Federal Repression System

By John Mauldin | October 9, 2016

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> *However beautiful the strategy, you should occasionally look at the results.*
>
> – Winston Churchill
>
> And from "To a Mouse, on Turning Her Up in Her Nest with the Plough":
>
> *Scottish version:*
>
> But Mousie, thou art no thy-lane,
> In proving foresight may be vain:
> The best-laid schemes o' Mice an' Men
> Gang aft agley,
> An' lea'e us nought but grief an' pain,
> For promis'd joy!
>
> *English translation:*
>
> But little Mouse, you are not alone,
> In proving foresight may be vain:
> The best laid schemes of Mice and Men
> Go often askew,
> And leave us nothing but grief and pain,
> For promised joy!
>
> – Robert Burns, 1785

The Federal Open Market Committee, to almost no one's surprise, did absolutely nothing at its last meeting other than say that maybe, if the data allow, they will raise rates in December. My cynical view on their dithering will be detailed below. And of course, the Bank of Japan met and decided that maybe they had gone a bridge too far; and rather than lowering already negative rates when the yield curve was flat out to 40 years, they decided to see if they could create a fulcrum around the 10-year Japanese bond at zero. So far, the move has not been a rousing

success.

This is partially because their banks are bleeding cash and screaming at them, and they have got to figure out some way to walk back what is becoming a very destructive program. When you look at what low rates have done to the Japanese economy and Japanese retirees, Kuroda-san's coming to Jackson Hole and declaring that negative rates have been a success demonstrated a fair amount of chutzpah. But then he supplied only a small helping of the staggering amount of hubris displayed at Jackson Hole by central bankers from all over the world, who were celebrating the success of the most repressive monetary policy conditions in the history of mankind. The IMF, the BIS, and the World Bank are all revising their global growth predictions downward at a rapid clip. You get the feeling these guys could spin Napoleon's invasion of Russia into a positive story and one they could take credit for.

In today's letter we are going to look at the FOMC's decision-making process for monetary policy and survey the unpalatable future that our leaders are cooking up for us. But we won't be living in the fantasy world they have created for themselves; we are going to have to live in the real world instead, where investment portfolios make a difference to our lifestyle and retirement, not only for ourselves but for our families and clients.

I must confess, the more I think about where the "monetary policy community" of academic elites has brought us, the angrier I get. It has been a long time since I have been this passionately upset about something. And not merely because the policies are stupid. If I got passionately upset about every stupid idea I come into contact with, I would soon require serious blood pressure medication. Having been intimately involved in the political process for almost 25 years in a prior life, I daily came into contact with stupid ideas and thought myself somewhat immune.

No, what the Fed has done is to destroy the retirement hopes and dreams of multiple tens of millions of my fellow US Boomers, and when we include the effects of the destructive policies of the rest of the world's central banks, the number becomes hundreds of millions. The secure and protected world our central bankers live in is far removed from that of the American or European middle class retiree. The purity of their theory and the clarity of their economic thought is evidently far more important to them than people's wellbeing is.

However, numerous thoughtful scholars and those in the business community are mounting a serious pushback. They may be considering the wisdom of Winston Churchill's remark, "However beautiful the strategy, you should occasionally look at the results."

Central bankers of the world look around them and see nothing but confirmation of their brilliance. Mostly they see it reflected from the stock markets, but some of us are beginning to think they are going blind.

This week I want to expand on my recent Federal Reserve criticism. I've talked about the mistakes I think they will make in the next recession (whenever it starts). We need to think about that future in the light of the Fed's mistakes in the wake of the last recession. That is really where our

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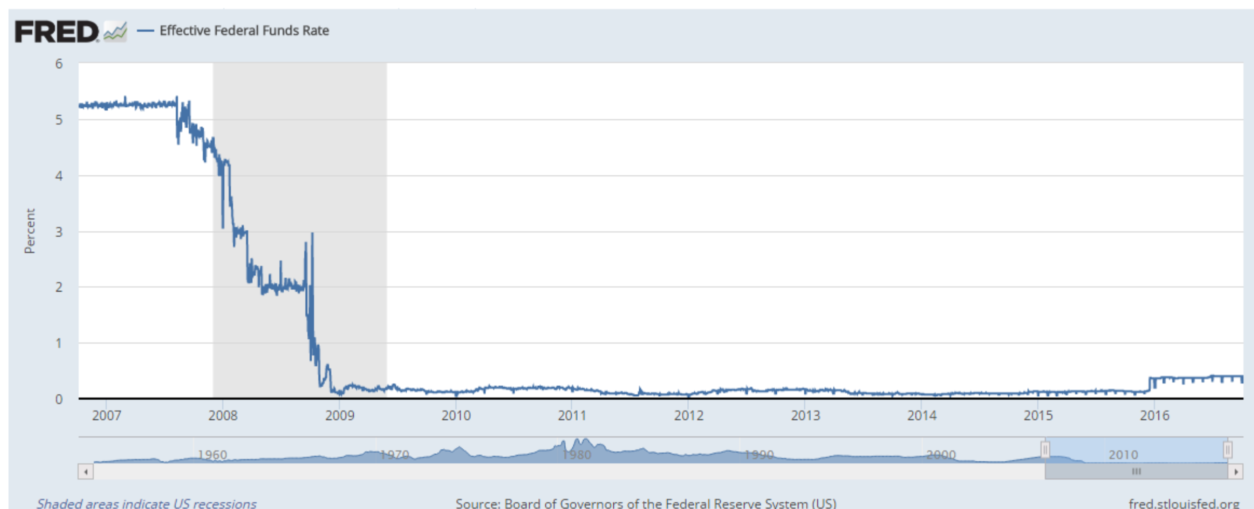
disagreement with them began. The Fed believes its policies worked**. I say those policies did not work, and the dismal recovery we have suffered through occurred in spite of the Fed, not because of it. Federal Reserve policy has actually thwarted the normal recovery process.**

The Fed's Fruitless Follies

If the Fed had really believed their own post-recession forecasts, they would have been normalizing interest rates by 2012. Instead, they went on devising, deploying, and now winding down various shotgun stimulus tools. Maybe they honestly believe they hit the target, but the rest of us aren't convinced.

Almost everything the Fed did to us since 2008 falls into two broad categories: interest rate repression and quantitative easing.

Here is the federal funds rate from 2007 to 2016. The shaded area is what we now call the Great Recession.



The Federal Open Market Committee entered 2007 with the rate target at 5.25%. They starting lowering it in August of that year – months before the economy went into recession. Why was that? Recession or not, many folks weren't doing well. Even then there was talk of banks having difficulty, though the worst was yet to come.

Look how fast rates fell. In July 2007 savers could buy Treasury bills, certificates of deposit, or other principal-protected savings instruments and enjoy a 5% or better risk-free yield. Longer-term fixed-income products actually offered even higher yields. A year and a half later, the fed funds rate was bumping the zero bound, and savers could make nothing without taking on market risk, which few wanted to do at the time, because iconic brands were blowing up everywhere.

Here is the great irony and possibly the most iniquitous part of the Fed's monetary policy initiative. They wanted investors to move out on the risk curve. But did they bother to look at the demographics of this country? We have a huge bulge of Boomers – retirees and near-retirees who

do not need to be moving out the risk curve at this time in their lives. They need Steady-Eddie returns, and they need to be reducing their risk, not increasing it.

A sober look at the current economic environment reveals overvalued, overbought, and illiquid markets everywhere. The global central bank community's ultra-low and negative interest rates have created an environment of risk that is looking more and more like a bubble in search of a pin. If and when it bursts, it will take the retirement dreams of millions of Americans with it.

From the Fed's perspective, super-low interest rates were economic *stimulus.* With borrowing costs so low, we were all supposed to race out and buy stuff. Companies should have expanded and hired more workers. Homebuilders should have been incentivized to build more McMansions in the suburbs, knowing qualified buyers would appear like magic.

What was supposed to happen was a normal recovery. What we got was the weakest recovery on record. The Federal Reserve will offer the counterfactual that if they had not given us their stimulus, the recovery would have been even weaker. That, of course, is something that neither they nor we can prove, one way or the other. We can go back and look at a far worse recession in the early 1920s, when the government did nothing and the resulting recovery gave us the Roaring '20s. Very few people remember what was called the Depression of 1920–21. Unemployment was close to 12%, and there was extreme deflation – the largest one-year percentage price decline in 140 years of data. Christina Romer estimates it was a 14.8% decline. Put that in your CPI pipe and smoke it. Industrial production dropped by 30%. And there was a horrendous bear market.

By the time President Harding and his Commerce Secretary, Herbert Hoover, got around to calling for a conference and organizing committees, the economy was already recovering. Notably, the administration did cut income taxes, which helped reinforce the Roaring '20s.

A large part of the problem in the late '10s was that the Fed was raising rates into the recession in an effort to protect the dollar and fight what they considered to be inflation. Central bankers of that era had a gold and hard-dollar fetish that led to massive policy errors. When they actually began to normalize their monetary policy, the economy took off. A *normalized interest rate policy,* what a concept…

In our own generation, we got stimulus for Wall Street in the form of QE, and it led to an inflation of asset prices. No one really minds if the value of their stocks, real estate, and other assets go up; and there was the assumption that a rise in the stock market and real estate would trickle down to Main Street. Clearly, it has not.

Speaking of asset price inflation, Peter Boockvar writes this week:

> **The inflation/deflation debate we know goes both ways for consumer prices. Where there should be NO debate is the asset price inflation we've seen over the past 5+ years.** We also know that the asset price inflation was more than just in stocks and bonds. It also spilled over into high-end apartments, antique cars, and paintings. It also spread into

> other 'hard assets.' In 2014, the Action Comics #1 comic book that introduced Superman sold for $3.2mm up from $2.2mm three years earlier for another copy of the same comic in similar condition. That was a record high price. A few days ago a T206 Honus Wagner sold at auction for $3.2mm, also a record high price for the same exact card that sold for 'just' $2.1mm three years ago earlier. In case you missed it yesterday, the WSJ quantified the returns on Mickey Mantle baseball cards over the past 10 years. For the ultimate Mantle card, his Topps rookie year of 1952, the percentage increase has been 674% for a high-grade card. The average return for his 16 Topps cards was 544%. These returns compare with 85% for gold, 40% for home prices, and 59% for the S&P 500 over the same 10-year time frame. The Fed, though, has no reason to be fearful on inflation for as long as they don't include asset prices in the CPI or PCE so we magically won't have any inflation much above 2%.

(Okay, how many Boomers just like me are kicking themselves for not keeping their shoeboxes full of baseball cards? I had those Mickey Mantle and Willie Mays cards, and all the others. And because my dad had played semipro, I collected a lot of the older cards of several previous generations that he told me about. The Ty Cobb and Cy Young cards were the anchors of my portfolio. Ahh, but I dream…)

Back to the real world. What *did* happen was the *opposite* of stimulus, at least for those who were not the direct beneficiaries of quantitative easing. That would be the people who actually wanted to be prudent and save and put money in fixed-income and certificates of deposits. Remember when you could invest in a CD at 5% to 6%? What a quaint notion.

By reducing the incomes of retirees and terrifying near-retirees, the Fed successfully reduced economic activity. Hopefully, that was not their intent, but that is what happened. They claim they managed to save the banking system from collapse, and I would agree that QE1 was necessary and beneficial to the system. I guess that's something to their credit, but it came at tremendous cost. They put much of the cost of rescuing the banks on the shoulders of *completely innocent people*. The cost was borne by savers and small investors.

In the Middle of a Massive Monetary Policy Error

I would argue that the Great Recession was a result of a massive monetary policy error: keeping rates too low for too long, which, when coupled with lax or no regulation in the mortgage markets, resulted in a housing bubble and a crash, which bled over to global markets. This outcome should not have been a surprise to anyone. A number of us were writing as early as 2004–05 about the problems that were the primary triggers for the Great Recession.

As noted above, it was central bank errors in 1919 and 1920 that caused the 1920-21 depression. And pretty much everyone agrees that the Federal Reserve had a big hand in causing the Great Depression. Certainly, the wrong monetary policies resulted in the recessions of '80 and '82. Note: it was not the policies of Paul Volcker that caused the back-to-back recessions but those of his

immediate predecessors who allowed inflation to get out of control. Volcker's hand was forced, and he had to act aggressively. I lived through that time as a businessman, and I vividly remember borrowing at 18%. It was not fun.

I believe we are again suffering the effects of a massive monetary policy error. The error has already been committed, but we have just begun to endure the consequences. We are still living in a dream, but we're nervous, much like we were in 2006. The Federal Reserve has repeated the mistakes of the last cycle. They have kept rates too low for too long, but this time they have outdone themselves, clinging desperately to the zero bound. In doing so they have financialized the economy and made it hypersensitive to interest rate moves.

Ben Bernanke made a big mistake by opting for QE 3. Arguably, if he had begun to normalize rates rather than to create a "third mandate" for the Federal Reserve to support stock market prices during and after QE 3, we would not be in the situation we are in today, where the very hint of normalizing rates sends the markets into a frenzy.

Bernanke should have looked the stock market straight in the eye during the Taper Tantrum, summoned his inner Paul Volcker, and told the market, "I am not responsible for stock market prices." The markets probably would have suffered a rather quick, sharp correction and moved on. And it might not even have been much of a correction. Markets often correct, as they did in 1987 or 1998, without becoming lasting bear markets if there is not a recession.

Admittedly, a normalized short-term interest rate today would likely still have a "2 handle" or even lower. Short-term rates, at least in normal times, have tended to be in the vicinity of inflation. The 10-year Treasury bond rate has had a close relationship with nominal economic growth.

I would prefer to allow a market mechanism (rather than a committee of 12 people who are prone to enormous biases) to determine short-term rates. A committee that prioritizes the interests of the stock market above the interests of savers and retirees and pension funds is a dangerous committee.

If the FOMC had begun to normalize rates in 2012 rather than looking at the stock market as a primary indicator of the health of the economy, the economy and the stock market would be doing much better today, and savers would at least be getting some return on their money. And perhaps, if rates were normalized, the governments of the world would be motivated to control their deficits. (I know, that last statement proves I'm a dreamer.)

Greenspan had monstrous confidence in the wealth effect and how it would trickle down. The data is now in; the papers have been written; and the nearly overwhelming conclusion is that the wealth effect is, at best, inconsequential. What we have is another instance of the Federal Reserve ignoring Winston Churchill's maxim: "However beautiful the strategy, you should occasionally look at the results."

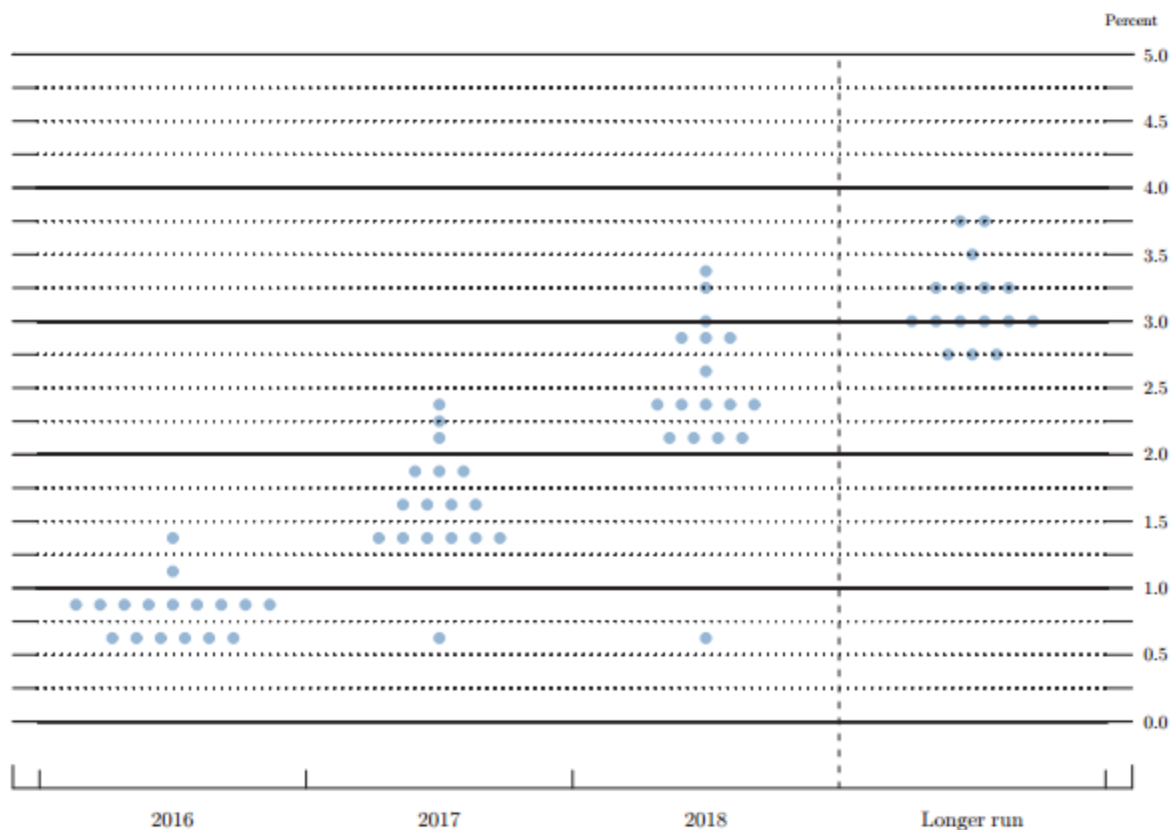
Yet, the policy geniuses at the Fed appear certain that the wealth effect is going to trickle down to

Main Street any day now.

How Do You Mess Up the Easiest Prediction in the World?

A few weeks ago we got the new dot plots showing where FOMC members expect interest rates to be in the future. If you were to look at this predictive path in isolation, you would make the rational assumption that interest rates are going to rise by 2% or more in the next two years. The chart below shows their expected rate increases four months ago: In **June,** by a margin of two to one, FOMC members were expecting at least two rate increases, if not more, *this year*.

Figure 2. FOMC participants' assessments of appropriate monetary policy: Midpoint of target range or target level for the federal funds rate



Has the economy changed much since then? Not really, but somehow, afraid of their own shadow, FOMC members are now projecting by a three to one margin that there will be only one rate increase this year, of 25 basis points or less. Here is the plot from the **September** meeting:

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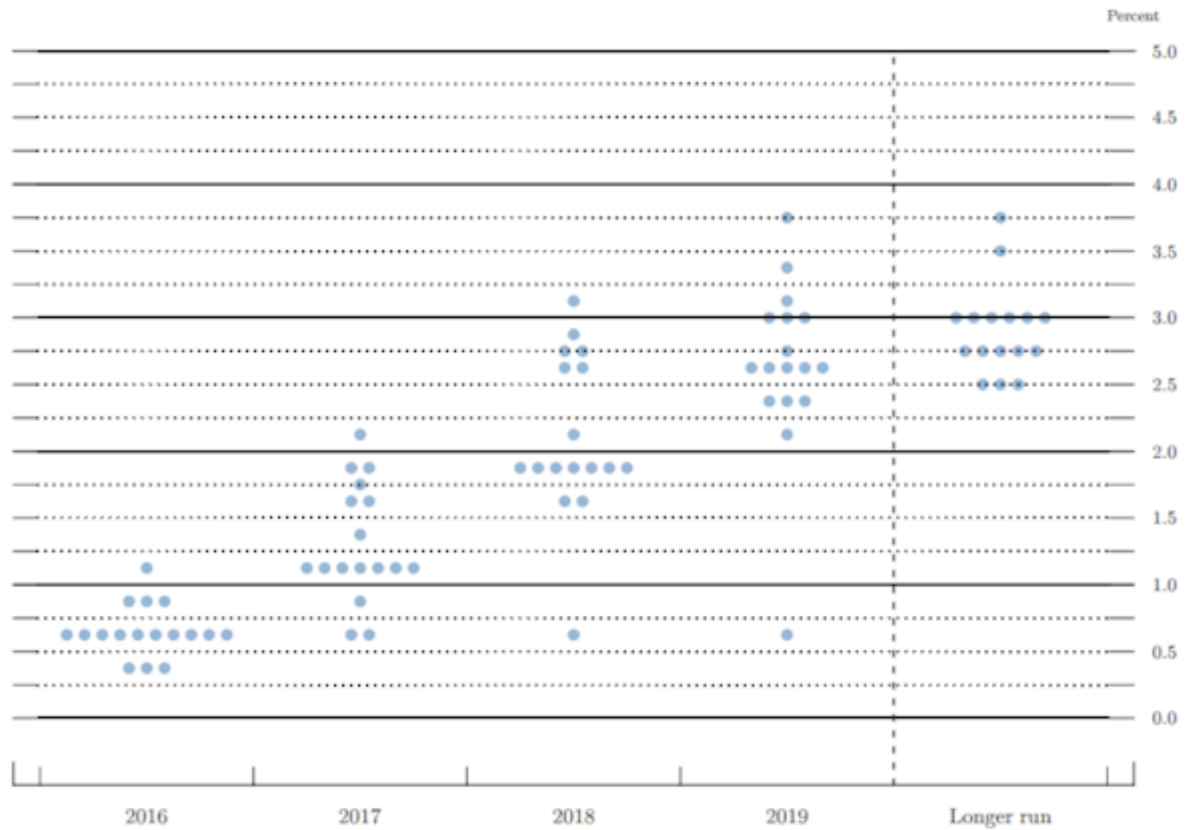
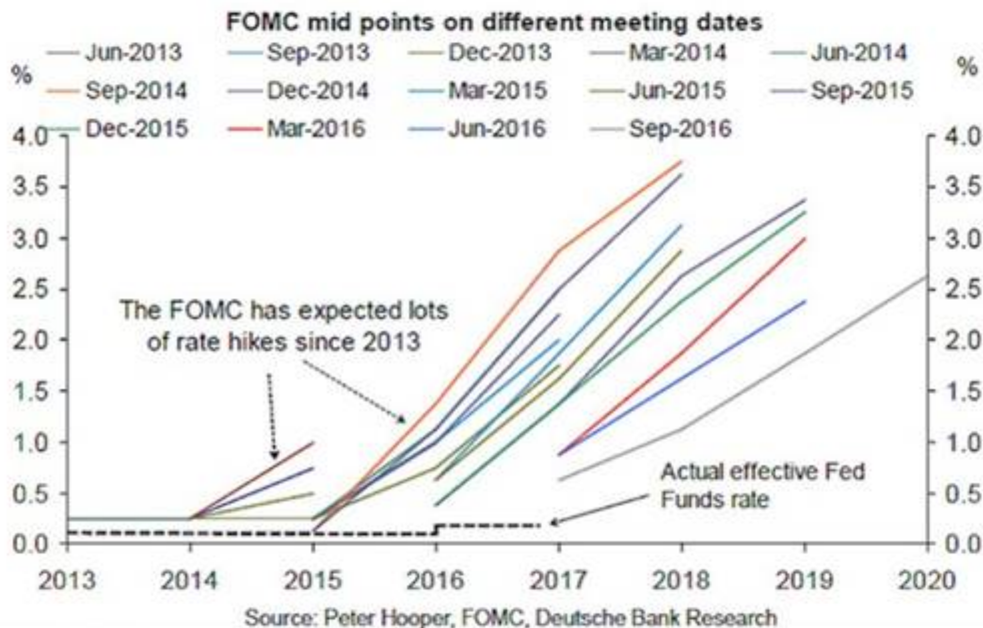


This constant rethink is not just a recent phenomenon. We have seen it ever since the FOMC began to give us their forecasts for interest rate hikes. Less than two years ago they were expecting rates to be around 3% today and to reach 4% by the end of 2018! Each subsequent quarterly plot is revised downward, but the pattern always remains the same. Rates are going to "normalize" in a time frame that is always just around the corner but never seems to arrive. The chart below, from Business Insider, shows the paths of their rate predictions, and the dotted line down at the bottom shows what has actually happened.



This reveals an interesting dichotomy. The Fed determines what interest rates will be. So what they are doing is predicting what their own decisions will be. And while Federal Reserve economists have basically gone "0-fer" with all their predictions for the growth of the economy – a predictive task that is orders of magnitude more difficult than predicting what they will decide on interest rates – they have also gone 0 for 11 quarters with their predictions for their own monetary policy!

While I have been known to change my mind now and then, the FOMC members have been thinking seriously about interest rates every quarter for as long as there has been an FOMC. They know they have to make forecasts. They meet regularly, and I am sure they have phone calls and private dinner meetings and conferences, just like any other board of directors would. The easiest prediction in the world should be to tell me what they are going to do with policy rates.

The dot plot tells us what they think should happen, but between the time their forecasts are made and the time they actually have to make a decision, something always happens to keep them from pulling the trigger. I think that something is Yellen and her inside crowd of ultra-doves in the leadership of the Fed.

Dr. Stanley Fischer, vice chairman of the Fed, when asked his views on negative rates, said:

> 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.

Stanley Fischer is the intellectual leader of today's Federal Reserve. He is one of the most respected members of the "policy community." During the last crisis, when he was head of the Bank of Israel, in pursuing his quantitative easing he bought literally anything in Israel that was not nailed down. So when he says that he must put the interests of investors in the stock market ahead of the interests of savers and retirees because he thinks that is best for the overall economy, you have to realize that this is the dogma being whispered into the ears of every FOMC member.

And while there is a growing drumbeat from banks and serious members of the "policy community" in Europe and Japan that negative interest rates are damaging the system, you are not hearing that from Stanley Fischer and Janet Yellen and the other leaders of this Federal Reserve. Yves Mersch of the ECB talked about the problems banks are having and said, "The longer [rates] remain low, the more pronounced the side effects will be." Deutsche Bank and other major European bank economists are starting to sound semi-apocalyptic as they bemoan the policies of the ECB. Here at Mauldin Economics, we are doing some in-depth research based on a few small reports about how desperate the European insurance community is. Understand that European insurance funds are several multiples the size of their banking community.

Low interest rates have traumatized US pension funds and basically made it impossible for funds to meet their investment targets. And the consultants to whom the funds pay large fees are still showing them models (based on gods know what assumptions) that say it is okay to project 7% to 7.5% compound returns for the future.

So here we are, in a weak recovery that grows longer in the tooth with each passing month. I have discussed the assorted potential crises that could set off the next recession. You know the list: China, Japan, Italy, Germany (99% of investors do not understand how vulnerable Germany is), our own elections here in the US, or just a gradual slowdown as consumers lose the will or ability to spend. Something will happen to set off another shock, and it will probably happen in the next year or two. Then what?

This brings us to perhaps the biggest danger of all: People are losing faith in the Federal Reserve. Not without reason, either. Ben Hunt says the Fed is "losing the narrative." By that he means that most Americans are skeptical of the Fed's happy talk and no longer believe that Fed policies will result in the economic growth projected.

Sadly, that group of "most Americans" does not include Federal Reserve governors and bank presidents. All evidence suggests they believe their policies are working out swell. Unemployment is down, so Janet Yellen is happy. Stocks are up, so Stanley Fischer is happy. They invited all their friends to Jackson Hole to plan the next party, in which they will spin the bottle on negative rates and try to get Congress to eliminate $100 bills. They think it will be fun. Many in the economics

profession want to party with them.

We will have another financial crisis and/or recession, probably soon, and we can't trust the Fed to respond correctly. We'll be lucky if whatever comes out of their Frankenstein lab is *only* ineffective. There's a very real risk they will make the situation far worse. The masses of unprotected people are in no mood to swallow more monetary policy medicine, much less any additional remedies that globalist plutocrats may try to shove down their throats.

In an ideal world we might be glad to see the Fed stand aside and let markets adjust themselves. The problem is that said adjustment will now be extremely painful for a large part of the population. So the Fed may be damned if it does and damned if it doesn't.

I have no idea how the election will turn out. It seems to me that Donald Trump now needs a very good debate Sunday night. But win or lose, Trump is a huge canary in the political coal mine, and the political and monetary-policy elite should listen up. Brexit was a warning, and Austria and Italy and Germany – indeed all of Europe – are sending a similar warning. The Unprotected are beginning to push back, and not just at the edges. The center is not holding. A new center is going to be created, one that the elites may not appreciate.

The Protected elites of both major US political parties may genuinely think they are acting in the best interests of the country. But middle- and lower-class Americans are learning that politics and economics as usual mean diminished lifestyles and futures, not only for them but for their children.

> The best-laid schemes o' Mice an' Men
> Gang aft agley…

Winter is coming. You need to have a plan. Over the next few months I will be talking about how I intend to get through the coming economic winter. If my plan does not work for you, then you need to come up with your own. Hope is not a strategy, my fellow Baby Boomers.

Dallas, Planning, and Writing

I will be speaking at the MoneyShow Dallas, which will take place October 19–21. I will be speaking three times on Thursday, October 20. The first presentation will be a midmorning panel with Steve Moore and Mark Skousen on how the presidential election will affect your portfolio. The second one will take place shortly thereafter: I will share my thoughts on how the Federal Reserve will react in the macroeconomic environment that is unfolding. Then that afternoon I will make my first presentation to the public on how I think portfolios should actually be structured to meet the upcoming challenges, and I will be going into some detail. Click on the link above and register. You can see the rest of the speakers and the agenda there, too. There are some very good speakers at this conference (including friends Steve Forbes and Jeff Saut), and I am looking forward to interacting with as many of them as I can. Attendance is free, and I will actually have a booth in the exhibit hall where I will spend time meeting and talking with attendees.

I am speaking for my friends at the Commerce Street Bank at their annual Investment Conference

on Thursday, October 27, at the George W. Bush Library here in Dallas.

Longtime readers have probably noticed that there is not a lot of travel in my upcoming schedule. That is on purpose. I feel like I have been planning the Normandy Invasion. I have developed a rather straightforward new approach to constructing a core portfolio for what I think is likely to be our economic future. But the logistics of making that approach a reality I can share with you – of attending to the regulatory complexities in a world where every *i* must be dotted and *t* must be crossed, and helping a score of new players get to know each other and learn to work together – is somewhat daunting. That said, I feel like I have rounded the final turn and can see the finish line in front of me. We will be announcing the new Mauldin Solutions Smart Core Portfolios in the not-too-distant future.

Not to mention that I am still working on my book about what the next 20 years will look like. I have rough drafts of eight chapters (out of a planned 25 or so); and as soon as we have finished the groundwork for Mauldin Solutions, I will pivot the bulk of my writing time to finishing the book. I will be glad to get both projects done. When that happens, I have promised Shane that we can take off for a few weeks on a real vacation. We can go anywhere she wants as long as there is wi-fi, a real gym, and a reasonable variety of foods to eat. But I must admit that I am not booking hotel rooms yet.

Some 25 years ago (where does the time go?) I took daughter Tiffani to a Dallas Mavericks basketball game (I have been a season ticket holder for some 34 years, although back then my tickets were up in nosebleed territory). Afterwards we took the elevator to the top of "the Ball" (Reunion Tower), which is still a Dallas skyline highlight. She had a virgin daiquiri and saw all of Dallas at night. It evidently made an impression on her, because tonight she wants to relive that experience and take her almost 7-year-old daughter, Lively, along to sit in the ball and watch Dallas go by as it revolves, while I think about how fast 25 years goes by. And realize that in 25 years from now it might be a great granddaughter. (It's hard to get your head around that.)

You have a great week. I am hoping to finish a number of projects that are all so very close to being done, so that the real work can get started.

Your reading too many legal agreements analyst,

John Mauldin

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PAST RESULTS ARE NOT INDICATIVE OF FUTURE RESULTS. THERE IS RISK OF LOSS AS WELL AS THE OPPORTUNITY FOR GAIN WHEN INVESTING IN MANAGED FUNDS. WHEN CONSIDERING ALTERNATIVE

INVESTMENTS, INCLUDING HEDGE FUNDS, YOU SHOULD CONSIDER VARIOUS RISKS INCLUDING THE FACT THAT SOME PRODUCTS: OFTEN ENGAGE IN LEVERAGING AND OTHER SPECULATIVE INVESTMENT PRACTICES THAT MAY INCREASE THE RISK OF INVESTMENT LOSS, CAN BE ILLIQUID, ARE NOT REQUIRED TO PROVIDE PERIODIC PRICING OR VALUATION INFORMATION TO INVESTORS, MAY INVOLVE COMPLEX TAX STRUCTURES AND DELAYS IN DISTRIBUTING IMPORTANT TAX INFORMATION, ARE NOT SUBJECT TO THE SAME REGULATORY REQUIREMENTS AS MUTUAL FUNDS, OFTEN CHARGE HIGH FEES, AND IN MANY CASES THE UNDERLYING INVESTMENTS ARE NOT TRANSPARENT AND ARE KNOWN ONLY TO THE INVESTMENT MANAGER. Alternative investment performance can be volatile. An investor could lose all or a substantial amount of his or her investment. Often, alternative investment fund and account managers have total trading authority over their funds or accounts; the use of a single advisor applying generally similar trading programs could mean lack of diversification and, consequently, higher risk. There is often no secondary market for an investor's interest in alternative investments, and none is expected to develop.

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