TOCQUEVILLE

The Bell Curve

BY ROBERT KLEINSCHMIDT ON *MARCH 31, 2022*

Generally, in contemplating the current economic outlook and how it will affect markets we consider the many factors at play in any one scenario: The rebound from Covid, technology advancements, the budgetary conditions, money creation and its aftermath, the level of inflation and interest rates, valuation, tax rates, regulatory policies, wage rates, unemployment, labor force participation, demographics, geopolitics, the domestic political outlook, et cetera, et cetera, et cetera. And after all that contemplation and speculation we return to our discipline of investing from the bottom up, rather than from the top down, finding all of the myriad macro cross currents impossible to handicap, and something of a fool's game to try in our estimation.

One can be forgiven, however, in these singular circumstances, when considering the macroeconomic outlook and how it will affect markets, for focusing on only one thing: The war in Europe. The conduct of the war and its outcome along with its implications dwarf all our usual considerations and present a potential existential threat to markets, as we know them, and wealth preservation in any conventional understanding of the phrase.   It is, what we called in our quarterly report, the Unthinkable. And yet, we must think about it now, and little else.

Let’s look at the possibilities from the framework of the Bell Curve. (Using its other name, the Normal Curve, seems just too blasé in the current situation).

The middle of the curve, one standard deviation from either side of the median, the most probable outcome, we’ll save for last.

Let’s start with the tail risks, two standard deviations or more away from the most likely outcome. On one side we have Armageddon. We needn’t spend too much time on this, by definition, although one could argue that maintaining a healthy amount of cash or gold nearby in one’s own personal vault is a prudent investment philosophy under these worst of possible scenarios. The world as we know it may come to an end, but it is unlikely that it will stop spinning. Spendable currency could be valuable. So might a copious supply of canned food as well as firearms and ammunition. Stocks and bonds for the most part, will be worthless, as will most collectibles.

The tail risk on the other side, is the removal of Putin, either by assassination or revolution, and a full-scale Russian withdrawal from Ukraine. This too is highly unlikely, but in the event, would be very bullish for stocks, especially European stocks and, eventually, Russian stocks and bonds. Commodities would weaken.

A third scenario, more likely than the previous two, say one to two standard deviations away from the center, is a hot war in Europe, but not a nuclear one. This means war along many fronts, including, possibly, recent NATO members and great continuing uncertainty. Except for various defense companies and certain commodity producers, this would be a significant negative for most equity markets (although the U.S. would likely be partially exempted in our view) at least until a resolution was in sight.

Of more or less equal probability on the other side is Cold War II, at least in Europe, if not in the rest of the world, since this would not be an ideological contest between competing economic systems. A new Cold War, nonetheless, and one that shuts off great parts of the globe, and its markets, from another. China and, surprisingly, India, may wind up joining the Russian side of this cold war which would not benefit the economies or the markets of the West. No doubt, spy novels would improve and James Bond, who never really left, will return, but the trajectory of global economic growth would flatten considerably, and markets would reflect that. U.S. and European multinationals would likely suffer.

Finally, and, in our view, the most likely longer-term outcome is the eventual victory of an exhausted Russia in Ukraine, followed by a long, partial, contested and inconclusive occupation, not unlike the one experienced in Afghanistan, by both Russia and the U.S. An exhausted and hobbled Russia would hardly be a plus to the global economy, but markets would eventually get used to this outcome and go back to focusing on the traditional economic and political parameters. This is the most bullish of scenarios, as well as the most likely, and the one most consistent with our investment philosophy, but it does not seem to have been priced into the market as of yet.

Under either of the more likely outcomes, U.S. budgetary and debt issues, as well as the inflationary forces they helped to kindle, will re-emerge, and, perhaps, get worse. The challenge to the Fed to thread the needle between containing inflation and preventing a budget wrecking steep rise in interest rates will be more than merely formidable. It is nearly unfathomable. To do this without creating a recession and further wrecking the budget is a task that would make Hercules blush in our view. Markets are not likely to focus on these factors until a resolution of the war is in sight, but when they do, they will face significant headwinds and stock picking will be crucial in generating successful returns.

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