From: Ben Hunt
Sent: Sunday, November 18, 2012 11:24 PM
To: Ben Hunt
Subject: Friday was an important day

I believe that the White House meeting on Friday between Obama and the Minority and Majority leaders of both the House and Senate marked a critical turning point in the market perception of the fiscal cliff dilemma. I'm not sure if it was an actual turning point in the negotiations … in fact if I had to guess I'd say that absolutely nothing changed in the various real-world positions of Boehner et al … but the manner in which those positions were publicly communicated after the meeting was very positive for risk assets from a common knowledge perspective.

Here's a link to the C-Span coverage so that you can judge for yourself –
http://www.c-span.org/Events/Pres-Obama-Meets-with-Congressional-Leaders-on-Fiscal-Cliff/10737435879/ –
but basically Boehner, Pelosi, Reid, and McConnell strolled out onto the front lawn together, held hands, and sang hymns in praise of cooperation and compromise. The word that they had clearly agreed to use in their characterization of the talks was "constructive", which in Washington-speak is a good word. If instead they had characterized the discussion as "frank", then we should abandon all hope. The entire purpose of this exercise was to send a message to US markets. I mean, when Nancy Pelosi (Nancy Pelosi!) talks about how crucial it is for them to communicate their confidence in a pre-Christmas solution so that markets don't fret, then you know who they are talking to. When Harry Reid says that the "cornerstones of an agreement" are in place and that "both sides" will give up closely held positions, he's saying that entitlement programs will be cut. When Boehner and McConnell say nothing about objecting to marginal tax rate increases on the rich (excuse me, "job creators"), but focus their comments on some sort of spending cuts, they are close to a deal.

The chart below shows the immediate market reaction to the press conference.

The S&P 500 rallied about 10 points on the public statements, rose a bit more over the next hour, faded fairly significantly, and then rallied steadily from 2:30p into the close. I won't get into the gory details, but this is the sort of intra-day price action I expect from CK game dynamics.

The fact is that most of the significant intra-day market moves over the past few weeks (months, years) have been driven by policy announcements. Below is the daily chart from Friday, November 9th, when Obama's first post-election press conference and its confrontational tone dropped the S&P by 10 points.

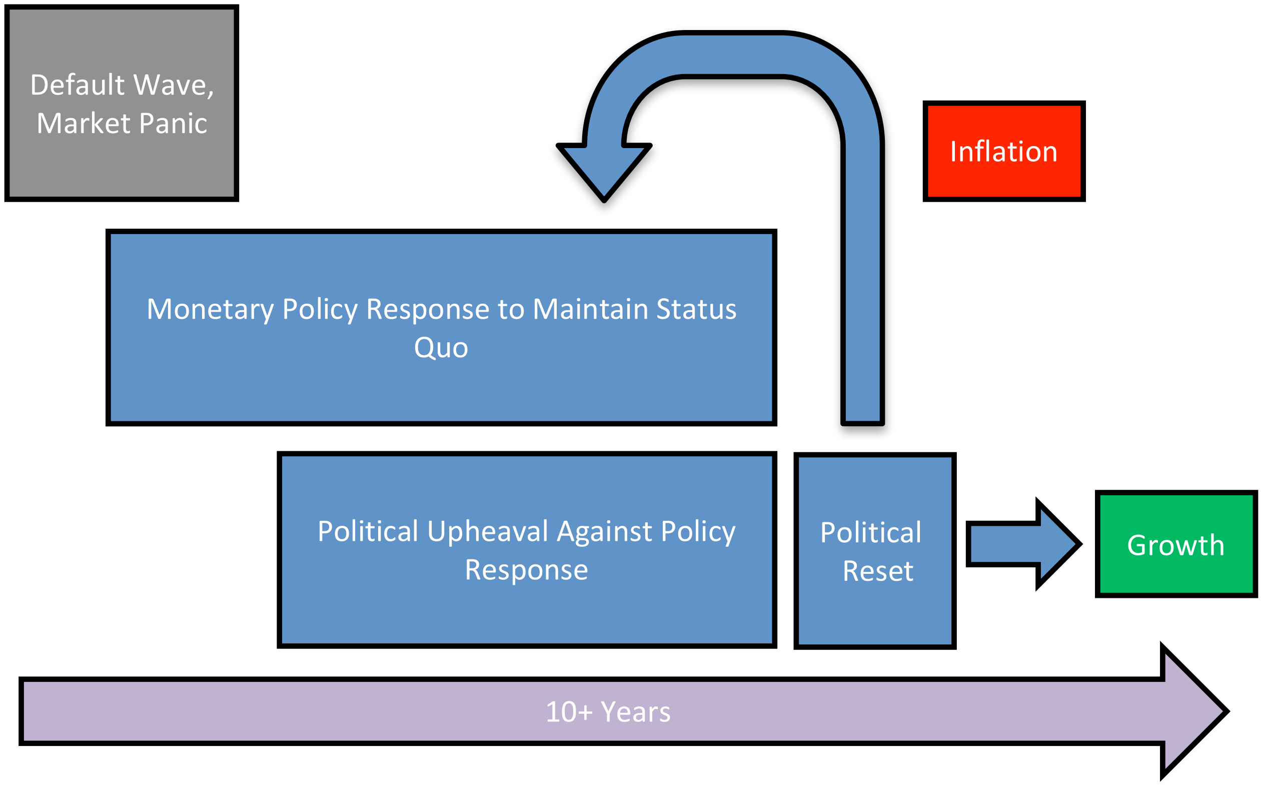
Or below is the daily chart from Wednesday, November 14th, when first Olli Rehn hit the market with his assessment of Spain's efforts to meet EU debt-to-GDP requirements, and then the FOMC minutes hit the market again on their release at 2p.

Or below is the daily chart from Thursday, November 15th, when Bernanke's comments on Fed support for the US housing market resulted in a nice, but transitory pop in US markets. The spike down at 10a that day was the result of the Philly Fed report, which is just another sort of public message that impacts markets as per the CK game framework.

There is no doubt that these policy announcements have a marked impact on any given market day (and yes, I'm developing a process for acting on this short-term policy-driven opportunity set). The critical question is whether the Friday White House press conference is a one-day wonder, or whether it has a lasting impact on market trends. If Bernanke's whatever-it-takes comments on the 15th weren't enough to sustain a market rally, why should anything that Nancy Pelosi says do any better?

My strong belief is that the Friday statements will indeed have a lasting impact, perhaps enough to drive a strong rally in risk assets into year-end. Why? Because relative to what everyone thinks that everyone thinks, the Friday statements were extremely novel and credible. I'm not saying that Bernanke is not credible with his Thursday statements. He is, at least from a market reaction perspective. But his speech on Thursday was not at odds with common knowledge. It was confirmatory, which means that it was not particularly impactful. The Friday White House statements, on the other hand, were both credible (but only because both Republican and Democrat leaders spoke!) and at odds with the market's common knowledge. A proper exposition requires a longer discussion than this letter allows, but the CK game is based on a Bayesian understanding of decision making and information processing … in other words, only new information that is at odds with prior perceptions of the world makes a difference in subsequent perceptions of the world. In the same way that macro data or earnings announcements have a greater impact when they come as a surprise, so does a press conference statement.

But even if you accept this description of a CK game dynamic, the question remains as to why a novel and credible statement regarding policy intentions should have even a transitory impact on market prices, much less a persistent impact on market price trends. The answer to that question, I believe, rests within a fundamental view of the structural political and economic responses to a global debt crisis. As I've described at length in prior notes, a close historical examination of immediately prior global debt crises in the 1870's and the 1930's reveals a pattern of political action and reaction that can be summarized in the figure below, where an initial wave of defaults, combined with deflationary and deleveraging pressures, forces a series of policy actions and reactions.



While the world experiences this long-term, structural dynamic as an intense political struggle, with a corrosive dynamic of fragmentation both within and between countries, I believe that markets see this through a simpler prism: the twin pressures of fear and greed. That is, in the 1870's, the 1930's, and today, market participants appear to experience this structural dynamic as a continual weighting of the threat of default, deflation, and deleveraging (what I will refer to as D3) against the promise of policy support and succor. "Threat" and "promise" are two sides of the same coin. Both are expressions of an expected utility calculation, which is a preciously academic way of describing an assessment of the probability of various future states of the world against the benefits associated with those various future states of the world.

Both D3 and Policy Support are complex entities, spanning multiple geographies and multiple modalities. And critically, these entities are not objectively measurable, but are the behavioral results of mediated and manipulated data streams. So yes, it makes a difference if the BLS tolerates systematic errors in the weekly initial jobless claims data. Yes, it makes a difference if the FT changes its primary op-ed piece on August 2nd from "Draghi's Blunder" to "Draghi's Bold Move". Grrrrrrr. But I digress …

This weighting question can be roughly represented by the (simplified) notation below, where N is the total of geographies and modalities that markets care about. The way to read this is that if the sum of the expected utilities of all the D3 threats across all geographies and modalities (which will be a negative quantity) plus the sum of the expected utilities of all the Policy Support promises across all geographies and modalities (which will be a positive quantity) is less than zero, then the market will trend down. And if the sum is greater than zero, then the market will trend up.

$$\sum_{i=1}^{N} EU(D3)_i + \sum_{j=1}^{N} EU(\text{Policy Support})_j \overset{?}{<>} 0$$

My research suggests that there are only two geographies that matter on a consistent basis for D3 threat and Policy promise: the US and the EuroZone. Japan and China only make a difference once in a blue moon. The crucial modalities for D3 are PMI's (or in the US, the ISM reports), as well as Industrial Production and Employment data, and for Policy Support are central bank decision-making and large-scale fiscal policy. Importantly, because this is an expected utility calculation, the only thing that matters about any of these inputs is their relevance for future conditions. But if you can weight these relevant D3 and Policy Support inputs accurately, then adjust for mediation and manipulation, you have your market narrative. You have your market trend.

Now to be sure, that's easier said than done. But if you apply this framework to every significant market transition over the past four years … it works. And if you apply this framework to the current accumulated set of media messages regarding future growth prospects and future policy prospects in the US, then inject the Friday press conference as understood through a CK game, you get a sum that's greater than zero, a positive market trend. The expected utility of Policy Support, if a fiscal cliff compromise is in the works, is clearly a greater positive quantity than the negative quantity of the expected utility of D3.

There are two risks to this rosy view of market trends.

First, the ongoing media narrative required to support and amplify Friday's strong public announcement could fail to materialize. We saw this sort of fizzling-out in media coverage in the second half of September after open-ended QE was announced, which I wrote about at the time. I don't think we will see the same here, because there's nothing about the fiscal cliff that's academic or difficult to explain in a sound bite. Every US politician, regardless of party, has a strong incentive to repeat Friday's message ad nauseam, and we saw that today on the Sunday talk shows today. But you won't have another actual negotiation meeting until the week after Thanksgiving, so I'll be tracking the media narrative in the meantime carefully.

Second, Europe could deteriorate. While I expect a more-or-less positive resolution to the immediate Greek funding debate this week, negative domestic political catalysts continue to develop and accelerate in Spain and Italy.

In Spain, the vote in Catalonia later this month, which is effectively a referendum on secession, is the first step in what I expect to become a full-blown Constitutional crisis over the next six months. This is a domestic fight over debt and austerity, with almost exactly the same dynamic as the fight within the EuroZone internationally. In the domestic case, however, the Spanish government plays the role of Germany, holding the checkbook and insisting on austerity, and the autonomous regional governments play the role of Spain, threatening an uncontrolled exit and playing chicken with their creditors. This is a perfect example of the fragmentation forces that are the historical constants in the long-term, structural framework of a global debt crisis.

As importantly, Olli Rehn's pronouncement last Wednesday on the EU's assessment of the Spanish sovereign's progress (or lack thereof) in meeting deficit spending targets placed a new roadblock in front of any Spanish request for a sovereign bail-out from the ECB's OMT program. While the EU blessed Spain's efforts for 2012 and 2013, under the argument that even though the country won't hit its targets for either year there were sufficient structural reforms in place to tips the scales in their favor, Rehn said that 2014 projections were insufficient for the EU. What this means in practice is that any bail-out under the OMT program will require a new set of severe austerity measures. These measures will probably be necessary in any event, but making a formal request from the ESM and ECB crystallizes the austerity requirement at the moment of the request. If anyone was looking for a Spanish bail-out request in 2012, those hopes were effectively dashed.

In Italy, Berlusconi's party continues to implode and is threatening to unwind the current Monti caretaker administration in favor of early elections. The ostensible argument is over whether regional elections should take place prior to national elections, but the underlying issue is how Berlusconi's party can remain relevant without picking a fight with the Monti Administration sooner rather than later and running against his austerity policies. At the same time, there is a burgeoning movement to draft Monti for an elected term in office, an effort spearheaded by Ferrari chairman Montezemolo and culminating in the formation of a new political party this weekend. This will not end well.

So while I expect the US markets to enjoy a nice rally from Friday's developments, the safer way to play this would probably be to go long the spread between US and European equities. If we see volatility events emerge that drive all risk assets down in the next six weeks, they are much more likely to emanate from Europe (or the Middle East) than the US. Alternatively, there are specific equities and sub-sectors that are largely immune to European woes but are highly levered to US fiscal cliff, sequestration, and growth fears, such as defense and housing. This is how Procella will be acting on this view.

****

W. Ben Hunt, Ph.D.
Portfolio Manager
TIG Procella Fund

Direct: (212)396-8787
Email: bhunt@tigfunds.com

TIG Advisors, LLC
520 Madison Avenue, 26th floor
New York, NY 10022
****