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

As the Fed Turns

JOHN MAULDIN | December 19, 2016

"Monetary policy has less room to maneuver when interest rates are close to zero."

– Ben Bernanke

"Many Americans rely on interest income from their savings to help cover their cost of living."

– John Delaney

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When I was growing up – and until I was well into my 60s, in fact – one of the fixtures of daytime TV was the soap opera *As the World Turns.* It was often the highest rated of the soaps, but I have to admit that I probably watched it only once or twice. Its stars were the reality-TV celebrities of their time.

Now, there is a high probability that you too are a soap opera fan, but a soap in a different genre, though still brought to you by our beloved mass media…

As the Fed Turns

The highest-rated soap opera ever, at least among those with an economic and investment approach to life, is the show put on by US Federal Reserve. I'm going to have a few things to say about the recent FOMC meeting, and we'll use it as a springboard to chew the fat about the new season and upcoming episodes of our very own soap opera: *As the Fed Turns.* Just as devotees of *As the World Turns* used to speculate about what their favorite characters were up to, we can have a little fun opining about the Fed's next moves. Now, a Trump presidency offers a lot of potentially juicy drama, too, and we'll certainly want to chat about it. And of course, we won't be forgetting that this is soap opera with real-world implications for the markets and our investment portfolios.

Very few things are certain in financial markets these days. We used to be certain, for instance, that interest rates would always positive be positive. Now we know that's not so! But last week we experienced a moment of near-certainty when federal funds futures contracts said the odds of an interest rate hike were 95% or better. That turned out to be true.

What wasn't certain was what we would hear in Janet Yellen's commentary and see in the projections of the FOMC participants. They gave us some things to talk about, and they even gave us their dot plots; but there is very little that's certain in those. In next season's Fed, executive produced by Donald Trump, those dot plots will have even less predictive power than they do now. There are some obvious reasons why the plots are continually wrong, but they're about to be more wrong.

What We Learned from *As the Fed Turns* This Week

1. The Fed thinks GDP growth is stuck in low gear.

2. They believe the US economy is at or near full employment.

3. Interest rates will rise but not too much.

4. They don't want to think about fiscal policy.

5. Janet Yellen will stick around through 2017.

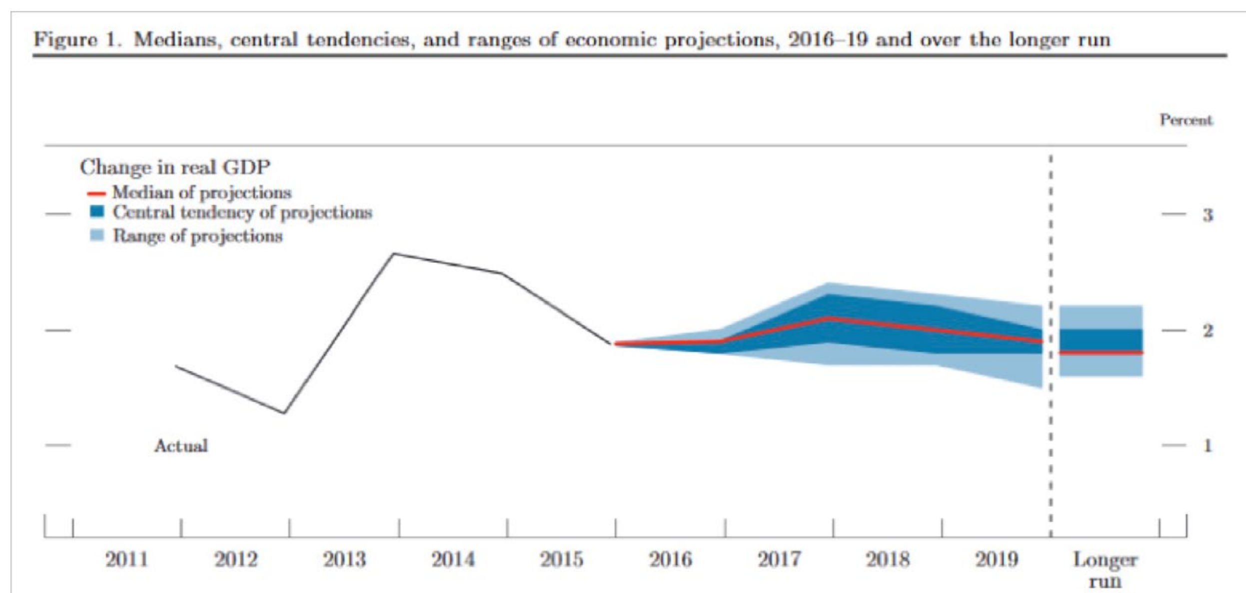
6. And the fun part – speculation about the drama surrounding new appointments to the FOMC. Will Trump get to appoint just two governors or the full monty of seven? Both scenarios are possible. As in any soap, you need to have some uncertainty to keep people off balance and paying attention. Trump's appointees will make a difference in policy, but will their policy change the reality on the ground of the global economy?

I'll expand on each of the above points. I was travelling or in meetings most of the week, so I wasn't able to tune into this week's drama as it unfolded. I think that may be just as well. Initial analyst and public response is often wrong, but it can "anchor" our thinking in ways that aren't helpful. Sometimes it's better to walk into the room late and then just calmly meditate on what you see.

Secular Stagnation Forever?

Promoting economic growth and employment is one of the Fed's core missions, assigned to it by Congress in (I believe) 1974. It was a triumph of Keynesian thought over Hayek's beliefs; and despite all evidence to the contrary, most market participants still think that monetary policy is the magic that drives the business cycle. Policy is supposed to moderate the boom-and-bust cycle and lift the economy out of recessions within a reasonable period. On that point, monetary policy has failed miserably. We're seven years out of recession and have yet to see GDP growth break above 3%.

The Fed's answer in this week's episode was to throw in the towel: Expect more of the same. Here's actual growth since 2011 and the FOMC's projections through 2019. Notice that the top end of the range of growth is barely more than 2%.



You can see that 2013 was a "good" year. Ben Bernanke was confident enough to start talking about "tapering" down from quantitative easing. Staying on that path another year or two might have changed everything. But it didn't. There was a global taper tantrum; Growth fell back again; and now even the most optimistic FOMC participants see little chance that it will climb much above 2% through 2019.

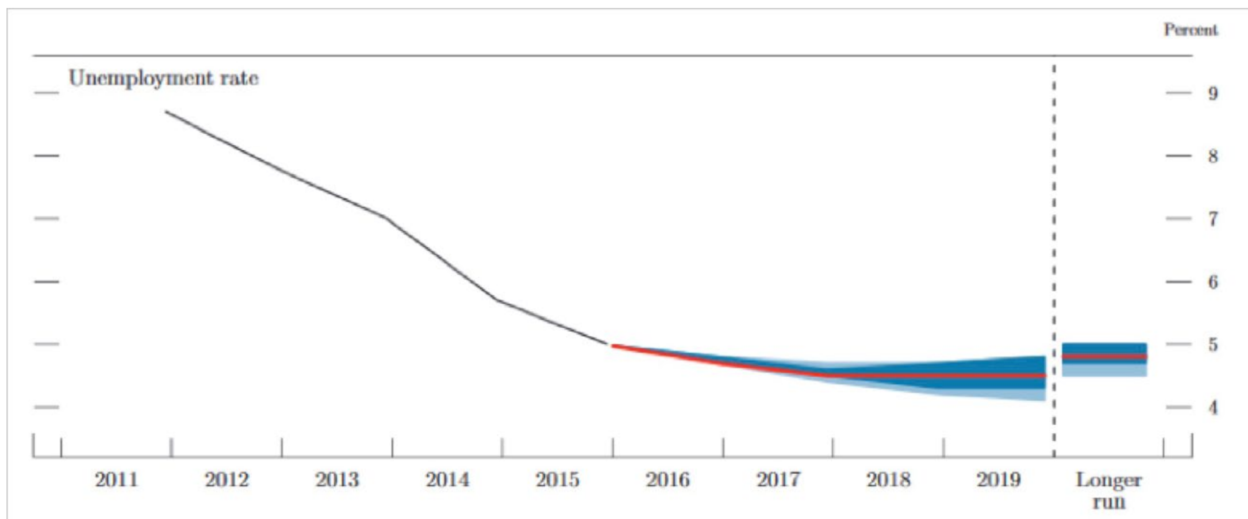
(One caveat – and it's one that I feel the need to keep repeating: GDP is a deeply flawed statistical measure that doesn't fully capture the way today's economy works. We use it because we have nothing better.)

Former Treasury Secretary Larry Summers, who desperately wanted to star in the show Janet Yellen now headlines, famously called the current trend "secular stagnation." He thinks we should all get used to it because its structural causes are impossible to change. Yellen and her crew might not use language that strong, but they appear to mostly agree with Larry.

Are they right? Maybe, but I think we can escape this dreary fate if we play our cards right.

Jobs, Jobs, Jobs

The unemployment trend is looking better. The rate has fallen pretty steadily and is now below 5%. The FOMC expects it to stay there, too.



The problem is that not all jobs are equal. The wealthy law firm partner and the student-debt-plagued law degree holder who is instead driving for Uber both count as "employed," even though their situations are vastly different.

Also problematic: The unemployment rate is down in part because so many workers have left the labor force – or, increasingly, never entered it. My airplane reading this week included a short, fascinating book called *Men Without Work: America's Invisible Crisis*, by Nicholas Eberstadt. He documents evidence that this abandonment of the labor force isn't a new problem, either. It has been quietly building for decades. It has multiple causes that aren't at all easily solved. It is likely that I will write about this book in at least one or two future letters. Eberstadt's data is both compelling and depressing.

Roughly 10 million American males of prime working age have literally dropped out of the workforce. And we wonder why productivity is low. Again, this problem has been building steadily since the '60s. The trend has held steady through boom periods and recessions, and the Clinton/Gingrich welfare reforms didn't affect it. France and Greece have significantly higher labor force participation rates than the US does. And no, these dropouts are not Trump voters, and it's not just the labor force they don't participate in. This is a major and very troubling social trend.

However, let's not overlook progress we have made. We have indeed seen much improvement from the Great Recession's depths. Businesses are expanding and creating new jobs. The problem is that we have a mismatch between the skills of jobless people and the kinds of work employers need done. That is not something lower interest rates can solve.

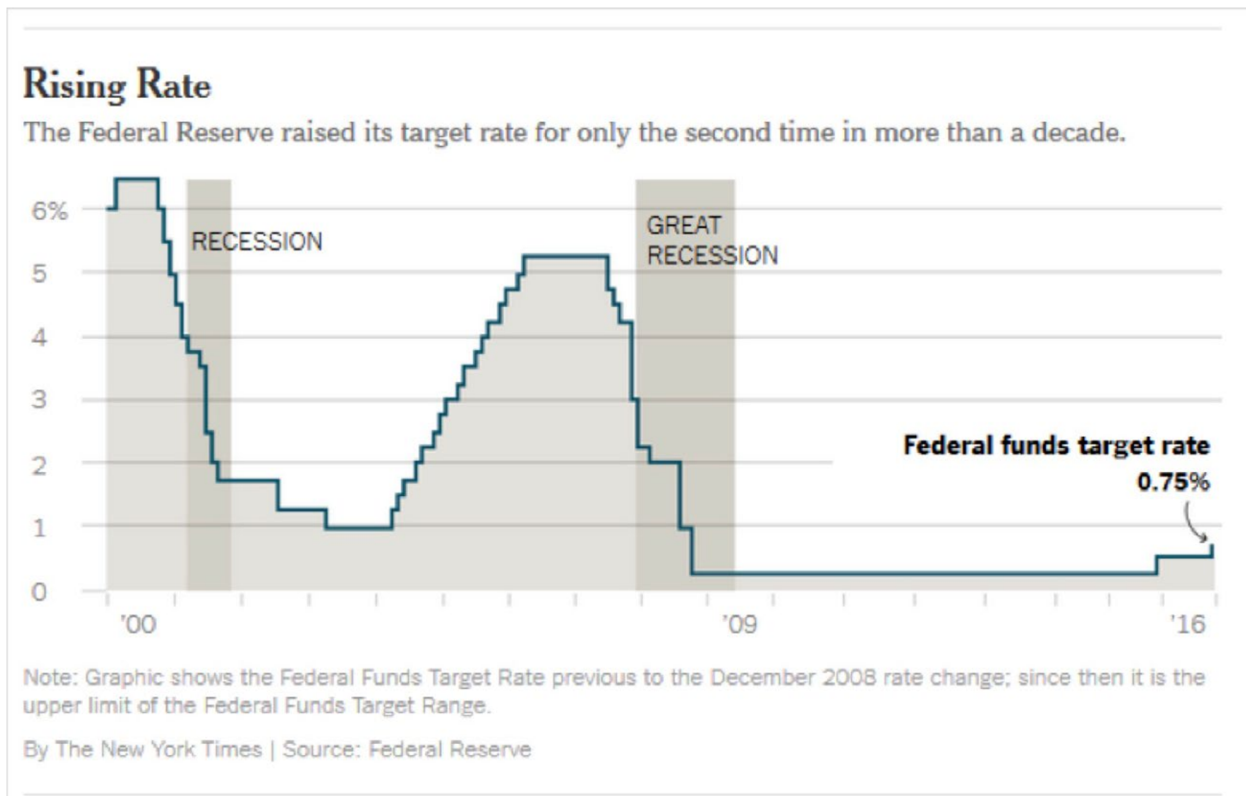
We Got Dot Plots

Now to the main course: Dot Plots du Jour. The dots that the FOMC members contribute to the plot indicate their expectations for the federal funds rate.

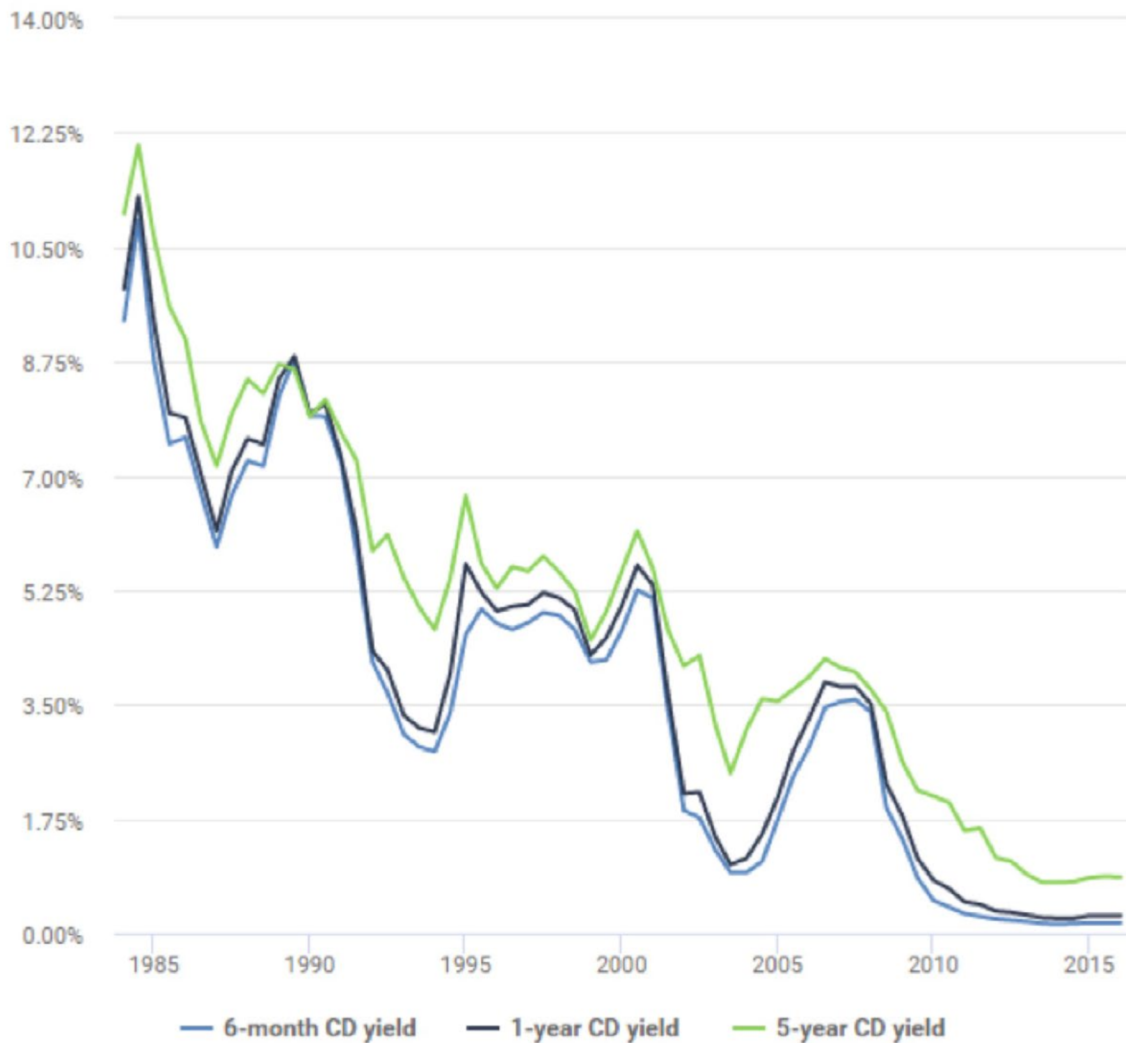
By the way, I saw a tweet this week in which someone said that the dot plots are not "forecasts." It's true that the Fed doesn't use that word. They call the plot their "assessment of appropriate monetary policy" for certain points in the future. So technically, it's what they think rates *should be,* not a prediction of what rates *will be* on those dates.

Is that a forecast? You can call it whatever you like. I think "forecast" is close enough.

But before we look at the whatever-you-call-it, here's a rate history of the last 16 years:



I've highlighted this fact before, but it's worth mentioning again: In 2007, less than a decade ago, the fed funds rate was over 5%. So were the interest rates for Treasury bills, CDs, and money market funds. People were making 5% on their money, risk-free. It seems like ancient history now, but that year marked the end of a halcyon era of ample rates that most of us lived through. The chart below shows historical certificate of deposit rates – but remember, you could put your money in a money market fund and do better than the six-month certificate of deposit yield, back in 2007.

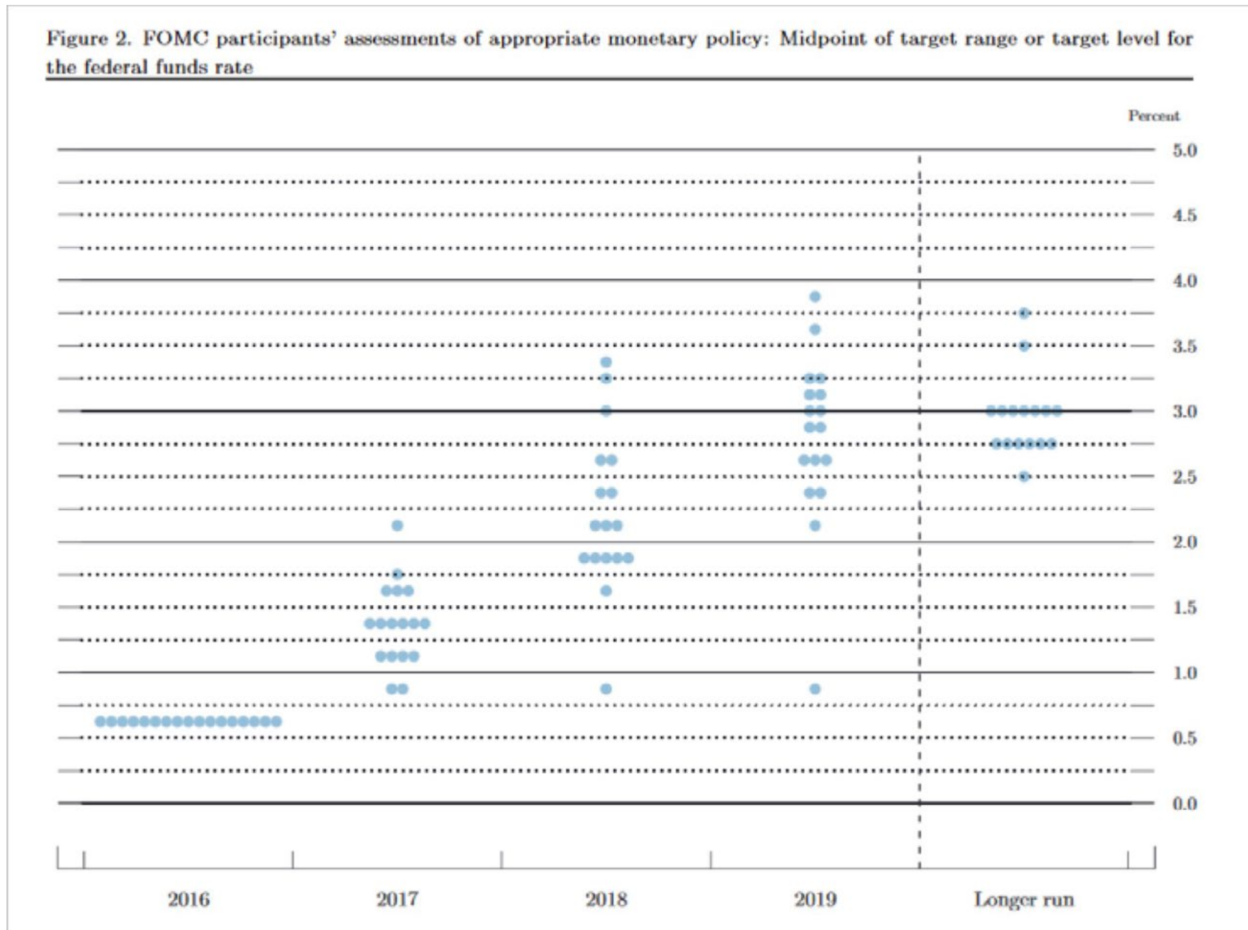


Today's young Wall Street hotshots have never seen anything like that. To them the jump from 0.5% to 0.75% must seem like a big deal. It's really not. If the chart above were a heart monitor readout, we would say this patient is now dead and that last blip was an equipment glitch.

The point to all this is that these near-zero rates to which we have all adapted are by no means normal or necessary to sustain a vibrant economy. We've done fine with much higher rates before. They are even beneficial in some ways – they give savers a return on their cash, for instance. But there are likely to be consequences once we embark on this rate-increase cycle, and I'll examine them later in this letter.

The FOMC cast members are all old enough to remember those bygone days of higher rates as well as I do. So we would think they might at least foresee a return to normalcy at some point in the future. Not so. They see nothing of the sort.

Here is the official dot plot published by the FOMC. (I have included their preferred heading so that no one complains about my calling it a forecast, even though that's what it is.)



Each dot represents the ~~forecast~~ assessment of an FOMC member. That group includes all the Fed governors and the district bank presidents. All 17 of them submit dots, including the presidents of districts who aren't in the voting rotation right now. There would be 19 dots if the two vacant governor seats had been filled.

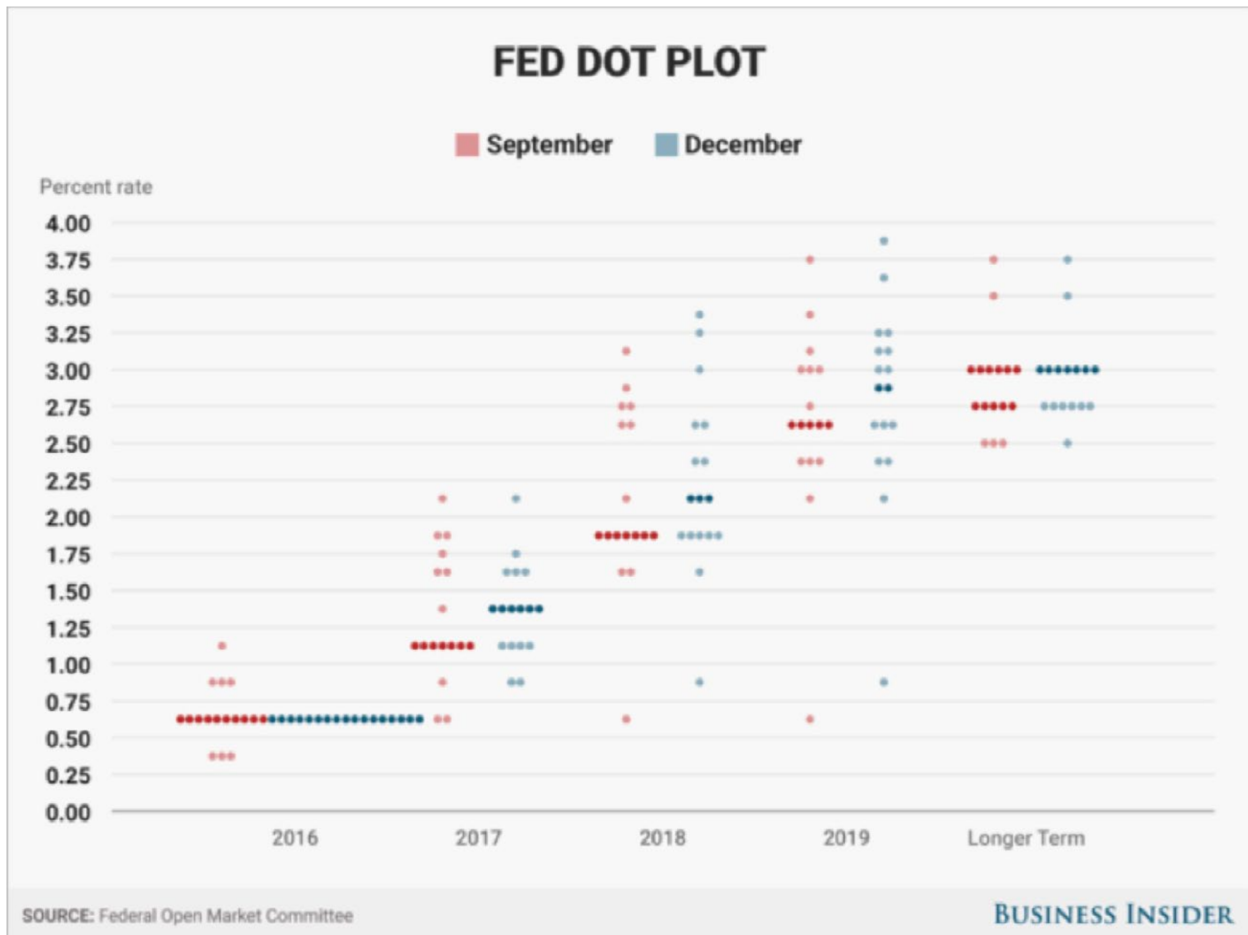
That flat set of dots under 2016 represents a rare instance of Federal Reserve unanimity: They all agree where rates are right now. (See, consensus really is possible.) The disagreement sets in next year. For 2017 there's one lone dot above the 2.0% line, but the majority (12 of 17) are below 1.5%.

Nevertheless, it will be a much different year than this one if they follow through. The dots imply that the fed funds rate will rise a total 75 basis points next year. Presumably, that would be three 25 bps moves, but they can split it however they want. They could ignore their expectations completely, too. This time last year, the FOMC said to expect a 100 bps rise, or four rate hikes, in 2016. We got only one.

Follow the dots on out and you see that their assessments trend a little higher in the following two years, and then we have the "longer run" beyond 2019. Most FOMC participants think rates at 3% or less will be appropriate as we enter the 2020s. The most hawkish dot is at 3.75%.

Think about what this means. Today's FOMC can imagine raising rates only to the point they fell to about halfway through their 2007–2008 easing cycle. **They see no chance that overnight rates will reach 5% again. None.**

Here is another view of the same data, courtesy of *Business Insider.* They added the September dot plots, so we can see how the dots shifted.



Looking at each set of red (September) and blue (December) dots, we see only a slightly more hawkish tilt than we saw three months ago. The "Longer Term" sets are almost identical – two of the doves moved up from the 2.5% level, while the two most hawkish hung tight at 3.75% and 3.50%.

That word *hawkish* is relative here. By 2007 standards, these two voters are doves. But, Toto, I've a feeling we aren't in 2007 anymore.

Trump? Who's That?

I got an email from the brilliant Peter Boockvar after the FOMC news. He said, "If something changed on November 8th, the Fed didn't see it." That was a good way to put it. The same election that jolted markets into some of the sharpest moves in years barely affected the FOMC participants. That's very clear from the near-identical red and blue dots in the chart above. Peter's take?

> Now the dots predict 3 in 2017, and the market this time actually believes we may get it because of Trumponomics and the reality that Fed forecasts must shift higher. Three rate hikes, though, will only take us to a whopping fed funds rate of 1.375%. Even with a zero rate for 8 straight years, the 25-year average in the fed funds rate is still about 2.75%. Headline CPI today is expected to print 1.7%. We should still see negative real interest rates in 2017. The dollar doesn't care about the absolute level of rates as it continues to rip on the continued growing rate differentials. I'm waiting for the Trump tweet complaining about the strong dollar. I find that to be inevitable if he wants to bring manufacturing jobs back to the US.

Are the Fed governors and bank presidents in denial? I don't think so. Whether they supported the election outcome or not, they know what happened. They know how markets reacted. They know a whole bunch of things are about to change. So why are they so stubbornly sticking to their guns?

This may surprise some of you, but I'm going to defend the Fed on this point.

I wholeheartedly believe Donald Trump and the Republican majority will enact a sweeping package of tax cuts, at least a modest infrastructure spending program, and hopefully some radical deregulation. It won't be exactly what any of us want, but they'll make some good moves that should help the economy, which is badly in need of some help. (As we will see below, there are other forces that are problematic.)

But here's the rub. **We don't yet know** exactly what it will all look like. Right now, we're hearing a lot of ideas and speculation. Presidents never get everything they want from Congress. Trump may get more than most, but I doubt he'll get it all. Senators and Representatives have their own ideas and incentives. Serious prognosticators are paying a lot more attention to House Ways and Means Chairman Kevin Brady than the media is. Brady's ideas are well-known, but they'd be a radical departure from current policy. And every economist knows that any change comes with a time lag before its effects are truly seen in the economy.

Likewise, the details matter. Tax reductions are generally good, but they can have more or less growth impact depending how they are constructed. There's also the question of how they will affect the debt. That problem isn't going away. The same with spending and deregulation.

There's a lot we don't know, and right now what we do have is mostly guesswork. Do we really want a Federal Reserve that reacts to guesswork? I don't. I want them to look at hard data and make their best judgment calls. This week's hike was probably going to happen no matter how the election turned out. They told us in the dot plot to expect more hikes next year, totaling 0.75%. They have plenty of time to react to whatever fiscal policy changes make it to the president's desk.

The same applies to their morose GDP projections. Do they think the coming changes will have no effect? Probably not. But they don't know exactly what the changes will be, which makes their impact hard to assess. Plus, while I don't agree with Summers on secular stagnation, I do agree that long-term forces are causing a generally slower growth environment.

We'll get a new dot plot at the mid-March FOMC meeting. By then we should have a much better sense of fiscal policy changes. I suspect the impact will be visible in that meeting's projections, and certainly by the meeting in June.

The Great Shake-Up

The current FOMC may have some new voters by March. There are two vacant seats Trump can fill as soon as he takes office and gets the Senate to confirm them. But it appears Janet Yellen isn't going anywhere. Asked about her own future at the news conference, she noted that the Senate had confirmed her to a four-year term as chair and that she plans to finish it on schedule, that is, on February 3, 2018.

And this is where we get some drama. Trump could have anywhere from a minimum of two appointments in his first term to possibly all seven. We'll start with some facts and then throw in some speculation. I should note that I have talked about this with a number of people who have deep insights and contacts in the Federal Reserve, but I owe a special word of thanks to Danielle DiMartino Booth, whose new book on the Fed will be out on Valentine's Day. We will preview it here, and I'm sure it's something you'll want to read. It is getting rave reviews from the coterie of insiders she has allowed to read it. Now to the drama…

At Yellen's press conference she made a couple of notable points. She specifically noted that Federal Reserve appointments aren't tied to presidential elections. I think that was a hint that she will defend the Fed's independence, or at least try to.

She also left open the possibility of staying on the Board of Governors even after her term as chair is over. Those are separate appointments. She can stay on the board until January 31, 2024. At age 70 now, I doubt she will, but it's possible. We know Supreme Court justices delay retirement so that a president they like can appoint their successor. I think Yellen was reminding Trump that she has that option.

The same is true for Vice Chair Stanley Fischer, by the way. His board term lasts until January 31, 2020, so if he chooses to stay it will be until either Trump's second term or someone else's first .

You all know that I think the Fed needs a major shake-up. I think Trump can do it, too, but only to the extent there are vacancies he can fill. There are the two current openings, but beyond them he will need some of the current five governors on the FOMC to step down voluntarily. The others' terms all extend through 2022 or later.

For the record, the other three serving Board of Governors members are Daniel Tarullo, whose term does not end until January 31, 2022; Jerome Powell, whose term isn't over until January 31, 2028; and Lael Brainard, whose term ends on January 31, 2026. They can all elect to stay.

Now, I am told that Yellen actually wanted to raise rates in September but that she would have had two dissenting votes from members of the Board of Governors. It's one thing to get dissenting votes from the district Federal Reserve presidents who are serving as voting members on the FOMC; it's another thing to get dissenting votes from the members who are appointed to the Board of Governors. There has not been a dissenting vote from a governor since 1996 – not to say it couldn't happen next meeting, but just to give you an idea how rare it is.

If Yellen and Fischer decided they wanted to stay and the other three current board members also agreed to stay on, together with the generally dovish district Federal Reserve presidents, they could seriously hamstring any real shift in Federal Reserve policy that Trump might prefer.

That means the two appointments that he initially makes may be his only true options to eventually become chairman and vice chairman. While I don't think this outcome is likely, is clearly an option in everybody's back pocket. That ratchets up the importance of the first two appointments.

Fortunately for Trump, it's pretty rare for Fed governors to complete their full 14-year terms. First of all, you have to realize that they get something like $169,000 a year. That's a rounding error in their speaking income, not to mention what they can get by sitting on major corporate boards and consulting. And seriously, you have to be a total data wonk to get any excitement out of some of the responsibilities they have. So consequently, they either retire or seek other opportunities (and maybe a bit more fun). So there's a good chance Trump appointees will hold at least four of the seven Board of Governors seats by the end of his first term. That could happen as soon as mid-2018 if Yellen and Fischer retire when their leadership positions end.

Okay, let's ratchet up the drama. Lael Brainard was hoping to be appointed Secretary of the Treasury under a Clinton administration. Clearly, that's not going to happen. She's young enough that a future Democratic president could appoint her to the position, but does she want to hang around on the Federal Reserve for a minimum of four more years? I am told she doesn't.

By people who know Governor Tarullo (and like him), I am told that he is likely to leave sooner rather than later. Currently, he is head of the Federal Financial Institutions Examination Council, a spot he is certainly qualified for but one that is generally given to the Federal Reserve vice chair. He is 64 years old, and I don't think he will want to hang around just holding down a spot.

Jerome Powell's background is impressive, but I wonder if he would want to be the last man standing of the current governors. I have heard nothing either way and no one seems to really know, other than Governor Powell. He is actually the lone Republican on the board but has not proven as hawkish as some people thought he would.

Also for the record, I know that both John Taylor and Kevin Warsh would like to be Fed chairman. Either one would be a good chairman, but my true preference would be Richard Fisher, the former Dallas Federal Reserve president. The coming times are going to be extremely difficult to navigate by the limited means of monetary policy, but within that scope, the wisdom and counsel of Richard Fisher would be a great addition. There are any number of good governor nominees, but let me put the names of Dr. Lacy Hunt and David Malpass on the list. Especially Lacy. True aficionados of the genre know that these two are not always on the same page, but they both bring an enormous amount of historical knowledge and economic sagacity. We are coming into a world where there will not be many good choices, and choosing among the – well, let's just call them less than optimal – choices will demand that wisdom. Just saying…

So it's possible that Trump gets at least six and maybe seven appointments within his first two years to the Board of Governors of the Federal Reserve.

Even if you like nothing else about Donald Trump, you really should celebrate this part. The stars have lined up to give an "outsider" president a shot at completely remaking the Federal Reserve. Washington is full of agencies that need a shake-up, of course. I expect many will get one. None need it more than the Fed. In terms of long-term impact, reshaping the Fed could be one of Trump's greatest undertakings.

That being said, if he gets the number of appointments that I think are likely, that means he "owns" the Fed, in terms of having to take responsibility for its actions. It goes back to Colin Powell's philosophical line, "You break it, you own it."

The problem is, as I have been repeating, that monetary policy is unlikely to be all that effective in the future. It is questionable how effective it has been in the recent pas,t aside from driving up asset prices, which hasn't done much for Middle America.

I keep pointing out that we really do have to be paying attention to what is happening in Italy and Europe, too. Italy is truly on the brink of a major crisis. Maybe I should write that as ***MAJOR CRISIS.*** One that can send Europe into a deep recession and push the world to a global recession.

Let's review the reality on the ground. In a conversation I had yesterday with Dr. Lacy Hunt, he pointed out that total US debt is $70 trillion. $20 trillion of that will have its interest rates reset within the next two years. That means a minimum of $200 billion more interest, which comes directly out of the productive economy. Now, that money is partially transferred here or there, but it is clearly not stimulus. As I have demonstrated in past letters, at some point debt becomes a drag on the economy, and we are at that point.

Further, and without getting too deep into the weeds, the QCEW (an employment report) suggests that the actual number of added jobs in the US may be overstated by 190,000 or more and will get adjusted next year when we get the normal revisions. And as I mentioned, 10 million American males are no longer in the labor force and aren't looking for work. No productivity or any other help for the economy there.

The bulk of the current FOMC members believe that GDP growth will remain below 2%. There is reason to think that 1.5% is closer to the real potential. For all intents and purposes, that's stall speed. A crisis in Europe, and President Trump has a recession on his hands. And as I have consistently pointed out for 20 years, presidents have *&^%&^% little control over the economy – but they get blamed or praised, take credit or point fingers, for whatever happens.

Whatever happens, it is going to be an interesting next four years. Let me make a personal admission. This will probably earn me no kudos from anyone, but in my private moments over the summer and going into the election, I consoled my friends with the possibility that while Republicans might lose at the ballot box, the fact that the likelihood of a recession in the next four years was so high that a Clinton presidency and progressives in general would be blamed for it. Blamed unfairly, at least to some degree, although they are responsible for the regulatory environment we live in today. But this would lead to a massive sweep in 2018 and 2020 and in the long view might change things for the following 10 to 15 years.

Now? Republicans own it. At least in the minds of the voters. And for the record, let me clearly state that the policies that I expect a Republican president and Congress to initiate will go a long way to mitigating the negative effects of a recession, far more than the dovish and more repressive regulatory and high-tax policies of a Clinton administration would have done. But arguing that things are at least better than they would have been does not make for a very good political campaign slogan.

To an agonizingly great degree, the incoming US administration is hostage to the German election cycle, which means that Merkel cannot condone bailing out Italian banks until after her election in the fourth quarter of next year. Sometimes, bond markets can be very inconvenient. Italy is in extremely deep kimchee. And that's putting it delicately. Unlike Greece, Italy matters. Italy is too big to bail out, too big to save. A breakup of the euro practically guarantees a deep recession in Germany – and I mean really deep. Which will suck in its other northern partners. A recession in Europe would drag the world down – including a debt-driven China.

You want soap opera? What happens when the currencies of the world start falling significantly against the dollar? Currency manipulation or the real world? What does a Trump Treasury Department do in response? Labeling everybody as currency manipulators won't work very well. Punitive tariffs are counterproductive. Do we actually respond by monetizing the federal debt (at least the debt held in the US) in order to reduce the value of the dollar and keep from completely devastating the potential positive aspects of a new corporate income tax policy? That would not be an irrational response, as it would essentially be what the rest of the developed world was doing.

Dear gods, we are moving into a world where we have absolutely no idea how things are going to unfold. The uncertainty gage is pegging into the far-right red zone.

There are so many moving parts to the puzzle that it is hard to keep track of them. I am going to get on a plane tomorrow to go meet in NYC with some of the "insider" economists and thought leaders of the upcoming administration. And I'm going to pose those very questions to them. For the most part, they are friends or at least acquaintances. And in their private moments, they show me that they "get it." I will readily admit to being the Debbie Downer in the group.

"The problems of victory are more agreeable than the problems the defeat. But they are no less difficult."

New York (again), Florida, DC, and the Caymans

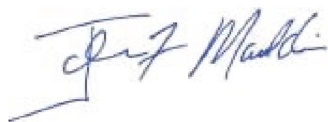
As noted above, I'm on my way to New York City on Monday and then hope to be back home for the holidays. There will be no letter on Christmas weekend. I'm still thinking about what to do over the New Year's weekend, but my annual forecast letter will come out the following week.

After that, I'll be at the Inside ETFs Conference in Hollywood, Florida, January 22–25. If you are in the industry and coming to that conference, make a point to meet with me. I will be making some big announcements at the conference. Then I'll be at the Orlando Money Show February 8–11 at the Omni in Orlando. Registration is free. There is also the high probability that I will be in Washington DC during the inauguration as one of the corporate boards I am on is probably going to shift their meeting to coincide with the inauguration. And I am tentatively scheduled for a conference in the Cayman Islands.

Let me wish you a sincere Merry Christmas and/or Happy Holidays. Most of the Mauldin clan will be gathering for Christmas, and I am looking forward to it. Some of them are dragging me, albeit not totally unwillingly, to *Rogue One* tonight. While I have seen all the Star Wars movies, they are starting to become redundant, derivative science fiction storytelling that doesn't acknowledge the real possibilities of a resplendent technological future. I was actually going to skip this one, but I am being pulled along by some of the younger members of the clan. I can't gripe, because at least it's not a chick flick.

For me, the time between Christmas and New Year's is when I think about the future, and for the last 50+ years it is always the most optimistic week of my life. Debbie Downer leaves the room and Pollyanna John emerges. The sun will come out tomorrow, etc. That attitude is not always reflected in my annual forecasts, but more often than not they have been pretty positive. But then again, I am often wrong but seldom in doubt, so you need to bear that in mind. In any case, I (probably foolishly) persevere in the annual predictive ritual.

Your trying to make sense out of this puzzle analyst,



John Mauldin

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