

Black Swan Meets White Swan

How would you hedge against a Black Swan event today?

We put our observation cap back on to find that, amid all the hedging going on, one bet stands out. In our search to find clues that determine future directions of financial markets, we find that inflation risk offers the most widespread cause for concern. Inflation, the White Swan, is a fundamental macroeconomic risk factor for a broad range of investments and therefore an obvious cause of anxiety.

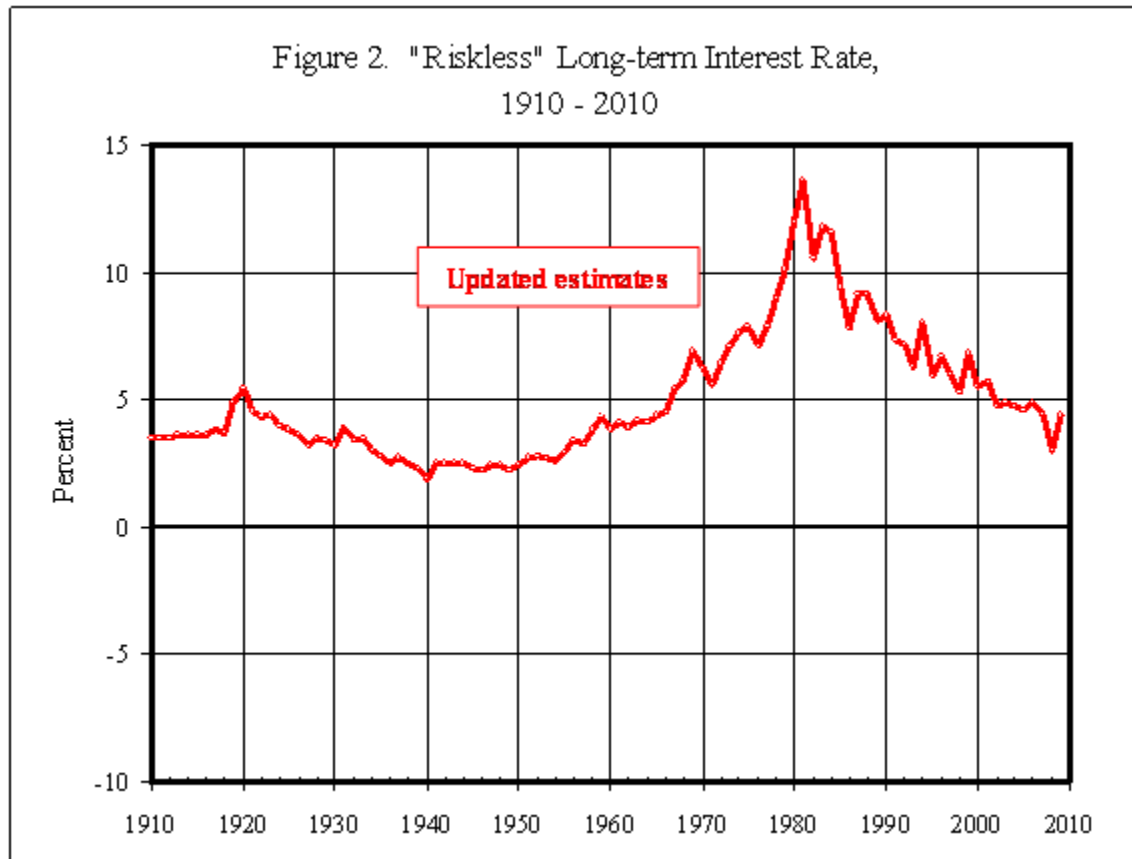
The prevailing wisdom is that, to protect against this risk, one should hold onto positions in emerging stock markets and commodities. We also find the use of Treasury Inflation-Protected Securities (TIPS) on the bond side very popular. In essence, these tactics are widely considered to be sure bets to safeguard against the inflation that will surely follow the large increase in the money base.

However, we constantly argue that poor immunization and assets mismatch will lead to a dynamic rebalancing act. We feel we are closer now to this event. Review my blog back in November 2009 at:

<http://www.zerohedge.com/article/guest-post-equity-duration-immunization-and-mismatch>

Perhaps most analysts still feel that a repeat of the 70s interest rate hike is possible. Such a hike would be like driving while looking in the rear-view mirror. Observing patterns from the 1970s to today, we can see that actual inflation trends are becoming more tame. Inflation shocks are practically non-existent in today's more stable environment. We can only conclude that monetary policy of the 70's was too accommodating.

If this mismanagement is a one-time event, rates will eventually revert to a suitable balance. Following is a long-term view of rates courtesy of Gary Burtless from the Brookings Institution.



This is an updated chart to works previously done in the Italian journal *L'Assistenza Sociale*, Winter 2000 edition. The long-term rates were derived in the period from 1910 to 1923 from adjusted high-quality railroad bonds. We thank Gary Burtless for his excellent work.

Our main point is that rates will find a natural equilibrium after a mismanaged monetary policy period. Our best guess is that they will trade between 2% and 4%, if the period 1910 to 1965 is a reliable indicator.

Don't do what I say, do what I do

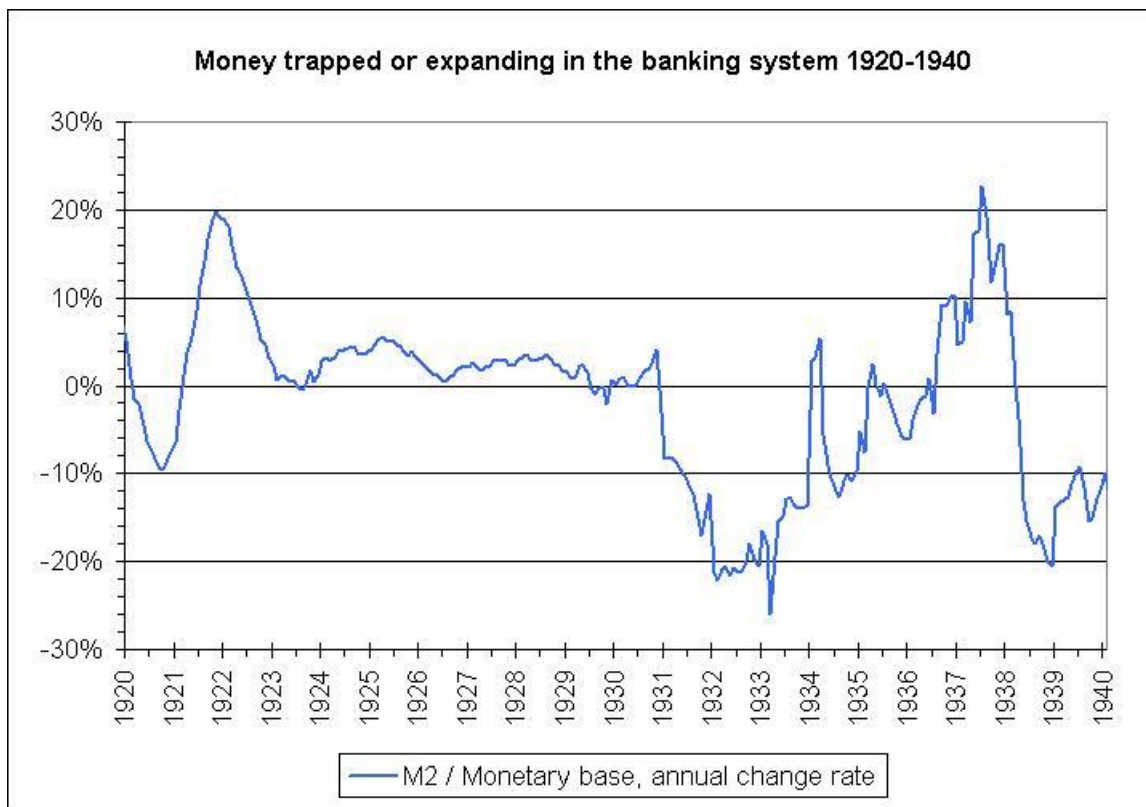
We sense that the primary Treasury dealers share our views partially. Recent surveys in which most bond dealers agree with higher rates are confusing. The best observation remains to look at their own positioning, which remains quite high by any standard.

<http://www.zerohedge.com/article/guest-post-observations-unusual-bond-deal-behavior>

If you hedge against inflation you don't carry that risk. In the event deflation, the Black Swan, reasserts itself, then you run for the exit.

We have already noted that a falling stock market only adds to the contraction of the money supply and is very deflationary. In turn, falling money velocity drags down stock multiples. It becomes a self-fulfilling circle of deflation. Massive derivative bets underlying both rates and currencies are about to add an extra layer of volatility. Add housing to the mix and you create such forces of deflation that it becomes quite difficult to reverse the incoming tide.

We notice that an expanding money base serves to maintain higher price/ earnings ratios, best represented by the period from 1930 to 1942.



We get a good correlation between velocity and stocks movements. The stimulus, however, is at odds with what is really happening to money. The recent rally fails to show any improvements in monetary velocity.

Oil clearly shows a head and shoulders pattern. Large energy stocks such as Exxon seem to be leading the price of oil lower. The Baltic dry index, which displays great correlation to oil, is now at its widest disparity. These are items influence the inflation premium.

I will argue that a lower term premium is required for holding long-term bonds, regardless of a few White Swan feathers that indicate inflation.

–Yves Lamoureux, Investment Advisor, Macquarie Private Wealth

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