

## **“The Power of Why, Exhibit 4,512 in a Continuing Series”**

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**No man is an Iland, intire of it selfe;  
Every man is a peece of the Continent, a part of the maine;  
If a Clod bee washed away by the Sea, Europe is the lesse, as well as if a Promontorie were, as well  
as if a Mannor of thy friends or of thine owne were;  
Any man's death diminishes me, because I am involved in Mankinde;  
And therefore never send to know for whom the bell tolls;  
It tolls for thee.**

*-- John Donne (1572 – 1631), “Devotions upon Emergent Occasions”*

I'm often asked what I read for Epsilon Theory, and the answer is that my daily fodder is the same as everyone else's – the NYT, the WSJ, the FT, Bloomberg, etc. But I think that I read media **differently** from most people, and that's the key for an Epsilon Theory perspective. I'm not reading these articles for facts, but for the effort to lead opinion...to communicate an opinion as if it were fact. It's not hard to read this way. Every time you see a word like “because” or anytime you read a “reason” why something happened the way it did, you just need to detach yourself from the article and consider how you are being played.

I don't mean that in a malevolent sense. It's what social animals DO. [It's what it means to be a social animal](#). Ants, bees, termites, and humans – the most successful species on the planet – are constantly signaling each other so that we can make sense of our world *together*. That's the secret of our success as social animals – *E Pluribus Unum*, as it says on the dollar bill – and we can no more separate ourselves from playing and being played than we can from our individual consciousness. We swim in a sea of communication and signaling. It is our *media* in the same sense the word is used for the agar in a Petrie dish, and that's how I think of media in the sense of newspapers and television and the like.

My favorite example? On November 24, 2008, President-elect Obama announced that he would nominate Tim Geithner as his Treasury Secretary. The S&P 500 was up about 6% that day, and Geithner's nomination was widely credited as the “reason”. All of the talking heads on the Sunday talk shows that weekend referenced the amazing impact that Geithner had on US markets, and this “fact” was prominently discussed in his confirmation hearings. Clearly this was a man beloved by Wall Street,

whose mere presence at the economic policy helm would soothe and support global markets. Yeah, right.

Was Geithner's nomination good news? Sure. I mean...I suppose. So long as Obama didn't nominate a raving Marxist I think it would have been a (small) positive development in the context of the collapsing world of November 2008. Was the specific nomination of specifically Tim Geithner *WHY* markets were up so much on November 24<sup>th</sup>? Of course not.

The inherent problem is that any market movement is over-determined. There are far more reasons that might account for a market move than actually account for the move, and that's without any consideration of [stochastic factors](#) or [game-playing behaviors](#). But the questions of "Why is the market up?" or "Why is the market down?" are the only questions that matter in the heat of a big move up or a big move down, and no one who is in the business of answering such questions is ever going to say "I don't know" or "no reason". You **MUST** provide an acceptable answer, or whoever is asking the question is quickly going to find someone else to replace you. Fortunately, you can't be proved wrong if you ascribe market causality to a contemporaneous event, so it's the totally safe play to say that the November 24th 2008 market was up "because" of Geithner. And once a prominent opinion-leader like the WSJ says it's true, it's not only a safe answer...*it's the only answer that's safe*.

The ability to convince someone that you know *WHY* a security is up or a security is down is at the heart of the entire financial advisory industry, maybe the entire financial services sector. It is the **Power of Why**, and it has no inherent connection to any true causal connection or the way the world truly works. Maybe it's all true. Probably it's partially true. But it really doesn't matter one way or another.

Once you start thinking of *everything* communicated by humans as a signal, as an intentional effort to make you see the world differently than you saw it before, your world will change. This is [the great insight of Information Theory](#) – that information is measured by how much it changes your mind, that the strength of any communication has *nothing* to do with truth or accuracy, but only with the subjective impact it has on your perceptions – and it's an enormously useful insight for making sense of markets.

Two days ago the WSJ ran the online headline "[China Intervenes to Lower Yuan](#)" together with a series of articles to support the thesis that recent declines in the yuan's value versus the dollar were the result of Chinese central bank intervention and some sort of master plan to achieve some set of policy goals. I want to include and comment on a selection from one of those accompanying articles – "[Why the Yuan's Decline Matters](#)" – not to criticize the author (I could just as easily chosen any number of other authors from any number of other media outlets), but as an example of what I mean by the Power of Why.

**Here's what happened:**

China's yuan has fallen steadily against the U.S. dollar in the past week. On Wednesday, The Wall Street Journal reported that it wasn't market forces or traders behind the move, but that the Chinese central bank was deliberately pushing the currency lower. That a central bank would do this on purpose has caught some off-guard, especially since the yuan was long seen by investors as a currency that was only going up.

**Why does this matter now? Why are they doing it?**

Currently, the yuan trades within a tight range set by the central bank every day. But, short-term traders and increasing demand is almost constantly pushing the currency higher within that

range. By denting the currency's value on purpose, the central bank is trying to spook away these traders who will now have to worry about the possibility China does this again. With fewer "speculators" trading the yuan, China hopes to have an easier path to widen the yuan's trading range further and, in the much longer term, make the yuan a free-floating currency that's driven only by economic and market forces.

#### **Why does China want to free its currency in the long term?**

Having a freely traded currency opens up a wide door for the yuan to become much more prominent in trade and payments across the globe. Perhaps most importantly to China, a freely convertible currency also makes the yuan a more attractive option for other central banks' stockpiles of cash, also known as their foreign exchange reserves. Currently the U.S. dollar dominates as the number-one reserve currency in the world—that's why so many central banks hold U.S. government bonds even when the U.S. economy doesn't look to rosy. China wants the yuan to challenge the dollar's long-established role, and gradually freeing its currency is a critical step to get there.

#### **Why else?**

China is also trying to push its economy away from relying so much on exports and investment. It, instead, wants more of its growth to come from domestic demand. Making the yuan behave more like a market-driven currency fits into this broader plan.

Okay. So the party line (no pun intended) is that the Chinese government is massively intervening in their currency market to make the yuan "more like a market-driven currency". The party line is that the Chinese government is forcing its currency lower in order "to push its economy away from relying so much on exports and investment".

Two reactions. First, I consider myself to be something of a connoisseur of opinion-leading writing, and from an artistic or aesthetic point of view I am quite simply blown away by the creativity and execution of this Orwellian masterpiece. It's the same reaction I have when I see a politician oh-so-naturally jab at the air or flash a wry grin during a particularly moving speech. It's a beautiful thing to see a professional excelling at his or her craft, and never so much than at moments like this when the craft becomes art.

On the other hand – from a risk management point of view – these articles made me throw up in my mouth a little bit.

Governments don't make their currency cheaper to reduce their reliance on exports and investment. They make their currency cheaper to spur export-led growth. The problem that the world has with China as a currency manipulator is not that the yuan has been going up. The problem is that it hasn't been going up fast enough. And now it's being forced down.

Look, I understand why the Chinese government wants the yuan lower. The political imperative in China is still growth. Period, end of story. Net exports are the swing factor in every country's GDP growth rates, and China is not an exception, it is the foremost exemplar. Do you think China is happy about the yen going down, down, down? Do you think China is happy about competing in export markets for advanced industrial products – because that's what China manufactures today – with an inexorably appreciating currency? Do you really think they're going to sit there and just take it?

I also understand why the Chinese government would prefer to characterize their actions as part of some grand domestic reform agenda, where they just need a wee bit more anti-market, export-supporting currency manipulation in order to move forward towards a glorious future of pro-market, domestic-focused life in the brotherhood of liberal nations. Pardon me if I am skeptical.

And finally, I understand why the financial media reports the Chinese government's party line (including some after-the-fact "we really didn't intervene that much" stories in the FT yesterday) as a True Fact rather than as a Narrative. When a market event like a plummeting yuan occurs the only thing that matters is presenting a plausible *WHY*, and China provided just that. Whether that story is the whole truth, some partial truth, or the equivalent of crediting Tim Geithner's nomination for a 6% move up in the market...well, that's really beside the point if you're a financial media publisher. But it's certainly not beside the point if you're an investor or an allocator.

All the best,  
Ben

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