MBS Mantra, LLC

Financial Economics Summarized – 11/26/2022

I was discussing last months 'All Roads Start with Paul Volcker' with an economist, and the following thought occurred to me.

- **Microeconomics determines prices – when marginal demand meets marginal supply.**
- **Macroeconomics provides the incentives for microeconomics**

As far as I am concerned **microeconomics is a science**. Prices in markets are always a result of the negotiations of buyers and sellers. There is no such thing as a 'black swan event' when market prices decline – price changes are always the result of buyers or sellers changing their view of value resulting in an imbalance.

Macroeconomics does not work as precisely as microeconomics. This becomes the realm of statistics and probabilities, as incentives provided by central bankers, from the perspective of central bankers, do not transmit as precisely or as expected.

I believe that the expectations issue is due to central bankers, who provide incentives, only looking at the subset of outcomes in their local economy. This perceived imprecision is largely due to leakages from carry trades, which are driven precisely by microeconomics. **In other words, macro incentives might be working scientifically, but the complete set of outcomes is not being measured.**

This creates the scope for Behavioral Economics, such as that in the work of Daniel Kahneman.

The link above from UChicago about describes Behavioral Economics as trying to understand '*how and why people behave the way they do in the real world. It differs from neoclassical economics, which assumes that most people have well-defined preferences and make well-informed, self-interested decisions based on those preferences*.'

Focusing on financial markets, I believe this is misstated. In financial markets, a subset of people do behave precisely in a Pavlovian manner in response to incentives provided by central bankers. **Behavioral economics should instead be the study of why people DO NOT behave in the way defined by microeconomics**. People that are not responding to incentives usually do not impact prices, but result in the inefficient transmission of incentives.

The perceived imprecision of macroeconomics leads central bankers to use bigger sticks or nuclear options, to force all people to respond to their incentives. **The ultimate weapon is Quantitative Easing (QE),** which is implemented as money supply created from interest rates policy is not being used – money velocity has peaked and is declining. This results in excessive money supply that results in asset inflation and speculative bubbles: Bezzle (see next section).

Bezzles burst when counter-incentives are supplied. Microeconomics forces lead to rational declines in financial prices that are viewed as 'Crises', Black Swan events, and 'Minsky moments'

Understanding Beta – Determinants of the US Stock Market demonstrates that Macroeconomic incentives are not as imprecise as perceived by economists and central bankers. The model has a 96% adjusted R-squared, far more precise than most models in science. (I have identified and used a broader set of macro incentives than used by most economists.)

The key is to have a complete set of measurements.

When looking at price outcomes, as I did, the complete set of incentives and counter-incentives need to be identified and measured. When viewed from the perspective of a single set of incentives (ie the policy of a single central bank), the complete set of outcomes needs to be identified and measured.

Bezzle – a most important word for Economics and Finance that I learned recently

Thanks to the FT. (from the link below)

https://carnegieendowment.org/chinafinancialmarkets/85179

https://www.ft.com/content/0e375355-85c7-4c4e-87fc-5e73ac268196

Bezzle, a word coined by Galbraith, explains what we are currently undergoing, with FTX and crypto blowing up, and PE ratios for most assets, but tech especially, declining – asset inflation deflating.

I'm not going to try and regurgitate the pieces, but I assure you they are worth your time to read them.

Regards, Samir Shah

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