Economic Update

Broadleaf Partners, LLC

Uncertainty and the Birth of Black Swans

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The stock market has been weak ***all week***. Many indices fell by over three percent yesterday and the carnage continues today. The perception of lower oil prices being a good thing has, at least in the short run, morphed itself into a negative interpretation, namely that a global recession and perhaps even depression are at hand. Fear's pendulum has swung from inflation to deflation overnight, a transition that has been felt throughout the global stock markets.

In this morning's meeting, Jeff and I talked a great deal about the prospect of a Black Swan event. Black swans are rare, but they do exist in nature. A black swan event is one that seems theoretically remote, but can also become real. Uncertainty always heightens our awareness to a realm of possible outcomes, including black swan events. As the market falls back to its July lows, our minds give birth to new scenarios, including black swans.

A couple of months ago, when the S&P 500 last visited the 1210 level it is approaching today, we wrote an update titled Ugly Days, Springboards and Silver Linings. In it, we mentioned that bear markets were a typical occurrence, happening on average once every three or four years.

The JP Morgan analysis we highlighted at the time suggested that bear markets which coincide with recessions typically fall by an additional 2% twelve months later while those that aren't accompanied by a recession gain about 25% over the same subsequent time period. Let's revisit this analysis for a moment, taking into consideration what has since transpired.

When we wrote that update, oil had surged to nearly $150 per barrel which led us to believe that the chances of a recession were likely inevitable. Since that time, however, oil has pulled back significantly to the $110 area. Second quarter GDP growth has also been revised upward to roughly 3.3%, continuing a positive trend since hitting a low of about .5% during last year's fourth quarter. While this reading and year to date trend may have been influenced by the one time rebate checks, it is nevertheless inconsistent with an economy in recession. On the other hand, unemployment's spike to 6.1% this morning from 5.7% in recent months is a definite negative and one that forces us to put a check mark in the recession column.

Recent evidence, therefore, continues to be mixed. While unemployment may be consistent with a recession, lower oil prices and higher GDP readings are not. Returning to JP Morgan's analysis, let's just take the conservative route once again and assume that we do get a recession. Historically speaking, this would suggest three percent additional downside from current levels. Nothing disastrous, especially if you're thinking longer term.

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There may be, however, an additional alternative and that is the possibility of a black swan. Uncertainty is the breeding ground for black swan scenarios and we would be lying if we didn't admit that we could feel its tug. The Black Swan today may be that this isn't a garden variety or recession based bear market, but one that is even rarer, the possibility of an economic depression.

In depressions, all asset classes tend to deflate or fall in value. Prices fall because investors, burned by recent attempts to buy assets on the cheap, realize that they've been grasping at falling knives. The profit incentive falls hostage to the fear of falling prices, regardless of level or asset class.

The oil and commodity markets have taken it on the chin in recent months. While this would normally be taken as a positive for the stock market, no new leadership area has immediately and convincingly emerged to take over its former leadership position. In the recent past, when the technology bubble popped, the money eventually found its way into a newly inflating bubble, namely housing. As CNBC's Cramer has said, there is usually a bull market somewhere.

For now, however, the stock market is in la la land, with no conviction in anything new. Unfortunately, this scenario plays right into the black swan's hand, where the fear of price deflation in all asset classes rears its ugly head, and the prospect of economic depression seems like a potential reality.

Fortunately, I am also very capable of envisioning a scenario where now that oil prices have finally come down, interest rates and particularly mortgage rates, might finally follow suit. We haven't seen a benefit from the Fed's rate cuts yet, but perhaps that is because higher oil prices in the last year had only neutralized their impact. If we can get mortgage rates to fall, we could see a wave of refinancings that would free up a little more cash flow in everyone's budget and perhaps launch the consumer into the market's now vacant leadership spot.

Bond fund guru Bill Gross admonished the Fed and the Treasury Department yesterday to stand behind the credit markets, supporting more than just the troubled investment banks. His thoughts and his timing are dead on. If long rates do come down, banks may need some additional encouragement to do what they do best, making loans to the ***loan worthy***.

Our conclusion? It's okay to consider the possibility of black swan events. They do happen at times. But we must also recognize the natural tendency to see them more easily when uncertainty is on the rise, as it is now. With oil prices now on the decline, the Fed's rate cuts may finally have a fighting chance to work their magic.

In the rush to see black, let's not forget that the white swan exists.

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