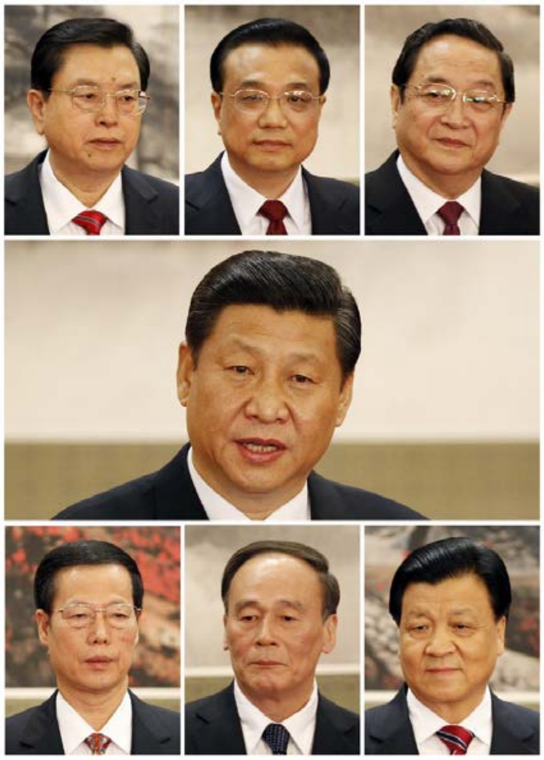
"Going Gray"



Everything under the sun is in chaos. The situation is excellent.
– Mao Zedong (1893 – 1976)

Forget it, Jake. It's Chinatown.
– Chinatown (1974)

Language is conceived in sin and science is its redemption.
– W.V.O. Quine (1908 – 2000)

I am, as I am; whether hideous, or handsome, depends upon who is made judge.
– Herman Melville (1819 – 1891)

All -ism's end up in schisms.
– Huston Smith (b. 1919)

What Asians value may not necessarily be what Americans or Europeans value. Westerners value the freedoms and liberties of the individual. As an Asian of Chinese cultural background, my values are for a government which is honest, effective and efficient.
– Lee Kuan Yew (b. 1923)

Two years ago, the new seven-member Standing Committee of the Chinese Communist Party Politburo – the most powerful political entity in the country – was introduced to great fanfare. All seven men walked on stage wearing a dark suit and a red tie, but to me the most striking aspect of their appearance was their hair. Yes, their hair. Their dark, immaculately coifed, powerful hair. Despite an average age of 65, not one of these men has EVER been seen in public without sporting a mane that would make their grandsons proud.

On the other hand, consider this handsome man, Bo Xilai. Once the princeling of princelings, the son of a Long March vet, Bo was enormously popular for his Redder-than-Thou politics and enormously rich from his mayoral "crackdown" on organized crime in Chongqing, a municipality with about the same urban population as New York City. **To put Bo Xilai in a US context, he was richer than Michael Bloomberg and more politically ambitious than Rudy Giuliani, if either of those two qualities can be imagined.** And of course, this 65 year old politician had the luxurious jet-black hair as befits a man of his position.

But alas, Bo's political reach exceeded his political grasp. Undone publicly for abuse of office and a murder conspiracy, privately for his creation of a top-notch intelligence operation that spied on his fellow Politburo princelings (again to put in a US context, imagine if a mega-billionaire mayor of New York City created his own electronic FBI that could monitor everyone's market activities … crazy, right?), Bo found himself on the wrong end of a show trial and is currently living out the rest of his days in a Madoff-style cell. How do we know that Bo is gone for good, that he has lost whatever political support he formerly commanded? **Because they took away his hair dye**. He's "gone gray", as they say in the Chinese political lingo, portrayed to the world as a frail old man who not only lost his freedom but *much* more importantly lost his mojo.

Patrick Henry famously said, "Give me liberty or give me death!", a sentiment that makes sense in Western political culture but is met with puzzled looks in the East. Personal liberty is, in an important sense, *everything* in Western political culture. In Chinese political culture … not so much. On the other hand, signifiers of personal potency – like maintaining dark hair – have enormous

meaning in China and, at times, a diametrically opposed meaning in the West.

Okay, Ben, kinda interesting in a cultural anthropology sort of way, but what in the world does this have to do with investing? Simply this, and it's a core Epsilon Theory tenet: **the meaning of events and market signals differ hugely from country to country, tribe to tribe, generation to generation**. Ferguson does not *mean* the same thing as Hong Kong. Hong Kong does not *mean* the same thing as Tahrir Square or even Tiananmen Square. Monetary policy does not *mean* the same thing in Beijing as monetary policy *means* in Washington, which in turn does not *mean* the same thing as monetary policy in Paris or Rome. **But we have an innate tendency to act as if these signals DO mean the same thing, and we can totally wrong-foot our investments as a result.**

The biggest thing happening in the world today is the growing divergence between US monetary policy and everyone else's monetary policy. There is a schism in the High Church of Bernanke, with His US acolytes ending the QE experiment in no uncertain terms, and His European and Japanese prelates looking to keep the faith by continued balance sheet expansion. That divergence plays out mostly in exchange rates, and it has three HUGE implications, one for investment strategy selection, one for global growth, and one for … (gulp!) gold.

First, this is great news for global macro strategies and their low-cost, populist cousins, so-called "alternative beta" strategies. Global macro performance has been absolutely atrocious over the past five years, driven primarily by a coordinated global monetary policy regime that squeezed out the historical patterns of difference between geographies and asset classes. Now that monetary policy is uncoordinated, with every major economic region essentially fending for itself, global macro and alternative beta strategies have "room" to work. To be sure, some of these strategies will still be confounded by an investment regime where monetary policy trumps economic fundamentals at every turn, but the sine qua non for ANY active investment strategy is distinction and dispersion. For the first time in more than five years, we can see this sort of distinction and dispersion in regional macroeconomic policies, giving traditional global macro strategies at least a chance of success. Vive la difference!

Second, this divergence in regional monetary policy creates enormous strains on the tectonic plates of modern international trade – currency exchange rates. In the absence of a re-convergence of monetary policy I don't see any compelling reason why recent dollar appreciation should slow down, much less reverse itself, with the obvious consequences for US S&P 500 earnings (negative), commodity prices and commodity-related securities (negative), most EM markets (negative), and European and Japanese earnings (positive). But the greatest risk for global economic stability from a dollar on steroids is, for my money, China. Why? Because as I've tried to point out in prior Epsilon Theory notes (here, here, and here), **China's political stability depends on economic growth – it's the mojo of the Party just as surely as jet-black hair is the mojo of Party leaders – and Chinese growth depends on exports.** So long as the yuan is effectively tethered to the dollar, a stronger dollar means a stronger yuan, which means weaker exports to Europe, Japan, and EM's. Sure, it's cheaper now to buy more iron ore and copper, so I suppose you could build another ghost city or two to keep the growth train on track, but the Politburo's only serious answer to the politically existential question of growth is to sell more advanced products to more people, most of whom don't live in China. That means selling medical devices to Japan and telecom equipment to Germany, tasks made much more difficult by a stronger dollar/yuan. To be clear, I do NOT see some imminent economic collapse in China. **But growth is much less *certain* in China today, and that's a *political* problem that the Politburo will stop at nothing to fix.** I expect the 180-degree shift in Chinese monetary policy that began this January and paused this summer to accelerate again, which in turn will accelerate political tensions abroad with the US and Japan, as well as political tensions domestically with the mega-rich princeling families. And speaking of domestic political tensions …

Look, I don't think the *meaning* of Hong Kong – even to the participants – is some pro-democracy uprising a la the Arab Spring or any of the "color revolutions" our media is so quick to christen. Maybe if we start to see fewer English-language signs and fewer teenagers lifting their smartphone "candles" I'll change my mind, but right now it seems a lot more like a tepid expression of political identity than a determined effort by determined citizens to change the political system at a fundamental level. This isn't a release-the-hounds moment like Deng believed Tiananmen Square to be, and it looks like the Gang of Seven in Beijing have decided as much with new orders to pull the police back and let the protesters block traffic and annoy everyone in the city who just wants to get back to business.

But I do think there's a deeper implication of the Hong Kong protests, one likely to be missed by Western investors who want to project a Western meaning on the events taking place. I think the most important lesson that mainland leaders in the CCP and PLA will take away from the Hong Kong protests is not that the population must be brought to heel, but that they can't be trusted, that they're not really one of us. And that's okay to a certain degree … the potential of "contagion" from Hong Kong to, say, Chongqing seems really remote given the State's control over media and information flow … but it's not okay if the "transmission wires" of Hong Kong's financial system can't be trusted. Hong Kong is an indispensable financial intermediary for the Chinese State, and I have zero doubt that Beijing will move to cement their control over the sinews of real power here, by any means necessary. One of those sinews of real power is the Hong Kong dollar, which means that Hong Kong monetary policy and the Hong Kong Currency Board – already reduced to a semi-independent satrap – is about to make the transition to full-fledged puppet. This lesson won't be lost on the mega-rich Chinese princelings, either. **The days of parking your mainland wealth in Hong Kong are now over, as it's no longer a safe haven from the long arm of the CCP.** Let the capital flight begin, and watch out below for the Hong Kong dollar.

As for my third point – the implications of monetary policy divergence on gold – I'm always reticent to write about gold because it incites such passion (and I don't just mean the gold bug camp … poke pretty much any academically-trained economist and you will unleash a furious anti-gold tirade). To be clear, I believe that the meaning of gold today is NOT as a store of value but as an insurance policy against central banks losing control. With market faith in the Narrative of Central Bank Omnipotence at an asymptotic top, the price of that insurance policy – call it $1,200/oz – is as low as it's going to go. **And now with a schism in the High Church of Bernanke, monetary policy divergence, and growing pressures on the tectonic plates of exchange rates we have catalysts for both a generic and geographically specific central bank loss of control.** Now I understand that gold means different things to different people, and to the degree that gold trades as a commodity or a dollar-denominated store of value it can trade cheaper as the dollar advances. I get that. But I don't think that's been the principal meaning of gold for the past 5+ years, and if you think as I do that this is the beginning of the end for the Golden Age of the Central Banker (or at least the end of the beginning), gold is pretty interesting here.

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