The U.S. and Global Economies: Outlook and Implications for P/C Insurance

Brokers & Reinsurance Market Association
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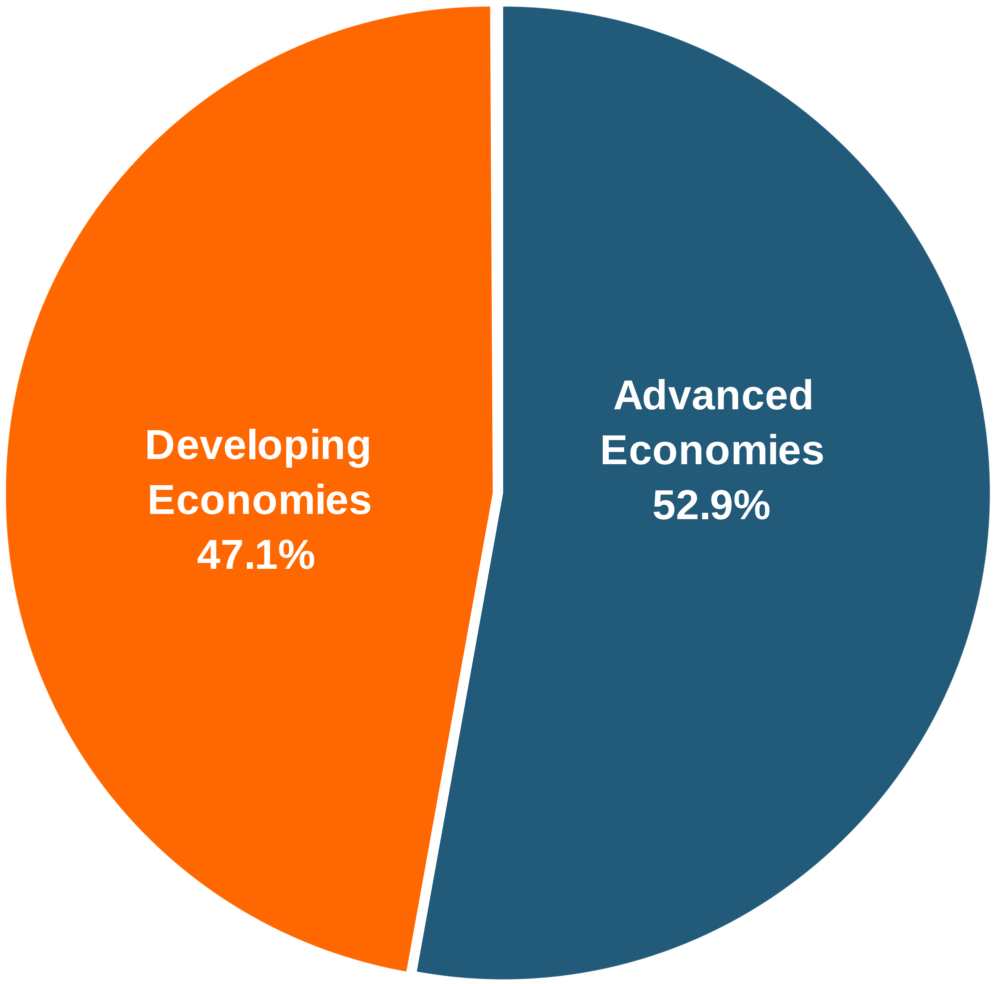
The Global Economic Outlook*

*Before March 11, 2011

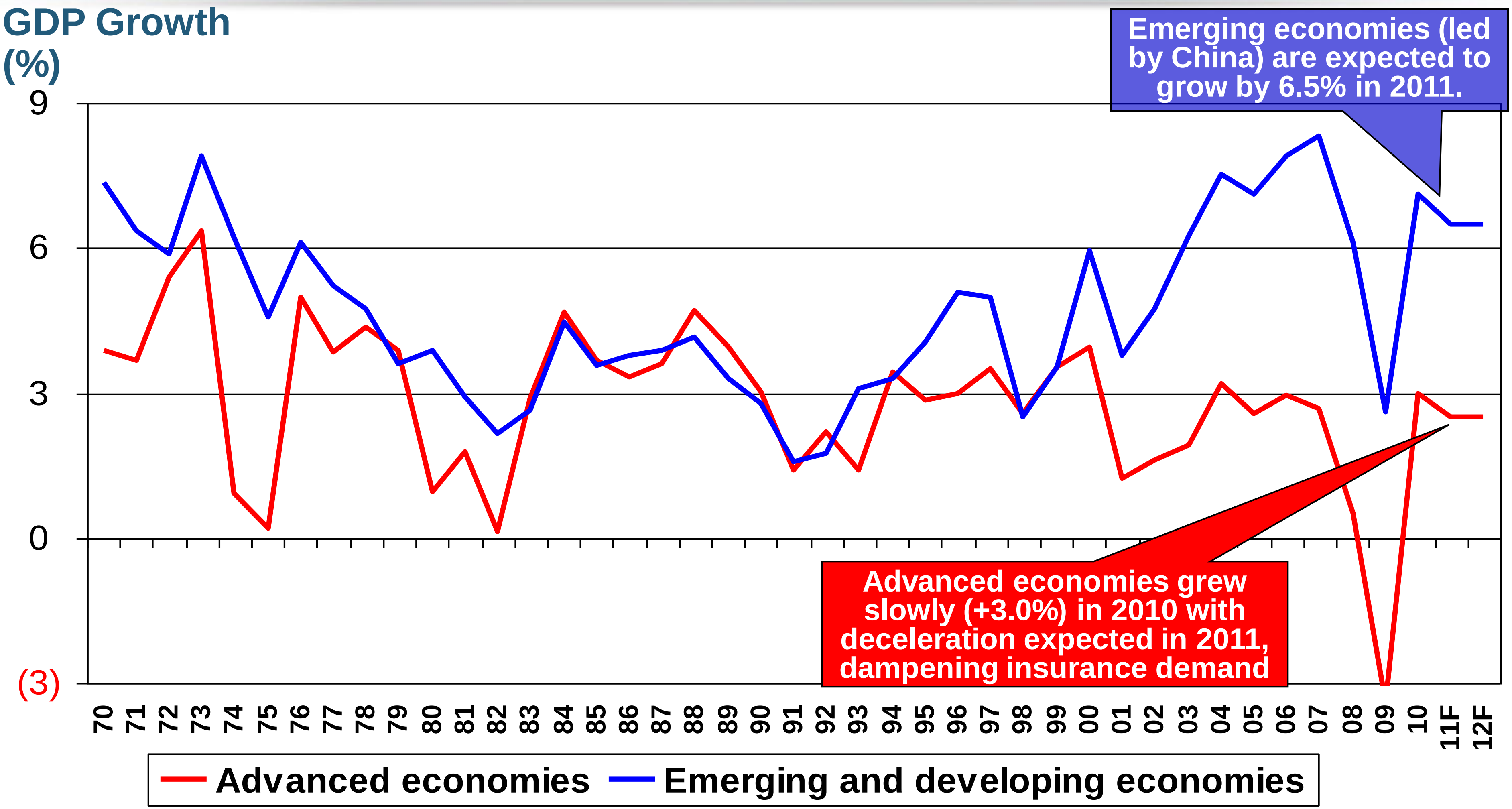
A Two-Speed Recovery: Emerging Economies in Third Gear, Advanced Economies in First

Relative Shares of Global Output, Advanced vs. Developing Economies, 2009



Source: EDC Economics, “The Moment of Truth: Global Export Forecast Fall 2010, at http://www.edc.ca/english/docs/gef_e.pdf

GDP Growth: Advanced vs. Emerging Economies, 1970-2012F



Source: International Monetary Fund, *World Economic Outlook Update*, January 2011; Ins. Info. Institute.

Forecasts of 2011 & 2012 GDP of Advanced Economies

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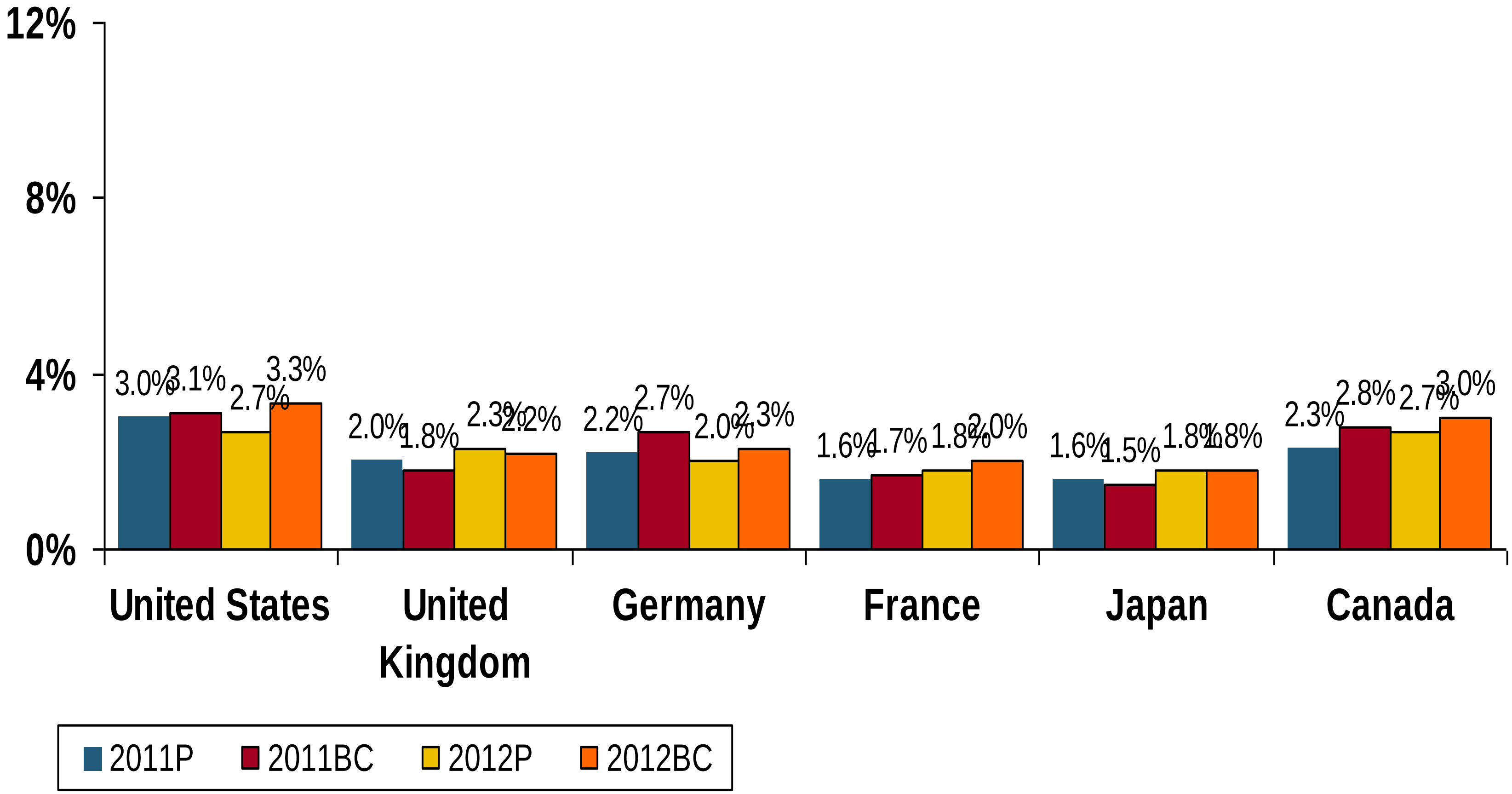
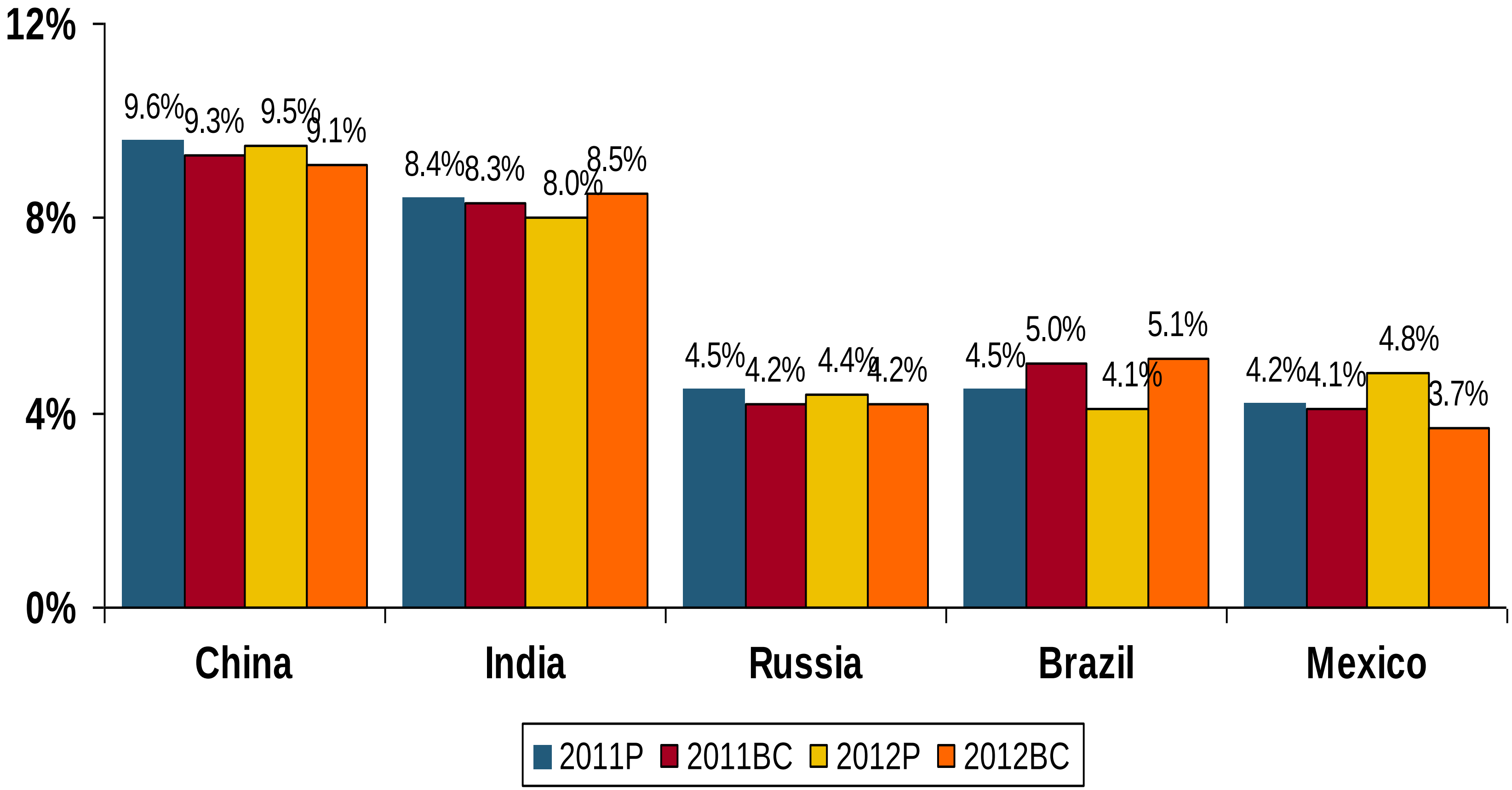


The January 2011 IMF forecasts for growth in advanced economies in 2011 is generally around 2%. The March 2011 Blue Chip forecasts are a little higher. The outcome could be worse if supplies of middle-eastern oil (political disruption), developments involving sovereign debt (the PIGS or other countries) or Japanese exports (earthquake/tsunami effects) are worse than expected.

Sources: IMF, World Economic Outlook, Jan 2011 Update; Blue Chip Economic Indicators (3/2011 issue); Insurance Information Institute.

Forecasts of 2011 & 2012 GDP of Developing Economies



IMF says growth in emerging and developing economies will outpace advanced ones in 2011. This will accelerate the growth of insurance exposures in emerging markets relative to the U.S., W. Europe and Japan.

Sources: IMF, World Economic Outlook, Jan 2011 Update; Insurance Information Institute.

Real Gross Fixed Investment: Advanced vs. Emerging Economies, 2007:Q1-2010:Q3

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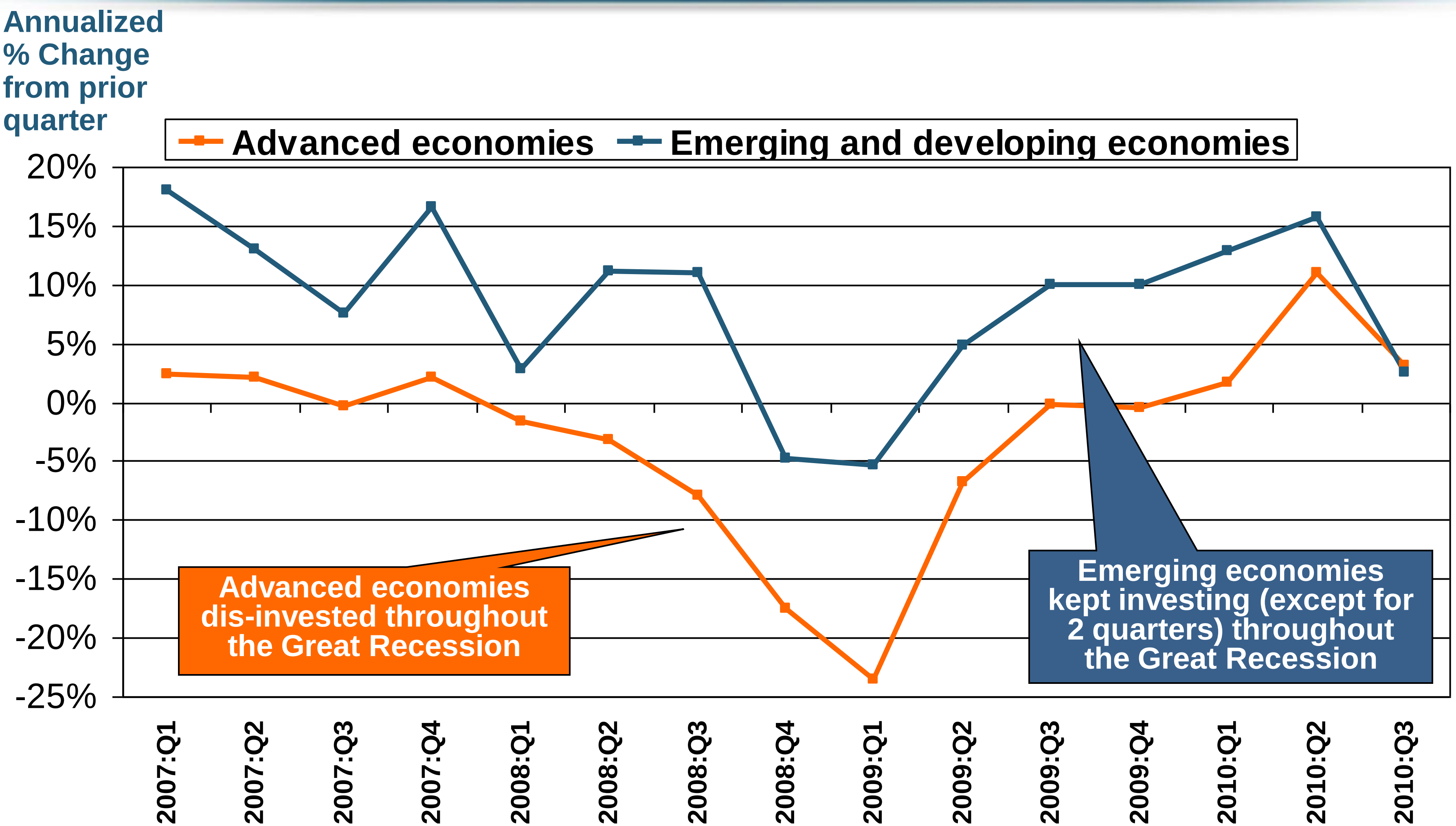

Source: International Monetary Fund, *World Economic Outlook Update*, January 2011; Ins. Info. Institute.

Insurance “Penetration” and “Density”

Beyond Exposure Growth, Insurers Need Increased Use of Insurance

Definitions:
Measures of Insurance Usage

- "Penetration"
  - The ratio of premium to GDP
  - Indicates the degree to which premium growth kept up with exposure growth (as proxied by GDP)
- "Density"
  - The ratio of premium to total population
  - Indicates the breadth of use of insurance

Source: Swiss Re, *Sigma*, various volumes

Non-life Premium/GDP* (Penetration) for Advanced Economies, 2001-2009

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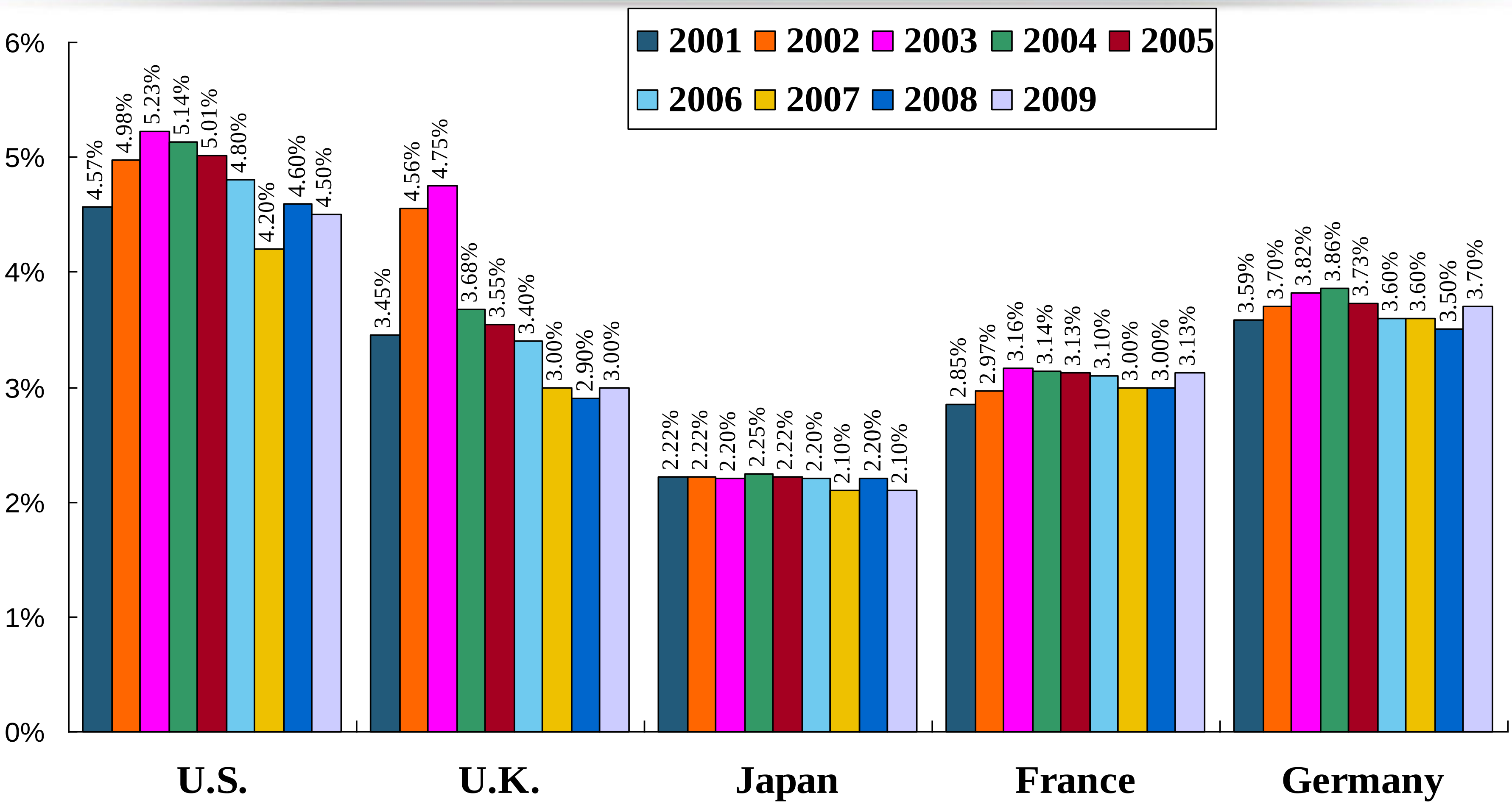

From 2001 to 2003, a hard market in the U.S. added 75 basis points to the Penetration ratio, but a soft market in subsequent years shaved a percentage point from the Penetration ratio.

*both measured in U.S. dollars; premiums exclude cross-border business

Source: Swiss Re *Sigma*, various volumes

Non-life Premium/GDP* (Penetration) for Emerging Economies, 2001-2009

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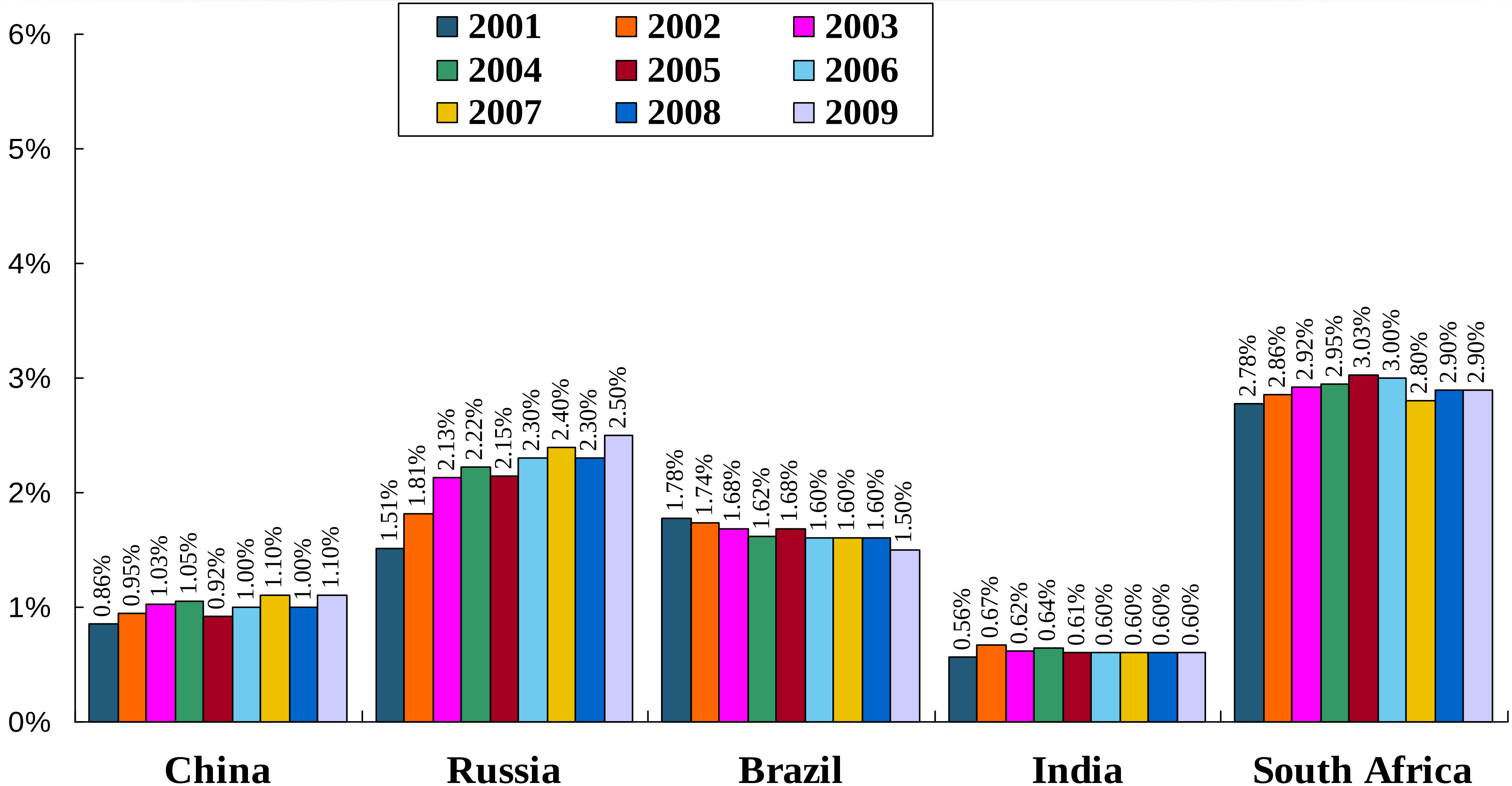

From 2001-2009, Penetration in China and Russia grew steadily—an especially strong showing in light of the rapid growth in GDP (denominator in the Penetration ratio). Similarly, although the Penetration ratios in Brazil and India were essentially flat, that means premium growth basically kept pace with exposure growth.

*both measured in U.S. dollars; premiums exclude cross-border business

Source: Swiss Re *Sigma*, various volumes

Non-life Premium* per capita (Density) for Advanced Economies, 2001-2009

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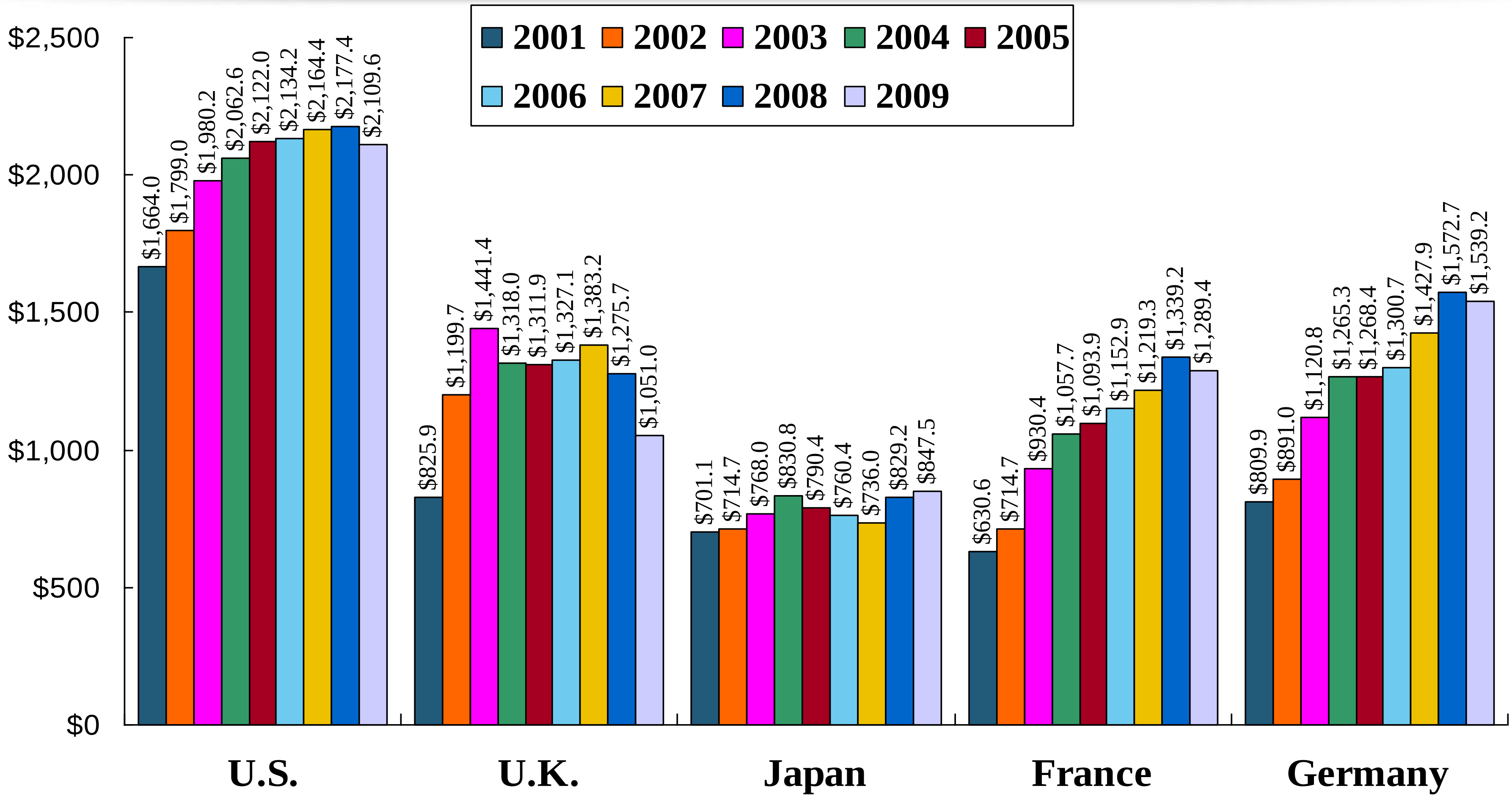

From 2001-2009, Insurance Density grew in most advanced economies, retreating only slightly during the global recession.

*excludes cross-border business

Source: Swiss Re *Sigma*, various volumes

Non-life Premium* per capita (Density) for Emerging Economies, 2001-2009

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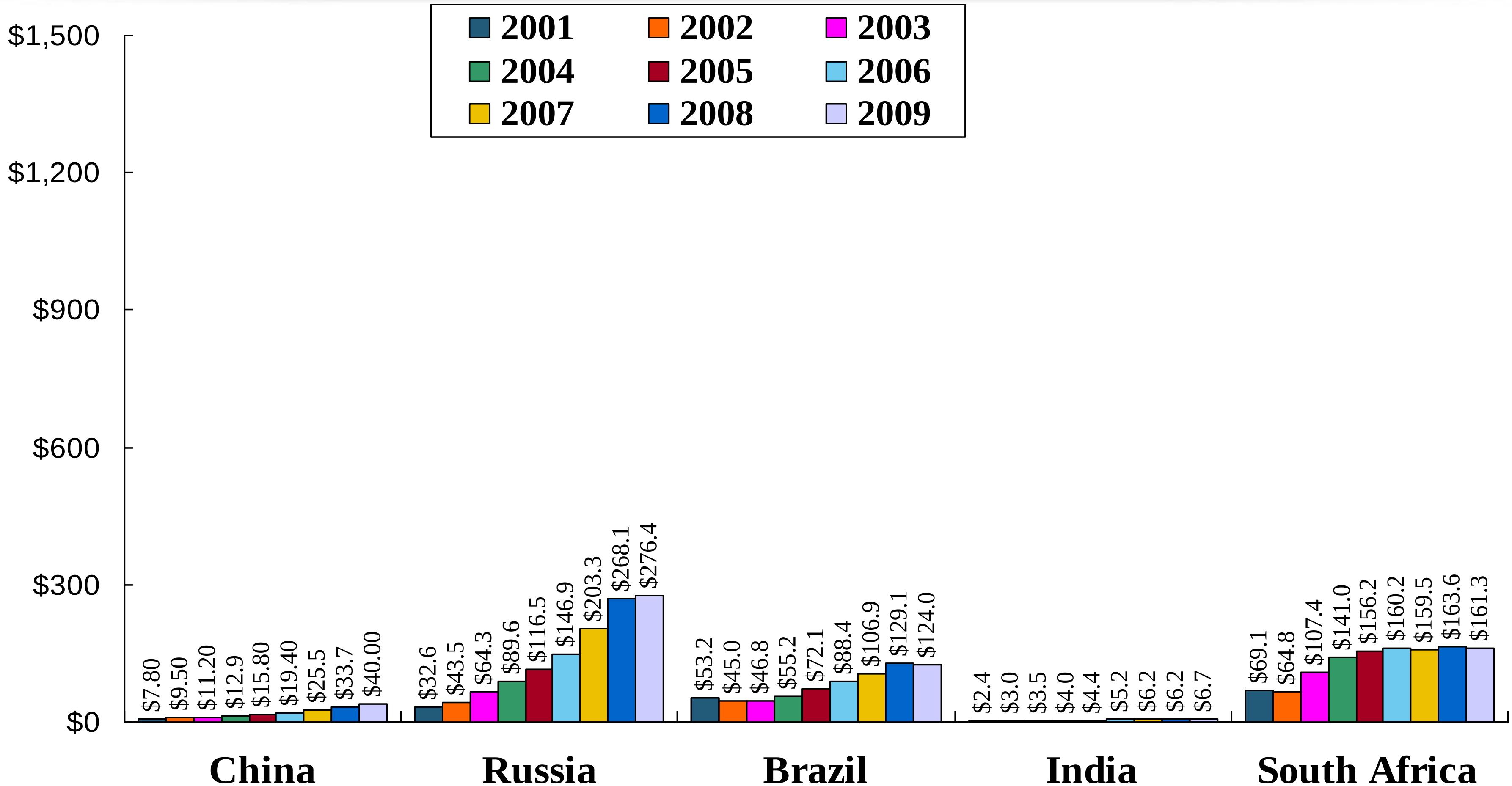

From 2001-2009, Insurance Density in India tripled, and in China it grew 5-fold. But the most spectacular Density growth in these years belongs to Russia: in 2009 Insurance Density in Russia was 9 times what it was in 2001!

* premiums measured in U.S. dollars, exclude cross-border business

Source: Swiss Re *Sigma*, various volumes

The New World Order: A New Level of Risk for Business

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- **Best Growth Opportunities are No Longer in Low-Risk Markets (W. Europe, US/Canada, Japan)**
- **Growth Rates are 2-3 Times Higher in Developing World**
  - Business investment will remain high, much of it in need of insurance
  - Investment conditions will remain challenging for decades
- **Unemployment Rates Are Much Lower in Emerging Economies**
  - Establishment of a middle class and a wealthy upper class
- **Incomes Are Rising Faster in Emerging Economies**
  - Fueling demand for goods and services
  - Foreign Direct Investment (FDI) and insurance exposure/demand
- **Immature Institutions Raise Risk/Possible Systemic Risks**
  - Legal system, financial markets, regulation, infrastructure issues
- **Instability in Emerging Nations Will Remain High**
  - Political instability; Corruption in some countries
  - Economic vulnerability (trade, xrt risk, credit risk, commodities, energy)
- **Natural Hazard Risks Are Often Elevated w/Minimal Mitigation**

Foreign Direct Investment

To Find Insurance Exposure Growth, Follow the Foreign-Direct-Investment "Dollar"

Global Foreign Direct Investment,* Net Inflows: 1990-2010

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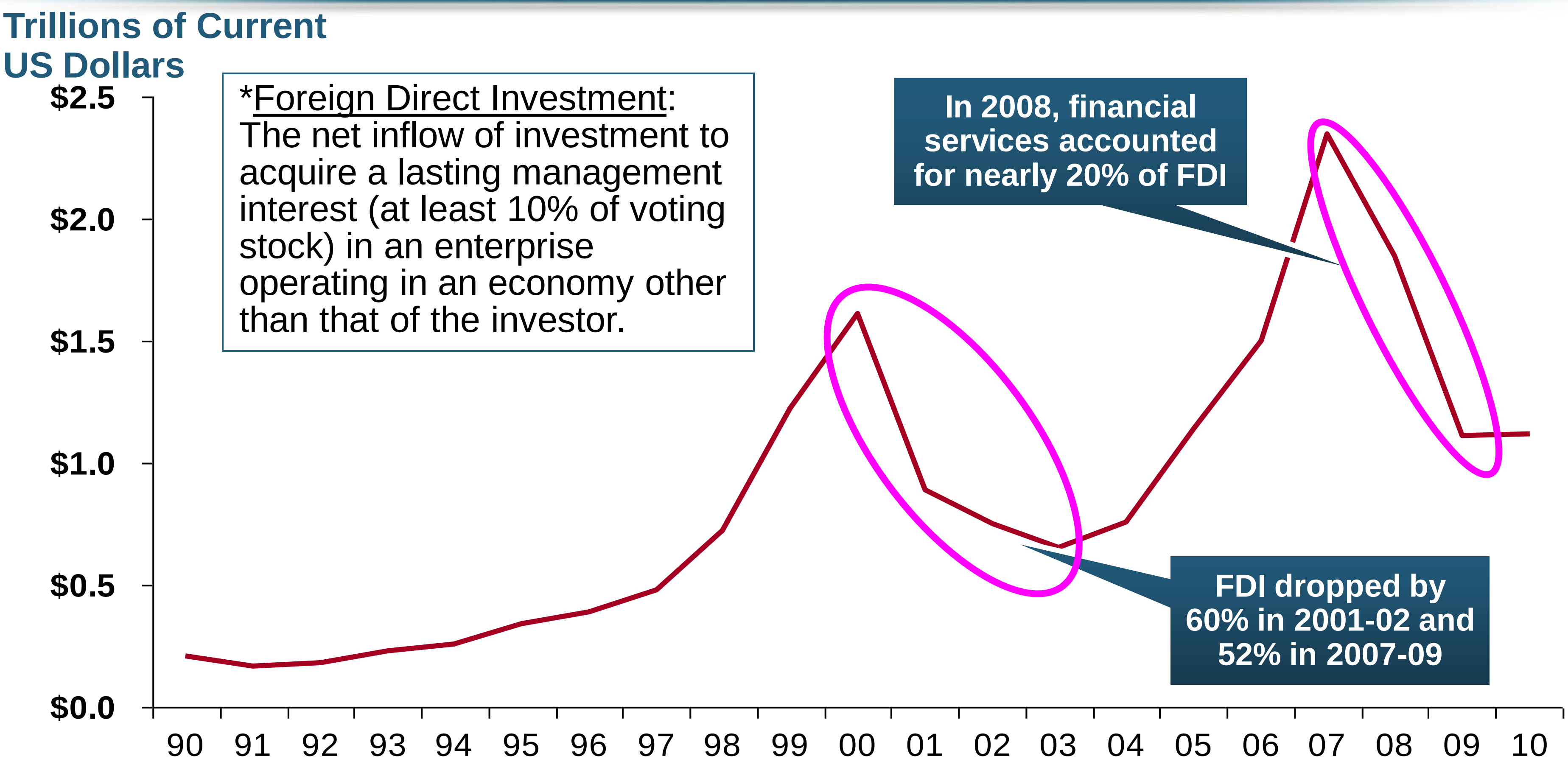


Most non-life insurer growth will be in parts of the world where Foreign Direct Investment (FDI) is high. FDI flows are highly volatile (so new income streams for insurers will also be volatile).

Sources: World Bank; Insurance Information Institute.

Following the Money Trail: Foreign Direct Investment

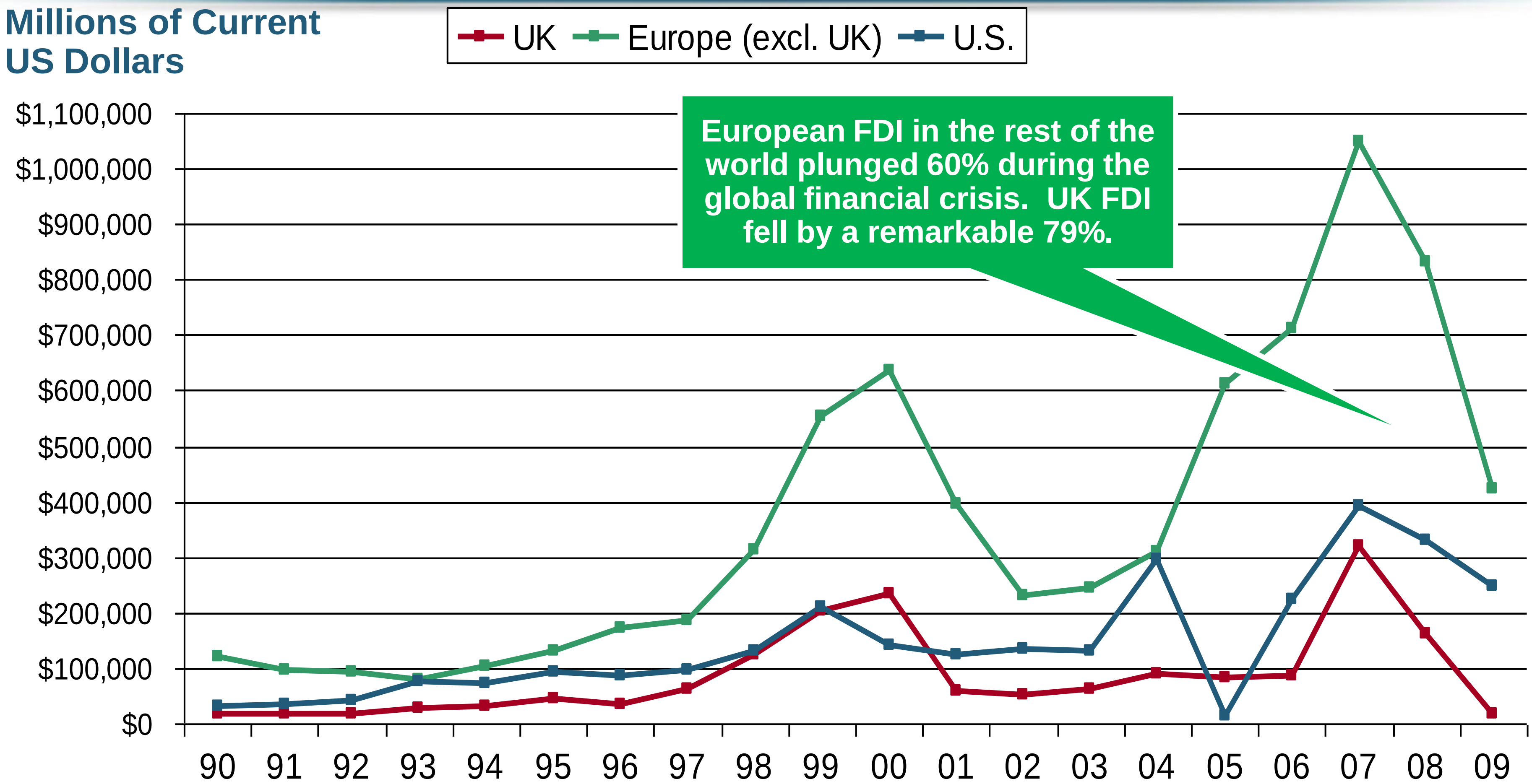
The UK's share of FDI peaked at 45% in 1914

The US's share of FDI peaked at 50% in 1967

China's share of FDI stood at 6% in 2009

Source: *The Economist*, Nov. 13 -19, 2010

Europe & U.S.: *Outward* Foreign Direct Investment*: 1990-2009



European Foreign Direct Investment Abroad Was Hit Much Harder than Asia or the Americas

*Foreign Direct Investments are defined as the net inflows of investment to acquire a lasting management interest (at least 10% of voting stock) in an enterprise operating in an economy other than that of the investor. Outward FDI represents flow from investing country to rest of the world.

Source: United Nations UNCTADSTAT; Insurance Information Institute.

China, Hong Kong, South Korea: *Outward* FDI: 1990-2009*

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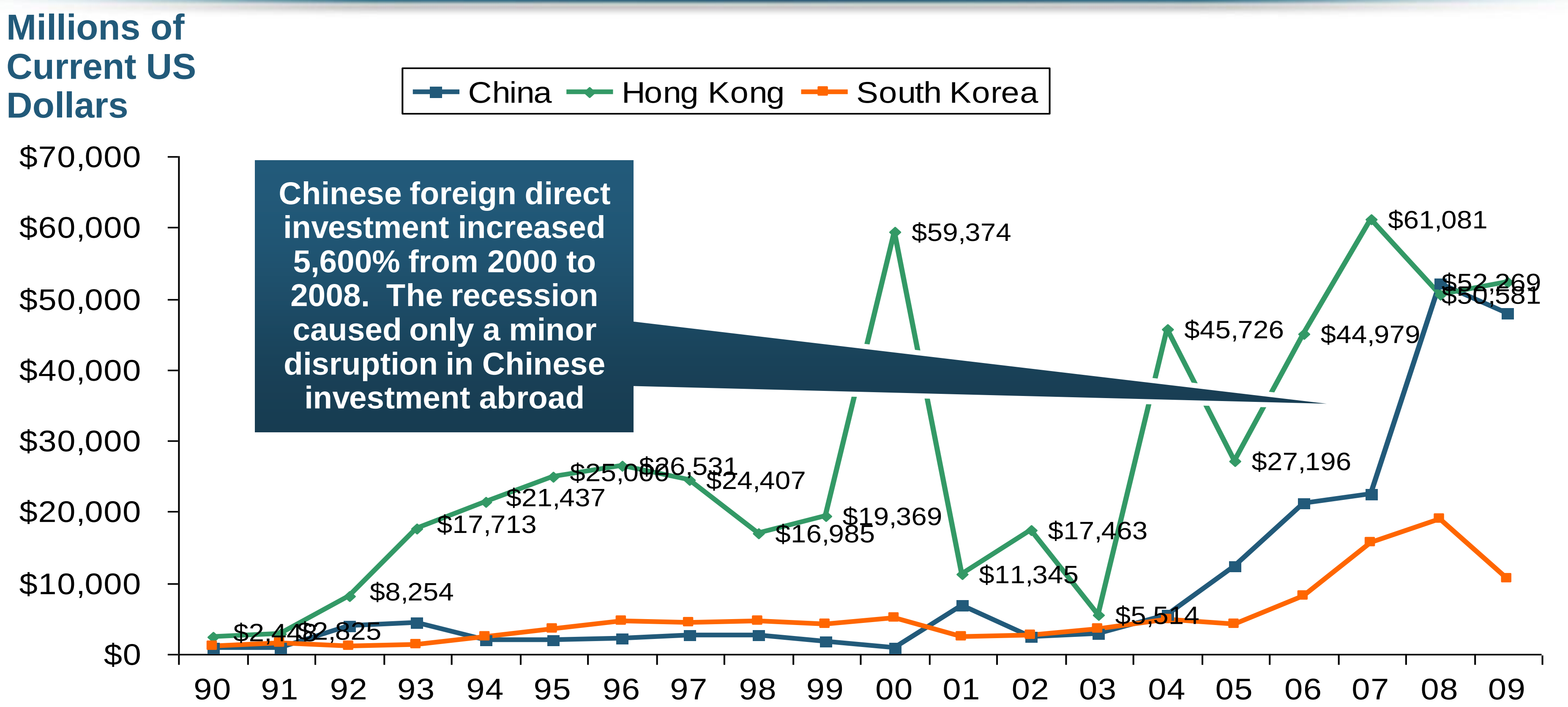


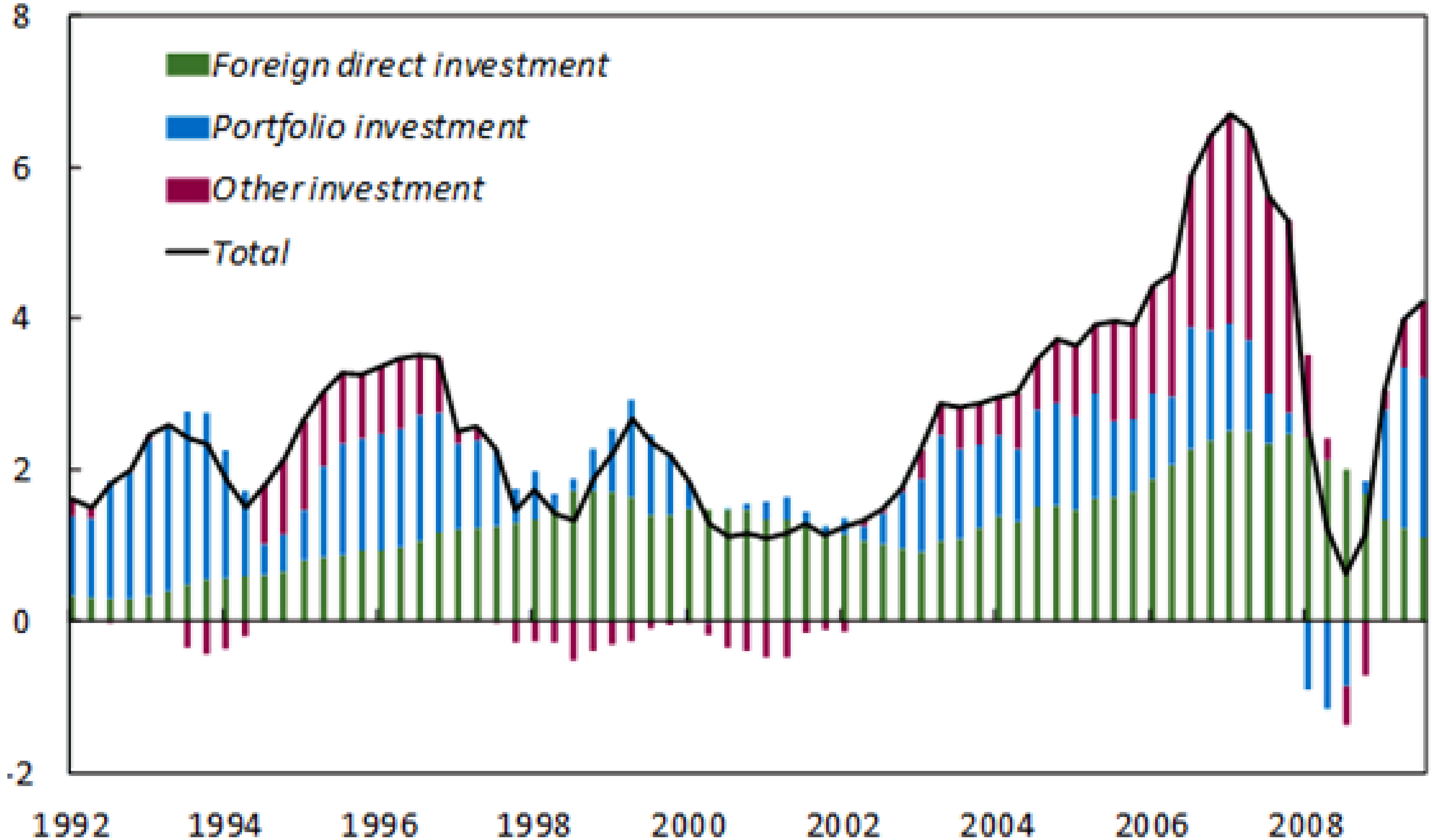
Despite the Crash in Foreign Direct Investment During the Global Financial Crisis, Chinese Investments Abroad Remain Near Record Levels. Implication: Growth Opportunities for Insurers May *Not* Be in China but In Chinese Investment Target Nations/Companies/Industries.

*Foreign Direct Investments are defined as the net inflows of investment to acquire a lasting management interest (at least 10% of voting stock) in an enterprise operating in an economy other than that of the investor. Outward FDI represents flow from investing country to rest of the world.

Source: United Nations UNCTADSTAT; Insurance Information Institute.

Figure 7. Capital Flows to Emerging Markets

(Net liabilities, percent of aggregate GDP, 4-quarter moving average)



Sources: IMF, International Financial Statistics; Haver Analytics; and IMF staff estimates.

Economic Threats to the Global (Re)Insurance Industry

At Least Eight to Monitor

Near-Term Issues

- Effects of the March 11 Earthquake/Tsunami/ Nuclear Reactor Accident
  - Lost final production
  - Disrupted supply chains
  - Lost Japanese consumption
- Inflation Transmitted Globally
  - China, Brazil and other countries
  - Soaring food and other commodity prices
  - Oil prices and supply reliability
- Tighter monetary/fiscal policy => Slower Growth?

Source: Insurance Information Institute.

Inflation Rate Forecast for Largest European Economies & Euro Area, 2011F-2012F

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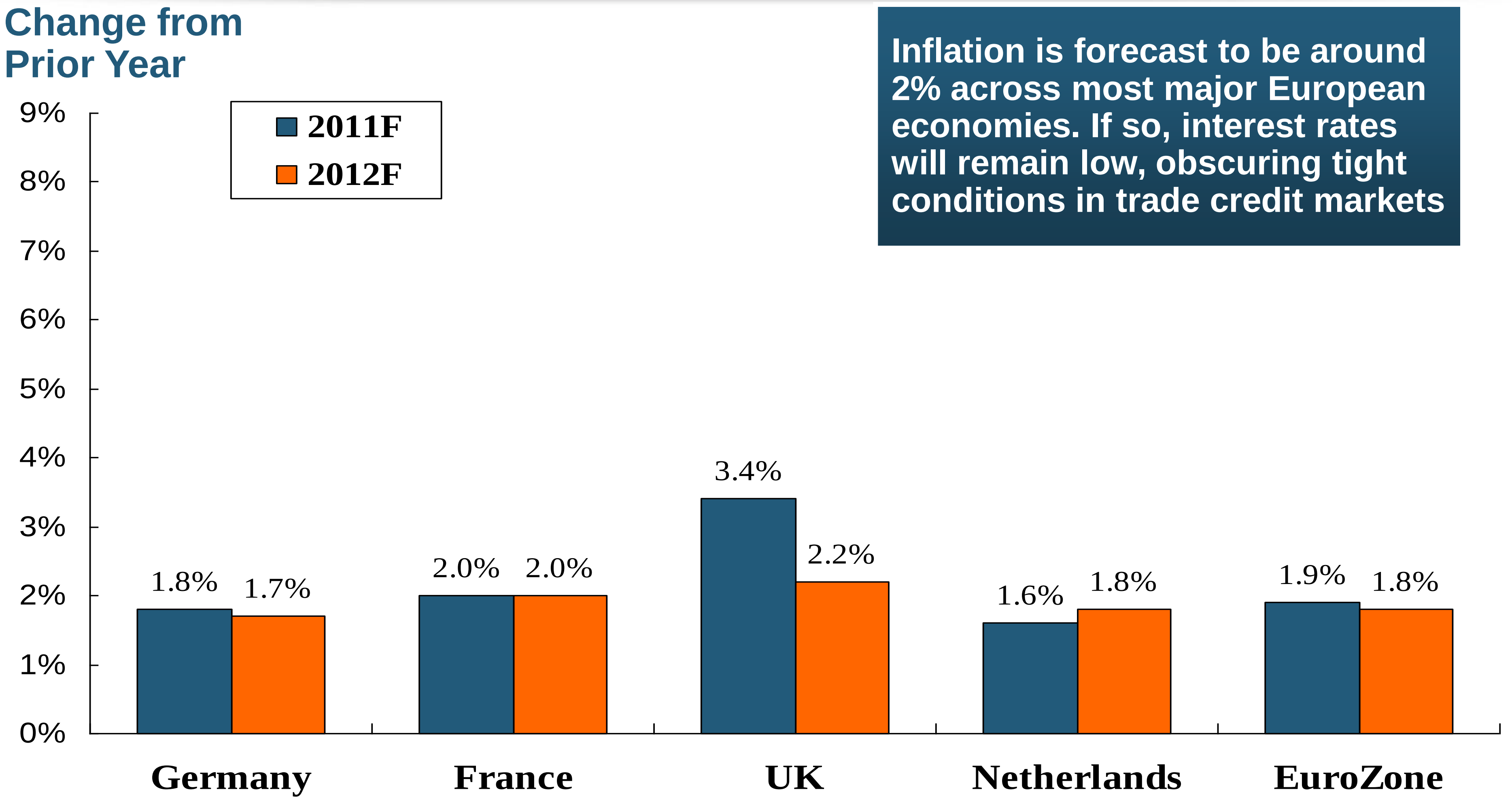

Inflation is forecast to be around 2% across most major European economies. If so, interest rates will remain low, obscuring tight conditions in trade credit markets

Source: Blue Chip Economic Indicators, March 2011 issue

Inflation Rate Forecast for Other Important Countries, 2011-12F

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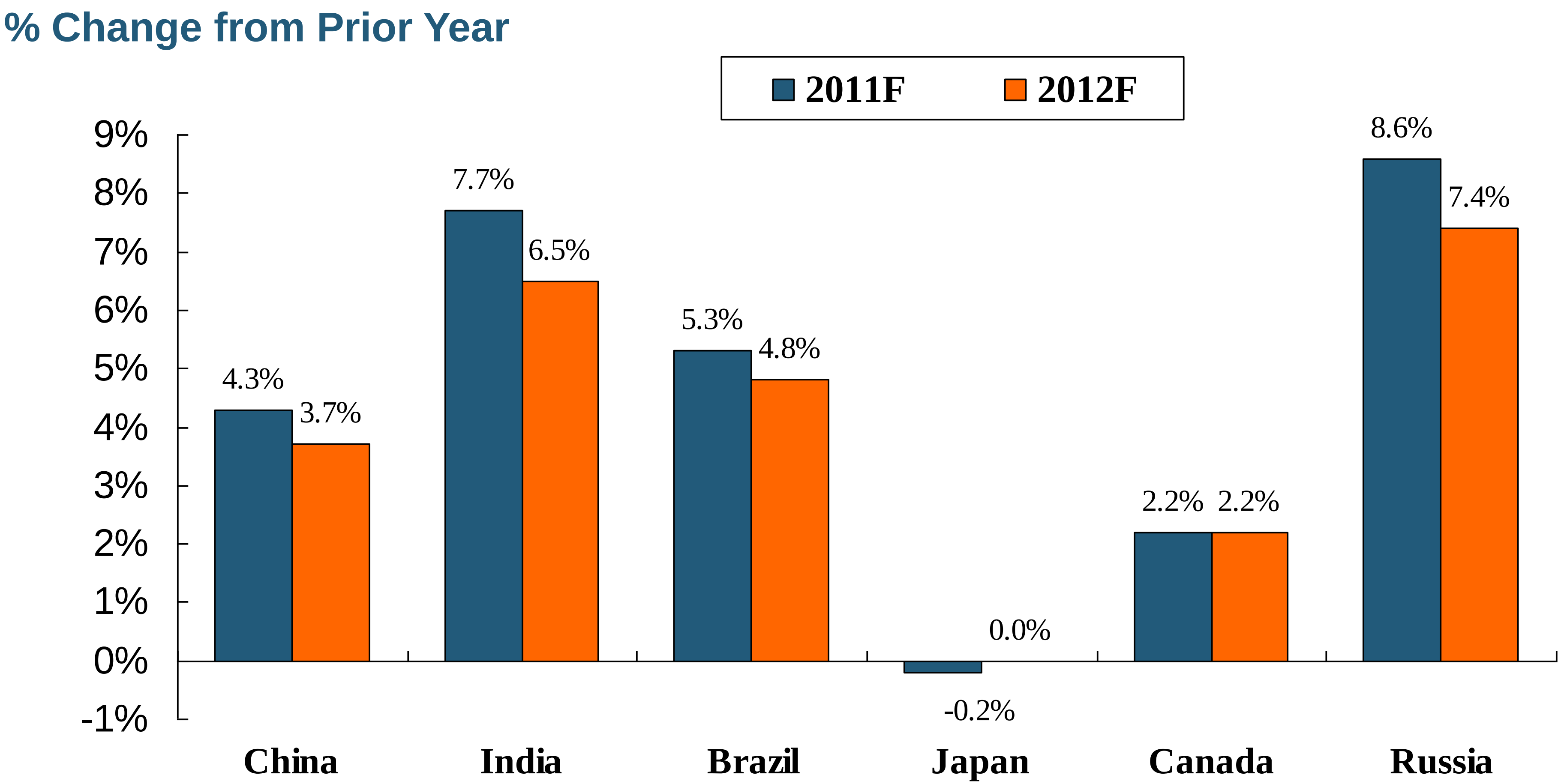
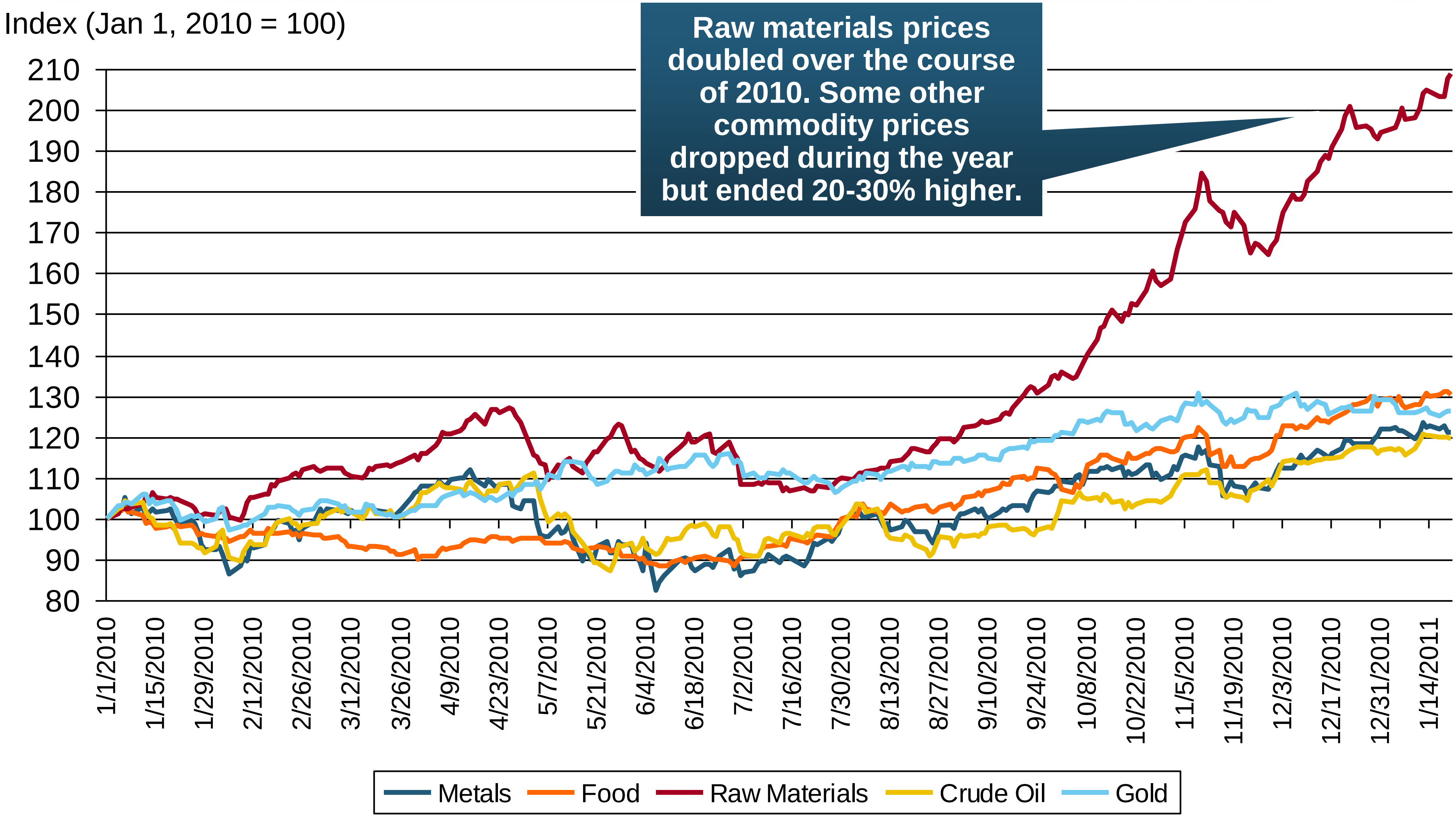


Inflation is much higher in fast-growing economies such as Brazil, Russia, India, and China (the BRIC group). Inflation there can spread to advanced economies because the advanced countries import significantly from the BRICs.

Source: Blue Chip Economic Indicators, March 2011 issue

Commodity Price Changes in 2010-2011*



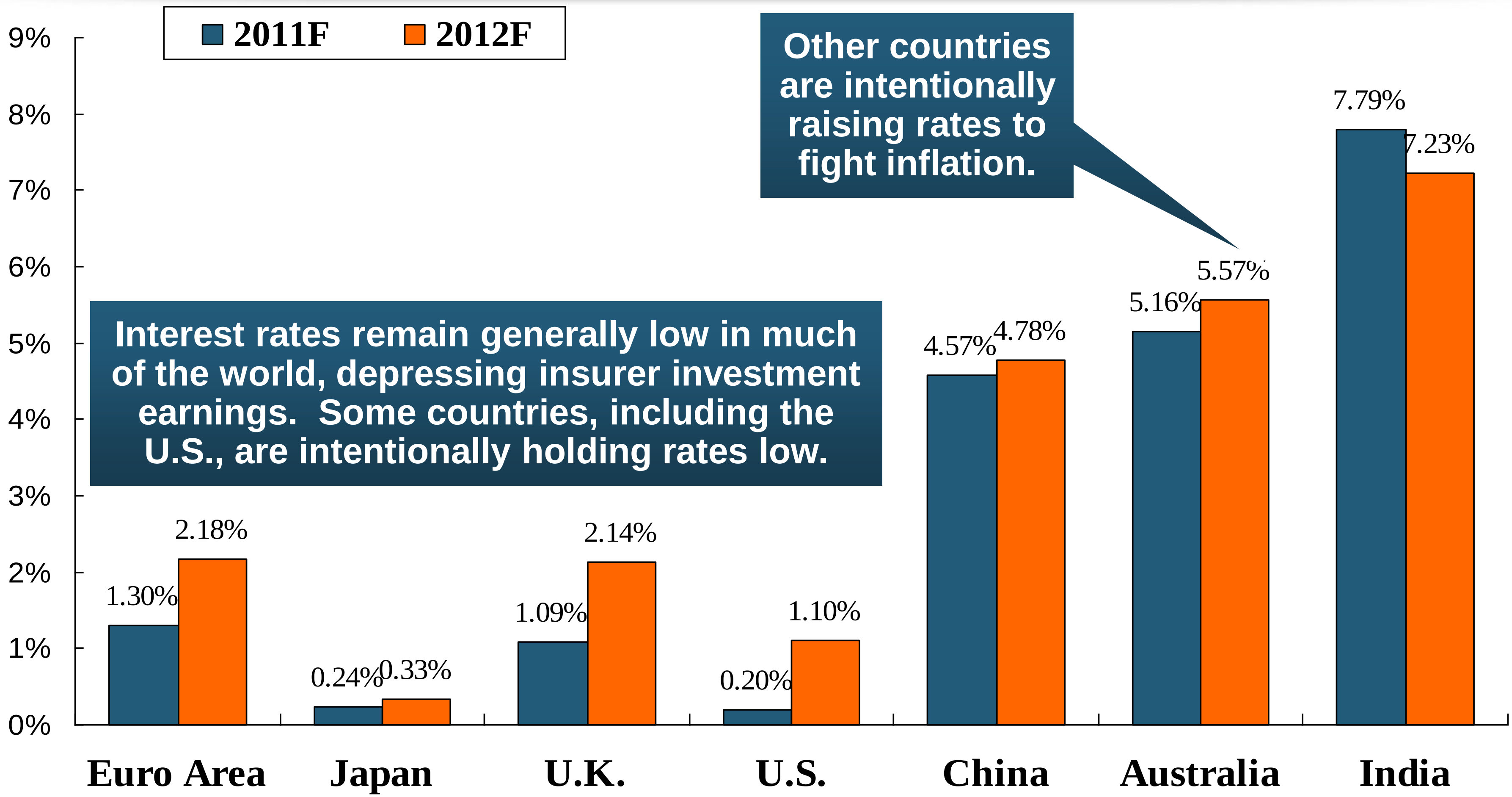
*data are through Jan. 20, 2011
Source: International Monetary Fund World Economic Outlook January 2011 update at http://www.imf.org/external/pubs/ft/weo/2010/update/01/data/figure_2.csv

Longer-Term Issues

- Persistently Low Interest Rates
  - Lower investment income, more pressure on u/w profit
- Currency Market Instability
- Sovereign Bond Market Concerns (Greece, Spain, Ireland, etc.)
- Strong Capital Flows to Emerging/Developing Economies => Asset Price Bubbles?
- Regulatory Backlash/Developments
  - Solvency II, Basel III
  - US Financial Services Reform

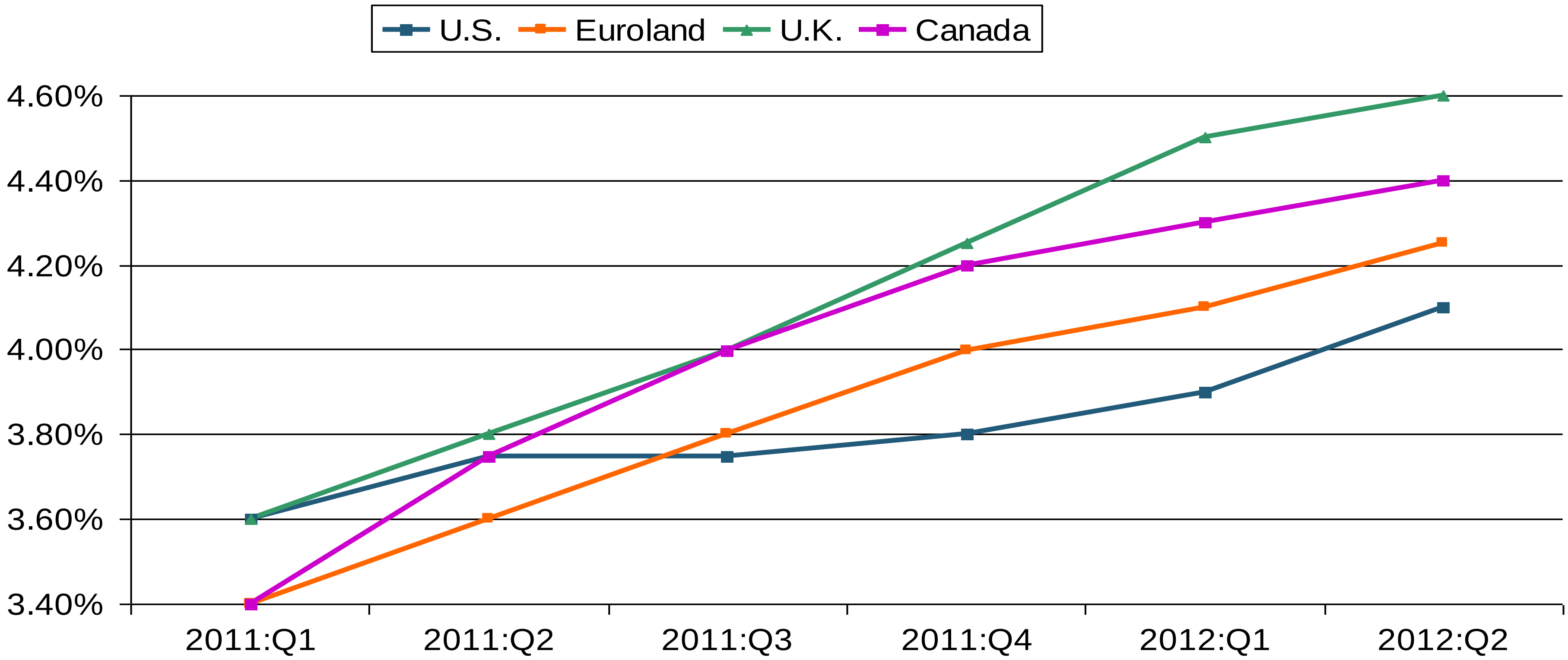
Source: Insurance Information Institute.

Forecast: End-of-Year 3-Month Interest Rates for Major Global Economies, 2011-2012F



Source: Blue Chip Economic Indicators, March 2011 issue

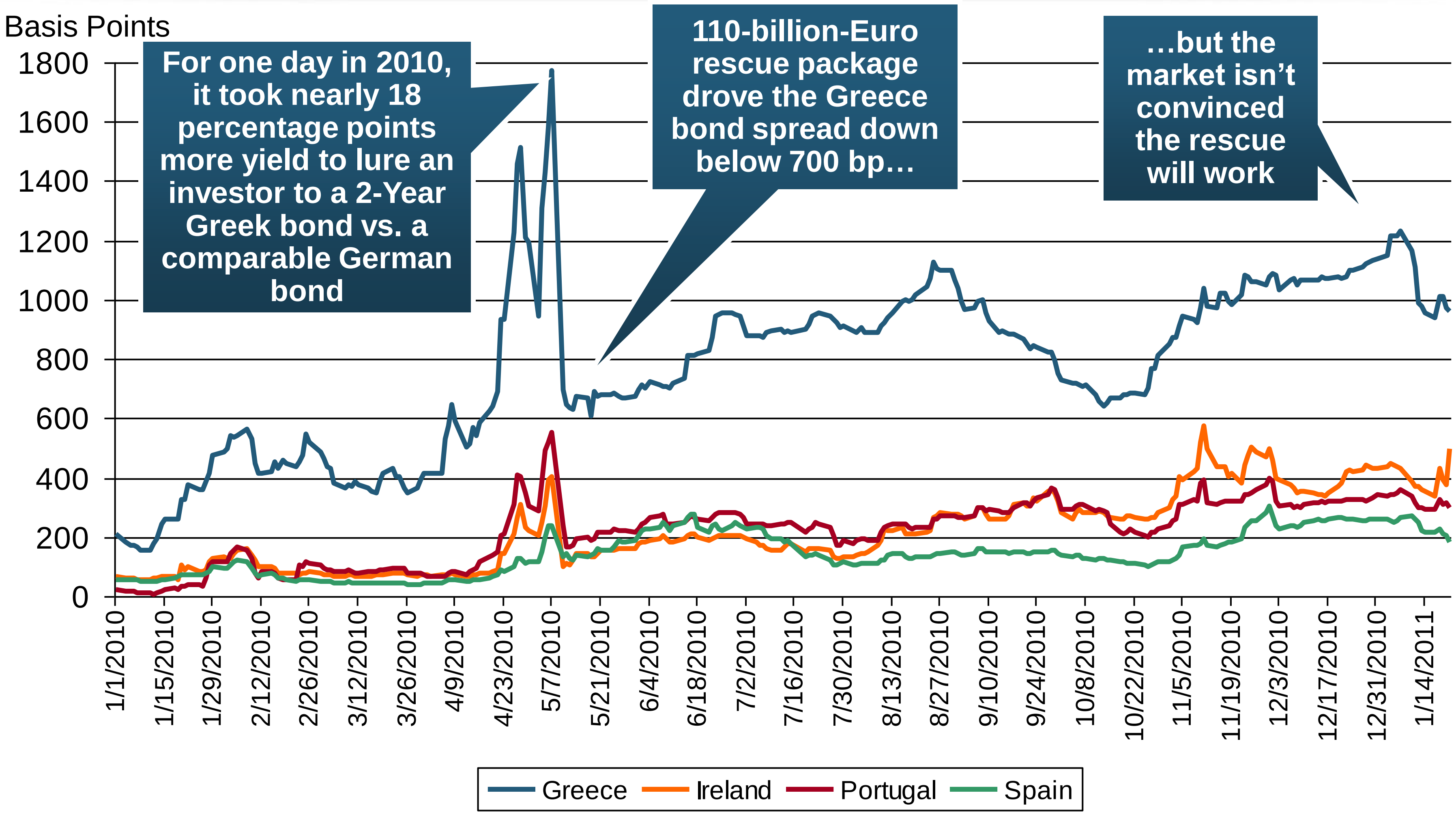
10-Year Bond: Yield Forecasts for 2011:Q1-2012:Q2



As these nations' economies improve, and actions to keep interest rates low are ended, the yields on longer-term bonds are expected to rise. But persistent high rates of unemployment and excess capacity, plus central bank concerns about inflation, will likely keep them from rising more than one percentage point by mid-2012.

Source: Wells Fargo Economics Group, Global Chartbook, March 2011

PIGS Government Bond Spreads
(2-Year Yield Spreads over German Bunds) in 2010-2011*



*data are through Jan. 21, 2011
Source: International Monetary Fund World Economic Outlook January 2011 update at http://www.imf.org/external/pubs/ft/weo/2010/update/01/data/figure_2.csv

Trade-Index-Weighted U.S. Dollar Exchange Rate*

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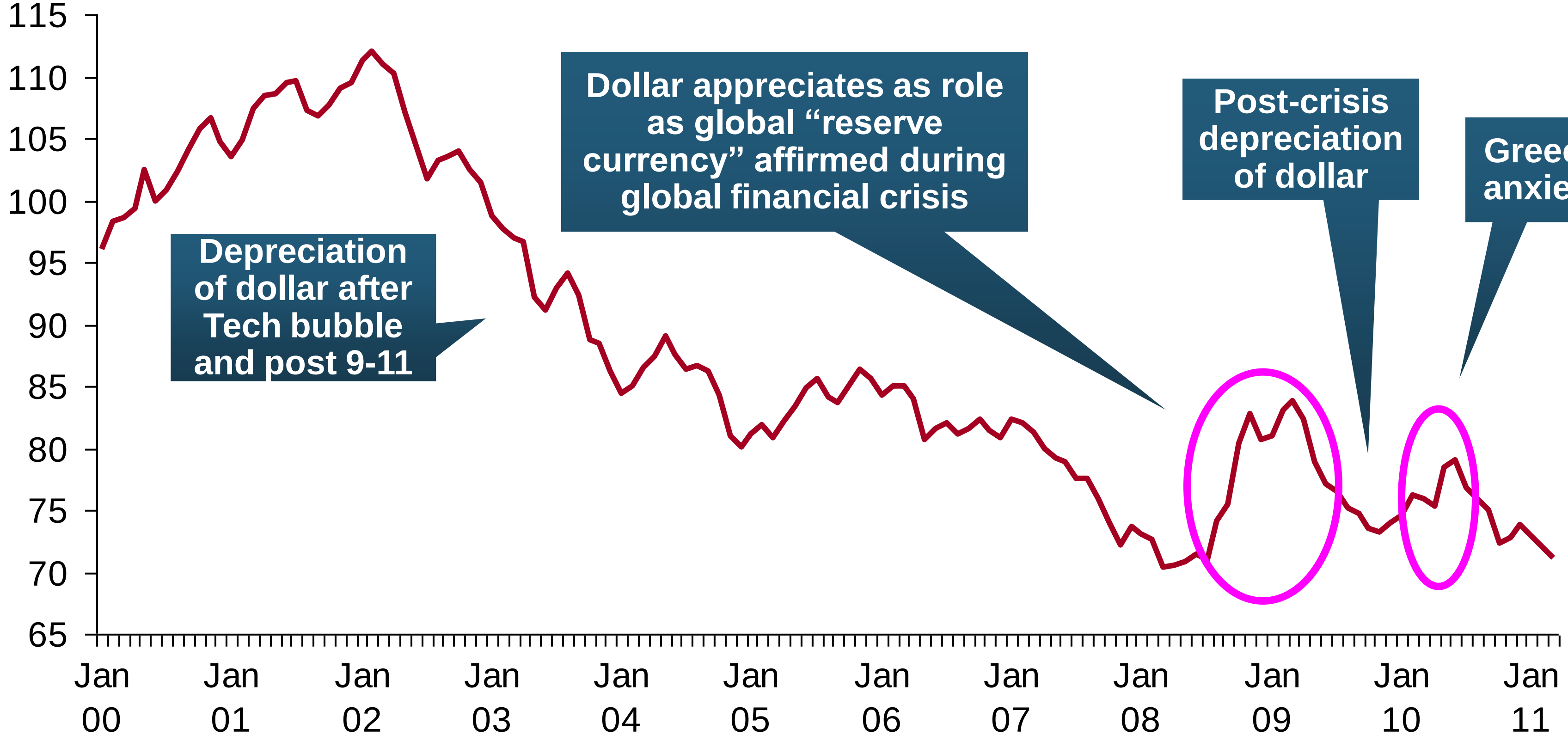
Monthly, January 2000 through February 2011



The global financial crisis created significant exchange-rate volatility in 2008-09 and 2010—when the world needed a "safe haven" currency. As global stability returns, the dollar is depreciating again.

*The Major Currency index is a weighted average of the foreign exchange values of the U.S. dollar against a subset of the currencies of a large group of major U.S. trading partners. The index weights, which change over time, are derived from U.S. export shares and from U.S. and foreign import shares.

Sources: US Federal Reserve, Board of Governors; Insurance Information Institute.

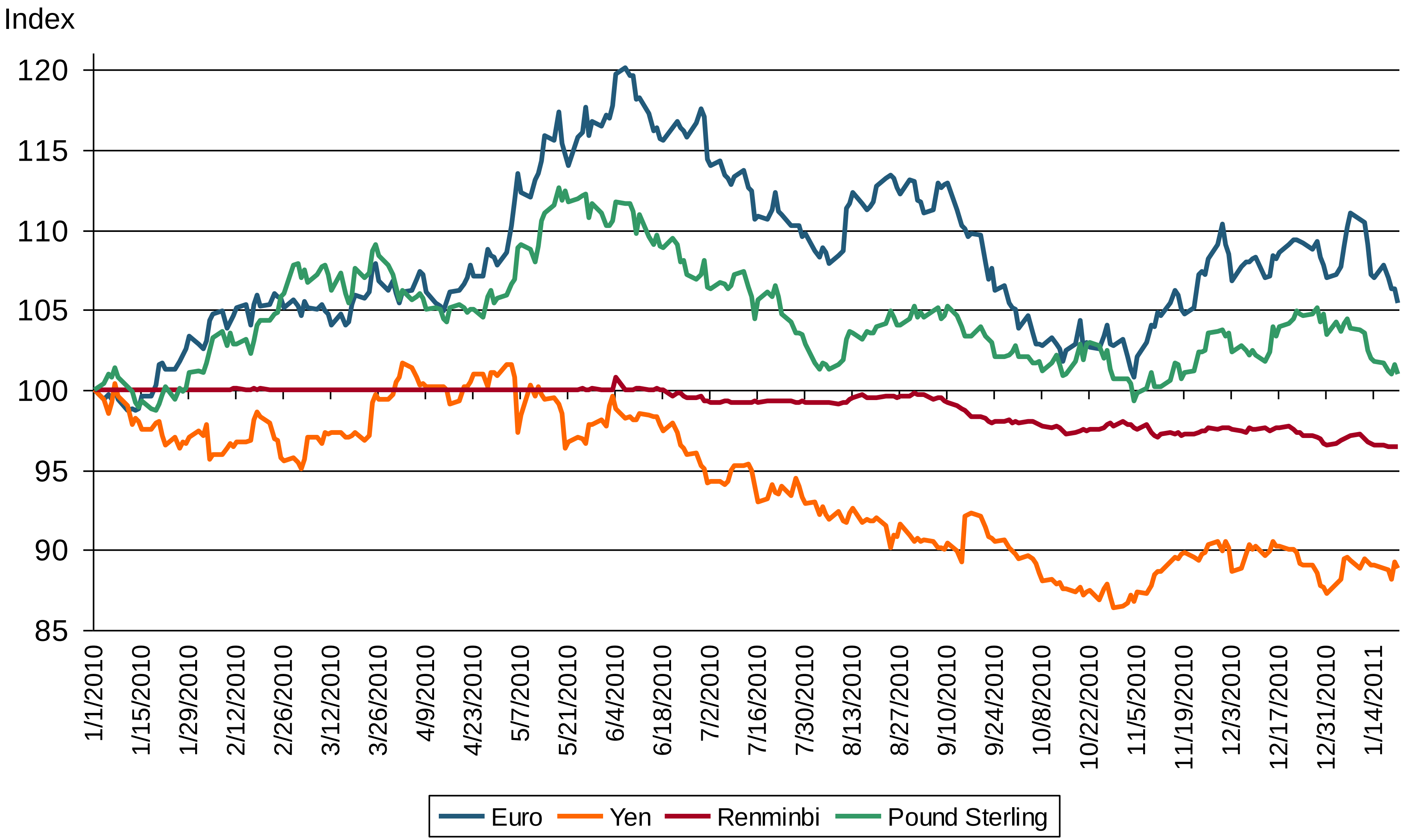
But Exchange-Rate Changes Generally Have Little Effect on U.S. Import Prices

- In theory, a change in the value of the dollar should raise or lower the cost of foreign goods, thereby reducing or increasing U.S. demand for imports.
- However, numerous economic studies have shown that when the dollar fluctuates against foreign currencies, U.S. import prices tend to show much less change.
- Using data for 1999 to 2008, a recent paper estimates exchange rate pass-through to U.S. import prices for aggregate U.S. imports (all imports excluding oil and consumer goods), and for prices of imports from Japan, the European Union (EU), Canada, the NIEs, and Latin America.
  - The exchange rate pass-through estimates were found to be low (0.47 for all imports excluding oil and 0.26 for consumer goods) over 4 quarters.
  - Estimates of bilateral exchange- rate pass-through range from 0.59 for Latin America (largely Mexico) to 0.0 for the NIEs (Taiwan, Singapore, South Korea, and Hong Kong).

Source: U.S. International Trade Commission at http://www.usitc.gov/publications/332/working_papers/ID-21_revised.pdf.

Exchange Rate Indices*

Daily (Jan 1, 2010 = 100)



*data are through Jan. 21, 2011
Source: International Monetary Fund World Economic Outlook January 2011 update at http://www.imf.org/external/pubs/ft/weo/2010/update/01/data/figure_2.csv

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Political Risk Insurance

Covers Various Risks, Including Currency Inconvertibility, Sovereign Non-Payment, Political Interference, Strikes, War/Riot

Political Risk: Insurers’ Greatest Opportunities Are Often in Risky Nations

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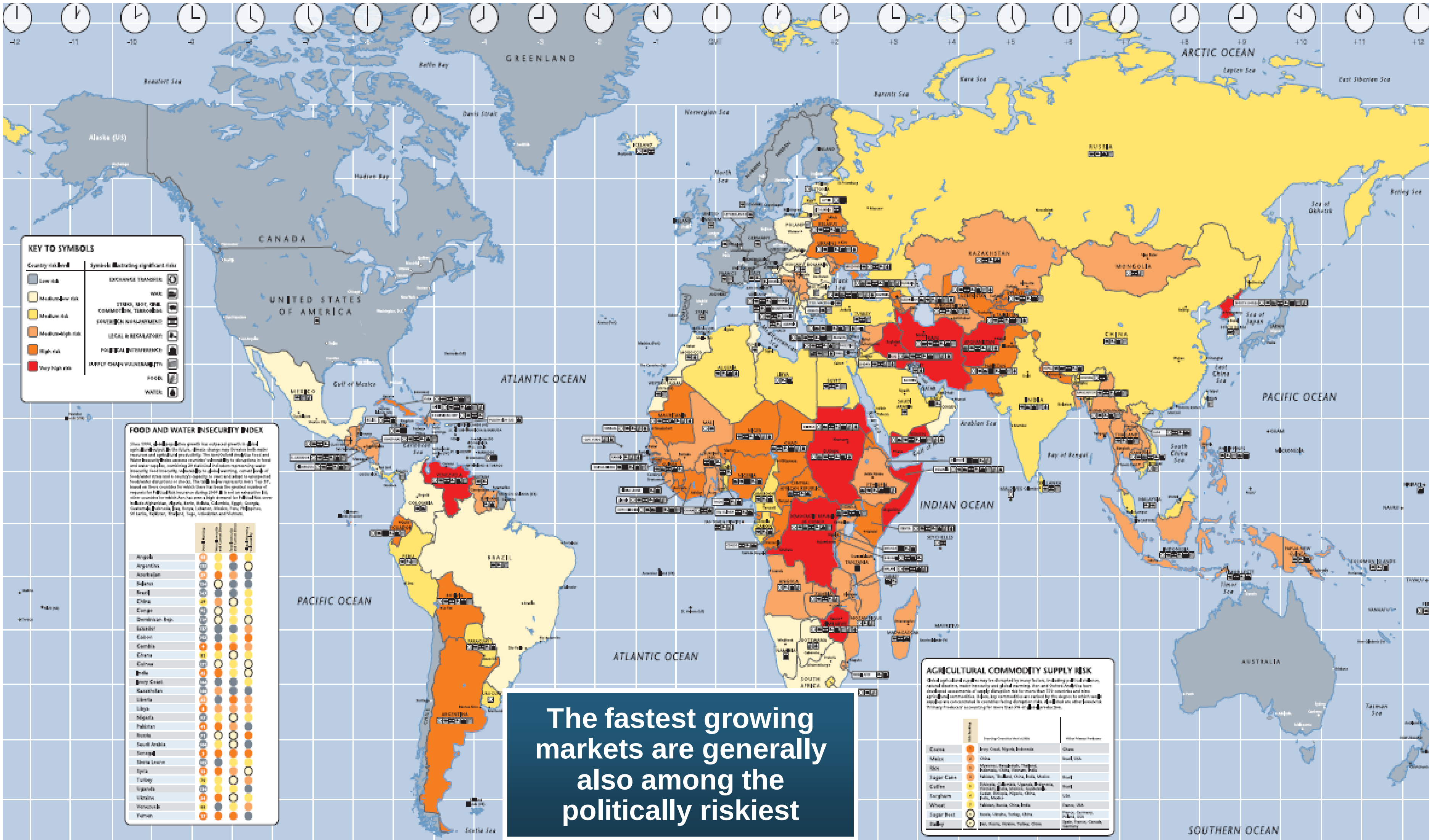
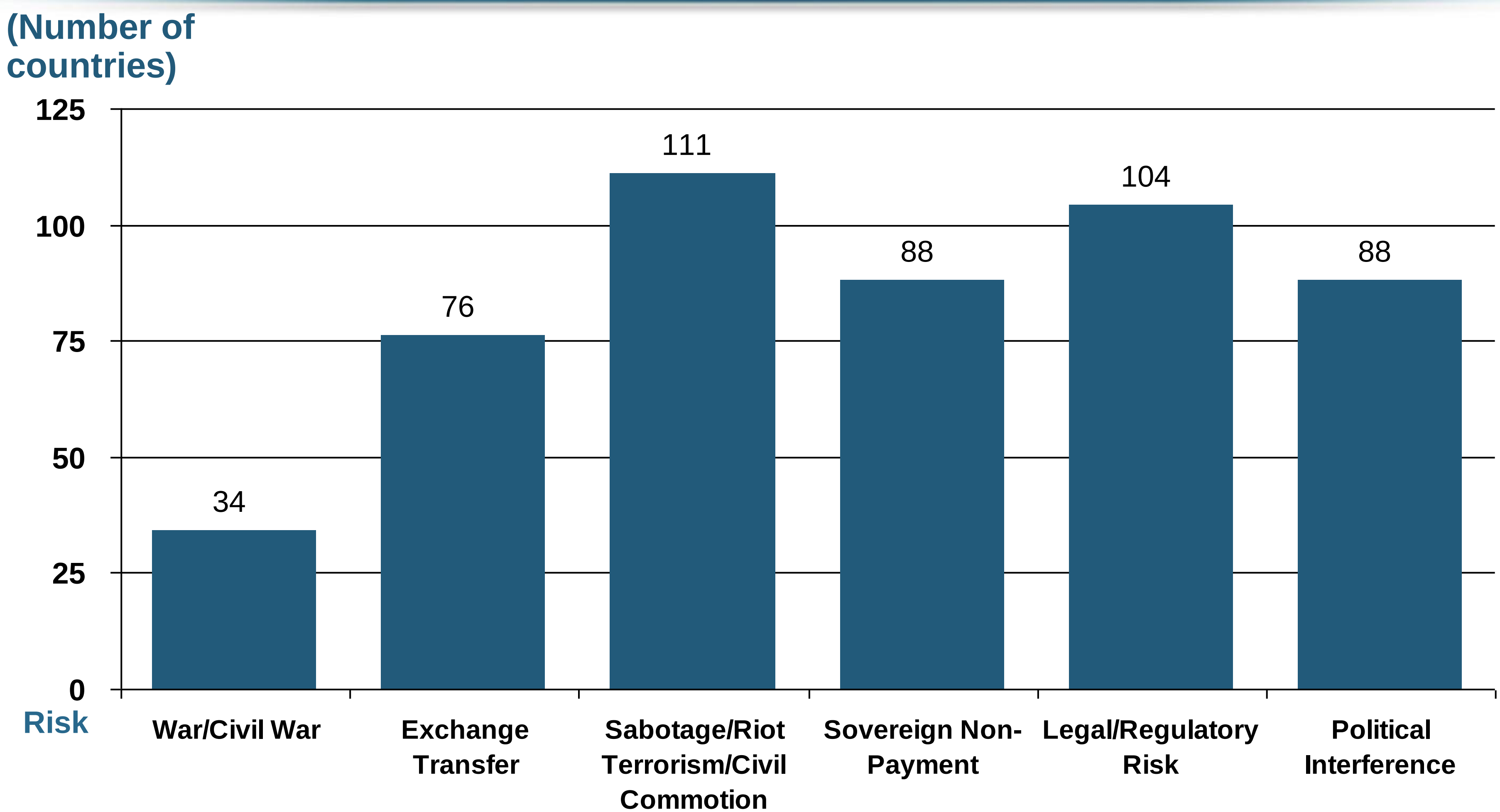


The fastest growing markets are generally also among the politically riskiest

Source: Aon

Aon: 2011 Political Risk, by Country Count



Chinese Banks' Lending Activity Abroad Showed Little Impact from the Global Financial Crisis

Source: Aon, published January 19, 2011, accessed at http://aon.mediaroom.com/index.php?s=43&item=2162

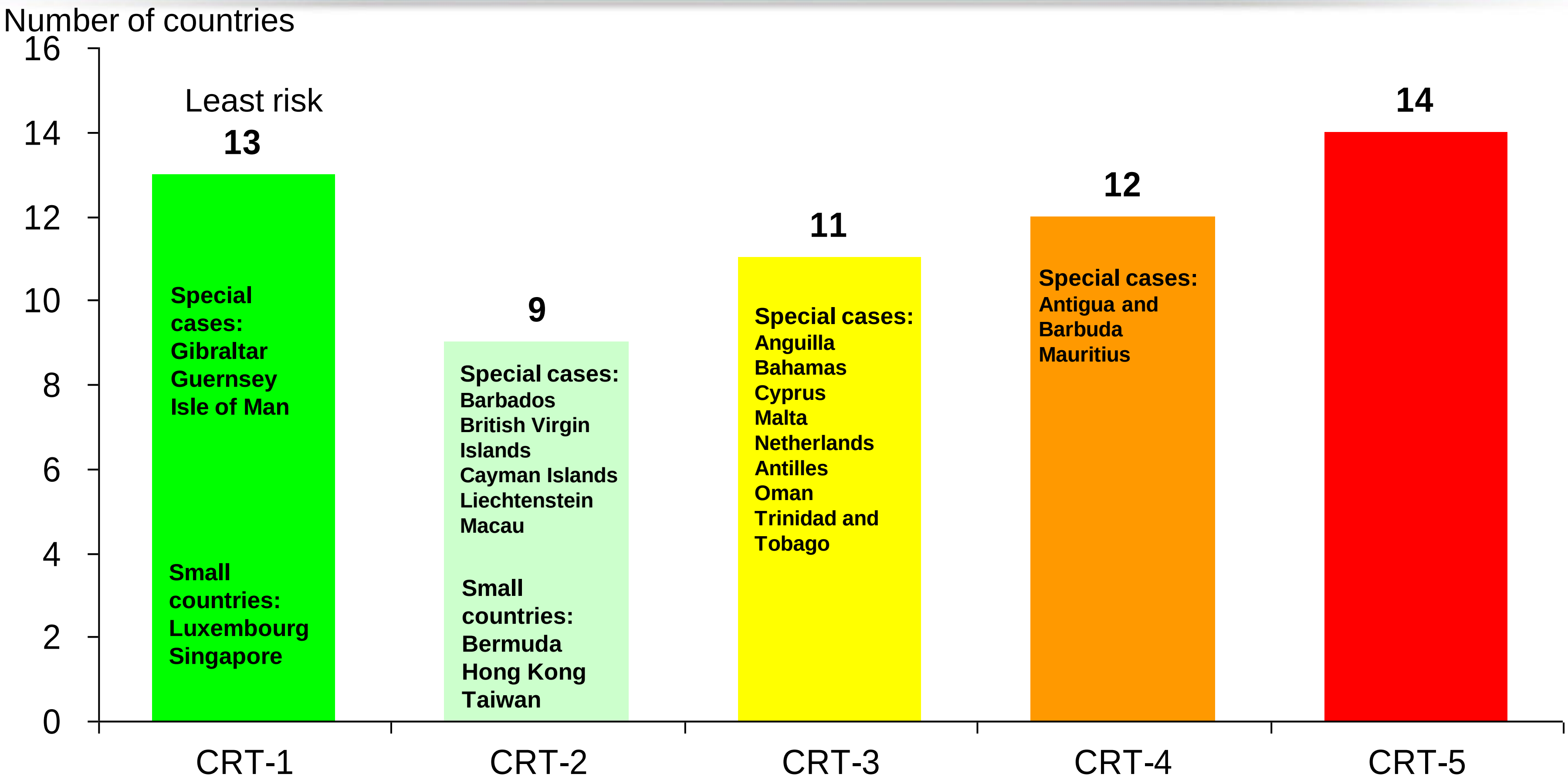
Changes on Aon's 2011 Political Risk Map

- ***Aon 19 downgraded countries at the start of 2011***: Algeria, Benin, Comoros, Antigua and Barbuda, Bahamas, Barbados, Bermuda, Cayman Islands, Dominica, Granada, Haiti, Netherlands Antilles, St. Kitts and Nevis, St. Lucia, St. Vincent, Trinidad, Myanmar, Iceland, Bahrain.
  - Many of these were downgraded because they rely on tourism for their prosperity and the global recession severely cut that revenue/ profit source
- ***Aon upgraded 8 countries/territories***: Kenya, Mozambique, Rwanda, Uganda, Zambia, Panama, Georgia, Uzbekistan, Indonesia, Malaysia, India

Bottom Line: **Political and financial instability remain a feature of the business landscape in 2011.**

Source: Aon, published January 19, 2011, accessed at http://aon.mediaroom.com/index.php?s=43&item=2162

A.M. Best: Country Risk Evaluation*



***Country risk: the risk that country-specific factors could adversely affect an insurer's ability to meet its financial obligations. A. M. Best places countries into one of five tiers: Country Risk Tier 1 (CRT-1, a stable environment with the least amount of risk), to Country Risk Tier 5 (CRT-5, countries that pose the most risk and greatest challenge to an insurer's financial stability, strength and performance).**

Countries in CRT-5): Algeria, Belarus, Bosnia and Herzegovina, Dominican Republic, Ghana, Jamaica, Kenya, Lebanon, Libya, Nigeria, Pakistan, Syria, Ukraine and Vietnam.

Source: http://www3.ambest.com/ratings/cr/crisk.aspx

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