

## “When Narratives Go Bad”

How many things served us yesterday as articles of faith, which today are fables for us?

– *Michel de Montaigne, The Complete Essays (1580)*

That same night, I wrote my first short story. It took me thirty minutes. It was a dark little tale about a man who found a magic cup and learned that if he wept into the cup, his tears turned into pearls. But even though he had always been poor, he was a happy man and rarely shed a tear. So he found ways to make himself sad so that his tears could make him rich. As the pearls piled up, so did his greed grow. The story ended with the man sitting on a mountain of pearls, knife in hand, weeping helplessly into the cup with his beloved wife's slain body in his arms.

– *Khaled Hosseini, The Kite Runner (2003)*

***A fable for our times, the ultimate disposition of extraordinary monetary policy. Bad news is good news until bad news is all we know. Global growth is the wife.***



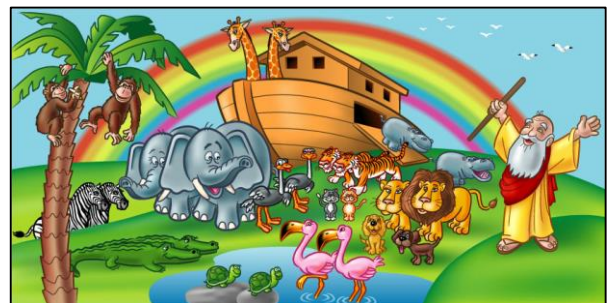
The idea of negative interest rates strikes many people as odd. Economists are less put off by it. ... The anxiety about negative interest rates seen recently in the media and in markets seems to me to be overdone. Logically, when short-term rates have been cut to zero, modestly negative rates seem a natural continuation; there is no clear discontinuity in the economic and financial effects of, say, a 0.1 percent interest rate and a -0.1 percent rate.

– *Former Fed Chair Ben Bernanke, "What Tools Does the Fed Have Left?", March 18, 2016*

***Bernanke is right — economists are not put off by the idea of negative rates. And that's exactly the problem. There's a huge discontinuity between a 0.1 percent interest rate and a -0.1 percent interest rate, but economists don't see it because it's a BEHAVIORAL discontinuity. Positive rates permit investing behaviors based on fundamentals and compounding. Negative rates require investing behaviors based on hope for a greater fool.***

My Sunday school teachers had turned Bible narrative into children's fables. They talked about Noah and the ark because the story had animals in it. They failed to mention that this was when God massacred all of humanity.

– *Donald Miller, Blue Like Jazz: Nonreligious Thoughts on Christian Spirituality (2003). The condescension of modern status quo Narrative construction is staggering. It's a mistake to do this with kids, and it's a bigger mistake to do this with voters and investors.*



A major European power, a longtime defender of liberal democracy, pluralism and free markets, falls under the sway of a few cynical politicians who see a chance to exploit public fears of immigration to advance their careers. They create a stark binary choice on an incredibly complex issue, of which few people understand the full scope — stay in or quit the E.U.

– *New York Times* columnist Tom Friedman, [doing his part to create a status quo protecting Narrative post-Brexit](#), where government “unforgivably” abdicated its responsibility by “allowing” foolish citizens who can’t possibly know their own self-interest to vote on something that’s “incredibly complex” and can only be understood by wise men ... like Tom Friedman.

He spotted the entourage and security personnel that signaled another important person’s plane. With the temperature over 103 degrees, Mr. Clinton, rather than chatting on the scorching cement, climbed aboard to say hello to Attorney General Loretta E. Lynch.

– *New York Times* “reporter” Amy Chozick, [in a yeoman effort to maintain the status quo protecting Narrative](#). Nothing to see here folks, move along, just a sociable man trying to get out of the heat.



Marie Antoinette (1755 – 1793)



“Duck Soup” (1933)

**Minister of Finance:** Here is the Treasury Department's report, sir. I hope you'll find it clear.

**Rufus T. Firefly:** Clear? Huh. Why a four-year-old child could understand this report.

[aside to Bob Roland]

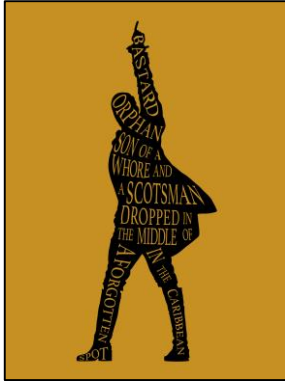
**Rufus T. Firefly:** Run out and find me a four-year-old child, I can't make head or tail of it.

**Stooges:** Simple Simon met a pieman,  
Going to the fair;  
Says Simple Simon to the pieman,  
Let me taste your ware.  
Said the pieman to Simple Simon,  
Show me first your penny.  
Said Simple Simon to the pieman:  
**Moe:** Scram! Ya don't get any! [throws pie in face]



“Fiddlers Three” (1948)

*You can learn a lot about political Narrative creation by looking at dominant forms of satire and comedy. Satire today is as arch and elitist as the status quo institutions it defends, in sharp contrast to the populist, slapstick comedy of the Marx Brothers or the Three Stooges. I'll bet there's a 99% correlation between UK Leave voters and people who think Benny Hill is funny, and the same between UK Remain voters and people who think John Oliver is funny. For the Tom Friedmans of the world, the solution is simple: “educate” people that John Oliver is hilarious, but you're a racist dope if you laugh at Benny Hill. Yeah, that'll work.*



I wrote my way out of hell.  
 I wrote my way to revolution.  
 I was louder than the crack in the bell.  
 I wrote Eliza love letters until she fell.  
 I wrote about The Constitution and defended it well.  
 And in the face of ignorance and resistance,  
 I wrote financial systems into existence.  
 And when my prayers to God were met with indifference,  
 I picked up a pen, I wrote my own deliverance.  
 – **Lin-Manuel Miranda, Hamilton (2015)**

***Why does Hamilton work? Because it's not arch and it's not elitist. Because it takes one of the most powerful and long-lived Narratives in modern history — the Founding Fathers — and tells the story without irony, without condescension, and without the (literal) whitewashing of other storytellers. The Old Stories still work when you play them straight. Thank you, Lin-Manuel.***

**Choronzon:** I am a dire wolf, prey-stalking, lethal prowler.  
**Morpheus:** I am a hunter, horse-mounted, wolf-stabbing.  
**Choronzon:** I am a horsefly, horse-stinging, hunter-throwing.  
**Morpheus:** I am a spider, fly-consuming, eight legged.  
**Choronzon:** I am a snake, spider-devouring, poison-toothed.  
**Morpheus:** I am an ox, snake-crushing, heavy-footed.  
**Choronzon:** I am an anthrax, butcher bacterium, warm-life destroying.  
**Morpheus:** I am a world, space-floating, life-nurturing.  
**Choronzon:** I am a nova, all-exploding... planet-cremating.  
**Morpheus:** I am the Universe -- all things encompassing, all life embracing.  
**Choronzon:** I am Anti-Life, the Beast of Judgment. I am the dark at the end of everything. The end of universes, gods, worlds ... of everything. Sss. And what will you be then, Dreamlord?  
**Morpheus:** I am hope.



– **Neil Gaiman, The Sandman, Vol. 1: Preludes and Nocturnes (1991)**

There was a tale he had read once, long ago, as a small boy: the story of a traveler who had slipped down a cliff, with man-eating tigers above him and a lethal fall below him, who managed to stop his fall halfway down the side of the cliff, holding on for dear life. There was a clump of strawberries beside him, and certain death above him and below. What should he do? went the question.

And the reply was, Eat the strawberries.

The story had never made sense to him as a boy. It did now.

– **Neil Gaiman, American Gods (2001)**

***The fin of any siècle is almost always a rough ride, even if we end up dreaming a better dream. In investing as in life there's never enough time, and we are beset on all sides. Eat the strawberries.***

Here's my most basic view on everything that's happening in the world right now, politically, economically, socially ... all of it: ***the Fix is still in, but it's getting harder and harder to maintain.***

The Fix is the status quo, and it goes by different labels of identity depending on what you're talking about. "European Union" is one of those labels. "Central Banking" is one. "Clinton" is another. They aren't real things at all, but are statements of shared identity that channel our behavior in highly predictable patterns that are, in turn, highly useful to The Powers That Be, and are maintained by [expressions of Common Knowledge](#) such as "everyone knows that everyone knows that Brexit was a grievous mistake" or "everyone knows that everyone knows that low interest rates spur the economy." **Those expressions of Common Knowledge are also called [Narratives](#), and the Narratives are dying.**

And yes, I know that this all sounds suspiciously philosophical and divorced from our investing reality, but bear with me for a moment, because the punchline here is going to be that I think what I'm describing is the ONLY thing that matters for our investing reality. Our reality is not determined by the antics of the flesh-and-blood Hillary Clinton or Donald Trump, but by the status quo ideas and institutions represented by and threatened by [the human-shaped cartoons we call "Hillary Clinton" and "Donald Trump"](#). **To figure out what's next for markets, we have to figure out why "Clinton" — shorthand for globalism (it's not called The Clinton Global Initiative for nothing) and a sort of technocratic, condescending, principle-less, democracy-suspicious manner of governing — is failing.** We have to figure out why Bill Clinton's stroll across the Phoenix tarmac to chat up the Attorney General was a) reported at all, and b) greeted by derision and despair within his own party. If you don't like my use of the label "Clinton" or if you think I'm being too political, replace it with "Brussels" or "Beijing". It's all the same thing, just three different shades of gray.

And I really couldn't care less, professionally at least, what actually transpired between Bill Clinton and Loretta Lynch, or what Hillary Clinton actually believed about her email security classifications. What I care deeply about, however, is how the Narrative around these events is being shaped and reshaped, because that Narrative will determine the path and outcome of every election and every market on Earth. And what I can tell you is that I am shocked by the diminishing half-life of status quo protecting Narratives, by the inability of Big Institutions and Big Money and Big Media and Big War and Big Academia to lock down an effective story that protects the State, even when their competition is primarily comprised of clowns (dangerous clowns, but clowns all the same) like Donald Trump and Nigel Farage. **There's a ... tiredness ... to the status quo Narratives, a Marie Antoinette-ish world weariness that sighs and pouts about those darn peasants all the way to the guillotine.**

We've seen this before. History is littered with failed Narratives, once-powerful arrays of Common Knowledge that somehow lose their ability to compel human behavior and eventually become mere myth. That's where Narratives go to die. They become fables, stories that we chuckle at, stories that we shake our heads at and ask "did people really believe in all that?" Michel de Montaigne — who invented the essay as a literary form and was the first blogger, albeit more than 400 years before Al Gore invented the Internet — wrote about the devolution of faith to fable back in the 16<sup>th</sup> century. It's a phenomenon as old as humanity itself. Manifest Destiny ... Cultural Revolution ... these were Narratives every bit as powerful in their day as European Union or Clinton in ours. Now they're historical curiosities, something you come across on a Wikipedia bender.



John Gast, "American Progress" (ca. 1872)



Mao Zedong Thought poster (ca. 1970)

The rarity isn't the Narrative that dies and fades into myth, but the Narrative that survives by re-inventing itself, by finding its words and stories repurposed and retold for a modern ear. For example, the Narrative of the American Founding Fathers is as potent today as it was 100 years ago, maybe more so, and that was before *Hamilton* gave it a new telling and a new power chord.

Why are the status quo protecting Narratives faltering so badly? **I think it's because status quo political and economic institutions — particularly Central Banks — have failed to protect incomes and have pushed income and wealth inequality past a political breaking point.** They made a big bet: we're going to bail-out/paper-over the banks to prevent massive losses in the financial sector, we're going to inflate the stock market so that the household sector feels wealthier, and we're going to make vast sums of money available for the corporate and government sectors to borrow really cheaply. And [as the McKinsey chart here shows](#), by Q2 2014 they had largely succeeded on all counts, certainly in getting the



corporate and government sectors to borrow trillions in new debt. The result, or so the thinking went, of all this pump-priming or bridge-building or whatever metaphor you please would be for all four basic sectors of the global economy — households, corporations, governments, and financial institutions — to consume more and invest more and fail never, which would in turn create a virtuous, self-sustaining cycle of risk taking, real growth, and real wealth creation.

It was a reasonable bet to make. But the bet failed. Why? There's a book or two to write on this, but I'll sum it up this way: **you can no more force corporations to invest for growth if they don't believe it's safe**



**than you can force people to watch John Oliver if they don't think he's funny.**

Sure, they'll tell you that they think he's funny, because everyone knows that everyone knows that John Oliver is funny, and they need to go along with the Common Knowledge to be successful social animals. But in their heart of hearts, they don't think John Oliver is funny. Now to be clear, I'm picking on John Oliver to make a point. Personally, I think he's funny. Some of the time. Well ... kind of funny. I guess. Okay, I don't really think he's very funny. Sorry. And the truth is

that if you paid me to watch HBO, just as Central Banks are basically paying corporations to borrow money, I'm going to watch 20 *Game of Thrones* re-runs before I watch a single episode of *Last Week Tonight with John Oliver*, just as corporations are going to buy back stock and hoard cash 20 times more than invest in new jobs or new equipment.

So what does this have to do with incomes? Two things.

First, little of the increased corporate or government borrowing trickled down into jobs or wage income growth. We've all seen the charts. Real wage growth is nonexistent in the Western world. Second, to make it feasible for corporations and governments to borrow these trillions of dollars in the first place, every bit of Central Bank balance sheet expansion (buying bonds) and balance sheet "twist" (buying longer duration bonds) and expansion of allowable securities for purchase (buying more kinds of bonds) and imposition of negative rates (charging *you* interest if *you* don't buy longish-term bonds) was designed to — you guessed it — buy more bonds and thus drive up bond prices and drive down interest rates, particularly longish-term bond prices and longish-term interest rates. That's great if you're an investor looking for a percentage return on your bond portfolio. **That's terrible, however, if you're an investor looking for an income from your bond portfolio.** Over the past seven years, Central Banks have rewarded the return-seeking bond buyer many times over, and they've done nothing but punish the income-seeking bond buyer.

Put these two income squelchers together — *zero wage income* growth because corporations aren't investing for growth and *less-than-zero investment income* growth because Central Banks have crushed rates — and you have a vast swath of the voting public in every developed nation on Earth that (rightfully!) feels aggrieved and left behind by the gleaming economic recovery that the status quo Narrative Missionaries tout at every turn. Notably, the failure of wage income growth skews younger and Democrat/left. The failure of investment income growth skews older and Republican/right. The status quo Narratives could survive (and have many times) an assault from one wing of the electorate or the other. But from both simultaneously? It's going to be a close call.

But here's the even larger problem lurking in the not-so distant future, and it's found in the behavioral *WHY* of return-seeking bond buyers versus income-seeking bond buyers. [These are two entirely different investor populations from a behavioral perspective, with different languages and different investment genotypes.](#) When I hear an investor or financial advisor ask, "Why in the world would I buy a Swiss bond with a -0.5% interest rate?" I know that I'm talking to an income-seeking bond buyer. The return-seeking bond buyer, on the other hand, says "Hey, if you're right about the world, those Swiss bonds currently yielding -0.5% are going to -1.0%, which means that the price is going up. Where can I buy one of those?"

**The only rational owner of a negative rate bond is a pure return seeker; there are zero income seekers holding negative rate bonds.** Why is this a problem? Because income seekers will continue to own bonds even if the price goes down (for a while, anyway; at the very least, they are sticky owners). Return seekers, on the other hand, are not sticky owners at all. They will only own a bond if they think that the price is going up — meaning in this case that yields will continue to become even more negative, i.e., that there's a greater fool (probably in the form of a Central Bank) willing to pay higher and higher prices for these income-destroying bonds — and they will sell in a heartbeat if they think this dynamic is changing.

There is, to cop a phrase from the People's Bank of China, a massive "one-way bet" on negative rate sovereign debt today. The momentum trade has crystallized to perfection in negative rate bonds, which has grown to become a \$10+ trillion (yes, that's trillion with a T) asset class. **I think it's the most crowded trade in the world from a behavioral or [investment DNA](#) perspective, and the moment you get even a whiff of the ECB or BOJ backing down from or reaching its limit of greater foolishness, you are going to get a rush to the exit on ALL sovereign bonds that will shake global capital markets to their core.** It'll be good times till then, as it always is, and I am seeing zero signs of Central Bankers backing down from their greater foolishness. But we have once again set up the global financial system as an inverted pyramid, with a \$10 trillion asset class poised on a single, solitary piece of Common Knowledge — what everyone

knows that everyone knows. **In 2008, the \$10 trillion asset class of residential mortgage backed securities (RMBS) was entirely based on the Common Knowledge that it was impossible to have a nationwide decline in U.S. home prices. When that Narrative failed, the entire inverted pyramid came crashing down. In 2016, the \$10 trillion asset class of negative rate sovereign bonds is entirely based on the Common Knowledge that there is no limit to the greater foolishness of Central Banks. If this Narrative fails, the entire inverted pyramid will come crashing down again.** Hence my punchline: monitoring this and related status quo protecting Narratives (like [the concerted effort to paint Brexit as a one-off blunder](#), just like [Bear Stearns was painted in 2008](#)) is the only thing that really matters for our investment reality.

What to do? **Convexity, convexity, convexity.** Our portfolios should minimize the maximum risk the world actually presents, not maximize the reward our crystal ball models predict. **Timing, timing, timing.** We need to pay attention to what matters, and right now that's all policy and all Narrative all the time. In a negative rate world, you've got to think in terms of catalysts, not "stocks for the long haul". And one more thing. **To paraphrase Groucho Marx in *Duck Soup*, if a four-year-old can't understand what you're doing in your portfolio, don't do it.** For me, that means real assets and real yield, fractional ownership in real companies with real cash flows from real economic activity with real people. You know, what a stock market used to mean [before it became a Central Bank casino](#). For more on all these points, I'd point you directly to the recent Epsilon Theory notes "[Hobson's Choice](#)" and "[Cat's Cradle](#)".

I know that this all comes across as very negative about the world and our investing future, and that's because it is. To use a poker analogy, we were dealt some bad cards, the Central Banks waaay overplayed the hand, and now we've got to figure out how to extricate ourselves without losing our entire stake. But is this a hopeless situation? No. The most important lesson I ever learned from my mentors in this business is this: always live to fight another day. We can do that. It won't be fun and it won't be pretty and we'll have some scars to show for it, but we can do that. The useful lesson from the Biblical Flood Narrative isn't a pleasant fable about Noah saving the cute and cuddly animals. The useful lesson is that hubris must be confronted, hope is always present, and that preparation and honest actions will see us through any storm. Yes, we can do that.



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