# 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 apparent weakness in the economy is likely to produce slower growth in private sector payroll, a key driver of WC premium. Slower job growth also means less upward pressure on claim frequency and exposure.

The labor market remains one of the weakest links in the current economic recovery, which officially began two years ago. However, from an employment perspective few people believe that recovery is on its way; indeed, to the millions of unemployed and underemployed, it seems as if the economy is still in a recession.

The US economy has been adding disappointingly few jobs over the last several months—and the unemployment rate remains higher than 9%.

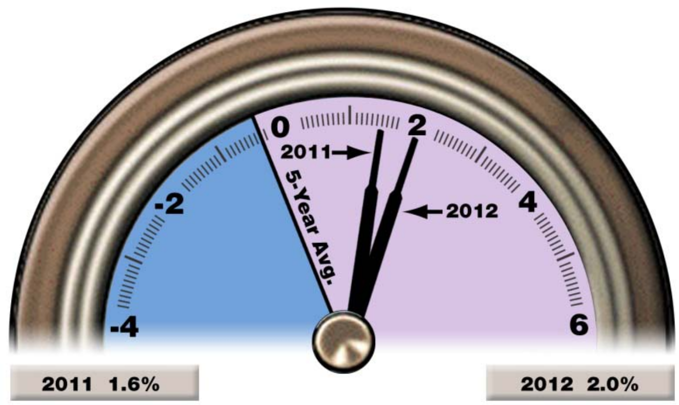



**Exhibit 1— Private Sector Job Growth Remains Sluggish**

### Wage Growth

Changes in indemnity severity are driven primarily by changes in the average weekly wage and by changes in the duration of temporary total claims. A continued weak recovery suggests that there will be limited growth in indemnity severity due to wage inflation. This means that growth in indemnity severity (cost per claim) will only rise slowly as benefits are linked to wages.

The preliminary QCEW wage estimate by the Labor Department indicates that the average weekly wage grew by 2.9% in 2010. Given the slack in the economy, wages are essentially flat on an inflation-adjusted basis and are expected to remain that way for 2011. Wage inflation is expected to pick up pace in 2012; however, it should not be a major concern for the WC industry because premiums are directly tied to wages, which may offset any negative effect on indemnity benefits.

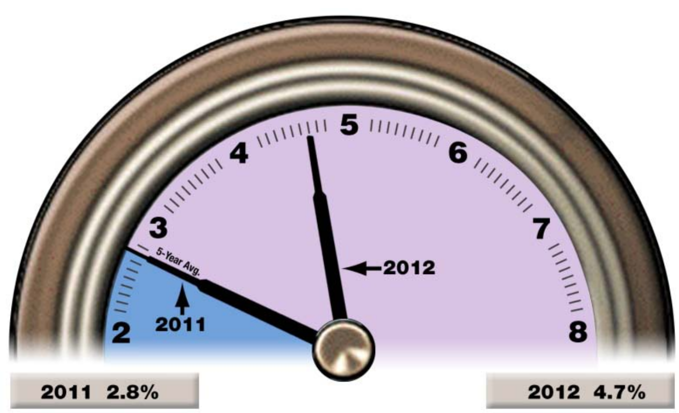



**Exhibit 2—Wage Inflation Pressure Remains Well-Contained**

Analysis and charts prepared July 2011.

## Medical Inflation

Inflation in medical prices will continue to be a key driver of changes in medical severity. Enhanced utilization, primarily due to an increasing share of more costly injuries (e.g., rotator cuff, knee) as a result of the growing obesity problem and an aging workforce, will likely add to upward pressure.

Despite some recent easing in general inflationary pressures, medical inflation is expected to remain strong and will likely keep upward pressure on medical severity. According to moodyseconomy.com, medical care inflation is projected to rise from 3.4% in 2010 to 3.6% in 2011.

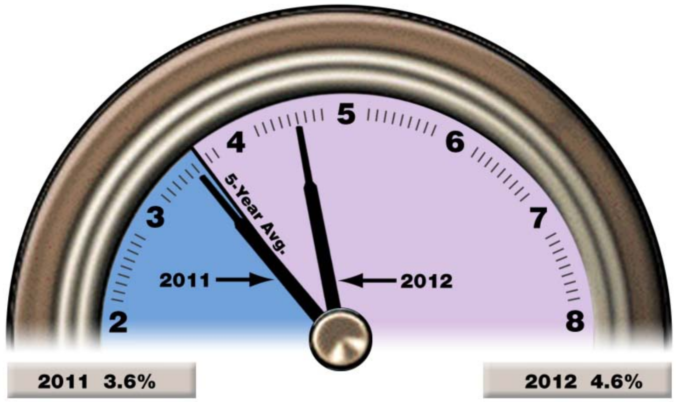



**Exhibit 3—Medical Care Price Inflation Pressure Will Continue**

## Interest Rates

There will be downward pressure on investment income for the P/C industry mainly due to actions by the Fed to keep interest rates very low. Amid the snail-paced economic recovery, monetary policy is expected to remain unusually accommodative. In fact, the Fed recently indicated that it plans to keep "exceptionally low" interest rates in place until at least mid-2013 as a way to help the recovery. Very low interest rates will limit the potential contribution of investment income to the industry's profitability.

The P/C industry's investment performance will likely improve as a result of a rise in long-term interest rates going forward. The latest consensus forecast (at the time of writing) from the monthly Blue Chip Economic Indicators shows that the 10-year Treasury constant maturity security is expected to average 4.0% in 2012 compared to the current rate of around 3.0% in mid-July.

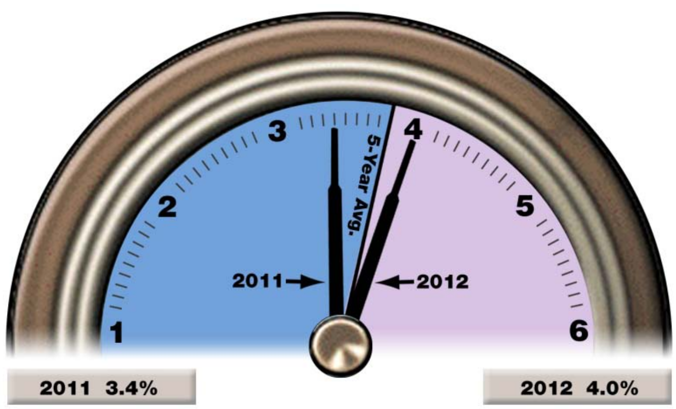



**Exhibit 4—Interest Rates Will Likely Increase by 2012**

Analysis and charts prepared July 2011.

# Behind the Gauges:

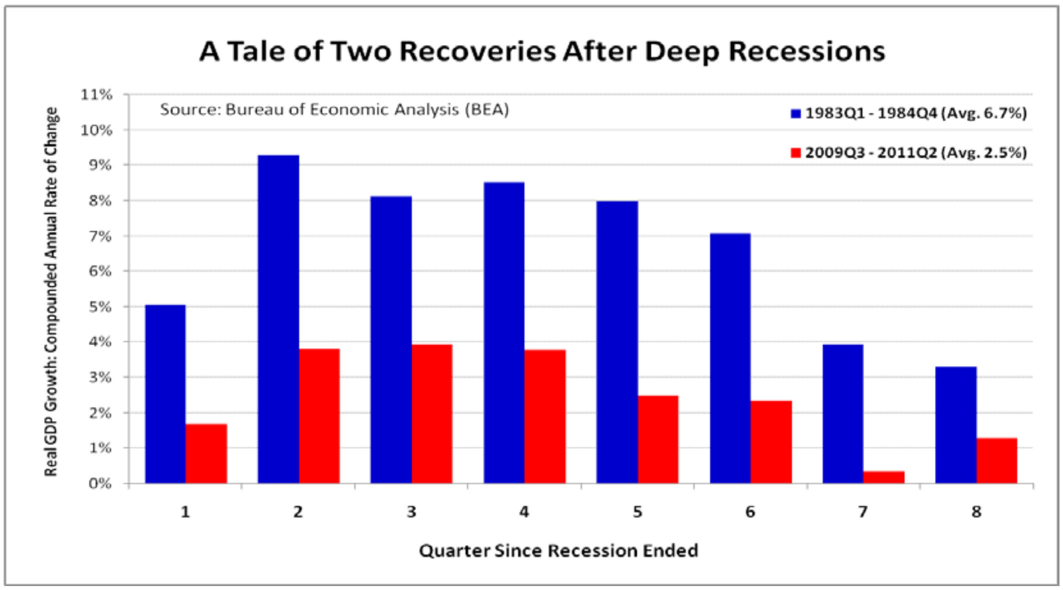
## Macroeconomic Outlook

*The following set of 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 GDP growth, unemployment, the housing market, industrial production and capacity utilization, personal income & consumption expenditures, and corporate profits.*

### 1. Real Gross Domestic Product (GDP)

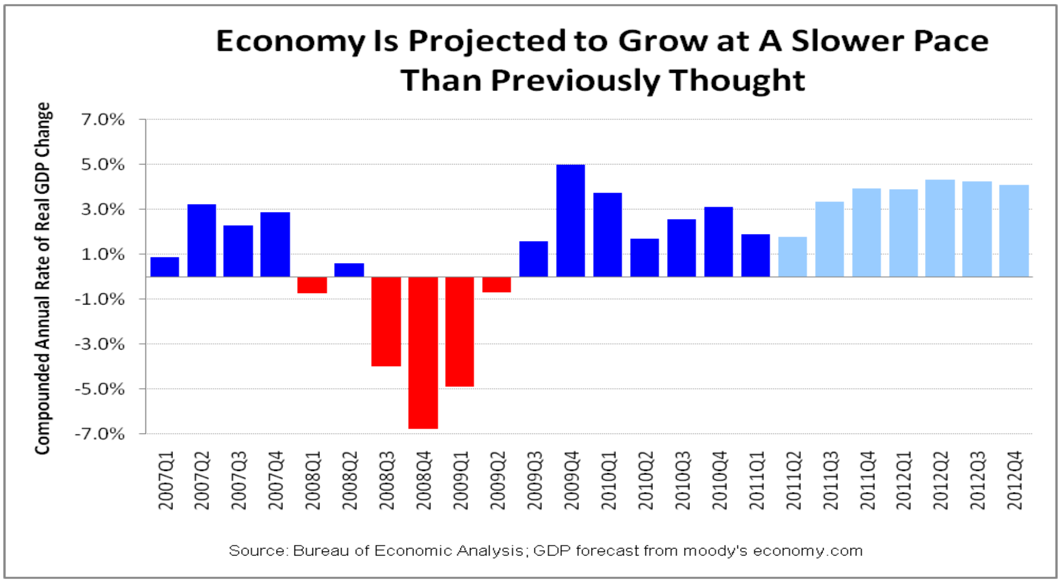
Continued weakness in economic growth suggests a very challenging environment for the workers compensation industry and its underwriting performance. The current recovery remains the weakest postwar expansion on record on almost all accounts. This weakness is a concern because the economy needs to grow above 3% annually for an extended period of time to make any headway in bringing the unemployment rate down from a stubbornly high rate of 9.2%.

Even though the level of GDP has recovered to its prerecession peak, the growth rate is paltry compared to the last deep recession (July 1981 to November 1982). Real GDP growth since the end of the current recession has averaged just 2.5% compared to 6.7% in the 1981–1982 recession. This weak growth is part of a disturbing pattern forcing most economists to revise their forecasts downward over the past few months. The Federal Reserve also lowered the central bank's latest GDP projections to 2.7% to 2.9% for 2011 and 3.3% to 3.7% for 2012. In January, the Fed's forecast was materially higher—3.4% to 3.9% growth for 2011 and 3.5% to 4.4% for 2012.




Raising taxes or cutting expenditures may put the brakes on an already troubled economy. Thus, neither is an attractive policy instrument—and each faces formidable political challenge. However, any credible plan to reduce the long-term deficit may help the struggling economy.

Analysis and charts prepared July 2011.

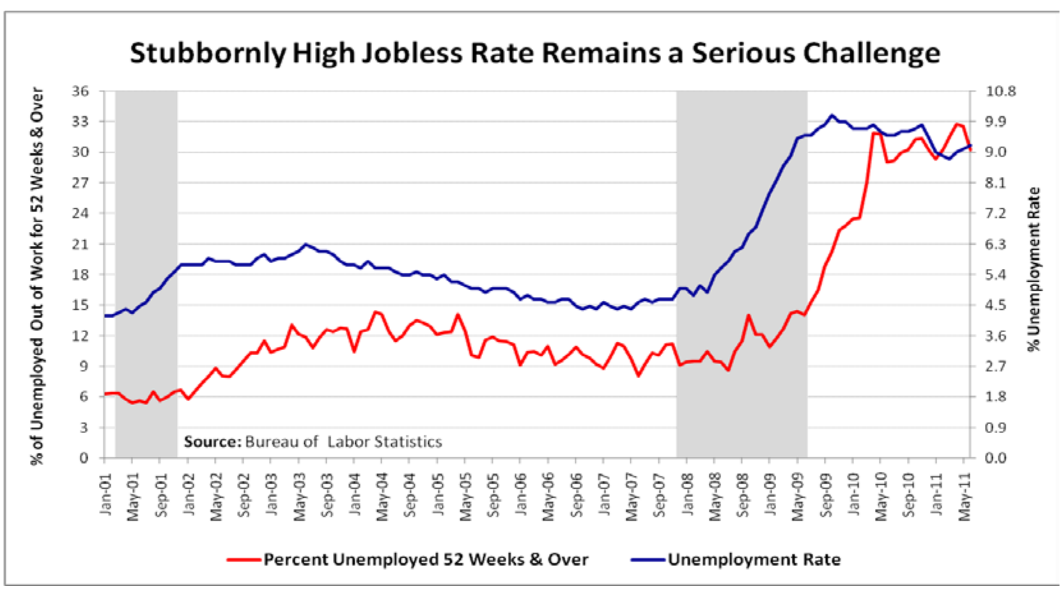



## 2. Unemployment

Changes in labor market conditions have the greatest impact on workers compensation premium income and on claim counts. The weak labor market recovery is less likely to generate a strong demand for workers compensation in the near future.

The latest unemployment data is very discouraging. Another indication of the woes of the labor market is the decline in the share of the population that have a job. The employment to population ratio has fallen to 58.2% in June—the lowest level in more than 25 years. Before the onset of the recession, the ratio stood around 63%.

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 two years, roughly 6.3 million people have been unemployed for more than 6 months. The extent of long-term unemployment has profound consequences because people 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 one gets caught in this vicious cycle, it becomes harder and harder to get out of it as time passes. With the jobless rate hovering higher than 9% and more than 44% of those jobless being unemployed for 6 months or longer, the job market has a long road to recovery.

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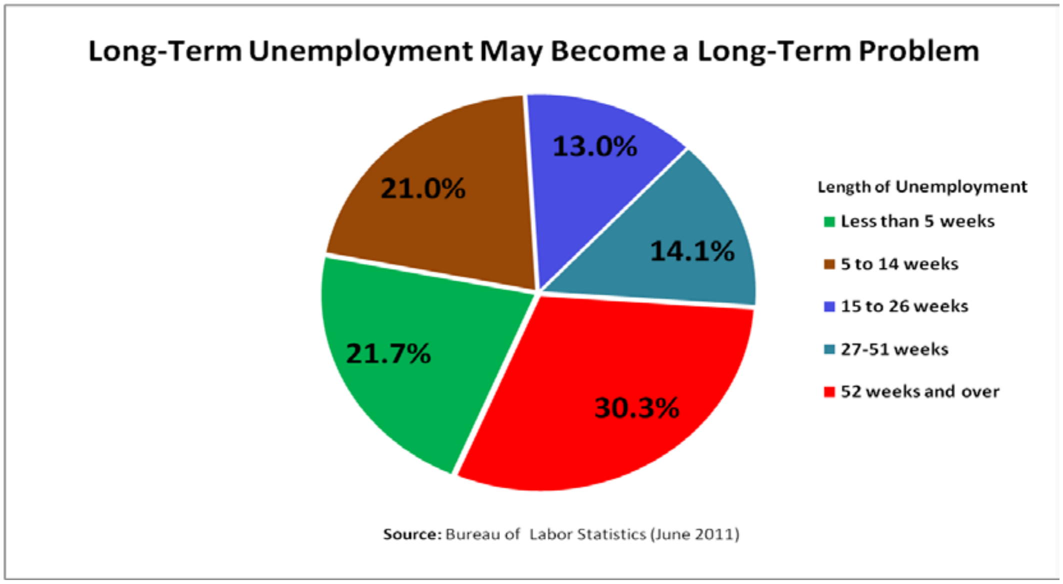
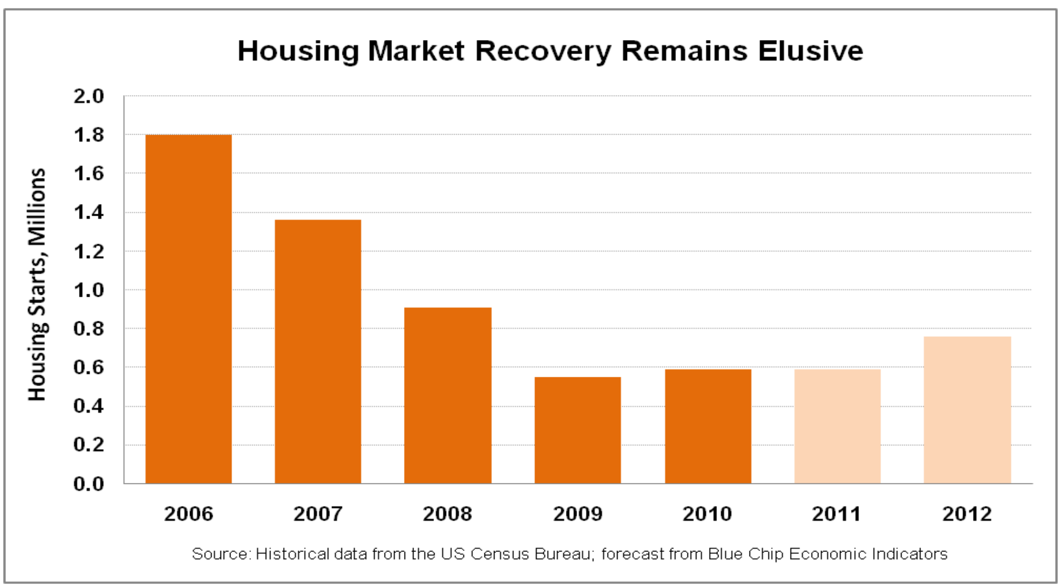
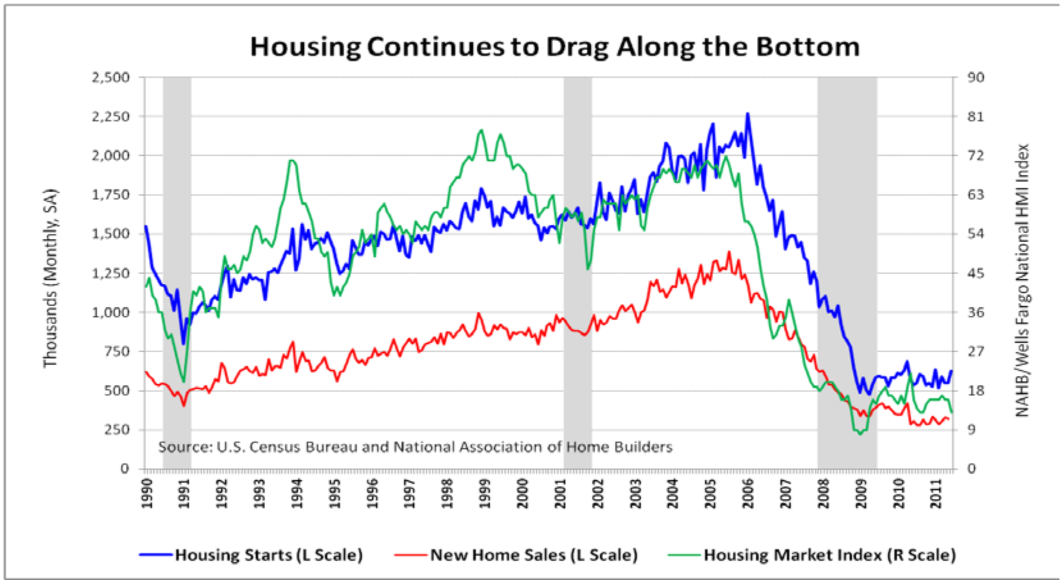



## 3. Housing Market

In many ways, the limited recovery in workers compensation is directly tied to weakness in the housing market because construction employment plays a huge role in WC premiums across all states.

The recovery in the housing market remains elusive as new construction continues to tread along the bottom. The stubbornly high unemployment rate, along with persistent problems in the housing sectors and slow economic growth remain key features of the current weak economic recovery. Depressed home prices, a glut of home inventory on the market, and a huge backlog of mortgages yet to enter the foreclosure process continue to cloud the housing outlook.



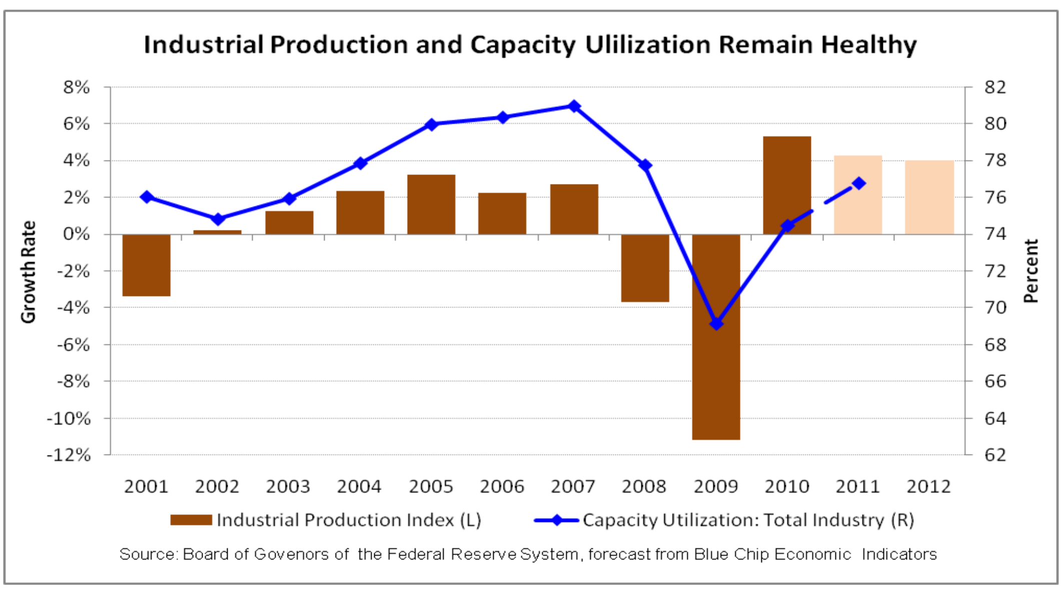



## 4. Industrial Production and Capacity Utilization

Continued improvement in industrial production (IP) and capacity utilization will lead to increase in demand for workers compensation insurance.

Industrial production remains a significant and vital part of the overall economy. Each month, the Federal Reserve estimates an index of IP measuring changes in output for manufacturing, mining, and electric and gas utilities industries. There is a very close relationship between changes in industrial output and GDP growth, making it a highly watched coincident indicator of economic activity. According to the latest data from the Federal Reserve, IP rose 0.2 percentage points in June; however, the increase was below expectations. So although industrial production remains stable, it appears to have lost some of the positive momentum observed over the past several months.

Capacity utilization measures the amount of slack in the economy and is measured by the ratio of actual to potential output. Generally, the higher the percentage utilization, the healthier the economy because it means resources, rather than sitting idle, are being put to productive use. But a capacity utilization rate higher than 85% can also indicate an imminent threat of inflation. Capacity utilization held at 76.7% in June, the same as in the prior month, suggesting that inflationary pressures are limited.

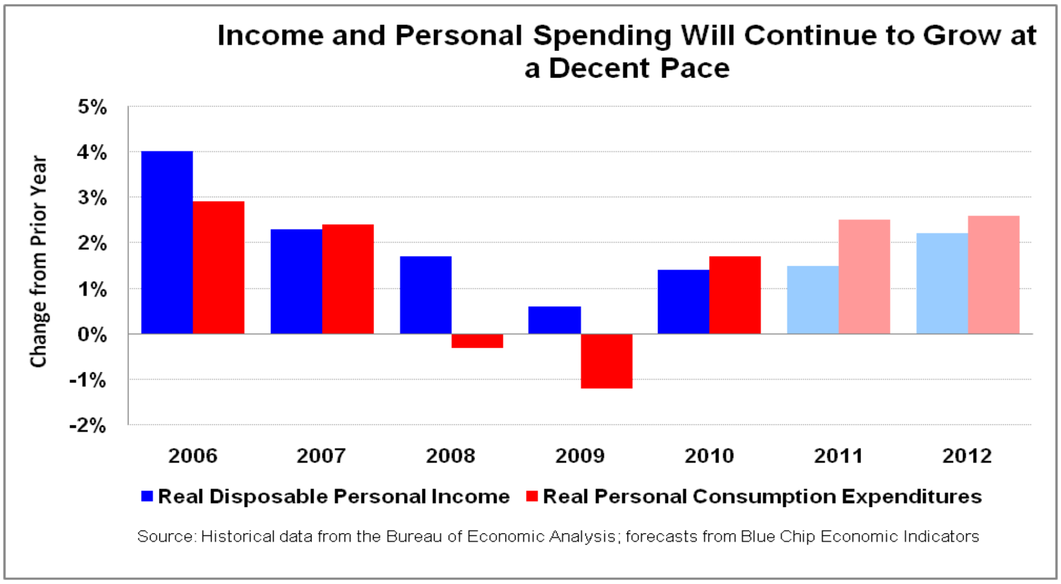


## 5. Disposable Income and Personal Consumption Spending

Disposable personal income (DPI) is the key driver of consumer demand, which historically has accounted for two-thirds of economic activity. Therefore, healthy income and consumer spending growth are keys to robust economic recovery, a necessary condition for recovery in the workers compensation market.

Unfortunately, like most other economic indicators, the projected DPI growth for 2011 and beyond has been lowered over the past few months. The downward revision points to serious challenges facing the recovery.

Despite immediate challenges and barring any serious policy missteps, consumption spending is projected to grow at a reasonably healthy pace over the next few years.



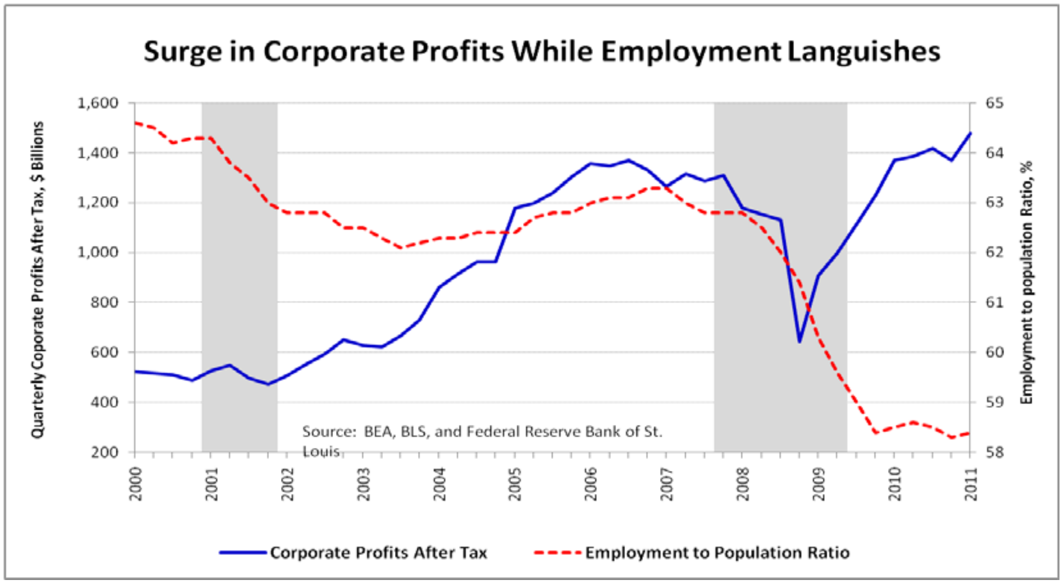

## 6. Corporate Profits

Healthy corporate profits are a key to a healthy economy. At some point, these profits should translate into more business spending and hiring, which will help increase demand for workers compensation coverage.

While the country struggles through the slowest recovery since the Great Depression, corporate profits continue to surge. Indeed, by all measures, corporate profits have been much stronger than the general health of the economy. Sales and profitability of US corporations, in part, benefited from strong demand from emerging markets. More importantly, cost-cutting measures taken during the recession have been the driving force in improving productivity and profitability. Companies having learned to do more with less were able to bring production back up to prerecession levels without hiring significantly more workers. The economy has recovered all of the output lost during the recession, without a comparable recovery in hiring—and that is the crux of the labor market woes.

Most companies are expected to post double-digit profit growth in the second quarter of 2011; however, during 2012, the growth in corporate profits will likely be in the single-digit range. The slowdown in profit growth will likely result from rising raw material cost, rising wage pressure, and weaker consumer sentiment as a result of continued weakness in the housing market and concerns about the general state of the economy.

Analysis and charts prepared July 2011.




## Summary

**Premium**—The apparent weakness in the economy is likely to produce slower growth in private sector payroll—a key driver of WC premium.

**Frequency**—Based on preliminary results for 2010, frequency (relative to premium) increased for the first time in 13 years. In part, this reflected the relative shift to high frequency office and clerical premium due to the decline in sectors such as construction and manufacturing. Going forward, 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**—Changes in indemnity severity are driven primarily by changes in the average weekly wage and by changes in the duration of temporary total claims. A continued weak recovery suggests that there will be limited growth in indemnity severity due to wage inflation. This means that growth in indemnity severity (cost per claim) will only rise slowly as benefits are linked to wages. Unfortunately, duration may remain a challenge due to the limited availability of light duty jobs needed for early return-to-work programs.

**Medical Severity**—Inflation in medical prices will continue to be a key driver of changes in medical severity. Enhanced utilization, primarily due to an increasing share of more costly injuries (e.g., rotator cuff, knee) as a result of the growing obesity problem and an aging workforce, will likely add upward pressure.

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