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Inflationary Expectations

Financial expectations have a way of holding up mean reverting processes, making them sticky. Inflation expectations are famous for this, with workers anticipating future levels of price increases and demanding higher pay to compensate. When rates stay abnormally high or low for long periods, especially when it is artificially induced, the changes to catch up are especially large and swift.

That is the position we are in today. Short term rates are being kept low through Federal Reserve policies. This is the same policy over the past decade that produced several asset class bubbles and increased systemic risk until it nearly took down the financial markets in late 2008. Now a combination of factors are building that will lead to high rates. There are a number of reasons for this, some new and some old.

Building Pressures

Many of the unfunded accruals have been documented elsewhere, but it recently became obvious to me that there are now so many that our path is predestined. It's not obvious how to avoid these issues through an investment strategy today, but a stress scenario that considers long-term Treasury rates of 10% or higher should be included in any strategic planning exercise. Here are some reasons why.

- Federal deficit – you can't print this many dollars without increasing inflationary pressure
- Trade deficit – we need dollars to buy oil and other imported goods. We don't export a comparable amount, so the dollar's inevitable trend is down. This is inflationary.
- Unfunded mandates
 - Social Security (annuity benefits) has a trust fund backed by promises of future taxpayers to pay retirees but little more than that.
 - Social Security (health benefits) has little in the trust fund today. It will get much, much, worse over the next 30 years.
- Willingness to bail out anyone and everyone – it is hard to argue that everyone who received federal bailouts so far were systemic risks. By providing these funds, implied promises were made that others would be helped too. This incents more risk in the system. Besides the union vote it is hard to argue that GM is now a systemic risk, yet lots of my money is being passed through to them and others who lacked understanding of risks and lived by the lobbyist. An academic should do a correlation study between lobbying expenses and bailout money. I think we would find that the first department to go after a bailout should be lobbying.

- Giveaways have no plan to slow down – several stimulus plan programs continue to push out the private sector by buying troubled assets. More market feedback is needed.
- Waiting in the wings – others are waiting to be bailed out, including states, municipalities and municipal insurers.

It occurs to me that a politician's legacy can change long after he/she is out of office. I wonder if Franklin Roosevelt, champion of the retirement safety net, has yet to meet his fate. If the United States government is bankrupted at some point due to generous benefits to seniors and federal deficits under a Keynesian mantle, it will put a new perspective to his ideas.

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