December 14, 2015

# "Storm Warning"

Unfortunately for mariners, the total amount of wave energy in a storm does not rise linearly with wind speed, but to its fourth power. The seas generated by a forty-knot wind aren't twice as violent as those from a twenty-knot wind, they are seventeen times as violent. A ship's crew watching the anemometer climb even ten-knots could well be watching their death sentence.
***– Sebastian Junger, "The Perfect Storm: A True Story of Men Against the Sea" (2009)***

[the crew watch emergency surgery performed on the ship's deck]
**Able Seaman**: Is them 'is brains, doctor?
**Dr. Stephen Maturin:** No, that's just dried blood. THOSE are his brains.
***– "Master and Commander: The Far Side of the World" (2003)***

[the *Konovalov*'s own torpedo is about to strike the *Konovalov*]
**Andrei Bonovia**: You arrogant ass. You've killed ***us***!
***– "The Hunt for Red October" (1990)***

Can everyone saying "a 25 bps rate hike doesn't change anything" or "manufacturing is a small part of the US economy today, so the ISM number doesn't mean much" or "trade with China is only a few percent of US GDP, so their currency devaluation isn't important" just stop? Seriously. Can you just stop? Maybe if you were making these statements back in the '80s – and by that I mean the 1880s, back when the US was effectively a huge island in the global economy – it would make some sense, but today it's just embarrassing.

**There is a Category 5 deflationary hurricane forming off the Chinese coast as Beijing accelerates the devaluation of the yuan against the dollar under the guise of "reform".** I say forming … the truth is that this deflationary storm has already laid waste to the global commodity complex, doing *trillions* of dollars in damage. I say forming … the truth is that this deflationary storm has driven inflation expectations down to levels last seen when the world was coming to an end in the Lehman aftermath. And now the Fed is going to tighten? Are you kidding me?

Look, I'm personally no fan of ZIRP and QE and "communication policy", certainly not the insatiable market devourers they've become over the past few years. But you can't just wish away the Brave New World of globally interlocked, policy-driven, machine-dominated capital markets in some wave of nostalgia and regret for "normalized" days. In an existential financial crisis, emergency government action *always* becomes permanent government policy, reshaping markets in similarly permanent ways. This was true in the 1930s and it's true today. It's neither good nor bad. It just IS. Did QE1 save the market? Yes. Did QE2 and QE3 and all the misbegotten QE children in Europe and Asia break the market? Yes. And in the immortal words of shopkeepers everywhere: **you break it, you bought it**. The Fed *owns* capital markets today, like it or not, and raising rates now, as opposed to a year ago when there was a glimmer of a chance to walk back the Narrative of central bank omnipotence, isn't "brave" or "prudent" or "necessary" or any of the other laudatory adjectives you'll hear from Fed media apologists after they raise. **It's simply buyer's remorse**. The Fed is sick and tired of owning the market, sick and tired of giving interviews to CNBC every time some jobs report hits the wires, sick and tired of this Frankenstein's monster called communication policy. So they're going to raise rates, declare victory, and hope that things go their way.

Am I annoyed by China's currency actions and their adept use of communication policy to shape the Narrative around devaluation? Not at all. This is exactly what China *must* do to bolster economic growth while maintaining the pleasant diplomatic fiction that they're not a command economy. What annoys me is the Fed's apparent hell-bent intention to force a low-level currency war with China AND whack our own manufacturing and industrial base on the kneecaps with a crowbar, just so they can get out of the communication policy corner they've painted themselves into.

Three or four years ago, one of THE dominant market narratives, particularly in the value investment crowd, was the "renaissance of American manufacturing". Not only was the manufacturing sector going to be the engine of job growth in this country (remember "good jobs with good wages"? me, neither), but this was going to be the engine of economic growth, period (remember the National Export Initiative and "doubling exports in five years"? me, neither). Now we are told that we're just old fogies to worry about a contracting US manufacturing sector. Now we are told that a global recession in the industrial and commodity complex is well contained here in our vibrant services-led economy. Right. You want some fries with that?

So what's to be done? You do what you always do in a deflationary, risk-off world – you buy long-dated US Treasuries. Stocks down, USTs up. Of course, if you think that the yield curve is going to steepen after the Fed does whatever it's going to do this week … you know, because the Fed rate hike is obviously an all-clear sign that we have a robust self-sustaining economic recovery and we're off to the races … then you want to do the exact opposite, which is to buy stocks and sell the 10-year UST. Yep, time to load up on some bank stocks if that's your view.

What else can you do? You can read the Epsilon Theory note "I Know It Was You, Fredo" and consider ways to make your portfolio more convex, i.e., more resilient and responsive to both upside and downside surprises in these policy-driven markets. The big institutional allocators use derivative portfolio overlays to inject convexity into their portfolio, and that's all well and good. But there are steps the rest of us can take, whether that's adopting strategies that can short markets and asset classes (like some tactical strategies and most trend-following strategies) or whether that's investing in niche companies and niche strategies that are designed to outperform in either a surprisingly deflationary or a surprisingly inflationary world. The trick really isn't to choose this fund or that fund. The trick is to broaden your perception of portfolio outcomes so that you don't have a misplaced faith in either the Fed or econometric models.

I suppose there's one more thing we should all do. We should all prepare ourselves to perform some emergency surgery on the deck of whatever portfolio ship we're sailing in 2016. Because with a Fed hike the currency wars will begin in earnest, magnifying the deflationary storm already wreaking havoc in industrials, energy, and materials. No sector or strategy is going to be immune, and we're all going to suffer some casualties.

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