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Scenario Planning

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I have spent the last two years researching and thinking about interest rates. It seems like the most common expectation is the same as a best case scenario: that interest rates will slowly rise. How likely is that? Not very, in my opinion, and for most lines of insurance it is the best case. The scenario I worry about is one where rates dip below zero, perhaps for several years, then spike. I believe there are two ongoing cycles. Long term, demographics and sustainability seem to point toward lower interest rates. But the world is awash in debt and manipulated markets, which eventually need to clear. This provides upward pressure. Will governments allow massive defaults, or lose the trust of the citizenry and allow hyperinflation to wash away the debt?

If rates dip, many bonds will default as the economy goes into a recession that catches those with leverage off guard. Hard as it would be to live through, I think if the system was allowed to clear quickly that growth would resume. Will this improve trust in the financial system? Or will the velocity of money explode and hyperinflation result? Stay tuned.

What if I'm wrong? This never gets asked when setting up base projections for incentive compensation. Insurer investments are typically shorter than liabilities today, assuming rates will increase. But their base projections do not use a matched portfolio. They have accepted more risk than they have shared with their senior management and board.

The New Normal

Am I better off in a 5% deflationary environment paying -2% when issuing a bond or in a 2% inflationary environment with a 5% return on the bond? Both have 3% real returns. I think it plays out the same but we don't think that way and we don't build stochastic generators that way.

Levels of adversity

A topic of interest during our ASB calls, and a subject Dave Ingram has written about, making it clear how bad a scenario is can do nothing but make analysis more transparent. Statistics like Value at Risk tend to use recent data and assumes it is typical. It results in too little being held during good times and too much in bad times. It is procyclical and does not include a process to fix it. Here is the wording the standard is suggesting.

a. Level of Adversity—Scenarios and stress tests may be insurer-specific or systematic. They may consider several levels of adversity, with the severity of each level defined, such as

1) periods of normal volatility;

2) a scenario representing a plausible disaster; and

3) a scenario representing an extremely unlikely adverse scenario.

Resiliency

Risk management is all about building resilience into an entity, whether it is government, company or individual. The next disaster is likely to be something we have not prepared for or experienced in the past. Risk managers should plan to bend but not break, preparing to survive an initial onslaught.

I wrote an essay in 2013 arguing that we should worry about the impacts on climate whether man made or natural cycles. If we ignore the issue because a just God would not do this to us then we have forgotten past wars, pandemics and flooding. We need to make sure we consider not only mitigation, but adaptation. Resilience is the key. In Collapse, one of the historical anecdotes Jared Diamond discussed dealt with northern Europeans attempting to settle in eastern Canada long before Jamestown or the pilgrims. They landed during a relative warm period and set up as farmers. Their timing was initially good, but they refused to adapt as the climate cooled. Eventually they all perished while native Americans survived in the same region. The Europeans were not resilient.

Tomas Sedlacek (@atomsedlacek) was quoted as saying *As a society, we've been trading sustainability for growth, and this leads to more economic volatility*. We need to seriously consider comments like these and figure out how best to move forward.

Manipulated Markets

The financial markets have been influenced by central banks and government spending in ways that are not stable in the long term. Unfortunately the markets treat these manipulations as if they had not occurred and recent history is assumed to be realistic as a proxy for the future. We saw a great example when Swiss francs lost the ceiling forced on it by its central bank. When market pricing returned, the markets moved quite suddenly. VaR can be a great regulatory tool, but why does anyone manage their business using it? Stress scenarios that show where exposures make you susceptible to change are much more useful. Leverage combined with rapid change always ends poorly.

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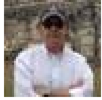
Expectations and Tweets

Jim Rickards posted a tweet on February 10, 2015 that was very thought provoking for me given that larger government implies slower growth.



Jim Rickards (@JamesGRickards)

2/10/15, 9:40 AM
Low growth lowers inflation, which raises real rates, which slows growth, which lowers inflation... #WashRinseRepeat #ZeroRatesForAll

Another tweet that I really liked came from Worth Wray of John Mauldin's team.

Worth William Wray (@WorthWray)

1/11/15, 1:40 AM
At @iCIOsummit '13, Jim Grant told me something VERY important: "Successful investing is having people agree w/ you... later."

This is similar to my investing philosophy – "I have a longer time horizon than you do."

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!