"The Risk Trilogy"

A trilogy is a pretty abstract notion. You can apply it to almost any three things.
– Jonathan Demme

Mozart:	**So then you like it? You really like it, Your Majesty?**
Emperor Joseph II:	**Of course I do. It's very good. Of course now and then – just now and then – it gets a touch elaborate.**
Mozart:	**What do you mean, Sire?**
Emperor Joseph II:	**Well, I mean occasionally it seems to have, how shall one say? How shall one say, Director?**
Orsini-Rosenberg:	**Too many notes, Your Majesty?**
Emperor Joseph II:	**Exactly. Very well put. Too many notes.**
Mozart:	**I don't understand. There are just as many notes, Majesty, as are required. Neither more nor less.**
Emperor Joseph II:	**My dear fellow, there are in fact only so many notes the ear can hear in the course of an evening. I think I'm right in saying that, aren't I, Court Composer?**
Salieri:	**Yes! Yes! Er, on the whole, yes, Majesty.**
Mozart:	**But this is absurd!**
Emperor Joseph II:	**My dear young man, don't take it too hard. Your work is ingenious. It's quality work. And there are simply too many notes, that's all. Just cut a few and it will be perfect.**
Mozart:	**Which few did you have in mind, Majesty?**

-- Peter Shaffer, "Amadeus" (1984)

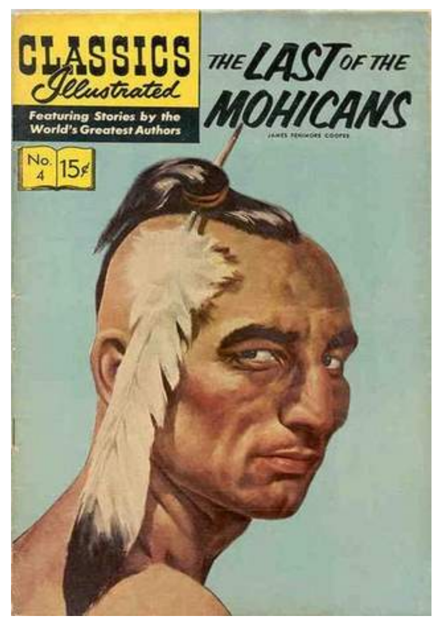
The most dangerous thing about an academic education is that it enables my tendency to over-intellectualize stuff, to get lost in abstract thinking instead of simply paying attention to what's going on in front of me.

– David Foster Wallace, "This is Water: Some Thoughts, Delivered on a Significant Occasion, about Living a Compassionate Life" (2009)

TLDR (Too Long Didn't Read)

– most common acronym I see on Zerohedge to describe an Epsilon Theory note

Gregg Greenberg at *TheStreet.com* was kind enough the other week to give me a few minutes (2:30 to be exact) in a video interview to enumerate the three biggest risks I saw facing markets today. At first I rolled my eyes at the request and the format. 150 seconds? Really? I mean, have you heard my Alabama drawl? It can take me 150 seconds just to order a cup of coffee. Then this past week Alex Coppola of the *Wall Street Journal* was similarly kind enough to give me a platform to talk about the Epsilon Theory perspective on markets for a forthcoming Voices column, again with a focus on the three biggest risks facing markets, again with a pretty strict format to prevent verbosity. How could I possibly communicate what I wanted to say in 400 words?



But you know what? I did. And my message was the better for it. Like David Foster Wallace, I have a tendency to over-intellectualize my work, and this was a healthy corrective. Is there an element of Short Attention Span Theatre in what Gregg and Alex do? Is there still a place in the world for a 25,000 word article in *The New Yorker* on the history of grain? Yes and yes. But there's also a place for busy people to get a Classics comic book version of a long-form saga. Not a dumbing down, but rather a condensation to essential elements and an invitation to dig deeper if desired.

And yes, I realize that I've spent the better part of a page describing how I intend to write a pithy note. So here's the drill. Three downside risks for markets, each summarized in a single page and linked to Epsilon Theory notes if you want to read more.

1) China has shifted from a monetary policy of choice to a monetary policy of necessity.

Just to be clear, I'm not one of those guys who sees China as on the brink of some enormous economic collapse. But I do believe that Chinese political legitimacy depends on the government delivering real economic growth … not the pleasant veneer of asset price inflation as in the US or the simple avoidance of abject deflation as in Europe. As that real economic growth becomes more difficult to achieve (three reasons: cheaper yen and greater Japanese competition in advanced export markets, more or less permanently depressed demand in primary European export markets, disappointingly slow growth in domestic consumer-led demand), the Chinese government increasingly faces the existential threat of a hard landing. Because it's an existential threat, it ain't happening. The Chinese government will seek to reverse economic growth uncertainty by any means necessary, including massive shifts in decades-long trends in monetary policy.

What is the primary instrument of Chinese monetary policy? It's not control over short rates or QE balance sheet expansion as in the West, both of which are powerful but indirect economic levers. It's direct control over credit availability and direct control over currency exchange rates. I'm particularly concerned about the latter. Recent forced declines in the value of the yuan are not simply efforts to "increase volatility" or "punish speculators", as the Party line and Western apologists would have you believe. No, the goal is to invigorate growth by making exports cheaper, and when that goal is a political necessity it will be pursued regardless of the tensions it creates with both Japan and the US. My concern is that this is what a modern-day trade war looks like ... conflict over exchange rates, not tariffs and quotas.

If you want a deeper analysis, the core Epsilon Theory note here is "Rosebud". Relevant shorter notes include "The Power of Why" and "Two Shifting Narratives".

2) The Narrative of Fed Omnipotence continues to reign supreme, but now in a tightening monetary policy environment.

A narrative is a set of widely held beliefs about what everyone thinks that everyone thinks (in game theoretic terms, "common knowledge") created by very public statements by very public people … Janet Yellen, Mario Draghi, even the WSJ's own Jon Hilsenrath. Over the past five years an extremely powerful narrative has been created, what I call the Narrative of Fed Omnipotence – whatever happens in the market, for good or for bad, happened because of what the Fed did, not because of what happened in the "real" economy. And for the past five years that's been great for the market (US market, anyway, EM's not so much) as the Fed did very market-supportive things. But now the Fed is starting to tighten, which is definitely not market-supportive. If the Narrative holds true, then the market will go down even if the real economy picks up. In fact, so long as the Narrative holds true, bad real world news is good market news because it keeps the Fed in play, and vice versa.

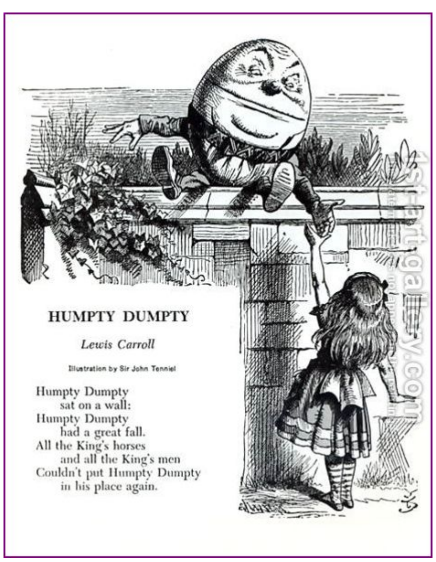
Is a declining market a foregone conclusion as the Fed continues to tighten? No, but for the market to go up from here will require the development of an alternative narrative that supplants the dominant Narrative of Fed Omnipotence. This is what I'm watching for, and movement on this front (or lack thereof) is what I'll try to alert you to through Epsilon Theory. The leading challenger? Same as it ever was – American exceptionalism and self-sustaining growth. The two variants on this theme? Technology-led growth (mightily damaged over past few months) and Energy-led growth (still going strong). But for now, at least, the Fed narrative still trumps all.

If you've read anything from Epsilon Theory, you're familiar with my arguments around Narrative and Common Knowledge. This is the heart of a game theoretic perspective on markets, and it's by far the most prevalent subject of Epsilon Theory notes. I'll highlight three: "It Was Barzini All Along", "How Gold Lost Its Luster", and "A World of Guarantees". Relevant shorter notes of late include: "The King is Dead. Long Live the King.", "Goldilocks and the Dog That Didn't Bark", and "Oh Stewardess, I Speak Jive".

3) The Hollow Market is cracked open by well-intentioned but destructive regulators.

The Hollow Market is my phrase for a market structure where humans trading to express an interest in the fractional ownership of a real world company account for less than 30% of market activity. Whether it's "liquidity provision" or algorithm-driven arbitrage, machine-to-machine trading dominates modern markets against a backdrop of increasingly concentrated holdings of securities, and that's a very unstable recipe. My concern with the Hollow Market is not only that it exists in such a Flash Crash-prone fashion, but that it's terribly misunderstood. The Big Data technology that created the Hollow Market cannot be un-invented, but government regulators are apt to really screw things up as they try to do just that. As always, market infrastructure is created in the intersection of human greed, technology, and regulation. As always, technological breakthroughs upend the market structure apple cart, allowing upstart players to bypass regulatory barriers and steal rents from incumbents. As always, the incumbents muster the support of their political allies to recapture their rents, absorbing or crushing the upstarts in the process.

What's different this time is that this brewing regulatory crusade is part and parcel of a larger regime effort to turn markets into social utilities, where private information is criminalized and broad market price inflation is effectively enshrined as a permanent government policy objective. As Clemenceau famously said about World War I, "War is too important to be left to the generals." Political leaders today, across the globe and regardless of political stripe, are saying of the Great Recession, "Markets are too important to be left to private investors." I have to admit, it's an ingenious political response to maintain social order in the face of a global deleveraging cycle, even as the small-l liberal in me weeps. Bottom line: I have no idea what market structure will look like in 5 to 10 years, but my strong suspicion is that alpha will be an even rarer commodity than it is today.



The core Epsilon Theory notes on this score include: "The Adaptive Genius of Rigged Markets", "Hollow Men, Hollow Markets, Hollow World", "The Levelers", and "A World of Guarantees". See also: "When E.F. Hutton Talks", "The Wages of Fear", and "Uttin' on the Itz".

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