Inflation watch - July, 2016

Insurance Industry

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The I.I.I. Inflation Watch spreadsheet contains the latest data from the U.S. Department of Labor's Bureau of Labor Statistics (BLS). Both current and expected near-term general inflation continue to be low by historical standards, but there are occasional signs of rising inflation. The CPI-U—the popular measure of inflation, sometimes called headline inflation—rose by 0.8 percent in July 2016 vs. July 2015, before seasonal adjustment. However, core inflation—the overall index minus the effects of price changes for food and energy—rose 2.2 percent for the 12 months ending July 2016. Most economists prefer a year-over-year time frame and the core—not the "headline"–inflation measure. The BLS year-over-year core inflation rate had been slowly trending up since May 2015 but has been essentially flat since March 2016. The core year-over-year Personal Consumption Expenditure (PCE) deflator—the Federal Reserve Bank's preferred inflation measure—has ranged from 1.3 percent to 1.9 percent since the end of the Great Recession and, as of June 2016, was 1.6 percent (the same rate as in every month since February). There still appears to be some slack in both the U.S. and especially the larger global economies, making sharp near-term overall future price increases unlikely. From a macroeconomic policy viewpoint, sharply rising inflation doesn't appear to be a current or near-future problem to combat, but gradually rising inflation is possible and is being watched by the Federal Reserve Board's Open Market Committee, among others. Many forecasters project headline CPI for the second half of 2016 to move higher, ranging between 1.4 and 2.7 percent in the third quarter and between 1.5 and 2.9 percent in the fourth quarter.

Price trends for items that more directly affect property/casualty (P/C) insurance claims do not necessarily follow broad-based price indexes. Prices for items such as intensive healthcare affect claims under third-party coverages such as workers compensation and bodily injury liability, as well as first-party coverages like Personal Injury Protection (PIP) and med pay and medical expense insurance. For many years these price increases have far outpaced both headline inflation and the overall price index for medical care. This pattern continued in 2016 for inpatient hospital services, but not for outpatient services. Seasonally adjusted on a year-over-year basis, in July 2016 prices for inpatient hospital care rose by 5.3 percent. Seasonally adjusted prices for outpatient hospital services rose by 2.9 percent in July 2016 over July 2015. The 2.9 percent year-over-year (y-o-y) rise in outpatient hospital prices, though modest by long-term historical standards, is a sharp increase from the y-o-y increases two and three months ago (up 1.0 percent in April and 1.1 percent in May). The reason for the sharp increase isn't an upsurge in outpatient prices in recent months (on a month-to-month basis in 2016, they rose 0.2 percent in January, -0.5 percent in February, -0.2 percent in March, 0.3 percent in April, 0.7 percent in May, 0.2 percent in June, and 0.4 percent in July). The spike in y-o-y outpatient prices is due to price changes compared to the month of June 2015, when prices dropped by 0.9 percent from their level in May 2015 and another -0.1 percent drop in July 2015 vs. June 2015. Price changes for prescription drugs have been rising strongly, on a month-over-month basis, in 2016, except in May (when they dropped by 0.4 percent). June 2016 saw the sharpest month-over-month rise (1.3 percent), which was followed in July by a 0.9 percent increase over June, producing a y-o-y rise for July 2016 of 5.2 percent.

Price increases relating to auto insurance property claims also have been quite moderate recently. Prices for motor vehicle parts and equipment, which affect not only comprehensive and collision claims, but property damage liability as well, dropped by 0.6 percent in July 2016 vs. July 2015. These prices fell in most months since August 2012 and, despite some monthly increases, are about even with prices in April/May 2011. Falling prices for motor vehicle parts and equipment are welcome, of course, but they should be put into context: between August 2000 and February 2012 these prices rose virtually every month, for a cumulative gain of 46.7 percent (a compound annual growth rate of about 3.3 percent). Prices for motor vehicle repair rose by 1.9 percent for the 12 months ended July 2016, thanks primarily to a one-month jump of 0.6 percent in March 2016 over February 2016 and another 0.5 jump in April over March; prices for motor vehicle body work rose by 2.2 percent year-over-year (not seasonally adjusted). The BLS survey of consumer prices for motor vehicle insurance in June 2016 rose by 6.3 percent y-o-y; this is partly attributable to a 1.2 percent increase in April 2016 over March 2016 and another 0.9 percent increase in May over April 2015. The April-over-March increase is the largest one-month increase since July 2013 and only the second time since April 2003 that we've seen an increase of that size. Of course, many factors other than prices for auto repair—such as the continuing drop in insurers' investment income, and continuing above-CPI growth in the prices for intensive medical care, and an unusual upturn in the collision rate, which is related to the increase in the number of people employed (and adding cars to rush hour)—likely are affecting these increases.

Also, there are some signs that wages are growing faster than inflation. The Atlanta Federal Reserve Bank's Wage Tracker's three-month moving average of wages for "job switchers" is up 4.3 percent, and its comparable average for "job stayers" is up by 3.1 percent. Overall, these measures show wages in the last three months up by 3.6 percent. Wage growth affects workers comp and, indirectly, liability and PIP claims. Wage growth above inflation means consumers have increased buying power, which could lead to stronger economic growth near term. As the economy approaches full employment wage gains over inflation are expected to widen, but that might take some time to develop. There is still slack in the labor market, as evidenced by the 5.94 million people who are working part-time but want full-time employment, the 591,000 people who say they are "discouraged" from even looking for a job, and others who are not in the labor force but could join if job conditions tighten, etc. The labor market slack is generally believed to restrain higher inflation, at least in the coming months.

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