

## It Was Barzini All Along



Tattaglia is a pimp. He never could have outfought Santino. But I didn't know until this day that it was Barzini all along. – *Don Vito Corleone*

Like many in the investments business, I am a big fan of the *Godfather* movies, or at least those that don't have Sofia Coppola in a supporting role. The strategic crux of the first movie is the realization by Don Corleone at a peace-making meeting of the Five Families that the garden variety gangland war he thought he was fighting with the Tattaglia Family was actually part of an existential war being waged by the nominal head of the Families, Don Barzini. Vito warns his son Michael, who becomes the new head of the Corleone Family, and the two of them plot a strategy of revenge and survival to be put into motion after Vito's death. The movie concludes with Michael successfully murdering Barzini and his various supporters, a plot arc that depends entirely on Vito's earlier recognition of the underlying cause of the Tattaglia conflict. Once Vito understood WHY Philip Tattaglia was coming after him, that he was just a stooge for Emilio Barzini, everything changed for the Corleone Family's strategy.

Now imagine that Don Corleone wasn't a gangster at all, but was a macro fund portfolio manager or, really, any investor or allocator who views the label of "Emerging Market" as a useful differentiation ... maybe not as a separate asset class *per se*, but as a meaningful way of thinking about one broad set of securities versus another. With the expansion of investment options and liquid securities that reflect this differentiation – from Emerging Market ETF's to Emerging Market mutual funds – anyone can be a macro investor today, and most of us are to some extent.

You might think that the ease with which anyone can be an Emerging Markets investor today would make the investment behavior around these securities more complex from a game theory perspective as more and more players enter the game, but actually just the opposite is true. The old Emerging Markets investment game had very high informational and institutional barriers to entry, which meant that the players relied heavily on their private information and relatively little on public signals and Common Knowledge. There may be far more players in the new Emerging Markets investment game, but they are essentially one type of player with a very heavy reliance on Common Knowledge and public Narratives. Also, these new players are not (necessarily) retail investors, but are (mostly) institutional investors that see Emerging Markets or sub-classifications of Emerging Markets as an asset class with certain attractive characteristics as part of a broad portfolio. Because these institutional investors have so much money that must be put to work and because their portfolio preference functions are so uniform, there is a very powerful and very predictable game dynamic in play here.

Since the 2008 Crisis the Corleone Family has had a pretty good run with their Emerging Markets investments, and even more importantly Vito believes that he understands WHY those investments have worked. In the words of Olivier Blanchard, Chief Economist for the IMF:

**In emerging market countries by contrast, the crisis has not left lasting wounds.** Their fiscal and financial positions were typically stronger to start, and adverse effects of the crisis have been more muted. **High underlying growth** and low interest rates are making fiscal adjustment much easier. **Exports have largely recovered**, and whatever shortfall in external demand they experienced has typically been made up through an **increase in domestic demand**. Capital outflows have turned into capital inflows, due to both **better growth prospects** and higher interest rates than in advanced countries. ... The challenge for most emerging countries is quite different from that of advanced countries, namely how to avoid overheating in the face of **closing output gaps** and higher capital flows. – April 11, 2011

As late as January 23<sup>rd</sup> of *this year*, Blanchard wrote that “**we forecast that both emerging market and developing economies will sustain strong growth**”.

Now we all know what actually happened in 2013. Growth has been disappointing around the world, particularly in Emerging Markets, and most of these local stock and bond markets have been hit really hard. But if you’re Vito Corleone, macro investor extraordinaire, that’s not necessarily a terrible thing. Sure, you don’t like to see any of your investments go down, but Emerging Markets are notably volatile and maybe this is a great buying opportunity across the board. In fact, so long as the core growth STORY is intact, it almost certainly is a buying opportunity.

But then you wake up on July 9<sup>th</sup> to read in the *WSJ* that Olivier Blanchard has changed his tune. He now says “**It’s clear that these countries [China, Russia, India, Brazil, South Africa] are not going to grow at the same rate as they did before the crisis.**” Huh? Or rather, WTF? How did the Chief Economist of the IMF go from predicting “strong growth” to declaring that the party is over and the story has fundamentally changed in six months?

It’s important to point out that Blanchard is not some inconsequential opinion leader, but is one of the most influential economists in the world today. His position at the IMF is a temporary gig from his permanent position as the Robert M. Solow Professor of Economics at MIT, where he has taught since

1983. He also received his Ph.D. in economics from MIT (1977), where his fellow graduate students were Ben Bernanke (1979), Mario Draghi (1976), and Paul Krugman (1977), among other modern-day luminaries; Stanley Fischer, current Governor of the Bank of Israel, was the dissertation advisor for both Blanchard and Bernanke; Mervyn King and Larry Summers (and many, many more) were Blanchard’s contemporaries or colleagues at MIT at one point or another. The centrality of MIT to the core orthodoxy of modern

economic theory in general and monetary policy in particular has been well documented by [Jon Hilsenrath](#) and [others](#), and it’s not a stretch to say that MIT provided a personal bond and a formative intellectual

experience for a group of people that by and large rule the world today. Suffice it to say that Blanchard is smack in the middle of that orthodoxy and that group. I'm not saying that anything Blanchard says is amazingly influential in and of itself, certainly not to the degree of a Bernanke or a Draghi (or even a Krugman), but I believe it is highly *representative* of the shared beliefs and opinions that exist among these enormously influential policy makers and policy advisors. **Two years ago the global economic intelligentsia believed that Emerging Markets had emerged from the 2008 crisis essentially unscathed, but today they believe that EM growth rates are permanently diminished from pre-crisis levels. That's a big deal, and anyone who invests or allocates to "Emerging Markets" as a differentiated group of securities had better take notice.**

Here's what I think happened.

First, an error pattern has emerged over the past few years from global growth data and IMF prediction models that forced a re-evaluation of those models and the prevailing Narrative of "unscathed" Emerging Markets. Below is a chart showing actual Emerging Market growth rates for each year listed, as well as the IMF prediction at the mid-year mark within that year and the mid-year mark within the prior year (generating an 18-month forward estimate).

EM Growth Rates (%)	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Actual	7.5	8.1	8.0	6.0	2.5	7.4	6.2	4.9		
Mid-yr est.	6.3	6.9	8.0	6.9	1.5	6.8	6.6	5.6	5.0	
18-mo. est.	5.9	6.0	6.6	7.6	6.7	4.7	6.4	6.4	5.9	5.4

Pre-crisis the IMF systematically under-estimated growth in Emerging Markets. Post-crisis the IMF has systematically over-estimated growth in Emerging Markets. Now to be sure, this IMF over-estimation of growth exists for Developed Markets, too, but between the EuroZone sovereign debt crisis and the US fiscal cliff drama there's a "reason" for the unexpected weakness in Developed Markets. There's no obvious reason for the persistent Emerging Market weakness given the party line that "whatever shortfall in external demand they experienced has typically been made up through an increase in domestic demand." Trust me, IMF economists know full well that their models under-estimated EM growth pre-

crisis and have now flipped their bias to over-estimate growth today. Nothing freaks out a statistician more than this sort of flipped sign. It means that a set of historical correlations has “gone perverse” by remaining predictive, but in the opposite manner that it used to be predictive. This should *never* happen if your underlying theory of how the world works is correct. So now the IMF (and every other mainstream macroeconomic analysis effort in the world) has a big problem. They know that their models are perversely over-estimating growth, which given the current projections means that we’re probably looking at three straight years of sub-5% growth in Emerging Markets (!! more than three years after the 2008 crisis ended, and – worse – they have no plausible explanation for what’s going on.

Fortunately for all concerned, a Narrative of Central Bank Omnipotence has emerged over the past nine months, where it has become Common Knowledge that US monetary policy is responsible for everything that happens in global markets, for good and for ill (see “[How Gold Lost Its Luster](#)”). This Narrative is incredibly useful to the Olivier Blanchard’s of the world, as it provides a STORY for why their prediction models have collapsed. And maybe it really does rescue their models. I have no idea. All I’m saying is that whether the Narrative is “true” or not, it will be adopted and proselytized by those whose interests – bureaucratic, economic, political, etc. – are served by that Narrative. That’s not evil, it’s just human nature.

Nor is the usefulness of the Narrative of Central Bank Omnipotence limited to IMF economists. To listen to Emerging Market central bankers at Jackson Hole two weeks ago or to Emerging Market politicians at the G-20 meeting last week you would think that a great revelation had been delivered from on high. Agustin Carstens, Mexico’s equivalent to Ben Bernanke, gave a speech on the “massive carry trade strategies” caused by ZIRP and pleaded for more Fed sensitivity to their capital flow risks. Interesting how the Fed is to blame now that the cash is flowing out, but it was Mexico’s wonderful growth profile to credit when the cash was flowing in. South Africa’s finance minister, Pravin Gordhan, gave an interview to the FT from Jackson Hole where he bemoaned the “inability to find coherent and cohesive responses across the globe to ensure that we reduce the volatility in currencies in particular, but also in sentiment” now that the Fed is talking about a Taper. Christine Lagarde got into the act, of course, calling on the world to build “further lines of defense” even as she noted that the IMF would (gulp) have to stand in the breach as the Fed left the field. To paraphrase Job: the Fed gave, and the Fed hath taken away; blessed be the name of the Fed.

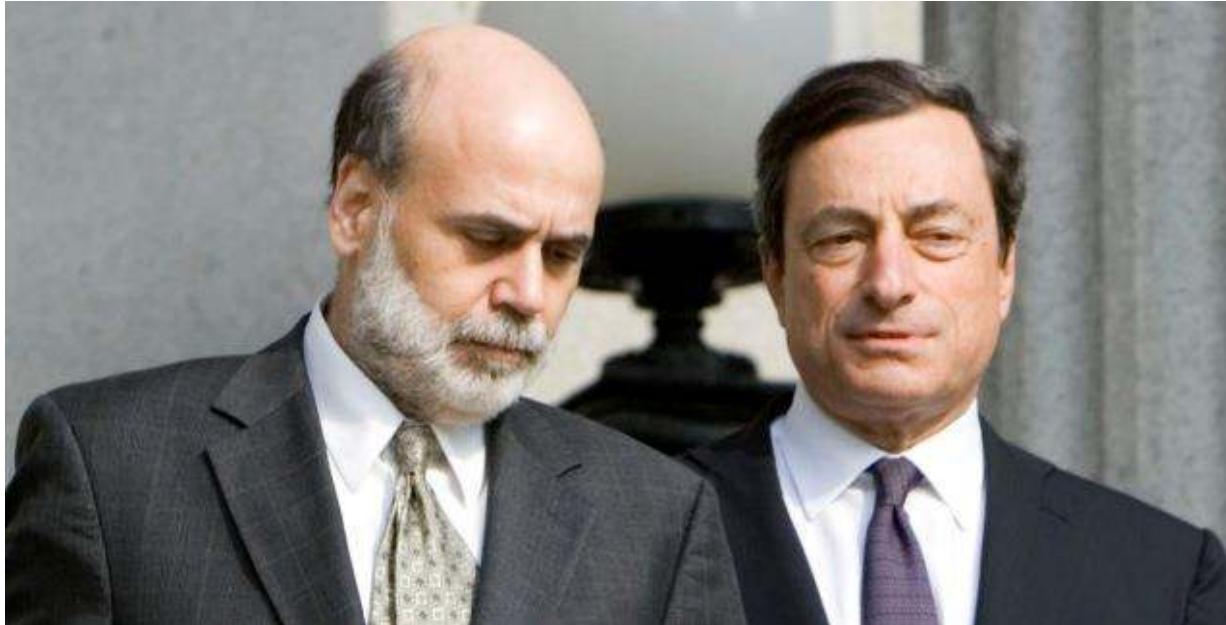
The problem, though, is that once you embrace the Narrative of Central Bank Omnipotence to “explain” recent events, you can’t compartmentalize it there. If the pattern of post-crisis Emerging Market growth rates is largely explained by US monetary accommodation or lack thereof ... well, the same must be true for pre-crisis Emerging Market growth rates. **The inexorable conclusion is that Emerging Market growth rates are a function of Developed Market central bank liquidity measures and monetary policy**, and that all Emerging Markets are, to one degree or another, Greece-like in their creation of unsustainable growth rates on the back of 20 years of The Great Moderation (as Bernanke referred to the decline in macroeconomic volatility from accommodative monetary policy) and the last 4 years of ZIRP. **It was Barzini all along!**

This shift in the Narrative around Emerging Markets – that the Fed is the “true” engine of global growth – is a new thing. As evidence of its novelty, I would point you to another bastion of modern economic orthodoxy, the National Bureau of Economic Research (NBER), in particular their repository of working papers. Pretty much every US economist of note in the past 40 years has published an NBER working paper, and I only say “pretty much every” because I want to be careful; my real estimate is that there are zero mainstream US economists who don’t have a working paper here.

If you search the NBER working paper database for “emerging market crises”, you see 16 papers. Again, the author list reads like a who’s who of famous economists: Martin Feldstein, Jeffrey Sachs, Rudi Dornbusch, Fredric Mishkin, Barry Eichengreen, Nouriel Roubini, etc. Of these 16 papers, only 2 – Frankel and Roubini (2001) and Arellano and Mendoza (2002) – even mention the words “Federal Reserve” in the context of an analysis of these crises, and in both cases the primary point is that some Emerging Market crises, like the 1998 Russian default, force the Fed to cut interest rates. They see a causal relationship here, but in the opposite direction of today’s Narrative! Now to be fair, several of the papers point to rising Developed Market interest rates as a “shock” or contributing factor to Emerging Market crises, and Eichengreen and Rose (1998) make this their central claim. But even here the argument is that “a one percent increase in Northern interest rates is associated with an increase in the probability of Southern banking crises of around three percent” ... not exactly an earth-shattering causal relationship. More fundamentally, none of these authors ever raise the possibility that low Developed Market interest rates are the core engine of Emerging Market growth rates. It’s just not even contemplated as an explanation.

Today, though, this new Narrative is everywhere. It pervades both the popular media and the academic “media”, such as the prominent Jackson Hole [paper](#) by Helene Rey of the London Business School, where

the nutshell argument is that global financial cycles are creatures of Fed policy ... period, end of story. Not only is every other country just along for the ride, but Emerging Markets are kidding themselves if they think that their plight matters one whit to the US and the Fed.



**Market participants today see Barzini/Bernanke *everywhere*, behind every news announcement and every market tick.** They may be right. They may be reading the situation as smartly as Vito Corleone did. I doubt it, but it really doesn't matter. Whether or not I privately believe that Barzini/Bernanke is behind

everything that happens in the world, I am constantly told that this is WHY market events happen the way they do. And because I know that everyone else is seeing the same media explanations of WHY that I am seeing ... because I know that everyone else is going through the same tortured decision process that I'm going through ... because I know that everyone else is thinking about me in the same way that I am thinking about them ... because I know that if everyone else acts *as if* he or she believes the Narrative then I should act *as if* I believe the Narrative ... then the only rational conclusion is that I should act as if I believe it. That's the Common Knowledge game in action. This is what people mean when they say that a market behavior of any sort "takes on a life of its own."

For the short term, at least, the smart play is probably just to go along with the Barzini/Bernanke Narrative, just like the Corleone family went along with the idea that Barzini was running them out of New York (and yes, I understand that at this point I'm probably taking this *Godfather* analogy too far). By going along I mean thinking of the current market dynamic in terms of risk management, understanding that the overall information structure of this market is remarkably unstable. Risk-On / Risk-Off behavior is likely to increase significantly in the months ahead, and there's really no predicting when Bernanke will open his mouth or what he'll say, or who will be appointed to take his place, or what he or she will say. It's hard to justify any large exposure to public securities in this environment, long or short, because all public securities will be dominated by this Narrative so long as everyone thinks that everyone thinks they will be dominated. This the sort of game can go on for a long time, particularly when the Narrative serves the interests of incredibly powerful institutions around the world.

But what ultimately saved the Corleone family wasn't just the observation of Barzini's underlying causal influence, it was the strategy that adjusted to the new reality of WHY. What's necessary here is not just a gnashing of teeth or tsk-tsk'ing about how awful it is that monetary policy has achieved such behavioral dominance over markets, but a recognition that it IS, that there are investment opportunities created by its existence, and that the greatest danger is to continue on as if nothing has changed.

I believe that there are two important investment implications that stem from this sea change in the Narrative around Emerging Markets, which I'll introduce today and develop at length in subsequent notes.

First, I think it's necessary for active investors to recalibrate their analysis towards individual securities that happen to be found in Emerging Markets, not aggregations of securities with an "Emerging Markets" label. I say this because in the aggregate, Emerging Market securities (ETF's, broad-based funds, etc.) are now the equivalent of a growth stock with a broken story, and that's a very difficult row to hoe. Take note,

though, **the language you will have to speak in this analytic recalibration of Emerging Market securities is Value, not Growth, and the critical attribute of a successful investment will have little to do with the security's inherent qualities (particularly growth qualities) but a great deal to do with whether a critical mass of Value-speaking investors take an interest in the security.**

Second, there's a Big Trade here related to the predictable behaviors and preference functions of the giant institutional investors or advisors that – by size and by strategy – are locked into a perception of Emerging Market *meaning* that can only be expressed through aggregations of securities or related fungible asset classes (foreign exchange and commodities). These mega-allocators do not “see” Emerging Markets as an opportunity set of individual securities, but as an asset class with useful diversification qualities within an overall portfolio. **So long as market behaviors around Emerging Markets in the aggregate are driven by the Barzini/Bernanke Narrative, that diversification quality will decline, as the same Fed-speak engine is driving behaviors in both Emerging Markets and Developed Markets.** Mega-allocators care more about diversification and correlations than they do about price, which means that the selling pressure will continue/increase so long as the old models aren't working and the Barzini/Bernanke Narrative diminishes what made Emerging Markets as an asset class useful to these institutions in the first place. But when that selling pressure dissipates – either because the Barzini/Bernanke Narrative wanes or the mega-portfolios are balanced for the new correlation models that take the Barzini/Bernanke market effect into account – that's when Emerging Market securities in the aggregate will work again. **You will never identify that turning point in Emerging Market security prices by staring at a price chart. To use a poker analogy you must play the player – in this case the mega-allocators who care a lot about correlation and little about price – not the cards in order to know when to place a big bet.**

In future weeks I'll be expanding on each of these investment themes, as well as taking them into the realm of foreign exchange and commodities. Also, there's a lot still to be said about Fed communication policy and the Frankenstein's Monster it has become. I hope you will join me for the journey, and if you'd like to be on the direct distribution list for these *free* weekly notes please sign up at [Follow Epsilon Theory](#).