Global Macro Notes: Twelve Major Risks for 2011

In the December issue of the Absolute Return Letter, Niels Jensen reveals his "dirty dozen" — twelve major risks for the year 2011. Many of these overlap with themes we have already highlighted or discussed.

> **"Most people view the future as likely to repeat past patterns, which it may or may not do.**
>
> **They tend to think of the future in terms of a single scenario, whereas it really consists of a wide range of possibilities."**
>
> *~ Howard Marks, Oaktree Capital*

With more explanation to follow, here are Jensen's 12 risks in brief:

1. High yields priced for perfection?
2. The risk of double dipping
3. The sinking ship of Japan
4. Beggar thy neighbor mentality
5. Capital flows too hot to handle
6. Chinese inflation out of control?
7. Food inflation induces civil unrest
8. India an accident waiting to happen?
9. European contagion and solvency risk
10. Massive refinancing program
11. Premature withdrawal of monetary suppport
12. Israel launching a pre-emptive strike on Iran

Against a backdrop of extreme bullish complacency, with many professional prognosticators seeing little to no risk at all through their rose-colored glasses, a discussion of "gray swans" — not so hidden risks of low probability but potential high impact — feels appropriate here.

As traders we have very little respect for overly precise market forecasts, especially smug ones. We're more inclined to agree with Howard Marks (see box).

No one can have absolute certainty as to what the future holds, which makes single-track forecasts ("the S&P will do this" etc.) an exercise in folly. And such unshakeable faith is not required anyway, because markets are an odds game.

Regardless of conviction, the most clear and compelling scenario can be utterly upended by a single variable that no one expected (or did not weight heavily enough).

So why isn't probabilistic thinking more popular? Probably because it is alien to conventional thought patterns (and often hostile to the ego).

Say, for example, there is a dominant "goldilocks" scenario in which everything goes right. This in fact seems the horse many are betting on. In the absence of any wild cards, 2011 could be a smooth year, propelled by the ongoing stimulative policies of Western governments, robust emerging market growth, and a slowly recovering U.S. economy.

But now further say there are a dozen top down shocks (i.e. "goldilocks derailment scenarios") that could disrupt the market if any single one occurred.

If each of these dozen shocks has a mere 6% chance of derailing the markets, what are the odds of goldilocks sailing through the year unscathed (avoiding all twelve)?

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A mere 47.6%, or worse than coin flip… even though each "shock" had only a 6% chance of occurring. As low probability risks add up, the realistic chance of avoiding them all goes down.

The confident predictors are thus the ones with egg on their faces. You can't really point to a gray swan scenario with only single-digit percentage odds and say "THIS, for certain, will destroy the bull case."

But nor can one confidently embrace the goldilocks case, given so many landmines that the odds of dodging them all are slim. **The year could go either way,** and that's just the way it is.

The answer to this "forecaster's dilemma"? Give up the childish need for certainty, or rather:

1. Recognize that artificial certainty is foolishness.
2. Be risk-aware, scenario-savvy, and skeptical of overconfidence.
3. Maintain flexibility and the ability to shift stance as needed.
4. Keep an open mind at all times.

Another reason to think probabilistically is the utility of reward to risk profiles — and the tendency of large payoffs to be associated with lower probability outcomes.

For instance, which of these trades sounds more attractive:

- Trade "A" with 30% odds of success, a 5 to 1 payout if successful, and clearly defined risk

- Trade "B" with 90% odds of success, a 0.2 to 1 payout if successful, and a modest but meaningful chance of catastrophic loss (10x or more)

Trade "A" will come up a winner less than 1 time out of 3, but returns $5 for every $1 risked, thus creating a nicely positive expectation. (If you could do this trade 1,000 times, you would make a lot of money).

The second trade wins almost every time (9 out of 10), but pays only 20 cents for every $1 risked, with the occasional disaster in which $10 or more is lost. Do this trade enough times and you will look smart and sophisticated — right up until the day your account blows up.

Amusingly, trade "B" is the rough equivalent of what many investors do in their quixotic quest for certainty. They mistake a high degree of certainty as the sole criteria for a good bet… or worse still, convince themselves they "know" and pretend as if they aren't wagering at all.

Now let's take a closer look at Jensen's "Dirty Dozen" — not all twelve, but the handful that stand out in light of our own scenario building:

- **High Yields Priced for Perfection.** This is the risk that, in "reaching for yield," investors have put themselves out on a limb with high yield corporate bonds. In a low return world characterized by central bank interest rates near zero, the temptation is to pay through the nose for a few extra basis points (in the assumption that nothing will go wrong). As corporate bonds inch ever closer to being "priced for perfection," the odds of someone yelling "fire!" in a crowded theater increase.

- **The risk of double dipping.** It has been widely assumed that the U.S. economy is out of the woods for 2011. This in spite of the fact that the U.S. housing market is already showing ominous signs of a "double dip," with potential for the rest of the economy to follow suit. Nor has there been much accounting for potential crisis at the state and local level… persistently high unemployment levels… or the possibility that the recent upturn in consumer spending and economic stats amounts to one final stimulus hurrah.

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- **The sinking ship of Japan.** Japan is simultaneously the deflation poster child — an example that frantic Keynesians like to point to in their calls for more stimulus — and the next potential time bomb in waiting, in the form of unsustainable demographics and declining savings trends. As Japanese retirees make the transition from "savers" to "spenders" in their old age, the ability of the JGB (Japanese Government Bond) market to domestically finance itself will be thrown into doubt. When a tipping point finally occurs, the massively debt encumbered Japanese government will find itself required to either 1) borrow from the rest of the world at impossible yields, or 2) print catastrophically large amounts of yen with which to prop up (monetize) a collapsing JGB market. The odd net effect is a binary outlook for the yen — rock solid until the day it collapses.

- **Beggar thy neighbor mentality.** In August we asked whether protectionism could be China's achilles' heel. The protectionism issue has been back-burnered by markets for now, but it is still a significant risk headed into the new year — not just for China but other nations too. The potential "super volatility" of currency markets in 2011 could further exacerbate this risk as special interest groups agitate, politicians pander, and governments retaliate.

- **Chinese inflation out of control.** We have talked a fair bit about Chinese inflation pressures — and we are far from the only ones concerned by "unsustainable" China trends. Via the Financial Times:

  China's growth model is unsustainable and the country faces a sudden slowdown unless it undergoes urgent economic and political reforms, according to a renowned Chinese academic and former member of the People's Bank of China's monetary policy committee.

  In a scathing indictment of the country's extraordinary growth story, Yu Yongding listed rising social tensions, choking pollution, a lack of public services and an over-reliance on exports and investment, particularly in real estate, as threats to the country's economic future.

  "China's rapid growth has been achieved at an extremely high cost. Only future generations will know the true price," Mr Yu wrote in an opinion piece published in the state-controlled China Daily. "[China's] growth pattern has now almost exhausted its potential. So China has reached a crucial juncture: without painful structural adjustments the momentum of its economic growth could suddenly be lost."

- **Food inflation induced civil unrest.** This ties into the Chinese inflation problem, though the issue is global in scope. In many developing world countries, food and energy represent a major portion of household expenditures — so major that the authorities risk riots if costs get too far out of hand. At the same time, spiraling food and raw materials costs threaten "demand destruction" and margin compression in Western markets, as we discussed via Winners and Losers in the Agflation Trend.

- **European contagion and solvency risk.** The euro zone is still a slow motion train wreck in respect to fiscal problems mounting and problems not being solved. The overly strong euro is acting like a de facto gold standard — not in a good way — for the heavily indebted periphery countries, forcing them into no-win situations in which austerity measures cause weak economies to contract further, magnifying the burden of unpayable debt. Germany and France can only look on with horror, given the large quantities of periphery debt on the books of the banks — a story that will end quite badly before it ends well.

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Lest it be said we are die-hard bears, it remains possible that all these serious risks are avoided (or otherwise "contained" for another few quarters). That is why there are a number of attractive long positions — not just shorts — in the Mercenary portfolios.

At the end of the day we are neither bulls nor bears, but traders — ready to maximize opportunity come what may.

JS

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