Epsilon Theory

Things Fall Apart (Part 3) - Markets

October 24, 2018

Our story so far …

Things Fall Apart (Part 1) – in politics we have what Yeats called a *widening gyre*, where a steady stream of extremist candidates, each very attractive to their party base, pulls all voters into a greater and greater state of polarization, leaving a center that does not and cannot hold.

Things Fall Apart (Part 2) – in markets we have a *black hole*, where the massive performance gravity of passively managed U.S. large cap stocks pulls all investors into its clutches over time, subverting both the reality of and the faith in portfolio diversification.

But the polarized electorate and the monolithic market are not stable. We are governed by the ***Three-Body Problem***, where multiple bodies that *act on each other* – like stars and their gravity or humans and their strategic interaction – form a system that has no general closed-form solution. There is no algorithm, no Answer with a capital A, that *solves* the Three-Body Problem.

Clear Eyes, Full Hearts, Can't Lose – we may not have an Answer to predict what's next, but we do have a Process to succeed with *whatever* comes next.

For every stock you buy and every vote you cast, the Process requires that you ask yourself:

- What are the **Narratives** (story arcs) I am being told?
- What are the **Abstractions** (categorizations) presented to me?
- What are the **Metagames** (big picture games) I am playing?
- What are the **Estimations** (the roles of chance) shaping outcomes here?
- Am I acting to promote **Reciprocity** (potentially cooperative gameplay)?
- Am I acting in a way that reflects my **Identity** (autonomy of mind)?

Ummm … hi, Ben, I'm not asking you to tell me what candidate to vote for or what stock to buy. But I AM asking you to show me how to apply this process to my real-world political participation and my real-world market participation, because that's by no means obvious here.

It's a simple question, Ben. WHAT DO WE DO?

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Heard.

In this conclusion to the Things Fall Apart series, I'm going to share with you what I'm doing with with MY political participation and MY market participation. You can decide if my application of the *Clear Eyes, Full Hearts* process makes sense for you, and in what ways. It's a lot to describe, so I'm going to divide it up into two notes. This note will be about what-to-do in investing, and my next note will be about what-to-do in politics.

Okay … what-to-do in investing.

To set the stage for this I'm going to use a comic book quote. I know, I know … *quelle surprise*.

In the *Sandman* comics by Neil Gaiman, Dream of the Endless must play the Oldest Game with a demon Archduke of Hell to recover some items that were stolen from him. What is the Oldest Game? It's a battle of wits and words. You see it all the time in mythology as a challenge of riddles; Gaiman depicts it as a battle of verbal imagery and metaphors.

Here's the money quote from Gaiman: "There are many ways to lose the Oldest Game. Failure of nerve, hesitation, being unable to shift into a defensive shape. Lack of imagination."

I love this. It is exactly how one loses ANY game, including the games of politics and the games of investing … including the metagames of life. This isn't just a partial list of how you lose any truly important game, it is a complete and exhaustive list. This is the full set of game-losing flaws.

- Failure of nerve.
- Hesitation.
- Being unable to shift into a defensive shape.
- Lack of imagination.

Of these four, lack of imagination is the most damaging. And the most common.

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In the comic, Dream and the demon Choronzon go through an escalating series of metaphors for physically powerful entities, culminating with Choronzon's verbal imagery of all-encompassing entropy and Anti-life. Dream counters by imagining a totally different dimension to the contest thus far, by making the identity statement, "I am hope." Choronzon lacks the imagination to shift over to this new dimension and loses the game, at which point he's wrapped up in barbed wire for an eternity of torment.

What's the point? The greatest investment risk I must minimize is not something that has already been imagined. It's not a recession or a Eurozone crisis or a trade war or a bear market. No, my greatest risk is a *failure of imagination* in understanding how the game might fundamentally change.

So let's put some meat on those bones. Here are the three great already-imagined investment risks that dominate today's game of markets. Let's call them the Three Horsemen of the Investing Semi-Apocalypse.

The Three Horsemen of the Investing Semi-Apocalypse

1. **The Fed** keeps on raising interest rates and shrinking its balance sheet, ultimately causing a nasty recession in the US and an outright depression in emerging markets.
2. **China** drops the trade war atom bomb by letting the yuan devalue sharply, sparking a global credit freeze that makes the 1997 Asian financial crisis look like a mild autumn day.
3. **Italy** and its populist government play hardball with Germany and the ECB in a way that Greece could not, leading to a Euro crisis that dwarfs the 2012 crisis.

Are each of these risks a clear and present danger for markets? YES.

Have I written A LOT about each of these risks? YES.

Will I write a lot more in future notes? YES.

Can you take steps to protect your portfolio from each of these risks? YES.

Should you take steps to protect your portfolio from each of these risks? MAYBE.

If any of these risks come to fruition, would you likely see a 20% decline in US equity markets? YES.

Would you be happy about that? NO.

Should you change your basic investment philosophy if any of these risks occur? NO.

That's right. Even if the Fed or China or Italy totally blows up our cozy market, you don't have to change anything in your fundamental investment philosophy. You can keep your 60/40 allocation. You can keep praying to the great god of diversification. You can keep your consultant. You can keep reading the same sell-side pablum. You can keep listening to CNBC blame "risk parity" for every down day. You can keep rejoicing at the big up days when central bankers save the day with their jawboning. You can keep your job, because everyone else will be just as smacked around as you are.

Why don't you have to change your basic investment philosophy? Because these are VERY well-known and VERY well-discussed event risks. These are anticipatable event risks. There will be a light at the end

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of the (maybe very long) tunnel. Will it feel like hell? Yes, it will. But as the old saying has it, if you're going through hell … don't stop. Whatever you've been doing? Keep doing it. With enough time (and that's the driving consideration for how much you must do to hedge or prepare for these Three Horsemen), you will survive the semi-apocalypse and come out fine on the other end.

But there is a Fourth Horseman. And it WILL require you to change your basic investment philosophy.

There is a future that today's common knowledge deems impossible, but I think is a distinct possibility. The Fourth Horseman doesn't (necessarily) come with a 20% market decline. It may not be as directly painful as any of its three junior partners. But it *will* change EVERYTHING about investing.

The Fourth Horseman of the Investing Apocalypse

4. **Inflation** is not a cyclical blip and inflationary expectations are not "controllable" by the Fed without taking politically suicidal actions. They don't commit political suicide, and the world enters a new inflationary regime.

It's the only question that long-term investors MUST get right in order to minimize their maximum regret. You don't have to get it right immediately. You don't have to track and turn with every small perturbation in its path. But you MUST get this question roughly right.

Am I in an inflationary world or a deflationary world?

For the past 30+ years, we have been in a non-inflationary world. For the past 10 years, we have been in a deflationary world. I don't mean that prices in lots of things haven't gone up. I don't mean that inflation hasn't been a monster in many places. What I mean is that inflation *expectations* have been declining for 30+ years, and they have been rock-bottom for the past ten. What I mean is that for a decade now, all of our investment *behaviors* – and by all of us I mean everyone from the smallest individual investor to the Chair of the Federal Reserve – have been predicated on the *belief* that a) there's no chance of future inflation for bad reasons (a currency that has lost the confidence of the world), and b) there's no chance of future inflation for good reasons (robust economic growth). Instead, the most pervasive and powerful piece of common knowledge in investing is simply this: *we are on a long gray slog to Nowheresville, a future of too much debt and not enough growth, a pleasant enough if thoroughly meh world.*

Each of the Three Horsemen of the Investing Semi-Apocalypse will create a severe deflationary shock.

That's why you don't have to change your investment playbook for a Fed-created recession, a China-created credit freeze, or an Italy-created Euro crisis. You already know the deflationary playbook. It's what you've been doing (or should have been doing) for the past ten years. Just keep doing THAT.

But if we enter an inflationary world, something that very few investors alive today have EVER experienced … well, everything you've been doing for the past ten years will be a mess. Your prayers to the great god of diversification, at least as that god is manifested today as the Holy Long Bond, will go unanswered. Your embrace of the cult of Vanguard, at least as that cult is expressed today as the worship of passive index

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funds, will give you pain rather than comfort. The very *language* that you use today to speak with other investors about core abstractions like Value and Growth will turn into gobbledygook.

Today's common knowledge rejects this Fourth Horseman of inflationary regime change. But, but … *demographics!*, you hear. Don't you understand that Demographics is Destiny™, that we are getting older and having fewer children, dooming us to the long gray slog? But, but … *technology!*, you hear. Don't you understand that robots and AI are going to replace all us mere humans, creating a world where our bread and circuses just get cheaper and cheaper? Yeah, I understand. I hear these narratives and memes, too.

But that's my point. We believe that we are in a deflationary world because we are TOLD that we are in a deflationary world. That's the common knowledge. Everyone knows that everyone knows that inflation is dead and gone, that it's a long gray slog going forward, forever and ever amen.

It's hard to imagine when you're immersed in it, but common knowledge can change.

That includes common knowledge of the fundamental inflationary/deflationary nature of our world.

I think it's happening. I could be wrong. But that's what I'm trying to imagine. Here's why I think we are witnessing the start of a sea change in our economic world.

Reason #1. Like I said, the Three Horsemen of the Investing Semi-Apocalypse are hugely deflationary in nature. Yet despite these well known and quite pregnant deflationary risks, inflation expectations are rising nonetheless. Want to imagine something? Imagine if one of these deflationary risks is resolved in a market-friendly way. Imagine what happens to inflation expectations and long-term bond yields then!

And these Three Horsemen WILL be resolved. One way or another, these event shocks always are. They may be resolved in a market-friendly way, or they may be resolved in a decidedly market-unfriendly way. It may be a miserable year or two or three for markets if any of these guys comes galloping through. But one way or another, this, too, shall pass. And what you need to be thinking about is … what then?

Reason #2. The three major narrative Missionaries for markets – the Fed, the White House, and Wall Street – are each beating the drums for inflation. They've all got their reasons. The Fed desperately wants to declare victory in its decade-long insistence that they can dispel the deflationary boogeyman, the White House desperately wants to grease the skids for a 2020 campaign by boosting asset price inflation and wage inflation any possible way they can, and Wall Street desperately wants both general asset price inflation and a good story about something to sell, what's called a *rotation trade*.

I've written a lot about how we can use Natural Language Processing (NLP) technology to actually measure this beating of the drums, to actually create a visual presentation of the narrative and sentiment dynamics of markets. It's what I call the Narrative Machine, and it's at the heart of how we see the world at Second Foundation Partners.

I won't repeat everything I wrote in April about the narrative dynamics of *Inflation!* in **The Narrative Giveth and The Narrative Taketh Away**, but I will give an update. The skinny of that note is that the *narrative intensity* in financial media accelerated dramatically in the 12 months ending April 2018 from the 12 months ending April 2017, that the narrative network map went from this:

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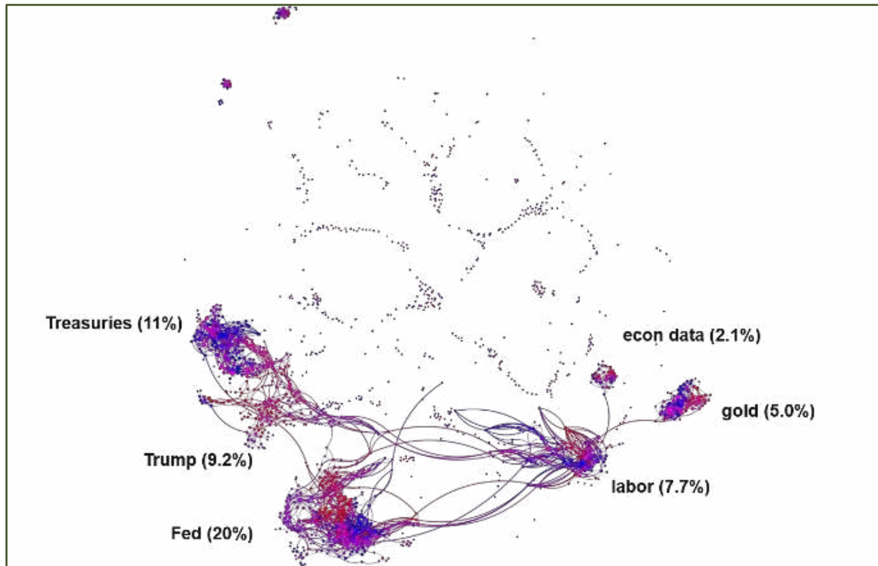

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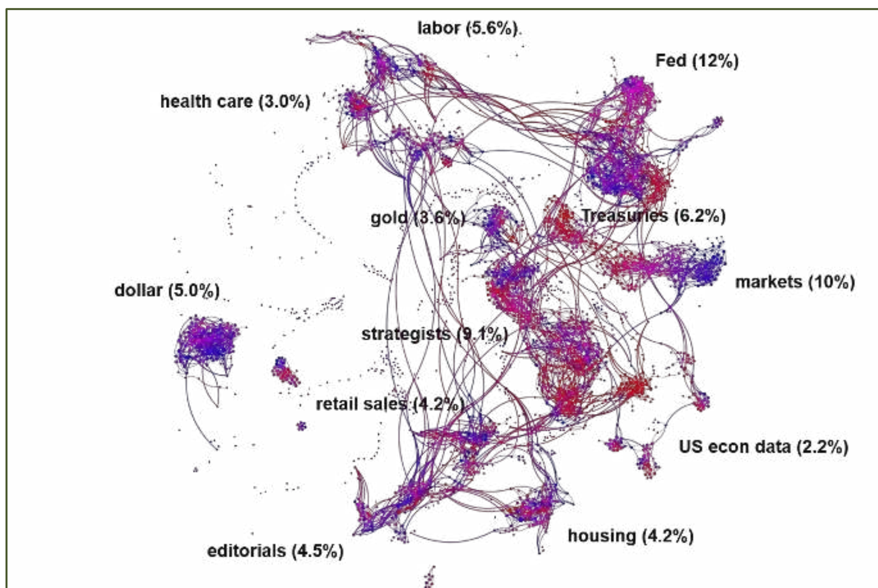
to this:



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Each of the thousands of dots in these narrative maps is a separate unique article from Bloomberg that contains the word "inflation", filtered to eliminate articles specifically about inflation outside the US. The articles are clustered by the NLP AI on the basis of similarity in word choice and structure, and they're colored by time of publication (blue is earlier, red is more recent). Like I say, to read more about the methodology you should **start with this note** or check out **the Quid website**, but the point here is pretty obvious: the frequency, centrality and intensity of the *Inflation!* narrative has picked up dramatically in the financial media sources that serve as the megaphone for common knowledge creation.

So here's an update for the 12 months ending October 21, 2018, capturing the six months since the maps above were generated.

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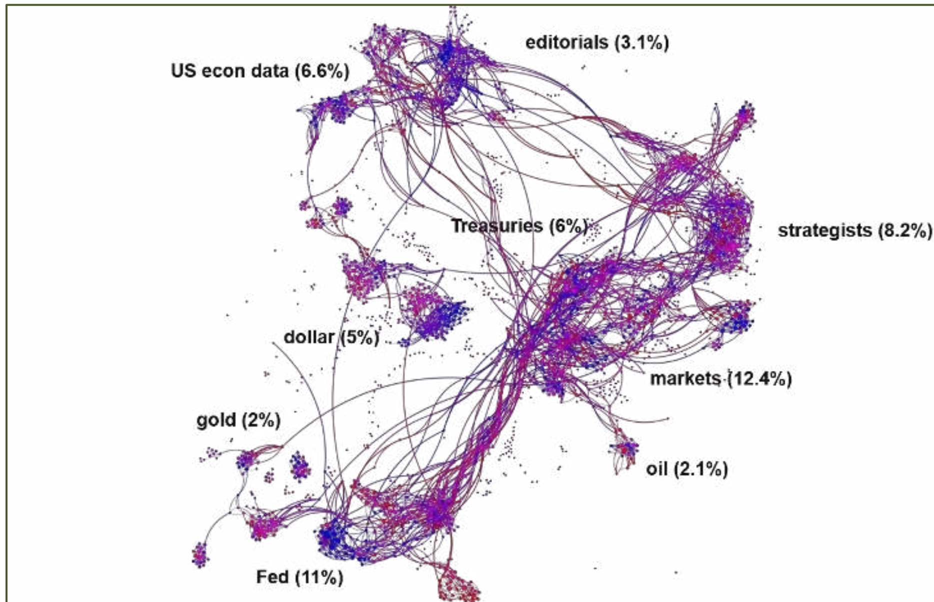

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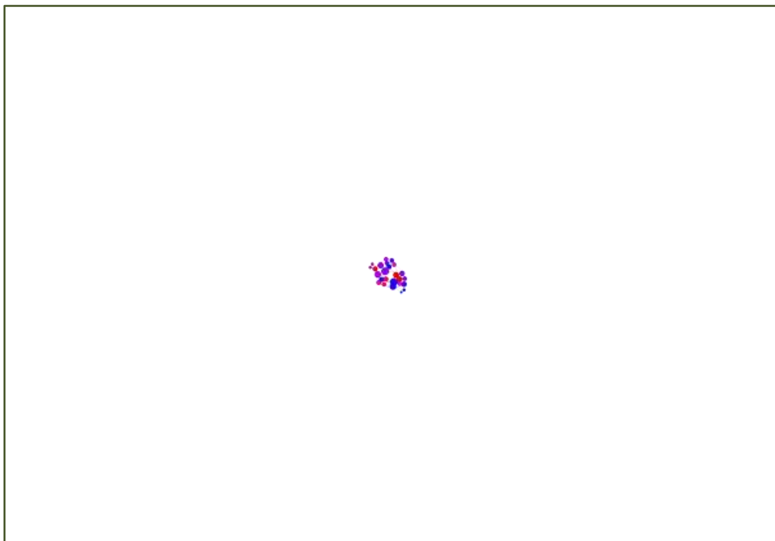
We've come down slightly over the past 6 months in narrative intensity for *Inflation!,* mostly because the narratives of *Trade War!* and *Midterms!* have gotten louder and have soaked up our finite attention, but this is still a drum-banging map, for sure.

Reason #3. As strong and as resurgent as the *Inflation!* narrative is today, the *Budget Deficit!* narrative is just as weak and fading. I'm going to present this narrative map without comment. It's the sum total of the unique Bloomberg articles published over the past 12 months that contain the words "budget deficit" and have anything to do with the US government.



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Okay, a bit of a comment. 25 articles talking about the federal budget deficit versus 2,200 talking about inflation over the same 12 month period from the same financial media source. I am not making this up. There is ZERO narrative creation around austerity in the United States. ZERO. And as long as that's the case, the *political dynamic* for inflationary debt-be-damned policies is unstoppable.

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<u>Reason #4</u>. In exactly the same way that the Fed (and the ECB and the BOJ) spurred *deflation* with their zero interest rate policies, even though they *thought* they would accomplish just the opposite, so will central banks spur inflation now that they are raising interest rates, even though they think they will accomplish just the opposite. Why? Because it's exactly the same driver for both the "we got deflation when we thought we'd get inflation" phenomenon when the Fed was easing and the "we got inflation when we thought we'd get deflation" phenomenon that I expect now that the Fed is tightening.

The Fed's singular goal in all of its extraordinary monetary policy decisions since the Great Financial Crisis has been to spur risk-taking from both investors (in the form of buying riskier assets than they otherwise would) and from corporations (in the form of investing more in plant, equipment and technology than they otherwise would). This is not a secret goal. This is the avowed purpose of quantitative easing and large-scale asset purchases and all that jazz. Of the two goals, spurring corporate risk-taking is far more important for our fundamental economic health and the Fed's "control" of real-world inflation – either to get it moving or to slow it down. But this far more important goal of spurring corporate risk-taking DID NOT HAPPEN as the Fed created the most accommodative financial conditions in the history of man, because the Fed *never imagined* what the real-world response of corporate management would be.

The Fed suffered a failure of imagination, and as a result they are now risking their maximum regret – a world where they do not "control" inflation.

I wrote about this in July 2017 in **Gradually and Then Suddenly**, when the Fed was just starting its efforts to turn the monetary policy barge around from easing to tightening, and I wouldn't change a word today. The money quote:

> **The reason companies aren't investing more aggressively in plant and equipment and technology is BECAUSE we have the most accommodative monetary policy in the history of the world, with the easiest money to borrow that corporations have ever seen.** Why in the world would management take the *risk* — and it's definitely a risk — of investing for real growth when they are so awash in easy money that they can beat their earnings guidance with a risk-free stock buyback? Why in the world would management take the *risk* — and it's definitely a risk — of investing for GAAP earnings when they are so awash in easy money that they can hit their pro forma narrative guidance by simply buying profitless revenue? Why in the world would companies take any risk at all when the Fed has eliminated any and all negative consequences for playing it safe? It's like going to a college where grade inflation makes an A- the average grade. Sure, I could bust a gut to get that A, but why would I do that?
>
> In the Bizarro-world that central bankers have created over the past eight years, raising rates isn't going to have the same inflation-dampening effect that it's had in past tightening cycles, at least not until you get to *much* higher rates than you have today. It's going to *accelerate* inflation by forcing risk-taking in the real world, which means that the barge is going to have to move faster and faster the more it moves at all. I think that today's head-scratcher for the world's central banks — why haven't our easy money policies created inflation in the real world? — will soon be replaced by a new head-scratcher — why haven't our tighter money policies tamed inflation in the real world?

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Okay, Ben, let's say I believe you that the biggest risk to my investment goals is the risk that no one is currently imagining, and that a change in the inflation regime could well be that unimagined risk.

My question still holds. WHAT DO WE DO?

Here's the trick. We're trying to figure out a way to be responsive to our very real concerns about the Three Horsemen of the Investing Semi-Apocalypse, each of which is a severe but short-to-medium duration deflationary shock if it happens, against a backdrop of a potential long-term change in the fundamental fabric of our investing world, which is what happens if the inflationary Fourth Horseman comes to town.

To pull off this trick we need to think about the nature of time and the exclusivity (or not) of states of the world. We need to think really carefully about *the path* that our portfolios will take in a probabilistic world, and our inability *to predict* the outcome of a Three-Body System.

To pull off this trick we need to differentiate between the analysis we should use for questions of *risk* and the analysis we should use for questions of *uncertainty*.

A risk is something where we can assign some sort of reasonable probability to its occurrence AND some sort of reasonable assessment of its potential impact, so that we can calculate what's called an "expected utility" … in English, so that we can talk meaningfully about risk versus reward of some action or decision. Of course we're not 100% sure about these probabilities and assessment. Of course we can't predict what's going to happen in the future. But we can *estimate* the short-term future probabilities and we can constantly *adapt* to those changing estimations, if that's what you want to do. To use Donald Rumsfeld's oft-maligned but in-truth brilliant characterization, a risk is a "known unknown".

An uncertainty is something where we either cannot assign a reasonable probability of occurrence OR its potential impact is so great that thinking in terms of probabilities and expected utilities and risk versus reward doesn't make much sense. In Rumsfeldian terms, uncertainty is an "unknown unknown", and historically the classic example of an uncertainty was whether or not you'd win or lose a major war. *In modern times, the classic example of an uncertainty is global climate change.* Hold that thought.

Modern financial analysis and modern financial advice is very proficient when it comes to decision-making under risk. In fact, that's all it is. Everything that your consultant tells you is based on decision-making under risk. Everything that your Big Bank model portfolio tells you is based on decision-making under risk. Everything that Modern Portfolio Theory tells you is based on decision-making under risk. It's all an exercise in *maximization* – maximizing your expected return over a series of risk vs. reward decisions –

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and that works out perfectly well if you have stable historical data and well-defined current risks. Less well if you have unstable historical data and poorly defined current risks. Cough, cough.

On the other hand, modern financial analysis and modern financial advice is *useless* when it comes to decision-making under uncertainty. Worse than useless, really, because you will get actively bad recommendations from an expected utility maximization machine (which is what modern financial analysis really is) when you apply it to questions of uncertainty. It's like using a saw when you need a hammer. Not only do you have no chance of driving in that nail, but you're going to damage the wood.

The Three Horsemen of the Investment Semi-Apocalypse are RISKS.

They're poorly defined risks, and we're going to talk about that, but a Fed-driven recession, a China-driven global credit freeze, and an Italy-led Euro crisis are, in essential form, risks rather than uncertainties. That means that the right tool kit for figuring out how to prepare and deal with them is basically the same tool kit that every advisor and investor has been using for the past 30+ years. You diversify your portfolio with long-dated government bonds, you pay a lot of attention to taxes and fees, and most importantly, *you don't lose your nerve*. You don't lose your nerve at the top by levering up, and you don't lose your nerve at the bottom by selling out. You stay invested in markets with a steady level of risk, which is why I'm a fan of the investment philosophy that underpins volatility-adjusted cross-asset investment strategies … you know, what the witch hunter crowd calls Risk Parity.

What this means in practice for many investors, maybe most investors, is that the right thing to do to hedge their portfolio against the Three Horsemen is … NOTHING.

I know, I know … I'm talking against my self-interest here, but my strong belief is that almost all investors, especially investors with a long time horizon, are making a mistake if they actively hedge their portfolios in advance against *poorly defined yet well known event risks*. This, too, shall pass, or maybe it never even happens, or maybe it doesn't happen the way everyone thought it would. I've seen waaaay too many investors (civilians and professionals alike) zig when they should zag, close the barn door after the horse is out, overpay for insurance, tie themselves into knots … I've got a thousand metaphors for misplaying prospective event risk with portfolio hedges.

Now what I DO think is advisable, though, is to *react* to event risk once it actually happens. What I DO think is advisable is to *have a plan* for what to sell and what to buy. What I DO think is advisable is to measure the *dynamics* of event risk as it happens and is converted into market-moving *narrative*, and use that as the *trigger* for the plan.

This is very similar to what a risk parity strategy does, which is why I like its philosophy so much. Risk parity reacts to a persistent event shock by selling the portfolio down as the realized risks go up. It's not trying to predict what's next. It's not trying to create "alpha". It's trying to keep you in the game while also trying to keep you from being carried out. Endorsed! I think it's the right investment philosophy for dealing with these poorly defined yet well known event risks, albeit in a (too) systematic and (too) blunt form. **I think it's possible to marry the reactive and profoundly agnostic investment stance of a risk parity strategy with narrative analysis and discretionary management.** *That's what I want to do with MY market participation.*

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What do you do about the Three Horsemen? You don't hedge your portfolio in advance. You wait until the Horsemen actually ride into town. And then you play the Oldest Game.

- You keep your nerve and embrace the game, because you are prepared.
- You don't hesitate to sell (or buy), because you have a plan.
- You're flexible enough to get defensive, because you know that the game may go against you.
- Most importantly, you can imagine *what's next*, because you're watching the market-moving narratives develop in real time.

This is the game to play over the next year or so, all the while setting up for the Fourth Horseman.

The Fourth Horseman of the Investment Apocalypse is an UNCERTAINTY.

And that requires a completely different tool kit, a completely different state of mind.

There's an urgency to an uncertainty, if you believe it exists, that doesn't pertain to a risk. The consequences of an uncertainty coming to pass in a bad form … well, that's the maximum regret. That's the path we MUST avoid. That's the probability we MUST minimize.

I mentioned earlier that the best modern example of an uncertainty is global climate change, and I love the direct comparison to global inflation regime change. Both are unfalsifiable because neither generates any experimental hypotheses, both are unprovable in any sort of classical scientific fashion, and both are, in my opinion, true and real. I've found that readers' reactions to one are predictive of their reactions to the other. If you're resistant to the circumstantial evidence for global climate change, I bet you're resistant to my circumstantial evidence for global inflation regime change. I get that. It's okay.

Both are BIG. I don't think anyone rejects the stakes here. And that actually makes my task of suggesting what-to-do a lot easier. Because unlike global climate change and the policies put forward to slow down or reverse it, I'm not trying to reverse anything with global inflation regime change. I'm not suggesting big macro policies to prevent this, I'm suggesting personal investment policies to survive this! So long as you accept the potential stakes of an inflation regime change, I think it's easier to contemplate the merits of taking steps to minimize the really bad ending.

Easier, but not easy. Here's what preparing your portfolio for an intrinsically inflationary world requires:

- Your long-dated government bonds will no longer be an effective diversifier. They'll just be a drag. I bet they're a big portion of your portfolio today.
- Highly abstracted market securities will be very disappointing. Even somewhat abstracted securities (ETFs) won't work nearly as well as they have. You'll need to get closer to real-world cash flows, and that goes against every bit of financial "innovation" over the past ten years.
- Real assets will matter a lot, but in a modern context. Meaning that I'd rather have a fractional ownership share in intellectual property with powerful licensing potential than farm land.
- The top three considerations of fundamental analysis in an inflationary world: pricing power, pricing power, and pricing power. I could keep writing that for the top ten considerations. No one analyzes companies for pricing power any more.
- When everyone has nominal revenue growth, business models based on profitless revenue growth won't get the same valuation multiple. At all. More generally, every business model that

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looks so enticing in a world of nominal growth scarcity will suddenly look like poop.

- Part and parcel of a global inflation regime change will be social policies like Universal Basic Income. I have no idea how policies like that will impact the investment world. But they will.
- Perhaps most importantly, the Narrative of Central Bank Omnipotence will be broken. Central Banks will still be the most powerful force in markets, able to unleash trillions of dollars in purchases. But the common knowledge will change. The ability to jawbone markets will diminish. We will miss that. Because the alternative is a market world where NO ONE is in charge, where NO ONE is in control. And that will be scary as hell after 10+ years of total dependence.
- God help us, but there's an argument for Bitcoin here.

In practical terms, the greatest conflict between the portfolio you have today, the portfolio you'll want if any of the Three Horsemen come around, and the portfolio you'll want if the Fourth Horseman appears is in one particular asset class: long-dated government bonds. You have them today – a lot of them if you're an institutional investor – and they've been great for you. You're a little nervous about them today, but they haven't killed you. You'll be happy to have them if we get a deflationary shock from one of the Three Horsemen, very happy. But if the Fourth Horseman arrives, your long-dated government bond holdings WILL kill you.

How do we reconcile all this? Partly through time, partly through planning, mostly through a state of mind. Meaning this:

Today, your long-dated government bonds are a core holding. They should become a tactical holding.

I don't mean that you sell them tomorrow. I don't mean that you sell them next week or next month or next year. In fact, if we get a deflationary shock from a Fed-driven recession, a China-driven global credit freeze or an Italy-led Euro crisis, you're going to want to buy more. This "tactical holding" will be a very large chunk of your portfolio. But make it a tactical holding. *Make it something that you are willing to sell. Without hesitation. Without losing your nerve.*

Henry Temple, aka Lord Palmerston, directed British foreign policy throughout the mid-19th century, when Britain was at the peak of its imperial power. Here's his great quote: "Nations have no permanent friends or allies, they only have permanent interests. We have no eternal allies, and we have no perpetual enemies. Our interests are eternal and perpetual, and these interests it is our duty to follow."

It's easy to mistake the ideas and the investments that have worked for us for 30 years to be permanent allies. They're not. It's easy to lose our imagination in considering what might work best for our interests, to cement allocations or asset classes as somehow sacrosanct to our portfolio. They're not. It's easy to confuse an event for a regime change. It's easy to confuse a risk for an uncertainty. They're not.

A change is coming, friends. It always is. But with clear eyes and full hearts we can achieve the ending we deserve. Or at least minimize the chances of the ending we don't.

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