Beware The Subtle Inflection Points

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"It is an easy thing for one whose foot is on the outside of calamity to give advice and to rebuke the sufferer."
Aeschylus (c.523 BC - c.456 BC), Ancient Greek tragedian

Every so often, the world experiences an event so major that it causes an inflection point in its wake, triggering a series of significant changes in the undercurrents which end up transforming our lives in such profound, lasting ways that we forget what life was like before[1]. Amongst the greatest of such events over the past century are the two World Wars, and without diminishing the horrific cost in lives and suffering they caused, the major inflection points that arose from them have led to such far-reaching social, political and economic changes that it is difficult to fathom how different the world would have been if those events had never taken place. Multilateralism and global trade, the welfare state, antibiotics, targeted cancer therapies and the internet to name a few have origins that can be directly traced to activities during the war periods.

Inflection points can be triggered by two main types of events. There are those caused by nature (earthquakes, volcanic eruptions, meteoric crashes, pandemics, solar flares) and the ones that are entirely man-made (nuclear, EMP or biological warfare and, soon to come, weaponized sentient AI). Humans have had experience with most forms of both categories of events, that have caused varying degrees of destructiveness across history. Some of these events have led to revolutions, upheavals or other major political and social changes, whilst others have brought about the development of wondrous technologies that have upended our lives in unimaginable ways. Thankfully, none of them have driven our kind to extinction: catastrophic events caused by nature are exceedingly rare, whilst for those created by mankind, credit should be given to our need for self-preservation, our instinct for survival and resilience in face of adversity.

These two main categories of events (natural or manmade) can be further classified into a subset of events determined namely by the time over which they develop. At one end, you find events the effects of which are almost instantaneous (like a nuclear attack). At the other extreme you have events that manifest themselves over periods spanning years, decades or even centuries (e.g. global warming). These very long to develop events are dangerously deceptive in the sense that their very slow progression blunts our sense of urgency in tackling them. Global warming is a phenomenon that has been occurring over more than a century, yet it is only now that we are becoming aware of the damage we have been causing and the massive inflection point ahead of us.

Integrated circuits introduced in the 1960's are another example; they ushered us into an era of exponential acceleration in computing power, a dynamic inflection point that has led to the rise of trillion-dollar giant tech companies exhibiting

[1] See our July newsletter entitled "The Before Time" for more on this.

monopoly-like dominant powers. The rapid and accelerating pace of change has meant that governments are falling dangerously behind in introducing legislation to better regulate novel, increasingly complex and disruptive technologies[2]. This means that new laws are increasingly anachronistic and therefore ineffective by the time they are introduced, exposing us to unpredictable dangers from the sentient artificial intelligence systems or synthetic lifeforms or biological weapons that are being developed and tested in labs across the globe.

Inflection points also play a central role in the investments field through their effects on the economy and, by extension, the financial markets. The recent and ongoing pandemic has caused all sorts of social, political and economic upheavals, and whilst most of them are bound to subside over time, especially as we get a better grip of the crisis, others are here to stay. Not surprisingly, countries that had experienced similar challenges in the recent past (e.g. Taiwan with SARS) have fared better in coping with the COVID pandemic than those that had not[3]. Investments follow a similar pattern in that you tend to be better prepared for adversity if you have experienced one recently. In contrast, investors tend to have a greater appetite for risk taking during protracted bull markets, which is also why they are less prepared and suffer the consequences when conditions take a sudden and sharp turn for the worse.

It is usually following a sharp correction, arising from an unforeseen event, that the shortfalls in risk management become glaringly apparent, prompting some sort of corrective action. This is also where we tend to fall into another type of cognitive trap: our asymmetrical aversion to losses means that we are more than likely to overshoot in the opposite direction. We are compelled to adjust portfolio risk in an overly cautious manner, significantly lessening its effectiveness in capturing the rebound when it eventually happens. The inflection points triggered by events that take time to materialize can have profound and lasting effects on investments. Apple's meteoric ascent from around $300 billion to $2 trillion in less than a decade is of no random occurrence. It is much more the consequence of opportunities from the accelerating progress in technologies. One of the main reasons why stock market indices appear to be so detached from the "real" economy is also because of the increasingly dominant role the tech sector has gained over the more recent past.

Where Do We Go From Here?

The second half of the year appears to be increasingly uncertain on several fronts, in ways that are bound to induce at least some degree of volatility as we approach certain key dates. The U.S. presidential elections this coming November and continued disruption and uncertainty from the global pandemic are amongst the most significant near-term sources of volatility that come to mind. The stakes are high, the stark differences in ideology and leadership between the contenders mean that this event is bound to produce an inflection point for the U.S., with likely long-term repercussions for the rest of the world. Anything is possible now; four years of Trump presidency has pushed ideological divisiveness in American society to such an extent that even a peaceful transition of power is uncertain.

America's systematic withdrawal from international commitments on a whole range of key matters has fractured global cohesion, creating a giant power vacuum that is being exploited and rapidly filled by powers that are inherently hostile to democratic principles and free societies. In a populism-driven world, leaders have become increasingly protectionist and inward looking with their policies, which is also why the fight against the pandemic has been far less efficient than comparable challenges in the past. Governments have either resigned themselves towards doing very little to curb the spread of the virus itself, causing bigger death numbers and greater burden on their healthcare systems, or have been unwilling to share and coordinate their efforts with others, leading to a much less effective end result.

In these uncertain times of transitions and upheavals, the glaring appearance of a disconnect between the financial markets and the real economy must be disconcerting for many, but the indices are also misleading, because of distortions

[2] https://digitalcommons.wcl.american.edu/cgi/viewcontent.cgi?article=1028&context=aublr
[3] https://europepmc.org/article/med/32663795

caused in large part by the tech sector. Although most sectors suffered to varying degrees from the ravaging economic repercussions of the pandemic, the tech sector appears to have sustained very limited damage, as demand for their products and services have soared as a consequence of the confinement measures applied across many regions. The bottom line of the big four (Apple, Facebook, Google, Microsoft) has been significantly boosted, propelling their stock prices and, in turn, their respective capitalization weights in major indices. Multiples are now highly stretched, well above their historical averages, and given that many industries have still to experience the full wrath of the pandemic induced disruptions, this is bound to be another source of volatility for markets in coming months[4].

Another recent development drawing attention has been the sharp rise in demand for gold and other precious metals. This appears to be a direct result of a change in sentiment on the economic outlook that has shifted from over optimism to being more cautious. It appears that the pandemic and its economic effects will drag along for the long haul, making a V shaped recovery less likely, which also means that governments and central banks may be applying stimulus for some time to come. In these conditions, precious metals can provide a hedge against the risk of stagflation, which happens when liquidity is injected onto an economy that is facing strong headwinds[5]. The record ascent of precious metals makes them another candidate for stoking volatility, especially given that that current conditions are far from stable and could shift abruptly at any moment over the rest of the year.

One may wonder with all that is going on what a reasonable portfolio strategy might entail. The decoupling of the stock markets with the real economy cannot continue forever, the post-COVID world may have been a financially rewarding one for the bloated tech sector, but they also face other, non-negligible risks: as their power and influence continues to expand, they are increasingly drawing the ire and scrutiny of both the public and regulators. The risks are plenty, the nature of the uncertainties is bound to produce inflection points of varying degrees. Prudence is therefore in order, which means ensuring a sufficient degree of diversification for all, profit taking and a buildup of cash and low volatility reserves for some, and initiating way out of the money option positions for others. Stay tuned because what happens in the next few months could end up defining the kind of world we will be living in for a long time to come.

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[4] https://www.wsj.com/articles/the-median-s-p-stock-has-never-been-more-expensive-11598202000?mod=searchresults&page=1&pos=1

[5] More liquidity also means that interest rates are going to remain low for the long term which means that bonds, a competing investment to gold, will also remain relatively less attractive.