MAI VIEW

VOL. XVII, NO. XXXI | www.macro-allocation.com | JULY 5, 2017

On the Couch

"Science may have found a cure for most evils; but it has found no remedy for the worst of them all – the apathy of human beings."

- Helen Keller

It used to be that the direction of stocks was determined by the general mood of investors, and so the market had a "personality" derived from collective human traits like greed and fear and everything in between. Today, the market's level – both price and value – is no longer determined by humans. "Capital" that flows in and out of stocks is actually unreserved credit steered by central banks, and the marginal daily decision makers are tied to pre-set liability, volatility, and algorithmic investment programs.

While *market narratives* remain the property of free-thinking investors and policymakers with all sorts of opinions and responsibilities, *market dynamics* have become the domain of quants and software indifferent to words, theory or subjectivity. Price and value are on an entirely different track than un-coded human thought, and it is unclear when the train will meet again. The broad market has become a steaming pile of self-reinforcing financial detritus, and most institutions and gadflies promoting its central role in society – beyond being a survey of social sentiment – sit somewhere along a spectrum of delusion.

Indeed, the contemporary financial environment reminds one more of today's political climate – framed by <u>A</u>pathy, <u>A</u>gnosticism, <u>A</u>ngst and <u>A</u>nger – than of capital markets supportive of sustainable output, stable prices and full employment. Warren Buffet recently observed that the largest businesses no longer require capital, which in turn implies that the markets no longer raise or price capital. Here, here.

If a self-reflexive market determines its own price and value, then abandoning active management altogether would seem to be the smart play. Hmmm. Indeed, many investors, allocators, and fiduciaries must believe this because they have already opted out, preferring to embrace the idea of *market beta exposure* or *quant investing* to that of an old-school, often relationship-linked reliance on picking winners.

We think investors relying on meta-markets will eventually get slaughtered in real (inflation-adjusted) terms, either when the nominal levels of market indexes drop to reflect sustainable capital-producing value or when central banks print even more unreserved credit to support asset levels in nominal terms. Show us the <u>A</u>lgorithm (another "A"!) that includes either of these two paths. It does not exist.

"Imagination is more important than knowledge."

- Albert Einstein

Knowledge is a collection of information, and intelligence is the ability to apply it. All the data known to man can be manipulated to extrapolate the odds of future investment success given certain conditions, but it cannot imagine paths and outcomes not accurately identified on a latticed option model. Software is only as smart as its programmers and it is dangerous to mistake knowledge-based quant investing for Artificial Intelligence (a fifth "A"!). Many investors are nevertheless migrating to investment programs that rely on coded models at the expense of those that rely on less defined human cognition. Why? Perhaps because Applied mathematics seeks to make the future statistically provable (i.e., the past can be correctly extrapolated forward), and therefore more compelling to insecure fiduciaries? It cannot.

The intellectual blind spot of quant investing is structural change, which requires intuition, imagination and human foresight. It occurs periodically like clockwork. Extrapolated models are inherently prone to substantial tail and Black Swan risks. Regulators, policymakers, central bankers and Wall Street should not be relied upon for warning. They are in the business of promoting confidence and involvement, and will not protect the investor class from itself. In *Get Angry* (March 3, 2017) we wrote:

> "We are angered by the elite conceit still on offer from parties benefitting from this unsustainable state of affairs and the collective passivity of public intellectuals and investors unwilling to think for themselves, identify obvious problems, and take action. Their benign neglect or, worse, near unanimous intention to exacerbate the problem through fiscal profligacy, actually evokes excitement among economists and investors. Lost in the frenzy is recognition of a dangerous financial and social setup. The preponderance of "free market" investors and allocators are betting their performance, compensation, careers and sense of self-worth on the hope that Trump Keynesianism and reforms will get them one or two more bonuses, and, failing that, that central banks will monetize financial assets at full value in real terms."

Someday, the market and its reliance on programmatic investing will face a severe reality check. Investors will have no incentive to swap one form of unreserved credit for another. Wealth will be lost, forever for most long-only baby boomers. They will then hoard whatever purchasing power remains and focus on stores of value. The cost of not suffering such a fate is relatively minimal today, but doing so is unpopular.

And so if today's market had a personality type, what would it be? Type-A personalities are known for excessive ambition, aggression, drive, impatience and the need for control. None of that describes the passivity of most investors today. Type-Bs are relaxed, less stressed, flexible, and have a laid-back attitude. "Laid back" does seem to describe the shift towards passive investing, but not the underlying Anxiety-ridden shift in the market's negatively convex valuation or the wholesale dis-intermediation of market-maker and policymaker influence. Type-Cs seem quiet and thoughtful, but are in fact frustrated and angry. That better describes old-school analysts like us who loathe current valuations and are suspicious of trusting highly levered financial markets with accumulated wealth. Type Ds are chronically distressed. Nothing could be further from describing today's market indexes at or near all-time highs. *We need a new personality description for the "A-hole" the market is in*. Suggestions welcomed.

Paul Brodsky
Macro Allocation Inc.
PostModern Partners

Property Notice & Disclaimer

The information contained in this document is for general information purposes only. It is provided by Macro Allocation Inc to Subscriber/Members, and, while we endeavor to ensure the information is up-to-date and correct, we make no representations or warranties of any kind, express or implied, about the completeness, accuracy, reliability, suitability or availability with respect to this document or the information, products, services, or related graphics contained in this document for any purpose. Nothing in this document should be taken to constitute professional advice or a formal recommendation, and we exclude all representations and warranties relating to the content and use of this document. Any reliance you place on such information is therefore strictly at your own risk.

In no event will Macro Allocation Inc, its affiliates, and employees be liable for any loss or damage including, without limitation, indirect or consequential loss or damage, or any loss or damage whatsoever arising from loss of data or profits arising out of, or in connection with, the use of this document.

Through this document you may infer that other sources of information mentioned in it could provide suitable analysis related to issues on which you may act and suffer damages. Any mention or reference herein does not necessarily imply a recommendation or endorse the views expressed or implied by it.

Macro Allocation Inc reserves the right to revise and amend this disclaimer notice from time to time and any revised version will be deemed to be applicable from the first date of publication of this document.