"Two Shifting Narratives"

Please feel free to forward this email to whomever you think might be interested, and all prior notes are available on the Epsilon Theory website. If you're receiving this note via forwarded email and 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. I'm building the Adaptive Investing framework in plain sight and in real time through these notes, and I'd welcome the widest possible participation, as well as your thoughts and comments. As always, if you're no longer interested in receiving these notes, please reply to this email to that effect.

Two brief observations on incipient shifts in powerful Narratives ...

First, China. The pleasant charade that recent currency intervention was nothing more than an effort to reverse the "one-way bet" of speculators and to "increase volatility" as part of China's accession to some brotherhood of liberal nations is starting to crumble. Let me put it this way … you know that your preferred Narrative is in trouble when even the *WSJ* runs a piece titled "Yuan's Decline Raises Concerns Over Currency War". This is something I've written a lot about recently, here and here, and the political repercussions of slowing growth in China continue to make my risk antennae quiver. Politically speaking, weak real economic growth can be papered over by Fed-engineered financial asset price inflation in the US and by *la dolce vita* social policies in Europe. Neither option is available to Chinese leadership. China needs to make and sell more *things* – domestically, internationally, whatever – to keep the *political* machinery from coming unglued, and that's the lens through which I see the China story.

Second, the Fed. I've been somewhat surprised by the trial balloons and back-bench grumblings posted recently by our favorite Fed amanuensis, Jon Hilsenrath – the latest out just this morning. It's too soon to read a lot into this (although it can't make Yellen, whose professional Narrative is all about being a "consensus builder", terribly happy), but of note was the criticism leveled at Michael Woodford, probably the most influential economist you've never heard of. Woodford is the guy behind the notion that the Fed can create a market reality just by saying something. He is the academic theory behind recent "communication policy" practice. Consumer spending and business investment not up to snuff? Want to get that inflation engine started? Just say that you're going to keep rates artificially low waaaaay longer than you ordinarily would. No need for reasons or justifications or credibility. Simply saying it will drive market expectations and thus make it so. (Here's a link to a recent Woodford paper on all this, "Fedspeak").

Is there a germ of truth in Woodford's theory? Absolutely. Words matter, and the Fed's words matter more than anyone's. But this is the classic mistake that academic economists always make – the quasi-religious belief in theory over practice, in the triumph of bloodless ideas over the market's fang and claw. Woodford's ideas are sweet music to the enormous egos of the academics who control the Fed: you can save the world just by stating your brilliant policy intentions. Your words will become self-fulfilling prophecies as the markets shape themselves in expectation of your mighty deeds.

And so what do we get? Horror shows like Bernanke's press conferences last summer or Yellen's press conference last week. Here's what I wrote last September after one of Bernanke's performances in the Epsilon Theory note, "Uttin on the Itz":

> "In *Young Frankenstein*, Mel Brooks and Gene Wilder brilliantly reformulate Mary Shelley's *Frankenstein*, a tragedy in the classic sense, as farce. The narrative crux of the Brooks/Wilder movie is Dr. Frankenstein's demonstration of his creation to an audience of scientists – not with some clinical presentation, but by both Doctor and Monster donning top hats and tuxedos to perform "Puttin' on the Ritz" in true vaudevillian style. The audience is dazzled at first, but the cheers turn to boos when the Monster is unable to stay in tune, bellowing out "UTTIN' ON THE IIIITZ!" and dancing frantically. Pelted with rotten tomatoes, the Monster flees the stage and embarks on a doomed rampage. Wilder's Frankenstein accomplishes an amazing feat – he creates life! – but then he uses that fantastic gift to put on a show. So, too, with

> QE. These policies *saved the world* in early 2009. Now they are a farce, a show put on by well-meaning scientists who have never worked a day outside government or academia, who have zero intuition for, knowledge of, or experience with the consequences of their experiments."

Now, less than a year later, we are suffering through exactly the same sort of miserable song-and-dance routine, just with a different actor playing the Gene Wilder role. If the Fed was surprised by the rotten tomatoes thrown up on the stage last year, they ain't seen nothing yet.

All the best,
Ben

DISCLOSURES

This commentary is being provided to you by individual personnel of Salient Partners, L.P. and affiliates ("Salient") and is provided as general information only and should not be taken as investment advice. The opinions expressed in these materials represent the personal views of the author(s) and do not necessarily represent the opinions of Salient. It is not investment research or a research recommendation, as it does not constitute substantive research or analysis. Any action that you take as a result of information contained in this document is ultimately your responsibility. Salient will not accept liability for any loss or damage, including without limitation to any loss of profit, which may arise directly or indirectly from use of or reliance on such information. Consult your investment advisor before making any investment decisions. It must be noted, that no one can accurately predict the future of the market with certainty or guarantee future investment performance. Past performance is not a guarantee of future results.

Statements in this communication are forward-looking statements.
The forward-looking statements and other views expressed herein are as of the date of this publication. Actual future results or occurrences may differ significantly from those anticipated in any forward-looking statements, and there is no guarantee that any predictions will come to pass. The views expressed herein are subject to change at any time, due to numerous market and other factors. Salient disclaims any obligation to update publicly or revise any forward-looking statements or views expressed herein.

This information is neither an offer to sell nor a solicitation of any offer to buy any securities. Any offering or solicitation will be made only to eligible investors and pursuant to any applicable Private Placement Memorandum and other governing documents, all of which must be read in their entirety.

Salient commentary has been prepared without regard to the individual financial circumstances and objectives of persons who receive it. Salient recommends that investors independently evaluate particular investments and strategies, and encourage investors to seek the advice of a financial advisor. The appropriateness of a particular investment or strategy will depend on an investor's individual circumstances and objectives.