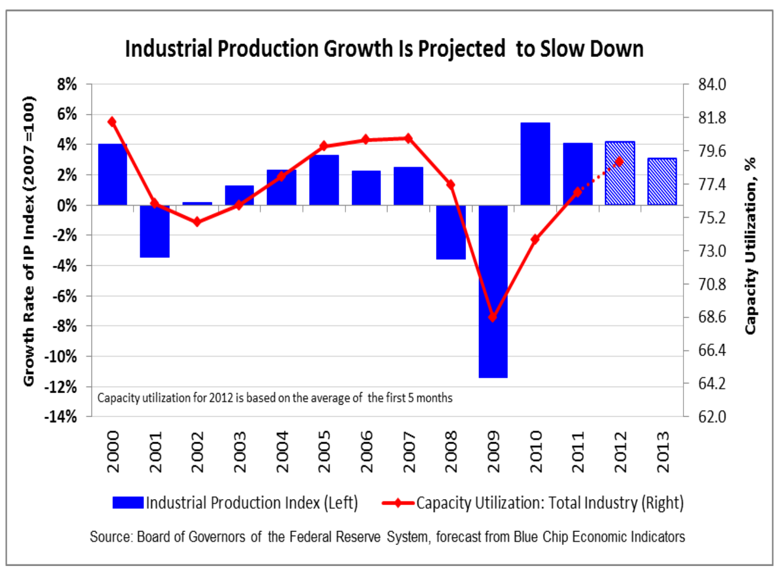
1. Real Gross Domestic Product (GDP)



Ongoing weakness in the economic recovery presents a challenging environment for the workers compensation industry and its underwriting performance. In fact, the current recovery has been the weakest post WWII recessionary expansion on record on almost all accounts. Since the technical end of the current recession nearly three years ago, the economy over the last 11 quarters grew on average by only 2.4% annually. By comparison, the economy's growth rate averaged 6.1% in the 11 quarters following the recovery after the deep recession of 1981–82.

This weakness is a concern because the economy needs to grow by at least 3% annually for an extended period to heal the labor market and bring unemployment down from the current elevated level (8.2%) to the previously more normal level (5% to 6%). The economy is projected to grow at a relatively modest 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



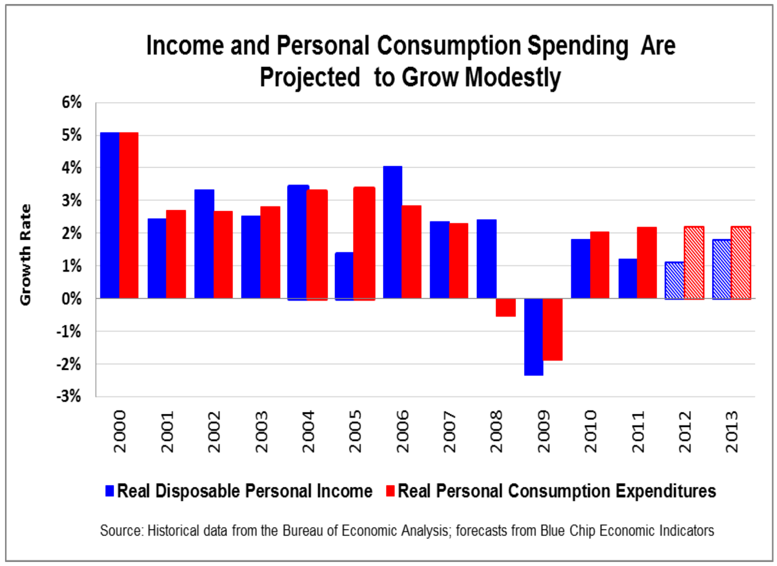
Continued improvement in industrial production (IP) and capacity utilization is considered crucial for increased demand for workers compensation insurance.

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.

Analysis and charts prepared July 2012.

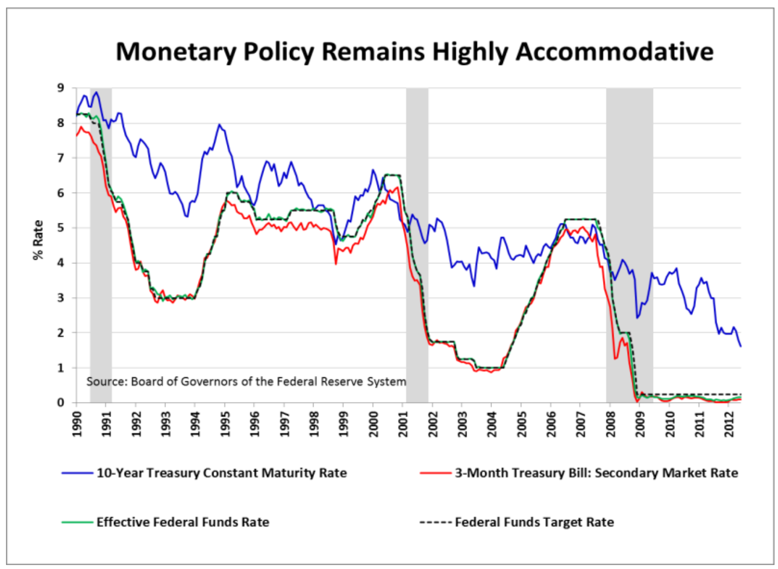
3. Disposable Income and Personal Consumption Expenditures



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 serve to increase demand for workers compensation insurance.

The consensus forecast calls for relatively modest 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 key downside risk to this forecast is the further slowing of the US economy resulting from deterioration of Eurozone economies as well as slowdowns across major emerging economies such as China and India. Furthermore, worries about the so-called "Fiscal Cliff" (looming tax hikes and spending cuts set to take effect early next year unless Congress does something to prevent it) will add a degree of uncertainty, which could negatively affect consumer spending and business investment in the second half of 2012.

4. Interest Rates



Short-term interest rates (such as the 3-month T-Bill) have declined sharply since the Fed began easing in September 2007. 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.

In contrast to short-term rates, changes in long-term interest rates are far less sensitive to the Fed's regular monetary policy and, at least until recently, have been determined more by market forces such as inflation expectations and prospects about economic growth at home and abroad.

The 10-year treasury yield has been on a long-term decline for about three decades and is now at its lowest levels since 1962. Added downward pressure on long-term interest will come from the Fed's decision to continue "Operation Twist," extending the maturities of assets on its balance sheet by selling roughly $267 billion of short-term securities and buying the same amount of longer-term debt to spur the economy.

The recent decline in the 10-year treasury yield can largely be attributed to investors continuing to seek the safety of US treasuries amid mounting concerns about Europe's worsening debt crisis, as well as the slowing of the US and other economies worldwide. The P/C industry's investment performance will be adversely affected as long as interest rates remain at such low levels. However, some of that negative effect will be offset by the realized capital gains on the industry bond portfolio as a result of low yields (as bond prices and yields move inversely).

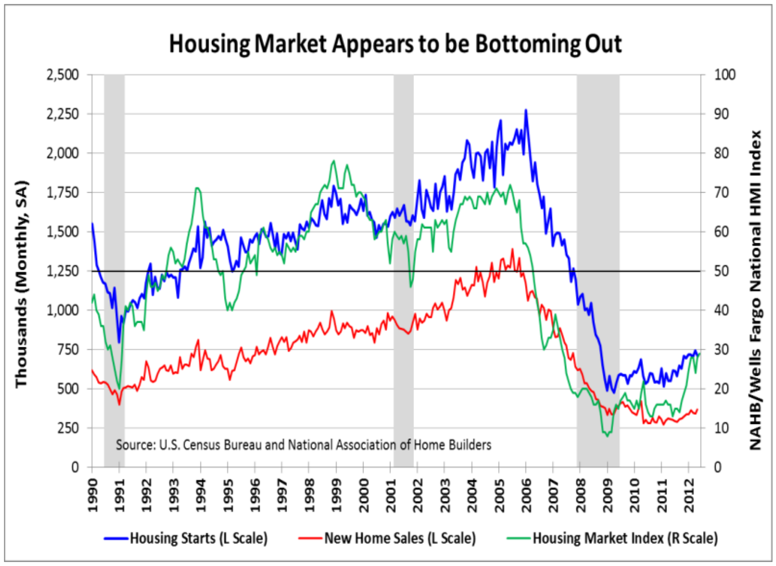
Analysis and charts prepared July 2012.

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 seen not only in the construction sector but also in supporting industries associated with building and buying houses.

Recent data on housing markets as well as on builders' confidence, as measured by the builder sentiment index (known as HMI), suggest that the market may have bottomed out after years of stagnation.

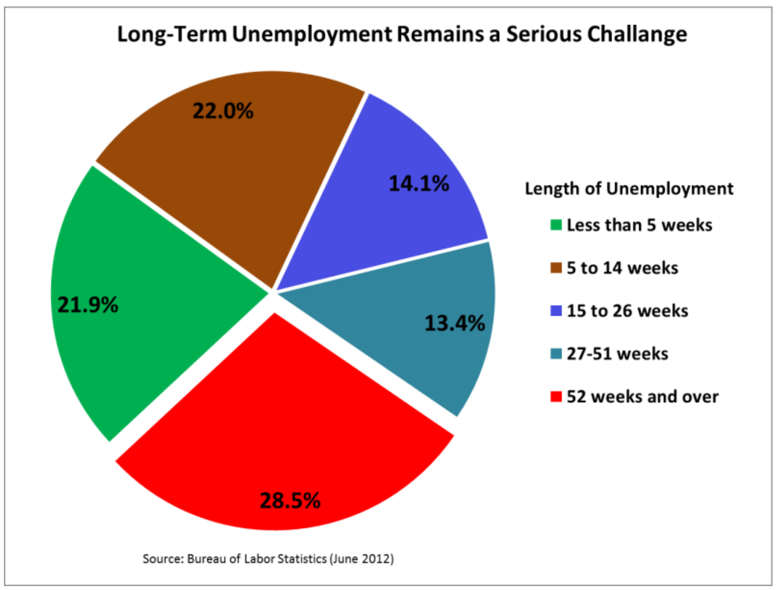
Despite a few hopeful signs of recovery, the market still has a long way to go because any reading of HMI below 50 indicates more negative sentiment about the housing market. Depressed home prices, a glut of home inventory on the market, and a backlog of mortgages yet to enter the foreclosure process will continue to weigh on the housing recovery.



6. Unemployment

Changes in labor market conditions have the greatest impact on workers compensation premium growth as well as claim counts. The ongoing weakness in the labor market suggests that increased demand for workers compensation will be highly unlikely in the near future.

Continued weakness in the labor market has been the hallmark of the current recovery. Even though the recession has technically been over for more than three years, roughly 5.4 million people have been unemployed for more than six months, and close to 29% of roughly 13 million unemployed workers have been out of work for more than a year.



Long-term unemployment has profound consequences since those in the labor force who have been unemployed for an extended period face the highest hurdle to reemployment. Employers generally fear that the longer a person is unemployed, the more skills he or she will lose. Once caught in this vicious cycle, it becomes harder and harder to get out of it as time passes. With the jobless rate hovering above 8% and more than 42% of those jobless being unemployed for more than six months, the job market still has a long road to recovery.

Analysis and charts prepared July 2012.

Summary

Premium—The recent slowdown in employment growth, along with the forecast for relatively subpar labor market conditions, suggests that workers compensation exposure-based premium growth will remain under pressure 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.

Preliminary results presented at NCCI's 2012 ***Annual Issues Symposium,*** which used NCCI's measure of frequency change (the frequency of lost-time claims per $1 million of premium), showed that frequency decreased 1% in 2011 compared to a 3% increase in 2010. Based on these numbers 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 downturns, likely due to the limited availability of return-to-work opportunities.

If the current recovery is not seriously derailed, the anticipated improvement in the labor market should ease the upward pressure of duration on severity. The impact of AWW on severity is less straightforward.

The projected recovery in the labor market suggests that pressure on severity due to wage inflation will increase since benefits are 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 number 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. Rising medical care inflation suggests increased pressure on medical costs 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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