Black Swans of 2010

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January 1, 2010

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Dr. Ed's Ten Bullish Black Swans of 2010

(Subjective Probability 70%)

(1) *The Old Normal trumps the New Normal.* The US economic recovery is par for the course. After rising by a surprisingly strong (though normal) 6.5% during Q4-2009, real GDP continues to be better than expected during 2010.

(2) *Unemployment subsides faster than expected.* The unemployment rate peaked at 10.2% during November 2009; it falls to 8% by the end of 2010. Revisions show that payroll employment started to rise during November 2009; it increases by 2 million in 2010.

(3) *Consumer spending leads the recovery in 2010.* Housing activity remains soft as mortgage rates rise, but home prices mostly edge higher. US capital goods exports are remarkably strong. Business spending on information technology booms.

(4) *The federal funds rate ends the year at 1%.* The Fed keeps the federal funds rate near zero through mid-year then starts raising it in 25-basis-point increments after each of the year's final four FOMC policy meetings, to 1% by year-end. The 10-year Treasury bond yield rises to 4.5%-5.0%, but credit spreads continue to narrow. Banks start to lend again.

(5) *Inflation remains subdued, with the core CPI inflation rate remaining under 2%.* While most commodity prices continue to move higher, the price of oil drops to $60 a barrel on ample supplies. The dollar continues to rally in 2010.

(6) *Stocks—and profits—are stronger than expected.* Stock markets around the world (including the US) rise to record highs by the end of 2010. The economies of Asia, Latin America, and the Middle East boom, led by both infrastructure spending and consumer spending, especially on technology. Corporate profits are extraordinarily robust almost everywhere and in most industries.

(7) *The federal budget deficit starts to narrow, and stress on state and local budgets starts to lift,* as a result of better-than-expected economic growth. Congress establishes a commission tasked with reducing the federal deficit.

(8) *The Obama administration turns more centrist* after Congress passes a token health reform bill that alienates the left wing of the Democratic Party. Nevertheless, the Democrats lose their majorities in both chambers of Congress in November.

(9) *The Iranian government falls and is replaced by a more democratic regime.* George W. Bush is hailed as a hero for bringing democracy to Iraq, which leads to the victory of the pro-democracy movement in Iran. Tensions in the Middle East subside. The price of oil falls to $60 a barrel.

(10) *The Bush tax cuts are extended,* following the congressional elections and before year-end. (Fairy tales can come true and usually have happy endings.)

Dr. Ed's Ten Bearish Black Swans of 2010

(Subjective Probability 30%)

(1) *The US economic recovery is subpar.* After rising 4% during Q4-2009, real GDP grows by only 1%-2% during the four quarters of 2010.

(2) *The unemployment rate rises to 11% by the end of 2010.* It goes even higher in 2011, when another recession hits after the Bush tax cuts expire at the end of 2010. Payroll employment remains unchanged all this year.

(3) *Consumer spending is very weak due to rising unemployment.* Housing starts and home sales decline as mortgage rates and foreclosures rise. Home prices fall. Business spending is also weak, because the capacity utilization rate remains depressed and the profits recovery stalls.

(4) *The Fed keeps the federal funds rate near zero* through year-end, and is forced to continue buying Agencies to avert a complete housing collapse. Fannie Mae and Freddie Mac need to borrow more from the Treasury, and are formally nationalized. The Treasury bond yield drops below 2%, but credit spreads widen significantly.

(5) *Inflation concerns give way to fears of deflation.* Commodity prices rise early in the year on renewed weakness in the dollar, but then drop as global economic activity plummets dramatically. The dollar takes a dive.

(6) *Stock markets around the world plummet again, led by bank stocks.* Sovereign debt crises in the PIIGS (Portugal, Italy, Ireland, Greece, and Spain) spill over into Japan, the UK, and even the US. Yields on government bonds rise sharply early in the year, then fall as the Bond Vigilantes force governments to reduce their structural fiscal deficits.

(7) *More bailouts and stimulus programs expand the federal budget deficit* on a cyclical basis to another record high. State and local governments are forced to slash their spending, their payrolls, and their pension benefits to avoid defaulting on their debts.

(8) *The Obama administration turns more leftist* after Congress passes a health reform bill—and pushes for even higher taxes on the rich. The Democrats narrowly hold onto their majorities in both chambers of Congress in November.

(9) *The Iranians crack down on the pro-democracy movement.* Tensions in the Middle East intensify, particularly between Israel and Iran. The price of oil soars over $150 during the summer, but then tumbles.

(10) *The Bush tax cuts expire.* This sets the stage for another recession in 2011. Future historians describe this period as the "Second Great Depression."

I. Known Knowns, Known Unknowns, and Unknown Unknowns

What might be the Black Swan that triggers the next calamity for investors in 2010? That's a tough question since these events by their nature tend to be random and unknowable. Furthermore, not all Black Swans are bad. There might be a good one on the horizon that will avert the next calamity. Black Swans aren't always bearish; they can be bullish. In other words, they come in more than one color.

At a press briefing on February 12, 2002, former US Defense Secretary Donald Rumsfeld famously said, "There are known knowns. These are things we know that we know. There are known unknowns. That is to say, there are things that we know we don't know. But there are also unknown unknowns. These are things we don't know we don't know."[1]

Black Swans tend to be Unknown Unknowns and can sometimes be Known Unknowns. In the preceding two tables, I map out alternative scenarios for the year ahead. The first one lists ten possible positive surprises for the economy and the stock market. The second lists ten possible negative surprises. I label them "Black Swans," though they are mostly of the Unknown Known variety. While predicting them is a New Year's ritual for economists and investment strategists, we shouldn't lose sight of the Known Knowns. Very often, they can be just as important to investors.

II. Today's Known Knowns

So what do we know today as we start a new year and a new decade? We know the following:

1. During the first week of the New Year, there will be a fireworks display of **employment** data. On Wednesday, the ADP data for private payroll employment will be released. Thursday will begin with the release of January 2 jobless claims, which have declined at a surprisingly fast pace in recent weeks. Then, all eyes will be on Friday's payroll employment report for December. There is a good chance that it might show a slight increase. There is even a better chance that November's preliminary drop of 11,000 will be revised to show a small gain.

   The Census Bureau is expected to hire 1.2 million census-takers this year. The peak of the bureau's hiring will be in late April and early May. By then, about 800,000 people are expected to be on its payroll, most of them as field workers, knocking on doors to follow up with households that did not return census forms mailed in March. The positions vary in length and pay, but the average job is 20 hours a week for six weeks, paying $10 to $25 an hour.

[1] Secretary Rumsfeld's statement referred to the increasingly unstable situation in post-invasion Afghanistan in 2002. It seems to be a skewed take on Confucius, as quoted in Henry David Thoreau's *Walden*: "To know that we know what we know, and that we do not know what we do not know, that is true knowledge."

2. The House will convene for legislative business on January 12. The Senate will do the same on January 20. The top priority of the **Democrats**, who have a majority in both chambers of Congress, is to pass a health care "reform" bill. They will probably achieve their goal, though the big surprise would be if they fail to do so. In a *New York Post* op-ed (12/25/09), Michael Tanner, a Cato Institute senior fellow, explains why getting the bill through a conference committee may be difficult.[2]

3. The **Financial Crisis Inquiry Commission** (FCIC), a ten-member panel appointed by Congress with the goal of investigating the causes of the financial crisis of 2007-2009, will question Lloyd C. Blankfein, the Chief Executive Officer and Chairman of Goldman Sachs, during the January 13-14 inaugural hearing. His firm denies allegation by the McClatchy newspapers that it peddled more than $40 billion in securities backed by risky mortgages during 2006 and 2007, even as the firm was secretly betting that a drop in prices would depress the securities' value.

   The hearings could inflame populist animosity aimed at Wall Street and set the stage for tougher regulations of the financial industry, including reinstating the **Glass-Steagall Act**, which prohibited commercial banks from entering the investment banking business. Senator John McCain (R., Ariz.) is promoting the idea.

4. During January, companies will report their results for the fourth quarter. There were plenty of positive **earnings surprises** during the first three quarters of 2009. Indeed, during the third quarter, 79.5% of the S&P 500 corporations reported such surprises—a record for the data, which started during Q1-1987. The bears growled that drastic cost cutting in the face of weak revenues accounted for the pleasant surprises. Well, revenues probably improved significantly during the fourth quarter. If so, earnings should beat expectations again, causing industry analysts to revise their 2010 and 2011 numbers higher. Higher should also be the direction of the stock market. If the stock market is up in January, as I expect, the odds are 89.7% that it will be up for the year based on the past 63 years since 1947. The S&P 500 was up in 39 of 63 Januarys—and the year ended up in 35 of those 39 years (See Figure 78 in our *Stock Market Handbook*.) There will be earnings seasons during April, July, and October. They are likely to confirm a V-shaped recovery in earnings.

5. The preliminary estimate of **real GDP** for the fourth quarter will be reported on January 29. November's inventory data will be reported on January 14. If the release confirms that inventories stopped falling in October, then the real GDP report could show a V-shaped jump of 6.5%. If inventories are just flat during the quarter, and if final sales also are flat, then real GDP would be up 4.4%. Final sales should be up, and inventories could show some accumulation.

[2] Michael Tanner, "Health Care: Now's the Hard Part," *New York Post*, December 25, 2009.

6. President Barack Obama will give his **State of the Union** message in late January or early February. We know that the President will start most of his sentences with "I." We know that he will say "let me be clear" a few times and "this is not about me" at least once. We know, and he knows, that the polls are showing that his popularity is taking a dive. So he may be forced to move more towards the center.

Indeed, on December 24, 2009, William M. Daley offered the following advice to the Obama administration in an op-ed in *The Washington Post*: "All that is required for the Democratic Party to recover its political footing is to acknowledge that the agenda of the party's most liberal supporters has not won the support of a majority of Americans—and, based on that recognition, to steer a more moderate course on the key issues of the day, from health care to the economy to the environment to Afghanistan." Daley is an influential Democrat and a former Commerce secretary, whose brother is Richard M. Daley, the mayor of Chicago.

7. The **FOMC** is scheduled to meet eight times this year, with the first meeting on January 26-27. Most of the Federal Reserve's special liquidity facilities will expire on February 1, 2010. The Fed will most likely stop buying Agencies by the end of March. Fed watchers will spend most of the year predicting when the Fed might start raising the federal funds rate. My guess is that the FOMC won't drop the "extended period" phrase for its zero-interest rate policy (ZIRP) until the April 27-28 meeting.

   The Fed's first rate hike of 25 basis points could follow after the June 22-23 FOMC meeting. That might be the Fed's only rate change for the rest of the year, if housing activity drops once the recently extended **mortgage tax credit** expires this spring. Taxpayers who go to contract for a principal residence by May 1, and close on that home by June 30, will benefit from the tax credit. New home sales, which are recorded when a contract is signed, could take a dive starting in May. Previously owned home sales could do the same, with a lag of a couple of months during the summer because they are compiled from contract closings and may reflect purchases agreed upon weeks or months earlier.

8. Offsetting the mortgage tax credit will be **higher taxes** owed by taxpayers to their state governments on April 15. Some states raised their rates late last year and made the increases retroactive to the start of 2009!

9. During the summer, the **political season** will heat up as congressional incumbents and their challengers fight to win the elections on November 2. The way the polls are going, there is a good chance that the Democrats might lose their majorities in one or both chambers of Congress. A "vote-'em-all-out" result is possible given the sour mood of the electorate. It could be a resounding defeat for the White House and a great victory for Gridlock.

10. The Bush tax cuts are set to expire at the end of this year. A major **tax hike** in 2011 could sink the economy next year.

III. Today's Known Unknowns

What do we know that we don't know? We all know that the economy is recovering, which is why stock and commodity prices, along with bond yields, are well above where they were a year ago. The key issue for investors is whether the recovery will gain strength in 2010 or fizzle. There are lots of Known Unknowns that will determine the outcome. Here is a small sample:

1. Will employers expand their payrolls as they normally do at this point in the business cycle? Or will we have a jobless recovery?

2. Will consumers save more? Or will near-zero interest rates discourage thrift? If consumers pour more money into stocks to get better returns, might the resulting positive wealth effect boost their spending on goods and services?

3. Will higher taxes depress consumer and business spending?

4. Is a second wave of foreclosures ahead? Might higher mortgage rates put a lid on the upturn in home sales?

5. Or, will a normal inventory-rebuilding cycle set the stage for self-sustaining economic growth? In the past, fiscal and monetary policy stimulus measures were no longer needed once self-sustaining growth kicked in. Is this time different?

6. If the private sector deleverages, will the government continue to leverage even more? Will mounting concerns about the creditworthiness of sovereign debt stymie the ability of governments to continue to prop up economic growth?

In the two tables that lead this *Topical Study*, I list how these issues might play out in either a bullish or bearish fashion. I don't know for sure, but I expect that 2010 will be a good year for the economy and for investors.

IV. Passive, Active, and Contrarian Investors

Financial markets usually fully discount the Known Knowns. Stock, bond, and commodity prices tend to efficiently reflect all of the currently available information that is publically accessible. A passive investor who is content with indexing his portfolio knows that he is betting with the crowd on the Known Knowns, recognizes that his risks are the Known Unknowns, and can be certain that he won't underperform the crowd. Also certain, though, is that he won't outperform.

Active investors prefer “hands-on” portfolio management over passive indexing. Such investors believe that they have a better understanding of the investment consequences of the Known Knowns than most others. They may also believe that they have access to better information for judging the probability and consequences of the Known Unknowns. Most investors ignore the Unknown Unknowns because they view them as “once-in-a-century” outliers.

Very few active investors have consistently beaten their benchmark indexes. Yet there are plenty who have underperformed their market benchmarks. In other words, successful active investors (like Black Swans) are a rare breed.

Some active investors are natural-born contrarians. They believe that they can beat the market indexes by betting against the crowd. As John Maynard Keynes said, “Successful investing is anticipating the anticipations of others.” Contrarians are constantly betting on Unknown Black Swans. The biggest market moves occur when the crowd is shocked that their bets on the Known Knowns turn out to be wrong, resulting in better-than-expected or worse-than-expected returns. Betting against the consensus is bound to be profitable on average, contrarians figure, because of the outsized upside potential if the consensus view turns out to be wrong relative to the downside if the consensus is right (since prices already reflect the expectation that the consensus view is right, there will be no price explosion/implosion if indeed it is). John Templeton once said, “The time of maximum pessimism is the best time to buy and the time of maximum optimism is the best time to sell.”

Contrarians are basically betting on the most inscrutable Black Swans. They know that eventually some of the crowd’s assumptions will usually be proven wrong. They just don’t know when that time will come, which assumptions, or why they will turn out to be wrong.

Contrarian investing doesn’t work—requiring a great deal of patience and potentially chewing up lots of net worth—during speculative bubbles and financial panics. During such times, the overwhelming consensus can be overwhelmingly right for a while. The power of the crowd’s “irrational exuberance” becomes self-fulfilling during bull markets, as we saw during the second half of the 1990s. Contrarians who bet against technology stocks back then were mostly wiped out if they bet too soon. During financial panics, it takes a great deal of courage, and very deep pockets, to grab all of the falling knives.

Whether passive, active, or contrarian, all investors need to be aware of what they know and don’t. This means being cognizant of both the Known Knowns and the Known Unknowns in the environment at every juncture and recognizing that inevitably the passage of time will bring the blackest of those Black Swans, i.e., unpredictable Unknown Unknowns that totally change the game.

Mr. Taleb on Randomness

Black Swan events were described by Nassim Nicholas Taleb in his 2007 book, *The Black Swan.* Taleb regards almost all major scientific discoveries, historical events, and artistic accomplishments as unpredictable "black swans." His list of such events includes the Internet, the personal computer, World War I, and the 9/11 attacks. Taleb asserted:

> ***What we call here a Black Swan (and capitalize it) is an event with the following three attributes. First, it is an outlier, as it lies outside the realm of regular expectations, because nothing in the past can convincingly point to its possibility. Second, it carries an extreme impact. Third, in spite of its outlier status, human nature makes us concoct explanations for its occurrence after the fact, making it explainable and predictable. I stop and summarize the triplet: rarity, extreme impact, and retrospective (though not prospective) predictability. A small number of Black Swans explain almost everything in our world, from the success of ideas and religions, to the dynamics of historical events, to elements of our own personal lives.***

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