CORE Comments

ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

April 5, 2011

The Triumph of Wishful Thinking

The resilience of the world's stock markets to the possible melt down at Fukushima and to the widening and violent revolts in North Africa and the Middle East is remarkable. But it is sensible?

The assumption seems to be that not much worse will come of the earthquake, tsunami and Fukushima reactors, and that the revolts and warfare will not cause more serious problems than already manifest.

This is a dubious assumption.

By

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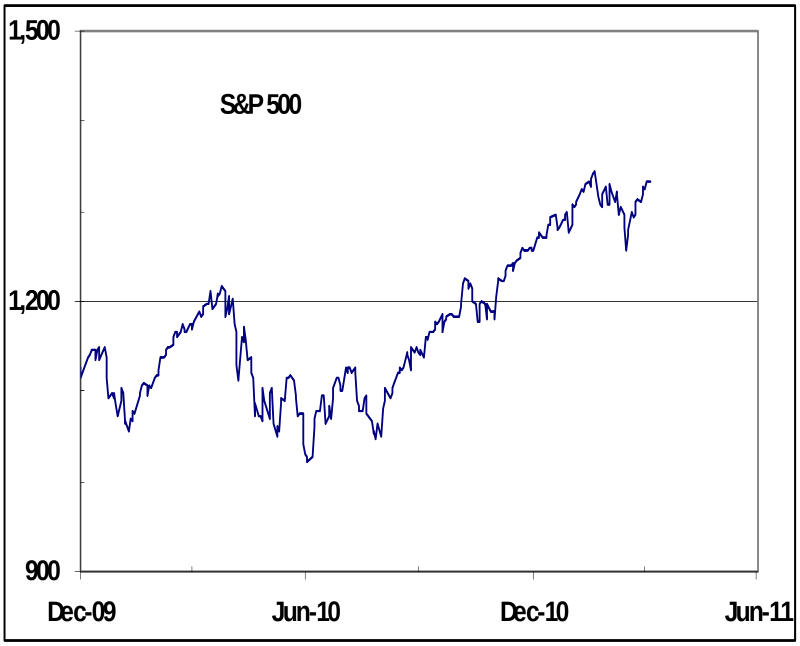
In the first three months of this new year, the world delivered about as much in the way of the unexpected and the unnerving as might be thought possible. The market's response? A brief--very brief--shudder, then a return to the drinks table. Is this the triumph of wishful thinking over common sense, or a sober assessment of risks presented by revolutions in North Africa and the Middle East and by the still-possible melt-down of nuclear reactors in Japan?

There is much in this economic and monetary environment to like and much to support strong stock markets. The recovery in the United States from the acute financial crisis and profound economic recession is still routinely described as 'fragile', but it appears increasingly robust. Last week's employment report provided modest upward revisions to the (already decent) January and February employment gains and reported a satisfactory increase in jobs in March. The Federal Reserve maintains its exceptionally accommodative monetary policy and continues its large Treasury bond purchase program, referred to as QE2. Despite the ever-present risks that Congress and the Obama administration will make a hash of fiscal policy in their fraught negotiations over budget matters, there is ever more reason to be confident that economic expansion will continue.

One must draw the careful distinction, in discussing the present environment, between its effect on people and its effect on capital. Despite the ostensibly improving job situation in America, it is obvious--and tragic--that there remain vast numbers of unemployed, under-employed and under-paid people in America. Moreover, prospects are poor for the creation of good, well-paying jobs in numbers sufficient to satisfy the demand for employment. The uncomfortable irony is that the very weakness of labor in this economy redounds to the benefit of capital. Those of us with money to invest are being well taken care of in the present economic environment.

The Problems. But even granting that the flow of economic reports and the Fed's monetary policy in the United States is favorable to capital, how are we to evaluate the insouciance of the financial markets to events unfolding in Japan and the Arab countries? Western powers have poured Tomahawk missiles onto Libya. Saudi Arabia sent troops to Bahrain to smother a Shia uprising there; the Assad family's four-decade Alawite regime in Syria now visits awful attacks on protestors; Yemen's president has said he would leave, but he has not; violence continues. In the countries in which revolutions have succeeded--Tunisia and Egypt--an uncertain path lies ahead. Will the secular and democratic forces carry the day? Will sectarian Islamist parties, having suffered grievously for decades, join secular forces in forming new governments and new societies? Probably--and then, what will emerge? Of course, all of this is unknowable, certainly to us in the United States. Libya had been a meaningful exporter of oil, but Saudi Arabia increased its production to make up cessations in oil exports caused by the civil war. there. What happens when Algeria goes 'offline'? When the Strait of Hormuz is mined to prevent shipment of oil from Iran and Iraq? Looking a little further afield, how brittle is Russia, now the world's biggest producer of oil? Well, it is brittle; and it is utterly dependent on its own oil and mineral export revenues; and it possesses an uneasy structure at the head of its government. Did the Russian people like the re-trial of Mikhail Khodkorvsky and his sentence to another long span of years? How did the governmental echelons right below Putin and Medvedev enjoy that spectacle? What lessons did business folks--Russian and foreign--take from that trial, conviction, and harsh sentence?



On the right side of the graph above, is the sharp, shallow and brief sell off that began in mid February and the swift recovery from it.

We shall see how all this unfolds.

The Market Response. One conclusion to be drawn is that the financial market response to all of this is strictly limited to the present. There is enough spare capacity in Saudi Arabia to make up for lost production in war-torn Libya; Bahrain is quiet now that the Pearl Roundabout has been cleared, however violently; riots in Syria are being met by stern resistance by Bashar al-Assad, but…. And, certainly, no one has yet dared to raise his or her head in Russia. Radioactive water is now being poured into the Pacific from Fukushima, but this is only a 'small' meltdown.

The financial markets, as shown by the sharp rebound in prices since March 16, the nadir of fears about all this, have voted to ignore the manifest problems and to look instead to the favorable economic and monetary conditions to support their expressions of the values of companies, commodities, and other assets. What might go wrong in this analysis may be ignored--until it does go wrong. In the last few months, as all this has unfolded, Core has moved some of your capital toward investments that stand to do well if things get worse in the Middle East, North Africa, and beyond. We have made new investments in oil-related securities, to benefit from already higher oil prices and against the possibility that oil could rise much higher in the next round of the unfolding dramas. We have cut investments in places and things we think likely to suffer from higher oil and agricultural prices. We have shifted toward export-oriented US companies, and away from the developing economies where higher prices for foods and oil loom much larger and more destructively than here.

Over my years working in financial markets, I have observed the proclivity of markets to ignore risks standing quite clearly before us and to focus instead on the similarly evident opportunities. At the risk of fighting the last war, one remembers that, in the autumn of 2007, when, despite the summer-time failure of two prominent Bear Stearns hedge funds deeply involved with mortgage-backed securities, the stock market rose to new highs even as the country entered its recession. It appears that we are in a sustainable economic expansion (and not about to slip into recession) and that a number of powerful companies will benefit handsomely. The prices to buy ownership interests in them is not terribly high, so it is reasonable to expect profits if we own them now. But, there is a widening set of revolutions in the Islamic world, where much oil lies. Thus the conundrum. Thus our caution.

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