MAULDIN ECONOMICS
Outside THE BOX

"You Look Like I Need a Drink": Comments Before the National Association of Chain Drug Stores

JOHN MAULDIN | July 12, 2017

Today's *Outside the Box* is a rollicking address to the National Association of Chain Drug Stores, delivered by my friend Richard Fisher, former President & CEO of the Dallas Federal Reserve Bank. Richard is simply one of the most entertaining and informative thinkers I know. I cherish his thoughts and the all-too-brief times I get to be with him. He is the source of a thousand stories, and you always learn something new. In this speech he makes all the points I just made in last week's letter – in spades.

Right off the top, we learn – and here's something I didn't know – that Richard was conceived in Shanghai in 1948 and smuggled out in his mama's tummy on the second-to-last ship to leave Shanghai before Mao's forces closed the ports.

Next there's a remarkable vignette featuring Lara Croft as played by Angelina Jolie in the film version of Tom Clancy's *Hunt for Red October*, Thor's Hammer ("considered the most awesome weapon in Norse mythology"), and the 17 dedicated members of Norway's Special Forces who used to track Soviet submarines on Jan Meyen Island, six hundred miles west of Norway – all this just by way of Richard's warning his audience that he's about to do his darnedest to explain "why, in the world in which we live today, what we are used to working doesn't. And why nobody seems to understand why."

That's a lot to bite off, but this is a guy who was a persistent and eloquent contrarian during his time on the Federal Open Market Committee. In 2007 he was sounding the alarm, loud and clear, on the imminent subprime crisis, while his colleagues slumbered; in 2013 he took on Bernanke & friends in outspoken opposition to their unholy love of quantitative easing.

Today's OTB is vintage Fisher: in part a heartfelt endorsement of the real change in Washington and the country that the Trump administration is trying to effect (there is frequent mention of an "Orange Swan") and in equal part a strong caution against "withdrawing from, rather than improving the present world order." But as Richard reminds us, after Churchill, "Americans always do the right thing – after they have tried everything else."

So dig in and enjoy an unbridled romp with Richard Fisher through the forever intertangled worlds of politics and economics. And, dear gods, I hope this man is our next Fed Chairman.

I find myself in the Delta Club in Minneapolis for a longish layover waiting to get to San Francisco and Palo Alto tonight. Burmese food with Andy Kessler and Rich Karlgarrd and dissecting the future is about as good as it gets. Then to bed early and up again for solid meetings. Fortuitously, my doctor, Mike Roizen, is coming into SFO just about the time I'll drive past the airport tomorrow, and we'll go into the City and have lunch before I make my way to the S&P conference and then dinner with VC genius Lou Gerken, where we will mostly talk about biotech and aging. Wow. Mental stretching plus time to read books on planes; what could be better – LOL.

You have a great week and find some friends and create your own great conversations. Get on a plane if you have to. Life is too short….

Your wondering what the Trump Fed will look like analyst,

John Mauldin, Editor
Outside the Box

"You Look Like I Need a Drink": Comments Before the National Association of Chain Drug Stores

With Reference to Thor's Hammer, Justin Moore, Orange Swans, Half-Wits, Phil Gramm, Ken Arrow, Mexico, Churchill, Tug-of-War, Marcus Nadler and Secretariat

By Richard Fisher
April 24, 2017, The Phoenician Resort, Scottsdale, AZ

Thank you David (Pothast).

I did indeed come straight from Beijing and admit to being jet lagged, though this great resort and the hospitality you and your association have shown me is a very nice way to recover.

Here is a little known fact: I have been going to China since 1948. How could that be? Well, my parents were on the second-to-last ship to leave Shanghai, the SS President Wilson, before Mao's forces closed the ports. They had been living in the Peace Hotel while my dad was on business there. I was born six months later in Los Angeles. So, like so many things we have here in the U.S., I was manufactured in China!

Now to more serious things.

Six hundred miles west of Norway there is a communications station on Jan Meyen Island where 17 hearty members of Norway's Special Forces tracked Soviet submarines. If you read Tom Clancy's *Hunt for Red October*, you would know it as "Loran C". If you played the video game Tomb Raider, you would recall that Lara Croft – played by Angelina Jolie in the film version – visits Jan Meyen in search of Thor's Hammer, considered the most awesome weapon in Norse mythology, capable of leveling mountains and performing the most heroic of feats.

When you arrive on the island you are greeted with this sign: Translated it reads:

> Theory is when you understand everything but nothing works;
>
> Practice is when everything works but nobody understands why.
>
> At this station, theory and practice are united: nothing works and nobody understands why.

Jim (Whitman) asked me to speak to you this morning to try to explain why, in the world in which we live today, what we are used to working doesn't. And why nobody seems to understand why.

I will give it my best shot.

"You Look Like I Need a Drink!"

Let's start with politics. The political scene has changed enormously since I received the invitation from Jim to speak to you today. Then, it was a given that Hillary Clinton would become the 45th president of the United States and that fiscal, regulatory and government policy would follow conventional form. In what was a shock to some (but not to this speaker), Donald Trump was elected on the premise that he would "drain the swamp" in Washington and turn the tables on the status quo. This has engendered enormous angst among those who had banked on business as usual. And great hope among those who worried that the magnificent machine that is the U.S. economy has been in decline.

The former group, those accustomed to the intoxicating ambrosia of the status quo, regard President Trump with a reaction not unlike that of country singer Justin Moore's title song "You look like I need a drink!"

The "Orange Swan" and "Half-wits"

The latter, especially sober business leaders, financiers and market operators, have turned the term "Black Swan" on its head. In the parlance of finance, a "Black Swan" is an unforeseen event that shocks the market place and leads to severe negative reaction. Business operators looked at the President's agenda of deregulation, pledges of tax cuts and reform, his cabinet appointments and Supreme Court nominee, and his general disposition toward curbing the intrusion of government on freedom of the "animal spirits" and saw what I will call in deference to the Candidate Trump's then hair color, an "Orange Swan" – a welcome surprise to the upside.

I'll put this in perspective with my favorite story told by Ronald Reagan. During the 1984 presidential campaign, President Reagan came to Dallas. My then father-in-law, Republican Congressman Jim Collins, a close friend of the president's, let me join him for a small gathering with the President at the Collins' ranch. Reagan told us a story of an Irish farmer named Paddy O'Toole who is visited by an Inspector from the Welfare and Work Security Ministry.

"Tell me, Paddy," the official asked, " how do you compensate your workers?"

"Well," says Paddy, " I pay the field workers 300 a month plus room and board and an annual bonus based on our profits."

"Ah, Paddy! Good man! That's way above minimum wage and very generous. Excellent!" says the bureaucrat. "And your processors?"

"I pay them 600 monthly and also provide them room and board plus a slice of profits."

"Brilliant! That's way above the norm too. You are indeed a good man, Paddy," says the Inspector. "Now tell me, are there any others?"

"Oh yes," says Paddy. "There is the half-wit. He works the longest hours of all, shoulders all of the farm's liabilities and risks, clears about 30 a month, gets to down a fifth of whiskey a fortnight, and gets to sleep with me wife on the weekends if he is up to it."

"Paddy, that is outrageous!," says the Inspector. " It is completely unacceptable. It violates every rule, regulation and law of the land. I demand to see the 'half wit' immediately!"

"Laddy," Paddy replies, "You're lookin' at 'im."

One could say that the "half-wits" that the elite scolds tend to look down upon revolted in the last election against taxes that strip them of what they earn by the sweat of their brow and the strength of their back, regulations that dictate their behavior where they work and live and study and worship and tend to their medical needs, and monetary policy that has crippled their savings and spending power, policy which I will turn to shortly.

Phil Gramm's Verification

If you are looking for statistical verification of the malaise that was afflicting the U.S. economy, go back and read last Thursday's excellent op-ed by former Senator Phil Gramm and Michael Solon in the Wall Street Journal. They documented the fact that "Economic growth during the (past eight) years averaged an astonishingly low 1.47%, as compared with the 3.4% average throughout all of the post-war booms and busts before 2009." They pointed out that in the recovery from the recent recession, "real growth in gross domestic product – our nation's output – averaged 2.1% per year, less than half the 4.5% average during previous recoveries of similar duration."

Mind you, these anemic growth rates followed a devastating downturn that crippled employment and depleted the savings of the vast majority of Americans. As we approached the election, we were indeed in the throes of what many economists described as "secular stagnation".

Small wonder that voters took a risk with a change agent who offered hope of relief. And with change agents that ran the table not just in the Electoral College but in the lower and upper houses of Congress, governors mansions and state legislatures, 27 state attorneys generals offices and a majority of counties across the land. The choice was between a candidate and a platform advocating more of the same and one who offered to provide relief by changing gears entirely.

Changing the gears of a ship of state as large as ours is not easy. Yesterday, the Wall Street Journal and NBC released a poll with a startling statistic: when asked if government should do more – more – to solve problems and help people needs, 57% of the respondents said "yes", while less than 49% said "no", that initiative should come from individuals themselves and businesses.

In the same issue of the Journal, there is another poll reported, this one from the Washington Post, that declares President Trump "the least popular president in modern times." And yet if you read the fine print of those poll results, while almost half of those polled said they had voted for Mrs. Clinton in November, only 40% said they would do so again. Despite the President's high disapproval rating and much-reported problems in getting things done in his first 100 days, he would still win the election if it were held today.

Polls and Ken Arrow's Forecasts

You can't take too much comfort in of polls; they are hardly the best predictors. We learned this with BREXIT, as well as with the pre-election polls of our own election. I monitor polls with a cynical eye, just as I do economic forecasts. They are as much art as they are presumably scientifically precise, and they can lead to misleading conclusions if taken at face value.

The best story I can share with you on this front is an iconic one in central bank circles.

One of the greatest modern economists was Kenneth Arrow. During WWII he served as a weather forecasting officer in the U.S. Army Air Corps, assigned the difficult task of producing month ahead weather forecasts as the date for Omaha Beach approached. A thorough man, he had his team review the accuracy of his forecasts: they confirmed statistically that they were no more accurate than random rolls of dice. So he cabled the High Command, to be relieved of this seemingly futile duty. Arrow's recollection of his superior's response was priceless: " The commanding general is well aware that the forecasts are no good. However, he needs them for planning purposes."

The value of immediate polls, like economic forecasts, may be questionable but I do think what we can surmise by reading the entrails is that the American people know deep in their gut that we have been drifting for too long into complacency in accepting what some would call a "nanny state" and that as much as we have been getting used to it, it somehow runs against the American fiber of individualism and self-reliance. What I saw in this last election was a desire to have someone – anyone – pull us off the path of continued decline.

One might say that voters were looking for a version of Thor's Hammer, a crude force capable of leveling bureaucratic mountains and performing the most heroic feat of putting us back on a course of growth and expansion, however great the risks.

Risks to Consider

To be sure, there are indeed great risks. I won't reiterate them here with the exception of saying that one that ranks at the top of my worry list is that of withdrawing from, rather than improving the present world order.

I am ardent believer in American exceptionalism. I believe the U.S. is indeed a uniquely successful experiment and that we have been an example to the world. Which means we have an obligation to continue being exemplary. I believe there is a need to update almost all of the post-WWII structures, ranging from the Bretton Woods institutions, the U.N., NATO and other strategic pacts, multilateral and bilateral, which we have led, and trade agreements like NAFTA, which I spent four years implementing as Deputy U.S. Trade Representative, to take account of the changes that have occurred since the fall of the Soviet Union, the rise of China, the growing nuclear threat of North Korea, the information-technology and cyber revolution, and other phenomena that have changed the global economy and the practice of politics and diplomacy, including ubiquitous social media and even Saturday Night Live.

But making needed changes will require delicate diplomacy, lest we unleash the destructive ghosts of isolationism and protectionism.

Let us hope that the new Administration and the Congress will guide us through much-overdue changes with aplomb rather than bombast.

Mexico Redux

Being here in Arizona, I have special concern with the delicate subject of Mexico, a nation of 120 million people who until recently delivered one of the best performing economies in our hemisphere, are our nation's second largest trading partner and share, by far, the most important trading relationship with the most prosperous state in the union, my home state of Texas. It will take a clever hand to update our relationship with Mexico without destroying it and giving rise to a U.S. equivalent of Europe having Turkey on its southern border.

By the way, I assume you have all heard the quip: "Of course a Wall works. China built one and they haven't seen a Mexican in over 2,000 years!"

All humor aside, pray that the new leadership corrects whatever imbalances exist in U.S. global trade and other commitments without overturning the apple cart.

Churchill's Dictum

Last comment on this front before turning to the challenge of present financial markets and monetary policy: should you be tempted to give in to all engrossing angst over the change agent that has been elected to lead the American people, remember Churchill's insightful dictum: "Americans always do the right thing… after they have tried everything else."

Monetary Policy: The Good and the Bad

Now to the economy and markets. As president and CEO of the Federal Reserve Bank of Dallas, I participated in Federal Open Market Committee (FOMC) deliberations from 2005 to 2015. Recall that despite my concerns and dissents, the FOMC cut overnight rates to zero and through Quantitative Easing, expanded the holdings of the Fed's balance sheet from less than $900 billion when I joined to almost $4.5 trillion presently, increasing the duration of the holdings in the portfolio to six years from what was typically the shortest of tenors.

The reason for doing so was to create what Ben Bernanke summarized as a "wealth effect" that would lift financial markets to the benefit of the economy. When you cut rates to the "zero bound", then flatten the yield curve by purchasing trillions of dollars of mortgage backed and U.S. Treasury securities, you are signaling to investors that they can literally discount future cash flows of the assets they invest in to infinity. And sure enough, with the FOMC having bought in $1.75 trillion worth by the end of February 2009, the equity market turned the first week of March and cap rates for properties began to plummet.

That was all to the good for investors in bonds, stocks, and property, including housing as mortgage rates declined. But the wealth effect the FOMC hoped for did not spread as planned to the broader economy. Savers were penalized as bank deposit and money market fund returns were decimated, and confidence in vehicles that ordinary Americans depend upon – pension funds, insurance companies and other vehicles used to protect their financial wherewithal in the long term – was undermined. Thus it took longer to restore confidence among consumers than monetary policy makers thought. Especially as fiscal policy and regulatory reform was dead in the water. With no encouragement from the fiscal and regulatory side, companies used cheaper and more plentiful money to restructure their balance sheets, buy in shares and increase dividend payouts, rather than commit to job creating capital expenditures (CAPEX). Employment, and the consumption that having a job allows, took longer to ramp up than we had hoped.

Accommodative policy is necessary but not sufficient to get the engine of the economy to full function. Money is the fuel for that engine but fiscal and regulatory policy is needed to incent the economy's drivers – private sector operators – to use that money and step on the accelerator of CAPEX and job creation to get that engine roaring.

The Fed's policy was followed and intensified in spades by the Bank of Japan and by the European Central Bank.

The Fed curtailed it QE program at the end of October of 2014, then 7 years to the day after we had cut the overnight funds rate to zero, raised it a mere 25 basis points (25/100ths of one-percent) , followed it up with two more moves to snug up to 1%, and is on a declared path to keep nudging it up in 25 basis point increments through year end. When all was said and done, as I stand here today, the FOMC had acquired and now holds $1.74 trillion in mortgage-backed securities and $2.46 trillion in Treasuries, roughly 35% of all U.S. Treasuries outstanding with greater than 5 years' maturity, in its System Open Market Account (SOMA).

The Bank of Japan, the ECB, and the Bank of England, however, carried on with their programs of radical monetary policy, with the result that after the Brexit vote took place, interest rates hit lows the likes of which have never been seen.

The only reliable long-term records we have on sovereign bonds are maintained by the Dutch. (Holland preceded England and the U.S. as the globe's financial epicenter). In the immediate aftermath of Brexit, 10-year Dutch sovereigns reached their lowest yield level in 500 years. The Bank of England's benchmark rate hit its lowest level in 322 years. And the benchmark 10 year U.S. Treasury traded at 1.366%, the lowest rate since Hamilton – not the musical but the real guy, the iconic first Secretary of the Treasury.

And as we all know, there was a plethora of long term issuance in the U.K. and in Europe and in Japan at negative or barely positive interest rates.

Then, as autumn approached, the markets seemed to gag on the low-to-negative interest rate diet prescribed by central banks. Here in the U.S. rates began to rise. By the time of the presidential election, the 10-year Treasury had risen to 1.8%; in Europe negative yields at longer tenors began to evaporate.

The Tug of War Between Rising Rates and the "Orange Swan"

Since the election, rates have risen further. Today the 10-year Treasury is trading at roughly 2.3% and recently traded as high 2.6%. One would have thought that underlying cash flows that support equities and cap rates would have been rediscounted to reflect this move. But that has not yet happened.

I attribute this to the "Orange Swan". The hope President Trump has engendered of tax reform, deregulation and a more pro-business government has over-ridden what might ordinarily have been a reversal of force in markets outside the fixed income space.

We have seen this before. Between when Ronald Reagan was elected and then inaugurated, the S&P 500 soared 8.5%. But in his first year in office, equities declined 20% as reality set in on the timetable for implementing the changes he promised. It wasn't until mid-way through his second term in office, for example, that he was able to get tax reform in place.

To be sure, the political dynamics are different today. In his first term, Reagan had to deal with a Democratic majority in the House, where tax reform must be executed. Today, Trump has a sizeable but fractionated Republican majority in the House and a marginal majority in the Senate – but still one where the Vice-president can cast a deciding vote in confirming Ms. DeVos as Education Secretary or the Senate can evoke the "nuclear option" to put Judge Gorsuch on the Supreme Court.

That said, despite the power of the Executive to issue unilateral orders, tax and regulatory reform requires the Congress. Let me show you how Congress really works. [Video: locker room and cell phone]

We may be living in a new world, where Congress has abandoned its spendthrift ways. Still, however pro-business President Trump's intentions, and even with a Republican Congress that has long been prepared to effect change, major initiatives take time. We will see how long the "Orange Swan" effect holds under the circumstances. And can counter the reality that a more robust economy, should it materialize as hoped, will result in higher interest rates and a Federal Reserve that will have to tighten monetary policy both at the short end and possibly along the yield curve as it deals with the roll over of maturing MBS and Treasuries in its portfolio where $195 billion mature this year, $423 billion mature in 2018, and $430 billion mature in 2019.

How markets will re-discount future cash flows under those circumstances remains uncertain. And then there are these historical precedents: Every Republican president since Ulysses S. Grant has experienced a recession in his first term, including the Gipper.

And since WWII, the Fed has initiated 13 tightening cycles; 10 of those 13 landed the economy in recession.

That ought to make your day!

Remembering Marcus Nadler

Now I don't want you to leave today thinking I am just one more former central banking sourpuss. I do see the potential for market and political storms. Members of NADSC will have to be alert and stay on the balls of their feet as the landscape in the United States shifts and is tested. But I remind you that Churchill was right: we Americans eventually do the right thing. The U.S. has the capacity to overcome even the greatest of reversals and mishaps and obstacles. We always have and we always will.

I doubt any of you have ever heard of Marcus Nadler. He was a leading thinker at the Federal Reserve during one of our toughest "stress tests", the Great Depression. With gloom all around and the most thoughtful of people questioning the very survivability of our form of democracy, Nadler put forth four simple propositions:

First, he said, "You are right if you bet that the U.S. economy will continue to expand."

Second: "You are wrong if you bet that it is going to stand still or collapse."

Third: "You are wrong if you bet that one element in our society is going to ruin or wreck the country."

And fourth: "You are right if you bet that (leaders) in business, labor and government are sane, reasonably informed and decent people who can be counted on to find common ground among all their conflicting interests and work out a compromise solution to the big issues that confront them," I know Nadler's third and fourth propositions may seem pie-eyed at present. They were equally outlandish in the 1930's. And yet we went on from there to become the most prosperous and powerful country in the world.

We might be experiencing political volatility.

We may be poised for a financial markets correction.

But Americans are a unique people. We screw things up pretty badly, pretty often. But we eventually do the right thing. We have no choice now but to do it again.

Horseshift!

During the financial crisis, I surveyed the global landscape and described the American economy as the "best looking horse in the glue factory". Today, I look at the U.S. economy through a different equine lens. I have another visual of our potential: that of Secretariat at the Belmont stakes in 1973. [Slide of Secretariat wining Belmont] Here he is winning Belmont by an unimaginable 31 lengths, with a heart that weighed 22 pounds, twice the size of any other thoroughbred's.

That is the American economy.

During the course of my lifetime I have encountered countless naysayers and doomsayers—those that said Europe would lap America, that Japan would lap America, that the so-called BRICS and China would lap America, that we could not compete in a post-Cold War, globalized, cyber-ized world. To this I say: Horseshift!

We are not the best looking horse in the glue factory. We are Secretariat.

We have the biggest heart.

We can win the race by 31 lengths, if only we can be given freer rein by the fiscal and regulatory authorities.

Just let us out of the stalls.

There's no country, there's no people, there's nobody anywhere on the planet that can outpace us if we are given the freedom to run.

Thank you.

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