

# Investment Update



October 2011

Vizzini: "He didn't fall? Inconceivable!"

Inigo Montoya: "You keep using that word. I do not think it means what you think it means."

— *The Princess Bride* (1987)

## Birds and Words

Though not an avid birdwatcher, I find the sight of a hummingbird flitting about the flowers enough to brighten any day. I am less fond of the woodpecker, who sometimes mistakes my home's cedar shingles for an acorn repository, or the mockingbird and its remarkable dog imitation, which has awoken me at three o'clock in the morning on more than one occasion.

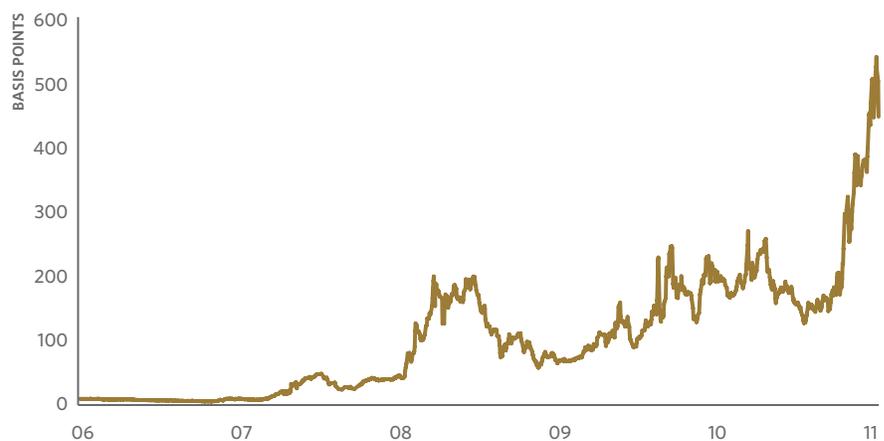
While I have my own avian preferences, one feathered creature seems of particular interest to observers of the financial world these days: the black swan. I have great respect for those few authors or commentators who coin an evocative word or catchphrase to describe events or conditions. "New normal," "contagion" and "black swan" are but a few recent examples. Unfortunately, as their popularity grows, these words become susceptible to misunderstanding and misuse. The result, as experienced by Inigo Montoya in one of my favorite films, is that confusion can be compounded at the worst possible times.

Author and academic Nassim Taleb developed the Black Swan Theory as a metaphor for high-impact but extremely rare events that fall well outside the range of normal expectations. Of late, though, a reader of the financial pages might be left with the impression that our skies have been darkened by great wedges of black swans. At every turn, economic and market events are bestowed with Taleb's label. To be a true black swan, however, an event should be so rare and consequential that it proves all prior observances irrelevant and fundamentally shapes the new view. By this standard, many of the recent occurrences branded as black swans — including the European debt crisis and the U.S. debt downgrade — simply do not qualify. That they may not have been easily predicted or followed a set path is not enough.

How then should we characterize and understand these events? In today's increasingly interconnected world, banking systems, liquidity, debt, consumption and even consumer confidence of different countries and regions have become more correlated. This means shocks have the ability to spread across markets faster and with greater impact than in the past. This is the definition of contagion. We are witnessing it in Europe, where Greece was the first carrier of a crisis that has since infected Portugal, Spain and other peripheral countries. As demonstrated by the rising cost of credit default swaps (CDS) in Exhibit 1, the contagion now has spread to Italy — a core country (CDS reflect the cost to protect against default).

## Exhibit 1 — Italian Bonds under Pressure

5-Year Credit Default Swaps



As of 9/27/11. Source: Bloomberg LP

Reacting to the contagion, markets became increasingly volatile and fell hard in mid-September. This was driven by fear that policymakers would fail to act in time to prevent a disorderly default in Greece, as well as by more pronounced signs of global economic weakness. Even gold, long perceived as a safe haven, dropped as investors faced losses and possible margin calls in some markets and were forced to sell in others. Declines of 6% to 10% in broad equity indexes during the week of September 19 may have convinced global policymakers that the markets were near the riot point. Meetings over the days that followed gave investors hope that action would finally be taken to manage the impact of the debt crisis and stem further contagion.

### Unintended Consequences

Of course, contagion doesn't explain everything we are witnessing. The law of unintended consequences also is alive and well. A benign and amusing example came several years ago from *The Economist*, when the publication planned to name its blog "Economics Exchange" — that is, until one of its developers pointed out that the URL could also be read "Economic Sex Change." This gaffe surely would have been blocked by most corporate web site filters!

Investors currently are contending with the unintended consequences of too little consumer spending and too much government spending. They also face the costs of too little policy action in some cases and too much government intervention in others, including new legislation and regulation.

Another recent example of the law of unintended consequences came from the press release following the September Federal Open Market Committee meeting. In the release, the Fed announced that it would extend the average maturity of its debt security holdings by selling short-term Treasuries and buying long-term Treasuries (Operation Twist). While Operation Twist should make homes more affordable by reducing interest rates, the reality is that interest rates are already low and affordability is not the main cause of current housing weakness. A solution still needs to be found that will reduce the inventory of foreclosed homes and underwater loans. Also in the release was the Fed's observation that "there are significant downside risks to the economic outlook, including strains in global financial markets." This comment, combined with the announcement of Operation Twist, certainly helped push Treasury bond yields lower. But it also unintentionally contributed to the equity market sell-off, as investors feared that the Fed had seen something in its economic outlook that they had not.

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### From Aversion to Affinity

The last few months have been riddled with very challenging data and political news flow. Investors have remained in almost constant risk-off mode. Every piece of news has been interpreted as negative, and justifiably so in most cases. Consumer and investor sentiment have at least stabilized, but at very low levels.

Over the next month or two, investors probably will need to contend with downward revisions to earnings and global economic growth, as well as ongoing political tension as partisanship and campaign positioning harden positions of both parties. This will not make the job of the U.S. congressional debt-reduction "super committee" any easier. Factor in the uncertainty around the actions European policymakers will take and it seems likely markets will remain erratic.

In light of the increased volatility, lack of clarity on policy and diminished confidence in future conditions, long-term investors have largely stayed on the sidelines, leaving higher-frequency traders to buffet markets with their moves. However, prices of many equity securities have been pushed low enough — especially compared to Treasury securities — that long-term investors soon may feel they are compensated sufficiently for the risks they may encounter in holding equities over time.

Unfortunately, strong decisions from policymakers around the globe have been as rare as the ivory-billed woodpecker lately. Perhaps they will come to their senses soon and declare, "Hey! We've been going about this all wrong. Let's try something different!" An acknowledgement of past mistakes and a willingness to take a different tack is the black swan event we all need now.



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