NCCI
Quarterly Economics Briefing
The nation's most experienced provider of workers compensation information, tools, and services
September 2015

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. Forecasts are derived from Moody's economy.com.

Employment Growth

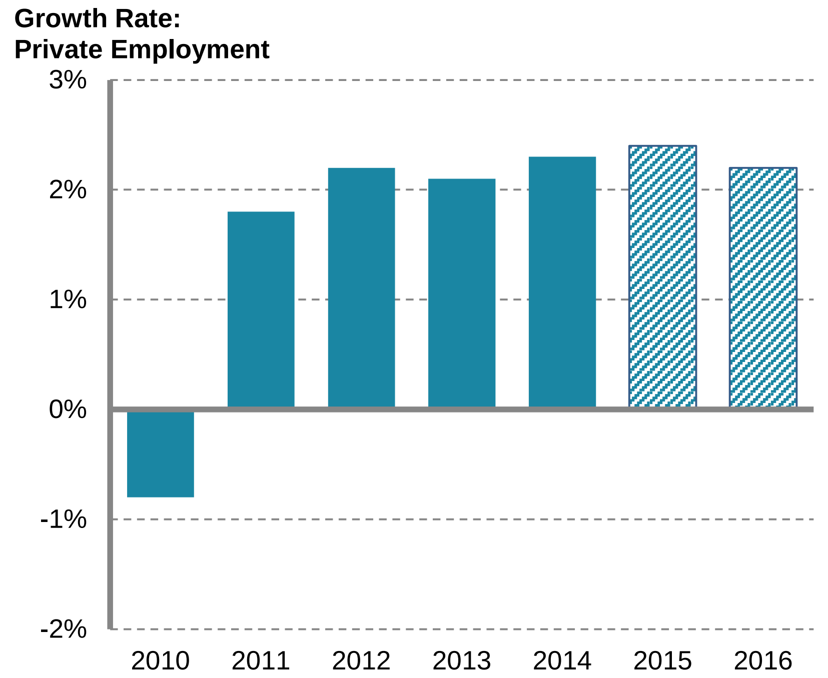
Growth in the US economy as measured by gross domestic product (GDP) rebounded in the second quarter after a soft first quarter.

Second quarter growth was broad-based, with increases in business investment, inventories, and government and consumer spending. However, the increase in inventories in the second quarter may reduce growth in the second half of the year as they dissipate.

In addition, the strong dollar and weakness overseas could hurt exports, constraining second-half growth and impacting workers compensation, since manufacturing accounts for 16% of premiums in NCCI states.

Given this outlook, Moody's forecast for employment is for continued slow growth, but at a slower pace than what was reported in last quarter's newsletter. Employment is still forecast to tick up slightly this year from the 2.3% growth in 2014, but now to 2.4% before slowing again to 2.2% next year. This compares to the 2.5% and 2.4% growth rates for 2015 and 2016, respectively, shown last quarter. The forecast growth rates are very similar to the increases posted for the last few years.

Employment: Forecast Is for Continued Slow Growth in the Private Sector



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

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

Wage Growth

The forecast for rising wages suggests that there will be upward pressure on indemnity severity. In 2014, average weekly wages grew by 3.1%, while our estimates show that indemnity severity increased by 4%.

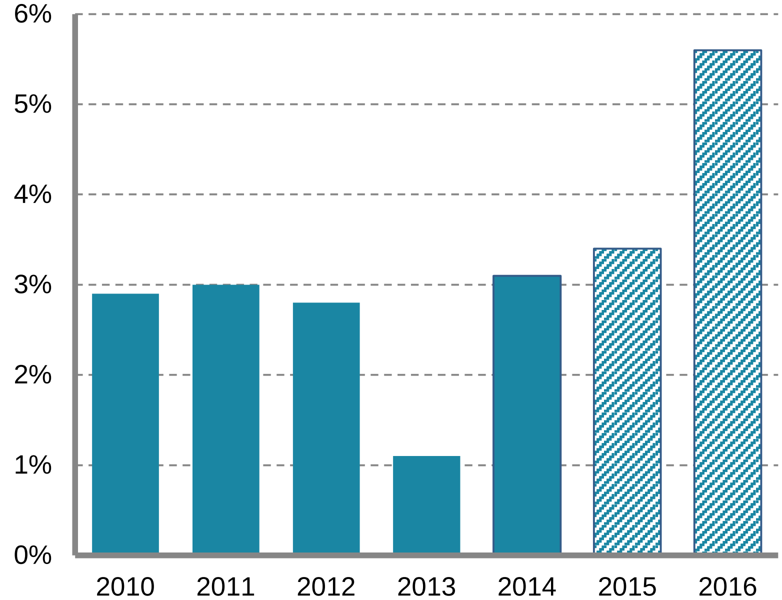
Except for 2013, when growth was even slower, wage growth has hovered around 3% since the end of the recession.

Labor market slack is contributing to the slow growth in wages. Despite the recent decline in the unemployment rate to 5.1%, there is continued slack in labor markets due to large numbers of part-time workers who would prefer a full-time schedule and large numbers of discouraged workers. Neither of these categories of workers is included in the official unemployment rate, but when they are, the unemployment rate more than doubles to 10.3%.

In addition, companies may be offering one-time bonuses, paid time off, or healthcare instead of annual raises, so they are not locked in to paying higher wages. According to Moody's, since 2010, these types of fringe benefits have increased 4.2% in real terms compared with only a 0.5% increase in real wages. Prior to 2010, they moved together.

Wages: Forecast to Accelerate Next Year

Growth Rate:
Average Weekly Wage



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

The forecast for wages for this year has been reduced from that shown last quarter, with wages expected to increase 3.4%, down from 4.1%. However, the manufacturing, professional and business services, and education and healthcare sectors are showing difficulty filling positions, and that will ultimately put upward pressure on wages. As the labor market tightens, wages are forecast to accelerate next year with a forecast of 5.6%, putting increased 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.

Medical Inflation

Rising medical care inflation suggests that we can expect increased pressure on medical costs per claim. Changes in costs are made up of changes in both price and utilization.

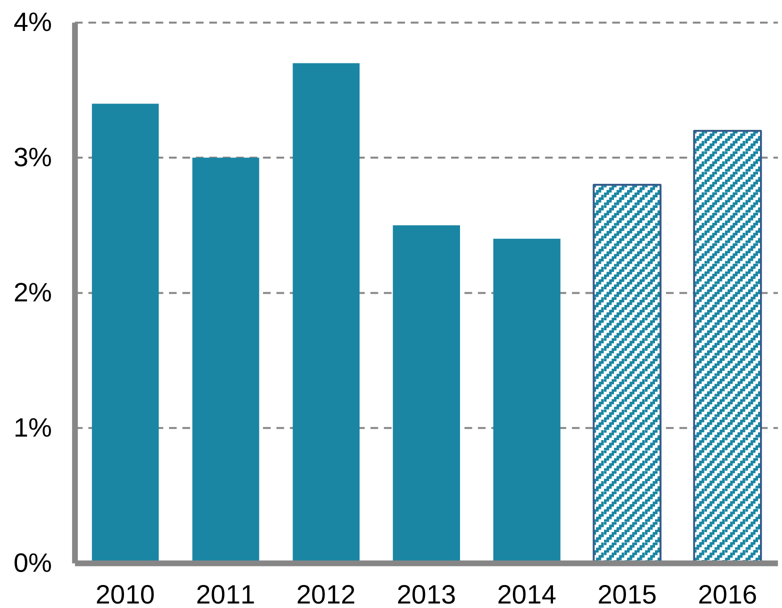
Medical care inflation is a measure of the price piece of that equation. In 2014, medical care inflation was subdued with an increase of only 2.4%, while our estimates are that medical severity on lost-time claims increased by 4%.

While still low, Moody's forecast is for medical care inflation to accelerate somewhat this year and next year, to 2.8% in 2015 (up from 2.7% last quarter) and 3.2% in 2016 (down from 3.4% last quarter).

Rising medical care inflation will put upward pressure on medical costs, although, as seen above, medical severity increases could be higher due to changes in utilization. Medical inflation will continue to outpace general inflation in the economy in the foreseeable

Medical Care Inflation: Growth Is Still Contained

Growth Rate:
Medical CPI, Urban Consumers



Source: US Bureau of Labor Statistics, Moody's Analytics future. Moody's forecast for general inflation is actually a slight decrease of 0.1% this year, and a 2.0% increase next year.

Interest Rates

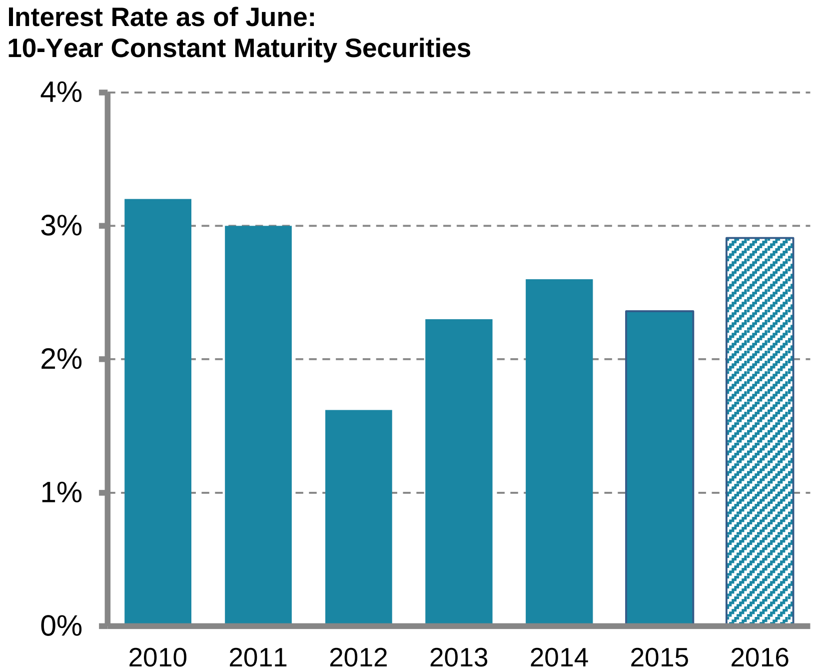
The current low-interest-rate environment continues to restrain investment income in the property/casualty (P/C) industry.

Since December 2008, the Federal Open Market Committee (the Fed) has maintained the target range for the federal funds rate at 0%–0.25%, and kept the rate unchanged at its September meeting.

However, the Fed may soon be raising the target rate, having indicated that it is moving toward increases this year. The Fed is weighing healthy economic growth domestically against slowing international growth, financial market volatility, the strong dollar, and low inflation to determine when to begin raising rates. See the discussion below on the Fed's September rate decision for more information.

The chart shows interest rates for 10-year Treasury notes as of June of each year. The rate declined this year to 2.4% from 2.6% in June 2014. Moody's expects interest rates on 10-year Treasury notes to increase to 2.9% in the second quarter of next year, down slightly from the expectation last quarter.

Interest Rates: Small Increase Next Year



Sources: Federal Reserve Board, Moody's Analytics

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

Drilling Down:
The Fed's September Rate Decision and Workers Compensation

At its September meeting, the Fed's Open Market Committee (FOMC) announced that it would maintain the federal funds rate in the range of 0–25 basis points, continuing the era of near-zero short-term interest rates that began in 2008. The Fed's decision to continue slack monetary policy for the time being was certainly not unexpected in light of the economic slowdown and yuan devaluation in China, flatlined growth in France and Italy, weakness in commodity-driven economies overseas, and export softness driven by the dollar's appreciation. Nonetheless, the Fed's cautious stance on interest rates raises the broader question of whether the US economy's recovery from the Great Recession has been derailed, or at least postponed.

We think the short answer is that the economic recovery in the United States remains on track, and continues to progress much as it has for the past several years. In our view, the Fed's decision to stand pat on the federal funds rate was motivated first by the absence of observed inflation in the US economy, and, second, by a desire not to commit prematurely to interest rate tightening while there remains the possibility of international economic contraction instigated by China and while important sectors of the US economy remain soft, particularly the residential housing market.

The Fed's statement accompanying the rate decision noted that "net exports have been soft," a nod to weakness in overseas economies and the impact of a strong dollar, and elsewhere affirmed that the Fed would increase its target for the federal funds rate when it sees "further improvement in the labor market and *is reasonably confident that inflation will move back to its 2 percent objective over the medium term*" (emphasis added). As to inflation, the core consumer expenditure deflator increased just 1.2% for the year ending in July, well below the Fed's target rate of 2%.

There are two important takeaways from the Fed's language. First, the decision to refrain from raising the federal funds rate is not a referendum on the US economic recovery. Rather, it is motivated by the lack of observed inflation to date. In general, low inflation in a growing economy is a positive, not a negative. Second, the focus on international economic uncertainty, which impacts the US economy through trade of goods and services, appears to point up a distinction between inflation and deflation in the Fed's thinking. While raising interest rates is an effective tool to "cool off" inflation, deflationary cycles have proven more difficult to counteract simply by cutting interest rates. The Fed is certainly concerned that the economic contractions of international trading partners may wind up "exporting" deflationary pressure to the United States, and it understands that a rate increase today would be awkward to reverse should it turn out to be premature.

In short, absent clear indication of incipient inflation, the Fed does not feel compelled to raise the federal funds rate; and in view of international economic uncertainty, it has elected to defer doing so for the time being. However, the question of a rate increase remains "when," not "if." The Fed's "dot plot" (in which Fed governors and regional bank presidents are surveyed for their expectations of the federal funds rate at future dates) shows that the first rate increase may come as early as October or December. This possibility was emphasized by Dennis Lockhart, president of the Atlanta Fed, as well as other Fed officials during the days immediately following the FOMC meeting. When the Fed *does* raise the federal funds rate, whether later this year or in 2016, the path of rate increases will be far more important than the mere fact that they have begun.

Does the Fed's September decision not to raise the federal funds rate directly impact workers compensation? In our opinion, no. By deciding to stand pat for now, the Fed is reacting to events that it neither caused nor can materially influence. Following the September meeting, bond yields across the maturity spectrum continue to price in an expectation that interest rates will rise over the next several years. This suggests that the Fed's rate decision confirmed market expectations but did not materially change them.

Even so, bond yields remain low, and international events that prompted the Fed's inaction also raise concerns about economic growth in the United States and globally, which increases uncertainty about when inflation and interest rates will shift up, and how strongly. Low investment yields mean that P/C insurers must continue to focus on underwriting profitability, and uncertainty about future yields means that they will continue to favor bond portfolios with shorter durations. Both themes are already familiar. Recent events suggest that they will remain so for at least a while longer.

The Fed Now Expects the US Unemployment Rate to Be Below 5% in 2016

In the June issue of the *Quarterly Economics Briefing*, we discussed the structural or "full-employment" rate of unemployment. We observed that the Federal Reserve has been revising downward its estimate of the structural unemployment rate since 2013. Those downward revisions look set to continue.

In June, the Fed's target rate for structural unemployment was 5.1%, and, at that time, the Fed's median estimate of the US unemployment rate as of year-end 2015 was 5.3%. However, as of the most recent data for August, the US unemployment rate is already down to 5.1%. At September's FOMC meeting, Fed officials dropped their median estimate for year-end 2015 unemployment to 5.0% and cut the median estimate for 2016 to 4.8% (from 5.1% in June). The decline in the aggregate unemployment rate to a level below the Fed's year-end target from just three months ago, together with the absence to date of wage inflation, strongly suggest that the Fed may revise its target rate for structural unemployment from the existing 5.1% level to 4.8% or lower, although it has not done so yet.

As it impacts workers compensation, a lower structural unemployment target indicates that employment in the United States is, indeed, continuing to recover from the Great Recession. Increased employment is clearly positive for premium collections, although it may also portend an increase in injury frequency as new and less experienced workers enter (or re-enter) the workforce. On the other hand, the premium increase due to growing employment is tempered by the absence of wage inflation. Since workers compensation premium is based on wages, it tends to increase both as the number of workers grows and as wages increase. Over the past year, average hourly earnings for private nonfarm employees have increased only 2.2% versus 1.2% growth in the core personal consumption deflator. Rising employment, accompanied by relatively static wage growth, takes away one of those drivers, at least for the time being.

However, there are clear indications that while benign for now, wage growth may be set to accelerate within the next year. Overall employment growth in the US has continued to be steady, averaging 247,000 jobs per month over the year through August, although employment growth in some sectors, notably manufacturing, has been relatively flat over the same period. As we observed above, the US aggregate unemployment rate has already declined to 5.1% and may go below 5% in 2016. While the structural or "full employment" unemployment rate is somewhat uncertain and may be less than 5%, there seems to be little doubt that we are getting close to it. A variety of hiring indicators and employer surveys suggest that slack in the labor market is now mostly gone, and that skilled positions have become particularly difficult to fill. We think it is likely that wage growth will begin to accelerate in 2016, marking the end of the prolonged period of declining or static wages since 2008.

What Does It All Add Up to?

The Fed's decision to maintain low interest rates is more about lack of inflationary pressure and the desire to preserve policy optionality in the face of international economic uncertainty than about the US economic recovery, which continues to be steady, if unspectacular. The sell-off in equity markets since May looks more like a bull market correction than the start of a new bear market. And, in any event, asset value fluctuations in financial markets do not necessarily imply anything about the underlying real economy, which refers to actual flows of goods and services—including labor services.

Significantly for workers compensation, aggregate employment continues to recover. The pace of recovery is uneven across sectors, and particularly in important sectors such as construction and manufacturing. But the overall employment trend remains positive, sector variability is nothing new, and perhaps most significantly, employment growth has been largely unaccompanied by wage inflation—so far. Paradoxically, wage inflation, when it does occur, should probably be seen as a positive sign for workers compensation, since it will indicate a healthy premium environment, even if incipient inflationary pressure also prompts the Fed to begin raising the federal funds rate in earnest.

Analysis and charts prepared September 2015.