# *Fragile Foresights And "Tilde" Shaped Recoveries*

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*"Now this is not the end. It is not even the beginning of the end. But it is, perhaps, the end of the beginning."*
*Winston Churchill (1874- 1965), British politician, army officer and writer*

Calamities are by their very definition unpleasant events. Whether in the form of a loss, lasting distress or severe affliction, we are undoubtedly better off without them. Mind you, not all calamities are created equal, they tend to come in different shapes and forms and even when they happen within the same context or circumstances (markets, economy, societal, individual), their signatures (origin, duration, ending) tend to differ, sometimes markedly, meaning that there isn't much that we can learn from them. In the absence of a distinct pattern, why bother "guestimating" the likely trajectory of a major crisis like the COVID-19 pandemic? Our internal wiring, a result of eons of being subjugated to the laws of natural selection, have conditioned us to be overconfident in our abilities to predict the future, to gaze into the stars and think we can make sense of it all, when it is just a foolish endeavor that ends up costing us way more than we bargained for.



Our biases cause all sorts of distortions, leading to costly mistakes that repeat themselves every now and then, after a sufficiently long period of time has lapsed, so that we forget or ignore those mistakes. When firms release their earnings results and we compare them to analyst forecasts, why do we systematically look at the results relative to the forecasts and not the other way around? If we frame the earnings results in terms of whether they are beating or missing analyst estimates, it invariably must mean that we are going to be ignoring the "elephant in the room" which is the quality of the forecasting. Now being overconfident in our forecasting abilities does not necessarily mean that we are going to miss the mark all the time, just like overestimating our driving skills does not mean that we are going to have an accident, although it does raise the probability.

Forecasting is not entirely useless, however, it does tend to work well in certain, vacuum-like conditions, e.g. when the environment is relatively calm, economic visibility is good and there is some sort of steady, directional momentum going on in the markets[1]. It works much less well when we attempt to predict the occasional outlier "time bombs" that creep out of nowhere, but, with hindsight bias, make it seem obvious once the harm is done. There are studies suggesting that these unpredictable "time bombs" may in fact be occurring more frequently and at larger scales, because the integrated and networked world we have constructed is thought to be causing far greater systemic vulnerabilities than those of our more "decentralized" past[2]. By not accounting for the dangerous effects of concentration in our models, we are seeing the world through flawed gaussian distribution tables instead of ones with "fat" tails.

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[1] The long-lasting bull market streak that followed the 2008 market crisis is a textbook example of conditions (deleveraging, steady liquidity infusions, low inflation) that provided good enough visibility for existing models to work.
[2] http://jasss.soc.surrey.ac.uk/9/4/9/9.pdf

The past may be a poor predictor of the future given that we live in a world that is neither static nor linear, but that doesn't mean we should dismiss it outright. Recessions tend to take place abruptly, soon after markets slide into bear territory, whilst recoveries from recessions are always more gradual, requiring a significant amount of hindsight before we even realize that we are in one. Armed with the knowledge that recession type conditions occur every decade or so and that we don't really know at what point the economy has bottomed and reverted to the process of recovery, provides valuable insights for investments[3]. Attempting to time the markets is not only futile, but frequently a costly exercise, since we are never going to get it right most of the time and in those rare occasions where we do, we risk becoming complacent and recklessly overconfident.

What we should be doing instead is ensuring that our portfolio of investments contains some form of safety mechanism that remains active <u>at all times.</u> This will ensure that a corrective shock, when it does eventually happen, will end up causing less of a drawdown than otherwise. We should also be ensuring that the portfolio has some sort of "rebalancing" mechanism and that it is applied when market conditions warrant it. This is especially true during a slump like the current one, given that we are never going to know that the economy is in a recovery phase until it is well under way. Granted, it is never easy to execute a task that appears to be counterintuitive, to build positions when everything is crumbling around you or get rid of them when they are performing, but this is the only truly effective way of maintaining the risk profile within a tight range.

Stock indices and bond market yield curves are frequently used as "leading indicators" for the economy, appearing to carry predictive power that can be actionable. Not long before the pandemic brought the world's economies to their knees, yield curves had already inverted on more than one occasion, a known forewarning of possible recession on the horizon and stocks also tanked before recessionary figures made the slump official. So, if leading indicators do contain foresight, shouldn't we be expecting an economic recovery soon, given that stocks have been recouping most of their losses in the last couple of weeks? It's actually misleading, it might have been the case in a distant past, when the composition of indices was more reflective of the local economy, but things have changed substantially since. Today, most of the constituent heavy weights of indices are almost all global tech firms, which means that the causative relation to the domestic economy may no longer apply[4].



### ***Where Do We Go From Here?***

The post pandemic world-order is shaping out to be very different from the one we knew before it, a variant "new normal" environment that is still in the process of unfolding. We still don't know the longer-term effects of various social and political behavioral changes from the COVID-19 fallout. We don't know right now much about their acute effects and the more permanent ways in which they will be affecting economies, in what time frame and at what pace the recovery will take place. If there are any lessons to be drawn from previous downturns, it would be that we can expect a substantial lag between the start of a recession and the point where it reaches a bottom. These second and third "order" economic effects mean that the worse is likely yet to come.

You would expect that this time around will be different, because the source and effects of this crisis are so very unlike previous ones. A near standstill of large segments of the economy for a considerable enough period, occurring almost parallel to a sharp curb in spending, have created powerful headwind-causing negative feedback loops that we are not really prepared for. This is a distant "outlier" event for a distribution curve the shape of which we are not even certain about. If a large chunk of the real economy (transportations, retail, restaurants) came to an abrupt standstill and remained so for some time, their recovery is in contrast going to be much more gradual, constrained not only by the

[3] This is the difference between forecasting, which is based on the false premise that we can actually predict the major events that matter most, and expectations which is drawn from looking into the past and extricating certain cyclical patterns that are likely to repeat themselves over time. We know with reasonable certainty that they will repeat themselves; what we don't know is when exactly this will happen.
[4] https://www.nytimes.com/2020/05/10/business/stock-market-economy-coronavirus.html

cautious, stepwise approach imposed by governments, but also from the time-decay consequences of remaining idle for the more vulnerable smaller businesses.

This is where the real dangers lie, the cascading effects that can arise from a sharp and lasting curtailment, emanating from the various sources of income. The massive layoffs and rapidly shrinking profit margins of firms, not to mention the more vulnerable smaller businesses on the brink of shuttering, could lead to a substantial drying up in taxation revenues for government entities, which, over the longer run, will force slashing expenditures, feeding into a spiraling negative feedback loop. The banking sector, despite entering this crisis well-funded, will also be seeing its income shrink, as a growing share of loans stand to degrade or become nonperforming. This means that they could be heading into something similar to 2007, where growing default risk led to a credit crunch, triggering government bailouts and further impairing the longer-term recovery.

Many businesses that in normal times would be thriving, are now facing the risk of bankruptcy, the consequence of an economic landscape that has changed so radically in a very short period of time. The shape of the recovery will be defined by the interaction of various competing forces, foremost of which will be how governments tackle the challenges ahead. The U.S. and European monetary and fiscal responses have so far been swift and substantial, a bid to attenuate the risk of a deeper slump for the economy. The negative feedback loop from cascading events, combined with the pandemic-induced behavioral changes and the lingering uncertainty about what happens next (will there be a second wave?) means that we can expect strong headwinds over an extended period. This is why the recovery is more likely to be tilde-shaped instead of the more traditional L, U or V recoveries observed in past cycles.

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