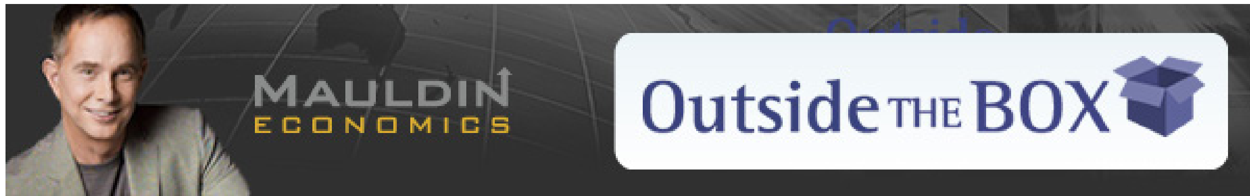

Whatever Happened to the Invisible Hand of Capitalism?

JOHN MAULDIN | March 18, 2016

It has been an interesting week for Fed observers and markets. There is an odd disconnect between the data that we are told the Fed depends on and the press release and follow-on press conference that the FOMC conducts after its meetings. But clearly the market likes it that way. This week's *Outside the Box* deals with the philosophical issue of the Federal Reserve setting the price of money. My friend and well-known value investor Vitaliy Katsenelson goes back to his youth in Russia, where some bureaucrat arbitrarily set the price of sugar, and likens that to the Fed setting the price of money – or interest rates. We all intuitively understand that a bureaucrat setting the price of sugar is a dumb idea. Yet the market seemingly loves having the Fed set the price of money.

But before we jump into Vitaliy's short but very thoughtful essay, I think the perfect set-up in is a note I got from my friend Peter Boockvar, who writes for The Lindsay Group. Every time I get in the room with Peter I come away with several nuggets to meditate on. Let's just jump into his remarks without a lot of comment:

> For the past few years the Fed has been chipping away at the concept that they are driving monetary policy dependent on the data that they see. We know that because they kept changing the rules of the game in that every time a goal was reached the goal was altered. Well, I believe it is safe to say that after yesterday's FOMC statement, the Yellen press conference and what was said in them, the communication and structural strategy of 'data dependency' has been officially neutered. The Fed's goal is now a perfect world. As we of course will never get there, the rest of us are left flying blind as to what to expect from monetary policy.
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> In the mean time, the Federal Reserve is essentially short commodities, short the dollar, short gold, short multi family landlords, short the never ending ability of healthcare costs to go up, etc…They are sitting with an effective fed funds rate of just .36% just as the inflation stats are accelerating and the employment rate at 4.9% is below the 50 year average of 6.2%. It was the most bizarre thing to watch the dovishness yesterday on the day the core CPI rate touched 2.3%, the fastest rate of gain in almost 8 years. It was like watching a child that puts their hands over its eyes and thinks it disappeared. They suspend reality for a moment.
>
> As to the Fed's worries about overseas growth, they will be waiting a long time if they think European growth is going to reaccelerate and they will be waiting a very long time if they think Chinese growth is going to reaccelerate. Their focus on wage growth is noble, we all want it to be more but they are focused on nominal wage growth where they should be looking at REAL wage growth. They want 2% inflation but if wage growth just matches that then what is the point. If what the Fed fears is going the opposite way to the actions of the BoJ and ECB because they are afraid of a stronger dollar, then just say it but remember exports are only 13% of the US economy and we have a trade deficit and thus buy more than we sell overseas.

> I'll finish by saying that savers are getting screwed again. Ben Bernanke and Janet Yellen should never travel to Florida for their own safety. There is currently about $10 Trillion of idle money sitting in savings accounts yielding about nothing. Check out these rates at Bank of America, https://www.bankofamerica.com/deposits/bank-account-interest-rates.go. If you have a standard rate savings account you can collect .03% per year in interest. If you are lucky enough to be a Platinum Honors member than you can DOUBLE that with a .06% rate! If 2% inflation is what we will soon get, it will drain $200 Billion in purchasing power from the $10 Trillion of savings if they Fed doesn't keep up and continue raising rates. It is no wonder that gold is finally gaining some traction to the upside and I believe it will continue to do so. Gold is just a few bucks from a 13 month high.

And while it is true that gold is in a bull run, I glance at my computer and note that the market has made a 2016 high (even as noted bears are protesting that the market is wrong – that would be you, Uncle Doug).

And I can't quit without giving you three sentences from David Zervos's email to me this morning, extolling the virtues of Janet Yellen and monetary easing. What's not to love? says David – Janet is making his trades go in the right direction. But he closes with this thought:

> That said, there will likely be plenty of near term confusion in markets as folks try to trade off of the old weak currency/strong equity market correlations. My guess is that correlation is about to break hard – and a bunch of black box systematic correlation junkies are about to get their heads handed to them. It's going to be a very interesting next few weeks in trading.

Not that it hasn't been an interesting few weeks in trading anytime in the past six months. But when past correlation history gets shot to hell, it has a tendency to do the same thing to performance. Just saying…

It's been an eclectic week of reading and writing (with of course a little gym), but every day I seem to get to bed just a little bit further behind as the to-do and must-read lists seem to keep piling up. And it looks like I'm going to make a trip to Abu Dhabi in the middle of May for a small but interesting conference. I might have a little time either before or after the conference, but the schedule is up in the air, as we are trying to work around a surprisingly full airline booking situation, even this far out. Who knew?

Have a great week, and sit and think about the unintended consequences of 12 people sitting around a table and deciding what the price of money should be…

Your not sure this ends up well analyst,

John Mauldin, Editor
Outside the Box

Whatever Happened to the Invisible Hand of Capitalism?

By Vitaliy Katsenelson

When I was growing up in the Soviet Union, our local grocery store had two types of sugar: the cheap one was priced at 96 kopecks (Russian cents) a kilo and the expensive one at 104 kopecks. I vividly remember these prices because they didn't change for a decade. The prices were not set by sugar supply and demand but were determined by a well-meaning bureaucrat (who may even have been an economist) a thousand miles away. If all Russian housewives (and househusbands) had decided to go on an apple pie diet and started baking pies for breakfast, lunch and dinner, sugar demand would have increased but the prices still would have been 96 and 104 kopecks. As a result, we would have had a shortage of sugar — a very common occurrence in the Soviet era.

In a capitalist economy, the invisible hand serves a very important but underappreciated role: it is a signaling mechanism that helps balance supply and demand. High demand leads to higher prices, telegraphing suppliers that they'll make more money if they produce extra goods. Additional supply lowers prices, bringing them to a new equilibrium. I am slightly embarrassed as I write this, because you may confuse me for an economist — I am not one. But this is how prices are set for millions of goods globally on a daily basis in free-market economies.

In the command-and-control economy of the Soviet Union, the prices of goods often had little to do with supply and demand but were instead typically used as a political tool. This in part is why the Soviet economy failed — to make good decisions you need good data, and if price carries no data, it is hard to make good business decisions.

When I left Soviet Russia in 1991, I thought I would never see a command-and-control economy again. I was wrong. Over the past decade our global economy has started to resemble one, as the well-meaning economists running central banks have been setting the price for the most important commodity in the world: money. Interest rates are the price of money, and the daily decisions of billions of people and their corporations and governments should determine them. Like the price of sugar in Soviet Russia, interest rates today have little to do with supply and demand (and thus have zero signaling value).

For instance, if the Federal Reserve hadn't bought over $2 trillion of U.S. debt by late 2014 when U.S. government debt crossed the $17 trillion mark, interest rates might have started to go up and our budget deficit would have increased and forced politicians to cut government spending. But the opposite has happened: As our debt pile has grown, the government's cost of borrowing has declined.

The consequences of well-meaning (but not all-knowing) economists setting the cost of money are widespread, from the inflation of asset prices to encouraging companies to spend on projects they shouldn't. But we really don't know the second, third and fourth derivatives of the consequences that command-control interest rates will bring. We know that most likely every market participant was forced to take on more risk in recent years, but we don't know how much more because we don't know the price of money.

Quantitative easing: these two seemingly harmless words have mutated the DNA of the global economy. Interest rates heavily influence currency exchange rates. QE by the U.S. and European Union caused the price of the Swiss franc to jump 15 percent in one day in January 2015, and the Swiss economy has been crippled ever since.

Americans have a healthy distrust of their politicians. We expect our politicians to be corrupt. We don't worship our leaders (only the dead ones). The U.S. Constitution is full of checks and balances to make sure that when (often not if) the opium of power goes to a politician's head, the damage he or she can do to society is limited.

Unfortunately, we don't share the same distrust for economists and central bankers. It's hard to say exactly why. Maybe we are in awe of their Ph.D.s. Or maybe it's because they sound very smart and at the same time make us feel dumber than a toaster when they use big econ terms like "aggregate demand" or "degenerate equilibrium" (okay, I made up the last one). Or simply because they often look just like our well-meaning grandparents. For whatever reason, we think they possess foresight and the powers of Marvel superheroes.

Warren Buffett — the Oracle of Omaha himself — admitted that he doesn't know how the QE experiment will end. And if you think well-meaning economists running central banks know, you may have another think coming.

Alan Greenspan — the ex-pope of the Federal Reserve — in a 2013 interview with the *Wall Street Journal* said that he "always considered [himself] more of a mathematician than a psychologist." But after the financial crisis, and the criticism he received for contributing to the housing bubble at the core of it, Greenspan went back and studied herd behavior, with some surprising results. "I was actually flabbergasted," he admitted. "It upended my view of how the world works."

Just as the well-meaning economist of the Soviet Union didn't know the correct price of sugar, nor do the good-intentioned economists of our global central banks know where interest rates should be. Even more important, they can't predict the consequences of their actions.

P.S. If Martian economists paid a visit to Planet Earth and surveyed our global economy, they'd form a very different view of its true health than most earthlings have. See, Martians wouldn't be influenced by the positive feedback loop generated by a seven-year bull market in stocks. The "low unemployment" numbers spat out by government agencies and touted by presiding politicians would also have little influence on them. They'd look at the percentage of people employed in the US, which is 3.5% below the 2007 high, and understand that true unemployment is probably double the official number.

The Martians would not be swayed by the calmness and confidence exuded by central bank economists. They'd see that the global economy is barely producing modest growth while government debt is on the rise and interest rates are mostly at zero or even less.

After they studied our wild- and not-so-wild life they would conclude that the most superior and resilient living species on Earth is the cockroach, which seems to survive anything. If the Martians were to set themselves the task of constructing a stock portfolio that would perform well under the tumultuous market conditions that pertain on the Earth today, they would of course try to model the portfolio after that incredible insect.

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