

Insurance Executive Review

Market Commentary on Current Developments within the P&C Insurance Industry

REVISITING OUR RECENT ECONOMIC OUTLOOK AND IMPACT ON THE U.S. PRIVATE INSURANCE INDUSTRY MARKET ... WAS OUR OUTLOOK TOO OPTIMISTIC?

We no sooner finished Newsletter #30 that contained our “U shaped” economic recovery position when we started to doubt our own forecast as being too optimistic. Although we thought it would take longer to recover from this recession well into 2012 it appears it may take much longer. So we decided to revisit that position. Notwithstanding the recent run-up in the equity market, there appears to be more compelling negative factors than company earnings reports (driven by productivity/lower overhead costs) are at work in the market. We will look at some of these based on work of various observers that give us further concerns.

Previous recession comparisons

There has been a great deal of effort to look at this economic downturn as bearing similarities to other recessionary periods particularly as to cause, duration and depth. While there are such similar characteristics they may not be as relevant to this recession as we might think. With specific regard to the current “exuberant enthusiasm” of the equity market the following comparison might be of interest.

Comparing the 1982 Bull Market with the 2009 Rally

<u>Rally Comparison</u>	<u>1982</u>	<u>2009</u>
P/E Multiple	8X	26X
Dividend Yields	6%	below 2%
Book Value	Discount to Book	2X Premium
Monetary Policy	Reducing money growth and inflation rates	Creating money growth and inflation rates
Fiscal Policy	Aimed at reducing nondefense spending	Aimed at accelerating nondefense spending
Deficits	Peaking and coming down relative to GDP	Surging to 10%+ relative to GDP
Global Trade Barriers	Were being torn down	Are being erected
Regulation	Deregulation in vogue	Re-regulation rising
US Dollar	Plaza Accord bull market	Mercantilist bear market
Household Credit	Balance sheets and participation rates expanding	Balance sheets now contracting
Tax rates	Income, capital gains and dividend taxes declining	Taxes Rising Now

Source: Gluskin Sheff, S&P, Bloomberg

The problem with making comparisons is that all recessions have some unique features that separate them from prior events so making projections based upon past performance may not always hold true. The current recession is different in a number of ways with the most significant being the credit availability bubble that households and business organizations built upon the notion of an ever expanding base of underlying asset appreciation. Once the asset base valuations stopped expanding (and then falling) the house of credit collapsed and the entire economy came to a halt. While government intervention initially focused on the issue of containment in limiting the financial distress/collapse of major financial institutions with global implications, the subsequent action in Washington has not adequately moved from Wall Street to Main Street.

Until we see some positive news with respect to employment, any other reference to economic improvement will be just window dressing to make things seem better. Private employment is now 2.6% below where it was in December 2000 nearly a decade ago.....we have lost more than a decade of job growth in over 24 months and counting.

Employment the key to recovery....how long will it take?

The employment outlook is very uncertain and any parallels to the past may be utterly inappropriate. The current under-employment has less cyclical characteristics and has more structural aspects.....simply stated many of the lost jobs will not come back. Here is where we are compared to the past.

STUCTURAL EMPLOYMENT CHANGE	
NEW NORMAL	PAST NORMAL
Private sector employment negative on a 10 year basis	Never happened in prior 6 decades
11 million full-time jobs lost of which 3 million shifted to part-time work	Usually only 3 million full-time jobs are lost
There are now a total of 9.3 million working part-time	Never went above 6 million
Workweek now 33.0 hours down from 33.8 hours is equivalent to another 2.4 million jobs lost	Workweek usually remained unchanged
5.6 million unemployed for at least 6 months or 36% share of jobless ranks	Usually 2 million unemployed at least 6 months or 20% share of jobless ranks
U6 measure* of unemployment is already at 17.5% or gap of 7.3 percentage points from the U3 rate of 10.2%	At prior 1982 high, of 10.8% (U3 rate) the U6 rate spread was only 3.5 percentage points or 14.3%

**U6 is a combined measure of unemployed and under-employed*

Given the conditions of the current situation, we would expect that further job losses will take place well into 2010. Assuming we see an economic recovery slowly taking place next year, the pace at which new jobs will be created to reverse the public U3 unemployment rate will face the following job sequence headwinds as employers will look at options:

- Boost the workweek hours of existing employees to pre-recession levels (equal to hiring 2.4 million workers);
- Hire back furloughed part-time employees into full-time (equal to 9.3 million of U6 under-employed workers);
- Hire back previously terminated employees or from the cheaper pool of new labor force entrants unable to

previously find work.

The demographics of the labor force is constantly changing not the least of which are new entrants joining the labor market, offset by retiring workers. The labor market as a percentage of the population is expected to decline after 2013 as the “baby boomers” start to retire (assuming they can still do so at age 65) moving the participation rate from 65.04% of the population today to 62.86% in 2020.

**GROWTH OF LABOR POOL
(Data in Millions of People)**

Year-end	Population	Participation Rate	Annual		Total Labor Pool	Jobs (start)
			Labor Pool Increase	Total Labor Pool		
2009	236.97	65.04%			154.13	138.08
2010	239.47	64.96%	1.43		155.56	
2011	241.63	64.89%	1.23		156.79	
2012	243.80	64.81%	1.22		158.01	
2013	245.99	64.69%	1.13		159.13	
2014	248.21	64.52%	1.01		160.14	
2015	250.44	64.36%	1.04		161.18	
2016	252.70	64.11%	0.82		162.00	
2017	254.97	63.86%	0.82		162.82	
2018	257.26	63.52%	0.59		163.41	
2019	259.58	63.19%	0.61		164.03	
2020	261.92	62.86%	0.61		164.64	????????

But since the population will be growing, the total labor pool will grow from 154.13 million workers today to 164.64 million workers by 2020 or an increase of 10 million workers (nearly 4 million of these workers between 2010 and 2012 alone). With an expected number of unemployed workers likely to reach 17 million by year-end 2009, the question becomes.....how many jobs must be created to bring unemployment down to a reasonable level, say 4.5 to 7.5% by 2020 or sooner? Well here are some possibilities but are they reasonable?

Source: U.S. Dept. of Labor and Census Bureau

**POTENTIAL JOB GROWTH SCENARIOS
(Data in Millions of People)**

Year-end	Total Labor Pool	Jobs (start)	Scenario A				Scenario B				Scenario C			
			Jobs Gain	Jobs Total	Unemployed	U 3 Rate	Jobs Gain	Jobs Total	Unemployed	U 3 Rate	Jobs Gain	Jobs Total	Unemployed	U 3 Rate
2009	154.13	138.08	-4.48	138.08	16.05	10.4%	-4.48	138.08	16.05	10.4%	-4.48	138.08	16.05	10.4%
2010	155.56		0.12	138.20	17.36	12.6%	0.12	138.20	17.36	12.6%	-0.12	137.96	17.60	12.8%
2011	156.79		0.80	139.00	17.79	12.8%	1.40	139.60	17.19	12.3%	-0.50	137.46	19.33	14.1%
2012	158.01		1.65	140.65	17.36	12.3%	2.04	141.64	16.37	11.6%	1.44	138.90	19.11	13.8%
2013	159.13		2.04	142.69	16.44	11.5%	2.04	143.68	15.45	10.8%	2.40	141.30	17.83	12.6%
2014	160.14		1.80	144.49	15.65	10.8%	2.04	145.72	14.42	9.9%	1.90	143.20	16.94	11.8%
2015	161.18		1.80	146.29	14.89	10.2%	2.04	147.76	13.42	9.1%	1.90	145.10	16.08	11.1%
2016	162.00		1.80	148.09	13.91	9.4%	2.04	149.80	12.20	8.1%	1.90	147.00	15.00	10.2%
2017	162.82		1.50	149.59	13.23	8.8%	2.04	151.84	10.98	7.2%	1.90	148.90	13.92	9.4%
2018	163.41		1.20	150.79	12.62	8.4%	1.90	153.74	9.67	6.3%	1.90	150.80	12.61	8.4%
2019	164.03		1.20	151.99	12.04	7.9%	1.90	155.64	8.39	5.4%	1.90	152.70	11.33	7.4%
2020	164.64		1.20	153.19	11.45	7.5%	1.90	157.54	7.10	4.5%	1.90	154.60	10.04	6.5%
2010 to 2020 Total-->			15.11				19.46				16.52			

Source: U.S. Dept. of Labor and Census Bureau(labor pool data); Unemployment assumptions are C R Market Strategies projections

Above are three scenarios that would produce the range of unemployment mentioned above by the year 2020. In each case the job creation assumptions are different with the U 3 rate rising before starting a downward movement. In Scenario C we see the effect of a modest continuation of job losses (double-dip recession) through 2011 before strong job development takes place thereafter. In each scenario we should remember that 1.5 million annual jobs equate to 125,000 per month average and 2 million per year is equal to 165,000 jobs per month. Our ability to generate these levels of job creation has not been evident in our recent history.

Look at the chart on the following page for a view of past job creation keeping in mind that 1999 was height of the internet boom.

**U.S. MONTHLY JOB GAINS/LOSSES
1999-2009**

Year	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Total Annual	Average Monthly
1999	121	410	106	376	213	266	291	192	202	408	294	294	3899	325
2000	249	121	472	286	225	(46)	163	3	122	(11)	231	138	2485	207
2001	(16)	61	(30)	(281)	(44)	(128)	(125)	(160)	(244)	(325)	(292)	(178)	(2084)	(174)
2002	(132)	(147)	(24)	(85)	(7)	45	(97)	(16)	(55)	126	8	(156)	(713)	(59)
2003	83	(158)	(212)	(49)	(6)	(2)	25	(42)	103	203	18	124	1	0
2004	150	43	338	250	310	81	47	121	160	351	64	132	2547	212
2005	182	221	121	312	212	259	322	190	87	98	380	160	3179	265
2006	294	274	282	151	24	70	186	149	147	82	261	219	2665	222
2007	180	36	184	35	156	54	(65)	(28)	100	165	215	120	1369	114
2008	(72)	(144)	(122)	(160)	(137)	(161)	(128)	(175)	(321)	(380)	(597)	(681)	(3551)	(296)
2009	(741)	(681)	(652)	(519)	(303)	(463)	(304)	(154)	(139)	(111)	(11)	(85)	(5482)	(457)

Source: Bureau of Labor Statistics

We created over 2 million jobs for the 3 years from 2004 to 2006 but these were directly and indirectly attributable to the real estate bubble (asset appreciation) and the financial market leverage that perpetuated easy credit. Those gains were more than wiped-out in the 2008-2009 period that we may someday call "The Great Recession". Simply stated, producing the jobs (15 to 19 million) necessary to validate any of the three previous scenarios does not look very good given current conditions.

Conclusion

The outlook for a prolonged period of very slow recovery appears to be the case here, as this recession was not cyclical but structural. In a recent article on bank credit the author stated ".....at this early point after a recession...." which (incorrectly) assumed that the recent positive GDP gain* was clear evidence the recession was over. That may have been a statistical technicality built on Federal borrowing rather than a sustainable trend. Aided by government spending programs, it is temporary nonproductive stimulus as only private investment can create jobs. Credit is still difficult to secure for business firms as banks hold onto excess reserves now estimated at \$1 trillion. Perhaps this is based on the theory that if they don't make loans they can never have a bad one! Rather, that capital may be needed soon to bolster their position on further expected commercial real estate and credit card losses. The housing market is still a drag on consumers with continuing declines in household wealth via a reduction in asset values, high mortgage defaults and growing home foreclosures through 2012. This all spells trouble for the P&C Insurance market as the declines in written premium based on rate competition and lower insurance demand that may not be matched by corresponding claim and operational costs. Our industry forecast in Newsletter#30 may have been more optimistic on the economic recovery than we suggest in the above focus on employment prospects, a lynchpin in such recovery. More financial insurance industry specifics in our next issue!



Charles L. Ruoff CPCU

CR Market Strategies
crmarketstrategies.com

Mr. Ruoff is President of CR Market Strategies Inc. an insurance marketing and risk management consulting organization based in Garden City, New York. Mr. Ruoff has been involved in insurance underwriting, international insurance brokerage and alternative risk management businesses having held executive management positions with Continental, AIG, Johnson and Higgins, Sedgwick James, and Acordia (Wells Fargo). He has been a speaker/panel member at numerous industry events during his over 40 years in the insurance industry including RIMS, CPCU and other conferences. His articles have appeared in many industry publications and is a member of the Advisory Board of St Johns School of Risk Management and Actuarial Science.

* the Third Quarter gain of 3.5% was later revised to 2.8%