



Newsletter

My name is Max Rudolph. I consult with companies on enterprise risk management and strategic planning topics. I live in Omaha, Nebraska, USA, am credentialed as an actuary and hold a CFA charter. I write a monthly newsletter, covering a variety of topics, and each January I post my predictions for the year. Check back late in the year when I analyze what actually happened. Coverage is mostly related to risk management and investments. Some are written at a high level, dealing with the general economy, and some cover very specific topics. Most cover issues that I am stewing over and need to do a brain dump. The newsletters are educational in nature and do not constitute investment advice. They are released publicly at www.rudolphfinancialconsulting.com about 6 months after they are released to subscribers (predictions are released soon after they are written).

For those interested in a 12-month subscription, corporations should send \$1,000 and individuals \$100 in US currency payable to

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You can also follow me on twitter at **maxrudolph**.

Financial Predictions for 2012

Please remember that these predictions are for fun. If I really knew what was going to happen, I would not share that information with you! You must make personal decisions regarding your unique financial circumstances and not hold others, especially me, responsible for your own financial planning. Enjoy!

General happenings.

Politics, regional conflicts and sovereign economic policies have a great impact on the worldwide economy, take years to play out and have unintended consequences.

Economic variables are mean reverting, cycling from low to high and back again. Bubbles and their opposite occur regularly, although they are often hard to identify until after the fact. Some of these can be recognized in advance, and the risk manager who considers two for each one that occurs has added value. Bubbles forming today are not as obvious to me as in some past years, so keep a look out. Interactions between risks and correlations should be considered in advance. How would these events impact you if they occurred in 2012? Consider higher order impact as well as unintended consequences.



- Cyber-terrorism causes ATMs to fail
- Space junk hits the space station
- An earthquake hits San Francisco or Mount Rainier becomes active
- Fracking is declared illegal due to environmental impact
- China erupts in civil war
- Greece leaves Eurozone
- Venezuela erupts in violence, shutting down their oil industry
- A disease (perhaps tuberculosis or influenza) develops drug resistance and becomes transmissible by air

These predictions were made in January 2012.

- Politics: Prediction – Romney/Gingrich (need someone from the south who isn't crazy) over Obama/Clinton (Hillary). The economy will improve in 2012 but continues to add jobs at a lackluster pace. Both parties will fight for independent moderate votes during the fall. Perry and Santorum will implode. Huntsman is running for 2016 and could be the next Romney type candidate. He would be an interesting VP nominee but does not balance the ticket with Romney. Health care reform can't be implemented at the same time as austerity programs, and Dodd-Frank is dead on arrival until the next recession. If we follow the 1930s pattern and it is severe then we would get far-reaching legislation and regulations. Watch for tensions to increase in Venezuela and Russia, with North Korea another obvious concern. Syria will fall to the Arab spring, Egypt will become pro-Iran and Iraq becomes influenced by China. I continue to worry about the mayhem unleashed when King Abdullah of Saudi Arabia dies. The Tea Party lost their chance at national prominence but remains strong in some far-right conservative areas. A third party candidacy (e.g., Ron Paul) would give the election to the Democrats. Europe is likely to finally make some decisions in 2012, and will kick out Greece but no one else. Over the next several years Greece will be at risk of colonialization-like efforts by China and others. The risk of unintended consequences in Greece is high. The risk of China experiencing an economic hard landing is increasing. This could have major consequences, everything from an internal revolt to a selloff in US Treasuries to an armed conflict. The next major wars will start in cyber-space, but the Middle East remains tense and any ground troops would likely be used there.
- Stocks: Although the US will do better than other developed countries, stocks won't explode. We remain in a trader's market, with regularly surging volatility. Small caps will do as well as large caps in 2012. I would be surprised to see below -5% or above 15% for the S&P500 but my best guess would be toward the upper end of that range (this assumes that contagion from Europe is contained). Over the next 10 years stocks will outperform both cash and especially bonds. Bonds at low interest rates are hard to get excited about as we prepare to enter an era of higher inflation. There is a slight chance of hyperinflation in the United States. It will take a few years to develop before suddenly appearing. Why are



utilities guaranteed 10% returns in today's low interest rate environment? Good companies to buy now are ones that can pass on their inflationary cost increases to their customers like those in the transportation (e.g., railroads) and energy sectors. Based on my filters here are a few companies that appear to be undervalued based on publicly available information (not recommendations, just ideas for further analysis) and year-end prices: Peabody Energy BTU 33.11, Xerox XRX 7.98, Walter Industries WLT 60.56, Tidewater TDW 49.3, HanesBrands HBI 21.86, Cummins CMI 88.02 and Johnson Controls JCI 31.26. The S&P500 closed 2011 at 1258. Full disclosure: my family owns shares in each of these 7 companies. None are controlling positions. ☺

- Unemployment: The world slows early in 2012 due to the end of the positive stimulus that followed the Japanese tsunami, then picks back up with slightly below normal growth (but still positive) in the US and lower elsewhere as the sovereign debt crisis keeps uncertainty high. Private employers are starting to hire in the US, but unemployment will remain sticky. If it gets below 8.0% this will help the incumbent democrats. Structural employment provides a floor of about 6% now, and public employers are not done with their staff reductions. Older workers will continue to struggle at the same time they know they have to work longer before retiring. The municipal market is still at risk of perceptions that drive spreads up, and some states and municipalities will default (I could be early on the states but it will happen eventually). This could have a positive impact on casualty insurers due to their concentrated exposure to these bonds. Certainly this is an unintended consequence of tax policy. I'd like to see the state run pension plans be consolidated either into Social Security (at least for new employees) or into a bigger pool that is more transparent. It also seems like companies have a lot of cash on their balance sheets right now. If they go on a buying spree for small and mid-sized corporations that would pay off the owners who could then go about creating new firms. These are the entrepreneurs that will eventually create jobs. The Washington uncertainty is keeping this natural process from occurring.
- Residential home market: we're not completely through the housing bust, and foreclosures will continue, but regional improvements will continue in 2012 for all but the highest end homes. Apartments and home rentals will continue to grow as economic reality takes hold. Not all markets will move together as regional diversification returns to the marketplace and it begins to loosen. Population will start to move to where the jobs are, for example away from Illinois and toward the Dakotas. Fannie and Freddie should enter the Presidential debates, but with no good ideas the candidates will try to avoid the subject. The trend of young and old moving in with empty nesters will continue, much to their dismay.
- Volatility has itself been volatile over the past couple of years. Too many investors are looking at VIX as a predictor of the future and there are too many big risks, both known and unknown, that should increase this statistic. Although I have not proven good at predicting VIX I think it should be in the 20-25 range but will continue to range from 15 to potentially as high as 40 or 50 if Europe blows up. At year-end 2011 it was 23.



- Oil: Oil is currently at \$99.75, toward the middle of my long-term mean reversion rate of \$80-120 range, but volatility continues to make short term predictions very risky. If oil prices fall below \$50, political instability in Russia and South America will quickly follow. As the world economy improves the price of oil should increase. Watch Venezuela for problems. As the technology to derive oil from shale increases supply, tensions in the Middle East, Russia and South America pull prices up. Shale results in a higher floor for the lowest prices but we could easily see a spike this year due to uncertainty and posturing as the US reduces its presence in the Middle East.
- Credit risk: there is not enough transparency to know how close we are to yet another blow up, but signs are abundant that credit risk is growing again. Liberal covenants, personal loans, and insurance guarantees are increasing credit risk. Municipal bonds, Fannie and Freddie could all have strong impact in 2012. Valuation methods for defined benefit pension plans allow off balance sheet liabilities to grow without transparency.
- Financial Services Consolidation: Bank consolidation will continue, with mid-sized and smaller banks merging to gain economies of scale and consumer trust. Bank of America will implode at some point in the next few years. Fire sale prices for their portfolio might add a lot of value for someone with cash available. Expenses at insurance companies are too high and industry overhead needs to be reduced. Insurance consolidation will accelerate, with household names and smaller firms being merged out of existence. In the long run I still expect to see a federal charter put in place, at least as an option, but a research project I recently completed showed the benefits of multiple regulators (regulatory concentration risk).
- Currency/Inflation: Currency trends will be driven by supply and demand for oil over the next several years. The next great threat to dollar dominance is a resurgent German led Europe or China, and both are several years away. China could partner with Middle Eastern states and move toward a regional or broader war, but that is not imminent. Resource shortages (food, water) will drive regional conflicts. At YE2011 the Eur/USD exchange rate was 1.28.
- Fed policy: low rates will continue through the election, encouraging leverage. While consumers have trouble accessing it, private equity firms have no concerns about borrowing. The US continues to be very susceptible to a large catastrophe, financial disaster, or armed conflict.

Emerging Risks - Concerns

- Levees in California, earthquakes/volcanos, water poisoning of NYC, cyber hackers – all potential issues to develop contingent plans for. I am becoming more aware of the cyber security threat and worry that the “cloud” may not be as secure as users think. I am getting tired of receiving a new credit card every few months because the old numbers have potentially become public. Everyone should have a stash of cash they can easily gain access to in case the retail banking sector goes down for a week.



- Infectious disease - increased resistance to antibiotics (e.g., tuberculosis, staff infections or pneumonia).
- Global warming – unexpected side effects like new viral/bacterial attacks, along with coastal flooding, increased hurricane activity and shifting weather patterns that impact farming.
- Earthquakes and hurricanes – the US is overdue for a major quake on the west coast and other areas not normally thought of for seismic activity due to long dormant periods (e.g., Seattle, Yellowstone, St. Louis, New York City) are well into their cycle. The US is also due for a strong hurricane season.
- Malthus – too many people, not enough food – will good intentions of the rich to save lives in the 3rd world lead to increased systemic risk for society (mass starvation and unstable regions) in the longer term?
- Concentration risk – this will be a hot topic over the next few years much as emerging risks have become. Whether it is power at the top of an organization, short term liquidity, geographic focus or silo risk focus, too much concentration in too few entities or people is a great risk. Eventually it will take you down. This should be a focus during strategic planning efforts.

Top Actuarial Issues

- Defined benefit plan valuation – needs to reflect marketplace economics, mean reversion and conservatism. Valuation methods have led defined benefit plans to be little more than an off balance sheet Ponzi scheme, relying on inflation to reduce the value to the retiree and the expense to the employer. The liabilities should balance every year economically. Actuaries and investment professionals from other disciplines should be welcomed, along with those from outside the profession. Focus should be on cash flows rather than regulatory requirements.
- Product design – designing products that are economically sound to both policy owner and company. Variable annuity writers seemed to have learned and adjusted with their new products, but have reverted back to features that make no sense to me. Why is it conservative to force asset allocations toward bonds in a low interest rate environment? Have insurers considered a hyperinflation scenario? They should.
- Obesity – how will the various drivers of mortality and morbidity interact (some good, some bad)?



Scenario Planning

What follows are a base set of scenarios that companies/individuals could use to plan for the next few years. Some analysis will reflect quantitative tools but all should look at the risks on a qualitative basis first. When models are used for extreme scenarios they do not perform very well.

- Higher interest rates and inflation: grade 3% per year until you get to 12%
- Qualitatively consider a 20% inflationary environment
- Flat equity markets combined with higher inflation
- Falling dollar – could combine with high interest rate scenario
- Global climate change – how will this impact your business
- New for 2012 Liquidity risk – consider your largest markets and what would happen if they dried up. Have you accepted risks that you thought were mitigated?
- New for 2012 - scenario where no diversification is allowed between risks

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