Monetary Mountain Madness

By John Mauldin | September 4, 2016

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> "Practical men, who believe themselves to be quite exempt from any intellectual influence, are usually the slaves of some defunct economist. Madmen in authority, who hear voices in the air, are distilling their frenzy from some academic scribbler of a few years back."
> – John Maynard Keynes

Scientific research says that leaving your normal environment can stoke creativity. This is one reason organizations send managers and workers to off-site retreats and conferences. "Getting

away from it all" seems to lubricate our brains.

You would think the effect might have been observable among the central bankers who attended the Federal Reserve's recent Jackson Hole, Wyoming, retreat. Sadly, however, having reviewed the speeches and the interviews that came out of the gathering, I found few if any fresh ideas, or at least none that would truly be helpful. Even the calls for "reformed thinking" turned out to be just variations on the same old thinking. For instance, rather than targeting inflation at 2%, why can we not think about 4% inflation? Instead of worrying about GDP, couldn't we worry about nominal GDP? As if such minor variations on old themes would make any real difference to employment or growth.

Indeed, what was revealed in the papers and discussions and then in the interviews that followed the conference alarmed me and in some cases truly outraged me to the point that I was spitting epithets. When the dust settled, I was left with a profound sense of sadness over our global economic leadership's obvious lack of understanding of the real world.

Jackson Hole revealed things that did not make it into the reporting of the event by the mainstream media. Turns out, the academic and philosophical underpinnings were laid down there for a radical expansion of the Federal Reserve's toolbox. I guess you could call that creative, but I wouldn't call it helpful, because the unthinkable policy that I have been warning about since last May – yes, we're talking negative rates – was not only discussed at Jackson Hole, it was discussed in a positive, even slavishly approving, manner. I am going to share with you my sense of what happened at Jackson Hole and what it really means. I trust that by the end of this letter you will better understand just how bankrupt – and disastrous – what passes for sound economic thinking among the world's central bankers actually is.

Putting Investors Before Savers

It is hard to know where to start, so let us start with what was most outrageous, an interview that had me muttering multiple expletive deleteds.

Last week Tom Keene of Bloomberg Radio interviewed Fed Vice Chair Stanley Fischer. (Tom is one of my favorite media personalities, because he asks the best questions and helps you say what you really want to say. You have to be careful, though, because Tom will also give you enough rope to hang yourself. When you are sitting with Tom Keene, you need to bring your A game, which is why he's so popular.) Dennis Gartman transcribed part of the Fischer interview in his Aug. 31 letter. Here it is, with some bold emphasis added.

> MR. KEENE: What did you learn about negative rates in the crucible of the markets? What have you learned in the last number of months?
>
> DR. FISCHER: Well, we've learned that the central banks which are implementing them – there were four or five of them – basically think they're quite successful and are staying with their approach, possibly with the exception of Japan. **They're thinking it through,**

> **and they have said they'll come back to try and make negative rates work better. <u>So we're in a world where they seem to work.</u>** I think one of the most interesting developments I've seen in theory is a paper that says, yes, they work up to a certain point and then they become counterproductive.
>
> MR. KEENE: Precisely. Yes, that's a critical point. I mean we have within the interviews of Bloomberg Surveillance that Francine Lacqua and I have had, Olivier Blanchard [former Bank of England Governor during the crisis and a friend] calls them an outright scam. Granted, he's not a public official anymore, I understand that. There is a raging debate about the efficacy of negative interest rates for central banks, for governments, and again for banking itself. What about the efficacy of negative rates for savers and the people of these different nations?
>
> DR. FISCHER: Well, clearly there are different responses to negative rates. **If you're a saver, they're very difficult to deal with and to accept, although typically they go along with quite decent equity prices. But we consider all that, and we have to make trade-offs in economics all the time, and the idea is, the lower the interest rate the better it is for investors.**

I have to say, reading that last part made my blood boil. For the vast majority of people with savings all over the world, zero or negative rates are not just "very difficult to deal with." They are in many cases the difference between living with a modicum of dignity and living in abject poverty. Or, if you're slightly better off, you may feel forced to take too much risk in your portfolio at the very time of your life when you should be taking few risks. But that's okay with Dr. Fischer, because negative rates also bring "quite decent equity prices."

Let's read that sentence again: "… the idea is, the lower the interest rate the better it is for investors." They are sacrificing mom-and-pop middle America, the hard workers who have played by the rules and retired and saved and now want to live out their lives enjoying their grandkids and a little well-deserved relaxation, and they find they can't do that because the Federal Reserve thinks that protecting Wall Street and wealthy investors and bankers is more important.

If you ask other Fed decision makers outright whether they support this remarkable view of Dr. Fischer's, they would of course cough, mumble, and then launch into a jargon-laden digression, since Fischer's little "trade-off" is so obviously politically incorrect. But the reality is that protecting investors at the expense of savers is precisely what Fed policy aims to do; and here Fischer, in an astonishing moment of candor, has come right out and admitted it. How in the name of all that is holy and just can you think that the public's savings have to be sacrificed on the altar of equity prices?

I should point out that we're not just talking about middle-class America, Europe, and Japan. The [multiple expletives deleted] central bankers are jackhammering to smithereens the very foundation of our retirement system. They are making it impossible for pension funds and

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insurance companies to meet their targets and to provide their services without massive contributions that will have to come from taxes and skyrocketing insurance rates that will have to be paid mostly by the middle class.

"We're in a world where they [negative interest rates] seem to work." Oh, really? For whom? And in whose reality? Europe ex-Germany is flirting with recession, indebted beyond any hope of growing out of the problem. Italy has just left the dock of the European budgetary agreement to sail back out into the choppy seas of ever-higher deficits and ever-greater debt, threatening to rival Greece. Italian debt is 132% of GDP today, and if they enact their announced tax and spending policies, they will soon be looking at 150% debt to GDP. And rising.

For all intents and purposes, Italian Prime Minister Renzi has looked the ECB's Mario Draghi in the eye and said, "I double dog dare you to stop buying Italian bonds, even though we are no longer keeping the agreement on deficits. You stop buying my bonds and allow my interest rates to go to market rates (which would blow Italy out of the water), and you will force us – your Italian countrymen! – to leave the European Monetary Union. You said you will "do whatever it takes"? What it is going to take is you buying my debt, no matter what we do. And if you don't keep buying, it will be your fault that the euro collapses." Side bet: Draghi blinks. Or decides to take a cushy consulting job in some big investment bank.

Japan has been lost in a two-decade eternity of growth paralysis. They have dug a huge hole for themselves, and amazingly, they just keep digging. As if low – and now negative – interest rates and gargantuan deficits will somehow now magically do for the Japanese economy what they have not done for the past 20 years…

The ultra-easy monetary environment of the US has produced 1% GDP growth over the last six months, almost no productivity growth, and an employment reality in which seven million men between the ages of 25 and 54 – prime working age – are no longer even looking for work. The only way you can possibly think your monetary policy is working, Dr. Fischer, is if you are measuring it only by the Dow Jones average. Which is not what most of us out here in the real world actually think about when we think of a thriving economy.

Whether equity prices are decent, indecent, or somewhere in between should have nothing to do with the Fed's monetary policy decisions. Their job is to encourage full employment and to minimize inflation. That's it. Propping up the stock market is not in the Fed's wheelhouse, yet it has obviously become the main driver of policy since Ben Bernanke and arguably since Alan Greenspan.

Bill Gross was on a tear in his September *Investment Outlook*. I am sure he wrote this with the Jackson Hole discussions in mind (emphasis mine):

> With Yellen, there is no right or left hand — no "on the one hand but then on the other" – there are only decades of old orthodoxy that follows the tarnished golden rule of lowering interest rates to elevate asset prices, which in turn could (should) trickle down to the real

economy.

> It was fascinating then to read a lone Fed wolf in wolf's clothing a week ago on *The Wall Street Journal's* op-ed page. Ex-Fed District President Kevin Warsh headlined a think piece titled, "The Federal Reserve Needs New Thinking." Now despite recent peekaboo ideas advanced by San Francisco Fed President John Williams, suggesting a 3% inflation target and a focus on nominal instead of real GDP growth (using the same old monetary weapons, however), Warsh took the Fed and (by proxy) other central banks to task, suggesting that a "numeric change in the inflation target isn't real reform." **"It serves," he wrote, "as subterfuge to distract from monetary, regulatory and fiscal errors." Warsh questioned the Fed's sincerity in speaking to income inequality while refusing to acknowledge that their polices have unfairly increased asset inequality.**

Let us hold that thought, and I'll finish with it at the close of the letter. But now, let's go back to Jackson Hole.

Who Goes There?

The Federal Reserve Bank of Kansas City has staged the Jackson Hole Economic Policy Symposium since 1982. Wyoming lies within the Kansas City Fed's jurisdiction (barely), so I guess the wilds of Wyoming were about as far-removed and creativity-enhancing a retreat site as the organizers could come up with without spilling onto the San Francisco Reserve Bank's turf. Over the years "Jackson Hole" has gone global.

The event even has its own official history book, titled *In Late August*. You can find it in PDF form here. Direct your attention to KC Fed President Esther George's introduction in the book's 2013 edition. She begins with this:

> For more than three decades, the Federal Reserve Bank of Kansas City has hosted the annual Economic Policy Symposium in Jackson Hole, Wyo. It is an honor for our Reserve Bank to be involved in organizing and facilitating a forum that brings together **central bankers, private market participants, academics, policymakers and others** to discuss the issues and challenges we hold in common.

I bolded her description of the attendees for you. Read it again, and then direct your attention **here** to the 2016 attendee list. Browse through it. You will see central bankers from many nations. You will see policy makers from the US Treasury Department, the Commerce Department, the International Monetary Fund, the European Commission, and other government agencies. You will see professors from a variety of global universities and think tanks.

What you *won't* see on the list is anyone who looks like a "private market participant." The chairman of JPMorgan Chase International was there under another guise (as head of something called the Group of Thirty, which actually has 32 investment banking, central banking, and academic members), but he really is an ex-central banker, so he is in the club. I know a lot of

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people from the private sector who used to get invitations. (Mine always seemed to get lost in the mail.) Esther George's statement in the 2013 book suggests they included the private sector as recently as three years ago. But they don't now. Why not? Inquiring minds want to know…

The Mysterious Footnote 8

Having identified the cast, we next consider the story line. What did these people talk about that was interesting and useful enough to draw such top talent?

The public part of the event is no mystery. Janet Yellen's opening remarks got all the media attention, but she was followed by a series of other speakers. The Kansas City Fed site has a handy agenda with links to each presenter's paper and handouts. Topics included:

- Adapting to Changes in the Financial Market Landscape
- Negative Nominal Interest Rates
- Evaluating Alternative Monetary Frameworks
- Central Bank Balance Sheets and Financial Stability
- The Structure of Central Bank Balance Sheets

Nodding off yet? Just reading those titles will put some people to sleep. Not us econo-nerds, though..

Remember the context here. At this gathering we have the top leadership from the Federal Reserve, the European Central Bank, the Bank of England, the Bank of Japan, the People's Bank of China, the Swiss National Bank, and a whole gaggle of less-central banks (including the Central Bank of Iceland, which might have a creative thought or two to tender). Thus the whole world's monetary brass is assembled in one place at one time. They have 48 hours to sort things out. It would be a huge waste not to use every one of those hours to full advantage.

Whoever set the agenda was well aware of all this urgency and settled on the five topics listed above. You might think that they would therefore dig into each topic deeply. Not so. Most of the presentations are only about thirty minutes long, and that includes time for a fellow academic to respond to the speech – hardly enough time for economists to finish clearing their throats.

So why were they there? The Friday and Saturday sessions both adjourned at 2:00 PM. At that point the attendees dispersed around the resort. I don't think they spent their time following elk tracks. No, they got down to the retreat's real business, and it was very much off the record.

Lacking further info, all we can go on is what was said publicly. None of it inspires confidence, because no one had any new ideas. Let's start with Yellen's speech, which was noteworthy only in how boring and uninspiring it was. She imparted no new information. It was universally reported, so I'll spare you the summary. What wasn't widely reported was her Footnote 8, in which she cited approvingly a mathematical formula that could put interest rates on autopilot. The Fed hasn't resorted to following the rule, but its mere presence in Yellen's paper suggests its use is on the

table.

For Yellen to adopt any fixed rule would be a major strategy shift. She has always maintained that the Fed should remain flexible but be "data-dependent." She has also declined to employ the so-called "Taylor Rule" favored by some economists. (Taylor is Stanford professor John Taylor, who was of course there at Jackson Hole.)

Following the rule on interest rates described in Yellen's Footnote 8 would have yielded truly bizarre results. It uses variables like core PCE inflation, the Fed's inflation target, and the unemployment rate to calculate an optimal Federal Funds rate target. If the Fed had been following the rule during the last recession, they would have dropped rates to -9%.

Yes, you read that right, -9%.

> To be fair, the Taylor rule would have taken interest rates to -3.75% during the Great Recession. Thus both rules are worthless as far as the real world is concerned.

As a point of reference, the ECB is right now at -0.4% and is experiencing all kinds of bizarre consequences. Yet here we have our own Fed chair bringing up a method that would send rates far lower still.

To be fair, Yellen didn't say she endorses this idea or wants to adopt it. She concedes it would have been impossible to drop rates that far in 2008. So why even bring it up?

A generous interpretation: Yellen wanted to demonstrate that the Fed's control over interest rates has limits as a tool for stimulating economic growth. And in her speech she does go on from there to talk about other policy tools. Still, it was no accident that she mentioned the rule for autopilot rates. This was another in a series of small nods to the idea that negative rates might be appropriate in some situations.

Learning the NIRP Ropes

Recall the series of Fed statements I listed in "The Age of No Returns." Between February and June of this year, Yellen went from being ***unsure*** that the Fed had legal authority to use negative rates to having ***no doubt*** that it could. That's not a small shift. It tells us that somewhere deep in the turgid bowels of the Fed, someone is at least cooking up some NIRP contingency plans.

Having established that it has legal authority to use NIRP, the Fed can now develop specific plans for doing so.

What better way to learn the NIRP ropes than by huddling with fellow central bankers who have actually taken the plunge? Jackson Hole gave them the chance. And sure enough, high on the agenda was that session on "Negative Nominal Interest Rates."

The lead presenter in that session, Marvin Goodfriend of Carnegie Mellon University, is an

unabashed cheerleader for NIRP. In the first paragraph of the first section of his paper, he says that he "… makes the case for unencumbering interest rate policy so that negative nominal interest rates can be made freely available and fully effective as a realistic policy option in a future crisis."

Dr. Goodfriend was joined on the dais by Marianne Nessén of the Swedish Central Bank, which presently touts a -0.5% policy rate. Neither of them sees any problem with dropping rates well below zero, and so our own Federal Reserve invited them along to explain how to do it.

Again, remember that Jackson Hole is not a summerlong retreat. Whatever makes it onto the agenda is there for good reason. The attendees didn't discuss NIRP for its entertainment value. They were carefully considering its effects and mulling over the practical aspects of implementing it. They also had the Group of Thirty leader in the room, ready to inform the big banks what was brewing.

Obviously this is all conjecture on my part, but I think it fits. I believe the Fed wants to have NIRP in its toolbox when the next recession hits. Having NIRP at the ready doesn't mean they will actually use it, but it does mean they could. The previously unthinkable is now fully thinkable.

If legality is no longer an issue, and the Fed is sorting out the operational details, what stands in the way of a negative rate policy? The banks and the markets aren't on board. The deference Fed officials show the markets is becoming more and more obvious.

Again, the Fed should not concern itself with market opinion and activity, but clearly it does. Yellen, Fischer, and the rest know they have to telegraph their every little move long in advance. **I think they are starting that process now with regard to negative rates**. I also think the policy will prove to be a giant, perhaps catastrophic mistake.

Inflation: The Impossible Dream

The final speaker at Jackson Hole this year was Nobel laureate Christopher Sims of Princeton University. His paper was titled "Fiscal Policy, Monetary Policy and Central-Bank Independence." It is actually a thoughtful paper that addresses some very real issues. It is worth reading, although I disagree with some of his conclusions. He does address the ineffectiveness of fiscal policy and some of the conundrums that arise with expanding central bank balance sheets. Given the chance, I would enjoy having dinner with him. Since I get to Princeton two or three times a year on personal business, who knows, maybe he will reach out.

He asks this question, and it's an interesting one: "Why has monetary policy been ineffective in the US, Europe and Japan?" He continues:

> The answer to this question should be mostly clear from the previous section's discussion. Reductions in interest rates can stimulate demand only if they are accompanied by effective fiscal expansion. For example, if interest rates are pushed into negative territory, and the resources extracted from the banking system and savers by the negative rates are simply allowed to feed through the budget into reduced nominal deficits, with no anticipated tax

> cuts or expenditure increases, the negative rates create deflationary, not inflationary, pressure.

I know I am being somewhat dismissive of Jackson Hole, but I should note that both Kevin Warsh, cited above as a critic of Fed policy, and John Taylor were in attendance. I am sure there were some late-night confabs over Scotch or whatever that, while collegial, found our troup of policy elites fundamentally at odds with one another. It is just that there are not enough of them who want to truly take new paths to swing the balance, at least not yet.

She Blinded Me with Science

To me, at least, the Yellen Fed's mental status gets clearer every day. They seem genuinely convinced that their crazed ideas – ZIRP, QE, Operation Twist, and the rest – are what brought the economy back from the brink of collapse. Last December's one-and-done rate hike was the victory lap. They think everything is peachy now and have turned their attention to preparing for the next recession.

This is all completely wrong. Yes, the economy did recovery (slowly), but it did so *in spite of* the Fed, not because of anything the Fed did. Trillions in QE bond purchases served only to cap interest rates and drive up asset prices – mainly stocks and real estate.

The Fed's base assumption, as I explained last week, is that making interest rates go down will stimulate demand for goods and services. That is true on the margin. It is not true always and everywhere. It is especially not true for non-bank private businesses and consumers. To them, interest rates are one of many costs and not necessarily the most important one. But interest income is most definitely important to a large number of consumers and businesses.

Bankers think differently, which matters, because it is bankers who have the most influence on Federal Reserve policy. To them, short-term interest rates are a kind of fuel cost. Liquidity is to bankers as crude oil is to refinery owners. You pump it into your refinery, process it, and out comes something your customers will buy – whether loan volume or gasoline.

We think of banks as lenders, and they are, but they are also borrowers. They borrow cash from depositors and bondholders, then loan it to borrowers at a marked-up interest rate. Cost of funds is critical to bankers. It is not critical to most other businesses. The decision to open a new factory or store location doesn't usually hinge on getting a lower interest rate. It depends on whether customers will buy whatever it is that the new business will produce.

Because the Fed is banker-driven, it thinks cost of capital is everything and therefore that a lower interest rate will stimulate activity. They're right up to a point, but that relationship is not linear. It flattens out as you get closer to zero.

Yellen is aware of this. Her point with Footnote 8 was that interest rates aren't always an effective stimulant. But also, she isn't the only vote. She has to convince the other governors and regional Fed bank presidents, and they are all influenced to varying degrees by the banking industry, which

loves lower rates.

Come to think of it, this might also explain Footnote 8. Negative rates are death to commercial banks. A -9% NIRP would kill many banks. So maybe that footnote was a warning, the Yellen equivalent of a brushback pitch to overly eager bankers. "Look what can happen if we don't do it my way."

I truly don't think Yellen will take us down to -9% or anywhere close to it. I do think she is mentally prepared to go below zero if she sees no better alternatives according to her personal economic religious beliefs. I also feel very confident that she and her colleagues won't take rates much higher from here. I think we will see 0% again (and below) before we see +2%.

Look, sooner or later a recession is coming. This recovery, feeble as it has been, is already long in the tooth. I think there is the real possibility we will enter at least a mild recession no later than the end of 2017, brought about by a crisis and recession in Europe. Those of us in the US really should pay close attention to what is going on at the polls in Europe just as we pay attention to the polls in Florida. How will the Fed respond when that recession hits?

The Fed is making those plans right now. If you think 2008–2009 was a wild ride, I suggest you fasten your seatbelt and prepare to take an airbag in the face. The next ride will be even wilder.

I am going to close here because the letter is getting a little long and it's Labor Day weekend. I truly have another letter's worth of notes and quotes that I would like to put in here. I am going to pick up next week exactly where we are leaving off today.

Thomas Jefferson once said, "I hold it that a little rebellion now and then is a good thing, and as necessary in the political world as storms in the physical." As a preview of next week's letter, let me assert that current monetary policy is a tax on the middle class and retirees by unelected government officials. A relatively minor tax on tea was ostensibly the trigger for the American Revolution. Perhaps the Boomer generation should once again man the barricades, this time in protest of something really damaging to the future of the country.

Denver, Dallas and George Gilder, Denver, and Dallas

I am going to be hosting a reception for my very good friend and one of the world's greatest philosophical and economic thinkers, George Gilder, on Friday, September 16, at my home in Dallas. He will be doing a presentation earlier in the day at the George W. Bush Presidential Library and will drop by afterward for the reception, where he will talk to us about his latest ideas and philanthropic pursuits. Gilder is the living author Ronald Reagan quoted most often; and his latest book, *Knowledge and Power,* is an intellectual tour de force in which George argues persuasively that information theory should be the driver of economic theory – a far cry from the academic garbage that has given rise to present economic policy.

Marry George's ideas about information theory with complexity theory and you have a working intellectual model that reflects how the world actually works, which means that you cannot stuff it

into an Excel spreadsheet and wait for it to spit out a policy directive. Rather, the conclusion you reach is that you have to let the actual interest-rate markets set the price of money. That approach would admittedly be somewhat more volatile, but it removes the potential for massive human policy errors. And large banks and institutions would soon develop products to smooth out the curve. Has the vol in LIBOR been all that much of an issue? You almost want to slap your forehead and go "Duh!"

I take every chance I can get to sit at the feet of George Gilder and ask questions. I seriously mean that. Some of my most memorable moments are of sitting somewhere (we seem to meet in the strangest places) and finally having to call it a night when the place – whatever place it is – closes. With George, the ideas just never stop.

The Weather Channel promises perfect Dallas weather for the reception; and I will provide wine, beer, and a few light hors d'oeuvres (plus whatever the guests bring, of course!), while George will provide the intellectual stimulus. Drop me a note at business@2000wave.com if you would like to come and are interested in the specifics.

I will be in Denver on September 14 for the S&P Dow Jones Indices Denver Forum. If you are an advisor/broker and are looking for ideas on portfolio construction, I will be there along with some friends to offer a few suggestions. Then I'll fly back to Dallas for the Gilder reception, only to turn right around and head back to Denver for the next few days to give the closing keynote at *Financial Advisor* magazine's 7th annual Inside Alternatives conference, where I will again share my thoughts on how to construct portfolios that are designed to get us to the other side of the problems I see coming in the macro world.

Bluntly, I think that portfolios constructed along the traditional 60/40 model are going to cause their owners significant pain in the future. And if you think the recovery has been slow this time, then you will not appreciate the snail's pace of the next recovery. Sometime in the fourth quarter I will go public with what I think is an innovative way to approach portfolio construction and asset class diversification.

I've been thinking about this new "Mauldin Solutions" portfolio model for a very long time, and now we are putting the final touches on the project. While the investment model itself is relatively straightforward, all of the details involved with making sure that the regulatory *i's* and business *t's* are crossed (the stuff that has to happen behind the scenes) are far more complex. Plus, as you might guess, there are white papers to write and web pages to construct. I am excited about a few new team members that I have finally persuaded to come on board.

I know, I know, I have been talking about this for a long time and especially in the last three weeks, and you are probably saying, "Come on John, just tell us what you're doing." I will as soon as I possibly can. The programmers are punching code, and the final details are being smoothed out. This project has been in the work for three years. Governments and central banks are trying hard to turn the investment world upside down. Just writing a book on what the world will look like in 20 years leaves me both enormously excited and terrified to my core. And when I think

about how to go about investing in such a world, I approach the process with fear and trembling. I say that in complete candor.

There are no easy solutions, no Easy Button; and certainly no status quo investing approach will get you through what's coming. Thankfully (and since it's the really big opening day for college football here in the US), I think I can see a hole in the line we can run through to daylight. Because daylight there will be. When we have muddled through the mess that our political and economic leaders are going to bring us, we're going to emerge into an exciting new world, rich with potential. We just have to make sure we get there with our assets (and our asses) intact.

It's time to hit the send button. Shane and I are off to dinner and a movie. I hope to see *Hell or High Water,* which I have had so many friends tell me is the best movie they have seen for a long time. I always feel a certain affection for movies with Jeff Bridges. You have a great week and remember to toast the working men and women who make the world go round.

Your probably not getting an invitation to Jackson Hole ever now analyst,

John Mauldin

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