American Bandstand

Well, Dick, it's got a good beat and you can dance to it.
– standard response to Dick Clark's "how do you rate this song" question

Dancing is a vertical expression of a horizontal desire.
– Robert Frost

I know nothing, except what everyone knows - if there when Grace dances, I should dance.
– W.H. Auden

Those who dance are considered insane by those who cannot hear the music.
– George Carlin, stealing a line from Friedrich Nietzsche

As long as the music is playing, you've got to get up and dance. We're still dancing.
– Chuck Prince, former Citigroup CEO, summer of 2007, before the Deluge

I don't set trends. I just find out what they are and exploit them.
– Dick Clark

In 1949, Yale anthropologist George Murdock spearheaded the establishment of an inter-university research organization to continue his life's work: the cataloguing of what he called cultural universals, the social behaviors that exist in every human society across time and geography. That institution – the Human Relations Area Files (HRAF) – is still going strong today, supporting all sorts of social science research by providing a fully-indexed electronic collection of cultural anthropological studies. The goal is to find patterns or commonalities in human social behavior, and it all stems from Murdock's List: his compilation of the 67 universal social behaviors of the human animal. Every now and then someone publishes an updated version of Murdock's List (either directly, like Donald Brown in his 1991 book, "Human Universals", or indirectly, like Steven Pinker in his 2002 book "The Blank Slate"), but it's hard to improve on the original. It's a fascinating list, with items such as "propitiation of supernatural beings", "eschatology", and "kinship nomenclature" right alongside "joking", "hair styles", and "mealtimes". Pretty much everything we do in life is instantly recognizable as an item on Murdock's List, and what isn't just needs a little tweak in perception to fit one category or another.

I like looking at human behaviors through the lens of Murdock's list for the same reason I like looking through the lens of evolutionary theory: behaviors that seem illogical or just plain stupid through our standard lenses of small-l liberalism or modern economic theory take on a new appearance with a change in perspective. In "Adaptive Investing" I discussed how non-economic behaviors such as routine mammograms and daily multivitamins (and portfolio risk scenario tests) make sense from an evolutionary perspective as a behavioral adaptation to demonstrate fitness, much like the dance of the Blue-Footed Booby or the ceremonial fight of the Oryx Gazelle, but they also make sense from a Murdock's List perspective as a "propitiation of supernatural beings", where we attempt to appease the great modern god Cancer (or in the case of risk scenario tests, the great ancient god Luck) with a ritualized sacrifice of our time and money.

One of Murdock's 67 cultural universals is dancing. You find dance in every human society that ever existed (more so than music), and it will exist in every human society in the future. Why? Because it is part of our eusocial nature, part of the 10% bee-ness than makes up the human animal. Like the bee, we dance both to communicate and as a hard-wired response to signals from fellow members of our species. It's not a language that we hear or generate in the same way that we speak English, but it has a grammar and a vocabulary nonetheless. Because it so primal, dance has an *urgency* that modern spoken languages do not, and I say that as an individual to whom dancing is very much a foreign language.

Interestingly enough, mathematics is not on Murdock's List. Mathematics is an entirely formal language, about as far away in human terms as one can get from the language of dance (and yes, there have been efforts to create formal linguistic representations of dance, none of which have caught on). The unfortunate fact is that it's very hard to represent human social behaviors in formal linguistic terms. That's true whether the social behavior occurs in an artistic or cultural setting, like dancing, or whether it occurs in a market setting, like the "dancing" that Chuck Prince was referring to in 2007 when Citi was still underwriting and securitizing Alt-A and sub-prime mortgages as fast as humanly possible. But just because it's really hard to describe a group dynamic like dancing with the same symbols that describe a capital asset pricing model doesn't mean that dancing (or "dancing") lacks a language and a grammar. You just need to develop an ear for it, and that's where game theory can help.

Game theory is a bridge between hot-blooded social languages like dancing and cold-blooded formal languages like mathematics. Game theory is an abstraction of dynamic social interactions. Because it's an abstraction, game theory usefully adopts some of the formal grammar of mathematics, which remains the most efficient way to represent theory regardless of what the theory is about. But game theory has no meaning or usefulness outside of a social setting. Like the tango, game theory takes two. Also like the tango, game theory is all about movement, the fluid movement of separate individuals who are bound up with each other in a system of mutual expectations and individual goals. Put it all together and game theory uses some basic mathematical concepts to organize our thinking about *dynamic* and *strategic* behaviors that have their origins in our social animal brains and Murdock's List. It's a powerful tool kit.

Some people have an intuitive ability to "speak" game theory fluently. These are geniuses like Dick Clark who can translate between the language of the social animal and the language of the self-aware brain effortlessly, and make an enormous fortune in the process. Clark recognized the trends, nuances, and idioms of popular culture just as surely as he recognized the economic formulas behind radio and television syndication. Was he a brilliant artist? Nope. Couldn't dance, sing, or act. But he spoke the *language* of performers and somehow figured out how to communicate that primal grammar to Middle America in a way that felt "safe". It seems weird today, as we are immersed in a popular culture of youth, but "youth culture" (a phrase coined by Paul Anka in reference to Dick Clark) didn't exist before American Bandstand. As much as anyone over the past 50 years, from the Beatles to Elvis Presley to any performer you want to name … Dick Clark was responsible for the modern landscape of how the languages of music and dance are communicated in a commercially lucrative fashion. His secret (other than a bizarrely youthful face)? Clark understood the Common Knowledge Game.

Clark didn't poll America to determine their taste in music. **He *told* them their taste in music … not directly, but by creating common knowledge – ideas that a crowd believes that the crowd believes.** With the American Bandstand group dance staging and scripted questions, Clark allowed the TV audience to see a *crowd* of attractive young people act *as if* the music were popular. This is all it takes. Clark didn't have to force his preferred choice of popular culture on his audience like some centrally-planned Ministry of Culture. The TV audience chose it all on their own, thinking all along it was *their* choice! This is the power of the Emperor's New Clothes. This is the power of the sitcom laugh track and the live studio audience. This is the power of public coronations and executions. This is the power of Tahrir Square and Tiananmen Square. This is the power of the crowd seeing the crowd, and it is the most potent force in the social world.

It's certainly the most potent force in the social world of markets, and every Central Banker today is playing the Common Knowledge Game just as hard as Dick Clark ever did.

Here's last Thursday's (Jan. 9) WSJ headline teaser at 9 am ET after the ECB press conference:

> European Central Bank President Mario Draghi used unexpectedly strong language to stress that the central bank will remain accommodative for as long as necessary.

How is this the Common Knowledge Game? Since August 2012 we have watched the markets dance to Draghi's tune. If you don't know by now that Draghi's words move the market crowd, then you're an idiot. But you're not an idiot. And neither is any one of the hundreds of thousands of people reading the WSJ headline. And neither is Draghi. We are told by the WSJ that Draghi's words today have a good beat and you can dance to it. So we do. We dance, just like we've been trained to do by watching this show 30 times before.

As a result, Italy and Spain's equity and credit markets outperformed Germany's by a mile after Draghi's signal … which was exactly the intended effect (Spain is now borrowing money at the cheapest rate in the euro era!) and exactly why it is so difficult to be a macro Value investor today.

All of your fundamental indicators that show (correctly) that Italy and Spain are ridiculously overvalued at current prices relative to, say, Germany don't matter in the least. Or rather, they matter, but they evaporate like dew when the Draghi sun shines at a press conference. Note to Jeremy Grantham: it costs Draghi *nothing* to use "unexpectedly strong language" to keep this game going for a looonnng time.

Here's last Friday's (Jan. 10) WSJ headline teaser at 9 am ET after the disappointing jobs report: "Weak jobs report complicates Fed plans." Seems innocuous enough, right? Nope, this is a market roiler, especially for the most sensitive assets to the Narrative of Central Bank Omnipotence … assets like gold.

Gold *rocked* last Friday, on *deflationary* news. Huh? I know that gold bugs will tell you how great gold can be in a deflationary environment, but come on, that only makes sense if you're talking about end-of-the-world deflation. The jobs report last Friday was run-of-the-mill, plain vanilla disappointing growth news. Not end-of-the-world news, not even negative growth news … just disappointing growth news. This should be *bad* for gold prices, not good, and Friday's price action made no sense through the lens of traditional economic theory. But it made perfect sense through the lenses of history and game theory, where the meaning of gold has shifted from an alternative store of value to insurance against Central Bank policy error.

Of course, this sort of challenge to the Narrative of Central Bank Omnipotence could not go unaddressed, and sure enough by 7 pm last Friday you had a WSJ article by none other than Jon Hilsenrath, the Common Knowledge spokesman for the Fed, titled "Fed Unlikely to Alter Course After Jobs Report." Over the weekend and on Monday you had at least three Fed Governors come out with similar statements, that there was no confusion or complication imposed by the jobs report. Nothing to see here folks, move along. **None of these Powers That Be are taking issue with whether or not the Friday jobs report was bad news … the only thing that matters is how this news impacts the common knowledge structure that generates their power to control market outcomes.** That's the threat that must be squelched. This is what Bernanke meant when he talked about using communications *as a policy tool*, and this is what Yellen (and Draghi and Abe and everyone else in the club) will continue to do … use public statements to play the Common Knowledge Game and drive market outcomes by proxy.

I can sleep well at night if you get nothing else out of Epsilon Theory beyond the recognition that a) you are being played, and b) there are rules and logic to how you are being played. But I'd also like to demonstrate that c) it's entirely rational to play along (to a point), and d) you can be a player, too.

It can be entirely rational to act as if the Emperor is wearing a beautiful set of clothes. In fact, when you're caught in a Common Knowledge Game others will look at you askance if you act publicly according to the evidence of your own eyes rather than the evidence of the crowd watching the crowd. But you need to recognize that's what you're doing. It's critically important to avoid internalizing your behavior, falling into what Kant called a "dogmatic slumber", believing in your heart of hearts that the Emperor truly looks marvelous. The tragedy of *1984* is not that Big Brother rules Oceania, but that in the end, Winston *loves* Big Brother and gives himself over to collective solipsism. The fright of *Invasion of the Body Snatchers* is not the cat-and-mouse with alien pod people, but that in the end, Donald Sutherland *becomes* a pod person and outs the human survivors.

Other than the minor detail of losing your free will, why is it so important to avoid becoming a pod person? Why is it a bad idea solely from the perspective of being an effective investor? **Because the tango is an unpredictable dance.** Because your best move in ANY game is not pre-ordained or even fully under your control. Your best move depends not only on Know Thyself, advice that Socrates gave almost 3,000 years ago and is still the smartest, deepest thing that anyone has ever said, but also on Watch the Other, the sensitivity that all social animals possess to look for and pick up on minute changes in the signals that our hive-mates emit.

The moment you give yourself over to the Dick Clarks of the world who create common knowledge, the moment you abdicate your keenly evolved human abilities of self-awareness and other-evaluation … that's the moment you put yourself at the most risk. Because the game will change. Even if the external conditions of the world today are exactly the same as the external conditions of the world yesterday, a change in the *internal* conditions of the *other* game-players, whether it's a queen bee like Draghi or a set of worker bees like us, can change your best move.

This is the insight that game theory provides, an insight that econometrics (which only looks at external conditions) can't – how social dynamics and group interactions impact market behaviors. Game theory predicts that gold prices will go up on ANY news – even deflationary news – IF that news creates a worker bee *perception* that the queen bees are rattled by the news. And vice versa, gold will go down on ANY news – even inflationary news – IF that news improves the perception that global central banks are large and in charge … the Narrative of Central Bank Omnipotence. It's not the news itself, which is what an econometric perspective would say, but how that news impacts the belief structures that comprise the game. It's not the card that's dealt (the news), but how that card fits the hand that your poker opponent is representing. An ace of spades is good news for your opponent in the abstract, but it might be terrible news if he's representing a heart flush. **Game theory is all about playing the player, not the cards.** That's not a replacement for understanding the fundamentals and the math of drawing this card or that, but it sure is a complementary skill set. If you want to win.

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