

Black Swans

In my last Insight article at the beginning of the year, I said my only prediction was that it would be an interesting year. Within this first quarter, extraordinary happenings have occurred, making predictions even more difficult. The powerful events can be split into those caused by nature, and those caused by man (and woman). They both have economic consequences.



The catastrophic earthquake and tsunami in Japan make the earthquake in Christchurch, New Zealand seem inconsequential now, but not to those who suffered it. The economic effects of the Japanese earthquake are yet to be determined as it is too early and the nuclear reactor sites are not yet fully secure. Already however there are two distinct consequences: the physical damage and the psychological one.

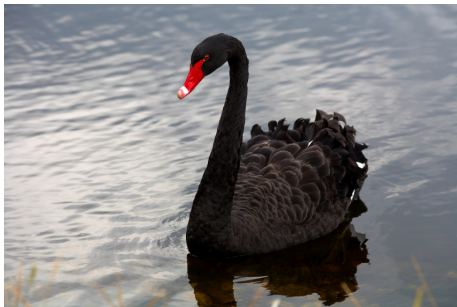
In physical terms the suffering of so many people is appalling. So too is the structural damage but at least that will be able to be rebuilt, albeit at a large cost. However the damage has meant the shut down of many engineering plants in Japan. Those engineering plants are not just producing end consumer goods in Japan, but components of all sorts of electrical and mechanical goods including parts that go into Volkswagen cars assembled in Germany, and many mobile phones. The financial crisis showed how interdependent we were in money matters and the Japan crisis shows how interdependent we are in physical goods which may affect the profits of many companies not normally associated with Japan.

Included in physical damage is the fact that a very large number of foreigners have left Japan fearing both further earthquakes and nuclear radiation emissions. They are not currently going back. This must have an immediate and serious effect on the economy, making some businesses inoperative.

On the psychological effect, the most damaging is the kneejerk reaction of some Governments to look again at their nuclear power programmes. Nuclear power plants produce much emotional reaction, not surprisingly since Chernobyl, but other power sources seem certain to run out (oil) or are themselves so polluting (coal) that it is difficult to see how the world requirements are realistically going to be met by any other method.

The Japanese stock market fell by about 20% in the first two days after the earthquake, but recovered some 15% after. World markets also fell but more modestly. The economic damage is difficult to assess, hence the volatility that has occurred. However Japanese shares looked relatively cheap before the disaster and fund managers are generally holding firm.

The dramatic event caused by humans is the rising up of peoples against unpopular Governments in the Arab world. Six countries have so far been involved, and the outcome from any of them is not yet entirely certain. Libya has involved the West with our intervention on humanitarian grounds. However the question being asked is how and when we withdraw. That is a question worth asking, but history would suggest that the better question to ask is what seeds are we sowing? Also are we able to afford this in the future? Can we afford not to?



The immediate economic effect has been the rise in the oil price which could cut Western and Eastern economic growth.

Could either of these dramatic events be predicted?

One of the very few sensible things that Donald Rumsfeld said was defining known unknowns and unknown unknowns. The earthquake in Japan was a known possibility. It is on a geological fault line, and earth movements are always a possibility. It is thus a known unknown. It is the severity and the timing that were unknown.

Similarly, although I have not been able to find any suggestion that anybody had a clue that it was about to happen, it was always a possibility that the Arab revolts could occur.

An unknown unknown is one where we can't even imagine what this may be. An example is the effect of asbestos related injuries on the insurance industry. Nicholas Taleb wrote a book called "The Black Swan", which essentially said that you can never make scientific predictions of what will happen as some items may never have happened before- thus making calculated prediction of them impossible. The title came from the fact that all swans were white, until some black ones were found in Australia. He forced the Economics world to re-examine its assumptions in their predictions.

However all such events including Black Swans also produce economic opportunities which may lead to much greater economic successes.

This brings me back to two main themes I have mentioned before. Firstly that economics cannot be seen in isolation. Politics and people have an effect. Economic theories often have the words "ceteris paribus" attached to them. This means that everything else remains equal. The trouble is it doesn't.

Secondly that diversification in investment is always vital, and vigilance required. Arrogance and complacency, the two demon killers of any business, also destroy portfolios.

My prediction is that volatility will continue for some time, and not only in Japan. It could be another six months before the markets can make sense of these current events; and by then we may be experiencing others. Domestic crises seem mild by comparison, which brings me to the U.K and the Budget.

In the U.S. the authorities are pumping money into the economy, but here George Osborne is looking to help business take up the slack which will occur when the public sector job cuts begin to bite. His austere policy has enabled us to retain low international borrowing costs which are much less than say Ireland because the international community believes our currency will hold up, and we will avoid a currency crisis.

The Budget was a mixing of some tax cuts and some tax rises as he really had little room to manoeuvre if he was to hold to his plan as detailed in last year's budget. Two interesting hints though of his aim to remove the 50% tax band at some stage, probably 2013, and the eventual merging of National Insurance and Income Tax are both welcome.

The Budget also confirmed some very welcome changes and simplifications to pension rules from which many of our clients will be able to benefit. This is an indication of a more realistic savings regime without the ability to be abused. It also has indexed the amount going into ISAs, which maximum for 2011/12 is £10,680.

His plan will work, but the time frame for it to work may be more of a challenge.

Thus we have an interesting time ahead with lots of challenges and opportunities.

Best wishes

Andrew Roberts