The Resurgence of Catastrophe Bonds and Fed’s Ultra-Low Interest Rate Policy –
An Analysis through Optimum Allocation in the Catastrophe Space

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Abstract

Cat bonds now command the fifth highest cumulative return among major global asset
classes since September 2008, and a recent Wall Street Journal article reports that “Investors
embrace ‘Cat bonds’”. We discuss how Fed’s ultra-low interest policy with three phases of
quantitative easing has been the driving force behind the resurgence of Cat bonds, inducing a
new normal in the catastrophe space with decreasing cost of insuring tail peril. We show, by
deriving and implementing a novel optimum allocation model in the space across the tailor-
made traditional reinsurance market and the capital market, how Fed’s policy has impacted the
allocation toward significantly less traditional reinsurance but more Cat bonds, underpinning
the rapid growth of the Cat bond market and inducing “convergence” between the two markets
in pricing and reaching equilibrium.

\textit{JEL} classification: G20; G22
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