



Epsilon Theory
In Summary

December 29, 2018 – January 4, 2019

LOL



Jay Powell describing the current size of his credibility at Friday's press conference

Jay Powell's narrative about-face last Friday inspired the title of this note: "LOL". I mean, if you can't laugh at this sort of craven performance art, you're taking the world way too seriously.

All of that stuff from December's FOMC meeting about looking at the real economy to figure out what monetary policy should be? All of that stuff about caring more about Main Street than Wall Street?

JK!

At Friday's presser, Jay Powell did what I thought he would do in December – he answered the prayers of all the Wall Street penitents, from schlocky TV evangelists like Jim Cramer to hair-shirted saints like Stanley Druckenmiller. **Please Lord, make me chaste ... but not yet.**

Powell on Friday: *I hear you, my children. I hear you.*

And there was much rejoicing.

Back in 1971, when Nixon took the U.S. off the gold standard and adopted a broad swath of activist and “modern” monetary policies, he famously said (ruefully, if the stories are to be believed), “I am now a Keynesian in economics”. In this he was channeling Milton Friedman, who coined the phrase “we are all Keynesians now” in the 1960s to describe the overwhelming political pressure to adopt easy money and stimulative policies whenever cold economic winds start to blow.

Today, though, easy money and stimulative policies aren’t enough. Or rather, they are so commonplace, so expected and banal, so much the warp and woof of Western political order, that it’s not enough – nearly enough! – to have an incredibly accommodative and market-friendly policy of ultra-low interest rates and a massive balance sheet.

No, today just DOING the right policy isn’t enough. You’ve also got to SAY the right policy.

In fact, saying the right policy IS the policy.

And everyone knows that everyone knows this is true. It’s the most pervasive Common Knowledge of our modern economic lives, that the instrumental words of “guidance” are themselves the only policy of meaning.

We are all Epsilon Theorists now.

LOL.

Anyway ... what does this mean for portfolio positioning?

In the big picture, we’re still in the middle of a technically uncertain game of Chicken between the U.S. and China. You should still reduce your gross exposure and shrink your active book, whatever that means to you. For most, that means having a higher level of cash than normal.

But Powell’s VERY public about-face on Friday, coupled with the VERY strong jobs report, creates a VERY different investment backdrop for the US-China trade impasse.

- 1) The focus of [last week’s ET Pro report](#) was that recession drumbeats were starting to diminish. **I expect that the Imminent Recession narrative will now disappear, both because it worked (Powell caved) and because it’s belied by the facts (the US economy is humming).** As a result, your recession-sensitive sectors, like Energy and Financials, should recover nicely. As a result, your recession-haven assets, like long-dated Treasuries, should sell off forthwith. The yield curve should steepen. Credit spreads should come in a bit. The dollar should weaken significantly. Where all of this comes together most prominently for me is US Regional Banks, which have been well and truly tattooed over the past six weeks. Every narrative coming out of Friday is supportive of a recovery there. If you want something a bit more broad-based, but with the same general profile, the Russell 2000 would do perfectly well.

- 2) Whatever happens with the US-China trade negotiations, the market's negative reaction to "bad news" coming out of that news cycle will be more muted now that Powell said he is "watching carefully" the China situation. **Powell has established a Fed backstop to US-China negotiations**, and even if a full-scale trade war isn't something that the Fed can ... you know, actually backstop ... it will certainly reduce the volatility we've experienced of late with an AWOL Fed.

Bottomline: it's still not safe to go back in the deep water for a swim, but you can wade in the surf again.

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