

The Blacker Swan

By John Mauldin | July 3, 2020



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“A similar effect is taking place in economic life. I spoke about globalization in Chapter 3; it is here, but it is not all for the good: it creates interlocking fragility, while reducing volatility and giving the appearance of stability. In other words, it creates devastating Black Swans. We have never lived before under the threat of a global collapse. Financial institutions have been merging into a smaller number of very large banks. Almost all banks are now interrelated. So, the financial ecology is swelling into gigantic, incestuous, bureaucratic banks (often Gaussianized [bell curve] in their risk measurement)—when one falls, they all fall.

The increased concentration among banks seems to have the effect of making financial crisis less likely, but when they happen they are more global in scale and hit us very hard. We have moved from a diversified ecology of small banks, with varied lending policies, to a more homogeneous framework of firms that all resemble one another. True, we now have fewer failures, but when they occur... I shiver at the thought. I rephrase here: we will have fewer but more severe crises. The rarer the event, the less we know about its odds. It means that we know less and less about the possibility of a crisis.”

—Nicholas Nassim Taleb, *The Black Swan*, presciently written 2006ish

Happy Fourth of July, when we in the United States celebrate independence from England. This year ironically proves independence has limits. It didn't protect us from a virus that originated elsewhere.

In a further irony, the same virus has compelled every government on the planet to, in various ways, declare independence from allies and trading partners. Similarly, consumers and businesses have also declared a kind of "independence" from each other because close contact is suddenly risky.

We knew pandemics happen and can have big consequences. No one knew in 2019 one was coming in 2020. It was what my friend Nassim Taleb called a "[Black Swan](#)" in his 2007 book with that title. (That book, along with [Antifragile](#), are his two best. You only need to read the first half of *Antifragile* to get the point, making it a short but very important read.)

I read *The Black Swan* shortly after it came out. The financial crisis and Great Recession were brewing, and I was already beginning to predict a recession. We sensed something big was coming but didn't know the details. Rereading my September 2007 review of Taleb's book is an eerie glimpse into the past. It's also a good reminder that more big events lie ahead.

This week I'm giving my staff (and myself) some much-needed time off. This letter will just be some excerpts from that 2007 *Black Swan* review. You can [read the whole letter](#) in our archives. It is excellent food for thought as we try to discern what lies ahead. Think of the future as The Blacker Swan.

I'll be back at the end with some closing comments.

The Black Swan

Note: The following was originally published September 14, 2007. Comments in [brackets] were added this week.

Last week, seemingly so long ago and so far away, I was wandering through St. James Park in London. It was a perfect afternoon in a perfect park, with willow trees reflecting on the pond and the Eye of London in the distant background. And then there it was. It swam into my vision. A Black Swan. A rather inelegant bird when compared to its august white brethren, but recognizable as a swan nonetheless. Seeing a Black Swan seemed to cap off the day, as I had just finished reading a book whose title was inspired by the dark fowl.

Just because all the data says that there are only white swans does not prove that Black Swans do not exist. All we can confidently assert is that no one has seen one—yet. To prove that a Black Swan does not exist would take an infinite number of observations, and yet only one observation is needed to prove they exist. And thus philosophers debated the Black Swan issue and showed that by induction you could reason they did not exist.

And that was the case until explorers did indeed find a Black Swan in Australia. The term “Black Swan” has come to mean an event or discovery whose existence was not predictable from the available data, and whose effect on society or the markets yields surprising and unexpected results.

Taleb attacks (the correct word) the social sciences (in particular economics) which uses standard Gaussian bell curves to “prove” their points. Everything has to fit within the curve. There is little room in the neat world of the bell curve for events that are far from the center. He creates a world he calls Mediocristan which is the world of white swans, bell curves, and predictability. He contrasts this with Extremistan which is the world of chaos, fractal geometry, power laws, Black Swans, and where the unpredictable happens.

There are parts of our lives which inhabit Mediocristan and parts which dwell in Extremistan. Not knowing the difference can be problematic, if not fatal. And it is difficult to know where one country starts and the other ends. If you are in Mediocristan, then you can use your bell curve assumptions without fear. But if you wander into the murky border areas, you are no longer safe in your assumptions. And yet, the longer and deeper you go into Extremistan without a problem, thinking you are safe in Mediocristan, the larger the disruption is likely to be.

“To summarize, in this (personal) essay, I stick my neck out and make a claim, against many of our habits of thought, that our world is dominated by the extreme, the unknown, and the very improbable (improbable according our current knowledge)—and all the while we spend our time engaged in small talk, focusing on the known, and the repeated. This implies the need to use the extreme event as a starting point and not treat it as an exception to be pushed under the rug. I also make the bolder (and more annoying) claim that in spite of our progress and the growth, the future will be increasingly less predictable, while both human nature and social ‘science’ seem to conspire to hide the idea from us. (Prologue xxvii)

“When I ask people to name three recently implemented technologies that most impact our world today, they usually propose the computer, the Internet, and the laser. All three were unplanned, unpredicted, and unappreciated upon their discovery, and remained unappreciated well after their initial use. They were consequential. They were Black Swans. Of course, we have this retrospective illusion of their partaking in some master plan. You can create your own lists with similar results, whether you use political events, wars, or intellectual epidemics.

“You would expect our record of prediction to be horrible: the world is far, far more complicated than we think, which is not a problem, except when most of us don’t know it. We tend to ‘tunnel’ while looking into the future, making it business as usual, Black Swan-free, when in fact there is nothing usual about the future. It is not a Platonic category!” (p. 135)

I think there is a physical reason Taleb is right in that we will see more unpredictability in the future than we saw only a few hundred years ago, or even last century, as wild as that century was. I wrote a few years ago of Ray Kurzweil's book, [The Singularity is Near](#). (Also very highly recommended.) Ray wrote (in 2000) that the pace of change as encompassed by technology is accelerating.

“The first technological steps—sharp edges, fire, the wheel—took tens of thousands of years. For people living in this era, there was little noticeable technological change in even a thousand years. By 1000 A.D., progress was much faster and a paradigm shift required only a century or two. In the nineteenth century, we saw more technological change than in the nine centuries preceding it. Then in the first twenty years of the twentieth century, we saw more advancement than in all of the nineteenth century. Now, paradigm shifts occur in only a few years' time. The World Wide Web did not exist in anything like its present form just a few years ago; it didn't exist at all a decade ago.

“The paradigm shift rate (i.e., the overall rate of technical progress) is currently doubling (approximately) every decade; that is, paradigm shift times are halving every decade (and the rate of acceleration is itself growing exponentially). So, the technological progress in the twenty-first century will be equivalent to what would require (in the linear view) on the order of 200 centuries. In contrast, the twentieth century saw only about 25 years of progress (again at today's rate of progress) since we have been speeding up to current rates. So the twenty-first century will see almost a thousand times greater technological change than its predecessor.”

Ray is saying most people project future growth in technology at today's rate of change. But the rate of change is accelerating, so that more and more change is packed into smaller and smaller amounts of time. While the vast majority of the thousand times greater technological change Ray is talking about happens in the last part of this century, some of it happens in the next twenty years. How much change are we talking about? Well, from when he first penned those words, the pace of change has picked up. At current levels, that means the 20th century was equivalent to about 20 years of progress at today's rate of change. That pace will continue to increase the amount of innovation we pack into just a few years. [That is even more true today than it was 20 years ago when he wrote it or 13 years ago when I quoted it.]

When “Because” Isn't Enough

Having seven kids, I have answered more than a few hundred questions with the brilliant “because such and such.” The younger kids will sometimes even accept such answers, when a true skepticism would be more in order.

I admit to sometimes giving in to such a rationale today. I, along with my fellow humans, like causality. B happens because of A. And it is tempting to ascribe a simple “because” to today's Black Swan in the credit markets. It is all the fault of the subprime mortgage lenders. If they had not made bad loans we would not have the problem.

I would suggest the problem is more systemic than that. Assume we had the rational laws in place five years ago that we will enact next year preventing bad mortgage underwriting. Then there would have been excess and a bubble in some other part of the markets at some other point in time. As humans, that is what we do. We push the limits of greed, especially when accompanied by the illusion of stability, until the bubble bursts.

Sometimes the “because” is a synergy of multiple events. The internet is not possible without multiple inventions. It was around for 20 years before it began its rather meteoric rise in the late ‘80s. There is no simple because, but the implications and the unpredictability of the results were not clear in 1987 to all but a few wild-eyed, and generally considered crazy, individuals.

“This in itself greatly weakens the notion of ‘because’ that is often propounded by scientists, and almost always misused by historians. We have to accept the fuzziness of the familiar ‘because’ no matter how queasy it makes us feel (and it does make us queasy to remove the analgesic illusion of causality). I repeat that we are explanation-seeking animals who tend to think that everything has an identifiable cause and grab the most apparent one as the explanation. Yet there may not be a visible because; to the contrary, frequently there is nothing, not even a spectrum of possible explanations.” (p. 119)

Gliding into Disorder

We tend to think of Black Swans as bad events. But as noted above, there are good Black Swans which positively impact human existence. And Taleb himself sees a glimmer of the positive:

“We are gliding into disorder, but not necessarily bad disorder. This implies that we will see more periods of calm and stability, with most problems concentrated into a small number of Black Swans.” (p. 225)

It is easy to take the credit disruptions of today and straight line the present into the future. But it might be more useful to see how the previous Black Swans of financial disruptions were dealt with.

Let’s look at 1987, 1998, and 2000 [and now 2008]. Each period had rather solid US economies preceding them. All had rather significant disruptions. And each one saw the Fed open the liquidity flood gates.

You can expect the same today. As I have often written, when the Fed embarks upon a new course, they will go further and the course will last longer than anyone thought at the beginning of the process. Who thought when the Fed began to loosen monetary policy in early 2001, when rates were 6.25%, that we would see 1% within a short period of time? And who thought it would stay that way for so long? And when they began tightening again? Who thought it would get to 5.25%? Back then, 4% seemed like a very high rate.

Right now, the market is pricing in rate cuts of 75 basis points by the end of the year and another 25 basis points within 12 months. I think that is low. If the Fed is cutting, it is because they see the economy weakening. And I think that means they will cut more than anyone expects. What is the end number? I don't know. But I bet it is a lot lower than 4.5%. [Turns out I was right on target.]

Why? Because the credit markets are going to take a lot longer to sort out the mortgage problems than we might think. And that means that a lot of homes are not going to move for some time, which is not good for consumer sentiment or spending. And there will be substantially less mortgage equity withdrawal. As home prices drop 10% and then 15% and then 20% [I was such an optimist], Boomers are going to realize that a large part of what they thought they had for retirement in the equity of their homes is not there. That means they need to spend less and save more. While that is good as an individual policy, it is rough on the economy at large. I still think this process ends in a recession.

But John, (I hear you ask) if the Fed cuts rates, won't that make mortgages cheaper? The answer is that for conforming loans it will. But right now, if you want a home with a loan larger than \$417,000, you are looking at interest rates as high as 9%, even with excellent credit. And if you have poor credit? There are no subprime loans for you, without substantial down payments.

The problem, as I repeat, is not the availability of liquidity. It is the lack of credibility. No one is buying paper they are not absolutely 100% sure about...

It will take some time, but the current disorder will again become order and the process will begin again, with a bubble happening in some other market which will eventually come undone and create a new Black Swan event.

[End 2007 quote]

Big Dreams

All right, back to 2020, where we are facing "a new Black Swan event" like the one I referenced back in 2007. It turns out Black Swans are everywhere. Some are more powerful than others. And they're not always bad, though this one certainly is.

I keep saying, and still believe, we will not see any kind of quick recovery. The damage is just too great. But our economy will recover and, slowly but surely, the good will outweigh the bad.

We have many challenges ahead. We also have big dreams, as they did back in 1776. They fought for their dream because they thought it was worth the effort. We can honor their spirit by doing the same.

Birthdays, Anniversaries, and the 4th of July

Last weekend Shane and I celebrated her birthday and our third wedding anniversary. After three years together, Shane and I were visiting our good friends Meredith and George Friedman down in Austin on her birthday. I made the extremely wise decision to ask her to marry me on her birthday while we were eating barbecue with Meredith and George. We were married exactly one year later.

Shane and I had four years together before marriage, not because I had any doubts, but I wanted her to have “full disclosure” on your humble analyst. Let’s just say that I might not be the easiest person to live with. I travel a lot (or used to) and I tend to sit in front of the computer or iPad for long periods. And I tend to get caught up in binge reading when I obsess on a topic. Weird hours and all that.

She actually seems to love all that about me, which I find remarkable. We are now living in a Caribbean paradise that truly has become our own personal paradise. Yes, we will have to deal with the occasional hurricane. But Texas was no picnic, weather-wise. I have personally seen more than my fair share of tornadoes. Every geographic rose seems to have a few thorns.

For those of us who are celebrating 244 years of declared independence, happy Fourth of July! And an early happy Canada Day and Bastille Day to my Canadian and French readers. And since each country has its own special day, let me wish everyone the best.

It is good to remember our history and where we came from, especially when many want to erase that history instead of learn from it. Context matters. It is easy to grab for simple slogans, but nations are not built on slogans but on hard work, cooperation, and progress.

And while the Founding Fathers might be somewhat horrified at where we have taken some of their ideas, I think they would also be proud of our progress. The great trade of our time will be long humanity, short government.

But that is a topic for another letter, or maybe even a book. Have a great week, and be careful out there!

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