

MV Capital Management Thought Leadership

X-Factors Run Amok: An Uncertain and Volatile Landscape

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*There shall not be found among you any one that...useth divination, a soothsayer...
Deuteronomy 18:10*

Over the centuries a vast amount of human effort and resources has gone into the forecasting industry. We humans, of course, have a basic, deep-seated desire to know the future – and have always shown a ready willingness to pay all manner of riches to those who claim to be able to satisfy our insatiable need to know what lies in store. Stone runes and tea leaves have given way to dense statistical analysis and complex simulations of alternative scenarios grounded in advanced quantitative methods. Many times these appear to be on the mark – and then sometimes world events remind us that like the soothsayers of old we are still limited in how confidently we can predict the future.

We are in such a time right now. The explosion of popular uprisings all across North Africa and the Middle East seemed to come out of nowhere. Of course that is not the case – the legitimate, widespread resentments and grievances that spilled into the streets of Cairo, Tripoli, Sana'a and elsewhere in the region have been years in the making and are grounded in decades-long mismanagement and blinkered incompetence by small enriched national elites at the expense of their citizens. Now the world is watching – and wondering what the consequences will be on many different levels.

Geopolitical unrest is a perennial X-factor. Those of us in the business of analyzing markets and economies have long lists of these X-factors – lurking threats that could suddenly erupt into real-time risks. What one never knows in advance is which X-factors will actually develop, when they will develop, and how far-reaching their effects will be. In the case of the Middle East, though, we believe that we are only seeing the beginning today of a very complicated, nuanced realignment of the economic, political and social make-up of this region. This realignment will probably last a long time – but some of the economic effects could be felt in the very near term.

So what are these effects? The conventional wisdom has quickly settled on the obvious variable – oil. Libya is the world's 12th leading exporter of oil, the leading producer of a specialty variety called light sweet crude, and a major energy supplier to Mediterranean Europe, notably Italy. The fact that major cracks are running through the fault lines of the Gulf States leads many to contemplate the more dire consequences of supply disruptions from the pulsating heart of Hydrocarbonia – Saudi Arabia. To date while there are discernable flutters of unrest in the Oil Kingdom there are no obvious signs of imminent chaos – but the X-factor is out there and that is enough for some prognosticators.

But in today's world there do not have to be actual disruptions – not one lever of production has to actually shut off for other factors to carry oil prices ever higher. Major production centers – China and other large growth markets – face dire consequences to their input cost structures if oil prices skyrocket, and they may escalate purchase of futures contracts to lock in rates for longer periods. Leveraged speculators can certainly do their part – we saw this play out during the commodities price boom of summer 2008. And it's not just oil – many other commodities from agriculture to base and precious metals are trading up towards or surpassing their all-time highs.

Gavyn Davies, a well-known British economics and investment expert and *Financial Times* contributor, noted recently that each of the last five global economic downturns has been foreshadowed by a major jump in oil prices (at varying times for supply side or demand side reasons). When it's not just oil but across-the-board surges in commodities prices the economic effects can be even more pronounced. Think of it this way: in the US, where consumer spending drives the economy like nothing else, household budgets are slowly regaining their footing after the travails of the Great Recession. It's a fragile footing: unemployment remains high,

incomes are still stagnant, debt levels are still high and home prices are not rising fast enough to bolster the equity side of the balance sheet. Now: two of the largest contributors to monthly household spending are gas and groceries. So those high crude oil, corn and coffee prices have a direct, rapid effect on consumer behavior – an effect that could sharply choke off the ginger loosening of the purse strings for discretionary spending.

And it's not just households: businesses will feel the pinch as well. For most manufacturers the largest expense item on their income statements is Cost of Goods Sold – direct costs including raw materials and labor. Labor costs are not going up any time soon – but those raw materials costs get hit every time oil or copper or aluminum jump another 5%. Businesses have to decide whether they can eat those costs and suffer potentially lower profit margins (leading to lower earnings projections, which we know Wall Street hates with a passion) or try to pass them onto those already-beleaguered consumers. Not much of a choice – and not one with a discernable economic upside.

The fact is, in today's global economy there is no point asking whether an X-factor like geopolitical unrest will cause X to happen, or Y or Z. The economy is too interlinked. Not only will X, Y and Z all probably experience some effect, so also will Γ and Φ and Ω . Plus something else that nobody is even thinking about right now. And it may turn out that what is disruptive today may be a great gift to the economy in ten years time. Think about a Middle East with actual emergent democracies and market-friendly, free trade economies in the offing. Sound improbable? It seems that the most irrelevant phrase in the English language today is “that could never happen”. An awful lot of things that could never happen have already happened. In life, as in investments, past precedent is an unreliable guide to future outcomes.

The events in the Middle East are complex and nuanced, befitting societies that have their roots in ancient civilizations with long and rich histories. Whatever happens this week or next, these changes will be shaping our world for quite some time to come – for the better and for the worse depending on where, when and how. In times like these there is always a yearning for soothsayers to look into and predict the future. But divination is a fool's errand. Flexibility, diligence and preparedness for what may lie around the next bend are the ingredients for navigating through the uncertainty.

With warm regards,

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