DOWGATE CURIOUS INVESTOR - ISSUE 11
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'Markets, mind, or matter?'

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In November 2008, eight weeks after the collapse of Lehman Brothers, markets were in freefall; the UK stock market was down 35% over the previous 12 months, and London inter-bank lending had evaporated. The banks were being sustained in financial intensive care by taxpayer bailouts, a moment in our economic history that resonates fifteen years later. Amidst all this, the late Queen visited the London School of Economics (LSE) to open a new building. She gently enquired why none of them had noticed all this, and an awkward silence followed. To the extent anyone has subsequently answered the royal question, it has not been the orthodox economics profession. Instead, more answers have emerged from the thoughts of financial market practitioners.

Market participants often refer to the market's mood and its expectations. They confer the market with a personality. Benjamin Graham, the father of value investing, much beloved by Warren Buffet, talked about Mr Market with emotions that gyrate share prices. As Buffet simplified it, buy when markets are fearful and sell when they are greedy.

Investor George Soros also wrote about understanding the market's mind. While studying at the LSE in the 1950s under the Austrian philosopher of science, Karl Popper, the young Soros was disturbed by the contradiction between Popper's theory of knowledge, emphasising man's imperfect understanding of the world, and the theory of perfect competition, enshrined in economic orthodoxy.

After the LSE, George's first job was in the arbitrage department of a London merchant bank, where his real-world financial experience confirmed his belief that markets were, in fact, fallible but also reflexive. His book, The Alchemy of Finance, was subtitled Reading the Mind of the Market. Although academic economists attacked Soros's lack of intellectual rigour, it was harder to argue with the investment success he achieved by its application.

While investors like Graham and Soros were writing about their experiences of an organic market with human-like behaviour, economics had succumbed to rational economic man. For them, the economy was akin to a smoothly running machine that tended to equilibrium. Aggregated economic data were measured and modelled. The models were simplified such that anything complicated (like a financial crisis) was considered an exogenous variable (a given). Despite their simplicity, these models were used to derive new economic policies.

Economics had been overcome by physics envy. Economists were in awe of particle physics mathematical precision, and it became simplified and quantified. Little did it matter that particle physics and markets are different, if you assume the awkward, messy things away, and markets follow known laws, just like physics. But physicist Richard Feynman got the point in saying, imagine how much harder physics would be if electrons had feelings.

Investors, like Graham and Soros know markets are messy, chaotic, and fallible and understood that there was more learn from psychology than physics when studying markets. Another investor, Patrick Schotanus, has recently developed a new synthesis of economics and cognitive science with his book, The Market Mind Hypothesis (MMH). He holds that economics' mechanical worldview based on simplified rational economic agents leads to faulty thinking and practices. Instead, he offers a worldview akin to complexity theory, in which markets and economies are, like us, best understood as complex adaptive systems, more organic than physical. While behavioural economics allows for some cases of human bias that deviate from the presumed rational norm, MMH fully aligns economics with neuroscience and psychology, asking fundamental questions about the nature of human consciousness and intelligence.

Options trader turned philosopher of probability Nassim Nicholas Taleb is another experienced market participant who understands market psychology and timing. He wrote his second book, the Black Swan: The Impact of the Highly Improbable, a year before the Global Financial Crisis and the Queen's visit to the LSE. But unlike her hosts, Taleb would have wasted little time answering her question. He knew that market efficiency assumptions and financial risk measures relying on deviations from a normal distribution (Value at Risk or VAR scores) used by banks were shortcuts unfounded upon any practical understanding of how markets work.

In a later book, Antifragile, Taleb distinguished deterministic from adaptive systems by comparing a rabbit and a washing machine. A washing machine exists for a reason. Its purpose is to wash clothes and improve efficiency, and for as long as it serves its purpose, it will survive. In contrast, rabbits, humans, and market processes, unlike washing machines, have built-in error correction, allowing them to advance their knowledge one setback at a time. They might not exist for any explicit reason, but they only survive for a reason. As the saying goes, what does not kill us makes us stronger.

Markets like us, (and one presumes, rabbits) are periodically prone to bouts of hubris and humility, causing episodic financial bubbles and crises. However, with the help of the philosopher market professionals such as Graham, Soros, Taleb and Schotanus, investors can be better prepared to read the market mood and "error correct" for future success in what is a case of mind over matter.

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JACKSON'S CHART - GOLD (WEEKLY)
An analysis by Jackson Wray

Source: TradingView.com

EXPLANATION

In Issue 1 of The Curious Investor, Gold was sat on 3 critical support at the 1920 region. This area failed to hold, and price action trickled down to the 1800 region to confirm a new area of importance, shown here by the rectangular zone. Price then gravitated to the broken trend-line support and has been fighting this resistance ever since, with an initial rejection on October 23 and an unconfirmed breakout at the end of November. Although momentum eventually brought a close above this trend line, this was confirmed as a fake-out, with the following weekly closing below once again. This can be attributed to the major resistance in 2075, which has now been rejected for the 4th time in 4 years. Following the strong sentiment towards Gold, the price has been consolidating well above the 1990 support and now has a decision: Can gold finally break 2075 and make a significant ATH at the targeted 2075 region or will the stalemate continue? The 2075 'wall' has been attacked 4 times in recent years. Will it have enough energy (sell pressure) to hold out again?

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FURTHER READING & LISTENING

- The Market Mind Hypothesis: Understanding Markets and Minds Through Cognitive Economics
- The Alchemy of Finance
- The Black Swan, Second Edition: The Impact of the Highly Improbable: With a new section: "On Robustness and Fragility"
- The Intelligent Investor Rev Ed.
- Antifragile: Things that Gain from Disorder
- Patrick Schotanus – The Market Mind Hypothesis

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