Thoughts from the FRONTLINE
John Mauldin's free weekly investment and economic newsletter

The Cost of Code Red

JOHN MAULDIN | April 27, 2014

IN THIS ISSUE

(It is especially important to read the opening quotes this week. They set up the theme in the proper context.)

> "There is no means of avoiding the final collapse of a boom brought about by credit expansion. The alternative is only whether the crisis should come sooner as the result of a voluntary abandonment of further credit expansion, or later as a final and total catastrophe of the currency system involved."
>
> – Ludwig von Mises

> "No very deep knowledge of economics is usually needed for grasping the immediate effects of a measure; but the task of economics is to foretell the remoter effects, and so to allow us to avoid such acts as attempt to remedy a present ill by sowing the seeds of a much greater ill for the future."
>
> – Ludwig von Mises

> "[Central banks are at] serious risk of exhausting the policy room for manoeuver over time."
>
> – Jaime Caruana, General Manager of the Bank for International Settlements

> "The gap between the models in the world of monetary policymaking is now wider than at any time since the 1930s."
>
> – Benjamin Friedman, William Joseph Maier Professor of Political Economy, Harvard

To listen to most of the heads of the world's central banks, things are going along swimmingly. The dogmatic majority exude a great deal of confidence in their ability to manage their economies through whatever crisis may present itself. (Raghuram Rajan, the sober-minded head of the Reserve Bank of India, is a notable exception.)

However, there is reason to believe that there have been major policy mistakes made by central banks – and will be more of them – that will lead to dislocations in the markets – all types of markets. And it's not just the usual anti-central bank curmudgeon types (among whose number I have been counted, quite justifiably) who are worried. Sources within the central bank community are worried, too, which should give thoughtful observers of the market cause for concern.

Too often we as investors (and economists) are like the generals who are always fighting the last war. We look at bank balance sheets (except those of Europe and China), corporate balance sheets, sovereign bond spreads and yields, and say it isn't likely that we will repeat this mistakes which led to 2008. And I smile and say, "You are absolutely right; we are not going to repeat those mistakes. We learned our lessons. Now we are going to make entirely new mistakes." And while the root cause of the problems, then and now, may be the same – central bank policy – the outcome will be somewhat different. But a crisis by any other name will still be uncomfortable.

If you look at some of the recent statements from the Bank for International Settlements, you should come away with a view much more cautious than the optimistic one that is bandied about in the media today. In fact, to listen to the former chief economist of the BIS, we should all be quite worried.

I am of course referring to Bill White, who is one of my personal intellectual heroes. I hope to get to meet him someday. We have discussed some of his other papers, written in conjunction with the Dallas Federal Reserve, in past letters. He was clearly warning about imbalances and potential bubbles in 2007 and has generally been one of the most prescient observers of the global economy. The prestigious Swiss business newspaper *Finanz und Wirtschaft* did a far-reaching interview with him a few weeks ago, and I've taken the liberty to excerpt pieces that I think are very important. The excerpts run a few pages, but this is really essential reading. (The article is by Mark Dittli, and you can read the full piece here.)

Speculative Bubbles

The headline for the interview is "I see speculative bubbles like in 2007." As the interviewer rolls out the key questions, White warns of grave adverse effects of ultra-loose monetary policy:

> William White is worried. The former chief economist of the Bank for International Settlements is highly skeptical of the ultra-loose monetary policy that most central banks are still pursuing. "It all feels like 2007, with equity markets overvalued and spreads in the bond markets extremely thin," he warns.
>
> **Mr. White, all the major central banks have been running expansive monetary policies for more than five years now. Have you ever experienced anything like this?**
>
> The honest truth is no one has ever seen anything like this. Not even during the Great Depression in the Thirties has monetary policy been this loose. And if you look at the details of what these central banks are doing, it's all very experimental. They are making it up as they go along. I am very worried about any kind of policies that have that nature.
>
> **But didn't the extreme circumstances after the collapse of Lehman Brothers warrant these extreme measures?**

Yes, absolutely. After Lehman, many markets just seized up. Central bankers rightly tried to maintain the basic functioning of the system. That was good crisis management. But in my career I have always distinguished between crisis prevention, crisis management, and crisis resolution. Today, the Fed still acts as if it was in crisis management. But we're six years past that. They are essentially doing more than what they did right in the beginning. There is something fundamentally wrong with that. Plus, the Fed has moved to a completely different motivation. From the attempt to get the markets going again, they suddenly and explicitly started to inflate asset prices again. The aim is to make people feel richer, make them spend more, and have it all trickle down to get the economy going again. Frankly, I don't think it works, and I think this is extremely dangerous.

So, the first quantitative easing in November 2008 was warranted?

Absolutely.

But they should have stopped these kinds of policies long ago?

Yes. But here's the problem. When you talk about crisis resolution, it's about attacking the fundamental problems that got you into the trouble in the first place. And the fundamental problem we are still facing is excessive debt. Not excessive public debt, mind you, but excessive debt in the private and public sectors. To resolve that, you need restructurings and write-offs. That's government policy, not central bank policy. Central banks can't rescue insolvent institutions. All around the western world, and I include Japan, governments have resolutely failed to see that they bear the responsibility to deal with the underlying problems. With the ultraloose monetary policy, governments have no incentive to act. But if we don't deal with this now, we will be in worse shape than before.

But wouldn't large-scale debt write-offs hurt the banking sector again?

Absolutely. But you see, we have a lot of zombie companies and banks out there. That's a particular worry in Europe, where the banking sector is just a continuous story of denial, denial and denial. With interest rates so low, banks just keep ever-greening everything, pretending all the money is still there. But the more you do that, the more you keep the zombies alive, they pull down the healthy parts of the economy. When you have made bad investments, and the money is gone, it's much better to write it off and get fifty percent than to pretend it's still there and end up getting nothing. So yes, we need more debt reduction and more recapitalization of the banking system. This is called facing up to reality.

Where do you see the most acute negative effects of this monetary policy?

The first thing I would worry about are asset prices. Every asset price you could think of is in very odd territory. Equity prices are extremely high if you at valuation measures such as Tobin's Q or a Shiller-type normalized P/E. Risk-free bond rates are at enormously low levels, spreads are very low, you have all these funny things like covenant-lite loans again. It all looks and feels like 2007. And frankly, I think it's worse than 2007, because then it was a problem of the developed economies. But in the past five years, all the emerging economies have imported our ultra-low policy rates and have seen their debt levels rise. The emerging economies have morphed from being a part of the solution to being a part of the problem.

Do you see outright bubbles in financial markets?

Yes, I do. Investors try to attribute the rising stock markets to good fundamentals. But I don't buy that. People are caught up in the momentum of all the liquidity that is provided by the central banks. This is a liquidity-driven thing, not based on fundamentals.

So are we mostly seeing what the Fed has been doing since 1987 – provide liquidity and pump markets up again?

Absolutely. We just saw the last chapter of that long history. This is the last of a whole series of bubbles that have been blown. In the past, monetary policy has always succeeded in pulling up the economy. But each time, the Fed had to act more vigorously to achieve its results. So, logically, at a certain point, it won't work anymore. Then we'll be in big trouble. And we will have wasted many years in which we could have been following better policies that would have maintained growth in much more sustainable ways. Now, to make you feel better, I said the same in 1998, and I was way too early.

What about the moral hazard of all this?

The fact of the matter is that if you have had 25 years of central bank and government bailout whenever there was a problem, and the bankers come to appreciate that fact, then we are back in a world where the banks get all the profits, while the government socializes all the losses. Then it just gets worse and worse. So, in terms of curbing the financial system, my own sense is that all of the stuff that has been done until now, while very useful, Basel III and all that, is not going to be sufficient to deal with the moral hazard problem. I would have liked to see a return to limited banking, a return to private ownership, a return to people going to prison when they do bad things. Moral hazard is a real issue.

Do you have any indication that the Yellen Fed will be different than the Greenspan and Bernanke Fed?

Not really. The one person in the FOMC that was kicking up a real fuss about asset bubbles was Governor Jeremy Stein. Unfortunately, he has gone back to Harvard.

The markets seem to assume that the tapering will run very smoothly, though. Volatility, as measured by the Vix index, is low.

Don't forget that the Vix was at [a] record low in 2007. All that liquidity raises the asset prices and lowers the cost of insurance. I see at least three possible scenarios how this will all work out. One is: Maybe all this monetary stuff will work perfectly. I don't think this is likely, but I could be wrong. I have been wrong so many times before. So if it works, the long bond rates can go up slowly and smoothly, and the financial system will adapt nicely. But even against the backdrop of strengthening growth, we could still see a disorderly reaction in financial markets, which would then feed back to destroy the economic recovery.

How?

We are such a long way away from normal long-term interest rates. Normal would be perhaps around four percent. Markets have a tendency to rush to the end point immediately. They overshoot. Keynes said in late Thirties that the long bond market could fluctuate at the wrong levels for decades. If fears of inflation suddenly re-appear, this can move interest rates quickly. Plus, there are other possible accidents. What about the fact that maybe most of the collateral you need for normal trading is all tied up now? What about the fact that the big investment dealers have got inventories that are 20 percent of what they were in 2007? When things start to move, the inventory for the market makers might not be there. That's a particular worry in fields like corporate bonds, which can be quite illiquid to begin with. I've met so many people who are in the markets, thinking they are absolutely brilliantly smart, thinking they can get out in the right time. The problem is, they all think that. And when everyone races for the exit at the same time, we will have big problems. I'm not saying all of this will happen, but reasonable people should think about what could go wrong, even against a backdrop of faster growth.

And what is the third scenario?

The strengthening growth might be a mirage. And if it does not materialize, all those elevated prices will be way out of line of fundamentals.

Which of the major central banks runs the highest risk of something going seriously wrong?

At the moment what I am most worried about is Japan. I know there is an expression that the Japanese bond market is called the widowmaker. People have bet against it and lost money. The reason I worry now is that they are much further down the line even than the Americans. What is Abenomics really? As far as I see it, they print the money and tell people that there will be high inflation. But I don't think it will work. The Japanese consumer will say prices are going up, but my wages won't. Because they haven't for years. So I am confronted with a real wage loss, and I have to hunker down. At the same time, financial markets might suddenly not want to hold Japanese Government Bonds anymore with a perspective of 2 percent inflation. This will end up being a double whammy, and Japan will just drop back into deflation. And now happens what Professor Peter Bernholz wrote in his latest book. Now we have a stagnating Japanese economy, tax revenues dropping like a stone, the deficit already at eight percent of GDP, debt at more than 200 percent and counting. I have no difficulty in seeing this thing tipping overnight into hyperinflation. If you go back into history, a lot of hyperinflations started with deflation.

Many people have warned of inflation in the past five years, but nothing has materialized. Isn't the fear of inflation simply overblown?

One reason we don't see inflation is because monetary policy is not working. The signals are not getting through. Consumers and corporates are not responding to the signals. We still have a disinflationary gap. There has been a huge increase in base money, but it has not translated into an increase in broader aggregates. And in Europe, the money supply is still shrinking. My worry is that at some point, people will look at this situation and lose confidence that stability will be maintained. If they do and they do start to fear inflation, that change in expectations can have very rapid effects.

More from the BIS

The Bank for International Settlements is known as the "central bankers' central bank." It hosts a meeting once a month for all the major central bankers to get together for an extravagant dinner and candid conversation. Surprisingly, there is been no tell-all book about these meetings by some retiring central banker. They take the code of "omertà" seriously.

Jaime Caruana, the General Manager of the BIS, recently stated that monetary institutions (central banks) are at "serious risk of exhausting the policy room for manoeuver over time." He followed that statement with a very serious speech at the Harvard Kennedy School two weeks ago. Here is the abstract of the speech (emphasis mine):

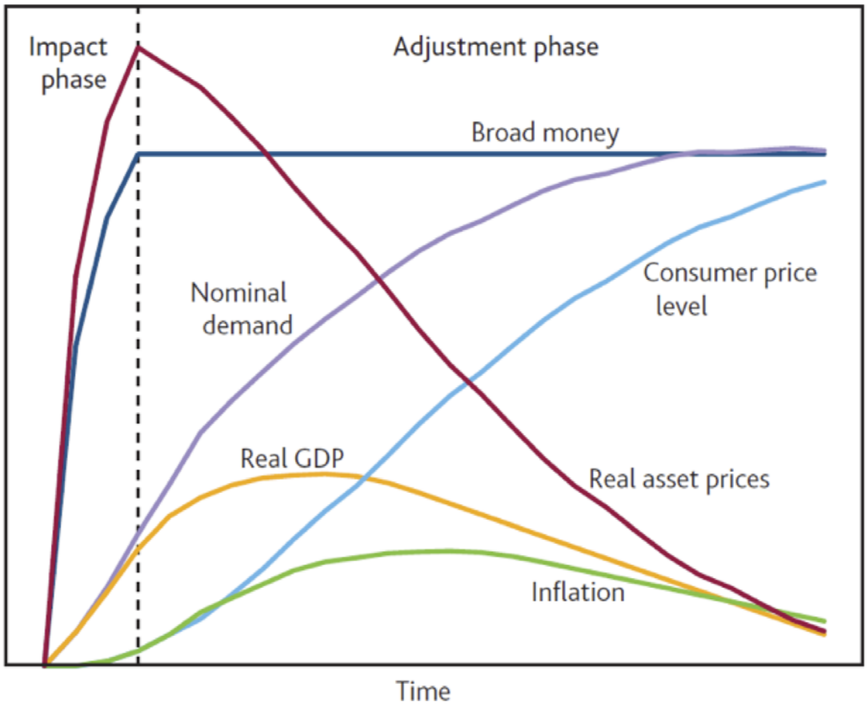
> This speech contrasts two explanatory views of what he characterizes as "the sluggish and uneven recovery from the global financial crisis of 2008-09." One view points to a persistent shortfall of demand and the other to the specificities of a financial cycle-induced recession – the "shortfall of demand" vs. the "balance sheet" view. The speech summarizes each diagnosis [and]… then reviews evidence bearing on the two views and contrasts the policy prescriptions to be inferred from each view. The speech concludes that the balance sheet view provides a better overarching explanation of events. **In terms of policy, the implication is that there has been too much emphasis since the crisis on stimulating demand and not enough on balance sheet repair and structural reforms to boost productivity.** Looking forward, policy frameworks need to ensure that policies are more symmetrical over the financial cycle, so as to avoid the risks of entrenching instability and eventually running out of policy ammunition.

Coming from the head of the BIS, the statement I have highlighted is quite remarkable. He is basically saying (along with his predecessor, William White) that quantitative easing as it is currently practiced is highly problematical. We wasted the past five years by avoiding balance sheet repair and trying to stimulate demand. His analysis perfectly mirrors the one Jonathan Tepper and I laid out in our book *Code Red*.

How Does the Economy Adjust to Asset Purchases?

In 2011 the Bank of England gave us a paper outlining what they expected to be the consequences of quantitative easing. Note that in the chart below they predict exactly what we have seen. Real (inflation-adjusted) asset prices rise in the initial phase. Nominal demand rises slowly, and there is a lagging effect on real GDP. But note what happens when a central bank begins to flatten out its asset purchases or what is called "broad money" in the graph: real asset prices begin to fall rather precipitously, and consumer price levels rise. I must confess that I look at the graph and scratch my head and go, "I can understand why you might want the first phase, but what in the name of the wide, wide world of sports are you going to do for policy adjustment in the second phase?" Clearly the central bankers thought this QE thing was a good idea, but from my seat in the back of the plane it seems like they are expecting a rather bumpy ride at some point in the future.

Chart 1 The qualitative economic impact of QE



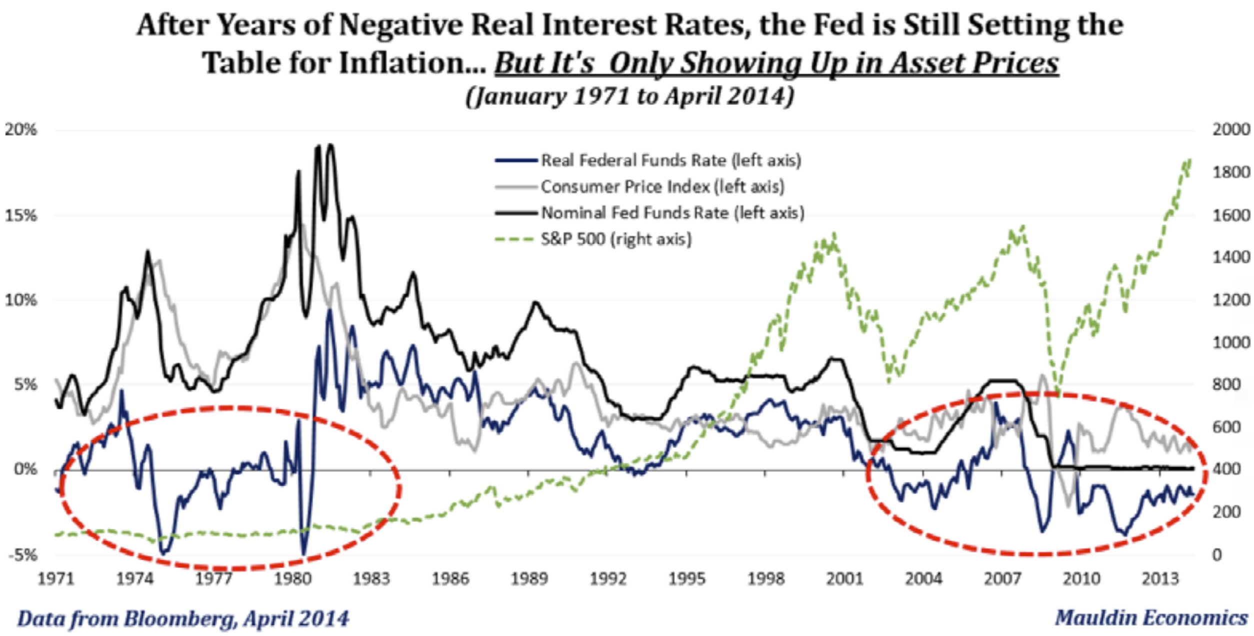
Let's go to the quote in the BoE paper that explains this graph (emphasis mine):

> The overall effect of asset purchases on the macroeconomy can be broken down into two stages: an initial 'impact' phase and an 'adjustment' phase, during which the stimulus from asset purchases works through the economy, as illustrated in Chart 1. As discussed above, in the impact phase, asset purchases change the composition of the portfolios held by the private sector, increasing holdings of broad money and decreasing those of medium and long-term gilts. But because gilts [*gilts* is the English term for bonds] and money are imperfect substitutes, this creates an initial imbalance. As asset portfolios are rebalanced, asset prices are bid up until equilibrium in money and asset markets is restored. This is reinforced by the signalling channel and the other effects of asset purchases already discussed, which may also act to raise asset prices. Through lower borrowing costs and higher wealth, asset prices then raise demand, which acts to push up the consumer price level.

[Quick note: I think Lacy Hunt thoroughly devastated the notion that there is a wealth effect and that rising asset prices affect demand in last week's *Outside the Box*. Lacy gives us the results of numerous studies which show the theory to be wrong. Nevertheless, many economists and central bankers cling to the wealth effect like a shipwrecked sailor to a piece of wood on a stormy sea. Now back to the BoE.]

> In the adjustment phase, rising consumer and asset prices raise the demand for money balances and the supply of long-term assets. **So the initial imbalance in money and asset markets shrinks, and real asset prices begin to fall back. The boost to demand therefore diminishes and the price level continues to increase but by smaller amounts.** The whole process continues until the price level has risen sufficiently to restore real money balances, real asset prices and real output to their equilibrium levels. Thus, from a position of deficient demand, asset purchases should accelerate the return of the economy to equilibrium.

This is the theory under which central banks of the world are operating. Look at this rather cool chart prepared by my team (and specifically Worth Wray). The Fed (with a few notable exceptions on the FOMC) has been openly concerned about deflationary trends. They are purposely trying to induce a higher target inflation. The problem is, the inflation is only showing up in stock prices – and not just in large-cap equity markets but in all assets around the world that price off of the supposedly "risk-free" rate of return.

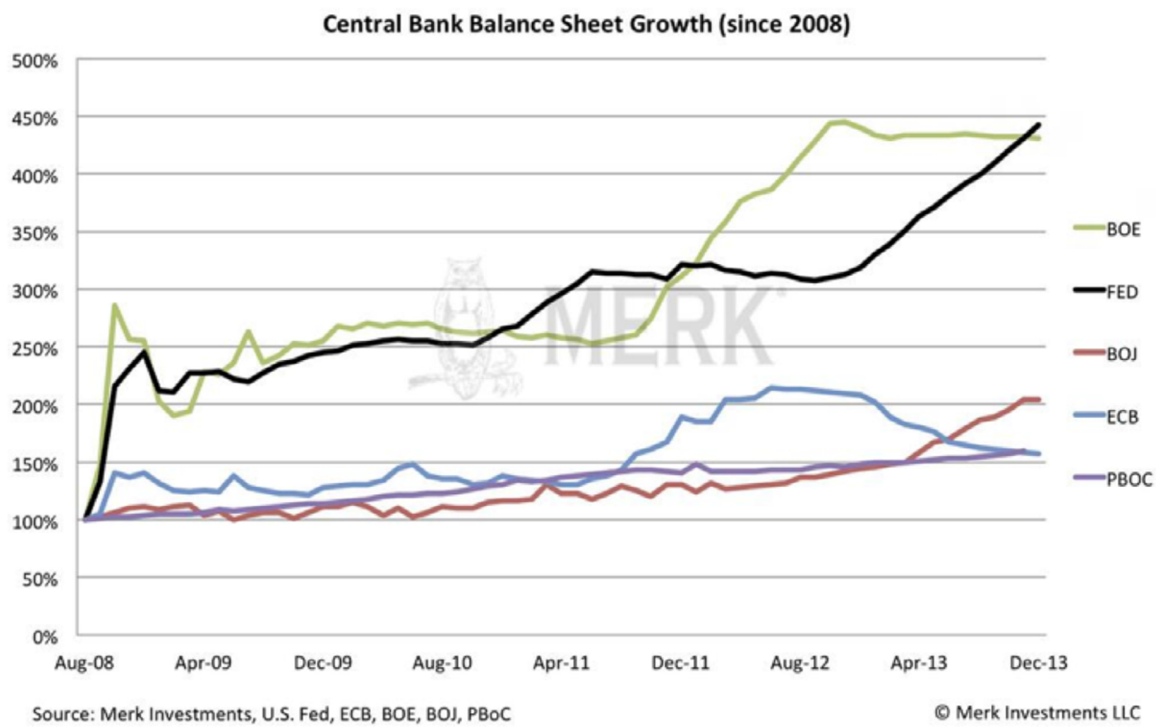


I hope you get the main idea, because understanding this dynamic is absolutely critical for navigating what the Chairman of the South African Reserve Bank, Gill Marcus, is calling the next phase of the global financial crisis. Every asset price (yes, even and especially in emerging markets) that has been driven higher by unnaturally low interest rates, quantitative easing, and forward guidance must eventually fall back to earth as real interest rates eventually normalize.

Trickle-Down Monetary Policy

For all intents and purposes we have adopted a trickle-down monetary policy, one which manifestly does not work and has served only to enrich financial institutions and the already wealthy. Now I admit that I benefit from that, but it's a false type of enrichment, since it has come at the expense of the general economy, which is where true wealth is created. I would rather have my business and investments based on something more stably productive, thank you very much.

Monetary policies implemented by central banks around the world are beginning to diverge in a major way. And don't look now, but that sort of divergence almost always spells disaster for all or part of the global economy. Which is why Indian Central Bank Governor Rajan is pounding the table for more coordinated policies. He can see what is going to happen to cross-border capital flows and doesn't appreciate being caught in the middle of the field of fire with hardly more than a small pistol to defend himself. And the central banks even smaller than his are bringing only a knife to the gunfight.

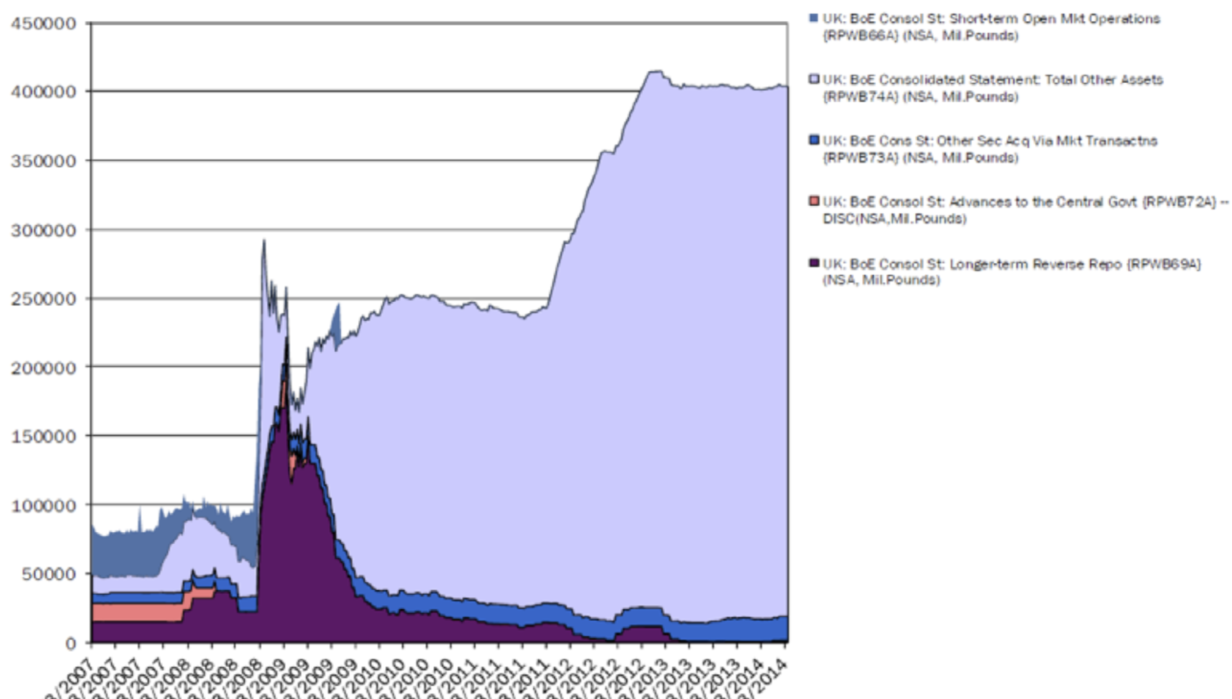


The Fed & BoE Are Heading for the Exits…

In the United States, Federal Reserve Chairwoman Janet Yellen is clearly signaling her interest – if not outright intent – to turn the Fed's steady $10 billion "tapering" of its $55 billion/month quantitative easing program into a more formal exit strategy. The Fed is still actively expanding its balance sheet, but by a smaller amount after every FOMC meeting (so far)… and global markets are already nervously anticipating any move to sell QE-era assets or explicitly raise rates. Just like China's slowdown (which we have written about extensively), the Fed's eventual exit will be a global event with major implications for the rest of the world. And US rate normalization could drastically disrupt cross-border real interest rate differentials and trigger the strongest wave of emerging-market balance of payments crises since the 1930s.

In the United Kingdom, Bank of England Governor Mark Carney is carefully broadcasting his intent to hike rates before selling QE-era assets. According to his view, financial markets tend to respond rather mechanically to rate hikes, but unwinding the BoE's bloated balance sheet could trigger a series of unintended and potentially destructive consequences. Delaying those asset sales indefinitely and leaning on rate targeting once more allows him to guide the BoE toward tightening without giving up the ability to rapidly reverse course if financial markets freeze. Then again, Carney may be making a massive, credibility-cracking mistake.

Bank of England Assets in Pounds Sterling from 01/03/07 to 04/16/14



Source: Bank of England.

While the BoJ & ECB Are Just Getting Started

In Japan, Bank of Japan Governor Haruhiko Kuroda is resisting the equity market's call for additional asset purchases as the Abe administration implements its national sales tax increase – precisely the same mistake that triggered Japan's 1997 recession. As I have written repeatedly, Japan is the most leveraged government in the world, with a government debt-to-GDP ratio of more than 240%. Against the backdrop of a roughly $6 trillion economy, Japan needs to inflate away something like 150% to 200% of its current debt-to-GDP… that's roughly $9 trillion to $12 trillion in today's dollars.

Think about that for a moment. At some point I need to do a whole letter on this, but I seriously believe the Bank of Japan will print something on the order of $8 trillion (give or take) over the next six to ten years. In relative terms, this is the equivalent of the US Federal Reserve printing $32 trillion. To think this will have no impact on the world is simply to ignore how capital flows work. Japan is a seriously large economy with a seriously powerful central bank. This is not Greece or Argentina. This is going to do some damage.

I have no idea whether Japan's BANG! moment is just around the corner or still several years off, but rest assured that Governor Kuroda and his colleagues at the Bank of Japan will respond to economic weakness with more… and more… and more easing over the coming years.

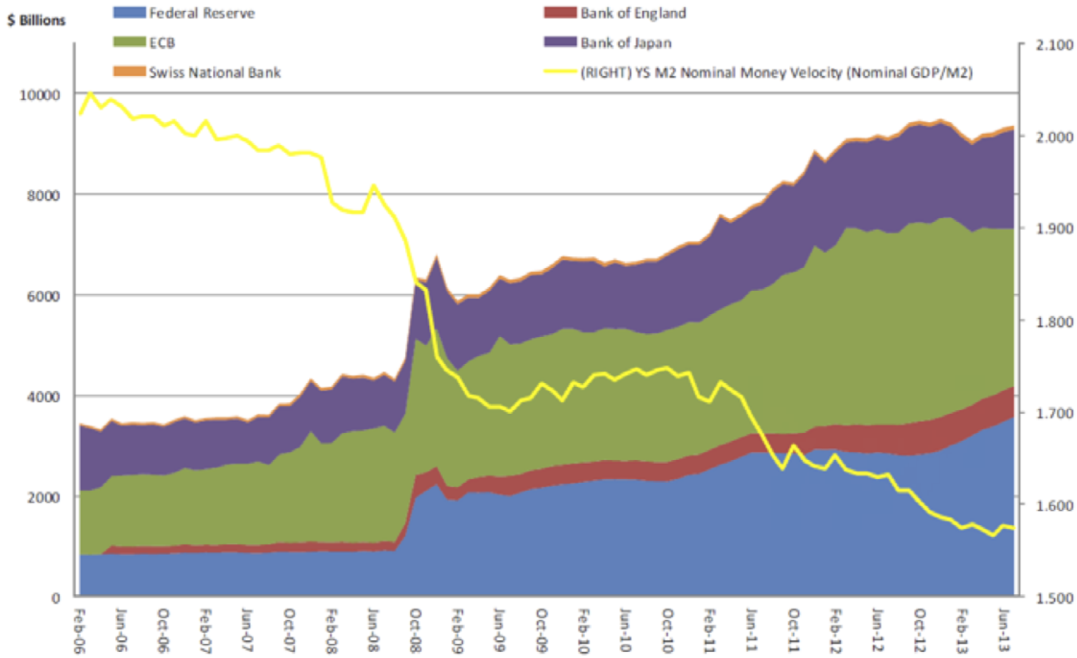
In the euro area, European Central Bank Chairman Mario Draghi – with unexpected support from his two voting colleagues from the German Bundesbank – is finally signaling that more quantitative easing may be on the way to lower painfully high exchange rates that constrain competitiveness and to raise worryingly low inflation rates that can precipitate a debt crisis by steepening debt-growth trajectories. This QE will be disguised under the rubric of fighting inflation, and all sorts of other euphemisms will be applied to it, but at the end of the day, Europe will have joined in an outright global currency war.

I don't expect the Japanese and Europeans to engage in modest quantitative easing. Both central banks are getting ready to hit the panic button in response to too-low inflation, steepening debt trajectories, and inconveniently strong exchange rates.

While the Federal Reserve, European Central Bank, Swiss National Bank, Bank of England, and Bank of Japan have collectively grown their balance sheets to roughly $9 trillion today, the next wave of asset purchases could more than double that balance in relatively quick order.

This is what I mean by Code Red: frantic pounding on the central bank panic button that invites tit-for-tat retaliation around the world and especially by emerging-market central banks, leading to a DOUBLING of the assets shown in the chart below and a race to the bottom, as the "guardians" of the world's primary currencies become their executioners.

Monthly Central Bank Assets (Dollar Equivalents on Left Scale $ Billions) for US, UK,Japan, Euro Area, and Swiss National Bank with US M2 Velocity/$GDP (RightScale) from June-06 to Mar-14



The opportunity for a significant policy mistake from a major central bank is higher today than ever. I share Bill White's concern about Japan. I worry about China and seriously hope they can keep their deleveraging and rebalancing under control, although I doubt that many parts of the world are ready for a China that only grows at 3 to 4% for the next five years. That will cause a serious adjustment in many business and government models.

It is time to hit the send button, but let me close with the point that was made graphically in the Bank of England's chart back in the middle of the letter. Once central bank asset purchases cease, the BoE expects real asset prices to fall… a lot. You will notice that there is no scale on the vertical axis and no timeline along the bottom of the chart. No one really knows the timing. My friend Doug Kass has an interview (subscribers only) in *Barron's* this week, talking about how to handle what he sees as a bubble.

"Sell in May and go away" might be a very good adage to remember.

Amsterdam, Brussels, Geneva, San Diego, Rome, and Tuscany

I leave Tuesday night for Amsterdam to speak on Thursday afternoon for VBA Beleggingsprofessionals. There will be a debate-style format around the theme of "Are there any safe havens left in this volatile world?" I plan to write my letter from Amsterdam on Friday and then play tourist on Saturday in that delightful city full of wonderful museums. Then, if all goes well, I will rent a car and take a leisurely drive to Brussels through the countryside, something I have always wanted to do. I may try to get lost, at least for a few hours. Who knows what you might stumble on?

I will be speaking Monday night in Brussels for my good friend Geert Wellens of Econopolis Wealth Management before we fly to Geneva for another speech with his firm, and of course there will be the usual meetings with clients and friends. I find Geneva the most irrationally expensive city I travel to, and the current exchange rates don't suggest I will find anything different this time.

I come back for a few days before heading to San Diego and my Strategic Investment Conference, cosponsored with Altegris. I have spent time with each of the speakers over the last few weeks, going over their topics, and I have to tell you, I am like a kid in a candy store, about as excited as I can get. This is going to be one incredible conference. You really want to make an effort to get there, but if you can't, be sure to listen to the audio CDs. You can get a discounted rate by purchasing prior to the conference.

The Dallas weather may be an analogy for the current economic environment. To look out my window is to see nothing but blue sky with puffy little clouds, and the temperature is perfect. My good friend and business partner Darrell Cain will be arriving in a little bit for a late lunch. We'll go somewhere and sit outside and then move on to an early Dallas Mavericks game against the San Antonio Spurs. Contrary to expectations, the Mavs actually trounced the Spurs down in San Antonio last week. Of course the local fans would like to see that trend continue, but I would not encourage my readers to place any bets on the Mavericks' winning the current playoff series.

I live only a few blocks from American Airlines Center, and so normally on such a beautiful day we would leisurely walk to the game. But the local weather aficionados are warning us that while we are at the game tornadoes and hail may appear, along with the attendant severe thunderstorms. That kind of thing can happen in Texas. Then again, it could all blow south of here. That sort of thing also happens.

So when I warn people of an impending potential central bank policy mistake, which would be the economic equivalent of tornadoes and hail storms, I also have to acknowledge that the whole thing could blow away and miss us entirely. I think someone once said that the role of economists is to make weathermen look good. Recently, 67 out of 67 economists said they expect interest rates to rise this year. We'll review that prediction at the end of the year.

I've been interrupted while trying to finish this letter by daughter Tiffani, who is frantically trying to figure out how to buy tickets to get us to Italy (Tuscany) for the first part of June for a little vacation (along with a few friends who will be visiting). I am going to take advantage of being in Rome at the end of that trip, in order to spend a few days with my friend Christian Menegatti, the managing director of research for Roubini Global Economics. We will spend June 16-17 visiting with local businessmen, economists, central bankers, and politicians. Or that's the plan. If you'd like to be part of that visit, drop me a note.

Finally I should note that my Canadian partners, Nicola Wealth Management, are opening a new office in Toronto. They will be having a special event there on May 8. If you're in the area, you may want to check it out.

Have a great week, and make sure you take a little time to enjoy life. Avoid tornadoes.

Your hoping for a major upset analyst,

John Mauldin

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