Negative Rates Nail Savers

By John Mauldin | September 14, 2016

The Economy Is Rigged
The Creature from Jekyll Island
Let's Slap a 50% Tax on Your 401(k)s and Retirement Plans
What Will Happen from Here
Denver, Dallas, Denver, and Back to Dallas

> "You shall not crucify mankind upon a cross of gold."
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> – William Jennings Bryan, July 9, 1896
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> "You shall not crucify the retiree and saver on a cross of negative rates."
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> – John Mauldin, September 14, 2016

The Economy Is Rigged

As is now the practice on many college campuses, I should preface this week's newsletter with a trigger warning. What you are about to read could give you serious heartburn, especially if you are an economist or a central banker. Or a retiree or just someone who has lived life playing by the rules, and now you find yourself getting no return on your savings, forcing you to save even more and work even longer. Let me be careful to point out that I am not including all economists in my rather sweeping indictments. But if the shoe fits…

I also know that this special letter is a little longer than the average. But I think the topic requires a whole-cloth approach rather than yet another two- or three-part series.

Before we jump in, I want to note that economic chaos is not my only concern. We face a whole different kind of chaos on the geopolitical front. To a considerable degree it overlaps with the economic problems I'll discuss today. George Friedman has been calling the Eurasian landmass a "cradle of disorder." It's home to 5 billion people, and it's floundering in a sea of accelerating crises.

Regular readers know that George doesn't exaggerate. He may be the most fact-driven person I've ever worked with. He looks at good evidence and draws sound conclusions. And right now he sees evidence in Eurasia that looks chillingly similar to what happened in the years leading up to World War II. I know that's a strong statement. George doesn't issue it lightly. He is genuinely concerned

– and I am, too.

We decided the best way to share George's conclusions with you was visually. So, we're making a short documentary film titled *Crisis & Chaos: Are We Moving Toward World War III?* George and a film crew are in New York right now, putting it together.

I hope you'll join me on September 26 at 2:00 PM EDT for the online premiere of this provocative documentary. You can reserve your free, online seat by clicking here.

I devoted my last two newsletters to the Fed's seemingly unstoppable momentum toward a negative interest rate policy. Here are links in case you missed them:

- Six Ways NIRP Is Economically Negative
- Monetary Mountain Madness

Those letters brought a lot of responses but one in particular from my friend Newt Gingrich, who forwarded a column from John Crudele with the provocative headline "You're not imagining things, the economy really is rigged against you."

Newt asked me a question that was characteristically short and simple: "Where are you on the rigged economy theme and the Fed–big bank alliance against normal people?"

And, as his short questions tend to do, it required a long answer. I sat and thought about it for several days. Crudele has a point, I told Newt when I wrote back, but the issue he addresses is nuanced and the solution far from obvious. And the more I thought about it, the more it seemed that the best way to answer Newt's question was to write this week's letter.

Yes, the system is rigged, just not in the way that 99% of the people think it is and not by those they think are doing the rigging. Greed is not the reason for the rigging, nor are any of the other usual "follow the money" reasons. We cannot make a convenient demon out of Wall Street or the big banks and investment banking houses. The real culprits are far less sinister and are actually sincere in their motives, so you won't see an Oliver Stone movie about the conspiracy to defraud the middle class and strip them of their hard-earned retirement savings. No, the "bad guys" in the story are just Nobel laureates, tenured professors, and other honorable members of the economic academic establishment, what Ken Rogoff calls the "policy community." The Occupy Wall Street crowd had a right to be angry, but they should have been demonstrating in front of the economics schools at Harvard, MIT, Princeton, Yale, etc. You know, the schools that many of those Occupy Wall Street protesters themselves attend.

The economy has been rigged through a process that may have seemed innocent enough at any given point but that quickly put us on a slippery slope as ideological forces captured the ramparts of academic economic science. A brief history will bring us up to date.

The Creature from Jekyll Island

In 1913, the Federal Reserve was created by the major banks as a way to protect them from crashes. (The disastrous Bankers' Panic of 1907 was still fresh in their minds). And there is no doubt that the Fed was designed so that the big banks retained as much control as they could convince a skeptical Congress to grant them, while giving in on a few minor points. But sometime in the '90s power shifted. The servant became the master; and while it is certainly true that Wall Street and large banks and investors currently benefit from the policies of the Federal Reserve, they really are not in control anymore.

In the 1930s and into the early '40s, an intense debate ensued among economists about how to best measure the national income and gross productivity. The questions were magnified by the Great Depression. I have written about this debate at length in reviewing a 140-page book called *GDP: A Brief but Affectionate History,* by Diane Coyle. The book can be read in a pleasant Sunday afternoon, and I highly recommend it. I am going to quote a paragraph and summarize the rest below. Writes Ms. Coyle:

> There is no such entity out there as GDP in the real world, waiting to be measured by economists. It is an abstract idea…. I also ask whether GDP alone is still a good enough measure of economic performance – and conclude not. It is a measure designed for the twentieth-century economy of physical mass production, not for the modern economy of rapid innovation and intangible, increasingly digital, services.

So how did this nonsensical measure we call GDP come about? Fact is, you actually do have to try to measure an economy if you are going to be a government and especially a wartime government. Without such a measure, how do you know how much can you actually tax and produce for the war effort, let alone for welfare and other services?

The argument boiled down to debates between followers of John Maynard Keynes and more conservative economists, either the disciples of Friedrich Hayek and Ludwig von Mises or followers of the classical school of economics. Conservative voices argued that the government's taxing and spending simply took money from the citizens/taxpayers and put it to work somewhere else, so that it was not really contributing to the true productive economy. (The argument was far more nuanced and detailed than that, but I boiled it down to its simple central idea.) Those on the other side argued that you had to know about the effects of taxes, depreciation, and the myriad forms of government spending in order to understand the economic capacity of the country.

But the issue really came down to the political argument: If you do not include government spending in GDP, the economy will appear to be shrinking in the middle of a war or in a recession, even though the government is spending money hand over fist. From the point of view of politicians who wanted the government to spend more on goods and services (and yes, war), including government spending in GDP made total sense, because you want to be able to tell the citizens the economy is growing. Politicians have been spinning data and news for ages. Whether we're talking about the results of reading sheep entrails or of dicing modern economic data, the information is spun to make the politician look good.

The controversial decision to include government spending in GDP was a political move made by

President Roosevelt and the Democrats, who were in charge during the Great Depression.

Within a short time, the inclusion of government spending in GDP was accepted as economic dogma by all major economic institutions. This of course made it easier to argue for and act on Keynes's assertion that government should spend during recessions, stimulating the animal spirits of consumers and driving up consumption. Who could even question such an assumption? Only troglodytes, the less-educated along, and other sorts of deplorables.

In the '50s and '60s, economists succumbed to physics envy. They wanted their less-than-precise discipline to be considered a hard science, too. Theirs was a far cry from the approach of Adam Smith and the classicists. As economics became more and more concerned with data and data analysis, with statistics and statistical analysis, it seemed to academic economists that with enough research they could actually develop models that would tell us how the economy really works.

In the '70s and '80s, the current leadership of the central banks of the world were all bright-eyed students at the same schools – the MITs, Harvards, Columbias, and Princetons of this world. The University of Chicago and its "freshwater" economists (as opposed to the "saltwater" economists on the East and West Coasts) held sway for a time, too, but that time has sadly passed.

Keynesian and then neo-Keynesian economics became the driving force in academia. Politicians and bureaucrats courted them because Keynesian economists basically gave them permission to spend money. See for easy reference any of Paul Krugman's *New York Times* columns advocating ever more fiscal spending and ever easier monetary policy.

The neo-Keynesian philosophy now dominates the thinking of central bankers worldwide; but before we explore that point further, I want to quote from a brilliant book review by my friend James Grant of *Interest Rate Observer* fame of Prof. Ken Rogoff's latest book, *The Curse of Cash*. I have found this book and the reviews of it disturbing, because Rogoff was one of my heroes for his earlier book *This Time Is Different,* which is a brilliant tour de force on the problems of debt. Having met Rogoff, I can assure you he is a very pleasant, easy-going man. But his argument in *The Curse of Cash* is not quite so benign or pleasant.

The *Curse of Cash* argues that we should get rid of the $100 bill because it hampers the Federal Reserve's control over the money supply and makes it more difficult for the Fed to employ negative interest rates. Let me quote one paragraph from Grant's review (emphasis mine):

> In a deep recession, Mr. Rogoff proposes, the Fed ought not to stop cutting rates when it comes to zero. It should plunge right ahead, to minus 1%, minus 2%, minus 3% and so forth. At one negative rate or another, the theory goes, despoiled bank depositors will stop saving and start spending. **According to the worldview of the people who constitute what Mr. Rogoff fraternally calls the "policy community" (who elected them?),** the spending will buttress "aggregate demand," and thus restore prosperity.

You may doubt this. Mr. Rogoff himself sees difficulties. For him, the problem is cash. The ungrateful objects of the policy community's statecraft will stockpile it.

I have a problem with Mr. Rogoff's proposing negative rates, but the problem I want to focus on in this part of the letter is the makeup of what he refers to as the "policy community." What he means by that is the leaders of the economic community, a kind of self-defining non-organization in which very few non-Keynesians are included.

And now we get to the root of the issue. Economics has been divided into religious camps. It is a field every bit as divided as the Protestants and Catholics were in the 1500s or the Shia and Sunni are today. There are those who are considered orthodox and those who are considered heretics, and there is a priesthood of the believers. When you are anointed as a high priest, you become part of the "policy community." Yes, the priesthood has its own disagreements. These are, after all, academics, and they make their academic bones by proposing ideas and producing papers (generally with lots of math that's hard to follow) and then arguing about them.

In general, to be accepted as a high priest in the Keynesian economic religious community you have to agree to a certain set of principles contained within their catechism. And one of the most important principles is that consumption is the driver of economy, a corollary to which is that the twin dials of money supply and interest rates can raise or lower consumption and thus moderate inflation and deflation. Implied within that principle is the assumption that it is incumbent upon the central bank, as an independent figure in the economy, to control the money supply and interest rates in the best interests of the overall economic polity.

Let us look back for a moment, some 2,400 years, to the time of Plato in Athens. Plato was writing his *Republic,* which has profoundly influenced Western thought across the centuries. In the book he idealized what he called Philosopher Kings. They are the rulers of Plato's utopian city of Kallipolis. If his ideal city-state is ever to come into being, Plato says, "philosophers [must] become kings… or those now called kings [must]… genuinely and adequately philosophize."

Today's academic economists would certainly dismiss the notion that they are Philosopher Kings, but that is essentially what they have become. The world's central bankers have taken upon their sturdy shoulders the mantle of infallibility: they see themselves alone as being sufficiently knowledgeable and competent to be able to determine the price of the single most important commodity in the world, money, and have determined that the setting of that price cannot be left to the hoi polloi of the marketplace. To trust the unruly, unpredictable market with such matters would plunge the world into chaos; and thus the High Priests have assumed responsibility for the general economic wellbeing.

And there you have it. The rigging of the economy against the interests of average citizens is not the fault of Wall Street, nor even of Washington, DC, but rather is the result of a historical process that, step by step and byte by byte, has elevated economics and its leading practitioners to the status of an almighty priesthood.

I have met many of these men and women. As individuals, many are quite humble and personable. But when they assemble in groups and sit around tables at central banks, they consign to themselves the magical ability to divine what is best for an economy of 330 million people in the US and billions around the globe.

Of course, they would resent the reference to magic. They would argue that, far from resorting to hokus pokus, they employ theories and models that are highly mathematical and every bit as valid as anything physics or engineering can muster. The only problem is, these models have proven themselves to be unbelievably incapable of predicting anything about the future and have an unblemished record of failure in describing what is going to happen in the world.

All these models can do is apply economic theory to the data. Data that cannot be readily plugged into the mathematical model must be ignored. Data that is sketchy or incomplete corrupts the output from the model. And the Federal Reserve certainly does not have access to all the data that would be required to model an economy as complex as that of the United States.

Further, models are created from assumptions. And the assumptions behind them are just simply wrong. Though today's economic Philosopher Kings have Nobel prizes and PhDs, though they understand all sorts of mathematics that I will never get my head around, the simple fact is that their models have been proven to be consistently wrong. Any business that operated according to models so demonstrably bad would be bankrupt overnight, and the wizards who created those models would be fired. Yet central banks continued to crank out models that don't work and then endlessly tweak them without ever challenging their core assumptions.

Nearly all economic models assume the theoretical existence of some sort of dynamic equilibrium state. That's because you can't model a system that is complex and chaotic in an Excel spreadsheet or even in the latest and greatest statistical software. To even begin to reliably model the economy, you would have to apply complexity economics, a field that is still in its infancy.

George Gilder's great insight is that knowledge is the currency that has real value, a fact that he derives from Claude Shannon's information theory. Knowledge is the signal in the noise that lets the markets know how to respond and helps each of us to decide what to buy and sell, whether to go to work or to stay home, every day.

And that understanding of the economy, with knowledge and the informed decision making of economic players at its core, is not going to make it into any mechanistic model that the Priesthood of Economists concocts to determine what the price of money should be. Because we simply do not have the tools to model that kind of complexity.

As an aside, I want to make clear that not all of the high priests agree with a move to negative interest rates. There are actually some notable economists (including Nobel laureates) who think negative rates are a very bad idea; but in general, what we heard out of Jackson Hole is that they are quite an acceptable idea. The masterminds who hatched the philosophy that is used by the Fed are clearly planning to apply negative interest rates to the world's reserve currency when the next recession hits. They would of course deny this and say that that negative rates are just another tool in the toolbox, which we should have ready just in case. Then in the same breath they'll turn around and say, "Look, negative rates are working quite well in Europe and Japan." You have got to wonder what they are smoking.

At the beginning of the letter I offered links to the two previous letters I have written on the problems with negative interest rates. Let me repeat those links right here:

- Six Ways NIRP Is Economically Negative
- Monetary Mountain Madness

You will read in the second letter my reaction to some truly outrageous comments by Federal Reserve Vice Chair Stanley Fischer, who shared a moment of perfect candor with Bloomberg's Tom Keene, not realizing that some of us out here in the real world might take offense. Keene asked him about the impact of negative interest rates on savers (emphasis mine).

> 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.**

That's about as clear as it gets. The Fed has no interest in helping savers earn a decent return on their bank deposits or money market funds. Dr. Fischer thinks "decent equity prices" are wonderful and lower interest rates are good for investors. They are willing to trade off your returns on fixed-income for a rising stock market. Charitably, Dr. Fischer is looking at the economy as a whole rather than the specifics of individuals. He clearly sees his mandate as responsibility for the entire economy. The fact that some have to make "sacrifices" is part of the process. This is the burden of a Philosopher King. Someone has to make the difficult choices.

Is it even true that ultra-low or negative interest rates are better for the overall economy than rates that more accurately reflect unfettered market dynamics? There is a mountain of research to the contrary. By lowering rates to the zero bound, the Fed has stacked the deck in favor of a relatively small number of people who own the vast majority of financial assets. In so doing, it has created the conditions for moribund economic growth, persistent unemployment and underemployment of working-class citizens, and impoverishment of savers.

Further, the FOMC becomes breathless at even a hint of wage inflation, wondering if it will force them to raise rates; but the massive inflation they have caused in the stock market and other asset prices is somehow seen as a good thing. Bernanke and other central bankers have actually bragged about the effects of Federal Reserve monetary policy on the stock market. As if the stock market is something that the Fed should be focused on. I always kind of thought the focus was supposed to be on Main Street and the average guy out in the real world.…

Let's Slap a 50% Tax on Your 401(k)s and Retirement Plans

If a politician came to you and said he thought he should tax the income from your retirement plan today, right now, at 50% (no matter where you are in the retirement process, that would certainly hurt the ability of your portfolio to compound), what would you think (other than that he was completely Looney Tunes)?

But that is exactly what the Federal Reserve has done. They have reduced the fixed-income returns in your retirement plans and the broad pension plans upon which so many people are dependent to practically nothing in the name of propping up asset prices. They have painted us all into the mother of all corners, from which there is no rational exit.

Rather than allowing rates to normalize years ago when they should have, the Fed and other major central banks have now unbalanced the financial system so badly that the markets very likely will have another tantrum – no, make that a grand mal seizure – when rates start to rise. And that means your bond funds will get killed as well as your equity funds. It is going to be an unmitigated disaster for retirement and pension plans, and any right-thinking person understands that.

That is precisely why the Yellen Fed is having trouble coming to the point of actually normalizing interest rates. They know the reaction from the stock market is going to be really, truly, unbelievably ugly. And because they have been the pushers of the heroin of ultra-low rates, they are going to be blamed for the withdrawal.

Larry Summers went on a full-throated rant last week in the *Washington Post.* It's instructive reading. His title is:

> "The Fed thinks it can fight the next recession. It shouldn't be so sure."

He points out that despite all the happy talk from Janet Yellen at Jackson Hole, the Fed doesn't have any ammo left. His paper and others point out that typically the Fed reduces interest rates by about 550 basis points in a recession. If a recession kicked in tomorrow, that would plunge us to the breathtaking interest rate of -5%. As I wrote last week, a footnote that Janet Yellen cited approvingly in her paper suggested that rates should go to -6% or -9% during the next recession to be effective. Now here's Larry, teeing off:

> My second reason for disappointment in Jackson Hole was that Federal Reserve Board Chair Janet L. Yellen, while very thoughtful and analytic, was too complacent to conclude that "even if average interest rates remain lower than in the past, I believe that monetary policy will, under most conditions, be able to respond effectively." This statement may rank with former Fed chairman Ben Bernanke's unfortunate observation that subprime problems would be easily contained.
>
> Rather I believe that countering the next recession is the major monetary policy challenge before the Fed. I have argued repeatedly that (1) it is more than 50 percent likely that we will have a recession in the next three years (2) countering recessions requires four to five percentage points of monetary easing (3) we are very unlikely to have anything like that much room for easing when the next recession comes.

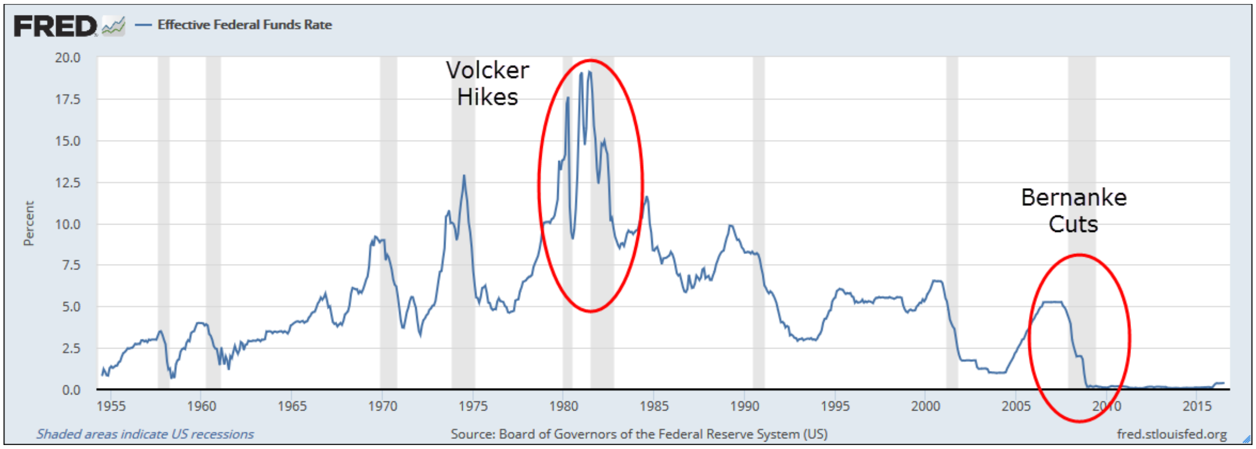
And here is where one of the highest of High Priests and I agree. Models have serious limitations, and we should be very skeptical of policies based on models that rely on past performance:

> There is an important methodological point here: Distrust conclusions reached primarily on the basis of model results. Models are estimated or parameterized on the basis of historical data. They can be expected to go wrong whenever the world changes in important ways. Alan Greenspan was importantly right when he ignored models and maintained easy policy in the mid-1990s because of other more anecdotal evidence that convinced him that productivity growth had accelerated. I believe a similar skeptical attitude toward model results is appropriate today in the face of the clear evidence that the neutral real rate has fallen. I pay attention to model results only when the essential conclusion can be justified with some calculation where I can see and follow each step….
>
> I suspect that prevailing views at the Fed about the efficacy of quantitative and forward guidance substantially exaggerate their likely impact. I don't think the Fed has taken on board the lesson of the three-year period since QE ended. If longer-term rates had risen after QE and forward guidance ended, this would surely have been taken as further evidence of their potency. It follows that the fact that term spreads have fallen substantially since the end of unconventional policy, as shown in Figure 3, should lead to more skepticism about their efficacy.

(And hot off the press – it literally just landed in my inbox as we were about to send this letter out – **here** is another, possibly even more heavyweight indictment of economic modeling and the state of the economics profession in general, from Paul Romer, chief economist of the World Bank and former NYU and Stanford prof. He just released this version of his paper today, and he notes that it's a work in progress.)

What is new in the Fed's (and other central banks') performance is the sheer magnitude of monetary manipulation in recent years, and the very constrained maneuvering room the Fed now has as a consequence. And of course it's questionable whether they should even be trying to maneuver the economy to the degree that they are. The current predicament is a direct result of mistakes made during and after the last financial crisis.

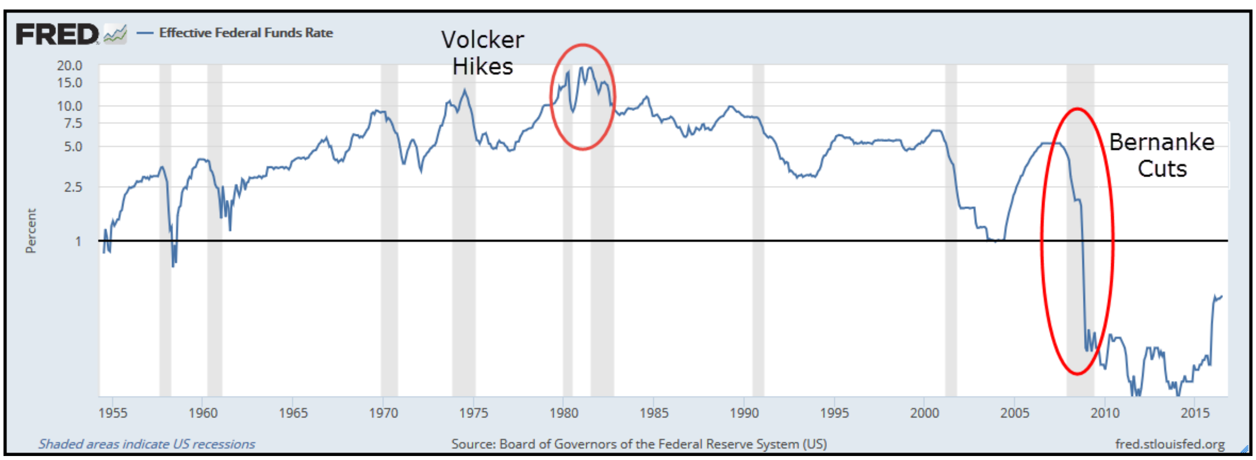
Here is a long-term chart of the federal funds rate, the Fed's main policy tool:



The gray vertical bars represent recessions. You can see how the Fed has historically dropped rates in response to recessions and then tightened again when those recessions ended. I red-circled the particularly drastic loosening and retightening under Paul Volcker in the early 1980s and Ben Bernanke's cuts to near-zero in 2008.

To this day, the Volcker rate hikes are legendary. No Fed chair has ever done anything like that, before or since. You hear it all the time. Problem: it's not true.

Here is the same chart again, this time with a log scale on the vertical axis. This adjusts the rate changes to be proportionate with *percentage* rises and falls. The percentage change between 5% and 10% is the same as between 10% and 20%, since both represent a doubling of the lower number.



Looking at it this way, the Volcker hikes are tame, almost unnoticeable. Meanwhile the Bernanke cuts dwarf all other interest rate changes since 1955. Nothing else is even close. **Bernanke's rate cuts were far, far more aggressive than Volcker's rate hikes.**

Why did Bernanke et al. cut rates to zero? Because moving rates up and down was all they knew to do. It had always worked before. If it wasn't working this time, they figured more of the same should do the trick.

Well, more hasn't done the trick over the longer term, either. It might have worked for a year or two, but after that the Bernanke-led Fed was so scared of a negative stock market reaction that they kept rates artificially low for eight years – and decimated fixed-rate income returns of pension funds and retirement plans for the middle class. Central banks all over the world did the same, and more. The suffering caused by this bone-headed policy approach has intensified for all these years. You may not be suffering yourself, but I bet someone close to you is. And I flipping guarantee you that your retirement funds have suffered.

Now, would the markets have screamed bloody murder if the Fed had raised rates back to 3% in, say, 2010 or 2011? For sure, but then the members of the FOMC are the High Priests who have taken it upon themselves to make these weighty decisions. They are not there to be popular; and whether they know it or not, they are not there to worry about the level of asset prices.

In any case, the result has been nearly a decade of return-free risk for millions of savers and investors. Those living off of fixed-income portfolios – never mind simple savings accounts or CDs – have grown steadily more desperate as each holding matured and couldn't be reinvested at a decent rate.

And so they have created a bubble. My friend Louis Gave writes this morning:

> But there are "lows in bond yields", and then there is the reality of a third of outstanding OECD government bonds offering investors negative yields. This latter proposition makes no financial sense whatsoever. Who would willingly pay a percentage, year after year, to have money taken off their hands? The answer suggests that one candidate for the definition of a financial bubble would be:
>
> 1) The establishment of prices that, by any historical measure, make no sense whatsoever.
>
> 2) The broad financial community, although acknowledging that these prices do not make sense, persuades itself, perhaps through the use of new valuation metrics (remember market cap per eyeball?), that in some greater scheme of things they can in fact be rationalized.

Now, the Fed will argue that the low rates did work. The economy emerged from recession. Unemployment drifted back down, however slowly. Yay for us, said the Fed.

Don't buy that statistical economic garbage. The economy recovered *in spite of* Fed policy, not because of it. The economy recovered because business owners, entrepreneurs, and workers rolled up their sleeves and made things happen. It involved a lot of pain: layoffs, asset sales, lost customers, and more. But the hard-working citizens of this country slowly and painfully pulled themselves out of the nosedive. Those are the people who deserve the credit. As they have for every recovery since the Medes were trading with the Persians.

Of course the High Priests and the politicians take credit for the recovery. But to borrow a phrase, you did not build that. Even while talking up the need for economic growth and for businesses to thrive, they disdain the actual workings of the free market, not giving it credit when it, not monetary policy, is actually the driver of the economy.

Look where we are now. The supposedly humming economy is certainly going to suffer another recession in the not-too-distant future. What then? The Fed can't cut rates again unless it first raises them considerably from here. And they can't do that because then they would no longer be supporting those "decent equity prices" that are so important to Stanley Fischer.

So, for lack of anything else to do, the Fed is preparing to send interest rates below zero when the economy next needs goosing. That was clearly the message from Jackson Hole. Fed economists truly think that negative is the right direction to go with rates, and that we plebeians should simply trust them to puppeteer the economy.

And they point to the data. Or their interpretation of it. They are correct that they lowered interest rates and kept them low overlong and that the economy has kind of, sort of, modestly recovered. Yes, both of those things happened at the same time. There is undoubtedly correlation, but the High Priests see causation. They think that the one thing (low rates) led to the other thing (recovery).

Central banks were trying to get the economy going again, and the mandarins at the major central banks think that low rates are the driver for employment, so it is worth reducing interest rates, which destroys returns for retirement plans, pension funds, and normal businesses that need fixed returns, in order to drive up employment. The fact that there is no evidence other than correlation to demonstrate that low rates were actually the cause of lower unemployment and recovery does not slow them down a bit. If any science student resorted to the same conflation of statistical correlation and causation, his paper would be thrown out and he would fail the course. But that same nonsense passes for academic excellence in economic circles.

An economist sees what he wants to see and disregards the rest, to paraphrase an old song. The Fed is plenty willing to disregard the "financialization" of the economy, which has made it cheaper to buy your competitors than to compete with them and has resulted in reduced capital spending and lower employment. They would say that without their lower monetary rates there would have been even less capital spending. The fact that credit spreads are at their lowest level ever and capital spending is punk doesn't seem to fit in their equations. They fail to see that correlation. But it's not a lack of capital that is the problem. It's the lack of decent opportunities, even at ultra-low rates, to put capital to work.

Admittedly, that is not just a problem with the Federal Reserve. Opportunities are also constrained by the ridiculously overregulated business environment, a tax structure that makes no sense, and debt that is exploding not just in the US but globally. The whole world is upside down.

I should note here that there is considerable disagreement about central bank behavior in economic academia. There are many accomplished economists who viscerally disagree with current central bank philosophy. Much of the argument falls into the "How many angels can dance on the head of a pin?" category, a debate over relatively meaningless trivia having to do with largely nonsensical topics, but you can find serious contention occurring at even our most high-falutin' universities. So please don't think I'm labeling all economists as arrogant Philosopher Kings. No, just the ones who advise and run central banks.

I should also note that many of the Federal Reserve regions deliberately choose centrist or independent regional presidents who are not in sync with the Governors of the Federal Reserve. There is a similar lack of consensus at the ECB. And at the Bank of Japan. But, by hook or by crook, the reigning central bank paradigm has clearly shifted toward policies that just a few decades ago would have been seen as utterly radical and unhealthy. Who even muttered the words *negative rates* in the '90s, or even in the depths of the crisis in 2008?

How in Hades did we arrive in a place where negative rates were considered a good idea? One of the most patently stupid ideas ever cooked up in academia is now seen as rational and globally applicable. I equate that sort of thinking with the rationality that says, if five leeches sucking blood out of the patient works, maybe we should use 10. If one virgin sacrifice helped satisfy the Volcano God and kept him from blowing his top this year, maybe next year we should give him two.

The problem today is that if you call into question the High Priests' interpretation of the data, you are consigned to the economic basket of deplorables. In their minds, you simply don't comprehend what is to them self-evident. And because they control the levers of power, they are going to do what they think they should do.

And that is to balance the interests of savers and retirees and pension funds against the interests of banks and stock market investors – and then lopsidedly favor the latter. The imbalance started with Greenspan and the so-called "Greenspan put," but Bernanke doubled down with his total capitulation after the Taper Tantrum, rather than looking the market in the eye and saying, "Deal with it."

So coming back around to what I told Newt in my letter (and then followed up on with a two-hour phone call), yes, the economy is rigged. But it is rigged by an economic priesthood that is in the seat of power at central banks around the world, and particularly at the Fed. Wall Street (and, admittedly, small-scale stock market investors) are simply the beneficiaries of the policy. Of course the big boys on the Street do hire former Fed economists and governors as consultants, so the entire setup is incestuous. But since, in the current mania, Federal Reserve policy drives the markets, it makes perfect sense for Wall Street to hire people who were once in the belly of the beast and can still read the entrails and tell their bosses what is likely to happen so they can make sure to run ahead of the curve. It would be foolish and an abdication of their fiduciary responsibility to their shareholders and investors not to do so.

What should we do? There are not many options. Maybe someday we'll elect a president who will replace Federal Reserve governors with those who favor allowing the market to set interest rates. Or maybe we could get Congress to remove the Federal Reserve's mandate to achieve full employment (as if interest rates that are far lower than natural market-driven rates can make much of a difference on employment) and take that responsibility for themselves, rather than trying to blame the Federal Reserve for employment numbers. And in the absence of those unlikely events, perhaps we can rally some members of Congress to really put the heat to the Federal Reserve about negative interest rates.

Let me make it clear that if somehow or other I was made the Head Philosopher King and decided to allow the markets to set interest rates, the ensuing volatility and problematic markets would be serious for more than a few months. My idealistic move would likely precipitate a serious recession as markets adjusted. There is no magic wand to get us to normal. If there were, I'm pretty sure the Federal Reserve would wave it at once, because I think everybody realizes that rates should already have been normalized – and that to do so now is going to be problematic. We really have come to a place where there are no good choices.

At the end of this letter (which is coming, I promise) I will give you a two- or three-paragraph summary of what I think the country should do, as I did in this letter a few months ago. And even that summary will be chock full of economic heresy that I find myself struggling to accept, because of the untenable situation we find ourselves in. We will be only a few years into the next recession when total US debt tops $30 trillion. Wrap your head around what the interest-rate bill on the federal debt will be if rates are normalized. Yes, everybody can see that that would be ugly, too, and create its own crisis.

What Will Happen from Here

Here is the most likely scenario I think we are facing. We are going to go into the next recession with interest rates still stuck in the sub-1% range, not giving the Fed much ammunition. There have been numerous studies from within the ranks of economists who could certainly qualify as High Priests that show quantitative easing didn't really do anything, other than maybe goose the stock market. There is also no data demonstrating any positive benefit from the so-called wealth effect, which was all the academic rage at the beginning of this process. Forget the wealth effect – the stock market going up does not trickle down to the average guy on Main Street.

(I find supreme irony in the fact that the very economists who derided supply-side economics as trickle-down economics have adopted trickle-down monetary policy. Seriously, that is so messed up on so many levels.)

My friend Dr. Lacy Hunt has identified some 15 serious research papers that say the money multiplier for government spending is very low or even negative. Of course, you can also round up many neo-Keynesian papers whose authors see a fabulous multiplier for government spending, so Paul Krugman and friends go on urging ever more deficit spending.

But the Federal Reserve will not sit on its hand and do nothing. We will get quantitative easing on a scale that is currently unimaginable, blowing out the Fed's balance sheet to a level that is unrecognizable. Unless there is considerable pushback from Congress – and I do mean considerable, not just the usual suspects on the far right of the Republican Party grousing about an out-of-control Fed – we are going to see negative rates in the world's reserve currency. Then there will be a regular snowstorm of papers from the High Priests, conclusively demonstrating that negative rates will have all manner of positive effects on the economy and employment. And none of them will be worth the electrons used to publish them, because their conclusions are just theoretical blather, based on outmoded assumptions about the way the world works.

The central bankers of Europe who are experimenting so exuberantly with negative rates came to Jackson Hole and told everyone that the rates are working wonderfully. Never mind that the hoarding of cash in Switzerland is at astronomical levels. (It's a fascinating arbitrage: bank rates are -75 bips, and you can insure your cash in a safe deposit box for about 10 bips. And in Switzerland you can find a bill worth $1000. It makes total sense.)

Negative rates will drive consumer spending down, not up. They will result in less income in retirees' pockets, forcing them to save more, work longer, and spend less. A negative rates regime must be aggressively opposed by the public to the point that the Fed does not feel capable of actually initiating such a program. Our battle cry must echo William Jennings Bryan:

> "You shall not crucify the retiree and saver on a cross of negative rates!"

The next 10 years will see an explosion of government debt and an implosion of the ability of governments to fulfill their promises. Any economic or investment model based on past performance under previous economic conditions will be worthless. As in, just as worthless as the Federal Reserve's models. We are truly going to have to go outside of the box if we are going to figure out how to get our portfolios from where we are today to the other side of the coming crisis. There is truly no way to predict what our investment portfolios should look like six months or one year or two years or six years from now.

I see no way for Europe to avoid that crisis. The US might if we made radical decisions in 2017. You can ask yourself how likely that is. Ben Hunt, the brilliant writer of the *Epsilon Theory* letter, came into town Thursday night, and we spent four hours at a local watering hole talking about the current situation and what the likely outcomes are. Our views are pretty similar. He calls the current economic philosophy "magical thinking." I see it more as religious thinking, but that may be because I went to seminary and Ben opted for a more secular academic path.

I am telling you, this is not going to end well. You cannot assume that your investment returns are going to look anything like the average for the last 20–30–40 years. I know there are those out there who will tell you that is exactly what is going to happen. Many of them are my friends, and I enjoy sitting and talking with them over a bottle of wine and a great meal. But I will look them in the eye and tell them that they're walking into economic hell with their eyes closed. And anyone who is following them is going to see their portfolio go up in smoke.

This is going to be the most difficult investing environment of the last 100 years. Modern Portfolio Theory was created in 1952 by my friend and Nobel laureate Harry Markowitz, who argued that diversification among asset classes is the only true free lunch. I think MPT is going to become problematic.

We are still going to need to diversify, but I think we have to diversify among trading strategies that diversify among asset classes. Being long or short anything these days on a buy-and-hold basis is just plain dangerous. Maybe the investment turns out wonderfully, but I think the risk versus reward of a one-way strategy is now much higher than most people think. In my view, if you are in a standard 60/40 portfolio, you are going to have your portfolio derrière handed to you.

Then again, I could be a Cassandra. I could be wrong. The world could go along just as it has for the last 70 years, and we could pile up all the debt in the world and the markets wouldn't care. In that case the diversified trading strategy I will propose will underperform the never-ending bull market. It will not do poorly, but it will not match an S&P that compounds at 15% forever. So I guess you have to decide how much you think the S&P can compound from where we are today, given roughly 2% annual growth in GDP.

I said I would give you a few paragraphs on what the country should do.

1. We should radically alter our tax policies. I would drop the corporate income tax to no higher than 15% and preferably 10% on total global income. But no deductions for anything. Not even oil depletion allowances. That would make us competitive with the world. If we created that corporate tax so that it looks like a business value-added tax, our corporations could deduct the tax for their products manufactured in the United States when they sent them overseas, which would give us a monster manufacturing advantage, along the lines of what Europe already has. Sorry Europe, I am being a total homeboy now.

2. To get really creative, increase that business consumption tax to the point where we can get rid of the Social Security tax for both employees and employers. Employees get an increase in pay (especially those at the lower end, reducing income inequality), and the measure is relatively neutral for businesses. Deductible at the borders for exporters. That will go a long way towards helping the income inequality situation while still providing a safety net.

3. That allows you to radically reduce the income tax, which is the most destructive of all taxes, in terms of incentive. Properly constructed, you could actually not even charge income tax for incomes below $100,000 and make it 20% above that level. No deductions for anything. Period. We can quibble about the numbers, but you get the idea.

4. Completely replace the FDA and other destructive bureaucracies that function as prison guards of the past. It's the 21st century and we should begin to act like it. I would not argue that we don't need drug and food, financial and banking, environmental, and a host of other types of regulatory oversight. However, oversight has become overkill. The bureaucracies have become an innovation-killing force unto themselves, forever expanding their own fiefdoms. Pare them back. Forced them to eliminate 5% to 10% of their rules every year for 4 years until they get down to the essential ones.

5. Finally, the true heresy: If we change the policies currently driving the Federal Reserve, it

> is highly likely that the economy will fall into a recession sooner rather than later. If we do nothing of the sort, it is also likely that we will fall into a recession. I know that recessions are part of the normal business cycle, but it is difficult to watch large numbers of people go unemployed. No president wants a recession on his or her watch.

So the only thing you can do is to hit the fiscal spending button. But in a recession we are already running up massive debt. Where to get the money without creating even more of a burden for taxpayers? As president, you sit down with the Federal Reserve and the senior lawmakers in Congress and you say, "I want you to authorize a bill allowing the Federal Reserve to issue US government-guaranteed, one-percent, forty-year infrastructure bonds to any self-funding city, county, or state project approved by a bipartisan commission with no politicians on it. There must be serious guidelines for getting access to this inexpensive funding. No one gets to build a bridge to nowhere in their district. We know that we need at least $3 trillion and maybe closer to $4 trillion of infrastructure building just to bring up our water systems, ports, electric grid, roads and bridges, transportation systems, and so forth up to snuff. The money for infrastructure rehab is going to have to be spent sooner or later anyway, so let's do it now in one massive 5- to 10-year program and put 3 million people work in good-paying jobs." Yes, I know that some of the projects will be boondoggles. There are no perfect solutions, but we must rebuild if we want to see the future more evenly distributed and our children's infrastructure needs taken care of.

The Fed can slowly sell their Ginnie Mae bonds, which the market will snap up and convert into the 1% infrastructure bonds. It will take a while to ramp up the infrastructure projects that I'm talking about. But within two years the infrastructure construction business could be booming. Congress will have to authorize that. The president will have to beat Congress over the head during his or her first 90 days in office to force this through. And Congressman on the wings of both parties will want to attach all sorts of bullshit riders to the bill. The speaker and the majority leader must not allow that to happen.

Short of this massive infusion of fiscal spending, we are going to go into an even deeper recession than we did last time, and it is going to take longer to recover. If you think your portfolio was slow to recover this time, don't hold your breath next time. Do you want to wait another eight or nine years to get back to where you are right now? How does that play into your retirement plans? I sigh as I write this, knowing that the bulk of the American populace – and its leadership – is going to sit and do absolutely nothing. And I do not know what to do to change that. The prospect truly saddens me.

What we should do is going to be the subject of numerous letters here in the next month or so. Yes, I am getting around to it. But now it's time to hit the send button. I truly appreciate your attention if you made it this far with me.

Denver, Dallas, Denver, and Back to Dallas

I finish in this letter Denver, where I am for the S&P Dow Jones Indices Denver Forum. Then I'll fly back to Dallas for the Gilder reception (see below), 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.

As I mentioned last week, I will be hosting a reception for my friend and brilliant economist and author George Gilder this Friday, September 16, in my home. 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.

Mike West (the CEO of BioTime) and Patrick Cox were in town Saturday evening, and we sat and talked at length and in depth about biotechnology and the future … and, I am sure, got lost down all sorts of rabbit holes, which happens when we get together. It was an absolutely fascinating evening sitting by the pool. Shane had ribeyes to grill, along with all the fixings, but the most important thing was the conversation. We live in some of the most exciting times in the history of the world. I fully believe what I wrote last week: The world will see more advances in medical science and biotechnology in the next 20 years than we have seen in the last 250 years combined. It's about the acceleration of research and knowledge. And one of the really exciting things is that the cost of healthcare, the cost of making you healthy before you get sick, is going to be far less expensive than you might imagine.

Meanwhile, each of us holds in our hands today a computer that is far more powerful than the ones that we used to put men on the moon back in the day. To the moon and back on 64K. Seriously, that's all the computing power we are talking about. Mike mentioned research that would come out of his computer sometime this week. His computer had been plugging away at it for a few days, but only 10 years ago it would have taken one million years to get it done. The research being done inside computers today is absolutely staggering.

That same power law is going to drive the cost of healthcare downwards as major medical interventions are transformed by digital and biotechnological advances and become easily and cheaply replicable. I am not just talking about patching you back together after accidents; I am talking about cures for the major diseases that cause death and debilitation. And while I don't think it will happen within 20 years, it will be only shortly thereafter that we grab the demon of aging by the throat and take away its power. And yes, I see the irony of my outrageous optimism for the future in contrast with the total pessimism that I feel about governments and central banks. There are moments when I do experience a little whiplash.

You have a great week. I am sure I will have lots to report from Denver.

Your ready for a little relaxation and conversation analyst,

John Mauldin

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