

Newsletter – 2013 Predictions

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 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 specific topics. Most discuss 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.rudolph-financial.com about 6 months after they are released to subscribers (predictions have a more timely release).

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

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
- 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
- Fracking is declared illegal due to environmental impact
- China erupts in civil war
- Greece or Germany leaves Eurozone
- Venezuela erupts in violence, shutting down their oil industry
- A virus develops drug resistance and becomes transmissible by air
- War erupts in Asia with battles over resources, with China the aggressor

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.
- Immigration reform: both political parties will reach out to Hispanics through legislation to set up the 2016 election.
- 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 1426. 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.

- 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.
- 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.
- 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.
- 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.
- 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.

- 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.
- 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.
- 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.

Emerging Risks - Concerns

- Levees in California, earthquakes/volcanos, water poisoning of NYC, cyber hackers.
- 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. I'm starting to worry more about an atmospheric river event in California.
- 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.
- 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.

Top Actuarial Issues

- Defined benefit plan valuation – valuation methods need to be revamped.
- 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.
- 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

Warning and disclaimer: 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. Have fun!