Last week I wrote an email describing a nascent shift in the 20-year old Narrative surrounding Emerging Markets … that there is a growing set of influential public statements in financial media saying that Emerging Market growth rates are a function of Developed Market monetary policy. To the degree that this Narrative becomes Common Knowledge, replacing the old Narrative of an inherent and irrepressible growth story in Emerging Markets, there will be massive repercussions throughout the business of money management, much less the price of this security or that.

Today I want to write about an inflection point in the 1-year old Narrative surrounding Central Bank Omnipotence, a Narrative described at length in my June 30th note "How Gold Lost its Luster". There are two aspects of this inflection point – one in regards to perceptions of Fed competence and one in regards to perceptions of non-Fed Central Bank abilities – both of which are reflected in the human signals coming out of Jackson Hole this week and the market signals coming out of forex markets.

This diminishment of the Central Bank Omnipotence Narrative impacts the informational structure of almost every security, and in general serves to increase the prominence of Risk-On/Risk-Off behavior. The asset classes that are most directly impacted by Risk-On/Risk-Off behavior – precious metals and forex – will see the most obvious impact, but so will the stocks and bonds that are most closely linked to Narratives such as "the Fed has got your back" or "there's a growth story in Country X".

In the same way that gold hardly had a single good day after the Central Bank Omnipotence Narrative solidified in late September 2012, it will be hard for gold to have a bad day now that the Narrative is clearly weakening in late August 2013.

The shift in perceptions of Fed competence is being driven by opinion leaders' public statements questioning the Fed's communication policy. Here's the critical point from an Epsilon Theory perspective: these public statements are not questioning the content of Fed communications; they are questioning the USE of communications as a policy instrument in and of itself. **In exactly the same way that a magician immediately becomes much less impressive once you know how he does his trick, so is the Fed much less impressive once you start focusing on HOW policy is communicated rather than WHAT policy is being implemented.**

For example, this past Saturday Jean-Pierre Landau, a former Deputy Governor of the Bank of France and currently in residence at Princeton's Woodrow Wilson School, presented a paper at Jackson Hole focused on the systemic risks of the massive liquidity sloshing around courtesy of the world's central banks. For the most part it's a typical academic paper in the European mold, finding a solution to systemic risks in even greater supra-national government controls over capital flows, leverage, and risk taking. But here's the interesting point:

"Zero interest rates make risk taking cheap; forward guidance makes it free, by eliminating all roll over risk on short term funding positions. ... Forward guidance brings the cost of leverage to zero, and creates strong incentives to increase and overextend exposures. This makes financial intermediaries very sensitive to "news", whatever they are."

Landau is saying that the very act of forward guidance, while well-intentioned, is counter-productive if your goal is long-term systemic stability. There is an inevitable shock when that forward guidance shifts, and that shock is magnified because you've trained the market to rely so heavily on forward guidance, both in its risk-taking behavior (more leverage) and its reaction behavior (more sensitivity to "news"). This argument was picked up by the WSJ ("Did Fed's Forward Guidance Backfire?") over the weekend, and it continues to get a lot of play.

Landau's paper is probably the most public example of this meta-critique of the Fed, but I don't think it's been the most powerful. Highly influential opinion leaders such as David Zervos and John Mauldin have recently written in their inimitable styles about the Fed's use of words and speeches as an attempt at misdirection, as an ultimately misguided effort to hide or sugarcoat actual policy. FOMC members *themselves* are starting to question the Fed's reliance on communications as a policy instrument, as evidenced by the minutes released last week. Combine all this with the growing media focus on the "battle" between Yellen and Summers for the Fed Chair – a focus which will *create* policy disagreements between the candidates in the public's perception even if no such disagreements exist in reality – and you have a recipe for accelerating weakness in perception of Fed competence.

The shift in perception of non-Fed central bank competence, especially of Emerging Markets central banks, is even more pronounced. Actually, "competence" is the wrong word to use here. The growing Narrative is that Emerging Market central banks are powerless, not incompetent. The academic foundation here was made in a paper by Helene Rey of the London Business School, also presented at Jackson Hole, where the nutshell argument is that global financial cycles are creatures of Fed policy … period, end of story. Not only is every other country just along for the ride, but Emerging Markets are kidding themselves if they think that their plight matters one whit to the US and the Fed.

Just as malcontents with the exercise of Fed communication policy may be found within the FOMC itself, you don't have to look any further than Emerging Market central bankers and finance ministers themselves for outspoken statements protesting their own impotence. Agustin Carstens, Mexico's equivalent to Ben Bernanke, gave a speech on the "massive carry trade strategies" caused by ZIRP and pleaded for more Fed sensitivity to their capital flow risks. Interesting how the Fed is to blame now that the cash is flowing out, but it was Mexico's wonderful growth profile to credit when the cash was flowing in. South Africa's finance minister, Pravin Gordhan, gave an interview to the FT from Jackson Hole where he bemoaned the "inability to find coherent and cohesive responses across the globe to ensure that we reduce the volatility in currencies in particular, but also in sentiment" now that the Fed is talking about a Taper. Christine Lagarde got into the act, of course, calling on the world to build "further lines of defense" even as she noted that the IMF would (gulp) have to stand in the breach as the Fed left the field. To paraphrase Job: the Fed gave, and the Fed hath taken away; blessed be the name of the Fed.

I'll have a LOT more to say about all this in the weeks and months to come, but I thought it would be useful to highlight these shifts in Narrative structure in real-time as I am seeing them. Informational inflection points in the market's most powerful Narratives are happening right now, and this is what will drive markets for the foreseeable future.

All the best,
Ben

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