Gauging 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.

Although our economists have not recently published a newsletter assessing the outlook for the key economic drivers of workers compensation there has been little to write about during this period. In contrast to the rather upbeat consensus forecasts reported in mid-2012, economic growth continued to follow the modest pace of 2010 and 2011. This was repeated in 2013. As we approach the end of the fifth year of the current recovery, employment has just returned to its prerecession peak. The unemployment rate remains above 6.0%, interest rates are only slightly above historic lows, the stock markets have recovered from the collapse following the financial crisis, and concerns about inflation remain muted due to excess capacity in both labor markets and the markets for goods and services.

Similarly, little has changed in the workers compensation arena. Premium increases continue to reflect the slow but steady growth in employment and payrolls, frequency has resumed its moderate pace of decline, and the growth in medical and indemnity severity remain subdued. The most notable change is the modest tightening in workers compensation premium rates that began in 2011. This trend is apparent in data on renewal pricing from Goldman Sachs and from The Council of Insurance Agents & Brokers, as well as in data submitted to NCCI that measures the extent that carrier pricing departs from NCCI's filed loss costs. To answer a question first raised by NCCI's economists in the 2010 ***Issues Report***, "yes, there does appear to be some recovery in the workers compensation market." Additional details on current market performance are presented in NCCI's most recent State of the Line analysis at **ncci.com**.

So Much for Recent History, What's the Outlook for 2014?

The consensus economic outlook in the first quarter of 2014 envisioned an increased pace of economic growth over the next couple of years. Things are off to a weak start, however. The initial estimate for GDP growth in the first quarter came in at 0.1% rather than the anticipated 1.1% (the latter having been reduced from earlier projections because of the harsh 2013–2014 winter conditions). A month later, the estimate was revised downward to indicate a decline of 1.0%; the most recent revision shows that GDP actually fell by 2.1%. Consequently, the consensus forecast has been revised downward in response to the unexpected shortfall. We now have the initial estimate for GDP growth in the second quarter of 2014. It is a seemingly impressive plus 4.0%—but it is more of a rebound from a depressed first quarter. The current estimate for growth for the entire six months is only 1.0%.

The earliest estimate for GDP growth in the first quarter, while disappointing, suggested underlying strength because, at 3.1%, the growth in consumer spending appeared to be strong in spite of the much-discussed adverse winter weather. The final revision deflated that view. It now appears that consumer spending grew by a much lower 1%. The key factor in the original estimated growth was the anticipated impact of the implementation of the Affordable Care Act on healthcare spending. In contrast to the initial estimate of a 9.1% *increase*, the final numbers report that actual healthcare spending *declined* by 1.4%.

Construction and manufacturing employment, key sectors that have played a leading role in past recoveries, remain well below their prerecession highs. These sectors typically have taken advantage of low interest rates to ramp up activity; this time their growth remains tepid in spite of historically low interest rates.

Residential construction appears to be hampered by the reduced levels of household formation. This is being attributed in part to limited employment opportunities for young adults as well as the burden of student debt, which now totals more than what is owed on credit cards by all consumers. In contrast, output in the manufacturing sector is now close to its prerecession peak, while employment in manufacturing remains modestly above its late recession low. This is a continuation of the long-term pattern of increasing productivity in this critical sector. But ironically, if productivity can be sustained, then continued growth in manufacturing output is not likely to lead to a marked increase in employment.

However, there are positives. Hiring by state and local governments has started to pick up as their tax bases recover due, respectively, to sales tax increases as consumption grows and real estate taxes increase as housing values rebound. Business opportunities in transportation, oil well supply, and petrochemicals, among others, are also expanding as the energy sector continues to deliver growing amounts of oil and natural gas. The rate of growth of healthcare spending has eased.

There are also reasons to be wary: economic recovery in western Europe was uneven prior to the geopolitical crisis in Ukraine. The much vaunted emerging economies of the BRIC nations (Brazil, Russia, India, and China) have lost momentum. The outlook for China is becoming increasingly shaky as stories surface highlighting problems in the housing sector and missing collateral backing billions of dollars of loans. The Federal Reserve is steadily ratcheting down its Quantitative Easing, which directly supports housing finance and indirectly serves to reduce longer term interest rates generally.

What Seems Most Likely?

The most likely scenario is that 2014 will repeat the experiences of the past several years—an optimistic forecast in the first quarter followed by diminishing expectations as the year unfolds. It will not be a bad year; it just will not be a great one. The year will deliver modest employment growth and lower unemployment, modest increases in longer term interest rates, some volatility in the stock market, and mild anxiety about the risk of inflation. This should be good news for workers compensation.

- Growing employment will generate increased premium income
- The modest pace of hiring will not put material upward pressure on frequency
- Modest wage growth will mean only modest pressure on indemnity severity
- Growth in medical severity is difficult to predict, but a reasonable view is that it, too, will remain muted

The most critical unknown for workers compensation is related to the outlook for investment income—portfolio yields have remained strong, but low reinvestment rates should eventually cause investment income to fall.

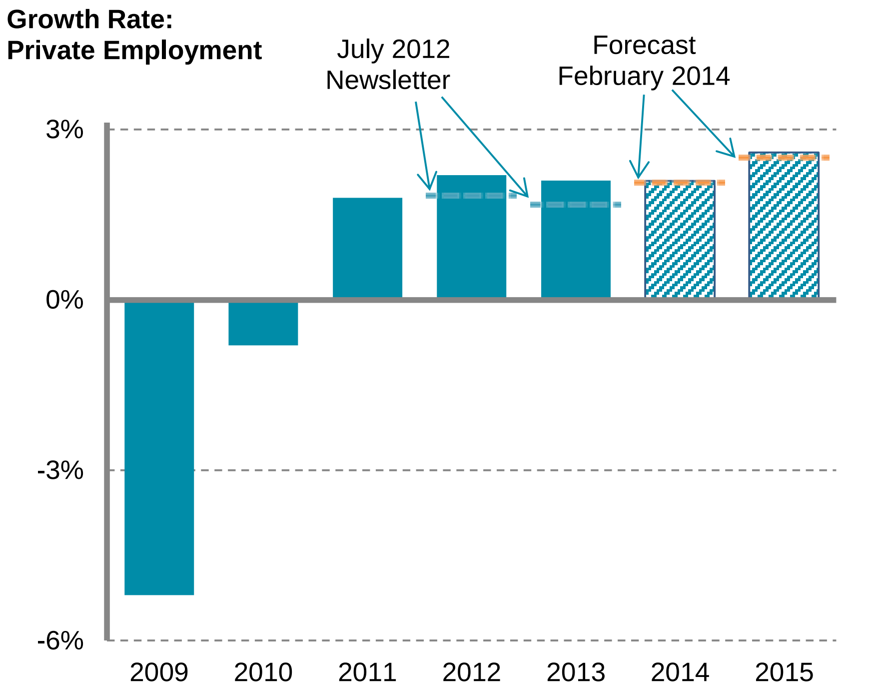
The exhibits below reflect the current economic outlook for factors that typically impact workers compensation. Each exhibit also provides some context for the outlook, relative to the historical data. The exhibits also show a comparison to the forecast for 2012 and 2013 published in the last ***Gauging the Economy*** newsletter in July 2012, and comparisons for 2014 and 2015 between the current forecast and a prior forecast.

Employment Growth

Although the International Monetary Fund recently revised downward its outlook for employment growth in the United States, the current consensus forecasts remain strong. Speculation has been that “catch-up spending” in the second quarter will make up for the weather-induced economic shortfall in the first quarter. On a positive note, private sector employment actually grew over the past two years at a somewhat faster pace than projected in July 2012. This growth in exposure is a positive for workers comp premium. The modest pace also suggests that there will be little upward pressure on frequency.

Moody’s Analytics continues to expect modest but steady growth in private sector jobs.

Employment: Forecast is for Growth in the Private Sector



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

Wage Growth

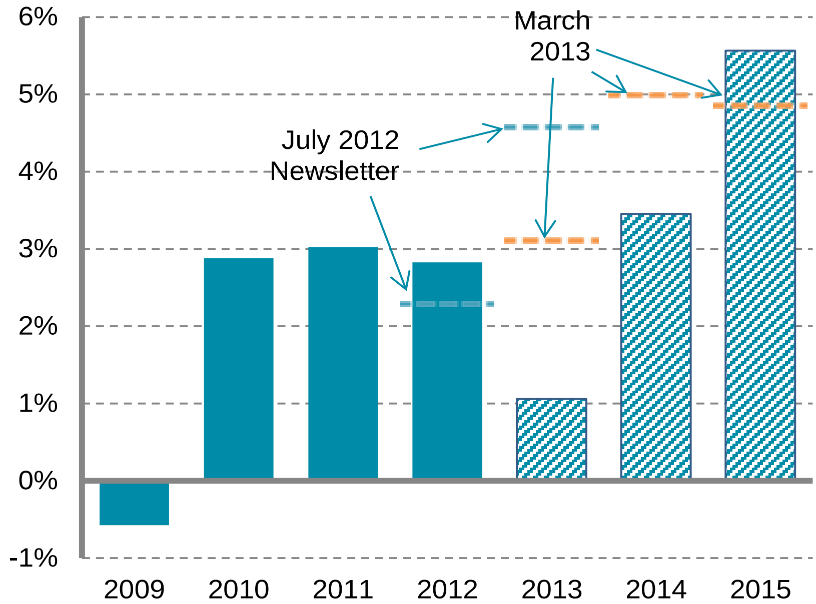
Changes in average weekly wages (AWW) are a key factor in determining indemnity severity. Stronger wage growth is indicated for both 2014 and 2015. So far this year, the growth is due entirely to increases in hourly wages rather than changes in hours worked per week. This suggests that there will be upward pressure on indemnity severity. Private sector payrolls should also grow due to the combined impacts of higher employment and increases in the AWW.

According to preliminary data from the US Bureau of Labor Statistics, AWW is projected to have grown by a modest 1.1% in 2013, significantly lower than the 3.1% forecast a year ago. (Final data are expected in late September.) The forecast for 2014, based on data from Moody's Analytics, has been revised down, but still calls for a rebound to a more normal 3.5% in 2014, with acceleration continuing into 2015.

Since AWW is increasing modestly, we expect its impact on severity to also be modest.

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

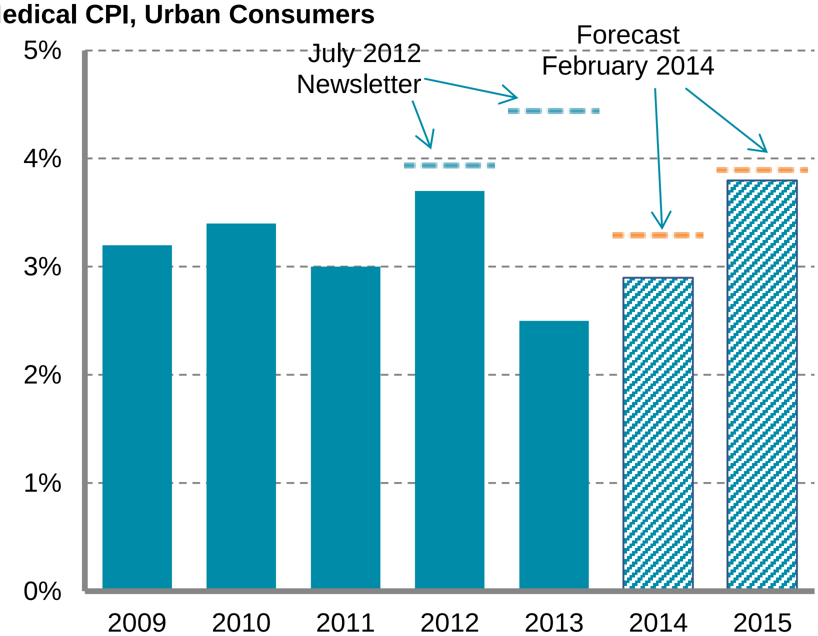
Medical Inflation

Medical price inflation has been a major driver of changes in medical severity. However, compared to the experience prior to the recent recession, both medical price inflation and the growth in medical severity have been rather subdued over the past two years. This suggests that utilization growth has been flat. This pattern in workers comp medical severity is aligned with medical costs trends in the country as a whole. Experts disagree over whether the modest growth reflects structural changes and is likely to continue, or is due primarily to the recent economic slump and therefore will rebound with a strong economic recovery. This is an area of considerable interest and uncertainty.

According to Moody's Analytics, medical price inflation is expected to increase slightly from the low of 2.5% in 2013.

Medical Care Inflation: Expected to Remain Below 4%

Growth Rate: Medical CPI, Urban Consumers



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

Analysis and charts prepared July 2014.

Interest Rates

The current low interest rate environment continues to put downward pressure on investment income for the property/casualty industry.

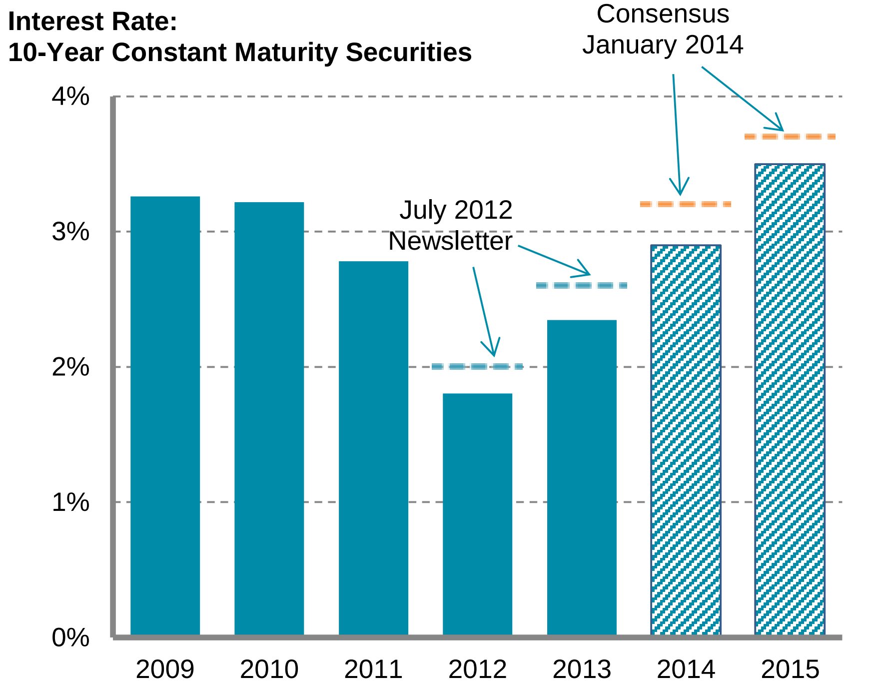
Since December 2008, the Federal Open Market Committee has maintained the target range for the federal funds rate at 0–0.25%.

Blue Chip Economic Indicators' consensus expects the 10-year Treasury constant maturity security rate (annual average) to increase to 2.9% in 2014 and then increase to 3.5% in 2015, but the outlook has notably shifted downward from the consensus at the start of the year.

Indeed, the actual rates for 2012 and 2013 are 1.8% and 2.3%, respectively, slightly lower than the outlook in July 2012 for both years (2012: 2.0%; 2013: 2.6%).

This pattern of downward adjustments reflects the relatively slow economic recovery compared to the optimistic forecasts for 2012, 2013, and the first quarter of 2014.

Interest Rates: The Federal Reserve Is Letting Up More Slowly Than Forecast



Source: Federal Reserve Board, Blue Chip Economic Indicators

Summary

Premium—The projected moderate pace in employment and wage growth as labor market conditions improve should result in increases in workers comp exposure and upward pressure on written premium. Changes in premium rate departures and the underwriting cycle are the big unknowns. Industry observers are reporting that the pace of tightening appears to be easing; however, low interest rates for newly invested funds suggest that the industry soon may need to look to improved underwriting results to maintain an acceptable return on surplus. One likely scenario is that the industry is offsetting underwriting losses by harvesting unrealized capital gains on its bond portfolio and reinvesting temporarily in short-term securities while waiting for the long-term end of the yield curve to rise as the economy comes out of recession. If so, the hope must be that interest rates will return to higher levels soon to take the pressure off of underwriting.

Frequency—Preliminary results presented at NCCI's 2014 ***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 2% in 2013, comparatively milder than the 6.1% decrease in 2012. Based on these numbers, it appears frequency will continue to follow its long-term downward trend. Although new job creation puts upward pressure on frequency, the modest pace suggests this impact may not be significant.

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 tends to fall during periods of economic growth, likely due to the increased availability of return-to-work opportunities.

If the current recovery is not seriously derailed, the anticipated improvement in the labor market should result in unchanged or falling duration. The projected increase in the AWW should cause benefit levels to increase; but the impact on financial performance will be muted by offsetting increases in premium.

Medical Severity—The increase in medical severity in the past two years has been relatively modest. This appears to be the result of reduced pressure from both medical price inflation and medical utilization. Experts disagree over whether this is because of the recent recession (in which case medical severity will increase as the economy recovers) or is structural (continuing over at least the near future).

As usual, medical severity is likely to be the major factor contributing to changes in loss costs over the next couple of years.