

“Flatland”

To lose one parent, Mr. Worthing, may be regarded as a misfortune; to lose both looks like carelessness.

– Oscar Wilde, “The Importance of Being Earnest”

Behold yon miserable creature. That Point is a Being like ourselves, but confined to the non-dimensional Gulf. He is himself his own World, his own Universe; of any other than himself he can form no conception; he knows not Length, nor Breadth, nor Height, for he has had no experience of them; he has no cognizance even of the number Two.

– Edwin A. Abbott, “Flatland: A Romance of Many Dimensions”

There are only patterns, patterns on top of patterns, patterns that affect other patterns. Patterns hidden by patterns. Patterns within patterns. .. What we call chaos is just patterns we haven't recognized. What we call random is just patterns we can't decipher. What we can't understand we call nonsense. What we can't read we call gibberish.

– Chuck Palahniuk, “Survivor”

The FOMC will conclude a two-day meeting on Wednesday afternoon. There's no press conference after this meeting, no opportunity for Bernanke (in his last FOMC meeting) to provide additional “communication policy”, no opportunity for Yellen to signal her personal take on the weak December jobs report and the Emerging Markets carnage of the past week. Whatever the formal statement says is all the market will get, until, of course, Jon Hilsenrath weighs in with a WSJ article to tell us what the FOMC really meant to say.

From a game theory perspective, whether or not the Fed continues the taper with an additional \$10 billion in cuts to the monthly bond purchase program is a really big deal. Not because it's the consensus outcome if you poll economists (consensus actually means very little for how the market plays the Common Knowledge game), and certainly not because of any fundamental economic implications of purchasing “only” \$65 billion in securities per month rather than the current \$75 billion. No, the importance of an additional \$10 billion monthly taper is simply that it will be the second \$10 billion cut in a row. It sets a pattern. It turns a point into a line. It creates what game theorists call a “focal point”, which exerts an extremely strong gravitational pull on common knowledge construction.

Tom Schelling, who won a Nobel prize for his work and is, for my money, one of the two all-time best thinkers about real-life applications of game theory (I'll talk about the other, Bill Riker, in this Sunday's note) wrote extensively about the idea of a focal point, particularly in his must-read book "The Strategy of Conflict." As Schelling describes, a focal point IS common knowledge – it is the belief that we have about what the other party believes, and vice versa – and it will almost always be the equilibrium outcome of a free-form strategic decision, particularly if we cannot communicate directly with the other party. In one of Schelling's examples, you've agreed to meet a friend at noon in New York City, but you forgot to agree on a place to meet. What happens? You both end up at the clock in Grand Central Station right at noon. Each of you thought of the clock as what your friend would think of as a meeting place and, recursively, what your friend would think of what you would think of what your friend thought. The clock is a focal point. A focal point, however created, reduces ambiguity and uncertainty in our decision-making. Usually that's a good thing, but sometimes – as the Fed will discover if they stick to \$10 billion in additional tapering – it's not.

From a game theory perspective, the Fed is much better off increasing the taper by \$5 billion or \$7 billion ... even a **larger** amount than their last meeting, say \$12 billion ... than sticking with the same \$10 billion figure. This is how the Fed can best maintain useful ambiguity in their communication policy, what they have referred to as "data dependence" and is what Schelling calls "the threat that leaves something to chance". If you're long the market in any way, shape, or form ... if you are relying on the notion that "the Fed has got my back" in your investments ... this sort of ambiguity is exactly what you want to see in the FOMC statement. At this point in the lifecycle of the Narrative of Central Bank Omnipotence, clarity and predictability are entirely counterproductive.

I know it sounds weird to put so much weight on a second identical number, but the human animal will not see a second \$10 billion as "just a number". The human animal has been biologically evolved for millions of years and culturally trained for tens of thousands of years as a pattern recognizer extraordinaire. We simply can't help ourselves. Like it or not, a second \$10 billion cut will be seen as the establishment of a pattern, and that's a problem. Why? Because once you identify a pattern you will extrapolate a continuation of the pattern ... this is what humans DO in their strategic decisions ... and you will start to see opinion leaders attaching a final number to the size of QE3. It's a big impressive number, to be sure, but it's not open-ended. It's not infinity. It's a limit. It's a clear signal

(much clearer than the single data point from last meeting) that the Fed is reducing the pace of asset purchases and headed to zero.

Once these final-size-of-QE3 stories start to appear, everyone associated with the Fed, from the Chair to the Governors to the media mouthpieces, will bend over backwards to say that tapering is not tightening, that they are not putting on the brakes but only taking their collective foot off the accelerator. This is a misreading of game dynamics and the forward-looking creation of mutual expectations. In a game of Chicken, where you and James Dean are racing your cars towards the cliff, you win (and James Dean knows you've won) when he takes his foot off the accelerator. Once that happens, the game is over. Putting on the brakes is the final move, but it's not the moment where the game is won or lost! In technical terms, it's the second derivative of behavior (acceleration/deceleration) that makes all the difference in game-playing, not the first derivative (velocity).

There's a long note laying out this James Dean game dynamic on the [Epsilon Theory website](#) if you're interested in reading more. Please feel free to forward this email and attached note to whomever you think might be interested, and if you're not yet on the direct distribution list (and you find it a worthwhile read), I'd appreciate the opportunity to [add you to the list](#). As always, if you're no longer interested in receiving these notes, please reply to this email to that effect.

All the best,

Ben

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