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## Weekly Market Flash

### The Problem of Non-Quantifiable Risk

*June 7, 2019*

Consider the following: at some point between now and the end of July there will in almost all likelihood be a new prime minister in the United Kingdom, as current PM Theresa May has stated her intention to resign within that time frame. Now consider this: the next prime minister of a nation of 66 million citizens will be chosen by...approximately 124 thousand of them. These enfranchised citizens constitute the registered, card-carrying members of the Conservative Party and they alone will receive the ballots asking for their preference between two Conservative Members of Parliament (whose identities have not yet been decided). Whoever wins the larger percentage of those ballots will, given the make-up of the core Conservative Party membership, very likely be in the camp of “hard Brexit” and thus anathema to as much as 53 percent of the total UK electorate. For various reasons both constitutional and procedural, there is an entirely plausible case to make that this next Tory government could drive the UK over a no-deal Brexit cliff before or upon the current decision deadline of October 31.

#### Quantify This!

We bring up this particular issue not for the sake of political analysis, but to illustrate a particularly challenging issue in the current capital market environment: how to price in risks that are, for all intents and purposes, unquantifiable. Brexit is of course not the only issue whose multiple moving parts and lack of historical precedents befuddle conventional risk analysts. The health of global trade and of the very system of unfettered flows of capital, goods and services across borders that has served as the default backdrop for more than three decades of valuing assets is uncertain. The system’s most important player, the United States, has embarked on a program of weaponizing the tools of this system for perceived national gain. Elsewhere, the traditional center-right and center-left political parties that have dominated the political scene throughout the entire postwar period are in radical decline.

How does one price any of this into the valuation of this or that asset? Sure, it’s easy enough to throw together a conventional model, assigning probabilities to various outcomes and then matching each outcome with a guesstimate as to the price impact on stocks, crude oil or high yield bonds. But those guesses amount to no more than throwing a dart at the wall while blindfolded. Would a hard Brexit, or a hot trade war, or a sharp turn towards authoritarian populism in more of the developed and developing world be good or bad for Brent crude or the US tech sector or the euro? Who knows? There is literally no hard empirical data to suggest the correctness of one guess – one throw of the dart – versus another.

#### In Powell They Trust

In the absence of the ability to rationally price the various organic risks afoot in the global marketplace, all the eggs find themselves in one basket: the willingness of central banks, principally the US Fed, to do anything it takes to keep risk asset markets from falling. Last fall we saw what happens when that faith is shaken. For a period of weeks between late September and late December 2018 it became clear that there was a less than certain chance the Fed would step in to backstop falling markets. Had the Fed not radically reversed course in early January with a major policy U-turn, it is entirely plausible that the near-bear market reached on December 24 would have turned into a real bear market. But the Fed lived up to its reputation as the redeemer and comforter for the investor class, and all was well again.

The Fed put, in effect, has become the substitute for organic risk analysis in a world of profound macro uncertainties. This explains why the dominant characteristic of markets in 2019 to date is that bonds and equities are joined at the hip – the prices of both rising under the expectation that central banks will continue to – and continue to be able to – underwrite whatever disruptions actually come about as a result of a hard Brexit or a tsunami of tariffs or whatever else comes along.

We'll have another chance to see, very shortly, whether this undiluted faith in the Fed is justified. The market is currently pricing in about a 70 percent chance that the Fed will cut rates three times in the next year. Some comments this week by Chair Powell provided succor to this view – equity markets surged on Tuesday on the interpretation that any negative outcomes from an aggressive US tariff policy will be offset by a flood of Fed dollars. On June 19 we will see just what combination of words and/or action support that view when the FOMC concludes its June meeting.

And therein lies the ultimate exercise in non-quantifiable risk. Either the Fed and other central banks can prop up asset markets indefinitely, come what may, or they can't. Assign a probability to each outcome, put on a blindfold and throw the dart.

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