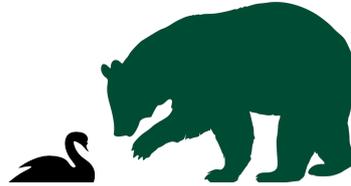


Black Swans And Bear Markets



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"Meanwhile, fears of a universal disaster sank to an all-time low over the world"
Isaac Asimov (1920- 1992), Russian born, American writer and professor of biochemistry

Yes, it was going to happen eventually: a market crisis followed by a global recession. The fact that we find ourselves in economic contraction should not come as a surprise. The preceding bull market broke longevity records and the market complacency "froth" had been accumulating for almost half a decade of herd-driven euphoria. One could also argue that we should be forgiven for failing to anticipate the gravity of the situation, before it morphed into the global pandemic train wreck, with still uncertain consequences for both the economy and society. How can we blame ourselves when recent brush ups with more lethal variants of the flu didn't bring us anywhere near what is happening today? Who would have thought that this time would be different?

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You might be wondering why I didn't mention the more distant past, when pandemics did happen, taking lives by the millions. The black plague and the Spanish flu caused unparalleled misery and economic destruction, but those were very different times and it is doubtful that much can be extricated from it. I should also mention that we suffer from a certain cognitive flaw in our "collective" memories, one that prevents us from giving sufficient consideration to anything that happened in the too distant past¹. What we are experiencing is truly singular, unprecedented! We could not have anticipated it, let alone prepared for it mainly because much about it remains uncertain. The two World Wars upended lives of entire nations, causing immense suffering for many, but they nowhere near brought manufacturing to an almost complete standstill. Unlike in the present crisis where millions are losing their jobs, employment was redirected towards the war effort whilst factories switched from producing diapers to making arms.

Globalization brought us the integrated supply chains, ushering manufacturing into an era of unmatched efficiency, as resources were put to their most efficient/productive use, opening the doors to economies of scale that could not have been achieved otherwise. Diversification in risk was gained by redistributing the various stages of production across the globe, meaning that businesses could better "weather" unplanned disruptions in any single link of the chain. But who could have imagined an almost complete stop in most of the links, just as demand was collapsing? This is the sort of catastrophic, unplanned for event that flew right across the face of logical reasoning. Investing has taught us to diversify, to avoid putting all "eggs" into one basket, meaning that your portfolio should contain many, preferably lowly correlated positions to mitigate risk.

¹ https://en.wikipedia.org/wiki/Availability_heuristic

Likewise, we would have expected the effects of globalization to have shielded firms from the risk of a single point of failure², but what about multi-point failures? This is like placing your “eggs” into various baskets and having most of them “fail” simultaneously. Unlike the pandemic itself, which should not be considered a black swan event because it is not as if such an event could not have been expected (even after taking into account our cognitive biases), its response, which has been to shut down production and force people into confinement, is where the real black swan lies. The occurrences over the last couple of months have exposed major frailties and failings in our systems, we appear to have been grossly underestimated the risk, wasting precious time in combating the emerging threat. There is a disturbing pattern in our nature that consists of poorly planning for catastrophic events that have low probability of occurrence (the so-called tail risks)³.

Only after such an event (such as an airplane crash) has taken place do we take action to mitigate its recurrence. Likewise, the pandemic crisis will undoubtedly lead to the introduction of a series of measures, whether it be by enforcing more stringent hygiene rules, comprehensive disease surveillance tools or more targeted drug developments, that will undoubtedly curtail both the economic and human costs of such events in the future. But we risk overshooting, by saving as many lives as possible, we don’t want to be destroying the economy, which would take even more lives with it. Some pundits have gone as far as questioning the drastic measures that were put in place, and whether we may have gotten carried away by panic, causing even greater long-term harm on the economy⁴.

Alas, all this won’t be of much use in preventing the reoccurrence of black swans. Such events are by their very nature impossible to predict (there will always be something out there that we didn’t think of, not to mention the complacency that will just amplify its effects). Perhaps there are other lessons that can be drawn from the pandemic crisis: Just as the SARS, MERS and Ebola epidemics were forewarnings of what could happen if they were allowed to spread, the COVID-19 pandemic might just be a “dress rehearsal” to something far worse, like the solar storm of 1859 taking place in the present⁵. It is certainly an extreme tail event, one that might have very low probability of occurrence, but because its consequences could be so significant, maybe we should be paying more attention to and preparing for such risks.

Where Do We Go From Here?

The world economy is now deeply entrenched in bear market territory, but it is how we got there that will make this recession markedly different from previous ones, which also means that it is currently almost impossible to predict when we reach the bottom or its likely duration. The consequences and effects of having entire sectors of the economy at a near complete stop, for what still remains an indefinite period of time (even though governments have started to announce tentative dates), is likely to linger for long after the crisis ends⁶. An external shock of this scale has prompted governments across the globe to deploy wartime-like efforts in a bid to reduce its negative economic repercussions, but we still don’t know if they will suffice to bring us back to a recovery path.

Governments are facing substantial challenges not only due to the fact that a significant proportion of the necessary resources to contain the “damage” was already spent on the prior crisis, the protracted duration of that crisis and the ensuing bull market driven “complacency” have also meant that not much was done to prepare for the next big one. Despite all the uncertainties surrounding the current bear market environment, there are a couple of observations/predictions that can be made on the basis of what has happened so far. The process to jumpstart the economy is bound to be a protracted one, there is still a lot that remains unknown and some confusion about the

² https://en.wikipedia.org/wiki/Single_point_of_failure

³ The accelerating discoveries and technological progress that have taken place in the last few decades, whether it was new drug discoveries and therapies or the emergence of AI and Big Data, have also played a role by imbuing us into complacency, a false sense of confidence in our abilities to face almost any kind of challenge out there.

⁴ <https://www.wsj.com/articles/the-lockdowns-were-the-black-swan-11587765416>

⁵ If something comparable to the Carrington Event were to occur in today’s technology imbued world, the consequences would be catastrophic, transporting us back to a world resembling the stone age.

⁶ The unprecedented drop in oil prices into negative territory is a perfect example of the distortions that a novel crisis with dynamics that have never been experienced before can cause. More such distortions are likely to appear in coming months.

pathogen itself (seasonal resistance, transmission rates, mutation risks), countries and regions find themselves at differing stages of the pandemic cycle (some are emerging, some have peaked, and other appear to be declining), emerging markets have yet to experience the full wrath of the virus⁷, and a potentially more lethal “second wave” of the disease might emerge if the process of getting back to normal is botched.

Then there are the economic implications of having governments and central banks using all means at their disposal to avoid the recession from turning into something far worse that needs to be considered. Money is being printed to keep firms afloat, confront mass unemployment expenses and prevent the stock markets from tanking, which means that deficits are going to be ballooning (a certain burden for future generations)⁸. The US economy is particularly vulnerable to this crisis not only for not having taken more forceful actions earlier in the crisis but also because of the damaging effect that collapsing oil prices will be having on the fracking industry that has gained significance over the last decade. A near stop in output for many sectors are also like a ticking time bomb, the longer the situation persist given that many firms have accumulated higher levels of debt over the years.

In Europe, apart from the longer term expansion in the budget deficit from the welfare actions that are being taken to counter the sharp rise in unemployment, it is the social and political ramifications of the disunity that the crisis appears to have highlighted that will be its greatest challenge in the months and years to come. The future of the European Union is clearly at stake: another departure à la Brexit would spell disaster. Things don't bode well for the rest of the world either, the social and economic ramifications of the pandemic are likely to be far more severe for emerging markets, given the limited means and resources at their disposal to counter it.

This won't be the end of globalization as we know it, what is more likely to emerge from all this is a resumption in the “partial” disengagement process that has been occurring for some years already. The pandemic has created an even greater sense of distrust amongst allies and foes, we should therefore expect this event to accelerate the push towards a “looser” form of global integration. A growing number of technology and healthcare products are already being earmarked as “strategic”, which means that they will be manufactured locally in the future. Households will also be emerging from the confinement experience much changed, whether it is regarding social norms or consumption behaviors, some things will be permanently altered. Businesses will have to adapt to a “variant” new-normal era or risk bankruptcy. The world is entering a “creative destruction” mode, with its many opportunities and threats that will become more apparent in coming months. Stay tuned!

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⁷ <https://blogs.worldbank.org/opendata/impact-covid-19-coronavirus-global-poverty-why-sub-saharan-africa-might-be-region-hardest>

⁸ These actions also risk igniting inflation which would create an additional barrier towards a full and sustained recovery of the economy.