Don’t Touch the Jenga Tower

By Kerry Pechter *Fri, Nov 20, 2015*

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Arriving at the Society of Actuaries Equity-Based Insurance Guarantees conference in downtown Chicago last Sunday, I greeted the host, Ravi Ravindran of Annuity Systems, Inc. He asked me, in a gesture of cordiality, what I’m currently writing about.

When I mentioned interest rates (among other things), the person sitting next to Ravindran, an actuary at one of the top 10 annuity issuers, whom I had never met before, virtually leaped out of his chair. He said that, contrary to his employer’s official position on the subject (which is that mean-reversion will restore rates eventually), he’s sure that the Federal Reserve won’t raise short-term interest rates in December.

In fact, it’s unlikely that the Fed will raise rates at all in the foreseeable future, he said. As evidence, he didn’t cite feeble GDP growth or a strong dollar or our aging society. Instead he mentioned the towering Jenga-pile of leverage in the U.S. economy. Since this is what I tend to believe, and since validation is so gratifying, I leaned in and listened closely to what he had to say.

If interest rates go up, he said, the prices of existing bonds will be instantly adjusted downward. Eventually, so will the prices of things that are financed with borrowed money. A deflation in asset values will be more or less devastating for those who have borrowed against them. Inflation is a debtor’s friend; deflation is deadly. And deflation is what higher rates could produce.

“We’re stuck,” was the actuary’s verdict. The U.S. has backed itself into a corner. Low rates have made it possible for households to carry $12 trillion worth of debt, and to support the highest-ever prices for homes and for equities (which are backed by almost $500 billion in margin debt). Even a small rate hike, by signaling that the 23-year bull market in stocks and bonds is truly over, might therefore bring the Jenga pile down.

Judging by recent public comments at Project-Syndicate.com and the Financial Times’ website, my new friend isn’t alone in believing that a rate hike is unlikely this year. But most other observers think the Fed doesn’t *need* to raise rates. The actuary I met in Chicago was one of the few who believes that the Fed *can’t* raise rates. In his view, the current economy may look static—but only in the sense that, say, a spring-loaded bear trap looks static.

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