Mad Hawk Disease Strikes Federal Reserve

By John Mauldin | June 25, 2017

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> "A serious writer may be a hawk or a buzzard or even a popinjay, but a solemn writer is always a bloody owl."
>
> – Ernest Hemingway

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Welcome to the new, improved, faster-to-read, better yet still-free Thoughts from the Frontline. *My team and I have been doing a lot of research on what my readers want. The reality is that my newsletter writing has experienced a sort of "mission creep" over the years. Bluntly, the letter is just a lot longer today than it was five or ten years ago. And when I'm out talking to readers and friends, especially those who give me their honest opinions, many tell me it's just too much. There are some of you who love the length and wish it were even longer, but you are not the majority.*

Not even close. We all have time constraints, and I wish to honor those. So I am going to cut my letter back to its former size, which was about 50% of the length of more recent letters. (Note: this paragraph is going to open the letter for the next month or so, since not everybody clicks on every letter. Sigh. Surveys showed us it's not because you don't love me but because of demands on your time. I want you to understand that I get it.) Now to your letter…

Longtime readers know I am not the Federal Reserve's #1 fan. I can't recall ever resting easy, confident that the Fed was ably looking out for our economy and banking system. However, I have experienced varying degrees of skepticism and distrust. I must also acknowledge that we are all still here despite the Fed's many mistakes.

Once or twice a year the Fed rekindles my frustration and concern with a particularly boneheaded statement or policy change. Last summer, the Fed's annual Jackson Hole Economic Policy Symposium outraged and saddened me at the same time – which, given my emotional makeup, is quite an accomplishment. I shared my rage with readers in "Monetary Mountain Madness." Feel free to read it again if you enjoy a good rant. I would have been even more depressed if I had known that one of the academic presenters there, Marvin Goodfriend of Carnegie Mellon University, an unabashed cheerleader for NIRP, would appear on the short list of candidates for Donald Trump's first two appointments to the Fed.

Goodfriend is nominally a monetarist, but he doesn't quack or waddle like any monetarist I know. The session that he presented was entitled "Negative Nominal Interest Rates." In the first paragraph of the first section of his paper, he says that "[M]y current paper makes the case for unencumbering interest rate policy so that negative nominal interest rates can be made freely available and fully effective as a realistic policy option in a future crisis."

So the first appointment to the Fed that Donald Trump will reportedly make is an unabashed advocate of negative interest rates as a policy option. It doesn't sound like Trump wants a Fed that is modeled on the far more disciplined principles of a Richard Fisher or a Kevin Warsh.

While my rant last summer was about the Fed's apparent willingness to embrace negative rates, we now face the opposite risk. Janet Yellen & Co. are asserting that inflation is such a serious threat that they must tighten policy with a two-pronged approach. They are already raising the federal funds rate and will soon begin reducing the massive bond portfolio accumulated in the QE years.

I don't think these moves will create a crisis on their own. Rather, I think the mentality that they reveal may lead to much bigger mistakes when the next recession arrives. The mistakes may already be unfolding.

Here's my key question: Is the Fed really as "data-dependent" as Yellen and others say, or do other factors influence them? I think the latter. You'll see the other factors in a little bit.

Inflation Fail

That the previously dovish Janet Yellen took the Fed chair when she did is almost comedic. Ben

Bernanke had uttered that word *taper* in 2013, signaling that quantitative easing's days were numbered. No one knew how the Fed would extricate itself from years of QE and near-zero rates. But, to her credit, Yellen accepted the challenge in late 2013.

Having tapered the Fed's bond buying down to zero (except for reinvestment of dividends and maturity rollovers) and begun the rate-hike cycle, Yellen has accomplished a few things; but normalizing interest rates under a Democratic president was not one of them.

Another objective Yellen hasn't been able to achieve is to create enough inflation. Yes, you read that right. It is part of the Federal Reserve's job to keep inflation at an acceptable level, which it defines as 2%. This mandate is articulated in the Federal Open Market Committee's "Statement on Longer-Run Goals and Monetary Policy Strategy." The boldface is mine.

> **The inflation rate over the longer run is primarily determined by monetary policy**, and hence the Committee has the ability to specify a longer-run goal for inflation. The Committee reaffirms its judgment that inflation at the rate of 2 percent, as measured by the annual change in the price index for personal consumption expenditures, is most consistent over the longer run with the Federal Reserve's statutory mandate.

The Fed itself says monetary policy determines the inflation rate. The Fed determines monetary policy, so inflation (or lack thereof) falls squarely in their laps.

That is actually quite a startling statement, if you think about it. The Fed doesn't just regulate inflation; the Fed *causes* inflation, not as a side effect of something else but because they think it is desirable. And they admit doing so, right in their own documents.

But wait, there's more.

> The Committee would be concerned if inflation were running persistently above or below this objective.

PCE inflation has lagged persistently below 2% for years now. The Committee reminds us at every meeting that it is, in fact, concerned about this. But its concern has not stopped it from plowing ahead with policies that produce everything but inflation.

Personally, I think low inflation is preferable to high. It preserves the purchasing power of our currency. The point here is that, **by its own self-imposed goals and definitions, the Fed has failed to accomplish a key part of its mission**. It wants 2% inflation. It says its policies can create inflation, but those policies haven't. This is failure by any definition of the word.

Let me comment on the section that I bolded above: **"The inflation rate over the longer run is primarily determined by monetary policy…."**

Really? If inflation or deflation is primarily determined by monetary policy, why is there no inflation in Japan today, and why hasn't there been for 25 years? With the most massive quantitative easing and extraordinarily low interest rates ever seen, Japan has been trying as hard as it can to create inflation; but Japan has been pushing on a string, and I think some of the same conditions (demographic and market) that have foiled Japan are beginning to apply in the US and Europe. And I suspect the Fed's efforts will be as futile as the Bank of Japan's have been.

When a person or an organization fails – and of course we all do – the best response is to show some humility, identify the problem, and modify the strategy. The Fed is doing the opposite.

Ignoring the Market

FOMC members customarily enter a "quiet period" before each policy meeting. That means we get a heavy dose of speeches and interviews the week after they meet. Last week was that week, and it kicked off with New York Fed President William Dudley.

Speaking at a Business Roundtable event, Dudley reportedly expressed great confidence in both the economy and the Fed's policy moves. (I'm relying on press reports here because the NY Fed did not release Dudley's prepared remarks, if he had any.)

The *Financial Times'* account captured it best:

> Despite some jitters among investors, Mr Dudley reckons continued progress in the jobs market will push wages higher at a more rapid clip, something that would be expected to boost inflation closer to the Fed's targets.
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> The policymaker added that stopping rate increases at this point could be dangerous for the economy. His stance echoes that of other senior central bankers who worry that with the jobless rate near levels seen as natural in a properly functioning economy, there is a rising risk of inflation overshoots.

I see zero indication that Dudley is even slightly concerned about the Fed's overshooting with its rate hikes. However, he is supremely confident that inflation will overshoot if the Fed *doesn't* tighten policy. Perhaps more disturbing, a MarketWatch story says that Dudley remarked that he "is not paying much attention to signals of concern from the bond market."

Read that again. If someone has his exact quote, I'd love to see it, because this is astonishing. The NY Fed's president is a permanent FOMC member precisely *because* he is closest to the bond market and is responsible for executing the Fed's trades. Yet by his own admission he is ignoring the market's concerns.

Could that be because Dudley doesn't like the markets' message? Futures prices show that traders do not believe the Fed will raise rates as aggressively as the FOMC's dot plots say it will. That's kind of an important signal. Dudley's job is to listen to it. If he's not listening, why not?

I have a theory.

Great Fed Rotation

All this is happening as the Fed is on the cusp of drastic change.

The Federal Reserve System has a seven-member Board of Governors. Three of those seven seats are currently vacant. President Trump has not nominated anyone yet, although two names have been floated in the press (including NIRP lover Goodfriend). Even if Trump were to nominate them tomorrow, they would still have to go through Senate confirmation, and the Senators have a lot on their plates.

Meanwhile, Janet Yellen's term in the chair expires on February 8, 2018, and Vice-Chair Stanley Fischer's term ends in June 2018. Their board terms are separate, so both could theoretically remain governors after their leadership terms expire, but most observers expect them to retire. Their staying would not be without precedent (I think there was one exception), but it certainly would be an eye-opener. So, if things go as expected, Trump will have two more seats to fill.

So, we are potentially one year away from a Board of Governors with ***at least*** five of the seven being Trump appointees. And it seems highly likely that Lael Brainard will not stick around much longer after Yellen leaves, and then the only question remaining is whether Jerome Powell steps down. I know nothing of his plans, but it could happen. Is his ideal career move to remain on the FOMC as the odd man out?

The seven Fed governors – when there are that many – all sit on the Federal Open Market Committee, which sets interest rates and makes other monetary policy. Also voting on the FOMC are the New York Fed's president and a rotating cast of four other regional Fed presidents.

President Trump does not appoint the regional Fed bank presidents. They answer to their own boards, which comprise bankers from their regions. So the FOMC has both political appointees and commercial bank representatives. It was set up that way on purpose. But it's also no accident that the political appointees constitute a majority – or will when more Trump appointees take their seats.

The FOMC works by consensus. Most of its decisions are unanimous or almost unanimous. Fed chairs strive mightily to get everyone on the same page, which I'm sure is tough, on the level of herding cats or getting Republicans in the House to agree. It's also important – banks and private businesses want to see stability.

Enter Donald Trump, for whom stability is a lesser priority.

The FOMC members must see what is coming. Their beloved unity is in danger, and I doubt they are pleased. I believe a faction on the FOMC wants to cement its own preferred policies in place and make it difficult or impossible for a new majority to change course in 2018 or thereafter. Yellen, Fischer, and Dudley all seem to be of that mind, and they are now taking a hawkish approach to monetary policy. That's why they don't want to do the otherwise sensible thing, which is to wait for more evidence that inflation is a problem before tightening further, especially so late in the recovery cycle.

Note also that Yellen and Fischer can further complicate the situation by staying on the board next year. Yellen won't be chair unless Trump reappoints her, but her board term runs through 2024. Fischer is likewise on the board until 2020.

Can Trump fire Fed governors, like he did the FBI director? Maybe. The Federal Reserve Act says governors can be "removed for cause by the president." He could certainly find cause if he wished to do so. But firing Fed governors would send a horrible signal to markets. Far better to give them incentives to resign, which could be done quietly. And frankly, I think those around him would let him know that firing would be a really bad idea. Just not done. Independence of the Fed and all that…

In any case, right now we have a Fed that is arguably letting its own parochial political concerns seep into its policy decisions. By raising rates when inflation is nowhere near problematic, they risk tipping the economy into recession. We're overdue for a recession anyway, and I get that they want to have room to cut rates if necessary. But that will be cold comfort if their own actions trigger the recession. But it even goes further than that…

Bitter Enemies

Division on the FOMC is a microcosm of a much broader problem: the increasingly bitter division within American society. I know many people blame the split on Donald Trump, but it was already well underway before he ran for office. I think Trump is a symptom, not a cause.

The survey data is stark and horrifying. This is from a June 15 *New York Times* story titled "How We Became Bitter Political Enemies."

> "If you go back to the days of the Civil War, one can find cases in American political history where there was far more rancor and violence," said Shanto Iyengar, a Stanford political scientist. "But in the modern era, there are no 'ifs' and 'buts' – partisan animus is at an all-time high."
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> Mr. Iyengar doesn't mean that the typical Democratic or Republican voter has adopted more extreme ideological views (although it is the case that elected officials in Congress have moved further apart). Rather, Democrats and Republicans truly think worse of each other, a trend that isn't really about policy preferences. Members of the two parties are more likely today to describe each other unfavorably, as selfish, as threats to the nation, even as unsuitable marriage material.

This isn't just party loyalty. A sizable majority of Americans of both parties now see the other political party as not just mistaken, but as close-minded, immoral, and dangerous, clueless on policy and the correct way to run the country. Again, that's on both sides. The animus is also clearly visible in the disdain that party elites feel for the members of their own party – no matter what they say when they're up at the podium.

The current split is even wider than what we think of as more divisive issues like race or gender identification. Regardless of which side you are on, this ought to be terrifying. How can we ever come to a national consensus on crucial issues when this is the underlying environment? More from the NYT story:

> Mr. Iyengar also points out that Americans are willing to impugn members of the other party in ways that aren't publicly acceptable with other groups, like minorities, women or gays. There simply aren't strong social norms holding partisans back.

This is a terrible state of affairs, and I see no good way out of it. It's going to manifest itself in many ways, in every institution and corner of society; and in many cases it already has – including at the Federal Reserve. That means it is affecting the economy.

Let me be clear: I am not trying to convert anyone to my own side of the aisle or assert that my side is morally superior. This is a bipartisan problem with plenty of blame to go around. Pretending it doesn't exist helps no one. I write this because I must hold out hope that we can somehow restore a civic space where we can have adult conversations and somehow recover our lost national unity.

Like it or not, politics is not separate from our private and business lives. It has real-world consequences that affect everyone's well-being.

And that brings me back to the Fed and their current actions. The following is speculation on my part and will be vigorously denied by anyone associated with the Fed.

I think there is a mixture of political bias and legacy-building that is driving Federal Reserve policy.

The simple fact of the matter is that the Fed should have been normalizing interest rates starting in 2013. Fifty basis points a year and we would be at 2% now. That is not exactly a torrid rate-hike path. It cannot be seen as putting your foot on the brakes; it's simply moving to normalize a situation that everybody realizes is abnormal. I think that everyone on the FOMC recognizes that rates do have to be normalized, and they don't want to leave the Committee with rates sub-1% as their legacy.

But when these governors walk into an FOMC meeting, try as they might, they can't leave their biases in the anteroom. It's a simple fact that for four years during a Democratic administration they basically refused to raise rates. They said their actions were data-dependent and that the data was telling them it was too early to tighten. Then Donald Trump gets elected, and all of a sudden the data is telling them it's time to raise rates.

After they have blown a series of bubbles with their low rates, in housing, stocks, all sorts of debt instruments, the automobile market, markets of all sorts, now somehow the data is different, and we have to raise rates.

No two ways about it: There is no significant difference in the data today from that of four years ago – except that four years ago we didn't have all the bubbles I ticked off above. And we are already late in the cycle. And – the elephant in the room – we now have a Republican president. Who is not going to reappoint these governors.

Let's look at the data. Unemployment was low four years ago, and it is lower now. The Fed keeps talking about wage inflation, but there is no evidence of it. Further, the Fed's models are backward-looking and based on historical economic trends and patterns that no longer exist.

In a future letter I'm going to write in depth about the difference between the service class and the working class. The working class generally makes stuff, working at trades and manufacturing jobs. The service class works in the retail sector, in stores and restaurants, and represeents the bulk of the country's employees. The skill sets are entirely different. There may be in fact some wage pressure in the working class due to a lack of qualified and trained employees (welders, carpenters, and other craftsmen), but that is not the case for the service class. (There are indeed other classes of workers who are more information-oriented or who are professionals. But that is for another letter.)

When Sears goes bankrupt the next time, up to 160,000 people will be joining the unemployment rolls and looking for other service jobs. Ditto for all the other retail jobs that Amazon is gobbling up. There will be millions of such workers in the service industry looking to find jobs – not exactly the stuff that wage inflation in the service job market is made of.

According to a Merrill Lynch study, auto production is going to drop from the projected 17.9 million for this year to 13.8 million in 2021, due to lease roll-offs and other pressures. That dramatic dip in production is going to make a huge dent in the need for workers in the working class. This is not the stuff of wage-pressure-induced inflation.

Subprime auto loan defaults are rising, as are student loan defaults. There are signs everywhere that we are much closer to the end of this business cycle than we were in 2012. There are so many data points that seem to be rolling over. We are not at the end yet, but we're a lot closer.

The FOMC members are now coming to the realization that leaving the Committee without normalizing rates is going to be disastrous for their legacy, whatever that is. And so they are embarked on a tightening cycle. And they no longer have to worry about creating a recession during a Democratic administration. How convenient. Although they would aggressively deny that any such thing would be ever part of their decision-making process.

And intellectually, I think they are being totally honest. But our emotional biases are not part of our intellectual makeup: This fact of life is basically behavioral psychology 101. Our biases cause us to look at situations (and economic data) in ways that are not always entirely rational. Overcoming our own personal biases is one of the single most difficult things humans can do. So I am not really criticizing the members of the FOMC; I'm just making some observations and freely admitting that I am chief among sinners when it comes to allowing biases to influence thinking.

As David Rosenberg has pointed out, Fed tightening cycles always end with a US market crash or an emerging-market crash or both (but usually just a US market crash). The Fed keeps tightening until we get an unpleasant event.

You really can't ignore the fact that the FOMC is telling you they are going to raise rates at least once more this year. I know that the two-year bond doesn't believe that, but I think you need to take it very, very seriously. And I would bet on a January rate hike, in the last month of Yellen's chairmanship. Doesn't quite get us to 2% rates but… close enough for government work.

They are hoping that by raising rates slowly they won't push the economy into a slowdown before they can abandon ship. Then the next chairman and the Fed can deal with it.

One last thought: I want to reiterate that the potential appointment of Marvin Goodfriend is disturbing to me. I'm sure he's a good guy and a brilliant economist; but it all boils down to this: If you can wrap your head around negative interest rates, I don't want you anywhere near the policy steering wheel.

If the Goodfriend choice is part of a trend and Mnuchin or whoever is advising the president on these choices, that suggests to me that the Trump team is not looking to appoint a hawkish, less activist FOMC. That means we are not going to get a Kevin Warsh or a Richard Fisher as chairman. We're certainly not going to get a Volcker. I truly, deeply, sincerely hope I am wrong. I hope I have to eat those words.

Thinking the unthinkable: Could we see a return to QE before the end of Trump's first term? It's way too early to tell, and maybe somebody will get with the president and discuss the dynamics of Federal Reserve policy and the problems of quantitative easing and NIRP or zero boundary rates. A recent Princeton study (pointed out to me by Lyric Hughes Hale) suggests that when rates fall below 2% there is no real stimulative value and, in fact, rates that low hurt the economy.

We need a new mindset at the Fed. If we don't not change the underlying philosophical posture that 12 people can sit around a table and set the price of the most important item in the world, money, and do that better than the market can, we will continue to flounder. If, after all the new appointments, we still end up with an activist FOMC that believes in its own models, which have been preposterously wrong for 30 years and that will continue to blow a series of bubbles in all markets, which will eventually crash, then we are destined to a wash, rinse, and repeat series of financial crises.

This Fed has already engineered the next crisis, just as Greenspan kept rates too low for too long, ignored his regulatory responsibility, and engineered the housing bubble and subprime crisis. If you can't see this next crisis coming, you're not paying the right kind of attention. The Trump Fed is going to have to deal with that crisis, but we still have many questions as to what a Trump Fed will actually look like or do.

But make no mistake, whomever Trump puts on the FOMC, it will be an FOMC that he will have to take full ownership of, no matter what they do. Very few other presidents have ever had the opportunity to reshape the FOMC as completely as Trump will do.

And make no mistake, if we plunge into a recession and the market drops 50%, ardent pleas will issue from all points of the world to give us more quantitative easing. Just give us one more fix, the market will beg. "This time we promise not to get too irrationally exuberant again. Just give us a few more rounds of even more massive QE…."

With each passing quarter, the Great Reset is coming nearer. You need to think hard about how you're positioned in the markets and in your own personal life and businesses, in order to weather the crisis that's coming as skillfully as possible.

Getting Married on St. Thomas, Omaha, San Francisco, and Freedom Fest in Las Vegas

Shane and I are leaving today for St. Thomas in the US Virgin Islands and will be married on some beautiful beach on June 26, her birthday. Then I actually intend to relax for a week, enjoying time with my new bride and reading books with no redeeming social value (also known as science fiction/fantasy). I will begin final writing on my new book when I come back. I am finally really ready to attack the topic of what the world will look like in 20 years.

I have a quick trip to Omaha in the middle of June; then I'll head directly on to San Francisco and Palo Alto for speaking engagements (and have dinner with my good friends Andy Kessler and Rich Karlgaard). I will be speaking the next day, Thursday July 13, in San Francisco at the S&P Dow Jones Indexing Conference at the Omni Hotel from 12 till 4. Here's a PDF of the agenda. If you are an advisor or broker, you can attend for free. I look forward to meeting you there.

Afterward, I'll come home to Dallas, recover for a few days, and then fly with Shane to Las Vegas for the Freedom Fest. It has become one of the largest libertarian gatherings in the world, and I have so many good friends who go that it's really a lot of fun for me. And while I am not much of a gambler (as in I suck at it and hate losing money to people who are much richer than I am), I really do like the shows. And dinners with friends.

That covers July, and August is, of course, the annual Maine fishing trip; but right now the rest of August looks to be pretty wide open. If I can figure it out, I may go somewhere that has a much cooler climate than Texas does in August and relax and write.

It's time to hit the send button – the driver will be here in a few minutes. I've been officially informed that calories do not count on St. Thomas and that if you're on your honeymoon they are actually negative. I'm going to test that theory. Personally, I think it's about as reliable as Fed models are; but like the Fed, sometimes you do something just because you have a theory about how the world works and the theory makes you feel good. I think I see a serious diet in July…

(Update: Flights have been delayed, so we will be getting into St. Thomas a day late. Extra time in airports is so much fun. And now they are talking about rain on Monday. But I confidently predict that the sun will come out when we get married.)

Your out of here analyst,

John Mauldin

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