

“The Minsky Moment Meme”



That’s not how it works. That’s not how any of this works.

– Esurance “Beatrice” commercial

There’s a wonderful commercial in heavy rotation on American television, where three women of a certain age are discussing one of the friend’s use of Facebook concepts such as “posting to a wall” or “status updates”. The protagonist of the scene, Beatrice, takes these concepts in an entirely literal way, attaching actual photographs to an actual wall and delivering an un-friending message in person, at which point her more hip friend says, “That’s not how it works. That’s not how any of this works.”

I have exactly the same reaction to today’s overuse and misuse of the phrase “Minsky Moment”, originally coined by PIMCO’s Paul McCulley to describe how economist Hyman Minsky’s work helped explain the market dynamics resulting from the 1998 Russian financial crisis, such as the collapse of investment firms like Long Term Capital Management. **Today you can’t go 10 minutes without tripping over an investment manager using the phrase “Minsky Moment” as shorthand for some Emperor’s New Clothes event, where all of a sudden we come to our senses and realize that the Emperor is naked, central bankers don’t rule the world, and financial assets have been**

artificially inflated by monetary policy largesse. Please. That's not how it works. That's not how any of this works.

Just to be clear, I am a huge fan of Minsky. I believe in his financial instability hypothesis. I cut my teeth in graduate school on authors like Charles Kindleberger, who incorporated Minsky's work and communicated it far better than Minsky ever did. Today I read everything that Paul McCulley and John Mauldin and Jeremy Grantham write, because (among other qualities) they similarly incorporate and communicate Minsky's ideas in really smart ways. But I'm also a huge fan of calling things by their proper names, and "Minsky Moment" is being bandied about so willy-nilly these days as a name for so many different things that it greatly diminishes the very real value of Minsky's insights.

So here's the Classics Comic Book version of Minsky's financial instability hypothesis. Speculative private debt bubbles develop as part and parcel of a business/credit cycle. This is driven by innate human greed (or as McCulley puts it, humans are naturally "pro-cyclical"), and tends to be exacerbated by deregulation or laissez-faire government policy. Ultimately the debt burdens created during these periods of market euphoria cannot be met by the cash flows of the stuff that the borrowers bought with their debt, which causes the banks and shadow banks to withdraw credit in a spasm of sudden fear. Because there's no more credit to be had for more buying and everyone is levered to the hilt anyway, stuff either has to be sold at fire-sale prices or debts must be defaulted, either of which just makes the banks withdraw credit even more fiercely. The Minsky Moment is this spasm of private credit contraction and the forced sale of even non-speculative assets into the abyss of a falling market.

Here's the kicker. **Minsky believed that central banks were the solution to financial instability, not the cause.** Minsky was very much in favor of an aggressively accommodationist Fed, a buyer of last resort that would step in to flood the markets with credit and liquidity when private banks wiggled out. In Minsky's theory, you don't get financial instability from the Fed massively expanding its balance sheet, you get financial stability. Now can this monetary policy backstop create the conditions for the next binge in speculative private debt? Absolutely. In fact, it's almost guaranteed to set up the next bubble. But that's a problem for another day.

If you don't have a levered bubble of private debt you can't have a Minsky Moment. Do we have one today? Sorry, but I don't see it. I see crazy amounts of public debt, a breathtaking level of nitroglycerin-like bank reserves, and a truly frightening level of political fragmentation within and between every nation on earth. All of these are problems. Big problems. HUGE problems. But none of

them create a private debt bubble. To be sure, we can all see worrisome *examples* of speculative excess popping up in every financial market. But that's a far cry from a bubble, even a garden-variety tech bubble or LBO bubble, much less something like the housing bubble of 2004-2007 where private Residential Mortgage-Backed Securities (RMBS) went from practically nothing to a \$4 trillion debt asset class. Maybe a private debt bubble is building somewhere, but it ain't here yet. The one place I see a potential private debt bubble is in China around infrastructure construction (which looks suspiciously like American railroad financing in the 1870's), but even there it's far from clear how levered this effort is, and it's perfectly clear that the debt is inextricably intertwined with public and pseudo-public financing.

Why is the distinction between a public debt bubble (which we have) and a private debt bubble (which we don't) so important? Because a private debt bubble is always ultimately popped as Minsky suggests, with current cash flow concerns and a surprise default prompting private lenders to turn off the spigot of credit. It doesn't work that way with a public debt bubble. It doesn't work that way because current cash flow is only a minor part of the sovereign debt purchase calculus, at least when it comes to a major country. It doesn't work that way because central banks can purchase a government's debt securities, either directly as in Japan or indirectly as in the US. It doesn't work that way because public debt is always and in all ways a massive confidence game, dominated by the [Common Knowledge Game](#). Put simply, **sovereign debt does not have the same meaning as private debt**, and that makes all the difference in the world in how our current market environment ultimately plays out.

It's why I am negatively inclined towards investment managers that use fundamental economic rationales as the basis for some can't-miss trade that Country _____ [fill in the blank] will inevitably implode. Just look at the difference between Spanish or Portuguese sovereign debt yields in the summer of 2012 (trading like a distressed corporate credit about to go BK) and those same bonds today (trading close to all-time highs). Did the Spanish and Portuguese economies experience some miraculous renaissance, some explosion of real economic growth to support enormously tightened spreads at a fundamental level? Yeah, right. No, what happened was that Mario Draghi and Angela Merkel made a **political** statement – “whatever it takes” – to create an informational structure where everyone knows that everyone knows that the European Powers That Be will not allow Spain and Portugal to default. That's it. That's all it took. Just words. Words that have no place in Minsky's theory (or any economic theory), but are the beating heart of the Common Knowledge Game.

Can a public debt bubble pop? Of course it can! **But the dynamic process that leads to a public debt bubble popping has very little to do with Minsky's theory and a whole lot to do with game theory, very little to do with economics and a whole lot to do with politics.** It's this game theory piece that last week's Epsilon Theory note, "[When Does the Story Break?](#)" tried to explain.

To recap ... no money manager I know thinks that the real economy is off to the races, which is why the long end of the yield curve remains so depressed and no one trusts these stock market highs. US GDP was negative in Q1 of this year! I don't care what the weather was like, that's nuts. And global growth is even more anemic. But at the same time, no money manager I know thinks that the Fed will **allow** financial markets to crack. The QE genie is out of the bottle, and there's no putting it back in regardless of whether the Taper gets all the way back to zero monthly purchases or not. **There is an unbelievably strong Common Knowledge informational structure around the unlimited power of central banks to control market outcomes – what I call the [Narrative of Central Bank Omnipotence](#) – and until that confidence game is broken this public debt bubble will not be popped.**

Look, I totally understand why so many investors, [particularly dyed-in-the-wool value investors](#), are so frustrated with the repercussions of Zero Interest Rate Policy (ZIRP). When the risk-free rate is nothing, of course you are forced to reach for yield. The Fed has successfully pushed **everyone** into buying riskier assets than they would otherwise prefer to do. But just because you're frustrated is no reason to believe that the situation **must** change. **Just because you have personal experience with private debt bubbles and a catchphrase (Minsky Moment!) to describe those experiences does not mean that you are looking through the right lens at today's market environment of a coordinated public debt bubble throughout the Western world.** This is a different animal, unseen since the 1930's, and it requires a different vocabulary and perspective. That's what I'm trying to provide with [Epsilon Theory](#).

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