

Newsletter – 2013 Predictions (Results)

My name is Max Rudolph. I consult with companies on enterprise risk management, investment 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 and each January I post my predictions for the year. Late in the year I review and analyze what actually happened, including any tweets I got right during the year. Coverage is mostly related to risk management and investments. Some are written at a high level, dealing with the general economy, and some cover specific topics. Most discuss issues that I am stewing over and need to do a brain dump. I read a lot, and that impacts what I am thinking about. The newsletters are educational in nature and do not constitute investment advice. They are released publicly at www.rudolph-financial.com about 6 months after they are released to subscribers (predictions have a more timely release).

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Financial Predictions for 2013

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 your own personal decisions, considering your unique financial circumstances, and not hold others (especially me) responsible for your own financial planning. Enjoy!

General happenings.

Perceived stability is hiding a growing risk as debt levels remain high, which will lead to currency wars and inflation. Sometime soon the calm will break. It's like we're sitting on a dinosaur about to wake up.

The world has been positioning itself toward a tipping point for several years. We are entering an uncertain future, but it will be different from the present. The financial crisis and Arab Spring, along with the continuing European debt crisis, evolving Chinese landscape, and fracking developments, have set the stage. Political and economic restructuring, possibly driven by climate change, will result in changing leadership as resource availability drives the winners and losers. It reminds me of the arguments

presented by Jared Diamond in *Guns, Germs and Steel*. Today he might change the title to technology, water and oil. Those who have it will win. So what does that mean for 2013, incorporating event interactions and unintended consequences of actions?

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 can be recognized in advance, and risk managers don't have to be perfect predictors to add value. Bubbles are forming, especially in alternative asset classes as bond yields have been set artificially low by the Fed. Here are some outlier scenarios that I think are more likely to happen in the next several years.

- Cyber-terrorism impacts the banking system or shuts down power stations (Results: the Target breach during the holidays was a reminder of this risk)
- Space junk knocks out a satellite used for TV/phone transmission
- Atmospheric river hits California and dumps rain on San Francisco for a month
- A severe earthquake hits California or St. Louis
- Mount Rainier or a super-volcano becomes active (Results: it was reported that the super-volcano beneath Yellowstone National Park has several times the magma previously thought)
- Fracking is declared illegal due to environmental impact (Results: several train derailments – ND and Quebec – have kept this issue in the forefront)
- China erupts in civil war
- Greece or Germany leaves Eurozone
- Venezuela erupts in violence, shutting down their oil industry (Results: recent currency devaluation moving toward this unfortunate result)
- A virus develops drug resistance and becomes transmissible by air (Results: mild outbreak from Middle East of MERS coronavirus)
- War erupts in Asia with battles over resources, with China the aggressor (Results: China has been working with African nations for resources)

These predictions were made in January 2013.

- Politics: Prediction – President Obama will become known as the oil president, much to his chagrin. Gun laws evolve but don't seem to stop massacres. The Republicans start to line up to run for president in 2016 as Hillary Clinton fights health issues on the democratic side. Joe Biden has no chance. The economy will improve early in 2013 but tax increases will hold it back by the end of the year. Watch for major problems in Venezuela, with Syria and Iran hotspots in the Middle East. I continue to worry about the mayhem unleashed when King Abdullah of Saudi Arabia dies. Europe continues to kick the can down the road. They will continue to do so as long as they can, but it will end badly. Japan has moved closer to the Endgame by launching a currency war. Others will join in. The risk of China experiencing an economic hard landing and consolidating around nationalism 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. A lessened reliance on imported oil by the US due to fracking might cause China to make a resources driven power grab.
- **Politics: Results.** Correct. As we look back on 2013 from the distant future, the growth of fracking and loose monetary policy will likely overshadow other stories, at least from the US perspective. The way the two stories interact, lowering trade deficits and decreasing the importance of Saudi Arabia, will have major repercussions in the future especially as the US and China vie to be the world leader. Unfortunately gun control is no closer now than it was a year ago in the aftermath of the Newtown, Massachusetts massacre of young children. School shootings seem to be so frequent that they don't even get reported nationally any more. It's very sad that the gun lobby is so powerful. Political posturing has begun for the presidential 2016 race, with Hillary Clinton the clear Democratic frontrunner and Paul Ryan starting to show signs for the Republicans. A sign that the Democrats are evolving in their environmental stance is the money Clinton has accepted from fracking. The 2013 economy has outperformed my expectations, driven by monetary stimulus that overwhelmed the fiscal contraction from the sequester and government shutdown. This inconsistent policy will have unknown long-term effects. The decision to taper slowly, almost imperceptively, has been received favorably by Wall Street but long-term leads us closer to John Mauldin's Code Red event (although it might delay it beyond 2014). Venezuela moved closer to chaos with a late year currency devaluation, with the Syrian civil war and Iran dance continuing. The revelations that the NSA collects data from everyone is concerning but has not been handled well by the Obama administration. I believe what was reported is common to all intelligence services, and if a country's leader chooses to use an unprotected phone it seems like they are a bit naive. Europe continues to kick the can down the road, but Japan started a currency war they will eventually be responded to. China, with its new leadership team, is changing paths and trying to stake out territory. There is a risk that it will blow up, especially as they attempt to control islands also claimed by others. The similarities between now and a century ago that led to WWI are too many for me to be comfortable that we won't end up in a war somewhere. North Korea continues to be a wild card, and Asia in general is heating up.
 - **Immigration reform:** both political parties will reach out to Hispanics through legislation to set up the 2016 election.
 - **Immigration reform: Results.** Correct. Both parties are reaching out to Hispanics and will continue to do so leading up to the 2014 mid-term and 2016 presidential elections. With the poor economic results of the past few years, there have been fewer opportunities in the US so the focus will be on citizenship for long-term alien residents rather than on keeping new immigrants out. If there are no jobs there is less of an immigration problem.
 - **Stocks:** As long as the Fed maintains artificially low rates stocks will outperform other asset classes. The US consumer has begun the deleveraging process and is

ahead of other developed countries. Although government debt remains high seemingly everywhere, the US will outperform. Despite a strong start to the year in mid January it will be a trader's market and the final results will not vary 5% in either direction from here, with small losses or single digit gains. 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. It is hard to understand why variable annuities force investors into bond funds when their options are in the money. It seems like a mispricing is in there somewhere. There is a slight chance of hyperinflation in the United States. It will take a few years for inflation to develop before suddenly appearing. Good companies to buy now are staples that can pass on inflationary cost increases to their customers. 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: Tidewater TDW 44.68, and Johnson Controls JCI 30.67. Both are carryovers from last year's list. The S&P500 closed 2012 at 1,426. Full disclosure: my family owns shares in each of these companies. None are controlling positions. ☺ For those interested you can follow my portfolio at www.tickerspy.com under maxrudolph.

- **Stocks: Results.** Correct on relative direction but not level of returns. I was right that stocks would outperform other asset classes, but the level of absolute performance was much higher than I expected. At this point I find few equities that pass my filter. Most are “pick and ax” companies for the oil fields like TDW, HOS, CKH and RIG. I also like CHK. (long TDW and CHK) It appears that a correction is likely, but a crash would be driven by government policy and not overvaluation. The US deleveraging process has continued except for student loans, which is a red flag for future economic progress. The stock market could use a general correction as it is not grossly overvalued but certainly is fully valued for most companies. There may have been a taper delay due to the transition from Ben Bernanke to Janet Yellen as Fed Chair. A trigger could be a spike in interest rates or a negative event such as a major fracking accident or earthquake. Stocks mentioned early in the year were Tidewater TDW 44.68 (59.27 on Dec 31, 35% total return), and Johnson Controls JCI 30.67 (51.30 on Dec 24, 70% total return). The S&P500 closed 2012 at 1426, stands on December 31, 2013 at 1848.36, and had a 32.39% total return for the year.
- **Unemployment:** Structural employment provides a floor of about 6% now. We may see another wave of both private and public layoffs, but these are more likely in 2014. The military drawdown may impact US financials too.
- **Unemployment: Results.** Correct. The unemployment rate has dropped from 7.8% in December 2012 to 7.0% in November 2013. Some of this is from potential workers leaving the work force and some is from the economy slowly adding jobs. Currently Congress has chosen not to extend unemployment benefits so the 2014 rate may drop early in the year as more leave the work force.
- **Residential home market:** most US regions will continue to improve in 2013. Hardcore problem areas, like Las Vegas, will continue to struggle to work through

- excess inventory. This will free up the employment markets as well since it will be easier to move regionally if your mortgage is not under water. Fracking will drive markets if the industry can convince workers to move their families. Fannie and Freddie are still a mess, and it would be a miracle to see a solution in 2013. The trend of young and old moving in with empty nesters will continue, much to their dismay. Watch for the Canadian bubble to pop over the next couple of years.
- Residential home market: **Results.** Correct. Most US regions improved in 2013 with entry homes leading the way as excess inventory was worked through nationwide. Fannie and Freddie continue to be undefined yet still a major part of the housing market. Refinancing is now essentially done as rates move off their generational lows. Once tapering starts and the Fed stops buying these assets this market will need to clear. The Canadian housing bubble is getting a lot more attention now.
 - Volatility: The VIX closed 2012 at 18.02 (range 13-27). Volatility itself has been volatile over the past couple of years. If VIX was a predictor of the future it would be higher. Known risks include heavy personal and government debt levels. I find it impossible to predict VIX but I think a reasonable range would be 20-25. A single digit VIX is definitely too low and above 35 is too high, but I see more possibilities for a higher result in 2013.
 - Volatility: **Results.** Wrong. The VIX closed 2012 at 18.02 and on Dec 31 closed at 13.72 with an annual range of 11.05 to 22.72. This “predictor” continues to vex and confuse me. The risks are much higher than this index shows. Much like equities, the VIX seems to trade on emotion rather than fundamentals. Long-term plays are probably okay to make as long as you avoid leverage.
 - Oil: Oil on December 31, 2012 was about \$91, toward the middle of my long-term mean reversion rate of \$80-120 range, but volatility continues to make short term predictions very risky as fracking comes on line. If oil prices fall below \$50, political instability in Russia and Venezuela will quickly follow. As the world economy improves the price of oil should increase with demand. As the technology to derive oil from shale increases supply, tensions in the Middle East, Russia and Venezuela will try to 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.
 - Oil: **Results.** Correct. Oil rose during the year from about \$91 to \$99 per barrel. US supply due to fracking is keeping the WTI rate about \$10 lower than Brent crude.
 - Credit risk: credit spreads continue to be too low given the risk in the system due to excessive debt. Municipal bonds continue to chip away at results.
 - Credit risk: **Results.** Correct. Spreads continue to be low. Detroit’s bankruptcy hit many pension plans and other institutional investors. Junk bonds do not pay the investor for the excess risk accepted.
 - Financial Services Consolidation: Bank consolidation continues, driven by small and mid-sized insolvencies. A consolidator of these banks will grow to a large size over the next few years. Among too big to fail banks, Bank of America seems

- most likely to implode. Insurance company consolidation is coming, with Europeans looking to reduce exposure. Who will be the buyers? Private-equity or sovereign funds seem most likely, with national institutions like China Life also in the hunt. A federal charter is still years away from being an option.
- **Financial Services Consolidation: Results.** Right. Some insurance blocks were bought by sovereign funds and private equity, but banks continued on their merry way. Deutsche Bank reportedly has a 60 to 1 leverage ratio at the end of 2013. The Federal Insurance Office report posted in late 2013 did not go as far as many expected with regards to a federal charter and made you wonder why it took them two years to write.
 - **Currency/Inflation:** Japan has started a currency war. Who will be the next participant? At YE2012 the Eur/USD exchange rate was 1.32. The dollar should be weak, but its competitors are much worse.
 - **Currency/Inflation: Results.** Correct. Abenomics has begun a path down a slippery slope that will keep the world's monetary policy loose for several years. The Eur/USD exchange rate strengthened from 1.32 at the end of 2012 to 1.38 on Dec 31. This result is intertwined with shale oil and the European crisis.
 - **Fed policy:** low rates continue through 2013 as tax increases will slow the economy and keep monetary policy loose. The US is very susceptible to a large catastrophe, financial disaster, or armed conflict. Valuation methods for defined benefit pension plans need to be redesigned. In the meantime insurers will continue to offer to accept the risks while interest rates are artificially depressed.
 - **Fed policy: Results.** Correct. The recent start of tapering is a very timid move. Our monetary policy is so loose, and fiscal debt so high, that a shock to the system would be hard to deal with. Sometime soon we need to reload.

Emerging Risks - Concerns

- Levees in California, earthquakes/volcanos, water poisoning of NYC, cyber hackers. **Results:** cyber hackers are now on everyone's minds.
- Infectious disease - increased resistance to antibiotics (e.g., tuberculosis, staff infections or pneumonia). **Results:** MERS and new forms of influenza included clusters of health professionals, generally a sign that the disease can spread through the air.
- Global warming – unexpected side effects like new viral/bacterial attacks, along with coastal flooding, increased hurricane activity and shifting weather patterns that impact farming. **Results:** extreme weather continues to expand. I spent a lot of time thinking and reading about this topic in 2013, and will defer here to the article I wrote on Sustainability in the December 2013 issue of The Actuary.
- 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. I'm starting to worry more about an atmospheric river event in California. **Results:** thank goodness it wasn't worse this past year, but Hurricane Haiyan, wildfires, flooding and convective storms created their own furor.

- 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? Are there unintended consequences and systemic risk associated with the “giving pledge” by the rich? **Results:** the IPCC report shows that scientists are statistically certain that mankind is driving the higher temperatures, although unintended consequences abound. The sea is absorbing more of the heat than expected, and using 1998 as a base year has turned out to be misleading as it was an especially warm year for its era. This is yet another example where looking at all the data graphically can counter those who want to lie with statistics. Population continues to exacerbate the problem. Some estimate the earth already holds three times as many people as is sustainable.
- 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. I have found that those who have strong investing abilities choose to avoid leverage. **Results:** margin debt is revisiting levels not seen since 2008. Not a good sign.

Top Actuarial Issues

- Defined benefit plan valuation – valuation methods need to be revamped. **Results:** still a problem, though municipal plans are currently the headliners. See my November 2013 newsletter.
- Capital requirements – call it Basle, Solvency II or PBA – regulators and practitioners aren’t compromising so we end up with tools that don’t work. Trying to implement reserves before capital is just crazy talk. **Results:** IFRS implementation is expected to be very expensive. In the US regulators have delayed updating assumptions around simple fixes like C-3 Phase 1 capital (for annuities) for years and now the changes would lead to material increases in capital requirements so expect the insurance industry to fight them. They would have been better to encourage an earlier adoption as they ignored the higher capital cost in their pricing.
- Product design – be sure to look at exposures if hedges are not available.
- Obesity/smoking – how will the various drivers of mortality and morbidity interact (some good, some bad)?

Strategic Scenario Planning

Look at scenarios qualitatively and graphically in addition to quantitative focus. Consider a combination of several deterministic scenarios, including one where the Wall Street tool kit is not available.

- Higher interest rates and inflation: grade 3% per year until you get to 12%

- Qualitatively consider 20% inflation environment
- Flat equity markets combined with higher inflation
- Falling dollar – combine with high interest rate scenario
- Global climate change – how will this impact your business and suppliers
- Liquidity risk – consider your largest markets and what would happen if they dried up or were regulated out of business. Have you accepted risks that you thought were mitigated?
- No diversification is allowed between risks

Results: firms should include a low interest rate scenario as they consider potential futures. Goldilocks (slow up) is a fairy tale.

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