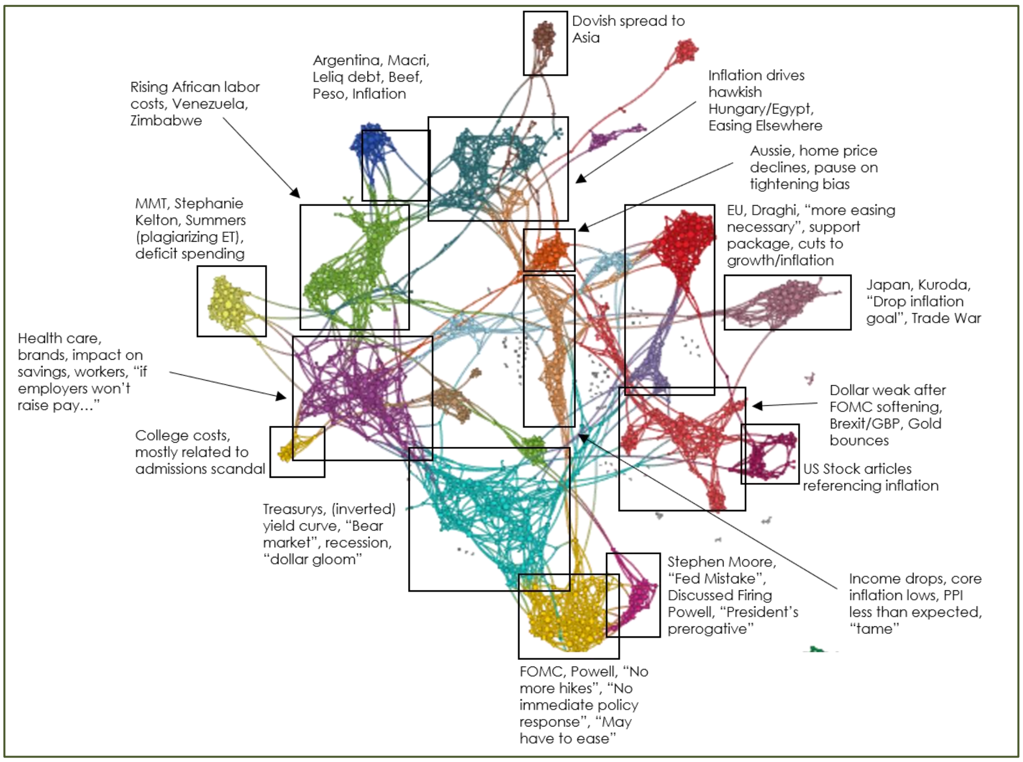
Epsilon Theory

In the Flow

Risk Management with ET Pro

April 9, 2019



Inflation narrative map as of 3/31/19 (source: Quid and Epsilon Theory)

There are plenty of "use cases", to employ some marketing jargon, for the financial media narrative research that we report in ET Professional. If you're a slow-twitch macro trader, and who isn't these days in one form or another, our research can identify specific macro trades with an appropriate time frame. If you're a value investor with a specific view on a stock or sector, our research can identify when your view (or an opposing view) begins to get narrative traction.

The universal use case for ET Pro research, though, is portfolio risk management.

Whether you're a trader or a portfolio manager or a financial advisor or an allocator, we can help you identify both the inflection points and the trajectory of the market Zeitgeist – particularly the question that any long-term portfolio owner MUST get roughly right in order to succeed: *are we in an inflationary or deflationary world, and how quickly (if at all) and in what ways is that world changing?*

There's no single trade we can recommend off this research that will be useful for all of our subscribers … probably not even a majority of subscribers. But every subscriber cares about the way their individual investment exposures work with each other to create (or not) a coherent and understandable investment whole, and we CAN help you with that.

Every ET Pro subscriber cares about the WHY of their portfolio. If I'm down this month, why am I down? If I'm up this month, why am I up? Are the components of my portfolio acting the way I would expect them to act given what's happening in the world? We can talk about this in terms of covariance matrices and correlations and volatility skews and any number of ten-dollar words if you like, but those words are all getting at one simple question: *do I understand why my portfolio is doing what it is doing?*

Understanding the WHY of your portfolio is the fundamental purpose and meaning of risk management.

Unfortunately, all of our risk management heuristics – another ten-dollar word that means our "rules of thumb" or our basic sense of the WHY of portfolio construction – have been developed in a deflationary Zeitgeist. We've had 40 years of declining interest rates, and more recently we've had a solid decade of central banks doing anything and everything – literally, "whatever it takes" – to support financial assets against deflationary outcomes. We are all well and truly trained in deflationary risk management of portfolios, regardless of what type of portfolio we work with, and we are all well and truly defended by central bankers against deflationary threats.

That's why I think the biggest practical investment risk for everyone reading this note is a shift from a deflationary Zeitgeist to an inflationary Zeitgeist. Sure, that shift will affect a trader's trades differently than it affects an investor's investments and differently than it affects an advisor's advice and differently than it affects an allocator's allocations.

But it will affect everyone – trader, investor, advisor, and allocator alike – differently *in the same way*.

None of these portfolios will work the way "they're supposed to" in a shift from deflationary expectations to inflationary expectations. The WHY of these portfolios – *whatever that WHY might be* – will no longer make as much sense.

The solution? To start exercising a new set of risk management muscles now, well before you need those muscles to carry a heavy load.

How? By learning how to "see" the shift in the Zeitgeist and tracking the WHY of your portfolio as that shift occurs.

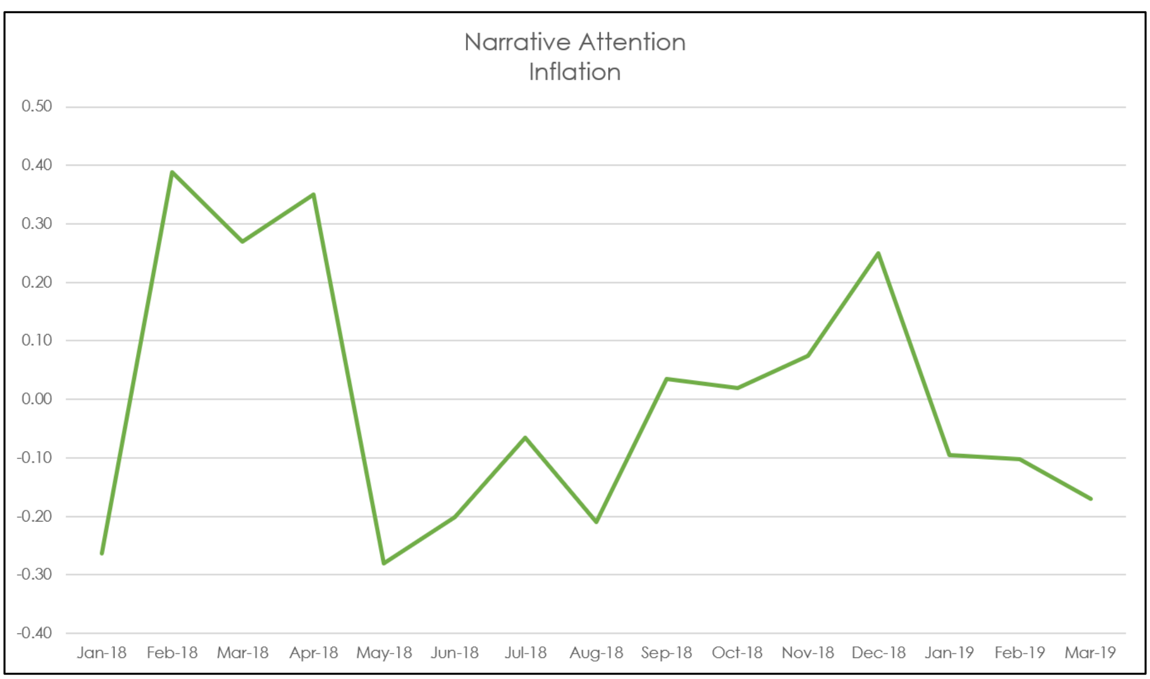
Here's how ET Professional can help you see a change in the Zeitgeist …

I'm going to call your attention to a couple of charts that you can find in the Monitors section of the **ET Pro website**. When you click on any of the five Monitors for a given month – Inflation, Central Bank Omnipotence, Trade & Tariffs, US Fiscal Policy, and Credit Cycle – you'll arrive at a page that gives a quick summary of our research on that specific narrative topic for that specific month. What you'll also see at the top of each page is a link to a **Powerpoint deck**, a PDF version of **that same deck**, and the **underlying data** for the deck in Excel. **Those decks and that Excel file contain *all* historical data and charts for *all five* Monitors.** In other words, you don't have to make five separate downloads for five separate Monitors to get the most recent data and charts … one will do.

In this note on a Zeitgeist shift from deflation to inflation, I'm going to focus on two narrative Monitors – *Inflation* and *Trade & Tariffs*. Inflation is an obvious choice, because its narrative context in any queries we set up is a direct match for what we're trying to measure. If narrative Missionaries want to talk about inflationary impulses and expectations, they use the word "inflation" a lot. With deflationary impulses and expectations, though, it's a little different. People use many different phrases to mean deflation, but they rarely use the word itself. So when people talk about "slowing global growth", they mean deflation. When people talk about "credit freeze" or "banking crisis", they mean deflation. When people talk about "trade war" or "tariffs", they mean deflation. *For the past year or so, ever since the Trump White House launched this as its primary foreign policy initiative, financial media about Trade & Tariffs has been the dominant narrative context for HOW people talk about deflation.*

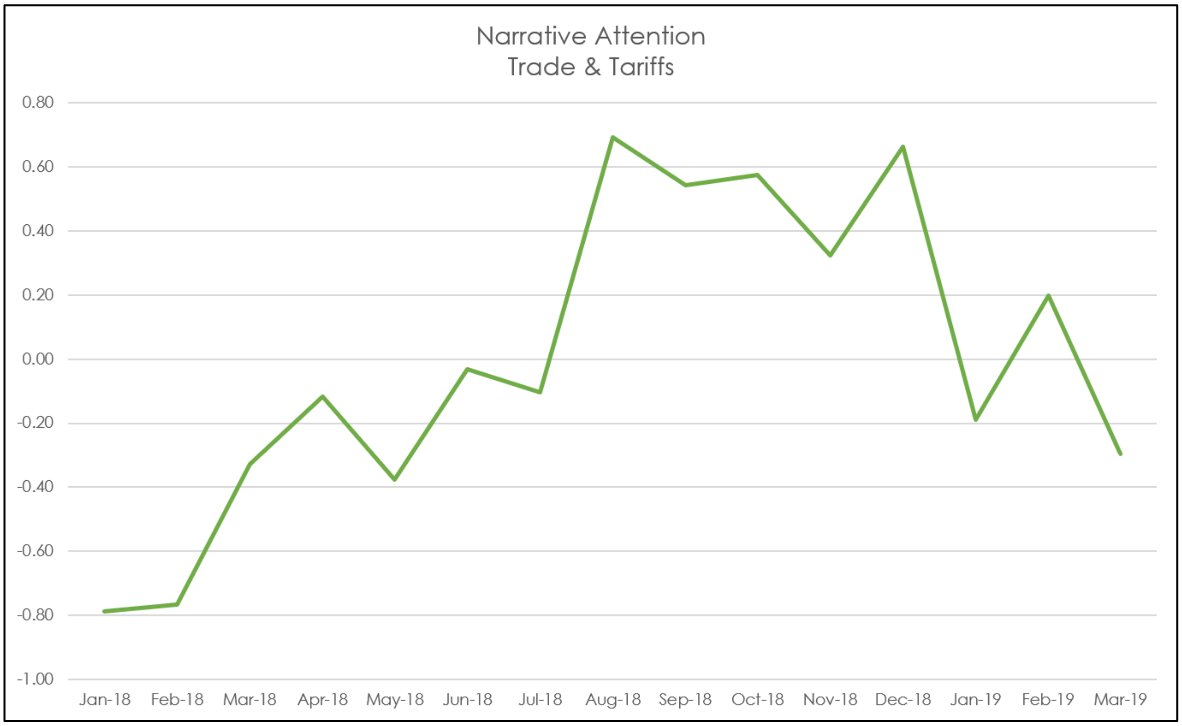
For both Inflation and Trade & Tariffs, I'm going to focus on the patterns we've observed in **Narrative Attention**. To recap (and you can read more on this in **The Epsilon Strategy** note from the other week), Narrative Attention measures the persistence and prevalence of a given financial narrative topic within the larger universe of ALL financial narrative topics over time. It's a measure of how central the Inflation-relevant articles or Trade & Tariff-relevant articles are to ALL financial media articles over time. We think it's a good measure of how much "drum-beating" the financial media and Wall Street are doing on a given topic, and we calibrate its measurement by how much more or less active the given month's drum-beating is relative to the average level of drum-beating for that topic.

Here's Inflation:



So in February, March and April of 2018, the level of financial media and Wall Street effort to call attention to inflation spiked well above average. That effort largely collapsed in May 2018, climbed back to "average" in the fall, saw another spike in December, and then has fallen again sharply so far in 2019.

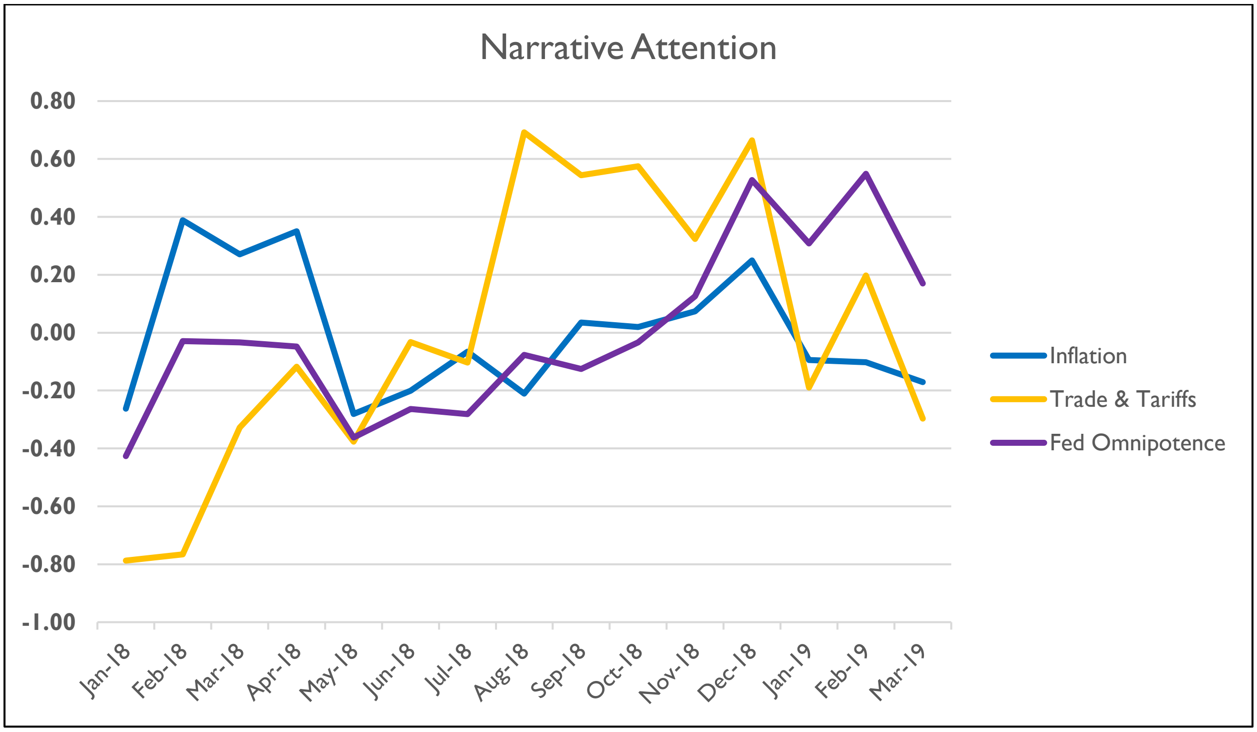
In contrast, here's the Narrative Attention timeline for Trade & Tariffs over the same timespan.



For all practical purposes, there was no Trade & Tariffs narrative before March 2018, but once it was introduced by the Trump Administration it became an enormously powerful narrative from a media drum-beating perspective. By August the Trade & Tariffs Attention score is much higher than the Inflation Attention score was at its peak, and stayed that way through December. In January of this year, however, Trade & Tariffs Attention started a sharp decline, and March took us back to levels not seen since the narrative was launched.

For both Inflation and Trade & Tariffs, these measurements ring true for our subjective experience with these narratives. The spike in the Inflation drum-beating was very noticeable to us last spring, and we wrote about it then, as was the incessant *Trade War!* narrative and meme of last fall.

So now let's put these Attention charts together in one graph, and let's include the Central Bank Omnipotence Attention data for good measure.



I'd draw two conclusions from this chart:

1) **December was an INSANE month for narrative drum-beating and Attention scores.** All three of these core macro narratives show above-average media Attention effort, and I don't think it's an accident that December was an insanely bad month for global risk assets, culminating in a shocking (to me, anyway) about-face in Fed policy and guidance at the very end of the month. I don't think that was a coincidence. *I think that the end-of-month reversal in Fed policy was the intended and successfully executed result of all of that end-of-world Wall Street drum-beating.*

2) **In general, though, and to quote the Highlander catch phrase, there can be only one! One dominant narrative that draws the lion's share of market attention, that is.** Last spring a strong narrative emerged that inflation was starting to bite. That narrative collapsed as a deflationary narrative of a global trade slowdown emerged out of *nowhere*, taking center stage and dominating financial media (and crushing risk assets), until that narrative was in turn vanquished by a resurgent Fed Omnipotence story. Notably, both the deflationary Trade & Tariffs narrative AND the Inflation narrative have diminished as the Fed Omnipotence narrative has surged.

So what's next? This, too, shall pass. Meaning that the Fed Omnipotence narrative will lose its dominant position in a couple of months, to be replaced by … drumroll, please … either a resurgent and deflationary Trade & Tariffs narrative OR a deflationary Euro Crisis narrative OR a resurgent Inflation narrative.

This is the narrative playbook I laid out in **Things Fall Apart, Part 3.**

It's all happening.

I think there are 3 deflationary narratives in the world today – a Fed-tightening recession, a China-trade recession, and an Italy-euro crisis/recession – what I called the Three Horsemen of the Investment Semi-Apocalypse in that note.

Of the three, the Fed-tightening recession is now off the table. We're done with that one, and Trump won't allow it to return. One deflationary Horseman down, two to go.

Could we have a resurgence of the deflationary China Trade War narrative? Could it evolve into some sort of deflationary Europe Trade/Currency narrative. Absolutely. But even if these narratives spike for a couple of months, they will ultimately be defeated by the Central Bank Omnipotence narrative, *just as they were in December*.

Inflation, on the other hand, what I call the Fourth Horseman of the Investment (True) Apocalypse … there's no taking that off the table. There's no Omnipotence narrative that's geared to deal with THAT, because all the central bankers have told us that they're not going to deal with THAT, that they're more than happy to let inflation ride back into town. And so it will. Just like it did last spring, only this time it will stay for a while longer. Sure, it will eventually get beaten back for a bit by a deflationary story, but each time it will come back stronger than before.

That's how a Zeitgeist shifts. Not in one fell swoop, but in an ebb and flow. Just more flow than ebb. All taking place most clearly in narrative-world.

Until one day you're swimming in an entirely new ocean of water.

ET Professional is here to help you see that ebb and flow in narrative-world and help you prepare for it.

Because whether you're a trader or an investor or an advisor or an allocator, we all have one shared directive: Don't Drown.

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