From: Ben Hunt [mailto:ben.hunt@epsilontheory.com]
Sent: Thursday, June 20, 2013 11:14 AM
To: 'ben.hunt@epsilontheory.com'
Subject: Epsilon Theory: what's the opposite of "green shoots"?

I've gotten a lot of emails since my post yesterday, all posing the same basic questions: why aren't markets going up on the good news of improving US labor conditions and continued Fed bond purchases? Isn't this good news for the fundamental health of the US economy, and thus good news for corporate earnings and revenue growth? Hasn't the Fed been crystal-clear that it has no intention of actually tightening, but is going to remain historically accommodative even as conditions improve?

So here's my answer. Yes, this is good news for corporate earnings and revenue growth. Yes, the Fed has made it abundantly clear that, to use Bernanke's analogy from his press conference yesterday, the Fed is only taking its foot off the accelerator, not putting its foot on the brake. But no, this is not good news for the market. This is terrible news for the market, and here's why …

For more than four years now, the market has been trained (and by "the market" I mean both human investors and trading algorithms) to take Bernanke communications as the single most influential signal in determining investment decisions. The only other signal emitters that even come close in their informational influence are Draghi and Merkel. Everyone else – and that includes Obama – are an order of magnitude less important from an Information Theory perspective. This is an empirical fact, not opinion.

Bernanke's signals are not communicated to us directly, but are mediated by a host of self-serving entities, from political institutions to individuals (including Bernanke himself) to corporations large and small. We hear a constructed representation of these signals and – critically – everyone believes that everyone else is hearing the same things.

Last September Bernanke explicitly linked QE to the unemployment rate. This was a mistake. Why? Because the unemployment rate is going down no matter what the Fed does or doesn't do as trend employment growth rates decline. That's not my opinion, that's the Chicago Fed's view.

More importantly, though, this was a mistake because **every signal mediator – from the White House to CNBC to everyone in-between – has fixated on the "good news" declining unemployment rate as it serves *everyone's* institutional and personal self-interest.** Read any interview with David Axelrod over the past 6 months. He says that the reason Obama won in November is that the unemployment rate went down in the months leading up to the election. Look at the ratings for CNBC on Jobs Friday versus any other day of the month … it's not even close.

Viewing US labor conditions solely through this single constructed number is simplistic and kinda stupid. But it is what it is. This is how a Narrative is constructed … because it serves the interests of Narrative creators. As a result, here's the mediated Bernanke signal that every market participant has been well trained to respond to in a strategic decision-making context: the Fed will reduce monetary accommodation as the unemployment rate declines.

Yesterday, the Fed said that the unemployment rate is declining even faster than it thought a few months ago. This is hitting the market hard because **the Common Knowledge game is extremely sensitive to second derivative information.** In the same way that Common Knowledge is defined not by what everyone knows, but by what everyone knows that everyone knows, so is the informational structure of the CK game impacted not just by change in information, but by change in the change in information.

From a second derivative perspective, taking your foot off the accelerator is just as important an event as putting your foot on the brake.

What we are witnessing today is the opposite of the "green shoots" Narrative of 2009. In exactly the same way that the market went up sharply in 2009 even as the real economy got worse, so today can the market go down sharply even as the real economy gets better. The Narrative in both cases, which is what drives the game-playing, has everything to do with the rate of change and how that is tied to Fed policy. **Market game-playing happens at the margins, and yesterday was an inflection point.**

As always, thanks for your time and attention. – Ben

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