THOUGHTS FROM THE FRONTLINE

Hubris at the Fed

By John Mauldin | July 23, 2022

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Finding just the right word brings great pleasure to writers like me. As I think and write about the Federal Reserve, the word "hubris" keeps coming to mind.

The Merriam-Webster dictionary defines hubris as "exaggerated pride or self-confidence." The entry notes the concept originated in ancient theater.

> "In classical Greek tragedy, hubris was often a fatal shortcoming that brought about the fall of the tragic hero. Typically, overconfidence led the hero to attempt to overstep the boundaries of human limitations and assume a godlike status, and the gods inevitably humbled the offender with a sharp reminder of their mortality."

This fits well if you think of central bankers as characters in a Greek tragedy. In recent decades many decided "human limitations" would no longer constrain their policies. The inflation they thought defeated came back to humble them.

Today we'll conclude my exploration of William Chancellor's new book, *The Price of Time: The Real Story of Interest*. I have only touched on his main points; this is an important, must-read book and I urge you to get it when published next month. You will learn much.

We can draw a direct line from the Fed's low rate regime to today's surging inflation, asset inflation, and income and wealth inequality. Low rates produce asset bubbles which ultimately pop, but not before blowing themselves larger and multiplying into other bubbles. The process that pushed stock prices higher is the same one that is now pushing food, energy, labor, and every other cost higher. Just follow the bouncing ball.

Chancellor demonstrates a theme that has been repeated throughout history. Reinhart and Rogoff's magisterial This Time Is Different has more historical context. Today's central bankers have no excuse for not knowing what happens when hubris meets even good intentions. It always ends in real tragedy: maximum pain for the middle and lower classes.

Intertemporal Bridge

As I explained earlier in this series (see Time Has a Price), interest rates aren't simply prices; they are information. Artificially manipulated rates deliver wrong information, causing poor decisions. Ill-conceived central bank policies produce random noise, preventing markets from discerning the necessary signals. Chancellor has possibly the best metaphor I've ever seen to explain this.

> "Imagine that the present and future are two countries, separated by a river. Finance is the intertemporal bridge that joins them together, connecting the present with the future. By acts of borrowing and lending, and saving and investing, we shift expenditures across time. Interest is the toll levied on borrowers for bringing forward consumption and the fee paid to savers for moving consumption into the future. The level of interest regulates the traffic on the bridge and its general direction. When the interest toll is raised spending is pushed into the future, and consumption is brought forward when the toll is lowered. In an ideal world, people should save enough to meet their future needs, but not so much that current spending is depressed. Under such circumstances, the traffic across the bridge is orderly in both directions.
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> "This delicate balance is upset when the market rate of interest falls below society's 'crystallized impatience.' When the interest rate is higher than an individual's time preference, he or she will save more for the future. Conversely, when the market rate is below the public's time preference people borrow to consume. An abnormally low rate of interest boosts current spending, but the benefits don't last. You cannot have your cake and eat it, at least not indefinitely. Cake is not the only item on the menu. People have a choice: jam today or more jam tomorrow. The rate of interest influences their decision."

The problem isn't just artificially low rates. Artificially high rates send wrong signals, too. The point is this process works only when it finds its own equilibrium. Outside interference—like that of central banks—distorts these intertemporal transactions.

It is important to remember that well past the middle of the last century the Federal Reserve concerned itself mainly with bank solvency, not interest rates. Greenspan was the first to realize that he could "juice" the markets and make everyone happy. It was the beginning of the current round of hubris.

Years of near-zero interest rates covered Chancellor's bridge with giant concrete roadblocks, preventing almost all investment in the future. This forced capital to stay in the present. With nowhere else to go, it raised the prices of existing assets. Private equity took advantage of the low rates to buy small businesses and combine them into large ones. Business growth became less about competition and creative destruction and more about buying your competitors.

In the early years this "asset inflation" didn't raise living costs in statistically visible ways, so many shrugged it off. That was a mistake.

Everything Bubble

One of those who denied asset inflation was Fed Chair Janet Yellen. Chancellor shares this anecdote.

> "On 7 April 2016, the current and former heads of the Federal Reserve were gathered at a meeting in New York City. During a panel discussion, the then head, Janet Yellen, was asked whether the United States was a bubble economy. Her response was discursive: she pointed to recent jobs growth and low inflation. In her view, the US economy was on a solid course. The Fed, Yellen said, was looking out for 'clearly overvalued' asset prices, strong credit growth, and reaching for yield—in other words, the financial conditions prevailing prior to the subprime crisis—but saw no reason for present concern. No, America's top central banker was adamant, the United States was not a bubble economy. To her side, the oldest surviving Fed Chairman, Paul Volcker, pulled out a handkerchief and loudly blew his nose."

Chancellor adds this in a footnote:

> "At the meeting, Volcker publicly agreed with Fed Chair Yellen. But only a few months later I asked Volcker in person whether he stood by his words. 'No,' he replied, 'of course there's a bubble. My grandchildren can't afford to buy apartments in New York City. I just didn't want to say so in front of *The Wall Street Journal*.'"

Yellen notwithstanding, in 2016 the US economy very much was in a bubble and is far more so in 2022. Two weeks ago (see John Bull and Two Percent) I reviewed Chancellor's description of the way low interest rates drove historic asset bubbles. It rarely goes well but that's human nature. And because it's human nature, the pattern hasn't changed.

A few years ago, many used the phrase "Everything Bubble" to describe seemingly irrational asset prices. The "everything" part wasn't literal; they mainly meant stocks, real estate, crypto, meme stocks, NFTs, extremes of tech companies, unlisted unicorns, vintage cars, etc. But in hindsight, I think "everything" was exactly right.

Think about this word "bubble." In the physical world, bubbles come from a process called *inflation*. Now think of Chancellor's intertemporal bridge metaphor. If capital can't reach its best use in the future, it will stay in the present and consume something that's already here.

There's no reason that process should restrict itself to any particular asset class. As long as the bridge stays closed, the inflation will continue, creating new bubbles and enlarging existing ones.

That means the bubbles we usually consider—those with visible public markets like stocks—were only the beginning. Yes, they blew up because low and zero rates triggered an inflation process. But the process didn't stop there. It spread slowly but surely, raising the price of *everything*, not just financial assets.

Which is how we got to 9.1% official CPI inflation—and worse to come if that intertemporal bridge doesn't open fast enough.

Unnatural Heights

Federal Reserve officials, in their hubris, knew their policies were blowing bubbles. They thought the bubbles were *good*. And why not? Leaders from Greenspan forward looked at their predecessors and saw only success and acclaim.

Ben Hunt described the process as only he can, in the letter I quoted last week. Here's more (emphasis mine).

> "The Yellen Fed was peak Fed. Peak, not in the sense of maximum balance sheet expansion, but in the sense of maximum faith and maximum zealotry that the Fed's three toolboxes—short-term interest rates, balance sheet operations, and communication policy—could achieve any desired macroeconomic outcome in this, the best of all possible worlds. Business cycle? What business cycle? Welcome to the era of permanent recovery! As for financial crises… well, haha, it would *perhaps* be presumptuous to say that a financial crisis will *never* occur again, **but with our current knowledge and tools for prudential monetary policy, certainly we can say that a financial crisis will not occur in our lifetimes. These were, in fact, Janet Yellen's literal words.** [JM—Seriously, the link quotes her saying those very words: "Not in our lifetimes." Cue Greek gods judging hubris.]
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> "Ben Bernanke and Janet Yellen were true-believers in the power of monetary policy to control markets and the economy in a way that—in my experience as a former professional academic—only former professional academics can be. They were true-believers in a way that, to read his memoir, Alan Greenspan was not. Greenspan thought he could sneak in some wealth creation on the coattails of Volcker's inflation-crushing campaign, not that he could eliminate the business cycle and rule the world from the Mount Olympus of the Eccles Building. Now, to be sure, that doesn't let Greenspan off the hook here. In fact, you can argue that Greenspan was the most culpable of the lot because he knew better!

"I think that Jay Powell is a lot more like Greenspan than Bernanke and Yellen. I think he knows better. I think he knows that it is economically unsustainable, socially destructive, and politically poisonous to inflate wealth so much more than an economy grows. I think that his efforts to raise interest rates and start shrinking the balance sheet, efforts he started making almost as soon as he was sworn in as Fed Chair, are a reflection of this.

"…And then came Covid.

"And then came the economic response to Covid, which was not only a resumption of full-bore QE and balance sheet expansion (about $2 trillion worth), but also the largest stealing pulling forward of wealth for direct distribution to the already well-off of any government program in the history of man."

Ben goes on to describe how it wasn't just the Fed. The various COVID fiscal programs were, in theory, supposed to maintain jobs and support the unemployed. To some extent they did, but vast amounts also flowed to well-off households who were in no danger. Here's Ben again.

"For millions of Americans, particularly relatively wealthy Americans like lawyers and doctors and bankers and accountants and consultants and financial advisors, 2020 wasn't a difficult year financially, it was their best year ever.

"This is what drove the enormous post-pandemic acceleration of wealth growth over economic growth.

"This is what created resurgent inflation and inflation expectations.

"This is what broke the world.

"How? Because the hundreds of billions of non-emergency dollars pulled forward from future Americans that went straight into the pockets of Americans who suffered zero economic damage from Covid on top of the hundreds of billions of non-emergency dollars pulled forward from future Americans that went straight into the pockets of relatively well-off Americans from the 2017 Tax Cuts and Jobs Act on top of the TRILLIONS of non-emergency dollars spent by the Fed to artificially lower the price of money and inflate financial assets and channel mal-investment and create the worst decade of productivity growth in the history of the United States and make us FEEL rich without BEING rich… yeah, THAT is what causes inflation.

"The entire justification for Greenspan's original sin was that a little bit of egregious wealth inflation wouldn't spur inflation in the real economy. So long as inflation stayed tamped-down in the real economy, *so long as it wasn't persistent, so long as everyone knew that everyone knew that inflation wasn't a problem*… we could party on. We could survive the central-banking-as-religion academic zealots. We could survive the reputation-over-soul bankers. But once that common knowledge shifts, *once everyone knows that everyone knows that inflation IS a problem*, it all goes poof."

Ben's use of "original sin" brought back memories from my ministerial training. He uses it correctly. Original sin is the idea that humans inherit a sinful nature, tracing back to the sin of Adam. We don't have to consciously want to sin. We sin because the tendency was built into us before birth.

The Fed's actions under Yellen and Powell were the natural progression of Greenspan's original sin: thinking the Fed could and should use its power over interest rates to produce desirable economic outcomes.

To be fair, low rates had some positive effects. But the future was unevenly distributed and certainly not permanent. Fed leaders thought this time was different. It wasn't.

So here we are, facing maybe not the worst inflation in history, but probably the *widest* inflation in history. The US economy is the world's largest—far larger now than in the 1970s. And we don't have a Volcker to do the dirty work this time.

Ben had some other thoughts that aren't pleasant but you need to read them.

> "I am thinking about what happens to the games of markets and politics if we have wealth destruction along the lines of what I suspect will be necessary to wring out inflation from our insanely financialized world.
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> "I am thinking about what happens to the games of markets and politics if we DO NOT have wealth destruction along the lines of what I suspect will be necessary to wring out inflation from our insanely financialized world, but instead choose to order inflation away through the fiat commands of price controls and economic dirigisme.
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> *"How do we live when we know full well how this story ends?*
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> "Because we all know exactly how this Old Story ends, right? We know that when prideful human leaders lift themselves and their people up to unnatural heights by stealing what is not rightfully theirs, their society is struck down in retribution. We've seen this movie a thousand times before."

Prideful human leaders, their societies struck down in retribution, are the definition of hubris. And, sad to say, it's the only word that fits.

And finally, I will end with some of Chancellor's thoughts from an important interview with Mark Dittli of NZZ Zurich.

> "As the American economist Herb Stein has said: If something cannot go on forever, it won't. During the lifespan of the Greenspan Put, say over the last thirty years, people kept saying that central banks have reached the end of the rope, the Fed has run out of bullets, and so on. But what we have seen was that central bankers turned out to be more innovative than one could have imagined.

> "It's difficult for us to realize this now, but up until 2009, nobody seriously conceived of imposing negative interest rates. It just didn't seem possible. But, and this is the crucial point: Everything was posited on the view that central bankers could behave this way because inflation was low. And why was it low? Because of their sound monetary policies. They referred it back to themselves! And now, the moment inflation goes out of control, they say: Oh, it's not our responsibility, it has to do with Ukraine, or supply chains, or China's lockdowns.
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> "There is much less leeway for the Fed Put today. And that really means that the imbalances within the system—the high debt levels, misallocations of capital, potential insolvency of EU countries—are liable to come to the fore. Two of the features of the Fed Put, lower market volatility and high valuations, are undermined. So volatility rises and valuations come down.
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> "I see inflation as a sort of resolution of structural imbalances. If a society can't come to an arrangement to solve its distributional problems, then one of the things inflation does is inflate the size of the cake. Of course, inflation is not a smooth process, it's very painful for some people who are badly positioned…
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> "Inflation is a brutal and merciless way of resolving imbalances. When Paul Volcker eventually took over in 1979, he brought inflation under control, causing two nasty recessions along the way. There was a period of relatively smooth sailing after that."

(*Over My Shoulder* members will receive a highlighted copy of that full Chancellor interview next week. Click here to make sure you get it.)

I will end there. I had a series of meetings and dinners with names you would recognize in New York this week. The recurring question was how does this end? No one really knows. They all expect an adjustment or series of adjustments. Some were more hopeful than others. I am not sure how the adjustments Chancellor describes will play out. **But I do agree that after we get through them, the 2030s will be a period of relatively smooth sailing.**

Market adjustments mean market opportunities. I see opportunities everywhere I turn, not just in buy-and-hold index funds. The first rule of going through a market adjustment is to preserve your capital as much as possible. The second rule is to carefully, cautiously take advantage of opportunities when you see them, with whatever you consider the risk portion of your portfolio.

You can be fully invested without being subject to "the market." You just need to find better vehicles with proper risk properties so you can fully participate after the storm abates.

Cleveland, British Columbia, and Dallas(?)

Sometime in mid-August I will be in Cleveland at the Cleveland Clinic for an extensive round of checkups I've put off during COVID. Now there is a backlog, especially for an "old man" whose body seems to want to fall apart all at the same time.

I plan to be in British Columbia at the end of August for salmon fishing, something that has long been on my bucket list. And I rather suspect I will be in Dallas at least once. That is a lot of flying time from Dorado Beach.

I had a wonderful time in New York. In addition to dinners with friends and client meetings, I got to sit down with David Bahnsen, Renè Aninao, and friends for a very wide-ranging conversation—from epistemology to the detailed particulars of very narrow credit trades. David and Renè, who understand markets, geopolitics, and macro themes as well as anybody I know, somehow help me understand the path through. I always walk away more optimistic than when I walk in. Their optimism is contagious. Honestly? I need more dinners like that. Some of my reading can be quite dark. It helps to have some light to filter out the darker pessimism that seems so pervasive today.

With that I will hit the send button and wish you a great week. I hope you can find your own sources of optimism and spend some time with them. It's always good for the soul.

Your seeing multiple paths through the turmoil analyst,

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