

November 2015

Normally I am pretty good about writing about what I knew on the first day of the month of the newsletter, but on December 8 I have several topics I want to do a brain dump about so am using the November newsletter (December will be the year's tweets and January is the predictions letter).

Currency Wars

By Max J. Rudolph, FSA CFA CERA

I have identified several higher order interactions regarding the recent currency wars, and I'm sure there are others. In about a week the US central bank is expected to raise rates for the first time in this cycle, taking the rate from 0 to 25 bp. This follows the end of the most recent cycle of quantitative easing a year ago. This is estimated to have been equivalent to about 300 bp tightening during this period. At the same time the EU and Japan have been loosening, with the dollar strengthening and oil dropping in price. It was only in the fall of 2014 that I realized how correlated these metrics are, and this has driven the economy since then.

When Japan loosened monetary policy last fall, there was an immediate reaction in the price of oil. Saudi Arabia chose not to cut supply and support the prior price in an apparent attempt to drive the frackers out of business. The cost to extract a barrel of oil using fracking methods is higher than simply pumping it out of the ground, but other OPEC members wanted the price supported to counteract geopolitical issues in Russia, Venezuela, Iran, Iraq and other oil producers. The price dropped below \$40 per WTI barrel and then stabilized between \$40 and \$50. Prices at the pump fell, but miles driven offset the drop and by fall 2015 the US was spending more on gas than prior to the price drop. Some thought the Fed would raise rates during its last cycle, but just before that China announced an easing and the markets became turbulent so rates were held steady. In early December Mario Draghi announced additional easing in the EU. It was not as much as expected (apparently the Europeans meet with big players in the currency markets to telegraph rates) so markets initially acted as if the EU had tightened, with the dollar falling in value. It did not take long until oil again traded below \$40. This trickery, I believe, gave the Fed added momentum to tighten. The last big piece of data was the employment figures, and they came in nearly as expected. Now in December, assuming no disaster occurs in the next few days, Janet Yellen will announce a small increase in rates.

What is this likely to mean to markets, and who are the potential winners and losers? When the Fed announces it has tightened, assuming it is 25 bp (larger would create discontinuities in the market, larger but in the same direction), the dollar will rise, oil will

fall, US exports will decrease, and US imports and travelers will enjoy a strong dollar against nearly every currency. This will hurt oil exporters who rely on this revenue such as Russia and Venezuela even if there is a rebound. Saudi Arabia can survive for a few years before having to make some tough decisions. Then they will fight the culture they have developed over the last 50 years of immigrant laborers. Gold will continue to drop in value, as will other commodities due both to the dollar's rise and slowing in China.

Many frackers have used below investment grade debt, or junk bonds, to fund their operations. Spreads on BIG bonds have already started to rise in anticipation of higher defaults in the sector. Much of the debt written during the Obama administration was for fracking operations, as this sector led the US economy out of the 2008 crisis. Now that may all change, with unintended consequences for all of us. There will be sympathy market value losses as other junk bonds are sold to offset the losses incurred from fracking. The stronger dollar will lead the US back into recession as currency wars continue as the only currency moving up while others are moving down in value. This will also pressure the credit market. The added variable is that 2016 will be an election year in the US. A recession right before the November polls will help the Republican candidate, so there will likely be pressure on the Fed to ease in 2016. It could be a very short tightening cycle, or another option would be for the Fed to maintain the asset level on its balance sheet rather than paying it down. In any case sometime in the next few years the US is almost certain to have a recession. Note the discussion regarding velocity of money in my last newsletter and other writings. It may prove to be a key indicator but may lag results.

Winners: opposition parties in Russia (are there any or will they go straight to chaos), Venezuela, Brazil, Argentina. Cash is king, so public companies like Berkshire Hathaway and private firms with no activist intervention that keeps its powder dry should do well (relatively, and set themselves up for the next growth boom).

Losers: people with no savings as technology takes their jobs. The US economy as exports are hurt by the strong dollar and this leads to recession. If only the financial system had cleared and the federal books were balanced.

Policy that would help but won't be enacted: gasoline tax to keep prices at the pump at \$3.50 or \$4 designed to balance the budget in the general account. There are no bullets left to fire. We need to reload our economic tool kit.

Family Firms have Advantages

In the US most companies are public and anyone can invest in them. In Europe more are family owned. As activist investors have become more demanding of public companies, it becomes harder to maintain a contrarian strategy. This requires holding cash, and an activist will demand this be distributed to shareholders through either a dividend or share buybacks.

I believe one result from this is that growth companies will continue to be publicly controlled in the US but that private equity, families and hedge funds will increasingly own the “cash cows” of the business world. I believe this may be part of the reason Warren Buffett recently took a foothold in Europe with a firm that makes motorcycle accessories. It may be easier to make acquisitions of the type he likes, where lots of cash is sent to the home office, in this case from outside the US.

ALM vs. Liquidity

On a volunteer call recently liquidity was discussed based on time horizon, a strategy I discussed 15 years ago when setting liquidity ratios based on 30, 90 and 365 day time frames. Another way to look at this was short term liquidity, event liquidity (e.g., pandemic) and pricing liquidity (assumptions are wrong). What was missing in the discussion was the base case. You need to match asset and liability cash flows reasonable well for most liquidity tools to work. Otherwise you aren't working on the margins but trying to overcome bets you have made about cash flow timing or interest rates. This is an important discussion to have. When the liquidity trap became apparent in 2008 insurer risks did not adequately consider their own liquidity needs as the high involvement in overnight securities lending programs showed. Risk-based capital included liquidity risk with either C-3 disintermediation risk or C-4 as a catch-all, but we weren't really sure. As we consider liquidity we should be sure to incorporate strong ALM practices in the discussion.

Time Horizons in Sports

With two high school students I see a lot of basketball games these days. It amazes me how many really athletic kids fail to recognize that everyone else at the next level will be just as athletic as they are. Many clearly have never taken the time to practice jump shots, focusing only on dunks and layups. These players wash out at the college level because they never learned to play all facets of the game, yet they are surprised by this outcome. Many of these athletes have never applied themselves in the classroom either.

Warning: The information provided in this newsletter is the opinion of Max Rudolph and is provided for general information only. It should not be considered investment advice. Information from a variety of sources should be reviewed and considered before decisions are made by the individual investor. My opinions may have already changed, so you don't want to rely on them. Good luck!