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Monetary Policy, Telling a Story and Ebola

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Systemic risk of the highest order

It is my belief that neither interventionist (Keynes) nor hands off (Hayek) methods are always correct. It depends on the current environment and what works will cycle over time. We did not exit the Great Depression due to spending on infrastructure, although the Ken Burns show on the Roosevelt clan makes it clear to me that infrastructure built during the 1930s did have a major role to play in growth after WW2. Some argue that war spending brought the world economy out of the economic blight, but I hope it's no truer than an argument that heavy mortality prior to 1920 and 1945 led to growth cycles. In recent times there has been so much government intervention that no historic period can be used for guidance. We are in new territory, and it is scary. For those who have saved for their future, the biggest risk is that politicians will screw it up. It strikes me that this is similar to an argument during the Cold War but with social breakdown replacing nuclear obliteration. A complete melt down of the social order, returning to a Wild West mentality, would destroy everything built up over centuries. Part of me fears for this, while another part assumes this is part of yet another cycle. We think today's partisan politics are something new, but during the Adams and Jefferson Presidential terms it was a lot worse. At least we haven't had any duels involving administration members lately (Aaron Burr/Alexander Hamilton).

I recently listened to Keynes Hayek: The Clash That Defined Modern Economics, and recommend it to others as background reading. I did not realize they knew each other well, and the personal histories and how they interacted with others was very interesting.

Velocity of Money and Reserve Currency

If the velocity of money was a constant, we would be in a highly inflationary period today. But it clearly isn't, and the current figure is at the lower end of historical results. Right now Ben Bernanke can't refinance his mortgage, which reflects more on the underwriting process, but this shows how unwilling banks are to loan money. Businesses are afraid to borrow and have accumulated huge stashes of money, some domestically and some overseas due to tax concerns. It seems like trust in the system is the driver of VM, but how do you measure that?

The dollar remains the world's reserve currency, although others would like to see a weighted mix of currencies or the emergence of a regional currency like the ruble (Russia) or renminbi/yuan (China). This won't happen until China untethers from the dollar and Russia becomes less dependent on commodities. A wild card in this discussion is those who want to return to a gold standard. While gold has no economic value except that it is a stable element that doesn't rust, its purpose is to keep politicians in check as they are limited in their ability to print money. This ties back to the Keynes/Hayek cyclical discussion as a gold standard makes less sense on its own but when the corrupt manage the economy with short time horizons and stay in power when things appear to be going well it incents them to spend more. This is easier to do, and for a longer time, in the country that has the dominant reserve currency.

The Importance of Telling a Story

At the ERM Symposium in early October there were lots of modeling sessions. As I listened I felt the importance to translate the model, both input and output, into a story to manage risk. Stochastic analysis is useful, but often represented by a single number as if that represents everything important. Unless I know the assumptions underlying the model, including the discounting methodology, I might get the wrong impression. Graphics, including some of the intermediate results, are much more useful to senior management, the board and stakeholders. The same is true for stress testing. Explain why you think a scenario is important and a driver of my results. A stress test is not universal. What matters to your block of business may not be what is important to mine. ORSA does not require stochastic analysis. I'm not convinced it even needs all that much quantitative analysis. Qualitative analysis is much more important. Make sure you understand the risk profile, identify key risks, and the drivers of those risks so you know the threats to your objectives. The ORSA methodology should work for all - public companies, mutuals, fraternals, private equity firms and privately held firms. Set your objectives (risk and return), taking into account any defined constraints.

I very much enjoyed the networking at the symposium this year, catching up with old friends and meeting new ones. It is very refreshing to cross paths with someone who has read one or more of my papers and where they have influenced the way they deal with risk.

I am hearing the term "Three lines of defense" more and more, and it concerns me. There is no "one" way to manage risk. In this method, the lines of business are the first line, the risk department is second, and the auditor is third. This method tends to define ERM using the COSO framework, which is useful but not complete. At many companies there is no risk department, and while the audit function is important they rarely have the skill set to truly manage risk by using contrarian methods. Their focus is on controls, not being skeptical of the overall strategy. As long as someone owns the risk, and it is not passed off to someone else as soon as the sale is made, you have the foundations of a strong risk process. Someone needs to independently review what the line does and look at aggregation of risk across the firm. This can best be thought of as a board process, with a risk team and auditors both contributing.

Ebola

With the outbreak of Ebola in western Africa, principally Liberia, many are worried about a spread to the western world or the United States in particular. Much of the success will be luck as our border entry points are fairly easy to work around if you know how. (I don't know how, but based on historical data it seems not too hard for those who want to – in this case we might see someone who wants better medical care – what are you going to do, leave him in customs until he dies?) The bigger concern is twofold – one is that someone travels to an area not set up with isolation units like India, rural China or Russia. Worst yet would be for a terrorist to perform a form of suicide bombing where they infect themselves on purpose and then travel to a war zone like Afghanistan or Syria before developing symptoms. An opponent like ISIL may not have a moral concern with this tactic, and it could be used to travel nearly anywhere in the two weeks before symptoms appear.

Predictions

On September 22 I predicted on Twitter that the Alibaba IPO would represent a market high. At that time the S&P 500 closed at 1994, down from 2 days earlier when it closed at 2011. Let's see how I do. I haven't bought a stock since May, and have recently sold several positions, especially in the oil sector, so my money and mouth are aligned.

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