"When the Story Breaks"

The Three Types of Fear:

- The Gross-out: the sight of a severed head tumbling down a flight of stairs. It's when the lights go out and something green and slimy splatters against your arm.
- The Horror: the unnatural, spiders the size of bears, the dead waking up and walking around. It's when the lights go out and something with claws grabs you by the arm.
- And the last and worst one: Terror, when you come home and notice everything you own has been taken away and replaced by an exact substitute. It's when the lights go out and you feel something behind you, you hear it, you feel its breath against your ear, but when you turn around, there's nothing there.

— Stephen King

Brody: You're gonna need a bigger boat.
— "Jaws" (1975)

Back in my portfolio manager days, I was a really good short seller. I say that as a factual observation, not a brag, as it's not a skill set that's driven by some great intellectual or character virtue. On the contrary, most short sellers are, like me, highly suspicious of all received wisdom (even when it is, in fact, wise) and have weirdly over-developed egos that feed on the notion of "I'm right even though the world says I'm wrong". But what set me apart as a short seller were two accidents of experience. First, I didn't come out of Wall Street, so I wasn't infected with the long-bias required of those business models. Second, my professional career prior to investing was all about studying mass behaviors and the informational flows that drive those behaviors.

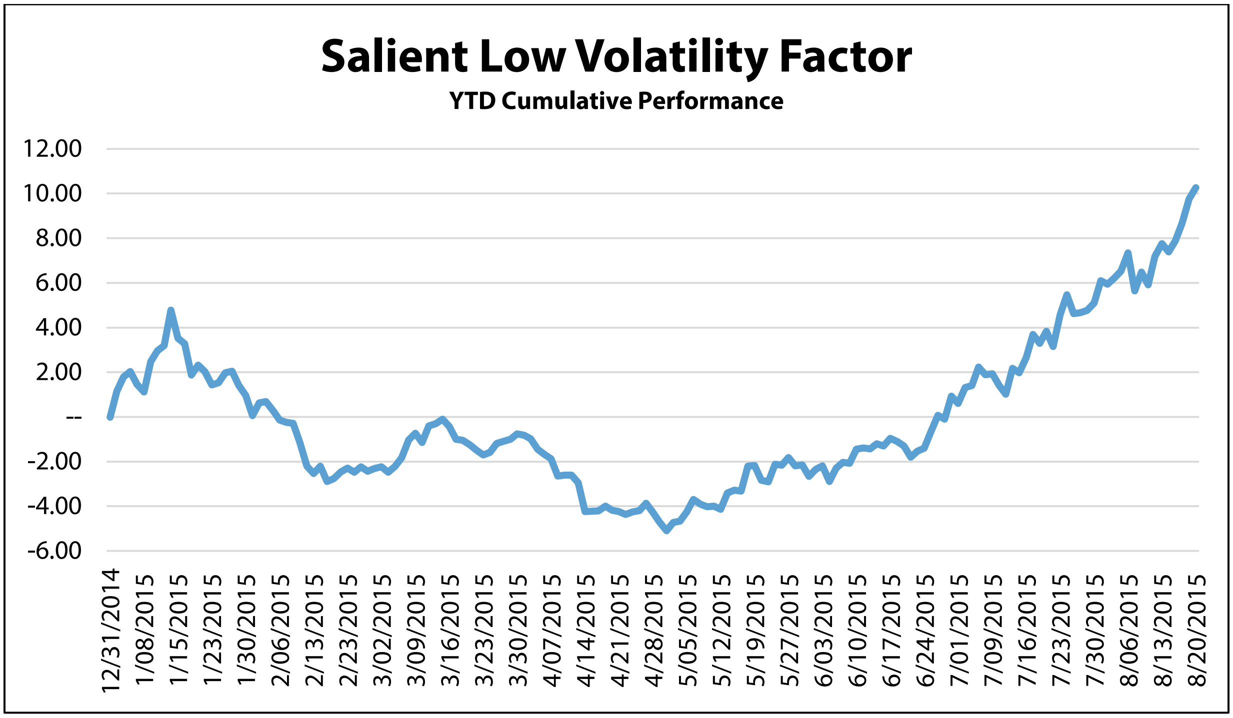
Here's why that's important. The biggest difference between shorting and going long is that shorts tend to work in a punctuated fashion. One day I'll write a full note on the Information Theory basis for this market fact, but the intuition is pretty simple. There's a constant flow of positive information around both individual stocks (driven by corporate management) and the market as a whole (driven by the sell-side), and as a result the natural tendency of prices is a slow grind up. But occasionally you'll receive an informational shock, which is almost always a negative, and the price of a stock or the overall market will take a sharp, punctuated decline. The hardest decision for a short seller is what to do when you get this punctuated decline. Do you cover the short, pocket a modest gain, and look to re-establish the position once it grinds higher, as it typically does? Or do you press the short on this informational validation for your original negative thesis? It's an entirely different mindset than that of most long-only investors, who – because they have the luxury of both time and informational flow on their side – not only tend to add to their positions when the stock is working (my thesis is right, and I'm raising my target price!) but also tend to add when it's not working (my thesis is right, and this stock is on sale!).

Solving the short seller's dilemma requires answering one simple question: *is the story broken?* Is the informational shock sufficient to force long-only investors to doubt not just their facts, but – much more crucially – *their beliefs,* thus turning them into sellers, too? The facts of the informational shock are almost immaterial in resolving the short seller's dilemma. Your personal beliefs about those facts are certainly immaterial. The only thing that matters is whether or not the river of information coming out of the sell-side has shifted course in a way that swamps the old belief structures and establishes new Common Knowledge.

The China growth story is now broken. To be clear, I am NOT saying that China's economy is broken. On the contrary, I'm a China bull. What I'm saying is that what everyone believes that everyone believes about Chinese growth – the Common Knowledge about Chinese growth – has now shifted dramatically for the worse. **What I'm also saying is that China-related stocks and markets are going to have a very hard time *working* until the investors who *believed* in the China growth story are replaced by investors who *believe* in a different China story, probably a China value story.** That can take a long time and it can be a very painful transition, as any value investor who ever bought a mega-cap tech stock can attest. But it *will* happen, and that's a very powerful – and ultimately positive – transformation. Ditto for Emerging Markets in general.

In the meantime, what we've been experiencing in markets is the plain and simple fear that always accompanies a broken story. The human reaction to a broken story is an emotional response akin to a sudden loss of faith. It's a muted form of what Stephen King defined as Terror … the sudden realization that the helpful moorings you took for granted are actually not supporting you at all, but are at best absent and at worst have been replaced by invisible forces with ill intent. The antidote to Terror? Call the boogeyman by his proper name. It's the end of the China growth story, one of the most powerful investment Narratives of the past 20 years. And that's very painful, as the end of something big and powerful always is. It will require investors to adapt and adjust if they want to thrive. But it's not MORE than that. It's not a sign of the investment apocalypse. It's the end of one investable story, soon to be replaced with another investable story. Because that's what we humans do.

Here's a great illustration of what fear looks like in markets, courtesy of Salient's Deputy CIO and all-around brilliant guy, Rusty Guinn.



These are the cumulative pro forma (i.e., purely hypothetical) returns generated by selling (shorting) the high volatility S&P 500 stocks and buying an off-setting amount of the low volatility stocks (0% net exposure, 200% gross exposure). The factor is up 10% YTD and 15% from the lows in May. Now just to be clear, this is not an actual investment strategy, but is simply a tool we use to identify what factors are working in the market at any point in time. There are any number of ways to construct this indicator, but they all show the same thing – investors have been embracing low volatility (low risk) stocks ever since Greece started to break the European stability story this summer, and that dynamic has continued with the complete breakdown of the China growth story. This is what a flight to safety looks like when you don't trust bonds because you think the Fed is poised for "lift-off". This is the fear factor.

Three final Narrative-related points...

First, while the breakdown in the China growth story has reached a tipping point over the past week, this is just the culmination in what has been a two year deterioration of the entire Emerging Market growth story. The belief system around EM's has been crumbling ever since the Taper Tantrum in the summer of 2013, and it's the subject of one of the most popular Epsilon Theory notes, "It Was Barzini All Along". Everything I wrote then is even more applicable today.

Second, I see very little weakness in either the US growth story (best house in a bad neighborhood, mediocre growth but zero chance of recession) or the Narrative of Central Bank Omnipotence. Do I think that the Fed is being stymied in its desire to raise short rates in order to reload its monetary policy gun with conventional ammo? Yes, absolutely. Do I see a significant diminution in the overwhelming investor belief that the Fed and the ECB control market outcomes? No, I don't. Trust me, I'm keeping my eyes peeled (see "When Does the Story Break?"), because in many respects this is the only question that matters. If this story breaks, then in the immortal words of Chief Brody when he first saw the shark, "You're gonna need a bigger boat."

Third, while I'm relatively sanguine about the China growth story breaking down, as I'm confident that there's a value story waiting in the wings here, **I'll be much more nervous if the China political competence story continues to deteriorate.** This is a completely different Narrative than the growth story, and it's the story that one-party States rely on to prevent even the thought of a viable political opposition. In highly authoritarian one-party nations – like Saddam's Iraq or the Shah's Iran – you'll typically see the competence Narrative focused on the omnipresent secret police apparatus. In less authoritarian one-party nations – like Lee Kuan Yew's Singapore or Deng Xiaoping's China – the competence Narrative is more often based on delivering positive economic outcomes to a wide swath of citizens (not that these regimes are a slouch in the secret police department, of course). **From a political perspective, this competence Narrative is THE source of legitimacy and stability for a one-party State**. In a multi-party system, you can vote the incompetents (or far more likely, the perceived incompetents) out of office and replace them peacefully with another regime. That's not an option in a one-party State, and if the competency story breaks the result is always a very dicey and usually a violent power transition. I am seeing more and more trial balloons being floated in the Western media (usually with some sort of Murdoch provenance) that indicate "dissatisfaction" with this or that cadre. And it's not just a markets story any more, as grumblings over the Tianjin fire disaster appear to me to have grown louder over the past week. I haven't seen this sort of signaling coming out of China in 20 years, and it certainly bears close watching.

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