Bear Markets, Fed Mistakes, and Quick Shots from John

By John Mauldin | December 28, 2018

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A winters day,
In a deep and dark December…

"Wait, it doesn't feel like winter. It's not deep and dark, and it's actually warm, and the sun is shining. ~~Toto~~ Shane, I don't think we're in ~~Kansas~~ Texas anymore."

Yes, we have actually moved from Texas to a new location. I'll explain why and where below. But first, we really do have to follow up last week's letter. Today, we'll address several things, so think of this as my year-end "Quick Shots from the Frontline." It will be more like a personal, from the heart, fireside chat. (Trigger warning: I will be taking off my politically correct gloves. Naming names and pointing fingers. Just Uncle John telling it like it is.)

This letter may run a little longer, but next week I promise to get back to the typical 3,000 or so words. Today is just you and I having a conversation. Pick up your favorite beverage (for me, it's a glass of coffee or tea now), sit back, and let's chew on the world.

Powell Was Right but the Fed Is Wrong

Last week. I argued Jerome Powell did the right thing by raising rates a mere 25 basis points. He forcefully declared the Fed's independence from the market and politicians for the first time since Volcker. Greenspan, Bernanke, and, in particular, Yellen all gave the markets a "put" option—basically a third unofficial mandate to make sure that asset prices keep rising. Now, of course, that's not the way they would express it, but that is, in fact, what they did. They created a series of bubbles, which spectacularly (and predictably) blew up, particularly screwing the little guys who didn't know better and could least afford losses. We should not be where we are today, ***and we would not be here today***, without their seriously screwing up Federal Reserve policy.

But they had the hubris to take credit for fixing the crises they created. Exactly like the arsonist taking credit for fixing the fire he started. They have no shame. Jay Powell is not the culprit in raising rates. The main problem is that Janet Yellen failed to raise rates before him, and I think she did so out of political bias for a Democratic president and then to help a Democratic candidate (Clinton). She would vigorously deny this, of course, but if it looks like a duck and quacks like a duck…. The Federal Reserve was not independent of either the markets or politicians during her watch. Shame on her. Double shame on her!

Now, having said Chairman Powell did the right thing, let me tell you where he and the current Fed leaders are royally ~~screwing up~~ making a mess. I've mentioned it before, but I want to highlight it as we go into the New Year. This is critically important.

No serious scientist would run a two-variable experiment. By that I mean, you run an experiment with one variable to see what happens. If you have two variables in your experiment and something either good or bad happens, you don't know which variable was the cause. You first run the experiment with one variable, then do it again with the second one. After that, you have the knowledge to run an experiment with both of them.

The Federal Reserve is running a two-variable experiment without the benefit of ever having run a one-variable experiment to determine what the results would be. **It is decidedly the stupidest monetary policy mistake in a long line of Fed mistakes.**

(Like I said earlier, the gloves are off. This is my opinion. You may disagree.)

What are the two variables? They are raising interest rates (albeit slowly) and aggressively reducing their balance sheet. I think many of the problems we see in the market are results of this combination. They should do one or the other, not both.

Of these two, everybody wants to blame the last rate hike, but let's look at the other variable.

While the Fed radically reduces its balance sheet, the European Central Bank is also ending its QE (quantitative easing), as are other central banks. They are taking away the market's crack cocaine. Note also that all of the ~~crack cocaine~~ QE began to disappear worldwide toward the beginning of October. While I realize correlation is not causation, especially with only one data point, I find it suspicious that the markets turned volatile about that same time.

I find it just as plausible that the balance sheet reduction is as responsible for the market volatility as the increased rates. If QE made the markets go up, especially in concert with the ECB, the Bank of England, and the Bank of Japan, then it's no surprise if ending it makes the markets fall.

Let's get real. The Fed Funds target is now at 2.25%, barely above inflation. Zero real interest rates mean they are still essentially giving away free money, and free money causes bubbles. If Powell was trying to "lean into the market" and cut off budding inflation (that frankly I don't see), he would have rates at 4% or 5%. Now *that* would mean we should blame the Fed for pushing us into recession and other bad things.

But, in fact, rates are still barely over inflation. Janet Yellen should have had them there four $#%%!@#$$ years ago. You want to castigate someone? You want to point fingers? Janet Yellen and the two previous Fed chairs are good places to start.

Warning: I'm next going to insult a bunch of smart, maybe even brilliant, people. This is not polite nor is it politically correct. I will try to be better in 2019, but right now, I am pretty pissed. (Again, this is Uncle John talking and not your normal, humble analyst. Uncle John uses words like that.)

Powell and the Federal Open Market Committee listen to extremely smart PhDs from all the best schools with their fabulous multi-algorithmic models, which prove that you could raise rates and reduce the balance sheet at the same time with no problems.

Bluntly, those smart people (many of whom are actually quite brilliant, and I'm sure they are nice people, and their kids and dogs love them) mistakenly trust models based on past performance, and even worse (much, unbelievably, really badly, worse, which I can't emphasize enough!) on monetary theory that is clearly, evidently, badly, manifestly wrong.

They have been using these models to forecast future market actions and the economy for decades, and they are about 0 for 300 in being right. It is statistically impossible to be that bad unless your models/assumptions are fundamentally flawed, which they are. Their underlying economic theories manifestly don't work. Because they have no politically and academically acceptable theories to substitute, they are slaves to their own mal-education. They think this makes them smarter than the markets. I can't say it any stronger than that. I have actually been in the room when someone was aggressively (I use that word precisely, as it is the correct word for that particular conversation) remonstrating a Federal Reserve economist about said models. He went so far as to say that the best thing that Powell could do would be to fire all those PhDs and ignore their models.

As you might imagine, the Fed economist was not happy with that analysis. The veins in his neck were popping, he was red faced and his voice was raised. Having known him for 10 years, I was rather shocked. He is actually a rather mild-mannered guy. But this clearly got his goat.

Now, here's the shocking thing… and the lesson that I learned, which was burned into my brain. He asked a very simple question, (neck veins popping): "You can't take away a model without replacing it with another model. What model will you replace it with?" The interlocutor, who is perhaps the best observer of the bond markets I know, stammered a little bit and then forcefully said, "You can't actually model the future," or something to that effect. (This was back when I was drinking, it was later in the evening and more than a few bottles of wine may have been involved. As you might guess, like me, he was not a fan of models. And it was the nature of this gathering to disagree with each other late at night…)

Personal sidebar: my day job for the last almost 30 years has been to look at money managers, who usually have a model that looks at past performance and projects it into the future. Every hypothetical performance model I have ever seen looked absolutely awesome. I can't say that I've seen a thousand of them, but it is not an exaggeration to say that I've seen more than a few hundred… well, maybe many hundreds. And then I have observed the performance of those models after I have seen them. Bluntly, it makes me skeptical of all models—including the ones that I build myself.

When I say the words "past performance is not indicative of future results," I damn skippy mean them. All past performance models were built in a particular macroeconomic environment. Unless you can find a macroeconomic environment that is similar (as in, very closely similar) to where we currently are and where we are currently going, your particular model deserves a tad bit of skepticism. Maybe it will work and maybe it won't. It is up to the macro analyst (that would be guys like me) to try and figure out which one will work well enough to confidently invest your money (as in, your money and mine).

I can't tell you how hard and difficult and truly daunting that is. Especially after you have done it for many years and have the scars to prove it. I know, I know, I should write a rather lengthy essay/book on choosing money managers. Let me just leave it at this: If you have a buy-and-hold, 60/40, traditional portfolio, I think you are going to be hammered in the future. It will not serve you or your retirement well. You may not like what happened to your portfolio this month and we're not even in a recession. Not even close. Well, maybe closer than we would like but it is still in our future. But I digress…

I've also looked at a lot of macroeconomic models. You can't understand the depths of how much I would deeply love to find a macroeconomic forecasting model that was actually reliable. To have such a crystal ball would not only be soul soothing but also extremely profitable for my clients and, admittedly, me. It would be the Holy Grail.

All those PhDs at the Fed still haven't found the Holy Grail after 40 or 50 years. Hell, they haven't even found a decent cup of coffee. But they think they have, so their bosses confidently run a two-variable experiment with our economic system.

Time for an Emergency Fed Meeting

Just between you and me, I think the Fed has raised rates for the last time this cycle. I think in the first quarter of 2019, the FOMC members will begin to see the data weakening and realize that further hikes would make the situation worse, not better. But in any case, they should use their best judgment and ignore both political pressure and market volatility. If inflation rises and the economy strengthens, then hike another time. I don't expect either to happen. (My actual forecast is next week. I have to save something for that letter.)

However, they also need to end this two-variable experiment nonsense. It is a major monetary policy mistake. Powell should call an emergency FOMC meeting (as in, next week) at which they suspend the balance sheet unwinding. One thing at a time. That is not responding to the markets. It is correcting a prior policy error.

And with all that said, here are some personal notes.

Living on Island Time

Shane and I have been having long talks for the past year. We've both lived in Texas all our lives. Texas is the greatest state in the Union (at least, according to our admittedly biased opinion), but for various personal reasons we both wanted a "reset." Even though we love our home and Dallas is probably the best place in the world for somebody who travels as much as I do, we needed a change.

Bluntly, life had lost a little bit of its "joie de vivre." My work, which is absolutely the best in the world, a true dream job, is a gift to me. But over the last year or so, it became, well, *work*. And it was beginning to show up in my writing style, my attitudes about deadlines, and in my personal life… which Shane gently and kindly pointed out. She also said that, I swear to God, that I needed to get out and swing a golf club to loosen up because I was stiff.

When was the last time a wife said, you need to get a golf club in your hands? So, after 20 years of not golfing, I bought a custom set of golf clubs (when did these things get so expensive?) and actually used them on some course in Georgia for the first time. For the price I paid, I thought they should have magic in them. Turns out, they were merely expensive golf clubs designed for my old-man swing, and there was no magic. I played the worst golf of my life… but walked off the course feeling better than ever. I could see my life changing, at least on a physical level.

So, two parts to the puzzle: We needed this change of location, and I needed somewhere I can golf year-round, or at least go to the driving range as I don't have time to play two or three games a week. Fortunately, even 30–45 minutes on the driving range helps a lot. And who knows, maybe I'll even learn to make contact with the ball again and watch it go forward. Maybe not far, but at least straight and in the air.

Shane and I are not cold-weather people. She is a beach lover. So, we needed year-round golf and beaches. And, of course, a good gym and an airport with lots of connections, and someplace we could make new friends. A real community.

I have been to 65 countries and all 50 states and most of the provinces in Canada. So, it's not like I haven't looked around. Savannah was a possibility, as was Florida. But once we started looking in that direction, our eyes drifted south and we looked at the Caribbean. There were some real possibilities. But for our personal needs, Puerto Rico stood out like a flashing beacon. We made some exploratory trips, and the more we looked, the more we liked.

And yes, there is a powerful tax break if you live more than 183 days a year in Puerto Rico. Looking at my calendar, I spend an average of 240 days a year in Dallas. So, no problem meeting that residence requirement. And my businesses are well-suited to be moved to Puerto Rico. So, sun and beaches and golf and a great gym, and we have found an amazing community that we are quite comfortable in.

We physically moved December 7. Turns out, it was party season here. (Christmas and all!) We began to meet our neighbors and already have many new friends. Almost everywhere I go, somebody comes up and asks, "Are you John?" We quickly trade phone numbers and set up times for lunch or dinner. Turns out that I have a number of friends here already. Just ones that I hadn't met yet.

All that to say I am more charged up and excited about life than I have been a very long time. Oddly (for me), I'm waking up early in the morning and getting down to my computer as soon as I can. I can't wait to begin the day. With this new energy I could probably write two or three letters a week. But I'm not—it would be more than you need to read. I will channel that time into actually writing my book and other things.

My friends and business partners have noted, with no prompting on my part, a new tone in my voice and passion in my writing, all for the better. So, even though we will keep an apartment in Dallas after my condo sells, and it will be our "US base," as we do have family there, we have found a new home. Getting to the West Coast will certainly take longer, but there are direct flights from San Juan to all over the East Coast, Chicago, and Dallas. And frankly, a nice seat in an airplane is just like a second office to me now. I have even been able to get shorter books completely read on a flight, with highlights and notes—a very good use of time. And Puerto Rico is a US territory, so no customs as we travel on our US passport.

And yes, the 4% total tax rate and 0% capital gains is attractive. I wouldn't for one moment deny it. But it is not the main reason we moved here. We can get everything we need at the local Costco, Home Depot, Best Buy, and all the other chain stores that you would expect to find on the mainland. Amazon delivers right to our doorstep. And there are amazing restaurants and places to see close to us. It is a pretty small island.

I wake up, come to my computer to get a start on the day. When the sun gets a little higher, I go sit out by the pool to catch a few rays and make my phone calls. I am currently the whitest white guy in Puerto Rico. I need to slowly change that. And Pat Cox tells me sunshine is a great source of vitamin D.

I know this will create an interest in Puerto Rico for some of my friends and readers. If there is enough interest, I and some of the locals will hold small seminars here and introduce you to some of the contacts you would need to contemplate such a move. I was lucky in that the son of my longtime CPA is now a mature young man whose business helps people navigate the admitted cultural and economic/business maze that is Puerto Rico. Paraphrasing the ad, don't leave home without him. Or someone like him.

Even the *Wall Street Journal* is raving about Puerto Rico. In a recent article headlined Puerto Rico on the Rebound: A Three-Day Getaway Guide, it extols the virtues of a vacation here. Look me up if you come to Dorado, as they suggest.

Quick Shots from the Frontline

- You really need to read Jonathan Tepper's new book, *The Myth of Capitalism: Monopolies and the Death of Competition*. Admittedly, I may be a little biased, as he co-authored two of ~~my~~ our best sellers, but this book is just out-of-the-ballpark good. He highlights a real problem, the growing monopolies and duopolies all over the developed world and the regulatory systems which favor them and stifle competition, and offers some solutions. You can't invest today without understanding this. Get this book and read it. I can't say it any stronger.

- Let me remind you that I have written multiple times in the past that if bear markets, (which we clearly just entered and may not be through with) are not accompanied by recessions, they generally end in a V-shaped recovery. Admittedly, we were already in an overbought and overvalued market, so I'm not sure what the word "recovery" means in that context. But Wednesday was clearly a short-covering rally. How do we know that? Because all of the stocks which had the most shorts on them recovered the most. Case closed.

- I spent two days at the Cleveland Clinic seeing about 10 doctors in their executive wellness program. I wish all of my readers could go there or somewhere like it. I want to be writing for you for a very long time. I need us both to be healthy.

  Shane went with me. She got a perfect bill of health. Me, not so much. They proved irrefutably beyond a shadow of a doubt that I am getting older. My cholesterol has gone off the charts. I have a little plaque starting to develop in my carotid artery. I am developing cataracts (which means three more trips to Cleveland in the next few months so they can replace my eyes) and several other minor issues. They told me what I needed to hear, not what I wanted to hear. Kind of like some of my letters to you. What I learned was even more reason to move to Puerto Rico. Fresh fish, which is available locally, is now a mainstay of my diet. Well, and chicken and turkey and vegetables. No more cream in my coffee (Shane has me on almond milk) and no cheese (ouch and multiple groans!). And egg whites for breakfast, although she has found some nondairy cheese substitute to soften the no-cheese blow.

- As I periodically say, I read all the letters and comments you send. They are important to me, and I find that the new energy I have discovered in Puerto Rico lets me reply to more of them. I just can't help myself when they are particularly well written.

- I can't end the year without giving a major set of thanks to my Mauldin Economics team, without whom none of this would be possible. Just as many major thanks need to go to my business partners who help me in the money management side of my life. Without them, I couldn't do what I do. I am one ~~lucky~~ seriously blessed man. Part of the reason for moving to Puerto Rico is to give all of "Team Mauldin" a bigger hand in running the business side of my world, so that I can do more of the reading and research and writing and speaking and thinking that I like to do. It is the best thing that I can do for my readers and clients, not to mention for myself, and I am truly grateful. All I now do is say, "We are going in that direction!" and they take off. 2019 is going to be the most awesome year ever.

  A special shout out to Jared Dillian, one of the co-writers here, whom I have watched for the past five years develop into an outstanding newsletter writer. You really should subscribe to his *Daily Dirtnap* and his other letters. Some of us of an older generation might not get some of his cultural references, yet once you get into the swing of things, you realize that he has an excellent feel for the market. As good as anybody I know.

- Note to President Trump: stop with the blame game already. Don't take credit for the markets, whether they go up or down. Yes, of course, you get blamed when the markets go down, but it's not your fault. If you want to blame anybody, blame Reagan and Bush and Obama for appointing Fed chairs who created serial bubbles. And then move on. You have enough on your plate without taking responsibility for the market as well.

- If you are not reading *Over My Shoulder* you're missing out. The combination of my remarkable set of friends who let me send you their letters (which are often behind pretty high pay walls), not to mention my longtime friend and associate Patrick Watson's ability to summarize and interpret them for you, makes for what I think is the best curated information source anywhere. I could say it's priceless, yet it's actually quite inexpensive. At least that's what this not so very humble analyst thinks.

- One last plug: You do not want to miss the 2019 Strategic Investment Conference, May 13–16 in Dallas, Texas. My team will be sending you multiple links to sign up. Do it early and get the early bird price. I promise this is going to be the greatest SIC ever. When you see the line-up, you will definitely want to be in the room. I am pretty sure it is going to sell out, so don't procrastinate. Sign up now, book your room, and make your airline reservations. Be there.

I could go on, but the letter is getting long and it really is time to hit the send button. As we approach the new year, I realize I have been writing this letter for going on 20 years. Many of you have been with me since the beginning. And some of you found me just last week. To those who are new, I say an enthusiastic "welcome aboard." Admittedly, I may not be everyone's cup of tea, but I am extraordinarily grateful and humbled by those who have been along for what has been an extraordinary ride.

The markets in the future are not going to get any easier to navigate than they have been the last few weeks. In fact, if anything, they are going to become even more difficult. And so is the social environment, not to mention the political environment. We are in the last half of the Fourth Turning (the end of a repeating 80-year cycle). In fact, we are approaching the last half of the last half, and for the last 500 years of Anglo-Saxon history, that has been the most volatile period of history, with wars and worse often accompanying that period. I've been having deep and long conversations with Neil Howe and Pat Caddell and other political and social commentators that frankly leave me troubled… indeed, very troubled and worried. It isn't time for dried food, guns, and gold, but it is also not going to be business as usual.

More on that in future *Thoughts from the Frontline* letters. I will be here to walk with you every step of the way, offering a few insights of my own but especially those I pick up from my wide range of contacts, who are also trying to navigate through what many of us think will be the most tumultuous time in our lives. It is not just markets that are the problem anymore. There are also major opportunities as well. I will try and point out both.

That being said, thank you from the bottom of my heart. It is with excitement and a full heart that I look forward to 2019. It is going to be our best year ever! I hope you can spend some time with friends and family over the New Year's holiday. My best to you as we walk bravely, without fear in our hearts, with the excitement and wonder of little children, not knowing what we face, into the future. It is going to be awesome!

Your quivering with excitement and joy analyst,

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