



## Gauging Current Conditions: The Economic Outlook and Its Impact on Workers Compensation

The gauges below indicate the economic outlook for the current year and for 2007 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.

### Slowing Job Growth May Foster Continued Frequency Declines

Job growth is expected to slow in 2007, as higher oil prices and borrowing costs appear to be taking a toll on household spending and business confidence. Slower job growth suggests less upward pressure on claim frequency, since fewer poorly trained/inexperienced workers are added to payrolls (Exhibit 1). The actual direction of claim frequency will depend on the balance among such employment-related effects and a wide range of other forces that have contributed to the ongoing decline in frequency since the early 1990s.

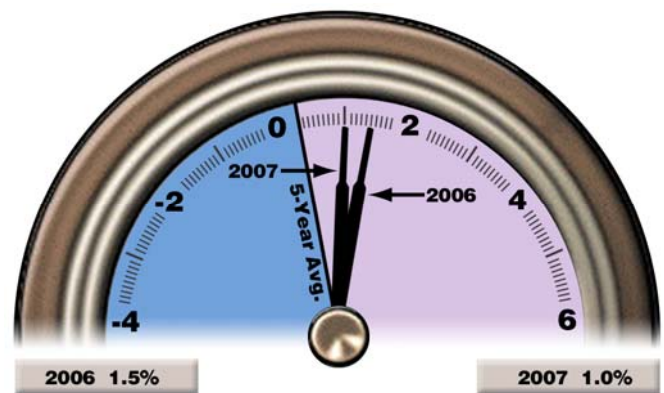


Exhibit 1—Private Sector Employment Growth Slowing

### Continued Wage Gains Suggest Further Increases in Indemnity Severity

Wage gains are expected to pick up a bit in 2007. Tightening labor markets are providing workers with increased leverage to effect increases in their compensation, while ongoing gains in productivity enable businesses to fund such increases without unduly affecting costs. The rise in wages suggests further increases in indemnity severity since indemnity benefits are tied to wage growth (Exhibit 2).

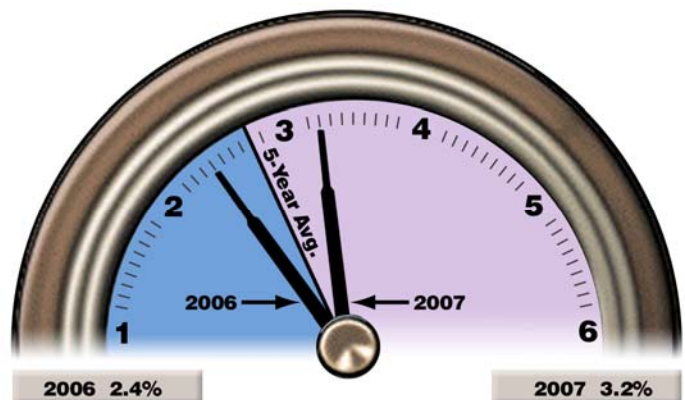


Exhibit 2—Average Weekly Wages Continue to Rise

### The Quickening Pace of Medical Care Prices Suggests Further Increases in Medical Severity

Medical care price increases (as measured by the Medical Care component of the Consumer Price Index) are expected to accelerate through 2007, in part reflecting increases in both labor and energy costs. Those increases are likely to be reflected in additional upward pressure on medical severity (Exhibit 3).

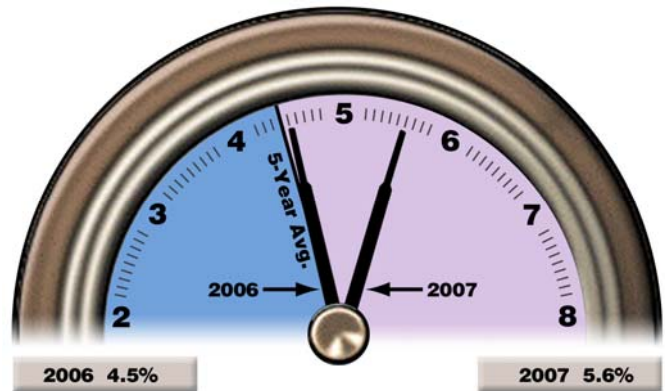


Exhibit 3—Medical Care Price Increases Continuing

### Firming Interest Rates in 2006–2007 Suggest Better News on Investment Income

After increasing the federal funds' interest rate 17 times since June 2004, the Federal Reserve (Fed) paused in August in response to signs of a slowdown in economic growth (although it also indicated that rates could move higher again if inflationary pressures intensified). The more recent tightening by the Fed (since mid-2005) has been accompanied by increases in long-term rates (increases that have also paused in line with the Fed's latest action). Although higher yields suggest a boost to fixed income returns on newly invested funds, the rise in rates, combined with investor concerns about energy supplies and the Middle East unrest have caused some volatility in stock prices. The ability of carriers to achieve realized capital gains on their stock portfolios will depend, on no small part, on whether the stock market can hold on to the gains made so far this year. (The "gauge" [Exhibit 4] shows the rate of the seven-year Treasury note because the average maturity of Treasury securities held by P/C carriers is roughly seven years.)



Exhibit 4—Interest Rates – Pausing for Now

# Behind the Gauges

## Financial Markets

The following set of charts focuses on financial market conditions and their implications for the property/casualty industry.

### Portfolio Composition of Invested Assets

As of year-end 2004, private carriers had slightly more than \$1 trillion in invested assets, 70% of which were in fixed income securities (about half in tax-exempts) and 20% in common and preferred stocks (about two-thirds in “unaffiliated” common stocks). Most of the balance was in cash and other short-term investments. (Exhibit 5)

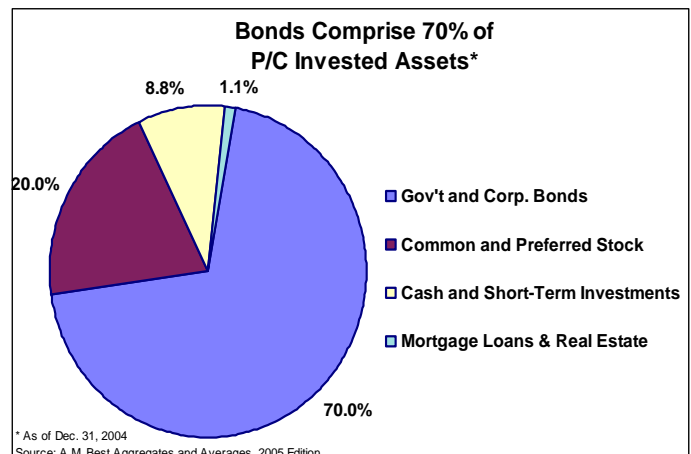


Exhibit 5

### Stock Market

The S&P 500 stock price index is up 7% versus 2005 through mid-September (measured on an average year-to-date basis versus the same period in 2005)—an increase similar to the full-year rise in 2005 (versus 2004) (Exhibit 6).

Stock price averages remain vulnerable to a wide range of factors, including the direction of oil prices (which have eased recently but are still well above year-ago levels), the near-term direction of Fed policy, and the uncertain situation in the Middle East.

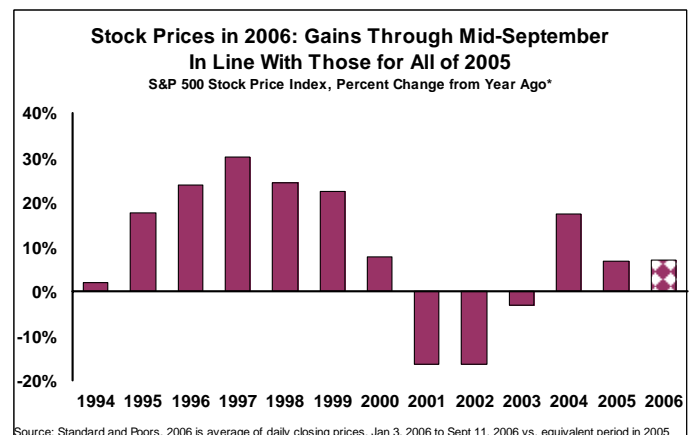


Exhibit 6

### Interest Rates

The Federal Reserve refrained from raising short-term interest rates at its August meeting, leaving the key federal funds' interest rate at 5.25%. The rate was just 1% when the Fed began its current round of tightening in June 2004.

Long-term rates, which had remained flat during the early rounds of Fed tightening, have begun to move higher, with the yield on 10-year Treasury notes in mid-September up 60 basis points (to just under 4.8%) since the same period in 2005. (Exhibit 7)

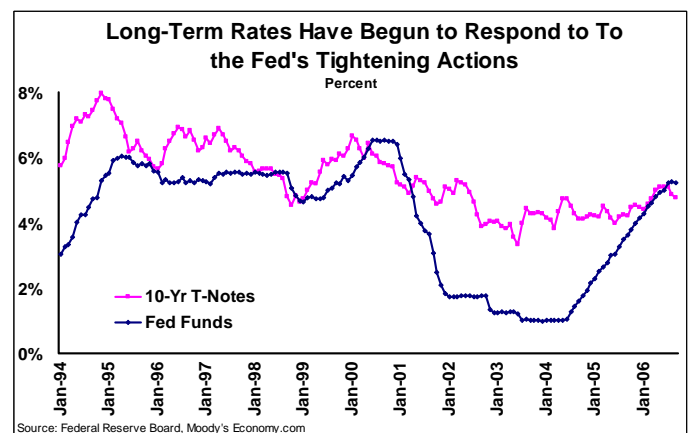


Exhibit 7

**New vs. Embedded Yields**

The rise in interest rates boosted new money yields available to P/C carriers in 2005, building upon gains in 2004. (New money yields reflect funds invested in 2005 and are based on the portfolio distribution of fixed-income assets among private carriers.)

With new money yields rising, the protracted slide in embedded yields (i.e., the return on previously invested funds) has been slowing—with a further slowing (if not a reversal) likely in 2006 if market rates continue to rise.

As shown in Exhibit 8, these trends have had a beneficial impact on investment income. (Note that data specific to workers compensation is not available for Exhibits 8–10.)

**Components of P/C Investment Returns**

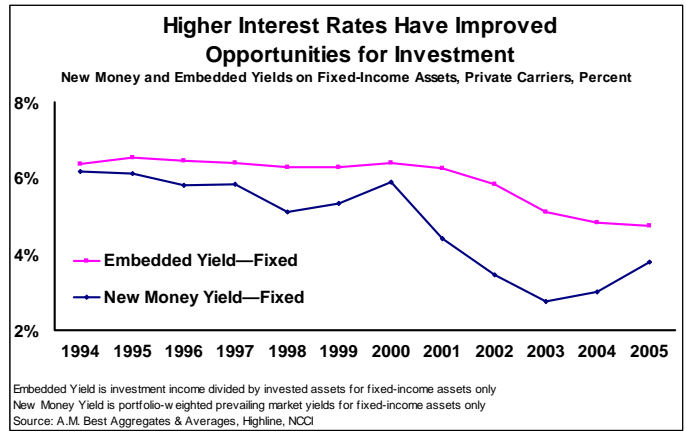
In part reflecting higher interest rates, interest and dividend income surged in 2005, increasing nearly 25% above its 2004 level and surpassing its previous high in 1997. Prospects are good for continued increases in 2006, based on the direction of interest rates so far this year.

Far less certain are prospects for realized capital gains, which largely depend on the stock market's performance. Such gains made substantial (and increasing) contributions to investment income in 2003–2005, consistent with the stock market's gains in those years. (Exhibit 9)

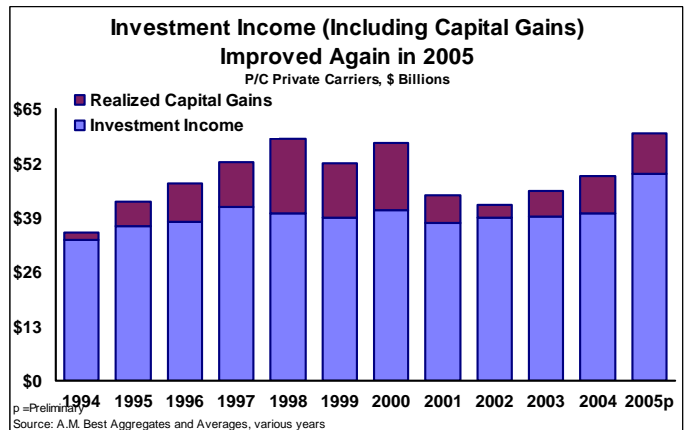
**Return on Surplus**

The P/C industry's return on surplus (ROS) in 2005 was down just slightly from its 2004 level but still well above the average 7.5% return posted between 1994 and 2004.

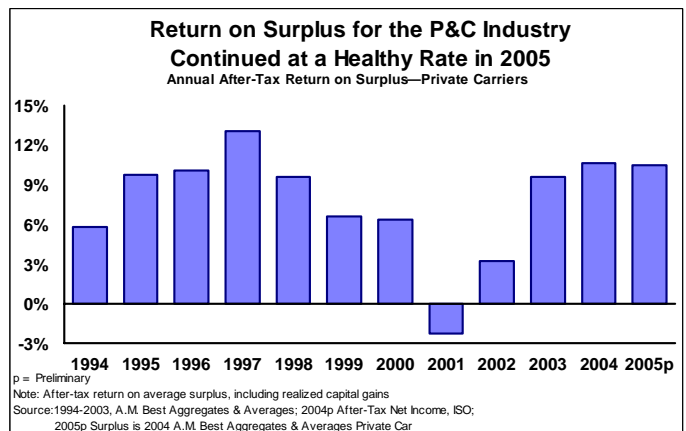
Last year's results reflected the aforementioned gains in investment income as well as continued excellent underwriting results (with the combined ratio at 101%—the third year in a row with that ratio near or at 100%). These results were especially remarkable considering that last year included the largest weather-related disasters in US history. (Exhibit 10)



**Exhibit 8**



**Exhibit 9**



**Exhibit 10**

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