

Potemkin Puzzle

A form of Winston Churchill's quotation, made in a radio broadcast in October 1939:

"I cannot forecast to you the action of Russia. It is a riddle, wrapped in a mystery, inside an enigma; but perhaps there is a key. That key is Russian national interest."¹

It could have been written yesterday as it sums up what many of us are feeling regarding the Russian invasion of Ukraine.

No missiles on Russian borders?

Seems absurd when there is MAD (mutually assured destruction) from as far away as the other side of the world.

Anyway it doesn't matter now... It has happened and nothing seems to be able to stop it.

Well almost nothing... I ascribe a non-zero probability of a backlash from inside Russia or Belarus in spite of the population having been coerced into terrified submission. One only has to look at the terrified stony faced individuals alongside Putin in his Potemkin-like attempts to show unity and to change the current world narrative.

Russian and Belarussians have tasted freedom once and I am sure they liked it. As Charlie Munger wrote in his epic piece "25 areas of human misjudgement"², super deprivation is a very big motivator i.e. giving something to someone and then taking it away.

Now, despite the Russian narrative of it being a "principled war" (to relieve their Ukrainian neighbours of a Nazi, fascist regime), individuals in those countries could be facing some serious cognitive dissonance as they observe the majority of the world ganging up on them; taking away their credit cards, branded clothes and other decadent niceties to which they would have become so accustomed. Closer to the epicentre of power, the oligarchs I'm sure are questioning the wisdom of what increasingly looks like an overreach?

If this backlash happens and succeeds, I think it could be the Waterloo of totalitarian forms of government, especially in Russia. It could be their last stand.

To this vague hope I cling.

What it has done however is to rocket propel the inflation genie out of the bottle. Even if the most bullish scenario happens, it seems improbable that inflation could mean revert to where it was before.

I have often cited my fear of this most wealth-destroying form of stagflation, where the paper assets you currently own go down, whilst what you eventually need from the proceeds of those same assets goes up... exponentially. Today, it seems this fear has become a reality.

Central banks are powerless to counteract these forces, having used the last of their monetary "bullets" over the Covid crisis. Well, pragmatic bullets anyway. To slow interest rate increases in the face of what looks to be even higher inflation would be careless.



¹ Winston Churchill, BBC Broadcast, 1st October 1939

² Charlie Munger, The Psychology of Human Misjudgment

If every day, the place you have to get to drops by increments of 3 feet, your best bet is to drop 3 feet every day and eventually get to your goal. Frighten away from the prospect that in a week you risk serious injury as you have to now drop 21 feet, procrastinate for a month and when you eventually leap the 90 required feet down, you will kill yourself.

This is the dilemma facing central banks and interest rates today. Leave it too long and you will seriously injure the economy when they eventually take the leap and raise interest rates higher enough to make a difference to inflation.

What will happen?

Macro prognostications are practically useless in the fog of war. All I know for sure is that it is better to head for safety of shore when a shark is in the water and someone's bleeding.

Voltaire Costeau wrote in his rules for swimming with sharks... "don't bleed"³.

It's time to play defence.

What better defensive play than long volatility funds?

Volatility funds are again proving their worth as a portfolio diversifier and tail hedge, a waterproof bandage if you will, stemming the flow of blood whilst you swim in these shark infested financial waters.

Gold is worthy of mention here, as I view the gold price as akin to a central bank credit default swap (CDS). By weaponizing SWIFT and other freezing central bank assets you have basically assured the future of gold as a form of Central Bank payment, where central banks suddenly realize their paper asset holdings could be frozen at a moment's notice whereas gold held locally is, well, good as gold.

It feels heartless to talk money in the face of this disaster but I do fear the financial system is now exceedingly fragile and all portfolios are at increased risk, even if the risk does not seem immediate.

³ Voltaire Costeau, How to swim with sharks: A Primer

Disclosure

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