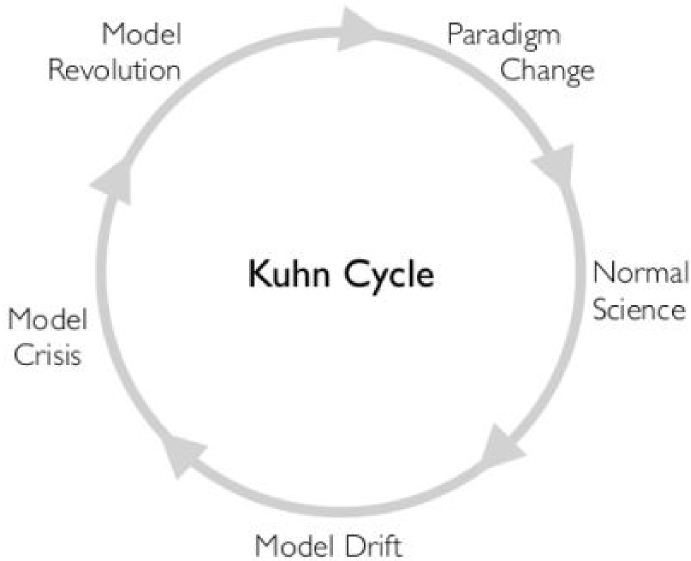
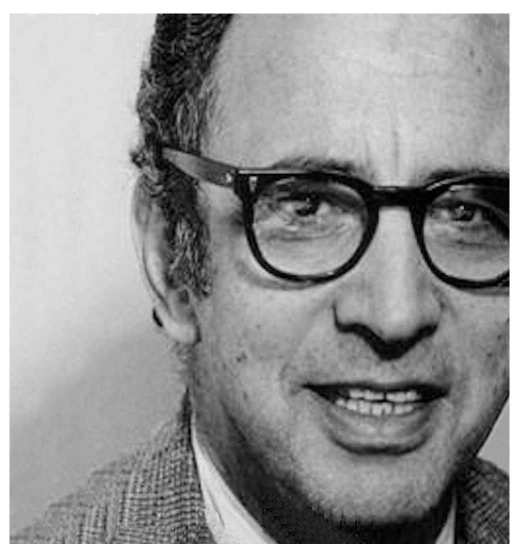
The Kuhn Cycle



Thomas Kuhn, a well-known physicist, philosopher, and historian of science, is regarded by many as one of the most influential thinkers of the 20th century.



In 1962, Kuhn wrote a book titled *The Structure of Scientific Revolutions* which transformed not only the philosophy of science, but the actual way in which scientists approached their work.

One of the more profound concepts introduced in the book is the role of what Kuhn called “paradigm shifts” in the evolution of scientific thought. He defines a paradigm shift as “an important change that happens when the usual way of thinking about or doing something is replaced by a new and different way.” Kuhn argues that it’s these dramatic shifts in thinking that induce periods of rapid scientific advancement. This evolution of commonly accepted beliefs is called the “Kuhn Cycle” (shown above) and applies to many other areas outside of science.

The implication of the paradigm shift concept I find most interesting is that nothing is truly ever “known”; scientific facts are merely transitory opinions which can never be proven absolutely true or false.

The paradigm shift concept is part of the mental model we use (something we call regime change) to view markets.

Regime change, in its simplest form, is the idea that market cycles are driven by narratives. Narratives are the opinions and beliefs of various participants in the market. In each cycle, one to a few narratives dominate all others (we call these the dominant narratives). And it’s these dominant narratives that make up market regimes.

The process of regime change is similar to the Kuhn Cycle. It’s something we refer to as the “Soros Cycle” because it was George Soros’ work that first got us thinking about the importance of narratives in markets.

The Soros Cycle plays out like this:

> An established regime exists and is comprised of a few dominant narratives —>
>
> Narrative drift begins as information starts to challenge accepted fact, which leads to data cherry picking and growing cognitive dissonance —>
>
> Narrative crisis hits because reality has diverged too far from the dominant narrative for the regime to be sustained (narratives always lag shifts in reality) —>
>
> Narrative revolution finally happens when reality forces the majority of people who were reluctant to admit they were wrong to adopt a new narrative —>
>
> Regime change occurs when a new narrative becomes dominant and accepted by the majority of market participants. It’s reinforced by reality which eventually brings us full circle back to the established regime.

We’re in a narrative crisis right now. The accepted wisdom of the last few years has been dominated by narratives of “secular stagnation”, the “central bank put”, and “lower for longer”. These narratives were predicated on the belief that interest rates in the western world would stay near zero for a long time. In fact, many financial pundits and academics seriously stated that “rates might not rise again during their lifetimes”.

This lower for longer regime drove markets to price assets (particularly bonds) for an environment where the possibility of inflation and thus rising rates was virtually zilch.

Like all market narratives, this belief was only true for so long, but now reality has changed… which means the dominant narrative must change as well.