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Outlook 2012 - Steve McElhiney, CPCU

With the onset of 2012, EWI would again like to offer our insights into the insurance, reinsurance, and financial markets as well as various macro-economic trends.

Our forecasts for 2011 were generally accurate:

2011 Forecast Results:

- Insurance Capacity and Rates: “the supply/demand dynamic continues to favor buyers of insurance and reinsurance” – **Correct.** There remains ample capacity for risks and across the board, and rates are generally flat.
- Potential game changer: “a key potential game changer is a global Mega-CAT event in 2011” – **Correct.** The Tohoku EQ, Tsunami and nuclear release had broad sweeping impacts upon the insurance markets and highlighted the risks of supply chain disruptions and contingent business interruption across a variety of industries. A tragic loss of life ensued; our hearts go out to all of those affected in Japan.

Overall, 2011 has brought substantial insured CAT losses on a global basis, including:

- Tohoku: \$30BN
 - New Zealand EQ: \$10BN
 - Thailand Flooding: \$10BN
 - Hurricane Irene: \$7.0BN
 - New Zealand EQ: \$5.0BN
 - US Storms April: \$5.0BN
 - US Storms May: \$4.9BN
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- Emerging markets: “emerging markets are in secular growth cycles” – **Correct.** On balance, the level of GDP growth in the so called BRIC (e.g. Brazil, Russia, India, and China) and emerging Asian economies (e.g. Singapore and Indonesia) continues to outpace that of the US and EU and rest of world.
 - US Economy:
 - “We do not subscribe to a double-dip down-turn in 2011” - **Correct.** The US economy is showing improvement in GDP growth, unemployment levels and overall economic activity. Unemployment has declined from 9.6% to 8.8%. US nominal GDP has increased from 4.2% in 4Q 10 to 5.0% in 4Q11.
 - “The main event in 2011 in the United States will be the continued impact of budgetary shortfalls in various states and municipalities.....swelling pension liabilities” – **Correct.** The US sovereign rating was downgraded in August 2011 due to our overall debt levels relative to GDP. Various states (Wisconsin, California, New Jersey, others) have faced protracted hurdles from budgetary shortfalls. Pension liabilities for public companies are mounting. The unsustainable level of public debt continues to be a key global issue in the face of limited growth in the post-credit crisis environment.

- Euro-zone:
 - “The situation in Spain, Italy, and to a lesser extent, Portugal will continue to be problematic and will cause continued political tension with relatively stronger Euro-zone export driven economies such as Germany”. **Correct** – the Euro-zone crisis has escalated to very high levels and some level of sovereign defaults are increasingly likely. Credit spreads in Greece, Spain, Italy, and Portugal have increased dramatically in 2011.
- Financial Markets:
 - “US Dollar will improve relative to most other currencies” – **Mixed**. The USD ends the year at approximately those at the start of the year. The first six months shown USD weakening, with a strong rally since the summer due to the European crisis.



(The above table reflects the US Dollar Index – a broad measure of the USD relative to a basket of currencies)

- “Interest rates will increase during 2011 - **Incorrect.** The 10 year Treasury note declined from 3.30% at 12.31.10 to 2.10% currently due to Quantitative Easing II and a decline in global economic output. Deflationary pressures from economic contraction have outpaced inflationary pressures from commodity prices due to central bank actions.
- “Commodity prices increases will be contained” - **Correct.** Gold ranged from \$1,432 at 1.1.11 to a high of \$1,923 on 9.6.11, to a current price of \$1,595 (12.27.11). Copper has declined nearly 20% during 2011, coupled with similar trends in other metals. Oil (WTI) has ranged from ~\$88.00/bbl at the start of the year to ~\$97/bbl currently. On balance, there has not been significant commodity price inflation.
- “We see the S&P 500 continuing to perform in a trading range of between 1,000 and 1,350 over 2011” - **Correct.** During 2011, the S&P has ranged from 1,075 to 1,380 (current ~1,265).
- Insurance Markets:
 - “Insurance companies will face interest rate reinvestment risk in 2011” - **Correct.** The declining interest rate environment coupled with the extreme equity market volatility has created a challenging insurance industry investment model in the current environment. ROE targets are increasingly focused on pure underwriting profits, given the minimal investment “lift” in the current environment.

2012 Forecast:

We have separated our 2012 forecasts into the following key segments:

Reinsurance Capacity:

The reinsurance market can be effectively characterized as having firmed; however, only select pockets are showing signs of any appreciable hardening (e.g. US southeast and Midwest CAT risk, post RMS v 11.0; financial institution D&O). There remains ample capacity for most lines of reinsurance and conditions are not reflecting any significant contractions.

The lack of hurricane activity in Florida is an anomaly and the frequency of such events should increase in 2012. The unusual tornado and hail storms of 2011 appear to be outlier events and should revert more to the mean during 2012.

As mentioned in last year's forecast, the key "game changer" for reinsurance capacity remains a mega-CAT event that will serve to reduce the over-capitalization that still exists in the market.

A major EQ event in CA or the mid-continent would have a market changing impact during 2012 and would also strain public services given the fiscal situation in CA, in particular. Likewise, continued major east coast storms could have a major impact on CAT capacity.

The industry should continue to watch aggregations and exposures in emerging CAT zones in the US and globally (i.e. those zones with limited activity in recent history).

These include:

- Northeast wind (Long Island and Chesapeake regions particularly)
- CA EQ activity (Hayward, Elysian, and southern San Andreas faults)
- South Carolina, Arizona, Utah and Pacific Northwest EQ
- Hawaii wind and EQ
- West coast tsunami

CAT bonds and capital market products have shown contraction in 2011; however, we see such capacity increasing by at least \$1BN during 2012 as risk appetite continues to recover.

There remains very little reinsurance appetite for financial guaranty type risks in the post-crisis environment. This trend will continue in 2012.

Casualty risks will face some unexpected hardening pressure in the face of diminished investment returns that will impact the ROE models of reinsurers. In other words, the NPV profits of such accounts will need to rely more upon improved underwriting profits to sustain ROE thresholds. There will be an increased emphasis on account selection and monitoring.

Reinsurers are anticipated to continue to be vigilant about emerging latent exposures in treaty restrictions and capacity allocations to certain industries.

There will be continued consolidation amongst reinsurers (particularly the Class of 2005), and brokers.

US Risk Management trends:

Enterprise Risk Management (ERM) will grow in awareness among Russell 2000 companies as well as with insurance carriers. Boards will be increasingly concerned about ERM exposures as a result of rating agency pressures and increasing institutional investor vigilance.

The SEC and NAIC may elevate their focus upon ERM in 2012; this will be a key catalyst for action. To date, ERM has been the focus of major Fortune 500 groups. EWI anticipates this trend will move down market in 2012 to encompass a more expansive group of companies.

Captive formations in the US have been impacted in 2011 from the continued impact of the financial crisis (a general desire by companies to restrict expansion into new initiatives) and plentiful capacity. We anticipate a modest increase in captive formations in 2012. As a general matter, major increases in captive formations are usually the result of major catalyst events.

Macro-economic trends:

The situation in the Euro-Zone will continue to dominate the financial markets through the first half of 2012. Clearly, the magnitude of the issues facing the Euro-Zone will require years to fully rectify as well as the continued efforts of the ECB, cooperation among governments from the more fiscally stable northern European countries towards an integration solution, support from the IMF, and the long-term success of very significant austerity measures throughout Europe.

That said, Europe will show signs of improvement during 2012 and the dampening effect of this “over-hang” issue to the US capital markets will begin to abate in the spring. While Europe will continue into a modest economic contraction, the US markets will continue to experience a gradual economic expansion (albeit at a slower pace than would be the case in the absence of a European crisis).

Across all measures, the US economy will continue to show modest improvement (e.g. employment, factory output, consumer confidence, etc.).

An improving job climate in the US 8.8% unemployment rate currently is forecast to show momentum during 2012 and into the 3rd Quarter particularly (pre-election). We see the national unemployment rate breaking 8.0% and hovering around 7.6% by Election Day.

Political stalemate is likely to continue unabated in 2012 with implications to the US fiscal position. Accordingly, a second notch credit rating downgrade to the US sovereign rating from S&P is anticipated in late 2012

China is anticipated to face increased economic pressure in 2012 in concert with a real estate bubble in certain regions that are showing early stages of a collapse. An economy predicated on “at least 7% GDP growth” for the sustainability of population shifts from rural regions to cities, will be under strain. China’s GDP for 2012 is forecast to drop to a 5% level (from 9.1% in 2011).

Global Risks:

The geopolitical environment in 2012 has the potential to be the key surprise with increased turmoil likely in the Middle East. Global sanctions towards an increasingly recalcitrant Iran as respects its nuclear ambitions will be tested. Pressures towards military actions to disable this nascent capability may escalate during the year with substantial potential repercussions to the region. A closure of the Straits of Hormuz could result (with an attendant oil embargo drastically impacting the US, Europe and Asia).

The nascent governments of Iraq and Afghanistan will be tested by sectarian violence that may escalate in the face of US troop strength reductions.

We do not anticipate any adverse issues arising from the change in the leadership of North Korea during 2012.

US interests at home and abroad continue to face threats from global terrorism. Given the enormous strides made to secure the US homeland, the risk of a mega-terrorist strike is becoming increasingly remote in 2012.

Financial Markets and Commodities:

Given an improving US economic outlook, we anticipate the following trends:

- S&P 500 – the markets will show continued volatility during the 1st Quarter of 2012 (due to Europe); however, we see markets beginning to show sustained recovery during the latter half of the year. The so-called “Risk-on”, “Risk-off” trade of 2011 will fade and a continued growth in earnings and revenues will fuel growth in all equity indices. Small capitalization stocks should outperform during the year. The S&P is forecast to open at ~1,300 and trade down during the 1Q to a low of 1,100, before staging a rally throughout the remainder of 2012 to close at 1,475 (a ~16.5% return for the year based on the current level). A Euro-Zone unraveling, or Middle East embargo or hostilities, could bring the markets to a low of 900 on the S&P; however, this is not anticipated.
- Interest rates will increase in the second half of 2012, in concert with an improving economy. The 10 year rate is forecast to increase from ~2.1% currently to 3.25% by 12.31.12.
- The USD will weaken only slightly against most currencies through 2012. Recent strength has been due to a flight to safety from the EU crisis; this will abate in 2012.
- Gold will show only a modest increase for the year (from \$1,600 ounce to \$1,700 ounce). Gold could, however, show marked volatility from volatile global events.
- Oil (WTI) will stabilize at a level of \$100/bbl by the end of 2012, due to lessened demand from China and Asia, and Europe, offset by growing domestic demand. That said, significant volatility could emerge if geopolitical issues surface in the Middle East (with concomitant downward economic pressure globally). The harsh 1974 recession was a result of a broad oil embargo in the region.