"Oh Stewardess, I Speak Jive"

Instead of a long-form note this Sunday, I thought I'd write a briefer note in advance of this Friday's jobs report. I'll be back next Sunday, Feb. 16, with a long note taking an Epsilon Theory view on portfolio diversification. 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.

Oh, Stewardess, I speak jive.

-- Barbara Billingsley, "Airplane"

This is an important jobs report. Not because it matters in the least whether the US economy added 170,000 new jobs or 185,000 new jobs. Not because it matters a whit whether the unemployment rate goes up or down $1/10^{th}$ of 1 percent. No, the importance of this jobs report rests is two related linguistic games. Here's how to translate the lingo …

First, do the Hilsenrath's and Liesman's and Cramer's of the world proclaim from their pulpits that this is a positive report or a negative report?

If by this time next week the Common Knowledge surrounding the jobs report is that it was a dud, then there will be a COLOSSAL effort by Famous Journalists, Famous Economists, and Famous Investors to pressure the Fed into reducing the Taper. If by this time next week the Common Knowledge is that this was a positive jobs report, then you will merely see a continuation of the current assertion by the opinion-leading Powers That Be that the Emerging Markets carnage we are witnessing is a tempest in a teapot so long as the US remains on a self-sustaining growth trajectory. Nothing to see here, folks. Stay calm and carry on.

Of course, the jobs report could miss expectations and still generate a positive Narrative, as "bad weather" or some other devil is identified as the one-off cause (funny how good weather is never credited with macro data results that surprise to the upside). Conversely, a jobs report that beats expectations may still be recast in a horrible light. If there's one lesson that I hope even a cursory reading of Epsilon Theory delivers, it's that the reality of macro data is only indicative of its ultimate media communication, not dispositive! The public perception of macro data is incredibly mutable, politicians and media prey on our weakness for a good story, and so we won't know for another week what the final Common Knowledge or Narrative construction looks like here.

Second, what does Yellen communicate in reaction to this jobs report Narrative?

There will be no reaction to the jobs report itself, because it really doesn't matter to anyone, including the FOMC. What matters is the Narrative or Common Knowledge structure around the jobs report, and that's what the Fed will both shape and be shaped by. We will start to receive these signals from Yellen directly as early as next week with her Congressional testimony, and you should expect a media feeding frenzy over her every word, culminating in her first press conference as Fed Chair on March 19th. If you were a wee bit tired of the markets racing up and racing down in response to breathless Bloomberg headlines parsing everything that every Fed Governor does (or doesn't) say … well, sorry, but the circus is back in town.

There's not as much pressure on Yellen if the Common Knowledge around the jobs report is positive, because it won't be an overt "reason" for her to change the current policy course of the Fed. But if it's negative … oh, boy. Then Janet Yellen is going to be tested. Whoever said that hell hath no fury like a woman scorned apparently never met a levered long equity manager who sees the easy money punchbowl starting to drain without another obvious punchbowl (like the Narrative of Global Growth) there to take its place. And by levered long equity manager I mean almost everyone. I mean every politician, every financial media outlet, every CEO, (almost) every asset manager. Everyone is levered to either massive liquidity or global growth, and if both of those pillars of the current economic world are now in doubt you will hear a howl of pain and anger that will make the Earth shake. Oh, the protestations will be dressed up in their Sunday best clothes, full of phrases like "monetary policy transmission mechanisms", but there's no mistaking the animal under those clothes. The markets have had almost 5 years of central banks suspending the rules of business cycles. That's fun. It's like a magic pinball machine where your ball never drains. Of course no one wants to go back to the old days of actually having to suffer through temporary economic weakness, much less (gasp!) a garden-variety recession. We want our magic pinball machine! And we just might get it.

So how does all this game-playing and Narrative construction connect to market outcomes? If Yellen stays the course with the current Taper path then regardless of whether the jobs report Narrative is negative or positive I think there's a negatively biased informational surface to this market. It's easier for the market to go down than to go up when Common Knowledge says that the Fed is tightening. That's particularly so if the struts are kicked out from under the US Growth Narrative with a negatively portrayed jobs report, but even if the US Growth Narrative is intact, a Taper-as-she-goes Fed puts enormous pressure on Emerging Markets and the short-Yen trade. That means that big levered positions in risk assets will continue to unwind, at times violently. This is a very ugly risk environment.

But if Yellen succumbs to the addicts' plea, either because she wants to appease or because she actually believes the Narrative tripe that the plea will be gussied-up in … well, the market will get its fix. The Fed still has your back, Mr. Levered Long Equity Investor. Or rather, the Fed is now even more a monkey on your back. And as addicts have learned since time immemorial, shaking that monkey gets harder over time. And harder. And harder. I've written at length (here and here) about how I believe QE has been transformed from an emergency government policy that saved the world in 2009 into a permanent government program that stifles growth and well-functioning markets, and I think that's true regardless of what happens over the next few weeks or months. You can't unring the QE bell, and this will be a go-to monetary policy in the aftermath of any negative economic news, no matter how mild. But if this is all it takes to shift the second derivative of US monetary policy, if mildly disappointing macro data is all it takes to return to an "emergency" acceleration of the Fed balance sheet … that's just sad.

All the best,

Ben

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