



Gauging Current Conditions:

The Economic Outlook and Its Impact on Workers Compensation

The gauges below are updated quarterly to reflect the current economic outlook for factors that typically impact workers compensation. Each gauge also provides some context for the outlook, relative to a historical average of the previous five years.

Employment Growth

The job market continues to heal though at a much slower pace than everybody would like to see. The most recent data is encouraging as strong private sector hiring in March brought the jobless rate to its lowest level in two years. Furthermore, the unemployment rate is a full percentage point below its rate four months ago. Nonfarm payrolls in March increased by 216,000 and private sector employment increased by 230,000—a hopeful sign that the economy is moving in the right direction despite many challenges.

While private sector hiring is slowly picking up, the public sector continues to trim jobs, especially at the local government level due to severe budget crises. Despite recent improvements in labor market conditions, there are still about 13.5 million unemployed people. The unemployment rate will remain uncomfortably high throughout 2011, and it will take years before joblessness can be brought down to a more normal 5% to 6% range.

Wage Growth

Improving labor market conditions suggest some wage inflation pressure building up as the economy continues to recover. This implies that the growth in indemnity severity (cost per claim) may also rise slowly.

The growth rate of average weekly wages (AWW) steadily decelerated from 2006 to 2009 and for the first time since record keeping, the AWW fell by 0.6% in 2009. The preliminary Quarterly Census of Employment and Wages (QCEW) estimate by the Labor Department indicates that AWW grew by 2.7% in the first three quarters of 2010 compared to the first three quarters of 2009.

Wage inflation should not be a major challenge for the WC industry because premiums are directly linked to wages, thereby offsetting the indirect and direct effect on indemnity benefits.



Exhibit 1— Private Sector Job Growth Will Continue to Improve

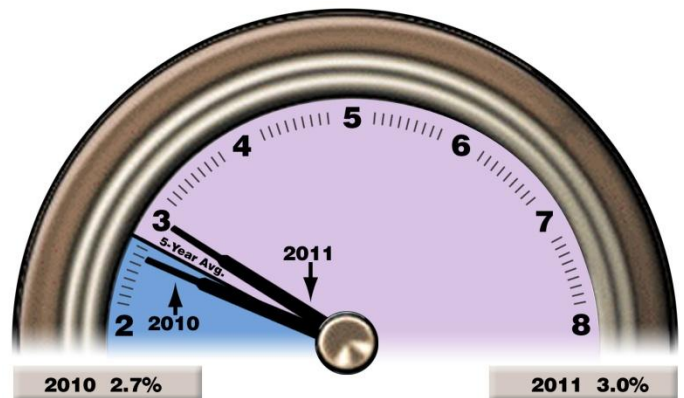


Exhibit 2—Wage Inflation Pressure Is Expected to Slowly Build Up

Medical Inflation

Last year's fear of general price deflation by some economists have been replaced by concerns for rising inflationary expectations this year. Despite rising commodity, food, and energy prices driving near-term inflation expectations, the underlying inflation still remains relatively tame. Medical inflation is expected to remain relatively strong and will continue to keep upward pressure on medical severity.

According to Moody's Economy.com, medical care inflation is forecast to increase to 4.1% in 2011 compared to 3.4% in 2010. In comparison, the average overall inflation rate was 1.6% in 2010 and is projected to reach 2.0% in 2011. Medical price inflation will continue to outpace general inflation in the economy in the foreseeable future. This will lead to continued pressure on medical severity (cost per claim) in the future. Medical severity will be further impacted by the enhanced utilization of medical services mainly due to the aging of the workforce and more use of higher cost drugs and treatments.

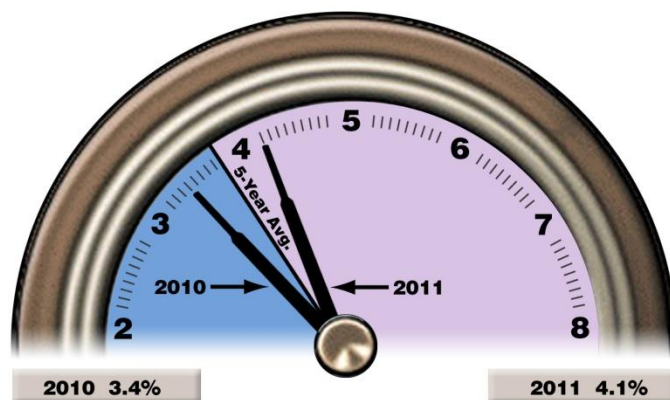


Exhibit 3—Medical Care Price Inflation Pressure Will Continue

Interest Rates

Investment income is hampered by the continued Federal Reserve policy of keeping short-term interest rates at historically low levels. In addition, attempts to drive long-term interest rates down through its bond buying program (QE2), which is due to continue through the end June 2011, is also keeping investment income down.

The Fed has a dilemma to deal with. On the one hand, higher oil prices are putting upward pressure on inflation requiring it to consider the possibility of raising short-term interest rates soon to lock emerging inflationary pressures. On the other hand, rising food and energy prices are constricting the purchasing power of consumers, which is elevating the risk of slower growth and requiring continued accommodative monetary policy. The latest minutes of the Fed's Open Market Committee reveals no change in their stance of keeping short-term interest rates at close to zero for an "extended period." But if the economy continues to improve as predicted and inflation expectations remain elevated, then it may be a matter of months before the Fed will tighten its monetary policy.

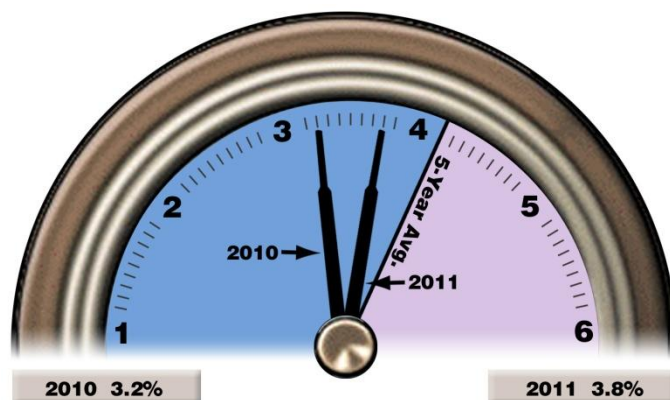


Exhibit 4—Interest Rates Have Started to Edge Up

The P&C industry's investment performance will be directly impacted by rising inflation, which drives up interest rates and lowers the market value of fixed income securities. The short-term impact of rising inflation on the underlying market value of investment portfolios will be depressing; however, some of that negative effect will be offset by the higher yield of fixed income securities that are being added to investment portfolios.

Behind the Gauges:

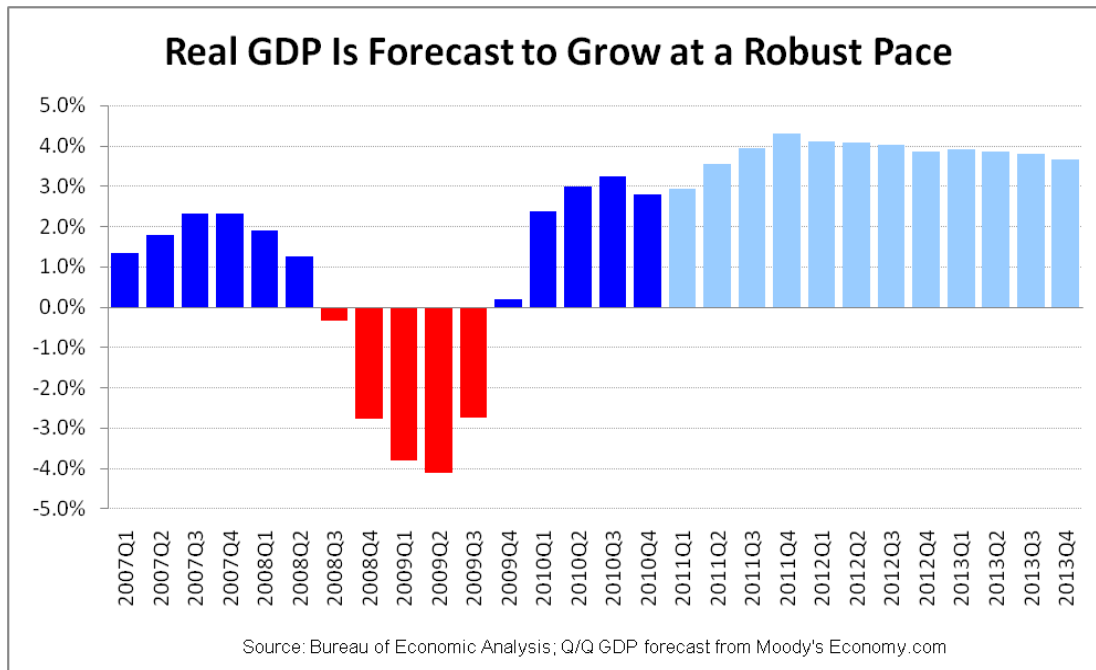
Macroeconomic Outlook

The following set of charts and the accompanying "Implications" article 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 GDP growth, the housing market, industrial production and capacity utilization, personal income and consumption expenditures, the stock market, and dollar exchange rate, and US exports.

1. Real Gross Domestic Product

The expansion continues as last year's fear of a double-dip recession is now well behind us. All the economic data, especially leading economic indicators, point to increased economic growth. The economy is expected to grow above the long-run trend of 2.7% in the next few years. According to the latest forecast from the Fed, the nation's GDP is expected to rise between 3.1% and 3.3% in 2011. The economy remains on firmer footing, leading to a gradually strengthening recovery over the coming quarters.

Despite this renewed sense of optimism, most economists expect a very gradual decrease in the unemployment rate, which still remains very high. There are still some serious challenges going forward such as the housing market recovery and budget problems for state and local governments. Currently, there is significant unrest in the Middle East and the question is how much of a threat are oil prices to the economic recovery? Rising oil prices can turn into a significant headwind but are unlikely to derail the underlying economic recovery. The positive feedback loop is already under way as industrial production is up, hiring is picking up, wages are firming up, and people can now afford to spend a little extra.



2. Housing Market

The housing market had shown some signs of stabilizing but it is still treading along the bottom. Real estate continues to be a dark spot in the recovery process. Housing starts remain well below the levels needed to provide a strong impetus to economic activity. Home prices remain near their post-bubble-bust lows. Adding insult to injury, Robert Shiller—co-founder of the S&P/Case-Shiller home price index—predicted that there is substantial risk of home prices falling another 15% to 25%. This double-dip scenario is the worst nightmare for the housing market since any perspective buyer will put purchasing plans on hold in anticipation of a better deal later.

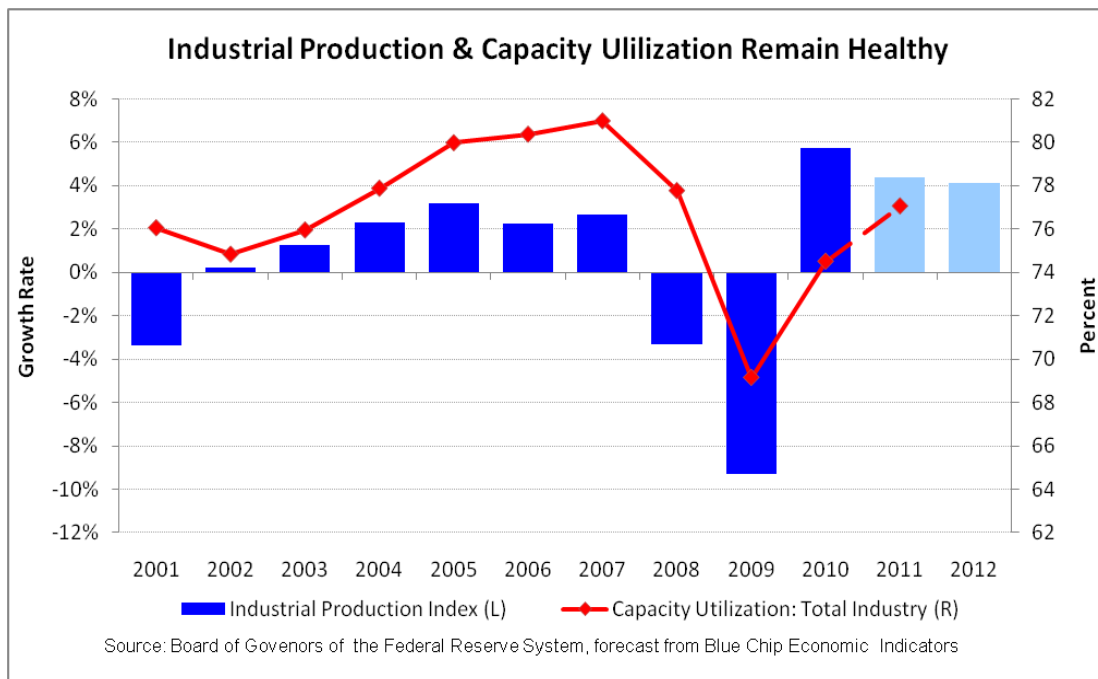
Even if a double-dip scenario in housing does not happen, the market will likely bounce along the bottom for all of 2011. New construction will continue to be slow due to competition from low-priced foreclosed properties returning to the market. Given the fact that millions of homeowners still remain underwater and face high joblessness, there is likely a long road to recovery in the housing market.



3. Industrial Production and Capacity Utilization

Industrial production (IP) measures changes in output for the industrial sector, which includes the manufacturing, mining, and utilities industries. The IP numbers have sprung back since the start of the economic recovery and appear to be on stable footing. But it will take months if not years of sustained growth before IP reaches a more normal level on a sustainable basis.

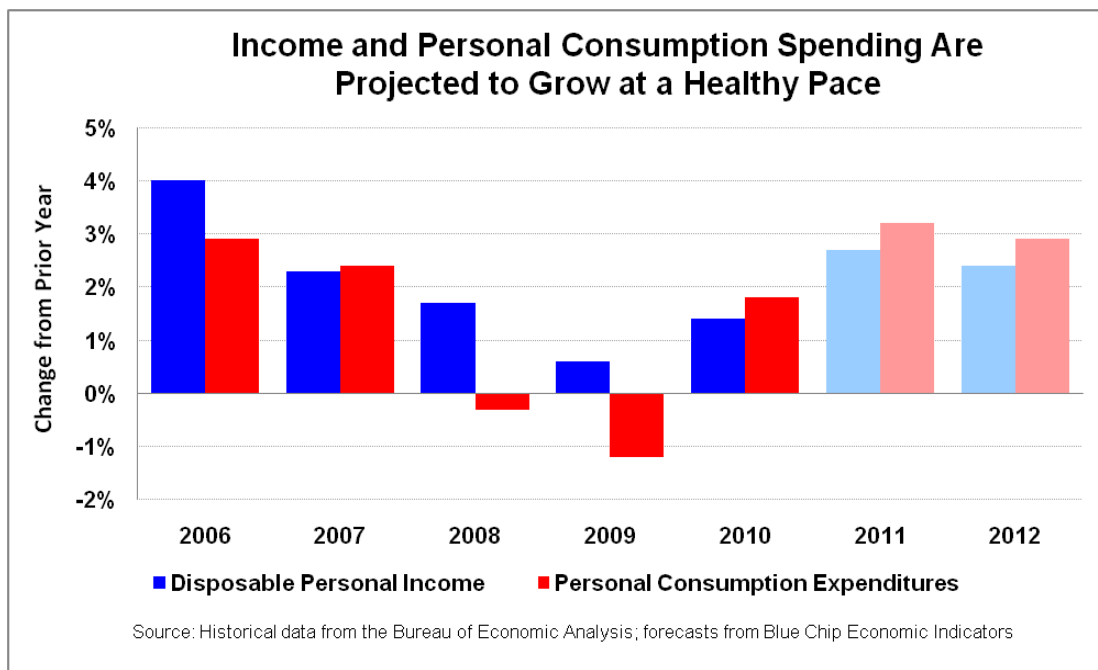
The capacity utilization rate gives an insight into the overall slack in the economy and is measured by the ratio of actual to potential output. Generally, a capacity utilization rate above 85% is considered a signal for imminent inflation. According to the newly revised data from the Federal Reserve, the capacity utilization rate in February edged down slightly by 0.1 percentage point to 77%. That is 4.8 percentage points above the rate from a year earlier but 3.6 percentage points below its long-run average from 1972 to 2009. Going forward, the uncertainty created by the unfolding crisis in Japan and unrest in North Africa and the Middle East will likely create some headwinds for further improvement in capacity utilization and industrial production. However, these developments should not derail the recovery process. Continued improvement in IP and capacity utilization figures should help increase demand for workers compensation insurance.



4. Disposable Income and Personal Consumption Spending

Personal income is one of the indicators gauging the direction of future consumer demand, which drives two-thirds of economic activity. From a demand-side perspective, recessions can occur if consumers suddenly stop spending, which in turn can drive down income growth, which leads to still further deterioration in consumer demand—a vicious cycle. Most recent readings on consumer spending and disposable personal income point to a healthy economic recovery. However, one of the main risks to the consumer spending outlook is what happens to oil prices going forward.

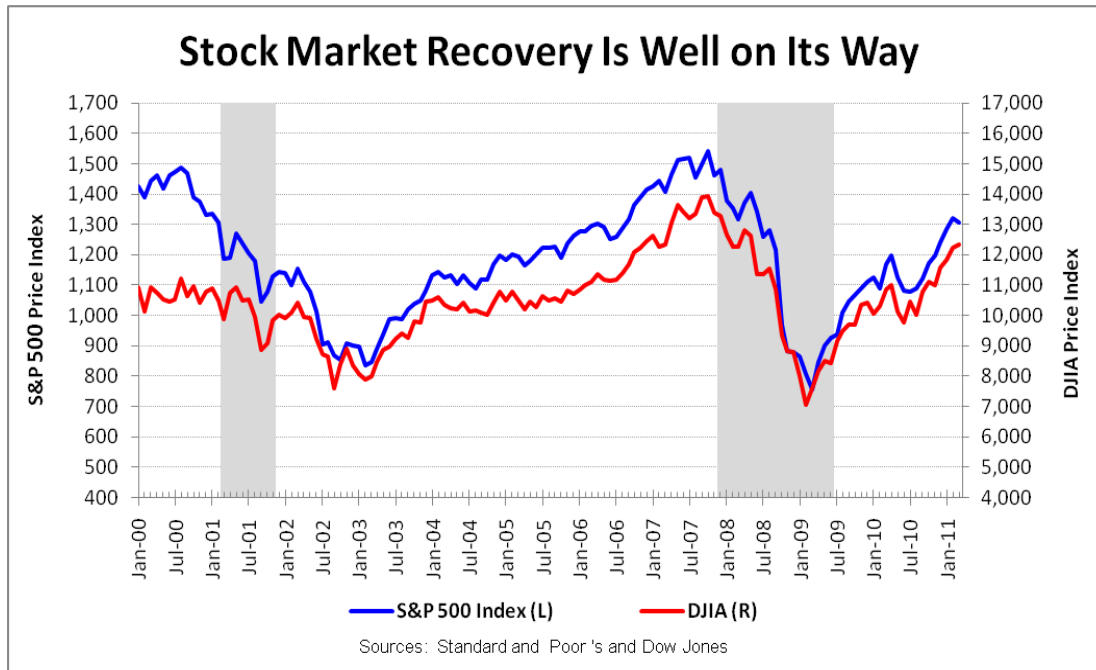
One of the reasons consumer spending will likely grow well into 2011 is because of improvement in the labor market. People who have jobs are not as fearful of losing them as prospects for economic growth continue to improve. Consumers' urge to splurge will likely gain momentum as people become tired of the frugality of the last few years. Current pent-up demand will likely fuel consumption spending at a healthy pace over the next few years.



5. Stock Market

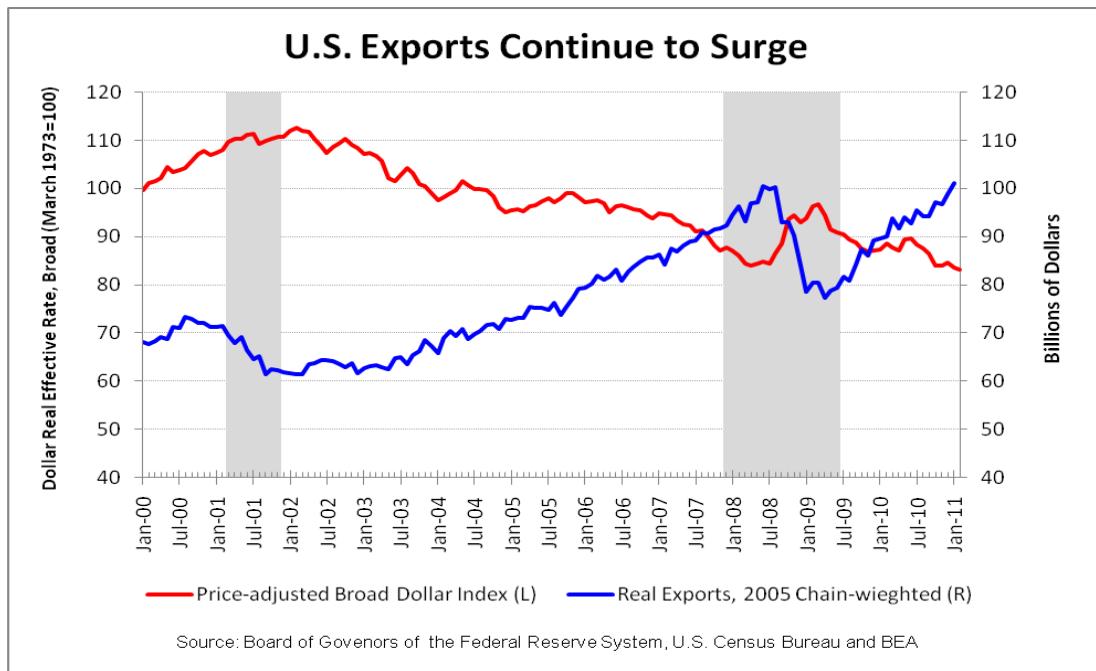
Despite high oil prices, ongoing geopolitical upheaval in the Middle East, and the nuclear crisis in Japan, the stock market continues to move along in a positive direction on the heels of favorable economic news. Markets have recovered to their mid-2008 levels, after bottoming to their lowest level of the decade two years ago. The revival in economic growth coupled with stock market performance over the last year indicates that the market recovery will continue at a decent pace if not a great one.

Insurance industry's profitability should improve due to improving market conditions. Current very low interest rates are certainly a negative for the industry, but the improving stock market should buoy realized investment gains and help overall investment performance of the industry. The majority of US company balance sheets are in great shape with more than a trillion dollars in cash; however, things can always go awry if geopolitical headwinds and oil shocks get out of hand.



6. Dollar Exchange Rate and US Exports

In terms of real exports, the economy has fully recovered to its prerecession high. It is not surprising that at the height of the international debt crisis the US dollar strengthened and exports took a dive. A strong dollar makes US exports less attractive to foreign buyers and vice versa. With a few fits and starts, the dollar slide has continued since May 2009 pulling exports up along with it. People may argue that the recent dollar weakness is due to the increase in oil prices, the amount of debt that the government has amassed in recent years, or the Fed's easy money policy. But whatever the reason, a weaker currency may help US exports by making them more competitive on the world market. The key is a gradual and orderly decline, not a crash of the world's reserve currency.

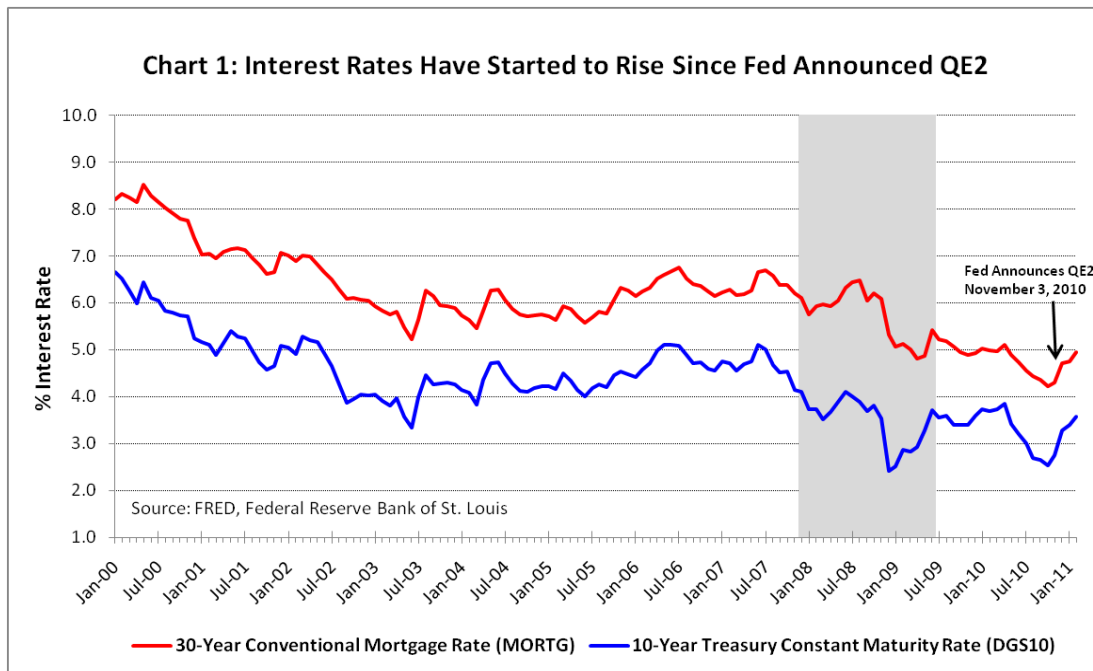


Implications:

Interest Rates Have Been Rising: Wasn't QE2 Supposed to Drive Rates Down?

The surge in long-term interest rates raises serious questions about the Federal Reserve Policy of quantitative easing (QE2), which was supposed to drive interest rates down. The rise in interest rates (see Chart 1) has baffled ordinary people as well as policy experts. Has the Fed's policy backfired? This short article attempts to answer these questions in a broader economic framework.

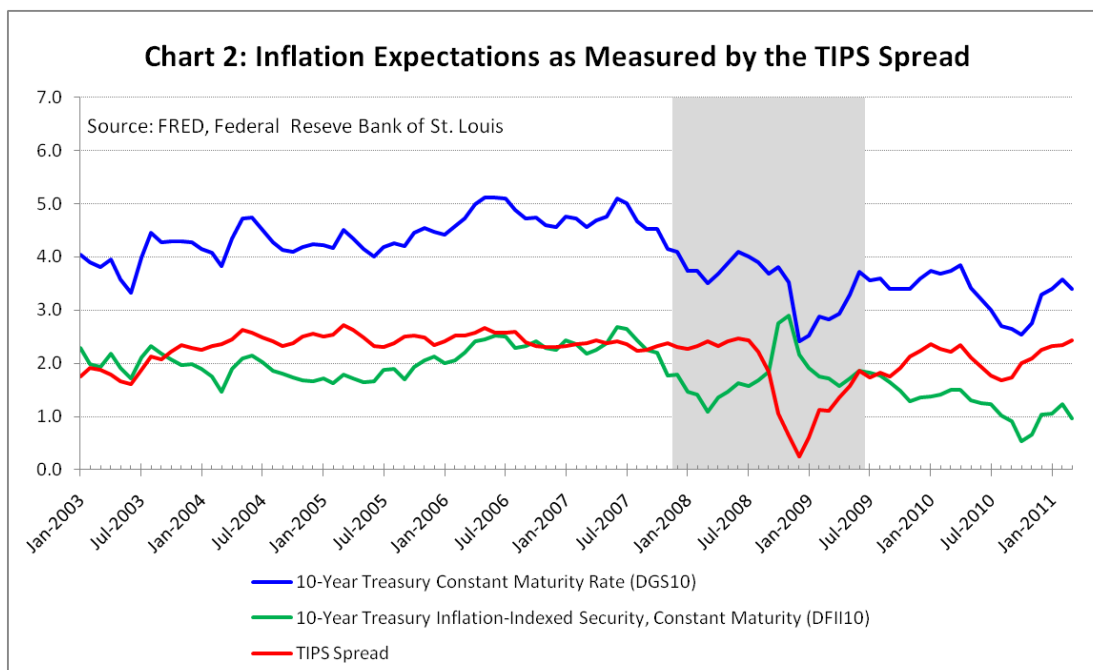
After the announcement of the second round of the Fed's bond buying program to inject \$600 billion of liquidity into the financial system, US interest rates were supposed to be falling, not rising. The Fed's rationale in implementing QE2 was that buying up government debt will drive long-term interest rates down, especially mortgage rates, which move in tandem with benchmark Treasury yields. This will help stimulate the economy because investors will be encouraged to buy stocks and corporate bonds rather than treasuries. The stronger demand for treasuries will bid up the prices and push down the interest rates on those securities as a result. Many policy experts and politicians contend that the rise in interest rates is a sure sign that the policy not only failed but also aggravated the situation even further. However, a careful analysis of the situation reveals that the rise in the rate may not necessarily be bad and may actually reflect strengthening of the economy, among other things.



There are three key factors that may explain the rise in interest rates since the implementation of QE2.

1. Rising Inflation Expectations

It is important to understand that while the Fed's stated goal was to achieve lower yields with QE2, the real goal was also to change expectations about inflation to avoid a deflationary spiral. Toward that end, it looks like the Fed has been successful in shaping inflation expectations as measured by the rising TIPS Spread—the difference between the yield on 10-year Treasury bills and 10-year Inflation Protected T-bills (see Chart 2). The rise in inflation expectations itself causes the bond market to demand higher yields to hedge against that risk, which partly explains the rise in Treasury yields over the last few months.



2. Increasing Budget Deficits and Mounting Debt

Interest rates may rise as concerns over the federal budget deficit and debt mount (see Charts 3 and 4) since deficits are financed by the issuance of Treasury bonds. The US budget deficit is projected to be \$1.5 trillion in 2011, which will be the highest amount in absolute terms and the second-highest as a proportion of gross domestic product. As debt grows, investors fear that huge debt issuance will require ever higher rates to attract sufficient demand from investors, so one theory goes. There is a great deal of debate among economists as to how the private sector and financial markets react to deficits. In reality, historical data shows little direct empirical correlation between interest rates and deficits. For example, as budget surpluses began to deteriorate in late 2000 and turned from 2.4% of GDP to a deficit of 3.4% of GDP by 2003, interest rates actually declined. Similarly, deficits shrank from 3.5% of GDP in 2004 to 1.2% in 2007 while the Treasury yield showed a modest upward bias during that time period, contrary to what might be expected. Data from 2007 and 2010 again show contrary results to what might be expected.

It is also important to recognize that even if the direct empirical evidence seems sketchy between budget deficits and Treasury yields, budget deficits can still impose a burden on future generations. Furthermore, huge budget deficits with no end in sight can bring inflationary pressures (especially, if the debt is monetized)—the bond market does not like inflation because it erodes the value of fixed-income assets. One of the challenges in comparing changes in budget deficits and changes in interest rates is that there are many factors that affect interest rates. To determine the effect of budget deficits on interest rates, all these factors must be held constant using econometric techniques. There is no consensus as to what the proper model should be and that is why empirical evidence on the direct link between budget deficits and interest rate is mixed.^{1,2}

Despite this uncertainty, more recent evidence tends to support a stronger and positive relationship between budget deficits and interest rates. According to a 2004 study³, “each percent-of-GDP in current deficits reduces national saving by 0.5 to 0.8 percent of GDP. Each percent-of-GDP in projected future unified deficits raises forward long-term interest rates by 25 to 35 basis points, and each percent-of-GDP in projected future primary deficits raises interest rates by 40 to 70 basis points.”

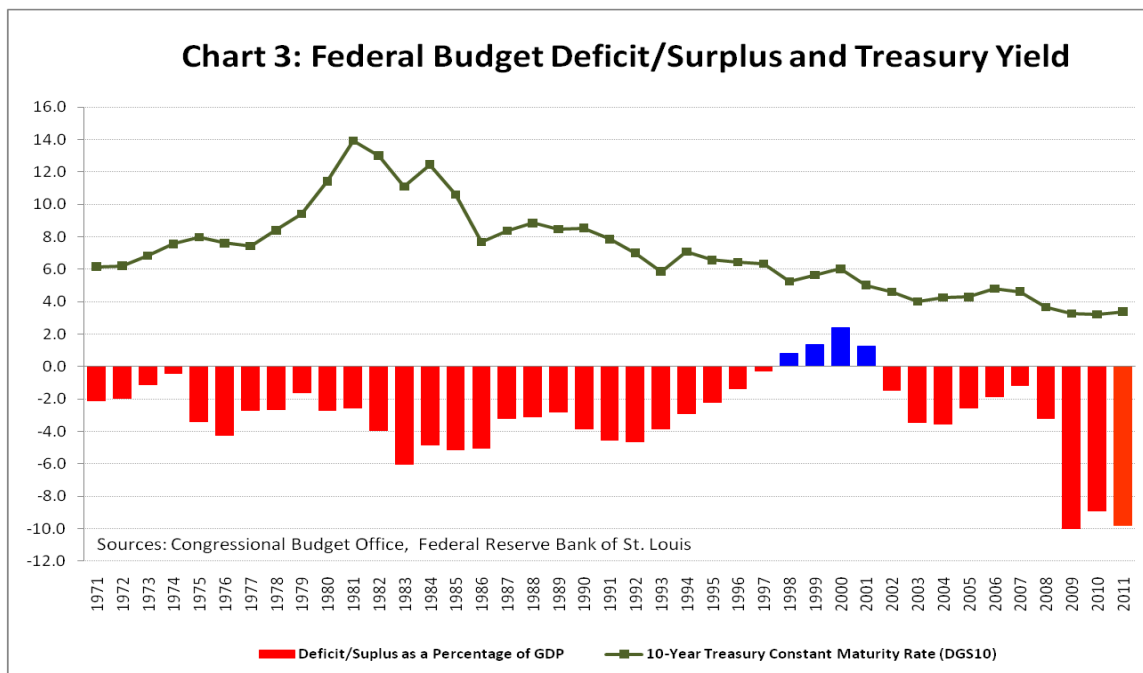
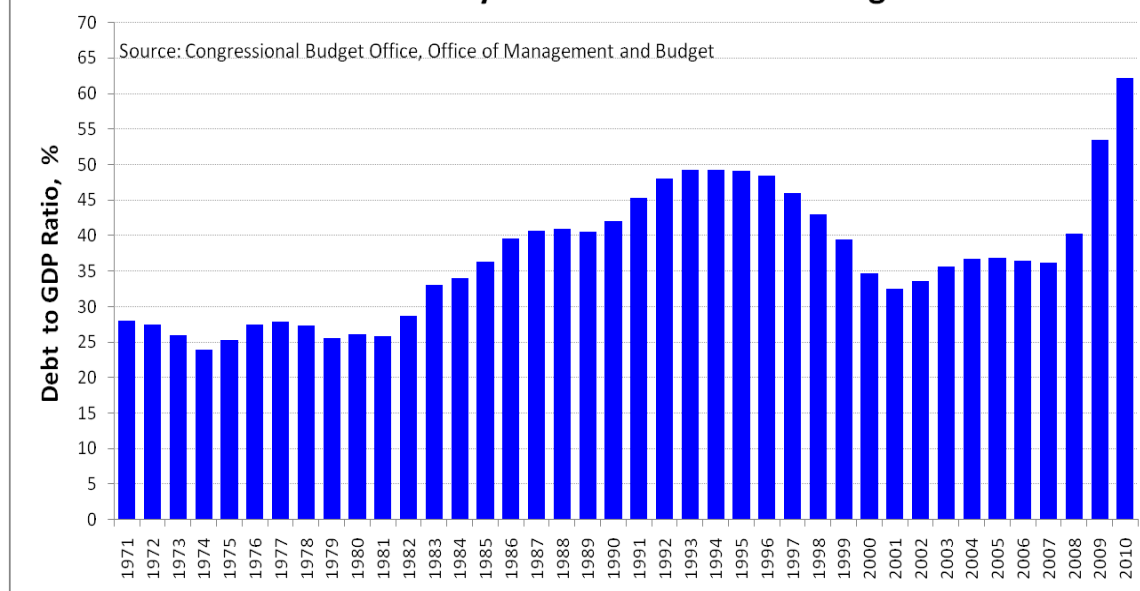


Chart 4: Debt Held by the Public as a Percentage of GDP



3. Improving Economy

Many factors shape bond market yields. One of the key factors affecting recent hikes in Treasury yields is improvement in general economic conditions as well as expectations about future economic conditions. Most indicators of economic activity—GDP growth, Consumer Confidence Index, Consumer Sentiment Index, Leading Economic Index, ISM Business Barometer, retail sales, business investment, exports, manufacturing output, stocks, and corporate profits—point to general improvement in economic conditions going forward. An improved economic outlook has made investors look more favorably at stocks, with fewer investors buying bonds; borrowers must pay a higher yield to attract credit.

Conclusion

There are some so-called “good reasons” for interest rates to go up such as the improving economy or optimism about general economic conditions and some “bad reasons” such as the rising federal deficit, ballooning debt, and rising inflation making bonds riskier investments going forward. It can also be argued that rising interest rates do not necessarily mean failure of the monetary policy per se. First, rates may have risen even higher in the absence of QE2 purchases by the Fed. Second, if the long-term rates were actually not rising, then it would have indicated that the economy may be even in more serious trouble because investors were more worried about deflation and no recovery in sight. Furthermore, although rates have been rising lately, they are still close to historic lows and likely have no way but to go up in the long run.

End Notes:

- ¹ Barth, James, George Iden, Frank Russek, and Mark Wohar, “The Effects of Federal Budget Deficits on Interest Rates and the Composition of Domestic Output” in Rudolph Penner, ed., *The Great Fiscal Experiment*, Washington DC: Urban Institute, 1991, pp 69–75
- ² Reynolds, Alan, “Do Budget Deficits Raise Long-Term Interest Rates?” *Cato Institute, Tax & Budget Bulletin No 1*, February 2002
- ³ Gale, William G., and Peter R. Orszag, “Budget Deficits, National Saving, and Interest Rates.” *Brookings Institution, Brookings Panel on Economic Activity*, September 2004