

“Watching the Narratives”

You think you’re alone until you realize you’re in it.

Now fear is here to stay. Love is here for a visit.

-- Elvis Costello, “Watching the Detectives”

A quick email to follow up on yesterday’s market debacle. The question, of course, is whether this was simply a blip – yet another one-day BTFD opportunity – or the start of something bigger and worse. The answer, I think, depends on how the media Narrative surrounding yesterday takes shape over the next several days. That’s what I’m watching closely, and I think you should, too.

Right now the media Narrative about yesterday is in complete disarray, because there was no obvious “reason” for the sell-off. Or rather, there were too many possible reasons, from bad earnings reports to the Argentina default to worries about a strong jobs number to Espirito Santo cracking up to new Russian sanctions to just a generic “we were overdue for this”. **From a game theory perspective, this sort of seemingly out-of-the-blue sharp move had very little to do with *anything* that happened yesterday, but is a natural by-product of the Common Knowledge Game in action.** The game was put into motion by Yellen’s recent version of Greenspan’s “irrational exuberance” words, together with continued Fed-speak about tightening sooner and faster rather than slower and later. As described in the Epsilon Theory note [“When Does the Story Break”](#), the Common Knowledge Game plays out in investors’ heads, not in their behaviors, until a predictable tipping point is reached and a large group of investors simultaneously heads for the exit. Yesterday’s sell-off really began a couple of weeks ago. We’re just seeing the market manifestation of it now.

Were yesterday’s events important? Sure, particularly the Espirito Santo news, which puts a big crimp in the market-positive story that the ECB will take over the Fed’s role as the global punchbowl provider (see [“The Red King”](#) for more). These events were each catalysts, providing a wrapper of sorts for the decisions to sell. But they were neither necessary nor sufficient for the market sell-off. They just happened to be the subway train that stopped in front of us when we walked into the station. If it hadn’t been this train, another would have been right behind it.

So what now? Everything hinges on how the “Missionaries” like Yellen and Draghi and their mouthpieces respond. Like clockwork, Jon Hilsenrath is already out with his first [remain-calm-all-is-well](#) piece, and I expect several more before markets open on Monday. But we haven’t heard yet from the really big voices, and we have yet to see how the media microphones either amplify or mute the second-tier Missionaries like Hilsenrath. I’ll be watching closely and posting occasional updates on Twitter [@EpsilonTheory](#), but in general you want to see more articles like Hilsenrath wrote today (jobs data not strong enough to make Fed accelerate tightening) and fewer about failed loans and cracks in the monetary policy dam that the Fed and ECB have built. On this latter point, an Argentine default has extremely little impact on the Narrative of Central Bank Omnipotence. European bank defaults and forced capital raises, on the other hand ... well, that’s the sort of thing that can make the [Red King](#) wake up. And that will not be a pretty sight.

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