From: Ben Hunt [mailto:ben.hunt@epsilontheory.com]
Sent: Wednesday, July 31, 2013 5:08 PM
To: 'ben.hunt@epsilontheory.com'
Subject: Epsilon Theory: The Framing of Macro Data

It's been a while since I put out an email commenting on current events, and that's intentional, as I'm focused on developing (and writing about) the methodology and tools of Epsilon Theory. But the Narrative formation around today's US GDP data release is too pertinent to pass up. It is prima facie evidence that the *framing* of signals -- that is, HOW a signal is presented -- has as much influence on market behaviors as WHAT is being signaled.

The number that drives virtually all market decision-making based on aggregate economic activity is formatted as an annualized quarter-over-quarter rate of change. This is not the only way that the signal of US aggregate economic activity could be formatted, but through whatever combination of merits and accidents of history this is the only representation that matters.

The new information released today by the US Bureau of Economic Analysis was that Q1 GDP -- which had previously been reported as 1.8% -- was now given a final value of 1.1%. Also, Q2 GDP -- which had been estimated by economists to come in at 1.0% -- was now given an initial value of 1.7% by the BEA.

Here is a very typical interpretation of these results, by Vincent Cignarella at DowJones, as published in the Wall Street Journal Moneybeat section and as read by (my guess) *tens of thousands* of investors:

"The numbers weren't that great – second-quarter GDP was better than expected, but the first quarter numbers were revised downward. But what it did for me is suggest that forward momentum of the U.S. economy is on solid ground. I'm not trading anymore, but if I were, in theory, that would be enough to push me – and from the looks of the dollar's rally after the data, plenty of traders – off the fence and into a long dollar position."

Now I know that it will look like I am picking on Mr. Cignarella, but really I'm not. His conclusion -- that he is more confident that an improving trend exists in the US economy after seeing this data than he was before seeing this data -- is exactly the same conclusion that I heard or read in *every* commentary today regarding what the numbers *mean*.

This conclusion is wrong. It is a natural, all-too-human mistake, but it is a mistake.

When you look at the actual numbers that represent Q2 GDP, as opposed to the annualized quarter-over-quarter change, the estimated result was almost EXACTLY what the reported number turned out to be, $15.6487 trillion. The actual numbers were NOT better than expected. They were essentially identical to what was expected. If you look at today's Q2 GDP data over any timeframe longer than the immediately preceding quarter, there is ZERO information that would make you MORE confident regarding an improving trend in the US economy.

To be clear, I am not saying that the US economy is not improving or that the US economy is not "on solid ground". It may be. I really don't know. But what I do know is that today's data release was a "positive surprise" only in relation to the immediately prior quarter. It has zero informational value versus the prior consensus estimate over any other time frame, and -- unless you think that the US economy meaningfully slows and accelerates on a dime -- if this data release changes your opinion about the strength or trajectory of a US economic recovery you are updating your views in an entirely natural, but entirely illogical manner.

Of course, to the degree that this opinion becomes Common Knowledge -- that everyone knows that everyone knows that the US economic recovery is on more solid ground because of the Q2 GDP data -- then it really doesn't matter whether the creation of that opinion was based on a logical fallacy or not. If this becomes the Narrative, then regardless of the correctness of your private opinion, you will be a less effective investor if you try to fight that Narrative.

That said, I may not want to fight this or any other Narrative, but that doesn't mean I have to add to any exposure to join it! If I'm going to invest alongside a Narrative I'd like to have some confidence that its factual and logical underpinnings are solid, and that's not the case with the Narrative I'm seeing around this morning's GDP macro data.

All the best,
Ben

****
W. Ben Hunt, Ph.D.

60 Church Lane
Westport, CT 06880

Tel: 203-858-1037
Email: ben.hunt@epsilontheory.com
****