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Black Swans, Oil, and the Middle East

Once again, a highly improbable and totally unexpected turn of events is taking place in the world. I am of course referring to the “game changing” political changes taking place in the Middle East and Northern Africa.

In Nassim Taleb’s 2007 best seller The Black Swan, Taleb defines a Black Swan event as a highly improbable occurrence with three main characteristics. It is largely unpredicted, it has the potential to have a significant impact, and observers attempt to concoct an explanation to make it appear less random and more predictable than it actually was.

The recent overthrow of Hosni Mubarak’s 30 year autocracy, the pending dismantling of Muammar Gadhafi’s 42 year reign of terror, and the challenges to power spreading throughout the region certainly qualify as such events.

The potential geopolitical and economic consequences of these events have the potential to be significant, but in either a hugely positive or a significantly negative way. In the short term, it’s about oil, but the long term ramifications are totally unpredictable at this point in time. We’ve all witnessed the recent spike in oil prices which sent jitters through the markets. At a time when commodity and raw material prices have been creating inflation concerns, the timing is not particularly good. It is often termed that higher energy prices serve like a tax on consumers and the economy. Regardless how one may try to conserve their personal energy consumption, higher energy costs filter their way into almost every aspect of our lives. Should high prices persist, the economy can be at risk of inflation, stagflation or at the minimum, slower growth. Unfortunately, it is too early to predict the many variables that will determine energy prices going forward. What seems quite likely however is that both stocks and commodities will experience increased volatility as ramifications of these changes unfold, and investors need be prepared.

Politically, many suggest that these Middle Eastern countries are better prepared for democracy than at any time in previous decades. Unfortunately, rogue nations like Iran and Syria and other extremists stand prepared to leverage any power void, similar to what they have done in Lebanon.

What never changes however is the part of human nature that feels a need for and finds comfort in prognostications and predictions about how a potentially tumultuous and fluid turn of events will play out. Despite the fact that there is no way to predict such outcomes, we tend to gravitate to those who engage in trying to read the tea leaves, despite most “experts”’ dubious track record at divining the future. I suppose that it is more reassuring to hope for a “best case positive scenario” than to withstand the anxiety of uncertainty.

In our year-end letter, while we acknowledged improvements in the market's fundamentals, we tried to convey the idea of not getting carried away despite the market's two year recovery. The need for safety and hedging one's portfolios still very much existed despite the enthusiasm over QE2's potential impact and higher and higher price targets being set for the S&P 500.

While Black Swan events are not daily occurrences, Taleb argues that their frequency is on the rise, given globalization, the internet, political extremism and the number of economic and political high wire acts that exist today. The magnitude of the impact of events like Hurricane Katrina, the BP oil spill, the Madoff scandal, the 2008 financial crises which ended the legacy of Lehman Brothers and Bear Stearns, or even the success of something like Facebook demonstrate how highly unexpected events can have deep and lasting reverberations throughout the world and economies.

As I mentioned above, while many in the political and financial media will continue to offer opinions and predictions about the outcome of current events in the Middle East, Centerpoint humbly maintains that a healthy respect for "what we don't know" about the future may be as equally relevant as what we think we do know. In attempting to be risk-conscious in our investment selections and fixed income strategies, we feel better prepared to "weather the unexpected."

Like everyone, we are staying tuned with considerable interest to these recent events and are closely following issues that we think could impair the current recovery or add additional geo-political risk to the market. I would like to say we are cautiously optimistic but I think cautious is a better characterization of how we feel about the markets until there is greater visibility and evidence of some meaningful stability.

Sincerely,

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