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It's Complicated

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The turmoil surrounding the UK's decision to exit the European Union moved me to write about something that has been on my mind for some time and that is the propensity of most players to oversimplify economics, finance, and politics. In each of these arenas, events are generally complex, and often characterized by secondary and tertiary effects that are extremely difficult to forecast. Why are they so hard to predict? Economics, finance, and politics are all human endeavors, and human behavior is driven by emotions often leading to irrationality and volatility. Yet, pundits make grand pronouncements with great confidence, investors make snap decisions in their portfolios, and politicians pass legislation without considering the possibility of unintended consequences. I will discuss a couple of examples of the complexity of finance and then conclude with several lessons learned.

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Brexit

On June 23rd, voters in the UK shocked the world by voting to leave the EU which resulted in gloomy predictions including a recession in the UK and possibly in the remainder of the EU, the likely departure of Scotland and Northern Ireland from the UK, the possible departure of other countries from the EU, a spillover effect on the US economy, and so on. Immediately following the vote, the British Pound fell almost 14% versus the US dollar, and the British and American stock markets declined by more than 5%. Three UK property funds suspended withdrawals because redemption requests soared as a result of fear on the part of investors of a catastrophic decline in UK real estate values. And, of course, there was mayhem with respect to the leadership of both political parties in the UK.

Today, several weeks later, the mood has changed somewhat. The UK had an orderly change in government. And, while there are still concerns that the UK might be headed toward a recession, several recent articles in the financial press have suggested that there won't be much impact on the US economy. A recent Bloomberg piece argued that Brexit won't stop globalization and both the UK and US stock markets have not only recovered their losses but are trading several percentage points above their respective levels immediately prior to the referendum. And the British Pound has rallied about 2%.

There will continue to be ups and downs for a long time because the reality is that Brexit will take place over a number of years and even the "experts" have no idea what the ultimate impact will be on economies and markets. The outcome depends on the decisions of consumers, business leaders, and politicians, all of which are largely unknowable. And, with respect to virtually every issue, there are countervailing forces which make it difficult to predict who will win the shoving match. Therefore, many (if not most) who make bold predictions or radically change investment strategy are likely to be proven wrong. To wit, at least temporarily, those who shifted their portfolios in response to the vote have left money on the table. We are already being asked about the implications of the US election in the fall and the same comments apply. Regardless of the winner, there will be gloomy predictions, some of which may well come to pass, but there will likely be positive surprises as well. And given the nature of political campaigns, the actual proposals ultimately brought forth by the new administration as well as the response by economic players are impossible to forecast.

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Energy

Perhaps the best example of the complexity of economics is the huge number of crosscurrents associated with fluctuations in the price of oil during the past two years. From June of 2014 to January of 2016, the price of oil declined from $108 to $26.70, a decrease of 75%. Predictably, there were blaring headlines that the price would inevitably fall to $5. To the surprise of most market observers, it has since rallied to around $45 after briefing exceeding $50 per barrel. The consensus seems to be that the price will ultimately find an equilibrium at about $60 although there are credible observers who believe that it will return to the $20's.

Many forecasters argued that the associated decrease in gasoline prices would lead to strong consumer spending and therefore stronger economic growth. Well, during the past two years, consumer spending has increased at a 3.7% annual rate versus the average over the past ten years of 3.5%. Rather than spend their gasoline windfall, many consumers have chosen to save and repair their balance sheets-a great example of why consumer behavior is difficult to forecast. And, GDP has grown at a 1.8% annual rate versus an average over the past seven years of 2.1%; hardly the boom that many envisioned.

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To illustrate the difficulty in forecasting oil prices, let's look at some of the forces that might lead to higher or lower prices.

Lower Prices

- Modest global economic growth. For example, China is growing at 6.7% versus its longer term growth rate of 10.7%.
- Oil in storage is approximately 20% above longer term averages and at or near capacity.
- OPEC has maintained production despite weak demand.
- Improved efficiency of fracking has reduced the cost of US production.

Higher Prices

- $380 billion in energy related capital projects have been canceled.
- Drilling rigs in operation are down 50% from one year ago.
- Vehicle sales roughly doubled from recession levels. The growth has been concentrated in light trucks and SUV's that typically consume more gasoline.
- Miles driven are up materially.

And just for fun, let's add a few more complexities:

- Distressed energy companies are impacting lenders and bondholders.
- Various governments have lost significant tax and other revenues.
- Lower prices may impact the nascent alternative energy industry.
- 170,000 jobs have been lost in the energy industry which has impacted various regions and government budgets.

Well, you get the picture. This is an exceedingly complex issue that makes it difficult to forecast with any confidence, and very risky to stake out an extreme investment position.

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Unintended Consequences

My favorite examples of the complexity of economics and the inevitability of secondary and tertiary effects involve the impact of legislation passed by various governments.

In 1990, in a search for revenue, the US Government imposed a 10% excise tax on the sales of "luxury" items such as yachts, jewelry, furs, and expensive automobiles. The sponsors of the bill simply multiplied the annual sales of these items by the 10% tax and forecasted that it would generate around $400 million in revenue for the Treasury over the subsequent five years. Well, yacht sales ground to a halt, a number of manufacturers and their suppliers went bankrupt, and around 100,000 people lost their jobs. Revenues from the excise tax were minimal, and after taking into account lost income taxes and the cost of unemployment benefits, the net effect was a drain on the Treasury. The tax was repealed in 1993. Supposedly, Congressional staffers now use "dynamic" models that attempt to capture these kinds of effects. But, the next example is more recent which leads me to wonder whether legislators have really learned their lesson.

In 2010, New York State increased taxes on a pack of cigarettes from $2.75 to $4.35. Not surprisingly, buyers either turned to the black market or crossed state lines to make their purchases resulting in a decrease in actual tax collected of $400 million per year and foregone revenue of approximately $1.3 billion.

What both of these examples have in common is that the powers that be did not understand that people would respond to legislation by changing their behavior. In other words, they did not consider the possibility of unintended consequences. In the first example, either the size of the tax or the very fact that it was imposed was enough to scare off buyers. And, in the second instance, people were willing to accept mild inconvenience in order to avoid what they viewed as a punitive tax.

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Other Examples

The complexity I have discussed is present in most economic and financial decisions. Let me briefly describe several more. Going back to Alan Greenspan, the Federal Reserve has aggressively tried to smooth out the business cycle through the use of monetary policy. While well intended, there are those who believe that this has actually increased risk taking and speculation because of the belief that the Fed will always be there to bail out investors and companies. Similarly, the Fed's Quantitative Easing programs were designed to stimulate economic activity by lowering interest rates. But, by doing so, they disadvantaged many retirees who were living on the interest generated by their savings and in turn benefitted stock and bond owners. In both cases, there were secondary effects and unintended consequences. Finally, the decision to keep interest rates in the US somewhat higher than the rest of the industrialized world has resulted in a strong dollar which increases imports and penalizes exports among other effects. The net impact on the economy is unclear.

So, What's the Point?

Understanding and accepting the complex nature of politics and economics should help us both emotionally and financially. First, a key lesson is that one should not overreact to headlines because the ultimate implications of a given event are never clear. Second, we should take the forecasts of most "experts" with a grain of salt. With respect to investing, it is rarely smart to make meaningful changes in a portfolio in response to news and it is very dangerous to take an extreme position based on a particular point of view. The better course is to admit that we don't know a great deal and invest accordingly. That means, a well thought plan, diversification, and a consistent approach. Also, you will sleep better along the way. ■

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