April 11, 2011

Dear Clients and Friends,

"I find it unethical on the part of economists to teach Ricardo's 'comparative advantage' - something that is 'optimal' under some set of fixed, nonstochastic assumptions - without telling us about the Irish potato famine, (which was) the exact result of a model error. I've found so many cases of collapses coming from such optimization: Egypt from cotton, Lebanon from silk … "

- Nassim Nicholas Taleb, author of *The Black Swan: The Impact of the Highly Improbable*

As our quoted author Nassim Taleb reports, in 2003 the Japanese Nuclear Commission set a goal of reducing the risk of a fatal nuclear accident to a mean probability of about "1x10^6,"or once *per million years*. While it is yet unclear whether any deaths can be attributed directly to nuclear fallout from the past weeks' events in Japan, it appears their one-in-a-million accident very nearly happened, a mere eight years after the risk-reduction goal was set. But how does one predict, let alone prepare for, one of the biggest earthquakes ever recorded *causing* one of the most damaging tsunamis ever recorded *causing* a nuclear power plant accident? The predictive model, which gave comfort based on a *mean* likelihood, would have said the odds of what actually transpired were so low as to be meaningless. Statistically, it is an error.

There is precedent, as British blogger Tim Heydon writes, for the populist uprisings in the Middle East. That precedent is the Irish potato famine, in which blight caused the country's primary staple crop – and primary export crop – to be reduced by nearly 80%. Problem was, the British authorities who governed Ireland at the time, and who set its export policies, refused to cut off potato exports or open the Irish ports to imports. The British economic models factored Pounds for potatoes, not the possibility of a million deaths.

Egypt and other Middle-Eastern nations, subject to arid soil, are highly dependent on grain imports. Egypt, in fact, is the world's largest importer of wheat, making it vulnerable to supply disruptions. Late last year, Russia, the biggest exporter of wheat to the Middle East, banned wheat exports following fires that destroyed their crops. The fires, in turn, were caused by droughts brought about by climate swings, yet another Black Swan defying prediction! The move by Russia doubled the price of wheat in the Middle East in a brief two-month time period, causing the price of other foods to rise dramatically as well. (Contrary to what some say in the financial press, the food price spikes were not caused by the Fed's monetary stimulus programs here in the US.) The surge in food prices was not the only factor behind the turmoil in the Middle East, but it appears to have been the spark for the uprisings we've witnessed in the past month. The Middle East events have lifted other commodity prices – notably oil – to multi-year highs. Commodity pricing models do try to take weather patterns into consideration; we've yet to see one that calculates probabilities for street riots and NATO air strikes.

The impact of these events on the US financial markets has been surprisingly muted. There was a 5% intra-quarter swing in stocks, and Treasury bond yields drifted lower to about where they started the year, but overall the markets have been surprisingly tame. However, we believe there are long-term implications from these events that need to be considered, and which will provide additional headwinds to the markets in time. For instance, the resurgent nuclear power industry in the US and other developed nations has been stopped in its tracks following the Japanese situation, which means the US and other nations will remain dependent on fossil fuels for a longer period of time. The Middle East commotion, coincident in its timing, has placed an additional premium on the price of oil.

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The result is that several major Wall Street firms have lowered their GDP forecasts for the US. We cautioned at the start of the year that there seemed to us to be too much optimism on Wall Street, so we are not surprised to see their enthusiasm tempered. However, it is increasingly likely that corporate earnings forecasts will be trimmed if GDP does indeed slow.

There is also the growing problem of the US budget deficit, over which the fevered political debate often appears as stylized as Kabuki theater. What we learned from the most recent budget dance is that neither the Republicans nor the Democrats seem serious about reining in spending, opting instead to ‘kick the can’ down the road. Though the economic recovery remains fragile *at present*, making deeper cuts more risky, there are many signs that the recovery is becoming increasingly self-sustaining.

The deficit and resultant debt hold the potential to be serious long-term problems. As Egypt depends on wheat imports, the US depends on *capital* imports. Our ability to run a budget deficit depends, in part, on our ability to raise debt by selling Treasury bonds to foreign creditors. If we raise taxes to pay our creditors, growth may suffer. If we don’t, the US dollar’s decline may accelerate, causing inflation as imports become more pricey. Neither solution is optimal. Moreover, the deficit weakens other nations’ confidence in the US (and memories of our Black Swan banking crisis from three years ago surely don’t help,) with some going so far as to call us “the next Greece.” While that view is extreme, it is clear our stature in global economics has been somewhat diminished, as evidenced by the current BRICS economic summit and calls from China and elsewhere for an end to US dollar hegemony. (Ironically, a debased dollar would hurt our creditors, China included.)

What are the investment implications? Ultimately, investing is a game of probabilities, and seemingly random events can have a dramatic impact on investment outcomes, rendering all predictive models flawed. At FBB, we try to shift the odds in our favor by focusing on cash flows and a business’ return on invested capital. Those are calculable, and they tend to *trend*, even if they are not entirely predictable. As economic globalization increases and money flows with few restrictions, we are likely to see more companies from outside the US meeting our investment criteria, and we anticipate a gradual shift in allocations toward more global exposure.

Commodity prices should continue to move higher as demand continues to strengthen from emerging markets – we discussed our increased exposure to commodities last quarter. Non-US equities with above-average dividends are increasingly attractive, but there will be opportunities for traditional growth investments as well. In the very near term, stocks (both US and non-) could see an increase in volatility as lower GDP estimates translate to somewhat lower earnings estimates, but again we believe the underlying trend is positive, albeit not as robust as it has been in past recovery periods.

For fixed income, we are likely to see higher rates in the US, but not dramatically higher as we’ve established in prior letters – the recovery is too shallow to warrant substantially higher rates. We do expect the Fed to raise short-term rates, perhaps by the end of this year, but moves in longer-dated bonds should be tame unless there is a jump in inflation (yet another flawed model: the official US inflation gauge, the Consumer Price Index (CPI), doesn’t seem to give a whiff about commodity inflation!)

We believe a focus on the longer-term can help investors avoid the traps of near-term market volatility. While some events are substantial and impact our investment view, much of what transpires on a daily basis is statistical noise. The financial media – television, newspapers, websites, tweets – will try to explain the market’s every move, but often there is no explanation. Often, in the short run, there is simply randomness.

Sincerely yours,

Mitch Schlesinger