A Sloppy Thermostat

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"Luck, effort and ability are often indistinguishable."
Mieko Kawakami (1976 -), Japanese author.

It goes without saying that the sweltering heat of the summer has probably left a lasting impression on most of the inhabitants of our increasingly "climate change" prone planet, and not without cause. Thankfully, we have air conditioning units that can almost instantly transform the "unbearable" into something pleasant and with the help of thermostats ensure that they stay that way. All this is good in a vacuum, of course, but surely not in a world where fuel prices are remaining elevated long enough to put a dent in our wallets, where climate change is becoming much more than a footnote, and where an increasingly volatile war on the doorsteps of Europe is fomenting an energy crisis that appears more intractable than ever before.

If burning fossil fuels makes us existentially more vulnerable in the long run, and there is plenty of evidence for this, a breakdown in global supply chains caused by a toxic combination of pandemics, politics and war have created a certain sense of urgency to tackle the multitude of challenges we face. With the energy crisis, what had until now been a predominantly "supply" driven issue (namely the scarcity of resources coupled with the effects of war) is increasingly spilling over to the demand side of the equation, as households are having to grapple with higher costs and governments, fresh out of the pandemic experience, explore imposing tighter restrictions to curb the emissions[1].

The current major undercurrents (pandemic, climate change, inflation, economic slowdown, war) that the world is facing may be leading us into a paradigm shift[2] of sorts. To borrow from the thermostat analogy again, it's like setting it to a temperature cool enough that we don't perish but higher than to our liking, so that its damaging effects on the environment are diminished. Remember that a thermostat is a moderating tool of sorts: its purpose is to ensure things don't drift into the extremes.

Nature also comes with its own built-in thermostat, a powerful self-regulating system that intervenes when a condition overshoots its "normal" state, pulling it straight back to where it should be[3]. Temperatures can reach extremes on both ends of the scale, but they gravitate along a certain mean value (there is growing evidence that the average is also shifting over time) because otherwise life in its current state could not be sustained. Same goes with stock markets, there is an invisible regulating force; when things drift into the extremes, even if they can remain there for a while, they do eventually come back.

[1] https://www.nytimes.com/2022/08/22/world/europe/france-private-jets-restrictions.html?searchResultPosition=1
[2] https://www.npr.org/sections/13.7/2016/07/18/486487713/what-is-a-paradigm-shift-anyway?t=1661182290599
[3] https://www.eurekalert.org/news-releases/696923

Investors tend to become aware of bubbles only after they have burst. Their "formation" phase, as with climate change, can take long enough that by the time an inflection point has been reached, complacency has blinded us to the dangers. The thermostat in this case may seem sloppy, but it's still there and a reversion to the mean does eventually occur. We get overshooting because of a series of deep-seated cognitive biases that make us overconfident[4] in our decisions, actions and abilities to the point where it does more harm than good. The pleasure of achievements (passing a tough exam, winning an election, picking the right stocks) is such that we forget to appreciate the significance of chance.

A successful entrepreneur is likely to exhibit traits of overconfidence, ambition and determination, which will at some point lead him to go overboard, causing setbacks or even worse. The Forbes billionaire list with a roughly 60% turnover rate per decade says it all. Likewise with politicians; history is replete with examples of overly ambitious leaders of the typically autocratic blend, dragging their economies from the immense success of earlier years to ruin (Putin is just the latest example). In all these cases, the "thermostat" is certainly not broken, the real problem is in the lag for it to "kick-in", by which time it may be too late.

It seems that our overconfidence biases override reason to the point where those that can create tremendous value are also less likely of keeping it. That is because getting "rich" requires a very different, almost opposite set of skill sets from those needed to preserve those gains. If gathering wealth requires risk taking and self-confidence, keeping it entails vigilance and risk-averseness. The same cognitive flaws appear to be driving many of the events we are presently experiencing. A war with Russia with no end in sight, an overconfident Fed that now finds itself "behind the curve" and a stock market that, from a multiples perspective, is in a bubble. A bit of moderation on most of these fronts would go a long way, but who is listening?

Where Do We Go From Here?

Central banks are having to grapple with an inflation outlook that remains very uncertain at this stage, given the many factors affecting prices. Markets are anticipating further Fed tightening activity for the rest of this year, but next year appears to be very hazy. The sudden sharp recovery, after two years of pandemic driven lockdowns, caused major supply chain bottlenecks, triggering inflation. Conditions began to improve only to be blindsided by the conflict in the Ukraine, now in its sixth month, sending food and fuel prices on an upward spiral. Although the sharp rise in headline inflation has yet to trickle meaningfully into the core figures, there are worrying signs of price pressures spreading across a broader segment of the global economy.

With a war that shows no signs of abating, globalization that is clearly backtracking and the uncertainties from supply chain disruptions caused in large part by China's aggressive COVID containment measures, the inflation problem appears to be with us for the long haul. The perseverance of higher inflation also means that interest rates are going to remain elevated, which will cause additional headwinds for the recovery. Higher interest rates have also meant a stronger dollar, which has certainly benefitted the U.S. economy by lowering imported inflation, although the effect is somewhat mitigated through its negative effects on export demand.

The soaring dollar is also causing havoc in several of the emerging markets, forcing their respective central banks to drain reserves as they attempt to salvage their dwindling currencies. The risk lies in the persistence of a stronger dollar, especially for countries that are heavily exposed to dollar borrowings, but also because purchases for the more critical items, such as food and energy, are mostly conducted in dollars[5]. Sri-Lanka, unable to honor its dollar debt obligations,

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[4] https://en.wikipedia.org/wiki/Overconfidence_effect

[5] Emerging markets are burning through stockpiles of U.S. dollars and other foreign currency at the fastest rate since 2008, raising the risk of a wave of defaults across the world's most fragile economies.

has become a failed state. The risk of contagion is high, as others, including Egypt, Nigeria, Peru and to a lesser extent Turkey, struggle to steer their fragilized economies through growing uncertainties and turbulences in the global markets.

Stock markets have continued to climb despite a weakening recovery, continued inflationary pressures, rising interest rates and an outlook that is far less certain than just a few months earlier. Stocks have made gains mainly because earnings were not impacted as much as had been feared. Although inflation has clearly trickled into input costs, it has also given businesses greater pricing power, which is why earnings appear to have been less impacted by the headwinds. The stock markets are also skewed towards technologies, a sector that has been riding the demand wave, especially during the pandemic period. This disconnect between the economy and the markets cannot last forever however, and the longer economic challenges persist, the greater will be its gravitational pull on the markets[6].

Inflation and the global rise in interest rates mark the beginning of a new cycle. The months ahead are likely to be very different from what we have been accustomed to over last decades. There are a couple of significant “unknowns” at this stage that will chart the path for markets. Inflation remains untamed, which means that central banks run the risk of dragging economies into a hard landing recession. Russia is already in a deep technical recession, and although it appears to be relatively contained, the risk of contagion is elevated through the geopolitical repercussions of its conflict with the west. The world is increasingly splitting into a more overt rivalry between the “liberal” democracies of the west and the autocratic regimes in the east, which means we can expect greater political and economic frictions ahead.

Growing distrust and a lessening will to “integrate” will create powerful headwinds in the years to come. Reducing the geopolitical tensions and confronting the climate change threat effectively requires close cooperation and coordination, but the world appears to be going in the opposite direction. It is going to be tough for markets to match the performances of the past. What we are more likely to see are drawdowns and occasional “bull traps”. This is an environment for broadly diversified investment strategies, both across asset classes and within them, with a clear bias towards caution and minimal trading. The pendulum is swinging, but the thermostat has not been activated yet. Hang in there because these conditions could drag along for some time to come.

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[6] https://www.nytimes.com/2022/08/26/business/stock-market-jerome-powell.html