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## Daily Comment

# Exogenous vs Endogenous Shocks

Financial markets can be hit by two types of crisis: exogenous, like 9/11, SARS, Katrina, BP Horizon Gulf spill, etc., or endogenous, often the result of too much leverage (e.g., Nasdaq at 5,000, subprime mortgages, real estate in Spain). The big difference is that an exogenous crisis is unforeseeable while an endogenous one is predictable—even if getting the timing right is very challenging. For this reason, we have found that it makes more sense to try to cushion portfolios against endogenous crises.

**It is hard to hedge against exogenous shocks, which tend to go away more quickly than endogenous ones**

This is not to say an exogenous shock is not tremendously scary and destabilizing, if only because it makes us question everything that we believe in and take for granted. Take yesterday's bomb attack in Boston, or the bird flu currently working its way across the Chinese eastern seaboard, or North Korea's saber-rattling. Any one of these events will make us question our ability to safely send our children to school, or go to the office without encountering senseless death and devastation.

To believers in the "invisible hand" like ourselves, hysterical media reports serve a purpose: not only do they ensure a rapid dissemination of knowledge, but also that people will change their behavior (wash hands more frequently, be more careful about unattended luggage or shifty looking people, etc). And in turn, this means that diseases always end up having far less dire consequences than initially feared (as was the experience with SARS and all recent bird-flu outbreaks), just as terrorism, while traumatizing for the families impacted, typically ends up having a very marginal economic impact. So, as destabilizing as exogenous shocks can be for the psyche, their market impacts never tend to last long.

The same cannot be said of endogenous shocks. They tend to cast a very long shadow. And unfortunately, today, the world is confronting several possible endogenous shocks:

### Checking The Boxes

Our short take on the latest news

| Fact | Consensus belief | GK Research reaction |
|---|---|---|
| **NAHB homebuilders' survey fell** to 42 in April, from 44 | Worse than expected rise to 45 | NY regional mfg survey also disappointed; April data not getting off to strong start |
| **EMU trade surplus widened** to €12bn in Feb, up from €8.7bn | Consensus expectations was for a €10bn trade surplus | Slightly encouraging; but intra-EMU imbalances remain —we need more GE reflation |
| **India's WPI slowed** to +6.0% in Mar, from Feb's +6.8%; CPI also slowed | Lower than expected 6.3%; but some of the slowdown is from a rising base last year | Lower gold price was major contributor; helps case for rate cuts as does cheaper oil |
| **Japan industrial production revised up** to +0.6% MoM for Feb | Better than initial –0.1% | Encouraging consecutive improvements, although YoY still –10.5% |

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Exogenous vs Endogenous Shocks

**Endogenous shocks could be brewing in Europe or China**

1. Far from recovering, southern Europe is increasingly dragging other European economies into a secondary depression, chief amongst them France (see **France On The Brink Of A Secondary Depression**). France's downward economic drift, combined with its lackluster political leadership, is amplifying calls that the economic experiment called the euro has been an utter failure and continues to wreck lives all across Europe. As Charles put it in a number of our European debates: "*The euro was a solution looking for a problem; it is now a problem without a solution*".
2. The European Union, in a typical displacement pattern, is increasingly dealing with the above grim reality by attacking the world of finance (caps on bonuses, taking down tax havens, Tobin tax...). This course of action should logically trigger a collapse in the velocity of money all across the Old Continent, thus making a bad situation worse.
3. The great commodity bull market of the past decade probably peaked in 2010 along with China's capital spending binge, and is now rolling over. This means that a lot of investments that took place in recent years will turn out to be uneconomical (how else do we explain the brutal collapse of most mining stocks?). If such investments were bank financed (and by all accounts they mostly were), the continued commodity bear market could also have a short term impact on the velocity of money.
4. The fourth possible endogenous shock is that the Chinese growth model, based on the ever-expansion of bank, state enterprise and local authority balance sheets, is undergoing a serious transformation. This transformation may or may not succeed.

**The crash in gold points toward a liquidity black-hole somewhere in the system**

All these endogenous shocks bring us to the recent price action in gold. Is the crash in gold a reflection of some exogenous shock (forced gold sales by bust European countries? Japanese selling gold to buy back a weaker yen? Margin requirement changes in Shanghai and Chicago? US tax-day selling gone wild)? Or is it the reflection of an endogenous problem (less demand from China given the growth slowdown and corruption crackdown? Russian oligarchs selling after Cyprus losses and the gradual slip of Russia into recession)?

The recent market behavior of gold, combined with the increased volatility in the JGB market and the spike in VIX, probably points towards the existence of a "liquidity black-hole" somewhere in the system. If so, and until this black-hole is identified, markets are likely to remain skittish.