Distinguishing Signal From Noise

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"The idea that the future is unpredictable is undermined every day by the ease with which the past is explained."
Daniel Kahneman (1934 –), Israeli American psychologist and economist

Jerry Seinfeld, the renowned comedian, took the world by surprise in 1998 when he announced that he would be ending his popular Seinfeld show just when its viewership was at its all-time record. Even more astonishing was that he had declined a startling $100,000,000 offer to produce one last season. He later went on to remark that "even if the public wanted more, the public is not in show business, so you should do the opposite of what the public wants. There is a reason they are not in show business."[1] If we were to use the stock markets as an analogy, this would be akin to taking profit on the entire portfolio at the latter stages of a major bull-run, just when things couldn't be looking any better. It does require extraordinary effort and discipline to execute, if only because it runs counter to the allmighty "herd mentality" currents that tend to direct our thoughts and actions.

But this was no gut-driven decision taken on a whim. It demonstrates a high degree of wisdom and skill to not only be mindful of the multiple cognitive flaws that affect our decision making in negative ways, but also the need to remain focused on the ever elusive "signal" amidst all the noise (not an easy task when almost everything around you is suggesting otherwise). Now if everyone behaved like Seinfeld, pulling out right at the peak and imbued in complacency, wouldn't that spell the end of market booms and busts? Maybe so, but such a scenario would never occur for the simple reason that it runs counter to our nature. Since we almost never really know if we have reached a peak until after we experience the decline, our inherent greed and curiosity will invariably drive us into pushing the boundaries, until it is too late to profit from it. In that sense, it would seem that booms and busts are here to stay.

We devise fancy formulas to calculate the "intrinsic" value of stocks at any given point in time, so that we can create order out of the perceived "chaos" in our complex, multi-faceted world. We do this because chaos is a generator of volatility, one of humankind's greatest scourges, but that "order" is mostly illusionary when most of the figures that are fed into the said formulas are themselves tainted by our inherent biases like the overconfidence we tend to place in our abilities to forecast the future. Drawing greater awareness to these biases should in theory help diminish volatility, but what about the other factors influencing our decision making that are not as apparent[2]? We all know that people differ in their opinions on just about everything, if only because of differences in temperament and experience.

[1] https://medium.com/the-mission/how-to-go-out-at-the-top-9263bc6dcb64
[2] https://www.bloomberg.com/news/articles/2021-05-18/-noise-by-kahneman-sibony-and-sunstein-has-one-very-big-idea

Two individuals are likely to come up with very different conclusions when presented with the exact same problem. This is known as "level" noise which is readily observable in almost any setting[3]. Less known are the variabilities that can occur within an individual. There is "pattern" noise which looks into the small deviations in a person from their "typical" views. You might, for example, be more bearish than average on cryptocurrencies, but then turn outright panicky just because Elon Musk tweeted that he no longer supports Bitcoin because of its carbon footprint. And then there is "occasion" noise which explores the influence of "mood" on our decision making. Mood, it seems, is an underestimated powerful influencer of judgment. Being in a good mood when entering a negotiation is known to yield more successful outcomes, but it can be a double-edged sword because good mood can also make us more gullible and therefore more prone to deception in certain settings.

Studies have shown that the severity of a sentencing imposed by a judge can vary, sometimes significantly, depending on the weather conditions at the time[4], just like a doctor is apparently more likely to order a battery of tests on the same patient on an early Monday morning than on a late Friday afternoon. If being in a good mood makes us more prone to risk taking, that would also help explain the irrational exuberance that are typical precursors to the formation of stock market bubbles. Maybe that same noise explains why we tend to be least proactive on dangers we face over the longer term, such as pandemics or climate change. If the technologies at our disposal can shield us from becoming more directly involved and affected by such threats, surely it also diminishes any sense of urgency we may conjure in combatting them.

The real danger with mood is that it doesn't take much effort to change, which means that big tech can very easily build them into their algorithms. Imagine the havoc they could cause, armed with such influence and control on our behavior? Jerry Seinfeld demonstrated great wisdom in exiting when he did, right at the peak, because even though the success would likely continue, it would do so in decline. He had overcome his overconfidence and the many other biases he most certainly must have felt at the time. He also seems to have kept his "mood" in check, how else can you explain his passing up a $100 million check? This was a man that was clearly focused on the signal amidst the noise and if there are any lessons to be taken from this, it would be to be a bit more mindful of your current state of mind before making an important decision.

Where Do We Go From Here?

Markets of late have been jolted by the specter of inflation, as large-scale vaccinations and warming temperatures appear to be markedly diminishing the pandemic's effects, prompting governments across the globe to relax some of the more stringent rules that were put in place to counter it. This, in turn, is boosting household sentiment, leading to a sharp pickup in consumption demand for many of the sectors that had been hit hard by COVID imposed lockdowns. The sharp rise in demand is not only creating substantial bottlenecks across supply chains that had spent earlier months diminishing their capacities, the spike in commodity prices is also translating into higher input costs, leaving manufacturers with little choice than to hike prices in the near term.

Accommodative monetary and fiscal policies are also further accentuating the inflation worries, adding pressure on governments and central banks to take action just as we enter a more delicate phase of the recovery. The observed inflationary pressures are to be expected, as supply gradually adjusts to the sudden shift in demand in coming months. What is less certain, however, is how inflation expectations for the future are likely to evolve. The longer it takes for supply to adjust to the pent-up demand for consumption, the greater will be the risk that inflation expectations become permanently anchored to a higher level, which won't bode well for stock markets.

Markets are also being jolted by the "noise" that has been building up for more than a year, as zero commissions and fractional trading are empowering less experienced, activist-type investors to get their voices heard, creating an

[3] https://www.oxfordrisk.com/blog-posts/introducing-noise-audits-for-financial-advice
[4] https://thepsychologist.bps.org.uk/weather-and-behaviour

additional source of volatility along the way. The recent sharp swings in bitcoin stock are also reflective of the growing power and influence of certain individuals and social media platforms, such as twitter, in swaying the markets in either direction. Expect more of this in coming months[5]. Even though the general outlook appears more encouraging than just a couple of months ago, significant potential headwinds remain on the horizon. As the production of vaccines continue to ramp up, the immunization of a wider segment of the population should contribute to further diminishing infection rates, but it won't take much effort to derail those gains if a more resistant variant emerges. This is why the recent pandemic-driven crisis in India is causing worries for the rest of the world.

The other major potential headwind is squarely on the geopolitical front. It appears that Trump has left a power vacuum of sorts that want to be exploited by the various belligerents across the globe. Is it just sheer coincidence that China appears to be bolder, more hostile and less conciliatory in its dealings with the U.S.? Or that the Middle East has once again become the flashpoint of armed conflicts? The recent forced landing of a European commercial jet by the Belarus authorities is yet another troubling event to add to the list[6]. After Trump's brazen leadership, Biden's style may appear relatively "soft" to autocrats, and whether that is just a perception or for real, it does open the door to a potentially more unstable future.

As mentioned before, how things unravel in the next couple of months holds the key to what the world will look like for some time to come. The pandemic and the ensuing lockdowns were such a shock that it led to what is known as the "before time" (see our July 2020 newsletter) in which we became conditioned to a "new way of life" that is so different from what came before, that even the beginning of last year appears more distant than it actually is. We are now entering the post-Covid world, a sort of hybridized environment that will contain elements of the pre-pandemic period and what has happened since. This certainly feels like a new era, as if the pandemic caused a partial reset of our more destructive ways, making us more aware of not only the immense power we wield but how to use it more wisely so that we can prosper over the longer term. Of course, I could be wrong, it could just be my mood playing tricks on me.

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[5] https://www.bloomberg.com/news/articles/2021-05-21/crypto-limps-to-weekend-after-hammer-blows-from-musk-china-tax
[6] https://www.nytimes.com/live/2021/05/24/world/belarus-ryanair-protasevich