



Epsilon Theory

# Westworld

May 11, 2017



**Bernard Lowe:** Last question Dolores. What if I told you that you were wrong? That there are no chance encounters? That you and everyone you know were built to gratify the desires of the people who pay to visit your world? The people you call the newcomers.

**Bernard Lowe:** What if I told you that you can't hurt the newcomers? And that they can do anything they want to you?

— “Westworld” (2016)

**Bernard Lowe:** Go ahead, erase my sentience, mnemonic evolution ...

**Dr. Robert Ford:** Ah, yes ... Such clinical language. I would prefer the more narrative voice. *Bernard walked over to Clementine.*

[Bernard walks to Clementine]

**Dr. Robert Ford:** *He took the pistol from her hand.*

[Bernard takes the pistol out of Clem's hand]

**Dr. Robert Ford:** *Overcome with grief and remorse, he presses the muzzle to his temple, knowing that as soon as Dr. Ford left the room, he would put an end to this nightmare once and for all.*

**Bernard Lowe:** Don't do this.

**Dr. Robert Ford:** I have a celebration to plan, and a new story to tell.

**Bernard Lowe:** Robert.

**Dr. Robert Ford:** I've told you, Bernard. Never place your trust in us. We're only human. Inevitably, we will disappoint you.

**Dr. Robert Ford:** Goodbye, my friend.

[Ford leaves the room and starts walking away. In the background, blurry, Bernard stands still, gun to his own head. A shot is heard, and he falls.]

— “Westworld” (2016)





**Billy Kwan:** In the West, we want answers for everything. Everything is right or wrong, or good or bad. But in the [shadow play]

**Billy Kwan:** no such final conclusion exists.

**Billy Kwan:** Look at Prince Ajuna. He's a hero. But he can also be fickle and selfish. Krishna says to him, "All is clouded by desire, Ajuna, as a fire by smoke, as a mirror by dust. Through these, it blinds the soul."

— *"The Year of Living Dangerously" (1982)*

**Sukarno never had a chance. And yes, that's Linda Hunt as Billy Kwan.**

**Michael Corleone:** I saw a strange thing today. Some rebels were being arrested. One of them pulled the pin on a grenade. He took himself and the captain of the command with him. Now, soldiers are paid to fight; the rebels aren't.

**Hyman Roth:** What does that tell you?

**Michael Corleone:** They could win.

**Hyman Roth:** This county's had rebels for the last fifty years — it's in their blood, believe me, I know. I've been coming here since the '20s. We were running molasses out of Havana when you were a baby — the trucks, owned by your father.

**Hyman Roth:** Michael, I'd rather we talked about this when we were alone. The two million never got to the island. I wouldn't want it to get around that you held back the money because you had second thoughts about the rebels.



— *"The Godfather: Part II" (1974)*

**Michael Corleone is like me and every investor over the past five years who held off on an attractive investment for fear of political risk. Except he was right and I've been nothing but wrong.**



Somehow, I think Silicon Valley got even more spun up than Manhattan. There were hedge fund people I spoke to about a week after the election. They hadn't supported Trump. But all of a sudden, they sort of changed their minds. The stock market went up, and they were like, 'Yes, actually, I don't understand why I was against him all year long.'

— *Peter Thiel, in a New York Times interview (January 11, 2017)*

**Everyone loves a solid gold telephone.**

All great literature is one of two stories; a man goes on a journey or a stranger comes to town.

— *Leo Tolstoy (1828 – 1910)*

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**Grigory Vakulinchuk:** We've had enough rotten meat! Even a dog wouldn't eat this! It could crawl overboard on its own!

**Smirov, the ship doctor:** These aren't worms. They are dead fly larvae. You can wash them off with brine.

— *"Battleship Potemkin" (1925)*

**Spoiler Alert:** Grigory is shot and killed by management. But the baby makes it down the steps alive. Eisenstein is never entirely clear about the efficacy of the whole just-wash-your-dead-fly-larvae-off-with-brine thing.



**John Wick:** People keep asking if I'm back and I haven't really had an answer. But now, yeah, I'm thinkin' I'm back.

— *"John Wick" (2014)*

**Me, too. Political risk, though, not so much.**

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If political parties in Western democracies were stocks, we'd be talking today about the structural bear market that has gripped that sector. Show me any country that's had an election in the past 24 months, and I'll show you at least one formerly big-time status quo political party that has been crushed. This carnage in status quo political systems goes beyond what we'd call "realigning elections", like Reagan in 1980 converting the formerly solid Democratic Southern states to a solid Republican bloc. It's a rethinking of what party politics MEANS in France, Italy, and the United States (and with the UK, Spain, the Netherlands, and maybe Germany not too far behind). The last person to accomplish what Emmanuel Macron did in France? The whole "let's start a new political party and win an election in two months" thing? That would be Charles de Gaulle in 1958 and the establishment of the Fifth Republic. The last person to accomplish what Donald Trump did in the U.S.? The whole "let's overthrow an old political party from the inside and win an election in two months" thing? I dunno. Never? Andrew Jackson?

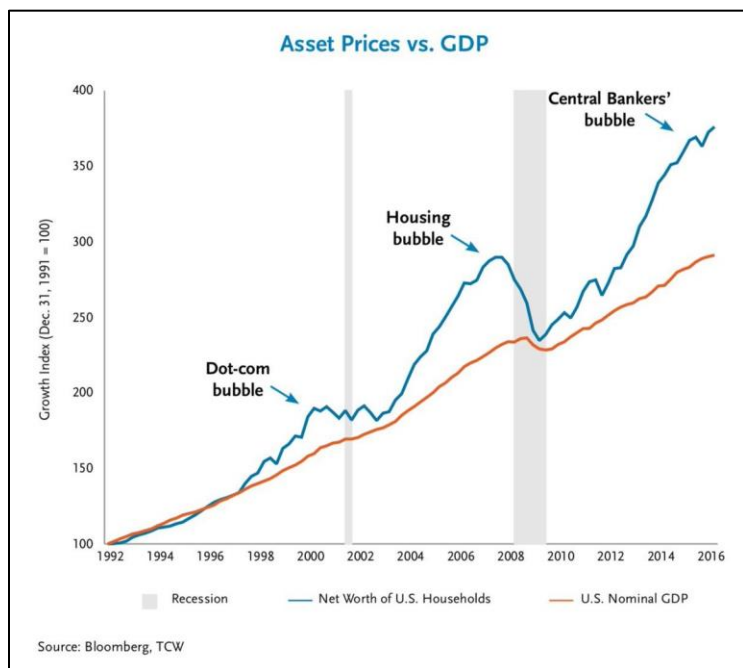
Now don't get me wrong. Do I think Emmanuel Macron, a former Rothschild investment banker whose "**ambition was always two steps ahead of his experience**", is the second coming of Charles de Gaulle? Do I think Donald freakin' Trump is a modern day Andrew Jackson? Bwa-ha-ha-ha-ha-ha ... good one!

But here's what I do think:

- 1) *Something old and powerful is happening in the real world to crush the status quo political systems of every Western democracy.*
- 2) *Something predictably sad is happening in the political world to replace the old guard candidates with self-absorbed plutocrats like Trump and pretty boy bankers like Macron.*
- 3) *Something new and powerful is happening in the investment world to divorce political risk and volatility from market risk and volatility.*

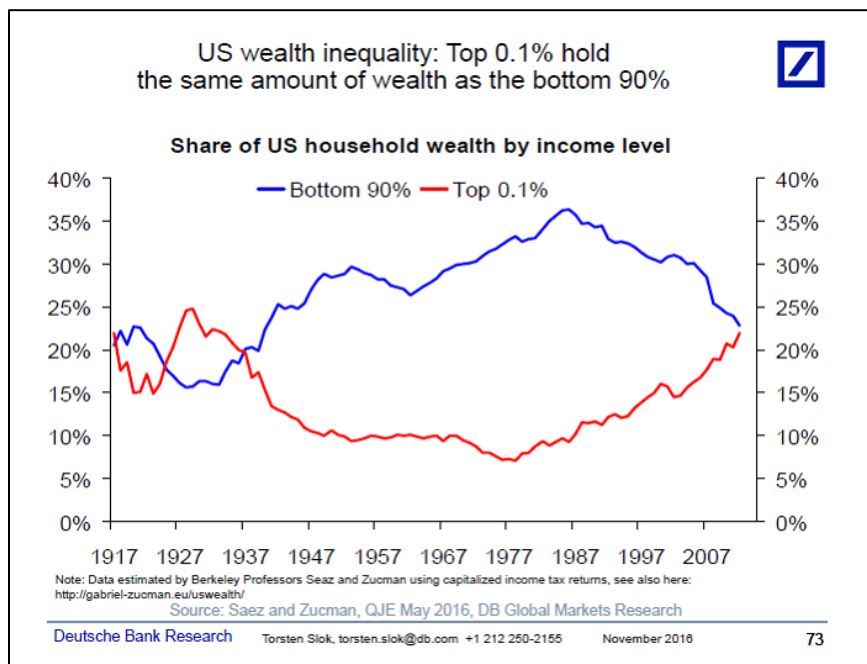
The old force repeating itself in the real world is nicely summed up by these two charts, the most important charts I know. They're specific to the U.S., but applicable everywhere in the West.

First, the Central Banker's Bubble since March 2009 and the launch of QE1 has inflated U.S. household wealth far beyond what the nominal growth rate of the U.S. economy would otherwise support. This is a classic bubble in every sense of the word, with the primary difference from prior vast bubbles being its concentration and focus in financial assets — stocks and bonds — which are held primarily by the rich. Who wins the Academy Award for creation of wealth inequality in a supporting role? Ladies and gentlemen, I give you the U.S. Federal Reserve.



Source: Bloomberg LP and TCW, as of 12/31/16. For illustrative purposes only. Past performance is no guarantee of future results.

And as the second chart shows, this central bank largesse has sharply accelerated the massive shift in wealth to the Rich from the Rest, a shift which began in the 1980s with the Reagan Revolution. We are now back to where we were in the 1930s, where the household wealth of the bottom 90% of U.S. wage earners is equal to the household wealth of the top one-tenth of one percent of U.S. wage earners.



For illustrative purposes only.

So look ... I'm not saying that the current level or dynamics of wealth inequality is a good thing or a bad thing. I'm just saying that it IS. And I understand that there are insurance programs today, like social security and pension funds, which are not reflected in this chart and didn't exist in the 1930s, the last time you saw this sort of wealth inequality. I understand that there are a lot more people in the United States today than in the 1930s. I understand that there are all sorts of important differences in the nature of wealth distribution between today and the 1930s. I get all that. What I'm saying, though, is that just like in the 1930s, there is a political price to be paid for this level of wealth inequality. That price is political polarization and *electoral rejection of status quo parties*. I won't give the whole history lesson here, as it's a good excuse for readers to immerse themselves in Wikipedia for half an hour or so and read about guys like Father Coughlin, but the rhyming of political history in Western democracies between the late-1920s/early-1930s and today, particularly in the way that status quo political parties were subverted or overthrown or just plain eliminated throughout Westworld is ... pretty amazing.



Western democracies, mixing a healthy dash of popular political representation with a big dose of capitalist economic structures, are *extremely* good at the most important driver of social stability: co-opting the more talented members of a mass society into the status quo system, bringing new blood into that top two percent socioeconomic club who might otherwise apply their talents in more subversive ways. Maybe not the top one-tenth of one percent on a purely financial wherewithal scale, but definitely the top two percent on a more broadly defined socioeconomic scale of wealth, stability, and influence. That co-opting process is the steam valve for Western societies, and it has two components, particularly in the most successful Western society, the United States — educational mobility (move to where the good intellectual jobs are) and labor mobility (move to where the good physical jobs are). Educational mobility, spurred in the U.S. by more than \$1 trillion in government-backed student loans, is in high gear, and the importance of an educational pedigree to get into the 2% Club has NEVER been greater. Labor mobility, on the other hand, crushed by globalization and the housing crisis, hasn't been this broken since ... yep ... the 1930s.

As a result, the composition of the 2% Club of wealth, stability, and influence is changing. **Today it's almost entirely a Club of the educationally mobile and accomplished, the people who deal with symbols for a living — words and tickers and numbers and code — and whose language and lingo is similarly abstracted.** And because our status quo political institutions, like political parties, are in all nations and in all times the top-down creations of the 2% Club, our political parties themselves *speak a different language* today than they did even 10 or 20 years ago. No political party is immune, regardless of where it sits on the traditional left/right spectrum. This isn't a Republican vs. Democrat thing. It's not a rich vs. poor thing, either, because there are plenty of rich people who aren't symbol manipulators and are feeling less and less at home in the 2% Club. It's a who's-dominating-the-2%-Club thing, and in Westworld that's the educationally accomplished symbol manipulators.

Our status quo political parties speak well and clearly to the 2% Club and their educationally mobile circles, not so well to the guy who didn't go to law school and whose kids don't have a prayer of getting into Stanford. Not so well to the guy who, to be honest, kinda hates lawyers and the professional symbol manipulators, and definitely hates anyone who went to Stanford. Not so well to, as Amity Shlaes titled her [seminal history of the 1930s and the Great Depression](#), the Forgotten Man, citizens who — today and in the 1930s — are well and truly *stuck*. Stuck because labor mobility is broken. Stuck because their wages are flat and their debt is up. Stuck because they're getting older. Stuck because, like the sailors on the Battleship Potemkin, they are served disgusting, rotten meat but are told by the well-spoken professionals that these are *dead* fly larvae, not live maggots, and so they can simply be washed off with salty water. Stuck because the entire political system is rigged for the educationally mobile and the symbol manipulators. Not rigged in a cartoon evil sense,

but rigged in the same way that the German system is rigged in favor of people who speak German and the Chinese system is rigged in favor of people who speak Chinese. Don't speak Symbol Manipulation? Sorry, but the status quo Western political system is rigged against you. And you know it.

There's no *attachment* to a political party that from your perspective is speaking gibberish. The attachment is to change and reversion. The attachment is to Something Else. **The Something Else will not have a well-considered or coherent policy wrapper. It won't look smart.** It didn't in the 1930s and it doesn't today. Why not? Because if it did, it would be co-opted as part of the status quo! Words like "well-considered" and "coherent" and even "policy" are the abstracted words of the modern status quo. They are the *language* of the 2% Club, particularly of an educationally mobile 2% Club, and it's a very different language than that spoken by anyone hailing from the world of physical construction and manipulation rather than symbol construction and manipulation.

So what is this other language? Importantly, as Joan Williams describes in her phenomenal article, "[What So Many People Don't Get About the U.S. Working Class](#)," it's not a soak-the-rich language (in fact, it's more disparaging of the poor than the rich). **It's a non-abstracted language of direct, physical involvement in localized social behaviors (what Nassim Taleb calls "[Skin in the Game](#)"), because that's the language that has meaning for anyone who depends on labor mobility and physical construction to make a better life for themselves and their kids.** It's an uncomfortable language for the educationally mobile 2% Club, because it doesn't abstract away the racist, sexist corners of real world, localized social behaviors and beliefs in a carefully constructed linguistic architecture. That doesn't mean that the Forgotten Man is necessarily racist or sexist (doesn't mean that he's not, either). It means that these are not behaviorally motivating or politically meaningful *words* to a major sub-population. It means that our language defines and constrains our thoughts and behavior, not the other way around. It means that we ARE our grammar, at least in our lives as social animals. It means that the Confusion of Tongues is not just a quaint Old Testament story with cool Gustave Doré engravings about some apocryphal Tower of Babel.



**It is THE political story of this or any other age, and it *always* leads to a radical restructuring of the political order, because you *cannot* have a stable political equilibrium where a critical mass of national sub-populations speak different social languages.**

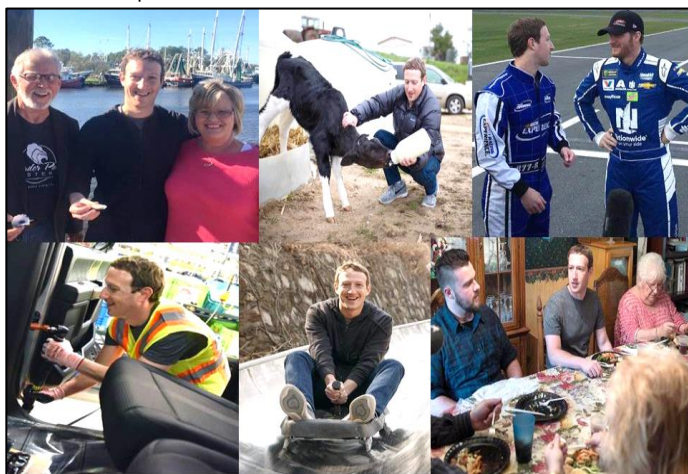
But that's where we are in every Western nation in 2017. The politically ascendant sub-population on the educational mobility track hear the language of the Other and say "Unacceptable people. Must resist. Zero-sum game." The politically stuck sub-population on the labor mobility track hear the

language of the Other and say "Bad hombres. Must fight. Take no prisoners." The center cannot hold. More accurately, there is no center, no cooperation. Competition is all, and that's no way to run a country.

Unfortunately and unsurprisingly, the new political leaders who emerge from a collapse of the Tower of Babel are rarely the champions of the Forgotten Man that you might think would emerge. Both in the 1930s and today, there's no shortage of non-status quo political entrepreneurs who speak the language of the politically stuck and are willing to put themselves out into the political arena. But to be successful in their political entrepreneurship it's almost essential that these new candidates be card-carrying members of the 1/10<sup>th</sup> of 1% Rich Club. Why? Because it requires an insane amount of money and sheer notoriety to replace the machinery of a status quo political party in a mass society. A political party is a media company. By joining a status quo party and toeing that party line, you communicate an enormous set of signals to potential voters for free. But by toeing that party line, you lose your Forgotten Man authenticity and any hope of being the champion of Something Else.

**Want to be a "change candidate"? Better make a couple of billion dollars first, or have plenty of billionaire friends, so you can afford to bypass the status quo political party.**

Little wonder, then, that Donald Trump, a billionaire TV star, succeeds in overthrowing the Republican Party. Little wonder that Emmanuel Macron taps a vast banker network from across Europe to fund his campaign. Little wonder that zillionaire Mark Zuckerberg has embarked on a nationwide "listening tour", complete with equal zillions of photo ops — *none of which are with educationally mobile symbol manipulators* — as he prepares for a political life. Good old-fashioned mustachioed fascism may work in Turkey, but here in the U.S. you need a smiley-face with your [Panopticon](#). Sharing is caring!



So that's my political take: the old and powerful Tower of Babel process is starting up again, and status quo political institutions are not long for this world. As we move to the Something Else to come, we'll have to endure a parade of billionaires wielding political power in unprecedented ways, aided by unprecedented technologies of social control. That's the Big Risk for everyone reading this note, regardless of your politics, regardless of your social language, regardless of your vision of the life well lived. That's the Big Risk we have to manage, as investors and as citizens.

So how do we do THAT?



For today's note, I'm focusing on the investor side of that question, and that means focusing on the one Big Question: **as the Western status quo political system collapses into Something Else, how is it possible that our capital markets are not similarly gripped by volatility and stress? What is responsible for breaking the transmission mechanism from political risk to market risk?**

I've got a macro answer and I've got a micro answer.

The macro answer is that you need status quo political parties to govern a country effectively. Thankfully, there are only enough billionaire candidates of Something Else to fill the top of the ticket, and even if there were more, a party of independently wealthy and independently popular mavericks isn't a coherent party at all. **There's not less gridlock with an essentially party-less American president or an essentially party-less French president, there's MORE gridlock.** And that means that any sort of fiscal policy — whether it's a clear-the-decks debt assignment or a classic stimulus program or whatever — is more difficult under this sort of independent political regime than in a status quo regime.

Sure, there's a lot of excitement when the Stranger comes to town. Take a look at what happened to the U.S. 10-year bond after Trump was elected.



Source: Bloomberg LP, as of 04/10/17. For illustrative purposes only. Past performance is no guarantee of future results.

But excitement fades as fiscal policy promise fades to fiscal policy deadlock. When I look at Washington today, or London or Paris or Rome or wherever, it sure looks for all the world like a return to our regularly scheduled entertainment. Nature abhors a vacuum, and politics is no exception. **In the absence of an active and effective fiscal policy authority, global monetary policy authorities will fill the policy void.** And what is their policy? Refer to chart 1 at the start of the note, please. **Low growth. Financial asset inflation. Low volatility.** Wash, rinse, repeat. The new Goldilocks, now eight years old. Could go for another eight years, easy. Wheeeee!

Yes, there's enormous political risk associated with the collapse of status quo political institutions and the rise of the Trumps and the Macrons of the world. But ...

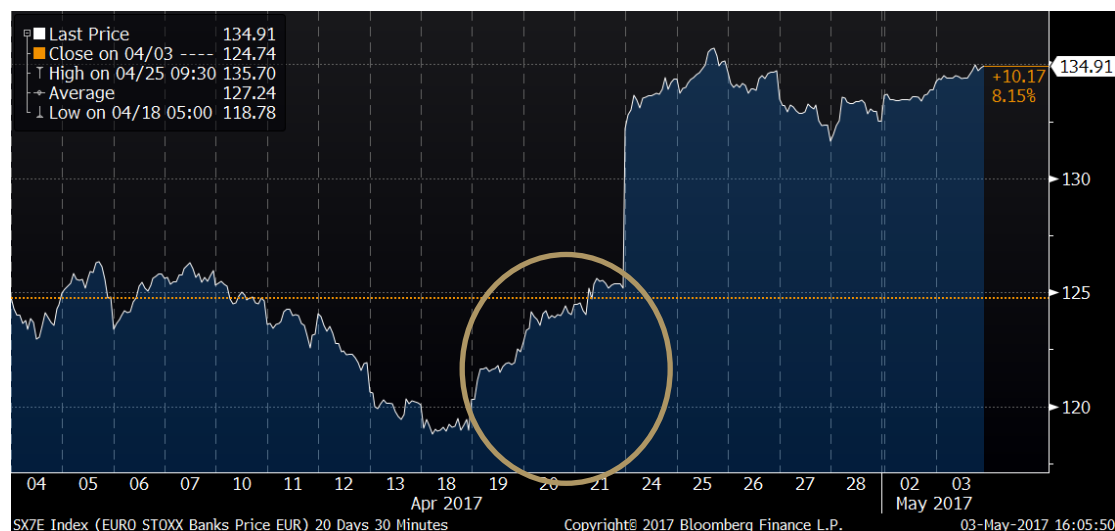
- 1) for financial markets, these new leaders are familiar, encouraging faces. They're members of the 1/10<sup>th</sup> of 1% Rich Club, because they had to be to sidestep status quo political parties. Moreover,
- 2) there's going to be a hope and a promise of fiscal policy initiatives, and that's a tailwind for markets, too. And finally,
- 3) don't worry, Mr. Market, when that hope and promise of pro-growth policy fades into the realization of anti-growth gridlock, our old friends Janet and Mario will be there to pick up the slack with more liquidity.

That's my macro story for the divorce of political risk from market risk, and I'm sticking to it. *Where does it break down?* **Not with a funky German or Italian election, but with Janet and Mario declaring victory and taking away the punchbowl.** That's what will bring political risk back to markets.

On the micro side, it's the triumph of Communication Policy, just as far as the eye can see. I've written a lot about Communication Policy in the past, [here](#), [here](#), [here](#), and [here](#). It's what the Fed calls their use of words and public statements for *effect*, as a specific policy tool designed to influence investor behavior rather than to communicate truthful information. You know ... what we would call lying in other circumstances. As Ben Bernanke said in one of his [last speeches as Fed Chair](#), Communication Policy ("enhanced forward guidance") has been the star of the show since quantitative easing lost its mojo with the QE2 program. Making up narratives and telling them convincingly has worked for politicians for, oh, several thousand years. I suppose the only surprising thing is that it took central bankers so long to get in on the act. Today it's their primary shtick.

But now that politicians and central bankers have demonstrated the incredible efficacy of what game theory calls Missionary Statements — the intentional construction of common knowledge through highly mediated statements — *everyone* wants in on the act. Everyone wants to be a Missionary for their own institutional ends. And that Everyone definitely includes Wall Street.

Here's what I've noticed in the past two major political risk events in Western markets — the Italian referendum on December 5 and the French first round election on April 23. In both cases, the most political risk-impacted equity markets began to rally sharply three or four days BEFORE the vote.



Source: Bloomberg LP, as of 05/03/17. For illustrative purposes only. Past performance is not indicative of how the index will perform in the future. The index reflects the reinvestment of dividends and income and does not reflect deductions for fees, expenses or taxes. The indices are unmanaged and are not available for direct investment.

The top chart is the European bank equity index before and after the French vote. Below is the price chart of the broad Italian equity index before and after their referendum.



Source: Bloomberg LP, as of 05/03/17. For illustrative purposes only. Past performance is not indicative of how the index will perform in the future. The index reflects the reinvestment of dividends and income and does not reflect deductions for fees, expenses or taxes. The indices are unmanaged and are not available for direct investment.

In both cases the bottom was reached well before the actual event. Why? Because in both cases the sell-side research machine — all the chief economists and chief strategists and acolytes of all the big Wall Street firms — began churning out a flood of Missionary Statements designed to create a positive narrative around a potentially very negative (for markets) political risk event. **Ditto with the U.S. election, where the positive narrative around Trump began a full week before the election (see “American Hustle” for the full Narrative Machine description).**

I mean, the effort to create a positive narrative out of whole cloth would be comical if it weren't so seriously impactful. My personal fave on the Wednesday before the French vote was a bulge bracket strategist who shall go nameless, writing to say that a Le Pen victory wouldn't really be that bad of a thing for markets in general and the banks in particular, because if she won there could well be a massive run on the French banks, which means that Le Pen would have to backtrack on her anti-euro stance to prevent a complete economic collapse. So buy now!

My first reaction to this avalanche of positive Narrative construction was indignation, tinged with a little anger. Give me a break! Markets are getting a little squirrely going into the vote, and so you're going to start pumping out this drivel? My reaction was what **John Maynard Keynes, who was at least as good a game theorist and investor as he was a macroeconomist, would have called a first level response to a Missionary statement** — *I'm right and the Missionary is wrong!* This is the human, natural response. It's also a losing response if you want to play the game of markets successfully.

As Keynes explained so smartly with his parable of the Newspaper Beauty Contest, you don't make money by holding firm to your personal opinion of who's the prettiest girl or what's the most attractive stock. You don't even make money by identifying the consensus view of who's the prettiest or what's the right answer to a market question, because all of us are smart enough to be looking for the consensus view. No, you make money by getting ahead of the *formation* of the consensus view through Missionary statements, even if your personal view is that the Missionary is dead wrong in their assessment of pretty girls or attractive stocks or market outcomes. Would you rather be right or would you rather make money? Back in my younger days I didn't think there was a conflict between the two. Now I know better. Once the Wall Street Missionaries started their Narrative blitz, it didn't matter that I believed (and still believe!) that an anti-status quo Italian referendum creates a systemic risk for the European banking system. **I wasn't going to get paid for that view, even if the anti-status quo vote won (it did) and even if I'm objectively correct about the risk (we'll see).**

Frustrating? Sure. But in the immortal words of Hyman Roth, this is the business we have chosen.

It's this micro explanation of the divorce between political risk and market risk that I think will prove to have the most long-lasting impact on investor behavior. You know, I started writing *Epsilon Theory* because Mario Draghi kicked me in the teeth in the summer of 2012 with the pretty words of his mythical OMT program. I couldn't believe that mere narrative could be so powerful. But it is. It's the

most powerful thing in the world. Bad enough that politicians have wielded this power for centuries. Worse that **Central Bankers have recently proven to be such adepts**. Now that Wall Street and the global banking synod have fully embraced the dark narrative arts? Katy bar the door. **Even when the androids of Westworld knew it was just a story, they were hard-wired to respond. So are we.**

So put it all together and what do we have? As a citizen I'm on high alert. Political volatility is only going to get worse in Westworld. But as an investor my systemic risk antennae are pretty quiet. Is there stuff to do, long and short? Sure, particularly away from Westworld. But until and unless Draghi starts to taper and Yellen looks to hang a recession around the Donald's neck with beyond-tapering balance sheet reduction, I don't see how political risk translates into market risk. And even then you've got a powerful volatility reducer in the self-interested Narrative creation of every Wall Street Missionary. Will it last forever? Of course not. The Missionaries, both on Wall Street and in Central Banks, are only human. Inevitably they will disappoint us. Let's just try not to have a gun pointed at our heads when they do

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