THOUGHTS FROM THE FRONTLINE

The Maine Surprise Was Time

By John Mauldin | August 10, 2018

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I'm back from Camp Kotok. As always, it was both rejuvenating and enlightening. The Maine woods, lakes, and general environment encourage more candor than I see most places. This, combined with David Kotok's talent for assembling a diverse group *and* the always-marvelous Maine hospitality, made it another great success. It helps that David aggressively enforces Chatham House Rules and the Jackson Hole Rule. So you really don't have to worry what you say.

Basically, Chatham House Rules say that you cannot quote anyone without their permission, but you can share your general impressions of the gathering. The Jackson Hole Rule says that if you overhear another conversation, don't talk about it without permission. What happens at Camp Kotok stays at Camp Kotok.

However, this time did bring something new. Having gone 13 consecutive years now, I know many attendees and we speak throughout the year. And many of them write just as I do, so I get to get monthly or weekly updates on their thinking. I usually have some general sense of the group's outlook even before I arrive, which lets me spend the time filling in details.

This year, I quickly sensed a more upbeat mood. Not that many that were wildly bullish, but most were positive or at least neutral. There weren't nearly as many bears as I expected. "Cautious optimism" seemed to be the theme. That led me to refine my own views with a wide variety of participants. Today, I'll do the same for you.

Data Dependence

First question: Is John Mauldin bullish or bearish? The answer is "Yes."

I've received several reader e-mails accusing me of straddling the fence. I can see why some might think this. I wrote a rather depressing "Debt Train Wreck" series (recap here) then capped it by describing the good things waiting on the other side. That's perfectly consistent in my mind, but not everyone read it that way. So let me clarify again.

The key is to keep our time frames straight. Here's what I think.

Long Term (2030 and beyond): I'm amazingly bullish and optimistic. The Great Reset will be behind us (although we will be living with the outcomes) and an honest-to-God recovery will be gathering speed, technology will have created many new jobs, and we'll be healthier and longer-lived thanks to biotech breakthroughs. I can't wait to get there. But then again, part of the adventure is in the journey.

Medium Term (2020–2030): We will experience a rough decade as crushing debt forces the global economy into a series of recessions and credit events, culminating in some kind of debt liquidation, i.e. the Great Reset. It will stretch out for several years. We will see social and political turmoil and possibly wars as well. People are going to get hurt, badly. I am not looking forward to this period at all.

As I've said recently, I think we can not merely survive, but actually thrive. It won't be by continuing to do business as usual, however. As the header for this letter says, the Maine surprise was time. I now believe we have more time to prepare than I thought a year or two ago.

Short Term (2018–2020): This is where I am genuinely uncertain. I'll admit to having wavered, mostly because the data has wavered, too. I thought the second quarter's 4.1% US GDP growth estimate pretty impressive, but not necessarily enough to prevent a latter-half 2019 recession. But now some data suggests the third quarter will be north of 3%, too. That is much better than we have seen in a long time.

So for the next couple of years, call me "neutral to concerned" that we can totally avoid a recession into the early 2020s. I think there are good reasons to expect recession sooner rather than later. But if (and it's a big if) this whole tariffs/protectionism thing can be brought to a reasonable resolution, then perhaps the recovery can last a little bit longer. Headwinds? Sure. But there are some nice tailwinds as well.

I hope that clears up any confusion. Like the Fed, I remain "data dependent" and may revise my outlook as new information appears… and some did at Camp Kotok. As Keynes said, "When the facts change, I change my mind. What do you do sir?"

Two Differences

Camp Kotok begins with a Thursday night reception and dinner. My associate (and Over My Shoulder co-editor) Patrick Watson was also there, and we split up so we could cover more of the room. (This was his third time so he has learned the drill.) After a few hours, we met outside to compare notes. Both of us had quickly and independently reached the same impression: this crowd was *significantly* more optimistic than we expected, and more so than last year or the year before.

Of course, we wondered why. Here was a group of highly intelligent, well-connected economic experts. That doesn't make them infallible, but it means we should (and do) take their opinions seriously. So Patrick and I spent the rest of the weekend trying to understand this difference in outlooks. It boiled down to two things.

- They aren't nearly as worried about tariffs and a trade war for an odd mix of reasons.
- They think tax cuts and deregulation will postpone recession.

I was already starting to agree with the second point. My personal belief is we are seeing more benefits from the deregulation side than the tax cut side, but we can't ignore the tax cuts.

You wouldn't know it by reading mainstream media, but most taxpayers saw a real percentage decrease in their tax rates and an actual increase in money in take-home income. Maybe an extra hundred dollars a month isn't a lot of money to you, but to someone making $40,000 a year, it's real money. Yes, corporations did get the biggest part. I wish it was spurring more investment, but we are at least seeing some businesses hire and expand.

As noted, the latest GDP data was encouraging. In discussions with other business owners over the past year, I have sensed a growing optimism. The employment data is much improved this year. The tax cuts, deregulation, and other legislation seem to have stoked "animal spirits" in ways we haven't seen for quite some time. My worry has been that this sentiment is unsustainable, that the bump will last only a quarter or two. The Camp Kotok consensus was it could extend through 2019 and some saw it going into 2020.

That is hard for me to believe, in part because of the first point. I see significant risk that US trade policy will spark a larger trade war and recession. Camp Kotok was more optimistic there, too, and that launched some lengthy debates.

I should note that over the years the consensus has been for more formal debates and larger group discussions. David is actually very good at matching debate partners. Sometimes they get a tad heated, but then everyone sits down with an adult beverage and the camaraderie returns.

Trade Talks

Trade negotiations are insanely complex even in the best of circumstances. Conducting them Trump-style is a radical change that has obviously upset many participants, both within and outside the US. People have such strong pro-Trump or anti-Trump feelings that objective, fact-based analysis is hard to find. I did find some at Camp Kotok, though, from people with strong Washington connections.

Here's the insider's expectation, as articulated by a China trade expert (who is not at all a Trump fan, by the way). While I would not necessarily call this the consensus view, it's not far off.

- The US and Mexico are very close to a bilateral agreement on NAFTA issues. Incoming Mexico president Lopez Obrador is on board, but it will likely be signed before he takes office in November.

- The Trump administration will use the Mexico accord to extract concessions from Canada. Faced with the prospect of NAFTA falling apart otherwise, Canada will agree.

- With NAFTA revisions done, Trump will pivot to China. The current slate of tariffs is starting to bite Beijing, and it looks willing to substantially increase purchases of US goods. A Chinese agreement could come later this year or in early 2019. My personal bet is that Trump tries to get something done prior to the midterm elections. It will probably be China's best option and will help calm tensions in the business community.

- By 2019–2020, the US-China trade deficit will be much lower, giving Trump an accomplishment on which to run for re-election in 2020.

- Europe will be harder to actually get accomplished than seems to be the mainstream belief, but there seems to be a willingness to negotiate tariffs down to zero. Over what timeframe? I guess that is for the negotiators to figure out.

That all sounds swell but leaves out a few things.

First, it doesn't address the broader issues of China's intellectual property abuses and state support for its "private" businesses. Those are harder than tariffs and, in the long run, far more important. However, China does seem to be working harder at protecting intellectual property, and something like $15 billion a year (if I remember reading correctly) is now coming our way as part of royalties and other patent rights. That's a start.

Second, reducing the trade deficit will generate a separate set of thorny problems. It would mean the US sends fewer dollars overseas, which will likely strengthen the greenback and make US exports more expensive to foreigners. It will also throw a wrench in the dollar-based global trading system, encouraging other countries to settle trade in different currencies. Not good if you want the dollar to stay the world's reserve currency. With that capital now going elsewhere, and federal spending still way out of control, our debt servicing costs will rise and so will interest rates.

(Sidebar lesson: in a fiat currency world, it is the somewhat odd "obligation" of the world's reserve currency issuer to ensure that global trade can be done in that currency. And let's be clear, China would like to become *a* world reserve currency on the way to becoming *the* world reserve currency. It's not anywhere close yet but will keep trying. And it will be willing to supply all the yuan other countries need. This will happen faster if the US gives nations reasons to find another currency. Focusing on the trade deficit is shortsighted and may ultimately be foolish if the world begins to look for other ways to fund global trade. Right now, the US has an exorbitant privilege of running large deficits financed by foreigners. I would be far more focused on keeping that privilege than on keeping the trade deficit down.)

Third, what about Europe? We have serious trade issues there, too. Camp Kotok sources say they fully expect that Trump will impose his threatened automotive tariffs, likely worldwide and soon, but then generously grant exemptions to everyone *except* the EU. Markets will not like this at all, but it will play well politically for Trump. They think he will relent after the midterm elections.

The 25% tariff that the US imposes on imported "trucks" means that trucks made in the US offer considerably more profit potential than small cars. Ford is cutting back car production, which will save it about $5 billion, more or less. Small cars are simply not large sources of profits for US automakers in general.

Nevertheless, the Camp Kotok bottom line on trade is that (a) any serious problems are deep in the future and (b) markets and business owners are too worried. This will be apparent to all by early 2019 and possibly sooner. With that concern off the table, the economic recovery (or "boom," if you prefer) will intensify and endure into 2020. So we should all enjoy the good times while we can.

Financial Industry Changing

Aside from the economy, we had considerable discussion about changes in the financial industry—the so-called "fintech" revolution. Many warned of a massive move to online account management (especially mobile), which would shift assets away from legacy banks and brokers to lower-cost managers. Fidelity recently launched some index funds with 0% management fee. They will make money in other ways, but I heard a great deal of concern nonetheless.

Those expressing the most concern were from the big banks and institutions whose dominion is threatened. They are competing on price, and prices are going down. Yes, younger investors are shifting away from traditional management. But for now, at least, those are also smaller accounts that cost more to maintain and service.

However, a very well-known asset manager argued that the simple fact is that people are not going to manage a $500,000 or $1 million account or more from their phone. Most are still going to use a financial advisor/broker (or two or three), even if they do take a sharper pencil to the fees (which they should).

Fees are going to fall across the board in the industry. Those who have been selling high-fee services and products are going to see less demand. And clients are going to become more sophisticated. This will be especially true after the next bear market, when for the third time in 20 years, traditional portfolio managers will have once again charged high fees for very low returns.

And as Lacy Hunt has shown, massive and growing global debt will make the next recovery even slower until that debt gets "rationalized" in some way. If you are an advisor or broker you must find ways to keep your clients out of that very unhappy group or *you* will become unhappy, too. And if you are an investor, you need to really look at how your investment managers have positioned you, what their philosophy is *and* whether it matches yours.

The Gift of Time

Again, the above forecasts are the consensus I heard. I'm not fully on board with it, nor was every single Camp Kotok participant. I talked to others who share my concerns and a few who were even more negative. I am quite concerned about tariffs affecting the recovery sooner rather than later. I have maintained in this letter for almost two decades now that my biggest concern is protectionism and trade barriers. They will be difficult for businesses to overcome.

Furthermore, one former Federal Reserve official told me the Fed is locked-in on the tightening path and will keep hiking even if the economy weakens. That's a scary thought. That matches my reading, which is that the Fed is pretty much locked into three more rate increases and four if they feel they can get away with it. I think they will keep tightening so long as the economy grows 3% and inflation is a tad over 2%. This week's inflation data makes me think Jerome Powell will lean against it more aggressively. But he knows they have to be careful. Or at least I think he does. We will find out.

It's also not the case that people at the gathering were raving bulls. In the formal survey we take at every camp, the average S&P 500 forecast for a year from now was 2901, close to the current level. The 12-month real GDP growth outlook was 2.7%, which is actually lower than we're seeing right now.

How to reconcile this? Most Camp Kotok attendees have lived through several cycles. They know that big change happens slowly. The global macro forces that could derail this decade-old recovery and bull market are real and will eventually assert themselves… but not this year or next, at least in the consensus opinion.

This is good news because it gives us *time*. If the Camp Kotok consensus is right, we have another year or two to accumulate capital, prepare our portfolios and businesses for the downturn, and help others do the same.

Two weeks ago in Endgame Strategizing, I said this:

> *Imagine I had come to you in early 1929 and told you about the Great Depression. If you believed me, you would have changed your life and your investments, preparing to protect your assets and take advantage of opportunities.*
>
> *So I'm whispering now. Get prepared. We have time. Shane and I are making rather large changes ourselves, actually eating my own cooking, so to speak. This isn't just theoretical to me.*

After Camp Kotok, I'll revise that slightly. Instead of early 1929, maybe we're in 1927 or 1928. The events we anticipate are still coming, but we have more time to get ready for them. That's good. Now we have to use the additional time effectively and most importantly, wisely.

Beaver Creek and New Plans

Shane and I leave for Beaver Creek, Colorado on Monday for a combination of work and vacation. I will attend a board meeting for Ashford, Inc. and a few dinners, but the rest of the time will be relaxation… and of course, I will be writing next week's letter. My intent right now is to talk about all the good things going on in the world. Good News Johnny. There are a lot of things to make you optimistic, both on the economic and technological fronts.

I don't have much travel planned for the next two months, but a number of things are "up in the air" that could again take me to the airport—when and where still to be determined. We are putting the final touches on some business changes and sometimes that means face-to-face meetings. Not everyone comes to me. Sometimes Mohammed must go to the mountain.

It is time to hit the send button. Last weekend's intellectual festival was a tad exhausting. You have a great week, and I hope you are staying out of the heat!

Your ready to be positive for a while analyst,

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