Colorado Scattershots

By John Mauldin | September 2, 2017

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Ask a child, "What do you want to be when you grow up?" and you'll probably get a standard answer: firefighter, doctor, teacher – all occupations we learn to recognize at an early age. Rarely do you hear a young one say, "I want to be a writer." I don't recall ever saying it. Yet here I am, with writing as one of my several occupations.

It may have been my very early love of reading and feeling the rhythm of the words on the page that put me on this road. One my real influences was the legendary sportswriter Blackie Sherrod. For decades he wrote a column for the *Dallas Times Herald* and later the *Dallas Morning News.* Reading him made me think of being a sportswriter, although that kind of writing is now is the farthest thing from my mind. But I did pick up a lot of style and storytelling tips from Blackie's columns.

Blackie usually focused on one subject, but on occasion he would do what he called "scattershooting" instead. The column would be a series of short paragraphs with no connection to each other and in no particular order. I loved those days. To me, they were a kind of sports buffet that let me sample a little bit of everything.

Today's letter will be my version of Blackie Sherrod's scattershooting. I've been in Colorado with Shane all week. Beaver Creek is stunningly beautiful in the summer, so it's been hard to keep up with the news or check email.

Instead of delving deep into one subject, I'll give you my quick thoughts on several different items. They aren't connected to each other, nor do they build up to any sort of conclusion. They're just what is on my mind as we wrap up summer 2017.

Now, let's go scattershooting.

Photo: USDA

Economic Storm

The top-of-mind news is the havoc wreaked by Hurricane Harvey on South Texas and Louisiana. Houston is getting most of the publicity, but the affected area is much larger. As a lifelong Texan, I have many friends in that region. They've lived through many storms and normally take what natures throws at them in stride. Not this time. I am seeing headlines calling this a thousand-year flood. It seems that over 100,000 homes in Houston alone were flooded. Harvey meant business. Recovering from this storm will take a long time and a lot of resources.

Economically, Harvey will likely be big enough to actually show up in national data. The weird part is it may eventually look like *growth* instead of destruction, because of the way we measure GDP. Gross domestic product looks at what the nation produces. It doesn't matter if we lost something else on the way there and are merely rebuilding to get it back.

Houston is the fourth largest city in the country. If it were a separate nation, it would be the 23rd-ranked country in terms of economic size. And that isn't even counting the surrounding areas that were devastated.

Here's reality. Tens, perhaps hundreds, of thousands of people in Houston alone lost their homes, their cars, probably most of their possessions. Some are now unemployed. Thousands of businesses will be closed for weeks, possibly months. Had Harvey not come along, those workers

and businesses would all have been producing something that added to GDP. Now they aren't.

Getting these people productive again will generate a lot of spending: new homes, office buildings, cars, etc. This isn't growth; it simply restores what the storm destroyed. But to GDP, it looks like production.

Reader Craig Pierce of Corpus Christi kindly sent me a Morgan Stanley report on this topic. I thought its first sentence was unintentionally hilarious:

> Natural disasters are never good for the economy, but they can cause a temporary increase to GDP.

In other words, "the economy" is not synonymous with GDP. Technically we knew that, but the disconnect is still funny to see in print.

Morgan Stanley's initial estimate was that Harvey would cause $30–40 billion in damages. Sources are now talking as much as $150 billion. The number will be a big one in any case. As for GDP, Morgan Stanley says:

> [T]he timing of Hurricane Harvey is key. We have over a full month left in the third quarter, which means the economic effects of Harvey may be fairly neutral on 3Q as a whole, but the lagged effects of rebuilding homes and replacing motor vehicles can last longer, providing a lift to GDP in 4Q and beyond.

Last week also brought the second estimate for second-quarter GDP, a surprisingly strong 3%. If the third quarter can hold up and then Harvey-related rebuilding activity adds a few points to the fourth quarter, 2017 might end with GDP looking pretty good relative to recent years. That outcome might in turn affect Federal Reserve decisions and all sorts of other choices. Simply having that 3-handle on GDP will be a psychological boost for many people, even if is a Harvey-driven illusion.

Sidebar: We desperately need a better growth measure than GDP is, but for now it's all we have.

Bending the Phillips Curve

One of this year's big macro questions – perhaps *the* macro question – is why low unemployment isn't sparking higher inflation as the fabled Phillips curve says it should. The Fed is tightening because it believes in the Phillips curve. But what if it shouldn't rely on the Phillips curve with such blind faith? Some new research from the Fed itself says that may be the case.

A new paper from Philadelphia Fed researchers says the Phillips Curve doesn't actually help predict inflation. The authors say their results suggest, instead, that "monetary policymakers should at best be very cautious in their reliance on the Phillips curve when gauging inflationary pressures."

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Now, when I hear Federal Reserve economists say we should "at best be very cautious" about something, I figure they are really saying, "Don't do that, you idiot." But of course, they can't say that directly to the FOMC. Fortunately, they don't need to. The committee's July minutes said that "a few participants" suspected the Phillips framework was "not particularly useful."

How many would "a few" FOMC members be? We don't know. At this point, apparently not a majority. Maybe they have the Philly Fed paper on their summer reading lists.

Let's be clear: Serious economists have long questioned the Phillips curve. The problem is that it's the only arrow the Fed has in its quiver to predict inflation relative to employment. As one Fed economist said to me, you can't take away the Phillips curve model without replacing it with another model.

This observation brings to mind a story. I can't put my finger on its actual source, but it's about an American soldier working as a weather forecaster in England during the critical days of World War II. His commanding officer came to him and said he had to have a forecast in order to make a decision on troop movements (I can't remember whether it was D-Day or not). The soldier pointed out that the weather forecasts weren't all that reliable, and so the officer shouldn't make a decision based on them. The officer retorted, "I have to make a decision, so you have to give me a forecast."

(I want to say that the soldier went on to be a famous person in information theory and computer science, and this episode came to light in his biography or other comments he made; so if anyone has the source, I would really love to know it.)

I guess the Federal Reserve is kind of like that commanding officer. They feel they have to make predictions about inflation, and so they're going to use the Phillips curve, even if many

economists, and even their own staff economists, generally agree that it doesn't hold water.

Jackson Hole Hijinks

Speaking of summer and central bankers, the annual Jackson Hole symposium produced fewer interesting nuggets than usual. That doesn't mean nothing happened. The speeches media are allowed to cover are not the main event. Far more interesting – if only we could be flies on the wall! – are the many private conversations among the assembled monetary geniuses.

We did learn something important, though: Janet Yellen has no interest in staying on as Fed chair after her term ends in February. We know this because her speech was a frontal assault on President Trump's financial deregulation agenda. She warned against rolling back Dodd-Frank and the other post-crisis regulations.

The Fed has two important jobs: monetary policy and bank regulation. Dodd-Frank created a new Fed vice-chair position to lead the bank supervision role. President Obama left that position vacant for some reason, but Trump has nominated Randal Quarles for the job. Quarles is more sympathetic to the banking industry than Yellen is.

From what I can gather, Yellen doesn't want to stay, and Trump doesn't want to keep her. His comments to the contrary were just an effort to keep everyone guessing. The job appears to be Gary Cohn's – if he wants it.

Chairman Cohn?

Seeing the former president of Goldman Sachs take charge of the Federal Reserve is going to make some people's heads explode. Other heads will simply shake, classifying the appointment as the fulfillment of prophecy. Regardless, it seems likely to happen.

I am not sure Cohn has much loyalty to Goldman Sachs. Yes, he had a long career there. But according to some reports, he capped that career by trying to take the CEO job from Lloyd Blankfein. That attempt was not the best career move, to say the least, so accepting his current White House role actually afforded him a graceful exit from Goldman.

Cohn and Yellen are the only two names Trump has mentioned for Fed chair. Others were supposedly in the mix, but I see no signs of movement. Could Trump surprise us? Yes, he does that all the time, but I believe Cohn is now the default choice.

My friend (and previous SIC speaker) Jason Cummins, who is chief US economist for Brevan Howard, penned a *Financial Times* guest column last week that asked the critical question, what would a Gary Cohn-led Federal Reserve look like?

Jason starts out by noting that Cohn likes low interest rates and a weak dollar. As a former Wall Street denizen, he also presumably leans bullish on stocks. Putting those three factors together,

Jason uses the Fed's own macro model to predict Cohn's impact:

> If we imagine a scenario where Mr Cohn leaves unchanged the central bank's federal funds rate over the next two years. If we then assume the exchange value of the US dollar falls 10 per cent to 2014 levels and the stock market grows by 10 per cent, bringing it further into record-setting territory.
>
> Such assumptions seem reasonable, perhaps even conservative. Yet the Fed's model says that a combination of that kind would deliver real gross domestic product growth of nearly 3 per cent a year, a lower unemployment rate bottoming out at a multi-decade low of 3.5 per cent and higher inflation rising above the Fed's 2 per cent target. That is before the possible beneficial effects of tax reform and deregulation.

That all sounds attractive. Jason's one concern is whether Cohn would be quick enough to crack down on inflation by taking away the proverbial punchbowl. He might not – but I doubt he will need to. The next decade will bring many challenges for whoever leads the Fed, though I don't think hyperinflation (or even 3% or 4% inflation) will be one of them, absent significant quantitative easing – and by significant I mean far larger than anything we have seen so far.

September to Remember

This month will be busy for us macro monitors. The FOMC meets September 19–20 and will likely hike rates another notch, launch its balance-sheet-reduction plan, or both. I will be very surprised if they don't do either.

The greater suspense is elsewhere in Washington. Congress returns from its summer vacation recess after Labor Day and has a lot on its plate. Two deadlines are potentially perilous.

The federal government will hit its statutory debt ceiling on September 29. Unless Congress acts, the Treasury will have no authority to borrow money after that date, a conundrum which could lead to the US government's not paying its bills, including the principal and interest due on Treasury debt, on time.

We went all through this headache in 2011, prompting S&P to cut the US's credit rating, and again in 2013. The debt-ceiling debate is a rather silly argument, in my view, because it doesn't reduce spending and actually costs taxpayers money by making the Treasury pay slightly higher rates on its near-term borrowing. Yet some in Congress want to use the debate as leverage to get their priorities passed. Holding the full faith and credit of the US hostage to a political debate over the debt ceiling is a dangerous game, and I hope they don't play it.

On top of that, September 30 is the end of the fiscal year, and there is presently no budget for FY 2018. If Congress doesn't pass one, or if they do pass one and the president vetoes it, the government has to stop operating on October 1.

A shutdown actually happened in 2013, and the government was offline for 16 days before an

agreement was reached. In reality, however, much of the government stays open. Law enforcement, the armed forces, and other "essential" departments continue operating, even without a budget.

Closing down the government doesn't net savings, either, since Congress ends up paying the furloughed "nonessential" workers for the time they aren't working. This time around we have another complication, too: President Trump's border wall. He said at his Phoenix rally last month, "If we have to close down the government, we're building that wall." It's not clear whether a budget that funds the wall can pass Congress; nor is it clear whether Trump will veto a bill that doesn't fund the wall.

On top of all that, the Federal Aviation Administration and the Children's Health Insurance Program both need reauthorization this month, and now there's likely to be a Harvey disaster relief bill, too. All those matters will eat up legislative time and energy. Time spent on them is time Congress won't spend on what should be its top priorities: tax reform, healthcare, and an infrastructure stimulus program.

Stock Bubble

After my "All Things Bullish" letter last week, I received a number of comments from people who asked questions about valuations. In fact, everywhere I've been in Colorado, the topic of valuations has come up, whether with retail investors or professional advisors. So when I read this note from my friend Michael Lewitt (who writes a killer letter at The Credit Strategist), it seemed the perfect way to wrap up a scattershooting letter:

> In early August, David Stockman did some excellent work highlighting the exorbitant valuations in the tech sector. FB, AMZN, GOOG, NFLX, AAPL and MSFT saw their weighted average P/E increase by 50% over the last 30 months. Between January 2015 and early August, their collective market cap accounted for 40% ($1.4 trillion) of the S&P 500's increase in value from $17.7 trillion to $21.2 trillion. This pattern of a small sliver of tech giants accounting for a disproportionate amount of market gains is a repeat of what happened during the Internet Bubble when MSFT, DELL, CSCO and INTC saw their market caps double from $850 billion to $1.65 trillion. At the March 2000 peak, MSFT's P/E was 50x, INTC's was 60x and CSCO's was 200x compared to FB's 40x P/E, AMZN's 190x P/E and NFLX's 217x P/E today. Two years later, the four tech giants of the Internet Bubble had lost 75% of their value. AMZN stock has gone parabolic from around $300/share at the beginning of 2015 to around $1,000/share today. NFLX and FB followed similar patterns. Throw in TSLA and you have living proof that investors are driven by emotion and learned nothing from what happened at the turn of the century. I am confident in saying that these stocks will come back to earth and that those buying them at these valuations are playing a dangerous momentum game.

Chicago, Lisbon, Denver, and Lugano

I'm writing from Denver today. Shane and I will head home on Sunday. I don't have much travel scheduled until later in September, when I will be in Chicago for a couple of days (26–28) for a speech, fly out the next day to Lisbon, and return to Dallas to speak at the Dallas Money Show on October 5–6. You can click on the link for details. I will speak at an alternative investments conference in Denver on October 23–24 (details in future letters). I will again be in Denver on November 6 and 7, speaking for the CFA Society and holding meetings. After a lot of small back-and-forth flights in November, I'll end up in Lugano, Switzerland, right before Thanksgiving. A busy month!

For many of us of a certain age in the US, summer is not really over until after Labor Day. When I was growing up, school boards wouldn't think of starting the school year before Labor Day; it just became ingrained in our minds that the Tuesday after Labor Day, we had to get back to work. (For those not from the US, Labor Day is the first Monday in September.) Although I do try to "move the ball down the field," the last two weeks of August just seem to be slower, less productive times. And then we hit the ground running in early September.

Again, my mind turns to my fellow Texans and all those along the coast who have suffered one of the most devastating storms in US history. A lot of families are going to end up on the short end of the financial stick as they find out that their home insurance may not cover their losses and their auto insurance may not pay off the full amount that's left on the note, especially for a newer car. I know that a lot of you are donating money and goods, so as a Texan I want to thank you and encourage you to do more.

Some of the locals here have told me it may be the altitude, but I am "off my feed" for the past few days. I don't normally have a problem traveling, but something has hit my system that is kicking back, so we're not going to get to enjoy the city as I was hoping to. But it looks like I'll have a few opportunities to get back before the end of the year. You have a great week.

Your filling out my end of summer to-do list analyst,

John Mauldin

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