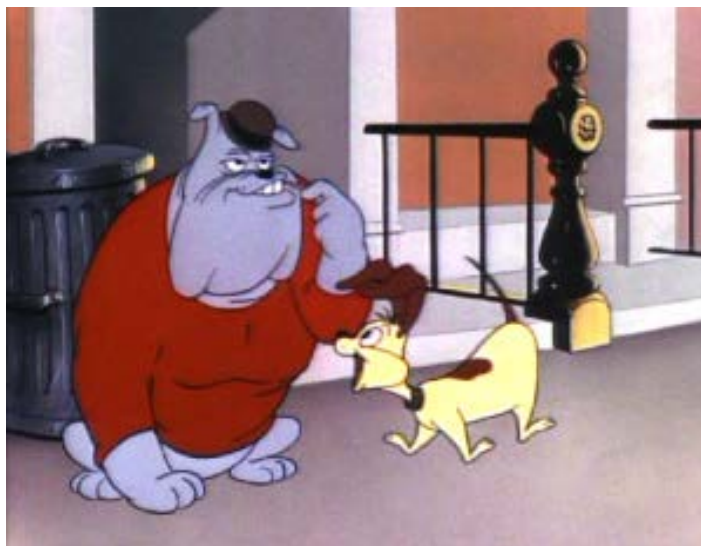


“Hey, Spike!”



The strong do what they can, while the weak suffer what they must.

-- Thucydides, *"The History of the Peloponnesian War"* (395 BC)

Global growth is really bad! Hooray!

That was the verdict of US markets yesterday, as the Fed minutes “revealed” (to use the breathless phrasing of mainstream financial media) a “growing concern” with the damaging impact of European torpor and a stronger dollar on US growth, and it’s a perfect example of why I’ve called a top in the Narrative of Central Bank Omnipotence. Not a top in market price levels (although I’m increasingly thinking that, too), but a top in market *faith* that price levels are completely determined by central bank policy. This is an observation that I’ve discussed at length (and perhaps ad nauseam) in recent Epsilon Theory notes like [“The Ministry of Markets”](#) and [“Fear and Loathing on the Marketing Trail”](#), so I won’t belabor that again here.

What’s interesting to me is not this latest success of the Narrative of Fed Omnipotence. **No, what’s interesting to me is this week’s failure of the Narrative of ECB Omnipotence.** The Fed minutes totally bailed the market out today and (truly) revealed the Fed as the only central bank with the

Common Knowledge firepower to withstand a serious growth scare. The ECB, on the other hand, has lost an enormous amount of Narrative mojo over the past week. The perception of Mario Draghi has clearly shifted from Super-Mario, willing and able to do “whatever it takes”, to what we would call in Texas “all hat and no cattle”.

Is this fair? Is this reflective of fundamental reality? No, of course not, but since when did that matter? Draghi didn’t change. Germany’s position didn’t change. Miserable European growth rates didn’t change. What changed is the direction of US monetary policy. **Draghi’s beautiful words work wonders when he’s standing behind the 600-lb gorilla of the US Fed.** But when that gorilla begins to stumble off along a different jungle path, as we’ve seen over the past few months ... well, that’s an enormous challenge even for as skilled a Missionary as Mario Draghi. Toss in a few well-timed slashes from a master bureaucratic knife-fighter like Jens Weidmann, some disappointing macroeconomic news, and all of a sudden you’ve got a crisis in confidence with European markets.

I’m reminded of the distinction in political regime theory between “sensitivity” and “vulnerability”. Sensitivity reflects the forcefulness with which external events impact a country or institution within a given regime. Vulnerability reflects the cost of changing that regime. So, for example, while both the US and Japan would be quite sensitive to a supply shock in the price of oil from a Middle Eastern blow-up, Japan would be far more vulnerable than the US if that temporary shock became a permanent change in the oil supply picture. Because the US has more domestic energy alternatives, *the long-term cost of adapting* to a new and different energy world would be much greater for Japan than the US. Similarly, **while both the Fed and the ECB are sensitive to growth shocks, the ECB is far more vulnerable to a world of secular growth stagnation.** And the market smells that vulnerability like stink on a wet dog.

I’ll have more to say about sensitivity and vulnerability in future notes, because I think it’s a valuable concept for asset allocation and risk management. Beta and volatility are measures of sensitivity, not vulnerability, but they dominate our econometric risk measurement techniques. We need a measure of portfolio vulnerability (and this is not at all the same thing as tail risk), and I think it lives in the *epsilon* term.

Today, though, the Epsilon Theory point is that we’re seeing the first unexpected ramification of a divergence in global monetary policy – the ECB is revealed as the yappy little Chester to the Fed’s bulldog Spike. Now in the cartoons there’s always a large enough scare to turn big bad Spike into a

quivering mess, and that may well turn out to be the case as the global growth boogiemer continues to grow in scale and scope, [particularly if it spreads into the political sphere](#). But for now markets are still fervent believers in Fed Omnipotence, even as faith in the ECB is starting to crumble. I'm a seller of both Narratives.

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