



A Bank of Swans

"A black swan is a highly improbable event with three principal characteristics: it is unpredictable; it carries a massive impact; and, after the fact, we concoct an explanation that makes it appear less random, and more predictable, than it was."¹

In November last year I would have categorised a virus epidemic in this way. There was no way of knowing when or where it was going to occur.

In January, it looked like this particular black swan became a grey swan.

*"A grey swan is a highly probable event with three principal characteristics: it is predictable; it carries an impact that can easily cascade; and, after the fact, we concoct an explanation that recognizes the probability of occurrence, but shifts the focus to errors in judgment or some other human form of causation."*²

Coronavirus has a long dormancy period, it is fairly lethal and has the ability to cascade exponentially in spite of gargantuan efforts to stem its reach. From an economic point of view, the antidote is nearly as painful as the disease. Basically shutting everything down until the transmission rate is diminished. This dramatically affects economic affairs, travel, leisure, tourism, and productivity to mention a few.

Yet the financial markets totally discount this risk? Some would even argue that the grey swan is turning white as we speak.

*"A white swan is a highly certain event with three principal characteristics: it is certain; it carries an impact that can easily be estimated; and, after the fact, we concoct an explanation that recognizes the certainty of occurrence, but again, shifts the focus to errors in judgment or some other human form of causation."*³

They argue that they cannot see how the effects of the spread of coronavirus is going to stop. I really hope they are wrong. The reason they say that is the dormancy period of up to three weeks without symptoms. This basically means that detection in this period is basically impossible. Temperature guns will only pick up those in the later stages of the illness. Even barring a worldwide ban on travel I don't see how it will stop spreading.

In my experience, most people tend to overestimate the probability of black swans turning grey or white in the initial stages and then, counterintuitively, underestimate the probability when it becomes a lot clearer that it is a grey or white swan! All we know at this stage is that the chance of this particular swan taking flight is non zero. We also know that the financial system, loaded with debt and with interest rates already on the floor, is fragile and not in a good position to deal with the economic fallout of a worldwide pandemic.

Financial options which reflect the price of future uncertainty, have not moved. Especially the options less than three months to expiry which are now effectively binary. Either the virus will be out of control in three months or it won't. It seems like a Wile E. Coyote moment.

If it doesn't spread, we get back to global asset inflation races.

If it does, world economic activity and output will face a cataclysmic drop. Central banks will have limited levers to pull to try and stimulate the economy with monetary policy and most company's earnings will suffer steep falls.

¹ <https://accendoreliability.com/black-swans-grey-swans-white-swans/>

² <https://accendoreliability.com/black-swans-grey-swans-white-swans/>

³ <https://accendoreliability.com/black-swans-grey-swans-white-swans/>

From an economic point of view, if this happens, the modification of people's behaviour will determine prices. It won't be the virus itself but what must be done to get control of it that drives prices and volatility.

We sincerely hope authorities can get in front of this swan before it takes flight.

The mismatch between the price of uncertainty as reflected by volatility and the actual uncertainty which exists, makes me even more comfortable with volatility as a viable hedge.

*"Either you deal with what is the reality, or you can be sure that the reality is going to deal with you."*⁴

Disclosure

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⁴My Soul Looks Back, 'Less I Forget: A Collection of Quotations (1993) by Dorothy Winbush Riley.