"Goldilocks and the Dog That Didn't Bark"

Det. Gregory: Is there any other point to which you would wish to draw my attention?
Holmes: To the curious incident of the dog in the night-time.
Det. Gregory: The dog did nothing in the night-time.
Holmes: That was the curious incident.

-- Arthur Conan Doyle, "Silver Blaze"

The market was down more than 2% last Monday. Why? According to the WSJ, CNBC, and all the other media outlets it was "because" investors were freaked out (to use the technical term) by poor US growth data. Disappointing ISM number, car sales, yada, yada, yada. But then the market was up more than 2% last Thursday and Friday (and another 1% this Tuesday), despite a Friday jobs report that was more negative in its own right than the ISM number by a mile. Why? According to those same media arbiters, investors were now "looking through" the weak data.

Please. This is nonsense. Or rather, it's an explanation that predicts nothing, which means that it's not an explanation at all. It's a tautology. What we want to understand is what makes investors either react badly to bad news like on Monday or rejoice and "look through" bad news like on Friday. To understand this, **I sing the Epsilon Theory song, once more with feeling … it's not the data! It's how the data is molded or interpreted in the context of the dominant market Narratives.**

We have two dominant market Narratives – the same ones we've had for almost 4 years now – Self-Sustaining US Growth and Central Bank Omnipotence.

The former is pretty self-explanatory. It's what every politician, every asset manager, and every media outlet wants to sell you. Is it true? I have no idea. Probably yes (technological innovation, shale-based energy resources) and probably no (global trade/currency conflict, growth-diminishing policy decisions). Regardless of what I believe or what you believe, though, it IS, and it's not going away so long as all of our status quo institutions have such a vested interest in its "truth".

The latter – Central Bank Omnipotence – is something I've written a lot about, so I won't repeat all that here. Just remember that this Narrative does NOT mean that the Fed always makes the market go up. It means that all market outcomes – up and down – are determined by Fed policy. If the Fed is not decelerating an easy money policy (what we've taken to calling the Taper), the market tends to go up. If the Fed is decelerating its easy money policy, the market tends to go down. But make no mistake, the Common Knowledge information structure of this market is that Fed policy is responsible for everything. It was Barzini all along!

How do Narratives of growth and monetary policy come together? Well, there's one combination that the stock market truly and dearly loves – the Goldilocks scenario. That's when growth is strong enough so that there's no fear of recession (terrible for stocks), but not so strong as to whip the flames of inflation (not necessarily terrible for stocks, but sure to provoke Fed tightening which is terrible for stocks).

Over the past few years the Goldilocks scenario has changed. Inflation is … well, let's be straight here … inflation is dead. I know, I know … our official measures of inflation are all messed up and intentionally constructed to keep the concept of "inflation" and the Inflation Narrative in check. I get that. But it's the Narratives that I care about for trying to predict market behaviors, not the Truth with a capital T about inflation. If you want to buy your inflation hedge and protect yourself from the ultimate wealth-destroyer, go right ahead. At some point I'm sure you'll be right. But I'm in a business where the path matters, and I can't afford to make a guess about where the world may be in 5 to 10 years and just close my eyes. The Inflation Narrative is, for the foreseeable future, dead because there is zero wage inflation, which is the sine qua non for an Inflation Narrative. It's a zombie, as all powerful Narratives are, so it will return one day. But today Goldilocks has nothing to do with inflation.

The Goldilocks scenario today is macro data that's strong enough to keep the Self-Sustaining US Growth Narrative from collapsing (ISM >50 and positive monthly job growth) but weak enough to keep the market-positive side of the Central Bank Omnipotence Narrative in play. That's the scenario we've enjoyed for the past few years, particularly last year, and it's the scenario that our political, economic, and media "leaders" are desperate to preserve. So they will.

On Monday we had bad macro data on the heels of the Fed establishing a focal point of $10 billion in additional Taper cuts per FOMC meeting, a clear signal that monetary easing is decelerating on a predictable path. This is the market-negative side of the Central Bank Omnipotence coin, which turns bad macro news into bad market news. And so we were down 2%. And so the Powers That Be started to freak out. Did you see Liesman on CNBC after the Monday debacle? He was adamant that the Fed needed to reconsider the path and pace of the Taper.

And then we had Friday. Honest to God, I thought Liesman was going to collapse of apoplexy, what my grandmother from Scottsboro, Alabama would have called a conniption fit, right there on the CNBC set. The Fed MUST reconsider its Taper path. The Fed MUST do everything in its power to avoid even a whiff of deflationary pressures. Heady stuff. By 10 am ET that morning the WSJ was running an online lead story titled "U.S Stocks Rise as Focus Returns to Fed", acknowledging *and promulgating* the dynamic behind bad macro news driving good market news.

It's not necessary (and is in fact counter-productive from a Narrative construction viewpoint) to switch the Fed trajectory 180 degrees from Taper to no-Taper. **What's necessary is to inject ambiguity into Fed communication policy**, particularly after the non-ambiguous FOMC signal of two weeks ago that led directly to Monday's horror show. The need for ambiguity is also something I've written a lot about so won't repeat here. But this is why Hilsenrath and Zandi and all the rest of the in-crowd are writing that the Taper is still on track … probably. Unless, you know, the data continues to be weak. What you're NOT seeing are the articles and statements by the Powers That Be placing a final number on QE3, extrapolating from the last FOMC meeting to a projected QE conclusion. And that's the dog that didn't bark. It's the projection that Yellen won't be asked about in her testimony; it's the article that won't be written in the WSJ or the FT. Is the Taper still on? Two weeks ago the common knowledge was "Yes, and how." Today, after a stellar bout of Narrative construction, the answer is back to "Yes, but." That's the ambiguous, "data dependent" script that Yellen and all the other Fed Governors now have the freedom to re-assert. Fed support for the market is back in play.

If I'm right, what does this mean for markets? It means that our default is a Goldilocks scenario between now and the next FOMC meeting in mid-March. It means that bad macro news is good market news, and vice versa. If the next ISM manufacturing number is a big jump upwards, the market goes down. Ditto for the February jobs number. If they're weak, though, that's more pressure on the Fed and another leg up for markets.

Place your bets, ladies and gentlemen, the croupier is about to spin the roulette wheel. Pardon me if I sit this one out, though. My crystal ball is broken.

If I'm right, what does this mean for the real world? It means an Entropic Ending to the story … disappointing, slow and uneven growth as far as the eye can see, but never negative growth, never an honest assignment of losses to clear the field or cull the herd (two qualities that, not coincidentally, are clearly present in the growth sectors of technology and energy). That's not my vision of a good investment world, but who cares? We've got to live in the world as it is, even if it's a long gray slog.

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All the best,
Ben

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