

## "Stalking Horse"

*[Jeremiah and Bear Claw hunt elk]*

**Jeremiah:** Wind's right, but he'll just run soon as we step out of these trees.

**Bear Claw:** Trick to it. Walk out on this side of your horse.

**Jeremiah:** What if he sees our feet?

**Bear Claw:** Elk don't know how many feet a horse has!

– *"Jeremiah Johnson" (1972)*



Gaston Phoebus, "Livre de Chasse" (1387)

**In war, truth is the first casualty.**

– *Aeschylus (525 – 456 BC)*

**I honestly believe that people of my generation despise authenticity, mostly because they're all so envious of it.**

– *Chuck Klosterman, "Killing Yourself to Live: 85% of a True Story" (2005)*

**I began my time as Chairman with the goal of increasing the transparency of the Federal Reserve, and of monetary policy in particular. In response to a financial crisis and a deep recession, the Fed's monetary policy communications have proved far more important and have evolved in different ways than I would have envisioned eight years ago.**

– *Ben Bernanke, "Communication and Monetary Policy" (Nov. 19, 2013)*

The stalking horse is a hunting technique that goes back thousands of years, where a hunter finds it much easier to get a drop on wild game by hiding behind an animal or a representation of an animal that the prey finds more familiar in its natural environment than a human. My favorite description of how the stalking horse technique works comes from the 1972 Robert Redford movie, "Jeremiah Johnson", where the old trapper Bear Claw patiently explains to newbie trapper Jeremiah that they can walk behind their horses to get a good shot because "elk don't know how many feet a horse has". Of course Bear Claw is right, and he and Jeremiah eat well that night.

**Today's markets are chock-full of stalking horses, not for something as trivial as setting up a hostile takeover (which is how the phrase has traditionally been used in investment circles), but for setting up politically-driven macro-economic goals.** Whether it's the use of words to create a representation of a stalking horse or a direct investment in a security to turn it into a stalking horse, governments today are more manipulative (and I mean that in the technical sense of the word) than at any time since the 1930's. Very little is at it seems in modern markets.

And yes, we're the elk.

Here's a great example of what I mean. This past Wednesday the *WSJ* published an article titled "[China Plays a Big Role as US Treasury Yields Fall](#)", pointing out that the Chinese government bought US Treasuries at the fastest pace in the first five months of 2014 than at any point since this data started being collected more than 30 years ago. China added \$107 billion to its Treasury holdings over these five months, almost 10% of its total Treasury holdings of \$1.27 trillion, which is itself about 10% of the total \$12 trillion US Treasury market. As the article points out, these massive purchases go a long way towards explaining "the mysterious US bond rally of 2014", where, for example, yields on the 10-year note fell from 3% at the end of 2013 to about 2.5% over this five month period, despite widespread expectations at the start of the year by both market savants and investor public opinion that rates were on a one-way path up, up, and away.

The reason I characterize China's purchases as a stalking horse rests on both the *meaning* of the purchases for the Chinese government and the *perception* of the purchases by market participants.

China is not buying US Treasuries for the same reasons that, say, PIMCO buys US Treasuries. China is not an *economic* buyer of US Treasuries, making an asset allocation decision based on some evaluation of fundamental global growth prospects. **No, China is a *strategic* buyer of US Treasuries, purchasing US dollar-denominated assets in order to weaken its own currency and spur domestic growth by boosting exports.** I've written about this sea change in Chinese monetary policy a lot ([here](#), [here](#), and [here](#)), and what we are seeing in China's acceleration of US Treasury purchases is part and parcel of this existential political calculus and its challenge to the Western "rules" of global economics.

What's really interesting to me – and this gets to the market perception question – is that this "explanation" of the 2014 US bond rally is just now being promulgated by one of the major media

[arbiters of taste](#). I mean, China's Treasury purchases are no secret. The data is published monthly with about a 6-week delay. In April (data released more than a month ago) China bought more Treasuries than the US Fed, but there was hardly a peep about it in any major financial media outlet. **What's interesting about the perception by market participants of China's accelerated Treasury purchases is that there was essentially NO perception of these purchases as an explanation of falling rates.** It's as if China were invisible or something, which, of course, is EXACTLY how China wished to be perceived in these actions. The market's inability to recognize that China was buying massive amounts of US Treasuries to weaken the yuan is exactly like the elk herd's inability to recognize that Jeremiah Johnson was standing on the other side of his horse to get a cleaner shot. The market has access to all the data, just like the elk can see how many feet are under Jeremiah's horse. We see six feet under the horse, but we can't comprehend the *meaning* of six feet under a horse. This is the secret of the stalking horse.

To be clear, I'm NOT saying that there is some grand conspiracy between financial media and China to keep their actions and motives hush-hush. Even if, to use a purely hypothetical thought experiment, Rupert Murdoch were perfectly willing to carry Beijing's water to the ends of the Earth, the simple truth is that the Chinese regime doesn't need to resort to these Citizen Kane tactics to carry out a stalking horse operation.

Also to be clear, I'm NOT saying that China's Treasury purchases are the only reason for falling rates or that there are no fundamental economic reasons for continued strength in global bond markets. On the contrary, I'm firmly in the camp that global growth is structurally challenged, miserable as far as the eye can see, and that [Western monetary policy is part of the problem, not the solution](#).

**What I'm saying is that in [the Golden Age of the Central Banker](#) it is impossible to distinguish fundamental economic reasons for asset class price movements from politically-driven strategic reasons.** Are European sovereign bonds so strong over the past few months because growth remains pathetically weak or because Draghi is promising his own version of QE? Answer: yes.

What I'm saying is that:

- a) Just as the elk is hard-wired to trust a horse standing in a field no matter how many legs it has, so are we wired to watch stocks go up and down and think about fundamental economic explanations for market outcomes no matter how many signals exist that non-economic game-players are really calling the shots.

- b) Government actors, from the Fed to the ECB to the White House to the Chinese Politburo, understand how we are wired and strategically use that understanding to further political goals such as market stability (US) and trade regime change (China). They stand behind their horses – stocks and bonds and fundamental economic explanations – in order to hunt down their true quarry without spooking anyone.

Once you start thinking about what's happening in markets and the world as an inextricable weave of fundamental events and political efforts to shape our interpretation of those events to achieve a political end, you start to see stalking horses everywhere. A Fed QE program ostensibly to reduce unemployment and help Main Street? Stalking horse. A [regulatory Big Data program](#) ostensibly to identify brokers who churn accounts? Stalking horse. A Chinese banking program ostensibly to liberalize currency exchange rates? Stalking horse.

And it's not just actual programs or actual market behaviors like the Chinese purchase of US Treasuries. **When words are used for strategic effect rather than a genuine transmission of information you create a virtual stalking horse.** This, of course, describes every use of words by every politician and every central banker. This is what Bernanke and Yellen and Draghi and Abe and Obama and Merkel mean when they refer to *communication policy*. Communication policy is the strategic use of words to shape perceptions and expectations. It's a focus on how something is said as opposed to what is described. It's a focus on form rather than content, on truthiness rather than truth. **It's why authenticity is as rare as a unicorn in the public world today.**



Look, I understand why politicians and bankers have completely abandoned authenticity, an uncommon quality even in the best of times. The Great Recession was a near-death experience for the global economy, and slamming a syringe of adrenaline into the patient's heart – which was basically what QE 1 did – doesn't happen without long-term side-effects. To switch the metaphor around a bit, this was a war to preserve the System, and as Aeschylus said 2,500 years ago, the first casualty of war is truth. I really don't think Bernanke or Draghi came into office thinking that their public statements would become the most powerful weapon in their arsenal, or that they could train markets to respond so positively to words presented strategically for effect, but there you have it. This is what worked. This is how the war was won.

So ... I understand *why* politicians and bankers have adopted a stalking horse technique to shape market expectations and behaviors, but that doesn't mean I have to like it. And while I am happy to condone the use of emergency powers to win a war and save the world, I am not at all comfortable with their continued use once the crisis is over. Unfortunately, I believe that is exactly what has happened, that **"strategic communication policy" has mutated from an emergency measure designed to prevent an economic collapse into a standard bureaucratic process designed to maintain financial stability.** Is this banal assumption and routinization of power a natural bureaucratic response to a crisis, something we also saw in the aftermath of the Great Depression? Yes, but I've got examples going the other way, too. Lincoln suspended habeas corpus in 1861, and good for him. But in early 1866 – *less than a year after Lee's surrender at Appomattox* – the US government stood down and restored Constitutional protections. **I am really hard-pressed to understand how the exigencies of recovery from the Great Recession, now more than 5 years on, are somehow more deserving of ongoing emergency policies than the immediate aftermath of the freakin' Civil War.**

Wait a second, Ben. Are you seriously equating the government's use of "strategic communications" to a suspension of Constitutional protections? Doesn't that seem a tad over the top? Yes I am, and no I don't think so. The bedrock assumption of limited, representative government is that we, the people have an inalienable right to make an informed decision about who will make policy decisions on our behalf. Of course this is an imperfect process, and of course the information we use to make these decisions will be mediated and skewed by all sorts of competing interests. But it makes a big difference if the government itself is fully committed to mediating and skewing this information. **And it makes all the difference in the world if relatively apolitical institutions like the Fed and various regulatory authorities – institutions which have been granted a vast array of powers over the years precisely because they have been viewed as relatively apolitical – now embrace the highly political act of mediating and skewing information in service to their [own particular visions of stability and status quo preservation.](#)** This is the danger of strategic communication policy. This is the price we pay for a loss of authenticity within our most important institutions.

Whew! Okay, I'll climb down from the soap box for now. **What is the practical [investment adaptation](#) to all this, where historical market patterns based on economic principles can and will be turned on their heads by government "hunters" determined to capture their non-economic goals?** I believe that now, more than ever, a portfolio based on what I call [profound agnosticism](#) is in order. It's



not easy to admit that your crystal ball is broken, that you have no idea what will happen next or when it will happen, but that's the required mind-set, I think. Importantly, however, this mind-set does not require hiding under a rock or going to cash or playing defense all the time. Is the Golden Age of the Central Banker a time for investment survivors rather than investment heroes? Absolutely. But as I'll discuss in [Epsilon Theory](#) notes over the next few weeks, a wily elk can still do pretty well for himself if he recognizes the hunters' games and sticks to the ground he knows. If you're not already a subscriber, I hope you [join the herd](#).

In closing, I thought I'd share one more illustration from the 14<sup>th</sup> century "Book of the Hunt". Here we see a method of trapping wolves that involves a long circular corridor with a one-way door forming a concentric circle around a holding pen where the bait (a live sheep and a blood trail source) is placed. It's important to use the concentric lay-out for three reasons. First, the circular outer wall is hard for the wolf to escape if he gets wise to the trap, and the circular inner wall keeps the live bait ... alive. Second, wolves *expect* to hunt and track their prey. By establishing a longer trail that must be navigated successfully the wolf becomes more committed to the trap the farther he goes. Third and most importantly, the design prevents the wolves from seeing each other until they get to the end of the blood trail, at which point it's too late to escape what they now know is a trap.



Gaston Phoebus, "Livre de Chasse" (1387)

In many respects this medieval wolf trap is an even more effective metaphor for modern markets and the Narrative constructions of politicians and bankers than the stalking horse. So for all you investors and allocators who see yourselves as solitary wolves rather than as an elk or some other herd animal, just remember that these hunters have a plan for you, too. You can learn a lot from an old book ...

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