

36 South Views

BY RICHARD "JERRY" HAWORTH

MAY22

"Self-organising, non-linear feedback systems are inherently unpredictable. They are not controllable. They are understandable only in the most general way... Our science itself, from quantum theory to the mathematics of chaos, leads us into irreducible uncertainty."

Donella H Meadows

Societies and their various financial markets are an example of this type of system. This quote explains very neatly why trying to predict the timing of volatility is a fool's errand. The best one can hope for is to glean an understanding of whether the "price" of volatility is cheap or expensive, relative to history, and then to procure some with enough time to be right.

Fortunately, the "price" of volatility is determined by participants with inherent, deadly flaws and behavioural biases. They believe, counterintuitively, that if a market is quiet and stable it will remain so for the foreseeable future and, when it is turbulent, they believe it will remain turbulent.

In reality, volatility is cyclical in nature, although its timing remains unpredictable.

... "Even smarter analysis is no match for the irreducible uncertainty of systems."

"Indeed, ironically it may be the very effort to reform that precipitates the collapse."

Immoderate greatness: Why civilizations fail. (Ophuls, 2012)¹

Whilst the timing of volatility is unknown, one can make a prognostication on the fragility of a particular system and its valence to volatility.

Various factors drive this probability of increased volatility, due to inherent fragility.

Complexity – the more complex, the more fragile.

Leverage – the more debt and leverage, the more fragile.

Delusional thinking – the more delusional thinking is imbedded in the collective consciousness, the more fragile.

I shudder when I write this, as I re-realise how fragile our current financial system is.

Our society is complex, over reliant of technology and just in time supply lines.

Leverage... well enough ink has been spilt on just how over-levered financial markets are.

Delusional thinking... the supposition that inflation is cyclical and not exponential in nature, meme stocks and the belief in the power of the herd (running with the bulls straight into the abattoir!), the permanence of the central bank put, the wisdom of buy and hold, the wisdom of unlimited quantitative easing and money printing and so on.

¹ Ophuls, W., 2012. Immoderate greatness. North Charleston: Createspace.

Probably the biggest current driver of fragility is inflation

"Inflation is always an evasion of reality— an attempt to maintain an artificial prosperity that objective conditions would not otherwise allow. Leaders resort to inflation because they are desperate. They have been backed into a corner by events and lack the moral courage or the political support to institute fundamental reforms, which would require them to inflict pain on the mass of commoners and vanquish powerful elites...) Charged with governing a populace accustomed to living well beyond its means, overwhelmed by a multiplicity of difficult problems, hemmed in by a host of vested interests, burdened by a deteriorating physical and social infrastructure that is increasingly costly to maintain, encumbered with ecological, thermodynamic, and fiscal debts that have come due, rulers bereft of backbone, ingenuity, and capital attempt to postpone the impending crisis by inflating, whether this takes the form of clipping coins, printing money, or loosening credit." (Ophuls, 2012)²

Immoderate Greatness: Why civilizations fail

Sound familiar?

Probably the greatest lie of all is that wealth invariably compounds over time. I wrote once that Cleopatra's bracelet sold for the equivalent of \$100 dollars at the time and compounded at 4% a year could produce enough income to give every person in the USA a lottery style pay-out.

This has never happened. Why? Wealth is subject to entropy just like everything else.

This entropy variably occurs in very short time periods in-between large periods of stability and growth that I suppose is why we ultimately believe it wealth compounds over time.

Add all of this up and I wonder why more investors don't procure some positive exposure to volatility... and I suppose we are just wired for optimism even in the face of the rising probability and yes inevitability of black swan events.

"From barbarism to civilization requires a century, from civilization to barbarism need but a day."

Will Durant

Disclosure

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² Ophuls, W., 2012. Immoderate greatness. North Charleston: Createspace.