March 1, 2016

“Welcome to the Jungle”

Zero-sum, Elliot. You're playing a game you already lost. You know I'm right.
– “Mr. Robot” (2015)

You can have anything you want
But you better not take it from me
– Guns N' Roses, “Welcome to the Jungle” (1987)

I'm not expecting it. I'm observing it.
– George Soros, January 22, 2016

To do that would mean, not merely to be defeated, but to acknowledge defeat -- and the difference between these two things is what keeps the world going.
– Upton Sinclair, “The Jungle” (1906)

Trump: My whole theme is make America great again. We don't win anymore as a country. We don't win with trade, we don't win with the military. ... We're going to make a great country again. We're going to start winning again. We're going to win a lot, it's going to be a big difference, believe me. ... I don't mind trade wars when we're losing $58 billion a year.
– Republican presidential debate transcript, February 25, 2016

Sanders: The wages that high school graduates receive today are significantly less, whether you are white or black, than they used to be. Why is that? Because of a series of disastrous trade policies which have allowed corporate America through NAFTA and Permanent Normal Trade Relations with China ... [which] have enabled corporate America to shut down in this country, throw millions of people out on the street.
– Democratic presidential debate transcript, February 11, 2016

Question: You supported Obama's trade deal, the Trans-Pacific Partnership or TPP, dozens of times. You even called it the "gold standard." Now, suddenly, last week, you're against it.

Clinton: Well, actually, I have been very consistent. ... I did say, when I was secretary of state, three years ago, that I hoped it would be the gold standard. It was just finally negotiated last week, and in looking at it, it didn't meet my standards. My standards for more new, good jobs for Americans, for raising wages for Americans. And I want to make sure that I can look into the eyes of any middle-class American and say, "this will help raise your wages." And I concluded I could not.
– Democratic presidential debate transcript, October 13, 2015

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There is one great positive-sum game in all of human economic history -- trade. But there are periods of time in human history when this core engine of growth and prosperity falters, when it becomes, *at best*, a zero-sum game of equal winners and equal losers. We are entering one of those times.

Why? Because this is what ALWAYS happens as independent nations struggle with the domestic political consequences of massive debt. Debt begets wealth inequality. Wealth inequality begets political polarization. Political polarization begets shocking electoral outcomes as the median voter theorem fails and shocking market outcomes as the central tendency fails. So go ahead ... ask Nate Silver how well his electoral models are working. Ask any Fed staffer how well their econometric models are working. Democracy is hacked, not in the sense of some Mr. Robot f-society conspiracy, but in the sense of what Sen. Lindsey Graham appropriately calls “bats**t crazy” domestic political behavior, behavior that ALWAYS emerges under these circumstances. It happened in the 1870s. It happened in the 1930s. It's happening today. As George Soros would say, I'm not expecting it. I'm observing it.

Under the strain of domestic policy errors and domestic policy uncertainty (uncertainty in the technical sense of the word, where neither outcomes nor probability distributions can be known), global trade volumes and global trade prices ALWAYS roll over. Again, this happened in the 1870s, it happened in the 1930s, and it's happening today. And when this global economic pie begins to shrink, the strategic interaction between nations inexorably changes from a Cooperative game to a Competitive game (read "The Silver Age of the Central Banker" for more). This is the moment where trade activity -- in goods, services, and capital -- shifts from a positive-sum game to a zero-sum game, where domestic political institutions ALWAYS shift towards protectionist policies. In the modern context, this political shift takes place primarily in monetary policy, specifically monetary policy that impacts currency exchange rates. Why? Because currencies are the linchpin for both trade in goods and trade in capital. Currency intervention is the quickest and most direct way to protect your slice of a smaller and smaller pie, even though it's exactly this currency intervention, when done by everyone, that is making the pie shrink.

I can't emphasize strongly enough how this politically-driven shift in the equilibrium payoffs of global trade and capital flows -- and its expression in monetary policy focused on currency exchange rates -- changes *everything* for investors.

But I also can't tell you how this all ends up. I know this is a really disappointing statement I'm about to make, but the outcome of most Competitive Games is not predictable. And by "not predictable" I don't mean that there's an equal chance of this or that outcome. I mean that any attachment of any probability distribution to any set of potential outcomes just doesn't work in a predictive sense. Or if it does work, then it worked by pure luck. For example, there are two equilibrium outcomes in a game of Chicken, but that doesn't mean that each equilibrium is equally likely. It means that the entire concept of likelihood or probability functions has no *meaning* here (read "Inherent Vice" for more). It means that the entire econometric toolkit is about as useful as a socket wrench kit is useful in baking a cake. Again, I know how hard it is to wrap one's head around this fact, and I know that many readers will just reject it out of hand. But it's still true.

So I can't tell you what the ultimate outcome of this Competitive Game between nations will be. But I can tell you what the *process* of this game will be. I can tell you what the *dynamic* of this game will be. I can give you a perspective that works for the times we're in, and I can identify specific asymmetric risk/reward set-ups (but call them by their proper name -- trades -- not "investments"). That's the most that is *possible* here, and I think anyone who says otherwise is mistaking luck for skill.

What is the dynamic of the Competitive Game of nations here in 2016? Specifically, what's next? I think I can sum up my views in two pictures.

First, here's a group shot from the G-20 meeting that just concluded in Shanghai. There's Christine Lagarde of the IMF on the left, the belle of the ball ... and then there's Janet Yellen on the right, looking about as uncomfortable as it's possible for a human to look.

[Photo: Rolex Dela Pena / AFP]

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Frankly, as an American ... and as someone who recognizes that the nature of the international game has changed from Cooperation to Competition ... I'm pleased that Yellen isn't all buddy-buddy with her fellow conferees. That's no slight on Lagarde -- her institution is intentionally designed to promote the Cooperation game, she offers carrots rather than swings a big stick, and it makes perfect sense that anyone who runs the IMF would be highly charismatic and the life of the party (true for her predecessor, DSK, too, although maybe he was too much the life of the party ... just sayin'). Yellen, on the other hand, has no institutional mandate for international cooperation and swings the meanest stick, by far, in the global economy. Yellen is the big stack, to use a poker playing analogy (poker being a zero-sum game, of course), and short of wearing a hoodie and mirrored shades to convey intimidation and an intentional separation from the crowd -- an effective big stack strategy, by the way -- I can't think of more effective game-playing body language than Yellen displays here.

So what's next for this high-stakes poker game? **A series of raises (in the poker sense!) from Europe and Japan, with the US calling and checking down every step of the way, until ultimately China goes all-in by floating the yuan or otherwise sharply devaluing their currency.** Less metaphorically, that means I expect the ECB to lower its negative interest rates significantly this week, and the Bank of Japan will do ... something ... of similar or greater magnitude later in March. The US will be dragged from its current tightening bias to a neutral bias (maybe as early as the March meeting, but probably not), and then to an easing bias, and then to actual easing. But the US won't be initiating any of these moves, they will be responding to the actions of the ECB and the BOJ.

With every action by the ECB and the BOJ, the dollar gets stronger, oil and commodities go lower, and S&P 500 earnings get hit. That's bad for the US and it's bad for China and it's bad for global trade and it's bad for the global industrial and commodity complexes, but if you're Draghi or Kuroda you really don't care. Or rather, they might care, but when the payoff from being a currency "defector" becomes potentially greater than the payoff from being a currency "cooperator", there's a dominant strategy and it's called beggar-thy-neighbor.

That same dominant strategy exists for the US and China. For the US that means turning the monetary policy barge around from tightening to easing, and with every move Yellen makes, the dollar will go down, oil and commodities will go up, S&P 500 earnings will look better, and equity markets will rally. But it's a short-term rally because this will only spark further currency-weakening actions by the ECB and the BOJ, starting another leg down in the protectionist spiral. Wash, rinse, repeat.

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The big loser in this spiraling dynamic is China. To torture the poker analogy a bit more, they're the short stack at this table -- not from a purely economic perspective (that's Japan), but from a political perspective (where Japan may actually be the strongest). It's political strength that matters most in this game, and the Chinese political regime is existentially vulnerable to declining volumes of global trade. They have no choice but to go all-in here to spur exports and domestic industrial production, and at some point they will. There are several ways China can shove their chips into the pot, but my guess is that they go all-in by floating the yuan. That will be the risk-off moment of this or any other year, an atomic bomb of deflationary power, and I think it's an easy putt from there to negative rates in the US.

Yes, that's right. Negative rates in the US. It's coming. It's inevitable, really, not because the FOMC wants negative rates -- they don't -- but because they must pursue negative rates out of national self-interest and sheer self-defense in a Competitive game where your adversaries (get used to that word) have rolled out the equivalent of mustard gas in the trench warfare that we're going to endure.

And that brings me to my second photo that's worth a thousand words, this from a recent meeting of Sweden's central bank, prior to their February reduction of interest rates to -0.5%.

"We have become seasoned. Things which once made us say 'oh my God' don't seem that dramatic anymore."
-- Sweden Riksbank Deputy Gov. Per Jansson (on left)

[Photo: Associated Press]

I mean, this is what it's come to, right? Where smirking Ph.Ds who have never spent a day of their adult lives outside of the governmental or academic womb, where earringed, pony-tailed apparatchiks who have never managed a dime, who have never counseled a retired couple trying to live on their savings, now unilaterally and without limitation make political decisions that determine the fate of that retired couple. Not just in Sweden, but everywhere in the world. Yeah, I shouldn't mention the whole earring and pony-tail thing, but you know what? It's an intentional statement of identity, an identity that I recognize from my decade as a political science professor, an identity that not only elevates elegant theory over practical experience, but more than that, *dismisses* practical experience as inherently inferior to the tenets of an academic faith. It's the hubris, the overweening pride that oozes from this photo that makes me cringe. We've seen this movie before, and it always ends in tears. There's a reason that Pride is one of the Seven Deadly Sins, and nowhere is pride more dangerous than when it comes to financial "innovation." What the Gaussian copula was to securitized mortgages in 2008, negative rates are to monetary policy in 2016.

But here's the thing, and this is true for any Competitive game, whether it's poker or World War I or a Republican primary or strategic monetary policy -- **once one player enjoys some success with a new strategy or a new weapon, ALL players must adopt that strategy or weapon, regardless of whether or not a player thinks it's distasteful or misguided.** Even if you think you're doing the wrong thing in the long run, if you don't adopt the new strategy you're going to lose in the short run, and that's something no politician and no central banker can stomach. I'm reminded of the (in)famous line from Chuck Prince, former Citigroup CEO, in 2007: "When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you've got to get up and dance." Just as all of the big banks were dancing to the music of Alt-A mortgages and trillions of dollars in mortgage-backed securitizations in 2007, so are all central bankers dancing to the music of negative rates and currency devaluation today. It was the rational move for Prince and Fuld and Thain and Mozilo then, and it's the rational move for Yellen and Draghi and Kuroda and Zhou today. Once negative rates (or liar loans or Trump-esque campaign tactics) are introduced into the field of battle you can't wish them away. You have to fight fire with fire until a big structure burns down, with the hope that at that point everyone can get together and rebuild. Or you can surrender. Welcome to the jungle.

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