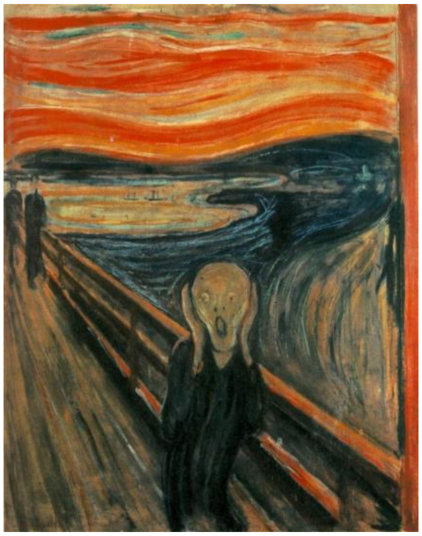
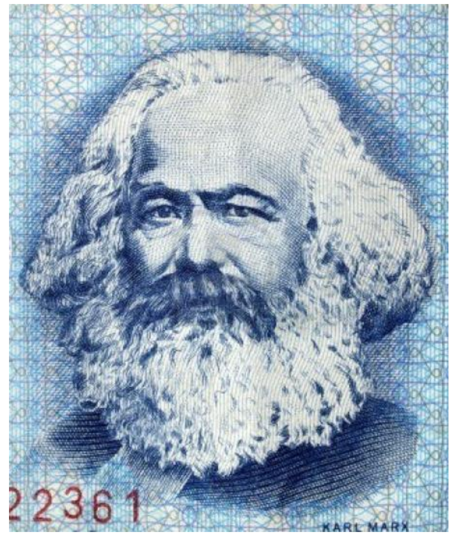
The 18th Brumaire of Janet Yellen





One of the more painful lessons in investing is that the prudent investor (or 'value investor' if you prefer) almost invariably must forego plenty of fun at the top end of markets. This market is already no exception, but speculation can hurt prudence much more and probably will. Ah, that's life. And with a Fed like ours it's probably what we deserve.
– Jeremy Grantham, macro fund manager and noted Bear (Nov. 19, 2013)

I cannot look at myself in the mirror; everything I have believed in I have had to reject. This environment only makes sense through the prism of trends.
– Hugh Hendry, macro fund manager and noted Bear (Nov. 22, 2013)

The hippies, who had never really believed they were the wave of the future anyway, saw the election results as brutal confirmation of the futility of fighting the establishment on its own terms.
– Hunter S. Thompson, "The Hashbury is the Capital of the Hippies" (1967)

In the sunset of dissolution, everything is illuminated by the aura of nostalgia, even the guillotine.
– Milan Kundera, "The Unbearable Lightness of Being" (1984)

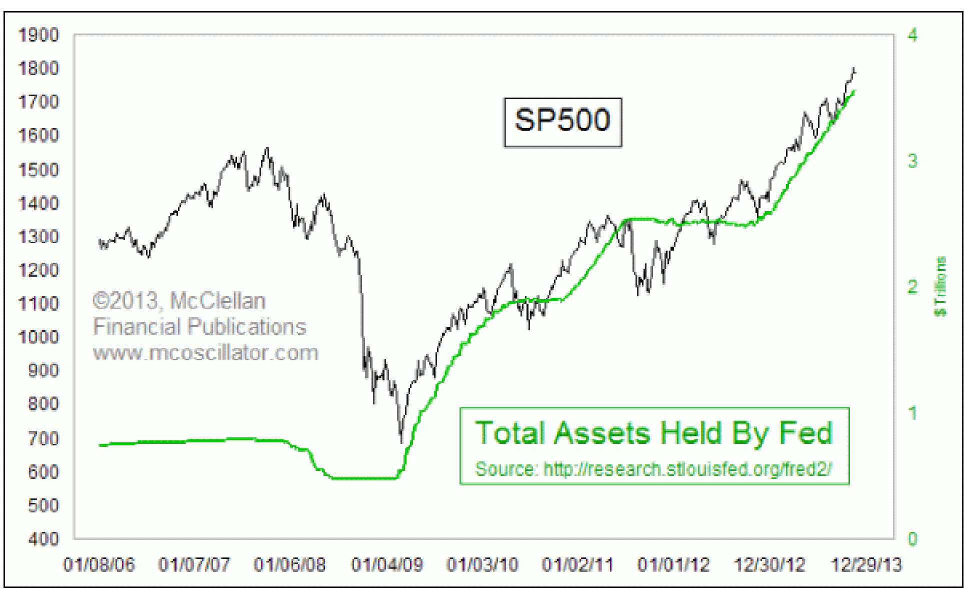
The Greek word for 'return' is *nostos*. *Algos* means 'suffering.' So nostalgia is the suffering caused by an unappeased yearning to return.
– Milan Kundera, "Ignorance" (2000)

The class which has the means of material production at its disposal, has control at the same time over the means of mental production. The ruling ideas are nothing more than the ideal expression of the dominant material relationships.
– Karl Marx, "The German Ideology" (1846)

"Let's go." "We can't." "Why not?" "We're waiting for Godot."
– Samuel Beckett, "Waiting for Godot" (1953)

Karl Marx may not have had a small-l liberal bone in his body, but he was one of the keenest observers of the human condition to ever live, and his writings are a phenomenal resource for anyone seeking to understand our lives as social animals. In 1852 Marx published an essay titled *The 18th Brumaire of Louis Bonaparte*, recounting the 1851 coup where Louis-Napoleon Bonaparte (nephew of THE Napoleon) seized dictatorial powers in France. The essay was, Marx wrote, intended to "demonstrate how the class struggle in France created circumstances and relationships that made it possible for a grotesque mediocrity to play a hero's part," and it is here that Marx describes his view of the individual's role in history. Which is to say … not much, as individuals are almost always prisoners of the past and their class, particularly shadow or derivative individuals, as Louis-Napoleon was to his uncle and Yellen is to Bernanke. This was the essay where Marx famously said that history always repeats itself, only the second time as farce, a phenomenon I've written about at length as the emergency Fed policies that saved the world in 2009 have been transformed into a more or less permanent government insurance program.

I started this note with quotes from two prominently bearish money managers – Jeremy Grantham and Hugh Hendry – both of whom are throwing in the towel on the upward trajectory of the market in the face of inexorable government bond-buying. Their change of heart reflects (finally and begrudgingly) the overwhelmingly dominant Narrative of Central Bank Omnipotence, that for better or worse it is central bank policy (particularly the Fed's QE policy) that determines market outcomes. This Narrative is encapsulated in the following chart, a graph that we've all seen a million times in one form or another and has become a meme unto itself.



This is the Common Knowledge of our day … that so long as the Fed continues to buy, the market will continue to go up. Maybe they taper the rate of purchases or even stop expanding altogether, but if the market gets squirrelly they will just start buying again. The Narrative of Central Bank Omnipotence doesn't mean that the market will only go up; it means that central bank policy is the overwhelming causal factor for market levels. It is as powerful a Common Knowledge structure as I've ever measured, and it's at the heart of Grantham and Hendry's hand-wringing. They aren't capitulating to the market going up, but to WHY the market is going up. It's a market dynamic that is alien to their (formidable) talents as money managers and to their (strongly held) belief structures on the *meaning* of an investment.

But for both Grantham and Hendry (and I suspect every investor who has been fighting the Fed in one way or another), this is a temporary capitulation. They both cling to the notion that this, too, shall pass, that we shall someday return to a market environment where real-world business fundamentals matter more than monetary policy. Maybe the return to "normal" comes with a bang … some sort of "Minsky moment" and asset price collapse where there's a sudden realization that the Emperor has no clothes (or no more bonds to buy) … or maybe it comes with a whimper, as the Fed slowly and calmly drains the excess reserves it has built up in the financial system with the magical "tools" that are touted every time Bernanke (and now Yellen) testifies before Congress. To which I say … maybe. Or maybe that's just wishful thinking for a market clearing Shock Ending or Happy Ending, as opposed to what seems to me to be the more likely outcome of the Entropic Ending, a long gray slog through a more or less permanently depressed world and a more or less permanently Fed-centric market.

Louis-Napoleon's reign may have been a farcical shadow of his uncle's Emperorship, but the truth is that Napoleon I set into motion structural changes in the world that dominate our lives still. Napoleon changed the *meaning* of nationalism. He changed the *meaning* of war. He changed what it means to live as a human animal in a mass society. I mean, the entire concept of mass society really begins with Napoleon and the *levée en masse*, the Napoleonic Code, the notion of Total War, and the authoritarian co-opting of revolutionary ideals. Put the political inventions of Napoleon (and his Prussian and English opponents) together with the mechanical inventions of the Industrial Revolution and you have … the modern nation-state, a massive and entrenched insurance company attached to an equally massive and entrenched standing army.

I think it's likely that government policy initiatives of the past ten years, particularly monetary policy and particularly US monetary policy, have created a structural shift in the *meaning* of capital markets and the global economy that rivals what Napoleon did almost exactly 200 years ago. I think Larry Summers is right – we are mired in a world of secular stagnation and a more or less permanent liquidity trap. The degree to which ZIRP and QE and bubble-promoting monetary policy *creates* that secular stagnation by delaying the deleveraging, loss assignment, and creative destruction that vibrant growth *requires* is ludicrously underappreciated in Summers' speech, but as a statement of economic reality it's pretty spot-on. I think Paul Krugman is right, too – in for a penny, in for a pound. Central bankers have come this far. Do you really think they're going to back down now? I'm not saying that Krugman's argument is "right" in terms of being intellectually honest or even very smart. I'm saying that I believe it is an accurate representation of the world as it is.

Here's the crucial part of what Summers and Krugman are saying: this is not a temporary gig. This isn't going to just "get better" on its own over time. This really is, as Mohamed El-Erian of PIMCO would call it, the New Normal. And if you're Jeremy Grantham or anyone for whom a stock has meaning as a fractional ownership stake in a real-world company rather than as a casino chip that gives you "market exposure" … well, that's really bad news.

So what's the point of all this?

Denial ain't just a river in Egypt, and alienation ain't just a movie with Mandy Patinkin in heavy make-up. For my money, the smartest thing Marx ever wrote was on the concept of alienation, the separation of a worker from the *meaning* of his labor. Marx believed that the greatest theft that capitalism perpetrated on the working class was psychological. The Industrial Revolution and the assembly line crushed a worker's spirit by eliminating the sense of pride, the sense of accomplishment, *the sense of place and meaning* that an honest day's work previously imbued. Instead of seeing, feeling, and knowing the object of his labor, the modern worker made … a widget. He made a cog and he was a cog.

What traditional value investors like Grantham are experiencing today is alienation in the traditional Marxist sense. In today's context it's not the separation of a worker from the meaning of his labor, but the separation of an investor from the meaning of his investment. Sure, you can go on investing on the basis of your discounted cash-flow model or your earnings margin reversion-to-the-mean model or whatever it is that floats your boat, but it's just going to be a continuing exercise in frustration so long as we live in a Fed-centric universe. As Hugh Hendry says, it's hard to look at yourself in the mirror every morning when everything that you've held dear as your investment belief structure doesn't seem to matter much anymore. Nostalgia, as Milan Kundera points out, is a form of suffering. Life's way too short to wallow in those waters.

Marx has an answer to the alienation problem … end it, don't amend it. Take your ball and go home, or at least find a different game. For the alienated proletariat, this is easier said than done. You've got to throw off your chains, rise up in violent class struggle, create a vanguard political party that maintains the necessary ideological discipline, watch out for counter-revolutionaries … creating a worker's paradise is hard work! For the alienated value investor, on the other hand, the portability of capital makes the road to greener pastures quite a bit easier -- just get out of public markets. Go buy a farm … or an apartment building … or a fleet of tankers … or a portfolio of bank loans … anything where your investment process has meaning again and isn't hijacked by the game-playing and trend-following that dominates public capital markets. If you have to stay in public securities, at least move into areas of the market where you are not dominated by the game-players and where there remains a critical mass of your fellow value investors to make a community of sorts … small and mid-cap industrials, say, or maybe activist targets. Just don't kid yourself into thinking that your deep dive into the value fundamentals of some large-cap bank has any predictive value whatsoever for the bank's stock price, or that a return to the happy days of yesteryear is just around the corner. It doesn't and it's not, and even if you're making money you're going to be miserable and ornery while you wait nostalgically for what you do and what you're good at to matter again. Spoiler Alert: Godot never shows up.

But maybe you're not a dyed-in-the-wool value investor wracked by feelings of severe alienation. Maybe you're pretty agnostic about the whole investment style box thing and you're just looking to grow your wealth as quickly as possible with the least risk as possible. If you don't really care WHY the markets are going up, only that they ARE going up; if you don't feel an existential angst about Fed policy, but are actually quite happy that they've got your back; if you're looking to play the investment game better, regardless of what the rule changes might be … well, Marx has some good advice for you, too. **Think for yourself.**

Marx is most famous for his concept of “the means of production”, the notion that human history is best seen and understood through an economic lens, that what we have been told is a story of Great Men and Empires and Discovery is really just a byproduct of class struggle for the control of those economic means of production. But what’s less appreciated is that Marx made a distinction between material production (all the stuff that we characterize as economic activity) and what he described as “mental production” – the creation of “the ruling ideas” that do all the heavy lifting in maintaining *control* over the proletariat. Now Marx wrote this in the 1840’s (!), so it’s going to need some contextual updating to speak clearly to us 170 years later. To wit: in the same way that Marx’s concept of alienation is more relevant today to capitalist investors than it is to labor, so, too, is this concept of mental production and ruling ideas. **We investors – big or small, retail or institutional – are the proles.** A well-to-do and content proletariat, to be sure, kind of like professional athletes, but a proletariat nonetheless. We control neither the means of material production (the public capital markets in which we labor) nor, more importantly, the means of mental production – the creation of the ruling ideas that drive our behavior and are taken for granted. We are ALL suckers for a good story that has more truthiness (to use Stephen Colbert’s word) than truthfulness, and you don’t have to be a raving Marxist to believe that the institutions that do in fact control the means of material and mental production depend on this central truth about human nature to maintain their position.

What are the ruling ideas in investment theory and practice today? There are plenty, but I’ll highlight two: “stocks for the long haul” and Modern Portfolio Theory. I’m not going to go into a long critique of either ruling idea, as I’ve written on this topic here, and I have lots more planned for the future. But for now I’ll just ask this: **does the Narrative of Stocks For the Long Haul or the Narrative of Modern Portfolio Theory serve your best interests and your clients’ best interests … or theirs?** It’s a question that deserves to be asked and explored again and again, and that’s what I’ll keep doing with Epsilon Theory.