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As the world's most expensive and fractious playground fight (otherwise knows as US budgetary process) continues into its second week, investors appear to be getting more and more nervous that this time it's different – the possibility is arising that this collection of Washington egos really could "crater" the world's largest economy with their antics.

As I've mentioned in a previous post, we don't believe so. Even so, events of the past couple of weeks – and their negative impact on the financial markets ARE worth discussing because they illuminate investor behavior and how markets move in general.

One of the hallmarks of the financial markets is that they are generally considered "efficient". That is, the level of the market (and of its individual components) instantly reflects all available information about them as it becomes available. For instance, Royal Bank stock at today's price of $66.30 per share reflects the market's combined understanding of the value of the company, now and into the future. As new information comes along (as it does every day) the company's share price instantly rises or falls to reflect that information.

Of course, historical or current information is one thing – future information is another. Because future information isn't a known quantity yet (duh!), probabilities get attached to it. For instance, say the markets (collectively) believe that Royal Bank will earn $5 per share next year. Then the economic outlook becomes more uncertain and the forecast changes to only a 90% probability of $5 in earnings with a 10% chance that something awful happens and earnings fall to $4 per share. Doing some math gives us a blended estimate of $4.90 per share – i.e. the small chance of a bad result drags down the overall estimate for the stock (which, I would expect, would probably fall by about 2%).

That's what is happening to the markets today. I think the majority of investors believe the U.S. budgetary impasse will be solved and that it's extremely unlikely that the U.S. could actually default on its debts. But because there is a small chance that it could happen, that probability of disaster (which some would call a "Black Swan" event) is automatically factored into the markets – and down they go.

Of course, the reverse of the above situation can lead to a rally – and it can be dramatic (and quite puzzling) when it happens. The situation in Europe is a great example. I think most investors would be shocked to hear that European markets, as measured by the ishares S&P Europe Index, were up over 20% (!) in the past 12 months. It's not so much that Europe is booming (anything but), it's, I believe, in large part that the risk of catastrophe has fallen considerably. If a similar situation unfolds in the U.S., we should be able to look forward to a pretty good rebound.

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